



# Local Government Own Revenue, Land Use, and Economic Development Policies in Serbia: The Case of Nis

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## **Abstract**

The purpose of this note is to help both local and national government officials think through possible strategies for addressing one of the fundamental issues facing Serbian municipalities today: How do Serbian local governments increase the revenues they need to improve their public infrastructure while simultaneously creating an environment favorable to private investment and local economic development? This is a dilemma that local governments face throughout the world but which is particularly pressing in many developing and transition countries where local governments must address huge deficits in urban infrastructure without at the same time over taxing their business communities upon which their future growth depends. It is also of particular importance in Nis, the third largest city in Serbia and the economic engine of the southern and least developed part of the country.



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The purpose of this note is to help both local and national government officials think through possible strategies for addressing one of the fundamental issues facing Serbian municipalities today: How do Serbian local governments increase the revenues they need to improve their public infrastructure while simultaneously creating an environment favorable to private investment and local economic development?

This is a dilemma that local governments face throughout the world but which is particularly pressing in many developing and transition countries where local governments must address huge deficits in urban infrastructure without at the same time over taxing their business communities upon which their future growth depends. It is also of particular importance in Nis, the third largest city in Serbia and the economic engine of the southern and least developed part of the country.

The note is divided into two parts. The first part highlights the most pressing problems concerning the nature and structure of local government own revenues. Special attention is paid to the policy issues—both local and national—raised by the devolution of the property tax and other revenue collecting powers to municipalities. I also discuss the land use and land development fees; the business sign fee; the self-contribution fee; and utility pricing. I include utility prices in the discussion because while income earned by utilities from the sale of goods and services are not general budget revenues of municipalities, they are of critical importance in helping local governments meet their infrastructure needs. They also directly and indirectly affect the business community.

The second part of the note looks at these same issues in Nis today. On the one hand, I situate how Nis is using its own revenue raising powers within the larger context of what seems to be going on elsewhere in the country. On the other hand, I outline select policy directions designed to increase Nis's own revenues and improve the local business environment.

Both parts of the note should be regarded as something of a work in progress. This is unavoidable because many of the own revenue powers of Serbian local governments are both in flux and conceptually problematic. Indeed, there is little question that they will change in the immediate future as more and more jurisdictions take over the property tax; as utility financing



practices move closer to European norms; and as urban construction land is devolved and privatized.

Nonetheless, I hope the note will help clarify the policy issues related to improving local government own revenue powers, and of aligning these powers with more general economic development strategies. Indeed, I hope the note will provide a constructive framework for the further discussions of these issues at both the local and national level, as well as perhaps to illuminate some of the practical problems of addressing the tension between local government revenue mobilization, and improving the enabling environment for businesses in the developing world.

## **Part I. Historical Legacies and Current Trends in Local Government Own Revenue Powers and Policies**

Serbian local governments, like most of their continental European counterparts, derive the majority of their revenues from grants, transfers, and shares of national taxes. Until the passage of the 2007 Law on Local Government Finances however, these grants, transfers, and tax shares were set annually in the Republic's Budget Law. As a result, the primary sources of local government revenue were open to both bargaining and uncertainty. At the same time, Serbian local governments had few true own tax powers and thus limited ability to increase their revenues. Taken together, these structural weaknesses have meant that Serbian local governments have looked historically first to the national government to improve their finances. Or put another way, they have been essentially "revenue takers."

The Local Government Finance Law, however, went a long way towards eliminating these weaknesses. On the one hand, the law defined the most important local government transfers and tax shares in framework legislation. This has radically reduced the bargaining and uncertainty that surrounded the most important local government revenues. On the other hand, the Law made the property tax a local government own revenue and obliged municipalities to take over the tax's administration by January 1, 2009. As a result, many municipalities are now setting up local tax departments to administer the property tax as well as other own revenues that had previously been administered for them by the Republic Tax Offices of the national government.

Taken together, the stabilization of national government transfers and shared taxes and the devolution of own revenue powers to local governments can be expected to lead to a progressive shift in the perspective of Serbian municipalities away from being "revenue takers" and towards becoming "revenue makers." This, at least, has been the experience in other countries in the region.

As elsewhere, however, this shift in perspective will be complicated by the general tendency of local governments to tax enterprises—who do not vote—more heavily than individuals—who do. Moreover, it will be taking place within an institutional, historical, and legal environment that remains confused with respect to both the nature of certain own revenues, and how local governments can (and should) impose and administer them.



Table 1 presents the share of local government own revenue in total revenues in 2007. By own revenue, I mean a fee, charge, or tax over which a local government has—at minimum—some control over the relevant rate. As can be seen from the table, the most important local government own revenues are in one way or another directly related to real estate (land and buildings). Here I am talking about the property tax (4.2 percent); the land use fee (5.2 percent); the land development fee (13.1 percent); the land lease fee; and fees from the rental or use of public assets (2.9 percent).

In the rest of this section, I briefly review the status of the most important of these own-revenues. Here I highlight some of the conceptual and practical problems associated with them both as specific sources of income, and as part of a more general system for financing urban development.

**Table 1. Own Revenues, all Local Governments, 2007**

	Budget Code	dinars	% of total
<b>Total current Revenues</b>	<b>700000</b>	<b>154,048,206,650</b>	<b>100.0</b>
Self Contribution	711180	1,552,362,329	1.0
Property Tax	713120	6,543,199,686	4.2
<i>of which physical persons</i>	713121	2,928,425,742	1.9
<i>of which legal persons</i>	713122	3,614,773,944	2.3
Vehicle Registration Fee	714513	1,990,489,472	1.3
Road Fees	714514	1,168,214,936	0.8
Hotel Tax	714552	341,990,820	0.2
Business Registration Tax	716110	2,686,110,434	1.7
Land Use Fee	741534	7,971,721,573	5.2
Other 741	other 741	3,519,606,745	2.3
Rental of Municipal Premises	742142,742151-2	4,391,390,597	2.9
Land Lease Fee	742143+153	3,337,582,471	2.2
Land Development Fee	742253	20,228,014,920	13.1
Income from sale of goods and services	other 742	1,140,009,741	0.7
<b>Total Local Government Own Revenues</b>		<b>54,870,693,724</b>	<b>35.6</b>

#### A. The Land Use and Land Development Fees

The land use and the land development fees deserve special attention because they are particular to post-Yugoslavian countries. Both fees were introduced in the late 1970s and have a dual character. On the one hand, they were designed to provide local governments with some of the revenues they needed to maintain and develop urban infrastructure. On the other hand, they represented an attempt to introduce elements of a capital market in land into the socialist

economy by charging users of publicly owned assets differential prices for real estate based on its location.

The land use fee is charged every year on the basis of how many square meters of land a given building takes up. Local governments are allowed to set the fee on the basis of zones that at least in theory reflect the amount and quality of urban infrastructure that has to be maintained in given parts of a municipality. Typically, local governments also charge differential rates for businesses and residents, as well as for public institutions like schools and hospitals. Here, it is interesting to note that neither the old Law on Urban Construction Land, nor the new Law on Planning and Construction explicitly mentions using the “type of activity” to which the land is put as a basis for setting the fee.<sup>1</sup> Local governments, however, justify distinguishing between business and residential users by arguing either that businesses put more stress on urban infrastructure than households, or simply by saying that business can afford to pay, while households cannot.

The recurrent nature of the fee and the fact that it is higher in more desirable (developed) areas of the municipality makes it similar to a property tax. At the same time, the fee is called a fee because in theory it is supposed to represent the real costs of providing a particular public service. In practice, however, this idea is essentially a fiction because the level of the fee is not related to any objective calculation of the costs of “maintaining public infrastructure.”<sup>2</sup>

- Local governments do not define which public infrastructure the fee is supposed to maintain, nor do they define how much they are actually paying to maintain public infrastructure. As a result, the fee cannot be understood as a payment for a particular type of service. This is true despite the fact that some local governments have developed very complicated point systems that seem to “scientifically” allocate these costs across different types of users because none of the systems defines which costs are in fact being charged for.
- The rate schedules that most local governments use to set the fee clearly discriminate against businesses. In all of the local governments I examined, 70 to 80 percent of the fee comes from legal entities,<sup>3</sup> and while it is true that some businesses impose higher maintenance costs on public infrastructure than households, it is certainly not the case that 70 percent of these costs are related to business activities.
- Many local governments impose lower fees on businesses that typically “use” more infrastructure (e.g. manufacturers) than on those that use less (e.g. commercial enterprises)

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<sup>1</sup> See article 27 of The Law on Urban Construction Land, 2001 Jugoslovenski pregled, 2001, and article 77 of the Law on Construction and Planning. Article 17 of the Law on Local Government Finance however, allows local governments to use “type of activity” as a basis for distinguishing rates for *all* communal fees.

<sup>2</sup> It seems that legislators called the land use fee a fee and not a tax because they felt it was inappropriate to allow the taxation of state-owned land. See Boris Begović, Boško Mijatović, and Marko Paunović, “The Reform of Urban Land Finances,” Center for Liberal Democratic Studies, 2006.

<sup>3</sup> It should be noted that unlike with the property tax, the Serbian Chart of Accounts does not distinguish between the land use fee derived from businesses and the land use fee derived from individuals. To the degree that the fee remains a part of the Serbian system of public revenues, this oversight should be corrected.

and service providers). Here, in other words, the fee blatantly leaves behind any logic of a user charge and is instead being imposed on the basis of what local policymakers think the market can bear<sup>4</sup>.

In short and in practice, the fee is really a badly constructed tax on businesses that should eventually be eliminated. Or put another way, the fee should be replaced by the greater use of two different local government revenues. On the one hand, the general purpose, quasi-tax character of the fee should simply be folded into the property tax. On the other hand, its quasi-fee character should be expressed in higher utility charges so that providers of public services—such as water and solid waste companies—cover more of their costs out of revenues that are directly related to how much of a given service particular users consume.

There are similar conceptual and practical problems with the land development fee. The land development fee is a one-time charge that local governments are allowed to impose on investors for constructing or improving residential buildings or business premises<sup>5</sup>. In 2007, the land development fee constituted 13.2 percent of all local government revenues and was the single most important source of own revenue. The significance of the fee, however, differs greatly across jurisdictions. In the four big cities it constituted 20 percent of all revenues, while in all other municipalities it constituted only 4 percent of local government revenue or less than the existing share of the property tax.

Like the land use fee, local governments typically differentiate the fee on the basis of both the location of the investment and its purpose, though in practice they tend to use a much shorter list of purposes to differentiate the land development fee than they do for the land use fee.

Nonetheless, and like the land use fee, the land development fee is not really a fee. It is called a fee because it is supposed to represent a calculation of the costs that local governments have *already incurred* to build municipal infrastructure. There is, however, no reasonable way to price—or for that matter apportion—the historical costs of all infrastructure that local governments have built over the last 50 years.

Equally important, the fee is not related to the costs of any new infrastructure that might be necessary to service the new development. On the contrary, investors are expected to carry these costs themselves, either in the form of hook-up charges paid directly to utilities or by fixing roads and other public amenities on their own.<sup>6</sup> Thus the land development fee is essentially a tax on new investment dressed up as a fee for old investment.

More recently, however, and at least in Belgrade, it has become a way for local governments to capture the market value of unused construction land at the moment when they lease out state-

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<sup>4</sup> Similar points are made in Begović, Mijatović, and Paunović, *op. cit.*

<sup>5</sup> It is worth adding that the fee is imposed simply if the purpose of building is changed from residential to commercial use.

<sup>6</sup> Some local governments are willing to negotiate the fee downward if the investment is particularly attractive and the investor must make significant additional payments for hook-up charges.

owned property to third parties. Thus, Belgrade has ceased calculating the fee as a charge independent of the lease fee for a state-owned property, and instead establishes the value of both in a single auction procedure.

Strangely however, the city then calls this value the development fee, when in fact it is really much closer to the market value of the lease fee which by law must be established through auctions. As a result of this “accounting” practice, Belgrade reported more than 13 billion dinars in revenue from the land development fee in 2007 but only 150 million dinars in revenue from the land lease fee. Or put another way, the land development fee accounted for more than 20 percent of the city’s total revenue while the land lease fee amounted for less than 0.2 percent.

This situation in Belgrade has profound implications for how the business development fee should be thought about. The first implication is simply that 70 percent of all local government income from the land development fee is coming out of Belgrade and that everywhere outside of the capital—including in the other cities—the importance of the fee as a local government revenue source is much closer to 4 percent than it is to 13 percent.

The second implication is that at least with respect to the amount of the fee that is coming from new investment in unused construction land—certainly the major source of the fee in all jurisdictions outside of the capital and perhaps in Belgrade itself—local governments could capture the current value of the land almost entirely through the prices they receive through auctions for the lease fee. Or put another way, current lease prices are now being discounted by investors by the amount they are expecting to pay in the land development fee. As such, simply eliminating the fee is likely to result in auction prices for leases increasing substantially, a movement that would undoubtedly be even more pronounced if instead of auctioning off leases, local governments were auctioning off ownership rights.

As a tax on new investment, the land development fee, like the land use fee, should eventually be eliminated and its revenue raising role replaced by two different instruments. First, particular investments that create measurable needs for new public infrastructure—such as new roads, new schools, or additional capacity in the water and sewage system—should be calculated separately and imposed on individual investors as forward-looking *impact fees*.<sup>7</sup>

Developing sound methodologies for the calculation of impact fees, however, is not a simple business, and bad methodologies can result in charges that are as opaque and discriminatory as the current development fee. Worse, it may take a number of years before Serbian municipalities (and their utilities) have the information systems and the cost data necessary to construct reasonable and equitable impact fees.<sup>8</sup>

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<sup>7</sup> In fact, investments that place additional burdens on network infrastructure such as water and sewage systems are often charged for as a special part of a hook-up fee. In other words, one part of the fee is calculated on the basis of the additional piping and metering that must be built to service the site; and another part of the fee is based on the share of the additional capacity the investment will use.

<sup>8</sup> The MEGA program is currently investigating how to construct a reasonable impact fee that might be calculated in Serbia today.

Second, the role of the land development fee as badly constructed business tax should be replaced by a fiscal instrument that more equitably shares the costs of building and maintaining public infrastructure between businesses and residents. And here again, the basic answer lies in making more effective use of the property tax.

Before turning to the property tax, however, it is important to understand how these fees have been administered in Serbia. Until recently, these fees have almost everywhere been administered by Land or Construction Directorates. The Construction Directorates are public utilities founded and owned by local governments and ultimately responsible to them. But like commercial companies, they have corporate boards, separate legal identities, and should—at least in theory—support most of their activities through the sale of goods and services.

During the 1970s and 1980s, the Construction Directorates were entrusted with an incredibly wide variety of important municipal responsibilities. These responsibilities included the development of general and detailed urban plans; the issuing of building permits; rental and management of municipal assets; the planning, contracting, and monitoring of all major municipal investments, including those of all other municipal utilities; and the administration and collection of the land use and land development fees.

The concentration of these functions in self-standing public enterprises—particularly that they collected the most important “municipal” revenues as the own revenues of the enterprise—made them something of states-within-a-state. Indeed, in many local governments this is still an apt characterization of the Construction Directorates today.

This situation, however, began to change, with the passage of the 2002 Budget System’s Law. According to the law, the revenues collected by the Construction Directorates from the land use and land development fees are no longer the revenues of the utility, but are now general revenues of the municipal budget. This is as it should be because as we have seen these fees are best understood as taxes. Or put another way, whatever they are, they are certainly not charges for a particular service provided by the company itself.

Nonetheless, Construction Directorates remain public enterprises of a very particular type. Like other public enterprises they retain their independent management structure, their legal identities, and the right to set their own wage and employment policies. Moreover, in many local governments they remain responsible for virtually all investment planning, contracting, and monitoring. But unlike most other public enterprises, they no longer have significant own revenues and are now dependent almost entirely on the municipal budget for their finances.

This new financial dependency has weakened the Construction Directorates’ status as states-within-a-state, and many local governments are slowly beginning to take back responsibilities that were previously entrusted to them. For example, many local governments have taken away at least some of their urban planning functions by creating municipal urban planning departments. Meanwhile, others have begun to internalize asset management functions that were previously entrusted to the Directorates.

For our purposes, however, two other recent trends are important. The first concerns the way some local governments are beginning to restructure their relationships with communal enterprises, particularly water and solid waste companies. Here, what we see is that a number of local governments have made these companies responsible for planning their own investments. As a result, this responsibility has been taken away from the Construction Directorates, and some of the engineers and planners that previously worked there have been assigned to the respective communal enterprises, while others begin to work directly for city hall.

I will discuss the significance of making communal enterprises directly responsible for their own investment planning in greater detail later. But for the moment, suffice it to say that these efforts substantially clarify discussions between the utility and the local government over how much investment needs to be carried out, and how much of that investment can be reasonably paid for from the utility's own revenues.

The second trend concerns the efforts of many municipalities to take over the administration of local government revenues that were previously administered for them by the Republic Tax Offices.<sup>9</sup> Here, what local governments are finding is that Republic Tax Offices did a very poor job registering land, buildings, and taxpayers for the property tax. As a result, they are comparing the data they have received from the Republic Tax Offices with the other databases available to them, including those on the land use fee maintained by the Construction Directorates.

When they do this, they realize that though both data sets are imperfect, they both contain similar types of information that should be unified and maintained by a single agent within the local government. And not surprisingly, many of them are now taking steps to move the people and the data systems that Construction Directorates have been using to administer the land use fee into their new revenue collection departments. In short, they are beginning to relieve the Construction Directorates of at least some of their revenue collection functions.

## **B. The Property Tax**

The 2007 Law on the Local Government Finance transformed the property tax from a shared tax into a local government own-revenue source which local governments must begin to administer on their own by January 2009. As an own-revenue source, the property tax is now at the discretion of local governments, which are free to set the tax rate up to the maximum level specified in the Law on Property Taxation.

In 2007, about a dozen jurisdictions began administering the tax for themselves, and this number increased to about 40 in 2008. Some jurisdictions—most notably Belgrade, Kragujevac, Vranje, and Vranjska Banja—began this process on their own. Others have been receiving hardware and software through a national government pilot program that included five local governments in

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<sup>9</sup> According to the Standing Conference of Serbian Cities and Towns approximately 45 municipalities did not sign contracts for the administration of their own revenues with the Republic Tax Offices for 2008.

2007 and which was increased to 27 in 2008 with funds from the National Investment Program. Under the pilot program, local governments are receiving own revenue administration software developed by the Mihalo Pupin Institute as well as—at least in some cases—the hardware necessary to support this software<sup>10</sup>.

Not surprisingly, local governments have encountered a number of problems in taking over the administration of the property tax and their other own revenues. First, and as I have already noted, the databases that they have received from the Republic Tax Offices are very poor.<sup>11</sup> Indeed in most jurisdictions it seems that between 30 and 50 percent of all properties were not taxed in the past, and that many of those that were have been undertaxed because their owners have made significant improvements in their properties since filing their initial tax declarations.

As a result, the first challenge facing local governments is to create a comprehensive and reliable database on all taxable properties and taxpayers. But as painful as this process is, it also clearly constitutes a very significant opportunity for local governments to significantly increase the yield of the tax. Indeed, those local governments that have most aggressively taken over the administration of the tax are already seeing revenue gains of 15 to 20 percent simply by adding new properties to the tax rolls.

There have also been legal uncertainties about the exact nature of the powers local governments have to compel taxpayers to file property tax declarations; to physically inspect properties to verify the accuracy of these declarations; and to enforce collection. Indeed, many of these uncertainties remain to be resolved and there is clearly a need for a discussion between the national government and local governments about amendments to the Law on the Property Tax.

At the same time however, it is also clear those local governments that have gone farthest in improving the administration of the tax have done so simply by assuming that they have virtually all the powers that the Republic Tax Offices had prior to the devolution of the tax. And so far, at least, no one has challenged this interpretation of the law.

There have been similar uncertainties about the right of local governments to adjust the base of the tax for physical persons by revaluing properties. Under the Rule Book on the Method of Tax

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<sup>10</sup> Unfortunately, the number of local governments that actually received computer hardware under the Pilot and NIP programs has been limited because of delays at the Ministry of Telecommunication in issuing the necessary tenders. There have also been problems debugging the Mihalo Pupin software and actually making it work for both the property tax and for the other local government revenues the software is designed to administer.

It is beyond the scope of this paper to analyze the problems of the Pupin software. But two things are worth saying. First, in recent months, the Pupin Institute seems to be successfully resolving many of these problems. And second, some of these problems have arisen from the fact that the way local governments have been setting and administering many of their other own revenues (e.g. the land use fee, the self-contribution fee, and the firmarina) are so different that accommodating them in a single software package has proved a challenge.

<sup>11</sup> The reasons for this are simply that the collection of the property tax was never a priority for the national government because the administration of the tax is labor intensive, because the yield of the tax is low in comparison to other taxes available to the national government, and because 100 percent of the yield was assigned to local governments. It is also perhaps worth adding that there seems to be considerable variation across local Republic Tax Offices in how seriously they took the administration of the tax.

Base Setting for the Property Tax, the value of individual properties is set by multiplying an average market price for a square meter of property in each jurisdiction by the zone the property is in, and by a coefficient determined by the characteristics of the property.<sup>12</sup>

Article 4 of the Rule Book states that the average square meter price of property in the jurisdiction will be determined in accordance with data on sales values kept by the “Republic body in charge of statistics.” Unfortunately, however, it seems that the Republic body in charge of statistics has not been maintaining these valuations, and even if they have, Republic Tax Offices have not been using them.

As a result, the average square meter prices used to value property for physical persons have nothing to do with current market values. This means that the average property tax burden on households in most jurisdictions is extremely low, ranging from between 1,000 to 2,500 dinars per year (12–24 euros). Moreover, these low levels of property taxation are being achieved despite the fact that all jurisdictions are taxing property at the maximum allowable rates under the law (0.40 percent).

In 2007, the statements by the Ministry of Finance suggested that the Ministry did not think that the devolution of the property tax to local governments included giving them the right to recalculate the base square meter charge being used to calculate the tax in their jurisdictions. More recently however, officials from the Tax Department of the Ministry have declared that this power has in fact been devolved to local governments, and that they are free to recalculate the base using data on the property transfer tax.<sup>13</sup>

What this means is that there is a huge space for local governments to increase the yield of the tax on physical persons by recalculating and applying a more realistic average market price for a square meter of real estate in their jurisdictions. Indeed, there is so much room for improvement in the valuation of the base, that any attempt to move towards real market prices would undoubtedly be politically and socially unacceptable *if local governments did not at the same time significantly lower existing tax rates*.<sup>14</sup>

The ability of local governments to revalue the base of the property tax combined with their rate setting powers (in this case, ironically to lower the rate) gives them a powerful tool to improve their own revenues. It also suggests a rather clear path for future reform in most jurisdictions.

- First, local governments should make sure that they have a complete and accurate registry of all properties in their jurisdictions. This means first getting all properties not being taxed into their data bases, and probably eventually requiring all tax payers to file new

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<sup>12</sup> These characteristics include such things as type of windows, floors, staircases, sanitary, sewage, electrical, and heating systems. Official Gazette of RS, no. 45, from April 2004.

<sup>13</sup> Conference on Property Tax Devolution, Belgrade, April 12, 2008. Obviously, however, a written statement (or better yet a legal act) of national government policy on this issue is needed to fully clarify the situation.

<sup>14</sup> It is also possible to revalue properties, and keep the rate the same, but phase in the cost of the tax to taxpayers by using only X% of the new valuation as the base of the tax in year 1, Y% in year 2, Z% in years 3 and so on.

property tax declarations to ensure that the information about their properties is up to date.

- Second, local governments should examine data on property transactions to determine what the average square meter price of land and buildings is in their jurisdictions and how these prices differ across different areas. The information necessary for these calculations should be gotten from data on the tax for the transfer of absolute rights, as well as from local realtors. Moreover, the collection of information about the market values of property should be institutionalized because this information is of great use in asset management, land use policy, and infrastructure planning.
- Third, information on the relative prices of real estate in different areas of the municipality should be used to redefine the zones the local government has been using for the property tax and for the land use and land development fees.
- Fourth, once a new base value for property in the jurisdiction has been set and new zones established, local governments should simulate how much revenue the property tax would yield at different tax rates. These simulations should be designed to set a rate in which the average tax burden on households is *at least equal* to the level of the current burden created by the property tax *and the land use fee*. This will allow local government to eliminate the land use fee (at least for physical persons) without any loss in revenues. It will also allow them to radically reduce the costs of administering and collecting their own revenues.

This type of reform will require at least two or three years to fully implement. At a minimum, all properties should be accurately registered before the base of the tax is revalued because revaluing the base only for existing taxpayers is not only unfair but probably politically suicidal. Equally, local governments will have to develop public relations campaigns that explain why property taxation is being increased and what the increase in taxation will yield in terms of improved services.

As such, property tax reform will undoubtedly be both technically and politically challenging. But these challenges are worth facing for at least three reasons.

- Over the long term, a market-calibrated property tax is the single most powerful fiscal instrument that local governments can be given to increase their own revenues.
- A market-calibrated property tax automatically provides local governments with a way to capture some of the value of the investments they make into their own communities because the investments typically raise property values.
- Greater use of the property tax will help shift the burden of taxation away from businesses and towards individuals, a shift that is important for Serbia's overall economic development, as painful as it may be politically. Similarly, shifting the property tax

burden to households will give local governments greater fiscal space to use property tax abatements for businesses as an instrument for local economic development.

Here, however, it is useful to consider one of the particular problems that folding the land use fee into the property tax is likely to encounter. As I have noted, in most jurisdictions 70 to 80 percent of the land use fee comes from legal and not physical persons. At the same time, the current law on property taxation states that the valuation of commercial property is based on the book value of the company's real estate.

As a result, and unlike with the property tax on physical persons, local governments do not have an easy mechanism by which to increase the valuation of commercial properties. Indeed, from a policy point of view, it may not be desirable to grant them significant powers in this area—at least in the short term—because of the general tendency of local governments to overtax businesses.

This does not mean that the rules governing the valuation of commercial properties should not be reviewed. On the contrary they should be reviewed for three reasons. First, because while the national government's administration of the property tax for legal persons was certainly better than for physical persons, it was far from perfect. Second, the Law on Property Taxation contains a number of loopholes for the taxation of commercial properties, particularly concerning the treatment of properties rented for business purposes. And third, because going forward it is unclear which level of government should be responsible for verifying whether firms report the book value of their assets accurately.

Nonetheless, the basic financial dilemma associated with the complete elimination of the land use fee should be clear: If the fee is eliminated for both firms and individuals, and if the property tax rate is set to only yield revenue equal to the current burden of the property tax and the land use fee for *physical persons*, then local governments will lose some of the revenue that they currently get from the land use fee on enterprises.

Obviously, this dilemma can be solved by setting the property tax rate on physical persons high enough to at least recoup some of the losses that will come from eliminating the land use fee on businesses. And as a theoretical matter, there is little question that this is the most desirable solution. Indeed, in practice most jurisdictions will probably be able to make up for the loss without radically raising the property tax on individuals simply by extending taxation to all households. But there will be some jurisdictions where this is not the case and where other solutions to this politically difficult problem will have to be considered.

### **C. The Land Lease Fee**

The land lease fee was introduced into the Serbian local government finance system in 2001 by amendments to the Law on Construction Land. The amendments made it possible for local

governments to lease state-owned, unused urban construction land to third parties.<sup>15</sup> In 2004, income from the fee constituted a little more than 1 percent of all local government revenues. But the importance of the fee has probably increased since then as municipalities aggressively try to use “their” assets to attract investors and raise revenues.

According to the Law on Planning and Construction, lease fees must be set through public auctions. In most local governments, the reserve auction price for the lease fee is set on the basis of the same zones that they use for the property tax and for the land development fee. And in most the square meter reserve price is different for residential and commercial uses.

In some jurisdictions, however, the reserve price of the lease is set as a percentage of the presumed market value of the parcel (e.g., 90 percent), and there is no distinction made between residential or commercial users. Instead, it is assumed that the municipality’s urban plan—by specifying possible land uses—will govern the type of bidders and the parcel’s estimated market value.

The law also requires that all leases must be regulated by a contract between the municipality and the investor. This contract must specify the length of the lease; the designated purpose of the land; the characteristics of the structure the investor intends to build; the time frame in which it must be built; and the rights and duties of the contracting parties in the event that the investor fails to use the land or build on it as planned.<sup>16</sup>

In practice, local governments seem to be issuing 99-year leases for residential purposes, and leases of various periods for business purposes. And most are requiring that the lease fee be paid up front or in a very limited number of installments during the first year of the contract<sup>17</sup>. Indeed, some are discounting the auction price of the lease by as much as 30 percent if the lease fee is paid in its entirety at the beginning of the lease period. It also seems that in many jurisdictions the lease contracts are weak documents that fail to clearly specify the rights and obligations of either the investor or the municipality during the period of the lease.

The fact that most local governments require that lease payments be paid up front and that many lease agreements contain limited provisions about the procedures for revoking a lease should an investor fail to construct—or for that matter maintain—what he has promised to build suggests that there is an assumption on both sides of the transaction that 99-year leases are the functional equivalent of outright sales or privatization. This assumption however, is extremely problematic.

Long-term leases are used in many cities throughout the world. And in some of them, the real estate market regards them as the functional equivalent of sales, with little difference between

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<sup>15</sup> These possibilities were maintained in the Law on Planning and Construction which replaced the Law on Construction Land in 2004.

<sup>16</sup> The Law on Urban Construction Land, 2001 Jugoslovenski pregled, 2001, articles 23-24.

<sup>17</sup> It is worth noting here that the Serbian Chart of Accounts (logically) treats the lease payment as a recurrent or operating income when the current practice of taking the lease payment in a single transaction really makes it capital revenue.

the prices for 99-year leases of publicly owned land and the prices of equivalent private land. This is true however, only if the lease holder has the right to sell or lease his or her lease rights to a third party.

The situation in Serbia today, however, with respect to a leaseholder's right to transfer his lease to a third party is unclear. Article 84 of the Law on Planning and Construction makes it possible for leaseholders to on-lease their property rights to third parties, but only if municipalities pass an ordinance granting leaseholders this right. Moreover, as far as I can tell, not only have municipalities not passed such ordinances, but lease agreements do not contain provisions that would make leasing to third parties easy even if such ordinances were passed.

What this means is that if an investor builds a facility, and for one reason or another wanted (or needed) to transfer his lease rights to a third party, he could not do so without a specific municipal decision granting him this right. Here, it is easy to imagine situations in which a municipality might have a very strong incentive not to agree to this and to instead try to annul the lease and thus repossess the land.

Similar problems are created by the fact that many lease agreements do not clearly specify the conditions under which a lease might be revoked, and how this would be carried out procedurally. On the surface, the lack of these provisions suggests that the investor is more or less free to do what he wants once the land is acquired. In other words, here again, the lease is assumed to be a "sale."

But this lack of contractual specificity in fact creates serious liabilities for both parties. For the local government, because they do not have a clear way of forcing investors to meet their promises; and for the investors because a future municipal administration might decide that he had breached his lease agreement in one way or another and make a serious and costly effort to repossess the property.

The resolution of these problems would obviously be easier if local governments were the true owners of the properties they now control, and could actually sell land instead of just leasing it. Nonetheless, even if local governments are—as expected—to be given title to unused urban construction land, there is a legitimate use of leases that local governments should consider as a policy instrument alongside of privatization, and perhaps as an improvement on their current leasing practices.

In countries where local governments own property they obviously have the right to both sell and lease it. And in practice, many do both. For example, Polish local governments have made extensive use of long-term leases as a way to protect themselves from selling land at prices well below those they knew would be available on the market when Poland moved closer to the European Union. Moreover, the mechanism they use to do this is relatively simple and used in other cities around the world.

As in Serbia, lease rights in Poland are put out for auction, and as in Serbia the bidder who submits the highest bid for the property is awarded the contract. But unlike in Serbia, the lease

payment is not taken up front.<sup>18</sup> Instead, lease payments are set as an annual percentage of the auction value the property—usually between 1.5 and 3 percent a year for the life of the lease—and paid out in periodic (e.g. monthly) installments.

At the same time however, the lease contract specifies that every three to five years the market value of the property will be reassessed and the (residual) value of the lease and the lease payment adjusted upward in line with the reassessment. This contractual mechanism for adjusting lease values and lease payments in line with changes in the market value of land allows local governments to capture some of the increase in property values that will occur over time, and indeed as a product of their own investments. Moreover, it could be useful in Serbia where—as we have seen—the method for establishing the value of commercial properties for property tax purposes is unrelated to the market value of the property itself.

Nonetheless, the use of such a mechanism is not without serious problems. Above all it requires that there be an independent, reliable, and cost-effective way for the market value of leased properties to be periodically assessed. Indeed, without a way to determine the fair market value of leased property over time, this sort of mechanism might even be dangerous.

But the real point is that at the moment in Serbia, leases of state-owned but municipally controlled land are neither real leases, nor real sales. Property devolution and privatization will of course eventually resolve much of this problem. But both in the interim, and even after privatization becomes possible, there is a serious need for most local governments to take their lease agreements much more seriously than they currently do, both to protect their own interests and the interests of investors.

#### **D. The Business Sign Fee (*Firmarina*)**

In 2007, 1.8 percent of local government revenues came from the business registration fee. As with other local government revenues, the share of revenues coming from the fee differs substantially across jurisdictions.

According to the Law on Local Government Finance, local governments are allowed to charge the fee on all individuals or firms that post a sign indicating that a particular location is a business premises. Article 17 of the law states that local governments may determine the business sign fee in the same way that they determine the size of other communal fees, meaning that they may set fees of “different amounts depending on the type of activity, size and technical characteristics of facilities, according to different parts of the territory, i.e. zones in which the facilities and areas are located, i.e. objects or services subject to the fee payment rendered.”

These rules are extremely open-ended and it is not surprising that in practice there is a huge amount of variation in the way local governments set the fee:

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<sup>18</sup> In practice, some percentage of the lease value (10–15 percent) is often required as an up front payment, in what is known in the business as “key money.”

- Some local governments charge the fee only for the headquarters of a business entity, while others charge it for all business premises that a firm may have in the jurisdiction.
- Some local governments make use of zones, and some do not.
- Some local governments adjust the fee on the basis of how much physical space the business occupies and some do not.
- Some charge different fees based on the size of the enterprise (large, medium, and small) while others do not use this distinction.
- Many local governments set many different fees for many different types of business activities (e.g. banks, insurance companies, petrol stations, retail shops, wholesalers, different types of manufacturers, etc.) while others use a shorter list (commercial, industrial, services) or no list at all.

Moreover, local governments have been extremely creative in combining different possible ways of adjusting the fee with each other and there is a dizzying array of schemes across Serbia as a whole. As a result, not only do the fee schedules clearly discriminate for and against certain types of businesses in many jurisdictions, but they are often extremely complicated and non-transparent.

In short, the existing regulations governing the *firmarina* essentially give local governments a free hand to tax businesses in any way they like and really at any level they choose. This situation obviously makes possible all sorts of abuse. But determining how many local governments are actually abusing the tax and indeed defining what exactly constitutes abuse are not easy questions to answer.<sup>19</sup> At a minimum, they would require substantial empirical analysis that is well beyond the scope of this undertaking.

With that said, however, two things should be clear. The first is simply that, local governments themselves should think very carefully about how they set the *firmarina* both in terms of the overall level of taxation they are imposing on businesses and in terms of the transparency and equity of the system they are using to set the fee. Second, the national government should be aware that any fiscal pressure that is exerted downward on local governments may well end up being dumped on business through the *firmarina* (and the current land use fee) if the boundaries for setting the fee are left as open as they are today.

## **E. The Self Contribution Fee**

One of the more interesting features of the Serbian intergovernmental finance system is the self-contribution fee. Local governments can impose this fee (which is clearly a tax) only on the basis of a popular referendum in which citizens vote on both the level of the fee and the specific

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<sup>19</sup> In general, the literature on public finance regards giving local governments the power to tax movable assets—such as businesses—as a bad idea because it can lead to competition between jurisdictions to lower tax rates in what is commonly known as “a race to the bottom.” As a practical matter, however, most countries do allow one form of business taxation or another, no matter what theorists say. Equally importantly, racing to the bottom is probably not Serbia’s problem—at least at the moment.

purposes for which the revenue from it will be used. The fee thus clearly links people's willingness to pay a tax to the provision of improved public services and, at least in this respect, provides something of a conceptual model for how local governments should think about all local government taxation in the future.

In 2007, 138 of Serbia's 145 local governments collected revenue through the self-contribution fee. Income from the fee however, constituted only 1 percent of total local government revenues, and in the vast majority of municipalities, revenue from the fee constituted less than 2 percent of their total income. Indeed, in most cases the fee is used only for small infrastructure projects such as road extensions or water supply systems in particular MZs (sub-municipal community associations) and it is only the people in these communities who are voting to tax themselves.

Nonetheless, in 25 jurisdictions revenue from the fee constituted more than 4 percent of total local government revenue, and more than 10 percent in seven jurisdictions. Here, in other words, the fee was an extremely important source of local government revenue and it can be assumed that it was being paid by the vast majority of residents and being used for infrastructure designed to service the whole community.

As attractive as the self-contribution fee is, however, it is not without serious problems. First, as a practical matter it is getting harder and harder to get a majority of citizens to participate in the necessary referenda, something that over the longer term may make use of the fee as a major source of revenue problematic. Second, and more importantly, determining an equitable base of the fee for different sorts of citizens is very difficult in Serbia today.

Article 26 of the Law on Local Government Finance gives local governments the right to set the base of the fee differently for different sorts of citizen, while article 25 actually allows them to accept payment in non-monetary equivalents. Thus the fee can be imposed on the wages of employees; on income from agriculture and forestry; on income from private business activity subject to income tax; on property values; and on pensions.

In practice however, the fee has been most frequently imposed on wages and pensions for two reasons. First, because these were the easiest sources from which the fee could actually be collected. And second, because the base of the other possible sources of the tax (property values, income from agriculture and forestry) were too poorly registered or too insignificant to yield appropriate revenue.

What this means is that where the tax is imposed, it is typically paid for primarily by wage earners, and much less (if at all) by citizens engaged in other types of economic activities. How unfair this is obviously differs across communities based on both how heterodox their populations are, and on what infrastructure is being built with the proceeds of the fee. If a community is composed primarily of wage earners and pensioners, then using wages and pensions as the basis of the fee is both fair and simple.

If, on the other hand, the fee is being primarily imposed on wages, but is being used to build a health clinic in a community in which 40 percent of the population is engaged in agriculture, it is

clearly inequitable. Worse, there is no easy or obvious way to solve this problem by creating a uniform base for the self-contribution fee.

Nonetheless, it is interesting to consider for a moment the implications of using property values as the uniform base of the fee. The theoretical grounds for doing this are that all households and businesses make use of taxable property, and that the relative value of property constitutes a reasonably equitable way to allocate the burden of the fee. Indeed, these are precisely the grounds that public finance theorists consider the market-based property tax as the single best local government tax.

Doing this in Serbia today however is problematic for two reasons. The first is simply that until properties are better registered and better valued, it would make no sense. Indeed, this is precisely why property values have not been used as a base for the fee until now. The second reason is that under the Property Tax Law, the base of the property tax for agricultural land is set at five times the annual cadastral income of the land. Unfortunately, however, the way cadastral income is currently calculated means that the fee would still yield virtually no income from citizens engaged in agriculture. As such it would not resolve the equity problem I have described above.

Both of these problems, however, are at least theoretically resolvable. Local governments are improving the registration of taxable properties and can, it seems, bring the valuation on non-agricultural, residential properties closer in line with market values under existing legislation. Moreover, it is at least conceivable that the legislation on property taxation could be reformed to create a more realistic way of valuing agricultural land.

But the really interesting thing here is that if these things were done, much of the need for the self-contribution fee would simply whither away. After all, local governments could now raise additional revenue for particular infrastructure projects by increasing the property tax rate. And citizens, if they did not like what their increased property taxes bought them, could simply vote their local officials out of office at the next round of election.

In short, while the self-contribution fee is an interesting fiscal instrument because it clearly links taxation with the provision of improved services, perfecting the property tax will serve the same function in a much simpler and more transparent way.

## **F. Utility Fees and Charges**

Income earned by utilities from the sale of goods and services are not local government budget revenues. But they are hugely important for local government revenue systems as systems. Indeed, if these systems are understood as a three-legged stool in which the first leg consists of grants, transfers, and shared taxes, and the second leg consists of own revenues, then third leg is utility finance. Moreover, there is little doubt that in Serbia today, utility finance is the weakest leg. There are many reasons for this.

The most fundamental one is that, historically, the governing philosophy of infrastructure finance in Serbia has been that utility prices should only cover the operating and maintenance costs of public services while investment costs should be paid for from other revenues. This philosophy is now considered obsolete. Equally importantly, EU directives for the last ten years insist that countries move towards “full recovery pricing,” meaning that the price of utilities should include—to the greatest degree possible—all the costs of providing the concerned service, including its investment costs.<sup>20</sup>

The second and related reason is that this philosophy expressed itself institutionally in Serbia in a particularly debilitating way: On the one hand, utilities were supposed to manage only their day-to-day affairs and the prices of their services—set by municipal councils—were only supposed to support their operating costs. On the other hand, the Construction Directorates have not only planned and executed their investments for them, but they were expected to get the lion’s share of the revenue needed for these investments from the land use and development fees.

Taken together, this institutional arrangement has rendered the problems of municipal utilities virtually invisible: Municipal councils, always reluctant to raise utility prices for political reasons, simply assumed that if the utility managed to operate last year at a given price level, it could operate next year at more or less the same level. Over time however, this has resulted in prices—particularly for households—that do not even cover operating and maintenance costs. Indeed, in the water sector this has led to a situation in many jurisdictions in which piping and pumping stations are so old that leakage rates exceed 40 percent and the distinction between maintenance and investment costs has become virtually meaningless.

At the same time, the Construction Directorates have by and large failed to make the investments necessary to maintain utility infrastructure, to say nothing of improving it. In part this is because they themselves have not had the necessary resources. But equally important is the fact that the Construction Directorates see themselves as representing the investment needs of the entire city and not just those of the utilities. Indeed, in theory, this broader overview of municipal infrastructure was supposed to produce more rational investment spending.

In practice however it has proved a disaster for water companies in particular and utilities in general. Throughout the world there is a tendency for municipalities to underinvest in utility infrastructure because investments in the water, heating, and solid waste sectors are costly, take a long time to mature, and are less immediately visible to citizens than investment in, say, roads, parks, or school buildings. Indeed, throughout transitional Europe, municipal water companies

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<sup>20</sup> There are many reasons why full cost recovery pricing is now required by the EU. The most important one however is that if the price of a service—particularly water services—does not reflect the full costs of its provision, people overconsume a scarce resource, which in turn requires greater investment costs to expand the system to meet the excess demand created by the initial underpricing of the good, creating an environmentally bad and economically costly vicious circle. See: Communication From the Commission to the Council, The European Parliament and the Economic and Social Committee: Pricing policies for enhancing the sustainability of water resources, July 2000. “By 2010, Member States must ensure that water pricing policies provide adequate incentives for users to use water resources efficiently and that the various economic sectors contribute to the recovery of the costs of water services including those relating to the environment and resources. This cost recovery rule is expected to impact particularly irrigated agriculture, where users have not paid the full costs of water supply.”

have had to fight to get municipalities both to raise prices and to provide budget funds to make desperately needed investments.

In Serbia however, this struggle has been confused by the existence of the Construction Directorates. On the one hand they, like municipal councils, have been more or less happy to accept the fiction that existing water prices are sufficient to maintain Serbia's crumbling public infrastructure. On the other hand, they are reluctant to fully acknowledge the real investment needs of Serbia's utilities because they know that if these needs are really recognized and prices are kept the way they are, then there would be few investment funds left over for any of the politically more attractive investments—like roads—that they are also responsible for.

As a result, the current struggle between water companies and municipal governments over investment funds resembles a fight in which the water companies have one hand tied behind their back—the idea the prices should only cover operating costs—and a referee—the Construction Directorates—who generally sides with the opponent. Worse, for the last few years the national government has further rigged the game by capping increases in utility prices. Indeed, utility prices in Serbia are now so low (30 to 50 percent of the European average) that water companies are in many jurisdictions literally losing money on every cubic meter of water they sell (to households).

All of this has potentially devastating consequences for municipal finances in Serbia for the simple reason that over the next 10 to 20 years the most costly investments facing Serbian municipalities will be in the area of environmental infrastructure, particularly in developing modern sewage treatment systems and solid waste dumps. Indeed, given that there are only a handful of such facilities in Serbia today, the scale of the investment needs on this front is breathtaking.

In fact, the investment needs are so huge that there is no way that utility prices can rise to full-recovery levels anywhere in the near future because the price shocks would be socially and politically unacceptable. But with that said, it is also true that without significant price increases municipal budgets will either have to carry the full costs of these massive investment needs on their own—leaving little room for anything else—or the investments will not be made. Or put another way, until utility prices are raised, and until utilities themselves are not made fully responsible for both their operating and investment performance, local government budgets are likely to bleed money at a rate similar to the water leaking out the country's pipes.

## **Part II. The General Situation of Own Revenues in Nis Today**

In 2007, own revenues accounted for 35.6 percent of total local government revenue. However, this share differs significantly across municipalities. For example, the share drops to about 25.1 percent of total revenues if the four big cities are removed from the picture, while it rises to over 44 percent if only the four big cities are considered. In general, the share of own revenues in total revenues increases as jurisdictions get larger.



This second part of the note looks at local revenue collections and economic development in Nis, the third largest city in Serbia and the economic engine of the southern and least developed part of the country. I start by presenting how Nis is using its own revenue raising powers in the context of what is going on elsewhere in the country. Next, I outline select policy directions designed to increase Nis's own revenues and improve the local business environment.

Table 2 shows the share and composition of own revenues in Nis's budget in 2007. As can be seen from the table, own revenues constituted less than 32.5 percent of Nis's total revenues. This is above the national average for all municipalities, but substantially lower than the average for the four big cities.

**Table 2. Own Revenues of Nis 2007**

	<b>Budget Code</b>	<b>dinars</b>	<b>% of total</b>
<b>Total Current Revenues</b>	70000	<b>4,506,831,062</b>	<b>100.0</b>
Self Contribution	711180	596,621	0.0
Property Tax	713120	193,200,454	4.3
Property Tax on physical persons	713121	91,834,775	2.0
Property Tax on Legal Persons	713122	101,365,679	2.2
Vehicle Registration Fee	714513	24,689,228	0.5
Road Fees	714514	37,389,091	0.8
Hotel Tax	714552	5,934,193	0.1
Charge for environmental protection	714547	21,778,432	0.5
Other local Fees	other 714	2,815,643	0.1
Business Registration Tax	716110	55,951,354	1.2
Charges for the Use of Public Space	741520,31+2,35,41	28,161,297	0.6
Interest Income and other Local Charges	other 741	22,591,101	0.5
Rental of Municipal Premises	742152	68,614,518	1.5
Land Lease Fee	742153	29,664,798	0.7
Land Use Fee	741534	253,375,408	5.6
Land Development Fee	742253	505,416,713	11.2
Income from sale of goods and services	other 742	20,321,692	0.5
<b>Total Local Government Own Revenues</b>		<b>1,463,700,997</b>	<b>32.5</b>

### **A. The Property Tax and the Land Use Fee in Nis Today**

As can be seen from table 2, the share of Nis's own revenues coming from the property tax in 2007 was virtually identical to the national average (4.3 percent vs. 4.2 percent). In 2007, however, the municipality decided to take over the administration of the tax from the Republic Tax Office. As a result, the municipality created a separate revenue collection department and purchased new revenue administration software from the Mihailo Pupin Institute. The city is currently migrating data from the Republic Tax Office into new revenue administration software, which should allow the city to administer all its own revenues and not just the property tax.

At the moment, the new Revenue Collection unit is separate from the city's Finance and Budget Department, but this is apparently supposed to change. The unit is also supposed to eventually assume full responsibility for the collection of the land use and land development fees, responsibilities that are currently shared with the Directorate for Construction Land.

In 2007, the city issued 59,711 property tax bills, of which 613 were to legal entities and 59,098 were issued to individuals. The solid waste company, however, issued bills to 71,631 individuals and to 3,703 legal entities. If we assume that the billing records of the solid waste company are reasonably accurate, then only 82 percent of households and 16 percent of firms are being billed for the tax.<sup>21</sup>

Table 3 presents data on the yield of the property tax in 2007. Unfortunately, the data from the city's budget (derived from the Treasury System) do not agree with the data provided by the revenue collection unit. It is also unclear how much was actually billed to either physical or legal persons because (I suspect) much of the amount owed is actually from years prior to 2007. As can be seen from the table, about 48 percent of the yield of the tax comes from households and about 52 percent from businesses, if we use the year-end budget data as the more reliable measure. This is in line with the average for Serbia as a whole.

**Table 3. Estimation of the Property Tax in Nis in 2007**

Property Tax	Number of Tax Payers Billed	Amount collected (according to budget)	%	Amount Collected (according to Revenue Unit)	%	Amount owed (according to Revenue Unit)
Physical persons	59,098	91,834,775	48%	74,395,993	36%	44,635,808
Legal persons	614	101,365,679	52%	133,135,046	64%	878,442
Total	59,712	193,200,454	100%	207,531,039	100%	45,514,250

Table 4 presents an estimation of the average burden of the tax on both households and firms. For the purposes of this estimation I have assumed that 30 percent of households and 10 percent of firms do not pay their property tax bills. These estimates are based on findings in other municipalities, and may over- or understate the level of non-payment. As can be seen from the table, if we divide the yield of the tax (according to the budget) by the adjusted number of households and firms we get an average property tax burden for households of 2,200 dinars or about 28 euros, and for firms, 183,400 dinars or about 2,290 euros. So despite the fact that the yield of the tax comes more or less evenly from households and firms, the tax constitutes a much greater burden on legal persons than it does on individuals.

<sup>21</sup> Data received from the water company suggested that about 340,000 bills were issued to households. This figure is very strange: It seems much too high if it represents the number of households billed, and much too low if it represents the total number of bills processed during the year. The records of the Construction Directorate show that 3,693 legal entities were billed for the land use fee, a number very close to the number billed by the solid waste company.

**Table 4. Estimate of the Property Tax Burden in Nis in 2007**

<b>Property Tax</b>	<b>Estimate of tax payers who paid the tax ( 70% and 90% of those billed)</b>	<b>Amount collected (according to budget)</b>	<b>Average Tax Burden per payer (dinars)</b>	<b>Average Tax Burden per payer (euros)</b>
Physical persons	41,369	91,834,775	2,220	28
Legal persons	553	101,365,679	183,434	2,293
Total		193,200,454		

Indeed, the apparent average burden on firms is extremely high. So high that it suggests that the Republic Tax Offices have either only been subjecting Nis's largest firms to the property tax, or that the data I have received on the number of legal entities paying the tax is not correct. In any case, it is important to understand why so few legal entities seem to be paying the property tax in Nis today.

If we assume, somewhat unreasonably, that all households in Nis receive the 40 percent tax credit for owner occupancy then the average burden of the tax for individuals before the credit is 3,700 dinars (60 percent \* 3700 = 2200). And, if we further assume that all properties are being taxed at the base rate of 0.4 percent, then the average value of an apartment or a residence in Nis for property tax purposes is about 925,000 dinars ( $3700/.004 = 925,000$ ), or about 11,500 euros. This clearly understates the average market value of residential properties in Nis today.

Nis uses an extremely complicated point system to assess the level of the land use fee for both residences and businesses. Ultimately, the sum of points for any given object is used as a coefficient which is applied to a base square meter charge in order to determine the level of the fee for square meter of a particular type of object in a particular location.

The point system is based on the distance of the object from the center of the city; the distance from public institutions (schools, hospitals, cultural centers, bus stations, train stations etc.) and the distance from public infrastructure (roads, water mains, heating systems, telephone lines, parking, etc.). There are also points for the population density of the area of the city in which the object is located; the possibilities for future growth; the rationality of the existing use of space; and for ecological impact. For business, all point categories are differentiated by eight different types of economic activity. The decision on the measurement of the fee contains six pages of different point categories

Taken together, this system is dizzying in its complexity and non-transparency. It is also difficult to administer since virtually any new private or public construction should (at least in theory) lead to the recalculation of everyone's points.

Unfortunately, I was not able to obtain complete information on the land use fee for 2007. We know from the budget that the fee yielded about 253 million dinars in 2007. And I received information from the Land Directorate that, in 2007, 179 million dinars came from 5,167 legal

entities. But we do not know how many physical persons were billed for the fee; how many legal and physical persons actually paid it; and how much debt is outstanding.<sup>22</sup>

Table 5 summarizes this incomplete information. The yield of the fee for individuals is derived by subtracting the amount the Land Directorate says came from firms from the total figure shown in the budget. I have assumed, without much justification, that the same number of households who were billed for the property tax were billed for the fee. This is probably overly optimistic. Conversely, however, it should be noted that while only 614 legal entities were billed for the property tax in 2007, 5,167 were billed for the land use fee.

**Table 5. Estimates of the Yield and Burden of the Land Use Fee in Nis in 2007**

Land Use Fee	Number billed	Estimate of number who actually pay (70%)	Yield of the Fee	%	Average Burden of the fee (70% collection)
<b>Physical persons</b>	59000?	41300	74,368,130	29	1,801
<b>Legal persons</b>	5167	3,617	179,007,278	71	49,492
<b>Total</b>			253,375,408	100	

Finally, to estimate the average burden of the fee, I have assumed collection rates for both groups to be 70 percent. If these assumptions are correct, then the average burden of the fee for households is about 1,800 dinars or about 23 euros a year, and the average burden for firms is about 620 euros.

Table 6 simulates in a very rough way the effects of the property tax reform strategy I described in Part I Section B of this note. In other words, I simulate the financial impact on both taxpayers and Nis's budget if:

- the land use fee was entirely eliminated;
- the property tax was extended to all households and collected in full;
- the average square meter price used to assess residential properties in the jurisdiction was substantially increased;
- and the property tax rate for residential properties was reduced.

In the table, I use the total number of physical persons currently billed by the solid waste company (71,000) as a proxy for the number of individual households that should be paying the property tax. I also assume that the average real value of a residency in Nis is three times higher than the value currently being used for property tax purposes. In other words, I assume that the average cost of a living dwelling in Nis is closer to 35,000 euros than it is to 11,500. I also assume that all households continue to receive the 40 percent tax credit for owner occupancy.

<sup>22</sup> The Directorate provided us with information on the fee for nine months of 2008. It was clear from this information that there are very serious problems with collecting the fee from both legal and physical persons. But it was impossible for us to determine how many fee payers of either category were being billed, or were actually paying the fee.

**Table 6. Thought Experiment: Revaluation of the Property Tax and the Elimination of the Land Use Fee**

	Number of Tax Payers	Average Value of Residential Property	Property Tax Rate	Average burden of the tax including 40% tax credit	Yield of the tax
Physical persons	71,631	2,775,000	0.0030	4,995	357,796,845
Legal persons	615			216,832	133,351,878
					491,148,723
<b>Current Combined burden of the Property Tax and Billed Land Use Fee</b>					
Physical persons property tax	41,000	925,000	0.004	2,220	131,192,536
Physical persons land use fee	41,000			1,800	74,368,130
Legal persons property tax	615			216,832	133,135,046
Legal persons land use fee	5167			49,492	179,007,278
					517,702,990
<b>Percent increase or decrease in total tax burden of and yield</b>					
Physical persons				24%	173%

At the same time, I cut the property tax rate for residential property from 0.4 to 0.3 percent. Finally, I leave the collection of the property tax for commercial properties at its current level. Here, however, it should be noted that while local governments cannot affect the valuation of commercial properties, there are undoubtedly ways for Nis to improve the extremely low collection rate of the commercial property tax.

As can be seen from the table, for individuals, the new property tax yields about 1.7 times more in budget revenue than the current property tax and land use fee combined. Indeed, it yields almost enough revenue to provide the city's budget with same amount of money that is currently coming from the property tax and the land use fee on *both* individuals and firms.

The change in valuation increases the average property tax burden on individuals by 24 percent (over the combined burden of the existing property tax and land use fee). But the average property tax bill is still only 62 euros a year. At the same time, the tax burden on businesses declines dramatically because the land use fee has simply been eliminated. Indeed, the elimination of the land use fee would radically simplify revenue administration for the city. Finally, the drop in the property tax rate for households means that in the future the municipality will have the tax space to increase its revenues by increasing the rate should it need to do so and as the economy improves.

Obviously, realizing some version of this strategy requires a radical change in the way Nis has been treating local revenue collection. Above all, it would require explaining to citizens why it is both necessary and fair for all citizens to pay the new property tax, as well as clearly presenting how the new revenues will be used. Before attempting to realize such a strategy, however, the city must develop much better data on why billing rates for certain groups of tax and fee payers are so low, and why collection rates have been so poor.

## B. Land Development Fee and Lease Fees

In 2007, Nis collected about 30 million dinars in revenue from the land lease fee, which constituted 0.7 percent of its total budget revenues. At the same time, the city collected over 500 million dinars from the land development fee, which constituted 11.5 percent of its total revenue. The land development fee is thus far and away the city's largest source of own revenue, and the situation in Nis more resembles the situation in Belgrade, than it does in the rest of Serbia.

As I have argued in Part I Section A of this note, the business development fee in Serbia constitutes a tax on new development and as such is not a particularly desirable fiscal instrument. Moreover, in most cases, most of the potential revenue from the fee could be captured by better auctions of lease rights.

Table 7 presents data received from the Construction Directorate on the yield of the land development fee in 2007. Unfortunately the table is problematic for a number of reasons. First, and most importantly, according to the Directorate the total amount of revenue derived from the fee in 2007 is larger by more than 10 million dinars the amount shown in the city's budget. Second, despite being able to distinguish between the number of transactions for completely new construction, and the number of transactions to adapt or modify an existing structure, it remains unclear how much of the fee was derived from each category.

**Table 7. The Land Development fee in Nis in 2007**

<b>Land Development Fee</b>	<b>Number of transaction of green-field sites</b>	<b>Number of transactions involving change of purpose for already developed urban land</b>	<b>Yield of Land Development fee from all transactions</b>
<b>Legal Persons</b>	112	103	49,5067,436
<b>Physical persons</b>	236	322	14,2539,300
<b>Total</b>	348	425	63,760,6736

This information is important because it seems fairly clear that in Nis, as in Belgrade, the effective price of lease fees for unconstructed urban construction land would rise dramatically if investors were not discounting their bids based on what they expected to have to pay in land development fees. Or put another way, it seems likely that in Nis there would be little loss in revenue from the lease of unused urban construction land if the land development fee were simply eliminated.

At the same time, however, the overall impact of simply eliminating the land development fee on the city's budget—or for that matter, reasonable alternative policies—cannot be estimated until

we know how much of the fee is being derived from charges imposed on investors who are simply adapting or modifying the use of an existing structure.

### **C. Business Sign Fee**

In 2007, Nis derived about 56 million dinars from the business sign tax. This constituted about 1.2 percent of Nis's total revenues and was less than the national average by about 30 percent (1.7 percent).

The way Nis calculates the business sign fee is relatively simple, and in comparison with other jurisdictions, relatively non-discriminatory. For the purposes of imposing the fee, the city distinguishes between eight zones in the city and between two basic groups of business. Curiously, the highest price zone is the center of the city, and not the so-called extra zone. More importantly, the rate structure between the zones does not differ as dramatically as in other jurisdictions (5 to 1 for the first class of business, 3 to 1 for the second).

The first group of businesses includes financial services, telecommunications, energy, the tobacco industry, and games of chance. The second group seems to include all other sectors. Businesses in the first group pay more than businesses in the second group, but interestingly not much more except in the highest priced zone. The highest level of the fee, for the first type of business in the center of the city is 60,000 dinars or about 750 euros. For businesses of the second group located in the center of the city, the fee is 35,000 dinars or about 430 euros. There are also discounts for small- and medium-sized businesses, and for businesses run by individual entrepreneurs.

Unfortunately, the city was unable to provide information about the yield of the fee broken down by firms and individual entrepreneurs, or the amount either group owes. But the local tax office estimates that there are about 4,000 firms paying the fee, and 6,000 individual entrepreneurs. If we assume (unreasonably) that all of them are actually paying the fee, then the average burden of the fee in Nis is a modest 60 or 70 euros a year.

### **D. Utility Finance**

Nis is currently reorganizing the way it manages and finances its utilities by taking them out from under the control of the Construction Directorate, and placing them under the direct supervision of city hall. For reasons that I have already outlined in the first section of this report, this is clearly a step in the right direction.

As I understand it, however, the city intends to retain responsibility for planning all infrastructure investments, instead of placing primary responsibility for this function at the utility level. While this may make sense over the short term, my feeling is that sometime in the foreseeable future utilities should be made responsible for planning the entirety of their operations. This does not mean, of course, that the city should stop monitoring and controlling their behavior. On the

contrary, this control and monitoring should be increased. But it does mean that the utilities should be required to develop integrated operating and investment plans that are clearly tied to their tariff schedules, and which reflect the city's priorities.

The price of water supply and sewage treatment for households in Nis is respectively 24 and 4.56 dinars per cubic meter. The rates for businesses are three times as much. For both businesses and households, these tariffs are close to the national average, and thus well below "full-cost recovery" prices. The situation for solid waste is similar where rates for both businesses and households are close to the national average (respectively 6.5 and 3.25 dinars per cubic meter).

According to information from the water company, only 42 percent of all water used in the system is billed for. How much of this is due to poor billing and collection, and how much of this is due to losses produced through leakage is not clear. (Interestingly, the water company did not provide clear information about the total number of users it bills on a monthly basis.) What is clear, however, is that collection is poor and that total outstanding debt in the sector for both legal and physical persons is equal to more than a year's worth of total revenues from tariffs (revenues: 780 million dinars; outstanding debt: 807 million dinars). As such, it should be clear that there is a crying need to improve the collection of water and sewage charges.

The situation with respect to solid waste is distinctly better. The solid waste company claims that it is billing all households and firms in the city and provided exact numbers for both categories of users. More importantly, total outstanding debt is only 30 million dinars compared to close to 280 million dinars in revenues. Moreover, the amount of debt from households is trivial, with almost all of the 30 million dinars in debt coming from businesses, which generate approximately 80 million dinars in revenues for the company annually. The apparent ability of the solid waste company to a) bill all users and b) collect from the vast majority of them suggests that the basic problem with in the water sector (and possibly heating) lies not with people's willingness or ability to pay, but in the management of the utility companies themselves.

#### **E. Recommendations for Improving Local Revenues in Nis**

Numerous steps can be taken to improve both the local revenue system as well as local revenue administration in Nis. For a start, the city should move all revenue collection functions into the new unit for revenue collection. This unit should be made a part of the Budget and Finance Department, and should be responsible for cross-checking the records the city possesses for all households and firms (water and solid waste bills, land use fee, property tax, *firnarina*, etc.) to determine where its records for each type of fee, charge, or tax are incomplete. This data effort should include work on determining how much debt is from previous years, and how much is from the current year, allowing the city (and its utilities) to consider introducing policies that write down the value of old debts (to clear the books) while simultaneously moving to strictly enforce the collection of current obligations.

In addition, the city should move quickly to extend the property tax to all households and to work with the local tax office of the Republic Government to ensure that all businesses that should pay the tax are being billed appropriately. The move to extend the property tax to all

taxpayers should be accompanied by a public relations campaign that stresses that it is unfair if only some of the city's residents pay their taxes, fees, and charges while others get a free ride. This campaign should be extended to the utility sector as well.

Other evidence-based revenue reforms should be considered. For instance, the city should begin to monitor the price of real estate transactions in different parts of the city so as to be able to model the financial consequences (for both the budget and household incomes) of potential changes in the base and the rate of the property tax. In the process, the city should consider the eventual elimination of the land use fee, particularly for households. If the fee is retained for businesses, its calculation should be radically simplified (the point system should be eliminated in favor of a flat square meter charge based solely on zones). The city should further analyze from what sorts of transactions it is deriving revenue from the land development fee and consider eliminating the fee for new construction on unused construction land.

Other improvements in the city's organization, processes, and procedures can further improve revenue collections as well as local economic development. The city should improve the procedures to auction leases so as to capture the full value of the market price of the leases. Nis could further consider creating an infrastructure planning and development department whose primary role would be to negotiate with the utilities development plans that clearly reflect the cities investment priorities, and shift the burden for financing these investments from the city to the utilities themselves. The city should require that the utilities improve their accounting, billing, collection, and financial reporting systems, for instance by requiring that utilities develop service contracts that specify the quality and timeliness of services they deliver to citizens, and which contain easily monitored targets for service improvement.

## **Concluding Remarks**

Beyond providing a record of the reform of local government own revenue powers and policies in Serbia—and the case of Nis in particular—a number of larger points can be drawn from this study. First, the own-revenue regimes of developing and transitional countries are typically complicated and confused. There are often many different fees and charges whose names sound familiar but whose real nature and use can only be deciphered through in-depth studies of what actually stands behind the title contained in the Chart of Accounts.

Second, and related to the first, is that the actual use of these revenues by local governments is typically poorly regulated and often differs both across municipalities and from legally prescribed norms.

Third, the costs of this chaotic situation are muted in environments where local governments are essentially revenue takers: So long as they are dependent on unpredictable and non-transparent grants and transfers from the central government, then they will make relatively little effort to maximize revenues from these sources because the local political cost is too high.

Fourth, and conversely, once the intergovernmental transfer regime has been stabilized, and local governments come to believe that they will not be penalized for raising more money on their own, then the incentives for trying to maximize the yield of these own-source revenues change. This shift in perspective creates both systemic dangers and opportunities for reform. The danger is that, if left unreformed, these neglected and chaotic own-revenue regimes will be used by local governments primarily to extract revenues from the business community because businesses, unlike citizens, do not vote.

The opportunity, on the other hand, is to use local governments' desire to increase their own revenues as the basis for a more systemic overhaul of the regulatory regime. This overhaul must involve the reengagement of the national government in a domain that it has typically forgotten about, if for no other reason than that it derives no revenue from it. And here, the crucial first step is to convince national government actors that the failure to provide local governments with a sensible own-revenue regime can only have two consequences: greater pressure on them for more grants and transfers, or intensifying efforts by local governments to extract wealth from legal entities.