THEORETICAL CONCEPTS OF PROPERTY TAX, AN ESSENTIAL SOURCE OF LOCAL GOVERNMENT REVENUE IN EUROPE

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The article explores the problems of theoretical aspects of local tax system rationalisation. The deliberations conducted concern possibilities of referring recommendations made by the contemporary theoretical achievements describing economic effects of property taxation to the tax practice of certain European countries (for example Poland). The content of the article indicates that conclusions resulting from the theory of property taxation should support the operational transformations of the local tax system. Having analysed influential studies on property taxation the author expresses his opinion that despite essential differences, both approaches (benefit view and capital view) have a great value. It should be stated, however, that we have to do with the tax which is not a pure tax on benefit because the owners of property, while improving it, are charged with higher taxes, being thus discouraged from any investments. Simultaneously, benefits resulting from social and economic programmes conducted at the local level are reflected in the local property value. The article applies the method of analysis and literature criticism as well as the intuition method.

JEL Codes: H71; K34.
Key words: local taxation system, property tax, local government revenue.

1. Introduction

Within a long-lasting discussion on the need for the reform of the local government financial system in certain European countries, substantial coverage is given to the system of property taxation. The significance of the problem of property tax well justifies the research. Firstly, due to the difficulty connected with the explanation of the concept of asset taxation (wealth acquired in the past); secondly, due to the fact that property tax determines the revenue potential of local governments and constitutes a stable part of their own revenues; thirdly, because of the possibility of application of tax tools to affect the social and economic development of local communities.

Property tax is one of the first forms of taxation analysed from the economic perspective. Interestingly, despite the abundant literature, unanimity concerning basic property tax issues has not been achieved so far.

The literature on property taxes includes two varying concepts. One of them is
a benefit tax view, in the framework of which there is an analysis of benefits in favour of property owners through a system of wealth taxes. The theory which consists in approaching the local property tax as tax on benefits was developed by B. W. Hamilton (1975). The other theory – a new tax view, which claims that property tax is a diversified capital tax, distorting allocation of capital in local jurisdictions. It was derived by P. Mieszkowski (1972) and H. J. Aaron (1975), and next elaborated by G. R. Zodrow and P. Mieszkowski (1986).

The article is aimed at the attempt to refer the recommendations of the contemporary theoretical achievements describing economic effects of property taxation to the tax practice of certain European countries (for example Poland). There is a research question in the spotlight: could conclusions drawn from these theories support operational transformations of the local tax system in Poland? The implementation of this research goal required the presentation of the current state of theoretical and empirical research on effects of property tax incidence and determination of the basic trends of their further development.

Analysis and literature criticism as well as the intuition method are the research methods used in the article.

2. Character and functions of property tax

Tax on property is a characteristic element of the contemporary system of local government revenues. Its position and fiscal significance are different in European countries, which results from many factors, for example:

- different perception of the local government operational scope (limitation to tasks in the area of public utilities or also support for social and economic development through impact on the environment),
- diversified groups of local taxes (there are two dominating models in which the most important local tax is property tax or local income tax),
- diversified property taxation systems (systems based on the property value registered in property cadastre and systems in which the property area serves as tax basis),
- practical problems connected with property tax (tax basis erosion, incorrect tax management).

Property taxation includes different kinds of levies, for example regular taxes on property and transaction taxes on property. The former usually assume the form of annual payments by the property owner or user. The amounts due depend on the adopted property value measure set at a given moment and periodically updated. And transaction taxes are calculated in the case of property sales or ownership transfers of different kinds. Despite certain common features, the application of regular and

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3 In the structure of local government revenues of federal states property taxes are dominating, for example, in Australia, Canada, Mexico or the United States. While in unitary states property taxes are most significant in the structure of local government revenues, for example in Great Britain, New Zealand, Holland and France (OECD 2013).
transaction taxes leads to different economic and social effects. The article is confined to the presentation of economic and social consequences of the application of regular property taxes (Felis, 2013):

- they cause distortions of the market mechanism on the plane of decisions about the choice between the present and future consumption, and also those about the structure of production and factors of production used;
- they are highly predictable, which is really significant for the public finance stability. They may be ascribed a certain immanent feature – rigid character of revenue reaction to changes in the market situation. The estimated and registered value in the cadastre shows a natural resistance to flexible and automatic adjustment to the market situation changes. A high level of budget revenue stability makes budget planning easier. It is also particularly significant for the investment activity and rationalisation of financial economy of the government sector. It is impossible not to notice a certain cyclicality of this kind of levies (for example tendency to increase tax dues in the phase of price decline), caused by the lack of immediate and full property valuation update;
- the postulate of tax justice is implemented more effectively. Justice standards in property taxation can only be reached through adoption of a value tax basis thanks to which the convergence is possible between the volume of tax incidence and the degree of real ability to raise tax. It is also essential to introduce a complete and coherent cadastre system, honest estimation of property value and afterwards proper management and administration of the cadastre system.

Speaking about the regular property tax, one should remember two different taxes: on residential property and non-residential property (commercial or utility). The need for looking at the problem of taxing utility and residential property is to be justified in the context of the aforementioned planes of distortion of the market mechanism by distorting taxes and the role of tax at the local level. Property in the possession of entrepreneurs is used as a factor of production in the manufacturing process; thus, taxing it leads to the distortion of the structure of factors of production. There are no consequences like that within residential property tax. Property tax may be ascribed certain features regarded as favourable for the local tax system. Therefore, it is treated by the majority of European countries as the most common local tax. It seems that the features which should be possessed by taxes having the basic revenue potential for local governments include: even distribution of the tax basis, territorial explicitness, permanent spatial relation of the tax basis and tax visibility (ensuring social responsibility and transparency). Property characteristics is important as a source category of own revenues at the local level, i.e. diversity, strong connection with a concrete location (immobility) and durability (longevity). Ignoring the scholarly discussion presented in a further section of the article on the scope and nature of property tax, it may be assumed that property tax – on account of the aforementioned arguments and also the relation between the kinds of financial services at the local level and the benefit for the property value resulting from it – is a suitable solution for the financial economy of local governments. However, there are serious
doubts whether or not the role of residential and non-residential taxes may be equally assessed, for instance due to the fact that every tax imposed on factors of production corrects the producer’s market decision adjusting the volume and structure of production to tax rationality (Grądalski, 2006). Hence, the literature underlines that there are many economic arguments in favour residential property tax, which cannot be said about commercial property tax (Slack, 2010). The imposition of high corporate property taxes may hinder investment and modernisation processes. They contribute to a potential threat of creating a trend towards liquidating parts of fixed assets which temporarily, for variety of reasons, may not be involved in manufacturing. This, in turn, means serious distortions of market decisions made by entrepreneurs, whose adjustment reactions are often irrational and costly.

3. Property tax effects in the light of different theories

In the benefit tax view worked out by B.W. Hamilton property tax plays a role of a poll tax as suggested by C. M. Tiebout (1956) in his model of effectiveness of local public services provision. In his model Hamilton makes certain assumptions, first of all: joining entities into local jurisdictions according to demand for public services; a definite number of districts within larger agglomerations providing diversified services; consumers’ perfect mobility in order to make use of public services; compulsory limitations on spatial management applied by communities. According to B. W. Hamilton (1975) these assumptions are sufficient to create equilibrium in which all communities are homogeneous (with regard to public services as well as types of residential property). Obviously, a complete homogeneity of property value in relation to all communities is not realistic, so in his successive research Hamilton extends the logic of the benefit tax view, accepting heterogeneous communities with regard to property value, though they remain homogeneous with regard to demand for public services. Eventually, he proved that within a non-homogeneous community the difference between benefits received from public services and tax incidence are capitalised in the prices of property. Importantly, B. W. Hamilton (1975) claims that the achievement of an effective level of public services will be possible if local governments can impose regulations on spatial economy. Thus, spatial planning instruments used to implement fiscal policy reduce, down to a certain minimum level, the value of residential buildings which may be erected in the area. With such a minimum value, property tax revenue will exactly balance the value of the received public services. Similar conclusions may be found in the studies published by W. A. Fischel (1975) and M. J. White (1975), where the authors focus on the issues of commercial and industrial property taxation, extending in this way the scope of the benefit tax view.

The review of Hamilton’s theoretical considerations allows for the formulation of the following conclusions with regard to the role of property tax according to benefit tax view:
property tax as an effective incidence for using local public services does not lead to distortions of consumption of residential property as well as the level of public services provided;

- replacing local property taxes by other typical taxes at the national level will cause a decline in effectiveness.

P. Mieszkowski and G. R. Zodrow (1986), the representatives of the other trend (a new tax view or capital view) criticize the approach to local property taxes seen from the perspective of benefit. They claim that the assumptions concerning spatial economy are not realistic (extensiveness and obligatoriness). The capital tax view is placed in the general equilibrium model with permanent national capital resources and two types of local jurisdiction characterised by relatively high and low tax rate. P. Mieszkowski proved that property tax rates exceeding an average domestic level will result in the outflow of capital from the jurisdiction with high taxes to the jurisdiction with relatively low taxes. Thus, diversification of property tax leads to an ineffective allocation of capital in different jurisdictions. It should also be noted that an average incidence of all property taxes imposed in the country rests on the owners of capital (the so-called effect of profit), and local differences, in comparison with the average level in the country, are borne by consumers or residential buildings providers. In this view, it is claimed that the imposition of property tax has a progressive character. According to P. Mieszkowski (1972), diversification of property tax also determines the so-called effect of excise, which means that in the jurisdictions with higher tax, residential property prices will be higher and remuneration and land prices lower than in the jurisdictions with relatively low taxes. Assuming that these more or less symmetric effects of excise tend to cancel each other, according to G. R. Zodrow (2007), it is the effect of tax profit that is the major factor affecting the division of tax incidence in the capital view. According to the cited economist, if we assume that this view is right, then the replacement of local property taxes by any typical tax instrument at the national level will have a variable impact on effectiveness. The effect will depend on the relation of the costs of incorrect allocation of capital and insufficient public service provision within property tax to those within the selected tax instrument at the national level.

The following conclusions may be drawn from this trend of research on property tax:

- as diversified capital tax distorts capital allocation in local jurisdictions, in the case of residential property it distorts decisions about residential property consumption;
- the application of the property tax by local governments leads to decline in local public services provision, which prevents the outflow of mobile capital outside their jurisdictions (the problem of tax competition).

To recapitulate different implications of the presented property tax theories in the most synthetic way, it may be stated that the economic effects of capital tax view result from the tax induced relocation of residential property capital, while in benefit tax view such relocations are made impossible by respective limitations on spatial
management or by perfect capitalisation in the context of fully developed communities (Zodrow, 2007).

It appears that the results of empirical research conducted so far aimed at the verification of the new and benefit perspectives do not provide irrefutable proofs of their rightness. In majority of empirical studies the authors focus primarily on the degree in which the property taxes and the level of public spending made by local authorities are capitalised in the value of residential buildings. Although empirical research on capitalisation (Oates, 1969) suggests that property taxes and government expenditure are capitalised in the property value, they must not be treated as a confirmation of the benefit tax view because also in the new tax view there is a phenomenon of capitalisation (Cameron, 2000). Different conclusions on the role of property taxes may be found in the research devoted to the analysis of changes in the aggregated value of wealth tax basis and diversification of rent levels between agglomerations. R. W. Wassmer (1993), R. J. Carroll and J. Yinger (1994) confirmed the perception of wealth tax, postulated in the new tax view as, at least partly, not neutral form of capital taxation.

It is worth adding that although none of the theories have been fully verified in empirical research, they made researchers focus on other important issues connected with immovable property taxation. For example, D. L. Cameron (2000) claims that the benefit tax view became a stimulus to research on the possibility of analysis of wealth tax in isolation from goods and public services which are financed from it. It is primarily about research on political behaviour of local authorities in the area of tax competition, i.e. rivalry of local authorities in attracting capital through changes in property tax rates. This kind of research was conducted for instance by D. Coates (1993) and J. Edwards as well as M. Kenn (1996).

The results of presented theoretical consideration and empirical research conducted so far induce a question about a possibility of reconciliation of two extremely different notional frameworks. It seems that the agreement in the long-lasting debate about which view reflects property tax effects better can be reached due to hybrid models (hybrid models with immobile inhabitants, hybrid models with perfectly mobile inhabitants and interjurisdictional capitalisation model)\(^4\). Another proposal worth mentioning is the one according to which a research trend should focus also on a strategic choice, which is synonymous with the application of models which would use the game theory (Mandel, 2001) with regard to reflect local governments and other entities.

### 4. Conclusions

1. Summing up the achievement of influential studies on property tax it may be stated that although there is no consensus with regard to many issues, both approaches have a considerable value. It should be assumed then that we have to do with the

\(^4\) Description of models: e. g. Zodrow (2007).
tax that cannot be said to be a pure benefit tax because the owners of property when improving the property will be borne with a higher tax and in this discouraged from any investment. Simultaneously, the advantages resulting from social and economic programmes implemented at the local level are reflected in the value of the local property.

2. The research on the issues connected with property taxation is closely connected with the research on public benefits as - what is mentioned by D. L. Cameron (2000) – every analysis of general equilibrium in the area of property taxation has to refer to public goods provided with the use of property tax system.

3. The evolution of the property tax doctrine presented in the article and empirical research conducted for nearly 40 years should be taken into consideration in the discussion on property tax in Poland.

4. Economic wealth taxation models used in different theories may be considered in creation of social and economic policy programmes within the frameworks of which the diversification of tax rate levels and certain procedures of tax basis estimation will encourage the protection of agricultural land or development of urban areas.

References


NEKILNOJAMOJO TURTO MOKESČIO KAIP ESMINIO VIETOS SAVIVALDOS PAJAMŲ ŠALTINIO EUROPOJE TEORINĖS KONCEPCIJOS

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Santrauka

Raktiniai žodziai: vietinių mokesčių sistema, nekilnojamojo turto mokesis, vietos savivaldos pajamos.
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