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**THE REFORM OF
URBAN LAND FINANCES**

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Executive Summary

1. Generally speaking, it can be said that the regulatory framework regarding both financing of infrastructure construction in municipalities and urban land management is rather bad. Above all, the current Constitution does not allow private property over urban land. Besides that, the Constitution does not recognize the concept of municipal property and the Law on the Property of the Republic of Serbia explicitly states that all the property used by municipalities is the property of Serbia. The model inherited from the previous regime, and which was not substantively reformed is based on the following elements:

- the monopoly of the public (state – Republican) property over urban land;
- non-existence of the urban land market;
- administrative allocation of land;
- discretionary decision-making by public officials;
- fees as quasi-fiscal mechanism for collection of local revenues.

2. Land use and land service fees, as the most important sources of revenues for urban land financing, have major conceptual problems and are totally inadequate for the modern market economy.

3. The standard criteria used for calculation of fees (location, use, size of structure) can only partly be justified. It can be concluded by examining the applied criteria and methods of determining levels of the fee that the real aim is to put financial burden on the value of the land, i.e. to tax property.

4. Municipalities in Serbia apply very different methods of calculation and collection of the land use and land service fees. Methods applied for collection of land use fee are mostly very discriminatory towards service and commercial activities and in favor of industry. Also, businesses pay much more than physical persons.

5. Municipalities analyzed in this study have created specialized public companies for managing urban land. Although they are formally public companies, these organizations, as indirect budget users have no independence in doing their business activities.

6. One of the factors of inefficiency of existing system are social and political criteria applied to calculating the levels of the urban land related fees. As any other public activity, the urban land management in a democratic transition country is necessarily politicized, and the decisions are made, not only based on financial and economic analyses, but also by taking into consideration political issues: who wins, who loses, what political effect will some decision have on the government rating, what are the interests of the coalition members, how shall the voters react etc.

7. In the best-case scenario, if major changes were desired, it would be necessary to implement comprehensive urban land privatization and to incorporate land use fee in the property tax. Until recently, one of the reasons municipalities were reluctant to integrate tax and fee was that land use fee was original municipal revenue, while property tax represented a transfer from the budget of Serbia. However, since the new Law on Financing of Municipal Self-Governments has been passed, it is clear that such reluctance is now obsolete. Also, the fact that municipalities will have

to define property tax rates presents an excellent opportunity to integrate the tax and the fee, to calculate it and collect jointly.

8. It would be ideal if the current, administratively determined property tax base and land use fee base were changed to market determined tax base by using computerized mass property appraisal systems¹, which would significantly reduce administrative costs, increase fiscal revenues, and lead to a more equal distribution of tax burden, since the tax would depend on the property value, not on discriminatory administrative decisions. Also, as a result of well argued theoretical conclusion that property taxes (especially land taxes), compared to other tax bases (revenue, income, profit) generate significantly lower dead-weight loss, the increase of property tax with simultaneous reduction of some other taxes would have significant positive effects on economic efficiency of the overall economy.

9. Integration of the land use fee and property tax could be done in several ways. The first way would require the amendment of few laws (Law on Planning and Construction, and the new Law on Financing of Municipal Self-Governments) and adequate increase in the maximum property tax rate. The second way would be amending two mentioned laws in order to define the land use fee as *ad valorem* fee (the percentage of the market price). Third and probably the least effective way would be to leave the decision to municipalities whether they want to integrate the fee and the tax. It seems that existing Directorates could have a role in the administration of such fiscal revenue, since they have the information on existing objects, and on object under construction. Even if the integration does not occur, it would be advisable to use the capacities of Directorates in collecting property taxes.

10. Which are the major obstacles to the integration of these two public revenues? It seems that the obstacles are mostly political. Property tax is relatively unpopular tax, since it is direct (tax payer are fully aware of the taxes they pay) and it does not allow the same level of discrimination of legal entities in favor of physical persons. This discrimination is surely politically popular since legal entities do not vote. The quoted study has demonstrated that the integration would result in significant increase of the total tax payments by physical persons, relative to legal entities.

11. If municipalities, for whatever reason do not want to integrate tax and the fee, it would be advisable to implement the following proposals:

- stop the discrimination of service and commercial activities relative to industry
- increase the number of zones, especially in Belgrade
- use the same zone classification for both fees and property tax, in order to create the single registry database which would reduce the administrative costs
- harmonize criteria for the collection of land use fee and property tax
- include the land use fee in the joint collection system, if possible
- start the preparation and implementation of longer term business plans, since currently only one year plans are being prepared

¹ For the detailed proposal of integration of land use fee and property tax see «Taxation Reform 2» CLDS, 2004

12. Regarding the level of the Republic of Serbia, it would be advisable to amend the Law on Financing of Self-Governments in order to specify the maximum land use fee and prevent huge discrimination. Potentially, municipalities could introduce specific group of activities, in which one single activity would be in (maybe even just a single company) and charge the land use fee 100 times higher than for any other activity. According to current regulations it would be possible, and it has already happened with some other municipal fees, especially after the big companies are sold to large foreign investors. The government of Serbia has a strong interest to prevent such behavior of municipalities and in that sense a certain level of legal security has to be guaranteed to the investors.

13. Regarding land servicing, the current system, in which the land servicing includes directorates on one side and local communal companies on the other side, is unnecessarily complicated and nontransparent. Also, this system will become mostly obsolete and pointless when the land is privatized.

14. Land servicing includes two types of activities, with different economic character – some of them are public, and some are private goods. Regarding private goods (economically speaking), such as water, sewage, gas etc., investor should negotiate the price and other terms and conditions directly with the company, whether local public, or any other. Directorates (or similar institutions) should be in charge (and financed for those activities from the local budget) for providing the land only with the local public goods – atmosphere sewage, roads and sidewalks. Land service fee would then be much lower than it is now, set at the average costs of providing those local public goods. Also, since local public companies are local monopolies, a regulatory mechanism has to be put in place in order for them not to abuse monopoly position.

15. Regarding the future of directorates and similar organizations, it can be concluded that, at medium term, their perspective is rather good. Taking into account that, when the new Constitution is passed, the privatization and denationalization of the land can be expected, directorates represent a natural choice for implementing one part of the privatization process, since they know the local circumstances, have a needed technical knowledge and sometimes even experience in performing similar tasks. It is needed to join the resources existing in these Directorates with the experience and knowledge of the Privatization Agency employees, in order for the process to work well.

16. However, the question of long-term future of the directorates, after the privatization of land is finalized, is not that easy. Then, it would be very difficult to find the rationale for providing private goods to the private land by state company, taking into account that the owner, in accordance with the zoning regulations, will be able to service the land and transfer the ownership. Directorates, as indirect budget beneficiaries, are not even now real public companies. It can be expected that the tendencies of taking their responsibilities away from them will be continued and that they will be transformed into agencies or similar municipal bodies. As already mentioned, they will probably, in the name of the municipality, finance land servicing with local public goods, but that job will be of much lower scope than today's. Also, directorates (or government bodies of similar authorities) would continue performing tasks which shall not be influenced by privatization, such as financing of street refurbishment, maintenance of buildings, public lights etc.

1. Introduction

Municipalities in Serbia are facing significant challenges in terms of development and implementation of urban land policies, as well as in terms of maintenance and development of communal infrastructure. Larger cities, such as Belgrade, collect significant resources from land use and land service fees, but the way those fees are collected and used is not generally known. Zones and levels of fees are frequently determined in an arbitrary and nontransparent manner, with significant discrimination among users. Also, unclear and undefined regulatory and legislative framework resulted in a significant variation among Serbian municipalities, so there is a need to evaluate different mechanisms and to propose changes.

Also, this system will, most likely in the near future, undergo through significant changes. First, privatization of urban land will probably occur. It will render many of the used mechanisms obsolete. Second, property tax will become significant source of revenues for the municipalities, which should lead municipalities to turn to traditional sources of revenues (taxes) and away from the various quasi tax instruments, such as fees.

Having in mind the significance of land as a resource necessary for dynamic economic growth, it can be concluded that the urban land policy is one of the areas that really needs reforms. Although the part of the existing problem is linked to the Constitution, it seems that it would be possible to accomplish many things in order to make the system more transparent, just and efficient, even in the current constitutional framework.

Having that in mind, this Study has the following objectives:

- to analyze and assess the current regulatory framework in which municipalities operate, related to the urban land finance issues
- to analyze and assess specific mechanisms used in five Serbian municipalities
- to offer suggestions regarding identified conceptual and technical difficulties

The following Study has four parts. The first part provides analysis of the current constitutional and legal framework for local urban land policy development, as well as its assessment, from the point of view of economic efficiency and consistency of existing mechanisms. The second part provides overview of five specific urban land finance systems used by the following municipalities: Belgrade, Subotica, Kragujevac, Paracin and Smederevo. The third part gives the assessment of the effects of the current system, specifically taking into account five examples. The final part provides some specific suggestions and recommendations.

2. Regulatory Framework

The Constitution of Serbia (articles 69, 114 and 115) stipulates that municipalities in Serbia have to have budgets which contain all of their revenues and expenditures, and that all of the budgetary resources are gathered through taxes and other public revenues, established by a law. It also envisages that municipalities can define organization and management structures in the municipal Statute. Article 60 of the Constitution envisages that all of natural resources and goods in public use, as goods of public interest, jointly with urban land, are either socially- or state-owned. Also, one of the provisions, which significantly limits the powers of municipalities, is a provision of the Law on Property of Republic of Serbia, which stipulates that all resources obtained by municipal bodies and organizations are the property of the Republic of Serbia.

Law on Public Revenues and Expenditures (article 25) prescribes that, for financing the public expenditures, the municipality can have the following revenues:

1. taxes - part of the personal income tax, property tax, inheritance and gift tax, property transfer tax;
2. charges - local communal charges, municipal administrative charges;
3. other revenues - fees for land use, construction, maintenance and usage of local roads and streets and other municipal infrastructure, for the protection of environment and other public revenues.

Law on Local Self-Governance (article 78) lists original municipal revenues:

1. municipal administrative charges;
2. local communal charge;
3. temporary stay charge;
4. land use fee;
5. land service fee;
6. natural medical factor fee;
7. environmental protection fee;
8. revenues from renting state property used by municipality, or other organization established by a municipality;
9. revenues from selling movable state property used by municipality or other organization established by a municipality;
10. revenues from concession fee for performing communal activity and revenues from other concession activities which municipality negotiates in accordance with the law;
11. revenues from interest earned on municipal resources;
12. fines charged in the misdemeanor procedure for misdemeanors introduced by the act of municipal assembly, and assets forfeit in that process;
13. revenues collected by municipal bodies, institutions and organizations in performing their duties;
14. voluntary taxes introduced in the municipality;
15. grants;
16. other local public revenues established by a law.

Law on Financing of the Local Self-Governments also lists all of the original revenues of municipalities, but somewhat differently, since property tax is defined as the original municipal revenue, but the natural medical factor fee is no longer on the list.

The primary interest of this study is specifically the treatment of urban land, usage, financing of preparation and servicing the land and the collection of revenues linked to it. The Law on Planning and Construction (article 73) prescribes that construction land is the land on which the objects are built on and the land used by these objects. Also, the construction land includes the land that is planned for construction. According to this law, construction land can be either public or other land. The idea of this separation into public and other land was the attempt to circumvent the above-mentioned constitutional provision. Since the «other land» category does not exist in the Constitution, the obligatory state ownership is not necessary, so it seems that the intention was to allow the privatization of the land. The effects have so far been rather limited. The possibility that any individual privatization is judged to be unconstitutional represents significant obstacle for the initiation of privatization. However, it is interesting that three years after the adoption of the Law on Planning and Construction, nobody challenged this provision at the Constitutional Court.

The public construction land is considered to be the land on which public objects are built on, the land under the public areas, and the land on which the construction of public objects or public areas is planned. The public construction land can be prepared or unprepared, constructed or unconstructed. The municipality services the public construction land and takes care of its use in accordance with the plan. Preparation of the public construction land is consisted of its initial preparation and it's equipping.

The Law also provides opportunity for municipalities to create a public company or other institution, in order to provide conditions for preparation, usage, development and protection of construction land. The municipality statute defines the way these tasks are organized.

It is envisaged that the financing for preparation of the construction land is provided from the following public revenues:

1. construction land rent;
2. land service fee;
3. land use fee;
4. other sources defined by the Law.

Proceeds for the land service and land use fees are used for the preparation and equipment of the construction land and for the construction and maintenance of the communal infrastructure objects. Land service fee is paid by the investor (developer). The level of the fee is determined in the contract signed between the investor and the municipality or the authorized company and is based upon the criteria set by the municipality. The contract defines the conditions for the preparation of the land, the level of the fee, dynamics of fee payments, as well as the scope, structures and deadlines for the preparation of the land.

Land use fee for the constructed public construction land and state-owned other construction land is paid by the owner of the building. The level of the land use fee is determined based on the scope and level of the land equipment, the highest possible construction index, its position in the settlement, proximity to the objects of social standard, street linkages to local center, industrial zones and other structures in the settlement, or other conveniences that are provided to the user. The municipality is authorized to define specific criteria, level, ways and dynamics of paying the fee. The forced collection of this fee is done in accordance with the Law on Tax Procedure and Tax Administration. It is interesting to notice that the law does not prescribe the discrimination based on the economic activity, although municipalities discriminate heavily.

Land use fee is also paid for the privately owned other construction land if it has been equipped with the basic communal infrastructure (power grid, water, sanitation, road) by public resources or other resources in state ownership.

The Law on Planning and Construction also prescribes (with the intention of circumventing the constitutional limitation regarding the property) that other land is all constructed land not designated as the public construction land. It is also envisaged that the municipality is taking care of the rational use of other construction land and can adopt a program of the servicing of that land. The municipality can buy, equip, rent or sell other construction land, in accordance with the law. Other state owned un-constructed land can be rented out, for construction by public bid or sealed bid procedure.

2.1 The Assessment of the Regulatory Framework

Generally speaking, it can be said that the regulatory framework regarding both financing of infrastructure construction in municipalities and urban land management is rather bad. Above all, the current Constitution does not allow private property over urban land although the Law introduces the concept of the other construction land in order to circumvent this constitutional provision. Besides that, the Constitution does not recognize the concept of municipal property and the Law on the Property of the Republic of Serbia explicitly states that all the property used by municipalities is the property of Serbia. Fortunately, these provisions are not really implemented, so that, effectively, municipalities are managing the urban land. It is clear, even from these two general provisions that efficient and effective urban land management is practically impossible.

The model inherited from the previous regime, and which was not substantively reformed is based on the following elements:

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- the monopoly of the public (state – Republican) property over urban land;
- non-existence of the urban land market;
- administrative allocation of land;
- fees as quasi fiscal mechanism for collection of local revenues.

The existing model, although bad, is relatively consistent. Taking into account that private property is not allowed, the market cannot exist. Also, in these circumstances the urban land can

only be allocated administratively, and it is not possible to use property taxes as a way of collecting revenues. Therefore, municipalities introduce fees as a substitute for taxes.

2.2. The assessment of the land use fee

The revenues from the collection of the land use fees were 5.5 billion dinars in 2005 in all municipalities in Serbia (around 70 million Euros). These revenues were an important source of revenues for the Serbian municipalities, especially cities, which have the most valuable land and real property. Also, revenues from rents should be added to these revenues (869 million dinars in 2005), resulting in total revenues of 6,408 million dinars in 2005, or 6.3% of total municipal revenues.

The Law on Planning and Construction, as already mentioned, did not prescribe the detailed criteria for the collection of this fee, but has left this jurisdiction to the municipalities. Therefore, there are significant differences among municipalities regarding the methods used to determine all the relevant factors –base, rates and exceptions.

The standard criteria used in order to determine the level of the land use fee are:

1. area of the constructed object
2. location of the land/object
3. the purpose of constructed object

We can immediately note that the fee is usually not paid based on the area of the land, but area of the constructed object. At the first sight, this is wrong since it negates completely the whole concept of the land use fee and introduces additional property tax.

However, the applied principle has some justification. The value of the land is directly proportional to the purpose of the land and allowed area of the constructed object. The value of the land which has or can have a big structure on it is definitely higher than the value of the land which has or can have only an individual house built on it, since the owner does not have a full freedom in construction, but is limited by the regulation plan which usually prescribes the maximum area on the given land. So, the value of the land is, on the free market, directly proportional to the zoning conditions, the purpose of the land and allowed area of the building, so the land on which only individual building is allowed is significantly lower than the value of the land on which the skyscraper is allowed. Therefore, the area of the building is an important factor in the land value and it is only natural that it is taken into consideration when the level of fee is being determined.

However, the bad effect of this method of determining the fee (by using the area of the building, not the area of the land) is potential lack of incentives for efficient use of the land, since those who irrationally use the land pay lower fee. In other words, when someone who keeps a small object on the large lot of land pays the low fee, especially when that land is in downtown area, then it is really difficult to talk about rational urban land management system.

Regarding location as a criterion, it is used primarily as a proxy for location conveniences, which is definitely one of the most important elements of the land value and which is a normal basis for the collection of the rent. However, the zoning practice in Serbia is that usually a small number of zones are determined (in Belgrade only four), so it is difficult for such a limited number of zones to represent the vast variety of location advantages. Furthermore, significant variety exists between micro locations in the same zone – for example between the main street and a side street in downtown. This demonstrates the nonsense of the whole system. By using various criteria (like local conveniences etc.) municipalities are trying to determine the market price of the property, but no explicit reference to market price is mentioned. Various, arbitrarily determined criteria are used, then arbitrary weights are added to those criteria, instead of using the market price of land as a synthetic information about all advantages and disadvantages of the specific location.

Secondly, the location criterion should, according to the Law, represent a proxy for communal and other infrastructure of the location, based on the false assumption that better locations have better infrastructure. Naturally, this assumption is frequently not met, since old town centers, which have the best location advantages also have communal infrastructure of inferior quality, compared to some suburbs. Therefore, many municipalities explicitly also take into account elements of the communal infrastructure, objects of «social standard» etc.

The usual criterion for determining the level of land use fee is also the use of the built structure. At the general level, this approach makes sense since the value of the land depends on the allowed use of the object. If a commercial object is allowed on a specific location, the market price of the land is usually higher than when the only allowed use is residential, even if the allowed area is the same. Therefore, this criterion makes sense and its use should be continued.

In Serbia, however, this criterion is perverted in practice. When the level of the land use fee is determined, the municipalities usually go far beyond the traditional use of this criterion. Instead of using the traditional possible purposes (residential, commercial, industrial), many municipalities include various social and development elements, providing special incentives to industrial use (or alternatively – providing special disincentives to commercial activities).

Even if it is accepted that criteria for determining the level of the land use fees are chosen well, the question of quantifying and weighing remains as a problem. Namely, each of them has to be expressed in dinars or points and objective way of quantification does not exist. Which ratio between business and commercial land use fees is the right one – the one used in Belgrade of 66.3 or the one used in Paracin of 14.4? It is clear that only using the market price and a unique tax rate provides objective ratio.

As we have demonstrated, there are significant conceptual and technical weaknesses in the procedures used to calculate land use fee. It can be concluded that land use fee does not represent exclusively a fee for using communal infrastructure, but also a method of property taxation, since it does not exclusively depend on the communal infrastructure provided to the land, but mostly depends on other criteria.

Based on the analysis of the land use fee, we can make two conclusions, which are relevant for the purpose of this study:

1. It is evident that the procedure for determining land use fee represents the attempt to assess the value of the land by using many parameters, such as area, location and purpose; this attempt can not succeed since, as the experience for the 20th century demonstrates, the government can not assess, outside the market and without market prices, the price of an economic resource. The concept itself is flawed and the quantification is impossible, since there are too many unknown variables.
2. Land use fee suffers from the problem of the unclear character: does it represent a rent, or a charge for infrastructure, or a property tax? It seems that the answer is – all of the above –, which does not solve the problem since triplicity of character makes the meaningful policy development and implementation impossible.

2.3. The assessment of the land service fee

The second land fee that is used is land service fee. It is paid by the investors prior to the beginning of construction works, for the expenses of equipping the land with the needed infrastructure. In other words, through paying the land service fee, the investor acquires right for:

1. land preparation – solving property disputes, dislodgement, plans and technical documentation, readjustments of the terrain
2. equipping the land with the needed communal and other infrastructure – water, sewers, roads and streets, parking places, green areas etc. In Belgrade, for example, these costs do not include power grid, telecommunication network and heating, which have to be negotiated separately, while in Novi Sad power grids and heating are included in price.

Total revenue from the land service fee was very high in 2005 (10.5 billion dinars – around 120 million euros), which represents 10.3% of total municipal fiscal revenues. Practically all municipal decisions state that this fee is calculated based on real expenditures for preparing and equipping the land, but one can observe that the level of the fee is determined based on completely different criteria. These criteria are usually the same as the ones used for determining the land use fee: area of the object, purpose and location. Most frequently the quantification of the criteria is different between these two fees – different number and location of zones, different classification of potential object purposes, different criteria for determining communal infrastructure – but the principle is the same. As with the land use fee we can see the attempt to tax the value of the object and of the land through this fee.

In principle, the linkages between the value of the location and its communal infrastructure should not exist. It is logical to assume that all locations in a settlement have equally good (or equally bad) communal infrastructure, but that the value of locations is very different. It is obvious that land service fee does not simply represent compensation for the communal infrastructure costs, but also a way of collecting city rent.

In some cities (Belgrade, for example), when the land is being leased, this fee is basically used as the auction price, so that the land is leased to the bidder that offers the highest land service fee. This system leads to excellent results on New Belgrade and other attractive locations. This bidding mechanism of determining level of the fee clearly demonstrates that city authorities recognize that the traditional way of determining the fee – through the use of formulas – is not the most adequate and that results are sub optimal, especially when the best locations and good investment climate are at stake. It is obviously superior method to have an auction and collect significant proceeds, but also select the best investors – those who are willing to pay the most for the specific land.

Undoubtedly, significant resources collected by using auctions (tens of millions of euros) have no real link to the quality of communal infrastructure and expenditures linked to it, but represent capitalized rent. In other words, high level of land service fees is actually a price for a right to use attractive location. This price does not give full property rights to the investor, but only the right to use, and therefore it is not a purchasing price.²

This completes the land use system:

- the first component is a one time paying of the land service fee; a part of it are costs of infrastructure, but a part of it is a price of land which is almost solely determined by the attractiveness of location;
- the second component is a rent/land use fee, which is paid monthly

That way of collecting (one part up front plus periodically) seems useful for the municipal public finances, since this way they are able to collect significant resources needed in short run. Periodical rent/land use fee stream is coming continuously.

Land service fee therefore only partially represents what it nominally is – the infrastructure cost. Furthermore, it can also be claimed that this role of the land service fee is useless and that it represents the relic from the old days when it was necessary to justify its collection, so the reason of covering past and future costs was made up although it is quite obvious that the level of the rent does not depend on the level of the these costs, but on some other criteria. And these criteria try, by using formulas, to establish the value of the land, which has nothing to do with the infrastructure costs. This little game did not make a lot of sense at the time when it was introduced, and it makes even less sense now, when the circumstances have changed. Now it should be possible to collect from the investor not the reputedly costs of infrastructure, but collect what it really is – full rent in accordance with the value of the land. The state leases the land to the investor and it has a right to collect rent in the form that is the most suitable for both sides – either as a one-off payment or as a periodical payment.

At the end, who is managing the urban land? One of the issues, which the Law on Planning and Construction left for the municipalities to decide, was the way of organizing the management of the land. Two basic forms of managing the land evolved – the local public company (Directorate) or the municipal administrative bodies.

² Although de facto the ownership is transferred jointly with the existing structure

Poll done for the purposes of the CLDS Study «Privatization of the state owned land in Serbia» has shown that 71% of the municipalities have decided to transfer the urban land management to the specialized public companies, while 29% are doing it through municipal administrative bodies.

There is vast a variety of names among the public companies dealing with the urban land management, reflecting the variety of their competencies. Most of these companies have a word «directorate» in the name, although it doesn't fit with the fact that these are companies, although public. Frequently there is a word «construction» in the name, suggesting that the company has a wide range of activities in the construction industry. Also sometimes «urban land» appears in their names, usually linked to roads, construction, communal activities etc. Public companies exclusively dealing with urban land are rare.

In those municipalities, which have decided not to create a special company, these tasks are mostly performed by different departments (urban planning, economy, communal activities). Some other municipalities have budgetary funds that manage urban land, while administrative tasks are performed by municipal administration.

3. Case Studies

3.1. Belgrade

3.1.1. *Financing*

The municipal Decision on the Land Use Fee specifies that paying of the fee is mandatory for all the urban land, both publicly and privately owned. The decision basically has the same provision as the Law on Planning and Construction about criteria that will be used (which, as already mentioned does not contain the possibility to use economic activity as one of the criteria), but the City of Belgrade does use economic activity as criteria. In that sense, Belgrade discriminates based on economic activity more than any other observed municipality, and separates all of the economic activities into five groups with two subgroups within each group. Economic activities are grouped by statistical codes of activities. On the other side, whole Belgrade is divided into only four zones, which is definitely too few. In principle, it can be said that Belgrade is regulating in detail something that probably should not be regulated at all and does not regulate in detail something that should be regulated in more detail. Huge discrimination can be observed. For example, if a company from group two, subgroup A (e.g. slaughter house) has a building in the I zone it pays 1.24 dinars/m². A company from the group six, subgroup B (e.g. wholesale shop) pays 96.75 dinars/m².

It is important to mention that, unlike other municipalities in Serbia, the management of the database used for the collection of land use fee is not performed by land directorate, but by Belgrade Institute for Statistics and Informatics. Physical persons are paying land use fee through joint collection system, jointly with other communal services. Legal entities pay the land use fees

through Tax Administration. The land directorate does not use the revenues generated from this fee, but it is exclusively financed by the proceeds from the land service fee.

The municipal Decision on Criteria for Determining the Rent and Land Service Fee specifies that this fee is determined by using zones and economic activity as criteria. This decision separates the City of Belgrade into 6 zones. It seems that 6 zones are not enough for the city the size of Belgrade. Also, zones are specified differently than for land use fee.

Land servicing includes costs of preparation and equipping the land, specifically:

- preparation of the urban land includes exploratory works, preparation of geodetic and other bases, preparation of planning and project documentation, solving the property issues, demolition of objects, preparation of land service program etc.
- equipping includes construction of water network and objects, sewage, streets, parking, construction of public green areas etc.

It is important to mention that land service fee does not include costs that are separately negotiated with municipal communal companies (electricity, distance heating, cable systems, gas network).

The level of the fee is determined depending on:

- the costs of servicing the land
- the intended use of the object (land)

One should keep in mind that although the Decision explicitly states that the level of the fee depends on the costs of servicing, it can be concluded, from the following Decision provisions, but also from the practice, that that is not so. The fact that land is frequently being auctioned by using the level of the land service fee as the auction price clearly demonstrates that this fee has nothing to do with costs. The fee is used to simulate the market, which is good.

Land service fee is paid by area of the object, not by the area of land, and it depends on the intended use. The level of the fee is between 3,419 dinars/m² (40 euros) for social objects in V zone, and 38,220 dinars/m² (450 euros) for commercial objects in Extra zone.

Regarding intended use of objects, six groups of economic activities are defined: social objects, residential objects, industrial objects, service objects, commercial objects and single-family housing. It is obvious that level of the fee is administratively determined and that they have no clear link to real costs. For example, in the I zone, the fee for industrial, service and commercial buildings is 16,303, 19,950 and 27,300 dinars/m². It is difficult to see why the costs of servicing the land where the commercial object is going to be built (like supermarket) «costs» 67% per m² more than when the factory of equal size is being built. It seems that this is the relic of communism when special importance was given to industry and therefore they were «supported». One positive example from the decision is that in the extra zone the fee is the same for condominiums and for single-family housing – 20,475 dinars/m². What is surprising though, is that in all other zones the fee is 60-65% higher for multi family housing than for residential objects per m². Also, worth mentioning is the fact that when gas stations are constructed, the

level of the fee is multiplied by 2, and the area beneath the gas station roof is taken as full size. This land does not impose costs for land servicing.³

It is interesting to see which fee reductions are stipulated in the decision. First of all, there is Red Cross (40% reduction), state administration (20%), apartments built by the Solidarity Fund, apartments built by the Foundation for Housing of Young Scientists and apartments built for socially vulnerable groups, financed from the budget. It is interesting to see that the fee is reduced by 90% when religious objects are built. This means that this fee is not only used to pursue social and economic goals, but also as a tool of religious policy.

Also, it is expected that Directorate does not pay the fee to itself, so when it is constructing apartments and other objects for the purpose of dislodgement, this fee is not paid. The same is applied when any communal object is built.

3.1.2. Organization

The municipal Assembly of Belgrade has created a Public Company for Urban Land and Construction of Belgrade in 1995 as a successor to the previously existing City Social Fund for Roads and Urban Land. The public company's mandate is to:

1. Prepare the “Program of Urban Land Servicing and Construction of Communal Infrastructure with Financial Plan”;
2. preparation of studies and feasibility analyses, activities on preparation, communal equipment and servicing of urban land;
3. preparation of all required bases and elaborates for renting the land, specification of the reservation price of land, implementation of the renting process and negotiation of contract with the future users of land;
4. protect and take care that the urban land is being used rationally;
5. manages data base on urban land;
6. activities of engineering, consulting and management during the preparation of land and construction of public objects;
7. preparation and construction of Belgrade subway system and all capital object of city significance;
8. purchasing, selling and renting the real estate for the purpose of land servicing.

Besides the items defined in the Decision, the land directorate independently prepares and submits to the City Assembly the Draft Decision on the Criteria for Determining the Rent and Land Service Fee.

Directorate employs 306 people (out of which 166 with university degree). The Report on activities in 2005 states that total planned revenues were slightly above six billion dinars (70 million euros). Collected revenues were 97% of planned. It is important to mention that the

³ This example demonstrates that land service fee comes down to collection of city rent, and has nothing to do with real costs of land servicing.

Directorate, as all other similar institutions in Serbia operates within the public finance system of Serbia as an indirect budget beneficiary, within the consolidated treasury account of the city of Belgrade. That means that, if we take into account the whole collection of land service fee (not just the part which was allocated to the Directorate), total revenues were around 8 billion dinars (95 million euros) or 132% of the planned amount. Revenues from the land service fee were two billion dinars above the plan and as such are registered as surplus in the City of Belgrade budget. These resources are transferred to the 2006 Directorate budget.

Out of total six billion dinars, 94% are budgetary resources, while remaining 6% are own Directorate revenues. Directorate is calculating, contracting and collecting both budgetary and own revenues. Budgetary revenues are transferred to the budget and then transferred back to Directorate in accordance with the financial plan of the Directorate.

The most significant budgetary revenues in 2005 were:

1. Funds from 2004 – 1,500,000,000
2. Land service fee – 4,004,788,000 dinars, although the total collection was 6,063,059,485 dinars (50% more than planned)
3. Land rent – 52,756,696 dinars. This revenue is also budgetary revenue and is collected by the Directorate for the budget, in accordance with the contracts negotiated by the Directorate with the users.

The most significant own revenues are:

1. Funds from 2004 (surplus) – 230,862,100
2. Sale of apartments and business premises, rent of apartments and business premises and others – 121,827,956 dinars

Regarding expenditures, they can be grouped in the following programs:

I Program of servicing of the public construction land:

Category	Amount (din)	%
1. Obtaining plan documentation	413,197,012	7.98%
2. Streets	1,389,903,232	26.83%
3. Water	1,927,589,876	37.21%
4. Sewage	629,813,190	12.16%
5. Preparation of free areas	5,519,086	0.11%
6. Construction of cemeteries	814,688,681	15.73%

II Program of servicing of other construction land

Category	Amount (din)	%
1. Construction and acquisition of apartments and other space for dislodgement, solving the property issues, reconstruction of housing and business premises	177,636,031	80.29%
2. Preparation of land for auctioning	20,713,775	9.36%
3. Arrears	22,889,864	10.35%

Expenditures for the Directorate operations are planned in the amount of 600 million dinars and actual expenses were 445 million dinars, or 74% of the plan. In that sense, the Directorate can be assessed as relatively efficient, as the ratio of operations expenses was 7.5% of the total expenditures.

3.2. Subotica

3.2.1. Financing

The municipal Decision on Criteria for Determining the Rent and Land Service Fee stipulates that the fee is calculated by taking into consideration the existing communal infrastructure. For example, if the location is fully equipped (which includes electricity, sidewalk, sewage etc.) the basic fee is from 45dinars/m² (for the VII zone) to 2,300 dinars/m² (for extra zone). This basic amount is multiplied by a coefficient, which depends on the economic activity on the property. This coefficient varies from 0.5 for public buildings to 2.5 for gas stations, casinos etc. As in Belgrade, industry pays lower fee (coefficient 1.2) relative to the services (1.8) and commercial activities (2). Unlike Belgrade, where single houses pay lower fee, the situation is opposite in Subotica (coefficient is 0.8 for apartments and 1 for single family houses)⁴. It is also interesting that in Subotica religious objects are not being subsidized (the coefficient is 1).

Regarding fee reductions, the Mayor can reduce the fee mostly by 25%, as «an incentive to construct the building of the special interest for the municipality». He can do that in the following cases:

- significant number of people will work in the building relative to the size of the building;
- investor is investing significant resources in communal infrastructure which is of public importance;
- the investor will pay the contracted amount within 30 days;
- the object is helping the preservation of environment.

The municipality of Subotica is divided in eight zones (extra zone plus seven), which seems too much, taking into account the size of the town and the number of villages. Also, it is not clear

⁴ It is possible that this policy choice is the result of the fact that Subotica is the town with the lowest housing density in Serbia. This means that more revenues are being collected.

why the villages are grouped into different groups, so the fee is in some of the villages (like Backo Dusanovo) twice as high as in other villages (like Tavankut). It would be difficult to justify that costs of servicing the land are twice as high.

Subotica calculates the land use fee by using points, which is probably the worst and the most complicated method, as it demands a lot of detailed data, and a lot of those data are subject to frequent changes. The level of the fee is determined by the following 6 groups of criteria (the number of criteria in each group is given in the brackets):

- communal infrastructure (13);
- proximity to commercial objects (1);
- proximity to non-commercial objects (6);
- quality of the environment (2);
- special urban landmarks (2);
- specific elements (6).

Analogous groups exist for industrial and business buildings, but those groups are differently defined and weighted.

This method demonstrates that the essence of this fee is not just to pay for the usage of public land, but that it also represents a way of collecting the property tax. Also, it can be concluded that it is practically impossible to maintain database for just and efficient collection of this fee. For example, we can take construction of a department store, which determines the level of the fee, as one of the commercial criteria. After a new department store is built, it would be necessary to redo the weighting of points of all the land in the city. The same should be applied when a new pharmacy or new cinema is built, which are, for unknown reasons, considered to be non-commercial activities.

3.2.2. Organization

Public Enterprise “Directorate for the Construction of Subotica Municipality” has been established only recently (June 2005) jointly with the Public Enterprise “Institute for Urbanism”, by the consolidation of the previously existing Social Fund for the Construction of Subotica and Public Enterprise “Institute for Urbanism and Construction of the Subotica Municipality”.

Municipal Decision on Establishment of the Directorate, stipulates that the activities of the Directorate are financed from the following sources:

- land use fee;
- land service fee;
- fee for construction, maintenance and usage of local roads;
- communal charge for holding a motor vehicle;
- income from rents, from the property used by municipality and organizations established by the municipality;
- part of revenues from wage tax;
- voluntary tax;

- earmarked funds from the budgets of Republic of Serbia or Autonomous Province of Vojvodina;
- grants.

The aim of establishing the Directorate is development, facilitation and provision of the permanent activities in the areas of:

- preparation, protection and rational use of urban land;
- maintenance and construction of communal goods of public interest;
- maintenance, reconstruction and construction of local roads;
- protection of business and housing fund owned by the Republic of Serbia, which is given to management to the municipality of Subotica.

Besides these activities, the Directorate is authorized to perform tasks of the preparation of investment plans, technical and economic services in the area of the building construction, and the supervision during the construction period, for other principals, on the free market. However, until today, within the last few months since the establishment of the Directorate, they haven't used this opportunity.

Directorate is divided in three sectors: technical, financial and general (legal). Financial sector is authorized for the collection of both land use fee and land service fee.

Total revenues planned for 2006 are 876 million dinars (10 mil Euros), out of which 850 million dinars form the municipal budget and 26 million from other sources. Out of budgetary resources the most significant sources are wage tax (217 million), land use fee (130 million), land service fee (121 million) and earmarked sources from the republican and provincial budgets of 120 million for the implementation of three programs.

Regarding expenditure side, for the program of use of communal goods (maintenance of hygiene, public lights and maintenance of Palic lake) 255 million dinars are allocated; program of preparation and equipment of urban land 156 million dinars; program of maintenance and construction of local roads 253 million; program of maintenance of and usage of business real estate 187 million (out of which 110 million for the construction of facilities on Palic Lake and sports center); program for construction of sports facilities 17 million; program of construction of parking places 50 million (financed from the parking construction fee – paid by investors who have not constructed parking space); Directorate operations costs 75 million.

3.3. Kragujevac

3.3.1 Financing

Regarding fees, both fees are introduced by the municipal Decision on the criteria for the determination of rent and land service fee, which is applied to all five city municipalities (Stari Grad, Aerodrom, Pivara, Stanovo, Stragari).

Rent by m² of the structure is determined based on the zone and intended use of structure, and the fee is determined based on the zone, intended use and the costs of servicing. The city is divided in six zones (extra plus five) and possible intended uses are social activities, multifamily housing, industrial, services, commercial, and single family housing.

It seems that Kragujevac is very eager to discriminate service and commercial activities. In the I zone, rent is more than six times higher for commercial, and 4 times higher for services than for industrial activities.

When the land service fee is calculated, the discrimination also exists but is not as significant as when rent is calculated. The ratios of services-to-industry and commercial-to-industry are 1.2 and 1.8. Regarding housing, multifamily housing units pay four times higher land service fee than single family housing units, which is very discriminatory and has bad effects on economic efficiency. Also, religious structures are very favored by collecting only 10% of the usual fee. The following provision is very discriminatory: «companies and institutions established by the city of Kragujevac, when appearing in the capacity of and investor, if they do not provide parking places, pay the fee in the amount of 25 thousand dinars, while other investors pay 130 thousand dinars». This provision gives undue advantage to the state owned investors and creates elementary inequality.

Also, there is a possibility to reduce the fee for 30%, if it is paid within 15 days. The possibility for paying the fee by barter also exists (either by goods, other property or services). This way of paying should not be allowed because of low transparency and high possibility for corruption.

3.3.2. Organization

As in Subotica, Public Enterprise «Enterprise for Construction of the City of Kragujevac» has been established only in 2005 by consolidating activities of “Social Fund for the Servicing of Urban Land”, “Fund for Local Roads and Communal Activities in Villages of the Municipality of Kragujevac”, “Specialized Social Fund for Construction of Waste Water Treatment System and Solid Waste Disposal of the City of Kragujevac” and Public Enterprise “Directorate for Urbanism and Construction of Kragujevac” which provided technical support to the funds. This consolidation of business activities can be evaluated as very useful since it has resulted in clearly defined roles and responsibilities in the process of planning and servicing of urban land.

The plan for 2006 has estimated that total revenues and expenditures of the directorate will be 640 million dinars (out of which 470 million from the budget of Kragujevac and 170 million from the Republican Road Directorate and Republican Water Fund). The most important local revenues are land service fee and land use fee (110 and 100 million dinars) and the part from the wage tax – 85 million. Regarding expenditures the plan estimates following categories:

Category	amount (din)	%
- Water and sewage	35,000,000	3.9%
- water regulation	15,000,000	1.7%

- gas network	27,000,000	3.0%
- power network	7,000,000	0.8%
- streets, bridges	263,000,000	29.6%
- City of Kragujevac	108,000,000	12.2%
- Republican Road Directorate	155,000,000	17.4%
- Preparation of project documents	8,000,000	0.9%
- Construction of business premises	4,000,000	0.5%
- communal maintenance	104,381,250	11.7%
- equipment	2,000,000	0.2%
- other operational costs	160,021,590	18.0%

Directorate employs 40 people. Regarding the collection of rent, the bills are sent through the system of joint collection as of 2003. The result has been an increase in the collection from 10% in 2000 to above 80% in 2005. Regarding the collection of the fee from business entities, the possibility to collect it through Tax Administration has been considered, but the Tax Administration was not prepared for that at the time, so the collation is still being done by the Directorate through monthly bills.

3.4 Paraćin

3.4.1. Financing

The Decision on the Criteria for Determining the Level of the Land Service Fee stipulates that the level of the fee depends on the level of infrastructure equipment of the land and intended use of land. The components of total fee are: costs of preparation of the land, costs of the equipping the land with main routes and primary structures, costs of equipping the land with secondary structures and amenities provided by the location.

For each of the six possible uses (defined the same way in other analyzed municipalities) all the components of the fee related to costs are clearly defined and seem logical, except the fact that in Paracin slight discrimination of service and commercial activities exist related to industry (1,390 dinars/m² for industry and 1,650 dinars/m² for service and 1,920 dinars/m² for commercial activities). It is important to mention that, for this component of the fee, zones are not taken into consideration. Zone comes in effect as another fee component, related to the location amenities. There are six zones, and the fee is between 50 dinars/m² for social buildings in VI zone to 1,900 dinars/m² for commercial use in I zone.

Regarding land use fee, it is introduced by the municipal Decision on Land Use Fee. Paracin is an exception related to other analyzed municipalities as they do not take intended use of the structure into consideration when calculating the amount of fee, if the structure is used for business purposes. In that sense, the level of the fee is between 1 and 3.7 dinars/m² for housing,

depending on the zone, and between 2.35 to 53 dinars/m² for business purposes, annually. Also, the important difference comparing to other municipalities, where the fee is calculated based on the area of the structure, it is determined based on the area of the land in Paracin, if it is larger than the size of structure.

3.4.2. Organization

Regarding Directorate, the Directorate for the Construction of Paracin has been created in 2004. Unlike other analyzed municipalities which specify the source of revenues transferred from the municipal budget (land use fee, land service fee, part of wage tax etc) in Paracin Directorate the structure of revenues is much simpler – out of total 207 million dinars, 195 million is planned as the budgetary resources, 10 million are grants and 1,6 million are own income. Taking into account the provisions of the Law on Public Revenues and Public Expenditures, which defines fees as public revenue, the method implemented in Paracin is fully adequate. Basically, Directorate receives the planned amount of money no matter how hard they try to collect fees so the method applied by other municipalities is misleading.⁵

Regarding expenditures, the plan for 2006 stipulates the following categories:

Category	Amount (din)	%
A Implementation of the industrial zone plan	49,000,000	12.97%
A1 Preparation of the land for the first phase of the zone	11,750,000	3.11%
A2 Servicing of the land for the first phase of the zone	37,250,000	9.86%
B Preparation of the land on other locations	5,671,600	1.50%
C Equipping of the land on other locations	122,215,847	32.34%
C1 Construction of sewage network	21,200,000	5.61%
C2 Construction of streets	30,000,000	7.94%
C3 Preparation of the new city cemetery	2,110,847	0.56%
C4 Construction of low voltage network	5,900,000	1.56%
C5 Construction of open sport facilities	1,500,000	0.40%
C6 Construction of other public areas	10,000,000	2.65%
C7 Maintenance of local roads	23,305,000	6.17%
C8 Maintenance of atmosphere sewage system	700,000	0.19%
C9 Maintenance of public hygiene	9,500,000	2.51%
C10 Maintenance of green areas	5,000,000	1.32%
C11 Maintenance of public lighting	13,000,000	3.44%
D Other	9,620,000	2.55%
E Operational costs	20,215,000	5.35%

⁵ As already mentioned, the revenue from the fees is revenue of local municipality just like any other public revenue. In that sense, the source of financing for operations of Directorates is irrelevant

Directorate employs 25 people. The Directorate is in charge of the collection and administration of the land use fee. The initiative for the simplification of the collection method came from the Directorate as they had significant problems in the administration, especially in the case when frequent changes in the use of object occurred.

3.5. Smederevo

3.5.1. Financing

The Decision on the land use fee stipulates that the criteria for the collection of the fee are: the scope and level of the land equipment, the highest possible construction index, its position in the settlement, equipment of the objects of social standard, street linkages of the land to local center, industrial zones and other objects in the settlement, or other conveniences for the user.

Smederevo is divided in seven zones. Regarding housing, zone coefficients are in the range of 50 to 125. Regarding business structures these coefficients are in the range of 2 to 15, which implies that zones affect businesses much more than housing values.

Smederevo also discriminates in favor of industry compared to services. Coefficient of businesses activity, which is used to additionally multiply the base, is in the range from 1.5 for social activities, over 6 for industry to 25 for financial, technical and business services.

Regarding land use fee, its administration and collection is defined by the Decision on the Criteria for the Determination of Rent and Land Service Fee on the Territory of the Smederevo Municipality. The way of determining this fee is different from other municipalities. Namely, the basis for the determining the level of the fee is based on the average costs of construction in the last year, zone and intended use of structure.

The first element is the most interesting one. The average costs of production “are determined by the Executive Committee of the Municipality of Smederevo, based on the proposal from the Managing Board of the Directorate, based on the average costs of construction, determined in such a way by calculating the average costs of construction obtained from the companies building housing and commercial objects.” Average price obtained this way is totally unreliable and their replacement with some of the other observed methods is advised

Then, depending on the type of structure (apartments, business premises, industrial objects, warehouses etc) this average cost is reduced by certain percentage (for example, for apartments it is 0%, for single family houses 70%, for industrial premises 50%). Then, the basis determined that way is multiplied by some percentage, depending on the zone. That percentage is in the range from 5% for VIII zone to 15% for the I zone. Basically, it means that someone building apartment in the I zone pays the fee in the amount of 15% of the average costs of construction in the last year, while someone constructing the factory in the VIII zone is paying 2.5% of the average cost of construction.

Smederevo Municipality expects to collect 40 million dinars from the land use fee and 45 million dinars from the land service fee.

3.5.2 Organization

Directorate for Construction, Urbanism and Urban Land of Smederevo is established by the municipal decision of Smederevo Assembly in 1995. Directorate is fully responsible for the administration and collection of both fees taking into account that the system of joint collection does not exist.⁶

4. Assessment of the effects of the existing urban land system

The existing urban land property and management systems, as well as the system of financing the urban land hardly has any good sides. The only visible things are its weaknesses, and the further discussion shall be focused on them.

Inefficient land use system. The existing system does not allow the land market and the possibility to transfer the ownership over the land, so it does not recognize the category of market price of land. However, the economic theory and practice of the developed countries demonstrate that without real market of a specific resource there are no possibilities for its rational (or economically efficient) use. In order for allocation to be efficient it is required that the system of transferring resources from the inefficient owners to the more efficient ones – the ones that are willing to pay the highest price for owning it, or for using it,. That mechanism is the market, on which the land is traded based on the free will and agreement of both sides, and on freely agreed prices.

This fact also applies to the urban land as one of the most important resources in modern economies and in Serbia. Namely, non-existence of urban land market means that the price is not determined based on supply and demand, or alternatively said, on costs and benefits that usage of the land creates, but on some other criteria.

When this institutional setup is assessed at the level of one land lot (location) it can be seen that that specific lot is not being used by the potential user who is willing to pay the highest price for using it. It means that the lot is not being used by the most efficient user, but by someone else, leading to the inefficient system. Inefficient allocation of land among users is the result of two factors: first, the user is determined administratively, by the decision of the government body; second, the fee for using the land is not paid proportionally to the amenities that it provides to the user (its potential profitability), but some other price (costs of servicing or administratively determined level of rent, based on social and other, basically political criteria). That system of

⁶ Low level of information related to the Directorate is the result of the fact that the employees of Directorate did not want to provide the Report for 2005 nor the Program for 2006.

price creation usually leads to the price that covers costs no matter how high they are, and not to the economically efficient land use.

Besides that, the right of use of urban land cannot be transferred to other person (physical or legal), which leads to very low flexibility in land use. Namely, the selected user is forced to indefinitely use the land, without taking into consideration changes that have occurred in the business environment in the meantime. It prevents the moving to another location, which reduces the mobility of the users, resulting in the inflexible use of urban land.

Besides non-existence of market, other factors of inefficiency of existing system are social and political criteria applied to calculating the levels of the urban land related fees. As any other public activity, the urban land management in a democratic transition country is necessarily politicized, and the decisions are made, not only based on financial and economic analyses, but also by taking into consideration political issues: who wins, who loses, what political effect will some decision have on the government rating, what are the interests of the coalition members, how shall the voters react etc.

In those circumstances, social issues are taken into account more than they should be. For example, the government frequently shows too much sympathies for keeping the land in use by the inefficient company which still exists only for social reasons, namely to delay the increase in unemployment. Or, when the land use fee is calculated groups of users are defined (citizens, industry, financial services etc) based on their perceived ability to pay the fee.

Of course, these social factors negatively influence the land allocation efficiency, as land is still being used by those who need these social “support”, who are not able to efficiently neither use the land nor pay the real costs of using it.

The following two characteristics of the land use fee are especially negatively influencing the economic efficiency of the land use system:

1. Collection of the fee based on the constructed area; this creates incentives for the inefficient land use, because it does not penalize (financially) the ones who are using the land extensively; so the same price is paid by two users of identical structures out of which one uses the small and the other uses large lot of land in downtown area. This system leads to degradation of the most valuable land, like the one in downtown area, because it does not create incentives to the current user, nor the mechanism to force him to enlarge the building on the valuable land or to move somewhere else if he is not able to enlarge it. In other words, the investor, or the land user, from the point of view of the costs linked to this fee, is indifferent whether the index of construction is 1 or 20, as the only relevant factor is the size of the building. This system directly stimulates inefficient use of land especially in downtown areas. It means that the most valuable land is used by the inefficient user, which reduces overall efficiency of the city economy. This also means that one can observe the ruined houses on the most valuable land in Belgrade, but their users are still paying very low land use fees, as they are determined not based on the size of land, but on the size of structure.

2. The discrimination of users based on the economic activity. The Serbian municipalities have certain affection towards industry and other «productive» activities so they pay relatively low rents and land use fees. This discrimination stimulates inefficient land use even on valuable locations, which should be used intensively, and that leads to sub optimal economic results. In market economies, level of rent (which can up to a certain degree be compared to land use fee) is determined exclusively based on the location since the intended use is a purely private decision of the user, unless of course, it is not in accordance with the urban zoning restrictions. Therefore in market economies, land is used only by intensive land users in the most valuable locations, since others cannot cover costs.

Not only do these two factors of land use and financing system not create incentives for efficient land use, they even create incentives for inefficient use of land.

Lower levels of construction/investments. The existing land use model does not create solid ground for making investment decisions. Namely, these decisions are not solely dependent on the commercial aspect of the transaction, but also on the predictable and stable land use on which the structure shall be built. If the land use system is uncertain or unpredictable, then the interest of potential investor is also lower.

There are several sources of uncertainty in the existing land use system. First, there is the uncertainty of the length of lease. Namely, when the land is either given for unlimited period of time or for a limited period of time there is no solid guarantee that the government shall respect that and that the user will be able to use the land. The government can, and it has done that previously, change the terms and conditions of land use through amending the laws or municipal decisions and to significantly affect the terms and conditions of the lease contract. It is possible, for example, by amending the law to change the period of time from unlimited to limited (such as 99 or less years). It is also possible that the regulation plan is changed and that the possible uses of some land are changed, so that the lease is cancelled based on that. Simply, with the government as the contracting party, the safety of contract is not the same as with the private contracting party, because the government can change the terms of use by one-sided acts.

Second, there is the uncertainty related to privatization of urban land, specifically related to the privatization method. The urban land privatization is a probable option in all transition countries and potential investors have a problem in assessing the probability and the direction of that change. It is reasonable that privatization could create problems for them: 1) since the privatization method is unknown until the parliament adopts the laws, the user can not know until then how will he be treated and whether he will be allowed to continue the use of land; 2) even if he is allowed, he could be forced to pay significant price for continuation of use, which could, with previously paid land service fee, be very high, possibly even higher than he was willing to pay at the first time.

Third, the level of the land use fee and the rent could be changed, leading to another uncertainty. This is not of a private contract where the indexation mechanism can be agreed prior to signing the contract, but it is a contract with the government which can amend it. Long-term effects of such change can be very high.

Fourth, investor can only with very great difficulty, and sometimes cannot at all, estimate the price of land. The reasons are, besides the mentioned uncertainties, non-existence of land market and non-existence of property right over land. Legal urban land market does not exist because it is a state property and can only be allocated for use and users cannot sell it without the structure build on it. The trade of land is allowed only jointly with the structure but then it is not possible to separate the value of the structure from the value of the land. State property of the urban land leads to the fact that each land user has only a part of property rights.

The transfer of land is possible only jointly with the existing structure, but it is impossible then to separate the price paid for the land from the price paid for the structure. Because of the state ownership over urban land, users only have a right to use the land. However, even then the land has certain economic value for the user because it allows economic activities to take place on it. Uncertainty about the value of the land de-stimulates potential investors to invest, as it is difficult to invest in something if you are not really clear on what the market price of it is.

All of these sources of uncertainties reduce the willingness of potential investors to invest in Serbia. This applies both to real estate developers, but also to those investing in other economic activities. This conclusion is also reflected in statements of the current investors – they are unsatisfied with the current urban land system, especially regarding uncertain future of that system.

Reduced fiscal income. The existing urban land system does not allow municipalities to collect as much revenues as it would be possible if the land was privatized. There are several sources of fiscal loss.

The first loss is the loss of privatization proceeds.⁷ Even if privatization process is followed by restitution process, in which one part of urban land is given back to former owners, and for other part the monetary compensation is used, significant additional privatization proceeds can be expected, from the land which was state-owned even before nationalization, and from the probable difference between sale price and compensation price.

Second, current system does not generate as many resources as it could, primarily as the result of lower collection of the land use fee compared to the property tax. There are four components of this loss:

1. Municipalities in Serbia are trying to pursue social policy through land use fees, by differentiating users by intended use of land, which leads to the loss of revenues. If property taxes were collected, which would include land, pursuing those broad social policy goals would not be possible, so the fiscal revenues would be higher.
2. When the zones used for collection of land use fees are large, the average collected fee in the zone is biased downwards. Namely, when it is needed to make a single fee for very different locations, the fee is usually set based on the worst locations in the zone, not based on the best. This process necessarily leads to lower fiscal collection.

⁷ We assume that privatization proceed will not be taken by the Government of Serbia.

3. Less than efficient land use also leads to lower fiscal revenues because the basis for the fee is not increasing as fast as it would if the usage was more efficient. Namely, fiscal revenues from real estate value, including land, critically depend on real estate value as the tax base. So, in advanced cities this value is higher than in less advanced cities and their property tax revenues are higher. The same will be true for Serbia – the better the use of land and the more dynamic economic growth – the more valuable property and more property taxes.
4. Loss resulting from the fact that land is not being sold, but leased to 99 years leads to reduced investors willingness to pay for that land.

5. Several Suggestions

Based on everything stated so far, it is clear that significant changes are necessary in the way the urban land financing system operates.

In the best case scenario, if major changes are desired, it would be necessary to implement comprehensive urban land privatization and to incorporate land use fee in the property tax. Until recently, one of the reasons municipalities were reluctant to integrate tax and the fee that was that land use fee was original municipal revenue, while property tax was a transfer from the budget of Serbia. However, since the new Law on Financing of Municipal Self-Governments has been passed, it is clear that such reluctance is obsolete. Also, the fact that municipalities will have to define property tax rates presents an excellent opportunity to integrate the tax and the fee, to calculate it and collect jointly.

It would be ideal if the current, administratively determined property tax base and land use fee base were changed to market determined tax base by using computerized mass property appraisal systems⁸, which would significantly reduce administrative costs, increase fiscal revenues, and lead to a more equal distribution of tax burden, since the tax would depend on the property value, not on discriminatory administrative decisions. Also, as a result of well argued theoretical conclusion that property taxes (especially land taxes), compared to other tax bases (revenue, income, profit) generate significantly lower dead weight loss, the increase of property tax with joint reduction of some other taxes would have significant positive effects on economic efficiency of the overall economy.

Integration of the land use fee and property tax could be done in several ways. The first way would need the amendment of two laws (Law on Planning and Construction, and the new Law on Financing of Municipal Self-Governments) and increase in the maximum property tax rate. The second way would be amendment to two mentioned laws in order to define the land use fee as *ad valorem* fee (the percentage of the market price). Third and probably the least effective way would be to leave the decision to municipalities whether they want to integrate the fee and the tax. It seems that existing Directorate would have a major role in the administration of such fiscal

⁸ For the detailed proposal of integration of land use fee and property tax see «Taxation Reform 2» CLDS, 2004

revenue, since they have the information on existing objects, and on object under construction. Even if the integration does not occur, it would be advisable to use the capacities of Directorates in collecting property taxes.

Which are the major obstacles to the integration of these two public revenues? It seems that the obstacles are mostly political. Property tax is relatively unpopular tax, since it is direct (tax payer are fully aware of the taxes they pay) and it does not allow the same level of discrimination of legal entities in favor of physical persons. This discrimination is surely politically popular since legal entities do not vote. The quoted study has demonstrated that the integration would result in significant increase of the total tax payments by physical persons, relative to legal entities.

If municipalities, for whatever reason do not want to integrate tax and the fee, it would be advisable to implement the following proposals:

- stop the discrimination of service and commercial activities relative to industry
- increase the number of zones, especially in Belgrade
- use the same zone classification for both fees and property tax, in order to create the single registry database which would reduce the administrative costs
- harmonize criteria for the collection of land use fee and property tax
- include the land use fee in the joint collection system, if possible
- start the preparation and implementation of longer term business plans, since currently only one year plans are being prepared

Regarding the level of the Republic of Serbia, it would be advisable to amend the Law on Financing of Self-Governments in order to specify the maximum land use fee and prevent huge discrimination. Potentially, municipalities could introduce specific group of activities, in which one single activity would be in (maybe even just a single company) and charge the land use fee 100 times higher than for any other activity. According to current regulations it would be possible, and it has already happened with some other municipal fees, especially after the big companies are sold to large foreign investors. The government of Serbia has a strong interest to prevent such behavior of municipalities and in that sense a certain level of legal security has to be guaranteed to the investors.

Also, one of the specific problems facing the municipalities and Directorates is the application of Article 19 of the Law on Postal Services. Namely, if the Directorate wants to send bills, according to this law it has to use official postal service. The problem with this is that bills are relatively low and that frequently they do not even cover postal costs. This provision of the Law on Postal Service should be changed in order to allow Directorates and municipalities to evaluate themselves which way is the most cost effective – official postal service, hired courier or something else.

Regarding land servicing, the current system, in which the land servicing includes directorates on one side and local communal companies on the other side, is unnecessarily complicated and nontransparent. Also, this system will become mostly obsolete and pointless when the land is privatized.

Land servicing includes two types of activities, with different economic character – some of them are public, and some are private goods. Regarding private goods (economically speaking), such as water, sewer, gas etc., investor should negotiate the price and other terms and conditions directly with the company, whether local public, or any other. Directorates (or similar institutions) should be in charge (and financed for those activities from the local budget) for providing the land only with the local public goods – atmosphere sewage, roads and sidewalks. Land service fee would then be much lower than it is now, set at the average costs of providing those local public goods. Also, since local public companies are local monopolies, a regulatory mechanism has to be put in place in order for them not to abuse monopoly position.

Regarding the future of directorates and similar organizations, it can be concluded that, at the medium term, their perspective is rather good. Taking into account that, when the new Constitution is passed, the privatization and denationalization of the land can be expected, directorates represent a natural choice for implementing one part of the privatization process, since they know the local circumstances, have a needed technical knowledge and sometimes even experience in performing similar tasks. It is needed to join the resources existing in these Directorates with the experience and knowledge of the Privatization Agency employees, in order for the process to work well.

However, the question of long-term future of the directorates, after the privatization of land is finalized, is not that easy. It will be very difficult then to find the rationale for providing private goods to the private land by state company, taking into account that the owner, in accordance with the zoning regulations, will be able to service the land and transfer the ownership. Directorates, as indirect budget beneficiaries, are not even now real public companies. It can be expected that the tendencies of taking their responsibilities away from them will be continued and that they will be transformed into agencies or similar municipal bodies. As already mentioned, they will probably, in the name of the municipality, finance land servicing with local public goods, but that job will be of much lower scope than today's. Also, directorates (or government bodies of similar authorities) would continue performing tasks which shall not be influenced by privatization, such as financing of street refurbishment, maintenance of buildings, public lights etc.