# Financing Community Redevelopment through Land Value Increments: An Alternative to TIF

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# **Community Redevelopment Financing**

Under tax increment financing law (TIF), a municipality is authorized to issue bonds to finance the construction of public facilities that are expected to precipitate new private investment within "blighted" areas. This results in rising site and building values, hence a higher property tax base. The tax revenue collected from the *increased* property assessments within a designated redevelopment district is used to pay off the bond debt. The "increment value", then, is the amount over and above the "base value"—the fair market value determined at the time a redevelopment district is established. The incremental revenues are diverted from taxing jurisdictions for the duration of the bond debt-servicing period. When the public improvements are paid for, all subsequent property tax revenues revert to the taxing jurisdictions.

Over the past three decades, TIF has become the primary local financing tool for urban redevelopment, replacing the federally funded urban renewal programs dating from 1949. State enabling laws require local jurisdictions to provide evidence that private capital investment in a blighted area would not reasonably be anticipated without the adoption of a redevelopment plan, publicly assisted land assembly, and supporting public improvements.

## TIF Criticisms and Reform Efforts

Public interest organizations throughout the country are voicing concerns about the use and benefits of tax increment financing. The Community Development Network challenged the Portland Development Commission over issues of involuntary displacement on the Interstate Corridor Urban Renewal Area, Portland, Oregon's largest TIF district encompassing 3,700 acres. Some local organizing efforts are aimed at limiting the destructive impacts of TIF on low-income residents. Others, aimed at exposing abuses of TIF laws, charge cities with using the tool to underwrite projects in affluent suburbs, to subsidize construction on flood-prone land and exurban greenfields, and to finance auto-dependent shopping centers and sports venues. Indeed, the definition of "blighted" has been gradually expanded beyond the traditional factors that include structural dilapidation, obsolescence, abandonment, and sub-standard habitability. Under pressure from business associations, many of the 47 states with TIF legislation include *economic* obsolescence as a qualifying criterion.

Still others criticize the proliferation of TIF districts, many of which are developer-driven and have as their primary purpose a commercial rather than a community use. The City of St. Louis has as many as 85 ongoing TIF projects; Chicago has almost as many. While bonded indebtedness mounts and property tax revenues are diverted from city services, the effective tax burden is shifted onto residents who are often less able to carry the tax load than the corporate owners who benefit at the city's risk. Examples of TIF projects that critics have targeted as abusive or excessive include the St. Louis suburban jurisdictions of Webster Groves (Lockwood Ave. business district), Des Peres (West County Center shopping mall), Hazelwood (Missouri Bottoms industrial park), and Olivette (a developer-proposed retail complex).

In response to mounting debt accumulating from ongoing multiple TIF districts, some states have authorized the expansion of the tax increment base to include *economic activity taxes* such as the sales and earnings tax. Criticism against this approach stems from the observation that unlike the property tax base, the EAT base does not actually expand with new development; rather, sales-generating outlets in TIF districts are likely to have moved from non-TIF areas or captured sales volume from outlets in other locations. The taxation of retail sales transactions also carries with it a troubling set of incentives. Experience shows that local redevelopment agencies often seek out project areas with the greatest potential to generate tax revenue, even if the areas are not blighted or depressed. If the tax base consisted of sales receipts, then local officials would lean towards income-producing projects—most likely commercial ventures rather than community revitalization.

Voices for TIF reform are beginning to be heard in statehouses throughout the country. The major reform efforts have focused on: (i) tightening the definition of "blight", (ii) restricting the use of TIF for retail development, (iii) prohibiting the delineation of TIF districts on greenfields or sensitive land, (iv) excluding sales tax revenue from tax increments, (v) limiting the size and number of TIF districts. Recent TIF reform bills introduced in the Missouri legislature attempt to address some of these issues as well as the problem of negative fiscal impacts on school districts.

## Evaluation of Conventional Taxation Methods

The use of the conventional property tax to capture tax increments sets up a system of adverse incentives. Generally, building value constitutes the bulk of real property assessments. By imposing heavy tax burdens upon substantially improved properties, the property tax discourages new investment in targeted areas. When designating a TIF district in a neighborhood where private investment has remained stagnant, a local jurisdiction commits to sizable investments in public infrastructure and facilities. This results in the rise of market value of land sites, regardless of ownership or use. The intent to precipitate development is thwarted when owner/developers are faced with substantially higher tax burdens for investing in new buildings. Responding to this adverse incentive, property owners may well find it more lucrative to hold onto vacant or underutilized sites for later resale, rather than to undertake timely improvements. Hence, the conventional tax system amounts to an inducement to speculate on sites and capture the windfall gain. A more progressive tax increment financing mechanism would capture the "economic rent", or the surplus payment deriving from a site's locational advantage, public improvements, and synergistic spillovers from general growth and development.

# Value Capture Financing

Clearly, there is a need for a tool as powerful as tax increment financing, yet with safeguards that prevent undesirable outcomes. A legal financing structure is needed to ensure that urban growth management objectives, including compact urban centers and affordable housing, are met. It should include built-in incentives for developers to construct in accordance with pre-adopted comprehensive plans, and include disincentives to speculate on sites intended for redevelopment.

## Principles

Public sector commitments, in the form of approved detailed plans, up-zoning, and capital funding, will stimulate private sector investments in commercial space and housing. Together, these public and private investments will result in the growth of economic rent. Site value increases are experienced generally, that is, independent of capital investments in building improvements that individual property owners may undertake. Owners and purchasers make investment decisions based upon local government performance. Thus, public sector actions coincidentally *give* property added value, frequently labeled "betterment".

This surplus value, reflected in <u>land value</u> assessments, can either be retained by individual owners as capitalized assets, or captured by the public sector to be distributed through revenue expenditures in the

form of public benefits. A basic principle in liberal economic theory holds that legitimately created value belongs to the creator of that value. Hence, government in its role as the steward of publicly created value is justified in collecting what the community has given. Public jurisdictions have the legitimate right to recapture land values, either through property taxes, or developer exactions requiring direct contributions to a prescribed public purpose such as the provision of below market-rate housing. On the other hand, <u>improvement value</u>, the remaining (usually larger) component of property assessments, is attributable to private capital investment in individual parcels. Owners have the legitimate right to retain the building value that they themselves have created.

The appropriation of land value can be accomplished on a broad scale through the general property tax by converting the system to a *land value tax* (LVT) – based either entirely on land assessments, or mostly on land assessments (accomplished by a split rate). Alternatively, it can be applied to specific tax benefit districts. In the case of TIF, this 'surplus' increment can be used - at the front end - to help finance the public improvements needed to induce desired private building investments. The key is to collect tax increments through *value capture* rather than through the conventional property tax, which because of the burden on building value, reduces the incentive for new private investment where it is most needed.

The capture of incremental land value produces two socially desirable effects: (1) It reduces the temptation for land owners to speculate on sites by keeping them out of productive use, and (2) It raises land holding costs to a level at which owners will seek a better return on their property investment by making building improvements. Legislators should resist the temptation to augment tax increment receipts by taxing improvement values as well as land values. This would only slow the redevelopment process and extend the bond indebtedness period.

### Application

The principle of value capture is relatively easy to put into practice due to the fact that taxable benefits are closely tied to true value land assessments. As with any TIF legislation, cautionary measures must be taken so that the capital costs of public improvements to be recovered through tax increments do not exceed the cumulative increase in land values expected to occur over a reasonable cost recovery period. In preparing plans for a TIF district, a redevelopment agency would first estimate the total redevelopment capacity of undeveloped and underdeveloped sites within the proposed district. An estimated improvement value is placed on the projected new redevelopment, and the expected land value growth within the district is projected.

In the case of value capture, taxable assessments are based primarily on total annual land value. This coincides with land rent, or annual "unearned" capitalized gain that all property owners within a limited sized district would experience. Here is where the major distinction is drawn between value capture and conventional tax increment financing, which collects land <u>and</u> improvement values. In order to achieve revenue neutrality (in the base year), the land tax rate is set to the mill rate that captures an amount equal to the conventional property tax.

Tax allocation bonds in the amount of projected land value tax increments are issued at the time construction of public improvements commences. The term "geo-bond" might be used to distinguish the capture of land rent as a bond financing mechanism from other taxing mechanisms that include the building component of assessed value. In practice, no urban jurisdiction in the U.S. adopting the land value tax method has entirely eliminated the building tax; rather, split rates are used whereby the larger portion of the combined tax rate applies to land assessments.

#### Illustration

The City of Seattle identified several "urban centers" in its 1994 comprehensive plan. By 2000, all 38 detailed neighborhood plans were approved by City Council and are currently the focus of departmental and citizen efforts to find the appropriate means of implementation. The proposed Brooklyn Center, a key element of the University Community Urban Center plan offers a case study of how value capture might be utilized to fund planned public improvements in a "CRF" district. (In Washington State, the nomenclature is Community Revitalization Financing.) Planned major redevelopment activity converges on an 8-block area consisting of 89 parcels. Predominant uses currently consist of auto-related commercial establishments including expanses of surface parking. The plan envisions a high density, mixed-use residential community. A small area is chosen for this case study so as to enhance the leverage effect of public improvements on site values. In order to stimulate new private investments in a local area, the public impact needs to be concentrated and highly visible.

Stages in this case study include: (1) estimates of land redevelopment potential and new development capacity; (2) a simulation model capable of projecting the incidence of rebuilds on underdeveloped parcels, and estimating the growth of land and building assessments over a redevelopment period; (3) hypothetical tax applications on aggregated parcels, comparing revenue outcomes from both conventional and land value taxation systems; (4) calculation of tax increments available for urban renewal bonds; (5) an estimate of financial incentive, measured by the shift of tax burdens off of building assessments.

The 1996 assessed value of land and improvements in Brooklyn Center is \$54.6 million. Land value as a proportion of total value in the core area is 57%, compared to 42% for the city as a whole, meaning that building value comprises only 43% of the total assessment base. This high land-to-total value (LTV) ratio is one prime indicator of under-investment. A second indicator is a standard measure of site utilization. The floor area ratio (FAR) is the internal floor area of buildings divided by lot area. The aggregate FAR is 0.76 – less than a one-story building. The potential for redevelopment in the target area can be estimated by establishing thresholds for both of these valuation and site utilization ratios. In this case study, those parcels on which the LTV ratio is higher than .66 and the FAR is less than 0.75, fall into the category of "underutilized".

Within the 19.6-acre district, 48 parcels meet both threshold criteria for vacant or underutilized. Exceeding both thresholds on a given parcel precipitates a rebuild, or new construction. Inserting a target LTV ratio of .32, which is the ratio of land-to-total assessment that is the norm for recently developed areas, optimizes the redevelopment simulation model. This means that over an extended period, land values will increase in the redevelopment district at an average annual rate of about 11.5 percent as new building activity takes place. As land values rise, additional parcels exceed the threshold levels, thus precipitating more rebuilds. The model projects 64 rebuilds within a period of 17 years.

In accord with rezoning plans for Brooklyn Center, building capacity averages out at a density of 2.5 FAR. If these 64 redevelopable parcels were fully developed at the capacity FAR, the total projected floor space would amount to 1.5 million square feet. Using an estimate of typical building assessments for new mixed-use mid-rise construction proposed in the UCUC plan, a total of \$234 million in added building value is projected within the area. Adding this volume and value of new construction means that total building values (including existing fully-developed parcels) would grow at an average rate of 19 percent annually. Assuming an even rate of rebuilds, a longitudinal array of 17 annual land and building assessments is derived for use in the simulated property tax applications.

For purposes of this case study, Brooklyn Center is designated as a Community Revitalization District (CRF). All the normal methods of tax increment financing are implemented here with the exception of the differential property tax rates that are applied to land and building assessments. The aim is to capture land

value increments rather than growth in building values. The "land value tax rate ratio" is set at 90%, meaning that 90 percent of the combined tax rate is applied to land assessments.

Following recommended practice when converting to an LVT system, a split rate in the base year produces the same revenue as the conventional single-rate tax. The question of where revenue neutrality is established is critical to implementing LVT, as the resulting tax shift across properties is significantly affected. Under a 2-rate system, the breakpoint – determined by the overall LTV ratio in the taxing jurisdiction wherein revenue-neutrality is established – locates the fulcrum from which upward or downward tax shift occurs. In essence, the tax shift experienced by any single parcel depends upon its own LTV ratio relative to the aggregated LTV ratio of all other properties within the jurisdiction.

Tax shift outcomes are "normalized" when the total land and building assessments used to establish revenue neutral tax rates are taken from a larger jurisdiction such as the county or city. A case in point: The overall LTV ratio of assessments in King County (and the City of Seattle as well) is .42. Individual parcels having a higher ratio than .42 will experience a positive tax shift; parcels having a lower ratio will experience a negative shift. If the 8-block CRF district were the locus of revenue neutrality, the overall assessment ratio of 57% would locate the fulcrum in a different position. Thus, some parcels in the district, which at the county level would experience a positive shift, would instead experience a negative shift. Because of the predominance of underutilized sites, the district is not representative of the metropolitan region as a whole; therefore establishing split rates at the district level would distort the incentive effects of the LVT.

The previously derived array of 89 annual land and building assessments is associated with a set of split rates derived from aggregate county assessments that are projected to grow at the historic trend rate of about 6% annually. A conventional rate of \$12.50 per \$1000 AV is the total tax rate for the Seattle Levy Code area, and is used as the base year rate. The split rates derived for the levy code area are proportional to the split rates derived at the county level. For over a decade, property taxes in Washington State have been subject to statutory limitations; hence, a 6% annual revenue growth limit is applied to the algebraic formula used to obtain split rates.

At the base year, the conventional property tax on the 89 parcels in the CRF district yields \$682,406 in revenue. The split rates of \$24.63 applied to land assessments and \$2.74 applied to building assessments yields \$835,922. The difference in base-year yields is due to the large number of underutilized properties in the district. Because the LTV ratios on these sites are high and tax burden is shifted onto land values, the tax yield is higher. This phenomenon occurs in the early years of the tax increment financing period; but as construction activity increases, the LTV ratios gradually decrease, yielding comparatively smaller revenues in the later years.

The base year revenue from the land value tax is subtracted from each subsequent year's tax revenue to produce an annual tax increment used to finance bonds for public improvements in the district. The bond period includes Year 2 through Year 16. Cumulative tax increments over the 15-year period amount to \$22.5 million. This is about \$4 million less than the amount that a conventional tax would yield, but unlike the single-rate tax, the LVT does not depend upon the accumulating building values in the district. Total assessed value in Brooklyn Center grows to a projected \$581.7 million by the 17<sup>th</sup> year. The cumulative increments will finance an estimated \$18.7 million in bonding capacity. The total \$234.2 million of added building value generates a 12.5:1 ratio of private-to-public investment.

Finally, the incentive effects of the LVT expressed in terms of tax shift are examined. Over the 15-year tax increment financing period, a conventional tax would capture \$21.8 million in taxes on buildings compared to only \$4.8 million from a 90% LVT. This amounts to a cumulative savings of \$17 million for property

owners investing in redevelopment. On the other hand, a total tax burden of \$15.5 million is shifted onto land values, especially in the beginning years when properties are largely underutilized.

#### Observations

The important feature of the value capture method applied to TIF is that cumulative taxable building value, in this case totaling \$234 million, is barely taxed. This incentive to redevelop sites is enhanced by lifting a \$17 million cumulative tax burden off of building owners.

Because the scheduled public improvements are concentrated in a small 8-block area, the impact on land values in the area is clearly visible; all properties will be uniformly and strongly affected. Moreover, because the \$54.6 million first-year district assessment is only 0.13% of the city-wide assessment, the city's taxing districts are not heavily impacted by the diversion of base-year revenues.

Value capture as an alternative tool to the conventional property tax should be able to discourage land speculation within taxing districts and place community-generated value where it justly belongs—in the public realm. There is no reason to limit the value capture method to redevelopment districts. Reforms of property tax legislation at the state level could authorize the use of LVT by counties and cities as well.



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# Slide Presentation: Financing Community Redevelopment through Land Value Increments

Introduction: Land value taxation principles and methods - Jeff Smith

Case study of applied LVT in the Brooklyn Center urban renewal district - Tom Gihring

Illustrations of the incentive effects of LVT on selected properties - Jeff Smith

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