Financing Transit Station Improvements through Geo-Bonds

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PROBLEM: Estimated costs of building Sound Transit's planned Central Link LRT system are increasing beyond expectations. Unanticipated inflationary trends in the real estate market, especially rising land prices along the rail line, have driven costs beyond the project's $1.8 billion budget. It is speculation on potentially valuable sites in station areas that drives up land prices. If speculative value is not appropriated for the public benefit, it constitutes a private windfall.

PRINCIPLE: Land value, as opposed to improvement value, is attributable to general growth and development, as well as locational advantage—supported by public infrastructure and capital projects, neighborhood plans, and land use regulations (e.g., station overlay districts). It is legitimate for local governments to appropriate this community-generated value through taxation. Improvement value, on the other hand, is attributable to private capital investment in particular land parcels. The public purpose is enhanced by *not* appropriating owners' investments that stimulate economic growth, wage and income generation. Taxing land values for public benefit is known as "value capture".

SOLUTION: First, the best results would be achieved by changing the present general property tax to a 2-rate system, where the tax rate on land values is higher than the rate on improvement values. **Land value taxation** (LVT) effectively shifts the tax off of private investment capital onto the speculative value of real estate—rising land values. Tax shift helps to spur infill development activity in central places, including transit station areas.

Next, a special assessment district is created around each major transit station, using **value capture** to appropriate rising land values attributable to station improvements, and the district is re-zoned to accommodate new *transit oriented development* (TOD). Tax allocation bonds are issued after the construction of transit infrastructure begins. The term "geo-bond" is used to distinguish the capture of land rent from other bond financing mechanisms that tax the building component of assessed value. Geo-bonds work in similar fashion to two other mechanisms: tax increment financing (TIF), and local improvement districts (LID).

When setting up *transit benefit districts* (TBD) to encourage TOD, a local jurisdiction declares its intent to stimulate new building-intensive development by making sizable investments in transit facilities and "place-making" infrastructure. Capturing incremental land values through TBDs is an application of the "benefit principle". That is, some portion of the economic benefits of a public transit project derived by property owners should be recaptured and reinvested to help pay for the value-enhancing transit improvements.

The principle is easy to put into practice due to the fact that benefits are closely tied to ad valorem assessments and ordinary property taxes. The governing agency need only estimate the revenue

needed to support the planned project improvements in each TBD, and set a special tax rate. Two qualifications: First, a land value gains tax is based on the *change* in assessed land value, from year to year. This coincides with land rent, or annual unearned economic gain. Secondly, the capital costs of transit improvements to be recovered through value capture cannot exceed the increase in land values projected to occur over a reasonable cost recovery period.

Here is where the major distinction is drawn between value capture and tax increment financing. TIF is a manipulation of the general property tax, whereas value capture is a separate tax. Because general property tax revenues are not affected, the constitutional prohibition against non-uniform taxation does not arise. Moreover, regular taxing districts (such as school districts) are not deprived of the increases in property tax revenues they need to meet increased demand for services created by new households and businesses added to the benefit districts.

How much of the total land rent that should be captured from properties within a benefit district is a matter of policy judgment. The more radical approach would be to set a land value gains tax rate high enough to capture the anticipated total annual gain in land values. A more moderate approach is to set the tax rate sufficient to capture only the incremental increase in land values beyond the growth levels that had been generally occurring without the project improvements. A middle ground approach seeks to resolve the built-in tension between capturing all publicly created value and losing the interest of property developers. Such a solution might moderate the full gain tax with a rebate of the building portion of the regular property tax.

ADVANTAGE: By not taxing improvement values, capital investment in transit-oriented development is stimulated, further enhancing the value of station area properties. By collecting land values only, an incentive is created for property owners to put their sites into the highest and best use. Likewise, land speculation in station areas is discouraged. This is because a heavy tax on land and little or no tax on improvements can potentially reduce general property tax liability on properties with significant building improvements (compared to the conventional system of taxation).

EXAMPLES: Early in the 20th Century, California State funded a system of dams and canals by selling "geobonds", a public debt that was repaid by taxing land values--which increased rapidly due to the enhanced usefulness of the surrounding property. Hence, public improvements, funded by the value they themselves generated, were responsible for the growth of the Central Valley.

A number of studies lend empirical support to the conclusion that real estate price increases do occur in areas near transit stations. When the Washington DC Metro subway was one-third completed, $2 billion in new land values over and above normal growth was identified. Later findings at completed stations estimated the growth in Metro-induced land values to be in excess of $3.5 billion, compared with the running cost of $2.7 billion in federal funds.

A special assessment district was created in New York's West Side Red Line corridor, wherein adjacent property owners pay annual taxes to retire a 20-year $25 million general obligation bond. Benefit districts circumscribing five subway stations in Los Angeles are generating $130 million per year to retire transit bonds that helped fund the first segment of the line.

In Washington State, a unique opportunity exists to rework an existing statute that authorizes the formation of "Public Transportation Benefit Areas" (RCW 36.57A), which has not been used due to unresolved legal issues. The law could be reformulated to specifically support TOD and fund transit-related improvements in station areas designated by a local jurisdiction.