
Incentive Property Taxation Supports Transit Oriented Development

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Brief

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OBJECTIVE: The Central Puget Sound Regional Transit Authority recently completed its environmental review of 26 stations along the proposed 21-mile “Link” light rail route, connecting SeaTac airport with Seattle downtown and the University District. An 82-mile “Sounder” train system plans to provide long-distance commuter service on an existing rail network. The RTA and constituent local jurisdictions are firmly committed to the currently popular concept of “TOD”, the creation of transit station communities, or compact, mixed use activity areas, centered around stations, that by design encourage residents, workers and shoppers to walk and ride transit.

Planning for compact land uses around new high volume transit stations is a useful way to counter the effects of urban sprawl. A mix of multifamily residences with nearby shopping and neighborhood services and convenient transit access is beneficial because it makes more efficient use of existing urban infrastructure, is convenient to residents, consumes less land, and ultimately preserves open space, farms and forests at the urban fringes. Reduced automobile dependency leads to lower household costs, and a quieter, less congested neighborhood environment. The transit-land use relationship is symbiotic, in that TOD is likely to increase transit ridership and increase pedestrian trips - which in turn support the nodal type of commercial development (a cluster of contiguous storefronts with zero setback, and minimal surface parking space).

PRINCIPLE: Joint development of station areas is based on the premise that transit investments improve regional accessibility, and lead to higher land values in transit station communities. A primary determinant of land value is accessibility. No individual or business will build a transit line as a profitable investment. Yet, many land owners reap large benefits in the form of higher land values (and resale prices) attributable to public expenditures on transit improvements. Higher values, in turn, give owners the potential for higher commercial rents, larger scale construction and the rapid absorption of building space.

A number of empirical studies have found that urban rail transit will significantly raise site values and rents in station areas, especially if the regional economy is growing, and complimentary regulatory and joint development programs are in place. Examples include permissive zoning, street improvements, and design features such as pedestrian plazas. Most of the land use and value impacts occur within a quarter mile of stations, where office rents tend to increase and housing prices are higher.

While acknowledging the benefits of newly created value from public transit investments, it is also important to recognize the distinction between community-created value and privately-created value, and between the creator and beneficiaries of value. These distinctions can be

found in real estate property assessments and are manifested in the property tax system. Assessed land value is attributable to general economic growth and development, as well as locational advantages--supported by public infrastructure and capital projects, neighborhood plans, and land use regulations. Improvement value is attributable to private capital investment in particular land parcels. Each of these two components of property value is quite different in its derivation, and liberal economic principles hold that created value should be returned to its creator. Hence, government in its role as the steward of publicly created value is justified in collecting what the community has "given" as an unearned increment, or surplus value. On the other hand, owners have the inherent right to retain most of the building value which they themselves have created.

Because buildings comprise most of the assessed value in real estate, an equal tax rate on land and improvements results in a relatively high burden on improvement values—the capital investment of owners. By appropriating this privately created value, the conventional tax system discourages further private investments in new station areas, where land and building values are rising. In fact, the system rather encourages land speculation, or the withholding of parcels from the market, and the reaping of windfall gains as land prices rise faster than in other areas. This is because taxes on land-intensive uses or underutilized properties are comparatively low. How can these incentives be reversed in order to encourage new private investment in transit-oriented development?

SOLUTION: The present equal rate property tax system could be changed to a split-rate method, whereby the tax rate on land values is higher than the rate on improvement values. This effectively shifts the tax off of private investment capital onto the speculative component of real estate—rising land values. The tax shift helps to stimulate infill development activity in all central places, including LRT station areas. It is both legitimate and fair that the public domain, which initiates and pays for transit improvements, should regain a larger portion of the value which itself has created. The rationale behind land value recapture is both economically and legally sound. The constitutionality of differential rate taxation in Washington state has been questioned; however, legal precedence in other states with similar uniformity provisions does not seem to preclude its implementation here. Pennsylvania has had a successful history of 2-rate property taxation.

EVIDENCE: Tax shift effects accompanying a conversion to a 2-rate property tax can be simulated by finding the split rate that produces the same jurisdiction-wide revenue as derived under the present tax regime. The Broadway/John St. station area affords a case study of the incentive/ disincentive effects of alternative property taxation. The aggregate city-wide ratio of land-to-total value determines the point at which tax shift occurs in the change to a split rate system. Because the set of parcels within a half mile radius of this intersection has building assessments higher than the city as a whole, the land-based tax would produce a slight downward shift in tax liability. But when the station area parcels are divided into fully utilized and underutilized sites (based on assessment and floor area threshold ratios), differences emerge.

More intensively utilized sites, including retail stores and apartment buildings, would experience a negative 21% tax shift, about \$431 thousand less than the annual conventional tax yield. On the other hand, the underutilized subset which includes surface parking lots and vacant lots, would see a positive tax shift of about 93 percent. Thus, owners of intensively used parcels (consistent with TOD objectives) would be rewarded with comparatively lower taxes; or in other terms, they would not see their capital investments expropriated. Conversely, land owners whose principal economic activity is the accumulation of potential windfalls from rising values (created by new transit improvements and general upgrades in the station area) are required to give back a

more reasonable portion of the annual gain. The 2-rate tax incentives are both negative and positive.

Suppose that owners of underutilized sites were to respond to the positive incentive of lower taxes on fully developed properties. If the sites were all redeveloped into multifamily and mixed use buildings at the same development intensity as existing fully utilized properties, the collective building value would increase 14 times. This would tip the land-to-total value ratio to the other side of the scale, where building values comprise over 70 percent of the assessment. Now, the same properties redeveloped would experience a reduction in taxes of nearly 30 percent, compared to what the conventional tax would take annually. Again, owners are rewarded for investing their own capital or releasing land for new development consistent with TOD objectives. An added bonus is the nearly 1,600 new dwelling units that could be built on these parcels at the development intensity normal for this area.

EVALUATION: Is the land-based tax fair to all classes of property owners? Would it impose an unduly high tax on single family residents, whose homes happen to be located in a designated station area where land values are expected to appreciate rapidly. One measure of tax equity is ability-to-pay. Another measure is cost-benefit. This restates the principle of ability-to-pay *in proportion to benefits received*. Those benefiting from government actions should be responsible for returning a fair proportion of community-generated gain.

Over a projected 12-year holding period, the conventional tax captures a constant low proportion of land rent from a variety of property types, including single family, surface parking, and high to low value commercial buildings. On most sites, the conventional tax captures only about one tenth of the cumulative gain in land value. But on fully utilized commercial sites, the capture rate is double, illustrating the perverse incentive of the current tax system. By way of contrast, the LVT captures over a quarter of the total land rent; but, in no single year does the tax capture more than 40 percent of the land rent. The LVT consistently captures cumulative land value gain at the rate of about 28 percent, while leaving building value largely untaxed. Under these simulated circumstances, it would appear that the land-based tax is fair and equitable.

Note: A slide presentation of LVT incentive effects in the Capitol Hill station area is available upon request.