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Take a Big Look at Incentive-Based Growth

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Take a Big Look at Incentive-Based Growth Management

BY TOM GIHRING AND KRIS NELSON

In 2005, Senate Bill 82 set in motion a comprehensive review of Oregon's state-wide land use planning program, with recommended changes to be sent to the 2009 Legislature. The *Oregonian* voiced clear support for the bill, urging Gov. Ted Kulongoski to offer strong leadership and not let the effort turn into a "Big Yawn" by allowing the recently adopted Measure 37 to obscure the task force's wider mission (*The Oregonian*, January 10, 2006).

How can the property tax be re-tooled to encourage the preservation of rural lands and support infill development?

That nearly happened, but the governor revived the effort at the beginning of this year. In March 2008 the Big Look Task Force came up with a list of intended outcomes, calling for growth management tools to include non-regulatory methods that add more flexibility and individuality to the state's planning system.

The task force has since produced a draft document seeking the public's input on its preliminary recommendations. Among these are: (i) complement regulations with market-based tools to protect at-risk rural resource lands from development pressures; and (ii) find additional revenue sources for infrastructure to support infill development. (Big Look Stakeholder Booklet,

draft, 5/30/08).

The key words here are: non-regulatory and market-based tools. This opens the door to the possibility of *financial incentives* and a re-examination of the general property tax structure. How can the property tax be re-tooled to encourage the preservation of rural lands and support infill development? The tax system as currently instituted in Oregon requires that land and buildings on parcels be assessed separately but taxed at the same rate. Inherent in the equal rate method is a set of incentives that many economists and a growing number of legislators find to be counterproductive. Taxing building assessments produces a financial inducement to neglect structural improvements and delay capital investments. The aggregate effect is land speculation.

Incentive Taxation

Population growth pressures and expansion of urban development, even with planning goals and land use regulations in place, produce pressures that result in urban sprawl and the consumption of rural resource lands. When the value of surrounding areas that are becoming more intensely developed begins to rise, the present owners of marginally used land have no financial incentive to likewise develop their properties. Rather, they will often find it more profitable to let their sites remain idle until rising lot prices in

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the vicinity offer the prospect of windfall gains upon resale. At the same time, centrally located urban sites are often overlooked by developers, remaining idle (vacant) or underutilized.

Land values and building values are defined as classes of property under the Oregon constitution and cannot be taxed at different rates. But land and buildings are fundamentally different. Public sector commitments, in the form of land use plans, zoning regulations, and capital investments in infrastructure, will stimulate private sector investments in housing and new businesses. This economic activity results in the growth of "location rents," or rising land values. Comparable land value increases are experienced generally, that is, on all parcels with similar location attributes—independent of capital investments in building improvements that individual owners may undertake. When local jurisdictions up-zone urban districts to accommodate more residential units or commercial floor space, the underlying land values are likely to increase precipitously. Similar effects will occur when urban growth boundaries (UGBs) are extended to accommodate urban expansion. These are regulatory actions that result in "givings" – the converse of "takings." If these givings are not appropriated in the form of land tax revenues or "betterment" levies, they amount to windfalls. Building values, on the other hand, are attributed to the capital investments of individual property owners. Unlike land values, they are site-specific.

Location rents, reflected in land value assessments, can either be (i) retained by individual owners as a capitalized asset (an unearned increment) or (ii) captured by the public sector to be applied to public benefits such as additional infrastructure which further boost site values. Under the present equal rate taxation system, owners have no financial incentive to improve property because a higher tax liability will result from taxing the building improvements. Unless the property tax system is allowed to shift the tax rate off of building values onto land values by applying differential rates, the former outcome is inescapable. The Sightline Institute's Alan Durning states in his book *Tax Shift*: "Most northwest jurisdictions seek to

prevent urban sprawl through the regulatory tools of land-use planning. Yet a simple reform to the existing property tax would turn it into a powerful incentive for investment."

Land value taxation (LVT) is based upon the principles advocated by 19th Century political economist Henry George. The theory of land taxation holds that a property tax based upon site values provides an incentive to bring land into productive use; simultaneously, a reduction or abolition of taxes on site improvements should encourage more efficient land use. Contemporary issues that can be addressed by LVT include the protection of rural resource lands from urban encroachment, the prevention of urban sprawl, and the revitalization of underutilized urban centers.

A basic principle in liberal economic theory holds that legitimately created value belongs to the creator of that value. Land value is created cumulatively by the community as a whole, and as such belongs to the community; building value is created by private capital, and as such, belongs to the owner. Hence, government is justified in recapturing by means of property taxation what it has "given." This theory was never applied in its pure form – the abolition of all taxes save the tax on land, yet the idea lived on and was subsequently incorporated into law in several British Commonwealth countries, as well as in Taiwan, Denmark, Estonia, and in the U.S. state of Pennsylvania. In all instances where a form of LVT has been adopted, land values are taxed at a higher rate than building values. The tax rate differential is subject to local preferences.

There is good reason to believe that incentive property taxation would work in concert with Oregon State growth management policies. The following assertions, frequently advanced by land tax proponents, explain this connection:

1. As a result of placing proportionately higher taxes on land, it would become too costly to hold onto vacant or underutilized centrally located sites. A trend would emerge

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toward infill development and a gradual re-centralization of urban development. Simultaneously, there would be a diminishing demand for peripheral sites at the urban fringe.

2. A reduction in tax burden on improvements would facilitate the renewal and replacement of obsolete buildings in a region's older central cities. Property owners, responding to the fiscal inducement to reduce the land-to-building value ratio, would build more intensively on vacant and underutilized sites. Stagnating local business districts (including historic "main streets") could be revived under the LVT because, unlike strip malls, street-oriented shops have less expansive sites.
3. The 2-rate tax would discourage land speculation, or holding unimproved or under-improved property for the purpose of reselling without making substantial capital investments. A sufficiently heavy land tax would deplete cash reserves of the holdout owner.
4. Because the differential-rate tax is applied uniformly to all properties within a jurisdiction, the general effect would be a restraint on rising land prices, leading towards greater housing affordability. When the land tax encompasses an entire housing market, there is a general downward pressure on location rents. This occurs because the higher tax on land values is capitalized into lower residential land sales prices.

Coordination with the Task Force on Comprehensive Revenue Restructuring

The timing of the Big Look Task Force's recommendations could not be better. This is because a parallel effort is now underway: the Task Force on Comprehensive Revenue Restructuring. Local elected officials and the state legislature are keenly aware of the fact that Oregon's tax system is broken. Not only do public officials feel the need to find additional sources of revenue to fund new infrastructure to accommodate urban growth, but also they are becoming attentive to the inequities

brought about by past attempts at property tax limitations, notably Measure 50.

This short-sighted effort to ease taxpayer burdens eliminated *true market value* as the basis for computing individual tax billings. Over the past decade, the effect of placing a cap on annual growth in assessments has been an accumulation of distorted values and an unintended shift in property tax burdens. Properties experiencing rapid rises in market value pay less than they would have under true market assessments; slower appreciating properties pay more.

Illustrations from the Salem Study

In our 1999 study of a hypothetical land-based property tax in the Salem metro area, we examined the unplanned tax shift that occurs across groups of parcels by applying revenue-neutral tax rates to both 'taxable' values under M-50 and true market values.

The purpose of this case study is to examine tax burden shifts that would accompany: (i) a change back to true market value assessments and (ii) a reform of the present tax system from a single tax rate applied to land and improvement assessments to a split tax rate, the higher rate being applied to land values.

Distortions in tax burden were shown to vary by developed status. For example, within the Salem central business district, owners of developed parcels pay more taxes under the assessment limitation than they would under real market value, whereas owners of undeveloped parcels pay less. The effect of this particular distortion is a financial reward for not developing downtown sites. The average benefit to undeveloped central sites is a 7.5% decrease in tax burden under M-50.

The tax break that relatively few properties now receive under M-50 is offset by higher tax burdens that most land use classes must absorb. The tax burden resulting from Oregon property tax limitations has clearly shifted

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onto residential property. The tax distortion amounts to about \$4.9 million in added taxes coming from single family and multi-family parcels. The vast majority of properties would experience a decrease in taxes accompanying a change to a taxation method based on real market assessments.

The second step in the study design consists of tax simulations comparing the tax burden effects of the split rate land value tax with that of the conventional tax. Applications utilize real market values (RMV) rather than taxable values, as it would be unreasonable to institute a tax reform based on distorted assessments. Revenue neutrality is assumed.

The overall land-to-total value ratio (L-T-V) determines the direction of tax shift that a single parcel experiences in a change from a conventional RMV tax to a 2-rate tax. In the case of Salem City, any parcel upon which the

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land assessment comprises more than 30% of the total value will experience an upward tax shift. The intensity of the shift depends upon the *tax rate differential* that is selected. This case study elevates the proportion of the total rate that is applied to land assessments to as high as 95%.

Tax simulations reveal significant differences across land use categories. The *single family* class is slightly above the overall 0.30 mean L-T-V ratio, resulting in moderate upward tax shifts under the 95% rate differential ratio (or negligible change under lower rate ratios). Because of their comparatively low L-T-V ratios and presumably greater building bulk (measured in floor area ratios), *multifamily* properties experience a significant decline in tax burden under the two-rate system: -36.5% in Salem City. Because

of their minimal improvements, simulated tax yields from *surface parking lots* increase under the maximum land value tax level by over 175% in Salem City. Vacant lots and undeveloped parcels follow the same trend.

Moving Towards Reform

The land value taxation system compares favorably in the context of urban growth management and as a means for revenue enhancement. In countries where site value taxation has been adopted, the property tax and land use regulatory structure work in concert to produce a self-generating system to finance local infrastructure. This perpetual process, fed by publicly created value, leaves private capital investments in the form of building values largely untaxed.

The efficient-use consequences of the land-based tax system also become evident. When the tax rate is shifted from building to land values, the lower tax on improvements increases the incentive to invest in buildings and to develop vacant and underutilized sites. Similarly, raising the holding cost of unused sites discourages land speculation. Previous studies of land value taxation (LVT) show that the incentive effects are strongest in high value, central locations.

A property tax reform bill, designed as a split-rate variation of the land value tax was introduced (SJR-1) in the 2005 legislative assembly. The bill proposes amending the state constitution to allow the taxation of land and improvements at differential rates. Effectively undoing Measures 5 and 50, the reformed tax system would base tax collections on true market assessments. Limitations could then target revenue growth, not individual assessments.

Now, what do the Big Look and Comprehensive Revenue Restructuring task forces have in common? The answer – a sorely needed repair of the state's broken property tax system as an incentive-based method to promote smart growth.

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The use of land in Oregon is influenced by both regulatory mechanisms put in place over 30 years ago and tax inducements put in place almost 20 years ago. Now is the time to find a way to align both of these influences to make them work in concert. The Big Look Task Force appears to be open to the idea that smart growth is not only a function of regulatory compliance but can also be financially rewarding.

It is possible that another LVT bill will be introduced in the 2009 session. Will the Oregon APA take a "big look" at the state-wide planning system and advance smart land use practices by supporting property tax reforms? Now is the time for the professional planning community to step outside of the regulatory box for a bigger look at innovative solutions.

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