CONSOLIDATED TAX REFORM HPAC FINANCE WORKGROUP

HPAC Work Group Recommendation Template

Excerpts:

RECOMMENDATION

Taxes are both a tool to raise revenue for government and to shape taxpayer behavior. Attaining the Governor's desired housing production goals will require significant new revenue; this recommendation highlights actions that can address revenue shortfalls and encourage a shift in taxpayer behavior to support housing production.

Reform Oregon's tax system to encourage development of needed housing and provide adequate revenue for local governments to support housing production. Potential actions include (but are not limited to):

A) Targeted Measure 50 Reform:

1. Increase annual Maximum Assessed Value change to 5%.
2. Authorize voters to increase the permanent levy of their local jurisdiction.
3. Exempt Cities and Counties from compression.

B) Adopt Land Value Tax

C) Eliminate Mortgage Interest Deduction for Second Homes (i.e., abolish income tax deduction for interest paid on second homes).

D) Enact temporary property tax exemption for new housing at 120% AMI or below.

E) Reduce or Eliminate Tax Expenditures (i.e., tax exemptions) not related to housing.

WORKGROUP ADOPTION

October 11, 2023 by unanimous consent.

Co-chairs Guidance: Standards for Analysis

1. CLEARLY DESCRIBE THE HOUSING PRODUCTION ISSUE THAT THE RECOMMENDED ACTION(S) WILL ADDRESS.

A) Targeted Measure 50 Reform

Property taxes are the single largest source of tax revenue for cities (League of Oregon Cities, 2019). However, unrestricted revenue for local governments has not kept pace with the demands placed on them, especially with respect to infrastructure expansion and maintenance (EcoNorthwest, 2022).

Oregon's land use system artificially constrains the supply of buildable land to encourage compact, orderly development of urban centers while protecting rural land from urbanization and sprawl. Successful execution of this policy requires large, well thought-out infrastructure investments. Prior to the tax revolt in the 1990s, infrastructure planning, funding and implementation was predominantly the responsibility of local governments. However, as general fund revenues became constrained, the cost and planning burden shifted to new development. Thirty years on, we are faced with a significant amount of land that is eligible for urbanization under Oregon's land use system, but economically infeasible for private parties to develop.

The following three reforms to Measure 50 will increase unrestricted general fund revenues for local government:

1. Increase annual Maximum Assessed Value change to 5%.

Measure 50 created the concept of Assessed Value (AV). The 1997-98 Maximum Assessed Value (MAV) for each property was set at 90% of its 1995-96 real market value (RMV). If no new construction occurs on the property, then the growth in maximum assessed value is capped at 3% per year. However, the assessed value cannot exceed real market value. First, the current year MAV is set to the greater of (a) 103 percent of the prior year's AV or (b) 100 percent of the property's maximum AV. Then, the AV is set as the lesser of (a) the current year's MAV or (b) the Real Market Value (RMV) (Oregon Department of Revenue, 2009, p. 3).

Since adoption, Real Market Values have grown significantly faster than Maximum Assessed Values; for the assessment as of January 1, 2021, Assessed Value was 56.2% of Real Market Value on a statewide basis. Said another way, property values have increased 433% while assessed values have only increased 243% (Legislative Revenue Office, 2023, p. D6).

Voters have responded by authorizing additional taxes at the local level. During the same time period, voter approved bonds, local option levels, and newly created special districts increased property tax rates by approximately 30%. However, voters have been constrained in their ability to raise taxes by Measure 5.

Increasing the annual MAV cap will allow assessed values to trend towards RMV over time while still providing meaningful protections and predictability to rate payers. This has two major benefits:

i. The difference between inflation (the increased cost of providing government services) and unrestricted revenue provided by property tax will decrease over time.

ii. Inequalities between similarly situated property owners (similar assets paying different tax amounts) will decrease over time.

2. Authorize voters to increase the permanent levy of their local jurisdiction.

Measure 50 did not replace Measure 5, but rather established a second level of restrictions. Measure 50 gave each district a permanent tax rate which cannot be increased without a constitutional amendment. However, voters can approve local option levies for up to five years for operations, and up to the lesser of ten years or the useful life of capital projects. Local option levies, as well as general obligation bonds, must be approved by a majority vote at a general election.

In response to these limits, voters have adopted numerous special districts, operating levies, and bond programs. Essentially, creating a special district is a workaround to the permanent limits – for example, a city can convert its fire department to a special district with its own, newly established tax rate. The permanent rate for the City does not decrease but the permanent rates paid by citizens does increase (Legislative Revenue Office, 2023, p. D2).

The proliferation of special districts (together with operating levies and bonding programs) makes it clear that voters want more services and are willing to pay for them through increased property taxes. However, the permanent tax rates for cities and counties are based on the rates that existed at the time M50 was adopted. This creates two problems:

> i. General property tax levy amounts in 1996 were based on materially different economic conditions than exist today, especially for rural counties. This has led to a significant inequity between jurisdictions which continues to be exacerbated over time.
>
> ii. Local governments are being asked to shoulder more financial responsibility than in the 90s. Decreasing Federal and State funding of infrastructure is a prime example of how local governments are being asked to pick up the slack when addressing problems that affect society (EcoNorthwest, 2022, pp. 11-22).

3. Exempt Cities and Counties from compression.

As an alternative or in addition to action B above, exempting Cities and Counties from compression would make more unrestricted general fund resources available. Compression occurs when a property's tax rate must be lowered so that the tax imposed on the assessed value of a single property does not exceed $10/$1,000 of the property's real market value for non-school taxing districts and $5/$1,000 for school taxing districts. While Compression is primarily driven by M5, the RMV/AV ratio established by M50 can also contribute to the problem.

This recommendation would adjust the sequence in which revenues are reduced, so that Cities and Counties are the last to see their revenue decrease.

B) Adopt Land Value Tax

Oregon's property tax system disincentivizes improvements to real property; eliminating the disincentive will lead to the creation of more housing units. Property taxes are based on the value of a property, which generally consists of the value of the land plus the value of the improvements on the land. As the value of either component increases, taxes increase proportionately. While this approach appears to be simple and fair on its face, it ignores the fundamental differences between what drives value for land compared to improvements thereon. Simply put:

• The value of LAND is driven by factors outside the owner's control, such as proximity to public amenities (transport; parks, police & fire protection) and the overall supply of similarly situated available land.

• The value of IMPROVEMENTS are driven by the amount of capital investment by the owner. The more an owner invests (constructs, remodels, etc.), the more valuable the improvements will be.

Under the existing taxing scheme, the more an owner invests in a property, the higher the owner's taxes will be. This increase in costs is a direct disincentive to improve property – examples for housing production include: new construction of housing on vacant land; infill housing such as ADUs; and adaptive reuse of underutilized improvements.

The proposed regime assesses tax solely on the value of land. For any given amount of revenue to be raised, the tax will transfer value from the property owner to the government based only on the value created by society. Any value created by the owner will remain with the owner.

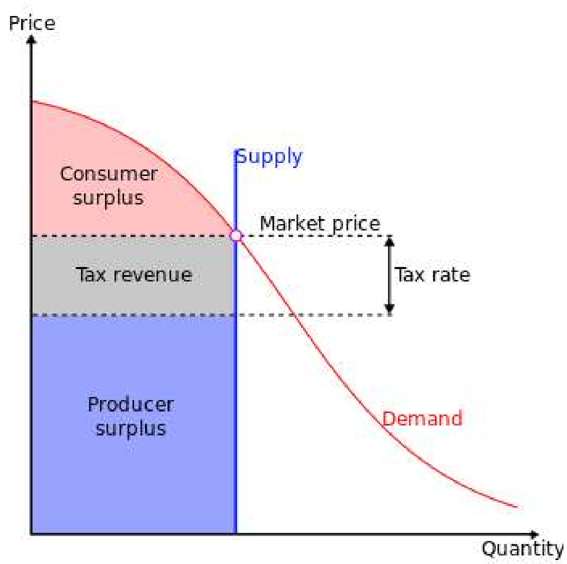
E) Reduce or Eliminate Tax Expenditures[3] (remove exemptions)

Oregon has 138 exemptions from Property Tax amounting to approximately $12 billion in foregone revenue during the 23-25 biennium; additionally there are 184 Income Tax expenditures of which 86 flow from Oregon specific statutes (Oregon Department of Revenue Research Section, 2023, p. 5). While individual tax exemptions may make sense on their own, when analyzed collectively, they represent a serious impediment to local government being adequately funded.

2. PROVIDE AN OVERVIEW OF THE HOUSING PRODUCTION ISSUE, INCLUDING QUANTITATIVE/QUALITATIVE CONTEXT IF AVAILABLE.

B) Adopt Land Value Tax

The economic analysis of the Land Value Tax has a rich history, with support from free market luminaries like Adam Smith and Milton Freedman, who famously described it as *"the least bad tax"* because of its minimal distortion to economic incentives. Any resource which is valuable and scarce will produce economic rents. However, when supply is perfectly inelastic (i.e., no more land can be produced) taxes on the good will reduce producer surplus.



As such, this tax is especially well suited to Oregon where our land use system further constrains the supply of urbanizable land (beyond the natural fact that there is a fixed supply). Adam Smith summarized the argument as follows in Book V of The Wealth of Nations:

"The tax upon land values is, therefore, the most just and equal of all taxes. It falls only upon those who receive from society a peculiar and valuable benefit, and upon them in proportion to the benefit they receive. It is the taking by the community, for the use of the community, of that value which is the creation of the community. It is the application of the common property to common uses. When all rent is taken by taxation for the needs of the community, then will the equality ordained by Nature be attained. No citizen will have an advantage over any other citizen save as is given by his industry, skill, and intelligence; and each will obtain what he fairly earns. Then, but not till then, will labor get its full reward, and capital its natural return." (Smith, 1776).

4. PROVIDE AN OVERVIEW OF THE EXPECTED OUTCOME OF THE RECOMMENDED ACTION(S), INCLUDING QUANTITATIVE/QUALITATIVE CONTEXT IF AVAILABLE.

A) Targeted Measure 50 Reform
Reforming Measure 50 will increase the amount of revenue available to local governments by approximately $165 million per year.[5]

B) Adopt Land Value Tax
Conversion to a Land Value Tax would have three major impacts (Local Housing Solutions, n.d.):

- Discouraging speculative holding of vacant land – landowners pay the same tax for a vacant lot as the same lot with improvements constructed on it.

- Encourage the additional development of partially improved land – the owner of a single family house + lot would benefit from the construction of an ADU and not be penalized by additional tax.
- The increased cost of holding land would generally depress land prices which may reduce the ultimate cost of housing.

6. PROVIDE A GENERAL OVERVIEW OF IMPLEMENTATION, THE WHO AND HOW FOR THE RECOMMENDED ACTION(S).

A) Targeted Measure 50 Reform

- Each of the proposed changes requires amending Oregon's constitution. We recommend that the legislature draft the referrals to ensure the technical language is appropriately vetted.

B) Adopt Land Value Tax

- This change will require an amendment to the Constitution followed by several statutory changes and OAR changes. We recommend that the legislature draft the referrals to ensure the technical language is appropriately vetted.
- Additionally, significant work will be required by County assessors to adjust assessment systems and methodologies; while land assessments are included in the current property tax regime, they will play a much larger role with the adoption of this recommendation. We expect a significant amount of initial appeals and recalculations.
- Due to the monumental shift in methodology, we recommend gradual phased-in approach over several years during which the ratio of land/improvement values for tax calculations trend to 100%.

7. OUTLINE THE DATA AND INFORMATION NEEDED FOR REPORTING TO TRACK THE IMPACT AND IMPLEMENTATION OF THE RECOMMENDED ACTION(S).

B) Adopt Land Value Tax
- Track total revenue for local jurisdictions; ensure that millage rates are set correctly such that changing assessment basis is revenue neutral.

Commentary on the HPAC Work Group Recommendations, by Common Ground-OR/WA:

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."

In this sense, a returned "giving" does not result in relinquished revenue. On the other hand, property tax exemptions, the favored relief method of elected officials, are not revenue neutral. Over the past several years they have shifted the tax burden from the business sector (having received the majority of tax breaks) onto households.

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.

This theory 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. Thus far, no U.S. public entity has taxed solely the value of land – the "single tax". In all instances where the split-rate form of LVT has been adopted, land values are taxed at a higher rate than building 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."

By shifting taxes from capital investment onto land and natural resources the land value tax is a fairer tax. Taxing private use of land and natural resources keeps prices low and stable, broadening ownership and encouraging productivity (i.e. putting land to its "highest and best use").

Common Ground OR-WA is a regional chapter of Common Ground USA (commonground-usa.net), a 501(c)4 non-profit organization, committed to reducing and replacing taxes on labor and capital, and to appropriate the value of land and other natural resources to pay for essential government services. For more than ten years, we have been conducting research on land-based taxes, and actively promoting state legislation to reform the existing property tax system.

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. By repealing Measures 5 and 50, a reformed tax system would base tax collections on true market assessments. More recent drafts of a tax reform bill have evolved into an LVT study bill and a local option LVT.

We are pleased that the Tax Reform Working Group recognizes the failure of Measures 5 and 50 to bring equity and fairness to Oregon's property tax. It also acknowledges that limiting assessments and tax rates fails to provide adequate local government revenue and encourage development of needed housing. We agree with all the recommendations of the Working Group, with one exception:

We do not believe that increasing the annual Maximum Assessed Value change to 5% will achieve meaningful results. The Legislative Revenue Office's RESEARCH REPORT #4-15: *Analysis of Options for Restructuring Oregon's State and Local Revenue System* found that Measure 50 created a rigid, inflexible system leading to horizontal inequities for taxpayers – the unequal tax treatment of taxpayers with similarly valued property. This inequity is caused by the divergence of assessed value from real market value. When general home prices rise, horizontal inequities can increase over time. Land values in some neighborhoods within a county grow more rapidly than others.

The Northwest Economic Research Center, College of Urban and Public Affairs, Portland State University, FINAL REPORT: *Oregon Property Tax Capitalization: Evidence from Portland*, March 2014, confirmed the inequities of the system based on differing rates of changes between maximum assessed value (MAV) and real market value (RMV). The study found that differences in property tax payments are having a significant effect on sale price. Houses that have experienced large growth in value since the inception of the current system tend to be paying less as a percentage of their homes' value in taxes, which increases sale price. This disproportionately benefits property owners who can afford to buy in areas with faster increases in property values. This report focuses on Portland, but this same dynamic is likely at play in the rest of the state.

We have to conclude that the MAV system by any means of contrivance is problematic. When authorizing additional taxes at the local level whether by voter approved bonds, local option levels, or newly created special districts, the effects are sporadic and stop-gap at best. Measure 5 also constrains the ability of local jurisdictions to raise tax revenues.

The HPAC Work Group is clear in its diagnosis: Oregon's property tax system disincentivizes improvements to real property; eliminating the disincentive will lead to the creation of more housing units. LVT is the clear path to this objective.

A reduction in tax rate on improvement assessments would facilitate the renewal and replacement of obsolete buildings in a region's 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 land value tax.

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 from the holdout owner. 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 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.

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.

These propositions have been supported by several independent studies conducted by LRO, PSU's NERC, Common Ground-OR/WA, City Club of Portland, Portland METRO, and Institute of Public Policy & Management, University of Washington. These studies cover the jurisdictions of Portland, Multnomah & Washington counties, Salem-Kaiser, Clark County, King County, and Washington State.

The adoption of LVT requires amending Oregon's constitution because Measures 5 and 50 were inappropriately baked into the constitution, effectively changing a revenue-based property tax system to a mostly rate-based system, and shifting the burden of funding primary and secondary education from counties to the state government. A second constitutional barrier is the uniformity clause, which is regrettably interpreted to treat land and improvements as different classes of property. An ordinary reading of the law would differentiate between classes of land use, not two components of property. This precludes the use of split rates on land and improvements.

Common Ground-OR/WA has proposed a constitutional amendment authorizing a local option LVT, whereby counties or cities may by popular vote switch to a split-rate LVT system and be granted an exemption from Measures 5 & 50. We encourage the HPAC Work Group to explore this route.

HPAC recommendations state the need to follow constitutional changes with a state statute prescribing the mechanisms of LVT. We too recommend that the legislature draft the referrals. Since Common Ground-OR/WA has already prepared draft language for previous LVT bills with some success in garnering legislators' support, we recommend that HPAC examine these texts.

We too have stated that significant work will be required by county assessors to adjust assessment systems and methodologies. Georgist organizations around North America, most especially in Pennsylvania, have firmly expressed the need for accurate and up-to-date property assessments, which is the only way that the built-in incentives of LVT can become effective. In fact, Common Ground-OR/WA has prepared language for a Best Practices Assessment bill, refining details with suggestions from Oregon Department of Revenue staff.

We too recognize the need for a gradual phased-in approach over several years during which the ratio of land/improvement values for tax calculations trend to 100 percent. This is precisely what we have been developing over the past several years – a six-step process, including buffered phase-out / phase-in from MAV to RMV assessments over a 5-year period, as well as a homestead exemption and tax deferral to minimize the burden of a precipitous increase in tax liability for some homeowners.

It is clear that a change to LVT will have to be revenue neutral, meaning that the combined split-rate applied to RMV assessments will likely be lower than the existing rate for MAV assessments. All simulation modeling that we have performed or reviewed incorporates this assumption. However, a change back to a revenue-based tax system will require some method of limiting revenue growth – out of political acceptability and popular consent. Washington State, using RMV assessments, uses the standard system of limiting annual revenue increases to a given percentage; other factors can be added such as population growth and cost of living increase.

Finally, the HPAC Recommendation Template included a NERC citation: Northwest Economic Research Center, *Land Value Tax Analysis: Simulating the Effects in Multnomah County*, June 2019. It is worth noting that Common Ground-OR/WA commissioned this study, with the financial support of Oregon Community Foundation, and Schalkenbach Foundation. The report's conclusion states:

"Ultimately, land-based property tax systems, whether a split-rate LVT or a building exemption tax, are found to achieve what they are designed to do—place more of the tax burden on wealthier landowners and encourage the highest and best use of land. An LVT would provide a more equitable tax structure, incentivize building upgrading and development of underutilized properties, and discourage "holding" land for speculative purposes."

Common Ground – OR/WA

www.commongroundorwa