



Making The Transition To A Land Value Tax

Property Tax Reform for Oregon

Common Ground OR-WA proposes a local option land value tax (LVT) for Oregon counties or cities that choose an exemption from Measure 5 and 50 limitations with an LVT replacement. This document shows how in six steps the transition to a land-based tax would help minimize economic displacement caused by inevitable tax shifts.

Property tax reform would make two changes from Oregon's current system: 1) applying the tax rate to real market (RMV) assessments instead of the limited tax method using maximum assessed value (MAV) assessments, and 2) taxing land values at a higher rate than improvements. The land tax is conceived to produce desirable incentives – to invest in substantial property improvements, not to speculate on sites and raise the costs for later occupants. The premise is simple: tax buildings less and the supply expands; tax land more and it is conserved. We do not suggest that the LVT will change every landowner's investment decision through a tax shift, but the effects *in the aggregate* are significant.

The land value tax is necessarily based on RMV, not MAV as is the current case under 1997 Measure 50 (M-50) mandates. This law limits annual growth in taxable assessments to three percent beginning in 1996. By now MAV assessments lag so far behind RMV that the current county-wide MAV:RMV ratio for Multnomah County is only 39 percent. If urban land values continue to escalate, the gap widens. One of the most acute problems is that Oregon's system has effectively disconnected the amount paid in property taxes from the real value of property. This results in horizontal inequity, the case in which property owners with similarly valued properties and levels of service pay dramatically different property tax rates.

Is it possible that some homeowners might be disadvantaged as a result of shifting the property tax rate to land assessments? Yes, particularly those who live in older and smaller homes on high value lots. High land-to-structure ratios of assessed value might be affected by large lot size, up-zoning to commercial or multifamily uses, or trends in neighborhoods where small homes are being replaced by large homes. Legitimate concerns about equity and fairness should guide the decision to introduce measures that minimize undue burden on homeowners.

Transition to LVT

The following measures are suggestions for mitigating the unintended effects of changing Oregon's property tax from the current single rate and limited assessment system to a split-rate and land-based tax using RMV. Some property owners may become financially overburdened by a sudden change.

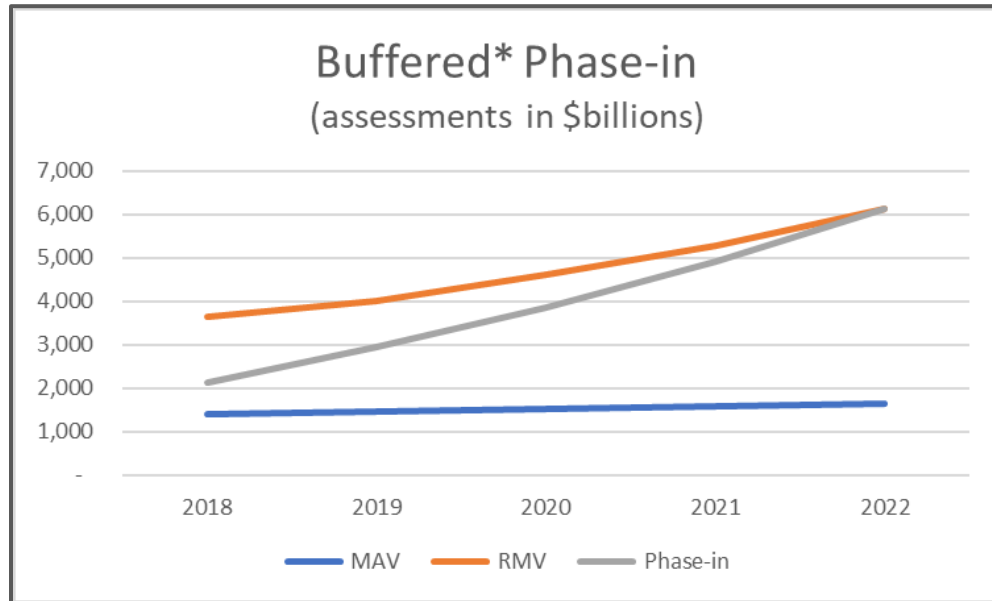
Steps in the Transition to LVT

1. **Close the assessment gap** over a 5-year period.
2. **Graduated split rate LVT** over a possible 10-year period.
3. **State standards for assessments** CAMA mass appraisal.
4. **Property tax deferral** for property owners who are equity rich but income poor.
5. **Construction loan assistance** source of funding for low and moderate-income homeowners applying for ADU permits.
6. **Opportunity to purchase** granting nonprofits the right of first refusal upon sale of rental apartment buildings.

Step 1 GRADUAL TRANSITION TO REAL MARKET VALUES: CLOSING THE ASSESSMENT GAP

It makes no sense to base LVT tax levies on what are in effect false assessments. The first step in transitioning to a land value tax is to change assessments from MAV to RMV. But an immediate full introduction of real market assessments will be a shock to most property owners, especially those whose MAVs are only 20 to 40 percent of RMV. Other jurisdictions within the U.S. have dealt with a similar problem where property assessments have over time fallen short of true value even when they are not beset by mandated growth limitations.

Enacting an assessment “phase-in law” would allow any value adjustment needed to correct an under-assessment to be phased in over the next five years. Because RMV assessments change over the phase-in period, the assessor must account for this moving target. We suggest a method of introducing RMVs when properties have been historically undervalued: A **Buffered Phase-in** over a 5-year period. A simultaneous phase-out / phase-in is calculated each year using one fifth of the current assessment gap plus a percentage of the current RMV. This factored increment results in annual cumulative phase-in values reaching the estimated target year RMV. (See the following graphic.)

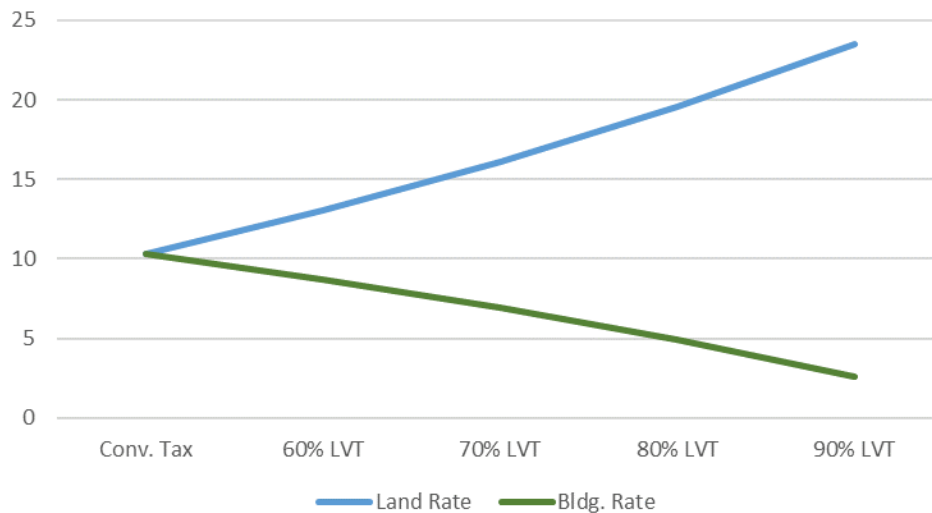


Step 2 GRADUATED SPLIT RATE LAND VALUE TAX

The next step is to phase-in the LVT option. The question is: do we undertake this process simultaneously with the MAV to RMV phase-in period? In the beginning years we are still using assessments that fall short of RMV; yet we do not want to base the new LVT rates on under assessed values (MAV), distorting the desired incentive effects. On the other hand, we do not want to delay the transition to LVT when a county or city has chosen this option. The optimal choice is to phase in both RMV and LVT simultaneously.

In the first year of transition, it is important to maintain revenue neutrality, a policy objective that perhaps most legislators would insist upon. The split rate LVT applied to the new RMV assessment produces the same jurisdiction-wide revenue the MAV levy would have yielded. The LVT tax rate will decrease as the RMV assessment increases.

To start the **LVT phase-in**, we begin with “LVT Light”: implement LVT in a limited fashion by phasing in the differential rates on land and improvement assessments. Begin with a small rate differential and gradually increase it over a ten-year period. The conventional tax system taxes land and improvement values at the same rate. With a gradual phase-in, we would start with a small rate differential. The standard method is to express the split rate as the percentage of the total tax rate applied to land assessment. Starting with a low LVT ratio, for example 55/45 is a 55 percent LVT where 55 percent of the total rate is on land and 45 percent on improvements. A graphic of this process appears as follows:



From the second year onward, the split rates are set to collect a predetermined target revenue. LVT as it is conceived is ‘revenue agnostic’. It takes no stance on the overall size of government. Some jurisdictions will aim for a larger tax slice of the economic pie, others for a smaller one. The resulting tax shift is compatible with both positions. LVT’s reform agenda is not about the size of the slice but how the pie is cut.

Step 3 ADOPT STATE STANDARDS FOR ASSESSMENTS

LVT finds favor among economists because taking the tax off buildings engenders no drag or “deadweight loss” on the local economy. Urban planners favor the land tax because it encourages compact, more efficient development patterns and dampens land price inflation, the main cause of housing price escalation. These are the desired outcomes of LVT which depend upon accurate property assessments.

Historically, U.S. assessors tended to undervalue land relative to improvements. In order to avoid taxpayer complaints and lawsuits, they sometimes simply lower the assessment on land. If a jurisdiction shifts to two-rate property taxation, however, both components need to be measured accurately.

We strongly recommend that the Oregon State Department of Revenue adopt appraisal standards that must be applied by county assessors in jurisdictions electing to adopt the LVT local option. State-of-the-art appraisal methods should be in effect by the time LVT is being phased in. Current best practice is **Computer Assisted Mass Appraisal**. CAMA can value many properties at the same time, lowering administrative cost.



Step 4 PROPERTY TAX DEFERRAL

In order to minimize the burden of a sudden increase in tax liability for homeowners, an adopting jurisdiction may elect to authorize a **homestead exemption** on building assessments for homeowners (i) with a household income less than a *specified percentage* of median income within the jurisdiction in which the home is located, and (ii) for whom the tax increase resulting from the conversion to a land value tax exceeds a *specified percentage* over the previous year under the conventional tax.

However, because the long term trend in real estate shows substantial land price increases, most homeowners have been seeing significant equity build-up. The land value portion of private property yields an *unearned increment*, a public benefit received. As the principal contributor to land value, a local public jurisdiction is entitled to recapture most of this value through property taxation.

Thus, we prefer a property **tax deferral** rather than a broad-based exemption. This will achieve the dual objectives of returning to the public realm revenues in proportion to benefits received (from accumulated land rent), and retaining the financial incentives built into the LVT system as this land-based tax remains applicable to the property independent of ownership. Also, revenue losses can be avoided if a relief measure were in the form of a deferral.

Deferrals could be granted with no age or physical ability limitations to homeowners who may have seen large equity gains but are struggling to make current property tax payments. The property owner may apply to have the annual property tax payment capped based on ability to pay (e.g., some percentage of annual income taking into consideration savings). The accumulated tax liability then accrues as a lien against the property to be paid out of the proceeds of sale or transfer of ownership via inheritance. Interest could be charged on the total amount owed, based on inflation and administrative costs.

Step 5 HOMEOWNER CONSTRUCTION LOAN ASSISTANCE

By shifting the tax burden onto underdeveloped sites, LVT's incentive effect is to reward investment in new construction and upgrades. While these positive incentives will undoubtedly result in increased housing production, the change to LVT may overburden some homeowners, especially in lower value neighborhoods where lot sizes are large and houses are modest.

How can we turn this dilemma into a favorable outcome? Here are the existing conditions that can be leveraged to solve the problem: 1) a surplus of buildable land on private lots; 2) the need for income generation to strengthen homeowners' financial solvency; 3) the need for more low-income housing units for renters.



From the owner's perspective, the logical solution is to reverse the negative effect of an upward tax shift by investing in building upgrades or new construction. This will bring down the land-to-total value ratio, thus receiving a favorable tax treatment under LVT. Constructing an accessory dwelling unit (ADU) can help solve the dilemma, simultaneously providing income support for cost-burdened owners and contributing to the supply of low-income housing.

But without access to construction loans many homeowners could never participate in this promising solution; practically no low to moderate income owners will qualify for a loan from conventional lenders. A custom-built ADU can cost as much as \$150,000. The public sector will have to step into the lending process as a partner. What state and municipal government can do is establish a loan loss reserve fund, or pass an affordable housing bond that supports loan guarantees. In Oregon, the legislature will have to address a constitutional bar on government lending to private entities. (The Legislature can set aside state funds that the Treasurer oversees in a partnership with community banks and credit unions through an administrative board for lending.)

These are first steps. Ultimately the solution will be a public source of construction loan funding for income qualified homeowners applying for ADU permits. The time has arrived for a public institution such as a Bank of Oregon, modeled after the successful North Dakota State Bank. An option is for the state to authorize the establishment of municipal public banks. Public banking is distinguished from private banking in that its mandate begins with the public's interest. Public banks are able to reduce taxes within their jurisdictions because their profits are returned to the general fund thus providing a new source of income for cities and states and a source of funding for projects such as infrastructure, renewable energy, and affordable housing.

An alternative method for public loan funding in Oregon is a Housing Opportunity Fund established in the State Treasury to serve as a custodian bank. The HOF directs the state treasurer to deposit money into the fund, and partners with local financial institutions under the administration of a Housing Opportunity Board.

Step 6 OPPORTUNITY TO PURCHASE

The preceding steps to ease the transition to LVT focus primarily on property owners, but what measures can be taken to assist renters? Previous studies of LVT effects have made it clear that the multifamily land use category faces a favorable outcome due to the higher ratio of improvement value to land value. A great number of apartment units are occupied by renters whose owners stand to benefit by the land tax. LVT also incents new construction, encourages higher density, and expands the housing supply.



Nevertheless, where neighborhood upgrading or gentrification is already occurring LVT favors newer and larger infill developments. What can be done to assist renters at risk of displacement? This requires a novel solution independent of the property tax system, a solution that will enable renters to remain in their existing homes and neighborhoods.

Progressive economists are calling for residential ownership models that remove dwelling units from the private market, claiming that affordability over the long run can only be sustained by intentionally holding down land prices. Community Land Trusts like Portland-based Proud Ground are a prime example of social housing... perpetual ownership of land titles by a non-profit corporation, offering a more stable form of tenancy.

The way to accomplish this evolution is through the transfer of older affordable multifamily properties to public or quasi-public owners. In many cases properties currently under rental assistance or other government subsidy programs and subject to affordability restrictions are approaching expiration at which time owners may elect to convert them to market rate housing. Here is the opening for a local ordinance requiring owners selling their residential properties to extend the first opportunity to purchase to qualified non-profit housing organizations: the “right of first refusal”.

Oregon’s statute ORS 456 requires owners subject to an existing affordability contract to extend right of first refusal to qualified purchasers. We join our housing advocate colleagues calling for a broadened version of the law to include all multi-family residential buildings for sale. This guarantees local nonprofits a window of time to make an offer on any property before the owner can sell, and an extended interval to match other bids. The new non-profit owner pledges to undertake any repairs needed and manages the building for a 99-year term. If a state or municipal bank becomes a reality, a city could establish a fund from which is allocated funding for qualified non-profits to assist purchasing and management.

Tenant opportunity-to-purchase policies will not necessarily create new housing units, but they will serve to slow the process of displacement. Meantime, if a local option LVT becomes a reality, the incentive effects will undoubtedly help increase the total housing supply, discourage land speculation, and exert a downward pressure on land prices.



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