

# **Funding Long-Term Infrastructure Needs**

## **For Growth, Sustainability & Equity**

### **Appendix 4 Questions & Answers**

**September 27, 2013**

# CONTENTS

<b>INTRODUCTION</b>	6
<b>PRELIMINARY QUESTIONS</b>	8
1 DO TAXES MATTER?	8
2 WON'T SOME BUSINESSES WILL LOCATE IN WASHINGTON REGARDLESS OF TAXES AND COST?	8
<b>TRANSPORTATION PRICING</b>	9
3 MOST PEOPLE DON'T HAVE A CHOICE ABOUT DRIVING, SO WHY WOULD ROADWAY PRICING HAVE ANY IMPACT ON CONGESTION?	9
4 WHY DOESN'T THE DISTRICT PUT A TOLL ON ALL ROADS AND BRIDGES INTO THE DISTRICT?	11
5. WHY IS A CLEAN AIR COMPLIANCE FEE ACT (CACFA) IMPORTANT?	13
6. HOW SIGNIFICANT WILL BE THE IMPACTS OF CACFA?	14
7. WHY WOULD THE FEDERAL GOVERNMENT COMPLY WITH A CLEAN AIR COMPLIANCE FEE ACT?	15
8. WHY WOULDN'T CONGRESS INTERFERE AS THEY WOULD WITH A "COMMUTER TAX?"	15
9. HOW DOES INFRASTRUCTURE EXACERBATE SPRAWL?	16
<b>QUESTIONS ABOUT PUBLIC SERVICE ACCESS FEES – "<u>VALUE CAPTURE</u>"</b>	20
<b>I VALUE CAPTURE &amp; PUBLIC SERVICE ACCESS FEE CONCEPT</b>	20
10. WHY SHOULD THE DISTRICT REDUCE THE TAX RATE ON BUILDING VALUES AND INCREASE THE TAX RATE ON LAND VALUES?	21
A. <u>Impact of Taxes on Building Values</u>	21
B. <u>Impact of Taxes on Land Values</u>	21
Where do land values come from?	21
What is the impact of taxing land values on land prices?	23

<b>II</b>	<b>EFFECTS &amp; IMPLICATIONS</b>	24
11.	REDUCING THE TAX RATE ON BUILDING VALUES AND INCREASING THE TAX RATE ON LAND VALUES WILL IMPACT DIFFERENT PROPERTY OWNERS IN DIFFERENT WAYS. HOW CAN WE KNOW THESE IMPACTS?	24
12.	IS A VALUE-CAPTURE APPROACH TO PROPERTY TAXATION PROGRESSIVE?	25
13.	WILL VALUE-CAPTURE TAXATION PROMOTE AFFORDABLE HOUSING?	27
14.	WILL VALUE CAPTURE EXACERBATE PROBLEMS ASSOCIATED WITH GENTRIFICATION?	29
	Types of Displacement	29
	The Role of the Existing Property Tax	31
	The Impact of a Value-Capture Approach	32
15.	WOULD TAX ABATEMENTS AND OTHER SUBSIDY PROGRAMS BE MORE APPROPRIATE FOR ACHIEVING AFFORDABLE HOUSING	32
16.	WON'T NEIGHBORHOODS WITH LARGE YARDS BE PENALIZED?	34
17.	ISN'T THE DISTRICT MOSTLY BUILT-UP? HOW MANY VACANT LOTS ARE THERE?	34
18.	THE DISTRICT ALREADY HAS A PENALTY TAX ON VACANT AND BLIGHTED BUILDINGS. WHY NOT RELY ON THIS APPROACH TO SPUR DEVELOPMENT OF BOARDED-UP BUILDINGS?	36
19.	WOULD THE DISTRICT LOSE REVENUE FROM SPLIT-RATE TAXATION?	40
20.	WOULD THE DISTRICT LOSE REVENUE FROM NEW CONSTRUCTION?	42
21.	WOULD A SPLIT-RATE TAX FAIL TO COMPENSATE THE DISTRICT FOR COSTS IMPOSED BY DEVELOPMENT?	42
<b>III</b>	<b>HOW DOES ZONING RELATE TO PROPERTY TAXATION?</b>	43
22.	WHAT IS THE ROLE OF ZONING?	43
23.	HOW DO LANDOWNERS RELATE TO ZONING?	43
24.	HOW DOES THE PROPERTY TAX INTERACT WITH ZONING?	45

25.	WOULD MUNICIPAL REGULATIONS BE MORE EFFECTIVE IN DETECTING PARKING LOTS AND UNDERUTILIZATION OF LAND?	47
26.	WHAT IMPLICATIONS EXIST, IF ANY, REGARDING THE DEBATE ABOUT CHANGING THE DISTRICT'S HEIGHT LIMIT?	48
<b>IV WILL THE VALUE CAPTURE APPROACH ENCOURAGE TOO LITTLE OR TOO MUCH DEVELOPMENT?</b>		49
27.	WILL THE VALUE CAPTURE APPROACH TO PROPERTY TAXATION BE TOO INSIGNIFICANT TO AFFECT DEVELOPMENT?	49
28.	WILL A VALUE CAPTURE TAX INHIBIT LAND ASSEMBLY?	50
29.	AREN'T VACANT LAND AND SURFACE PARKING NECESSARY?	50
30.	WOULD HISTORIC BUILDINGS AND SMALL BUILDINGS SUFFER NEGATIVE CONSEQUENCES FROM A VALUE CAPTURE APPROACH?	51
31.	DOWNTOWN D.C. IS HEALTHY. WHY TRY TO STIMULATE IT?	53
32.	WILL A VALUE-CAPTURE PROPERTY TAX LEAD TO CONGESTION?	54
<b>V. MECHANICS</b>		55
33.	TYPICALLY, LAND AND BUILDINGS ARE SOLD TOGETHER. HOW CAN SEPARATE ASSESSMENTS BE MADE ACCURATELY FOR BUILDING VALUES AND LAND VALUES?	55
34.	CAN PROPERTY OWNERS APPEAL THE WAY THEIR ASSESSMENTS ARE DIVIDED BETWEEN LAND VALUES AND BUILDING VALUES?	56
35.	WHAT IS THE FORMULA FOR SHIFTING TAXES OFF OF BUILDING VALUES AND ONTO LAND VALUES?	56
36.	WOULD A VALUE-CAPTURE APPROACH TO PROPERTY TAXATION BE TOO RADICAL?	57
37.	WOULD THE VALUE CAPTURE APPROACH CREATE WINDFALLS AND WIPEOUTS?	58

<b>VI</b>	<b>OUTCOMES FROM VALUE-CAPTURE IMPLEMENTATION</b>	<b>58</b>
38.	WHERE HAS THE VALUE CAPTURE APPROACH TO PROPERTY TAXATION BEEN IMPLEMENTED?	58
39.	WHAT HAS BEEN THE EXPERIENCE OF PENNSYLVANIA CITIES WITH VALUE CAPTURE?	59
40.	WEREN'T TAX ABATEMENTS THE REAL KEY TO PITTSBURGH'S SURGE OF DEVELOPMENT?	62
	<b>CONCLUSION</b>	<b>63</b>
	<b>NOTES</b>	<b>63</b>
	<b>FIGURES</b>	
	Impact of Traffic Volume on Speed	10
	Transportation Facility Creates Growth Opportunity	16
	Rising Land Costs Impede Growth	17
	Growth Diverted to Cheap Sites	18
	Cycle Begins Again	19

## INTRODUCTION

A report prepared for the D.C. Tax Revision Commission (“Funding Long-Term Infrastructure Needs for Growth, Sustainability and Equity,” presented June 17, 2013),<sup>A4-1</sup> recommends that the District of Columbia rely less on general taxes and more upon public service user fees and access fees to fund public facilities and services related to transportation, water and sewer, solid waste, parks, etc. User fees and access fees are charges based upon the benefits received from using public goods and services or upon the costs imposed upon the government and the public from using public goods and services.<sup>A4-2</sup> The primary reasons for this recommendation are as follows:

- **Equity:** User fees and access fees can be structured so that those who benefit from public goods and services – or those who impose costs on the provision or enjoyment of public goods and services – will make payments in proportion to the benefits that they receive or to the costs that they impose. This is particularly important in the District to the extent that user fees and access fees can obtain payments from non-residents without violating the Congressional prohibition on the taxation of non-resident income.
- **Efficiency & Sustainability:** Consumers generally seek to maximize benefits and minimize costs. When consumers of public goods and services make payments related to the benefits they receive and/or the costs that they impose, they adjust their behavior to conserve public resources and make more efficient use of them. For example, if drinking water were paid for by sales tax revenues rather than by a per-gallon fee, there would be little or no economic incentive for people to fix leaky pipes. Likewise, transportation fees that are related to distance traveled and to levels of congestion, encourage people to make transportation decisions (when, where and how to travel) and land use decisions (where to live, work, shop & play), that minimize congestion and maximize access to high-demand areas. Properly designed and implemented user fees and access fees can reduce per capita energy consumption and pollution, thereby enhancing the District’s sustainability.
- **Growth:** The underutilization of user fees and access fees promotes land speculation and sprawl – which push businesses and residents to outlying (suburban) locations. When properly designed and implemented, user fees and access fees encourage businesses and residents to locate in high-value central locations – thereby energizing the District’s economy, enhancing employment opportunities and minimizing the environmental and energy-consumption impacts of growth.

Many reports about paying for infrastructure focus on the use of general taxes (income, sales, etc.) or on the use of financing (borrowing techniques for converting future revenues into funds available today). Therefore, an approach recommending user fees and access fees may seem unusual. It might also raise questions and concerns. This appendix presents common questions and concerns that are raised by people learning about this approach to infrastructure funding.

Most people will not want to read this entire appendix. Please use the table of contents to direct you to those questions and answers that are of interest to you.

*[Remainder of page intentionally blank]*

## PRELIMINARY QUESTIONS

### 1. DO TAXES MATTER?

The Commission has heard conflicting testimony about the importance of taxes in residential and business location decisions. Some have testified that, among the array of decision-making factors, tax rates tend to rank fairly low down on the list. Others have noted that tax rates play a more important role. Perhaps these conflicting positions can be reconciled:

First, there are a large number of factors that go into location decisions – for both residents and businesses. For businesses, proximity to business inputs (resources & labor), collaborators and customers are considered to be among the most important. But once a business analyzes the factors that are most important (and generally, taxes will not be in that “most important” list), it may find that there are several locations that are comparably suitable. At this point, without having a strong preference among these comparable jurisdictions, business leaders may approach political leaders and ask them for a “deal.”

Thus, even though taxes and tax rates were probably not ranked very high in the initial screening of suitable locations, they might play a determinative role in the final location decision. And for this reason, governors, mayors and state and local legislators may reasonably conclude that tax rates are very important, simply because they are the last factor to be considered after more important and fundamental business requirements have been analyzed.

For residents, the top three factors are understood to be cost, safety and schools. To the extent that taxes affect cost, they will matter.

Furthermore, tax systems can encourage or discourage land speculation. Land speculation can have a significant impact on land costs – and land costs are a significant factor in both the cost of housing and business locations.

### 2. WON'T SOME BUSINESSES WILL LOCATE IN WASHINGTON REGARDLESS OF TAXES AND COST?

While it is hard to conceive that cost will never be a factor in a business location decision, it is true that some businesses will have a very strong preference for a DC location (often for reasons of prestige, branding or efficiency). Such firms might be

very prominent, but constitute only a small percentage of the entire business community. And tax policy that assumes that businesses will pay higher District taxes because these businesses won't move, will inevitably impinge upon businesses that are sensitive to cost considerations. Stephen Fuller, in his discussion with the D.C. Tax Revision Commission, noted that the District economy is heavily reliant on caterers, landscapers, and building operations and maintenance firms (to name just a few). These service businesses exist within a very cost-competitive environment. Few, if any, of these service businesses are physically located within the District. So District tax policy must be cognizant that both types of firms exist. Some small businesses that service District neighborhoods and employ District residents tend to have small or precarious profit margins. They will be very sensitive to cost factors. Some of these businesses might not move if costs rise. Instead, they might simply cease to exist.

Given the Commission's goals of promoting fairness while also promoting business and employment growth, how should tax policy proceed? Taxes should be justified. Compelling justifications for taxation include:

- Compensating the District government for benefits that it confers upon residents, businesses and non-residents; and
- Compensating the District for costs that residents, businesses and non-residents impose upon the government or public.

## **TRANSPORTATION PRICING**

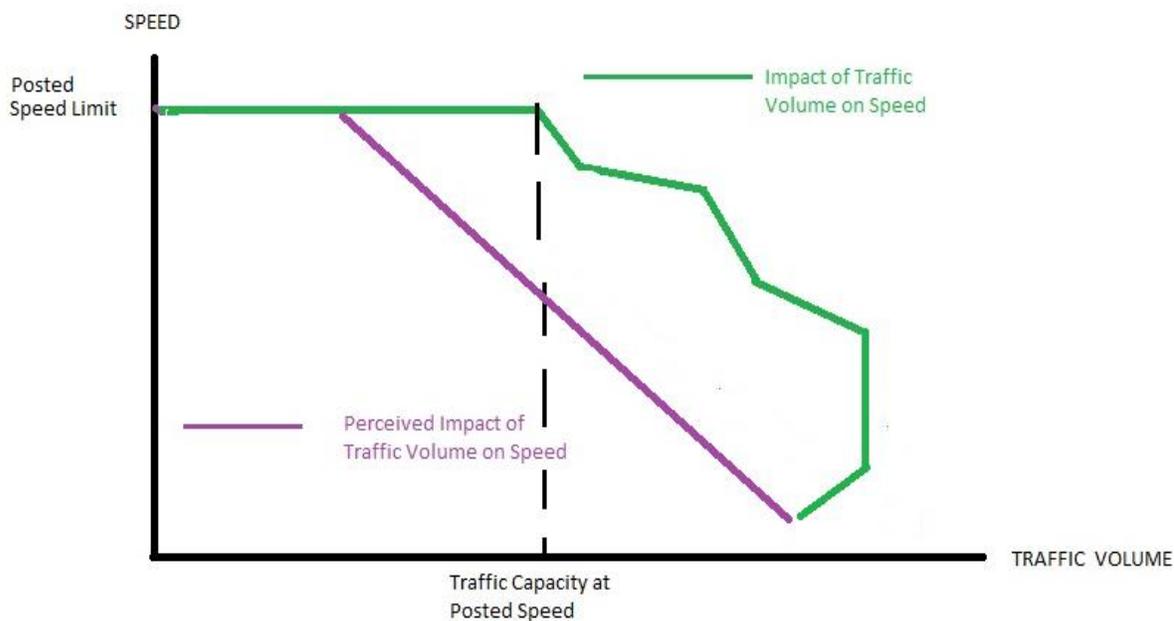
### **3. MOST PEOPLE DON'T HAVE A CHOICE ABOUT DRIVING, SO WHY WOULD ROADWAY PRICING HAVE ANY IMPACT ON CONGESTION?**

Because the costs of roadways and traffic management are hidden in general taxes, most of us experience roadway use as if it were free. For this reason, we make numerous decisions about the locations of our homes, schools, shopping etc. without much regard to the distance between these activities. Additionally, because the monetary cost of driving and parking is generally the same regardless of congestion, we don't have an economic reason to avoid traveling on congested roads at congested times. And, until recent times, gasoline was one of the cheapest liquids one could buy. Therefore, through countless decisions, both large and small, we have built our lives around automobile travel. As a result, it may seem as if there is no alternative.

In the Washington DC metropolitan area, however, we have an unusually robust and extensive transit system. Most residents are within a quarter mile of a bus stop. But,

if we have no reason to consider using transit, we might not even be aware of where that bus stop is or where the bus goes. If roadway or parking fees were increased, people would become more aware of their alternatives to driving. (As noted in the main report, 80% of household trips are not work-related, and many of those trips are within distances that could be accomplished by walking or biking.)

Most importantly, traffic congestion is not proportionate to the number of vehicles on a roadway. Thus, in order to reduce congestion by 10% it is not necessary to reduce the number of cars on the roadway by 10%. Empirical evidence has shown that relatively small reductions in traffic can yield significant reductions in traffic congestion. The reason for this is shown in the illustration below:



The purple line shows people’s perception that congestion is proportionate to traffic volume. The green line shows that congestion is a “step function” related to roadway capacity at different speeds. Thus, if a lane-mile of road has a capacity of  $x$  cars per hour when they are traveling at  $y$  miles per hour, there is generally no experience of congestion as cars are added to the roadway as long as the total cars in the roadway segment are below this capacity. However, once traffic volume nears capacity, then new cars entering the roadway require other cars to slow down. This causes a sudden drop in speed. However, as cars slow down, they require less space in between for safe and comfortable operation. So, at the new, slower speed, additional cars can be added without causing an additional drop in speed. However, although more cars can be accommodated in this roadway segment at the slower speed, there

is a capacity constraint at this speed also. Once this capacity constraint is reached, then new cars entering the roadway will cause another sudden drop in speed.

When congestion reaches a critical point, the friction caused by new cars attempting to enter the roadway reduces the ability of the roadway to accommodate vehicles and vehicle throughput declines. (This is the backward bend in the green line.) The perversity of severe congestion is that it reduces roadway carrying capacity at times when this capacity is needed most.

The good news associated with this understanding of congestion is that a relatively small reduction in traffic volume can result in a significant increase in roadway speed and carrying capacity. Thus, as long as roadway (or parking) pricing can encourage a few people to change their travel behavior (whether to travel, when to travel, what route to take, what mode to use), then these pricing techniques can have a beneficial impact on the transportation system.

Experience from London, Stockholm and other cities around the world shows that pricing a road network within an urban area dramatically and immediately reduces roadway congestion.<sup>A4-3</sup>

#### **4. WHY DOESN'T THE DISTRICT PUT A TOLL ON ALL ROADS AND BRIDGES INTO THE DISTRICT?**

Some people have heard that the District Government is not allowed to impose a “commuter tax.” Many of these people believe that a toll on bridges or roads into the District would constitute a “commuter tax” and therefore be prohibited.

In actuality, the term “commuter tax” is a colloquial expression. The law, itself, as expressed in the District of Columbia Home Rule Act prohibits the imposition of tax on the income of “any individual not a resident of the District.”<sup>A4-4</sup> A toll on a road or bridge into the District, applicable to and payable by all drivers, regardless of jurisdiction of residence, would not be construed by most courts as a prohibited tax on non-resident “income.” So why not do it?

The answer lies in another section of the Home Rule Act.

SEC. 601. [D.C. Code 1-206] “Notwithstanding any other provision of this Act, the Congress of the United States reserves the right, at any time, to exercise its constitutional authority as legislature for the District, by enacting legislation for the District on any subject, whether within or without the scope of legislative power granted to the Council by this Act, including legislation to amend or

repeal any law in force in the District prior to or after enactment of this Act and any act passed by the Council.”

In essence, the Congress can do whatever it wants, whenever it wants with respect to laws governing the District of Columbia.

Therefore, while a toll might be perfectly “legal,” it is not hard to imagine a Congressman taking to the floor of the House or Senate and saying, “The District of Columbia, by imposing a toll on its roads and bridges, is trying to circumvent the Congressional prohibition on commuter taxes. Therefore, I propose that Congress veto this law.” Until and unless the District achieves legal autonomy, it must avoid provoking such adverse actions by Congress.

The District of Columbia, as a member of the Washington Metropolitan Area Council of Governments (MWCOG) has supported and participated in studies related to roadway pricing. Not long after high-occupancy toll lanes (HOT lanes) were pioneered in California and elsewhere, some officials in our region saw HOT lanes as a potential way to create new highway lanes in a manner that would be financially self-supporting without raising general taxes. The studies performed by MWCOG, however, demonstrated that HOT lane revenues would cover only about 43% of the costs of creating these new lanes.<sup>A4-5</sup>

An assumption underlying these studies was that only the new HOT lanes would be priced – and that the other existing lanes and roadways would remain un-priced. It is now apparent that, in order to remedy congestion, make roadways financially self-supporting and pay for the additional transit services that would be required, some or all of the existing lanes must be priced also. In other words, there must be a regional system of priced roads.

Such a system of priced roads should be accompanied by a reduction in other taxes and fees. The point is not to raise more total revenue, but to raise revenue in ways that encourage more efficient transportation and land use decision making. Suburban jurisdictions have been built and operated on the premise of unpriced roadways. At the present time, even a revenue-neutral application of roadway pricing cannot obtain enough political support to allow an in-depth study of the pricing of existing lanes.

If and when congestion becomes bad enough, the suburban jurisdictions might relent to such a study. (Maryland, for example, recently opened the Inter-County Connector and imposes a variable toll on all cars in all lanes on that facility. Virginia has recently implemented congestion pricing on HOT lanes on part of the Beltway, I-495.)

If Maryland and Virginia come to support a regional system of priced roads, then the District should participate as a partner in such a system. Due to high traffic volumes in the District, the District could raise significant funds by charging a lower per-mile fee than suburban jurisdictions. Suburban implementation and a more modest District charge will not guarantee that roadway pricing in the District would survive Congressional scrutiny. But it would be politically more difficult for Congress to thwart the District's participation in a regional road-pricing system than to veto a District-only toll.

In the meantime, parking is a scarce and desirable commodity for those who drive in the District. The District can and should ensure that the pricing of public and private parking reflects the costs of environmental degradation and traffic management required by all the cars seeking those parking spaces. Performance-based parking pricing (mentioned in the report) and the Clean Air Compliance Fee Act (mentioned in the report and also in Appendix 1) are two policies that the District should actively pursue. These policies could have substantially the same benefits as roadway pricing by internalizing many of the externalities of automobile traffic and by obtaining compensation from those (including non-residents) who use and benefit from the District's transportation infrastructure.

These policies will also encourage some people to car-pool and encourage others to take transit. The net impact of private decisions motivated by these policies will be to reduce congestion and improve the efficiency of the District's transportation systems.

## **5. WHY IS A CLEAN AIR COMPLIANCE FEE ACT (CACFA) IMPORTANT?**

In the main report, there is a recommendation to enact a fee on free commuter parking. According to survey data from MWCOG, where employees have free parking at work, 82% of employees drive alone to work and only 7% use transit. However, where employee parking is not free, only 45% drive alone to work and 39% use transit.<sup>A4-6</sup> Paying for parking clearly influences transportation choices for commuters.

In the early 1990s, Susan Gygi of the Metropolitan Washington Council of Governments (MWCOG) developed an inventory of free parking spaces at federal facilities in the Washington area. She found 37,489 federal employee parking spaces located in the District of Columbia.

We know, anecdotally, that there are other employers in the District who provide free parking to all or some employees. Universities, hospitals and other large institutions

often have huge parking lots. Some retail stores have large parking facilities – and their employees might park there for free. Although the District has no inventory of employment parking, page 95 of the 2013 State of the Commute Survey indicates that 35% of employees in the Region’s inner core (DC, Arlington and Alexandria) have access to free parking at work.

One section of CACFA requires property owners to provide such an inventory. Even without the application of a fee, this inventory of employment parking would be valuable to the District Government in terms of traffic management and transportation facility planning.

## 6. HOW SIGNIFICANT WILL BE THE IMPACTS OF CACFA?

Typically, the significance of the impact will depend upon the significance of the fee. However, there are exceptions. In January 2010, the District imposed a \$0.05 fee on plastic bags used for groceries and similar sales. This isn’t much. But any fee is a big difference from free. An analysis by the Beacon Hill Institute estimated that the nickel fee reduced the consumption of plastic bags by more than 50%.

Likewise, a fee on employment parking of \$30 per month might not seem like much compared to the monthly market rate for downtown parking, which can run from \$250 to \$300 or more. Yet, a \$30 per month fee is a big increase from “free.”

From a revenue perspective, even if only the 37,489 federal spaces identified by MWCOG paid a \$30/month fee, this would yield about \$13.5 million per year for the transit component of the District’s clean air compliance program.

From an air quality perspective, MWCOG performed an analysis using their transportation and air quality models in 1994, when the proposed fee was \$20/month. At that time, the MWCOG models estimated the following impacts:<sup>A4-7</sup>

Vehicle Trips	14,500 fewer vehicle trips per day
VMT	217,500 fewer vehicle miles traveled per day
1996 VOC	0.20 tons/day reduction in Volatile Organic Compounds
1996 NOx	0.41 tons/day reduction in Nitrogen Oxides

If the Clean Air Compliance Fee Act were reintroduced, MWCOG would update this analysis based on the proposed fee, new traffic data, and revisions to MWCOG’s transportation and air quality models.

**7. WHY WOULD THE FEDERAL GOVERNMENT COMPLY WITH A CLEAN AIR COMPLIANCE FEE ACT?**

Typically, the federal government is not required to comply with state or local regulations and fees. However, the federal Clean Air Act of 1990 as amended contains an explicit waiver of sovereign immunity. Section 118(a) of the federal Clean Air Act requires the U.S. Government to comply with all state and local clean air requirements “in the same manner and to the same extent as any nongovernmental entity.”<sup>A4-8</sup> Therefore, if the District imposes a clean air fee on employment parking spaces in the District, federal employment parking spaces would also be subject to the fee.

The Justice Department is charged, among other duties, with protecting the legal interests of the federal government. Therefore, in spite of the explicit waiver of sovereign immunity contained in the Clean Air Act, the Justice Department has litigated clean air fees applied by other jurisdictions. At the time that the Council last enacted the Clean Air Compliance Fee Act, the federal government had not succeeded in any of these law suits. Therefore, the District should not be surprised if the federal government were to challenge its liability under such an act. But, absent any reversal of prior legal precedent, the District should expect to prevail.

**8. WHY WOULDN'T CONGRESS INTERFERE AS THEY WOULD WITH A “COMMUTER TAX?”**

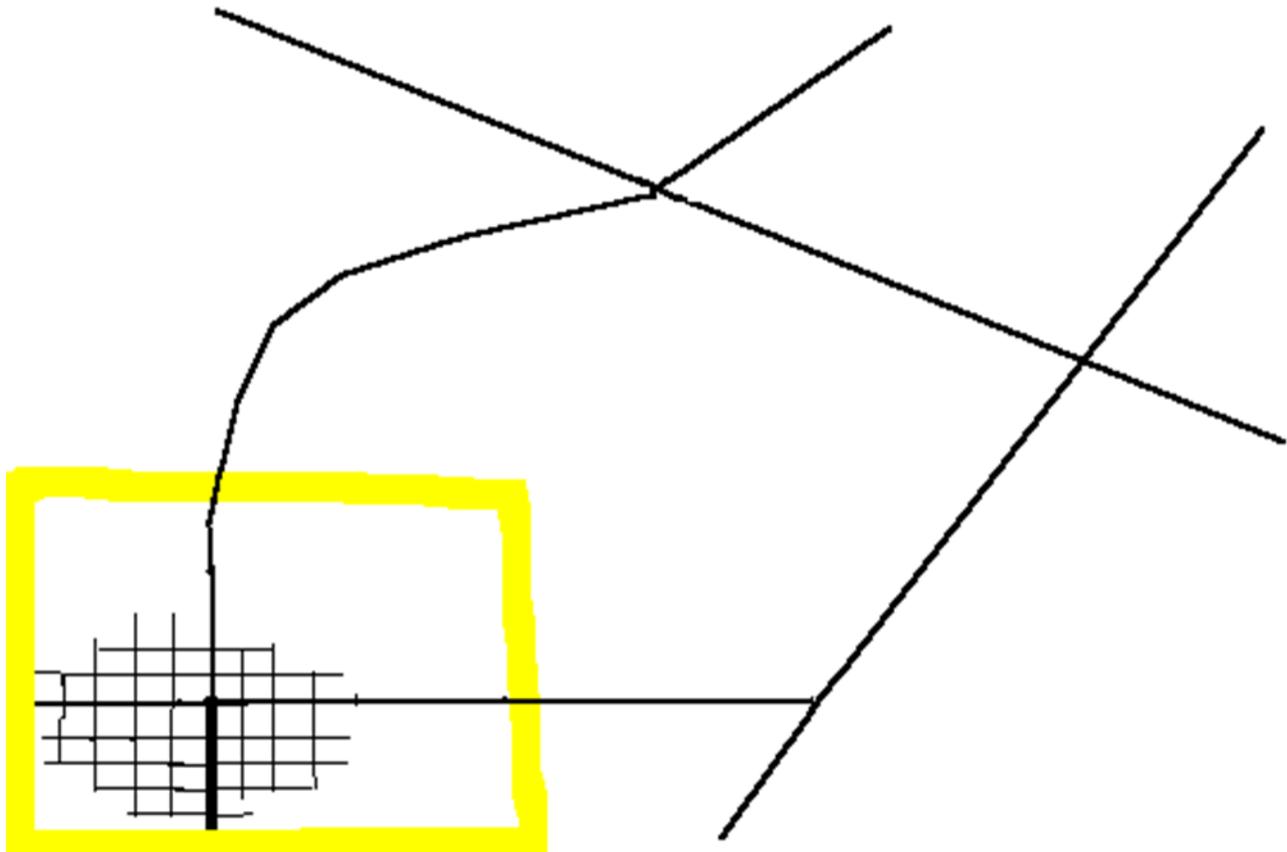
There is always a risk that Congress might interfere with District legislation. However, there has been increasing public support for the idea that the federal government should abide by the same rules as other entities. Additionally, many support the idea that subsidies for autos and transit should have a more level playing field.

In 1997, Congress repealed the District’s Clean Air Compliance Fee Act of 1994. The repeal was buried in a small paragraph at the back of legislation that provided federal assistance and oversight to extract the District from a financial crisis.<sup>A4-9</sup> At that time, the District was in no position to contest this assault on home rule. Today, the District is financially sound. A stand-alone bill to repeal the District’s enactment of this legislation would meet with vigorous opposition and would be unlikely to garner public support outside of the District’s suburban districts.

For these reasons, Congress might be less likely to interfere with the District’s enactment and implementation of a Clean Air Compliance Fee Act.

## 9. HOW DOES INFRASTRUCTURE EXACERBATE SPRAWL?

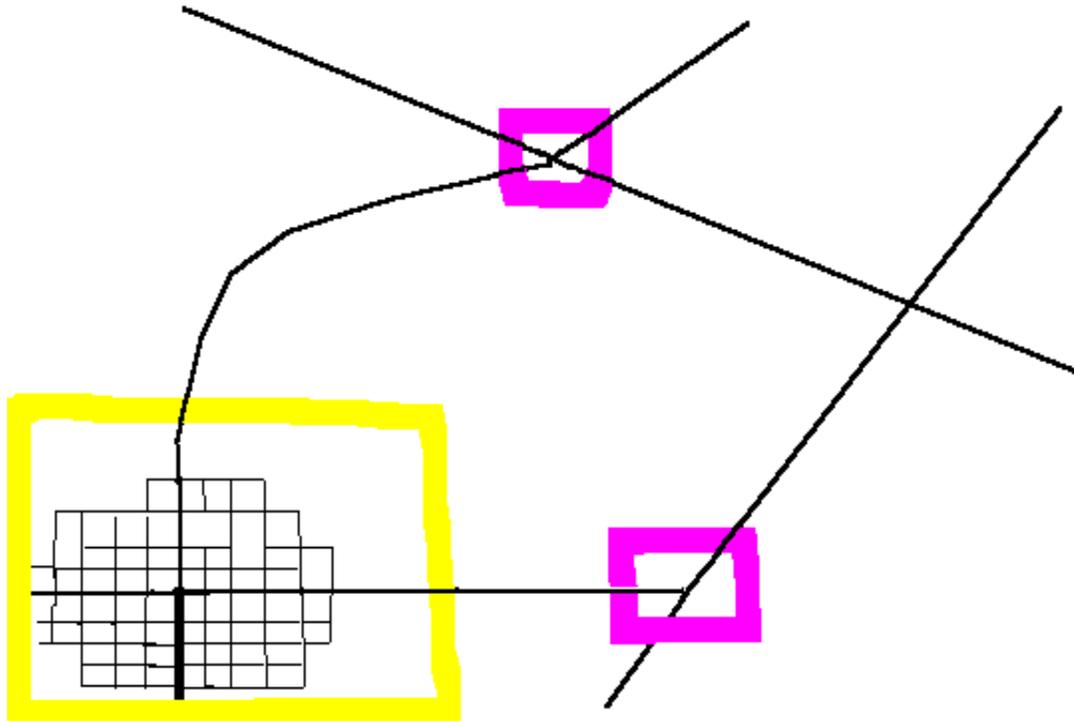
The main report notes that the provision of infrastructure can exacerbate sprawl. How does this occur?



## **Transp. Facility = Growth Opport.**

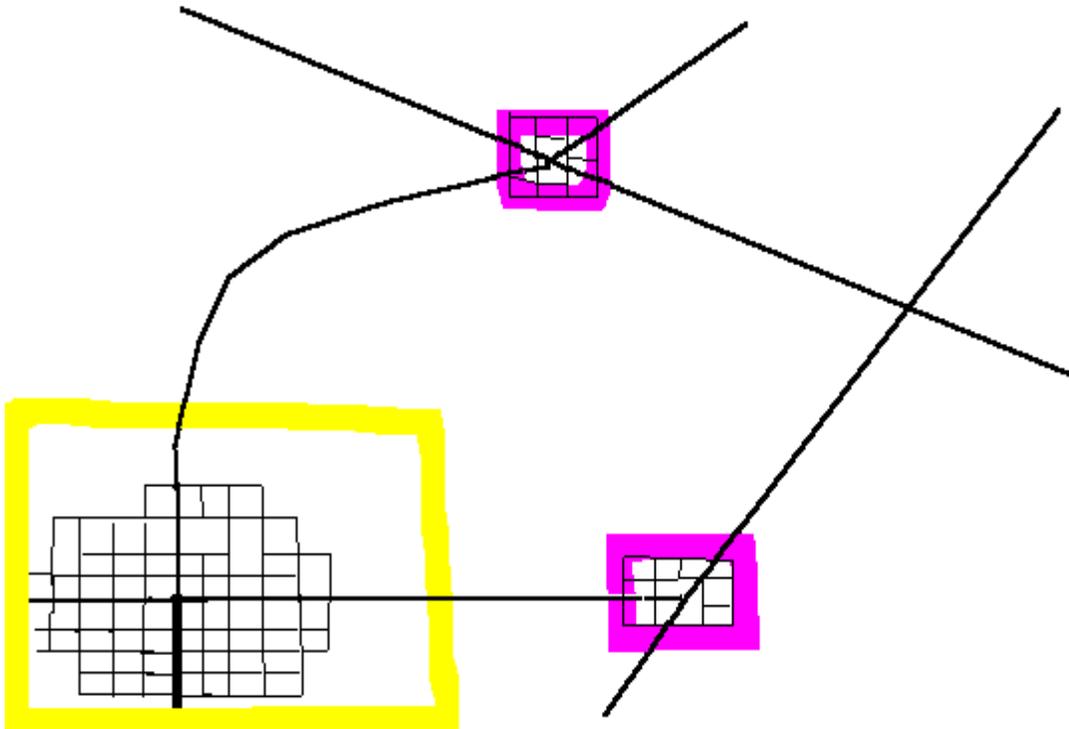
Above is an illustration of a transportation network. At the bottom left is a small town located outside of a major city and employment center (located off the map to the bottom). Line widths are related to the carrying capacity of either roads or transit services.

From the middle of the small town is a thick black vertical line headed south. This represents a new transportation facility (a wider road or perhaps a new or improved transit service) that provides a better connection to the major city to the south. This new transportation facility creates makes it easier to access the jobs in the central city and creates an opportunity for more development in the small town. This “growth opportunity” is illustrated by the yellow rectangle around the town.



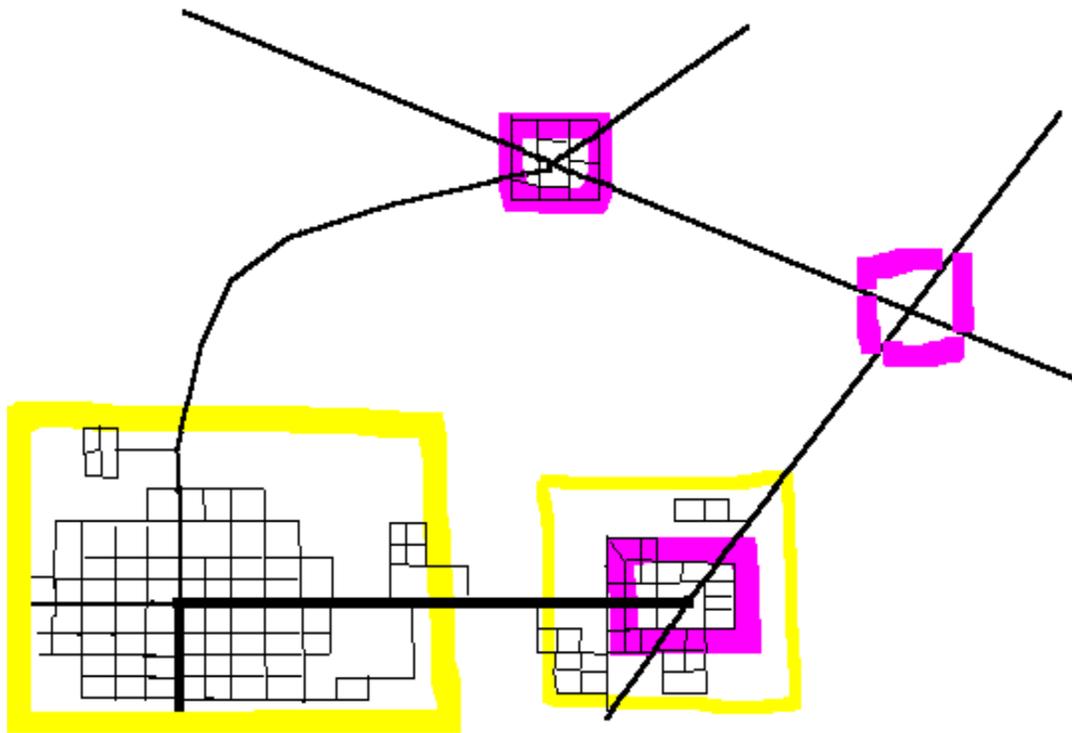
## Rising Land Costs Impede Growth

New growth does occur, as illustrated by the expansion of the transportation network within the yellow rectangle. But landowners quickly realize that their land is much more valuable than it used to be. Some of them decide that it might be foolish to sell their land at its current market price when this land could be even more valuable in the future. So these landowners refuse to sell or try to sell land at prices they think will be realized in the future. Developers will only buy land at prices that can be supported by their potential tenants or buyers. So as land prices rise in excess of what actual users will pay, developers seek cheaper sites. These new development opportunity areas are identified by the purple rectangles.



## **Growth Diverted to Cheap Sites**

Although some growth does continue within the initial growth opportunity area, a considerable amount of new growth is diverted to cheaper, more remote sites. As these remote sites develop, the existing infrastructure at these locations becomes inadequate. Residents and businesses at the remote sites petition politicians for an extension of the transportation facility or service to their area – even though excess capacity exists at the initial infrastructure location. Politicians would love to make everyone happy, but budget constraints prevent that. As a result, only one of the remote communities can receive an infrastructure extension.



## Cycle Begins Again

So, although there remains plenty of capacity for growth in the town where infrastructure was initially provided, infrastructure is extended, at great expense, to one of the more remote communities. And, when this happens, the cycle begins again. Thus, infrastructure intended to facilitate development ends up chasing it away. Infrastructure is extended to more remote sites, but never catches up. The resulting sprawl impairs the environment due to excessive traffic and impervious surfaces. Agricultural, recreational and conservation lands are lost or impaired as well.

Sprawl is also very expensive. All the growth pictured here could have easily fit within the yellow growth opportunity area created by the initial provision of new or improved infrastructure to the small town. But instead, the same number of people will now need much more infrastructure. Thus, the per-capita tax burden required to support sprawl exceeds what would be needed for more compact, “smart growth.” There are many causes of sprawl, but infrastructure-induced increases to land prices and subsequent land speculation are significant causes that are often overlooked.

## **QUESTIONS ABOUT PUBLIC SERVICE ACCESS FEES – “VALUE CAPTURE”**

The concept of public service user fees (e.g., per gallon fees for water & sewer, parking fees, roadway tolls, etc.), are relatively well-known and understood. Much less talked about, however, are public service access fees or “**value capture**.” In other words, regardless of whether public goods and facilities are being used at a particular site, their availability enhances the value of that site and provides a direct economic benefit to the site owner. The process whereby the public retains some or all of the site value (land value) that it creates is referred to as “value capture.”

As mentioned in the main report, the value capture concept can be used to transform the property tax into a public service access fee by reducing the tax rate on privately-created building values and increasing the tax rate on publicly-created land values. Because this change would reduce building taxes for all property owners (instead of just a favored few), this technique could be referred to as the “universal abatement” approach to property taxation. When people are first introduced to the “value capture” concept, questions and concerns arise. Some of these are addressed below.

Section I deals with the basic concept related to the different effects of taxing buildings and land. Section II answers questions about the effects & implications of this approach, particularly those related to assessments, appeals, and revenues. Section III discusses how zoning relates to property taxation. Section IV discusses whether the value capture approach to property taxation will cause too little or too much development. Section V will address the experience of communities that have implemented value capture.

### **I VALUE CAPTURE & PUBLIC SERVICE ACCESS FEE CONCEPT**

“The property tax is, economically speaking, a combination of one of the worst taxes—the part that is assessed on real estate improvements . . . and one of the best taxes—the tax on land or site value.”

-- William Vickery, 1996 Nobel Prize Winner for Economics <sup>A4-10</sup>

## 10. WHY SHOULD THE DISTRICT REDUCE THE TAX RATE ON BUILDING VALUES AND INCREASE THE TAX RATE ON LAND VALUES?

### A. Impact of Taxes on Building Values

Building values are privately created and maintained. The property tax on building values is a cost of production. After all, if there is no building, there is no tax. So the tax on building values makes it more expensive to construct, improve and maintain buildings. The property tax on buildings in the District is typically between 1% and 2%. This might not seem like much. But unlike a sales tax that is paid only once, a property tax on building values is paid each and every year that an improvement adds value to a property. This stream of payments can have an economic impact equivalent to a one-time sales tax of between 10% and 20% on construction labor and materials.<sup>A4-11</sup> The property tax applied to building values imposes a financial burden on their creation and maintenance, thereby reducing jobs and diminishing the affordability of space for residents and businesses.

Reducing the tax rate on building values makes buildings cheaper to construct, improve and maintain. This enhances the supply of buildings and employs more people. The additional supply of residential and commercial space helps keep market rents more affordable and this is good for residents and businesses alike. And, by reducing the 10% to 20% cost penalty on building improvements, some additional energy-saving retrofits of existing buildings can become economically viable, reducing energy consumption and carbon emissions while creating jobs that cannot be outsourced.

### B. Impact of Taxes on Land Values

**Where do land values come from?** Land values are created by the community. They result from public goods and services and from the efforts of the entire community to make an area a good place to live, work and play. People who own the best-served land, typically commercial land in cities, charge rents based, in part, on the value of their land's location. Thus, private landowners are in a position to profit from the provision of public goods and services. If taxes improve transit services, land near the stations will rise in value. If transit services are good and the transit agency reduces fares, land near the stations will rise in value. The ability of private landowners to profit from publicly-created land values encourages land speculation. In other words, instead of making land available to people who need to use it for residences or businesses, some landowners simply hold onto land hoping that it will

become more valuable in the future. They are hoping to make money off of other people's work.

In Brooklyn, New York, declines in manufacturing jobs combined with years of speculation and landlord neglect resulted in the destruction of vast areas. During the 1980s and early 1990s, some neighborhoods were characterized by block after block of vacant lots and burned-out buildings, resembling a war zone. Most of the land was owned by New York City or private banks as a result of landowners defaulting on their taxes and mortgages. Here and there, a few lots were still privately owned. A coalition of churches and labor organizations realized that constructing affordable homes, one here and one there, would not be sufficient to regenerate this neighborhood. So they decided to create a neighborhood by revitalizing several square blocks at one time. After getting commitments for donated labor and materials, they approached New York City which agreed to transfer the land to them for a nominal fee. The banks (and even the few scattered private owners) were happy to be free of the liabilities associated with these vacant parcels and they too agreed to transfer the land for a nominal fee. After constructing affordable workforce housing over several square blocks, people moved in and the Nehemiah Project was a great success.

There was so much demand for the affordable houses that Nehemiah sought to expand its project into adjoining blocks. Again the city was willing to transfer land for a nominal fee. But the banks and the private landowners took a different point of view. They noted that the area had become "a thriving neighborhood." Therefore, their land was worth a lot of money. So the Nehemiah Project was forced to pay a premium price for land that Nehemiah had made valuable in the first place.<sup>A4-12</sup>

Here in the District, we pay taxes to help build and operate the Metro transit system. And we pay a fare when we ride it. But, if we want to take full advantage of the system, we want to have our home or our business close to a transit station or stop. When we offer rent money to a landlord, the landlord's response could be, "Well, that would be rent for a typical space in the District. But this apartment isn't typical. It's right next to the Metro. You've got to pay more." So we end up paying a premium rent to a landlord in order to get access to the transit system that we've already paid for through our taxes and fares. The apartment or store near Metro is worth more than a typical one elsewhere. But it is worth more because of what Metro has produced with our taxes and fares. Therefore, the premium value of the apartment was created by the public, not by the landlord who collects the rent.

Metrorail cost about \$10 billion to construct. Conservative estimates indicate that Metrorail service has created more than \$10 billion in land values around the

stations.<sup>A4-13</sup> If Metrorail were able to recapture the values it created, it could be financially self-sustaining. And, by capturing and recycling the land values that it creates, Metro could afford to minimize fare increases and reduce its demand for subsidies from the general public.

Thus, because land values are created by the community, either through the provision of public infrastructure or through the aggregate actions of private community members, land values are an appropriate source of funding for public goods and services.

**What is the impact of taxing land values on land prices?** Surprisingly, the effect of taxing land values is to make land prices go down. In our experience, most taxes make things more expensive – like the tax on buildings. What accounts for this difference?

First, land is not produced. There is a fixed supply of land. There is as much land after a tax is applied as there was before. (For goods that are produced, taxing them causes fewer goods to get produced. It is the reduction in the supply of taxed goods that causes their price to rise after taxes are imposed.) Assuming that the demand for land does not change, nobody is willing to pay any more for land after the tax is imposed than they were before it was imposed. In a theoretical world where all land is fully utilized, people pay the same for land after the tax as they did before. However, more of the land payment goes to the government (in taxes) and less goes to owners in rents or sales prices.

In the real world, however, we know that there are significant amounts of land that are underutilized. There are vacant lots, boarded-up and half-vacant buildings, surface parking lots, etc. Some of these underutilized parcels are held out of use because it is relatively inexpensive to do so. If the tax on land values were to rise, some people would no longer be able to afford to withhold their land from development – particularly if that land is in a high-value location. Thus, an increase in a land tax could cause some speculators to develop their land or sell to others who will. This increase in the supply of land available for development could cause land prices to decline in real terms. (NOTE: If the tax on building values is reduced, that would tend to increase land values by making sites potentially more profitable.)

Reducing the tax rate on privately-created building values and increasing the tax rate on publicly-created land values allows a community to raise the same amount of tax revenue, but in a way that makes both residential and commercial space more

affordable and in a way that encourages infill development on high-value sites near transit and other infrastructure amenities.

## II EFFECTS & IMPLICATIONS

### 11. REDUCING THE TAX RATE ON BUILDING VALUES AND INCREASING THE TAX RATE ON LAND VALUES WILL IMPACT DIFFERENT PROPERTY OWNERS IN DIFFERENT WAYS. HOW CAN WE KNOW THESE IMPACTS?

For any jurisdiction, there will be a jurisdiction-wide ratio of improvement values to land values. If an individual property has the same improvement-to-land-value ratio as the entire jurisdiction, then a shift in taxes from building values to land values will not change the amount of tax due, assuming that the total jurisdictional tax revenue is the same under both systems. (It is important for making fair comparisons that the shift from one tax system to another is “revenue-neutral.”)

If an individual property has a lower improvement-to-land-value ratio, then the shift in taxes from building values to land values will result in a tax increase. An extreme example would be a vacant lot that has no building value. The taxes on this property would rise when rates were lowered on building values and increased on land values. If an individual property has a higher improvement-to-land-value ratio, then the shift in taxes from building values to land values will result in a tax decrease.

In 1990, actual District assessments were obtained from DFR. In 1991, both the existing tax rates and a hypothetical set of “value capture” rates were applied to those assessments. For the value capture tax rates, the tax rate on buildings was reduced and the tax rate on land was increased until there was a 1:2 ratio of building tax to land tax. Thus, a different set of hypothetical tax rates was established for each class of property in effect in 1991. The hypothetical tax rates were designed to raise the same total citywide revenue as the existing rates. The study was presented in testimony to the Committee of the Whole of the Council of the District of Columbia on June 21, 1991 regarding proposed real property tax rates for 1992. Throughout the remainder of this appendix, this will be referred to as the “**1991 Tax Rate Study.**”

The methodology and results of the 1991 Tax Rate Study are shown in Appendix 2 to the main report.<sup>A4-14</sup> Residential properties in the District exceeded the jurisdictional improvement-to-land-value ratio. Thus, the typical homeowner property experienced a 12% tax reduction and the typical rental property experienced an 18% tax reduction.

Surprisingly, the improvement-to-land-value ratio tends to be higher in low- and middle-income neighborhoods than in affluent neighborhoods. Thus low-income and middle-income neighborhoods generally experience greater tax reductions than affluent neighborhoods as a result of this tax reform. The results of this study were consistent with a similar study conducted by DFR in the 1970s.<sup>A4-15</sup>

Nonetheless, it has been more than 20 years since the 1991 Tax Rate Study was conducted. The Office of Tax and Revenue (OTR) could update this study and determine the impacts of this reform by neighborhood and by type of property.

Among the factors essential in generating an accurate and useful update are:

- Segregating improved properties from vacant properties. A “value capture” approach to property taxation has divergent impacts on developed and vacant properties. Lumping them together produces a confusing result. Therefore vacant properties should be segregated as part of the analysis. Surface parking lots (which have minimal improvement value) should be analyzed along with vacant properties and their minimal improvement values can be discarded without compromising the study.
- Translating existing property tax programs and features (such as classification and the homestead deduction) into the new tax system must be done with care in order to provide an “apples to apples” comparison between the status quo and a value-capture system.

## **12. IS A VALUE-CAPTURE APPROACH TO PROPERTY TAXATION PROGRESSIVE?**

The existing property tax does not bear any direct relationship to owner income. Shifting the property tax burden off of buildings and onto land also does not bear any direct relationship to an owner's income. However, there tends to be a greater correlation between land value and income than between building value and income. In other words, there are people of modest means who own their own home. But people of modest means typically own homes in neighborhoods where land values tend to be much lower. Affluent people, on the other hand, tend to locate in neighborhoods where land values are a high percentage of property value. In the 1991 Tax Rate Study,<sup>A4-16</sup> shifting taxes off of building values and onto land values created the largest tax reductions in middle- and low-income neighborhoods. Thus, shifting taxes off of building values and onto land values could create a stronger relationship between tax liability and ability to pay.

Some believe that reducing taxes on improvements will primarily benefit folks who own expensive houses and office buildings. However, the value of land under expensive structures tends to be a higher proportion of total value than the value of land under less expensive buildings. Thus, the primary beneficiaries of a split-rate property tax will be owners of residential property in the central and eastern portions of the District, where modest homes nonetheless represent a higher percentage of total property value than luxury homes in more affluent neighborhoods.

Why should the District impose any tax or fee that is not related to income? As previously mentioned, a tax on land values has some characteristics of a user fee. Landowners pay in proportion to the value they receive from the community through the provision of public goods and services. It seems fair to collect taxes based on the value of benefits provided by the community to individual land owners. Also, taxes or fees related to the value of infrastructure send important signals to landowners about the importance of developing properties that are well-served. If we did not tax land at all, perhaps the owners of land atop Metro Center might keep it vacant or build only single-family homes there. That would be a terrible waste of the billions invested in the Metrorail transit system that make these sites among the most accessible (and potentially productive) in the entire region. High land taxes at this location help ensure that this land is developed intensively. As a result, the public benefits more fully from its infrastructure investments there.

If property taxes are out of proportion for low-income households, there are several programs already in place to provide assistance.

- The homestead deduction subtracts a designated amount from homeowner assessments before the property tax rate is applied. This deduction provides a greater percentage reduction for lower-valued properties, thereby making the property tax more progressive. <sup>A4-17</sup>
- For qualifying seniors whose household income falls below \$100,000, their property tax bill is reduced by 50%. <sup>A4-18</sup>
- The “circuit breaker” provision stipulates that property taxes should not exceed a given percentage of income for low-income households. If property taxes exceed the statutory threshold, these households (both tenants and homeowners) are entitled to relief on their DC income tax. <sup>A4-19</sup>

- Some multifamily and single family rental and cooperative housing for, and individual condominium units rented to low and moderate income persons receiving federal housing assistance may be totally exempt from property taxation. (In other cases, some payment in lieu of taxes might be required.)<sup>A4-20</sup>
- Another program allows homeowners to defer increases in property taxes if taxes increase above a given percentage from the prior year.<sup>A4-21</sup>

These programs can be continued if property taxes are shifted off of building values and onto land values. In some cases, the mechanics might need to be adjusted. For example, would the homestead deduction be subtracted from the land value, from the building value or half from each? The answer might depend on a number of factors, including administrative and political feasibility.

### **13. WILL VALUE-CAPTURE TAXATION PROMOTE AFFORDABLE HOUSING?**

The 1991 Tax Rate Study<sup>A4-22</sup> showed that homeowners in low-income neighborhoods received the greatest percentage reductions in their property taxes compared to what they pay under the present system. This should help maintain homeownership in these neighborhoods where homeowners are important role models. Money that is not spent on taxes increases disposable income that can be used to maintain homes and patronize neighborhood businesses, further strengthening these communities.

The 1991 Tax Rate Study also showed that most rental properties received tax reductions. To the extent that the cash flow of these properties can be improved, without any increase in rents, this should reduce pressure to raise rents or to convert apartments to condominiums.

Although all rental properties must be registered pursuant to the District's rent control law, many units are exempt from the rent stabilization provisions.<sup>A4-23</sup> As of 2011, there was not a definitive database of rent-controlled units. An Urban Institute report in June 2011 estimated about 79,000 units subject to rent control in the District.<sup>A4-24</sup> The D.C. Fiscal Policy Institute estimates that D.C. has lost more than half of its low cost rental units over the last decade. During this time, the number of low cost rental units—defined as having monthly rent and utility of less than \$750 a month—fell from 70,600 to 34,500.<sup>A4-25</sup>

Although rent stabilization should limit rent increases for the remaining units, hardship petition rent increases can be obtained by owners who show that they are not making the minimum rate of return guaranteed by the law. Capital improvements can also qualify a landlord to enact rent increases above the standard annual increase for inflation.

To the extent that a value-capture approach to the property tax reduces expenses, the number and severity of hardship petition rent increases should be reduced. Likewise, capital improvement increases could be mitigated by the reduced tax rate applied against the value of those improvements.

Where vacant land or boarded-up buildings exist in areas zoned for residential uses, a value capture approach to property taxation will create an incentive to develop residential buildings. What type of residential development will occur will depend on market demand, zoning and the availability of financing.

Even if these new rental units are market-rate units, they can contribute favorably toward affordable housing to the extent that they accommodate tenants who might otherwise bid up the price of existing affordable units and displace low-income tenants.

The value capture approach to property taxation will make housing less expensive. This will not eliminate the need that some households have for housing subsidies. But, by reducing the costs to build, improve and maintain rental housing, a value-capture approach to property taxation should make local and federal housing subsidy dollars go further than they do today.

Regardless of what actual rates are implemented, when compared to the existing property tax, shifting property taxes off of building values and onto land values should:

1. Reduce housing costs in the District somewhat, particularly in middle- and low-income neighborhoods;
2. Reduce the cost to maintain or improve buildings; and
3. Provide both a carrot (lower building taxes) and a stick (higher land taxes) to incentivize the redevelopment of some vacant land and boarded-up buildings.

#### 14. WILL VALUE CAPTURE EXACERBATE PROBLEMS ASSOCIATED WITH GENTRIFICATION?

**Types of Displacement.** Homeowners and tenants frequently move between cities or within cities for a variety of reasons. And the freedom to move is generally seen as a good thing. However, when tenants or homeowners are forced to move against their will, such moves can be unpleasant and disruptive. Being forced to move is referred to as “displacement.”

As a general rule, it is somewhat unusual for affluent households to move into low-income neighborhoods. However, in neighborhoods where this becomes a trend, affluent households bid up the price of land. Less affluent households can be involuntarily displaced due to rising rents, rising property taxes or both. This type of displacement is referred to as “gentrification.”

However, in the absence of gentrification, real estate speculation and disinvestment in existing buildings can create horrible living conditions. When conditions become intolerable, residents leave. Vacant or partially-vacant buildings attract drug users and other criminals. This reduces land values for nearby properties and previously “responsible” landlords might determine that there is no economic return from maintaining their property. Thus, disinvestment and blight can spread like a cancer infecting entire neighborhoods. In these neighborhoods, vacant or half-vacant buildings testify to involuntary displacement. Here, households are not displaced by an influx of the affluent, but by neglect and disinvestment in existing buildings.

Gentrification tends to get a lot of media attention. This is particularly true when the ethnicity, age or culture of newcomers are markedly different from long-time residents, thereby engendering social friction in addition to economic coercion. Yet, more tenants are displaced by disinvestment and blight than by gentrification.<sup>A4-26</sup>

The displacement of low- or moderate-income homeowners by gentrification is a problem. Yet, the media will often focus on these victims of gentrification (who as homeowners can sell their homes and realize some economic gain from which to acquire new housing) while ignoring the plight of more numerous and less affluent tenant households impacted by disinvestment.

The District’s rent control and condo conversion control laws have reduced displacement from both disinvestment and gentrification. The District’s rent control law is referred to as “moderate” because it allows for rent increases under certain circumstances:

- Annual increases pegged to inflation as measured by the consumer price index;
- Hardship petitions to allow landlords to make a minimum guaranteed rate-of-return;
- Voluntary agreements whereby landlords & tenants negotiate rent increases in exchange for building improvements;
- Capital improvements or substantial renovation increases;
- Vacancy increases to bring units closer to market rents.

In order to take advantage of statutory provisions for increasing rents, housing accommodations must be in compliance with the housing code. Thus, landlords who depend on rent revenues have an incentive to bring their units into compliance. This helps combat displacement by disinvestment.

Second, because rent increases associated with vacancies would provide landlords with an incentive to evict tenants, the rent control law limits landlords' ability to evict tenants. Prior to rent control, many tenancies were "at will" and could be terminated with little or no notice by the landlord. After rent control was enacted, tenants could only be evicted for non-payment of rent and/or a failure to abide by terms of the lease (such as prohibitions on engaging in illegal activities or destruction of property). Thus, law-abiding tenants who pay their rent have security of tenure. This helps combat displacement by gentrification.

If a landlord wishes to sell a property, the tenants must be given an opportunity to purchase the building either by making an offer or by matching the offer of a third party. (This is referred to as "tenants' first right of purchase.") If tenants do not elect to purchase the building, they are entitled to relocation assistance.

Taken together, the requirement for housing code compliance, security of tenure and first right of purchase are among the most important aspects of the District's housing laws in relation to preventing displacement.

In spite of these protections for tenants, the amount of affordable housing in the District has declined significantly over time.<sup>A4-27</sup> Until the Tax Reform Act of 1986, generous depreciation allowances encouraged high-income individuals and partnerships to buy rental housing as a tax shelter against their earned income. Properties would often be flipped between investors at inflated prices that had little relation to their rent-earning capacity, merely to generate depreciation allowances.<sup>A4-28</sup>

These owners often had little or no interest in (or knowledge about) the business of providing rental housing. For some low-income rental buildings, revenues from rent may have been minimal compared to tax-shelter benefits. Therefore, some “tax-shelter landlords” may have concluded that it was not worth their effort to maintain buildings to code in order to achieve nominal rent increases.

Thus, in spite of rental properties being bought and sold every few years (when the accelerated depreciation had run out), little or no actual investment in maintenance or rehabilitation of essential building systems would occur. “Demolition by neglect” evicted many tenants in Shaw and other neighborhoods years before any influx of affluent tenants or homeowners might have displaced them.

**The role of the Existing Property Tax.** As mentioned in the main report and in this appendix, the property tax on building values can have the economic impact of a 10% to 20% sales tax on construction labor and materials.<sup>A4-29</sup> This is a substantial cost. Older buildings, which are often most in need of maintenance and rehabilitation, are most burdened by this tax penalty. And a 10% to 20% cost penalty can easily place even basic maintenance and repair costs out of the reach of the low- and moderate-income households residing in older buildings.

While making it difficult for low- and moderate income households to maintain decent housing, this tax penalty also ensures that only the affluent will be able to afford to make the types of investments that older buildings require. Thus, property repairs and improvements come to be associated with gentrification to the point where a long-time resident who fixes a porch might engender fear among neighbors that this repair will send a signal prompting affluent households to move in. Others may fear that an increase to the assessment of one property will be applied to the rest of the neighborhood.

This situation also prompts a common misunderstanding about how property values are increased. If a single affluent household moves into a low- or moderate-income community and undertakes a massive renovation, the cost of the renovations might exceed increases to the market value of the property. And, such renovations are unlikely to affect the assessment or taxes of neighbors. However, when many affluent households demand housing in a low-income neighborhood, they drive up land prices. Higher land prices may then prompt renovation of existing buildings and/or new construction to accommodate this demand. But because land values are invisible to most, many people believe that renovation and new construction cause neighborhood assessments to rise. Instead, widespread renovation and new construction are the results of higher land prices.

**The Impact of a Value-Capture Approach.** Using value capture to re-orient the property tax into a public service access fee, by reducing the tax on building values and increasing the tax on land values will generally make housing more affordable. As shown in the 1991 Tax Rate Study, this re-orientation could result in significant property tax reductions for both homeownership and rental properties throughout the District with the most significant reductions on a percentage basis occurring in moderate- and low-income neighborhoods. So, the transition from the existing property tax to a value-capture approach would benefit existing low-income residents and not create economic pressure for gentrification.<sup>A4-30</sup>

If the property tax is restructured using value capture, any subsequent sudden increase in neighborhood land values would have a greater tax impact on existing households than under the current system. As mentioned above, rent control and condominium conversion control (along with several programs that provide property tax relief to low- and moderate-income households) would slow down, but not eliminate, the gentrification process.

Just as displacement due to neglect and disinvestment outweighs displacement due to gentrification under the status quo, the ability of the value-capture approach to enhance the supply and affordability of housing citywide might exceed any losses that might be experienced in gentrifying neighborhoods. Increases in building improvement and maintenance citywide should also provide enhanced employment opportunities to some low- and moderate-income households, bolstering their ability to avoid displacement.

Furthermore, improving the affordability of decent housing in all neighborhoods combined with the tax penalty on vacant and boarded-up properties could reduce blight in many neighborhoods. This might reduce the tendency of affluent households to focus their residential acquisitions in only a few neighborhoods. If the location decisions of affluent households were not so intensely focused on only a few neighborhoods, then their location decisions might be less likely to cause land prices to spike, thereby weakening the gentrification phenomena.

## **15. WOULD TAX ABATEMENTS AND OTHER SUBSIDY PROGRAMS BE MORE APPROPRIATE FOR ACHIEVING AFFORDABLE HOUSING**

A suggestion to use abatements and other subsidies instead of a value capture approach to promote low-income housing indicates a possible misunderstanding of

the situation. The cost of providing housing is very expensive, and beyond the means of some households. Various types of deep subsidies will always be needed to adequately house these households. A value-capture approach, by itself, will not address the housing needs of those who require deep subsidies.

A value capture approach to property taxation is designed to encourage all property owners to maintain and improve their properties within the limits established by economic demand, zoning and other development regulations. Because residential properties generally have a high ratio of improvement value to land value, they generally receive tax reductions in a revenue-neutral switch to a value-capture system. As shown in the 1991 Tax Rate Study, housing in low-income neighborhoods generally receives the largest tax reductions.<sup>A4-31</sup> For these reasons, proponents of a value-capture approach have referred to it as a "pro-housing" proposal.

The value-capture approach will make most housing more affordable. By reducing the market rate prices and rents of housing generally, value capture can help reduce the gap between what low-income households can afford and the market rents and prices for housing. Thus, given limited funds for housing subsidy programs, those funds will help more people as a result of a value-capture approach reducing the market rents and prices of housing.

Abatements, unlike the value-capture approach however, entail a loss of revenue and therefore require additional taxes or spending cuts. How is the benefit of the abatement weighed against the impacts of additional taxes or spending cuts? Abatements must also be approved by legislation, introducing opportunities for favoritism.

Abatements are typically available only to new projects. Thus, older buildings in distressed neighborhoods that have struggled to provide housing, office or retail sites during hard times, may suddenly face new buildings, constructed with tax abatements, competing for their residential and business tenants. The new abatement buildings can undercut and threaten the viability of older ones which don't have the benefit of tax abatements.

In such instances where abatements lead to the demise of older buildings, abatements merely substitute new units for older ones. A value-capture approach encourages property maintenance and improvement for all buildings – old and new ones alike.

Property tax reform and housing subsidy or linkage programs are not "either / or" propositions. Rather, a value-capture approach complements other housing programs. Lower land prices that could result from a value-capture property tax allow a given amount of subsidy money to help more households from either a demand-side or supply-side approach. Reduced building taxes reduce the cost of maintaining affordable housing once it has been created.

Value capture is not intended to substitute for housing subsidy programs. Instead, value capture complements them and allows these programs to be more effective than they are under the existing property tax system.

**16. WON'T NEIGHBORHOODS WITH LARGE YARDS BE PENALIZED?**

It is not the absolute size of a lot that determines the change in tax burden. Instead, it is the ratio of improvement value to land value. Therefore, the answer to this question is, "It depends." The 1991 Tax Rate Study in Appendix 2 showed that even neighborhoods with large yards would experience a tax reduction as a result of the recommended tax shift from building values to land values. Deanwood, for example, has many homes on large lots. Yet the average Deanwood home experienced a 26% tax reduction and the typical Deanwood rental property experienced a 20% reduction. On the other hand, the average home in American University Park experienced only a 6% tax reduction while rentals experienced a 14% reduction. This was not because the American University Park lots were larger than those in Deanwood, but because land values in American University Park comprised a higher percentage of total property value (41% compared to 27%).

**17. ISN'T THE DISTRICT MOSTLY BUILT-UP? HOW MANY VACANT LOTS ARE THERE?**

Discussions about using value capture to transform the property tax into a public service access fee often focus on the role of this reform in promoting the development of vacant, boarded-up and underutilized properties. Some people doubt that there is much development opportunity in this regard.

In 1990, data from the Department of Finance and Revenue (DFR), indicated over 11,000 lots that were either vacant or used for surface parking. Specifically, DFR listed 10,424 vacant lots, and 1,108 surface parking lots for a total of 11,532 lots.

This data included taxable property only. Government and tax-exempt properties were excluded.

At that time, several neighborhoods were characterized by vacant and underutilized land including Buzzard's Point, Shaw, Anacostia, Deanwood, Hillcrest, Congress Heights, Old City #1, Randle Heights, Woodbridge, Brookland, the New York Avenue corridor, the area from Union Station to Eckington, Marshall Heights, and segments of Georgia Avenue and North Capitol Street, to name a few. Some of these areas, such as the area north of Union Station, have seen considerable development activity in the past 20 years. But others have not. To update the 1990 data about vacant lots and surface parking lots, a request would have to be made to the Office of Tax and Revenue (OTR).

Buildings that are vacant or partially vacant expand the supply of potentially developable space even further. In spite of the District's robust economy and a high demand for residential and commercial space, a report by the District's Department of Housing and Community Development (DHCD) in 2010, identified 2,900 vacant buildings in the District.<sup>A4-32</sup>

Some vacant buildings are "abandoned." In other words, the owners have stopped paying utilities, taxes and even mortgages. In these cases, a bank or the District Government own these properties as a result of mortgage or tax default. However, in the District, many owners of vacant and boarded-up buildings are current on taxes and mortgage payments.<sup>A4-33</sup> These properties are being held for "speculation" in the hope that their land value will appreciate in the future. (Buildings, on the other hand, typically depreciate in value over time without constant maintenance and upkeep.)

Neither land nor buildings need to be completely vacant for speculation to be occurring. Slum dwellings, run-down commercial strips, surface parking lots and porno shops are symptoms of land speculation. Marginal buildings and parking lots can generate enough income to cover meager taxes. But while these owners await future economic opportunities, the District is deprived of decent housing and jobs.

A prime example of this existed on 14<sup>th</sup> Street, NW between H and I Streets during the 1960s, 1970s and 1980s. Only two blocks from the White House, this block of derelict buildings contained several strip clubs and pornographic movie and magazine stores. Even though there were no vacant lots or boarded-up buildings, real estate speculation was occurring there. These marginal buildings were so dilapidated that typical businesses would not pay rent there. However, sexually-oriented businesses were able to bring in cash while the owners waited for public investments in the

Metrorail transit system to improve business opportunities there. Today, this block has been completely redeveloped.

The point is that the owners of these sites held blighted buildings for a long time, at little or no net cost. After these property owners contributed only blight to the neighborhood, they were rewarded with millions of dollars by developers who paid top dollar to acquire these properties due to their strategic location near the White House, the K Street corridor, federal triangle, and a Metrorail station entrance. Any business that wants to use space in this neighborhood today must pay very high rent to do so.

Today, some neighborhoods remain impaired by derelict and partially-vacant buildings. The value capture approach to property taxation contains both an incentive and a penalty to induce the improvement and revitalization of these areas.

Other areas (like 14<sup>th</sup> Street between H and I NW) have experienced substantial redevelopment. But how will these new developments be maintained over time? Will they be maintained or will they fall into disrepair? Blighted neighborhoods are the result of a long period of investment and dis-investment decisions where decisions to defer maintenance and disinvest in properties eventually overwhelm decisions to maintain and improve. Thus, even in the absence of vacant land, reducing the tax rate on privately-created building values and increasing the tax rate on publicly-created land values is important because it encourages owners to maintain and improve existing structures over time.

**18. THE DISTRICT ALREADY HAS A PENALTY TAX ON VACANT AND BLIGHTED BUILDINGS. WHY NOT RELY ON THIS APPROACH TO SPUR DEVELOPMENT OF BOARDED-UP BUILDINGS?**

A value-capture approach to property taxation is a broad reform that would affect most properties. It is broad because it corrects a broad adverse policy embedded in the existing property tax that discourages property improvement and encourages land speculation. Property improvements define urban areas and make them vibrant and vital places to live and work. Speculation in land, however, saps the vitality of an urban area and holds productive members of the community hostage to inflated land costs and building rents.

Under the existing tax system, those who provide housing and jobs are penalized with higher taxes when they improve their property and speculators are rewarded with lower taxes for disinvesting in buildings or leaving land vacant. The reason for a

value-capture approach to property taxation is to turn these upside-down incentives right-side up. Doing so provides substantial benefits for owners and users of all improved properties.

But even if the only reason for value capture was to discourage vacant land and buildings, value capture would still be preferable to stand-alone penalty taxes on vacant land and buildings. The intention behind these penalty taxes is to discourage the underutilization of property. However, as enacted and implemented in the District, they have not been effective or successful.

In 1990, a group called the Pro-Housing Property Tax Coalition was advocating for a value-capture approach to property taxation. (They referred to it as a “split-rate tax” because the tax on buildings would be lower than the tax on land.) Some real estate interests opposed this approach. Thus, a penalty tax on vacant land and unoccupied buildings was proposed as an alternative. The legislation, Bill 8-537, created “class 5” property that would be subject to a higher tax.

The law provided numerous exemptions that would prevent a property from being classified as class 5. These exemptions included:<sup>A4-34</sup>

For Vacant Land (unimproved property)\*

- Zoning does not allow construction of a building as a matter of right;
- Property has been acquired within the prior two years;
- A building permit has been issued and is in effect;
- Property is used as a parking lot;
- Property subject to probate or its title is subject to litigation; or
- Development approvals are pending with the Board of Zoning Adjustment, the Zoning Commission, the Historic Preservation Review Board, the Commission on Fine Arts, or the National Capital Planning Commission.
- \*(When this legislation was enacted, it was amended to exempt specifically identified vacant lands north of Union Station. The Councilmember offering the amendment opined that subjecting these land to class 5 would inhibit their development.)

For Vacant Buildings (unoccupied improved property), all the exemptions above plus

- Property is for sale;
- Property was damaged by fire or flood;
- Property is subject to a demolition permit; or
- Property has historic landmark status

In 1991, only the tax on vacant land was to be implemented. (The effective date of the tax on vacant buildings was delayed until 1992 in order to provide the Department of Finance and Revenue an opportunity to create a regulatory framework for implementing this aspect of the law.) Yet, out of about 11,000 vacant lots, only about 2,000 were subject to the penalty tax on vacant land.<sup>A4-35</sup> In other words, the exceptions swallowed the rule.

Since 1991, the tax on vacant land and unoccupied buildings has gone through many iterations. The tax on unoccupied buildings in the initial legislation was not implemented because the Council could not agree to the regulations promulgated by DFR. Nonetheless, the law was on the books and the number of suspected arson cases increased by about 400% after the enactment of Bill 8-537 (DC Law 8-160). The Council abandoned the penalty tax on vacant land and buildings in 2002, only to resurrect it in 2003. In 2010, the penalty tax was no longer applied to vacant land and only applied to blighted buildings. And from 2011 until the present time, a 5% penalty tax was imposed on the value of vacant buildings and a 10% penalty imposed upon blighted buildings.

Why has this targeted approach to discouraging vacant land and buildings been so unsuccessful?

First, although vacant land is easy to identify, unoccupied buildings are not. An inventory must be taken of all buildings to determine which ones are unoccupied. Assessors who determine the value of buildings cannot necessarily determine whether buildings are occupied or not. A new data collection effort is required. (NOTE: Partially-vacant buildings are not subject to the penalty tax.)

- Many buildings must be vacant for at least a little time to facilitate changes in occupancy (allowing current occupants to leave and new ones to arrive). So, it would not be appropriate to impose a penalty tax on a building that has been vacant in the ordinary course of changing occupants. Therefore, a decision must be made regarding how long is too long for a building to be vacant, after which the penalty tax will be imposed. This decision, by its nature, will be somewhat arbitrary.
- As soon as this inventory of unoccupied buildings is completed, it becomes obsolete. Some vacant buildings become occupied and some occupied buildings become vacant or begun to exceed the allowable vacancy period. Thus, the inventory of vacant and blighted buildings must be continually updated. Assessors are trained to value land and buildings. The task of determining whether buildings are occupied or not requires other skills. In recent years, the determination of building vacancy or blight was delegated to

the Department of Consumer and Regulatory Affairs (DCRA). DCRA must now devote staff to continuously evaluate and update an inventory of vacant and blighted buildings.

Second, blight is typically the result of a long period of disinvestment. And, the existing property tax rewards owners with lower taxes as buildings deteriorate. To suddenly impose a large penalty tax at the end of a long disinvestment process is incapable of retroactively changing decision-making early in the process – when such a change would make a difference.

Third, owners of unoccupied buildings can avoid the penalty tax due to numerous exemptions noted above. Thus, in addition to the administrative costs associated with creating a vacant and blighted building inventory, additional time and costs will be associated with the classification appeals process. And these appeals will be a burden to property owners as well.<sup>A4-36</sup> After all this effort by the Government and property owners, the collection rate on unoccupied buildings is only 60%. On blighted buildings the collection rate is only 29%.<sup>A4-37</sup>

Fourth, owners of unoccupied buildings can avoid the penalty tax by demolishing their building. If there's no building, there's no unoccupied or blighted building penalty tax. Because many owners of unoccupied buildings are speculating in land value appreciation, they are not concerned about the fate of the building. As mentioned previously, the cases of suspected arson jumped after the penalty tax on vacant buildings was initially enacted into law.

Yet, the cost of building units from scratch is often higher than the cost of rehab. By encouraging owners to destroy vacant buildings, the District loses a potential source of new units that could be provided at lower cost than new construction. When the property tax falls primarily on land values, owners of vacant units don't receive an economic advantage from tearing or burning them down.

Fifth, developers who might be able to redevelop vacant land or unoccupied buildings might be reluctant to acquire them, fearing that the penalty tax would be imposed upon them until they obtain an approved demolition or building permit. And even then, developers might be nervous about how such permit approvals would be communicated between DCRA and OTR in order to have the penalty lifted. This policy is a “stick” without a “carrot.” Additionally, the very people who could begin to turn the property around might fear having the “stick” applied to them.

The assessor's office annually updates assessments for both buildings and land. The value-capture approach to property taxation takes advantage of the existing assessment process and does not require a separate record-finding and record-keeping operation. Relying on assessments avoids the complexity of knowing whether individual buildings are occupied or vacant. It also avoids making an arbitrary determination about how long a building must be unoccupied before it becomes subject to the penalty. Most importantly, the value-capture approach provides beneficial incentives (both "carrots" and "sticks") continuously throughout the property investment process.

The penalty tax no longer applies to vacant land. So the existing penalty tax offers no assistance regarding the redevelopment of vacant lots. The tax on vacant and blighted buildings relies on an economic penalty. But this penalty is only applied after a complicated regulatory and administrative process to determine "vacancy" and "blight." And after accounting for all the exemptions and loopholes, if the economic penalty is applied, it is applied only at the end of the disinvestment process rather than at the beginning.

The difficulties associated with this approach can be observed from the way that the District Government has lurched from one legislative and regulatory framework to another. The law applying a penalty tax to vacant land and buildings has changed nine times since 1991.<sup>A4-38</sup> Property investment decisions are typically made with a long-term perspective. Continually changing penalties and regulations cannot easily be integrated into decision-making by property owners.

## **19. WOULD THE DISTRICT LOSE REVENUE FROM SPLIT-RATE TAXATION?**

Revenues are a function of the tax rates chosen by the Council. Reducing the tax rate on buildings will result in lower revenue only if there is no compensating increase in the tax rate applied to land values.

Appendix 2 of this report contains the 1991 Tax Rate Study that used actual District property assessments from 1990. These assessments were multiplied by the actual 1991 tax rates and by a set of hypothetical rates. The hypothetical rates that were chosen raised the same revenue as the actual rates.

Clearly, the Council can set tax rates to raise more or less revenue. "Revenue-neutral" rates were chosen simply to make a fair comparison between the two different tax systems.

In the 1980s and 1990s, the District had a law that established “calculated” tax rates. This law adjusted the property tax rates automatically, based on the relationship between inflation in property assessments and the Consumer Price Index (CPI). If increases in property assessments exceeded the CPI, the property tax rate would fall automatically so that the same revenue (adjusted for CPI inflation and new construction) was collected as in the prior year. Every year that this law was in effect, increases in property assessments exceeded the CPI. Yet, every year the Council overrode the “calculated rates” by re-enacting the prior year’s rates.

This was never an indication that the existing property tax system was unable to raise sufficient revenues. It was merely a political choice of the District Government to raise revenues above what would be required to keep pace with inflation. Regardless of whether the District employs a traditional property tax or a “value capture” approach, the Council retains the power to set tax rates to raise the amount of revenue that it deems appropriate.

From a somewhat different perspective, it is important to understand that the current tax system discourages building construction, improvement and maintenance. This impairs the District’s economy and diminishes revenues.

Additionally, boarded-up buildings and vacant lots are now a tax drain on the District. By definition, vacant and boarded-up properties produce no sales, income or business taxes. By creating an artificial scarcity of housing, they drive up rents, driving out residents and businesses and increasing the costs of District rent subsidy programs. As noted in the presentation by Daphne Kenyon, the punitive tax rates imposed upon them produce relatively little property tax revenue.<sup>A4-39</sup> Vacant and boarded-up properties also consume District resources. They harbor criminals, increasing expenditures related to crime and arson. They also reduce revenues by depressing nearby land values.

Higher taxes on publicly-created land values combined with lower taxes on privately-created building values will promote development of vacant lots and boarded-up buildings. This should reduce some District expenditures on crime and arson while generating income, sales and business taxes where previously there were none. Thus lower tax rates on building values combined with somewhat higher tax rates on land values, even if revenue-neutral from the perspective of property tax revenue, should provide the District with a net positive fiscal impact.

**20. WOULD THE DISTRICT LOSE REVENUE FROM NEW CONSTRUCTION?**

Using value capture to transform the property tax into a public service access fee does not necessarily eliminate new construction as a source of tax revenues. Most jurisdictions that use this approach continue to tax building values. They just tax building values at a lower rate than land. Thus, new construction would continue to provide additional revenue. Even if new construction were totally exempted, an increase in economic activity associated with new construction and the subsequent occupation of these buildings by residents or businesses will produce additional income, sales and business franchise tax revenues.

**21. WOULD A SPLIT-RATE TAX FAIL TO COMPENSATE THE DISTRICT FOR COSTS IMPOSED BY DEVELOPMENT?**

Some people believe that new development creates costs for the District, and therefore taxation based on the value of new construction seems fair. It is important to acknowledge, however, that many costs of public infrastructure are related to distance, and not to whether or not development occurs. Streets, sewers, water mains, bus and subway lines, utility lines must all run past every property in their path, regardless of whether the property is developed or not. Potholes and broken water mains cannot go unrepaired simply because they are in front of a vacant lot.

If development occurs on a vacant lot, user charges related to the use of the property will kick in. Fees will be paid for the amount of water consumed and sewage discharged. Occupants will pay parking fees or transit fares. If the development is residential, new income taxes will be paid. If development is commercial, franchise taxes, sales taxes, and other fees will be paid.

If development requires the temporary closing of streets or sidewalks, the developer must obtain public space permits and pay public space fees. If development imposes other costs that require compensation, those costs should be identified and the impact fee should be closely tied to compensating the District for those costs. To the extent that the District may wish to impose special user charges or impact fees on new development, such as a housing linkage fee, this can be accomplished regardless of the property tax structure. A higher fee on office parking, for example, could compensate the District for increased traffic and street expenses. (See the recommended Clean Air Compliance Fee Act in Appendix 1.)

### III HOW DOES ZONING RELATE TO PROPERTY TAXATION?

#### 22. WHAT IS THE ROLE OF ZONING?

Zoning is a technique for, among other things, reducing the scale or intensity or limiting the use of development compared to what would have occurred in its absence. In other words, zoning an Iowa corn field for skyscrapers will not result in skyscrapers being built there. On the other hand, if market demand exists for 20-story buildings on Pennsylvania Avenue, zoning that land for 12-story buildings will limit development to 12 stories. Some of the unsatisfied demand for additional stories will be displaced to alternative sites. The reduced supply of space on Pennsylvania Ave (compared to the demand) will inflate rents there compared to what rents would have been if 20-story buildings had been erected.

#### 23. HOW DO LANDOWNERS RELATE TO ZONING

As mentioned above, zoning can restrict the choices that landowners have regarding the ways in which they develop and use their land. But landowners are generally not compelled to develop their property as intensely as zoning allows. Zoning is less powerful than it could be because landowners react to the market for developable land very differently than laborers react to the market for labor and very differently from the way that owners of capital react to the market for capital.

For example, assume hamburger joints are paying cooks \$7 per hour. There's a vacancy and two cooks show up for the job. They both have similar skills and experience. Cook #1 says that she is willing to work for \$7 per hour. Cook #2 recognizes that the going wage is \$7 per hour, but states that he is special and will only work for \$8 per hour. Cook #1 will get hired. Cook #2 will not. If Cook #2 depends upon getting a job for earning a living (most laborers do not have an independent source of income) his insistence on receiving higher wages than the market allocates for persons of his skill and experience may doom him to poverty or even starvation.

Or, imagine two banks with money for car loans and assume the market rate for interest on car loans is 6%. A prospective car owner goes to Bank #1. The loan officer states that they have \$25,000 available at 6%. Bank #2 tells the prospective car owner that they also have \$25,000 available. Bank #2 acknowledges that the going interest rate is 6%, but states that its depositors are special people who deserve more. Therefore, Bank #2 will charge 7% for a car loan. The prospective car owner

will borrow money from Bank #1. These funds will earn 6% for Bank #1's depositors. The money controlled by Bank #2 will sit in the bank and earn nothing. So both labor and capital must bring their resources into the market at the prevailing market price. Otherwise, labor will starve and capital will waste away.

But landowners generally face a different reality. History tells them that their land is likely to become more valuable over time. And persons who own land that they don't live on or have their business on, typically have other sources of income. Unlike laborers or owners of capital, landowners can often afford to wait for land to appreciate and are not materially disadvantaged if they don't employ their land at the highest price that it can obtain under current market conditions.

In the 1970s, there were three adjacent lots in Anacostia with boarded up houses. An economic development professional felt bad that these vacant houses were blighting the neighborhood. He assumed that the owners couldn't sell due to a lack of interest. His community development corporation had funds to purchase property so he approached the owners. He offered them the assessed value for their property – thinking that they would be grateful to receive such an offer. Instead, the owners said that they would be foolish to sell these properties at their current value. They mentioned that a subway station was planned for just a few blocks away. Their properties would be worth much more later.<sup>A4-40</sup> The Anacostia Metrorail Station opened in 1991. In 2010, these three properties remained vacant.

In a less extreme example, a strip of one- and two-story cinder block retail stores was built in the 1300 block of U Street, NW near the time when the Metrorail station opened half a block away. Clearly, this was not the highest and best use of the land at this location. But it was a cheap and low-risk way for the landowner to wait and see what more intensive development demand might arise in the future. But while this landowner is waiting, the neighborhood (and the Metrorail system) are deprived of the housing, retail and employment activity that could be there in addition to the few stores that occupy the cinder block building.

Yet another story can be found above, under **Question 17** ("ISN'T THE DISTRICT MOSTLY BUILT-UP? HOW MANY VACANT LOTS ARE THERE?") about the porn shops along 14<sup>th</sup> Street between H and I Streets, NW during the 1960s and 1970s.

These stories shows that landowners are not under the same compulsion as laborers or capitalists to bring their resource into the market at current prices. Because land owners might not develop their land according to present market demand as shaped by zoning, the effectiveness of zoning is reduced.

Several years ago, residents participating in a revision of the District's Comprehensive Plan were puzzled that the Office of Planning (OP) recommended a larger area be zoned for offices than was justified by the demand for office space as projected by a consultant's study. Here is a possible explanation:

OP may have thought that limiting the commercial-zoned area to an area no larger than indicated by projected demand would give landowners in commercially-zoned areas too much power to charge exorbitant land prices. After all, office developers would have nowhere else to go in the District. OP did not want excessive land prices to send developers away from the District in favor of cheaper suburban locations. Therefore, OP may have dedicated more land for office than demand studies indicated would be needed, hoping that this would prompt landowners to compete among themselves for development and thereby mitigate landowners' ability to increase land prices. However, because land owners are often not under much compulsion to develop their land, the assumption that land owners would compete with each other for developers may be mistaken. This might be particularly true in the District where landowners, aware of historical trends for increasing demand for office development, might feel that there is little risk associated with turning down a development offer.

#### **24. HOW DOES THE PROPERTY TAX INTERACT WITH ZONING?**

Landowners can make money in two ways. First, they can develop a piece of land and hope that the users will be pay enough rent to cover the development and operating costs plus a profit. Second, they can make money simply by doing nothing and waiting for the price of land to rise. So landowners weigh the alternatives – either to optimize their buildings to fit more closely with the intersection of economic demand and zoning, or to do nothing and hope that land values will increase in the future.

When landowners are unwilling to develop or sell at current market prices, the supply of development sites is artificially reduced, leading to real increases in land prices. At some point, developers are compelled to find cheaper locations. But these cheaper locations are cheaper for a reason. They are less conducive to development than the prime sites that are being withheld.

Thus, land speculation does more than mess up a city's plan. It impairs the economic productivity of developments that are forced to occupy less suitable sites. Higher transportation costs, worse access to employees, customers and collaborators (or a

combination of these factors) will impact the bottom line, making businesses less profitable and less able to hire new workers. Conflicts with neighboring land uses might also be a result of development being forced away from sites that are optimal as defined by the intersection of economic demand and zoning.

As mentioned previously, the property tax has two components – a tax on building values and a tax on land values. The tax on building values is a cost of production. Although typically between 1% and 2%, this tax can be a deterrent to the development, improvement and maintenance of buildings. Unlike a sales tax (that is paid only at the time of sale), a property tax on building value is paid each and every year that an improvement adds value to a property. Over time, this stream of payments can have the economic impact of a one-time sales tax of between 10% and 20% on construction labor and materials. This is a significant cost that adds to the profit risk associated with the development, improvement or maintenance of buildings.

On the other hand, for every \$100 of publicly-created land value, owners must pay only \$1 or \$2 per year. The net present value of this stream of payments is between \$10 and \$40, depending upon the capitalization rate used. The net result is that between 60% and 90% of publicly-created land values will end up as windfall gains for landowners.

Thus, the tax on land and the tax on buildings become part of the equation that landowners grapple with as they decide whether to improve their property or whether to sit and wait. Using value capture to transform the property tax into a public service access fee, by reducing the tax rate on privately-created building values and increasing the tax rate on publicly-created land values, would impact this calculation. The higher tax on land values would reduce the net gain from land value appreciation and the lower tax on improvements would reduce the cost of creating, improving and maintaining buildings.

A value capture approach to property taxation would provide both a carrot and a stick to encourage property development at an intensity more commensurate with the intersection of market demand and zoning permission than under the present system. Thus, value capture actually strengthens the power of zoning and other regulatory controls.

Above there is a discussion about OP over-allocating land for commercial zoning (in hopes of getting landlords to compete for development and thereby avoiding excessive land price inflation). An alternative (or complementary) approach would be to implement value capture. Value capture would reduce the profits from sitting and

waiting. And this would make it more costly to underutilize land relative to current market demand. This approach could facilitate a reduction of the area zoned for office to an area more commensurate with projected demand. The problem of excessive land price increases would be mitigated by taxing them away. As a result, more area could be zoned residential or mixed-use.

**25. WOULD MUNICIPAL REGULATIONS BE MORE EFFECTIVE IN DETERRING PARKING LOTS AND UNDERUTILIZATION OF LAND?**

A value capture approach to property taxation discourages the underutilization of land. The degree to which it is effective depends on the actual rates that are chosen, zoning and other development regulations, and the underlying market demand. If zoning is inappropriate or financing is unavailable, a value-capture property tax will not guarantee improved land use.

Should the District refuse to transform the property tax into a public service access fee because this reform, by itself, cannot correct or prevent all undesirable development or lack thereof? Making “the perfect” the enemy of “the good” is a strange basis for rejecting a reform that creates economic incentives for more affordable housing and job creation at no net cost to the taxpayers.

Where land is vacant or underutilized, this re-orientation of the property tax will encourage development to occur more quickly and more affordably than under the present system. However, the present system rewards disinvestment and blight, pending redevelopment at some distant future time. This is disruptive to the quality of both residential and commercial neighborhoods.<sup>A4-41</sup>

A value capture fee encourages owners to keep existing structures in use until the time for redevelopment is at hand. Historic structures are protected under current law (and should be under a value-capture approach as well) by “current-use” assessments.<sup>A4-42</sup> Thus, even under a value-capture system, neighborhoods would be characterized by structures of different sizes and ages, at different stages in their life cycle.

Zoning and tax policy are not an “either / or” proposition. Zoning and tax policy should work hand-in-hand. Using value capture to transform the property tax into a public service access fee complements zoning and makes it more robust.

**26. WHAT IMPLICATIONS EXIST, IF ANY, REGARDING THE DEBATE ABOUT CHANGING THE DISTRICT'S HEIGHT LIMIT?**

Assuming that there is a demand for additional development, zoning changes to increase height or density create an opportunity for affected land to support additional development and to earn additional rent. This opportunity will be reflected in higher land values. Under a traditional property tax, affected landowners must return only 1% or 2% of that additional value each year. The net present value of these tax payments, depending upon the capitalization rate used, will be between 10% and 40% of the publicly-created increase in land values. Thus, public action to create additional development rights results in windfall gains to affected landowners.

Today, there is a debate going on about whether to increase the height limits that now restrict development within the District. The heights of buildings in the District are restricted by an act of Congress, the Height Act of 1910.<sup>A4-43</sup> Because of the high demand for residential and office space, the height limit constrains the amount of residential and office development within the District – and thereby makes housing and office space more expensive than it otherwise would be.

Without addressing the merits of whether the Height Act should be relaxed in whole or in part, the Office of Planning has noted that there are many places in the District where the zoning envelope does not permit development as high as is presently permitted under the Height Act. Additionally, there are many places where existing development does not fill up the zoning envelope.

Although there is demand for additional residential and commercial space in the District and although that demand could be accommodated within the existing zoning and height-limit regulations, many landowners are not providing development to meet that demand. By reducing the tax rate on privately-created building values and increasing the tax rate on publicly-created land values, the costs of development would be reduced and the costs of underutilizing land would be increased. Thus, **without any changes in zoning or increases in allowable building heights, using a value capture approach to property taxation would increase the amount of developed space – both residential and commercial – which would help make the District more affordable to residents and businesses alike.**

Of course, if height limits and zoning allowances were increased yet further, a value capture approach to property taxation would make it more likely that landowners would respond by increasing development commensurate with the intersection between economic demand and zoning.

If value capture re-orientes the property tax to be more like a public service access fee, then a greater percentage of the land value created by height and zoning increases will be returned to the public. Thus, whenever the District acts to permit more intense development for an area than was previously allowed, the District's revenues will increase more substantially than under the present system.

Likewise, any downzoning would reduce land values. As a result of reducing owners' potential for generating income from their sites, the District would collect less tax. The fairness of this approach lies in its ability to recapture the value of publicly-created opportunities (expressed through higher land values) and to relieve owners of tax liability to the extent that public decisions reduce income-generating opportunities or other amenities (expressed through lower land values).

#### **IV WILL THE VALUE CAPTURE APPROACH ENCOURAGE TOO LITTLE OR TOO MUCH DEVELOPMENT?**

##### **27. WILL THE VALUE CAPTURE APPROACH TO PROPERTY TAXATION BE TOO INSIGNIFICANT TO AFFECT DEVELOPMENT?**

Under hypothetical tax rates used in the 1991 Tax Rate Study, the average homeowner property received a 12% tax reduction (equivalent to about \$168) and the average rental property received an 18% tax reduction (equivalent to about \$340) when compared to taxes they would have paid under the actual 1991 tax rates. Average percentage reductions in middle- and low-income neighborhoods were significantly higher than the citywide average.<sup>A4-44</sup>

Furthermore, the hypothetical tax rates in this study resulted in tax increases on vacant land that varied between 23% and 53%. Although many factors are important in development decisions, the regional economy is strong and these tax changes should be significant enough to prompt a change in plans for some owners of vacant and underutilized properties.

The significance and impact of a value-capture property tax will depend on the actual rates chosen by the Council to implement it. If the difference in tax rates applied to land and buildings is small, the impact will be small. To the extent that the difference is larger, the impact will be larger. No matter how large the difference in tax rates

applied to land and buildings, property tax reform is only a part of what the District must do to address problems related to housing and employment.

Yet, regardless of the size of the impact, this reform accomplishes something positive without requiring additional spending or higher taxes. Given the significant needs for more affordable housing and job creation, and given the lack of resources for subsidy programs, a revenue-neutral tax reform that provides some improvement in these areas should be worthwhile.

## **28. WILL A VALUE-CAPTURE TAX INHIBIT LAND ASSEMBLY?**

Under the present system, land assemblies often take a long time. Increasing the tax rate on land values would appear to have a negative impact on the assembler. However, a primary reason that land assembly takes a long time is that those who own parcels to be acquired by the assembler have little incentive to sell and considerable incentive to hold out. It is common knowledge that a developer will pay more for the last parcel of land needed for an assembly than was paid for the first.<sup>A4-45</sup>

Under a value capture approach, it will become more expensive for owners of sought-after parcels to hold out. This should encourage them to sell more quickly. Thus, the higher expense of holding land by the assembler could be offset by a shorter time period required to complete the assembly. The costs of assembly can also be mitigated by keeping acquired properties in use until the assembly has been completed.

## **29. AREN'T VACANT LAND AND SURFACE PARKING NECESSARY?**

Some might claim that vacant lots are necessary to facilitate new development. This is not true. Most of us are aware of developed properties where the building is renovated. We are also aware of developed properties where the existing building is demolished prior to construction of a new building. Thus, vacant land is not necessary to foster new development – either in the form of new construction or in the form of renovation.

Others are concerned about the impact of value capture on community gardens. Some owners of private vacant lots make them available to the community for growing flowers and vegetables. And while subsidized parking for commuters might encourage excess traffic, some people are concerned that parking for retail and

grocery stores is necessary – and might be impaired by a value-capture approach to property taxation.

These issues are not dissimilar to existing concerns about historic properties. Many smaller historic buildings in areas zoned for greater height and density cannot compete with larger and more modern buildings. Existing law recognizes that the importance of preserving some historical buildings can exceed their ability to produce profits. Thus, the law provides "current-use" assessments to help maintain the economic viability of historic properties. In other words, these properties are not assessed according to their market value (which might lead to the demolition of historic buildings and their replacement by larger buildings capable of realizing a greater percentage of a site's income potential). Instead, they are assessed at a value based on their current income-earning capabilities.<sup>A4-46</sup> The concept of current-use assessments could be extended to other valued uses if their value to the public exceeds their value to private owners.

Current use assessments could be provided for:

1. Vacant private land dedicated for community gardens and parks.
2. Parking lots dedicated to grocery stores or other neighborhood retail businesses.
3. Residential buildings located in commercial zones. Current-use assessment could help preserve these buildings for residential use. (Of course, a better approach might be to change the zoning for such properties from "commercial" to "residential.")

**30. WOULD HISTORIC BUILDINGS AND SMALL BUILDINGS SUFFER NEGATIVE CONSEQUENCES FROM A VALUE CAPTURE APPROACH?**

Many small commercial buildings are located in neighborhood commercial centers, providing needed community services. The 1991 Tax Rate Study indicated that most of these properties would experience a tax reduction under the hypothetical value capture rates.

There are also many small buildings and historic properties located in the downtown. In a market economy, owners of small structures in high-value areas will be under economic pressure to increase the income from their property. This is true under the

existing property tax as well as under the proposed value-capture system. However, the economic pressure would be increased under a value-capture system.

Fortunately, several aspects of the market and District law can mitigate this pressure. First, if a building has been designated as a historic landmark by the Joint Committee on Landmarks of the National Capital and the owner of the building has entered into an agreement with the District government to maintain the building for a period of at least 20 years, the building is eligible to be assessed at its “current-use” value.<sup>A4-47</sup>

A binding agreement to maintain a historic structure for 20 years eliminates the opportunity to replace the historic building with a larger one during that time and thereby reduces the market value of the land. Current-use assessments reduce market pressure for redevelopment while providing the District the assurance that lower taxes will not merely subsidize speculation. This feature should remain under a value-capture system.

Historic districts, to the extent that they restrict the free hand of the owner to develop or redevelop property, and to the extent that they require lengthy and bureaucratic review processes prior to such activity, reduce the market value of land to reflect these impediments. To the extent that affluent space users are willing to pay high rents to locate in a historic district, this will increase the value of the property.

However, the price of land should never rise to a point where a buyer must engage in a prohibited act to realize the value of the purchase price. In other words, if historic preservation rules prohibit the destruction or alteration of buildings, buyers would only be willing to purchase them at prices justified by the rents that the historic buildings can produce. This limitation on their value, likewise limits their tax liability, avoiding economic pressure for demolition.

Similar economic principles apply to many small commercial buildings downtown that are located on small parcels. It is not feasible to develop these small parcels, individually, into new structures that can command top-of-the-line rents for space. Thus, the separate ownership of small lots reduces the market value of these sites. Of course, if and when these separate lots come under common ownership, redevelopment becomes feasible and land values could rise.

Wherever the District desires to maintain low-rise structures, it must zone the area accordingly and/or create historic designation. However, the District must be aware that preserving small buildings in high-demand areas restricts the number of space users who can take advantage of the District and its amenities (including the subway).

By limiting the amount of space for users, the price of available space is increased. Thus, merely insuring the retention of low-rise buildings will not insure the survival of businesses or organizations whose rent paying abilities are limited.

On the other hand, a zoning provision that requires a substantial percentage of floor area in the shopping district be devoted to retail use, by expanding the supply of retail space, should help keep retail rents more affordable, even in new developments. In fact, to the extent that retail space provides a lower economic return than alternative office use, the retail space requirement should reduce land values in the affected area from the level they would be at in the absence of this regulation.

### **31. DOWNTOWN D.C. IS HEALTHY. WHY TRY TO STIMULATE IT?**

The health of downtown rises and falls with economic cycles and with cycles in federal government activity. A recent trend to allocate less office space per employee could have a negative impact on the District's office market.

Additionally, some office tenants are lost to the suburbs because of their cheaper land. Vacant and underutilized land within the District exacerbate land-price inflation and encourage the flight of some businesses to cheaper suburban locations. A value-capture approach helps keep commercial rents down by reducing the cost of constructing, improving and maintaining buildings. It also keeps rents down by encouraging development of underutilized downtown land. This protects and helps sustain the District's economic vitality.

And what if the District's downtown economy was weak? Critics of value capture would say that the District should not create development incentives when there isn't enough demand to fill existing space. (But these spaces might be empty because landlords are holding out for excessive rents in light of existing market conditions.) In short, for some critics of value capture, it is always the wrong time to implement it. A more thoughtful understanding would yield a different view. At every stage of the economic cycle, it behooves the District to promote affordable space and increase its competitive advantage over the suburbs.

It should also be noted that many neighborhood commercial centers are distressed. These neighborhood commercial centers are vital to the livability of surrounding residential neighborhoods. They are also vital sources of first-time and long-term employment opportunities for those whose skills or temperament are not suited for working in an office or high-tech environment.

The 1991 Tax Rate Study showed that most improved properties in neighborhood commercial centers would receive tax reductions under the hypothetical value-capture rates. Of course, the vacant and boarded-up properties would receive an increase. A value-capture approach to property taxation can encourage residential and commercial development consistent with zoning in the neighborhoods outside of downtown.

Some areas within the District are thriving economically. But will they thrive in the long term? How will the tax penalty on building improvement and maintenance impact these areas in the future? A value capture approach makes the District economy more vital over the long term, thereby making it more sustainable. And, there are many neighborhoods where residential and commercial development are needed. A split-rate property tax can provide needed tax relief to residential and commercial properties in distressed areas while also providing development incentives for vacant and boarded-up properties.

### **32. WILL A VALUE-CAPTURE PROPERTY TAX LEAD TO CONGESTION?**

Water systems, roads, public transit are expensive. They can only be provided under certain conditions. First, much of their expense is related to distance. Therefore distances must be kept short. Second, many people must share the cost of these services to make them affordable. The coexistence of many people within a small area creates density.

Some people fear that a value-capture approach will increase development and create density that leads to congestion. As indicated on page 14 of the main report, congestion is most painful in some of the suburbs where medium densities combined with segregated land uses require auto trips for each and every activity. Thus, some suburban areas suffer from congestion similar to much denser areas within the District. At least in the District, its grid-system of streets combined with nearby destinations make it easier to circumnavigate congestion by car. The District's grid-system of streets and mixed-use land use patterns also make walking, cycling and transit convenient alternatives to auto trips.

The Height Act of 1910 prohibits the construction of skyscrapers in the District. Yet, between 1960 and the late 1990s, the District's population declined by more than 200,000. After accounting for the population increases of the last 10 years, there remains room in the District for more residents without abandoning the low-rise

character that makes the District unique and aesthetically pleasing. The District's wide streets, excellent public transit system and improving cycling infrastructure can accommodate more growth without undue congestion.

In this regard, it is worth noting that the Ballston Corridor in Arlington, Virginia was characterized by relatively low-density development and severe traffic congestion prior to the development of the Metrorail Orange Line. Since the opening of the Ballston Corridor Metrorail stations, development has boomed with large increases in residential, office and retail space. Yet traffic congestion along this corridor has not gotten worse – and has even improved according to Arlington officials.<sup>A4-48</sup> Walkability and convenient bike and transit opportunities can thus reduce congestion in spite of increased development.

## **V. MECHANICS**

### **33. TYPICALLY, LAND AND BUILDINGS ARE SOLD TOGETHER. HOW CAN SEPARATE ASSESSMENTS BE MADE ACCURATELY FOR BUILDING VALUES AND LAND VALUES?**

The District uses a computer-assisted mass appraisal (CAMA) system for determining assessments. CAMA systems typically include a multiple regression module that can be used for the purpose of establishing separate assessments for land and for buildings.

The District is characterized by large numbers of row houses built at the same time. Yet identical structures in very similar condition can sell for very different prices in different neighborhoods. Regression analysis and the "cost of replacement" approach to assessing building values are standard techniques that can accurately determine, from total sales values, the amount of value attributable to the building, and the amount attributable to the land.

From time to time, a developed property is purchased and the building torn down prior to new construction. Sales prices for these properties reflect the value of the land to the developer minus the cost of demolishing the pre-existing building. Sales of these properties are clear indications of land values. Developers also lease land and air rights adjacent to Metrorail stations from the Washington Metropolitan Area Transit Authority. These transactions are also clear indications of land value.

Prior to the 1980s, according to John Rackham, former Assessment Standards Specialist, the District used private real estate experts to double-check land assessments. Periodically, the private experts were asked to provide estimates of land value per square foot at certain locations. Although the experts provided their estimates individually, their estimates would typically be very close to one another. This indicates that land values can be determined even in the absence of vacant land sales.

**34. CAN PROPERTY OWNERS APPEAL THE WAY THEIR ASSESSMENTS ARE DIVIDED BETWEEN LAND VALUES AND BUILDING VALUES?**

In the District today, property owners are not allowed to appeal the apportionment their total assessment between its land and building components if they do not contest the total value. Because the same tax rate is applied to both the land and building assessments, contesting the apportionment of an assessment between land value and building value makes no difference in the total tax bill and therefore is seen as an unproductive use of the court's time.

However, if the District were to lower tax rates applied to building values and raise the rates applied to land values, then the apportionment of the total assessment between its building value and land value components would have a material impact on tax liability even if the total assessment was not contested. Therefore, if the District uses value capture to transform the property tax into a public service access fee, the District must allow property owners to appeal the apportionment of land and building assessments, even if the total assessment value is not contested.

**35. WHAT IS THE FORMULA FOR SHIFTING TAXES OFF OF BUILDING VALUES AND ONTO LAND VALUES?**

The District's property tax system is complex. There are different classes of property and different rates applied to each class. A homestead deduction is provided to homeowners and there are other features as well. Each of these features has a policy rationale. In order to make a fair comparison between the existing property tax and a "value capture" approach to property taxation, both approaches must raise the same revenue. And, in order to compare only the impact of shifting taxes off of privately-created buildings values onto publicly-created land values, features such as property classification and the homestead deduction must remain. Otherwise, we would be measuring the impact of eliminating the homestead deduction or the classification

system instead of measuring the impact of shifting taxes off of buildings and onto land.<sup>A4-49</sup>

Professor Robert Schwab, who analyzed this issue for the 1998 Tax Revision Commission wanted to make an “apples to apples” comparison between the traditional property tax and a value capture approach to property taxation. His approach was to eliminate the homestead deduction and the property classification system from the traditional property tax. He then calculated property tax burdens under this stripped-down version of the District’s property tax. Next he calculated property tax burdens under a value-capture approach that raised the same revenues and likewise had no homestead deduction or property tax classification system. In doing this, Schwab concluded that residential properties in the District would typically pay less tax under the value capture approach.<sup>A4-50</sup>

But, the classification system and the homestead deduction will likely remain. Therefore, a comparative analysis should be performed in which both the existing property tax and value-capture approach maintain these popular features. But in doing so, how should the homestead deduction be calculated? Should it be deducted from the land assessment, from the building assessment or from both assessments?

There is no single answer. Each of these alternatives is possible. When determining how to retain and implement property tax programs or features within the structure of a value-capture approach, alternatives should be evaluated in terms of the objectives of the programs or features being retained. Political feasibility for a workable transition could also be one of the criteria.

**36. WOULD A VALUE-CAPTURE APPROACH TO PROPERTY TAXATION BE TOO RADICAL?**

Under the present property tax system, the District is required to assess both land and buildings at 100% of market value. Under the proposed value-capture approach, this would remain the same. Under the present property tax system, the District taxes both the value of buildings and the value of land. Under the proposed value-capture approach, the District would continue to tax both the value of buildings and the value of land. Therefore, reducing the tax rate on buildings and increasing the tax rate on land appears to be more like a technical adjustment than a radical change.

**37. WOULD THE VALUE CAPTURE APPROACH CREATE WINDFALLS AND WIPEOUTS?**

Any sudden and dramatic change in tax rates could create economic windfalls and wipeouts. But communities that have implemented a value-capture approach typically phase-in the different tax rates gradually over a period of years. This provides property owners time to adjust their behavior to take advantage of the new incentives.

And, as mentioned previously, there are several programs that can mitigate the economic impact in instances where property taxes rise dramatically in a short period of time.

**VI OUTCOMES FROM VALUE-CAPTURE IMPLEMENTATION**

**38. WHERE HAS THE VALUE CAPTURE APPROACH TO PROPERTY TAXATION BEEN IMPLEMENTED?**

There has been an increase in interest in “value capture” over the past few years. An extensive study of it has been conducted for the Lincoln Institute of Land Policy.

“More than 30 countries around the world have implemented land value taxation, so it is not a utopian proposal. In the United States, experience with land value taxation dates back to 1913, when the Pennsylvania legislature permitted Pittsburgh and Scranton to tax land values at a higher rate than building values. A 1951 statute gave smaller Pennsylvania cities the same option to enact a two-rate property tax. While most municipal governments in the state have not adopted two-rate taxation, and a few have tried and then rescinded it, about 15 communities currently use this type of tax program.”<sup>A4-51</sup>

Denmark utilized a property tax on land value only from 1844 until 1903. At that time, the property tax was replaced with one imposed equally on the value of land and buildings. Surprisingly, the shift away from the land tax hurt small farmers (who had invested heavily in improvements and owned small acreage). They lobbied for a return to a land tax which was implemented in 1922.<sup>A4-52</sup>

A number of jurisdictions in Australia use a value-capture approach to property taxation. Studies showed that cities using this approach had more

compact residential development than comparison cities that taxed land and buildings at the same rate.<sup>A4-53</sup>

In Canada, some of its western provinces utilize the value-capture approach, although they implement it by exempting improvements from the tax or by assessing buildings at a lower percentage of market value than land, while leaving the tax rate itself uniform.<sup>A4-54</sup>

In 1929, value capture was used to finance a series of flood control dams along the Miami River in Ohio. Elimination of the risk of flooding enhanced the value of 77,000 properties adjacent to the river. They were charged based on this benefit as measured by the increase in their value.<sup>A4-55</sup>

Instead of taxing the value of land, Hong Kong's transit agency controls land holdings above and around its stations. Utilizing value capture, the transit agency leases out land and air rights (made more valuable by the transit system). This provides an economic return that, when combined with fare box revenues, exceeds the cost of providing transit.<sup>A4-56</sup>

“After surveying the experiences of taxing jurisdictions around the world, we conclude that land value taxation is more than an intriguing and attractive idea. It is a form of taxation that has actually worked since the nineteenth century at national, state, and local levels of government. Taxation of land values began with its 1849 adoption in New Zealand, and today it is practiced in countries as diverse as Estonia, Fiji, and the United States. Proposals to tax land values more heavily than improvement values can find support in both historical experience and economic theory.”<sup>A4-57</sup>

### **39. WHAT HAS BEEN THE EXPERIENCE OF PENNSYLVANIA CITIES WITH VALUE CAPTURE?**

Several Pennsylvania cities, including Pittsburgh, have implemented property taxes that employ lower rates on building values than on land values. These cities reported declines in vacant housing and increases in buildings permits after implementation. These results are consistent with the economic theory. But would these results have occurred anyway, even if value capture had not been implemented?

This is a good question. And, as most people know, conducting a scientifically-controlled experiment regarding the effects of policy implementation in a real city is difficult if not impossible to do. Many of the Pennsylvania cities that adopted this approach to property taxation during the 1970s were in the midst of an economic crisis precipitated by the collapse of the steel and auto industries. So, while their individual performance improved after implementing property tax reform, their overall performance remains poor when compared to most other cities. Many academics reviewing this data end up stating that these studies are “inconclusive.” However, there are some important findings that should not be overlooked.

First, in the cities studied for which before-and-after data regarding the number or value of building permits was gathered, none of them experienced a decline in the number or value of building permits after implementing the value-capture approach to property taxation. That, by itself, is rather exceptional.

Second, a multiple-regression analysis of 15 rust-belt cities was performed, looking at the average annual value of building permits from 1960 to 1979 and from 1980 to 1989.<sup>A4-58</sup> The only one of these cities employing a value capture approach was Pittsburgh. Although Pittsburgh had employed this approach to property taxation since 1913, it dramatically increased the differential between its land tax and building tax rates in the late 1970s and early 1980s.

Pittsburgh, in spite of the severe decline in steel and related industries, was an outlier (in a positive direction) as one of only two cities to experience growth during the study period. (The other city was Columbus Ohio, and its growth was attributable to the annexation of its suburbs.) Pittsburgh did not annex any of its suburbs. Pittsburgh’s growth (a 70.4% increase), exceeded the performance of Columbus (a 15.4% increase), making it the real outlier in the study. The change in average annual value of building permits for all 15 cities, including Pittsburgh and Columbus was a 14.4% decline. Also, Pittsburgh’s growth was located primarily within its downtown rather than in its suburbs. This is contrary to national development trends during the 1980s, but consistent with economic theory related to value capture. This observation bodes well for the District, given its need to be more competitive with its suburban jurisdictions.

Third, Harrisburg, Pennsylvania was listed as one of America’s most distressed cities in the 1970s. Its downtown was being hollowed out by flight to the suburbs when Hurricane Agnes and a big flood of the Susquehanna River inundated Harrisburg’s downtown in 1972. Thousands of properties in the downtown were vacant lots or boarded-up buildings. Under the leadership of Mayor Stephen Reed, Harrisburg re-

oriented its property tax toward the value-capture approach by taxing building values at a lower rate than land values. Harrisburg's finance director credited this reform with helping reduce the number of vacant properties by almost 78% over seven years.<sup>A4-59</sup>

In spite of the recent failure of a municipally-financed waste-to-energy incinerator (unrelated to property tax policy) which caused Harrisburg to file for bankruptcy in 2011,<sup>A4-60</sup> Harrisburg's turn-around from one of the most distressed cities to one with a thriving downtown is evidence of the efficacy of the value-capture approach. Harrisburg is a state capital and 42% of its properties are tax-exempt.<sup>A4-61</sup> In this respect, Harrisburg is a bit more similar to the District than Pittsburgh.

Fourth, as stated previously, "before-and-after" data for implementing cities leave observers wondering whether some factor other than property tax reform might be responsible for the observed changes. Fortunately, in a few cases, the same "before-and-after" data was analyzed for nearby cities of comparable demographic and economic character – except for the fact that these cities used a conventional property tax during the time period being analyzed. In these cities, building permits which had been declining continued to decline during the period when the value-capture cities saw a turn-around.

Outside of Pittsburgh are three small cities – McKeesport, Duquesne and Clairton. Each of these cities is characterized by a population largely-descended from eastern Europeans. In the late 1970s, each city had a closed-down steel plant. Each city was also experiencing declines in the number and value of building permits issued each year. McKeesport adopted the value-capture approach to property taxation in 1980. The value of building permits from 1977 - 1979 was compared to the value of permits from 1980 – 1982. The period after implementation showed a 38% increase in the value of building permits compared to the three years before.<sup>A4-62</sup>

Was this a coincidence? Would it have happened anyway? Unlikely, because during the same time period after McKeesport's implementation of tax reform, building permits continued to decline in nearby Duquesne (-20%) and Clairton (-28%). Not surprisingly, both Duquesne and Clairton adopted this tax reform shortly after this information became known.

Similar results were observed looking at data from Scranton (which increased its tax rate differential in 1980) and Wilkes-Barre (which employed a traditional property tax. As before, the value of permits issued between 1977 and 1979 was compared to the value of permits issued between 1980 and 1982. The value of permits in Scranton

increased by 23% during the second period. However, the value of permits in Wilkes-Barre declined by 47% during this same time period.<sup>A4-63</sup>

The economies of the Pennsylvania cities that adopted the value-capture approach to property taxation are struggling. The loss of thousands of manufacturing jobs is not easily overcome. And, property tax reform does not guarantee that new businesses will appear. However, at any given level of demand by businesses for locations and employment, a city will translate more of that demand into businesses and jobs under the value-capture approach than they would under a traditional approach. In other words, if Detroit were to implement this tax reform, it would perform better than it is performing today. But implementing this reform would not cause the lost manufacturing plants and jobs to suddenly reappear.

*“Raising the tax rate on land has few undesirable effects, while lowering the rate on improvements has many benefits. Land is effectively in fixed supply, so an increase in the tax rate on land value will raise revenue without distorting the incentives for owners to invest in and make use of their land. By contrast, the part of the property tax that falls on structures or other improvements discourages investment. The burden of the tax on land falls entirely on landowners, who have no opportunity to shift the tax to others (such as renters). The land value tax is neutral with respect to the choice of when to develop a parcel and the density of its development, whereas the taxation of improvements is likely to increase low-density sprawl.”<sup>A4-64</sup>*

#### **40. WEREN'T TAX ABATEMENTS THE REAL KEY TO PITTSBURGH'S SURGE OF DEVELOPMENT?**

First, relatively few projects received abatements.

Second, part of the property tax transformation proposed for the District would be a reduction in the tax rate applied to building values. Such a reduction in rates could be comparable to a tax abatement. However, unlike typical abatements, the rate reduction would apply to all properties and not only to new developments. All property owners could benefit, without concern about preferential treatment or graft. (Thus, a suitable nickname for this reform might be the “universal tax abatement.”) Finally, unlike abatements, reduced building taxes under a revenue-neutral value-capture approach to the property tax would not result in any revenue losses for the District.

## CONCLUSION

This appendix has not anticipated every possible question or concern about relying more heavily on user fees and access fees to fund public goods and services. And the answers to some questions or concerns may be incomplete. But the evidence from around the world is clear that relying on well-designed user fees and access fees can result in measurable improvements regarding:

- Reduced Sprawl
- Reduced Traffic Congestion
- Reduced Energy Consumption
- Reduced Air and Water Pollution
- Greater Efficiency and Affordability of Public Goods and Services
- Greater Financial Self-Sufficiency for Public Goods and Services
- Enhanced Job Creation and Retention
- Enhanced Housing Affordability

If you have any additional questions or concerns, please contact the author at [r.rybeck@justeconomicsllc.com](mailto:r.rybeck@justeconomicsllc.com) .

## NOTES:

A4-1 Rick Rybeck, “Funding Long-Term Infrastructure Needs for Growth, Equity & Sustainability.” (DC Tax Revision Commission) 2013. See <http://www.dctaxrevisioncommission.org/#!documents/cp9p> and scroll down to “Presentations and Papers ...” Find “Rybeck” and click on “full report.”

A4-2 Ibid, p. 18.

A4-3 Rick Rybeck, “Public Acceptability of Road-Use Pricing: Literature Review,” April 28, 2012, p.16 at <http://www.mwcog.org/transportation/activities/congestionpricing/materials/Appendices/Road-Use%20Pricing%20Literature%20Review-Just%20Economics.pdf> . See also, “Congestion Charging Info Graphic” at <http://infographiclist.com/tag/congestion-charging/>

A4-4 District of Columbia Home Rule Act, Pub. L. No. 93-198, tit. 6, sec. 602(a)(5); 87 Stat 774, 813 (December 24, 1973).

- A4-5 MWCOC, "Evaluating Alternative Scenarios for a Network of Variably Priced Highway Lanes in the Metropolitan Washington Region: Final Report," February 2008, Table 9 p. 34.
- A4-6 MWCOC, "State of the Commute Survey 2013: Technical Survey Report, DRAFT," September 17, 2013, p. 97. <http://www.mwcog.org/uploads/committee-documents/Z11aXVIW20130904155720.pdf>
- A4-7 Siva Sailam (MWCOC) e-mail memo to Rick Rybeck, May 18, 1994
- A4-8 Clean Air Act as amended, Public Law 101-549, 42 U.S.C. §7418(a) at <http://www.law.cornell.edu/uscode/text/42/7418>
- A4-9 The National Capital Revitalization and Self-Government Improvement Act of 1997, Public Law 105-33, §11702.
- A4-10 William Vickrey, "Simplification, progression, and a level playing field," in Land-Value Taxation: The Equitable and Efficient Source of Public Finance, K.C. Wenzer, ed. (M.E. Sharpe), 1999.
- A4-11 This can be determined using a net-present-value calculation. Results will differ depending upon the length of the useful life of the improvement and upon assumptions about inflation.
- A4-12 This information was obtained during an interview with Nehemiah Project officials during the 1990s.
- A4-13 Walter Rybeck, "Transit-Induced Land Values," *Economic Development Commentary*, (National Council for Urban Economic Development) Volume 5 /No. 4/ October, 1981 pp 23-27. (The article is based on study performed for the House Banking, Finance and Urban Affairs Committee. The study was performed when the Metrorail system was only 40% complete. I assumed that Metro-induced land value increases continued to outpace costs through the completion of the system. In this regard, it is important to note that as new stations are completed, not only do land values increase around the new stations, but values continue to increase around existing stations as well due to their enhanced accessibility to (and connectivity with) the new stations.
- A4-14 Rick Rybeck, "Funding Long-Term Infrastructure Needs for Growth, Equity & Sustainability: Appendix 2a and Appendix 2b"  
See <http://www.dctaxrevisioncommission.org/#!/documents/cp9p> and scroll down to "Presentations and Papers ...". Find "Rick Rybeck" and click on the links for Appendix 2a and Appendix 2b.

A4-15 Walter Rybeck, Re-Solving the Economic Puzzle, (Shepherd-Walwyn) 2011, citing a study by John Rackham, DFR Assessment Standards Specialist, pp 102-103.

A4-16 Rick Rybeck, Op. Cit., Appendix 2

A4-17 Homestead Deduction: DC Code, 2001 Ed. § 47-850(c) (1)

A4-18 Senior Deduction: DC Code, 2001 Ed., § 47-863

A4-19 Circuit Breaker: DC Code, 2001 Ed. §47-1806.06

A4-20 Property Tax Exemption for Qualified Low-Income Housing: See DC Code, 2001 Ed. § 47-1002(20) (A) & (B)

A4-21 Tax Deferral: DC Code, 2001 Ed. §47-845

A4-22 See footnote A4-14 above.

A4-23 Rent Control in the District is authorized by the Rental Housing Act of 1985 as amended. See DC Code, 2001 Ed. §45-3501 *et seq.*

A4-24 Peter A Tatian & Ashley Williams, "A Rent Control Report for the District of Columbia," (Urban Institute), May 18, 2011.

A4-25 Jenny Reed, "Disappearing Act: Affordable Housing in DC Is Vanishing Amid Sharply Rising Housing Costs," (DC Fiscal Policy Institute) May 7, 2012, p. 1.

A4-26 The District's population peaked at about 800,000 in the 1950s. White flight from integrated schools and the lure of new suburban communities caused the population to decline in the 1960s. This flight accelerated after the riots associated with the assassination of Martin Luther King, Jr. Yet, in the early and mid-1970s, rising rents and fears about gentrification led to the imposition of rent control and condominium conversion control. These measures slow, but do not halt the process of affluent folks moving into certain neighborhoods. In spite of gentrification in some high-profile neighborhoods, the District continued to lose population throughout the 1970s, 1980s and 1990s indicating that displacement by disinvestment exceeded displacement by the influx of the affluent. See Steven J Diner, Jerome S Paige, Margaret M. Reuss, Irving Richter, *Housing Washington's People: Public Policy in Retrospect*, University of the District of Columbia, 1983, p 117, In response to housing code violations, tenants engaged in rent strikes and landlords retaliated with **evictions that exceeded 100,000 per year from 1964 - 1974.**

A4-27 See footnote A4-25 above.

A4-28 Rick Rybeck, Meeting America's Housing Needs, (Conference on Alternative State and Local Policies, Public Policy Report 7) 1982, pp 23-32.

A4-29 See footnote A4-11 above.

A4-30 Gentrification is not a recent phenomenon. It motivated the imposition of rent control and condominium conversion control as early as the 1970s and 1980s. Yet, in spite of an influx of some affluent households, the District's population continued to decline until the late 1990s.

A4-31 See footnote A4-14 above.

A4-32 DHCD, "Carrots or Sticks: Debating Incentives and Penalties for Stimulating Reinvestment," 2010

A4-33 In 1979 and 1980, Rick Rybeck investigated boarded-up buildings by examining their sales and assessment histories. He was surprised to discover that most of the buildings he reviewed were not in default on either their mortgages or taxes. Why would owners be making payments on properties that were providing no income? First, these buildings were still providing depreciation tax shelter to owners. Second, owners may have been anticipating future land price appreciation.

A4-34 District of Columbia Real Property Classification Amendment Act of 1990, Report of the Committee on Finance and Revenue on Bill 8-537, April 30, 1990

A4-35 Discussion with Department of Finance and Revenue officials in the early 1990s.

A4-36 In some cases, new homeowners who took occupancy of their homes after a short vacancy period have been surprised by vacant building penalty taxes being applied to their homes. They have been required to pay the tax and then submit documentation to correct the error and receive a refund. Even if a refund is eventually received, these homeowners end up angry and disgusted with the District Government. This information obtained from discussions with DC Realtors.

A4-37 Daphne A. Kenyon, "Real Property Tax Classification in Washington, DC," presentation to the D.C. Tax Revision Commission, May 20, 2013, p. 29. See <http://www.dctaxrevisioncommission.org/#!/documents/cp9p> and scroll down to "Presentations and Papers ...". Find "Daphne A. Kenyon" and click on "full report."

A4-38 Ibid., Table 2, p. 8.

A4-39 Id.

A4-40 Account of Robert Richards.

- A4-41 As mentioned above under Question #13, the legislative “on-again / off-again” ping pong surrounding the penalty tax on vacant and boarded-up properties is so uncertain and so full of exceptions, that it cannot be effective.
- A4-42 Historic Property Current-Use Assessment: See DC Code, 2001 Ed. §47-842.
- A4-43 Pub. L No. 61-196, 36 Stat. 452 (1910), D.C. Code § 6-601.05. Contrary to popular belief, this law was not enacted to protect the visibility or pre-eminence of the Capitol or any of the other monuments. It was enacted as a fire regulation. By relating a building’s height to the width of the adjacent street, if a building caught fire and collapsed the burning debris would not light the buildings on the other side of the street, thereby containing the calamity. Today, the fire suppression rationale has been diminished due to advances in building technology and improved fire-fighting equipment and techniques. The law continues in effect because many people appreciate the aesthetic of a city without sky-scrapers.
- A4-44 See note A4-14 above.
- A4-45 Of course, there are examples around the District where a landowner held out for too much too long, and the developer simply developed around the holdout’s property.
- A4-46 Historic Property Current-Use Assessment: See DC Code, 2001 Ed. §47-842.
- A4-47 Id.
- A4-48 Tom Fairchild, Director, Mobility Lab: “Arlington Focuses on Moving People, Not Cars, in the Nation’s Worst Traffic Metro Area,” February 5, 2013. “Despite huge growth over the last 20 years, Arlington traffic counts on major arterials have amazingly . . . gone down.” See <http://mobilitylab.org/2013/02/05/arlington-focuses-on-moving-people-not-cars-in-the-nations-worst-traffic-metro-area/>
- A4-49 Robert Schwab & Amy Rehder Harris, “Analyzing the Graded Tax,” *Taxing Simply, Taxing Fairly*, (Greater Washington Research Center) 1998, Chapter G, pp 235-239.
- A4-50 Ibid., page 237.
- A4-51 Richard F. Dye and Richard W. England, Assessing the Theory and Practice of Land Value Taxation, Lincoln Institute of Land Policy, 2010, pp. 2 - 3. See also, Robert V. Andelson, ed. Land-Value Taxation Around the World. (Blackwell), 2000.
- A4-52 Robert Schwab & Amy Rehder Harris, Op. Cit., p 230.
- A4-53 Ibid., p 231 citing studies by Kenneth Lusht and John Flaherty

A4-54 Ibid., p 232 citing J. Harvey Perry, *Taxation In Canada*, 5<sup>th</sup> Ed., (Canadian Tax Foundation) 1990.

A4-55 Walter Rybeck, Re-Solving the Economic Puzzle, (Shepherd-Walwyn) 2011, pp 164-165.

A4-56 Neil Padukone, "The Unique Genius of Hong Kong's Public Transportation System," *The Atlantic*, September 10, 2013. See <http://www.theatlantic.com/china/archive/2013/09/the-unique-genius-of-hong-kongs-public-transportation-system/279528/>

A4-57 Richard F. Dye and Richard W. England, 2010, Op. Cit., p. 16.

A4-58 Wallace Oates and Robert Schwab, "The Impact of Urban Land Taxation: The Pittsburgh Experience," *National Tax Journal*, Vol. 50, March 1997, pp. 1 – 21.

A4-59 Walter Rybeck, "Pennsylvania's Experiments in Property Tax Modernization," NTA Forum (Spring 1991) pp 1 -5, quoting Robert Kroboth, Harrisburg Finance Director that vacant buildings were reduced from 1,800 to about 400 over only seven years.

A4-60 "Harrisburg, Pa. May Soon Renew Bankruptcy Threat As Ban Ends," Reuters, November 28, 2012 <http://www.reuters.com/article/2012/11/28/harrisburg-bankruptcy-option-idUSL1E8MJ5VN20121128>

A4-61 Napoleon (Nate) Saunders, Harrisburg Business Administrator, speaking at a Philadelphia Conference January 29, 1998.

A4-62 Steven B. Cord, "The Evidence for Land Value Taxation," (Center for the Study of Economics) 1987, pp 9 – 11.

A4-63 Ibid., pp 8 – 9.

A4-64 Richard F. Dye and Richard W. England, Assessing the Theory and Practice of Land Value Taxation, Lincoln Institute of Land Policy, 2010, p. 2.