

# Just Economics

## TESTIMONY BEFORE THE DC TAX REVISION COMMISSION

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*"Markets are not perfect, and they cannot solve every problem. But they are extremely powerful and when governments reshape them to serve a public purpose, they can have a tremendous impact."*

--David Osborne, "Ten Ways to Turn D.C. Around,"  
The Washington Post Magazine, 12/19/90

My name is Rick Rybeck. I am the director of Just Economics, LLC, a firm that helps communities create economic incentives for job creation, affordable housing, transportation efficiencies and sustainable economic development.

I prepared a report for the D.C. Tax Revision Commission titled "Funding Infrastructure for Growth, Sustainability and Equity." It can be reviewed on the Commission's web site at [http://media.wix.com/ugd/ddda66\\_d46304b5437c178e2f092319a6f30364.pdf](http://media.wix.com/ugd/ddda66_d46304b5437c178e2f092319a6f30364.pdf).

Since World War Two, infrastructure has increasingly been funded by general taxes like income and sales taxes. As a result, there is less connection between what we consume and what we pay. We take for granted the services we rely upon and appear to consume for free. Yet we are very aware of the taxes we pay (particularly income and property taxes). This disconnect between what we consume and what we pay causes many of us to assume that our tax dollars aren't well spent.

Re-establishing the connection between what we pay and what we consume makes government more transparent. This is one of the goals of the Commission. Prices for public goods and services are more than money. If properly structured, they are information that can lead to better decision-making. Well-designed user fees and access fees can thus help create greater equity and efficiency in the provision of public goods and services.

#### **TRANSPORTATION FUNDING – FEES FOR ROAD USE & PARKING:**

The report notes that transportation and other types of urban infrastructure are rife with economic externalities that lead to counter-productive behavior. For example, when road use and parking appear to be free, we tend to drive and park in congested places at congested times more so than we otherwise would. Pricing only has to change the behavior of a relatively small number of drivers to create a disproportionately large improvement in traffic flow.

Many people think that pricing transportation by distance and congestion is very novel. Perhaps it is on the roadways, but Metrorail has been doing this for years, and the public has accepted it. Metrorail trains are very full during the rush hours – and that's what we want. But the system would be much more congested if Metrorail charged the same fare at all times of

day. The off-peak discount lures some discretionary trips away from rush hour and into the off-peak time periods. This makes the system more efficient and more valuable to everyone. Recently, Maryland has implemented dynamic congestion pricing on the Inter-County Connector. A similar system is in place on Virginia HOT lanes on the beltway. So drivers are becoming increasingly familiar with this concept as well.

Because roadway pricing is so politically contentious, a more realistic approach is to utilize performance-based pricing at on-street meters. DDOT has successfully implemented several pilot demonstrations. The Commission should applaud the Council for authorizing its implementation citywide.

Unfortunately, many people get free parking at work as a perk. This encourages more rush-hour auto traffic. This is bad for the region's environment and for its economy. Appendix 1 of my report contains a draft of a "Clean Air Compliance Fee Act" that would place a charge on employee parking that does not contribute to the District's parking sales tax. See [http://media.wix.com/ugd//ddda66\\_d3cb106b51d99d2066463fcdf168af70.pdf](http://media.wix.com/ugd//ddda66_d3cb106b51d99d2066463fcdf168af70.pdf).

This fee would raise funds largely (but not exclusively) from non-residents and would help the District fund the transit component of its air quality improvement program. By obtaining funding from non-residents who benefit from District infrastructure, this proposal helps increase fairness in the apportionment of taxes and it broadens the base. These are primary goals of the Commission.

This approach to impose a fee on free parking should be seriously considered as an alternative to **Commission Policy Option #6** to increase the parking sales tax on parking that is already very expensive.

#### **PROPERTY TAX REFORM – CREATING A “UNIVERSAL ABATEMENT:”**

My report's recommendation to reform the property tax has garnered the most attention. The proposal relies on classical economic theory about making markets work better. The proposal is also based upon real-world experience from jurisdictions where it has been successfully implemented.

It appears that the public, the business community and government officials are united by their desire for more jobs and more affordable housing. Yet, when landowners construct or improve buildings to provide commercial space or housing, assessments rise and so do taxes. When owners allow buildings to deteriorate, assessments fall and so do taxes. It would appear that the economic incentives associated with the traditional property tax are upside-down.

How serious is this disincentive? The property tax on buildings increases not only when an improvement is made, but every year thereafter that the improvement adds value to the property. Over time, a 1% or 2% tax on the value of buildings can have the economic impact of a one-time sales tax of 10% to 20% on construction labor and materials. (Little wonder that big

development projects seek tax abatements. However, homeowners and small entrepreneurs don't have the clout to obtain these abatements. Therefore they subsidize those who do.)

At the same time that government is making privately-created building values more expensive, the government is giving away the lion's share of publicly-created land values. For every \$100 of publicly-created land value, only \$2/year is returned to the public. Thus billions of dollars have been given away to the owners of commercial land around Metrorail stations while government is nickel-and-diming riders with fare increases and imposing higher taxes on the general public to pay Metro subsidies.

The solution to this upside-down property tax is to use "value capture" to convert the property tax into a public service access fee. This is accomplished by reducing the tax rate on building values and increasing the tax rate on land values. This is **Commission Policy Option #46**. It could be referred to as the "Universal Abatement Policy" because all building owners would receive lower building taxes as a result.

Lower tax rates on building values would make buildings cheaper to construct, improve and maintain. Less expensive buildings would be good for residents and businesses alike. It would help make the District more economically competitive with its surrounding jurisdictions. Expanding business and job opportunities and making the District more competitive with its surrounding jurisdictions are two of the primary goals of the Commission.

Regarding problems with the traditional property tax, the Council has tried to nibble around the edges. The Council has experimented with penalty taxes on vacant properties. The Commission received a report indicating that this approach has been fraught with administrative difficulties and unintended consequences. As a result, the Council has changed the vacant property tax penalty criteria and rates nine times since 1991. Property investment and disinvestment decisions are made over the life of a building. It makes little sense to reward disinvestment with lower taxes over a period of many years and then suddenly impose a large penalty because the disinvestment has gone "too far."

Problems with the current approach are discussed in Appendix 4 to my report. See pages 36 – 40 at [http://media.wix.com/ugd/ddda66\\_2817111b198bdd64898d8b19e4ac331c.pdf](http://media.wix.com/ugd/ddda66_2817111b198bdd64898d8b19e4ac331c.pdf) .

The "universal abatement" makes it cheaper to construct, improve and maintain buildings throughout their entire life cycle. It is predictable, fair and effective.

On the other side of the coin, the higher tax rate on land values is a value-capture fee for access to public goods and services. Public goods and services increase the value of well-served land. Like a user fee, a value-capture access fee charges landowners in proportion to the benefits that they receive. Enhancing fairness in the apportionment of taxes is a primary goal of the Commission.

And, like a user fee, a value-capture access fee creates productive incentives. Those with the most valuable land pay the most. Because fees based on land value cannot be avoided, owners of high-value sites must generate income from which to pay them. This encourages development at high-value locations – and this is where development is generally most appropriate.

Surprisingly, imposing a higher value-capture fee on land values actually helps keep land prices more affordable. Value-capture fees reduce the profit from land speculation. Thus, speculative demand for land is reduced. This reduction in demand helps moderate prices and also helps moderate the “boom-and-bust” cycles that are fueled by speculation and which are so harmful to residents and businesses.

As Commissioner Brunori has pointed out, Nobel-winning economists from all ends of the political and philosophical spectrum have endorsed this concept. Of equal importance, it has been successfully implemented in a number of jurisdictions in the United States and abroad.

Pittsburgh implemented this type of property tax in 1913. It is credited with minimizing some of the effects of the Great Depression in the 1930s. More recently, it was credited with helping Pittsburgh outperform 14 other rust-belt cities during the manufacturing depression of the 1980s. The Commission heard from former Pittsburgh Mayor Tom Murphy (now a senior fellow at the Urban Land Institute), that this approach was good for Pittsburgh and would be good for most cities including the District. Mayor Murphy’s testimony can be seen at [http://media.wix.com/ugd//ddda66\\_6efa69378fd03b8beb16acdc3bca097a.pdf](http://media.wix.com/ugd//ddda66_6efa69378fd03b8beb16acdc3bca097a.pdf) .

In the 1970s, Harrisburg was named as one of the most distressed cities in the country. Harrisburg was reeling from floods and urban flight that devastated its downtown. In the mid-1970s, Harrisburg reformed its property tax by taxing building values at a lower rate than land. Contrary to national trends, Harrisburg saw a renewal of its downtown during the 1980s and was then named as one of the best American cities of its size.

In spite of nearly unanimous support from prominent economists and its real world successes, some are hesitant to pursue this reform. Here are the objections listed in the policy memo prepared for the Commission:

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- Changing the tax rates could create “winners and losers,” which cannot be identified at this time.

Winners and losers can be identified. This was accomplished in a 1991 study of 1992 tax rates using actual DC assessments. This study showed changes in tax burden from the existing system by neighborhood and by class of property. The 1991 study showed that, while raising the same revenue, the “universal abatement” would reduce the average tax burden in all residential neighborhoods. Tax reductions, as a percentage of the existing tax liability, were

more substantial in moderate- and low-income neighborhoods. Commercial properties in many neighborhood retail areas received reductions as well.

If and when a specific set of tax rates is proposed, the District can run these rates against its property assessment database and know which properties benefit and which ones do not. Likewise, each property owner would be able to review their assessment and ascertain whether they would pay more or less under the new approach.

Over twenty years have elapsed since the 1991 study. At least one of the Commissioners requested that it be updated. I was recently called in to assist in this regard. I received the District's property tax database about two weeks ago. It contains 210,080 records in 215 fields. I have had some preliminary discussions with the Office of Revenue Analysis about how to organize the database so that a hypothetical reform scenario can be somewhat comparable to the scenario from 1991, thereby allowing the Commission to observe how the passage of time may have affected favorable and unfavorable outcomes of this approach. I expect to have results in about another week.

Although any sudden change in tax policy will create "winners and losers," that is not the point of this proposed reform. The point of the "universal abatement" is to enhance equity, reduce the cost of improving and maintaining buildings and ensure that valuable District land is more available for residential and commercial users. To avoid the unfairness of creating "winners and losers" the Council can phase-in this reform gradually. Small rate changes made in the early years will have little immediate economic impact. But, a clear communication about the ultimate direction that the reform is taking will allow "would-be losers" time to adjust their property investment decisions so that they can become "winners" by taking advantage of the new incentives.

- Would require the Office of Tax and Revenue (OTR) to create and implement a new property tax assessment system. This would require new training and possibly additional staff.

The District already assesses both land and building values. Therefore, it does not need a new assessment system. Nonetheless, this new approach to taxation would require some new procedures and some additional training and staff. When compared to the high cost of tax abatements, exemptions or other special treatment for a favored few, this is a very small price to pay for a property tax system that makes housing and business locations more affordable for all, encourages property maintenance and improvement by all landowners, and enhances job creation and retention.



- Calculating two assessments (land and building for each property) could increase valuation challenges (and controversies).

Although separate assessments of land and building values occur today, landowners cannot appeal the apportionment of value between land and buildings because it makes no difference in the taxes paid. If the “universal abatement” was implemented, even if the total value of a property was not contested, the apportionment of value between land and buildings could have a material impact on taxes paid and therefore be a legitimate subject for appeal.

Of the approximately 182,000 properties in the District, about 172,000 are residential. There are many sales of residential properties and the multiple regression analysis module of the District’s CAMA system is capable of arriving at realistic and defensible estimates of residential land values.

I have spoken to the District’s chief appraiser, Stephen Cappello, about the appeals issue. He agrees that CAMA can handle the residential properties. However, Mr. Cappello is concerned about commercial property assessments. There are not enough commercial property sales for multiple regression analysis to be reliable with regard to the apportionment of property value between its land and building components.

I shared Mr. Cappello’s concerns with Ted Gwartney, a professional assessor who has been successful in assessing both land and building values during his career. Mr. Gwartney has prepared testimony about best practices in this regard. These techniques are logical and transparent and have been successfully defended in court.

Perhaps it is worth noting in this regard that land values within a defined area and controlled for zoning and other development restrictions are relatively more uniform than individual building values which are more idiosyncratic. Therefore, once the assessor’s office has better confidence about land values, they will be easier to defend. Building values might be a bit less certain, but appealing them will be less appealing because the tax rate on buildings will be lower and the remuneration for the appeal will decline accordingly.

The District is already a client of CoStar Group. CoStar conducts research to produce and maintain a large and comprehensive database of commercial real estate information. Their services enable clients to analyze, interpret and gain insight on commercial property values, market conditions and current availabilities. This resource will further enable the District to have confidence in its commercial assessments.

The professionalization of property tax appeals under the leadership of Mr. Syphax and Mr. Amato should also be helpful in this regard. Likewise, legislative proposals to have assessment appeals to Superior Court utilize the record established by the Real Property Tax Appeals Commission (rather than operate as a trial *de novo*) should help reduce administrative burdens on the District while also reducing the gamesmanship of some appellants who rely on overwhelming the court system to coerce administrative settlements.

## CONCLUSION

“There is nothing more difficult to take in hand, or more uncertain in its success, than to take the lead in the introduction of a new order of things. Because the innovator has for enemies all those who have done well under the old order of things, and lukewarm defenders in those who may do well under the new.”

-- Machiavelli, *The Prince*

Machiavelli's observation about the politics of change are quite astute. Nonetheless, change does happen. In my lifetime, I did not expect to see the disappearance of the Berlin Wall and the Iron Curtain, at least not without World War III. Based on vested economic, political and social interests, who thought that the civil rights movement (or the environmental movement or the women's movement) had any chance of achieving significant change?

Most of the recommendations in my report, related to shifting infrastructure funding from general taxes to user fees and access fees, require legislation and the political choreography necessary to bring that about. A discussion about this choreography appears in Appendix 3 to my report at [http://media.wix.com/ugd/ddda66\\_a46d8e5dd78f3d77d58c4335fcbfd565.pdf](http://media.wix.com/ugd/ddda66_a46d8e5dd78f3d77d58c4335fcbfd565.pdf).

But this effort is not as heavy a lift as it might seem. Utilizing congestion pricing for parking and roads might seem strange to some people. But Metrorail uses congestion-pricing every day. Likewise, the property tax reform might seem strange. But today the District is taxing both the value of land and the value of buildings. Under the reform, the District would continue to do so, but simply tax one a bit less and the other a bit more. In cities that have implemented this reform, real estate agents and chambers of commerce have supported it. In the District, the Coalition for Smarter Growth and the Sierra Club have already endorsed it. And, the tax comparison study update now underway can inform taxpayers about the potential impacts on them, their neighborhood and the District as a whole.

Machiavelli is correct that change is difficult. But, it's not impossible. The stakes are high-enough in terms of affordable housing, job creation, and a livable and sustainable community, that those of us who can digest the wonky technical stuff should be willing to undertake the effort to reach out to the public, educate them, and involve them in crafting the solutions.

We recently commemorated the 50th anniversary of the March on Washington for Jobs and Freedom. We celebrated the movement's successes and achievements. Thousands of people



risked their lives and their property in the struggle for equality and better working conditions. Martin Luther King Jr.'s last efforts were made on behalf of sanitation workers who were striking for dignity and safe working conditions. We honored the efforts and sacrifices of those who worked for change. We remembered those who were martyred. And we recognized that significant work remains. As many civil rights leaders have pointed out, if you have the right to sit at a lunch counter, but cannot afford to pay for a meal, the right to sit and be served does not mean so much.

The reforms mentioned in this report can help create jobs and more affordable housing. They may require some political effort to achieve. But in light of the sacrifices already made to achieve civil rights and better working conditions, can we say with good conscience that we are not willing to make that effort? If we know how to make "economic justice" and "ethical economics" not seem like oxy-morons, then why wouldn't we use our knowledge to harmonize economic incentives with sensible and important public policy objectives?

