USING IMPROVED INFRASTRUCTURE FUNDING TO INTEGRATE LAND USE AND TRANSPORTATION FOR AFFORDABLE, SUSTAINABLE & EQUITABLE COMMUNITIES

If smart growth is so smart, how come there’s so much dumb growth? Part of the answer lies in our failure to understand the way that public investments, intended to benefit communities, result in economic displacement and incentives for sprawl. Fortunately, some communities are correcting this problem. They are using value capture to transform their property tax into a public services user fee. This creates more sensible economic incentives that foster more employment combined with more sustainable and affordable development.

The Public Infrastructure Conundrum

Public goods and services are created to make communities more productive and more livable. For example, we create transit service to provide mobility to those who do not drive and to facilitate development near transit stops and stations. Yet, if transit is well-designed and well-executed, the price of land around transit stations will rise. This results in the displacement of low-income households and pushes some new development away from station areas in order to obtain affordable land. Unfortunately, affordable sites tend to be far away from transit. Officials then extend transit to these more remote sites, only to have the process repeat itself. Thus, the infrastructure that we create to help low-income people often puts them at a disadvantage. The infrastructure that we create to facilitate development ends up chasing it away. We chase after it with more infrastructure, but never catch up. The resulting sprawl impairs rural land that is more suitable for agriculture, conservation and recreation. Sprawl makes us dependent on cars for transportation. This pollutes the air, wastes energy, creates traffic congestion, and multiplies the amount of impervious surface, thereby exacerbating stormwater runoff. It also cripples municipal budgets because expensive infrastructure is underutilized in the urban core while being duplicated at the urban fringe.

One key to this problem is that private landowners can appropriate infrastructure’s publicly-created land values. As private landowners become aware that transit has made their land more valuable, some will sell their land for development. But others will think it foolish to sell land at its present market value when it seems likely to become even more valuable in the future. So they just sit and wait. The more owners withhold land from development, the more they create an artificial scarcity of development sites. This artificial scarcity of development sites results in real increases in land prices. Thus, land speculation can lead to higher land prices and becomes a self-fulfilling prophecy – at least initially.
At some point, however, land prices become so high that land users (businesses and residents) are priced out of the market. At this point, speculators are buying and selling only from each other. This creates a real estate price bubble. And when the bubble bursts, it can bring the entire economy to its knees. (Most of this country’s major recessions and depressions has been preceded by a real estate boom and bust.)

At the beginning of a real estate bust, falling land prices create an opportunity for businesses to obtain more affordable space. But landowners are typically unwilling to sell at a loss. By refusing to put land on the market at its new market price and by depriving businesses of more affordable sites, business opportunities are reduced, unemployment is exacerbated and the recession or depression is made worse than it otherwise would be. Thus, during the “bust” phase, real estate speculation becomes a self-defeating activity.

Some studies have shown that the land values created by transit can exceed the cost of transit construction. The role of transit in increasing land prices near stations is easily observable. Although not as easily observed, most other public goods and services such as schools, police and fire protection, also result in higher land prices in areas that are well-served by well-designed and executed services. If publicly-created land values were returned to the local governments that created them, public goods and services could be financially self-sustaining to a greater degree. This could result in lower general taxes and transit fares while providing governments with sufficient funds for operations and maintenance.

**Unnecessary Barrier to Jobs & Affordable Development**

Public officials state that they desire more jobs and more affordable housing. Yet, how do most governments treat property owners who construct or improve buildings? In most cases, new and improved buildings result in higher property taxes. Yet, when owners allow buildings to deteriorate, depriving communities of housing and jobs, property taxes are reduced. Given public policy goals for affordable housing and job creation, it would appear that the economic incentives of the traditional property tax are upside-down.

Many people underestimate how serious property taxes are as a barrier to affordable development. After all, the typical property tax is only 1% or 2% of value. Yet, unlike a sales tax that is paid only once, a property tax is paid each and every year that an improvement adds value to a property. Using a net present value calculation, the economic impact of the property tax can be equivalent to a one-time sales tax of between 10% and 20% on construction labor and materials. This is a substantial barrier to building construction, improvement and maintenance. Little wonder that developers often refuse to undertake major new developments unless they first receive a property tax exemption or abatement.

This tax penalty for property improvement is a particular problem regarding investments in the energy efficiency of existing buildings. Retrofitting and weatherizing buildings require an up-front investment. The return, in terms of lower utility bills, is realized in small increments over a long period of time. As if this was not enough of an impediment, making such an investment will increase the value of the building and result in higher property taxes. This may not only push the pay-back period farther into the future, but may ultimately render the investment
unprofitable. Thus, at a time when we need to conserve energy, avoid global warming, and increase employment, the property tax on building values makes it more difficult to make the investments necessary to achieve these important goals.

**Using Value Capture To Transform the Property Tax Into A Public Services User Fee**

Some jurisdictions have addressed the infrastructure conundrum and the unnecessary barrier to affordable development by using value capture to transform their property tax into a public services user fee. This is accomplished by reducing the property tax rate on building values and increasing the property tax rate on land values.

**Impact on Affordability**

The tax on building values is a cost of production. (No building, no tax.) Whenever the cost of production is increased, the result is that fewer things are produced and the price of what’s left goes up. Thus, a lower tax rate on building values makes them cheaper to construct, improve and maintain. This results in more affordable buildings and is a benefit to residents and businesses alike.

Surprisingly, the higher tax on land values helps keep land prices more affordable as well. This is because land is not produced. Thus, a tax on land value is not a cost of production. Because land prices reflect the expected benefits of ownership and because a tax on land value reduces those benefits, the tax on land values reduces what potential buyers are willing to pay for land. Most importantly, the supply of land does not decrease as a result of the tax.

The tax on land values takes some of the profit out of land speculation. Thus, by reducing the speculative demand for land, land prices stay more affordable for land users. To the extent that this reform helps keep the market price of housing down, limited housing subsidy dollars can help more people because the difference between their incomes and the market rate for housing is smaller.

**Impact on Equity**

Under the traditional property tax, owners of well-developed properties pay higher taxes while owners of boarded-up buildings and vacant lots pay less than their more responsible neighbors. By shifting taxes off of privately-created building values and onto publicly-created land values, a value-capture approach charges landowners in proportion to the benefits that they receive from public goods and services. Thus value capture makes the property tax more like a public services user fee. In some respects, this is a more equitable way to pay for the fixed costs associated with public goods and services.

**Impact on Sprawl and Sustainability**

As mentioned at the beginning, real estate speculation exacerbates the extent to which land prices rise near transit and other infrastructure amenities, thereby exacerbating
sprawl. Using value capture to transform the property tax into a public services user fee has very different results.

Building value is created and maintained by building owners. Owners can avoid a tax on building values by:
- Allowing a building to deteriorate;
- Not constructing or improving a building; and by
- Making building investments in another (lower-tax) jurisdiction.

NOTE: These actions to avoid the building tax result in fewer buildings and higher rents or prices for residents and businesses.

Land values are created by communities, not by individual owners. Land values, in an urban context, represent the potential productivity of sites for residential or commercial purposes. This is largely determined by a site’s zoning and its access to public goods and services (location, location, location). Because land values are determined by community actions, landowners cannot avoid a land tax. After all, can landowners:
- Reduce the location-value of their site? or
- Move their land to a lower tax jurisdiction?

No, landowners cannot do these things. Thus, the tax on land values cannot be avoided and must be paid. Where land values are high, there will be economic pressure to develop these sites in order to generate income from which to pay the tax. High-value sites tend to be infill sites near urban infrastructure amenities (like transit).

High-value, urban infill sites are the very locations where smart growth advocates want development to occur. Because the demand for developed space is finite at any point in time, developing these infill sites reduces the pressure to develop low-value, outlying areas that are more appropriate for agriculture, conservation and recreation. Thus, using value capture to transform the property tax into a public services user fee helps make development more compact around existing infrastructure. And compact development makes it easier to walk, bike, take transit or use another mode of shared transportation.

The theory behind this tax reform is generally agreed to by economists – even from diverse schools of thought. More importantly, the jurisdictions that have employed this technique have achieved favorable results in terms of infill development and affordability.

Pittsburgh, Pennsylvania used this technique from 1914 until 2000, when a botched reassessment made it politically expedient to return to the more traditional property tax. Yet, during the Great Depression, Pittsburgh land values fell by much less than other major cities, demonstrating that this approach was successful in curbing the excesses of real estate speculation. And, in spite of the collapse of traditional smokestack industries that were the heart of the Pittsburgh economy, Pittsburgh made a successful transition from a manufacturing economy to a service-based economy. (This is something that most other rust-belt cities were unable to do.) Part of the reason for Pittsburgh’s success was its lower tax on buildings and higher tax on land which created an economic imperative to put vacant factory sites back into use.
In 1972, flooding from Hurricane Agnes devastated the downtown of Harrisburg, Pennsylvania, leaving thousands of vacant and boarded-up properties. Shortly thereafter, Harrisburg adopted this property tax reform. Within 15 years, over 85% of Harrisburg’s vacant properties had been redeveloped. During an era when investment typically shunned cities in favor of suburbs, Harrisburg successfully rejuvenated its downtown.

In 1978, there were five Pennsylvania jurisdictions that employed this property tax technique. Today, there are roughly seventeen jurisdictions doing so. Most of them began with a small differential between the building tax rate and the land tax rate. Then they increased the differential over time. Altoona has found this to be so successful that it completely eliminated its property tax on buildings within the past year.

**Conclusion**

Sprawl is straining the environmental and fiscal resources of our communities. It also places many households at a serious disadvantage if they have to travel long distances to access jobs, school and shopping. Federal and state resources are becoming harder to obtain due to deficits and political gridlock. Therefore, communities must look increasingly to their own resources and capabilities to resolve these problems.

Using value capture to transform the property tax into a public services user fee can produce substantial benefits in terms of more affordable and sustainable development while also providing a more equitable means of infrastructure funding. Several examples of the efficacy of this approach can be found in this country and from around the world. Yet, most people have never heard about it.

While the notion of lower taxes on building values is generally welcomed, many people have the common misconception that higher taxes on land values lead to higher land prices. Yet, land taxes tend to lower land prices and make development patterns more compact. When implemented, this reform has proven effective in harmonizing economic incentives with public policy objectives for affordable housing, employment, compact development and environmental protection.

The Smart Growth Network is uniquely positioned to help educate the general public and policy makers about this technique and to make it a more widespread component of the toolkit for more affordable, sustainable and equitable communities.

Submitted by:

Rick Rybeck, Director
Just Economics, LLC