Mayor's Office of Sustainability

RE11: **Land Value Tax** Implementation Study

February 19, 2013

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Introduction

This report fulfills initiative RE11 of the recovery plan, which calls for the City to "Explore a change to a Land Value Tax structure." This study will be done in the context of the current 2013 property tax, and consider the impact of a revenue-neutral shift to the land value tax.

The study will attempt to achieve the following objectives:

1. Introduce City officials and Act 47 coordinators to the concept of a land value tax
2. Provide a comprehensive study of a land value tax shift within the City's current property tax
3. Demonstrate the relevant impacts of such a tax shift, especially on tax classes, council districts, and property quintiles

Background

The land value tax has been reviewed in Reading for a number of years, by different groups:

- 2003: City Council considered a formal study and decided against it, citing the need for more information
- 2009: The Mayor's Blue Ribbon Panel on fiscal distress recognized LVT as a potential reform and requested additional consideration
- 2010: The Act 47 Community Committee endorsed LVT as part of its recommendations for fiscal stability and economic development
- 2010: PFM included an LVT review as an initiative in the Act 47 Recovery Plan
- 2011: The Mayor's *Rebuilding Reading* Poverty Commission endorsed LVT as a way to stimulate the economy and help reverse poverty conditions

Key Points to Keep in Mind

The property tax is a good and reliable tax.

The property tax is our main source of tax revenue, and already has many advantages over other municipal tax options. It is an ad valorem tax (tax on value) that uses a single rate (in millage) to tax both the value of land and any buildings (improvements to land) on each property.

From the recovery plan (emphasis added):

> *The property tax is the City's largest revenue source and one of the few major revenues it can adjust unilaterally. … **From an economic perspective, taxes on property have a smaller economic impact than taxes on income or business activity because land, unlike individuals and businesses, property is immobile and cannot relocate to escape higher taxes.***

If the goal is to facilitate economic recovery in the City of Reading, then the property tax is a crucial approach to prefer.

The land value tax is a simply a better property tax.

Yet while the property tax is good, it can be greatly improved. LVT simply replaces the existing property tax, fixing many of the problems related to it. Like the property tax, it also is an ad valorem tax, but uses split rates for land and building values separately on each property. The main difference is that land is taxed higher than buildings, which yields many positive advantages.

Taxing land is better than taxing buildings.

Basic economics proves that taxes on land have no negative economic consequence; in fact, higher land taxes improve economic conditions by rewarding building construction and maintenance while reducing blight and vacancies. This creates a real carrot and stick to repair our real estate problems. We will discuss this further down below.

The land value tax shifts tax burden from buildings to land, with no loss in revenue.

LVT is often implemented over several years, by reducing the millage rate on buildings while increasing the millage rate on land. This is done with no loss of revenue to the City, often referred to as being revenue neutral, but additional revenue can easily be added while shifting the tax. The property tax revenue could be shifted 20% to land each year, and eliminate building taxes in five years.

Berks County's long-outdated property assessments significantly distort the property tax.

No other tax base records, such as income or sales, are allowed to fall behind, as it would inaccurately determine who owes what. Real estate, however, is unfairly treated through politically charged county assessments that lag several decades behind. New property owners are often taxed higher because of recent values, while existing property owners remain valued at the last reassessments numbers. A reassessment would correct this distortion.

In addition, regular reassessments capture returns on public investments, through rising property values.

Land value taxation recycles public money through the virtuous cycle of value creation and value capture.

Generally speaking, land appreciates in value while buildings depreciate, and thus property values do change from year to year. Public services and infrastructure investments, such as reduced crime, better schools, and improved infrastructure, increase land value, and regular reassessments reclaim public money through increased tax revenue. Therefore, more services and infrastructure lead to more revenue for further service and infrastructure improvements. The cycle then continues.

In this sense, annual city improvements would accurately grow the tax base, bringing in additional revenue in a virtuous cycle—so much so, in fact, that all policies should consider the property value impact. Because we currently do not reassess, the city could be passing up on revenue from public investments, leaving money on the table for property owners when they sell or rent their properties at higher values.

However, the current assessments are good enough to do a land value tax shift.

As we will demonstrate below, although far from perfect, the current assessments are good enough to keep the property tax and are also good enough to shift to a land value tax. They already provide land and building values, and offer enough consistency in land values to set split rates.

In almost all cases, renters pay the property tax, but under a land value tax the landlords do.

Renters are often accused of not contributing their fair share to the cost of public services because they do not own their home. On the contrary, renters do pay the property tax as part of their rent, and thus share in the burden of taxation. Under LVT, however, additional costs cannot be shifted to tenants simply because of location value, so the property owner ultimately must pay the bill. This protects renters from excessive rents, and neighborhoods from gentrification risks. The same concept actually applies to commercial tenants as well.

How a Land Value Tax Works

Just like the property tax, a land value tax levies tax rates against a property's value. An example will illustrate this concept.

Right now, every property already is assessed for both land and building values, with building values averaging three to five times the value of land. For example, a property of $100,000 might typically have a building value of $80,000 and a land value of $20,000. This means that for every $1 of land value, there is $4 of building value, or a 4:1 building to land ratio.

A tax on this building of 10 mills would yield $1,000. The property tax does this by levying 10 mills on the $80,000 building value to yield $800 and 10 mills on the $20,000 land value to yield $200, for a total of $1,000. This is how it works today.

If this property had no building and was instead a vacant lot, it would still be worth $20,000, and would still be taxed on the land value to yield $200 in property tax.

Were we to have these two properties side-by-side, as is often the case when buildings are burned or torn down, the property with the building would owe $1,000 and the vacant lot would owe only $200. Combined, we receive $1,200 in total tax revenue.

In essence, the vacant lot is much cheaper to own than a property with buildings and other improvements to land. Any improvements to the vacant lot will increase the tax liability of the property; a $50,000 investment to make the lot productive will raise the tax bill to $700 each year, essentially penalizing the property investment.

With a land value tax, we treat land and buildings differently by simply adding a separate millage rate to the value of land. Now let's consider if the building rate were dropped by 50% to 5 mills, and the land rate increased to 20 mills to still bring in $1,200 total.

The first property would be charged $400 for the building value, and also $400 for the land, for a total of $800 with a decrease of $200 (from $1,000). The second property, however, would now pay $400 for the land with an increase in $200 (from $200). The total would still yield us $1,200, but shift more of the tax burden to the vacant lot.

Were there no tax on buildings, and a 30 mill land rate to stay revenue neutral, the first property would pay $600, and the second property would also pay $600, further shifting the tax burden to the vacant lot by $400. In this optimal case, the first property would be rewarded for upkeep and the second property would be pressured to invest or sell, but without penalty on future improvement value. This is the carrot and stick in action.

Land Value Tax Advantages Over the Property Tax

General redevelopment advantages

1. The land value tax provides relief to properties with relatively high building values and lower land values. The property tax does the opposite, making building ownership costly but land ownership cheap.
2. The land value tax shifts tax burden to blighted, vacant, or otherwise underutilized properties with higher land values. The property tax unintentionally subsidizes blight.
3. For underutilized properties, the land value tax protects against penalties for reinvestments, pushing such properties into productive use. The property tax discourages redevelopment.

Tax administration advantages

1. The land value tax is the most visible and unavoidable tax. Land is always in plain sight, cannot be hidden or relocated, and is arguably easier to value than buildings. The property tax must factor buildings and their value, and creates "window tax" dilemmas.
2. The land value tax is simple to understand. When fully implemented, a property will pay a single, predictable cost from a simple calculation on a simple bill. The property tax has this as well, but building values and assessment appeals heavily complicate matters.
3. The land value tax is the most stable and predictable tax. Land values are more consistent and constant than building values, especially factoring in the impacts of blight, arson, and other often-sudden changes to property. Buildings as part of the property tax are more exposed to these risks.
4. The land value tax is more equitable, both in terms horizontal and vertical equity as well as the ability to pay and benefits received principles of taxation.

Economic development advantages

1. The land value tax (along with reassessments) captures increases in revenue from public economic development investments, which are reflected in rising property values.
2. The land value tax discourages real estate speculation, where properties are held out of use for anticipated future gains, which drains money from revitalization efforts and artificially drives up the cost of property for homes and businesses. This helps explain why otherwise useful properties remain vacant for sometimes decades.

Neighborhood stabilization

1. The land value tax makes it more affordable to finance homeownership by lowering the capitalization of land value increases in the selling price of property. In simple terms, it can reduce

mortgage payments, helping more potential homeowners to secure a loan.
2. The land value tax improves the competitiveness of the rental market, giving tenants more quality options for housing and responsible landlords more incentives to invest and compete.

Comparisons to Other Similar Programs

Keystone improvement zones (KOZ)

From DCED:

> *Keystone Opportunity Zones (KOZ) and Keystone Opportunity Expansion Zones (KOEZ) are geographic areas that can provide specific state and local tax benefits. The goal of the KOZ/KOEZ program is to revive economically distressed urban and rural communities with one of the most powerful market-based incentives – eliminating taxes.*

The land value tax begins the process of turning the entire city into an enterprise zone, preserving incentives for investments and commerce while maintaining a sustainable tax base to tap for revenue. It can be used to phase out any Act 511 taxes, all of which create disincentives for economic activity.

Local economic revitalization tax assistance (LERTA)

In 2010 the City of Reading established a LERTA program to provide a "means of enticing development and/or the rehabilitation of deteriorated property within the City boundaries." This program allows for "commercial, or business property owners that are contemplating repair, construction, or reconstruction of such property within the City of Reading [to] receive a prorated ten- (10) year tax break on the assessed valuation of the improvements to the real property."

This ten-year tax abatement program offers an attractive incentive for redevelopment, removing a portion of the tax liability on improvements (such as buildings). While a helpful tool to stimulate such economic activity, it has several disadvantages:

1. It applies to only new development activity of a commercial nature. Residential properties are excluded, and therefore have no equivalent incentive program to spur improvements. Also, no prior investments are applicable.
2. It phases out over time, discounting the improvement value until it is completely taxable again.

The land value tax, however, acts as a universal and permanent abatement:

1. It applies to all taxable property, including residential properties.
2. It is retroactive, rewarding heavily developed properties with prior investments.
3. It never expires, providing annual tax savings that can instead be spent elsewhere.

Legal Basis for a Land Value Tax

In 1951, Act 299, incorporated into Senate Bill 357, dealt with taxation and assessment of land and improvements. Thereafter, Public Law 37531 (Purdon) allowed 3rd class cities to go two-rate (for a land value tax).

Because Reading is a Home Rule city, it is generally eligible to use any type of taxation offered by the Commonwealth to its subsidiaries (boroughs, cities, counties, etc.).

From the DCED Taxation Manual:

> *The cities of Pittsburgh and Scranton may levy real property taxes at a lower rate on buildings than the rate levied on land. Third class cities may also set different rates for land and buildings providing they are uniform within each classification. Boroughs may set different rates for land, except for farmland, and buildings. Third class school districts coterminous with third class cities may also levy separate rates on land and buildings.*

More information can be found in the full DCED Taxation Manual publication, available at http://newpa.com/webfm_send/1520.

The ordinance would simply have to specify separate rates for land and buildings, both derived from a calculation that determines targeted building rate deductions and required land revenue amount.

Current Implementations in Pennsylvania

Starting in the early 20th century, the Commonwealth has benefitted from the broadest enabling legislation for land value taxation in the nation. At the moment, the following PA cities utilize land value taxation:

- Aliquippa
- Allentown
- Altoona
- Clairton
- DuBois
- Duquesne
- Harrisburg
- Lock Haven
- McKeesport
- New Castle
- Pittsburgh (downtown BID)
- Scranton
- Titusville
- Washington

Of particular note, in 2011 Altoona became the first city in the U.S. to completely eliminate its building tax, following a 10-year transition to a land tax. Additionally, Allentown's home rule charter essentially froze all municipal taxes besides the property tax and explicitly adopts a phased-in land value tax:

> *Beginning in 1997, the City of Allentown will adopt a property taxation system designed to encourage development of new properties and improvements to*

> *existing properties. The system will accomplish this by gradually reducing the tax rate applied to all buildings relative to the tax rate applied to all land (whether developed or undeveloped).*

Reading is encouraged to look to Allentown, which is experiencing significant redevelopment at a time when most other cities are not, for further consideration of the benefits of land value taxation.

Current Constraints and Necessary Reforms

While it is possible to immediately adopt land value taxation, it is necessary to acknowledge some known shortcomings and challenges to maximizing the benefits of this tax.

The first is the dilution of its impact on real estate decisions due to the restriction on municipal levies: at the moment, Reading is unable to have its school district or county taxes shift to land because of restrictions on state law. Work must be done to change this, as school and county taxes account for nearly 60% of combined property tax revenue, and thus heavily influence land value taxation outcomes.

In addition, the lack of reassessments reduce the frequency and accuracy of building and land valuation, which can cause some property owners to feel that the tax shift is unfair and trigger appeals. Such cases are limited, but the City must be made aware of them. It is important to note that such cases highlight deficiencies in the tax base, as opposed to the effective of land value taxation, which is solely acting as the tax rates.

Another important and often neglected objective is the follow through on annual shifts from buildings onto land, as well as the phase out of Act 511 taxes on business and commerce activity. Reducing such taxes actually stimulates the local economy, and subsequently improves the property tax base and revenue potential.

Finally, tax policy alone will not turn a city around. Harrisburg had been the poster child for redevelopment—due in large part to land value taxation—only to now find itself in worse financial shape than Reading. Sound fiscal management, lasting economic development, and state support for key legislative reform must all be part of a sustainability strategy for small cities. There is no one silver bullet policy that can do this, particularly in short order.

Methodology for Determining a Land Value Tax

A land value tax can be established using this commonly followed methodology:

1. Split the total taxable property value into its land and building subtotals.
2. Start with the current millage for both land and buildings.
3. Add any additional revenue needed.
4. Reduce the building millage 20%.
5. Increase the land millage necessary to remain revenue neutral.
6. Multiply the building rate to building value and land rate to land value to calculate the tax bill.

Specific calculations for the City of Reading have been already done in the accompanying LVT Analysis worksheet.

Findings and Recommendations for Reading

Included with this packet is the full quantitative analysis of the potential for a land value tax shift in the City of Reading. This study was done using the official 2012 property tax duplicate data from the County, and can be easily updated as soon as the 2013 duplicate is available. These are the numbers used to generate the property tax bills.

This information was merged with the City's GIS data on council districts, deed records, and several other useful fields to enhance the context of the information. Additional data, such as the market value analysis (MVA) study, will be integrated in the future to provide a comprehensive spatial database of property records and activity.

Initial Findings

1. The current property tax base will support a shift to a land value tax. The taxable building value is $987,543,900, or 70% of total taxable value, while the taxable land value is $425,071,600, or 30% of total taxable value, and can handle the additional revenue of $4,928,358 in the first year. Assuming a five-year shift, the full property revenue of $23,248,431, or 5.4% of taxable land value, can be covered at the appropriate time.

2. A 20% tax shift will not result in a dramatic change in tax burden across classes, but will provide a productive start. Reading would not experience a significant tax burden shift off of residential properties onto commercial and industrial, as historically was often the case in towns adopting land value taxation, largely due to both the heavily declined demand for commercial and industrial property and the exemption of many such properties while in tax incentive programs or under religious use. The general results are as follows:

- Citywide, 42% of taxable properties would see reductions from a land value tax. The average change for a majority of properties would be a $3 increase.
- 45% of all residential properties would be reduced; when restricting to owner-occupied (stripping out absentee-owned and vacants), 47% of homeowners would see lower taxes. Of those that do go up, the average increase for homeowners would be $6.
- 32% of all commercial properties would be reduced. Of the 68% that would increase, their bill would go up an average of $58.
- 59% of all industrial properties would be reduced, with an average decrease of $1,197.
- 100% of the 1,178 vacant properties citywide would have their bill increased $131.

Additional numbers are available in the accompanying analysis.

Report Recommendations

1. The City should consult with PFM to ensure that this proposal satisfies the recovery plan's revenue requirements in a predictable and reliable manner.

2. The City should adopt the land value tax through a five-year phased transition, starting in 2014, with a 20% reduction on the building rate to be repeated annually with appropriately adjusted land rates. Based on current figures, a revenue neutral tax shift schedule would be as follows:

- 2014: 12.559 on buildings, 22.995 on land
- 2015: 9.419 on buildings, 30.291 on land
- 2016: 6.280 on buildings, 37.587 on land
- 2017: 3.14 on buildings, 44.883 on land
- 2018: 0 on buildings, 52.179 on land

3. Plan for a freezing and draw down of Act 511 taxes and non-utility fees, and a revenue shift to the land value tax. By reducing and eventually eliminating business and nuisance taxes, Reading will become more attractive and competitive as a place to come.

4. Pressure the County and State to move on reassessments to help keep the tax base fair and accurate. As Reading continues to grow and improve, the ability to recapture increases in property values, and thus revenues from the increases in the tax base, will be essential. It is also fundamentally important that, like any other tax, the tax rates are applied to a consistent and up-to-date tax base.

5. Lobby Harrisburg for the ability to convert the school district's property tax to a land value tax. By itself, a municipal land value tax can help to begin incentivizing real estate investment while discouraging blight and speculation. When combined with the school district's taxing power, however, nearly 80% of every property's levy would be shifted to land. This would provide compounding benefits in stimulating the economy and revitalizing both commercial corridors and residential neighborhoods.

6. Develop a set of hardship case programs for homeowners to buffer the impact as well as support the development of capital financing to do building improvements. There are a number of potential approaches to handle "cash poor, land rich" situations, such as deferrals, which would lock-in the current tax bill as long as the owner remains in the home, and place a lien on the property to be recovered at the time of sale.

Many property owners will also argue that they need financing support to help their properties becoming productive and income earning. The City should use its leverage to induce greater local lending and increase access to credit and capital in the community.