

TAX SHIFT - SEQUENTIAL TO A LAND-BASED PROPERTY TAX SYSTEM IN SALEM, OREGON

Tom Gihring, Ph.D.
Housing & Planning Consultant
Seattle, Washington

Kris Nelson, MBPA
Geonomics Consulting
Portland, Oregon

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EXECUTIVE SUMMARY

In 1990, the Oregon state legislature passed Measure 5, a law limiting increases in property tax assessments. Thus began a succession of laws further limiting growth in tax rates and individual assessments. No longer are property taxes determined on the basis of true market value (the actual sale value), but rather “taxable value”. Over the ensuing years, the effect of these limitations has been a cumulative shift in tax burden amongst properties within taxing jurisdictions. Some owners pay less than they would if the tax rate were applied to their property’s true worth in the real estate market; others pay more. These tax shifts, indicative of favorable treatment for some and added burden for others, amount to a distortion of Oregon’s property tax structure.

The purpose of this case study is to examine tax burden shifts that would accompany: (i) a change back to real market value assessment, and (ii) a reform of the present tax system from a single tax rate applied to land and improvement assessments to a split tax rate, the higher rate being applied to land values.

In Oregon, real property must be assessed on the basis of two separate appraisals: land, and improvements attached to the land. Constitutional limitations mandate the taxation of both components at the same rate. It can be argued that a market based land value tax (LVT) would not only rectify the distortions caused by inequitable tax limitations, but would dampen the growth of speculative land prices and discourage urban sprawl by rewarding the more intensive utilization of infill sites.

Property Tax Limitations in Oregon

Property taxes comprise about 31 percent of all state and local tax revenue in Oregon. The second largest tax in Oregon, the property tax provided \$4.8 billion in the 1995-97 biennium.

Measure 50, enacted in 1997-98, constitutes a first-time departure from the just practice of assessing property at true market value. Besides reducing taxes, it caused the structure of the system to change in three ways:

1. It replaced most tax levies with permanent tax rates.
2. It recalled the assessed value of every property in the state to 90 percent of its 1995-96 assessed value or real market value.
3. It limited the future growth in each property's assessed value to three percent per year.

In one single year, total taxable assessed value declined 12 percent while real market values actually increased 10 percent. In 1990 Oregon voters passed Measure 5, placing limits on levy rates that remain in effect under Measure 50. The cumulative effect is a distortion of reality and a shift in tax burden from properties that are growing rapidly in value (largely due to location and amenity) onto properties not experiencing high increases (usually in less “desirable” locations).

Salem Metropolitan Area

The Salem-Keizer metropolitan area, situated between Portland and Eugene in the mid-Willamette Valley, falls within Oregon’s “Silicon Forest”. During the period 1990-97, the population of Salem City increased by 15%, and Keizer City increased by 29 percent. The area within the Salem-Keizer urban growth boundary (UGB) is projected to increase during 1995-2015 by 32 percent, to 244,200. Much of metropolitan Salem’s employment growth is occurring in two business zones, both featuring property tax abatements for qualifying industries under state enterprise zone legislation.

Concurrent with high population and employment growth is an even more rapid development of raw land to accommodate housing, industry, and commerce. High rates of land consumption attributed to raw land conversion near the urban fringe occur despite the availability of buildable sites well within the existing urbanized area including central and suburban zones.

Study Methodology

The primary data file consists of 1998 land and improvement assessments of parcels in the Salem Metropolitan Area, including the municipalities of Salem and Keizer, and unincorporated lands within the Salem Mass Transit District. The Marion County Assessor’s office retains parcel records of real market value (RMV) as well as the taxable values upon which tax billings are currently based. The raw data matrix consists of 60,942 tax lots and 14 fields consisting of location, land use, and valuation variables.

The study methodology incorporates a two-step tax simulation model. The first step models the cumulative tax shift effects of property tax limitations under Measures 5 and 50, both in terms of total revenues collected and tax burden shifts. This is accomplished by comparing simulated tax outcomes from TAXABLE assessments with RMV assessments. Step 2 consists of simulated tax applications comparing the effects of a land value tax at various rate levels with the conventional tax, utilizing real market assessments under a revenue neutral assumption. The final step combines the effects of steps 1 and 2 to reveal total tax shift. The land tax rate level is expressed as the proportion of the total

tax rate that is applied to land assessments. An optimum level might vary from a minor differential such as 55% land tax rate to a large differential approaching 100 percent. This study establishes a 95% LVT as the maximum split rate tax.

Effects of Limiting Taxable Value

Following the compounded roll-back effects of Oregon's tax limitations, the gap between total real market value and total taxable value has grown wider over the years. By 1998, total Salem area taxable assessments were 26% less than RMV assessments. The resulting differences in revenue yield reveal a total annual shortfall of over \$32 million. Parcels in Salem City alone would yield over \$26 million in additional revenue if the tax limitations were not in effect, that is, if real market values were used to calculate tax bills.

Distortions in Conventional Tax Burden

All subsequent tax simulations utilizing real market value assessments are calculated under a revenue-neutral assumption. That is, hypothetical RMV tax rates are derived to produce the same total revenue as the taxable assessment rates. Distortions, then, are illustrated by the difference in tax outcomes on parcel aggregations *within* jurisdictional data sets representing various use or locational classes.

Five out of 19 classes of land use, representing only 3 percent of the total parcels, experience an increase in tax burden when changing from taxable to RMV assessments. These properties, most of which are industrial and other land-extensive uses (homestead, farm, and vacant), benefit most from the existing tax limitations. The vast majority of properties would experience a decrease in taxes accompanying a change to a taxation method based on real market assessments.

By location, the greatest difference in revenue is found in the South sub area, while the least difference occurs in the North sub area. Keizer City appears closest to a real market value outcome. East sub area properties currently pay 4.8% more taxes than they would if the tax limitations were not in effect.

Distortions in tax burden are also shown to vary by developed status. For example, within the Salem central business district, owners of developed parcels pay more taxes under the assessment limitations than they would under real market value, whereas owners of undeveloped parcels pay less. The effect of this particular distortion is a financial reward for not developing downtown sites. The average benefit to undeveloped central sites is a 7.5% decrease in tax burden.

The tax break these few use classes now receive is offset by higher tax burdens that most land use classes must absorb. Considering the type and number of properties affected, the tax burden resulting from Oregon property tax limitations has clearly shifted onto residential property. The tax distortion amounts to about \$4.9 million in added taxes coming from single family and multi-family parcels.

Tax Shifts Accompanying LVT

The second step in the study design consists of tax simulations comparing the tax burden effects of the split rate land value tax with that of the conventional tax. Applications utilize real market values (RMV) rather than taxable values, as it would be unreasonable to institute a tax reform based on distorted assessments. Revenue neutrality is assumed.

The land-to-total value ratio (L-T-V) determines the direction of tax shift accompanying a change from a conventional RMV tax to a 2-rate tax. In the case of Salem City, any parcel upon which the land assessment comprises more than 30% of the total value will experience an upward tax shift.

In all three jurisdictions, the *single family* class is slightly above the overall 0.30 mean L-T-V ratio, resulting in moderate upward tax shifts. Tax simulations reveal significant differences across land use categories. Because of their comparatively low L-T-V ratios and presumably greater building bulk (measured in floor area ratios), *multifamily* properties experience a decline in tax burden under the 2-rate system, ranging from -36.5% in Salem City to -42.3% in the unincorporated sections of the county.

Retail properties experience an upward tax shift, although on average the trend is a moderate one. The *industrial* category experiences the greatest variation by jurisdiction among all generalized land use classes. Due to extraordinarily low RMV land assessments, industrial L-T-V ratios in Salem are considerably lower than other classes, resulting in a sharply downward tax shift.

Because of their minimal improvements, simulated tax yields from *surface parking lots* increase under the maximum land value tax level by about 120% in the lower value jurisdictions of Keizer and the unincorporated areas, and by over 175% in higher value Salem City. Vacant lots and undeveloped parcels follow the same trend. Natural resource activities, mostly *farms*, experience moderate tax burden increases within the two cities, and a moderate decline in the unincorporated area.

The annual mean tax for all *developed* parcels in Salem City under the conventional system is \$2,550. Under the maximum 2-rate tax, the same parcels would see an average 6% reduction to about \$2,400. In the aggregate, taxes on *undeveloped* parcels would rise from the conventional mean of \$578 to a 2-rate maximum of \$1,671.

Total Tax Shift Accompanying RMV and LVT

Reforming Oregon's property tax system would entail a two-step process. The first step corrects the assessed value distortions caused by the property tax limitations currently in effect. The second step introduces a graduated land-based tax system that targets land rent as the legitimate source of local government revenue. The course in tax shift that results by combining the two steps, may or may not be unidirectional.

In the instance of *single family* parcels, the change from taxable value to RMV assessments produces a downward shift in conventional tax burden. Then, the change from

conventional taxation to land value taxation produces an upward shift. At tax differentials below 80%, single family parcels show an *overall* decrease in tax burden. At the maximum 95% differential tax rate, taxes increase in the aggregate by a modest 4.5 percent. This gradual increase is explained by higher than average L-T-Vs, which may be a function of low land value assessments of non-residential properties, or prevailing low density residential development patterns, or both.

Multifamily properties, because they are over-burdened under current Oregon property tax limitations, and because their L-T-V ratios are less than the overall average, receive a tax reduction under the maximum 2-rate tax, ranging from 8.5% for 2-4 family buildings to 52.2% for larger apartment buildings. *Homesteads*, because they currently receive a tax break under the tax limitations, and because they are land-consuming (resulting in high L-T-V ratios), are subject to a combined 19 percent increase in taxes.

Within the commercial category, some of the highest upward tax shifts occur in *retail* and *auto related* commercial uses. In these cases, the high LTV ratios offset the negative tax shifts that accompany the first-step conversion to RMV assessments. Building-intensive uses, such as *office buildings*, receive a tax reduction under the 2-rate system.

Industrial properties are currently undervalued when measured against RMV assessments, but their generally low L-T-V ratios offset this first-step conventional tax burden increase. Their maximum differential tax savings amounts to 19 percent, in the aggregate. However, because of the wide variation in 2-rate tax shift between jurisdictions, some industrial sites within Salem City can expect a larger tax break.

Due to the high ratio of land-to-improvement value assigned to *vacant lots* and *surface parking lots*, the total tax shift in proportional terms is substantial. In absolute dollar values, however, the additional tax burden is modest—less than the shift experienced by all retail uses. *Undeveloped parcels* in the Salem central business district are subject to a total tax burden increase of 222 percent, given the low tax billings imposed under the conventional tax.

Evaluating Influences on Tax Shift

DISLOCATION EFFECTS OF UNDERVALUED NON-RESIDENTIAL LAND:

Ultimately, the tax shift on any individual parcel accompanying a change to a land-based tax is determined by the entire set of property assessments within a jurisdiction, particularly the value of land relative to buildings. If some land sites are undervalued or overvalued, the tax burden effects will be felt on all other parcels. The L-T-V ratio (.08) for the industrial land use class, for example, appears to be unusually low – especially in the Salem jurisdiction. Conversely, the unit building values for this class seem high in view of the low floor area ratios observed. If the industrial land and building assessments were adjusted to match the L-T-V ratio of developed property in the commercial class (.27), the tax burden effects on other use classes would change significantly. It is noted that in other metropolitan areas these two classes exhibit similar value ratios.

Single family homes constitute about 85% of the total properties in metro Salem. As previously reported, the total combined tax shift accompanying a change to the maximum land value tax amounts to a 4.5% increase for this class. At the lower LVT rate levels, however, the tax shift is negative. Given the current assessment structure, the tax shift switches from negative to positive at about the 80% LVT level. By way of contrast, the industrial class experiences a change from positive to negative tax shift at about the 90% LVT level. If the *adjusted* assessments were used in a hypothetical tax application, the single family class as a whole would experience a negative tax shift at all LVT levels, while the industrial class would see a positive shift at all levels of a land value tax.

As for the *numbers* of single family property owners affected by tax shifts, the majority would experience a negative shift during the phase-in of the LVT, given the current assessment structure. The balance would tip into the positive range at about the 75% LVT level. If the assessment ratios for the industrial class were adjusted, the majority of single family parcels would not see an upward tax shift until about the 85% LVT level.

DIMINISHED INCENTIVE POWER OF LVT ON LARGE LOTS:

Within the large category of single family properties, LVT impacts are found to be similar on both small and large-lot parcels. The incentive power of land taxation is therefore diminished because tax impacts on residential sites are not commensurate with land consumption and would not produce the incentive to develop more intensively. This is attributed to the standard practice of assigning a lower value to “excess land” on individual large-lot parcels. If land assessments were instead based on standard unit land values (a uniform square foot basis), the L-T-V on the large-lot sub class would double, resulting in a more than doubling of the tax impact observed under current assessments.

LAND PRICE INFLATION DAMPENING EFFECTS OF A LAND VALUE TAX:

If the annual land value growth rates in an urban land market are high compared to the rate of monetary inflation, the cumulative gain over a holding period can be substantial. If the gain remains untaxed, owners *capture* this added value by selling at higher prices. When an owner declines to improve the site, the resale profit from holding that site becomes speculative gain or a windfall, because all the increase in value is derived from land value that is largely attributed to public amenities and locational advantages. By shifting the tax burden onto sites through a land value tax, the community places a damper on the price of land. That is, as the public domain claims a larger share of the rent from land, less value remains for owners to capitalize into higher market prices. Effectively lowering the cost of land frees sites from speculative land holding and opens up new opportunities for development. Conversely, shifting the tax off improvement values enhances the incentive for owners to make capital investments.

Owners of all real estate, including owner-occupied residential properties, realize land rent as long as land values continue to rise. The question as to how much rent is retained by owners and how much is captured through annual property taxes can be answered by extrapolating land value growth rates over a hypothetical holding period and modeling the capture effects of both conventional and 2-rate tax systems.

The annual growth in Salem City single family home prices is estimated at 9.1% per year, with assessed land and building values increasing at the same rate. Over a back-dated ten-year holding period, this results in a land value appreciation of over \$26,000 and a total home equity growth of about \$80,000. The total conventional tax captures 54% of the cumulative land value gain, whereas a 95% LVT captures 62 percent.

This cumulative home equity realized by the average Salem City homeowner exceeds the estimate holding costs including down payment, mortgage payments, taxes, insurance and maintenance, yielding a 1% return on cost. Model results show that the rate of return on cost (ROC) is highly sensitive to changes in property appreciation. That is, a slight difference in land or building growth rates produces a significant difference in ROC, supporting the supposition that the land price dampening effects of LVT could exert considerable leverage on speculative tendencies in the land market. How, then, are land prices effectively dampened?

Most economists studying the effects of land value taxation agree that the marginal tax liability (the difference between the LVT and the conventional tax amount) is capitalized into lower land prices. By using the present year's tax differential to discount the next year's assessed land value, repeating the procedure through successive tax applications throughout the holding period, the simulation model produces a cumulative land value gain of about \$24,000. This slightly lower gain results in a moderately higher LVT capture rate of 66 percent, and a moderately lower ROC of -1.6 percent.

If building assessment increases were held down, closer to the rate of general inflation, and the balance shifted to land value increases, the price dampening effects of LVT would be enhanced. Model results show that the capture rate would diminish somewhat, and the ROC would decline to -12%, indicating that the total cost of ownership over a ten-year holding period amounts to about \$9,000. This change in assessment practice may be more realistic, as it is difficult to conceive of real building values rising at nine percent annually without a substantial movement of structural upgrading.

In conclusion, the split-rate tax captures a larger proportion of land value gain than does the conventional tax, but under a revenue neutral assumption does not capture anywhere near the total gain realized over a holding period. Thus, by capitalizing the marginal land tax liability into lower resale prices and lowering the expectation of speculative returns, the 2-rate LVT helps housing prices become more widely affordable, and still leaves a substantial amount of equity in the hands of the homeowner.

DISTRIBUTIONAL EFFECTS OF A LAND VALUE TAX:

A general measure of fairness associated with a property tax system is the distribution of tax burden amongst property owners. Again, single family parcels can be used to compare the distributional effects under the taxable value conventional tax currently in effect, with the land value tax. Under a conventional tax application, the top decile (10%) of a rank order frequency distribution of tax billings contribute 20.3% to the total tax for this class. The bottom decile of homeowners pay 4.6% of the total tax collection.

As an LVT is introduced, the distribution of tax burden evens out, becoming progressively more even as the LVT level increases. At the 95% LVT level, the top decile of homeowners owe 17.2% of the total tax, while the bottom decile owe 6.5% of the total.

Conclusion

Combining the two steps towards progressive property tax reform in Oregon would result in a tax system that eliminates distortions caused by tax limitations currently in effect. The study illustrates the utility of land value in taxation, which is less punitive to owners who undertake substantial capital investments—who put their land into production or use land more intensively. Tax simulations demonstrate the significant upward tax shifts associated with vacant and underutilized sites, especially those in central locations. Lower tax rates on building improvements conversely lower tax burdens on intensively used sites. The LVT also tends to distribute tax burdens more evenly amongst property owners.

In dollar figures, tax shift accompanying reforms is modest. The conversion to a differential land-based tax might be introduced on a graduated basis, increasing from a 55% tax rate on land assessments to a 75% or 95% land value tax. The higher LVT rate levels (simulated in Step 2) are found to have more of an impact on total tax shift than the initial change from taxable value to true market value (simulated in Step 1).

In the final analysis, tax shift outcomes are determined not only by real market values vs. limited taxable values, or by a conventional equal rate tax system vs. a split rate tax, but also by assessment practices. The growth trend in property values is driven by population and employment expansion and the accompanying demand for land and desirable locations—primarily reflected in land values. The practice of adjusting building assessments on existing developed sites roughly in proportion to land value increases can be called into question. It is expected that buildings would *lose* value relative to land as they approach obsolescence. The practice of devaluing “excess” land on large-lot parcels might be re-evaluated, considering that the diminished site values weaken the incentive effects of LVT. The question could also be raised as to whether industrial and some commercial sites are undervalued when compared to residential sites. Genuinely accurate real market assessments would in all probability affect a more equitable distribution of tax burden and strengthen the power of incentive taxation.

