REDEFINING PROGRESS

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MARKET-BASED POLICIES FOR REDUCING SPRAWL: A CRITICAL OVERVIEW

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Sprawling strip malls and vacant parking lots are no one's idea of progress, yet too often they occur when growth is encouraged but not managed. The problem of unchecked growth is gaining popular attention, as evidenced by a recent survey that found that 78% of Americans favor policies to combat sprawl.[1]

To help policymakers achieve this public mandate, this report presents three recent market-based policy innovations.[2] These policies—location-efficient mortgages, space-based impact fees, and split-rate property taxes—harness the market's power to encourage denser development close to existing infrastructure. (See center spread for a description of why market-based policies are important.) We hope that this report broadens understanding of these exciting policy innovations and illustrate the unique advantages of market-based incentives in combating sprawl.

LOCATION-EFFICIENT MORTGAGES

HOME LOAN QUALIFICATION REFLECTS TRANSPORTATION SAVINGS

Location-efficient mortgages (LEMs) are home loans that factor the location of a residence into the borrower's budget, and therefore into the level of the available loan. LEMs recognize that people can save money by living close to their workplace and commercial districts (or close to public transportation). Lenders estimate a homebuyer's transportation savings resulting from the home's proximity to a center city or public transit, and then raise the amount of the allowable loan accordingly. Estimates of the average commute savings from proximity to city centers range as high as $7,000 per household per year,[3] which considerably increase a homebuyer's qualifications for a loan.[4] Such savings would allow a homebuyer to support a mortgage of an additional $87,500 (at 8% interest rates). By providing a financial incentive to live close to public transit, LEMs also help reduce the social costs of driving such as pollution, congestion, destruction of natural habitat, and urban heat island effect.

COURTESY OF FANNIE MAE AND BART

Advocates claim that LEMs will reduce sprawl by enabling prospective homebuyers to purchase in currently unaffordable urban areas, rather than being forced to buy in less expensive newly developed suburbs farther from city centers. Increased demand for properties that qualify for LEMs would also address developers' concerns about low demand for urban infill housing. By increasing the number of people who can afford these properties, LEMs would increase the competition for, and therefore the value of, these properties. As a result, developers' profits would increase and infill development would become more attractive to developers.

EXAMPLE: LOCATION-EFFICIENT MORTGAGES AT WORK

The location-efficient mortgage is currently being test-marketed in five areas in the United States: Atlanta, Chicago, Los Angeles County, the San Francisco Bay Area, and Seattle. The Federal National Mortgage Association (Fannie Mae) has provided $100 million for lenders to offer mortgages to low- and middle-income consumers who wish to live in densely populated urban areas with access to public transportation. The Center for Neighborhood Technology has developed calculators to estimate the Location-Efficient Value for homes in these areas (locationefficiency.org).

While the program is too new to offer conclusions at this time, LEMs seem to be working better in Chicago than the other areas. Fannie Mae has capped the allowable LEMs at $252,700,[5] and median home prices in other urban areas that qualify as location-efficient exceed what this mortgage limit will typically support. For example, with the median home price in San Francisco at $510,000,[6] very few units are available at the allowable level.

Location-efficient mortgages are most helpful to low and middle-income people who would choose to live near public transit or city centers, if they could afford to. By increasing demand for these transit-efficient homes, LEMs make infill development attractive relative to greenfield development, while making housing affordable for poorer home-buyers. LEMs can also be catalysts to show developers that infill development can be profitable, thus encouraging future infill development.

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POTENTIAL OBSTACLES

By allowing borrowers to qualify for higher mortgages, LEMs could potentially exacerbate default risk. LEMs are not subsidies. Theoretically, borrowers can pay off higher debts with their transportation savings. In fact, if banks do not raise the amount of the mortgage dollar for dollar with transportation savings, LEMs could *decrease* default. Wider application of LEMs should provide evidence of their effect on mortgage defaults.

While the number of available units in the cities would likely increase (the goal of an anti-sprawl policy), a policy such as LEMs that target demand would also likely result in higher inner-city housing prices unless the supply of units grew with the increased demand. This could affect not only LEM recipients but also other residents living in these units. Therefore, policymakers should be aware of this potential affect on rents.

DEVELOPER/IMPACT FEES

CHARGE HIGHER FEES FOR SPRAWLING DEVELOPMENT

Governments often compel developers to pay impact fees on new construction to defray the costs of new development for infrastructure and public facilities. These fees go by many different names: impact fees, developer charges, benefit assessments, connection charges, exactions or extractions (by developers), or donations (by jurisdictions).[7] Some localities even charge development excise taxes, which are similar to fees but more difficult to enact as law. The most common fees are used to recoup the costs of water and sewer services, followed by highway construction costs.[8]

These fees, however, do not typically incorporate externalized costs of fringe development, such as traffic congestion or pollution. As a result, impact fees may marginally discourage development, but they do little to curb sprawl. Instead, developer fees can and should be structured to provide incentives that discourage sprawl. Charging higher rates for new development away from the city's core creates an incentive for infill development, which imposes fewer external costs on society. This type of fee structure more accurately reflects the costs of infrastructure and facilities such as new roads, parks, and sewers.

EXAMPLE: LOCATION-BASED FEES AT WORK

The city of Lancaster, California (about 60 miles outside of Los Angeles) is often cited for its use of impact fees to discourage sprawl. In 1992, as part of its Urban Structure Program (USP), the city modified its impact fees for new development to defray costs of the required streets, signals, drainage and flood control, and parks. The farther a development is from the city's core, the greater the fee. Five years after the USP went into effect, Lancaster's population had increased by 16%, but little of the growth had occurred outside the urban core. Hence, developer and impact fees can function as effective anti-sprawl measures, when fees are based on the distance from the city's core as a proxy for externalized costs.

POTENTIAL OBSTACLES

Impact fees should be designed to clearly link the level of fees to the cost of providing services to a development and to environmental costs. Otherwise, opponents would have an easier time dismissing them as new taxes. To be defined as a fee and not a tax, the fee must be designed to pay for specific development costs. To calculate these costs and clarify how fees are assessed, Lancaster has created a spreadsheet that clearly identifies them as fees that defray development costs.

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WHY MARKET-BASED INCENTIVES INSTEAD OF REGULATION?

Land-use regulatory laws such as urban growth boundaries (UGBs) and zoning ordinances are the most common policy responses to sprawl. These policies lack the flexibility and built-in enforcement of market-based policies.

The UGB, theoretically the most stringent land-use planning policy, draws a boundary around the area available for development and bans new development outside that urban core. The success of UGBs depends largely on enforcement. While both Oregon and Florida have had laws on the books for over a decade, Oregon's enforcement of the laws has resulted in laudable growth management while Florida's more lax oversight has allowed rampant sprawl.* A successful UGB also relies upon a flexible growth management plan that allows higher density development within the growth area, which cities have rarely been successful in passing. UGB critics complain that reducing the amount of land available for development contributes to unnecessarily high land prices, making the area unaffordable for low-income residents.

Restrictive zoning laws in potentially dense areas can drive developers and homebuyers to the suburbs as well. To be effective, zoning must allow for mixed-use or higher density developments. For example, minimum lot and yard sizes were reduced in a new development called The Hammocks in Miami, Florida, to allow for more common greenspace throughout the neigh-

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* Some critics claim that the Portland growth boundary was successful largely because the boundary was set so wide that developers were not interested in developing outside the boundary.

borhoods. By changing the zoning code in this manner, the development gained an average net residential density of 11.5 units per acre, twice its gross density. The overall land area for the development remained the same, but the houses were built closer together, with smaller individual yards so that more contiguous open space could be preserved.** While this type of zoning policy can effectively preserve open space within a development, it does very little to reduce incentives to develop on the fringes.

Market-based incentives to combat sprawl offer three significant advantages over land-use regulations. First, market-based policies alleviate the externalized costs of sprawl, such as taxpayer-funded infrastructure, pollution, and traffic, by using taxes to compensate society for these costs. Second, setting the right market incentives can achieve the same environmental results as regulatory policies *and* raise revenue that can compensate those who pay more under a tax shift, finance complementary environmental projects, or reduce other taxes. Third, market-based policies do not restrict the choices of buyers and sellers — they merely make sure that market participants pay the full social costs of their transactions. The market based policies we describe here offer more permanent solutions to sprawl because they recognize that sprawl results largely from the relative cheapness of building on open land versus dense development. Market-based policies correct the underlying problem of inaccurate prices rather than simply applying a regulatory band-aid to the problem.

** Sprawlwatch Clearinghouse. 2000. "Best Practices, Land Use Planning and Zoning." [WWW Document] Accessed 10 August 2000: <http://www.sprawlwatch.org/zoningandplanning2.html>.

SPLIT-RATE PROPERTY TAX

LOWER TAX ON STRUCTURES, RAISE TAX ON LAND

One of the potentially most effective ways of reducing sprawl is by enacting a "split-rate" property tax shift. A split-rate property tax levies one rate on land and a lower rate on the structures built on the land. The split-rate tax should produce both a higher level of investment in property and more compact development by using two market-based incentives: it reduces a tax that discourages efficient improvements on land (a structures tax), while raising a tax that lowers the return on un- and under-developed land.

COURTESY OF SPRAWL WATCH CLEARINGHOUSE

Land is a unique investment in that 1) it can easily increase in value without any investment in productive use or development, and 2) development is costly to undo. Therefore, landowners frequently have strong incentives to simply hold land that could be used for productive purposes, such as housing.

Because the property tax is based largely on the value of structures on a site, it penalizes property owners for making improvements to their buildings. Hence, lowering a tax on structures creates incentives for higher quality development on a given plot of land. The lower structure tax also increases the incentive to develop land more densely, since more buildings or units per acre would not raise taxes as much. In other words, building out (using more land) would increase a developer's taxes more than would building up (using land more densely).

A revenue-neutral split-rate property tax is likely to benefit renters. Because the split-rate shifts the property tax burden from structures to land, owners of densely developed plots are likely to pay less in property taxes (while owners of undeveloped land pay more). Because the reduced property tax gets partially passed on to renters (as most economists agree), the split-rate tax would reduce rents to the extent that renters live in properties on denser lots. Reduced rents in dense developments would raise the demand for apartments in these areas, which would further reinforce the supply-side incentives of the split-rate tax.

Unlike most other taxes, a tax on land can raise revenue for government services without detrimental effects on economic incentives. As Henry George noted over 100 years ago, this is because the supply of land is relatively fixed—raising the land tax does not reduce the supply of land. This also means that the land tax is almost "neutral"—landowners can do little to avoid the tax except to sell the land. Therefore, the land tax, in and of itself, will do little to change the incentives that encourage sprawl.[9] In contrast, increasing the structure tax may cause owners to forego improvements on existing structures.

Despite this land tax neutrality, an increased land tax makes sense as an anti-sprawl incentive for many reasons. A land tax is relatively efficient at raising revenue—because it is hard to avoid, a given tax rate on a land tax base should raise more money than the same rate on other bases. A land tax is equitable in that it taxes profits earned simply from idle ownership, not profits from the owner's productive effort. Further, the land tax is an intuitive and politically sensible complement to the structure tax decrease in that it could maintain the level of overall property tax revenues.

EXAMPLE: SPLIT-RATE PROPERTY TAXES AT WORK

Only about ten American cities, all located in Pennsylvania, have actually implemented a split-rate property tax. Pittsburgh is the only major city to have done so. In those cities where a split-rate property tax has been implemented, it has encouraged significantly higher levels of construction within the city than would have occurred under a single property tax.[10]

In 1979-80, Pittsburgh restructured its property tax system by raising the rate on land to more than five times the rate on structures. During this same year, the city experienced a building boom that far outpaced the performance of any other city in the region. Eighty-five percent of homeowners in Pennsylvania pay less with the split-rate tax than with the single rate property tax.[11]

POTENTIAL OBSTACLES

As a tax mechanism, a split-rate property tax could pose constitutional and political problems. Several states, including California, mandate equal taxes on land and buildings. So in order to raise the rate on land relative to buildings, advocates must persuade state legislatures to change their state constitutions, usually with at least a 2/3-majority vote.

A formidable obstacle is the likelihood that politicians and citizens will doubt that a tax shift would be revenue neutral instead of a tax hike. Studies show many businesses and members of the public believe that once politicians get a hold of new tax revenue, they will not offset other taxes.[12]

However, the split-rate property tax in Pennsylvania shows that these obstacles can be overcome. In fact, in Pittsburgh most people's taxes have been *reduced.*

CONCLUSION

The three policies described here all offer new policy options that use the market to curb sprawl. No one policy will completely shift development away from sprawl; these incentives incorporate some of the social costs of sprawling development into market prices for land and property. Discouraging sprawl will require a concerted effort to change not only the financial incentives that encourage horizontal development, but also other economic, political and cultural factors as well. In attempting to curb sprawl while also encouraging growth and more affordable housing, policymakers should consider policies such as these that harness the power of the market to accomplish their goals.

ABOUT REDEFINING PROGRESS

Redefining Progress is a nonprofit research and policy organization based in Oakland, CA, that believes that genuine progress entails providing a better life for all within the capacity of nature.

RP tools and policies emerge from three "big ideas":

SUSTAINABILITY

Sustainability is rooted in the realization that ever more of us live on a planet with shrinking regenerative capacity. RP uses the Ecological Footprint to document overuse of resources and workshops to explore fair and effective ways to live once more within the means of nature.

ACCURATE PRICES

Accurate Prices advances market mechanisms and incentives that provide accurate feedback about the full cost of our purchases and decisions to ourselves, others, and Nature.

COMMON ASSETS

Common Assets establishes the value and encourages the strengthening of natural and community-based systems that help meet basic needs.

RP also applies these Big Ideas to the problem of **global warming** through two campaigns to promote fair and low-cost policies to address climate change.

NOTES

1 Chen, Don. "Greetings from Smart Growth America." [WWW Document]. Washington D.C.: Smart Growth America <http://www.smartgrowthamerica.com/report.htm>

2 Transportation policy is also important for curbing sprawl, but is beyond the scope of this report. For an analysis of market-based transportation policies, please see Cobb, Clifford W. 1998. "The Roads Aren't Free: Estimating the Full Social Costs of Driving and the Effects of Accurate Pricing." San Francisco: Redefining Progress.

3 Hoeveler, James K., and Donna Liu. 1999. "Accessibility vs. Mobility: The Location Efficient Mortgage." [WWW Document]. Accessed 25 August 1999: <http://www.cnt.org/lem/apa.htm>.

4 Also see "Driven to Spend", a report on the household costs of driving by the Surface Transportation Policy Project and Center for Neighborhood Technology, November 2000.

5 This cap is designed primarily to allow more homebuyers access to a limited level of funds.

6 National Association of Home Builders. "Housing Opportunity Index: First Quarter 2000." [WWW Document]. Accessed 1 December 2000. <http://www.nahb.com/facts/hoi/2000_2Q/complete_alpha.htm>.

7 Snyder, Ken and Lori Bird. 1998. “Paying the Costs of Sprawl: Using Fair-Share Costing to Control Sprawl.” Scoping Paper. San Francisco: Redefining Progress.

8 Snyder and Bird 1998.

9 Some argue that the land tax itself may also reduce sprawl. See T. Nicolaus Tideman, "Taxing Land Is Better than Neutral: Land Taxes, Land Speculation, and the Timing of Development," in *Land-Value Taxation: The Equitable and Efficient Source of Public Finance.* Ed. By Kenneth C. Armonk, NY: Wenzer. M.E. Sharpe. 1999.

10 Plassmann, Florenz and Nicolaus Tideman. "A Markov Chain Monte Carlo Analysis of the Effect of Two-Rate Property Taxes on Construction." *Journal of Urban Economics.* March 2000, vol.47, no.2.

11 Hartzok, Alanna. "Pennsylvania's Success with Local Property Tax Reform: The Split Rate Tax." *American Journal of Economics and Sociology.* 56(2) April 1997: 205-213.

12 LGD Insight. 1999. "Attitudes Toward Environmental Tax Shift Proposals." Portland, OR: LGD Insight.