LOCAL FINANCIAL INSTRUMENTS FOR URBAN GROWTH MANAGEMENT AND REVITALIZATION

도시성장관리 및 도심활성화를 위한 재정수단 연구

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I. INTRODUCTION

Decentralization in the 1990s has driven Korean local governments to seek financial instruments to provide funding for public services to their residents, infrastructure for urban development, and to encourage urban revitalization in the worn-down CBDs in some metropolitan areas. Unfortunately, local governments in Korea are experiencing difficulties in finding proper financial instruments. Even local taxes in Korea are, in reality, national taxes in that no local discretion in determining tax rates is allowed. Furthermore most discussions have focused on financial aid from the Central Government. Few studies explored the connections between local decisions about financial instruments and the role of local governments for urban growth management and urban revitalization.

This paper seeks to identify local financial instruments for urban growth management and urban revitalization. In contrast to the previous literature that focused on finding another revenue sources, the emphasis is put on the performance and economic efficiency of local governments throughout a system of local governments. To this end, the paper first explores the nature of local governments as municipal corporations. Under some conditions, so-called capitalization creates aggregate property rights that make it possible to define local governments as municipal corporations to maximize their aggregate property value. The vast literature shows that local governments' behavior to maximize aggregate property value leads to Lindahl equilibrium. Under such a local government system, property taxation becomes marginal pricing for providing public services. But without the help of perfect zoning, property taxation creates various economic distortions, especially under rapid urban growth and serious urban blight. Indeed, urban blight and rapid urban growth are both good reasons to consider alternative financial instruments. This paper examines development impact fees for managing rapid urban growth and Tax Increment Financing for encouraging urban revitalization. This paper also explores future possible reforms for financial instruments of Korean local governments in managing urban growth and encouraging urban revitalization.

II. CAPITALIZATION AND THE NATURE OF LOCAL GOVERNMENT

Let's suppose there is an ideal type of local government. Local tax rates and the classification of taxable items are decided by a popular vote among

residents. The local government provides public services balancing residents' preferences (as shown through the voting process) and the cost of providing public services. Because residents' preferences and the cost of public services may differ among local governments, each government provides a different package of tax burden and benefits. Local governments are too small to wield spatial monopolistic power. Households decide their residence after they compare local governments in terms of the levels of tax burden and benefit without cost (or at very low cost). Such a system of local government is an optimal environment for capitalization.

Capitalization is a process through which differences in local governments' tax burdens and benefits are reflected in real estate prices. Suppose every local government except local government L provides the same package of tax burden and public services, but L provides the same quality of public services with just half of the tax burden. Because people can compare the difference, they may well want to live within L's jurisdiction and be willing to pay more for real estate in L. Accordingly, the price of real estate in the local government will increase. If there is another local government whose residents pay the same amount in taxes but receive significantly better public services, the price of real estate in that government will increase in the same manner.

When capitalization occurs, local governments are driven to compete to provide better public services with a lower tax burden. If a local government provides better public services with a lighter tax burden, aggregate property value in the jurisdiction will increase. The optimal provision of public services will maximize aggregate property value of the local government. The vast literature in urban economics shows that the tendency of local governments to maximize aggregate property value leads to efficient resource allocation and achieves Lindahl equilibrium (or the Samuelson condition).

Let Pi be land value (or property value including housing), Ri be land rent for a year (or rent on property including housing), z represent the quality of local public services, Ti be the tax burden from land (or property including housing) for a year , r be the interest rate and C(z)( ) represent the costs of providing public services in a local government. Pi can be expressed as Equation 1.

(1) $$P_i = \frac{R_i(z) - T_i}{r}$$

If the government implements its expenditure under a balanced-budget constraint, the total value of all land (or property including housing) in the jurisdiction can be expressed as Equation 2.

$$(2)\ \sum_i Pi = \frac{\sum_i Ri(z) - c(z)}{r}$$

If we differentiate Equation 2 for z to decide the optimal level of local public services, the following equilibrium condition in Equation 3 satisfies Lindahl equilibrium leading to the efficient provision of local public goods.

$$(3)\ \sum \frac{\partial Ri(z^*)}{\partial z} = \frac{\partial C(z^*)}{\partial z}$$

Under this model a local government can be thought of as a municipal corporation to maximize aggregate property value. The capitalization process creates aggregate property rights for residents in a local government. Then residents vote for policies that maximize their aggregate property value. Residents become active in showing their preferences and monitoring public policies' influence on their property value, which means the aggregate property rights eliminate the free rider problem in providing public services. Then, the decision to live in a particular municipality is tantamount to entering into a contract with the local government for the tax burden (that they should pay) and benefits (that they can receive). Under such a system people continuously audit their local governments. If local governments do not abide by these contracts, people will leave for other municipalities that provide public services satisfying their preferences. With taxation and police power, local governments in turn audit their residents to make sure their residents also abide by the contracts. Both parties learn to pay close attention to policy formation and implementation. The creation of aggregate property rights through capitalization is the most important to stimulate innovative public policies. Without such a capitalization process, people will have no interest in policy formation and implementation because there is no disadvantage if they do not abide by the contract and there is no advantage if they do.

III. PROPERTY TAX'S ROLE AND ECONOMIC DISTORTION

Under such an ideal local government system, the best tax would be a property tax that captures the differences in real estate prices among local governments. Because differences in real estate prices reflect differences in local government performance, such a property taxation works as a marginal price for providing local public services: If voters choose the jurisdiction that provides their preferred spending and tax package, the property tax can be viewed as a non-distorting benefit tax and a user charge for living in the community that entitles the user to the available public services. (Bruce Hamilton, 1975, 1976, Hamilton,1976, White, 1975, Fischel 1975).

To serve as an ideal benefit tax, however, the property tax requires a perfectly binding zoning constraint. If each community strictly enforces the constraint that every resident must have a certain minimum amount of housing, then all residents in the jurisdiction will end up in similarly valued houses. Residents who wish to live in housing valued at less than the minimum and thereby to pay below-average taxes for the public good are precluded by the zoning ordinance. Residents who wish to live in more expensive houses will move to another community to avoid paying an above-average share of the cost of the public good. With all residents in a particular jurisdiction occupying housing of similar value, they all pay the same property tax, which is then identical to Tiebouts head tax (Mieszkowski and Zodrow, 1989, Ladd, 1998). But Peter Mieszkowski and George Zodrow (1989) and Ross and Yinger (1999) view the assumption of perfect zoning as extreme. The tools of zoning would need to be exceptionally foresightful applied with exceptional foresight to set zoning barriers at exactly the right level of housing. In most cases in which zoning is not perfect enough, the property tax is not appropriately viewed as a benefit tax and therefore distorts land use and investment decisions.

These property tax distortions emerge in four main forms (Ladd, 1998). First is the distortion associated with the reduction in the average after-tax rate of return to capital throughout the country. Second is the distortion that arises from differential property taxation of business and housing. Third is the distortion that arises from inter-jurisdictional differences in tax rates. Lastly, the fourth potential distortion relates to the provision of local public services. In simple models, the use of a tax on mobile capital leads to under-provision of the public good. In more complicated models in which housing and public goods

are complementary, the outcome could be either under- or over-provision (Mieszkowski and Zodrow, 1989). Within a metropolitan area, various theoretical studies (refer to Ross and Yinger, 1999) have suggested that the distortion associated with using the property tax (rather than a land tax) is low when people are relatively immobile, but much greater when residents are perfectly mobile between metropolitan areas. Furthermore, the distortions grow larger under conditions of either urban decline or rapid urban growth.

The property tax in Korea has been designed as a tax on capital to prevent land speculation. But it should be designed to work as a marginal pricing for providing public services efficiently. The uniform tax rate of the property taxation prevents Korean local governments from balancing residents' preferences and cost structures for providing public services. The heart of local autonomy in deciding local tax rates is to create aggregate property rights through the capitalization process which subjects local governments' performance to residents' evaluation. If property taxation in Korea is reformed to work as pricing for public services, policy makers and researchers should be aware of possible economic distortions due to property taxation and should be prepared to find possible alternative ways for managing and financing urban development and public services.

IV. DEVELOPMENT IMPACT FEES FOR MANAGING URBAN GROWTH

Although property taxation can work as an ideal tax system for providing public services under some conditions, it does not work well in managing urban growth, especially rapid urban growth. A property taxation distributes the cost of increased infrastructure and public services among *all* a city's residents. Existing residents should pay for something that doesn't benefit them. Because economic efficiency can be achieved only when people pay as much as they get, such a mis-allocation of tax burden and benefit creates economic distortions that become greater under rapid urban growth. The higher property tax burden on existing residents decreases the price of existing housing through capitalization. New residents also bear a small share of the increased property tax burden even though the price of new housing increases through the capitalization of infrastructure improvements. The aggregate property value of a municipality may even decrease if the total amount of the decrease in existing housing prices is greater than the increase in new housing prices. As we have observed, a

decrease in aggregate property value implies that resource allocation is not optimized under our assumption of the local govenment system. Brueckner (2000) and Kim (2001) showed that such a mis-allocation of resources under property tax financing does not lead to a rational urban growth.

Development impact fees may correct economic distortions due to property taxation. Such fees shift a portion of the cost of providing capital improvements to serve new real estate development from the general tax base to the developer. The famous rational nexus test of the U.S. Supreme Court[1] can be interpreted to imply that the fees should equal the marginal cost for providing new infrastructure induced by the new development. Yinger (1998) showed that new house values increase through the capitalization of an infrastructure improvement funded by the fees. Such an increase in house values increases the property tax base in a jurisdiction and the revenues that could be raised at the old rate. Under a balanced-budget constraint, the property tax rate must drop. The capitalization of such a decrease in the property tax rate will further boost the price of every property in a municipality. Development impact fees increase aggregate property value by 1) capitalization of the proper provision of infrastructure into housing prices at the time of new development, which is limited to the area of new development, and 2) capitalization of the decreased property tax rate that reflects a correction of economic distortion due to property taxation, which applies to the whole municipality. A development impact fee scheme generates an efficient urban growth path by maximizing aggregate property value (Brueckner, 1997) because developers are forced to pay the full costs of infrastructure generated by his development and to make a development decision that correctly balances social costs and benefits.

Based on the Pennsylvania experience, Lee (2001) provides results consistent with the theoretical expectations.[2] Municipalities with development

1) The U.S. Supreme Court in Nollan in 1987 required 1) that a connection be established between new development and the new or expanded facilities required to accommodate such development, 2) Identification of the cost of those new or expanded facilities needed to accommodate new development, 3) Appropriate apportionment of that cost to new development in relation to benefits it reasonably receives, 4) All fee revenues must be spent within a reasonable period of time and in proximity to the fee-paying development, 5) All revenues from such fees should be earmarked for the newly induced capital improvements necessitated by the new developments.

2) The existing literature has argued that development impact fees decrease social welfare by increasing the price of both new and old houses, which is also

impact fees experienced a faster increase in their aggregate property value than municipalities without the fees. Moreover, about 40% of such increases in the aggregate property value of municipalities with development impact fees were explained by the capitalization of the decreased property tax burden. The study implies that urban growth management such as development impact fees may enhance both quality of life and economic efficiency, a combination which has been thought to be difficult to achieve at the same time, but which lies at the heart of sustainability.

Development impact fees have shown phenomenal popularity since the 1970s and have been representative of a new trend in planning and urban growth management.[3] Recently Korean government has also introduced an Infrastructure Linkage Fee, a form of development impact fees. For a successful implementation, the Infrastructure Linkage Fee should reflect correctly the marginal social costs for providing infrastructure induced by new development. Local governments should construct a direct and reasonable linkage between a new development and the costs for the new or expanded facilities required to accommodate such a development. Local revenue from Infrastructure Linkage Fees should not be used for other local purposes. Otherwise such fees cannot work as marginal pricing of the costs of providing infrastructure required by new development. We also should note that public infrastructure costs associated

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expected to worsen housing affordability for low-income households. But the recent studies (Yinger, 1998, Brueckner 1997, Young-sung Lee, 2001) show that the increase in the housing price following development impact fees, however, reflect enhanced amenity by properly provided infrastructure and the correction of economic distortions of property taxation. Existing homeowners realize a capital gain because the decrease in the property tax rate is capitalized to increase the existing housing price. Furthermore enhanced amenities, proper infrastructure, and corrections of economic distortions resulting from property taxation are likely eventually to increase the housing supply under development impact fees. This view also agrees with Gyourko (1991). In his model the fees transfer to established residents some of the consumer surplus that low-income households gain from living in the community to established residents. Compared with the situation without the fees, both groups are made better off and more low-income housing is provided.

3) Although few local governments adopted developmemnt impact fees before 1970s, the most recent survey in the U.S. reports about 60% of cities and 40% of counties charge the fees (U.S. General Accounting Office. 2000). Furthermore more countries seem now to depend more on development impact fees although their motivations and planning contexts are different. Planning gain, a U.K.-type development impact fee, has played more role in the U.K. since the 1970s. Canada also has applied development impact fees to new development.

with new developments vary significantly according to where the new developments occur: Infrastructure costs may well differ between large and small cities, and even among large cities. Therefore such fees should not be applied uniformly without regard to local variations in public infrastructure costs. In addition, the administration of such fees should be as simple as possible. Although the law requires the designation of an Infrastructure Linkage Fee Area beforehand, such a designation seems unnecessary if there is a direct and reasonable linkage between a new development and the costs for the new or expanded facilities. The key to a successful implementation of such fees is to show the direct and reasonable relation between a new development and the costs for the new or expanded facilities, and to apply such a relationship to building permits.

Let us note as well the conditions under which development impact fees can correct property tax distortion and lead to more rational urban growth. The results of economic efficiency of the recent studies are based on the capitalization process that requires household mobility, various packages of tax burden and benefits in a local government system. And local governments should not be able to yield monopolistic power. If capitalization does not occur, the resulting increases in housing (real estate) value do not reflect the enhanced amenities brought along with urban growth management such as development impact fees. Instead, increases in the value of housing (or real estate) are purely the result of a supply restriction in the face of a growing population. In this respect, the Korean local financing system needs additional reform.

V. TAX INCREMENT FINANCING (TIF) FOR URBAN REVITALIZATION

Although property taxation can work as an ideal tax system to fund public services under some conditions, it also meets with considerable difficulty in supporting urban revitalization under conditions of urban blight. The typically weak tax base under urban blight makes it difficult to generate financing resources for urban revitalization. Furthermore, the increases in property tax rates needed for urban revitalization would discourage investment and economic activity and, in the end, aggravate the urban blight. Tax Increment Financing (TIF) is a form of tax liquiditization that allows a qualifying development project to recapture and utilize the incremental increase in property tax

revenues (and, in some cases, sales tax as well) to fund a variety of public capital improvements and the urban revitalization projects themselves.[4] A TIF program typically begins with the designation of a geographic area as a TIF district. Then a base-assessed property valuation is determined and TIF bonds are issued. TIF is a form of tax liquiditization that issues bonds taking securities on possible future tax revenues, especially property tax. Other local taxing jurisdictions within the designated TIF district continue to collect property taxes generated from the base-assessed valuation, but taxes derived from an increase in the assessed values are used to pay for the interest and principal of the TIF bonds. When all the debts incurred by the TIF district have been repaid, the TIF district is dissolved and the full increased assessed valuation of the area is returned to all existing taxing bodies. TIF is not a general obligation of a community and does not fall under debt limitation. Property owners do not pay more than the normal tax burden. Moreover, TIF is very broadly applied to various kinds of urban development projects, and not limited to urban revitalization.

A TIF district is, however, likely to increase demand for government services provided by overlapping governments that are forced to increase spending on public services due to the increased demand generated by growth in the TIF district. Because overlapping jurisdictions are not allowed to use tax revenue increases resulting from property value growth in the designated area for a long period, TIF may depress the local economy in adjacent municipalities while it stimulates economic activity in the TIF district itself (Dye and Merriman, 2000). Therefore TIF needs to be supported by a consensus to get rid of urban blight even if TIF discourages economic activity outside the TIF districts.

TIF relies on revenue from a limited geographic area; an increase in assessed value is not always guaranteed. This makes a TIF bond riskier than a general obligation bond, resulting in a higher interest rate and more total interest paid. The key to the successful use of TIF is to achieve an excellent credit rating: If the credit of the bonds is excellent, the interest rate of the TIF

4) First used in California in 1952, Tax Increment Financing (TIF) has achieved widespread popularity as the primary funding source for urban redevelopment.By 1997, 48 states had passed legislation authorizing the use of TIF by local governments (Johnson and Kriz, 1997). TIF was used by over 5400 agencies in the U.S. in 1992 (Forgey, 1993). In states with TIF, nearly all cities with populations over 50,000 use TIF.

bonds will be low, which means that it is easier to retire all the debts incurred by TIF. Several factors affect TIF bonds' credit rating: excellence in planning and design of the relevant urban revitalization projects, the feasibility of the urban redevelopment projects, the qualifications of project management, the cooperation of overlapping jurisdictions, etc. To satisfy these factors, TIF districts exert considerable effort to make and implement better plans based on market feasibility. The credit rating process leads related parties of TIF to produce their highest performance.

Because property taxes represent only a small portion of local tax revenues, TIF districts in Korea should be allowed to use future increments in real estate acquisition taxes, real estate registration taxes, real estate transfer taxes, and progressive land ownership taxes if TIF is introduced in Korea. Because revenues from these real estate taxes account for 50-60% of local tax revenues, future increments from these taxes will be good financial sources. In the long run, however, the Korean local tax system should be reformed because increments in these taxes do not correctly reflect the performance of TIF districts. Even if people and businesses leave a TIF district that performs poorly, revenues from real estate transfer taxes may increase. Real estate acquisition taxes and real estate registration taxes do not reflect TIF district performance, either. On the ground that business activity in the TIF districts is greatly affected by the TIF districts performance, some TIF districts in the U.S. are allowed to use increments in the sales tax to retire the interest of TIF bonds. Although sales taxes are now a national tax in Korea, they should nevertheless be considered for TIF. For TIF districts to work as hard as possible to achieve peak performance, there should be a clear lien between tax increments and the performance of TIF districts. Such a lien forces TIF districts to produce and implement the highest quality planning and design for urban revitalization.

VI. THE IMPORTANCE OF A MATURED FINANCIAL MARKET

Although most local public finance research in Korea has been interested primarily in raising local revenue to offset local governments' weak tax bases, a more important issue is economic efficiency in raising and spending local revenue that leads to efficient management of urban growth and urban blight. Under the ideal local government system that we considered in Section II of

this paper, the strictest evaluation of local government performance in providing public services is reflected in where people choose to live. But people must be correctly informed about differences among tax and benefit packages that local governments provide. The flood of information provided by recent technology does not give as clear a picture as a matured financial market might provide.

A matured financial market determines interest rates based on various criteria, including the general fiscal health of local governments, the economic feasibility of public programs, due process for conflict resolution between governments and residents, capital improvement programs under local governments, and the qualifications of mayors and managers of local governments. Therefore a matured financial market's credit rating provides an excellent snapshot of local governments' performance, which also forces local governments to enhance their performance.

The medium-range capital improvement programs that Korean local governments should plan are at best nominal in the current financial market. Such a nominal capital improvement program would adversely affect the implementation of Infrastructure Linkage Fees, which operate in Korea as development impact fees. For a successful implementation of such fees, local capital improvement programs should be incorporated into planning process. Reflecting projections of growth in population and geographic areas within the community where the growth will occur, capital improvement programs serve as the basis for determining the capital facilities that will be needed to support projected growth, establishing the costs of providing these facilities, and calculating such fees. A nominal capital improvement program would fail to build a rational nexus between the costs of new infrastructure and new urban development and, as a consequence, it would not induce developers to pay the marginal social costs induced by their developments.

A matured financial market is also important for the introduction of TIF to Korea. Although TIF is expected to be a very useful financial resource, TIF bonds should be sold in the financial market. Currently most governmental bonds in Korea are 3-5 year bonds. Furthermore, significant quantities of governmental bonds are bought by other governmental organizations, including the central government, not in the market. The Korean financial market should be mature enough to issue long-term bonds. Fortunately the Korean financial market has been experiencing a significant transformation since the late 1990s

by introducing REITs, ABS (asset-based securities), and MBS (mortgage-based securities). For further development of the financial market, especially for TIF, income from governmental bonds should be deducted from the income tax. Furthermore, credit guarantee of TIF bonds, credit lines, and credit enhancement should be considered before introducing TIF in Korea.

VII. CONCLUSION

When people are able to compare various packages of tax burden and benefits of different local governments and to move their preferred residence, so-called capitalization process occurs, creating aggregate property rights that makes it possible to characterize local governments as municipal corporations. Under such an ideal local government system, property taxation works as marginal pricing for providing public services. Without the help of perfect zoning, however, property taxation creates economic distortion that becomes greater under rapid urban growth and serious urban blight, which, after all, provides the rationale to explore alternative financial instruments. This implies that Korean policy makers should be prepared for possible economic distortions caused by property taxation under rapid urban growth and urban blight. This paper examined alternative financial instruments, namely development impact fees to manage rapid urban growth and Tax Increment Financing to encourage urban revitalization. The Korean government recently introduced Infrastructure Linkage Fees, a form of development impact fees. And some researchers have proposed Tax Increment Financing for some worn-down CBDs. But to successfully implement such alternative financial instruments, the local government system in Korea should be transformed into the system described in this paper. Moreover, the Korean financial market should be reformed going forward into the future.

The discussion in the paper does not mean that we should introduce total local fiscal autonomy. In fact, most Korean governments do not have tax bases that are strong enough for complete local fiscal autonomy, as evidenced by considerable disparities among local governments in local fiscal health. But even partial introduction of tax autonomy with various financial instrument for urban growth management and urban revitalization would greatly enhance Korean local governments' performance in urban growth management and urban revitalization.

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초록

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Key words: property taxation, capitalization, aggregate property rights, development impact fees, Tax Increment Financing, liquiditization of future tax increments Infrastructure Linkage Fee

국문주요단어: 재산세, 자본화, 집합적 재산권, 개발영향부담금, 기반시설연동제, 조세유동화

지방정부가 주민의 선호체계와 지방공공재 공급비용을 고려하여 세율과 세목을 자유롭게 정하고 사람들이 이를 비교하여 주거지를 결정한다면 조세부담과 지방공공재의 차이가 토지, 주택 등 부동산 가격에 반영되는 자본화현상이 나타난다. 자본화 현상은 지방정부 차원의 집합적 재산권을 형성시켜 지방정부에 의한 여러 가지 혁신이 가능케하는 원동력이다. 이때 재산세는 지방공공재에 대한 한계비용으로서의 역할을 하여 지방공공재가 효율적으로 공급되도록 한다. 앞으로 우리나라의 재산세도 지방정부가 제공하는 지방공공재에 대한 가격으로서 자리잡아야 할 것이다. 그러나 재산세는 급격한 도시성장이나 도심의 침체하에서는 경제적 왜곡을 심화시키므로 지방정부의 효율성을 제고하고 도시성장관리와 도심활성화를 위해서는 새로운 financing 기법에 대한 논의가 필요하다. 특히 우리나라의 대도시는 난개발로 인한 문제점과 쇠락해가는 도심의 문제를 동시에 겪고 있는 실정이다. 본 논문에서는 도시성장관리와 도심활성화를 위한 financing 기법 가운데에서도 최근 많은 관심을 끌고 있는 개발영향부담금(development impact fees)과 조세유동화제도(tax increment financing)를 고찰하고 있다. 재산세가 지방공공재에 대한 가격으로서 자리잡고 개발영향부담금과 조세유동화제도 등이 도시성장관리와 도심활성화를 위해 적극적으로 활용되기 위해서는 지방정부의 능동적인 참여를 유도하고 지방정부의 능력과 성과(performance)가 시장에서 엄정하게 평가되도록 하는 동시에 그 평가결과가 시민들에게 효율적으로 제공되도록 해야 하는데, 이를 위해서는 금융시장의 발전이 긴요함을 지적하고 있다. 더불어 자본화현상을 통한 집합적 재산권의 형성과 선진금융시장의 발전이 도시성장관리 및 도심활성화를 위한 제반의 financing기법들이 발전하는데 어떠한 의미를 지니는지 우리나라의 상황에 비추어 되새겨보고 있다.