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NEW FUNDS FOR OLD NEIGHBORHOODS California's Deferred Special Assessment

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The Problem of Underinvestment in Older Neighborhoods

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Without a continuing flow of public investment, older neighborhoods can deteriorate over time as their original infrastructure decays or becomes outmoded, and as families migrate to newer neighborhoods in search of greater environmental amenity. Unfortunately, this migration to newer neighborhoods can collectively leave sidewalks, streets, and other public infrastructure literally falling apart in the older, more central neighborhoods.

Even in cases where the benefits of investment to improve the amenity of older neighborhoods would greatly exceed the costs, it is often difficult to finance the public investment because the benefits flow to private property owners while the government has to pay the cost. Cities can't be expected to use their general revenue to finance such investment just because it would increase *private* property values by more than the *public* cost.

The failure to finance public investments that would increase property values in older neighborhoods may seem to be a problem only for the affected owners, but the problem has extensive ramifications. First, a lack of public investment in older neighborhoods decreases the supply of desirable housing because in many cases a shortage of housing stems not so much from a shortage of housing units but from a shortage of neighborhoods where people want to live. And second, the lack of public investment in older, central areas means that many families must move to newer neighborhoods in outlying areas to find the amenities they want.

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A New Solution: Deferred Special Assessment

California enacted legislation in 1984 designed to help cities pay for public improvements and amenities in older neighborhoods, without using general revenue. This summary explores how cities can use this new finance technique — called deferred special assessment — to increase public investment in older neighborhoods. The special assessment is a long-established public finance mechanism that, in theory, seems ideally suited to financing any infrastructure investment that increases the total value of benefited property by more than the cost of making the investment. A special assessment is a levy to pay the cost of public improvements in a defined area, with the levy apportioned among the benefited properties in proportion to the benefits they receive. If the increase in total property value exceeds the cost of the public improvement, and if the cost is apportioned among properties according to increase in property value, each property's increase in value should exceed its special assessment. Therefore, every property owner should be better off as a result of the *combined* effect of the public improvement and the special assessment that finances it.

The Cash Flow Problem Caused by Special Assessments

Although conventional special assessments are in theory ideally suited to paying for public investments that increase property values, in practice they have the severe disadvantage that the special assessment seems unique among taxes in its total neglect of the taxpayer's ability to pay. It can be argued that if the benefited owner's capital gain exceeds the special assessment, the capital gain itself should provide the ability to pay. The problem with this argument is that the special assessment has to be paid when the public investment is made, but the capital gain isn't realized until the benefited property is sold. Therefore, the

unrealized capital gain created by the special assessment project at the time it is implemented doesn't provide the ability to pay the special assessment.

Even if it is agreed that property owners should pay for the special benefits they receive from public investment, and even if the benefits exceed the costs for each specially assessed owner, the cash flow problem caused by having to pay the assessment before the benefit is realized in cash by sale of the property can prevent residents who very much want a public improvement from voting for a special assessment to pay for it.

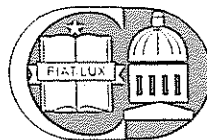
Solving the Cash Flow Problem by Deferment

The cash flow problem is a serious impediment to financing public investment by special assessment, but cities can eliminate this cash flow problem by allowing owners of benefited property to defer paying their special assessments, with accumulated interest, until they sell their property.

The local government would, in effect, offer to lend the benefited owners the money to pay their special assessments for as long as they continue to own their property. Owners could repay all or any part of the debt at any time before they sell their property, with any remaining debt, plus accumulated interest, due at sale. If owners were charged the market rate of interest on the deferred assessment debt, the present discounted value of all future payments would equal the initial special assessment, so the government would lose nothing by the delay.

Thus, the offer to allow owners to delay payment, with interest, until the assessed property is sold, is what distinguishes a deferred special assessment from a conventional special assessment.

Although offering assessed owners the option to defer paying their special assessments may seem to be merely a well-intentioned way to soften the burden of a tax that otherwise neglects ability to pay, deferment can significantly increase both the political



acceptability of special assessments and the willingness of citizens to tax themselves to improve their neighborhoods.

To explore whether the new deferment option increases citizens' willingness to vote for special assessment projects, a telephone survey of property owners was conducted in a proposed special assessment district that was being formed to restore the Venice Canals neighborhood in Los Angeles, the most ambitious special assessment project ever attempted to restore an older neighborhood in Los Angeles. After it was explained to the respondents that a new California law authorized local governments to allow property owners to defer paying their special assessments until sale, 52 percent of them said that they personally would be interested in deferring payment, and 70 percent of those interested in deferring payment said that the cash flow problem caused by the special assessment would be the most important reason affecting their decision whether or not to defer payment. Finally, of those who were opposed to or were undecided about the special assessment project, 40 percent said that the option to defer payment until sale would make them more willing to support the special assessment project. These responses suggest that the option to defer paying special assessments until sale can increase the political support for neighborhood improvements financed by special assessments.

In addition, several respondents made unexpected but encouraging comment that they thought the deferment option was a good idea, not only because they personally might use it, but also because they knew of lower-income neighbors who they thought could benefit from it. And several owners said that their only hesitation in petitioning for the project to restore the Venice Canals had been their fear that it might impose an undue financial burden on their lower-income neighbors.

Thus it was not merely self-interest but also concern for their neighbors that generated citizen support for the deferment option. If this sentiment is widespread, it is another way that deferment would

increase the political acceptability of using special assessments to finance public investments in older neighborhoods with a diverse population, some of whom lack the ability to pay.

Effects on the Distribution of Income

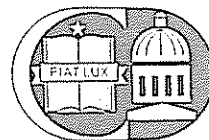
Even with the option to defer payment until sale, if property owners are charged for public services according to the benefits they receive, the resulting distribution of the tax burden might be expected to bear most heavily on those with the lowest incomes.

To answer the question about how fairly or unfairly the burden of special assessments is distributed according to ability to pay, census tracts in Sacramento were selected to represent low, middle, and high-income neighborhoods, and two alternative ways to pay for the same level of local public spending were compared: (1) a conventional property tax based on the value of property, and (2) a special assessment based on equal payments per front foot of property (a common method of apportioning special assessments).

Because higher-income families live in more expensive houses and therefore pay a higher property tax, it seems obvious that taxing the value of property would be more progressive than taxing front footage, but the data surprisingly show just the opposite: because the lower-income households live at a much higher density and thus split a front-foot assessment among many more households, *the special assessment apportioned according to front footage of property can be distinctly more progressive than a conventional property tax apportioned according to the value of property.*

The Government's Own Cash Flow Problem

It might appear that a local government would, by offering to solve the cash flow problem that its



special assessments create for property owners, merely transfer these cash flow problems to itself. That is, rather than *solve* the cash flow problem, doesn't deferred assessment simply *shift* it to the government?

Surprisingly, data collected on property sales over a 30-year period demonstrate that, because owners who sell their property pay their full assessment plus interest, deferred assessments would be repaid *faster* than required to service the assessment debt with level amortization over a 30-year period. In that case, it is not correct to say that deferred assessment shifts the cash flow problem from individuals to the government. Rather, *deferment can solve the cash flow problem that conventional special assessments create for taxpayers, without creating a cash flow problem for the government itself.*

Conclusion

The main defect of the conventional special assessment as a method of financing neighborhood public investment results from a gap in the capital market: specially assessed property owners face a cash flow problem because they must pay their special assessments before they realize the capital gain caused by the public investment. In turn, this gap in the capital market has created a gap in the public finance system, with profitable opportunities for public investment at the neighborhood scale blocked by the cash flow problems associated with special assessments.

Deferred special assessments, by solving the cash flow problems associated with conventional special assessments, can greatly increase the usefulness of special assessments as a self-help method of financing infrastructure and amenities in older neighborhoods, where the diversity of incomes, ages, and family circumstances makes it difficult for everyone to pay for public goods on the same schedule.

By offering its taxpayers the option to defer paying special assessments, with interest, until sale, a local government can, without any subsidy, encourage

its citizens to spend their own money to improve their own neighborhoods. Because it makes financing public investment in older neighborhoods easier and more fair, deferred special assessment is a moderate, incremental, and potentially important step toward empowering citizens to use their own resources to solve their own problems.

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