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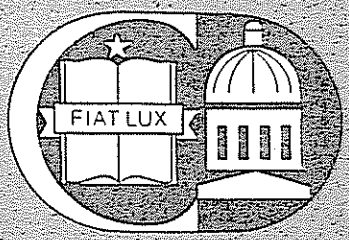

A Joint University of California/ State Government Program

NEW FUNDS FOR OLD NEIGHBORHOODS

California's Deferred Special Assessments

by

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CONTENTS

EXECUTIVE SUMMARY

The Problem of Underinvestment in Older Neighborhoods

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 that they want.

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 report 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, but 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 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 felt 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. That is, it was not merely self-interest, but also concern for their neighbors which 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, California, 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 the 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 they 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

In 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 fairer, deferred special assessment is a moderate, incremental but potentially important step toward empowering citizens to use their own resources to solve their own problems.

INTRODUCTION

The owner of a large parcel of land who is subdividing it for new urban development has a clear financial incentive to invest in neighborhood-scale infrastructure – such as roads, sidewalks, underground utilities, street trees, open space, and other environmental amenities – because it increases the attractiveness of the subdivision and thus raises the market value of the individual building sites. Because the developer reaps the benefits of the neighborhood improvements when the building sites are sold, the developer is motivated to search for and invest in any improvement to the neighborhood's environment that will raise the market value of the land by more than its cost.

But once a neighborhood has been subdivided into multiple ownership, no developer has any further incentive to improve the neighborhood (although developers do, of course, continue to improve individual sites), so if incomes rise and the demand for neighborhood amenities increases over time, older neighborhoods can fall behind compared with new neighborhoods that are being subdivided with all the amenities that buyers demand. Further, the original infrastructure that the developers initially installed in the older neighborhoods can decay over time, so without a continuing program of infrastructure maintenance the older neighborhoods can become even less attractive compared to new neighborhoods. *Even where investment in improving the infrastructure and amenities of these older neighborhoods would increase the total market value of the neighborhood by more than the cost of making the improvements, once the land has shifted from single ownership to multiple ownership, no entrepreneur has the financial incentive to make the improvements.*

Since private enterprise lacks the incentive to make infrastructure investments that benefit a whole neighborhood, the local government becomes responsible. But local governments can't be expected to use general revenue to finance all infrastructure investments that increase *private* land values by more than the *public* cost. First, given all the other claims on general revenue, there may not be enough public money to make all these neighborhood investments. And second, since the benefits of the investment flow to landowners in the form of increased land values, it seems unfair to spend general tax revenues to provide special benefits to individual owners.

The failure to finance neighborhood infrastructure improvements that could more than pay for themselves through increased land values may seem to be a problem only for the affected landowners, but the problem has extensive ramifications. First, in many cases a shortage of housing stems not so much from a lack of housing units but from a shortage of neighborhoods that people want to live in. Therefore, public investment in older

neighborhoods can increase the supply of desirable housing without requiring new housing construction. And second, the lack of public investment in older, central areas means that many families move to newer neighborhoods in outlying areas to find the amenities that they want. Unfortunately, this individual search for neighborhood amenity can collectively leave sidewalks, streets, and water mains literally falling apart beneath peoples' feet in the older, more central neighborhoods.

California has recently enacted legislation to help property owners in older neighborhoods to club together to invest in the public infrastructure and amenities they want. *This report explores how, without using general public revenue, this new method can be used to finance public investment in older neighborhoods.*

1. SPECIAL ASSESSMENTS FOR PUBLIC INVESTMENT

Special assessments are a long-established public finance mechanism that, in theory, seem 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.[1] The special assessment is limited to paying the cost of the public improvement, so 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. If so, just as the subdivider of a large parcel of raw land is willing to install urban infrastructure that costs less than the resulting increase in the value of the subdivision, property owners even in areas of fragmented ownership should be willing to pay for any sort of public improvement that costs less than the resulting increase in the total value of their neighborhood. In this sense, a special assessment district is a sort of compulsory club of property owners formed to pay for a neighborhood public improvement that benefits them all.

Ideally, the cost of a special assessment project is apportioned among the benefited properties according to the resulting increase in each property's value, but in practice this ideal is impossible to achieve. Estimating property values is a difficult task, and estimating the increase in property values before and after a proposed public improvement even more difficult. Therefore, alternative *indicators of benefit* are used to distribute the costs among

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[1] To demonstrate some of the details involved in a special assessment project, Appendix A includes some of the documents drawn from a case study of a typical small special assessment project for a neighborhood in Redding, California. For an excellent history of special assessments and a thorough exploration of the issues involved in using special assessments, see Chapter 12 in Donald Hagman and Dean Misczynski, Windfalls for Wipeouts: Land Value Capture and Compensation (Chicago: American Society of Planning Officials, 1978).

properties, with the indicator depending on the type of improvement that is being financed.[2] For example, for projects such as sidewalks, curbs, and street lights, where the cost is a function of the total length of the frontage served, the cost is usually apportioned among the benefited properties according to the number of front feet of each property abutting on the improvement. Second, for a project such as flood control, where the cost is a function to the total area served, the cost can be apportioned according to the number of square feet of the benefited property. Third, for projects that benefit each property equally, such as sewer laterals leading to individual properties, the cost can be divided equally among the benefited properties (the "one-each" method). Fourth, when all or almost all of the benefit from a public improvement accrues to one particular property, the cost can be directly assessed to that one property. And often a combination of different methods are used to allocate the different components of the cost of a project, but *the aim in each case is to apportion the cost of the project according to the benefit received by each property.*

Financing infrastructure by special assessment is different from the more general proposition that betterment (increases in land value) caused by government action should be recaptured for the benefit of "the community." Rather, a special assessment is a pragmatic method of paying for public spending that benefits specific property, and is *limited to recovering the cost of particular projects, even if the betterment created by the project is much greater than this cost.* In a sense, for a special assessment "the community" is defined as the property owners benefited by a particular project, and the cost of the project is distributed among this community according to the benefit each property receives. Although in this sense the special assessment is not motivated by the goal that betterment created by society should be recaptured for society's use, it is in a limited way certainly compatible with that goal.

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[2]For a thorough discussion of how special assessments are apportioned among benefited properties, see Alfred Liff, "Methodology of Special Assessment Spreading Practices," City of Los Angeles Department of Public Works, Bureau of Assessments, January 12, 1977.

2. THE PROBLEM OF ABILITY TO PAY

Although in theory special assessments seem ideally suited to paying for public investments that increase property values, in practice they have the severe disadvantage that, because they are levied strictly according to the benefits-received principle of taxation, they ignore the taxpayer's ability to pay. In this century the idea that taxes should be related to the benefits the taxpayer receives has lost ground to the idea that taxes should be related to the taxpayer's ability to pay, and *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, but the problem with this argument is that *the special assessment has to be paid when the project is undertaken, 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 accepted that property owners should pay for special benefits they receive, and even if the benefits exceed the costs for each specially assessed owner, the *cash flow problem* can prevent residents who very much want a public improvement from voting for a special assessment to pay for it. The government can ameliorate the cash flow problem by selling bonds and spreading the assessment payments over time, like a mortgage, but even the regular debt service can present a serious cash flow problem for some owners, especially in lower-income neighborhoods where the owners don't have a reliable and predictable cash income. Property owners can be rightly suspicious of voting for a special assessment to pay for a neighborhood public improvement if it means that they can subsequently lose their homes to foreclosure if they can't pay the debt. This problem was clearly demonstrated in the United States during the Great Depression when widespread defaults and foreclosures on special assessment liens occurred. In cities with a population of over half a million, total special assessment revenue fell almost 90 percent between 1930 and 1940, and special assessments have never regained their former importance. For all U.S. cities, special assessments provided 7 percent of general revenue in 1930, and less than

1 percent in 1986.[3] Clearly, although special assessments would seem to be both a fair and an efficient way to finance the public improvement of many older neighborhoods, many voters are unwilling to support, and local governments are reluctant to impose, a tax that so completely neglects the taxpayer's ability to pay.

[3]Data for 1930 from Tax Foundation, Special Assessments and Service Charges in Municipal Finance (New York: Tax Foundation, Inc., 1970). Data for 1986 based on State-Local Government Finance Diskettes supplied by the U.S. Advisory Commission on Inter- governmental Relations (Washington, DC, 1988).

3. A POSSIBLE SOLUTION: DEFERRED SPECIAL ASSESSMENT

If it is agreed that the cash flow problem is an impediment to financing public investment by special assessment, *one way to deal with this cash flow problem is to allow owners of benefited property to defer paying their special assessment, 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 timing of payments entirely at the owner's option distinguishes a deferred special assessment from a conventional special assessment.*

Local governments would run little risk of borrowers' defaulting on deferred assessments because when the assessment is due the seller has the cash available from the sale of the property. Despite its great security of repayment to the lender, a deferred assessment can never result in foreclosure for nonpayment by the borrower because, by definition, it would not be due until a property is sold. Even where a special assessment is the only way to finance a greatly desired public investment, many owners understandably resist any tax that threatens the loss of a home by foreclosure. Because the terms of a deferred assessment specifically exclude the possibility that an owner will ever be evicted for nonpayment, a deferred assessment should be more popular than other taxes that are a lien on property.

The benefits of deferred assessment from the property owner's point of view are clear. They can obtain desired neighborhood public improvements without any cash flow problem or fear of foreclosure; and where public improvements raise property values, the increased property value can be used to pay the deferred assessment due at sale.

The benefits of deferred assessment from the government's point of view are also clear. *If a market rate of interest is charged on assessment debt, the deferment option requires no subsidy.* Yet because it eliminates the cash flow problem caused by conventional special assessment, deferred assessment can encourage self-help improvement of older neighborhoods without using general revenue. And if owners pay their special assessments when they sell their properties, they have more money to spend in their community while they own their properties, and less to take away from their community when they sell and leave. In this sense, deferred assessment resembles Monty Python's proposal to solve Britain's economic problems "by taxing foreigners living abroad." More seriously, because homeowners tend to move to higher income neighborhoods as their own incomes increase,

financing public improvements by deferred special assessment would tend to increase spendable income in lower-income neighborhoods, and later decrease wealth in richer ones. This *voluntary redistribution* of income through time (but *not among individuals*) requires no subsidy if owners are charged the market interest rate for the right to defer paying their assessments until sale.

I first proposed the potential advantages of deferred assessments in a 1980 article in the *National Tax Journal*.[4] Subsequently, the California Policy Seminar, which is funded by the California Legislature to encourage academic research relevant to public policy, awarded me a grant to do further research on the concept and to draft legislation that would enable local governments to set up deferred assessment programs. The resulting legislation was enacted in 1984 (see the Appendix for the text of the new law). I am very grateful to the California Policy Seminar for supporting the further research on deferred assessments reported here.

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[4]See Donald C. Shoup, "Financing Public Investment by Deferred Special Assessment," National Tax Journal, December 1980.

4. POLITICAL IMPACT OF DEFERRED ASSESSMENTS

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

To illustrate the impact of deferment on political acceptance, consider a case where, without the option to defer paying a special assessment, only one-third of the property owners in a neighborhood are in favor of a special assessment to improve the neighborhood, and two-thirds are against it. Suppose also that half of the two-thirds who are against the special assessment project would be in favor of it if the government offered to solve their cash flow problem by allowing them the option to defer paying the special assessment until sale. That is, on any vote on the special assessment:

1/3 would vote YES even without deferment
1/3 would vote NO without deferment but YES with deferment
1/3 would vote NO even with deferment

In this case, by swinging one-third of the owners from NO to YES, offering the option to defer payment would convert the two-thirds vote against the neighborhood investment into a two-thirds vote for the neighborhood investment. The one-third who would vote YES without deferment join a satisfied two-thirds pro-spending majority, while the one-third who would vote NO even with deferment would become a disgruntled anti-spending minority.

Although in this example the option to defer converts the NO-even-with-deferment voters from a majority to a minority, the deferment option can reduce the degree of their opposition to the neighborhood improvement by making the payment terms less onerous. At the same time, the option to defer can increase the degree of approval of those who would vote YES-even-without-deferment. Thus, the focus on simple YES-or-NO votes can underestimate how much the deferment option can increase a neighborhood's property owners' willingness to help themselves by spending their own money to improve their own environment.

A second political impact of deferred assessment concerns the attitude of the elected local leaders who ultimately must impose special assessments. Even if a majority of property owners are willing to pay for improving their neighborhood by conventional special assessment, the local council is still in the position of imposing a tax obligation that disregards the taxpayers' ability to pay. Since all owners are compelled to pay the special assessment even if they don't have the ready cash, the local council can impose the special assessment with a clearer conscience if it knows that assessed owners have the option to defer paying until they sell their property and realize their capital gains in cash. In this

sense a deferred assessment is a "special assessment with a human face," and elected officials should be less averse to imposing a deferred special assessment than to imposing a conventional special assessment. Thus, by increasing voter support, and by reducing the politicians' "guilt" associated with imposing a tax that disregards ability to pay, offering the option to defer payment can significantly enhance the political acceptability of financing public investment by special assessment.

5. EVIDENCE FROM THE VENICE CANALS

To explore the potential for deferment to increase the political acceptability of special assessments, a telephone survey of property owners in a proposed special assessment district in Los Angeles was conducted in 1985. This special assessment district was being formed to restore the Venice Canals neighborhood in Los Angeles, and it is the most ambitious special assessment project ever attempted to restore an older neighborhood in Los Angeles.

The Venice Canals were developed at the beginning of this century by an entrepreneur who bought the land, excavated the canals, installed the infrastructure, and subdivided the land into building sites fronting on the newly created canals. The incentive for the developer to create this unusual residential amenity – housing sites on a romantic system of canals – was the resulting increase in land value, but after the sites were sold to individual owners, there was no mechanism for maintaining the canal infrastructure, and they have been decaying ever since, with the canal-front sidewalks sliding into the water facing many sites. The restoration of the canal infrastructure would greatly increase the attractiveness and value of the sites facing the canals, just as the creation of the canal infrastructure did initially, but the City of Los Angeles has been unwilling to allocate general funds to a project that would primarily enrich private landowners.

With no other funding source available, the owners of more than 75 percent of the sites facing the canals petitioned for a special assessment project, and the map in Figure 1 shows the proposed district. Almost all of the 397 properties facing the canals are of exactly the same size, and except for corner lots and a few lots facing the Grand Canal almost all have a 30-foot frontage on a canal. Although the estimated total cost of restoring the canals by draining them, relining them, and rebuilding the banks, sidewalks and some bridges is quite high, the large number of small sites with unusually narrow frontage means that the cost per site will be in the neighborhood of $4,000 to $6,000.

Almost all the sites on the Venice Canals would benefit equally from the restoration project, but there is a great diversity of household income, household age structure, and housing quality in the neighborhood. In the 1980 Census, 10 percent of the households in the census tract had incomes below the poverty level, and 43 percent had incomes below $15,000 per year. Most of the household heads are young (52 percent of the tract population were between 20 and 34), so many of them would presumably have an expectation of higher future earning capacity, but would not have a high current income. Finally, there is a great diversity in the assessed value of the canal sites for purposes of property taxation. Because of Proposition 13's provision that properties be assessed at their purchase price, with subsequent increases in assessed value limited to 2 percent per year,

MAP 1

VENICE CANALS ASSESSMENT DISTRICT
(proposed)

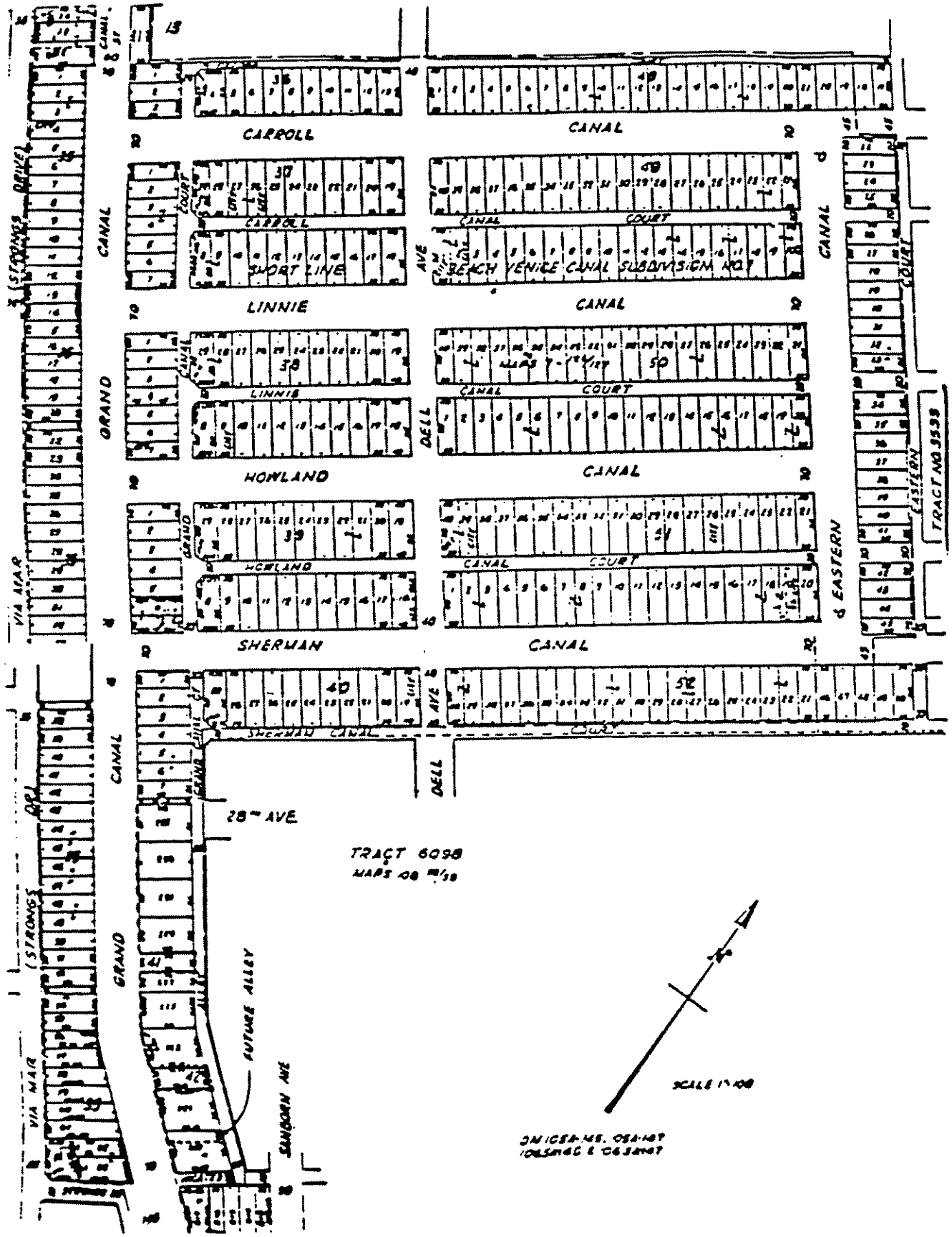

Table 1.

Survey of Venice Canal Special Assessment District Property Owners

1. Are you in favor of the special assessment project?

	Owner Occupied	Rental Property	Vacant Land	Total Sample
Favor	88%	82%	80%	85%
Oppose	6%	18%	0%	9%
Undecided	5%	0%	20%	7%
Total	100%	100%	100%	100%

2. How much do you think the project will increase property values?

	Total Sample
Less than $4,000	0%
$4,000 to $6,000	10%
More than $6,000	61%
Unknown	29%
Total	100%

3. Would you be interested in deferring payment of the special assessment until you sell your property?

	Owner Occupied	Rental Property	Vacant Land	Total Sample
Yes	52%	50%	0%	52%
No	39%	38%	0%	36%
Undecided	9%	13%	100%	12%
Total	100%	100%	100%	100%

4. What factors would influence your decision to defer payment?

	Owner Occupied	Rental Property	Vacant Land	Total Sample
Cash flow problem	20%	100%	0%	70%
Interest rate charged	80%	0%	67%	20%
Other	0%	0%	33%	10%
Total	100%	100%	100%	100%

5. Would the option to defer payment until sale make you more willing to support the special assessment project? (Asked of those who opposed or were undecided about the project.)

	Total Sample
Yes	40%
No	60%
Undecided	0%
Total	100%

the properties that have been bought recently have a far higher assessed value than do properties that have been owned by the same owner for a long time. Vacant lots that are otherwise identical except for the date of purchase range in assessed value from $11,000 to $195,000, a ratio of eighteen to one. Since the canal restoration would benefit all lots equally, financing the cost by a tax on assessed value would seem quite unfair, because some owners would be paying eighteen times as much as others for the same benefit. At the same time, the high prices paid for the recently purchased lots demonstrate that there is a substantial equity in most properties that could be used to secure any deferred assessment for the restoration of the canals.

Table 1 shows the results of the telephone survey of canal property owners. Five percent favored the special assessment project (Question 1). This large majority in favor is not surprising, because no one thought that the project would increase the value of their property by less than $4,000, and 61 percent thought that it would increase the value of their property by more than $6,000 (Question 2). 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 (Question 3). 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 (Question 4). 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 (Question 5).

Only half of the random sample of 78 owners out of the total population of the 397 sites in the special assessment district were able to be contacted by telephone, and the small sample size means that the responses cannot be interpreted as statistically representative of the entire population. Nevertheless, the responses do illustrate the proposition that the option to defer paying until sale can reduce the political opposition to a special assessment for public improvements. In addition, many respondents made unexpected but encouraging comments about the deferment option. Although the comments were informal, and were not tallied, many owners said 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 felt could benefit from it. And several owners said that their *only* hesitation in petitioning for the project had been their fear that it might impose an undue financial burden on their lower- income neighbors. That is, *it was not merely self-interest, but also concern for their neighbors which generated their 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.

6. THE INCOME DISTRIBUTION CONSEQUENCES OF SPECIAL ASSESSMENTS

If the option to defer payment until sale made special assessments more acceptable to taxpayers and elected officials, how would an increased use of special assessments to finance public services affect the ultimate distribution of the tax burden among income classes? Even with deferment, if property owners are charged for public services according to the benefits they receive, without regard to the value of their property or to their ability to pay, the resulting distribution of the tax burden might be expected to bear most heavily on those with the lowest incomes. Is this so?

The Distribution of Special Assessments Among Income Classes

To answer the question about how fairly or unfairly the burden of special assessments is distributed according to ability to pay, it is helpful to compare the income distribution consequences of two alternative ways to pay for the same level of local public spending: (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, regardless of property value. Special assessments for infrastructure – such as street lights, sewers, water supply, and flood control – are often apportioned among the benefited properties simply according to their front footage, so a comparison between property tax finance and front foot finance can illuminate the distributional consequences of special assessments.

To compare the distributional consequences of the two ways to finance infrastructure – property taxes and front-foot special assessments – three census tracts in Sacramento, California, were selected to represent low-, middle-, and high-income neighborhoods. The first census tract has approximately half the median family income for Sacramento, the second census tract has approximately the median family income for Sacramento, and the third census tract has approximately double the median family income. Within these three census tracts, three residential blocks which appear to be physically typical of their census tracts were chosen for investigation, and Table 2 shows the results. Although the census tracts and blocks were not selected on a random basis, and thus cannot be said to represent the city as a whole, the following analysis illustrates the issues that are involved in estimating the relative progressivity or regressivity of using benefit-based special assessments versus value-based property taxes to finance local public services.

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 assembled in Table 2 unexpectedly show just the opposite: they show that because the lower-income households live at a much

higher density and thus split the front foot assessment among many more households, the special assessment apportioned according to front footage is more progressive than a conventional property tax apportioned according to property value.

In Table 2, Columns 2 and 3 show the median household incomes and average housing values for the low-, middle-, and high-income census tracts in which the three sample blocks are located. Column 4 shows the total assessed property value, obtained from the Sacramento County Assessor, for each of the three blocks. Surprisingly, the total assessed value of the high income block is less than half that of the low-income block. This surprising result is explained in Column 11, which shows that housing density decreases as income increases: even though assessed housing value increases with household income, the 37 dwelling units on the low-income block have a higher *total* assessed value than the 11 dwelling units on the high income block.

To compare the alternative distributional consequences of financing a given level of local public services either by a property tax or by a special assessment, first suppose that the local services are financed by California's uniform 1 percent property tax rate applied to all three blocks. Column 7 shows that the total revenue is $27,539, with the low-income block paying $11,899, the middle income block paying $10,141, and the high income block paying only $5,499. Although the tax *per dwelling unit* increases with higher income, the tax *per block* decreases because the number of dwelling units per block decreases faster than the tax per dwelling unit increases.

Now suppose that this same total revenue is raised by a special assessment spread among the three blocks on the basis of front footage alone, without regard to income or property value. A special assessment of $6.22 per front foot on the 4,425 total front feet of all three blocks raises the same total revenue as the 1 percent property tax on the $2,753,889 total assessed value of all three blocks. Column 8 shows the distribution of the total special assessment among the three blocks. Taken together, Columns 7 and 8 show that, in comparison to the property tax, the special assessment reduces the total tax burden on the low- income block from $11,899 to $7,935, and increases the total tax burden on the high income block from $5,499 to $8,844. The total tax burden on the middle income block is about the same in either case. Thus, although the property tax *seems* inherently more progressive because of its explicit relation to property value, in this case the special assessment is more progressive.

The explanation for this seemingly strange result is that even though the assessed value per dwelling unit rises with higher incomes, the density of dwelling units per front foot falls faster, so the assessed value per front foot is higher in the lower-income neighborhood, as Column 6 shows. Therefore, the lower-income neighborhood pays less and the higher income neighborhood pays more when taxes are based on front feet value rather than on property value. *Surprisingly, using a special assessment rather than a property tax to pay for public investment thus reduces the tax burden in the lower income, higher density neighborhood.*

Finally, we can show the relationship between taxes and income for both the property tax and the special assessment. If we assume that each of the three blocks has the same median household income as the census tract in which it is located, Columns 15 and 16 express the tax per housing unit as a percentage of median household income. They show that although both taxes are regressive, the special assessment is markedly less regressive than the property tax. Both taxes average 2.5 percent of median household income for the three neighborhoods taken together, but the property tax ranges widely from 4.2 percent

TABLE 2. DISTRIBUTION OF TAX PAYMENTS: THE GENERAL PROPERTY TAX COMPARED TO A SPECIAL ASSESSMENT

BLOCK	TRACT MEDIAN HOUSEHOLD INCOME	TRACT AVERAGE HOUSING VALUE	BLOCK TOTAL ASSESSED VALUE	BLOCK TOTAL FRONT FEET	BLOCK ASSESSED VALUE PER FRONT FOOT	TAX PER BLOCK		TAX PER FRONT FOOT		HOUSING UNITS PER BLOCK	TAX PER HOUSING UNIT		HOUSEHOLD INCOME PER BLOCK	TAX PER HOUSING UNIT AS % OF HOUSEHOLD INCOME	
						PROPERTY TAX	SPECIAL ASSESSMENT	PROPERTY TAX	SPECIAL ASSESSMENT		PROPERTY TAX	SPECIAL ASSESSMENT		PROPERTY TAX	SPECIAL ASSESSMENT
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1	$7,734	$49,100	$1,189,897	1275	$933	$11,899	$7,935	$9.33	$6.22	37	$322	$214	$286,158	4.2%	2.8%
2	$17,263	$62,500	$1,014,135	1729	$587	$10,141	$10,760	$5.87	$6.22	24	$423	$448	$414,312	2.4%	2.6%
3	$36,548	$136,500	$549,857	1421	$387	$5,499	$8,844	$3.87	$6.22	11	$500	$804	$402,028	1.4%	2.2%
TOTAL			$2,753,889	4425		$27,539	$27,539			72			$1,102,498		
AVERAGE			$917,963	1475	$622	$9,180	$9,180	$6.22	$6.22	24	$382	$382	$367,499	2.5%	2.5%

Data Sources:
Block 1 is Census Tract 5, Block 308.
Block 2 is Census Tract 23, Block 303.
Block 3 is Census Tract 58.02, Block 207.
Columns 2 and 3 are from 1980 US Census.
Columns 4 and 5 are from Sacramento County Assessor.
Column 6 = (Column 4) / (Column 5).
Column 7 = (Column 4) x (0.01).
Column 8 = (Column 5) x (Column 10).
Column 9 = (Column 7) / (Column 5).
Column 10 = (Total Property Tax) / (Total Front Feet) = ($27,539) / (4,425) = $6.22 per front foot.
Column 11 is from 1980 Census.
Column 12 = (Column 7) / (Column 11).
Column 13 = (Column 8) / (Column 11).
Column 14 = (Column 11) x (Column 2).
Column 15 = (Column 12) / (Column 2).
Column 16 = (Column 13) / (Column 2).

of income in the poor neighborhood to 1.4 percent in the rich one, while the special assessment ranges only from 2.8 percent of income in the poor neighborhood to 2.2 percent in the rich one.

Of course, these data do not prove that a special assessment apportioned according to front footage is, in general, less regressive than a conventional property tax for financing local public services that benefit property. They do, however, show the error of asserting that a special assessment apportioned according to front footage is, when judged by the criterion of ability-to-pay, necessarily or even typically less fair than a conventional property tax based on property value. The crucial intervening variable is density: with higher density in poorer neighborhoods, a front foot charge can be split among many more households than in richer neighborhoods, and thus the special assessment *per dwelling unit* is lower in poorer neighborhoods than in richer neighborhoods. Where, as income increases, the density of dwelling units decreases faster than property value per dwelling unit increases (as in the above example), then the special assessment is *more* progressive (or less regressive) than the property tax. Thus, even though the unique characteristic of the special assessment is apportionment of cost according to the benefits-received principle of justice in taxation, the resulting distribution of the tax burden according to ability-to-pay principle is not necessarily less fair than the most common alternative method of financing services to property, the property tax.

Although the data in Table 2 were assembled to evaluate the distributional consequences of special assessments, they also illustrate the important point that *many densely populated areas must have a great capacity to pay for public services where cost is a function of the front footage served.* The residents of a crowded urban block might be quite willing to vote for a special assessment per front-foot if they knew that *all the revenue would be devoted to providing benefits for their block alone*, and yet quite unwilling to vote for a general citywide property tax increase because they understandably see no direct connection to better public services in their neighborhood. And it is more likely that a neighborhood's *own* preferences will be considered in the spending decision if the neighborhood has to vote for both the tax and the public service.

Targeted Aid for Low-Income Owners

Even if special assessments do impose a smaller tax burden on lower-income households *as a class*, there remains the problem that some *individual* low-income households who live at untypically low density could face a large special assessment seriously out of line with their ability to pay. Although deferring payment of special assessments until sale solves the *cash flow problem* for the assessed owners, they must still pay their assessments sooner or later, and this can cause a *hardship problem* for very low-income owners. Do these hardship cases severely limit the usefulness of special assessments, even deferred ones, to pay for public services that benefit property owners?

Some cities have solved the problem of individual hardship caused by special assessments by using public funds to pay for some or all of the special assessments of very low-income owners. For example, Santa Monica, California, offers to pay the special assessment for owners whose income is less than 80 percent of the median income in the County. The federal government specifically authorizes all cities to use Community Development Block Grant funds to pay special assessments for low-income owners.

By offering to pay the special assessments of low-income owners, a city can specifically target aid only on those who need it. Where a city offers to pay the special assessments of poor owners and therefore to pay *only* the share of the total project cost that would otherwise fall on poor owners, the rest of the cost is paid by benefited owners who are not poor. Because the city's subsidy to pay the special assessments for poor owners stimulates all the special assessment payments made by nonpoor owners, the city can finance more public services than would be the case if the problem that *some* owners can't pay special assessments were used to justify a policy of using general funds to pay for *all* public services, even those that benefit *only* specifically identified property. Using special assessments to finance public projects that specially benefit easily identified private property, and then using general public funds to pay the special assessments only for low-income owners gets around the typical public finance problem of having to spread a banquet for everyone so that those who can't pay for their own food won't go hungry.

It should be noted that because a conventional special assessment must be paid out of the owner's current income, the relevant criterion regarding whether the owner of assessed property needs aid in paying the special assessment is the owner's *current income*. But with a *deferred* assessment, income is not the only measure of the benefited owner's ability to pay, and if the value of the assessed property is also taken into account, a special assessment can be high in relation to the owner's current income but low in relation to the owner's ability to pay when the specially assessed property is sold. That is, with a deferred assessment the owner's equity in the assessed property is also a measure of ability to pay, especially for public projects that increase the market value of the assessed property and thus provide the means of paying the deferred assessment at sale.

If a low-income owner has a large equity in the assessed property (as is often the case with retired persons, for instance), it is illiquidity that creates the problem of paying the special assessment, not the owner's low income. Therefore, in the case of low-income owners with a large equity in specially assessed property, allowing owners to defer payment until the property is sold and the equity is realized in cash can substitute for subsidizing the special assessments of low-income owners. That is, in the case of deferred special assessments, the government may decide to pay the special assessments only for owners who have both a low income and a low equity in their property, because the equity in the benefited property is also a measure of the owner's ability to pay the deferred special assessment. If so, unsubsidized deferment of the special assessment can in some cases replace an outright subsidy to help low-income owners to pay a conventional, undeferrable, special assessment.

The Problem of Renter-Occupied Property

The preceding discussion of the distributional consequences of special assessments has implicitly referred to owner-occupied property, where the owners pay the special assessment and enjoy both the consumption value of the neighborhood public improvement financed by it and the associated capital gain at sale. Therefore, the owner-occupier, in deciding whether or not to support a special assessment, would presumably weigh the present discounted value of the consumption benefits until sale, plus the capital gain at sale, against the cost of the special assessment. For the owners of renter-occupied property, the equivalent decision rule is to weigh the increased rents caused by the neighborhood public improvement, plus the associated capital gain at sale, against the cost of the special

assessment. Thus, for renter-occupied properties, the owners would presumably advocate the special assessment only if the present discounted value of the increased rent, plus the expected capital gain at sale, exceeds the special assessment.[5] This does not mean, however, that owners simply "pass on" the special assessments to the renter, and that the burden of the special assessment is therefore incident on the renter rather than on the owner.

To illustrate the incidence of a special assessment on renter-occupied property, consider two adjacent and otherwise identical renter-occupied neighborhoods that both benefit from the same public investment, such as street lighting. In one neighborhood the street lighting is financed by a grant from the federal government, and in the other neighborhood it is financed by a special assessment on the benefited properties. If residents value the street lighting to the extent of being willing to pay higher rent to live in a neighborhood that has it, competition among renters to live in the improved neighborhoods would increase the rent in both neighborhoods by the same amount. By raising rents in the improved neighborhoods, this market competition among renters shifts some (or all) of the benefit of the street lighting from the renters to the owners, regardless of how the improvement was financed. In the case of the federal grant, all federal taxpayers (including renters) pay the cost of the neighborhood improvement, while in the case of the special assessment only the owners of the benefited property pay. That is, if rents and property values rise as a result of a neighborhood improvement financed by a special assessment, it is because competition for rental housing shifts the benefits of the neighborhood improvement to the neighborhood's owners, not because the owners can shift the burden of the special assessment to the renters. Given the decision to spend public money to improve the neighborhood, the key distributional question is who should be taxed to pay for the neighborhood improvement: all taxpayers, or only the owners of the specially benefited property?

It may seem a fine distinction whether the benefits of a neighborhood improvement are shifting from renters to owners, or whether the costs of a special assessment are shifting from owners to renters, but the distinction is crucial in understanding the distributional implications of special assessments to finance public improvements. It would be a mistake to think that it is inappropriate to use special assessments to improve a neighborhood <u>because</u> the neighborhood is occupied by renters. Rather, financing neighborhood improvements by special assessments that are paid only by the benefited owners (when they sell their property) seems more favorable to renters (as a class) than financing the same improvements by general taxes paid by owners and renters alike.

Special assessments are used <u>only</u> to finance public spending that specially benefits certain identifiable private property, and are never used to finance public spending for general purposes such as health, education or welfare. Therefore, the fact that a renter occupies a benefited property is no reason on equity grounds not to specially assess the

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[5]Because the expected capital gain at sale is itself the present discounted value of the subsequent increased rent associated with the neighborhood public improvement financed by the special assessment, the owner's decision whether to support a special assessment on renter-occupied property depends on whether the discounted value of all future increased rent caused by the special assessment exceeds the special assessment.

owner of that property for public spending that specially increases the value of that property.

7. METHODS OF DEFERMENT

Property owners could in theory borrow privately to defer paying a conventional special assessment, but in practice there is no private-market financial instrument that allows a property owner to accumulate debt indefinitely until sale, with repayment timed entirely according to the borrower's preference. There are, however, several successful public precedents that demonstrate the feasibility of allowing property owners to defer paying special assessments.

California's Senior Citizen Property Tax Postponement Program

California's Senior Citizen Tax Postponement Law has since 1977 allowed citizens who are 62 years or older or blind or disabled and with a household income of $24,000 or less to defer paying *all* their property taxes, including special assessments, until they move, sell their property, or die. All residential property tax bills in California include an invitation to eligible taxpayers to apply to postpone paying their property taxes, and if they meet the requirements the State Controller sends them coupons which they can use to pay any or all of their local property tax bills. The senior (or blind or disabled) citizen submits the coupons to the local government in lieu of the property tax payment, and the local government forwards these coupons to the State Controller, who reimburses the local government and takes a lien on the property for the deferred taxes and accrued interest. The State charges an interest rate on each year's postponed taxes which is based on the rate earned by the State's Pooled Money Investment Fund.[6] Total administrative costs for the State have averaged only 2.2 percent of the total deferred taxes, and there has never been a failure to repay the postponed taxes when an owner has died or sold the property. Forty percent of the postponed taxes have been repaid *before* the sale of the property or death of the owner. Aside from charging a simple rather than a compound interest rate, and the state's absorption of the administrative cost, there is no subsidy to the postponement program.

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[6]The interest rate charged to senior citizens is a *simple* interest rate, and the interest rate on each year's postponed taxes stays the same in future years. The interest rate can thus differ on taxes postponed in different years. For example, a senior citizen can be charged 6 percent interest on taxes postponed in one year, and 8 percent interest on taxes postponed in another year, but the interest on one year's debt does not change in future years.

Mountain View's Deferred Assessment Program

California's Senior Citizens Property Tax Postponement Program suggests one model for offering the option to defer special assessments, but it is not necessary to have centralized state finance for the program. Any city can operate its own program, as the experience of Mountain View, California, demonstrates. Mountain View has established the first deferred assessment program in the state, with the stated purpose of alleviating "the financial hardship, such as being ousted from one's home due to a high assessment and being forced to relocate, caused persons of low income by special assessments." The City pays the entire special assessment for income-eligible families, and takes a lien on the property to secure the debt, with repayment deferred until the owner sells the property or applies for a building permit to enlarge it (presumably because anyone who has enough money to enlarge their house can repay their special assessment). The deferred assessment debt is financed by a special $200,000 revolving fund appropriated by the city, and the interest rate charged to borrowers is 2 percent less than the interest rate on the particular special assessment bonds the city sells to finance the special assessment project. As with the Senior Citizens Property Tax Postponement program, there have been no defaults resulting from Mountain View's deferment program.

An unusual feature of Mountain View's program is that an experienced financial counselor visits every homeowner in any proposed special assessment district, and explains the process to them, including the owner's right to protest the project, and, if the project is approved, the owner's option to (1) pay the special assessment in full right away, without any interest, or (2) to have the City sell special assessment bonds to spread the payments over time like a mortgage, with interest, or (3), for income-eligible owners, to defer paying the special assessment with the debt accumulating at interest.

Los Angeles's Silent Second Trust Deeds

A third working model for deferring payment of special assessments is what has come to be known as the "silent second" program, which Los Angeles and some other cities use to aid low-income families to buy their first home. For families who can demonstrate that they have sufficient income to service a mortgage on a home, but who do not have sufficient savings to make a down payment to secure a conventional mortgage, the City will in certain circumstances lend them the down payment, with the loan being repayable, plus accumulated interest, when the family sells the house. The loan becomes a second trust deed lien on the home (junior to the first mortgage), but is "silent" in the sense that the owner does not have to make any payments to amortize the loan. This "silent second" program is designed to alleviate a cash flow problem for families who would otherwise be unable to purchase their own home, and the "silence" feature of the second trust deed is essentially the same as the deferrability feature of a deferred special assessment.

One interesting contrast between the existing "silent second" programs and a deferred assessment program is that silent seconds are intended to finance individual investment in private property, while deferred assessments are intended to finance neighborhood public investment. There would seem to be at least as much public purpose involved in fostering neighborhood *public* improvements through deferred assessments as in fostering the purchase of *private* property through silent seconds, and far less risk of default.

These three existing government programs – California's tax postponement for senior citizens, Mountain View's deferred special assessments for low-income owners, and Los Angeles's silent second trust deeds – show that it is administratively and financially feasible to offer property owners the option to pay their special assessments when it is convenient for them, with any unpaid assessment debt accumulating at interest. Because California charges its senior citizens a simple rather than a compound rate of interest, and Mountain View charges a below-market rate of interest, both programs involve an element of subsidy, which is justified by the low income of the target groups eligible for aid. But deferral (or silence) and subsidy are conceptually separate issues. The important advantage of offering the deferral option to *all* owners of specially assessed property, and not just to low-income owners, is that it increases a neighborhood's willingness to redirect its resources from private consumption toward collective neighborhood improvements. When the deferral option is offered to everyone, however, it is more important to charge a market interest rate. Charging a below-market interest rate of deferred assessment debt would encourage owners to defer payment simply in order to make money by borrowing cheaply from the government, regardless of any cash flow problem, and would therefore require the government to finance a larger debt. The deferment option should be directed toward solving the cash flow problem caused by special assessments, not to subsidizing borrowing at artificially low interest rates.[7]

Although at the outset I used the example of public investment that creates an unrealized capital gain greater than the special assessment, the precise size of the capital gain is not central to the argument for deferred assessment. Rather, property owners who choose to defer paying a special assessment are using the equity in their property to secure a loan, and thus can be expected to weigh very carefully the wisdom of both the public investment and the decision to defer payment. Homeowners sometimes invest in home improvements that cost more than the resulting increase in the market value of their home, for the valid reason that they value the improvement more highly than the market does. Homeowners may also, for the same valid reason, vote for a special assessment project that will cost them more than the resulting capital gain in the value of their home, but since they will ultimately reap both the benefits and the costs of the project they will presumably consider it carefully. Because a deferred assessment is secured by the owner's entire equity in the property, the owner can default on the deferred assessment only by walking away

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[7]Interest rate subsidies can be both more costly and less effective than unsubsidized deferral in easing the burden of paying special assessments. For example, in Bogota, Colombia, special assessments are normally due within six months, but low-income owners are granted periods of up to five years to pay in yearly installments with no interest charges (see William Doebele, Orville Grimes, and Johannes Linn, "Participation of Beneficiaries in Financing Urban Services: Valorization Charges in Bogota, Colombia," *Land Economics*, February 1979). This offer requires a substantial subsidy (if the market rate of interest is 10 percent per year, the present value of the subsidy over five years is one-quarter of the special assessment) but does not solve the cash flow problem because the low income owners are still required to make fixed yearly payments regardless of their ability to pay. The deferment option would completely solve the cash flow problem for all owners, and yet require no subsidy if a market rate of interest is charged on the debt.

from the property with nothing, and the fear of this consequence is a strong discipline for property owners not to undertake the debt unwisely.

The Government's Own Cash Flow Problem

Despite the demonstrated technical feasibility of deferring assessments until sale, it can be argued 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?

First, if a market interest rate is charged on the assessment debt, many owners will probably choose not to defer payment at all; in the survey of Venice Canals owners, only 52 percent expressed an interest in the deferment option. Therefore, the local government can *offer* the deferment option to everyone, but many won't exercise the option, preferring instead to pay the full assessment right away, or to make level annual payments necessary to amortize the special assessment over a fixed period.

Second, even if owners do choose to defer paying until sale, this will not necessarily create a significantly different total cash flow compared with the case where all owners make level annual payments necessary to amortize the same total assessment debt over a fixed period. When all owners defer payment until sale, most owners pay nothing in any one year, but the few who do sell their property pay the full assessment, plus interest. Depending on the rate of property sales, a large portfolio of deferred assessments can produce a cash flow of payments that is faster, slower, or the same as the level cash flow that occurs when all owners, regardless of their individual ability-to-pay problems, make level yearly payments in lock-step with one another.

To investigate the cash flow pattern of deferred assessment debt, Figures 2-5 show the results of an examination of property sales of single family houses in a representative Los Angeles neighborhood for the years 1950-1980. If a special assessment had been imposed on this neighborhood in 1950, and if *every* owner had deferred payment until sale, the solid lines show the cash flow from the deferred assessment, and the dashed lines show the cash flow if each owner had made an annual level payment necessary to amortize the special assessment over 30 years. At a 5 percent interest rate the deferred assessment is repaid a bit *faster* than the conventional assessment, and at a 10 percent interest rate the deferred assessment is repaid a bit slower, but in both cases the total cash flows for the deferred and the conventional assessment are remarkably similar. Although the figures refer to data from only one neighborhood for the years 1950 to 1980, its property sales rate was almost identical to the national average for single family homes over the same period, and the results are therefore generally representative.

The assumption used in constructing the cash flows in Figures 2, 3, 4, and 5 is that no owner ever pays anything until a property is sold, but the experience of California's Senior Citizen Property Tax Postponement Program has been that 40 percent of those who defer their taxes repay them *before* the property is sold or the owner dies. If a similar pattern of prepayment were to occur for deferred assessments, the clear implication is that deferred assessments would be repaid *faster* than required to service the debt 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, *deferred assessment can solve*

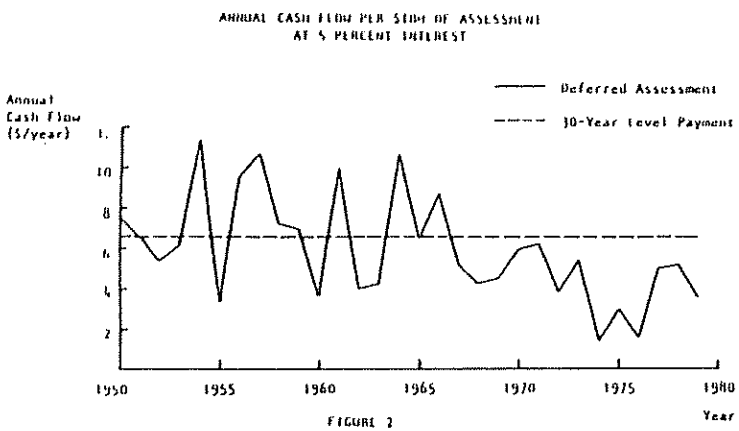

FIGURE 2

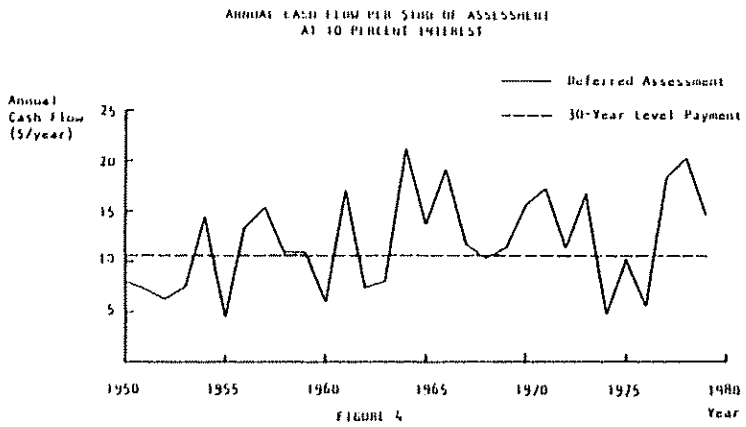

FIGURE 4

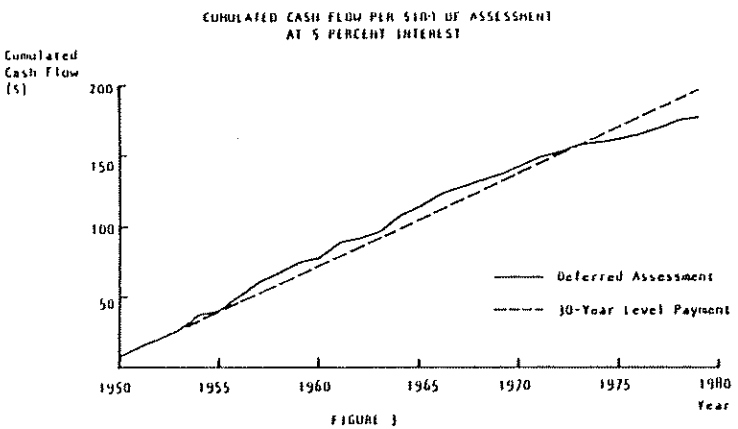

FIGURE 3

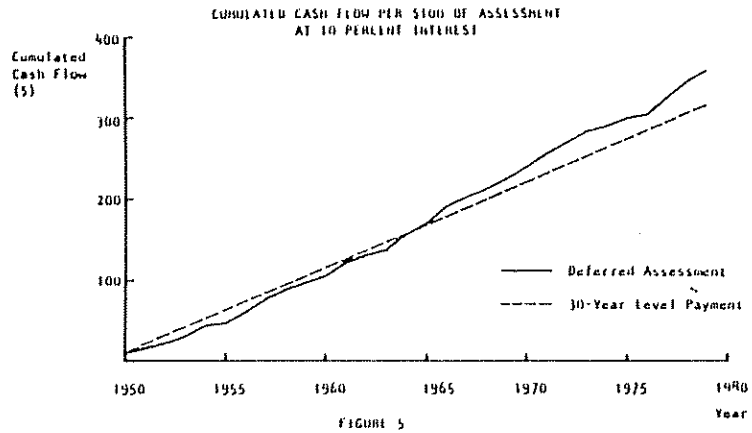

FIGURE 5

Source: Donald C. Shoup, "Financing Public Investment by Deferred Special Assessment," National Tax Journal, December 1980, pp. 413-429.

the cash flow problem that conventional special assessments create for individuals, without creating a cash flow problem for the government itself.

CONCLUSION: SPACE, TIME, AND MONEY

Although it seems to be a sensible, pragmatic method of financing public spending that benefits specifically identified private property, the special assessment has always suffered from the severe defect that, almost alone among taxes, it neglects the taxpayer's ability to pay. This defect has severely limited the special assessment as an instrument to finance neighborhood public improvements, even in cases where investment at the neighborhood scale would produce returns far greater than the cost.

I have argued here that *the main defect of the special assessment as a method of financing neighborhood public investment results from a hole 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 hole in the capital market has created a hole 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.

Although it may appear that low-income families would be harmed by heavier reliance on a tax that ignores ability to pay, it is not at all clear that special assessments are regressive when compared to the local property tax. Lower-income families tend to live in lower valued houses and therefore pay a lower property tax per house, but they also tend to live at higher density and therefore split a special assessment among more houses. If, as incomes increase, housing density decreases faster than the value per house increases, lower-income families pay less to finance public spending by a special assessment than by a property tax, as Table 2 showed. In any case, where an individual low-income households do face a special assessment that is seriously out of line with their ability to pay, the government can pay some or all of those individual households' special assessments, without subsidizing all the other households who *can* afford to pay. Further, because a *deferred* special assessment can be paid from the equity realized when property is sold, current income is not the only measure of the owner's ability to pay, and when the value of the assessed property is also taken into account, a special assessment that appears high in relation to the owner's current income may be low in relation to the owner's ability to pay when the specially assessed property is sold.

Offering property owners the option to defer paying special assessments, with interest, should increase the perceived fairness of special assessments. Perhaps more important, evidence from the Venice Canals special assessment district suggests that offering owners the option to defer paying will increase the willingness to vote for public investment financed by special assessment. Quite aside from the survey evidence, there is also the evidence from one's own personal experience. Would you look more favorably on a special assessment to provide a desired public investment in your neighborhood if you and all your neighbors could pay when it is most convenient? If the answer is yes, then by offering the option to defer payment, a local government can, without any subsidy, encourage you to spend your own money to improve your own neighborhood. By making public investment in neighborhoods easier, deferred special assessment is a moderate, incremental but potentially important step toward empowering citizens to use their own resources to solve their own problems.

APPENDIX

Enabling Legislation for Deferred Special Assessments
California Senate Bill No. 2055
(Approved by the Governor September 19, 1984)

SEC. 29. Chapter 8 (commencing with Section 10700) is added to Division 12 of the Streets and Highways Code, to read:

CHAPTER 8. DEFERRAL OF ASSESSMENTS

10700. Notwithstanding any other law, the legislative body may determine, by resolution, to allow landowners to defer payment of their assessments pursuant to this chapter. This chapter may be used only if 80 percent or more of the area of the assessment district is developed for residential, commercial, or industrial use.

10701. The legislative body may determine criteria that property owners must meet to qualify for deferral, and may determine procedures to ensure that the criteria are satisfied.

10702. No deferral arrangement may restrict, reduce, or eliminate any remedy of a bondholder provided by this division in the event of a default.

10703. Deferral may be provided through a year-to-year agreement between the city and an eligible property owner, which provides that the city will make assessment payments on behalf of the property owner for that year. No agreement shall commit the city to make deferral payments beyond one year. No agreement of this type shall be construed as a debt of the city.

10704. Alternatively, the city may create a deferral fund for the assessment district, and deposit into the deferral fund an amount sufficient to pay the asessments being deferred for a specified period of time. Funds in the deferral fund may be invested as other city funds are invested, or in more restricted ways as determined by the legislative body. Any investment of the funds in the deferral fund shall comply with federal arbitrage rules.

10705. A city may increase the principal amount of bonds issued under this division by an amount sufficient to fund a program pursuant to this chapter. The proceeds of bonds issued for this purpose shall be placed in the deferral fund created pursuant to Section 10704, and may be used for no other purpose than financing deferrals. The proceeds may be invested in interest-bearing securities of the federal government with maturities occurring on or before the maturity of the bonds issued pursuant to this section. Any investment of those bond proceeds shall comply with federal arbitrage rules (26 U.S.C. Sec. 103 and the rules adopted pursuant thereto).

10706. The amount of any deferred assessments, including interest at a rate determined by the legislative body, shall be due and payable whenever the parcel of property upon which the assessment was levied is transferred, or at the time of last maturity of the bonds issued for the improvement pursuant to this division, or at other times as determined by the legislative body.