Split-Rate Property Taxation in Detroit: Findings and Recommendations

Summary for Policymakers

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Introduction and Context

Detroit's local tax structure emerges from a decades-long history of industrial restructuring, migration patterns, and a host of other factors that have depopulated and reshaped the city, including migration to suburbs due to subsidized highway development, white flight and racial unrest, and employment dispersion. The consequence of these trends is a persistent, self-reinforcing dilemma: properties of all types are taxed at rates that exceed most other large United States cities but have the lowest market values of any large city. Over time, chronically low taxable values cause local governments to pass higher tax burdens onto each dollar of property value, hastening capital flight and causing further reductions in the tax base. Without a good option to stabilize revenue, cities in distress will cannibalize remaining property value.

Collecting more taxes on fewer properties has created significant challenges for residents and investors in Detroit. High tax rates on residential properties correspond to higher rates of tax delinquency, home abandonment, and foreclosures. Meanwhile, almost all new construction requires fixed-term or permanent exemption from the tax structure. Detroit property owners need incentives that reward development or redevelopment; homeowners and employers need relief from high effective property tax burdens; and local governments need to expand their tax base. A solution that converges on all these needs is a split-rate property tax system.

What a Split-Rate Tax Does

A split-rate property tax applies differential tax rates to the taxable value of properties, with a higher rate applied to land value and a lower rate applied to structures and improvements. In this way, the property tax system provides increased efficiency; that is, less distortion in development timing and capital improvement decisions by property owners. Adoption of a split-rate property tax system discourages the holding of vacant and underutilized property and accelerates development and redevelopment of property.

Past research affirms that taxing land promotes economic growth. Anderson (1999) has shown that the adoption of a split-rate tax system will speed the timing of development and increase the capital intensity of development in cases of decentralizing or declining cities such as Detroit. Oates and Schwab (1997) analyzed Pittsburgh's adoption of a split-rate tax system and found that "…the reliance on increased land taxation played an important supporting role by enabling the city to avoid rate increases in other taxes that could have impeded development." In addition to positive effects on investment, land taxes are widely considered an optimal source of local public revenue because they match government spending to the value it creates (Arnott and Stiglitz 1979; Glaeser 1996; Mirrlees et al. 2011). Because land cannot be withdrawn, taxing it is also more fiscally productive.

Beyond the known effects of a split-rate tax on growth, this report also evaluates whether it would improve effective tax rate equity, both between similar properties and across properties of different value. Analysis of immediate and long-term effects on low- and middle-income homeowners is included.

Findings and Forecast

Three technical papers produced for this study cover subjects of central importance to the City of Detroit: tax delinquency, business formation, and property value effects.

First, analysis of Detroit's recent reassessment shows that tax foreclosures are reduced significantly when effective tax rates on residential properties are lowered. Furthermore, current-year delinquency rates are reduced, and homeownership rates increase.

Second, an analysis of Pennsylvania municipalities that adopted split-rate tax systems shows a sizable, statistically meaningful, and immediate increase in the number of business establishments within those municipalities.

Finally, the experience of Pennsylvania municipalities suggests that there is a statistically significant, positive effect on real property market values after initial implementation, with modest declines in land values offset by increases in the value of structures.

Tax Delinquency, Foreclosure, and Homeownership

- Tax reductions on residential property in Detroit would generate decreases in tax delinquency and foreclosure and increase homeownership rates. If Detroit implemented a 5:1 split-rate tax, the reductions alone would reduce the foreclosure rate by 8.6 percent. Homeownership rates would modestly increase, while current-year tax delinquency would modestly decrease.
- The effects would be greatest in the year following the change, with lesser effects lasting at least three years.
- These estimates support the notion that, if a split-rate tax were to be implemented in Detroit, it would improve tax compliance and increase homeownership among residential properties.

Business Formation

- Based on the experience of Pennsylvania municipalities, there is a sizable and statistically meaningful immediate increase in the number of new businesses when municipalities switch to a split-rate tax system.
    - The increase in new businesses is most apparent in the wholesale, retail, construction, manufacturing, and transportation industries.
    - Losses are observed in service industries, and to a lesser extent in the finance, insurance, and real estate industries.
- The initial increase in the number of new businesses is followed by a slow but significant linear decline of approximately 1.5 percent per year in the five years after implementation.
- After the initial implementation of a rate split, marginal changes to the split-rate ratio do not seem to coincide with changes in the number of business establishments in a municipality.

Property Values

- Switching from conventional property taxation to split-rate taxation has a significant, positive effect on aggregate market values. The average effect of changing split-rate parameters during the sample period is much smaller, and its size is sensitive to empirical specifications.
- Effects differ across property types:
    - Switching to split-rate taxation has significant, positive effects on residential and commercial property values.
    - Compared to residential and industrial property classes, commercial property values benefit most from split-rate taxation, suggesting opportunities to revive commercial districts.
- The effect of split-rate taxation on land values is negative, but small compared to growth in total property value.
    - At most, land values fall by about 2 percent under a 2:1 tax ratio, or 8 percent under a 5:1 tax ratio.
    - Using appropriate valuation methods is crucial for the implementation of a split-rate tax system. Accurate valuations are also important when examining the effects of implementation.

Detroit Forecast

Revenues

- The baseline forecast, using a 5:1 tax rate ratio phased in over five years, estimates a 16.3 percent growth in the total value of taxable property from 2019 to 2024, or 3.1 percent annualized growth.
- The City general levy increases by 10.9 percent over the forecast period (2.1 percent annualized) and the City debt levy increases by 8.4 percent (1.7 percent annualized). These estimates are conservative; additions to the levy from taxable value (TV), uncapping, or new construction are excluded from the model.
- All other tax levies see comparable growth, except the 1-mill Downtown Development Authority (DDA) administration levy, which grows by only 4.4 percent.
- Potential levy growth is greatest for the Detroit Public Schools (DPS) operating levy because its tax base excludes principal residences, a property class with substantial tax reductions.
- DDA tax capture revenues are forecast to grow by 46.4 percent.

Effects on Homeowners

- Improved residential properties—primarily owner-occupied and rental housing—receive an average reduction of 18.3 percent in property tax bills by the end of the phase-in period.
    - Owner-occupied residences alone see a 17.5 percent reduction, an average savings of $160 per year. This compares favorably to the 17.9 percent exemption received by Neighborhood Enterprise Zone Homestead (NEZ Homestead) applicants. Properties not receiving tax abatements see a higher average reduction of 19.1 percent.
- Almost all neighborhoods see tax savings, with lower-value housing seeing moderately greater savings. Increases in housing values are concentrated in Midtown (12.0 percent) and Downtown (14.7 percent). These areas are dominated by residences with NEZ Rehab and NEZ New tax abatements, which relieve taxes on improvements and thus reduce tax savings from a lesser improvements tax. Tax-abated residences see tax savings compared to their post-abatement tax burden.

Recommendations

- Implement a split-rate property tax system, with a higher tax rate applied to land and a lower rate applied to structures and improvements.
- When choosing the split-rate ratio, consider taxing land at least five times the rate of structures and improvements (i.e., a 5:1 ratio). The land-to-structure ratio could be phased in over time.
- To ensure optimal implementation of a split-rate tax system, taxable land values must be measured accurately and reflect market values.
- For maximum effect, include all units of local government in the split-rate system implementation, to the extent allowable under Michigan law.
- Reevaluate commercial tax abatement underwriting.
- Reconsider the role of the NEZ Homestead program under a split-rate tax system.
- Inform lenders about the implications of changes to the tax system to increase visibility and accelerate market response.
- Use available land price indices or cost-approach methods to validate local sales data.
- Advance policies to reduce accrued delinquent taxes to speed the realization of benefits from a split-rate tax structure.