Urbanizing for Equity: Harnessing Upzones as a Redistributive Policy Tool

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Abstract

Alternative land use policies are needed to ensure equitable housing. This article explores the often lottery-like characteristics of significant land value increases that certain property owners realize following local zoning changes. Traditionally, property owners enjoy a financial windfall from land use modifications when provided the opportunity to redevelop to a higher density or sell to a developer. We propose an alternative policy that enables cities to capture a portion of this land value increase in order to fund housing equity priorities.

Introduction

The *New Urban Agenda* urges the reconsideration of equity as a fundamental component of urbanism. Although cities have long been places of opportunity, urbanization often prompts an increased cost of living, housing shortages, and other externalities that disproportionately burden low-income and poverty-stricken individuals and families. To respond to this paradox, the *New Urban Agenda* declares, "We commit ourselves to promoting equitable and affordable access to sustainable basic physical and social infrastructure for all" (UN, 2016: 7). If urban developments are to be sustainable, they must "leave no one behind" (UN, 2016: 5).

Beyond envisioning equitable cities as a desired outcome, the process of urbanization also offers equity-related challenges and opportunities. At a micro level, cities grow by the parcel or lot. A family farm begets a group of single-family homes, which begets an urban community of mixed use, multistory buildings. Even historical city centers grow taller and denser. The new development that enables urbanization creates an inequitable economic bounty; few mechanisms exist to redistribute the profits associated with new construction and rising land values.

In growing economies, changes in allowable land use often facilitate increased land values. This phenomenon is simplest as a function of density—as the allowable density of a land parcel expands, the value of the land usually increases. In the United States, local zoning processes typically determine land use and associated changes. Traditional zoning policies enable landowners to enjoy the financial benefits associated with zoning changes by selling or redeveloping properties to take advantage of newly allowed uses. In either scenario, the public action of zoning creates private wealth through increased land values.

Zoning changes can be a boon to private landowners, but land value increases create additional costs for renters and first-time homebuyers. Redevelopment can catalyze gentrification and the displacement of low-income renters. Although affordable residential density fosters access to the benefits of cities, the urbanizing process tends to exacerbate economic inequalities.

In response to the inequality inherent to urban growth, this article proposes a policy that enables cities to incorporate equity priorities into zoning changes. Rather than allowing for zoning changes to enrich private landowners, the proposed policy captures this wealth for redistributive purposes. The creation of Upzone Development Rights (UDR) separates the ownership of newly created allowable uses from the ownership of the land and its existing use. This article explores the potential for how such a policy might work in practice, acknowledging the likely political and legal challenges to such a radical innovation. This article contributes to the implementation of the *New Urban Agenda* by proposing an innovative policy tool that integrates equity into the development agenda.

Upzone Development Rights Policy Overview

In tight property markets with relatively few housing vacancies, existing zoning policies enable development demand and potential to build up in desirable locations. Unrealized demand percolates until cities grant permission to build new densities or uses. When governments allow for denser development in certain areas, they create bottlenecks of development demand. This excess demand drives up the market value for the properties within newly zoned areas.

Zoning decisions are (usually) strategic and tend to reflect existing or future infrastructure or growth trends. However, we use the term *lottery-like* to describe the somewhat arbitrary nature of exactly where zoning boundaries exist. An *upzone* refers to a defined geographic area within an urban setting rezoned for a higher, denser, or more profitable use.

Zoning boundaries can distinguish two parcels that may experience the characteristics of their neighborhood in very similar ways. For instance, two neighboring plots may benefit from a neighborhood's transportation access, safety, schools, and commercial establishments, but one lot may be zoned for midrise development and the other may permit only a single-family home. On either side of the zoning boundary, stark differences are likely for properties and property owners. Whereas a newly upzoned home may become a target for prospective developers previously unable to develop multifamily or commercial development in the area, the value of a similar home outside the zoning boundary remains relatively unchanged. This phenomenon creates winners who, much like those in a lottery, receive significant wealth despite taking the same action (or inaction) as their unlucky neighbor.

Rezoning can transfer significant value to property owners who win this lottery. We draw on the conceptual framework of Hagman and Misczynski (1978) and refer to property value gains created by public action as *windfalls*. Property owners enjoy some legal protections against zoning changes that decrease their property values, but they typically enjoy the entire increase in value that zoning and other publicly funded improvements create. Governments do expect indirect financial benefits due to increased property tax assessments, but greater tax revenues are comparatively small and often delayed by several years.

This article proposes that the public should benefit from the spikes in property values created by zoning policies, and once captured this wealth should help increase equity. A dedicated revenue source for redistributional purposes can serve as a meaningful antidote to the negative impacts of the urbanizing process on low-income populations. This practice embeds an equity component into urbanization, extracting value for redistribution only when market forces recognize land value increases.

The idea of windfall recapture is not novel in theory, and cities already possess some tools for capturing value from property owners. Several municipal finance tools harness the newly gained property values from public-sector investments to help finance those investments. Cities across the United States use instruments like tax increment financing, local improvement districts, impact fees, and the sale of development permissions to pay for investments within particular communities. Our proposed policy, UDR, is a variation on the sale of development permissions.

Our proposal differs from existing policies on a few key points. First and most important, we specifically address increased value for landowners resulting from zoning changes rather than capital projects. Unlike tools used to finance infrastructure projects, zoning increases do not require financing. Through a UDR system, cities obtain revenues not directly offset by corresponding costs. If windfalls fund equity investments, property owners within an upzone may not receive private financial gains from city zoning policy. Instead, we argue that the benefits of the wealth (property value increases) created through public action (upzones) need not accrue exclusively for the neighborhood where the wealth was created. Capturing windfalls for public purposes can fund broader issues of urban equity such as housing subsidies or targeted investments in less prosperous neighborhoods. This represents a significant departure from other common tools for capturing land value.

Second, we advocate that cities allow for market-based pricing systems when granting development permissions. Through the similar value-capture tools mentioned previously, government agencies determine the price or rate that community members pay for the public investments from which they benefit. The market-based approach, through a bidding or negotiation system, could maximize the value capture without imposing costs that disincentivize development or skew the market. This component is essential for ensuring the intended outcome of urbanization (that is, fostering the growth of cities so that more people may access benefits and lower prices from increased supply). To harness urbanization without impeding it, a UDR policy must not substantially delay or reduce multifamily development, because exacerbating current multifamily supply-demand imbalances could unintentionally offset equity benefits. However, if administered effectively, UDR could equitably redistribute gains without affecting the incentive structure to build.

Third, we argue for collecting an unmaterialized value by imposing a new cost to the buyer, rather than selling a development standard of value—like density bonuses—or taxing a realized property value increase. We expect that developers have a finite willingness to pay for parcels to develop newly allowable higher-density projects, so they will cut acquisition costs elsewhere in order to secure UDR. Imposing a new expense to bid for and secure the development permissions for the newly acquired parcel should lead to a corresponding decrease in the price the developer offers to the seller. Simply, we expect the developer to offer less to the property owner, thus transferring most of the windfall to the government for redistributive purposes.

Although a UDR policy reduces the incentive for homeowners to sell, the number of upzoned parcels likely remains a finite resource. Therefore, a homeowner may still extract a modest windfall compared with similar parcels outside the upzone. Rather than eliminating windfalls, this proposal merely enables a city to collect revenue to reinvest toward equity goals. Many cities already experience neighborhood opposition to upzones, and a UDR system may even foster broader support for upzones as the resulting wealth creates citywide benefits. Regardless, it is essential that cities maintain their commitment to upzones in order to achieve the positive outcomes density can provide.

Finally, we firmly assert that the recaptured windfall must advance "equitable and affordable access" to a city. Although we stated previously that a UDR system enables cities to obtain revenues not directly offset by corresponding costs, we view certain urbanizing trends such as rent increases, gentrification, and the displacement of low-income households as the costs of upzones. The upzoned parcels may not exemplify these trends, but a more holistic perspective reveals these aggregate effects of urbanization. The specific needs of a city should determine how exactly to use these funds, but programs such as rent subsidies, downpayment assistance, and community revitalization projects may appropriately promote equity goals while supporting urbanization and reaping the benefits that upzones and density provide.

To present a compelling argument for such a policy innovation, we first establish the connection between zoning, windfalls, and equity. We then describe a brief case of windfalls in practice. We then present a review of existing mechanisms for capturing windfalls. We conclude with our policy proposal for a UDR system based on market forces.

Zoning, Windfalls, and Equity

Our policy proposal echoes long-ignored calls to better moderate the effect of public policy on land values. Hagman and Misczynski (1978) described the lottery-like nature of the status quo: planning, even when conducted in the public interest, can be perceived as an "arbitrary and capricious […] non-system of planning" through which a landowner could win or lose millions by "the decision of a government body or by the stroke of a planner's pen" (Hagman and Misczynski, 1978: 21). Although city- or neighborhood-level scrutiny may convey logical land use policies, parcel-level decisions about zoning boundaries rarely result from such careful analysis.

Land use regulation is an effective tool for balancing the density needs of a growing city with other urban priorities, such as open spaces, the preservation of historic buildings, and affordable housing. Changes in land use policy, however, often create new inequities. When residential

neighborhoods are upzoned, seemingly random homeowners may sell their properties at inflated prices, reflecting new development potential. Under this system, homeowners capture the entire windfall attributed to zoning actions. Neighbors outside of a rezoned area lack this opportunity. Mitigating the ability of existing property owners to capitalize on zoning changes would lessen the inequities currently inherent to zoning changes.

By offsetting the lottery-like effects of upzones, a windfall capture scheme also dampens the potential for politically motivated zoning boundaries. Developers and influential property owners have less incentive to disrupt planning if the parcel-level decisions have lower financial stakes. Planning can focus on maximizing public benefit rather than engaging in disputes centered on private benefit concerns. Thus, recapturing windfalls would both diminish the inequitable fortunes caused by zoning and reduce the likelihood that private interests drive parcel-level planning decisions.

The link between zoning and geospatial inequity related to housing affordability also justifies harnessing zoning as tool for the redistribution of land values. In many parts of the country, the price of housing generally reflects the price of construction; however, in particular high-cost cities, the traditional land-value and construction-cost model poorly predicts the price of housing (Glaeser and Gyourko, 2002). Instead, evidence suggests that zoning and land use restrictions prompt higher housing prices (Glaeser and Gyourko, 2002). Although zoning provides a variety of public benefits related to the strategic growth of a city, its link to increased housing costs and geospatial inequity validate distributing the financial gains from zoning to those adversely affected by zoning and land use restrictions. Other city planning strategies can mitigate these negative externalities, but we advocate harnessing the windfalls through a value capture mechanism and investing them in equity-focused strategies.

A Brief Case of Windfalls in Practice

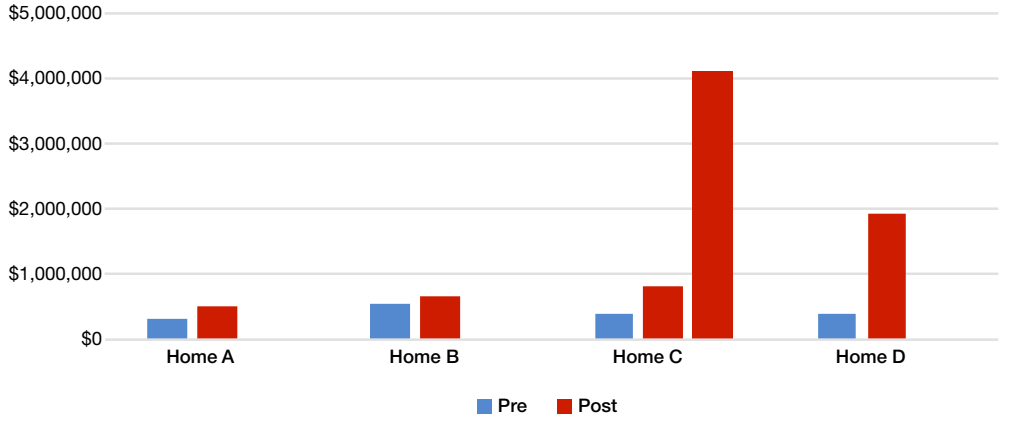
To illustrate the phenomenon of windfalls, we examine the market value changes of four single-family homes within or adjacent to the Roosevelt Upzone in Seattle, Washington. In 2012, the city of Seattle increased density and height allotments in several zones surrounding a future light rail station in the Roosevelt neighborhood. Large public investments like light rail generally increase property values, but examining the vastly different resale values of a few similar properties illuminates how zoning affects values independently from public investments.

This case presents four properties that, due to their proximity, should benefit similarly from the public and private investments in the area, including the forthcoming major infrastructure improvement to the neighborhood. All four homes are in the same neighborhood; however, homes A and B were not rezoned for higher allowable building uses, whereas homes C and D were. Exhibits 1 and 2 illustrate the increase in market value and percentage increase in market value, respectively, before and after the Roosevelt Upzone. The median sale prices of homes in the Roosevelt area increased at an average rate of 6.84 percent per year during the past 5 years.[1]

[1] http://www.trulia.com/real_estate/Roosevelt-Seattle/6869/market-trends/.

Exhibit 1

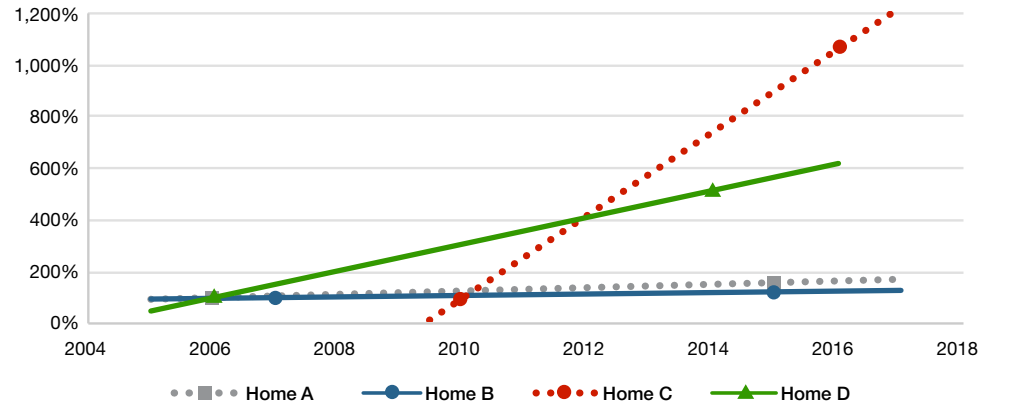
Pre- and Post-2012 Roosevelt Upzone Market Value



Source: King County Assessor's Office, parcels 922140-0695 (A), 922140-0555 (B), 952810-2875 (C), and 952810-2640 (D)

Exhibit 2

Market Value as a Percentage of Pre-Upzone Sale Price (2012 Roosevelt Upzone)



Source: King County Assessor's Office, parcels 922140-0695 (A), 922140-0555 (B), 952810-2875 (C), and 952810-2640 (D)

Home A has two bedrooms, one bathroom, and 1,020 square feet. It was built in 1919 and is in fair condition.[2] Home A sits on a 2,400-square-foot lot that remains zoned for single-family homes and is three blocks from the heart of the Roosevelt Upzone. Home A sold for $332,000 in 2006 and resold for $525,000 in 2015. This represents a 58-percent market value increase over 9 years. This increase breaks down to $21,444 per year, or 6.5 percent per year of the 2006 value equally distributed over 9 years, similar to the overall neighborhood average.

[2] Parcel records and condition quality designations are according to the King County Assessor's Office.

Home B sits one block east of home A in the same residential neighborhood surrounding the Roosevelt neighborhood commercial development. Home B is a three-bedroom, two-bathroom, 1,750-square-foot single-family home built in 1920. Home B is also in fair condition and, like home A, its zoning did not change during the 2012 rezone. Unlike home A, home B's 3,807-square-foot lot is currently zoned for lowrise development, although the only existing structure is a single-family home. Home B sold for $550,000 in 2007 and resold for $673,000 in 2015. This represents a market value increase of 22 percent 8 eight years. This increase breaks down to $15,375, or 2.8 percent, per year of the 2007 value equally distributed over 8 years.

Because no single-family zones were upzoned during the 2012 Roosevelt Upzone, the closest comparisons are single-family homes built in lowrise zones, like home B, that sold after their lots transitioned from lowrise to midrise zoning. Home C spent the better part of the past two decades as a single-family home on a 4,120-square-foot lot zoned for lowrise development. During the 2012 rezone, home C's zoning designation changed to midrise. Home C is a 960-square-foot, two-bedroom, one-bathroom single-family home built in 1919. In 2010, home C sold for $388,500. In 2015, after the rezone, home C sold for $815,900, which represents an increase of 110 percent over 5 years. The increase breaks down to $85,480, or 22 percent, per year of the 2010 value equally distributed over 5 years. Home C sold again in August 2016 for $4.133 million, with no property improvements since the previous sale. Comparing this second sale to the 2010 sale price represents an increase of 964 percent over 6 years. This increase breaks down to $624,083, or 161 percent, per year of the 2010 value equally distributed over 6 years.

Home D experienced a similar transition as home C and previously existed as a single-family home on a 4,634-square-foot lot zoned for lowrise. The structure, built in 1904, featured two bedrooms, two bathrooms, and 1,410 square feet of finished space. During the 2012 Roosevelt Upzone, home D's zoning changed to midrise. Home D was demolished 2 months after its most recent sale. The demolition illustrates the divergence of land values from the value of property improvements after land suddenly inherits additional development potential. Home D best depicts this land value increase after an upzone, because it sold for a highly inflated price almost immediately before being torn down. Home D sold for $377,500 in 2006 and, following the rezone, sold for $1.946 million in 2014. This price represents an increase of 415 percent over 8 years, which breaks down to $196,000, or 52 percent, per year of the 2006 value equally distributed over 8 years. On the former site of home D, construction began on a midrise apartment building 2 weeks after demolition of the single-family home.

A comparison of market values for the properties outside of the rezone (homes A and B) with the values of those within the rezone (homes C and D) illustrates divergent value trends. Whereas this brief case cannot account for an isolated monetization of zoning changes in this neighborhood, the examples of a few single-family homes that were upzoned to midrise and subsequently sold demonstrate the significant discrepancies in land value increases compared with neighboring homes outside of the upzone. Rather than allow for zoning to drive such disparate trends, recapturing and redistributing the zoning-induced windfall would harness that value for the public good.

Existing Mechanisms for Land Value Capture

Land value recapture is already a well-established policy tool. Municipal financing tools such as tax increment financing, local improvement districts, and impact fees exploit the presumed value engendered by public investment in order to help pay for the improvement. Existing policy tools take advantage of the positive financial forecast attributed to the public benefit infrastructure project.

Through tax increment financing, governments finance infrastructure improvements by earmarking property tax revenues from the area that the improvement is likely to benefit (Dye and Merriman, 2006). Local improvement districts enable benefiting properties to finance capital improvements through bond issues by forming special assessment districts and paying the debt obligations for the projects that benefit them over time through assessments on their property (MRSC, 2009). Some local governments require impact fees from new developments to provide public capital facilities for that development.

> Local governments throughout the country are increasingly using impact fees to shift more of the costs of financing public facilities from the general taxpayer to the beneficiaries of those new facilities. As a general matter, impact fees are capitalized into land values, and thus represent an exaction on the incremental value of the land attributable to the higher and better use made possible by the new public facilities. (APA, 1997)

Our policy proposal relies on a sale of development permission system as an administratively feasible and effective structure to frame UDR for equity reinvestment. A sale of development permission system is predicated on government controlling the right to develop and granting such permission in exchange for contributions toward public goods—in this case, purchase of the right to build on newly awarded allotments within a particular zone. Under a sale of development permission system, a government can recapture unearned windfalls as a return to the community that created the value (Hagman and Misczynski, 1978).

The experience of São Paulo, Brazil, provides a clear example. During a budget crisis in the 1990s, the São Paulo municipality began granting the right to exceed building height restrictions within certain zones in exchange for "equivalent value in monetary resources, land, or public works" (Froes and Rebelo, 2006: 1). The funds generated through the sale of additional occupancy allotments by the São Paulo municipality helped finance part of the São Paulo Metro Line 4 project (Froes and Rebelo, 2006). São Paulo's regulations do not require density fee payments from developers "for buildings that fall within the normal limitations on floor space." However, in specified high-development zones, developers must pay for additional floor space above normal density (Peterson, 2009: 76).

Under São Paulo's system, once the total stock of new development potential was tallied, the system allows for the "transfer of individual lots … through property certificates … which are not linked to any specific lot" (Froes and Rebelo, 2006: 5). The prices of these permissions are set on an area-by-area basis by the municipality (Froes and Rebelo, 2006). The funds generated from this system are dedicated to financing the urban investments outlined in the law that created the sale of development permission system (Peterson, 2009). An additional benefit to the development permission systems is the speed at which government funds can be materialized.

> This form of syndication of additional construction area allows the anticipation of resources for the implementation of public works, which are going to enhance the appreciation of the value of the areas which they serve. The sale of potential construction through auction by the Stock exchange also allows for a faster process and gets significant resources in volume in a shorter period of time. (Froes and Rebelo, 2006: 5)

A similar policy in the state of Maharashtra, India, allows developers to buy additional floor space beyond the maximum allowable amount under current policy within two specific districts. According to Peterson (2009: 77), for "upper-income housing, the cost per square foot of additional building area will be set at 80 percent of the price per square foot of land in the assessment zone."

Systems based on transfer of development rights (TDR) operate similarly, although they are founded on different principles. TDR systems allow low-density property owners to monetize their forgone development potential by selling the potential to enable extra density in a high-density area. TDR systems can incentivize the preservation of open space, historic buildings, and rural areas, but they do not account for the negative externalities of high-density spaces on disadvantaged populations nor the inequitable process that designates some property owners as TDR-receiving sites whereas others lack that opportunity. In short, TDR systems help preserve some public benefits, but the wealth created through density increases stays in private hands.

Upzone Development Rights: A Market-Based System

Although windfall capture mechanisms exist, they often finance infrastructure investments more directly beneficial to those paying for development permissions, thus resembling the theoretical framework of a special purpose assessment. Using these revenues to redistribute zoning-induced wealth to achieve intracity equity creates an additional degree of separation between payer and beneficiary.

The aforementioned examples of sale of development permission systems in Brazil and India rely on unilateral pricing, whereby local governments set the prices for development permissions. However, unilateral price controls risk stifling or significantly altering the development landscape if pricing schemes do not reinforce market preferences. Alternatively, a market-oriented pricing system for development rights would maximize the efficiency of the value capture and minimize the disincentives for development (Hagman and Misczynski, 1978).

A market-based approach could involve blind bidding, public auction, or a negotiation system for development permissions, thus enabling a city to recapture the maximum windfall while protecting incentives to develop.

Under this market-based proposal, ownership of development rights for achieving new zoning maximums could be purchased divorced from ownership of the land, which could trigger a secondary negotiation between the landowner and the holder of newly acquired development permission (Hagman and Misczynski, 1978). Market-based TDR systems and private purchases of air rights provide precedents for enabling market mechanisms to determine a monetary value for development rights unique to each transaction.

Compared with a government pricing system, a market-based system minimizes the risk that a development permission price is set too low and substantial windfalls are not captured, or that the price is set too high and development is stifled in areas prioritized for denser development. However, a few pitfalls to this system persist. A bidding or auction system may lead to a slowdown of development if owners of development rights do not utilize them or are unable to negotiate successfully with landowners, although this risk mirrors dynamics in the existing real estate market.

Existing city permitting structures could incorporate a market-based UDR system. Although political hurdles are inevitable with any large-scale policy change, especially one with redistributive intentions, the untethering of the value of increased development potential from property acquisition costs can be streamlined. Once zoning authorities adopt upzones, construction-permitting agencies could create permits specifically for achieving new zoning potential, which the market could then monetize for density-increasing redevelopment. With marketable development permissions a new requirement, the value of the permissions, which the developers pay the city to acquire, should lead to a corresponding decrease in the price the developer offers to the seller if we assume developers have a maximum of land acquisition costs based on a project's earning potential. At this point, the buyer can make an offer to the seller and negotiate a price for the home.

Zoning changes that allow for additional density, height, or uses of new developments in an area will trigger the creation of UDR. Each parcel within the upzone area is bestowed affiliated UDR; however, consistent with the aforementioned proposals for market-based pricing systems, the UDR for each parcel is marketed as a separate, severable entity. A negotiation system between the government and one or multiple bidders will determine the UDR value from that upzone, thus reflecting the market value for increasing density on a particular lot. Through processes outlined within adopted city policy, developers must purchase from the city the UDR of each parcel on which it wishes to build to the newest zoning potential. The city will transfer all revenue from the sale of UDR, net administrative costs, to the designated agencies, programs, or redistributive mechanisms charged with improving urban equity. UDRs would capture value increases before transactions with, or redevelopment by, property owners; therefore, this system would enable most of the capital previously granted to homeowners to provide funding for redistributive purposes administered by the local government.

Conclusion

The Habitat III United Nations conference sought innovative approaches to urban sustainability, prioritizing the role of equity in development. A UDR system responds to this challenge by radically altering land transactions in urbanizing areas. By harnessing the financial windfalls created through public land use decisions, a UDR system can simultaneously tame the lottery-like repercussions of current zoning practices and fund investments in more equitable cities. Although the political barriers for transferring private gain into redistributive policies are likely to be high, this policy innovation that embeds equity into the urbanizing process deserves consideration.

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