

Working Paper 2018-1

**CENTER FOR APPLIED HOUSING RESEARCH**

School of Public Affairs & Civic Engagement

San Francisco State University

Fiscal Zoning: Why Does it Happen? How Often Does it Happen? And  
Does it Need to Happen?

Jeremy Hill  
November 1, 2018

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## **Abstract**

Among the commonly perceived obstacles to increasing housing supply in California are excessive regulation, local homeowner resistance to new development, and developer preference for large, single-family high-value residences over lower-value high-density projects. In addition to these issues, many academics and activists have argued that city governments do not do affordable housing advocates any favors when they show preferential zoning treatment to commercial land use over new residential development. This tendency is commonly referred to as fiscal zoning. This review presents a survey of the literature on fiscal zoning in order to provide some refreshing alternative perspectives on how municipal leaders (including elected officials, city managers, and voters themselves) can re-think their perspective on zoning and land use decisions and the relationship between these factors and a municipality's fiscal health. The three areas in which this review found promising research are: indirect impacts from zoning are not factored into land use decisions; multi-family housing could provide more tax revenue on a per-capita basis than single-family residential land use; and smart growth, which often combines residential and retail, could have significant fiscal benefits for cities.

# **Fiscal Zoning: Why Does it Happen, How Often Does it Happen, and Does It Need to Happen?**

**Jeremy Hill<sup>1</sup>**

**November 1, 2018**

## **INTRODUCTION**

The need for a greater supply of affordable housing is one of the most pressing concerns in California in 2018. Politicians, social commentators, activists, and academics all have raised the issue and many have suggested that one stumbling block for increasing the supply is the zoning preferences of city managers and elected officials. One common narrative that circulates around this issue is that cities, as a result of Proposition 13, are reluctant to zone for sufficient new housing because residential neighborhoods do not generate enough municipal revenue in exchange for the level of public service that must be provided to support them. Instead, according to this narrative, municipal zoning decisions show preference for commercial and industrial land use and cities are less inclined to zone for new residential land use and development. This review will examine this narrative by summarizing existing research. First, the basic principles of “fiscal zoning” will be outlined in light of California’s Proposition 13. Second, research that has examined how frequently, and where, this type of zoning actually occurs will be presented, some of which suggests that the frequency of fiscal zoning has been overstated. Third, the review will summarize solutions that have been proposed that would alter how state and local revenues are raised. Finally, the review will present three sets of existing research that should demonstrate to city managers and other elected officials that the actual benefits of fiscal zoning to avoid residential land use might not be as strong as previously understood.

## **FISCALIZATION OF LAND USE**

Zoning based on tax revenue is generally referred to now as the “fiscalization of land use.” Karen Chapple (2018) defines this concept as “when local governments make local land use decisions in order to maximize revenue generation through both the attraction of tax-generating uses and the reduction of government service costs” (295). This definition itself suggests that local governments could and perhaps should be making different land use decisions based on factors other than revenue generation and service costs, including equity or sustainability. The term was first coined by Dean Misczynski in 1986, in an article on the after effects of California’s Proposition 13 (passed by voters in June 1978), a successful and now legendary ballot initiative that constrains local government’s ability to generate property tax

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<sup>1</sup> Graduate Associate, PACE Center for Applied Housing Research, San Francisco State University. E-mail: jhill5@mail.sfsu.edu

revenue.<sup>2</sup> Many scholars have described the effects of Prop 13 in stark terms: Jonathan Schwartz (1997) refers to California local governments as “prisoners of Proposition 13,” and Jack Citrin (2009) has referred to “the fiscal noose it placed around the neck of California government” (1). Several scholars have argued that one of the principal effects of this law is to force city governments to look for revenue in other places besides property tax, whether it may be by “chasing the sales tax,” limiting residential development, or increasing their use of fees and other charges not covered by Proposition 13 (Citrin 2009; Sexton et al 1999; Barbour 2007; Schwartz 1997; Gottlieb 2006). Jonathan Schwartz (1997) has argued forcefully, “the reliance on sales taxes to replace lost property tax revenues has motivated planning and economic development decisions that sacrifice the long-term fiscal and environmental health of communities for short-term gains in sales tax producing land uses.” Barbour (2007) also validates the notion that cities have had to turn to alternate sources of revenue, including additional fees and charges. The notion that city managers prefer sales tax-generating land uses is supported by a comprehensive survey of California city managers conducted in 1999 (Lewis and Barbour 1999). Paul Lewis and Elisa Barbour surveyed top administrative officials in 330 California cities. Without asking about specific policy behavior, they asked the officials to rank a range of factors influencing land use decisions in terms of their preference as city managers. Perhaps unsurprisingly, the ability to generate new sales tax was the most popular response (city council support was second) and meeting affordable housing needs ranked near the bottom of the list.

As this review shows, Proposition 13 is frequently cited as an obstacle to efficient or equitable development, and the ballot initiative certainly did create many thorny issues of equity and public service provision. Two scholars who have studied its effects have also suggested, however, that the extent of fiscal zoning often attributed to the law’s passage in 1978 could potentially be overstated (Seljan and McCubbins 2015). Karen Chapple, even while analyzing fiscal zoning as a phenomenon, also cautions against attributing too much causality to the link between the proportion of retail and the explicit “chasing of the sales tax” that a strong reading of “fiscalization of land use” would imply; she has suggested that there are only a handful studies that have found this link, and most of these well over a decade ago. Though these studies suggest that the prevalence of fiscal zoning may be often overstated, it is still important to note when and where it could be happening. One study has demonstrated that the reliance on sales tax for municipal revenues tends to be higher in suburban areas than urban areas, and this has increased the amount of large-scale retail complexes found in the suburbs, and consequently increased the amount of sprawl (Wassmer 2002).

Whether the link between Prop 13 and zoning decisions is considered strong or weak, the importance of municipal revenue generation and the methods available to local governments to raise funds are central issues. As well, the perception that, all else being equal, retail would be preferable to a city’s bottom line, more so than residential development, is a powerful notion that could be hindering the zoning required to rapidly enlarge the state’s housing supply. Drawing on the city manager survey data referenced earlier, Paul Lewis (2001) has suggested that the actual

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<sup>2</sup> The ballot initiative known as Proposition 13 passed in June 1978. The law implemented the following restrictions: limited the property tax rate to 1% of market value; rolled back property assessments to their March 1975 values; limited future value increases to instances of ownership change or new construction; prohibited any new taxes on the sale of real property; and, required a two-thirds approval from voters for any new special taxes in a municipality (Chapman 1998, 438).

result “is largely a fiscalization of municipalities’ land-use *orientations* rather than a fiscalization of land-use *outcomes*” (31, italics mine). This distinction between orientation and outcome is crucial in thinking about how powerful the forces that produce the fiscalization of land use really are; as Lewis and others have pointed out, there is only so much retail to go around and not every city that wants to add retail to their economy will be able to effectively. However, even in the absence of a marked increase in retail over residential land use, the orientation away from residential development still plays a role in causing housing to be underzoned and underbuilt.

## **POTENTIAL SOLUTIONS**

Many scholars who have researched this topic have looked at this problem and suggested that major changes need to be made in how local governments raise revenue, whether this be through increasing their power to raise property taxes or through other more innovative solutions such as revenue sharing within a larger region. For example, with climate change and environmental sustainability specifically in mind, Chapple (2016) has proposed changes to the current tax revenue model that could orient cities toward encouraging residential development. She has suggested that tax reform proposals “return more property tax to municipalities based on their willingness to build more compact, high-density development,” and “share property and/or sales tax regionally, rewarding jurisdictions that meet their regional housing obligations” (22). Building on Lewis and Barbour (1999) and Wassmer (2002), Chapple also argues in the same article that counties could distribute sales tax revenues to cities and towns on a per-capita basis, thus encouraging and rewarding cities that promote residential growth. Schwartz (1997) has also advocated for a tax revenue swap, where more retail sales tax is returned to the state and in exchange more property tax revenue is distributed to local governments. This idea is referenced frequently by scholars investigating this dilemma but so far has not gained much traction politically (Barbour 2007). One change that has gained some momentum in California politics, however, despite many claims that it would be politically untenable is the idea of “split-roll” reform to Proposition 13. Prop 13 has capped property taxes on both residential and commercial property; some reformers have recently pushed for removing the cap on commercial property tax.

Several scholars and policy advocates who have addressed fiscal zoning have argued for making changes to the state’s tax laws that would allow local governments to raise revenue more efficiently without having to prioritize the sales tax and thus allow for more productive and equitable development. Many of these ideas are innovative and potentially quite ground-breaking (Gottlieb 2006; Schwartz 1997; Chapple 2016; Fischel 2004) but they would all require a longer-term implementation, since they would involve significant changes to the state’s laws and maybe even constitution. This review, however, presents and summarizes three different strands of research (not all of which have fiscalization of land use explicitly in mind) that could demonstrate to city managers, elected officials, and voters, that even in the current legal and political landscape, zoning for more residential land use could still be better for a city’s fiscal “bottom line” than zoning for retail or other sales-tax generating land use. The research gathered and synthesized in this review will hopefully show the miscalculation involved in blindly chasing the sales tax and argue that more savvy “fiscalization of land use” could actually involve zoning for more housing and increasing a city’s residential revenue base.

The three unique planks of this argument are as follows. First, there are quite possibly a large set of indirect impacts that result from zoning and land use decisions, which are not factored into the basic equation. For instance, using zoning to encourage retail development leads to a preponderance of low-wage employment opportunities, which hampers the economic vitality of the city or county. Second, residential land use and property tax revenues are still too often considered in terms of large-lot single-family housing. In fact, it might actually be beneficial for cities to encourage multi-family housing because the per-capita tax base is greater. By not zoning for multi-family residential land use, cities could be losing out on a hidden “bargain.” Finally, and connected to the push for more multi-family developments, there are many arguments for cities to encourage “smart growth.” In the long run, smart growth developments are much more efficient and economically sustainable for a city, and smart-growth principles tend to encourage a mix of residential, retail, and office use. The benefits of this style of development include more efficient use of transportation and energy infrastructure, reduced costs of mitigating environmental problems, and increased appeal to both employers and residents. The benefits of smart growth could still use more empirical research, but thinking in terms of mixed-use and encouraging both residential and commercial development is one way for cities to address their fiscal success as well as long-term environmental sustainability.

### **Opportunity Costs and Other Indirect Impacts**

Chapple (2018) has argued that “the conversion of land to sales tax-generating uses in particular may have opportunity costs by crowding out other uses” (294) These opportunity costs are important to think about but hard to understand in a concrete way since we cannot know precisely how the road not taken would have turned out. Still, Chapple argues that one of the opportunity costs could be the chance for higher-wage jobs; if city governments encourage retail at the expense of other commercial or industrial land a preponderance of lower-wage jobs could result. She combined data on conversion of land use parcels from 2007 to 2013 with a compactness index and business and wage information from the National Establishment Time Series and the U.S. Census. She did find that conversion of land from non-taxable use to taxable use was correlated with a jurisdiction’s strong reliance on property and sales tax for revenue, suggesting the potential fiscalization of land use. Most of these jurisdictions were concentrated in suburban areas, a finding that matches the results in Wassmer’s (2002) study as well. She found that a “less compact urban form” was significantly associated with conversion to fiscally lucrative land use functions (299). Furthermore, Chapple’s analysis finds a connection between greater conversion of land use to taxable purposes and wage decline at the census tract level. She concludes that cities may be trading off tax revenue for lower wages within their jurisdiction, which would have its own consequences on overall revenue.

Kurt Paulsen (2014) has also argued that there could be a form of opportunity cost that city leaders are not considering when they make fiscal land use decisions. He has suggested that most fiscal impact analyses used by local governments do not take into account the range of *indirect* impacts that result from each land development decision in a community. Such indirect impacts could include increases in existing retail land values (more customers) if more housing is built, or the possibility that businesses will re-locate or avoid locating in a municipality because of the lack of “workforce housing” if not enough housing is built (Paulsen 2014, 33-4).

## **Fiscal Benefits of Multi-Family Housing**

As Chapple and Paulsen both argue, focusing on the short-term direct impacts can be short-sighted and lead to both fiscal imprudence as well as insufficient housing and overall equity for a city. But even the most direct impacts could be misunderstood by city leaders. Another strand of research works to poke holes in the myth that multi-family housing developments do not provide sufficient property tax base, relative to the large-lot single family dwellings that cities are generally seen to prefer. If city managers are choosing between retail and large-lot single family dwellings, these assumptions might explain their preference for commercial land use. Ryan Gallagher (2016) compiled and analyzed census data from suburban U.S. households from 1980 to 2010. Gallagher argues that households which self-select into apartments tend to be smaller, and thus have the potential to provide more per capita tax base value. It makes more analytic sense to think of the goods being provided by a city on a per capita basis, rather than per household; large households consume more services and therefore their larger tax return for local government might not make up for the increased level of services required to provide. Gallagher found that “because single-family homes have relatively more occupants and school-aged children when compared to apartments, their per-capita property tax base is diluted to a higher degree. Indeed, going back to at least 1975, single-family homes’ disproportionate share of the school-aged population completely overwhelms the influence that their higher property values have on the per-capita tax base” (252).

Gallagher’s focus is not restricted to California and in fact the lens through which he looks at public finance and zoning is one where property taxes primarily fund public services such as K-12 education. However, his observations can still be extrapolated to the issue of whether to zone for new residential development and whether or not there are fiscal benefits to a city for encouraging this land use. Most importantly, the emphasis on multifamily housing’s lower per-capita use of public services is an important corrective for civic leaders who imagine multi-family housing to create a greater strain on public services, though this perspective is potentially based on class and racial assumptions about who lives in these kinds of housing developments. As Gallagher points out, the claims about fiscal value could be a cover or misdirection for larger social and political aversion to multi-family housing, and what looks like fiscal zoning could be more appropriately considered exclusionary zoning. There are many studies that have looked into this tendency, but for the purposes of this review we will focus on the fiscal concerns. The assumption in the review is that city managers, city councils, and local voters, are resistant to zoning for residential land use for mostly fiscal reasons, so the findings presented here will focus primarily on fiscal reasons for changing land use orientations of city governments.

Dorothy Ives-Dewey (2007) has also studied the fiscal impacts of new multi-family housing developments for municipalities and also found the counter-intuitive (to some) evidence that fiscal impact, if there is any, relative to single-family housing is positive for the municipality. Ives-Dewey argues that city leaders are often relying on an older myth about multi-family housing and the size of the population and number of school-age children: “These notions persist despite overwhelming evidence of demographic shifts that have changed the composition of multi-family households. Concern over negative fiscal impacts from multi-family development is unfounded if based on a misunderstanding of demographic conditions” (2007, 40). This focus on the comparison between single-family and multi-family relative to property



tax revenues for education might not have quite as much relevance for California, where Prop 13 limits property tax and schools are funded with state aid, but the re-orientation of municipal leaders' thinking about the fiscal benefits of residential housing, multi-family housing in particular, is still salient. This leads into the third and final plank of this review's suggestions: smart growth.

### **Smart Growth**

The emphasis on higher-density residential developments leads to the third plank of this review's arguments against fiscal zoning: the value of smart growth to a city's long-range fiscal health. Smart growth is a broad term that encompasses a range of planning ideas and values, including an emphasis on overall density, preference for public transit over automobile use, and a mix of land uses and types. Many activists have presented evidence to municipal leaders that smart growth is better for city budgets (Haughey 2005; Muro and Puentes 2004). The evidence does appear to still be mixed, however. Kurt Paulsen points out that capital-intensive utilities such as water, sewer, and waste do appear to be more efficient with greater degrees of density, the evidence is still mixed or inconclusive (mostly because of lack of rigorous data) for more labor-intensive service delivery such as education, social service, and public safety (Paulsen 2014, 29). One research group has compiled seventeen cases studies from municipalities across the U.S., where municipalities had commissioned reports for advice on development decisions. The research group sorted development scenarios into two broad categories: smart growth development, characterized as "more efficient use of land; a mixture of homes, businesses and services located closer together; and better connections between streets and neighborhoods," and conventional suburban development, which they characterize as "less efficient use of land with homes, schools and businesses separated and areas designed primarily for driving" (Fulton et al. 2013, 4). The authors acknowledge the limitations of their research design model (their cases studies did not account for all possible design scenarios, an overall small sample size and need for more data, and the fact that some service costs were broadly estimated), but they found strong support for the value of smart growth. They estimate that smart growth development can save one-third the cost of upfront infrastructure, an average of ten percent for ongoing service delivery, and generate ten times more the tax revenue per acre compared to conventional suburban development. These numbers are not insignificant, and as the authors point out, resonate with much of the previous theoretical and empirical work on smart growth.

### **CONCLUSION**

In order to put the stakes of fiscal zoning in a larger context and understand some of what is at stake, we can look to Daniel Mullins' work on tax and expenditure limitations in general. Mullins (2004) notes that, especially since the 1970s and the anti-tax movement of which Prop 13 is the most well-known manifestation, there has been a larger trend toward limiting local governments' ability to tax and spend, even as the need for resources and services often still grows. Mullins created a data set of 787 metropolitan counties, with fiscal data compiled at five-year intervals from 1972 to 1997. The study measured the effects of tax and expenditure limitations imposed on local governments in these counties and found these limitations had a differential or asymmetric effect based on a county's geography and wealth. Counties in urban cores and those with relatively disadvantaged populations felt the effects of the tax and expenditure limitations more acutely. Mullins makes the case that the "tax limitation movement" has resulted in blunt instruments intended to impose an externally derived definition of fiscal

responsibility on local governments and populations. In so doing, it has often taken its greatest toll on the jurisdictions and populations which can least afford a relative decline in resources and in the availability of public services” (147).

The principal aim of this review has been to address the fiscal benefits and costs of zoning for residential land use, with the larger goal of clarifying what factors increase housing supply (and specifically affordable housing) in California. Even though it is very difficult to establish definitive proof of fiscalization of land use or “chasing the sales tax,” it cannot be denied that powerful notions about the economic feasibility of residential zoning exist in city planning circles. This review has summarized much (though not nearly all) of the existing literature on this phenomenon, including several scholars who have put forth innovative proposals for changing how local government revenue is generated and shared.

Based on the synthesis of research reviewed here we can make a three-pronged case for why city leaders, even in the current political and social landscape, should look to residential development as a way to improve the fiscal health of their municipality. The three planks are: 1) the unintended or indirect impacts of fiscal zoning are not often understood or taken into consideration; 2) the dichotomy between commercial versus residential zoning might be leaning too heavily on fiscal assumptions about single-family residential and not taking the fiscal benefits of multi-family housing into account; and 3) though more research needs to be completed, smart growth, which often combines retail and residential land use, could yield more fiscal benefits to municipalities than is generally understood.

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