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*Property Taxation and
Land Development*

PROPERTY TAXATION AND
LAND DEVELOPMENT

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This Bulletin in Brief

The real property tax, because of its dominant position on the urban scene, has been a source of continuing study for the Bureau of Municipal Research¹. In this issue of *Civic Affairs*, the Bureau investigates the real property tax specifically in terms of the various effects it may have on land use planning.

The property tax exerts numerous pressures on land development. For the most part these pressures have been unintended and remain uninvestigated with empirical data. Yet it is the conclusion of this bulletin that many of these side-effects produce sub-optimal land use patterns, which, in most cases, conflict directly with sound urban planning principles.

The bulletin suggests possible changes in the present system of property taxation. Some of these are mere incremental adjustments in the tax base, and others are more sweeping innovations in the entire structure of municipal taxation. While a few of these reforms have been tried in foreign jurisdictions, others can only be suggested as theoretical alternatives. In any case, each alternative is evaluated not only as a tax, but, also in terms of its impact on land use planning in Ontario.

1. "The Impact of Property Taxes in Metro" *Civic Affairs*, February, 1964; "Financing Metro - Additional Sources of Revenue", *Civic Affairs*, August, 1965; "Assessment - The Recurrent Controversy", *Civic Affairs*, April, 1966; "Market Value Reassessment", *Civic Affairs*, Summer, 1970.

Property Taxation and Land Development

The Canadian property tax is not a fresh subject of enquiry as, almost daily, governmental and academic studies are being published. Prolific research is readily available on the history, administration and theory of the tax. For this there are two probable explanations. First, municipalities have long been almost entirely dependent on the property tax as a source of revenue². And secondly, the tax is highly visible to the public eye since it is assessed and collected externally by government officials and often is payable in one lump sum. In turn, the revenues generated are used to provide services at the local level so that the taxpayer is able to conduct his own personal cost-benefit evaluation of the tax and its administration.

A perusal of the literature reveals that researchers and government officials have documented and exploited only one aspect of the relationship between property taxation and land use planning. They show that land uses have a direct effect on the property tax rate since property use determines needed municipal services and property assessment determines the tax base. But, at the same time, the property tax may also affect the land use itself, and this part of the relationship has been totally ignored. The important effects of the tax on its base, (i.e. taxable real property) have been overlooked to such an extent that less is known about this impact than of any other major tax³.

The property tax, like any tax system, is an instrument of public policy, as well as a revenue system. As does any form of taxation, it has effects and implications which may be used to regulate specified activities in order to achieve social, economic and political purposes. In general, the property tax directly and indirectly affects the quality and character of land uses, as well as investment in new development and renewal. The purpose of this bulletin is to outline many of these effects as specifically as possible in the absence of empirical data. This investigation is based on a firm belief that it is important to be aware of these effects in order to eliminate conflicts between land use goals and local tax policy, and to develop our local areas in a more orderly fashion.

THE PRESENT SYSTEM OF PROPERTY TAXATION – THE INDICTMENT

Property taxation in Ontario has existed for over 175 years. In 1793 the first *Assessment Act* was enacted in order to provide for the payment of wages to the members of the House of Assembly and to fund the construction and maintenance of gaols, the payment of gaolers' salaries, the control of bears and wolves and other necessary services⁴. In view of these limited objectives and the socio-economic climate

2. Over 70% of total municipal revenue in Ontario is generated by real property taxation. Department of Municipal Affairs, *Summary of Financial Reports of Municipalities*, 1969, Vol I, p. xxiv.
3. D. Netzer, *Economics of the Property Tax*, The Brookings Institution, 1966, p.1.
4. 33 Geo III, C.3.

of the times, this was a relatively appropriate and successful tax, despite a bothersome rate of evasion.

Today, despite substantial criticism and changed circumstances, the tax scheme in Ontario remains basically intact. Briefly, the real property tax is an "ad valorem" tax (i.e., according to value), which is based on the full market value of a property. The tax base then is the value of real property, including any improvements, subject to taxation in the jurisdiction of the local government⁵. The total tax revenues are obtained from three sources:

1. tax on taxable real property;
2. business taxes, which are a percentage of the taxable real property, varying according to the nature of the business;
3. special classification properties which are impossible to assess in the normal way, e.g., telephone companies, railway properties, etc.

Tax revenues are calculated by applying a pre-determined mill-rate against the assessed value of the individual property. A mill, used for purposes of accuracy, is one tenth of one cent. To set the mill-rate, the annual budget of the municipality is divided by the total assessment to produce a ratio which, when applied to all individual assessment, will produce the necessary revenues. For example, if the total estimated expenses for the year are \$200,000, and the total value of assessed property in the jurisdiction is \$10,000,000, to produce tax revenues of \$200,000, it is necessary to charge \$20 tax for every \$1,000 of assessment. Thus, a mill-rate of 20 mills is struck and when applied against a home assessed at \$20,000 would generate taxes in the amount of \$400.

Perhaps the most likely explanation for the continued survival of the real property tax system is fiscal inertia; that is, the reluctance of government officials to revise a tax system which has, in the past, successfully generated large revenues. For example, in 1969 on a total taxable assessment of \$16,589,482,376, Ontario municipalities raised a total of \$1,309,415,601 in tax revenues. Metropolitan Toronto alone raised \$495,212,004. However, while the property tax has in the past been productive, by 1969 both Metro Toronto and the combined total of local municipalities in Ontario ran deficits⁶.

It seems clear that the present property tax must be strained in order to generate sufficient revenues to finance the expanding services being provided in developing centres. This is particularly true in urban areas where the "soft" services budget is beginning to expand rapidly. In 1969, Metro Toronto spent almost 30% of its total budget on the provision of health, welfare and recreational services alone. Consequently, tax rates in the urban centres and their surrounding areas are quickly reaching a level beyond which they cannot be raised without counter-productive results. Property taxes beyond this "squawk point" would result in deterioration and abandonment of properties, dislocation of landowners, and disruption of the balance among industrial, commercial, residential and farm properties, which is vital to the economic health of the local community.

Beyond the problem of revenue generation, there are more telling charges to be levelled against the present property tax. First, a major difficulty lies in the fact that a

5. For the purposes of real property taxation, an "improvement" is some valuable addition made to the real estate. Usually this takes the form of a physical structure.

6. *Deficiency of Revenue in 1969*

Metropolitan Toronto	\$3,570,213.
Total Local Municipalities	\$1,297,931.

Source: Ontario, *Summary of Financial Reports of Municipalities*, vol. 1. p. xxxi.

real property base cannot cope with the urbanization process. Historically, the ownership of real property has been regarded as evidence of ability to pay taxes and a manifestation of benefits received in the form of various services. This general assumption that the measure of ability to pay is the market value of the taxable realty owned ignores the capitalization effect of the tax on the value or income stream of the property itself. Land taxes are capitalized at a prevailing rate of interest of the sum paid as taxes on a piece of land. The result of such a calculation is the amount by which the capital value of the land might be reduced if it were offered for sale. For example, if the annual taxes on a piece of land are \$100 and the prevailing interest rate is 4 per cent, a capital sum of \$2,500 will be needed to yield an amount equal to the taxes. This sum of \$2,500 may be taken into consideration by a prospective purchaser and deducted from the price that he would otherwise be willing to pay.

Furthermore, the actual incidence of the tax must always be carefully considered. As Seligman points out:⁷

First, a tax may be imposed on some person, secondly, it may be transferred by him to a second person; thirdly, it may be ultimately borne by the second person or transferred to others by whom it is finally assumed.

At the same time, the social, political, economic and institutional climate, as well as the character and significance of real property have changed vastly. In previous times, environment was characterized by minimal and decentralized government and the predominance of agricultural land use. Municipal governments were not required to perform a significant positive servicing function. Investment and salary incomes were also generally uncommon. Wealth was primarily held in the form of realty and local tax policy was established accordingly. Today, however, individual wealth is held in new and different forms of complex and diverse interests⁸. Consequently, other measures, such as income flows, have pre-empted real estate holdings as more realistic indicators of ability to pay.

Real property is no longer an accurate measure of benefits provided by the taxing government. Historically the real property base was justified by the belief that the provision of services enhanced the market value of land and that the financial burden of the servicing should therefore be borne by the property owner. However, there no longer seems to be any true relationship between real property values and the worth of services received. Today local governments provide many "soft services", which are, at best, only vaguely related to real property values. Admittedly, the property tax is still used primarily to finance essential "hard services"⁹. But, even with respect to the provision of these property-related services, real property ownership is often not congruent with the benefits received. For example, few equally-valued parcels of property place identical demands on municipal services, since the consumption of services differs according to land use. Thus, by using real property as a base, certain types of land use are in effect discriminated against.

In short, neither "ability to pay" nor "benefits received" can justify the use of the present real estate tax any longer. First, income rather than real property is a superior measure of ability to pay in our economic society. And, secondly, the yield of the tax greatly exceeds the cost of local expenditures, which directly benefit the owners of real property. In particular, education and social services benefit the entire

7. E.R.A. Seligman, "Introduction to the Shifting and Incidence of Taxation", in R.A. Musgrave & C.S. Sharp, *Readings in the Economics of Taxation*, 1959, p. 202.

8. C.A. Reich. "The New Property" *73 Yale Law Journal*, 1964, 733-787.

9. In 1969, 68.45% of the total expenditures of Ontario municipalities were allocated to the protection of persons and property, public works, sanitation and waste removal. *Summary of Financial Reports of Municipalities. Ibid.*, Vol. I, p. xxii.

community, but do not serve the realty. Admittedly every such expenditure indirectly enhances the value of urban realty; but if the real property tax is to be properly construed as a benefit tax, there must be some direct relation between the tax paid and the benefit received.

A third criticism often made of the real property base is that it is unstable over the business cycle. Critics contend that since real estate is available only in a finite quantity, the supply is fixed and cannot be manipulated according to demand. Consequently, since market value of land is highly variable, the yield of a land tax must be unstable. In practice, however, this is not the case. First, it is the supply of "serviced" land which is relevant in an economic sense and this supply can be manipulated. In addition, assessments have not directly mirrored market value changes since assessors have purposely created time lags in their valuations. As a result of "assessment lag", the revenue yield of the tax remains relatively stable during fluctuations in the amplitude of the business cycle.

While the deliberate delaying of valuations may be a desirable practice, other administrative problems make the tax particularly unpopular. A main irritant is, of course, that the amount of tax payable is not decided by the taxpayer himself (like most other taxes) but by government appointed assessment officials¹⁰. Furthermore, in determining this amount, the official must rely on the valuation of real property which, because of the heterogeneous nature of realty, is necessarily a baffling task. To arrive at this valuation, assessors are directed to use one of three assessment methods to determine the market value of the property: the cost of replacement less depreciation, the comparative sales figures, and/or the income capitalization rate. Yet, despite these formulae and sophisticated manuals, valuation remains an art rather than a science. Because of the uniqueness of property, inadequate data, and the element of futurity introduced by "highest and best use" assessment¹¹, the final decisions must often be based on value judgments. As a result, in practice, inaccuracy and gross inequalities can be commonly found. Since a 20% co-efficient of dispersion, which would be outrageous in the income tax field, is generally considered to be acceptable¹², property owners can be and are treated in a way that is both dramatically and erratically different.

Leaving aside these applied administrative inequalities, the real estate tax itself, is inherently regressive in nature¹³. Certainly the tax does tend to redistribute income from higher to lower income people by financing many social services, but this redistribution is often uneven. The incidence of the tax, with a few exceptions, bears relatively more heavily on lower income groups. This is due first to the fact that higher priced houses and properties have in the past been consciously undervalued. However,

10. That this need not be the case is shown by Holland and Vaughan, who in *The Property Tax and its Administration* edited by Lynn, have proposed 3 different types of self-assessment, all of which involve penalties for the property-owner if his assumed value of the property is exceeded by 20% by an offer of purchase during the tax year.

11. In most jurisdictions, including Ontario, properties are assessed according to their highest and best use. For example, a parcel of land occupied by a single-family residence but located in an area zoned for multiple-residential use would be valued according to its development potential rather than its existing use. However, in so doing, the value of the single-family dwelling is not taken into account.

12. "The coefficient of dispersion is a measure, in percentage terms, of the average departure of individual assessments from the typical or median level of valuation to the kind of property involved in a particular assessing area. Thus, a low percentage denotes uniform assessments and a high percentage reflects variations." United States, Assessors Information Digest, April, 1969 quoted in F.H. Finis *An Introduction to Real Property Taxation*, Toronto, 1972, p. 139.

13. J. Morgan et al., *Income & Welfare in the U.S.*, McGraw-Hill, 1962, ch.19.

since the *Assessment Act* was recently amended to direct assessors to avoid such fractional valuation, in favour of full market value assessment¹⁴, this particular problem should be alleviated¹⁵. The economic fact remains, however, that expenditures on housing show a relatively low order of income elasticity; that is, the response of the demand for housing to changes in the real income of consumers is generally slight. Housing choices are generally made infrequently and thus higher income people remain in their accommodation while their income rises rapidly. As a result, the rich tend to spend proportionately less than the poor on housing accommodation¹⁶. Moreover, the property tax payable, can often be shifted from property-owners to tenants or to consumers of the corporate tax-payer's final product (i.e., from the more affluent to the less affluent). Thus a higher percentage of the income of low income taxpayers is ultimately captured by a real property tax.

In addition to its oft-quoted adverse fiscal effects, the present real estate tax exerts many pressures on land use which are largely unintended and unexplored. These pressures are felt most severely by the core areas of urban regions. In the central city, the conflict between local tax policy and land use goals is particularly acute. Two major sources of the problem are: the composite nature of the tax (i.e., both "land" and "improvements" are subject to taxation) and assessment based on the "highest and best use" of the property.

As a residential area, the central city generally attracts relatively more inhabitants of low income, old age and other disabilities. Yet, as an occupational area, it is the heart of the metropolis, attracting commuters from the suburbs and beyond. Consequently, the central city must provide a high level of services, while its tax base is being eroded. This problem is aggravated by the fact that since improvements are taxed, new construction, refurbishing and maintenance are not encouraged. The improvement tax is, in effect, higher on new buildings than on deteriorated buildings and yet the latter have higher municipal costs. Consequently, the landowner is tempted to discontinue good upkeep, since proper maintenance and remodelling would reduce his net return as well as result in a higher assessment¹⁷.

The residential developer engaging in new construction in the core is also faced with a hidden burden. The cubic foot construction expense of residential units declines as unit size increases due simply to the economies of scale¹⁸. Yet the property tax, by taxing the combined assessed value of land and improvement, encourages smaller units. Consequently, investment in new construction may be economically inhibited, unless the tax can be shifted to tenants. This has an additional effect: when the tax is shifted, rental charges are increased and disposable tenant income is therefore decreased. Consequently, the demand for quality accommodation declines, which results in inadequate maintenance.¹⁹

14. See *Assessment Act*, R.S.O. 1970, c.32 as am. So. 1971, c.79

15. A 1959 study showed that the "mean dollar expenditures per family on housing as a proportion of mean total expenditures declined from 28% in the \$2,000 income group to 12% in the \$10,000 and over income group". At the same time the study found that in Canadian centres with populations over 100,000, real property taxation in 1961 represented 20.2% of mean money income for tax payers in the under \$2,000 income group and 1.6% for those in the \$25,000 and over group. F. A. Clayton, "Distribution of Urban Residential Property Tax, Burdens and Expenditure Benefits in Canada", Ph.D. Thesis, Queen's University, Kingston, Ontario.

16. See "Market Value Reassessment", *Civic Affairs* Summer, 1970.

17. G. Steinlieb, *The Tenement Landlord*, Rutgers, 1966.

18. C.L. Harriss, *Property Taxation: Economic Aspects*, Tax Foundation Inc., 1968, p.4.
W.A. Morton, *Housing Taxation*, Madison, University of Wisconsin Press, 1955.

19. D. Netzer, *op. cit.*, p.63ff.

The availability and more especially the type of accommodation in the downtown area is also affected by highest and best use assessment. Because the central city is zoned for highly intensive uses, under-developed parcels, such as a single-family dwelling lot, are valued as a potential site for high density development. Consequently, the taxable assessment of the lot will be inflated beyond any relation to its existing use. The downtown owner must then attempt to shift the tax to tenants who can pay the increased rent; to absorb the increase, probably by foregoing all but essential upkeep expenses; or to sell the property to others who are able to develop it. Depending on the owner's course of action, downtown structures tend to take three separate forms: high-rise developments; dilapidated, unrefurbished structures; and a restricted number of properly maintained structures owned or rented by persons who are willing and able to pay the increased costs.

It is sometimes suggested that a simple reduction of present tax rates would stimulate new construction and adequate maintenance. In all likelihood, a tax decrease would, in fact, reduce expenses and increase profits. New construction would thus be encouraged, thereby increasing the supply of accommodation, which in turn would reduce rents, everything else being equal. However, the resultant demand for land would eventually increase prices and curtail new construction. Consequently, a short-term increase in the supply of new private development which would subsequently deteriorate would probably be the best result that could be expected from reducing tax rates.²⁰

The central city finds itself in the vicious circle of high taxes — decreased construction and increased deterioration — eroded tax base — high taxes. To break this circle, most cities engage in highly intensive commercial zoning, density bonusing and density transfers. Less intensive uses are effectively prohibited, as only a highly intensive development could bear the increased tax burden. According to conventional theory, these taxes cannot be shifted, and must be capitalized, which results in lower property values.

The supply of downtown serviced land, however, is not constant. Thus, in cities of economic growth and high demand, tax increases need not be capitalized and land prices continue to spiral causing further dislocation of low-density uses. Principles of social planning are thus ignored and the necessary balance of diverse land use patterns is destroyed. The situation becomes especially ironic when mill rates must again be raised to buy the park-land recommended by planners.

In the face of rising taxes, the central city often experiences an increased migration to the suburbs and beyond. Early studies of the locational effects of property taxation on non-residential land owners had assigned it only a marginal impact²¹. However, more recent studies, while agreeing that the property tax plays only a slight role in the initial location decision, have found that once the decision is made to locate or relocate in a particular area, the property tax rate becomes an important determining factor²². That is, the correlation between tax rate and location becomes much stronger as the area of future location becomes more specific. Once the

20. F. H. Finnis, "Slums and Property Taxation" *Canadian Tax Foundation*, Vol. 16, 1968, p. 154;

D. Clark, "Urban Renewal and Municipal Taxation", *Canadian Tax Journal*, Vol. 10, 1962, p. 387.

21. J.F. Due, "Studies of State-Local Tax Influences On Location of Industry", *National Tax Journal*, June 1961, p. 163-173.

22. C.R. Beaton & Y.P. Joun, *The Effect of Property Tax on Manufacturing Location, California*, 1968.

issue narrows to which part of a metropolitan area shall be chosen, the decision will probably be made according to "Gresham's Law": all things being equal, firms will tend to gravitate to the low tax areas.

The impact of the property tax rate on the migration of individuals rather than commercial and industrial taxpayers, may still be questionable. Nevertheless, when these pressures are combined with differentials in tax rates between neighbouring municipal jurisdictions, inefficient spatial distribution and interpersonal inequity inevitably will result.²³

This migration effect and the rapid urbanization pressures on the fringe areas have resulted in rampant speculation and a diversity of land-use patterns. These new developments, particularly residential communities, create heavy public service demands. Expenditures are further increased by land speculation, as the provision of these services must be extended past stretches of open space which have been held for speculative gains. Due to political fragmentation and local autonomy with respect to the tax rate, urban areas are tempted to compete for high-base and low-cost taxpayers. Thus, by the use of selective tax incentives and "mercantilist zoning", light industry and shopping centres are solicited, while high cost, low-base residential developments are discouraged. Suburban tax shelters and industrial enclaves are thereby created which result in suboptimal and distorted land uses.

In summary, the property tax, which forms the backbone of the municipal revenue system, can be criticized on many grounds. First, the tax no longer is in touch with the economic realities of the modern day. This has resulted in serious problems of adequate revenue generation and a questioning of the philosophical justification of real property tax. Secondly, the difficulties of accurately and fairly assessing and administering a real property tax remain. And, finally, the costs and impacts of the tax in terms of land use planning principles merit a careful reconsideration of municipal taxation in Ontario.

ALTERNATIVES TO THE PRESENT SYSTEM OF REAL PROPERTY TAXATION

Despite the criticisms made of real property taxation, some of which have been voiced for over a century, the structure and philosophy of property taxation in Ontario have changed only slightly. We have already indicated that a main reason for this lack of response is fiscal inertia on the part of governmental officials. Taxing authorities in general are reluctant to alter a system in which in the past has successfully generated revenue while becoming tolerated by the public as a necessary evil. The province of Ontario in this area seems to have accepted the maxim that he who wishes to disturb the status quo must conclusively prove his case.

The Smith Report which studied the property tax in Ontario reflected this static approach in its conclusion that the tax ought not be abolished. This decision was summarily arrived at as follows:²⁴

We take this position because we have been unable to discover or devise a workable alternative to the real property tax as the major revenue source of local governments that would not drastically reduce, or even destroy, either local autonomy or local fiscal responsibility.

The Report gave rather cursory treatment to many of the available alternatives and their supporting arguments. Alternatives which have been successfully enacted in

23. H.E. Brazer, "Some Fiscal Implications of Metropolitanism", *Metropolitan Issues: Social, Governmental, Fiscal*, G. S. Birkhead, ed., Syracuse University, 1962.

24. *Report*, The Ontario Committee on Taxation, Queen's Printer, Toronto, 1967, Vol. 2., p 1.

other jurisdictions were often dismissed offhandedly. This was so despite the fact that these tax systems have increased the fiscal viability of the enacting tax jurisdictions without diminishing their local autonomy. In addition, in many cases basic inconsistencies between tax policy and land use planning goals have been effectively averted.

ALTERNATIVE TAX STRUCTURES

This section is devoted to discussing the possibility and potentials of completely revamping the present real estate tax system in Ontario. Those approaches which are considered feasible alternatives or supplements to the present system are analysed and discussed. Other tax possibilities were dismissed initially as being clearly inadequate or unrealistic. For example a local sales tax was rejected because many products are already being taxed to the saturation level by the province. Such a tax could not then be sufficiently productive to support local fiscal autonomy. In addition, a sales tax is inherently inequitable since it is regressive at the extremes of the income spectrum. At best, a local sales tax may be a partial alternative.

Seven changes in the tax structures do merit consideration as possible alternatives for a local tax system:

1. net income taxation
2. gross rental tax
3. 'British rates' taxation
4. user charges
5. land value increment taxation
6. site value tax
7. municipal income tax

To effectively compare these alternatives certain criteria were established. First, the traditional testing criteria of any tax policy were used, including the equity of the tax, the adequacy and stability of its yield, and its administrative feasibility. Further, because there are many conflicts between sound planning objectives and the present tax policy, the neutrality of each particular tax with respect to land use planning is an additional consideration which could not be overlooked. Thus the effect of each tax on land use decisions was adopted as an important criterion.

Net Income Taxation

The first three alternative tax structures under consideration adopt an income rather than a capital approach to real property value. The net income tax is assessed on the actual net income from the site and the improvements combined. Consequently, the property is valued on the basis of the income actually obtained minus the expenses paid by the owner, excluding taxes. Since capital value is approximately equal to net income capitalized at current market interest rates, there will probably be no significant difference in tax liability between property owners taxed according to an annual income and those taxed according to capital value approach.

In terms of tax theory, a net income base can reasonably be justified on the basis of equity since it is related to the owner's ability to pay. Like the present property tax, however, a net income tax discriminates against those who invest their wealth in realty. The adequacy of net income tax revenues would appear to be satisfactory when compared to the yield of the present real property tax. More questionable may be the stability of the yield over the business cycle. The yield should not, however, be greatly

affected by short-term fluctuations, particularly since long-term leases are so prevalent in commercial practice. In brief, the yield stability of a net income tax probably depends on the avoidance of major depressions.

The most telling criticism of the taxes using an income base in place of a capital value base, are the administrative problems entailed. The administration of a net income tax would only be relatively simple for rental or business properties. Even if income tax returns could not be used to compute this tax, the tax could feasibly be self-assessed, although this might raise problems of evasion. But, in the case of owner-occupied properties, the difficulties involved could well be insurmountable. Assessment officials would be obliged to rely on imputed net income, which is a very difficult concept to understand and administer. In terms of government expense, public confusion, and probable litigation, the costs of this approach appear on balance to outweigh its benefits.

With respect to land use, the net income tax appears to be neutral in its impact. The percentage tax on profits takes uniform percentage, no matter what the profits are derived from (whether from office buildings or retail outlets or residential units). The property owner or builder, therefore, will base his development decisions not on their tax advantages or disadvantages (since these are the same for all decisions), but on their over-all efficiency and profitability. Consequently new construction, redevelopment and remodelling decisions should not be affected by anything other than the usual planning and zoning regulations and market considerations.

Gross Rental Tax

This is another of the income, as opposed to capital, approaches to value. In effect this is a tax on the consumption of real estate services as reflected by gross rents. It is a proportional tax imposed on an annual property value which is related, if not equal to gross rental from the combined uses of the site and improvements. This tax is common in Western Europe and is used in St. John's, Newfoundland, the only jurisdiction in Canada which does not use a composite capital value approach.

The yield of a gross rental tax, while perhaps less stable than the present norm since rent is more unstable than assessed market value, has proven to generate adequate revenue to cover municipal expenditures. It is important to note, however, that both in Europe and in St. John's local taxation generally plays a far smaller role than in most other jurisdictions. For example, in St. John's the City is not responsible for funding education or police services and its contribution to local health and welfare services is virtually insignificant.

The yield from the gross rental tax would be stable over the business cycle. As Heilbrun points out,²⁵ during a depressed business cycle, a gross rental tax may stimulate abandonment, but the tax yield will not be significantly affected since tenants will move to other buildings. As a result, the gross rents of these buildings will be increased.

With respect to owner-occupied properties, the difficulties of administration are similar to those of the present tax structure. Faced with a lack of reliable rental evidence, officers would have to impute the gross rental incomes. This introduces such common problems as public misunderstanding, subjective calculation, and distorted assessment lag.²⁶ But, since the tax is assessed on a gross and not a net base, the difficulties of determining and auditing expenses are eliminated. On the other hand,

25. J. Heilbrun, *Real Estate Taxes and Urban Housing*, New York, 1966.

26. City of Montreal, *Report on Property Taxation*, July, 1962.

the application of the tax to rented properties would, at first glance, seem to be a simple task, provided the municipality has access to the financial statements of the owner.

Beyond the matter of administration lies the more basic question of equity. Is a tax based on gross rentals fair? Although the gross rental tax is presumably based on "ability to pay", in some situations it may be inequitable to allow the base to be market-determined. The contract rent may not take into consideration the fact that different landlords provide different levels of services and therefore incur different levels of expenses. These expenses may or may not be accurately reflected in the gross rental income. If this variance is deemed common and substantial enough to make this consideration something more than a philosophical nicety, the base would then have to be imputed or self-assessed.

The gross rental tax does not have a neutral impact on land use decisions. As the tax is levied purely on actual gross rent, vacant property would be totally tax exempt. In any case, the tax would be low on vacant land and this would encourage land speculation. Suboptimal use would also be encouraged since the tax is proportional to rental income. The speculative owner, therefore, would tend to minimize his payments by putting his land to some non-productive use. Finally, although rents would tend to stabilize (if not fall), the quality of operation, the rate of maintenance and remodelling would also probably decline as the owner attempted to reduce operating costs.

"British Rates" Taxation

The British rates tax is a third alternative to the capital value approach of property taxation. The tax is generally imposed directly on the occupier and not the owner of the property. The base of the tax is the annual rental value of the occupied property minus costs of maintenance. These deductions are not for actual expenses but are statutorily determined according to a graduated scale. Thus the permissible deductions decline as gross rents increase.

With a few exceptions, the British rates tax operates in a similar manner to the gross rental tax. The same considerations apply with respect to revenue productivity since the base is the gross rent minus statutory expenses. As these deductions are a percentage of the gross rent, the base cannot fall to zero, which could happen if a net rent were used.

The yield will tend to be less stable than that of the present tax. The current gross earning power of a piece of property is likely to be more volatile than its capital value, because the latter is related to all expected future returns, while the former is only related to the current yield. Again, however, this tendency may be stabilized by long-term leases and assessment lags.

The British experience has demonstrated that this tax system is feasible. Its administration is simplified in the case of rented properties because the contract rent is an objective, although potentially inequitable, measure. For the non-rented property however, the tax must be subjectively determined. Yet, even where the assigned rental value of the property is not tested by the market (since the property is never in fact rented), the large number of rentals each year should provide sufficient comparable data to ensure that the rental income imputed to the property is not out of line.

Some of the land use implications are similar to those for gross rental taxation, since the rental value, and therefore the tax imposed on vacant land, is zero, speculation as well as under-use is encouraged. Although this has not proven to be a significant problem in Britain where land is a scarce commodity, it could reach

seriously undesirable proportions in Ontario at this time. In addition, this form of taxation would tend to discourage both maintenance and remodelling. First, the tax is levied on the tenant-occupier. Although rents will be proportionately lower, public demand for high quality housing will probably be reduced. Secondly, since actual costs and expenses are not deducted from the tax, these will be kept at a minimum and will result in lower maintenance standards. During times of economic growth, however, new construction and investment should be attracted, since properties with high profit-to-rent ratios would be taxed relatively less.

User Charges

A possible supplementary tax is the user charge or benefits tax. This tax is used in several European countries where the tax structure has been divided into two parts. The primary tax structure finances soft services, while user charges fund hard services. (A charge is levied in much the way as gas and hydro charges are made in Ontario). The tax paid is therefore directly related to the benefit received, since the charge is proportionate to the services it finances.

The drawbacks of a benefit tax are the difficult problems of classification of services and allocation of costs. To fairly administer the charge, a decision must first be made about whether the benefit was received by a resident or whether it was received by a property-owner. This distinction between personal services and property-oriented services is not an easy one to draw. In response to the problem of allocating costs for services provided, William Vickrey has presented an interesting proposal in which cost criteria for each hard service are established. For example, a sewage charge could be levied on the basis of the frontage of the land since the cost of the sewage mains is proportionate to their length and relatively independent of the required volume of flow.²⁷ Presumably, if a user charge system were adopted in this province, other such cost-benefit connections could be determined.

Land Value Increment Taxation

In both Denmark and Spain, a tax is imposed on the increase in the market value of land. It can be either imposed annually or deferred until the date the property is transferred, in order to ease the burden on the taxpayer. The rationale behind this tax is that the increase in value is a social product unearned by the individual owner. This unearned increment is caused primarily by the municipal provision of services and therefore at least part of this publicly-given benefit should be returned to the community. Property value increases, however, are not wholly determined by the provision of public services. Consequently, unless the earned and unearned portions of the increase could be separated out, which would be a difficult administrative task, many taxpayers would be penalized.

An increment tax would probably reduce speculation, although many landholders could easily absorb the tax if their land values appreciated significantly. Taxing this gain on real estate investments, however, should have the effect of depressing land prices and thus encouraging development.

Because this tax relies on such an unpredictable and restricted base, its revenue yield would, of necessity, be unstable and totally inadequate. Therefore, an increment tax could only be used as part of the total tax structure. In this supplementary role, however, it may be a useful means of financing municipal capital improvements.²⁸

27. W. Vickrey, "General and Specific Financing of Urban Services; Public Expenditure Decisions in the Urban Community", H.G. Scholler, ed., *Resources for the Future*, 1963, p.67.

28. For the present system of financing capital improvements in Ontario see *The Local Improvements Act*, R.S.O. 1970, c255.

Site Value Taxation

The alternative tax structure which is most often proposed is site value taxation. This tax separates realty and improvements for the purposes of valuation and exempts the latter. The philosophy of site value taxation has its underpinnings in the scholarly writings of Henry George, before the turn of the last century. Since then the 'single tax' debate has been carried on at a highly emotional and dogmatic pitch. In recent years, however, the site value tax has found renewed support in both theory and practice. This has encouraged officials and academics to once again give the tax serious consideration.

In brief, the theory of site value taxation is based on the conceptual division of land and capital. Site valuers criticize contemporary economics for combining these two distinct economy entities which, they claim, react totally differently to taxation. They postulate that land is a fixed asset of "original and indestructible powers", which cannot be consumed or created. Any increase in the value of raw land could then only be an unearned increment which the community is entitled to recoup through taxation.

The improvement, on the other hand, is the result of individual enterprise and capital investment, which should be stimulated rather than discouraged. Yet, they claim, this is precisely what our present composite tax does. By assessing improvements, a disincentive tax is actually being levied. Consequently, a property owner is tempted to under-use his property and allow his improvements to deteriorate, for which he will be rewarded with a reduced assessment. However, they argue, by exempting improvements from taxation, either totally or partially, each taxpayer will be encouraged to put his property to the most profitable use which the market will bear. Since it would be economically unwise to under-use property (in view of the tax load land must carry), speculation and slow urban sprawl would be replaced by rapid and orderly development.

To turn to the established criteria of tax equity, does site value taxation treat persons who are apparently situated in equal circumstances in a similar fashion? This depends on the index of taxpaying capacity which is adopted. If the value of real property owned by the taxpayer is used as the measure, the tax is an equitable one. If however, income is accepted as the basis of judgment, the argument is quite different. Since the tax places the highest relative burden on those whose property is vacant and therefore generating no income, the tax becomes regressive in nature.

The question then becomes: which is the more desirable index of taxpaying capacity? For the proponents of site value, the choice is obvious. Since a high percentage of land value is due to population growth and public improvements, the community is entitled to recapture this unearned profit. But the issue remains, why single out this one particular increment as the basis for tax capacity?

Not only does site value taxation penalize less intensive uses of land, such as farms and low-rise accommodation, but it also prejudices those persons who have put their funds into realty rather than other kinds of wealth. This is especially unjustifiable for present owners who have paid full price for the property even though past owners may have reaped the unearned increments in value. Heilbrun points out that the untaxing of improvements will stimulate new construction which may in turn increase land rent thereby offsetting this increased burden but the actual extent of the offset is uncertain. The best the site valuers can offer to avoid this transitional prejudice is to suggest that the tax system be adopted over a period of years.

Although the revenue yield from a site value tax should be stable because realty is

a fixed and non-deteriorating base, its adequacy is questionable.²⁹ Admittedly the revenue adequacy has been proven in South Africa and Australia where the tax is used by some jurisdictions. These site value areas, however, tend to be of a rural nature and are not called upon to fund urban services. In more heavily populated centres where this tax has been enacted, it has been found that only a partial exemption could be given to improvements, as otherwise the base would be too narrow.³⁰ Both James Heilbrun and Dick Netzer, who write favourably of site value taxation, criticize it for its inability to support the services necessary in urbanized areas.³¹ More specifically Heilbrun has stated that due to urbanization the "sum of all public expenditures in the U.S. has long since out-distanced the whole rent of land."³²

Because only the "original and indestructible nature of the soil" is to be taxed in theory, the tax becomes almost impossible to administer in practice. The purists of site value theory contend that the assessment of land value must be made according to a "standard state". This standard state of land would be defined in physical terms which are independent of the actual state and use of the particular parcel of land. Even where the base-date state of the land (i.e., the actual state at the time of assessment) is inferior to the standard state due to swamps, mining and so on, an assessment would be made of the market value of this land at its standard state; and tax credits would be awarded to encourage the owner to improve the physical condition of the land up to the standard state value. A new owner's costs of demolishing a "negative improvement" would similarly be taken into account. Presumably, man-made realty such as land-filled areas, would be deemed a capital improvement and therefore not taxed. Obviously, the administrative problems involved in calculations of this theoretical value are even greater than those involved in calculating straight market value assessment. Other proponents of the site value system, more concerned with administrative costs, have maintained that, on balance the simple market value of the existing physical state of the land would be a satisfactory and workable base.

No matter which approach is taken, the assessment must separate the value of the site from the value of the improvement. But some critics argue that the realty and the improvement cannot be separated, even in theory, unless the property is vacant.³³ They argue that the value of land is inseparable from its location and surrounding development. Furthermore, the improvement at least partially determines the site value since the demand for a particular site is qualified by the intensity and character of the demand for certain structures and the nature of the improvement on that site.

On the other hand, site value proponents argue that although it is difficult, it is possible to separate site and improvement values since jurisdictions presently using site value taxation are doing just that. To do this, however, there must be sufficient vacant lands to make these separate assessments possible. The lack of enough vacant lands remains a basic obstacle to the implementation of site value taxation in Ontario. Henry George assumed that assessors would always be well supplied with evidence of bare site sales. However, many jurisdictions, such as Britain, which have tried the single tax have

29. G.D. Hepditch, "Site Valuation as a Base for Local Taxation" *Conference Report*, Canadian Tax Foundation, 1961, p. 105-109.

30. The City of Pittsburgh originally adopted a graded property tax system under which buildings were taxed at half the rate on land. However, the revenue generated was insufficient to such an extent that the differential has had to be reduced to 51%-49% in recent years. See Harrison, "Housing Rehabilitation and the Pittsburgh Graded Property Tax," *2 Duquesne Law Review*, p.213.

31. J. Heilbrun, *Real Estate Taxes & Urban Housing*, New York, 1966, p.150-154. D. Netzer, *Economics of the Property Tax*, Washington, 1966, p.210-212. For Netzer's Second Thoughts see D. Netzer, *Economics and Urban Problems*, New York, 1970, p.198.

32. J. Heilbrun, *ibid*, p. 150.

33. E.M. & R.M. Fisher, *Urban Real Estate*, New York, 1959, p. 54-57.

abandoned it upon discovering a lack of market evidence through which sales of improved and unimproved sites could be compared. Objective valuations must be based on comparative sale prices and in a developed area, there are not a sufficient number of independent sales of unimproved sites.

In terms of land use policy, site value taxation is not, and is not intended to be, totally neutral. It represents a deliberate attempt to deal with the basic causes of what its adopters consider to be "suboptimal" land use. As a result, this particular tax can only be evaluated in relation to its likely effects on land use decisions.

The over-all benefit claimed for the single tax is that intensive land use, through new construction and redevelopment, will be stimulated and vacant or under-used land will be discouraged. Undoubtedly, extensive and intensive use of real property would result. The elimination of the improvement tax would mean that tax liability, regardless of the level of use, would be fixed. Since the total tax cost as a percentage of improvement value would decrease as improvements were added, the landowner would intensify his use to its most profitable level.

Ironically, this so-called "fixed-cost effect" and the resulting demand for improvable realty may in fact serve to increase land values and encourage speculation. However, there are two other effects of site valuation which would militate against these tendencies. First, land taxes usually cannot be shifted easily, with the result that the additional tax burden on the land may be capitalized into lower land values and prices³⁴. Also, the increased costs of holding a parcel of land vacant or underimproved may depress land values unless the site has excellent development potential and these holding costs are offset by the fixed-cost effect.

Even if a site value tax met its goal of encouraging more intensive uses, several other costs and side-effects of such a programme need to be considered and weighed. First, since urban land will be forced to bear a large tax burden, its owners will be encouraged to develop smaller sites and to erect the improvements which will generate the most income. However, the most profitable land usage for the property entrepreneur will often not be the most efficient land usage in a social planning sense. Thus, whereas urban sprawl may be curbed, it would probably be replaced by urban congestion and premature development.

In addition, certain uses may be subjected to unexpected pressures. For example, all vacant properties (and not just those held as a speculative venture) would be subject to increased holding costs. In the urban areas where community assets such as historical landmarks and open spaces are most desirable, these costs may be prohibitive since only extensive and contemporary improvements could support the tax burden. A case in point is Hawaii which, after enacting a graded tax, found it necessary to adopt ad hoc zoning ordinances to preserve properties of historical, cultural and recreational interest. Other problems undoubtedly would arise from the inability of site value taxation to discriminate between desirable and undesirable low intensity uses. For example, because the tax cannot distinguish between low-income housing and deteriorated slums, it would tend to eliminate them both, which would cause widespread social dislocation.

In sum, site value taxation involves the theoretical separation of land, which is taxable, and capital, which is tax exempt, in a positive attempt to influence land development. In practice, the administration of the tax involves serious difficulties which can only be eliminated by foresaking some of its theoretical attractions. As well, the ultimate effect of the tax, that is to say widespread and intensive development, is now inappropriate to our large metropolitan areas. We believe that such development,

³⁴. R. Turvey, *The Economics of Real Property*, George Allen & Unwin Ltd., 1957, p. 87-89.

where it remains desirable, can be selectively encouraged and more effectively controlled by other means, including other tax devices.

Municipal Income Tax

The final alternative fiscal structure under consideration is the municipal income tax. Two types of income tax have been used by municipalities — tax on personal income and a tax on corporate profits. This form of local taxation is not uncommon in North America and is becoming increasingly more popular³⁵. Today this tax is levied by about one-quarter of the largest cities in the United States. In these cities, the tax generally falls only on earned income rather than interest, dividends or capital gains. However, there are many noteworthy exceptions to this general rule. Some municipalities levy a flat rate on all forms of income. Others impose a progressive rate. New York City for example, imposes a graduated rate, which ranges from 0.4% on the first \$1,000 of taxable income to 2.0% on taxable income over \$30,000. In other cases the tax is calculated as a percentage of the tax payable to the federal government. Nevertheless, eighty percent of the cities taxing income, have adopted a flat rate tax for administrative ease. The tax rates imposed in these municipalities vary from 1/8 of 1% in Williamsport, Pennsylvania to 2.0% in Newport, Kentucky. The majority of cities have found a tax rate of between 0.5% and 1.0% to be sufficient.

Various municipalities have also levied a tax on corporate net profits attributable to activities within the taxing jurisdiction. A flat rate of between 1 and 2% is usually levied, except in New York City where the tax rate is 5 1/2% of net income. Typically, the determination of taxable profits follows the federal tax legislation, with some minor adjustments. The major difficulty in administering a municipal corporate income tax is fairly allocating corporate net income where the business is operated in more than one taxing jurisdiction. Most municipalities use the "Massachusetts formula" to perform the necessary separation of net income. This method is based on a simple average of three ratios:³⁶

- a) real and personal property within the tax unit as a percentage of the total property holdings of the corporation.
- b) gross receipts in the tax unit as a percentage of the gross receipts of the corporation.
- c) total wages, salaries and compensations for personal services paid within the tax unit as a percentage of the total of such compensation paid by the corporation.

The resulting average percentage is then applied to the net income of the corporation to obtain the total taxable income attributable to the taxing jurisdiction.

Other ratios are sometimes used to make this computation. Dayton, Ohio, for example, substitutes the cost of production for total payroll figures. These variations in definitions and ratios can lead to undertaxation or double taxation for the corporation in different municipalities. The Massachusetts formula, however, is quickly becoming the uniform method of allocation.

A municipal tax on either corporate or individual income recognizes that ability to pay is not today dependent on property holdings but rather on income flows. To

35. In fact, a local income tax was authorized by statute in Ontario in 1850. This enabling legislation remained on the statute books in this province until 1941.

36. J.G. Davis & A.S. Ranson, "An Evaluation of Municipal Income Taxation", 22 *Vanderbilt Law Review*, p.1313.

that extent, a degree of equity is achieved. However, where a flat rate is used or where only earned income is included in the tax base, the tax becomes regressive and discriminatory. One means of balancing the tax equities is to permit the taxpayer to claim exemptions and deductions. Despite this, those cities in the United States which use a local income tax are of a split opinion as to the extent to which exemptions and deductions should be allowed. Some of the smaller municipalities contend that the use of deductions would seriously diminish their revenues by restricting the tax base and increasing administrative costs. On the other hand, most larger cities follow Detroit's example of allowing a personal exemption of \$600 for the taxpayer and each dependent, but requiring the tax to be paid on all forms of income. These jurisdictions take the view that this use of exemptions is more equitable and introduces an element of progressivity even to a flat rate tax structure. In addition, since the number of individuals with taxable income is thereby reduced, an administrative benefit is a reduction in the number of applications filed. Only in New York and Baltimore, which follow the federal tax scheme, are personal expenses also deductible.

A major problem facing a jurisdiction levying a local tax is the determination of who should be taxed. Clearly, residents of the tax unit should bear a fair proportion of the tax load. In addition, however, there is considerable justification for taxing non-residents who are employed in the city. These commuters increase the city's congestion costs and exploit its services. In terms of benefits received and ability to pay, the non-resident employee should therefore be subject to local taxation³⁷. Since the commuter does not enjoy all the services consumed by a resident, a fair allowance has to be made. One alternative is to tax the non-resident only on that portion of his income actually earned in the jurisdiction. But to avoid the difficulties of separating and allocating incomes, many jurisdictions have simply adopted a lower non-resident rate. For example, in all those cities in Michigan which impose a municipal income tax, the non-resident rate is one-half the rate levied on residents. In New York City, where residents are taxed according to a graduated rate on income minus deductions and exemptions, non-residents are taxed at a flat rate on income which is reduced by a sliding scale of exclusions.

The taxation of non-residents raises the spectre of double taxation in the case where a person works and resides in different jurisdictions and both claim taxation powers. One solution to this problem would be the expansion of tax jurisdiction to a regional or even provincial level. However, due to local diversities and a passion for local autonomy, other approaches seem preferable. As a result, most American cities have adopted one of the four alternatives.

First, in some cases the right to tax is given exclusively to one jurisdiction. In so doing, an unreasonable advantage is awarded to either the peripheral municipalities or the central city, depending on whether the place of residence or the place of employment is allocated sole tax jurisdiction. To avoid this difficulty, some metropolitan areas have adopted a second approach, which involves the use of reciprocal agreements between the central city and the surrounding communities. For example, the cities around the Toledo, Ohio area have successfully concluded negotiations whereby the receipts from taxes levied by all of the municipalities on their residents are shared according to an agreed upon formula. The objective of this tax-sharing plan is to ensure that the taxpayer pays no more than if he lived and worked in the same jurisdiction.

A third approach has been tried in Pennsylvania, where, except for Philadelphia,

37. M.R. Merz, "Municipal Personal Income Taxation of Non-Residents" 31 *Ohio State Law Journal*, p. 770.

the jurisdiction of domicile has a *prima facie* tax priority; but if this unit does not impose a tax or imposes a tax at less than a 1% rate, the jurisdiction of employment may levy a tax rate differential. As a result, residents of communities surrounding a central city which imposes a tax, would pay a tax, unless their jurisdiction of domicile levied a tax of at least a full 1% rate. In practice, tax competition is encouraged and all surrounding suburbs have levied a full 1% tax on their residents. Thus, the primary objective of a local income tax, to compensate the central city for the use of its services, has been soundly defeated.

The fourth and best approach is used in Michigan, where priority is given to the city of employment. The city of residence can then tax all earned income except that which may already be taxed in the place of employment. In administering its tax, the city of residence allows a tax credit for payments which have already been made to the place of employment. This method of redistributing funds, tries to ensure both that no taxpayer is prejudiced and that each municipal unit is compensated for the services it is called upon to provide.

The adequacy of this compensation, however, remains an important outstanding issue. The productivity of the tax, of course, is responsive to economic growth and produces an expanded yield during inflationary periods. By taxing a percentage of income, the tax yield parallels fluctuations in the business cycle. This can be illustrated from some of the figures available. In Philadelphia, a city comparable in size to Metropolitan Toronto, a tax rate of 1 1/2% resulted in a yield of \$16.3 million, just following the Second World War. This same rate in 1960 produced a tax yield of \$72.2 million. In 1958, 21 of 33 Ohio cities which imposed a municipal income tax, found their income tax yield exceeded property tax collections by 200% or more. By 1966, income taxes provided from between 20% and 70% of the total tax receipts of the cities using it. Today, as a result, the per capita property tax is considerably lower in income tax cities than in those which have not adopted it. In view of these figures, at least one analyst has concluded.³⁸

The income tax has not been supplemental so much as substitutive and has taken some of the pressure off the property tax.

Another factor which obviously affects the actual productivity of the tax is its costs of administration. In part, these costs are determined by the complexity of the tax structure. Some jurisdictions have selected a structure which is relatively simple and therefore inexpensive to administer, but which sacrifices tax equity. Others have adopted a more equitable, but a more complex system, which relies on a wider tax base to offset the increased costs. One inexpensive and at the same time equitable system which could be made available in Ontario municipalities is the Canadian federal taxation scheme. A local surcharge could be added to the federal income tax which is administered and collected at the national level. Upon collection, the revenue yield would be returned to the local municipalities by a series of federal-municipal transfer payments. The obstacle which may, however, forestall this particular approach is the strong desire among local governments for increased financial independence and autonomy. In any case, regardless of which collection technique is chosen, administrative costs will decline as officials gain expertise and experience. This has been the case in the United States, where these costs have been reduced to between 2 and 5 per cent of the total collections.³⁹

38. I.E. Deran, "An Overview of the Municipal Income Tax," in R.H. Connery, ed., *Municipal Income Taxes*, New York, 1968, p.25.

39. "Municipal Income Taxes", *The Proceedings of the Academy of Political Science*, vol. xxviii, no. 4, 1968.

Finally, a particular advantage of a municipal income tax is that it is generally neutral with respect to the land development decisions of private property owners. Since the tax captures a percentage of income, the profit maximizing point of the undertaking is not affected. Thus, the property owner will choose his most desirable level of operation even though the tax will claim a certain percentage of the resulting profits. These decisions will be determined basically by the market in conjunction with local planning legislation and will not be skewed by property tax considerations.

The tax need not necessarily always play a passive role. One of the attractions of a municipal income tax is the use of deductions to obtain desirable ends. For example some local authorities in the United States have initiated the practice of allowing tax deductions to businesses that have provided such municipal benefits as parkland or pollution control programmes.

In summary, the income tax is a viable alternative to the present system of municipal taxation in Ontario. As a source of revenue the tax is relatively simple and economical to administer without unfair results. Our investigation uncovered no jurisdiction which had completely abandoned the property tax. To do so would strain the income of the taxpayer while wholly overlooking his property holdings as a taxable asset. But, where the two tax systems have operated in tandem at least some of the tax burden has been shifted from real property to personal and corporate income. Even in this supplementary role an income tax would serve to relieve many of the unintended, but very real, pressures and inequities of the present property tax.

CHANGES IN THE TAX BASE

So far in this bulletin, many of the most blatant faults of the Ontario local tax system have been noted. The conclusion has been reached that a complete restructuring of the existing property tax system is necessary. The discussion of possible fiscal alternatives, however, pointed out that the available alternatives are not without problems. Furthermore, the restraining effect of inertia and the political problems associated with a total tax reform have been outlined. In view of these constraints, the optimism of G. W. Mitchell who predicted that by 1976 the property tax "will have become an all-but forgotten relic of an earlier fiscal age",⁴⁰ unfortunately seems unfounded. It appears appropriate, then, to explore minor alterations in the tax base which could be adopted as interim measures directed at encouraging efficient and desirable land use.

Development and Redevelopment

Two tax moratoriums have frequently been used to stimulate more intensive land use in the form of both new construction and re-development. These are selective tax abatements and improvement exemptions. A tax abatement usually entails either a total or gradually decreasing tax exemption, or a tax freeze for the qualified properties. An improvement exemption takes the slightly different form of a total or partial exclusion from tax liability for any new improvements added to the site. Both of the programmes usually operate over a specified number of years. The object of these devices is to make the rate of return on investment sufficient to attract new development and renewal, with the added hope that when the incentive is lifted, the cost of the property tax will be spread over an expanded permanent tax base.

40. G. W. Mitchell, "Is This Where We Come In?" *Proceedings of the National Tax Association*, 1956, p. 454.

Critics of these programmes accuse them of being sources of inter-municipal competition and unequal treatment of property owners. First, it is argued, those individuals who are offered the incentive and take advantage of it receive an unfair benefit. Secondly, the resultant stock of new or improved structures would in all likelihood forcibly depress the rents in structures not given a tax abatement. Thirdly, the probable effect of these abatements or exemptions would be the shifting of an increased share of the tax burden to non-qualifying properties. This would be particularly unjust where the investment would have been made even without a tax incentive. And finally, critics contend that this is a short-term solution which will end as soon as the profit level in the stimulated type of investment falls below the return which could reasonably be expected from other capital investment. Nevertheless, provided that the demand for new investment in the municipality is sufficient to outweigh these costs and the tax concession is awarded according to rational and established criteria, the tax moratorium may well be justified.

As is evident, the purpose of abatements and exemptions is to promote development and redevelopment where they would not ordinarily be provided by private enterprise. This is not however, the primary problem facing at least the larger municipalities where the economic climate alone provides sufficient stimulus. In most of these municipalities, the most urgent concern is the preservation of desirable unintensive uses and open space areas. There are several tax mechanisms available which perform these tasks with varying degrees of effectiveness.

Charitable Exemptions

One of the more common approaches in Ontario is the permanent exemption of specified uses from taxation. Briefly, the *Assessment Act* exempts from taxation the properties of educational, religious and certain charitable institutions, as well as the lands owned by the federal, provincial and municipal governments.⁴¹ Apart from the exemptions of government lands (which was given for constitutional and administrative reasons) the purpose behind these exemptions is to ensure that certain services, deemed to be of special social value, are supplied to the public. These statutory exemptions, apart from being historically justified, are a politically palatable method of government assistance, since a particular special interest can be indirectly indulged, with the resultant costs being spread over the entire tax-paying population. Once legislated, however, these exemptions are rarely amended or repealed and thus tend to reflect the petrified wishes and needs of an earlier age. In addition, the use of a statutory list of specific exempted uses unreasonably restricts the eligible applicants. Not only should these exemptions be more open and contemporary, but they should also not be contingent on property ownership. If a service is socially desirable, it should be subsidized if necessary; and this subsidy should be provided by a programme of direct and renewable grants based on merit and need.⁴²

Finally, the exemption from taxes by provincial legislation narrows the taxable base available to the municipality and thereby increases the tax burden on the remaining property owners. Since the exempt properties tend not to be evenly distributed, this erosion of the tax base has especially harsh effects in the central cities. Although assessment statistics dealing with tax exempt properties are not wholly reliable, it is nevertheless significant that in 1969 exempt properties in Metropolitan Toronto alone were valued at \$1,246,493,734. This total valuation was divided

41. *The Assessment Act*, R.S.O. 1970, c32, s3,s4,s6,s26,s35.

42. For a criticism of the property tax exemptions given under the *Assessment Act* see the Smith Report, *The Ontario Committee on Taxation*, Queen's Printer, Toronto, 1967, vol. 2, p.125.

between the City of Toronto (\$703,366,594) and the other five boroughs (\$543,127,140).⁴³ Notwithstanding a programme of payments in-lieu-of taxes adopted by the federal and provincial governments, it remains clear that the use of outright property tax exemptions imposes disproportionate burdens among local communities.

Open Spaces

Finally, the government can take an active part in the provision of open space areas.⁴⁴ For example, the public purchase of conservation easements or developments rights, although not common in Canada, has been fairly common in the United States, despite the fact that a substantial outlay of funds is sometimes required.⁴⁵ Municipal open space zoning (which relies on the right of Ontario municipalities to pass restricted area by-laws)⁴⁶ is another approach. The chief drawback of open space zoning is that it can seriously depreciate the development value of the land without providing compensation. And, even though the development potential of the land may be a function of community energy and funds, rather than individual effort, such depreciation without compensation may be unduly harsh and oppressive. In addition to these positive government steps, there are certain tax incentives which can be used to stimulate the preservation of open or underdeveloped land. This favourable treatment for open tracts of land is justified primarily for the obvious ecological and recreational benefits offered to the population at large. At the same time some relief is offered to the owner of undeveloped land since his property places no demands upon municipal services.

To encourage the supply of open spaces, many jurisdictions grant a tax deferral to eligible property owners. Generally, payment of taxes is postponed on any portion of the market value which is in excess of the restricted or present use. Payment does not become due until there is a change in the use (e.g., the open space is built up) or until the restriction is removed and the property is subsequently sold. Since almost all of the tax payments are eventually recovered, the tax costs are not shifted and the property owner receives no advantage other than the postponement of payments due until a less onerous time. However, unless the deferral is limited to a fixed percentage, the programme becomes overly difficult and expensive to administer since two assessments would be required of each property.

An approach similar to the above open space tax deferral scheme, is the use of a tax preference scheme. In this case, the land is not valued according to its highest and best use, but according to its legally permissible or present use. The essential difference between a tax deferral and a tax preference is that the latter confers unilateral benefit on the private landowner, because there is no tax recapture at some future date. Consequently, under a tax preference scheme, the speculative value of the land remains untaxed. In Ontario, which has adopted a preference rather than a deferral system of taxation with respect to farm lands, this has proven to be the case.⁴⁷ We

43.. *Summary of Financial Reports of Municipalities*, 1969, p.1.

44. "Urban Open Space: Parks People and Planning", *Civic Affairs*, Bureau of Municipal Research, Summer 1971.

45. "Recreation Easements" *BMR COMMENT.*, Bureau of Municipal Research, 1971, No.129.

46. *The Planning Act*, R.S.O. 1970, c349, s.35(1).

47. Section 27 of the *Assessment Act* directs assessors when valuing legitimate farm lands to ignore the sales of surrounding lands to persons whose principal occupation is other than farming. This is an attempt to exclude the speculative element from farm assessments. However, in the case of *Clark v. The Township of Chinguacousy et al.* the Ontario Municipal Board felt obliged to rule that even the sales of surrounding lands to *bona fide* farmers could not be used as a basis of valuation because these sales as well had been influenced by speculative expectations.

suggest, however, that before either a tax deferral or a tax preference system is adopted, certain essential issues must be raised and met.⁴⁸

Initially, the criteria for establishing the types of properties which are to be preferred (agricultural, recreational and/or conservation areas, and so on) must be clearly set out in the legislation. This classification will be determined partly by land use planning priorities and partly by considerations of tax equity. For example, the preference given to farmlands in Ontario arose from both a desire to preserve open agricultural spaces and a realization that the existing property tax falls more heavily on farmers, since the less intensively a property is developed, the greater the difference between its present use value and its "highest and best" use value.

These same goals and priorities, as well as the order in which they are ranked, will also decide any more specific qualifications to be met. As an illustration, a minimum size limitation is generally established since granting a tax advantage to a small vacant lot would convey little public benefit. Also, some jurisdictions have decided to include improvements, in addition to land, within the preferred classification. Thus in Alberta farm buildings are given statutory tax exemption. While the special treatment of improvements may be justified in unusual circumstances, it appears on balance that the preference of barns, golf course clubhouses, and so on, in Ontario would be an unnecessary and unfair favouritism in violation of the benefit theory of tax equity.

Next, it must be decided how the tax formula will be linked to zoning legislation and use. If there is no reliance on the applicable zoning by-laws to guide the scheme, then any properties meeting the use requirement will qualify; but the social and planning benefits may be extremely limited (for example, there may be little value in granting tax preference to an owner of open land in a primarily industrial area where few people live could benefit from the preserved open space). This is the case with farm land valuation in Ontario. Under the *Assessment Act*, the prevailing local zoning is of no import and all farm lands, as defined by the Act, are entitled to the benefit conferred. Since no public control is exerted over the use, the landowner remains free to convert the use at any time and no tax payments will be recovered.

A preferable approach would be to rely on affirmative zoning. Thus, in order to benefit, not only would the land have to meet the requisite use, but the area must be zoned accordingly. These joint requirements would go some way to deterring the type of speculation that the Municipal Board found to be evident in the *Clark* case. An even stricter scheme is found in some American jurisdictions which also require a prior conforming use as a prerequisite for the tax advantage. This requirement restrains many landowners from converting to the desirable use even though they may wish to do so. As a result this latter test is as unduly harsh and restrictive as the simple actual use test is lenient.

Another criterion that is often employed to curb speculation while encouraging open space and underdeveloped landholding, is an occupation requirement. The legislative intent underlying such a requirement is undoubtedly to ensure that the landowner is *bona fide*.

But, although the policy behind an occupation requirement is appealing, in the cases where it has been used, the actual determination of occupation has proved difficult for the assessing officials. This, when combined with a markedly high

48. For a discussion of many of these issues see D. G. Hagman, "Open Space Planning and Property Taxation", 1964, *Wisconsin Law Review*, p.628.

avoidance rate⁴⁹, has generally resulted in prohibitive administrative costs. In practice, a combination of the actual use and affirmative zoning tests would be a sufficient and realistic safeguard.

CONCLUSION AND RECOMMENDATIONS

In the past, the Province of Ontario and its municipalities have relied almost exclusively on planning legislation to order and control land use. Minor alterations in the property tax base have virtually been ignored as a land use planning tool. Yet, as has been pointed out, the considered use of exemptions, preferences and deferrals can have a positive impact on land use patterns. When these devices are combined with a sound zoning framework, either intensive development or open space preservation can be stimulated and governed according to the general need, without undue infringement upon private property rights.

However, the actual results brought about by these changes are, at best, only short-term solutions, having limited effectiveness. Minor alterations in the tax, such as those discussed above, are not directly aimed at the root causes of suboptimal land use and thus can only be considered as interim measures. A complete re-examination of the present property tax system remains a necessity.

A consideration of the available alternative tax systems has illustrated that no one tax structure offers a perfect solution. Each particular method of taxation has its particular advantages and liabilities. In the table below these strengths and weaknesses are compared to the present real property tax. These rankings are both subjective and relative, since a positive score indicates only that, in the opinion of the Bureau, the tax is comparatively superior to the existing tax system with respect to that particular criterion. Similarly, a negative score indicates an inferiority and a zero score is indicative of no overall advantages or disadvantages relative to a real property tax.

A Comparison of Alternative Tax Structures with the Existing Real Property Tax According to Selected Criteria

	Net Income Tax	Gross Rental Tax	"British Rates" Tax	User Charges	Land Value Incre- ment Tax	Site Value Tax	Muni- cipal Income Tax
Equity	0	0	+	+	+	-	+
Stability of Yield	0	-	-	-	+	+	0
Adequacy of Yield	0	0	0	-	-	-	-
Administrative Feasibility	-	0	0	-	-	-	+
Effect on Land Use Planning Decisions	+	-	-	0	0	0	+

49. In Ontario in order to claim a farm land assessment preference, the principal occupation of the applicant must be farming. However, see, for example, *Re. County Assessor for Ontario County v. Runnymede Investment Corporation Ltd.*, (1966) 10.R. 577 where the corporate applicant has its assessment reduced from \$200 and \$300 per acre to \$50 per acre since a crop of buckwheat had been planted and harvested.

In conclusion, no single tax structure can be recommended as a wholesale replacement for the existing property tax system. No single alternative answers all the difficulties posed in balancing the requirements of a viable tax policy with the goals of land use planning. Rather, some attempt should be made to arrive at a composite structure which is encompassed in a comprehensive tax statute.

Many combinations are possible. For example, in Germany, farm lands are taxed on the basis of capitalized income; urban real estate is taxed on the basis of rental values; and a special tax is levied on dormant lands suitable for development. The personal recommendation of Dick Netzer is a composite structure employing site value taxation, land value increment taxation, user charges and a housing tax of five per cent.⁵⁰

It can be generally concluded that the *Assessment Act* should be substantially amended, if not repealed *in toto*. Our preliminary investigation has suggested that a municipal income tax is both attractive and feasible. Even in a supplementary role this tax offers several considerable advantages while offsetting many of the problems of the present property tax. However, it would be premature to recommend the final tax mix appropriate to this province. This would require substantially more economic and planning analysis. Yet, in remodelling the property tax, it will be essential to acknowledge the relationship between taxation and land use and to ensure that the adopted tax policy is congruent with the planning objectives of the community.

The one positive recommendation which the Bureau does make has been already proposed by the National Commission on Urban Problems:⁵¹

In summary, the highest priority would seem to attach to de-emphasis of the property tax *per se*. It is a generally inferior tax instrument, although not the worst of all possible taxes. But an inferior tax becomes a monstrous one if applied at high enough rates.

There *are* alternatives to ever-increasing property tax rates in urban areas, alternatives which require a willingness to accept real change in the most conservative of institutions, local government.

50. D. Netzer, *Economics of the Property Tax*, The Brookings Institution, 1966.

51. Report to the Joint Economic Committee, Congress of the United States of America, 1968, as quoted in F.H. Finnis, *An Introduction to Real Property Taxation*, Toronto, 1972, p.2.

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