A TALE OF TWO TAXES

Property Tax Reform in Ontario

Richard M. Bird, Enid Slack, and Almos Tassonyi

A TALE OF TWO TAXES

Property Tax Reform in Ontario

Richard M. Bird, Enid Slack, and Almos Tassonyi

LINCOLN INSTITUTE
OF LAND POLICY
CAMBRIDGE, MASSACHUSETTS

Library of Congress Cataloging-in-Publication Data

Bird, Richard M. (Richard Miller), 1938–
A tale of two taxes : property tax reform in Ontario / Richard M. Bird, Enid Slack, and Almos Tassonyi.
p. cm.
Includes bibliographical references and index.
ISBN 978-1-55844-225-2
1. Property tax—Ontario. 2. Tax assessment—Ontario.
HJ4122.O6B57 2012
336.2209713—dc23

2011029206

Designed by Westchester Book Services

Composed in Adobe Garamond Pro by Westchester Book Services in Danbury, Connecticut.
Printed and bound by Puritan Press, Inc. in Hollis, New Hampshire.

♻ The paper is Rolland Enviro100, an acid-free, 100 percent PCW recycled sheet.

MANUFACTURED IN THE UNITED STATES OF AMERICA

CONTENTS

CHAPTER 1

Getting Property Taxes Right

An Impossible Dream?

More than 40 years ago, a provincially appointed committee issued a clarion call for property tax reform in Ontario, a reform centered on a province-wide market value assessment (Ontario Committee on Taxation 1967). Since Ontario municipalities depend entirely on the property tax for tax revenues, as they have access to no other major tax bases, this proposal was central to the committee's vision of the appropriate role of local government in the province.

After three decades of inaction, attempted action, and reaction, the provincial government finally answered the committee's call and undertook a market value assessment in 1998. The initial and subsequent assessment operations were major technical undertakings, and the province's ability to launch and maintain the new system provided an equally major test of the political system. The technical task, the assessment, was successfully accomplished within a few years. However, the real challenge of property tax reform is not technical but political. Unfortunately, in the case of Ontario in the decade following 1998, the complex and confusing institutional and political changes and compromises that proved necessary to put the new system in place and keep it going make it difficult to understand and evaluate the many reforms undertaken. It is also still impossible to fully determine how successful the massive reform has been, although, as we shall see, there is room for doubt as to whether it has worked in terms of reforming either the property tax or local finance.

To confuse matters further, at the same time that it was reforming both assessment and the property tax itself, the province undertook two other major initiatives that significantly affected local government. First, service responsibilities between the provincial and municipal governments were substantially realigned and, as part of that realignment, the structure of provincial-municipal transfers was significantly changed. Second, the province encouraged (to the point of forcing) amalgamations in many municipalities. Not only was there a major amalgamation in the largest city in Ontario, Toronto, but between 1996 and 2004 the number of municipalities in Ontario overall was reduced from more than 800 to 445.[1]

Some years ago, two of us wrote a paper titled "Can Property Taxes Be Reformed?" (Bird and Slack 1981). Our conclusion was that it would be very hard to reform the property tax in Ontario. Nonetheless, after considerable delay major reform did finally take place a decade ago, albeit in a convoluted way, as detailed in chapters 3 through 5. In a sense, the question we ask here is: Was Ontario's property tax reform worth doing? Or, to put it another way, was the price paid to achieve market value assessment worthwhile? Although much of the dust stirred up by the 1998 reform has now settled, in some ways the answer to this question resembles what China's Zhou Enlai reportedly once said when asked what he thought of the French Revolution of 1789: "It is too soon to say." However, it is not too soon to say that still more changes are needed if the Ontario property tax is to be improved and become a key part of a sustainable local finance system.

At least three tentative conclusions emerge from this account of the Ontario experience. First, one cannot get to a good property tax simply by instituting a good assessment system. Even the best market value assessment may not lead to a better or more productive property tax. Indeed, as we suggest in chapter 9, in the case of Ontario the new assessment system may, in the long run, have weakened the role of the local property tax, although the last chapters of this story still remain to be written. Second, good property tax design needs to recognize, more explicitly than most of the literature does, that there are important differences between taxing housing and taxing business property. If this is not acknowledged, both the rhetoric and the reality of the property tax may be distorted, and the outcomes of reform may depart widely from those originally intended. Although the evidence reported here is far from complete, some distortions seem apparent in the Ontario experience, as discussed in chapter 8. Third, as useful and indeed essential as a good property tax system is in financing local government, larger urban areas in particular are unlikely to be able to pay for the range and level of public services for which they are responsible solely (or almost solely) with revenue from the property tax. Of course, none of these tentative

1. As the scope of these policy changes suggests, and as we discuss further in chapter 2, legally Canadian provincial governments may, subject to political constraints, do more or less whatever they want with respect to their local governments: they can change their boundaries, their electoral systems, their expenditure responsibilities, and their revenue and borrowing power more or less at will, and they have often done so (Tindal and Tindal 2009).

conclusions implies that it is impossible to design and implement a good property tax, or that such a tax does not have an important role in financing local government. They do suggest, however, that these aims will not necessarily be achieved by reforming property tax along the assessment-driven path conventionally recommended in the literature and generally followed in Ontario for the past decade.

Why the Property Tax Matters

One reason to get property taxes right is simply because such taxes are significant. As table 1.1 shows, on average around the world property taxes collect about 1 percent of gross domestic product (GDP), with the proportion being twice as high in the more developed countries in the Organization for Economic Co-operation and Development (OECD).[2] Property taxes are particularly important in Canada, which appears to be at or near the top of the international league when it comes to property taxes as a share of GDP, a figure that usually falls in the range of 3–4 percent.[3] Property taxes are especially important in Ontario, where they amounted to 4.5 percent of provincial GDP in 2006, with local property taxes alone accounting for 4.0 percent.[4] Asset-based taxes at such levels matter economically. In 2006, for example, property taxes in Canada were as productive a revenue source as corporate income taxes. Since property taxes imposed on the (estimated) value of real property are equivalent to taxing the income from such property, arguably their potential economic effects are likely to be comparable to those arising from the corporate income tax. Any tax that costs the average Canadian $1,578 a year (in 2006) and the average resident of Ontario even more ($1,872, or over 5 percent of personal income) is worth attention for that reason alone.

Getting property taxes right is a matter of great fiscal importance for local governments, particularly in Canada, where the property tax is essentially the only local tax source, accounting for 98.5 percent of local taxes in 2006 (Treff and Perry 2008). As table 1.2 shows, on average around the world property taxes finance at most a little more than 10 percent of local government expenditure in developed countries. In Canada, however, the comparable share is 39 percent, or almost four times the world average. Ontario, where 44 percent of local expenditure is financed by local property taxes, seems to be at the leading—or perhaps

2. For further discussion of property taxation around the world, see Bahl, Martinez-Vazquez, and Youngman (2008) and Bird and Slack (2004).

3. Bahl (2001) reports a figure of 4.0 percent for Canada in 2001 (using IMF GFS data). Treff and Perry (2008) report a 2006 GDP share of only 2.9 percent for local taxes (98.5 percent of which are property taxes). However, if one takes into account that some property taxes are collected by provincial governments, this figure rises to 3.5 percent.

4. Calculated from data in Treff and Perry (2008) and Statistics Canada (2008).

TABLE 1.1
Property Taxes as Percentage of GDP

	1970s	1980s	1990s	2000s
OECD countries	1.24 (16)	1.31 (18)	1.44 (16)	2.12 (18)
Developing countries	0.42 (20)	0.36 (27)	0.42 (23)	0.60 (29)
All countries	0.77 (37)	0.73 (49)	0.75 (58)	1.04 (65)

NOTES: Includes all taxes on property, whether levied by local or other governments. Number of countries in sample indicated in parentheses. Data for 2000s are simple averages of 2000 and 2001. "All countries" includes data on some transitional (formerly Soviet-dominated) countries mainly in Eastern and Central Europe.

SOURCE: Bahl and Martinez-Vazquez (2008).

TABLE 1.2
Property Tax as Percentage of Subnational Expenditure

	1970s	1980s	1990s	2000s
OECD countries	9.70 (16)	9.88 (17)	13.65 (16)	12.40 (19)
Developing countries	18.65 (21)	15.97 (27)	13.49 (24)	18.37 (20)
All countries	14.49 (38)	12.89 (48)	11.63 (58)	13.40 (59)

NOTES: Number of countries in sample indicated in parentheses. Data for 2000s are simple averages of 2000 and 2001. "All countries" includes data on some transitional (formerly Soviet-dominated) countries mainly in Eastern and Central Europe.

SOURCE: Bahl and Martinez-Vazquez (2008).

bleeding—edge when it comes to the dependence of local expenditures on local property tax support. Given the increasingly critical role played by larger urban areas in driving regional and local growth and the need to adequately fund the urban infrastructure (both human and physical), once again the importance of getting property taxes right is evident.[5]

Property taxes also matter because people care about them. For decades, surveys in the United States have reported that the property tax is the least favored of all taxes. In a 2005 Gallup poll, for example, 42 percent chose the local property

5. Slack and Bird (2008) discuss the importance of cities as growth drivers in Canada. An especially critical factor in the growth equation relates to education. Although education finance in Ontario is a subject in itself, as we discuss in chapter 6, it is nonetheless closely related to property taxation.

tax as the worst or least fair tax while only 20 percent nominated the federal income tax for this dubious honor (Bowman 2008). Canadians, too—not least the 40 percent or so of them who live in Ontario—appear to take a generally dim view of the property tax. Indeed, few taxes have been more vigorously debated in both the provincial and local political arenas in Ontario than the property tax. No one seems to like the tax much, yet it continues to be the mainstay of local government finance.

While the problem arising from the apparent dichotomy between the need for local revenue and the dislike of the main source of such revenue, the property tax, is especially sharp in Canada, there have been no property tax "revolts" in Canada similar to those in the United States. Miller (2008) suggests that the main explanation lies in the very different political and economic context of the property tax in Canada, as discussed with respect to Ontario in the next chapter. Nonetheless, as Miller notes, the same pressures that led to the well-known Proposition 13 property tax revolt in California some years ago have been felt in Ontario and other Canadian provinces. To date, however, perhaps owing in part to the combination in Canada of strong legal and institutional constraints on independent local fiscal actions (as discussed further in chapter 2) and the absence of such "direct democracy" provisions as the referenda and initiatives that exist in some U.S. states, these pressures have mainly emerged at the provincial level and have been manifested less overtly through the complicated and drawn-out process of reforming the reform that has taken place over the past decade, as discussed in chapter 4.

All these factors are clearly evident over the long history of property taxation in Ontario (see chapter 3). However, the immediate stimulus for this book was the deep and broad reform of the Ontario property tax in 1998. The objective of this reform, as discussed in chapter 4, was not only to solve most of the perceived problems with the tax, but also, more ambitiously, to establish a property tax system that would be broadly acceptable and thus would largely remove property tax reform from the provincial political agenda. Although the 1998 reform was widely lauded by experts at the time and was in many ways a major technical and political achievement, the objectives of the 1998 reform were clearly not achieved. Property tax reform remains on the agenda, and over the past decade, more and more suggestions have emerged for drastically altering the existing form of the tax or for finding an alternative (though usually poorly specified) method of financing education and local government.

As discussed further in later chapters, most suggested alternatives proposed softening the blow of increased assessments, especially on homeowners. In the campaign leading up to the provincial election in 2007, for example, one opposition party (the New Democrats, on the political left) proposed a California-style freeze on a property's assessed values until a change in ownership. The other opposition party (the Conservatives, on the political right) proposed an indefinite 5-percent cap on assessment increases until a change of ownership. Thus attacked from both the left and right, the centrist Liberal government's response was essentially ameliorative, introducing yet more measures to dampen the effects of assessment changes, specifically by introducing a four-year assessment cycle combined with a four-year phasing in of any increased assessments.

On the local level, in Toronto the mayor initially looked not to the provincial legislature but to the federal government in Ottawa for relief, by appealing for a share of federal revenues from the Goods and Services Tax (GST), Canada's federal sales tax.[6] However, sustainable solutions to financing Toronto and other large cities will require deeper consideration of the appropriate role a redesigned property tax can and should play in financing local government.

Objective of the Book

This book aims to explain why Ontario's success in instituting an efficient and effective system for province-wide market value property assessment failed to enhance either the economic efficiency or the political acceptability of the property tax as the major local revenue source. In fact, the new assessment process arguably made things worse. Those in other jurisdictions interested in establishing better systems of property taxation and local government finance may learn some lessons from this cautionary tale.

Ontario's recent reform of its system of property assessment and taxation certainly has some positive lessons to offer. The post-1998 experience demonstrates that it is possible to administer a conventional market value assessment–based property tax more equitably and efficiently than had been done in Ontario in the past and is still the case in many other jurisdictions.[7] The Ontario experience also shows that in a developed jurisdiction with about five million properties, it is possible to reform the assessment system completely and effectively in a relatively short time.

However, the Ontario experience also suggests that placing too heavy a demand on property taxes may risk the political destruction of this important instrument of local finance. As sensible and generally desirable as market value assessment is as the basis for a good property tax, it can be a mistake to push it too far and too fast. In particular, doing so may lead to political reactions resulting in hasty and ill-thought-out temporary expedients, such as caps and freezes, that

6. Toronto mayor David Miller, from a report on *CTV News,* 6 February 2007 (http://toronto.ctv.ca/servlet/an/local/CTVNews/20070226/one_cent_gst_070226/NFL).

7. For discussion of this question in the very different context of the developing countries, see Bird and Slack (2007).

can leave the property tax system even more illogical, inequitable, and in some ways even more politically unacceptable than it was before the reform process began.

An old story tells of a group of blind men, each of whom touches a different part of an elephant, and their resulting disagreement about how best to describe the beast. Many analyses of property taxes are like this story. What one sees is some combination of what one is looking for and what is there, and how one interprets the relationship between theory and what seems to be reality offers yet more room for interpretation. What a property tax is, how it functions, what its effects are, and how it may best be reformed in any particular jurisdiction are all heavily dependent on the specific context. For example, without some understanding of both education finance in Ontario and the changing structure of its local governments, it is simply not possible fully to understand or follow the progress of property tax reform in the province over the past decade.

The aim of chapter 2 is to help those unfamiliar with the local terrain wend their way through to the end of this tale. It sketches out in brief the general institutional framework within which the recent property tax reform has played out.

History matters as well as context. Old institutions hardly ever really die, and they seldom even fade away. Instead, they evolve into or are subsumed by new institutions as circumstances and incentives alter over time. Chapter 3 therefore reviews two centuries of Ontario property tax developments leading up to the 1998 reform, with emphasis on the three decades immediately preceding the reform.

The pace of the story picks up in chapter 4, which sets out the key elements of the 1998 reform and what happened after they were put in place. The twists, turns, and reversals of policy made in reaction to the reform are set out in some detail. Overall these changes, through the introduction of a series of assessment caps and "clawbacks" and a complex property-classification scheme, considerably dampened the impact of market value assessment. Given this combination of factors, the outcome of property tax reform seems in some instances to be quite different from what was originally intended.

Reformers sometimes think their job is done once a change has been designed and accepted. Owing to the way in which the executive and legislative functions of government are combined in the Canadian parliamentary system (particularly when there is, as there usually is, a majority government), Canadian reformers may fall into this trap more easily than Americans. In Canada, if a provincial government decides to do something, it can do it without being subjected to a variety of amendments in the legislative process. Understandably, governments like this system. The downside, however, is that if the government gets it wrong, it can get it very wrong. As the experience outlined in chapter 4 shows, if a majority government does get something (politically) wrong, it can usually fix its mistakes quickly and without much fuss. Once again, however, there is a downside. The very ease with which governments can fix perceived mistakes may lead them to make still more mistakes: haste may not always make waste, but the hasty correction of perceived problems can certainly lead to new problems. The never-ending story told in chapter 4 indeed seems unlikely to reach an end anytime soon, and the end to which it is apparently leading may not be all good.

Chapter 5 turns to the key element of the 1998 reform and the foundation of any property tax system, the assessment process. The chapter describes in some detail the assessment methodology now in place for residential and nonresidential properties, including the computer-assisted mass appraisal (CAMA) model and multiple regression analysis (MRA), used mainly for residential properties (and an increasing number of commercial properties); the assessment of farmland based on current use; the cost approach, used for industrial properties; the income method, used for many larger commercial and multiresidential properties; and the special approaches used for particular property classes, such as railways and pipelines. Every assessing jurisdiction uses a similar array of methods. It is far from clear, however, that the implications, both economic and political, of these different techniques have always been adequately considered during reform discussions.

Although market value assessment (called current value assessment, or CVA, in Ontario) has, with some hiccups, been implemented in Ontario more or less as originally envisaged and the reform has achieved almost everything originally intended in a technical sense, in some ways its very success may have sown the seeds for the partial destruction of the local property tax. To dampen or offset the changes in tax burden that were an intended economic and administrative outcome of CVA, so many changes have been made in property tax policy that the major political objective of the original reform—taking property tax off the provincial agenda and turning it into a minor matter for local politicians—has not been achieved. Indeed, the main effect of the past decade of continuous reform in Ontario's property tax system has been to make it obvious that, when it comes to local finance, it is provincial politicians who are almost entirely responsible. An attempt to minimize the difficulties for provincial politicians arising from local financial problems has resulted in further "provincialization" of local governments, which has problematic implications for the prospects of improving urban governance.

Some aspects of this theme are developed in chapter 6, which describes and assesses the important changes over the past decade in how primary and secondary education is financed in Ontario. Unlike the situation in many parts of the United States, education in Ontario has never been solely or even mainly a local concern. The province has long had a dominant role in, and control over, the education system. Ontario's property tax had been levied by the lower (municipal) tier of local government on behalf of school boards and, in much of the province, the upper (regional) tier of government. However, the introduction of the new assessment system was accompanied by a provincial takeover of the education property tax, a move that both formalized provincial domination of education and further underlined the fact that local governments have at most a minor role in providing primary and secondary education in the province. The provincial component of the property tax, the education property tax, is now imposed at a uniform rate on all residential properties in the province. Interestingly, however, it is still imposed at a nonuniform rate on nonresidential properties, although it is hard to understand this feature of the present system in any rational way. The provincial takeover of education finance was coupled with a move to lower the education property tax, thus offering more "room" for municipal property taxes. These changes have had an effect on local finance in general and on both of the two taxes—the residential property tax and the nonresidential property tax—that are commonly discussed as a single tax: the property tax.

Chapter 7 completes the story of property taxation in Ontario by looking at a variety of other taxes imposed on property. At the local level, the most important of these, again largely treating housing and business property differently, are the development fees that municipalities charge developers to cover the growth-related costs associated with their projects. Development charges may be levied on a uniform basis throughout a municipality or on a project-by-project basis, and how such charges are imposed clearly has an impact on local land-use patterns. The degree of freedom municipalities have had in imposing such charges stands in sharp contrast to the many constraints hindering what they do with respect to the basic property taxes on either business or housing. It is thus not surprising that rapidly growing municipalities, like many in the Greater Toronto Area (GTA), have at times preferred to increase such charges rather than raise taxes on existing properties. Chapter 7 also discusses new financing devices, such as tax increment financing and tax increment grants, as well as transfer taxes and business improvement levies.

Chapter 8 looks first at whether the property tax reform has succeeded in revenue terms. Did the reform enable local governments to climb farther up the revenue hill? The chapter examines empirical evidence on whether municipalities in the GTA have exhausted their capacity to raise the residential or the nonresidential property tax, or both. Once again, it proves critical to understand the differences, in economic and political terms, in the treatment of residential and nonresidential property. The same is true regarding a second empirical question: How did tax reform affect local property tax policy? Since 1998, Ontario municipalities have had the ability, within limits, to set different tax rates for different classes of property (residential, multiresidential, commercial, industrial, and so on). Initially, these tax rate differentials reflected the differentials that existed prior to reform. Chapter 8 reviews how Ontario municipalities have determined the effective tax rates applicable to residential and nonresidential properties within their jurisdiction, and discusses the likely effects of the reform on tax competition within the GTA.

Chapter 9 attempts to answer the logical question raised by this story of a mountainous reform effort that appears to have resulted in a molehill of change, and possibly created an even more distorted and limited system of local governance and finance. Where should Ontario go from here with respect to property tax reform? The chapter addresses three underlying problems that will affect the answer. First, the property tax has inherent limitations as a means of financing local government in a modern society: it simply cannot be pushed too far. In particular, there is nothing to be said in favor of the classified nature of the property tax, with its much heavier taxation of nonresidential property. Perhaps the best way to deal with this problem, as well as the more basic problem of connecting local taxes and local expenditures in a more meaningful fashion, would be simultaneously to change the property tax and the system of education finance, in addition to considering the possibility of introducing a new form of business tax. Second, the limitations of property taxation may reflect not so much the inherent nature of the tax as the problems associated with determining individual tax bills on the basis of current market value assessments. Nonetheless, the chapter concludes that a uniform property tax should continue to have an important role in financing local government, Finally, chapter 9 considers a vital but often neglected issue: the selling of the property tax, or, more properly, the selling of the two distinct but related taxes on housing and business property that are bundled under this label.[8] With Ontario's history, the suggested reforms—essentially, imposing a uniform property tax at the local level and instituting provincial financing of education—seem most likely to prove acceptable if a new form of business tax is introduced to make up for the sharp reduction in business property taxation.

8. Although this issue has not received nearly as much attention as it deserves in the literature, we are by no means the first to raise it. In Canada, for example, important differences between the two property taxes were incisively discussed by Bossons (1981) and Thirsk (1982) and analyzed empirically by Ballantine and Thirsk (1982).