



C.D. Howe Institute
Institut C.D. Howe

PROPERTY TAXATION: REFORM OR ABOLISH?

By

Jack M. Mintz
President and CEO
C. D. Howe Institute

And

Arthur Andersen Professor of Taxation
J. L. Rotman School of Management, University of Toronto

*Prepared for the Canadian Property Tax Association, 35th Annual National Workshop,
“Property Tax in the Information Age”, Kelowna, British Columbia, Oct. 1, 2001.

Property taxation is one of the oldest revenue sources in Canada but probably one of the least understood taxes. It accounts for a substantial amount of revenue raised by Canadian governments – about \$40 billion or nearly 10% of total taxes. In fact, the property tax generally raises more money than the corporate income tax, the latter the subject of most papers written on taxation.

As a source of revenue, Canadians often criticize property taxes as inefficient and unfair taxes. Many homeowners argue that the property tax is a substantial burden especially for the elderly who do not have sufficient annual income to pay the tax. Businesses complain that the property tax discourages development and is applied at unfair high rates on commercial and industrial properties.

Such criticisms of property taxation are troubling. If true, the tax should be considered for reform, if not outright abolition.

Yet, we do not know enough about the property tax to evaluate its impact. For example,

- We do not fully understand how property taxes impact on construction and building use in the Canadian economy.
- We do not know how much property tax is paid by specific industries since governments do not collect this information.
- We do not know who bears the burden of the property tax – the user or the owner.

These and other issues need to be better understood. My purpose in this discussion is to provide a road map for better analysis of the property tax to determine its viability and usefulness as a source of revenue for governments.

As part of this road map, two questions should be ultimately answered. First, given that governments, especially at the municipal level, must raise revenue to pay for public services, would it be better to replace the property tax with other sources of revenues?

Second, if property taxes should remain an important part of the tax system as it is today, how should it be reformed?

My answer to these two important questions can be provided at the outset.

- First, it would be unrealistic to expect the property tax to be abolished. Given fiscal needs of government, the property tax is one of the better taxes for governments to rely on, especially in the 21st century. However, it is not a perfect tax and over-reliance on the property tax can result in economic harm to the economy. In particular, municipalities need access to replacement sources of revenue for the property tax, especially taxes and fees related to the municipal services provided to residents.
- Second, it would be realistic to expect the property tax to be reformed. Given its size as a source of revenue, the property tax is distorting and unfair in application. Effective rates are far too high on non-residential property. An unfair burden is imposed on rental compared to owner-occupied housing. In principle, property taxes should be applied at similar rates on property values. I will suggest some reforms that should be considered by provinces and municipalities for future policy.

Should the Property Tax be Abolished?

Like any tax, the property tax can reduce economic growth and job creation by discouraging households and jurisdictions from moving into a town or city. On the other hand, property taxes help cover the cost of public services including transportation (roads and public transport), police and fire protection, water and sewage treatment and education, services that make towns relatively attractive communities for people and businesses.

Assuming that governments must raise a certain amount of revenue to provide needed public services, one could ask the question as to whether it is necessarily the property tax that should be used to help finance these services.

Some Good Aspects of Property Taxes

There are some good reasons why properly designed property taxes should be part of the overall tax system. It is not that property taxes are a “good” tax – no tax is “good” tax. It is just that property taxes can be less harmful to the economy as compared to many other taxes.

One problem with any tax is that it could substantially discourage economic activity. Any tax will have some impact on household and business decisions. It is only a question of the size of the impact. A corporate income tax, for example, tends to have a substantial impact on the amount of income reported in a jurisdiction and also deters investment. Thus, some experts view corporate income taxes as having high economic costs and should therefore be avoided as a revenue source as much as possible.

A properly designed property tax, however, has a significant but not a large impact on economic decisions. The best-designed property tax is a neutral one that is levied at a single rate on the value of property. Given that property taxes are levied on real estate and machinery and equipment affixed to property, a neutral tax discourages investment only in new structural investments since land and old structures cannot pick up and move to other jurisdictions.

Further, if property taxes are levied that match the cost of municipal services provided to households and businesses, the property tax operates as an efficient and, might I add, fair user charge. An efficient and fair property tax supports better political decision-making since the benefits of public programs correspond with the tax “prices” assessed to pay for the services. People and businesses will migrate to the jurisdiction that offers their most preferred combination of public services and taxes.

With increased economic integration, governments will need to have competitive tax systems to finance public services. Competitiveness not only means keeping taxes as low as possible, but also keeping the tax system as efficient as possible. Compared to more distortive taxes, such as income and capital taxes, the property tax can be a good tax for a country in a global economy.

However, there are some important arguments that can be given as to why we might want to limit the use of property taxes as a source of revenue. I will emphasize two criticisms of property taxes – unfairness in tax burdens, and distorting the use of property.

Unfair Tax Burdens on Low-Income Property Owners

The most important criticism of the property tax is that it is an unfair burden on low-income individuals. For example, suppose Mrs. Marple, an elderly retired woman, has \$14,000 in Old Age Security and other pension income and pays property taxes of \$2000 for her condominium. Property tax is almost 15% of her income. Only \$12000 is left to cover her food, heat, electricity, medical needs, transportation, entertainment and other expenses. On the other hand, suppose Mr. Smith, a property tax lawyer, has \$100,000 in income and pays \$4000 in property tax on an owned-property. Even though he pays much more property tax, the property tax burden is only 4% of his income. Thus, given this argument, the elderly Mrs. Marple faces a much greater burden of property tax compared to Mr. Smith.

Although the above argument is the basis for most criticism of property taxation, it leaves out some important issues that turn the argument on its head.

First, property taxes pay for some municipal services that the property owners derive. Surely, a tax on property that reflects the value of services received by the owner improves fairness in the tax system. One might want to relieve Mrs. Marple from the

burden of paying for private and public goods and services but there are simpler ways of achieving equity objectives. For example, income support programs like Old Age Security and the Guaranteed Income Supplement and an income-tested property tax credit offset the burden of taxes for low-income taxpayers.

Second, property taxes can be capitalized in the value of property, meaning that real estate prices can be reduced by the imposition of property taxes. With capitalization, the effect of property taxes is to reduce the income earned by the owners of residential and non-residential property. Using the above example, if Mrs. Marple rented property rather than owned it, the property tax may be borne by the owner of rental property rather than Ms. Marple if competition in the rental market with a fixed supply of housing forces the owner to bear the tax. Thus, in the case of rental property, the landlord may bear the tax by receiving less property income rather than Mrs. Marple bearing the tax by paying higher rents. Mr. Smith, however, owning his own property, bears the full brunt of the property tax.

Although these theoretical arguments raise some doubt about the validity of the argument that property taxes are unfair, we really do not know who bears the burden of the property tax. The property tax burden is so non-uniform across different classes of property and municipal services vary so much across different uses of property that it is unclear as to how much property tax is borne by property users and owners of various income classes. Governments operate somewhat in the dark when it comes to understanding the true impact of property tax on incomes and expenditures of Canadians.

Distorting Property Taxes Falling Heavily on Some Uses

The property tax can have quite uneven impacts on the property values, according to use and age. Without the use of proper market value assessment, as in some provinces, property taxes might have little relationship to property values. Non-residential property owners pay much more tax on the value of property compared to residential owners in

several cities. Multiple-unit residential property is often taxed more heavily than single-unit residential property. Commercial property is often taxed differently than industrial property. Farm property is provided preferential treatment in most provinces. Some provinces provide exemptions for machinery and equipment for particular uses. Further, in many provinces, property taxes on owner-occupied housing are set lower than property taxes on rental housing of equivalent value.

A further distortion is introduced when property taxes are out of line with the value of municipal services provided to enhance the use of property. Canadian studies have shown that property taxes paid by owners of residential housing is less than the value of municipal services provided to such property. On the other hand, the amount paid in non-residential property taxes is well above the value of municipal services provided to non-residential property. Thus, current property taxes discriminate substantially against the use of property for non-residential purposes.

Such differentials in the application of property taxes can weigh significantly on the use of property.

- High property taxes, net of the value of municipal services for some properties, such as for industrial use, have the expected effect of encouraging businesses to locate in low-tax jurisdictions, including those outside Canada.
- A condominium can be substantially less taxed than an equal-sized flower shop or small jewelry manufacturer, therefore discouraging the use of property for business purposes within a municipality.
- Property taxes that are levied at higher rates on residential rental compared to owner-occupied housing encourage the use of single dwelling units. With multiple-unit housing being subject to higher taxes compared to single-unit dwellings, urban sprawl is encouraged since it is more costly to built rental housing in downtown core areas.

Given economic distortions arising from poorly applied property taxes, some might argue that the system is sufficiently “broke” that it cannot be fixed. Any attempts at reform, as

in the recent move to market valuation in Ontario, results in sharp changes in property values once taxes are reassessed. The public is resistant to such sharp changes in property taxes and it is therefore difficult to reform the system. So some might argue that the abolition of property taxes is warranted.

However, it is unrealistic to think that the property tax would ever be abolished. It is too important of a revenue source, especially for local governments. Properly designed, it can be much less harmful to the economy compared to some other taxes like income taxes. But the current property tax in Canada is not a perfect tax. It should be reformed.

How Should the Property Tax Be Reformed

The above evaluation of property taxation raises two issues.

- First, do Canadian governments rely too much reliance on property taxation? Even though the property tax is likely here to stay, the \$40 billion raised in property tax may be viewed as too much compared to some “optimal” level, if that can be defined.
- Second, is the property tax system well designed? Is there a better way to levy the tax to minimize its economic costs?

Below, I will suggest a number of reforms that would address these two specific issues.

Reducing Reliance on the Property Tax

Canada has the highest property tax burden among all other industrialized countries except the United Kingdom – about 4% of GDP, which is twice the average level of the OECD. It is the primary source of revenue for municipalities, accounting for almost 60% of their expenditures. Property taxation is also the most important revenue source to fund education expenditures.

If Canada were to reduce reliance on property taxation, it could only take place if provincial and municipal governments could reduce reliance on property taxation to fund municipal services and education.

In the case of municipal services, property taxation has increased its importance in recent years with reductions in provincial grants to local governments. The municipal governments have argued that the property tax field is not a good source of revenue to fund down-loaded expenditure responsibilities. In part, property taxes do not grow with the economic needs as fast as income or consumption taxes. Further, the municipalities feel that further increases in property taxes could deter development and investment as well as become too much of a burden on low-income residents.

Thus, the municipalities need new fields of taxation that could reduce their reliance on property taxation. Since the mayors depend on provincial acquiescence to new forms of taxation, the provinces play a key role in determining what tax fields are available to local communities.

To reduce reliance on property taxes, the most appropriate revenue sources for municipalities would be new or higher user charges to be paid by businesses and households for municipal services, including water treatment, transportation and waste disposal. Compared to property taxes, user charges are far more fair and efficient since they are assessed according to a person's use of municipal services. Like property taxation, it is often argued that user charges may be too great of burden on low-income households. However, with an appropriate income transfers and an income-tested tax credit for user fees, one could still maintain efficiency and fairness of user charges with relief for low-income residents.

Other tax fields that could be used by municipalities to reduce reliance on property taxes could be considered but would be less efficient. Certainly, gasoline taxes, as a surrogate charge for the use of roads, could be considered. So would some other specific excise

taxes on telecommunications and tourism be good candidates for local taxation. More debatable would be a local income or payroll tax since residents could migrate to low-tax adjacent communities and avoid the taxes. Certainly, however, there is room to reduce some reliance on property taxes with new taxing powers given to municipalities.

Similarly, there is room to reduce reliance on property taxation as a source of funding for education. If further reforms are made to make education more competitive in supply, increased reliance on tuition fees (with appropriate offsets for the poor to ensure accessibility) can improve both the efficiency and fairness of the education system.

Property Tax Reform

To make the property tax more efficient and fair, greater attention should be paid to removing current distortions in the system. An efficient property tax is one in which a single rate is applied to the market values so that the use of property is not distorted. To this end, one would look for the following:

- The elimination of the distinction in property tax rates assessed on owner-occupied and rental housing. A fallacious argument given for higher taxes on rental properties is that the owner is able to deduct property taxes from income; therefore, owners are able to bear property taxes more easily. However, the rental property owner must pay tax on rents received so the deductibility of property tax for the rental property owner avoids double taxation under the income and property tax systems.
- The same rate of tax should be applied to the market value of non-residential property, no matter its use. Since the market value of property reflects the value of the service provided to the user – whether commercial or industrial – there is no need to have differential rates on property. Some industries receive preferential treatment – this neither efficient nor fair. Similarly, there should be no distinction made between properties of different size so long as the values are being properly assessed.

- Non-residential and residential properties should be taxed at similar rates. Since mayors and municipal councils depend on the votes of people rather than businesses, there is a strong incentive for municipalities to impose higher taxes on non-residential property owners (whose votes count less). Nonetheless, businesses are responsible for job creation in many communities and high property tax rates increase the cost of doing business in the municipality.
- Property tax reforms, as recently achieved in several provinces, should strive to put in place periodic market value assessment. With the appropriate valuation of properties, the property tax applied at similar rates will be neutral with respect to the use of property.
- Property taxes should not be applied to mobile property, as found in some countries, including Japan and the United States. The application of property taxes to moveable machinery and inventory can substantially increase the economic cost of property taxation when applied to mobile capital. In some provinces, some moveable property is still subject to property tax. This should be avoided.

Conclusions

A message that property taxes are likely here to stay is not exactly good news since any tax imposes some harm on the economy. However, well-designed property taxes are one of the better taxes for governments to use as a source of revenue.

There is some question, however, as to whether Canadian municipal governments rely too much on property taxes since the property tax is not altogether well matched to their expenditure responsibilities. Municipalities should be using more user fees to fund their expenditures and, if need be, given access to some new excise tax fields.

Further, given that there is some value to maintain property taxation in Canada, it would be best to reform the current system to make it neutral. A single rate on market values would reduce the current distortions in the property tax system.