Can Property Taxes and Development Charges Help Shape Metropolitan Areas?

The effect of property taxes and development charges on development.

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TO WHAT EXTENT do property taxes and development charges affect the shape of metropolitan areas, and can these instruments be used by municipalities to modify their growth patterns? This question becomes particularly relevant as municipalities increase development charges to finance infrastructure. Property tax political thresholds and resistance to growth may require the use of development charges to pay for the consequences of growth. The need for "sustainable" development makes it important that the spatial and environmental consequences of public policies are identified. In addition, differential development charges may provide an effective tool for discouraging greenfield development.

This article examines a number of hypotheses regarding the spatial consequences of property taxes and development charges using a survey of developers in the Toronto and Ottawa areas. The survey questionnaire solicited opinions about the development process and the decisions that determine urban form.

IMPACTS

Property taxes and development charges are expected to have a number of land use consequences. When differences in taxes and development charges reflect differences in municipal services, then people desiring more services select municipalities that provide these services, at a higher charge, and no excess burden is produced. Thus, for taxes and charges to distort behavior, they need to create a burden beyond the perceived value of the services they support.

Regardless of the levels of service provided, property taxes create a substitution effect leading to lower-than-optimal densities, as the tax burden on land is capitalized into lower land prices, while the tax on buildings remains as a tax on capital. As a result, developers are expected to reduce the capital structure portion of their real estate investment in favor of the land component. By changing the relative rates at which the land and the building components are taxed, municipalities have tried to change the intensity with which land is developed. Pittsburgh, for example, uses differential tax rates on land and buildings, with the goal of stimulating downtown development. Planners in New Zealand and Australia have advocated the use of land value rather than the property value taxation to stimulate development. Half of the municipalities in the Melbourne region tax only the land component of real estate to avoid the substitution effect. However, despite these precedents, there is little compelling empirical evidence of the efficacy of using fiscal instruments to shape cities.

Theory recognizes that property taxes and development charges change the value of holding vacant or underused land for later development. The delay affects the optimal density of development by changing the economic conditions under which it occurs. In a growing metropolitan area, land values increase with time and delays are therefore expected to encourage a more frugal use of land, which increases density. Development occurs not only in a planning context but also in the political arena, which integrates and mediates the concerns of residents with market forces. When new developments are not seen as paying their "fair share" of infrastructure costs, local residents' resistance to growth makes it difficult for developers to obtain approvals. Development charges may reduce this resistance and help speed the development process by ensuring that the infrastructure is funded. In fact, it may even subsidize current residents. This may reduce the risk and uncertainty of attempting to develop at higher densities.

Whether these expectations are borne out depends on the awareness of real estate developers of the potential impacts of the instruments, and their decision processes. If developers fail to perceive the effect of the instruments, changes in the instruments will have little direct impact on their development decisions. To improve our understanding of the spatial impacts of property taxes and development charges, we surveyed developers, asking the following questions:

- Do property taxes and development charges affect decisions on the location of projects?
- Do differences in tax rates and development charges reflect differences in service costs?
- Do property taxes affect decisions on project density?
- Do property taxes affect decisions on development timing?
- Do the existing development charges schedules encourage low-density development?
- Do development charges affect city form by delaying development?
- Do development charges ease the development approvals process? Do they ensure that infrastructure is provided on time?

These questions were addressed through a questionnaire sent to 112 developers in the Toronto and Ottawa regions in 1999. The developers were asked to indicate the extent to which they agreed or disagreed with each statement. Background information was also gained on the volume and nature of their companies. Thirty-six responses were obtained. The small sample means that the conclusions developed here are suggestive but not conclusive.

THE CONTEXT

Canadian property taxation is a provincial responsibility. In the province of Ontario, property taxes are assessed at rates that vary by property type. However, the Ottawa and Toronto metropolitan regions have different fiscal arrangements, and the relationship between assessed values and market values varies across municipalities. For example, at the time of this survey, municipalities in metropolitan Toronto based their assessments on property values dating back to the 1940s, while many suburban areas used current market values as the basis for assessments.

In metropolitan Ottawa the property tax regime is simpler. First, there is only one upper-tier government, using a current market value system to equalize assessments across municipalities. Second, tax-rate differentials between property types are not as great as in the Toronto region. For example, in the City of Ottawa, the effective tax rate for residential properties of six units or less is 72 percent of the commercial rate, while in the City of Toronto it is only 27 percent. Thus, property taxes in the Ottawa study area tend to present a more level playing field across geographical locations and land uses, while non-residential property taxes in metropolitan Toronto tend to be much higher (on a market value basis) than in the adjacent suburban areas, whereas residential property taxes tend to be lower.

Development charge regimes display more uniformity across the two regions. Municipalities in both regions have development charges. Most charges are based on estimates of capital costs associated with new growth, including hard and soft infrastructure such as schools, fire stations, public administrative offices, and recreation centers. Many municipalities have adopted bylaws charging less than the theoretical rates, especially for non-residential charges. Generally these bylaws differentiate between dwelling types, charging higher rates on detached single-family dwellings, lower rates on row houses, and the lowest rates on apartments. In some cases, development charges vary according to the location of the project within a municipality, with lower charges for unserviced rural areas. Across each region, municipalities within core areas tend to have lower development charges than suburban and rural municipalities.

SURVEY RESULTS

Do property taxes and development charges affect decisions on the location of projects? The survey suggests that property taxes are moderately influential in some cases, but most developers consider them unimportant in their location decisions. Developers tend not to see property taxes as affecting them directly, knowing these taxes will be paid by the homebuyers. It may also be that property taxes reflect the quality of municipal services and therefore create no excess burden for homebuyers. With regard to development charges, reactions differ remarkably. Development charges are directly paid by developers. Most developers consider differences across municipalities in development charges when making location decisions, at least some of the time. When infrastructure costs vary across a municipality, fees should differentiate across planning sectors. The survey results suggest that area-specific fees steer the location of development within the metropolitan area.

Do differences in tax rates and development charges reflect differences in service costs? Taxes and development charges create no burden when they accurately reflect the incremental cost of municipal services, as they are then fair prices for value rendered. Our survey indicates that developers believe that differences in tax rates and development charges do not reflect differences in quality and quantity of the services and infrastructure supplied by municipalities. One might expect developers to react to the taxes and fees in ways that reduce their burdens. A high tax on a per-dwelling basis would encourage developers to build fewer houses on a tract of land but charge a higher price per dwelling. If charges and taxes on apartment buildings are higher than the cost of servicing them relative to the charges and costs of detached dwellings (as is often the case in Canada) then the fiscal instruments would distort development decisions in favor of the lower-density and higher-priced housing options. However, our survey also reveals that developers are relatively indifferent to property taxes. This suggests that either property taxes do reflect services delivered, or that developers do not recognize the indirect burden of the taxes, either because they are not aware that property taxes reduce the consumer's ability to pay for houses, or because the tax burdens have been capitalized back into lower land prices and therefore into lower house prices. Such capitalization would mean that the landowner absorbs the burden, leaving the developer unaffected.

Do property taxes affect decisions on project density? The tax on the land component of real estate was once thought to be capitalized into land prices and therefore left development patterns unaffected. However, the part of the tax that rests on the building is a tax on capital. It increases the developer's burden as the capital-to-land ratio is increased. To reduce this burden the developer can substitute more land for capital. In other words, the substitution effect of property taxes should encourage developers to build less dense projects, which would cause metropolitan areas to spread out. Differences in tax rates on apartments and single-family houses are also expected to favor low-density development options.

Are developers aware of the substitution effect, and does it alter densities? The survey suggests that developers see no connection between property taxes and the profitability of varying the capital portion of their projects. Property taxes are not treated as a tax on the improvement. Some developers believe that the reduction of the higher rate on apartments would lead to more apartment construction. Almost as many developers believe that property taxes are too small to matter much, and the equalization of rates would therefore have virtually no effect on what was built. Interestingly, informal interviews with developers in the two regions suggested that, in some cases, proposed apartment projects were judged unfeasible due to the higher tax rates.

Do property taxes affect decisions on development timing? Since property taxes affect the cost of holding vacant and underused land, tax increases are expected to induce the owners of underused inner-city land to redevelop more quickly. In the suburbs, timing decisions may be also affected when the intensity with which the land can be developed increases with time. When zoning constraints are not binding in a growing metropolitan area, the delay in development will lead to higher-density projects. In a growing metro area, land values rise, making later development use the higher-priced land more intensely.

According to our survey, property tax increases do not, in the opinion of developers, lead to earlier redevelopment in the inner city. The higher taxes on the redeveloped project might induce them to delay until rents and prices increase to cover the tax burdens. Delays are not seen to produce higher densities. Zoning constraints tend to determine project density, not marginal changes in land values. This makes sense, as zoning effects must swamp the tax and fee effects, in dollar value.

Do existing development charges encourage low-density development? Suburban municipalities are often thought to discriminate against higher-density projects as a result of the NIMBY syndrome. Development charges might be set in ways that encourage the construction of single family houses in the suburbs. Toronto-area developers tend to agree that suburban municipalities discriminate against higher-density land uses, while the Ottawa developers offer a mixed reaction. Development charges are seen by Toronto developers to favor large lot subdivisions; Ottawa developers disagree. Differences in the municipal attitudes toward higher-density uses are reflected in differences in development cost charge schedules.

Do development charges delay development? In a growing metropolitan area, a delay in development will mean that development densities will increase. With time, land values rise and the higher price of land leads to less being used in the production of real estate. However, developers' survey responses indicate that increases in development cost charges would delay development but that the burdens are capitalized into lower land prices. When development charges lead to lower land prices, they do not raise housing prices. This land market impact greatly reduces the ability of development charge policy to influence developer behavior.

Do development charges ease the development approvals process? Do they ensure that infrastructure is provided on time? By paying for municipal infrastructure associated with new projects, development charges are expected to reduce impediments to urban growth. In some cases, development charges are thought to be higher than the incremental cost of the infrastructure needed to accommodate a new project and yield a net fiscal dividend to the city. The reliance on development charges to pay for infrastructure expansion is therefore expected to ease the approvals process and to ensure that services are provided at the time the project needs them. However, neither expectation is borne out by the survey. As developers see it, development charges have not eased the approvals process, nor have charges helped ensure the timely delivery of services. This is probably because areas that are against growth are against it many ways: fees, delays, restrictive zoning, and so on.

OVERVIEW

The survey results reveal that property taxes have little or no effect on decisions regarding the location of development when all of the other factors, namely market conditions, zoning and the approvals process, are the same. The relatively higher taxes on apartments may discourage apartment construction. However, developers are not particularly sensitive to property tax differences across municipalities even though they do not see the differences as reflecting differences in the levels of service. Development charges affect location decisions and may be used to direct development toward the parts of the urban region deemed more suitable for expansion. For the fiscal instruments to have a noticeable effect on built form, the differences in tax rates and development charges have to be large enough to really matter to the developers, and even then they are only one of myriad factors affecting development decisions.

Increases in development charges delay development but do not change development patterns, which are determined primarily by zoning. Development charges reduce land prices and this tends to reduce their potential impact on built form—and on housing prices. When raw land prices are low, as was the case in the Ottawa area at the time of the survey, high development charges cannot be absorbed by reducing land prices and they force housing prices upward and make lower-density housing less affordable. This, in turn, favors suburban town-house development. However, the main potential effect on density is through the differentiation of the charges in ways that accurately reflect the relative cost to the municipality of the different building types and densities.

Development charges can make cities more compact when the initial price of land is low or when large fee differences are established to reflect the difference in the full social cost of low- and high-density projects. They are less effective as instruments in demand-driven markets with rapidly rising land prices because the development charge burden is absorbed into lower land prices.

Development charges are theoretically designed as charges for services rendered and should therefore eliminate one of the contentious issues in development approvals, namely whether the municipality can afford to service the proposed development. However, the Ottawa and Toronto developers we interviewed do not believe that the institution of development charges has eased the approvals process or ensured that infrastructure is in place when needed.

Setting fee differentials across a region to reflect differences in service costs will redirect development in normal markets. The design of fee differentials can help municipalities deal with the costs of urban growth. Area-specific fees that differentiate across the region in ways that recognize the differences in infrastructure and environmental costs created by new developments have a place in the array of land-use planning instruments.

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