TO:	**CHAIR AND MEMBERS** **FINANCE AND ADMINISTRATION COMMITTEE** **MEETING ON NOVEMBER 2, 2011**
FROM:	**MARTIN HAYWARD** **CITY TREASURER, CHIEF FINANCIAL OFFICER**
SUBJECT:	**FUTURE TAX POLICY**

RECOMMENDATION

That, on the recommendation of the City Treasurer, Chief Financial Officer, the following actions **BE TAKEN** with respect to property taxation:

1. That tax ratios in the City of London for the industrial and multi-residential property classes be reduced in the future so that they are equal to the commercial property class;

2. That City Council decide during budget deliberations for 2012 whether to implement recommendation # 1 above immediately in 2012 or phase-in implementation over a number of years, the time period for phase-in to be determined during budget deliberations.

PREVIOUS REPORTS PERTINENT TO THIS MATTER

Finance and Administration Committee Report, March 30, 2011 – Year 2011 Tax Policy

BACKGROUND

What is a tax ratio?

Tax ratios compare the tax rate for <u>municipal purposes</u> in a particular property class to the residential class. The ratio for the residential class is deemed to be 1.00. A tax ratio of 1.98 for the commercial class would therefore indicate a <u>municipal</u> tax rate 1.98 times the residential municipal tax rate. (Education tax rates are set by the Province and are not dependent on tax ratios approved by municipal councils.)

What are the Provincial thresholds for tax ratios?

Beginning in the year 2001, the Province established threshold tax ratios for three property classes - commercial, industrial, and multi-residential. At the time, the Province indicated that these threshold ratios represented the Provincial average in each class. Under provisions of the Municipal Act and related regulations, municipalities were not permitted for the year 2001 or subsequent years to impose a general municipal levy increase on a property class which had a ratio exceeding the Provincial threshold or average. Beginning in 2004, this restriction was modified somewhat to permit levy increases at half the residential rate in property classes with tax ratios above Provincial thresholds. The Province has permitted this flexibility every year since 2004. The general principle however continues that property tax increases cannot be spread evenly over all property classes if any tax ratio exceeds the Provincial thresholds.

How do London's tax ratios compare to Provincial thresholds and other municipalities?

None of the property classes in the City of London have tax ratios that are above the Provincial thresholds. The only property class in London that was ever above the Provincial threshold was the industrial class. Council moved the industrial ratio down to the threshold for 2001 taxation. At the time of the last reassessments in 2006 and 2009, Council maintained the policy of not permitting tax ratios in any property class to exceed Provincial thresholds.

Schedule A attached summarizes the tax ratios for all municipalities with populations greater than 100,000 included in the 2010 Municipal Study prepared by BMA Management Consulting Inc. When residual and large industrial optional classes are combined, London is within about 7% of the median tax ratio value for all property classes on Schedule A even without any weighting of the City of Toronto to reflect its size in the group. This would suggest that the relative treatment of property classes in London for the purposes of municipal taxation is in the typical or average range when considered in the context of the entire Province.

The tax ratios in effect for the year 2011 and their proximity to the Provincial thresholds or averages established in 2001, as well as the Provincial targets or allowable ranges can be summarized as follows:

	City of London 2011 Tax Ratio	**Provincial Threshold/Average (O.Reg. 73/03)**	**Provincial Targets/Allowable Ranges (O.Reg. 386/98)**
Commercial	1.980000	1.98	0.6 to 1.1
Industrial	2.630000	2.63	0.6 to 1.1
Multi-Residential	2.087700	2.74	1.0 to 1.1
Pipeline	1.713000	N/A	0.6 to 0.7
Farm	0.250000	N/A	N/A
Residential	1.000000	N/A	N/A

Schedule B attached provides comparative information on how different municipalities tax the various different major property classes. The information from Schedule B comes from the 2010 BMA Municipal Study and includes all municipalities with populations greater than 100,000. The last column of Schedule B is a theoretical calculation that shows the tax increase that would be required in the residential property class in each municipality if all property classes had a tax ratio of 1. The Schedule indicates that the theoretical adjustment for the City of London would be close to the middle of the group without giving special weighting to Toronto to reflect its much larger size. Schedule B again reinforces the perspective that the City of London's tax ratios are in the average range and not unusual when compared to other major centres in the Province.

Why are tax ratios different for different property classes and why does each municipality have different tax ratios?

Prior to 1970 the assessment of property for property taxation purposes was under the jurisdiction of each individual municipality in the Province. One result of this highly decentralized system was that the assessment valuation system within the Province was inconsistent from one municipality to another. Another result was that difference in the treatment of different property classes developed within municipalities. In 1970, after a report by the Ontario Committee on Taxation, the Provincial Government assumed responsibility for property assessment from all the municipalities in the Province. The new system started in 1970, was a market value system, however, adopting a pure market value system was offered to municipal governments on a voluntary basis.

Since the adopting of a pure market value assessment system in 1970 would have resulted in major shifts in taxation between property classes, virtually all municipalities did not adopt a pure market value assessment system. Instead municipalities adopted a factored market value system where taxation shifts between property classes did not occur. Under a factored market value system, each property within a property class was given an assessment value calculated as its market value multiplied by a specific factor expressed as a decimal. This specific factor was a uniform decimal number for each property class. By this method, taxes were allocated based on market value within each property class. At the same time, however, taxes did not shift between property class, and the classes maintained the same tax burden that they had before the change to market value assessment.

In preparation for major property tax reform to begin implementation in 1998, the Province passed the Fair Municipal Finance Act, 1997. This legislation required the entire Province to be reassessed based on market value and brought an end to factored assessments. Beginning in 1998 all properties were required to be assessed at market value rather than a factored market value and this un-factored market value was to be the taxable amount shown on tax bills.

At the same time, the Province recognized that they could not cause huge tax shifts between property classes as a result of the new system. To prevent tax shifts, the Province permitted property classes to have different tax rates as determined by the municipalities. The concept of tax ratios was then created in the new legislation so that the Province could set the rules as to what would be permissible with respect to tax rate differences between property classes. These are the rules we live with today and some of which have been briefly described earlier in this report.

Is there any logical justification for tax ratios being different in different property classes?

When the Province introduced the Fair Municipal Finance Act, 1997, the implied assumption in the legislation appeared to be that all property classes should have a tax ratio of 1 and there was no logical justification for tax ratios in different classes greater than one. This thinking was demonstrated in the rules adopted in the legislation with respect to changing tax ratios, the establishment of thresholds for certain classes and the allowable ranges/targets established with Ontario Regulation 386/98 (see previous table in this report).

At the same time however, the Province recognized in the legislation that immediately moving to tax ratios of 1 for all major property classes was not realistic or practical. History since 1998 has also shown that moving quickly to tax ratios of one for all property classes was not realistic or practical. The reasons these courses of action are problematical is the impact on the residential class. Earlier in this report a reference was made to Schedule B of this report. Schedule B of this report shows the impact of a pure market value system with tax ratios of 1 for a large sample of municipalities in the Province.

In addition to possible concerns about the simple impact on the residential class of a uniform tax ratio of 1, there are significant issues relating to logic of such an approach. These are as follows:

1. Historical tax ratios are built into the present system and competitive environment;
2. Property taxes in certain property classes are tax deductible;
3. Market value has a different meaning in different property classes.

1. Historical Tax Ratios are Built into the Present System

Historical ratios are built into the economic environment and reflected in prices and wages in the local economy. When looking at this issue one has to consider the larger economy of the Province and beyond, as well as the local economic environment of the City. For some commercial enterprises their primary competitors will be other enterprises in the City. For others, the primary competitors will be in the greater region, elsewhere in the Province, in other provinces or in other countries. The tax ratios applicable to other competitors will be a factor in the competitive equation for doing business in the City.

The City will want to ensure that tax ratios faced by London businesses are at least competitive with tax ratios applicable to their competition. If the tax ratios in London are competitive then it may not be advisable to significantly alter taxes in the residential class. It should always be kept in mind that maintaining competitive tax ratios in all classes including the residential class are a requirement for robust economic development. The availability of a productive labour force may be a more significant factor for economic development than the level of property taxation in a particular non-residential class. Schedule B indicates the significant adjustment that would result in the residential class if all tax ratios were immediately equalized to the residential class.

As indicated previously in this report, both the attached Schedules A and B suggest that tax ratios in London are in a range similar to other municipalities in Ontario. Schedule A indicates that London's multi-residential tax ratio is just slightly below the median, London's commercial tax ratio is just slightly above the median and London's industrial ratio is about 7.1% above the median.

It should be kept in mind however, that the general trend in recent years has always been to decrease tax ratios in non-residential classes both as a result of the requirements of Provincial legislation and deliberate decisions by municipal councils. Schedule A shows the tax ratios for municipalities with populations greater than 100,000 which were included in the BMA study. The average tax ratios for all the non-residential property classes shown on that Schedule (i.e. multi-residential, commercial and industrial) have declined in recent years. Since 2006, the multi-residential class average tax ratio for the group has declined by about 4%, the commercial tax ratio has declined by about 2% and the industrial tax ratio has declined by about 5%.

2. Property Taxes in Certain Property Classes are Tax Deductible

Property taxes in the commercial, industrial, and multi-residential are deductible in computing income for tax purposes. Residential property taxes for the most part are paid from after tax income. Depending on marginal tax rates, there can be large differences when expenditures are viewed from a pre-tax or an after-tax perspective. Tax deductibility also indicates the purpose behind the expenditure. Taxes paid on residential property for the most part represent personal expenditures for a place to live and provide the requirements of life, whereas taxes paid in non-residential class will often represent the commercial activities of large enterprises.

3. Market Value has a Different Meaning in Different Property Classes

Properties are valued by very different methods in residential versus non-residential property classes. In the residential class, properties are valued based on the actual sale of similar individual properties. There are usually numerous similar individual sales on which to base the determination. Properties sell in a market where houses are sold one at a time.

In the commercial and multi-residential classes, a property's market value is determined based on the income approach. This means that the income that the property generates is determined and then that income stream is capitalized using an applicable multiple based on an appropriate interest rate. This valuation method illustrates that the only consideration in value determination in these kinds of properties is income generating capabilities. Other types of factors will go into the valuation of a residential property. In the industrial property class, properties are generally valued based on construction costs. Buildings in this class are often built to suit and there is not a large volume of transactions involving generic type buildings.

In addition, multi-residential properties, although they may be residential in nature sell in a completely different kind of market from a single unit residential property. Multi-residential properties sell in large unit volumes between large commercial enterprises whereas single unit residential properties sell one at a time and involve individuals. The differences in the market places can be viewed like the differences between a wholesale market and a retail market. The result is that properties that are physically very similar can sell at substantially different prices in the two market places. In many large cities, a residential condominium unit will have a much higher market value than a physically similar multi-residential apartment unit. The difference in market value will be so large that despite the fact that the tax ratio for the multi-residential class is much higher than the residential class, the taxes on the physically similar condominium unit will be higher than the multi-residential unit.

Is there any logical justification for the industrial and multi-residential tax ratios being higher than the commercial tax ratio?

The simple short answer to this question would seem to be "no". All three of these property classes represent commercial activity. The property taxes paid in all three of these classes would be deductible from income taxes. All three of these property types trade in commercial markets where value is determined by cash flow. The general advice of economists to governments is to keep a level playing field and try not to pick winners and losers in the determination of tax policy. There would appear to be little justification for keeping any kind of tax ratio differential for these three property classes. It is therefore recommended that the multi-residential and the industrial property class be reduced to the same level as the commercial class (i.e. a tax ratio 1.98).

We have noticed recently in reviewing the BMA Study of municipalities in Ontario that the Region of Waterloo has been gradually equalizing its non-residential tax ratios over the period 2006 to 2010. In 2006, the Region had non-residential tax ratios very similar to London. Its industrial ratio in 2006 was 2.61 compared to London's 2.63. Its multi-residential ratio was 2.74 compared to London's 2.1455. Its commercial ratio was 1.95 compared to London's 1.98. Over the period 2006-2010 the Waterloo Region reduced both their multi-residential and their industrial tax ratios so that they were equal to their commercial tax ratio of 1.95. As can be seen on Schedule A of this report, most municipalities have maintained their historical patterns of higher industrial and multi-residential tax ratios, however, as noted previously the general trend has been to reduce tax ratios in all three non-residential classes on Schedule A.

What is the financial impact of recommendation #1 of this report?

Reducing tax ratios in the industrial and multi-residential property classes would increase municipal taxes in the all the other property classes by about 1.3%. The other property classes that would experience the 1.3% increase include the two largest property classes in the City (i.e. the residential class and the commercial class). At the same time, the industrial class would experience a 23.46% decrease in the level of municipal taxation while the multi-residential class would experience a 3.90% decrease. In dollar terms, $1.6 million in municipal taxes would come off the multi-residential class and $3.8 million would come off the industrial property class. At the same time, municipal taxes would increase by $4.1 million in the residential class and $1.3 million in the commercial class.

Primary reason for this change is to promote competitiveness and economic development in industry and multi-residential classes.

As indicated above, an immediate implementation of recommendation #1 would result in a municipal tax increase in the residential and commercial property classes on average of 1.3%. For a typical residential property in 2011 this would have amounted to about $31. The primary benefit of the recommendation would be to improve the City's **competitiveness** and **promote economic development** particularly in the industrial and multi-residential classes. As indicated in the financial impact described above, the incentive in the industrial class is significant. At a time when unemployment is high and economic growth is slow it is important for the City to adopt property tax policy that will promote economic development and employment growth both in the short term and the long term as conditions may improve.

It is difficult to assess how quickly the potential economic benefits of recommendation #1 can be realized. Council has to consider other financial pressures that are occurring each year and their impact on the final tax increase to be approved regardless of any tax shifts occurring between classes as a result of tax policy decisions. It would seem the best time for Council to make this judgement would be at the same time that the tax increase for the year is being finalized during budget deliberations.

What are the benefits and other considerations that should be taken into account in the implementation and timing of the recommendations of this report?

Recommendation #1 fulfils all the other basic tax policy principles as described in Schedule C attached. The recommendation will promote equity in the tax system by eliminating tax ratio differences in the major non-residential classes. The recommendation will be transparent in that it would be communicated clearly to the public and its purpose should be easy to understand and explain. The recommendation also qualifies as administratively efficient in that it will not require any significant changes to computer systems or staffing levels.

The benefits of recommendation #1 however, must be weighed against the other effects of implementation. Taxes will be transferred somewhat to the residential and commercial property classes. The effect on the commercial class should not be significant. There are ongoing education tax decreases in the commercial class until 2014 that began in 2008 that are much larger than any tax change due to recommendation #1 of this report.

It should also be kept in mind that 2013 will be the next general reassessment year for all municipalities in the Province. Whenever there is a reassessment there is the potential for taxes to shift between property classes in ways that cannot be accurately predicted in advance. The potential tax shifts from the reassessment in 2013 may or may not be an issue to be considered when implementing changes in tax ratios in that year. Detailed analysis of the situation will be done in 2013 as part of the annual review of tax policy.

How would any tax changes between property classes be presented on tax bills in the section of the bill titled "Explanation of Tax Changes"?

Section 344 of the Municipal Act, 2001 gives the Minister of Finance authority for the Province of Ontario to regulate the form and content of municipal property tax bills. In accordance with that section the Minister has approved Ontario Regulation 75/01. Sections 10 to 14 of the regulation set out the requirements with respect to reporting changes in taxation on residential property tax bills. The regulation requires that all tax changes for a single tier municipality be classified as one of three categories as follows:

1/ municipal levy change
2/ provincial education levy change
3/ change attributable to current value reassessment

Section 14 of the regulation appears to prohibit any other tax change categorizations or the presentation of additional fields on the tax bill to describe tax changes. As a result the change resulting from a tax ratio change as described in this report would have to be allocated to one of the above three categories although it could be reasonably argued that none of the categories exactly describes the type of change that is occurring.

We have discussed the presentation issue with the consultants who run the OPTA web site (Ontario Property Tax Analysis) on behalf of the Ministry of Municipal Affairs. The OPTA web site is a tax calculation tool that the Province operates to assist municipalities in their property tax calculations. The Province's consultants have acknowledged the limitations of the three categorizations indicated in Ontario Regulation 75/01. The Province's consultants have indicated that their own calculation process would allocate any tax changes resulting from tax ratio decreases to category indicated above as "change attributable to current value reassessment". Based on this information we would propose to use the same categorization and include a note indicating that tax changes related to changes in tax ratios for property classes are included in the "current value reassessment" line.

Additional Background Information on Tax Policy Attached to this Report as Schedule C

A summary report on tax policy development in the City of London was prepared for the 2010 Financial Report. For reference purposes, that summary report is attached to this report as Schedule C. The summary report is divided into four sections – History of the Present Environment, Principles of Property Taxation in the City of London, Tax Policy Formulation 1998 to present, and Future Tax Policy. Reference was made in the summary report attached as Schedule C to future preparation of this report.

SUMMARY

It is recommended that the tax ratios in the Industrial and Multi-residential classes be reduced so that they are equal to the commercial tax ratio. (i.e. 1.98) after 2011. It is further recommended that the determination as to how quickly to move the industrial and multi-residential tax ratios to the commercial level be made during 2012 budget deliberations at the same time that the tax levy for the year is being finalized.

The recommendations of this report if implemented would result in increases of 1.3% in the municipal portion of the property tax bill in other property classes (e.g. the residential and commercial property classes). At the same time the recommendations would decrease taxes in the industrial and multi-residential property classes by 23.46% and 3.9% respectively.

The benefits of the recommendations of this report would be to promote economic development and employment in the City. The recommendations are also consistent with the other basic principles of property tax policy as described in schedule C attached in that they would promote equity in the tax system, would be transparent to the public, and could be implemented in an administratively efficient manner.

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Attachments