Residential Development Charges Lead to a Hidden Tax for City Residents

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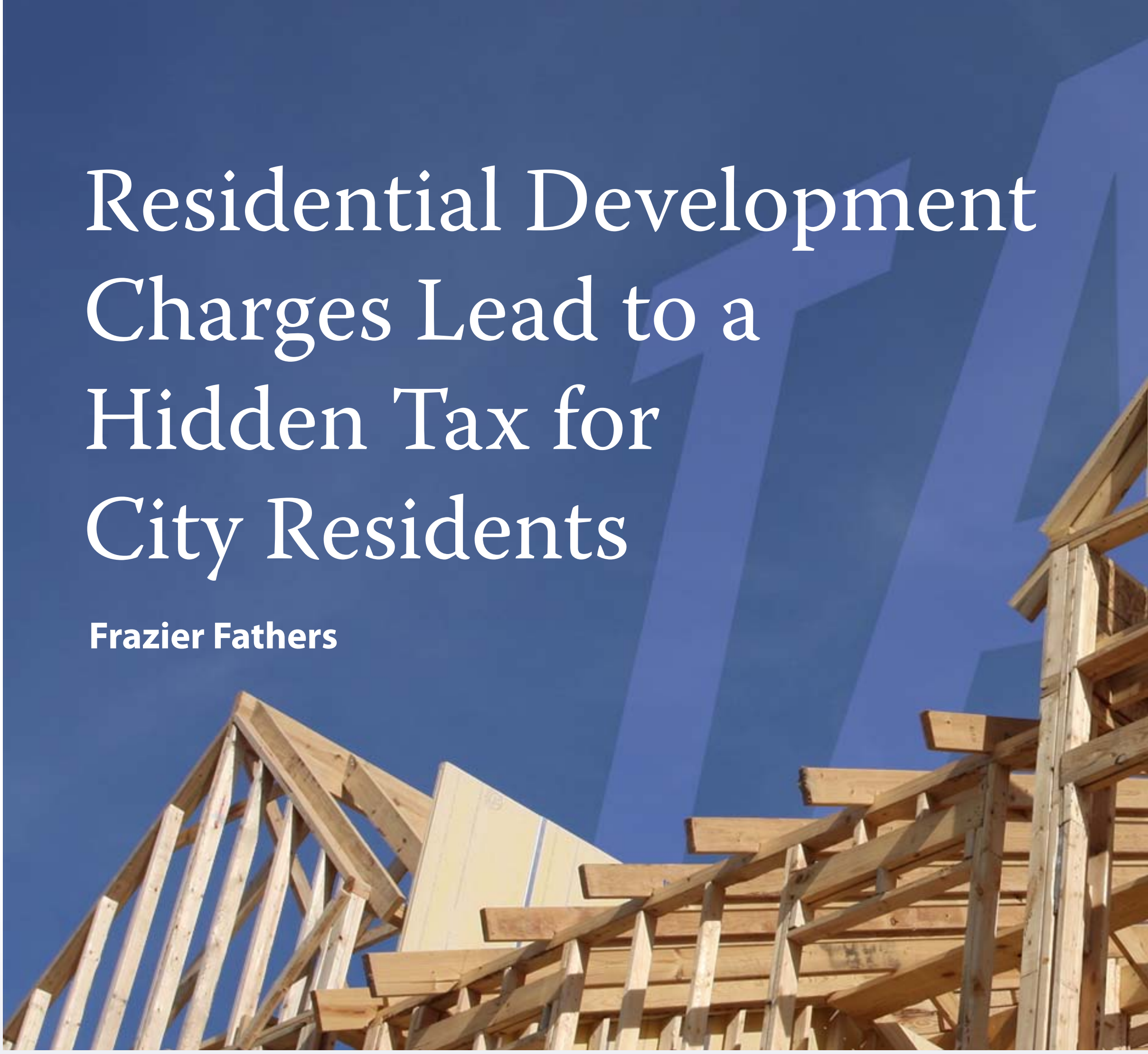

The argument that development charges are an efficient way to pay for new or upgraded infrastructure (roads, sewers, and mass transit) has been long favoured by urban planners and politicians as a practical alternative to increased property tax rates or user fees.[1] Unfortunately, development charges represent a bait and switch on city taxpayers. Although the charges force developers to pay for new infrastructure to support their developments, these same charges translate into higher housing prices and property tax rates for all residents.

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Origins of development charges in Ontario

Development charges emerged in Ontario in the 1950s as a result of the municipal growth pressures of the post-war period. Up to that point, the cost of development was covered by local tax levies that were implemented on developers and those who benefited from the service improvements of the development under the Local Improvement Act of 1914. Unfortunately, this funding formula saw municipalities become indebted as a result of developers failing to fulfil their obligations (Skaburskis and Tomalty, 2000: 304-05).

Citizens will ultimately pay through higher property tax assessments

Development charges partially emerged as a means for municipalities to ensure that developers fulfilled their obligations and what evolved were two distinct methods of implementation: marginal cost development charges and average cost development charges. Urban planners want to see land and city services used efficiently and argue that by setting these charges to the marginal cost of development in a neighbourhood or city district they can effectively control the type and speed of development that occurs. Marginal cost charges can theoretically control growth by lowering costs in certain segments of a city while blanket average cost charges tend to encourage urban sprawl (Skaburskis and Tomalty, 2003: 144).

Developers, who prefer no charges at all, tend to also prefer the marginal or lot specific charges when compared to blanket average cost development charges. Marginal charges allow developers to pick the regions of a city with the lowest charges, which allows for higher profits rather than forced cost burdens from other parts of the jurisdiction on their projects (Skaburskis and Tomalty, 1997: 1993). In the 1980s developers challenged and lost cases (ex. Wimpey v. Durham Region) on average cost development charges at the Ontario Municipal Board (OMB).

From an economic standpoint, the average cost method seems to be the more efficient method. Local politicians often fall in line with economists with these charges, as they want to deliver services and amenities to their constituents while ensuring that the costs are kept low or are borne by other groups. Blanket charges, which are easy to understand and implement, ensure that costs are borne by the largest group possible and limit political resistance.

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Municipalities adopt various types of charges for different reasons, including: equity, efficiency, administrative considerations, public acceptability, and political considerations (Snyder and Stegman, 1988). Although the size of the jurisdiction does have an impact on the type of charges that are implemented, average cost charges have become increasingly common. Many larger and growing jurisdictions use a hybrid method with blanket average cost charges augmented by marginal cost charges or exceptions in certain areas to encourage or discourage growth compared to the mean. However, the altruistic motivations behind marginal cost charges have largely not been observed in practice. Evidence from some research shows that certain forms of development are more readily authorized as a result of financial revenues that come from the development charges and the future property tax potential of the development (Skaburskis and Tomalty, 2000: 317-318).

For the average citizen already living in the city, the idea of making developers pay for the infrastructure of a new development through development charges is an attractive but misleading option; they will ultimately pay indirectly for the new infrastructure through higher property tax assessments and home prices.

Who pays the development charges?

Of course the charges outlined above need to be paid by someone, the question is whether the developer, the consumer, or both pays the additional cost. In general, development charges must be paid when acquiring a permit, which means that before a single scoop of earth has been moved the developer is often on the hook for millions, if not tens of millions, of dollars.

There is little question that the developer initially pays these statutory charges but the question of whether their costs are absorbed by the developer or passed directly to the consumer is important. To answer the question of who pays the charges one must look at the broader characteristics of the housing market, the availability of supply, and the demand for housing, along with their interrelated elasticities (Slack, 1994: 43-44). In cities, where demand for housing is high or supply is constrained, a seller's market exists. Developers of new homes hold purchasing power and are able to charge maximum prices for their property. The costs of development are then passed on to the buyer. The opposite is true for weaker housing markets where excess supply or low demand exist and buyers hold the purchasing power, and sellers are forced to reduce prices and absorb a portion of costs (or lessen their profits) (Watkins, 1999: 419-422).

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Market fluctuations will determine how much of the charges developers will have to absorb

From these factors it would be expected that high demand or low supply markets, based on consumer willingness to pay a higher price, would result in at least a portion if not all of the development charge being passed on to consumers. A 2004 report commissioned by the City of Toronto recognized this fact and concluded that the possibility of the increased charge being passed to consumers is much higher in high demand areas of the city, such as the central downtown area, while also acknowledging "increased selling or rental prices by a small magnitude." The same report justifies the raising of development charges by claiming that implementation will offset the need for tax increases or user fees, thus lowering the tax burden on the new residences (Hemson, 2013: 46).

Effect of development charges on housing prices and property taxes

Increasing development charges rather than tax rates may protect citizens from a direct tax increase, but in booming housing markets these charges have an impact on property taxes.[2] A City of Hamilton study of development charges found that for every dollar increase in a charge, a $1.60 increase in the price of new and existing homes occurs (C. N. Watson and Associates, 2007: 39).

In Ontario, calculation of property taxes is carried out by the Municipal Property Assessment Corporation (MPAC) in accordance with the Ontario Assessment Act. This assessment of home value is generated by MPAC through an evaluation of as many as 200 factors with the five primary factors being: location; lot dimensions; living area; age of the property, adjusted for any major renovations or additions; and quality of construction. They then take these factors and compare them to other housing in the area (MPAC, 2013).

Increasing development charges can lead to higher prices for new and existing homes

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As a new development enters a neighbourhood, higher development charges prior to construction are not only passed on to the purchaser (depending on the elasticities of supply and demand) but they also raise the future tax cost of the unit being purchased through a higher property tax assessment (Urban Development Institute, 1990: 3). Since property taxes are calculated by using comparable purchase and sale prices, increased development charges also increase existing home values. This higher price is then passed onto the tax assessment of existing residences of the neighbourhood, resulting in a higher tax bill.

Conclusions

Raising development charges in order to fund major infrastructure projects or support a city's finances as a means to prevent property tax increases is a political bait and switch. Although these charges may bring some benefits, like access to greater amenities, the cost imposed on a city's residents results in an inflation of prices for new and existing homes which in turn impacts future property tax assessments. This coupled with evidence that development projects that garner greater charge fees and higher long run property tax assessments are more likely to be approved by cities, means that higher development charges are going to cost all city residents in the long term through higher tax rates and more expensive housing.

Notes

1 A development charge is a onetime fee that is charged to new development within a jurisdiction. These rates range in Canada from approximately 5-19% of a home's value (Canada Mortgage and Housing Corporation, 2010: 5). Property taxes and user fees are annual or usage based charges that are assigned to an owner of a property in a jurisdiction.

2 Property taxes are calculated based on an assessment of a household property value within a city.

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