



Property Tax *Disrupted*

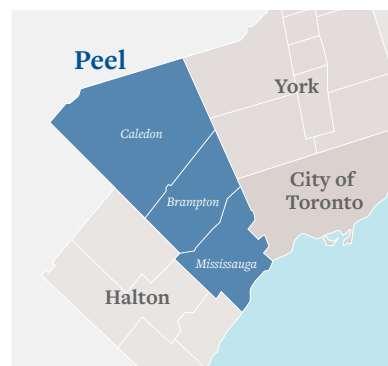
BY SHAYNE KAVANAGH

Technological change has disrupted many traditional industries. Some of the most notable include print media, telecom, retail, and music. Some cities have firsthand experience with rideshare technologies like Uber and Lyft disrupting the traditional taxi industry. Many more local governments, though, have experience with technology disrupting traditional revenues.

The effect of online retail on sales taxes is perhaps the most obvious example of local government revenue disruption. More recently, short-term rental platforms like Airbnb disrupted local hotel taxes. Technology has also begun to disrupt the biggest local government revenue of them all: property taxes. Property tax is the largest revenue generated by local government in North America. In the United States, for example, it accounts for approximately 30 percent of all revenues generated by local governments.¹

It might seem that because the property tax is rooted in physical land use, it would be insulated from technology-led disruption. There is no single, big, obvious technological force we can point to as a disruptor, as we can for hotel taxes and Airbnb or sales taxes and online retailing, but many less obvious 21st-century technological forces are conspiring to reduce the relevance of property taxes, which have been in use in North America since at least the mid- to late 1600s.²

About the Region of Peel



The Region of Peel is located to the west of Toronto. It has a population of 1.48 million, projected to grow to 1.97 million by 2041. Peel provides services such as public health, housing, waste management, and transportation. The cities of Brampton, Mississauga, and Caledon are located in Peel, which is also a center of commerce, with \$1.8 billion worth of commodities traveling through every day.

The Region of Peel, Ontario, recognized this disruption and decided to do something about it. According to Stephen VanOfwegen, chief financial officer of the Region of Peel, “As the economy and labour market evolve, we must actively explore ways to maintain financial sustainability and modernize approaches to revenue generation.” Peel is very dependent on property taxes, so the regional government’s financial foundation was at stake. The Region of Peel has practiced long-term financial planning for many years, so it recognized that it needed to start adapting before the disruption became a crisis. In this article, we will review how the Region of Peel has started to tackle this problem.

ESTABLISH TRUST

Addressing disruption of the property tax means raising revenues in some other way. This means more taxes or fees would come out of the pocket of Peel citizens in some way. This is not a comfortable conversation for public officials or the public, but the goodwill and trust that the region’s financial staff had built up made it possible.

Peel has a AAA credit rating, has received GFOA awards for financial reporting and budgeting, and is the only local government to receive an Excellence Canada Platinum Award, which recognizes high-performing organizations across the country. All of this helped give Peel staff the credibility to raise potentially difficult issues about the inadequacy of local taxes with elected officials and the public. It also provided Peel

staff with the credibility to raise the issues with other organizations that would need to be part of the solution, especially the Ontario provincial government and other local governments.

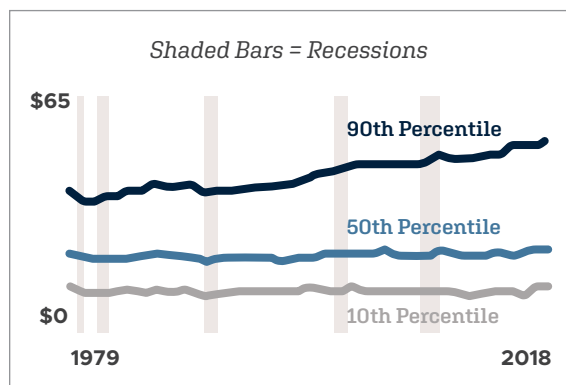
Of course, not every local government can be AAA-rated or be the only local government to win a national award for quality. Fortunately, there are other ways that a finance office can build a trustworthy reputation. The GFOA Code of Ethics (gfoa.org/ethics) is centered on building the trustworthiness of the finance office and is based on scientific research on how trust is built.³ If finance offices adopt the behaviors described in the GFOA Code of Ethics, they have a better chance of building the kind of credibility necessary to have uncomfortable conversations about taxes.

ESTABLISH A SHARED SET OF FACTS

Peel recognized two critical features of the property tax problem. First, technology-led disruption of the property tax is not something Peel could solve on its own. The region would need to work with other local governments in Ontario and with the Ontario provincial government. Second, because there is no single, big, obvious disruptor of the property tax, policymakers would need help recognizing the problem. Peel would have to facilitate a common understanding of the problems that the property tax was facing.

So, as a first step, Peel engaged a local research organization, the Mowat Center, which is affiliated with the University of Toronto. Mowat was asked to identify the trends that were threatening to make the property tax obsolete. The trends that the research highlighted are applicable to local governments across Canada and the United States.⁴ We’ll review these trends over the next few sections.

Exhibit 1: Real Wages in U.S. Since 1979



Median real wages have been stagnant for decades in the United States. Median wages are usually considered a better measure than mean wages because if we use the mean, large gains by people at the top of the income distribution would pull up the average, even if wages for most people have remained flat. Therefore, the mean is not a good description of many people’s experience.

Source: “Real Wage Trends, 1979 to 2018,” Congressional Research Service, July 23, 2019.

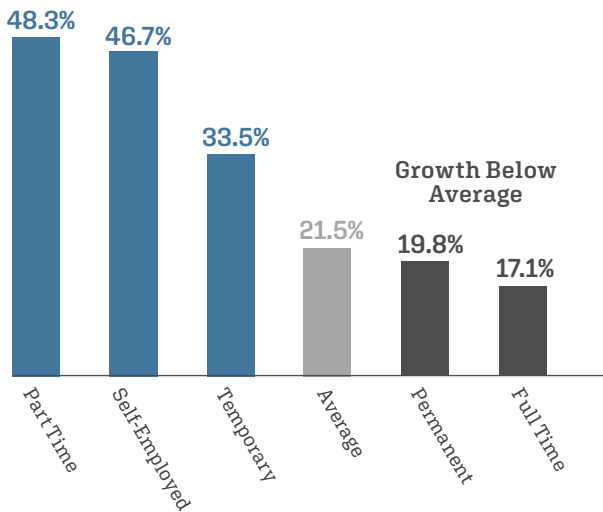
STAGNANT REAL WAGE GROWTH

The real median wage is essentially unchanged in the United States since 1980, as Exhibit 1 shows.⁵ In Ontario, where Peel is located, real wages have lagged behind the growth of the economy as well. For example, in Peel, inflation has increased 21 percent from 2007 to 2017. During the same time period, median hourly earnings have only increased 17.6 percent.⁶ If real wages are staying essentially the same (or going down) but taxes go up at more than the rate of inflation, then that means people are less able to afford taxes. If they are less able to afford taxes, they are more likely to resist paying them or, worse, not pay them at all. The property tax is an unpopular tax already,⁷ so it would bear the brunt of popular resistance to taxation.

Of course, stagnant wages also make it more difficult for people to buy new homes, and new homes add to tax rolls. In the United States, homeownership rates steadily

Exhibit 2: Employment in Peel, 2007-2017

Growth Above Average



declined from 2004 to 2016 before leveling out and rising through 2018 (though 2019 was down again).⁸

Stagnant wage growth is due in no small part to technological change. First, automation has eliminated the need for many lower-skilled jobs. This decreases the demand for lower-skilled workers and, therefore, reduces the wages they can obtain. Automation shows few signs of abating, and many experts expect large numbers of jobs to be automated in the future. For example, a report by the Brookings Institution suggests that about 25 percent of U.S. jobs are at high risk of automation.⁹ To cite one concrete example, driverless automotive technology could endanger many jobs in trucking and other driving professions. This is not to say that automation doesn't have benefits, but real median wage growth does not appear to be one of them, up to this point.

A second technological force behind stagnant wage growth is the increased mobility of business activities and the ability to locate work in the lowest cost area, including offshore. Call centers are an example we all have direct experience with in our personal lives, but bookkeeping, manufacturing, and other tasks have been offshored as well. Again, this depresses demand for lower-skilled labor in high-cost countries like the United States and Canada.

The collective impact of these forces can be seen in the types of jobs that have been created in Peel over the last number of years. As Exhibit 2 shows, Peel has seen far more part-time, temporary, and self-employed jobs created than permanent or full-time positions. The latter types of jobs often are better compensated and certainly produce more reliable income.

SHIFT FROM GOODS PRODUCTION TO GOODS MOVEMENT

Technology has facilitated an expansion of international trade. Though increased trade has certainly brought many benefits to consumers, it's also had the effect of displacing many traditional manufacturing industries. Peel, for instance, has seen a decline in many of its manufacturing industries. The goods produced abroad must be transported to consumers, so manufacturing has been supplanted by warehousing. Peel has experienced some benefit from this trend as it has become a national freight hub in Canada.

Of course, not all communities that see a decline in manufacturing can go on to become freight hubs. But even among those that do see warehouses replace factories, warehouses tend to employ fewer people (contributing to wage stagnation). Also, depending on local assessment practices, warehouses may generate less tax revenue than a manufacturing facility of similar size.

SHRINKING WORKPLACES

The trend toward deindustrialization and the expansion of the services industry has led to less demand for physical workspace. Peel's research found that the average square footage per employee for an industrial space (e.g., manufacturing) is approximately 2,000 square feet, whereas the average for office and retail spaces is approximately 400 square feet per employee.¹⁰ Furthermore, office spaces are often less valuable per square foot.

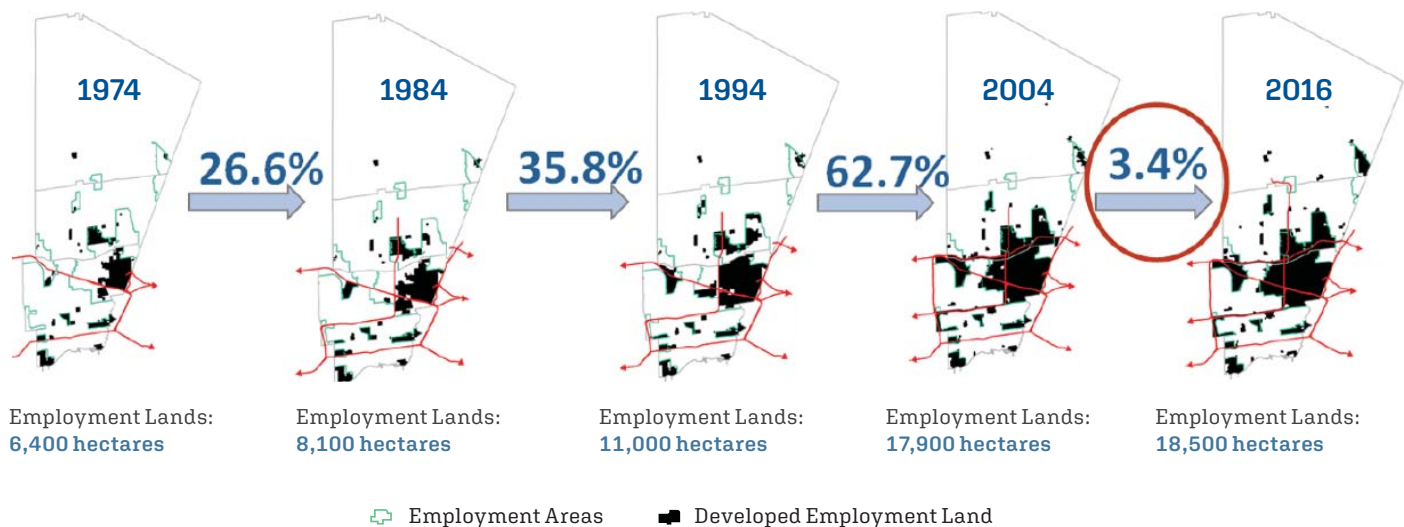
If this didn't place enough pressure on the property tax already, technology is reducing the demand for office space. For instance, digitization has reduced the need for filing space for paper, while cloud computing reduces the demand for space for the computers the digitized files are stored on.

Of course, people, not files or computers, require most of the space at many offices, and technology has reduced demand there as well. Communications technology makes flexible work arrangements like telecommuting and office hoteling more practical. It has also given rise to the "gig economy," where many of the human resources an organization needs can be secured through short-term contracts. These freelancers may work from home or perhaps a co-working space, reducing the demand for conventional office space in either case.

In Peel, growth in the amount of land used for employment has decreased dramatically in the last 10 years. Exhibit 3 shows a map of the Region of Peel over approximately the last 40 years. The black areas are land used for employment purposes. We see significant growth up to 2004 and then massive slowdown in growth.

Exhibit 3: Trend in Land Area Dedicated to Employment Use in the Region of Peel

The rate of increase in the land area dedicated to uses that employ people in Region of Peel has slowed dramatically in the last decade.



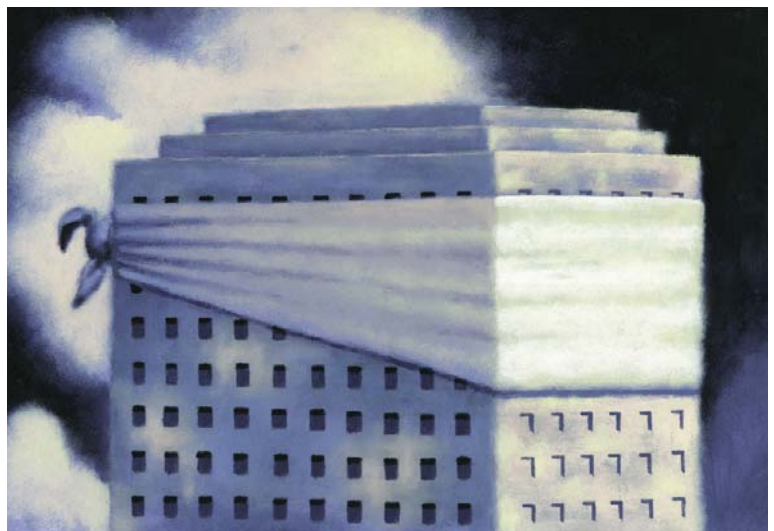
SHRINKING RETAIL SPACE

Internet retailing doesn't just impact the sales tax. It also means less demand for the spaces that retailers occupy. For example, according to a report by Credit Suisse, between 20 and 25 percent of American malls will close between 2017 and 2022. One of the main culprits is the increasing popularity of online shopping.¹¹ The buildings that these retailers occupied were often not of very high quality and have few other potential uses. Once the building becomes vacant, its value (and the taxes due) plummet.

Technology might even have an impact on commercial activity we might otherwise think of as firmly anchored in physical space, like eating out. The sales of online food ordering and delivery have almost quadrupled since 2016.¹² If people are eating less in restaurants and instead taking food home, restaurants may decide they need less space to seat customers.

THE IMPLICATION: RESIDENTS PICK UP THE SLACK

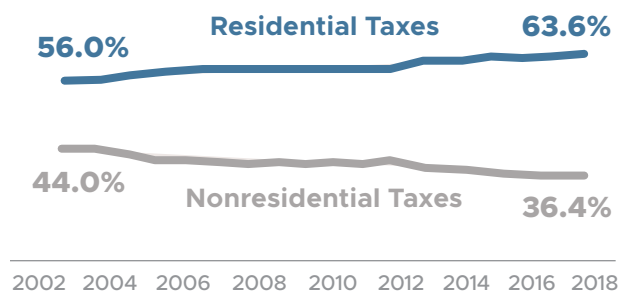
If industrial and commercial properties are becoming a less-important source of tax revenue, that means residential properties will become a more important source of tax revenue. This is what has happened in the Region of Peel, as Exhibit 4 shows. As we have seen earlier, median wages have stagnated, which means many residents are unable to shoulder an increased responsibility to fund local government.



Dark Store Theory: The Even Darker Side of the Decline of Brick-and-Mortar Retail

Some tax lawyers have made the argument that retail spaces should be valued as if they were vacant, even when the retail space is still in use! Their logic is that the low prices that vacant buildings sell for prove that the buildings themselves have little inherent value. This "dark store theory" is still being worked out in the courts, but it further illustrates the difficulty that the property tax is having in adapting to modern circumstances. [See, for example, Laura Bliss, "It Might Be Lights Out for Wisconsin's 'Dark Store' Tax Loophole," CityLab, February 9, 2019.]

Exhibit 4: Nonresidential Versus Residential Property Taxes as Share of Total



RECRUIT ALLIES

The information we reviewed over the previous sections was news to many people in the Peel government. They had a sense that Peel's revenues were under pressure, but they did not have a firm grasp on the causes.

Though informative for people inside the Peel government, the information would do little lasting good if it stayed within the local government. Further, these trends were not applicable to just Peel—they affect all local governments. Therefore, Peel realized that it needed to work with other governments to change the institutions that determine how local governments raise revenue. The region's well-established history of long-term financial planning helped Peel recognize the importance of building alliances to address this problem. Peel is making a concerted effort to share its research with policymakers outside of the Peel Regional Government. For example, Peel has shared its research in publications that are read by provincial and local government officials. Peel has also presented at provincewide conferences, like the Association of Municipalities of Ontario. The goal is to inform officials in the provincial government and other local governments in Ontario to create a shared objective of a sustainable revenue structure for local government that is affordable for citizens.

To help with outreach, Peel has a subcommittee of its governing council called the "intergovernmental relations committee." The council members on this committee also participate in regional bodies like the Association of Municipalities of Ontario. This includes serving on the governing board of these regional bodies. The Peel council members ask these regional bodies to consider adopting policy positions based on Peel's research. In this way, both Peel elected officials and staff are working to recruit allies.

Peel is making progress. For example, the Federation of Canadian Municipalities, a nationwide association of municipal governments, has been inspired to produce a report on the state of municipal finance across Canada.

The report will touch on many of the same themes as Peel's research. The intent is to spark a nationwide conversation about how local governments can get the revenue they need.

"It is very important that we share the findings of this report. Municipalities need to work together on these challenges and sharing information will spark ideas to find ways for mitigating the future risks."

— Peel Regional Chair Nando Iannicca

CONCLUSIONS

Property tax is the largest and probably least popular local government revenue source and adapting it to modern realities will not be easy. The solution might involve both updating the property tax itself and finding new revenues that are better aligned with the sources of economic value in today's world. The Region of Peel has shown us how we can get started with this essential work by building trust, establishing a shared set of facts about the problem, and assembling a coalition to solve it. ■

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- 1 The Tax Policy Center's Briefing Book (taxpolicycenter.org/briefing-book/what-are-sources-revenue-local-governments).
- 2 David Brunori, *Local Tax Policy: A Federalist Perspective* (2007: The Urban Institute Press).
- 3 GFOA worked with ethicalsystems.org, a collective of leading researchers on ethical issues, to develop the code.
- 4 Sunil Johal, et al, "Rethinking Municipal Finance for the New Economy," Mowat Center report #187, March 2019.
- 5 "Real Wage Trends, 1979 to 2018," Congressional Research Service, July 23, 2019.
- 6 Sunil Johal, et al.
- 7 Brunori.
- 8 "Quarterly Residential Vacancies and Homeownership, Second Quarter 2019," United States Census Bureau, Release Number: CB19-98, July 25, 2019.
- 9 Mark Muro, Robert Maxim, and Jacob Whiton, "Automaton and Artificial Intelligence: How Machines are Affecting People and Places," Metropolitan Policy Program at Brookings, January 2019.
- 10 Mowat's "Rethinking Municipal Finance for the New Economy" cites: Cushman & Wakefield, "Employment Strategy Discussion Paper," to develop the code. Prepared for the Region of Peel.
- 11 The report also points out that the retail sector had been overbuilt in the United States even before online retail became popular. See Chris Isidore, "Malls are Doomed: 25% Will be Gone in 5 Years," CNN Money, June 2, 2017.
- 12 Derek Thompson, "The Booming, Ethically Dubious Business of Food Delivery," The Atlantic, August 2, 2019.