**REPORT OF THE**

**STANDING COMMITTEE ON FISCAL ISSUES**

**DATED JANUARY 12, 1999**

On motion of Councillor Clement, the Report of the Standing Committee on Fiscal Issues, dated January 12, 1999, was considered clause by clause.

Moved by Councillor Clement,
That the Consent Agenda, Clauses 1 and 2 be adopted.

Carried.

**The Tax Penalty By-law - Corporate Finance Department Taxation & Miscellaneous Revenue Division**
**File FL (Vol. 5)**

**273 -** 1. Section 209 of The City of Winnipeg Act provides that Council may pass by-laws fixing the date or dates on which realty and business taxes are due. Additionally, Section 212 of The City of Winnipeg Act provides that Council may, by by-law:

a) fix the rate of interest to be paid as a penalty on taxes that are due and unpaid or prescribe the manner in which the rate of interest is to be fixed;

b) provide for compounding the interest and prescribing the manner of compounding;

c) provide that the penalties be added to the taxes at a specific time or times.

By-law No. 5796/91, adopted by Council on January 23, 1991, and amended on November 16, 1994, established the compounding of penalties added to unpaid taxes at year end. Specifically, on December 31 of each year, the penalties which are added in that year to unpaid taxes are compounded and transferred with the taxes remaining due and unpaid to the tax roll for the next year as unpaid taxes. In the next year, and subsequent years until the taxes and penalties are paid or the land is sold for taxes, the penalties are charged upon the previously compounded amount.

The Tax Branch has administratively implemented the above compounding methodology in the current legacy tax billing and collection computer system. This system is being replaced with a new computer system (MANTA) to be both year 2000 compliant and compatible with the new Electronic Assessment Roll system. The new system provides the opportunity to change the methodology of compounding interest on unpaid taxes from an annual compounding method to a monthly compounding method.

The Taxation and Revenue Division has historically compounded interest on unpaid taxes on an annual basis. Prior to the amendment of By-law 5796/91 in November of 1994, this compounding methodology was stipulated in The Municipal Act, Section 774. Amendments to both The Municipal Act and The City of Winnipeg Act on July 5, 1994, required the City of Winnipeg to pass a by-law providing for the compounding of tax penalties.

The current method of determining and compounding penalty rates has been in place for several years. While some may view the rates as high in relation to interest rates, the penalty rates are not meant to approximate an interest rate. There is no intention for the City to become a financing agency for unpaid taxes. The penalty rate must be sufficient to encourage the payment of taxes, rather than having taxpayers view the City as an easily available and inexpensive form of financing. If the taxes are paid on the due date, there is no penalty applicable. There is a substantial cost to the City, to not only pursue the collection of outstanding taxes, but also for the potential write-off of business taxes that cannot be collected through the means available in legislation.

The penalty rate is currently determined monthly and calculated based on a formula taking the prime rate plus 4% divided by 12 (months), rounded to the nearest .05%. The rate is recalculated on the last day of any month if the prime rate has cumulatively increased or decreased by 1% or more from the date the penalty rate was previously established. When the rate is recalculated, the new penalty rate is effective on the first day of the following month.

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On December 31 of each year, the penalties which are added in that year to unpaid taxes are compounded and transferred with the taxes remaining due and unpaid to the tax roll. This amount becomes unpaid taxes for the next year. In that year, and each subsequent year until the taxes and penalties are paid or the land is sold for taxes, the penalties are charged upon the previously compounded amount. Old legislation and our current by-law have resulted in the penalties being compounded annually.

The Taxation and Revenue Division currently uses a legacy computer system to implement the compounding of penalty interest as outlined in the by-law. This computer system is being replaced in early 1999 with a new tax billing and collection system. This will ensure integration with the Assessment Department's new Electronic Assessment Roll system and be year 2000 ready.

The proposed new tax system applies late payment penalties using the monthly compounding method. Rather than undertaking relatively costly changes to the system and to follow the City's accepted monthly accrual of revenue, it is proposed the penalty calculation as detailed in the by-law be revised to incorporate the compounding of the penalties from month to month. With a target installation date of the new system being March 1999, the effective date for monthly penalty interest compounding is April 1, 1999.

The following table outlines the effect of changing the penalty calculation to accommodate the compounding:

Comparison of Penalties on Current Realty Taxes

| Year | Current Annual Penalty Rate [1] (%) | Proposed Monthly Compounding Effective Annual Rate [2] (%) |
|---|---|---|
| 1998 | 5.50 | 5.63 |
| 1997 | 4.50 | 4.59 |
| 1996 | 5.00 | 5.11 |
| 1995 | 6.10 | 6.26 |
| 1994 | 5.70 | 5.84 |
| 1993 | 5.10 | 5.21 |

1 The annual penalty rate for the current years realty taxes is based on the par date of the end of June. Penalties are then applied on the first day of each month thereafter, up to and including December 1. This column represents the total penalty interest rate from July 1 to December 31 for each of the indicated years. If payment is made before December 1, the month in which payment is made will include the penalty amount for that full month, and the penalty rate is reduced accordingly.

2 This column represents how the recommended change in compounding penalty interest for current realty taxes effects the annual penalty rate. The percentages shown are the effective annual penalty interest rates based on the monthly compounding of the penalty interest.

Comparison of Penalties on Arrears of Taxes

| Year | Current Annual Penalty Rate [3] (%) | Proposed Monthly Compounding Effective Annual Rate [4] (%) |
|---|---|---|
| 1998 | 10.60 | 11.13 |
| 1997 | 9.00 | 9.38 |
| 1996 | 10.75 | 11.30 |
| 1995 | 12.60 | 13.35 |
| 1994 | 10.80 | 11.35 |
| 1993 | 10.50 | 11.02 |

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3. This column represents the current annual penalty rate for tax arrears based on the full calender year, January 1 to December 31. The interest rate is determined monthly and then summed for each consecutive month. If payment of tax arrears is made before December 1, the month in which payment is made will include the penalty amount for that full month, and the penalty rate is reduced accordingly.

4 This column represents how the recommended change in compounding penalty interest for tax arrears effects the annual penalty rate. The percentages shown are the effective annual penalty interest rates based on the monthly compounding of the penalty interest.

While the change in compounding methods does not significantly add to the effective annual rate for penalties on either current taxes or arrears, it should encourage earlier payment of the amounts outstanding. It is expected the amount of additional revenue generated by the higher rates will be offset by this earlier payment and therefore be revenue neutral.

The Standing Committee on Fiscal Issues recommends:

I. That, in accordance with Section 212 of The City of Winnipeg Act, Council amend By-law No. 5796/91 to change the methodology of compounding interest on unpaid taxes from an annual compounding method to a monthly compounding method effective April 1, 1999.

II. That the City Solicitor be requested to prepare the necessary amending by-law to The Tax Penalty By-law No. 5796/91, in accordance with the foregoing and submit same directly to Council for approval.

III. That the Proper Officers of the City be authorized to do all things necessary to implement the foregoing.

Adopted by consent.

**Shift in Assessment Values from Apartment Blocks to Residential**
**File AA-3 (Vol. 7)**

**274 -** 2. Council, at its adjourned meeting held on June 25, 1998, ruled automatic referral of the following motion to the Standing Committee on Fiscal Issues, under Rule 16.1 of the Procedure By-law No. 5400/90:

*Moved by Councillor Angus,*
*Seconded by Councillor Eadie,*

*WHEREAS there has been a shift in assessment values from apartment blocks to residential properties over the last several years;*

*AND WHEREAS this has increased property taxes on single family homes;*

*THEREFORE BE IT RESOLVED that the Standing Committee on Fiscal Issues review the reasons for this shift in assessment values;*

*AND BE IT FURTHER RESOLVED that the Standing Committee on Fiscal Issues recommend possible strategies to ameliorate this shift.*

The Standing Committee on Fiscal Issues at its meeting held on January 12, 1999, considered an administrative report dated November 16, 1998, in this regard, which advised that over the last number of reassessments, the amount of taxes forthcoming from the multi-residential sector has been in decline. This has resulted in a shift in taxes to other property types and, in particular single family residential properties. The Professional Property Managers Association (PPMA) has requested the City of Winnipeg to take a position with regard to rent controls and their impact on the assessment base of the municipality. In addition, there are other factors, which have an influence on this tax shift such as portioning levels and assessment accuracy that must be weighed.

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There is no empirical evidence available as to the effect that rent control has had on the assessment base of the City of Winnipeg. Economic theory suggests that rent controls will have a negative impact on the assessment base. The legislated portioning of assessed values plus more accurate valuations have had a discernable impact on the shifting of the tax burden from Residential 2 Class Code (Apartments) to Residential 1 (single family residences).

Rent Controls

An examination of the issue of the effect of rent control on the value of apartment buildings raises many issues, namely:

- the impact of rent controls on supply and demand for apartments;
- the impact of rent controls on the maintenance of apartment buildings;
- the impact of rent controls on the investment in apartment buildings;
- the impact of rent controls on the market value of apartment buildings; and
- the impact of rent controls on the assessment base.

Supply and Demand

Basic economic theory describes the relationship of supply, demand and price as the wheel of the economy. The demand will typically drive the infusion of supply and the price will be set by the relationship between supply and demand. When supply or demand changes, the normal market will move to correct the imbalance. In other words, an open market will always be moving towards equilibrium.

This cycle changes under rent restrictions. As there can be no short run price increase, there will be no incentive to increase the long run supply. Investors will not commit to projects where the income may be restricted to increases less than the expense increases. There will be need for further market intervention to encourage investors to increase the supply of rental accommodations.

The long run consequences are that no investment in controlled rental dwellings will occur. There will be pressure to disinvest to remove the buildings from rent controls. This has occurred in Winnipeg with a number of apartment buildings being registered as condominiums. As costs increase and rents are limited there will be pressure on landlords to reduce losses by deferring maintenance costs or reducing expectations as to level of return. This is a gradual form of disinvestment in that the net income will diminish until operation of the property is economically unfeasible.

Deferred Maintenance

As rent controls limit the income ability of a property while fixed and variable costs increase, there is little incentive to do regular maintenance or upgrades. Landlords may find they are operating buildings that may become a liability in the long run. The landlords who were operating property in a loss minimizing position in the short run will have a strong incentive to disinvest in their property rather than face losses in both the long and short run. For a while, losses can be reduced by cutting maintenance on the property, thereby reducing costs. The result of this gradual form of disinvestment is that the building will at some point have no value and be abandoned by the landlord leading to a further reduction of the housing stock. There has been instances, presented to the appeal boards, where deferred maintenance has reduced the market value of some properties.

Investment in Apartments

There has been a marked decrease in the construction of apartment buildings since the introduction of rent controls. There has been very little construction activity in the past few years. A review of the number of construction starts for apartment buildings since 1985 reveals a reluctance to invest in this property type. Some apartments have been converted into condominiums and the new construction that occurs is predominantly seniors housing such as personal care homes and life lease projects. Other jurisdictions have seen an increase in the construction of apartments when rent controls were phased out.

Impact on Market Value

The value of apartment buildings is typically determined by the income approach to value by the Assessment Department. This is similar to what investors will do before purchasing an apartment. This is accomplished by measuring the amount of potential cash flow expected in the future, then deducting allowances for vacancy,

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collection loss and operating expenses to arrive at a net operating income. To the net operating income a capitalization rate is applied to arrive at an estimate of value.

From this equation it is easy to deduce that the value will decrease in direct correlation to the decrease in net operating income. If the net operating incomes were to increase then the value would increase.

The issue of quantifying effect of the removal of rent control on the value is difficult to surmise. It is unknown what percentage of any rent increase would be committed to maintenance that has been deferred. The suggestion put forward by the Professional Property Managers Association that landlords should be allowed to negotiate market rents with new tenants while maintaining controlled rent levels for existing tenants is now being used in Ontario but the impact on value is not yet identifiable. Vacancy rates in the core area of Toronto, for example, do appear to be on the rise as more entry level workers find they cannot afford the 40% to 50% increases in rent which are occurring as existing tenants vacate. It is unknown where an open market would find equilibrium. The simple answer is that if there were more net operating income the market value would be higher.

Impact on the Assessment Base

The apartment sector has in excess of 1,800 buildings with a 1998 assessed value of over 1.8 billion dollars (at a 1995 level). The market data collected on apartments for the 1998 reassessment increased significantly over the data collected for the 1994 reassessment due to the cooperation of the property owners. This resulted in more accurate valuations for assessment purposes.

Accuracy of Previous Assessed Values

The lack of 1994 data due to the poor response rate makes trending of expense ratios difficult to do accurately. The poor response rate contributed to inaccurate assessments being placed on apartment properties in 1994.

The 1994 Realty Assessment Roll had a total of $1,835,992,680 (at a 1991 level) for Residential 2 class code taxable property, which is primarily apartments. The 1996 Realty Assessment Roll had total of $1,691,628,740 (at a 1991 level) for Residential 2 class code taxable property. The difference of $144,363,940 can be primarily attributed to the reductions as a result of appeals. The reduction in value between the 1994 and 1996 roll cannot be attributed to rent controls as both of those particular roll years reflect the 1994 reassessments at the same level of value - 1991.

Portioning

The Portioned Values Regulation was introduced to minimize the impact of tax burden shifts due to the assessments going to market value. The Legislature has made a conscious decision to decrease the level of taxation on multi-residential properties to the level of single family homes. The following provides the portioning rates from the Portioning Values Regulation of The Municipal Assessment Act for Residential 1 and Residential 2.

| Year | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2001 |
|---|---|---|---|---|---|---|---|---|---|
| Residential 1 | 47% | 45% | 45% | 45% | 45% | 45% | 45% | 45% | 45% |
| Residential 2 | 68% | 64% | 64% | 61% | 57% | 57% | 53% | 49% | 45% |

The impact on the shift in tax burden is evident. For example, between 1994 and 1996 the Residential 2 portion had been reduced from 64% to 57% while the Residential 1 portioning remained the same. The intent of the portioning was to phase-in the impact of the shift of tax burden to Residential 1 properties.

It can be argued that the reduction in the level of property taxes offsets a degree of the negative impacts on value of rent control by reducing operating expenses.

Conclusion

The income and expense data that the Assessment Department possesses does not cover a long enough period of time to sufficiently test the hypothesis that rent controls are reducing the values of apartment buildings.

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The reduction due to appeals during the last reassessment cycle were not the result of rent controls. The values originally established were not accurate due to incomplete and inaccurate information available at that time.

Economic theory suggests rent controls have a negative impact on the assessment base in that rent controls discourage new construction, rent controls contribute to disinvestment by deferred maintenance and rent controls below expense inflation erode the net operating income causing reduced market value.

The Portioned Values Regulation of The Municipal Assessment Act will continue to produce a shift of tax burden from Residential 2 to other classes of property until the portioned percentage is equal in the year 2001.

Inasmuch as both the Rent Control Legislation and the Portioning Regulation have a negative impact on the City's tax base and result in a tax transfer primarily to single family homeowners, Council could request a Provincial review of both legislative controls.

Committee also heard representation from Mr. D. Grant, Executive Director, Professional Property Managers Association, who submitted a brief in this connection. Mr. Grant asked that Committee take positive action in this regard.

For the information of Council, the Standing Committee on Fiscal Issues directed that the Assessment Department work jointly together with the Professional Property Managers Association to compile relevant data in relation to rent controls and their impact on assessment values, for report back at the earliest opportunity.

The Standing Committee on Fiscal Issues therefore recommends:

I. That the report be received as information and the motion, referred by Council on June 25, 1998, be filed.

II. That the Proper Officers of the City be authorized to do all things necessary to implement the foregoing.

Copy of attachments referred to in the above clause are on file in the office of the City Clerk.

*For the information of Council, the Executive Policy Committee has requested that a copy of the report to be prepared by the Assessment Department and the Professional Property Managers Association on rent controls and their impact on assessment values, be forwarded to the Task Force on Inner Winnipeg Neighbourhood Redevelopment.*

Adopted by consent.

## STANDING COMMITTEE ON FISCAL ISSUES

## CONSIDERATION OF BY-LAWS

**275** - On motion of Councillor Clement, By-law No. 7370/99, a by-law of The City of Winnipeg to amend By-law No. 5796/91, being a by-law to fix the date on which realty and business taxes shall be due and payable and to establish a rate of penalties to be added to taxes in arrears, was read a first, second and third time, the rule being suspended for the third reading, and was passed and ordered to be signed and sealed.
File FL (Vol. 5)