Is Growth Paying for Growth in Ontario? The Case for Development Charges

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Presentation Themes

- Fiscal Challenge of Growth
- Economic Rationale for Development Charges
- Misconceptions of Development Charges
- Ontario's Development Charges Act
- Conclusions

Fiscal Challenge of Growth

- Growing municipalities in Ontario overwhelmingly rely on development charges (DCs) to recover growth-related capital costs.

- DCs are one-time fees levied on new development giving rise to growth and hence the need for the extension of municipal services.

- DC rates typically vary by development type to reflect anticipated differential demands on municipal services; they often also differ by location and other factors relating to municipal service level and /or cost differentials.

Fiscal Challenge of Growth

- Municipalities extend their services to growth typically through capital works that expand capacity or restore existing excess capacity.

- Two broad types of growth-related capital works:

  - Local: Developer-provided capital works (e.g. 150mm watermains) servicing only a particular development.

  - Non-local: Municipality-provided capital works (e.g. bridges) servicing multiple developments.

Fiscal Challenge of Growth

- Growth-related capital works typically exhibit indivisibilities:
  - Engineering: Bridges, road lanes, traffic lights etc. provide all-or-nothing capacity.
  - Legal: Water and sewage systems etc. are subject to regulations requiring advance expansion.
  - Cost: Economies of scale (as with treatment plants and trunk sewers) and congestion (as with roads and libraries).

Fiscal Challenge of Growth

- Indivisibilities impose minimum capacity constraints, some of which related to long-run cost-minimization.

- Growth, however, occurs gradually.

- Growth-related capital works are therefore installed with excess capacity.

- This timing inconsistency is referred to as "non-concurrence".

Fiscal Challenge of Growth

- Two general ways to recover growth-related capital costs:
    - Pooled cost recovery: Combines growth-related and growth-unrelated costs; implemented through general user fees and property taxes.
    - Segregated cost recovery: Isolates growth-related costs and recovers them exclusively from growth through development charges (DCs) or special user fees and property taxes.

Fiscal Challenge of Growth

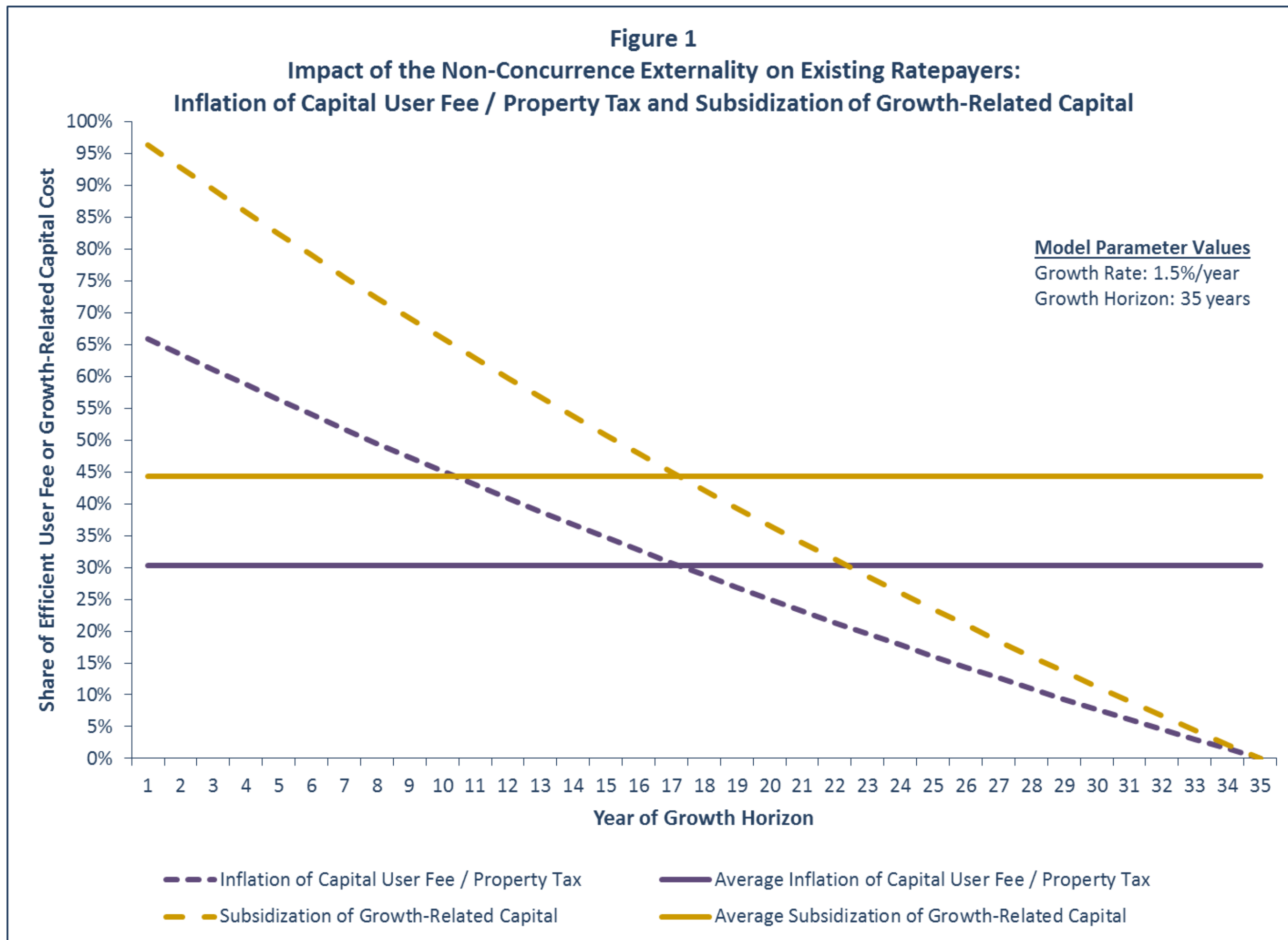
- Growth-related capital works create costs and excess capacity upfront, but growth generates revenue only upon materialization.

- Under pooled cost recovery, therefore, growth-related revenue inadequately recovers growth-related capital costs from growth.

- This deficiency shifts growth-related capital costs to existing ratepayers in the form of higher user fees and property taxes.

- The resulting fiscal distortion is referred to as the "non-concurrence externality".

Fiscal Challenge of Growth



Fiscal Challenge of Growth

- The non-concurrence externality causes multiple inefficiencies:
  - Reduced service levels and growth: Municipalities reduce service levels and slow or halt development approvals.
  - Diminished fiscal capacity: Increased risk of debt regulation violations, credit downgrading and insolvency.
  - Increased service congestion: Occurs if municipalities attempt to avoid the non-concurrence externality by installing growth-related capital works after growth occurs.

Economic Rationale for DCs

- Overcoming the non-concurrence externality requires segregated recovery of growth related capital costs.

- Doing so protects existing ratepayers from inflated user fees and property taxes, ensuring these prices/levies reflect municipal service levels.

- However, it also means the non-concurrence externality is concentrated on growth if segregated cost recovery is implemented with user fees or property taxes.

Economic Rationale for DCs

- The growth-concentrated version of the non-concurrence externality causes two inefficiencies:

  - Reduced growth: Through property markets, the feedback effect of inflated user fees and property taxes levied on new ratepayers depresses developable property values and hence growth.

  - Delayed growth: Early growth subsidizes later growth, introducing a perverse incentive to delay development in an attempt to free-ride on the over-contributions by earlier development. This is moreover a self-reinforcing effect.

Economic Rationale for DCs

- Overcoming the non-concurrence externality therefore requires a segregated cost recovery tool not susceptible to the distortions arising from the different timing of segments of growth.

- Thus, such at tool must be levied on a one-time basis irrespective of the timing of growth: This is the defining property of DCs.

- DCs are one-time fees qualitatively equivalent to developers' costs of installing local capital works.

Economic Rationale for DCs

- DCs enable maintenance of user fees and property taxes at values reflective of adopted municipal service levels.
- Thus, user fees and property taxes will continue to include a capital component paid by all (existing and new) ratepayers.
- To prevent overpayment for capital, growth would receive a temporary capital-related rebate annually based on average consumption or deemed allocation of services.
- As the rebate cannot be influenced by a single ratepayer, efficiency of service consumption will be maintained.

Misconceptions of DCs

- Claim: DCs are designed to force growth to subsidize existing ratepayers and therefore should be replaced by increases to user fees and property taxes.

- Response: Without DCs, the non-concurrence externality, and hence inflated user fees and property taxes, will arise, causing inefficiently low service levels, depressed growth and subsidization of growth by existing ratepayers.

- Conclusion: The economic function of DCs is the maintenance of efficient and equitable user fees, property taxes and services at appropriate levels.

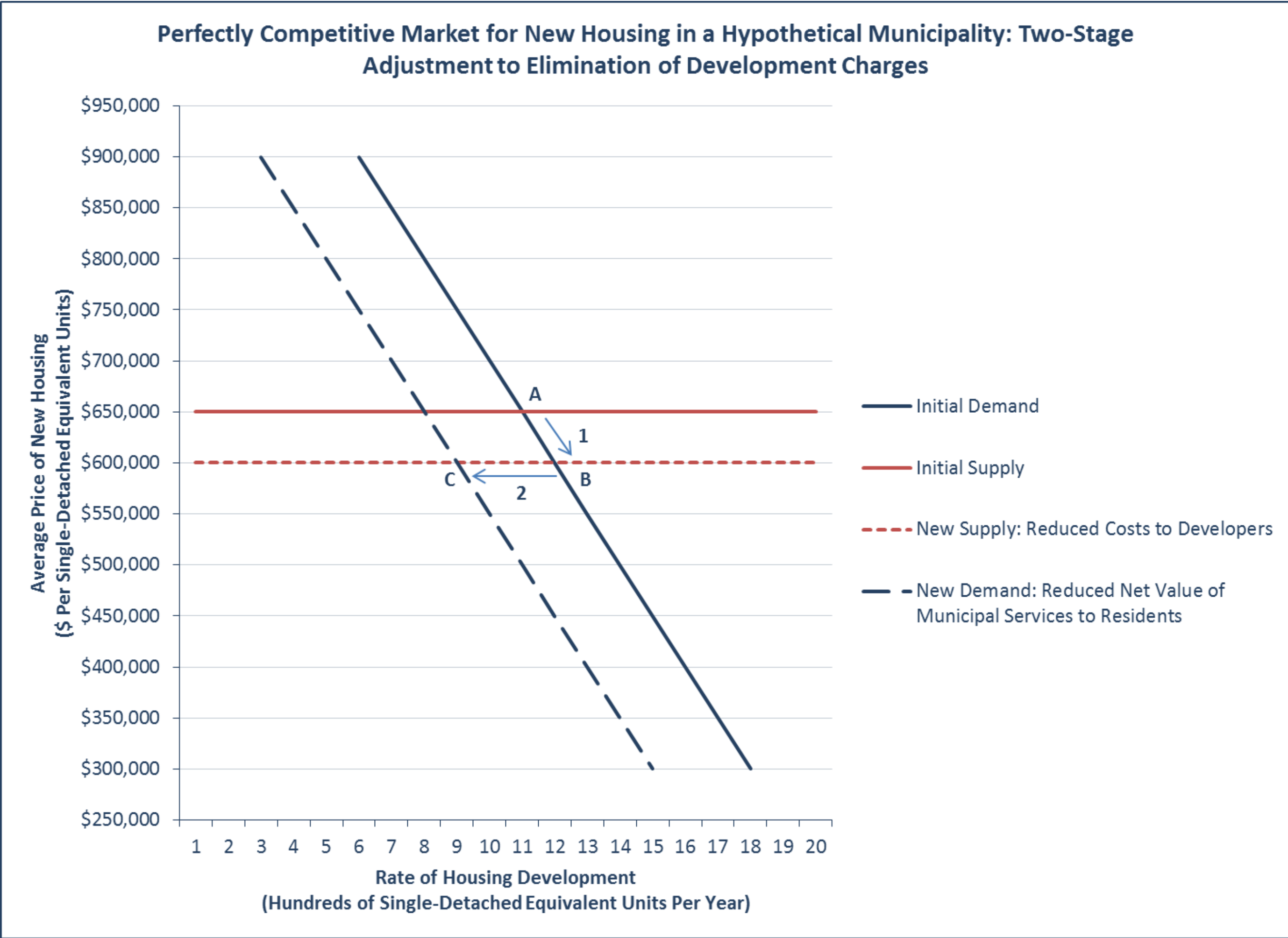
Misconceptions of DCs

- Claim: DCs inflate housing prices, and hence their elimination would enhance housing development rates and affordability.

- Response: While elimination of DCs would lower developers' costs, it would also (i) depress demand for housing due to inflated user fees and property taxes and reduced service levels and (ii) cause municipalities to slow or halt development approvals.

- Conclusion: As effects (i) and (ii) are surely to dominate the effect of lowered developers' costs, given housing substitutability across jurisdictions, elimination of DCs is highly likely to reduce rates of development and thus housing availability in the long run.

Misconceptions of DCs



Misconceptions of DCs

- Claim: As electricity distributors incorporate growth-related capital costs into their user fees, so too should municipalities respecting water and sewage services.

- Response: The Ontario Energy Board permits Ontario's electricity distributors to recover growth-related capital costs through "capital contributions", which are DCs in all but name.

- Conclusion: With capital contributions the apparent norm in Ontario's electricity distribution industry, municipalities are in good company with electricity distributors.

Misconceptions of DCs

- Claim: Since existing ratepayers receive economic benefits from growth, they ought to share in growth-related capital costs.

- Response: The prescription fails to follow from the premise. Moreover, the existing community reciprocates economic benefits (e.g. agglomeration economies), and it is impossible for municipalities to quantify this exchange.

- Conclusion: Even if the exchange of economic benefits could be quantified, it is irrelevant to growth-related capital costs and the recovery of such costs from growth via DCs.

Ontario's DC Act

- Ontario's DC Act (1997) and its regulation O.Reg. 82/98 govern municipal DCs.
- While ostensibly the purpose of the Act is to ensure growth pays for growth, it utterly fails to live up to this principle due to its numerous cost-recovery deficiencies.
- Moreover, the Act's overly prescriptive and complex provisions needlessly undermine municipal autonomy and accountability.

Ontario's DC Act

- Many provisions needlessly or arbitrarily undermine growth-related capital cost recovery:
  - Exempted growth and ineligible services
  - Deductions for grants and other contributions
  - Truncated planning horizons
  - Truncated and ill-defined service levels
  - Ineligibility of existing excess capacity
  - Arbitrary final 10% deduction
  - Inflexibility in updating DC rates

- Combined with the findings of Watson & Associates (2019), growth-related capital cost recoverability is well under 75%.

Ontario's DC Act

- Among developers, municipalities and academics, the only broad consensus is the need for reform to DC legislation.
- But what to do about the highly-deficient DC Act?
- Repeal it and replace it with a DC section added to the *Municipal Act* and *City of Toronto Act*.
- There is no sensible rationale for DCs to remain the only major municipal finance tool outside these acts, and the general permissiveness they afford.

Conclusions

- One barrier to much-needed DC legislation reform is the absence in the literature of an economic rationale for DCs.
- IMFG Paper No. 41 provides this, whereby DCs are complements to rather than substitutes for user fees and property taxes.
- Only once the growth-pays-for growth principle is fully respected, however, can the full potential of DCs be realized.
- Hence the need to repeal the DC Act and codify the growth-pays-for growth principle in the *Municipal Act* and *City of Toronto Act*.