Special Study: New Finance Options for Municipal Governments

Harry M. Kitchen and Enid Slack*

KEYWORDS: MUNICIPAL FINANCE ■ MUNICIPAL TAXATION ■ GRANTS ■ GST ■ PAYMENTS ■ PROPERTY TAXES

CONTENTS

* Of the Department of Economics, Trent University, Peterborough, and of Enid Slack Consulting Inc., Toronto, respectively. We would like to acknowledge the Canadian Tax Foundation's financial assistance in supporting our research for this project. With the assistance of the Federation of Canadian Municipalities (FCM), we gathered information for this paper from officials in Toronto, Montreal, Vancouver, Calgary, Winnipeg, and Saskatoon. This information was particularly useful in understanding the provincial legislation as it governs cities in different provinces, the amount of GST paid by municipalities, issues concerning payments in lieu of taxes, and the advantages and disadvantages of alternative tax sources. Donald Lidstone, of Vancouver, provided additional information on provincial legislation. We would also like to thank two anonymous referees for their helpful comments and Lee D'Anjou for her editorial assistance. Any remaining errors or omissions are our responsibility.

OVERVIEW

Recent interest in the financial condition of Canadian cities stems partly from the realization that large cities and city-regions are the major drivers of economic prosperity in this country and partly from the perception that their future financial viability is threatened.[1] The fiscal environment in which cities now operate is characterized by increased roles and responsibilities yet no significant change in their revenue sources. This situation has led to the call for a new fiscal deal for cities that would give them access to additional revenue-raising tools.

1 Indeed, one author argues that financial issues are responsible for putting cities back on the policy agenda. See Enid Slack, "Have Fiscal Issues Put Urban Affairs Back on the Policy Agenda?" in Caroline Andrew, Katherine A. Graham, and Susan D. Phillips, eds., *Urban Affairs: Back on the Policy Agenda* (Montreal and Kingston, ON: McGill-Queen's University Press, 2002), 309-28.

The three main parts of this paper focus on various ways of providing additional revenues to local governments in Canada. The options considered include additional tax sources (income, sales, fuel, and hotel and motel occupancy taxes), more realistic payments in lieu of taxes from the federal and provincial governments, exemption from the goods and services tax (GST), and intergovernmental transfers. This overview provides the context for the rest of the paper.

The Importance of Cities

Perhaps the most important reason Canadians need to care about cities is that they (especially large city-regions) are the main drivers of economic prosperity for the provinces in which they are located and for the country as a whole. Halifax accounts for 47 percent of Nova Scotia's gross domestic provincial product (GDPP); the former Montreal Urban Community for 49 percent of Quebec's GDPP; the greater Toronto area for 44 percent of Ontario's GDPP; Winnipeg for 67 percent of Manitoba's GDPP; Calgary and Edmonton together for 64 percent of Alberta's GDPP; and Vancouver for 53 percent of British Columbia's GDPP.[2]

To be competitive, cities need to build and maintain infrastructure and to deliver services that attract skilled individuals and firms. They have to provide not only roads, transit, water, sewers, and other hard services but also services that enhance the quality of life, such as parks, libraries, and recreational facilities. The pressure to provide both kinds of services is increasing.

Simultaneously, senior governments have shifted to cities further expenditure responsibilities (such as the maintenance of some provincial highways in Ontario). The federal and provincial governments have also reduced transfers to municipalities—for example, transfers for roads, transit, and social housing—and, in effect, devolved to them increased funding requirements. The federal and provincial governments have also downsized their own responsibilities in areas such as immigration settlement at the federal level and education in some provinces.[3] Municipalities, particularly the large urban centres, feel the need to fill the void.

Overall, this off-loading, combined with the need to be competitive, means that cities are delivering and funding more services than ever before.

In the face of these increasing responsibilities, cities continue to rely largely on the property tax and some user fees to meet those demands. Since municipal

2 Conference Board of Canada, *Metropolitan Outlook*, Autumn 2001.

3 Sorting out provincial and local responsibilities has been going on across Canada since the 1970s. British Columbia and New Brunswick were among the earliest to undertake this exercise by placing the funding of soft services (social services and education) at the provincial level and hard services (such as roads, water, and sewers) at the local level. The Quebec government undertook a major realignment of services in 1990 when it transferred the financing of a number of services, most notably public transit and road maintenance, to municipalities. Local restructuring in Alberta in 1994 had the provincial government assuming full funding for elementary and secondary education and halving the number of school boards. The provinces to undertake local services realignment most recently were Nova Scotia in 1995 and Ontario in 1998.

governments must, by law, balance their operating budgets and are restricted in how much they can borrow to meet capital requirements, the only avenues open to them are to increase property taxes or other own-source revenues or to allow services and infrastructure to deteriorate. Neither of these options can help them attract businesses or skilled workers. This situation compromises the ability of cities to compete internationally and undermines the economy of the country as a whole. Consequently, many analysts, politicians, and citizens suggest that municipalities be given access to additional revenue sources.[4]

The Benefit Model of Local Government Finance

When analysts evaluate the role of additional revenue sources, they often rely on the benefit model of local government finance. According to this model, the essential economic role of municipal government is to provide local residents with those public services that they are willing to pay for. The subsidiarity principle states that the efficient provision of services requires decision making to be carried out by the level of government closest to the individual citizen. Thus, municipalities are in the best position to determine local priorities and to make decisions about what services to provide, how much to provide, and how to pay for them.

Municipal governments provide services ranging from those with private-good characteristics (such as water, sewers, and garbage collection) to those with public-good characteristics (such as parks, street lighting, and police protection). For services with private-good characteristics, municipal governments should charge user fees to ensure efficient provision. Those who receive a service pay for it. Charges provide local governments with a signal that tells them how much of the service to provide.

For those services with public-good characteristics, user charges are impractical; taxes are a more appropriate means of payment. These taxes should, as much as possible, reflect the benefits received from the services. Municipal governments should finance services that benefit local residents from taxes such as property taxes and income taxes that are borne by local residents.[5] For services that benefit commuters and visitors, other taxes, such as sales taxes and hotel and motel occupancy taxes, may be more appropriate.

---

4 See, for example, Toronto City Summit Alliance, *Enough Talk: An Action Plan for the Toronto Region* (Toronto: Toronto City Summit Alliance, April 2003); TD Economics, *A Choice Between Investing in Canada's Cities or Disinvesting in Canada's Future* (Toronto: TD Bank Financial Group, 2002), 15; Toronto Board of Trade, *Strong City: Strong Nation* (Toronto: Toronto Board of Trade, 2002); Harry M. Kitchen, "Canadian Municipalities: Fiscal Trends and Sustainability" (2002) vol. 50, no. 1 *Canadian Tax Journal* 156-80; Harry M. Kitchen, *Municipal Revenue and Expenditure Issues in Canada*, Canadian Tax Paper no. 107 (Toronto: Canadian Tax Foundation, 2002), chapter 9; and "Canada's Big Cities Find Their Voice," *Toronto Star*, May 25, 2001, editorial.

5 The benefits model is most easily approximated where services do not generate externalities (spillovers), where the services are mainly not income-redistributional in nature, where individuals can be excluded from consuming the service if they do not pay, and where precise measurement of output and costs can be calculated.

Provincial grants play a role in the benefits model. They fund municipal services that generate externalities (spillovers), finance services in which the province has an interest in maintaining uniform or minimum standards, and they provide funds in the face of a fiscal gap (a mismatch in local own-source revenues and expenditure responsibilities) or a need to ensure that municipalities can provide comparable levels of service for comparable tax rates (equalization).

Trends in Local Government Expenditures and Revenues

Recent studies review the trends in local government expenditures and revenues in Canada.[6] Some of these studies' findings are illustrated in the tables below.

Table 1 sets out the size of the 1988 and 2001 municipal sectors across Canada, using three measures of municipal expenditures.[7] Per capita expenditures show the level of municipal spending in each province; municipal expenditures as a percentage of gross domestic provincial product (GDPP) reflect the relative importance of the municipal sector in the overall economic activity of the province; and municipal expenditures as a percentage of consolidated provincial-municipal spending indicate the size of the municipal sector relative to the total provincial-municipal government sector. In all cases, the data include both capital and operating expenditures.[8]

In 2001, Canadian municipal governments spent an average of $1,546 per capita. The amount ranged from a low of $379 in Prince Edward Island to a high of $1,951 in Ontario, where the high expenditures were driven, at least partially, by the reality that it was the only Canadian province in which the municipal level paid a significant proportion of social service and social housing costs. Over the period from 1988 to 2001, expenditures per capita in constant dollars (not shown in table 1) increased by 8.7 percent.

Municipal government expenditures as a percentage of GDPP remained roughly the same over the period (4.6 percent in 1988 and 4.5 percent in 2001). Municipal spending as a percentage of consolidated provincial-municipal spending increased

---

6 See, for example, Harry Kitchen, "Financing Cities and Fiscal Sustainability," in Paul Boothe, ed., *Paying for Cities: The Search for Sustainable Municipal Revenues* (Edmonton, AB: University of Alberta, Institute for Public Economics, 2003), 19-36; and Melville L. McMillan, "Municipal Relations with the Federal and Provincial Governments: A Fiscal Perspective," paper prepared for Municipal-Federal-Provincial Relations: New Structures/New Connections, a conference sponsored by Queen's University, School of Policy Studies, Institute of Intergovernmental Relations, May 9-10, 2003.

7 We used 1988 because it is the first year for which uniform and consistent data are available.

8 Our data do not include school board expenditures or revenues. See Wade Locke and Almos Tassonyi, "Shared Tax Bases and Local Public Expenditure Decisions" (1993) vol. 41, no. 5 *Canadian Tax Journal* 941-57, for a discussion of the way in which education taxes can crowd out municipal taxes. The authors argue that education tax rates can crowd out municipal tax rates. Since municipal governments collect property taxes for school boards (or, in many cases, for the province), they are concerned about the overall property tax rate. In some cases, this concern puts downward pressure on the tax rates levied for municipal purposes.

TABLE 1 Municipal Expenditures, Canada, 1988 and 2001

(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Per capita		% of GDPP		% of provincial-municipal total	
Province	1988	2001	1988	2001	1988-89	2001-2
	dollars		*percent*		*percent*	
Newfoundland	563	767	4.0	2.9	9.2	8.0
Prince Edward Island	252	379	1.8	1.5	4.5	4.3
Nova Scotia	865	1,061	4.5	4.0	15.3	13.1
New Brunswick	551	864	3.3	3.2	10.0	10.1
Quebec	1,002	1,341	4.9	4.3	15.3	13.7
Ontario	1,181	1,951	4.6	5.3	20.1	23.5
Manitoba	871	1,091	4.5	3.6	13.8	11.7
Saskatchewan	814	1,143	4.5	3.5	12.3	12.2
Alberta	1,306	1,579	5.2	3.2	17.9	16.0
British Columbia	830	1,286	3.8	4.0	15.4	14.5
Average, Canada[a]	1,035	1,546	4.6	4.5	16.7	17.3

[a] Includes all provinces and territories.

Source: Calculated from Statistics Canada data, Financial Management Systems (FMS) (mimeograph, June 2002); 2001 data are estimates.

slightly from 16.7 percent in 1988-89 to 17.3 percent in 2001-2, with Ontario accounting for the rise. Elsewhere, except in New Brunswick, municipal spending as a proportion of provincial-municipal spending decreased over the period.

Table 2 indicates the relative importance of expenditures by function for 1988 and 2001 across Canada. The distribution was roughly the same in the two years, except for social services in Ontario, which were a considerably smaller proportion in 1988. Although the table does not show provincial breakouts, Ontario was the 2001 outlier. The largest expenditures throughout the period were for transportation (roads and transit) followed by protection (police and fire), environment (water, sewers, and solid waste), and social services.

Notice that debt charges as a percentage of expenditures fell over the period studied. The decline has two sources: a decrease in interest rates, and, a decrease in the municipal sector's reliance on borrowing as a means of financing capital projects.

Table 3 examines the distribution of municipal revenue sources for 1988 and 2001. Property taxes were by far the largest source in 2001, as they were in 1988. Indeed, as a percentage of total revenues, property taxes increased. So did user fees. Grants, however, decreased significantly over the period.

The Need for Additional Revenue Sources

These revenue and expenditure trends indicate that municipalities have been meeting their increased expenditure responsibilities with existing revenue sources. But will cities have the capacity to generate sufficient revenues to meet their expenditure needs in the future? Can they continue to raise property taxes and user fees? To put the question another way, is there an argument for additional revenue sources?

TABLE 2 Distribution of Municipal Expenditures, Canada, 1988 and 2001

	1988	2001
	percentage of total spending	
General administration	9.9	11.0
Protection	14.8	15.9
Transportation	22.3	19.8
Health	2.0	2.0
Social services	7.4	12.6
Education	0.4	0.4
Resource conservation	2.1	2.0
Environment	14.6	14.0
Recreation/culture	11.6	11.1
Housing	1.8	2.6
Regional planning	2.1	2.2
Debt charges	9.5	5.9
Other	1.6	0.5
Total	100.0	100.0

Note: Because of rounding, the columns may not sum to the exact total shown.

Source: Calculated from Statistics Canada data, Financial Management Systems (FMS) (mimeograph, June 2002); 2001 data are estimates.

TABLE 3 Distribution of Municipal Revenue Sources, Canada, 1988 and 2001

Revenues	1988	2001
	percentage of total revenue	
Own source		
Property taxes	48.6	52.2
Other taxes	1.4	1.3
User fees	20.0	23.0
Investment income	6.0	4.9
Other	1.1	1.6
Total own-source revenue	77.1	83.0
Grants		
Unconditional grants	5.8	2.4
Conditional grants	17.1	14.6
Federal	0.7	0.4
Provincial	16.4	14.2
Total grants	22.9	17.0
Total revenue	100.0	100.0

Source: Calculated from Statistics Canada data, Financial Management Systems (FMS) (mimeograph, June 2002); 2001 data are estimates.

Provincial legislation prohibits municipalities from incurring deficits in their operating budgets. Operating expenditures are not allowed to exceed operating revenues. On the capital side, municipalities face provincial constraints in terms of how much borrowing they can undertake.[9] This high degree of provincial control means that municipalities simply must balance their budgets. If, however, they achieve the required budget balance by reducing expenditures to less than maintenance levels or by raising taxes so high that the tax base flees, they may be in a fiscally sustainable position but at the expense of being unable to provide the services and the infrastructure needed to be competitive.[10]

Although research on the state of municipal infrastructure in Canada is not extensive and much more is needed, the studies that have been done all suggest that a municipal infrastructure deficit exists and that it is large and growing. For example, the Canadian Urban Transit Association (CUTA) estimates that the infrastructure requirements of the country's conventional urban transit systems (scheduled, fixed-route service) are $13.6 billion for the period from 2002 to 2006. Of the $13.6 billion in infrastructure requirements, $4.8 billion (35.5 percent) is needed for rehabilitation or renewal and $8.8 billion (63.5 percent) for expansion or ridership growth.[11]

Other studies, such as that of TD Economics, report that the total infrastructure shortfall is growing by approximately $2 billion per year.[12] The Conference Board of Canada estimates the infrastructure gap for sewers, aqueducts, and road systems for Quebec municipalities to be between $15.0 billion and $17.9 billion.[13]

The questions of whether property taxes are already too high in Canadian municipalities and whether even higher taxes would chase away the tax base is difficult to answer. Although we have no Canadian studies on limits to the property tax, a study of revenue hills in US cities suggests that some (New York, Philadelphia, and Houston but not Minneapolis) may have reached the peak of their revenue

9 Richard M. Bird and Almos Tassonyi, "Constraints on Provincial and Municipal Borrowing in Canada: Markets, Rules, and Norms" (2001) vol. 44, no. 1 *Canadian Public Administration* 84-109.

10 This problem is already becoming apparent in Canadian cities. See, for example, Federation of Canadian Municipalities, *A Partnership for Competitive Cities and Healthy Communities*, a submission to the Standing Committee on Finance, Montreal, November 7, 2002 (Ottawa: Federation of Canadian Municipalities, 2002).

11 See Canadian Urban Transit Association, *Report on a Survey of Transit Infrastructure Needs for the Period 2002-2006* (Toronto: Canadian Urban Transit Association, October 2001). This estimate is based on a survey of transit system members. Seventy-five percent responded, representing 99 percent of total Canada-wide transit operations according to annual operating costs. The data were extrapolated to represent the infrastructure needs of the 13 smaller systems that did not respond to the survey.

12 TD Economics, supra note 4.

13 Conference Board of Canada and Union des Municipalités du Québec, *The Fiscal Situation of Quebec's Municipalities: Summary Report* (Ottawa and Quebec: Conference Board of Canada and Union des Municipalités du Québec, May 2003), 18.

hills for the property tax. Any increase in property tax rates in those cities would likely result in a smaller tax base because people would leave them.[14]

A comparison of property taxes in two Ontario cities (Toronto and London) with those in five large US cities (Atlanta, Boston, Chicago, Detroit, and Los Angeles) and five medium-sized US cities (Augusta, Fremont, Grand Rapids, Rockford, and Worcester) concludes that per capita property taxes (residential and non-residential combined) are higher in the Ontario cities than in the US cities except Atlanta.[15] Overall, however, municipal taxes per capita are lower in both Ontario cities than in the US cities.

The study on revenue hills and the comparison of municipal finances in Ontario and US cities do not provide much guidance on whether property taxes could be increased in Canadian cities. The answer depends on the specific circumstances of each city—for example, the type and quality of services provided, the extent of user fees, and the use of other revenue sources.

The Plan of the Paper

Whether or not property taxes are now too high, a case can be made for a greater mix of taxes at the municipal level. Such a mix would give municipalities flexibility to meet local needs at the local level. It would reduce the pressure on the property tax base to fund services that would be more appropriately financed in other ways. For example, income taxes would be better to fund services of a redistributive nature; sales taxes might be better to fund services that are used by commuters or visitors.

The following pages examine new finance options for municipal governments. The first major part describes and evaluates four alternative sources of tax revenue—income taxes, sales taxes, fuel taxes, and hotel and motel occupancy taxes[16]—and gives estimates of potential revenues at the municipal level for each of these sources. The next major part focuses on the federal and provincial governments' current levies on municipal governments in the form of payments in lieu of property taxes and the GST. Changes in each of these items could potentially result in more revenues for cities. The following part analyzes the role of the federal and provincial governments with respect to cities and assesses the advantages and disadvantages of providing additional revenues through intergovernmental transfers.

---

14 Andrew Haughwout, Robert Inman, Steven Craig, and Thomas Luce, *Local Revenue Hills: A General Equilibrium Specification with Evidence from Four US Cities*, National Bureau of Economic Research Working Paper no. 7603 (Cambridge, MA: National Bureau of Economic Research, March 2000).

15 Enid Slack, *Are Ontario Cities at a Competitive Disadvantage Compared to U.S. Cities? A Comparison of Responsibilities and Revenues in Selected Cities*, a report prepared for the Institute for Competitiveness & Prosperity (Toronto: Institute for Competitiveness & Prosperity, June 2003).

16 We studied only these four local taxes, although a little thought reveals other possibilities, such as vehicle registration taxes and liquor taxes. A similar analysis of revenue yields could be undertaken for these taxes.

Here are some key findings of the three parts.

- Municipalities should have access to more tax sources than they do currently. As noted above, a larger mix of taxes would give municipalities more autonomy and flexibility to meet the demands for services and capital infrastructure.
- Municipalities should set their own tax rates (although it is administratively easier for provincial governments to administer and collect the taxes on their behalf). Unless municipalities are given this freedom—even if it means they make mistakes—truly accountable and responsive municipal government can never be a reality.[17]
- Setting the right price is important for municipalities. Wherever possible, they should charge user fees. Where such fees are not possible, taxes should be based on the benefits received from local services. Intergovernmental transfers should not be designed to discourage municipalities from charging for services.
- One size does not fit all. Every revenue source described in this paper is not appropriate for all municipalities under all circumstances. Different municipalities might need to act in different ways. For example, large cities and city-regions might be able to take advantage of additional taxing authority; smaller municipalities might not derive sufficient revenues from additional tax sources to make the effort of levying these taxes worthwhile.
- Intergovernmental transfers have a role to play where municipalities lack the fiscal capacity to provide adequate local services with their own-source revenues, even if the number of tax sources increases. Transfers also have a role in cases of externalities because, in the absence of transfers, municipalities generally do not consider the benefits of their services to people outside their jurisdiction.
- If the federal and provincial governments allocated sufficient funds in their own areas of responsibility (for example, immigration and education), the pressure to fund related services at the municipal level would be reduced.

ADDITIONAL TAX SOURCES

Property taxes and user fees have been the backbone of municipal finance in Canada for many decades, but the past few years have seen increasing concern and growing skepticism about the ability of the municipal sector to continue to meet its expenditure requirements with existing revenues. Many authors conclude that municipalities would benefit from being able to levy additional taxes.[18]

17 See Richard M. Bird and Enid Slack, *Urban Public Finance in Canada*, 2d ed. (Toronto: Wiley, 1993), 66.

18 See, for example, Harry M. Kitchen and Enid Slack, *Business Property Taxation*, Government and Competitiveness Project Discussion Paper no. 93-24 (Kingston, ON: Queen's University, School of Policy Studies, 1993); and KPMG, "Study of Consumption of Tax-Supported Services," a report for the City of Vancouver (mimeograph, 1995).

Here we describe and evaluate four taxes that municipal governments around the world levy and that would have some merit for use by Canadian municipalities: a personal income tax (PIT), a general sales tax, a fuel tax, and a hotel and motel occupancy tax. The main focus is on estimating the potential revenue yield for cities from each of these taxes; we also review briefly the advantages and disadvantages of each revenue source.

We proceed as follows. First we describe the desirable characteristics of a municipal tax and make the case for giving municipalities access to tax sources other than the property tax. Next we summarize the use of various local taxes in 27 countries of the Organisation for Economic Co-operation and Development (OECD). Then we describe provincial restrictions on the use of alternative tax sources at the municipal level. Finally we review the four specific tax options, provide estimates of the expected revenue yields from each of them, and compare those yields. A brief summary concludes the part.

Tax Sources at the Municipal Level: Background

Before making the case for additional tax sources at the municipal level, we find it useful to set out the desirable characteristics of a local tax. Bird suggests a number of them.[19] First, the tax base should be relatively immobile so that local governments can vary the rates without losing a significant portion of the base. Second, the tax yield should be adequate to meet local needs, increase over time as expenditures increase, and be relatively stable and predictable. Third, the tax should be one that is not easy to export to non-residents. Fourth, the tax base should be visible to ensure accountability. Fifth, taxpayers should perceive the tax to be reasonably fair. Sixth, the tax should be reasonably easy to administer.

Whatever tax or taxes are chosen at the local level, local governments need to be able to set their own tax rates. International experience tells us that the most responsible and accountable local governments are those that raise their own revenues and set their own tax rates.[20] Unless the rates can be altered by municipal governments, they cannot achieve local autonomy or accountability. Moreover, local rate setting provides predictability for municipal governments and gives them the flexibility to respond to different and changing circumstances.[21]

---

19 Richard Bird, *Intergovernmental Fiscal Relations in Latin America: Policy Design and Outcomes* (Washington, DC: Inter-American Development Bank, Sustainable Development Department, 2000), 16-24.

20 Richard M. Bird, *Subnational Revenues: Realities and Prospects* (Washington, DC: World Bank Institute, 2001), 3.

21 Winnipeg's recent proposal to reduce the property tax significantly and raise user fees and other taxes at the local level is a move in the right direction because the proposal includes local rate setting for a number of taxes, such as the sales, fuel, and liquor taxes. See *Winnipeg Free Press*, September 23, 2003.

Currently, the main tax source available to Canadian municipal governments is the property tax. Although it has many of the desirable characteristics described above—the base is relatively immobile, it is difficult to export the residential tax to non-residents, revenues are fairly stable and predictable, and the tax base is visible—it cannot achieve all of them. Property values generally respond more slowly to annual changes in economic activity than do incomes;[22] the non-residential property tax can be exported to non-residents; and the yield is often inadequate to meet the growing expenditure needs of municipal governments, especially where they are required to fund social services.

Access to a variety of taxes would allow Canadian municipalities to levy those that achieved the full range of desirable characteristics. Moreover, a mix of taxes would give municipalities more flexibility to respond to local conditions,[23] such as changes in the economy, evolving demographics and expenditure needs, and changes in the political climate.

For example, sales taxes, as well as income taxes that fall only on wages and salaries (payroll taxes), are more effective than a property tax at linking the costs and benefits of services when people commute to work from one jurisdiction to another. Recent US evidence suggests that the cost of inner city services used by people who live in the suburbs but commute to work in the city centre exceeds, sometimes substantially, what they pay for those services.[24] Local income and sales taxes would help to reduce this disparity.

Sales and income taxes would also allow municipal governments to benefit from the prosperity in their cities during an economic boom. Property taxes, on the other hand, may be more appropriate than income and sales taxes where there is a need for a stable revenue source. US cities have found that their relatively heavy reliance on income and sales taxes, coupled with restrictions on their ability to raise property taxes (such as provided by proposition 13 in California and proposition 21/2 in Massachusetts), has meant a significant fall in their revenues during the recent economic downturn.[25]

Any single tax is almost certain to create local distortions, some of which could be offset by other taxes. For example, the property tax discourages investment in

22 Richard M. Bird and Enid Slack, "Land and Property Taxation Around the World: A Review" (2002) vol. 7, no. 3 *Journal of Property Tax Assessment & Administration* 31-80, at 40.

23 See James D. Rodgers and Judy A. Temple "Sales Taxes, Income Taxes, and Other Nonproperty Tax Revenues," in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finance*, 4th ed. (Washington, DC: International City Management Association, 1996), 229-58, at 229.

24 Howard Chernick and Olesya Tkacheva, "The Commuter Tax and the Fiscal Cost of Commuters in New York City" (2002) vol. 25, no. 6 *State Tax Notes* 451-56; and Howard Chernick, "The Effect of Commuters on the Fiscal Costs of the District of Columbia" (December 2002, mimeograph, 36 pages).

25 Michael A. Pagano, *City Fiscal Conditions in 2002* (Washington, DC: National League of Cities, 2002).

housing. The income tax, on the other hand, encourages investment in owner-occupied housing because the imputed income of such housing is not taxed. With a number of different tax sources to rely on, municipalities might find that the distortions in one tax were counteracted by the distortions in other taxes.

Comparisons in OECD Countries

Worldwide, local taxes differ considerably in type and in relative importance. Table 4 sets them out for 27 OECD countries in 1998. This information can assist Canadian decision makers by revealing the extent to which municipal governments in different countries use different taxes.

Income Taxes

Income taxes, both corporate and personal, are the most important source of local tax revenues in 13 of the countries listed in table 4 (column 2).[26] In the Scandinavian countries and Luxembourg, income taxes account for more than 90 percent of local tax revenue. In contrast, local governments do not have access to income taxes in Australia, Canada, France, Hungary, Ireland, the Netherlands, New Zealand, or the United Kingdom.

In the United States, approximately 3,800 local governments levy local income taxes. Although local governments in Pennsylvania account for 2,800 of the total, localities in 15 other states also rely on this tax.[27] Local income taxes are levied primarily by municipal governments but are imposed by counties in some states (Indiana and Maryland, for example) and by school districts in Pennsylvania, Ohio, and Iowa.[28] Income tax revenues generate more than 20 percent of local tax revenue in Ohio and Pennsylvania and about 30 percent in Maryland. In some cities, income taxes account for more than 50 percent of own-source revenues.[29]

The tax is generally levied on residents at a flat rate, ranging from a low of 1 percent to a high of almost 5 percent. Five of the 24 largest US cities (Philadelphia, Detroit, Columbus, Cleveland, and Indianapolis) impose a lower PIT rate or a tax on wages on non-residents (commuters).

Sales Taxes

Of the various consumption taxes, not many countries use a general consumption or sales tax (column 3 of table 4). But such a tax does contribute more than 10 percent of all local tax revenue in a few, including Austria and Spain. In the United States,

---

26 In some jurisdictions, the local income tax is piggybacked onto the one levied by the federal or provincial level of government. In others, municipalities administer their own tax.

27 Rodgers and Temple, supra note 23, at 242-43.

28 For a discussion of local income tax structures and issues in the United States, see Robert L. Bland, *A Revenue Guide for Local Government* (Washington, DC: International City Management Association, 1989), 89-101.

29 Rodgers and Temple, supra note 23, at 242-45.

TABLE 4 Relative Importance of Local Taxes in Selected OECD Countries, 1998

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	Tax sources as a percentage of total local tax revenues							
		Sales						
Countries	Income[a]	General[b]	Specific goods & services[c]	Use of goods etc.[d]	Total[e]	Property[f]	Other[g]	Local taxes as a % of GDP
Federal								
Australia	0.0	0.0	0.0	0.0	0.0	100.0	0.0	1.1
Austria	56.0	19.6	8.8	1.9	30.3	9.6	4.1	4.6
Belgium	84.2	1.7	0.0	12.5	14.2	0.0	1.6	2.2
Canada	0.0	0.1	0.0	1.4	1.5	92.7	5.7	3.3
Germany	79.1	4.8	0.5	0.4	5.7	15.0	0.2	2.8
Switzerland	84.3	0.0	0.2	0.1	0.3	15.4	0.0	5.2
United States	6.3	11.1	5.0	4.8	20.9	72.8	0.0	3.5
Unweighted average	44.7	5.3	2.1	3.0	10.4	43.7	1.9	3.3
Unitary								
Czech Republic	89.8	0.0	0.2	5.0	5.2	4.9	0.1	4.5
Denmark	93.6	0.0	0.1	0.0	0.1	6.3	0.0	15.8
Finland	95.8	0.0	0.0	0.0	0.0	3.9	0.2	10.2
France	0.0	0.0	6.2	4.0	10.2	50.6	39.1	4.7
Hungary	0.1	70.2	1.2	5.2	76.6	22.6	0.7	1.7
Iceland	80.2	6.5	0.0	0.0	6.5	13.2	0.0	7.7
Ireland	0.0	0.0	0.0	0.0	0.0	100.0	0.0	0.6
Italy	12.9	0.0	8.2	6.7	14.9	17.3	54.9	4.9
Japan	47.2	7.1	8.5	5.2	20.8	31.1	1.0	7.2
Korea	15.3	0.0	16.0	13.9	29.9	51.4	3.4	3.7
Luxembourg	92.6	0.0	1.0	0.2	1.2	6.0	0.3	2.6
Netherlands	0.0	0.0	1.4	35.7	37.1	62.8	0.0	1.2
New Zealand	0.0	0.0	1.2	7.9	9.1	90.8	0.0	2.1
Norway	90.2	0.0	0.0	2.0	2.0	7.8	0.0	8.0
Poland	63.0	0.0	0.0	3.3	3.3	33.6	0.1	3.3
Portugal	21.6	18.4	13.1	3.3	34.8	43.2	0.4	2.1
Spain	26.4	11.6	11.0	12.8	35.4	34.6	3.5	5.7
Sweden	100.0	0.0	0.0	0.0	0.0	0.0	0.0	15.8
Turkey	27.7	25.3	4.3	0.5	30.1	2.3	39.9	4.7
United Kingdom	0.0	0.0	0.0	0.0	0.0	99.5	0.5	1.4
Unweighted average	40.8	6.6	3.4	6.3	16.3	32.5	10.3	5.1

(Table 4 is concluded on the next page.)

TABLE 4 Concluded

[a] Includes individual and corporate income tax.
[b] Value-added taxes, sales taxes, and other general taxes on goods and services.
[c] Special taxes on goods and services that are not taxed under a general sales tax (taxes on fuel and on hotel and motel occupancy).
[d] Taxes levied on the use of goods or permission to use goods (pollution taxes, for example) and not on the goods themselves.
[e] Total of columns 3, 4, and 5.
[f] Includes taxes on property including recurring taxes on net wealth.
[g] Includes taxes at death (Finland and Portugal); some residual taxes, mainly on business (France, Italy, Netherlands, New Zealand, and Norway); and miscellaneous taxes everywhere.

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics 1965-1999* (Paris: OECD, 2000), tables 133 and 134.

local governments in 31 states and the District of Columbia levy general sales taxes. Some of these states impose a relatively low rate of 0.25 percent in a number of transit districts to subsidize public transportation. In other states, the rates may be as high as 5 percent with revenues not earmarked for specific expenditures.[30] In some states (for example, Virginia and California), all cities levy a local sales tax. In other states, only some municipalities levy it. Generally, general sales taxes are ad valorem (rather than per unit taxes), and the tax is levied on retail purchasers.[31]

Many but not all countries employ local taxes on specific goods and services (column 4 of table 4). Only in Korea, Portugal, and Spain does this tax group account for more than 10 percent of all local tax revenue.

Finally, taxes on the use of goods or permission to use goods (column 5 of table 4), as distinct from taxes on the goods themselves, are imposed in all but seven countries. This tax source contributes more than 10 percent of local tax revenues in Belgium, Korea, the Netherlands, and Spain.

Overall, local sales taxes (column 6 of table 4) generate between 14 and 76 percent of total local tax revenues in 11 of the countries listed, countries as diverse as Austria, the United States, Hungary, Korea, and the Netherlands. Local governments in 10 of them either do not use this tax source at all or it accounts for less than 2 percent of all local tax revenues.

Property taxes (column 7 of table 4) accounted for more than 90 percent of all local 1998 revenue in only five of the OECD countries listed: Australia, Canada, Ireland, New Zealand, and the United Kingdom. At the other extreme, nine of the countries received less than 10 percent of their tax revenue from the property tax.

Property and Other Taxes

Local governments in France, Italy, and Turkey relied fairly heavily on other local taxes, mainly on businesses in 1998 (column 8 of table 4). In Austria, some US states,

30 Ibid., at 232-34.

31 Bland, supra note 28, at 51-67.

Italy, Japan, Korea, Portugal, and Spain, municipal governments have a wide range of taxation powers at their disposal.

Relative Reliance

The last column of table 4 provides information on the extent to which the sum of local taxes absorbs GDP (a measure of the level of national income generated in each country). Generally, local taxes take up the highest proportion of GDP in countries with the heaviest reliance on local income taxes. All local taxes combined absorb the highest proportion of GDP—from 10 to 16 percent—in Denmark, Sweden, Finland, and Norway and the smallest proportion of GDP—2 percent or less—in Australia, Belgium, Hungary, Ireland, the Netherlands, New Zealand, Portugal, and the United Kingdom.

In Canada, local governments' share of GDP absorbed by taxes (3.3 percent) is equal to the unweighted average for federal countries (countries with federal, state or provincial, and local governments) and is well below the average for unitary countries (countries with federal and local governments). A possible explanation for this difference is simply that unitary countries have fewer levels of government than federal countries.

Tax Autonomy

Local governments in OECD countries vary considerably in the extent to which they can determine their own tax base and set their own tax rates for different taxes. Table 5 shows that they can set both the tax base and the tax rate in fewer than half of the countries listed. Furthermore, where both are at the discretion of local governments, local taxes tend to be a very small percentage of overall taxes except, for example, in New Zealand, Portugal, and Spain.

Local governments in every country except Mexico have some control over local tax rates. In many countries—as different as Belgium, Iceland, Japan, Sweden, and the United Kingdom—a significant portion of local tax revenue is obtained from taxes for which local governments control their own rates. Local governments in Canada, the United States, and Australia also have considerable control over local tax rates and in a few cases over the local tax base, a point not reflected in table 5.

Also not shown in the table is the fact that many countries have a form of revenue sharing between local and state (federal) or local and central (unitary) governments for a portion of local tax revenues. In none of these countries is the revenue-sharing split determined by local governments.

Current Legislation About Municipal Taxation

The previous subsection made clear the variety of taxation revenue sources used by municipalities around the world, and the next pages focus on an evaluation of some of these sources for Canadian municipalities. Nevertheless, readers should also recognize the extent of provincial constraints in this country.

For example, although any federal or provincial government could provide municipalities room in its PIT, no province has legislation permitting municipalities to

TABLE 5 Local Taxes by Type of Tax Autonomy, Selected OECD Countries

Country	Local government sets		
	Tax rate and base	Tax rate only	Tax base only
	Percentage of local taxes		
Federal countries			
Austria	9	11	
Belgium	13	84	
Germany	1	52	
Switzerland		97	
Unitary countries			
Czech Republic	2	5	3
Denmark		96	
Finland		89	
Hungary		30	
Iceland	8	92	
Japan		94	
Mexico			
Netherlands		100	
New Zealand	98		
Norway		5	
Poland		45	1
Portugal	49	14	
Spain	33	51	
Sweden	4	96	
United Kingdom		100	

Note: In the countries that appear in more than one column, local tax arrangements differ across municipalities. Some set both the tax rate and the tax base; others in the same country set only one of these variables.

Source: Organisation for Economic Co-operation and Development, *Taxing Powers of State and Local Government* (Paris: OECD, 1999), table 1.

levy income taxes. The following paragraphs provide a few more examples of the types of restrictions on what municipalities can do in terms of levying new taxes.

- In *British Columbia*, the city of Vancouver is governed by the Vancouver Charter and, where the charter is silent, by the Local Government Act which governs all other municipalities in the province.

  Under the Vancouver Charter, the city can levy property taxes, permits and licences, development levies, zoning bonuses (known as "community amenity contributions") and fees and service charges. Vancouver and Victoria have a hotel tax that is collected by the provincial government through its sales tax system. The proceeds of the 4 percent tax on the cost of a room are remitted to the two cities to be spent on tourism.

The Vancouver Charter allows for the collection of water rates, watermain rental charges, and connection charges. The city can require the owners or occupiers of any parcel of property, whether or not they are hooked to a sewer or drain, to pay a levy. The city may also charge a fee for use. It can charge a basic solid waste levy and may set user charges on the basis of classes of waste, users, property, quantities of waste, or services.

British Columbia is currently introducing community charter legislation to replace the Local Government Act, but Vancouver will not fall under this charter, which is intended to give local governments more autonomy and new powers, including access to new revenue sources. Current drafts of the legislation, however, still restrict municipalities to traditional revenue sources, such as property taxes, permits and licences, fees, and user charges. Further study is being undertaken of less traditional sources, such as road tolls, hotel taxes, fuel taxes, local entertainment taxes, resort taxes, and parking stall taxes.

- In *Alberta*, the Municipal Government Act gives municipalities authority to levy property and business taxes and a business revitalization zone tax. They can also levy special taxes for specific services and specific purposes, such as waterworks, sewers, boulevards, dust treatment, ambulance services, incentives for health professionals to reside and practise in the municipality, fire protection areas, drainage ditches, and recreational services. There are also provisions for a tax on well-drilling equipment and a local improvement tax.

  Currently, provincial legislation in Alberta does not allow municipalities to impose income taxes, sales taxes, hotel taxes (either a direct tax or a share of provincial hotel taxes), or road tolls. Although Calgary and Edmonton have a fuel-tax-sharing agreement with the province, they cannot levy their own fuel tax under current legislation.
- In *Saskatchewan*, The Cities Act, although new, does not contain taxing powers for cities outside of the property tax and does not allow licence fees to exceed the costs to the city for administration and enforcement except in relation to transient traders, contractors, and home-based businesses. The only expansion of taxing authority is to allow city councils to pass special tax bylaws to raise revenues from property taxes in all or a portion of the city to pay for a specific purpose.[32] This means that municipalities in Saskatchewan are not permitted to levy income taxes, sales taxes, hotel and motel occupancy taxes, or fuel taxes.
- In *Manitoba*, the city of Winnipeg currently uses the following tax tools: property taxes, property frontage levy, business tax, local improvements taxes, natural gas and electricity tax, and an amusement tax. Although the city has an agreement, in principle, with the province to levy hotel and motel occupancy taxes, liquor sales taxes, and land transfer taxes, Winnipeg does not

32 Formerly, under The Urban Municipality Act, 1984, SS 1983-84, c. U-11, this power was limited to snow removal, dust control, and lane maintenance.

currently levy any of these. The city does not have direct access to income taxes, fuel taxes, or road tolls.

- In *Ontario*, the Municipal Act, 2001, gives municipalities natural person powers within specified spheres of influence except as restricted by the act and its regulations. This statute is interpreted to prohibit municipalities from levying income taxes, poll taxes, consumption (sales) taxes, fuel taxes, or resource extraction taxes, but it does permit road tolls, subject to regulation.

Overall, the past few years have witnessed a few provincial initiatives to give municipalities more control over their operations. These changes appear, however, to have been fairly minor in terms of increasing cities' ability to levy new taxes. Municipalities are still very much under the control of the provinces. Their fiscal tools have not, by and large, been altered, and their ability to act independently has not been greatly improved.

Potential Finance Options in Canada

Given the variety of local taxes used successfully in the developed world, Canadians interested in the finance of the growing needs of their municipalities would be wise to look beyond the property tax and user fees. Thus, this section reviews the potential municipal use of four taxes—personal income taxes, general sales taxes, fuel taxes, and motel and hotel occupancy taxes[33]—and provides estimates of their potential revenue yield for Canadian cities.[34] In each case, we assume that municipalities would piggyback onto the existing provincial tax system. (Although complete local autonomy would require that municipalities determine their own tax base, the administrative cost of establishing it would generally outweigh the potential benefits.)[35]

Our estimates do, however, assume that municipal governments would set their own rates for each of the taxes. Therefore, there could be differentials across municipalities and in people's responses to these differences. For example, a differential retail sales tax could encourage individuals to purchase goods and services in those municipalities with lower tax rates.[36] A differential hotel and motel occupancy tax, fuel tax, or income tax would result in similar behavioural responses.

---

33 For a discussion of similar taxes for developing countries, see Bird, supra note 20.

34 For an estimate of the revenue yield of these and other possible taxes for municipalities in Quebec for the year 2006, see *The Fiscal Situation of Quebec's Municipalities: Summary Report*, supra note 13.

35 As noted above, municipalities in some countries do determine their own bases for some taxes. Indeed, some US municipalities willingly incur such administrative costs in order to have local flexibility and autonomy (see Bland, supra note 28, at 89-101).

36 Concerns over the behavioural response to sales taxes may be overstated, however. Presumably, if retail sales taxes diverged enough to lure customers from one community to another, the municipal council in the higher-tax community would recognize this problem—almost certainly, local retailers would make the elected officials aware of it—and change the rate. If the situation were not seen as a problem, the local tax system might be producing the desired results.

These reactions would, however, differ little from the location decisions currently caused by differential property tax rates. This type of tax competition can create an environment in which municipalities become more efficient in their use of resources and more accountable to their taxpayers.[37]

Nevertheless, there is clearly a tradeoff between the accountability and flexibility advantages of local setting of tax rates and the potential disadvantages of differentials. One way to minimize the distortions would be to have regional taxing authorities that cover large city-regions (rather than individual municipalities) set the rates so as to pay for services region-wide.[38]

A final note. The estimated potential revenue yields that we report below are not strictly comparable across taxes because of differences in the nature of the tax base and tax rates. For example, a one percentage point increase in the retail sales tax represents a 12.5 percent increase in an existing 8 percent provincial tax rate. By comparison, a 1 percent surtax on a PIT represents only a 1 percent increase in the existing tax. (To estimate the impact of a 10 percent surtax on the PIT multiply the estimates in this paper by 10.)

The data on which we based each estimation series, all from the year 2000, are set out, with their sources, in appendix table 1.[39]

Personal Income Tax

In Canada, the PIT field is shared between the federal and provincial governments; Ottawa currently administers its own tax and that of every province except Quebec, which administers its own system. The corporate income tax (CIT) field is also a shared field; Ontario, Alberta, and Quebec administer their own systems.[40]

Canadian municipalities are not without experience in levying income taxes. More than 80 years before the imposition of the federal income tax in 1917, both provincial and municipal governments levied a tax on income.[41] Indeed, municipal income tax revenues then exceeded provincial income tax revenues in every year up

37 Richard M. Bird and Thomas A. Wilson, "A Tax Strategy for Ontario," draft paper prepared for the Panel on the Role of Government (Toronto, 2003), 23.

38 Some parts of Canada have regional authorities (for example, the Greater Vancouver Regional District), but such a structure does not exist everywhere. For example, the greater Toronto area currently has no regional authority.

39 We used 2000 because it was the last year for which income tax data were available at time of estimation.

40 This paper does not consider municipal access to CIT revenues for some important reasons. First, these taxes have recently fallen in every major trading country so there appears to be no justification for making it more costly for Canadian corporations to compete. Second, CITs are generally imposed on a mobile tax base and are, therefore, not a good candidate for local taxation. Third, property taxes on the commercial-industrial sector already overtax business; there is no reason for an additional tax burden that bears no relationship to the cost of municipal services consumed. See Kitchen and Slack and KPMG, supra note 18.

41 Sheldon Silver, "The Feasibility of a Municipal Income Tax in Canada" (1968) vol. 16, no. 5 *Canadian Tax Journal* 398-406, at 398-99.

to and including 1930.[42] By the end of the 1930s, every province in Canada had accepted some form of municipal income tax, although the rates and structure varied.

A significant change came in 1941 when the provinces entered into the wartime tax rental agreement with the federal government, temporarily surrendering their right and the right of their municipalities to levy income taxes. Since that time, no municipality in Canada has been able to levy an income tax.

A major advantage of a municipal income tax is its revenue elasticity.[43] A further advantage of an income tax on payrolls is that it taxes commuters, permitting a municipality to tax those individuals who use city services but do not pay for them under the property tax.[44] Some US cities tax commuters through a payroll tax. (New York City, however, repealed its payroll tax in 1999.)

Income taxes can also be justified, particularly in large metropolitan areas, on the grounds that local governments are increasingly being called upon to address issues of poverty, crime, regional transportation, and other region-wide needs. The property tax alone cannot provide sufficient funds for these growing expenditure needs. Moreover, to the extent that local governments are required to provide social services, an income tax is probably more appropriate than a property tax because the former is more closely related to ability to pay.

Municipalities could piggyback onto the provincial income tax system in one of two ways. The tax could be applied, as it is in the Nordic countries, at a locally determined flat rate on the same tax base as the national income tax and collected by the central government. Alternatively, the locally determined tax rate could be set as a percentage of the national tax liability, as in Belgium, or of the provincial tax liability, as in Switzerland and some US states.[45]

In the Canadian context, taxpayers calculate their federal and their provincial PIT liabilities separately. A municipal income tax surtax could be handled by adding one more line to the provincial income tax return. Taxpayers within the taxing jurisdiction (defined by postal codes) would multiply either their PIT payable or the PIT base by the local tax rate set by the municipality. The calculated local tax would be the amount remitted to the municipality.

Revenue Estimates

A municipal income tax could provide local governments with considerable revenue. Table 6 provides our estimates of the potential revenue yield from a 1 percent

42 Calculated from data in Canada, *Report of the Royal Commission on Dominion-Provincial Relations*, book III (Ottawa: King's Printer, 1940), sections 1 and 3; and F.H. Leacy, ed., *Historical Statistics of Canada*, 2d ed. (Ottawa: Statistics Canada, 1983).

43 Revenue elasticity can, however, be a problem in times of economic downturn. The current recession in the United States has hurt those municipalities that depend on elastic tax revenues such as income and sales taxes.

44 Chernick and Tkacheva, supra note 24; and Chernick, supra note 24.

45 Bird, supra note 20, at 19.

TABLE 6 Estimated Municipal Income Tax Revenue from a 1 Percent Surtax on Provincial PIT Payable for 2000

(1)	(2)	(3)	(4)
		Revenue from the surtax as a percentage of	
Province, city	Estimated municipal revenue from the surtax[a]	Municipal property taxes[b]	Own-source revenue[c]
	$000	*percent*	
Newfoundland	6,055	3.3	2.3
St. John's	1,810	2.2	2.0
Prince Edward Island	1,446	4.1	2.7
Nova Scotia	11,982	1.8	1.4
Halifax	6,104	1.9	1.5
New Brunswick	9,009	3.1	2.0
Fredericton	872	2.1	1.8
Quebec	184,930	3.1	2.2
Quebec City	3,891	2.0	1.1
Montreal	25,271	2.1	1.4
Ontario	179,092	1.8	1.0
Ottawa	16,115	2.1	1.3
Toronto	44,658	1.8	1.0
Hamilton	6,437	1.4	0.6
London	4,852	1.8	1.1
Windsor	3,411	1.8	0.6
Sudbury	1,979	1.6	0.7
Thunder Bay	1,470	1.6	0.8
Manitoba	16,340	3.0	1.6
Winnipeg	10,921	2.5	1.8
Saskatchewan	12,912	2.5	1.5
Saskatoon	3,265	3.8	1.1
Regina	3,206	3.3	1.5
Alberta	46,251	2.1	1.1
Calgary	18,632	3.3	1.5
Edmonton	9,162	2.3	0.9
British Columbia	57,840	2.5	1.4
Vancouver	10,778	2.5	1.5

[a] Estimated by applying a 1 percent surtax to provincial PIT payable (as recorded in column 2 of appendix table 1) adjusted by using a tax-price elasticity of –0.25 for each province and –0.50 for each city.

[b] Obtained by taking the income tax revenue from column 2 as a percentage of municipal property taxes collected (as reported in column 5 of appendix table 1).

[c] Obtained by taking the income tax revenue from column 2 as a percentage of municipal own-source revenues (as reported in column 6 of appendix table 1).

Source: Calculated from data provided in appendix table 1.

municipal surtax on the provincial PIT paid in 2000 for each Canadian province and for selected cities. The calculations are based on the taxpayer's residence, not the place of work, and include all income. This approach is the same as that used for the current federal and provincial PITs. The estimates for individual cities assume that each applies a 1 percent surtax and their neighbours do not. This assumption, as noted below, has implications for the responsiveness of taxpayers to the tax; for example, they might move to avoid paying it.

A 1 percent municipal tax rate would increase effective PIT rates[46] (unless the federal or provincial governments lowered their rates) and possibly reduce the income tax base. Although tax price elasticity (the responsiveness of taxable income to changes in tax rates), has been surveyed in a number of US studies,[47] it has not been examined with the same frequency in Canada. However, a recent Canadian study,[48] concludes that the overall tax-price elasticity in Canada for working-age individuals is relatively small at about –0.25, although it is higher for high-income individuals. This estimate is smaller than similar US estimates, which range from –0.8 to about –3.0.[49]

For estimating the impact on the tax base arising from an increase in effective rates (table 6), we used two different tax-price elasticities: –0.25 for the provincial totals in column 2 and –0.50 for the city estimates in the same column. The reason for the difference is that a local income surtax in one city and not in adjacent areas would raise the effective tax rate in that city and, in turn, provide an incentive for individuals to move to minimize their tax burden. The extent to which this might happen is unclear although a US study provides some evidence that the tax-price elasticity for a city income tax may be higher than for a state or national income tax.[50]

---

46 A 1 percent surtax would increase effective tax rates by less than one-tenth of 1 percent in every province except for Quebec where the increase would be about two-thirds of 1 percent. The increase in Quebec would be higher because federal income tax rates in that province are lower than in the other provinces and, correspondingly, its own tax rates are higher. For a discussion of federal and provincial tax rates, see Karin Treff and David B. Perry, *Finances of the Nation 2001* (Toronto: Canadian Tax Foundation, 2001), chapter 3.

47 Gerald Auten and Robert Carroll, "The Effect of Income Taxes on Household Income" (1999) vol. 81, no. 4 *The Review of Economics and Statistics* 681-93; Richard Blundell and Thomas Macurdy, "Labor Supply: A Review of Alternative Approaches," in Orley Ashenfelter and David Card, eds., *Handbook of Labor Economics*, vol. 3A (Amsterdam: Elsevier, 1999), 1559-1695; Emmanuel Saez, *The Effect of Marginal Tax Rates on Income: A Panel Study of "Bracket Creep,"* National Bureau of Economic Research Working Paper no. 7367 (Cambridge, MA: National Bureau of Economic Research, September 1999); and Joel Slemrod, "Methodological Issues in Measuring and Interpreting Taxable Income Elasticities" (1998) vol. 51, no. 4 *National Tax Journal* 773-88.

48 Mary-Anne Sillamaa and Michael R. Veall, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1988 Tax Flattening in Canada" (2001) vol. 80, no. 3 *Journal of Public Economics* 341-56.

49 Ibid.

50 Haughwout et al., supra note 14. This study also finds statistically significant income-tax elasticities for New York City that range from –0.84 to –0.72 but statistically insignificant

Given our calculations, Toronto could have collected almost $45 million from a 1 percent surtax on provincial PIT in 2000. This amount would have been 1.8 percent of property tax revenue (column 3) and 1.0 percent of own-source revenues (column 4). Montreal could have collected $25 million (about 2.1 percent of property taxes and 1.4 percent of own-source revenues). Calgary could have collected almost $19 million (3.3 percent of property tax revenue and 1.1 percent of own-source revenue), Ottawa $16 million (2.1 percent of property tax revenue and 1.3 percent of own-source revenue), Winnipeg (2.5 percent of property tax revenue and 1.8 percent of own-source revenue), and Vancouver almost $11 million (2.5 percent of property tax revenue and 1.5 percent of own-source revenue).[51]

Table 7 sets out estimates of the increased tax burden arising from this 1 percent surtax on four hypothetical taxpayers at three levels of taxable income in each province. For example, a single taxpayer with $50,000 of taxable income could be expected to increase his or her income tax liability by $72 in Quebec (the highest estimate) and by $30 in Ontario and British Columbia (the lowest). For a senior with no dependants and a taxable income of $25,000, the comparable increase would range from a high of $24 in Quebec to a low of $7 in Ontario, Alberta, and British Columbia.

Final Comments

In summary, a PIT with locally set tax rates could provide cities, especially large ones, with two important benefits. It would increase the revenue elasticity of the local tax base, and it would permit municipalities to tax commuters who use city services but do not now pay for them.

A major downside of considering a local PIT, however, is that federal and provincial income tax rates have declined over the past few years. Permitting municipalities to move into the income tax field could partially offset the positive results of those initiatives to enhance Canada's competitiveness in global markets.

General Sales Tax

In addition to the GST, each Canadian province and territory except Alberta has its own general sales tax.[52] British Columbia, Saskatchewan, Manitoba, Ontario, and

---

wage-tax elasticities for Philadelphia. These results have, however, been challenged because some important variables were allegedly omitted, and these variables, not changes in tax rates, might have caused the tax base to change. For a discussion, see Moshe Adler, Oliver Cook, and James Parrott, "Do Tax Increases in New York City Cause a Loss of Jobs? A Review of the Evidence" (2002) vol. 24, no. 5 *State Tax Notes* 385-89.

51 This surtax would have increased effective provincial PIT rates, measured as provincial PIT liability (including a 1 percent municipal surtax) divided by total income, by something between six- and eight-hundredths of 1 percent.

52 For more detail and analysis of provincial and federal commodity taxes, see Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy*, 3d ed., Canadian Tax Paper no. 103 (Toronto: Canadian Tax Foundation, 1999), chapter 5.

TABLE 7 Estimated Impact of 1 Percent Surtax on Four Hypothetical Taxpayers with Three Levels of Taxable Income

Province	Single taxpayer			Single taxpayer with one dependant age 6		
	$25,000	$50,000	$80,000	$25,000	$50,000	$80,000
	Increase in dollars					
Newfoundland	17	54	109	11	47	102
Prince Edward Island	16	47	98	10	41	91
Nova Scotia	16	50	98	9	44	92
New Brunswick	15	48	95	9	42	89
Quebec	23	72	143	2	64	135
Ontario	9	30	70	1	25	64
Manitoba	17	52	101	7	45	94
Saskatchewan	17	48	93	8	39	84
Alberta	10	34	64	1	21	51
British Columbia	9	30	63	5	25	59

Province	Two-income family with two children, ages 6 and 12			Senior, age 65 and no dependants		
	$25,000	$50,000	$80,000	$25,000	$50,000	$80,000
	Increase in dollars					
Newfoundland	16	51	109	14	55	111
Prince Edward Island	15	44	98	13	48	101
Nova Scotia	15	47	98	13	51	102
New Brunswick	14	45	95	12	49	98
Quebec	16	37	143	24	83	157
Ontario	1	28	70	7	30	72
Manitoba	10	47	101	12	54	105
Saskatchewan	12	41	93	13	49	95
Alberta	10	32	64	7	35	66
British Columbia	9	28	63	7	31	66

Source: Estimated from tax-impact model provided by David Perry of the Canadian Tax Foundation.

Prince Edward Island administer their own provincial sales tax (PST) systems, which generally exclude the taxation of services. In Newfoundland, Nova Scotia, and New Brunswick, the federal government administers a harmonized federal-provincial sales tax (HST) that is applied at a uniform rate of 15 percent (7 percent GST and 8 percent PST) to the GST base. Finally, Quebec administers its own sales tax (QST) as well as the GST within its own boundaries.

Historically, the only cities in Canada to levy a municipal sales tax were in Quebec. Montreal introduced a retail sales tax on May 1, 1935. Its revenues were primarily designed to meet heavy relief payments that threatened the city's ability to balance its budget. The rate of 2 percent was applied to all retail sales of tangible personal property except food and certain goods bought by manufacturers. On July 1, 1940, the province of Quebec entered the retail sales tax field, levying a rate of 2 percent. The Montreal sales tax continued but was administered by the province. Several

other Quebec municipalities introduced sales taxes of their own, also at the rate of 2 percent. In 1964, the province took over the whole sales tax field and established a uniform rate province-wide.

A general municipal sales tax is usually calculated as a percentage of the selling price of taxable items.

The rationale for a municipal retail sales tax as a supplement to the local property tax is similar to the rationale for a municipal income tax. As long as municipal services are funded only from property taxes imposed on local residents, some users may escape paying taxes for services they consume. Broadening the local tax base to include sales would help to address some of the externalities in municipal services (some beneficiaries of services, such as commuters and visitors, do not pay for them), would give cities greater flexibility and breadth in determining their own tax structure, and would allow them to benefit from growth in the economy.[53] These arguments were behind the recommendations of Quebec's Pichette Task Force in 1993. It recommended that Montreal and the other core cities receive a portion of the provincial sales tax collected in their jurisdictions. The argument was that a share of that tax would capture the benefits to non-residents and give Montreal a direct link to the level of economic activity.[54]

Revenue Estimates

One percentage point of general sales tax revenue would provide cities with sizable amounts of revenue. Table 8 provides estimates of the potential yield. Our estimates are based on municipalities' piggybacking on the PST. For example, in provinces where the sales tax rate is 8 percent, it would rise to 9 percent and so on.[55] The additional tax revenue would be collected along with the existing sales tax and remitted to the taxing jurisdiction. Obviously, we could calculate no estimates for Alberta municipalities because the province has no sales tax. In the four provinces that have harmonized sales tax systems (Quebec, New Brunswick, Nova Scotia, and Newfoundland), we assumed the combination of PST and GST would require somewhat different implementation. A local tax would be based on value-added (similar to the GST in other provinces) and not turnover (as with PSTs in the non-harmonized provinces).

Column 2 of table 8 records one percentage point of sales tax revenue collected in each province in 2000. This column also shows the amounts that large cities might have expected to receive if the province had relinquished revenue from one

53 See Task Force on Greater Montreal, *Montreal: A City-Region* (Quebec: Ministère des Affaires Municipals, December 1993).

54 Ibid., at 82.

55 An increase of one percentage point would amount to an increase of 16.7 percent in the effective tax rate in a province with a current sales tax rate of 6 percent, an increase of 14.3 percent where the current tax rate is 7 percent, and an increase of 12.5 percent where the current rate is 8 percent.

TABLE 8 Estimated Municipal Tax Revenue from a 1 Percent General Sales Tax in 2000

(1)	(2) Yield from the tax with	(3)	(4) Revenue from the tax as a percentage of	(5)
Province, city	Existing base[a]	Base changed because of higher rate[b]	Municipal property taxes[c]	Own-source revenue[d]
	millions of dollars		*percent*	
Newfoundland	61.2	57.0–59.7	30.8–33.3	21.9–23.7
St. John's	15.7	14.5–15.2	17.8–19.2	15.8–17.0
Prince Edward Island	15.2	14.3–14.8	40.2–42.7	26.9–28.6
Nova Scotia	102.3	94.6–99.1	14.5–15.7	11.0–11.9
Halifax	48.5	44.8–46.9	13.8–14.9	10.7–11.5
New Brunswick	81.1	75.0–78.6	25.7–27.8	16.3–17.7
Fredericton	7.2	6.7–7.0	15.9–17.2	14.1–15.2
Quebec	882.9	812.3–853.5	13.8–15.0	9.8–10.7
Quebec City	19.6	18.0–18.9	9.1–9.9	5.3–5.8
Montreal	118.3	108.8–114.3	9.1–9.9	6.1–6.7
Ontario	1,689.4	1,562.7–1,636.6	15.4–16.6	9.1–9.8
Ottawa	142.3	131.6–137.8	16.8–18.1	10.2–11.1
Toronto	389.9	360.6–377.7	14.5–15.6	7.8–8.4
Hamilton	65.0	60.1–62.9	13.0–14.0	6.0–6.5
London	47.5	44.0–46.0	16.3–17.6	10.3–11.2
Windsor	33.7	31.2–32.7	16.3–17.6	5.1–5.5
Sudbury	20.7	19.2–20.1	15.9–17.2	7.0–7.6
Thunder Bay	15.7	14.5–15.2	15.5–16.6	8.3–9.0
Manitoba	144.0	131.7–138.9	23.8–26.0	13.2–14.5
Winnipeg	92.6	84.7–89.3	19.7–21.5	13.7–14.9
Saskatchewan	123.7	111.3–118.5	21.6–24.0	12.7–14.1
Saskatoon	51.2	46.1–49.1	54.3–60.3	15.1–16.8
Regina	28.3	25.4–27.1	26.0–28.9	12.1–13.4
Alberta	[d]	[d]	[d]	[d]
British Columbia	523.3	478.4–504.6	20.7–22.7	11.4–12.4
Vancouver	87.3	79.8–84.2	18.2–19.9	11.3–12.3

[a] Calculated by dividing the figures in column 3 of appendix table 1 by the PST rate.

[b] The first number reported on each line in this column is the estimated impact on tax revenue if the elasticity coefficient was -0.60; the second is the estimated impact if the elasticity coefficient was -0.25. A US study of New York and Philadelphia reports these impacts for the two cities respectively (see the text and note 14).

[c] Calculated in the same way as columns 3 and 4 in table 6.

[d] As noted in the text, our assumption of piggybacking prevented us from making estimates for Alberta, which has no PST in place.

Source: Calculated from data provided in appendix table 1.

percentage point of sales tax revenue; that is, if the provincial sales tax rate were 8 percent and the province had simply remitted an amount equivalent to one percentage point to the cities. Toronto could have received $390 million, Ottawa $142 million, Montreal $118 million, Winnipeg $93 million, Vancouver $87 million, and so on.

To assume that the provinces would relinquish one percentage point of sales tax revenue may, however, be unrealistic. The more likely possibility—if there is one at all—is that they would permit some municipalities to add one or two percentage points to the existing PST rate; the provinces would collect all revenues and remit to the cities the extra amount collected.

Moreover, any increase in the tax rate might have a negative impact on the tax base. The extent to which the tax base may be sensitive to higher rates is important in estimating the ultimate revenue impact for any city. For example, if all contiguous municipalities adopted the same sales tax rate, the impact on the tax base might be less than if it were imposed or increased in one city and not in its neighbours. The incentive for cross-border municipal shopping would be greater under the latter scenario. However, this effect might be insignificant compared to the local autonomy that could be gained if municipalities were permitted to levy a sales tax.

Canada has no empirical estimates on the sensitivity of the municipal sales tax base to an increase in the sales tax rate. One US study[56] estimates a general sales tax-price elasticity coefficient of –0.60 for New York and a gross receipts tax-price elasticity coefficient of –0.25 for Philadelphia. In other words, a 1 percent increase in the municipal sales tax rate leads to a decrease in the sales tax base (due to cross-border shopping and a lower level of economic activity) of three-fifths of 1 percent in New York and one-quarter of 1 percent in Philadelphia.

When we used the elasticity coefficients from the US study to estimate the range of tax revenues that might arise from an increase of one percentage point in the sales tax rate in each province, we obtained the amounts listed in column 3 of table 8. Notice that each cell reports a two-number range. The first figure in each is the estimated impact on tax revenue if the elasticity coefficient was –0.60 and the second is the estimated impact if the elasticity coefficient was –0.25. On the basis of these elasticity coefficients, a municipal sales tax of one additional percentage point could generate between $361 and $378 million dollars for the city of Toronto, between $80 and $84 million for Vancouver, and so on.

This estimated sales tax revenue is listed in column 4 as a percentage of 2000 municipal property taxes and in column 5 as a percentage of own-source revenue in the same year. Because we cannot know what effect the sales tax would have on the tax base, we again report our estimates in ranges. The first number in each pair results from assuming a tax-price elasticity coefficient of –0.60 (the worst-case negative impact we used), and the second from assuming no impact whatsoever on the tax base.

56 For a discussion of this study, see Haughwout et al., supra note 14.

Notice that the revenue generated from a municipal sales tax could be considerable for each city in the sample. As a percentage of municipal property taxes, we could expect something between a high of 54 to 60 percent in Saskatoon to a low of 9 to 10 percent in Montreal and Quebec City. As a percentage of own source revenue, the range is far less striking, extending from a high of 15 to 17 percent in Saskatoon to a low of 5 to 6 percent in Quebec City and Windsor.

Final Comments

A one percentage point increase in the sales tax rate would generate much more revenue than a 1 percent surtax on personal income taxes. This contrast is not surprising given that a one percentage point increase in the sales tax is equivalent to an increase of 10 percent (on a 10 percent tax rate) to 17 percent (on a 6 percent tax rate) of the current tax rate. A sales tax may also be preferrable to an income tax because the general pattern of taxation in most of the countries with which Canada competes is shifting away from income taxes toward consumption-based taxes, the latter being deemed more efficient and effective tax policy tools.[57] Finally, a sales tax would satisfy the benefits-based principle of financing local government because it would permit municipalities to collect revenue from those who benefit from municipal services—visitors and commuters—but cannot be captured by the property tax.

Fuel Tax

Many US cities levy fuel taxes. None are levied at the municipal level in Canada. A few cities and regions do, however, share in provincial fuel tax revenues; the provincial government sets the tax rate, collects the revenue, and remits it to the eligible cities or regions. For example, in the Greater Vancouver Regional District (GVRD), the province remits 11 cents per litre of its fuel tax revenues to the Greater Vancouver Transit Authority (TransLink).[58] These funds are to be used for capital and operating costs of transit services and major roads within the GVRD.

Similarly British Columbia remits two and a half cents per litre of its provincial fuel tax revenue to the transit system in the capital region (around Victoria) for operating expenses and capital projects. Calgary and Edmonton receive provincial grants for transportation infrastructure that are estimated to equal five cents per litre from all provincial fuel tax revenue collected in the two cities.[59] The Agence

57 Boadway and Kitchen, supra note 52, at chapters 1 and 2.

58 These revenues are made up of three components: 4 cents previously collected on behalf of TransLink, which only applies to the GVRD; 5 cents of provincial fuel tax revenue, which was transferred to the transit authority when it was created in 1999; and 2 cents increase as of April 1, 2002, which applies only in the GVRD.

59 Karin Treff and David B. Perry, *Finances of the Nation 2000* (Toronto: Canadian Tax Foundation, 2001), chapter 12.

Metropolitaine de Transport, which provides transit services to Montreal and surrounding municipalities, receives one and a half cents per litre of all provincial fuel taxes collected in this area.

Fuel taxes can be viewed as benefit-based taxes to the extent that they are paid by those who use the road system. Different cities or city-regions could impose taxes at different rates, but they could probably not vary much from the rates imposed by their neighbours, given the mobility of the tax base. To the extent that a fuel tax is intended to price either the use of publicly provided roads or externalities (for example, pollution and congestion), it is a crude instrument. Congestion charges (tolls), on the other hand, function better because they can vary by time of day and by location. Licence fees are also better because they can vary by vehicle age and engine size, vehicle axle weight, and location of vehicle—factors that affect the amount of pollution, congestion, and road damage more than fuel consumption.

Fuel tax revenues are generally earmarked for local roads and public transit and often replace provincial grants for these purposes. Such earmarking offers several potential advantages.[60] First, if the funds are used to pay for roads and transit infrastructure, earmarking links the cost of transportation to the users. Second, it is likely to improve the motivation and efficiency of local decision makers. If funds are not earmarked, surplus revenues from the sale of goods and services may be used to lower local tax rates, probably discouraging managerial efforts to improve efficiency and to reduce costs as well as the introduction of innovative techniques and future investment that could lead to cost savings and efficiencies.

Third, there is no solid economic reason why revenues generated by selling a specific good or service should be used to subsidize local taxpayers or why those taxpayers should subsidize the users of a specific good or service. Such cross-subsidization may lead to undesirable distortions and a departure from efficient and accountable pricing and investment practices.

Earmarking may present problems, however. It can shield expenditure programs from the critical assessment that budgetary authorities might otherwise provide. There is no guarantee that it would generate the amount of revenue required annually as local circumstances change or that it would be evaluated relative to the other priorities of local governments. In short, it might reduce municipal flexibility.

The current regime of fuel taxes in Canada also presents some difficulties for designing a practical municipal fuel tax. Provincial governments levy the tax per litre at the pump. In contrast, the federal government levies its tax at the refinery.

The federal tax would be much more difficult for municipalities to piggyback on because of the difficulties of determining the base in each municipality. A municipal tax rate on top of the federal one would bring in revenue only to cities in which refineries are located.

---

60 Richard M. Bird, "Analysis of Earmarked Taxes" (1997) vol. 14, no. 25 *Tax Notes International* 2095-2116; McCormick Rankin Corp., "How Should the User Pay? Opportunities for Financing the Region of Ottawa-Carleton Transportation System," a report prepared for the Regional Municipality of Ottawa-Carleton, December 1998.

If the federal government made tax room for municipalities in its fuel tax, it could do so in one of three ways. First, it could allocate a portion of the revenues to municipalities through a grant formula (for example, one based on population). The problem with this method is that it would not allow municipalities to set their own tax rates and thus would do nothing for local autonomy or accountability. The revenue would be simply a transfer.[61] Second, Ottawa could allow the imposition of different fuel tax rates at the refinery level with the refiners acting as collection agents for municipal governments and remitting taxes according to fuel shipments. This approach might, however, increase refiners' compliance costs. A third way would be to provide tax room that would be picked up by provincial governments, which would, in turn, allow municipalities to levy their own tax rates at the pump. A potential problem with this method is that it would require the cooperation of all three levels of government.

Potential Revenues

Given the difficulties of levying a municipal fuel tax on the federal fuel tax base, we set up our projections on the assumption of a per-litre tax piggybacked onto the fuel tax of the relevant province.

Table 9 records the revenue yield that municipalities might expect from imposing a one cent per litre tax on fuel. The provincial totals in column 2 of this table record the revenue that was generated in 2000 from one cent of provincial fuel tax. For the city amounts, we used two approaches. For Edmonton and Calgary, we report the actual revenue received from one cent per litre. For Vancouver and Montreal, we do the same, but we note that the area served by the Greater Vancouver Transportation Authority includes more municipalities than the city of Vancouver and the area served by the Agence Metropolitaine de Transport includes more municipalities than the city of Montreal as it was in 2000.

For other cities, we estimated the dollar value of fuel tax revenue collected in each by multiplying the provincial fuel tax revenue by the ratio of city income to provincial income. These city totals were further adjusted to reflect differences in public and private transit use; for example, if private transit in a city was 70 percent of total transit and its use for the entire province was 80 percent, we adjusted the city's estimated fuel tax revenue to reflect the proportionate difference.

In each case, the figures given in column 2 of table 9 are for revenue from one cent of fuel tax if the existing fuel tax base remains constant. These estimates suggest that Toronto might expect to get about $39 million, Ottawa $14 million, Winnipeg $12 million, and so on.

The assumption that the tax base would remain constant if fuel tax rates increase may, however, be unrealistic. The more likely outcome would be some response to higher tax rates, although what it would be is far from obvious since no

61 This approach appears to be the one currently being suggested by Prime Minister Paul Martin.

TABLE 9 Estimated Municipal Tax Revenue from a One Cent Per Litre Tax on Fuel, 2000

(1)	(2)	(3)	(4)	(5)
	Yield from the tax with		Revenue from the tax as a percentage of	
Province, city	Existing base[a]	Base changed because of higher rate[b]	Municipal property taxes[c]	Own-source revenue[d]
	millions of dollars		*percent*	
Newfoundland	7.9	7.5–7.8	4.0–4.3	2.9–3.1
St. John's	1.8	1.7–1.8	2.1–2.2	1.8–2.0
Prince Edward Island	2.5	2.3–2.4	6.4–6.9	4.3–4.6
Nova Scotia	15.0	13.9–14.8	2.1–2.3	1.6–1.7
Halifax	6.5	6.0–6.4	1.9–2.0	1.4–1.6
New Brunswick	17.2	15.6–16.8	5.3–5.9	3.4–3.7
Fredericton	1.5	1.3–1.4	3.2–3.5	2.8–3.1
Quebec	103.4	96.6–101.7	1.6–1.8	1.2–1.3
Quebec City	2.4	2.2–2.3	1.1–1.2	0.7
Montreal	29.6[d]	27.7–29.1	[e]	[e]
Ontario	188.3	175.5–185.1	1.7–1.9	1.0–1.1
Ottawa	14.3	13.4–14.1	1.7–1.8	1.0–1.1
Toronto	38.9	36.3–38.3	1.5–1.6	0.8
Hamilton	7.7	7.2–7.6	1.6–1.7	0.7–0.8
London	5.7	5.3–5.6	2.0–2.1	1.2–1.3
Windsor	4.3	4.0–4.2	2.1–2.2	0.6–0.7
Sudbury	2.5	2.4–2.5	2.0–2.1	0.9
Thunder Bay	2.0	1.8–1.9	2.0–2.1	1.0–1.1
Manitoba	19.4	17.7–19.0	3.2–3.5	1.8–1.9
Winnipeg	12.2	11.1–11.9	2.6–2.8	1.8–2.0
Saskatchewan	23.0	21.5–22.6	4.2–4.5	2.5–2.6
Saskatoon	9.5	8.9–9.4	10.5–11.2	2.9–3.1
Regina	5.4	5.0–5.3	5.1–5.5	2.4–2.6
Alberta	64.4	57.3–62.7	2.6–3.0	1.3–1.5
Calgary	17.0[d]	15.1–16.5	2.7–3.0	1.2–1.4
Edmonton	13.0[d]	11.6–12.6	2.8–3.2	1.1–1.2
British Columbia	81.6	74.2–79.8	3.2–3.5	1.8–1.9
Vancouver	20.0[d]	18.2–19.5	[e]	[e]

[a] Calculated by dividing the figures in column 4 of appendix table 1 by the provincial fuel tax rate.

[b] The first number reported on each line in this column is the estimated impact on tax revenue if the elasticity coefficient was –1.0, the second is the estimated impact if the elasticity coefficient was –0.25.

[c] Calculated in the same way as columns 3 and 4 in table 6.

[d] Actual amount the transportation area received from the province.

[e] Not applicable because the revenue yield is for a larger area than the city itself.

Source: Calculated from data provided in appendix table 1.

Canadian studies have measured fuel tax-price elasticity. To give some notion of this response, column 3 of table 9 provides ranges of estimates based on elasticities of –1.0 and –0.25; that is, if the fuel tax rate was to increase by 1 percent, the tax base would fall by an amount between 1.00 and 0.25 percent. These estimates suggest that Toronto could expect to get between $36 and $38 million from a tax of one cent per litre, Ottawa $13 to $14 million, and Winnipeg $11 million to $12 million.

Final Comments

With a few exceptions (such as Saskatchewan, Prince Edward Island, and New Brunswick), a one cent tax per litre would generate revenue equivalent to between 1 and 3 percent of municipal property taxes in most cities and provinces (column 4 of table 9) and a somewhat smaller proportion of their own-source revenue (column 5 of table 9). If the tax rate was higher than one cent per litre, the revenue yield could be quite significant and extremely useful in funding public transit and transportation.

Hotel and Motel Occupancy Tax

A separate hotel and motel occupancy tax at the municipal level is currently levied by Vancouver (yielding $8.4 million in 2000 and $8.2 million in 2001)[62] and Montreal (yielding $7.9 million in 2000, $8.3 million in 2001, and $8.4 million in 2002),[63] and legislation in Manitoba permits such a tax. Over the past two decades, many local governments in the United States have levied hotel and motel occupancy taxes.

An occupancy or room tax is an additional levy imposed on the existing provincial retail sales tax on hotels and motels. It is justified on the grounds that it compensates local governments for the expanded services provided for tourists and visitors (for example, the additional police and fire protection, and highway and public transit capacity needed to meet weekend or peak convention and tourist demands). In Montreal, revenues from the hotel and motel occupancy tax go to the tourist association.

Although income and retail sales taxes fall on both residents and non-residents, a hotel and motel occupancy tax falls mainly on visitors. As with local income or retail sales taxes, local governments in Canada could choose between two methods of administration. They could simply piggyback a few extra percentage points onto the existing retail sales tax on hotel and motel rooms. Alternatively, they could set up their own administrative structures to administer and collect the tax. As with other possible tax sources, the piggyback scheme would be administratively less expensive, but local governments would have less flexibility and no potential for altering the tax base.

---

62 City of Vancouver, *Annual Report 2001* (Vancouver: City of Vancouver, 2001), 33.

63 Information obtained from Pierre Bolduc, Ville de Montreal, May 20, 2003.

The levying of a hotel and motel room occupancy tax by selected municipalities and not by competing communities would provide individuals an incentive to stay in hotels and motels in those municipalities without the tax. The extent to which the differential would actually deter visitors from renting rooms is uncertain. But if the demand for hotel and motel rooms is sensitive to price, then noticeable losses might occur. Convention arrangements are often highly cost-sensitive, so decision makers should consider the impact on the convention business if their municipality imposes a municipal hotel and motel tax that does not exist in potentially competitive centres.

Municipalities themselves should set the rate for the hotel and motel occupancy tax. If they get it wrong and drive away tourists and convention business, they will soon alter the rates to remedy the situation. As with each of the tax options described in this section, municipalities need to be accountable.

Potential Revenue

We based our calculations on a tax of 1 percent on current room rates. Column 2 of table 10 lists the potential revenue yield of such a tax. Because the calculation included the average room rate, the number of rooms, and the average occupancy rate, it is not surprising that the estimated yield for the larger and more tourist-popular cities far exceeds the revenue for the smaller, less popular centres.

Because the tax yield is highly sensitive to occupancy rates and room rates, we re-estimated the potential revenue yield (see column 3 of table 10) assuming that it could be 10 percent lower or 10 percent higher than the estimate provided in column 2. Toronto could expect to collect between $7.3 and $8.9 million; Montreal between $5.0 and $6.1 million; and Quebec City and Winnipeg between $1.0 and $2.0 million. Smaller cities would get less than $1.0 million.

Final Comment

At the margin, the revenue yield described above might be important if it was earmarked or designated for marketing and promoting tourism. In the overall municipal finance picture, however, a 1 percent room tax would not be a large revenue generator. In fact, it would account for less than 0.5 percent of property tax revenues and less than 0.2 percent of own-source revenues in most cities (see column 4 of table 10). Such a low yield might prompt some to consider a higher tax rate, even bearing in mind that as rates rise, the likelihood of a negative impact on the tax base increases.

A Comparison of Revenue Yields

The previous estimates of potential revenue cover different tax bases and apply different tax rates: a 1 percent surtax on provincial PIT liability, a one percentage point increase in the existing PST rate, a fuel tax of one cent per litre, and a tax of 1 percent on hotel and motel occupancy room rates. Because each set of estimates involves a different tax base and different rates, we need a common index or benchmark to compare the proposed taxes' yields.

TABLE 10 Estimated Municipal Tax Revenue from a 1 Percent Tax on Hotel and Motel Room Rates

(1)	(2)	(3)	(4)	(5)
	Yield from applying the tax to existing room rates with		Revenue from the tax as percentage of	
Province, city	No change in occupancy rates[a]	Occupancy rates changed[b]	Municipal property taxes[c]	Own-source revenue[c]
	thousands of dollars		*percent*	
Newfoundland				
St. John's	424	381–466	0.5–0.6	0.4–0.5
Nova Scotia				
Halifax	886	797–975	0.2–0.3	0.2
Quebec				
Quebec City	1,456	1,309–1,600	0.7–0.8	0.4–0.5
Montreal	5,582	5,024–6,140	0.4–0.5	0.3
Ontario				
Ottawa	2,412	2,170–2,653	0.3	0.2
Toronto	8,102	7,292–8,913	0.3–0.4	0.1–0.2
Hamilton	262	236–288	0.1	0.0
London	538	484–592	0.2	0.1
Windsor	691	622–761	0.3–0.4	0.1
Sudbury	282	254–310	0.2–0.3	0.0
Manitoba				
Winnipeg	1,489	1,340–1,638	0.3–0.4	0.2–0.3
Saskatchewan				
Saskatoon	586	527–645	0.6–0.8	0.2
Regina	484	435–532	0.4–0.5	0.2–0.3
Alberta				
Calgary	2,220	1,998–2,442	0.4	0.2
Edmonton	2,631	2,368–2,894	0.6–0.7	0.2–0.3
British Columbia				
Vancouver	4,100[d]	3,690–4,510	0.8–1.0	0.5–0.6

[a] The tax base for each city was obtained by multiplying the number of hotel and motel rooms by the average room rate and then by the average occupancy rate (data were provided by city personnel). Potential tax revenue was then estimated by multiplying this tax base by 1 percent.

[b] Since the tax base depends on both the room rate (including tax) and the occupancy rate, this column estimates the expected range of revenue by assuming it could be 10 percent lower or higher than the figures reported in column 2. The first number reported on each line is 10 percent less, and the second 10 percent more.

[c] Calculated in the same way as columns 3 and 4 in table 6.

[d] Based on actual amount received.

Source: Calculated from data provided in appendix table 1.

The comparison can be made in two ways: by calculating across provinces and selected cities the rates necessary for each of the new taxes to yield (1) additional revenue of $100 million, or (2) an amount equal to 10 percent of the municipal property tax. Following are our results from applying each of these methods.

Notice that in reporting our results from following both methods, we do not include an estimate for a hotel and motel occupancy tax. The reason is that the yield from this tax would be much lower than from the other taxes we examined, so the rate would have to be unreasonably high to generate either $100 million or the equivalent of 10 percent of the property tax's yield.

$100 Million in Revenue

For each of three of the new taxes, Table 11 sets out the estimated impact on municipal tax rates in each province and selected cities from raising $100 million of additional tax revenue. Column 2 records the surtax on the provincial PIT that would be required to raise $100 million annually. For the larger cities, the rate would be reasonable: 2.2 percent in Toronto, 5.4 percent in Calgary, and 9.3 percent in Vancouver. But cities with a much smaller tax base would require a much larger surtax; Fredericton, for example, would need 114.7 percent, and Thunder Bay 68 percent.

If $100 million were to be generated by an increase in the general sales tax rate (column 3), Toronto would need an increase of three-tenths of one percentage point (0.3, raising the current rate from 8.0 percent to 8.3 percent) and Vancouver 1.2 percentage points. As the table indicates, the smaller cities would require much higher tax rates to generate the same amount of revenue. Higher tax rates would mean greater distortions.

A similar pattern appears for a potential municipal fuel tax (column 4 of table 11). To generate $100 million annually, the additional rate would have to be set at 2.7 cents in Toronto, at 3.5 cents in Montreal, at 5.2 cents in Vancouver, at 6.2 cents in Calgary, and at 7.2 cents in Ottawa. In the smaller cities, the increase would be prohibitive if it were to produce the same yield.

10 Percent of the Property Tax's Yield

Because the tax base in smaller cities is not as large as in bigger ones, we are not surprised that the tax rates must be much higher in the former to generate a fixed amount of revenue. Table 12 partially standardizes for this phenomenon by estimating the impact on the same three tax rates if cities were to raise an additional amount equal to 10 percent of their municipal property taxes in 2000 (column 2 records these amounts). Column 3 reports the surtax on the PIT that would be required to generate that amount. In those cities and provinces where property taxes are relatively lower, a surtax in the range of 3 to 5 percent would be adequate. For cities in Ontario, where property taxes are higher in both absolute and per capita terms,[64] the surtax would have to range from 5 to 7 percent.

64 Kitchen, *Municipal Revenue and Expenditure Issues in Canada*, supra note 4, at 29.

TABLE 11 Impact on Municipal Tax Rates of Raising $100 Million of Additional Revenue from a Surtax on Personal Income Tax, a General Sales Tax, or a Fuel Tax

Province, city	Surtax on provincial PIT	Increase in PST rate	Increase in fuel tax
	percent	*percentage points*	*cents per litre*
Newfoundland	16.5	1.7	13.0
St. John's	55.2	6.6	56.9
Prince Edward Island	69.2	6.8	42.1
Nova Scotia	8.3	1.0	6.9
Halifax	16.4	2.1	15.9
New Brunswick	11.1	1.3	6.1
Fredericton	114.7	14.4	70.6
Quebec	0.5	0.1	1.0
Quebec City	25.7	5.3	43.3
Montreal	4.0	0.9	3.5
Ontario	0.6	0.1	0.5
Ottawa	6.2	0.7	7.2
Toronto	2.2	0.3	2.7
Hamilton	15.5	1.6	13.3
London	20.6	2.2	18.1
Windsor	29.3	3.1	24.2
Sudbury	50.5	5.0	40.9
Thunder Bay	68.0	6.6	52.6
Manitoba	6.1	0.7	5.4
Winnipeg	9.2	1.1	8.6
Saskatchewan	7.7	0.8	4.5
Saskatoon	30.6	2.0	10.8
Regina	31.2	3.7	19.2
Alberta	2.2	[a]	1.6
Calgary	5.4	[a]	6.2
Edmonton	10.9	[a]	8.1
British Columbia	1.7	0.2	1.3
Vancouver	9.3	1.2	5.2

Note: All tax increases used here are based on the average of the elasticity assumptions for the taxes reported in tables 6, 8, and 9.

[a] As noted in the text and in note d to table 8, our assumption of a piggybacked tax prevented us from making estimates for Alberta, which has no PST.

Source: Calculated from data provided in tables 6, 8, and 9, and appendix table 1.

Similarly, a general sales tax increase of about six-tenths of a percentage point would generate an amount of revenue equivalent to about 10 percent of the property tax in most Ontario cities. The comparable rate would be lower in many other Canadian cities where a provincial sales tax is currently levied. Finally, for a fuel tax to generate the same amount of revenue, the rate would have to be 6.6 cents per litre in Toronto. In most other large cities and provinces, the comparable rate would be less than 5 cents.

TABLE 12 Impact on Municipal Tax Rates from Raising Additional Revenue Equivalent to 10 Percent of Property Taxes in 2000

Province, city	10 percent of property tax revenue	Surtax on provincial PIT [a]	Increase in PST rate [a]	Increase in fuel tax [a]
	$ millions	*percent*	*percentage points*	*cents per litre*
Newfoundland	185.2	3.1	0.3	2.4
St. John's	81.7	4.5	0.5	4.6
Prince Edward Island	35.6	2.5	0.2	1.5
Nova Scotia	652.2	5.4	0.7	4.5
Halifax	325.2	3.3	0.7	5.2
New Brunswick	282.0	3.1	0.4	1.7
Fredericton	41.9	4.8	0.6	3.0
Quebec	5,885.7	3.2	0.7	5.9
Quebec City	198.3	5.1	1.1	8.6
Montreal	1,180.9	4.7	1.0	4.1
Ontario	10,147.5	5.7	0.6	5.6
Ottawa	784.2	4.9	0.6	5.7
Toronto	2,494.3	5.6	0.7	6.6
Hamilton	463.1	7.2	0.7	6.2
London	269.5	5.6	0.6	4.9
Windsor	191.1	5.6	0.6	4.6
Sudbury	120.6	6.1	0.6	4.9
Thunder Bay	93.8	6.4	0.6	4.9
Manitoba	553.5	3.4	0.4	3.0
Winnipeg	431.0	3.9	0.5	3.7
Saskatchewan	516.4	4.0	0.4	2.3
Saskatoon	84.9	2.6	0.2	0.9
Regina	98.0	3.1	0.4	1.9
Alberta	2,175.7	4.7	[b]	3.6
Calgary	560.5	3.0	[b]	3.5
Edmonton	406.2	4.4	[b]	3.3
British Columbia	2,306.7	4.0	0.5	2.9
Vancouver	439.3	4.1	0.5	2.3

[a] All tax rate increases are based on the average of the elasticity assumptions for each tax reported in tables 6, 8, and 9.

[b] Actual amount the transportation area received from the province.

Source: Calculated from data provided in tables 6, 8, 9, and appendix table 1.

Concluding Comments

Direct municipal access to one or more of the provincial PIT, the provincial general sales tax, hotel and motel occupancy taxes, and the provincial fuel tax can be justified on the grounds these levies can reflect the benefits from municipal services and could expand municipalities' range of taxes, providing more flexibility. Regardless of which option or options municipalities chose, they (not the provinces) need to set their own rates to achieve accountability and efficiency in local

decision making. Municipal rate setting needs to be done on a region-wide basis to minimize economic distortions and pay for services that have region-wide benefits.

REVISIONS TO PAYMENTS IN LIEU OF PROPERTY TAXES AND ELIMINATION OF THE GST ON MUNICIPALITIES

The previous part discussed four tax sources that would help municipalities, especially large cities and city-regions, meet their ongoing expenditure needs and commitments. This part continues the same theme of finding funds for municipalities but is directed at two other areas: the current payments in lieu of the property tax program, and the federal GST that municipalities must pay on goods and services they purchase.

Payments in Lieu of Property Taxes

Section 125 of the British North America Act, now the Constitution Act,[65] states, "no lands or property belonging to Canada or any Province shall be liable to taxation." That clause was enacted to ensure that the powers of taxation of one level of government would not interfere with another level's control of property.[66] It means, inter alia, that local governments do not have legislative power to collect property taxes from properties owned by federal and provincial governments or their enterprises. (Federal government enterprises are generally Crown corporations, and provincial government enterprises are diverse entities, such as housing corporations, liquor control boards, and power authorities, to name a few.)

Instead of property taxes, federal and provincial governments have adopted the practice of making payments in lieu (sometimes referred to as grants in lieu) of property taxes to local governments on federal and provincial properties. Some provinces also make payments in lieu of taxes on local government enterprises (generally utility companies, including gas, electricity, and telephone), on public sector institutions (universities, hospitals, and correctional facilities) and on non-governmental organizations (for example, properties of a few private corporations and non-profit organizations, such as the Red Cross). Below we review the revenue yield of these payments, and then we identify and discuss issues around the use of payments in lieu of property taxes.

Revenue Yield

The revenue yield from payments in lieu of taxes depends on two factors: the number of federal, provincial, local and non-governmental properties on which payments are made and the extent to which payments reflect the amount of taxes that would

65 Constitution Act, 1982, being schedule B to the Canada Act 1982 (UK) 1982, c. 11.

66 For a thorough discussion of the purpose and interpretation of this clause, see G.V. La Forest, *The Allocation of Taxing Power Under the Canadian Constitution*, 2d ed., Canadian Tax Paper no. 65 (Toronto: Canadian Tax Foundation, 1981), 182-94.

have been paid if these properties had been subject to standard property tax liability. A municipality with a large number of government properties that are not making payments in lieu equivalent to the property taxes that would be paid on comparable private properties has a lower fiscal capacity than other municipalities have.

Table 13 summarizes the revenue yield per capita and the relative importance of payments in lieu, both of which are aggregated for all municipalities in each province for 2000. Municipalities in Quebec received the highest payments at $92 per capita, and those in Prince Edward Island the lowest at $1 per capita. The Canadian average was $55 per capita. The low value for PEI reflects that the provincial government pays municipal property taxes on most of its properties instead of making payments-in-lieu.

The relative importance of these payments is reflected in part B of table 13. As a percentage of property-tax-related revenues, the payments in lieu in New Brunswick (the highest province) accounted for 13.3 percent; the comparable figure for Prince Edward Island (the lowest province) was 0.5 percent. For all Canada, payments in lieu represented 6.9 percent of property-tax-related revenues.

Provincial governments generate the largest amount of payment-in-lieu revenue in seven provinces, and the federal government is more important in the other three. Payments in lieu are less significant for federal and provincial government enterprises, and payments for universities, colleges, and hospitals are significant only in Ontario. Local government enterprises make payments in lieu in Ontario, Manitoba, Saskatchewan, and Alberta. But those enterprises that receive local government subsidies (for example, municipal transit commissions) do not make payments in lieu of taxes.

When we consider payments in lieu as percentages of own-source revenue (part C of table 13), New Brunswick was the highest province in 2000 with the payments accounting for 8.9 percent of all locally generated revenues. Prince Edward Island was the lowest province with the payments accounting for 0.3 percent. The Canadian average was 4.3 percent.

Table 14 sets out payments in lieu of property taxes for a few cities across the country. The range in relative importance is very wide. In Quebec City, for example, payments in lieu accounted for more than 20 percent of all property-related taxes and more than 16 percent of own-source revenue. They accounted for between 12 and 19 percent of all property-related revenues in Montreal, Winnipeg, and Calgary (the next highest) and for 3.1 percent in St. John's (the lowest).

Issues Around Payments in Lieu

The consensus of the municipal officials we questioned was that the payments in lieu program has improved significantly over the past decade in Canada[67] but that

67 For a discussion of earlier problems with the federal grants in lieu program, see Harry M. Kitchen and François Vaillaincourt, "The Federal Grants-in-Lieu of Property Taxes Program: An Assessment" (1990) vol. 38, no. 4 *Canadian Tax Journal* 928-36.

TABLE 13 Payments in Lieu of Property Taxes, 2000

	Nfld.	Prince Edward Island	Nova Scotia	NB	Quebec	Ontario	Manitoba	Sask.	Alberta	British Columbia	Canada
					Part A. Municipal Services (dollars)						
Per capita payments	22	1	43	59	92	51	44	51	36	24	55
					Part B. Grants in Lieu as a percentage of property tax revenue (%)						
Federal government	2.8	0.0	2.9	2.0	1.4	1.3	2.1	0.8	0.4	1.3	1.3
Federal goverment enterprises	0.5	0.0	0.8	0.0	0.3	1.0	0.4	0.1	0.0	0.1	0.6
Provincial governments ...	2.5	0.5	1.3	11.3	5.3	1.5	4.3	1.4	1.3	0.9	2.7
Universities	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.1
Colleges	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.1
Hospitals	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Provincial government enterprises	0.2	0.0	0.8	0.0	3.3	0.8	1.1	4.9	0.4	1.8	1.6
Local government enterprises	0.0	0.0	0.0	0.0	0.0	0.4	0.4	2.1	2.6	0.0	0.5
Total	6.0	0.5	5.8	13.3	10.3	5.5	8.3	9.2	4.7	4.0	6.9

(Table 13 is concluded on the next page.)

TABLE 13 Concluded

	Nfld.	Prince Edward Island	Nova Scotia	NB	Quebec	Ontario	Manitoba	Sask.	Alberta	British Columbia	Canada
					Part C. Grants in Lieu as a percentage of own-source revenue (%)						
Federal government	2.1	0.0	2.2	1.4	1.0	0.8	1.2	0.5	0.2	0.7	0.8
Federal government enterprises	0.3	0.0	0.6	0.0	0.3	0.6	0.2	0.0	0.0	0.0	0.4
Provincial governments ...	1.8	0.3	1.0	7.5	3.9	0.9	2.5	0.8	0.7	0.5	1.7
Universities	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.1
Colleges	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Hospitals	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Provincial government enterprises	0.2	0.0	0.6	0.0	2.4	0.5	0.6	3.0	0.2	1.0	1.0
Local government enterprises	0.0	0.0	0.0	0.0	0.0	0.2	0.2	1.3	1.4	0.0	0.3
Total	4.4	0.3	4.5	8.9	7.6	3.3	4.8	5.7	2.5	2.2	4.3

Source: Calculated from Statistics Canada data, Financial Management Systems (FMS) (mimeograph, June 2001).

TABLE 14 Payments in Lieu for Selected Cities, 2000

	As a percentage of all property-related taxes	As a percentage of own-source revenue
	percent	
St. John's	3.1	2.8
Halifax	7.3	6.1
Quebec City	22.0	16.5
Montreal	15.4	12.2
Ottawa	9.5	6.4
Toronto	7.0	4.0
Hamilton	4.8	2.3
London	4.2	2.8
Windsor	8.8	3.0
Sudbury	6.8	3.2
Thunder Bay	7.3	4.2
Winnipeg	12.6	10.0
Saskatoon	4.2	1.2
Regina	6.3	3.1
Edmonton	5.4	2.2
Vancouver	5.0	3.3

Source: Provincial summaries of municipal statistics and annual reports of the cities.

some problems remain. The main improvement is that provincial and federal governments now pay close to 100 percent of what cities bill them, rather than the 90 percent paid in the past. Also, municipalities do not have to wait as long to collect the payments as they used to.

Yet some aspects of the payments-in-lieu program still present concerns. First, the payments continue to be made at the discretion of the provincial and federal governments, with no guarantee that they will be made at full value.

Second, in those cities (and provinces) that levy a general tax on the nonresidential sector plus a business occupancy tax on the tenant,[68] payments in lieu are generally made only for the realty portion. Exclusion of the business occupancy tax because of ownership and occupancy is clearly discriminatory. Both government-owned and privately owned commercial and industrial properties use the same locally provided government services, so as long as privately owned properties are required to pay a business occupancy tax, government-owned and -occupied properties ought to be required to include that tax in their calculation of payments in lieu where they are conducting business. Indeed, the exclusion of the business occupancy tax from the payments-in-lieu base has been the primary reason why some

68 For a discussion of the provinces with a separate business occupancy tax and those that include such a tax in the non-residential rate, see Harry M. Kitchen, *Municipal Revenue and Expenditure Issues in Canada*, supra note 4, at 74-78.

provinces have, in the past, replaced their separate business occupancy tax with higher realty tax rates on commercial and industrial properties.[69]

A third concern is about properties that are exempt, most because of provincial and federal legislation. Examples include universities, colleges, correctional facilities, and provincial parks that lie within municipal boundaries, as well as churches, schools, seniors' nursing homes, and properties owned by non-profit corporations.

For properties such as post-secondary institutions, hospitals, and correctional institutions, the province may pay municipalities a per student or per bed grant; the revenue from such a regime is considered significantly less than it would be if the cities were permitted to impose property taxes. In 2000, Toronto, for example, received payments in lieu of $10.2 million for universities, colleges, hospitals, and correctional facilities; city officials estimate that the property tax revenue from these properties might have ranged from $29 million (based on the residential rate) to $100 million (based on the commercial rate). Calgary officials estimate that their city would receive an additional $55 million annually if all exempt properties were required to pay property taxes. For many other properties, municipalities are not able to collect property tax revenue nor do they receive payments in lieu, even though many of these properties use municipal services.

Justification may exist for exempting some properties from local taxes and from payments in lieu. For example, if the excluded properties provide services that benefit the local community collectively (that is, they create a public good), one can argue that no payments in lieu should be made because local residents (and, by extension, local governments) already benefit from the property and should not benefit twice. This argument has some validity for large spaces, such as urban parkland, and certain public structures, such as docks.

Another argument is that unique federal and provincial properties, such as canals, airport runways, roads, streets, and museums, should be excluded because their inclusion in the payments-in-lieu base may provide municipalities with an incentive to set unusually high tax rates to increase local revenue. This argument is weak, however, because unique privately owned properties are not excluded from property taxes.

It is also argued that payments in lieu should not be made on government structures such as monuments and communications towers because they use few if any local government services. This argument is hard to defend, particularly when comparable privately owned and occupied properties that consume few municipal services are taxed anyway. There is one exception: where the capital infrastructure and operating costs of, for example, sewers, water mains, and roads, especially on military bases, are provided and funded by either the provincial or federal government because the local government will not provide it. Arguing that these properties should make payments in lieu would be difficult.

---

69 Harry M. Kitchen, *Property Taxation in Canada*, Canadian Tax Paper no. 92 (Toronto: Canadian Tax Foundation, 1992), 106.

A fourth concern about the payments-in-lieu program involves disagreements about the assessment. The federal or provincial government withholds payments until the matter is resolved. Yet all other taxpayers are required to pay taxes when due; a change in assessment arising from a complaint results in a tax adjustment at a later date.

Fifth, where federal and provincial government property is leased out, legislation requires that the lessee pay property taxes instead of payments in lieu. This practice adds complexity to the government program and increases the administrative burden on municipalities. Moreover, the municipality often receives notification of the leasing arrangement too late to collect tax revenue from the property.

The Goods and Services Tax

Another way to provide funds to municipalities would be to eliminate the tax transfer they presently make to the federal government for the GST. Goods and services provided by municipalities fall under the tax-exempt category of the GST; no tax is collected on the final sale, and no credit is permitted to offset the taxes the final seller paid on inputs. Thus, residents and businesses who benefit from these goods and services (the final purchasers) do not pay GST on them, and municipalities cannot claim full credit for the GST they pay to the federal government. (Canadian municipalities pay the 7 percent rate. The federal government gives them a rebate of 57.14 percent of the tax paid, however, reducing the effective tax rate for municipalities to 3.0 percent.)

For all Canada, the municipal GST rebate for 2000 is estimated at $620 million[70] indicating that the net cost of the tax paid by all municipalities was $465 million in that year. As well, a recent report on Quebec estimates that if the GST and Quebec sales tax (QST) were completely refunded, the province's municipalities would save a combined total of $469 million in 2006.[71] Although the evidence by city is scanty, table 15 shows that the net cost of the GST for most cities is about 2 to 3 percent of all property-related taxes and about 1 to 2 percent of own-source revenues.

The current system causes a number of distortions.[72] One is a bias toward providing goods and services internally, using municipal employees, because the services of independent contractors are taxable. There is also a bias against privatization and against shifting public activities to the voluntary sector.

Over the past few years, the Federation of Canadian Municipalities (FCM) and a number of city officials have claimed that municipalities should not be required to

70 Canada, Department of Finance, *Tax Expenditures and Evaluations 2001* (Ottawa: Department of Finance, 2001), table 3.

71 *The Fiscal Situation of Quebec's Municipalities: Summary Report*, supra note 13, at 24-25.

72 See Satya Poddar, "Exemptions Under the Sixth VAT Directive: Issues and Options," paper presented to the Research Center for Economic Policy conference on Tax Policy in the European Union, Ministry of Finance, The Hague, October 17-19, 2001.

TABLE 15 Net Cost of the GST and Its Relative Importance in Selected Cities, 2000

	Net GST payable	GST as a percentage of Property tax revenue	GST as a percentage of Own-source revenue
	$ millions	*percent*	
Montreal[a]	33.1	2.8	1.9
Toronto	49.8	2.0	1.1
Winnipeg	7.8	1.8	1.3
Saskatoon	2.2	2.6	0.7
Calgary	11.8	2.1	0.9
Vancouver	5.1	1.2	0.7

[a] The 2000 figure was not available so the 2001 GST figure is reported here.

Source: Data obtained from municipal officials who responded to a request for information.

pay GST on the goods and services that they purchase. One argument is that municipalities are creatures of the province, and since provinces are not required to pay GST (because the federal government, under the constitution, cannot tax provinces), municipalities should not be required to pay it either. In its 2003 federal pre-budget submission, the Board of Trade of Metropolitan Montreal, noted that "with respect to the Goods and Services Tax (GST), the status of municipal administrations is both unusual and surprising."[73] The federal and provincial governments cannot charge each other sales taxes but municipalities do not enjoy such an exemption. Yet, the board argues, most of the goods and services purchased by the city are used to provide services to citizens who are not charged the GST.

To eliminate the GST for municipalities, the goods and services they provide could be shifted from the tax-exempt category to the zero-rated category. The latter involves no tax on final sales to the final sellers, and they can claim input tax credits for any tax they have paid on inputs. This provision removes all tax from these goods and services. Thus, the final recipients of the goods and services would still not pay the GST, and the federal government would receive less revenue from the tax.[74]

An alternative to eliminating the GST for municipalities would be to apply the tax to all municipal goods and services, including the property tax (as is currently done in New Zealand).[75] Under this option, every public body would be treated as a taxable person; it would be taxed at standard rates on all of its activities and could deduct all its input taxes. This option would simplify compliance costs and allow

73 Board of Trade of Metropolitan Montreal, *Federal Pre-Budget Submission 2003: Competitive Cities and Businesses for a Prosperous Canada*, presented to Minister of Finance John Manley (Montreal: Board of Trade of Metropolitan Montreal, December 2002), 5-6.

74 TD Economics, *The Greater Toronto Area (GTA): Canada's Primary Economic Locomotive in Need of Repairs*, TD Economics Special Report (Toronto: TD Bank Financial Group, May 22, 2002), 30.

75 For a more detailed description of the New Zealand model, see Poddar, supra note 72, at 8.

local governments to recover their input taxes fully. The Canadian system is already close to this treatment of supplies for federal and provincial governments but not for local governments.

Concluding Comments

Judging whether payments in lieu are sufficient is difficult. Doing so would require knowing what property taxes would have been on the properties involved if they had been privately owned. Since this information is not available, we cannot know if payments in lieu are significantly less than property taxes. Discussion with municipal officials suggest, however, that the problem with payments in lieu has less to do with magnitude than with the process by which they are estimated and paid to municipal governments.

Although the issue of whether one order of government should tax another (either through payments in lieu or the GST) is beyond the scope of this paper, the current system is clearly inconsistent. For example, the provincial governments do not pay GST but municipal governments are required to. Moreover, the arguments in favour of eliminating the GST for municipalities could also be applied to the provincial PSTs. Whether or not these arguments are valid, the savings for municipalities from removing the GST would be far less significant than the potential revenues from new tax sources.

INTERGOVERNMENTAL TRANSFERS

Even if new tax sources are made available to municipalities, as suggested earlier, a need for transfers from senior orders of government is likely to remain. This part of the paper describes the economic and political rationales for transfers to municipalities, reviews the use of transfers in Canada, and considers some problems with them in relation to municipalities.

One of the themes of this paper is that one size does not fit all when it comes to municipal taxes. The same is true of transfers. For some municipalities, transfers are essential to fiscal sustainability; others can meet their expenditure needs with their own resources. Also, the objectives of transfers may vary across municipalities, and transfer design needs to reflect this diversity.

Another continuing theme in this paper is that efficiency demands charging directly for services wherever possible and getting the prices right. Efficient delivery of services requires that those responsible for providing them have a clear mandate, adequate resources, and sufficient flexibility to make decisions and are accountable for the decisions they make. Transfers need to be designed to ensure that these conditions are not violated.

Trends in Canada

Intergovernmental transfers, as noted earlier (look back at table 3), are an important source of revenue to municipal governments in Canada. The federal government transfers some funds to municipalities, but most grants to them come from provincial

governments (largely because municipalities are constitutionally creatures of the provinces).

Transfers from the federal and provincial governments to municipal governments have steadily declined over recent years (see table 16). In 1988, for example, transfers accounted for 22.5 percent of municipal government expenditures; in 2001, the comparable amount decreased to 16.6 percent. Over the same period, federal grants as a percentage of municipal government expenditures fell from 0.7 to 0.4 percent, but provincial grants declined from 21.8 to 16.2 percent.[76]

Overall, during the 1988-2001 period, provincial grants to municipalities declined significantly in every province except Quebec. The interprovincial differences in the amount of change are interesting, however.

Types of and Rationales for Transfers

Types

Intergovernmental transfers can be either conditional or unconditional. Conditional transfers, as the name suggests, have conditions attached to them. In particular, the funds have to be spent on specified kinds of expenditures—for example, on roads or parks. Also, some of these transfers are matching grants: the recipient municipalities have to match some proportion of the donor's funds. For example, a province may offer a transfer that covers 80 percent of the cost of road construction; municipalities have to raise the funds to cover the remaining 20 percent. In other cases, conditional transfers are lump-sum and do not require matching.

In contrast, unconditional transfers have no conditions attached. The funds can go to any expenditure or be used to reduce property taxes. In some cases, the amount of transfer received depends on the size of the municipality's tax base, its population, or both.

Federal transfers to municipalities in Canada are all conditional; provincial transfers may be either conditional or unconditional.

Rationales

The economics literature sets out three basic justifications for transfers from senior governments to local governments: the existence of a fiscal gap, the presence of externalities (also known as spillovers), and equalization.[77] Each is discussed below, as are some political rationales for intergovernmental grants.

---

76 The pattern of grants to local governments in the United States is similar to that in Canada. Although the data are not strictly comparable across countries, it is interesting that federal transfers in the United States also declined from about 14 percent of city revenues in 1977 to less than 5 percent by 1992. John J. Harrigan and Ronald K. Vogel, *Political Change in the Metropolis*, 7th ed. (New York: Longman, 2003).

77 For a more detailed discussion of these rationales for intergovernmental transfers, see Bird and Slack, supra note 17; and Robin W. Boadway and Paul A.R. Hobson, *Intergovernmental Fiscal Relations in Canada*, Canadian Tax Paper no. 96 (Toronto: Canadian Tax Foundation, 1993).

TABLE 16 Intergovernmental Grants as a Percentage of Municipal Government Spending, 1988 and 2001

	1988			2001		
	Federal	Provincial	Total	Federal	Provincial	Total
Newfoundland	2.7	33.4	36.1	2.6	21.0	23.6
PEI	0.2	12.3	12.5	0.3	8.0	8.3
Nova Scotia	0.4	23.1	23.5	0.5	5.4	5.9
New Brunswick	1.6	34.4	36.0	1.0	16.1	17.1
Quebec	0.2	7.8	8.0	0.2	13.8	14.0
Ontario	0.9	30.5	31.4	0.3	20.0	20.3
Manitoba	1.2	24.6	25.8	1.2	17.8	19.0
Saskatchewan	0.3	18.2	18.5	1.9	8.8	10.7
Alberta	0.5	20.9	21.4	0.5	17.0	17.5
BC	1.1	14.0	15.1	0.4	4.7	5.2
Canada	0.7	21.8	22.5	0.4	16.2	16.6

Source: Calculated from Statistics Canada data, Financial Management Systems (FMS) (mimeograph, August 2002).

Fiscal Gaps

A fiscal gap occurs for a local government when its expenditure responsibilities are mismatched with the revenues it raises from its own sources. One way to address this gap is for the federal or provincial government to provide a grant to the local government. Generally, the grant is unconditional; the recipient can spend the funds on any expenditure category or use them to reduce local taxes.

Which level of government should provide transfers to fill municipalities' fiscal gaps? A stronger case can be made for provincial governments than for the federal government. In Canada, the provincial governments assign both expenditure responsibilities and revenue-raising tools to municipalities. For this reason, it seems logical that provincial governments should either ensure that revenues and expenditures are matched or provide transfers to close the gap.

Externalities

Externalities occur when the benefits or costs of services spill over a jurisdiction's boundaries. With benefit spillovers, a problem arises because the jurisdiction providing the service rarely takes account of external benefits when deciding how much to spend. Rather, it considers only the benefits to its own residents and taxpayers. Thus, the municipality is likely to spend too little on the service relative to what is efficient. One way to encourage the jurisdiction to take account of all benefits is to provide a grant that equals the cost of the spillover. For example, if 25 percent of the benefits spill over local boundaries, the grant should have a rate of 25 percent. The type of grant appropriate for addressing externalities is thus a conditional, matching grant. It is conditional in that the funds must be spent on the service

whose benefits spill over; it is matching because the grant is intended to cover only the portion that the municipality would not have provided on its own.

Which level of government should provide the transfer? The answer is the province for services that spill over municipal boundaries but stay within the province. For municipal services that spill over provincial boundaries, the federal government should provide transfers. In most cases, municipal services spill only over municipal, not provincial, boundaries. In some cases, however, a federal transfer may be appropriate. For example, services that affect the environment often spill over provincial boundaries.[78]

Other benefits that often spill across municipal and provincial boundaries are from housing and services to the homeless. Because people are mobile between municipal and provincial jurisdictions, the provision of housing or services to the homeless population in one jurisdiction can result in people moving there.[79] Yet a municipality has no incentive to provide services to people from outside its taxing jurisdiction if only taxpayers within that jurisdiction are paying for them.

Equalization

A third justification for intergovernmental transfers is to provide equalization grants to local governments. Like their federal counterparts, these grants are designed to, in the words of the constitution, ensure that jurisdictions "have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."[80] In the absence of grants from a senior level of government, local governments may not be able to achieve this objective for at least three reasons.

1. Tax bases per capita differ from one jurisdiction to another. Thus, to collect the same amount of revenue, a jurisdiction with a small per capita tax base must levy a higher tax rate than that of a jurisdiction with a large per capita tax base.
2. The per-unit costs of providing comparable public services may be higher in one jurisdiction than in another. Thus, more tax revenues are required to provide the same level of service in some jurisdictions than in others.

78 A significant portion of the federal commitment to reduce greenhouse gas emissions (GHGs) under the Kyoto protocol will probably be met in cities, but many of the resulting benefits will spill over municipal and provincial boundaries. Analysts estimate that investment in municipal infrastructure, such as efficiency retrofits of buildings and facilities, landfill gas capture and utilization, and urban transit, could contribute up to 25 percent of Canada's GHG reduction target. See *A Partnership for Competitive Cities and Healthy Communities*, supra note 10, at 3.

79 The Toronto Mayor's Task Force on Homelessness, for example, reports that 47 percent of the people using shelters in Toronto came from outside the city. See Toronto, *Taking Responsibility for Homelessness: An Action Plan for Toronto*, report of the Mayor's Homelessness Action Task Force (Toronto: Access Toronto, January 1999), 18.

80 Constitution Act, 1982, supra note 65, section 36(2).

3. The need for particular public services differs across jurisdictions (for example, municipalities with a high proportion of low-income households may have greater needs for affordable housing and social services). Thus, some jurisdictions may require larger expenditures (and therefore larger tax revenues) to provide the same level of service as their neighbours.

Equalization grants, based on expenditure needs and the ability of local governments to levy taxes, can ensure that those municipalities with small tax bases and great needs and costs are able to levy taxes at rates comparable to those in other jurisdictions. Also, if local governments were given the authority to levy additional taxes, as discussed previously, the ability to do so would vary among municipalities. Additional tax sources might thus necessitate introducing some form of equalization to address disparities in tax capacity.

Which is the appropriate level of government to make equalization transfers to municipalities? The federal government already makes equalization payments to provinces on the basis of their fiscal capacity. (The calculation involves 33 different revenue sources including the property tax.) The purpose of an equalization transfer to municipalities is to ensure that each can provide a standard (or average) level of service by levying a standard (or average) tax rate. Since the provinces determine municipalities' expenditure responsibilities and the types of taxes they can levy, it seems appropriate that provincial governments should provide equalization transfers to municipalities that have difficulty meeting those requirements without levying an unduly high tax.

Political Rationales

In addition to the economic rationales for intergovernmental transfers, there are also political rationales that are unlikely to be related to fiscal gap, externalities, or equalization. Intergovernmental transfers are often used to provide incentives for local governments to act as agents of the donor government. In this way, the donor government benefits from local management's providing a service.

Conditional grants are sometimes given to acquaint local governments with services they would not have provided on their own; the expectation is that they will eventually take over the funding for them and the senior governments can withdraw.[81] Senior governments may also use conditional, lump-sum grants to encourage local governments to provide at least a minimum standard of service in areas such as road safety, ambulance services, and water and waste water treatment.

Federal and Provincial Transfers to Canadian Municipalities

Most transfers to municipalities, as already noted, are from a provincial government. Federal transfers are mainly for infrastructure and are always conditional. Some provincial transfers are conditional, and some are unconditional.

81 Boadway and Hobson, supra note 77.

Following are some examples of both federal and provincial transfers to Canadian cities.

Federal Transfers

The federal transfer programs now in place to aid cities include:

- *Infrastructure Canada*, introduced in 2000. Under this program, the federal government has committed itself to providing $2.65 billion over six years for clean air and water, transportation, and affordable housing. The program design involves partnerships among all three levels of government with equal participation by each.[82] Municipal governments propose projects for funding according to their priorities, and joint federal-provincial-territorial management committees evaluate each proposal on its merits.
- A $100 million *Green Municipal Investment Fund* and a $25 million *Green Municipal Enabling Fund*, initiated in 2000. In the December 2001 budget, these amounts were increased to $200 million and $50 million respectively. These non-matching grants are designed to help municipal governments improve the eco-efficiency of their operations. Although this program is a federal one, the Federation of Canadian Municipalities' national board of directors approves project funding. It is one of the few examples of federal initiatives that offer financial assistance directly to municipalities without the participation of the provinces.
- The *National Homelessness Initiative* was initiated in 1999 to reduce and prevent homelessness. The federal government committed $432 million to it over three years through the following programs: Supporting Communities Partnership Initiative ($305 million), Youth Homelessness ($59 million), Urban Aboriginal Homelessness ($59 million), and Planning and Research ($9 million). The Supporting Communities Partnership Initiative, the largest component, provides funds for equal cost-sharing agreements with volunteer, non-profit groups in the public or private sectors. In 2003, the federal government extended the initiative until 2006 and committed a further $405 million

Provincial Transfers

Unconditional Transfers

In the country as a whole, about 15 percent of provincial grants to municipalities are unconditional. The range is huge: 85 percent in Newfoundland to 8 percent in Quebec.[83]

---

82 Federation of Canadian Municipalities, *Early Warning: Will Canadian Cities Compete? A Comparative Overview of Municipal Government in Canada, the United States and Europe*, prepared for the National Round Table on the Environment and the Economy (Ottawa: Federation of Canadian Municipalities, May 2001), 26.

83 For a more detailed description of provincial-municipal grants in Canada, see McMillan, supra note 6.

Many provinces use unconditional equalization grants. Some of them (like the federal government) use a formula based only on tax-base deficiencies (fiscal capacity); others also recognize need. For equalization grants, some provinces establish classes of municipalities or at least separate urban and rural municipalities. The reason for such differentiation is that expenditures and revenue-raising capacities can diverge widely across different types of municipalities. In New Brunswick, for example, the three largest cities (Saint John, Fredericton, and Moncton) are in one group. Without the groupings, these cities' high expenditure levels and revenue-raising capacities would skew fiscal needs and fiscal capacity in the formula.

In some provinces, the equalization formula includes all expenditure categories. But others use only a few of them (for example, mandatory expenditures, such as police, fire, water, and sewers, but not spending on parks, culture, and recreation).

Most provinces equalize only for the property tax base, but Saskatchewan includes other own-source revenues. Since municipalities have access to other sources of revenue, such as user fees, their reliance on property taxes depends, in part, on their use of these other revenue sources.

In many provinces, the equalization grant covers only a portion of the difference between expenditure needs and revenue capacity. In other words, the amount of the payment, although based on the formula, also reflects the ability or willingness of the provincial government to fund equalization.

The use of unconditional transfers by provinces across Canada is summarized in the following list.

- *Newfoundland.* The components of operating grants include equalization based on assessment, revenue need based on revenue per household, a flat amount per household, and a road subsidy per kilometre.
- *Prince Edward Island.* The equalization grant is based on per capita assessment. Rural municipalities also receive grants for roads and police, but these grants are unconditional. Urban municipalities receive a rebate for a portion of the provincial property tax.
- *Nova Scotia.* The equalization grant is based on the local expenditure need and the local revenue base; expenditure need is measured by a standard expenditure (average of expenditures other than recreation, culture, and debt service) per dwelling unit, and four classes of municipality. The revenue base is estimated by the assessment base per dwelling unit multiplied by a standard tax rate (total standard expenditures for municipalities in the class divided by total uniform assessment for the same municipalities). The grant funds 95 percent of the difference between standard expenditures and revenues.
- *New Brunswick.* The equalization grant is similar to that used in Nova Scotia except the program uses six groups of municipalities, expenditures are weighted by a density factor, and the formula incorporates a threshold (minimum) tax rate.
- *Quebec.* The grant equalizes fiscal capacity, but the amount is calculated without an expenditure component or standard tax rate. The formula includes a weighting factor, which varies by poverty level.

- *Ontario.* The Community Reinvestment Fund was introduced as part of local services realignment in 1998. It was designed to fill the gap between what was downloaded and the provision of local tax room.
- *Manitoba.* Through a tax-sharing program, 2.2 percentage points of provincial PIT and one percentage point of CIT are distributed on a per capita basis. Revenues from video lottery terminals are also distributed among municipalities.
- *Saskatchewan.* A rural municipality receives an equalization grant based on comparing expenditure needs for road construction and maintenance with fiscal capacity. There are also maintenance grants for roads and grants for organized hamlets; the latter consist of a base amount for each hamlet and a per capita amount. An urban municipality gets a basic grant, a per capita grant, and an equalization grant. Equalization is based on recognized expenditures and revenues (the latter include user fees, utility surplus or deficit, and other own-source revenues besides taxes.) The grant covers a small percentage of the shortfall.
- *Alberta.* The grant is based on the per capita formulas that existed in 1994, when a number of grants were combined.
- *British Columbia.* A small community-protection grant is based on a formula that includes population and assessment. A regional-district grant is based on population. A third grant is based on municipal policing costs.

Conditional Transfers

Provincial governments in Canada have historically relied more heavily on conditional rather than unconditional grants to municipalities. In 2000, conditional grants in Ontario accounted for 86 percent of all grants, but this situation is unique in Canada because this province uses grants to fund a large proportion of social service costs. Nova Scotia has uploaded social services to the provincial government, thereby reducing the need for provincial-municipal transfers in that area.

In most provinces, conditional grants now represent a small proportion of all grants. Where they are used, they are generally applied to transportation and the environment (water and sewers). Even these grants are in decline in most provinces, however.

Revenue Sharing

Some provincial governments share revenues with municipalities under various programs. Here is a brief summary.[84]

- *British Columbia.* The BC government currently remits 11 cents per litre of provincial fuel tax revenues to the Greater Vancouver Transportation Authority (TransLink) to meet capital and operating expenditures for transit and

84 The descriptions of fuel tax rates and revenues are based on Transportation Association of Canada, "Innovations in Financing Urban Transportation," *TAC Briefing*, June 2002.

major roads in the region. In 2000, when the municipal share of the fuel tax was 9 cents per litre, TransLink received about $181 million or 33 percent of its revenue from the fuel tax. The BC government also remits 2.5 cents per litre to the transit system in the capital region (Victoria and the surrounding area).

- *Alberta.* Since April 2000, the Alberta government has been giving Calgary and Edmonton transfers for transportation infrastructure equal to 5 cents per litre of the taxable gasoline and diesel fuel delivered to service stations in those cities. The amount works out be about $65 million per year in Edmonton and $85 million per year in Calgary.[85] The purpose of the funding is for expenditures on capital transportation projects. The dedicated fuel tax replaced various funding grants for the cities involved.
- *Manitoba.* The provincial government allocates 2.2 percentage points of the PIT and 1 percentage point of corporate taxable income to municipalities on a per capita basis.
- *Quebec.* The provincial government gives 1.5 cents per litre to AMT from provincial fuel taxes collected on motor fuel sold in the greater Montreal area. For 2000, AMT received $44.4 million from the gas tax.

In all of these cases, revenue sharing is very similar to a transfer because the provincial government determines how much tax to levy in each municipality, collects it, and remits the revenues to the relevant transportation authority or local government. If the provincial government chooses to change the amount of tax it collects or how much it remits, it can do so unilaterally.

Issues and Potential Problems

Although intergovernmental transfers have economic and political justifications, as noted above, grant funding is not always the best way to address municipal fiscal problems. This section reviews some of the issues and potential problems with intergovernmental transfers.

Distorting Local Decision Making

Conditional transfers require municipalities to spend the funds they receive according to provincial (or federal) guidelines and often to match those funds. A matching transfer, by lowering the price of some services, encourages municipalities to spend more on those services. In the presence of externalities, this change in behaviour may be appropriate. Where there are no externalities, however, or where the amount of the grant exceeds the amount of the externality, the resulting distortion in municipal behaviour is inappropriate.

Funding from senior governments can also lead to inefficient local revenue decisions. In particular, municipalities have no incentive to use proper pricing

85 Ibid.

when grants cover a large proportion of operating and capital costs. For example, large grants for water treatment plants in some municipalities have meant that they had no incentive to use volumetric pricing to reduce the demand for water or to engage in asset management. As noted in the overview section of this paper, charging the right prices wherever possible is important for local governments to ensure efficient service delivery. Intergovernmental transfers should not be working against that objective.

Encouraging People To Stay in Communities at Risk

Intergovernmental transfers may prop up communities that simply cannot survive on their own. Some small, rural, and remote communities, for example, may be unable to provide an adequate level of services at a reasonable tax rate.[86] On the expenditure side, low population density often means very high per capita spending because these communities cannot take advantage of economies of scale in service provision. Moreover, spending on roads, water, and sewers is often relatively high because of harsh climatic conditions and terrain. On the revenue side, such areas often do not have sufficient capacity to finance local expenditures. The tax base is limited relative to local needs, and the high cost of services means that people would not be able to pay the user fees required to cover the full cost of provision.

Under these circumstances, senior levels of government often provide grant assistance to small, remote municipalities so that they can deliver local services. If service provision requires disproportionately high levels of financial assistance, a question arises about the use of federal or provincial resources to artificially foster communities in remote areas.[87] If these communities cannot survive in the absence of senior government funding, should they exist at all?

Arguments can be made for and against government subsidization of remote areas. If a remote municipality is essential for the provision of an important public service, such as national security, the public good benefit of this service and the externalities associated with it may justify high grant assistance to keep the community viable.

The argument against subsidizing remote areas is based on efficiency. Reliance on grant funding reduces the incentive for residents to move to areas where employment and educational opportunities are greater. Politics sometimes leads to a different conclusion, however; people form emotional attachments to communities, and politicians are reluctant to move them even though the long-term costs of not doing so are high.

---

86 For a detailed discussion of the challenges facing these communities and the appropriate role for government, see Enid Slack, Larry Bourne, and Meric Gertler, "Small, Rural and Remote Communities: The Anatomy of Risk," paper prepared for the Panel on the Role of Government (Toronto, 2003).

87 The issue is not whether taxpayers in remote communities should be excluded from paying for municipal services. Clearly, they should pay at least some of the costs of services if accountability, fairness, and efficiency are to be achieved.

Reducing Accountability

When two or more levels of government are funding the same service, accountability problems can arise. If users or taxpayers want to complain about the service, they are often not sure which level of government is responsible for the problem. Moreover, when the level of government making the spending decisions (municipalities in this paper) is not the same level that is raising the revenues to pay for them (provincial or federal governments), accountability is blurred. No one has much incentive to be efficient when someone else is responsible for funding. Thus, local governments are more likely to treat expenditures in a responsible manner if they are also raising the revenues to pay for them.

Reducing Stability and Predictability of Revenue

From the perspective of local governments, transfers are rarely a stable or predictable revenue source. The amount of money local governments receive varies from year to year, in part depending on the fiscal state of the donor governments. Lack of predictability makes it difficult for municipalities to plan expenditures. When grants decline, municipalities have to make up the lost revenue by increasing property taxes, user fees, or other revenues or by reducing expenditures.

The sharing of fuel tax revenues in Alberta provides a prime example of how donor governments can unilaterally change funding. Since April 2000, the Alberta government has been giving Calgary and Edmonton transfers for transportation infrastructure equal to 5 cents per litre of taxable gasoline and diesel fuel delivered to service stations in those cities. In October 2001, however, the provincial government announced that it would reduce that funding to 4.25 cents per litre as of April 2002. In the end, it relented and left the funding at 5 cents per litre, but this example shows how vulnerable cities can be to the whims of donor governments.

One way to get around the problem of arbitrary changes to grant rates is for the province to set the amount as a percentage of federal or its own tax revenues (as Manitoba does for the PIT and CIT) or as a percentage of GDP. This approach would not, however, eliminate instability resulting from cyclical swings in the economy.

Concluding Comments

Regardless of any alternative tax sources made available to local governments, transfers will continue to provide an important source of revenue to local governments in Canada. For example, transfers will be needed for those municipalities that do not have the fiscal capacity to provide adequate local services with their own-source revenues. Transfers will also be needed in cases of externalities because municipalities generally do not consider the benefits of their services to people outside their jurisdiction.

A number of problems can, however, arise when one government gives another transfers. In particular, accountability is blurred when one level of government delivers services and another level pays for them. Transfers can also distort local decision making in ways that create inefficiencies in service delivery. But if local

governments follow the benefits model as set out early in this paper, transfers should be designed to get the prices right, and funds from another level of government should not get in the way of municipalities' charging appropriate user fees for services where appropriate.

Federal and provincial governments have important roles to play in addition to providing transfers. Both senior levels of government are involved in policy areas that have a direct impact on cities. If these governments provided greater funding in the areas under their own jurisdiction, municipalities would be relieved of responsibilities that are not rightly theirs and local revenues would be released for truly local functions.

At the federal level, these areas include, for example, immigration, urban aboriginals, and payments in lieu of taxes. Immigration puts pressure on municipalities because they provide some settlement services for new immigrants (such as language training and housing). As Frances Frisken notes, "federal immigration policy makes little attempt to ease the strains imposed on cities or city neighborhoods by large influxes of new immigrants."[88] Increased federal funding for immigration settlement would particularly help cities, such as Toronto, Vancouver, and Montreal, that receive a disproportionate share of immigrants to Canada.

Aboriginal policy is largely under federal jurisdiction, so Ottawa should fund programs and services for the aboriginal population in cities that are currently being funded by municipalities. Western cities have a higher concentration of aboriginal people than cities in the rest of Canada and would thus benefit relatively more from increased funding in this area.

Similarly, provincial governments have primary responsibility for health and education. To the extent that these services are funded appropriately, pressure on municipalities could lessen. For example, school boards and municipalities both provide recreational services. When provinces cut back education funding for these services, municipalities have to provide more of them.

CONCLUSION

This paper has focused on different ways to provide additional revenues to Canadian municipalities, ways that include authority to levy new taxes (income, sales, fuel, and hotel and motel occupancy taxes), revisions to payments in lieu of taxes from the federal and provincial governments, elimination of the GST for municipalities, and intergovernmental transfers.

Our most important finding is that Canadian municipalities should be able to levy a wider range of taxes than they are currently permitted to do. A mix of taxes would give municipalities more autonomy and flexibility to meet the demands for services and capital infrastructure. Moreover, municipalities should set their own

88 Frances Frisken, "Introduction," in Frances Frisken, ed., *The Changing Canadian Metropolis: A Public Policy Perspective*, vol. 1 (Toronto: Canadian Urban Institute, 1994), 1-35, at 19.

tax rates, rather than sharing tax revenues with the federal or provincial governments. Only by setting rates themselves can municipalities be truly accountable.

Notwithstanding the importance of local taxing authority, all tax sources are not appropriate for all municipalities. Treating different municipalities in different ways may be necessary. For example, large cities and city-regions might be able to take advantage of additional taxing authority; smaller municipalities might not derive sufficient revenues from additional tax sources to make the effort of levying these taxes worthwhile.

Intergovernmental transfers have a role where municipalities lack the fiscal capacity to provide adequate local services with their own-source revenues. There is also a role for transfers in cases of externalities because, in the absence of transfers, municipalities generally do not consider the benefits of their services to people outside their jurisdiction.

If the federal and provincial governments allocated sufficient funds in their own areas of responsibility (immigration, education, and so on), the pressure to fund related services at the municipal level would be reduced. Moreover, revisions to payments in lieu of property taxes on government properties and the elimination of the GST for municipalities could increase municipal revenues.

APPENDIX TABLE 1 Data from 2000 Used For Estimations

(1) Province, city	(2) Provincial PIT paid[a]	(3) PST revenue collected[b]	(4) Provincial fuel tax revenue collected[c]	(5) Municipal property tax revenue[d]	(6) Municipal own-source revenue[d]
			thousands of dollars		
Newfoundland	606,973	493,000	131,000	185,227	260,287
St. John's	181,903	125,751	29,839	81,732	92,202
Prince Edward Island	144,974	152,000	32,000	35,574	53,163
Nova Scotia	1,201,158	818,000	203,000	652,160	860,733
Halifax	613,455	387,659	88,036	325,244	419,953
New Brunswick	903,110	649,000	184,000	282,043	459,000
Fredericton	87,667	57,714	15,851	41,884	47,367
Quebec	19,296,056	6,622,000	1,572,000	5,885,675	8,251,039
Quebec City	405,997	146,899	36,166	198,275	339,749
Montreal	2,636,869	886,845	189,530[e]	1,180,856	1,769,493
Ontario	17,954,049	13,515,000	2,768,000	10,147,510	17,170,709
Ottawa	1,619,608	1,138,270	210,605	784,154	1,286,631
Toronto	4,488,254	3,119,049	572,285	2,494,312	4,622,013
Hamilton	646,912	519,641	113,905	463,148	998,068
London	487,618	380,209	83,635	269,503	425,502
Windsor	342,855	269,934	62,638	191,134	611,947
Sudbury	198,893	165,919	37,094	120,580	274,278
Thunder Bay	147,697	125,571	28,880	93,831	174,989
Manitoba	1,638,102	1,008,000	223,000	553,521	995,372
Winnipeg	1,097,637	648,411	139,880	430,978	620,219
Saskatchewan	1,294,466	742,000	345,000	516,353	876,078
Saskatoon	328,125	307,281	142,708	84,888	305,073
Regina	322,247	169,635	80,610	97,971	210,539
Alberta	4,636,738	[f]	580,000	2,175,716	4,290,431
Calgary	1,872,518	[f]	204,268[e]	560,539	1,254,741
Edmonton	920,817	[f]	121,734[e]	406,155	1,071,175
British Columbia	5,798,465	3,663,000	898,000	2,306,680	4,213,216
Vancouver	1,083,174	611,209	144,548[e]	439,327	709,064

(Appendix table 1 is concluded on the next page.)

APPENDIX TABLE 1 Concluded

[a] Income tax data obtained from Canada Customs and Revenue Agency, *Income Statistics: 2002 Edition*, 2000 Tax Year (Ottawa: Canada Customs and Revenue Agency, 2002) (available online at http://www.ccra-adrc.gc.ca/tax/individuals/stats/menu-e.html). Provincial PIT data were taken from ibid., basic table 2, "All Returns by Total Income Class," and total city income tax payable (federal plus provincial) extracted from ibid., geographic table 1, "All Returns by Counties or Census Division and Selected Localities." The ratio of provincial to federal tax payable for the province was applied to each city total to obtain the provincial tax payable in that city.

[b] General PST revenues obtained from the Financial Management Series data set available from Statistics Canada. The dollar value of sales tax revenue collected in each city was estimated by taking PST revenue and multiplying it by the ratio of city income to provincial income as reported in ibid., geographic table 1, "All Returns by Counties or Census Division and Selected Localities." For example, income tax statistics indicated that Toronto accounted for 23.1 percent of total Ontario income in 2000; therefore, we assumed that the same percentage of PST revenue came from that city. The same calculation was made for the other cities.

[c] Provincial fuel tax revenues obtained from the Financial Management Series data set available from Statistics Canada. For cities other than Vancouver, Edmonton, Calgary, and Montreal, we estimated revenues in the following way. The dollar value of fuel tax revenue collected in each city was obtained by taking provincial fuel tax revenue and multiplying it by the ratio of city income to provincial income. These city totals were further adjusted to reflect differences in public and private transit use (data available from Statistics Canada, Census Statistics, 2001); for example, if private transit in a city was 70 percent of total transit when provincial use was 80 percent, estimated city fuel tax revenue was further reduced by the same proportion.

[d] Data obtained from FMS data from Statistics Canada, annual city reports, and provincial summaries of municipal financial information. Municipal property taxes and own-source revenues exclude education taxes and payments in lieu of taxes.

[e] Actual amount the local transportation area received from the province. For Edmonton and Calgary, we report actual revenue received from one cent per litre. The figure reported for Vancouver covers the area serviced by the Vancouver Transportation Authority, an area that includes more municipalities than the city of Vancouver. The figure reported for Montreal covers the area serviced by the Agence Metropolitaine de Transport, an area that includes more municipalities than the city of Montreal as it was in 2000.

[f] Alberta has no PST in place.