

BUILDING PROSPERITY  
FROM THE GROUND UP:  
RESTORING MUNICIPAL  
FISCAL BALANCE



JUNE 2006



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## LETTER FROM THE FCM PRESIDENT



Every day, as mayors and councillors, we see what needs to be done in our communities, but too often we do not have the resources to do it. We also know this is not just a problem for our individual community; it is a national problem. And we know the need for a solution is urgent. The system is broken and the time has come to fix it.

To fix this problem, we need to find the causes. We know the immediate cause: municipal governments have too few resources to meet their growing responsibilities. But why is that?

One reason is Canada's municipal fiscal imbalance. Out of every tax dollar collected, the federal government receives 50 cents and provincial/territorial governments get 42 cents. That's leave just eight cents of every tax dollar for municipal governments.

With this, we must deal with responsibilities that include roads, water-supply systems, solid-waste management, recreation, policing, fire services, affordable housing and even social services, public health and childcare, in some jurisdictions.

When the revenue shortfall is combined with our growing responsibilities, you have a formula for financial crisis. We can see the effects in our communities, not just potholes and worn-out bridges, but people with lost opportunities and no place to live.

This report is our contribution to the national conversation that must take place if we are to tackle this issue successfully. As part of this conversation, we recently met with the Prime Minister and all Provincial and Territorial Ministers Responsible for Local Government across the country .

Our goal was to seek their input and encourage them to see the municipal fiscal imbalance as an issue of concern to all orders of government. Their response was that we share a common goal: making our cities and communities the best places in the world in which to live.

This report complements and builds on the Big City Mayors' Caucus report on cities and the fiscal imbalance, which was released at our annual conference on June 1. It takes a wide-angle view at municipal government across the country. We trust its analysis and insight will provide a basis for thorough discussion and sound policy-making.

Gloria Kovach, President  
Federation of Canadian Municipalities





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# EXECUTIVE SUMMARY

As a result of the pressures of urbanization and offloading, Canada's municipal governments are providing much more than their traditional responsibilities of basic services to property. These new municipal "responsibilities" include everything from immigrant-settlement programs, to affordable housing, to emergency preparedness and, in some jurisdictions, even day-care.

However, municipal governments lack the resources and fiscal tools they need to meet these new responsibilities. They are largely dependent on the property tax, a regressive and unresponsive revenue source, and user fees. They are facing a fiscal squeeze, caught between a growing range of responsibilities and inadequate financial resources.

This squeeze has caused the deferral of much-needed investments in infrastructure, leading to a physical decay that harms cities' and communities' capacity to compete in the global economy and contribute to prosperity.

The numbers tell the story: currently, 50 cents of every tax dollar collected in Canada go to the federal government, while 42 cents go to provincial and territorial governments. Municipal governments are left with just eight cents of every tax dollar.

This fiscal imbalance affects not only urban centres, but also rural and northern communities that, with small and often shrinking populations, must try to make ends meet with limited economies of scale and rising service expectations.

The fiscal imbalance, the root cause of the many challenges faced by Canada's cities and communities, is illustrated clearly by the municipal infrastructure deficit, estimated to be \$60 billion and growing at \$2 billion a year. The consequences of this deficit are evident in every community: potholes and rusting bridges, water treatment and transit systems that cannot keep up with demand, gridlock, poor air quality and a lack of affordable housing.

The infrastructure deficit compromises Canada's competitiveness, lowers the community's quality of life, and hampers the efforts of Canada's cities and communities to attract and retain educated and skilled professionals.

Canadians pay enough tax. An equitable, rational and predictable distribution of responsibilities and funding among all orders of government is the only solution.

This report makes the following recommendations for restoring municipal fiscal balance:

- 1. Clarify roles and responsibilities:** We must reinvent the way governments work together to find economies, efficiencies and street-level solutions. This includes evaluating the public policies and programs that overlap among orders of government and re-aligning roles and responsibilities with adequate and appropriate sources of revenue.
- 2. Develop a long-term plan to eliminate the infrastructure deficit:** The \$60-billion municipal infrastructure deficit is the principal barrier to structural fiscal reform and has been pushed beyond the scope of what municipal governments can finance alone. A long-term plan is needed to eliminate the deficit, including a long-term legislative framework for sharing federal gas tax or other revenue and long-term funding for targeted infrastructure programs.
- 3. Diversify municipal revenue tools:** The municipal fiscal framework must be modernized to allow for a more equitable sharing of fiscal resources among all orders of government. FCM recommends that a long-term revenue-sharing agreement be developed, as well as a targeted infrastructure program to ensure that cities and communities have access to predictable and adequate sources of revenue to repair, maintain

or invest in municipal infrastructure and other critical services. A long-term, revenue-sharing plan would enable municipal governments to reduce their financial dependence on property taxes.

- 4. Focus on integrated approaches to rural and northern development:** The fundamental challenges faced by rural and northern communities are such that a one-size-fits-all approach to addressing the municipal fiscal difficulties won't work. FCM recommends that all orders of government coordinate their respective activities to provide economic diversification and development strategies in rural and northern communities to lessen their dependence on single industries. These communities face unique challenges. To enable them to compete in the marketplace, they must have access to broadband Internet and adequate transportation infrastructure to compensate for their limited accessibility and economies of scale.
- 5. Invest in public transit:** Safe and reliable public transit is the only universally accessible form of urban transport that provides economic, social and environmental benefits. Under-investment in public transit is a glaring manifestation of the infrastructure deficit, and FCM believes it must be addressed through a long-term national plan. According to the Canadian Urban Transit Association, transit systems in Canada need \$20.7 billion invested in infrastructure between 2006 and 2010 to rehabilitate, replace and expand existing systems to accommodate the growing numbers of public transit users.
- 6. Change municipal practices:** All orders of government must work together to review the legislative and administrative framework in which they operate, and municipal governments must evaluate how they plan for growth, price their services and generate revenues. A long-term plan, with targets and milestones, must be put in place to help phase in these changes over the next 20 years.

FCM is ready to help mobilize municipal governments to build partnerships and effect real change. We are calling on the Government of Canada to take a leadership role in tackling the fiscal imbalance and help make cities and communities great places to live and work.

# INTRODUCTION

IMMEDIATELY UPON BEING ELECTED, MY GOVERNMENT WILL BEGIN CONSULTATIONS WITH THE PROVINCES AND MUNICIPAL REPRESENTATIVES WITH THE INTENTION TO REACH A LONG-TERM, COMPREHENSIVE AGREEMENT, ADDRESSING BOTH THE VERTICAL AND HORIZONTAL FISCAL IMBALANCE. THIS WILL BE A MAJOR PRIORITY OF OUR GOVERNMENT AND HAS TO BE RESOLVED SO THAT OTHER LEVELS OF GOVERNMENT CAN OPERATE WITHOUT THE ACCUMULATION OF DEBT.

January 12, 2006 letter from then-Opposition Leader Stephen Harper to Premier Ralph Klein (Chair of the Council of the Federation)



## Municipal Governments: At the Heart of Canada's Prosperity

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Our cities and communities are central to Canada's prosperity and quality of life, they are where economic wealth is generated; they are the crucibles of our national identity and the places people call home.

Cities and communities are also where many national, regional and local issues intersect. From public safety to immigrant settlement to efficient transportation, municipal governments are on the front lines of a multitude of issues and provide other governments with local delivery capacity and responsiveness.

Whether the issue is environmental stewardship, economic competitiveness or quality of place and life, municipal governments are often leading the way, taking innovation and vision and applying it to real problems affecting ordinary Canadians.

But this has come at a price. The intersection of local, regional and national priorities in the heart of our cities and communities has led to a blurring of accountabilities. Within an institutional framework that reflects 19<sup>th</sup>-Century realities, intergovernmental cooperation and coordination are often replaced by jurisdictional silos that increase costs and reduce efficiencies.

Being on the front lines has also meant that municipal governments are where people turn for answers when new problems arise. But the difference between the fiscal capacity of local governments on one hand and the cost of non-traditional and growing demands on the other has put pressure on traditional local government activities. The most visible manifestation of this fiscal imbalance is the infrastructure deficit.



"WE HAVE TO CHOOSE THE STRATEGIC PRIORITIES ON WHICH ACTION IS REQUIRED, A FEDERAL ROLE IS JUSTIFIED, AND FOR WHICH MY PORTFOLIO IS ENTRUSTED WITH PRACTICAL TOOLS. THERE ARE FOUR: ECONOMIC COMPETITIVENESS; QUALITY OF LIFE; THE ENVIRONMENT; AND ACCOUNTABILITY TO CANADIANS. THESE FOUR STRATEGIC PRIORITIES REPRESENT CHALLENGES OF NATIONAL SCOPE, AND IMPORTANT FEDERAL RESPONSIBILITIES."

*Speech delivered by Transport, Infrastructure and Communities Minister Cannon to FCM's Annual Conference, Montreal, June 4, 2006.*

Beyond jurisdictional considerations, municipal governments' central role in meeting national priorities, including quality public infrastructure, establishes a rational and critical link to the federal agenda. As Prime Minister Harper said in his remarks to FCM delegates on June 2, "the federal role must be defined to deal with projects of national significance." We ask, what could be of greater national significance than this—to help build cities and communities that are great places to live, that contribute to our national prosperity and that are the foundation of our success?

## Balancing the Equation

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The Government of Canada has identified the fiscal imbalance among all orders of government as a priority. Of particular relevance to municipal governments is Prime Minister Stephen Harper's explicit campaign commitment to work with the municipal sector to restore the fiscal balance, a commitment that he made first to Premier Ralph Klein of Alberta (as head of the Council of the Federation) and subsequently to FCM (Appendix 1).



"THE FISCAL IMBALANCE IMPACTS ALMOST ALL CANADIAN PROVINCES AND MUNICIPALITIES AND IS A THREAT TO THE PROPER FUNCTIONING OF THE CANADIAN FEDERATION."

*Speech delivered to the Board of Trade of Metropolitan Montreal by Prime Minister Stephen Harper, April 20, 2006.*



The Speech from the Throne, the Budget and several significant speeches by the Prime Minister, by Finance Minister Flaherty and by Transport, Infrastructure and Communities Minister Cannon build on this election commitment by identifying the vertical fiscal imbalance as the root cause of many of the challenges facing cities and communities. The Government of Canada has signalled its willingness to include municipalities, along with provincial and territorial governments, in discussions on restoring fiscal balance.

This commitment appears firm and has opened the door to what could be a far-reaching reassessment of municipal finance in Canada. But a structural solution to municipal governments' chronic fiscal woes will require the full engagement of provincial and territorial governments as well.

For the purpose of this report, we define the vertical fiscal imbalance as existing when “the fiscal capacity of one order of government is insufficient to sustain its spending responsibilities while the fiscal capacity of another order of government is greater than is needed to sustain its spending obligations.”<sup>1</sup> While we recognize that structural solutions to the vertical fiscal imbalance will require a reordering of responsibilities, revenues and spending across all orders of government, this report focuses only on a discussion of the vertical fiscal imbalance as it affects municipal governments.

This report expands on that of the Advisory Panel on Fiscal Imbalance of the Council of the Federation by identifying the nature of the municipal component of this imbalance. While it is virtually silent on this matter, the Council's report shares much of the language municipal governments have been using regarding protecting and enhancing accountability, competitiveness and quality of life. How we achieve this is a matter for discussion, but there can be no question that action is needed, and soon.

## CONSULTING PROVINCES AND TERRITORIES

Before starting this report, we met with each provincial and territorial minister responsible for local government to inform them of our process and to receive their feedback and perspectives on the issue.

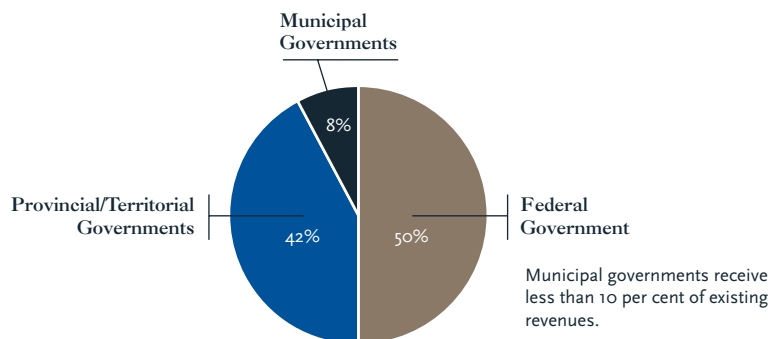
Overall, provincial and territorial response was positive and constructive. Ministers appreciated our respect for their prerogatives as well as the opportunity to contribute to our report and their insight and advice have improved this report. They recognized that we have a common interest in ensuring that Canada's municipalities have the resources they need to provide and protect the quality of life and economic competitiveness demanded by and expected by citizens.

In this context, the current debate provides municipal governments with a strategic opportunity to achieve long-term structural change to their fiscal framework.

### The Roots of the Challenge

Municipal leaders understand the Prime Minister's focus on fixing the fiscal imbalance, because they live with its consequences every day. The numbers tell the story: 92 per cent of every tax dollar collected in Canada goes to the federal and provincial governments; 50 cents for the federal government and 42 cents for the provincial and territorial governments. That leaves just 8 cents of every tax dollar collected in Canada for municipal governments to meet growing and varied responsibilities.

Figure 1: Municipal Government Share of All Tax Revenues



<sup>1</sup> Standing Committee on Finance. 2005. "The Existence, Extent and Elimination of Canada's Fiscal Imbalance." Ottawa: House of Commons.

We see the effects of this imbalance in our communities: streets, buses, bridges, water systems—all not working as well as they should and not maintained as well as they could be. From the potholes in our streets to the lack of quality affordable housing to transit systems that stifle consumer demand, the municipal infrastructure deficit is both a symptom of the fiscal imbalance and a measure of how big the problem is.

Municipalities are now expected to do more—because of offloading from other orders of government, increased global competition for human capital, and rapid growth—with the same limited revenue tools they have been using since the 19th century.

And it is not just maintaining and expanding physical infrastructure to meet growing needs that is straining municipal capacity. Municipal governments are increasingly responsible for the social infrastructure in their communities. They deliver programs that support immigrants, opportunities for Aboriginal people, affordable housing, childcare (in some jurisdictions), sport and recreation, and emergency preparedness and public security. In rural communities, the challenge is compounded by a small (and in some cases shrinking) population base, limited economies of scale and rising service expectations. Today, as a result of the fiscal imbalance, many of these responsibilities are under-funded and services are suffering, as are competitiveness and quality of life.

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“CITIES ARE CAUGHT ON THE FRONT LINE BETWEEN THE CITIZENS OF CANADA AND THE CAUSE AND EFFECTS OF FEDERAL AND PROVINCIAL/TERRITORIAL GOVERNMENT POLICIES AND PRIORITIES: WHAT OTHER GOVERNMENTS DO EVENTUALLY BECOME MUNICIPAL ISSUES.”

*FCM Big City Mayors' Caucus report, 2006: Our Cities, Our Future: Addressing the Fiscal Imbalance in Canada's Cities Today.*

Unlike other orders of government, municipalities do not have access to a diversified set of fiscal instruments. The backbone of municipal finance today remains the property tax, which may have been suited to the task 100 years ago, but is no longer adequate to meet modern realities. As TD Economics pointed out in its 2002 study of the state of Canada's cities, the property tax is regressive, inelastic and generally unresponsive to local economic conditions.<sup>2</sup> While municipalities generally also have access to user fees as well as conditional and non-conditional transfers from other governments, the latter have been shrinking as a percentage of municipal revenues (from 23 per cent to 16 per cent between 1988 and 2004<sup>3</sup>) and the former require provincial authority to be implemented.

The root of the problem lies in the imbalance between the services municipalities must provide and the resources at their disposal. Canadians pay enough tax. What is needed is an equitable sharing of the fiscal pie and a rational distribution of responsibilities among all orders of governments.

Dealing with the fiscal and structural roots of the problem will help diversify municipal sources of income, reduce municipal dependence on property taxes and, most importantly, give Canada's cities and communities the resources to maintain and renew their infrastructure and ensure they do not fall back into disrepair. Municipal governments are not asking for handouts or band-aids. They are asking for a long-term partnership and a plan that will get results.

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“ACCOUNTABILITY AND CLARITY OF ROLES AND RESPONSIBILITIES REQUIRE THAT EACH ORDER OF GOVERNMENT HAVE ACCESS TO THE REVENUE REQUIRED TO FULFILL ITS ROLES AND RESPONSIBILITIES.”

*Federal Budget 2006, Restoring Fiscal Balance in Canada – Focusing on Priorities.*

<sup>2</sup> TD Bank Financial Group, 2002. “A choice between investing in Canada's cities or disinvesting in Canada's future.”  
<sup>3</sup> See Appendix 2.

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## Size of the Municipal Fiscal Imbalance: Some Methodological Issues

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This report will not present a single estimate of the municipal fiscal imbalance. As will be discussed later, there are significant methodological challenges and data gaps that will need to be overcome to come up with a reasonably accurate valuation of the imbalance. In fact, as Dr. Slack points out in her contribution to this report (see Appendix 3), “...from a fiscal perspective, Canadian municipalities appear to be quite healthy. It may be, however, that municipal accounting practices do not tell the whole story. The overall health of our municipalities has less to do with balancing their budgets, which they are required to do by law in any event, than with the adequacy of the services that are being provided and the current state of municipal infrastructure.”

As Dr. Slack points out in her conclusion: “The undertaking of any analysis on fiscal imbalance and on the options for reducing it requires the collection of information on the revenues and expenditures of individual municipalities across the country on a comprehensive and consistent basis. This type of information is not currently available in Canada on a comparative basis. More data and analysis are also needed to quantify the service delivery and infrastructure gaps at the municipal level.”

These prescriptions speak to the challenge of estimating the size of the municipal fiscal imbalance at the national and sub-national level.

There is limited comparative analysis on municipal–provincial/territorial arrangements across Canada. Understanding how provincial and territorial governments have approached challenges such as municipal financing and service delivery within their jurisdictions, will provide important input to the fiscal imbalance debate.

In addition, as the FCM Big City Mayors’ Caucus pointed out in its recent report (see Appendix 4), scoping out the size of the problem should follow a thorough analysis of the roles and responsibilities of each order of government. Doing otherwise would lead to a highly theoretical exercise.

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## Our Report

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This introduction summarizes the main themes discussed in our report.

**Chapter 1, *Our Cities and Communities: A National Priority***, paints a picture of Canada’s cities and communities and identifies their characteristics, roles and current challenges. Also discussed is the key role played by Canada’s cities and communities in building prosperity and quality of life, as well the fiscal context in which they operate. This chapter sets the tone.

**Chapter 2, *Making the Case***, summarizes the data and analysis contained in four commissioned studies to make the case that Canada’s municipal governments are in a situation of structural fiscal imbalance. Importantly, this chapter looks at services and other pressures faced by Canada’s rural communities, and it situates the fiscal imbalance in the context of rurality. It also outlines the special circumstances of communities in the Territories.

**Chapter 3, *The Fiscal Imbalance from the Ground Up***, illustrates the cost drivers that fuel the municipal fiscal imbalance. Through a series of case studies, we look at traditional and new responsibilities with which municipal governments contend.

**Chapter 4, *Balancing the Equation: Restoring the Municipal Fiscal Balance***, presents our recommendations for balancing the municipal fiscal equation. The complexity of the issue, as well as the contextual differences in how this imbalance plays out in each province and territory, make it difficult to assert sweeping prescriptions. However, one element of this imbalance, the infrastructure deficit, stands out as having a consistent impact across jurisdictions. As such we propose more definitive and immediate action in this regard.

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## ACKNOWLEDGMENTS

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FCM was fortunate to have assembled an outstanding team of outside advisors to support staff and provide background and direction to this process. We are especially grateful to our contributors—Dr. Enid Slack, Professor Harry Kitchen, Professor David Douglas and Dr. François Vaillancourt—for their rigorous and perceptive analysis in the background papers prepared for this report. We thank Dr. Roger Gibbins and Mario Lefebvre for their comprehensive and insightful paper on the infrastructure deficit, as well as retired Major General Clive Addy for his lucid assessment of some of the security and emergency preparedness challenges faced by municipal governments. City of Toronto staff contributed their first-hand experience to an informative piece on immigrant settlement and Dr. Michael Roschlau, President and CEO of the Canadian Urban Transit Association, contributed an article on urban transit. Finally, a special word of thanks goes to Don Drummond for keeping us focused in our analysis and our arguments.

Acknowledgements and thanks would not be complete without mentioning the support, contribution and direction provided to this process by Canada's municipal sector.

FCM's Big City Mayors' Caucus released its report outlining the perspective on this issue of Canada's largest cities on June 1 (see Appendix 4). From the outset, the Caucus' report, *Our Cities, Our Future: Addressing the Fiscal Imbalance in Canada's Cities*, was designed to inform FCM's wide-angle look at fiscal imbalance. We thank the Caucus and in particular the members of the Mayors' Task Force on New Revenues for their leadership

and unique and important perspective on the fiscal balance. Of equal importance has been the support of Canada's provincial and territorial municipal associations, their presidents and executive directors, as well as that of FCM's Executive Committee members and the chairs of its policy committees, who provided invaluable direction throughout this process.

The result is a consensual position of a large and diverse order of government that is central to meeting Canadians' most immediate needs and to growing prosperity and quality of life, but that is hamstrung by outdated fiscal and institutional arrangements. It is our hope that this report will stimulate change.

# CANADA'S CITIES AND COMMUNITIES: A NATIONAL PRIORITY

A NEW WAY OF THINKING IS URGENTLY REQUIRED—ONE THAT PUTS THE AFFAIRS OF CITIES FRONT AND CENTRE ON CANADA'S ECONOMIC AND POLICY RADAR SCREENS.

TD Bank Financial Group report, 2002: *A choice between investing in Canada's cities or disinvesting in Canada's future.*



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## Portrait of Canada's Cities and Communities

*Despite its image as a land of wilderness and open spaces, Canada is one of the most urbanized nations.*

The 2001 Census reported that 79.4 per cent of Canadians live in urban areas (defined as having a population of 10,000 people or more), compared with 78.5 per cent in 1996. During this five-year period, the population of these areas increased 5.2 per cent, while the population living outside them declined slightly (by 0.4 per cent).

Canada's 27 Census Metropolitan Areas (CMAs) account for 64 per cent of the country's population. Statistics Canada notes that seven of these CMAs recorded growth rates at least double that of the national average.

CMAs near the Canada–American border attract immigrants and have economies based on manufacturing or services. According to Statistics Canada, the populations of these CMAs increased the most. Populations of areas with resource-based economies—such as northern Quebec, northern Ontario, northern British Columbia and large segments of rural Manitoba and Saskatchewan—declined. The only resource-based exception was Alberta, where the oil industry attracted newcomers.

With three exceptions, the CMAs with the strongest growth were located in three regions: the extended “Golden Horseshoe” in southern Ontario; the Calgary–Edmonton corridor; and British Columbia's Lower Mainland and southern Vancouver Island. Growth in these regions combined accounted for nearly all of the growth recorded in Canada between 1996 and 2001. There was also growth in Ottawa-Gatineau, Windsor and Halifax.

This trend toward urbanization has been accompanied by a change in the Canadian economy, from a heavy focus on resources to services. Before 1994, commodities accounted for most exports. The proportion exceeded 60 per cent in the early 1980s but had fallen to 41 per cent by 2000. This transition reflects movement to higher-value-added goods and services, outputs that are primarily those of cities.

The TD Bank has called the emergence of the “new economy” the most significant development of the 1990s and a major benefit to city economies. The concentration of a young, diverse and educated workforce provides an important advantage for Canada's cities.

### Rural Communities Still the Heart of Canada

Despite growing urbanization, rural communities remain critical to the economic, social and environmental fabric of Canada. Depending on the definitions used, anywhere from 22 per cent to 38 per cent of Canadians live in rural areas. Natural resource industries supported by rural communities comprise over 13 per cent of Canada's gross national product and generate over 50 per cent of Canada's exports. Rural areas are primary sources of food, water, energy and other resources for rapidly growing urban centres, and these communities sustain industries that contribute to Canada's economic prosperity. Rural communities also provide important opportunities to improve quality of life, which is evident in the number of Canadians travelling to rural Canada for recreation. Rural and urban Canada are inseparable and depend on each other for their mutual success.

### The Role of Cities and Communities in National Prosperity

*Urban economies are where people live, where jobs are created and where most goods and services are produced and consumed.*

Successful national economies in the 21st century are increasingly measured by their capacity to generate wealth through innovation and to attract labour and capital to support the knowledge economy. Free trade, global markets and high technology define an international context for local economic growth and development.

Canada's economic growth is a function of the goods and services provided by cities. Urban economies generate an inordinate percentage of Canada's GDP and new jobs. The 10 largest urban economies in 2000 accounted for 47 per cent of gross domestic product. At \$155 billion, Toronto's GDP is larger than that of eight provinces and 29 American states. Many cities account for half or more of provincial GDP.

From the 2001 to 2004 period, 82 per cent of the total increase in employment in Canada took place in urban centres. Over the past four years, 60 per cent of new jobs were created in our 10 largest cities. Calgary, Toronto and Montreal, with only 30 per cent of the Canadian population, accounted for 43 per cent of these jobs and by 2004, these three cities accounted for 50 per cent of employment growth.

Canada's cities are incubators of innovation and magnets for skilled immigrants from around the globe. World-wide competition for labour and capital is pushing Canadian cities to compete with cities in Europe, Australia, Japan and, most vigorously, the United States. Canada's ability to be more competitive, innovative and productive is increasingly dependent on the success of cities.

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“CANADA'S QUALITY OF LIFE AND ECONOMIC COMPETITIVENESS DEPEND IN PART ON HAVING RELIABLE, EFFICIENT INFRASTRUCTURE THAT IS PROVIDED IN LARGE PART BY THE MUNICIPAL, PROVINCIAL, TERRITORIAL AND FEDERAL GOVERNMENTS.”

*Federal Budget 2006, Restoring Fiscal Balance in Canada – Focusing on Priorities.*

A key element in this global competition is the capacity to attract and retain human and financial capital. Our success as a nation, therefore, requires our cities and communities to be among the best in the world in which to live and work. We must ensure they function well—that their transportation infrastructure moves people efficiently; that their solid-waste management is sustainable and cost-effective; that their water is safe to drink; and that their residents have access to recreation and culture.

Current academic research supports this view. Harvard's Michael Porter has called regional economies the building blocks of competitiveness. He has pioneered the concept of clusters of inter-related industries that are a driving force behind innovation and improved productivity.

Richard Florida at Carnegie-Mellon University has illustrated other indicators of success in the new economy. While the key factor in the old economy was cost-efficiency, the new economy is more dependent on human capital and talent. The competitive advantage has shifted to those regions that can generate, retain and attract the best talent.

The mobility of the labour force, enhanced by international trade agreements, has created a global labour market. This reality provokes a key question: what attracts creative people to a specific place? Florida's analysis suggests that the availability of jobs and career opportunities is a necessary but insufficient condition for attracting knowledge workers.

A second necessary condition is “quality of place.” Florida argues that creative people will migrate to city-regions with:

- High environmental quality supported by excellent public services;
- Natural amenities and an attractive urban form;
- Recreational opportunities;
- A social character reflecting ethnic and lifestyle diversity, tolerance and a rich cultural scene with a high population of people working in creative and artistic occupations; and
- A high level of safety and security.

## Quality of Life

In Canada, municipal governments have much of the responsibility for creating “quality of place.” It is, therefore, a matter of the highest national interest that all orders of government collaborate to ensure that Canada’s urban economic engines retain their competitive edge through adequate investments in transportation, environmental infrastructure, skills development, housing and other building blocks of the urban economy.

There is, of course, another compelling reason to maintain and improve the quality of life in our cities and communities: they are where Canadians live, and quality of life is important to everyone. The ability of people to enjoy daily life is clearly an appropriate measure of national prosperity.

But although Canadians know what they want for their communities—clean, green, productive and well-run cities and communities—instead they see signs of decline.

Canada’s municipal governments are facing a wave of dynamic and far-reaching social change and many of the forces affecting urban communities are beyond their jurisdiction and capacities. Among these forces are a rapidly aging population accompanied by a rapidly growing population of children and youth; an expanding immigrant population; a rapidly expanding population of young Aboriginal people in Prairie cities; a shrinking labour force requiring ever-increasing levels of education; and growing demand for too few adequate and affordable childcare spaces.

FCM’s series of *Quality of Life* reports have found that quality of life in the 20 urban municipalities surveyed is at risk, as pressures continue to mount on income, the environment and people living on the margins. Despite improvements in rates of post-secondary education, employment growth and home-ownership, quality of life has deteriorated for a growing number of people.

Improvements in income and poverty rates since 1996 have been offset by a growing income gap, housing affordability problems and changes to social programs.

If these trends continue, Canada’s cities and communities will fail to attract newcomers and to provide a high quality of life to their residents. The long-term consequences of both outcomes will be a decline in our standard of living, community cohesion, personal satisfaction, and competitiveness.

Municipal governments, already struggling in the face of shrinking resources and growing responsibilities, have neither the means nor the jurisdiction to respond to these challenges alone. Federal and provincial governments must adapt their policies and programs that affect municipalities or risk permanent damage to Canada’s quality of life.

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“IF CANADIAN CITIES WANT TO SUCCEED IN ATTRACTING BUSINESS AND INVESTMENT AND PROVINCIAL/TERRITORIAL AND FEDERAL GOVERNMENTS WANT TO BENEFIT FROM THE SUBSEQUENT WEALTH GENERATED, CANADIAN CITIES NEED SIMILAR ACCESS TO REVENUES THAT GROW WITH THE ECONOMY AND TRANSPORTATION INFRASTRUCTURE PROGRAMS THAT THEIR U.S. AND EUROPEAN COMPETITORS ENJOY.”

*FCM Big City Mayors’ Caucus report, 2006: Our Cities, Our Future: Addressing the Fiscal Imbalance in Canada’s Cities Today.*

In short, we need cities and communities that provide the infrastructure and services necessary for economic activity and social cohesion. If they don’t, we risk creating economic black holes that consume tax revenue, rather than economic engines that create wealth.

# Municipal Fiscal Challenges

*Of every tax dollar collected in Canada, the federal government receives 50 cents, provincial and territorial governments 42 cents, and municipal governments 8 cents.*

Municipal governments support quality of life. They are the stewards of our civic resources, investing billions in physical and social infrastructure. They also deliver programs that support immigration, the environment, Aboriginal peoples, affordable housing, public health, and emergency preparedness and public security.

Many of these responsibilities are new and unfunded. For example, federal, provincial and territorial governments require cities and communities to meet water quality standards, often without providing the funds to meet those requirements. These requirements are known as “unfunded mandates.”

Furthermore, compared to other orders of government, municipal governments have far fewer tools to raise revenue. No municipal government in Canada levies an income tax or sales tax, unlike U.S. municipalities that are often funded primarily through these sources. Fuel-tax revenue to support transportation is available only to a few cities in Canada. The rate is determined by the provincial government, which collects the revenue and transfers it to the cities to be dedicated to transportation expenditures. Canadian municipal governments cannot make their own choices about taxes, spending and debt, and thus they must rely on other governments to support their fiscal needs.

✦ “MUNICIPALITIES SHOULD HAVE ACCESS TO MORE TAX SOURCES THAN THEY DO CURRENTLY.”

*Harry Kitchen, and Enid Slack, 2003: “New Finance Options for Municipal Governments.” Published in the Canadian Tax Journal, Volume 5.*

Municipal revenues are not keeping up with the cost of living, let alone additional responsibilities. Since municipal governments are prohibited from running deficits, municipal councils are faced with the choice of either denying needed services to residents or postponing infrastructure repair and renewal. The problem has been building for well over a decade but has become more severe in recent years, aggravated by other orders of government fighting their deficits by cutting transfers to municipal governments. Its roots are tangled in outdated fiscal and institutional arrangements that fail to recognize the modern role of municipal governments in growing prosperity and quality of life.

As a result, a large gap has emerged between the community’s needs for core services such as police and fire-fighting services, transportation and transit, water supply, waste-water treatment, solid-waste systems, and recreation and cultural facilities and the municipality’s ability to pay for them.

This gap is most clearly seen in the national municipal infrastructure deficit, which is now estimated at \$60 billion and growing by \$2 billion a year. This acts as a brake on Canada’s competitiveness and dampens quality of life in our communities.

This infrastructure includes streets, sidewalks, bridges and viaducts, water purification and water treatment plants, as well as public transportation, libraries, recreational facilities, traffic-control systems, police and fire-service infrastructure. This infrastructure is the backbone of our communities. It is vital to the economic expansion of our communities and our quality of life.

We can see other indicators of decline in our communities:

- An explosion of homelessness, with countless families, many of them single-parent and working, housed in shelters;
- Infrastructure investments not keeping pace with demand;





## Unique Challenges Facing Rural Canada

Canada's thousands of rural municipalities face an array of formidable challenges. They do not have the financial capacity to meet these challenges, because of the revenue bases available to them and the level of services expected of them.

Rural areas play a critical role in building national wealth, but some of these communities are losing their capacity to foster economic activity and maintain quality of life. Programs and strategies to reverse this trend must avoid a one-size-fits-all approach by recognizing rural communities' unique challenges and opportunities.

The absence of broadband Internet significantly impedes rural economic development. Communities without broadband access are denied competitive advantages, such as electronic delivery of health and education services and the ability to gain access to markets. Without adequate communications infrastructure, the service-delivery capacity of these communities is much weaker than in fully serviced urban areas.

Beyond traditional and communications infrastructure, successful economic development also requires social and cultural infrastructure, such as libraries, parks, post offices and community centres, to improve quality of life in rural communities. Although roads and bridges will do much to get people to rural communities, quality of life will ultimately influence their decision to stay.

Inadequate infrastructure to support health service delivery is a serious impediment to economic development in rural Canada. People in rural communities face major barriers to receiving health care because of their remote locations and the shortage of health professionals. Although health care is not generally a municipal responsibility, it affects municipal governments' ability to attract businesses and individuals to their communities, which makes it a municipal concern.

Rural municipal governments recognize that strategies to eliminate barriers to economic development must be accompanied by new and innovative approaches that will attract people to rural communities. They need infrastructure that connects them, not just to the rest of Canada, but to each other and to their own residents. To attract the talent and skills necessary to sustain vibrant local economies, these communities must become attractive to young people, immigrants and Aboriginal people. In many cases, rural communities may attract retired Canadians, who bring their own demand for goods and services.

*See Appendix 6 for more in-depth discussion of these issues by Professor David Douglas.*

- Traffic congestion and gridlock reflecting inadequate investment in transit and transportation;
- Aging buses and transit equipment;
- Delayed maintenance or replacement causing much higher costs later;
- Concerns about water pollution and the safety of drinking water;
- Poor air quality;
- Service level reductions in recreation programs and libraries; and
- Reduced funding for arts and culture.

In short, the very features that attract the talent needed to make our cities and communities economically successful are eroding, because they are in the midst of a fiscal crisis that is compromising their competitiveness.

## Recent Trends in National Municipal Policies

*Municipal governments need not only more and better fiscal tools but also true partnerships with other orders of government.*

Domestic and international experience demonstrates that municipal governments need access to predictable sources of revenue, including long-term programs and growth-sensitive taxes. More options are needed if



Canada's cities and communities are to remain competitive and continue to deliver a high quality of life.

Since 1993, the federal government has invested close to \$12 billion in cost-shared infrastructure-investment support programs for local, provincial and territorial governments. The February 2005 Budget broke new ground by introducing a revenue-sharing plan based notionally on the transfer of a portion of the federal gas tax. The 2006 Budget also boosted investments in public transit and affordable housing—critical elements of more viable communities. These are positive steps, but the problem is far from solved.

## Provinces and Territories Lead the Way

A number of provinces and territories have significantly enhanced municipal governance and financing. Many of these advancements are key building blocks for today's cities-and-communities agenda. Updated provincial and territorial municipal legislation, new funding, improved intergovernmental coordination and innovative program delivery are all part of the municipal success story.

Some examples include, but are not limited to:

- **Alberta** led the country in 1994 with a new *Municipal Act* that granted municipalities “natural person powers” and delegated broad discretion and authority to govern within broad spheres of jurisdiction, reversing the traditional delegation of very narrowly prescribed authorities. This new approach opens the door for more autonomous, accountable local government, and it has since spread to almost every jurisdiction. In 2005, in recognition of the mounting infrastructure demands in the province, Alberta also announced \$3 billion over five years for municipal infrastructure priorities.
- **British Columbia** built on and extended Alberta's leadership in the 2002 *Community Charter Act* amendment to local government legislation. The Community Charter introduced a requirement that the province consult with municipalities through the

provincial municipal association, before changing the *Municipal Act* or other related regulations. This advance led three years later to the Union of British Columbia Municipalities participating as a co-signatory to and administrator for the federal gas tax agreement in B.C. British Columbia has also long collected a portion of the provincial excise tax on gasoline in the Greater Vancouver region on behalf of the regional government.

- Through the “Building Manitoba Fund,” **Manitoba** shares provincial income and fuel tax revenues with municipal governments, setting a precedent for sharing revenues that grow with the economy to support municipal infrastructure and service delivery needs.
- **Ontario** signed a Memorandum of Understanding with the Association of Municipalities of Ontario in 2001. This MOU formalizes intergovernmental relationships in that province. Ontario also agreed to share two cents of the provincial excise tax on gasoline with municipalities.
- Shortly after the Government of Canada announced the “New Deal for Cities and Communities,” the Government of the **Northwest Territories** and the territorial municipal association agreed to a New Deal for the North that fundamentally altered and modernized intergovernmental relations in the jurisdiction.
- In 2005, **Yukon** embarked on a joint effort with its territorial municipal association to develop a new approach to sustainable community planning, which set the precedent for closer, more respectful government-to-government relations.
- The Government of **Nunavut** created the “Nunavut Community Infrastructure Advisory Committee” jointly with the territorial association, which gives communities there direct input to territorial policy making on infrastructure issues.
- **Quebec** recently announced the signing of a new “Fiscal Partnership” agreement with its municipalities. The agreement re-writes the book on fiscal intergovernmental relations in that province, transfers significant new funds and exempts municipalities from the provincial sales tax.

Provincial and territorial governments have always been the “first partner” to Canada’s municipalities. All three orders of government will need to work together to overcome many of the most significant challenges facing municipalities. However, their constitutional responsibility, intimate knowledge, and close working relationship with municipal governments means provinces and territories are where the details of many of the solutions will have to be worked out.

## Conclusion

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In Canada and around the world, a broad consensus has emerged that quality of life in both urban and rural areas is central to the economic success of regions and countries. Canada’s cities and communities have the potential to be among the best in the world. They are clean, safe, diverse and welcoming, but they are struggling to keep up with community needs.

Municipal governments in Canada are on the right track. They recognize the importance of quality of life in ensuring their communities grow in a sustainable way, economically, socially, culturally and environmentally. Leadership at the local level is succeeding in harnessing community resources, planning for strategic infrastructure investments and building on regional strengths.

But unlike local governments in other countries, Canada’s municipal governments have limited sources of revenue and are limited to property taxes and some user fees. In the face of increasing responsibilities, they cannot raise the revenue they need by themselves. All orders of government must work together to increase investment in physical capital, skills development, research and development and social capital.

# MAKING THE CASE

EXPENDITURES UP; TRANSFERS DOWN; AND  
HARD-TO-INCREASE OWN SOURCE REVENUES:  
IT SOUNDS LIKE A PRESCRIPTION FOR FISCAL CRISIS.  
IT IS THUS NOT SURPRISING THAT THERE HAS BEEN MUCH  
CONCERN WITH THE FISCAL SUSTAINABILITY OF CITIES  
IN CANADA IN RECENT YEARS.

Enid Slack and Richard M. Bird, 2006: *Cities in Canadian Federalism*.  
Published by the Institute on Municipal Finance and Governance,  
University of Toronto.



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In the last federal election, then-Leader of the Opposition Stephen Harper made a commitment to address the vertical fiscal imbalance in Canada and, in particular, to include municipalities in discussions, along with the federal and provincial/territorial governments.

Although the debate over the fiscal imbalance as it affects the federal and provincial/territorial orders of government has been well documented,<sup>4</sup> much less has been written about how the fiscal imbalance affects the municipal order of government.

What does this imbalance mean for municipal governments? Are the issues the same as for the federal and provincial/territorial governments? Do municipalities have sufficient revenue-raising capacity to meet their expenditure responsibilities?

While we recognize that structural solutions to the vertical fiscal imbalance will require a reordering of responsibilities, revenues and spending across all orders of government, this report focuses only on a discussion of the vertical fiscal imbalance as it affects municipal governments.

Although it is difficult to measure the extent of the municipal fiscal imbalance (as will be discussed in the following pages), there is widespread agreement that municipalities do not in fact have sufficient revenue-raising tools to meet their expenditure responsibilities.<sup>5</sup>

As this chapter will discuss, municipal governments have been facing increasing expenditure pressures while, at the same time, they have seen no diversification in their revenue-raising tools.

Municipal governments rely largely on property taxes, user fees, and intergovernmental transfers to meet their expenditure needs. But the property tax, while providing revenue stability, is an inelastic and regressive tax that is not well suited to meeting municipal governments' growing responsibilities.

## A Changing Fiscal Environment

Many commentators—including the TD Bank, the Canada West Foundation, the Conference Board of Canada and leading academics—have expressed concern about the current fiscal condition of Canadian municipalities. These experts are questioning the fiscal sustainability of Canadian cities—their continued ability to meet expenditure requirements<sup>6</sup> with existing sources of revenue.<sup>7</sup>

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“MUNICIPALITIES HAVE LITTLE CHOICE WHEN IT COMES TO SUCH PRESSING SOCIAL ISSUES AS HOMELESSNESS, IMMIGRATION, AND SETTLEMENT SERVICES, DRUG ABUSE AND CRIME. WHEN OTHER ORDERS OF GOVERNMENT FAIL TO PROVIDE ADEQUATE FUNDING OR SUPPORTS TO ASSIST MUNICIPALITIES WITH THESE SOCIAL OBLIGATIONS, CITIES ARE LEFT WITH BOTH THE SOCIAL AND ECONOMIC CONSEQUENCES.”

*FCM Big City Mayors' Caucus report, 2006:*  
Our Cities, Our Future: Addressing the Fiscal Imbalance in Canada's Cities Today.

Several recent trends have had a profound effect on the municipal fiscal environment:

- The “offloading” of services such as housing, social services or land ambulances by the federal and provincial governments has meant increased responsibilities for municipalities throughout the country. In other cases, offloading has meant that provincial governments have reduced transfers to municipalities (see Table 2 in Appendix 2) and, in effect, increased municipal funding requirements. In still other cases, offloading has meant that federal and provincial governments have downsized their own responsibilities. An example is the federal government's offloading of immigration settlement and the offloading of education by some provinces. Municipalities, in most of these cases, have felt compelled to fill the void left by other governments.

<sup>4</sup> Reference Appendix 3: For a summary of the debate, see Lazar et al. (2004) and the Standing Committee on Finance (2005).

<sup>5</sup> Reference Appendix 3: See, for example, TD Economics (2004), Kitchen and Slack (2003) and Vander Ploeg (2004).

<sup>6</sup> The definition of “expenditure requirements” is controversial, because there is no agreement on the standard to which services should be provided.

<sup>7</sup> Reference Appendix 3: See, for example, TD Economics (2004), Kitchen and Slack (2003) and Vander Ploeg (2004).

- Canada's future is increasingly linked to the fortunes of its large cities and city-regions, where employment, wealth and productivity growth are generated. In the new global environment, cities have to compete in the international marketplace to attract business and skilled labour. To do this, they have to provide sophisticated transportation and communications infrastructure and services that enhance the quality of life in their communities.
- For many rural municipal governments, economic uncertainty impedes efforts to sustain financially viable rural communities.
- Municipalities facing rapid growth are also, in many cases, experiencing the higher costs associated with urban sprawl. For rural municipalities, growing concerns regarding liability and risk, increased costs associated with new regulations as well as escalating demands for services from residents have served to drive expenditures.
- While municipalities are facing increased pressure on the expenditure side of their budget, there has been no parallel diversification of their revenue sources.

“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.”

*Harry Kitchen, and Enid Slack, 2003: "New Finance Options for Municipal Governments." Published in the Canadian Tax Journal, Volume 5.*

Current financial data makes it difficult to paint a definitive portrait of municipal government finances. Over the past decade, for example, municipalities have not run deficits in their operating budgets, because deficits are not permitted under provincial legislation. Few municipalities, if any, have borrowed excessively to pay

for capital expenditures, in part because the amount of borrowing is also constrained by provincial governments. Few municipalities have raised property taxes significantly and few have run up large tax arrears. Overall, municipalities in Canada have also become less reliant on provincial grants. From a fiscal perspective, Canadian municipalities would appear to be quite healthy.

“...IT WOULD BE FALSE TO ASSUME THAT ANY GIVEN CITY IS FINANCIALLY HEALTHY BECAUSE ITS BOOKS ARE BALANCED.”

*Conference Board of Canada report, 2005: Performance and Potential 2004–05: How Can Canada Prosper in Tomorrow's World?*

It may be, however, that municipal accounting practices do not tell the whole story. The overall health of our municipalities has less to do with how they balance their budgets, which is required by law, than with the adequacy of the services that are being provided and the current state of municipal infrastructure.

Municipal governments in Canada may appear fiscally healthy, but only because they have underinvested in services and infrastructure essential to their economic health, such as transportation, roads, sewers and recreational facilities. If so, the seeds of a serious future threat to the health of municipalities may have been sown already. This prospect does not bode well for the future well-being of our municipalities or, by extension, for the country as a whole.

Unlike fiscal measures, the state of service delivery and infrastructure are both difficult to measure and are thus often ignored in the debate over fiscal imbalance. Nevertheless, there is an emerging consensus that there is a substantial infrastructure deficit in Canada's cities, especially in the larger cities, and that this deficit is becoming a serious competitive disadvantage for those cities and for the country as a whole.<sup>8</sup>

<sup>8</sup> Reference Appendix 3: See, for example, TD Economics 2004.

A number of Canadian studies have attempted to measure the magnitude of the “infrastructure gap” or “infrastructure deficit” and have come up with a wide range of estimates.<sup>9</sup>

In Chapter 3, Gibbins and Lefebvre argue that the cause of this deficit has been the large and increasing share of infrastructure that is now vested with municipalities, combined with offloading and cuts to transfers. According to the authors, in a context of scarce resources, these added responsibilities have resulted in downward pressure on infrastructure investments.

Some authors have also argued that the solution to this imbalance is for municipalities to raise user fees and property taxes on residential properties.<sup>10</sup> Indeed, residential property taxes have not increased dramatically over the last 20 years, and user fees could probably be expanded to include a few more services.<sup>11</sup> Correct pricing, in many cases, would also reduce demand for services and infrastructure and remove some of the pressure on expenditures. Some municipalities could borrow more to pay for infrastructure.

However, in rural and northern municipalities, governments are grappling with small, stagnant or declining property tax bases that offer little room for revenue expansion. Even if there were room in the rural property tax base for increases, the modest rate of industrial and commercial investment growth limits potential for revenue expansion in rural areas.

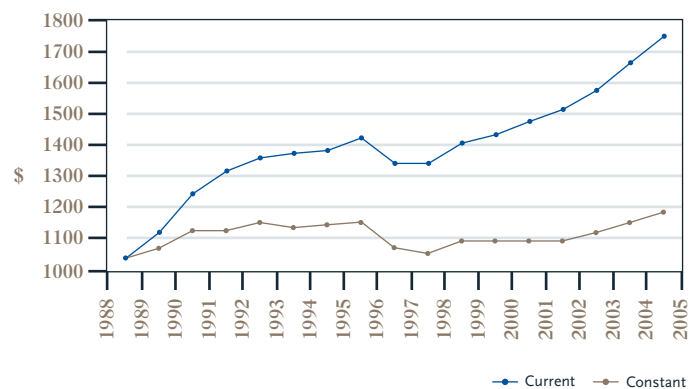
Although there is likely room for some municipalities (in some provinces) to increase residential property taxes and user fees, it is not clear that such actions would be sufficient to solve the problems of under-investment in infrastructure. All of these measures are still likely to fall far short of meeting existing expenditure requirements.<sup>12</sup> See also Gibbins and Lefebvre in Chapter 3 for a greater discussion of this point.

In general terms, this is because municipalities do not have the same ability to increase taxes and user fees as do the federal or provincial governments. First, municipalities are required by provincial governments to deliver certain services, while at the same time they are restricted in how they can raise revenues. Second, the main source of revenue to municipalities is the property tax, and this tax has unique characteristics that make it more difficult to increase than income and sales taxes.

## Municipal Expenditure Trends<sup>13</sup>

Trends in municipal finance over the last 15 years show that municipal spending has increased steadily. Overall, municipal government expenditures per capita in constant dollars increased at an annual average rate of 0.9 per cent over the last 16 years (see Figure 2). The largest proportionate increase has been for housing, reflecting the offloading of this service to municipal governments in Ontario in 1998. But this is only the most obvious example of a much broader offloading issue that has been replicated in most other jurisdictions.

Figure 2: Total Municipal Expenditures in Canada, Current and Constant Dollars per Capita, 1988-2004



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

<sup>9</sup> Reference Appendix 3: For a detailed description and evaluation of the numerous studies that have attempted to estimate the infrastructure gap in Canada, see Kitchen (2003).

<sup>10</sup> Reference Appendix 3: Mintz and Roberts (2006) note two important exceptions to this recommendation, however: Alberta (where municipal user fees are relatively high) and Ontario (where the cost of social services is shared with municipalities). In those two provinces, the authors recommend a new tax on earned income.

<sup>11</sup> Reference Appendix 3: Unfortunately, there has been no research done in Canada on the question of whether individual municipalities could raise property taxes further and not lose their tax base. Interesting work along these lines has been done for four American cities by Haughwout, Inman, Craig and Luce (2004).

<sup>12</sup> Reference Appendix 3: Courchene 2005.

<sup>13</sup> See Appendix 2 for background and data sources for this section.

Expenditures on water and sewage also appear to have increased over the past 16 years, as have expenditures on policing and garbage collection. This pattern reflects, partially at least, the growing demand for increasing municipal spending on environmental and safety concerns at the expense of roads, spending on which (including parking and snow removal) is lower at the end of the 16-year period than it was at the beginning, as are transit expenditures (see Figure 3).

The majority of rural municipalities are also under severe pressures because of the scope of services provision, the economies of scale for services provision, and the expected levels of service. In most rural municipalities, expenditures on roads and bridges exceed the proportion suggested in the general patterns. This is especially the case as many rural municipalities will have no expenditures on such services as health, social services and housing. In addition, the Walkerton tragedy contributed to an upgrading of standards and regulations enforcement that is unaffordable for many rural communities.

Northern communities must also deal with harsh climates, rough terrain, sparse populations and remote locations. Expenditures per capita on roads, water and sewers, for example, are higher than in the south. In 2004, municipal

expenditures per capita were \$2,666 in the Northwest Territories and \$2,651 in Yukon (or roughly 1.5 times the provincial average in both territories) and \$5,162 (or three times the provincial average) in Nunavut.

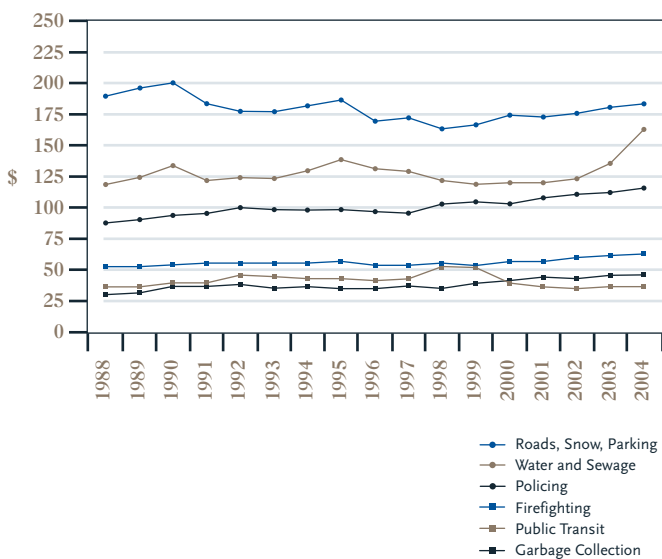
## Municipal Revenue Trends<sup>14</sup>

At the same time as municipalities need to spend more on a broader range of services, they are becoming more reliant on traditional revenue-raising tools. Property tax represented 48.6 per cent of municipal revenues in 1988 but 53.3 per cent in 2004. Property taxes were the largest source of revenue for municipalities in 2004, as they were in 1988. Meanwhile, user fees increased in relative importance by 17 per cent, rising from 20 per cent of all revenues in 1988 to 23.4 per cent by 2004.

Municipalities also collect revenue as transfers from provincial and territorial governments. These transfers, however, have decreased significantly. General purpose (unconditional) grants, in particular, fell by 48 per cent in relative importance, from 5.8 per cent of all revenues in 1988 to 3.0 per cent of all revenues in 2004. At the same time, specific-purpose (conditional) transfers fell by almost 25 per cent in relative importance, from 17.1 per cent of all revenues in 1988 to 12.9 per cent in 2004. When specific-purpose grants are separated by source, the provincial decline of almost 29 per cent in relative importance was partially offset by an increase in the relative importance of federal grants, primarily for environmental projects. Overall, the relative importance of grant funding fell by 30 per cent from the beginning of the period. This has had a very significant effect on the municipal balance sheet.

Municipalities in some provinces can also levy selective sales taxes on hotel and motel occupancy, but these taxes account for only a small part of local revenues. By contrast, cities in other parts of the world can collect income, sales and selective sales taxes.

Figure 3: Selected Municipal Government Expenditures, per Capita Constant Dollars, 1988-2004



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

14 See Appendix 2 for background and data sources for this section.



Table 1: Per cent Distribution of Local Tax Revenues by Type of Tax in Selected OECD Countries, 2002

COUNTRIES	INCOME	PROPERTY	SALES			OTHER TAXES	
			General Taxes	Specific Goods and Services	Taxes on Use etc.		Total Sales
<b>FEDERAL</b>							
Australia	0.0	100.0	0.0	0.0	0.0	0.0	0.0
Austria	56.0	10.0	23.6	3.8	1.7	29.1	4.9
Belgium	86.4	0.0	1.6	7.4	4.3	13.3	0.3
Canada	0.0	91.5	0.2	0.0	1.8	2.0	6.5
Germany	75.8	17.7	5.4	0.5	0.5	6.4	0.3
Mexico	0.1	89.5	0.0	1.9	0.5	2.4	7.9
Switzerland	83.2	16.6	0.0	0.2	0.1	0.3	0.0
United States	5.2	72.6	11.4	5.0	5.8	22.2	0.0
<b>UNITARY</b>							
Denmark	93.1	6.8	0.0	0.1	0.0	0.1	0.0
Finland	95.2	4.6	0.0	0.0	0.0	0.0	0.1
France	0.0	53.2	0.0	7.5	3.4	10.9	35.9
Greece	0.0	67.8	3.5	25.7	3.0	32.2	0.0
Hungary	0.2	22.5	71.3	0.9	4.2	76.5	0.3
Iceland	79.5	13.1	7.4	0.0	0.0	7.4	0.0
Ireland	0.0	100.0	0.0	0.0	0.0	0.0	0.0
Italy	21.6	13.6	2.5	12.9	7.6	23.0	41.8
Japan	44.6	33.0	7.3	8.3	5.7	21.3	1.0
Korea	12.4	51.9	0.0	14.3	5.8	20.1	15.6
Luxembourg	93.4	5.2	0.0	1.0	0.2	1.2	0.3
Netherlands	0.0	56.6	0.0	1.5	41.9	43.4	0.0
New Zealand	0.0	90.3	0.0	1.2	8.5	9.7	0.0
Norway	88.0	9.4	0.0	0.0	2.5	2.5	0.0
Poland	75.4	23.4	0.0	0.0	1.2	1.2	0.0
Portugal	21.1	47.0	0.0	0.0	0.0	0.0	0.0
Slovak Republic	54.1	22.0	0.0	17.9	6.0	23.9	0.0
Spain	25.2	24.3	23.8	17.4	8.1	49.3	1.1
Sweden	100.0	0.0	0.0	0.0	0.0	0.0	0.0
Turkey	35.1	12.5	37.1	4.3	1.5	42.9	9.4
United Kingdom	0.0	100.0	0.0	0.0	0.0	0.0	0.0

NOTES:

1. Income taxes include individual and corporate income taxes.
2. Property taxes include taxes on property including recurring taxes on net wealth.
3. General sales tax includes VAT, sales tax and other general taxes on goods and services.
4. Specific taxes on goods and services include special taxes on goods and services that are not taxed under a general sales tax (e.g. fuel, hotel, and motel taxes).
5. Taxes on use include taxes levied on the use of goods or permission to use goods and not the goods themselves (e.g. pollution taxes).
6. Other taxes include taxes on net wealth, taxes at death, and residual taxes mainly on business.

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics 1965-2003* (Paris: OECD, 2004), Tables 136 and 138.

When the growth in municipal revenues is measured in constant dollars per capita, total revenues grew at an average annual rate of 0.7 per cent, which is less than the 0.9 per cent growth rate for expenditures noted above.

The situation is particularly acute in rural and northern communities. Small population bases, limited economies of scale, accessibility, location and rising service expectations influence the ability of these communities to balance their budgets while maintaining the infrastructure necessary to sustain vibrant local economies.

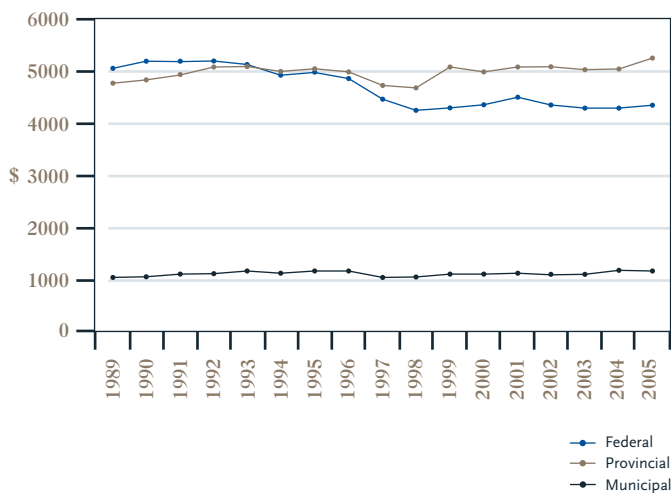
## Comparisons to Other Orders of Government<sup>15</sup>

When we compare expenditures for all three orders of government over the period from 1989 to 2005, we see that federal expenditures per capita in constant dollars have fallen and provincial expenditures have increased. Municipal expenditures have also increased but at a slower rate.

Federal transfers to the provinces accounted for 19 per cent of provincial revenues in 2005, a slight increase over the period. Overall, the annual average growth in provincial revenues in constant dollars per capita over the 16-year period was 0.8 per cent, which is somewhat greater than the rate of growth in expenditures (at 0.6 per cent).

Transfers from the provinces to municipalities, on the other hand, fell at an annual average rate of 3.7 per cent over the 16-year period. Overall, federal government revenues per capita in constant dollars have increased at the annual average rate of 0.6 per cent at the same time that expenditures were falling at the annual average rate of 0.9 per cent. Municipal governments in the northern territories rely much more heavily on territorial transfers. Whereas provincial-municipal transfers accounted for less than 16 per cent of total municipal revenues on average across Canada in 2004, this ratio was 42 per cent in Yukon, 48 per cent in the NWT and 59 per cent in Nunavut.

Figure 4: Federal, Provincial and Municipal Government Expenditure, Constant Dollars per Capita, 1989-2005



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Federal-territorial fiscal relations differ from federal-provincial fiscal relations, in that territorial governments do not have the same constitutional status as provinces. The three territories are much more heavily dependent on federal government transfers than are the provinces. Federal transfers account for 75 per cent of revenues in the NWT, 83 per cent in Yukon and 91 per cent in Nunavut.

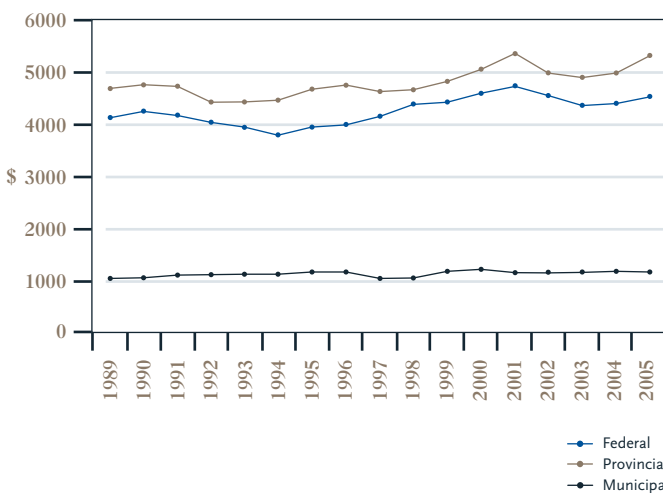
We can also compare total revenues per capita in constant dollars for each of the three orders of government. This shows that, on a per capita basis, provincial and territorial governments raise the most revenues. The increase in municipal government revenues, which are limited to the property tax, has been much more modest.

<sup>15</sup> See Appendix 2 for background and data sources for this section.

“THE FEDERAL AND PROVINCIAL/TERRITORIAL GOVERNMENTS HAVE A SIGNIFICANT FISCAL ADVANTAGE OVER MUNICIPALITIES: THEIR REVENUES ARE VARIED, WIDE-RANGING, ELASTIC AND GROW WITH THE ECONOMY.”

*FCM Big City Mayors’ Caucus report, 2006: Our Cities, Our Future: Addressing the Fiscal Imbalance in Canada’s Cities Today.*

Figure 5: Federal, Provincial and Municipal Government Revenue, Constant Dollars per Capita, 1989-2005



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

## The Limits of Property Tax<sup>16</sup>

“THE PROPERTY TAX IS INHERENTLY FLAWED AS A SOURCE OF FUNDING FOR CITIES’ GROWING NEEDS.”

*TD Bank Financial Group report, 2002:*  
A choice between investing in Canada’s cities or disinvesting in Canada’s future.

In its 2002 report on the state of Canada’s cities, TD Economics outlined some of the major structural weaknesses of the property tax. It noted that the tax is regressive, inelastic and generally unresponsive to local economic conditions. In addition, the commercial portion of the tax hinders competitiveness.

Property tax is inelastic. When the economy grows, property values rarely grow as quickly as do incomes and sales. And even when they do grow as quickly, there is usually a lag between assessed values and market values in many jurisdictions, so that it takes time for the tax base to catch up to the actual growth.

Property tax does have advantages and will remain the backbone of municipal finance. It is a highly stable and predictable form of taxation, one that does not vary much from year to year. The property tax is certainly appropriate for financing certain types of services, primarily services to property, such as infrastructure and fire fighting.

But the property tax also has a number of fundamental weaknesses, most notably that it is a regressive tax. As shown below in Figure 6, the poorest quintile paid 9.62 per cent of their gross income on property taxes in 2003, versus 1.95 per cent for the wealthiest quintile. In contrast, the poorest quintile paid 4.1 per cent of their gross income in income tax, versus 25.8 per cent paid by the richest quintile. This is particularly troublesome in situations where the property tax is used for services that redistribute income, such as welfare, immigrant services and public housing. As shown elsewhere in this report, it is these types of expenditures, for which the property tax is inappropriate, that are a growing municipal responsibility.

It is also difficult for some northern communities to levy a property tax, because the tax base is limited relative to local needs. Many smaller northern municipalities do not have taxing authority or have relatively few privately owned properties to tax. Property taxes, which for Canada as a whole accounted for more than 53 per cent of municipal government revenues, accounted for only 33 per cent in Yukon, 25 per cent in the Northwest Territories, and less

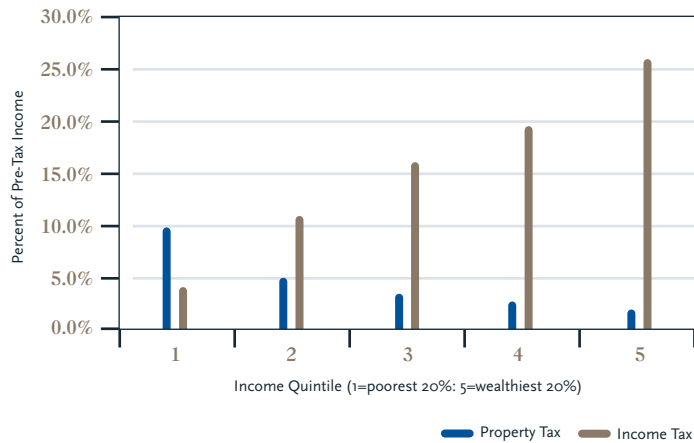
<sup>16</sup> See Appendix 5 for background and data sources for this section.

than five per cent in Nunavut (where only the territorial capital, Iqaluit, is a tax-based community).

In addition, provincial property taxes account for a proportion of provincial revenues that, while small, has been growing during the last 16 years, largely because most provinces have taken over the education portion of property taxes. This increase could become a significant issue if it starts to crowd out a municipal government's ability to raise property taxes for its own purposes. A study in Ontario in the early 1990s (when school boards had taxing powers) concluded that local school property taxes crowded out municipal property taxes.<sup>17</sup> We may still be seeing this impact with provincial property taxes for education expenditures (see Appendix 5, Table 3).

Finally, the property tax is not appropriate for funding local social services. Because these services redistribute income to the poor, income taxes are more appropriate to pay for social services. Table 2 below examines the match between municipal revenue sources and expenditure responsibilities.

Figure 6: Incidence of Property and Personal Income Tax in Canada (Five Quintiles, 2003)



Source: "Detailed average household expenditure by household income quintile for Canada and provinces, 2003", Statistics Canada catalogue number: 620032XDB.

Table 2: Relationship Between Expenditures and Revenue Responsibilities in the Canadian Context

TYPE OF EXPENDITURE	RELEVANCE OF PROPERTY TAX	OBSERVATIONS AND OPTIMAL SOURCES OF REVENUES
Fire protection	High	N/A
Solid waste collection and disposal	Medium-High	User fees
Economic development	Medium-High	Some spillovers
Police	Medium	Income tax for externalities
Road maintenance and cleaning	Medium	Complemented by User Fees
Public transit	Medium	User fees, local income tax and transfers
Water and waste water	Medium	User fees
Culture (including libraries)	Medium	Local income tax could have a role
Sports and parks	Medium	Local income tax could have a role
Public housing	Low	General income tax at the provincial level
Immigrant settlement	Low	Federal income tax
Social services	None	General income tax at the provincial level

Source: Adapted from Vaillancourt, 2006 (See Appendix 5)

17 Wade Locke and Almos Tassonyi. "Shared Tax Bases and Local Public Expenditure Decisions," (1993), vol. 41, no. 5, Canadian Tax Journal 941-57.





## Assessing the Property Tax

The property tax is one of the oldest taxes in the world. When assessing taxes, economists examine their micro-economic aspects, such as the tax's incidence, efficiency and equity, as well as the compliance costs and the avoidance and evasion activities associated with it.

- **Incidence** refers to the ability of the payer to pass on the tax. For owner-occupied housing, the owner pays the tax. For rental housing, whether residential, commercial or industrial, the owner passes on the tax. As the tax is less visible for renters than for owner occupiers, there is a tendency to set higher tax rates on these properties.
- **Efficiency** refers to the impact of the tax on how individuals consume and locate their property. In many instances, individuals will locate at the periphery of an urban area as land is cheaper, lowering their overall tax burden relative to servicing costs. Many economists consider the property tax a significant contributor to urban sprawl.
- **Equity** refers to how similar and different people are treated by the tax. Horizontal equity compares the treatment of residential, commercial and industrial property, while vertical equity compares the amount of tax paid relative to income. Unlike income taxes, which rise with ability to pay, the property tax is particularly regressive, accruing disproportionately to poorer members of society.
- **Compliance Costs/Avoidance/Evasion:** the cost of administering the property tax is considered relatively small, and evasion/avoidance is not a significant issue.

In addition, economists also examine the revenue-generating aspects of the tax, such as its predictability, stability and elasticity. The property tax is considered a highly stable source of tax revenue for municipal government that

does not vary much from year to year. However, the tax is also considered to be relatively inelastic, because it does not respond to economic growth as well as income or sales taxes do. This can be a problem for municipalities, as servicing costs (particularly for water, roads and public transit) are more closely aligned with economic growth.

### Appropriate Uses

Historically, the property tax has been used to finance services to property. This is still the greatest portion of public expenditure by municipalities, making the property tax an appropriate form of taxation. However, municipalities are now responsible for a much greater range of services than previously. These new services, including social services, public housing, immigrant settlement and some police and environmental services, are more appropriately financed through other forms of taxation. Services that are particularly redistributive in nature, such as social services, should be financed through progressive taxes.

### Strengths and Weaknesses

The primary strengths of the property tax are its predictability, stability, and relationship to property servicing, which is a core function of municipal government. However, the property tax also has some major flaws. The property tax is strongly regressive, rising significantly as a portion of income as income levels decrease. Moreover, its low visibility among renters of all classes of property makes it a natural target for tax increases. Perhaps most pernicious, it encourages urban sprawl. Land is cheaper at the periphery of a municipality, and consumers are rewarded for locating further from the core. Ironically, property tax returns decrease as servicing costs increase. This is a serious obstacle to financial management and infrastructure delivery at the municipal level.



## Conclusions

A fiscal imbalance exists when an order of government does not have the fiscal capacity to meet its spending responsibilities. The fiscal position of municipalities is obscured by provincially imposed limits on their ability to run deficits or to borrow for capital purposes. Meeting these restrictions has required municipalities to starve infrastructure and service delivery. The apparently healthy financial picture only means that costs have been pushed off the balance sheet and onto the street. Put another way, deferring infrastructure expenditures does not mean that those expenditures were not necessary. In fact, delaying these expenditures only grows and compounds the problem, as the following chapter will discuss.

Although there may be some room for municipalities in some provinces to increase residential property taxes and user fees, doing so will not cover under-investment in infrastructure and services. Moreover, provincial restrictions on municipal revenue sources and the regressive and inelastic nature of the property tax combine to prevent municipalities from raising their revenues in the way provincial and territorial governments do.

## The Fiscal Imbalance and Rural Municipalities

Canadians and their governments are particularly sensitive to the adage that “no one size fits all,” especially when we consider the different ways that the fiscal imbalance affects urban, rural and northern municipalities. In traditional tripartite infrastructure-funding arrangements, federal, provincial/territorial and municipal governments each contribute one third of the cost of new infrastructure. But rural and northern municipalities may not be able to raise enough revenue to contribute their share. In addition, national funding allocation formulas based purely on population place these communities at a disadvantage, because their higher costs require a disproportionately higher share of the funding.

For many of these communities, economic uncertainty impedes efforts to sustain financial viability. Economic development and diversification will make rural communities less dependent on single industries and natural resources. It will also mitigate the strains on municipal governments coping with boom-and-bust local economies. Adequate public infrastructure is even more critical for rural economies, which must compensate for limited accessibility and economies of scale.

Though not conclusive, evidence suggests there is a capacity challenge in rural communities. Scale, location, organization and other salient factors that characterize rural municipalities across Canada combine to constrain the municipal finance resource base. Part of the challenge may relate to traditions, attitudes, habits and practices and may require changes in political choices and in policy and management practices. The mix of factors that exist in rural communities (the small, fragile economic base; political attitudes; and the backlog in deferred infrastructure investments), all point to a mismatch between available fiscal resources and the portfolio of services that rural municipalities are charged with providing.



## The Territorial Perspective

The ability of municipal governments in the three northern territories (the Northwest Territories, Yukon and Nunavut) to meet their expenditure responsibilities with existing revenue sources is somewhat different than for municipalities in the rest of Canada. In terms of expenditures, it is much costlier to deliver public services in the northern territories. In terms of revenues, municipalities in the territories are more limited in their ability to raise revenues and many communities do not even have the authority to levy property or other taxes. The result is that municipalities are much more dependent on intergovernmental transfers than are their southern counterparts. Higher costs and limited revenue-raising ability also mean that territorial governments are more dependent on federal grants than are provinces.

Higher costs stem from the harsh climatic conditions, sparse population and isolated communities with limited or no road access. These factors have resulted in higher transportation costs, higher heating costs and higher labour costs in the territories. The cost of living is 30 per cent higher in the Northwest Territories (NWT) than in the rest of Canada, 40 per cent higher in Yukon and 64 per cent higher in Nunavut.<sup>18</sup> The result is that municipal expenditures per capita are much higher in the territories than in the rest of Canada. In 2004, municipal expenditures per capita were \$2,666 in the Northwest Territories and \$2,651 in Yukon (or roughly 1.5 times the provincial average in both territories) and \$5,162 (or 3 times the provincial average) in Nunavut.

Expenditures per capita on roads, water and sewers are higher in the territories because of the harsh climatic conditions and terrain. Local governments in remote communities with small populations are unable to take advantage of economies of scale in administration, so general government expenditures per capita are higher than in municipalities in the provinces. Expenditures on recreation and culture are considerably higher on a per capita basis because many municipalities have a community centre, an ice arena and recreational programs.

The sources of revenue available to municipal governments in the three territories are, at least in theory, the same as for other municipal governments in the country: property taxes, user fees and intergovernmental transfers. In reality, however, the characteristics of the population and the tax base in the territories restrict the use of many of these revenue sources. For example, it is difficult for some communities to levy a property tax because the tax base is limited relative to local needs. Many smaller local governments in the northern territories do not have taxing authority and many of those with taxing authority have relatively few privately owned properties to tax. Property taxes, which accounted for more than 53 per cent of municipal government revenues for Canada as a whole accounted for only 33 per cent in Yukon, 25 per cent in the NWT and less than 5 per cent in Nunavut (where only the territorial capital, Iqaluit, is a tax-based community).

Municipal governments in the northern territories rely much more heavily on territorial transfers than do their counterparts in the rest of the country. Whereas provincial–municipal transfers accounted for less than 16 per cent of total municipal revenues on average across Canada in 2004, this ratio was 42 per cent in Yukon, 48 per cent in the NWT and 59 per cent in Nunavut. Although the formulas for territorial–municipal transfers vary among the territories, the transfers generally recognize the high cost of delivering services in the North. For example, unconditional transfers in the NWT are based on population, assessed value of property (or an estimate of assessed value where assessment is not done) and a factor designed to reflect cost differentials across communities in the NWT. The transfer from Nunavut to municipalities is needs-based and includes an array of factors that reflect the different cost of providing municipal services in different communities.

<sup>18</sup> The Council of the Federation, Ottawa, 2006. Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance, Report prepared by the Advisory Panel on Fiscal Imbalance, p. 45.



Federal–territorial fiscal relations are also different from federal–provincial fiscal relations. Territorial governments do not have the status of provinces under the Constitution. The territories are governed by federal legislation and the territories cannot change this legislation without the approval of Parliament and two-thirds of the provinces representing at least 50 per cent of the Canadian population.<sup>19</sup> Moreover, the territories require federal approval to borrow money and the federal government sets limits on that borrowing. Territorial governments have gradually assumed responsibility for delivering provincial-type programs such as health, education, social services, housing and transportation. They do not, however, have access to revenues from natural resources.

Territorial Formula Financing (TFF) is the main federal transfer payment to the territorial governments. TFF, established in 1985, is designed to allow territorial governments to provide a level of basic services that is comparable to the services available in the provinces, taking into account the higher costs of services in the territories and the more limited ability to raise revenue. Unlike federal–provincial equalization transfers, TFF included a measure of expenditure needs in recognition of the higher costs of public services in the territories. In October 2004, the federal government announced a new framework for TFF (and for equalization) and replaced the TFF agreements with federally legislated grants. The three territories are much more heavily dependent on federal government transfers than are the provinces. Federal transfers account for 75 per cent of revenues in the NWT, 83 per cent in Yukon and 91 per cent in Nunavut. Federal transfers account for less than 19 per cent of total provincial revenues for Canada as a whole.

Clearly, approaches to fixing the municipal fiscal imbalance that work well “south of 60” will not necessarily work as well in northern communities, which face dramatically different cost pressures, and often do not have the same capacities to undertake projects. For example, in traditional tripartite infrastructure funding arrangements, federal, provincial/territorial and municipal governments each contribute one third of the cost of new infrastructure. These agreements limit participation by northern municipal governments, which cannot raise enough revenue to contribute their share. In addition, national funding allocation formulas based purely on population place northern communities with extremely small populations at a disadvantage because their higher costs require a disproportionately higher share of the funding to implement the same types of projects as in the provinces. Territorial governments and their municipalities are doing the best they can to meet their unique challenges within the existing fiscal framework, but clearly a more robust approach is required.

<sup>19</sup> Ibid p. 47.



## Key Findings

- Federal government expenditures in constant dollars per capita have been declining, while revenues have been increasing. Provincial and territorial government expenditures have been increasing at a somewhat slower rate than revenues. Only municipal government expenditures have been increasing at a faster rate than revenues.
- Municipal government expenditures have been increasing more rapidly than either federal or provincial government expenditures. The annual average growth rate in revenues, however, has been highest for the provincial and territorial governments.
- The pattern of municipal government spending changed over the 16-year period, with a growing emphasis on environmental and protection services at the expenses of roads and public transit.
- Federal and provincial tax revenues in constant dollars per capita increased over this 16-year period, while local tax revenues remained fairly flat.
- Federal and provincial/territorial governments rely on personal income taxes, corporate income taxes and consumption taxes, as well as on other tax and non-tax revenues. Some provincial governments also levy a property tax. Municipal governments rely largely on the property tax, plus user fees and provincial and federal transfers. This suggests that it may be more difficult to prove a provincial/territorial fiscal imbalance exists than a municipal one, because provincial and territorial governments have the same revenue-raising tools as the federal government.
- A greater increase in the relative importance of provincial property taxes for education and a relatively smaller increase in municipal property taxes may suggest some crowding out of municipal property tax room by the provincial property tax in some provinces.



# THE FISCAL IMBALANCE FROM THE GROUND UP



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The roles and responsibilities of federal, provincial, territorial and municipal governments often overlap and continually evolve, reflecting changing social, political and economic realities. Today, municipal governments provide Canadians with far more than the basic services they were traditionally responsible for when the Constitution was written.

In most Canadian jurisdictions, municipal governments are key players in the implementation of all governments'

priorities and policies. They are direct providers and advocates of national and regional priorities, such as transportation, public safety, economic development, social services, housing and immigration-settlement services, to name just a few. The principle of subsidiarity<sup>20</sup> suggests that since municipal governments are more familiar, visible and accessible to Canadians, they are often in the best position to make the most informed and efficient decisions on the delivery of key public services.

Table 3: Current Roles and Responsibilities in Canada

	FEDERAL	PROVINCIAL	MUNICIPAL
Emergency preparedness	✓	✓	✓
Arts and culture facilities/events	✓	✓	✓
Economic development	✓	✓	✓
Parks and recreation	✓	✓	✓
Pensions and income support <sup>21</sup>	✓	✓	✓
Aboriginal peoples	✓	✓	✓
Immigration	✓	✓	✓
Public health	✓	✓	✓
Industry	✓	✓	✓
Environment	✓	✓	✓
Policing	✓	✓	✓
Transportation infrastructure	✓	✓	✓
Housing	✓	✓	✓
Border security	✓		✓
Emergency medical services		✓	✓
Hydro services		✓	✓
Bylaw enforcement		✓	✓
Health care <sup>22</sup>		✓	✓
Social assistance and social services		✓	✓
Administration of justice		✓	✓
Indirect taxation	✓	✓	
Direct taxation	✓	✓	
Post-secondary education, training & research	✓	✓	
Agriculture	✓	✓	
Municipal streets and roads			✓
Water and wastewater			✓
Waste and recycling services			✓
Fire protection			✓
Public transit			✓
Municipal planning			✓
Public libraries			✓
Business and building licensing			✓
Parking			✓
Money and banking	✓		
International and inter-provincial/territorial trade	✓		
Airlines and railways	✓		
Telecommunications and broadcasting	✓		
Foreign affairs and international assistance	✓		
Defence and veterans affairs	✓		
Employment insurance	✓		
Criminal law	✓		
Fiscal equalization	✓		
Primary and secondary education		✓	
Municipal institutions		✓	
Natural resources		✓	

Source: Adapted from Government of Canada. 2006. "Restoring Fiscal Balance in Canada – Focusing on Priorities" Department of Finance. Ottawa.

<sup>20</sup> Subsidiarity is the principle that states that public policies and programs should be handled by the smallest competent government authority – that is, public services should be delivered by public bodies that are located as close to the citizen as possible.

<sup>21</sup> Municipalities provide income support in some jurisdictions

<sup>22</sup> Municipalities provide dental care/home care/nursing support in some jurisdictions

Furthermore, federal and provincial/territorial priorities and programs must often be viewed through a cities-and-communities lens, because the vast majority of Canadians live within municipal boundaries. The inter-connection between the priorities, policies and roles and responsibilities of all orders of government must be acknowledged as a first step in developing a more rational allocation of public resources in this country.

The debate on the fiscal imbalance provides the opportunity for a close look at how services are delivered, priorities apportioned, and resources allocated. It would be next to impossible to address the scope of this vertical imbalance without first addressing the “who does what and why” question.

As Table 3 illustrates, the roles and responsibilities of all orders of government overlap in a number of key areas. All governments are active in cities and communities. The fiscal imbalance discussions provide an opportunity for all governments to work together to ensure that service delivery is adequately funded and that these services are provided to Canadians efficiently and without unnecessary duplication.

This chapter will examine in much greater detail the effect of offloading and squeezed municipal budgets in the areas of public transit, affordable housing, immigrant settlement, environmental protection, public safety and emergency preparedness. It will also examine the effect of these policies in creating the infrastructure deficit which is both a cause and a reflection of the vertical fiscal imbalance.

## Municipal Infrastructure Deficit

*By Mario Lefebvre, Conference Board of Canada,  
and Dr. Roger Gibbins, Canada West Foundation*

During the past 20 years, Canadian municipalities have been squeezed by increasing responsibilities and reduced transfer payments from other orders of government, a situation not unlike that faced by provincial governments. This has had direct and negative consequences for Canada’s infrastructure. Unlike other orders of government, municipalities are not allowed to run deficits on their operating budgets. This, in turn, has put tremendous downward pressure on municipal capital budgets (which do not face the same immediate pressures as operating expenditures, making capital investments easier to delay), fueling the creation of a substantial national municipal infrastructure deficit. This deficit has become structural and now requires a structural solution.

The national municipal infrastructure deficit manifests in a number of ways. Municipalities are finding it extremely difficult to manage current infrastructure demands, let alone address the accumulated backlog of needed infrastructure maintenance and rehabilitation. This is compounded by population growth, which further strains existing infrastructure resources while creating additional demand for more infrastructure.

Across Canada, municipalities are at an infrastructure breaking point. Most of our infrastructure was built during the rapid growth period between the 1950s and 1970s. Much of it is due for replacement, and much of that very soon. Given municipalities’ already strained fiscal situation, we are rapidly approaching a tipping point on the infrastructure deficit, one that will seriously harm both our quality of life and our competitiveness and productivity. This section will examine how we have arrived at this situation and look at the implications for municipal finance.

# MUNICIPAL INFRASTRUCTURE DEFICIT



## Apportioning Canada's Capital Stock

Municipal government is capital intensive. A core responsibility of municipal governments is to provide the physical foundations to support shelter, employment, economic production and trade, and recreation and leisure. This burden is both extensive and growing. In 1961, during the initial phase of the heavy infrastructure investment period, federal, provincial/territorial and municipal governments each controlled 23.9, 45.3 and 30.9 per cent of the national capital stock, respectively. By 2002, the situation had changed dramatically. The federal government's share dropped from 23.9 per cent to 6.8 per cent. Over the same period, the municipal portion of the national capital stock increased by nearly 70 per cent, from 30.9 to 52.4 per cent of all infrastructure.

## Declining Investment

Between 1955 and 1977, new investment in infrastructure grew by 4.8 per cent annually. This was a period of intense capital investment that closely matched Canada's population growth and rate of urbanization. This period stands in stark contrast to the 1978 to 2000 period, when new investment grew by just 0.1 per cent per year on average. Although the rate of population growth also declined, this does not account for the almost complete withdrawal from capital investment during this period. Clearly, all orders of government were under-investing.

More recently, capital spending by local governments has increased.<sup>23</sup> Real investment spending posted an average annual increase of 7.5 per cent between 2001 and 2003. New investment—the portion of investment that actually adds to the overall capital stock—has been particularly strong, expanding at a pace of more than 11 per cent per year over the same time period.

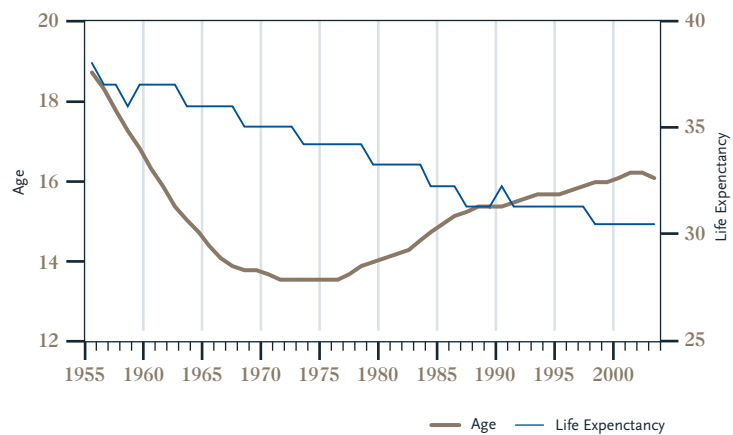
However, this recent growth in infrastructure spending should not be viewed as a resolution of the structural infrastructure deficit. Much of this recent increase in investment can be traced

to a strong up-tick in urbanization over the past 10 years, and it is not clear that this increase in capital stock is sufficient to meet this population growth. Moreover, it has neither met the current annual rehabilitation needs of the existing capital stock nor alleviated the current backlog of maintenance and rehabilitation that has accumulated over the period.

## Aging Infrastructure

This situation is reflected in our aging municipal infrastructure. The average age of local governments' capital stock has increased since the end of the 1970s, because investment has been insufficient to replace deteriorating stock. Until the mid-1970s, the average age and the life expectancy of the capital stock followed a similar downward trend (see Figure 7).<sup>24</sup> However, a divergence begins around 1977, with the capital stock's age increasing. This is a result of slower growth in capital spending, most of which is dedicated to infrastructure. The average age of local government capital stock rose from 13.7 years in 1976 to 16.2 years in 2000. Over the same time period, the life expectancy of new investment declined to 30 years in 2000 from 34 years in 1976.

Figure 7: Age and Life Expectancy of Municipal Capital Stock 1955-2004



Source: Statistics Canada

<sup>23</sup> The investment data from Statistics Canada's Capital Stock Division is not broken down by municipalities. This is unfortunate because it would be interesting to know whether this surge in investment was generalized or concentrated in just a few areas.

<sup>24</sup> The average age of the capital stock does not necessarily move in tandem with life expectancy. For example, if a given city invests a significant amount of money to maintain a relatively old bridge or building, the service life of the capital stock will be extended.

## The Infrastructure Deficit

This analysis points to a tremendous fiscal challenge for municipalities. Over the past 40 years, municipalities have assumed a growing (now the largest) portion of Canada's capital stock. This has had to be financed mainly through the property tax, a form of taxation that is (relative to income and sales taxes) the least responsive to economic growth.<sup>25</sup> Predictably, as the responsibility for infrastructure investment has shifted to municipalities (and the municipal property tax), there has been a precipitous decline in capital stock investment since the late 1970s. As a result, the average age of municipal infrastructure has increased significantly over this period. In short, a vicious cycle has been created.

This general trend towards decreasing investment has been further compounded by cuts in transfers combined with significant offloading of responsibilities since the mid-1990s. According to Kitchen and Slack (see Appendix 2), in real terms transfers from other orders of governments to municipalities declined (on a per capita basis) by 1.4 per cent annually between 1988 and 2004. During the same period, municipal expenditures for housing, health and social services increased from 11.2 per cent to 16.4 per cent of municipal expenditures, crowding out investment in core physical infrastructure.

The rapid expansion of municipal capital stock and offloading, combined with reduced transfers, has created a critical backlog of investments in municipal infrastructure. Although this deficit is clearly massive, determining its exact size is difficult. The generally accepted figure is \$60 billion, but estimates vary widely. For example, the Canadian Society of Civil Engineering set the deficit at \$57 billion in 2002.<sup>26</sup> Meanwhile, M. Saeed Mirza and Murtaza Haider believe that the existing infrastructure gap stands at \$125 billion.<sup>27</sup> For its part, TD Economics estimated in 2002 that this deficit was growing by approximately \$2 billion per year.<sup>28</sup>

The size of the problem focused the attention of both governments and the public on the need for solutions. However, the lack of a clear understanding of its scope,

or even agreement on a definition of infrastructure, makes rational solutions difficult. Three things must be clarified before any long-term strategy can be developed to deal with the infrastructure deficit: (a) the scope and size of the infrastructure deficit; (b) geographic and jurisdictional specificity; and (c) investment priorities.

## Effects on our Economy

The health of Canada's economy is closely linked to the scope and quality of municipal infrastructure investment. Our quality of life and our productivity and competitiveness all depend on infrastructure investment. Statistics Canada estimates that a one-dollar net increase in public capital stock generates approximately 17 cents on average in private-sector cost savings.<sup>29</sup> For the transportation sector, each dollar invested in transportation infrastructure is projected to generate a saving of more than 40 cents.<sup>30</sup>

The cost of not investing in infrastructure is equally high. It is estimated that the loss from congestion and shipment delays in the Greater Toronto Area totals \$2 billion annually.<sup>31</sup> Indeed, federal Finance Minister Flaherty echoed this concern, stating "infrastructure challenges are more than a daily inconvenience; they pose real risks to the future prosperity of our communities, and to the entire country."<sup>32</sup>

However, the quality of our cities and communities is itself a precondition for economic development. Cities that provide world-class cultural and leisure activities; clean, attractive, safe and well-managed environments; and good roads and transit systems, enjoy a competitive advantage. As TD Economics said in its 2002 report on cities: "Economic competitiveness and quality of life are inextricably intertwined."<sup>33</sup> This is also true for smaller and rural communities, which are thwarted in their efforts to retain population (particularly younger people), in part because of a lack of quality recreation infrastructure.

This is a concern for all orders of government. When considering the quality of life and economic competitiveness of Canada, intergovernmental cooperation should be the norm, not jurisdictional silos. Each order of

<sup>25</sup> See Appendix 5.

<sup>26</sup> The Canadian Society for Civil Engineering, *Critical Condition—Canada's Infrastructure at the Crossroads*, 2002.

<sup>27</sup> M. Saeed Mirza and Murtaza Haider, *The State of Infrastructure Policy in Canada*, a report submitted to Infrastructure Canada, March 2003.

<sup>28</sup> TD Bank Financial Group, *A Choice Between Investing in Canada's Cities and Disinvesting in Canada's Future*, p. 12, April 2002.

<sup>29</sup> In *Mind the Gap* (pp. 5–6), the TD Bank argues that if the infrastructure gap had not been allowed to open in the first place, an additional \$100 billion or more in spending would have been required, implying a reduction of nearly \$17 billion in private-sector costs. However, had the money for this spending been borrowed at a rate of 6 per cent, a full \$6–\$9 billion in higher annual debt service payments would have been the result. This is still well below the \$17 billion in private-sector savings.

<sup>30</sup> Tarek M. Harchaoui, Faouzi Tarkhani and Paul Warren, *Public Infrastructure in Canada: Where Do We Stand?* (Ottawa: Statistics Canada, 2003).

<sup>31</sup> TD Bank Financial Group, *Mind the Gap: Finding the Money to Upgrade Canada's Aging Public Infrastructure*, p. 5.

<sup>32</sup> Honourable James M. Flaherty, P.C., MP, Minister of Finance to the Whitty Chamber of Commerce, Whitby, Ontario March 9, 2006.

<sup>33</sup> TD Bank Financial Group, 2002. "A choice between investing in Canada's cities or disinvesting in Canada's future."

government shares in the success of Canada's cities and communities through both gains in employment and tax revenue, as well as citizen satisfaction with the quality of government service delivery.

## The Federal Response

In 1993, the federal government began investing in municipal infrastructure. Between 1993 and 2011, the federal government has invested or plans to invest \$17.4 billion in infrastructure, slightly less than \$1 billion a year over the period. The federal government estimates that 70 per cent of its infrastructure expenditures have been directed to municipal governments.

This has been further complemented by the gas tax transfer. Between 2005/6 and 2009/10, the federal government will directly transfer \$5 billion in federal gas tax revenues to municipal governments. Combined, these investments represent an important contribution to addressing the municipal infrastructure deficit.

However, as the federal government itself points out in "Restoring Fiscal Balance in Canada: Focusing on Priorities", a companion document to its 2006 Budget:

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"FEDERAL INVESTMENTS IN INFRASTRUCTURE ARE SIGNIFICANT, BUT THIS FUNDING NEEDS TO BE PUT ON A LONG-TERM TRACK TO ALLOW FOR LONG-TERM PLANNING, ESPECIALLY GIVEN THE TIME SPANS INVOLVED IN PLANNING AND BUILDING MAJOR INFRASTRUCTURE PROJECTS."

This comment goes to the very core of the infrastructure problem.

Infrastructure financing, by its very nature, is a long-term financial undertaking. It is an investment with a 30, 50 or 70-year time horizon. Furthermore, infrastructure investments give shape to the urban form, and are a basic foundation and required precursor for all economic activity. As a consequence, while ad-hoc contributions from the federal government have been useful, they have not provided the long term structural solution needed to address the infrastructure deficit for good.

Simply put, for the nation to prosper, urban infrastructure investments must respond to and support the economic potential of the community. For this to happen, financing must reflect the long-term nature of infrastructure investments and will require an undertaking on the part of all orders of government to commit to and develop a long-term investment strategy with agreed-upon priorities. This plan must bring long-term certainty to infrastructure funding, one that will promote new efficiencies, technologies and best practices to the field of infrastructure delivery.

## Confronting the Infrastructure Challenge

For Canada, the consequences of not investing adequately in our infrastructure are immense. If we continue to invest at current levels, we will not realize our full economic potential. Our infrastructure will continue to deteriorate and the infrastructure deficit will continue to balloon, diminishing our long-term economic prospects. Even investing at a level sufficient to maintain our current capital stock and accommodate future population growth will not meet the challenge.

In the absence of a national plan to address the municipal infrastructure deficit, municipal governments will continue to use most of their revenue to meet their operating expenditures, investing the remainder into capital improvements. Given current municipal revenue growth projections, this will prove problematic.

### *A Declining Revenue Source*

Municipalities currently rely on property taxes for 53.3 per cent of all municipal revenues. Approximately one-third of total revenues are derived from residential property taxes alone.<sup>34</sup> The Conference Board of Canada has concluded that the aging population will decrease the growth in demand for new housing, limiting the overall growth in property tax revenues to 2.5 per cent annually over the next 20 years.

Over the same period, a conservative forecast of operating expenditures (excluding interest payments) would yield growth equal to inflation plus the rate of increase in population. This is the rate of increase needed to maintain

<sup>34</sup> See Appendix 3.

a constant level of real per capita operating expenditures over the 20-year period. Municipal operating expenditures are likely to grow by roughly three per cent (one per cent population growth and two per cent inflation) per year on average, outpacing the expected gain in property taxes. As a result, investment in rehabilitation and expansion of the current capital stock will be further eroded, increasing the current infrastructure deficit.

The infrastructure for which municipal governments are responsible is vital to Canada's success. Investments in this critical infrastructure are too important to be tied to the property tax, a declining source of revenue.

### *Rehabilitation and Expansion*

The scope of the infrastructure deficit, combined with the shortcomings of the existing municipal fiscal framework, make it impossible to fix the problem without imposing debilitating increases in property tax.

Historically, each one per cent increase in municipal population increases growth in real new investment by two per cent. With population growth currently averaging one per cent per year, real new investment should rise by two per cent per year. In nominal terms, new investment spending should rise by four per cent per year.

Data from Statistics Canada's Capital Stock Division reveals that the historical depreciation rate of municipal government capital stock has been, on average, roughly 3.5 per cent per year. This rate of depreciation implies that investment for replacement purposes must increase by about five per cent per year. To maintain existing capital stock and expand it to accommodate future population growth, total investment would have to rise, on average, by 4.5 per cent per year over the next 20 years. Given that property taxes are anticipated to grow by 2.5 per cent per year during the same period, significant tax increases will be required just to maintain the current capital stock and expand it to meet population growth pressures.

## Conclusion

During the past 40 years, Canada's municipal governments have become the primary deliverers of economic infrastructure. Roughly 53 per cent of all infrastructure is now vested with municipalities, and this is expected to grow. Based on current trends, projected municipal revenue growth will not be sufficient to rehabilitate and expand capital stock, or deal with the estimated \$60-billion infrastructure backlog.

Municipal governments lack the range of revenue sources needed to meet this responsibility. Municipal capital stock is critical to maintaining both our productivity and quality of life; it is also a precondition for continued economic growth. Canadian municipalities face a serious structural imbalance between their fiscal capacity and their need to repair, replace and expand infrastructure.

Given their projected needs and anticipated revenue growth, municipal governments cannot meet this challenge alone. All orders of government have a central economic and social interest in seeing the infrastructure deficit eliminated. Only then will Canada be positioned to compete globally and succeed.

## Public Transit

By Dr. Michael Roschlau  
Canadian Urban Transit Association

Public transit is the only universally accessible form of urban transport that provides access to employment, education, health care and recreation. Safe, reliable and efficient public transit is vital to the movement of people in urban economies, presenting undeniable economic, environmental and social benefits.

Without public transit, many of our urban centres would be gridlocked, as growing numbers of vehicles compete for scarce road-space. Investments in public transit should be part of a strategy to make best use of our physical resources and to conserve precious road-space. It is one of the best congestion mitigation strategies. One peak-hour bus carries the same number of people as 40 to 50 cars, and one rail-line carries as many people as 15 lanes of traffic.

Increasing public transit ridership is also particularly important for achieving environmental benefits for Canadians. On average one passenger-kilometre traveled on transit produces 76 grams of CO<sub>2</sub> whereas one person-kilometre traveled by an urban automobile produces 254 grams, or more than 3 times as much. Transit also reduces air pollution, contributing to the health of Canadians. On average, each automobile emits 4 tonnes of pollutants each year; while buses emit significantly fewer nitrous oxides, volatile organic compounds, carbon monoxide per passenger-kilometre compared to a car.

In 2005, Canada's public transit systems carried 1.63 billion passengers, an all-time record. This is 2.5 per cent higher than in 2004 and represents a 10.9 per cent increase over the four-year period since 2001.

In Canada, fare revenue from transit users covers, on average, 62 per cent of operating costs. This compares favourably with other OECD countries. In the Netherlands, fare revenue covers 28 per cent of costs; in Italy, 33 per cent; in the United States, 39 per cent, in Sweden, 44 per cent; in France, 55 per cent; and in Germany, 60 per cent.

Nevertheless, meeting public transit's capital costs (the establishment of fixed facilities and the rolling stock itself) remains difficult. The costs are even more significant for larger cities with rail or bus rapid-transit systems, but so are the economic benefits, since moving the volumes of people carried by rapid transit would require additional road capacity.

Meeting transit's capital costs will require commitments from all orders of government. In fact, Canada remains the only OECD country without a long-term, predictable federal transit-investment policy, even though moving people efficiently in urban areas requires a partnership among all orders of government.

The Canadian Urban Transit Association has estimated that transit systems across the country need \$20.7 billion for infrastructure between 2006 and 2010, which covers rehabilitating and replacing existing systems, as well as expansion plans to accommodate increasing numbers of riders. This figure includes both currently financed plans and those plans contingent on external funding.

Of the \$20.7 billion required, 44 per cent is needed to rehabilitate or renew existing infrastructure, while 56 per cent is needed to expand service capacity to serve more riders (see table). These figures speak to the need both to maintain infrastructure and to respond to the growth potential for transit. We must both restore transit infrastructure and respond to the increasing mobility needs of the growing Canadian urban population.

Table 4: Public Transit Capital Expenditures 2006-2010

INFRASTRUCTURE	PLANNED EXPENDITURES	CONTINGENT ON NEW EXTERNAL FUNDING	TOTAL
Rehabilitation	\$7,305,520,431	\$1,807,576,297	\$9,113,096,728
Expansion	\$8,031,184,817	\$3,571,637,520	\$11,602,822,337
Total	\$15,336,705,248	\$5,379,213,817	\$20,715,919,065

Source: CUTA Infrastructure Needs Report 2006-2010



# PUBLIC TRANSIT



BACK

Equally notable is the split between projects: 79 per cent of the funding is for current plans, while 21 per cent is contingent on external funding. This suggests a significant shortfall in funding for the period from 2006 to 2010.

Transit systems estimate they will need almost \$9.1 billion during this period just to maintain their equipment. Although the average age of Canadian transit buses has decreased from 11 years to 10 years since 2005, it is still well above the recommended vehicle age of six to nine years. Rehabilitation and replacement projects totalling \$7.3 billion are currently planned, but many of these investments have not been budgeted by municipalities and local authorities and may not be approved.

Transit systems estimate they will need to invest \$11.6 billion to meet projected expansion demands between 2006 and 2010. While there are tentative plans to invest \$8 billion, much of the work that needs to be done cannot proceed without the assistance of the federal and provincial governments. Canada's three largest census metropolitan areas (CMAs) need over 68 per cent of this \$11.6 billion, and their populations are increasing, adding extra transit pressure in these urban centres and in their surrounding suburbs.

Moreover, it will be difficult to combat traffic congestion, air pollution and increasing greenhouse-gas emissions without these investments. During the 2006 election campaign, the Conservative Party pledged to "fight congestion through public transit," saying that "improved public transit usage will help both reduce traffic congestion in our urban centres and reduce carbon dioxide and other emissions."

This is encouraging, as are the benefits of earlier investments now being realized. Recent trends show that total transit infrastructure needs have stabilized, after rising steadily since the late 1990s (from \$8.5 billion in 1999 to \$20.7 billion in 2006). Furthermore, the proportion of these needs that can be dealt with through existing funding programs has increased from half to three quarters, largely because the federal government has invested more in infrastructure in recent years. Examples of this investment are the transfer of a portion of the federal gas tax to municipalities, the Canada Strategic Infrastructure Fund (CSIF), and the recently announced three-year, \$900 million Public Transit Capital Trust.

However, these investments are not part of a long-term national public transit plan. As transit's share of urban travel continues to grow, federal and provincial governments must provide long-term reliable funding, so that transit systems have the financial certainty they need to meet the needs of Canadians now and in the future.

## Affordable Housing

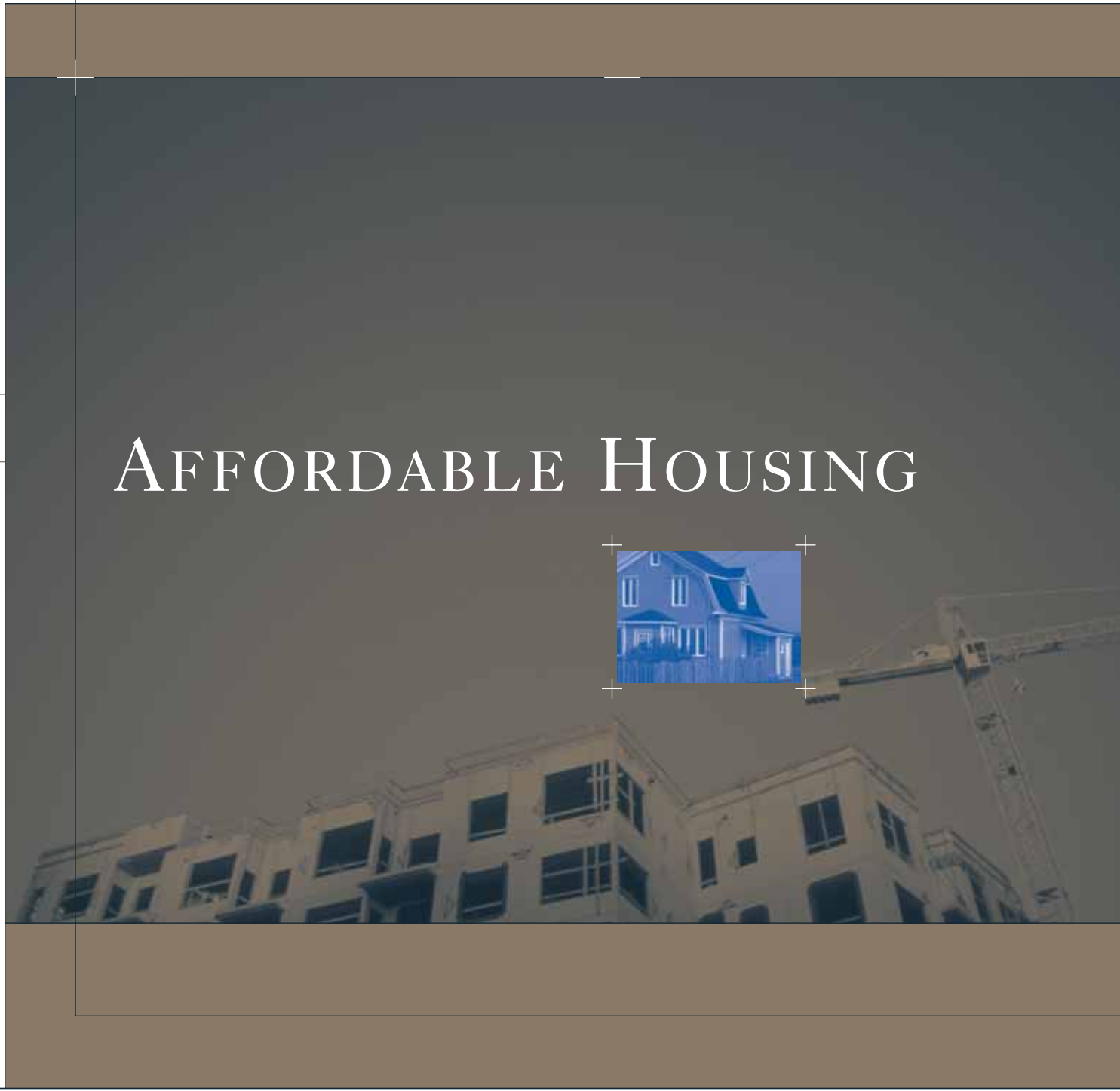
Recent changes in federal and provincial housing policy have shifted many of the responsibilities and costs of building and maintaining the nation's affordable housing stock onto municipalities, without any concomitant sharing of additional revenues. The result is an increased burden on a municipal balance sheet that is largely restricted to raising the required revenues through the property tax, an inappropriate source of funding for these types of activities.

### Background

Constitutionally, housing is primarily a provincial and territorial responsibility, although there is a long history after World War II of active federal involvement and, more specifically, funding to support the construction and rehabilitation of housing.



# AFFORDABLE HOUSING



The municipal role in housing has traditionally focused on planning and regulating new development. However, some municipalities have also had direct roles in building and managing affordable housing through municipal non-profit housing corporations, which use federal and provincial subsidies but which absorb some of the overhead costs. Some municipalities, such as Vancouver and Montreal, also contribute to funding under some older public housing agreements and typically cover 12.5 per cent of the total subsidy cost.

Housing is, by its nature, delivered locally and most benefits accrue locally. However, affordable housing's significant benefits also accumulate regionally or nationally. Many cities tend to carry the burden of shelter and income concerns for the surrounding region. Moreover, fundamental regional, provincial, territorial or national policies and initiatives, such as economic development and immigration, depend, in part, on the ability of people to find a place to live in cities.

An analysis conducted for FCM in 2004 determined that each unit of new affordable rental housing generates financial benefits disproportionately in favour of the federal and provincial government, based on a production of 25,000 units (5,000 at market and 20,000 below market) a year.<sup>35</sup>

Investing in affordable housing has broad local benefits. It is an economic stimulus through construction employment generation. Affordable and quality housing is widely acknowledged to be a foundation for health, educational and other critical outcomes. An investment in affordable housing can also lower other costs typically incurred by homeless individuals.

## Federal and Provincial Housing Policy in the 1990s

Federal support for new social housing was terminated in the 1993 federal budget. The then-existing federal expenditure of \$1.9 billion (related to some 600,000 assisted units) was retained, but no new funding was available to expand supply or to meet demand. Because of the linked, cost-shared nature of F/P/T social housing, the federal budget freeze also allowed provinces and territories to eliminate or reduce budgets for new affordable housing.

The consequence is persistent levels of housing need and more visible problems of homelessness. There are also less visible consequences as low or moderate income households struggle to make ends meet as shelter costs rise above half their total income, crowding out other needs. The official measure of housing need jumped from 1.3 million households in 1991 to 1.56 million in 1996, and, by the last available estimate, still remains above the 1991 level (1.48 million households in 2001).<sup>36</sup> There is little evidence to suggest significant improvement since then.

The lack of a sufficient number of affordable dwellings has an important impact on both the local and national economy. High housing costs impact labour markets and labour mobility. A lack of affordable homes drives up wage costs and limits labour supply, especially in the lower paying service sectors.

<sup>35</sup> Moving Forward: Refining the FCM Recommendations for a National Affordable Housing Strategy. FCM, 2004.

<sup>36</sup> Homelessness – Causes and Effects. Vol 3: The Costs of Homelessness in British Columbia. British Columbia Ministry of Social Development and Economic Security, Victoria, 2001.

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## The Municipal Response

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In the face of declining federal and provincial funding, many municipalities have taken on the challenge of building new affordable housing. This includes using municipal revenues to fund new affordable development. It also includes foregoing municipal revenues by reducing property tax rates for affordable rental development and waiving a range of municipal fees and development charges intended to cover the associated cost of municipal infrastructure, such as roads, fire halls, police stations and community centres. As reducing fees is a hidden cost, distinct from direct expenditures, it is not reflected in national financial accounts. As such, estimates of aggregate local government spending on housing under-represent the true cost.

Separate from new responsibilities related to the construction of affordable housing, in Ontario both the administrative and funding responsibility for existing social housing subsidies was transferred from the province to municipalities.

Local government expenditures on housing subsidies are up from \$1.1 billion in 1998 to \$2.1 billion in 2004.<sup>37</sup> Since 2000, the aggregate expenditures of local government on housing programs have increased by almost \$600 million, while federal aggregate expenditures increased by only \$160 million and aggregate provincial expenditures declined by \$625 million. The provincial figure, however, is largely a function of the devolution of funding responsibility to the municipal level in Ontario.

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## Recent Changes

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Federal withdrawal from new supply funding, and provincial emulation of the expenditure freeze, left a void in new housing expenditures through the remainder of the 1990s until the 2001 Affordable Housing Initiative.

In response to the alarming trends in housing affordability and homelessness, the federal government, in 1999, authorized the National Homelessness Initiative and, in 2001, a new Affordable Housing Initiative with \$1 billion in capital funding to develop affordable housing. Municipal governments connect to the program in different ways, depending on the province or territory, although in all jurisdictions municipalities have been required to contribute to the provincial contribution and to participate in the development and planning approval process. While some municipalities have been able to actively participate and contribute, others have lacked either the expertise or, more significantly, the fiscal capacity to do so.

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<sup>37</sup> The Cost of Homelessness: An Analysis of Alternate Responses in Four Canadian Cities. Prepared for the National Secretariat on Homelessness, Human Resources and Skills Development Canada, 2005.

## Immigrant Settlement

Today's pattern of immigration has significantly changed the face of communities in Canada. Municipalities are now required to be active in all phases of settling and integrating new Canadians, often doing so beyond existing federally and provincially funded programs. These new areas of responsibility are often only partially consistent with traditionally defined municipal roles and available fiscal resources. Municipal governments have had to develop the expertise and capacity to provide community infrastructure and services that respond to the needs and potential of immigrants. This is a vital but unfunded mandate.

### Background

Immigration enriches our communities and strengthens our economy. In 2004 alone, Canada welcomed more than 235,000 immigrants and refugees.<sup>38</sup> Immigration today represents an important response to low birth rates and the subsequent declining labour force and scarcity of particular skills. Between 1991 and 1996, immigration was responsible for over half of Canada's population growth and an even higher portion of its labour market growth. In recent years, the Government of Canada has consistently set high immigration targets. Not only is the total number of immigrants as a portion of the total population growing, immigrants are also coming from more countries.

The combination of more and increasingly diverse immigrants means that the issues of settlement and integration of newcomers have changed, both in character and scope. Nevertheless, the extent to which immigrants succeed in our communities contributes significantly to the successful implementation of Canada's immigration policy.

The critical period of settlement and integration lasts at least the ten years following the initial immigration. Initial settlement often requires services to provide food, clothing, shelter and orientation, followed by equally vital but broader services linked to access to language training, labour markets, health services, affordable housing and civic engagement in economic, cultural, social and political life.

## Settling and Integrating Newcomers: the Municipal Role

Municipal involvement in initial settlement services—the shelter, food and initial language training provided when immigrants first arrive—varies across the country. Regardless, municipalities are consistently involved at some level in crucial first-phase settlement services because of the gaps they know exist.

First-phase settlement services, including language training, are generally provided for through federal and provincial programs. However, municipalities are often involved in delivering first-phase services, even though these services are generally not funded by federal or provincial sources. Municipalities may fund community-based organizations that work with newcomers. Or they may fund more direct avenues, such as municipal library services, which often provide programs to serve immigrants across the country. For example, the libraries of Winnipeg and Vancouver offer English-as-a-second-language (ESL) classes and materials specifically targeted to recent immigrants, which supplement existing programs that may not meet local demand.

There are other settlement needs, not met by federal policies or programs, to which municipal governments must respond, since they are the order of government immigrants often approach first when they encounter settlement challenges. For example, while refugees wait for their applications for landed immigrant status to be approved they are often excluded from many federally and provincially funded services; municipalities will often become the service providers of last resort. Refugees, as residents without legal status, are ineligible for provincial social housing in Quebec, but they have been increasingly directed to the City of Montreal's municipal non-profit housing agency, which will serve them. Some Ontario municipalities have been using municipal funds to provide emergency income assistance to refugees in cases of sponsorship breakdown.

Beyond more direct settlement services, municipalities realize that, in order to help newcomers integrate and to realize the full economic and social benefits that immigrants can bring to their communities (and to the nation), they must ensure that municipal services meet

<sup>38</sup> Citizenship and Immigration Canada. Facts and Figures 2004: Immigration Overview <<http://www.cic.gc.ca/english/pub/facts2004/overview/3.html>>

# IMMIGRANT SETTLEMENT



## Environmental Protection

their unique needs. For example, because close to half of new immigrants arrive in Canadian communities without sufficient French or English language ability, information about many essential municipal services—everything from garbage pick-up schedules to emergency services—must be translated. Developing culturally sensitive civic institutions that reflect the population, as well as taking measures to ensure their communities are welcoming, is also critical. This means that the municipal balance sheet ends up covering cultural awareness training for municipal staff and anti-discrimination public education programs.

### Who Pays? Who Benefits?

While these additional and adapted services that municipalities are now providing are significant, there is an imbalance in how these initial services are paid for and in how the wider benefits that immigrants bring are distributed to communities, regions and the country as a whole. Some municipalities are immigration “magnets” that initially attract newcomers, and therefore provide these initial settlement and integration services, whereas others, often in surrounding communities, may receive immigrants after the initial, costly settlement period is over.

A further imbalance exists in that some municipalities are not traditional immigration destinations, but still need to attract new residents, so they try to draw immigrants to their communities without necessarily having the resources to do so. While the wide-reaching social and economic benefits of immigration for the country as a whole are evident, there is clearly a considerable imbalance in where the resources required to reap these benefits are coming from.

### Immigrant Services – Another New Cost-Driver

The extent and cost of immigration settlement activities provided by municipalities is exceedingly difficult to measure, as virtually all municipal services are involved. However, some examples of direct costs related to immigration have been measured by individual municipal governments. The City of Toronto estimates that, in 2005, they paid \$2.2 million in shelter costs for refugees, based on an average length of stay and average costs.

Responsibility for environmental protection and sustainable resource use is shared among all orders of government, with the federal *Canadian Environmental Protection Act* serving as the primary legislative framework. For their part, provincial and territorial governments carry out responsibilities related to federal legislation by establishing environmental regulations and policies, such as those related to air, water, waste, energy, brownfields and pesticides.

### New Regulations, New Costs

In 2002, following the province’s Core Review of all ministries, British Columbia’s Ministry of Air, Land and Water Protection was faced with a 50 per cent reduction in its annual budget. Concerned that these reductions would result in a transfer of financial responsibilities to local governments, the Union of British Columbia Municipalities (UBCM) reviewed the potential implications of new environmental regulations on local governments in British Columbia.

The review noted that the Ministry’s shift to a “shared stewardship” approach, in combination with new environmental regulations, would result in uncertainty regarding the division of environmental responsibilities and in the assignment of accountability. In some cases, UBCM also indicated that responsibility for environmental management was clearly being transferred from the Ministry to local government—and without the appropriate transfer of supporting resources.<sup>39</sup>

The situation in British Columbia is not unique. Rather, it appears to be the norm. In making his recommendations with respect to the Walkerton Inquiry, Justice O’Connor estimated that it would cost Ontario’s municipal and provincial governments more than \$280 million to fully implement his 121 recommendations. To date, the additional capital cost to Ontario municipalities to respond to the recommendations has in fact exceeded \$800 million. Considerable additional capital expenditures are thought to be required to fully address the operating, training and testing requirements mandated by the province.<sup>40</sup>

<sup>39</sup> Union of British Columbia Municipalities, 2003. “New Environment legislation: Impacts and Implications for Local Government.”  
<sup>40</sup> Province of Ontario, July 2005. Watertight: Report of the Water Strategy Expert Panel. Toronto



# ENVIRONMENTAL PROTECTION



Similarly, the province of Quebec has established aggressive recycling and diversion targets for municipalities, to be achieved by 2008. While the province estimates incremental costs of \$50 million, half of which will be paid by the private sector, the City of Montreal alone expects to invest more than that to meet the legislated requirements.

As federal legislation such as the *Canadian Environmental Protection Act* (CEPA) and the *Canadian Environmental Assessment Act* (CEAA) continue to be amended and reviewed, provincial and territorial governments are forced to respond with strengthened regulations and renewed policies. As a result, municipal governments are faced with the task of responding to new requirements, whether it be upgrading wastewater treatment systems, improving landfill design and maintenance, enhancing waste diversion and recycling programs or improving public transportation systems to help reduce air pollution and greenhouse gas emissions. Often, they are doing so with inadequate consideration and compensation of the implementation challenges faced by municipal governments.

## Paying for New Regulations

In some cases, municipalities can recover the costs of service provision through user fees, such as transit fares and charges for water and sewers. However, most environmental services are funded through the property tax. In the case of sewage treatment, for example, only 43.5 per cent of the total cost is covered by user fees;<sup>41</sup> the remainder is supported by the general tax base (25.8 per cent); reserves and/or debt financing (23.5 per cent); private/public partnerships (2.8 per cent); and provincial or territorial contributions (4.5 per cent).<sup>42</sup>

The National Roundtable on the Environment and the Economy (NRTEE) noted in its 2003 report on environmental quality in Canadian cities that, because of heavy reliance on property tax revenues, “cities have been unable to meet these new fiscal challenges and maintain the levels of investment and reinvestment needed to sustain urban environmental quality.”<sup>43</sup> The challenge of responding to environmental and other responsibilities is even more prevalent in Canada’s rural, remote and

northern communities, where revenue generated from property taxes and user fees is not sufficient to cover the costs of delivering services or implementing programs.

## Making Do: Managing New Regulations

Little comprehensive national data exist to detail the cost to municipal government of meeting federal, provincial and territorial environmental regulations. This issue points to a need for all orders of government to analyze and publicly share the cost implications of new regulations on municipal government. Providing this analysis would strengthen public policy decision-making, and doing so would improve cooperation and coordination across all three orders of government.

As Canada’s international reputation as an environmental leader continues to slide, we can—and should—expect the emergence of new environmental regulations and policies. The municipal sector hopes that this process of strengthening Canada’s environmental regulations will recognize the need for an updated fiscal policy that provides better horizontal coordination and improved vertical alignment of fiscal policies and programs.

## Public safety and emergency preparedness

*Based on a report prepared for FCM by the National Security Group*

There has been little change over time in how the three orders of government have shared responsibility for emergency preparedness in the nation’s communities. What has changed is the real and perceived risk environment, to which all orders of government must respond. A recent survey of municipalities carried out for FCM revealed that they perceive an increase in all categories of risk, particularly regarding the frequency and severity of risks involving weather, electrical power distribution systems, public health and hazardous materials transportation.<sup>44</sup>

<sup>41</sup> According to the national average

<sup>42</sup> Infrastructure Canada, 2003. *The State of Infrastructure in Canada*: [http://www.regionomics.com/Publications/Infrastructure%20study\\_Murtaza\\_Mirza.pdf](http://www.regionomics.com/Publications/Infrastructure%20study_Murtaza_Mirza.pdf)

<sup>43</sup> NRTEE, 2003. “Environmental Quality in Canadian Cities: the Federal Role”

<sup>44</sup> Municipal Emergency Preparedness and Management Costs, Global Change Strategies International Company, Ottawa, for FCM, October 2004



# PUBLIC SAFETY AND EMERGENCY PREPAREDNESS



The need to respond has resulted in significant additional costs to municipalities, particularly relating to fire, police and emergency medical services. Municipalities have, in many cases, devoted more resources to improved emergency operations centers, upgraded water treatment facilities, upgraded emergency plans, improved flood protection systems, emergency capacity of health units, development of public health as a core municipal emergency preparedness function, training, simulations and public education. The survey cited above found that most of these additional costs were funded out of already tight municipal budgets with few additional resources from the federal and provincial governments.

Ensuring “on the ground” preparedness in the face of increasing risk has fallen substantially to the municipalities, a de facto and largely unfunded change in responsibilities.

## Background

The term “public safety” covers many issues from the point of view of municipal governments. As the primary provider of first response capabilities, municipalities must have in place responses to a range of potential emergencies, including both natural and human-caused events. They must ensure that critical infrastructure, such as water systems, are protected and that business continuity is provided in such essential services as police operations, firefighting and sanitation. Municipalities are also responsible for protecting public health, including the control of outbreaks of infectious disease. Finally, they must provide for elements of public security, ensuring order at border crossings, ports and airports, and during public events.

Public safety, in general, also depends on the day-to-day operations of police, fire and ambulance services, and in all of these cases, expenditures are growing, particularly in smaller communities. However, this analysis will concentrate on the extent to which municipalities have become responsible for security and preparedness, as well as for the management of, response to and recovery from emergencies. These responsibilities have been offloaded or left to municipal governments without concomitant transfer of resources in the face of increased need and public expectations.

In all of these cases, municipal responsibilities are related to the responsibilities of the provinces, territories and federal government and of their police, health and defence services. Moreover, municipalities must respond to the load placed on local services by, in particular, national policies.

Essentially, the responsibility for dealing with an emergency moves from the municipality, which typically will use its first responders and services, to the province or territory, when local resources are not sufficient. Responsibility moves to the federal government, when the emergency is beyond the capabilities of the province, is national in scale or involves terrorism.

Federal legislation sets out the powers and responsibilities of the Government of Canada. The same legislation defines provincial and territorial interests regarding federal assistance provided during a provincial or territorial emergency. Municipal responsibilities are set out in provincial and territorial legislation governing all aspects of municipal operations.

Federally funded programs provide resources for specific requirements, such as the Joint Emergency Preparedness Program (JEPP), which shares the cost for key emergency preparedness activities and equipment among the three orders of governments. Another such program is the Disaster Financial Assistance Arrangements (DFAA), which provide compensation for recovery costs when they exceed a threshold based on provincial population. Federal, provincial and territorial infrastructure programs provide some resources for preparing infrastructure to mitigate risks.

The federal, provincial and territorial governments provide, to some extent, training and standards for emergency plans, as do some municipalities.

There is some disagreement as to whether health emergencies are covered by the current federal legislation on emergencies and, if so, whether the legislation would allow timely and effective national response and communications.

## Sharing Responsibility for a National Priority

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A significant consideration, when looking at the extent to which a service is being delivered and paid for by the correct jurisdiction, is the extent to which it is based on a specific location and whether or not the benefits “spill” out to others who are not paying for the service.

The federal, provincial and territorial governments do indeed handle overall planning of emergency management and do provide security through national bodies. Most services, however, are delivered in a specific place, and usually by the municipal government. For example, a major tie-up at border points, like Windsor, or the Port of Montreal, in which case municipal forces would be directly implicated, would affect flows of goods and materials all over Canada and the United States.

Likewise, the Toronto Transit Authority, and Toronto’s police, fire and ambulance personnel, are responsible for being prepared for an emergency on the subway line. Depending on the scale of the incident, however, the response to it could affect the lives of thousands of people working but not living in the city itself and could also affect business and life throughout a much larger urban area.

There has already been an incident where we have seen “spilling.” The control of the SARS outbreak several years ago fell largely on the City of Toronto’s public health authorities, even though SARS could have had major consequences for much of Canada had the response not been successful.

Finally, in the event of a disaster, municipalities are responsible for continuity of most critical services, the absence of which could quickly affect people and business in adjacent jurisdictions, if not the entire country.

## The Financial Cost of Keeping our Communities Safe

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Municipalities rightly perceive an increase in all types of risks, particularly, as noted above, the frequency and severity of weather-related events. For instance, the

number of weather-related natural disasters in Canada increased six-fold from 1960 to 2000 and the cost of these calamities have risen from under \$2 billion to over \$13 billion.

Protection is the single largest growing expenditure, representing from a quarter to half of municipal expenditure growth. Emergency services are taking up an increasing proportion of municipal growth at the expense of other important services. For six western cities, spending for protection services (police, fire, and EMS) rose 53 per cent from 1990 to 2002, taking an increasing share of overall operating budgets (26 per cent for fire and 39 per cent for police). Winnipeg estimated in 2004 that EMS costs alone increased by about 40 per cent over the past five years. Edmonton’s emergency budget rose by 300 per cent in 2003, while Ottawa and Calgary provided additional capital funds over the last five years (\$3.1 million and \$7.1 million respectively).

Payments in lieu of taxes (PILT) do not adequately compensate municipalities for the additional emergency preparedness costs associated with certain types of federal, provincial or territorial infrastructure. Nor do they compensate for the municipal costs of hosting large international events or visiting foreign leaders. For example, as of October 2004, the City of Calgary was still waiting for final payment from the federal government to compensate it for hosting the 2000 G8 conference.

Most municipalities have or are in the process of renewing their emergency plans due to provincial legislation, with little or no support funding. There is a general lack of resources for training key personnel. Some Canadian municipal emergency responders along the border are trained for free by the United States. The proportion of total municipal budgets devoted to protection is at 19 per cent or 20 per cent and is predicted to rise quickly.

The emergency services budgets of most municipalities have increased faster than other budget items, partly because of pressures beyond municipal control, and there is little or no funding from other orders of governments to offset these increases.

BALANCING THE EQUATION:

# RESTORING THE MUNICIPAL FISCAL BALANCE

FIRST AND FOREMOST, THIS REQUIRES ONGOING RESPECT FOR LOCAL AUTONOMY AND DIVERSITY AND FOR THE ROLES AND RESPONSIBILITIES THAT OTHER ORDERS OF GOVERNMENT ARE BEST PLACED TO PERFORM, WHETHER BY VIRTUE OF THEIR EXCLUSIVE CONSTITUTIONAL JURISDICTION OR BECAUSE THEY HAVE A COMPARATIVE ADVANTAGE IN THE DELIVERY OF PROGRAMS AND POLICIES IN PARTICULAR AREAS.

Federal Budget 2006,  
*Restoring Fiscal Balance in  
Canada – Focusing on Priorities.*

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## The Urgency of Action

When it set out to prepare this report, FCM started with an ambitious goal: to define the extent to which a vertical fiscal imbalance between the federal, provincial/territorial and municipal orders of government exists and determine its causes.

One of our key findings is that the municipal fiscal imbalance had been pushed off the balance sheet and onto our streets. National public accounts do not capture the municipal fiscal imbalance. Municipalities must, by law, balance their books. Therefore, the municipal fiscal imbalance is measured primarily by its opportunity costs and deferred expenditures.

This report also illustrates how, in addition to an exploding infrastructure deficit, the principal cost drivers of the municipal fiscal imbalance are non-traditional responsibilities for which the property tax is not an adequate source of revenue.

Finally, this report demonstrates that, in the absence of an updated fiscal tool kit, these increased demands and responsibilities create a vicious circle that undermines critical investment in municipal infrastructure, creating a massive infrastructure deficit.

Cities and communities are the keys to Canada's well-being and prosperity, the dynamos that drive economic growth for the country. They are where most Canadians live, and they set the markers by which our success as a nation is measured.

Yet, although we depend on strong cities and communities for our prosperity and quality of life, these dynamos are faltering. We see the signs of decline, the wear and tear that signals trouble. We see streets, buses, bridges, water systems—all not working as well as they should, not maintained as well as they could be. And we see municipal governments unable to provide needed human services, often offloaded onto them by other orders of government, without consultation or compensation, with inadequate resources.

We cannot afford to let this continue. The link between healthy cities and communities and productivity and competitiveness is well established. The key to maintaining international competitiveness is the capacity to attract and retain human and financial capital. To do this, our cities and communities must be among the best in the world in which to live and work. That distinction is no longer guaranteed.



“EACH ORDER OF GOVERNMENT MUST THEREFORE CONTRIBUTE TO CREATING AN ENVIRONMENT THAT ALLOWS THE PRIVATE SECTOR TO GENERATE THE WEALTH NECESSARY TO FOSTER SHARED GOALS OF JOB CREATION AND HIGH LIVING STANDARDS, WHILE MAINTAINING A SUSTAINABLE ENVIRONMENT AND HIGH-QUALITY PUBLIC SERVICES. DOING SO WILL ALSO MEAN REDUCING TAXES FOR ALL CANADIANS SO THAT THEY HAVE MORE MONEY TO MAKE CHOICES ABOUT WHAT TO BUY, WHEN TO SAVE, AND WHERE TO INVEST TO ALLOW OUR ECONOMY TO GROW TO ITS FULL POTENTIAL.”

*Federal Budget 2006, Restoring Fiscal Balance in Canada – Focusing on Priorities.*

We must ensure that our cities and communities function well; their transportation infrastructure moves people and goods efficiently; their solid-waste management is sustainable and cost-effective; their water is safe to drink; and their residents have access to housing, recreation and culture.

Canada now stands at an historic crossroads. Our country faces international competition on a level never before seen. And it faces off against these new economic tigers at the same time as demographic pressures are placing a growing strain on public finances. As the Council of the Federation report, *Reconciling the Irreconcilable*, points out, the demands placed on the healthcare system and other services by our aging population will greatly diminish our fiscal room in the future.



That is why it is so important to address the municipal fiscal imbalance now. We do not have the luxury of waiting 20 years before resolving the municipal fiscal crisis. We cannot fall further behind. It will simply be too late.

This report does not recommend a definitive or singular remedy for the municipal fiscal imbalance. Rather, it outlines six elements essential to the establishment of a national framework that respects provincial/territorial jurisdiction but secures a rational model to address the fiscal challenges facing municipalities today.

## Converging Interests

“FEDERAL, PROVINCIAL, TERRITORIAL AND MUNICIPAL GOVERNMENTS, WORKING TOGETHER, HAVE CREATED A NETWORK OF PROGRAMS COVERING HEALTH, EDUCATION, SOCIAL SERVICES, INFRASTRUCTURE, JUSTICE AND A RANGE OF ECONOMIC AND SOCIAL POLICIES DESIGNED BOTH TO IMPROVE THE QUALITY OF LIFE OF CANADIANS AND TO ENHANCE THE ECONOMIC PERFORMANCE OF THE COUNTRY.”

*Federal Budget 2006, Restoring Fiscal Balance in Canada – Focusing on Priorities.*

In the last Budget, the Government of Canada committed to streamlining roles and responsibilities and to focusing on delivering “federal services that reflect Canada-wide needs and priorities.” Provinces and territories applauded this apparent renewed federal respect for their jurisdiction. We also believe that it is an essential precursor to finding lasting solutions to the fiscal imbalance.

Canada’s cities and communities are the direct constitutional responsibility of provinces and territories, but their success is also in the national interest. The challenges faced by our municipal governments threaten the nation’s continued success and are too large to be dealt with by any one order of government alone.

At the same time as our cities and communities falter, fighting to succeed in the absence of a national vision that anticipates their needs and leverages their strengths, the other orders of government struggle to find the keys to unlock greater national productivity, continued prosperity and the protection of our valued and envied quality of life. We are convinced that we will find solutions if we acknowledge that there exists a convergence of interests that can inspire all orders of government. It is from that point of convergence that we must begin our search for solutions.

“TO ENSURE GROWING LIVING STANDARDS AND ENABLE CANADIANS TO RECEIVE THE QUALITY PUBLIC SERVICES THEY EXPECT OF THEIR GOVERNMENTS, THE GOVERNMENT OF CANADA IS COMMITTED TO REDUCING OR ELIMINATING IMPEDIMENTS TO THE COMPETITIVENESS AND EFFICIENCY OF CANADA’S ECONOMIC UNION.”

*Federal Budget 2006, Restoring Fiscal Balance in Canada – Focusing on Priorities.*

## Options to Restore Balance to Municipal Finances

Finding a solution to the municipal fiscal imbalance will require a concerted plan of attack from Canada’s three orders of government. As FCM’s Big City Mayors’ Caucus pointed out in its report, “there is no single action that any one government can take on its own to rebalance the municipal, provincial/territorial and federal fiscal relationship.”

To succeed, municipal governments must be able to diversify their revenues while operating in a more rational and predictable public policy environment. This means that current roles and responsibilities must be reassessed. It also means that the crippling structural infrastructure deficit municipalities are now saddled with must be reduced and eventually eliminated.

These recommendations are presented for consideration by the Government of Canada and all provincial and territorial governments. They are designed to begin a dialogue we hope will result in a national plan to balance Canada's fiscal equation.

## 1. CLARIFY ROLES AND RESPONSIBILITIES

“ACCOUNTABILITY AND CLARITY OF ROLES AND RESPONSIBILITIES REQUIRE THAT EACH ORDER OF GOVERNMENT HAVE ACCESS TO THE REVENUE REQUIRED TO FULFILL ITS ROLES AND RESPONSIBILITIES.”

*Federal Budget 2006, Restoring Fiscal Balance in Canada – Focusing on Priorities.*

A long-term plan and new fiscal arrangements are key steps to restoring the fiscal health of our cities and communities and renewing their infrastructure, but more is needed. We must reinvent the way governments work together. We can no longer afford governments working at cross-purposes or in isolation.

Taxpayers do not care about jurisdictional squabbles. They expect their governments—federal, provincial/territorial and municipal—to work together to find economies, efficiencies and street-level solutions. They expect smart government, and that means collaboration, not competition or confrontation.

Many public policies and programs overlap among orders of government. All governments need to work together to re-align roles and responsibilities with the appropriate financial resources. Identifying clear roles, responsibilities and resources is essential to ensure that the services governments provide are delivered with quality, equity and efficiency. Working together will ensure that each government's expertise meaningfully informs policy and program development and implementation.

Much of the offloading experienced by municipalities in the 1990s was not informed by a rational debate on which order of government is best suited to deal with these issues. Many of these offloaded services cannot or should not be funded by the property tax, limited as it is in its growth potential and regressivity.

In the context of the fiscal imbalance discussions, all governments must identify areas of policy and program overlap and begin coordinating efforts. It is imperative that municipal governments be consulted in all areas of program and policy development that have the potential to affect them. Additionally, any discussions must include consideration for funding joint mandates.

“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.”

*Harry Kitchen, and Enid Slack, 2003: “New Finance Options for Municipal Governments.” Published in the Canadian Tax Journal, Volume 5.*

Clarifying roles and responsibilities, as well as looking at options for reducing the fiscal imbalance requires information on the revenues and expenditures of individual municipalities across the country that is not currently available on a comparative basis. More data and analysis is also needed to quantify the service delivery and infrastructure gaps at the municipal level. Planning for the collection and analysis of this data will need to be part of discussions on clarifying roles and responsibilities.

## 2. DEVELOP LONG-TERM PLAN TO ELIMINATE THE INFRASTRUCTURE DEFICIT

“... LARGER, ONGOING INVESTMENTS IN CANADA'S INFRASTRUCTURE WILL BE NEEDED TO BUILD A STRONGER ECONOMIC UNION, TAKE ADVANTAGE OF OPPORTUNITIES ABROAD AND ENHANCE QUALITY OF LIFE. THE FEDERAL GOVERNMENT, PROVINCES AND TERRITORIES, CITIES AND OTHER COMMUNITIES EACH HAVE IMPORTANT ROLES TO PLAY IN THIS REGARD.”

*Federal Budget 2006, Restoring Fiscal Balance in Canada – Focusing on Priorities.*

Estimates place the municipal infrastructure deficit at approximately \$60 billion. This is the principal barrier to structural reform and it must be redressed. As we have shown, the size of this deficit, coupled with inadequate municipal revenue sources and growing responsibilities, have pushed it beyond the scope of what municipal governments can finance alone. What is needed is a long-term plan to provide a strategic decision and financing framework for infrastructure investments in municipal infrastructure. Given the scope of the problem and its implications for our national competitiveness and prosperity, the Government of Canada must lead the way, working with provincial/territorial and municipal governments to establish realistic targets and accountabilities.

This plan must be based on a real commitment to eliminate the infrastructure deficit and on agreed-upon investment priorities and strategies. It must include a new longer-term legislative framework for sharing federal gas tax or other revenue; long-term funding for targeted infrastructure programs; and the development of new municipal efficiencies and accountabilities through tools such as FCM's InfraGuide and the development of transparent performance indicators.

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“ELIMINATING THE FEDERAL ANNUAL BUDGET DEFICIT PRODUCED SIZEABLE DIVIDENDS FOR CANADIANS, HELPING GENERATE THE CURRENT SURPLUS AND FREEING UP RESOURCES FOR HEALTH CARE AND OTHER PURPOSES. ELIMINATING THE INFRASTRUCTURE DEFICIT WOULD RELIEVE THE ECONOMY OF THE DRAG OF OUTWORN, INEFFICIENT INFRASTRUCTURE ALWAYS IN NEED OF REPAIR.”

*FCM President Gloria Kovach, Ottawa Citizen, 2006*

### 3. DIVERSIFY MUNICIPAL REVENUE TOOLS

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“WHETHER OR NOT PROPERTY TAXES ARE NOW TOO HIGH, A CASE CAN BE MADE FOR A GREATER MIX OF TAXES AT THE MUNICIPAL LEVEL.”

*Harry Kitchen, and Enid Slack, 2003: “New Finance Options for Municipal Governments.” Published in the Canadian Tax Journal, Volume 5.*

In contrast to the limited revenues available to municipal governments, the provincial/territorial and federal governments have access to multiple sources of revenue. This diversity of revenue sources, coupled with their revenue-generating capacity, gives these orders of government a significant fiscal advantage.

We need a more equitable sharing of current fiscal resources among all orders of government and a modernization of existing municipal fiscal authorities. This can be achieved, in partnership with provincial/territorial governments, by modernizing the municipal fiscal framework—for example, through a share of more elastic tax revenues and increased capacity to levy user fees. In partnership with the federal, provincial and territorial governments, this can be achieved through a long-term revenue-sharing agreement and a targeted infrastructure program that will ensure sustainable, adequate and predictable sources of revenue for investment in municipal infrastructure.

Dealing with the fiscal roots of the problem will help to reduce municipal dependence on property taxes, diversify municipal sources of income and, most importantly, give Canada's cities and communities the resources to maintain and renew their infrastructure and ensure they do not fall back into disrepair.

Cities and communities clearly need a greater diversity of revenues to fund the wide range and types of services they deliver. The fiscal imbalance discussions provide the venue for all governments, in partnership, to determine the appropriate mechanisms to achieve this objective.



#### 4. FOCUS ON INTEGRATED APPROACHES TO RURAL AND NORTHERN DEVELOPMENT

Many of the measures proposed here, such as addressing the municipal infrastructure deficit or diversifying municipal revenues, will assist in developing fiscal sustainability of rural, remote and northern communities. However, they will not be sufficient. A one-size-fits-all approach to addressing the municipal fiscal imbalance will not work. This is why these additional measures specific to rural, remote and northern communities are needed.

For many municipal governments in rural, remote and northern regions, economic uncertainty impedes efforts to sustain financially viable communities. Economic development and diversification of these communities will make communities less dependent on single industries and natural resources and will mitigate the strains municipal governments face in coping with a boom-and-bust local economy. The provision of adequate public infrastructure is even more critical for rural, remote and northern economies that must overcome or compensate for limited accessibility and economies of scale, in order to compete effectively. Similarly, broadband internet, although often delivered by private sector interests, is a required component of rural, remote and northern infrastructure.

An effective response to these challenges has to address rural development policies and programs of all orders of government. The economic base is *the* central factor in the fiscal viability of the majority of rural municipalities; a pivotal means to the ends. For the most part, each order of government has separately undertaken visions and strategies for rural development. However, efforts must be made to integrate and coordinate policies and programs among all governments and avoid a one-size-fits-all solution by recognizing the unique challenges and opportunities that exist in rural, remote and northern communities.

#### 5. INVEST IN PUBLIC TRANSIT

Public transit is the only universally accessible form of urban transport that provides access to employment, education, health care and recreation. Safe, reliable and efficient public transit is vital to the movement of people in urban economies, presenting undeniable economic, environmental and social benefits. Without public transit, many of our urban centres would be gridlocked, as growing numbers of vehicles compete for scarce road-space.

Traffic congestion has far-reaching health and economic implications. Under-investment in public transit is one manifestation of the infrastructure deficit. It must be addressed through a long-term national plan and commitment. The Canadian Urban Transit Association has estimated that transit systems across the country need \$20.7 billion for infrastructure between 2006 and 2010, which covers rehabilitating and replacing existing systems plus expansion plans to accommodate increasing numbers of riders.

Canada is the only G-8 country without a national transportation program. This is affecting our global competitiveness. Recent measures by the Government of Canada, such as recent transit-funding announcements, gas-tax sharing, and the introduction of a transit-user tax credit are all important. What is required now is the development of a permanent plan to support transit.

#### 6. CHANGE MUNICIPAL PRACTICES

Addressing the fiscal challenges of Canada's cities and communities as part of the fiscal-balance discussions will require a commitment by all three orders of government. Municipal governments will need to work with their provincial and territorial partners to review the legislative and administrative framework within which they operate. Municipalities will need to look at how they price their services, plan for growth and generate revenues. Municipalities are ready to do their part, but their efforts must be coordinated with and supported by the other orders of government to maximize outcomes, leverage synergies and achieve clear and ambitious objectives.

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None of this can happen overnight. These structural changes, involving different governments, legislative changes and administrative reforms, will be complex and interdependent. Targets and milestones must be set, performance indicators developed, and a long-term plan put in place to phase in these changes over the course of the next 20 years.

## The Way Forward

The link between healthy cities and communities and national prosperity and competitiveness is well understood. Our cities and communities are competing against the best in the world, but they are ill-equipped to compete. If they fail, Canada will fail, and our standard of living and quality of life will suffer.

We must ensure that our cities and communities are great places to live and work, with safe streets, clean air and water, efficient transportation for people and goods, sustainable waste-management, and access to housing, recreation and culture. We can debate how best to achieve this, but no one can deny it must be a key national goal. If we do not move quickly to fix the problems hampering our cities and communities, we may well lose our position in the front rank of nations and never get it back.

The Federation of Canadian Municipalities is ready to do its part to mobilize the resources of the municipal sector to find solutions, build partnerships and effect real change. But this is a national project. It remains for the Government of Canada to take the lead and set Canada on a course that will stand as a model of how smart, practical government, working in the service of people, can build cities and communities that create prosperity while preserving quality of life for everyone.

# APPENDICES



  
BACK

# 1. Conservative Party of Canada's January 17 Letter to FCM

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January 17, 2006

Attention: James Knight – Chief Executive Officer, FCM

## *Re: Conservative Party of Canada Response to the Federation of Canadian Municipalities*

Thank you very much for the opportunity to address your concerns. As you are no doubt aware, the Conservative Party is supportive of efforts to eliminate the infrastructure deficit, develop a long-term plan for the gas-tax transfer, maintain infrastructure funding, and include municipalities in discussions of issues related to their jurisdiction and concerns.

The Conservative Party has released its platform related to infrastructure and municipalities, and it contains the following measures related to your questions:

- The Conservative party recognizes and is committed to helping municipalities tackle the infrastructure deficit. After 12 years of the current Liberal government, cities have seen a vast reduction in the quality of their infrastructure and their own ability to help pay for improvements. Immediately upon being elected, my government will begin consultations with the provinces and municipal representatives with the intention to reach a long-term, comprehensive agreement, addressing both the vertical and horizontal fiscal imbalance. This will be a major priority of our government and has to be resolved so that other levels of government can operate without the accumulation of debt. The fiscal imbalance problem has allowed federal mismanagement of taxpayers' money totaling billions of dollars.
- Our plan includes maintaining the funding for the New Deal for Cities and Communities and fully implementing the transfer of the equivalent of five cents per litre of gasoline to cities and communities by 2009-10 for municipal infrastructure. However, we will expand the program so that all cities and communities, including those with more than 500,000 people, can use gas tax transfer dollars to build and repair roads and bridges, improve road safety, and fight traffic congestion, should they wish to do so.
- We will also maintain or enhance current infrastructure funding, including the Border Infrastructure Fund, the Canada Strategic Infrastructure Fund, the Municipal Rural Infrastructure Fund, and the Infrastructure Canada Program. As well, a new Conservative government will create a \$2 billion Highways and Border Infrastructure Fund, designed to upgrade Canada's National Highway System and improve border crossings. When fully implemented, the fund will provide \$600 million per year in federal investment for highways and border crossings.
- On the transit file, the Conservative party has developed a two-pronged approach to helping cities and commuters access high quality transit. First, we support the combined transit funding as outlined in Bills C-43, C-48 and C-66, including the \$800 million over the next two years for public transit infrastructure. At the same time, a Conservative government would also provide commuters with a 16% tax credit on the costs of transit passes. This will save the average commuter \$153 per year in transit costs. This will also provide incentives to commuters to use transit, and will result in more revenues for transit authorities across the country. With these revenues authorities will be better able to provide more and better services tailored to the specific needs of their ridership.
- Finally, a new Conservative government will also develop a national Road Congestion Index to track progress in reducing road congestion, and work towards reducing congestion levels in municipalities across Canada.

The Conservative Party was the first party to raise the gas-tax issue in the House of Commons, and we will continue to raise infrastructure issues as a government. We are proud of our record, and we will continue to work to build a country that includes and benefits Canadians who live in both urban and rural Canada.

Kind regards and thank you for your enquiry.

**The Conservative Party of Canada**

## 2. Trends in Public Finance

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By Professor Harry M. Kitchen

Trent University

and

Dr. Enid Slack

University of Toronto

Canada is a federation with three levels of government: the federal government, ten provincial and three territorial governments, and about 4,000 local governments. To understand trends in public finance in Canada, it is important to understand first the division of powers and responsibilities among the three orders of government.

The *Constitution Act*, 1982, lists the jurisdictions over which federal and provincial governments have lawmaking authority. The federal government maintains the “peace, order and good government” of the whole country by making laws with respect to immigration, unemployment insurance, trade and commerce, national defence, native affairs and criminal law. Provincial governments are empowered to control regional and local affairs including education, health, social services, property rights, administration of justice, local public works and municipal institutions. Some responsibilities are shared between the federal and provincial governments, such as immigration, agriculture and pensions. The responsibilities of municipal governments in Canada are set out in legislation in each province but generally comprise police and fire protection, roads and transit, water and sewers, solid waste, recreation and culture and planning.

The current division of spending responsibilities among the three orders of government and their ability to use own-source revenues to fund these responsibilities has led to concerns about the existence of a vertical fiscal imbalance. A vertical fiscal imbalance is said to exist when “the fiscal capacity of one order of government is insufficient to sustain its spending responsibilities while the fiscal capacity of another order of government is greater than is needed to sustain its spending obligations, while both orders of government provide public services to the same taxpayer.”<sup>45</sup> This paper does not discuss the fiscal imbalance but it does provide an assessment of trends in the levels of expenditures and revenues by all three orders of government, trends that are important in assessing the extent to which there is a fiscal imbalance.<sup>46</sup>

This paper begins with a presentation of trends in municipal expenditures over the period from 1988 to 2004. This discussion is followed by a description of trends in municipal revenue sources for the same period. Expenditure responsibilities and revenue trends of both the federal and provincial/territorial governments are also examined in separate sections of the paper. The paper concludes with a summary of findings and the implications for municipal fiscal imbalance.

<sup>45</sup> See the Standing Committee on Finance, “The Existence, Extent and Elimination of Canada’s Fiscal Imbalance.” Ottawa: House of Commons, 2005, p. 19.

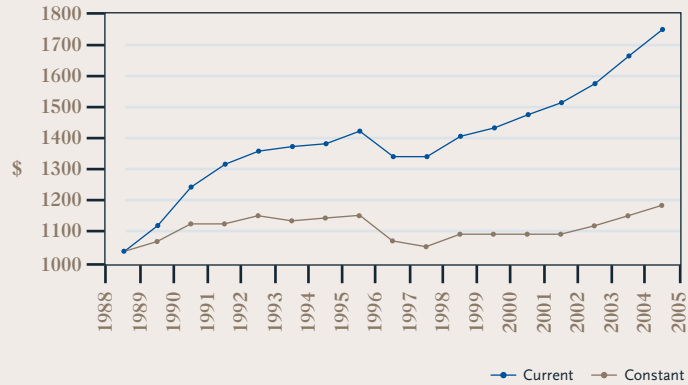
<sup>46</sup> For a discussion of the municipal fiscal balance, see Enid Slack, “Fiscal Imbalance: the Case for Cities.” A report prepared for the Federation of Canadian Municipalities, March 13, 2006.

## Municipal Expenditure Responsibilities and Trends

Over the period from 1988 to 2004, municipal expenditures in Canada increased steadily but the revenue-raising tools available to municipal governments have not changed. Figure 1 shows total municipal spending per capita<sup>47</sup> (including operating and capital expenditures)<sup>48</sup> over the 16-year period in current dollars and in constant (1988) dollars.<sup>49</sup> Although the average per capita expenditures for all municipal governments in Canada increased from \$1,039 to \$1,734 over the period, when adjusting for inflation per capita expenditures only increased from \$1,039 to \$1,181, representing an increase of less than 1 per cent per year, on average.

Table 1 shows the relative importance of expenditures by function for 1988 and 2004. Municipal governments in Canada are responsible for transportation (roads and transit), protection (police and fire), environment (water, sewers, and solid waste) and social services. They are

Figure 1: Total Municipal Expenditures in Canada, Current and Constant Dollars per Capita, 1988-2004



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Table 1: Distribution of Municipal Government Expenditures by Category, Canada 1988 and 2004

	1988		2004		% ANNUAL AVERAGE GROWTH RATE IN PER CAPITA CONSTANT DOLLARS
	(\$millions)	% of Total Expenditures	(\$millions)	% of Total Expenditures	
General Government Services	2,749	9.9	4,889	8.8	0.1
Protection	4,121	14.8	9,269	16.7	1.8
Transportation	6,197	22.3	10,796	19.5	0.0
Health	560	2.0	1,379	2.5	2.5
Social Services	2,053	7.4	5,655	10.2	3.6
Education	128	0.5	206	0.4	-0.5
Resource Conservation	585	2.1	1,044	1.9	0.1
Environment	4,064	14.6	10,052	18.1	2.6
Recreation and Culture	3,241	11.6	6,825	12.3	1.3
Housing	489	1.8	2,072	3.7	8.9
Regional Planning	572	2.1	1,025	1.8	0.1
Debt Charges	2,657	9.5	2,204	4.0	-3.3
Other Expenditures	432	1.6	56	0.1	-5.8
<b>Total Expenditures</b>	<b>27,849</b>	<b>100.0</b>	<b>55,472</b>	<b>100.0</b>	<b>0.9</b>

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

<sup>47</sup> Data for all figures are calculated from Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006).

<sup>48</sup> FMS data combine operating and capital expenditures. Municipalities are not permitted to run a deficit in their operating budgets but they are allowed to borrow to make capital expenditures. Operating expenditures generally increase steadily over time; capital expenditures tend to be lumpy. The construction of a major road in one year, for example, will increase capital expenditures significantly in that year. Capital expenditures in the following year could be much lower.

<sup>49</sup> Expenditures per capita in constant dollars eliminate the growth in population and inflation over the period.

also involved in public health, social housing, recreation and culture, and planning and development. The distribution of expenditures has not changed significantly over the 16-year period, with the exception of social services in Ontario, which increased significantly following the local services realignment in that province in 1998. Over the 16-year period, protection expenditures, expenditures on recreation and culture, and environmental expenditures increased as a proportion of total expenditures whereas expenditures on transportation, general administration, regional planning and debt charges fell. Overall, municipal government expenditures per capita in constant dollars increased at an annual average rate of 0.9 per cent. The largest proportionate increase has been for housing, reflecting the offloading of this service to municipal governments in Ontario in 1998.

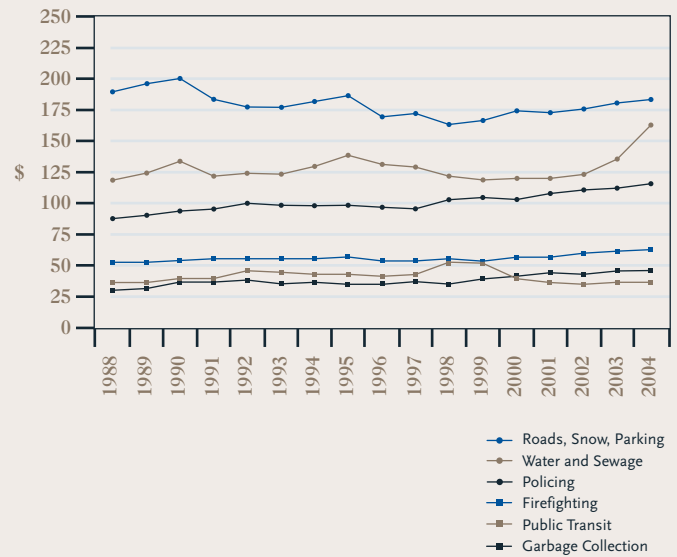
Figure 2 shows the trend in municipal expenditures per capita in constant dollars for the major expenditure categories. Expenditures on roads (including parking and snow removal) are lower at the end of the period than they were at the beginning of the period, as are transit expenditures. Expenditures on water and sewage, on the other hand, appear to have increased over the period as have expenditures on policing and garbage collection. This pattern reflects, partially at least, the growing demand for increasing municipal spending on environmental and safety concerns at the expense of roads.

## Municipal Revenue Sources and Trends

Table 2 compares the distribution of municipal revenues for 1988 and 2004. Property taxes were the largest source of revenue for municipalities in 2004, as they were in 1988. As a percentage of total revenues, they increased in relative importance by almost 10 per cent over the 16-year period,<sup>50</sup> rising from 48.6 per cent of all revenues in 1988 to 53.3 per cent in 2004. At the same time, user fees increased in relative importance by 17 per cent, rising from 20 per cent of all revenues in 1988 to 23.4 per cent by 2004. Intergovernmental transfers (mainly from provincial and territorial governments), on the other hand, decreased significantly. General purpose (unconditional) grants, in particular, fell by 48 per cent in relative importance, from 5.8 per cent of all revenues in 1988 to 3.0 per cent of all revenues in 2004. At the same time, specific purpose (conditional) transfers fell by almost 25 per cent in relative importance, from 17.1 per cent of all revenues in 1988 to 12.9 per cent in 2004. When specific purpose grants are separated into provincial and federal, the provincial decline of almost 29 per cent in relative importance was partially offset by an increase in the relative importance of federal grants, primarily for environmental projects. Overall, the relative importance of grant funding fell by 30 per cent from the beginning of the period.<sup>51</sup>

When the growth in municipal revenues is measured in constant dollars per capita, total revenues grew at an average annual rate of 0.7 per cent, which is less than the 0.9 per cent growth rate for expenditures noted above.

Figure 2: Selected Municipal Government Expenditures, per Capita Constant Dollars, 1988-2004



<sup>50</sup> This increase reflects the percentage change in the contribution of each revenue source to total municipal revenues over the period.

<sup>51</sup> Our estimates indicate that, if grants per capita in constant dollars had remained unchanged over the 16-year period, municipalities would have received an additional \$552 million.

Table 2: Distribution of Municipal Government Revenue, Canada, 1988 and 2004

	1988		2004		% ANNUAL AVERAGE GROWTH RATE IN PER CAPITA CONSTANT DOLLARS
	(\$millions)	% of Total Revenues	(\$millions)	% of Total Revenues	
Property and related taxes	13,187	48.6	28,399	53.3	1.4
Other taxes	384	1.4	770	1.5	0.9
User fees	5,426	20.0	12,491	23.4	2.0
Investment income	1,628	6.0	2,394	4.5	-1.0
Other	292	1.1	776	1.5	3.2
Total own-source revenue	20,917	77.1	44,830	84.1	1.4
General purpose transfers	1,579	5.8	1,576	3.0	-2.7
Specific purpose transfers	4,649	17.1	6,900	12.9	-1.0
- Federal	194	0.7	672	1.3	6.1
- Provincial	4,455	16.4	6,228	11.7	-1.3
Total Transfers	6,228	22.9	8,476	15.9	-1.4
Total Revenue	27,146	100.0	53,306	100.0	0.7

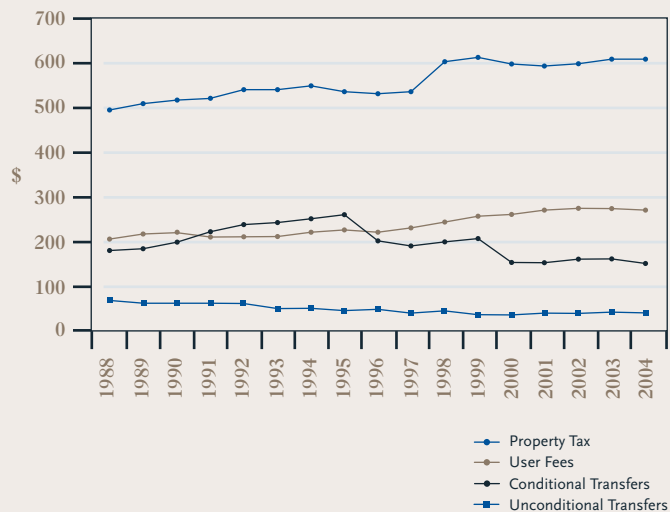
Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Figure 3 presents trends in property taxes, user fees, and conditional and unconditional grants. User fees in constant dollars per capita increased the most, rising at an annual average rate of 2.0 per cent while property taxes increased at a rate of 1.4 per cent, rising from a level of \$492 in 1988 to a level of \$605 in 2004. General purpose transfers, on the other hand, fell by 2.7 per cent and specific purpose transfers fell by an average of 1.0 per cent annually.

### Expenditure Responsibilities and Revenue Trends of the Federal and Provincial/Territorial Governments

This section reviews the expenditures and revenues of the federal, provincial and territorial governments over the same 16-year period.<sup>52</sup>

Figure 3: Major Municipal Government Revenues by Source, Constant Dollars per Capita, 1988-2004



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

<sup>52</sup> The estimates for the federal, provincial and territorial governments are from 1989 to 2005 because their fiscal year is April 1 to March 31. The year 1989, for example, thus refers to 1988/89.

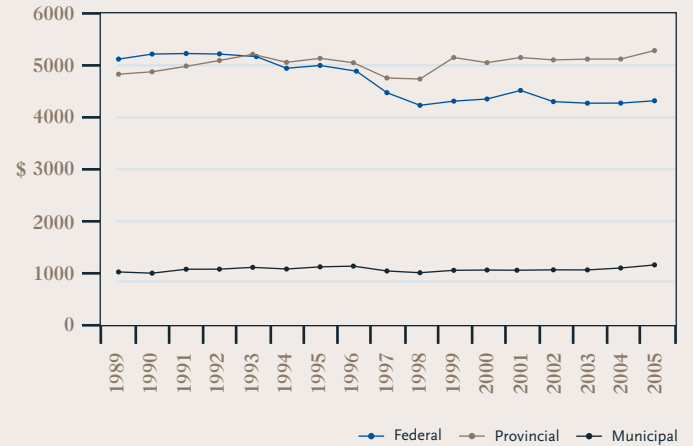


### Federal, Provincial and Territorial Expenditures

Figure 4 compares expenditures for all three orders of government over the period from 1989 to 2005. It indicates that federal expenditures per capita in constant dollars have fallen over the period, provincial expenditures have increased and municipal expenditures have increased but at a slower rate.

Table 3 indicates that the largest proportion of federal government expenditures is on social services, followed by debt charges, protection (policing), health and transfers to provincial governments. Over the 16-year period, debt charges have declined, in part, because interest rates have fallen but also because the federal government has been running a surplus and using some of it to pay down the federal debt.

Figure 4: Federal, Provincial and Municipal Government Expenditure, Constant Dollars per Capita, 1989-2005



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Table 3: Distribution of Federal Government Expenditures by Category, Canada 1989 and 2005

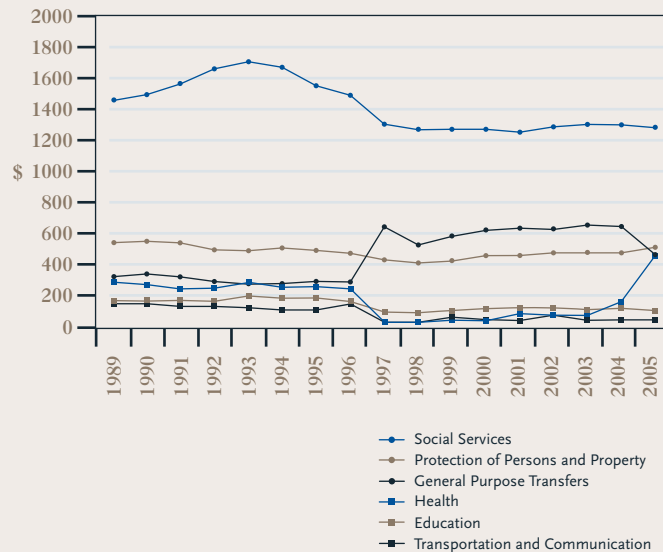
	1989		2005		% ANNUAL AVERAGE GROWTH RATE IN PER CAPITA CONSTANT DOLLARS
	(\$millions)	% of Total Expenditures	(\$millions)	% of Total Expenditures	
General Government Services	4,425	3.2	7,501	3.7	-0.2
Protection	14,758	10.8	23,861	11.7	-0.5
Transportation	4,249	3.1	2,314	1.1	-4.3
Health	7,723	5.7	22,377	10.9	4.1
Social Services	39,209	28.7	60,789	29.7	-0.7
Education	4,491	3.3	4,938	2.4	-2.3
Resource Conservation	8,150	6.0	8,027	3.9	-2.7
Environment	600	0.4	1,929	0.9	5.2
Recreation and Culture	2,381	1.7	4,093	2.0	-0.1
Labour/Employment/Immigration	1,938	1.4	2,739	1.3	-1.2
Other	6,675	4.9	10,474	5.1	-0.7
General Purpose Transfers	8,763	6.4	21,988	10.8	2.7
Debt Charges	33,190	24.3	33,324	16.3	-2.7
<b>Total Expenditures</b>	<b>136,559</b>	<b>100.0</b>	<b>204,382</b>	<b>100.0</b>	<b>-0.9</b>

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Figure 5 shows that transfers to the provinces have increased and federal expenditures on social services have fallen (although not as a proportion of total federal expenditures). In 1997, the Established Programs Financing (EPF) and the Canada Assistance Plan (CAP) were replaced by the Canada Health and Social Transfer (CHST). This change explains the increase in transfers and reduction in social service expenditures at the federal level. At the same time, federal expenditures increased for health and the environment, as did transfers to provincial governments. Overall, federal government expenditures per capita in constant dollars fell at an average annual rate of 0.9 per cent over the 16-year period.

The distribution of provincial and territorial government expenditures is set out in Table 4. The largest provincial government expenditures both in 1988 and 2005 were for health, education, social services and debt charges. Over the 16-year period, health expenditures as a proportion of total provincial government expenditures increased significantly. Transfers from the provinces to municipalities, on the other hand, fell at an annual average rate of 3.7 per cent over the 16-year period.

Figure 5: Federal Government Expenditures by Function, Constant Dollars per Capita, 1989-2005



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Table 4: Distribution of Provincial/Territorial Government Expenditures by Category, Canada 1989 and 2005

	1989		2005		% ANNUAL AVERAGE GROWTH RATE IN PER CAPITA CONSTANT DOLLARS
	(\$millions)	% of Total Expenditures	(\$millions)	% of Total Expenditures	
General government services	2,499	1.9	4,622	1.9	0.3
Protection	4,802	3.7	9,941	4.0	1.1
Transportation	7,074	5.5	10,367	4.2	-1.0
Health	33,449	26.0	82,648	33.6	2.6
Social services	21,646	16.8	39,158	15.9	0.2
Education	26,778	20.8	48,978	19.9	0.3
Resource conservation	7,489	5.8	11,414	4.6	-0.8
Environment	1,588	1.2	1,873	0.8	-2.0
Recreation and culture	1,554	1.2	2,747	1.1	0.1
Other	3,480	2.7	6,343	2.6	0.2
General purpose transfers	2,452	1.9	1,746	0.7	-3.7
Debt charges	15,768	12.3	26,384	10.7	-0.3
<b>Total expenditures</b>	<b>128,577</b>	<b>100.0</b>	<b>246,224</b>	<b>100.0</b>	<b>0.6</b>

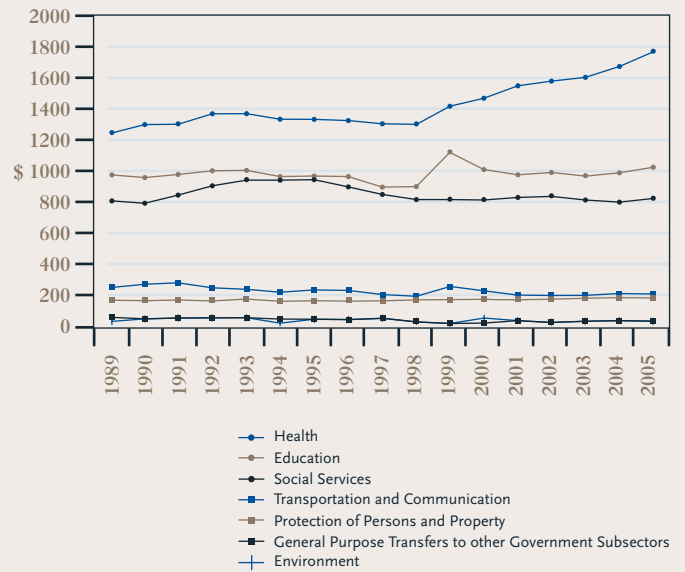
Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Figure 6 shows the trends in provincial government expenditures from 1989 to 2005. By far the most striking feature of this graph is the increase in provincial health expenditures. Overall, provincial expenditures per capita in constant dollars increased at an annual average rate of 0.6 per cent per year.

### Federal, Provincial and Territorial Revenues

Tables 5 and 6 show the distribution of revenue for the federal and provincial governments, respectively from 1989 to 2005. The largest sources of revenue for the federal government are personal income taxes, consumption taxes, and corporate income taxes. Over the 16-year period, revenues from both personal and corporate income taxes have increased at the federal level; consumption tax revenues have fallen. Overall, federal government revenues per capita in constant dollars have increased at the annual average rate of 0.6 percent at the same time that expenditures were falling at the annual average rate of 0.9 percent.

Figure 6: Provincial Government Expenditures by Function, Constant Dollars per Capita, 1989-2005



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Table 5: Distribution of Federal Government Revenues, Canada 1989 and 2005

	1989		2005		% ANNUAL AVERAGE GROWTH RATE IN PER CAPITA CONSTANT DOLLARS
	(\$millions)	% of Total Revenues	(\$millions)	% of Total Revenues	
Personal income taxes	47,750	43.5	97,488	45.9	1.0
Corporate income taxes	11,730	10.7	30,372	14.3	3.0
Consumption taxes	26,375	24.0	47,126	22.2	0.1
User fees	3,858	3.5	6,705	3.2	-0.1
Investment income	5,523	5.0	6,208	2.9	-2.2
Other	379	0.3	1,163	0.5	4.7
Total own-source revenue	109,519	99.7	211,499	99.7	0.6
General purpose transfers	328	0.3	590	0.3	0.2
Specific purpose transfers	45	0.0	84	0.0	0.4
Total transfers	373	0.3	674	0.3	0.2
Total revenue	109,892	100.0	212,173	100.0	0.6

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

In terms of provincial and territorial revenues, the largest sources are personal income taxes and consumption taxes (see Table 6) followed by transfers from the federal government. Another major source of revenue at the provincial level is investment income, driven primarily by their importance in provinces heavily endowed with natural resources: Saskatchewan (over 20 per cent of provincial revenues), Alberta (almost 40 per cent of provincial revenues) and British Columbia (almost 17 per cent of provincial revenues).

Although provincial property taxes only account for a small proportion of provincial revenues, they did increase over the 16-year period, largely because most provinces have taken over the education portion of property taxes. At the moment, school boards in Manitoba and Saskatchewan are the only ones that have local taxing power, a vast change from the beginning of the period when school boards in almost every province had taxing authority (New Brunswick was an exception). New Brunswick is the only province that has a province-wide provincial property tax for general purposes, although most provinces have collected property taxes for general purposes in unorganized territories and districts for some time.

Table 6: Distribution of Provincial Government Revenues, Canada, 1989 and 2005

	1989		2005		% ANNUAL AVERAGE GROWTH RATE IN PER CAPITA CONSTANT DOLLARS
	(\$millions)	% of Total Revenues	(\$millions)	% of Total Revenues	
Personal income taxes	31,099	25.0	56,693	23.0	0.2
Corporate income taxes	5,876	5.0	15,416	6.0	3.1
Consumption taxes	28,114	23.0	56,836	23.0	1.0
Property taxes	3,607	3.0	9,488	4.0	3.1
User fees	3,601	3.0	6,405	3.0	0.1
Investment income	12,527	10.0	27,602	11.0	1.6
Other	14,446	12.0	28,128	11.0	0.7
Total own-source revenue	99,270	80.0	200,568	81.0	1.0
General purpose transfers	9,209	7.0	26,174	11.0	3.9
Specific purpose transfers	15,697	13.0	19,607	8.0	-1.8
Total transfers	24,906	20.0	45,781	19.0	0.3
Total revenue	124,176	100.0	246,349	100.0	0.8

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

This increase in the relative importance of provincial property taxes may not seem significant in total but it may be important at the margin because it might be crowding out a municipality's desire to raise property taxes for municipal purposes. A study in Ontario in the early 1990s (when school boards had taxing powers) concluded that local school property taxes crowded out municipal property taxes.<sup>53</sup> We may still be seeing this impact with provincial education property taxes.

Finally, federal transfers to the provinces accounted for 19 per cent of provincial revenues in 2005, a slight increase over the period. Overall, the annual average growth in provincial revenues in constant dollars per capita over the 16-year period was 0.8 per cent, which is somewhat greater than the rate of growth in expenditures (at 0.6 per cent).

<sup>53</sup> Wade Locke and Almos Tassanyi. "Shared Tax Bases and Local Public Expenditure Decisions," (1993), vol. 41, no. 5, Canadian Tax Journal 941-57.



## Comparative Analysis of Revenue-Raising Capacity of the Federal, Provincial/Territorial and Municipal Governments

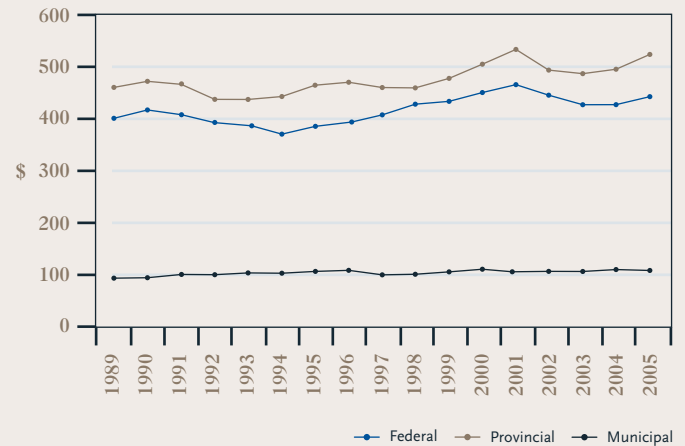
Figure 7 compares total revenues per capita in constant dollars for each of the three orders of government. It shows that, on a per capita basis, provincial and territorial governments raise the most revenues. Moreover, both federal and provincial/territorial government revenues are considerably larger than municipal government revenues and they have increased over the 16-year period. The increase in municipal government revenues has been much more modest.

### Summary of Findings and Implications for Municipal Fiscal Imbalance

The major findings of the comparative analysis of revenues and expenditures for all three orders of government suggest the following.

- Federal government expenditures in constant dollars per capita have been declining while their revenues have been increasing. Provincial and territorial government expenditures have been increasing at a somewhat slower rate than revenues. Only municipal government expenditures have been increasing at a faster rate than their revenues.
- Local government expenditures have been increasing more rapidly than either federal or provincial government expenditures. The annual average growth rate in revenues, however, has been highest for the provincial and territorial governments.
- The pattern of local government spending changed over the 16-year period, with a growing emphasis on environmental and protection services at the expenses of roads and public transit.
- Federal and provincial tax revenues in constant dollars per capita increased over this 16-year period, while local tax revenues remained fairly flat.
- Federal, provincial and territorial governments rely on personal income taxes, corporation income taxes and consumption taxes, as well as on other tax and non-tax revenues. Some provincial governments also levy a property tax. Municipal governments, on the other hand, largely rely on one tax—the property tax—and user fees and provincial and federal transfers. These findings suggest that it may be more difficult to prove that there is a fiscal imbalance at the provincial/territorial level than at the local level because provincial and territorial governments have the same revenue-raising tools as the federal government.
- A greater increase in the relative importance of provincial property taxes for education and a relatively smaller increase in municipal property taxes may suggest some crowding out of municipal property tax room by the provincial property tax in some provinces.

Figure 7: Federal, Provincial and Municipal Government Revenue, Constant Dollars per Capita, 1989-2005



Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Overall, these findings tell us little about municipal fiscal imbalance except to note that expenditures have been rising more quickly than revenues at the municipal level and that municipal governments have fewer revenue-raising tools than the federal, provincial and territorial governments to carry out their responsibilities. A simple comparison of municipal revenues and expenditures, however, does not reveal a significant imbalance because municipalities are not permitted under provincial and territorial legislation to run a deficit in their operating budget. Few municipalities, if any, have borrowed excessively to pay for capital expenditures because the amount of borrowing is also constrained by provincial governments and because municipalities have been reluctant to borrow.

From a fiscal perspective, Canadian municipalities appear to be healthy. The overall health of municipalities, however, has less to do with balancing their budgets (which they are required to do by law in any event) than with the adequacy of the services being provided and the current state of municipal infrastructure. Unlike the fiscal measures set out in this paper, the state of service delivery and infrastructure are both difficult to measure and are thus often ignored in the debate over fiscal imbalance. Although there is likely room for municipalities at least in some provinces to increase residential property taxes and user fees, it is not clear that such actions would be sufficient to solve the problems of under-investment in infrastructure.

### 3. Fiscal Imbalance: The Case for Cities

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In the recent federal election, the Conservative Party made a commitment to address the fiscal imbalance in Canada and, in particular, to include municipalities along with the federal, provincial and territorial governments in discussions to resolve the fiscal imbalance. Although the debate over fiscal imbalance at the federal–provincial/territorial level has been well documented,<sup>54</sup> much less has been written about the extent of a fiscal imbalance at the municipal level. What does fiscal imbalance mean at the municipal level? Are the issues the same as the federal–provincial/territorial issues? Do municipalities have sufficient revenue-raising capacity to sustain their expenditure responsibilities? Can they raise their existing revenues (which largely come from property taxes and user fees) to meet their expenditure requirements?

The purpose of this paper is to explore the nature and extent of the fiscal imbalance at the municipal level in Canada. The first part of the paper sets the overall context by briefly reviewing the elements of the fiscal imbalance debate at the federal–provincial/territorial level. The second part provides some background on the trends in municipal finance in Canada over the last 15 years and compares municipal revenue-raising tools to those in other OECD countries. The third part identifies the fiscal challenges faced by Canadian municipalities. The fourth part discusses whether Canadian municipalities are fiscally sustainable and whether they could make policy choices that would reduce the fiscal imbalance. The final part suggests areas for further discussion and research.

<sup>54</sup> For a summary of the debate, see Lazar et al. (2004) and the Standing Committee on Finance (2005).

## 1. Setting the Context: The Fiscal Imbalance Debate

There are two aspects to fiscal imbalance: horizontal and vertical. A horizontal fiscal imbalance is said to exist when “provinces/territories differ in their fiscal capacity to provide similar levels of public services to their citizens at similar rates of taxation” (Standing Committee on Finance 2005: 19). A vertical fiscal imbalance exists when “the fiscal capacity of one order of government is insufficient to sustain its spending responsibilities while the fiscal capacity of another order of government is greater than is needed to sustain its spending obligations, while both orders of government provide public services to the same taxpayer” (Standing Committee on Finance 2005: 19). Although both aspects are important, this paper focuses on vertical fiscal imbalance.

The current debate in Canada between the federal and provincial/territorial governments over the vertical fiscal imbalance centres on whether it exists and, if it does, whether it is an “enduring feature of the division of taxing and spending powers in the Canadian federation or whether it reflects a policy choice” on the part of provincial governments (Lazar et al. 2004: 142). Provincial governments have been arguing for some time that there is a vertical fiscal imbalance between the federal and provincial/territorial governments that needs to be corrected. They argue that the federal government has revenue-raising capabilities that exceed its expenditure requirements, whereas the provinces have insufficient revenue-raising capabilities to meet their constitutional obligations, especially with respect to health care, education and social services. Moreover, the provinces argue that the cost of delivering these provincial programs is rising more rapidly than the cost of federal programs, at the same time that provincial revenues are growing more slowly than federal revenues.

The federal government, for its part, argues that provincial governments have access to the same tax bases as the federal government (mainly income and sales taxes). Provinces can set their own rates and face no formal constraint on their ability to raise revenue. Indeed, the federal government argues that virtually all provinces have chosen to reduce taxes in recent years, suggesting that the provinces believe that they have sufficient revenues to meet their expenditure demands.

Both the federal and provincial governments have the right to levy taxes on all of the major tax bases and they do so. The problem of vertical fiscal imbalance arises, in part, because both orders of government believe that there are effective limits to taxation and they behave accordingly (Lazar et al. 2004: 155). If the overall tax burden is perceived to be at or above that limit, then having the power to tax is not very helpful from a political or economic perspective if it is not desirable to raise those taxes.<sup>55</sup> According to this argument, vertical fiscal imbalance can still exist even if all governments have the power to tax.

It is not the intent of this paper to enter the debate over whether there is a vertical fiscal imbalance between the federal and provincial/territorial governments in Canada. Rather, it is to consider how this debate can be applied to the fiscal imbalance at the municipal government level. As will be shown below, municipalities in Canada have been facing increasing expenditure pressures for a variety of reasons and, at the same time, they have seen no diversification in their revenue-raising tools. They rely largely on property taxes, user fees and intergovernmental transfers to meet their expenditure needs. The property tax, however, is considered to be a strikingly inelastic tax, since it does not grow with the economy in the same way as income and sales taxes.

Although it is difficult to measure the extent of fiscal imbalance at the municipal level (as will be discussed below), there is widespread agreement that municipalities do not have sufficient revenue-raising tools to meet their expenditure responsibilities.<sup>56</sup> The remainder of this paper evaluates whether Canadian municipalities are fiscally sustainable and the extent to which they can solve their own fiscal problems.

<sup>55</sup> Since tax bases are more mobile across provincial borders than they are across national borders, for example, the ability of provincial governments to tax is less than that of the federal government. Mobility is even greater across municipal borders.

<sup>56</sup> See, for example, TD Economics (2004), Kitchen and Slack (2003) and Vander Ploeg (2004).

## 2. Trends in Municipal Finance in Canada and Other Countries

Trends in municipal finance over the last 16 years show that municipal spending has been increasing steadily but that the revenue-raising tools available to municipal governments have not changed. Over the period from 1988 to 2004, expenditures per capita in constant dollars increased by an annual average rate of 0.9%. Total municipal expenditures in Canada in 2004 were almost \$55 billion or \$1,735 per capita on average across the country. Expenditures per capita ranged from \$483 in Prince Edward Island to over \$2,100 in Ontario.<sup>57</sup> The high Ontario expenditures are driven in part by the significant proportion of social service and social housing costs that are paid for at the local level in that province.

Table 1 shows the relative importance of expenditures by function for 1988 and 2004. The distribution of expenditures was roughly the same as in 1988, with the exception of social services in Ontario, which were considerably less in 1988. 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. Over the 16-year period, protection expenditures, expenditures on recreation and culture, and environmental expenditures increased as a proportion of total expenditures whereas expenditures on transportation, general administration, regional planning and debt charges fell.

Table 2 compares the distribution of municipal revenues for 1988 and 2004. Property taxes were the largest source of revenue to municipalities in 2004, as they were in 1988. As a percentage of total revenues, property taxes have increased somewhat. User fees have also increased over the last 16 years. Grants (mainly from provincial governments) have however decreased significantly over the period. Overall, however, the sources of revenue for municipal governments have stayed roughly the same over the period.

In terms of tax revenue at the local level, Canadian municipalities largely rely on the property tax. In some provinces, municipalities are also able to levy selective sales taxes such as taxes on hotel and motel occupancy but these taxes account for only a small part of local revenues. Cities in other parts of the world, however, have access to other tax revenue sources such as income, sales and selective sales taxes. Table 3 shows the distribution of local tax revenues by type of tax for eight federal countries (countries with a central government, state or provincial governments and local governments) and 21 unitary countries (countries with only central and local governments).

**Table 1: Distribution of Municipal Expenditures by Category, Canada, 1988 and 2004**

	1989	2004
General Administration	9.9	8.8
Protection	14.8	16.7
Transportation	22.3	19.5
Health	2.0	2.5
Social Services	7.4	10.2
Education	0.5	0.4
Resource Conservation	2.1	1.9
Environment	14.6	18.1
Recreation/Culture	11.6	12.3
Housing	1.8	3.7
Regional Planning	2.1	1.8
Debt Charges	9.5	4.0
Other	1.6	0.1
<b>TOTAL EXPENDITURES</b>	<b>100.0</b>	<b>100.0</b>

Source: Statistics Canada, CANSIM, table 385-0004

**Table 2: Distribution of Municipal Revenue Sources, Canada, 1988 and 2004**

REVENUES	1989	2004
Property Taxes	48.6	53.3
Other Taxes	1.4	1.5
User Fees	20.0	23.4
Investment Income	6.0	4.5
Other	1.1	1.5
<b>Total Own-Source Revenue</b>	<b>77.1</b>	<b>84.1</b>
Unconditional Grants	5.8	3.0
Conditional Grants	17.1	12.9
- Federal	0.7	1.3
- Provincial	16.4	11.7
<b>Total Grants</b>	<b>22.9</b>	<b>15.9</b>
<b>TOTAL REVENUE</b>	<b>100.0</b>	<b>100.0</b>

Source: Statistics Canada, CANSIM, table 385-0004

<sup>57</sup> Per capita municipal expenditures are actually highest in Nunavut and the Northwest Territories because of the high transportation and heating costs in the North, which is also unable to achieve economies of scale in its small and remote communities.

Table 3: Per cent Distribution of Local Tax Revenues by Type of Tax in Selected OECD Countries, 2002 per cent

COUNTRIES	INCOME	PROPERTY	SALES			OTHER TAXES	
			General Taxes	Specific Goods and Services	Taxes on Use etc.		Total Sales
<b>FEDERAL</b>							
Australia	0.0	100.0	0.0	0.0	0.0	0.0	0.0
Austria	56.0	10.0	23.6	3.8	1.7	29.1	4.9
Belgium	86.4	0.0	1.6	7.4	4.3	13.3	0.3
Canada	0.0	91.5	0.2	0.0	1.8	2.0	6.5
Germany	75.8	17.7	5.4	0.5	0.5	6.4	0.3
Mexico	0.1	89.5	0.0	1.9	0.5	2.4	7.9
Switzerland	83.2	16.6	0.0	0.2	0.1	0.3	0.0
United States	5.2	72.6	11.4	5.0	5.8	22.2	0.0
<b>UNITARY</b>							
Denmark	93.1	6.8	0.0	0.1	0.0	0.1	0.0
Finland	95.2	4.6	0.0	0.0	0.0	0.0	0.1
France	0.0	53.2	0.0	7.5	3.4	10.9	35.9
Greece	0.0	67.8	3.5	25.7	3.0	32.2	0.0
Hungary	0.2	22.5	71.3	0.9	4.2	76.5	0.3
Iceland	79.5	13.1	7.4	0.0	0.0	7.4	0.0
Ireland	0.0	100.0	0.0	0.0	0.0	0.0	0.0
Italy	21.6	13.6	2.5	12.9	7.6	23.0	41.8
Japan	44.6	33.0	7.3	8.3	5.7	21.3	1.0
Korea	12.4	51.9	0.0	14.3	5.8	20.1	15.6
Luxembourg	93.4	5.2	0.0	1.0	0.2	1.2	0.3
Netherlands	0.0	56.6	0.0	1.5	41.9	43.4	0.0
New Zealand	0.0	90.3	0.0	1.2	8.5	9.7	0.0
Norway	88.0	9.4	0.0	0.0	2.5	2.5	0.0
Poland	75.4	23.4	0.0	0.0	1.2	1.2	0.0
Portugal	21.1	47.0	0.0	0.0	0.0	0.0	0.0
Slovak Republic	54.1	22.0	0.0	17.9	6.0	23.9	0.0
Spain	25.2	24.3	23.8	17.4	8.1	49.3	1.1
Sweden	100.0	0.0	0.0	0.0	0.0	0.0	0.0
Turkey	35.1	12.5	37.1	4.3	1.5	42.9	9.4
United Kingdom	0.0	100.0	0.0	0.0	0.0	0.0	0.0

NOTES:

1. Income taxes include individual and corporate income taxes.
2. Property taxes include taxes on property including recurring taxes on net wealth.
3. General sales tax includes VAT, sales tax and other general taxes on goods and services.
4. Specific taxes on goods and services include special taxes on goods and services that are not taxed under a general sales tax (e.g. fuel, hotel, and motel taxes).
5. Taxes on use include taxes levied on the use of goods or permission to use goods and not the goods themselves (e.g. pollution taxes).
6. Other taxes include taxes on net wealth, taxes at death, and residual taxes mainly on business.

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics* 1965-2003 (Paris: OECD, 2004), Tables 136 and 138.

Income taxes are very important in four of the federal countries (Austria, Belgium, Germany and Switzerland) and in seven unitary countries (Denmark, Finland, Iceland, Luxembourg, Norway, Poland and Sweden). In some of these countries, the local income tax is piggybacked onto the tax levied by the federal or provincial/state government. In other countries, local governments administer their own income tax.

In the United States, 16 states permit municipalities to collect local income taxes.<sup>58</sup> Local income taxes make up more than 10 per cent of local tax revenues in only five states (Maryland, Kentucky, Ohio, Pennsylvania and New York) and the District of Columbia, however. Only eight states authorize local governments to impose taxes on corporate income: Kentucky, Missouri, Michigan, New York, Ohio, Oregon, Tennessee and West Virginia (Brunori 2003: 98).

Property taxes accounted for more than 90 per cent of local government tax revenues in Australia, Canada, Ireland, New Zealand and the United Kingdom (see Table 3).<sup>59</sup> With the exception of Belgium and Sweden, local governments in each of the countries listed in Table 3 levy property taxes.

General sales taxes are not as widely used by cities around the world as are income and property taxes. Local governments make extensive use of a general sales tax in Austria, Hungary, Spain, Turkey and the U.S. In the U.S., local governments in 31 states and the District of Columbia levy general sales taxes (Kitchen and Slack 2003).

Local governments in many countries levy excise taxes on specific goods and services. This is an important source of revenue in only a few countries, however: Greece, Italy, Korea, Slovakia and Spain. The two main selective sales taxes imposed by local governments in the U.S. are taxes on hotel and motel occupancy (allowed in 43 states) and meals (allowed in 27 states). Some local governments also tax tobacco products, fuel, liquor and real estate transfers. Local governments in some countries levy other taxes, such as taxes on business. The greatest reliance on other taxes can be found in France, Italy and Korea.

### 3. Fiscal Challenges Facing Municipalities

Many commentators have expressed concern about the current fiscal condition of Canadian municipalities and have questioned whether they will be able to provide the services that people want at reasonable tax rates (TD Economics 2004, Kitchen and Slack 2003, and Vander Ploeg 2004). These concerns arose after recent events that have had an important impact on the municipal fiscal environment.

First, the “offloading” of services by the federal and provincial governments has meant increased responsibilities for municipalities throughout the country. In some cases, federal and provincial governments have shifted expenditure responsibilities directly to municipalities (such as social services and social housing in Ontario, for example). In other cases, offloading has meant that provincial governments have reduced transfers to municipalities (see Table 2) and, in effect, increased municipal funding requirements. In still other cases, offloading has meant that federal and provincial governments have downsized their own responsibilities in areas such as immigration settlement at the federal level and education in some provinces. Municipalities, in most of these cases, have felt the need to fill the void left by other governments. Finally, federal and provincial requirements have mandated that cities meet certain requirements (for example, for water quality standards) without providing the funds to meet those requirements (these are known as “unfunded mandates”). In all of these cases of offloading, pressure has been placed on municipalities to increase expenditures (and revenues).

<sup>58</sup> For a comparison of expenditure responsibilities and revenue sources in selected American and Canadian cities, see Slack (2003).

<sup>59</sup> Note that Table 3 calculates the property tax (and other taxes) as a proportion of total local tax revenues. Table 2 calculates the property tax as a percentage of total local revenues including other own-source revenues and intergovernmental grants.

Second, Canada's future is increasingly linked to the fortunes of its large cities and city-regions where employment, wealth and productivity growth are generated. Our success as a country depends critically on the success of our cities. In the new global environment, cities have to compete in the international marketplace to attract business and skilled labour. To do this, they not only have to provide sophisticated transportation and communications infrastructure but they also have to deliver services that enhance the quality of life in their communities (Slack, Bourne and Gertler 2003). These services include, for example, parks, recreational and cultural facilities, social services, public health services and police protection. The need to provide this wide range of services has put added pressure on municipal finances.

Third, municipalities that are facing rapid growth are also, in many cases, experiencing the higher costs associated with urban sprawl. The literature on the costs of sprawl in both Canada and the U.S. suggests that infrastructure and service costs are higher in sprawl developments than compact developments (Slack 2002). As an example, the Greater Toronto Area (GTA) Task Force estimated that a more compact and efficient development pattern in that region could save an estimated \$12.2 billion in capital costs over the next 25 years or roughly 22 per cent of the projected \$55 billion capital investment required to sustain current development patterns. The higher cost of sprawl places financial pressures on growing municipalities.

Fourth, at the same time that municipalities are facing and will continue to face increased pressures on the expenditure side of their budget, there has been no parallel diversification of their revenue sources. To a large extent, municipal revenues have not kept pace with the rapidly changing expenditure needs of municipalities. Unlike many other cities around the world, municipalities in Canada continue to rely primarily on property taxes and user fees to finance service provision. As noted earlier, property taxes do not increase directly with growth in the economy as do, for example, income and sales taxes.

#### 4. Are Canadian Municipalities Fiscally Sustainable?

In light of this new fiscal environment, municipal finance experts are questioning the fiscal sustainability of Canadian cities—their continued ability to meet expenditure requirements with existing sources of revenue.<sup>60</sup> And yet, because of the available data to assess fiscal sustainability, it is often difficult to prove that Canadian cities are fiscally unsustainable. Over the past decade, for example, municipalities have not run deficits in their operating budgets because they are not permitted to do so under provincial legislation. Few municipalities, if any, have borrowed excessively to pay for capital expenditures because the amount of borrowing is also constrained by provincial governments. Few municipalities have raised property taxes significantly; few have run up large tax arrears. Overall, municipalities in Canada have also become less reliant on provincial grants. From a fiscal perspective, Canadian municipalities appear to be quite healthy.

It may be, however, that municipal accounting practices do not tell the whole story. The overall health of our municipalities has less to do with balancing their budgets, which they are required to do by law in any event, than with the adequacy of the services that are being provided and the current state of municipal infrastructure. If municipal governments in Canada appear fiscally healthy because they have under-invested in services and infrastructure essential to their economic health (transportation, roads, sewers, recreational facilities, for example), the seeds of a serious future crisis may already be sown in terms of the overall health of our municipalities. This prospect does not bode well for the future well-being of our municipalities—or, by extension, for the country as a whole.

<sup>60</sup>The definition of "expenditure requirements" is controversial because there is no agreement on the standard to which services should be provided.

Unlike fiscal measures, the state of service delivery and infrastructure are both difficult to measure and are thus often ignored in the debate over fiscal imbalance. A number of Canadian studies have attempted to measure the magnitude of the “infrastructure gap” or “infrastructure deficit” and they have come up with wide ranging estimates.<sup>61</sup>

Unfortunately, it is difficult to draw firm conclusions from these studies because some cover all municipal infrastructure while others cover only specific types of infrastructure such as water and sewers. Some separate replacement and rehabilitation from investment needs while others do not. Many obtain their data from surveys of people who may have a vested interest in over-stating the infrastructure deficit, and most assume no policy changes in the future such as charging efficient user fees that will result in curbing demand.

Nevertheless, there is an emerging consensus that there is a substantial infrastructure deficit in Canada’s cities, especially in its larger cities, and that this deficit is becoming a serious competitive disadvantage for those cities and for the country as a whole (see, for example, TD Economics 2004).

Some authors have argued that municipalities in most provinces simply need to raise property taxes (on residential properties but not on commercial and industrial properties) and user fees to solve the imbalance (Mintz and Roberts 2006).<sup>62</sup> This argument is similar to the one used by the federal government to support the position that there is no fiscal imbalance between the federal and provincial/territorial governments. There is some truth to this argument at the municipal level—residential property taxes have not increased dramatically over the last 20 years and user fees could probably be expanded to include a few more services.<sup>63</sup> Correct pricing, in many cases, would also result in reduced demand for services and infrastructure and remove some of the pressure on expenditures. Some municipalities could borrow more to pay for infrastructure. Nevertheless, all of these measures are still likely to fall short of meeting existing expenditure requirements (Courchene 2005).

More importantly, the ability of municipalities to increase taxes and user fees is different than the ability of federal or provincial governments to increase their revenues for at least two different reasons. First, municipalities are constrained by provincial governments in terms of the services that they are mandated to deliver, on the one hand, and the restrictions on revenues they are permitted to levy, on the other hand. Second, the unique characteristics of the property tax make it more difficult to increase than income and sales taxes.

Under Section 92 of the Constitution, “Municipal Institutions in the Province” are under exclusive jurisdiction of the province. In reality, this provision means that provincial governments establish the very existence of local governments and their geographic boundaries; mandate most of the expenditure responsibilities of municipalities and, in many cases, minimum standards for local service provision; determine the revenues they can raise; set rules for levying the property tax; further shape and direct municipal expenditures through grant programs; prohibit municipalities from incurring a deficit in their operating budgets; and determine the extent to which municipalities are allowed to borrow to meet capital requirements. At one level, what this high degree of provincial control means is that there simply cannot be any “fiscal crisis” at the local level because municipal governments are strictly held to balanced budgets for operating purposes and because borrowing to meet capital expenditures is constrained by provincial regulations. At another level, however, it means that municipal governments do not have complete autonomy in setting their own tax policy and are constrained from solving their own fiscal problems.

The main source of revenue to municipalities is the property tax, which has characteristics that make it different from other taxes. As noted earlier, the property tax is an inelastic tax. It is inelastic because property values do not grow as quickly as do incomes and sales during a period of economic growth.<sup>64</sup> Even when they do grow as quickly, there is usually a lag between assessed values and market values in many jurisdictions, so that it takes time for the tax base to

<sup>61</sup> For a detailed description and evaluation of the numerous studies that have attempted to estimate the infrastructure gap in Canada, see Kitchen (2003).

<sup>62</sup> Mintz and Roberts (2006) note two important exceptions to this recommendation, however: Alberta (where municipal user fees are relatively high) and Ontario (where the cost of social services is shared with municipalities). In those two provinces, the authors recommend consideration of a new tax on earned income.

<sup>63</sup> Unfortunately, there has been no research done in Canada on the question of whether individual municipalities could raise property taxes further and not lose their tax base. Interesting work along these lines has been done for four American cities by Haughwout, Inman, Craig and Luce (2004).

<sup>64</sup> Although the property tax is in many ways a good tax for municipal governments, it does have some limitations. For example, the property tax can encourage undesirable sprawl. Since the tax is a tax on property values (including land and improvements), any investment that increases the value of the property (including increases in density) will result in a higher tax (see Slack 2002). Also, the property tax is not appropriate for funding social services at the local level. Because these services redistribute income to the poor, income taxes are more appropriate to pay for social services.

catch up to the actual growth. The ability to raise revenues from residential property taxes may be further limited in the future because it is anticipated that the tax base will not continue to grow as quickly as it has in the past. An aging population will mean a drop in housing starts, downsizing and limited growth in housing prices (The Conference Board of Canada 2004). The ability to increase tax revenues from non-residential property is limited because the property tax already over-taxes this sector in most municipalities when compared to residential properties and to the services it receives (Kitchen and Slack 1993; Mintz and Roberts 2006).

Perhaps the most important characteristic of the property tax is its visibility, which makes it difficult to increase. Unlike income taxes, property taxes are not withheld at source. Rather, property taxes are paid once, twice or six times a year by the property taxpayer. Unlike sales taxes, which are paid as a percentage of each individual purchase, property taxes are paid in lump sums during the year. The result is taxpayers are much more aware of the total property taxes they pay each year than total income or sales taxes.

Visibility is a good thing because it makes municipal politicians accountable to taxpayers. It does, however, restrict municipalities from increasing property taxes by a significant amount each year. Indeed, most municipalities are forced to reduce tax rates when property values increase so that taxes do not increase by the full amount of the increase in the tax base.<sup>65</sup> This type of tax reduction does not occur when incomes and sales increase. Rather, those tax revenues increase automatically when the base increases.

## 5. Conclusions

Fiscal imbalance is said to exist when the fiscal capacity of a government is insufficient to meet its spending responsibilities. Since municipalities in Canada are required to balance their operating budgets and the amount of borrowing they undertake for capital purposes is restricted by provincial governments, it does not appear initially that they suffer from a fiscal imbalance. Yet, the required balance has been achieved in large part by under-investing in infrastructure and service delivery. Unfortunately, the state of municipal infrastructure and the quality of services are much more difficult to quantify than are fiscal measures and so less is known about them. This lack of information does not mean, however, that municipalities are not facing a fiscal crisis.

Although there may be some room for municipalities in some provinces to increase residential property taxes and user fees, there does not appear to be sufficient room for them to solve the problems of under-investment in infrastructure and services. Moreover, the ability of municipalities to increase their revenues is different from the ability of provincial and territorial governments to increase their revenues. Municipalities cannot easily increase their own-source revenues (property taxes and user fees) because of provincial restrictions on municipal revenues and because of the inelasticity and visibility of the property tax. For these reasons, the existence of a fiscal imbalance at the municipal level is less debatable than is the existence of a vertical fiscal imbalance between the federal and provincial/territorial governments.

It is not the purpose of this paper to analyze solutions to the problem of fiscal imbalance at the municipal level but rather to describe the nature and extent of the imbalance. Nevertheless, some obvious ways to restore the balance between expenditure responsibilities and revenues can be suggested. These include, for example, increasing residential property taxes, user fees and borrowing; transferring responsibility for some expenditures to the provincial or federal governments (“uploading”); transferring revenue-raising power (tax room) to municipal governments (such as an income tax or selective sales taxes); and transferring funds from the federal and provincial governments to municipal governments through conditional or unconditional grants.

<sup>65</sup> A well-publicized example of the implications of municipalities not reducing property tax rates in the face of property value increases is California prior to 1978. The result was a property tax revolt and the introduction of Proposition 13. Under this proposition, assessment is increased annually by the rate of inflation or 2 percent per year (whichever is less) until the property is sold and tax rates cannot exceed 1 percent of the property's market value. In other words, the ability of municipalities in California to raise property taxes is severely limited by state legislation. A number of other states in the U.S. followed with similar legislation.

The appropriateness of each of these options and the implications of implementing them will be different for different municipalities and for the federal and provincial governments. Further research is needed to develop these options more fully and to test their impact. To complicate matters, the undertaking of any analysis on fiscal imbalance and on the options for reducing it requires the comprehensive and consistent collection of information on the revenues and expenditures of individual municipalities across the country. This type of information is not currently available in Canada on a comparative basis. More data and analyses are also needed to quantify the service delivery and infrastructure gaps at the municipal level. Going forward, Canadian municipalities will have to gather the needed information and use it to present a compelling case on fiscal imbalance along with suggestions and analysis of viable options for resolving it.

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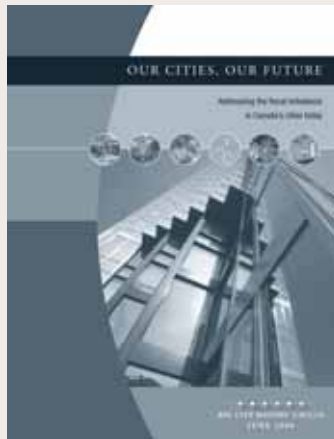
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## 4. FCM Big City Mayors' Caucus Report on the Municipal Fiscal Imbalance: Our Cities, Our Future



For the full report visit [www.fcm.ca](http://www.fcm.ca)

## 5. The Property Tax: Its Role In Financing Canadian Municipalities

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Thanks to Viorela Diaconu for research assistance.

This section briefly reviews the nature of the property tax, examines its appropriateness in funding various types of municipal expenditures and presents evidence of its importance in funding Canadian municipalities.

### 1. The Nature of the Property Tax

The property tax is one of the oldest taxes in the world, as people have used land and shelter since time immemorial. When assessing taxes, economists examine their microeconomic aspects, such as the tax's incidence, efficiency and equity, as well as the compliance costs and the avoidance and evasion activities associated with it. They also examine revenue-generating aspects of the tax, such as its predictability, stability and elasticity.

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## MICROECONOMIC ASPECTS

### *Incidence*

Incidence refers to what an economic agent (such as an individual or a firm) pays under a specific tax. When one agent gets a tax bill, can the bill be “shifted” to another agent? In the case of the property tax, three types of agents are legally liable for the property tax: owners occupying residential property, owners renting residential property and owners occupying or renting a commercial or industrial property (including farms).

Owners occupying residential property cannot pass on the property tax. But the two other types of agents can pass it on. Owners renting residential, commercial or industrial space can raise rents and owners of commercial or industrial space can increase the prices of the products they make or sell. This means that the burden of the property tax on non-owner-occupied residential properties is not always visible, making it a natural target for politicians to set it at a higher level than what is required to cover the costs of municipal services to these businesses. In the end, only individuals pay taxes, whether as workers, consumers or capitalists.

### *Efficiency*

Efficiency refers to the impact that a specific tax has on the choices of individuals and businesses. For example, does a higher personal income tax rate reduce the amount of time individuals want to work?

Property tax can affect both the quantity of property used and the location of the activity. Higher taxes will encourage user of land and structures to use less of these inputs than otherwise and to move where taxes are lower. The second effect holds only when the locations (such as access to markets and the distance to the downtown core) are similar and services are similar between high and low tax jurisdictions. If there are fewer services provided publicly in low-tax jurisdictions, this may increase private costs such that there are no savings overall. If one location is further away from the relevant market or the downtown core, then the answer will depend on the value individuals put on their time. Cash-poor individuals that want to own a home may be willing to incur high commuting time and thus to encourage urban sprawl.

### *Equity*

Economists examine whether taxes treat agents in similar positions equitably, which is called horizontal equity, and they explore whether taxes increase as the capacity to pay increases, which is called vertical equity.

In the case of the property tax, one usually observes similar treatment of a dollar of property value within broad classes of assets, such as residential, commercial and industrial. Hence, there is horizontal equity within classes. However, there may not be horizontal equity when one compares the treatment of a dollar of property from one class to another. In terms of vertical equity, the detailed data for 2003 and the summary data for 1997 are presented in Table 1. This table shows that the residential property tax is explicitly or implicitly (as a share of rents) a regressive tax. This means that the share of household income represented by this tax goes down as income goes up. This is the opposite of what happens with personal income tax, which is an example of a progressive tax.

For example, the wealthiest quintile’s household income (before taxes – \$136,691) was nine times greater than the poorest quintile’s household income (before taxes – \$15,199). In terms of income tax, the poorest quintile paid less than 2 per cent of the income tax paid by the richest quintile (\$625 vs. \$35,289, respectively). Yet, in contrast with household income and income tax paid, homeowners in the poorest quintile paid 54.8 per cent as much property tax as homeowners in the richest quintile (\$1,461.54 vs. \$2,667.02, respectively).

As a percentage of household income, homeowners in the poorest quintile paid 9.62 per cent of their income on property taxes. In comparison, homeowners in the wealthiest quintile paid 1.95 percent of their household income on property taxes, five times less (relative to income) than the poorest quintile. Moreover, comparing 1997 and 2003, the property tax burden for homeowners slightly decreased for every quintile except the poorest quintile. While the wealthiest quintile saw its property tax burden (relative to income) decrease by eight per cent, the poorest quintile saw its property tax burden (again, relative to income) increase by three per cent. This phenomenon is related to the lack of elasticity, discussed in the next section.

**Table 1: Incidence of the Property and Personal Income Tax, Canada, five quintiles, 2003 and 1997**

ITEMS	FIRST (POOREST) QUINTILE	SECOND QUINTILE	THIRD QUINTILE	FOURTH QUINTILE	FIFTH (RICHEST) QUINTILE
<b>2003 DETAILED INFORMATION</b>					
Household income before tax	15,199	31,908	50,274	74,837	136,691
Spending on shelter	6,327	8,361	10,747	13,616	18,872
Spending on rent	3,368	3,176	2,687	1,749	934
Spending on property taxes	551	890	1,215	1,700	2,483
Spending on property taxes by owners	1,461.54	1,603.60	1,773.72	2,050.66	2,667.02
Spending on rent by tenants	5,406.01	7,137.08	8,530.16	10,228.07	13,536.23
Spending on personal income tax	625	3,478	8,011	14,447	35,289
% Shelter /income	41.63	26.20	21.38	18.19	13.80
% Rent by tenants / income	35.57	22.37	16.97	13.67	9.90
% Property taxes by owners /income	9.62	5.03	3.50	2.74	1.95
% of homeowners	37.7%	55.5%	68.5%	82.9%	93.1%
Number of households in sample	3,839	3,640	3,422	3,161	2,637
Estimated number of household	2,360,680	2,360,680	2,360,690	2,360,680	2,360,680
<b>1997 SUMMARY INFORMATION</b>					
% Rent by tenants / income	35.81	23.14	17.36	14.52	11.58
% Property taxes by owners /income	9.33	5.32	3.66	2.89	2.12
% Personal income tax/ income	3.22	11.09	17.37	21.08	26.56
% Personal income tax / income	4.11	10.90	15.93	19.30	25.82

Source: "Detailed average household expenditure by household income quintile for Canada and provinces, 2003", Catalogue Number: 620032XDB, <http://www.statcan.ca/bsolc/english/bsolc?catno=62F0032X>

NOTES:

- 1 Spending on property taxes by owners = Spending on property taxes \* 1/ % of homeowners.
- 2 Spending on rent by tenants = Spending on rent \* 1/ (100 - % of homeowners).
- 3 % Shelter /income = (Spending on shelter/Household income before tax)\*100.
- 4 % Rent by tenants /income = (Spending on rent by tenants / Income before tax)\*100.
- 5 % Property Taxes by owners /income = (Spending on property taxes by owners / Income before tax)\*100.
- 6 % Personal income tax /income = (Spending on personal income taxes / Income)\*100.

The share of non-residential property tax born by a specific quintile will depend on how that tax it is shifted to individuals. It probably falls on them according to consumption and is thus mildly regressive.

### *Compliance Costs*

Compliance costs are incurred to insure that tax payments are made in accordance with the law. They are incurred by both private agents (in terms of time spent and fees for experts) and the public sector (in terms of the cost of tax-collection administration). In the case of the property tax, these costs are seen as small, as a share of GDP, when compared to the compliance costs for other taxes.

### *Avoidance and Evasion*

Avoidance is using tax dodges to reduce taxes. Evasion is outright fraud. Neither is seen as a significant issue for the property tax.

## *REVENUE GENERATION*

### *Predictability*

The short-term evolution of the property tax is fairly predictable as the tax base (quantity x price) does not vary much from year to year.

### *Stability*

The property tax offers a more stable tax base than do other taxes. We calculated coefficient of variations for various taxes. A score of zero would indicate no variation. We calculated a score of 0.39 for corporate income taxes and 0.23 for all taxes. But the score is only 0.20 for both property taxes and PIT. This means that property tax revenues do not go up or down from year to year as much as other taxes. Hence, municipalities do not constantly have to make important changes to their tax mix.

### *Elasticity*

The elasticity of a tax tells us how it increases when a relevant indicator of income or wealth increases. We calculated the elasticity of the property tax, with respect to GDP, to be 0.89 per cent. In other words, a one per cent increase in GDP would have increased property tax revenues of municipalities by 0.89 per cent over the 1988 -2003 period. This compares to an elasticity of 0.99 per cent for all taxes (PIT, CIT, sales and property).

For example, imagine GDP increases by \$1,000 per capita from \$40,000 to \$41,000. Now assume that property taxes are calculated at \$1,200 per capita. In this scenario, property taxes would increase by only \$22 per capita or 1.8 per cent of the original amount. Hence, the tax mix available to municipal government is less elastic to GDP than the tax mix available to provincial or federal governments. Thus, municipalities do not benefit to the same extent as these two governments from the economic growth associated with an increase in GDP. In fact, they may instead incur important greater costs for water, public transit or road usage. As a result, it is more difficult to finance those expenditures that have a spending elasticity above 0.9.

## **2. The Appropriate Uses of the Property Tax**

In Canada and throughout the world, the property tax is used mainly to finance local governments, such as municipalities.<sup>66</sup> In fact, the use of property taxes to finance schools is seen only rarely outside North America.

66 Robert Ebel and François Vaillancourt "Revenue Sources of Local governments: Nature and Determinants in Enhancing Urban Management in East Asia M Freire and B Yuen, Ed) UK Ashgate Publishing, 2004, 131-144

In the previous section, we presented the revenues and expenditures of municipal governments in Canada. In this section we comment on the relevance of using this tax for financing these expenditures. Table 2 examines the match between municipal revenue sources and expenditure responsibilities. These key points emerge.

- Property taxes are an acceptable form of revenue for quite a few municipal expenditures.
- Property taxes are not an acceptable form of revenue for financing redistributive policies.
- User fees could be a useful complement or a main source of revenue for many types of municipal expenditure. Such fees are often an important expenditure for low-income households. Provincial re-distributional support, either through the tax or transfer system, would limit the burden on low-income households.

**Table 2: Relationship Between Expenditures and Revenue Responsibilities in the Canadian Context**

TYPE OF EXPENDITURE	RELEVANCE OF PROPERTY TAX	OBSERVATIONS AND OPTIMAL SOURCES OF REVENUES
Police	Medium: high for property crimes, low for crime against persons	Local income tax. Some policing in large CMAs may have externalities for non-residents.
Firefighting	High: similar to an insurance premium linked to the value of assets protected	-
Road maintenance and cleaning (including snow)	Medium: some relationship between income, property value and automotive ownership	User fees for downtown parking and access fee, plus a mileage charge would be a more appropriate or useful complement
Public transit	Medium: property values are affected by access to public transit but congestion and pollution benefits are not directly linked to property values	User fees, local income tax and transfers from provincial government are complementary sources
Social services	None	General income tax at the provincial level is the appropriate funding source for transfers from provincial government
Water and sewer (environment/pollution)	Medium	User fees (water meter) are preferable
Garbage removal (environment/pollution)	Medium to high	User fees by volume or weight are preferable
Culture (libraries included)	Medium	Local income tax could have a role
Sports and parks	Medium	Local income tax could have a role
Public housing	Low	General income tax at the provincial level is the appropriate funding source
Economic development	Medium to high	New economic activity usually increases property values but this could spill over at the supra-municipal level
Immigrant integration	Low	This is more akin to social services and thus better funded through income taxes. One should note that there can be direct costs as well as costs in the provision of all services.

Source: author

Table 3: Indicators of Use and Importance of Property Taxes, Canada, 1989-2004 (\$ in 000)

Years	Property and related taxes provincial and local governments (1)	Property and related taxes, provincial government (2)	Property and related taxes, general local government (3)	Property and related taxes, school boards (4)	% Property and related taxes local general government/ Property taxes provincial and local governments (5)	% Property taxes and related taxes general local government/ Total government own revenue (6)	Property and related taxes general local government per capita (7)	% Property taxes and related taxes general local government/ GDP (8)
1989	23,916,000	3,607,000	14,442,112	8,090,101	60.39	5.84	529.37	2.19
1990	26,701,000	4,169,000	15,601,333	8,849,349	58.43	5.71	563.28	2.29
1991	28,671,000	4,220,000	16,806,435	9,522,371	58.62	5.81	599.56	2.45
1992	30,619,000	4,290,000	17,936,420	10,226,228	58.58	6.11	632.30	2.56
1993	33,092,000	4,930,000	18,500,589	10,615,606	55.91	6.18	645.03	2.54
1994	34,225,000	5,109,000	19,055,608	10,126,998	55.68	6.25	657.11	2.47
1995	35,491,000	6,309,000	19,158,680	10,180,707	53.98	5.97	653.83	2.37
1996	35,846,000	6,507,000	19,545,258	10,433,593	54.53	5.80	660.07	2.34
1997	36,935,000	6,956,000	20,156,358	10,926,304	54.57	5.74	673.96	2.28
1998	38,545,000	7,463,000	23,202,176	7,801,048	60.20	6.21	769.38	2.54
1999	38,556,000	7,553,000	24,166,067	8,009,046	62.68	6.27	794.84	2.46
2000	40,255,000	8,080,000	24,347,710	7,999,391	60.48	5.88	793.37	2.25
2001	41,063,000	8,716,000	25,216,004	8,105,789	61.41	5.64	812.86	2.27
2002	41,730,000	8,408,000	26,120,156	8,226,500	62.59	5.97	832.58	2.25
2003	42,742,000	8,396,000	27,582,322	8,555,070	64.53	6.19	871.19	2.26
2004	44,765,000	8,628,000	28,398,513	8,897,855	63.44	6.12	888.94	2.20

Sources:

- Property and related taxes, provincial and local governments X \$1,000, Series number: v631817, CANSIM Table number: 385-0001
- Property and related taxes provincial government X \$1,000, Series number: v206433, CANSIM Table number: 385-0002
- Property and related taxes general local government X \$1,000, Series number: v513426, CANSIM Table number: 385-0004
- Property and related taxes local government X \$1,000, Series number: v644235, CANSIM Table number: 385-0003
- Total revenue, federal, provincial and local governments X \$1,000, Series number v156254, CANSIM Table number: 385-0001
- Population, Canada, Series number: v466668, CANSIM Table number: 051-0012
- PIB Current Prices X \$1,000, Series number: v687341, CANSIM Table number: 384-0002
- [http://estat.statecan.ca/cgi-win/cnsmcgi.exe?LANG=E&CANSIMFILE=ESTAT/ENGLISH/CII\\_1\\_E.HTM](http://estat.statecan.ca/cgi-win/cnsmcgi.exe?LANG=E&CANSIMFILE=ESTAT/ENGLISH/CII_1_E.HTM)

NOTE'S:

- Property and related taxes school boards = Property and related taxes local government – Property and related taxes general local government
- Property and related taxes general local government per capita = Property and related taxes general local government / Population Canada
- % Property and related taxes general local government / Property taxes provincial and local governments = (Property and related taxes general local government / Property taxes provincial and local governments)\*100
- % Property taxes and related taxes general local government/ Total revenue = (Property taxes and related taxes general local government / Total revenue, federal, provincial and local governments)\*100
- % Property taxes and related taxes general local government / PIB = (Property taxes and related taxes general local government / PIB)\*100
- Note that the total in (1) differs from the sum of (2), (3) and (4) since we use consolidated amounts in (1)



### 3. Current Uses of Property Taxes

Table 3 shows the following points.

- Municipal governments are not the sole users of property taxes in Canada. The traditional competitors were school boards. By 2004, provincial governments had become almost as important in that field, in part because they use the tax to fund schools. Insofar as provinces occupy a greater share of this tax field, this makes it more difficult for municipal governments to make greater use of the field, in part because municipalities are regulated by provinces.
- The share of property taxes collected by municipal governments is slightly higher at the end than at the beginning of the period.
- Municipal property taxes represented a slightly greater share of all government revenues in 2004 than in 1989. The share of municipal property taxes in GDP has remained unchanged over the period.

### Strengths and Weaknesses of the Property Tax for Municipalities

Given the information above, one can note the following strengths and weaknesses of the property tax as a source of revenues for Canadian municipalities:

- Property tax lends itself to differentiated treatment of properties of similar values with different uses. This can lead to an inefficient use of land and structure.
- Property tax can contribute to urban sprawl, since it is based on the ability to pay, as measured by property values, which is an indicator of wealth. In fully built-up areas, this is not an issue. But in municipalities with unbuilt land, land at the periphery is less expensive. Even with similar lot sizes and service costs for periphery land and for core land, the cost burden will shift from periphery to core owners when there is a single property tax rate. If larger lots are purchased in the periphery, then with a single property tax rate, core owners will subsidize periphery owners, since larger lots (as measured by frontage) are more expensive to service (such as longer pipes and roads), even if the overall value of the two types of properties are similar.
- Property tax is a regressive tax from an income perspective, although less so from a wealth one. There is little link to benefits received.
- Property tax is a visible tax for homeowners. This is desirable, since visibility requires politicians to justify increases or decreases explicitly. However, since other taxes are less visible, it is more difficult for municipal governments to raise taxes than for federal or provincial/territorial governments. This is a case of differentiated visibility.
- Property tax is a predictable, stable source of revenue for municipalities, one that is fundamentally under their control.

### Conclusion

The property tax is an appropriate revenue source for certain municipal expenditures. It is a stable, predictable and autonomous source of revenues with some reasonable links to some services provided by municipalities. However, given the nature of services provided by municipalities, it cannot be the sole source of their revenues. Its use to tax commercial and industrial property may reduce the international competitiveness of Canadian businesses if other countries do not impose similar burdens on their businesses. It needs to be complemented by greater use of user fees, with redistribution issues taken into account at the provincial or municipal level, as well as by a more judicious use of transfers to municipalities, using them when justified by externalities such as pollution reduction.

## 6. The Fiscal Imbalance and Rural Municipalities

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By Professor David Douglas

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Unique conditions, characteristics and challenges exist in rural areas that have distinct implications for municipal governance. Small population bases, limited economies of scale, accessibility, location and rising service expectations influence the ability of municipal governments in rural communities to balance their budgets while maintaining the infrastructure necessary to sustain vibrant local economies.

The central issue in this report relates to the question, “Are current municipal revenues adequate to meet their existing and growing responsibilities and challenges?” In addressing this important question, Canadians and their governments are particularly sensitive to the adage that “no one size fits all.” In this section we address the context, conditions, characteristics, challenges and municipal financial options particularly relevant to rural municipalities.

### “Rurality”: Conditions and Characteristics

#### POPULATION

The geographical, social, economic, cultural and other characteristics of rural communities are highly complex, diverse and dynamic (Reimer, 2005). Municipalities operate through an enormous variety of community sizes and types, spread over considerable distances. Various forms of local government operate throughout much of rural Canada, including municipal districts, townships, municipalités régionales de comté and First Nations communities. These bodies provide services and facilities to most citizens outside urban areas.

Depending on the definitions used, anywhere from 22 per cent to 38 per cent of Canadians live in rural areas (Douglas, 1989; du Plessis, et al. 2001; Bollman, 1992; Hodge and Qadeer, 1983). The rural population has been in decline in most parts of Canada for over half a century, though the longevity, continuity, pattern and extent of decline varies enormously from region to region (Bollman, 1992; Rothwell, et al, 2002). Decline has been long term and continues in many parts of Newfoundland and Labrador, in Northeastern Ontario, in Eastern Quebec, in Prince Edward Island, in parts of Saskatchewan and elsewhere. This contrasts with population growth in so-called metro-adjacent regions (such as the Greater Toronto Area, the Halifax Regional Municipality and the Calgary and Edmonton regions) and in a large proportion of mid-sized towns (with populations between 3,000 and 6,000) throughout most regions.

With exceptions, a general aging of the population continues, mirroring the Canada-wide phenomenon, but exacerbated by chronic and selective out-migration of the younger labour force. Most rural communities are therefore not only characterized by small populations, but by a relatively large seniors’ cohort (in which 20 per cent or more of the population is 65 years or older) and a small, aging labour force. Demographics may be different in resource-based communities, retirement communities and the more urban “dormitory communities” in the “commuter-sheds” of large towns and cities.

Unlike many Canadian cities, very few rural communities are destinations for international migrants. Likewise, except for some dormitory, retirement and a small number of mining communities, few rural communities attract inter-provincial migrants. A large proportion of Canada's rural communities is either stagnant, declining or growing slowly in terms of their resident populations (Mwansa and Bollman, 2005).

### *THE COMMUNITY ECONOMY*

Typically the economic base of Canada's rural communities is small. It is an exposed, open economy, highly dependent upon trade, external inputs (such as raw materials, services and government transfers) and external markets in the surrounding region, or far beyond. For many communities the local economy is quite stagnant with little growth or diversification evident. It is often quite specialized and highly dependent on single industries.

These characteristics translate into relatively low employment and participation rates in the labour force, a preponderance of smaller business enterprises (often family- and owner-operated), modest operating margins and relatively low levels of commercial and industrial investment. While official unemployment rates may be low, serial out-migration accounts for much of this, often masking systemic weaknesses in the capacity of the local economy. While there are many exceptions (such as thriving dormitory centres, expanding mining communities, vibrant tourism and specialty manufacturing centres), and while there is an inspiring record of local economic development initiative (Perry 1987, Galaway and Hudson, 1994, Douglas, 1994, 1995), *small scale, fragility and vulnerability* are very often the distinguishing hallmarks of the rural economy.

### *ACCESSIBILITY*

Location and distance are central considerations of "rurality" (Bollman and Prud'homme, 2006) and have significant economic and political effects. Distance from markets and the sources of major inputs to production pose serious burdens and constraints on rural businesses. Even in today's expanded telecommunications technologies and the promises of broadband, and even with lower land costs and the lowering of some labour and other costs, the costs of production and the overall transactions costs for many private-sector enterprises are higher in rural areas than in larger towns and major cities. The lower residential and business enterprise densities in rural regions reduce market and other opportunities. The cost of distance militates against many investment, business location, expansion and even retention opportunities. Distance has significant effects in terms of social provision (such as doctors, hospitals and community colleges). The availability, the condition and quality of transportation and communications infrastructure is, therefore, of paramount importance. Country roads, bridges, highways, railways, trans-shipment facilities, electricity, fibre optics, wireless and other components of modern infrastructure are vital.

Accessibility in all its dimensions is a central, daily facet of lives lived in rural Canada, with multiple implications.

### *CHALLENGES*

The conditions and characteristics of rurality pose many challenges for rural municipal governments. These range from a dearth of young active volunteers (for example, to serve on advisory committees and special purpose bodies, or to run as council candidates), and a limited pool of readily available expertise from the private and public sectors to draw upon, to a variety of challenges associated with municipal revenues and expenditures.

## REVENUES

Some of the revenue challenges faced by rural municipal governments relate to the buoyancy, or the extent and the appropriateness of locally available sources of revenue. Others relate to the dependency on external transfers from other orders of government, including criteria and control associated with these grants, and their degree of predictability.

The small, stagnant or declining property tax base characteristic of so many rural communities offers little room for revenue expansion. Even if there is more room in the property tax base than might commonly be assumed (Kitchen, 2002), the modest rate of industrial and commercial investment growth limits potential for revenue expansion in rural areas. In addition, constraints relating to political risk, visibility and the regressive nature of the property tax base are especially evident in smaller, more intimate communities than they might be the case in larger towns and cities (Turcotte, 2005). The high proportion of elderly and others on fixed incomes in many rural communities further limits room for revenue growth from the property base. Expansion of the property tax base from commercial and industrial sources is no less limited, though there will be case by case exceptions. For some rural municipalities (particularly those in Saskatchewan), a depleted agricultural economy is virtually the sole source of property tax revenues.

Rural municipalities are very conscious of the highly competitive markets in which they live. They will resist any real or perceived deterioration in their comparative advantage on the basis of property taxes (or any other charges) on local businesses. Given the clear evidence of a significant capacity gap to undertake local economic development and foster economic expansion (Douglas, 2003), exacerbating the capacity deficit here by adding to the costs of doing business would seem a counterproductive step for most rural municipalities.

While own-source revenues have escalated in importance for municipalities across Canada (e.g. Kitchen, 2002; Slack, 2006), the property tax remains the centrepiece for locally generated revenues. For most rural municipalities, transfers from other orders of government are modest relative to their total revenues (on average, around 10 per cent to 15 per cent). With property taxes accounting for approximately two thirds of own-source revenues, the degree of revenue dependency for rural municipalities can be readily appreciated. The result is high dependency on an inelastic, and for some a declining, revenue source combined with *structural local* economic conditions that militate against any significant further expansion.

With respect to other sources of local revenues, the room for expansion of user fees is uncertain. The same logic of allocative efficiency can be applied, at least partially, to rural municipalities as it can to all municipalities (Kitchen, 2002). The coverage of user fees for ice rink time, swimming, ball park time and other parks and recreation services varies considerably. Likewise, the application of anything close to marginal cost pricing to water and sewage services (where communal services exist), to garbage collection (where it exists) and to disposal and other services remains a rarity. In part, constraints emanate from the modest development prospects that characterize the majority of rural communities. Likewise, opportunities for growth in development charges are limited for most rural municipalities. Combining all of this with the evident constraints on the municipality's property base, as a buoyant source of revenues, serves to place constraints on the capital account. Therefore, it may be calculated that the level of allowable debt, and hence the capital budget, are circumscribed. This in turn circumscribes investments in new infrastructure, infrastructure renewal and maintenance.

## EXPENDITURES

From the expenditure side, the majority of rural municipalities are under severe pressures relating to the scope of services provision, the economies of *scale* for services provision and the expected *levels* of service. This tripartite squeeze is especially onerous and compromises the viability of many rural municipalities (Marshall and Douglas, 1997).

The *scope* of services, including but not limited to the basic services to people and property (such as water and sewage, policing and fire) has been under pressure for some time.

Pressures emanate from a variety of sources, depending on the jurisdiction and the location of the rural municipality in relation to major urban centres. In rural communities with a more mobile residential population, and in some instances urban-to-rural in-migrants, combined with expanded communications, there is some evidence of an increase in expectations for facilities and services. Regardless of the size of the rural municipality, demands for some form of public transportation are not uncommon. These demands include childcare facilities and services, Internet and related services through public libraries, and, in some cases, housing. In addition to public expectations, some rural municipalities, most notably in Ontario in recent times, have been forced to expand their service offering due to legislative change (Downey and Williams, 1998). In the most recent case, Ontario rural municipalities expanded their services profile into public health care, land ambulance services, social welfare and assistance (OntarioWorks), highways, roads and bridges, and public housing for counties. In Quebec, the formerly provincially provided police services now have to be paid for by the rural municipality. In other contexts a reverse process, known as “uploading,” has occurred. These service transfers have had significant impacts on municipalities and raised contentious concerns about the appropriate means of funding all or part of these, i.e. primarily from the local property tax base (e.g. AMO, 2005).

In terms of *scale*, smaller municipalities face the opportunity costs of not being able to reap economies of scale on many fronts, including fire protection services, contracted police services, cultural and recreation facilities, economic development, and other service areas. They are just too small to either invest in the capital facilities in demand (such as swimming pools) or to secure the levels of use to avoid costly “downtimes” and other operational diseconomies (such as trucks and construction equipment). Some scale economies can be and have been achieved through inter-municipal collaborative arrangements and, in some cases, through amalgamations.

With reference to the *level* of service, again, changing resident consumer expectations are evident in increased demands in many communities, which are increasingly drawn into the expanding commuter-sheds of burgeoning metropolitan centres. These demands are augmented by increased expectations in communities where cottaging, second home and retirement in-migrants are looking for urban-type municipal services (such as extra police coverage, expanded street lighting, garbage pick-up and increased snow ploughing). With the benefits of the high technology and information economy and a mobile labour force and enterprises, there are additional demands from high paid senior employees for urban-type amenities, recreation and cultural services, as well as for high-quality access to health services and communications networks.

These accumulating demands for upgraded levels of service are sometimes further augmented by offloading from other orders of government and the associated directives for services provision (such as construction design and maintenance standards, social housing, welfare and law enforcement). In addition to all of these pressures on the levels of services, increased public and government concerns about water quality and safety, and associated concerns with wastewater and sewage treatment, have all contributed to an upgrading of standards and regulations enforcement accompanied by a premium that is unaffordable for many rural communities, particularly after the Walkerton tragedy and other serious cases of water availability and quality. Evidence of growing concern regarding municipal liability (such as liability for personal safety) and a more litigious climate have placed additional pressure on service standards at the municipal level, both rural and urban.

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## Trends Municipal Finance: Some Rural Considerations

### *OWN-SOURCE REVENUES, TRANSFERS AND THE PROPERTY TAX BASE*

The data bases readily available to us (such as CANSIM and Statistics Canada's *Financial Management Systems*) do not allow for the identification of rural municipalities, however defined. All municipalities are identified under the rubric "local," as opposed to provincial, territorial or federal. This is an area awaiting a substantial research effort. However, the overall trends illustrated in other parts of this report set out the general conditions for most rural municipalities.

As has been discussed, own-source revenues remain the dominant revenue base for most municipalities. Rural municipalities in Canada, because of their relatively small economies and some political reluctance to aggressively expand their user fee practices, continue to rely particularly heavily on the local residential property tax base. At the same time, rural municipal governments, like their urban counterparts, have been as reluctant to raise taxes over the last decade. It is very likely, therefore, that the overwhelming reliance on the (residential) property tax base has been combined with zero or very modest tax increases, and therefore the municipalities' financial capacities has recently expanded modestly. All of this has, not surprisingly, been accompanied by a growing backlog of deferred capital maintenance, especially in physical infrastructure.

### *EXPENDITURES*

Though we do not know the specifics of rural trends at this time, the overall expenditure patterns discussed earlier seem to generally reflect rural municipal trends. In fact, it is likely that for most rural municipalities, especially the lower-tier or local municipalities, where they exist, expenditures on roads and bridges exceed the proportion suggested in the general patterns. This is especially the case as many rural municipalities will have no expenditures on such services as health, social services and housing.

We cannot with absolute confidence glean the definitive trend in the profile of rural municipal revenues and expenditures from the readily available databases. However, estimating from the general municipal trends and using empirical examples from practice and case study research suggests that the dominance of own-source revenues continues, together with a continuing reliance on the regressive, small and inelastic property tax base. While expenditures on roads, bridges and, to some extent, water and sewage services, appear to consume the rural municipal financial budgets, deferral or neglect of physical infrastructure investments is likely common.

### *CURRENT AND FUTURE COST DRIVERS*

The primary cost drivers for rural municipalities will vary somewhat by jurisdiction, and on the basis of their particular geographical characteristics (such as whether they are urban fringe dormitory communities, remote resource centres or rural retail service centres). Cost drivers are also influenced by policies and practices of other orders of government, which are often short term, unpredictable and highly issue oriented. Where there are two-tier local government systems in place, some differences in cost drivers will be evident due to regional delivery of services.

The core expenditure areas of roads, bridges, water, stormwater and sewage infrastructure will continue, and with the backlog in deferred maintenance and renewal, it is very likely that these will escalate as cost drivers. This will be heightened by growing concerns regarding liability and risk, increased activity resulting from imposed regulations and enforcement protocols by the other orders of government, and escalating demands for enhanced levels of services from taxpaying residents.

## THE CAPACITY CHALLENGE

Though not conclusive, evidence suggests there is a capacity challenge in rural communities. Scale, location, organization and other salient factors that characterize rural municipalities across Canada combine to constrain the municipal finance resource base. Part of the challenge may relate to traditions, attitudes, habits and practices and may require changes in political choices and in policy and management practices. The mix of factors described in this report (the small, fragile economic base; political attitudes; and the backlog in deferred infrastructure investments), all point to a mismatch between *available* fiscal resources and the portfolio of services that rural municipalities are charged with providing.

## CONCLUDING REMARKS

Acknowledging the great diversity of circumstances that characterize Canada's thousands of rural municipalities, one can readily recognize the array of formidable challenges that they face today and are very likely going to face in the future. Do they have the financial capacity to meet these challenges, in terms of the revenue bases available to them and in terms of the services expected of them? This is not at all certain. However, there is at least indicative evidence that there is a significant fiscal imbalance here.

The absence of bankruptcies, chronic indebtedness and operating deficits, suggesting that rural municipalities have and indeed *can* survive under current financial policies and practices and service expectations, is misleading. They do so because they are legislated to balance their books and manage debt within strict limits. We do not know the real costs of meeting these rules, for example in terms of sub-optimal services, allocative inefficiencies and inadequate facilities (Slack, 2006). We do know that if we persist in such a degree of reliance on the property tax base, the economic base of the community, which underpins the very viability of the rural community and its local government, will be a more and more critical factor in rural municipal financial viability. It is evident that with small, relatively undiversified, open and vulnerable economies, which are fragile, many rural community economies still directly or indirectly dependent on primary resources. There is also widespread evidence of a depleted labour force and relentless urban-based (and global) market competition. Given this, rural municipalities face particularly onerous challenges.

For many municipal governments in rural areas, economic uncertainty impedes efforts to sustain financially viable rural communities. Economic development and diversification of rural communities will make communities less dependent on single industries and natural resources and will mitigate the strains municipal governments face in coping with a boom-and-bust local economy. The provision of adequate public infrastructure is even more critical for rural economies that must overcome or compensate for limited accessibility and economies of scale, in order to compete effectively.

Integrated responses to these challenges have to address rural development policies and programs of other orders of government. The economic base is the central factor in the fiscal viability of the majority of rural municipalities; a pivotal means to the ends (Douglas, 2003). Other orders of government have undertaken visions and strategies for rural development. However, efforts must be made to coordinate policies and programs among governments and avoid a one-size-fits-all solution by recognizing the unique challenges and opportunities that exist in rural communities.

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