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STRENGTHENING COMMUNITIES:
ON THE PATH TO FISCAL SUSTAINABILITY

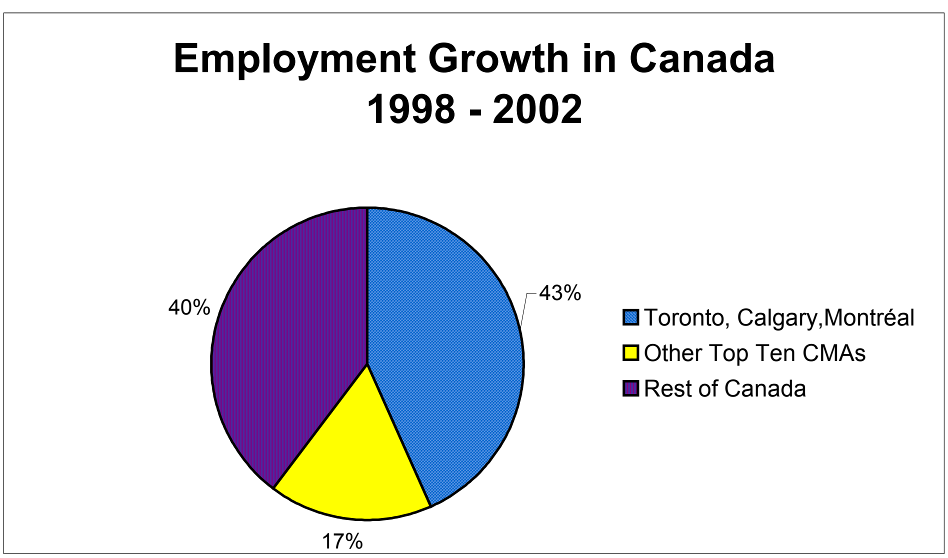
1. INTRODUCTION

A growing consensus is emerging that cities in Canada need a new deal. Charlie Baillie, Chairman of the TD Bank, the Prime Minister's Caucus Task Force on Urban Issues, CEOs of Chambers of Commerce in five Canadian Cities (C5), Anne Golden, CEO of the Conference Board of Canada, Judith Maxwell of Canadian Policy Research Networks, numerous federal ministers and David Dodge, Governor of the Bank of Canada, are among those who have expressed concern about the fiscal sustainability of our urban regions.

FCM is concerned about the sustainability of all communities, large and small, southern and northern. Specific issues respecting remote, rural and resource-based municipalities are the subject of other FCM reports and suggestions. Nevertheless, the recommendations in this document are central to the interests of **all** Canadian communities. As is stressed below, a sustainable and competitive urban Canada creates demand for the agricultural and food products, materials and energy produced in every corner of the country. A vital rural Canada depends on a vital urban Canada and urban Canada is nothing without its rural counterpart.

Urban quality of life is key to attracting business and talent and ensuring Canada's competitiveness in international markets. Recent employment growth in Canada has come from robust activity in urban centres. Sixty per cent of Canada's total employment growth in the last four years took place in ten urban regions, with 43% coming from three hot markets: Calgary, Toronto, and Montreal (Figure 1).

FIGURE 1



Source: Conference Board of Canada, Statistics Canada Labour Force Survey, March 2002.

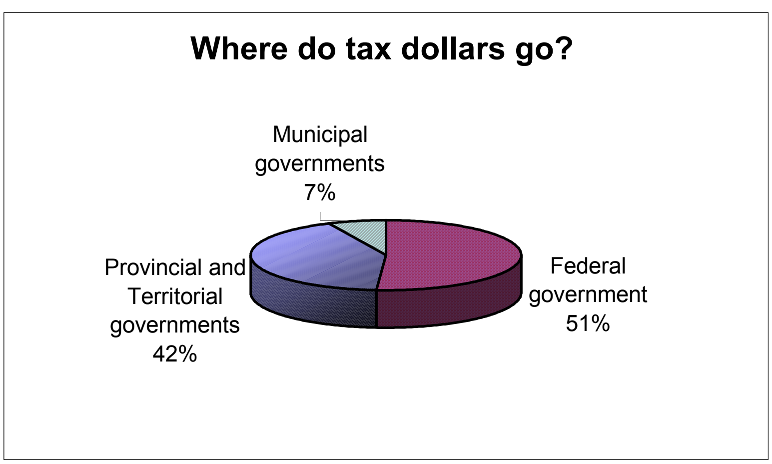
Rapid urban growth, however, has its downside. Investment in new infrastructure is pressing, the social support needs of many new urban residents are growing, and aging infrastructure in the core of our urban centres is eroding. At the same time, the municipal governments have assumed more responsibilities as services and programs have been offloaded from other governments.

Municipal governments are teetering on the brink of fiscal unsustainability, as their expenditure requirements increase and revenue sources are inadequate. In its October 2001 federal budget submission, FCM recommended that an appropriate federal contribution to these needs (infrastructure, integrated multi-modal transportation including public transit and affordable housing) at an additional $4.3 billion per year for five years.

1.1 Municipal Revenues and Responsibilities: A Mismatch

Municipal governments in Canada are responsible for delivering a wide array of services essential to Canada's social, economic and environmental sustainability. These services comprise: transport, such as roads, municipal transit, airports; police and fire protection; sewer and water; solid waste management; emergency preparedness; licensing; building inspection; economic development; resource conservation and environment; libraries; recreation and culture; building inspection; general administration and local and regional planning, to name only the obvious. In some provincial jurisdictions, municipal social services are important and comprise: social services, such as social housing and homelessness, general welfare assistance, including family and child care; education; and health services, such as public health and ambulance. Yet, only 7% of the tax dollar goes to municipal governments compared to 93% for the federal (51%) and provincial/territorial governments (42%) (Figure 2).

FIGURE 2



Statistics Canada, Government Revenue and Expenditure, 2000-2001

Growth in municipal revenues lags behind that of federal and provincial/territorial governments. From 1996 to 2001, federal revenues increased 25%, provincial/territorial revenues 25%, and municipal governments only 14% (Statistics Canada, Government Revenues and Expenditures, 2002). Municipal governments have made real efforts in coping with fiscal stress relative to other governments by increasing their reliance on own source revenue. For example, in the municipal sector, between 1996 and 2001:

- own source revenues jumped from 77.6% to 83% of municipal revenues;
- property tax climbed from 48.6% to 52% of municipal revenues (1991 – 2001);
- other governments' transfers to municipal governments decreased from 22.4% to 16.9% of municipal revenues;
- municipal spending increased 50% faster than that of the federal government (15% versus 10%) but slower than that of provincial and territorial governments (24%) (Statistics Canada, Local general government revenue and expenditure, August 2002).

Already over-reliant on property taxes, municipal governments are further disadvantaged with a form of taxation that is regressive and unresponsive to economic growth. Property taxes are inappropriate for funding redistributive services, such as affordable housing. The property tax also leads to greater taxpayer resistance to increases because it is highly visible – it is the only tax levied by a bill in the mail!

Another typical municipal revenue source is user fees. When efficiently set (using marginal cost pricing), user fees can be an effective way to cover the costs of certain services, such as roads, water and wastewater, and solid waste disposal.

1.2 Access to Other Revenue Sources in Canada and OECD Countries

Compared to other orders of government, municipal governments have far fewer tools to raise revenue (Figure 3). No municipal government in Canada levies an income tax or sales tax. Fuel tax revenue to support transportation is available only to a few cities in Canada-Vancouver, Victoria, Calgary, Edmonton and Montreal. 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 do not possess the independence to make their own choices about taxes, spending and debt and thus must rely on other governments to support their fiscal needs.

As for our competitors south of the border, the fiscal toolkit available to municipal governments in the U.S. offers more devices than those available to their Canadian counterparts (Figure 4). Fourteen U.S. states provide for municipal income taxes, and 31 allow local sales taxes. U.S. municipal governments spend twice as much as their counterparts (excluding local schools) in 1996 – 1997 (Figure 5).

In other OECD countries, municipal fiscal arrangements are also very different. Municipal income taxes are levied in many OECD countries. The Value Added Tax (VAT) is commonly used to support municipal governments and fuel taxes are used to support urban transportation needs.

Domestic and international experiences demonstrate that Canadian municipal governments need a fiscally-sustainable framework for access to predictable revenue sources, at a minimum through long-term federal programs and ultimately through access to growth-sensitive taxes. The Federation of Canadian Municipalities (FCM) believes that the overall tax burden of Canadians need not be increased, but rebalanced among governments.

FIGURE 3

ACCESS TO REVENUE SOURCES IN CANADA

	FEDERAL	PROVINCIAL	MUNICIPAL
Personal income taxes	√	√	
Corporate income taxes	√	√	
Sales taxes	√	√	
Payroll taxes	√	√	
Resource royalties		√	
Gaming, liquor profits		√	
Property taxes		√	√
Customs import duties	√		
Taxes on non-residents	√		
User fees	√	√	√
Fuel Tax	√	√	(Limited)√

Source: Department of Finance, Government of Canada and FCM, “Early Warning: Will Canadian Cities Compete?”, 2001.

FIGURE 4

MUNICIPAL AUTHORITY: USA and CANADA		
	USA	Canada
Property tax	**x**	**x**
Sales tax	**x**	
Hotel/motel tax	**x**	*
Business tax	**x**	x
Fuel tax	**x**	*
License fees	**x**	
Income tax: individual and corporate	**x**	
Development charges	**x**	**x**
Tax-exempt municipal bonds	**x**	
Tax incentives	**x**	
Grants to corporations	**x**	
Borrow money	**x**	**x**
***indicates rare instances of this type of authority**		

Source: FCM, "Early Warning: Will Canadian Cities Compete?", 2001.

FIGURE 5

Per Capita Municipal Government Expenditure	
Canada	**$ 785 US**
United States	**$1,652 US**

Source: FCM "Early Warning: Will Canadian Cities Compete?" 2001

2. WHY THE GOVERNMENT OF CANADA SHOULD CONTRIBUTE

Public finance experts often employ a benefits model as an appropriate framework to gauge fiscal responsibility. Benefits which stay within the community should be paid for locally. However, where benefits spill over onto other jurisdictions, it is appropriate to consider additional funding mechanisms. As well, benefits may be direct or indirect. For example, an urban transit system supports workers coming in from adjacent communities. At the same time, Canadians generally realize indirect benefits from public transportation systems that allow reduced car-dependency, less smog and decreased GHG emissions.

The benefits of robust urban regions are realized well beyond municipal boundaries. As the country's primary economic engines, cities create opportunities for innovation and generate wealth and social and human capital. Employment growth is fuelled by large urban centers not only locally, but in agricultural and resource based communities that provide essential food, materials and energy. The goods and services produced in urban regions account for an increasing share of GDP: the ten largest urban economies in Canada accounted for just under half of the country's GDP in 2000 (Conference Board of Canada, "Metropolitan Outlook").

Unfortunately, in the current fiscal regime, the consequences of a buoyant economy are negative for our cities and urban regions. For example, while the Edmonton region leads the country in economic growth, it cannot support the investments needed to sustain that growth from property taxes alone. It takes fully ten years for Edmonton to recover its investment in services (roads, water supply, sewers, etc) from the property taxes that ultimately flow. Overwhelming, the benefit of such growth flows not to the city which made the initial investment, but to the federal and provincial governments through GST, corporate, personal and fuel tax revenues.

In sum, all Canadians benefit from investments in urban regions. To be competitive globally, Canada needs cities with a high quality of life – cities where people and goods can be transported reliably, where housing is affordable, where clean water is always available, where community amenities are accessible.

One should also consider a "costs" model – to assign a funding responsibility to the federal government when its policies and programs impose new costs on the municipal government. There are countless examples. Federal immigration policies lead to substantial costs in urban areas that are magnets for refugees and new Canadians. Federal responsibility for Aboriginal Canadians falls short of offsetting costs associated with the increasing numbers migrating from reserves to cities. Federal regulations provide telecommunications carriers easy access to municipal rights of way without an obligation to pay incremental costs, forcing local taxpayers to subsidize private sector undertakings. Federal water quality and environmental obligations also impose a heavy burden on municipal governments.

Indeed, municipal governments pay a portion of the GST on the public goods they purchase such as water treatment equipment, ambulances and engineering services, not to mention the full excise tax imposed on the fuels used for urban transit.

3. CRITERIA FOR ACCESSING NEW RESOURCES

In assessing the most appropriate new revenue sources for municipal governments, the following criteria must be considered:

- Reliable and responsive to growth: The revenue source should grow sufficiently to cover the rising costs of services without risk of interruption.

A more reliable source of revenue makes it easier for cities to make long-term plans.
- Transparent and visible: There should be a clear link between the tax and the services received by beneficiaries.
- Low administration and compliance cost: The revenue source should be easy and not too costly to administer and collect.
- Efficient: The revenue source should not unduly distort the allocation of resources.
- Equitable: The approach should be fair, either by matching beneficiaries with those bearing the burden or by levying taxes based on ability to pay.
- Strategic: Programs should meet key priorities to advance common governments' objectives.
- Adequate: Municipal governments should have the capacity to generate sufficient revenues at reasonable tax rates to meet expenditure needs and changing fiscal circumstances.

4. OPTIONS FOR MUNICIPAL FINANCING

There are three broad options for municipal governments to access resources from the federal and provincial/territorial governments: contribution programs, revenue sharing and empowering municipal governments to levy growth taxes. The focus here is on the first two options, those available to the Government of Canada.

4.1 Federal Contribution Programs

Government of Canada contribution programs are effective in assisting with municipal infrastructure gaps and specific social needs involving populations at risk such as the homeless, youth and urban aboriginals. However, short-term programs by definition unstable and unreliable are thus effective neither in dealing with long-term capital projects nor endemic social issues. Further, short-term infrastructure programs, while they are welcome, tend to skew municipal priorities by changing the focus from strategic, long-term community needs toward using the funds before because they are available now. Long-term commitments would address the problem of stability and reliability.

4.2 Revenue Sharing

An alternative is to give municipal governments access to revenue streams generated by growth taxes levied by other governments. The Government of Canada could provide to municipal governments a share of the receipts from federal taxes such as personal income tax (PIT), excise tax or GST.

Two approaches are used in other countries:

- The national government agrees to commit a fixed percentage of its revenues from a particular tax source or sources for municipal purposes. These new municipal revenues fluctuate with changes in national revenues. The funds are distributed to the municipalities from which they were collected or they are distributed according to an agreed-upon formula. The advantage for the national government is that its contribution declines as its revenues decline.

- Each municipal government or regional body sets its own rate for income / excise/ sales tax rate based on its expenditure needs. The national government may or may not create "tax room" for municipal governments to set these rates. Municipal revenues would vary according to the tax rate and the local tax base. In order to minimize border issues and tax avoidance by persons moving to a neighboring tax jurisdiction, establishment in metropolitan areas of an appropriate regional body with the authority to tax should be encouraged. Fortunately, the border problem tends to ensure individual municipal governments do not levy taxes higher than the norm.

The common or shared national-municipal tax base reduces administration and compliance costs. Differences in the size of the tax base across municipalities means a different ability to generate revenues. Under these circumstances, an equalization formula to take into account different fiscal capacities may improve equity but will reduce municipal autonomy and accountability. Both approaches score high on administrative cost, while the latter scores higher on accountability, reliability and adequacy. Personal Income Tax (PIT), the excise tax and the VAT or GST rate high on accountability, responsiveness to urban growth, reliability, efficiency and equity.

ALTERNATIVE PROGRAM DELIVERY MECHANISMS

Ensuring the efficient use of funds and respect for municipal priorities and accountability depend upon the establishment of effective structures for program delivery. Five distinct approaches are currently used to deliver federal resources to support municipal economic and social needs:

4.3 Tripartite National Programs

- Tripartite infrastructure programs are a longstanding model of collaboration among all orders of government. They have been well received by municipal governments and has done much to improve the quality of life in Canadian communities. Historically, a weakness has been the propensity of some provincial/territorial governments to appropriate the federal funds for their own purposes. This factor has been limited in those jurisdictions where municipal associations have played a full role on the program management committee. A second reality has been that the program has been "broad brush", supporting a large number of small projects, but lacking the means to support large projects critical to national, strategic interests.

4.4 Strategic Federal Investments

- The Strategic Infrastructure Fund (SIF) was announced in the December 2001 federal budget. Funded initially at $2 billion, the Fund is designed to support those projects beyond the scope of the Infrastructure Canada Program. Large investments in strategic urban needs including water and waste water treatment facilities, transit and transportation, and tourism facilities will likely be supported. The partnerships for each project will be individually structured and may involve the Government of Canada acting on its own, or in partnership with any combination of municipal, provincial/territorial, and private sector interests.

- Assuming that the commitment to the Fund is long term, and that resources will be topped up as funds are depleted, SIF could prove an effective instrument in meeting the needs of Canada's municipal governments.

4.5 Targeted Tripartite Programs

- To address complex social and economic problems in defined urban areas, the Government of Canada has entered into trilateral agreements with the other two orders of government to ensure the coordination of resource deployment. A current example is the Canada/British Columbia/Vancouver agreement targeting the social, medical and economic needs of the City's lower east side.

4.6 Direct Federal-Municipal Transfers

- In its support of the homeless population in selected cities, the Government of Canada has concluded agreements directly with municipal authorities and community organisations through the Supporting Communities Partnership Initiative (SCPI). Another example is Transport Canada's Urban Transportation Showcase Program.

4.7 Federal Investments Channelled Through The Federation of Canadian Municipalities

- With the Green Municipal Funds, the Government of Canada has endowed the Federation of Canadian Municipalities with resources to stimulate investments by municipal governments in leading edge environmental technologies. The results have been quick and effective.

Emerging needs in cities, such as innovation, skills development, child development, youth at risk, access to recreation and cultural infrastructure, crime prevention, anti-drug strategy, and urban aboriginals could be accommodated by one of the above approaches depending on the complexity of issues and municipal circumstances.

5. PROPOSALS FOR ACTION IN THE 2003 FEDERAL BUDGET

The issues that have been identified require both immediate and long-term action by both the federal and provincial governments. The following suggestions describe a range of options available to the Government of Canada. FCM's 2003 Federal Budget Submission will further elaborate on specific proposals. The suggestions are intended to target urban needs paralleling with the Government of Canada's "Rural Partnership" and are intended as mechanisms to support the recommendations of the Prime Minister's Caucus Task force on Urban Issues.

5.1 Federal Commitment to a Permanent Infrastructure Program

The infrastructure needs of Canadian communities are daunting. The TD Bank estimates that the total municipal infrastructure shortfall is at least $44 billion (1996) and continues to grow at a rate of $2 billion per year. By their very nature, infrastructure investments take time to plan and implement. Short-term programs may distort priorities and stimulate investments not optimal for a communities needs.

FCM urges the Government of Canada to provide permanent infrastructure programming with stable, reliable increased funding to replenish the Infrastructure Canada Program and the Strategic Infrastructure Fund as funds are used to meet the pressing needs of Canadian communities. These programs must be flexible and sensitive to the different needs of municipal governments in rural and remote areas as well as urban regions.

5.2 Extend the National Affordable Housing Program

The need for affordable housing is escalating in our cities, undermining their social stability, competitiveness and security. In 1996, CMHC found 1.7 million Canadian households to be in what is called "core need" as families find it increasingly hard to find money for food, clothing, medicine and other basic necessities. FCM commends the Government of Canada's announcement of a federal/provincial/territorial capital grants program for affordable rental housing totalling $680 million over five years. To date, only the British Columbia, Ontario, Alberta, Saskatchewan, Quebec, the Northwest Territories and Nunavut have signed an agreement.

In order to address the root causes of the housing crisis, long-term solutions are also necessary. These should include:

- creating 20,000 new or acquired affordable units each year, for 10 years;
- rehabilitating 10,000 affordable units a year, for 10 years;
- providing income or rental assistance to make units affordable for 40,000 incremental households per year, for 10 years; and
- offsetting the Goods and Services Tax on new rental housing development, allowing rental investors to qualify for the small-business deduction, restoration of CCA pooling to encourage capital reinvestment in new properties and the creation of Labour Sponsored Investment Funds.

FCM urges the Government of Canada to implore those provinces/territories that have yet to reach an understanding to conclude an agreement now. As the program is put into action, it should be ramped up to greater amounts over time to address both present and long-term housing needs.

5.3 Support a Multi-Modal Integrated, National Transportation System Including Urban Transit

Inadequate urban transportation systems slow the movement of goods, increase greenhouse gas emissions, and create health and safety problems. Efficient transportation strengthens economic growth, competitiveness, and environmental sustainability. Canada is the only G7 country with no central government provision of funds for urban transit and transportation infrastructure. The interim report of the Prime Minister's Caucus Task Force on Urban Issues called for a program specifically to address these needs.

FCM urges the Government of Canada to establish, in collaboration with provinces and territories, a multi-modal integrated, National Transportation Infrastructure program that includes urban transit. Municipal governments would be required to present plans for transportation infrastructure improvements that meet criteria related to sound land-use and transportation planning principles. For urban transit projects, support from the Government of Canada would require presentation of municipal plans that establish conditions for increased transit ridership and revenues. Combined with legislative or regulatory changes to make employer-provided transit passes a non-taxable benefit, this program would significantly contribute to increasing ridership and revenues

Release of a final portion of federal disbursements would occur upon completion of an approved community-developed plan. The program would require up to $1 billion per year within the first five years.

5.4 Increase the GST Rebate to the Municipal Sector/Remove Municipal Excise Tax Burden.

The Government of Canada could improve in the short term the fiscal sustainability of municipal governments by building upon the current GST rebate to municipal governments.

FCM urges the Government of Canada to increase the GST rebate provided to the municipal sector from 57.14 % to 100%. The benefit to municipal governments would be about $450 million after three years. Excise taxes on fuels used in providing essential public goods should be eliminated.

6. PROPOSALS FOR FUTURE ACTION

6.1 Allow Municipal Governments to Share Tax Revenues Levied by Other Governments.

The Government of Canada, in cooperation with provincial/territorial governments, would allow municipal governments to share growth tax revenues levied by other orders of government including PIT, GST and fuel taxes.

For example, further to encourage increased urban transit ridership, the federal government could allow municipal governments to share the excise tax on fuel levied by the federal government. Provincial governments would also be encouraged to share a portion of their fuel tax as is already the case in some provinces. As a general rule, the federal government, in collaboration with provinces and territories, would agree to commit a fixed percentage of their revenues for municipal purposes. These funds would be distributed to the municipal governments from the territories of which they were collected or would be distributed according to an agreed-upon formula. This approach could apply to the excise tax on fuel, PIT or GST.

It is assumed that the overall tax burden of Canadians will not be increased but rebalanced among all orders of government.

FCM urges the federal government, in collaboration with provinces and territories, to allow municipal governments to share tax revenues levied by other orders of government for municipal purposes. Municipal governments would use a common tax base and existing tax collection systems, thus encouraging tax harmonization and minimizing compliance and administrative costs.

FCM will work with provincial and territorial municipal associations to press for these ideas provincially and territorially.

6.2 Establish a National Municipal Finance Corporation to Finance Municipal Infrastructure

The role of the private sector in the financing of municipal infrastructure should be explored. FCM seeks to increase and improve the access of Canadian municipal governments to private sector financing in a number of ways, including:

- the provision of independent professional financial advice concerning options – traditional and non-traditional – for financing infrastructure capital expenditures, with the objective of minimizing interest expense and financial risk to municipal governments; and
- the development of financial products that maximize private sector leverage on any form of federal government support provided for municipal infrastructure capital projects.

FCM urges the federal government to provide a relatively modest federal interest rate subsidy of $75 million. This would be sufficient to provide investors an interest rate incentive of 1.5 % over ten years, which would release up to $1 billion of private sector debt financing to municipal governments for specific and verifiable infrastructure projects.

FCM would collaborate with the federal government to develop these capabilities - either within FCM or through the creation of a new tax-exempt national municipal finance corporation owned or controlled by FCM.