

# **Financing Canadian Cities In The Future?**

**By**

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### **Financing Canadian Cities in the Future?**

The title of this paper is posed as a question. This is deliberate for no one really knows what the future will bring even though there is considerable speculation and any number of ‘doomsday’ predictions with catastrophic consequences. To set the framework for this discussion, the following section outlines the constitutional status of Canadian cities. This is followed by a discussion of what Canadian cities do; their current funding sources; their current and future fiscal sustainability; and what they should do on their own and what provincial governments should permit them to do to ensure fiscal sustainability in the future.

#### **Constitutional Status of Cities**

In Canada, cities are ‘creatures of the province’.<sup>1</sup> Their governing structures are created by provincial statutes, and their powers, expenditure responsibilities, and access to revenue sources are all ultimately under provincial control. Provincial legislation that defines city responsibilities is embodied in a municipal act and many additional statutes and regulations. For example, in the province of Ontario, it has been estimated that 150 pieces of legislation govern the operations of city government. In the provinces of British Columbia, Manitoba, and New Brunswick, the cities of Vancouver, Winnipeg, and Saint John are each governed by a charter that confers additional powers and responsibilities not given to other municipal governments. Interest in charter cities has grown recently, primarily in response to difficulties facing larger cities in meeting their expenditure commitments from their limited municipal revenue base. No where is this more apparent than in the City of Toronto where a group of citizens has been working to have Toronto’s status changed to a Charter City.

#### **What Do Cities Do?**

While the objective of this paper is to consider future financing, a few paragraphs will be devoted to current expenditure responsibilities for this drives the need for financing requirements. Even though cities operate in a restrictive environment, their expenditure responsibilities vary from province to province. As well, over the past decade, cities have been saddled with increasing spending responsibilities (provincial

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<sup>1</sup> Section 92 of the *Canadian Constitution Act* mentions that “Municipal Institutions in the Province” are under exclusive jurisdiction of the provinces.

downloading), faced reduced grant funding, and been given no direct access to additional tax sources (Kitchen, 2002, chapters 1 and 2).

Tables 1 and 2 highlight major interprovincial spending similarities and differences for the entire municipal sector (cities, towns, villages, townships, counties, regions and districts). This use of aggregated data, when discussing cities only, is not the most desirable option but it is all that is available since there is no uniform and consistent data set for Canadian cities only. Even so, using aggregated data should not be a problem, when discussing cities only, because the data are dominated by the pattern in cities and large urban areas – over 80 percent of Canada’s population lives in urban centers.

From Table 1, the following may be noted.

- Per capita municipal spending ranged from a low of \$379 per capita in Prince Edward Island to a high of \$1,951 for Ontario with the weighted average for Canada being \$1,546. Interprovincial differences of the sort noted in this table may be attributed to a number of factors including; different municipal expenditure responsibilities; higher servicing costs in some areas; greater municipal needs in the more highly urbanized provinces; higher quality of service; or possibly, more waste and inefficiency in service delivery in some places.
- As a percent of gross domestic provincial product (GDPP) which is a measure of economic activity, municipal spending for the entire country changed ever so slightly - from 4.6% in 1988 to 4.5% in 2001. When compared interprovincially, municipal spending increased in relative importance in two provinces only – Ontario, from 4.6% to 5.3%; and British Columbia, from 3.8% to 4.0%.
- As a percent of total provincial/municipal spending, municipal expenditures increased in relative importance in Ontario (from 20.1% to 23.5%) and New Brunswick (from 10.0% to 10.1%) only. In all other provinces, municipal spending declined as a percent of the combined provincial and municipal sector.

| Province<br>(1)   | 1988 -<br>Per Capita<br>(2) | 2001 -Per<br>Capita<br>(3) | 1988 -<br>% of GDPP<br>(4) | 2001 -% of<br>GDPP<br>(5) | 1988/89 - %<br>of provincial-<br>local total<br>(6) | 2001/02 -% of<br>provincial-<br>local total<br>(7) |
|-------------------|-----------------------------|----------------------------|----------------------------|---------------------------|---|--|
|                   | \$                          | \$                         | %                          | %                         | %   | %  |
| Newfoundland      | 563                         | 767                        | 4.0                        | 2.9                       | 9.2   | 8.0  |
| Prince Edward Is. | 252                         | 379                        | 1.8                        | 1.5                       | 4.5   | 4.3  |
| Nova Scotia       | 865                         | 1,061                      | 4.5                        | 4.0                       | 15.3  | 13.1   |
| New Brunswick     | 551                         | 864                        | 3.3                        | 3.2                       | 10.0  | 10.1   |
| Quebec            | 1,002                       | 1,341                      | 4.9                        | 4.3                       | 15.3  | 13.7   |
| Ontario           | 1,181                       | 1,951                      | 4.6                        | 5.3                       | 20.1  | 23.5   |
| Manitoba          | 871                         | 1,091                      | 4.5                        | 3.6                       | 13.8  | 11.7   |
| Saskatchewan      | 814                         | 1,143                      | 4.5                        | 3.5                       | 12.3  | 12.2   |
| Alberta           | 1,306                       | 1,579                      | 5.2                        | 3.2                       | 17.9  | 16.0   |
| British Columbia  | 830                         | 1,286                      | 3.8                        | 4.0                       | 15.4  | 14.5   |
| Average - Canada  | 1,035                       | 1,546                      | 4.6                        | 4.5                       | 16.7  | 17.3   |

Note: 1988 is the first year for which the data were provided on a uniform and consistent basis and 2001 is the last year for which data were available at the time of writing.  
 Source: Calculated from Statistics Canada data, Financial Management Systems (FMS), mimeograph, June 2002.

Municipal responsibilities differ from province to province. Table 2 records the relative importance of municipal expenditures by function (what they actually do) for each province. The more notable points from this table are listed here:

- Social services are almost entirely a provincial funding responsibility in every province except for Ontario where they account for 25 percent of municipal spending – as of 2002, Nova Scotia removed social service funding from the local property tax base
- Nova Scotia is the only province where municipalities are responsible for funding some public education - school boards and/or provinces are responsible for this expenditure elsewhere.
- Health expenditures are the responsibility of the provinces except for relatively small expenditures made by municipalities for preventative health care programs (anti-smoking campaigns, for example).
- Expenditures on transportation (roads, streets, snow removal, public transit), protection (police and fire) and environmental (water, sewage, solid waste collection and disposal) services account for over 50 percent of all municipal expenditures in every province except for Ontario (it is proportionately lower here because of large municipal spending on social services).
- Expenditures on recreation and cultural services account for between 9 and 22 percent of the municipal total everywhere.

Table 2: Per Capita Level and Distribution (in percent) of Municipal Government Expenditures by Province, 2001

|                    | Nfld. | Prince Edward Island | Nova Scotia | New Brun. | Quebec | Ontario | Manitoba | Sask. | Alberta | British Columbia | Canada |
|--------------------|-------|----------------------|-------------|-----------|--------|---------|----------|-------|---------|------------------|--------|
| Municipal Services |       |                      |             |           |        |         |          |       |         |                  |        |

|                        | %     | %     | %     | %     | %     | %     | %     | %     | %     | %     | %     |
|------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| General Administration | 16.2  | 12.9  | 10.4  | 11.1  | 12.2  | 8.9   | 13.7  | 12.4  | 12.2  | 10.0  | 11.0  |
| Protection             | 4.7   | 23.2  | 20.1  | 21.0  | 16.7  | 13.4  | 19.7  | 17.6  | 14.3  | 18.8  | 15.9  |
| Transportation         | 28.6  | 21.5  | 16.9  | 20.2  | 27.2  | 18.2  | 23.4  | 31.8  | 28.3  | 16.5  | 19.8  |
| Health                 | 0.1   | 0.1   | 0.1   | 0.4   | 0.2   | 3.5   | 2.2   | 0.6   | 1.6   | 1.8   | 2.0   |
| Social Services        | 0.2   | 0.0   | 4.5   | 0.0   | 1.4   | 24.7  | 0.3   | 0.5   | 1.6   | 0.2   | 12.6  |
| Education              | 0.1   | 0.0   | 14.2  | 0.0   | 0.1   | 0.0   | 0.0   | 0.0   | 0.3   | 0.0   | 0.4   |
| Resource Conservation  | 0.7   | 1.7   | 0.8   | 2.4   | 2.8   | 1.6   | 2.4   | 3.6   | 3.4   | 1.4   | 2.0   |
| Environment            | 22.1  | 12.7  | 16.8  | 25.4  | 12.0  | 13.3  | 17.4  | 15.4  | 13.9  | 20.4  | 14.0  |
| Recreation/Culture     | 14.5  | 21.9  | 10.7  | 12.7  | 12.4  | 8.7   | 9.4   | 14.2  | 13.8  | 19.6  | 11.1  |
| Housing                | 0.6   | 0.0   | 0.2   | 0.3   | 2.9   | 5.0   | 0.4   | 0.4   | 0.7   | 0.6   | 2.6   |
| Regional Planning      | 1.2   | 2.3   | 1.5   | 2.0   | 2.5   | 0.1   | 2.3   | 1.7   | 3.0   | 2.3   | 2.2   |
| Debt Charges           | 11.1  | 3.7   | 3.7   | 4.2   | 9.4   | 2.3   | 8.5   | 1.7   | 7.1   | 6.3   | 5.9   |
| Other                  | 0.0   | 0.0   | 0.0   | 0.2   | 0.0   | 0.2   | 0.4   | 0.1   | 0.0   | 2.2   | 0.5   |
| Total                  | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

- Protection includes courts of law, correction and rehabilitation, police, firefighting, and regulatory measures.
  - Transportation and communications includes roads and streets, snow and ice removal, parking, and public transit.
- Health includes hospital and preventive care.
  - Resource conservation & Industrial Development includes agriculture, tourism, trade and industrial development.
- Environment covers water, sewer, solid waste collection and disposal, and recycling.
- Regional planning and development covers planning, zoning and community development.
- Debt charges cover interest payments.

Source: Same as Table 1

- Debt charges (for capital projects only because municipalities are not permitted to borrow to cover a budgeted operating deficit) show considerable variation ranging from a high of 11 percent of total municipal spending in Newfoundland to a low of less than 2 percent in Saskatchewan.

## How Are Cities Currently Funded?

City revenues consist of grants (conditional and unconditional, primarily from the provincial government with very little coming from the federal government) and funds generated from own sources including property taxes and user fees with small sums coming from investments and a miscellaneous collection of amusement taxes, licences and permits, and fines and penalties.

This comparison is presented in Table 3.

- **Own source revenue (OSR)** accounted for a high of 94 percent of municipal revenue in Nova Scotia and a low of 74 percent in Newfoundland with the average for Canada being 83 percent.

- **Conditional and unconditional grants** account for the remaining municipal revenues – ranging from 26 percent in Newfoundland to 6 percent in Nova Scotia.
- **Property taxes**, the major component of OSR, accounted for 74 percent of all municipal revenue in Nova Scotia (the highest) and 44 percent in Alberta (the lowest). For all of Canada, property taxes contributed 52 percent of all municipal revenue in 2001. The property tax is discussed in more detail below.
- **User fees** - as with property taxes, there is considerable variation in the relative importance of user fees - they accounted for a high of 29 percent of all municipal revenue in British Columbia and a low of 16 percent in Newfoundland and Nova Scotia.
- **Since the late 1980s** – the relative importance of (reliance on) municipal property taxes and user fees has grown with dependence on provincial grants correspondingly falling.

## The Property Tax

The property tax is the only tax available to cities and it is frequently shared with school boards and provinces. Table 4 records per capita levels of property taxation by province for 2001 along with the percentage breakdown of property taxes that were collected by municipal governments, provincial governments and school boards. From this table, the following may be noted:

- Wide variation exists in the level of per capita property taxes across Canada – Newfoundland is lowest at \$382 for municipal purposes (no school board and provincial property tax) and Ontario is the highest at \$1,398 (\$924 for municipal purposes and \$473 for school boards although the rate is set by the province).
- In every province, the property tax is shared between the municipal sector and the province and/or school boards.
- Provincial involvement in property taxation is linked to the province’s direct interest in taxing property to fund a portion of the costs associated with elementary and secondary schooling. The general practice is for provinces to stay

Table 3: Distribution (in percent) of Municipal Government Revenue by Province and Territory, 2001

| Revenue Source     | Nfld. | Prince Edward Island | Nova Scotia | New Brun. | Quebec | Ontario | Manitoba | Sask | Alberta | British Columbia | Canada |
|--------------------|-------|----------------------|-------------|-----------|--------|---------|----------|------|---------|------------------|--------|
| Property Taxes     | 54.3  | 62.3                 | 73.7        | 55.1      | 64.3   | 48.3    | 46.7     | 54.3 | 44.4    | 53.0             | 52.2   |
| Other Taxes        | 1.1   | 0.6                  | 0.1         | 0.5       | 0.3    | 1.3     | 2.5      | 4.5  | 1.6     | 2.7              | 1.3    |
| User Fees          | 16.4  | 26.9                 | 16.4        | 25.3      | 16.6   | 23.9    | 23.4     | 24.3 | 26.1    | 29.3             | 23.0   |
| Investment Income  | 1.9   | 1.6                  | 3.6         | 1.0       | 2.0    | 4.2     | 8.0      | 4.4  | 10.3    | 8.6              | 4.9    |
| Other              | 0.6   | 1.5                  | 0.2         | 0.5       | 2.3    | 1.7     | 0.8      | 1.0  | 1.6     | 0.6              | 1.6    |
| Own Source Revenue | 74.3  | 92.8                 | 94.0        | 82.4      | 85.5   | 79.3    | 81.5     | 88.5 | 84.1    | 94.2             | 83.0   |

|                      |       |       |       |       |       |       |       |       |       |       |       |
|----------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Unconditional Grants | 6.3   | 3.3   | 2.7   | 12.4  | 1.9   | 2.3   | 7.9   | 4.6   | 0.9   | 1.1   | 2.4   |
| Conditional Grants   | 19.4  | 3.8   | 3.3   | 5.2   | 12.6  | 18.3  | 10.6  | 6.9   | 15.0  | 4.8   | 14.6  |
| Federal              | 2.9   | 0.3   | 0.5   | 1.0   | 0.2   | 0.3   | 1.2   | 2.1   | 0.5   | 0.5   | 0.4   |
| Provincial           | 16.5  | 3.6   | 2.8   | 4.2   | 12.4  | 18.0  | 9.5   | 4.9   | 14.6  | 4.3   | 14.2  |
| Total Grants         | 25.7  | 7.2   | 6.0   | 17.6  | 14.5  | 20.7  | 18.5  | 11.5  | 15.9  | 5.8   | 17.0  |
| TOTAL                | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

- Property taxes: taxes on real property, developers contributions and lot levies, special assessments, grants-in-lieu of taxes and business property taxes.
- Other taxes: amusement taxes, licences and permits.
- User Fees: water and sewage, rentals, concessions and franchises.
- Investment Income: profits from own enterprises, interest and penalties from taxes.
- Other: fines and penalties

Source: Same as Table 1.

| Province          | Per Capita Property Taxes |              |            |       | Distribution of Property Taxes |              |            |       |
|-------------------|---------------------------|--------------|------------|-------|--------------------------------|--------------|------------|-------|
|                   | Municipal                 | School Board | Provincial | Total | Municipal                      | School Board | Provincial | Total |
|                   | \$                        | \$           | \$         | \$    | %                              | %            | %          | %     |
| Newfoundland      | 382                       | 0            | 0          | 382   | 100.0                          | 0.0          | 0.0        | 100.0 |
| Prince Edward Is. | 273                       | 0            | 346        | 618   | 44.1                           | 0.0          | 55.9       | 100.0 |
| Nova Scotia       | 769                       | 0            | 0          | 769   | 100.0                          | 0.0          | 0.0        | 100.0 |
| New Brunswick     | 463                       | 0            | 357        | 820   | 56.4                           | 0.0          | 43.6       | 100.0 |
| Quebec            | 832                       | 150          | 47         | 1,028 | 80.9                           | 14.5         | 4.6        | 100.0 |
| Ontario           | 924                       | 473          | 1          | 1,398 | 66.1                           | 33.8         | 0.0        | 100.0 |
| Manitoba          | 523                       | 354          | 176        | 1,053 | 49.7                           | 33.6         | 16.7       | 100.0 |
| Saskatchewan      | 577                       | 595          | 1          | 1,173 | 49.2                           | 50.7         | 0.1        | 100.0 |
| Alberta           | 773                       | 59           | 353        | 1,185 | 65.2                           | 5.0          | 29.8       | 100.0 |
| British Columbia  | 603                       | 0            | 357        | 960   | 62.8                           | 0.0          | 37.2       | 100.0 |
| Average - Canada  | 790                       | 256          | 110        | 1,156 | 68.4                           | 22.1         | 9.5        | 100.0 |

Source: Same as Table 1.

away from provincial property taxes if local school boards have the power to tax property.

- At the moment, Manitoba and Saskatchewan are the only two provinces that permit school board taxation in any significant way. School boards in some of the remaining provinces raise small amounts of revenue from property taxes. Elsewhere, elementary and secondary schooling funding is entirely the responsibility of the province.

## Are Cities Fiscally Sustainable At The Moment?

The growing importance of cities<sup>2</sup> raises the question of whether Canadian cities have adequate fiscal tools or levers to fund necessary programs and requirements.<sup>3</sup> To thrive financially, cities must have the capacity to generate sufficient revenues to meet their expenditure needs, obligations and commitments. This is impacted by the cyclical sensitivity of their funding responsibilities - do expenditure programs vary with the growth or slow down in economic activity (social services, social housing, for example)? As well, it is affected by the capacity of the local revenue base and local taxes to keep pace with expenditure responsibilities – is there enough revenue elasticity in the local tax base to permit revenues to rise and fall with expenditure requirements? Finally, it is affected by the ability of cities to control their own destiny – do they have sufficient control over their expenditure responsibilities and revenue sources to meet changing fiscal circumstances? (Kitchen, 2002a)

Currently, cities appear to be meeting their increased expenditure responsibilities with current revenue sources and are, one could argue, fiscally sustainable. This, however, is at a time when the economy has come through a sustained period of growth with relatively low unemployment and comparatively low (by past standards) social service expenditures – this is particularly important for Ontario cities because they are responsible for funding about 25 percent of all social service expenditures. In many cities, the growth in the property tax base over the past few years has been sufficient to meet on-going expenditure requirements without noticeable property tax increases.

Where property tax rates have increased, the issue of fiscal sustainability goes hand in hand with the question of whether or not there is an acceptable threshold or maximum tax rate or tax level that can be implemented (Haughwout et. & al., 2000). This is frequently followed by the assertion that the property tax has insufficient revenue generating capacity to meet increased expenditure needs. In short, there is no definitive way in which one can determine this, just as there is no solid evidence to suggest that there is less revenue generating capacity in the municipal property tax than in provincial taxes. Property tax rates can be increased, although city politicians generally deem this to be political suicide. To gain some insight into the extent to which municipal property taxes have changed vis-à-vis provincial income and sales taxes, the reader is referred to Table 5.

When municipal property taxes, provincial income and consumption taxes are taken as a percent of gross domestic provincial product (GDPP) for 1971/72 and 2001/02, the following is observed. Municipal property taxes declined in relative importance in all provinces except for Newfoundland and New Brunswick. For all of Canada, the decline

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<sup>2</sup> Halifax accounts for 47 percent of Nova Scotia's gross domestic provincial product (GDPP); the former Montreal Urban Community for 49 percent of Quebec's GDP; the Greater Toronto Area for 44 percent of Ontario's GDPP; Winnipeg for 67 percent of Manitoba's GDPP; Calgary and Edmonton together for 64 percent of Alberta's GDPP; and Vancouver for 53 percent of British Columbia's GDPP (Conference Board, 2001).

<sup>3</sup> For a more detailed discussion of measures of fiscal sustainability, see Slack and Bird, 2004.

amounted to 1.5 percentage points (from 3.8 percent to 2.3 percent of GDPP) with the largest decline occurring in Saskatchewan (by 3.0 percentage points of GDPP).

Provincial income taxes, by comparison, increased in relative importance in every province. Provincial consumption tax revenues also increased in relative importance in every province, except for Prince Edward Island and New Brunswick where there was a slight decrease.

While these numbers do not, by themselves, support the case for higher property taxes, they do suggest that property taxes as a percent of a common base have grown more slowly than provincial income taxes or provincial consumption tax revenues. The high visibility of the property tax, a perception that it is highly regressive, and concern over a possible taxpayers' revolt have contributed to a resistance by cities to use it more extensively. All of this suggests that cities are fiscally sustainable at the present time.

| Province          | 1971/72                  |                         |                              | 2001/02                  |                         |                              |
|-------------------|--------------------------|-------------------------|------------------------------|--------------------------|-------------------------|------------------------------|
|                   | Municipal Property Taxes | Provincial Income Taxes | Provincial Consumption taxes | Municipal Property Taxes | Provincial Income Taxes | Provincial Consumption taxes |
|                   | %                        | %                       | %                            | %                        | %                       | %                            |
| Newfoundland      | 1.0                      | 2.8                     | 6.0                          | 1.5                      | 4.9                     | 6.6                          |
| Prince Edward Is. | 3.0                      | 2.3                     | 7.4                          | 1.1                      | 5.2                     | 7.1                          |
| Nova Scotia       | 3.7                      | 3.0                     | 5.0                          | 2.9                      | 5.9                     | 6.1                          |
| New Brunswick     | 0.8                      | 3.4                     | 5.6                          | 1.7                      | 5.4                     | 5.5                          |
| Quebec            | 3.7                      | 5.6                     | 4.6                          | 2.7                      | 8.5                     | 5.2                          |
| Ontario           | 4.1                      | 3.4                     | 3.2                          | 2.5                      | 5.9                     | 4.8                          |
| Manitoba          | 4.0                      | 3.9                     | 3.5                          | 1.7                      | 5.8                     | 5.2                          |
| Saskatchewan      | 4.8                      | 1.8                     | 4.0                          | 1.8                      | 4.3                     | 5.0                          |
| Alberta           | 3.7                      | 3.3                     | 1.3                          | 4.3                      | 4.3                     | 1.8                          |
| British Columbia  | 4.0                      | 3.4                     | 3.7                          | 1.6                      | 5.4                     | 4.7                          |
| Prov. Average     | 3.8                      | 3.9                     | 3.7                          | 1.9                      | 6.1                     | 4.5                          |
|                   |                          |                         |                              | 2.3                      |                         |                              |

Source: All federal income and consumption tax revenues are excluded from the calculations in this table. Property taxation refers to municipal taxes. Provincial Income taxes include personal and corporate income taxes. Provincial consumption taxes include retail sales taxes, motive fuel taxes, alcohol and tobacco taxes. Data were taken from Statistics Canada, *Public Finance Historical Data 1965/66-1991/91*, Catalogue 68-512 Occasional; and from data provided by Statistics Canada, Financial Management Systems (FMS), August 2002.

## **A. Will Cities Be Fiscally Sustainable In The Future?**

The answer to this question is that they might be but they might not be. It will depend on a number of things. Economic and political events, in particular, will play a role. Will the economy experience a period of slow growth? If so, this could have significant and severe impacts on the ability of some cities to meet their expenditure needs with their existing tax and user fees. In particular, social service expenditures, where they are partially a local funding responsibility, as in Ontario, would rise. A slowdown in economic activity could significantly retard growth in the property tax base in many cities. City politicians may continue, as in the recent past, to resist raising property tax rates. Finally, based on recent experience in every province, provincial and federal grants are unlikely to grow in relative importance as a source of city revenue although the provincial government in Ontario in its budget of May 18, 2004 announced that it would transfer to municipalities revenue from one cent of the provincial fuel tax if this money were spent on transportation and public transit. There have also been rumours that the federal government will initiate a similar move, although nothing has happened at the moment.

The combination of these likely occurrences suggests that municipalities in many, if not all, provinces could face a future that will be more challenging than anything experienced in the recent past. To improve their capacity for meeting these challenges and to strengthen their resolve to be fiscally sustainable and to allocate their resources in a more economically (allocatively) efficient manner, a number of policy changes should be implemented. Some of these could be introduced by cities without provincial approval. Others, however, would require provincial approval and implementation and assistance. These are discussed next.

### **Fiscal Changes Initiated By Cities**

Changes over which municipalities have control revolve around changing the current structure and application of property taxes and user fees.

#### **Property taxes.**

The current practice of imposing higher tax rates on non-residential (commercial and industrial) properties vis-à-vis single unit residential properties either through the application of higher assessment to market value ratios with a constant tax rate or through the application of differentially higher tax rates (Kitchen, 2002b) has the potential for misallocating municipal resources, being less accountable than it should be, and generally unfair in its impact on taxpayers. Failure to correlate benefits from city services, as reflected in differences in effective property tax rates, with the extra cost of service provision has the potential for generating a level of output that is not optimal or allocatively efficient (Bird, 1993; Kitchen, 2000; and McClure, 2001). Over spending leads to higher taxes making it more difficult for cities to be fiscally sustainable and

competitive in the global economy. To illustrate the type of overspending and over taxation that is a problem at the local level, one study (Kitchen and Slack, 1993) reviewed property taxes and municipal expenditures in eight Ontario municipalities in 1990 and concluded that non-residential (commercial and industrial) property taxes accounted for something between 28 and 51 percent of total local property taxes but this sector received only 31 to 40 percent of municipal expenditures. This led to the observation that the residential sector is the recipient of proportionately more benefits from local government services (welfare, elementary and secondary education, libraries, recreational facilities, etc.) than the non-residential sector. When combined with higher effective property tax rates paid by the non-residential sector, the study concluded that the non-residential sector is over-taxed and the residential sector under-taxed. This is inefficient because users are paying for services they do not consume (non-residential sector) or using services for which they do not pay (residential). In either case, the optimal level of output will not be achieved. It is unaccountable because there is no direct and clear-cut link between the cost of the service consumed and payment for it by the beneficiary of the service. Finally, it is unfair because the beneficiaries are either underpaying (residential) or overpaying (non-residential).

A 1995 study for the City of Vancouver (KPMG) on relative consumption patterns of municipal services suggests that residential properties paid 40 percent of property taxes and consumed 71 percent of the services while non-residential properties paid 60 percent of all property taxes and consumed only 29 percent of municipal services. Because of these findings, City Council in Vancouver shifted (over a five year period) some of the tax burden to the residential class and away from the non-residential class.

A recent study in the City of North Vancouver concluded that industrial taxpayers pay \$2.45 in property taxes for each dollar of net city services consumed while the residential sector pays only \$0.58. For the larger district of North Vancouver, the results were similar – industrial taxpayers pay \$2.45 in property taxes for each dollar of benefits while the residential sector pays \$0.86 for each dollar of net services consumed (MMK Consulting Inc., 2004).

This over taxation of commercial and industrial property creates a further potentially significant problem for Canada. The amount of tax in excess of that which is necessary for funding municipal services consumed is effectively an annual fixed cost of doing business – it has no relationship to the cost of municipal services used and it must be paid regardless of whether a profit is made or a loss incurred. This fixed cost component has the potential for creating a number of distortions and allocative inefficiencies that could lead to a lower level of economic activity than should otherwise exist. To elaborate, when a profit-insensitive tax leads to over-taxation of businesses, it has the potential for lowering economic activity, reducing output, generating fewer jobs and leading to a less competitive business environment (Department of Finance, 1997). This concern should not be treated lightly. It is particularly important for Canada because of its heavy reliance on exports and resources and its exposure to world markets.

In summary, if allocative efficiency became a stronger objective of city financing policies and if the property tax were applied to capture more accurately benefits received, the current discriminatory practice in the taxation of residential versus non-residential

property would be reduced, if not fully removed. This could be achieved through the application of variable tax rates designed to capture cost differences across properties, property types, and neighbourhoods within cities (Kitchen, 2003a). As well or alternatively and as is done in some cities, this variation could be captured through a judicious use of special assessment or benefiting area charges on properties in receipt of more costly municipal services.

### **User Fees.**

Current reliance on user fees should also be altered and expanded to improve efficiency, accountability, and fairness in funding municipal services. Ultimately, the objective in setting fees should be to establish a clear link between services received and fees paid. This should be relatively easy for water and sewers, public transit, public recreation, libraries, solid waste collection and disposal where pricing structures could take into consideration cost differentials attributed to economies of scale, capacity constraints, differential demand in peak and non-peak periods, when second-best circumstances are prevalent and when externalities exist (Bird, 2001a; Bird and Tsiopoulos, 1997; and Kitchen, 1997).

Current practice in setting user fees, however, almost always deviates from that which is fair, efficient and accountable. The tendency is to set fees to generate revenue rather than to allocate resources to their most efficient use. Refusal to introduce efficiency considerations (price equals marginal cost) into the pricing structure or to entertain in any serious fashion, suggestions for expanding the role for user fees has been defended on grounds that they are regressive. This claim, however, is about as relevant as the claim that milk prices and movie tickets are regressive.

Failure to price properly has created a good deal of unplanned and implicit redistribution, much of which would be unacceptable if it were made explicit. As an example, the tendency to charge a fixed price for water, regardless of quantity consumed, on the premise that fixed income earners (poor and seniors) could not afford to pay, provides an implicit subsidy for higher income households with larger lawns to water and more cars to wash. Failure to vary charges by time of day, season of the year, when capacity constraints exist, when second best considerations are prevalent, when externalities are observed, and furthermore, failure to include all costs (asset replacement costs and a variety of opportunity costs) in charging and pricing structures has led to a demand for services and subsequently, a demand for physical infrastructure that is not allocatively efficient or optimal. In general, inefficiently set user fees have led to overinvestment and larger plants or facilities than would be justified if more efficient pricing practices were adopted (Kitchen, 2003b).

### **Fiscal changes initiated by provinces.**

There are a number of changes that provincial governments could initiate to improve the fiscal viability and sustainability of cities (Kitchen, 2003d). These include

the transferral of funding responsibilities for certain types of expenditures away from cities and back to the provinces and the implementation of additional tax sources in every province. For example, shifting funding responsibilities for all social service, social housing, and land ambulance expenditures to the provincial government in Ontario, as is the practice elsewhere in Canada, would not only assist local governments, it would make sound economic sense – all income distributional services should be the responsibility of more senior levels of government (Boadway and Kitchen, 1999).

### **New Taxes.**

Not only is it impractical and unreasonable to expect municipalities to fund their increased spending responsibilities and requirements from a single tax, it is almost certain to be economically inefficient and unfair. The time has come for provincial governments to give cities access to additional tax sources. The question, then, is which one or which ones? Possible options include access to the income tax and/or to one or more consumption based taxes - general sales tax, hotel and motel occupancy tax, and fuel tax (Kitchen and Slack, 2003). Furthermore, these options should be viewed as supplementary to the property tax and not as substitutes for it.

### ***Desirable characteristics of a local tax***

Before making the case for additional city taxes, it may be useful to set out the desirable characteristics of a local tax. There are a number of them (Bird, 2000). First, the tax base should be relatively immobile so that local governments can vary the tax rates without losing a significant portion of the tax base. Second, the tax yield should be adequate to meet local needs, increase over time as expenditures increase, and be relatively stable and predictable. Third, the tax should not be one that is easy to export to non-residents. Fourth, the tax base should be visible to ensure accountability. Fifth, taxpayers should perceive the tax to be reasonably fair. Sixth, the tax should be relatively easy to administer.

Whatever tax or taxes are chosen at the local level, local governments need to be able to set their own tax rates. International experience tells us that the most responsible and accountable local governments are those who raise their own revenues and set their own tax rates (Bird, 2001b; and Kitchen, 2003c). Unless local governments can alter tax rates, they will not achieve local autonomy or accountability. Moreover, local tax rate setting provides predictability for municipal governments and gives them the flexibility to change rates in response to different circumstances.

Although the property tax achieves many of the desirable characteristics of a local tax – the base is relatively immobile, it is difficult to export the residential tax to non-residents, revenues are fairly stable and predictable, and the tax base is visible – it cannot achieve all of them. Property values generally respond more slowly to annual changes in economic activity than do incomes (Bird and Slack, 2002); the non-residential property tax can be exported to non-residents (Kitchen, 2003a); and the tax yield is often

inadequate to meet the growing expenditure needs of city governments, especially where cities are required to fund social services.

### ***Rationale for new taxes.***

Access to a mix of taxes would allow cities to levy taxes that achieve the full range of desirable characteristics. Moreover, a mix of taxes would also give cities more flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs, changes in the political climate, and other factors.

Sales and income (payroll) taxes, for example, are more effective than the property tax at linking the costs and benefits of services when people commute to work from one jurisdiction to another. Recent U.S. evidence suggests that the cost of inner city services used by people who live in the suburbs and commute to work (in the city center) exceeds, sometimes substantially, what they pay for inner city services (Chernick, 2002; and Chernick and Tkacheva, 2002). There is no reason to believe that Canadian experience in large cities and suburban surroundings would be any different. Local income and sales taxes could help to reduce this disparity.

Sales and income taxes would also allow city governments to benefit from the prosperity in their cities during an economic boom. Property taxes, on the other hand, may be more appropriate than income and sales taxes where there is a need for a stable revenue source

Any single tax like the property tax is almost certain to create local distortions, some of which could be offset by other taxes. For example, the property tax discourages investment in housing. The income tax, on the other hand, encourages investment in owner-occupied housing because the imputed income of owner-occupied housing is not taxed. By having a number of different tax sources to rely on, there is the possibility that the distortions in one tax would be counteracted by the distortions in other taxes.

Finally, if Canadian cities were permitted (by the province) to implement one or more of these tax options, the revenue yield would not be insignificant. As well and to achieve administrative simplicity, any new tax should be piggybacked onto the provincial tax with the tax rate set locally.

### **Income tax**

Whenever a city income tax has been suggested for implementation in Canada, most advocates have argued for a form of revenue sharing as opposed to schemes that require cities to set their own tax rate. This exists in Manitoba where municipalities receive per capita unconditional grants from the province with the annual grant based on the amount of revenue generated from 2.2 percentage points of the provincial personal income tax and 1 percentage point of the provincial corporate income tax. This is not a local income tax in the true sense - local officials have no say over the tax rate or base.

Although supporters of direct city access to income taxation have been around for some time, there are serious drawbacks that are likely to make it less desirable than

giving cities access to one or more consumption-based taxes. First, the federal and provincial governments in Canada have recently lowered personal and corporate income tax rates to permit Canadian businesses to remain competitive (or become more competitive) internationally. If cities are permitted direct access to income taxation, higher tax rates could offset, or partially offset, federal and provincial initiatives and make it more difficult for businesses to compete. Second, the current practice in many developed countries, supported by most of the economic literature, is to lower reliance on income taxation and increase reliance on consumption-based taxes. This, it is argued, creates fewer distortions and reduces the deadweight costs associated with taxation (Boadway and Kitchen, 1999).

### **Consumption-based taxes.**

There are three consumption-based taxes that are potential candidates for municipalities. A *general city sales tax*, currently not permitted in Canada, is one possibility. In the current Canadian context of lowering personal and corporate income tax rates, implementation of a city sales tax would be preferable for reasons noted above.

A *city fuel tax* is a further consumption-based tax that receives frequent mention as municipal possibility. While many American cities levy fuel taxes, municipally levied fuel taxes are scarce in Canada. In the Greater Vancouver Regional District (GVRD), the province remits 11 cents per litre of its fuel tax revenue to the Greater Vancouver Transit Authority (Translink). This revenue is to be used for capital and operating costs of transit services and major roads within the GVRD. Similarly, British Columbia remits two and one-half cents per litre of its provincial fuel tax revenue to the transit system in the Capital Region (around Victoria) for operating expenses and capital projects.

Calgary and Edmonton receive provincial grants for transportation infrastructure that are estimated to equal five cents per litre from all provincial fuel tax revenue collected in the two cities. The Agence Metropolitaine de Transport, which provides transit services to Montreal and surrounding municipalities, receives one and one-half cents per litre of all provincial fuel taxes collected in this area.

A *city hotel and motel occupancy tax* is another possibility. At the moment, provincial and federal sales taxes are applied to hotel and motel accommodation. In Manitoba and British Columbia, however, municipalities also have the option of levying hotel and motel occupancy taxes. Where occupancy or room taxes are used, they are piggybacked onto the provincial tax and the revenue is collected by the province and returned to the municipality.

### **Revenue yield of new taxes**

Because estimates of potential revenue yield<sup>4</sup> are based on different tax bases, Table 6 records the city tax rate (for selected cities) that would be needed to raise \$100

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<sup>4</sup> Estimates are for the year 2000 because this is the year for which comparable data were available.

million of additional tax revenue from each of three new taxes - income, general sales, motor fuel. Revenue from a hotel and motel occupancy tax is not included because the yield from this tax is much smaller than the yield from the other taxes and any comparison of this tax yield with that from the other tax possibilities would be basically meaningless.

Column 2 records the surtax on provincial income tax that would be required to raise \$100 million annually. A surtax of 2.2 percent would be required in Toronto, 4.0 percent in Montreal, 5.4 percent in Calgary, 6.2 percent in Ottawa, 9.2 percent in Winnipeg, and 9.3 percent in Vancouver.

If \$100 million were to be generated by an increase in the general sales tax rate (column 3), an increase of three-tenths of one percentage point (from 8.0 percent to 8.3 percent, for example) would be needed in Toronto, seven-tenths of one percentage point (0.7) in Ottawa, nine-tenths of one percentage point (0.9) in Montreal, 1.1 percentage point in Winnipeg and 1.2 percentage points in Vancouver. As the Table indicates, smaller cities would require much higher tax rates to generate the same amount of revenue and higher tax rates mean greater distortions.

A similar pattern is noted for a potential municipal fuel tax (column 4). In Toronto, a fuel tax of an additional 2.7 cents should generate \$100 million, 3.5 cents would be required in Montreal to generate the same amount of revenue, 5.2 cents in Vancouver, 6.2 cents in Calgary, and 7.2 cents in Ottawa. As for the smaller cities, the fuel tax increase would be prohibitive if it were to produce the same yield.

Table 6: Impact on Municipal Tax Rates From Raising \$100 Million of Additional Tax Revenue from Three New Taxes – Surtax on Personal Income Tax; General Sales Tax; and Fuel Tax – in Selected Cities

| Province/City<br>(1) | Surtax rate on prov.<br>personal income tax<br>(2) | Increase in<br>provincial sales<br>tax rate<br>(3) | Increase in fuel<br>tax<br>(4) |
|----------------------|--|--|--------------------------------|
|                      | (percent increase)                                 | (percentage point<br>increase)                     | (cents per litre)              |
| Montreal             | 4.0  | 0.9  | 3.5                            |
| Ottawa               | 6.2  | 0.7  | 7.2                            |
| Toronto              | 2.2  | 0.3  | 2.7                            |
| Hamilton             | 15.5   | 1.6  | 13.3                           |
| London               | 20.6   | 2.2  | 18.1                           |
| Winnipeg             | 9.2  | 1.1  | 8.6                            |
| Calgary              | 5.4  | n.a.   | 6.2                            |
| Edmonton             | 10.9   | n.a.   | 8.1                            |
| Vancouver            | 9.3  | 1.2  | 5.2                            |

n.a.: estimates not possible because there is no provincial sales tax.

Source: From Table 11 in Kitchen and Slack (2003), p. 2251

Because the tax base in the smaller cities is less than in the bigger cities, it is not surprising that the tax rates must be much higher in the former to generate a fixed amount of revenue. Table 7 partially standardizes for this by estimating the impact on the same three tax rates if cities were to raise an additional amount of money equal to ten percent of their municipal property taxes as collected in the year 2000. The figures in column 2 record this amount of revenue. Column 3 reports the surtax on provincial income taxes that would be required to generate the same amount of money (as reported in column 2) in each city. In those cities where property taxes are lower, a surtax in the range of three percent to five percent would be adequate. For cities where property taxes are higher in both absolute and per capita terms, the surtax would range from five to seven percent.

Similarly, a general sales tax increase of about six-tenths of a percentage point would generate an amount of revenue equivalent to about ten percent of the property tax in cities in Ontario. The comparable rate would be lower in most other Canadian cities where there currently is a provincial sales tax. Finally, if the same amount of revenue were generated by a fuel tax, the rate would have to range from about 4.6 cents per litre to 6.6 cents per litre in cities in Ontario. In most other large cities and provinces, the comparable rate would be less than 5 cents per litre.

Table 7: Impact on Municipal Tax Rates in selected Cities From Raising Additional Tax Revenue That is Equivalent to Ten Percent of Property Taxes

| Province/City | Ten Percent of Property Tax Revenue in 2000 | Surtax rate on prov. personal income tax | Increase in provincial sales tax rate | Increase in fuel tax |
|---------------|---|--|---------------------------------------|----------------------|
|               | (\$ millions)                               | (percent increase)                       | (percentage point) increase           | (cents per litre)    |
| Montreal      | 1,180.9                                     | 4.7                                      | 1.0                                   | 4.1                  |
| Ottawa        | 784.2                                       | 4.9                                      | 0.6                                   | 5.7                  |
| Toronto       | 2,494.3                                     | 5.6                                      | 0.7                                   | 6.6                  |
| Hamilton      | 463.1                                       | 7.2                                      | 0.7                                   | 6.2                  |
| London        | 269.5                                       | 5.6                                      | 0.6                                   | 4.9                  |
| Winnipeg      | 431.0                                       | 3.9                                      | 0.5                                   | 3.7                  |
| Calgary       | 560.5                                       | 3.0                                      | n.a.                                  | 3.5                  |
| Edmonton      | 406.2                                       | 4.4                                      | n.a.                                  | 3.3                  |
| Vancouver     | 439.3                                       | 4.1                                      | 0.5                                   | 2.3                  |

n.a.: estimates not possible because there is no provincial sales tax in the province.

Source: From Table 12 in Kitchen and Slack (2003), p. 2252.

## Conclusion

The combination of increased funding responsibilities for Canadian cities, reduced provincial grants, and corresponding increases in reliance on own source

revenues over the past twelve to fifteen years has changed the fiscal environment in which cities now operate. This has emerged at the same time as cities and urban centered regions have become increasingly important players in the competitive global economy. These events have brought to the forefront the importance of carefully redesigning property taxes and user fees so that city governments are able to establish more optimal levels of service provision and to fund these services in a fair, efficient and accountable manner. At the same time and to meet ongoing expenditure commitments, there are solid economic and, some might say, political arguments for giving cities access to one or more consumption-based taxes piggybacked onto the existing provincial taxes with rates set locally.

Changes in the current structure and application of property taxes and user fees plus access to new tax sources will make it easier for Canadian cities to remain fiscally sustainable and economically vibrant in approaching distant goals and confronting future challenges.

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