EASING THE FISCAL RESTRAINTS ON CANADIAN CITIES

By Enid Slack

It is now a commonly held view that Canada's cities are critical to the economic prosperity of the country. To be competitive, our cities need to build and maintain infrastructure and they need to deliver a wide range of services to attract and retain skilled workers and businesses. Among the services they need to deliver are those that enhance the quality of life—parks, recreational and cultural facilities, public health, and police protection are examples.

Cities also face pressure from the "offloading" of services by the federal and provincial governments. Offloading has taken a number of different forms. Federal and provincial governments have shifted expenditure responsibilities onto cities. Provincial governments have reduced transfers to cities. Both the federal and provincial governments have downsized their own responsibilities (such as immigration settlement at the federal level). Finally, federal and provincial requirements have mandated that cities meet certain requirements (for example, water quality standards) without providing the funds to meet those requirements (these are known as "unfunded mandates"). In all of these cases, cities feel the pressure to fill the void left by the federal and provincial governments.

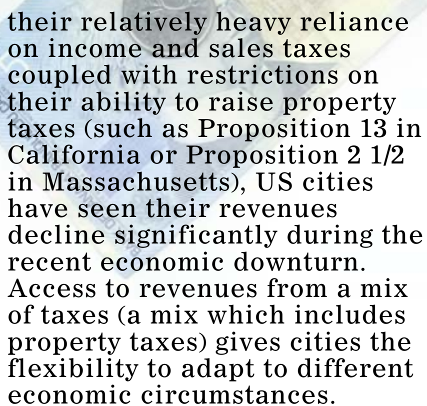
Although the roles and responsibilities of cities have been changing, there has been no diversification of their revenue sources. Canadian cities still depend largely on property taxes, user fees, and provincial transfers to meet their growing expenditure needs. The result is that there is a mismatch between the expenditures for which cities are responsible and the available revenue tools. This situation has raised questions about the fiscal sustainability of Canada's cities.

The fiscal pressures on one city, Toronto, have recently been recognized by a joint Ontario/Toronto task force that has been set up to review the *City of Toronto Act* with a view to making the City "more fiscally sustainable, autonomous, and accountable." A new *City of Toronto Act* could go a long way towards increasing Toronto's ability to raise revenues. It could also provide a catalyst for changes in revenue tools for other cities across Canada.

How would cities benefit from new revenue-raising tools? Revenues from a mix of taxes would give cities more flexibility to respond to local conditions such as changes in the economy, evolving demographics, and expenditure needs. Although the property tax is, in many ways, well suited to local governments, because of the connection between many of the services typically funded at the local level and the benefit to property values and because

revenues are fairly stable and predictable over time, the property tax does have some shortcomings. It does not operate as a benefits tax for commuters and visitors who use municipal services (such as roads and policing, for example). The property tax is not an "elastic" source of revenue meaning that the tax base does not increase automatically as the economy grows as do income and sales tax bases.

There is, of course, a downside to revenue elasticity as we have seen in US cities. With



their relatively heavy reliance on income and sales taxes coupled with restrictions on their ability to raise property taxes (such as Proposition 13 in California or Proposition 2 1/2 in Massachusetts), US cities have seen their revenues decline significantly during the recent economic downturn. Access to revenues from a mix of taxes (a mix which includes property taxes) gives cities the flexibility to adapt to different economic circumstances.

What revenue-raising tools should they use? The options for new local taxes are many and include: personal income taxes, payroll taxes, corporate income taxes, general sales taxes, and excise taxes (including taxes on hotel/motel occupancy, meals, fuel, liquor, tobacco, vehicle registration, and land transfer). Regardless of the tax chosen, cities should piggyback onto existing provincial taxes wherever possible to minimize administrative costs.

Why should cities levy their own tax rates? It would b better if cities set their own tax rates so that they can achieve local autonomy, accountability, and predictability. When federal or provincial governments allocate a portion of their taxes to cities based on a formula (as is currently being done with provincial fuel taxes in Vancouver, Victoria, Calgary, Edmonton and Montreal, for example), revenue sharing is simply a transfer. Cities have no control over how much they receive from year to year and there is no relationship between the amount cities have to spend and the revenues they collect from the transfer.

Local taxing authority is not without problems, however. Since individuals and businesses can easily move between jurisdictions, a differential retail sales tax rate, for example, could encourage individuals to purchase goods and services in those municipalities with lower tax rates. A differential hotel and motel occupancy tax, fuel tax or income tax would result in similar behavioural responses. These reactions would, however, be similar to the location decisions currently caused by differential property tax rates.

Tax competition can create an environment in which municipalities become more efficient in their use of resources and more accountable to taxpayers. If individual cities can convince taxpayers that they are getting more services in return for the higher taxes, there may be less incentive to move. Nevertheless, there is a clear trade-off between the accountability and flexibility advantages of local setting of tax rates and the potential disadvantages of differential local tax rates. For this reason, it may be necessary for provincial governments to set a minimum rate to minimize tax competition and a ceiling rate to prevent excessive tax exporting.

How will cities raise new taxes? If cities were given new revenue-raising tools, they would have to decide when and how to use them. Raising taxes is never easy. One option is for cities to introduce new taxes and, at the same time, reduce property taxes (as was proposed in Winnipeg a few years ago). Although this type of substitution would give cities access to new tax sources that would grow with the economy, it would not solve current fiscal problems.

A second option is for the federal or provincial governments to reduce their taxes to provide cities with tax room. This option would require cities to convince the other governments that reallocating the tax burden in this way would be beneficial to the province and the country.

A third option is to raise new revenues with a commitment to improve service delivery. In other words, taxpayers would pay more taxes but they would receive more services. Under this option, cities would have to convince taxpayers that they would actually be receiving new and improved services in return for higher taxes.

There are many issues concerning new revenue tools for Canadian cities. At the Institute on Municipal Finance and Governance, we will be analyzing the issues and options, evaluating the use of different revenue tools in other cities around the world, and determining their applicability to Canadian cities. The future of our cities is critical to the future of our country; we need to ensure that they are fiscally sustainable now and in the future.

Enid Slack is Director of the Institute on Municipal Finance and Governance for the Munk Centre for International Studies at the University of Toronto.