CITY WIDE IMPLICATIONS

CITY OF HAMILTON

CORPORATE SERVICES DEPARTMENT
Budgets, Taxation & Fiscal Policy

Report to:	Mayor and Members Committee of the Whole	**Submitted by**:	Joseph L. Rinaldo, General Manager
Date:	September 22, 2003	**Prepared by:**	Roberto Rossini 546-4523 Mike Zegarac 546-2739

SUBJECT: A Call for Federal and Provincial Revenue Sharing (FCS03155)(City Wide)

RECOMMENDATION:

a) That Report FCS03155, "A Call for Federal and Provincial Revenue Sharing" be received for information.

b) That Council endorse in principle the proposal for Federal/Provincial/Municipal negotiations for a "comprehensive strategy" in favour of revenue sharing, to begin within the next 6 months, as recommended by the FCM Task Force on Revenue Sharing Options, and the Inter-Municipal Team on New Revenue Sources.

c) That Council request the Province to remove or reduce the funding of social services from the property tax base.

d) That failing Provincial agreement to recommendation (c), Council request that the Province include the City of Hamilton in the existing GTA pooling formula for municipal social housing and social assistance costs.

e) That a copy of this report be forwarded to the Premier of Ontario, the Minister of Finance, the Minister of Municipal Affairs, and the Minister of Community, Family and Children Services.

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Joseph L. Rinaldo, General Manager
Finance & Corporate Services

ECUTIVE SUMMARY:

This report reviews recent municipal initiatives aimed at both the Federal and Provincial governments that would secure some level of revenue sharing. In February 2001, the Big City Mayors' Caucus (BCMC) outlined a ten point "Action Plan for Cities". In January of 2002, the Federation of Canadian Municipalities (FCM) released the symposium report "Communities in an Urban Century". The symposium report synthesizes the main ideas that were raised by the nearly 200 participants from across Canada, the United States, and the UK. Discussion of the symposium focused on the following critical issues: global competitiveness, effective government, and fiscal resources.

On May 30, 2002, the BCMC held a special meeting prior to the FCM Annual Conference in Hamilton, at which time they endorsed the "Model Framework for a City Charter". BCMC members agreed to use the model charter in discussions with their respective provinces aimed at modernizing the legislative framework for cities.

At the May 2003 Annual General Meeting of the Federation of Canadian Municipalities a resolution (see Attachment 1) requested an FCM task force to develop an action plan to identify new revenue sharing options from the Government of Canada, in order to provide better support for Municipal responsibilities.

To respond to the request of the FCM BCMC and the Board of Directors for a plan and discussion document to begin negotiations on revenue sharing, the FCM Task Force on Revenue Sharing Options has engaged a consultant, Mr. David Watters. Formerly Assistant Deputy Minister at the Federal Department of Finance during the tenure of Paul Martin, Mr. Watters has had significant exposure to FCM issues. He was instrumental in the creation of the FCM Green Municipal Funds. It is expected that Mr. Watters will deliver a draft report, with recommendations, for FCM's and the BCMC's consideration sometime in mid to late September 2003.

The FCM technical committee and task force have considered the following possible Federal revenue sharing options listed below as a starting point for negotiations with the Government of Canada. The following two Federal revenue sharing options provide the opportunity of being relatively straightforward to implement, therefore allowing the possibility to be incorporated in the Federal 2004 Budget.

i. Sharing the Federal Fuel Excise Tax

The Federal fuel excise tax is 10 cents per litre (11 cents per litre for leaded gasoline) based on volumes produced at refineries. Each 1 cent/litre is valued at approximately $500M. A new Municipal revenue source of 5 cents/litre would be valued at $2.5 billion per year (or about $25 billion over 10 years).

This revenue source could provide significant new funding for municipalities and could be constructed to be administratively simple to transfer. Further, at a May 29^{th} speech in Winnipeg elaborating on a New Deal of Cities, Paul Martin committed to sharing part of the gas tax with municipalities.

ii. Expanding the Municipal GST Rebate

Expanding the Municipal GST rebate from its current level of 57.14% to 100% would generate new revenues. In 2000, municipalities paid 7% GST for a total of $1,085 million and received a rebate of $620 million. Therefore under the proposal an additional $465M would have been received by municipalities in that year. It the case of the City of Hamilton, total GST payments in 2002 amounted to approximately $21.3 million. After accounting for rebates and credits, the impact of expanding the GST rebate for the City of Hamilton, based on 2002 payments, would have been approximately $8.6 million.

While $465M is not a huge new revenue source, it could contribute, as part of a larger package, to more sustainable Municipal financing. Moreover, it would be easy to administer and therefore very "doable" as part of the next Budget package. In the case of Hamilton, a preliminary assessment by staff have identified approximately $45 million in budget pressures for 2004, $8.6 in expanded GST rebates would alleviate approximately 19% of the preliminary assessment.

A number of additional Federal revenue sharing options are provided in the background section of this report. The other options should be considered as part of future negotiations with the Federal, as well as Provincial governments. There are similarly a limited number of Provincial revenue sharing options provided in the background section of this report.

The issue of revenue sharing and the need for additional revenue sources for municipalities in Canada has drawn the attention of a number of other agencies. These agencies have similarly prepared or commissioned reports relating to the need for additional revenue sources for municipalities in Canada. Examples of some of these reports are: "Early Warning: Will Canadian Cities Compete" (National Round Table on the Environment and the Economy), and "A Choice Between Investing in Canada's Cities or Disinvesting in Canada's Future" (Toronto Dominion Bank).

iii Ontario Initiatives

The Inter-Municipal Team on New Revenue Sources (IMTNRS) released two papers in April 2003 titled "A New Funding Framework for Ontario Municipalities". The papers focus on the immediate financial pressures facing Ontario municipalities, as well as solutions proposed to form the scope and framework for negotiations with the Federal and Provincial governments for a new financial deal for Ontario municipalities (see attachment 2). In addition to recognizing the financial pressures facing Ontario municipalities, the IMTNRS also identified a number of trends urban municipalities are experiencing, including: economic growth, increased external migration and continued migration of rural residents to urban areas. Theses trends result in significant pressures on municipalities in the service areas of transportation, transit, as well as affordable housing.

In addition to growth related pressures the IMTNRS also highlighted that municipalities are faced with increasing capital renewal pressures, which may have originally been financed by the Province and/or Federal government(s). The problem is exacerbated by the inability of many municipalities to properly fund replacement costs given other expenditure pressures (social assistance, homelessness, social housing, etc.) or revenue constraints.

The problem is most acute in mature municipalities with lower assessment growth, where often each of the aspects of the problem manifest.

The IMTNRS also highlights that municipalities in general have less spending flexibility that the federal and provincial counterparts. While high levels of government can reduce transfers to lower levels of government during times of fiscal constraints, municipalities are invariably directly accountable for any service implications to the public.

The IMTNRS is continuing in its efforts by furthering its initial contribution through an analysis intended to identify the lack of capital funding urban municipalities are facing. The IMTNRS is currently in the process of accumulating this information from various municipalities, including the City of Hamilton.

CKGROUND:

The powers and resources of municipalities have their origins from the 1849 Baldwin Act of Canada and the distribution of powers under the Constitution Act, 1867. Municipal functions, responsibilities and duties have changed dramatically since 1849 and 1867. A number of trends are giving rise to the need for municipal autonomy, powers, and resources. These trends include Federal and Provincial disengagement from services (described as decentralization, offloading, and abdication of responsibility); Provincial grant reductions; rapid growth rates in some urban centres; the need for infrastructure upgrades; and demands and needs for new services that were not contemplated in the mid-1800s.

In response to increasing responsibilities and expectations placed on local governments along with changing urban conditions, a number of municipalities have been granted a variety of financial resources, the following list provides a sample of these resources.

- Local Income Tax
    - Manitoba allocates revenues from two percentage points of the personal income tax and one percentage point of the corporate income tax for the distribution to municipalities in the form of a per capita grant.
    - Municipalities in Pennsylvania have access to local earned income taxes. Local income taxes generate 20% of Municipal revenues and represent about one-sixth of local government revenues.

- Local Sales Tax
    - In British Columbia, legislation provides that the province share retail sales tax revenues with municipalities.
    - New York City is entitled to a portion of state sales tax.
    - Municipalities in California have access to the sales tax.

- Gasoline Tax
  - In most cases, revenues from a gasoline tax are earmarked for local roads and public transit. The tax affects both residents and visitors.
  - For every one litre of gasoline sold in Ontario, the Provincial government collects almost 15 cents.
  - It is estimated that every cent of taxes levied on a litre of gasoline raises revenues between $19 million and $28 million.
  - Montreal's Agence Metropolitaine de Transport (AMT) is partially funded by a 1.5 cent/litre gas tax (total raised: $47 million).
  - The Cities of Calgary and Edmonton receive 5 cents/litre or $85 million and $65 million, respectfully.
  - Greater Vancouver's TransLink (Vancouver Regional Transit System) is partially funded by a 4 cents/litre gas tax (total raised: $79 million).
  - Public transit is the U.S. is receiving 2.8 cents per gallon (0.7 cents/litre) from gas taxes to reduce deficits (Transportation Equity Act for the 21st Century). It is estimated that American transit systems will receive more than $29 billion from gas taxes over the next five years.

The FCM technical committee and task force have considered the following possible revenue options.

<u>Federal</u>:

The possible revenue sharing options from the Federal government include:

i. sharing the Federal fuel excise tax
ii. expanding the Municipal GST rebate
iii. sharing Federal income tax revenue
iv. sharing GST revenue

<u>Provincial</u>:

The possible revenue sharing options that were briefly discussed but not developed further because they are within Provincial jurisdiction are:

i Provincial sales tax
ii. Provincial income tax
iii. Provincial fuel excise tax
iv. hotel/motel taxes
v. introducing/expanding Municipal PST rebate
vi. vehicle registration fee
vii.[onloading (uploading) selected Municipal services in exchange for property or other source tax room.]

It is possible that some of these revenue options would be discussed as Provincial contributions to municipalities, particularly the Provincial fuel excise tax, during a

Federal/Provincial/Municipal negotiation to determine appropriate new Federal revenue sources.

Other:

Other expenditure sources that were briefly discussed included:

i. Federal grants in lieu of taxes
ii. Federal and Provincial program expenditures (including possible new initiatives such as, Federal debt financing of Municipal infrastructure).

In order to respond directly to the FCM resolution, the task force focused on assessing the four Federal revenue sources identified above. Similar analogies could be made with sharing Provincial revenues of the same type.

The possible revenue options identified by the FCM technical committee are similar to those identified by the Inter-Municipal Team on New Revenue Sources (IMTNRS), however are not as exhaustive (see attachment 2). The papers released by IMTNRS, in April 2003, identify key principles for future discussions amongst the three main levels of government:

- New funds be identified for capital transportation, transit and affordable housing programs
- New funding be administered so as to ensure its sufficiency, stability, and so that accountability is maintained through appropriate mechanisms
- In recognition of two distinct types of need, that funds be segregated into (1) a Municipal capital fund for expansion related expenditures, and (2) a Municipal capital equalization fund for infrastructure renewal.

Assessing the Four Possible Federal Revenue Sources

I. Sharing the Federal Fuel Excise Tax

The federal fuel excise tax is 10 cents per litre (11 cents per litre for leaded gasoline) based on volumes produced at refineries. Each 1 cent/litre is valued at approximately $500M. A new Municipal revenue source of 5 cents/litre would be valued at $2.5 billion per year (or about $25 billion over 10 years). Annex B outlines a one-page scenario describing how this option could work.

This revenue source could provide significant new funding for municipalities and could be constructed to be administratively simple to transfer. Further, at a May 29th speech in Winnipeg elaborating on a New Deal of Cities, Paul Martin committed to sharing part of the gas tax with municipalities.

A number of key issues that have yet to be determined are listed below:,

i. How much money should be transferred?
ii. Who should the money be transferred to?

iii. How would the money be allocated between municipalities (what “formulae” would be used)?
iv. Would the funds be earmarked (for “transportation infrastructure” or “capital” generally) or not?
v. What would municipalities want in a Federal/Provincial/Municipal agreement (e.g. no program clawback, no sourcing from new taxes) and, what would they be willing to offer to other orders of government (e.g. more use of user fees, better pricing of Municipal services, more efficient delivery of Municipal services, more use of PPP initiatives, more efficient application of property taxes, etc.)
vi. What accountability measures would be reasonable for the use of the new revenues?
vii. What Federal visibility/communications provisions would be appropriate?

II. Expanding the Municipal GST Rebate

This option would generate new revenues from expanding the Municipal GST rebate from its current level of 57.14% to 100%. In 2000, municipalities paid 7% GST for a total of $1,085 million and received a rebate of $620 million. Therefore under the proposal an additional $465M would have been received by municipalities in that year.

While $465M is not a huge new revenue source, it could contribute, as part of a larger package, to more sustainable Municipal financing. Moreover, it would be easy to administer and therefore very “doable” as part of the next Federal budget package.

Key issues that would need to be addressed include:

i. Should the rebate be targeted for any particular Municipal expenditures?
ii. Should the expansion of the rebate be phased in?
iii. Would the government be required to expand this to the MUSH sector generally – and if so, at what cost?

III. Sharing Federal Income Tax Revenues

This option would involve transferring a percentage of Federal personal income tax revenues to Municipal governments using existing tax collection procedures. A transfer of 1% of the tax base would amount to about $524M annually. Of course any transfer would not be designed to create any net new taxes on Canadians.

IV. Sharing GST Revenue

This option would involve transferring a portion of general GST revenues to Municipal governments, using existing revenue collection mechanisms. In 2000-01 net GST collections were $25 billion, therefore 1% of this amount would be $250M annually and alternatively 1 percentage point of the 7% GST rate would amount to about $3.5 billion in new revenues annually.

ALYSIS OF ALTERNATIVES:

Urban 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.

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.

Already over-reliant on property taxes, Municipal governments are further disadvantaged with a form of taxation that is regressive and unresponsive to economic growth. Increases in economic activity translate to increased financial burdens on municipalities. Without the appropriate revenue generating tools, municipalities will have to rely more and more upon property taxation.

IANCIAL/STAFFING/LEGAL IMPLICATIONS:

The 2003 Tax and Rate Current Budget Variance report to June 30, 2003 (FCS03140) indicates a projected 2003 year-end tax-budget shortfall of $13.8 million. Similarly, the "2004 Business Plan and Budget" report (CM03018) reported that a preliminary assessment by staff have identified approximately $45 million in budget pressures. It is essential that in addition to other initiatives such as "social pooling", that municipalities such as Hamilton be provided the necessary progressive financial tools to offset some of the program pressures which translate into significant financial pressures.

LICIES AFFECTING PROPOSAL:

N/A

NSULTATION WITH RELEVANT PARTMENTS/AGENCIES:

FCM Task Force on Revenue Sharing Options

Y STRATEGIC COMMITMENT:

The provision of progressive financing tools will allow the City to mitigate some of the program pressures, hence financial pressures. Thereby, providing the opportunity for the local economy to compete, as well as allow departments to provide the programs necessary to improve the quality of life within the City of Hamilton.

Attachment 1

FCM Big City Mayors call for revenue sharing with the Federal Government –

Winnipeg, May 30,2003 – The mayors of Canada's largest cities today adopted a resolution calling on the Government of Canada to identify options to support Municipal responsibilities. These should include at least five cents per litre of the Federal fuel tax.

http://www.fcm.ca/english/communucations/may312003.htm

The mayors are in Winnipeg as part of the Federation of Canadian Municipalities (FCM) annual conference.

The text of the resolution follows.

RESOLUTION of the Federation of Canadian Municipalities' (FCM) Big City Mayors Caucus (BCMC)

WHEREAS the FCM Big City Mayors' Caucus is committed to meeting the challenge issued by Paul Martin;

WHEREAS Paul Martin challenged Municipal governments to provide the Government of Canada with proposals for a New Deal that would include options for revenue sharing such as a share of the Federal fuel tax, co-ordination and funding of social and environmental programs like affordable housing, immigration, urban aboriginals and formal consultation on Federal budget processes;

WHEREAS the Government of Canada would engage provinces in negotiations to ensure that the:

· provinces create a mechanism for Municipal governments to raise and/or receive gas tax revenues vacated by the Government of Canada;

· mechanisms are created that ensure financial support for services to immigrants, urban aboriginals; and affordable housing and the environment reach Municipal governments;

· provinces commit that agreed revenue streams are new and incremental and do not result in clawing back of other transfers; and

· agreements establish net new revenue streams that are guaranteed to be long term.

WHEREAS a sharing of gas tax revenue would not be the only revenue stream in the New Deal;

WHEREAS Provincial governments could match Government of Canada revenue commitments;

BE IT RESOLVED that the FCM Big City Mayors' Caucus calls upon the Government of Canada to establish revenue sharing options to support Municipal responsibilities;

BE IT RESOLVED that these revenue sharing options, include a minimum of 5 cents/litre of the fuel excise tax to Municipal governments;

BE IT RESOLVED that these be net new revenues; and

BE IT RESOLVED that BCMC create a task force to develop an action plan to realize these policies. <![endif]>

Appendix A to FCS03155

Summary Document

A New Funding Framework For Ontario Municipalities

Inter-Municipal Team on New Revenue Sources

April 12, 2003

1. Introduction

This document summarizes a discussion paper which builds upon a number of research papers recently released, each calling for a new financial deal for Canadian municipalities, primarily because Canada's economic prosperity is increasingly centred in Canada's largest urban centres and the fiscal responsibilities that municipalities face have not been matched by appropriate revenues.

This paper focuses on the most immediate financial pressures facing Ontario municipalities: capital investments in transit, transportation and affordable housing. The solutions proposed are intended to form the scope and framework of negotiations with the federal and provincial governments for a new financial deal for Ontario municipalities.

2. Municipal Infrastructure and Funding Challenges

Aging Infrastructure

- **Older/mature municipalities have fiscal burdens from aging infrastructure, stagnant revenue growth, and high social costs**

  As the substantial infrastructure investments made by Ontario municipalities over the past decades age, many municipalities are faced with increasing capital renewal pressures. Much of the original investment in municipal infrastructure was put in place with provincial and, in some cases, federal funding, which is no longer assured. The problem is exacerbated by the inability of many municipalities to properly fund replacement costs given other expenditure pressures (social assistance, homelessness, social housing, etc.) or revenue constraints. The problem is most acute in mature municipalities with lower assessment growth, where often each of the aspects of the problem are manifest.

Growth

- **Fast growth in some municipalities has put funding pressures on transit, transportation and social housing**

  Some Canadian municipalities, and Ontario municipalities in particular, have grown and continue to grow at significant rates due to economic growth, increased immigration, and continued migration of rural residents to urban areas. The population influx has caused significant service pressures for municipalities especially in the areas of transportation, transit and affordable housing.

Key Municipal Infrastructure Priorities

- **Transportation**

  The Federation of Canadian Municipalities' (FCM's) recent analysis showed that more than 80 percent of all infrastructure-related spending by Canadian cities is channelled into buried utilities, roads and bridges. According to the National Research Council (NRC), the capital stock of municipal roads in 1996 was $25 billion (1996 dollars). The financial burden on municipalities to maintain and expand this infrastructure is huge, and traffic congestion and infrastructure deterioration are the result.

- **Transit**

Across Canada, provincial contributions to transit capital spending decreased from 87 percent in 1992 to 14 percent in 2000 and about 6% in Ontario. A recent study by the Canadian Urban Transit Association identified that there is a significant gap between current capital funding and future needs of almost $1.4 billion annually to accommodate growth in transit ridership[9].

Recently the Province of Ontario has announced renewed participation in transit capital funding that could reduce the municipal share back to as low as 33 percent. However, the resolution of issues such as eligibility rules, and matching funding from the federal government is still required.

- **Affordable Housing**

The need for affordable housing is escalating in Canadian municipalities. In 1996, CMHC found 1.7 million Canadian households to be in "core need" as families find it increasingly difficult to find money for food, clothing, medicine and other basic necessities[8]. In Ontario, municipalities face unique pressures, as they are the only municipalities in Canada required to fund 100 percent of social housing costs from the property tax base. Although the federal government announced a five-year $680 million federal/provincial capital grants program for affordable rental housing, this is only to begin addressing the problem. Municipalities are calling for long-term solutions to address the root causes of the housing crisis.

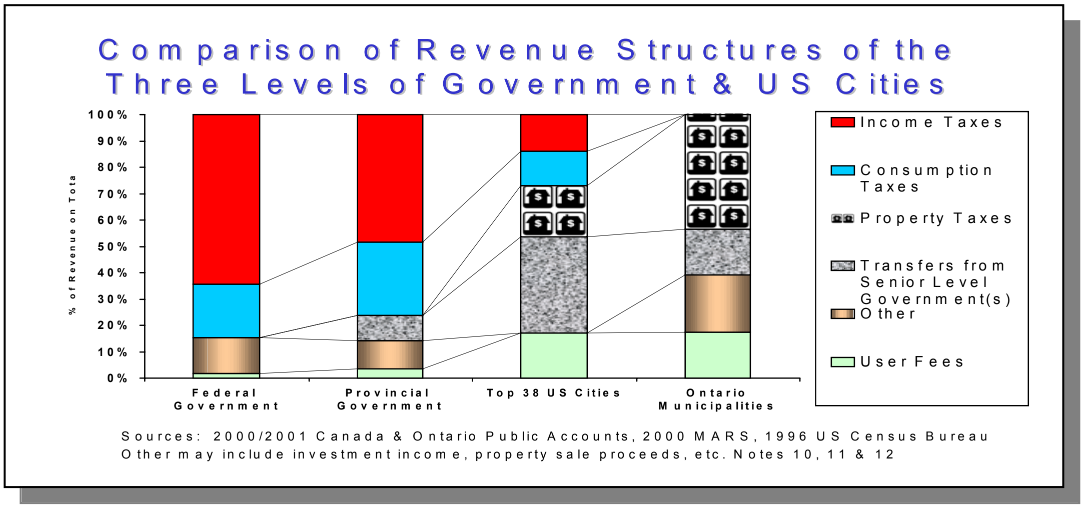
There are other areas of municipal responsibility that require significant increases in capital investment, particularly those related to environmental services. For example, water, wastewater & solid waste management are major issues. While these problems will require additional investment in most municipalities, an improved legislative regime is a fundamental part of the solution.

Municipal Funding Capacity

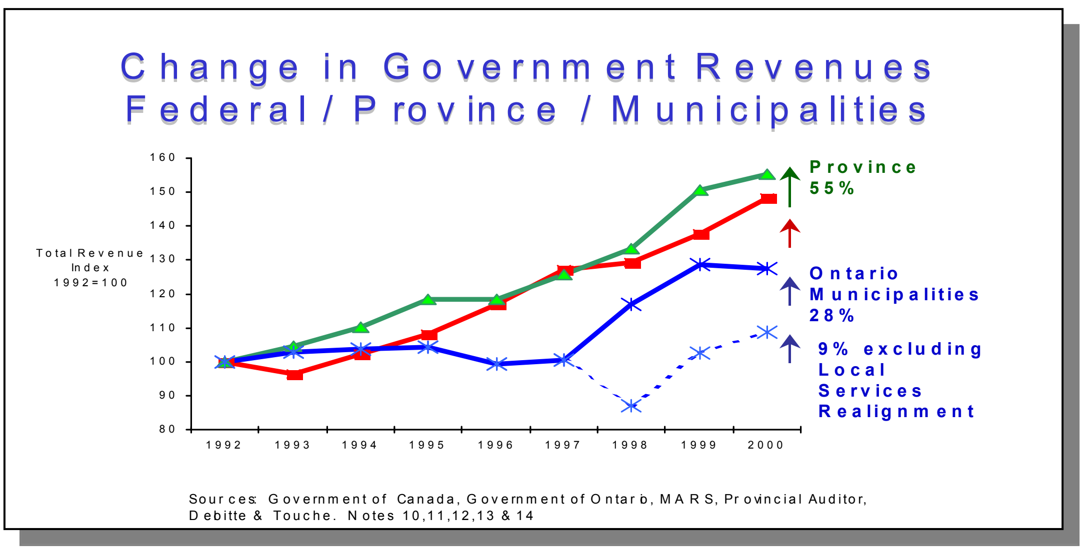
- **Flexibility**

Municipalities in general have less spending flexibility than their federal and provincial counterparts. Direct operating expenses, comprising mostly non-discretionary salary costs, constitute almost 70 percent of Ontario municipal expenditures. On the other hand, transfer payments form the biggest share of senior government expenditures. In times of fiscal constraints, senior level governments have the ability to reduce the transfers to municipal governments, whereas municipalities invariably are directly accountable to the public for any service implications.

In a strong economy, senior government revenue sources such as income and consumption tax revenues outperform property tax revenue growth (which is also distributed very unevenly across the province). In times of restraint, municipal governments are much more dependent (about 20 percent of revenues) on senior government transfers than their provincial counterparts. In addition, municipal user fee revenues are susceptible to downturns in the economy; particularly transit fares and building related fees and charges. Finally, senior governments have recourse to deficit financing in their current accounts, which is unavailable to municipalities.



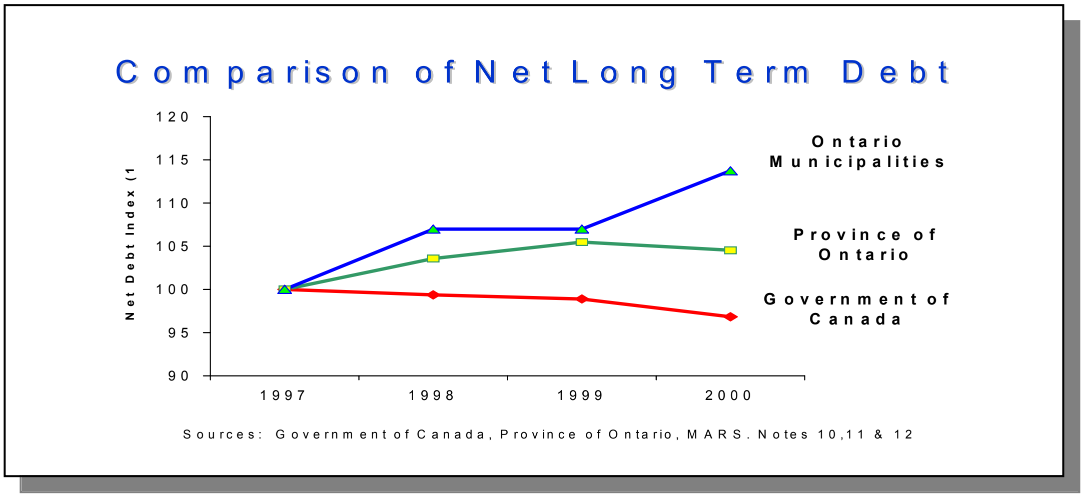
Between 1992 and 2000, municipalities, unlike senior governments, have not benefited from the improvements in the Canadian economy. Federal revenues increased by 48 percent, while provincial revenues increased by 55 percent. Ontario municipal revenues increased by only 28 percent in gross dollars. When the impacts of Local Services Realignment are removed (LSR increased municipal revenues and expenditures relative to the pre 1998 period), the net increase of municipal revenues was only a mere 9 percent, much less than the rate of inflation of 14 percent during the same period.



Debt and Infrastructure

The following chart shows a stark contrast between the growth rates of municipal debt levels and those of senior governments. Without the revenue growth enjoyed by senior governments, municipalities have increased their debt levels.

Unlike senior governments, municipalities can borrow for only capital expenditures. These debts are being incurred in large measure to renew existing infrastructure to the benefit of current taxpayers. Increasing the relative municipal debt burden shifts the repayment cost to future taxpayers. This is completely at odds with provincial legislation prohibiting provincial operating budget deficits, justified as a means to avoid shifting tax costs to the future.



Independent Verifications of Municipal Financial Condition

A variety of studies have come out recently documenting the financial challenges experienced by municipalities in Canada and Ontario. Some of the diverse authors fare listed below:

- Prime Minister's Caucus Task Force on Urban Issues – November 2002
- Toronto Board of Trade – June 2002
- Federation of Canadian Municipalities – May 2002
- TD Economics – April, May 2002

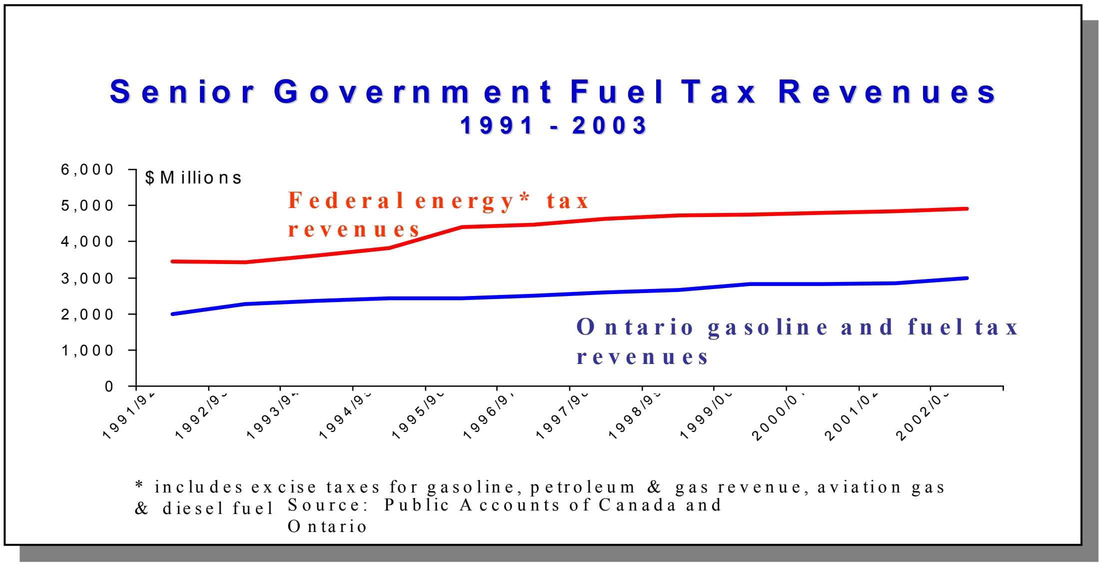
3. Objectives

Municipalities need secure and stable revenue sources

The following are the key considerations for a new funding delivery mechanism.

Revenue Stability

The goal from the municipal point of view is to obtain adequate revenues sources that are relatively stable (like property tax) and that permit a reasonable degree of self-determinism (like property tax). Local service delivery is simply too important to people's daily lives to suffer service fluctuations each time the government changes or the economy dips. Federal and Provincial Fuel Tax revenues exhibit the consistency and steady growth that municipalities require for program funding.



■ **Accountability**

From the senior government perspective the key issues may be ensuring that their priorities are reflected in expenditures, and that some fiscal flexibility is maintained. These objectives have been attained in the past through short-term (three-year) programs, prescriptive eligibility clauses, and senior government control of the funding approval process.

■ **Funding Sufficiency – Allocation Mechanism**

It is proposed under the new regime of sustained capital funding that a performance results based approach be used as the means for determining the basis for allocating funding and the centrepiece of measuring value for money.

4. Potential Solutions to Municipal Funding Challenges

Any new funding arrangements need to address both growth or demand related pressures, and infrastructure renewal burdens, particularly in older communities. In addition, some distinction between growing communities (in terms of assessment) and those contracting or with flat assessment growth may be required. As a consequence of these differences between municipalities, one system or funding mechanism may not be the answer.

This section identifies strategies to achieve alternative funding for municipalities: (1) the creation of a new growth capital fund, and (2) creation of a new unconditional equalization replacement capital grant.

Municipal Capital Fund

The Municipal Capital Fund would be the repository of the funding and within the accountability frameworks described below, funds would flow to cities for expansion related needs. Unlike the federal and provincial capital funding programs in the past, the Municipal Capital Fund would be permanent with dedicated income sources. In addition, the funds would be allocated based on a municipality's most pressing needs as determined by objective and transparent measures within the three targeted program areas.

Municipal Capital Equalization Fund

Before a capital growth fund can be helpful, certain municipalities will need assistance in dealing with the capital repair and replacement burden of aging infrastructure in the aftermath of Local Services Realignment. The Province has recognized, in part, the municipal capital rehabilitation needs through the Municipal Capital Renewal Program for municipal transit rolling stock. The age and cost of replacing physical infrastructure varies across the Province, particularly as it compares to the historical burden per assessment dollar. Unless this situation is rectified, municipalities in these circumstances will find themselves unable to participate in funding schemes for new works under the capital growth fund.

The Municipal Capital Equalization Fund would be different from previous initiatives in that it would be a permanent program, sourced from specified revenues, allocated based on means and infrastructure renewal needs, but expended on an unconditional basis reflecting existing municipal responsibilities and accountability.

Other aspects of the New Deal

Funding Sources: Many studies have identified the various revenue sharing/funding options available and in use around the globe. Appendix 1 of the main report contains a partial list and provides comments on their suitability for various purposes.

Federal Government

- Fuel and Sales Tax Revenue Sharing
- Immigration Grant
- GST Exemption
- Income Tax Act Amendments
- Land Holdings and Railways
- Funds from General Revenues

Provincial Government

- Fuel Tax and PST Sharing
- Hotel Tax
- Vehicle Registration
- Driver's Licences
- Funds from General Revenues
- PST and Land Transfer Tax Exemptions
- Land Transfer Tax
- Land Holdings and Electricity Transmission Corridors
- Education Tax Room

Municipalities

- Parking Tax (with enabling legislation)
- Property Tax Premiums
- Smart Growth Incentives
- Land Holdings

The key objectives in identifying specific revenue streams should be (a) their linkage to the expenditure purpose (b) their adequacy; and (c) their relative stability.

Service Swaps: The Province and the municipalities could carry out some additional service funding swaps that would strengthen the accountability relationship with tax-paying public and narrow the scope of the provincial/municipal funding relationship to the most important issues facing the cities today. Municipalities deliver many programs on a shared basis with the Province. In exchange for reduced municipal funding of income re-distribution programs such as Ontario Works and affordable housing, an option to consider is that municipalities assume 100 percent of the capital and operating expenses of some of these programs.

Reduced municipal social assistance and social housing funding responsibilities would also decrease the amount pooled in the GTA, which has been problematic since its inception in 1998.

The Federal and Provincial Government interest

The health, education and environmental programs that are at the top of the public's agenda can only be financed from a vibrant and growing economy. Since most of Canada's economic activity takes place in cities, it is imperative that cities have the ability to provide the infrastructure needed to maintain their competitiveness on the world stage.

Tackling these three issues is also seen as essential to combating poor air quality in the major cities which is now a serious concern for all three levels of government. Ultimately, effective transportation and transit systems and availability of affordable housing improve the attractiveness of urban centres as places in which to live and invest.

The final report of the Prime Minister's Caucus Task Force on Urban Issues acknowledges the importance of these three sectors and has recommended the development of a National Transportation Strategy and a National Affordable Housing Program[3]. The September 2002 federal throne speech announced a new 10-year infrastructure initiative would focus on transportation and affordable housing. It is clear that these issues are finally being recognized at the federal level. It is critical that solutions implemented in the next 12 months are designed with the real needs of municipalities in mind, which can only be achieved through appropriate consultation.

Performance based funding should be considered

Under the performance based accountability process, a municipality's allocation of revenues would be based on the projected and actual benefits of the project. A set of well articulated objectives would be established to identify what projects would be funded under this program and when they would proceed. For each objective, performance measures would be used to establish the amount of financing that would be delivered to the project and to measure the success of the venture.

The test for capital renewal funding eligibility is inherently different than that for new infrastructure. The funding stream must recognize both the nature of the physical asset responsibilities being carried by a municipality and the health of the assessment base. Once the annual amount is quantified, the municipality should be free to allocate the funds as it deems necessary from year to year.

The need for means and needs tested funding is based on avoiding the situation where new works are being built while existing infrastructure decays. In that case, the public is not being served, and the unfunded infrastructure renewal responsibilities of the municipality are increased.

5. Conclusion

The recommendations put forward are intended to focus the co-operative action of all levels of government on the most pressing issues facing large urban centres today and into the foreseeable future. The strategies articulated hinge upon needed actions by both federal and provincial levels of government to allocate a share of their revenue sources, among other initiatives, to help fund priority capital investments in Canadian urban centres and to ensure a base level of funding for ongoing capital infrastructure renewal.

Increased funding from dependable sources is the key to revitalized municipalities, but will require careful consideration of allocation methodologies to ensure that funding is invested strategically. Accordingly, principles for future discussions are identified including:

- New funds be identified for capital in transportation, transit and affordable housing programs
- New funding be administered so as to ensure its sufficiency, stability, and so that accountability is maintained through appropriate allocation mechanisms
- In recognition of two distinct types of need, that funds be segregated into (1) a municipal capital fund for expansion related expenditures, and (2) a municipal capital equalization fund for infrastructure renewal

By concentrating government action on transportation, transit and affordable housing, cities will be able to continue to generate the economic activity that supports our health, social and education programs that are fundamental to the Canadian identity. By addressing these issues, the quality of life within the cities will improve and urban centres will become stronger.

Appendix B to FCS03155

A New Funding Framework For Ontario Municipalities

Inter-Municipal Team on New Revenue Sources

April 12, 2003

1. Introduction

This discussion paper builds upon the research papers released by the Federation of Canadian Municipalities (FCM)[1], the Toronto Dominion Bank[2], and on the recent final report of the Prime Minister's Task Force on Urban Issues[3], among others[4,5,6]. Each of these reports has called for a new financial deal for Canadian municipalities primarily because Canada's economic prosperity is increasingly centred in Canada's largest urban centres and the fiscal responsibilities that municipalities face have not been matched by appropriate revenues.

This discussion paper focuses on the most immediate financial pressures facing Ontario municipalities: capital investments in transit, transportation and affordable housing. It proposes solutions that are intended to form the scope and framework of negotiations with the federal and provincial governments for a new financial deal for Ontario municipalities.

2. Municipal Infrastructure and Funding Challenges

A. Scoping the Problem

Aging Infrastructure

Older/mature municipalities have fiscal burdens from aging infrastructure, stagnant revenue growth, and high social costs

As the substantial infrastructure investments made by Ontario municipalities over the past decades age, many municipalities are faced with increasing capital renewal pressures. Much of the original investment in municipal infrastructure was put in place with provincial and, in some cases, federal funding, which is no longer assured. The problem is exacerbated by the inability of many municipalities to properly fund replacement costs given other expenditure pressures (social assistance, homelessness, social housing, etc.) or revenue constraints.

The problem is most acute in mature municipalities with lower assessment growth, where often each of the aspects of the problem are manifest.

Growth

Fast growth in some municipalities has put funding pressures on transit, transportation and social housing

Canadian municipalities and Ontario municipalities in particular have grown and continue to grow at significant rates due to:

- Economic growth
- Increased immigration
- Continued migration of rural residents to urban areas

The accommodation of this influx of population has caused significant pressures for municipalities especially in the following three areas:

- Transportation
- Transit
- Affordable housing

These three areas are linked in that problems in one area cannot be solved in the absence of the other two. They are all essential to maintaining a competitive environment for businesses in an increasingly global workplace. Businesses require an efficient transportation system to move raw materials and finished goods. Businesses also require a competitively priced workforce, who in turn must rely on affordable housing and transit. An effective transit system is an integral component of an efficient transportation system. Furthermore, households cannot contribute to their local economies in a meaningful way if a significant portion of their income is devoted to housing and transportation costs.

The immediate need in each of the three areas is for capital funding to catch up to the level of investment that should have been made to accommodate past growth and to fund the infrastructure that will be required to accommodate future growth.

The official Capital Plans of municipalities will not reflect the real financial requirement in these programs. For example, affordable housing programs generally do not include provisions for unmet demand due to financial constraints and in some cases regulatory uncertainty (for example, administration of equalization payments for shared social housing costs among regional municipalities and the City of Toronto in the GTA). In the transportation and transit programs, annual GTA expenditure forecasts were estimated to be approximately $800 million below the required level identified in a 1999 study[7], before consideration of capital maintenance under funding. Similar circumstances are likely occurring elsewhere in the Province. Accordingly, future 10 year forecasts can be expected to identify significantly larger expenditure requirements once funding issues have been resolved. This paper does not attempt to measure the total amount of the capital investment required, but provides examples that point to the magnitude of the problem. Each municipality, however, should be able to identify and provide their capital program either over the next five or ten years for each of these three areas.

Key Municipal Infrastructure Priorities

The need for funding to support ongoing investment in municipal infrastructure is most acute in three key areas.

- **Transportation**

  The Federation of Canadian Municipalities' (FCM's) latest analysis showed that more than 80 percent of all infrastructure-related spending by Canadian cities is channelled into buried utilities, roads and bridges. According to the National Research Council (NRC), the capital stock of municipal roads in 1996 was close to 660,000 km - two-lane equivalent - with a value of $25 billion (1996 dollars)[8]. Municipal government expenditures on roads in that year were just above $6 billion.

  The design life of most roadways is 20 years. Owners of new bridges expect them to have a service life of 75 to 100 years with only routine maintenance required. The reality, however, is that many existing North American bridges that are only 10 to 20 years old already require costly and extensive rehabilitation. In fact, approximately 40 percent of Canadian bridges are more than 35 years old, with a deferred maintenance backlog estimated at $10 billion. An inventory of Ontario municipal roads would no doubt show a similar or more severe situation, in addition to the growth related pressures identified in the 1999 GTA study referenced above.

- **Transit**

  Until the mid-1990s, Canadian municipal governments provided on average only about 20 percent of capital funding for transit. Across Canada, provincial contributions to transit capital spending decreased from 87 percent in 1992 to 14 percent in 2000.

  Funding sources for each province in 2000 varied. In Ontario, municipal funding covered 94 percent of municipal capital expenditures. A recent study by the Canadian Urban Transit Association identified that there is a significant gap between current capital funding and future needs of almost $1.4 billion annually to accommodate growth in transit ridership[9].

  The return of provincial funding for transit capital through the Golden Horseshoe Transit Investment Partnership (GTIP) program and others has been an excellent signal, and an invitation for a sustained federal role for transit funding.

- **Affordable Housing**

  The need for affordable housing is escalating in Canadian municipalities. In 1996, CMHC found 1.7 million Canadian households to be in “core need” as families find it increasingly difficult to find money for food, clothing, medicine and other basic necessities[8]. Although the federal government announced a five-year federal/provincial capital grants program for affordable rental housing of $680 million, this is only to begin addressing the tip of the iceberg. Municipalities are calling for long-term solutions to address the root causes of the housing crisis.

  In Ontario, municipalities face unique pressures, as they are the only municipalities in Canada required to fund 100 percent of social housing costs from the property tax base. As a result, development of social housing has virtually halted and homelessness has become an entrenched problem.

Because of the sheer size of the individual investments required, and because the investments are often required well in advance of when assessment growth can pay for them, cities are ill equipped to finance these investments within the existing financial regime.

The final report of the Prime Minister’s Caucus Task Force on Urban Issues acknowledges the importance of these three sectors and has recommended the development of a National Transportation Strategy and a National Affordable Housing Program[3]. The September 2002 federal throne speech announced a new 10-year infrastructure initiative would focus on transportation and affordable housing. It is clear that these issues are finally being recognized at the federal level. It is critical that solutions implemented in the next 12 months are designed with the real needs of municipalities in mind.

Water and Wastewater infrastructure is primarily an ongoing municipal funding responsibility

There are other areas of municipal responsibility that require significant increases in capital investment, particularly those related to environmental services. For example, solid waste management is a major issue, requiring development of new landfill and enhanced landfill mitigation. While these problems will require additional investment in most municipalities, an improved legislative regime is a fundamental part of the solution.

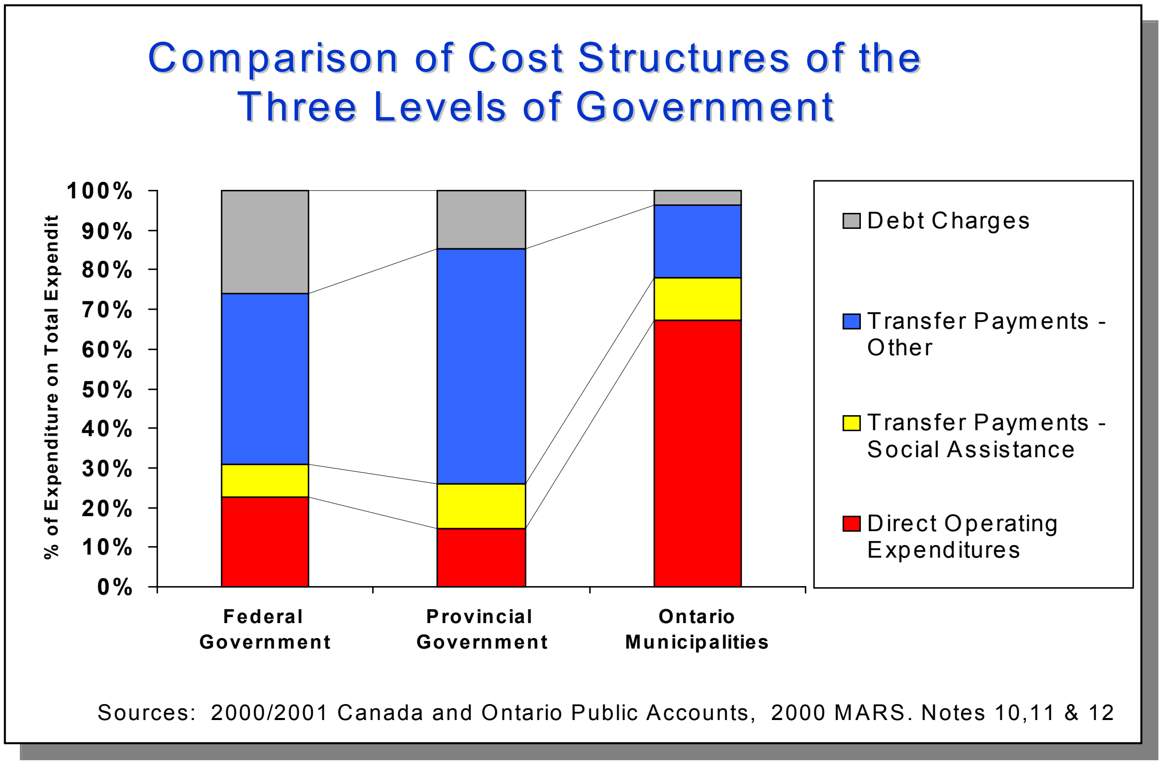
The other municipal services that require significant capital re-investment are water and wastewater services. However, the authors of this paper are not advocating an ongoing federal or provincial role in the funding of these services. In most jurisdictions, sustainable water and wastewater systems are a matter of appropriate pricing of rate supported service. The water and wastewater systems in Ontario's larger urban centres are of a size and sophistication such that they should be totally self-sustained by user rates.

Nevertheless, there are many situations that will require one-time support, such as large-scale water projects that are to bring new sources of water to areas that the Province would like to see develop further and support Smart Growth. The "big pipe" proposal to bring water to Central Ontario from Georgian Bay would be one such example. There may also be a need for transitional funding from the Province to assist some municipalities adapt to the changes expected to arise out of Bill 175 - *Sustainable Water and Sewage Systems Act* once fully implemented. Ontario Small Town and Rural (OSTAR) funding for water projects will come to an end within its 5-year period in 2004. Also, in some areas significant reinvestments are needed to meet stricter effluent standards. For example, a massive investment is required to deal with the decades-old problem of combined sanitary and storm water overflows and resulting contamination.

B. Expenditure and Revenue Flexibility

Ontario municipalities have less flexibility to manage expenditures

Municipalities in general have less spending flexibility than the federal and provincial counterparts. The following chart compares the cost structures of the three levels of government. Direct operating expenses, comprising mostly non-discretionary salary costs, constitute almost 70 percent of Ontario municipal expenditures. On the other hand, transfer payments form the biggest share of senior government expenditures. In times of fiscal constraints, they have the ability to reduce the transfers to the lower levels of government, whereas municipalities invariably are directly accountable for any service implications to the public.



Municipal control over direct operating expenditures also represents an opportunity to control costs. However, the evidence of decreasing service levels under fiscal constraints and rising demand suggests that cost control alone is not the answer. Furthermore, a large portion of municipal spending is non-discretionary – related to mandated social programs or emergency services. Efforts to increase efficiency of service delivery and control discretionary expenditures have been underway in earnest for over 10 years since provincial funding began to decrease. Ongoing efforts [*] may yield some dividends in the future, but not on the scale required to resolve capital funding problems identified in this report.

Ontario municipal revenues are more vulnerable than those of the two senior governments

The following chart compares the revenue structures of the three levels of government. Each category of revenue behaves differently over time. When the economy grows, senior government sources such as income and consumption tax revenues outperform property tax revenue growth, which is also distributed very unevenly across the province. In times of restraint, municipal governments are much more

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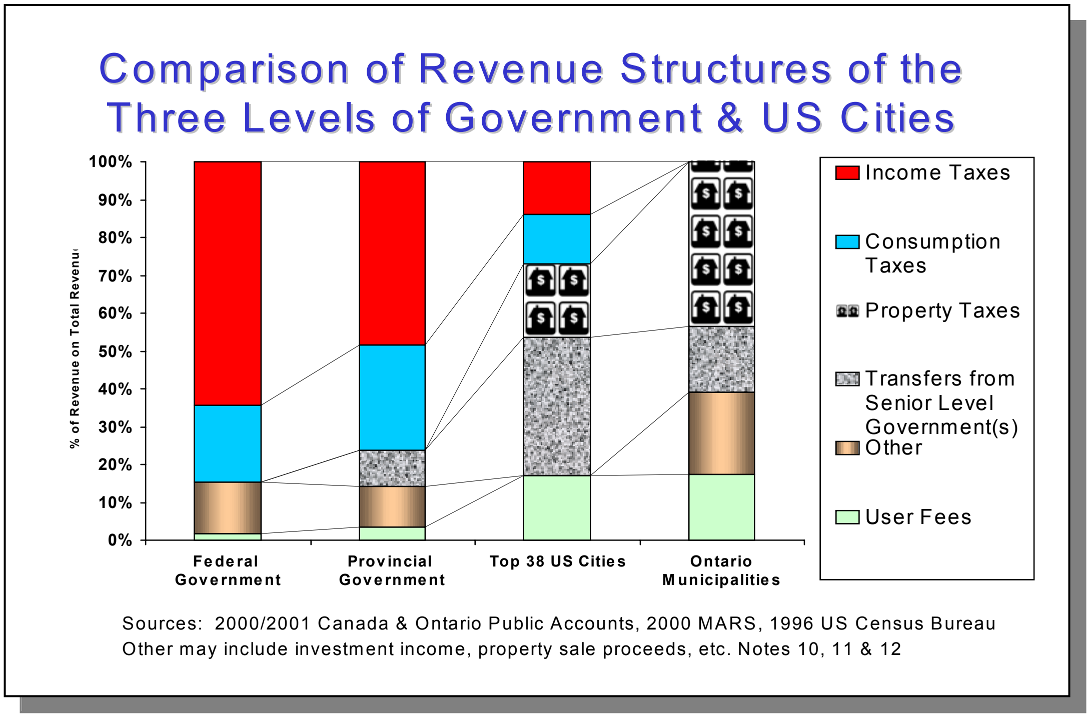
(*)
Municipal Performance Measures Program (MPMP)
Ontario Municipal Benchmarking Initiative (OMBI)
Ontario Centre for Municipal Best Practices (OCMBP)

dependent (about 20 percent of revenues) on senior government transfers than their provincial counterparts. In addition, municipal user fee revenues are susceptible to downturns in the economy; particularly transit fares and building related fees and charges. Finally, senior governments have recourse to deficit financing in their current accounts, which is unavailable to municipalities.



Property taxes are the only tax revenues available to Ontario municipal governments, and they make up approximately 45 percent of total municipal revenues. The senior governments and U.S. cities have access to income taxes and consumption taxes that give them added financial flexibility.

The property tax is a relatively inelastic revenue source, matching traditional municipal spending activities having stable demand and cost per unit, and providing revenue stability during economic downturns. However, it does not match the growth in income and consumption tax revenues associated with economic growth (as illustrated on the next page) nor is it able to support social service costs to the degree now required of municipalities.

Provincial Government withdrew financial support for Ontario municipalities

The economic downturn in the 1990s has led senior governments to gradually withdraw funding to municipalities in the three priority areas: transportation, transit and affordable housing. In 1996, the Province began to withdraw from funding 75 percent of transit capital and by 1998 was no longer funding transit. Provincial funding of roads was eliminated somewhat earlier, and additional responsibilities (assets) turned over to the municipalities. Provincial funding for social assistance was reduced and for affordable housing was eliminated completely at the same time.

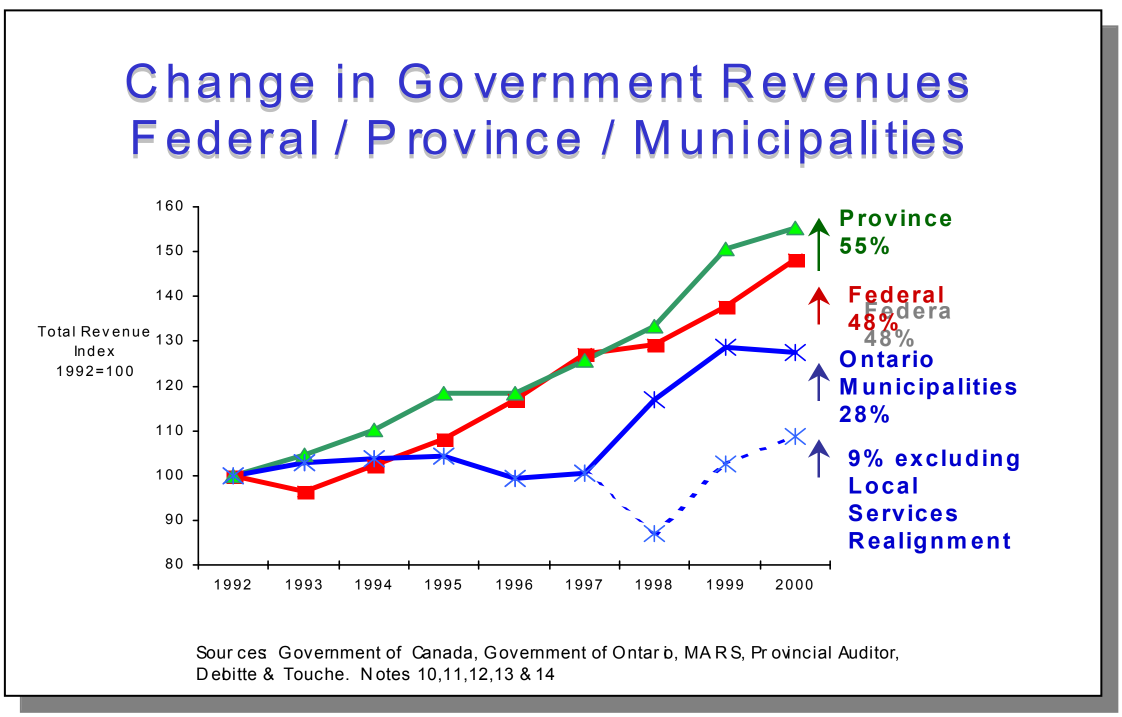
At the same time, the Province has imposed constraints on user fees to limit charges to cost recovery in areas such as licensing, building permits and water rates, preventing generation of fee revenues for use to support under funded program areas.

Recently the Province has announced renewed participation in transit capital funding that could reduce the municipal share back to as low as 33 percent. However, the resolution of issues such as eligibility rules, and conditional matching funding from the federal government are still required.

The reductions in provincial funding were known as Local Services Realignment (LSR). The laudable goals of simplifying, streamlining and disentangling funding responsibilities between the province and municipalities were not always advanced. In spite of the oft mentioned transfer of education tax room to municipalities, the lasting impact of financial and social service responsibility downloading has significantly impacted municipalities and will remain a key reason behind the current drive for change.

Municipal revenues have not benefited from improvements in the economy

Between 1992 and 2000, municipalities, unlike senior governments, have not benefited from the improvements in the Canadian economy. Federal revenues increased by 48 percent, while provincial revenues increased by 55 percent. Ontario municipal revenues increased by only 28 percent in gross dollars. When the impacts of Local Services Realignment are removed (LSR increased municipal revenues and expenditures relative to the pre 1998 period), the net increase of municipal revenues was only a mere 9 percent, much less than the rate of inflation of 14 percent during the same period.



Sources: Government of Canada, Government of Ontario, MARS, Provincial Auditor, Debitte & Touche. Notes 10,11,12,13 & 14

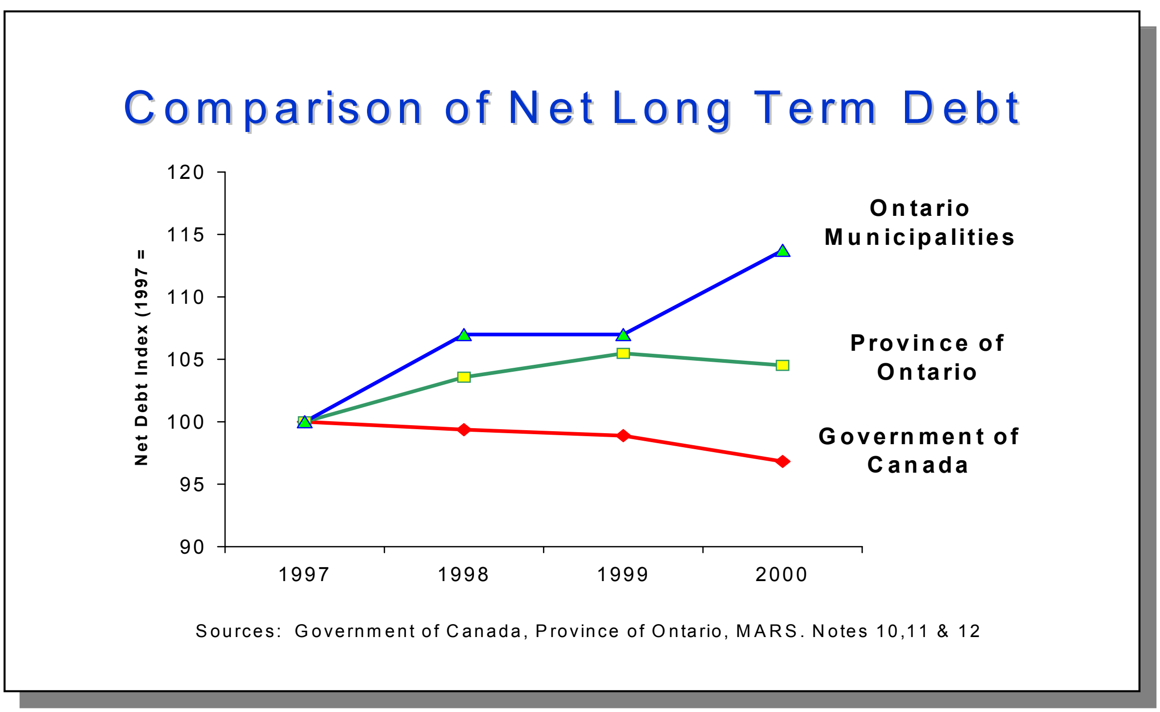
C. Debt and Infrastructure

The following chart shows a stark contrast between the growth rates of municipal debt levels and those of senior governments. Unlike senior governments municipalities can borrow for only capital expenditures. Without the surpluses and hence the flexibility enjoyed by senior governments, municipalities have increased their debt levels. If this trend continues, the main problems are:

- rising carrying costs of the debt will crowd out other municipal operating priorities; and
- municipal credit ratings will face downward pressures which will push up the cost of issuing debt, further aggravating the impact on the operating budget.

Unfortunately, these debts are being incurred in large measure to renew existing infrastructure to the benefit of current taxpayers. Increasing the relative municipal debt burden shifts the repayment cost to future taxpayers. This is completely at odds with provincial legislation making provincial operating budget deficits illegal specifically to avoid shifting tax costs to the future.

Municipal debt levels are rising



Ultimately the quality of life is affected by insufficient capital maintenance

There are many implications of insufficient ongoing capital maintenance:

- The cost of neglect/deferred maintenance
  - Road deterioration/gridlock
  - Health & safety
  - High overall cost
- Implications for economic competitiveness
  - Quality of life
  - Organization's image, e.g. vehicles

D. Independent Verifications of Municipal Financial Condition

A variety of studies have come out recently documenting the financial challenges experienced by municipalities in Canada and Ontario. A few of the key reports and their proposed solutions are listed below.

Several non-municipal organizations have verified need for additional funding

Prime Minister's Caucus Task Force on Urban Issues – November 2002[3]

- Cities in crisis: Urban regions cannot compete - have insufficient revenue & older infrastructure
- Solutions:
  - National affordable housing program
  - National infrastructure program
  - National transportation program

Toronto Board of Trade – June 2002[5]

- Confirmation of the decline in Toronto validated the need for change
- Potential solutions:
  - 5-year interim funding agreement between the City & senior governments
  - a new public finance model for the city
  - a new governance structure

FCM – May 2002[1]

- municipal revenues and responsibilities are mismatched, unsustainable
- potential solutions:
  - Federal commitment to a permanent infrastructure program
  - Extend the National Affordable Housing Program
  - Support an integrated national transportation system
  - Increase the GST rebate to the municipal sector
  - Allow municipal governments to share tax revenues levied by other governments
  - Establish a national municipal infrastructure finance corporation

TD Economics – April, May 2002[2]

Property tax not right for the job

- U.S. cities have greater taxing powers, and broader use of tax incentives
- Solutions:
    - Local governments need property tax reform
    - Senior governments to:
        - grant "Natural Person Power"
        - provide stable & reliable funds
        - exempt municipalities from PST & GST
        - reduce gasoline tax rate & transfer tax room to municipalities

Municipal Revenues in Other Jurisdictions[15]

(All currencies in this section are in Canadian dollars)

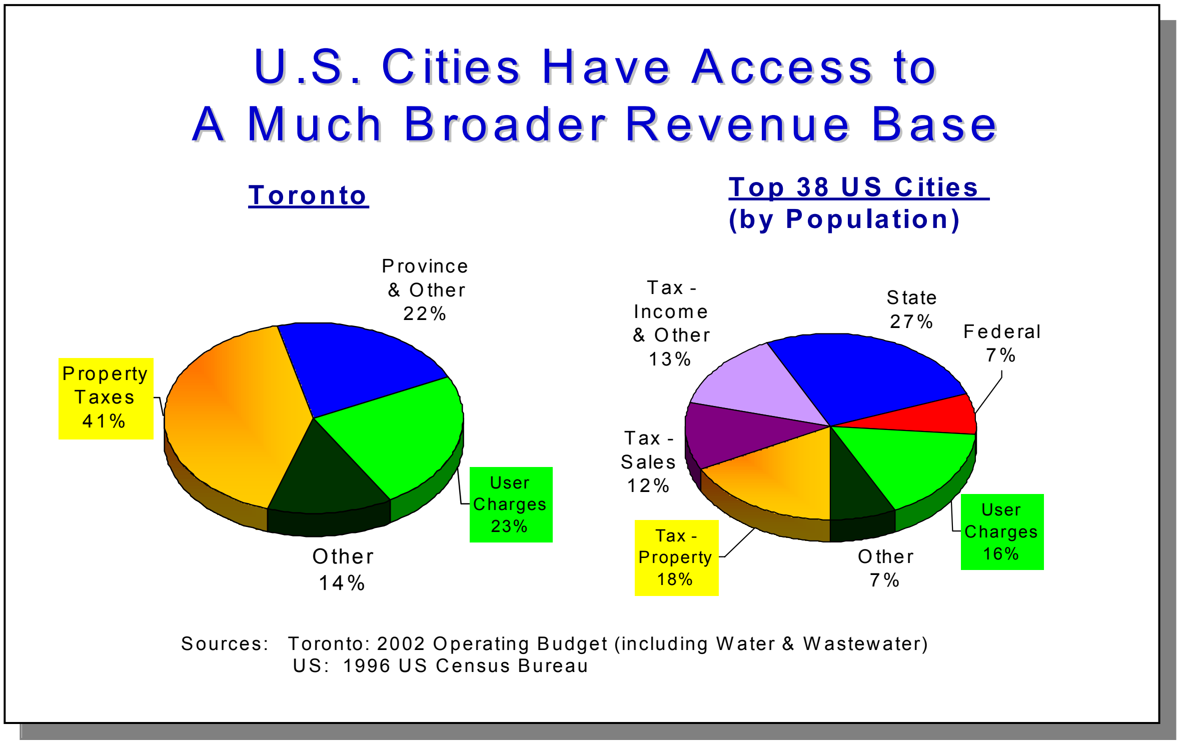
Contributions by local government to municipal infrastructure vary greatly among countries, states and cities. Senior governments and the private sector may also provide municipal capital infrastructure funding. The 1996 per-capita total municipal capital spending varies greatly across Canada, U.S. and Europe, with Canada lagging well behind. Comparisons like those below are relevant because Canadian cities compete for business and investment with other cities in North America and around the world.

- Europe (average of 43 countries): $3,150
- US: $2,480
- Canada: $1,180

The United States

U.S. Cities have access to a much broader revenue base

As illustrated in the pie chart below, which uses Toronto as the Canadian example, U.S. municipal governments draw on a wide array of financing mechanisms, including local income and sales taxes, and greater support from state and federal governments. U.S. cities have access to a much broader revenue base than Canadian cities.



In the area of government support, the single largest infrastructure investment program in the U.S. is the Transportation Equity Act for the 21st Century (TEA-21). More than 75 programs make up TEA-21, and a total of $217 billion was allocated over six years (for projects including highways, transit, and rail)[15]. This investment is more than 100 times the Canada Infrastructure Program ($2.05 billion).

As an illustration, if Toronto were an U.S. city, it is estimated that the City would have been eligible for $290 million in funding in 2001 under this program. Proportionate funding would be available to other Canadian cities.

European Jurisdictions

European municipalities also have access to a broad revenue base

In Europe, many municipalities receive significant support for infrastructure from the European Union (EU), with the stated goal being the reduction of regional disparities within the EU. The primary vehicle for infrastructure funding is the European Regional Development Fund (ERDF) whose budget is approximately $260 billion over 7 years, making up one-third of the entire EU budget. This fund is intended to co-finance infrastructure with host countries through contributions from local/national governments, the private sector, lottery funds, etc. In addition, within the European G-7 countries, national governments fund 15-30 percent of all operating costs, and 30-100 percent for capital expenditures on public transportation. Public-private partnerships have been on the rise as a means of financing infrastructure[15].

Alternate Revenue Sources in Europe[16]

- Local Income Tax
  - Germany - State government distributes 15 percent of national income tax to local government where taxpayer resides
  - Sweden
- Business Tax
  - Frankfurt, Germany - accounts for 2/3 of tax revenues and 1/4 of total revenues
- Municipal investments enhanced by EU funds aimed at reducing regional disparities

Other Canadian Jurisdictions

Ontario cities lead the nation in social service responsibilities. They also lag most major cities in terms of revenue sharing with the provincial level of government. Vancouver, Calgary, Edmonton and Montreal all receive a share of gas tax revenues in support of transit expenditures, as well as other supportive measures for municipal infrastructure.

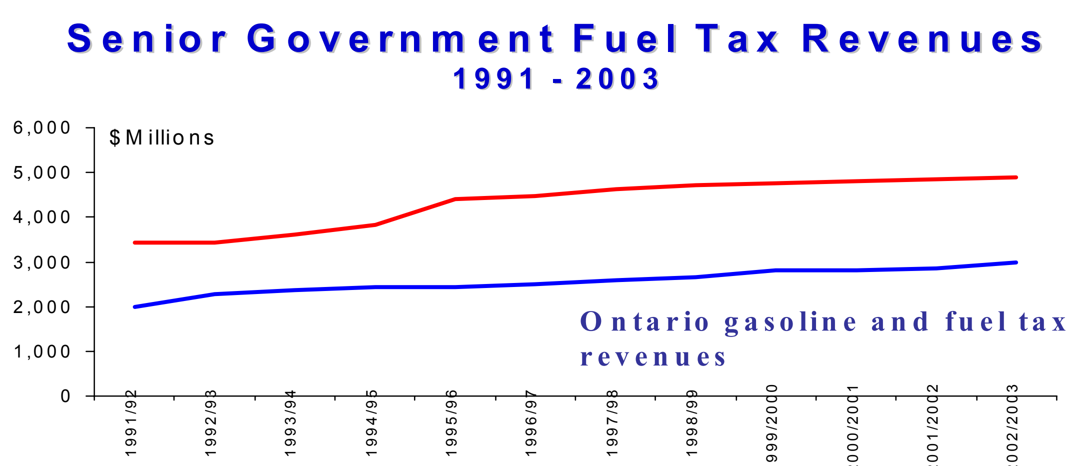
3. Objectives

Any new funding arrangements need to address growth or demand related pressures, and infrastructure renewal burdens, particularly in older communities. In addition, some distinction between growing communities (in terms of assessment) and those contracting or with flat assessment growth may be required. For example, in a community where assessment is growing, the demand for affordable housing as a percentage of revenues may be relatively stable compared to other jurisdictions. Even so, accumulated growth-capital requirements could represent a substantial obstacle to program expansion. In urban centres, social service costs may crowd out required re-investments in infrastructure renewal. As a consequence of these differences between municipalities, one system or funding mechanism may not be the answer. In addition, conflicting objectives described below also augur for more than one approach.

Revenue Stability

Municipalities need secure and stable revenue sources to support capital rehabilitation, replacement and growth

In terms of selecting a mechanism for enhanced funding of municipal capital programs, the goal from the municipal point of view is to obtain adequate revenues sources that are relatively stable (like property tax) and that permit a reasonable degree of self-determinism (like property tax). Responsible elected local government should not constantly be running to the Province for funding. Nor should it be subject to the political trials and tribulations of the provincial and federal levels of government. Local service delivery is simply too important to people's daily lives to suffer service fluctuations each time the government changes or the economy dips.



* includes excise taxes for gasoline, petroleum & gas revenue, aviation gas & diesel fuel Source: Public Accounts of Canada and Ontario

Federal and Provincial Fuel Tax revenues exhibit the consistency and steady growth that municipalities require for program funding.

Accountability

From the senior government perspective the key issues may be ensuring that their priorities are reflected in expenditures, and that some fiscal flexibility is maintained. These objectives have been attained in the past through short-term (three-year) programs, prescriptive eligibility clauses, and senior government control of the funding approval process.

Funding Sufficiency – Allocation Mechanism

It is proposed under the new regime of sustained capital funding that a performance results based approach be used as the means for determining the basis for allocating funding and the centrepiece of measuring value for money.

4. Potential Solutions to Municipal Funding Challenges

This section identifies strategies to achieve alternative funding for municipalities:

- creation of a new Municipal Capital Fund funded from federal and provincial revenue sources, and
- creation of a new unconditional equalization capital grant

Municipal Capital Fund

As mentioned above, what is needed is a reliable, sustainable source of capital growth funds that for the purposes of this paper will be called a Municipal Capital Fund. Similarly, the federal throne speech (Sept 2002) calls for the establishment of a long-term national infrastructure program that will build on current programs to provide stable reliable funding (i.e. 10 years).

The Municipal Capital Fund would be the repository of the funding and within the accountability frameworks described below, funds would flow to cities for expansion related needs. Unlike the federal and provincial capital funding programs in the past, the Municipal Capital Fund would be permanent with dedicated income sources. In addition, the funds would be allocated based on a municipality's most pressing needs as determined by objective and transparent measures within the three targeted program areas.

For example, one city may draw on the fund exclusively for affordable housing projects, while another may need to use the fund for a major transportation project.

Municipal Capital Equalization Fund

Before a capital growth fund can be helpful, certain municipalities will need assistance in dealing with the capital repair and replacement burden of ageing infrastructure in the aftermath of Local Services Realignment. The Province has recognized, in part, the municipal capital rehabilitation needs through the Municipal Capital Renewal Program for municipal transit rolling stock. The age and cost of replacing physical infrastructure varies across the Province, particularly as it compares to the historical burden per assessment dollar. Infrastructure renewal costs in the 1950's, 60's and 70's when a large portion of the assets were new, property tax revenues were growing and cost sharing arrangements were common, is completely different from the burden faced today in mature municipal centres. Unless this situation is rectified, municipalities in these circumstances will find themselves unable to participate in funding schemes for new works under the capital growth fund.

The Municipal Capital Equalization Fund would be different from previous initiatives in that it would be a permanent program, sourced from specified revenues, allocated based on means and infrastructure renewal needs, but expended on an unconditional basis reflecting existing municipal responsibilities and accountability.

Potential sources of funding

Many studies have identified the various revenue sharing/funding options available and in use around the globe. Appendix 1 contains a partial list and provides comments on their suitability for various purposes. The key objectives in identifying specific revenue streams should be (a) their linkage to the expenditure purpose (b) their adequacy; and (c) their relative stability.

Other aspects of the New Deal

In addition to a new financial deal on transit, transportation and affordable housing, the Province and the municipalities could carry out some additional service funding swaps that would strengthen the accountability relationship with tax-paying public and narrow the scope of the provincial/municipal funding relationship to the most important issues facing the cities today.

Currently, municipalities have 100 percent funding responsibility for the following services:

- Business development
- Fire protection
- Roads
- Police
- Parks
- Recreation and culture
- Planning and building control
- Social Housing
- Water
- Wastewater
- Waste collection and disposal
- Street lighting

With the exception of the capital needs of roads, transit and social housing, it is proposed that municipalities continue to fund 100 percent capital and operating needs of these services without federal or provincial assistance.

Municipalities also deliver the following programs on a shared basis with the Province:

- Transit
- Libraries
- Ambulance services
- Public health services
- Subsidized child care
- Supporting housing for seniors and mentally challenged
- Long term care
- Ontario Works & related social assistance programs

In exchange for reduced municipal funding of income re-distribution programs such as Ontario Works and affordable housing, an option to consider is that municipalities assume 100 percent of the capital and operating expenses of:

- Ambulance services
- Public health services

Reduced municipal Ontario Works funding responsibilities would also decrease the amount pooled in the GTA, which has been problematic since its inception in 1998.

- **User Fees**

  Under the new *Municipal Act* and its regulations, the Province has retained significant powers to influence when user fees may be applied and how the rates of the fees are established. Municipal discretion to charge and set user fees should be left relatively unrestricted by the Province.

The Federal and Provincial Government interest

The federal and provincial interest in addressing the new financial deal is relatively straightforward. The health, education and environmental programs that are at the top of the public's agenda can only be financed from a vibrant and growing economy. Since most of Canada's economic activity takes place in cities, it is imperative that cities have the ability to provide the infrastructure needed to maintain their competitiveness on the world stage.

Tackling these three issues is also seen as essential to combating poor air quality in the major cities which is now a serious concern for all three levels of government. Ultimately, effective transportation and transit systems and availability of affordable housing improve the attractiveness of urban centres as places in which to live and invest.

The recent Census results indicate two notable developments that have significant impacts for cities:

- over 80 percent of the Canadian population lives in urban areas and
- natural population growth is relatively flat

Immigration will likely play a greater role in increasing the population. The vast majority of immigrants settle in large urban areas. Consequently the pressure for effective transportation and transit systems and for affordable housing will only intensify in Canada's urban centres.

Performance based funding should be considered

Under this approach, a set of well articulated objectives would be established to identify what projects would be funded under this program and when they would proceed. For each objective, a set of performance measures would establish the amount of financing that would be delivered to the project and to measure the success of the venture.

Examples of the objectives and their respective performance measures are as follows:

Objective	Measures
The housing supply within the municipality matches the income profile of its inhabitants	Ratio of affordable homes and rental units available to households by income group
Worker commuting time is minimized.	▪ Ridership on public transit ▪ cost per rider per vehicle per kilometre.
Greenhouse gases are minimized.	Number of passenger car trips per day decreases
Cost of worker commute is minimized	Cost per public transit trip decreases

Under the performance based accountability process, a municipality's allocation of revenues would be based on the projected and actual benefits of the project.

In order for the allocation process to operate efficiently and on a timely basis, the decision making process for allocating funds to specific projects must be carefully considered, especially in the areas of transportation and transit. Currently in Ontario, transit and transportation are financed and operated by the Province, Regional and Single Tier municipalities and lower tier municipalities. In the larger urban areas like the GTA, an integrated cross-regional approach to transportation and transit is likely best suited to bringing about the highest and best use of capital funding. This may mean that local preferences are deferred to the larger regional priorities. The Province should consider how it will manage the different interests of municipalities within a larger economic area.

Without funding for capital rehabilitation and replacement projects, many municipalities will be unable or unwilling to participate in even a small share of growth or expansion projects. However, the test for capital renewal funding eligibility is inherently different than that for new infrastructure. The funding stream must recognize both the nature of the physical asset responsibilities being carried by a municipality and the health of the assessment base. Once the annual amount is quantified, the municipality should be free to allocate the funds as it deems necessary from year to year.

The need for means and needs tested funding is based on avoiding the situation where new works are being built while existing infrastructure decays. In that case, the public is not being served, and the unfunded infrastructure renewal responsibilities of the municipality are increased.

5. Conclusion

The recommendations put forward in this paper are intended to focus the co-operative action of all levels of government on to the most pressing issues facing large urban centres today and into the foreseeable future. The strategies articulated in this paper hinge upon needed actions by both federal and provincial levels of government to allocate a share of their revenue sources, among other initiatives, to help fund priority capital investments in Canadian urban centres and to ensure a base level of funding for ongoing capital infrastructure renewal.

Increased funding from dependable sources is the key to revitalized municipalities, but will require careful consideration of allocation methodologies to ensure that funding is invested strategically. Accordingly, principles for future discussions are identified including:

- New funds be identified for capital in transportation, transit and affordable housing programs
- New funding be administered so as to ensure its sufficiency, stability, and so that accountability is maintained through appropriate allocation mechanisms
- In recognition of two distinct types of need, that funds be segregated into a municipal capital fund for expansion related expenditures, and a municipal capital equalization fund for infrastructure renewal

By concentrating government action on transportation, transit and affordable housing, cities will be able to continue to generate the economic activity that supports our health, social and education programs that are fundamental to the Canadian identity. By addressing these issues, the quality of life within the cities will improve and urban centres will become stronger.

6. Next Steps

This paper intends to establish a starting point for the discussion of a structuring a new financial deal for cities with the federal and provincial levels of government. It is proposed that this report be submitted to the Regional and Single Tier Chief Administrative Officers for their considerations and development of a strategy for engaging the senior governments in the funding solutions.

Appendix 1

Potential revenue sources

The following section outlines potential financial and non-financial solutions to meeting the capital needs of transportation, transit and affordable housing categorized into each of the three levels of government.

Federal Government

The solutions in which the federal government could participate are based on the existing constitutional framework. The proposals will put Canada on the same footing as other G7 countries that all have national transportation and housing programs. As mentioned previously, the federal Urban Issues Task Force has identified the need for the federal government to develop national strategies for transportation and affordable housing.

Federal Government – contributions to Municipal Capital Fund

It is proposed that the Federal Government establish a *sustained* capital funding program for transit, transportation and affordable housing which could be financed from the following sources:

- **Fuel and Sales Tax Revenue Sharing**

  The federal government collects a substantial portion of its revenues through sales and fuel taxes, the majority of which are generated from the cities. The federal government could contribute to the capital needs of cities identified above by dedicating a portion of the gasoline tax or the GST or both to the Municipal Capital Fund.

  The Federal Government currently collects approximately $4.8 billion across the country in gasoline and fuel excise taxes. In Ontario, this Federal excise tax is currently fixed at 10.0 cents per litre of gasoline sold. GST is also levied on each sale. If the Federal Government were to give Ontario municipalities a share of gasoline tax revenues in Ontario, the amount that would go into the Municipal Capital Fund is estimated to be approximately $150 million annually for each cent per litre shared. This amount is estimated from the total amount of gasoline sold in Ontario in 1999.

  The Federal Government collects approximately $25 billion in Goods and Services Tax (GST) annually. Ontario's share is roughly $10B based on its share (of 41 percent) of the national GDP. If the Federal Government were to give Ontario municipalities one percent (of the 7 percent) of the GST on all relevant sales in Ontario, the amount that would go into the Municipal Capital Fund is estimated to be approximately $1.5 billion annually.

- **Immigration Grant**

  The Federal Government has appropriately recognized the potentially crippling labour shortage that could occur as the result of Canada's ageing population and low birth rates. Accordingly, immigration is to be increased. Since the vast majority of immigrants initially settle in the largest urban centres which places an additional strain on municipal infrastructure, it would be appropriate for the Federal Government to contribute a per capita immigrant grant to the Municipal Capital Fund.

- **Other Funding**

Federal Government - initiatives beyond Municipal Capital Fund

The federal government could undertake several initiatives that would provide direct financial benefits to municipalities apart from providing funding to the Municipal Capital Fund.

(1) GST exemption

The federal government does not have the authority to tax the provincial and territorial governments. The exemption of tax should be extended to municipalities as they are often acting as extensions of their respective provincial governments in many service areas. Exempting GST on the capital investments in transit, transportation and affordable housing would reduce the amount of funding municipalities need to raise themselves.

Goods and services provided by Ontario municipalities fall under the "exempt goods" category of the GST. They receive 57.14 percent rebate on GST they have paid, leaving them paying a 3.0 percent effective GST rate. According to the May 2002 Special Report by TD Economics, all Canadian municipalities pay about $425 million of GST to the Federal Government per year. The Ontario share would be just under $100 million.

An across the board GST exemption is not ideal in that it puts funds in municipal hands without corresponding accountability controls or a fiscal capacity test. Consequently, a targeted GST exemption (transit or housing expenditures, which are potentially simplest to isolate) might be more successful.

(2) Income Tax Act Amendments

The federal government could assist municipalities in attracting ridership to its transit systems and discourage the use of personal vehicles in urban areas by amending the Income Tax Act in the following ways:

- Eliminating the employee taxable benefit for employer paid public transit - passes, while retaining the tax deduction for employers.
- Designating employer supplied/paid parking expenses non-deductible for employers while retaining the taxable benefit for employees.

To encourage more private sector investment in affordable rental housing the federal government could reduce or eliminate the capital gains tax on the disposition of rental housing.

(3) Land Holdings and Railways

The federal government has extensive land holdings in municipalities, some of which are surplus to federal needs. In addition, the federal government has significant influence over the railway industry that not only holds significant lands in the urban areas but also control the all important rail corridors that, in Ontario's case are used by GO Transit.

The federal government should consider offering surplus lands to the cities as a grant provided that they are used for affordable housing, transit and transportation uses. Further, the federal government should use its influence and financial resources to assist cities in securing access to railway lines and lands.

Federal land holdings are unlikely to consistently be a good match with municipal housing requirements. Consequently, a process for communicating surplus lands prior to disposition (similar to internal processes within municipalities) and where appropriate transferring lands at deemed market but funded through applicable support programs might be the most effective. In this way municipalities could avoid bidding wars and transaction costs when federal surplus land meets the requirements of the housing program, without distorting the site selection process with arbitrary subsidies of free surplus land.

(4) Measurement

The Federal Government, through Statistics Canada, could also assist in measuring both the needs and the outcomes of a sustained capital program as outlined in the accountability section of this paper. The federal Urban Issues Task Force calls for improved data gathering at the federal government level to better inform policy development affecting municipalities.

(5) Funds from General Revenues

An alternative to a dedicated revenue source(s) is a simple allocation from general revenues. From a municipal standpoint, this does not provide as secure a revenue source as others shown above and therefore does not satisfy the principle of revenue stability.

Provincial Government

The Province of Ontario already plays a major role in transportation as the owner and operator of the 400 series highways. In many urban areas, the 400 highways are operating above their capacity for much of the working day. Expanding the network is hugely expensive and has a significant impact on the environment. The Province should assist municipalities in local transportation and transit projects that will help to diminish the demand on the 400 series of highways. Closer co-operation and funding in these areas are also fundamental in achieving Smart Growth in urban centres.

The provincial government also has a stake in the affordable housing issue. Maintaining and expanding the affordable housing stock will ensure that employers continue to have access to a workforce that is affordable. Expanding the affordable housing stock within existing urban boundaries will also help alleviate the pressure on the road networks caused by long distance commuting from lower cost communities and supports Smart Growth.

The Province is also seen by the Ontario public as the level of government most responsible for the protection of the environment, particularly air quality. Air quality in Ontario is a key and growing public concern. Pollution from car and truck traffic is a major contributor to the problem. Investments in public transit and efficient housing patterns are part of the solution.

Provincial Government - Contributions to Municipal Capital Fund

- **Fuel Tax and PST Sharing**

  Like the federal government, the provincial government earns a substantial portion of its revenues from gasoline and sales taxes generated in municipalities. It is proposed that some of this revenue be dedicated to a sustained Municipal Capital Fund.

  The Ontario government collects more than $2.9 billion in gasoline and fuel taxes a year[11]. This provincial excise tax is currently fixed at 14.7 cents per litre of gasoline sold. If the Province were to give Ontario municipalities one cent from each litre of gasoline sold in Ontario, the amount that would go into the Municipal Capital Fund is estimated to be approximately $150 million annually. This amount is estimated from the total number of gasoline sold in Ontario in 1999.

  In addition, the Province collects more than $14 billion in retail sales tax (PST) annually[11]. If it were to give Ontario municipalities one percent (of the 8 percent) of the PST on all relevant sales in Ontario, the amount that would go into the Municipal Capital Fund is estimated to be approximately $1.7 billion annually.

  Neither fuel tax nor PST raised locally is reflective of the local demand for funding, except possible in the case of transportation capital and fuel tax. As such, locally raised funding may not be the most appropriate mechanism for allocating the funds.

Other major Canadian cities are collecting a share of fuel tax from their Provincial Governments: Montreal: 1.5 cents/litre; Greater Vancouver 11 cents/litre; Victoria 2.5 cents/litre; Calgary & Edmonton: 5 cents/litre

- **Hotel Tax**

For some jurisdictions like Toronto, Ottawa and the Niagara Region, tourism places an additional burden on the transit and transportation systems of these urban areas. A hotel tax placed on the hotel room rate could be used to help offset the transit and transportation investments of these cities.

For example, a 3 percent hotel tax in Toronto would net between $20 million and $25 million. Note that in Ontario the Hotel PST rate is currently 5 percent and the addition of the 3 percent would take the rate to the 8 percent PST rate on general goods.

Of course, hotel taxes may have a detrimental effect on local tourism and economic activity. Consequently, one would want some local control on how and if such taxes were applied. Another factor is that the total revenue potential of this option is much lower than the probably requirement. As a result, this funding source should not be considered a priority for the capital fund or equalization budget, but rather a potential targeted revenue for tourism, marketing and/or economic development activities.

Other Canadian cities that have local Hotel Taxes:
Vancouver: Hotel levy @ 2 percent + PST @ 8 percent + GST @ 7 percent
Montreal: Hotel levy @ $2/room/night + PST @7.5 percent + GST @ 7 percent

- **Vehicle Registration**

The Province currently charges $75 annually for vehicle registration. Transferring this revenue to the cities would provide a revenue source for transportation that is directly related to the demand for that service.

Currently the Ontario Government collects about $370 million in vehicle registration fees for passenger cars, from a fee of $74 per vehicle per year in Southern Ontario and $37 in Northern Ontario[11].

One way of sharing this revenue with municipalities is to allocate a fixed amount per vehicle to municipalities, e.g. $50 per vehicle in Southern Ontario and $25 per vehicle in Northern Ontario. Under this regime, the amount that would be contributed to the Municipal Capital Fund is estimated to be approximately $250M a year. This figure is calculated by applying the above fees onto the number of registered active passenger vehicles in Ontario, assuming the split between Southern and Northern Ontario is 75 percent:25 percent.

One interesting aspect of vehicle registrations is that on a local per capita basis, more registrations will exist the less transit dependent the community and the more affluent the community i.e. with less demand for affordable housing. Consequently, vehicle registration may be inappropriate as a means of allocating funds between jurisdictions. On the other hand, on a macro basis, registration fees are a (minor) deterrent to car ownership and therefore pro transit. Therefore, they may be a good source of funding for a growth capital fund.

In Montreal, there is a $30/car/year vehicle registration fee dedicated to transportation funding.

- **Driver's Licences**

  A share of driver licence fees could also be contributed to the Municipal Capital Fund for similar reasons as vehicle registration fees.

  Ontario Driver's Licence renewal fees are currently $10 per year[11]. With more than 8.1 million licensed drivers in Ontario, it is estimated that the Province collects more than $81million in Driver's Licence fees. An example of sharing this revenue with municipalities is to contribute 10 percent of the total take, i.e. $8 million to the Municipal Capital Fund.

- **Funds from General Revenues**

  An alternative to a dedicated revenue source(s) is a simple allocation from general revenues. From a municipal standpoint, this does not provide as secure a revenue source as others shown above and therefore does not satisfy the principle of revenue stability.

Provincial Government - Initiatives beyond Municipal Capital Fund

The Province could introduce selected measures that would provide significant benefits across Ontario municipalities.

- **PST and Land Transfer Tax Exemptions**

  A PST exemption of up to $2,000 per unit currently exists for affordable housing. Extending this exemption to the Land Transfer Tax would assist in brining the cost of housing down.

Extending the PST exemption to transit and transportation projects would reduce the cost of these projects to municipalities.

The TD Economics Special Report[2] estimated that Ontario municipalities currently pay about $275M in PST on their annual purchases. As with the GST, consideration should be given to eliminating this tax transfer, with corresponding savings for municipalities.

- **Land Transfer tax**

  The Land Transfer Tax itself could be a source for either the municipal capital or municipal capital equalization funds. Across the Province this quasi-consumption tax has raised approximately $650 million annually in recent years, based on transactions involving real property[11].

- **Land Holdings and Electricity Transmission Corridors**

  Like the Federal Government, the Province holds title to significant amounts of land in the urban areas through the Ontario Realty Corporation. In addition, through its ownership of Hydro One, it can exercise significant control over the use of Hydro One's electricity transmission corridors.

  Granting provincial land for affordable housing initiatives would substantially reduce the capital investment required by municipalities to deliver affordable housing. Electricity transmission corridors offer low cost, low disruption routes for public transportation.

- **Education Tax Room**

  The Province has the opportunity to continue its migration of fiscal and funding responsibility for education away from local government by reducing the education property tax and funding an increased share of education through its general revenue fund. If the municipalities are permitted to take up the tax room, many funding problems can be solved, without the creation of new funding mechanisms or new accountability issues.

  An across the board transfer of education tax room lacks the allocation methodologies required to ensure optimal or targeted use of the funds as discussed throughout this report. One option might be to focus the transfer on equalization, and permit either a transfer of tax room or a tax reduction depending on local circumstances.

Municipalities

Transit, transportation and housing have a huge impact on the liveability and economic strength of a city. Cities do have access to development charges to help pay for the cost of new growth infrastructure. However development charges cannot be used to fund affordable housing, transit routes and to addressing existing infrastructure shortfalls. Although it is clear that cities need financial assistance from other levels of government to meet their capital needs, there are additional avenues that cities can explore to contribute to the capital funding solution, with applicable legislative or regulatory amendments.

Municipalities – New revenue sources (for matching the Municipal Capital Fund)

Municipalities can show leadership in developing solutions to fund infrastructure including the following measures.

- **Parking Tax**

  As a source of revenues and as a way to manage passenger vehicle traffic and other public policy objectives (e.g. environment) in the urban areas, a special parking tax could be imposed.

  One way of implementing this would be to levy a municipal parking surcharge on all non-residential, off-street parking spaces used for all-day parking. As an illustration, it is estimated that each $1 surcharge a day in the City of Toronto would generate approximately $70 million annually based on the existing number of non-residential off-street parking spaces.

  Parking taxes are most applicable in downtown situations where fees are already a standard. However, unless improved transit options are available, parking taxes simply provide another disincentive to downtown development and exacerbate municipal revenue problems in the long run.

  Currently the Greater Vancouver Regional District receives $10M a year from the Province of British Columbia, based on the amount of PST generated by paid parking in the region. The BC Government is currently reviewing this amount.

- **Property Tax Premiums**

  As an extension of the parking tax, a premium dollar value could be attached to the assessment of residential, commercial and industrialized properties that have parking spaces in excess of a Smart Growth standard. For example, property assessments would be artificially increased for residences with more than two parking spaces or shopping malls which currently offer free parking. This would act as a source of new revenue for the targeted services and act as a financial disincentive to build more free parking.

The Province would have to amend the legislation to allow for this and it could be offered as an option that individual cities may or may not take advantage of.

In addition to suffering from the same issues as Parking Taxes, this option should be vetted through planning officials who in most cases are concerned with ensuring that sufficient parking spaces are provided with new development – in other words an over-supply is rarely in the interest of the developer.

Municipalities – initiatives beyond new revenue

- **Smart Growth Incentives**

  Municipalities can consider other "non-revenue" strategies to help support sustainable infrastructure investments over the long-term.

- **Land Holdings**

  Municipalities also have extensive land holdings that should be reviewed for their suitability to affordable housing initiatives.

  Most municipalities already have policies and procedures in place to ensure that surplus land holdings are considered for municipal needs prior to disposition.

Appendix 2

Contributors:

- Len Brittain (Chair) – City of Toronto
- John Bech-Hansen – MFOA
- Stephen Cairns – County of Norfolk
- Martin Hayward – City of London
- John Murphy – Region of Niagara
- Roberto Rossini – City of Hamilton
- Karen Tippett – City of Ottawa
- Tom Webster – Region of York
- Cam Weldon – Region of Halton
- Ed Zamparo – Region of Peel

Notes

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