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New Tax Sources for Canada's Largest Cities: What Are the Options?

Harry Kitchen and Enid Slack

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The Institute on Municipal Finance and Governance (IMFG) is an academic research hub and non-partisan think tank based in the Munk School of Global Affairs at the University of Toronto.

IMFG focuses on the fiscal health and governance challenges facing large cities and city-regions. Its objective is to spark and inform public debate, and to engage the academic and policy communities around important issues of municipal finance and governance.

The Institute conducts original research on issues facing cities in Canada and around the world; promotes high-level discussion among Canada's government, academic, corporate and community leaders through conferences and roundtables; and supports graduate and post-graduate students to build Canada's cadre of municipal finance and governance experts. It is the only institute in Canada that focuses solely on municipal finance issues in large cities and city-regions.

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Executive Summary

Canadian cities face many challenges – changing demographics, increased income inequality, increasingly complex expenditure demands, deteriorating infrastructure, and so on. These challenges have increased over the last few decades, yet the revenues available to cities to meet those challenges have remained largely the same – property taxes, user fees, and transfers from federal and provincial governments. For a long time, Canadian cities have been calling for access to more taxes, comparable with what large U.S. and European cities have.

This issue of IMFG Perspectives, based upon a full-length report in the IMFG Papers series, argues that additional taxes are entirely appropriate for major cities and estimates the potential revenue that some of these taxes could generate in eight Canadian cities – Vancouver, Calgary, Edmonton, Winnipeg, Toronto, Ottawa, Montréal, and Halifax. First, however, the paper sets out a framework for analysing appropriate tax revenues for large cities and evaluates the advantages and disadvantages of each. The findings from this research are as follows:

1. Decisions on public spending need to be linked with revenue decisions.

For governments to operate efficiently, it is important that a clear link be established between expenditure and revenue decisions – those who make expenditure decisions should also make revenue decisions and the revenue tool should match the type of expenditure being funded. A direct link such as this should result in more accountable government and in greater willingness on the part of taxpayers to pay taxes, as long as they know where their tax dollars are being spent.

2. The property tax is a good tax for local government.

The property tax has many of the characteristics of a good local tax – property is immovable so it cannot escape the tax, it is fair based on the benefits received from local government services, and revenues are stable and predictable. Recent evidence suggests that, in many cities, there is room to increase the residential property tax without dire economic consequences, except for those who may be asset-rich but income-poor. Even so, the property tax may not be sufficient to meet the growing needs of large cities.

3. User fees bring in necessary revenues and play an important role in altering economic decisions.

Cities should charge for services wherever possible. Properly designed fees enable citizens to make efficient decisions about how much of a service to consume and governments to make efficient decisions about how much of the service to provide. Under-pricing (or failing to charge for) services leads to over-consumption and demands to build more under-priced infrastructure.

4. Cities would benefit from a mix of taxes.

The property tax is a good tax for local governments, but it is relatively inelastic (does not grow automatically as the economy grows), highly visible, and politically contentious almost everywhere. It is thus unlikely to be sufficient to fund the complex and increasing demands of local governments and it may not be the appropriate tax to fund some of these services. A mix of taxes would give cities more flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs, changes in the political climate, and other factors. A portfolio of taxes would allow cities to achieve revenue growth and revenue stability while ensuring fairness in the impact on taxpayers.

5. Personal income taxes have the potential to generate considerable revenue for large cities.

Many cities around the world have access to revenues from sources such as income, sales, hotel, fuel, and motor vehicle taxes. For Canadian cities, personal income taxes have the potential to bring in a significant amount of revenue. For small and medium-sized municipalities, however, new taxes may not be appropriate because they may not generate sufficient revenues to justify the tax. Smaller municipalities may have to rely more heavily on transfers from provincial governments than their larger city counterparts.

6. Cities should set their own tax rates.

It would be administratively cost-efficient if cities “piggybacked” new taxes on to the provincial tax with the province collecting the revenue and remitting it to cities. It is critical, however, that local governments set their own tax rate. In this way, they would be accountable to taxpayers through the linking of taxes to the services consumed.



Photo by Alan Cleaver via Flickr (<http://bit.ly/2bCd7rd>)

Introduction

Large Canadian cities need access to more tax revenues, like their U.S. and European counterparts, if they are to meet their growing expenditure requirements. The range of services for which cities are responsible – from water, sewers, roads, and transit to social services and public health – has led many to suggest that the property tax cannot meet these challenges, nor is it the most appropriate tax for funding certain services.¹

A growing number of cities are also looking to the federal and provincial governments to share some revenues.

Any new taxes at the local level would require provincial approval and the provinces would likely want a good reason for granting this authority.

However, by allowing cities to raise more taxes on their own, the provinces could shed responsibility for some provincial-municipal transfers to large cities and focus on smaller municipalities.

This IMFG Perspectives paper is a summary of a full-length report in the IMFG Papers series. The question here is:

For the public sector to operate efficiently, it is important to establish a clear link between expenditure and revenue decisions.

are some tax sources better than others for cities? How do we decide?

Decisions on public spending should be linked to revenue decisions

For the public sector to operate efficiently, it is important to establish a clear link between expenditure and revenue decisions. Expenditure responsibilities must be matched with revenue resources, revenue capacities matched with political

accountability, and benefit areas matched with financing areas. Services provided by the public sector are then “sold” to those who receive them and the revenues from such sales are sufficient to pay for the cost of providing the service. In effect, this approach treats

local governments as “firms” that produce and sell services to their customers.

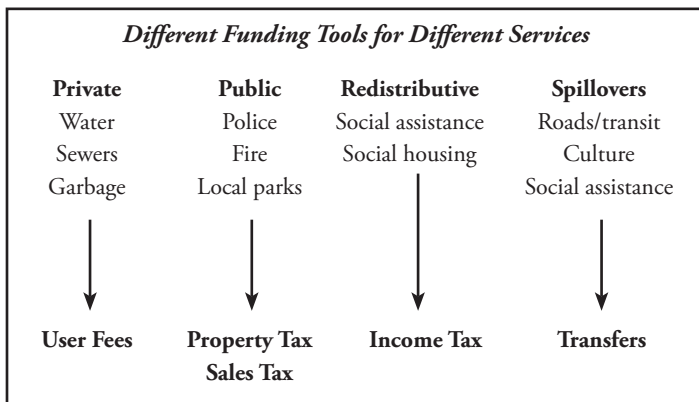
For services with “private good” characteristics (such as water, sewers, transit, garbage collection and disposal, and most recreation), user fees are efficient and fair. In general, user fees should be adopted wherever there is a clear link

between the fee charged and the benefit received. When this link is in place, the taxpayer can choose the amount of the good he or she wishes to consume. Equity concerns can be addressed either by targeting lower-income individuals with existing provincial income-transfer programs or by lowering or waiving fees for low-income users.

Services with “public good” characteristics (police and fire protection, neighbourhood parks, local streets, and street lighting) generate collective benefits that are enjoyed by all local residents. Benefits from these services cannot be assigned to individual beneficiaries and therefore, specific charges cannot be levied. In lieu of charges, then, some form of local benefit-based taxation such as the property tax should be adopted. A city sales tax and personal income tax could also be used to pay for services with public good characteristics.

For other services, the benefits (or costs) spill over municipal boundaries, but local provision is still desirable. Positive spillovers (externalities) occur if residents of neighbouring jurisdictions receive a service for free or at less than the cost of providing the service. For example, roads constructed in one jurisdiction may be used by residents of another jurisdiction without any charge to the latter. One way to fund this kind of service is a transfer from the provincial government or from one local government to another.²

Services that redistribute income should be funded from income tax revenues because it is the most progressive tax available. For cities, these services include social assistance and social housing.



This paper focuses on large cities and metropolitan regions. New revenue sources may not be appropriate for small and medium-sized municipalities. Because residents and businesses can easily cross municipal borders to do their shopping, locate their business, or buy their gas, many of these new taxes would have to be levied on a metropolitan or region-wide basis. Moreover, giving a small town access to income or sales tax revenues would not generate sufficient funds to justify the cost of collecting the tax. The tax base would be too small; hence, smaller municipalities may have to rely more heavily on transfers from provincial governments.

The property tax is a good tax for cities, but a mix of taxes would be preferable

The property tax has many of the characteristics of a good tax (see box). Its base is largely immobile – the residential portion cannot be exported to taxpayers in other jurisdictions – and therefore, relatively efficient because distortions in economic behaviour are minimized.³ It is at least partly effective in funding services for which the collective benefits accrue to the local community; hence, it satisfies the fairness criterion based on benefits received. Revenues are relatively stable and predictable. It is highly visible, so it makes local governments accountable for the tax levied.

How do we know if a tax is a good tax for local government?

A good local tax has the following characteristics:⁴

- **Fairness:** the tax is perceived to be fair in terms of the benefits received from local public services
- **Immobile tax base:** if the tax base can't move, the tax will be borne by local residents and not passed on to people living in other jurisdictions
- **No harmful competition:** the tax does not result in harmful competition between local governments or local governments and senior levels of government
- **Sufficient, stable, and predictable revenues:** the tax generates revenues local governments can count on
- **Visible, transparent, and accountable:** taxpayers understand the tax, so they can hold governments accountable
- **Ease of administration:** the tax is easy to administer locally

A potential downside of a local property tax is that it may be more expensive to administer than other local taxes (income, sales, fuel, for example) that can be piggybacked onto existing provincial taxes. This cost may be a small price to pay, however, if local governments are to have autonomy and flexibility in setting tax policy – important ingredients of responsible, efficient, and accountable local government.⁵

Although recent evidence suggests that the property tax may be enough to fund municipal services,⁶ the real question is not whether the property tax is *adequate*, but whether it is the *best* tax for funding all city services.

The property tax is relatively inelastic (it does not grow automatically as the economy grows), highly visible, and politically contentious. It may therefore be insufficient to fund the complex and increasing demands on local

governments. Moreover, policymakers are concerned about the impact of the property tax on taxpayers who are asset-rich but income-poor, such as the elderly on fixed incomes.

Furthermore, a single tax such as the property tax almost always creates local distortions, some of which may be offset by other taxes. For example, the property tax may discourage investment in housing.⁷ An income tax, on the other hand, may encourage investment in owner-occupied housing, because the imputed income of owner-occupied housing is not taxed in Canada. With a range of tax sources, distortions in one tax may be counteracted by distortions in other taxes.

A mix of taxes would give cities more flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs, changes in the political climate, and other factors.⁸ Access to a portfolio of taxes would provide cities with both stability (through the property tax) and elasticity (through income, sales, or business taxes). Moreover, relying on many sources means that a city can set lower tax rates for any single tax to levy a given amount of revenue. Since the burden of a tax increases with the tax rate (that is, the distortions increase as the tax rate increases),⁹ a more diversified system should yield a given amount of revenue more efficiently with a smaller negative impact on the overall tax base.¹⁰

Tax sharing is not the same as local taxation

New taxes at the local level in Canada would require provincial approval and possibly new legislation. When city officials in Canada ask for access to more revenues (such as sales taxes), they are generally after a share of federal or provincial government tax revenues. This request amounts to a form of tax sharing; similar to what exists in Manitoba and Saskatchewan.

Tax sharing is popular with municipal politicians, but it is not the same as local taxation. Tax sharing, whereby the federal or provincial government collects revenue from a tax and shares it with local governments, leads to little or no local autonomy, because the local government has no control over the tax rate or tax base. Tax sharing is virtually synonymous with intergovernmental transfers. It does not meet the criteria of autonomy, accountability, and transparency.¹¹

Cities in many countries around the world rely on a mix of taxes to finance local expenditures. The table on page 4 shows the distribution of local tax revenues for 2013 in eight federal, one regional, and 25 unitary countries in the Organisation for Economic Co-operation and Development (OECD).¹²

The relative importance of local taxes in a country's overall tax system and as a percentage of GDP is generally less in federal countries than in unitary countries – in federal countries, state, provincial, or regional governments collect some taxes that are the domain of local government in unitary countries.

User fees are an important source of revenue and can alter economic behaviour

Local governments should, wherever possible, charge directly for services. Appropriately designed user fees allow residents and businesses to know how much they are paying for the services they receive from local governments. When appropriate fees or prices are charged, governments can make efficient decisions about how much of the service to provide and citizens can make efficient decisions about how much to consume.

Under-pricing a service results in over-consumption. For example, if water rates are not efficiently structured and do not encourage conservation, they will lead to over-use and over-investment in water infrastructure.¹³ Inefficiently structured fees or prices can also induce over-investment where the service is under-priced – or under-investment where it is over-priced.¹⁴ Thus, proper pricing not only brings in revenues for cities, but also reduces pressure on municipal finances by reducing the apparent need to invest in under-priced infrastructure.

Economic efficiency dictates that prices or fees should equal the marginal cost of providing the goods or services; that is, where the price per unit of output equals the cost of the last unit consumed. Current practice in setting user fees, however, almost always deviates from the fair, efficient, and accountable.¹⁵ The tendency is to set fees to generate revenue rather than to allocate resources to their most efficient use.

Municipal efforts to increase reliance on user fees are often criticized on the grounds that user fees are regressive. In reality, the opposite is often true – those who benefit most from under-priced services are often those who use them the most, and these beneficiaries are often in higher-income groups. By not charging the marginal cost of water, for example, those who are heavy consumers of water – for watering lawns, washing cars, filling swimming pools, and so on – are undercharged for the water they use. Relatively simple pricing systems, such as low initial “life-line” charges often deal with any perceived inequity from introducing more efficient pricing systems.

Road pricing

The fiscal and economic case for road pricing is solid, yet road pricing is often rejected by politicians and the public at large.¹⁶ Efficient road prices offer a number of advantages. They are widely recognized as an effective travel demand management tool for reducing congestion, pollution, and other external costs of driving. They can influence all

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<i>Relative importance of local taxes in selected OECD countries, 2013</i>						
Countries	Tax sources as a % of total local tax revenues				Local taxes as a % of GDP	Local taxes as a % of all taxes ⁵
	Income ¹	Sales ²	Property ³	Other ⁴		
Federal:						
Australia	0.0	0.0	100.0	0.0	0.9	3.4
Austria	63.9	9.1	14.8	12.2	1.3	3.2
Belgium	34.5	7.3	58.9	0.3	2.0	4.7
Canada	0.0	2.1	97.4	0.5	2.9	9.3
Germany	79.4	5.8	14.6	0.2	2.9	8.2
Mexico	0.0	3.2	75.3	21.5	0.3	1.2
Switzerland	84.9	1.5	13.6	0.0	4.2	15.2
United States	6.0	22.4	71.6	0.0	3.6	14.5
Regional:						
Spain	18.4	34.4	42.0	5.1	3.3	9.9
Unitary:						
Chile	0.0	58.8	41.2	0.0	1.4	7.3
Czech Republic	0.0	44.1	55.9	0.0	0.4	1.3
Denmark	88.8	0.0	11.2	0.0	12.5	26.3
Estonia	91.4	1.4	7.2	0.0	4.2	13.3
Finland	93.3	0.0	6.6	0.1	10.2	23.4
France	0.1	24.0	51.9	24.2	5.8	12.9
Greece	0.0	3.7	96.4	0.0	2.0	5.6
Hungary	0.0	79.9	20.0	0.0	9.5	5.9
Iceland	81.9	1.1	17.0	0.0	0.9	26.6
Ireland	0.0	0.0	87.9	12.1	2.6	3.1
Israel	0.0	5.7	94.3	0.0	2.2	7.3
Italy	25.3	21.0	16.4	37.2	7.2	16.2
Japan	50.8	19.2	28.9	1.1	7.5	24.2
Korea	17.7	25.4	44.6	12.3	3.9	15.5
Luxembourg	90.9	1.5	7.5	0.2	1.3	3.5
Netherlands	0.0	46.9	53.1	0.0	0.8	3.7
New Zealand	0.0	9.5	90.5	0.0	2.1	6.7
Norway	87.7	1.3	10.9	0.0	5.4	13.1
Poland	57.0	4.7	33.8	4.5	4.1	12.9
Portugal	30.2	24.2	42.4	3.3	3.0	7.0
Slovak Republic	0.0	25.8	51.4	22.8	0.8	2.9
Slovenia	79.7	5.2	15.1	0.0	4.0	10.8
Sweden	97.4	0.0	2.6	0.0	15.8	36.9
Turkey	23.9	51.5	13.8	10.9	3.0	8.8
United Kingdom	0.0	0.0	99.3	0.7	1.6	4.9
<p>1. Includes individual, corporate, and payroll tax.</p> <p>2. Includes general consumption taxes, value-added taxes, specific taxes on goods and services (fuel taxes, hotel and motel occupancy), and taxes on use of goods or on permission to use goods or perform activities.</p> <p>3. Taxes on property, including recurring taxes on net wealth.</p> <p>4. Includes a miscellaneous collection of local taxes.</p> <p>5. Total includes central government, state government, local government, and social security funds.</p>						
Source: OECD, Revenue Statistics 1965-2014 (Paris: OECD, 2015), from tables 77, 78, 84, 86, 87, and 88.						

dimensions of travel choice: trip frequency, destination, travel mode, time of day or week, route, and so on. To the extent that traffic demand is managed, cost pressures on city budgets are lowered, because traffic-related costs are reduced and infrastructure demands lowered. Furthermore, if revenues are dedicated to public transit and roads, there is almost certain to be more public acceptance of the tax than if the funds come from general revenues.

Many road pricing schemes are in place around the world, but only two are serious candidates for implementation in large Canadian cities. One option is a network of High Occupancy Toll (HOT) lanes, used in some metropolitan areas in the U.S. and candidates for larger cities and metropolitan areas in Canada.¹⁷ A HOT lane is a variant of a High Occupancy Vehicle lane (HOV). Tolling is applied only to vehicles that are below a minimum occupancy requirement – typically two people (HOV2) or three people (HOV3). Tolls can be varied by time of day to maintain high speeds on the HOT lanes. The tolled infrastructure would be new, and it would offer drivers a choice of paying for a quicker trip or using existing toll-free lanes. HOT lanes could replace all or part of a province's HOV or planned HOV lanes. HOT lanes could also be constructed on some major municipal and arterial roads and highways that enter into or pass through large cities.

A second possibility is to toll major highways and even major arterial roads and highways that run into or through cities. Tolling is more common than HOT lanes in most countries where road pricing is used. Tolls may be set as a flat charge or may vary by time of day, as on Highway 407 in the Greater Toronto Area or the Autoroute 25 expressway in Montréal. Tolling all lanes at different rates is more efficient than tolling only some lanes, because it is easier to control the total number of vehicles using the road as well as the distribution of traffic across lanes on the road.

Several estimates have been made of the potential revenues from road tolls in the Greater Toronto and Hamilton Area (GTHA). For example, in 2011, 407 International (the owners of Highway 407) earned gross revenues of \$675 million (net income \$128.3 million) from tolls on Highway 407, with an average revenue per trip of \$5.89.¹⁸

Efficient parking levies or taxes could help reduce the volume of traffic, leading to less congestion, faster trips, fewer policing and traffic enforcement costs, and reduced demand for new and expanded roads and highways.

Parking charges

Parking in large cities includes a mix of residential and non-residential spaces on private land, the street (curbside), surface lots, and parking garages. Not only do parking policies encourage more people to drive, parking is inefficiently priced.

On-street parking in high-demand areas is often priced well below its scarcity value. As a consequence, drivers spend considerable time looking for a vacant spot, leading to traffic congestion and pollution, as well as inefficiencies and lost productivity.¹⁹ In the United States, for example, it has been

estimated that cruising for parking accounts for roughly 30 percent of traffic in some cities at certain times of day.²⁰ Meanwhile, privately owned garage parking is over-priced, because operators benefit from a degree of monopoly power due to their unique locations. Over-pricing of garage parking contributes

further to the number of cars cruising for parking,²¹ thus increasing traffic-related costs.

Efficient parking levies or taxes could help reduce the volume of traffic, leading to less congestion, faster trips, fewer policing and traffic enforcement costs, and reduced demand for new and expanded roads and highways.²² They could also generate much-needed revenue for improving and expanding public transit.

Three policies could be considered. These include:

- a *commercial parking sales tax*, which is a special tax imposed on parking transactions;
- a *parking levy*, which is a special property tax applied to non-residential parking spaces;
- changes to on-street and off-street parking practices.²³

Taxes on income, sales, vehicle registration, fuel, and hotel stays are an effective and efficient way to diversify taxes at the local level, but cities need to set their own tax rates

Personal income tax

Some cities in Canada deliver social services, which are most appropriately funded from personal income taxes.²⁴ Income tax is more progressive than the property tax, although not as closely related as the property tax to the benefits received from municipal services.

Should cities levy their own personal income tax or piggyback onto the provincial tax?

There are two ways in which cities could levy a personal income tax. The first would be by applying a local tax rate to the income tax base of a senior level of government. In Canada, the taxing city could apply a fixed tax rate within a specified range to either the taxpayers' assessed provincial income tax base or as a surtax on provincial income taxes payable. Piggybacking of this sort would be relatively inexpensive to administer, because the province would collect the revenue and periodically remit the local share to the city. The downside is that the city has no control over the tax base and may have to wait for tax remittances, which might be infrequent.

The second option is for cities to set up their own income tax structure and administration. A major problem with this approach, however, is that there would be little coordination across local jurisdictions and it would be expensive to administer and collect the taxes. Offsetting these drawbacks is the increased autonomy, control, and flexibility that cities would have over both the tax base and the tax rate. As well, cities would not have to wait for periodic remittances from the province.

An income tax can be residence-based or payroll-based. For a residence-based income tax, an additional line could be added to the provincial personal income tax form after the line on which taxpayers report their provincial income tax liability. All taxpayers with postal codes that are part of the taxing city would be required to complete this line by multiplying their provincial income tax liability by a certain percentage (as determined by city council) and reporting the dollar value. The province could collect the revenue and remit it to the city.

For a tax on payrolls or earnings, each employer within the city would be required to apply a surtax (at a rate set by the city) to provincial income taxes deducted from all employees. This payroll tax would not be on all income received by taxpayers, only on wage and salary income (hence its name). The tax would be paid by employees who live in the city as well as those who live outside the city but work in it. The revenue would be collected along with provincial income taxes and remitted to the city.

A personal income tax levied in a city and not in the surrounding area may result in economic inefficiencies or distortions. If it is residence-based, it provides an incentive for people to move to areas that do not levy a similar tax. If it is levied on payrolls, it provides an incentive for employers to locate in areas that do not levy the tax or that levy it at

a lower rate. The extent to which these kinds of distortions are important will depend on how responsive taxpayers are to municipal tax differentials. The impact on location and employment decisions is likely to be reduced if the tax is levied on a metropolitan or region-wide basis.

Municipal sales tax

A municipal sales tax permits cities to tax non-residents who use local services. It gives cities greater flexibility and breadth in determining their own tax structure and allows them to benefit from growth in the economy.

To the extent that differential tax rates across neighbouring municipalities create an incentive for consumers to shop in lower-tax jurisdictions, some tax avoidance could ensue. Although there is no experience in Canada with municipal sales taxes, studies in the United States suggest that local sales taxes have an impact on the local economy when they are adopted or when rate increases create a differential, but that distortions of this type are minimized if all municipalities within the state or region impose similar taxes.²⁵

A piggybacked city sales tax similar to those levied in the United States might not be possible in Canadian provinces that have the harmonized sales tax (HST) or the goods and services tax (GST),²⁶ but it is a possibility in provinces that have their own provincial retail sales tax (Manitoba, Saskatchewan, and British Columbia).²⁷

More recently, it has been argued that large cities and metropolitan areas in Canada could benefit from the substitution of a "business value tax" for the relatively high and discriminatory effective property tax rates currently levied on business properties.²⁸ Moreover, it would complement the existing GST/HST and not compete with it. A tax of this sort is currently used by local governments in France, Japan, and Italy and could be introduced in Canada, but it could lead to additional administrative costs, at least at first.²⁹

Fuel tax

Although many U.S. cities levy fuel taxes, cities in Canada do not. The federal government in Canada, however, provides grants to municipalities (distributed according to population and public transit ridership) that were originally based on 5 cents per litre of federal gas tax revenue. In recent years, the grant has been increased by the inflation rate. As well, in a few Canadian cities and regions, provincial fuel tax revenues are shared between the province and the city or region.³⁰

A municipal gas and diesel fuel tax is a benefit-based tax as long as revenues are earmarked for funding local roads and public transit. It can be an appropriate tool for internalizing the costs of greenhouse gas emissions, because emissions increase as the amount of fuel burned increases. It can reduce the cumulative or total distance driven, thus also reducing unnecessary driving or engine idling. It provides an

incentive for switching to more fuel-efficient cars and public transit. It can help reduce urban sprawl – one Canadian study found that a 1 percent increase at the pump in the 12 largest Canadian metropolitan areas between 1986 and 2006 resulted in a 0.32 percent increase in population living in inner cities and a 1.28 percent reduction in low-density housing units.³¹ As with other potential municipal taxes, cross-border distortions will be minimized if the tax is levied at a metropolitan or regional level rather than at the city level.

Although a municipal fuel tax could have many benefits in the short run, it is unlikely to be effective in the long run. Fuel tax revenues are projected to decline because of a growing trend towards more fuel-efficient and hybrid vehicles as well as an increasing reliance on non-fossil-fuel vehicles such as electric cars; younger adults, especially those living in highly urbanized areas, are driving less; and retiring baby boomers are driving less than they did when they were younger. These factors suggest that other means of financing urban transit and roads will be required in the not-too-distant future.³²

Fuel taxes could be piggybacked onto the provincial rate, with the province collecting the tax and remitting the municipal portion to the city.

Are dedicated (earmarked) taxes a good idea?

The case for earmarking is largely based on benefit grounds. When there is a close link between the tax and the use of revenues to finance additional expenditures, earmarking reveals taxpayer preferences for the public services and sends a clear signal to the public sector about how much of the service to provide. Earmarking also facilitates long-term planning and can prevent the political abuse of funds. Politicians like earmarking because it reduces taxpayer resistance to higher taxes and taxpayers like the greater accountability that they perceive with how the funds will be spent. Public acceptability, as it turns out, is often the remaining barrier to the implementation of new taxes in most jurisdictions; therefore dedication of revenues is advisable if new taxes are to be considered.

The most-cited argument against earmarking is that it leads to inefficient budgeting by creating rigidities in the expenditure allocation process and preventing the authorities from reallocating funds when priorities change. One way to avoid this problem is by tying the funds to financing infrastructure. If done properly, earmarking will end when the project is completed.³³

Although a municipal fuel tax could have many benefits in the short run, it is unlikely to be effective in the long run.

Motor vehicle registration fee

Vehicle levies are fixed charges on vehicle ownership that do not vary with usage. Vehicle levies include registration fees that are levied annually in every province. The City of Toronto introduced a \$60 levy on passenger and light commercial vehicles on September 1, 2008, but terminated the levy on January 1, 2011.

Vehicle fees could be based on features such as age and engine size – older and larger vehicles generally contribute more to pollution – or emissions, with low-emission vehicles charged less than high-emission vehicles. Location could also be a factor (cars in cities add more to pollution and to congestion) or axle weight (heavier vehicles do more damage to roads and require more costly roads to be built). The fees are relatively easy to administer if piggybacked onto the provincial tax and are generally perceived to be fair on the basis of benefits received.

There is little research on the impact of vehicle levies on vehicle ownership or usage.³⁴ A modest levy

(such as the former \$60 Personal Vehicle Tax in Toronto) has little if any effect on ownership, and virtually none on usage. A fee based on fuel efficiency might have some influence on choice of vehicle type, as would a fee based on vehicle purchase cost. Nevertheless, small, fixed levies do not modify travel behaviour because they are unrelated to usage. A levy could be limited to residents living in areas that are well served by public transit. Such a levy might increase the incentive to use transit, but it would have a narrower base.

Vehicle levies are transparent because of the clear link between payment and the right to drive. They are accountable if the revenues are dedicated to transportation. A vehicle tax is a crude instrument for handling traffic congestion, however, because it does not vary with time of use, traffic volume, distance travelled, or the area in which vehicles travel (central-city versus inter-city trips). On the other hand, it is a charge on those who use roads, at least in some capacity. It is also likely to have a greater impact on the rich than the poor, because the latter have a lower rate of car ownership. To minimize tax avoidance, provincial requirements could prevent owners from registering their vehicles in a jurisdiction (such as cottage country) other than their principal place of residence.

Vehicle registration fees are a fairly stable and predictable source of funding. However, to the extent that the fee has any effect on vehicle ownership and usage, it would reduce revenues from usage charges, including fuel taxes, parking fees, and tolls. If a levy were based on fuel efficiency or

emissions, revenue would decline as the efficiency of the vehicle fleet improved.

Hotel and motel occupancy tax

An occupancy or room tax is an additional levy imposed on hotels and motels. This tax, it can be argued, compensates cities for services provided to tourists and visitors (for example, additional police and fire protection, and highway and public transit capacity needed to meet weekend or peak convention and tourist demands). The advantage of a hotel and motel occupancy tax over income and sales taxes is that it falls primarily on visitors.

Several cities in Canada levy hotel or motel occupancy taxes.³⁵ In some cities, the tax is mandatory, but in other cities, a voluntary destination marketing fee is levied by those hotels that wish to participate. As with other taxes, cities could piggyback onto the existing sales tax on hotel and motel rooms through the addition of a few percentage points (the most common method used in Canadian cities) or set up their own administrative structure.

A tax on hotel and motel rooms in selected cities and not in competing communities provides an incentive for individuals to stay in hotels and motels in those cities without the tax. The extent to which differential tax rates would actually deter visitors from renting rooms is uncertain, however. If the demand for hotel and motel rooms is sensitive to price, then noticeable losses may occur. Since convention arrangements are often highly cost-sensitive, the impact on the convention business might be significant.

Personal income taxes and sales taxes could bring in considerable revenue for cities

We have estimated the revenue that could be generated in eight cities in Canada – Toronto, Ottawa, Calgary, Edmonton, Vancouver, Halifax, Winnipeg, and Montréal – from a city surtax on the provincial personal income tax paid by residents.³⁶ Depending on the rate of surtax, the revenue yield could be quite large.

A 1 percent municipal surtax, for example, would have generated a high of about \$57 million in 2012 in Toronto and a low of slightly more than \$10 million in Vancouver. As a percent of property taxes, revenue from a 1 percent surtax would equal about 2.9 percent of property taxes in Winnipeg (the highest) and 1.2 percent of property taxes in Ottawa (the lowest). A 1 percent surtax has a modest impact on taxpayers; for example, a person with a provincial tax liability of \$5,000 would see an increase of \$50 and a person with a tax liability of \$10,000 would face an increase of \$100. Some of this increase could be offset by lower residential property taxes.

<i>Revenue estimates for a city income surtax, 2012</i>		
Cities	1% municipal surtax on provincial personal income tax	
	Estimated revenue (\$000,000)	% of property tax
Toronto	57.3	1.5
Ottawa	16.4	1.2
Calgary	28.6	2.4
Edmonton	17.8	1.7
Vancouver	10.3	1.6
Halifax	11.8	2.3
Winnipeg	16.4	2.9
Montréal	41.0	1.5

Estimated by authors using personal income tax data from Canada Revenue Agency; property tax revenue data from provincial summaries of municipal statistics; demographic data from Statistics Canada's Census Metropolitan Areas.

The next table estimates potential revenue from the implementation of a 1 percent municipal sales tax. These revenues are significant. They range from a low of \$90 to \$94 million in Halifax to a high of \$524 to \$546 million in Toronto. As a percent of property taxes, they range from a high of 24.9 to 26 percent in Winnipeg to a low of 9.2 to 9.6 percent in Ottawa.

<i>Revenue estimates for a city sales tax</i>		
Cities	1% municipal sales tax	
	Estimated revenue (\$000,000)	% of property tax
Toronto	524 to 546	13.9 to 14.5
Ottawa	122 to 127	9.2 to 9.6
Calgary	192 to 200	16.4 to 17.1
Edmonton	120 to 125	11.6 to 12.1
Vancouver	134 to 140	20.8 to 21.7
Halifax	90 to 94	17.9 to 18.6
Winnipeg	142 to 148	24.9 to 26.0
Montréal	321 to 335	11.7 to 12.2

Estimates by authors. Provincial sales tax revenues were used as a basis for making city estimates, except for Alberta where GST revenue was used. Other data sources were the same as in the previous table.

The final table provides an estimate of revenue that might be generated in each city from a city fuel tax of 10 cents per litre. Like the previous estimates, these revenues are not inconsequential. They range from a low of \$52 to \$57 million in Halifax to a high of \$311 to \$330 million in Toronto. As a percent of property taxes, the estimates range from a high of 19 to 20 percent in Calgary to a low of 5.9 to 6.5 percent in Montréal.

<i>Revenue estimates for a city fuel tax, 2014</i>		
Cities	10 cents per litre on motor and diesel fuel	
	Estimated revenue (\$000,000)	% of property tax
Toronto	311 to 330	8.2 to 8.7
Ottawa	104 to 110	7.5 to 7.9
Calgary	258 to 272	18.9 to 19.9
Edmonton	188 to 198	15.8 to 16.7
Vancouver	68 to 71	10.1 to 10.6
Halifax	52 to 57	9.9 to 11.0
Winnipeg	86 to 88	14.5 to 15.0
Montréal	162 to 179	5.9 to 6.5

Estimates based on an average price of \$1.15 per litre for 2014; the 2014 federal tax on motor and diesel fuel; the 2014 provincial tax on motor and diesel fuel; and the applicable HST/GST rate. Estimates based on methodology used in Kitchen (2014).

How were the estimates done? To calculate the potential revenues from a city income, city sales, and city fuel tax, one must consider the impact of a tax rate increase on the size of the tax base. For example, if the personal income tax rate rises, people may choose to work less or to move to a city that does not levy a surcharge, thereby reducing the size of the income tax base. The impact on the revenues will not simply be the increased rate multiplied by the existing tax base. The responsiveness of the tax base to a change in the effective tax rate is known as the “tax price elasticity.”

U.S. evidence suggests that a 1 percent increase in the tax rate will result in a 0.5 percent reduction in the size of the tax base.³⁷ Similarly, a city sales tax may affect spending behaviour by providing an incentive for buyers to shop in neighbouring communities or to reduce their total spending. Tax price elasticity estimates in the U.S. suggest that a 1 percent increase in the sales tax rate is likely to lead to a reduction in the tax base of 3 to 7 percent.³⁸

The impact of increased fuel taxes on fuel tax revenue depends on how the tax affects driving behaviour. The effects of fuel prices on fuel consumption, vehicle ownership, total vehicle kilometres travelled, and emissions of local pollutants and greenhouse gases have been studied extensively since the

1970s. Three recent North American studies present evidence that fuel prices may have larger impacts on fuel consumption and travel behaviour than older studies suggest. Using U.S. household data and a sophisticated model of household vehicle purchase and usage decisions, it has been estimated that a 10 percent increase in price leads to a 6.7 percent reduction in demand for fuel. A related study by the same author found that household gasoline price elasticities are higher for households with better access to public transit.³⁹

Summary and conclusions

Large cities in Canada face many challenges – changing demographics, increased income inequality, increasingly complex expenditure demands, deteriorating infrastructure, among others. Although the challenges have increased over the last few decades, the revenues available to cities to meet those challenges have remained largely the same – property taxes, user fees, and transfers from the federal and provincial governments. Other cities around the world use a wider range of tax choices including income, sales, fuel, and other vehicle taxes. It is time for Canadian cities to have access to some of those choices as well.⁴⁰

For governments to operate efficiently, it is important that there be a clear link between expenditure and revenue decisions – those who make the expenditure decisions should also make the revenue decisions and the type of revenue (user fees, property taxes, income taxes) should match the type of expenditure being funded (transit, policing, social assistance). A direct link should result in more accountable government and in less opposition from taxpayers to paying the taxes when they know where their tax dollars are going.

Although setting up their own tax systems would grant cities the most fiscal autonomy, this option would be costly. For this reason, it is advisable that cities piggyback new taxes on to provincial taxes, with the province collecting the revenue and remitting it to cities. To promote local accountability, however, it is essential that local governments set their own tax rates. In this way, taxes levied would be linked to services consumed. The following table summarizes the arguments for and against the potential new revenue sources for cities.

<i>Summary of potential new taxes and fees for cities</i>		
Potential Revenue	Strengths	Weaknesses
Surtax on personal income tax (residence based or payroll based)	<ul style="list-style-type: none"> • satisfies some criteria for a good local tax • if payroll-based, taxes commuters • broadly based; large revenue potential 	<ul style="list-style-type: none"> • residence-based tax does not tax commuters and visitors • payroll-based tax does not tax visitors • incentive to locate outside taxing area, but this will be less noticeable the larger the geographic size of the taxing jurisdiction
Municipal sales tax	<ul style="list-style-type: none"> • satisfies most criteria for a good local tax • taxes commuters and visitors, more than the property tax does • broadly based; large revenue potential 	<ul style="list-style-type: none"> • incentive to purchase outside taxing area, but this will be less noticeable the larger the geographic size of the taxing jurisdiction • at the moment, not permissible as a piggy-backed tax in HST/GST provinces
Dedicated fuel tax	<ul style="list-style-type: none"> • satisfies most criteria for a good local tax • broadly considered a benefit-based tax if revenues are earmarked for funding local roads, highways, and public transit • relatively inexpensive and simple to implement and administer • tax rates could be set locally and piggybacked onto the provincial tax rate 	<ul style="list-style-type: none"> • blunt instrument for targeting congestion • incentive to purchase fuel outside taxing area, but effect will be less noticeable the larger the geographic size of the taxing jurisdiction • revenues will be difficult to sustain with the increase in fuel efficient and non-fossil-fuel vehicles
Parking sales tax or levy	<ul style="list-style-type: none"> • satisfies most criteria for a good local tax • broadly considered a benefit-based tax if revenues are earmarked for funding local roads, highways, and public transit • relatively inexpensive and simple to implement and administer • tax rates could be set locally and piggybacked onto the provincial tax rate 	<ul style="list-style-type: none"> • may divert business away from taxed areas
High occupancy toll (HOT) lanes	<ul style="list-style-type: none"> • large potential to reduce congestion; hence, future infrastructure needs • large revenue generator • more likely to be accepted if funds are dedicated to roads and transit 	<ul style="list-style-type: none"> • may not reduce congestion, only switch the lanes travelled
Highway tolls	<ul style="list-style-type: none"> • large potential to reduce congestion; hence, future infrastructure needs • large revenue generator • more likely to be accepted if funds are dedicated to roads and transit 	<ul style="list-style-type: none"> • traffic diversion to untolled substitutes
Vehicle registration levy	<ul style="list-style-type: none"> • satisfies the minimum criteria for a good local tax for roads and transit • inexpensive to implement and administer • more likely to be accepted if funds are dedicated to roads and transit 	<ul style="list-style-type: none"> • does not tax commuters and visitors • not effective for handling congestion
Hotel and motel tax	<ul style="list-style-type: none"> • taxes visitors 	<ul style="list-style-type: none"> • may be a disincentive to visit or host conventions in taxing jurisdiction • small revenue

Endnotes

1. See, for example, Enid Slack, *Financing Large Cities and Metropolitan Areas*. University of Toronto, IMFG Papers on Municipal Finance and Governance, No. 3, 2011.
2. Other ways to internalize externalities would be to have the service provided at a metropolitan or regional level or by the province.
3. The same is not true of the non-residential property tax, however, which can be exported to other jurisdictions.
4. Richard M. Bird and Enid Slack, (eds.) *International Handbook of Land and Property Taxation*, Northampton, Mass: Edward, Elgar Publishing Limited, 2004; Richard M. Bird and Roy Bahl, "Subnational taxes in developing countries: The way forward." University of Toronto: Joseph L. Rotman School of Management, Institute for International Business Paper No. 16, 2008.
5. Richard M. Bird, "Subnational taxation in developing countries: A review of the literature." *Journal of International Commerce, Economics, and Policy* 2(1), 2011, 139–161.
6. Mel McMillan and Bev Dahlby, "Do local governments need alternative sources of tax revenue? An assessment of the options for Alberta cities." University of Calgary, School of Policy Studies, SSP Research Paper 7(26), 2014; Enid Slack and André Côté, *Is Toronto Fiscally Healthy? A Check-up on the City's Finances*. University of Toronto, IMFG Perspectives No. 7, 2014; Almos Tassonyi, Richard M. Bird, and Enid Slack, *Can GTA Municipalities Raise Property Taxes? An Analysis of Tax Competition and Revenue Hills*. University of Toronto, IMFG Papers on Municipal Finance and Governance, No. 20, 2015.
7. The property tax will also have an impact on decisions about where to live or work, where to locate a business, and other economic decisions.
8. New taxes at the local level in Canada would require provincial approval and possibly new legislation.
9. For example, a residential property tax may discourage investment in housing improvements, a retail sales tax may discourage consumption of goods, and so on. A mix of taxes can reduce the distortion of any one tax by keeping each tax rate low.
10. Howard Chernick, Adam Langley, and Andrew Reschovsky, *Revenue Diversification and the Financing of Large American Central Cities*. University of Toronto, IMFG Papers on Municipal Finance and Governance, No. 5, 2010. The authors also argue that greater revenue diversity means a more complex tax system that most people do not understand and thus results in less resistance to tax increases. Furthermore, greater revenue diversity may be associated with higher expenditure needs.
11. See Bird, "Subnational taxation in developing countries."
12. OECD, *Revenue Statistics 1965–2014*. Paris: OECD, 2015.
13. Michael Fenn and Harry Kitchen, *Bringing sustainability to Ontario's water system: A quarter century of progress, with much left to do*. Report prepared for the Ontario Sewer and Watermain Construction Association, 2016.
14. Philip Bazel and Jack Mintz, "The free ride is over: why citizens must start paying for much needed infrastructure." University of Calgary, School of Public Policy, SSP Research Papers 7(14), 2014; Harry Kitchen and Robin Lindsey, "Financing Roads and Public Transit in the Greater Toronto and Hamilton Area." Report for the Residential and Civil Construction Alliance of Ontario, 2013, available at www.rccao.com
15. Fenn and Kitchen, *Bringing Sustainability to Ontario's Water System*; Harry Kitchen and Almos Tassonyi, "Municipal taxes and user fees," in Heather Kerr, Ken McKenzie, and Jack Mintz (eds.), *Tax Policy in Canada*, ch. 9, Toronto: Canadian Tax Foundation, 2012.
16. Daniel LeBlanc and Les Perreux, "Quebeckers pan Champlain toll," *Globe and Mail*, May 9, 2014, p. A12. See Kitchen and Lindsey, "Financing Roads and Public Transit," for a more detailed discussion of road pricing.
17. The Province of Ontario announced in December 2015 that it will be building 16.5 km of new HOT lanes in the western Greater Toronto Area in 2016.
18. Reported in Kitchen and Lindsey, "Financing Roads and Public Transit."
19. Bern Grush, "Reduce, rethink, reform." *Thinking Cities*, 2013, 132–137. Available at: <http://paybysky.com/wp-content/uploads/2013/04/Reduce-Rethink-Reform-from-Thinking-Cities.pdf>
20. Donald C. Shoup, "Cruising for parking." *Transport Policy* 13, 2006, 479–486.
21. Richard Arnott and John Rowse, "Downtown parking in auto city." *Regional Science and Urban Economics* 39(1), 1–14, 2009.
22. Kitchen and Lindsey, "Financing Roads and Public Transit."
23. For a more detailed discussion of parking practices and changes that could be made to improve them, see Harry Kitchen, *Taxing Motor Gas and Diesel Fuel in the GTHA: Will This Generate Sufficient Revenue?* Report for the Residential and Civil Construction Alliance of Ontario, 2014. Available at www.rccao.com
24. A municipal corporate income tax is not considered for the following reasons. First, corporate income taxes have fallen in major trading countries, so there does not appear to be any justification for making it more costly for Canadian corporations to compete. Second, taxing mobile corporate capital and corporate profits encourages firms to shift their investments and profits to lower-taxed jurisdictions. Taxes based on a mobile tax base are not good candidates for local taxation. Third, property taxes on the commercial/industrial sector already overtax business and thus there is no reason for an additional tax burden that bears no relationship to the cost of municipal services consumed.
25. For a summary of these studies, see John L. Mikesell, "The contribution of local sales and income taxes to fiscal autonomy," in G.K. Ingram and Y-H Yang (eds.), *Municipal Revenues and Land Policies*, ch. 6, Cambridge, Mass: Lincoln Institute of Land Policy, 2010. The cross-border impact means that the tax base in neighbouring municipalities expands, although there is no evidence on the amount by which it could expand.
26. Cities cannot piggyback municipal sales tax onto the HST or GST because of the way these taxes are administered in Canada. GST and HST revenues collected in each province are not tracked by the federal government and remitted to that province. Rather, all GST/HST revenues are collected annually by the federal government and the entitlement for each province is calculated

by a formula that estimates the consumption expenditure base in that province and then applies the tax rate for that province to its calculated share of the base. Revenues allocated to each HST/GST province are thus driven by the estimated taxable consumption base in that province.

27. Jim Flaherty, former Federal Finance Minister, rejected this option in 2013 when it was proposed as one way of raising revenue to fund some of Metrolinx's (GTHA) capital expansion program.

28. Richard M. Bird, Enid Slack, and Almos Tassonyi, *A Tale of Two Property Taxes: Property Tax Reform in Ontario*. Cambridge, Mass: Lincoln Institute of Land Policy, 2012.

29. Richard M. Bird, *A Better Local Business Tax: The BVT*. University of Toronto, IMFG Papers on Municipal Finance and Governance, No. 18, 2014.

30. For example, in Metro Vancouver, the Province of British Columbia remits 17 cents per litre of provincial fuel tax revenues to the Greater Vancouver Transit Authority (TransLink) for the capital and operating costs of public transit. In the B.C. Capital Region (Victoria), the Province remits 3.5 cents per litre of the provincial fuel tax revenue to the transit system in the Capital Region (around Victoria) for operating expenses and capital projects. In Calgary and Edmonton, the City receives 4.5 cents per litre of the 9 cent provincial gas tax. In Montréal, the Agence Métropolitaine de Transport receives 3 cents per litre of all provincial fuel taxes collected on motor fuel sold in the Greater Montréal Area. And in Toronto (and other Ontario municipalities), the Province shares 2 cents per litre from gas tax revenues with municipalities for public transit and the funds are distributed to municipalities on the basis of population and ridership.

31. Georges A. Tanguay and Ian Gingras, "Gas prices variations and urban sprawl: An empirical analysis of the 12 largest Canadian metropolitan areas." CIRANO – Scientific Publication No. 2011s-3, 2011. Available at: <http://ssrn.com/abstract=1919003>

32. Kitchen, *Taxing Motor Gas and Diesel Fuel in the GTHA*.

33. See Richard M. Bird, and Joosung Jun, "Earmarking in theory and Korean practice," in S. Phua (ed.), *Excise Taxation in Asia*, 2007, pp. 49–86. Singapore: National University of Singapore.

34. For a review of studies that examined the effects on vehicle ownership of fuel taxes, income, population density, and access to other transport modes, see Todd Litman, "Road pricing: Congestion pricing, value pricing, toll roads and HOT lanes," 2012, available at: <http://www.vtpi.org/tadm/tadm35.htm>

35. For example, British Columbia municipalities can levy a hotel tax to a maximum of 2%. British Columbia shares between 1 and 4 percentage points (amount determined by the province depending on the type of development) of the 8% provincial hotel room tax in 13 resort municipalities. Winnipeg levies a 5% hotel tax; Montréal levies a 3.5% hotel tax; Charlottetown levies a 3% tax; and Banff, Calgary, Edmonton, Regina, and Saskatoon have a voluntary destination marketing fee.

36. Data did not permit estimates of a surtax on payrolls.

37. Mikesell, "The contribution of local sales and income taxes to fiscal autonomy."

38. Ibid.

39. Elisheba Spiller and Heather M. Stephens, "The heterogeneous effects of gasoline taxes: Why where we live matters." Resources for the Future Discussion Paper No. 12-30, 2012.

40. In cities with new taxes, provincial and federal governments would likely experience a reduction in tax revenue if existing federal and provincial tax rates were retained. At the same time, the elasticity estimates suggest that the tax base in neighbouring municipalities would increase because of cross-border effects; hence, federal and provincial revenues would rise in these municipalities. In other words, a loss in one municipality will be partially offset by an increase in neighbouring municipalities; the overall impact would be hard to determine.

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