Revenue Sharing Options for Canada's Hub Cities

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Executive Summary

Canada's hub cities have relied largely on three revenue sources (property taxes, user fees, and intergovernmental transfers) for decades even though expenditure demands have been increasing and cities in other countries have access to other revenue sources (such as income, sales, and excise taxes). Access to revenues from a mix of taxes would give Canada's hub cities more flexibility to respond to changing expenditure needs. As part of the tax mix, the hub cities need revenues that allow them to benefit from economic growth.

Criteria for Evaluating Tax Options

To evaluate the merits of different tax options for cities, the following public finance criteria can be applied:

- **Mobility of tax base:** The tax base should be relatively immobile so that cities can vary the tax rates without losing a significant portion of the tax base.
- **Tax yield:** The tax yield should be sufficient to meet local needs and should increase along with the increase in expenditure needs.
- **Stability and predictability:** The tax yield should be stable and predictable over time.
- **Ability to export tax:** It should not be possible to export much of the tax burden to non-residents. In other words, the tax should not be passed on to residents of another jurisdiction to pay for services enjoyed by residents of the taxing jurisdiction.
- **Visibility and accountability:** The tax should be visible to ensure accountability.
- **Fairness:** Taxpayers should perceive the tax to be reasonably fair. There are two measures of fairness. One is based on the benefits received from municipal services; the other is based on taxpayers' ability to pay taxes.
- **Ease of administration:** The tax should be relatively easy to administer efficiently and effectively.

The Mechanics of Revenue Sharing

Revenue sharing options differ according to the following characteristics:

- **Who determines the tax base:** The main advantage of having the federal or provincial governments determine what is included in the tax base is the cost of administration.
- **Who sets the tax rate:** There is a trade-off between the accountability and flexibility advantages of local tax rate setting, on the one hand, and the potential disadvantages of tax competition among cities, on the other hand.
- **Who collects the tax:** Tax collection will be costly at the local level because of the inability to achieve economies of scale.
- **How the funds are distributed to cities:** If tax revenues are distributed by a formula, there is no link between the level of economic activity in the city and the

amount of revenue it receives. This type of revenue sharing is the same as a transfer.

Based on the above characteristics, there are five main options for sharing revenues with cities:

- The federal or provincial governments transfer a share of their revenues to cities.
- Cities piggyback onto federal/provincial taxes at a uniform rate of tax and tax revenues are transferred to the cities partly on the basis of a formula and partly on the basis of where the revenues were collected.
- Cities piggyback onto federal/provincial taxes at a uniform rate of tax and tax revenues are transferred to the cities in which the taxes are collected.
- Cities piggyback onto federal/provincial taxes with locally set tax rates.
- Cities levy and collect their own taxes.

<u>Which Taxes to Share</u>

The following tax options were evaluated according to the public finance criteria: personal income, corporate income, general sales (retail sales taxes and GST), and excise (including taxes on hotel/motel occupancy, meals, fuel, liquor, tobacco, and land transfer taxes). The key findings are:

- Access to **personal income taxes** would provide cities with the most revenue. Income taxes are responsive to changes in the economy, appropriate to pay for social services because they are based on ability to pay, and easy to administer with locally set tax rates (local tax rates would require region-wide cooperation to avoid tax competition, however). Because income tax revenues are responsive to changes in the economy, revenues will increase during an economic boom but they will also decline during a downturn.

- **Corporate income taxes** are not an appropriate revenue source for cities because it is difficult to determine where revenues are collected, the tax base is mobile, revenues are volatile, and the tax bears no relationship to benefits received from municipal services.

- **Sales tax** revenues are responsive to changes in the economy but less so than income taxes. Locally set tax rates would be difficult to administer because of the inability to determine where revenues are collected; revenue sharing on the basis of a formula is possible.

- **Excise taxes** would add to the mix of taxes at the local level but they generally do not yield significant revenues. **Hotel/motel occupancy tax** revenues are responsive to changes in the economy and could compensate cities for the benefits received by visitors from municipal services. Other excise taxes could be used to a limited extent to provide the hub cities with access to revenues from a range of tax options.

Revenue Sharing Options for Canada's Hub Cities

Canada's hub cities deliver a wide range of services – police and fire protection, roads and transit, water and sewers, garbage collection and disposal, recreation and culture, public health, housing, planning and development, and in some municipalities, social services. Expenditure pressures on hub cities have increased significantly over the last decade for several reasons: increased urbanization, the "offloading" of services by both the federal and provincial governments, aging infrastructure, and international competition which has put pressure on the hub cities to provide the services and infrastructure that will attract skilled labour (the "knowledge workers").

At the same time that the hub cities are facing increasing expenditure demands, there has been no diversification of their revenue sources. Canadian cities continue to rely mainly on property taxes and user fees to finance the array of services that they are required to provide. Cities in the US and other OECD countries, however, have access to a wider variety of revenue sources such as income, sales, and excise taxes.

The purpose of this report is to set out new revenue sharing options for Canada's hub cities. The report is divided into six parts. The first part provides a justification for why hub cities in Canada need access to revenues from a mix of taxes. The second part sets out the basic public finance criteria for evaluating different tax options. The third part describes the mechanics of revenue sharing between federal and provincial governments and hub cities. The fourth part presents different taxes that could be shared and evaluates them in terms of the public finance criteria. The fifth part summarizes previous estimates that have been made of the potential revenues from four tax options – income taxes, retail sales taxes, fuel taxes, and hotel/motel occupancy taxes. The sixth part offers some concluding observations.

1. Why Cities Need Access to Revenues from a Mix of Taxes

The main source of revenue for Canadian cities is the property tax. The property tax has many good features. For example, property is immovable – it is unable to shift location in response to the tax. Although a change in property tax may be capitalized into property values in a particular community, and in the long run tax differentials may affect where people locate, these effects are of a smaller magnitude than those that would occur with income and sales taxes at the local level. Property tax revenues are also fairly stable and predictable over time.

Another feature that makes property taxes well suited to local governments is the connection between many of the services typically funded at the local level and the benefit to property values. In essence, the property tax is a benefits tax.[1] It does not operate as a benefits tax, however, for commuters and visitors who use municipal services (roads, policing, etc.) but do not pay property taxes in that jurisdiction.

The property tax also has limitations:

- Property taxes respond more slowly to annual changes in economic activity than do incomes. The property tax is not an "elastic" source of revenue meaning that the tax base does not increase automatically as the economy grows. The reason is that property values respond more slowly to annual changes in economic activity than do incomes. To maintain property tax revenues in constant dollar terms (in other words, adjusting for inflation) or to raise property tax revenues, it is necessary to increase the rate of the tax.[2]

  It should be noted that there is a downside to revenue elasticity, however. U.S. cities have found that their relatively heavy reliance on income and sales taxes coupled with restrictions on their ability to raise property taxes (such as Proposition 13 in California or Proposition 21/2 in Massachusetts) has meant their revenues have fallen significantly during the recent economic downturn.[3] Access to revenues from a mix of taxes (including the property tax) gives cities the flexibility to adapt to different economic circumstances.

- The property tax, because it is not as closely related to taxpayers' ability to pay as is the income tax, is not an appropriate source of funding for social infrastructure (such as public health, social services, and social housing). These services should, in principle, be financed by income taxes.

- Property taxes have the potential to discourage investment in property, other things being equal. The reason is that an improvement in one's property increases the market value and this triggers an increase in the assessed value. Since the property tax is levied on the assessed value of the property, the improvement will result in an increase in property taxes.

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[1] There is some debate in the literature on the extent to which this is true. See Richard Bird and Enid Slack, "Land and Property Taxation Around the World: A Review" *Journal of Property Tax Assessment and Administration*, Vol. 7, No. 3, 2002.

[2] It is also difficult to increase property tax revenues because of the visibility of the tax. Unlike income taxes which are withheld at source, property taxes are generally paid in lump sum payments. This means that taxpayers are aware of the property taxes they pay. When property values increase, there is pressure on city councils to lower tax rates so that the property tax burden does not increase.

[3] See Michael Pagano, "City Fiscal Conditions in 2002,"National League of Cities, Washington, D.C.

- Property tax revenues are not sufficient to pay for all of the services and infrastructure that hub cities are required to deliver. Moreover, some authors anticipate that the ability of municipal governments to raise revenues from the property tax in the future will be limited because of the shift from a manufacturing to a service-based economy. [4] This shift will mean that less space and fewer non-residential buildings will be required in the future.

The changing demands on hub cities, coupled with the inability of the property tax to address all of these demands, provides a strong justification for revenues from a mix of taxes for cities. Revenues from a mix of taxes would give cities more flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs. A case can also be made for revenues from a mix of taxes to the extent that other taxes are more effective than property taxes at linking the costs and benefits of services when people commute to work from one jurisdiction to another.

Access to revenues from a mix of taxes, particularly taxes that grow with the economy, could provide cities with an incentive to make those kinds of investments (in infrastructure, for example) that stimulate economic growth. Currently, the contribution that municipal infrastructure makes to economic growth is felt more by the federal and provincial governments that have access to growth taxes than by municipal governments. As one author notes, "one wonders whether cities would be more inclined to invest in infrastructure if they had a more diverse tax system that allowed them to better recapture a portion of the returns generated by such investments."[5]

2. Criteria for Evaluating Tax Options

The following are standard public finance criteria that are used to evaluate tax options: [6]

- **Mobility of tax base:** The tax base should be relatively immobile so that cities can vary the tax rates without losing a significant portion of the tax base.

- **Tax yield:** The tax yield should be sufficient to meet local needs and should increase along with the increase in expenditure needs.

- **Stability and predictability:** The tax yield should be stable and predictable over time.

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[4] David Brunori, *Local Tax Policy: A Federalist Perspective*, Washington, DC: The Urban Institute Press, 2003, p. 11 and Union des Municipalités du Québec and The Conference Board of Canada, "The Fiscal Situation of Quebec Municipalities," May 2003, p. 4.

[5] Casey Vander Ploeg, "No Time to be Timid: Addressing Infrastructure Deficits in the Western Big Six," Western Cities Project Report #30, Calgary: Canada West Foundation, February 2004, p. 7.

[6] These are based on Richard Bird, "Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization," *National Tax Journal*, Vol. 46, June 1993, p. 208.

- **Ability to export tax:** It should not be possible to export much of the tax burden to non-residents. In other words, the tax should not be passed on to residents of another jurisdiction to pay for services enjoyed by residents of the taxing jurisdiction.

- **Visibility and accountability:** The tax should be visible to ensure accountability.

- **Fairness:** Taxpayers should perceive the tax to be reasonably fair. There are two measures of fairness. One is based on the benefits received from municipal services; the other is based on taxpayers' ability to pay taxes. With respect to ability to pay taxes, progressive taxes are those in which taxes relative to income increase as incomes increase.[7]

- **Ease of administration:** The tax should be relatively easy to administer efficiently and effectively.

3. The Mechanics of Revenue Sharing

A truly "local" tax is one in which the local government determines the tax base, sets the tax rates, collects the tax, and keeps the revenues. Although a truly local tax has all of these dimensions, the most important characteristic of a local tax is the ability of the local government to set the tax rate. A "shared" tax is one in which the proceeds of the tax accrue in whole or in part to local governments but the federal or provincial government sets the tax rates and assesses and collects the tax. Shared tax revenues can be distributed among municipalities on the basis of where the revenues were collected or on the basis of a formula. Shared tax revenues are not really taxes; they are transfers based on federal or provincial tax revenues. The following summarizes and evaluates four major characteristics of revenue sharing options:

- **Who determines the tax base:** The main advantage of having the federal or provincial government determine what is included in the tax base is the cost of administration. There are obvious economies of scale in tax administration that are less likely to be achieved at the local level. The disadvantage of federal/provincial determination of the tax base is the lack of local autonomy when another order of government determines what is or is not taxable. These disadvantages are, in most cases, outweighed by the cost advantages of having the federal or provincial government determine the tax base.

- **Who sets the tax rate:** Local autonomy and accountability require that local governments set their own tax rates to meet their expenditure needs. If the federal

[7] Regressive taxes, on the other hand, are those in which taxes relative to income decrease as incomes increase.

or provincial governments set the tax rate, it is likely to be uniform nation-wide or province-wide and it is less likely to respond to local needs. If cities set their own tax rates, however, they would need to take into account the tax rates prevailing in the immediate region because individuals and businesses can easily move between jurisdictions. For example, a differential retail sales tax could encourage individuals to shop in municipalities with lower tax rates.[8] Such tax competition may encourage cities to be efficient in their use of resources and to be accountable to taxpayers. Nevertheless, there is a clear trade-off between the accountability and flexibility advantages of local setting of tax rates and the potential downside of tax competition.

- **Who collects the tax:** Tax collection at the local level is likely to be very costly because of the inability to achieve economies of scale. There will be some loss of local autonomy without local tax collection but not as much as would be lost if tax rates were not set locally.

- **How the funds are distributed to cities:** Where tax rates are set locally, the funds collected in each city would remain in that city. Where there is a uniform tax rate, the funds collected could be distributed to the cities in which the funds were collected or they could be distributed by a formula. If tax revenues are distributed by a formula, the link between the level of economic activity in the city and the amount of tax revenue it receives is severed. This type of revenue sharing is simply a transfer.

Based on the above characteristics, there are five main options for sharing revenues with cities, ranging from direct control by federal/provincial governments to complete local discretion. These options, which are summarized in Table 1, include:

- **Transfer a share of federal/provincial revenues to cities:** Under this option, the federal or provincial government determines the tax base, sets the tax rate, collects the tax, and distributes it to cities according to a formula. For example, the funds could be allocated to cities on the basis of one or more criteria such as population or public transit ridership (in the case of fuel tax revenues). This option is similar to providing a transfer except that municipal revenues are tied to federal or provincial government tax collections.[9] The main advantage of this option is that revenues to cities automatically increase as that revenue source increases. To be a stable source of revenue to cities, however, the federal or provincial government has to maintain the percentage share going to them over time. There is no enhancement to local autonomy under this option, except to the extent that municipalities retain discretion on how to spend the funds.

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[8] These reactions would be similar to the location decisions currently caused by differential property tax rates.

[9] An example is the Provincial-Municipal Tax Sharing in Manitoba whereby the provincial government allocates 2.2 percentage points of the provincial personal income tax and one percentage point of corporate taxable income to municipalities on a per capita basis.

- **Cities piggyback onto federal/provincial taxes at a uniform rate of tax and tax revenues are transferred to the cities partly on the basis of a formula and partly on the basis of where the revenues were collected:** As above, the federal or provincial government determines the tax base and sets the tax rate at a uniform rate for municipal purposes. The federal or provincial government collects the tax revenues and distributes them to the cities partly on the basis of a formula (as above) and partly on the basis of where the revenues were collected (see below). The setting of the tax rate thus does not relate to the expenditure requirements of the city but rather is a rate set by the federal or provincial government. Under this option, a portion of the revenues is based on the growth in the local economy.

- **Cities piggyback onto federal/provincial taxes at a uniform rate of tax and tax revenues are transferred to the cities in which tax revenues are collected:** The federal or provincial government determines the tax base and sets the tax rate at a uniform rate for municipal purposes. The federal or provincial government collects the tax revenues and distributes all of the revenues to the cities in which the revenues were collected. This means that the cities receive revenues that are based on the growth in the local economy.

- **Cities piggyback onto federal/provincial taxes with locally set rates:** The tax base is still determined by federal/provincial governments but each city can set its own tax rate based on its expenditure needs. The federal or provincial government collects the tax. This option results in much more local autonomy than the other options because cities set their own rates. This option could be modified so that the federal or provincial government sets a uniform rate and permits cities to levy an additional tax rate up to a maximum amount. Where municipal boundaries do not coincide with the economic region, region-wide coordination of tax rates would be necessary to avoid tax competition.

- **Cities levy their own taxes:** With truly local taxes, cities determine both the tax base and the tax rates and collect the taxes. This model provides the most autonomy and accountability at the local level. The cost of administration would likely be prohibitive, however. The problems identified above with respect to the impact of tax differentials among cities and the need for region-wide coordination also apply to this option.

Table 1: Revenue Sharing Options

	Tax Base	Tax Rates	Tax Collection	Distribution of Revenues
Transfer a share of federal or provincial tax revenues	Determined by federal or provincial government	Set by federal or provincial government	Federal or provincial government	Based on a formula
Piggyback at uniform rate and distribute funds partly on the basis of a formula and partly on the basis of where revenues were collected	Determined by federal or provincial government	Set by federal or provincial government	Federal or provincial government	Based partly on collection of tax revenues and partly on a formula
Piggyback at uniform rate and distribute funds where revenues are collected	Determined by federal or provincial government	Set by federal or provincial government	Federal or provincial government	Based on collection of tax revenues
Piggyback with tax rates set locally	Determined by federal or provincial government	Set by cities	Federal or provincial government	Based on collection of tax revenues
Local tax	Determined by cities	Set by cities	Cities	Based on collection of tax revenues

4. Which Tax Revenues to Share

Having established the case for revenues from a mix of taxes for Canada's hub cities, this part of the report sets out the advantages and disadvantages of several tax options: personal income tax, corporate income tax, general sales taxes (retail sales taxes and GST), and excise taxes (including taxes on hotel/motel occupancy, meals, fuel, liquor, tobacco, and land transfer).

4.1 Personal Income Tax

In Canada, the personal income tax field is shared between the federal and provincial governments. The federal government administers its own tax and the tax of every province except Quebec, which administers its own personal income tax system.

Although municipal governments have levied income taxes in Canada in the past,[10] they are currently not permitted to do so.

Local income taxes exist in many of the industrialized countries of the OECD. In the U.S., 15 states permit municipalities to collect local income taxes. New York State, for example, authorizes two cities (New York and Yonkers) to tax income. New York City imposes an income tax on residents and part-year residents and the tax is administered by the state.

If permitted by provincial legislation, municipalities could piggyback onto the federal/provincial income tax system in one of two ways. The tax could be applied, as it is in Scandinavian countries, at a locally determined rate on the same tax base as the federal income tax and collected by the federal government. Alternatively, a locally determined tax rate could be set as a percentage of the federal tax liability, as in Belgium, or of the provincial tax liability, as in Switzerland and some US states.

Taxpayers in Canada calculate their federal income tax liability and provincial income tax liability separately. The municipal income tax tax could be handled by adding one more line to the provincial (or federal) income tax return. This would require taxpayers within the taxing jurisdiction (defined by postal codes) to multiply either their provincial (federal) income tax payable or the provincial (federal) income tax base by the local tax rate set by the municipality. The calculated local tax would be the amount remitted to the municipality.[11]

An evaluation of local income taxes suggests the following:

- **Revenue elasticity:** The income tax is revenue elastic -- revenues increase as the economy grows. When income rises, it is taxed at a higher rate (under the progressive rate structure). This means that, as incomes increase, income tax revenues increase more than proportionately relative to income. Of course, it is also true that income tax revenues fall when incomes fall, which is why cities require access to revenues from a mix of taxes.

- **Sufficient revenue yield:** Income taxes are particularly appropriate for large metropolitan areas because, as noted earlier, the property tax does not yield sufficient revenues to meet increasing needs with respect to poverty, crime, regional transportation, and social services.

[10] Municipal governments in Canada levied income taxes until 1941 at which time provincial governments temporarily surrendered their right and the right of municipalities to levy them.

[11] One of the issues that would have to be addressed with a local income tax is the taxation of commuters. In some jurisdictions, commuters are taxed in the jurisdiction in which they work and a credit is applied to their tax in the jurisdiction in which they live. The New York City income tax does not permit a credit for taxes paid to other jurisdictions.

- **Not stable and predictable:** Revenues increase or decrease with changes in economic activity.

- **Fair based on ability to pay:** Income taxes, because they are more closely related to ability to pay than are property taxes, are a more appropriate means to pay for social services.

- **Easy to administer:** Local income taxes that are piggybacked onto the provincial (or federal) personal income tax could be easily administered by the federal government.

- **Mobile tax base:** The main disadvantage of a local income tax (with locally set tax rates) is that taxpayers are mobile and can avoid the tax income taxes by working in or moving to a neighbouring jurisdiction. This problem can be somewhat alleviated through coordination among municipalities within larger regions or by having regional authorities (where they exist) set the tax rates for the region.

- **Deters economic growth:** An income tax could also deter economic growth if the combined federal, provincial, and local taxes are too high. Moreover, if municipalities levy a personal income tax (and not a corporate income tax), they would be taxing the profits of sole proprietors but not that of corporations.[12] As noted below, however, there are reasons why cities should not levy corporate income taxes.

4.2 Corporate Income Tax

In Canada, the federal government administers the federal corporate income tax and the tax for seven provinces. Quebec, Ontario, and Alberta administer their own corporate income tax. There are no corporate income taxes at the local level in Canada.

Only eight states in the U.S. authorize local governments to impose taxes on corporate income: Kentucky, Missouri, Michigan, New York, Ohio, Oregon, Tennessee, and West Virginia.[13]

Although the corporate income tax is often popular with residents, in part because the tax can be exported to non-residents, there are few advantages to levying a corporate income tax at the local level:

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[12] TD Economics, "A Choice Between Investing in Canada's Cities or Disinvesting in Canada's Future," Special Report, April 22, 2002, p. 25. This report goes on to note, however, that a local income tax (with locally set tax rates) passes the tests of accountability, simplicity, equity, and reliability.

[13] David Brunori, 2003, p. 98.

- **Mobile tax base:** Corporate taxes are generally imposed on a mobile tax base. As such, they are not a good candidate for local taxation. Moreover, corporate income taxes have recently fallen in every major trading country so there does not appear to be any justification for making it more costly for Canadian corporations to compete.

- **Not stable and predictable:** Corporate income tax revenues are volatile.

- **Deters economic development:** Business taxes in general deter economic development and spur competition between local governments trying to attract business.

- **Not fair based on benefits received:** 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.[14]

- **Difficult to administer:** Corporate income taxes are difficult to administer because taxpayers have to determine how much of the income is attributable to the local jurisdiction imposing the tax. Because many corporations conduct business in a number of jurisdictions, taxpayers and tax collectors both have trouble determining how much income is taxable in any particular jurisdiction.

4.3 General Sales Taxes

General sales taxes include value-added taxes such as the federal goods and services tax (GST) in Canada and retail sales taxes such as the provincial sales taxes in all provinces except Alberta.

The GST is levied at the rate of 7 percent on a wide range of goods and services. Sellers collect the tax on behalf of the federal government. The GST is imposed on the sale of goods and services in all stages of production and consumption. Businesses are allowed input tax credits or refunds for all GST they have paid on goods and services.

The retail sales tax (RST) is a provincial tax (except in Alberta and the three territories where there is no retail sales tax). Retail sales taxes are levied on the final purchase price of products sold. Retailers act as the tax collectors for the provincial government. The federal government levies a harmonized sales tax in Newfoundland, Nova Scotia, and New Brunswick. It collects the 15 percent tax and remits 8 percentage points to the three provinces. Quebec administers its own sales tax as well as the GST in the province.

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[14] See Harry M. Kitchen and Enid Slack, *Business Property Taxation*, Government and Competitiveness Project Discussion Paper no. 93-24 (Kingston, Ont.: Queen's University, School of Policy Studies, 1993.

Sales taxes are not shared between provincial and municipal governments anywhere in Canada. Only municipalities in Quebec have ever levied municipal sales taxes; Montreal introduced a retail sales tax in 1935. Municipalities in 33 U.S. states levy a sales tax. The following evaluates the use of sales taxes at the local level:

- **Revenue elasticity:** Municipal sales tax revenues increase with growth in the economy, [15] although less so than the income tax.[16] The retail sales tax base has been steadily declining relative to the overall economy, however, because of the shift from a manufacturing to a service-based economy (services are not taxed by the retail sales tax) and the increase in purchasing through the Internet.[17]

- **Captures benefits received by non-residents:** The sales tax captures the benefits to non-residents (such as commuters and visitors) who use services in the municipality but do not otherwise pay taxes to that municipality.

- **Mobile tax base:** As with the income tax, there are problems of taxpayer mobility. People will purchase goods outside the jurisdiction where they live if they can avoid the tax. Although income taxes are also subject to mobility problems, residence is less mobile than consumption.[18] Cooperation among municipalities within regions or tax rates set by regional authorities would reduce this problem.

- **Unfair based on ability to pay:** The sales tax is a regressive tax. To make it more progressive, it is necessary to shrink the potential tax base by excluding items consumed by low-income households. Shrinking the base reduces the potential revenues from the tax.

- **Deters economic growth:** In most provinces, sales taxes are detrimental to economic growth because they tax inputs heavily. The exceptions are Quebec and Atlantic Canada where they have harmonized their sales taxes with the GST (a value-added tax).[19]

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[15] Sharing provincial sales tax revenues was recommended for Montreal a number of years ago on the grounds that sales taxes provide a direct link to economic activity. See the Report of the Task Force on Greater Montreal, *Montreal: A City-Region,* Montreal: Task Force on Greater Montreal, December, 1993.

[16] Sales taxes are less elastic than income taxes because they are levied at a single rate. Sales increase in line with income increases so, for example, if incomes double, sales could double. This is in contrast to the income tax, as noted above, where tax revenues more than double when incomes double.

[17] David Brunori, 2003, pp. 75-76. The same argument does not apply to the GST which does tax services.

[18] Mel McMillan, "Municipal Relations with the Federal and Provincial Governments: A Fiscal Perspective," Prepared for the Municipal-Provincial-Federal Relations Conference, Queen's University, May 9-10, 2003.

[19] See TD Economics, "A Choice Between Investing in Canada's Cities or Disinvesting in Canada's Future," Special Report, April 22, 2002, p. 26 and Richard M. Bird and Thomas A. Wilson, "A Tax

- **Difficult to administer:** Perhaps the most significant problem with piggybacking onto the RST or the GST is the administration of the tax. It is not possible to identify where the tax revenues are collected. For example, chain stores report their sales tax revenues in their regional offices and pay taxes through regional tax offices. It is not clear what municipalities the taxes were actually collected in. Moreover, a large retail store just outside the boundary of a municipality may collect most of its tax revenues from shoppers in that municipality but the revenues would be recorded outside of that municipality. A further problem would arise with differential GST rates. When transactions occur in different jurisdictions, there would be significant administrative problems in allocating input tax credits to each municipality.

4.4 Excise Taxes

Excise taxes (also known as selective sales taxes) are imposed on designated items at fixed amounts per unit or as a percentage of the selling price. The two main selective sales taxes imposed by local governments in the U.S. are taxes on hotel/motel occupancy (allowed in 43 states) and meals (allowed in 27 states). Some local governments also tax tobacco products, fuel, liquor, and real estate transfers.

In Canada, hotel/motel occupancy taxes exist at the local level in Vancouver, Victoria, and Montreal. The tax is an additional levy imposed on the existing provincial retail sales tax rate on hotels and motels and is generally collected by the provincial government through the provincial sales tax system. Although Ontario municipalities are prohibited from levying a hotel/motel occupancy tax, the Greater Toronto Hotel Association instituted a voluntary 3 percent "destination marketing fee" which is directed towards marketing the GTA.

In a few cities and regions in Canada, provincial fuel tax revenues are shared between the province and the city, region or transit authority. The provincial government sets the tax rate for municipalities, collects the revenues, and remits it to the eligible cities/regions. Provincial fuel tax revenues are shared in the Greater Vancouver Regional District, the B.C. Capital Region (around Victoria), Calgary, Edmonton, and Montreal. The Ontario government recently made a commitment to share 2 cents per litre with municipalities beginning in October 2004. The federal government has agreed to share up to 5 cents per litre of the federal tax with municipalities. In both cases, it is not yet clear how the revenues will be distributed among municipalities.

No Canadian municipalities levy liquor or tobacco taxes (although municipalities in Manitoba are permitted to levy liquor taxes). Provincial legislation does permit local governments to levy land transfer taxes in three provinces -- Nova Scotia, Quebec, and Manitoba (although municipalities in Manitoba do not levy land transfer taxes).

Strategy for Ontario," International Tax Program and Policy and Economic Analysis Program, University of Toronto, August 2003.

An evaluation of excise taxes suggests the following:

- **Mobile tax base:** Unlike general sales taxes, which are imposed on all goods (and services in the case of the GST) except those that are exempt from the tax, excise taxes are imposed only on designated items. This means that they are more likely to affect the behaviour of taxpayers (away from the taxed item) than a general sales tax that applies to all goods and services. Differential tax rates will thus result in people shopping in neighbouring jurisdictions.

- **Inelastic revenues:** The general sales tax is imposed as a percentage of the price of the product whereas excise taxes are often imposed on a per unit basis (for example, litres of fuel, packages of cigarettes). Whereas general sales tax revenues increase with economic growth, most excise taxes only increase with increased consumption of the taxed good or with tax rate increases. The exception is hotel/motel occupancy taxes, which are generally levied as a percentage of the room rate.

- **Insufficient tax yield:** Compared to the potential revenues from income and sales taxes, the tax yield on most excise taxes is relatively small.

- **Stable and predictable:** Excise tax revenues are moderately stable and predictable and less volatile than income tax revenues.

The advantages and disadvantages of specific excise taxes are summarized:

- **Hotel/Motel Occupancy Tax:** Of all of the excise taxes described in this report, hotel/motel occupancy taxes probably make the most sense for municipalities. This tax compensates local governments for the benefits received from expanded services provided for tourists and visitors (for example, the additional police and fire protection, and highway and public transit capacity needed to meet weekend or peak convention and tourist demands). Revenues from a hotel/motel occupancy tax increase with growth in the economy but the yield is fairly small. The levying of a hotel and motel room occupancy tax in selected municipalities and not in competing communities provides an incentive for individuals to stay in hotels and motels in those municipalities without the tax.

- **Meals Tax:** The tax is imposed on the value of meals purchased. To the extent that people who eat in restaurants have higher incomes, the tax may be considered to be progressive. Some of the tax, especially in metropolitan areas and tourist areas, is paid by non-residents. Because tax differentials will have an impact on where people eat (at home or in restaurants in different locations), cities are constrained in terms of how high a tax rate they can levy.

- **Fuel Tax:** The fuel tax can be viewed as a benefit-based tax to the extent that those who use the road system pay the tax. To the extent that a fuel tax is intended

to price either the use of publicly provided roads or externalities (pollution and congestion, for example), it is a crude instrument, however. Congestion charges (tolls), on the other hand, can vary by time of day and by location. License fees can vary by vehicle age and engine size, vehicle axle weight, and location of vehicle. These factors affect the amount of pollution, congestion, and road damage more so than would fuel consumption.

Fuel tax revenues do not increase with the economy in the same way as income or sales taxes.[20] Revenue growth comes only through increased fuel consumption or through an increase in the tax rate. Fuel taxes are unlikely to bring in as much revenue at the local level as income or sales taxes. Different cities or city-regions could impose taxes at different rates but they would probably not be able to differ much from the rates imposed by their neighbours, given the mobility of the tax base.

Since provincial governments levy a tax per litre on fuel, municipalities could piggyback onto provincial fuel taxes. Federal fuel taxes, on the other hand, are levied at the refinery. This tax is much more difficult for municipalities to piggyback onto because of the administrative difficulties in determining the base in each municipality. A municipal tax rate on top of the federal would only bring in revenues in those municipalities in which the refineries are located.

Sharing federal fuel tax revenues could be done in various ways. First, a portion of fuel tax revenues could be allocated to municipalities through a grant formula, for example based on population, fuel consumption and/or transit ridership. This is simply a transfer and does not allow municipalities to set their own tax rates. Second, different fuel tax rates could be imposed at the refinery level with the refiner acting as the collection agent for the municipal government and remitting taxes according to fuel shipments. This will, however, increase the compliance costs on refiners. Third, tax room could be provided that would be picked up by provincial governments who would, in turn, allow municipalities to levy their own tax rates at the pump. Fourth, the federal government could transfer funds to provincial governments on the basis of a formula and the provincial governments could, in turn, transfer funds to municipal governments on the basis of a similar or different formula. The last two methods require the cooperation of all three orders of government.

- **Liquor Tax:** Liquor is regarded as a "demerit" good and thus reducing its consumption by increasing the price can be considered good policy. The City of Winnipeg argued as part of its proposed "new deal" that municipal policing costs are related, to some extent, to liquor consumption and thus municipal access to liquor tax revenues is appropriate. Liquor taxes, however, suffer from the same

[20] Relatively slow growth of motor fuel sales has been predicted by Informetrica Limited, "Federal Financial Transfers to Canadian Municipalities: Review of Alternative Mechanisms," prepared for Federation of Canadian Municipalities, April 29, 2004, pp. 2-3.

problems as many selective sales taxes – they do not increase with inflation and differential rates across municipalities will result in cross border shopping.

- **Tobacco Tax:** Tobacco is also regarded as a "demerit" good. Local taxes on tobacco result in competition among local governments because consumers can purchase cigarettes in neighbouring jurisdictions with lower taxes. Tobacco taxes are regressive. Tobacco tax revenues are not likely to grow as a source of revenue for local governments because they are levied on a per unit basis. This means that revenues will not grow with inflation and the only way to increase tax revenues is to raise the rates.

- **Land Transfer Tax:** This tax is imposed at the time the real estate is transferred or recorded for sale and is generally levied on the sales price of the real estate. The existence of land transfer taxes in many countries is presumably attributable to administrative convenience: the "taxable event" – the recorded exchange of title – is visible. The land transfer tax does not yield significant amounts of revenue and it is not an elastic tax. Moreover, it can discourage development.

5. Potential Municipal Revenues from Four Taxes

Potential revenues have been estimated by Kitchen and Slack for four taxes (the personal income tax, the retail sales tax, the hotel/motel occupancy tax, and the fuel tax) for a number of Canadian cities. For each tax, the estimates assume that cities will piggyback onto the provincial tax.[21] Table 2 summarizes the estimated potential revenues from each of the four taxes for the hub cities.

A municipal income tax could provide the hub cities with considerable revenue. Estimates of the potential revenue yield from a municipal income tax, shown in Table 2, are based on a 10 percent municipal tax on the provincial personal income tax (PIT) paid in 2000. A 10 percent tax on provincial income tax is roughly equivalent to a 1 percent tax on income except in Quebec. [22] The calculations are based on the taxpayer's place of residence (not the place of work) and include all income. The estimate of potential income tax revenues recognizes that a local income tax in one city and not in adjacent areas would provide an incentive for individuals to move to another jurisdiction to minimize their tax burden. The responsiveness of taxable income to a change in tax rates is called the tax price elasticity.

Estimates of the potential yield from one percentage point of general sales tax revenue for municipalities are also shown in Table 2. A one percentage point increase means, for example, that in provinces where the provincial tax rate is 8 percent, it would rise to 9

[21] For other underlying assumptions, see Kitchen and Slack as referenced in Table 2.

[22] Provincial tax rates are higher in Quebec because federal tax rates are lower.

percent and so on. As with the income tax estimates, the estimates of potential revenues from sales, hotel, and fuel taxes reflect that taxpayers will respond to a tax being levied in one city but not in adjacent areas.[23]

Table 2: Estimated Potential Municipal Revenue Yield from Selected Taxes in 2000 ($ millions)

	10% tax on provincial personal income tax	1% provincial sales tax	One cent per litre tax on fuel	1% tax on hotel and motel room rates
Vancouver	107.8	82.0	18.9	4.1
Calgary	186.3	n.a.	15.8	2.2
Edmonton	91.6	n.a.	12.1	2.6
Regina	32.1	26.3	5.2	0.5
Winnipeg	109.2	87.0	11.5	1.5
Toronto	446.6	369.2	37.3	8.1
Ottawa	161.2	134.7	13.8	2.4
Montreal	252.7	111.6	28.4	5.6
Quebec City	38.9	18.5	2.3	1.5
Halifax	61.0	45.9	6.2	0.9

Note: A 10 percent tax on provincial income tax is roughly equivalent to a 1 percent tax on income except in Quebec.
Source: Harry M. Kitchen and Enid Slack, "Special Report: New Finance Options for Municipal Governments, *Canadian Tax Journal*, Vol. 51, No. 6, 2003.

6. Concluding Observations

Canadian cities have relied largely on three revenue sources (property taxes, user fees, and intergovernmental transfers) for decades even though expenditure demands have been increasing and cities in other countries have access to other revenue sources (such as income, sales, and excise taxes). Access to revenues from a mix of taxes would give Canada's hub cities more flexibility to respond to the changing expenditure needs and prevent further erosion of physical and social infrastructure. As part of the tax mix, the hub cities need some revenues that allow them to benefit from economic growth.

Although it would be very costly for cities to collect their own taxes, there are advantages to piggybacking onto federal or provincial taxes and levying their own tax rates. Local autonomy and accountability are achieved by cities setting their own tax rates to meet their expenditure needs. When federal or provincial governments allocate a portion of their taxes to cities based on a formula, revenue sharing simply becomes a transfer.

[23] The estimates in Table 2 reflect the average elasticity assumptions used by Kitchen and Slack.

Locally set tax rates will require region-wide cooperation, however, to avoid tax competition.

An evaluation of different tax options suggests that access to personal income taxes would provide cities with the most revenue. Income taxes are responsive to changes in the economy, are an appropriate way to pay for social services because they are based on ability to pay, and are easy to administer. Because income tax revenues are responsive to changes in the economy, revenues will increase during an economic boom and decline during a downturn. Corporate income taxes are not an appropriate revenue source for cities because it is difficult to determine where revenues are collected, the tax base is mobile, revenues are volatile, and the tax bears no relationship to benefits received from municipal services.

Sales tax revenues are responsive to changes in the economy but less so than income taxes. Locally set tax rates would be difficult to administer because of the inability to determine where revenues are collected; revenue sharing on the basis of a formula is possible. Excise taxes would add to the mix of taxes at the local level but they generally do not yield significant revenues. Hotel/motel occupancy tax revenues are responsive to changes in the economy and could compensate cities for the benefits received by visitors from municipal services. Other excise taxes could be used to a limited extent to provide the hub cities with access to revenues from a range of tax options.