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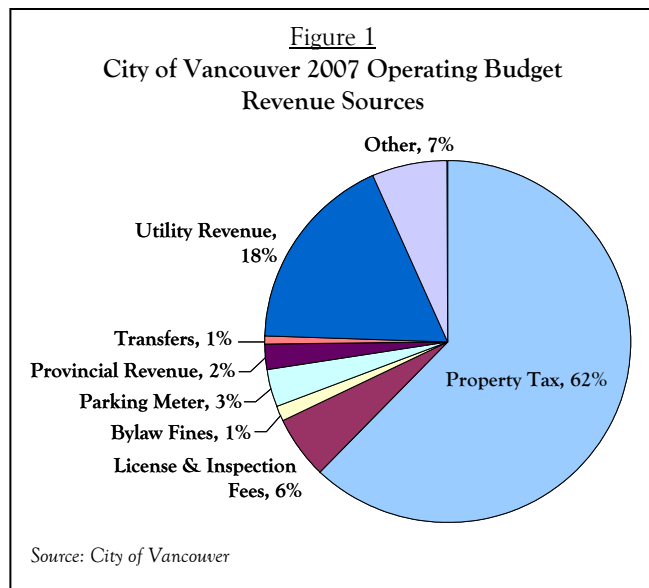
Editor: Jock A. Finlayson

FINANCING MUNICIPAL GOVERNMENT SERVICES: NEW FISCAL TOOLS AND STRATEGIES

Across Canada, municipalities face growing pressure to meet their budgetary obligations while maintaining services. The effects of federal and provincial downloading in the 1990s are still being felt, at a time when population growth and urban concentration mean more demands for civic infrastructure and services. Historically, local governments have relied on property tax for the biggest share of their revenue. Today, many cities are finding it harder to impose further burdens on property owners, most of whom are also voters. How do municipalities deliver basic services while balancing the books? This issue of Policy Perspectives considers municipalities' fiscal/service challenges, and identifies opportunities for them to use innovative financing strategies and alternate service delivery models to help meet citizens' needs while keeping taxes in check.

Funding Municipal Services

Under provincial legislation, British Columbia municipalities are not allowed to run operating deficits. Most rely on property taxes to pay their way. Property taxes account for almost two thirds of revenues for most of the larger municipalities in Metro Vancouver, including the City of Vancouver (Figure 1) at 62%, and Burnaby and Surrey at over 60%. Richmond bucks the trend, with property taxes providing 42% of its revenues. Overall, Metro Vancouver's dependence on property tax is greater than the provincial average of 56%.



User fees of various kinds are a second important source of municipal revenues. Currently, such fees generate an average of 10% of revenue for the four largest Metro Vancouver cities. A third category of revenue is utility charges, which vary widely by municipality. For the City



of Vancouver, utility charges supply 18% of operating revenue (mainly for water supply and garbage collection).¹

The City of Vancouver recently announced a substantial increase in property tax. However, there was a twist to this latest tax hike: it was limited to residential properties, while business property taxes were frozen. Limiting the increase to residential properties allowed the City to narrow slightly the wide gulf that exists between business/industry and residential property tax rates, though the ratios remain high (see Table 1). As a number of analysts have noted, many communities maintain business/industry property tax rates that far exceed residential rates, even though businesses generally consume fewer municipal services than residents.² For example, in the Lower Mainland, Vancouver's residential property tax rate in 2005 was the lowest among the four largest municipalities, while its business and light industry rates were the highest. Municipal councils often find it easier to tax non-residents (businesses) than local voters. The City of Vancouver's recent decision to increase residential but not business property taxes is an acknowledgement that current tax rate disparities are unjustified and risk driving businesses and jobs out of the City.

Table 1
Select Metro Vancouver Municipal Taxes 2005

	Vancouver	Richmond	Burnaby	Surrey
Residential tax rate	2.78	3.06	3.11	2.90
<i>Residential revenue</i> (\$ 000)	218,372	58,258	66,734	101,635
Business tax rate	16.44	11.05	12.96	9.49
<i>Business revenue</i> (\$ 000)	253,168	51,128	57,379	36,889
Light industry tax rate	15.52	13.63	12.96	9.49
<i>Light industry revenue</i> (\$ 000)	4,749	4,391	5,961	5,181
Major industry tax rate	28.31	11.00	51.49	15.67
<i>Major industry revenue</i> (\$ 000)	5,743 *	885	5,248	965
*Net of adjustment for port tax. Source: BC Ministry of Community Services				

¹ Sources: City of Vancouver 2007 Operating Budget; City of Surrey 3rd Quarter 2007 Financial Report; City of Richmond 2006 Annual Report; and City of Burnaby 2006 Financial Report.

² See Robert Bish, "Property Tax on Business and Industrial Property in British Columbia: Comparisons and Business Climate Observations," School of Public Administration, University of Victoria, Working Paper #11 (October 2003). See also Jack M. Mintz and Tom Roberts, "Running on Empty: A Proposal to Improve City Finances," C.D. Howe Institute *Commentary*, No. 226 (February 2006); and Harry Kitchen, "Financing City Services: A Prescription for the Future," *The AIMS Urban Futures Series, Paper #3*, The Atlantic Institute for Market Studies (September 2004).



The principal rationale for municipalities' reliance on property tax is that it is a stable source of revenue that does not vary much with economic conditions, unlike sales or income taxes.³ And in large part, revenue collected from property tax goes toward supplying basic local services such as civil protection, roads and parks. The own-source revenues which municipalities obtain from property taxes, and to a lesser extent from user fees and utility charges, are appropriately used to pay for services essential to local communities. When municipalities draw on locally generated revenues to fund local services, they provide a level of accountability to voters and taxpayers that is obscured when senior governments transfer funds to municipalities.

Some analysts believe there is no need for Canadian municipalities to broaden their revenue sources to fund local services; instead, municipal decision-makers should focus on improving the efficiency and equity of their taxation policies and increase their reliance on user fees.⁴ An alternative view is that provincial governments ought to expand the revenue sources available to municipalities, for example by giving them authority to levy sales taxes, entertainment taxes, fuel taxes, and even business turnover taxes. A wider range of taxing powers would allow local governments lessen their dependence on property tax and diminish their inclination to lobby senior levels of government for financial support.⁵

Of interest, both of these approaches endorse the idea of relying on user fees to fund more municipal services. This reflects the logic of a "benefits-based model," where only residents who derive benefits from particular services should pay for them. For certain services, adopting a benefits-based model can increase efficiency and improve fairness by assigning costs to those who gain most directly from the service while also improving transparency and political accountability. User-type fees also have potential as a demand-side management tool to moderate demand for a given service. Pricing services in this way (if possible at that optimal point where price equals the marginal cost of supply⁶) can also give municipal decision-makers information on the extent of demand for a service. The interaction between price/demand also provides information about the physical asset or capital that underpins the service and whether there is too little or too much of it.⁷

While the focus here is on financing municipal services rather than how to pay for municipal infrastructure, it is important to note that capital assets play a key role in providing local services. In the physical sense such assets can directly support service delivery

³ Some US cities have diversified their revenue sources by applying municipal sales taxes and/or income taxes. For a useful overview, see Enid Slack, "Are Ontario Cities at a Competitive Disadvantage to U.S. Cities? A Comparison of Responsibilities and Revenues in Selected Cities," prepared for the Ontario Institute of Competitiveness and Prosperity, Toronto (June 2003).

⁴ Mintz and Roberts, "Running on Empty," op. cit.

⁵ Kitchen, "Financing City Services," op. cit.

⁶ When this condition is satisfied, economists say that "allocative efficiency" has been achieved.

⁷ For an informative discussion of user fees in the Canadian local government context, see Donald Dewees, "Pricing Municipal Services: The Economics of User Fees," Canadian Tax Journal, Volume 50, Number 2 (2002).



- for example, water treatment plants enable municipalities to deliver clean drinking water. In a financial sense, capital assets and ongoing services may also be linked: depending on how a municipality structures the development and maintenance of a capital asset, user fees associated with the related service can help to offset maintenance costs and contribute to efficient delivery.⁸

Under a public-private partnership (P3) model - a model that has traditionally been under-utilized by municipalities in BC and the rest of Canada - the private sector takes on some of the risk of the capital investment, and often provides the associated service. Using P3s in municipal services, particularly P3 structures involving the design, build, finance and operate (and sometimes maintain) components, is one way to reinforce the linkage between the price of a service and the underlying cost of provision.⁹

Some municipal services may not be amenable to user fees (e.g., policing). In other cases, local governments may want to look beyond the traditional model of public provision to other options, including contracting, P3s and outright privatization.

Alternate Municipal Service Delivery

The principal reason for municipalities to consider expanded private provision of services is the opportunity to better manage costs while still meeting service obligations. Proponents of contracting for local services cite a number of potential benefits, including:

- reduced costs
- improved/expanded services
- avoidance of start-up/sunk costs
- increased flexibility
- greater response to consumer demand
- improved control

Box 1
**Characteristics of Local Governments
in British Columbia**

Municipalities
Number: 157
Size Range: 500 - 500,000 population
Median size: roughly 5,000

Regional Districts
Number: 27
All municipalities are members of a Regional District
Regional Districts are responsible for over 2,000 inter-municipal service partnerships

Municipalities and Regional Districts Combined
Annual Spending: \$5.6 billion
Contribution to BC GDP: 4%
Own-source revenues: 96%
- Share of revenues from property taxes: 56%
- Share of revenues from fees and charges: 31%

Source: Ministry of Community Services.

⁸ Harry Kitchen, "A State of Disrepair: How to Fix the Financing of Municipal Infrastructure in Canada," C.D. Howe Institute Commentary, No. 241 (December 2006).

⁹ Canadian Council for Public-Private Partnerships, "Models of Public-Private Partnerships". Accessible via http://www.pppcouncil.ca/aboutPPP_definition.asp.



Opponents of contracted municipal services point to certain alleged drawbacks:

- potential for undue private sector influence on service decisions
- difficulties with contract monitoring
- reduced control over service
- quality of capital equipment¹⁰

Services such as solid waste management have been held out as a suitable area for privatization for a number of reasons. Chief among these are that the output is measurable, contract monitoring is relatively straightforward, and capital costs (i.e. barriers to entry) are not significant. Cost savings are most likely to be achieved when a municipality takes account of the transaction costs of contracting with an outside provider – including costs related to monitoring the contractor’s performance. A carefully written contract that specifies desired outputs from the contractor – as opposed to the inputs required – is more likely to achieve the hoped-for cost savings and/or efficiency gains.

When a municipality chooses to contract for a service, it creates a market for that service. How efficiently that market functions depends on several factors:

- the private sector can produce the service or good at a lower total cost than the public sector
- the costs involved in transitioning to the private sector (transaction costs) are less than the cost savings from the efficiency gains of private provision
- the supply side of the market is sufficiently responsive that the private sector can enter the market rapidly (i.e. low barriers to entry)
- there are few information asymmetries between the public and private parties¹¹

Full Cost Accounting

Like other levels of government, municipalities require good information on costs in order to make sound decisions about service provision – e.g., decisions on how much of the service to supply and whether it should be provided “in-house” or through a private provider. In other words, local governments need to understand their costs, not simply from an annual budgetary point of view, but including all of the costs associated with the provision of a given service – something known in the public finance literature as “activity-based costing” or Full Cost Accounting (FCA). FCA goes beyond cash flow accounting by considering direct and indirect operating costs of the service, as well as past and future expenses. It is a tool which permits government managers to reconcile costs, increase transparency and accountability to taxpayers, and identify areas for potential saving.¹²

¹⁰ Local Government Center, “Alternatives for the Delivery of Government Services,” University of Wisconsin (April 2001).

¹¹ *Ibid.*

¹² The US Environmental Protection Agency has a full section dedicated to FCA in solid waste management on its website, and defines FCA as a method of accounting for all monetary costs of resources used or committed to an activity. FCA should be distinguished from triple bottom line accounting, which estimates social and environmental costs as well. See US EPA, “Full Cost Accounting,” accessible via <http://www.epa.gov/epaoswer/non-hw/muncpl/fullcost/index.htm>).



Several American cities have learned useful lessons in transitioning to an activity-based costing system. One of the best known is Indianapolis, Indiana. For Indianapolis, not only did the adoption of activity-based costing provide cost data on activities it was previously unable to track (e.g. how much does it really cost to repair a pothole?), but it also revealed areas where taxpayer dollars were being wasted (e.g. why did a garbage truck that was purchased for \$90,000 go through \$252,000 in repairs over four years?).¹³ The new costing system established a basis for understanding all costs associated with a service activity, thus making it easier to compare the costs of private versus direct municipal provision. In this way, Indianapolis was able to tender a number of municipal services, accurately determine the cost savings, and reap the benefits in lower taxes and better services for taxpayers.

When deciding to tender a service, local governments should not begin with the presumption that the private sector will always do a better job, or provide the same service at a lower cost, or both. In the United States, a number of cities that contracted out services subsequently returned to direct local government provision, as the public providers became competitive with outside contractors.¹⁴ The key issue is not who can deliver the service at a lower cost. Instead, it is about creating a competitive process that encourages proponents to introduce efficiencies into the services they want to provide.¹⁵

Managed Competition

Managed competition refers to a situation where public sector entities (departments, managers, employee groups, or some combination of these) can bid against private providers on tendered services. This is another way to introduce incentives for all bidders to pursue efficiency goals that benefit the local government and its taxpayers. A pioneer in using managed competition is Phoenix, Arizona. Between 1979 and 1994, Phoenix awarded 56 contracts across 13 municipal services. Over time, it developed a highly credible process of public-private bidding. Private providers won about three-fifths of the contracts, while the rest continued to reside with City agencies. During this period, managed competition saved the City tens of millions of dollars.¹⁶ In the case of one service, solid waste management, Phoenix initially contracted out zones, over half of which were won by private providers. A decade later, the City's public works department had won back all of these contracts.

¹³ Stephen Goldsmith, "Can Business Really Do Business with Government?" Harvard Business Review (May-June 1997).

¹⁴ Public providers in Phoenix, Arizona, Sacramento County, California, and Greensboro, North Carolina all won certain contracts back after successfully competing against private providers. EPA, "Full Cost Accounting," *op. cit.*

¹⁵ As Kitchen notes, "...most of the efficiency gains from contracting out have resulted from an increased scope for competition rather than from the fact that the service was provided by a private contractor." Harry Kitchen, "Delivering Local/Municipal Services," Department of Economics, Trent University (August 2004).

¹⁶ E.S. Savas, "Privatization and Public-Private Partnerships in Phoenix," National Council for Public-Private Partnerships (October 2003).



Managed competition not only opens an avenue for private sector participation in local service delivery, it also encourages public providers to look for cost savings and find innovative ways to deliver services. As seen in Phoenix, the most successful public sector bids often involve joint employee-management participation, where new relationships are forged and new thinking is applied to devise competitive methods of service delivery. And based on Indianapolis' experience, no matter who wins the bid, the most successful contracts are those that specify outputs rather than inputs.

Conclusion

Experience elsewhere with managed competition and contracting offers examples of how municipalities in BC and other Canadian provinces might better meet the demands of residents while managing costs effectively. Apart from direct service improvements, utilizing activity based costing systems should result in other benefits for residents and businesses, such as enhanced transparency and accountability. In short, revenue-constrained municipalities should be looking to help themselves by pursuing fiscal reforms: redressing the property tax imbalance between residents and businesses, making greater use of user fees, developing better information on the cost of services, and introducing competitive tendering for more local services.
