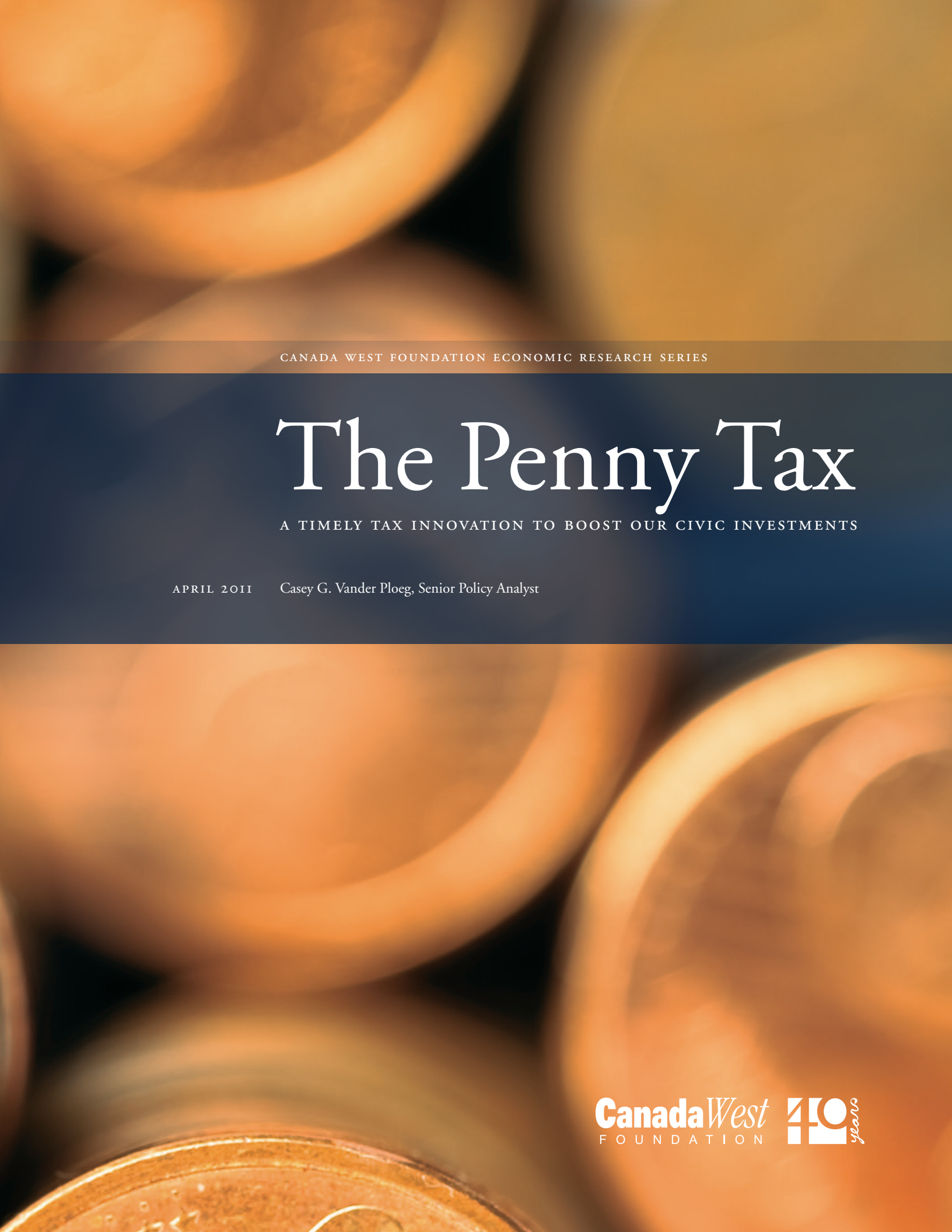

CANADA WEST FOUNDATION ECONOMIC RESEARCH SERIES

The Penny Tax

A TIMELY TAX INNOVATION TO BOOST OUR CIVIC INVESTMENTS

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CanadaWest FOUNDATION 10 years

ISBN 1-897423-79-0

Executive Summary

Over the past ten years, federal, provincial, and municipal governments have begun to invest much more heavily in Canada's stock of urban public infrastructure. While this suggests a measure of progress in addressing the nation's urban infrastructure liability, the fact remains that the funding gap reported by Canadian cities—the shortfall between needed infrastructure investments and the funding dollars available—remains very large. What is more, there is evidence to suggest that the gap continues to grow.

A review of current capital budgets of the seven largest western Canadian cities shows that the combined infrastructure need over the next ten years is reported at $63.0 billion, of which only $21.5 billion in funding is in place. This leaves a shortfall of $41.5 billion, or almost $4.2 billion annually. The great bulk of this funding shortfall is in areas traditionally funded through taxation, particularly transportation and parks, recreation, social, community, and cultural infrastructure.

The ability of western Canada's cities to meet these huge infrastructure requirements is hampered by a singular and heavy reliance on the property tax. Real per capita growth in property tax revenue is well below growth in tax revenues seen federally and provincially, and property tax revenues relative to disposable personal incomes and GDP are at some of the lowest levels ever seen. The attendant lack of diversity in tax tools constitutes a serious disadvantage when it comes to infrastructure investment. To help place our cities on a more firm fiscal foundation, reforms are needed that include the introduction of new tax tools.

From this need, the idea of a small locally-levied sales tax has emerged. This fresh, creative, and innovative option would enable western Canadian cities to get a better handle on their infrastructure funding challenges by broadening and enhancing the current set of municipal tax levers with a more economically robust tax source. Viewed simply, the tax would amount to a small, 1% value-added local sales tax that is piggy-backed off the federal GST. Because the tax rate is often fixed and capped at one cent on each dollar subjected to the tax, many prefer to use a more colloquial term for the levy—the "penny tax."

At first glance, the idea may seem to be more than a little problematic politically. But, much hinges on the features incorporated into a local penny tax—features that would build the most visible, transparent, and accountable tax in Canada. There is no reason to suspect that public support cannot be found for a penny tax that were voter-approved, with the tax rate capped, the revenues earmarked clearly for critical infrastructure investments, and any excess revenues rebated back to taxpayers in the form of property tax reductions. Support would also be strengthened if the tax were to automatically sunset after a prescribed period of time and governments were to provide voters and taxpayers with regular, comprehensive, and audited reporting on the usage of the tax revenue.

The critical rationale for supporting a penny tax option over other financial tools lies in the larger fiscal and policy context. Fiscally, a more diverse municipal tax system that included a local penny tax would result in better revenue growth for cities. Unlike the property tax, which attaches only to one aspect of the economy—real estate—a small local sales tax casts its net across the full range of goods and services in the local economy. A penny tax will allow cities to capture the effects of inflation and to retain a small but important portion of the economic growth occurring within the local region, and direct it to the infrastructure needed to accommodate that growth.

Demographically, a penny tax would enable cities to better cope with the rapid pace of urbanization and compensate for current patterns of population growth. Urban population growth—much of which now occurs not in the large "anchor" cities of our city-regions but in "metro-adjacent" municipalities just outside—meets up with a lack of diversity in municipal tax tools to press city finances. Without diversity, the burden of sustaining municipal services and the underlying infrastructure lands squarely on local property taxpayers as opposed to those who use the services and infrastructure. A small local penny tax helps ensure that all those coming into a city to use its services and infrastructure also help to pay for that infrastructure.

Economically, a small 1% penny tax has a minimal impact on tax competitiveness, particularly if the expenditures are dedicated to critical urban infrastructure, which is just as important to overall economic competitiveness as a competitive tax regime. Broad based value-added sales taxes are also among the most economically benign taxes possible.

Politically, because the penny tax is a local sales tax initiated and levied through local action it is unencumbered by top-down imposition—a particularly attractive option for cities. If local municipal interests in a certain infrastructure funding issue exceed the larger federal and provincial commitment, then the local interest can be given the tax tools and resources to push ahead.

The implementation of a penny tax would face some difficult challenges that require further exploration. First, linking the tax to the GST base raise some issues of administrative feasibility and the provinces would have to amend the enabling legislation that governs municipalities. Second, do sales taxes employed locally run the risk of producing economic distortions by shifting retail sales activity and consumer behaviour from one region to another. Third, now may not be the best time for a new municipal tax initiative—the economy that is restricting the fiscal capacity of the federal and provincial government to adequately fund infrastructure is the same economy that may not now need another tax imposed upon it.

While problematic, this report shows that these challenges are not at all insurmountable. A penny tax is conceptually possible, strategically desirable, administratively feasible and is timely innovation that can do much to boost our civic infrastructure investments.

Introduction

Over the past ten years, federal, provincial, and municipal governments have begun to invest much more heavily in Canada's stock of urban public infrastructure. This increased infrastructure investment has come through expanded federal and provincial capital grants, new federal and provincial fuel tax-sharing with municipalities, several tri-partite national infrastructure programs in the mid-1990s, a full rebate on the GST paid by municipalities, and more recently, billions of dollars in new capital funding under the national economic stimulus program.

While all of this suggests at least a measure of progress in addressing the nation's urban infrastructure liability, the fact remains that the funding gap reported by Canadian cities—the shortfall between needed infrastructure investments and the funding dollars available—remains very large. What is more, there is evidence to suggest that the gap continues to grow. In short, Canadians and their governments have yet to get a firm handle on the nation's growing urban infrastructure funding challenge.

There is additional risk moving forward. The federal and all provincial governments are currently running sizeable budget deficits. The worldwide economic slowdown has resulted in a tapering of tax revenue growth at the same time that operating and capital expenditures are increasing. Sooner or later, the federal and provincial books will have to be drawn back into fiscal balance. Historically, support for capital investment has always served as one of the first targets for any reduced spending when budgets are tightened.

In the future, then, there is certainly the potential for recent progress on the infrastructure front to stall. Now is an opportune time to consider creative and innovative funding options to keep critical urban infrastructure investments flowing. This discussion paper is designed to explore the potential of a small local option sales tax—a "penny" tax—to help address the urban infrastructure challenge. In particular, the paper discusses the following:

→ The Infrastructure Challenge: What is the current size of the urban infrastructure funding gap in Canada? What about western Canada's largest cities? What is the extent of the challenge? How does infrastructure fit into the larger set of municipal financial issues?

→ The Penny Tax: What is a local option sales tax or a municipal penny tax? What is the larger international experience with such taxes, especially the US?

→ Penny Tax Design: What principles of taxation should guide the structuring and design of a municipal penny tax? What features could be incorporated to increase acceptability and legitimacy, particularly given the traditional antipathy if not hostility toward sales taxes in general? What features might make a penny tax attractive and lead to higher levels of political support?

→ The Rationale: What is the rationale for considering the penny tax option? What are the demographic, political, fiscal, and economic reasons why a penny tax makes sense?

→ Potential and Promise: What are the potential upsides of a penny tax? What are some of the unique advantages, and how can they be strengthened?

→ Pitfalls and Problems: Conversely, what are the potential downsides? What particular concerns might emerge to work against the idea? What issues and concerns would need to be sorted out? Can these be effectively managed, accommodated, or mitigated?

From 2000 to 2009, the Canada West Foundation was heavily engaged in the municipal policy arena through its Western Cities Project. Much of the work under the Western Cities Project spun around municipal tax and finance issues, especially the urban infrastructure challenge. As a result of its research, the Foundation identified a package of municipal financial reforms. A key aspect of those reforms was to expand the tax tools available to Canada's cities. It was in this context that the idea of a penny tax first emerged—a small, local option value-added sales tax that would be voter-approved and earmarked for purposes of funding increased investment in urban infrastructure.

Over the years, there has been growing interest in the penny tax idea. In June 2008, the Competition Policy Review Panel, reporting to the federal Minister of Industry, issued its findings, and concluded that municipalities need a more stable, secure, and growing revenue source. The panel recommended (Recommendation 34) that provincial governments assess the feasibility of allowing any municipality to levy a 1% value-added sales tax within their jurisdiction, assessed on the harmonized goods and service tax (GST) base (Government of Canada 2008).

More recently, a Canada West Foundation presentation to some 300 civic leaders at the January 2011 National Infrastructure Summit in Regina spoke of the potential benefits of a small local value-added sales tax as a new source of infrastructure funding. Not only did the presentation generate considerable media interest, the idea was then picked up by several big city mayors, including a positive response by the mayor of Calgary (Calgary Herald 2011). Given renewed interest in the penny tax, it is time to hone in on the concept with more clarity of purpose.

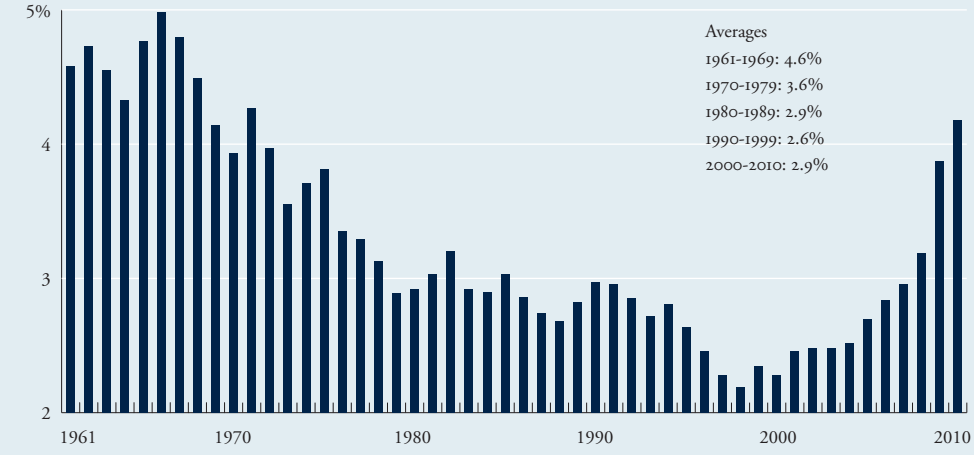
The Infrastructure Challenge

There can be no doubt that infrastructure in Canada has become a serious issue. Since the 1960s, the pace of investment in the total government public capital stock has fallen, and the infrastructure funding shortfalls reported by individual cities run into the billions. But just how big is the problem?

1. The Total Government Sector

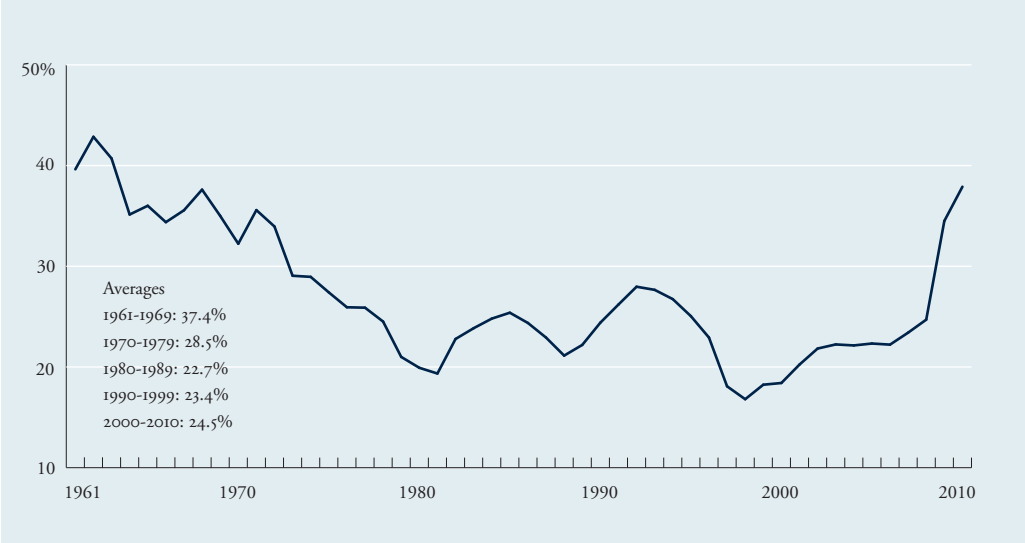
Since the 1960s, the level of investment by governments in their infrastructure assets was dramatically scaled back. Total government investment in fixed capital formation measured as a percentage of GDP peaked in the mid-1960s at almost 5.0% but then steadily fell to 2.1% by the late-1990s (Figure 1). Total public infrastructure investment relative to private capital investment also fell (Figure 2) as did the outstanding value of the public capital stock relative to the private capital stock (Figure 3). While total public investment in infrastructure relative to GDP and private capital investment has increased since 2000, it has yet to reach levels seen in the past, and the value of the public to the private capital stock remains lower than historical levels.

FIGURE 1: TOTAL PUBLIC CAPITAL FLOWS AS A % OF GDP (1961-2010)



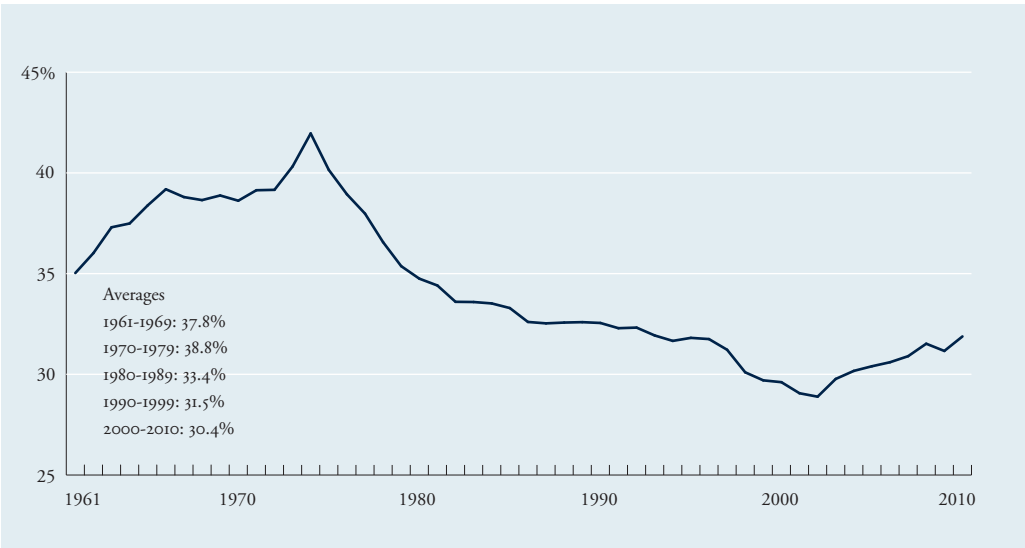
Source: Derived by Canada West Foundation from Statistics Canada

FIGURE 2: TOTAL PUBLIC CAPITAL FLOWS AS A % OF PRIVATE CAPITAL FLOWS (1961-2010)



Source: Derived by Canada West Foundation from Statistics Canada

FIGURE 3: TOTAL PUBLIC CAPITAL STOCK AS A % OF PRIVATE CAPITAL STOCK (1961-2010)



Source: Derived by Canada West Foundation from Statistics Canada

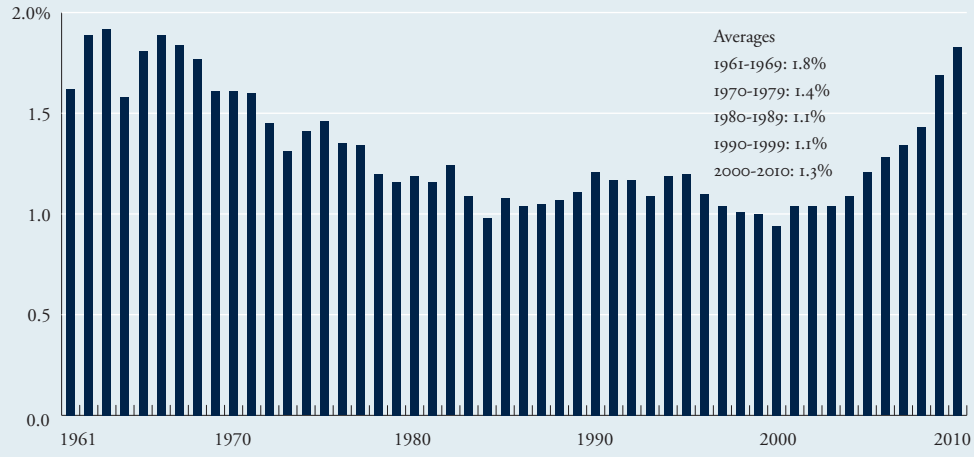
2. The Local Government Sector

The same general trends also hold for Canada's local governments. Local public infrastructure investment in fixed capital relative to GDP (Figure 4) and to private investment (Figure 5) has fallen since 1960. But since 2000, local investment has also shown a considerable rebound, and today is very close to reaching levels of investment seen in the past. For decades the value of the local capital stock to the private capital stock was generally flat, but it is now on an upward trend (Figure 6).

The upshot of the data is that over the last ten years governments have managed to successfully boost their investments in critical public infrastructure. While there may certainly be more work ahead, there can be no doubt that there has been progress. For the infrastructure challenge to be successfully resolved, however, these levels of investment must be increased and sustained over the long-term.

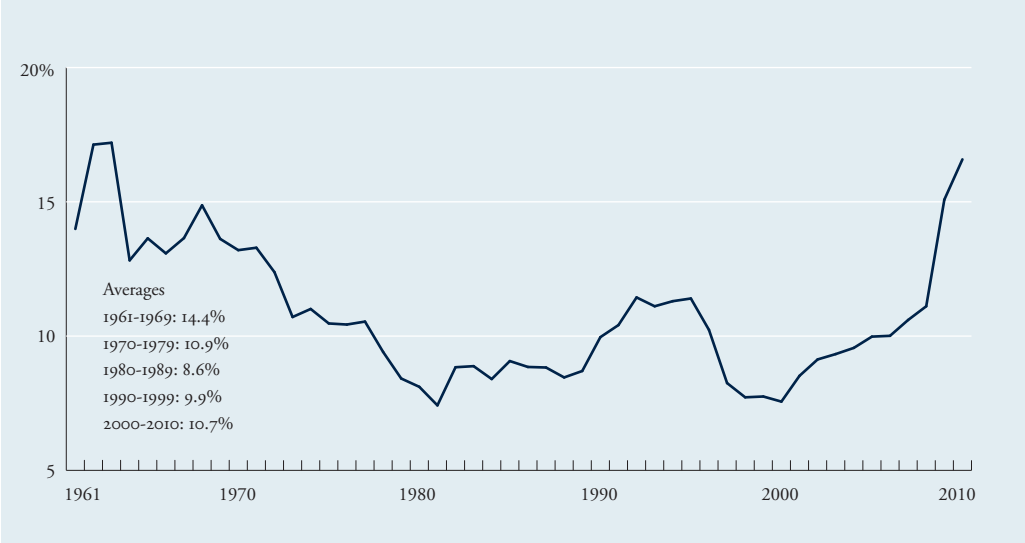
While the larger trend presents some very encouraging signs, the infrastructure funding shortfalls reported elsewhere is enough to temper a sense of enthusiasm. Since the late 1980s, the Federation of Canadian Municipalities (FCM) has tracked the local government infrastructure funding shortfall across the country through a set of in-depth surveys inquiring about infrastructure needs and available funding.

FIGURE 4: LOCAL PUBLIC CAPITAL FLOWS AS A % OF GDP (1961-2010)



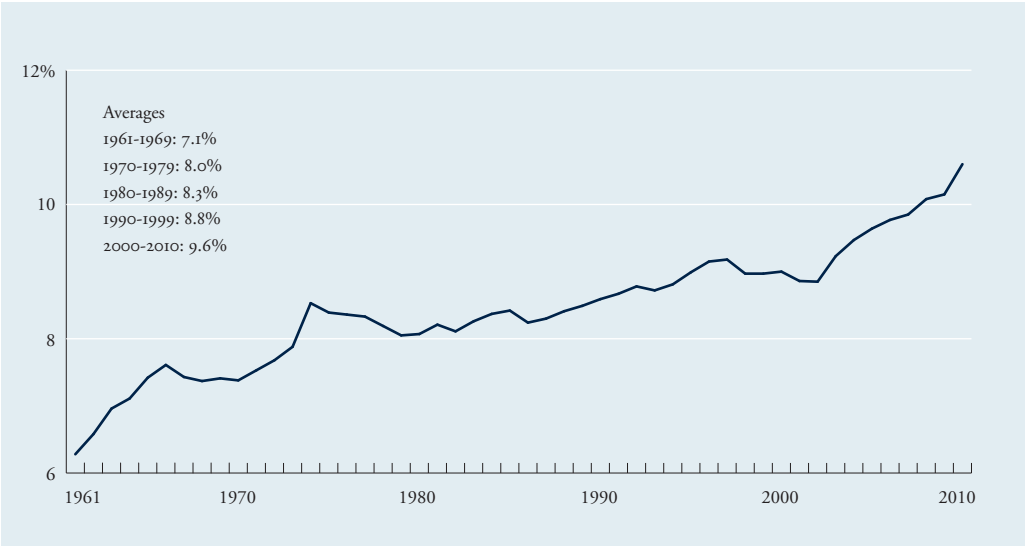
Source: Derived by Canada West Foundation from Statistics Canada

FIGURE 5: LOCAL PUBLIC CAPITAL FLOWS AS A % OF PRIVATE CAPITAL FLOWS (1961-2010)



Source: Derived by Canada West Foundation from Statistics Canada

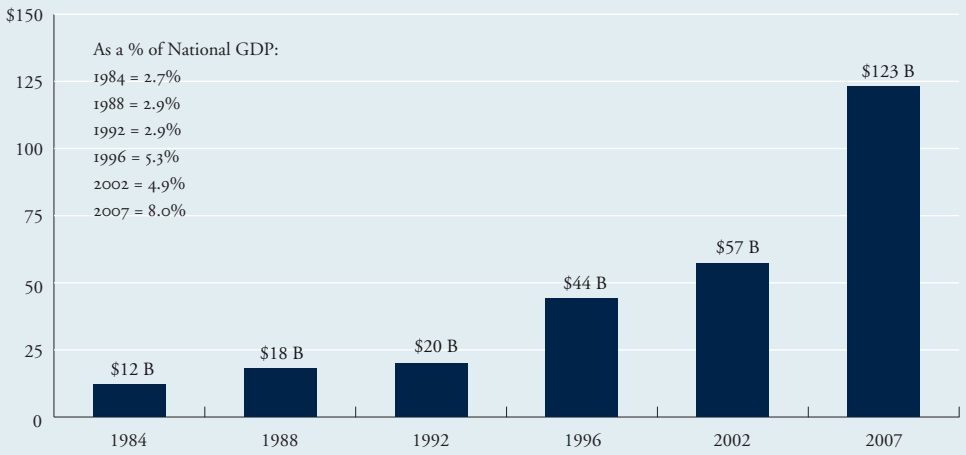
FIGURE 6: LOCAL PUBLIC CAPITAL STOCK AS A % OF PRIVATE CAPITAL STOCK (1961-2010)



Source: Derived by Canada West Foundation from Statistics Canada

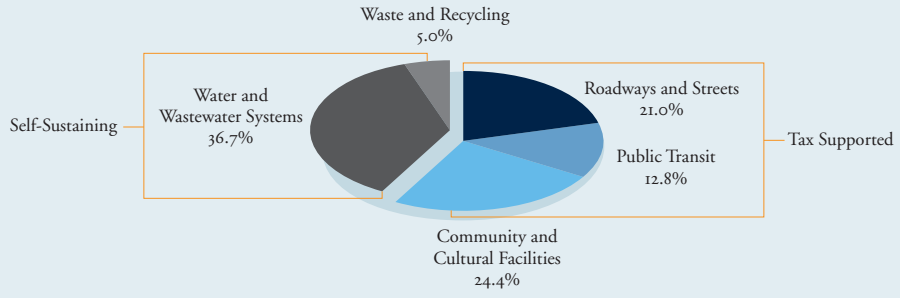
In 1988, the total infrastructure funding shortfall for local governments in Canada was estimated at about $12 billion, an amount representing 2.7% of GDP. This funding shortfall has steadily grown. In 2007, the funding shortfall was estimated at $123 billion, or 8.0% of GDP (Figure 7). According to FCM, this is just the amount of investment required to bring existing assets back to serviceable standards. FCM estimated another $115 billion is required for new infrastructure investments. It is also interesting to note where the funding shortfalls are the most acute. Almost 60% of the shortfall exists in tax-supported assets as opposed to infrastructure assets that can depend on user fees or use pay systems, such as water or wastewater systems (Figure 8).

FIGURE 7: MUNICIPAL INFRASTRUCTURE "DEFICIT" ESTIMATES (COMMONLY CITED ESTIMATES IN BILLIONS OF NOMINAL $)



Source: Federation of Canadian Municipalities (FCM), the McGill University Department of Civil Engineering, and the Canadian Society for Civil Engineering

FIGURE 8: WHERE THE MUNICIPAL INFRASTRUCTURE DEBT LIES (CANADA-WIDE DATA, 2007)



Source: Federation of Canadian Municipalities and the Civil Engineering Department at McGill University, *The Coming Collapse of Canada's Municipal Infrastructure, 2007*

3. The Big Western Cities

Most of the large cities in western Canada have begun to intensively inventory the state, condition, and age of their existing infrastructure assets to determine the required investments. The cities have also developed models to determine the investments to accommodate future growth. In 2003, the Foundation reviewed infrastructure in the six largest western cities (e.g., Vancouver, Edmonton, Calgary, Saskatoon, Regina, and Winnipeg) and found an annual $564 million infrastructure funding shortfall.

A review of current capital budgets shows that the reported infrastructure funding shortfall for the big western cities has exploded (Figure 9). The combined infrastructure need over the next ten years is reported at $63.0 billion, of which only $21.5 billion in funding is in place. This leaves a shortfall of $41.5 billion, or almost $4.2 billion annually. Again, the great bulk of this funding shortfall is in areas traditionally funded through taxation, particularly transportation and parks, recreation, social, community, and cultural infrastructure (PRSCC). Shortfalls in environmental and utility-based services such as water and wastewater tend to compose a smaller share of the shortfall.

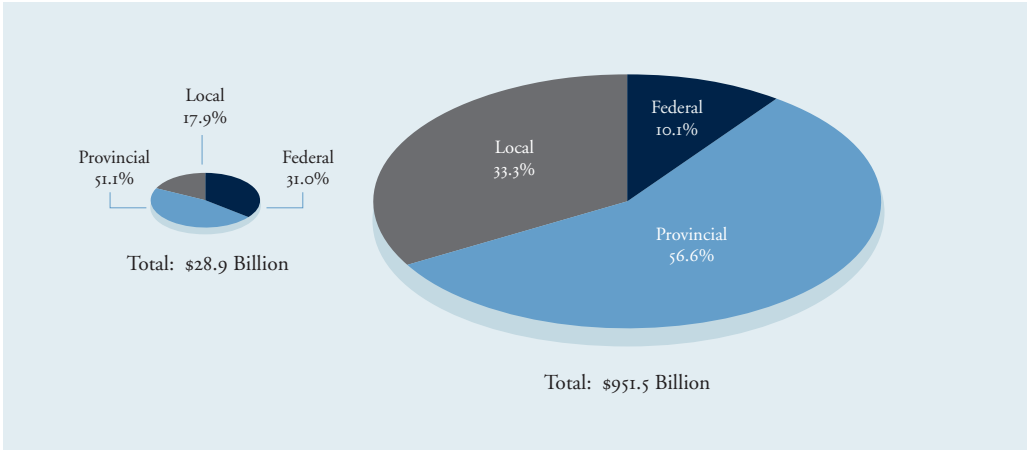
FIGURE 9: INFRASTRUCTURE FUNDING SHORTFALLS IN THE BIG SEVEN WESTERN CANADIAN CITIES

	Victoria	Vancouver	Edmonton	Calgary	Saskatoon	Regina	Winnipeg	Total
Time Period	2007-2008	2009-2011	2008-2017	2009-2018	2010-2019	2010-2019	2009-2018	Average over Next Ten Years
Annual Funding Shortfall	$47.0 M	$98.8 M	$1.920 B	$1.195 B	$93.0 M	$129.0 M	$737.0 M	$4.220 B
Annual Shortfall Per Capita	$602	$157	$2,454	$1,122	$425	$667	$1,092	$1,159
Protection	0.0%	2.9%	0.8%	7.2%	0.0%	1.6%	2.4%	2.1%
Transportation	32.0%	26.7%	59.4%	49.7%	77.0%	71.3%	69.2%	55.0%
PRSCC	22.9%	18.4%	15.5%	6.8%	0.0%	16.3%	15.6%	13.6%
Environment	44.0%	5.1%	2.8%	15.7%	12.2%	7.8%	11.7%	14.2%
General	1.2%	47.0%	10.7%	20.6%	4.2%	3.1%	1.2%	12.6%
Other	0.0%	0.0%	10.8%	0.0%	0.0%	0.0%	0.0%	1.5%
Total Shortfall	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Total Needs	$510.7 M	$739.2 M	$27.553 B	$19.999 B	$1.264 B	$2.120 B	$10.870 B	$63.056 B
Funded	$40.8 M	$442.9 M	$8.346 B	$8.049 B	$334.4 M	$830.0 M	$3.500 B	$21.543 B
Shortfall	$469.9 M	$296.3 M	$19.207 B	$11.950 B	$930.0 M	$1.290 B	$7.370 B	$41.513 B

Source: Derived by Canada West Foundation from various Capital Plans and Capital Budgets of the cities and Statistics Canada

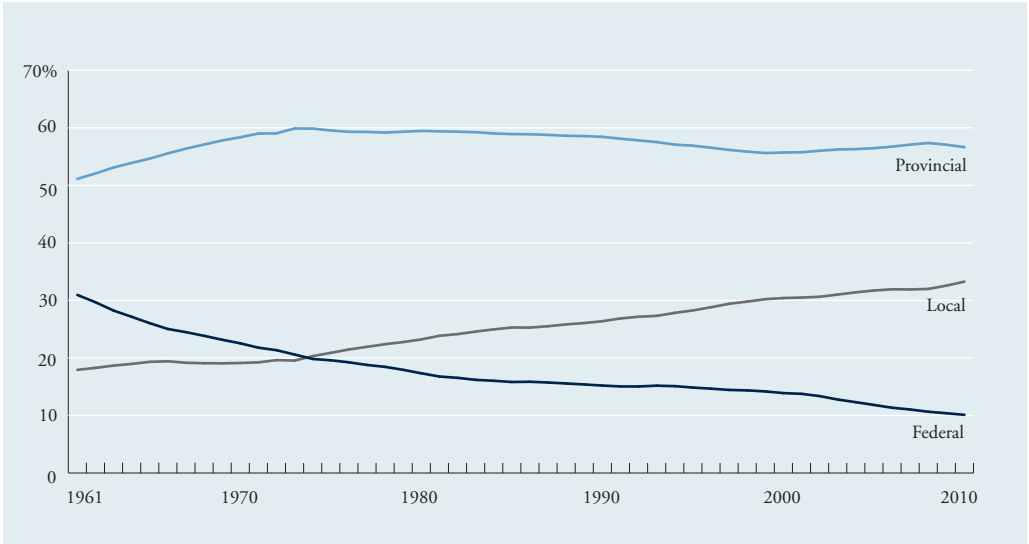
When it comes to public infrastructure, it is difficult to avoid the inherently local nature of the issue. In 1961, local infrastructure was only 17.7% of the total public infrastructure in Canada. In 2010, the local share had increased to 33.3% (Figure 10). The share of public infrastructure held by local governments has grown steadily since the 1960s (Figure 11). In fact, cumulative growth in the share of public infrastructure held by local governments has exceeded 80% compared to cumulative growth in the provincial share of 20%. Cumulative growth in the share of federal infrastructure has declined significantly (Figure 12).

FIGURE 10: SHARE OF THE PUBLIC CAPITAL STOCK BY GOVERNMENT (1961 AND 2010)



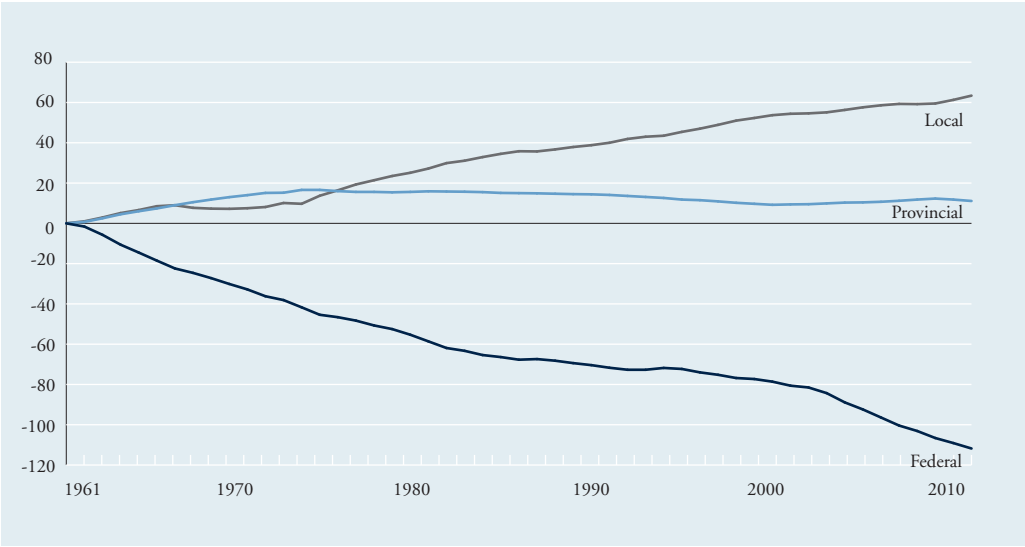
Source: Derived by Canada West Foundation from Statistics Canada

FIGURE 11: CHANGE IN THE SHARE OF THE PUBLIC CAPITAL STOCK (1961-2010)



Source: Derived by Canada West Foundation from Statistics Canada

FIGURE 12: CUMULATIVE CHANGE IN THE SHARE OF THE PUBLIC CAPITAL STOCK (1961-2010)



Source: Derived by Canada West Foundation from Statistics Canada

In many ways, the infrastructure funding challenge is the end point or the result of a number of fiscal challenges converging on Canada's large urban centres:

→ Rapid and changing patterns of population growth
→ Growing fiscal disparities across large city-regions
→ Urban sprawl
→ Aging and deteriorating infrastructure
→ Off-loading from senior governments
→ Grant funding yet to recover to historical levels
→ Ad hoc nature of operating and capital grants
→ Rising costs for city services
→ Rising standards for infrastructure
→ Restrictive legislative environment
→ Poor revenue growth
→ Singular reliance on the property tax
→ Lack of diversity in tax tools and revenue sources

- → Lack of correct pricing for infrastructure and services
- → Past fiscal restraint
- → Competing budget priorities
- → Lack of life-cycle costing and management
- → Accounting practices and priorities

Under the Western Cities Project, the Foundation argued that the ability of western Canada's cities to meet their huge infrastructure requirements is hampered by a singular and heavy reliance on the property tax. Real per capita growth in property tax revenue is well below growth in tax revenues seen federally and provincially, and property tax revenues relative to disposable personal incomes and GDP are at some of the lowest levels ever seen. To help place our cities on a more firm fiscal foundation, Canada West Foundation identified a package of fiscal reforms that included the following:

- → Keep the focus on core priorities and better match municipal responsibilities with appropriate revenue sources.
- → Move to user pay systems wherever possible, and pursue accurate pricing of services and infrastructure.
- → Adopt competitive models of delivery for both services and infrastructure, including PPPs.
- → Pursue innovation in the financing, funding, and delivery of infrastructure.
- → Lower reliance on the property tax by securing new tax tools or more robust forms of tax revenue sharing.

The Penny Tax

The idea of a small locally-levied sales tax emerges as a fresh, creative, and innovative option that would enable western Canadian cities to get a better handle on their infrastructure funding challenges by broadening and enhancing the current set of municipal tax levers with a more economically robust tax source. Viewed simply, the tax would amount to a small 1% value-added local sales tax that is piggy-backed off the federal GST. Across the US, these types of local sales taxes are generally referred to as the "local option sales tax." But because the tax rate is often fixed and capped at one cent on each dollar subjected to the tax, many prefer to use a more colloquial term for the levy—the "penny tax."

1. Local Sales Taxes in the OECD

The idea of a broad-based and locally-levied sales tax may be somewhat foreign in the Canadian municipal context, but the same cannot be said to hold for most other nations around the world (Figure 13). Local governments in countries that have strong historical ties to Great Britain or served as former British colonies (usually members of the Commonwealth of Nations) depend much more heavily on property taxation than do most other countries. This stands in sharp contrast to the experience of local governments in other European countries, as well as those in the US and southeast Asia, many of which collect various types of income taxes as well as a broad-based local sales tax and selective sales taxes on certain goods and services.

FIGURE 13: PERCENTAGE OF TOTAL LOCAL TAX REVENUE FROM VARIOUS TAX SOURCES

MEMBERS OF THE OECD AND COMMONWEALTH OF NATIONS	Property Tax	Income Tax	General Sales Tax	Selective Sales Tax	All Other Taxes
Australia	100.0%	0.0%	0.0%	0.0%	0.0%
Ireland	100.0%	0.0%	0.0%	0.0%	0.0%
UK	99.5%	0.0%	0.0%	0.0%	0.5%
Canada	92.7%	0.0%	0.1%	1.4%	5.7%
New Zealand	90.8%	0.0%	0.0%	9.1%	0.0%
MEMBERS OF THE OECD ONLY					
United States	72.8%	6.3%	11.1%	9.8%	0.0%
Netherlands	62.8%	0.0%	0.0%	37.1%	0.0%
Korea	51.4%	15.3%	0.0%	29.9%	3.4%
France	50.6%	0.0%	0.0%	10.2%	39.1%
Portugal	43.2%	21.6%	18.4%	16.4%	0.4%
Spain	34.6%	26.4%	11.6%	23.8%	3.5%
Poland	33.6%	63.0%	0.0%	3.3%	0.1%
Japan	31.1%	47.2%	7.1%	13.7%	1.0%
Hungary	22.6%	0.1%	70.2%	6.3%	0.7%
Italy	17.3%	12.9%	0.0%	14.9%	54.9%
Switzerland	15.4%	84.3%	0.0%	0.3%	0.0%
Germany	15.0%	79.1%	4.8%	0.9%	0.2%
Iceland	13.2%	80.2%	6.5%	0.0%	0.0%
Austria	9.6%	56.0%	19.6%	10.7%	4.1%
Norway	7.8%	90.2%	0.0%	2.0%	0.0%
Denmark	6.3%	93.6%	0.0%	0.1%	0.0%
Luxembourg	6.0%	92.6%	0.0%	1.2%	0.3%
Czech Republic	4.9%	89.8%	0.0%	5.2%	0.1%
Finland	3.9%	95.8%	0.0%	0.0%	0.2%
Turkey	2.3%	27.7%	25.3%	4.8%	39.9%
Belgium	0.0%	84.2%	1.7%	12.5%	1.6%
Sweden	0.0%	100.0%	0.0%	0.0%	0.0%

Source: Derived by Canada West Foundation from data presented in Kitchen and Slack (2003). Original data comes from the OECD's *Revenue Statistics 1965-1999.* (Note: Numbers may not total 100.0% due to rounding.)

2. Local Sales Taxes in the US

The US experience is particularly instructive. In the 1970s and 1980s, a number of US states enacted property tax limitations following passage of California's *Proposition 13* in 1978. These limits restricted the amount by which property taxes could be increased, which eventually caught local governments in the US in a revenue squeeze. Rather than remove the property tax limits, local governments in many states were provided with access to various forms of sales taxation.

When it comes to sales taxes in the US, the larger picture is easily sketched. The US federal government does not levy a broad-based general sales tax. However, 45 out of the 50 US states do, as does the District of Columbia. Only Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales tax. In 36 US states, various local governments also levy some form of local sales tax. Viewed in reverse, only 15 US states do not allow a broad-based sales tax at the local level.

About 12% of all local government tax revenue in the US accrues from various forms of local sales tax. Local government here includes counties, towns, cities, and other municipalities, school districts, and special districts that deliver services across municipal boundaries or county lines (e.g., water and sewer districts, regional transit authorities). Within the OECD, only local governments in Spain, Portugal, Austria, Hungary, and Turkey use sales taxes more than local governments in the US.

Each state does employ a set of specific rules when it comes to the local sales tax regime. Virtually all local sales taxes "piggy-back" onto the state sales tax. In other words, the local sales tax is applied to the same tax base as the state sales tax. There may be different exemptions within the state and local sales tax, but these tend to be small in number and relatively rare. In addition, most states do not allow local governments unfettered access to sales taxes. The state constitution or the enabling legislation governing the local sales tax regime either sets the tax rate or caps it by specifying a maximum rate. The state usually specifies the purposes for which local sales tax revenue may be used, and almost all local sales taxes see the state collecting the revenue and remitting the amounts. Every state also has comprehensive regulations regarding other administrative features, such as the procedures by which any local sales tax can be imposed.

There is wide variation when it comes to the sales tax rates currently employed by the various states and the local governments within those states (Figure 14). State sales tax rates range from a low of 2.9% in Colorado to a high of 7.25% in California. The maximum allowable local sales tax rate—which covers all types of local sales tax levied by all local governments in any one county—ranges from a low of 0.25% in Mississippi to a whopping 8.0% in Alabama.

FIGURE 14: STATE AND LOCAL SALES TAX RATES IN THE UNITED STATES (AS OF JANUARY 2011)

State	State Rate	Local Rate (Min)	Local Rate (Max)	Local Rate (Avge)	Total (Avge)	Total (Max)
Alabama	4.000%	0.000%	8.000%	2.150%	6.150%	12.000%
Alaska	—	0.000%	7.500%	1.130%	1.130%	7.500%
Arizona	6.600%	0.000%	5.500%	2.320%	7.920%	12.100%
Arkansas	6.000%	0.000%	5.500%	1.790%	7.790%	11.500%
California	7.250%	1.000%	3.000%	0.810%	9.060%	10.250%
Colorado	2.900%	0.000%	7.000%	4.340%	7.240%	9.900%
Connecticut	6.000%	—	—	—	6.000%	6.000%
Delaware	—	—	—	—	—	—
Florida	6.000%	0.000%	1.500%	1.010%	7.010%	7.500%
Georgia	4.000%	1.000%	4.000%	3.020%	7.020%	8.000%
Hawaii	4.000%	0.000%	0.500%	0.380%	4.380%	4.500%
Idaho	6.000%	0.000%	3.000%	0.000%	6.000%	9.000%
Illinois	6.250%	0.000%	4.250%	2.150%	8.400%	10.500%
Indiana	7.000%	—	—	—	7.000%	7.000%
Iowa	6.000%	0.000%	2.000%	0.940%	6.940%	8.000%
Kansas	6.300%	0.000%	5.000%	1.650%	6.950%	11.300%
Kentucky	6.000%	—	—	—	6.000%	6.000%
Louisiana	4.000%	0.000%	6.750%	4.430%	8.430%	10.750%
Maine	5.000%	—	—	—	5.000%	5.000%
Maryland	6.000%	—	—	—	6.000%	6.000%
Massachusetts	6.250%	—	—	—	6.250%	6.250%
Michigan	6.000%	—	—	—	6.000%	6.000%
Minnesota	6.875%	0.000%	1.000%	0.340%	7.220%	7.875%
Mississippi	7.000%	0.000%	0.250%	0.000%	7.000%	7.250%
Missouri	4.225%	0.500%	6.625%	2.950%	7.180%	10.850%
Montana	—	—	—	—	—	—
Nebraska	5.500%	0.000%	2.000%	1.010%	6.510%	7.500%
Nevada	6.850%	0.000%	1.250%	0.740%	7.590%	8.100%
New Hampshire	—	—	—	—	—	—
New Jersey	7.000%	—	—	—	7.000%	7.000%
New Mexico	5.125%	0.125%	5.625%	1.400%	6.780%	10.750%
New York	4.000%	0.000%	5.000%	4.300%	8.300%	9.000%
North Carolina	5.750%	2.000%	3.000%	2.320%	8.070%	8.750%
North Dakota	5.000%	0.000%	2.500%	1.000%	6.000%	7.500%
Ohio	5.500%	0.000%	2.250%	1.330%	6.830%	7.750%
Oklahoma	4.500%	0.000%	6.350%	3.940%	8.440%	10.850%
Oregon	—	—	—	—	—	—
Pennsylvania	6.000%	0.000%	2.000%	0.220%	6.220%	8.000%
Rhode Island	7.000%	—	—	—	7.000%	7.000%
South Carolina	6.000%	0.000%	3.000%	1.040%	7.040%	9.000%
South Dakota	4.000%	0.000%	2.000%	1.520%	5.520%	6.000%
Tennessee	7.000%	1.500%	2.750%	2.410%	9.410%	9.750%
Texas	6.250%	0.000%	2.000%	1.140%	7.390%	8.250%
Utah	4.700%	1.000%	5.250%	0.660%	6.610%	9.950%
Vermont	6.000%	0.000%	1.000%	0.000%	6.000%	7.000%
Virginia	4.000%	1.000%	1.500%	0.000%	5.000%	5.500%
Washington	6.500%	0.500%	3.000%	2.280%	8.780%	9.500%
West Virginia	6.000%	—	—	—	6.000%	6.000%
Wisconsin	5.000%	0.000%	1.500%	0.420%	5.420%	6.500%
Wyoming	4.000%	0.000%	4.000%	1.380%	5.380%	8.000%
D.C.	6.000%	—	—	—	6.000%	6.000%

Source: Developed by Canada West Foundation from the Sales Tax Institute, the Federation of Tax Administrators, and the Tax Foundation

Some local sales taxes in the US require voter approval before a local sales tax can be imposed. The wide range of local sales taxes in use indicates that many of these ballot initiatives must be successful. This conclusion is underscored by data produced by the Center for Transportation Excellence, which monitors tax referenda across the US for transportation and public transit. Since 2000, the Center has tracked almost 400 separate state and local ballot initiatives, many of them to implement a sales tax for transportation infrastructure. Almost three-quarters of these referenda have been approved (Figure 15). This high degree of success demonstrates that when the purpose behind a tax is both clear and highly valued, voters are quite willing to authorize additional sums of tax to achieve the objective.

FIGURE 15: SUCCESS RATES OF TAX REFERENDA FOR US FOR TRANSPORTATION PROJECTS (2000-2010)

Year	Total Referenda	Measures Approved	Measures Rejected	% Approval Rate
2000	33 State and Local Referenda	23	10	69.7%
2001	14 State and Local Referenda	8	6	57.1%
2002	41 State and Local Referenda	23	18	56.1%
2003	19 State and Local Referenda	14	5	73.7%
2004	54 State and Local Referenda	43	11	79.6%
2005	25 State and Local Referenda	21	4	84.0%
2006	50 State and Local Referenda	32	18	64.0%
2007	18 State and Local Referenda	12	6	66.7%
2008	47 State and Local Referenda	35	12	74.5%
2009	11 State and Local Referenda	8	3	72.7%
2010	56 State and Local Referenda	43	13	76.8%
Total	**368 State and Local Referenda**	**262**	**106**	**71.2%**

Source: Developed by Canada West Foundation from The Center for Transportation Excellence

Penny Tax Design

Public appreciation and acceptance of any proposal for a "penny tax" is far from guaranteed. In fact, any such proposal runs the very real risk of evoking considerable reaction—much of which will be negative if not overtly hostile. As such, some rather heavy girders are needed underneath any penny tax proposal—a set of specific features that make the idea acceptable if not attractive. A local penny tax for infrastructure should incorporate a number of unique features that would increase acceptability and legitimacy of the tax, and make it an attractive option that enjoys popular support. These features can combine to produce a very accountable and transparent tax. In our opinion, these features are not negotiable.

1. Piggy-Back off the GST

The administrative efficiency of a local penny tax would be maximized if it were to simply "piggy-back" off the existing federal sales tax. In other words, local jurisdictions in which the penny tax is implemented would pay GST at a 1% higher rate than jurisdictions that have not imposed the penny tax. This extra 1% would be collected by the federal government, and then returned to the provincial government much like the harmonized sales tax (HST). In turn, the province would hand over the revenues to the municipalities that imposed the penny tax. Attaching to the federal GST/HST eliminates the need to build and maintain an independent tax infrastructure, both of which carry considerable cost. Most of the discussion over the potential of any small local sales tax in the Canadian municipal policy community assumes this consideration at the outset.

2. Cap the Penny Tax Rate

The introduction of any new tax is often accompanied by public fears that the tax will increase over time. This fear may or may not be grounded in reality, but it would be best to head it off by capping the tax rate through the enabling legislation governing any local penny tax regime. While a capped tax rate is desirable, a legislatively fixed rate is less so. An element of local control over the tax is preserved when voters can choose their own rate of tax. For example, voters should not be forced to accept a fixed 1% penny tax when a 0.25% or 0.50% tax would be more acceptable and also accomplish the desired objectives. (Thus, the penny tax is a maximum. The maximum rate is 1¢ on the dollar, but it could be less.)

3. Voter Approval

Public acceptance of a penny tax would be strengthened if imposition and implementation were dependent on voter approval through a local plebiscite or referendum. In this way, any proposal for a penny tax initiative merely opens the door to the possibility of a local sales tax, but ultimate responsibility is left with the voters themselves. It is much more difficult to argue against such a proposal given the emphasis on local decision-making, its small "c" conservative nature, and its inherently democratic flavour. Local taxes in the US that depend on voter approval typically proceed with a simple majority vote, although some special taxes may require a two-thirds super-majority. Most ballot initiatives for local sales taxes in the US proceed at the same time as local elections. There is every reason to follow a similar approach in Canada, which also keeps costs to a minimum.

4. Earmark the Revenue

Earmarking refers to the practice of legislatively assigning revenue from a tax source to funding a specific expenditure. Earmarking can take a number of forms, each differing in terms of degree. For example, tax revenues can be earmarked for a general purpose such as infrastructure, earmarked for a particular type of infrastructure such as community facilities, or earmarked for a specific project or set of projects such as a new recreation centre, library, or museum. Earmarking can therefore be more general in nature or highly specific. When it comes to earmarking, there is a wide range of potential municipal infrastructure and physical assets that could benefit (Figure 16).

Potential projects that could be funded by a penny tax include protection (e.g, police, fire, and emergency medical response), transportation (e.g., roadways and transit), PRSCC services (e.g., parks, recreation, social, community, and cultural facilities), and general government assets (e.g., communications, information technology, public buildings). In fact, the only infrastructure assets and projects that should not be considered would be environmental and utility services such as water and wastewater systems, storm drainage, and waste and recycling. This infrastructure is better funded through a system of user fees, and reflects the practice generally followed today in most large western cities. Other than those systems, the range and application of penny tax funds is very broad indeed.

FIGURE 16: TAXONOMY OF MUNICIPAL INFRASTRUCTURE AND CAPITAL ASSETS

Transportation Infrastructure

Roadways:

Urban Expressways
Major Arterial Roads
Minor Arterial Roads
Collector Roads
Local Streets
Gravelled and Paved Back Alleys
Major Interchanges
Overpasses/Underpasses
On and Off-ramps/Merge Lanes
Major/Minor Intersections
Rail Crossing Infrastructure
Gates (e.g., vehicle traps)
Bridges and Tunnels
Culverts and Other Drainage
Traffic Sound Barriers
Traffic Signals and Systems
Road Signage
Curbs and gutters
Boulevards and Medians
Streetscaping
Streetlighting
Road Striping and Marking
Public Parking Garages
Public Parking Lots
Parking Meters
Road Maintenance Fleet

Pedestrian:

Sidewalks
Pedestrian Overpasses
Pedestrian/Bicycle Pathways

Transit (General):

Fare Collection Equipment
Ticket Dispensing Equipment
Communications and IT
Uniforms

Transit (Busing):

Buses and Related Equipment
Shuttles and Vans
Bus Stops and Shelters
Turn-outs, Loops, Transfer Points
Maintenance Garages and Equipment
Transit Supervisor Vehicles

Transit (Light Rail):

Rail Cars
Railbeds
Electric Lines
Train Signalling, Switching
Train Stations and Parking Lots
Access Platforms
Underground Tunnels/Subways
Bridges/Overpass/Flyovers

Other Transportation:

Multi-Modal Facilities
Ports
Harbours
Waterfronts
Municipal Airports

Municipal Policing and By-Law Enforcement

Central Police Headquarters
Branch Precincts and Local Police Stations
Central Lock-ups
Local Lock-ups
Longer-Term Remand Centres
Academy and Training Facilities
Forensic/Crime Labs and Equipment
Firing Range Facilities
Vehicle Impound Lots
Animal Pound Facilities
Vehicle Maintenance Facilities
Police Cruisers
Police Trucks and Vans
Mobile Command Centre Vehicles
Motorcycles
Bicycles
Horse Mounts
Helicopters
By-Law Enforcement Vehicles
Specialized SWAT Vehicles
Specialized SWAT Equipment (e.g., firearms, night-vision)
K-9 Units and Related Equipment
Uniforms
Firearms (e.g., handguns, rifles, shotguns)
Other Equipment (e.g., tasers, restraints)
Mobile Communications Equipment
Computers and Related IT
Audio/Video Surveillance Equipment

Emergency Response (Firefighting and EMS)

Fire Fighting:

Fire Halls and Local Stations
Firefighting Training Centres
Mobile Command Centre Vehicles
Aerial Apparatus and Related
Pumper Apparatus and Related
Tanker Apparatus and Related
Specialized Rescue Vehicles and Equipment
Watercraft and Related Equipment
Haz-Mat Units and Related Equipment
Chief, Deputy Chief, Supervisor Vehicles
Other Emergency Support Vehicles
Inspector Vehicles
Arson Investigation Equipment
Specialized Communication Equipment
Fire Fighter Uniforms
Firefighter Turn-out Gear

Ambulatory and EMS:

Ambulance Stations (often joint-use with firefighting)
EMS Ambulance Vehicles
Transfer Ambulances
EMS Supervisor Vehicles
Paramedic Uniforms
Specialized Paramedical EMS Equipment
Communications Equipment
IT Technology

Source: Developed by the Canada West Foundation

Urban Parks and Open Green Space

Natural Open Park Land
Landscaped and Groomed Park Land
Municipal Cemeteries
Horticultures (e.g., trees, bush, flowers)
Unpaved Hiking Trails, Pathways
Paved Trails and Pathways
Pedestrian Bridges
Hardsurfaces and Paved Parking Lots
Playgrounds and Related Equipment
Picnic Shelters, Tables, Grills, Fire-pits
Park Benches
Washrooms and Facilities
Concession Stands and Outbuildings
Parks and Recreation Fleet
Lawnmowers, Trimmers, Other Equipment

Recreation, Leisure and Tourism Facilities

Outdoor Recreation Facilities:

Integrated Sportsfields (e.g., track, ball, soccer)
Public Golf Courses
Large Outdoor Pools/Waterslides
Local Outdoor Pools and Splashparks
Local Outdoor Ice Rinks
Local Ball Diamonds

Indoor Recreation Facilities:

Integrated Leisure Centres (i.e., multi-purpose)
Indoor Hockey Arenas
Indoor Curling Arenas
Indoor Swimming Pools

Larger Regional Recreational and Tourism Facilities:

Convention and Conference Centres
Multi-Purpose Auditoriums
Large Historical Attractions (e.g., Heritage Park)
Metropolitan Zoos
Metropolitan Aquariums
Wild Animal Parks
Science Centres
Professional Indoor Sports Stadiums
Professional Outdoor Sport Stadiums
Local Exhibition Grounds
Tourism, Information, Visitors' Centres

Cultural Facilities

Concert Hall Auditoriums
Performing Arts and Theatrical Facilities
Museum Facilities and Collections
Art Galleries and Collections
Central or Main Library Facility
Branch Library Facilities
Library Holdings and Collections
Computers, Electronic Catalogues, Databases

Community and Social Service Facilities

Homeless Shelters
Drop-in Centres
Transitional or Temporary Housing
Affordable and Community Housing
Seniors' Lodges
Addiction Mitigation Facilities
Recovery and Treatment Centres

Environmental Infrastructure

Water Works:

Source Infrastructure (e.g., rivers, wells, lakes)
Source Control (e.g., weirs, dams)
Water Treatment Plants
Open Water Reservoirs, Storage Tanks, Basins
Water Recharge, Water Pumping, and/or Flow Control Systems
Trunk Mains (i.e., from treatment to reservoirs)
Large Distribution Mains (i.e., trunk to small mains)
Small Distribution Mains (i.e., small mains to service line)
Service Lines, Local Connections, Service Line Water Shut-offs
Water Meters
Fire Hydrants
Water System Fleet and Related Equipment

Wastewater and Sanitary Sewer:

Local Sewer Lines (often property owner's responsibility)
Lateral Lines (i.e., small diameters)
Branch Lines (i.e., medium diameters)
Main Lines (i.e., bigger diameters with manholes)
Trunk Lines (i.e., largest lines also with manholes)
Intercept Lines (connect trunks to treatment plant)
Lift Stations (pumping due to low gravity flows)
Force Lines (special lines off a lift station)
Wastewater Treatment Plants
Sewer System Fleet (e.g., Vacuum Trucks)

Storm Drainage:

Catch Basin Inlets (i.e., debris control)
Simple Inlets (i.e., no debris control)
Storm Drainage Pipes, Systems, Manholes
Effluent Discharge Infrastructure
Storm Drainage Fleet

Waste Management:

Regional and Local Landfill Sites
Refuse Transfer Stations
Operations and Processing Facilities
Vehicle Scales
Specialized Hazardous Waste Storage/ Disposal Facilities
Recycling Depots, Collection, Separation, Storage Facilities
Refuse Collection and Recycling Fleet
Collection Containers and Miscellaneous Equipment

General Government and Miscellaneous

Facilities and Buildings:

City Hall, City Hall Annexes, Other Civic Offices
All Other Municipally-Owned Buildings, Furnitures and Equipment
Public Works Facilities (e.g., Garages, Yards)

Information Technology and Communications:

Main Frames and Personal Computers
Main Servers and Computerized Networks
Miscellaneous Communications Equipment

Miscellaneous Infrastructures and Assets:

Publicly-owned, Undeveloped Lands (i.e., for future growth, parks)
Urban Brownfield Properties
Properties and Lands From Tax Arrears

Landscaping:

Flood Protection, Mitigation, Embankments
Erosion Controls
General Grading
Seawalls and Other Barriers

Earmarking the penny tax revenue carries two powerful benefits from the point of view of the taxpayer. First, the earmarking shields and insulates the revenue from various legislative and political pressures that might attempt to divert the revenue elsewhere. Second, earmarking results in better accountability, which is always enhanced whenever there is a clear connection between a tax source and a government expenditure. This tighter connection allows governments to build more public support for specific projects and the taxes needed to fund those projects. The reason is obvious—the link between the tax and the expenditure is more transparent.

Taxpayers are simply much more likely to support a tax used for a purpose that they value, rather than paying a tax that disappears into the "black hole" of a municipality's General Operating Fund. While the degree of earmarking desirable is open to debate, experience elsewhere indicates that presenting voters with a set of specific projects is probably the best way forward, and would do the most to increase public support (see Discussion Box 1).

DISCUSSION BOX 1: A MODEL FOR EFFECTIVE EARMARKING

The *special purpose local option sales tax* or *SPLOST* in the state of Georgia incorporates a unique set of features that have proven quite popular with voters. In fact, Georgia's SPLOST has become an important source of local infrastructure funding right across the state. The tax rate is fixed and capped at 1% by state legislation. For the tax to be imposed, it requires voter-approval via referendum. All SPLOST revenues are earmarked or dedicated for specific local capital projects.

In establishing a SPLOST, county commissioners first prepare a list of infrastructure projects to be funded by the tax. This list, and a proposal for the 1% SPLOST tax, are then placed on the ballot at a regularly scheduled local election. If approved, the tax is imposed, the projects proceed, and government follows up with regular reports on the tax. These reports detail the amount of tax collected, the infrastructure projects that have been completed, and the projects still in progress. The SPLOST tax works on a cycle that coincides with regular county elections. At the end of the cycle, the tax automatically sunsets or lapses. If a county wants to reinstate the tax, a new list of fresh projects must be proposed. This list and the proposal for a new SPLOST is then submitted to voters in another referendum.

The SPLOST process provides a unique opportunity for increased participation of citizens in local decision-making, and various safeguards ensure high levels of transparency and governmental accountability with the usage of the revenue. Transparency and accountability with SPLOST is a logical result of earmarking the tax revenue for specific projects.

To be sure, the concept of earmarking is relatively easy and straightforward, but choosing the particular form it should take and establishing qualifying purposes and projects is another matter altogether. Defining and limiting the potential scope of projects eligible for funding is an important decision that will require considerably more thought than can be given here. As such, we offer these initial thoughts to help guide any future process of decision-making.

→ Earmark the revenue for specific infrastructure projects: Earmarking of tax revenue for a broad category such as infrastructure will allow municipal governments more freedom to use the tax and respond to emerging realities, but it does so at the cost of lowering public support. To have the best chance to succeed, any proposal for a penny tax should be submitted to voters along with a list of specific projects, and their costs, to be funded by the tax revenue.

→ Emphasize initiatives that have wide popular appeal and are both easy to understand and communicate: The road to public acceptance of a penny tax is almost certain to be smoothed when the right set of purposes and projects are chosen and careful thought has been given to identifying popular initiatives that have broad appeal.

→ Establish the full range of possibilities and then narrow the field: The US experience shows that sales taxes can be used to fund a wide range of operating and capital expenditures, and a wide range of possibilities also exists within a more narrow focus on infrastructure. Before picking and choosing, it might be best to build a comprehensive list of possibilities and then narrow the focus on those that can be made to fit.

→ Ensure a balance in the projects selected: One of the unique aspects of a voter-approved and earmarked penny tax is how various infrastructure projects can be identified and proposed in an omnibus package that has potential to satisfy a wide range of voter preferences and priorities. There is no need to stack the projects with only transportation infrastructure, for example. Key transportation projects can be combined with environmentally "green" projects, which can also be combined with recreation centres and community and cultural facilities such as art galleries, museums, and concert halls. The trick is to ensure a balance in the projects such that it has wide popular appeal.

5. A Sunset Provision

To increase taxpayer acceptance and accountability with a penny tax, the tax should be in effect only during a specific time period or cycle. For example, provinces would amend their municipal legislation to first allow municipalities to use a value-added sales tax. This right to use the tax stays within the municipal legislative framework. The tax itself, however, only comes into effect if voters decide to implement the tax. If implemented, the tax would be operational for a set period of time—perhaps six years over two municipal election cycles—and will be used only to fund a set of specified projects. After the cycle is over and the projects completed, the tax will lapse or sunset. If civic leaders want to implement the tax again for another cycle, another set of projects would be identified and voters would again be asked whether they wanted to implement the tax.

Such sunset provisions provide a measure of assurance to taxpayers that the tax is temporary in nature and its continued existence depends on the voters themselves. Not only do the voters stay in control, the automatic sunset yields another positive side-effect in the form of improved political accountability. Governments continually confronted with the risk of losing one of their revenue mechanisms will work diligently to manage the tax wisely and spend the revenue prudently. This helps ensure continued voter support of the tax over more than just one cycle.

6. Rebate Excess Revenue

A penny tax as envisioned here would be approved by voters only as a mechanism to fund a specific project or set of projects whose costs have been established in advance. When casting ballots in a referendum, voters approve the projects and their estimated cost, as well as the tax needed to fund the projects. But like many taxes, it can be difficult to predict with certainty just how much revenue might accrue from the tax over time.

If the economy grows faster than expected, tax revenues will exceed expectations. Public acceptance of a penny tax would be increased if voters were assured that any excess revenue over and above the cost of the projects would be returned to taxpayers. One such scenario could see excess revenues pooled in a reserve fund until the end of the tax cycle when the tax sunsets. This revenue would then be returned in the form of reduced property taxes—a property tax abatement. Property taxes would be lowered and the revenue loss backfilled with the excess sales tax revenue held in reserve. More than a few municipalities across Canada have experience with such systems by employing property tax mill rate stabilization reserve funds. Of course, this is only one way to rebate excess revenue. There are other options as well. While more thought is needed on how rebates could be structured and managed, the sentiment is definitely worth considering.

Conversely, it may also be the case that penny tax revenues are lower than anticipated. This would mean that not all projects could go ahead. Consideration should be given to establishing a rank order of projects—those with a higher priority ranking would proceed while those with a lower priority ranking might have to wait until a later time. The issue of "cost over-runs" might also prove tricky. There will be a clear need to tighten forecasting and build in cost contingencies into any proposed projects.

7. Incremental Revenue

It is important to also stress that the idea and purpose behind the penny tax is to boost municipal revenues in order to expand infrastructure funding and to complete specific projects. In this sense, the revenue should be seen as additional, supplemental, and incremental to revenues that already exist. In allowing municipalities and voters the right to implement a penny tax, federal and provincial governments ought not to see the move as a way to reduce their current commitments to supporting investment in urban infrastructure.

8. Annual Reporting

Any penny tax proposal should also incorporate a comprehensive accountability and public reporting framework. For example, municipalities could issue a separate annual report on the tax to both the provincial government and to taxpayers. These annual reports need not be lengthy, but would include valuable information such as the amount of tax revenue collected, the usage of the proceeds, and the status of various projects funded through the penny tax. All of this would serve to up the accountability ante even further.

Given the right design and the right of voters and taxpayers themselves to impose and implement the penny tax, there is no reason to suspect that the public would immediately rule out the idea. Not only does the larger US experience seem to bear this out, but the design and structure of a penny tax as outlined here would—without question—constitute Canada's single most efficient, transparent, and accountable tax. Given the magnitude of the urban infrastructure challenge, serious consideration should be given to a voter-approved consumption tax at the local level that is dedicated to funding the renewal and rehabilitation of our existing local infrastructure and the provision of new assets.

The Rationale

A huge and growing urban infrastructure funding shortfall does little to answer the question of why a small local penny tax should emerge as a specific policy option. The answer here lies in turning to the larger fiscal and policy context. At the heart of the rationale behind the penny tax is the simple realization that Canada's large urban centres are both heavily and singularly dependent on the property tax. The attendant lack of diversity in tax tools constitutes a serious disadvantage when it comes to infrastructure investment. There is a complex argument here that weaves together a variety of fiscal and demographic considerations with concerns over governance and certain economic and political factors to support an intentional diversification of the local tax base. A small locally-initiated and locally-levied penny tax applied across a broad base is a fresh and innovative response that neatly aligns local preferences with a locally determined tax source, and would provide cities with a supplement to the property tax.

1. The Fiscal Rationale

Fiscally, a more diverse municipal tax system that included a local penny tax would result in better revenue growth for cities. Unlike the property tax, which attaches only to one aspect of the economy—real estate—a small local sales tax casts its net across the full range of goods and services in the local economy. Unlike the property tax, growth in sales tax revenue does not have to be achieved by intentionally increasing tax rates year over year. Rather, cities would have access to a tax source that better links to local population and economic growth. A penny tax will allow cities to retain a small but important portion of the economic growth occurring within the local region, and direct it to the infrastructure needed to accommodate that growth. Sales taxes grow based on the inherent vitality of a broad tax base and they also capture the effects of inflation, which are reflected in the final price of goods and services purchased.

In addition, the federal and many provincial governments have dramatically reduced their tax rates, which opens up significant opportunities for a bold municipal tax move. Federally, tax rates for personal income tax, corporate income tax, and the GST have all been dramatically reduced since 1990 (Vander Ploeg and Vicq 2010). Many provinces have also reduced their basket of various taxes. When the federal GST was reduced from 7% to 6% in 2006, and reduced again from 6% to 5% in 2008, the Prime Minister was very clear in an address to the Federation of Canadian Municipalities that the federal government was not necessarily "reducing" the sales tax but "vacating" the tax room for provincial as well as local community needs (Address by the Prime Minister 2006).

2. The Demographic Rationale

Demographically, a more diverse set of taxes that includes a penny tax would enable cities to better cope with the rapid pace of urbanization and compensate for current patterns of population growth. Rapid population growth increases the demand for more services, stresses existing infrastructure systems, and creates pressure for new infrastructure. A growing population is not ordinarily problematic for governments—it leads to economic growth and increased tax revenues. But cities are highly dependent on the property tax, which does not always capture the increased tax revenue that normally accrues from a growing population and an expanding economy. More tax diversity that included a penny tax would allow cities to better accommodate growth through tax revenues generated by that growth.

More important is the unique pattern of urban population growth, much of which now occurs not in the large "anchor" cities of our city-regions but in "metro-adjacent" municipalities just outside. This "donut growth" or "urban fragmentation" meets up with a lack of diversity in municipal tax tools to severely press city finances—the burden of sustaining municipal services and the underlying infrastructure lands squarely on local property taxpayers as opposed to those who use the services and infrastructure. While peripheral growth does stimulate the local economy, this does not always translate into additional property tax revenue, particularly as far as the residential property tax is concerned. A small local penny tax helps ensure that all those coming into a city to use its services and infrastructure also help to pay for that infrastructure.

3. The Governance Rationale

Issues of governance also provide part of the overall rationale. Just as cities have grown in size, importance, and complexity, so have the issues with which they must contend. Many of these new responsibilities are directed toward "people" services and infrastructure as opposed to "property" services and infrastructure. Today, our cities are responsible for a number of non-traditional functions that possess a strong social element (e.g., immigration settlement, drug abuse, crime) or possess clear income redistributive qualities (e.g., poverty mitigation, community social services, homelessness, and affordable housing). At the same time, there exists a mismatch between these newer forms of municipal expenditure and the type of tax cities have at their disposal. The property tax is ill-suited to address services and infrastructure to people if only because the property tax base is too narrow.

A small local penny tax would help increase tax diversity at the local level and provide an opportunity to better match revenue-raising capacity with current municipal expenditure responsibilities, and it would allow infrastructure to better compete for scarce property tax dollars. All the benefits of the evolving expertise of big cities and their proximity to these issues are retained at the same time that their current responsibilities are better squared with appropriate financial resources. Given the interconnectedness of governments today, disentanglement is not an option. Neither can cities unilaterally withdraw from these areas of responsibility. As such, better tax diversity remains one of the only viable alternatives.

4. The Economic Rationale

Economically, the current administration of the property tax cross-subsidizes service and infrastructure, leading to inefficiencies, waste, and artificially increased demands for more services and infrastructure. In many ways, the property tax also makes less sense in the new economy. No longer is property a key to creating wealth or income. Evidence of this comes from many cities that are reporting a declining commercial and industrial property tax base. In the new globalized information economy, new systems of taxation need to be considered if cities are to fund a high quality package of infrastructure and services that can attract and retain the highly skilled labour necessary for local, provincial, regional, and national economic success.

At the heart of the matter is how Canada's municipal tax distinctiveness constitutes a competitive disadvantage. It is important to recognize the benefits that accrue from a diversity of tax tools and revenue levers. No single tax is entirely fair or neutral with regards to investment patterns, economic distortions, or decisions about location and business inputs. Nor is every tax equally suited to generating predictable, stable and growing streams of revenue. No single tax source is equally suited to compensating for inflation, capturing growth in the local economy, or controlling for the problems with free-riding and fiscal disequivalence that inevitably result from more and more people filling the beltways around our cities. In short, the infrastructure challenge constitutes a powerful argument for employing a range of local tax tools and revenue levers, where the advantages of the property tax can be retained at the same time that its disadvantages are offset by the presence of other taxes (Kitchen 2000). In many ways, it is simply unreasonable to expect one tax alone to carry the burden of funding our large cities.

5. The Political Rationale

Politically, a more diverse tax system provides the opportunity to establish better accountability. More direct control to generate revenues would provide cities with more accountability to citizens, and increase the public's confidence that the dollars will be well spent. Only locally raised taxes and locally decided government expenditures can ensure the highest level of accountability. To fund infrastructure, cities currently rely on the property tax and capital grants provided by the provinces and the federal government. In the exchange, accountability is reduced. To the extent possible, locally-decided expenditures should be recovered through locally-generated tax revenues, and this requires a re-jigging of the municipal tax system. A penny tax is a good option to consider.

6. Fulfilling the Principles of Good Taxation

A properly designed and implemented local penny tax also stacks up quite well against the various principles that should guide tax policy and tax reform.

→ Taxpayers: For taxpayers, a small local penny tax can be quite fair and equitable, particularly if the rate is kept low, if basic goods like groceries and pharmaceuticals are exempted, and various low income offsets are available like the current GST rebate. A 1% tax on every $1 spent is also simple and straightforward. If the tax is earmarked for infrastructure, then transparency is also strengthened. Accountability is also enhanced as the penny tax would be voter-approved and locally levied, with expenditures being locally-determined and governments following up with annual reporting to voters and taxpayers.

→ Administration: Administratively, sales taxes already exist federally and in most provinces. The tax machinery is already in place, making it relatively easy and cost effective to extend. From the municipal perspective, the costs of administration and revenue collection would also accrue federally.

→ Economic Efficiency: A penny tax would allow all those who use a city's services and infrastructure to help pay for it—whether they live in the city or outside of it. Thus, the tax results in a tighter link between those who consume the services and infrastructure and those who pay. This tighter link can help improve allocative efficiency of public goods and services. If the tax base is kept broad, the tax rate kept low, and the tax is applied across the entire city-region, then it should also be relatively efficient and result in few distortions across the economy. Because a value-added sales tax exempts savings and investment and focuses only on consumption, the tax is a better alternative than personal or corporate income taxes. Unlike the residential property tax, which does not relate to ability-to-pay, and the commercial and business property tax, which is insensitive to profits, a sales tax targets consumption, which is an appropriate proxy for ability to pay.

→ Revenue Adequacy: A broad-based penny tax will generate revenue even with a very low rate of tax. This makes the option a better alternative than other forms of user pay sales taxes such as fuel taxes, which have a more narrow base and would require higher rates of tax to produce adequate revenues. The broad base also helps ensure that revenues are steady, reasonable, and predictable over time. A small penny tax would also be relatively elastic, generating revenues that track alongside economic and population growth.

→ Governance: Autonomy and local control over a penny tax can be assured and enhanced as long as the tax is locally-levied and expenditures are locally-determined. There is also sufficient room within the tax base given recent federal reductions in the GST and the lower rates of provincial sales tax (PST) and harmonized sales tax (HST) that are now being charged in some provinces compared to the early and mid-1990s. In many ways, a penny tax appears to make intuitive sense and also provides a logical fit. Today's cities provide services to a range of outsiders, whether commuters, truckers, business travellers, shoppers, or convention delegates. A small local sales tax allows all those outsiders to help finance the services and infrastructure that they use.

DISCUSSION BOX 2: THE UNIQUE CASE OF ALBERTA

The absence of a broad-based sales tax is a defining feature of Alberta's political culture. Any proposal for a penny sales tax in Alberta represents a clear and radical departure from the fiscal status quo. As such, it will attract significant attention, much of which could be negative. To be sure, voter-approval and earmarking the proceeds for local infrastructure initiatives are strong selling features that would generate support from many Albertans. But those voices could be easily drowned by the broader sentiment of provincial public opinion—a sentiment traditionally opposed to any consideration of a broad-based sales tax. While the idea of a small local penny tax has much to recommend it, the idea remains politically difficult and other administrative issues also arise.

The first problem is the lack of a provincial sales tax regime upon which to "piggy-back" a penny tax. For some, this may be reason enough to dismiss the idea outright. In our view, however, the lack of a provincial sales tax may complicate the implementation of a penny tax, but it does not rule out the option entirely. In fact, the concern may be largely irrelevant.

Conventional wisdom across the policy community asserts that any local sales tax—regardless of the province in view—should ignore the provincial sales tax regime entirely and tie directly into the federal GST. The reason is straightforward. The GST is a value-added tax (VAT) that exempts business inputs as goods and services move through production. This is not always the case under various provincial sales tax (PST) regimes. Value-added sales taxation is a more efficient form of sales tax. Therefore, whether or not Alberta currently has a PST is of little consequence.

This does not mean the province has no role. Matters of local governance and taxation are an area of exclusive provincial jurisdiction. As such, there are very real and practical limits on federal involvement without a specific request or approval from the province. From an administrative perspective, the province of Alberta would have to initiate and negotiate a sales tax agreement with the federal government similar to the Harmonized Sales Tax accords that already exist between Ottawa, Nova Scotia, New Brunswick, Ontario, Quebec, and Newfoundland and Labrador. Under these agreements, the federal government collects all federal and provincial general sales tax, and then remits the provincial portion. The provinces are free to employ that revenue for whatever purpose they see fit—including granting all of the tax revenue to various local governments.

It is conceptually possible for a local penny tax initiative in Alberta to follow the same pattern. From a federal perspective, the tax would amount to nothing more than another provincial sales tax, even though the revenue would end up in the municipal sector and the tax itself would have some unconventional features. The provincial perspective would be different. In the eyes of the province, the sales tax is a municipal tax with amounts remitted to local governments that have imposed the tax according to provincial processes and procedures.

A second problem concerns the *Alberta Taxpayer Protection Act*, which was passed by the province in the early 1990s. The act stipulates that before any general sales tax can be enacted in Alberta, the tax must be approved in a province-wide referendum. Whether or not a local penny tax falls under the act remains unclear. Certainly, one interpretation is that the sales tax referenced in the act is a provincial general sales tax and not a *municipal* penny tax initiated and approved by local voters. Under this interpretation, the Act could be said not to apply.

Another interpretation is that a local penny tax may not fall under the *letter* of the act, but it certainly falls under the *spirit* of the act. If the second interpretation carries the day, the act may effectively work against any proposal for a local penny tax. Even opening the door to the possibility may have to be submitted to a province-wide vote, which would have to be successful before a municipality could entertain the idea.

Of course, the province could amend the *Taxpayer Protection Act* to allow for a voter-approved penny tax. While the amount of political horsepower that would require is difficult to imagine, the province did manage to work around the legislative requirements to balance the books as stipulated by the *Balanced Budget Act*. Where there is a will, there is also a way.

Potential and Promise

There are a number of advantages to considering a small local penny tax for urban infrastructure, and why a broad-based value-added tax is the best choice over and above other taxes. First, there is certainly room within the tax base to accommodate a new sales tax initiative at the local level without seriously compromising tax competitiveness. Despite the objections that are sure to arise from opponents to the idea, a small 1% penny tax will not shatter tax competitiveness, particularly if the expenditures are dedicated to critical urban infrastructure, which is just as important to overall economic competitiveness as a competitive tax regime.

Second, broad based value-added sales taxes—like the federal GST and provincial HST—are among the most economically benign taxes possible. Sales taxes generally do the least amount of damage to the larger economy, particularly when stacked against other options such as the personal income tax, corporate income tax, capital gains tax, and taxes like the commercial and industrial property tax that are insensitive to profit and also target the productive capital of business. While specific selective sales taxes such as fuel taxes, restaurant taxes, lodging taxes, and tourism-related taxes are also an option, they carry a huge liability in that the tax base is narrow, and would require high rates of tax to generate the same revenue of a broad-based value-added sales tax with a very low rate of tax. A small but broad-based penny tax implemented through a process of voter approval and levied within an appropriate accountability framework with revenues earmarked for specific purposes would arguably be one of the best taxes going.

Third, the local focus makes the idea particularly attractive. Using the revenue of a new penny tax for infrastructure purposes does respond to concerns shared by many cities. But it is the local flavour and emphasis that may be even more important. The penny tax is a local sales tax initiated and levied through local action as opposed to top-down imposition. If local interest in certain infrastructure funding issues exceeds the larger federal and provincial commitment, then the local interest can be given the tax tools and resources to push ahead. This makes the option very attractive.

In issuing its report to the federal Minister of Industry, the Competition Policy Review Panel arrived at the same conclusion when it comes to broad-based value-added sales taxes, and argued that they were a superior form of taxation:

> From the standpoint of Canada's competitiveness, an overwhelming majority of economists and submissions to the Panel which dealt with this matter argue that priority should be given to the reduction of income taxes over consumption taxes because they are more conducive to business investment, which in turn improves productivity, creates jobs, and increases wages. The panel accepts and agrees with these submissions. (Government of Canada 2008).

Pitfalls and Problems

It is not possible to identify all the problems associated with a local penny tax initiative without considerable research effort. As such, the potential pitfalls identified here are limited to some brief initial perceptions on several challenges—both real and imagined. To some degree, the list also serves as an agenda for further work and research to develop the penny tax idea and bring more administrative coherency to the concept.

First, a penny tax attached to the federal GST base will require cooperation between the federal, provincial, and interested municipal governments. The federal government will have to assess administrative feasibility and the provinces will have to amend their enabling legislation that governs municipalities to allow for the use of a penny tax. While a lot certainly rides on a positive federal and provincial response, securing a useful answer to a largely hypothetical question is difficult. In the end, the only way to get a helpful read on the interest is to bring forward a formal request or proposal. To be sure, each province has its own potential administrative issues, whether that is the current sales tax debate raging in BC or the fact that Alberta currently has no broad-based sales tax (see Discussion Box 2, page 29).

Of particular concern is the administrative capacity of the Canada Revenue Agency (CRA). The penny tax we have described here is quite different than the standard GST, PST, or HST. All of these are levied province-wide and they continue year-over-year with little administrative change. But a penny tax would be in perpetual motion—new taxes coming on here, existing taxes lapsing there, and perhaps different rates of tax applying all over. Can the tax superstructure managed by the CRA administer such a complex and fluid tax? In other words, a penny tax may be conceptually possible, but is it practically and administratively feasible?

While there are no easy answers, past research by the Canada West Foundation does crack the window on the matter. The Canada Revenue Agency maintains several electronic databases on the federal and provincial personal income tax systems and the GST/HST. The agency also publishes data in various statistical compendiums. With respect to the GST/HST, revenues are broken out by province, provincial GST office, industry class, accounting system, filing period, corporate structure, and many other variables. All of these data are drawn from one primary source—millions of individual GST/HST registrants with their own GST registration number and the detailed information linked to that number. Each particular piece of information for each GST/HST registration number is then aggregated to produce the databases and various compendiums. Given all this, it certainly appears possible to isolate all GST registrants within a specific geographical area and then levy a penny tax.

Second, defining the various local taxing regions could require more than a little effort. Unlike the county system in the US, Canada has no regional or local governing entities that go beyond the traditional urban and rural municipality. As already noted, local sales taxes need to be applied across a sufficiently large region. Local sales taxes have the potential to produce economic distortions by shifting retail sales activity and consumer behaviour. One strategy to counteract this potential distortion is to apply a local option sales tax across entire city-regions as opposed to a single municipality. In connection with this, the tax rates must be kept low. Local sales taxes with relatively low rates of tax provide less incentive for consumers to shift their behaviour and for local governments to engage in destructive tax competition.

In the US, county governments easily fill this larger regional role, but the same does not exist in Canada. There are, however, at least some concepts that can serve as a useful spatial starting point. For example, most of the discussion over any local sales taxes has been restricted to the large cities, each of which serves as the anchor for a much larger city-region whose economic and social integration is recognized through Statistics Canada's Census Metropolitan Area (CMA) and Census Agglomeration (CA) designations. These two concepts capture into one city-region a number of urban and rural municipalities that exist in close proximity with strong geographic, demographic, economic, and social linkages. When it comes to identifying a sufficiently large city-region for local sales tax purposes, the CMA and CA designations are one possibility. Another possibility is to draw the regions around emerging entities like the Calgary Regional Partnership, the Capital Regional District in Victoria, the Greater Vancouver Regional District in the BC lower mainland, or the Edmonton Capital Region.

Third, some are sure to make the case that now may not be the best time for a new municipal tax initiative, regardless of the merits. One of the factors driving consideration of a penny sales tax is the large infrastructure funding liability and the diminished capacity of the federal and provincial governments to fund additional infrastructure within the current budgetary parameters. Yet, the economy that is restricting the fiscal capacity is the same economy that does not now need another tax imposed upon it. When the federal government followed through with its final GST rate reduction in January 2008, it was easy for the Prime Minister to hint that the provinces might want to pick up the vacated tax room. Today, those very same GST cuts have assumed a different status. The tax cuts are now seen and defended as coinciding nicely with an unanticipated economic slow-down, shoring up consumer confidence and stimulating aggregate demand. Given the current economic situation, any proposal to pick up some of that sales tax room will almost certainly draw criticism.

Conclusion

Western Canada's seven largest cities face an infrastructure funding shortfall that runs into the billions. Across the next ten years, the combined funding shortfall to maintain, renew, and rehabilitate existing infrastructure and invest in new infrastructure to accommodate growth is reported at $4.2 billion annually. A small local penny tax to continue funding our critical urban infrastructure represents a fresh, creative, and innovative policy response to a growing economic and social liability. The idea is conceptually possible, strategically desirable, and administratively feasible.

At first glance, the idea may seem to be more than a little problematic politically. But, much hinges on the features incorporated into a local penny tax—features that would build the most visible, transparent, and accountable tax in Canada. There is no reason to suspect that public support cannot be found for a penny tax that were voter-approved, with the tax rate capped, the revenues earmarked clearly for critical infrastructure investments, and any excess revenues rebated back to taxpayers in the form of property tax reductions. Support would also be strengthened if the tax were to automatically sunset after a prescribed period of time and governments were to provide voters and taxpayers with regular, comprehensive, and audited reporting on the usage of the tax revenue.

Previous Canada West Foundation research on local finance and infrastructure issues has been international in scope, spanning North America, Western Europe, Southeast Asia, and Australia. Across the globe, local governments are demonstrating a high capacity for innovation, not only on the expenditure side of their capital budgets but on the revenue side. The search for optimal infrastructure funding tools should not be restricted to historical Canadian practice. There is much to learn and appreciate from the approaches taken in other countries. A small local penny tax is one such approach that represents a timely tax innovation that can do much to boost our civic investments.

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