

A Fiscal Federalism Framework for Financing Infrastructure

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Introduction

- ▶ Canada alleged to have serious infrastructure deficit, but evidence limited
 - ▶ Congestion, crumbling bridges, rail lines, class sizes, wait lists, contaminated water, flood vulnerability
 - ▶ Productivity of public infrastructure
- ▶ Focus instead on implications of decentralized responsibility for infrastructure
 - ▶ Does decentralization lead to under-provision of infrastructure?
 - ▶ How should intergovernmental fiscal arrangements address infrastructure?
- ▶ Surprisingly little guidance in fiscal federalism literature

Begin with outline of current arrangements

Then turn to fiscal federalism context

Assignment of Responsibilities

- ▶ Federal government responsible for interprovincial transport, defence establishments, First Nations infrastructure, pipelines and telecommunications
- ▶ Provinces responsible for provincial roads, intercity transit, schools & hospitals; oversee municipal infrastructure
- ▶ Municipalities responsible for roads, buses, garbage and sewage, water, libraries, recreation facilities
- ▶ Provinces & municipalities responsible for local works other than those extending beyond a province, and those declared by Parliament to be of general advantage to Canada
- ▶ Sections 36(1), 36(2) commitments relevant: equal opportunities, economic development, essential public services, equalization
- ▶ Efficiency in internal economic union a national objective

Sources of Finance

- ▶ Infrastructure spending highly decentralized
 - ▶ In 2005, 58% of public capital stock in Canada was local, 30% provincial, and 12% federal
 - ▶ 1961 to 2005, importance of local infrastructure increased dramatically; federal & provincial shares declined
- ▶ Provincial & federal infrastructure financed from general revenues & borrowing
- ▶ Municipal infrastructure financed by current revenues, reserves, grants, and borrowing
- ▶ Municipal long-term borrowing permitted only for capital; tightly controlled by province
- ▶ Own-source revenues important for provinces & municipalities: modest vertical gaps
 - ▶ Provinces obtain 24% of revenues from federal transfers, mostly unconditional
 - ▶ Municipalities receive modest provincial transfers, mostly conditional

Provincial and Municipal Taxing Powers

- ▶ Provinces have unrestricted taxing & borrowing powers, constrained by tax room occupied by federal government
- ▶ Decentralization of revenue-raising has consequences
 - ▶ Could jeopardize tax harmonization
 - ▶ Increases horizontal imbalance, which strains Equalization
 - ▶ Reduces long-term insurance against regional shocks
 - ▶ Affects federal use of spending power and moral suasion
- ▶ Municipalities rely relatively heavily on property taxes supplemented by user fees, licenses, permits, and other property charges
- ▶ Provinces control municipal assessments, municipalities set the general property tax rate, constrained by ability to levy differential taxes
- ▶ Municipalities constrained by need to run balanced operating budget and lack of other major own source revenues

Federal-Provincial Transfers

1. Equalization

- ▶ Both provincial and municipal property taxes are included
- ▶ Significant horizontal imbalances remain: resource-rich provinces not equalized down
- ▶ Needs for infrastructure not equalized, but revenues are

2. Social transfers: CHT/CST

- ▶ Equal per capita transfers, so net revenue-equalizing except for resource revenues
- ▶ Mainly serve to fill vertical fiscal gap, but growth rate less than growth of provincial spending
- ▶ No distinction between current and capital program costs

3. Specific-purpose transfers, relatively small

4. Infrastructure transfers

- ▶ NBCF 2014-2024: \$10bn Provincial-Territorial Infrastructure Component (PTIC) plus \$4bn National Infrastructure Component (NIC)
- ▶ \$10bn Gas Tax Fund (GTF)
- ▶ Canada 150 infrastructure fund (\$150mill)

Infrastructure Transfers: Further Details

- ▶ PTIC: equal per capita based on prov requests for prov & mun projects that contribute to objectives related to economic growth, a clean environment and stronger communities; cost-shared with provinces, municipalities, P3s, non-profits
- ▶ NIC: for mainly transportation projects of national significance; cost-shared
- ▶ GTF: equal per capita to provinces for municipal infrastructure
- ▶ Accountability: Up-front application and back-end provincial-municipal reports
- ▶ Feds do not deal directly with municipalities, but influence via criteria
- ▶ Canada 150 infrastructure fund: once-off program to renovate municipal facilities
- ▶ 2015 Federal Budget: 2017-18 annual \$1bn infrastructure fund for private-public partnerships

Provincial-Municipal Transfers

- ▶ Equalization transfers to municipalities of variable effectiveness, mostly revenue-based
- ▶ Some grants to finance infrastructure, typically specific to certain items
- ▶ Limited unconditional transfers

Turn now to fiscal federalism considerations in financing infrastructure

Starting point is **principle of subsidiarity**: in absence of compelling contrary arguments, vest decisions in lowest level of government

Federal Role in Financing Provincial Infrastructure

1. Provincial infrastructure spending may have spillover effects, but these can be positive or negative
 - ▶ Positive: Shared-cost harmonizing grants; block conditional grants; user fees; out-of-province reimbursements
 - ▶ Negative: Expenditure competition for province-building, exacerbated if fiscal capacities differ
2. Section 36(1) of the Constitution: Equalization and social transfers, regional development agencies, NIC grants, federal infrastructure (Dodge)
3. Efficiency in internal economic union and international trade
4. Case for federal infrastructure grants limited, given provinces' incentives to invest in infrastructure
5. Vertical fiscal imbalance may constrain ability of provinces to finance infrastructure; but, addressed via general transfers

Provincial Role in Financing Municipal Infrastructure

- ▶ Beneficial spillovers addressed by provincial grants, regulations and supervisory oversight address that, amalgamation
- ▶ Much municipal infrastructure benefits local residents and businesses: No systematic incentive to invest too little
- ▶ Shortage of municipal infrastructure due to ongoing tendency for urbanization and (im)migration: backlogs
- ▶ Perceived shortage of discretionary finance: but, studies show that there is room for property taxes and user fees to provide sufficient finance for municipal expenditures
- ▶ Property tax may be relied on too heavily, especially for education and social services, and especially for bigger cities with growing infrastructure needs
- ▶ Case for more municipal revenue tools rather than infrastructure grants

Further Issue facing Municipalities

Municipal infrastructure financing constrained by vertical fiscal imbalance

- ▶ Downloading of financing of provincial public services to property tax (education, social services)
- ▶ Tendency for federal government to pass on fiscal deficits to provinces has parallel at provincial-municipal level
- ▶ Provincial-municipal transfers not systematically equalizing in all provinces: Municipalities with the most needs and costs are most financially stretched
- ▶ Lack of municipal fiscal discretion and access to more flexible revenue sources detract from ability to respond to infrastructure needs in a timely fashion (although it mitigates soft-budget constraint), and from local fiscal accountability

Federal Role in Financing Municipal Infrastructure

- ▶ Federal government better able to deal with municipal vertical imbalance than provinces
- ▶ Large municipal infrastructure investments may be engines of national growth
- ▶ But, direct dealings between federal government and municipalities undermine accountability to province
- ▶ Accountability between municipality and federal government constrained by distance and absence of day-to-day interaction
- ▶ Direct transfers from federal government to municipalities are not necessary to achieve national objectives; transfers via the provinces can be effective and accountable
- ▶ Federal involvement in municipal infrastructure has led to a waste of resources, additional administrative costs; accountability involves municipalities filing reports on how the funds are spent and verifying that these expenditures adhere to the federal governments terms of reference

Further Issue affecting Arguments for Transfers

Pricing/taxing of municipal services

- ▶ Discussion of infrastructure deficit does not take account of consequences of proper pricing of municipal infrastructure
- ▶ Efficient pricing complicated by scale economies, differential demand, capacity constraints, externalities/second best
- ▶ Purpose of pricing should be to establish link between services received and charge or tax for them
- ▶ Infrastructure grants should be conditional on implementation of efficient pricing and taxation policies at municipal level

Issues with the Current Arrangements for Financing Infrastructure

- ▶ Equalization, CHT/CST do take account of infrastructure and municipal spending
- ▶ Transfers may be inadequate if there is vertical fiscal imbalance: VFI causes crowding out of infrastructure spending by growth in public services: suggests adjustment in tax room and general transfers, not infrastructure grants
- ▶ Horizontal imbalance strains infrastructure for have-not provinces: province-building by resource-rich provinces
- ▶ Infrastructure investments delivered by provinces may serve a national purpose: spillovers, equity, opportunity, regional development (Sec 36(1)), antidote to Dutch disease?, internal common market and external trade infrastructure
- ▶ In general, provinces have strong incentives to provide infrastructure, if they can finance it

Two General Observations

Hard to support Premiers argument for permanent infrastructure-specific grant over and above the all-purpose grants that already exist. To the extent there is vertical imbalance, better to address it by tax room &/or general transfers

One possible argument of infrastructure shortage: short-sightedness of provincial/municipal politicians leads to underinvestment in infrastructure. Then, infrastructure grants act as commitment device. (This relies on federal politicians being more far-sighted than provincial/municipal)

Municipal Infrastructure Issues

- ▶ Vertical imbalance given reliance on property taxes, constraints on borrowing, limited access to broad-based tax
- ▶ Infrastructure relatively more important for municipalities than provinces
- ▶ Significant spillover benefits that might warrant provincial conditional grants
- ▶ Horizontal imbalances within provinces because of inadequate equalization systems
- ▶ Funding municipal infrastructure by borrowing works well; relatively immune to soft-budget constraint problems
- ▶ Should federal government act as banker for municipal infrastructure? Hard to imagine how this could occur without the federal government exercising approval and oversight over the municipal projects it finances

Implications for Intergovernmental Fiscal Arrangements I

- ▶ Governments have ample incentives and constitutional right to invest in needed infrastructure
Exception: spillovers, national efficiency/equity objectives
- ▶ Most provincial infrastructure needs could be financed by own-source revenues, borrowing and unconditional transfers (Equalization, CHT/CST)
- ▶ Most municipal infrastructure projects could be financed by own-source revenues (incl. user fees), borrowing and conditional provincial transfers
- ▶ Provincial/municipal infrastructure deficits largely reflect vertical imbalance, and can be addressed by some combination of transfers and tax room
- ▶ Vertical imbalance growing over time: Tie growth of social transfers to average rate of growth of social program spending

Implications for Intergovernmental Fiscal Arrangements II

- ▶ Equalization system leaves considerable horizontal imbalance because of resource revenues, leading to differential ability to provide infrastructure
- ▶ Provincial-municipal vertical imbalance harder to address because of constraints on municipalities
 - ▶ Additional sources of revenue for large municipalities: other taxes, user fees
 - ▶ Less reliance on property taxes for education and social services
 - ▶ Better needs-based municipal equalization systems
- ▶ Infrastructure projects of national interest
 - ▶ Improve efficiency in the internal economic union
 - ▶ Contribute to national growth, productivity, innovation
 - ▶ Improve equity in social union (equality of opportunity, regional development)
 - ▶ Often best delivered by provinces or municipalities supported by project-specific cost-sharing grants, rather than broad, dedicated infrastructure grant

Concluding Remarks

- ▶ Principle of subsidiarity supports high degree of decentralized responsibility for infrastructure
- ▶ Local infrastructure financing and provision not constrained by fiscal competition problems
- ▶ Federal government provides largely unconditional transfers to provinces that can be used for financing infrastructure
- ▶ Case for federal infrastructure transfers to municipalities limited to instances where there is clear national benefit
- ▶ Provincial transfers to municipalities tend to be more conditional and insufficiently equalizing
- ▶ Difficulties lower levels of government have in financing infrastructure attributable to vertical fiscal imbalance
- ▶ Room for expanding user fees at the municipal level and giving large cities access to additional taxes accompanied by provincial-municipal needs equalization