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CANADA'S INFRASTRUCTURE DEBT – PART II: ADDRESSING THE INFRASTRUCTURE SHORTFALL

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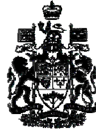

CANADA

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CANADA'S INFRASTRUCTURE DEBT – PART II: ADDRESSING THE INFRASTRUCTURE SHORTFALL

INTRODUCTION

As *Canada's Infrastructure Debt – Part I: Assessing the Infrastructure Shortfall*(1) documents, there is a general consensus that Canadian governments have underinvested in infrastructure renewal over the past several decades. The issue is complicated by the fact that municipalities – which are responsible for much of the country's infrastructure – do not possess the financial capability to address infrastructure needs.

While there exists general agreement that more funding is required to address this problem, finding the money to pay for an estimated $60-billion cumulative infrastructure shortfall poses major difficulties, notably that while the federal government's finances are in relatively good shape, provincial/territorial and municipal governments as a whole are facing the prospect of running deficits. The federal government continues to post large surpluses (reaching $9.1 billion in 2003-2004), but new spending commitments such as the $41 billion over 10 years for health care that was announced in September 2004, and potential increases in equalization payments to the provinces, could reduce the size of the surplus available to other initiatives such as infrastructure renewal. As well, municipalities, for reasons that will be discussed below, lack the ability to raise the funds needed to address infrastructure needs.

In response, several possible funding solutions have been suggested, ranging from transferring part of the 10-cents-per-litre federal excise tax on gasoline to the municipalities for infrastructure investment, to undertaking debt financing. Groups proposing these ideas have also remarked on a need for any investment to be accompanied by a long-term, planned commitment to infrastructure renewal.

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(1) Blayne Haggart, *Canada's Infrastructure Debt – Part I: Assessing the Infrastructure Shortfall*, PRB 04-33E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, June 2004.

This paper is divided into three parts. The first outlines the difficult fiscal situation faced both by municipalities (and, to a lesser extent, the provinces and territories) and by the federal government. The second examines the major funding alternatives proposed by those involved in the infrastructure debate, namely allocating a portion of the gas tax to infrastructure, larger infrastructure funding grants, public-private partnerships and deficit financing. The paper concludes with some general remarks.

FINANCIAL SITUATION

A. Municipal Finances

Simply put, municipalities – which are responsible for maintaining much of Canada's infrastructure – do not have the fiscal capacity to invest more in infrastructure. Years of downloading services on the part of the provincial/territorial and federal governments have left municipalities responsible for much more than they were a couple of decades ago, with no commensurate increase in their revenue-raising abilities. According to a June 2004 report by Statistics Canada, local governments "accounted for 56% of infrastructure investment by all three levels of government in 2003," followed by the provincial/territorial governments (23%) and the federal government (21%).(2) As an April 2002 TD Economics report noted: "Social housing, water systems, sewers, roads and public transit systems all require re-investment, but cash-strapped municipalities are in no position to deliver."(3) Furthermore, according to Statistics Canada, between 1988 and 2003 municipal governments allocated "more of their expenditure growth away from infrastructure and towards paying for more immediate costs."(4)

Furthermore, as Figure 1 indicates, municipalities' share of infrastructure investment is rising, while that of the other levels of government is falling.

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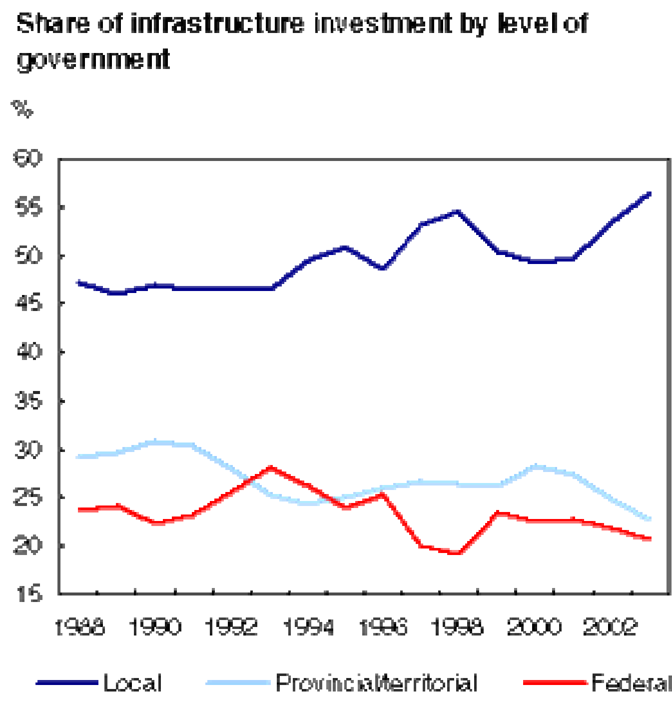
(2) Statistics Canada, "Government finance, 2003/04," *The Daily*, 18 June 2004, www.statcan.ca/Daily/English/040618/d040618a.htm.

(3) TD Economics, "A choice between investing in Canada's cities and disinvesting in Canada's future," 22 April 2002, p. 2, www.td.com/economics/special/db_cities0402.pdf.

(4) Statistics Canada (2004).

Figure 1



Source: Statistics Canada

Municipalities have been limited in their ability to provide adequate infrastructure investment for two reasons. First, transfer payments from other levels of government have not kept pace with spending demands. According to Statistics Canada, between 1988 and 2003 municipalities have seen transfer payments from other levels of government rise only marginally, from $6.2 billion to just under $8.1 billion. Over the same period, transfer revenue as a share of total municipal revenue fell from 23% to 16%.(5)

Second, most provinces/territories limit municipalities' revenue-raising tools to the property tax. As the Canadian Urban Transit Association (CUTA) has remarked to the House of Commons Standing Committee on Finance, road user fees and local taxes on parking spaces or hotel rooms "are generally not available to municipalities under the terms of provincial empowering legislation."(6) Based on the assessed value of properties, property taxes are a

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(5) *Ibid.*

(6) Canadian Urban Transit Association, "Investing in public transit for Canada's future," submission to the House of Commons Standing Committee on Finance, September 2003, p. 5.

regressive form of taxation: their revenues do not increase along with economic growth. According to TD Economics: "Between 1995 and 2001, local government revenues edged up by only 14% – a fraction of the gains of 38% and 30% reaped at the federal and provincial levels. This has left cities singularly ill-equipped to cope with the responsibilities being downloaded to them."[7] Because property taxes are only weakly linked to ability to pay, it is difficult for governments to increase property tax rates in order to raise revenue.

The TD Economics report suggests several ways in which municipalities could improve their revenue-raising situation within the current system. These include: more closely aligning property taxes with service-delivery costs; reducing the overtaxation of commercial properties relative to residential properties, downtown properties to suburban properties, and rental housing to owner-occupied housing; and bringing user charges more in line with the marginal cost of service provision. It also suggests that cities use more flexible labour contracts "to facilitate the contracting out of services to the private sector, when stringent cost and standards tests are met."[8]

While some of these solutions may help at the margin, they are unlikely to yield $60 billion in savings or new revenues. To take one example: the Canadian Urban Transit Association claims that Canadian urban transit systems already recover 62% of their total operating costs from fare revenue, compared with 55% in France, 44% in Sweden, 41% in the United States and 28% in the Netherlands. As a result, in urban transit, there is "no fat left to cut."[9]

B. Federal Government Finances

In the current debate over infrastructure funding, the underlying assumption has been that the federal government will be the main source of funds. As noted above, municipalities cannot alleviate the infrastructure shortfall without additional sources of revenue. Furthermore, according to the Conference Board of Canada, non-federal government finances are likely to be in a deficit position in most of the years to 2020, given current spending and revenue patterns, though GDP growth is likely to reduce non-federal government debt-to-GDP to

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(7) TD Economics (2002), p. 17.

(8) *Ibid.*, p. 3.

(9) Canadian Urban Transit Association (2003), p. 6.

15.9% in 2015, from 22.7% in 2001.(10) As a result, barring tax increases, provincial and municipal finances are likely to face greater constraints than federal finances.

The Conference Board, however, has suggested that if the federal government maintains its current revenue and spending levels, it will not be able to finance the $60-billion shortfall without raising taxes or running a budgetary deficit. According to the Board's calculations, after meeting the priorities listed in the 2003 federal budget – health care, education, national defence, overseas development assistance, infrastructure,(11) the environment and federal debt reduction, there is very little money left over to meet either new priorities or increased spending on existing priorities (e.g., infrastructure):

> We created a scenario in which the level of municipal capital spending was increased by $3 billion in 2004, and then by $6 billion from 2005 to 2012, and finally by another $3 billion in 2013, for a cumulative total increase of $54 billion. Increased transfers from the federal government financed this spending, in the process lowering the federal surplus (minus the $3 billion contingency) to an amount below the non-federal government deficit in every year except 2004. Affordability thus becomes an issue: infrastructure renewal cannot be financed out of expected future federal government surpluses, forcing some more difficult decisions if this policy priority is to be addressed.(12)

The Conference Board concluded that addressing the infrastructure debt would lead to an all-government deficit of "roughly $3.1 billion per year on average over the 2004-13 period."(13) This forecast, as noted, assumes no increase in tax rates or revenue.

This prognosis assumes continued economic growth, and that the federal government will not continue to post larger-than-expected surpluses, or that, if it does, these extra funds will be used to reduce the federal government's accumulated deficit, as has happened in the past. In every year since the federal government began posting budgetary surpluses, the

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(10) Conference Board of Canada, *Performance and Potential 2003-04: Defining the Canadian Advantage*, Ottawa, 2003, p. 122. The declining debt-to-GDP ratio for non-federal governments suggests that there is some room for deficit financing should provinces/territories wish to maintain their debt-to-GDP ratio at 22.7%.

(11) The 2003 federal budget allocated $3 billion in infrastructure funding over 10 years.

(12) Conference Board of Canada (2003), p. 12.

(13) *Ibid*., p. 129.

government has underestimated future surpluses by several billion dollars. Were this trend to continue, these unanticipated surpluses could be used to fund infrastructure investment.

POSSIBLE FUNDING SOLUTIONS

As the Conference Board of Canada remarks:

> If infrastructure is to receive the attention it requires, some difficult policy decisions will need to be made. The possibilities range from tax increases, perhaps in combination with spending cuts in other areas, to a consideration of alternative models for building, financing, and operating public infrastructure … .(14)

To date, there have been few requests for increased taxes (even from those groups calling for increased infrastructure spending), or for cuts to non-infrastructure programs, or deficit financing (another option suggested, but not recommended, by the Conference Board). Instead, attention in this debate has focused on two tax measures. First, the federal government has discussed allocating a portion of the federal excise tax on gasoline to municipalities' infrastructure needs, and general increased funding to various infrastructure plans and projects. Second, the 2004 federal budget fully exempted municipalities' purchases from the GST, the expectation being that municipalities would use the estimated $7 billion in savings over 10 years to fund infrastructure investment. To the extent that these two main options reduce revenues available for other federal government priorities, it is difficult to avoid the Conference Board's conclusion that "difficult policy decisions will need to be made" unless actual federal budgetary surpluses are higher than anticipated by the federal government.

Finally, because infrastructure investment is a long-term initiative, it will require long-term planning, in order to assure that funds are used appropriately.

The following sections discuss some of the options that have been suggested to the federal government to increase funding to infrastructure projects.

A. Excise Tax on Gasoline

The federal government charges a 10-cents-per-litre excise tax on gasoline. In 2002-2003, this tax raised $4.5 billion in revenue. Many groups have called for portions of this tax to be used either for general municipal infrastructure projects or for more specific, targeted

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(14) *Ibid.*, p. 130.

uses, such as Canada's National Highway System and/or public transit. The Federation of Canadian Municipalities' (FCM) proposal to divert 5 cents of this excise tax to municipalities' infrastructure needs is typical of the proposals that have been suggested. Such a diversion would equal about $2.25 billion in infrastructure-targeted revenue. According to the FCM, this revenue "would dovetail with municipal requirements, especially road, transportation and transit infrastructure."[15]

Many groups and politicians have received this proposal favourably, though exactly how such a revenue-sharing scheme would work is unclear and would depend on addressing the reality that cities are the constitutional responsibility of the provinces/territories.

Leaving aside constitutional issues, several financial issues would have to be addressed with respect to the gasoline tax. First is the allocation of the revenues. Sharing the gas tax among communities on a per capita basis would disadvantage small, rural and remote communities, who may not enjoy the economies of scale in infrastructure projects realized by larger communities. Indeed, the Association of Yukon Communities has voiced its disapproval of the gas-tax proposal, claiming that "the projected dollar value received by northern, rural and remote communities is too small to bother calculating."[16] To address the problem of inequitable distribution, the FCM has recommended that each province/territory receive a base 1% of the gas tax (for a total of 13%), with the remaining 87% to be distributed on a per capita basis.[17]

Second, with an accumulated infrastructure shortfall of an estimated $60 billion, which, according to TD Economics, is rising at a rate of $2 billion per year,[18] the $2.25 billion that would be raised by the gas tax would be enough to halt the increase in the infrastructure debt, but would only partly address the outstanding shortfall. The only possible conclusion is that additional funds would still be required, though the FCM claims that a dedicated gas tax would, in time, reduce the need for extra infrastructure grants.

This argument leads to the third issue. Presumably, this $2.25 billion is currently being used to fund other federal government programs. Assuming that federal government

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(15) Federation of Canadian Municipalities, "A new deal for community prosperity and well being," submission to the House of Commons Standing Committee on Finance, September 2003, p. 6.

(16) Association of Yukon Communities, 2003 pre-budget submission to the House of Commons Standing Committee on Finance, 5 August 2003, p. 8.

(17) Federation of Canadian Municipalities (2003), p. 7.

(18) TD Economics, p. 15.

projections regarding the size of the budgetary surplus turn out to be accurate, diverting $2.25 billion from federal revenues would entail program spending cuts, or tax increases, or deficit spending. If, however, federal budgetary surpluses continue to surpass official estimates, it is possible that this $2.25 billion could be financed partly or wholly out of surpluses without any other changes.

B. Grants and Programs

As the previous section suggests, allocating a share of the federal excise tax on gasoline to the country's infrastructure needs could halt the decline in the country's infrastructure, but it would not completely address the existing infrastructure spending shortfall.

Despite the recent infrastructure spending announcements – $3 billion over 10 years in the 2003 federal budget, for example – the federal government's infrastructure spending program has been criticized for lacking overall direction, and for being too short-term to allow for the planning needed for infrastructure investment, which is inherently a long-term proposal. Suggestions included a long-term (10-year) National Infrastructure Policy targeting both municipal infrastructure and Canada's National Highway System, and a National Highway Program designed to revitalize, maintain and, if required, expand the National Highway System to an internationally competitive standard. The Association of Consulting Engineers of Canada has called for the establishment of "a National Round Table for infrastructure, bringing together all relevant stakeholders to advise the government in the development of a comprehensive, multi-year National Infrastructure Action Plan, and [the commitment of] stable funding to implement the plan."(19) Echoing this proposal, the Canadian Council of Professional Engineers recommended a well-coordinated strategy that included funding to:

- catalogue and assess infrastructure inventories;
- identify risks and priorities;
- support lifetime costs for maintenance and repair of critical infrastructure; and
- implement innovative solutions and technologies to promote greater longevity, safety and value.(20)

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(19) Association of Consulting Engineers of Canada, "The second national debt: Canada's growing infrastructure challenge," submission to the House of Commons Standing Committee on Finance, 2 September 2003, p. 2.

(20) Canadian Council of Professional Engineers, "Brief to the Standing Committee on Finance regarding the federal government's pre-budget consultation process," 25 September 2003, p. 4.

As well, the Coalition pour le renouvellement des infrastructures du Québec advocated new administrative arrangements among the three levels of government to gain greater efficiencies, and suggested that infrastructure investment "will have to focus on the upgrading of existing facilities and infrastructures rather than compliance with new standards or the construction of new facilities, two objectives that are bound to also require considerable investment in the years ahead."(21)

Finally, grant and/or program spending commitments could be made in the form of tied transfers to the provinces/territories.

C. Public-Private Partnerships

Public-private partnerships (PPPs) have also been suggested as a way for governments to undertake needed infrastructure projects without spending much public money. Generally speaking, PPP proponents say that bringing in the private sector can be beneficial if government financing is not available for infrastructure projects, and can provide expertise and know-how governments may not possess.(22) Conversely, opponents of PPP(23) projects point out that governments can usually obtain better financing terms than private-sector firms because they generally have better credit ratings. As for cost advantage, it can be argued that the profit margin expected by private firms could either increase the cost of a project or divert funds that could otherwise be used for long-term maintenance. Finally, those who favour public-sector involvement suggest that public-sector ownership provides stability, since the public sector is focused on the long term, not the short term.

Indeed, while the Conference Board of Canada recommends that governments examine public-private partnerships for infrastructure renewal in the short run because of "the urgent need for infrastructure renewal and the limited capacities of governments to meet the entire shortfall with projected tax revenues," it does not advocate PPPs "as a primary strategy and certainly not as a panacea. To the contrary, the Canadian experience with PPPs has been

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(21) Coalition pour le renouvellement des infrastructures du Québec, "Mémoire présenté au Comité permanent des finances de la Chambre des communes, lors des audiences publiques sur les consultations prébudgétaires," September 2003, p. 3.

(22) Conference Board of Canada (2003), p. 14.

(23) See, e.g., Canadian Union of Public Employees, submission to the House of Commons Standing Committee on Finance pre-budget consultations, September 2003.

both ad hoc and mixed. There are serious issues of accountability and performance, and moreover, the success of PPPs for capital projects can be evaluated only over a long period of time."[24]

D. Debt Financing: The Borrowing Option

Over the past decade, borrowing to finance government operations has become anathema at all levels of Canadian government. This taboo is a political phenomenon (emerging partly from the large deficits the federal government ran in the 1970s, 1980s and part of the 1990s) that does not extend to consumer or business finance, where debts are incurred regularly, and where concerns are centred on borrowing size and purposes, not the fact of borrowing itself.

Regarding the wisdom of government borrowing, three important points should be noted:

- The absolute size of a country's (or individual's or business') debt is not as important as is the country's ability to service this debt, as measured by a country's net debt-to-GDP when discussing its indebtedness.

- There is no optimal debt-to-GDP ratio. As with personal finances, debt service payments simply represent the cost today of a purchase/investment made in the past; the level of debt service is a matter of choice.

- Not all debt-financing is created equal. Countries – as well as individuals and businesses – can make good debt-financing decisions and bad ones. As a rule of thumb, borrowing to finance current consumption merely moves to today consumption that would otherwise happen tomorrow. Borrowing to invest in something such as a highway – a good that will contribute to economic activity for years to come – yields a return that can be measured against the interest paid on the funds borrowed. In cases where investments yield returns over several years, interest payments can be seen as the price paid by future generations to enjoy an investment made today.

Projects funded through infrastructure investment typically occur over long periods of time during which they themselves support and promote economic activity. Public infrastructure investment encourages private-sector investment in the economy, contributing to economic growth.[25] As such, infrastructure investments – chosen wisely – can yield a stream of

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(24) Conference Board of Canada (2003), p. 14.

(25) For a discussion of this and related issues, see *Canada's Infrastructure Debt – Part I: Assessing the Infrastructure Shortfall*.

economic benefits typically lasting several years. An economic argument can therefore be made to support government borrowing in the service of sound infrastructure investments in much the same way that it makes sense for an individual to take out a mortgage on a property that he or she expects to live in for several years.

E. Provincial Options

The infrastructure problem is complicated by jurisdictional issues: cities are the constitutional responsibility of the provinces/territories, but it is the federal government that has the greatest financial room to manoeuvre. This reality prompted the Conference Board of Canada's conclusion that the federal government will ultimately have to finance any new infrastructure creation/maintenance.

The proposals presented in the previous sections of this paper assume the federal government would take a more or less direct role in addressing the infrastructure shortfall. Two other possibilities exist, however. Provinces/territories could either raise revenues on their own (through taxes or deficit financing) or provide municipalities with greater taxation powers. As well, the federal government could increase transfer payments, in the form of tax points or cash transfers, to the provinces/territories; this approach is related to the grants option, though the funds would be provided with no conditions attached.

Both approaches have the benefit of eliminating jurisdictional issues, though both also suffer from economic and political drawbacks. The first option – raising taxes or deficit financing – encounters the familiar problem of the ability and willingness of provincial/territorial citizens and businesses to pay higher taxes or allow their government to post deficits. Moreover, Canada's smaller provinces and territories might find it impossible to raise enough new revenue to pay down the infrastructure debt. The second option, meanwhile, raises concerns about accountability among the different levels of government, notably the possibility that transfer funds intended for infrastructure renewal but provided without conditions attached could be spent in non-infrastructure areas.

CONCLUSION

Infrastructure represents the physical foundation of society's prosperity and well-being. Without adequate and well-maintained roads, water treatment facilities, and electricity-generating and transmission systems, a country cannot provide the quality of life its citizens want

and deserve. Canada's aging infrastructure and lack of investment in it over several decades have left the country with an infrastructure shortfall that will require high and sustained levels of investment, and the general consensus is that current funding levels are not adequate to the task.

With municipalities lacking the ability to fund infrastructure renewal and provincial/territorial budgets strained by education and health spending requirements, citizens and other levels of government have turned to the federal government for financing, mainly through the suggested allocation of a portion of the 10-cents-per-litre excise tax on gasoline to municipal infrastructure needs. It is likely, however, that more funding will be needed. While innovative program structures such as public-private partnerships may relieve pressure in the short term, according to the Conference Board of Canada they do not seem to promise a comprehensive, long-term solution.

Should the federal government continue to post larger-than-forecast budgetary surpluses, these surpluses (above and beyond the Contingency Reserve and any economic prudence measure) could be used to fund the infrastructure shortfall. In the absence of these surpluses, addressing the infrastructure shortfall will require one or all levels of government to increase taxes, reduce program spending in other areas, undertake deficit financing, or implement a combination of all three.