

**Cost-sharing in Canada
and in the United States**

Selected Examples and Observations

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Introduction

After looking thoroughly at the two-tier system in Canada and the United States, we came to the conclusion that, although there are some interesting cost-sharing arrangements within two-tier governance systems, cost-sharing primarily takes place elsewhere, either through intermunicipal agreements or—and that’s where we found the most interesting and complex arrangements—at the regional level. The main reason why two-tier systems don’t offer much in terms of cost-sharing best practices is because in most states, the upper tier acts no differently than the local municipality. Although responsibilities undertaken by counties vary considerably from one state to another, the financial and fiscal relationships between counties and municipalities are usually rather limited as each tier has its own revenues and functions. In addition to counties and municipalities, special purpose districts are created and granted their own tax levies. They are responsible for local or regional services, such as water treatment and waste management. Their importance and number vary from one state to another, which makes it difficult to identify major trends applicable to the whole US system of local governments.

Consequently, we have found some innovative models of cost-sharing arrangements for regional services in Canada and in the United States outside of two-tier municipalities. For example, regional transit is a responsibility for which local governments tend to enter into expenditure sharing agreements extensively. It should be noted that our research does not pretend to be a comprehensive list of cost-sharing best practices and tries not to overlap with the content of the previous document on fiscal co-operation. However, it presents some interesting models in place, both in Canada and in the US. Thus, we have been able to separate our examples into three distinct categories: 1) regional services’ costs charged to local municipalities; 2) regional services funded through dedicated own-source revenues; and 3) regional services funded through a share of a local tax base.

1) Costs Charged to Local Municipalities

The first way to share the costs of regional services is probably the most obvious, but not necessarily the most popular. Local municipalities are sometimes billed or charged for their use of a regional service. Some services are better suited for this type of arrangement, such as wastewater treatment or water distribution, services that allow for a billing based on each municipality’s use of the service. Such an arrangement allows municipalities to turn around and charge the service to its residential and non-residential property owners through user fees or build the cost in its property tax levy. This type of arrangement might be better described in terms of equity as every municipality pays for the services received.

In Québec, local municipalities are charged in a different way, by the regional county municipality within which they are located. In fact, services are paid by local municipalities through their contributions (*quote-parts*) to the regional county municipality. For most services, these contributions are not based on each municipality’s usage of regional services, but on their capacity to generate revenues. A local municipality’s ability to generate revenues is measured by the standardized property value or, basically, the potential to generate revenues from their tax base. Local municipalities thus pay a share equivalent to their share of the regional county standardized property value. It is also important to note that similar to the regional districts in British Columbia, Québec local municipalities have the choice of opting out of certain services if they wish to do so. This way of doing things translates into a form of fiscal equalization within the region because wealthy municipalities are likely

to pay a greater share of the costs than what they are in fact “consuming” while poorer municipalities pay a smaller share.

Thirdly, we encountered some cases where services are charged on a per-capita basis. Municipalities pay a share of the costs that is equivalent to their share of the region’s population. One logical use of such a formula would be planning agencies. It may present a better alternative to billing for services in terms of equity for services where charging on a per use basis is not an option, such as regional planning.

Finally, there is the option of combining certain indicators to build a formula taking into account wealth, population, etc. Since regional arrangements can also be the result of political compromise, legislators may put forward more complex schemes to determine each municipality’s contribution to the cost of regional services.

2) Dedicated Sources of Revenues

For some specific tasks, government would prefer to implement a new dedicated tax or fee. It is in the field of regional transit funding that we find the most interesting examples of this category. In the United States, where state governments are less reluctant to let cities or regional entities levy sales taxes, regional sales taxes are a significant part of regional transit funding. In the examples listed in the table, the Regional Transit Authority of Chicago’s receipts from the tax are distributed among transit authorities under its authority following a formula established in the legislation that takes into account both population and users.

In Montréal, the \$30 vehicle registration fee and the 1.5¢ regional gas tax are also collected by the transit planning authority. While it keeps a share for the commuter trains and other services it directly provides, a major portion of the revenues are distributed to local operators following a formula that takes into account both the number of motorists in the territory of each transit operator as well as the amount of receipts generated by users of their services. The regional revenues coming from these sources are intended to compensate for services of a metropolitan scope provided by local transit operators.

Examples of dedicated sources of revenues are not limited to transit. In the states of Colorado and Washington, local governments can form, on a voluntary basis, Scientific and Cultural Facilities Districts to fund facilities of regional scope located in one or a few municipalities through a 0.1% sales tax applied on top of the state tax. It is important to note that, as is the case with most counties and municipalities, districts and transit authorities listed in the table do not have control over the tax base nor the rate. For example, they can only levy a 1% local-option sales tax on the same base as the state’s sales tax.

Dedicated sources of revenues for regional services have the characteristics of being highly visible to tax payers, present relatively modest administrative and compliance costs, but their use remains discouraged by international organizations, such as the OECD, because it may cause interjurisdictional competition between those who levy the tax and those who don’t. In the case of the sales tax, they are also regressive as they have a greater impact on low income tax payers.

3) Share of the Tax Base

The last category of cost-sharing mechanisms encountered is when the regional service provider has access to a share of a local tax base. For example, in Ontario and in most US states both the upper (region, district, or counties) and lower tier municipalities levy their own tax rates to fund the services they provide. The result is that the tax payers see on their bill the rate for local services (municipality's rate) and the rate for regional services (the region's or county's rate). In Ontario, the regional rate has to be uniform across the region. This means, for example, that all residential property owners of one region pay the same regional tax rate even though their local tax rate may vary from one local municipality to another.

Although, it is usually the property tax base that is shared among lower and upper tier municipalities, other tax bases may also be occupied by both tiers. Considering that U.S. municipalities and counties have broader responsibilities, they also have a wider range of fiscal revenue sources to choose from. Consequently, we observed cases where local municipalities and counties or special districts share a sales tax or a transaction and use tax.

Interestingly, in the US, when a tax base is also occupied by the state, the state legislature may decide to cap the rates levied by other level of governments. This is the case in California with the transaction and use tax where regional rates must not exceed the state-wide rate by more than 1.5%. The problem with several levels of government taxing the same base is that the efficiency and effectiveness of the tax tends to decline¹.

Concluding Notes and Observations

Several factors are taken into consideration when it comes to determining cost-sharing arrangements for regional services: the revenue sources available, the nature of the service for which cost-sharing is necessary, the need for cost-efficient solutions, and the institutional context (who is the service provider and who is benefiting from the service). These are in addition to any number of political considerations that are specific to each case. Also, some of these cost-sharing arrangements are, in part, the result of a negotiation process among higher levels of government and local actors.

The revenue sources available obviously influence the look of cost-sharing arrangements. This is especially true in Canada where avenues are somewhat limited for local governments in terms of new revenue sources. That is why most of the examples from Canada listed here and in the previous report involve almost exclusively the property tax (either through the levy of a regional rate or by determining municipalities' capacity to generate revenues based on their fiscal wealth). However, there are cases where provincial governments have agreed to let regional services be funded through a dedicated source of revenues that is somewhat linked to the service, for example, vehicle registration fees and a gas tax to fund transit in Montréal.

¹ Brunori, David. (2003). *Local Tax Policy, A Federalist Perspective*. Washington: The Urban Institute Press, p. 160

This leads to the second consideration for cost-sharing arrangements: the type of service for which cost-sharing is necessary. Transit is a good example of regional services for which local municipalities can't be charged based on their usage, as is regional planning. However, wastewater treatment, water distribution, and waste management can be more easily charged directly to local units based on the amount of water treated, the quantity of water consumed, or the estimate of waste collected, etc. Those are basically the same services that, at the local level, municipalities can charge a user fee for. With planning duties, this is obviously not possible, so that explains the existence of different models used to determine each municipality's contribution. That being said, dedicated sources of revenue are mainly used for one specific service, such as transit. When a metropolitan structure is responsible for a basket of services, then they tend to rely on property-based revenues or contributions from municipalities.

Obviously, the chosen arrangement must be cost-effective, hence the need for a solution that is easy to administer. Wherever regional structures can piggyback on an existing levy or get a share of an existing tax base, there is a smaller administrative cost compared to the implementation of a new tax. For example, property tax levies are usually easier to administer since all the regional service provider has to do is fix its own rate based on its estimated revenue needs or divide the cost among local municipalities based on their ability to pay. The assessment roll is already in place and the implementation can be done rapidly and at a low cost. It is the same situation when revenues are taken from a share of a higher level of government's revenue sources, especially if the regional body does not have to collect the sales tax or the vehicle registration fees itself.

The institutional context refers to the governance system of the region. For example, if there is already a regional body in place, the implementation of a new regional service allows for the possibility of building the cost of a new regional service into the existing funding structure. Then the possibility for municipalities to opt in or out of the regional or metropolitan structure would also influence the choice of funding mechanisms or, at the very least, allow for some added flexibility in the financing mechanisms. This factor is probably more important in the US where they are able to create special purpose districts with own source revenues at will.

Finally, there are also some political considerations that influence the choice of cost-sharing arrangements. Probably, the most obvious example is with the regional county municipalities in Québec where their cost-sharing arrangements are also an equalization scheme because municipalities' contributions are not based on "how much do they benefit from" the services, but on their actual ability to generate revenues, thus, their ability to pay.

In conclusion, there are obviously advantages and disadvantages to each model. For example, charging municipalities directly for the services they consume, when it is feasible, is a more equitable option as every municipality would pay for what it would get in terms of services. For example, if used for wastewater treatment and water distribution, this form of cost-sharing arrangement may also serve as an incentive for a more efficient delivery and a more responsible consumption of water by tax payers as it would be reflected on their tax bill. For all its accountability and equity advantages, however, it is the most regressive alternative as it would require a greater fiscal effort from poorer municipalities than from wealthier municipalities to pay for the services charged. The implementation of a dedicated source of revenues can be perceived as an unpopular political gesture, but depending on the choice of

new sources of revenues chosen, it has valuable upsides in terms of accountability as every tax payer would have a better sense of what use is made of their money and legislators have the flexibility of targeting a specific "clientele" with the tax. That's in part why taxes levied on motorists tend to be a popular funding mechanism for transit. At the same time, it also has accountability shortfalls since a rather large share of the tax base can be exported to non-residents. Finally, using a share of a local tax base can be a cost-effective option from an administrative standpoint, but there is also the risk of overcrowding a specific tax base. Unfortunately, there are no perfect solutions, nor obvious choices.