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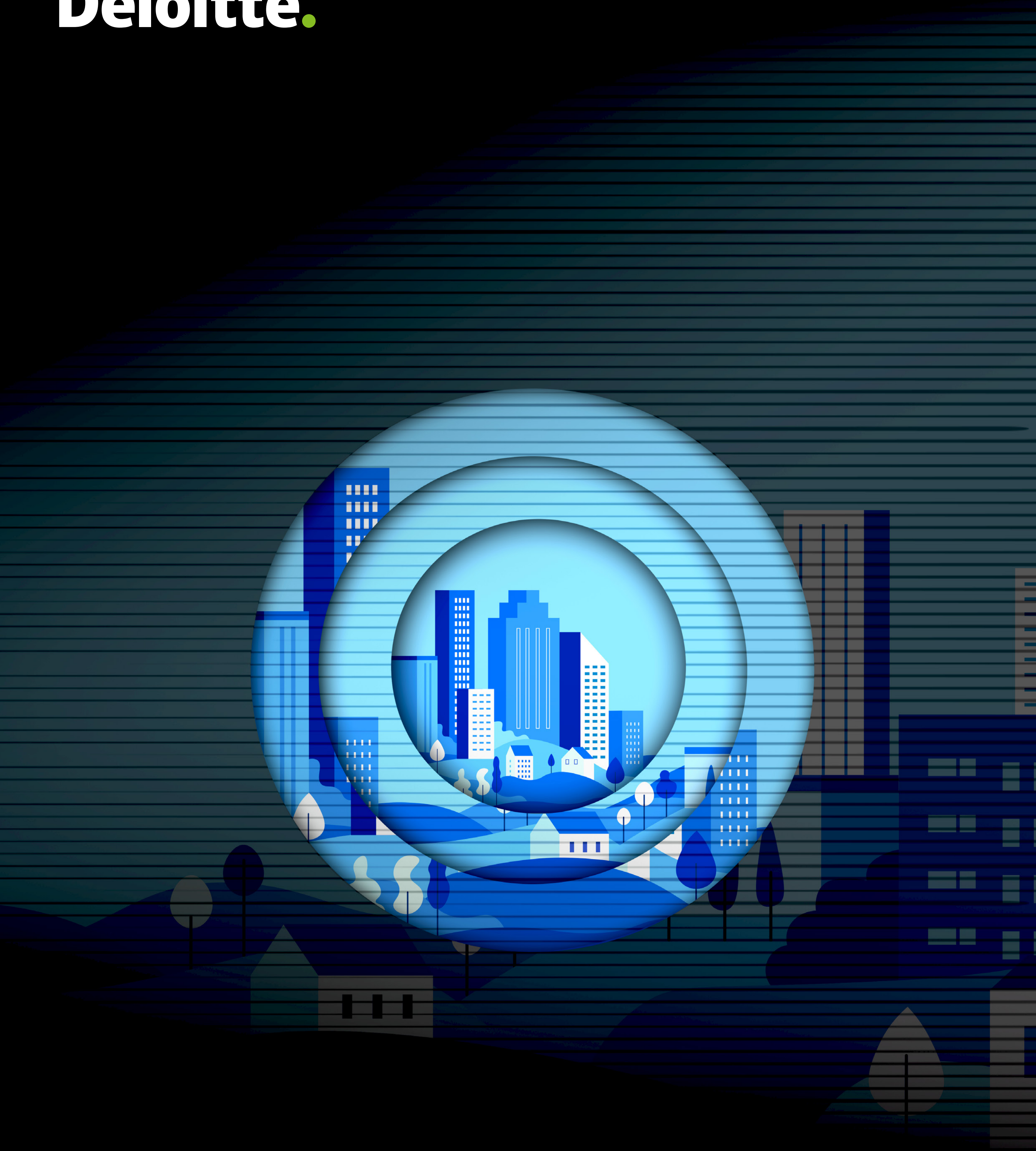
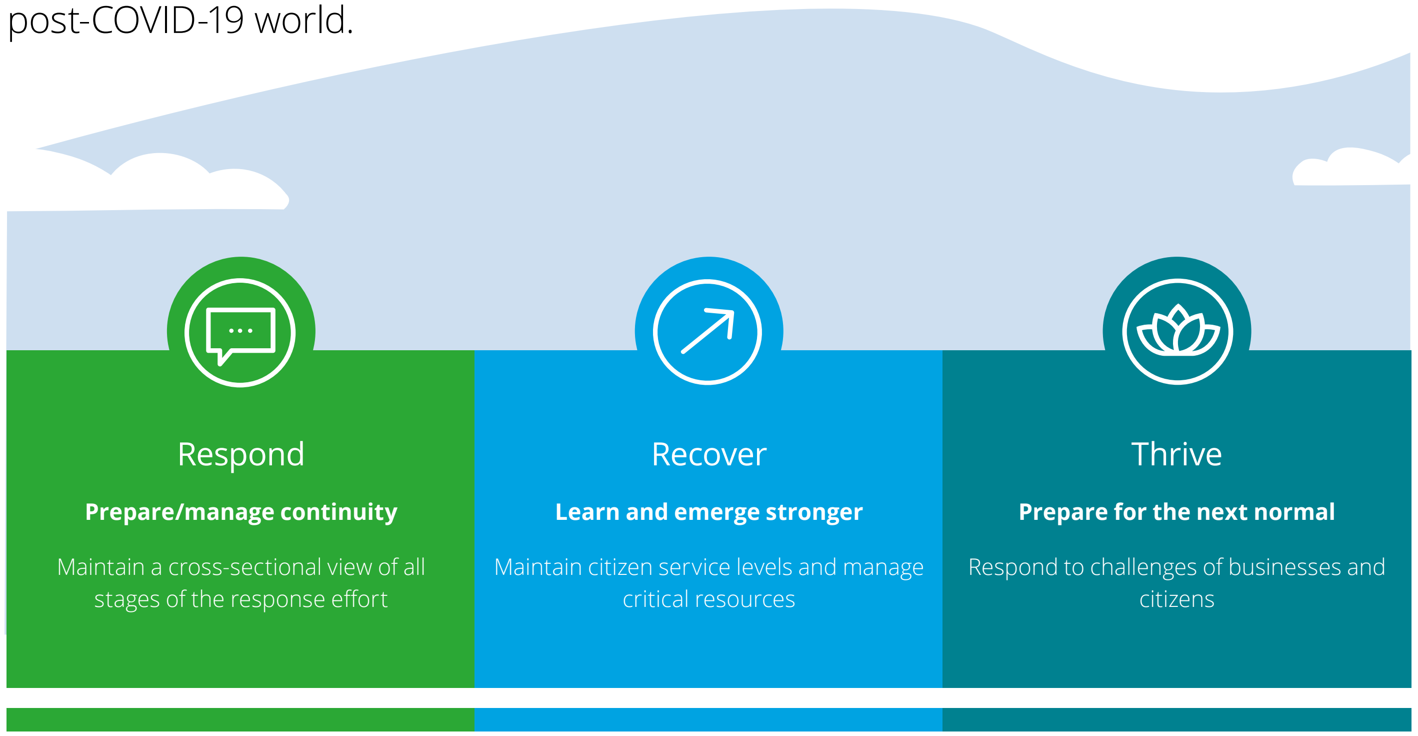


Building the foundation for cities to thrive after COVID-19

Introduction

The COVID-19 crisis has exposed major flaws in the resilience of traditional governance and financing capacities of municipal governments–particularly in their ability to cope with economic turbulence. Municipal leaders will be defined by what they do throughout the three dimensions of crisis management: respond, recover, and thrive. This is in addition to their ability to maintain a cross-sectional view of the organization's priorities, preserve citizen service levels, and respond to evolving challenges from businesses and citizens. In this final report of our three-part series, we provide context and guidance to help municipal leaders reimagine new service delivery and funding paradigms for their municipalities to thrive in a post-COVID-19 world.



Changes in urban lifestyle will dictate the next normal and what cities need to plan for to thrive

In July, the federal government announced a $19-billion fund for provinces and territories to help them with an economic restart. Of those funds, only $2 billion is earmarked for cities and it's not yet clear how the funding will be allocated. Other provinces—for example Ontario—have also recently announced short-term funding to support cities. However, the net impact on cities remains to be seen. The Federation of Canadian Municipalities stated in April that cities alone are facing a $10 billion to $15 billion shortfall due to a loss of revenue from property taxes, utility charges, and transit fees. This impact is likely to get worse as cities face a second and potential future waves of COVID-19.

Beyond the immediate cost of recovery, it is also highly likely that the densest urban centres in Canada will be the last to fully reopen their economies. Big-city officials are most concerned, however, about how the changing use of space could fundamentally alter the very shape of urban density relative to pre-COVID-19 expectations. How will cities adapt to thrive in the next normal?

Firstly, competing theories have emerged on the topic of commercial office real estate, a sector that previously drove the tax revenues and consumer spending habits of urban downtowns. The first theory holds that normality will return and office workers will largely resume their previous routines. In fact, guidelines around distancing could mean that organizations may actually need to double their office footprints as shared office space is no longer possible. The alternative theory suggests that, having been forced into a mass experiment in working from home, major corporations will abandon physical footprints in the name of cost savings. This will leave many metropolitan areas in Canada with high vacancy rates. The next normal will likely fall somewhere between these extremes. Both companies and employees will need to re-evaluate the merit of commuting downtown to high-rise offices every day. Remote work has proven to be both possible and effective, and the revenue impact on cities in terms of property tax values, taxable income, and spinoff consumer spending is likely to be negative in the long-term.

Secondly, Canada`s major cities rely heavily on fare-box revenue to support transit operations. With ridership down approximately 85 percent across Canada's major cities and some civic leaders holding the belief that the next normal may include more urban dwellers choosing to drive due to concerns of infection, it is unclear how much transit ridership revenues will recover. It is also too early to predict whether there could be a knock-on effect on the desirability and financial viability of transit infrastructure projects. Nevertheless, these are important factors to monitor.

Finally, as bricks-and-mortar retail, restaurants, and bars begin to reopen, many owners will wonder if they can achieve profitability with reduced floor capacity and seating under new distancing guidelines—and whether customers will ever feel safe enough to return.

While advocates of Canadian urbanization have long been in favour of municipalities getting access to more tax revenues, like their American. and European counterparts, that philosophy assumes continued urbanization[1]. Given the worst-case projections that COVID-19 will continue in waves for the next 18-24 months, or until a vaccine is found, each city must prepare for a profound shift in how citizens and major corporations think about density, as well as their own urban footprints. This will, in turn, drive structural changes in a city's service delivery imperatives, as well as the governance and funding models that underlie its abilities to deliver such services.

Is the current suite of funding and service delivery responsibilities for Canadian cities still viable in a post-COVID-19 Canada?

The prerequisite to considering governance and funding questions should be to consider the services Canada's cities ought to fund and deliver. Programming pressures on municipal budgets, especially in larger cities, had already reached a breaking point pre-pandemic. Urbanization and densification were already presenting their own new, complex challenges to municipal governments. COVID-19 has exacerbated many of these existing pressures.

A review of municipal involvement in certain programs and services versus that of its provincial or federal counterparts should begin with the sector that has most prominently come under scrutiny during COVID-19: health and social services. This includes not only public health, but also ambulance services, social housing, social assistance, and childcare. These are all major costs for cities and are vital to providing life stabilization support to residents in cities.

Recent events in long-term care homes have led many provinces in Canada to face heightened levels of criticism for how they have handled the care of senior citizens both before and during the pandemic. In Ontario, one out of every five long-term care homes is operated by municipalities[2] and while there is some research to suggest that the impact of COVID-19 was worse in for-profit homes, the sustainability and safety of the entire industry is in question.

Another area of concern and fiscal pressure for cities is homelessness. Our biggest cities have seen increases in homelessness through the pandemic, often driven by associated addiction and mental health challenges. While cities are undergoing increased scrutiny in this area, homelessness, in reality, is an extension of the provincially controlled health-care system.

The debate will continue around what autonomy cities should have to fund and deliver such services or which services to devolve themselves all together. Any review of each cities current responsibilities should consider that further autonomy given to cities to fund and deliver health and human services could lower adherence to federal and provincial standards–something that municipalities must continue to safeguard.

In contrast, a review should also consider whether better outcomes can be achieved by transferring responsibility to other levels of government with access to more revenue tool options. With the recent negative media surrounding long-term care home conditions, municipalities may find their provincial counterparts more receptive to reform. In Ontario, the province has already taken over the operation of five long-term care homes that were previously in private hands.

Beyond the evident complexities of the health and social services sectors, cities also need to consider the viability and desirability of their current funding and service delivery responsibilities across other sectors as well, filtered through the lens of the next normal.

Are traditional municipal revenue tools still sustainable given the current responsibilities of cities?

For the purposes of the following operating budget revenue analysis, we drew on research from public budgets for Toronto, Montreal, Vancouver-and Calgary.

Property taxes

Accounting for by far the highest proportion of revenue sources for operating budgets across all four of the selected cities (44.2 percent of 2019 total budgets), property taxes carry significant weight in determining the financial health of Canadian municipalities. Vancouver alone attributed 55 percent of its $1.516-billion 2019 operating budget to property taxes. Prior to the pandemic, property taxes had been a main source of growth in total municipality revenues. COVID-19 related risks could lead to downward pressure on future revenues due to falling property values, lower immigration rates, and the potential that a rise in personal bankruptcies will lead to property tax defaults. Reliance on property taxes as a primary source of income presents a sustainability issue, with cities such as Vancouver even projecting a $189-million short fall by the end of 2020[3] due to the potential volatility.

Rate revenues

Responsible for the second-highest revenue source for operating budgets across all four of the selected cities (34.3 percent of 2019 total budgets), rate revenues which are primarily derived from utilities, recreational fees, and other fee-for-service activities are a traditionally important source of liquidity. The longevity of fee-for-service revenues is under scrutiny given the potential for urban flight, lower immigration rates, and personal or commercial bankruptcies. Programs such as Toronto's 60-day grace period for water and solid waste utility bills could do little to prevent bill defaults in a deepening pandemic situation[4]. With rate programs normally priced for "full cost recovery" leading to historically negligible budget deficits in most municipalities, cities will be encouraged to reduce discretionary expenditures to curtail any budget shortfalls resulting from the pandemic.

Provincial/Federal transfers

Support from other levels of government accounted for 11.9 percent of total 2019 operating budget revenues in our selected cities. Prior to the pandemic, both federal and provincial governments alike recognized the economic return on investment that came from investing in cities. Toronto alone is expected to benefit from $3.2 billion in federal funding and $1.6 billion in provincial funding from 2020 to 2029. Despite planned expenditures, it is possible that COVID-19 driven pressure on provincial budgets could lead to downward pressures on their planned transfers to municipalities. Conversely, the federal government has emphasized the constitutional responsibility for provinces to support municipalities having encouraged further financial support to cities in early May 2020.[5]

Transport fares

Accounting for 6 percent of total operating budget revenue sources in 2019 across selected cities, transport fares are another important source of income. With population growth came sustainable increases in transit revenues across the selected cities until the pandemic, when users were told to "stay home". This has exerted significant revenue pressure in cities such as Toronto, calling into question the short-term sustainability of public transport in our cities. In the near term, cities are being encouraged to deploy infrastructure for cycling and vehicle commuters rather than transit where social distancing can be more difficult and fears of infection spread are higher. However, this is not a sustainable long-term strategy given inherent capacity limitations of road networks.

In the long-term, a survey conducted by the University of Toronto suggests just 5 percent of respondents would return to transit during Stage 1 of Ontario's reopening plan and 63 percent in Stage 3, leading to further questions about transit sustainability.[6] The advent of virtual work, as well as the potential for permanent office closures in many central business districts, could have the potential to limit transit use and revenues.

A balanced view that recognizes the very significant short-term changes with the longer-term implications will be needed.

What do these municipal revenue sources fund today?

The aforementioned revenue sources provide the funding to pay for city services that do not necessarily generate other direct revenues. The following is an overview of key municipal expenditures. The question remains as to whether pre-pandemic revenue sources can continue to finance them sustainably in a post-pandemic Canada.

Emergency services

Services such as municipal police forces and fire departments were by far the largest expenditure for the selected cities in 2019, accounting for 18 percent of total operating costs. Helping to support front-line personnel is a costly business driven by wage and benefit expenses, fixed assets, and other expensive equipment. Emergency services have proven to be important in the current health crisis with cities unlikely to pursue measures directed at finding potential savings for these services in the short-term.

Capital financing

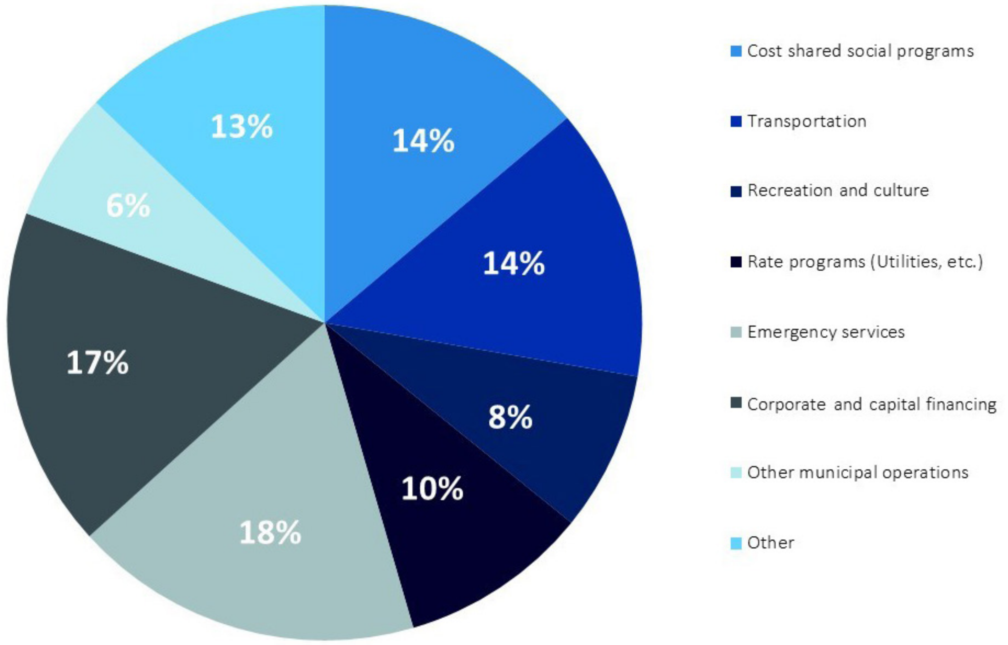
The second largest expenditure, accounting for 17 percent of total operating costs for the selected cities in 2019, was accounts for municipal transportation and other capital projects. Projects may be paused in the short-term to develop healthier balance sheets, but vital infrastructure must continue to be maintained in a post-pandemic Canada.

Cost-shared social programs

Activities under this category accounted for 14 percent of total operating expenditures for the selected cities in 2019. Programs such as shelters, daycares, emergency medical services, public health, and income support programs are partially funded by both municipalities and the associated province. Demand for these services continues to rise with population growth-and the cost of delivering these services traditionally rises faster than inflation. With the importance of these services highlighted even more given the current pandemic, cities must find innovative ways to continue to pay for these services or transfer more of the delivery/cost burden to their provincial counterparts to reduce funding shortfalls and service cuts.

Other operating expenditures from Toronto, Montreal, Vancouver, and Calgary are accounted for in the chart below:

Municipal operating expenditures (2019)



Note: Other expenditures include governance and corporate services, other agencies, road network, sewage, snow removal, etc.

Building the foundation for cities to thrive after COVID-19

Critical questions that will shape funding models and governance

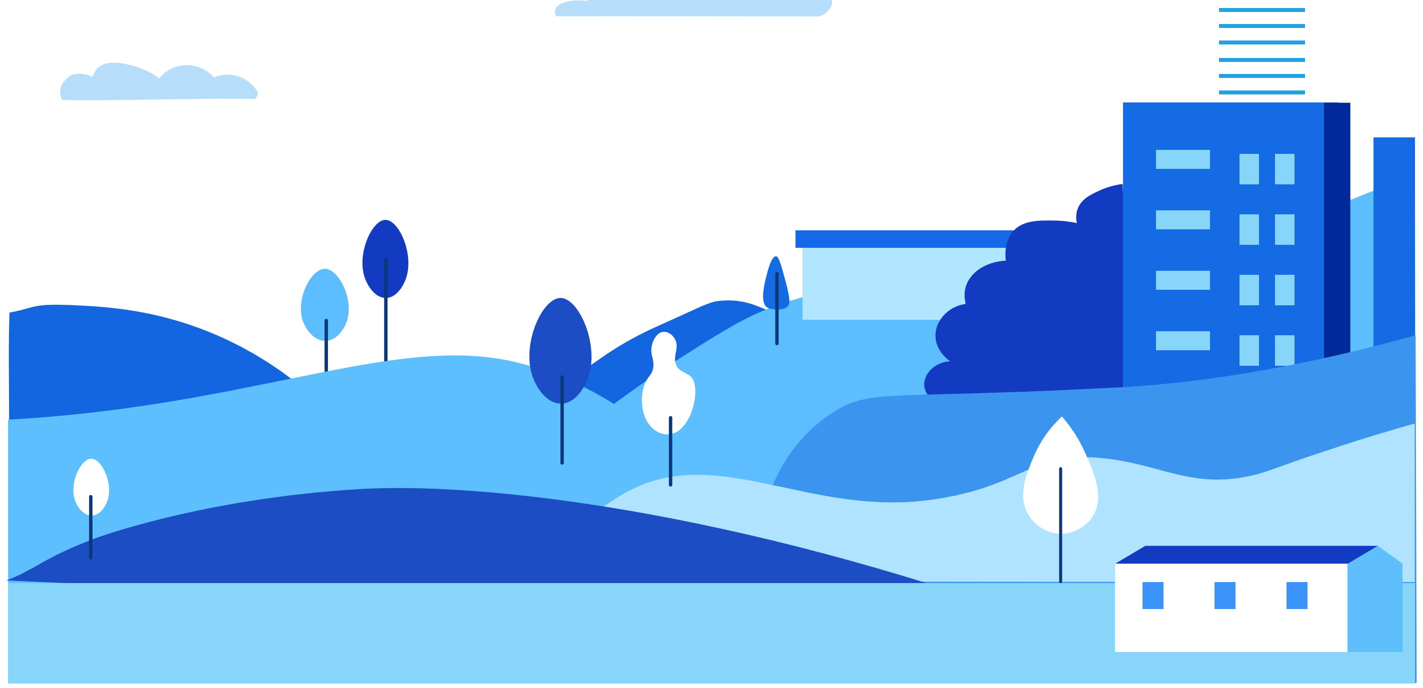
The crisis has brought into sharp focus the vulnerability of Canada's economic engines. The range of services for which cities are responsible—from water, sewers, roads, and transit to social services and public health—makes clear that an increase in property tax, a city's number-one revenue lever, cannot meet the challenge of the post-COVID-19 budget gap.[7] Further, this lever itself could become less lucrative as density is under pressure, leaving cities even more vulnerable to the next economic shock. The second most reliable revenue lever for Canadian cities—rate revenues—will be equally difficult to increase given the preponderance of services geared toward those groups hardest hit economically by the pandemic.

After speaking to municipal governance practitioners and experts from across Canada, it is clear that cities will be supported by emergency assistance payments from higher orders of government to support COVID-19-induced budget shortfalls. There is also consensus that cities should be financed more holistically to ensure greater self-sustainability going forward. However, there is significant divergence of opinion around the expected impact of remote work on a city's tax revenues, the scope of public transit disruption going forward, and even the desirability of a city taking on deficits to manage potential revenue declines. While there is no consensus on new revenue tools, there is agreement that cities must maintain responsibility for their current suite of services and consider choices about new revenue sources on a municipality-by-municipality basis through a few critical lenses.

First, cities must reconsider the responsibilities, services, and programs they are best positioned to fund and/or deliver. Once prioritized, cities must carefully balance the dueling imperatives of raising revenue, without further incentivizing urban flight. They must do so while considering changes to pro-density growth policies built around highest and best-use zoning and property taxes. Finally, cities must consider how the pandemic has accelerated the shift to digital work and how the composition of businesses may permanently shift.

To account for these simultaneous shifts and duelling imperatives, every revenue tool option must answer four critical questions in determining if it is appropriate as part of the next normal:

1. Should cities to be responsible for a given program or service—in terms of both funding and/or delivery?
2. How much revenue might a new tool generate in the short and long term?
3. What other orders of government must approve such a tool and what are its downstream governance implications?
4. Is it politically palatable to citizens, or is it likely to further incentivize urban flight?



Building the foundation for cities to thrive after COVID-19

New revenue tool options

Debt financing and increased ability to borrow

Municipal bonds, popular civic financing tools in many parts of the United States. and Europe, account for a miniscule portion of Canada's bond market. These products in Canada are not all guaranteed by provincial governments, thus making their creditworthiness suspect given the cowed capacity for municipalities to generate revenue. Provinces across Canada are already considering allowing municipalities to run deficits as part of COVID-19 recovery talks.[8] Any move to provide cities greater borrowing abilities and deficit financing capacities would require a fundamental rethink of their governance structures. This would require provincial governments to make legislative changes on a province-by-province basis, granting such new powers alongside enhanced political autonomy.

Privatization and asset sales

The most reliable method for a city to generate large-scale, one-time revenue is asset privatization. This could take shape as the sale of municipal utilities or privatization of transit. Projects of this nature generally require little if any involvement of higher order of government and cities can ensure future revenue by maintaining a stake in the companies. However, privatization of public assets often proves politically difficult, making such choices unpopular with large segments of voters. Instead, municipalities might do the opposite, optimizing their use of existing assets by creating new quasi-utilities that are semi-private from the start. This more sophisticated, modern approach takes advantage of existing assets. For example, CreateTO is a new agency in the City of Toronto, with a mandate to manage its portfolio of real estate assets. Cities could leverage such constructs to pool real estate assets into a trust and sell a minority stake, not only optimizing the assets, but also accounting for the changing nature of urban centres and hedging against the reprioritization of physical space.

Municipal income tax

In Manitoba and Saskatchewan, very small portions of provincial income tax revenues are already conditionally shared with municipalities. These amounts are much lower than some major American cities such as New York. Several major western European and Nordic states also allow municipalities of all sizes to collect income tax. This practice accounts for a majority of municipal revenues in these countries.[9] Personal income taxes would be considered a progressive new form of revenue for cities and could be based on either residence or payroll, the latter being able to capture commuters who work in, but do not live in, a given city. A study by the University of Toronto estimates that just one percent municipal income tax could generate about $57 million annually in Toronto, and $10 million in Vancouver.[10] Providing cities with these powers would again require provincial governments, on a province-by-province basis, to make legislative changes granting such new taxing authority.

Create new public assets

Building on the idea of creating new revenue-generating infrastructure out of existing assets, cities must also consider the creation of net new public utilities to manage and generate revenue from new digital assets. In South Korea, one of the major reasons that public health authorities had success in flattening the curve in the early days of the pandemic is due to cooperation with major telecommunications companies related to contact tracing and use of big data. In Canada, major companies already rely on public sources, such as Statistics Canada, to provide anonymized data that's critical to business decision-making. This could provide a model for a new kind of public data trust that cities could create and use to generate revenue. Going further, cities could consider the creation of their own 5G infrastructure corporations, becoming full partners in the future deployment of the underlying mobile networks that are the foundation of the data-intensive modern economy. Cities must fight for a stake in control over this underlying infrastructure.

Property tax changes

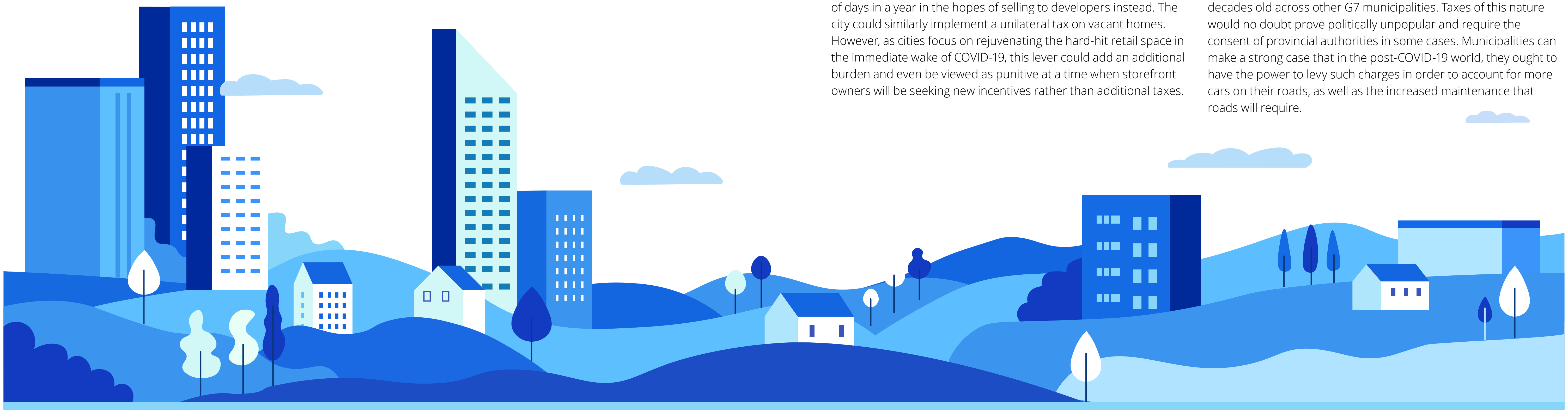
Changes to the property tax system continue to be the simplest form of revenue generation for cities. Such changes could include taxing vacant storefronts, which the city of San Francisco recently implemented via ballot measure. The measure will tax vacant storefronts along major commercial corridors, and tax owners who fail to activate vacant commercial storefronts for a certain number of days in a year in the hopes of selling to developers instead. The city could similarly implement a unilateral tax on vacant homes. However, as cities focus on rejuvenating the hard-hit retail space in the immediate wake of COVID-19, this lever could add an additional burden and even be viewed as punitive at a time when storefront owners will be seeking new incentives rather than additional taxes.

Increased share of current taxes

To find a long-term, major revenue source that does not disincentivize urban living, cities could look to consumption or value-added taxes that consumers and citizens are already paying. Launched in 2005, the federal gas tax fund is a permanent source of funding provided to provinces and territories, who in turn flow this funding to their municipalities to support local infrastructure priorities. Municipalities can pool, bank, and borrow against this funding. Municipalities could make a strong case for receiving a greater share of the gas tax as an offset for lower projected public-transit revenues in the post-pandemic world. Changes to this funding formula would require joint negotiation with provincial and federal governments, and the collective voice of municipal leaders via groups such as the Federation of Canadian Municipalities. However, the real prize in this space is not an increased share of the gas tax. It would be a new deal that could include a new share of the harmonized sales tax, a federal revenue stream that is predominantly generated in Canada's urban centres (see the example in the "Revised balance of powers" section on the next page).

New user fees in the form of road tolls and congestion charges

Road tolls and congestion charges for drivers have some of the highest revenue potential for consumption taxes. While this would be new in some parts of Canada, it is a method that is nearly two decades old across other G7 municipalities. Taxes of this nature would no doubt prove politically unpopular and require the consent of provincial authorities in some cases. Municipalities can make a strong case that in the post-COVID-19 world, they ought to have the power to levy such charges in order to account for more cars on their roads, as well as the increased maintenance that roads will require.



Other policies to alleviate budget shortfalls

Revised balance of powers

It has been argued that the future of growth in the globalized world lies in the support of its cities. The global pandemic underlines the potential need for a rebalance of powers across Canada's three levels of government. With more autonomy to control their own public finances, Canada's cities would then be able access new sources of income. This could include the potential to roll out a municipality-wide sales tax similar to that of New York City, which is expected to contribute approximately $8.2 billion in funding (8.9 percent of total revenue sources) to that city's top line in 2020[11].

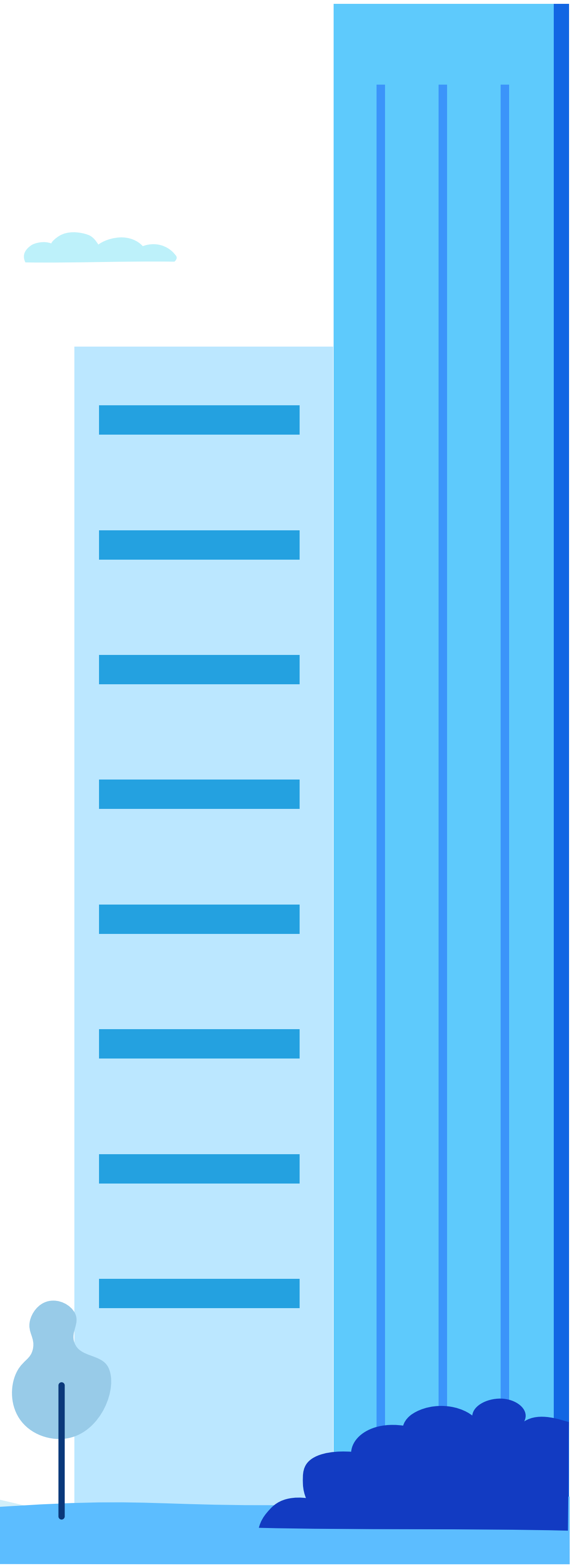
Civic crowdfunding

Tighter budgets have caused a deterioration of green spaces, streets, playgrounds, and other recreational infrastructure in our cities. This could be alleviated by innovative sources such as crowdfunding. Using this model, Canada's urban dwellers would be provided more autonomy to design and develop their neighborhood's infrastructure. Firms such as Spacehive provide a platform for citizens to pledge donations to ensure a project is successfully funded with associated responsibilities handed to private corporations, sometimes with limited support from city hall. An impressive use case by residents of Peckham, a district in London in the United Kingdom, led to plans for the revitalization of a derelict railway line into an elevated urban park using a mix of crowdfunding and volunteerism to ensure the project progressed into preliminary feasibility studies[12].

Cannabis Revenues

With the legalization of cannabis, the expectation was that 25 percent of collected taxes would be sent to the federal government, with 25 percent of the balance to be sent from the provinces to municipalities. In reality, however, the proposed revenues sharing structure has not been followed by many provinces, leaving municipalities struggling to convince their provincial counterparts to provide their fair share.[13] The federal government could broker a new revenue sharing deal between the provinces and municipalities to ensure equity.

Conclusion



COVID-19 has dealt Canada's cities an unwelcome case study, straining their capacity to deliver for citizens. The results have been mixed, in no small part due to the longstanding misalignment between what municipal governments are charged with delivering and what they are fiscally capable of providing. This trend, existing prior to COVID-19, has been amplified and accelerated in profound ways—many of which are still not fully evident as the recovery phase of the pandemic continues.

We know for certain that in a year or two, federal and provincial governments will be forced to address their own budget deficits. Funding for municipal governments already under significant pressure might become even scarcer. Cities need more autonomy to drive their own futures.

This process must be viewed relative to how the relationship between cities and their citizens evolves. This relationship will have to match the needs of a world in which population density, once an aspiration, is now a danger—at least until a COVID-19 vaccine becomes widely available.

What measures need to change now to help insulate cities from future pandemics or other shocks? Municipal leaders will be defined by how they lead through this next phase of the crisis, as well their ability to respond to the evolving challenges from businesses and citizens.

To reimagine new service delivery and funding paradigms for their municipalities to thrive in a post-COVID-19 world, cities must reconsider the responsibilities, services, and programs they are best positioned to fund and deliver. There is no one-size-fits-all solution.

For all cities however, there will be a degree of difficulty balancing the duelling imperatives of raising revenue, without further incentivizing urban flight, as they deal with possible reversals of pro-density growth policies. Finally, all civic leaders will grapple with how the pandemic has accelerated the shift to digital and remote work and how the composition of businesses might permanently shift.

To thrive in the next normal, municipal leaders must bear in mind these simultaneous shifts and competing imperatives, recalibrating as needed and taking bold action to reshape their relationship with higher orders of government in order to deliver for their citizens. This means articulating a clear commitment to the services that cities ought to fund on a municipality-by-municipality basis. It also means providing municipalities with sustainable revenue tools to match. In the case of the largest cities, with most complex service delivery needs, provincial leaders will have to legislate such tools as needed. None of this will be easy, but COVID-19 has demonstrated the necessity of shifting from the status quo.

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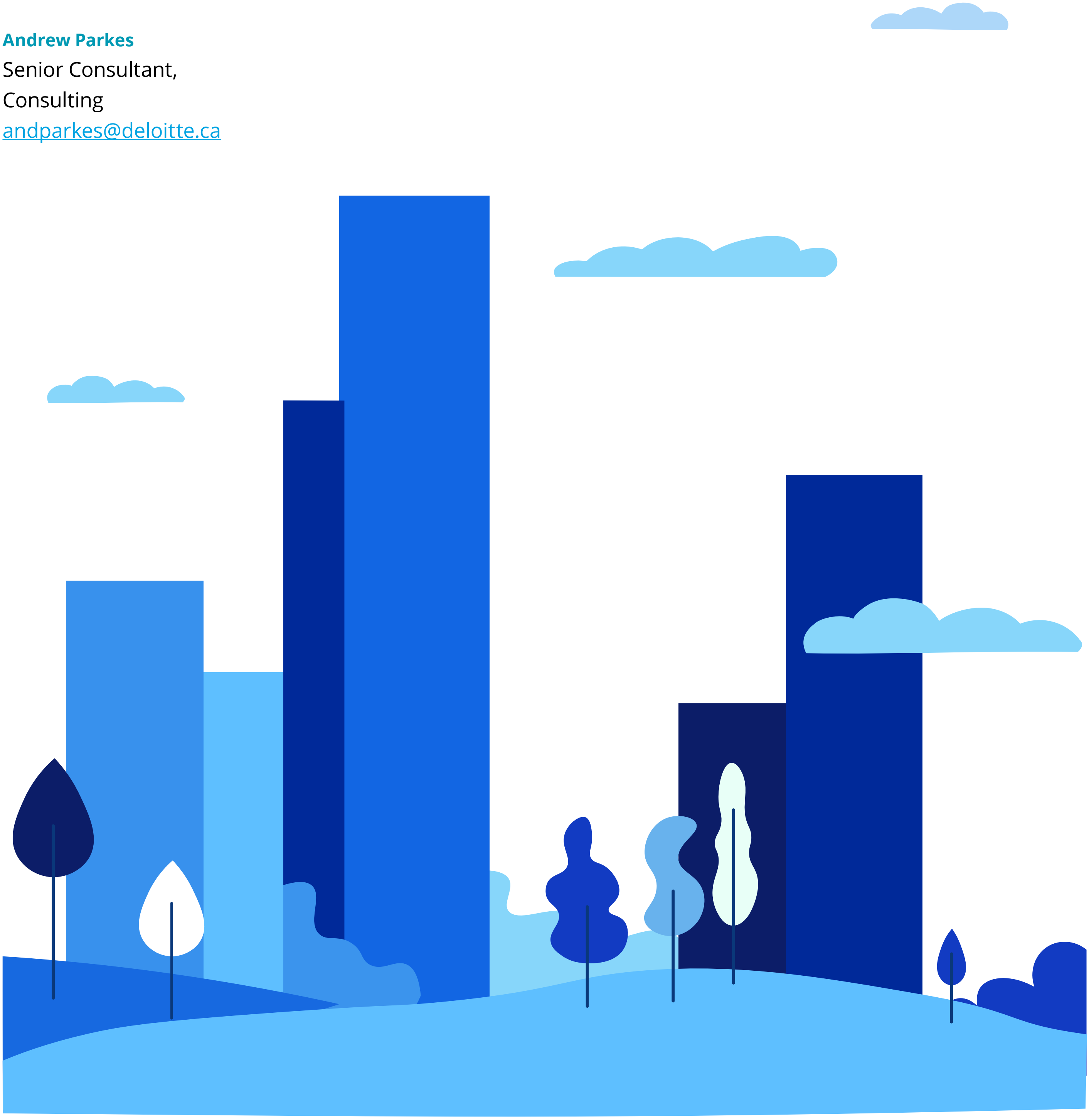

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