Report of the Expert Panel on Provincial Municipal Fiscal Arrangements in New Brunswick

September 2022

Vibrant and Sustainable Communities – Community Funding and Equalization Grants

Executive Summary

The Expert Panel was tasked with identifying, assessing, and proposing options related to a new system of fiscal transfers between the Province of New Brunswick and Local Government entities suited to the new local governance system as laid out in Working Together for vibrant and sustainable Communities, White Paper, 2021. The Panel was asked specifically to examine the system of community financing and equalization grants and to recommend a new system of fiscal transfers between the Province and Local Governments. The Panel researched the history of Provincial-Municipal transfers in New Brunswick and in Canada to study success and failure in meeting their intended purposes especially regarding equalization. Differences in approaches in the use of conditional and unconditional grants, utilization of other revenue sources to supplement property tax and user fees were all examined in the context of the reforms to local government as set out in the White Paper. The Terms of Reference for the Expert Panel are attached for ease of reference.

Phase Two Finances, as outlined in the White Paper, was not part of the work of the Panel and time did not permit a thorough review that is essential as reforms progress. The Panel does however recognize that a new equalization formula cannot be looked at in isolation of an overall funding strategy and as such has some recommendations for Phase 2 deliberations.

The vision for the future of local governments in New Brunswick is clearly and succinctly articulated in the White Paper as vibrant and sustainable communities working together to enhance the quality of life for all New Brunswickers. This policy objective clearly sets the stage for the collective efforts of all New Brunswickers and their local governments to work toward achieving.

This is the first significant strategic reform of local government in New Brunswick in 55 years. The province will move from 340 local entities to 77 local governments and 12 rural districts. Collaboration is key to reform and as such the mandates of the 12 Regional Service Commissions will be strengthened to promote cooperation and collaboration among communities in regions.

To guide its work on recommending a new system of fiscal transfers the Panel turned to the White Paper's guiding principles and criteria used in its strategic restructuring. Of particular importance were the following:

1. upholding the principles of Equal Opportunity such that all New Brunswickers enjoy comparable minimum standards of services and opportunities at comparable tax rates, regardless of the financial and economic opportunities of their locale.
2. increasing the capacity of communities through larger tax bases such that residents enjoy a higher and more sustainable level of service

Principles

The goal of equalization is to allow citizens to receive a reasonably comparable level of service at a reasonably comparable level of taxation. In Canada, Equalization is embedded in the Constitution: "Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation". (Subsection 36(2) of the Constitution Act, 1982)

In our report, the goal is to increase the fiscal capacity of municipalities such that municipalities have the financial resources to allow them to offer comparable services at a reasonable, yet comparable level of taxation The proposed formula does not identify or dictate which services should be offered by municipalities but rather respects the autonomy of locally elected officials to make these decisions. Thus, services across municipalities may vary.

The Panel recommends the following:

1 – The formula is based on fiscal capacity to equip local governments with a grant that will enable them to grow their tax rates to meet the average of their group.

2 - Five groupings of municipalities as follows:

  1 - Cities with a population of more than 40,000

  2 - Cities with a population of less than 40,000

  3 - Municipalities with a population of more than 10,000

  4 - Municipalities with a population of less than 10,000

  5 - Rural districts

3 - Transition period of five years

4 - Elimination of the core funding grant in the equalization program.

5 - Additional services offered by the Regional Service Commissions to be funded 50/50 by the provincial government and the municipalities. The province's share should be linked to the tax base, increasing as the value of the tax base increases, distributed on a per capita basis.

6 - The Panel recommends that the Equalization formula includes a component to recognize that roads in old local service districts (LSDs) will be financed by the provincial government.

7 - The Panel recommends that the Equalization Program should have an initial budget sufficient to bring everybody's capacity at their groups average.

8 – The Panel recommends that in the future, the Equalization Program budget be increase proportional to the increase of the province's tax base.

9 – The Panel recommends that the three-year averages be used for tax base and population, to reduce fluctuation and increase certainty for program recipients.

10 - The Panel recommends that the Equalization Formula be reviewed at the end of the five-year transition period to ensure it remains valid and more work be conducted in Phase 2 – Finances on other potential revenue sources that may be more appropriate after five years of experience with the reforms.

11 - The Panel recommends that varied potential additional revenue sources be further explored in Phase 2 – Finances.

12 – The Panel recommends an analysis of the province's property assessment process, as it is a fundamental element of the Equalization Program.

Provincial-Municipal Grant Funding in New Brunswick – A brief History

The history of provincial-municipal funding arrangements in New Brunswick has been well documented and studied in the years since the 1963 New Brunswick Royal Commission on Finance and Municipal Taxation commonly known as the Byrne Report.

The report recommended a new governance model as key to a prosperous and self-sufficient New Brunswick. The Province would assume responsibility for the provision and financing of services to people such as education, health, justice, and social services while local governments would provide services and funding to properties.

Property taxes from tax rates on both residential and non-residential property were the main sources of revenue for this new municipal governance model. Other municipal revenue was raised by various fees levied on property for such things as water and wastewater disposal. As the Province required more revenue for services for which it was responsible than it could raise through its own sources, namely income tax, sales tax, and federal transfers, it was determined that the Province and local governments would share the property tax field. That is to say, that both the Province and local governments would levy taxes on real property. Additional tax revenue was also required by the Province as it retained responsibility for the provision and payment of municipal-like services for LSDs. This sharing of property tax room remains to this day.

Byrne acknowledged the need for provincial-municipal grant funding to complement the revenue raised by property tax. An unconditional core funding grant was put in place for municipalities to cover the fiscal gap created due to insufficient property tax revenue to cover the expenditure needs of municipalities. In support of the principles of Equal Opportunity an equalization grant was instituted to address differences in the capacity of municipalities' ability to raise revenues to provide comparable services at comparable tax rates.

Provincial-Municipal Transfers

History shows that the original formulas were amended or suspended with regularity over the years. From 1974 until 2021 the formula was amended seven times to incorporate such variables as density, expenditures, average expenditures, and fiscal capacity. Equalization necessitates the grouping of reasonably similar types of communities to allow for fair comparisons regarding relative financial need and or capacity. Communities with similar populations have similar service demands and as such offer a reasonable basis for comparison purposes. Over the years the grouping methodologies have changed to reflect for example new census information or changes to the industrial base of any given community.

In 2008, the Finn Report, Building Stronger Local Governments and Regions, proposed sweeping reform of local governance including their fiscal arrangements. This was the first system wide review and recommendations for the future of local governance since the 60s. The preservation of the basic premise of Equal Opportunity in Finn's proposed governance model, set the tone for fiscal reform. It endorsed a new equalization formula based on three groupings of municipalities by population, elimination of the unconditional grant or core funding, and proposed a tax room transfer. The Province would vacate a portion of the Provincial share of property tax allowing local governments to occupy that space. The Finn report was not implemented but it helped inform the 2021 White Paper.

The 2001 Action Plan for a New Local Governance System in New Brunswick addressed community funding arrangements and introduced generally accepted Principles of Public Finance to guide the development of a new formula for funding. The principles enunciated were equity, accountability, predictability, simplicity, and viability. They remain as relevant a decade later and they guided the Panel's formulation of the recommended 2022 equalization formula.

The Community Funding and Equalization Grant was implemented in 2013 and included changes to the cost sharing of policing services and local taxation for LSDs. The grant included an unconditional transfer payment for core funding and the Equalization grant was tied to expenditure and fiscal capacity. The Community Funding and Equalization Grant addressed the principles of predictability, stability, and simplicity. This formula remained in place until 2021

The history of the efforts of many governments, municipal organizations, and various experts at designing an equalization formula that is acceptable to local governments and the provincial government has proven to be problematic over the years. The formula applications over the years and the suspensions of various formulas for prolonged periods have shown that unanticipated consequences can and do occur:

- A formula based on fiscal effort which took municipalities expenditures into consideration, resulted in rewarding spending, which greatly benefited some and penalized others.

- At its highest the grant pool funded 32.2% of net budgets because of the absence of a fully functioning formula. The unconditional grant was not a reflection of the municipalities' needs nor of their ability to raise revenue.

- Years of reductions in provincial funding as a cost-saving measure reduced the size of the grant pool resulting in higher property taxes and/or a decrease in municipal services.

- Poorly designed formulas or lack of formulas did not serve their intended purpose of increasing the fiscal capacity and financial autonomy of local governments and thereby reducing or eliminating dependence on provincial transfers.

- The Principles of Public Finance often did not guide the development of the funding mechanisms such that they were perceived as fair, providing adequate funding to meet local governments' needs, simple, easily understood and explained, transparent and providing adequate funding to facilitate longer term planning.

Provincial-Municipal transfer systems across Canada

The White Paper of 2021's policy objective of vibrant and sustainable communities can only be realized if local governments have the necessary resources to meet their existing needs and to finance their evolving mandates. All municipalities across Canada have many of the same challenges as those in New Brunswick and although there are similarities in the provincial-municipal arrangements across Canada there are also some marked differences. The Panel looked at funding arrangements of municipalities and regions of provinces including the cities.

Equalization Grants and Unconditional Transfers

Provincial-Municipal equalization grants in Canada all have the same goal of ensuring that local governments can provide reasonably comparable levels of service at reasonably comparable tax rates to their citizens. The notion of Provincial-Municipal equalization is based on the Federal-Provincial Equalization embedded in Subsection 36 (2) of the Constitution Act, 1982. The Act states: “Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”

These transfers can be unconditional and come in the form of revenue sharing or as equalization or other schemes. Transfers can also take the form of conditional grants which as the name suggests, come with prescribed conditions for their use. Both kinds of grants have a role in municipal funding:

Unconditional grants provide autonomy to local governments to determine the priorities of its citizens in terms of services and programs they expect. They require that local governments be accountable for policy decisions and for the execution of those decisions.

Conditional Transfers

Conditional grants are the most used form of provincial-municipal transfers in Canada. Alberta is an outlier receiving 100% of its provincial-municipal transfers as conditional grants. By contrast, New Brunswick receives 35% conditional grants.

Conditional grants are generally used in the funding of capital projects or for the provision of services and programs that are of benefit to both the provincial and local government. The largest conditional transfers in Canada are for transportation, infrastructure, environment (water and sewage) and in Ontario and Alberta for social services. The federal government also funds federal-municipal initiatives of interest to both levels as conditional grants.

The Panel is of the view that unconditional grants allow more autonomy to local governments to set their own priorities in the provision of services for which they are fully accountable to the citizenry. As noted above however conditional grants are suited to the realization of initiatives that benefit both local governments and provincial and federal governments and for the provision of social services.

Unconditional Transfers

The systems of provincial-municipal transfers in Canada bear similarities in how municipal governments are funded for the purpose of equalization and reducing fiscal gaps. Unconditional equalization grants form a component of provincial-municipal transfers in British Columbia, Ontario, Quebec, New Brunswick, Prince Edward Island and Nova Scotia.

The criteria for receipt of equalization and the ensuing formulas differ from province to province reflecting their geographies, municipal remoteness, and the economic viability of certain areas of provinces. As can be seen from the following, equalization grants in Canada serve the purpose of bringing areas of a province to a comparable level of services at a comparable tax rate but different approaches are taken to reach this end. Briefly, equalization grants in the six provinces are as follows:

Quebec, New Brunswick, and Nova Scotia equalization grants are based on a recognition of fiscal need and fiscal capacity, while Newfoundland and Labrador base its grant on population and a remoteness index.

Prince Edward Island's equalization grant is based on non-farm property assessment

British Columbia and Ontario provide equalization grants to small communities, northern and rural municipalities targeting those with challenging fiscal circumstances.

Provincial-Municipal Revenue Sharing

There has been some movement towards provincial-municipal revenue sharing in Canada, but it is not the norm. Municipalities, especially the largest cities, have long called for access to more tax revenue to supplement revenues from property tax and user fees.

Sharing tax room, tax room transfer, or imposition of municipal sales tax or income tax are all examples of diversifying the tax revenue mix in municipalities.

As provinces ask local governments to assume more responsibilities for various social and economic programs traditionally provided by provincial governments, local governments will require revenue over and above the revenue derived from their traditional sources.

Changing Economy and Society

New Brunswick's society and economy are in transition. Covid-19 changed the way we live, work, and spend our money. As examples, many workers who worked in traditional spaces such as office buildings made the transition to home offices and may never return to those spaces. E-Commerce has changed the way we shop thereby requiring stores and malls to adapt, repurpose or close their doors.

The population of New Brunswick has grown rapidly in the past five years. Latest Stats Can statistics report a population of more than 800,000 with an increase of 15,000 new residents in 2021-22 alone. This bodes well for the economy and for the growth of our municipalities. Demand for housing and new business opportunities will increase our overall wealth.

With a growing population and changing economy come many opportunities to grow a prosperous province. However, with growth comes societal challenges that municipalities in New Brunswick and across Canada are experiencing such as homelessness, mental health issues and poverty.

The White Paper acknowledges the important role municipalities play in service delivery and the importance of regional cooperation in realizing the vision of vibrant and sustainable communities. Municipalities are best placed to deliver services as they have the capacity to understand those factors that are unique to their own community. Building on the success of the Regional Service Commissions, the mandates of the Commissions will be expanded to include economic development, community development, regional tourism promotion, regional transportation, and cost-sharing on recreational infrastructure. This enlarged mandate that moves from a strict provision of services to property to one that includes services to people comes with a price. Property tax and user fees alone will not provide adequate revenue for the new reality. As provinces ask local government to assume more responsibilities for various social and economic programs and services traditionally provided by provincial governments, local governments will require revenue over and above the revenue derived from their traditional sources.

The Panel examined examples of provincial-municipal revenue sharing programs in Canada and potential sources of New Brunswick provincial revenue that could be shared with municipalities for the purposes of equalization, replacement of core funding, and for the expanded mandates of the Regional Service Commissions.

Provincial-Municipal Revenue Sharing

Three provinces, namely British Columbia, Saskatchewan and Quebec have some form of revenue sharing:

British Columbia transfers 100% of net revenues from traffic fines to municipalities as well as 10% of the net casino gambling revenues from community casinos and community gambling centers in their jurisdiction. This revenue transfer is unconditional.

Saskatchewan has a long-term revenue sharing program with its municipalities linked to the performance of the province's economy. It shares 0.75 of one full point of Provincial Sales Tax distributed on a per capita basis to cities, towns, villages, and resort villages and rural municipalities receive their share through an unconditional grant formula.

Quebec shares natural resource royalty revenue with municipalities that have mining or oil and gas production. Since 2021, all Quebec municipalities receive a share of the growth of one percentage point of the Quebec Sales Tax.

In these three provinces then, revenue sharing with municipalities comes primarily from fines and gaming revenues in one province, to a share of provincial sales tax in the others.

The Panel examined the following potential revenue streams in New Brunswick that are available to the Province that could be shared with municipalities, including to support the new mandates of the Regional Service Commissions:

-Cannabis tax

-Enhanced GST/HST rebate for local governments

-Property tax exemption for local government-owned property

-Property Tax Room Transfer

-Provincial Sales Tax

Panel Recommendations

This report set out to provide a context for the Panel's recommendations on provincial-municipal fiscal arrangements. An understanding of the evolution of these arrangements in New Brunswick and learning from the methodologies of fiscal arrangements of other jurisdictions in Canada helped guide its work. Of particular importance were respecting the Principles of Public Finance and the White Paper's guiding principles and criteria used in its strategic restructuring. These informed the Panel's thinking and subsequent recommendations.

Equalization

The focus of the new equalization program is on capacity such that municipalities with less resources are brought to the provincial average. The formula does not identify or dictate which services should be offered by municipalities but rather it is left to locally elected officials to make those decisions. The goal of the formula is to ensure municipalities have the financial resources to allow them to offer comparable services at a comparable level of taxation.

1. Methodology

All municipalities have their own unique characteristics. Equalization, however, necessitates the identification of reasonably similar types of communities to allow for fair comparisons regarding relative financial need. Groupings of communities based on population are most likely to have similar service and similar capacity to pay for these services. The Finn Report proposed three groupings: less than 10,000, 10,000 to 40,000 and more than 40,000. The present equalization program has eight categories plus another for LSDs for a total of nine categories.

The Panel recognizes that there are differences in New Brunswick's municipalities that require the creation of groupings. We also recognize that regional hubs have special characteristics including those hubs whose population does not exceed 40,000. As such, we have created a group of cities with a population of less than 40,000. Finally, we have created a separate group for rural districts.

The Panel proposes five groupings as follows:

1- Cities with a population of more than 40,000

2 - Cities with a population of less than 40,000

3 - Municipalities with a population of more than 10,000

4 - Municipalities with a population of less than 10,000

5 - Rural districts

2. Formula

The following principles from the White Paper informed the formulation of a new equalization program:

1 – upholding the principles of Equal Opportunity such that all New Brunswickers enjoy comparable minimum standards of services and opportunities at comparable tax rates, regardless of the financial and economic opportunities of their local.

2 – increasing the capacity of communities through larger tax bases such that residents enjoy a higher and more sustainable level of service.

The formula proposed by the Panel compares the municipality's tax base per capita with the tax base per capita average for the group. The steps are as followed:

1. Compare average tax base per capita vs average tax base per capita of the municipality's group

2. Measure the dollar value of the gap to measure the equalization that the municipality should receive:

   Gap X population X average tax rate of the group / 100

3. If the municipality's own tax rate is below the group average, the municipality's tax rate should be used in the above calculation. This is to represent fairness. Equalization's goal is to increase the capacity of the less wealthy municipalities. To receive equalization based on the group average, the municipality should minimally tax its own taxpayers at the group's average. If its own tax rate is below this average, equalization should be based on the rate it taxes its own citizens.

To calculate the tax base, we recognize that municipalities will be able to tax non-residential properties at a ratio between 1.4 and 1.7 of the residential rate. The formula must include this additional flexibility offered to municipalities. We also assume that tax rates in former LSDs will increase to cover their share of the administrative cost of the new municipalities.

Starting year 2, the calculation of equalizations grants needs to be revised annually to consider the variation in the tax base per capita, as well as tax rate variations.

3. A Transition Period

The proposed equalization program presents important changes to many municipalities. Some will benefit, while others, because of the elimination of the core funding, but also the impact of the mergers associated with the reform, will receive less in transfers. To guarantee a smooth transition, but also to give managers the time to take appropriate actions, the Panel proposes a five-year transition period, as follows:

Year 1: 20% new program, 80% old program

Year 2: 40% new program, 60% old program

Year 3: 60% new program, 40% old program

Year 4: 80% new program, 20% old program

Year 5: 100% new program, 0% old program

Note that the White Paper announced that a second phase of finance reform would be developed in 2024. To quote the White Paper "the intent is to bring forward further changes related to finances before January 1, 2025". In the transition period that we propose, assuming an implementation in 2023, the phase out of the transition period would correspond to the implementation of the changes from phase 2 of finance reform.

4. Elimination of Core Funding

The Panel recommends that the core funding grant be eliminated from the equalization program. The equalization program should be limited to increasing the capacity of municipalities whose asset base per capita is below the average of their group.

The broader questions of municipal financing will be addressed in phase 2 of finance reform, in 2024. Considering that the proposed change will have an important impact on some municipalities, we have proposed a five-year transition period. Furthermore, a temporary partial compensation to municipalities losing as a result from these changes is presented in the section titled "Roads".

5. Regional Service Commission

Additional services offered by the Regional Service Commissions are often services which in the past were offered by the provincial government. The Panel recommends that these additional services be funded 50/50 by the provincial government and the municipalities. The province's share should be linked to the tax base, increasing as the value of the tax base increases, distributed on a per capita basis, which will be through a property tax room transfer from the Province.

6. Roads

With the reform, the provincial government will maintain responsibility for roads in old LSDs. This is a form of subsidy that will be unevenly distributed: some municipalities will be benefiting more than others. Consequently, to recognize this fact, the Panel proposes that in the calculation of the equalization to be paid to municipalities, the value of the province's contribution for roads in old LSDs should de deducted from the equalization amount that the municipality would receive. In other words, the fiscal capacity measure (average tax base per capita) should be modified to consider the fact that the province will be paying for roads outside the municipal budget in the old LSD.

The amounts deducted from the equalization payments should then be redistributed prorated, for the transition period, to all municipalities losing money with the new equalization program compared to the previous one. For example, if the total amount of the reduction in equalization a result of the provincial road financing for LSDs is 16 million dollars and if the total reduction of transfers to municipalities receiving less money is 28 million dollars, each municipality experiencing a reduction in total grants would receive a temporary compensation of 57,1% (16/28) of the reduction. This would only be temporary, before the second phase of fiscal reform announced in the Department's White Paper takes effect.

7. Initial Budget

The Panel recommends that the Equalization Program should have the funds required to bring those municipalities eligible for equalization to the group's average capacity. To estimate the amount required, we must add all individual equalization amounts for which municipalities qualify based on the formula. This calculation will generate the initial budget for the equalization budget.

8. Future Budget Adjustments

After the initial year, the fiscal and financial reality will change. The equalization budget should be modified to consider these changes. One option would be to increase the budget based on inflation, measured using the consumer price index (CPI). The Panel does not favor this approach as this is linked to expenditures while the principle we propose in the equalization formula is one of capacity. Therefore, the Panel recommends that the program's budget be increased annually proportionally to the average increase in the province's tax base.

9. Three-Year Averages

Municipalities will benefit from certainty and stability in the program. This will improve municipalities' capacity to do more long-term planning. Consequently, the Panel recommends that in the future, three-year averages (the given year and the two previous years) be used to calculate equalization. Considering that the Panel is proposing a transition period for the program, the implementation of this three-year average component would be rolled out during the first three years of the new program. The first year, the data for this given year would be used. For the second year, it would be the average of the first year and the second year. The third year, and every year thereafter, the data for the given year and the two previous years would be used. The weight of all years would be equal (1/3 per year when using three years).

10. Evaluation of Equalization Program

In five years, after the completion of phase 2 of finance reform, we recommend that the equalization program should be the subject of a new analysis. The impact of municipal reform will be clearer. At this time, it is still too early to know how the new municipalities will ultimately operate (for example, what new services will be offered in old LSDs). Phase 2 of finance reform will possibly require revisiting the equalization program. Finally, any weaknesses of the proposed program could be analyzed, with the benefit of experience, and improvement proposed.

11. Recommendation - Revenue Sharing

The Panel examined expected tax revenues from various sources to assess the appropriateness as mechanisms to diversify the revenue base for local governments. The Panel recommends that these varied potential revenue sources be further explored in Phase 2 – Finances.

12. Property Assessment Process

The proposed equalization program is highly dependent on the assessment process to estimate property values. To not only increase the confidence in the assessment process, but also guarantee that the program’s objectives are truly met, the Panel recommends an analysis of the province’s property assessment process. One of the objectives of this assessment would be to identify any regional differences in assessment, where the difference between the assessed value and the market value would be different across the province. If this is the case, recommendations would be proposed to improve the situation.

ADDITIONAL ELEMENTS

Police Services

In the past, a component for police services was included in equalization. One reason for this was that the financing from LSDs was capped. This is no longer the case. Furthermore, the proposed equalization formula is based on capacity, allowing local leaders to make decisions with respect to what services are going to be offered, but also how they are going to be offered. The Panel considers that the equalization program should not be modified to consider those choices. It should only allow local leaders to be able to make decisions.

Potential Claw back

Is there a maximum level of equalization that a municipality should receive? If we are to set a maximum level, what should that level be? These are difficult questions to answer. In the last provincial budget (2022-2023 Budget Speech), we can see that the government of New Brunswick receives 21.9% of its revenue from the federal equalization program. This could be a threshold. The threshold could also be higher, 25% for example.

If a claw back is applied, should it be a hard number or a gradual reduction? One possibility would be to start a claw back at 25% of revenues from equalization. Over that amount, the municipality could only keep the additional equalization if its tax rate is above its group average – which is a concrete demonstration of need – and that this additional equalization would be in proportion to the relative difference between the municipality's tax rate and the average tax rate of the group. For example, if the municipality's tax rate is 30% above the groups' average, it would keep 30% of the equalization of the 25% threshold.