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Fiscal Limitations to Government Crisis Response: The Municipal Experience in Responding to Infrastructure Failure

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Key messages

- Government response to crises is limited by structural factors, including imperfect economic forecasting, preference for status quo, and short-term political cycles.
- Municipalities face significant financial constraints in crisis management due to limited revenue sources, reliance on regressive property taxes, and restrictions on borrowing.
- Local governments heavily depend on intergovernmental transfers, which can be unreliable and restrictive for crisis prevention and management.
- The infrastructure crisis in Canada, exemplified by Prince Rupert's water system failure, highlights the fiscal limitations of local governments in addressing predictable crises.
- Recommendations to improve municipal crisis response include broadening taxation powers, increasing intergovernmental transfers, and granting more financial flexibility to local governments.

Introduction

> *“Today’s crisis exposes cracks in the fundamentally outdated fiscal framework in which municipalities are still forced to operate. And as we now approach a tipping point, our next steps will reverberate through the lives of Canadians... This is why we are turning to our federal partners for emergency operating funding—to sustain municipal operations and essential services through these extraordinary times*
>
> —Federation of Canadian Municipalities (FCM, 2020).

In response to an increasingly complex world impacted by climate change, pandemics, financial crisis, and more, all levels of Government have shifted to focusing on risk, yet all remain limited in their ability to proactively manage and mobilize in crises. With full departments and programs allocated to certain forms of crisis and the financial leverage to create them, higher levels of government have demonstrated capacity to anticipate and react to change, while municipalities are more limited in their tools. This paper will explore the various limiting factors in local government response to crisis, with particular emphasis on the BC context, using the near collapse of the City of Prince Rupert’s water infrastructure in 2022 as an example to highlight those limitations. Finally, options to limit the vulnerabilities of local government to future crises will be explored.

Structural Limits to Government Management of Crises at all Levels

By virtue of their existence, crises will test the financial limits of a planned budget, which rely on predictability of events. Budgets include built in macroeconomic forecasts of revenues, expenditures, and outside economic influences used to test and validate financial priorities (Tellier, 2019, p. 103). Within this system, however, knowledge of the economy and likelihood of crisis is imperfect, preference is given towards status quo and elite decision making, and stability is emphasized at the expense of both process and outcome assurances (Atkinson and Mou, p.5, p 31-32, 197). Additionally, planning for the worst possible scenario feels overdone to politicians eager to produce results that can be captured within a four-year election cycle (Atkinson and Mou, 2024). These are all major limiting factors in the allocation of funds to both predict crisis and quickly mobilize a response to it.

Limitations to Municipal Crisis Response and the Impending Infrastructure Failure Crisis

Revenue limitations and Regressivity of Property Tax + Utility Fees

The main financial limitation for local government is revenue collection ability. Within the division of powers, municipalities are wards of their respective Provincial and Territorial governments, with higher levels of government having exclusive rights to generate new systems of taxation as well as programs and institutions to manage debt and regulate financial and real estate markets (Slack, p. 264). In addition, the Federal government has exclusive power to use monetary policy to seek to control inflationary impacts related to crisis (Tellie, 2019, p. 80).

The main revenue sources for Canadian municipalities are property taxes, user fees, and intergovernmental transfers (Slack, 2023, p. 269). This restrictive list of revenue options contributes to a 'vertical fiscal imbalance', where municipal taxes account for 10 per cent of all taxes collected in 2020; the Federal government accounted for 45 per cent and Provincial governments for 45 percent (Slack, 2023, p. 269; Tassony and Conger, 2015, p. 3). This imbalance is punctuated by the fact that municipalities overwhelmingly rely on taxation as their primary revenue and also maintain over 60% of public infrastructure in the country (FCM, 2024a). There are also limitations on municipal borrowing that prevents cities from taking on more than a set percentage of annual revenues as debt repayment (Province of BC, 2024a).

Revenue limitations have compounding effects. Municipalities must also have a balanced budget every year. They do not have the flexibility of other levels of government for 'tax smoothing' by taking on more debt or generating new sources of revenue to offset increases that are due to a crisis experienced in a single year. Property taxes and utility fees are also regressive, and arguably unduly burden those less able to pay (Mills, 2005). Where the Federal government operates through appropriation bills and the principle of the 'non-allocation of revenues' from the General Operating Fund (Tellier, p. 118), in the municipal budget, each line item must clearly denote how it will be funded. When allocations to crisis prevention are funded explicitly by new taxation and a corresponding increase to property taxes for residents, there may be less political will to raise taxes to set aside funds or conduct proper asset management (Tassony and Conger, 2015, p.1). All of these factors have a limiting impact on financial capacity for short term crisis management and long term crisis prevention.

Reliance on Government Transfers

Government transfers like those described below to Prince Rupert to respond to their water distribution system crisis are another critical source of revenue. For three decades since the 1970s transfers to municipalities diminished, with increases again in the 2000s, however it is unclear whether increases are enough to meet current expenditure needs, let alone catch up on infrastructure deficits or adequately prepare for the impacts of climate change (Slack, p.266). In addition, while non-conditional transfers exist they are limited to spending on capital projects, and conditional granting programs meanwhile requires local governments to have the capacity to apply, and in most cases to supply matching funds.

Once a crisis has actually occurred, municipalities can call a Local State of Emergency and appeal to their respective Province for financial support to respond; however there is no guarantee funding will be granted as there are restrictions on eligible emergencies that caters towards natural disasters instead of infrastructural failures (Province of BC, 2008, p. 7). In all cases, transfers are by nature restrictive and potentially unreliable for crisis prevention and management.

The Prince Rupert Water System Crisis

Crises have differing levels of predictability. Arguably infrastructure failure is among the most predictable given age and condition assessments are frequently conducted in asset management reviews. Still, many across the political spectrum highlight the deteriorating state of infrastructure across Canada as a crisis in and of itself, although they do not always agree on how to address it (Bruce, 2024; Flemming, 2024; Tassony and Conger, 2015; Caulfield, 2024; Slack, 2023). Why is it that the crisis of infrastructure failure has gone unabated? Infrastructure is primarily a local government responsibility, which, as noted above, are the least fiscally empowered of all levels of government. By way of example, the crisis within the City of Prince Rupert's water supply paints an illustrative sample of key limitations.

In December of 2022, the City of Prince Rupert called a State of Local Emergency to direct resources and draw attention to the escalating level of water main and service breaks in the community – a result of decades of underspending on utility replacement due to the loss of the City's major taxpaying industry in the early 2000s. This situation had overwhelmed local forces and if improperly managed could have led to the full collapse of the water distribution system (City of Prince Rupert, 2022). Within 3 months, the Provincial government stepped up to provide $65 million in funding towards funding replacement of the water lines in most dire need of replacement (CBC, 2023). Following that, the municipality applied for and then waited for approval of funding from the Federal government's Disaster Mitigation and Adaptation Fund and also approved $45 million in borrowing, to achieve a total purse of $205 million to put towards pipes at highest risk and consequence of failing (Forward, 2024).

This anecdotal experience, though only one case, is illustrative of the limited fiscal powers of local government as compared to their Provincial and Federal counterparts. It highlights the inability of local government to adequately abate an easily-anticipated crisis due to the restrictive nature of regressive property taxation and challenge of political will; the over-reliance on Federal and Provincial response and timelines to act on the emergency; and, the lack of financial flexibility to move out of crisis and into proactive infrastructure management.

As previously mentioned, to match provisioned higher level government funding City Council approved $45 million in borrowing to fund our portion of required spending to replace failing utilities. Although the impacts to utility rate payers were presented when borrowing was pursued, utility rate bylaws underwent multiple revisions in an attempt to reduce the transfer of cost to households.

Not only that, but Prince Rupert has the benefit of being home to a port that is a competitive gateway to the Asia Pacific and sees $65 billion in trade annually. Few municipalities of similar age, size, and infrastructure condition can claim the same, yet recent events in Calgary, Montreal and other municipalities suggests that Prince Rupert is by no means alone in its need for critical renewal (Flemming, 2024). The plea that, "If our port fails, you will fail" will not work to generate substantial transfers for all communities, and so a system of more sustainable and predictable revenue mechanisms is needed.

Recommendations and Conclusion

To correct fiscal imbalance and provide more flexibility for local governments to both prevent crisis and respond to it, there are several potential solutions, including, but not limited to: broadening municipal taxation ability to include income and sales tax transfer programs (Slack, p. 272); extension of the equalization payment program that exists currently in select provinces (Slack, p. 266); increasing the overall amount of direct Federal and Provincial annual transfers to municipalities and linking them to GDP (FCM 2024); broadening eligible expenditures under federal transfer programs to include operating as well as capital (infrastructure) costs (FCM, 2024); and, to consider granting municipalities new powers over taxes or user fees (FCM, 2024).

The theorem of decentralization notes that government services should be provided by, "the lowest level of government that can do so efficiently" because they are better attuned to local needs and constraints (Tassony and Conger, 2015, p. 3). They are also innately more democratic due to embedded budget consultation practice as compared to other levels of Government and their elite decision-making bodies (Atkinson and Mou, p. 197). Thus, empowering municipalities to be more nimble in crisis response has the potential to be one way to achieve a 'Great Reset' (Atkinson and Mou, 2024) and address some of the key issues facing higher levels of Government, such as overemphasis on process.

Local government and the services they deliver have immediate impact on Canada's crisis resilience, specifically with reference to the maintenance and renewal of infrastructure and also climate change adaptation and action (Slack, p. 263; Robinson and Gore, 2005). Municipal governments currently have direct or indirect control over approximately 44 per cent of GHG emissions in Canada (Robinson and Gore, p. 3). Additionally, acute climate related crises are increasingly impacting municipal coffers (MacDonald, 2023). A stable financial system that supports local government isn't just desirable to ensure vibrant, livable communities, it is essential for effective crisis response planning and management now and in the future.

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