Hugh Mackenzie

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HUGH MACKENZIE & ASSOCIATES

Summary

With the release of Toronto's 2010 staff-recommended operating budget on February 16, the public debate over Toronto's fiscal future is on.

As has been the case in previous years, the proposed 2010 budget contains a little bit of everything:

- A property tax increase – higher for residential taxpayers than for businesses;
- User fee increases across-the-board;
- Some expenditure cuts;
- Service cuts, characterized misleadingly as "efficiencies";
- And a request for stop-gap funding from the provincial government.

> Much of the commentary about the City of Toronto's 2010 budget starts from a legitimate concern about the state of Toronto's finances … and passes quickly to a set of pre-cooked and ultimately unhelpful "solutions" without anY serious consideration of the economic and political facts.

The good news in the recommended budget is what it does not contain. It resists the pressure to declare a dramatic tax freeze, with its devastating consequences. It rejects the idea of a fire sale of city assets as a solution to Toronto's budget problems. It resists the suggestion by some critics that all of Toronto's budget problems lie on the expenditure side of the revenue statement.

There are two major pieces of not-so-good news in the plan. One is that much of the heavy lifting in the budget balancing exercise is coming from undefined "efficiencies" – cityspeak for service cuts. Indeed, the "efficiencies" in the budget plan contribute almost exactly twice as much to the budget balancing exercise as property tax increases. The other is that while the plan produces a balanced budget, it does so assuming that the annual cap-in-hand approach to the provincial government for temporary transit operating funding support will succeed again in 2010.

As a result, Torontonians can expect to see a continuation of the longest running show in town -- the debate over Toronto's fiscal future. The purpose of this paper is to put that debate into perspective.

Most Toronto budget commentary starts from a legitimate concern about the state of the city's finances but degenerates into a set of pre-cooked "problems" and unhelpful "solutions" that take, as a given, that Toronto's spending is out of control.

A review of the facts behind Toronto's 2010 budget shows that these claims are not only misleading, they actually distract attention from the real issues behind Toronto's budget problems.

The fact that, over the past five years, wages and salaries have increased at a faster rate than inflation is often presented as proof that public employees' escalating pay is responsible for Toronto's fiscal problems. In fact, those increases reflect changes in pension and benefit funding requirements, changes in the city's accounting for employee benefits and an increase employment levels to provide increased service.

The simple assertion that there is massively wasteful spending at City Hall is presented as proof that getting rid of waste can make a significant contribution to alleviating Toronto's budget problems. But this assertion was blown out of the water by the city auditor's February report, which identified problems amounting to a tiny fraction of the city's budget, mostly due to legal problems with the collection of parking tickets.

> Toronto's spending has actually grown slightly more slowly than that of local government's in the rest of Ontario.

Toronto's spending is not "out of control". A comparison of spending growth rates between Toronto and other local governments in Ontario shows that between 2002 and 2008, both in absolute dollars and per capita, Toronto's spending has grown slightly more slowly than the rest.

The fact that Toronto is borrowing on public markets to finance its infrastructure renewal program is presented as proof that Toronto must sell off assets to reduce its debt but the opposite is true.

The headline concern over Toronto's increased reliance on borrowing from public markets is misplaced. The need to rebuild public infrastructure across Canada is beyond debate. It is essential that Toronto invest heavily in infrastructure renewal over the next 10 years. And the fairest and most reasonable way for Toronto to pay for its share of the costs is to spread those costs out over time through debt financing.

The real reason critics are talking about Toronto's debt is to use it as a launching pad for selling off key assets.

Selling off assets – specifically Toronto Hydro, the city's largest business asset – has been repackaged as a "new idea" and aggressively marketed by an investment industry that stands to make tens of millions of dollars if Toronto were foolish enough to put those assets on the market. An analysis of the relationship between the City of Toronto and Toronto Hydro shows that selling off Toronto Hydro would actually cost the city millions of dollars in annual lost revenue and cut it off

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from an important instrument of the city's environmental policies.

Toronto's finances are not under pressure because its spending is out of control. They are not under pressure because city employees' wages are out of control. And for the most part, they are not under pressure because of broader economic forces that are beyond the city's control.

Toronto's finances are under pressure as a result of political decisions made at the provincial level by the former Mike Harris government and at the local level largely under the administration of former mayor Mel Lastman. In the late-1990s, the Harris government rewrote the rule book on local government finance in Ontario. It reduced provincial support for local services and shifted financial responsibilities for services like social assistance, housing and public transit on a basis that worked massively against the financial interests of Toronto. In the late 1990s, the Harris government also mandated, but did not fund, a property tax reform that forced a tax shift away from business onto residential taxpayers.

> The three-year tax freeze that propelled Mel Lastman to victory also papered over increased costs resulting from amalgamation and the restructuring of the provincial-local financial relationship.

The three-year tax freeze that propelled Mel Lastman to victory as the Megacity's first mayor in 1998 also papered over increased costs resulting from amalgamation and the restructuring of the provincial-local financial relationship. But the impact of the tax freeze, along with the city's efforts to balance its budget against increasing costs without property tax growth, has had an ongoing negative effect on Toronto's finances.

Using a 3% annual increase as a reference point, the three-year Lastman tax freeze reduced Toronto's revenue base by nearly $250 million a year. And when the city emptied its reserve funds to cover increased costs during the freeze, it also reduced the city's flexibility to deal with budget fluctuations in the future.

These political choices promised short-term gain but Toronto continues to pay the price. A long-term solution is needed.

On the provincial front, some relief is on the way with promised reform of social assistance and court services funding. But it is still years away, and it leaves untouched the rewritten financing arrangements for transit and housing that still carve a huge hole in Toronto's finances.

One of the reasons why the federal government finds it so attractive to use transfer payments to the provinces to manage its own finances, and why the province uses transfer payments to local governments in the management of its finances is that the senior levels of government are shielded politically from the consequences of their decisions.

Part of the solution to Toronto's fiscal problems requires that the city connect politically to the province the measures that it must take to address its fiscal problems.

Part of the solution to Toronto's fiscal problems requires that the city makes the political connection to the province for the measures that it must take to address its fiscal problems.

But for the immediate term, there is no perfect, painless solution to the financial issues Toronto will face this year and in the next few years, it is obvious there is no credible way to continue to avoid politically difficult choices.

The services Toronto requires to function as Canada's biggest and most diverse city aren't free and unless the tooth fairy turns up looking for work, that means individual Torontonians and the businesses that thrive here will have to pay higher taxes.

Introduction

Since 1998, when the seven local governments that now make up the City of Toronto were forced into amalgamation by the provincial government, budget setting in Toronto has been a very public high wire act.

Every year a familiar drama unfolds around the shortfall between the revenue base of the city and its anticipated operating budget requirements.

Every year the refusal of the provincial government to pay its fair share comes into sharp relief.

And every year the underlying problem goes unaddressed, but the provincial government serves up what it invariably calls ‘one time only’ transfer payments, framed as a bailout.

This year, Toronto’s budget crisis is heightened by several factors, political and economical.

First, Toronto is in the midst of an election campaign for mayor. With the incumbent not running, contesting candidates have seized the opportunity to paint the city’s fiscal situation in the starkest possible terms as the foundation for their campaigns.

Second, Toronto faces particularly difficult fiscal pressures in 2010 because the combined effect of recession and Canada’s weakened Employment Insurance system places an inordinate burden on municipal social assistance rolls.

> Every year a familiar drama unfolds around the shortfall between the revenue base and operating budget requirements. In 2010, the drama has been heightened by five additional factors:
>
> - The election campaign for mayor
> - Pressures from the recession and a weakened EI system
> - The province’s own financial pressures
> - Debt-servicing costs for the city’s share of infrastructure spending
> - Unpredictable revenue sources that vary with the economy

Third, the provincial government is coming to terms with its own recession-related financial pressures, making it more difficult to bring forward the kinds of stop-gap measures offered in previous years.

Fourth, while the flow of infrastructure funding coming from federal and provincial stimulus spending initiatives has been a welcome down payment on the city’s infrastructure investment backlog, the debt-servicing cost generated by the city’s share of these projects has become an issue.

Finally, in the midst of a recession, Toronto is experiencing the down side of relying on unpredictable revenue sources like the land transfer tax and the

vehicle registration fee. Unlike other governments whose revenue sources vary with the economy, municipalities cannot run a deficit.

In an election year in the midst of a recession, the characterizations of the financial problems facing Toronto are all too predictable. Equally predictable are the “solutions” to Toronto’s financial problems: Get rid of waste at City Hall, get tough with the unions, contract out public services, impose massive service cuts, and sell off or “monetize” public assets.

This report puts Toronto’s financial troubles into perspective and points towards solutions to the city’s budget crunch.

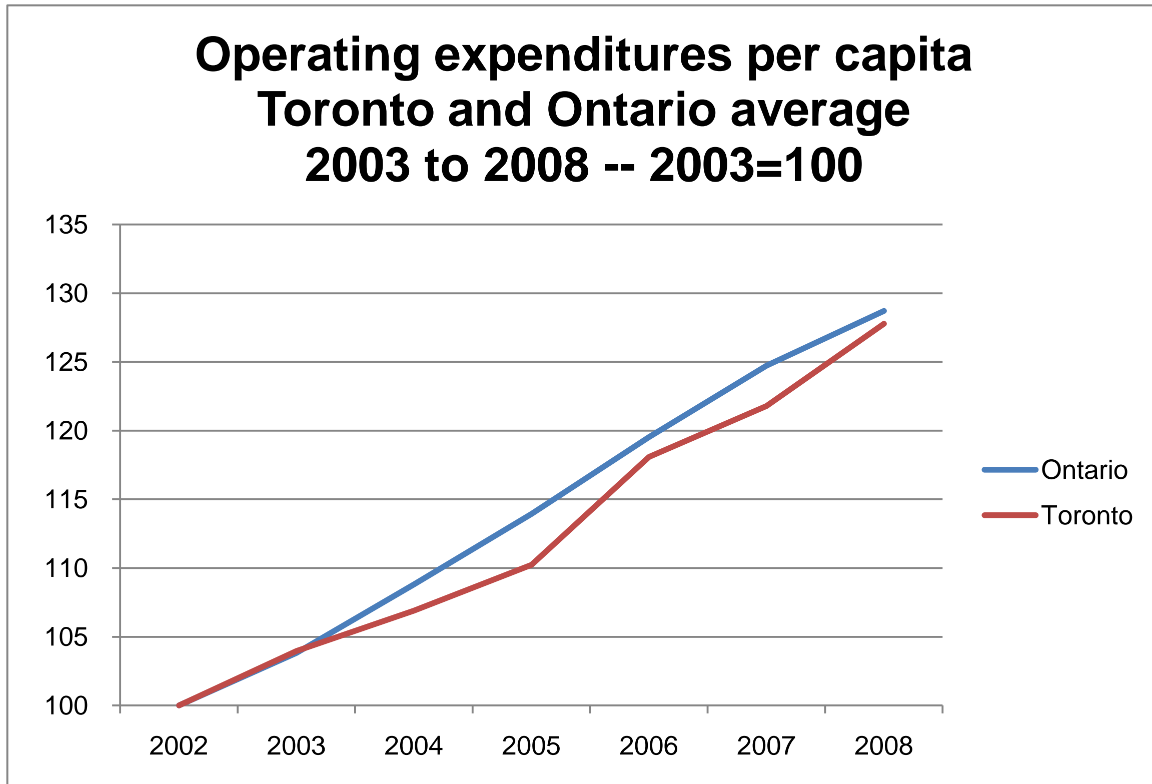
Local government spending in Toronto in perspective

There is no evidence that Toronto’s expenditures are out of control or out of line with local government expenditures in the rest of the province.

Between 2003 and 2008, the most recent year for which data are available, City of Toronto’s operating expenditures increased by 27%. Over the same period, municipal government operating expenditures across Ontario increased by 31%. Per capita operating expenditures in the City of Toronto increased by 23% compared to 24% across the rest of Ontario.

Chart 1 – Local Government Operating Expenditures per capita, 2003 to 2008, Toronto and Ontario, 2003 = 100[1]

[1] Sources: Toronto: City of Toronto budget documents, Statistical Information, 5-year review Ontario: Statistics Canada, CANSIM 385-0024



Factors contributing to Toronto's budgetary issues

Provincial policies: an unusual mix

In Ontario, we've become used to the fact that local property taxes are diverted to help fund public services like ambulance services, public health, court protection services and social assistance.

But compared with other provinces in Canada, Ontario is an outlier.

With 38% of Canada's population, Ontario accounts for 49% of the national total use by provincial governments of the local property tax base for other purposes. Ontario accounts for 95% of the national total of local government spending on social services. It accounts for 66% of Canada's local government spending on housing. It accounts for 80% of local government spending on health.[2]

While Ontario tends to rely on local governments to deliver provincial services to a greater extent than other jurisdictions in Canada, that reliance is not balanced by greater transfer payments from the province to local governments.

In 2008, Ontario accounted for just 27% of all transfer payments from provincial to local governments in Canada, compared to Ontario's 38% share of Canada's population and 43.6% share of total local government expenditures.

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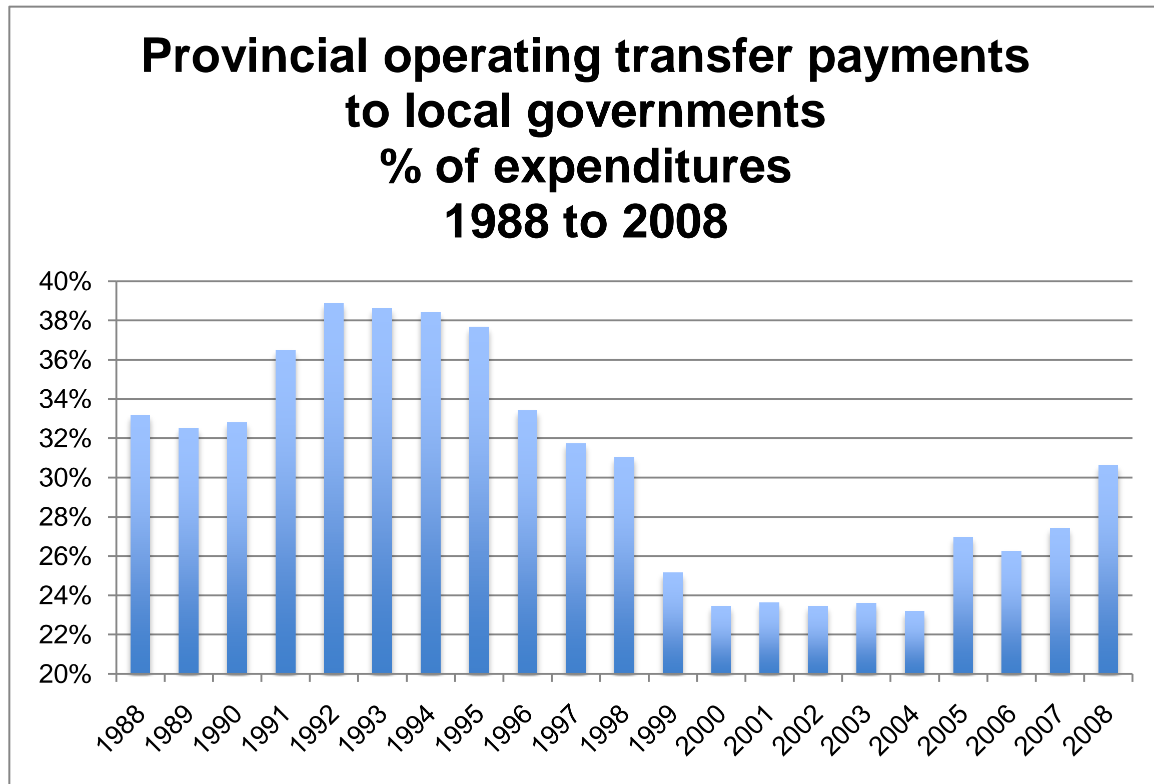
[2] Source: Statistics Canada, CANSIM 385-0024

Over the past 20 years, there has been a dramatic decline in provincial government support for local government services in Ontario.

Chart 2 shows provincial government transfer payments to local governments in Ontario as a percentage of local government operating expenditures from 1988 to 2008.



The principal culprit behind the drop in transfer payments from the province to local governments was the shift in spending responsibilities onto municipalities as a result of the Crombie "Who Does What?" exercise in the late 1990s. Provincial support for local government services went from a 38% high during the Rae government era, plunging to less than 24% in Harris' second term. By 2008, funding had been restored only to 30%.

It should be noted here that, in its marketing of local government financial restructuring, the Harris government gave itself credit for education finance reform as an offset to increased costs to municipal governments.

From Toronto's perspective, several issues are raised by this assertion.

First, the provincial government did not take education off the property tax. It eliminated the taxing powers of school boards, but continued the education property tax as a provincially mandated tax.

Second, education finance reform resulted in reduced total spending on education in Toronto, leading school boards to cut spending on services that

were complementary to municipal services. That put additional financial pressure on the city government.

Third, education finance reform did not deliver increased funding to local governments. By freezing education property taxes, it made a limited amount of additional property tax room available to local governments. But local governments would have had to increase their tax rates in order to occupy that additional room. Some local governments did, as is discussed more fully below. Toronto decided, instead, to freeze taxes.

One of the less visible effects of the Harris government's uncontrolled experiment in local government finance reform was the opening up of new service gaps. Because school boards and municipalities drew from the same tax base, many large urban municipalities started delivering community services through the school system. When the new funding formula for education came with its mantra that 'if it's not education, as the provincial government defines it, it won't be funded' many of these services were orphaned.

Toronto was disproportionately disadvantaged by this and other new arrangements.

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> At the same time, education finance reform did not deliver increased funding to local governments.
>
> Toronto was disproportionately disadvantaged by this and other new arrangements.

Responsibility for social housing was also shifted onto local government under the Harris era. Toronto accounts for 33% of local expenditures on social housing in the province.

Transit operating subsidies were eliminated despite the fact that the TTC accounts for 65% of urban transit system ridership in Ontario.

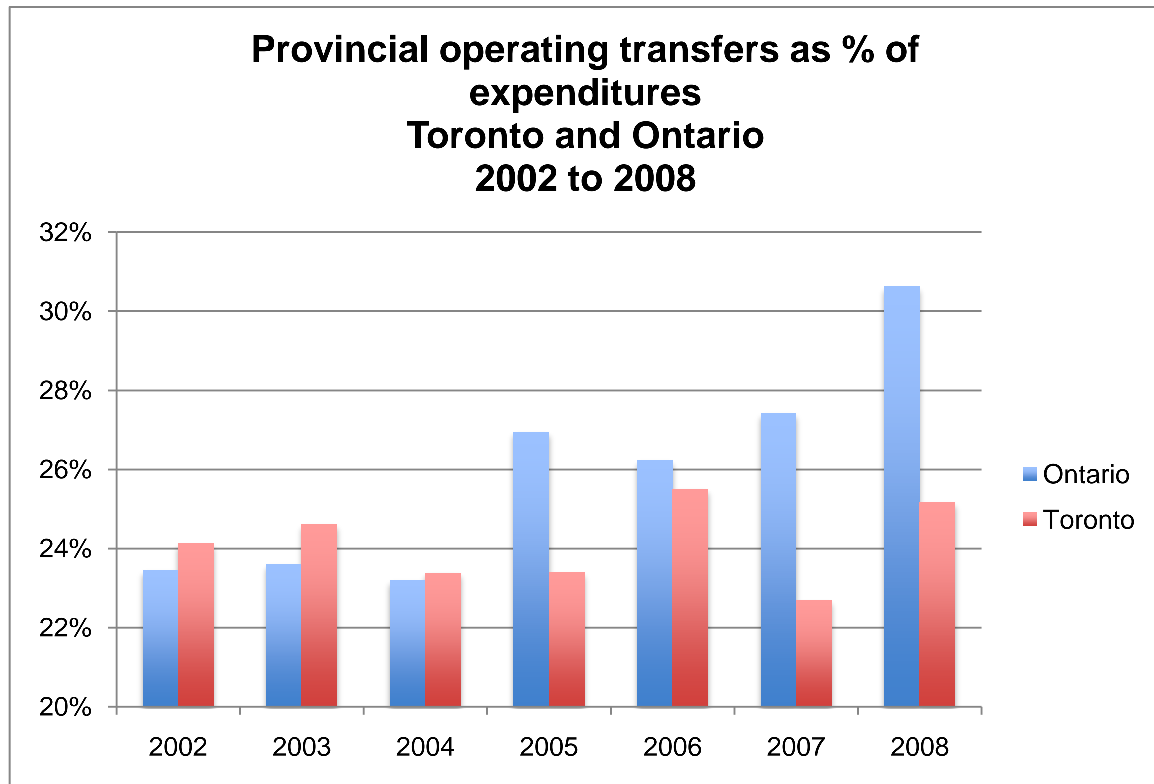
Local governments were made responsible for court security, community health and ambulance services, all of which are relatively more significant services in Toronto than in other parts of Ontario.

And local responsibility for funding social assistance was broadened to include benefits under the Ontario Disability Support Plan.

With provincial education taxes frozen, the 4% residential / 1.33% business (commercial, industrial and multiple residential) / 2.5% combined tax increase proposed in the 2010 staff recommended budget translates to a total combined municipal and education property tax increase of 2.8% residential / 0.8% business / 1.6% combined.

Despite the high-profile provincial “bailouts” of recent years, the provincial government hasn’t come close to recovering its former transfer levels to Toronto compared to other municipalities.

Chart 3 shows provincial transfers as a share of local operating expenditures for Toronto, from 2002 to 2008, pale in comparison to other municipalities.



Even the formal download of responsibilities does not capture fully the extent of its impact on the city’s budget. City staff estimated in 2009 that, if the provincial government funded its full share of jointly funded programs, city revenue would be $273 million higher than it is today.

The province’s use of the local property tax base to pay for provincial public services is a problem at the best of times. But when a weakened economy and inadequate unemployment insurance system force hundreds of thousands of Ontarians into reliance on social assistance, the problem becomes a crisis.

For Toronto, the rise in social assistance benefits goes straight onto the property tax base, because the city doesn’t have the option of borrowing to cover operating costs inflated by the recession.

Toronto's exposure to the recession is highlighted in the city's briefing notes on the 2010 budget. Toronto has 45% of the population of the GTA, but has:

- 75% of the households receiving social assistance;
- 62% of the children living in poverty;
- 63% of the seniors living alone;
- 72% of the tenant households; and
- 53% of the lone parent families.

Looking at Ontario Works alone – a $600 million+ program in Toronto – the city is projecting an average caseload of 105,000 for 2010, compared with an average for 2008 of 75,000. That suggests an increase in costs over two years of roughly $240 million, of which 20% of comes from the Toronto tax base.

A hidden, unfunded business tax reform

In addition to rewriting the rule book on responsibility for provincial/local shared programs, the Harris government also took control over municipal property assessment and mandated a uniform, province-wide system of market value assessment.

It dramatically changed the way businesses were taxed at the local level in Ontario.

Prior to the late-1990s, businesses were subject to two types of taxes at the local level: the regular property tax and the business tax. Rates of property tax on commercial and industrial properties varied in relation to residential property tax rates across the province. In addition, because assessed values varied in relation to market values among property classes, businesses generally paid higher taxes relative to market values than residences. These higher effective rates were often justified on the basis that because the taxes were deductible for income tax purposes, the effective rate of tax on business property was essentially the same as that on single-family residential property owners who could not deduct property tax as an expense.

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The Business Tax was levied as a percentage of the property tax, at rates that varied depending on the type of business operation.

When market value assessment was introduced, the Harris government folded the business tax into the commercial and industrial property tax, eliminating a cross-subsidy in the system that favoured small businesses. In addition, it imposed restrictions on local governments' taxing authority in two respects. First, it required local governments to recalculate their base tax rates at each

reassessment, to deny local governments automatic access to increased revenue when property values increased. Second, it mandated the establishment of a single rate of tax on all classes of property, requiring that the change be implemented by freezing any tax rate that exceeded the single-family residential tax rate to permit the single-family rate to “catch up” to the other rates.

For any municipality with a single family residential tax rate lower than its multiple residential, commercial and industrial tax rates, this effectively restricted local governments to single family residential taxpayers as a source of revenue to cover increasing local services costs.

Toronto was hit particularly hard by this requirement. At the time of conversion, the effect of this change was to protect properties that provided 70% of the city’s property tax revenue base from any tax increases. Effectively, Toronto had access to barely 30% of its property tax base for tax increases.

Despite the substantial impact of this provincially mandated business tax reform, no offsetting relief was provided to the affected municipalities.

While this restriction has since been relaxed, the legacy issues from unfunded property tax reform remain in the form of the city’s long-term plan to reduce the discrepancy between business and residential tax rates. The policy itself may be appropriate; its implementation has been less than transparent. The fact that residential tax rates have been increased more quickly than would otherwise have been required in order to fund a tax shift from businesses to single family residences has received little public attention. The impact is significant. For example, it would have taken a 2.5% across-the-board tax increase to raise the same revenue as that raised by the proposed 4% residential / 1.33% business tax increase. In effect, 1.5% of the 4% increase is required not to fund the costs of city programs but to fund a tax shift away from business.

The legacy of ill-advised tax freezes

Not all of the responsibility for Toronto’s current financial squeeze lies with the provincial government.

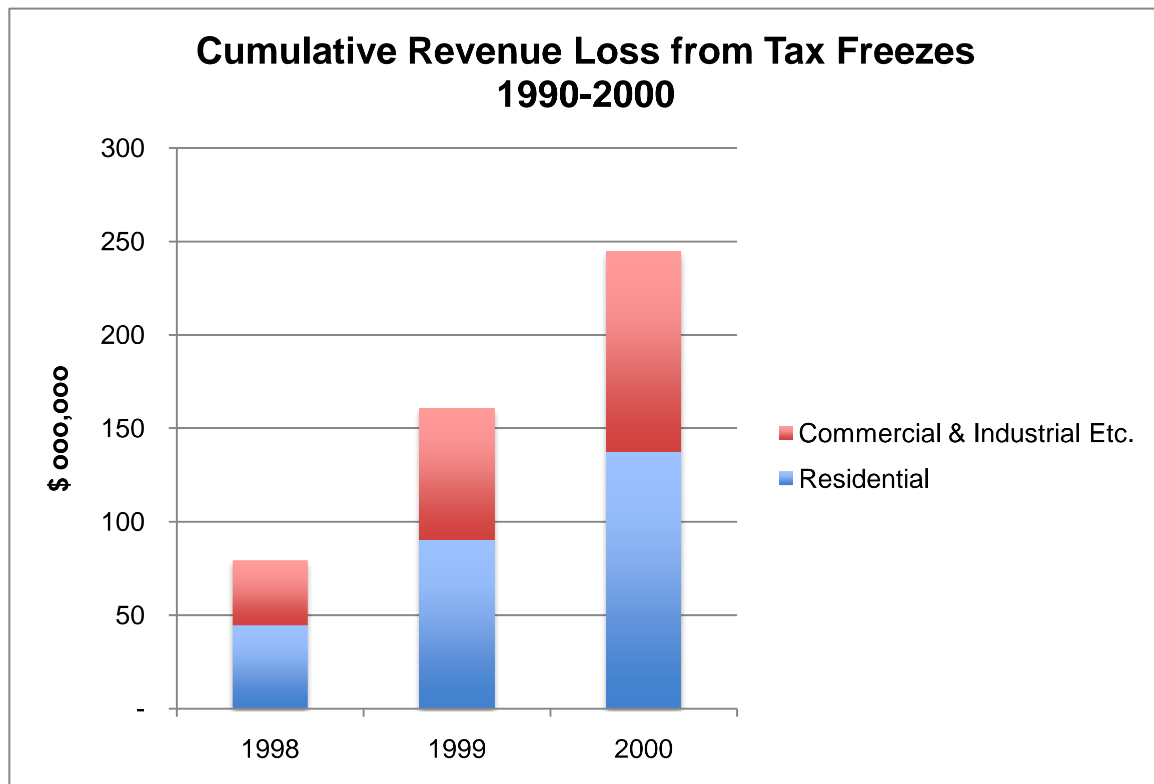
In 1998, North York mayor Mel Lastman realized a long-held dream when Premier Mike Harris forced the creation of a single City of Toronto to replace six local governments and Metro Toronto -- giving Lastman the opportunity to become the city’s first mayor. At the same time, the provincial government implemented a restructuring of the provincial-municipal financial relationship and took control over the elementary and secondary school system.

Mel Lastman made a three-year tax freeze the centerpiece of his election campaign. The freeze campaign worked for Lastman – he cruised to victory in the election – and it provided Mike Harris with the perfect rebuttal to critics of his government’s relationship with Toronto. But it was a financial disaster for the city. As the city struggled to make ends meet with no increase in property tax revenue, the claimed savings from amalgamation evaporated, services were cut,

reserves were drained and Torontonians were hit with new or increased user charges in every sphere of local government activity, from sewer and water rates to recreation centre fees.

The cumulative effect of tax freezes reduced Toronto's revenue base by approximately $250 million per year.

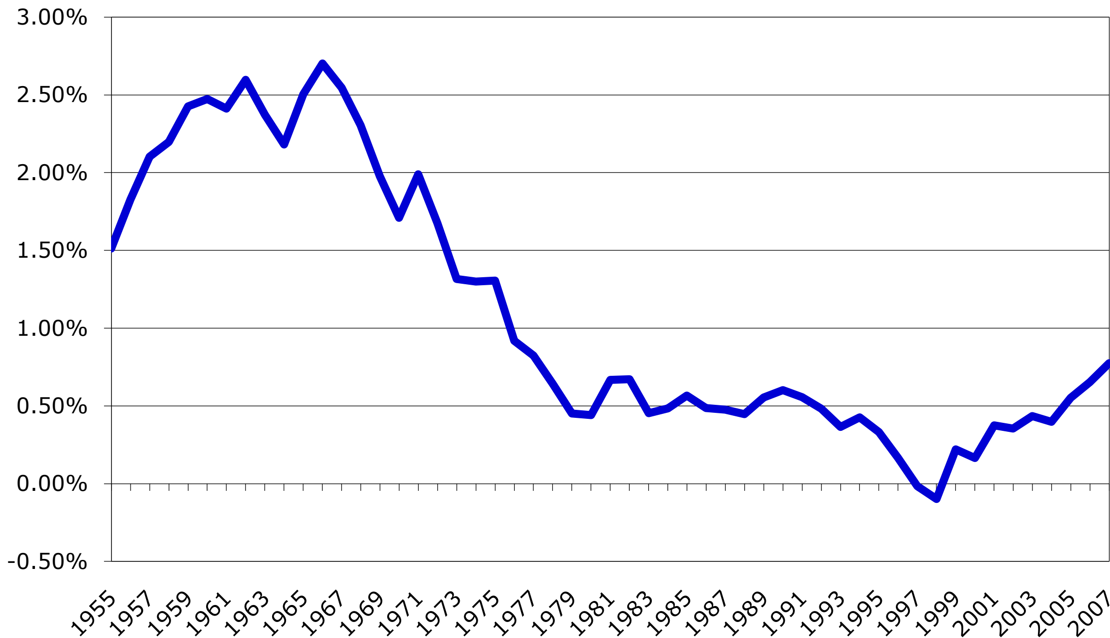
Chart 3 shows the building revenue loss from the Lastman freeze.



A massive infrastructure backlog

An analysis of the development public infrastructure and its funding in Canada reveals two long-term trends that have particular relevance to the City of Toronto.

First, most of Canada's public infrastructure was built between the mid-1950s and the mid-1970s. By 1977, investment in public infrastructure, net of depreciation, as a share of Canada's GDP had dropped from its high of 2.5% in the mid-1960s to less than 0.5%. From 1977 to 2005, investment net of depreciation was below 0.5%, well below the rate of population growth. In 1997 and 1998, investment net of depreciation actually fell below zero.

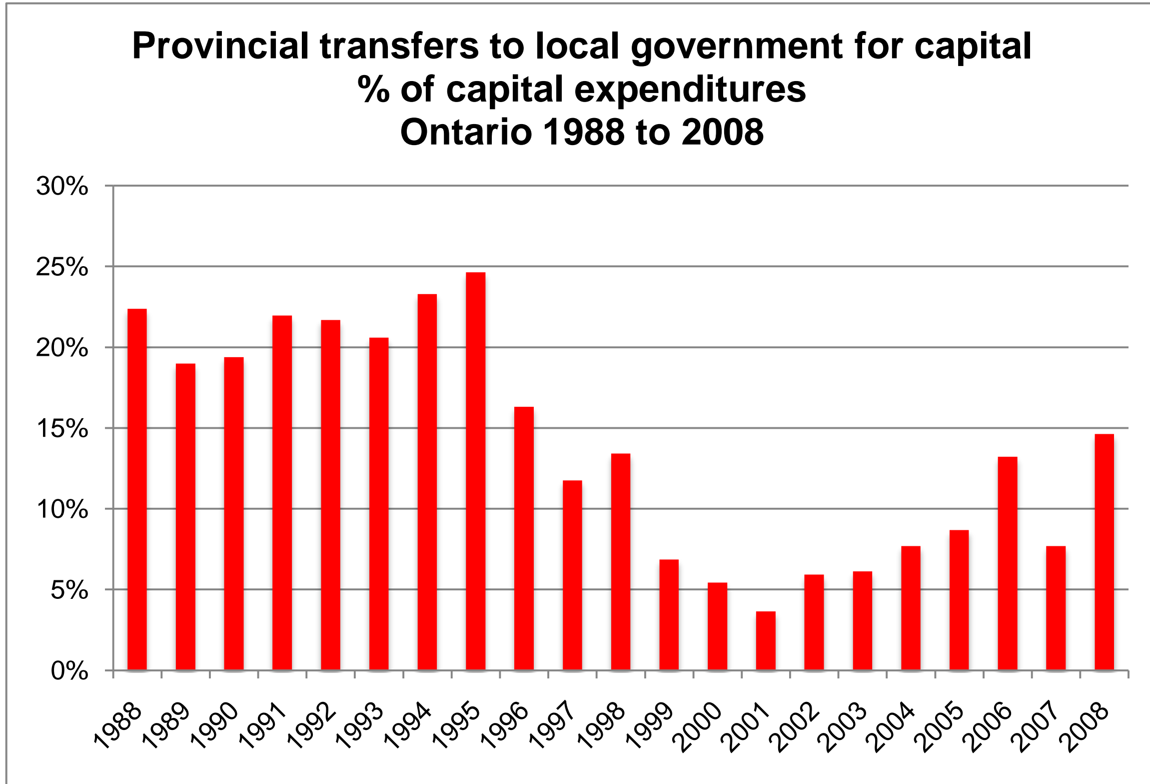


Second, over the period from 1955 to 2007, the share of public infrastructure investment accounted for by local government increased from 24% to 57%. Over the same period, the federal government's share dropped from 34% to 15%.

Provincial support for local infrastructure in Ontario dropped dramatically from the late 1980s to the early 2000s.

In addition, in the download of financial responsibilities by the provincial government in the 1990s, the City assumed full responsibility for a public housing stock that was literally falling apart from neglect by its owner – the provincial government – as well as for the funding of capital for a transit system whose major assets were reaching the end of their economic life.

With a legacy of over 30 years of underinvestment nationally and two decades of collapsing provincial, it is hardly surprising that the city's capital budget plan calls for a decade of substantial additional investments in infrastructure renewal. The investment required to overcome the backlog, coupled with an assumption that federal and provincial funding for local infrastructure will revert to pre-stimulus package levels once the recession ends, accounts for the pressure on the City's borrowing and debt servicing capacity identified in the City's capital plan.



The current debate

The first step in solving a problem is to identify the causes. The causes of Toronto's budget problems go back many years and are attributable to political decisions of federal, provincial and local governments that may have promised short-term gain – politically, if not economically – for long-term pain:

- Shifts in funding responsibilities without regard to the ability of local governments to generate the revenue to pay for them;
- Amalgamations at both the municipal and school board levels that imposed additional costs on local governments while taking a cavalier and politically motivated approach to the associated costs;

- Provincial and federal “budget balancing” exercises in the 1990s in which each level of government simply exported its financial problems to the next lower level of government, leaving the level of government with the least flexible tax base holding the bag;
- An unfunded property tax reform imposed by the provincial government that mandated substantial shifts in tax liability;
- Ill-considered and ultimately counterproductive tax freezes and artificial limits on local tax increases that forced the City to deplete reserves and defer the renewal of services.

Rather than come to terms with the actual underpinnings of the City’s current financial difficulties, Torontonians have been treated to a political recycling program in which every tired old suggestion for saving money we’ve seen in the past decade has been repackaged as a “new idea” worthy of consideration:

Torontonians have been treated to a political recycling program in which every tired old suggestion for saving money at the City that we’ve seen in the past decade has been repackaged as a “new idea” worthy of consideration.

These “ideas” may meet a political need to avoid reality; they will not solve Toronto’s financial problems.

- The city’s spending – both operating and capital – is out of control; tough expenditure controls will solve the problem;
- City government is trying to do too much; services should be cut back to the key services that Toronto really needs;
- Contracting out more city services would save money;
- There is massive waste and inefficiency at City Hall; address the waste and inefficiency problem, and we’d be a long way towards solving Toronto’s problems;
- Toronto could generate additional revenue and / or reduce its debt by selling off or “monetizing” key assets like EnWave, Toronto Hydro and the Parking Authority.

And to prepare Torontonians for the need to swallow these bitter pills, organizations like the Toronto Board of Trade that purport to be civic leaders have unveiled long-term projections that promise economic catastrophe within a decade.

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Forecasting Armageddon – fun with figures in projections

The projections unveiled in February 2010 by the Toronto Board of Trade[3] suggest that Toronto's budget deficit will be $1 billion a year by 2019. The projections themselves are not all that interesting. The assumptions that drive the projections are interesting.

To begin with, the Board of Trade projections assume Toronto will fail to balance its budget – as it is legally required to do – in 2010. So the projection starts out with a big negative number. As we move forward, the projection assumes the city's expenditures will grow more quickly than its revenue. It assumes there will be no fundamental change in provincial funding beyond the changes in social assistance and court services funding already announced. It assumes federal and provincial support for capital spending will revert to normal once the stimulus programs expire. It assumes local governments' efforts to access a broader range of revenue streams will fail. In short, it assumes that we do nothing.

If you make the Board of Trade's assumptions about revenue and expenditures, the result is a deficit of more than $1 billion in the operating account by 2020.

However, if you assume that property taxes will increase in step with the costs of local public services, the city's operating deficit actually turns to surplus by 2015.

The results are extremely sensitive to these broad assumptions. If you make the Board of Trade's assumptions about revenue and expenditures – a starting deficit of more than $300 million; 5% growth in most expenditures; 3% growth in property tax revenue (including 1% growth in assessment) -- the result is a deficit of more than $1 billion in the operating account by 2020.

However, if you assume that property tax rates will increase in step with the costs of local public services, the city's operating deficit actually turns to surplus by 2015. Despite the very real pressures, Toronto taxpayers actually can keep their city out of the red.

Is City spending really out of control?

Toronto's spending, both absolute and per capita, is growing more slowly than local government expenditures in the rest of Ontario.

Given the extraordinary expenditure pressures Toronto has experienced emerging from what the United Way has called Toronto's "lost decade," the fact that Toronto's expenditures have not grown more quickly than those of other local governments in Ontario is remarkable.

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[3] "The Growing Chasm: An Analysis and Forecast of the City of Toronto's Finances", Toronto Board of Trade, February 2010

With respect to capital investment, to suggest that Toronto's investment in infrastructure renewal is "out of control" after decades of neglect and underinvestment is ill-considered in the extreme. To the extent that there is any consensus on Toronto's budgetary matters, there is a consensus across the community that Toronto's infrastructure has been allowed to deteriorate for too long and that new and renewed investments are needed in the near future to maintain service levels and protect Toronto's economic competitiveness.

Are employee wages, salaries and benefits responsible?

As one would expect with a service organization like local government, the wages, salaries and benefits paid to city employees are the biggest item in Toronto's budget. And a superficial look at the line for wages, salaries and benefits in the city's financial statements certainly attracts attention.

Between 2003 and 2008, wages, salaries and benefits increased by 34%, or a total of approximately $1.1 billion. The general increase in average weekly wages and salaries in public administration in Ontario was 20%[4], explaining $595 million of the increase.[5] Approximately 8.4% is attributable to growth in employment for the provision of public services in Toronto, which would account for $253 million.

According to the city's Financial Information Returns filed with the provincial government for 2003 and 2008, full-time employment grew by 3,300 over the period. 45% of that growth was for TTC employees; 15% was for police.

In addition, between 2003 and 2008, there were substantial changes in pension costs, driven in part by the winding down of the OMERS contribution holiday over 2003 and 2004 and in part by increased costs associated with the city's frozen pension plans. Those increases amount to $193 million. Accounting costs for benefits increased by $213 million, a substantial proportion of which is attributable to the correction of an error in the city's estimate of sick leave costs. Finally, WSIB premiums increased by approximately $20 million.

In sum, the figures break down as follows:

2003 and 2008 wages, salaries & benefits	$1,100 million
General increases in public administration wages	595
Employment increase	253
Increased pension funding costs	193
Changes in accounting costs for benefits	213
WSIB premium increases	20
TOTAL explained by above factors	$1,274 million

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[4] Statistics Canada, CANSIM Table 281-0044

[5] This is calculated by applying a 20% increase to the 2003 wages and salaries component of the wages, salaries and benefits line in the 2002 City 5-year statistical review. Wages and salaries are isolated from the total using data on benefits and pensions from annual financial statements.

What the data show is that wages, salaries and benefits as reported by the city for 2008 are actually roughly $175 million below what would have been expected, given employment changes, general wage and salary increases and changes in costs for pensions and benefits.

Should the scope of City services be reduced?

The City of Toronto is a very large operation carrying out an extremely broad range of activities and delivering an extremely wide range of services. Its job is to serve an extremely diverse population with equally diverse needs and expectations.

The problem with the suggestion to cut is that it is a lot easier to say than it is to do. Everyone's list of what constitutes a core service is different. The mix of services the city delivers reflects an accommodation developed over many years among the diverse needs and priorities of a very diverse population. That mix makes the city a powerful contributor to Torontonians' sense of community.

That is not to say every service the city delivers should be maintained forever. Part of good management is continual questioning and renewal of services and priorities. But it is not as obvious an exercise as critics would suggest, nor is it new to city governance.

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Continual questioning and renewal of services is part of good management, but it's not as obvious as critics would suggest, nor is it new to city governance.

Equally important, once one gets past the obvious core services like transportation, sewer and water services, solid waste management, even the elimination of all of the remaining services would fall short of addressing the problem.

Is more contracting out a solution?

The most commonly suggested area for contracting out is garbage collection. Indeed, when challenged, advocates for increased contracting out are generally unable to come up with another example.

Garbage collection in Toronto is already managed through a variety of different delivery mechanisms, including privately funded private collection, publicly funded private collection, and publicly funded public collection. Other parts of the solid waste management program are also delivered through a variety of different mechanisms. For example, waste transfer stations are operated by the city, recycling facilities are a mixture of public and private operations; landfill areas have been publicly operated in the past, were contracted out for a number of

years, and are now transitioning back to the city-owned facility in southwestern Ontario. Long-distance transfer from the city to remote landfills has generally been contracted out.

When Toronto was amalgamated, residential service was provided by public employees in all parts of Toronto except the Cities of York and Etobicoke.

Since then, service in York has been brought back under the public umbrella, leaving the former City of Etobicoke as the only area with contracted-out residential garbage pick-up.

There is no evidence that contracting out garbage collection saves money. In fact, Toronto saved $4 million per year when it ended contracting out of York garbage collection.[6] Aspects of public delivery that suggest lower costs than contracted out delivery include:

- Economies of scale in vehicle procurement and management and route design;
- Lower financing costs for capital;
- The absence of a need to generate a return to the private operator;
- Integration with other parts of the waste management system;
- More straightforward implementation of service and technology changes.

There is no evidence that contracting out saves money.

While contracting out continues to be a feature of public debate in North America, the trend in much of Europe is to bring formerly privatized water and electricity distribution utilities back into public operation.

While contracting out public utility services continues to be a feature of public debate in North America, the trend in much of Europe is to bring formerly privatized water and electricity distribution utilities back into public operation once concession contracts have expired.[7]

Waste and inefficiency?

The release of the City Auditor's report in February 2010 was eagerly anticipated by conservative critics hoping for Auditor-General-like revelations of mismanaged and wasted public money and ill-considered spending decisions.

From that perspective, the report was a dud. The big number was $105 million. But it turned out that most of the amount was attributable to unpaid parking fines, accumulated over a number of years; some of which cannot be collected. It also

[6] "Etobicoke, York, Multi-Unit Residential and White Goods Collection Contracts", City of Toronto staff report to Public Works and Infrastructure Committee, 31 January 2007, p.2. That report also referred to savings of $400,000 per year from in-sourcing of the East York, Scarborough, York and Etobicoke white goods collection contract.

[7] IPS News, 28 January 2010.

identified about $590,000 in losses due to fraud, half of which was attributable to a business contracted to count and roll change from parking meters which is alleged by Toronto and other municipalities to have diverted public revenue to its own use.

With respect to parking fines, the report identified a loss over two years of $9.3 million when a vehicle was driven away before the ticket could be placed on the windshield and $7.6 million for tickets with errors. The total loss over two years from cancelled tickets was $35 million.

Selling, or "monetizing" city assets

The clamour for the city to sell off or "monetize" key assets has been building to a crescendo in the lead-up to the 2010 budget.

From the perspective of the investment industry and other vested interests, it is not hard to see why. It's all about the deal. The three top candidates for sale are Toronto Hydro, the Toronto Parking Authority and Enwave, the utility the city created to distribute deep lake chilled water for air conditioning in office buildings in downtown Toronto. According to Toronto's consolidated financial statements, the city's equity in these three assets amounts to roughly $1.2 billion. A sale involving those three assets would generate fees in excess of $100 million.

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For the investment industry, a large-scale privatization in Canada's largest city would be a welcome boost to an industry that has been hard hit by the recession of 2008-09. Over a period of a few months, a business model that had mobilized billions of dollars in investment capital every year virtually collapsed. Widening interest rate spreads and tighter lending standards imposed by financial institutions reduced the economic leverage available to these deals – leverage that was essential to the generation of the attractive returns that drew investors to these assets in the first place. Established infrastructure funds have been wound up or sold off. Existing funds have faced problems securing new deals, and have been forced to scale back their leverage in existing investments.[8]

While it is easy to understand the attractiveness of a Toronto privatization to the investment industry, it is much more difficult to understand why Toronto would be interested in doing so.

[8] For a more detailed analysis of the impact of the economic downturn on the P3 industry, see "Bad before, worse now: The financial crisis and the skyrocketing costs of public private partnerships (P3s)", Hugh Mackenzie & Associates, June 2009, available from the Canadian Union of Public Employees.

As a general proposition, for an asset sale to make sense to a government, it would have to make it possible to generate substantial savings or a significant new stream of income not available under public operation. Since the intended purpose for selling these assets would be to enable the city to reduce the cost of carrying its debt, the relevant comparison here is to the city's borrowing cost. The difference would have to be significant, because the underlying financing for these assets is much more attractive under public ownership than under private ownership, for three reasons.

First, as noted above, fees for putting together these deals are significantly higher than the underwriting costs for public debt. Whereas the underwriting fees for public debt would typically be less than 10 basis points (0.1%), fees for P3 deals would typically fall in the 8-10% range. That means that financing through a P3 will net roughly 90% of what public borrowing would realize after financing costs.

Second, the portion of a P3 deal that must be financed will be credit rated significantly below the rating of public debt. Whereas P3 debt is typically rated BBB or below, the City of Toronto's credit rating is AA. In current market conditions, the spread between AA debt and BBB debt would be approximately 1.25%; the spread between AA debt and BB debt would be in the 3.25% range. Since any deal would have to cover the purchaser's borrowing costs, the city would end up absorbing that difference in the purchase price.

Third, investors are not charitable organizations. They invest in these projects to get a return on their investment. Target returns in infrastructure investments are generally at least 10% on an unlevered basis and perhaps 12%-15% on a levered basis. Again, a deal would have to cover those anticipated returns.

When each percentage point difference between the city's borrowing cost and the return demanded by a buyer translates into a difference of 20-25% in value, the offsetting gains would have to be substantial indeed to justify an asset sale.

With that in mind, let's look at the leading candidate for sale, Toronto Hydro. The city's equity in Toronto Hydro is carried on its books at a value of $940.4 million. ($2.3 billion less $1.34 billion in debt). In the most recent audited financial year, that investment returned a dividend of $116.4 million, for a dividend rate of 12.4%. Since that is within the range of returns demanded by a potential investor, it would be reasonable to expect that, allowing for refinancing costs, a potential buyer would be prepared to pay just over $800 million for the city's equity. That would replace at most $40 million per year in debt servicing costs. So the city would be giving up an income stream of $116 million for a servicing cost savings of $40 million. To replicate the city's current revenue stream in reduced

borrowing costs, a buyer would have to be prepared to pay the city $2.3 billion for its equity. Not a very likely proposition.[9]

The situation with respect to the Parking Authority and Enwave would be similar.

The oft-cited example of Chicago's sale of the right to operate its parking meters is a case in point. Parking fees in Chicago have quadrupled. And the evidence is mounting that the city would have been much better off if it had retained the revenue from the meters itself.[10]

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The problems with sales or monetization don't stop there, however. Each of these entities plays a key role in the implementation of city policies. Because Toronto Hydro has a financial relationship with every household and business in the city, it is ideally placed to be the delivery vehicle for energy conservation policies. Enwave was conceived as a critical component of the city's environmental policy, and its continued success and expansion is important for the future of that policy. As a major provider of parking services and the delivery agency for the city's parking policies, the TPA plays a key role in economic development, transportation and environmental policies as well as generating a significant revenue stream.

To make sales a viable proposition economically, the upside in reduced costs or increased revenue generation would have to be both substantial and obtainable only through private ownership. There are some circumstances under which it might be argued that a private operator is in a better position to realize savings or extract additional revenue than a public operator. For example, it is possible that political considerations could be an obstacle to cost-saving changes or increases

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[9] Assuming that a buyer would be able to reproduce the financial leverage the city currently carries on its Hydro investment, the difference between the city's borrowing cost and borrowing at a BBB rating would be 1.25% or about $16 million per year. That would reduce the cash flow to $100 million. To achieve a 12.4% return, the purchase price for the city's equity would have to be reduced to approximately $800 million. In this example, no allowance is made for any increase in the value of the city's equity in Toronto Hydro as net income is reinvested in the business.

[10] "Company piles up profits from city's parking meter deal", New York Times 20 November 2009 p. 29A Chicago. The story arises from documents leaked from the company that bought the parking meter concession from the City of Chicago. According to the NYT story, "Financial experts who reviewed the data say Chicago could have made out much better in the long run had it just kept the meters."

in user charges. Neither would appear to be the case for any of these three assets.

Finally, it should be noted that even the proponents of asset sales are not suggesting that the proceeds should be directed towards alleviating the city's operating funding requirements. In other words, asset sales are not advocated as a response to the city's current financial needs; they are advocated as a political response to the atmosphere of crisis that they themselves are creating. Advocates of asset sales are urging the city to do something in a budgetary panic that will not address its immediate problems and that it will regret later.

Elements of a plan

While the city can and should look for efficiencies in program delivery and revenue generation, the unfortunate reality for city critics is that there is no way to avoid the need for Toronto to generate revenue to support the public services the city needs.

In the longer term, the problems with the structure of the provincial-local financial relationship have to be fixed. A financial structure that makes a government, whose revenue sources are largely unrelated to income, financially responsible for income-redistributive policies like social assistance and social housing is not sustainable. Nor is a system of funding for public transit that depends almost entirely on fare revenue when substantial benefits from public transit accrue to non-riders and non-residents. Nor is Toronto's heavy reliance on property taxes compared with the finances of comparable jurisdictions in the United States.

While the city can and should look for efficiencies in program delivery and revenue generation, the unfortunate reality for city critics is that there is no way to avoid the need for Toronto to generate revenue to support the public services the city needs.

Toronto should ignore Harris-era restrictions on what can be included in its tax bill mailings and clearly identify the portion of property tax that it attributable to provincial underfunding and the portion that is actually paying for provincial public services

Accordingly, part of the short-term plan must be for Toronto to become much more aggressive in building support in the community and outside for a more rational local financial system. For example, Toronto should ignore Harris-era restrictions on what can be included in its tax bill mailings and identify clearly:

- The portion of the property tax that is attributable to provincial underfunding of its own cost sharing obligations;
- The portion of the property tax – including the provincial education tax -- that is actually paying for provincial public services;
- The portion of the property tax that is attributable to the 1990s downloads and funding cuts; and
- The portion of the property tax that is funding business tax reform.

In the longer term, and regardless of the province's response to the structural problems created by its funding policies, the city will have to generate substantial additional revenue to keep its budget in balance and to meet future needs for local services.

It is important to keep the city's property tax funding requirements in perspective. Because the provincial government is committed to keeping its revenue from the provincial portion of the property tax constant, a given percentage increase in the city's property tax rate translates to a substantially smaller percentage increase in overall property taxes. As noted above, the 4% increase in residential taxes proposed in the 2010 staff recommended budget actually amounts to a 2.8% increase in overall property taxes. In other words, when it comes to generating additional revenue for local services, the "tax room" opened up when education property taxes were frozen is still available.

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That will require property taxes and average user charges to continue to increase as the costs of local services increase. In addition to addressing these longer-term issues, the city is required by law to balance its budget annually. The options that should be considered, pending a renegotiation of the city's financial deal with the province include:

- Temporary suspension of the shift in tax from commercial, industrial and multiple-residential property owners to residential, so that the city has access to its entire tax base for revenue increases to address the financing gap;
- Temporary restriction of tax funding for capital projects; and
- A special, time limited, funding gap levy tied to the shortfall between the revenue generated under the measures outlined above and the city's financing requirements.

The short-term implications of these proposals are not pleasant. However, the alternatives – further damaging Toronto's vital public services; allowing our infrastructure to deteriorate further; selling off income-generating public assets – are much worse. They will compromise the city's future, and impose additional costs that will endure long after the immediate funding shortfall has been resolved.