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Municipal Relations with the Federal and Provincial Governments: A Fiscal Perspective

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Ce chapitre permet d'examiner la situation fiscale des administrations municipales canadiennes et leurs rapports intergouvernementaux, depuis 1988, en ce qui a trait à la fiscalité. Un fait saisissant est la réduction marquée des subventions octroyées aux municipalités durant les années 1990. Ces subventions qui représentaient 25 pour cent des budgets au début de ces années ont chuté par la suite à 17 pour cent, traduisant ainsi la volonté des provinces de rééquilibrer leurs dépenses. La dépendance accrue des municipalités envers leurs propres sources de revenus a fait grimper les taxes foncières à leur plus haut niveau depuis trente ans, en relation aux revenus disponibles des contribuables. Ainsi, la proportion des revenus municipaux obtenue par le biais de l'impôt foncier est passée d'environ 32 pour cent à près de 42 pour cent. Tandis que la nécessité des municipalités de collecter des revenus était définitivement augmentée, il y a peu d'indications illustrant que leurs responsabilités en terme de dépenses aient été augmentées de façon considérable à l'extérieur de l'Ontario. Les compressions fiscales ont touché davantage les municipalités de l'Ontario que les autres villes canadiennes. Malgré la croissance économique et la situation fiscale des provinces, ces dernières, à l'exception de l'Alberta, ont démontré peu d'ardeur à restituer le système de subventions provincial. En outre, les initiatives du gouvernement fédéral visant à octroyer un remboursement complet de la TPS ainsi que les nouvelles ententes avec les villes et les communautés, qui totalisent environ 2 pour cent des budgets municipaux, apparaissent comme des avancées majeures dans le domaine. Il faut se rendre à l'évidence que la grande majorité des villes canadiennes n'auront d'autre choix que de subvenir elles-mêmes à leurs besoins. En définitive, ces municipalités devront ouvrir leurs horizons pour favoriser leur autonomie financière. Pour y arriver, certaines options ont été évaluées, par exemple, les sources de financement locales, les ventes et l'impôt sur le revenu.

INTRODUCTION

Municipal governments have received unusual attention during the past decade. Some significant reshuffling of provincial-municipal responsibilities in Ontario and some high profile amalgamations in Toronto, Montreal, and Halifax have particularly attracted public attention. In their shadow, less obvious changes have also occurred as the provinces have investigated options for the organization, responsibilities, and financing of municipal government.[1]

From another perspective, municipalities, and especially the cities, have been the focus of examinations by various public policy centres. For several years now, the Canada West Foundation has been engaged in its major Western Cities Project.[2] Previous to that, the Institute for Research on Public Policy undertook a project on city-regions (Hobson and St Hilaire 1997). Contributions have come from the C.D. Howe Institute (Kitchen 2000b; Slack 2002) and the TD Bank Financial Group (2002, 2004). In a recent "territorial review" of Canada, the OECD included major sections addressing urban and metropolitan issues (OECD 2002). The Canadian Tax Foundation recently published a series of papers as a symposium on municipal finance and governance reform (Canadian Tax Foundation 2002), and Kitchen and Slack (2003) extended this theme. The Canadian Policy Research Networks undertook a group of studies focusing on the federal government's role in cities (e.g., Seidle 2002). Complementing these independent works, the federal government established the Prime Minister's Caucus Task Force on Urban Issues, which reported in November 2002. There have also been a number of conferences on municipal issues, of which the one leading to this volume, the Institute for Public Economics' conference, Paying for Cities (Boothe 2003), and the September 2003 Strategies for Urban Sustainability conference in Edmonton are examples. As an illustration of ongoing interest, a nationwide academic study into multilevel governance and public policy in Canadian municipalities is underway.

Why this surge of interest and activity in municipal affairs and especially those of urban municipalities? Perhaps an underlying cause is a sense that municipalities are not living up to expectations or to their potential. Perhaps there is a feeling that municipal governments are becoming less able to achieve their goals and meet the needs of their residents. The validity of either of these speculations could be debated.

Addresses on municipal issues are commonly motivated by reference to urbanization, global competitiveness, and the fiscal squeeze. Also important, as revealed by papers elsewhere in this volume, is the municipal lack of voice (which is largely the result of their lacking of constitutional standing and coming under provincial jurisdiction); that is, municipalities are not engaged, or properly engaged, when they are affected by the decisions and actions of the provincial and federal governments. Much of that discussion has been focused on the settlement and integration of immigrants and Aboriginal people, affordable housing, and – more in the provincial context – amalgamation, funding changes, and responsibility realignment. The impact of all these factors could be explored further, but fiscal considerations are the focus here.

Fiscal matters have been a continuing concern of municipal governments.[3] Concerns typically focus on fiscal capacity and on fiscal arrangements with other governments. Matters dominating (but not unique to) recent discussions are the variability and uncertainty of intergovernmental transfers, the costs of offloaded or downloaded responsibilities, new (or the perception of expanding) local needs, a growing infrastructure deficit, and the constraints on own-source revenues imposed by reliance on a single major tax, the property tax.

The objective of this paper is to examine municipal governments' fiscal situation and their intergovernmental fiscal relations. The main directions are to outline what exists, to identify the forces shaping the structure, and to explore what might be. The paper begins with the fiscal picture. Included there is a search for evidence of the seriousness of the municipal fiscal problem. Municipal fiscal arrangements are briefly reviewed in the context of the lessons from fiscal federalism. Various suggestions have been advanced on how municipal finances and intergovernmental fiscal relations might be reformed. A number of these are outlined and assessed. Discussion and conclusions complete the paper. For a summary look ahead, this analysis suggests that the future of municipalities will largely be in their own hands (as it should be) but the municipalities' strength and dexterity could be improved.

THE FISCAL PICTURE

AN OVERVIEW

Municipal government expenditure represented 4.4 percent of GNP in 2001 and about 10.5 percent of total government outlays.[4] This percentage is slightly smaller than the 4.5 percent of GNP that it represented in 1988, the first year that independent municipal government data were available. Despite the slightly lower percentage, per capita real (GDP deflator adjusted) dollar expenditures by municipal governments increased 15 percent over this period.

The per capita levels and percentage distribution of municipal expenditures for 2001 are shown in table 1. The figures are total expenditures, including both operating and capital outlays. The range of per capita municipal expenditure is large – from a low of $378 in Prince Edward Island to $1,948 in Ontario. The (population weighted) average for Canada is $1,545. The provinces tend to divide into two groups. For Quebec and the provinces farther west, per capita expenditures are relatively high (above $1,050) while in Atlantic Canada they tend to be lower (below $1,050). Nova Scotia defines the upper end in Atlantic Canada because its municipal governments, unlike elsewhere, contribute significantly to schooling (14.2 percent of municipal expenditures), and, at 4.5 percent, still finance more than the norm of social services, though that share has dropped dramatically (from 23.3 percent in 1988) and a final reduction was expected to occur in 2003.[5] Ontario municipalities are the highest spenders because one-quarter of their outlays go to fund social services. Otherwise, the Ontario outlay would be second to that of Alberta and its distribution closely parallel to the Canada average. Among the other provinces, the average share of expenditures going to social services is less than 1 percent. Ontario has a tradition of placing somewhat more expenditure responsibilities on its municipalities than other provinces, and the local government "reforms" introduced during the 1990s exacerbated that burden. The province assumed full responsibility for funding schools (with new provincial property taxes to contribute to the cost) and, in exchange with the local level, shifted a variety of responsibilities (notably, all social housing costs, the costs of maintaining previously provincial highways, and half of the cost of land ambulances) to the municipal governments.[6] This reassignment of responsibilities to the municipalities, particularly the social services component, contrasts with the prevailing pattern and is contrary to "best practices" recommended by students of fiscal federalism. There will be occasion to reflect more on this situation below.

Social services in Ontario and education outlays in Nova Scotia are the major anomalies in table 1. To this, only the low share of protection costs in Newfoundland and Labrador might be added. Otherwise, the patterns are quite homogeneous. The major expenditure areas are protection (such as fire and policing), transportation, environment (water and sewerage services, solid waste management, and recycling), and recreation and culture. Together with general services (municipal administration), these categories account for almost 75 percent of municipal outlays Canada-wide and more than 85 percent in most provinces. Debt-servicing costs averaged 5 percent in 2001 but ranged from 1.7 to 11.1 percent. Unlike the federal and provincial governments, municipalities cannot borrow for operating purposes; they can only do so for capital expenditures.

A perspective on the revenue side of the municipal accounts is provided by table 2. There are two major sources of revenue – those from the municipalities' own sources and those from intergovernmental transfers. Transfers, or grants, accounted for 17 percent in 2001 and own-source revenues for 83 percent. Property and related taxes are the main source (63 percent overall) of own-source revenue and represent, across Canada, 52.2 percent of total revenue. Property and related taxes consist of real property taxes and property-related taxes. Real property taxes (those on land and improvements) provide, on average, 41.9 percent of total revenue. Property-related taxes (10.3 percent of municipal revenue across Canada) primarily consist of lot levies and special assessments (usually for cost recovery of specific improvements), payments in lieu of taxes from other governments and their agencies, and business taxes. Business taxes can be levied on a variety of bases (for example, rent, area,

Table 1: Level and Allocation of Municipal Government Expenditures by Province and for Canada, 2001

	Nfld	*PEI*	*NS*	*NB*	*Que*	*Ont*	*Man*	*Sask*	*Alta*	*BC*	*Canada*
Per capita expenditure (dollars)	767	378	1,020	865	1,284	1,948	1,091	1,141	1,581	1,284	1,545
						Percent allocation					
General services	16.2	12.9	10.4	11.1	12.2	8.9	13.6	12.4	12.2	10.0	10.4
Protection	4.7	23.1	21.1	21.0	16.7	13.4	19.7	17.6	14.3	18.8	15.1
Transportation	28.6	21.5	16.9	20.2	27.2	18.1	23.4	31.7	28.3	16.5	21.4
Health	0.1	0.1	0.1	0.4	0.2	3.5	2.2	0.6	1.5	1.8	2.2
Social services	0.2	0.0[1]	4.5	0.0	1.4	24.7	0.3	0.5	1.5	0.2	12.5
Education	0.1	0.0	14.2	0.0[1]	0.1	0.0[1]	0.0[1]	0.0[1]	0.3	0.0[1]	0.3
Conservation and development	0.7	1.7	0.8	2.4	2.8	1.6	2.4	3.6	3.4	1.4	2.1
Environment	22.1	12.7	16.8	25.3	12.0	13.3	17.4	15.4	13.9	20.4	14.4
Recreation and culture	14.5	21.9	10.7	12.6	12.4	8.7	9.4	14.2	13.7	19.5	11.5
Housing	0.6	0.0	0.2	0.3	2.9	5.0	0.4	0.4	0.7	0.6	3.2
Regional planning	1.2	2.3	1.5	2.0	2.5	0.1	2.3	1.7	3.0	2.3	1.3
Debt charges	11.1	3.7	3.7	4.2	9.4	2.3	8.5	1.7	7.1	6.3	5.0
Other	0.0[1]	0.0[1]	0.0[1]	0.2	0.0[1]	0.2	0.4	0.1	0.0[1]	2.2	0.4
Total[2]	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[1]Negligible (less than 0.05 percent)
[2]May not sum exactly, due to rounding

Source: Data from Statistics Canada, Public Institutions Division, Financial Management System (as of fall 2002); author's calculations sales), but assessed property value is the most common, and they are levied in addition to real property taxes. Unlike real property taxes, the occupant (not the owner) is liable. Business taxes are not collected in British Columbia, Ontario, New Brunswick, and Prince Edward Island. In fact, municipalities in Prince Edward have almost no property-related taxes and rely on the real property tax. Property and related taxes vary considerably in relative importance – from 44.4 to 73.7 percent of total revenue in Alberta and Nova Scotia, respectively. Because of the pattern of interprovincial revenues, there is somewhat less variation in the actual dollar amounts per capita collected. Revenues from the sale of goods and services, or user charges, are the next most important item, representing almost one-quarter of total revenue. Thus, property and related taxes and user charges account for about 90 percent of own-source revenue and 75 percent of total revenue. Investment income is a more modest source (4.9 percent across Canada), but it is still important, especially for municipalities in Alberta, British Columbia, and Manitoba. Much of this revenue comes from utility ownership. While own-source revenue averages 83 percent of the total, and municipal governments in most provinces are close to the average, it ranges from about 74 to 94 percent. Newfoundland is at the low end and Nova Scotia and British Columbia set the upper level.

The importance of own-source revenue varies with the contribution of intergovernmental transfers. Municipalities in British Columbia and Nova Scotia receive only about 6 percent of their revenue from grants, while those in Newfoundland get about 25 percent.[7] Overall, grants provide 17 percent of revenue. Intergovernmental transfers essentially mean provincial municipal transfers. The federal grants represent no more than 2.9 percent of total revenue in any province, and for all Canada they average 0.4 percent of total revenue (or about 2.4 percent of aggregate transfers to municipalities). All federal transfers are designated for specific (expenditure) purposes. Provincial transfers may be general purpose (unconditional) or specific purpose. Specific purpose grants dominate – 14.2 percent versus 2.4 percent overall – and dominate in all provinces except New Brunswick, though to a lesser extent in Nova Scotia and Prince Edward Island.

To summarize, municipal government represents about 10 percent of total government expenditure. Local expenditures are, with few exceptions, to provide services benefiting local residents (notably, fire and police protection, roads and public transport, water and waste management, and recreation and cultural services). Municipal government relies on own-source revenues for more than 80 percent of revenues. Own-source revenues essentially mean property and property-related taxes and user charges and fees. Transfers, which are almost entirely provincial transfers, now account for 17 percent of total revenue (down from 23 percent in 1988). These transfers are predominately conditional. Readers interested in a more detailed fiscal picture may refer to Kitchen (2003b). While much of the concern expressed about the municipal situation is being focused on cities, there is no uniform and compatible source

Table 2. Level and Allocation of Municipal Government Revenues by Province and for Canada, 2001

	Nfld	*PEI*	*NS*	*NB*	*Que*	*Ont*	*Man*	*Sask*	*Alta*	*BC*	*Canada*
Per capita revenue (dollars)	704	437	1,013	839	1,293	1,914	1,120	1,062	1,739	1,137	1,513
						Percent source					
OWN-SOURCE REVENUE											
Property and related taxes	54.3	62.3	73.7	55.1	64.3	48.3	46.7	54.3	44.4	53.0	52.2
(real property taxes)	(36.3)	(61.2)	(58.0)	(47.7)	(44.2)	(42.2)	(35.3)	(45.4)	(31.6)	(46.3)	(41.9)
Consumption taxes	0.1	0.0	0.0	0.0	0.0	0.0	1.4	3.6	0.0	0.2	0.1
Other taxes	1.0	0.5	0.1	0.5	0.3	1.3	1.1	0.8	1.6	2.4	1.2
Sales of goods and services[1]	16.4	26.9	16.4	25.3	16.5	23.9	23.4	24.3	26.1	29.3	23.0
Investment income	1.9	1.6	3.5	1.0	2.0	4.1	8.0	4.4	10.3	8.5	4.9
Other	0.6	1.5	0.2	0.5	2.3	1.7	0.8	1.0	1.6	0.6	1.6
Total own source[2]	74.3	92.8	94.0	82.4	85.5	79.3	81.5	88.5	84.1	94.2	83.0
TRANSFERS											
General purpose	6.3	3.3	2.7	12.4	1.9	2.3	7.9	4.6	0.9	1.1	2.4
Specific purpose	19.4	3.9	3.3	5.2	12.6	18.3	10.6	6.9	15.0	4.7	14.6
federal	2.9	0.3	0.5	1.0	0.2	0.3	1.1	2.1	0.5	0.5	0.4
provincial	16.5	3.6	2.8	4.2	12.4	18	9.5	4.9	14.5	4.3	14.2
Total transfers[2]	25.7	7.2	6.0	17.6	14.5	20.7	18.5	11.5	15.9	5.8	17.0
Total revenue[2]	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[1]Includes user fees, charges, etc.
[2]May not sum exactly, due to rounding

Source: Data from Statistics Canada, Public Institutions Division, Financial Management System (as of fall 2002); author's calculations of data for different classes of municipalities comparable to the Statistics Canada Financial Management System data utilized for this paper.

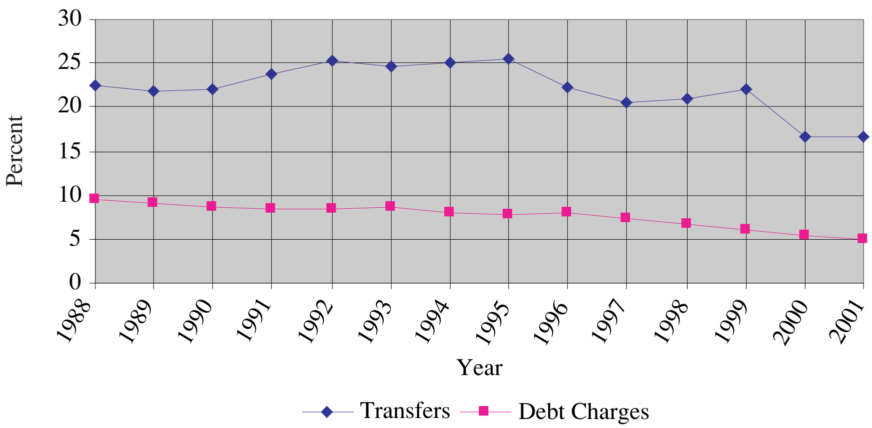
A FISCAL SQUEEZE?

As already noted, considerable concern has been expressed about Canadian municipalities, especially cities being squeezed fiscally between downloaded responsibilities, rising expectations, and a slowly growing tax and revenue base. This issue is examined in this section. Initially, only national data are considered, but then a revealing subnational perspective is taken.

A National Perspective

Intergovernmental transfers to municipalities have declined during the past decade as upper-tier governments cut transfers to fight their deficits. Figure 1 shows federal and provincial transfers to the municipalities as a percentage of expenditures from 1988 to 2001. Transfers declined after 1995 and again after 1999. Between 1988 and 2001, they fell from 22.4 to 16.6 percent of expenditures.[8] In fact, because of an anomaly relating to Quebec (to be explained below), transfers in the other provinces fell to 14.2 percent or by more than one-third on average rather than by one-quarter. The actual impact was even somewhat greater because transfers had amounted to about 25 percent of expenditures during the first half of the 1990s.

Figure 1: Intergovernmental Transfers and Debt Charges as a Percentage of Canadian Municipal Expenditures, 1988–2001

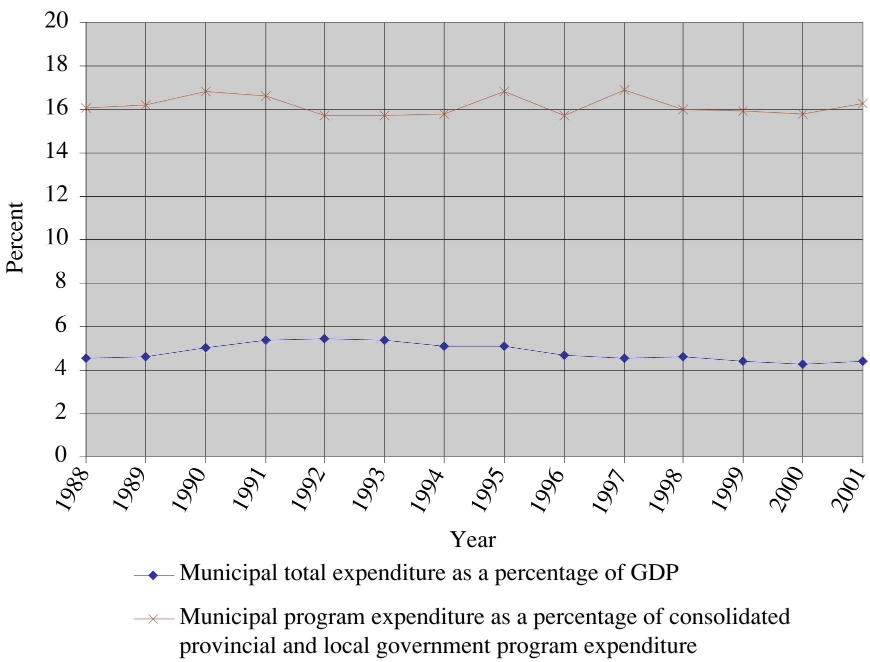


Sources: Data from Statistics Canada Public Sector Statistics, Financial Management System Basis, Catalogue No. 68-212, various years and parallel data from the Public Institutions Division

Transfers have declined since 1988, but so have the debt charges paid by municipalities. This too is shown in figure 1. Debt charges fell almost continuously from 1988 to 2001, from 9.5 to 5.0 percent of expenditures. To a large extent, the 5.8 percentage point drop in transfers was offset by the 4.5 percent drop in debt expenses. A result of these parallel trends was that, unlike federal and provincial governments, the municipal governments realized no fiscal dividend from declining interest rates. The fiscal flexibility that municipalities might have gained from lower interest rates was largely lost to (or captured by) the provinces through reduced transfers leaving the municipalities no better off.

Are there obvious consequences of these and other developments for municipal expenditures? Various (absolute and relative) expenditure series were calculated for Canadian municipalities over the 1988–2001 period. A review of these indicates that municipal expenditures have kept abreast – but only abreast – of national output, incomes, and other subnational (provincial and school board) expenditures over the 1988–2001 period. For example, see the two series plotted in figure 2. Municipal total expenditure as a percentage of GDP was 4.54 percent in 1988 and 4.4 percent in 2001.[9] In addition (but not shown in figure 2), municipal program

Figure 2: Trends in Canadian Municipal Expenditures, 1988–2001



Sources: Municipal financial data from same Statistics Canada source as tables 1 and 2; GDP data from Statistics Canada, CANSIM II; author's calculation spending also barely changed; as it moved only from 4.11 to 4.19 percent of GDP.[10] Finally, municipal program expenditures as a percentage of consolidated provincial and local (subnational) program expenditures also showed no trend, starting at 16.1 and ending at 16.3 percent. If municipalities have been burdened by downloading and if they responded by spending to meet those new responsibilities, one might have expected these shares to have become larger.

Generally speaking, it appears that municipal expenditures have kept pace with standard economic indicators over the 1988–2001 period. The municipal expenditure burden does not seem to have increased or, at least, to have resulted in larger relative expenditures. At the same time, note that real (inflation adjusted) per capita municipal total expenditures have risen about 15 percent, from $1,262 to $1,453.[11]

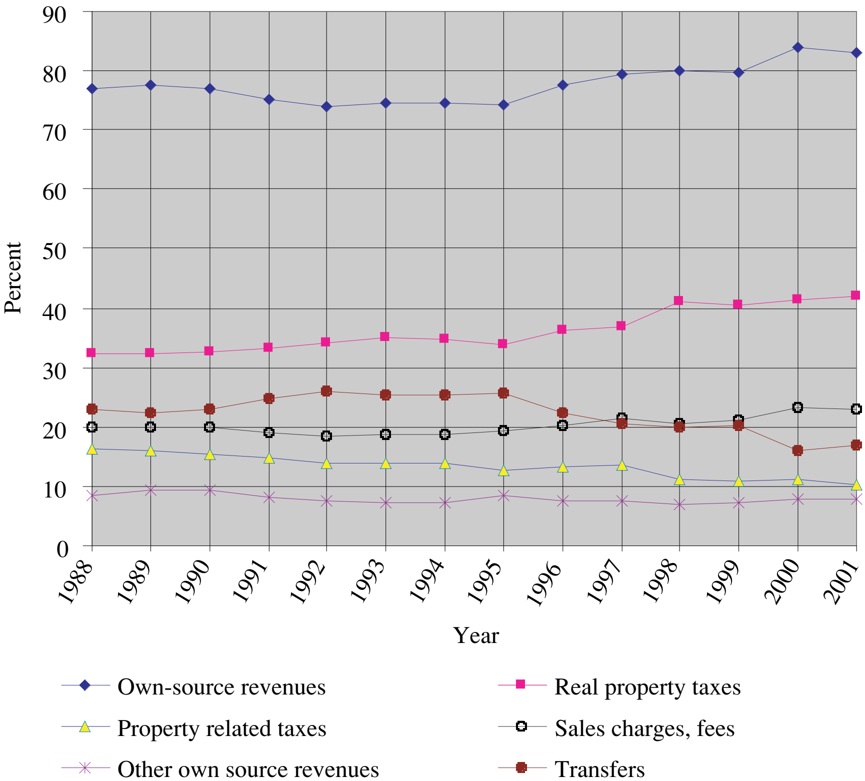
What has been happening on the revenue side of the municipal picture? Again, a number of series of indicators were calculated for the 1988–2001 period. Figure 3 shows the trends in municipal revenues. As a result of diminished transfers, own-source revenues increased from 76.9 to 83 percent of total revenues. As a percentage of personal disposable income, an indicator of burden, own-source revenues increased from 5.27 percent to 5.87 percent, an 11.4 percent increase over the fourteen years.[12]

The increase in own-source revenues primarily came from increased real property taxes. Real property taxes rose from 32.2 to 41.9 percent of total revenue – a 9.7 percentage point change representing a 30.1 percent increase in the real property tax share. Meanwhile, property-related taxes grew little over the period and declined from 16.2 to 10.3 percent of total revenue. Sales, fees, and charges increased from 20 to 23 percent; this was the only other major category to show an increase. Other own-source revenue declined. The contribution of transfers declined by almost six percentage points and the decline of property related taxes was of a similar magnitude. Thus, while sales, et cetera, made a contribution to the increase in own-source revenue, the real burden fell on the real property tax.

Between 1988 and 2001, real property taxes increased 26.8 percent as a percentage of GDP, 30.6 percent as a percentage of personal income, and 33.9 percent as a percentage of personal disposable income (PDI). The constant (1992) dollar per capita tax rose from $418 to $544, or by 30.1 percent. These are substantial increases in what is often regarded as a less popular tax.

Events of the 1988–2001 period lead to a number of observations and tentative conclusions. The municipalities managed to maintain their expenditures relative to GDP, PDI, and total subnational government spending. Real dollar per capita expenditures even rose by about 15 percent. Any new downloaded expenditure responsibilities do not show up as higher relative aggregate expenditures. This observation is not to deny their existence. However, downloads may have been small or accommodated by reductions elsewhere, but troublesome nonetheless. Capital spending may have suffered, and deteriorating

Figure 3: Contributions to Canadian Municipal Revenue



Sources: Statistics Canada, as in tables 1 and 2

infrastructure may be temporarily masking the problems. There is a lack of information on capital spending at the municipal level. For local government in total, however, real per capita capital acquisition held steady throughout the 1990s but continued (as from the 1960s) to decline relative to capital consumption allowances. Furthermore, there is evidence that, over this period, municipal debt was greatly reduced and their financial assets considerably augmented (for example, local government net debt was halved from 1994 to 2001). While more detail is needed, there is not substantial evidence (at least, from aggregate expenditures) of a fiscal squeeze adversely affecting Canada's municipal governments.

The obvious impact of recent developments affecting Canadian municipal government has been on the revenue side. Substantially reduced transfers have been replaced largely by sharply increased property taxes. The main downloading and the squeeze on municipal government during the past decade or more appears to have been primarily on the revenue side (rather than on the expenditure side) with municipalities having to support a larger share of municipal expenditures from their own sources as transfers declined.

The inelasticity of the property tax is a common though somewhat faulty complaint. Especially in the past, because the period between property tax reassessments was typically lengthy (every seven years and sometimes longer), property tax revenues have not automatically increased with property values or with economic activity but have required (seemingly unpopular) tax rate increases to maintain real dollar revenues and municipal government purchasing power. Despite this complication, the response of the property tax to the demands made upon it over the study period has been remarkable. Real property taxes have not only kept up with (as is fairly typical) but have increased relative to GDP, personal income, and personal disposable income, even during a period dominated by slow or no real income growth and an inhospitable environment for tax increases in many provinces. This development suggests that the property tax can be responsive when required. Not to be ignored, the movement to market value assessments as the property tax base and the trend to their annual (or at least frequent) adjustments are making the property tax more elastic. Still, the property tax is for many people a more obvious tax than many other, often larger, taxes, thus exposing it to greater scrutiny.[13]

Despite the recent success in maintaining municipal expenditures through property tax increases, Canadians may be pushing the limits of the property tax. This pressure could be contributing to calls for municipal fiscal reform. Municipal governments are not alone in their use of this tax. School boards (notably in Manitoba and Saskatchewan) and most provinces (largely as a result of provincializing the local school property tax when provincializing school finances) also impose property taxes. At about 70 percent of municipal taxes (2.1 compared with 2.96 percent of PDI in 2001), these taxes are significant and, in the case of provincial property taxes, the taxpayers see no direct local benefit as they do for municipal taxes. The consolidated provincial and local property taxes as a percentage of personal disposable income have risen from 4 percent to more than 5 percent (as high as 5.7 percent) since the early 1990s. These levels have not been experienced since the 1960s (Kitchen and McMillan 1985). During that period, the stress which the baby boomers put on local school financing prompted school finance reform, with greatly expanded provincial grants yielding notable reductions in the overall property tax burden. With those lower levels behind us, the return of potentially critical levels of property tax burdens may press for further reform. Perhaps economic growth and growing PDI will lessen the pressure. However, a logical change in the circumstances would be for the relevant provinces to reduce their property taxes and fund schooling entirely out of general revenues, leaving the property tax field entirely to municipal government.

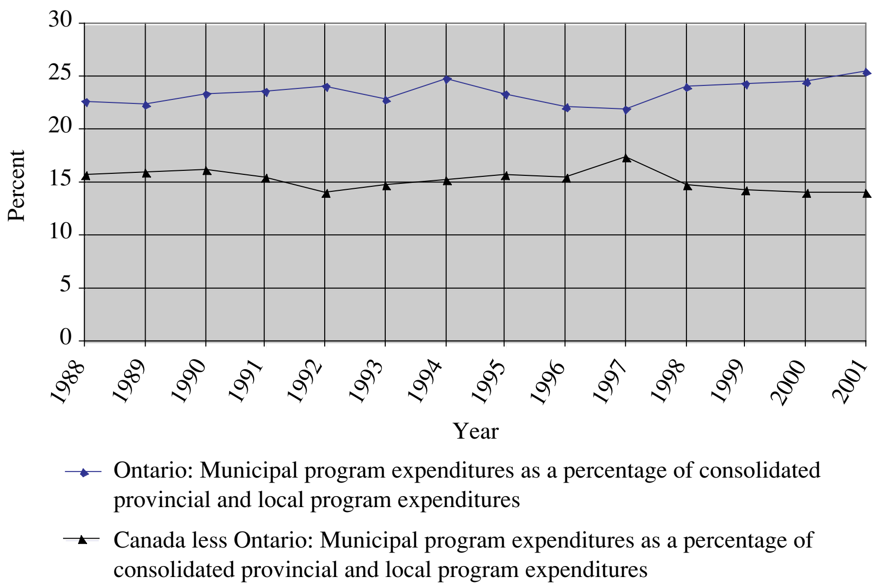
A Subnational Perspective

Nationally aggregated data can be helpful, but because municipal affairs come under provincial policy, they can mask as much as they reveal. Hence, it is also useful to consider a more provincial or at least subnational perspective. A province-by-province review cannot be done here, but it is useful to focus to some extent on Ontario, because it has followed a rather different approach with its municipalities and also with its 1990s reforms, and because the province is so large that its numbers can skew the national averages.

Subnational data indicate that Ontario is different. It has a relatively large municipal sector – 25.5 percent of consolidated provincial local expenditure, compared with 14.1 percent in the other provinces. Furthermore, unlike elsewhere, this sector has actually grown since 1997 (from 22 percent); see figure 4.

As in the other provinces, Ontario municipalities have become more reliant on their own revenues. However, the burden of own-source revenue as a percentage of PDI increased in only five other provinces, but the increases in them were swamped by the 1.6 percentage point increase (to 6.62 percent of PDI) in Ontario. The average burden of own-source revenue elsewhere actually

Figure 4: Program Expenditure Trends: Ontario and Other Provinces

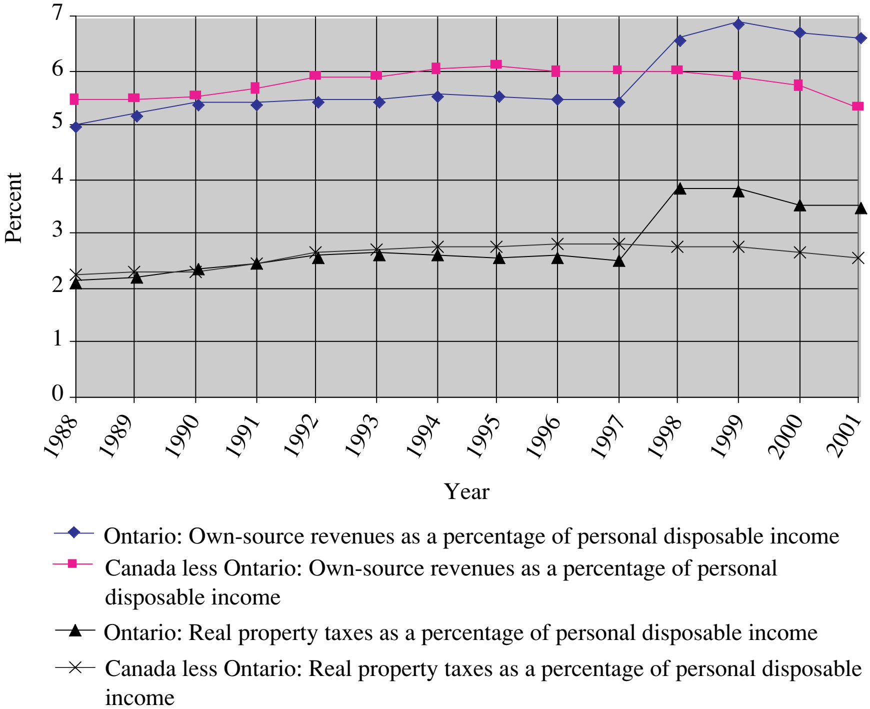


Sources: Statistics Canada, ibid.

declined marginally to 5.34 percent of PDI. The municipal real property tax burden (as a share of PDI) has increased in all provinces to meet rising own-revenue requirements, but this is especially so in Ontario, where it rose from 2.14 to 3.52 percent between 1988 and 2001, compared with an average increase from 2.25 to 2.57 percent in the other provinces.[14] Figure 5 shows the time paths of the own-source and real property tax burdens in Ontario and in Canada less Ontario. The sharp and significant changes in Ontario are obvious.

An interesting difference also appears in Quebec. Provincial data indicate that Quebec was the only province not to reduce transfers to its municipalities. Between 1988 and 2001, total transfers to Quebec municipalities increased from 8.0 to 14.0 percent of municipal expenditures. However, this growth was not entirely smooth. The latest data show that for the two years 1999 and 2000, transfers were at least 20 percent below their previous level but then

Figure 5: Municipal Own-Source Revenue and Real Property Taxes as a Percentage of Personal Disposable Income, Ontario and Canada less Ontario, 1988–2001



Sources: Statistics Canada, ibid.

recovered quickly to levels now at about 13 percent of expenditures. Also unique, as part of Quebec's fiscal restraint effort, the province required an annual contribution of $356 million by its municipalities for three years (1998–2000) to a Local Activities Special Financing Fund as part of their contribution to the province's fiscal restraint effort (Quesnel 2000, 119).[15] The $356 million annual contribution was equivalent to about 30 percent of the transfers then in place.[16]

Changes in social service financing in Nova Scotia also deserve comment. During the last half of the 1990s, social service outlays fell from one-quarter of municipal expenditures in 1995 to 4.5 percent in 2001 as the province assumed greater responsibility for social services. Because provincial transfers funded about three-quarters of municipal social service outlays, transfers to the municipalities declined as well, and the drop in transfers for social services accounted for 74 percent of the reduction in the total grants to municipalities over that period. Thus, the substantial fall in grants as a percentage of municipal expenditures (from 24.8 to 5.9 percent between 1988 and 2001) results partly from a provincial-municipal reallocation of responsibilities. A better comparison is that had the 2001 social service arrangements been in place in 1995, transfers would have represented about 15 percent of municipal expenditures. A decline in the contribution of transfers from 15 to 5.9 percent is still substantial but is more modest than the simple numbers suggest.

The pressure to maintain services in the face of declining grants during an economic slump posed problems for municipalities across the country throughout much of the 1990s. The result was fiscal pressure, especially from the revenue side. In general, though, the municipal governments seem to be coping relatively well. Although they rely more on own-source revenues and on real property taxes in particular, program expenditures are being maintained. However, the burden put on Ontario municipal governments and their taxpayers appears extraordinary, to the extent that the results suggest that the municipal fiscal squeeze may primarily be an Ontario problem.

Intergovernmental Transfers

Municipal governments receive transfers from both the federal and the provincial governments. The federal transfers are small. Even at their peak in the mid-1990s, they never exceeded 1.35 percent of expenditures ($19 per capita). In 2001 they amounted to 0.42 percent ($6.50 per capita). Federal transfers are specific purpose, small, and, at least recently, variable. Respecting provincial jurisdiction over municipalities, the federal transfers have been arranged through federal-provincial or federal-provincial-municipal agreements, which have often left the municipalities feeling that they are, if not outsiders, at least underrepresented. About one-half of the transfers have been directed to transportation and housing. Until the mid-1990s, federal money accounted for one-sixth of municipal spending on housing, but by 2001 it had fallen to only 2.3 percent. Beyond housing, only for resource conservation/industrial development and for “other” did federal transfers account for more than 1 percent of municipal outlays in the area. Currently, the federal contribution is very minor in all areas of municipal expenditure. Still, it may be significant to certain small subprograms not recognized at this level of aggregation.

The provincial transfers are much larger – about 16 percent of municipal expenditures overall (down from a peak of more than 24 percent). The magnitude and allocation of provincial grants vary considerably among the provinces. In 2001 provincial grants amounted to only about 5 percent of expenditures in British Columbia and Nova Scotia but amounted to about 20 percent in Ontario and Newfoundland. The per capita dollar amounts range from $40 in Prince Edward Island to $389 in Ontario. While the provinces do make unconditional transfers, the conditional (or specific purpose) grants dominate in all provinces except New Brunswick, and nationally they account for 13.9 of the 16.2 percent of municipal expenditures met through provincial transfers.

There is also considerable variation in the distribution of provincial grants. Ontario devotes almost 80 percent of its grants to social services. Outside Ontario, municipalities have very small social service responsibilities or none at all. Transfers for transportation, typically a major grant category, range from 4.9 percent of conditional transfers in Nova Scotia to 75 percent in Alberta. Large variations can also be found among the provinces in transfers to aid other categories of spending – for example, health, environment, and debt changes.

The contribution of transfers to municipal spending in the various areas is also of interest. In general, provincial transfers tend to be relatively large in comparison to expenditures in those areas for which municipalities normally have limited responsibilities (social services, health, housing, and conservation); but, with the exception of transportation and recreation, they are of less importance for those purposes that are major municipal expenditure areas. Even for transportation, specific purpose transfers exceed 12 percent of category expenditures in only four provinces.

THE MUNICIPAL SITUATION FROM A FISCAL FEDERALISM PERSPECTIVE

Thus far, this paper has outlined what exists. Very little has been said about why it is this way, what the positive and negative features are, or how improvements might be made. To be normative, standards or criteria are needed. Work by economists and political scientists on fiscal federalism provides a model useful for understanding and assessing intergovernmental fiscal relations. Although the main features can only be highlighted here, they are detailed elsewhere.[17] This assessment of the municipal situation is based on the fiscal federalism model.

The assignment problem is at the heart of fiscal federalism. The assignment problem is how to assign among governments (a) expenditure and service responsibilities and (b) revenue raising and tax powers. The major roles of government are often seen to be stabilization, distribution, and allocation (Musgrave 1959). For reasons of small size and interjurisdictional spillovers, neither stabilization nor (re)distribution is deemed an appropriate function for municipal government. However, allocation (using resources to provide services efficiently) is well suited to municipalities. Once there, the problem is to find the mix of responsibilities and funding that will realize that goal. Desirable characteristics for effective local government typically are said to include autonomy, responsiveness, accountability, and strong benefit-cost linkages for local services.[18]

EXPENDITURE RESPONSIBILITIES

Decentralization, or subsidiarity, is central to fiscal federalism. The principle is that responsibility for services should be assigned to the lowest level of government capable of providing the service effectively. When preferences or conditions vary geographically, devolution enhances efficiency plus responsiveness, autonomy, and accountability in a democratic environment. Substantial interjurisdictional spillovers, economies of scale, or decision-making costs may offset the advantages of decentralization and require alternative or modified solutions.

The services typically provided by Canadian municipalities are those well suited to local government: protection (fire, police), transportation, environment (water, sewerage, solid waste), recreation and culture, general services, conservation/development, and regional planning. These services – which together account for more than 75 percent of municipal spending nationally – essentially provide local benefits (that is, there are limited spillovers) for which tastes vary and for which local management and a local scale of operations are efficient. Such services are suited to the duties of a government limited to user charges and property taxes. An important and interesting feature of local government in Canada over the past twenty years has been the expanding provincialization of school finance, effectively make schooling entirely a provincial responsibility (despite the local school boards).

Social expenditures by municipalities – those for health, social services, education, and housing – are minor in most provinces. In eight provinces, they amount to 4 percent or less of total outlays. While municipal support for schooling makes Nova Scotia stand out, the striking anomaly is Ontario, where social spending represents one-third of municipal expenditures. Local governments are not well suited to financing redistributive services. This is why social services in particular, and social spending generally, have been progressively reduced (most recently in Nova Scotia) or virtually eliminated (in eight provinces) as a municipal responsibility. Ontario makes concessions towards social spending via transfers, but those directed specifically at social spending offset just over half of its costs. Thus, Ontario municipalities are still left with an unusually large share of social costs relative to the other provinces and to recommended practice. Ontario's reforms of the 1990s aggravated the situation, because although it was initially claimed that they were intended to be revenue neutral, "the numbers did not work out" as someone said. Ontario is the most obvious case of service responsibility downloading. Elsewhere, though arguably less so in Quebec, downloading has taken the form of shifting added revenue-raising (funding) responsibility onto municipal governments.

REVENUE RESPONSIBILITIES

Once there is a multitiered structure of government, tax assignment becomes an issue. Taxes on immobile tax bases – notably, property – and fees and charges on service beneficiaries are well suited to municipal government. Because efficient resource allocation is seen to be the major municipal objective, a close link between local public benefits and local public levies is strongly recommended; that is, the benefit principle should prevail. As Bird (1993, 111) has noted, "the essential economic role of local government is to provide local residents with those public services for which they are willing to pay." In addition, the levies to be imposed on local citizens in order to finance local services should be determined by their local government. Benefit-related finance and local determination of local levies are fundamental criteria. Furthermore, it is desirable that revenue sources are adequate, predictable, fair, visible, not exportable, and easily administered.

The revenue structure of Canadian municipalities conforms rather well to the model outlined. Own-source revenues account for 83 percent of revenues and they are almost entirely locally determined.[19] One-half of total revenues come from property and related taxes, and one-quarter come from user charges. Lot levies and special assessments (about 4 percent of own-source revenues) fit the benefit criteria well. More debatable is the business tax (about 3 percent of own-source revenues). Business taxes (because they are additional to the regular property taxes) and high property taxes on nonresidential property raise questions about tax shifting and exporting (Kitchen 2003a; Kitchen and Slack 1993). Further reliance on user charges is often advocated, especially for environmental and recreational services (e.g., Dewees 2002). Yet larger service charges have not figured predominately in the municipal response to the decade's fiscal stresses. Instead, greater real property taxes have carried the load.

Municipalities have not had revenue sources that correspond well to their major expenditure area – transportation. In particular, there is no mechanism with which municipalities can allocate costs directly to vehicles and their users, since fuel taxes and licence fees are the realm of the provincial and federal governments. Tolls have been limited to a few specific projects and to public transit.

The adequacy and appropriateness of the property tax can be questioned when municipalities are being asked or expected to meet significant social expenditures (without compensating transfers). Ontario is the obvious concern. There, social expenditures are now 33.2 percent of municipal budgets – at least half again as much as they were in 1988. In other provinces, social expenditures by municipalities have risen only marginally, if at all. A notable concern in the case of Ontario is not only that social expenditures have actually increased markedly but also that the responsibility for social spending has increased at the municipal level in the face of provincial and federal cutbacks.

The assumption of full financial responsibility for schooling by more provinces (for example, Alberta, British Columbia, and Ontario) has been a feature of recent local-provincial finance. The parallelling feature is their failure to fund schooling from traditional provincial revenue sources, instead choosing to convert the local school property tax to a provincial property tax. The school property tax, which does not relate well to school benefits or ability to pay, made sense when a local contribution to schooling was required and the only sufficient local tax base was property. Elimination of provincial property taxes for schooling (at least on residential property) might enhance the municipalities' ability to fund spending from traditional revenue sources.

INTERGOVERNMENTAL TRANSFERS

Objective and independent assignments of expenditure and revenue-raising responsibilities do not ensure either an efficient or an equitable fiscal system. One potential problem is a mismatch of fiscal capacity and expenditure responsibilities, resulting in a fiscal gap that calls for some reshuffling of responsibilities or revenue sources, or for unconditional gap-reducing intergovernmental transfers. Even if there is no fiscal gap at the municipal level overall, there still may be "rich" and "poor" municipalities and legitimate demands for (unconditional) equalization grants. Interjurisdictional spillovers of benefits and/or taxes call for grants to correct distortions and to improve fairness. Such grants are specific to the spillover activity. Specific purpose (or conditional) grants are a means by which different tiers of government can share responsibility for services that do not fit neatly into any single level. Schooling has been such a responsibility. Such transfers are also one way for one level of government to (essentially) contract with another level to perform specific services. There are also political reasons for intergovernmental grants. Raw political power may be a motivation, but a more positive view is that some grants are a means of motivating cooperation and contributions while stretching the grantor's budget. Hence, grants may exist for various reasons.

Because grant programs often appear to be aimed at meeting more than a single objective, assessment is complicated.

Unconditional grants to municipalities are provided only by the provincial governments and, typically, in relatively modest amounts. For Canada as a whole, unconditional assistance averages 2.4 percent of municipal revenues, with the largest relative contributions coming in Manitoba (7.9 percent) and New Brunswick (12.4 percent). These funds normally come from provincial general revenues, but in Manitoba they come from a well-established revenue-sharing program. These grants are distributed by formulae on some type of equalizing basis. Often, the available funds are not sufficient to meet the equalization requirements implied by the distribution mechanisms. Typically, some funds are allocated to every municipality; hence, the unconditional transfers may be motivated partly by fiscal gap-closing objectives. Given the modest size of these grants, the provinces must see the municipal fiscal gap problem as minor.

Conditional transfers in most provinces are for transportation, environmental services (water and sewerage), and recreation and culture. The externality element in transportation is obvious (external users) and also in the case of public transport and environmental considerations; but for the others, it is more obtuse.[20] Funding is predominantly for capital projects (or for debt service costs). Uneven subsidies for capital versus operating expenditures raises questions about potential misallocations between capital and operating costs.

A striking feature of conditional transfers is the variation in their relative contribution to municipal spending for a particular purpose. For example, transfers for transportation meet 2.9 percent of expenditures in Ontario but 42 percent in Alberta. However, spillovers are usually not easily determined and priorities can vary. It is interesting that the transfers for policing, a service probably involving significant externalities for most (if not all) municipalities, make only very small contributions to costs, yet for recreation, which is likely to provide local benefits, transfers cover a far higher share of its costs.

Ontario's loading of significant social expenditures on municipalities is exceptional. This unusual arrangement could be quite workable as a responsibility-sharing arrangement given the appropriate transfer programs; that is, with generous conditional social transfers and effective equalization. Ontario's social transfers still leave the municipalities to meet half these costs, which amount to about 16 percent of their total expenditures – a level that far exceeds the municipal social expenditure outlay in any other province.

Federal transfers to municipalities are small (0.4 of municipal expenditures in 2001), and they are directed mostly to social housing and transportation. With recent reductions, the federal contribution to expenditures in any of the main areas has become very minor, the largest in 2001 being to housing, where federal transfers provided 2.33 percent (down from 16 percent in 1995).[21] Federal transfers may contribute in important ways to various subprograms, but the overall contribution has been small and declining.

The analyst would expect federal transfers to be in areas involving national externalities or in areas of federal jurisdiction that benefit from municipal input and cooperation. Efforts to alleviate poverty – such as social housing, immigrant settlement, and off-reserve Aboriginal uplift – seem logical. Typically, as seems reasonable, these programs operate under federal-provincial-local agreements. However, it is debatable whether the allocation of responsibilities and cost sharing under these agreements, as well as the burdens that the underlying problems now impose, are appropriately distributed. Although housing has been identified as a component of the federal urban strategy, the levels planned will not notably enhance the federal role. The fiscal priority of the recent and announced federal strategy has, interestingly, been infrastructure.[22] Apart from the fact that federal visibility from input into municipal projects affords broad local public benefit (as opposed to small social projects benefiting narrow groups of disadvantaged people), the national interest in and benefit from many of these investments is difficult to imagine.

OPTIONS AND PROSPECTS FOR THE FUTURE OF MUNICIPALITIES' INTERGOVERNMENTAL FISCAL RELATIONS

The prevailing message from the municipal sector is that Canadian municipalities are bearing a greater and possibly unsustainable fiscal burden which, unless corrected, will have a negative impact on the development of municipalities, especially Canadian cities, and in turn on the social and economic future of the country. That the share of municipal expenditures met from own-source revenues has grown is without doubt (overall, about 83 percent in 2001, compared with 77 percent in 1988). Although the required adjustment has been relatively rapid and definitely difficult, the fact that municipalities generally are unable to sustain the larger burden is less obvious, especially when the bulk of the readjustment has been concentrated in one province, Ontario. The data examined here suggest that many of the claims of municipal crisis and incapacity may be overstated. For the most part, municipalities appear to have coped relatively well through rather difficult times. But this relatively positive assessment does not imply inaction is an acceptable response. There is still substantial scope for improving the fiscal environment of municipalities of all types. In this section, consideration is given initially to the prospects for easing the existing municipal fiscal burden through expanded transfers. This avenue is likely to be the most popular alternative with municipalities and, though with less enthusiasm, also with the provincial and federal governments. Because the transfer option may be inadequate or (at least in the minds of some) second best, options for making the municipal fiscal burden more manageable through expansion of own-source revenues are also considered.

INTERGOVERNMENTAL TRANSFERS

Although recent developments may suggest otherwise, it is difficult to hold much hope for substantial fiscal relief emerging from the federal government. In part, this view emerges simply because the federal transfers have traditionally been so small; even at their mid-1990s peak, they amounted to only 1.35 percent of municipal expenditures. However, there has been some expansion in federal infrastructure programs for municipalities. More notable has been the emergence of Prime Minister Paul Martin as the champion of a “New Deal” for municipalities, a cause he initiated during his campaign for leadership of the Liberal Party and one that is mostly associated with a sharing of federal fuel tax revenues (Martin 2003). Towards this initiative, the federal budget of 2004 provided municipalities full (versus the partial 57 percent) relief from the federal goods and services tax (GST). This measure was estimated to provide municipalities with $580 million in sales tax relief in its first year. The 2005 federal budget announced the New Deal for Cities and Communities program, which is to provide $5 billion in funds for municipalities over the next five years, starting with $600 million in 2005–6. The 2005 budget and the New Deal proposal are now mired in the uncertainties of minority government. Assuming that the program materializes, $600 million translates into about $18.75 per capita today, or about 1.2 percent of 2001 municipal expenditures. Immediate potential funding from the New Deal, plus the added savings from the GST, is equivalent to about 2.4 percent of 2001 municipal expenditures. Clearly, this is a healthy increase from recent levels of federal government transfers. However, even if the New Deal reaches the $2 billion annually projected after five years, these funds could be expected to amount to only about 3 percent of municipal expenditures. Whether more would become available is hard to say. The federal government faces many demands, and the municipalities are a provincial responsibility. However, federal transfers amounting to 3 percent of expenditures represent almost 40 percent of what the provinces collectively trimmed from their transfers to the municipalities. Hence, in a sense, the enhanced federal funding is as much a benefit to the provinces as to the municipalities. Perhaps, along with the fact that the New Deal funds flow through agreements with the provinces, this is why the provinces are strangely silent on this significant federal initiative into the municipal area.

The provinces are and will continue to be the source of the bulk of transfers to the municipalities. It is the provinces, too, that imposed the most burdensome cuts in these transfers. The cuts were imposed when most provincial economies were listless and the provinces were struggling with deficits and restoring fiscal balance. Both of those situations have improved considerably, so perhaps, with provincial budgets in better condition, the provinces will be more amenable towards restoring municipal transfers. While not indicating a negative trend, the latest (2003) data show no notable evidence of a recovery in transfers to municipalities (relative to their revenues and expenditures). Bearing in mind that health care and other demands place continuing pressures on provincial treasurers, perhaps the changes are yet to come. Some of the recent provincial budgets offer encouragement. For example, the Ontario government has initiated a sharing of the provincial gas tax with its municipalities to support public transit. And Alberta – an exceptional case, faced as it is with the infrastructure demands of strong growth but enjoying the benefits of the accompanying growth in resource revenues – is embarking on a program transferring $600 million (currently the equivalent of $180 per capita) annually to its municipalities for five years.

A careful analysis of the logic for and practice of transfers might sway provincial governments towards being somewhat more generous. A close look at the assignment and financing of social programs in Ontario should head the list. The entire package in all the provinces would likely benefit from review.

The re-examination of transfers might result in a more coherent system, but it might not result in a great deal more funding. To illustrate, Edmonton City Council received a report outlining inequities in the city's fiscal relationship with the province (Edmonton 2002). The report identified $88 million in costs which the city bore on behalf of the province and for which it should receive consideration. While a considerable sum, this represented only 6.3 percent of the city's total budget for the coming year. Many may have expected a larger share. In addition, the Alberta government may have some reasonable rebuttals and an independent analyst may propose something else again. Regardless, the gains from improved (rather than simply enlarged) transfer systems might not be large.

Indirect transfers are another possibility. In 2003, Ontario introduced Ontario Opportunity Bonds to fund municipal infrastructure lending, the interest on which was not subject to provincial income tax. This tax concession lowered the interest rate charged on municipal debt (a tax expenditure), providing an indirect subsidy to borrowing municipalities.[23] While on the surface appealing, such bonds distort incentives to investors, induce municipalities to rely more on debt to finance capital, encourage the substitution of capital investment for operating costs, and favour high-income investors most. Both the TD Bank (2002) and the C.D. Howe Institute (Mintz 2003) considered the Opportunity Bonds flawed. The federal government, and many would say wisely, did not provide a parallel tax concession.[24] Ontario's newly elected McGuinty government soon dispensed with the tax exempt status of infrastructure bonds and reformed the province's infrastructure lending authority.

Enhanced intergovernmental transfers do not appear to offer great opportunities for reducing the present fiscal pressures on municipalities. However, unexpected and substantial improvements in the fiscal situation of the federal government and especially the provincial governments could change that (as occurred in Alberta, for example). If so, it could start municipal government on another cycle of transfer volatility. Senior governments are fickle friends when it comes to providing grants. Some transfers are necessary for efficiency and equity reasons, so a well-designed and appropriately funded grant system is desirable. Even then, changing circumstances and political perspectives can be expected to ensure that some volatility will persist. While the expansions are normally regarded positively, the contractions are unpleasant. Municipalities may have more success in resolving their fiscal problems if they advance and secure improvements in their own-source revenues.

OWN-SOURCE REVENUES

Four topics are addressed here. While there are many possible alternative mechanisms for augmenting municipal revenues and many of those have been suggested in various contexts, most have very limited revenue-generating capacity (even collectively) and many have other drawbacks. Attention is focused here on options that offer significant revenue potential or potential improvements, or have gained some attention in the Canadian context.

The Property Tax

Growth in the property tax burden has been striking and may have heightened resistance to further increases. About 40 percent of property taxes are not municipal taxes; except in Manitoba and Saskatchewan, they are provincial taxes primarily supporting schooling. Provincializing the school property tax afforded a convenient transition, but as there are better alternatives, the provincial property tax (at least on residential property) should be phased out. Doing so would be a revenue-neutral change for the provinces – a reshuffling of (not an increase in) provincial taxes. Doing so would also rationalize the tax structure better. Especially when school property taxes are paid to the province, there is, at best, a weak connection between tax and benefits. As a benefit-related tax, the property tax is much better suited to municipal government. Even if the provinces were to abandon general property taxes, it is unlikely that this would create a tax room windfall for municipalities. Municipal taxpayers would still look for the quid pro quo and would carefully scrutinize the pros and cons of any proposed property tax increase.

Vehicle-Related Taxes

The absence of vehicle-related revenues for municipalities is striking, given the importance of their transportation expenditures. This anomaly detracts from the benefit-cost linkage considered important for municipal finance. It is reasonable that municipalities have access to vehicle fuel tax revenue. Hence, some have suggested that municipalities be permitted to levy their own vehicle gas taxes. While superficially attractive, the logic for individual municipal gas taxes is weaker. Vehicles are mobile, and drivers in many municipalities could easily make the choice of avoiding or minimizing this tax. Multijurisdictional communities afford the greatest opportunity to avoid local fuel taxes, and undoubtedly some municipalities would find gas stations a more attractive alternative to fuel taxes. Even for large municipalities (or where regional associations of municipalities agreed to cooperate) where the travel costs necessary to avoid a fuel tax would be larger, border problems would persist. To illustrate, near the City of Lloydminster on the Alberta-Saskatchewan border, the higher Saskatchewan fuel tax is graduated with distance from the border. In addition, in the regional context, while border problems diminish, the accountability problem is exacerbated. In the multijurisdiction environment with fuel tax levies collectively determined, who is held accountable for increased fuel taxes? Finally, even without the border problem, gas tax bases will vary greatly. Consider the major pit stops along the main intercity highways. Of the few places where local fuel taxes are in place in Canada (for example, the Greater Vancouver Regional District), they are provincially determined. Because of the potential social costs of tax avoidance efforts, the distortions to business location, and the uneven base, vehicle fuel taxes become a candidate for revenue sharing. The fuel taxes which the federal and provincial governments already collect could be shared, or an additional (dedicated municipal tax) could be collected for sharing. While administratively convenient and avoiding the noted distortions, revenue sharing poses problems of determining the appropriate amount of revenue to be raised, its distribution, potential arbitrary changes by the "sharing" government, and a weak tax-benefit linkage to local expenditures. Clearly, there are tradeoffs to be considered.

For a locally determined tax, a municipal vehicle registration charge is an attractive option. Owners of vehicles live in a particular municipality and, to a large extent, use their vehicles there. Since vehicle registration is linked to residence, the tax could not easily be avoided (especially if significant fines accompanied improper registration). Commercial vehicles used primarily outside the "home" community could be levied a representative supplementary provincial registration fee, to be shared among municipalities. Piggy-backing local fees onto the provincial registration system would minimize administration and compliance costs. A local vehicle registration fee relates user benefits to transportation costs only in a simple way, but since there is less potential for tax avoidance and tax exporting, it seems superior to local fuel taxes. Such a fee would be ineffective in easing congestion and would not account for use outside the municipality (excepting the aforementioned suggestion for certain commercial vehicles). However, provincial licence fees and fuel taxes, plus federal fuel taxes, go far towards taking account of certain externalities.

Roadway congestion charges are virtually nonexistent in Canada, so a local vehicle registration fee would be neutral on that front. However, the case for and appeal of congestion charges is increasing, and it deserves further attention, though it can be considered only briefly here.

Tolls geared to traffic volume are suited for controlling congestion in urban areas, and technology is making their use more and more feasible. Note, for example, the developments in throughway tolling in California, the well-established toll system in Singapore, and the charge recently introduced in central London, England. In fact, the British are considering developing a nationwide road-use toll system. Toll revenue should be shared among the governments responsible for providing and maintaining the roads (much as one would think should occur with the existing fuel taxes and registration fees).

General Sales Taxes

The municipal sales tax is another option for an expanded local tax base. Municipalities could be permitted to levy a general sales tax within their jurisdiction, to be collected by piggy-backing it onto a provincial sales tax or the federal GST. Local general sales taxes are relatively common in the United States but are not often found elsewhere beyond southern Europe. Municipal sales taxes can raise considerable revenue, and partly for this reason they have attracted some proponents in Canada (e.g., Kitchen 2000b, 2003a; TD Bank 2002). They account for about 10 percent of local tax revenue in the United States. There are, however, numerous criticisms of local sales taxes. Because consumers are mobile, local sales taxes affect where they buy and where businesses locate. Hence, as with municipal fuel taxes, economic activity can be subject to fiscal distortions. Also, the sales tax base is not uniformly distributed so access to sales taxes may disadvantage some (for example, rural jurisdictions) but be attractive to others, in part because of the potential for tax exporting. Because these social costs are rather obscure, municipal sales taxes may appear more attractive than is warranted. Hence, sales taxes may be better suited as a source of funds for revenue-sharing programs. Again, revenue sharing has its own set of problems; there are some significant tradeoffs involved with the local sales tax, the pros and cons are not always obvious, and they differ with the particular circumstances.

Personal Income Taxes

Municipal personal income taxes are another option. Although frequently overlooked,[25] they are not all that unusual.[26] They are the mainstay of municipal government in the Scandinavian countries, but municipal governments there have extensive responsibilities, especially in the social services area. In the

United States, which more closely parallels the Canadian situation, about 3,700 local governments levy local personal income taxes (compared with 6,500 using the sales tax), and those taxes generate 5.9 percent of local tax revenue (compared with 10 percent for local sales taxes). Municipal income taxes are especially popular with cities in the United States.[27] Canadian municipalities only lost their income tax powers with the 1941 federal-provincial tax rental agreement. Before then, local income taxes in Canada sometimes exceeded the provincial income tax collections.

A municipal personal income tax is typically levied at a low flat rate on the personal income of residents. A 1 percent rate is not unusual. Corporate income is not taxed, largely because of tax-exporting problems. However, to capture personal income comprehensively in Canada, the income of professional and small corporations may need to be included. The treatment of commuters varies and is debatable. A municipal income tax offers various advantages. It can easily be piggy-backed on provincial personal income taxes to minimize administrative and compliance costs. Because the tax (and the benefits it would help to finance) is based on residence, it is, like the property tax (but unlike municipal sales taxes), a relatively non-distorting revenue source. The personal income tax relates better to ability-to-pay than the property tax, so in combination with the property tax it might facilitate a better matching of benefits and costs at the municipal level (especially of social programs). Unlike sales taxes, neither rural nor urban municipalities are disadvantaged by access to this revenue source. Also, like the property and sales taxes, it is a visible tax that promotes accountability. On the negative side, a municipal income tax would (like a municipal fuel or sales tax) add a third tax authority to a shared tax base. Also, it might have some marginal adverse incentive effects on income earners. Again, there are tradeoffs to consider. A 1 percent tax could generate about 8 percent of municipal revenues, or the equivalent of 20 percent of the revenues from the real property tax. If the federal government were to offer to collect a low municipal personal income tax, this option would be open for discussion.[28]

SUMMARY AND CONCLUSIONS

THE FISCAL PICTURE

Municipal governments in Canada supply and finance services benefiting their own local residents. More than 83 percent of the costs of municipal services now come from own-source (locally raised) revenues, property and property related taxes, and user charges. This assignment of responsibilities and revenue sources conforms quite well with the recommendations of fiscal federalism analysis. For the most part, functions are decentralized appropriately and there is a strong benefit-cost linkage at the municipal level. Intergovernmental transfers account (on average in 2001) for 17 percent of municipal funding. Provincial transfers, representing 16.6 of the 17 percent, dominate. Transfers to municipalities are predominately (85 percent) for specific purposes rather than being unconditional grants.

Over the past decade, municipal government has been pressured by a fiscal squeeze precipitated by a sharp reduction in transfers (except to Quebec), from about 25 to 16.6 percent of municipal expenditures.[29] Reduced interest rates (and, in turn, lower debt service charges) softened the blow, but reduced grants erased for municipalities the fiscal dividend that they would otherwise have realized from falling interest rates.

The downloading of responsibilities has been a widespread complaint and concern of the municipal sector. Although widely spoken of, evidence of notable downloading on the expenditure side is much more muted. Between 1988 and 2001, there was hardly any change in municipal total expenditure as a percentage of GDP, of municipal program expenditure as a percentage of GDP, and of municipal program expenditure as a percentage of consolidated provincial and local program expenditure. However, municipal real dollar per capita expenditures increased 15 percent (from $1,262 to $1,453) over that period. This evidence does not necessarily demonstrate the absence of expenditure downloading, but it does demonstrate that, to the extent that it occurred and to the extent that municipal government has responded, it has not resulted in the growth of municipal government relative to the economy or relative to the subnational (notably, provincial) government sector.

Developments on the revenue side are more substantial. Reduced grants meant an increased reliance on own-source revenues. While user charges have become somewhat more important, the increase in real property taxes has been dramatic. Between 1988 and 2001, real property taxes increased from 32.2 to 41.9 percent of municipal revenues – a 30 percent increase. The burden of municipal property taxes moved in parallel, increasing as a percentage of personal disposable income (PDI) by almost 34 percent (from 2.21 to 2.96 percent).

Municipal property taxes are only part of the story. Provinces (and school boards in some provinces) also levy property taxes. Together, the aggregate property tax reached 5.6 and 5.7 percent of PDI during much of the 1990s. Canadians have not experienced this level of property taxation since the 1960s, when those levels contributed to school finance reforms. One might legitimately ponder whether the recent concern about municipal finance might stem from the escalating and high property tax burdens of the 1990s and whether pressure for reforms to relieve the property tax burden will escalate or be stayed by the gains of the recent economic recovery.

A subnational perspective offers further insights. Ontario stands out. A significant downloading of responsibilities to the municipalities occurred there. Municipal government increased in relative size only in Ontario. Also, while the municipal real property tax burden rose elsewhere, Ontario shifted to a new, higher plateau after 1998, which resulted in an increase from 2.14 to 3.52 percent of PDI between 1988 and 2001, while the average of the other provinces rose from 2.25 to 2.57 percent. The consolidated provincial and local property tax had a parallel shift. Ontario municipalities have experienced a substantial fiscal squeeze from both the expenditure side and the revenue side. In the other provinces, the squeeze was a revenue squeeze and was more modest.[30] Overall, while there has been a municipal fiscal squeeze across the country, the squeeze is the biggest in Ontario, and it appears to be primarily an Ontario problem.

FUTURE DIRECTIONS

Conventional Transfers

Reduced transfers have been the source of many of the municipalities' recent fiscal difficulties. Is there much likelihood of relief from this same source now that the federal government and most provincial governments have their fiscal houses in better shape? Perhaps, but there are many obstacles. The federal government has been a minor player in the municipal grant programs (contributing only 0.4 percent of municipal revenues in 2001). Even with the shift of municipalities in the federal priorities under the Martin government (with the full GST rebate and the New Deal for Cities and Communities), the effective additional relief afforded municipalities in the short term will amount to about 2 percent of municipal expenditures. While still relatively small, the new federal contributions are not trivial and are welcomed by municipalities. The provinces have been unusually quiet about this initiative of the federal government in an area of provincial jurisdiction, probably because they see federal assistance to municipalities as easing the expectations and burden on themselves – that is, it is a form of indirect assistance to the provinces. Despite these initiatives, the federal government should not neglect transfer programs involving municipalities in areas of federal responsibility (immigrant settlement and Aboriginal improvement) and those largely redistributive programs (such as affordable housing) where there is a relative advantage to national funding.

Changes in the much larger provincial transfers could be expected to have a more significant impact. A careful review of them might result in improved design and possibly expanded funding. Even so, the amounts might not be that large, and grant funding seems less dependent on grant rationale than on the availability of funds. To be realized, a change in priorities is required. To date, there has been little evidence of a major turnaround in provincial transfers to municipalities developing in most provinces.

Should federal transfers to municipalities increase and play a more important role? This is not a simple question to answer. Provincial transfers, it could be argued, will better reflect regional needs, interests, and priorities. However, if they are not emerging because of differences in the fiscal pressures on the federal and provincial governments or because of different priorities, greater federal transfers might be an acceptable alternative (although it could be argued that it might be more appropriate for the federal government to address provincial fiscal capacity and let decisions regarding municipalities be made there). At projected levels, added federal transfers will not undermine the reliance on local revenues and the local benefit-cost linkages relative to what they were a decade or more ago. Also, if modest and well designed, they are unlikely to distort local priorities or encourage inefficiencies – at least, not any more than provincial grants do. On the other hand, an expanded federal grant system adds complexity to intergovernmental relations. Perhaps worthy of note is that federal-municipal fiscal relations vary widely among federations, and the minimal interaction found in Canada is unusual.

Sustainability of the Status Quo and Some Direct Implications

If the prospects for a reinstatement of the conventional transfers must be viewed cautiously, can municipalities function effectively under the current situation with the heavier reliance on the property tax? Improved economic and fiscal conditions have raised PDI and diminished the relative burden of the property tax. Whether this easing will suffice is yet to be determined. The prospects here look more positive outside Ontario. Ontario, however, should rethink its municipal social expenditure assignment (or its funding). There are good reasons why social expenditures by municipalities are almost zero elsewhere.

An option for reducing the property tax burden in many provinces is to reduce provincial property taxes.[31] With access to superior alternatives at the provincial level for financing schools, a provincial property tax (at least on residences) could be eliminated without any increase in the overall provincial tax burden. Elimination of provincial property taxes would leave the property tax for municipal government. The municipalities, however, would still need to convince their taxpayers that additional municipal levies were warranted.

Some Less Conventional Options

A large share of municipal expenditure is related to vehicle transportation, but municipal government lacks the mechanisms to charge or tax vehicles or their use. Some have suggested that municipalities be granted the authority to levy municipal fuel taxes. Others propose municipal sales taxes as a solution to the broader fiscal problem. Consumer mobility (creating border problems and economic distortions), especially in multijurisdictional environments, and uneven tax bases could make these unattractive options. Fuel and sales taxes are better suited for revenue sharing, but that puts control of the revenue (and its distribution) in the hands of the sharing government. Municipal governments might be reluctant to endorse this option, given their recent experience with transfers, and the sharing governments might want municipal governments to take (greater) responsibility for the taxes from which they benefit.

There are other taxes that may be better suited to municipal government. Individual municipalities should levy a municipal vehicle registration fee (rather than fuel taxes), and congestion tolls deserve consideration, especially in large cities. A municipal personal income tax surcharge is another option. Like the vehicle registration fee, it could be collected through the existing collection systems. Both these taxes are residence based, and because residence is less mobile than consumption, they are less subject to distortion than taxes based on sales.

There is relatively little evidence to suggest that the provinces are inclined towards these less conventional options. In 2003 the City of Winnipeg advanced a carefully crafted New Deal Initiative that, among a variety of measures, included innovative proposals for a municipal general sales tax of 1 percent and a municipal fuel tax of $0.05 per litre.[32] The province, however, was unwilling to give the city new taxing powers. In Alberta, in 2002, the minister of municipal affairs created a high-level Provincial/Municipal Council on Roles, Responsibilities and Resources. This council was exposed to a wide range of alternatives across the three areas, and some innovative recommendations were advanced, including some for expanded municipal tax bases.[33] However, the council kept a very low profile, never issued public reports, and seemed to come to a close in 2004 with no resolution. The Canada West Foundation (Gibbins et al. 2004) issued a report that appeared to be aimed at outlining the council's unfinished agenda. Flush with energy revenues and facing an election, the province opted for reverting to a very large expansion of conditional transfers to support infrastructure development. Other provinces lack the fiscal flexibility of Alberta. Still, Ontario, in the fall of 2004, started sharing one cent per litre of the fuel tax (to reach two cents in 2006) with its municipalities. Hence, there seems to be little enthusiasm by the provinces for expanding municipal taxing capacity; instead, where possible, the provinces prefer to revert to conventional transfers.

FURTHER OBSERVATIONS

This discussion is limited in several respects. For one, the fiscal problems of municipalities may well differ among different types of municipalities. It has not been possible to address those differences here (largely for lack of suitable data by municipal type). It is, however, important to recognize that differences do exist and that possible solutions may not be universally applicable. There is also a problem that capital and operating budgets have not been separated (again a data problem). Municipalities are responsible for the bulk of total government infrastructure investment, and it is often argued that they suffer an infrastructure deficit. Hence, municipal capital warrants further attention.

Finally, there are many dimensions to municipal intergovernmental fiscal issues. Money matters, but it is not the only consideration, though it often overlaps with others. Fortunately, other aspects are considered elsewhere in this volume.

NOTES

The author thanks Harry Kitchen and the Public Institutions Division of Statistics Canada for providing data. He also thanks Junaid Jahangir for research assistance. Additional tables further documenting the data reported in the paper are available from the author or at the conference section of the Institute of Intergovernmental Relations website, where an extended version of this paper appears. Enid Slack and two anonymous referees are thanked for their comments. Various people are thanked for insightful comments and valuable references.

1 For a good overview of developments, see Kitchen 2003 and Garcea and LeSage 2005. The latter cover the extension of "natural person powers" to municipalities. Distinct from these developments, but not to be overlooked, are the changes in school finance (i.e., the provincialization of school finance) and the school district amalgamations that have occurred in parallel (e.g., Alberta, British Columbia, and Ontario).

2 For example see Berdahl 2002, who draws from many of these studies. More recent CWF publications relating to municipal finance have tended to focus on infrastructure.

3 Note the activities of the Federation of Canadian Municipalities. Recent assessments are provided by, for example, Kitchen 2000a, TD Bank 2002, and Vander Ploeg 2001, 2002a and b.

4 Before 1988, data were available only for local government; that is, for the combination of (the comparably sized) general purpose local authorities (municipalities) and local school authorities (school boards). The data suggest that, since 1965, the relative magnitude of local government has been quite stable.

5 The latest numbers from Statistics Canada Financial Management System (for 2002 and 2003) suggest that, although municipal social assistance expenditures continued to decline, there has been no further reduction in overall municipal social service spending in Nova Scotia since 2001.

6 For details, see, for example, Kitchen 2003b.

7 Transfers in Prince Edward Island also are relatively small (7.2 percent of total revenue), but municipal expenditures there are low.

8 The most recent data on municipal revenues and expenditures have revised the 2001 numbers, and that revision affects the 2001 values reported here. Note that the updated data show transfers to municipalities as accounting for 15.4 percent of municipal expenditures and revenues in 2001 (not the 16.6 and 17 percent reported here). The important implication of this is that the reduction in transfers to the municipalities is actually greater than indicated in the text of the paper. The volume of calculations using the earlier data prevent recalculation of all the numbers, so other changes are not noted (nor is the above change made in the text). More than marginal changes are not expected for most figures.

9 Due to the slow growth in GDP during the economic funk of the early and mid-1990s, the ratio in intermediate years rose because of the adverse effect on the denominator of the ratio. This affected several of the series examined. Fortunately, the initial and final years of the study period are both periods of relative economic prosperity and so are comparable.

10 Program expenditures are expenditures less debt-servicing costs; that is, expenditures directly on services (programs) for the community.

11 Nominal dollars are adjusted using the GDP price index. There is no price index for municipal government expenditure, but the GDP index seems more appropriate than the consumer price index, and it also approximates the index for (total) government current expenditures.

12 Because local taxes are paid from disposable income, it is reasonable to look at the municipal tax burden relative to disposable income, although that figure is affected by income taxes. For those interested, own-source revenues increased from 4.15 to 4.47 percent of personal income (a somewhat smaller 7.7 percent increase).

13 Also, the move to development charges has helped alleviate the problems of infrastructure financing.

14 The total (provincial and local) property tax burden (relative to personal disposable income) also increased between 1988 and 2001. In Ontario it rose from 4.70 to 6.05 percent, and the average increase in the other provinces was from 3.71 to 4.46 percent. Ontario has a particularly high provincial property tax, matched only by the school taxes in Saskatchewan.

15 Also see section 3, “Measures Regarding the Local Sector,” of Quebec’s 2000–2001 Budget.

16 Note, too, that as part of the municipal reform process in the two provinces, both Ontario and Quebec amalgamated many municipalities – a move rationalized in part by arguments for potential cost savings. These amalgamations were unpopular at the local level. The new Liberal government in Quebec allowed demerger referendums in 2004. Of the 213 merged municipalities in Quebec, 89 called for a referendum and the demerger vote carried in 31. While some municipalities have sought de-amalgamation in Ontario, the provincial government has not yet approved any.

17 Most undergraduate public economics texts have a chapter on fiscal federalism (e.g., Rosen, et al. 2002); the original work of Oates 1972 is valuable. References

directed more to local government include Bird 1993 and McMillan, forthcoming, a and b.

18 A variation on these points is (i) decentralized decision making, (ii) local autonomy, (iii) effective provision, (iv) interjurisdictional and interpersonal equity, and (v) adequate resources.

19 The leading exceptions are federal and provincial government payments in lieu of property taxes, which are included under own-source property and related taxes. These payments, however, are intended to approximately parallel taxes on similar private property.

20 Subsidies for environmental outlays are about half as large relative to the relevant municipal expenditures as those for transportation. Part of the reason for this may be that there is greater public acceptance of the idea that the polluter should pay the cost of avoiding (reducing) pollution (i.e., to meet environmental standards) than that road users should pay for local roads or for (and thus reduce) the congestion costs that they impose on others. Resistance to congestion pricing is diminishing, as is evidenced by the congestion tolls introduced recently in London, England, for example.

21 Of interest is the fact that, despite the fluctuations in federal funding, consolidated federal, provincial, and local expenditures for housing held quite stable at close to 1 percent of consolidated expenditures throughout the 1988–2001 period.

22 See, for example, OECD 2002 and Liberal Party of Canada, Prime Minister's Caucus Task Force 2002.

23 See Kitchen 2003a and McMillan 2003 for some discussion.

24 If the tax concession game is to be played, a more neutral concession would be to provide a refundable personal income tax credit for property taxes paid that are not now tax deductible; that is, essentially for owner-occupied residences. For further discussion, see McMillan 2003.

25 Note Vander Ploeg 2002a and b. Also, the TD Bank 2002 report cavalierly dismissed municipal income taxes with a reference to the inappropriate municipal taxation of corporate income.

26 See Kitchen 2003a and McMillan, forthcoming, a and b, for discussions of local income taxes.

27 Payroll taxes are a common form of taxing income at the local level in the United States and are encompassed in the reference to U.S. local income taxes. Local income taxes as suggested here do not include payroll taxes, because they typically are aimed in part at nonresidents and are incomplete in their coverage of their own residents. A local income tax piggy-backed on the federal-provincial personal income taxes requires explicit consideration of the tax-exporting issue and avoids the latter problem.

28 See Kitchen and Slack 2003 for discussion of alternative municipal taxes. Of particular interest is that they provide estimates of the revenues and tax rates associated with local income and of sales and fuel taxes for numerous Canadian cities. For a

discussion of the merits of alternative municipal taxes and of the experience in the United States, see Oates and Schwab 2004 and Sjoquist et al. 2004.

29 Recall that the latest data indicate that transfers in 2001 account for 15.4 percent of expenditures (not 16.6 percent), so the reduction in transfers was actually somewhat larger than stated; that is, from 25 to 15.4 percent.

30 Recall, too, that the bulk of the transfer reduction in Nova Scotia resulted from the province assuming responsibility for social assistance outlays (uploading, if you like) and thus reducing its transfers to the municipalities for that purpose.

31 Alternatively, where schooling is still largely funded by local school taxes, increased provincial school funding would enable a reduction in local school property taxes.

32 Information on Winnipeg's proposal can be found at www.winnipeg.ca/NewDeal.

33 For example, see Patterson et al. 2003.

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