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THE FEDERAL URBAN AGENDA: ISSUES AND OPTIONS

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Highlights

- A growing body of research in Canada points to the fact that although cities are critical to Canada's long-term economic prosperity and social welfare, there is a widening gap between municipal revenues and expenditure needs.

- This fiscal gap is the result of a combination of factors. After growing in lock-step with federal and provincial revenues in the 1980s, municipal government revenue growth slowed dramatically in the 1990s, particularly in the latter half of the decade. This was due in part to weak growth in the property tax base and also to a considerable reduction in transfer payments from the provincial and federal governments in the latter half of the 1990s.

- At the same time, municipalities faced considerable pressures on the expenditure side. Slow revenue growth led municipalities to defer infrastructure maintenance and upgrades, creating a backlog of necessary repairs. Other cost pressures included new responsibilities transferred from the provincial governments, and the effects of population growth and urban sprawl.

- The federal government has expressed its intention to assist municipalities. Most recently, the 2002 Speech from the Throne identified a new urban strategy as a key area of future policy development.

- However, the provinces may have the most important role to play in any new investment in Canada's cities. Municipalities fall under exclusive provincial jurisdiction. Provincial governments determine the boundaries, responsibilities and financial resources of municipal governments.

- Accordingly, any new federal urban strategy may be limited in scope. The federal government is prevented from granting new taxation, legislative or administrative powers to municipalities, short of a Constitutional amendment. Its choices are limited to the provision of financing through different types of grants and/or through dedicated taxes.

- Grants may be conditional or unconditional; paid directly or at arm's length through a third party; and/or made independently or as part of a cost-sharing arrangement with the provincial and municipal governments. The efficacy of each of these types of grants, as well as the dedicated tax option, depends on the federal policy objective.

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INTRODUCTION

The plight of Canada's major urban centres has emerged as a focal point of national policy debate. A number of recent studies and reports have pointed to a growing gap between available municipal revenues and expenditure needs. Given the growing recognition of the importance of cities to Canada's economic prosperity and social welfare, this has raised questions about whether municipalities have sufficient resources to sustain their position as attractive locations for investment, job creation and other engines of economic growth.

These studies and reports have stressed the need to re-examine the relationship between municipalities and the federal and provincial governments. They highlight, in particular, the present imbalance in municipal governance: the powers and responsibilities of local governments are not proportional to the economic and political significance of cities.

Proposed solutions to this imbalance are numerous, ranging from minor reforms of municipal statutes to a Constitutional amendment granting formal recognition of municipalities as a third order of government in Canada. Most common, however, are calls for the federal and provincial governments to increase their financial support to municipalities. This support can be direct, through increasing the value of grants and transfers to municipalities; or indirect, by providing municipalities with greater flexibility to meet their own financial needs.

Not everyone agrees, however, that there is a pressing need for reinvestment in Canada's cities. While most acknowledge the possibility that some municipalities may face urgent revenue shortfalls, they maintain that there has been little solid research on the subject and that statistical information on issues such as municipal infrastructure needs is unreliable at best.(1)

(1) Y. Poisson, *Public Infrastructure in Canada: Status, Priorities and Planning*, Background report based on a series of interviews with governments, associations, investors and others, Public Policy Forum, March 2002, p. 12.

Furthermore, critics insist that any shortfall in municipal finances should be addressed through municipal reforms, through the reallocation of existing funds, or by municipalities' respective provincial governments.

Nevertheless, the federal government has embraced the cause of Canada's urban centres as one of the components of its policy agenda. Recent budgets have invested billions of dollars in municipal infrastructure projects. The Prime Minister's Caucus Task Force on Urban Issues, created in May 2001, published in November 2002 its final report, *Canada's Urban Strategy: A Blueprint for Action*, highlighting the issues facing Canadian cities and recommending a plan of action for a national urban strategy. In addition, the 2002 Speech from the Throne identified a new urban strategy as one of the cornerstones of the government's ongoing public policy agenda.

The view that there is a federal role to play in urban investment is by no means universal, however. Some have denounced the federal plans as an intrusion into provincial jurisdiction, arguing that municipalities are a constitutionally mandated responsibility of the provincial governments. Furthermore, provincial governments have historically been very protective of their jurisdictions and likely would not welcome what would be perceived as federal interference.(2)

This paper examines the debate over the need to invest in Canada's cities and the federal decision to play an active role in this investment. It provides an overview of the broad trends responsible for urban issues emerging at the forefront of national policy debate. As well, it explores the financial options available to the federal government in pursuit of its urban strategy.

One of the primary factors contributing to the current focus on urban issues, as revealed by the most recent census results, is the growing importance of cities to the economic and political makeup of Canada. Canada is one of the most urban countries in the developed world and its largest cities are the engines for national economic growth. In an increasingly competitive environment, it is widely believed that Canada's cities must be well equipped to compete with other cities worldwide and to attract investment and economic opportunity to Canada. The growing significance of Canada's cities is discussed in section two of this paper.

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(2) E. Tolley and W. Young, *Municipalities, the Constitution, and the Canadian Federal System*, Background Paper BP-276E, Parliamentary Research Branch, Library of Parliament, Ottawa, October 1991, updated February 2001, p. 5.

The second and more immediate factor motivating the debate over renewed municipal investment is the growing financial pressure facing major urban centres. The third section of this paper reviews the powers and responsibilities of local governments, as well as their major revenue sources and expenditure obligations. It also provides an overview of the current fiscal challenges facing Canada's cities, challenges upon which is based the rationale for a new federal urban strategy. These include the relatively slow growth in municipal government revenues in recent years, as well as the increase in municipal responsibilities and cost pressures.

The fourth section of this paper examines the options available to the federal government in financing its urban strategy and offers an overview of some of the merits and drawbacks of these options. As a precursor to this discussion, issues of federal-provincial jurisdiction are also reviewed. It is noted that the federal government's role in any urban strategy is limited by provincial legislation, which determines the powers, responsibilities and even existence of Canada's cities.

THE GROWING IMPORTANCE OF CITIES IN CANADA

A. Urbanization

Canada has witnessed a remarkable period of urbanization over the past century. In the late 1800s, the national population was primarily rural: fewer than one in five Canadians lived in urban areas in 1871. Since that time, however, Canadians have flocked to the cities. In 1951, 57% of Canadians were urban-dwellers. By 2001, nearly four-fifths of the total population lived in one of Canada's urban areas.(3)

Leading the way have been Canada's largest urban centres – its Census Metropolitan Areas (CMAs). According to Statistics Canada, a CMA is an urban area with a population of at least 100,000 people that also serves as an economically and socially integrated core for surrounding urban and rural areas. Twenty-seven cities in Canada are considered to be CMAs, with Kingston, Ontario, and Abbotsford, British Columbia, newly added to the list as a result of the 2001 Census.

(3) An urban area, or census agglomeration, has a population of at least 10,000 people in or surrounding an urban core.

Over 20 million Canadians lived in a CMA city in 2001, accounting for 63% of the national population.(4) This proportion has been rising slowly but steadily in recent years, climbing from 60.5% in the mid-1980s, and is expected to continue to grow into the future.(5)

Table 1 - Canada's Major Urban Centres, 1991 and 2001

	Population (000s)		% growth	% of Canadian Population	
	1991	2001	1991-2001	1991	2001
Toronto	4,029	4,881	21.2	14.4	15.7
Montréal	3,291	3,512	6.7	11.7	11.3
Vancouver	1,647	2,079	26.2	5.9	6.7
Ottawa-Hull	972	1,107	13.9	3.5	3.6
Calgary	766	972	26.8	2.7	3.1
Edmonton	854	957	12.0	3.0	3.1
Quebec	661	693	4.9	2.4	2.2
Winnipeg	671	685	2.0	2.4	2.2
Hamilton	619	681	10.0	2.2	2.2
Kitchener	368	432	17.2	1.3	1.4
Sub-total	13,878	15,997	15.3	49.5	51.5
Other CMAs	4,335	3,586	-17.3	15.5	11.5
Rest of Canada	9,818	11,499	17.1	35.0	37.0
Canada Total	28,031	31,082	10.9	100.0	100.0

Source: Author's tabulation using Statistics Canada data.

Canada's urban population is dominated by a few large cities. The country's six largest cities – Toronto, Montréal, Vancouver, Ottawa-Hull, Calgary and Edmonton – were home to 13.5 million people in 2001, accounting for over 43% of the population nationwide. The population of Toronto alone exceeds that of any province in western Canada, while the population of Edmonton is greater than that of any of the Atlantic provinces.

(4) These figures do not include Kingston or Abbotsford. Because those two cities are recent additions to the list of CMAs, they are not yet included in most available Statistics Canada data.

(5) Statistics Canada's population projections estimate that CMA cities will account for about 64% of the population by 2005.

These same six cities are also responsible for much of Canada's population growth in recent years. The national population growth rate averaged 0.9% per year over the 1996-2001 period. However, for the six largest cities, the population grew by an average of 1.6% per year over that same period. In fact, together those cities accounted for nearly three-quarters of total national population growth from 1996 to 2001.

B. Contribution to the Economy

The growth in the urban share of Canada's population is closely linked to the evolution of the Canadian economy. When Canada's economy was primarily resource-based, the population was necessarily dispersed, dependent on the location of natural resources. As manufacturing industries increased in importance, however, the significance of cities also grew. Attracted to the larger labour pool, industries generally chose to locate in urban areas. This, in turn, attracted prospective labourers from rural areas to migrate to the city.

This trend was further reinforced by the shift towards a service-based economy. Agriculture, resource-based production and other manufacturing activity have all fallen in importance relative to the service sector in recent years. Knowledge-intensive services – such as those in the professional, scientific and technical services industries – depend on dense, localized markets with an educated workforce. At the same time, other industries – such as personal services, retail sales and wholesaling – thrive within a dense population base. In both cases, economic opportunities are created in metropolitan centres, promoting migration from rural areas to urban centres.(6)

As a result of this economic evolution, cities have become the backbone of the Canadian economy. The six largest cities were responsible for just under 48% of Canada's total economic output in 2001. In most provinces, the leading urban areas dominate provincial output. Winnipeg made up nearly two-thirds of Manitoba's GDP in 2001, while Edmonton and Calgary together made a similar contribution to the Alberta economy. Montréal was responsible for 59% of Quebec's annual output in 2001, while Toronto produced 54% of Ontario's GDP that year.(7)

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(6) N. Bradford, *Why Cities Matter: Policy Research Perspectives for Canada*, Canadian Policy Research Network discussion paper, no. F-23, Ottawa, June 2002, pp. 4-5.

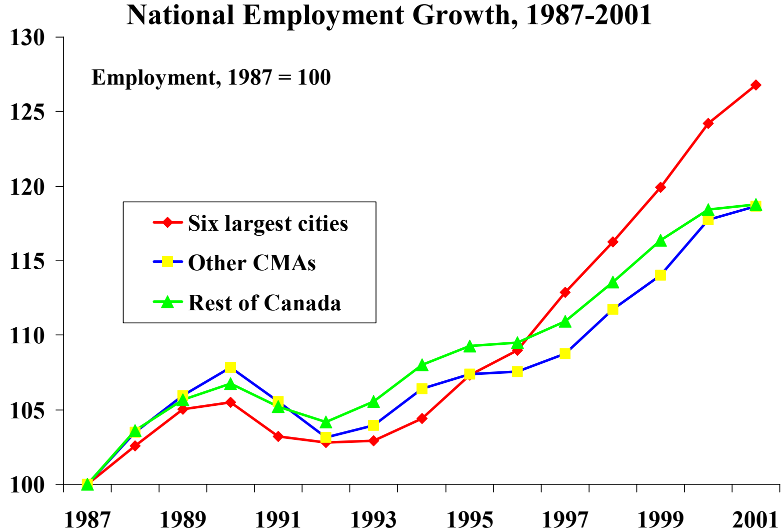
(7) Based on data from Statistics Canada and the Conference Board of Canada.

Table 2 - Gross Domestic Product by Major City, 1991-2001					
	GDP (millions of $1997)		% growth	% of Canadian Total	
	1991	2001	1991-2001	1991	2001
Toronto	120,085	176,915	47.3	17.2	18.8
Montréal	78,036	98,541	26.3	11.2	10.5
Vancouver	45,346	61,123	34.8	6.5	6.5
Calgary	26,655	41,489	55.7	3.8	4.4
Edmonton	24,084	35,636	48.0	3.5	3.8
Ottawa-Hull	26,634	34,870	30.9	3.8	3.7
Sub-total	320,840	448,574	39.8	46.0	47.7
Rest of Canada	376,700	491,432	30.5	54.0	52.3
Canada Total	697,540	940,006	34.8	100.0	100.0

Source: Author's tabulation using data from Statistics Canada and the Conference Board of Canada.

Similarly, Canada's job creation record in recent years has been driven by the economic growth and expansion of its urban centres. From 1996 to 2001, the Canadian economy produced 1.6 million jobs. Of these, nearly 1.3 million, or 78%, were created in one of Canada's CMAs. For their part, the six largest cities were responsible for 61% of Canada's employment growth over that period.(8)

Chart 1 - Canada's Major Cities Lead National Employment Growth, 1987-2001



Source: Author's calculations using Statistics Canada data.

(8) Author's calculations using Statistics Canada data.

AN OVERVIEW OF MUNICIPAL FINANCES IN CANADA

A. Municipal Powers and Responsibilities

According to section 92(8) of the *Constitution Act, 1867*, provincial legislatures are given exclusive responsibility for making laws related to municipalities within their borders.(9) Municipal authorities are technically not governments but, rather, statutory bodies. As such, their powers and responsibilities are limited to those that are directly conferred in provincial statute.(10) Provincial governments determine the boundaries, responsibilities and financial resources of municipal governments and can alter these arrangements through statutory amendment.

The way in which provinces define "municipal responsibilities" can take one of two forms. The first is a "laundry list" whereby provinces enumerate the specific obligations of local governments. The second approach ("sphere of jurisdiction") identifies broad areas of responsibility within which municipalities are able to act.(11) The latter is considered to be more flexible as it allows for some interpretation of municipal jurisdiction.

As a result of the differing ways in which powers are granted to local governments, specific municipal responsibilities vary from province to province. In general, however, areas of local responsibility include the regulation and provision of services to property (such as roads, water, power, police and fire services), parks, culture and recreation, and libraries, to name a few.

Similarly, municipalities are permitted to raise revenues only in areas specifically designated by the provinces. Through convention, municipal governments alone collect property taxes – their single largest source of revenues. Cities also raise own-source funds through business taxes, user fees, and licence and permit fees, as well as through investment income and the sale of goods and services.(12) In addition to own-source revenues, municipalities also receive transfer payments from the provincial and federal governments. These transfers are usually conditional on specific types of expenditure.

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(9) Tolley and Young (2001), p. 2.

(10) D. Wong, *Cities at the Crossroads: Addressing Intergovernmental Structures for Western Canada's Cities*, Canada West Foundation, Calgary, August 2002, p. 2. The legal status of municipalities is based on a 1993 Supreme Court interpretation of the *Constitution Act, 1867*.

(11) Wong (2002) provides an example of this involving nuisance laws in Calgary and Vancouver.

(12) *Ibid.*, p. 2.

Table 3 - Local Government Revenues by Source, 1990 and 2000					
	Value ($millions)		**% growth**	**% of Total Revenues**	
	1990	**2000**	**1990-2000**	**1990**	**2000**
Own-source:	32,643	44,699	36.9	81.2	84.9
Taxes	16,004	24,412	52.5	39.8	46.3
property taxes and related	15,601	23,845	52.8	38.8	45.3
licences and permits	316	494	56.3	0.8	0.9
other taxes	86	73	-15.1	0.2	0.1
Investment Income	2,282	2,246	-1.6	5.7	4.3
Sales of Goods and Services	6,476	9,526	47.1	16.1	18.1
Other Own-source	338	535	58.2	0.8	1.0
Government Transfers:	7,543	7,980	5.8	18.8	15.1
Federal	191	323	68.8	0.5	0.6
Provincial	7,352	7,658	4.2	18.3	14.5
Total	40,187	52,680	31.1	100.0	100.0

Source: Author's calculations using Statistics Canada data.

On average across Canada, close to 85% of local government revenues are own-source revenues. Taxes are the source of 46% of income, while investment income, the sale of goods and services, and other revenues – such as fines and penalties – make up about 23% of municipal income.

The remainder of municipal revenues – just over 15% – comes from transfers from other orders of government. Provincial transfers, both general-purpose and those for specific objectives, account for about 15% of revenues. Direct transfers from the federal government make up 0.6% of local government revenues. However, the federal government also contributes indirectly by providing funds to the provinces intended for local governments.

Table 4 - Local Government Expenditures by Destination, 1990 and 2000					
	Value ($millions)		% growth	% of Total Revenues	
	1990	2000	1990-2000	1990	2000
General government services	3,396	5,041	48.4	9.9	11.0
Protection of persons and property	4,975	7,275	46.2	14.5	15.9
Transportation and communications	7,429	9,104	22.5	21.7	19.8
Health and education	856	1,109	29.6	2.5	2.4
Social services	2,893	5,782	99.9	8.4	12.6
Environment	5,288	6,420	21.4	15.4	14.0
Recreation and culture	4,135	5,103	23.4	12.1	11.1
Housing	647	1,170	80.7	1.9	2.6
Regional planning and development	753	1,006	33.6	2.2	2.2
Other	972	1,144	17.7	2.8	2.5
Debt-servicing costs	2,940	2,717	-7.6	8.6	5.9
Total	34,286	45,872	33.8	100.0	100.0

Source: Author's calculations using Statistics Canada data.

Transportation and communications – led by roads and streets, public transit and snow removal – is the single largest category of municipal expenditure, accounting for one-fifth of total spending (see Table 4). Protection services, such as police and fire fighting, are also significant, making up 16% of total municipal expenditures. Social services and housing have been the fastest-growing areas of local government spending.(13)

B. The Fiscal Challenges Facing Canadian Cities

A perceived imbalance between municipalities' expenditure obligations and their ability to generate revenue is at the core of the call for assistance from other orders of government. Proponents of a new federal urban strategy point to the fact that despite the wide range of services provided by local governments, municipalities collect only seven cents per dollar of tax revenues in Canada.(14)

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(13) This summary of municipal revenues and expenditures is based on Statistics Canada figures for the year 2000 – the most recent year for which such detailed information is available.

(14) Federation of Canadian Municipalities (FCM), *A New Deal for Cities: On the Road to Fiscal Sustainability*, Draft Report, 2002, p. 2.

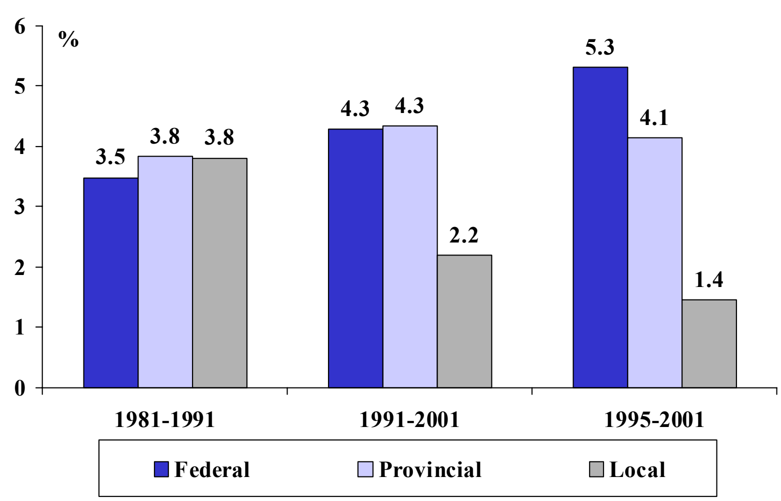
Furthermore, they maintain that this imbalance is growing. Through a combination of factors, municipal spending requirements have increased. At the same time, municipal revenue growth has been insufficient to make up the shortfall.

1. Revenue Availability

While the federal and provincial governments showed relatively solid income growth throughout the 1990s, municipal revenues have stagnated. This stands in sharp contrast to the previous decade, during which federal, provincial and local government revenues grew nearly in lock-step. Provincial and local revenues averaged 3.8% growth annually during the 1980s, while the federal government followed close behind at 3.5% per year.

In the 1990s, however, federal and provincial revenue growth remained strong, while local revenue growth dropped off. From 1991 to 2001, federal and provincial revenues both increased by an average of 4.3% per annum, while local governments saw an average annual increase of 2.2%. The gap in growth rates was even more pronounced in the latter half of the 1990s. From 1995 to 2001, federal revenue growth accelerated to 5.3% per year, provincial growth fell slightly to 4.1%, and the average annual increase in municipal revenues fell to 1.4%.

**Chart 2 – Government Revenues:
Average Annual Growth (%), 1981-2001**



Source: Author's calculations using Statistics Canada data.

The drop in revenue growth at the municipal level was largely due to a substantial decline in transfer payments from other orders of government beginning in the mid-1990s. Following solid growth in the late 1980s and early 1990s, provincial transfers to municipalities fell by a total of 23% from 1995 to 2000. Moreover, although direct federal transfers were not a significant source of income for local governments, the drop in those transfers since 1995 has been precipitous – falling from $560 million to $323 million five years later.

The decline in transfer payments placed additional stress on municipal own-source revenues to make up the difference. However, conditions for raising own-source revenues were poor throughout the 1990s. Property and land values in Canada fell in the recession of the early 1990s and remained flat during the entire decade. As a result, there was no natural increase in property tax revenue to help offset the loss in provincial and federal transfers. To compensate, property tax rates were raised frequently throughout the decade.(15)

Property taxes are frequently decried as a poor foundation for the financing of municipal spending in Canada. Critics point to the fact that property taxes are based on assessable property values and thus are only weakly related to ability to pay. As well, while economic growth raises the revenue-generating capacity of major fields of taxation such as income tax and consumption taxes, this is not necessarily true of property taxes. Finally, property taxes are poorly related to the cost of providing municipal services.

As a result of weak municipal revenue growth, and to help address rising expenditure needs, some provinces have allowed cities to access revenues from other sources. For example, Edmonton and Calgary receive five cents per litre of the provincial gasoline tax, and Manitoba transfers the equivalent of two percentage points of its personal income tax and one percentage point of its corporate income tax to its cities. British Columbia provides its cities with a share of the provincial sales tax, and Nova Scotia and Quebec permit their cities to levy a land transfer tax on sales of property.(16) However, notwithstanding initiatives such as these, provincial governments generally have been reluctant to grant municipalities access to new or additional tax sources.(17)

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(15) *Ibid.*, p. 3.

(16) D. Burleton, *A Choice Between Investing in Canada's Cities or Disinvesting in Canada's Future*, TD Economics Special Report, TD Bank Financial Group, Toronto, April 2002, p. 19.

(17) H. Kitchen, "Canadian Municipalities: Fiscal Trends and Sustainability," *Canadian Tax Journal*, vol. 50, no. 1, 2002, p. 166.

2. Rising Expenditure Needs

In addition to the pressures of weak revenue growth, municipalities are contending with a significant increase in their expenditure obligations. Advocates of increasing the availability of revenues to municipal governments point to several areas in particular need of renewed investment. Among them, urban transit, transportation infrastructure, housing, and water and sewage facilities have been frequently highlighted.

Cost pressures in these and other areas of municipal financing can be divided into three broad categories: the need to upgrade and modernize ageing infrastructure; the impact of new responsibilities downloaded onto municipalities from other orders of government; and the cost pressures associated with strong population growth and urban sprawl.

a. Ageing Infrastructure

Fiscal restraint at the federal and provincial levels throughout the 1990s led to a reduction in the availability of funds for a wide range of public services. As a result, government spending in areas such as health, education and infrastructure were all curtailed, as were federal transfers to the provinces and, as mentioned above, transfers to municipalities.

One of the most common ways to reduce expenditures without immediately compromising the quality or scope of government services is to delay regularly scheduled maintenance and upgrades of existing infrastructure.(18) This trend took place with all orders of government and across all infrastructure types. Investments in national highways, hospitals, medical equipment, and upgrades to university buildings and facilities – to name a few – were all postponed. At the municipal level, infrastructure such as road and bridge repairs, along with water and sewage upgrades, was affected.

The result of this deferred maintenance, according to many stakeholders, has been a significant accumulated deficit in infrastructure investment. With the federal and most provincial budgets in surplus, these stakeholders – which include the Federation of Canadian Municipalities (FCM) and several provinces – are calling for an injection of federal funds to help municipalities overcome the backlog of deferred maintenance and upgrading expenditures. The

(18) Bradford (2002), p. 11.

cost of eliminating this backlog is estimated to range from $50 billion to $100 billion.[19] Furthermore, it is widely believed that delaying repairs and maintenance will only lead to greater costs in the future.

b. Downloaded Responsibilities

Municipalities have seen a substantial increase in their spending responsibilities in recent years. As a result of fiscal retrenchment policies in the mid- to late 1990s, the federal and provincial governments withdrew from certain areas of public policy and service, passing responsibility to the municipalities. Depending on the specific responsibility, this withdrawal has taken one of two forms: governments formally passed responsibility for certain policy areas to the municipalities, or they simply abdicated their obligations, leaving local governments to fill the void.[20]

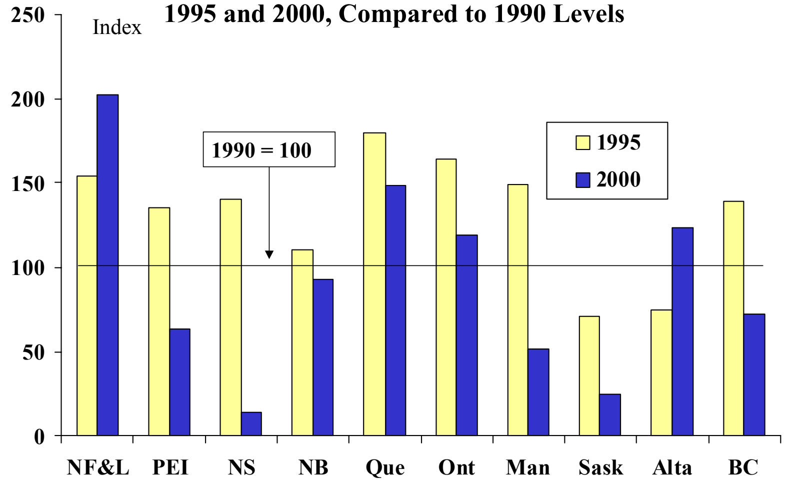
This latter form of withdrawal has been the more common across the provinces. When provinces cease to provide specific-purpose transfers – also known as conditional grants – the cessation is typically considered to be evidence of downloading responsibilities to municipal governments, particularly in the absence of any new unconditional grants to replace the lost funding. While the extent of this implicit downloading varies from province to province, in general provincial governments have moved away from supporting expenditures in transportation, the environment and social services, leaving local governments to fill the gap. With the exceptions of Newfoundland and Labrador and Alberta, all provinces have reduced overall conditional transfers to local governments since the mid-1990s. The most dramatic change has come in Nova Scotia. From a high of $271 million in 1995, conditional grants to local governments fell by 90% in only five years – to $27 million in 2000.[21]

(19) Poisson (2002), p. 15.

(20) C. Vander Ploeg, *Framing a Fiscal Fix-Up: Options for Strengthening the Finances of Western Canada's Big Cities*, Canada West Foundation, Calgary, January 2002, p. 2.

(21) These figures, and those in Chart 3, do not include the effects of inflation or population growth over the 1990s.

Chart 3 – Conditional Transfers from Provincial to Local Governments: 1995 and 2000, Compared to 1990 Levels



Source: Author's calculations using Statistics Canada data.

The formal transfer of responsibilities to local governments has not been as common as the implicit transfer described above. Ontario has been the most active province in the formal transfer of authority, which took place in the mid- to late 1990s and was precipitated by the province's desire to assume control of education spending by local school boards. In exchange for relieving local governments of the expenditure burden of these school boards, the province transferred to municipalities funding responsibilities for services such as social housing, provincial highways within city limits, and property tax assessments, to name a few. In many cases, cities did not receive any corresponding control over public policy or standards.(22) Furthermore, contrary to the provincial government position, municipal authorities maintain that these initiatives are not revenue-neutral and will require large municipal tax hikes once transitional funding runs its course.(23)

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(22) D. Lidstone, *A Comparison of New and Proposed Municipal Acts of the Provinces: Revenues, Financial Powers and Resources*, prepared for the 2001 Annual Conference of the Federation of Canadian Municipalities, Banff, Alberta, May 2001, p. 3.

(23) H. Kitchen, *Provincial-Municipal Fiscal Trends: An Interprovincial and Intertemporal Comparison*, presentation at Union of British Columbia Municipalities (UBCM) Convention, Vancouver, September 1999, p. 15.

c. Population Growth and Urban Sprawl

The third major source of increased spending obligations has been the combination of rapid population growth and urban sprawl. As discussed earlier, Canada's largest cities have driven national population growth in recent years. At the same time, however, growth in suburban communities has resulted in a gradual shift of the population away from the urban core to the outskirts of cities.

Several factors contribute to this sprawl, including readily available land, the low cost of individual transportation, rising living standards and a market for larger homes.(24) Perhaps the most significant factors, however, relate to the nature and structure of property taxes. Because property values are the chief determinant of property tax rates, land in the urban core is assessed at a higher tax rate than suburban land. This has contributed to the exodus out of downtown areas in Canada and to growth in the urban periphery.

The redistribution of the urban population places pressure on municipal finances in two ways. First, the movement out of the urban core (where property values are high) to suburban areas (where property values are lower) slows growth in municipal revenues. In many cases, since bedroom communities are separate municipalities, the central city loses that revenue altogether. To make up the revenue shortfall, cities have had to raise property tax rates, further accelerating the exodus from the downtown area.

A number of provinces have tried to address this issue through municipal amalgamation. Winnipeg, Halifax, Toronto, Ottawa and Montréal are the most significant examples of "mega-cities" formed when provincial governments merge a CMA and its suburban communities into a single municipal entity. In other cases, cooperation is voluntary, such as with Edmonton's Capital Region Alliance.

However, municipal amalgamation does not address the second source of pressure on municipal budgets: the resulting decrease in population density. As cities spread out, the cost of delivering municipal infrastructure and services increases with each kilometre. Since property taxes are based on land value, they do not reflect the higher cost of providing those municipal services. As a result, the expenditure burden on cities rises even as the tax base upon which those services are financed is eroded.

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(24) Vander Ploeg (2002), p. 2.

SUPPORT FOR A "NEW DEAL" FOR MUNICIPALITIES

Federal and provincial governments are increasingly sympathetic to the fiscal challenges facing Canadian cities. In recent years, several provinces have transferred portions of their tax revenues to their major cities; infrastructure spending is increasing in many jurisdictions; and some provinces have undertaken much-needed reforms to municipal property taxes. In addition, a number of provinces have made legislative changes in recent years aimed at broadening the powers of local government.(25)

The federal government has also increased its assistance for municipalities through several programs and initiatives. Among these measures are provisions in the December 2001 federal budget which set aside $2 billion to provide shared-cost assistance to provincial and municipal governments for large-scale infrastructure projects such as urban transportation, sewage treatment and highways. These funds are in addition to several other federal initiatives, including $250 million towards environmentally friendly municipal infrastructure.

Notwithstanding these and other recent cash infusions to municipal governments, a number of stakeholder organizations are publicly pressuring the federal and provincial governments to offer a "new deal" to cities – a change in the allocation of financing to municipal governments that more accurately reflects not only current expenditure needs, but also the growing importance of cities to Canada's economic well-being. Although debate continues on what exactly such an arrangement should entail, the notion of a new deal for municipalities has met with support from all orders of government.

Advocates of a new deal for Canada's cities have focused on enhancing the financial contribution of other orders of government. However, several studies have identified areas where municipalities have the capacity to improve local financing and efficiency without requiring more federal or provincial resources. Among the options cited are reforming municipal tax systems, improving regulatory environments and further exploring the use of alternative funding arrangements such as user fees and public-private partnerships for municipal projects and services.(26)

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(25) Burleton (2002), p. 17. Alberta was the first province to grant more authority and flexibility to its cities, in 1994. However, Newfoundland and Labrador's *Municipalities Act* is considered by some to be the most modern piece of legislation, promising to increase taxation, administrative and financial management powers.

(26) See, for example, Burleton (2002), Wong (2002) and Vander Ploeg (2002). In many cases, these municipal reform options require provincial approval.

The potential role that the federal and provincial governments, for their part, will play in any new deal can take two forms. The first is to increase their direct financial contribution to municipalities through cash transfers and dedicated taxes.(27) The second is to provide municipalities with greater autonomy and improve their ability to raise own-source revenues to meet local expenditure needs. This latter option could include granting cities access to revenues from different tax bases or allowing them to levy their own taxes.

The provinces have the most important role to play in any new deal for Canada's major cities. With Constitutional authority over municipalities, provincial governments have the most tools at their disposal with which to aid urban centres. Options available to the provinces include: reclaiming responsibility for expenditures previously transferred to cities; increasing the level of transfer payments; granting municipalities greater administrative and legislative powers to explore funding alternatives; and conferring additional tax sources or tax revenues for municipal use.(28)

The content of a federal urban strategy – the federal government's potential contribution to a new deal for municipalities – is necessarily limited in scope by Constitutional restrictions. Specifically, the federal government cannot change laws regarding municipalities, because cities are creatures of provincial legislation. This prevents the federal government from granting new taxation, legislative and administrative powers to municipalities, short of a Constitutional amendment. It does not, however, prevent the federal government from providing cash transfers or dedicated tax revenues to cities.

Even so, any action taken by the federal government through an explicit urban investment strategy, including direct transfer payments to municipalities, runs the risk of being interpreted by the provinces as an intrusion into provincial jurisdiction. Provinces have historically been resistant to any direct or formal federal involvement with municipalities.

A. The Rationale for Federal Participation

On the whole, it could be argued that investment in Canada's cities is a matter best left to the provinces and municipalities to sort out amongst themselves. While this view is shared by some commentators who believe that the federal government should not allow itself to

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(27) This category also includes tax credits in lieu of transfer payments. For example, in the 2000 budget, the federal government announced a 36% GST rebate on the construction of rental housing.

(28) Kitchen (2002), p. 172.

get involved in what is – by definition – a provincial matter, advocates of a federal urban agenda believe that the federal government should not be deterred from investing in Canada's cities.

As observed by Intergovernmental Affairs Minister Stéphane Dion, there is a difference between *municipal affairs* – which are unambiguously provincial jurisdiction – and *urban and rural issues*, where federal policies or activities have a direct impact on the welfare of cities.[(29)] Examples of the latter include federal regulations concerning water quality and the environment, as well as immigration and Aboriginal issues.[(30)] In instances such as those, Mr. Dion has argued that there is a strong case for direct cooperation between the federal government and municipalities.

This position can be extended to include all municipal spending that has national policy implications. It is generally agreed that the community should pay for benefits that stay within the local community. However, when the benefits of local government spending affect neighbouring jurisdictions, higher orders of government have a role to play. Some argue that urban transit is such an area. Urban transit, it is argued, not only benefits people in neighbouring communities, but also has the capacity to reduce dependency on automobiles and thus lower greenhouse gas emissions, helping Canada meet its international environmental commitments.

A number of recent studies have also argued that, in the current economic context, federal involvement in municipal issues is inherently in the national self-interest. Given the large and growing importance of Canada's cities to national economic growth and prosperity, internationally competitive cities are needed to attract investment, and the resulting economic opportunities, to Canada. This competitiveness is greatly enhanced by attractive, well-maintained cities offering good infrastructure, a high quality of life, and good recreational and cultural services.

B. Financial Options for the Federal Government

With or without provincial support, the federal government has made clear its intention to increase its financial support to Canadian cities. However, since the federal government cannot assign new taxation powers to cities, its choices are limited to: the provision of financing through different types of grants; and/or dedicated taxes.

(29) Poisson (2002), p. 34.

(30) FCM (2002), p. 6.

Even within this range of options, however, the federal government has many choices. In particular, grants, or cash transfers, come in a variety of forms, depending on the public policy objective of the transfer. Grants can be conditional or unconditional; they can be paid directly to municipalities or at arm's length through a third party; and they can be made independently, or incorporate elements of cost-sharing with municipal governments and/or the provinces. Combinations of many of these options are also possible.

As funding mechanisms, both transfers and dedicated taxes offer benefits and drawbacks for the federal government and for municipalities. In the case of federal grants, these merits and shortcomings vary somewhat according to the type of transfer used. As a result, the appropriate mechanism used by the federal government in increasing financial support to municipalities may vary, depending on the specific public policy objective.

1. Federal Transfers to Municipalities

Before examining specific types of federal transfers, it is useful to look first at the merits and drawbacks to federal grants in general. Federal grants are an effective way to deliver funds to municipalities. Cash transfers can provide immediate, fixed and predictable funding for the duration of the program or initiative. Apart from arbitrary changes to the grant program, transfers are stable from year to year and can easily be increased if necessary. From the perspective of the federal government, grants are also easy to implement and to administer.

However, many advocates of a new deal for municipalities are reluctant to support the provision of grants. Among their concerns is that federal transfers are not a reliable source of funds. Part of the reason municipal governments currently have insufficient revenues is because of past unilateral cuts in transfers from the federal and provincial governments. Cities are seeking reliable, long-term funding; short of a binding multi-year commitment, federal and provincial grants are widely seen as not sufficiently predictable to form part of a long-term financial solution for municipalities.

Efficiency concerns form another criticism of grants. Relying on outside funds to finance municipal expenditures reduces the incentive to deliver services in an efficient, cost-effective manner. Cities, it is argued, are more likely to be disciplined in their spending if they bear the political and economic costs of their decisions.(31) They would also be more likely to explore alternative funding sources such as public-private partnerships.(32)

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(31) Burleton (2002), p. 22.

(32) Poisson (2002), p. 33.

Related to the efficiency criticism is the perceived lack of accountability under any grant scheme. Municipal governments spend revenues raised by the federal (or provincial) governments. This makes it difficult to determine if funding levels are sufficient or if the money is being spent appropriately and efficiently.

a. Conditional versus Unconditional Grants

Federal transfers to municipalities can be either unconditional or tied to municipal spending in designated areas. Among the advantages of unconditional, or "block," grants is the freedom they allow cities to determine their own areas of priority spending. Since infrastructure and service needs vary across the country, municipalities are better able to address local issues and make strategic investments according to local need. This is especially pertinent given the backlog in infrastructure maintenance and investment in Canada's cities. In addition, a stable, block-funding commitment would give municipalities the latitude to focus on long-term community needs rather than on short-term projects required under conditional grant programs.

However, there are a number of disadvantages to block funding as well. Block transfers cannot be tracked, and thus cities cannot be held accountable for how funds are spent. Federal visibility is also negligible. Critics of block grants maintain that, in the past, municipalities have over-politicized the decision-making process, resulting in the construction of infrastructure of relatively low strategic importance. Critics also argue that previous block grants have been too broad and shallow to be as effective as funds explicitly targeted for certain types of spending.

The most significant improvement that conditional transfers offer over block grants is that some measure of control is restored. Cities must make expenditures in designated areas in order to qualify for the grant. This way, the federal government is able to provide much-needed financial assistance to cities while at the same time working to achieve broader public policy goals. The visibility of the federal contribution is also improved and the risk of local politicization of spending is minimized.

A disadvantage of conditional transfers is that municipalities lose the freedom to focus on long-term community needs and long-term strategic investments. Grants for infrastructure programs also put municipalities in the position of making specific economic decisions based on only a fraction of the actual program costs.[33]

b. Direct versus Third-party Spending

The differences between direct and third-party spending revolve around the way in which federal grants – be they conditional or unconditional – are distributed. Channelling federal grants through a foundation or non-profit organization offers several advantages over their more conventional, direct delivery. First and perhaps foremost, having a third party make the final decisions on which projects qualify for funding reduces the possibility of political influence affecting the final decision. Instead, decisions would be made based on community need and economic and social merit.

On the other hand, direct transfers are advantageous for the federal government, particularly in the case of conditional grant programs, because the government retains some control over expenditures and can monitor spending to ensure that the program is functioning according to design.

c. Unilateral versus Cost-shared Programs

The final choice in the type of grant programs available to the federal government is whether grants should be unilateral or be contingent upon some degree of matching funds from the provincial governments and/or the municipalities themselves.

The advantages to a cost-shared program are considerable. Since financial responsibility for grants is shared with other orders of government, the financial burden on the federal government is less. At the same time, cost-shared programs could be considered less intrusive by the provincial governments. Provinces are free to choose whether or not the cost-shared initiative proceeds by way of their decision on whether or not to supply matching funding. In addition, depending on the nature of the initiative, cost-shared programs can better accommodate differing local needs across the country. More local input can help target federal funds to areas in which they are needed.

However, there are a number of drawbacks to cost-shared programs as well. These initiatives require provincial cooperation in order to be effective. Failing broad federal-

(33) Poisson (2002), p. 33.

provincial consensus on the type of cost-shared grants to be implemented, the provinces may view such a proposal as unwelcome encroachment into their jurisdiction.

Another drawback to cost-shared programs is that there is less federal control over how funds are spent. Since municipalities are provincial creations, provinces ultimately decide how money is spent. Critics maintain that historically, some provincial governments have appropriated federal funds for their own purposes.(34) As well, cost-shared programs tend to support a large number of small projects, but the means to support large-scale strategic investments are lacking.(35)

Finally, cost-shared programs can exacerbate the difference between rich and poor provinces. In some cases, provinces may not be able to afford matching funds and, as a result, cities in those provinces forego the federal contribution. Cities in wealthier provinces, however, are still able to benefit.

2. Dedicated Taxes

An alternative to increasing transfer payments would be to dedicate an ongoing source of federal revenue to local governments. Under a dedicated tax arrangement, the federal government would commit to transferring a fixed percentage of revenues from a particular tax source (or sources) to municipalities. For example, it is frequently recommended that the federal government earmark several cents per litre of the national fuel tax to be transferred directly to municipalities.

Although the federal government has resisted dedicated taxes in the past, several provinces already engage in this practice. As noted earlier, Alberta, British Columbia, Quebec, Nova Scotia and Manitoba either transfer part of certain taxes to their cities or permit their cities to levy a tax on property sales. Dedicated taxes can be unconditional or earmarked for a specific area of expenditure.

In essence, dedicated taxes do not differ significantly from direct transfer payments. Both result in a transfer of cash from the federal government to the municipalities. Both are relatively easy to implement and administer, and both effectively deliver funds to their targets.

The one major – and important – difference is that in the case of the tax transfer, its value is tied to the strength of a particular tax base. The value of the tax transfer to

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(34) FCM (2002), p. 8.

(35) *Ibid*.

municipalities is more variable than the block transfer because tax revenues fluctuate depending on a number of factors, including economic strength. This is an advantage for the federal government because it introduces an affordability component into the transfer. When revenues decrease, federal payment obligations automatically fall as well.

Because the value of tax points rises over time, dedicated tax transfers provide municipalities with access to a growing revenue source. Municipalities and their advocates also prefer dedicated taxes over grants because the former appear to represent a firmer commitment on the part of the federal government.

Because of the similarities between transfer payments and dedicated taxes, the two funding options share many of the same disadvantages. In terms of the reliability of dedicated taxes, the impression that they represent a firmer funding commitment is dubious. Rules regarding dedicated taxes can be altered as easily as any other funding arrangement.(36)

Critics also maintain that dedicated taxes are inefficient in the same way as grants: cities do not have an incentive to provide services in a cost-effective manner. In addition, dedicated taxes do not address the accountability concerns of grants. It remains the case that the federal government generates revenue which is then spent by local authorities.

CONCLUSION

Cities are vital to Canada's economic prosperity. Not surprisingly, then, the current financial challenges facing municipalities are garnering increased attention across the country. Several studies have been published recently, outlining the case for renewed federal investment in Canada's major urban centres.

Canadian municipalities have struggled in recent years. The federal and provincial governments transferred new responsibilities to municipal governments during the 1990s, while at the same time decreasing their financial assistance to cities. This trend was exacerbated by other factors as well, including: rising costs associated with rapid population growth and dispersal to suburban areas; a weak property tax base throughout the 1990s; and a growing backlog of deferred infrastructure maintenance and repair.

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(36) For example, as mentioned earlier in this paper, Edmonton and Calgary receive 5 cents per litre of the Alberta provincial fuel tax. In its 2002-2003 budget, however, the provincial government without warning reduced the tax transfer to 1.2 cents per litre. The cut will be made in March 2003.

Strategic investment in urban areas has become a cornerstone of the federal government's policy agenda. However, primary responsibility for municipal welfare lies with the provincial governments. As a result, although the federal government is in a position to provide financial assistance to municipalities, any such initiative should be sensitive to jurisdictional issues. A coordinated approach involving all three orders of government improves the prospects of a new urban strategy and allows for the needs of municipalities to be addressed in the most effective and efficient manner possible.

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