Chapter 4:

Constraining Subnational Fiscal Behavior in Canada: Different Approaches, Similar Results?

Richard M. Bird and Almos Tassonyi[1]

I. Introduction

A common concern about fiscal decentralization has been that it may increase the risk of macro-economic instability. Subnational governments newly endowed with both financial resources and the freedom to spend them will, some have said, tend to spend too much, tax too little, borrow excessively, and generally to behave in a fiscally irresponsible fashion (Prud'homme, 1995, Tanzi, 1996). The consequences of such behavior for central governments are all bad. They may feel obligated to bail out, directly or indirectly, insolvent lower-tier governments. Even if bailouts are avoided, the drain on central finances imposed by the tax-sharing arrangements and intergovernmental transfers often associated with decentralization may be so large and rigid that central governments will lose control over the fiscal tools they need for macroeconomic management. Since well-publicized subnational fiscal disasters in some countries, notably Brazil and Argentina (Dillinger and Webb, 1999a) appear to confirm such bleak scenarios, it is not surprising that considerable attention has been paid to the apparent need to impose strong constitutional or

[1] Joseph L. Rotman School of Management, University of Toronto, and Ontario Ministry of Finance, respectively. We are grateful to Francois Vaillancourt and Jonathan Rodden for helpful comments on an earlier draft. The views expressed herein are entirely our personal responsibility, however.

administrative constraints on subnational governments -- to restrain their expenditures, to encourage their fiscal efforts, and above all to restrict their access to capital markets through the imposition of rigid ex ante controls by the central government on their borrowing (Ter-Minassian, 1996).

Nonetheless, as argued in the introduction to this volume, if the basic political and economic incentives facing decision-makers at all levels of government are correctly structured, there should be little or no need for such prior control (Bird, 1999a). Indeed, in these circumstances, rather than restricting access to the capital market in the name of imposing a hard budget constraint on subnational governments, such access may itself constitute an essential part of the institutional structure restraining governments from unduly reckless fiscal actions (Ahmad, 1999). Several recent analyses have attempted to characterize the combinations of political, economic, and administrative factors that may interact to produce better or worse outcomes from specific forms of decentralization in specific institutional settings (Rodden, 1999; Dillinger, Perry, and Webb, 1999).

Canadian experience is interesting with respect to these issues for several reasons. One reason is simply because Canada is one of the most decentralized countries in the world. Canadian provinces are responsible for most major social expenditures and have a virtually free hand in levying taxes. They face essentially no constitutional restraints on tax rates, bases, or collection systems and no requirement to harmonize either with each other or with the federal government. All provinces receive large unconditional transfers from the federal government, and in some provinces such transfers are more important sources of revenue than their own taxes. Moreover, if provinces wish to borrow, they may do so as and from whom they wish, with no central review or control. These are all factors that might be expected to induce the worst kind of opportunistic behavior by provincial governments. In Section II of the paper, however, we argue that, despite the occasional twinge, there is surprisingly little evidence of such behavior and that Canada has, on the whole, weathered the storms of time moderately well.

A second reason why Canada provides an interesting case is that at the same time as it offers a clear example of the strength of market and political budget constraints in the face of very soft – indeed, non-existent – hierarchial constraints at the provincial level, it also offers an equally clear example of almost the opposite in the highly-controlled and tightly constrained world of Canadian local government. Unlike Canadian provinces, Canadian municipalities are essentially agents of provincial governments and face explicit hierarchical budget constraints imposed largely by administrative fiat. As we argue in Section III, the very strength of these provincial controls in, so to speak, saving local governments from some of the possible consequences of opportunistic behavior, may to some extent create the moral hazard such controls are intended to offset. On the whole, however, this hierarchial system has been at least as effective as the market-cum-political constraints operating at the provincial level. Although a few smaller municipal governments have occasionally encountered such severe fiscal difficulties that they have been put under financial supervision, on the whole the municipal system, like the provincial system, seems to have avoided serious problems.

Finally, in the concluding Section IV we draw together some of the main considerations emerging from the diverse Canadian experience at the federal-provincial and provincial-local levels. Both systems, we argue, were largely effective in coping with recent crises. One reason may perhaps be because the hardest budget constraint is one that is forged in the fires of experience rather than one imposed from above, or from outside.[2] Countries (or, more accurately, such institutional manifestations as political parties and governments) may, like individuals, learn from experience and gradually inculate norms of behavior that constrain their actions even when none of the more obvious forms of hard budget constraint would seem to be applicable at the margin. This line of thought is explored further in the conclusion.

II. Hardening "Soft" Budget Constraints: The Provinces

"In the area of Canadian public finance, history is everything;
an understanding of yesterday is absolutely essential to an
understanding of today...." (Perry, 1955).

Canada has ten provinces, ranging from tiny Prince Edward Island with little more than 100,000 people to huge Ontario with around 10 million.[3] In this section, we first set out how some key aspects of Canada's federal-provincial fiscal and political structure that may *appear* to establish a soft budget constraint -- for example, there are large and unconditional federal-provincial fiscal transfers and a revenue equalization system -- and then suggest some reasons why the disasters some would expect as a result have not occurred. We shall first review the evolution and current structure of federal-provincial fiscal relations, and then sketch the political context before setting out briefly some of the relevant historical experience.

Federal-Provincial Fiscal Relations

[2] Another case in which historical factors seem critical in explaining fiscal outcomes would appear to be Colombia, long an outlier in Latin America in terms of fiscally prudent behavior (Dillinger and Webb, 1999b).

[3] There are also now three territorial governments in the Arctic region. These governments, which are very sparsely populated and depend heavily on federal transfers, differ in many ways from the provinces (Slack, 1991). They are not further discussed here.

Fiscal discussions in Canada have long been dominated by issues of federal-provincial relations. This complex subject is simplified here into three principal components:

First, there is a revenue equalization system introduced in more or less its present form in 1967, under which the federal government makes transfers to the seven poorest provinces (Annex 1). These transfers are intended to bring provincial revenues up to the level they would have received had they levied the national average (provincial) tax rate on a share of the national tax base equal to their share of national population.

Second, there is a separate and larger transfer to *all* provinces. Despite its name – it is called the Canada Health and Social Transfer -- it is basically unconditional in nature. This transfer was introduced recently to replace two previous transfers -- a conditional transfer in support of social assistance and another basically unconditional transfer which had itself been introduced in 1977 to replace earlier conditional transfers supporting health and post-secondary education (Bird, 1987). The total amount transferred is based on the amount of the transfers replaced in 1996-97, escalated by a moving average of GDP growth. Only part of this transfer is actually made in cash. The rest is a notional transfer of what are called "(equalized) tax points", that is, the estimated yield of federal "tax room" turned over to the provinces in earlier years.

Third, although provinces have almost complete freedom to choose their own tax bases and rates, in practice most provincial income taxes are collected by the federal government under tax collection agreements, under the condition that the same base is taxed as for the federal income tax. The federal government collects corporation income taxes for seven provinces and personal income taxes for nine provinces under such arrangements. Beginning in 1997, three provinces have also consolidated their sales taxes with the federal value-added tax (the Goods and Services Tax, or GST) as a Harmonized Sales Tax (HST), which is also collected by the federal government. On the other hand, in Québec, the provincial government collects the federal GST along with its own VAT. Five of the remaining six provinces continue to levy separate retail sales taxes.[4]

To sum up, although the federal and provincial governments essentially tax the same bases, the federal government collects more from its taxes than its direct spending. It has therefore for many years transferred much of the surplus through the two large unconditional transfer programs described above to the provinces which, under Canada's constitution, control all expenditure on education and health as well as social assistance. (On the other hand, as discussed further below, direct income maintenance programs for the elderly, children, and the unemployed are largely federal.)

Taxation

The present federal-provincial fiscal system has evolved slowly, and with reversals at times, over the last fifty years (Perry, 1997). With respect to taxation, for example, both federal and provincial governments now rely heavily on income and consumption taxes, although in both fields the provincial share has risen sharply over the postwar period. The result has been a marked rise in the importance of provincial taxation since 1960, in sharp contrast to the relative stability of both federal and municipal taxes as a share of GDP (Figure 1). From 1955 to 1995, for example, taxes in Canada grew from 22 percent of GDP to

[4] The recent evolution of the sales tax system is discussed in Bird and Gendron (1998).

36 percent. Over four-fifths of this growth was attributable to the increase of provincial taxes, and about two-thirds of this increase was in turn attributable to the marked rise of provincial personal income taxes (Bird, Perry, and Wilson, 1998). Despite the considerable attention which has been paid to sales tax issues in recent years, the real story of federal-provincial taxation in the postwar era has thus been the personal income tax.

The division of taxing powers between the two levels of government reflects more the outcome of political bargaining than the application of any consistent normative principles. This is perhaps as it should be, since norms are influential only to the extent they are accepted, and it is by no means clear that there is much agreement in Canada on the many contentious issues involved in tax assignment (Bird, 1993). No doubt the economic costs of taxation may be somewhat higher when both levels of government tap most major tax bases. To at least some extent, however, such costs appear to be accepted as part of the necessary price of maintaining Canada's version of federalism, which presumably has its own rationale -- or necessity -- given Canada's history.

Transfers

Federal transfers to provinces increased sharply in the first half of the postwar period but have subsequently stabilized and, in recent years, declined (Figure 2). Up to the early 1970s, the federal government reaped a revenue bonanza by maintaining an unindexed progressive income tax through the largest economic expansion in Canadian history. Rather than cut taxes, it chose to channel a substantial share of this revenue inflow to the provinces through several large transfer programs. The first big federal transfer was equalization, which was clearly unconditional.[5]

By far the biggest transfers, however, took the form of conditional shared-cost programs. These were essentially open-ended matching grants intended to foster provincial spending on the favored fields of post-secondary education, health, and welfare -- all of which are, in terms of Canada's 1867 constitution, matters of provincial, not federal, competence. The result was both a rise in transfers (in the early part of the period) and, especially, a huge drop in the share of total federal-provincial transfers that were essentially unconditional (Bird, 1987).

At first this cornucopia of funds for politically popular expenditure was, unsurprisingly, welcomed by most provinces, although from the beginning Québec was considerably less happy than the rest with this federal intrusion in provincial areas. Québec's objections were to some extent dealt with rather creatively by devising a system of "opting-out" under which, instead of receiving transfers, any province could choose instead to receive more tax room in the form of a lower federal income tax rate. Since only Québec chose this path, the result is that since 1966 Canadian federal finance has been clearly asymmetrical in the sense that the federal income tax rate levied in Québec is lower than in other provinces, while at the same time the transfers received by Québec are lower by approximately the same amount.

Over time, however, as the era of rapid growth came to an end and the federal government slipped into a long series of annual deficits, it became increasingly eager to turn off the transfer tap. Initially, this goal was accomplished by changing the form of the largest transfers (for education and health) to a basically

[5] Indeed, it could even have been used to finance a tax reduction -- although in Canada, as in every country, what evidence there is demonstrates that the last thing most governments that receive transfers do is to reduce taxes – an illustration of what has been called the “flypaper effect” – namely, that money sticks where it hits.

unconditional grant (the so-called Established Programs Financing, or EPF transfer) in 1977 -- a move that was actually welcomed at the time by provinces such as Ontario as reducing the degree of federal interference in provincial functions. As Figure 2 shows, the result was to restore the dominance of unconditional transfers (Bird, 1987). This process was virtually completed in 1996 when the last major federal conditional grant program, the Canada Assistance Plan, was added to the existing EPF transfer and its name changed to the Canada Health and Social Transfer (CHST). The relative size of federal transfers, especially to the better-off provinces (Ontario, Alberta, and British Columbia) had already been cut in several ways as the federal government in effect "downloaded" a significant part of its deficit to the provinces (Boothe and Johnston, 1993). The further sharp cut in federal transfers accompanying the introduction of the CHST meant that the provinces as a whole received relatively less from the federal government than in earlier years, although they could now virtually spend these funds as they wished.

Borrowing

Provinces may borrow money for any purpose, whenever, wherever, and however they wish. There no federal controls at all over provincial borrowing -- internal or external. Indeed, provinces do not even need to provide any information on their borrowing to the federal government. Although federal deficits were the driving force behind the rising public debt levels of the 1980s and early 1990s (Figure 3), provincial debt also rose sharply in part as provinces attempted to maintain social expenditures in the face of declines in both own-source and transfer revenues.[6] As we note below, this pattern was essentially the

[6] For a detailed analysis of the factors leading to provincial deficits over this period, see Kneebone and McKenzie (1999).

same as had occurred in the 1930s. Moreover, while there has generally been a rough correspondence between borrowing and capital expenditure at the provincial level, this link was broken in the recession of the early 1990s as several large provinces, almost for the first time since the crisis of the 1930s, borrowed substantially more than they spent on investment (Figure 4).

As some observers have noted, in principle this situation is not without potential dangers for sound monetary policy (Devereux, 1993). On the other hand, so long as there is no express or implied federal guarantee for provincial debt, there may also be something to be said for letting the capital markets do the monitoring – a task which, as seen below, they seem to perform quite well.

The Political Context

Although of course constrained by economic realities, federal-provincial fiscal relations in Canada are essentially, and indeed almost exclusively, determined by political factors. As we have noted, the first half of the postwar period was dominated by the extent to which the federal government found so much money flowing in so easily that it could not, given its limited constitutional sphere of action, spend it all itself. Rather than give this pot of gold back to taxpayers, federal politicians decided to spend it through the provinces.[7] The second half of the period (after the mid-1970s) saw not only the reassertion of long-standing provincial and regional concerns about undue federal control but also the end of the revenue bonanza at the federal level. As noted above, the upshot was increased provincial taxation and reduced

[7] There has been extensive discussion in Canada about the legitimacy of this use of what is called the federal "spending power" but it clearly exists (Watts, 1999).

(but less conditional) federal transfers -- with an accompanying unsustainable blip in provincial non-investment-related borrowing in the early 1990s which has now been virtually corrected. The recent return to a surplus position in the federal budget -- in part by reducing transfers to the provinces -- has led to renewed debate with respect to the appropriate role of different levels of governments in financing the politically popular, but costly, health system. We shall return to the question of how to deal with surpluses in Section IV.

None of these developments can be fully understood without understanding the political context. Four factors deserve attention.

In the first place, Canada appears to be unique among federations in the complete absence of any formal representation of provincial interests at the federal level (Watts, 1996). Although there is a federal senate with "regional" representatives, it not only has virtually no legislative power but its members are also appointed by the federal government.[8]

Secondly, since Canada has a parliamentary system, with the government being formed by the majority party -- and a "first-past-the-post" electoral system that usually produces a majority -- there is seldom meaningful legislative opposition to government policy in the House of Commons.

Thirdly, party discipline is extremely strong. Regional issues may perhaps be strongly represented behind the closed doors of the governing party's caucus, they are never manifested in any public forum. Canadian parties almost invariably present a monolithic front on all policy issues, just as Canadian governments almost invariably get the legislation they want.

[8] Colomer (1999) suggests that an upper chamber facilitates intergovernmental co-operation only if it both has power and represents different parties than those that dominate the lower chamber. Neither condition holds in Canada.

Finally, while the latter two characteristics also hold for the (unicameral) provincial governments, there is essentially no integration between provincial and federal parties. Canadians see nothing inconsistent with supporting one party at the provincial level and another at the federal level, and they frequently do so.[9] Moreover, there is very little "cross-over" between the federal and provincial levels. With very few exceptions, provincial politicians and officials make their careers at the provincial level, and federal politicians and officials at the federal level.

One result of these factors -- exacerbated by the small number of provinces (10) and the fact that only four of them (Ontario, Quebec, Alberta, and British Columbia) really matter much -- is that any policy issue with strong regional impacts sooner or later becomes a matter for dispute and negotiation between federal and provincial governments. Almost every major policy issue becomes a matter for what one author (Simeon, 1972) has accurately labelled "federal-provincial diplomacy." At the federal-provincial level, the dominant political style has thus long been one of "negotiated accommodation" (Hettich and Winer, 1999). Changes in either the political or the economic balance of the country have often been directly reflected in changes in the fiscal relations of levels of government to maintain political stability at the expense of allocative efficiency. Given the essentially distributive nature of this political process, it is not surprising that efficiency considerations sometimes fall to the wayside. There is thus no possibility of constraints from

[9] In the last federal election, for example, the Liberals won all but one seat in the three Maritime provinces. At the time, Liberal governments ruled in all these provinces. Now, all three have Conservative governments -- indeed, the Liberals are now in power in only one province in the country (Newfoundland). An interesting question is whether provinces gain or lose if they are controlled by the same party as the federal government. The proposition can be argued both ways. The federal government may be nicer to its political friends than its enemies: as we note later, this is basically the argument of Boothe (1995) with respect to Alberta's 1936 default. Alternatively, as the neighboring province of Saskatchewan has often demonstrated, it may be argued that knowing that you have to be self-reliant -- that you do not have a friend in Ottawa -- may lead to more fiscally innovative and responsible policies. And, finally, as Québec has long known, and shown, you can also sometimes do quite well out of being an enemy.

above -- or even politically-negotiated constraints -- on provincial budgets. Canada's provinces thus afford an extreme test of the viability of market-constrained decentralization.

Budget Constraints in Practice

It is not surprising that provincial budget constraints in Canada have been considered to be relatively soft by some analysts (McKinnon, 1997). Experience in the early years of the nineteenth century -- for example, in the Province of Canada (now Ontario and Quebec) before Canada itself was created in 1867 - - indeed showed some of the expected outcomes. Provincial (and local) governments repeatedly ran into difficulties in financing infrastructure such as railways and canals, largely through foreign bond issues, and then engaged in various manoeuvres to extricate themselves from the resulting problems (Piva, 1992).

These early experiences, however, also revealed two perhaps surprising but prevalent tendencies in Canadian public finance. First, one important result of the repeatedly necessary efforts at damage control was a continuing improvement in subnational financial management. As Piva (1992) put it, . "financial administration...involved exercises in crisis management; as often as not it was an exercise in damage control....Each crisis, however, led to a series of reform initiatives the final product of which was the creation of a relatively modern administrative system for managing government finance." Second, foreign bond markets proved to be very adept at interpreting the information available concerning what was going on in these far-away colonies, lagged and incomplete though it inevitably was in that era. Carlos and Lewis (1995), for example, demonstrate convincingly that the London market had little difficulty in pricing fairly accurately the ex ante positive probability that the Grand Trunk Railway -- the largest single foreign bond issue of the 1850s -- would be bailed out by the provincial government in the event of bankruptcy.[10] Both the adjustment of political and administrative practice in response to economic and financial problems and the discipline exerted by foreign capital markets continue to be equally evident a century and a half later.

After the formation of Canada, most provinces continued to encounter similar financial problems, and corrective checks -- for example, during the depression of 1875-95 (Perry, 1997). As in the pre-Confederation period, many provincial difficulties were occasioned by municipal indiscretions, with the result that, as discussed in Section III, many of the corrective administrative measures were introduced at that level. For example, in the early years of the twentieth century, Quebec dealt with the bankruptcy of several small suburban municipalities by amalgamating them with Montreal (Poitras, 1999).[11] The entanglement of provincial and municipal finance continued to give rise to problems even after the First World War, owing in part to the involvement of both levels of government in the provision of "relief". Although the newer western provinces -- Alberta and Saskatchewan were created in 1905 -- had begun to encounter debt problems even in the 1920s, the real crisis came with the depression of the 1930s, which quickly doubled debt service burdens even in some of the eastern provinces which were, in the words of one observer (Buck, 1949, p. 291), already "conservative by experience." As Forbes (1993) notes, such pressures were accentuated in the poorer provinces, and especially the poorer municipalities in the poorer provinces, by the uniform

[10] After many transmutations, this railway was indeed finally bailed out (by the federal government) -- in 1920!

[11] In this instance, there appears to be clear evidence of opportunistic behavior in that some local decision-makers seem to have made deliberately imprudent infrastructure investment decisions precisely in order to go bankrupt and force an amalgamation with the larger neighbouring tax base, thus shifting costs and preserving the value of their properties (Poitras, 1999).

"matching requirements" of federal debt relief.[12]

Perhaps the single most striking result of the crisis of the 1930s, however, was the first and only default of provincial debt in Canadian history -- that by Alberta in 1936. Alberta, which is now Canada's richest province, was then one of the poorest. It was experiencing drought as well as the general economic depression. Moreover, its newly-elected government professed a prairie populist version of an anti-(eastern) banking philosophy called "Social Credit". The new provincial government proceeded to put this philosophy into legislative form through a series of laws that were either "disallowed" by the federal government[13] or ruled *ultra vires* provincial authority.[14] The province's finances had been in a parlous state to begin with, and the prolonged and exceedingly acrimonious provincial-federal bickering that ensued did not help matters. The province, for example, refused to participate in a proposed loans council on the grounds that this would in effect cede control over provincial borrowing to the federal government (Boothe, 1995).

The upshot was that in 1936 the federal government flatly refused to bail out Alberta, thus forcing it to default on approximately one-third of its bonded debt (although it continued to pay a reduced rate of interest). That this decision was at least in part political has been suggested to some (Boothe, 1995) by the fact that, almost simultaneously, the neighbouring province of Saskatchewan, whose finances were in a

[12] As Feldstein (1975) argues, matching grants, unless adjusted for "wealth" (tax base), invariably disadvantage poor areas.

[13] In so acting, the federal government exercised a power granted it in the 1867 constitution for what turned out to be the very last time in Canadian history. This power is now generally considered to be dormant, if not dead.

[14] Such rulings were made by both the Supreme Court of Canada and the Judicial Committee of the Privy Council in London, which was, until 1982, the court of last resort on Canadian constitutional matters.

similarly debilitated state, was rescued by federal funds and therefore did not default.[15] Alberta actually stayed in default until 1945, when, after prolonged negotiations, the federal government in effect bailed the province out, explicitly in order to restore Canada's full credit-worthiness in foreign markets.[16] As the then federal finance minister put it when explaining his action: "I would like the public to have complete assurance that when *any* Canadian government gives its promise to pay it will abide by its undertakings" (quoted in Buck, 1949, p. 295; italics added).

On its face, this declaration and the federal action in bailing out (eventually) the provincial government seem to make it clear that the provinces indeed face a soft budget constraint and that the federal government had rendered itself implicitly liable for all provincial debt. Other postwar developments reinforce this conclusion. The explicit "stabilization" provision in the federal-provincial tax agreements (Annex 2), for instance, points in the same direction.

At a deeper level, however, other changes had taken place which had fundamentally changed the playing field. The advent of the war meant that no attention was explicitly paid to the recommendations of

[15] Saskatchewan was funded by the federal government's purchase, at favorable rates, of provincial treasury bills, the interest on which was paid by further issues of bills.

[16] Some might consider this a federalist interpretation of events. In an interesting recent example of continuing "Western alienation," Boothe (1995) presents the 1945-46 debt reorganization as an entirely provincial initiative, emphasizes the strong provincial efforts to reduce debt and raise revenues, and notes the federal payments in terms that make it clear they were less than Alberta was "owed." It is not surprising that his final words on the matter were that "...Ottawa did not use its financial resources to prevent the province's default in 1936, although Saskatchewan, in a similar position, was rescued by federal aid" (Boothe, 1995, p. 109). This interpretation seems questionable. As Perry (1997, p.19) points out, the two provinces were not really in a similar position because Alberta's problems were due more to the debt load it had accumulated in earlier years than to the relief payments which drove Saskatchewan into crisis. On the other hand, a recent study has suggested that the newly created Bank of Canada and the federal Ministry of Finance felt it was better to isolate Alberta and allow it to default in order to destroy the credibility of the Alberta administration and its "peculiar" ideas on debt relief and macroeconomic policy (Ascah, 1998). A full comparative analysis of the situation of the two provinces in the 1930s may be found in Bates (1939).

an important Royal Commission on Dominion-Provincial Relations (Rowell-Sirois, 1938) that the federal government should take full responsibility for the relief expenditures that had, for the most part, been the precipitating factor in both the provincial and the municipal fiscal crises of the 1930s. Nonetheless, two important constitutional amendments in 1941 (unemployment insurance) and 1951 (old age pensions) had in effect largely accomplished this goal. Henceforth, it would be primarily the federal and not the subnational government that was primarily charged with interpersonal income distribution. In addition, the wartime creation of a highly productive personal income tax, which after 1947 became a major source of provincial as well as federal revenues, greatly improved provincial finances.[17]

With both provincial expenditures and revenues thus in much better shape, Canada entered a new era after World War II. Provincial education and health expenditure, financed both by own revenues and by large transfers financed from equally buoyant federal revenues, grew sharply until the revenue tide turned in the mid-1970s, resulting finally in the latest federal-provincial fiscal crisis. Once again, however, much the same factors as already mentioned seem in the end to have largely offset the long-term detrimental macroeconomic consequences that some might have expected to result from Canada's extreme fiscal decentralization.

In contrast to earlier experiences, although the 1980s and early 1990s certainly saw a substantial increase in debt, especially federal debt (Figure 3), despite the fears of some who seem to have confused transitional problems with deep-seated flaws (Bruce, 1995; Devereux, 1993), the system seems, after a lag of a few years, to have adjusted adequately to the changed realities (Kneebone and McKenzie, 1999).

[17] Incidentally, the 1947 discovery of substantial oil and gas reserves in Alberta changed the fiscal base of that province from one of the weakest in the country to by far the strongest. One way or another, Alberta has always been the principal outlier in the Canadian fiscal scene.

Indeed, even before the federal government began to get its own fiscal house in order in the latter half of the decade, many provincial governments had already begun to deal with the fiscal problems arising not only from economic downturn but from the initial federal response of cutting transfers to the provinces (Boothe and Johnston, 1993). Interestingly, neither political affiliation nor transfer-dependence seem to have determined who did what when. One of the most "transfer-dependent" provinces, although governed by socialists (Saskatchewan), was among the first to take remedial action, and one of the least transfer-dependent provinces, although controlled by conservatives (Ontario) was among the last. What seems to have been more important than transfer dependence or ideology in determining the timing and strength of provincial adjustment is the extent of the fiscal problem faced by the various provinces, with the weakest provinces (with the narrowest fiscal bases) reacting earlier and more strongly than the more diversified, richer, and much less transfer-dependent provinces.[18]

The interaction of social norms, institutional modalities, political realities, and market forces that seems to have enabled Canada, and its provinces, largely to have escaped the macroeconomic trap sometimes thought to be inevitable in unconstrained decentralization evolved incrementally over time, in large part in response to previous crises. One part of the most recent corrective process which has received some attention has been the adoption, for the first time, of "balanced budget" rules by a number of provinces (Annex 3). The "self-adopted" nature of these rules and the general principle that no parliament can bind a future parliament suggests, however, that this development may have more symbolic than real

[18] See the detailed analysis by province in Kneebone and McKenzie (1999). As these authors show, ideological and electoral factors clearly affected the nature of fiscal adjustment – with, for example, more “left” governments being less inclined to cut expenditures than to raise taxes – but the clearest predictor of the strength and timing of the adjustment was the prior debt position, which in turn largely reflected the strength of the regional economy relative to the national economy.

significance.19 As we note in Section IV, the real lesson appears to be the flexibility of the Canadian political system and its ability and willingness to respond to market signals.

An additional point that deserves mention concerns the considerable importance of foreign borrowing at the provincial level. In contrast to the federal government, provincial governments have long been dependent on foreign capital markets, with about half of their borrowing being in foreign currencies. Their debt costs are thus sensitive not only to interest rates but also fluctuations in exchange rates. Since of course the policies that impact both interest rates and exchange rates are in federal hands, provincial budgets are even more dependent on federal actions than might at first appear (Shah, 1997). On the other hand, given the importance of the provinces and their foreign borrowing, it also follows that provincial fiscal difficulties may in turn affect exchange rates and hence federal budgets. Some have seen this as reason for federal concern about provincial budgetary policy (Harris, 1993) and have concluded that a federal "non-bailout" policy is therefore inherently non-creditable (Bruce, 1993).[20] This seems to go too far, however.

As Boothe (1993) notes, as debt levels increase, credit ratings decrease, thus increasing debt costs and, one assumes, reducing debt. If foreign capital markets at the end of the twentieth century are as good at reading Canadian political signals as they were in the middle of the nineteenth century (Carlos and Lewis,

[19] Such rules may perhaps make it more costly for future governments to breach them if, for example, doing so were to increase market perception of risk. As yet, however, the evidence does not suggest there has been any such effect (Millar, 1997). These rules may also make it bit more difficult for future governments to follow an expansionary path, although again the evidence on this is not strong. British Columbia, for example, passed a so-called 'Taxpayer Protection Act" in 1991 imposing both a spending limit (linked to past GDP growth) and a five-year balanced budget requirement. This Act was repealed the next year by a newly-elected government.

[20] Bruce (1995) adds the neat twist that the ease of interprovincial migration makes it easy for provinces to, as it were, "off-load" their debt burdens with a bit of a lag, although he offers no empirical evidence that any such effect is indeed perceptible. This proposition would appear to be testable, particularly in view of the much lower migration probability of the largely French-speaking population of Quebec.

1995), it seems unlikely that anyone in Ottawa should lose too much sleep about the problem of provincial indebtedness. Profligate behavior by provincial decision-makers will, it seems, be brought to their attention quite quickly enough by the capital market and reinforced by subsequent voter reaction.[21]

III. The "Second World" of Canadian Public Finance: The Municipalities

"Taxes, transfers, borrowing – the picture is similar.
The province proposes, and, on the whole, the province disposes"
(Bird and Chen, 1998).

Unlike Canadian provinces, Canadian municipalities face very explicit hard budget constraints imposed largely by administrative fiat. In the provincial-municipal world, in sharp contrast to the federal-provincial world, formal constraints on subnational fiscal actions abound (Bird and Chen, 1998). As a rule, for example, local borrowing requires prior provincial approval and is severely limited (Amborski, 1998). Moreover, both local revenue and expenditure decisions are tightly controlled, and the important transfers received by local governments from the provinces are generally highly conditional (Figure 5). Many of the rules and regulations governing local fiscal decisions that originated in the 1930s remained virtually unchanged until very recently. Although occasionally some smaller municipal governments have encountered

[21] A more important problem in some ways for many years was the fact that, in effect, the payroll tax funding nominally collected to finance the Canada Pension Plan was used (on a derivation basis) to support provincial borrowing at favorable rates. As Perry (1989, p.465) notes, "when the CPP appeared to be running out of money rather than call in some of the provincial borrowings revenues were increased by raising the contribution rates...." This system has now been changed, however. While CPP funds may still be invested -- now by an "independent" advisory board -- in provincial securities, the provinces no longer have a captive market and will no longer be able to borrow at less than full market rates.

such severe fiscal difficulties that they have been put under financial supervision (with, in principle, all costs being charged locally), on the whole this very different system also seems to have weathered the difficulties of the 1990s fairly satisfactorily. Indeed, one interesting, and somewhat unexpected, effect of the recent crisis has been, if anything, to liberalise rather than tighten provincial administrative control over local borrowing.[22]

Of the three levels of government in Canada, the municipal level is most visibly a provider of services to its inhabitants. The services for which municipalities are responsible vary from those which require considerable capital investment (water supply) to those that are highly labour-intensive (social services). Since most Canadians live in cities, it is not surprising that provincial politicians, despite some continuing rural bias in constituencies, often act in ways that imply that there is a strong implicit provincial "guarantee" of the services nominally financed through local budgets.[23] Modern urban economies are especially dependent on services that are highly capital-intensive, such as water supply, sewage treatment and transportation. When municipal capacity to finance both capital and operating costs is threatened, either by the demands placed on the municipal fiscal system by competing expenditure pressures to fund redistributive services, or by the inability of the existing political structure to cope with spillover effects among adjacent municipalities or simply to establish an adequate fiscal base, a policy response from the

[22] As Amborski (1998) notes, this liberalization has occurred even though the pre-existing restrictions on local borrowing do not seem to have been perceived by municipal governments as unduly restrictive. We shall discuss this question further below.

[23] Although primary and secondary education is delivered at the local level in Canada, it is not the responsibility of municipal governments but of separately-elected school boards. These boards may in most provinces impose a tax on real property which is collected for them by municipal governments which have no role in determining in determining the education rate. In Ontario and some other provinces, the provincial government in recent years has become the main player in both financing and controlling education. For further discussion of the complex system of education finance, see Auld and Kitchen (1995).

province has generally been forthcoming. This situation is by no means new, however.

Early Experience

As mentioned earlier, the early stages of local government development in Canada saw many local fiscal crises, and subsequent provincial responses. For example, the original Municipal Corporations Act (1849) of the Province of Canada was intended in part to avoid further increases in the provincial debt by empowering local governments with the power to tax and borrow and finance local improvements. When municipalities turned out to be unable to raise money on their own credit, a Consolidated Municipal Loan Fund was created in 1852, from which municipalities could borrow to support transportation improvements. At least in official eyes, if not necessarily those of creditors, the debentures issued by this fund did not represent an increase in the public debt of the province since they were not secured by the Consolidated Revenue Fund (Piva, 1992).

Most early local government legislation was intended more to prevent abuse than either to support or control local actions. In Québec, for example, which had perhaps the most extensive such legislation in place at the beginning of this century, the rules were not very restrictive. Municipalities were, however, required to inform the government when they wanted to borrow beyond the statutory limit (when interest and sinking fund payments exceeded half the annual revenue of the municipality). Ontario's situation was broadly similar. Other provinces -- New Brunswick, Nova Scotia and British Columbia -- had almost no explicit legislation apart from some control over audit. Only the two new provinces, Alberta and Saskatchewan, had formal departments of municipal affairs with broad powers of supervision over finances, debt, and audit (Taylor, 1991).

The Crisis of the 1930s

As the twentieth century unfolded, however, provincial legislative control over local governments became much more extensive, particularly as a result of the experience of the 1930s. Most provinces created departments of municipal affairs with extensive powers to supervise, influence and pass money to local governments. Explicit provincial control was extended over a wide variety of local government functions (Buck, 1949). In Ontario, for example, the severe effects of the depression on both provincial and municipal finances led the provincial government to modify drastically the existing framework for the regulation of borrowing and financial administration (Tassonyi, 1994).[24]

Although a few Western municipalities had defaulted after World War I, largely as a result of overly ambitious borrowing for infrastructure on the basis of inflated land values (Perry, 1955), it was really the depression that led to a wave of local defaults amounting to about 10 percent of total municipal debt (Buck, 1949). Nowhere was the situation more serious than in Ontario. By late 1934, over forty Ontario municipalities and school boards had defaulted on their obligations.[25] Most defaults occurred in 1932 and 1933, many of them in such one-industry "company towns" as Sturgeon Falls:

[24] Much of the material in this section is taken from Tassonyi (1994, 1997).

[25] Other important defaults occurred in the suburbs around cities such as Winnipeg, Montreal, and Vancouver that had expanded rapidly in the 1920s. Even Montreal itself defaulted in 1940, and its financial administration was taken over by the provincial government until 1944 (Dagenais, 1992).

"This northern Ontario company town of about 5000 people was in a hopeless position after Abitibi Pulp and Paper, its only major employer, closed down operations near the end of 1930. Two years later, the town found itself saddled with $350,000 in debentured debt, three out of every four members of its population on relief, and a growing mountain of almost $56,000 each year in unpaid tax levies. Beginning in July 1932 the provincial and federal governments agreed to pay 85 per cent of town's relief bills to stave off municipal default, but Ontario officials soon became horrified at the way the community was spending the province's money" (Struthers, 1991).

In response to such experiences, over the next few years Ontario established both a regulatory framework for municipal finance and the capacity to regulate, audit, investigate, and inspect municipal administration. In 1932, the Province established the Ontario Municipal Board (OMB) and gave this body extensive power to validate the borrowing by-laws of municipalities, to consider the nature of the undertaking, the financial position of the municipality, its existing set of obligations, and other matters.[26] A few years later, in 1935, the OMB was given power to control all municipal capital expenditures and to limit local borrowing without OMB approval.[27] Previously municipal debt had been limited in part by setting a mill rate limit on the amount that taxes could be increased to service debt, but municipalities had tended to increase their real property assessments artificially to avoid the limit.

The OMB was also given extensive powers of supervision over defaulting municipalities, exercisable

[26] There had been earlier bodies such as the Ontario Railway and Municipal Board and the Bureau of Municipal Affairs with similar powers, but they were largely toothless.

[27] Borrowing was limited to 70 percent of estimated revenues. The limit had previously been 80 per cent for municipalities with populations greater than 100,000 and 90 per cent for the others with no approval being required. No distinction was drawn between capital and short-term borrowing.

either at the request of council or, when in default or with high probability of default, by creditors who represented not less than twenty per cent of the indebtedness. The administration of the municipality could be turned over to a Committee of Supervisors with authority to manage the financial affairs of the municipality -- the collection of revenues, the making of expenditures, the establishment of the assessment rolls, the setting of tax rates, temporary borrowing, the disposal of assets, the consolidation of indebtedness, and the negotiation of new terms with creditors. Further borrowing could be done only with the approval of the OMB, which also retained extensive powers to review the decisions of supervisors.

The severity of the crisis in many communities provoked both creative responses from municipal officials and, and as suggested above with respect to Sturgeon Falls, provincial unease as to what was going on. In York Township, for example, an enquiry found that "in their desire to assist the unemployed and secure as large a payment as possible from the Governments of the Dominion and the Province, the officials undertook works that should not have been commenced at the time. They also claimed expenditures which were not properly within the scope of the agreement with the Province" (Commission, 1933, p.9).

By far the most serious crisis occurred in the Windsor area (on the U.S. border, opposite Detroit). In East Windsor, for example, in 1931, debt service represented 45 percent of expenditures. In 1934, no payments were made, and 40 percent of the total residential value of property in the municipalities of East Windsor, Windsor, Walkerville and Sandwich was in arrears. Committees of Supervisors were established in all these municipalities. Among the principal problems identified were "the practices of budgeting on the basis of collecting 100 per cent of the tax levy, and failing to pass the budget early in the year" (McPherson 1935, p.330). Two other common problems were recourse to short-term borrowing based on the notion of the unlimited power of municipalities to raise taxes and the overstatement of the revenue base through the assessment process (Brittain 1934).

For each of the Windsor area municipalities, refinancing schemes were suggested, generally to spread the retirement of the debt over forty years at rates between 3 to 3.5 percent with only interest being payable for five years. The severity of the problem in the Windsor area led to the appointment of a Royal Commission which reported in 1935. At that time, 29 per cent of the population was receiving relief, and assessments had fallen by nearly 40 per cent from their peak value in 1930. The Royal Commission (1935, p.7) noted that:

> The situation existing in the Border Area today is giving rise to a condition by which something approaching total default is threatened. The present budgets are to some extent fictitious as the provision for maintenance in every department is entirely inadequate. ... If the present scale of expenditure is continued, adequate maintenance resumed and a share of relief provided by the municipalities, there will be very little if anything, left to pay either principal or interest on the bulk of outstanding bonds. The consequence must be that the credit of the area, both public and private, will be destroyed.

In response to the continuing problems of the area, the Province drastically altered the jurisdictional framework, amalgamating the cities of Windsor and East Windsor and the towns of Sandwich and Walkerville and establishing the Windsor Finance Commission to prepare a plan for funding and refunding the outstanding debts of the amalgamated municipalities to be recovered on the rateable properties of their former jurisdictions. This Commission was provided authority similar to that granted to the Committees of Supervision.

In 1936, however, the provincial Department of Municipal Affairs, which had been established in 1934 to deal with the mounting local crisis throughout the province, replaced these Committees. By 1939, the Department had completed 15 refunding plans and six were in the process of being negotiated (Ontario, 1939). These plans generally followed the pattern set in the Windsor situation and involved negotiations with bondholders and the municipalities to obtain feasible terms of repayment of accumulated indebtedness. As late as 1944, fifteen municipalities remained under supervision, although in most cases supervision had been reduced to an approval of the annual budget and monitoring adherence.

Constraints on Municipal Fiscal Behaviour

The traditional argument with respect to tax assignment in a multi-level government suggests two conclusions: first, most taxes should likely be assigned to the central government; second, so far as possible, different taxes should be assigned to different governments (Bird, 1999b). At the federal-provincial level, as discussed above, Canada violates both these rules; at the provincial-local level, it largely satisfies them. Specifically, only the municipal level of government has a clearly separate tax source in most provinces -- the property tax. Despite recent provincial encroachments on property tax revenues in a number of provinces (usually as part of a realignment of provincial-local responsibilities for education), this situation seems unlikely to change drastically in the near future. Nonetheless, even with respect to their "own" property tax, assessment -- the determination of the tax base -- is carried out by provinces,[28] and, although local governments may generally set their own tax rates, even this freedom is often limited, for instance with respect to the extent of variation in the structure of rates between residential and other properties.[29]

[28] In consequence, municipalities have only very limited input into the process of assessment reform as inequities in the base arise.

[29] In addition, at least in the case of Ontario, where only lower-tier municipal governments impose property taxes, but where they must also impose such taxes on behalf not only of school boards but also of upper-tier

More generally, local governments in Canada are controlled by the provinces in all important fiscal respects: as a general rule they cannot tax, charge, borrow, or spend without explicit provincial approval (Bird and Slack, 1993). Although they can set property tax rates, on the whole municipalities thus get only the tax revenues that provinces let them have. In current fiscal circumstances it is unlikely that any province will allow municipalities to tap such potential revenue sources as income and sales taxes, so the striking stability of local taxes shown in Figure 1 seems likely to continue in the future.[30]

This local tax stability has been coupled with an inevitably greater role for local expenditures in an increasingly urbanized Canada largely by expanding the size (relative to GDP) of provincial transfers to municipalities. From 1955 to 1975, such transfers as a proportion of total local revenues almost doubled. Since then, this proportion has remained close to half (Figure 5). At the same time, however, transfers to municipalities actually constituted a *decreasing* share of provincial revenues, reflecting the more rapid rise of the latter (Bird and Chen, 1998).

Almost all of this huge stream of provincial-local transfers took the form of conditional transfers (Figure 5). In striking contrast to the federal-provincial case, the importance of unconditional transfers has remained both low and constant as a share of total municipal revenues throughout the post-war period. Local governments received sufficient provincial funds through transfers to enable them to expand expenditures substantially. But most such funds came with restrictions and controls aimed at implementing

(regional) governments, the "Wicksellian connection" (Breton, 1996) between local responsibility for taxes and for expenditures is largely breached (Locke and Tassonyi, 1993; Tassonyi and Locke, 1993).

[30] Although some provinces (for example, Alberta and Ontario) have in recent years increasingly encroached on the property tax base, largely as part of the on-going reform of educational finance, it might be argued that this may actually make it easier for municipal governments to raise their own property taxes as a result of the reduction in interlocal tax competition owing to the provincialization of education finance. This theme cannot, however, be further explored here.

provincial wishes at the local level.[31]

Most infrastructure expenditure in Canada, as in many countries, is carried out at the local level. In 1993, for example, municipal governments accounted for 52 percent of total public sector expenditure on roads, bridges, water and sewerage works and the like, with most of the balance being provincial expenditure (Slack, 1996). Some of this expenditure (for example, on water) may directly produce revenue through user fees. Other infrastructure expenditure (for example, on roads) may add to productivity and hence improve local taxpaying capacity. Moreover, almost by definition, local investment in infrastructure will render services for years to come. For these reasons, it has often been argued that most local infrastructure expenditure can and should be financed by borrowing. One of the more striking features of Canadian local government, however, is how little local borrowing there is. Indeed, borrowing by municipal governments has actually exhibited a slight downward trend for several decades. Moreover, only a fraction of local capital expenditure has ever been financed by borrowing in any case (Figure 4).

Why Don't Municipalities Borrow More?

Indeed, one reason local borrowing has been little studied in Canada is perhaps because municipalities make so little use of the well-developed capital market. Why this is so is a bit of a puzzle. As

[31] "Most provincial-municipal grants in Canada are conditional, closed-ended, matching grants that do not seem appropriate for achieving either allocative efficiency or fiscal equity. Provincial-municipal transfers in Canada thus appear to be designed to allow provincial governments to maintain a fair amount of control over the expenditure and taxing decisions of local governments while appearing to let local governments provide their own services. In effect, local governments in Canada, to a considerable extent, are really acting as agents, spending provincial funds on provincially designated activities" (Bird and Slack, 1993, p. 138).

noted earlier, it is true that municipalities are allowed to borrow only under strict provincial limits and controls: the type of debt they can incur, the time period for which they can borrow, and the use they can make of the funds are all strictly regulated. While the rules vary from province to province, all provinces have restrictive rules (Kitchen, 1984; Amborski, 1998). On the whole, local governments in Canada simply cannot incur any significant amount of long-term debt without the prior approval of the provincial government (and in some cases, of local taxpayers also). "An important advantage of this situation is that local governments in Canada...are most unlikely to go bankrupt. But this result is achieved only at the expense of severe restrictions on local autonomy" (Bird and Slack, 1993, p. 105).

The specific characteristics of the provincial regulatory framework which governs municipal budgeting, borrowing, term and supervision in cases of financial distress vary from province to province (Kitchen, 1984). In the case of Ontario, the legislative provisions pertaining to municipal supervision established in the 1930s have been maintained with little change. Both the Ontario Municipal Board and the Ministry of Municipal Affairs have a significant role in the process that regulates the level of indebtedness and the general financial affairs of municipalities. The statute allows for Ministry or Board appointees to take over the financial operations of the local government and to charge back the costs to the local tax base. The most recent instance was with respect to the Ottawa-Carleton French Language School Board from 1991-1998.

In every province, municipalities are required to budget for balanced operating budgets. In Ontario, for example, if a deficit is incurred for any reason, it must be financed in the next budget year. Approved auditors must be appointed, and generally accepted methods of accounting must be followed. Municipalities may borrow short-term for only two reasons. The first is to finance work in progress prior to the final sale of debentures. The second is to meet short-term obligations prior to the collection of taxes and the receipts of revenue. Such borrowing cannot exceed 50 percent of total estimated revenues when borrowed between January 1 and September 30 or 25 percent from October 1 to December 31.[32] Any councillor who knowingly authorises greater borrowings for temporary purposes may be disqualified from office for two years.

Long-term borrowing by municipalities is closely regulated in every province (Amborski, 1998). In some provinces, special agencies borrow on behalf of municipalities.[33] Elsewhere, municipalities do the borrowing directly, but are bound by provincially set rules and processes of approval directly administered by either a provincial ministry or agency. In Ontario, until recently, the OMB had to approve all capital undertakings requiring the issuance of debt or future financing beyond the term in office of a local council. To actually issue debt, an enabling by-law had to be adopted by the council. Commitments to commence the project and to arrange the sale of debentures could be made only after approval was obtained to undertake a project at a specified cost. There was no retroactive approval authority. As noted below, these rules have been liberalized in some respects in recent years. Nonetheless, even local governments with good credit ratings do not borrow as much as they can.

Generally, the OMB process was sensitive to the considerable differences in municipal fiscal and

[32] As part of a property tax reform, the 1998 limit was changed to 35 percent for the last quarter of the year and the 1999 limit was raised to 60 percent to deal with cash flow smoothing.

[33]Gilbert and Pike (1999) demonstrate that such pooling may lower servicing costs.

administrative capacity in Ontario (Annex 4). Capital expenditure quotas were set annually for Metropolitan Toronto, the Regional Municipalities, and others that normally submitted applications, and on application for others, on the basis of information submitted by the municipalities. Municipalities were required to report other forms of long-term obligation to the Board to be included in the calculation of expenditure quotas and debt limits. For example, lease agreements involving financing from current funds beyond the terms of council of a capital nature were capitalised for calculation purposes.[34]

Despite the generally deteriorating fiscal climate of the later 1980s and early 1990s, most Ontario municipalities maintained their bond ratings -- in part perhaps owing to the continuing existence of the approvals framework and the limitations imposed on Ontario municipalities, combined with their conservative budgetary practices. Although there was no apparent impediment to the ability of Ontario municipalities to raise money domestically or in foreign bond markets, nonetheless, after the mid-1970s their capital financing shifted away from the use of borrowed funds to pay-as-you go policies, placing a heavier reliance on development charges and user fees to fund capital expenditures, as well as experimenting to a limited extent with public-private financing options. Although the economic efficiency of in effect replacing public borrowing with private borrowing may sometimes be questionable (Slack and Bird, 1991), matters may look different from a municipal budgetary perspective. Local governments may perceive themselves as being crowded out with respect to their tax base, for example, and under great pressure to finance social

[34] Long-term agreements of an operating nature, involving a commitment of funds beyond the life of a council also required OMB approval, although the present values of such agreements did not form part of the quota and limit calculation. These detailed reporting requirements contrast sharply with the situation at both the federal and provincial levels (Alexander and Emes, 1998).

services at the expense of maintaining and improving infrastructure.[35]

Increasingly pressed by fiscal exigencies arising from both the economic downturn and the cuts in federal transfers at the end of the 1980s, Ontario began to download some of its problems onto local governments. In particular, the province argued that municipalities could bear a greater share of the financial burden related to infrastructure funding as well as current operations (Ontario 1989). Both unconditional transfers and transfers for roads were frozen at existing levels. In effect, the conservative management of Ontario's municipal governments, all of whom were well within the existing guidelines on capital financing, was rewarded by funding cuts.

Another reward for conservative local financing practices was, perhaps surprisingly, a suggestion by the province that the pay-as you-go policies of many municipalities (adopted in part as a reaction to the levels of interest rates prevailing for long term debt) meant that they had unused borrowing capacity and they should therefore finance a larger share of growing infrastructure needs. Unsurprisingly, the municipalities were not happy to learn that “good guys” finished last, so to speak. Metro Toronto, for example, argued that "unilateral actions by the Province, resulting in funding shortfalls, have weakened the financial partnership to the point that it is crumbling" (Municipality of Metropolitan Toronto 1989). Nevertheless, in 1992, in order to encourage local governments to borrow more, local government access to capital markets was liberalised, and municipalities were granted the ability to both borrow and lend money in foreign currencies and to vary the type of instruments used. The process for undertaking long-term financial

[35] In Ontario, for example, Locke and Tassonyi (1993) and Tassonyi and Locke (1993) demonstrated the pressure on mill rate decisions created by the sharing of the tax base with school boards and various special purpose bodies, while Kitchen and Slack (1993) suggested that the pressure to fund soft services reduced municipal expenditures on hard (infrastructure) services.

commitments was also streamlined.

The current limit for debt service is 25 percent of own-purpose revenues.[36] Since 1993, Ontario municipalities can borrow and undertake financial obligations that extend beyond the term of council without OMB approval, as long as the prescribed debt limit is not exceeded. Borrowing above the limit still requires prior approval by the OMB. Ontario municipalities may borrow for capital purposes and issue debentures. Regional municipalities, counties, local municipalities in counties and single-tier municipalities may borrow on their own behalf.[37] Interestingly, although local municipalities in a regional municipality are those charged with levying property taxes, they may not borrow on their own behalf. Instead, although municipal debentures are secured on the revenue base of the local government, and debt and debt service is an obligation of the lower tier, only the upper tier is allowed to borrow. Bonds may not be tied to the revenue generated by a specific project, but municipalities are permitted to use a variety of instruments including retractable bond and sinking funds. They can also borrow in prescribed foreign currencies, although such borrowing must be hedged in Canadian funds.

On the whole, the recent fiscal record of Ontario municipalities suggests that the regulatory

[36] The previous OMB formula limited annual payments relating to debt and financial obligations to exceed 20 percent of revenue fund expenditures. Two significant limitations of this measure can be identified. First, the measure did not recognize that not all revenues are necessarily within a municipality's control. Provincial conditional grants for example are not available to meet the exigencies of debt service. Furthermore, an increase in expenditures automatically reduces the ratio of debt charges as portion of the expenditures and consequently enhances the debt capacity measure. To emphasize the point, if social assistance expenses rise, debt capacity is improved in spite of the fact that it is likely that the own-source revenue base of the municipality may have been weakened. The change (in fiscal year 1995) to 25 percent of own-source revenues in part dealt with the first of these problems. In addition, however, in effect it reduced the limit for municipalities that rely on provincial grants for a relatively large portion of their annual revenues. The regions and larger cities, which do most of the borrowing, are not similarly constrained, however.

[37] They may also borrow on behalf of school boards. As noted earlier, school board finance is an important factor in Canadian local finance but cannot be discussed in detail here.

framework established in the depths of the depression withstood the recent fiscal difficulties. Ontario municipalities have a good reputation in both domestic and international capital markets. Still, the system is not without critics. Some argue that even the liberalised regulatory framework just described unduly hampers creative financing and the use of capital markets to their fullest. Others argue that the pay-as-you go philosophy pursued by municipalities places an unwarranted burden on current ratepayers.

A more fundamental problem, however, is that municipal finance in Ontario remains heavily dependent on a narrow tax base while at the same time local governments are responsible for a significant share of social assistance expenditures. When times are hard, the combination of compulsory debt service and local responsibility for social assistance may substantially impinge upon the ability of municipalities to maintain service levels in other categories. Policies such as those adopted recently to enhance the flexibility of municipal interaction with the capital market may be an improvement, but more appropriate placement of the financial responsibility for income redistributive services and perhaps some local access to more elastic revenue sources (such as the personal income tax) would clearly provide a more permanent solution to the problem.

Provincial authorities throughout Canada have begun to recognise the need for greater flexibility in the regulatory framework. While recent reforms in Ontario and Alberta simplified the regulatory process and presumably enhanced municipal ability to access innovations in the capital market, the system remains more complicated elsewhere (Amborski, 1998). In British Columbia, where a provincial body borrows on behalf of municipalities, except for Vancouver, long-term borrowing requires both provincial approval and a two-thirds council majority (and possibly a referendum). In Quebec, either voter approval or provincial approval is required for municipal borrowing except in Montreal and Quebec City, and all borrowing in foreign currency is controlled by the province. In Alberta, until 1995, borrowing bylaws were reviewed by the Local Authorities Board. Although provincial oversight has now been removed, unless debt limits are exceeded, provincial regulation specifies the total indebtedness (1.5 times municipal revenue) and the level of debt service (25 per cent of revenues) that is permissible.[38]

The Province Decides

In short, what local governments can do and how they can do it, and indeed what local governments exist and their boundaries, are largely in the hands of the provincial governments, which have not been reluctant to exercise these powers.[39] In Ontario, for example, most of the province's more urbanised areas were organised into two-tier regional governments in the 1970s. Neither the existing local governments nor local residents asked for this reorganisation. Basically, someone "up there" decided it was a good idea, and a new structure was imposed from above. People who had lived for decades in village A suddenly found themselves residents of city B in region C, whether they liked it or not. Of course, if people are really unhappy, the channels of democratic politics are sufficiently open in Canada for their discontent to be registered. If strong enough, extended and pervasive local dissent may slow down and even reverse the direction of policy. In part for this reason, reinforced by a series of review reports that found relatively few

[38] The two large Alberta cities, Calgary and Edmonton, are granted special provisions -- total indebtedness permissible is twice the municipal revenue and the limit for debt service is 35 per cent of revenues.

[39] Incidentally, provinces do not welcome direct federal relations with local governments, as the federal government found out in the early 1970s when it attempted to establish a federal department of urban affairs and was soon told, in effect, to cease and desist from interfering in provincial business. It did.

clear benefits from regionalization, the move to regional government in Ontario lost its momentum in the 1980s (Slack, 1995). Nonetheless, as the recent imposition by the provincial government of an amalgamated government in Toronto demonstrates, those who have power sometimes seem driven to use it, even if the results seem unlikely to prove either economically or politically desirable.

Provinces can do as they will with municipalities at least in the short run, even if, in the long run, the political system may in practice establish some limits to their theoretically unfettered powers. Indeed, as suggested by recent events in the Toronto area (Annex 4), provincial dominance may actually have been increasing in recent years despite the diminished role of provincial transfers to municipalities and the partial loosening of the borrowing strings noted above, in part as the result of the same forces that resulted in the cut in transfers.

In any case, Canadian provinces clearly get the municipal governments they want, and deserve. What they appear to want is, as a rule, to keep local governments under tight check. They do so by restricting their revenues, directing their expenditures, and in various ways controlling access to capital markets. If, nonetheless, local governments get into financial trouble, the province generally comes to the rescue in a variety of ways -- adjusting municipal boundaries, taking over functions, and, in the extreme, taking control of finances. Paradoxically, therefore, the very existence of tight provincial control of local finances, as evidenced by the proliferation of rules and restraints to which local budgets are subjected, means that in effect there is a strong implicit provincial guarantee that municipal obligations will, in the end, be met. Ex ante rules intended to "harden" budget constraints are thus offset to at least some extent by the ex post reality that the all-powerful and hence responsible province always, it seems, comes through. Since most costs under provincial supervision are borne locally, local citizens may still pay the cost of fiscal misbehavior by their local governments, but creditors, as a rule, do not.

IV. Two Roads to Realism?

Two roads diverged in a wood, and I --
I took the one less travelled by,
And that has made all the difference.
Robert Frost

We have noted in Sections II and III that recent events have, perhaps paradoxically, seen some apparent strengthening of hierarchical oversight mechanisms in the form of budget rules at the provincial level and some apparent softening of existing hierarchical constraints on local borrowing. In both instances, however, these formal changes, like the striking formal difference between the explicit rules in place at the two levels of subnational government in Canada, probably matter less than might at first be thought. In the end, both roads to fiscal discipline – the weak hierarchial and institutional constraints at the higher (federal-provincial) level and the strong formal constraints at the lower (provincial-municipal) level -- seem to have produced essentially similar outcomes. Contrary to the lines from Robert Frost used above as an epigraph to this section, in the Canadian governmental forest it does not seem to have made much difference what road is taken. All roads may not lead to Rome, but they do seem to have led, albeit sometimes after a short wander in the wilderness, to realism and generally prudent fiscal behaviour. The extent to which this conclusion may be generalised beyond the Canadian case, however, is by no means obvious.

Indeed, it may be that if Canada has any lesson in this respect it is that what matters most may be not the method by which "hardness" is sought but the setting (or, if one will, "culture") within which it is sought. Canada, it should perhaps be recalled, was founded as a country dedicated not to "life, liberty, and the pursuit of happiness" but rather to "peace and good government."[40] The symbolic image of Canada's frontier past is not the cowboy wild and free, but the mounted policeman bringing order. Even on a personal level, Canadians – at least outside of Quebec– have sometimes been characterised as people who will stand at an empty intersection on a cold winter's day waiting for the light to turn green before they venture to cross the road.[41] More directly related to our present topic, as we note in Section III, Canadian local governments do not even use the borrowing room they have, and appear to pride themselves on their restraint. In the circumstances, although no doubt the point can easily be overdone, almost any set of rules (or non-rules) might, in the end, have produced an acceptable outcome in Canada.

In any event, Canadian experience suggests that a complete analysis of government behaviour should take into account not only the political and market forces usually discussed as factors shaping the outcome of decentralization but also the important role that may be played in some circumstances by what are essentially social norms and conventions about appropriate behavior, themselves largely shaped by perceptions of shared historical experience. Specifically, what seems needed are not simply well-developed markets that in effect deliver strong and generally accurate signals to governments about the sustainability of their fiscal behaviour but also a political system that, admittedly with lags, responds to these signals and, over time, adjusts its behaviour accordingly. McCarten (1999) plausibly argues that for a capital-market-imposed hard budget constraint to work four conditions are essential: (1) borrowers should not have access

[40] The first quoted phrase of course comes from the American Declaration of Independence; the second phrase comes from a key section of Canada's 1867 Constitution.

[41] That this statement, to the extent it conveys a truth, is much more applicable outside of Quebec is an interesting comment on the reality of the "deux nations" nature of Canada.

to any "pooling"; (2) lenders should have full information on borrowers; (3) there should be a credible "no-bailout" rule; and (4) borrowers should respond to signals. Essentially the story we have told with respect to Canada is that while neither rule (1) nor – formally --rule (3) apply with respect to either level of government, rules (2) and (4) very much apply. And they seem to do the job.

Democracy *plus* markets, at least in a cold climate, thus works to overcome a number of institutional features that on their face might seem conducive to flagrant fiscal misbehaviour by provincial governments. In Canada's constitutional and political situation, budget rules, whether self-imposed (some provinces) or imposed from above (municipalities), can be effective only through the working of the same forces -- and if those forces work, it is not clear that much is gained by legislating such rules. In terms of the framework set out earlier in this book, although subject to no hierarchial constraints, and although many elements of the institutional structure – such as majority-rule strong provincial parties independent of federal parties and the partial underwriting of provincial revenues by the federal government through the equalization and stabilization agreements – also seem conducive to a soft budget constraint, in fact Canadian provinces have generally acted as though subject to the right economic incentives at the margin.[42] Three reasons seem to underlie this result. First, despite the words quoted earlier from a federal Minister of Finance fifty years ago, it seems to be accepted that there will be no federal bail-out. Second, credit markets clearly exert effective discipline on Canadian public sector borrowers. And third, generally prudent fiscal behavior has become an institutionalised norm in Canada, in part because fiscal profligacy, while hardly unknown in

[42] Rodden (1999) presents an interesting empirical study that does not seem to support this conclusion, perhaps in part because of the data period used. The more detailed study in Kneebone and McKenzie (1999) is consistent with the arguments here.

election years (Kneebone and McKenzie, 1999), has not proven an effective long-run electoral strategy.

On the other hand, municipalities are subject to formally hard hierarchial budget constraints, in part because the institutional incentives to behave well are less strong. Although local governments are also subject to credit market discipline, creditors can reasonably expect to be bailed out by the province. Local citizens may have to bear the cost of such bail-outs but the non-partisan weak mayor systems general in Canada mean that local institutional incentives to behave are weaker than at the provincial level. While, as suggested earlier, the generally prudent behaviour – "borrowing in a cold climate" – of Canadian municipalities is striking, at some level since provincial control of municipal action means that the province is ultimately responsible, these hierarchical constraints are somewhat offset. All in all, it seems that the very different approaches followed in the "two worlds" of Canadian public end up at a rather similar destination.

Some Possible New Problems?

While similar factors clearly affect the federal government also, it may well be that, as Shah (1997) argues, in the end it is the relative softness of the budget constraint at the *federal* level that really lies at the root of any problems the subnational finance system in Canada may have. The federal government's ability to run deficits for over two decades after revenues turned down in the early 1970s (Bird, Perry, and Wilson, 1998) in effect financed undue provincial (and, indirectly, local) expansion over this period. It was not until the federal government finally began to cut back on provincial support, starting in the mid-1980s, that provincial deficits began to rise, and, once they did, the provinces on the whole acted more quickly to bring their budgets back into control than had the federal government. No government can run deficits forever, but the federal government can clearly do so longer than the provinces. In the end, however, the day of reckoning always comes, and, so far at least, Canada's political system has proved sufficiently resilient to meet the bill.

At the present time, however, virtually every government in Canada is either in surplus or close to balance, so the real question now is whether Canadian governments at all levels – though especially the federal level -- will prove any better at managing surpluses than they were in the past. At least two aspects of surpluses appear to deserve consideration in the context of hard budgets. The first is perhaps peculiar to Canada: whatever the federal government does must be seen in the context of the federal-provincial system. If Canada is to have a future, it needs to maintain not only a sustainable economic balance but also a sustainable political equilibrium. The best way in principle to achieve the latter may be neither to cut federal taxes nor federal debt but rather, as in the heyday of the expansionary 1960s, to raise *provincial* expenditures and hence at least potentially to cut provincial taxes and provincial debts. Unfortunately, no one ever won a federal election by solving provincial problems -- or, of course, vice versa -- so it seems unlikely that anything very sensible will be done in the near future to work out these matters in a truly national context.

The second point is more general. In principle, both taxes and expenditures at all levels of government should presumably be set to maximise social welfare. If fiscal policy is optimal in this sense, the result may be large or small fiscal surpluses in the short run (for tax smoothing or cyclical purposes) or even in the long run (for example, to finance intergenerational transfers). If a surplus arose in such circumstances, however, a rational government would presumably not first consider how to "spend" it, whether by expanding expenditure or by lowering taxes. Instead, attention should presumably first be focused on the very different question of how to "save" it -- for example, by retiring debt or, more daringly, by perhaps acquiring higher-yielding foreign or domestic assets. Careful consideration of the optimal portfolio would thus appear to be an essential ingredient in any strategy of how to deal with the fiscal surplus. Although of course the emerging fiscal surplus at the federal (and to a lesser extent the provincial) level is not optimal in this sense, it is nonetheless surprising that, despite the intensive discussion of this question in the early 1990s when debt ratios were rising precipitately (Harris, 1993), no government in Canada appears to be thinking along these lines.

Contrary to what some have argued (Buchanan and Wagner, 1977), democratic governments, at least in Canada, appears better able to manage deficits -- largely, we suggest, because markets make them do so -- than they are to manage surpluses. This is by no means a minor problem, since mismanaged surpluses build up problems, for instance through the creation of unsustainable expenditure programs, when times turn bad. Hard budget constraints, it may be suggested, should thus cut both ways, restraining governments in good times as in bad. As we have argued, the fiscal perils of decentralization, to the extent they become reality, have, at least in the case of Canada generated market and political reactions that led to the correction of the initial errors.[43] Unfortunately, entry into the paradise of surpluses does not similarly set up countervailing forces, and errors seem more likely to be made.

All is not roses even in deficit-land, however, largely because of the inappropriate entanglement of provincial and, in the case of Ontario, even municipal governments in the cyclically-sensitive issue of poverty relief.[44] Although federal assumption of primary responsibility for unemployment insurance and old age

[43] A somewhat similar point is made more generally by Haggard, 1999.

[44] All serious analyses of provincial-municipal finances in Ontario have concluded that the full financial

pensions (including the parallel federal-provincial Canada and Quebec Pension Plans) means that a repetition of the 1930s "relief" crisis is unlikely, provinces are still somewhat vulnerable both because their revenues are cyclically sensitive (Devereux, 1993) and because they continue to have primary responsibility for other social assistance.

As mentioned earlier, the effects on the revenue side are somewhat muted through the pooling that in effect takes place through the equalization and stabilization agreements. Until 1996, similar risk-sharing occurred on the expenditure side through the Canada Assistance Plan -- broadly, an open-ended conditional grant under which the federal government paid 50 percent of provincial social assistance costs. Under the new CHST system, however, this link between provincial social expenditures and federal transfers has been severed, thus increasing the cyclical fiscal risk faced by provinces. Canada's federal-provincial transfer system commendably clearly puts the *marginal* impact of expenditure and (to a lesser extent) revenue decisions on provincial shoulders, thus largely obviating the problems some appear to consider inherent with large transfer programs.[45] There is simply no evidence in Canada, for example, to support the common suggestion (Rodden, 1999) that the more "transfer-dependent" provinces are, for that reason alone, more prone to behave badly –indeed, since such provinces are more likely to be economically vulnerable, the evidence is, on the contrary, that they are less likely to run up large debts for long periods of

responsibility for social assistance should be placed at the provincial level: see for example, Ontario Ministry of Community and Social Services, 1988. Nonetheless, the most recent reallocation of functions and finances continues, inappropriately, to place significant fiscal responsibility for these cyclically sensitive outlays on the decidedly non-sensitive local tax base (Slack, 1997).

[45] Contrary to McKinnon (1997), we would argue that the "Wicksellian connection" (Breton, 1996) remains largely intact at the margin for provincial governments and since decisions are made at the margin, that is what matters. (Incidentally, we decidedly do not agree with the sweeping assertion of Dillinger, Perry, and Webb, 1999, that when it comes to transfer programs "marginal" can be considered equal to "average" -- at least not in the case of Canada.)

time (Kneebone and McKenzie, 1999).

V. Conclusion

To sum up the principal lessons we derive from this brief examination of Canadian experience, there are essentially no administrative or formal political constraints on budgetary behaviour at the provincial level. While the obvious potential for soft budget constraints has certainly been tested, in Canada as in most democracies, by the growth of contingent liabilities (Alexander and Emes, 1998), the other two main channels through which undue "softness" may manifest itself -- non-delivery of services and accrual of unsustainable capital market liabilities -- have, to the extent they occurred, quickly engendered political and market forces leading to their correction. In effect, through the combination of the electoral process and strong markets, there is a moderately strong ex post Wicksellian linkage between revenues and expenditures at the provincial level in Canada.[46] This linkage is of course much stronger at the local level, where it is essentially imposed ex ante by provincial fiat. Nonetheless, experience suggests that despite these controls -- or perhaps to some extent because of them? -- the ills usually attributed to unduly soft budget constraints

[46] Although we have not spelled out the role of land markets in this paper, even a cursory view of Canadian fiscal history (Perry, 1955; Gillespie, 1991) demonstrates clearly the extreme sensitivity of Canadians -- and hence of Canadian politicians at all levels -- to changing land and natural resource prices. Contrary to U.S. experience (Inman, 1999) the major consequences have tended to be not on location within metropolitan areas – although there have clearly been some such effects, they have been considerably muted by the overriding role of the provinces in shaping municipal finances (Bird and Slack, 1993) – but rather at the provincial level owing to the great importance of natural resource revenues in provincial finances. It is this factor, for example, which lies behind the earlier reference to Alberta’s outlier status in Canada as well as behind the characteristic Canadian obsession with the effects of fiscal differentials on interprovincial migration (Day and Winer, 1991; Boadway and Flatters, 1992). But further development of these points would demand another paper.

seem if anything more likely to manifest themselves at the local level, with the likely remedy being even stronger ex post provincial rules. In the end, however, history plus democracy plus markets seems on the whole to have kept Canada's subnational governments, different though their paths may have been, more clearly on the path of fiscal prudence than the federal government.

In terms of the mechanisms discussed in the opening chapters of this book, Canadian provinces are fundamentally politically and administratively independent of the federal government but have fairly clear responsibilities and, on the whole, despite the fact that some of them are fairly transfer-dependent, face sensible marginal incentives in part because there are no provincial interests represented in the federal legislature and little room for log-rolling. Canadian municipalities, on the other hand, are fundamentally dependent on provincial governments and, although their responsibilities too are fairly well-defined, they are much more transfer-dependent and, on the whole, face less sensible incentives at the margin – a situation which is countered to a large extent by the imposition of fairly strict hierarchical controls on their activities. The softness inherent in some aspects of the federal-provincial system – notably the importance of unconditional and equalization transfers – is largely vitiated by the interaction of capital market discipline with political institutions which makes it difficult for provinces to shift either costs or deficits upwards. The softness inherent in municipal dependence on the provinces is, on the other hand, largely offset by administrative controls. Coupled with the lessons of history inculcating generally prudent fiscal behavior at both levels of government, each of these very different systems seems to have worked fairly well, at least so far, in constraining subnational fiscal behaviour in Canada.

Chart 1
Tax Revenue as % of GDP: By Level of Government
1948 - 1996

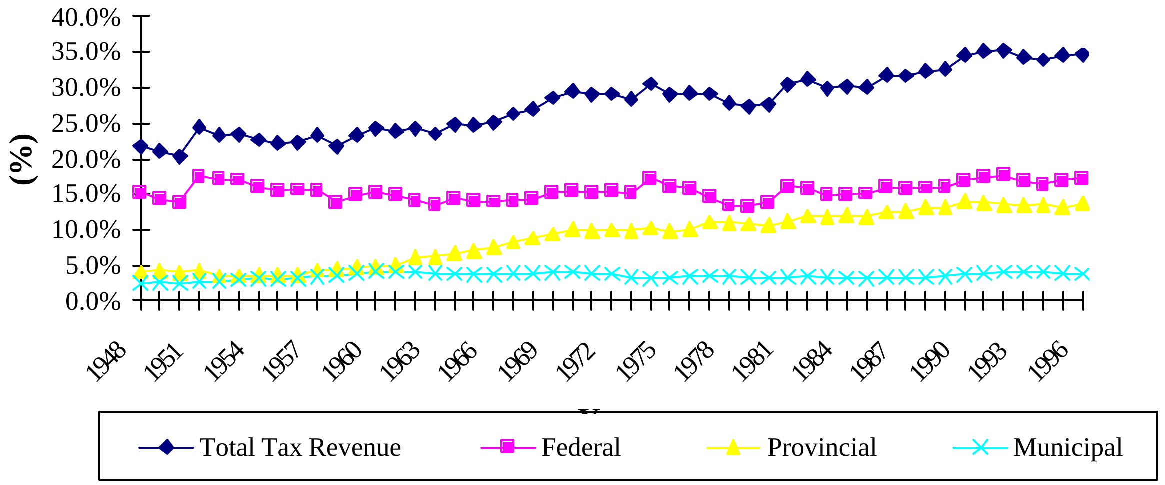


Chart 2
Federal Transfers to Provinces, 1948 -1996

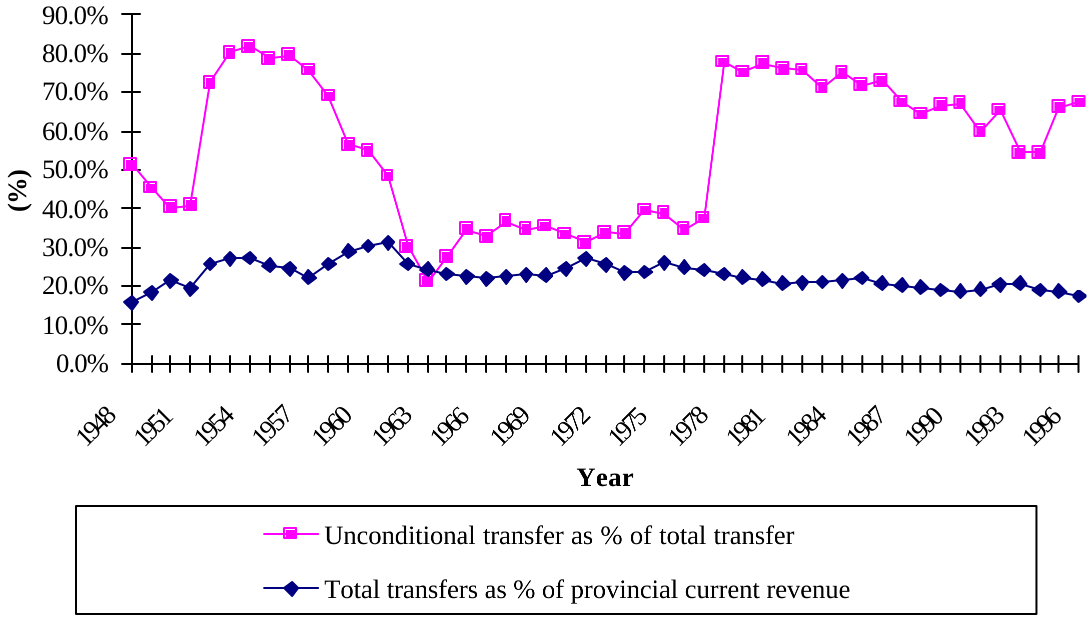


Chart 3
Provincial Transfers to Municipalities, 1948 -1996

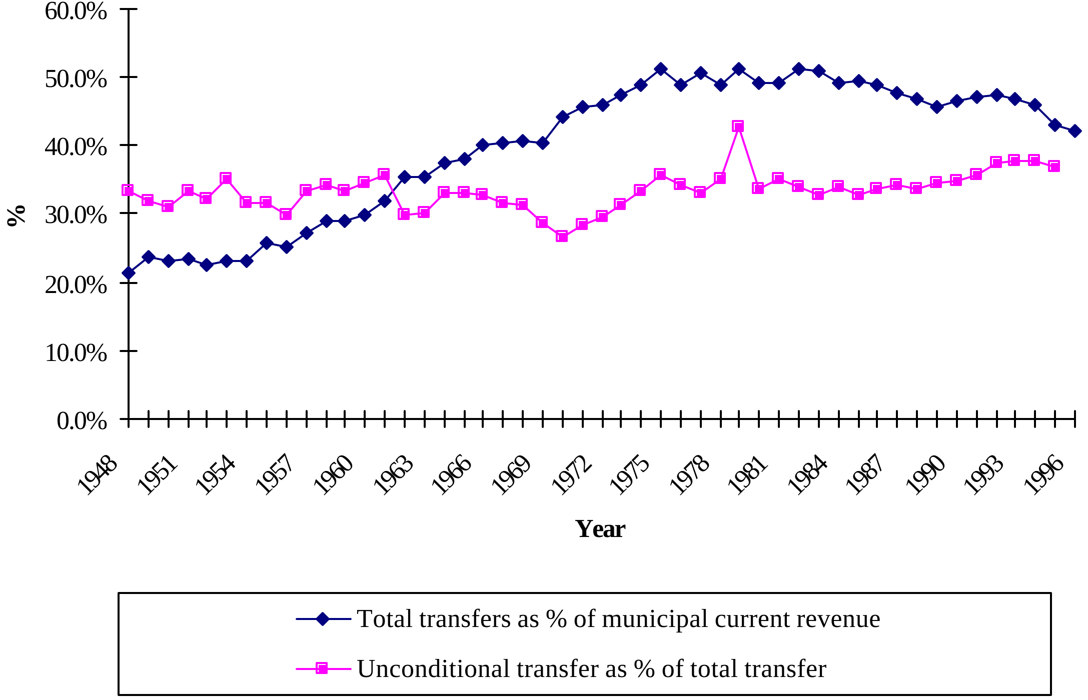


Chart 4
Net Debt as % of GDP: By Level of Government
1977 - 1995

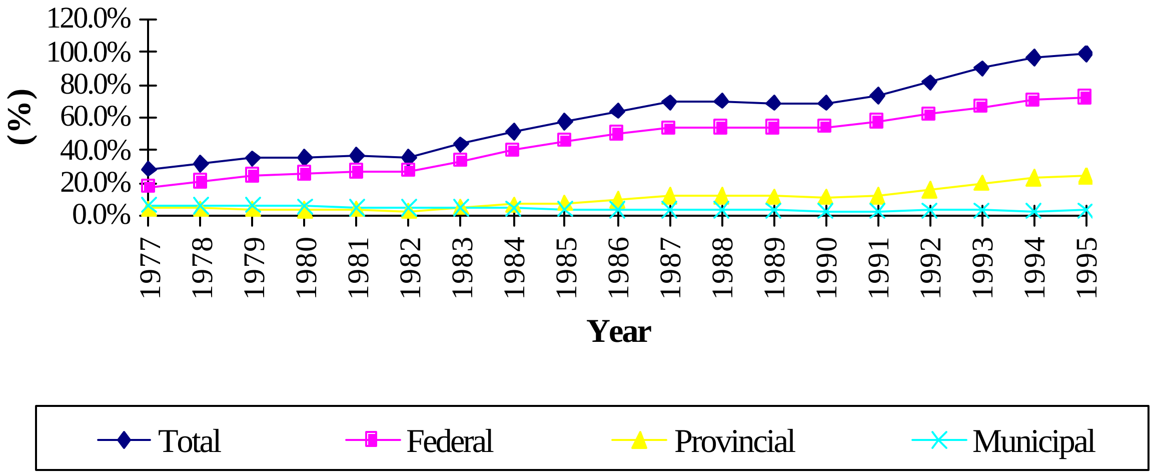
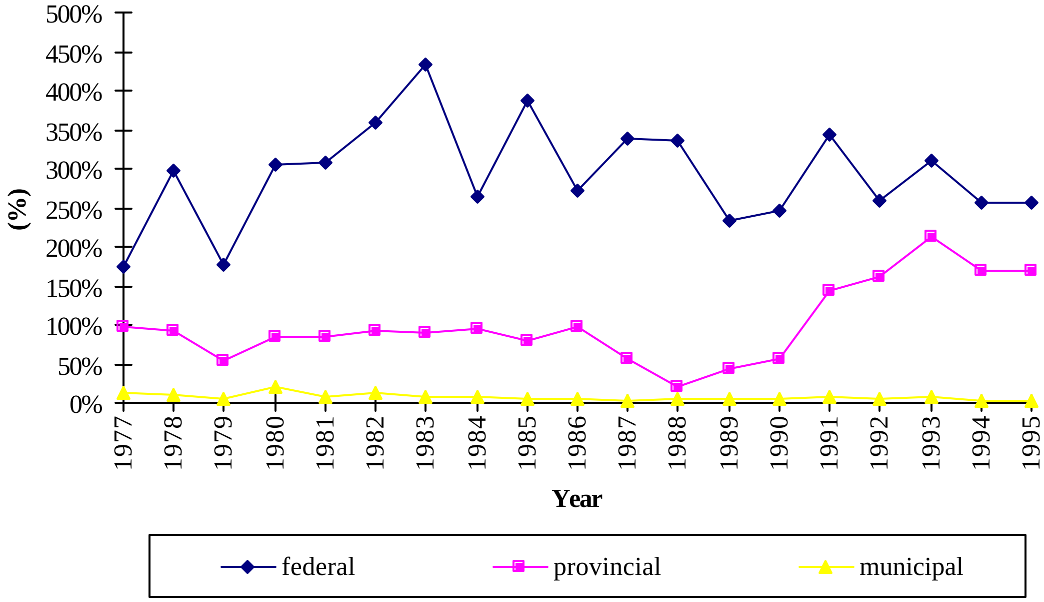


Chart 5
Government Borrowing as % of Government Capital Expenditure: By Level of Government, 1977 - 1995



Annex 1 - Fiscal Equalization

Fiscal equalization is mandated by Section 36 (2) of the Canadian Constitution, which states that "Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." Although this provision was added to the Constitution in 1982, an equalization program has actually been in place since 1957, when it was introduced as part of a realignment of taxing powers following the extreme centralization that had evolved during the war years.

In 1967 the equalization system took what is essentially its present form with the adoption of the so-called "representative tax system" (RTS) approach - an approach originally developed by the U.S. Advisory Commission on Intergovernmental Relations but not in fact used in that country. Under the RTS approach, the fiscal capacity of each province is calculated each year (by the federal Department of Finance) as the difference between the sum of its per capita fiscal capacity for each separate revenue source and a standard capacity measure based on the average per capita fiscal capacity of the "middle" five provinces (excluding oil-rich Alberta and the four small and poor eastern provinces). The system works as follows:

[1] Define and quantify all revenues with respect to which capacity is to be measured. At present there are over 30 separate revenue sources for which this calculation is made.

[2] Define a tax base for each revenue source which reflects the tax base typically used in practice. In some instances, as with the personal income tax, where the base is essentially uniform across the country, this task is simple. In others, as with respect to property taxes, it may be very difficult to define and calculate a credibly comparable tax base.

[3] Calculate a notional "national average tax rate" for each revenue source as the ratio of actual taxes collected by all provinces for the total standardized tax base.

[4] Apply this average tax rate for each source to the standardized base for each province to estimate that province's capacity for that source.

[5] Add up all the separate calculations to derive an estimate of total revenue capacity for each province.

[6] Divide this total estimate by the population of the province to obtain per capita revenue capacity.

[7] Compare these capacity estimates with the five-province standard mentioned above. If a province's per capita capacity is below the standard, it receives an equalization payment sufficient to

bring it up to that standard - which, on average, means to over 90 percent of the national average per capita capacity.

Four important aspects of this equalization system deserve emphasis.
First, no attempt is made to measure differences in expenditure needs. This has been considered several times but has been rejected largely on the grounds that the data required to measure such differences are not very reliable.

Second, although provinces below "standard" capacity receive equalization transfers, provinces with above-standard capacity are not penalized: equalization is paid entirely from federal revenues.

Third, in principle the total amount paid is determined by the calculations described above. In practice, however, total equalization entitlements are limited to 1.2 percent of GDP, and this limit has on several occasions resulted in a scaled reduction in the equalization payments generated by the formula.

Finally, while Canada's extensive experience with this system is generally considered a success and seems to be well accepted by most relevant actors in the political process, substantial technical criticisms have been made of various aspects of the system and it is not impossible that various changes may be made in the future - for example, to incorporate expenditure needs, to move from the RTS to some other basis of capacity calculation, to include other federal transfers in the sources for which equalization is calculated, or to reduce the extent to which the system biases provincial tax policy choices
.

Annex 2 - Federal-Provincial Stabilization Agreement

Since 1957, a formal stabilization provision has constituted an integral part of federal-provincial fiscal arrangements in Canada (Perry, 1997). The present system dates from 1967, when the RTS equalization system (Annex 1) was introduced. Essentially, the legislation provided that any province whose revenues (from the sources equalized under the formula, and at the previous year's rates) fell below the previous year's revenues would receive a compensating stabilization payment. Although various changes were made in this provision over the years, notably to limit payments with respect to declines in natural resource revenues, it was not until 1987 that any province actually claimed a payment.

In that year, Alberta claimed $539 million to compensate it for the sharp decline in its natural resource revenues. After some dispute about the amount, this claim was finally settled in 1991. With the recession in the early 1990s, a number of other claims were filed (for example, by Ontario) and by 1995, the federal government had paid out another $1.2 billion in stabilization payments. Perhaps unsurprisingly, as part of its new tighter fiscal policy in 1995 the federal government announced that henceforth it would make such payments only when provincial revenues fell below 95 percent of the previous year's revenue -- a limit that had earlier been in force during the 1967-72 period.

The main argument for the stabilization arrangement made by the federal government is essentially one of fairness -- to provide a cushion for the provinces that do not receive equalization (such as Alberta and Ontario) that is roughly comparable to that inherent in the equalization formula for recipient provinces, whose equalization payments automatically increase under the formula if their revenues decline relative to the average. As Perry (1997, p. 171-72) notes, however, the stabilization agreement, by putting a floor under provincial revenues, in effect provides a "letter of comfort" to prospective creditors by signalling an underlying federal guarantee of provincial debt-servicing capacity.

Annex 3 - Provincial Budget Rules

Since 1993, several provinces have enacted some form of "budget rule" (Millar, 1997). Alberta led the way with a 1993 law requiring the elimination of the deficit by 1997, followed in 1995 with another law requiring balanced budgets and the elimination of the provincial net debt over the next 15 years. Manitoba similarly legislated balanced budgets in 1995, with the unusual provision that the salaries of cabinet members would be reduced if this commitment was not kept. Completing the sweep of the Prairie Provinces, Saskatchewan in the same year passed a somewhat milder Balanced Budget Act which required a four-year balanced fiscal plan.

On the east coast, New Brunswick since 1993 has had the stated "objective" of balancing its operating budget, while Nova Scotia in 1994 established expenditure reduction targets and then in 1996 required budget appropriations not to exceed forecasted revenues and actual expenditures not to exceed appropriations by more than one per cent for any year. Finally, Quebec legislated deficit reduction targets for the 1996-99 period, with the budget to be balanced thereafter.

Four observations may be made about these laws. First, they clearly represent one component in the adjustment process discussed in the text. That is, these budget rules are perhaps better seen as symptoms of (or a response to) changing public preferences rather than as independent factors in themselves. Second, this interpretation is supported by the evidence that the adoption of such rules did not noticeably affect budgetary behavior (Millar, 1997). Third, these rules are, by the standards found in other jurisdictions -- such as New Zealand and the United States -- quite mild. Some of them refer to "plans", "objectives", and "forecasts." Others have multi-year targets. Apart from Manitoba, none really have any penalties for breaches. Moreover, all the provincial budget rules make ample provision for "contingencies" and "unforeseen circumstances" to soften their application. Finally, and in many ways most importantly, these laws are simply laws and can be altered and abolished at any time. This last point is important. Canadian provinces do not have constitutions. No provincial legislature can formally bind any future provincial legislature. Budget rules such as those described above thus at most reflect either the ideology of the party in power or a response to perceived public pressure. The government that passes such rules may to some extent feel morally or politically bound by them, but no successor government is likely to be similarly constrained.

Annex 4 - Ontario Muncipal Structure

Ontario's 10 million people live in over 540 municipalities, which vary significantly in population, responsibilities, administrative resources and ability to raise revenue. The large number of small, sparsely populated municipalities contrast sharply with a few very large municipalities, with the vast majority of the population concentrated in the area surrounding Metro Toronto. Almost 75 per cent of all lower-tier (local) municipalities in Ontario have fewer than 5,000 people and only 2 per cent have populations of more than 100,000. Differences in resource endowments, access to transportation and markets and balanced development versus single industry dependence are reflected in a variety of different municipal structures to deliver services of a "local nature" as well as those mandated by the provincial government. For example, in Northern Ontario, with the exception of Sudbury, single-tier municipalities provide local services. Across southern Ontario, two levels exist with the exception of some 23 "separated cities and towns" which are not part of any upper-tier municipal structure. Rural areas in the south are organized in the county system while urban areas are organized in the regional system.

The two-tier structure used to reorganize the municipalities in Metro Toronto in 1954 became the model for the reorganization of municipalities elsewhere during the 1970s. The reorganization was a response to pressures to create entities fiscally strong enough to finance the infrastructure costs associated with rapid urban growth and large enough to enable services to be planned effectively and delivered efficiently. Regions, counties and (until recently) Metropolitan Toronto are termed upper-tier governments while their constituent municipalities are generally known as lower-tier or area municipalities. Not all upper-tier municipalities have the same powers. Regional councils have considerable authority in such areas as policing, health services, social services, solid waste disposal, capital borrowing, and sewer and water treatment. Lower-tier municipalities tend to have responsibility for fire protection, recreation, municipal hydro services, public transit, tax collection, libraries and licensing. Both levels share responsibility for such services as roads, planning, sewer and water services, and economic development.

The county structure has existed in Ontario since 1849. The powers potentially available to county governments are more limited than those of regions; and the powers that counties normally exercise are even more limited. County councils have responsibility for county roads, homes for the aged, and welfare. Counties also have authority to provide policing, public utilities, parking, sewer and water services and transit (although no county does). In some counties, some welfare is administered by lower-tier municipalities.

Other agencies and boards provide certain local services and draw upon the local tax base for partial funding. In addition to school boards, of which there are now 168, such agencies include Childrens' Aid Societies, District Social Service and Homes for the Aged Boards in the North, and Conservation Authorities in southern Ontario.

In many ways, perhaps the most salient fact about local government structure in Ontario is that all relevant aspects of it are decided, virtually unilaterally, by the provincial government. The recent imposition of a so-called "megacity" (unified) structure in the Metropolitan Toronto Area provides a clear instance. The change reflected more the vagaries of provincial politics than any considered economic or political restructuring of the metropolitan area. Indeed, prior to the imposition of the unified structure two careful and detailed studies had recommended not the abolition of the lower-tier governments within Metropolitan Toronto but rather the elimination of Metropolitan Toronto (and the surrounding regional governments) and the creation of a new "Greater Toronto Authority" which would play much the same role in relation to the continuing municipal governments in an expanded territory as the Metropolitan government had originally played in its narrower geographical territory (Slack, 1995). In Canada, what the province wants with respect to local government the province gets, whether the issue be boundary adjustments, expenditure functions, revenue authority, or borrowing limitations.

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