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Draft

Canadian Subnational Governments: The Challenge of Globalization and Patterns of Response, Transformation or Persistence

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July 2003

Prepared for the Seminar on
Federalism in a Globalising World:
How Can States Contribute to a Competitive Environment?

New Delhi, India

Forum of Federations
and
National Institute of Public Finance and Policy

Canadian Subnational Governments: The Challenge of Globalization and Patterns of Response, Transformation or Persistence [1]

Introduction

This paper provides an overview of the challenge faced by Canadian subnational governments in responding to the pressures of globalization and the competition for the sources of economic growth. Recent analyses of the economic factors that contribute to competitive city-regions is reviewed. A conceptual framework to characterize the relationships between centres and margins as decision-makers is outlined and applied to intergovernmental governance and taxing arrangements. The Canadian perception of fiscal competition in the existing Canadian tax fields is summarized as is the capacity of local governments to respond to the prevailing environment.

Section I
A Context of Challenge

Canadian subnational governments have never been bereft of challenges or opportunities. In the Canadian context of two levels of subnational governments, provincial governments have considerable authority to react to challenges and changing environments. This is in contrast to the local government level. Despite being the level of government charged primarily with service provision, with limited access to fields of taxation and subject to a hierarchical relationship with senior levels of government, municipalities[2] in Canada have and are expected to respond to uncertainties in both the political and economic environment. This response has and will take place in a context of globalization of factor flows and the reduction of barriers to trade. [3] Further, while local governments in Canada may compete in a Tiebout sense within and across provincial boundaries, there is a growing concern that the real competition to attract and retain the economic activity deemed to be desirable is again (as it always has been) with international jurisdictions. There is also a related concern that the ability to respond in a dynamic fashion is impaired by a limited set of fiscal instruments.

Urbanization and the Macroeconomic Context

A recent set of reports by the TD Bank (TD Economics 2002 and 2003) have set out the principal economic characteristics of the Canadian context. Canadian population and economic activity is highly urbanized. Twenty-seven Census metropolitan areas (CMAs) as defined by Statistics Canada as urban areas possessing a minimum of 100,000 inhabitants now account for approximately two-thirds of the nation's total population, employment and real output. In 2001, according to the most recent census, this population is concentrated in the seven largest CMAs, Toronto, Montreal, Vancouver, Ottawa-Hull,

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[1] This paper has been prepared for a Workshop sponsored by the Forum of Federations and the National Institute of Public Finance of the Republic of India. I would like to acknowledge the assistance of Richard Bird, Enid Slack, Mel McMillan, Pierre-Pascal Gendron, Herb Emery, Wade Locke, Michael Smart, James Milway and Paul Boothe for helpful comments and for sharing materials used in this paper. Cindy Ryder assisted with tables. The views in this paper do not reflect the official position of the Ontario Ministry of Finance and are the sole responsibility of the author.

[2] In this paper, the term local government and municipality is used interchangeably.

[3] See Stiglitz (2002), O'Rourke and Williamson (1999), and Taylor (2003) for discussions of historical and current features of globalization, including the timing and impact of factor flows and financial crises.

Calgary, Edmonton and Winnipeg and accounted for 45% of Canada's total population. (See Table 1.)

The urbanization of Canadian population has been a continuous feature of Canadian economic development in the twentieth century. By 1921, more than 50 percent of Canadian population lived in urban areas (population greater than 10,000); by 1971, more than 50 % of the population lived in metropolitan areas with populations greater than 100,000. By the 2001 census, over 80 percent of the population lived in urban areas greater than 10,000 and more than 68% of the population in metropolitan areas.[4]

The Greater Toronto Area Task Force recently summarized the pressures created by urban sprawl on the costs of maintaining and providing infrastructure for all of the services provided by municipalities in the GTA. It has been estimated that more compact forms of development would save about 22% of the estimated $55 million necessary for investments in roads, water and sewer services. Furthermore, the other municipal services that visibly enhance the quality of life are also in need of funds.[5]

Competitiveness and Globalization

The authors of the TD reports suggest that there is a strong link between the increased rate in the urbanization of Canadian population and economic activity. The adoption of the Canada-U.S. Free trade Agreement (FTA) in 1989 and the North American Free Trade Agreement (NAFTA) in 1994 and a favourable exchange rate regime resulted in a significant restructuring and reorientation of Canadian trading patterns and significant growth in the urban economies close to the U. S. Border. The structural adjustment in Ontario has also been assisted by a favourable provincial tax climate. The ratio of Canadian international exports to interprovincial exports which was approximately 1:1 in the 1980's is now 2:1.[6]

While borders matter, it is indicative that the competitiveness of Ontario's urban areas is being measured by reference to a set of competing urban areas in the United States by Ontario's Institute for Competitiveness and Prosperity (ICP) [7]. The Institute measures prosperity in terms of estimates of GDP per capita. Having estimated a strong relationship between personal income and GDP per capita at the state and provincial level, the results are used to adjust personal income per capita by CMAs (Canada) and by Metropolitan Statistical Areas(MSAs) (US) as GDP data at the local level is unavailable.

The ICP's most recently released study[8] suggests that GDP per capita is 46% higher in metro areas than in non-metro areas of the jurisdictions in the "peer group". The median GDP per capita is $42,713 (in 2000) with a variance between the metro areas at $45,033 versus $30,833 in non-metro areas. The study points out the significant difference in

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[4] Bourne (2003) p.1
[5] GTA Task Force as cited in Bird and Slack (2002) p. 22.
[6] TD Economics (2002), p. 6.
[7] The Institute was established by the Premier in 2001 with a mandate to measure and monitor Ontario's competitiveness, productivity and economic progress compared to other provinces and U. S. states and to report to the public on a regular basis.

[8] This is summarized from Institute for Prosperity and Competitiveness (2003). The peer group consists of the provinces of Ontario and Quebec and the states of California, Florida, Georgia, Illinois, Indiana, Massachusetts, Michigan, New Jersey, New York, Ohio, Pennsylvania, Texas and Virginia.

productivity between the metro and non- metro (urban and non-urban) areas. It also points out that Ontario is near the bottom in the ranking of the peer group's urban GDP per capita (12.8 % below the average) while by contrast 3.0 % above the comparable average for non-metro areas. The Institute concludes that Ontario city-regions are under-performing relative to the competition in terms of 'urban prosperity" and significant productivity improvements will need to take place to close the prosperity gap.

In their view, the key determinants of prosperity (GDP per capita) are "Profile" (the potential labour force); Utilization (jobs as a proportion of the labour force); Intensity, (hours worked) and Productivity, (GDP related to hours worked) . The last factor is significantly affected by cluster mix, cluster content, urbanization and effectiveness.[9] Overall, the significant difference between Ontario's urban areas and those of the peer group in per capita GDP is due to a "productivity gap". Having ascertained that the mix of industry clustersand the content of the clusters is positive, the reasons for the gap are due to a somewhat weaker level of educational attainment in the labour force (about 21% of the deficit and a combined weakness in the interaction between urbanization and effectiveness defined as the ability to convert natural, physical and human resources into goods and services.[10]

The challenge to improvements in urban productivity is defined in terms of educational attainment, under-investment in physical capital and in structural adjustments in governance and fiscal arrangements. These findings are not about dismantling internal barriers to trade but rather responding to the challenge of attracting and retaining the appropriate factors of production that will reinforce the competitiveness of the existing cluster configurations especially in the context of the knowledge-based economy.

Structure of the Economy

The key challenge for local governments will be to implement measures that encourage the development and enhancement of agglomeration economies. Despite the costliness of city locations, recent work by Strange suggests that the benefits of labour market pooling, input sharing, knowledge spillovers, and risk minimization (in terms of alternative uses for sunk capital), consumption opportunities and information sharing tend to overcome the disincentives of urban location. (Congestion, rental costs, etc.) His empirical estimates based on geographic coefficients also suggest that an "entrepreneurial business environment is more productive than a hierarchical one".[11] Access to information networks are critical to enable such an environment.

While Strange's work shows higher localization coefficients for small and non-subsidiary firms and is rooted in classical concepts dating back to von Thunen rings, other studies have focussed their attention on human capital and social capital as being crucial to future competitive success.

[9] The concept of clusters is based on Michael Porter's work who defines clusters as a "geographically proximate group of interconnected companies and associated institutions in a particular field, linked by commonalities and complementarities. This includes concentrations of interconnected companies, service providers, suppliers of specialized inputs to the production process, customers, manufacturers of related products and government and other institutions. Wolfe (2001) p. 16.
[10] Institute for Prosperity and Competitiveness (2003), p. 21.
[11] Strange (2003) p.11. See the discussion below of entrepreneurial versus hierarchical behaviour.

In order to analyze further the role of human capital in the competitive process, the ICP commissioned a study based on the insights of Richard Florida.[12] The authors of the study identify four key variables:

> **Talent Index-** Talent is defined as the proportion of the population over 18 years of age with a bachelor's degree or higher.
>
> **Bohemian Index-** The Bohemian Index is defined using employment in artistic and creative occupations. It is a location quotient that compares the region's share of the nation's bohemians to the region's share of the nation's population.
>
> **Mosaic Index**- The Mosaic Index is the Canadian counterpart of Florida's 'Melting Pot Index'. Both are calculated as the proportion of the total population that is foreign-born.
>
> **Tech-Pole Index**- The Index compares a region's share of national employment in high-technology industries to the region's overall share of national employment; this is then adjusted for city-size by multiplying by a region's share of national high-technology employment. Therefore, it reflects both the region's degree of specialization in technology-intensive activity as well as its sheer scale of employment in these sectors.

Table 2 summarizes the North American rankings derived by Gertler et al. Ontario city-regions rank low on the Talent index with the exception of Ottawa- Hull. The authors suggest that the consistently low performance relative to American counterparts reflects divergent economic structures. They note that: " especially in Ontario, manufacturing activity (in which even highly skilled workers may not have a bachelor's degree) remains a considerably more prominent source of employment than it does in many American city-regions. (In 2000, manufacturing employment of total employment in Ontario was 18.7% compared to the US average of 14.4% or the Canadian average of 15.3%)".[13]

Ontario metropolitan regions perform better on creativity and diversity measures. The authors suggest that cultural diversity provide a strong base on which to continue to build the urban economy but that the weakness in the talent index merits further investigation. In their conclusion, the policy challenge is to "strengthen urban character by encouraging higher-density growth, diverse mixed-use neighbourhoods and the preservation of neighbourhood character. Presumably, such policy would enhance the opportunities for creative interaction and act as a magnet for talent and likely assist in the continued development of the agglomeration economies cited by Strange.

David Wolfe has noted that "the current period of growth is thus characterized by a *paradoxical consequence of globalization* in which the ever greater integration of national and regional economies into the global one accentuates, rather than minimizes, the significance of the local context for innovative activities.[14]

McMillan (2003) is more sceptical. He has recently noted that: "While growing internationalization probably increases the competitive exposure of all municipalities

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[12] This is summarized for Gertler, Florida et al. (2002).
[13] Gertler et al. (2002), p. 21
[14] Wolfe (2001) p.4.

marginally, only a few major cities in the country are likely to find the competitive pressure markedly increased. Even then, the determinants of their international competitive positions are by far dominated by provincial and national policies. Still, internationalization adds some impetus to the need for effective and responsive local government."[15]

In the context of competitiveness, the literature on subnational tax competition in Canada has been largely confined to the provincial setting. (Bird, 2001; Mintz, 2001) There have however been recent proposals to replace property taxation on businesses by a variant on VAT. (Bird and Mintz 2001, Bird and McKenzie 2001, Kneebone and McKenzie, 2002)

The "Fiscal Squeeze"

Lastly, there is a nation-wide debate that has emerged over the "fiscal squeeze". Receptiveness to municipal concerns may have precipitated the departure of the former federal Minister of Finance to make clear his differences with the Prime Minister; the MBA graduating class at the Rotman School of Business at the University of Toronto organize a workshop day on competitiveness and municipalities and invite the Mayor of Winnipeg as a keynote speaker; two separate academic conferences at major institutes of public finance focus on local issues and governments establish task forces for the usual reasons.

While some indicators may suggest a national "crisis", the "squeeze" likely varies at the provincial-local level. Differing intergovernmental arrangements affect the debate as to whether a squeeze really exists, whether there is a "sustainability" crisis, or just fiscal imbalance, a long-standing feature of the federal-provincial-local fiscal landscape.[16]

Section 2
A Conceptual Framework : Patterns of Transformation and Persistence

The impact of global factor flows and the competitive response of governments has been a constant feature of Canadian economic history . During the nineteenth century, Montreal and later Toronto competed with American interests for the trade of the Great lakes region and subsequently for the profits to be made from the exploitation of the natural resources of northern Ontario and western Canada. The openness of the Canadian economy to international economic fluctuations precipitated crisis and changes to municipal fiscal structures and in the economy.[17]

In analyzing the patterns of metropolitan rivalry in an international economic context, W. T. Easterbrook developed a useful framework for conceptualizing the processes of institutional and entrepreneurial response to changes in the "uncertainty setting" for decision-making.[18] This framework consists of five principal elements. These are the institutional form of decision-making; the underlying conditions of the environment for

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[15] McMillan (2003), p.2.
[16] See Bird and Slack(1993) on fiscal imbalance, Bird (2002) on the futility of measuring fiscal flows, and Bird and Slack (2002) on sustainability.
[17] See Tassonyi (1994) and Bird and Tassonyi (2001) for descriptions of institutional response to crisis in the mid-nineteenth century and in the Great Depression.
[18] This description relies on Ian Parker's introduction to Easterbrook (1990).

decision-making; the characteristics of response to uncertainty; and the interaction between centres and margins.[19]

In this formulation, two ideal types of social-economic organization are defined: ‘Bureaucracy’ and ‘enterprise’. Bureaucracies are characteristically authoritarian and centralized with an emphasis on continuity and permanence; the enterprise form of organizational structure is characterized by a more competitive, decentralized pattern with a dispersion of economic power and a short-term focus on profit maximization.

Easterbrook noted that for the ‘enterprise’ form of institution to be widespread, four different types of security are necessary: entrepreneurial security, the preservation of market order; social security or the protection against want (distributive security); ethical security or the social sanctioning of enterprise and political security or internal and external defence. Conceptually, these pre-conditions are similar to those noted by Douglas North and extended in the literature on market-preserving federalism. (Weingast and North, Dick)

In setting out the various forms of “security”, Easterbrook’s work anticipates the recent rediscovery of the importance of social capital and the descriptions of the appropriate seed beds for germinating clusters of enterprise as a feature of globalization. The concept of social capital as summarized by Wolfe (2001) describes the “social organization of a region” including “the presence of shared norms and values that facilitate and coordination and cooperation among individuals, firms, and sectors for their mutual advantage”. Two contrasting views are to be found in the literature. In one view, based on European studies, the emphasis is on trust built up through a prolonged process of interaction, rooted in “folklore” or a founding myth. An alternate view is of trust “ built through dense interactions of firms engaged in interrelated economic activities that have developed a high level of trust in their mutual dealings.” (Wolfe, 2001. p. 12) In his view, the successful North American regional economies have developed relational capital grounded in the “collaborative networks of interacting firms driven by mutual self interests” with performance reputation and the recirculation of human resources being key to this performance.

Easterbrook broadly defines the concept of “entrepreneurship”, being the “investment of time, capital and energy in economically significant pursuits”. (Easterbrook, 1990, p.xx) This broad definition allows for the applicability of the framework to decision-making in a broad sense. In this paper, we propose to use the concept to describe governmental response to changing circumstances and challenges.

Decision-making takes place in a context defined as an “uncertainty-setting”. The ‘uncertainty-setting’ comprises the context of challenges faced by decision-makers and the effects of the decisions taken. Effects may be in the form of institutional change in the context of hierarchical relationships or in the specific response of other entrepreneurial entities.

Patterns of change and response are defined in terms of a centre-margin **(C/M)** theme. [20] Two patterns are discernable, persistence **(C→m)** and transformation**(C↔m).** In a

[19] This is summarized from Easterbrook (1990) p. xix-xxv.
[20] See the Postscript in Easterbrook (1990) p.247-249.

persistence pattern of relationships between the centre and the margin, the limits and the boundaries of action remain as in the initial phase (or security-zone). These limits may be economic or political in form. In the latter, or the transformation pattern, limits are transcended and processes take place with the result that the relationship between the two may change to one of equivalent interaction.

With respect to the issues to be discussed in this paper, many would characterize Canadian local governments as being caught in a persistence trap, in hierarchical intergovernmental arrangements, limited fiscal tools and weak decision-making structures. All of this in the context of an uncertainty setting of global competition for the human and financial resources necessary to maintain the ability to compete and to continue to secure the resources necessary to sustain levels of service and quality of life for their inhabitants sets the stage to assess the capacity of local government and the existing policy framework to respond.

> "The challenge to centralist doctrine and practice was to come only with the beginning of active centre-margin interaction in the middle decades of the present century. The testing ground has been that of provincial-federal relations, in an uncertainty- setting as unfavourable as that of the past." Easterbrook (1990, p.197)

Section 3

Themes

Governance

Intergovernmental relations and governance exhibit patterns characteristic of both transformation and persistence between the two levels of centre-margin relationships. Bird and Chen[21] usefully distinguish the nature of intergovernmental fiscal relations as between the concept of "federal finance" and "fiscal federalism". In the federal finance model, both levels of government are acting as principals with defined sets of authority to accomplish what may be similar goals such as distribution or stabilization. This in general leads to conflict resolution that requires processes of negotiation rather than legislative fiat. Given, the extent of decentralized powers over various fields of taxation and expenditure, the federal-provincial relationship can be characterized as a pattern of transformation, with the continuing possibility of change in the relative degree of power. By contrast, Bird and Chen point out that the provincial-municipal relationship fits the "fiscal federalism" concept wherein there is a principal-agent or centre-margin relationship. Within that relationship, the centre sets the rules and in view of this hierarchical pattern of authority, a persistence pattern exists. This fact may ultimately constrain the response of local governments to the challenges outline in the preceding section.

Canada has ten provinces, ranging from tiny Prince Edward Island with little more than 100,000 people to huge Ontario with around 10 million.[22] The Canadian system at the federal level appears to be very centralized and likely to be bureaucratic in response at first appearances. In the first place, Canada appears to be unique among federations in the

[21] Bird and Chen (1998).

[22] This section is summarized from Bird and Tassonyi (2002).

complete absence of any formal representation of provincial interests at the federal level (Watts, 1996).

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. This is centralizing by implication but limited by the realities of the federa-provincial division of powers.

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.

Policy issues with strong regional impacts sooner or later become 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 above -- or even politically-negotiated constraints -- on provincial budgets. Canada's provinces thus afford an extreme test of the viability of market-constrained decentralization. While the maintenance of political stability has the appearance of a persistence pattern, the reality is that centre-margin relations as between the provinces and federal government is more characterized by transformation in the sense that the relative positions of power are in continuous flux and there is significant decentralized authority over fiscal instruments.

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 which are highly dependent on such services as water supply, sewage treatment and transportation, it is not surprising that provincial politicians, despite some continuing rural bias in electoral constituencies, often act in ways that imply that there is a strong implicit provincial "guarantee" of the services nominally financed through local budgets. When municipal capacity to finance the capital and operating costs of these services is threatened, whether by the demands placed on the municipal fiscal system by competing expenditure pressures to fund income redistributive services, or by the inability of the existing political structure to cope with spillover effects among adjacent municipalities or simply by the lack of an adequate fiscal base, a policy response from the province has generally been forthcoming. Local governments can therefore in the end reasonably expect to be bailed out by the provinces whose agents they essentially are. But this assurance comes at the price of substantial provincial control over all aspects of local finance. The historical roots of this situation are clear.

Early Experience in the Provincial- Municipal Relationship

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 to tax, 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.[23]

Most early legislation was intended more to prevent abuse than either to support or control local actions. In Québec, 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.[24]

The Crisis of the 1930s

As the twentieth century unfolded, however, provincial legislative control over local governments became much more extensive, particularly after 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.[25] In Ontario, for instance, 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.[26]

The New Millennium

Currently the provincial-local relationship has been radically altered in Ontario and to a lesser extent in Quebec and Nova Scotia; in the latter, Montreal and Halifax have been restructured by their respective provincial governments.

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[23] Piva, (1992) p.100.

[24] John B. Taylor, (1991), pp. 478-500.

[25] Buck, (1949), pp. 328-30.

[26] See Tassonyi (1994).

At a recent symposium, Michael Fenn, the Ontario Deputy Minister of Municipal Affairs and Housing, expressing his own views of the changing Ontario context summarized the three recent key reforms to the Ontario system:

- the long-avoided modernization of property tax and assessment;
- the reform of fiscal and functional relationships known as local services realignment (LSR); and
- widespread institutional restructuring, which has reduced the number of municipalities in Ontario from 838 to 447, or nearly 47 percent. (Fenn, 2002 p. 148).[27]

In particular, Fenn's paper highlights the implications of LSR in that municipalities were given significant new and increased responsibilities in the delivery of "human services" including social welfare; programs for children and the elderly; long-term care and hospital capital finance; ambulance and paramedic service; social housing and affordable housing; and public health. In his view, the challenge of delivering human services will outweigh the challenge in delivering the traditional "hard services" provided by Ontario municipalities. In his view, as well, municipalities will become more commercialized and will have to acquire staff with different managerial and operational skills. Specifically, the challenge will be:[28]

"To achieve lower unit cost and to meet performance standards in third-party contracts, municipal staff need the skills of project management, "results-focused" specification writing, and sound contract –negotiation and contract-administration practices. These requirements will obviously require a fundamental change in a public service schooled in in-house policy development and direct, "monopolistic" program delivery."

Bird and Vaillancourt [29] note "the emergent problem in Canadian political structure that is local government". In their view, the importance of local governments to people's lives is likely to increase even as the importance of higher tier governments recedes in the context of the pressure of continental integration. Attention will need to be focused on the effectiveness of the governance of the city-regions again. While there is little consensus as to how to best structure local government to meet concerns of accountability, efficiency in service delivery and the optimal geographic span of responsibility,[30] there is little doubt that the provinces acting as centres have acted bureaucratically to create transformed municipal structures. It is interesting to note that the stage may have been set for a significant transformation with the creation of larger entities in Toronto and Montreal. The provinces have created the potential for the development of an effective response to their centralizing tendencies.

Fiscal Arrangement Themes

To reiterate, Canada is one of the most decentralized countries in the world.[31] 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 essentially unconditional transfers from the

[27] Each of these has been subject to considerable criticism for a variety of reasons.
[28] Fenn (2002), p. 155
[29] Bird and Vaillancourt(2001)185.
[30] See Bourne (2001) and Slack (2001). See Milway and Nelles (2001),p.21.
[31] See Bird and Tassonyi (2003)

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 borrow as and from whom they wish, with no central review or control.

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 constraints in the face of very soft – indeed, non-existent – hierarchical 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 the provinces, municipalities are in fiscal matters essentially agents of higher-level governments and face explicit hierarchical constraints imposed largely by administrative fiat. A little over ten years ago, Paul Hobson described the provincial-municipal relationship as "creatures, chameleons, and consorts." More recently, Herb Emery used the word "feral" to describe the evolution of municipal fiscal behaviour.[32]

The relative importance of municipalities as compared to provinces may be judged by the following. Overall, municipal government represents somewhat over 4 percent of GNE and about 10 percent of total government expenditure. (See Table 3). Local expenditures are principally made to provide services benefiting local residents. The distribution of these expenditures varies from province to province but in this Ontario is the anomaly with a significant municipal responsibility for social services. (See Table 4).

However, in the context of this paper, the assignment of tax fields is revealing of the relative capacity of governments to react to their environments.

The Assignment of Tax Fields

Taxation in the Federal-Provincial Context[33]

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 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

[32] See Hobson(1991) and Emery(2002).
[33] This is summarized from Bird and Tassonyi (2002)

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.

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.[34]

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.

Property tax

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. Assessment -- the determination of the tax base -- is carried out by provinces, 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.

Property tax is used throughout the world despite being unpopular with taxpayers.[35] This is the only tax many directly confront and have to pay periodically as a visible lump sum. Other taxes are deducted from income or are hidden in the price of goods. As Bird (1999) points out, "the need to make such periodic large payments may well add to the accountability and responsibility of governments, but it also greatly increases the sensitivity of tax payers to even nominal increases in taxes." The tax burden is often poorly related to cash flow, and ownership yields only potential, not realized capital gains.[36] Although the property tax is perceived as tax on wealth, tax shifting can weaken

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

[35] See Bird and Slack (2002), McCluskey (1999) and Youngman, Malme (1994) with respect to the use of property tax world-wide.

[36] Many proponents argue that the real property yields an intangible income, because owners are able to obtain a mortgage secured by this property. On the other hand, owners do not have to pay rent as compared to tenants. In some jurisdictions, this imputed rent is taken into account in means tests for social assistance.

the reality of the 'wealth-tax view': the tax may be passed through to tenants or to consumers to the extent that taxes on non-residential properties are reflected in prices. Value-based property tax requires a complex assessment process, which has often been contentious with taxpayers. The method of assessment is not always easily understood. Mass appraisal systems may be based on variables that may be insignificant related to any particular property and the interaction of the determinants not readily understood by the individual property owner. Successful systems require effective communication with property owners. The administrative cost of maintaining an up-to-date assessment base is also expensive in terms of manpower and data-base management.

Property taxation can be a dynamic source of revenue. As prices on the real estate market increase, the tax base broadens unless rates are reduced as assessment is increased. Buoyancy is often viewed favourably as a positive feature of this tax. However, this dynamism can be pose a threat. In a period of economic boom, real property prices can increase at a faster rate than disposable income .One important positive feature of property taxation is its stability. It is widely recognized that the property tax acts as a rough form of benefit charge as well.[37] It is well documented that the value of real property is strongly influenced by the level of local services (i.e. capitalization effect) as well as location factors, and that construction values and physical characteristics often are less significant as explanatory variables.[38]

Local decisions can determine appropriate rates; a link can be perceived by ratepayers between benefits received and the level of local taxation; and, the tax can be made internally equitable through appropriate assessment and administrative practices. (Bird, 1993, Oates, 2001).

Fiscal Competition at the Subnational Level

Introduction

Mintz has recently been critical of the standard popular view that equates tax competition with fiscal competition. In his view, fiscal (or tax) competition is more aptly described as "a process by which governments maximize some payoff by strategically choosing fiscal instruments that interact with the strategic choices of other governments." [39]

Citing Oates (1972 p.143) on the outcome of tax competition: "The result of tax competition may well be a tendency towards less than efficient levels of output of local services. In an attempt to keep taxes low to attract business investment, local officials may hold spending below those levels for which marginal benefits equal marginal costs…"

On the other hand, if property tax is analyzed in the light of permanent income rather than current income , the relation between the value of real property and income is likely to be closer. Incidence issues are discussed in detail in Boadway, Kitchen, (1999).

[37] See Kitchen (2002). Fischel (2001) makes the case for the property tax as a benefits tax. Zodrow (2001) argues that further empirical evidence is needed. Nechyba (2001) summarizes the debate between the views on the property tax and the possible ramifications of tax reductions justified by the new view. Strauss (2001) cites evidence that increases in per-pupil spending are associated with an increase in the desire of homeowners to locate in such communities.

[38] The property tax can also be seen as a fee for increasing property value. Capitalisation effects are discussed in Oates (1969) in Oates (1998) and summarized in Inman (1999).

[39] Mintz (2001) p.3.

And Wilson's recent survey (1999, p.269):

"A central message of the tax competition literature is that independent governments engage in wasteful competition for scarce capital through reductions in tax rates and expenditure levels."

Mintz argues that a tax competition game can result in complicated results including:[40]

- governments do not necessarily follow what others do (e.g. cut tax rates when the other cuts its tax rates);
- it is not necessarily true that there is a race to the bottom with tax rates going to zero since governments do value having some public good consumption; and
- even if jurisdictions are identical, tax competition can result in non-identical outcomes.

These three results describe outcomes where jurisdictions are competing in a horizontal sense, i.e. as jurisdictions with access to the same tax base and having the same relative level of authority. As such, these comments are applicable to local governments.

In a federal system, with overlapping jurisdictions over tax bases, interdependencies arise and these externalities have been styled as "vertical" in nature. These include[41]:

- joint occupancy of tax fields, where a tax base may shrink if tax rates are changed by either or both levels of government;
- complementary or substitute tax assignment externalities, where a tax on one commodity may affect the demand for another taxable commodity, as in fuel taxes affecting the demand for automobiles;
- expenditure/fiscal externalities, where a tax by one level of government impacts on the expenditures of another level of government. In Canada, municipalities complain vociferously that their purchases of inputs such as fuel for transit-systems are not exempt from the Goods and Service Tax.

As noted, the three significant taxes levied by provincial governments in Canada include personal income taxes, corporate taxes (corporate income and capital taxes) and sales and excise taxes. Arguably a surficial case can be made that fiscal competition does exist. Significant variations have existed for many years in personal tax rates with the rates generally highest in Quebec and lowest in Alberta. (See Table 5)

Corporate Income Tax

In terms of corporate income tax, rates vary, although the differences in the tax bases are

[40] Mintz (2001) p. 10.
[41] Mintz (2001)p. 12

not significant. [42] (See Table 6). Three provinces (Alberta, Ontario and Quebec) together account for approximately 75% of the corporate income) and collect their own corporate income taxes. The rest of the provinces allow the federal government to collect the taxes on their behalf, while retaining the authority to set tax rates by statute. Of the major provinces, Quebec's rate is the lowest. As can be seen in the Table, the rates also vary by category of business.

Given the varying rates, Mintz[43] notes that: "Given that provincial corporate income tax bases do not vary much among provinces in Canada, one would think that a reaction function could be estimated for statutory tax rates as the policy variable. As of yet, I have not seen a study that has estimated reaction functions of this sort."

However, in a recent study, Mintz and Smart[44] model and analyze the decisions of multi-jurisdictional firms to reduce subnational tax liabilities. Their study takes advantage of a particular feature of corporate income taxation in Canada. Groups of corporate affiliates are not permitted to consolidate income for tax purposes. In contrast, multijurisdictional firms that do not incorporate separate affiliates in each province must allocate total income according to a statutory formula based on the distribution of sales and payroll among provinces. Allocation rules make it more difficult to shift income to low-tax jurisdictions. Accordingly, the sensitivity of taxable income to subnational rate changes should be lower for companies that allocate income compared with comparable firms that do not.

Using administrative tax data, Mintz and Smart have found that their estimates have borne out their hypothesis in that for income-shifting firms, the elasticity of taxable income is 4.9 while for others it is 2.3. In their view, the evidence that provincial governments have reacted to firm behaviour is weak and several factors affect the willingness of provinces to engage in tax competition. These include the federal equalization formula, the non-deductibility of provincial corporate income tax from federal tax and limitations on deductions against income.[45]

Based on work by Hayashi and Boadway[46], McKenzie points out that while Ontario tends to ignore other provinces when setting its business tax rates, the other provinces react to Ontario, raising and lowering and following the leader. It is surmised by these experts that the Ontario government is reacting to competition for capital with US jurisdictions. McKenzie does not see a race to the bottom in the current rate-cutting environment but rather a new lower level of stability.[47] This type of reaction fits within the Easterbrook framework of a center-margin reaction where Ontario as the margin is reacting to American competitive pressure with consequences for the other taxing jurisdictions in Canada.

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[42] This is summarized from Mintz, Smart (2003) p.9-10. I am indebted to both for sharing a pre-publication version.
[43] Mintz (2001) p. 19
[44] Mintz, Smart (2003)
[45] Mintz and Smart (2003) p. 11.
[46] Hayashi and Boadway as cited in McKenzie (2001) p.64-65. Hayashi and Boadway estimate a Stackelberg leader model which shows that " Ontario does not significantly react to any of the taxes of the other governments, while Quebec reveals a relatively large positive horizontal response to Ontario. (p. 502)
[47] McKenzie(2001) p. 65.

Sales Tax – VAT

As noted above, all provinces except Alberta impose sales taxes[48]. In New Brunswick, Nova Scotia, and Newfoundland, the federal government collects a Harmonized Sales Tax (HST) (a value-added tax) at a rate of 15%, of which 8% is a provincial tax (allocated between provinces on the basis of consumption). In Quebec, the provincial government collects both the federal sales tax (the Goods and Services Tax or GST at 7%) and its own VAT, the Quebec Sales tax at a rate of 7.5% on essentially the same base. The other five provinces impose their own retail sales tax on a substantially different base, which, in fact, includes a significant proportion of business inputs. These differences imply the possibility of fiscal competition.

Bird notes that fiscal competition with respect to sales tax has been largely implicit [49] in Canada. In his view, "cross-border" shopping is one area where the issue has arisen. Administrative arrangements have been made to handle the issue where a city or city-region straddles the provincial boundaries. The other form of fiscal competition noted is that approximately 25 percent of the total tax burden faced by Canadian business consists of indirect taxes (including property tax on business inputs. The tax impact depends on factor mix and the extent to which market conditions affect forward shifting. The competitive implications have been little discussed in the literature. Bird notes that: it is clear that industries located in Ontario,… are clearly disadvantaged compared to those in, say, Quebec, in terms of the marginal effective tax rate they face on production costs because they bear higher (non-creditable) taxes on a range of business inputs."[50] As is pointed out, the current major challenge is the treatment of e-commerce and to continue reducing the hidden impact of taxes on business inputs.

The feasibility of co-existence in sales tax systems is also demonstrated by the Canadian example. However, there appear to be several key conditions which are necessary to ensure the functioning of the system.[51] The first is that the best basis for a subnational VAT is a well-designed and comprehensive national VAT. The second is the existence of an adequate degree of trust in the competence of the respective tax administrations at both levels of government. Unified audit or high degrees of information exchange also are critical to the workings of the system.

The differences in rates and bases suggest the clear autonomy of the provincial governments but the smaller provinces are more susceptible to federal persuasion on centralization of the aspects of the tax system.

Fiscal Competition at the Local Level

Recent discussions of the issue of tax competition have pointed out that there is little conclusiveness to be gained in an examination of the theoretical debate. One widely held view is that if a local tax is levied on a mobile base, taxpayers have an incentive to relocate business activity where the tax rate is lower. The consequence may be that a municipality may gain some activity but be left with a diminished tax base, and the losers also have to reduce their tax rates in order to attract new businesses from others or to retain their

[48] This is summarized from Bird and Vaillancourt, (2001) p. 177.
[49] Bird (2001) p. 95-96.
[50] Bird (2001) p. 96.
[51] Bird and Gendron(2001) p.301.

existing base. At the end of this process, the local tax base will be reduced to an inefficient level – resulting in lowered local revenue-raising capacity and a weakened ability to maintain service levels. On the other hand, it is argued that tax competition serves to keep governments from taxing excessively and growing without constraint.[52] There is some evidence of the former in American jurisdictions.[53]

Tax exporting occurs where taxes are levied locally but the incidence can be shifted outside the jurisdiction. Local accountability is weakened as the local taxpayers bear a lower cost for the provision of local services because non-residents pay for them. This can be especially problematic when the local industry has market power and is able to pass taxes through an increase in the price of the export of its products. [54]

As noted, municipalities in Canada are limited to property taxation and user fees or expenditures as their tools of fiscal competition. Even in this, provincial rules constrain the extent of likely competition. Formal modeling of actual Canadian local government taxing behaviour is limited. In Ontario, where lower-tier municipal governments impose and collect property taxes, not only on their own behalf but must also impose such taxes on behalf not only of the province since 1998 and school boards but also of upper-tier (regional) governments, Breton's "Wicksellian connection" [55] between local responsibility for taxes and for expenditures is largely breached. This theme is developed in Locke and Tassonyi (1993) which examined the interaction between local tax decisions and the tax decisions of overlapping school boards prior to the major realignment of local services in Ontario.

British Columbia

Brett and Pinkse[56] estimate a model of the municipal tax base as a function of local characteristics and a weighted average of the tax rates of neighbouring jurisdictions for British Columbia (BC) municipalities. They also model the choice of tax rate, the size of the base being among its determinants using the business rate in BC as the data source. Their work lead them to conclude that there is no "strong evidence of cutthroat competition among BC municipalities. Further, the evidence is mixed on the impact of the non-municipal rates (provincial education rates) on the municipal rates. They state that: "Although we find some evidence that municipalities react to increases in the tax rates of their neighbours, we argue that it is not obvious that this implies widespread destructive competition for capital."[57] They acknowledge that the existence of provincial regulation does limit the scope for competition among municipalities in British Columbia. It is also possible that the sorts of business affected by standard municipal tax rates are not particularly footloose or that fiscal competition is using other instruments.

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[52] See Oates (2001) for a useful summary of differing perspectives and Wilson (1999) for a summary of the theories of tax competition.
[53] Smith , Webb (2001) cite the case of Philadelphia and Camden with differing tax bases and amenities with migration to Philadelphia causing problems for Camden.
[54] This phenomenon is examined in Thirsk (1982). His study provides estimates of tax exporting of non-residential property taxes in various Ontario cities with the highest estimates being generated where industrial properties represented a significant portion of the assessment base.
[55] Breton(1996).
[56] Brett and Pinkse(2000) p.696-711.
[57] Brett and Pinkse(2000) p 712.

Ontario

Prior to 1970, each municipality was responsible for preparing its own property assessments. This led to inconsistencies in the valuation of property across the province. Despite the takeover of property assessment by the Province in 1970, assessment reform was piecemeal throughout the 1980's and 1990's.

As usual, crises motivate institutional change and response. Between 1989 and 1992, the Ontario economy was affected by a serious recession.[58] Public attention was focused on the tax competitiveness of municipalities within the GTA, purported overprovision of local services and business outmigration from the core of the City and the impact of constant or increasing property tax burdens on commercial real estate experiencing significant declines in rental income, tenancy levels and market value.

In the municipalities that made up Metropolitan Toronto, taxable assessment declined in 1993 and 1994 and in some cases shrank below the 1988 levels. In the other parts of the GTA, taxable assessment showed steady growth during this period. Market values, (which at the time were not directly reflected in the assessment base) peaked in 1991 and in Metro Toronto declined by nearly 40%. Thus, while nominal mill rates were being constrained, effective tax rates comparing taxes to market values were increasing. While explicit tax competition is forbidden in Ontario, the implicit assessment ratios that translated market value into assessed value institutionalized the differences in effective tax burdens between Metro Toronto and the other municipalities in the GTA.[59]

These concerns were reflected in a series of studies that attempted to infer a connection with empirical facts and anecdotal evidence. [60] These concerns also led to the appointment of the GTA Task Force which also documented the institutionalized tax competition built into the then existing property tax system and made sweeping recommendations for property tax reform.[61]

A newly elected provincial government appointed the "Who Does What Panel" to examine and make recommendations on reforming the provincial-municipal relationship. By 1997, assessments were often outdated, in some instances as much as fifty years out of date. New properties and commercial and industrial properties tended to be over-assessed relative to market value. Consequently, similar properties in the same municipality often paid very different taxes on similarly valued properties and received the same levels of municipal services. It was difficult for owners to understand their assessments and to determine if their assessed values were appropriate.[62]

In 1998, Ontario implemented property tax reform.[63] The stated goals were to:

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[58] 64 percent of jobs lost in Ontario were in the Greater Toronto Area (GTA) some 200,000 jobs were lost permanently at this time. The main losses occurred in the Toronto CMA in construction, processing and clerical work. Locke and Tassonyi (1996) p. 6.

[59] Locke and Tassonyi (1996) p.11

[60] These include Kitchen and Slack(1993), Ontario Fair Tax Commission (1993),Board of Trade of Metropolitan Toronto (1994),Slack (1994), GTCC (1995a and b), and the Greater Toronto Area Task Force (1996).

[61] Greater Toronto Area Task Force (1996)p. 96-110.

[62] Ontario Fair Tax Commission (1993)p.625

[63] Slack (2002) provides an overview of the current system.

- Create a fair, accountable and understandable system for all taxpayers;
- Establish a consistent assessment base reflecting up-to-date values;
- Reduce high relative property taxes, particularly for businesses;
- Ensure a transition to the new system being manageable for all property classes.

The first province-wide reassessment was completed in 1998. All properties were assessed at their current value as determined on a common valuation date (June 30, 1996). Properties were subsequently reassessed in 2001 (June 30, 1999 values) with annual reassessment beginning in 2003.

In conjunction with the reassessment of the province, municipal taxing powers were also radically altered. The number of property classes was expanded and municipalities were given the authority to set variable tax rates in proportion initially to transition ratios which measured the relative tax burdens among the various classes of property (See Appendix 1 for definitions). However, municipalities were constrained from increasing the disparity in effective tax rates among classes of property.

Most municipalities adopted the prescribed transition ratios in 1998. Some chose to move ratios towards the ranges of fairness, with some tax shifting to be absorbed by other classes. The ratios among the tax rates in a given tax jurisdiction may be changed on annual basis as part of the budget-setting exercise. To some extent, they also perpetuate the institutionalized tax competition that existed prior to 1997 but municipalities now have the authority to explicitly reduce ratios and to rebalance class tax burdens with full awareness of the decisions of competing jurisdictions.

The following characteristics of the local municipal context are likely to have an effect on the decision to lower ratios as illustrated in Table 7.

1) Provincial levy restriction- variation by class and distance from provincially set threshold;
2) Local pressure- existence of plan for tax reduction or relative burden shift;
3) Composition of Assessment Base- dominance of industrial/large industrial/ commercial classes of property;
4) Composition of expenditure pressures—mandatory/discretionary;
5) Upper vs. single tier municipality;
6) Existence of optional business property classes;
7) Mimicking argument;[64]
8) Business Education Tax rate cut eligibility.

As yet, such a model has not been estimated.

Property tax reform by its nature is a hierarchical endeavour. Much political will was required. Particular goals involving the management of change and the rebalancing of the class tax distribution are in the process of being achieved. This has been accomplished at the cost of some of the discretionary authority of municipalities. Not a transition pattern but

[64] Brueckner,J.K. and Saavedra,L.A (2001) estimates a mimicking model for Massachusetts.

the overall modernization of the base makes fiscal competition explicit and has increased the accountability of municipalities as rate increases are explicitly visible.

Sustainability/Alternative Tax Forms/Capacity to Respond

A little over ten years ago, Paul Hobson described the provincial –municipal fiscal relationship in terms of chameleons or consorts. At the time, discussions of disentanglement and reforms of the provincial-municipal relationship were underway in several provinces. In the intervening years, especially in Ontario, significant reforms have been enacted. Whether the actual capacity for municipalities to assume a role in keeping with a "transformation" pattern has been created is not clear.

As noted in the introduction, there is apparently a widespread concern over the "fiscal squeeze" on municipalities. McMillan has summarized the numbers on the revenue and expenditure side as follows[65]:

"As a result of the late 1990s reassignment of provincial and local responsibilities there, Ontario is the only province for which municipal program expenditures increased as a percentage of consolidated provincial and local program expenditures. That is, municipal government increased in relative size only in Ontario. As a result, while own-source revenue started and ended the 1998 to 2001 period at about the same level relative to PDI in the other provinces, the own-source revenue burden increased in Ontario from 5.01 to 6.62 percent. Also, while the real property tax burden rose elsewhere, Ontario shifted to a new, higher plateau after 1998. As a percentage of PDI, real property taxes increased from 2.14 to 3.52 percent from 1998 to 2001 while the average of the other provinces was from 2.25 to 2.57 percent. Furthermore, consolidated provincial and local property taxes as a percentage of PDI went from 4.70 to 6.05 percent in Ontario but, on average, from 3.71 to only 4.46 elsewhere. These data suggest that municipalities in Ontario have experienced a substantial fiscal squeeze from both the expenditure and the revenue side. … While increased reliance on the property tax is without doubt burdensome almost everywhere, one is prone to wonder whether the municipal fiscal squeeze is primarily an Ontario problem."

Thus. the capacity of Ontario municipalities to respond to the changing policy environment may be adversely affected to the extent that the recent increase in local burdens and responsibilities is affecting local willingness to make decisions. These recent shifts in the levels of taxation has raised the issue of "fiscal sustainability" whether of the existing parameters of the provincial-municipal relationship or of the fiscal viability of municipalities.

Bird suggests that the concept of 'fiscal sustainability' is a term of art, not science.[66] Slack and Bird set out several possible interpretations as follows[67]:

"A simple and obvious interpretation of "fiscal sustainability"… might be simply that a government can cover its expenditures out of its own revenues, that is without depending on either transfers or borrowing. Another interpretation—structurally similar, but very different substantively—might be that a government can cover its operational expenditures out of its own current revenues (excluding transfers). Yet another might be that it can cover

[65] McMillan,(2002) p. 26.
[66] Bird (2003)p. 15.
[67] Slack and Bird (2003),p. 2.

all of its expenditures (including investment) out of its own revenues (taxes, fees), and pre-determined levels of transfers and borrowing."

In the municipal context, sustainability is essentially in the hands of the provinces. As noted, the constraints on municipal operating deficits and on access to tax fields suggests at one simplistic level that crisis cannot happen. But as Slack and Bird note that if the required balance can only be accomplished by reducing expenditures to below maintenance levels or by raising taxes that chase away the tax base, "a "sustainability" crisis of a deeper kind may result[68]. However, municipalities are affected by cyclical pressures on their funding responsibilities, senior levels of government changing the parameters of service delivery and the lack of control on their revenue sources to meet the changing exigencies of their circumstances.[69]

Slack and Bird conclude that the sustainability issue is really an issue of the capacity of the municipal sector's fiscal base to maintain and undertake the infrastructure investments and the service delivery to remain competitive in the global context. In order for a transformation pattern to emerge, this ability is critical. However, McMillan's work seems to imply that the amount of room to increase property tax burdens relative to income may be limited. There is evidence that such limitations on the capacity to expand local taxation levels without triggering adverse economic consequences may exist in several US cities.[70]

The perception that the current property tax system is reaching capacity and that it is not a particularly efficient tax (in the economic sense) with respect to taxing business capital has prompted some discussion of an alternative form of taxation, the Business Value-Added Tax. Bird and McKenzie (2001) provides the most wide ranging and thorough review of this possible alternative. Kneebone and McKenzie (2002) place this proposed reform at the end of their study suggesting that local governments be given more freedom to choose from tax instruments.

Ultimately, whether an enhancement of the capacity of local governments to react positively is given encouragement and whether the capacity for transformation is allowed to develop or is stifled still lies with the provincial governments. As long as the provincial-local relationship continues to be a **C→m** dynamic, fundamental reforms in the assignment of taxation powers seem unlikely.

Conclusion

Canadian subnational governments are coping with significant changes in the context of decision-making. Provincial governments have been given considerable latitude in their choice of fiscal instruments to meet these challenges in their areas of responsibility. There is an ability to use taxes as competitive tools and to adjust the methods of taxation to adapt to the actions of taxpayers. As such, their decision-making can afford to take some risks and in acting " entrepreneurially" can shift relationships with other centres of decision-making from persistence patterns to more dynamic patterns in which the relationship can continue to be more equal.(whether the federal government or US states or city-regions.)

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68 Ibid., p.3
69 Kitchen(2002),p. 167.
70 Haughwatt, Inman et al.(2003)

Local governments are more constrained by their status and by the persisting hierarchical fiscal relationship with the provinces. It is not clear that the current fiscal tools available to municipalities, that is, some limited authority in the property tax field and in setting some user fees and expenditure powers in the areas of local service delivery, is sufficient to meet the challenges outlined at the beginning of the paper. Thus, on balance, the decision-making patterns of local governments will likely continue to be in a persistence mode.

Appendix 1
Ontario's Property Tax Reform

To address historical tax inequities, the Province established rules that are designed to close the gap between residential and business tax rates. As a starting point in 1998, the Province identified the existing (pre-reform) municipal tax burdens in each municipality. Based on the 1998 assessment and 1997 taxes, relative municipal tax burdens were expressed in terms of transition ratios which compared the notional effective tax rate of a property class to the tax rate of the residential property class. The residential class is deemed to have a transition ratio of 1.0.
If the tax ratio of the commercial class in a municipality is 3.0, it means that commercial properties are taxed at a rate which is three times higher than the residential rate in that municipality. Municipalities set their tax rates based on the proportionalities among the tax ratios using the ratios to weight the taxable assessment to establish the constraint on widening the gap in effective tax rates, the Province prescribed "ranges of fairness" for each property class.

Ranges of fairness illustrate target levels of municipal taxation, expressed as tax ratios for each property class. The following table shows the prescribed ranges of fairness.

Standard Classes	
Multi-Residential	1.0 to 1.1
Commercial	0.6 to 1.1
Industrial	0.6 to 1.1
Pipeline	0.6 to 0.7
Optional Classes	
New Multi-Residential	1.0 to 1.1
Office Building	0.6 to 1.1
Shopping Centre	0.6 to 1.1
Parking Lots and Vacant Land	0.6 to 1.1
Large Industrial	0.6 to 1.1
Professional Sports Facility	0.001 to 1.1

As the tax impacts of the reassessment became known, provincial concern with municipal management resulted in the introduction of various other mitigating measures including optional classes, the 2.5 % limit and finally the provincial freeze imposed late in 1998 as a response to ratepayers concerns.

Limits for 1998 to 2000

In 1998, to ensure that the impact of current value assessment reform would be manageable for all taxpayers, the Province imposed mandatory limits on property tax increases for commercial, industrial and multi-residential properties of 10% in 1998, a further 5% in 1999, and a further 5% in 2000.

- The 10-5-5% limits applied in every municipality across the province except in the City of Toronto which chose to apply a 2.5% cap on the tax increases of commercial, industrial and multi-residential properties for 1998, 1999 and 2000.

- Under the 10-5-5% and 2.5% caps, taxes on a property were calculated each year based on the taxes that were levied on the property in 1997. In order to administer the caps, municipalities were required to maintain a frozen assessment listing (FAL).

  The FAL contained property-specific information for the 1997 tax year.

To assist municipalities with the maintenance of the FAL and the calculation of capped taxes, the Province made an internet-based computer program (known as On-Line Property Tax Analysis - "OPTA") available to municipalities free of charge.

As part of the 10/5/5 system, tax ratios were frozen for 1998, 1999 and 2000. Municipalities were constrained from initiating interclass shifts in the relative property tax burden**.**

With the sunset of the 10/5/5 limit and the reassessment of the province for 2001, municipalities were again provided with the authority to make local decisions on the relative burden of taxes by class of property.

Municipalities were provided with the flexibility to adjust their tax ratios based on their perception of local circumstances and provincial pressure. (See Table 6)

However, municipal flexibility in setting tax ratios and rates is subject to three limitations. Municipalities can only move tax ratios closer to the ranges of fairness. Tax ratios cannot be moved further away from the ranges of fairness. Once the tax ratio of a property class reaches the range of fairness, the municipality can adjust it up or down within the range.
If the tax ratio of the commercial, industrial or multi-residential class in a municipality exceeds the prescribed provincial average ratio ("threshold") for that class, the municipality cannot increase the tax burden on that class. The tax burden on the class could only be increased when the ratio moves below the threshold.

The following threshold ratios have been prescribed: commercial - 1.98; industrial - 2.63; multi-residential - 2.74.

The tax rate of the farmland and managed forest property classes must be set at 25% of the tax rate of the residential class

Limits for 2001 and Future Years

For 2001 and subsequent years, municipalities are required to limit the CVA-related property tax increases on commercial, industrial and multi-residential properties to 5% per year

The limit only applies to CVA-related tax changes. Taxes can only exceed the 5% limit if there is a physical change to the property or if the municipality applies a levy increase. The limit will be calculated each year based on the previous year's taxes (rather than continuing to refer back to the pre-reform base year of 1997.

This gives municipalities more flexibility than they had in 1998-2000 to finance the cost of the limits on tax increases and to reduce the taxes on business property classes. Financing options include using: revenue from assessment growth or savings or undedicated reserves or shifting taxes among property classes to reduce the overall tax burden on classes that pay high property taxes or applying levy increases on some or all property classes.

Table 1

Census Metropolitan Area's (CMA) Percentage of Provincial GDP, 2002

CMA	CMA 2001 Population	CMA 2001 Population as a Proportion of the Provincial Population	CMA 2002 GDP as a Percentage of the Provincial GDP
Toronto	4,682,897	41%	44%
Montreal	3,426,350	47%	50%
Vancouver	1,986,965	51%	53%
Calgary-Edmonton	1,889,240	64%	64%
Ottawa-Hull (Part of Ont.) **Ottawa-Hull (Part of Que.)**	806,096 257,568	7% 4%	%
Winnipeg	671,274	60%	64%
Halifax	359,183	40%	48%

Source: *Statistics Canada*, 2001 Census of Population. *TD Bank Financial Group*, "A Choice Between Investing in Canada's Cities or Disinvesting in Canada's Future", Special Report, April 22, 2002.

Table 2 – Competitive Indices

Ontario's City-Regions - North American Ranks by Population Size

	Talent	Bohemian Index	Mosaic Index	Tech Pole Index
Population more than 1 million (43 cities)				
Toronto	24	4	1	15
Ottawa	10	14	9	23
Population 500,000 to 1 million (39 cities)				
Hamilton	35	18	2	37
Population 250,000 to 500,000 (68 cities)				
Kitchener	46	15	3	15
London	28	18	6	26
Oshawa	67	36	11	54
St. Catharines-Niagara	66	27	8	58
Windsor	52	49	5	63
Population less than 250,000 (159 cities)				
Sudbury	142	128	16	120
Thunder Bay	125	103	6	76

Source: Gertler and Florida, 2002.,p.21

Table 3

Federal, Provincial and Local Government Expenditures as a Percentage of Gross National Expenditure, Selected Years (a)

Years	Federal	Provincial	Local	Total

			Municipal	Both	School Boards	Government (b)
1965	14.9	11.0		7.8		26.6
1975	20.8	18.4		8.5		38.8
1985	24.0	21.5		8.0		45.9
1988			4.54		3.74	
1995	22.6	23.3		9.0		47.7
			5.11		4.78	
2000	18.2	20.3		7.3		
			4.26		3.05	40.5

Source: "Municipal Relations with the Federal and Provincial Governments: A Fiscal Perspective", Melville McMillan, April 2003.
Notes: (a) Local data are only separated into municipal (i.e., local general government) and school board data since 1988.
(b) Because of the non-exclusionary accounting for intergovernmental transfers, the individual percentages cannot be summed to achieve this total.

Table 4
Level and Allocation of Municipal Government Expenditures for Selected Provinces, 2001

	NS	Que.	Ont.	Alta.	BC
Per Capita Expenditure ($)					
	1020	1284	1948	1581	1284
Percent Allocation (%)					
General Services	10.4	12.2	8.9	12.2	10.0
Protection	21.1	16.7	13.4	14.3	18.8
Transportation	16.9	27.2	18.1	28.3	16.5
Health	0.1	0.2	3.5	1.5	1.8
Social Services	4.5	1.4	24.7	1.5	0.2
Education	14.2	0.1	0.0 (b)	0.3	0.0 (b)
Conservation & Development	0.8	2.8	1.6	3.4	1.4
Environment	16.8	12.0	13.3	13.9	20.4
Recreation & Culture	10.7	12.4	8.7	13.7	19.5
Housing	0.2	2.9	5.0	0.7	0.6
Regional Planning	1.5	2.5	0.1	3.0	2.3
Debt Charges	3.7	9.4	2.3	7.1	6.3
Other	0.0 (b)	0.0 (b)	0.2	0.0 (b)	2.2
Total (a)	100.0	100.0	100.0	100.0	100.0

Source: "Municipal Relations with the Federal and Provincial Governments: A Fiscal Perspective", Melville McMillan, April 2003.
Notes: (a) May not sum exactly due to rounding. (b) Negligible (less than 0.05%).

Table 5

Personal Income Tax for a Single Taxpayer: Combined Federal and Provincial Marginal Rates, 2002, Excluding the Effect of Pension Plan and Employment Insurance Credits

Income, $	Combined Federal and Provincial Marginal Rates (%)				
	NS	Que.	Ont.	Alta.	BC
15,000…	28.99	27.06	20.52	24.21	20.53
20,000…	28.99	27.06	20.52	24.21	20.53
25,000…	23.99	27.06	20.52	24.21	20.53
30,000…	29.17	34.06	20.52	24.21	20.53
35,000…	35.17	36.07	29.62	30.21	29.63
40,000…	36.95	38.37	31.15	32.00	31.15
50,000…	36.95	38.37	31.15	32.00	31.15
75,000…	42.67	45.71	43.41	36.00	39.70
100,000…	44.34	45.71	43.41	36.00	40.70
200,000…	47.34	48.21	46.41	39.00	43.70

Source: Canadian Tax Foundation, *Finances of the Nation*, 2003.

Table 6

Provincial Corporate Income Tax Rates, 2002

Province	Small Business (%)	Manufacturing and Processing (%)	General (%)
Newfoundland and Labrador	5	5	14
Prince Edward Island	7.5	7.5	16
Nova Scotia	5	16	16
New Brunswick (a)	4/3.5	16/14.5	16/14.5
Quebec	9.04	9.04	9.04/16.51 (b)
Ontario (c)	6/12.5	11	12.5
Manitoba	5	16.5	16.5
Saskatchewan (d)	6	10	17
Alberta (e)	5/4.5	13.5/13	13.5/13
British Columbia (f)	4.5/13.5	13.5	13.5
Northwest Territories (g)	5/4	14/12	14/12
Nunavut	4	12	12
Yukon (h)	6	2.5	15

Source: Canadian Tax' Foundation, *Finances of the Nation*, 2003.
Notes: (a) The New Brunswick small business, manufacturing and processing, and general corporate rates were reduced, effective July 1, 2002, and the small business limit was increased from $300,000 to $350,000. (b) The higher rate applies to passive (investment) income of a corporation. (c) The Ontario small business limit for 2002 is $280,000. The benefit of the small business rate is phased out where corporate income exceeds $700,000. (d) As manufacturing and processing, income earned in Saskatchewan increases as a share of total manufacturing and processing income, its tax rate is reduced to as low as 10%. (e) The Alberta small business, manufacturing and processing, and general corporate rates were reduced effective April 1, 2002, and the provincial small business limit was increased from $300,000 to $350,000. (f) Effective April 1, 2002, the British Columbia small business limit was increased from $200,000 to $300,000. (g) The Northwest Territories rate reductions took effect on July 1, 2002. (h) The manufacturing and processing rate may be used by qualifying small businesses.

Table 7

1998 Regulated and 2002 Adopted Tax Ratios for Selected Ontario Municipalities

Municipality	1998 Regulated Tax Ratios						
	Multi-Residential	Commercial	Office Building	Parking Lot	Shopping Centre	Industrial	Large Industrial
City of Toronto	5.2355	4.2759				5.9685	
Durham Region	2.7103	1.4819	2.2960		1.2078	2.0907	3.8036
Halton Region	2.4439	1.4565				2.3599	
Peel Region	1.7336	1.2971				1.5986	
York Region	2.0875	1.1190				1.3427	
Niagara Region	2.5568	1.6464				3.6362	4.1880
Waterloo Region	3.2146	2.0148				3.2175	
Oxford County	2.8392	1.9018				2.9098	3.4636
City of Ottawa	2.3359	1.9577	2.3659	1.2829	1.6285	2.2439	1.9269
City of Greater Sudbury	1.9570	1.6614				2.4500	2.7560
City of Windsor	2.5202	1.9740	2.0071	1.0397	2.0269	2.8923	4.1218
City of Kingston	2.6526	1.6822				2.5702	
City of London	2.3852	1.9136	2.2810		1.6340	2.7633	3.1961
City of Hamilton	3.0614	2.2764		1.8967	2.2426	3.9654	4.717
City of Thunder Bay	2.9039	2.4450	2.5823	1.4939	2.2136	3.2301	3.4718
Municipality	**2002 Adopted Tax Ratios**						
	Multi-Residential	**Commercial**	**Office Building**	**Parking Lot**	**Shopping Centre**	**Industrial**	**Large Industrial**
City of Toronto	4.1700	3.8000				5.3000	
Durham Region	2.4000	1.4819	1.4819		1.3300	2.2598	2.9000
Halton Region	2.2619	1.4565				2.3599	
Peel Region	1.7336	1.2971				1.5986	
York Region	1.3000	1.1000				1.3000	
Niagara Region	2.0000	1.6147				3.3648	3.7052
Waterloo Region	2.7400	1.9800				2.6300	
Oxford County	2.7400	1.9018				2.8219	3.3667
City of Ottawa	2.1780	1.9288	2.3309		1.6044	2.2439	1.9269
City of Greater Sudbury	1.9570	1.6614				2.4500	2.7560
City of Windsor	2.5202	1.9740	2.0071		2.0269	2.7228	3.8803
City of Kingston	2.6526	1.6616				2.6299	
City of London	2.1077	1.8808				2.6300	
City of Hamilton	2.8326	2.2420		2.2420		3.5621	4.1770
City of Thunder Bay	2.5400	2.3500	2.4800		2.1300	3.1000	3.3300

Source: Ontario Ministry of Finance and OPTA Data Base.

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