

# On Local Public Finance in the Canadian Federation

Craig Brett\*

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## **Abstract:**

This paper provides an overview of the ways in which the structure of the Canadian federation shapes the fiscal realities faced by local governments in Canada. Emphasis is placed on how the federal system affects the taxation power and expenditure responsibilities of local governments, and the various types of intergovernmental granting schemes that are in operation or have been proposed. Recent interest in greater involvement by the national government in municipal finance has yet to develop into new policy arrangements. Some comments the potential forms of this involvement are offered.

\*Canada Research Chair in Canadian Public Policy, Department of Economics, Mount Allison University, Sackville, New Brunswick E4L 1A7, Canada. Email: cbrett@mta.ca. Tel: +1 (506) 364-2532. Fax: +1 506 364-2625.

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## 1. Introduction

Canada is a vast nation, with a federal system of government capable of generating effective national policies despite great variation in regional economies, customs, and even languages. Each region of the country features its own diversity of localities: large and small, densely and sparsely populated, integrated into urban systems and remote. Many of these localities have municipal governments, charged with a duty to manage local affairs, and afforded the power to collect taxes in order to finance their efforts. These local governments are not explicitly recognized in the Canadian constitution. Instead, the power of municipal government is delegated from provincial governments. This basic feature of the Canadian system has profound implications for the machinery of local government, the kinds of work municipal governments perform, and the financial tools at municipal disposal. Because municipalities are provincial constructions, there is limited scope for national government involvement in municipal affairs. Yet, there have been calls for the national government to be more than just a bystander in the local sphere.

The connections among the three orders of Canadian government have contributed to the evolution of local budgets. Because provinces are autonomous, the operating rules of municipal government are not identical throughout Canada. Thus, the evolution of local budgets show considerable variation in detail. Still, they are similar enough that it is possible to identify national patterns in local finance. These national patterns are the primary focus of this paper, but important regional variation is also noted. Over the past two decades, the fastest growth in public expenditure has been in areas of provincial responsibility not delegated to municipalities. Part of the response to the resultant fiscal pressure on provincial governments has been a reduction in resources afforded to the municipal sector. Some provinces have also adjusted municipal expenditure responsibilities. Meanwhile, pressures on the national treasury have eased over the past decade, sparking interest in ways to direct money from the national government to municipal governments, with or without provincial involvement.

The remainder of this paper is organized as follows. The next section contains a brief sketch of Canadian federal structures, with a view to situating local government within the Canadian system. Section 3 describes the main categories of local government expenditure and how the levels of these expenditures have changed in recent years. Section 4 provides an overview of municipal revenue sources and their recent changes. This is followed, in Section 5, by a discussion of the current interest in direct financial relations between the national government and the municipal sector. Finally, some concluding remarks, directed at potential measures to ensure sufficient resources for local government, are offered.

## **2. The Place of Municipal Governments in the Canadian Federal System**

Political control is apportioned among three orders of government in Canada: national, provincial, and local. The national government operates under a system patterned on the British model, with an executive chosen by members elected to the lower house of a bicameral parliament. The upper house is appointed, and wields little power. The country is divided into ten provinces and three territories. Each province has its own parliament, commonly referred to as a legislature, consisting of a single house, with elections conducted according to the British model. The territories have assemblies, and carry out many of the functions of the provinces, but do so under authority delegated to them by the national government. Provincial authority is explicitly described in the Canadian constitution (Department of Justice Canada, 1867-1982). One of the striking features of the Canadian federal system is the tendency for strict assignment of the functions of government to either the national or provincial government, with few areas of concurrent jurisdiction (Auclair, 2002). Among the powers apportioned to provinces under Section 92 of the Constitution Acts, 1987-1992, is control over municipal institutions. Thus, with few exceptions, the institutions of local government are set up by provincial statute and the powers vested in these institutions rest on provincial authority. In particular, a municipal government can set only those types of taxes set out in provincial law and can spend money only in those areas permitted by

provincial statute. Local borrowing is also mediated by provincial governments.

Provincial legislation usually makes a distinction between an incorporated municipality (city, town or village) and an unincorporated, usually rural, area. Some provincial governments (Saskatchewan and New Brunswick, for example) carry out the functions of local government in unincorporated areas, while in other provinces (Nova Scotia and Ontario, for example) rural areas are organized into a county-level municipalities with municipal councils. Despite the nominal size-based distinctions among cities, towns and villages, provincial statutes tend to treat all incorporated areas uniformly. Permitted types of expenditure and available revenue sources tend to be the same for small villages as for large cities. Some provinces allow cities flexibility not afforded to villages in the ways they conduct operations. However, special taxation powers for cities are not the norm.<sup>1</sup>

Municipalities are governed by elected councils. Cities and larger towns are typically divided into districts, called wards, with representation from each ward on the municipal council. Some members of city councils, and most members of smaller town councils are elected at large. The electoral calendars, procedures and boundaries are all described in provincial law. In most provinces, mayors are elected directly by citizens, although nomination by council was not uncommon in the recent past. Unlike the national prime minister or a provincial premier, a mayor is not a political executive. Instead, a mayor serves as a chairperson of the municipal council. In some councils, the mayor votes on local laws only if there is a tie in voting by the other councillors. While often visible and charismatic, Canadian mayors do not wield a great deal of power (Tindal and Nobes Tindal, 2000). National-provincial relations in Canada are often conducted via executive federalism (Simeon and Cameron, 2002), in which decisions are negotiated among the national and provincial executives. By nature of their non-executive status, municipal mayors would perhaps not be able to fully participate in such decision making procedures. In any event, they are seldom asked.

Local governments appear to be in a relatively weak political position inside the Canadian

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<sup>1</sup>For example, *The Cities Act* of the Government of Saskatchewan (2003) affords cities special power (so called “natural person powers”) but expressly rules out additional forms of taxation.

federation. The structures of the federation, cemented in 1867, suited a rural, sparsely populated land. At a time when most villages were too small to exercise political control, drafting the structures needed to maintain control was left for provincial governments to carry out at a later date. At the time of Confederation, little thought was given to the responsibilities of local government or to the finances needed to meet these obligations. But the population of Canada is no longer scattered among a myriad of smaller villages. More than three quarters of Canadians now live in metropolitan areas (Statistics Canada 2002). A typical metropolitan area is made up of one or two large cities, a few large suburbs, and some formerly rural areas surrounding the urban core. Indeed, the areas surrounding, but not inside, Canada's largest cities are gaining population faster than another other part of the country. As a result, an increasing number of Canadians are demanding a style of urban governance that the traditional village council model, tightly controlled by provincial legislation, is not likely to be able to give.

### **3. Municipal Expenditures**

The Canadian federation is remarkably decentralized. A wide array of government services are provided by provincial and municipal governments. The division of responsibilities between the two sub-national orders of governments has evolved throughout Canada's history to a point where most, but not all, provinces have adopted the principle that municipal governments provide services to property, while the provincial government provides services to people. Thus, municipalities provide such items as fire protection, policing and garbage disposal, while provinces typically handle public health care, education and social assistance. The most straightforward economic justification for the canonical division of power is that the benefits of property services are not likely to spill over to other jurisdictions, so they can be efficiently allocated within municipal boundaries. People, being more mobile than property, can either move to areas with enhanced levels of service or can receive services in areas other than their place of primary residence. In either of these events, benefits of

people services may extend beyond local boundaries, and standard externality arguments imply that local councils might under-provide these services.

Table 3.1 illustrates the expenditure responsibilities of local governments in Canada. The largest expenditure categories are transportation, which includes road maintenance and snow removal; protection, which includes policing and fire protection; environment, which includes water and sewer services and garbage collection and disposal. These functions are the sorts of things that usually come to mind when services to property are discussed. The next largest item is recreation and culture, which is a mixture of programme delivery and maintenance of physical infrastructure, such as parks and hockey rinks. While not exactly a service to property, this function of government is generally regarded as one for which adaptability to local circumstance is important. Municipalities play a limited role in financing health care and education. In many provinces, municipalities make no direct contributions to these activities.

The Canadian constitution affords each province the flexibility to allocate tasks to its municipalities and to set minimum standards of service for each function. As a result, the exact division of powers differs from province-to-province. Of equal importance is the fact that the paths taken by various provinces to the current division of responsibilities have been quite different. These different paths help to explain differences in financial pressures across provinces. Virtually all of the involvement of municipal government in social services is due to the division of responsibilities in the Ontario, Canada's most populous province and home to such cities as Toronto and Ottawa. The most recent re-alignment of responsibilities in that province is quite recent, and is commonly referred to as the disentanglement exercise. Before this exercise, responsibility for education rested partly with municipal governments. After disentanglement, the provincial government assumed full responsibility for education, but shifted some of the burden for social services to municipalities. The primary reason for this swap within the people services category appears to have been budget neutrality. The additional cost to the provincial treasury of more responsibility in education was offset by savings in the sphere of social assistance.

Table 3.1: Composition of Local Expenditures in Canada, 2002

<b>Expenditure Category</b>	<b>Percentage of Local Government Expenditure*</b>
<b>General Services</b>	9.6
<b>Protection</b>	16.7
<b>Transport</b>	20.0
<b>Health</b>	2.4
<b>Social Services</b>	11.2
<b>Education</b>	0.4
<b>Environment</b>	15.2
<b>Recreation and Culture</b>	12.1
<b>Debt Charges</b>	5.1
<b>Other</b>	7.3

\* Author's calculations based on Treff and Perry (2003, Table A.13)

Ontario is not unique in shifting the boundaries between provincial and municipal responsibility, nor is it the only province that introduced seemingly curious features out of concern for budget neutrality. The province of New Brunswick has a division of responsibilities that, on the surface, appears to approximate the property versus people division quite nicely. Before 1967, when the current division of responsibilities was enacted, local government was responsible for education and social assistance. When the province took on responsibility for these fields, it also instituted a provincial real property tax, thereby encroaching on a tax field that remains important to municipalities. When the province of Nova Scotia took on added responsibility in education and correctional services, it required municipalities to pay contributions to the provincial government for these services. In the case of education, these contributions are proportional to the local property tax base, so they have an effect very much like the New Brunswick provincial property tax.

There is a measure of concern in Canada about the ability of municipal governments

to cope with their expenditure responsibilities, along with calls on other levels of government to help meet these challenges. In order to get a sense of whether this is a new or growing problem, it is helpful to look at how the distribution of public spending among the various functions of government has changed. It is important to note that various realignments in responsibilities have, in some cases, altered through time the identities of the governments doing the spending. Moreover, constitutional orientation toward exclusive jurisdictions notwithstanding, each expenditure category typically includes spending by all three orders of government. Table 3.2 provides this information. It is apparent that expenditure on protection, the largest of the municipal expenditure categories, has risen in rough proportion to total public spending, while growth expenditure on transportation has been below growth in total public spending. Among the major areas of municipal responsibility, only environment and recreation and culture appear to be growing faster than total public budgets. The functions usually financed by provincial means, health, education, and social services, are among the fastest growing categories of public expenditure. The categories not displayed in Table 3.2, but included in the national aggregate, bring the national growth rate down. These categories are largely under national jurisdiction.

If the recent past is a guide to the near future, then we might expect that demands for expenditure in the areas under local jurisdiction (in most provinces) to be less pronounced than the demands for increased expenditure in areas under provincial jurisdiction. In this event, we are unlikely to see an expenditure-driven financial crisis in Canadian local finance. There are three important caveats to this prognosis. First, the recent slow growth in spending on transportation may have been the result of deferred maintenance of infrastructure. Thus, we might expect a reversal in expenditure needs in this category. Indeed, a recent task force report by the national government named transportation and infrastructure (including highways) as two of the three priority areas in a national urban strategy (Prime Minister's Caucus Task Force on Urban Issues, 2002). Second, the increased demands on provincial governments may lead to increased pressure on municipal politicians offer provincially services, such as certain components of recreation, caught in a financial squeeze. Third, perhaps

Table 3.2: Growth in Total Public Expenditures in Canada, 1984-2002

<b>Expenditure Category</b>	<b>Percentage Increase*</b>
<b>General Services</b>	24.8
<b>Protection</b>	84.3
<b>Transport</b>	51.0
<b>Health</b>	117.9
<b>Social Services</b>	99.2
<b>Education</b>	94.6
<b>Environment</b>	99.9
<b>Recreation and Culture</b>	100.8
<b>Total</b>	81.2

\* Author's calculations based on Treff and Cook (1995, Table 17.4) and Treff and Perry (2003, Table A.9)

other provinces will follow the lead of Ontario in assigning responsibilities for expensive people services to the municipal sector. The most significant knock-on effect of increased strain on provincial coffers, however, has occurred on the revenue side of municipal budgets.

#### 4. Revenue Sources

Municipal governments have not been endowed with an overwhelming array of revenue sources. Virtually all municipal operating revenue comes from one of three sources: real property taxation, fees for the provision of municipal services, and grants from other governments. Most grants to municipalities are unconditional aid from their respective provincial governments. The importance of grants from provincial governments has been declining in recent years. Provincial governments, for their part, have received smaller grants from the national government. Moreover, the provincial authorities have reallocated their budgets toward other priorities, notably health care. Thus, municipal governments have become increasingly reliant on own-source revenues to fund their operations. Table 4.1 demonstrates

the extent of the shifts in funding. It highlights the increasing share of property taxes and fees for municipal services in recent years. Given that provincial granting schemes tend to have an equalizing component,<sup>2</sup> an inevitable result of the increasing reliance on municipal own-source revenue is greater fiscal disparity among municipalities.

Table 4.1: Composition of Local Revenue in Canada, 1983 and 2002

Revenue Source	Percentage of Local Government Revenue	
	1983*	2002 <sup>†</sup>
Property Taxes	37.7	55.1
Other Taxes	0.3	1.3
User Fees <sup>‡</sup>	11.0	22.7
Intergovernmental Transfers	48.4	14.6
Other Revenue	5.7	6.3

\* Author's calculations based on Treff and Cook (1995, Table 17.8)

<sup>†</sup> Author's calculations based on Treff and Perry (2003, Table A.9)

<sup>‡</sup> Includes revenue from sales

As Table 4.2 illustrates, there is considerable variation in the composition of municipal funding among the provinces. Even among provinces with a similar share of funding via intergovernmental grants the relative importance of fees versus taxes is far from uniform. The province of Alberta is notable for generating a relatively high proportion of municipal revenue from additional sources, mostly from municipal investments. The case of Alberta also highlights that meagre (by the standards of recent history) grants from the provincial treasury are not necessarily the result of provincial financial crisis. Alberta is rich in oil and natural gas, and its provincial government is in a strong fiscal position due partly to the resource royalties it collects. Diminished aid to municipalities, it seems, is political fashion

<sup>2</sup>For example, the unconditional granting scheme in Nova Scotia is officially titled the Equalization Grant (Government of Nova Scotia, 2003).

as well as budgetary necessity.

Table 4.2: Composition of Local Revenue in Canada, 2002, Selected Provinces

Revenue Source	Percentage of Local Government Revenue*				
	New Brunswick	Quebec	Ontario	Manitoba	Alberta
<b>Property Taxes</b>	53.8	64.6	53.0	44.8	46.9
<b>Other Taxes</b>	0.6	0.3	1.2	2.5	1.6
<b>User Fees<sup>‡</sup></b>	27.2	19.0	21.2	25.2	30.5
<b>Transfers</b>	17.2	11.5	19.3	18.6	8.9
<b>Other Revenue</b>	1.3	4.6	5.3	8.9	12.1

\* Author's calculations based on Treff and Perry (2003, Table A.9)

‡ Includes revenue from sales

The pressing question is whether real property taxation and user fees are likely to generate sufficient revenue for municipal finance in the near future. Kitchen (2002) argues that these traditional revenue sources are capable of sustaining municipal governments, and that user fees remain under utilized in many provinces. Vander Ploeg and Berdahl (2002), on the other hand, argue that growth in property tax revenue has not kept pace with municipal growth in the largest cities of Western Canada. Table 4.3 illustrates the rate of growth in selected government revenue sources in recent years. The rate of growth in property tax collections is virtually identical to the rate of growth in total public revenue. Thus, there is little evidence that, throughout the entire country, property taxes have failed to keep pace with other tax sources.<sup>3</sup> User fees, meanwhile, are growing faster than total revenue.

Why are municipalities concerned about their ability to raise revenue through property taxes? The cause for this concern might lie in the fact that most provincial governments also levy property taxes. Moreover, taking Canada as a whole, the share of property tax

<sup>3</sup>Brett et. al (2004) report that the property tax base grew only slightly slower than provincial product in New Brunswick from 1983 to 2003, while property tax rates increased throughout the province.

Table 4.3: Growth in Tax Collections, All Governments, 1984-2002

Revenue Source	Percentage Increase*
Income Taxes	89.0
Taxes on Consumption	118.5
Property Taxes	110.1
Fees and Sales of Goods	129.1
<b>Total</b>	<b>111.0</b>

\* Author's calculations based on Treff and Cook (1995, Table 17.2) and Treff and Perry (2003, Table A.2)

revenue collected by provinces has increased from approximately ten percent in 1983 to approximately 25 percent in 2002.<sup>4</sup> While much of this change is accounted for by a shift in school taxes from local boards to provincial governments, the share of property taxes kept by municipalities fell in four provinces from 1988 to 2000 (Kitchen, 2002, p.29).

## 5. National Initiatives and Provincial Authority

Amid concern over the ability of property tax base to generate additional revenue for local governments at a sufficient rate to meet the demands of an increasingly urbanized municipal sector, municipalities are looking to exploit additional tax bases. Local governments cannot act alone, for additional taxation power must be validated by new provincial statutes. Some provinces, but not all, allow their cities to collect a business tax or a hotel occupancy tax. In any event, such levies are unlikely to provide a significant boost to local coffers. Other provinces share revenue from corporate taxes or public lotteries with their municipalities (Lidstone, 2004). To date, these sources have remained tiny in comparison to the property tax. Given recent trends in direct provincial aid to municipalities and in demands on provincial services, it is difficult to imagine provincial governments signing over signifi-

<sup>4</sup>Author's calculation, based on Treff and Cook (1995, Tables 17.6 and 17.8) and Treff and Perry (2003, Tables A.7 and A.9).

cant taxation instruments to their municipalities in the near future. Not surprisingly then, municipal leaders are looking toward the national government for new sources of income (MacLean, 2004).

Because provincial governments have constitutional authority over local government, the role of the national government is limited to providing financial transfers. The Canadian constitution does not forbid national spending in areas of provincial jurisdiction. Indeed, the ability of the national government to dispense funds as it deems appropriate, the so called federal spending power, has survived court challenges by provincial governments (Brown, 2002). The national government has four design choices to make in any programme of assistance to municipalities? Should grants be unconditional or conditional? Should the amount of national assistance be tied to specific national revenue sources? How should grants be allocated among municipalities? What, if any, involvement by provincial governments is required?

Many of the factors weighed in the choice between conditional and unconditional grants to municipalities occur in any intergovernmental granting arrangement. Unconditional grants have the advantage of not distorting municipal priorities, and allow the national government complete control over the total financial commitment. Grants conditional on performance of specific functions by municipalities require expensive auditing, but ensure that monies are spent in areas of priority to the national government. Matching grants, which require concurrent outlays by the recipients, distort the prices faced by municipal governments and may lead to over-investment in the areas covered by granting arrangements. Also of concern with matching arrangements is the ability of municipalities to cover their share of programme financing. Thus, an offer help from the national government might not be accepted because municipalities cannot afford to match. Moreover, it is likely to be the most cash-strapped municipalities that end up in this predicament.<sup>5</sup> Nevertheless, a cost-sharing arrangement for municipal infrastructure is among the items on the current Canadian political agenda.

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<sup>5</sup>This kind of outcome has occurred before in the context of Canadian national-provincial matching grant arrangements, when poorer provinces expressed concern over their ability to participate (Perry, 1997).

In addition to cost-sharing arrangements, direct payments to municipalities by the national government have been proposed (Office of the Prime Minister, 2004). The proposal calls for payments in proportion to the revenue raised by taxes on gasoline. For their part, municipal leaders prefer a slightly wider base, taxes on fuels (Federation of Canadian Municipalities, 2004). The arguments in favour of this type of arrangement include the potential for faster growth in fuel tax revenue than growth in property tax collections, and the view that fuel consumption is a good proxy for road usage, rendering gasoline taxes a close substitute for road user charges. It might also be the case that tying the size of the total grant pool to a source of national revenue balances concerns over the national government's ability to finance the grants with municipal concerns over the possibility of future cuts in assistance from the national government. It is by no means clear, however, that hypothecation of a specific revenue source is the only way to balance these concerns.

Many of the national government's concerns over municipal finances have been expressed in the context of urban renewal. Thus, there is a presumption that federal assistance is likely to be concentrated in cities, with rural areas receiving little, if any, new money. If some variant fuel tax sharing emerges, then either the revenue will be returned to the municipalities from which the fuel tax is collected, or it will be redistributed among municipalities. If the former option is adopted, rural areas will not benefit but the arrangement will remain an approximate local user fee. Should the latter option prevail, payments could be tailored to meet equity objectives including, but not limited to, rural-urban equity. A recent initiative in the province of New Brunswick illustrates the complexity of the grant allocation problem. In 1997, the provincial government began to phase-in a new method of allocating grants to municipalities. This system was designed to allocate extra assistance to municipalities with lower property tax bases. However, the change in the granting scheme coincided with a decrease in the aggregate level of provincial financial assistance to municipalities. As a result, many municipalities were to face significant cuts in grants (Government of New Brunswick, 2001). Concern over the fate of these municipalities and the resulting political pressure meant that the system was never fully phased-in. The national government of today

is in a slightly better position to implement revenue redistribution than the New Brunswick government of the late 1990s was, because it can ensure that all municipalities gain from a new arrangement.

Although the national government has the constitutional right to spend its money as it wishes, it must at least be mindful of provincial authority in the municipal sector as it prepares to embark on its spending to municipalities. Because provincial governments provide grants to their municipalities, they have a measure of control over total municipal budgets. Some municipalities fear that their provincial governments will claw back any money they receive from the national government through reduced provincial grants (Tower, 2004). Provincial involvement might also be desirable to the national government in its own right, as a way of respecting provincial jurisdiction, fine-tuning national programmes to differences in provincial circumstances, or easing tensions among the various levels of government. It is very difficult to imagine a national programme that can fully adjust for the differences in municipal financial need owing to differences in provincial legislation regarding the functions of local government. Provincial involvement in three-way cost sharing arrangements, requiring national, provincial and municipal contributions, is also a means to reduce national financial obligations.

## **6. Conclusions**

Local governments in Canada are clamouring for a new set of political and fiscal arrangements. A canonical refrain is that the primary source of municipal funding, the property tax, is not capable of generating enough revenue. This diagnosis of the problem is perhaps too simplistic, for there is some evidence that the property tax base is not exactly feeble. A deeper cause of fiscal strain on municipalities is the increasing demand for services provided by provincial governments. As provincial governments struggle to meet this demand, they re-prioritize their spending, often to the detriment of municipalities. Because the Canadian constitution vests power over municipalities with the provinces, any new taxation powers

afforded to local governments must meet with provincial approval. It would be difficult, and perhaps even unwise, for provincial politicians to sign over such authority when the provinces themselves might make use of this taxation power to meet growing demands on their own budgets. Indeed, there has even been a tendency for some provinces to claw back effective local taxation power by encroaching on property taxation. With provincial governments seemingly more concerned with other priorities, municipal leaders view the national government as a more likely donor of financial assistance.

Increased urbanization, particularly the concentration of the Canadian population in a handful of large urban regions (Bourne and Simmons, 2003), has created large variation in the size and character of municipalities within the same province. Increased fiscal decentralization means that the capacity to deliver local public services is now more closely tied to local financial means. As a result, even within a given province, municipalities are remarkably heterogeneous. Although every bit as diverse as provinces, municipalities lack the power to express this diversity through differences in the tax mix. The real choices afforded municipal governments in most provinces are between property tax finance and user fees, while provinces make choices on how to mix dozens of taxes to meet multiple provincial objectives. Just as some villages choose not to operate municipal water services (and charge no water service fees), not all municipalities would adopt hotel taxes or levies on local businesses should these revenue sources become available. But some might. Perhaps the most striking feature of local public institutions in Canada is how similar are the powers and responsibilities of municipalities throughout the country, and how they are more similar still within provinces. Thus, when a provincial government decides that it needs to cut unconditional grants or retain more property tax revenue, all municipalities feel the pinch. Moreover, those hit hardest lack mechanisms to offset their losses. It seems reasonable to allow more scope for tax mix by municipalities. This requires some new municipally administered taxes.

With national assistance to the municipal sector on the horizon, debate over the form and distribution of this assistance is only natural. There are those who fear that national money will be of most benefit to cities or come at the expense of provincial monies. If the

needs of cities are different from the needs of villages, or if the circumstances of cities vary from province to province, why must national policy be blind to these differences? At a time when federal-provincial arrangements are becoming increasingly asymmetric (Burgess, 2003), is it not time for provincial-local or federal-local relations to follow suit?

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