Innovative Mechanisms for Fiscal Transfers to Municipalities – The Canadian Experience in Municipal Financing

This case study highlights some of the innovative mechanisms used to transfer funds from the Canadian federal and provincial/territorial governments to Canadian municipalities. It is one in a series of thematic case studies that help inform FCM’s international cooperation activities and support knowledge sharing among municipal practitioners.
OVERVIEW
The Federation of Canadian Municipalities (FCM) is the national voice of municipal government in Canada. With more than 1,800 members, FCM represents the interests of municipalities on policy and program matters that fall within federal jurisdiction. Members include Canada's provincial and territorial municipal associations.

FCM draws on the strength of its municipal network to implement municipal capacity building programs in over 20 countries in Asia, Africa and the Middle East, Latin America and the Caribbean. With support mainly from the Canadian International Development Agency (CIDA), FCM’s international programs aim to support decentralization processes, foster governance and strengthen municipal management and service delivery. More than 200 Canadian municipalities and municipal associations, and 1,500 Canadian municipal experts have participated in FCM’s international program since its inception in 1987.

Municipal financing is a key issue of concern to the municipal sector both in Canada and globally. Municipalities are faced with increasing responsibilities to build and maintain municipal infrastructure, and deliver services, but most lack adequate resources to manage these responsibilities effectively. Local property taxes are but one of many sources of revenue that municipalities require to meet the needs of their citizens. Municipalities also commonly rely on fiscal transfers from higher orders of government and participate in revenue-sharing agreements.

In Canada, municipalities rely on fiscal transfers to meet about 20% of their budget requirements, while the remaining funds are derived locally from property taxes. In many parts of the world, particularly in developing countries new to the decentralization process, fiscal transfers make up the bulk of municipal revenues, comprising up to 70 or 80% of their budgets. Without access to stable and predictable funding through government transfers, these municipalities would be unable to provide the local services and infrastructure required to meet even the most basic needs of their communities.

This case study describes the Canadian experience in municipal financing, outlining some key examples that show how higher orders of government are fiscally supporting Canadian municipalities. It is intended to contribute to knowledge sharing among FCM’s international program partners and other institutions in its local governance network.

Section 1: Introduction
Canadian municipalities, like municipalities around the world, are experiencing increasing demands to deliver high-quality public services and to invest in major infrastructure. These demands come from a number of different sources. The need to be internationally competitive puts pressure on municipalities not only to supply basic local services such as water, roads, and garbage collection but also to provide the services and infrastructure that will attract skilled labour (the so-called “knowledge workers”). These services include, for example, cultural and recreational facilities and programs. The “offloading” of services by both the federal and provincial governments means that municipalities have taken responsibility for services that were previously funded by the other orders of government. A realignment of local services in the Province of Ontario in 1998, for example, resulted in municipalities paying for a larger portion of social services costs than they had previously. Aging infrastructure requires that municipalities replace many of their capital facilities that have been stretched beyond their useful life.

At the same time that municipalities are facing and will continue to face increased pressures on the expenditure side of their budget, there has been no parallel diversification of their revenue sources. Canadian municipalities rely mainly on property taxes and user fees to finance a wide array of services. The property tax is a good tax for local governments but the revenues do not increase directly with growth in the economy as do other taxes such as income and sales. To a large extent, municipal revenues have not kept pace with the rapidly changing expenditure needs of municipalities. The Federation of Canadian Municipalities estimates that the municipal fiscal imbalance in Canada now exceeds CDN $123 billion.

Canadian municipalities also depend on transfers from provincial/territorial governments and, to a lesser extent, from the federal government. Indeed, Canada has a long history of providing transfers to municipal governments. In some cases, these transfers are for specific purposes (for example, to pave roads or subsidize recreation
programs) and, in other cases, they are general purpose grants (for example, they can be used for any expenditures or to reduce taxes). This case study documents some of the innovative mechanisms used to transfer funds from the federal and provincial/territorial governments to Canadian municipalities.

The Intergovernmental Context in Canada
Canada is a federation with three orders of government — federal, provincial and territorial, and municipal. There are ten provinces, three territories, and approximately 4,000 municipal governments. In Canada, the term “municipality” refers to all authorities that have municipal responsibilities and these include local administrations, metropolitan and regional municipalities, and sectoral and multi-sectoral organizations. For example, there are towns, villages, townships, cities, counties, regional municipalities, metropolitan municipalities, and special purpose bodies. Each provincial/territorial government establishes its own terminology.

Under the Canadian Constitution, powers are divided between the federal and provincial governments. Municipal governments are not recognized in the Constitution except to the extent that they are the responsibility of provinces and territories. The federal government is responsible for maintaining the “peace, order and good government” of the whole country by making laws with respect to immigration, unemployment insurance, trade and commerce, national defence, native affairs, and criminal law. Provincial governments are empowered to control regional and local affairs including education, health, social services, property rights, administration of justice, local public works, and municipal institutions. Some responsibilities are shared between the federal and provincial governments such as immigration, agriculture, and pensions.

Under Section 92 of the Constitution, “Municipal Institutions in the Province” are under exclusive jurisdiction of the province. It is thus often said that municipalities in Canada are “creatures of the province.” In reality, this constitutional provision means that provincial governments establish the very existence of local governments and their geographic boundaries; mandate most of the expenditure responsibilities of municipalities and, in many cases, minimum standards for local service provision; determine the revenues they can raise; set rules for levying the property tax; prohibit municipalities from incurring a deficit in their operating budgets; and determine the extent to which municipalities are allowed to borrow to meet capital requirements. Provincial governments further shape and direct municipal expenditures through grant programs.

Figure 1: Composition of Municipal Expenditures, Canada, 2007

Source: Statistics Canada. Table 385-0024 - Local general government revenue and expenditures, current and capital accounts, CANSIM.
Notwithstanding the provincial control over Canadian municipalities, every municipality has the power to set up a variety of bodies to develop policy, discuss alternatives, and make decisions. The municipal council is the main decision-making and policy-making body that determines the municipality’s general guidelines for intervention and passes all budgets (operating and capital), policies, and programs that the administration is responsible for implementing. The municipal council (including the mayor) is elected with majority voting and a first-past-the-post system.

**The Fiscal Context**

Canadian municipalities make operating and capital expenditures on a range of services, as shown in Figure 1. The largest proportion of total expenditures is on transportation (roads and transit) and communications followed by environment (water, sewers, and waste management), protection to persons and property (mainly fire and police protection), and recreation and culture. Municipalities also make expenditures on general government administration, social services (mainly in one province—Ontario), housing, debt charges, planning, health, and resource conservation and development.

The distribution of municipal expenditures in Canada has not changed significantly over the last 20 years. Expenditures on protection, recreation and culture, and environmental expenditures have increased somewhat as a proportion of total expenditures whereas expenditures on transportation, general administration, regional planning, and debt charges have fallen slightly.

To finance municipal expenditures, the main sources of municipal revenues are property taxes (which account for almost half of all revenues and include payments in lieu of property taxes by the federal and provincial governments, special assessments, and business property taxes), user fees, and intergovernmental transfers (see Figure 2). Transfers account for just under 20 percent of total municipal revenues and the bulk of these transfers are received from the provincial/territorial governments. There are some transfers from the federal government as well. Most transfers (over 90 percent) are conditional — they have to be spent on specific functions. Other sources of municipal revenue include investment income and some other taxes but these account for only a small proportion of revenues.

As a percentage of total municipal revenues, property taxes and user fees have increased over the last 20 years. Intergovernmental transfers (mainly from provincial governments), on the other hand, have decreased significantly over the period.

**Figure 2: Composition of Municipal Revenues, Canada, 2007**

| Source: Statistics Canada. Table 385-0024 - Local general government revenue and expenditures, current and capital accounts, CANSIM. |
Section 2: Principles of Grant Design

The way in which fiscal transfers are designed has important implications both for local service provision and for the overall fiscal health of municipalities. The ten public finance principles shown in Table 1 can be helpful in designing fiscal transfers.

As with any list of criteria, it is not possible to design one transfer that simultaneously follow all of the principles in Table 1. As will be discussed below, however, different types of transfers can be designed to meet different objectives. To ensure that the transfer design reflects the needs of the municipal sector, consultation with municipal stakeholders is essential.

<table>
<thead>
<tr>
<th>Table 1: Ten Principles of Grant Design</th>
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<tr>
<td><strong>Efficiency:</strong> Efficiency is achieved if the grant is neutral with respect to local government decisions on the allocation of resources to different activities. The exception is where the grant corrects existing distortions in expenditure practices. For example, municipalities do not have the incentive to provide the correct level of services where the benefits extend to residents of other jurisdictions. A grant provides the incentive to increase expenditures to the optimal level.</td>
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<td><strong>Fairness (equity):</strong> Equity dictates that that all municipalities should be able to provide an adequate level of service without resorting to unduly high tax rates. To achieve this objective, the transfer to municipalities should vary directly with the fiscal need and inversely with the fiscal capacity of the municipality (capacity to raise own-source revenues).</td>
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<td><strong>Clear Objectives:</strong> Grant objectives should be clearly specified.</td>
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<td><strong>Accountability:</strong> The donor government should be accountable for the design and operation of the grant program. The recipient government should be accountable to citizens and the donor government for the use of the funds.</td>
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<td><strong>Transparency:</strong> This principle is an extension of the accountability principle. Transparency is enhanced when the recipient government and citizens/taxpayers have access to information about the grant formula and the allocation of funds.</td>
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<td><strong>Stability and predictability:</strong> Revenues should be stable and predictable so that municipalities can budget and plan for future expenditures.</td>
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<td><strong>Revenue adequacy:</strong> Municipal governments should have adequate revenues to discharge their expenditure responsibilities.</td>
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<td><strong>Autonomy:</strong> Municipal governments should have autonomy and flexibility to set their priorities and not be constrained by grant funding.</td>
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<td><strong>Responsiveness:</strong> The grant formula should be flexible enough to allow municipalities to respond to changing economic circumstances.</td>
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<td><strong>Simplicity:</strong> The grant formula should be based on objective factors over which local governments have limited control. The formula should be easy to understand.</td>
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Section 3: Role of Intergovernmental Transfers

According to the benefit model of local government finance, local government services, wherever possible, should be paid for on the basis of the benefits received from those services. This model suggests that user fees and local taxes are appropriate to pay for local services. Within this model, there is also an important role for intergovernmental transfers. Transfers can take many different forms, depending on the underlying rationale for the transfer. The types of transfers and their rationales are summarized in Table 2 on page 7.

Types of transfers

Transfers can be broadly categorized as unconditional or conditional. Unconditional transfers (also referred to as general purpose transfers) have no conditions attached to their use — they can be spent on any local service or they can be used to reduce local taxes. In some cases, unconditional transfers are given on a per capita basis; in other cases, the amount of the transfer depends on a formula which might take account of the expenditure needs of the municipality, the size of its tax base, or other factors.

Conditional transfers, as the name suggests, have conditions attached to them. These transfers have to be spent on specific expenditures, for example, roads, parks, or some other local service. Conditional grants are fungible, however, in the sense that, even though they come with strings attached, there is no guarantee that the recipient will spend the funds on what the donor government intended. For example, municipalities that are already spending considerable funds in the area specified by the donor government will be able to divert grant funds to other purposes and still meet donor requirements.

Within the category of conditional transfers, there are matching transfers and lump sum transfers. Matching transfers require that the municipality match donor funds. For example, the donor may offer a transfer that covers 80 percent of the cost of road construction. Municipalities, under this type of transfer, would have to raise their own funds to cover the remaining 20 percent of the cost. Lump sum conditional transfers (also known as block grants) do not require the municipality to provide matching funds.

Matching grants can be open-ended or closed-ended. Open-ended grants have no limits placed on them. This means that whatever the recipient government chooses to spend on the function to which the grant applies, the donor will fund the specified percentage of that amount. Few grants are truly open-ended for the obvious reason that the donor government’s exposure could be very significant and it does not know its exposure until the recipient has decided on its level of expenditures. Closed-ended grants have upper limits placed on them by the donor whereby the donor matches funds up to a specified amount. There are also other ways to place limits on conditional, matching grants. For example, the donor could specify the amount of eligible costs. In this way, the donor matches funds only for specified, pre-determined expenditures. Finally, grants are often closed-ended by requiring donor approval either at the political or bureaucratic level. This requirement implicitly places a limit on the size of the grant.

Rationale for Transfers

There are four possible justifications for intergovernmental transfers: fiscal imbalance (fiscal gap), equity, externalities, and political rationales such as the need to achieve minimum standards in service provision. The type of transfer that is appropriate depends on the underlying rationale.

Fiscal Imbalance (Fiscal Gap)

When municipalities have inadequate own-source revenues (such as local taxes and user fees) to meet their expenditure responsibilities, there is said to be a fiscal imbalance or fiscal gap. The resulting gap can be closed by an unconditional (lump sum or block) intergovernmental transfer that allows the municipality to spend the funds in whatever areas it deems appropriate. The total amount of the transfers allocated for this purpose can be determined in one of three ways: as a fixed proportion of the revenues of the donor government (known as revenue sharing); on the basis of a formula (for example, as a percentage of specific local government expenditures or some other characteristics of the local governments such as population); or on an ad hoc basis.

Under revenue sharing, the donor government allocates a portion of one or more of its tax revenues to local governments. For example, a provincial government may agree to share a percentage of its personal income tax revenues with municipalities. Once the total amount of funds available for grants is determined, funds can be allocated to municipalities on a derivation basis (on the basis of where they were collected) or on the basis of a formula (for example, on a per capita basis). Revenue sharing on a derivation basis favours richer areas where revenue collections are the largest. Revenue sharing distributed on a per capita basis has an implicit equalization component because richer areas give up tax revenues to poorer areas.

The advantage of revenue sharing over ad hoc grants is that the transfer to municipalities automatically increases as the yield from that revenue source increases. To be a stable source of revenue to municipalities, however, the percentage share going to municipalities has to be maintained over time. Revenue sharing does not enhance local autonomy, accountability, or efficiency because local governments do not set the tax rates or the tax base and they receive transfer funds regardless of their tax effort.

Fiscal gaps can be closed in other ways besides a transfer to the municipality. Provincial governments can transfer additional revenue-raising powers to local governments or they can reduce the expenditure responsibilities that local governments are required to undertake. For example, if provincial governments “uploaded” the funding of some services, then the expenditure responsibilities at the local level would be reduced and so would the extent of the local fiscal imbalance. Alternatively, the other orders of government could allow local governments to raise revenues from additional tax sources. Moreover, municipalities themselves could reduce their expenditures or raise their taxes to close the fiscal gap.
Equity
Some municipalities are unable to provide an adequate level of service at reasonable tax rates compared to other municipalities. This inability to provide an adequate level of service in the absence of a transfer may occur for at least three reasons. First, tax bases differ from one municipality to another and thus, to collect the same amount of revenue, a municipality with a small tax base will have to levy a higher tax rate than a municipality with a larger tax base. Second, the costs of providing public services may be higher in one municipality than another so that more tax revenues are required to provide the same level of service. Third, the need for particular public services may be greater in one municipality than another thereby necessitating higher expenditures (and higher tax revenues). Under these circumstances, an equalization grant is appropriate. These grants are usually unconditional but can be used for specific expenditure categories (e.g. education).

Equalization grants, based on expenditure needs and the ability of local governments to levy taxes, can ensure that those municipalities with relatively small tax bases and relatively higher costs and needs will be able to levy tax rates that are comparable to other jurisdictions. Generally, the formula calculates the difference between a standardized expenditure and a standardized revenue base. Standardized expenditures are calculated by a standard level of per capita expenditure multiplied by the population of the municipality; standardized revenues are calculated by multiplying a standard tax rate by the tax base of the municipality.

Externalities (Spillovers)
Grants are also appropriate where services spill over municipal boundaries (for example, in the case of regional highways). If the municipality responsible for the service bases its expenditure decisions only on the benefits captured within its jurisdiction, it will likely under-allocate resources to this service.

One way to provide an incentive to allocate more resources to the service generating the externality is a transfer from the federal or provincial government. The type of transfer that is appropriate for addressing externalities is a conditional, matching grant. The grant should be conditional in that it has to be spent on the service which generates the externality. It should be matching to reflect the extent of the externality. For example, if 50 percent of the benefits of highway expenditures spill over existing municipal boundaries, the matching rate should be 50 percent. The rate of grant may decline as expenditures increase on the grounds that the externalities diminish. For services that spill over municipal boundaries, a provincial transfer is appropriate. For services that spill over provincial boundaries, a federal transfer is justified.

Matching grants require that the municipalities contribute a portion of the funds to deliver the service. A uniform matching rate tends to favour richer municipalities because they are more able to match funds than poorer municipalities, unless there is an equalization component to the grant. Moreover, a matching grant will only stimulate spending if the municipality has the power over expenditures and the ability to increase taxes.

Political Rationales
In addition to the economic rationales for intergovernmental transfers, there are also political rationales that are unlikely to be related to fiscal imbalance, externalities, or equity. Transfers are sometimes established in response to successful lobbying by municipal associations (for example, the lobbying by FCM for a permanent federal gas tax transfer). Transfers have also been introduced in response to a public outcry over deteriorating services or infrastructure (as happened when there were problems with water quality and the public demanded higher standards and more funding).

Federal or provincial/territorial governments may use grants to encourage local governments to provide at least a minimum standard of service in areas such as road safety, ambulance services, and water

### Table 2: Intergovernmental Fiscal Transfers – Types and Rationales

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<td>Conditional Matching</td>
<td>Have to be spent on specified functions; municipality is required to match provincial funds</td>
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Federal or provincial/territorial governments may use grants to encourage local governments to provide at least a minimum standard of service in areas such as road safety, ambulance services, and water...
and waste water treatment. Intergovernmental transfers are often used to provide incentives for local governments to act as agents of the donor government. In this way, the donor government benefits from local management in providing a service. Conditional grants are sometimes given to acquaint local governments with services they would not have provided on their own with the expectation that they will eventually take over the funding for them and the senior governments can withdraw. To meet these political objectives, conditional, lump sum grants are usually used.

Section 4: Intergovernmental Transfers in Canada: Six Case Studies

There are many examples of intergovernmental transfers in Canada. Indeed, each province and territory provides both unconditional and conditional transfers to local governments. The federal government also has transfer programs for local services. This section describes and evaluates six programs — three federal programs and three provincial programs.

Federal Gas Tax Transfer: Federal Conditional Transfer

Starting in 2005, the federal government has directed a portion of federal gas tax revenues on a per capita basis to municipalities for environmentally sustainable municipal infrastructure (including roads). The funds, in most provinces and territories, flow through the provincial/territorial government but, as noted below, there are exceptions. The program provides for a targeted allocation for the three northern territories (Nunavut, Northwest Territories, and Yukon) as well as Prince Edward Island. The targeted allocation is a way to recognize the need for less populated jurisdictions to have sufficient funds for significant infrastructure investments and the increased costs associated with infrastructure in northern and remote areas. Annual funding of CDN $2 billion per year was recently made permanent.

To implement this program, very detailed agreements have been prepared with every province (and territory) establishing an allocation formula under which the revenues are allocated to provinces on a per capita basis. There are some differences, however, in the terms of the agreements across the country. For example, the share of the provincial amount that is spent directly by the province (rather than being passed on to municipalities) differs in different provinces/territories. Different formulas are used by each province/territory to allocate funding to municipalities. There is variation in the role of the provincial/territorial association of municipalities in distributing and monitoring the funds. Municipal associations in two provinces (British Columbia and Ontario) are the agents that distribute funds to municipalities; in all other provinces, except one (Québec), the provincial government distributes the funds. In Québec, the provincial government uses a crown corporation, the Société de financement des infrastructures locales du Québec (SOFIL) to act as a conduit for both federal and provincial funds to flow to municipalities for infrastructure projects.

Federal gas tax transfers are conditional, non-matching transfers. The funds have to be spent on environmentally sustainable municipal infrastructure and municipalities receive a lump sum amount (based on the size of their population). The total amount of funds available for this program is now based on an annual allocation of CDN $2 billion. The main advantage of this type of transfer sharing program is that it provides stable and predictable funding to municipalities, even more stable and predictable than a transfer based on gas tax revenues that fluctuate with the economy. Since the program has been made permanent, municipalities can count on these funds to plan for the future.

One of other principles underlying this program is to ensure equity between regions and between large and small communities. Equity, in this context, means equal treatment of municipalities because the grant is based on a uniform federal tax rate across the country and funds are distributed on a per capita basis. Although this type of revenue sharing provides stable and predictable revenues to municipalities, the “one size fits all” approach does not do a very good job of responding to local needs (some municipalities need the funds more than others but they are all treated equally). Moreover, it does not enhance local autonomy and accountability. If municipalities were to set their own tax rates on the federal tax base (tax base sharing), they would have more flexibility and be more accountable to taxpayers for the revenues raised. Under this model, the federal government would still be responsible for the administration of the tax and would distribute the funds to municipalities. Local tax rate setting does create the potential for tax competition among municipalities, however.

Green Municipal Fund: Federal Endowment Fund to the Federation of Canadian Municipalities

The Green Municipal Fund (GMF) was established in 2000 to stimulate investment in innovative municipal infrastructure projects and feasibility studies to improve air, water, and soil quality, to reduce greenhouse gas emissions, and more recently, to finance brownfield remediation. The GMF provides low-interest loans and grants, builds capacity, and shares knowledge to support municipal governments and their partners in developing communities that are more environmentally, socially, and economically sustainable.

When the GMF was first established, the Government of Canada endowed the Federation of Canadian Municipalities (FCM) with CDN $125-million. This amount was doubled in 2001/02 to CDN $250 million, and increased again in 2005 by CDN $300 million. In 2005, the mandate of the Fund was also expanded to include a greater degree of knowledge transfer and capacity building activities. The current endowment of CDN $550 million provides long-term funding for municipal governments and their partners.

FCM annually commits between CDN $65 million and CDN $90 million in grants and low-interest loans to leading examples of sustainable community plans, feasibility studies, field tests, and capital projects. GMF funding is complemented by a capacity building program which shares the knowledge and experience gained by muni-
principal leaders through GMF-funded initiatives. Knowledge is shared through events and products, including workshops, articles, reports, and an electronic newsletter. GMF projects are profiled in case studies to enable all communities to benefit from the lessons learned through these initiatives. In this way, the funding has advantages for all communities, even those that do not receive direct funding.

GMF is governed by the FCM Board of Directors, which is advised by a 15-member GMF Council. Five members of the Council represent, and are appointed by, the Government of Canada; the remaining ten are appointed by FCM. Of these ten, five represent the FCM Board of Directors and five represent private industry.

There are two aspects to the GMF that are innovative in the Canadian context. First, although this is a federal government initiative, the Federation of Canadian Municipalities’ Board of Directors approves project funding. The more common occurrence in Canada is for federal funding for municipal initiatives to be channelled through the provinces. Second, the use of an endowment approach to generate annual income is unique among federal and provincial/territorial grants. Federal funding does not generally take the form of an endowment but rather requires hundreds of millions of dollars of funding every year.

GMF is a conditional, non-matching transfer that has to be spent on innovative municipal infrastructure projects and studies to improve the environment. This transfer can be justified on the basis of externalities because the benefits of air, water, and soil quality, for example, cross over municipal boundaries. There are also spillover benefits from the case studies, tools and capacity building programs provided to municipalities. The funds are not matching, however, as would be appropriate for a transfer to address spillovers. Although the funding for any individual municipality is based on an application and is therefore less predictable than funding that applies to all municipalities, the overall level of funding is stable and predictable because of the existence of the endowment.

Municipal Rural Infrastructure Fund: Application-Based Federal Grant

Under the Municipal Rural Infrastructure Fund (MRIF), each province, territory, and First Nations community receives a base allocation of CDN $15 million, with the remaining funds allocated on a per capita basis to be used for smaller scale infrastructure. In an effort to achieve balance between the infrastructure needs of urban and rural parts of the country, at least 80 percent of funding under the MRIF is dedicated to municipalities with a population of less than 250,000. The remaining funds are available to municipalities with a population of over 250,000.

FCM supported the City of Burnaby, British Columbia’s transit station precinct parking study with a $30,000 GMF grant.
The MRIF is cost-shared, with the federal government contributing, on average, one-third of total project eligible costs. Provinces/territories and municipalities contribute the remainder. In recognition of the unique circumstances of the First Nations and the northern territories, where many communities have no tax base, the federal government may contribute more than one-third. In total across Canada, a minimum of 60 percent of funding under the MRIF, with a minimum of 40 percent per jurisdiction, targets "green infrastructure." These projects include water, wastewater, solid waste, municipal energy improvements, and public transit. The fund also invests in cultural, tourism and recreational infrastructure, local roads, and broadband connectivity.

MRIF is a conditional, matching transfer. It has to be used for specific infrastructure and it is matched by the federal and provincial/territorial governments. To the extent that the provision of this type of infrastructure yields benefits that cross municipal boundaries, this type of transfer is appropriate. Application-based grants of this nature require municipalities to apply for grant funding and generally provide only short term funding. As a result, this type of funding is not stable and predictable and is less appropriate for capital investments that are long term in nature and require funding for the duration of the asset. Municipalities need to know how much money they will be receiving over the term of the capital investment. Application-based funding is not only unpredictable but it is more susceptible to political manipulation than across-the-board funding. The concern about manipulation is likely to be even greater in countries where there the threat of corruption is significant.

**Provincial-Municipal Revenue Sharing in the Province of Manitoba**

The Province of Manitoba shares the revenues from five provincial taxes with municipalities: 4.15 percent of provincial income taxes (personal and corporate), 2 cents per litre of provincial gasoline tax revenue, 1 cent per litre of provincial diesel fuel taxes, 10 percent of video lottery terminal revenues, and 100 percent of provincial fine revenues for municipalities that provide their own policing (urban municipalities with a population over 750). Until 2005, these transfers were wholly unconditional. With the introduction of the Building Manitoba Fund in 2005, the unconditional nature of these grants was modified somewhat. Although the base amount remains unconditional, any increases over the 2005 base are conditional grants that have to be spent on infrastructure.

Revenue sharing of this type means that the provincial government determines the tax base, sets the tax rate, collects the tax, and distributes a portion of the revenues to municipalities on a per capita basis. This type of revenue sharing is similar to providing a transfer except that municipal revenues are tied to provincial government tax collections. The main advantage of this option (as with the federal gas tax sharing described earlier) is that the revenues to municipalities are predictable because they increase automatically as the provincial revenues from these taxes increase. To be a stable source of revenue to municipalities, the provincial government has to maintain the percentage share going to them over time. As with federal gas tax sharing, the funds are not necessarily allocated to where they are most needed but, unlike the federal gas tax sharing, municipalities have largely retained discretion over how to spend the funds since the transfer is, for the most part, unconditional.

**Equalization Transfer in Nova Scotia: Provincial, Unconditional Transfer**

The Province of Nova Scotia provides an unconditional transfer to municipalities that is based on an equalization formula. The formula calculates the difference between a standardized expenditure and a standardized revenue base for two classes of municipalities: Class I includes regional municipalities and towns; Class II includes county and district municipalities. The standard expenditure per dwelling unit is estimated by the average operating expenditure estimates per dwelling unit for the following services: police protection; fire protection; other protective inspections; transportation services excluding public transit; and 50 percent of garbage collection and disposal; and storm sewage collection and disposal, excluding sanitary sewerage. The formula excludes municipal expenditures for recreation and culture and debt service. The intention is to equalize only for services that are essentially non-discretionary and necessary for a functioning municipality.

The revenue base is calculated by taking uniform assessment per dwelling unit (the base of the property tax) and multiplying it by a standard tax rate and the number of dwelling units. The standard tax rate is equal to the total

Rural road construction in northeastern B.C.
standard expenditures for all municipalities within the class divided by the total uniform assessment for the same municipalities within the class. Each municipality's equalization entitlement is the difference between standard expenditures (the product of standard expenditures per dwelling unit times the number of units in each municipality) and standard revenues (the product of the standard tax rate and uniform assessment).

This provincial equalization transfer is an unconditional transfer to municipalities to address inequities in fiscal need and fiscal capacity among municipalities in the province. To the extent that some municipalities are unable to provide an adequate level of service at a reasonable tax rate, this type of equalization is an appropriate way to improve equity across municipalities.

City Special Transportation Grant in Alberta: Provincial Conditional, Matching Transfer

Each province/territory provides conditional transfers to municipalities to encourage them to increase their expenditures on services specified by the province. There are hundreds of examples across the country of conditional transfers. Alberta, for example, provides over 65 conditional grants to municipalities from 10 different provincial government departments. The City Special Transportation Grant is an example of a provincial, conditional matching transfer. This grant provides financial assistance for high priority transportation capital projects within cities. Funding is provided for capital transportation projects on highways and truck routes, capital transportation facilities, and highway maintenance. There are no specific project eligibility criteria but proposals are evaluated and prioritized by a review committee comprised of provincial department representatives and the Alberta Urban Municipalities Association. If approved, the province funds 75 percent of the costs leaving the cities to fund 25 percent. The maximum provincial share for any project is CDN $3 million.

This type of grant is a conditional, matching (closed-ended) grant and, as noted earlier, is a common type of provincial-municipal transfer across the country. On the assumption that the benefits of transportation infrastructure extend beyond municipal boundaries, this type of grant is appropriate. It does not provide stable and predictable funding, however, because it requires municipalities to apply for the transfer and they may or may not receive funding. This form of transfer also distorts local decision-making but, given that there are spillover benefits, this distortion may be warranted.

Section 5: Some Final Observations

Municipal governments in Canada and around the world play an important role in delivering a wide range of services to residents and businesses. Increased demands on municipalities, coupled with limits on their ability to raise revenues and a decline in transfers from the other orders of government, have led them to look for other sources of revenue. At the same time, many municipalities are seeking increased intergovernmental funding.

According to the benefit model of local government finance, user fees and local taxes are appropriate ways to pay for local services because they link the benefits and costs of those services. Within this model, there is also a strong economic rationale for intergovernmental transfers based on efficiency, equity, and fiscal imbalance. The types of transfers that are appropriate depend on the objective of the transfer. For example, if the objective is to compensate for the spillover of benefits across municipal boundaries (efficiency), then a conditional, matching transfer where the matching rate reflects the extent of the spillover is appropriate. If the purpose is to bridge the fiscal gap (fiscal imbalance), then an unconditional transfer is appropriate. If achieving equity across municipalities is the objective, then an unconditional equalization transfer is appropriate.

In addition to the principles of equity, efficiency, and restoring fiscal balance, this case study has identified other fundamental principles that are useful in designing transfers. For example, transfers need to be a stable and predictable source of revenue for municipalities. All too often, the amount of money local governments receive varies from year to year, in part depending on the fiscal state of the donor governments. Lack of predictability makes it difficult for municipalities to plan expenditures. Capital grants, in particular, need to be maintained for sufficiently long periods of time to allow municipalities to sustain capital investments. When grants decline, municipalities have to make up the lost revenue by increasing local taxes, user fees, or other revenues, or by reducing expenditures.

The objectives of the grant should be clearly specified and the grant design should be simple and transparent so that taxpayers and recipient governments can understand the purpose of the funds and how they are being allocated. Accountability will be greater when there is transparency in the design of the transfer and where mechanisms (such as performance-based measurement) are in place to ensure that funds are being used for the purpose for which they were intended and that they are having a positive impact on municipal services and infrastructure.

With the exception of addressing spillovers across municipal boundaries, transfers should not interfere with local government decisions about how to allocate resources among different service categories and how to pay for them. Local autonomy and flexibility to set priorities should not be constrained by grant funding.

In conclusion, Canada has had a long history of providing fiscal transfers to its municipalities. Indeed, there are hundreds of examples of transfers across the country. This case study has identified only a few of the new and innovative mechanisms that have been developed by both the federal and provincial/territorial governments. This experience will hopefully provide some lessons that can be applied in other countries.
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This publication was undertaken with the financial support of the Government of Canada provided through the Canadian International Development Agency (CIDA).

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