

**Easing the Fiscal Restraints:
New Revenue Tools in the *City of Toronto Act***

**Enid Slack
Director, Institute on Municipal Finance and Governance
Munk Centre for International Studies
University of Toronto
enid.slack@utoronto.ca**

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The City of Toronto faces increasing financial pressures from a number of different sources, including the need to be internationally competitive (providing those services and infrastructure that will attract skilled labour) and the need to deliver services that have been “offloaded” by federal and provincial governments. At the same time that the City is facing and will continue to face increased expenditure pressures, there has been no diversification of its revenue sources. The City continues to rely mainly on property taxes, user fees, and transfers to finance services. But property taxes are a relatively inelastic source of revenue -- that is, they do not increase directly with growth in the economy as do income and sales taxes – and are hence unlikely to provide the increased funding needed to cope with future expenditure needs.

With a population of 2.5 million people, Toronto is larger than six provinces; with a budget of \$7 billion, Toronto also spends more than those six provinces. Nevertheless, Toronto is part of a provincial-municipal relationship in which cities were once characterized as “puppets on a shoestring”(CFMM, 1976) and the provincial role as “father knows best.” (O’Brien, 1975). The Province establishes local governments and their geographic boundaries, mandates their expenditure responsibilities, sets standards for local service provision, limits their own-source revenues largely to property taxes and user fees, sets the rules around levying the property tax, influences municipal expenditures through its grant programs, requires that municipalities not incur a deficit in their operating budget, and determines the extent to which municipalities can borrow to meet capital requirements. In short, the City has limited discretion over its own expenditure and revenue decisions.

A joint Province of Ontario and City of Toronto task force has been established to review the *City of Toronto Act* with a view to making the City “more fiscally sustainable, autonomous, and accountable” (Joint Ontario-Toronto Task Force to review the *City of Toronto Act*, Terms of Reference). A new *City of Toronto Act* could go a long way both towards increasing Toronto’s ability to raise revenues and to improving the provincial-municipal relationship. By giving the City the ability to raise revenues from new sources, Toronto could have the mix of taxes it needs to meet its current responsibilities. By giving the City the ability to set its own tax rates, it would increase local autonomy and accountability and reduce the City’s financial dependence on the Province. It might even end the “blame game” that has each order of government blaming the other for insufficient resources at the local level.

This paper focuses on why Toronto needs new revenue sources, what new revenue sources might be included in the new legislation, and the need for local taxing authority. It does not address the existing revenue sources of the City – mainly property taxes and user fees —and the rules and regulations that apply to them. It also does not discuss, in any detail, the other areas of the legislation that will need to be addressed along with revenue changes. In particular, the need for additional revenue sources is directly related to the responsibilities that the City undertakes. Additional revenue sources should also be accompanied by governance changes that will ensure local accountability for these revenues.

The paper is divided into six sections. The first section compares the expenditures and revenues for the City of Toronto in 1978 and 2003 to show what has changed (and what has not changed) in the last 25 years. The second section sets out the reasons why, given its existing expenditure responsibilities, Toronto needs a mix of taxes. The third section summarizes the sources of revenue available to cities in other countries. The fourth section sets out principles for evaluating different taxes and applies them to a number of different taxes that could be made available to Toronto. The fifth section makes clear that, whatever tax tools are available to the City, it needs to set its own tax rates. The final section provides some concluding comments about the implementation of changes to the *City of Toronto Act*.

1. Expenditures and Revenues in Toronto, 1978 and 2003

In 1978, the combined operating expenditures of Metropolitan Toronto and its constituent municipalities (Toronto, York, North York, Etobicoke, East York, and Scarborough) were over \$1.4 billion (\$666 per capita). In 2003, the operating expenditures of the City of Toronto had increased to almost \$7.4 billion (\$2,975 per capita).¹ In constant dollars per capita (adjusting for inflation), expenditures increased at the rate of 1.7 percent per year, on average, over the 25-year period.²

Table 1 compares the distribution of expenditures by function in 1978 and 2003. Over the 25-year period, the largest growth by far was in social services and social housing. This increase reflects the offloading of social housing and an increased portion of social service costs to municipalities in Ontario in 1998. The result is that other expenditures as a proportion of total expenditures have generally fallen, with the exception of environmental services (water, sewers, solid waste collection and disposal) which also increased over the period. In 2003, the largest proportion of expenditures was accounted for by social services and social housing followed by transportation (roads and transit).

¹ Capital expenditures in 1978 were over \$280 million compared to \$904 million in 2003. It is difficult to compare capital expenditures in those two years, however, because capital expenditures are lumpy. In some years, there will be large expenditures (e.g. to build a new bridge or highway) and, in other years, there will be smaller expenditures.

² Expenditures per capita were deflated by the consumer price index (CPI) for Toronto. Although the implicit price deflator for government expenditures on goods and services would be more appropriate for government expenditures, it is not available by city. Population figures were taken from the census for 1976 and 2001.

Expenditure pressures on the City of Toronto, most of which are expected to continue in the future, are the result of a number of different factors. First, Toronto is a major driver of economic prosperity in Canada. To be competitive, the City must attract business and skilled labour. This means that it not only has to provide transportation and communications infrastructure but it also has to deliver services that enhance the quality of life (Florida et al., 2002). These services include, for example, parks, recreational and cultural facilities, social services, public health, and police protection.

**Table 1: Distribution of Operating Expenditures,
Metro Toronto, 1978 and City of Toronto, 2003
(%)**

	1978	2003
General government	9.3	6.4
Protection to persons and property	20.0	16.3
Transportation	27.7	20.8
Environmental services	13.4	16.5
Health services	3.0	4.0
Social services and social housing	12.7	27.4
Recreation and cultural services	12.3	8.0
Planning and development	1.7	0.7
Total expenditures	100.0	100.0

Source: Ministry of Municipal Affairs and Housing, MARS database

Second, at the same time that Toronto attracts skilled labour, it also attracts a disproportionate share of low-income individuals and households who seek employment opportunities and who are able to take advantage of a wider range of more specialized social services than are usually available in smaller municipalities. Toronto also attracts a very high proportion of the nation's new Canadians and, while the long-run benefits of this inflow of immigrants are obvious, the short-run costs to local governments of settlement and social integration can be significant (Slack, Bourne and Gertler, 2003).

Third, the provincially-imposed amalgamation in Toronto in 1998 increased financial pressures on the City rather than producing the overall cost savings that were officially projected (Slack, 2001). Although there have been some savings from amalgamation, the harmonization of wages and service levels has, on the whole, resulted in higher costs for the newly amalgamated city, which continue to be felt.

Fourth, the "offloading" of services by the federal and provincial governments has meant increased responsibilities for Toronto. Offloading has taken a number of different forms. Federal and provincial governments shifted expenditure responsibilities onto the city such as social housing in 1998. The provincial government reduced transfers to the City. Both the federal and provincial governments downsized their own responsibilities (such as immigration settlement at the federal level). Finally, federal and provincial requirements have mandated that cities meet certain requirements (e.g. water quality standards) without providing the funds to meet those

requirements (these are known as “unfunded mandates”). In all of these cases, pressure has been placed on the City to increase its expenditures.

The offloading of more responsibility to the City for social services and social housing as part of the local services realignment (LSR) in 1998 is particularly problematic. It is not appropriate to fund social service costs from property tax revenues³ because social service programs, such as welfare assistance, essentially redistribute income to the poor. It is more appropriate to redistribute income using the income tax than it is for municipal governments to fund these services using the property tax. Moreover, municipalities cannot borrow to meet operating deficits so they will have to either reduce other services or increase property taxes when the social service needs increase, for example, during economic downturns. Finally, since welfare recipients tend to congregate in larger urban centres, a disproportionate burden is placed on these centres: Toronto bears a heavier burden than the rest of the province.⁴

Over the 25-year period, operating revenues in constant dollars per capita increased at the rate of 1.5 percent per year, on average, or more slowly than the rate of growth of operating expenditures. Table 2 compares the distribution of operating revenues for Metropolitan Toronto and its constituent municipalities in 1978 and the City of Toronto in 2003.

**Table 2: Distribution of Operating Revenues,
Metro Toronto, 1978 and City of Toronto, 2003
(%)**

	1978	2003
Property taxes	49.4	40.0
Payments in lieu of taxes	4.5	0.9
User charges	18.0	19.6
Transfers from other governments	22.3	22.0
Other revenue	5.9	17.5
Total revenues	100.0	100.0

Source: Ministry of Municipal Affairs and Housing, MARS database

At one level, not much has changed in 25 years. Toronto still relies largely on property taxes, user charges, and transfers to meet its expenditure requirements. At another level, however, the distribution of revenues has changed. Most notably, the City relies much more heavily on “other revenues” than 25 years ago. A major component of other revenues in 2003 was contributions from the capital fund and from reserves and reserve funds. Although transfers from other

³ This was argued, for example, by the Who Does What Panel and by the GTA Task Force (1996).

⁴ The poverty rate in the City of Toronto in 2000 was 22.6 percent compared to 16.7 percent for the Toronto CMA and 14.4 percent for Ontario as a whole (Statistics Canada, Census, 2001). The poverty rate for Ontario excluding the City of Toronto was 12.1 percent.

governments as a percentage of total revenues have not changed much over the 25-year period, the composition has changed. A portion of those transfers in 2003 is accounted for by transfers from other GTA municipalities as part of the pooling of the costs of social services and social housing in the region. Taking those transfers out, provincial transfers accounted for approximately 19 percent of total revenues and these transfers were largely for social services. The City receives no unconditional transfers from the Province, only transfers that are conditional on being spent on specific functions.

2. Toronto Needs a Mix of Taxes

Toronto needs a mix of taxes, in large part, because of the increasing responsibilities that it has been required to undertake. As the European Charter of Local Self-Government (Article 9, Paragraph 2) states, “local authorities’ financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.” In other words, there should be a relationship between the tasks that local governments perform and the financial resources available to them. Clearly, sorting out “who does what” has to precede the discussion of how to pay for it.

New legislation will thus have to address both the City’s expenditure responsibilities and the revenue raising tools it needs to meet those responsibilities. If Toronto continues to share the costs of social services and social housing, for example, then it needs sufficient funding to deliver these services. An alternative approach is for the Province to take over the funding of social services, as is done in all of the other provinces. If the City continues to be responsible for funding a portion of these costs, however, then another option is to give it access to income tax revenues.

Although a case can be made for a mix of taxes, it should be emphasized that the property tax is, in many ways, well suited to local governments. Because of the connection between many of the services typically funded at the local level and the benefit to property values, the property tax can be regarded as a benefits tax (Bird and Slack, 2004). Residential property taxes, in particular, are appropriate to fund local governments because they are borne by local residents.⁵ Those who enjoy the benefits of local services are required to pay for them. Property taxes are also well suited to local governments because property is immovable – it is unable to shift location in response to the tax. Although a change in property tax may be capitalized into property values in a particular community, and in the long run tax differentials may affect where people locate, these effects are of a smaller magnitude than those that would occur with income and sales taxes at the local level. Property tax revenues are also fairly stable and predictable over time.

Nevertheless, the property tax does have some shortcomings. Although the property tax operates as a benefits tax for local residents, it does not operate as a benefits tax for commuters and visitors who use municipal services (roads and policing, for example) but do not pay property taxes in the City. Moreover, the tax on non-residential property, as it is generally applied, over-taxes businesses relative to the benefits they receive from municipal services (Kitchen and Slack

⁵ For a more detailed discussion of property tax incidence, see Bird and Slack (1993).

1993). Although a tax on business can be justified on the basis of benefits-received, the current tax on non-residential property tax may not be the most appropriate way to capture benefits.⁶

The property tax is not an “elastic” source of revenue meaning that the tax base does not increase automatically as the economy grows. The reason is that property values respond more slowly to annual changes in economic activity than do incomes. To maintain property tax revenues in constant dollar terms (in other words, adjusting for inflation) or to raise property tax revenues, it is necessary to increase the rate of the tax.⁷ The European Charter of Local Self-Government (Article 9, Paragraph 4) states that “the financial systems on which resources are available to local authorities are based on shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.” Excessive reliance on taxes that do not grow with inflation and other economic factors can create difficulties for local authorities providing services that do respond to economic factors.

There is a downside to revenue elasticity, however. U.S. cities, with their relatively heavy reliance on income and sales taxes coupled with restrictions on their ability to raise property taxes (such as Proposition 13 in California or Proposition 2 1/2 in Massachusetts), have found that their revenues have fallen significantly during the recent economic downturn (Pagano, 2002). Access to revenues from a mix of taxes (a mix which includes property taxes) gives cities the flexibility to adapt to different economic circumstances.

Cities argue that property tax revenues are not sufficient to pay for all of the services and infrastructure that they are required to deliver. This situation is likely to get worse. Some authors anticipate that the ability of municipal governments to raise revenues from the property tax in the future will be limited because of the shift from a manufacturing to a service-based economy (Brunori, 2003: 11 and Union des Municipalités du Québec and The Conference Board of Canada, 2003: 4). This shift will mean that less space and fewer non-residential buildings will be required in the future. It is also anticipated that residential tax base will not grow much in the future because of an aging population, which will mean a drop in housing starts, downsizing, and limited growth in prices (The Conference Board of Canada, 2004: 146-7).

Access to revenues from a mix of taxes, particularly taxes that grow with the economy, could provide cities with an incentive to make those kinds of investments (in infrastructure, for example) that stimulate economic growth. Currently, the contribution that municipal infrastructure makes to economic growth is felt more by the federal and provincial governments

⁶ A broad-based measure of business activity may be a more appropriate tax base than property value. Along these lines, the City might consider levying a business value tax (BVT), as proposed by Bird (2003). The BVT base would consist of the value added by labour (wages and salaries) plus the value added by capital (debt plus equity). By imposing the tax equally on capital and labour, the inherent distortion against capital in the non-residential property tax would be removed.

⁷ It is also difficult to increase property tax revenues because of the visibility of the tax. Unlike income taxes which are withheld at source, property taxes are generally paid in lump sum payments. This means that taxpayers are aware of the property taxes they pay. When property values increase, there is pressure on city councils to lower tax rates so that the property tax burden does not increase.

that have access to growth taxes than by municipal governments. As one author notes, “one wonders whether cities would be more inclined to invest in infrastructure if they had a more diverse tax system that allowed them to better recapture a portion of the returns generated by such investments”(Vander Ploeg, 2004: 7).

In summary, the changing demands on large cities like Toronto, coupled with the inability of the property tax to address all of these demands, provides a strong justification for revenues from a mix of taxes for cities. Revenues from a mix of taxes would give cities more flexibility to respond to local conditions such as changes in the economy, evolving demographics, and expenditure needs. A case can also be made for revenues from a mix of taxes to the extent that other taxes are more effective than property taxes at linking the costs and benefits of services when people commute to work from one jurisdiction to another.

3. Cities in Other Countries Have Access to More Revenue Sources

Toronto, like other Canadian cities, relies largely on property taxes, user fees, and intergovernmental transfers to meet its expenditure requirements. Cities in the United States and Europe have access to other revenue sources such as income, sales, and selective sales taxes. Table 3 shows the distribution of local tax revenues by type of tax for eight federal countries (countries with a central government, state or provincial governments, and local governments) and 21 unitary countries (countries with only central and local governments).

Table 4 shows the various local taxes in each country as a percentage of Gross Domestic Product (GDP), a measure of the level of national income generated in each country. Generally, in those countries where total local taxes combined absorb the largest percentage of GDP, local governments rely most heavily on income taxes. Examples include Denmark, Iceland, and Sweden. The exception is Spain for which local taxes represent a large proportion of GDP but local governments rely on a mix of income, sales and property taxes.

Income taxes are very important in four of the federal countries (Austria, Belgium, Germany, and Switzerland) and seven unitary countries (Denmark, Finland, Iceland, Luxembourg, Norway, Poland, and Sweden) in Table 3. In some of these countries, the local income tax is piggybacked onto the one levied by the federal or provincial/state government. In other countries, local governments administer their own income tax. In Denmark, for example, where cities are responsible for delivering social programs, the local tax is piggybacked onto the central government personal income tax and is applied against the nationally defined taxable income base (McMillan, 2004).

In the United States, 16 states permit municipalities to collect local income taxes. Local income taxes make up more than 10 percent of local tax revenues in only five states (Maryland, Kentucky, Ohio, Pennsylvania, and New York) and the District of Columbia. Although its use is limited, the income tax is applied in different ways in different states (Oates and Schwab, 2004: 10). In Maryland, county governments piggyback onto the state income tax. In Pennsylvania, the city of Philadelphia levies a wage tax on employers at a flat rate; unearned income is excluded. The District of Columbia and New York City tax all forms of income with a progressive rate

structure. In Kentucky, the cities of Lexington and Louisville and the counties tax earned income at a flat rate. In Ohio, municipalities and school districts tax earned income and corporate net profits. Income tax rates are generally low, ranging from 1.0 to 2.5 percent. Only eight states in the U.S. authorize local governments to impose taxes on corporate income: Kentucky, Missouri, Michigan, New York, Ohio, Oregon, Tennessee, and West Virginia (Brunori, 2003: 98).

Table 3: Distribution of Local Tax Revenues by Type of Tax in Selected OECD Countries, 2002
(%)

Countries	Income	Property	Sales				Other taxes
			General taxes	Specific goods and services	Taxes on use etc.	Total Sales	
Federal							
Australia	0.0	100.0	0.0	0.0	0.0	0.0	0.0
Austria	56.0	10.0	23.6	3.8	1.7	29.1	4.9
Belgium	86.4	0.0	1.6	7.4	4.3	13.3	0.3
Canada	0.0	91.5	0.2	0.0	1.8	2.0	6.5
Germany	75.8	17.7	5.4	0.5	0.5	6.4	0.3
Mexico	0.1	89.5	0.0	1.9	0.5	2.4	7.9
Switzerland	83.2	16.6	0.0	0.2	0.1	0.3	0.0
United States	5.2	72.6	11.4	5.0	5.8	22.2	0.0
Unitary							
Denmark	93.1	6.8	0.0	0.1	0.0	0.1	0.0
Finland	95.2	4.6	0.0	0.0	0.0	0.0	0.1
France	0.0	53.2	0.0	7.5	3.4	10.9	35.9
Greece	0.0	67.8	3.5	25.7	3.0	32.2	0.0
Hungary	0.7	22.5	71.3	0.9	4.2	76.4	0.3
Iceland	79.5	13.1	7.4	0.0	0.0	7.4	0.0
Ireland	0.0	100.0	0.0	0.0	0.0	0.0	0.0
Italy	21.6	13.6	2.5	12.9	7.6	23.0	41.8
Japan	44.6	33.0	7.3	8.3	5.7	21.3	1.0
Korea	12.4	51.9	0.0	14.3	5.8	20.1	15.6
Luxembourg	93.4	5.2	0.0	1.0	0.2	1.2	0.3
Netherlands	0.0	56.6	0.0	1.5	41.9	43.4	0.0
New Zealand	0.0	90.3	0.0	1.2	8.5	9.7	0.0
Norway	88.0	9.4	0.0	0.0	2.5	2.5	0.0
Poland	75.4	23.4	0.0	0.0	1.2	1.2	0.0
Portugal	21.1	47.0	0.0	0.0	0.0	0.0	0.0
Slovak Republic	54.1	22.0	0.0	17.9	6.0	23.9	0.0
Spain	25.2	24.3	23.8	17.4	8.1	49.3	1.1
Sweden	100.0	0.0	0.0	0.0	0.0	0.0	0.0
Turkey	35.1	12.5	37.1	4.3	1.5	42.9	9.4
United Kingdom	0.0	100.0	0.0	0.0	0.0	0.0	0.0

Notes:

1. Income taxes include individual and corporate income taxes.
2. Property taxes include taxes on property including recurring taxes on net wealth.
3. General sales tax includes VAT, sales tax and other general taxes on goods and services
4. Specific taxes on goods & services include special taxes on goods and services that are not taxed under a general sales tax (e.g. fuel, hotel, and motel taxes).
5. Taxes on use include taxes levied on the use of goods or permission to use goods and not the goods themselves (e.g. pollution taxes)
6. Other taxes include taxes on net wealth, taxes at death, and residual taxes mainly on business.

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics 1965-2003* (Paris: OECD, 2004), Tables 136 and 138

Table 4: Local Taxes as a Percentage of Gross Domestic Product (GDP), 2002 (%)

Countries	Income	Property	Sales				Other taxes	Grand Total
			General taxes	Specific goods and services	Taxes on use etc.	Total Sales		
Federal								
Australia	0.0	1.0	0.0	0.0	0.0	0.0	0.0	1.0
Austria	2.4	0.4	1.0	0.2	0.1	1.3	0.2	4.3
Belgium	2.0	0.0	0.0	0.2	0.1	0.3	0.0	2.3
Canada	0.0	2.6	0.0	0.0	0.1	0.1	0.2	2.9
Germany	1.9	0.4	0.1	0.0	0.0	0.1	0.0	2.4
Mexico	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.2
Switzerland	4.1	0.8	0.0	0.0	0.0	0.0	0.0	4.9
United States	0.2	2.7	0.4	0.2	0.2	0.8	0.0	3.7
Unitary								
Denmark	15.7	1.1	0.0	0.0	0.0	0.0	0.0	16.8
Finland	9.4	0.5	0.0	0.0	0.0	0.0	0.0	9.9
France	0.0	2.4	0.0	0.3	0.2	0.5	1.6	4.5
Greece	0.0	0.2	0.0	0.1	0.0	0.1	0.0	0.3
Hungary	0.0	0.5	1.5	0.0	0.1	1.6	0.0	2.1
Iceland	7.6	1.3	0.7	0.0	0.0	0.7	0.0	9.6
Ireland	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.6
Italy	1.5	1.0	0.2	0.9	0.5	1.6	2.9	7.0
Japan	3.0	2.2	0.5	0.6	0.4	1.5	0.1	6.8
Korea	0.6	2.4	0.0	0.7	0.3	1.0	0.7	4.7
Luxembourg	2.4	0.1	0.0	0.0	0.0	0.0	0.0	2.5
Netherlands	0.0	0.8	0.0	0.0	0.6	0.6	0.0	1.4
New Zealand	0.0	1.7	0.0	0.0	0.2	0.2	0.0	1.9
Norway	5.0	0.5	0.0	0.0	0.1	0.1	0.0	5.6
Poland	4.5	1.4	0.0	0.0	0.1	0.1	0.0	6.0
Portugal	0.5	1.1	0.0	0.0	0.0	0.0	0.0	1.6
Slovak Republic	0.8	0.3	0.0	0.3	0.1	0.4	0.0	1.5
Spain	2.4	2.3	2.3	1.7	0.8	4.8	0.1	9.6
Sweden	16.1	0.0	0.0	0.0	0.0	0.0	0.0	16.1
Turkey	0.7	0.3	0.8	0.1	0.0	0.9	0.2	2.1
United Kingdom	0.0	1.6	0.0	0.0	0.0	0.0	0.0	1.6

Notes: See Table 3

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics 1965-2003* (Paris: OECD, 2004), Tables 135 and 137

Although cities in Canada are not permitted to levy an income tax, the Province of Manitoba shares an amount of provincial personal income tax equal to 2.2 percentage points of basic federal tax and one percentage point of corporate taxable income with municipalities. Revenues are distributed to municipalities on a per capita basis.

With the exception of Belgium and Sweden, local governments in each of the countries listed in Table 3 levy property taxes. Property taxes accounted for more than 90 percent of local government tax revenues in Australia, Canada, Ireland, New Zealand, and the United Kingdom.

Sales taxes are not as widely used by cities around the world as are income and property taxes. Local governments make extensive use of a general sales tax in Austria, Hungary, Spain, Turkey, and the U.S. In the U.S., local governments in 31 states and the District of Columbia levy general sales taxes (Kitchen and Slack, 2003: 2229). Sales taxes are not currently levied at the local level anywhere in Canada. Only municipalities in Quebec levied municipal sales taxes in the past; Montreal introduced a retail sales tax in 1935.

Local governments in many countries levy taxes on specific goods and services. This is an important source of revenue in only a few countries, however: Greece, Italy, Korea, the Slovak Republic, and Spain. Taxes on the use or permission to use goods (as distinct from taxes on the goods themselves) are imposed in most of the countries in Table 3 but only account for significant revenues in the Netherlands. The two main selective sales taxes imposed by local governments in the U.S. are taxes on hotel/motel occupancy (allowed in 43 states) and meals (allowed in 27 states). Some local governments also tax tobacco products, fuel, liquor, and real estate transfers.

Under the *Provincial-Municipal Tax Sharing Act* in Manitoba, municipalities (including Winnipeg) may enact bylaws imposing taxes on persons who purchase or consume motel and hotel accommodations, meals in a restaurant, or liquor. Municipalities require the approval of the Lieutenant Governor in Council and, apparently no municipalities have formally requested the province to consider a bylaw (Lidstone, 2004: 43).

In a few cities and regions in Canada, provincial fuel tax revenues are shared between the province and the city, region or transit authority. The provincial government sets the tax rate for municipalities, collects the revenues, and remits it to the eligible cities/regions. Provincial fuel tax revenues are shared in the Greater Vancouver Regional District, the B.C. Capital Region (around Victoria), Calgary, Edmonton, and Montreal. The Ontario government recently made a commitment to share 2 cents per litre with municipalities beginning in October 2004. The federal government has agreed to share up to 5 cents per litre of the federal tax with municipalities. The Canadian examples do not really reflect local taxation but rather are simply transfers from the federal or provincial government based on their tax revenues.

In Canada, hotel/motel occupancy taxes exist at the local level in Vancouver, Victoria, and Montreal. The tax is an additional levy imposed on the existing provincial retail sales tax rate on hotels and motels and is generally collected by the provincial government through the provincial sales tax system. Although Ontario municipalities are prohibited from levying a hotel/motel occupancy tax, the Greater Toronto Hotel Association instituted a voluntary 3 percent “destination marketing fee” which is directed towards marketing the GTA.

No Canadian municipalities levy liquor or tobacco taxes (although municipalities in Manitoba are permitted to levy liquor taxes). Provincial legislation does permit local governments to levy land transfer taxes in three provinces -- Nova Scotia, Quebec, and Manitoba (although municipalities in Manitoba do not levy them). Municipalities in Ontario have the authority to impose tolls on roads only with provincial consent.

Local governments in some countries levy other taxes such as taxes on business. The greatest reliance on other taxes can be found in France, Italy, and Korea.

4. The Choice of Taxes

The benefit model of local government finance provides some assistance in determining which taxes are most appropriate at the local level. The model asserts that the essential role of

municipal government is to provide local residents with those public services that they want and that they are willing to pay for. In other words, those who pay taxes or user fees to finance local government should be the ones who are enjoying the benefits of local expenditures.

In the local government context, the application of the benefit principle is preferred to the ability-to-pay principle. Under the ability-to-pay principle, those paying taxes and fees to finance local expenditures should be those with the greatest ability to pay. Income redistribution at the local level can be problematic, however, because those who are taxed more heavily can leave the jurisdiction. For this reason, it is generally asserted that the ability-to-pay principle should play a smaller role at the local level and that redistribution should be a role for the federal and provincial governments.⁸ There are, however, times when a strict application of the benefit principle is not possible (for example, where it is not possible to identify the beneficiaries) or even desirable (for example, where the City is delivering social programs).

The choice of taxes to be included in the new *City of Toronto Act* should, to the extent possible, adhere to the benefit principle. Local taxes should also satisfy other public finance criteria: the tax base should be relatively immobile so that the city can vary the tax rates without losing a significant portion of the tax base; the tax yield should be sufficient to meet local needs and should increase along with the increase in expenditure needs; the tax yield should be stable and predictable over time; it should not be possible to export much of the tax burden to non-residents to pay for services enjoyed by residents of the taxing jurisdiction; the tax should be visible to ensure accountability; taxpayers should perceive the tax to be reasonably fair; and the tax should be relatively easy to administer.

The options are many and include local access to: personal income taxes, payroll taxes, corporate income taxes, general sales taxes (retail sales taxes and the GST), and excise taxes (including taxes on hotel/motel occupancy, meals, fuel, liquor, tobacco, vehicle registration, and land transfer). Although many of these taxes meet the standard public finance criteria set out above, only the income and sales tax would bring in significant revenues.

Personal Income Tax

Municipal governments in Canada levied income taxes until 1941 at which time provincial governments temporarily surrendered their right and the right of municipalities to levy them. Nevertheless, income taxes are appropriate for large cities such as Toronto because, as noted earlier, the property tax does not yield sufficient revenues to meet increasing needs with respect to poverty, crime, regional transportation, and social services. Moreover, income taxes, because they are more closely related to ability to pay than are property taxes, are a more appropriate way to pay for social services. One estimate of the amount of revenue that the City of Toronto could collect from a 10 percent surcharge on the provincial personal income tax (equivalent to 1 percent on taxable income) is \$450 million.⁹

⁸ See, for example, Bird and Slack (1993).

⁹ The estimate is for 2000 and is based on Kitchen and Slack (2003) where the underlying elasticity assumptions can be found.

The income tax is revenue elastic -- revenues increase as the economy grows. When income rises, it is taxed at a higher rate (under the progressive rate structure). This means that, as incomes increase, income tax revenues increase more than proportionately relative to income. Of course, it is also true that income tax revenues fall when incomes fall, which is why cities require access to revenues from a mix of taxes.

Local income taxes that are piggybacked onto the provincial (or federal) personal income tax could be easily administered by the federal government.¹⁰ If permitted by provincial legislation, the City could piggyback onto the federal/provincial income tax system in one of two ways. The tax could be applied, as it is in Scandinavian countries, at a locally determined rate on the same tax base as the federal income tax and collected by the federal government. Alternatively, a locally determined tax rate could be set as a percentage of the federal tax liability, as in Belgium, or of the provincial tax liability, as in Switzerland and some U.S. states. Although this type of piggybacking simplifies the administration of the tax, however, it reduces the visibility of the tax and weakens the link between expenditures and taxes (Oates and Schwab, 2004: 25).

The main disadvantage of a local income tax (with locally set tax rates) is that taxpayers are mobile and can avoid the tax by working in or moving to a neighbouring jurisdiction. An income tax could deter economic growth if the combined federal, provincial, and local taxes are too high. Moreover, if municipalities levy a personal income tax (and not a corporate income tax), they would be taxing the profits of sole proprietors but not that of corporations (TD Economics, 2002: 25).¹¹ As noted below, however, there are reasons why cities should not levy corporate income taxes.

Payroll Tax

Payroll taxes are imposed at a flat rate on earnings or wages and are the most common form of taxing personal income in U.S. cities. They do not apply to unearned income (such as dividends, interest, and capital gains). Payroll taxes would allow the City to tax both residents and commuters. To the extent that non-resident visitors increase the City's costs (for example, for police and fire protection and transportation), a payroll tax ensures commuters are at least paying for some of the costs (Brunori, 2003: 90). In some jurisdictions, commuters are taxed in the jurisdiction in which they work and a credit is applied to their tax in the jurisdiction in which they live.

In addition to allowing the City to tax commuters, other advantages of a payroll tax are that they are fairly easy to administer and can yield significant revenues. The main disadvantage is that the tax acts as a barrier to employment and introduces distortions into the choice of production

¹⁰ In Canada, the personal income tax field is shared between the federal and provincial governments. The federal government administers its own tax and the tax of every province except Quebec, which administers its own personal income tax system.

¹¹ This report goes on to note, however, that a local income tax (with locally set tax rates) passes the tests of accountability, simplicity, equity, and reliability.

techniques (Bird and Slack, 2004). Moreover, the payroll tax base is already heavily used to finance the social security system (Bird and Slack, 2004).

Corporate Income Tax

Although the corporate income tax is often popular with residents, in part because the tax can be exported to non-residents, there are few advantages to levying a corporate income tax at the local level.¹² Corporate taxes are generally imposed on a mobile tax base. As such, they are not a good candidate for local taxation. Corporate income tax revenues are volatile. Business taxes in general deter economic development and spur competition between local governments trying to attract business. As noted earlier, property taxes on the commercial/industrial sector already overtax business and thus there is no reason for an additional tax burden that bears no relationship to the cost of municipal services consumed (Kitchen and Slack, 1993). Corporate income taxes are difficult to administer because taxpayers have to determine how much of the income is attributable to the local jurisdiction imposing the tax. Because many corporations conduct business in a number of jurisdictions, taxpayers and tax collectors both have trouble determining how much income is taxable in any particular jurisdiction.

General Sales Taxes

General sales taxes include value-added taxes such as the federal goods and services tax (GST) in Canada and retail sales taxes such as the provincial sales taxes in all provinces except Alberta. If the City of Toronto could piggyback on to the provincial retail sales tax, it could generate significant revenues. An estimate of potential revenues from piggybacking onto the provincial sales tax suggests that a 1 percent surcharge (increasing the retail sales tax rate from 8 percent to 9 percent) could yield between \$360 and \$378 million in Toronto (Kitchen and Slack, 2003). Moreover, municipal sales tax revenues increase with growth in the economy, although less so than the income tax.¹³ The sales tax captures the benefits to non-residents (such as commuters and visitors) who use services in the municipality but do not otherwise pay taxes to that municipality.

Sharing provincial sales tax revenues was recommended for Montreal over a decade ago by the Pichette Task Force but never implemented (Task Force on Montreal, 1993). The Task Force recommended that Montreal and the other core cities receive a portion of provincial sales taxes collected in their jurisdictions on the grounds that sales taxes provide a direct link to economic activity and that they capture the benefits to commuters and visitors.

¹² In Canada, the federal government administers the federal corporate income tax for seven provinces. Quebec, Ontario, and Alberta administer their own corporate income tax.

¹³ Sales taxes are less elastic than income taxes because they are levied at a single rate. Sales increase in line with income increases so, for example, if incomes double, sales could double. This is in contrast to the income tax, as noted above, where tax revenues more than double when incomes double. Moreover, the retail sales tax base has been steadily declining relative to the overall economy because of the shift from a manufacturing to a service-based economy (services are not taxed by the retail sales tax) and the increase in purchasing through the Internet (Brunori, 2003: 75-76).

As with the income tax, there are problems of taxpayer mobility. People will purchase goods outside the jurisdiction where they live if they can avoid the tax. Although income taxes are also subject to mobility problems, residence is less mobile than consumption (McMillan, 2003). The sales tax is a regressive tax. If, as noted above, however, the main role of local government is to provide goods and services, then equity based on benefits-received is a more important criterion to evaluate local taxes than equity based on ability-to-pay. Sales taxes are also detrimental to economic growth because they tax inputs heavily.¹⁴ Perhaps the most significant problem with piggybacking onto the retail sales tax, however, relates to the administration of the tax because it is not possible to identify where the tax revenues are collected. For example, chain stores report their sales tax revenues in their regional offices and pay taxes through regional tax offices. It is not clear what municipalities the taxes were actually collected in. Moreover, a large retail store just outside the boundary of a municipality may collect most of its tax revenues from shoppers in that municipality but the revenues would be recorded outside of that municipality.

Excise Taxes

Excise taxes (also known as selective sales taxes) are imposed on designated items at fixed amounts per unit or as a percentage of the selling price. Unlike general sales taxes, which are imposed on all goods (and services in the case of the GST) except those that are exempt from the tax, excise taxes are imposed only on designated items. This means that they are more likely to affect the behaviour of taxpayers (away from the taxed item) than a general sales tax that applies to all goods and services. Differential tax rates will thus result in people shopping in neighbouring jurisdictions. The advantages and disadvantages of specific excise taxes are summarized below.

Hotel/Motel Occupancy Tax

This tax compensates local governments for the benefits received from expanded services provided for tourists and visitors (for example, the additional police and fire protection, and highway and public transit capacity needed to meet weekend or peak convention and tourist demands). Revenues from a hotel/motel occupancy tax increase with growth in the economy but the yield is fairly small. A 3 percent tax (the rate currently being levied voluntarily in the GTA) would yield roughly between \$22 and \$27 million for the City (based on Kitchen and Slack 2003). The levying of a hotel and motel room occupancy tax in selected municipalities and not in competing communities provides an incentive for individuals to stay in hotels and motels in those municipalities without the tax.

Meals Tax

The tax is imposed on the value of meals purchased. To the extent that people who eat in restaurants have higher incomes, the tax may be considered to be progressive. Some of the tax, especially in metropolitan areas and tourist areas, is paid by non-residents. Because tax differentials will have an impact on where people eat (at home or in restaurants in different

¹⁴ The exceptions are Quebec and Atlantic Canada where they have harmonized their sales taxes with the GST (a value-added tax) (TD Economics, 2002 and Bird and Wilson, 2003).

locations), cities are constrained in terms of how high a tax rate they can levy.

Fuel Tax

The fuel tax can be viewed as a benefit-based tax to the extent that those who use the road system pay the tax. To the extent that a fuel tax is intended to price either the use of publicly provided roads or externalities (pollution and congestion, for example), it is a crude instrument, however. Fuel tax revenues do not increase with the economy in the same way as income or sales taxes.¹⁵ Revenue growth comes only through increased fuel consumption or through an increase in the tax rate. Fuel taxes are unlikely to bring in as much revenue at the local level as income or sales taxes. For example, one cent per litre on the provincial fuel tax base would yield Toronto only between \$36 and \$38 million (Kitchen and Slack, 2003). To replace 10 percent of property tax revenues (or \$249 million in 2000), the City would have to levy a fuel tax rate of 6.6 cents per litre. Different cities or city-regions could impose taxes at different rates but they would probably not be able to differ much from the rates imposed by their neighbours, given the mobility of the tax base.

Other Taxes on Vehicles

Congestion charges (tolls) are better than fuel taxes in terms of pricing the use of roads or externalities. Tolls can vary by time of day and by location. License fees or vehicle registration charges can vary by vehicle age and engine size, vehicle axle weight, and location of vehicle. These factors affect the amount of pollution, congestion, and road damage more so than would fuel consumption. Vehicle registration fees act as a generalized benefit tax because the number of vehicles is related to the demand for expenditures on roads, emergency services, and policing. Differential vehicle registration taxes could result in people registering their cars in a lower taxing jurisdiction nearby, however.

Liquor Tax

Liquor is regarded as a “demerit” good and thus reducing its consumption by increasing the price can be considered good policy. The City of Winnipeg argued as part of its proposed “new deal” that municipal policing costs are related, to some extent, to liquor consumption and thus municipal access to liquor tax revenues is appropriate. Liquor taxes, however, suffer from the same problems as many selective sales taxes – they do not increase with inflation and differential rates across municipalities will result in cross border shopping.

Tobacco Tax

Tobacco is also regarded as a “demerit” good. Local taxes on tobacco result in competition among local governments because consumers can purchase cigarettes in neighbouring jurisdictions with lower taxes. Tobacco taxes are regressive but, as noted earlier, the benefit principle is more relevant to local government taxation than the ability-to-pay principle. Tobacco tax revenues are not likely to grow as a source of revenue for local governments because they are

¹⁵ Relatively slow growth of motor fuel sales has been predicted by Informetrica Limited (2004: 2-3).

levied on a per unit basis. This means that revenues will not grow with inflation and the only way to increase tax revenues is to raise the rates.

Land Transfer Tax

This tax is imposed at the time the real estate is transferred or recorded for sale and is generally levied on the sales price of the real estate. The land transfer tax does not yield significant amounts of revenue and it is not an elastic tax. Moreover, it can discourage development.

5. Local Taxing Authority

Regardless of which taxes the City is given access to, it is critical for local autonomy and accountability that the City be politically responsible for those taxes. In other words, it should be required to set the tax rates.

A truly “local” tax is one in which the local government determines the tax base, sets the tax rates, collects the tax, and keeps the revenues. Although a truly local tax has all of these dimensions, the most important characteristic of a local tax is the ability of the local government to set the tax rate. Only with tax rates set locally (rather than by the province) will there be local autonomy and accountability for local expenditures and revenues:

“...if a city government feels that it requires more money to do what it is expected of it by its citizens, then it should be in a position to get that money from the people who will be the primary beneficiaries of the resulting expenditures and to whom they are ultimately accountable to at the ballot box – the citizens and voters of the city”
(Kneebone and McKenzie, 2003: 61).

Moreover, local tax rate setting provides predictability for municipal governments and gives them the flexibility to change rates in response to different circumstances.

A “shared” tax, on the other hand, is one in which the proceeds of the tax accrue in whole or in part to local governments but the federal or provincial government sets the tax rates and assesses and collects the tax. Shared tax revenues can be distributed among municipalities on the basis of where the revenues were collected or on the basis of a formula. For example, the funds could be allocated to cities on the basis of one or more criteria such as population or public transit ridership (in the case of fuel tax revenues). This option is similar to providing a transfer except that municipal revenues are tied to federal or provincial government tax collections. Although shared taxes have the advantages that revenues to cities will automatically increase as the revenue source increases, they require that the federal or provincial government maintain the percentage share going to them over time to provide stable revenues. Shared tax revenues are not really taxes; they are transfers based on federal or provincial tax revenues.

Local taxing authority is not without problems, however. Since individuals and businesses can easily move between jurisdictions within the GTA or even within the Greater Golden Horseshoe, a differential retail sales tax rate, for example, could encourage individuals to purchase goods

and services in those municipalities with lower tax rates. A differential hotel and motel occupancy tax, fuel tax or income tax would result in similar behavioural responses. These reactions would, however, be similar to the location decisions currently caused by differential property tax rates. Tax competition can create an environment in which municipalities become more efficient in their use of resources and more accountable to taxpayers. If the City can convince taxpayers that they are getting more services in return for the higher taxes, there may be less incentive to move. Nevertheless, there is a clear trade-off between the accountability and flexibility advantages of local setting of tax rates and the potential disadvantages of differential local tax rates.

To avoid the problem that Toronto would face if only it has the authority to levy new taxes, the Province might consider allowing other municipalities to levy new taxes as well. Not all municipalities would choose to exercise that option but it would be available to them. Municipalities that do levy new taxes would likely impose tax burdens that are in line with their neighbours to prevent residents and businesses from moving to or shopping in other jurisdictions (Brunori, 2003: 76). Nevertheless, it may be necessary for the Province to set a minimum rate to minimize tax competition and a ceiling rate to prevent excessive tax exporting (Bird and Slack, 2004: 37). Setting restraints on “harmful competition” may be especially appropriate in the Toronto region where the location of economic activities is especially sensitive to fiscal differentials.

To the extent that the benefits of services (such as transportation, planning, and social services) cross municipal boundaries in the Toronto region, a case can be made for a regional body to coordinate the delivery of those services and to raise taxes to pay for them. The result would likely be a uniform tax rate across the broader region for those services. Further discussion of regional authorities is beyond the scope of this paper.

6. Concluding Comments

Toronto, like other Canadian cities, has relied largely on three revenue sources (property taxes, user fees, and intergovernmental transfers) for decades even though expenditure demands have been increasing and cities in other countries around the world have access to other revenue sources (such as income, sales, and excise taxes). A new *City of Toronto Act* that matches revenues with responsibilities would give the City the flexibility it needs to respond to changing expenditure needs.

Although it would be very costly for Toronto to collect its own income and sales taxes, for example, there are advantages to piggybacking onto federal or provincial taxes and levying their own tax rates. The City needs to set its own tax rates if it is to achieve autonomy, accountability, predictability, and stability. Locally set tax rates will require limits (minimum and maximum) on the rate of tax that could be levied locally both to minimize tax competition and tax exporting.

Once given these new revenue-raising tools, the City will have to decide when and how to use them. Raising taxes is never easy. One option is for the City to introduce new taxes and, at the same time, reduce property taxes. Although a substitution of this nature would allow the City to

have access to new tax sources over time that are more progressive and grow with the economy, it would not solve its current fiscal problems. A second option is for the federal or provincial governments to reduce their taxes (say, lower the rate on the personal income tax) to provide the City with tax room. This option would require the City to convince the other governments that reallocating the tax burden in this way would be beneficial to the province and the country. Tax room could also be justified on the grounds that the City is paying a portion of social service costs that were “offloaded” by the Province onto the property tax base. If the province does not take back social service responsibilities or provide increased funding for these services, it might consider providing tax room to the City. A third option is to raise new revenues with a commitment to improve service delivery. In other words, taxpayers would pay more taxes but they would receive more services. The City would have to convince taxpayers that they would actually be receiving new and improved services in return for higher taxes.

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