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Do ‘Fiscal Restraints’ Need to be Eased for Toronto?

I am honoured for three reasons to have been asked to make a few remarks on this occasion:

- First, I am absolutely delighted that this new Institute has been created at the University. I have long felt that the critical links between sensible local financial structures and good governance have not received the attention they deserve in Canada - and for that matter anywhere else.
- Secondly, I am particularly delighted that the founding director of the Institute is Enid Slack, a highly valued colleague with whom I have had the pleasure of collaborating for many years and from whom I have learned much of what little I know about the specifics of local finance in Canada.
- And thirdly, I am, I guess, delighted, if perhaps a bit surprised, to have been asked to say something that may perhaps be considered to be of some relevance to Toronto, a city in which I have worked for decades but about which, with one small exception last year – working with Enid of course! – I think I have never before said or written anything, largely, I suppose, because no one ever asked me to do so. Perhaps for good reason, as you may soon see!

Indeed, knowing my relevant ignorance of Toronto – and perhaps also suspecting, correctly, from various remarks I have made to her at different times that, as one of the ‘great unwashed’ from the dread ‘905’ area, my sympathies are not always 100% with truth, justice and the Toronto way of life as it often seems to be seen by the local media – Enid’s first suggestion was that I should talk about urban finance in the rest of the world, on the probably correct

premise that I am likely to know more about that subject than most of you, while knowing much less about Toronto.

Since I think that she did a nice job herself on the international side in the paper she prepared for this event, however, what I would like to talk about instead is simply a few implications that one might perhaps draw from the very last sentence of her formal presentation.

To refresh your memory, you will perhaps recall that she concluded on the relatively optimistic assumption that anyone in their right mind would have to give Toronto more power to raise its own income and or sales taxes in some way and then went on to give three options as to how the city might then behave:

- The first is that it imposes such taxes but cuts property taxes correspondingly – an appealing policy no doubt, but, as she notes, one that would not close the present fiscal gap;
- The second is that the provincial government would (in effect) reduce its own income and/or sales taxes to provide what Canadians like to call ‘tax room’ for a relatively painless increase in local taxes – something that I suspect she thinks is as unlikely as I do;
- And the third was and I quote, that ‘the City would have to convince taxpayers that they would actually be receiving new and improved services in return for higher taxes.’

Yes. Indeed, as I see it, that’s really what good local finance is all about anyway -- forging sensible, meaningful, links between what people pay and what they get. Without descending to the level of the meaningless fiscal flow calculations currently littering the press¹ - - calculations that seem to be based on the rather ridiculous assumption that the rich should have

¹ For much more on the virtual uselessness of such calculations, see “Fiscal Flows, Fiscal Balance, and Fiscal Sustainability,” Working Paper No. 03-02, International Studies Program, Andrew Young School of Public Policy, Georgia State University, March 2003, and “The Interregional Incidence of Public Budgets in Federations: Measurement Issues, Evidence from Canada, and Policy Relevance,” with Francois Vaillancourt, Paper prepared for Conference on Spatial Aspects of Federative Systems, Speyer, Germany, February 23-25, 2005.

more spent on them because they pay higher taxes – this is of course essentially an aspect of the ‘benefit’ approach Enid mentioned in her presentation.

I would go much further, however, and suggest that establishing such a link between revenues and expenditures is not only the key to good governance, whether at the local or any other level of government (as my distinguished colleague Albert Breton has long argued), but also really the reason why we have more than one level of government in the first place.

In other words, decentralizing spending responsibilities and revenue authority, if done appropriately, is one of the principal ways in which democracy can function so that it comes as close as possible to giving people what they want, in the amounts they want, and in the form they want – where, of course, as an economist by ‘want’ I always mean what they collectively (as decided through their political institutions) are willing to pay for. Ultimately, there is no such thing as ‘other people’s money’ and no free lunch at the democratic buffet.

I am of course well aware that central – and in this country also and especially provincial governments – appear often to view local governments as little more than a particularly annoying interest group. And I am equally aware that most of us in our daily lives know far less about how local governments work, and who runs them, than we do about the latest machinations of the NHL. I am also equally aware, however, that in the absence of meaningful, responsive, and responsible local governments, especially perhaps in decidedly non-homogeneous countries like Canada, not only is the health of democracy in some question but so too are the efficiency and adequacy of the many important public services for which local governments are wholly or partly responsible.

Since I also think, as I suspect most here do, that healthy cities are an essential component of a healthy country in the modern era, even those who are far removed from Hogtown – and who may, like me, still retain at some visceral level the old view of Canada as a cow that eats in the west, is milked in the centre, and deposits what’s left in the east (no prizes for guessing I’m originally from the Maritimes) -- a fiscally healthy Toronto, I would argue, is

to a certain extent in the interests of my relatives in the east and indeed my own interest as a '905er', as it is in the interests those who live east of Peel, west of Durham and south of York.

At an important level, it is thus neither possible nor desirable to think about Toronto's finances in isolation from either the rest of Ontario or the rest of Canada. At the most basic level, all local governments in this province and this country face the same problem: we have created a fundamental 'disconnect' between supply and demand in our public finances. However differently the matter may look from Ottawa or Queen's Park, the demand for public financing is increasingly, I would argue, at the local level, and especially in the larger metropolitan areas, while control over the supply of such finance remains firmly in the hands of what we tellingly call the 'higher' levels of government.

At present, the resulting fiscal gap is bridged, to the extent it is, in three ways:

- The first is to tell cities to tax themselves more heavily using the powers they now have. Actually, I think this is quite right, as I shall come back to in a minute. Of course, no city takes such advice well when it comes from governments that themselves almost never have to send taxpayers the full bill for their own expenditures, immediately, and in a very understandable fashion as cities do. The only governments in this country that even come close to 'fiscal democracy' in a semi-meaningful way are local governments, so it is not surprising, perhaps, that it is that level that often feels the sharp end of generalized citizen discontent with government in general...even though in fact local property taxes have not, in most cities, actually gone up much, if at all, in any relevant sense.
- The second approach is to tell cities to spend less if they cannot raise the money. Often, as we can feel when we drive over Toronto's crumbling infrastructure, the result is inadequate funding to maintain service standards. Sometimes, as when the generally sensible recommendations of the 'Who Does What' panel were so blithely ignored in the recent reorganization of governmental functions in Ontario, insult is added to injury by inappropriately shifting redistributive expenditures down to the local level without financial compensation.

- Finally, the gap is to some extent, never completely, always grudgingly, and usually at the last minute -- thus ensuring that even the best local governments cannot plan sensibly -- closed to some extent by tossing some largesse, often in the form of heavily restricted transfers, in the city's direction.

Some years ago, writing about an almost identical problem in another country I noted that 'central governments get the local governments they deserve'. I could say much the same about Ontario today. If the provincial government does not like the way local governments operate, the solutions lie mainly in their hands since they control virtually all relevant aspects of local government and are largely responsible for establishing the set of incentives to which local politicians and citizens react.

Nonetheless, let me conclude by setting out, without detailed justification, a few random propositions about how the new City of Toronto should be financed. If nothing else, perhaps some of these remarks may serve to provoke some discussion.

First, the primary fiscal obligation of any government is to demonstrate clearly to the people to whom it is responsible that it takes their money from them in a reasonable fashion and spends it for their betterment in a sensible and efficient manner. If a city like Toronto is charged with responsibilities for providing income-elastic services, it needs some form of income-elastic revenue. The property tax alone will not do the job.

My own first preference would likely be to take such responsibilities up to the level of government – the province – that has the right fiscal sources. But if the province is, for any reason, not going to do this, then I hope someone up there is listening to Enid's sensible advice about how to provide the city fiscal instruments that will not only provide some financial elasticity but perhaps also more incentive to encourage economic development more widely than simply building more towering high-rises that may generate additional property tax revenues less painfully than taxing single-family houses full of voters.

Secondly, it is not healthy for anyone to have cities regularly appearing at the provincial, and now the federal, budgetary window as mendicants. Toronto's immediate budgetary may be 'solved' it can simply get more money from the provincial or federal government, but no real solution lies in that direction.

Any new form of transfer, such as sharing some fraction of the gas tax, that is created will soon, if experience is any indicator, be littered with conditions as to on what and how it can be spent. What cities should be asking for – indeed demanding – is that the other levels of government bear the costs of policies such as immigration and social assistance that are presently falling to some degree on local treasuries. It may well be true that many such policies are best run locally, but that does not mean that local residents are the ones who should bear the costs of provincial and national policies that are presumably in the interests of those wider constituencies.

And finally, and this may be the least popular remark I make in this forum, if I were sitting in either Queen's Park or Ottawa, beyond the important points already mentioned about allocating responsibilities and finances to the right levels of government – in effect going back to Who Does What and tying it much more closely to Who Pays for What - I suspect that I would not be all that sympathetic either to pleas for more transfers or for more 'tax room.'

There are, for example, only three limited arguments for intergovernmental transfers:

1. One is to provide a more 'level playing field' between jurisdictions with different revenue capacities. Of course, this is the equalization case, which I would be happy to discuss on another occasion if anyone wants to do so. All I will note here is that this argument may also carry some weight at the local level, but even if it did it would certainly not produce any money for Toronto.
2. The second argument for transfers is essentially one of cost reimbursement when a locality incurs expenses in carrying out policies set from above: this case is solid and, as I have already mentioned, would bring some money to Toronto.

3. The third and most complicated argument is the spillover one - that some transfers may be needed to induce localities to act in ways that are in the interests of a community larger than that to which they are politically responsible. This argument is, I think, usually greatly overdone, at least in the sense that better solutions lie in appropriate assignments of functions and finances in the first place – as I said before, you need to get the expenditure mix right before you start tinkering with the revenue mix in an effort to clean up the mess – and also, in the case of metropolitan areas like the GTA by creating an appropriate ‘governmental’ structure for the economically relevant area²...though no doubt this idea will raise both questions and some hackles.

As for ‘tax room’, this is another one of those strange ideas like ‘fiscal balance’ that floats around fiscal discussion in Canada but really makes almost no sense. Governments collectively do not have some kind of absolute right to some share of national output that they can then divide up amongst themselves as they see fit. Governments at any particular level or in any particular city have no right at all to any more of taxpayers’ money than they can demonstrate to the satisfaction of those who meet their bills that they can spend effectively and efficiently.

When I see a local government that, for example, actually makes full and effective use of all the fiscal authority it already has – one that does not use any possible dodge it can to avoid facing local voters with the full fiscal consequences of its expenditure decisions, one that makes full and sensible use of its borrowing capacity, and one that actually attempts to figure out, sell voters on, and apply sensible user charges, then I will know that I have left Toronto, Ontario, and Canada and finally arrived at something I at least would recognize as a ‘fiscal paradise’ – although I suspect the dominant majority, who often seem to want more and more, provided, it appears, it is paid for by someone other than themselves, might view it more as a ‘fiscal hell’.

² On this question, see two recent papers with Enid Slack, “Fiscal Aspects of Metropolitan Governance,” ITP Paper 0401, International Tax Program, Rotman School of Management, University of Toronto, February 2004, and “The Fiscal Sustainability of the Greater Toronto Area,” ITP Paper 0405, International Tax Program, Rotman School of Management, University of Toronto, February 2004.

To put this last point in a perhaps less contentious way, from my perspective the way to approach the urban revenue problem is always and everywhere from the expenditure side. It is simply not productive constantly to lament that ‘there is not enough money’ – there never is – or to say, like Oliver Twist, ‘I want more.’ The important question is always whether the local public sector is doing the ‘right’ things in the ‘right’ way and the ‘right’ amounts.

Of course, mayors and councils faced with the reality of the revenue squeeze that comes from being at the bottom of the public power heap cannot be expected to see things this way. But the persistence of city revenue problems is a sign that there is a more basic problem that cannot and will not be solved by an additional grant here or access to a new tax base there.

To conclude, although as just mentioned I do think the city can manage its own affairs better I suspect that much of Toronto’s current problem reflects the interplay of four factors, three of which are completely beyond its direct control

- a mismatch between functions and finances that could be fixed relatively simply if the province (and to a lesser extent the federal government) really wanted to do so

- a more important mismatch between the territorial span of political jurisdictions and economic realities that would, I suspect, be much more difficult to resolve even if the province had an interest in doing so, which is far from obvious

- an inappropriate governance structure that makes strong and integrative leadership unnecessarily difficult

- and, finally, the need for the city itself to do a much better job than it (or indeed probably any city in the country) is currently doing both in how it raises revenue – mainly the user charge question and borrowing – and especially in how it spends them, and the (at present largely non-existent) links between the two.

So: do fiscal restraints need to be eased for Toronto? As a two-handed economist, there is only one possible answer: Yes. And no. Yes, in the sense that the city needs to be enabled to do what it should be doing, which will, I suspect, require changes in both fiscal and governance structures that are under the control of the province. No, in the sense that I would not simply give Toronto more money, and especially not in ways such as restricted grants or so-called revenue-sharing that will both make it more difficult to run the city properly and further attenuate the already far too slender links between revenue and spending decisions in Canadian public finances.

Until the province, and perhaps the country, has a more rational institutional framework within which to consider metropolitan area finance and governance – a day that may be long in coming – probably the best Toronto can do is to try to mobilize political impetus for more rational treatment from above on the one hand and, on the other, to do better than it appears, in my no doubt somewhat uninformed opinion, to have done to date in using the power and authority it already has. Life is not easy in politics, and especially not at the local level, and my approach would certainly not make it easier. But then, in a democracy, life is not supposed to be a bed of roses for those in the political game in any case.