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Provincial-Local Equalization in Canada: Time for a Change?

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munk school OF GLOBAL AFFAIRS & PUBLIC POLICY

UNIVERSITY OF TORONTO

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About the Urban Project

The Urban Project is an initiative led by the Federation of Canadian Municipalities (FCM) that brings city leaders together with other levels of government, academia, civil society, and the private sector to identify actionable and scalable solutions to the biggest challenges facing Canada's cities. With generous support from Maytree, Metcalf Foundation, McConnell Foundation, and TD Bank Group, IMFG has commissioned a series of papers focused on municipal legislative and fiscal autonomy, governance, and intergovernmental relations, drawing on discussions convened by the Urban Project.

About IMFG

The Institute on Municipal Finance and Governance (IMFG) is an academic research hub and non-partisan think tank based in the Munk School of Global Affairs & Public Policy at the University of Toronto.

IMFG focuses on the fiscal health and governance challenges facing large cities and city-regions. Its objective is to spark and inform public debate, and to engage the academic and policy communities around important issues of municipal finance and governance. The Institute conducts original research on issues facing cities in Canada and around the world; promotes high-level discussion among Canada's government, academic, corporate, and community leaders through conferences and roundtables; and supports graduate and post-graduate students to build Canada's cadre of municipal finance and governance experts. It is the only institute in Canada that focuses solely on municipal finance issues in large cities and city-regions.

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Provincial-Local Equalization in Canada: Time for a Change?

Richard M. Bird and Enid Slack

Abstract

This paper makes the case for provincial-municipal equalization transfers, to ensure that all local governments can provide reasonably comparable levels of service at reasonably comparable tax rates. A municipality's inability to provide a comparable level of service may arise because the costs of services in the municipality are higher, the need for services is greater, the tax base is smaller, or some combination of these factors. Although six provinces in Canada provide some form of equalization to municipalities, arguably none provides sufficient funding to achieve the underlying objective of equalization.

To design a proper equalization system, this paper sets out a number of issues that need to be resolved. These include the overall amount of equalization and how it is determined from year to year, which municipalities are entitled to equalization, whether the variables determining the grant allocation can be influenced by municipalities, how fiscal capacity is measured, how needs are measured, and whether transitional funding is required to ensure that no municipality is worse off even if fiscal capacity and needs change. The paper concludes that every province in Canada would do well to establish a sound equalization transfer approach, which is an essential element of a fair and efficient system of local public finance.

Keywords: Canada, fiscal federalism, provincial-municipal equalization, municipal finance

JEL codes: H73, H71

Provincial-Local Equalization in Canada: Time for a Change?

1. Introduction

Canadian municipalities have long argued that they do not have sufficient revenues to meet their growing expenditure needs. The main source of local revenue – the property tax – is a good tax for local governments, but it cannot provide an expanding tax base for most municipalities in the future. The changing nature of work, which has seen more people working from home, and the shift to online retail mean that there will be less need for commercial properties in the future. The implication of these changes is that the commercial property tax base may shrink and will in any case be less likely to provide a stable – let alone growing – source of revenue for municipalities.

Since no other existing own-source revenues will provide much additional local revenue in the next few years, local governments – not just one-industry towns such as those dependent on tourism or on a specific natural resource, but even large cities – may become even more dependent than they now are on provincial financial support to provide the services people expect. Both levels of government thus need to think more seriously about the role, design, and operation of provincial-municipal transfers.

Provincial transfers to municipalities in Canada are largely conditional in the sense that funds have to be spent on specific services designated by the provincial government and often have many conditions attached to them. These transfers may be appropriate where the benefits of services spill over municipal boundaries and municipalities are unable to cover all of the costs from their own-source revenues, or where the province wants to ensure its priorities are met. They are not well suited for general support, however. Although almost all provinces do offer some general financial support to at least some municipalities, arguably none delivers sufficient equalization grants to enable all local governments to ensure services of at least minimal acceptable quality, provided they exploit their own tax bases sufficiently.[1]

The case for equalization transfers at the federal-provincial level has long been widely – though not universally – accepted in Canada.[2] Just as the federal

1. Although Nova Scotia and New Brunswick do have equalization transfers based on expenditure needs and fiscal capacity, they probably do not provide sufficient funds. See section 5 for more information.

2. The federal government has provided provincial equalization grants since 1957; the principle of equalization was enshrined in the Constitution in 1982. For recent reviews of federal-provincial equalization, see Béland et al. (2017), Bird (2018), and Tombe (2018). The federal equalization system has been subject to question both legitimately, for the inadequate way it responds to abrupt changes in provincial finances, and less legitimately by politicians claiming that equalization – which is funded entirely from federal sources – takes revenues away from their province and transfers them to other provinces. Neither criticism applies to a provincial-municipal equalization system.

government provides equalization transfers to ensure that all provinces can provide a comparable level of service at a comparable tax rate, provinces should ensure that all municipalities in the province can do the same. However, although municipalities in every province depend on provincial fiscal transfers to support many of the services and infrastructure for which they are responsible, no province has an adequate equalization system that enables all municipalities to do so equally well if they make the same fiscal effort to exploit the revenue sources available to them.

This paper makes the case for provincial-municipal equalization, evaluates the extent to which current provincial-municipal equalization transfers across the country are sufficient, and suggests how to improve the design of these transfers. Section 2 provides an overview of the provincial transfer systems currently in place across the country. Section 3 makes the case for provincial-municipal equalization transfers specifically and discusses the appropriate role of equalization transfers. Since the factors and formulas that are used to determine how much equalization each municipality receives are central to equalization systems, section 4 sets out the mechanics of designing such a transfer, and discusses how they should ideally operate. Section 5 describes and evaluates the (usually quite limited) equalization transfers in place in the six provinces that use them, and concludes with some suggestions for designing a provincial-municipal equalization transfer.

2. Provincial-Municipal Transfers in Canada

Municipalities in every province depend on provincial fiscal transfers, either in the form of tax sharing or direct grants, to support many of the services and infrastructure for which they are responsible. Both the level and the structure of transfers differ across provinces and have changed over time in different ways in different provinces. In most, the transfer system is complex, confusing, and in a word, "messy." Transfers are allocated in ways for reasons and with results that are seldom easy to understand and almost always unclear.[3] Many transfers in most provinces are conditional, requiring that the funds are spent in certain ways on certain activities. Few transfer programs seem to be based on careful analysis or have a clear rationale and their effects seem equally unlikely to be evaluated carefully.

As Table 1 shows, federal and provincial transfers account for about 20 percent of total municipal revenues. Unfortunately, there are no comparable data by province that separate federal and provincial transfers, but data from earlier years suggest that provincial transfers account for most of this amount. Provincial grants for much of the later 20th century generally provided more of total local revenue (Kitchen, 1984, 2002), but Table 1 suggests that little has changed over the last

3. We focus here on provincial transfers to municipalities. There are also a number of federal transfers, most of which are small, to local governments, which are not discussed here because they are much less important in terms of revenue and because none provides funds that local governments are free to spend as they wish.

decade, despite some differences across provinces.[4] In 2019, for instance, transfers ranged from less than 10 percent of total municipal revenues in British Columbia to almost half in Prince Edward Island and even more in Nunavut and the Northwest Territories. Grants consistently account for the lowest percentage of municipal revenues in British Columbia, Québec, and Nova Scotia. Municipal reliance on transfers has changed in some provinces over the last decade or so. Transfers as a percentage of total municipal revenues in Newfoundland and Labrador are now much less than they were in 2008 and their importance has also declined in Saskatchewan. In contrast, in Prince Edward Island, grants as a percentage of municipal revenues have more than doubled over this period.

Table 1: Federal and provincial transfers as a proportion of municipal revenues, by province and territory, 2008–19 (%)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
British Columbia	7.8	6.0	10.1	8.2	5.7	3.9	4.4	4.5	8.1	5.9	7.9	8.9
Alberta	24.8	23.8	22.3	21.7	18.9	23.7	18.5	14.9	21.1	26.7	22.1	17.1
Saskatchewan	29.2	27.2	27.2	28.9	23.2	19.6	20.6	17.8	20.5	19.0	18.1	19.6
Manitoba	21.8	21.5	22.7	23.1	23.2	23.7	20.0	19.7	18.6	18.5	16.8	16.4
Ontario	20.9	25.5	27.5	22.5	22.8	23.3	22.3	22.6	22.8	23.1	23.3	22.4
Québec	13.4	16.3	14.8	14.0	13.8	12.5	11.0	12.4	11.2	17.3	15.9	15.8
New Brunswick	23.2	23.2	22.9	22.8	18.6	19.9	18.5	19.7	21.0	24.2	21.6	22.2
Nova Scotia	15.1	16.4	17.4	13.5	13.2	9.9	9.3	9.1	11.1	17.1	12.4	17.8
Prince Edward Island	21.8	17.6	41.1	41.6	37.1	36.6	34.4	32.0	35.4	43.0	45.2	46.9
Newfoundland and Labrador	35.9	40.6	40.7	35.8	24.3	25.6	25.0	24.6	19.2	20.7	20.6	20.6
Nunavut	53.4	54.7	56.0	53.9	50.5	54.6	53.2	50.7	49.1	46.7	46.5	48.6
Northwest Territories	66.1	67.9	62.4	60.4	56.3	59.9	58.3	54.1	47.3	59.3	58.4	58.1
Yukon	29.2	47.4	27.5	28.6	38.0	24.1	59.5	25.3	23.4	24.7	26.2	26.9
Canada Total	18.9	21.4	22.3	19.4	18.5	18.9	17.4	17.1	18.4	20.4	19.5	18.6

Source: CANSIM Table 10100020: Canadian Government Finance Statistics for Municipalities and Other Local Public Administrations via CHASS Data Centre; Statistics Canada Table: 10-10-0020-01

4. Hobson, Cameron, and Locke (2005) show that transfers fell from 25.7 percent of total municipal revenues in 1995 to 16 percent in 2003. Unconditional transfers stayed at around 3 percent of municipal revenues, but conditional transfers fell to 13 percent from more than 22 percent.

Table 2 provides a breakdown of federal and provincial transfers according to whether they are allocated for operating or capital purposes. Many grants are a combination of capital and operating components or the purpose is so unclear that they cannot be categorized at all. But for those that can be separated, about 60 percent, although with wide variation across provinces, is designated for operating expenses. Most grants are allocated to capital in Alberta, while more are allocated to operating purposes in Québec, New Brunswick, Nova Scotia, and Prince Edward Island. Although federal transfers cannot be disaggregated from the data, historically they have been used to pay for infrastructure. Recently, however, the federal government has provided funds to municipalities to cover operating deficits due to COVID-19. However, these transfers are not reflected in Table 2, which covers the 2019–20 fiscal year.

Table 2: Distribution of federal and provincial transfers by capital versus operating purposes, 2019–20 (%)

Province	Capital	Operating	Mixed or Undefined
British Columbia	30.8	17.4	51.8
Alberta	74.2	21.5	4.2
Saskatchewan	29.4	4.6	66.0
Manitoba	47.3	46.9	5.9
Ontario	4.4	39.9	55.7
Québec	41.3	57.5	1.3
New Brunswick	27.8	72.2	0.0
Nova Scotia	41.6	57.5	0.9
Prince Edward Island	48.2	51.8	0.0
Newfoundland and Labrador	48.2	13.0	38.8
Total	24.7	39.4	36.0

Source: Provincial-Territorial Officials Committee (PTOC) on Local Government, *Provincial and Territorial Transfers to Municipalities*, March 2020

The extent to which transfers in most provinces are unconditional has changed somewhat over time. In 1976, for example, unconditional transfers accounted for 13.5 percent of total provincial-municipal transfers (Ontario 1977) compared with 5.7 percent in 1988, 2.6 percent in 2000 (Kitchen 2002), and 19.6 percent in 2019–20.[5]

5. Unconditional transfers represented much less than half of total provincial-municipal transfers in 1976 with the exception of New Brunswick, where they accounted for 82 percent of the total (Ontario 1977).

As Table 3 shows, the relative share of unconditional (also known as general-purpose) grants varies substantially from province to province. Alberta, for example, has no unconditional municipal transfers, while in both New Brunswick and Saskatchewan, such transfers account for well over half of the total. There is no consistent information across Canada on the types of conditional grants to municipalities, but information from Alberta shows that the bulk of these transfers in that province support municipal capital projects (Dahlby and McMillan 2021).

Table 4 shows that unconditional grants can take the form of revenue sharing (in three provinces), equalization (in six provinces), or other grants based on population, remoteness, or other municipal characteristics (in six provinces). Even in provinces where unconditional grants are significant, explicit equalization grants are limited. Many transfers include some equalization element in their distributive formulas, but with the partial exception of New Brunswick (which first introduced an equalization grant in 1967) and especially Nova Scotia, none is based to any significant extent on "fiscal need," although some are based on "fiscal capacity."[6] Indeed, as Table 4 (and the later description of the existing provincial-municipal equalization transfers) shows, it is often difficult to understand exactly what the basis for grant allocation is in most provinces, let alone its rationale or likely effects.

Table 3: Distribution of federal and provincial transfers to municipalities, unconditional versus conditional, 2019–20 (%)

Province	Unconditional	Conditional
British Columbia	55.8	44.2
Alberta	0.0	100.0
Saskatchewan	65.0	35.0
Manitoba	46.9	53.1
Ontario	10.8	89.2
Québec	37.3	62.7
New Brunswick	64.2	35.8
Nova Scotia	48.9	51.1
Prince Edward Island	11.3	88.7
Newfoundland and Labrador	20.6	79.4
Total	19.6	80.4

Source: Provincial-Territorial Officials Committee (PTOC) on Local Government, *Provincial and Territorial Transfers to Municipalities*, March 2020

6. The terms in quotation marks are defined more precisely in section 3.

3. The Case for a Provincial-Municipal Equalization Transfer

As the tables in the previous section indicate, provincial governments do not engage very much in provincial-municipal equalization. Before considering why that should change, equalization needs to be considered in the context of the role of provincial-municipal transfers more generally.

3.1 Rationales for intergovernmental transfers

In considering intergovernmental transfers, the first question to consider is why a province should transfer funds to municipal governments.[7] It is not difficult to think of several reasons:

1. **Balancing revenue-raising and expenditure assignment.** One objective may simply be to close any "vertical fiscal gap" – the difference between the revenues that can be raised by the most prosperous municipality and the expenditures required to cover its assigned local government responsibilities – that may arise because local governments are assigned more responsibilities than can be financed by the revenue-raising powers at their disposal.[8]
2. **Inter-jurisdictional equity.** Another objective first set out in Buchanan (1950) and explored in depth in the Canadian context in Graham (1963) may be to treat all provincial residents, regardless of where they reside, as equally as possible by closing the additional "horizontal fiscal gaps" that face localities with fewer resources (and perhaps also higher expenditure "needs") compared with those in the best-off locality.[9]
3. **Externalities.** A third possible rationale and the most consistent with the efficiency framework familiar to economists, may be to offset possible distortions to local budgetary decisions owing to any external benefits and costs – that is, effects spilling over to other localities – of specific local government expenditure programs.
4. **Agency costs**. Another objective may be simply to reimburse local governments for costs they incur in implementing policies that the provincial government requires them to deliver as its agent, thus doing away with unfunded mandates.

7. For a recent consideration of this question, see Dafflon and Vaillancourt (2020), which emphasizes the important distinction between "differences" (in tastes and preferences, which depend on local decisions) and "disparities" (in costs, capacity, and needs, which are not within local policy control).

8. The rationale for this approach is set out in Bird (1993). Local government may be assigned inadequate taxing power because it may be more efficient for the provincial government to raise funds at a lower marginal cost (although this argument may seem implausible when an important marginal source of provincial taxes is what Dahlby and Ferede (2018) have shown is the extremely inefficient corporate income tax). Other reasons may be that provincial governments consider local governments incapable of raising revenue effectively or efficiently or wish to exert control over what localities do and perhaps to get some political credit for doing so.

9. The financial needs of the best-off municipality would be adequately met by closing the vertical gap.

Table 4: Unconditional transfers by type, by province, 2019–20

Province	Revenue Sharing	Equalization	Other
British Columbia	Traffic fines sharing. Provincial gaming revenue sharing.	Small community grant partially based on assessment.	Regional district grants based on population.
Alberta			
Saskatchewan	Provincial sales tax sharing: Funds distributed on a per-capita basis Funds split between: cities, towns, villages, and resort villages; rural municipalities and organized hamlets; and Northern municipalities Three components to rural revenue-sharing grant – unconditional portion based on roads and population data; organized hamlets per-capita grant; assistance to rural municipalities that assume financial liabilities related to environmental-based physical infrastructure when a village dissolves into a rural municipality. Some funds targeted to good governance, legislative compliance, and increased inter-municipal and regional cooperation.		
Manitoba			Strategic Municipal Investment Fund distributed on a per-capita basis; separate grant for Winnipeg.
Ontario		Ontario Municipal Partnership Fund (OMPF): assessment equalization grant. The grant for each municipality is based on the total assessment differential, which is calculated as the total municipal assessment below the median per household threshold. OMPF: northern and rural fiscal circumstances grant. The grant takes account of the fiscal circumstances of municipalities, using indicators for weighted assessment, median household income, change in assessment, employment, dependency ratio, and low-income population.	Other OMPF components: • per capita Northern communities grant • per-household amount for small and rural communities based on percentage of population in rural and small communities plus additional grant for communities with large percent of farmland • transitional assistance to guarantee support based on previous year's allocation.

Table 4: Unconditional transfers by type, by province, 2019–20 (continued)			
Province	Revenue Sharing	Equalization	Other
Québec	Natural resources royalty revenue sharing with municipalities that have mining, oil, and gas production sites. Share of the growth on one percentage point on Québec sales tax, starting in 2021.	Equalization determined by a formula that provides funds to a municipality whose tax base is lower than a standard tax base. Additional funding is also provided for devitalized municipalities; 20 regional county municipalities are guaranteed a minimum amount based on fiscal circumstances.	Québec government reimburses 50% of the provincial sales tax paid by municipalities
New Brunswick		Community funding and equalization grant based on size of the non-residential tax base.	
Nova Scotia		Equalization grant based on expenditures for four services and assessment base.	Towns receive a flat amount under the town foundation grant. HST offset grant is a portion of the grants in lieu from Nova Scotia Power to offset HST costs.
Prince Edward Island		Equalization grant based on taxable non-farm property assessment.	
Newfoundland and Labrador			Grant based on population and remoteness index. Partial rebate of provincial portion of HST.

Source: Provincial-Territorial Officials Committee (PTOC) on Local Government, *Provincial and Territorial Transfers to Municipalities*, March 2020

5. **Politics**. Finally, of course, as in any political system, political reasons (that may or may not be persuasive to those who do not directly benefit) frequently explain payments to particular localities. Such transfers may be intended to cope with specific problems (such as disaster relief) or to reduce the degree of perceived local discontent with the provincial government, or to induce or reward political support.

The first two rationales call for unconditional transfers – transfers with no strings attached. The remaining three point to conditional transfers that have to be spent on particular functions, often packaged with various conditions specifying exactly how the money is to be spent. As discussed in section 2, most provincial-municipal transfers in Canada are conditional and hence presumably justified for one or more of the last three rationales listed above. Some may be no more than the provincial government quite properly paying its share (up to and including the total cost) of some local expenditures that are really provincial expenditures – for example, constructing an intersection with a provincial road or building a long-term care home or other facility to fulfil a provincial mandate. Some such outlays may also be justified in terms of the externalities generated by the local expenditure, for example, the non-local traffic facilitated by a road or non-residents potentially served by the new facility. And, of course, provincial politicians from the ruling party are always glad to visibly demonstrate their usefulness by cutting ribbons on such projects in their constituencies.

Provincial governments may prefer conditional transfers precisely because they restrict local budgetary discretion. However, the fact that conditional grants override the preferences of subnational governments – municipalities get the road the province thinks they need, not the sports field that they might prefer – is also their major flaw. Provincial governments may sometimes complain that local governments do not adequately maintain the infrastructure that has been so generously bestowed upon them. But if they did not want it in the first place, why should they maintain it?

Provincial finance ministries want flexibility in determining the share of provincial revenues that flows to local governments, but they usually prefer to ensure that local municipalities face a hard budget constraint rather than that they spend the money in any particular way.[10] However, other provincial ministries and some legislators may have different concerns. Transport ministries may prefer conditional grants earmarked to roads, environment ministries grants earmarked to water and sewer infrastructure, and so on, because such grants enable them to maintain more control over their area of responsibility. On the other hand, ministries of municipal affairs, and indeed provincial politicians in general, may

10. A "hard" budget constraint ensures accountability in the sense that, if municipalities wish to increase spending, they must persuade their voters to either pay more taxes (or fees) either now or (if they borrow the money) in the future. For more on hard and soft budget constraints, see Bird and Tassonyi (2003).

prefer ad hoc arrangements that give them more discretionary power to respond to and influence their regional and local constituents.

Viewing a transfer system from the opposite direction – bottom up, that is, from the perspective of local residents – almost everything is reversed. Municipal governments typically favour a transfer system which provides both a guaranteed, adequate revenue flow and allows them to spend the funds as they choose. They prefer unconditional to conditional transfers and like "tax-sharing" systems such as those in Saskatchewan, which guarantee a revenue flow. However, it is difficult to devise an acceptable formula-based system for horizontal allocations. Which municipality gets how much money can vary because local governments differ in many ways – urban vs. rural, rich vs. poor, large vs. small, remote vs. adjacent to a big city.[11] The conflicting interests of different municipalities is one reason they seldom have much influence on the design of the intergovernmental transfer system. For example, larger and richer places may prefer "derivation-based" tax sharing whereby municipalities receive money to spend without requiring local politicians to get the support of local residents, but poorer municipalities are more likely to prefer horizontal sharing formulas that recognize their expenditure needs.

There is always the question of whether municipalities could increase their own-source revenues, particularly the property tax, rather than calling for more taxing power or more intergovernmental transfers.[12] But sometimes the call for transfers may be justified. Some localities may simply not have sufficient taxing power to finance their share or are simply not capable of increasing taxes.

Distinguishing "disparities" arising from real differences in needs or resources from "differences" arising from poor local policy choices is never simple (Dafflon and Vaillancourt 2020). But if a provincial government wishes to treat all residents, no matter where they reside, as fairly as possible, it is a task they should tackle. We suggest that the best way to do so is to establish as the core of the provincial transfer system a relatively simple equalization transfer. In addition to being more equitable than the existing transfers in most provinces, such a transfer also should improve both the efficiency and accountability of municipal governments by ensuring that all localities face the same incentives when responding to federal or provincial conditional transfers.

If municipalities with different capacities and needs are to operate on a relatively level playing field in responding to such transfers, they can do so only if there exists an underlying unconditional general-purpose (equalization) grant like that discussed next. With matching grants, in particular, where municipalities are required to match provincial or federal funds, an equalization transfer would help

11. And, of course, it is necessary to define what is meant by rich and poor, large and small, remote, etc.

12. In a study of GTA municipalities, for example, estimates showed that many municipalities could increase their residential property taxes without a major economic impact (Bird, Slack, and Tassonyi 2012).

them provide their contribution more easily. In terms of federal-municipal transfers designated for capital purposes, equalization will help ensure that all municipalities can cover the operating costs associated with that infrastructure.

3.2 The case for provincial-municipal equalization transfers

The case for equalization is to ensure that all local governments can provide reasonably comparable levels of service at reasonably comparable tax rates. The inability to provide a comparable level of service compared with other municipalities may be because the costs of services are higher, the need for services is greater, the tax base is smaller, or some combination of these factors. Needs or costs may be greater than average because of geographic location, population density, or other factors. For example, wages and rents are usually higher in cities with high population density and the cost per unit to provide services increases with increasing population because of congestion (Fenge and Meier 2001). Per-unit costs may also be higher than average in sparsely populated areas (Kitchen and Slack 2006). Needs may be higher for municipalities with a high proportion of low-income households who require affordable housing and social services. Taxing capacity is also unevenly distributed across municipalities, leading to disparities in the ability to finance the provision of local public services.

Although the federal-provincial equalization system is frequently discussed, there is a stronger economic case for provincial-municipal equalization transfers. Because local governments are the responsibility of provincial governments and, in principle, all residents of a province should have equal access to public services, including those delivered by municipalities, a principal function of provincial transfers to municipalities must be to ensure that they can provide an acceptable level of services to their residents. An equalization transfer placing all municipalities on a level playing field in this regard would help achieve this result. Because municipalities cover smaller geographic areas and there are many of them compared with the number of provinces, the range of disparities is likely to be greater than that among provinces.

Auld and Eden (1987), in an earlier examination of this question, also stressed that the arguments for equalization are especially strong at the local level. Because both resources and needs differ from municipality to municipality, even if all make the same effort to collect local taxes, the net fiscal benefits (value of the benefits from public goods and services minus taxes paid) to residents will differ from place to place. Unless there is full capitalization of net benefits, whereby taxes and benefits are fully reflected in property values (which is unlikely), there will be some fiscally induced migration as people move between municipalities in response to different net fiscal benefits. This movement of people may not be desirable from a policy perspective, because it does not reflect differences in labour productivity and results in an inefficient allocation of labour among municipalities, with too many workers in the municipalities with the highest net fiscal benefits (Boadway

and Shah 2009). Moreover, people are more likely to move from one municipality to another than move to a different province.[13]

At the same time, since municipal revenues depend largely on property taxes, a considerable share of which may come from commercial and industrial property and may create similar incentives for both investments and people to move in response to better services or higher taxes, undesirable shifts may also occur in the absence of an adequate degree of fiscal equalization.

Finally, municipalities in most provinces, as noted earlier, rely more heavily on conditional transfers compared with unconditional transfers. Many of these are matching transfers whereby municipalities have to match provincial funds. This reliance on conditional transfers reflects, to a large extent, the priorities of provincial governments. If fiscal capacity varies among municipalities, those with poor fiscal capacity will be unable to match provincial funds without raising tax rates or reducing services not covered by these matching funds. The same problem applies to federal conditional transfers. Equalization is needed to address these fiscal disparities.

Although the case for equalization transfers is strong, problems may arise if the transfers are not designed appropriately (see section 4). For example, it can be difficult to strike the right balance between reducing fiscal disparities among municipalities (enabling them to all deliver a roughly comparable level of service) while allowing them to choose different bundles of local public services in response to local preferences.

Moreover, because grants are inversely related to fiscal capacity, they may discourage local governments from increasing the size of their tax base – a local government that increases its tax capacity will inevitably receive fewer grants (Blöchliger and Petzold 2009). Grants may thus undermine the willingness on the part of local governments to strengthen the tax base; the result is that fiscal disparities are prolonged, rather than eliminated. Moreover, if the base expenditure used in the formula is the average expenditure for all municipalities, and some municipal governments have high but inefficient expenditures, the equalization formula may reward all municipalities to some extent for the inefficiency of a few.[14]

Finally, although equalization transfers can be justified on equity grounds, they should not discourage municipalities from collecting their own revenues or finding other ways to balance their budgets through efficiencies or restructuring (Slack and Bird 2013) and they should not discourage municipalities from charging the right price for services: "the basic task in transfer design is thus to get the prices 'right' in the public sector – right, that is, in the sense of making local governments fully accountable – at least at the margin of decision-making – to both their citizens and,

13. Between 2011 and 2016, 81 percent of internal migrants moved within a province (Statistics Canada 2016).

14. One way to determine if there are inefficiencies is through benchmarking municipal expenditures.

where appropriate, to higher levels of government" (Bird and Smart 2002: 899). There is no incentive to use proper pricing when grants cover a large proportion of municipal expenditures.

4. The Mechanics of an Equalization Transfer

The purpose of a provincial-municipal equalization transfer, as noted earlier, is to ensure that each municipality in the province can provide a comparable level of services by levying a comparable tax rate. The relevant equity consideration here is inter-jurisdictional and focuses on horizontal rather than vertical equity. The point is not to give more to the poor than the rich but to ensure that when it comes to local spending decisions, all potential recipients are roughly in the same position.[15]

To rephrase the argument in inter-personal terms, an optimal equalization transfer is in a sense a way to ensure that everyone (every jurisdiction) has something close to a basic income at least with respect to being able to afford a basic (or standard or even average) level of local services. To achieve this, the equalization transfer plus the municipality's own revenues (assuming it exerts the average (or standard) effort to exploit the revenue sources available to it) would have to be sufficient to provide the desired level of services. Designing such a transfer is not as simple as this formulation may make it sound, but a few key points are clear.

First, an equalization transfer should be unconditional. Conditions can and should be imposed on specific transfers when local governments are essentially agents implementing provincial policies or when transfers are intended to encourage local spending that in part benefits non-local residents.[16] But there is no place for such conditions in a general equalization transfer. The primary purpose of such a transfer is to establish as level a playing field as possible for all local governments, rich and poor, by enabling them to provide something close to an average package of local public services with no more than average tax effort.[17]

15. Poor people may live in rich local government areas and rich people in poor areas, and they may also move across jurisdictional boundaries in response to fiscal incentives, so the relationship between inter-personal and inter-jurisdictional equity is a complex one that cannot be further discussed here.

16. Although in principle, the amount of such a transfer should depend on the degree of external benefits involved, the marginal cost of providing the good, and the extent to which the local government will respond to the grant incentive (that is, the price elasticity of demand for the good), in reality the best that usually can be done is to make as good a guess as possible. Even the most precisely targeted "externality" grant is seldom based on more than guesswork and politics.

17. In some extreme cases, when it may be excessively costly to achieve this target – for example, when a "one-industry" town loses its industry and no feasible replacement exists – it may be more sensible (though seldom, if ever, more popular) to move the people than to "save" the community. The best-known example in Canada is perhaps the closing of a number of small outport communities in Newfoundland and Labrador some years ago. There is also the case of the closing in the 1960s of inland villages in the Eastern part of Québec (Bas St-Laurent/Gaspésie) by the BAEQ (le Bureau d'aménagement de l'Est du Québec) program. An early examination of this policy – colourfully called "the ghost town as an objective" – may be found in Graham (1963); for a more recent and wide-ranging review, see Kitchen and Slack (2006).

Second, although a fiscal gap exists in virtually every country between the revenues local governments raise from their own resources and the expenditures for which they are responsible, a first step in understanding the role of an equalization transfer is to view this gap as a combination of a vertical gap and a horizontal gap.

The *vertical gap* (or vertical fiscal imbalance) is the difference between (a) the amount local governments can raise from their own revenue sources if they exert a "normal" revenue effort and (b) the amount they must spend to provide a minimum level of the government services that have been assigned to them. If these two targets are clearly defined – they may be, but it is not always easy to do so – the gap for any particular level of subnational government is:

$$GAP = \sum_i (\tilde{E}_i - \tilde{R}_i) \qquad (1)$$

where:

$\tilde{R}_i$ = the revenue raised from own sources at normal effort by local government *i*

$\tilde{E}_i$ = the amount of expenditure needed to provide a minimum level of assigned services in local government *i*

The targeted vertical share (VS) – the share of provincial taxes that should be allocated to local transfers to close this gap, assuming that the provincial government wants to make it possible for local governments to provide a certain minimum package of services – can then be defined as:

$$\text{VS} = \frac{\alpha(GAP)}{CR} \qquad (2)$$

where:

α = the share (percentage) of the vertical gap that the provincial government intends to cover with the transfer system

CR = the total amount of current revenue (or, more simply, taxes) raised by the provincial government

In reality, few, if any, jurisdictions actually make such calculations. Most decisions on transfers are based on little more than a few crude indicators. Perhaps little more is needed. Expenditure "need" is a subjective concept, and, because the public generally has little idea of the real tax price of local public goods, the demand for local government services is always likely to outweigh the capacity (or willingness) at any level to finance them. There will always be some gap to be filled – and it is usually, though seldom completely, filled by provincial transfers. Nonetheless, even if it is not used to distribute grants, the formula set out above provides a useful baseline that helps to clarify what intergovernmental transfers actually do.

For example, the per-capita transfer a province makes to its richest municipality may be thought of as a measure of the size of the vertical gap between local

expenditures and revenues as the province sees it. In this scenario, one should assume local governments spend their own (non-transfer) revenues for services providing only local benefits; any services yielding spillover benefits to those in other localities are either ignored or assumed to be financed to the extent of the externality by transfers designated specifically for those services. In this case, provided that localities have sufficient taxing power to finance services at a level and quality that satisfy the province's concept of "acceptable" by imposing taxes and fees under their control at an average level, the best-off locality would receive no transfer, because there is no fiscal gap to be closed. But since, by assumption, all other municipalities have lower fiscal capacity, they would of course require larger equalization transfers to enable them to close the horizontal gap and meet provincial standards.

A *horizontal gap* (or horizontal fiscal imbalance) occurs when revenue powers do not match expenditure responsibilities for different municipalities in the province because, as noted above, not all municipalities will be able to provide the services that the richest municipality can deliver. Horizontal fiscal equalization is designed to offset differences in revenue-raising capacity and expenditure need and cost in different municipalities.[18]

To estimate the size of an equalization transfer to an individual municipality, in any given year, that is based on expenditure need and fiscal capacity, a province must first determine the average (or standard) per-capita expenditures and tax rates to fit into the following grant formula:

$$GR_i = [(E/P)^* - t^*(B/P)_i]P_i \qquad (3)$$

where:

GR_i = grant to municipality i

$(E/P)^*$ = standard (average) expenditure per capita

t^* = standard (average) tax rate

$(B/P)_i$ = tax base per capita in municipality i

P_i = population in municipality i

This formula ensures that each municipality, regardless of the size of its tax base, can make the average expenditures per capita without having to levy a higher tax rate than the average.[19] If a municipality spends more than the average per capita, it will receive a grant sufficient only to cover expenditures up to the average. Any expenditures above the average would have to be financed from local revenue sources. If a municipality spends less than the average, the grant is calculated on the

18. For example, for an analysis of how per-household municipal costs for fire and police services in Ontario vary by the size of a municipality, see Found (2012).

19. As noted in the concluding section below, the formula might also take into account more than one tax as well as other sources of municipal revenue such as user fees.

basis of the average. For a municipality in that situation, the grant could be more than it needs to fund the expenditures it currently makes.

In terms of taxes, this formula has the important advantage of providing an incentive for local governments to impose taxes at average tax rates at least. If they impose less than an average rate, the grant they receive does not increase, so the amount available for them to spend is less than it would otherwise be. On the other hand, if they impose an above-average tax rate, the grant they receive is not reduced, so they have more to spend. To put this another way, a formula based on the assumption that each local government imposes taxes on its available tax bases at the average rates imposed by all local governments in effect imposes a "tax" of 100 percent on the amount any government does not collect when its tax rates are lower than average. Conversely, it in effect imposes a "tax" of zero on any amount it collects by imposing above-average rates. When a grant is structured in this way, the incentive to increase local tax effort to the average is inherent in the design of the formula.[20]

Provinces need to update this information annually in a reliable and consistent fashion. There must be a reliable system to ensure the funds arrive in the locality's accounts in a regular and predictable way. Municipal accounting must be consistent, current, and comparable across the province. And finally, because municipalities with different characteristics will by definition receive different equalization transfers, there must be similarly reliable, current, and transparent information on those characteristics as well as clear guidelines that establish when any line implying different treatment is appropriate has been crossed. Full transparency to all, including the public, about precisely who gets how much and why is an essential element of a good equalization system.

None of these conditions is simple to satisfy even if one assumes – contrary to reality – that expenditure assignments are properly allocated, that local governments have adequate revenue-raising powers, and that the provincial government pays both for any local activities it directly controls and for any spillover benefits arising from decisions left in local hands.

Still, although establishing the level of the (appropriately defined) fiscal gap to be filled in each jurisdiction can be both a complex empirical task and a difficult political sell, such a system would be both easier to understand and more effective and equitable than the hodgepodge of current transfers in some provinces when

20. As usual, matters are not quite this simple, because such an equalization formula also tends to raise the total level of local taxes. It may also have differential effects on different localities if some municipalities do not receive grants or if some jurisdictions are much larger than others and thus play a more important role in determining the average. Other factors may also affect outcomes, including the weight of factors in the formula other than the ratio between the average local tax rate and the rate in a particular jurisdiction, how tax bases are estimated, what tax bases are included, and how the effective tax rate used in the formula is calculated. Given this complexity, it is not surprising that some formulas – for example, that used in Ontario – have become so complex that it is difficult for anyone to understand exactly what is being done and why, let alone what the effects may be in terms of service provision.

it comes to finding a distribution formula that will get the job done. At the same time, it would likely prove so difficult to justify reducing existing transfers to any municipality that, even if a different equalization system would be more equitable and more efficient, such a change could be made only if no municipality ended up with less, which might require a long and difficult transition period.[21]

Provincial governments also have to decide how much to allocate to equalization transfers overall. Most are reluctant to limit their budgetary choices by dedicating a fixed share of their revenues to municipal transfers: as Table 3 shows, only Saskatchewan has any explicit tax sharing in Canada (although with a very limited form of equalization sharing with respect to rural municipalities). In most provinces, transfers to municipalities are almost entirely discretionary. Perhaps in part to make sensible local budgeting possible, the usual practice appears to be to take the level (and the allocation, which in the Maritime provinces and to a limited extent in Québec and Ontario includes some equalization elements) of last year's transfers as a starting point, making adjustments as the province's budgetary situation and its objectives with respect to local governments suggest. With the exception of Saskatchewan – and Québec starting in 2021 – no province appears to have considered setting a predetermined level of transfers (through, for instance, a share of provincial taxes) to fund a general municipal equalization transfer. These two provinces have a formula allocation process through which the province can direct the funds as it wishes, while allowing the recipients to spend the funds as they wish, making explicit the exact criteria by which distributions among local governments are made.

The formula approach is appealing mainly because of its transparency and objectivity. For recipient governments to have confidence in the grant system, they must have confidence in the data on which it is based. A common problem, for example, occurs when a new census shows that some areas – usually large cities – have grown rapidly and others – mainly poorer rural areas – have declined. Politics may require maintaining or even increasing transfers to the declining areas, but meeting the aim of providing fair access to local services in growing regions may also require more funding. A good formula must be acceptable politically and technically feasible; it should also improve policy outcomes. Doing so is not easy in a changing environment and features such as minimum per-capita (or even per-municipality) grants often tend to creep into transfer formulas as a partial response to such conflicting pressures, thus obscuring what is being done and why. As always, whatever basis is used for allocating transfers should be as transparent and understandable as possible in order to keep the lines of accountability – what government is responsible for what decisions – as clear as possible.

21. Arguably, this transitional problem proved so intractable in Ontario in the 1990s that the final result of all the phasing and special provisions to avoid losses was that the redistributive goal of the equalization transfer eventually disappeared and the transfer was replaced in 1998 by the Community Reinvestment Fund as part of Local Services Realignment (Kitchen 2002).

Finally, it can never be forgotten that intergovernmental transfers, though important, are only one aspect of the total provincial-municipal political picture.[22] Inevitably, transfer programs reflect to some extent the political power and weight of the parties involved. For instance, a provincial government that depends primarily on rural support is unlikely to be as responsive to the different needs of metropolitan areas as one whose political base rests on big cities. Indeed, in some provinces, such as Ontario, equalization transfers are targeted *solely* at rural and remote communities.[23]

5. Provincial-Municipal Equalization Transfers in Canada

To what extent do provincial-municipal equalization transfers in Canada ensure that municipalities can deliver a reasonably comparable level of service by levying a reasonably comparable tax rate? This question is difficult to answer because, although provincial-municipal grants have existed in Canada for decades, it is often difficult to find any information on them, let alone any evaluation of their impact.[24] Twenty-five years ago, when seven provinces had some kind of explicit equalization program, Auld and Eden (1987, 515) stated that "equalization is now an important part of provincial-municipal finance…which makes the relative lack of attention to it to date surprising." The marked decline in the importance of provincial-municipal equalization since 1987 is no doubt one reason that even less attention is paid to it today.

This section describes provincial-municipal equalization transfers where they exist in six Canadian provinces. It shows that, to the limited extent that provincial-municipal transfers in Canada are explicitly "equalized," most emulate federal-provincial equalization transfers in focusing on fiscal capacity rather than expenditure needs. Moreover, to the extent they measure local capacity, they do so solely in terms of the amount of property taxes that could be raised from the assessed base if average rates were applied. No province has anything approaching the equalization system described in section 3. Even in the two provinces – New Brunswick and Nova Scotia – that come closest to doing so, the current equalization grant is only a small portion of the total transfer. However, all six take some of the relevant factors into account to some extent. Three make some allowance for fiscal capacity, two explicitly recognize both fiscal capacity and expenditure needs, [25]

22. For a brief discussion of the importance of the overall provincial-local setting for the design of transfers, see Bahl (2020).

23. The motive for supporting rural and remote communities may be political – to keep them alive – but it may also ensure they have an adequate tax base to deliver services so that the province does not have to step in.

24. For some early analyses of transfers to municipalities, see Slack (1980) and for provincial comparisons, Eden (1987) and Auld and Eden (1987). One of the few recent analyses is Brett and Tardif (2008), which focuses more on yardstick competition than on transfers, but suggests that decreasing unconditional transfers may result in increased local property tax rates.

25. Where expenditure need is included in the formula, the measure generally reflects operating expenditures.

and one takes into account a "municipal fiscal circumstances index" that includes measures of fiscal capacity and some proxies for need.

5.1 Fiscal capacity grants

British Columbia, Québec, and Prince Edward Island provide small equalization grants based on fiscal capacity.

In ***British Columbia,*** the Small Community Protection Grant is a formula-based grant that goes to small municipalities with a population up to 19,000. The grant includes a base amount of $200,000 plus an equalization component (calculated by multiplying $50,000 by an assessment weighting factor), and an amount based on population.

Québec has a fairly small equalization program for municipalities. The equalization grant, outlined in regulation,[26] is based on fiscal capacity and has two parts. A municipality is eligible for the first part of the grant if its standardized property value per capita is less than 80 percent of the median value for all municipalities. The second part of the grant, which targets fewer municipalities, provides funds to a municipality if the average value of the dwellings situated in its territory is less than 70 percent of the median value of all municipalities.

There is no measure of need in the formula except to the extent that population size reflects the need to make expenditures. Of course, as Boulenger et al. (2018) note, municipalities are small, open economies in which the daytime population (including workers and consumers) is not the same as the nighttime population (residents only). Although the daytime population increases the need for services, they are not taken into account in the formula. Moreover, even if needs were proportional to population size, population (however measured) is seldom the sole or even major determinant of service needs or costs. For example, it is more expensive to provide public transport or water services when the population density is lower.

In addition to potential consumers of municipal services who are not counted in the local population, Boulenger et al. (2018) identify five additional explanatory variables associated with municipal need:

- volume effects/economies of scale (measured by local population);
- geography (area and density);
- economic dynamism (measured by population growth, unemployment, low-income population, and number of social housing units);
- demographics (including number of students, youth, seniors, etc.);
- institutional framework (such as regional municipality, major city, etc.).

However, they found it difficult to model need. The exploratory model developed in their paper offers some explanation for municipal spending, but does not really assess needs.

26. *Act Respecting Municipal Taxation*, chapter F-2.1a.262.

Finally, ***Prince Edward Island*** makes an annual Municipal Support Grant payment, which includes a Municipal Services Grant and equalization funding. The underlying principle of equalization is that municipalities should be able to provide a similar level of services by levying similar tax rates. The formula for equalization multiplies the municipality's population by the difference between the average provincial municipal assessment per capita and the municipality's assessment per capita, multiplied by the municipality's non-commercial tax rate. Farm property is excluded from the calculation (Prince Edward Island 2017). Since 2017, the annual increase in the grant reflects the average increase in municipal assessments (Federation of Prince Edward Island Municipalities 2017).

5.2 Fiscal capacity and need grants

Two provinces take both capacity and needs into account to some extent – New Brunswick and Nova Scotia. Under the *Community Funding Act* (Bill 19) in ***New Brunswick***, the community funding and equalization grant has two components – core funding (set out in legislation at 16 cents per $100 of non-residential assessment of the municipality or rural community) and an equalization component based on expenditure need and fiscal capacity. The equalization formula is calculated as the adjusted standard (average) expenditure per capita of the municipality minus its fiscal capacity multiplied by the population.

For the equalization component, municipalities in New Brunswick are divided into seven groups based on the role they play within their region from a service delivery perspective. The equalization grant provides funding to allow each local government in a particular group to provide a comparable level of services at a comparable tax rate. If, at the average tax rate of its group, a local government can provide an above-average level of service, it does not receive an equalization grant. On the other hand, if at the average tax rate, a local government cannot meet the average level of service, it will receive equalization funding.

In 2008, a report on the Future of Local Governance in New Brunswick recommended a redesign of the equalization grant. In particular, it recommended that municipalities be divided into three groups (small, medium, and large) according to population size on the grounds that population reflects both the types of service demands on a municipality and its capacity to meet them (Commissioner on the Future of Local Governance 2008). These recommendations were not implemented.[27]

Under ***Nova Scotia's*** equalization program (known as the Municipal Financial Capacity Grant), each municipality receives an entitlement determined by a formula that reflects the community's expenditure need and its ability to pay.[28] The formula is applied separately to two classes of communities. Class I consists

27. Brett and Tardif (2008) estimated that falling equalization grants in New Brunswick over the 20-year period from 1983 to 2003 resulted in property tax increases at the municipal level.

28. This description is based largely on the *Municipal Grants Act* and Locke (2011).

of regional municipalities and towns (the larger municipalities) and Class II is mainly county and district municipalities (smaller municipalities)[29]; the two classes reflect differences in expenditures and revenue-raising capacities of municipalities of different size. Without these groupings, expenditure levels and revenue-raising capacity would overemphasize both fiscal needs and fiscal capacity in the formula, because the average would be increased by the significantly higher expenditure levels and tax bases in the largest cities.

The Nova Scotia equalization program is fairly standard. The equalization entitlement is determined by a formula that calculates the difference between the "standard expenditure" for the community and its corresponding "standard revenue." Standard expenditures do not include all municipal expenditures but are limited to police protection, fire protection, transportation services (excluding public transit and operating grants from the provincial government for public works), and 50 percent of expenditures on environmental services.[30] It is not clear how these expenditures were chosen. One possibility is that they are non-discretionary in the sense that councils have little discretion over the levels of service and that these are the services that are essential to the functioning of municipalities (Locke 2011). By including only some categories of expenditure, however, an incentive is created to use accounting practices to manipulate expenditure categories and the distribution of equalization entitlements.

"Standard revenue" is determined by multiplying the standard property tax rate times the uniform assessed value of property. The standard tax rate is calculated by the aggregate standard expenditure (for all municipalities in the group) divided by the aggregate uniform assessment. In other words, it represents the value of the tax rate that if applied to the aggregate uniform assessed value would, in theory, generate sufficient revenues to cover the standard expenditure.

Uniform assessment (after adjusting for certain exemptions) is the assessed value of all residential and commercial property for tax purposes (minus 25 percent of the taxable assessment of commercial properties occupied by a seasonal tourist business) and includes grants in lieu of taxes and payments made by utilities with respect to taxes. Assessment is not weighted to reflect differential tax rates between residential and commercial assessment. Since the tax rate on commercial properties is generally twice the rate of that on residential properties in Nova Scotia, a municipality with more commercial assessment would have greater fiscal capacity than a municipality that was largely residential. The equalization formula should reflect this difference, but it does not. The formula does not include all local revenues and leaves out user fees (Slack 2015). Including user fees could be

29. Before 2002, there were four classes: regional governments, large towns, small towns, and rural communities and districts.

30. The expenditures not included in the formula are general government services, protective services other than fire and police, public transit services, public health and welfare, environmental development, recreation and culture, and fiscal services. Hobson, Cameron, and Locke (2005) have estimated that only 40 percent of local expenditures are included in the formula.

tricky, however, since they may be structured differently in different municipalities. One suggestion is that actual expenditure be reduced by the amount of user fees (Hobson, Cameron, and Locke 2005).

The total entitlement for the equalization grant in Nova Scotia is estimated by summing the positive entitlements for both classes of municipalities and substituting zero for any negative entitlements. Equalization is not fully funded, so municipalities receive only a prorated share of the total grant pool available. As Locke (2011) has noted, the provincial government provides no stated or explicit policy on how it decides how much to put towards the equalization grant each year. Although a grant based on tax sharing would also result in variable prorating from year to year, it would not be set arbitrarily. Another consequence of scaling back the grant entitlements from the full amount dictated by the formula is that recipient municipalities are left with standardized revenues that do not equal standardized expenditures.

The provision that a municipality cannot receive less in equalization transfers than it did in the previous year means that a municipality that no longer needs equalization will still receive it. At the same time, with a given pool of funds, those municipalities entitled to equalization will receive less than the formula would dictate.

Since 2002, two additional features have been added to the grant – a Foundation Grant, which is an unconditional lump sum amount, and a Top-Up Grant that can be paid to a community to ensure that the equalization grant is not less than the amount it received in 2001–2002, or an amount determined by the Minister. Arguably, both these additions make little sense in the context of an equalization transfer.

5.3 Equalization and fiscal circumstances

Finally, Canada's most populous province has its own unique (and complex) system of provincial-municipal transfers.

Ontario's principal unconditional grant, the Ontario Municipal Partnership Fund (OMPF), comprises five separate grants: the Assessment Equalization Grant, the Northern Communities Grant, the Rural Communities Grant, the Northern and Rural Fiscal Circumstances Grant, and Transitional Assistance. The two grants of interest from an equalization perspective are the Assessment Equalization Grant and the Northern and Rural Fiscal Circumstances Grant. In all cases, the grants go to rural and northern (sparsely populated) municipalities only. Transitional Assistance is provided to ensure that Northern Ontario municipalities receive at least 90 percent of their OMPF allocation from the previous year, and Southern Ontario municipalities receive at least 85 percent. In 2021, OMPF will deliver $500 million in funding to 389 of the 444 municipalities in Ontario.

The Assessment Equalization Grant provides funding to municipalities with a limited property tax base because of low overall property values or limited non-

residential assessment. The grant to each eligible municipality is determined by its total assessment differential (that is, the total municipal assessment below the median per-household threshold of $300,000). Every $10,000 below the median in a municipality's total assessment differential results in an additional $30.10 in funding. This grant is a fairly straightforward fiscal capacity equalization grant; there is no component to reflect expenditure needs. Of the $500 million in funding under OMPF in 2021, $149 million has been allocated to the Assessment Equalization Grant and will go to 205 municipalities.

The second equalization-type grant is the Northern and Rural Fiscal Circumstances Grant, which provides additional funding to northern and rural municipalities that face more challenging fiscal circumstances than others in this category, as measured by the Northern and Rural Municipal Fiscal Circumstances Index (MFCI). The MFCI is determined on the basis of two primary indicators and four secondary indicators. The two primary indicators account for 50 percent of the index (25 percent on the basis of weighted assessment per household and 25 percent on the basis of median household income). The four secondary indicators each account for 12.5 percent of the index (average annual change in assessment, employment rate, ratio of working age to dependent population, and percent of population above low-income threshold). An indicator value above the median will have a positive score, which is reflective of relatively positive fiscal circumstances. An indicator value below the median will have a negative score, suggesting poorer fiscal circumstances. The MFCI is determined based on the average indicator score for a municipality and is measured on a scale from 0 to 10.

The Northern and Rural Fiscal Circumstances Grant formula, which distributes $92 million in total, is based on a small number of variables over which municipalities have no direct control, so they cannot influence the size of the grant. These variables attempt to capture the ability of municipalities to make expenditures through both capacity variables such as weighted assessment, changes in assessment, and median income, and also to some extent need variables such as the percentage of the population above the low-income threshold, dependency ratios, and the employment rate. Although the formula is based on only six variables, the calculation of the overall index is quite complicated (Ontario Ministry of Finance 2021, Appendix E). Moreover, the grant is directed solely at small northern and rural municipalities. Although large cities receive conditional funding for specific services, they receive no unconditional funding from the province. Such cities usually have more fiscal capacity than other municipalities, but they may also have greater fiscal needs.

6. The Way Forward

Designing a grant formula is as much an art as a science.[31] Whatever its name or supposed purpose may be, a good provincial-municipal transfer is presumably one

31. For a list of good practices in fiscal equalization in OECD countries, see Dougherty and Forman (2021).

which satisfies its policy objectives as well as possible in the circumstances. No magic solution is applicable everywhere, but two important factors must always be taken into account. First, both the best design of any particular transfer and its actual effect require close attention not only to other aspects of the transfer system but also to the full context of the provincial-municipal fiscal and governance structure. Second, both good design and good implementation require clear policy objectives and sufficient transparency to permit both levels of government – and, ideally, the public as well – to have as full, accurate, and current information as possible on what is done, why it is done, and its effects.

To be transparent, the formula needs to be relatively simple and everyone (legislators, bureaucrats, and at least some voters) should understand what it means and how changes in its different components will affect the final allocation. The province can alter how much any municipality receives by altering its choice of factors or the weights attached to them in the formula. In an equalization system, as noted earlier, the usual objective is to close the financing gap between the resources available to different localities and the costs of providing some basic level of services in a way that takes account of the differences among municipalities in both needs and resources. Sometimes the formula is more weighted toward expenditure needs, sometimes it is focused more heavily on fiscal capacity, and sometimes on the gap between expenditure needs and taxable capacity.

Unfortunately for policy designers and analysts alike, the fog generated by the conflicting political interests involved in intergovernmental transactions often makes it difficult to see what is really going on and why. However, as the brief review in section 4 shows, most provinces do not come close to meeting these standards.

To design a proper equalization system, the following issues need to be addressed:

1. The overall amount of equalization and how it is determined from year to year. Municipalities need stable and predictable funding that grows over time. Along these lines, one possibility would be to finance the transfer through a fixed share of provincial revenues (such as a percentage point or two of the sales tax, or a share of other major taxes, or a share of overall general revenues).
2. Which municipalities are entitled to equalization. A formula based on ensuring that municipalities can provide a comparable level of service by levying a comparable tax rate would provide an objective way to determine eligibility. Such a formula would need to recognize both the fiscal capacity and expenditure needs of municipalities. It would also need to determine what is meant by comparable. It could mean comparing each municipality to the average per capita for all municipalities, the amount in the municipality with the highest tax base or expenditure need, or some other measure.

3. Whether variables determining the allocation can be influenced by municipalities. As much as possible, variables in the grant formula should not include those that can be influenced by municipalities, but rather be external variables.
4. How capacity is measured. Since the property tax is the major source of revenue for municipalities in Canada, a measure of the size of the property tax base is most often included in equalization formulas. But municipalities levy other taxes and fees, and some of these revenue sources could also be included. Another possibility is to include other economic or income-based variables (Kitchen 2002).
5. How need is measured. Measuring need is very difficult and is not necessarily reflected in actual expenditures, which include not only cost differences, but also differences in preferences, and possibly expenditure inefficiencies. Moreover, if the formula is based on actual expenditures, municipalities would have an incentive to increase expenditures to increase their transfers. Thus, other measures of need differences in the equalization formula would be better, but would be harder to determine. It would also be necessary to determine average needs, although this level might not adequately recognize differences in expenditures across municipalities. It might be necessary to group municipalities by size or other characteristics such as structure (one-tier versus two-tier municipalities) or the nature of expenditure responsibilities if they differ across municipal types.[32] It might also be necessary to address any remaining differences in characteristics across municipalities by applying a weighting factor to the average expenditure to account for differences from the average in any particular municipality.[33] For example, if lower population density leads to higher costs, including a measure of density in the formula would provide more grants to low-density municipalities. Alternatively, a U-shaped measure could be used if costs are also higher in high-density municipalities.

32. To the extent that regional or metropolitan municipalities already engage in internal equalization (by providing comparable services at comparable tax rates throughout the geographic area), the provincial equalization mechanism should probably go to the regional or metropolitan government rather than the lower tiers. For a discussion of internal equalization, see Hirschl (2020).

33. Local government equalization in Australia uses a very complex formula to determine who is eligible for transfers. In the State of Victoria, for example, the Local Government Grants Commission bases expenditure need on nine expenditure categories, which together account for virtually all local government operating expenditures. Costs are adjusted for each expenditure category by one or more of 14 weighted indicators that reflect local conditions – number of aged pensioners, environmental risk, Indigenous population, urban roads, language, population density, population dispersion, population growth, population under six years, regional significance, remoteness, scale, socioeconomic factors, and tourism. Each cost adjustor is weighted because some have a greater impact on costs than others.

6. Whether transitional funding is needed to ensure that no municipality is worse off, even if need and fiscal capacity change. There is a trade-off with transitional funding. On the one hand, municipalities receiving fewer transfers will need time to adjust to lower levels of provincial funding. On the other hand, transitional assistance to those who are doing better comes at the expense of those municipalities that are worse off. Longer transitions and more municipalities receiving transitional funding defeat the purpose of equalization.

There is much that requires further thought, and little evidence that the provinces are addressing the questions in any serious way. But times are changing. More and more fiscal pressure is likely to be placed on municipalities, and no province seems to be doing anything much to cope with the obvious problems facing local governments everywhere. More attention needs to be paid to local finance in the next few years. This work includes clarifying the roles and responsibilities of each order of government, reconsidering the role of the property tax, and, as argued here, placing all local governments on a relatively level playing field with respect to conditional transfers and, more importantly, giving all citizens, no matter where they live, reasonably equal access to an acceptable level of local services so long as they make a reasonably equal effort to pay for what they get. In short, every province in Canada would do well to consider establishing a sound equalization transfer mechanism.[34]

While we cannot here do all the work needed to move very far in this direction, we can suggest a few approaches that should be considered. For example, most provinces could usefully replace much of their present hodgepodge of municipal transfer systems by an equalization transfer. To the extent that conditional grants (to finance provincially determined but locally administered expenditure items) are called for, they should be simpler, more carefully targeted, and better monitored (with respect to outcomes) than is now the case. Where necessary, provinces should also provide local governments in different regions with the information, training, and capacity needed to perform well with respect to both revenue effort and service delivery. Above all, provinces should state clearly what they expect from local governments and collect, analyze, and use information on local needs, capacity, and resources to improve their performance.

This may seem unduly idealistic to some, excessively ambitious to others, and unappealing both to provincial governments that need to do some hard thinking

34. Even in New Brunswick and Nova Scotia, which come closest to this model, there is a need to reconsider and revise the existing equalization systems to achieve the purposes for which those systems were originally designed. This conclusion is supported by Saillant (2021), who recently suggested that it is time to rethink municipal equalization in New Brunswick. Specifically, he suggests that questions should be asked about the appropriateness of the current formula, whether wealthier municipalities should continue to receive transfers, whether residents are receiving reasonably comparable levels of service at reasonably comparable tax rates, and how to maintain equity between regional entities if they receive more powers or new entities are created.

about their relations with their municipalities (and other local government agencies) and to the local governments themselves. It is always easier to carry on as usual, even when it is becoming increasingly evident that changes are needed.[35] But one way we can clearly "build back better" from current and likely future crises is to plan better and to work harder at implementing better plans and processes. Our aim in this brief review is to underline that provincial-municipal fiscal relations is an area that cries out for "better" and that a key ingredient in any future better system are sound equalization transfer arrangements. Assuming it is clear just what level of government has what degree of discretion in making what spending decisions, and that all report transparently and publicly what they do, a soundly designed and implemented equalization transfer provides an essential element of any fair and efficient system of local finance.

35. On this point, a small (nine-person) sample of municipal officials in Québec interviewed in 2017 showed little interest in equalization-type grants. They were much more concerned by the complexity and lack of temporal stability of grant programs and by an impression of politics playing a role in grants decisions (Boulenger et al. 2018).

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