

# Trends in Public Finance in Canada<sup>1</sup>

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Canada is a federation with three levels of government: the federal government, ten provincial and three territorial governments, and about 4,000 local governments. To understand trends in public finance in Canada, it is important to understand first the division of powers and responsibilities among the three orders of government. The *Constitution Act, 1982*, lists the jurisdictions over which federal and provincial governments have lawmaking authority. The federal government maintains the "peace, order and good government" of the whole country by making laws with respect to immigration, unemployment insurance, trade and commerce, national defence, native affairs, and criminal law. Provincial governments are empowered to control regional and local affairs including education, health, social services, property rights, administration of justice, local public works, and municipal institutions. Some responsibilities are shared between the federal and provincial governments such as immigration, agriculture, and pensions. The responsibilities of municipal governments in Canada are set out in legislation in each province but generally comprise police and fire protection, roads and transit, water and sewers, solid waste, recreation and culture and planning.

The current division of spending responsibilities among the three orders of government and their ability to use own-source revenues to fund these responsibilities has led to concerns about the existence of a vertical fiscal imbalance. A vertical fiscal imbalance is said to exist when "the fiscal capacity of one order of government is insufficient to sustain its spending responsibilities while the fiscal capacity of another order of government is greater than is needed to sustain its spending obligations, while both orders of government provide public services to the same taxpayer."<sup>2</sup> This paper does not discuss the fiscal imbalance but it does provide an assessment of trends in the levels of expenditures and revenues by all three orders of government, trends that are important in assessing the extent to which there is a fiscal imbalance.<sup>3</sup>

This paper begins with a presentation of trends in municipal expenditures over the period from 1988 to 2004. This discussion is followed by a description of trends in municipal revenue sources for the same period. Expenditure responsibilities and revenue trends of both the federal and provincial/ territorial governments are also examined in separate sections of the paper. The paper concludes with a summary of findings and the implications for municipal fiscal imbalance.

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<sup>1</sup> The authors would like to thank Chris Schranz for research assistance.

<sup>2</sup> See the Standing Committee on Finance, "The Existence, Extent and Elimination of Canada's Fiscal Imbalance." Ottawa: House of Commons, 2005, p. 19.

<sup>3</sup> For a discussion of the municipal fiscal balance, see Enid Slack, "Fiscal Imbalance: the Case for Cities." A report prepared for the Federation of Canadian Municipalities, March 13, 2006.

## Municipal Expenditure Responsibilities and Trends

Over the period from 1988 to 2004, municipal expenditures in Canada increased steadily but the revenue-raising tools available to municipal governments have not changed. Figure 1 shows total municipal spending per capita<sup>4</sup> (including operating and capital expenditures)<sup>5</sup> over the 16-year period in current dollars and in constant (1988) dollars.<sup>6</sup> Although the average per capita expenditures for all municipal governments in Canada increased from \$1,039 to \$1,734 over the period, when adjusting for inflation per capita expenditures only increased from \$1,039 to \$1,181 representing an increase of less than 1 percent per year, on average.

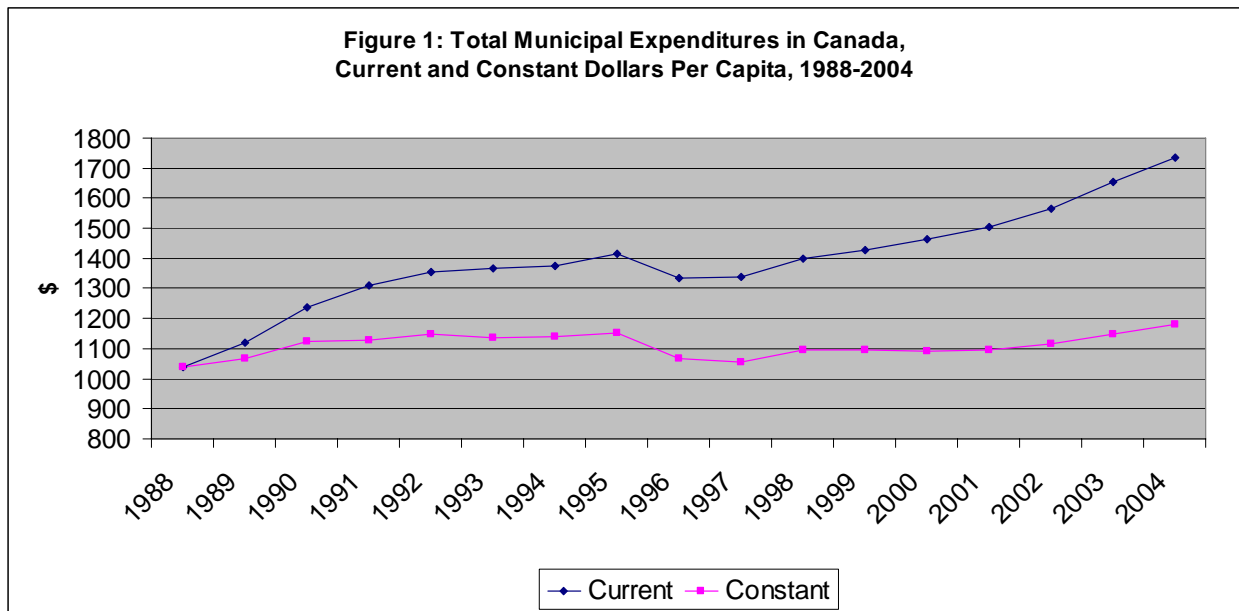


Table 1 shows the relative importance of expenditures by function for 1988 and 2004. Municipal governments in Canada are responsible for transportation (roads and transit), protection (police and fire), environment (water, sewers, and solid waste), and social services. They are also involved in public health, social housing, recreation and culture, and planning and development. The distribution of expenditures has not changed significantly over the 16-year period, with the exception of social services in Ontario which increased significantly following the local services realignment in that province in 1998. Over the 16-year period, protection expenditures,

<sup>4</sup> Data for all figures are calculated from Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006).

<sup>5</sup> FMS data combines operating and capital expenditures. Municipalities are not permitted to run a deficit in their operating budgets but they are allowed to borrow to make capital expenditures. Operating expenditures generally increase steadily over time; capital expenditures tend to be lumpy. The construction of a major road in one year, for example, will increase capital expenditures significantly in that year. Capital expenditures in the following year could be much lower.

<sup>6</sup> Expenditures per capita in constant dollars eliminate the growth in population and inflation over the period.

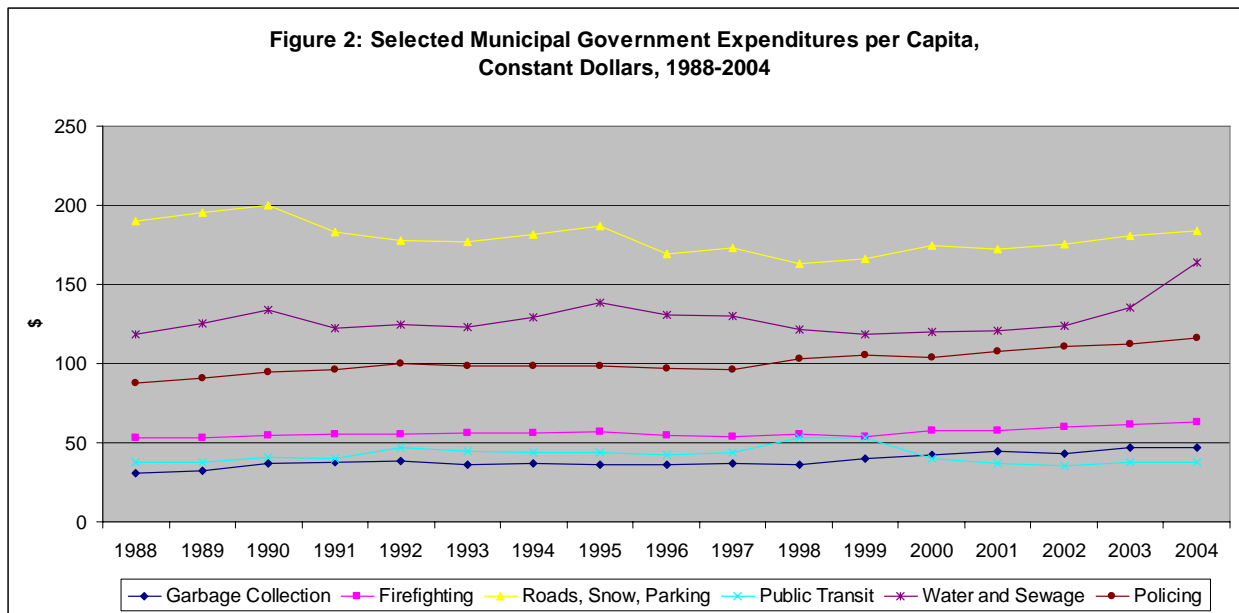
expenditures on recreation and culture, and environmental expenditures increased as a proportion of total expenditures whereas expenditures on transportation, general administration, regional planning, and debt charges fell. Overall, municipal government expenditures per capita in constant dollars increased at an annual average rate of 0.9 percent. The largest proportionate increase has been for housing, reflecting the offloading of this service to municipal governments in Ontario in 1998.

**Table 1: Distribution of Municipal Government Expenditures by Category, Canada 1988 and 2004**

	1988		2004		Annual average growth rate in per capita constant \$
	(\$millions)	% of total expenditures	(\$millions)	% of total expenditures	
General Government Services	2,749	9.9	4,889	8.8	0.1
Protection	4,121	14.8	9,269	16.7	1.8
Transportation	6,197	22.3	10,796	19.5	0.0
Health	560	2.0	1,379	2.5	2.5
Social services	2,053	7.4	5,655	10.2	3.6
Education	128	0.5	206	0.4	-0.5
Resource conservation	585	2.1	1,044	1.9	0.1
Environment	4,064	14.6	10,052	18.1	2.6
Recreation and culture	3,241	11.6	6,825	12.3	1.3
Housing	489	1.8	2,072	3.7	8.9
Regional planning	572	2.1	1,025	1.8	0.1
Debt charges	2,657	9.5	2,204	4.0	-3.3
Other expenditures	432	1.6	56	0.1	-5.8
<b>Total expenditures</b>	<b>27,849</b>	<b>100.0</b>	<b>55,472</b>	<b>100.0</b>	<b>0.9</b>

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Figure 2 shows the trend in municipal expenditures per capita in constant dollars for the major expenditure categories. Expenditures on roads (including parking and snow removal) are lower at the end of the period than they were at the beginning of the period as are transit expenditures. Expenditures on water and sewage, on the other hand, appear to have increased over the period as have expenditures on policing and garbage collection. This pattern reflects, partially at least, the growing demand for increasing municipal spending on environmental and safety concerns at the expense of roads.



### Municipal Revenue Sources and Trends

Table 2 compares the distribution of municipal revenues for 1988 and 2004. Property taxes were the largest source of revenue for municipalities in 2004, as they were in 1988. As a percentage of total revenues, they increased in relative importance by almost 10 percent over the 16-year period,<sup>7</sup> rising from 48.6 percent of all revenues in 1988 to 53.3 percent in 2004. At the same time, user fees increased in relative importance by 17 percent, rising from 20 percent of all revenues in 1988 to 23.4 percent by 2004. Intergovernmental transfers (mainly from provincial and territorial governments), on the other hand, decreased significantly. General purpose (unconditional) grants, in particular, fell by 48 percent in relative importance, from 5.8 percent of all revenues in 1988 to 3.0 percent of all revenues in 2004. At the same time, specific purpose (conditional) transfers fell by almost 25 percent in relative importance, from 17.1 percent of all revenues in 1988 to 12.9 percent in 2004. When specific purpose grants are separated into provincial and federal, the provincial decline of almost 29 percent in relative importance was partially offset by an increase in the relative importance of federal grants, primarily for environmental projects. Overall, the relative importance of grant funding fell by 30 percent from the beginning of the period.<sup>8</sup>

When the growth in municipal revenues is measured in constant dollars per capita, total revenues grew at an average annual rate of 0.7 percent, which is less than the 0.9 percent growth rate for expenditures noted above.

<sup>7</sup> This increase reflects the percentage change in the contribution of each revenue source to total municipal revenues over the period.

<sup>8</sup> Our estimates indicate that, if grants per capita in constant dollars had remained unchanged over the 16-year period, municipalities would have received an additional \$552 million.

**Table 2: Distribution of Municipal Government Revenue, Canada, 1988 and 2004**

	1988		2004		Annual average growth rate in per capita constant \$
	(\$millions)	% of total revenues	(\$millions)	% of total revenues	
Property and related taxes	13,187	48.6	28,399	53.3	1.4
Other taxes	384	1.4	770	1.5	0.9
User fees	5,426	20.0	12,491	23.4	2.0
Investment income	1,628	6.0	2,394	4.5	-1.0
Other	292	1.1	776	1.5	3.2
Total own-source revenue	20,917	77.1	44,830	84.1	1.4
General purpose transfers	1,579	5.8	1,576	3.0	-2.7
Specific purpose transfers	4,649	17.1	6,900	12.9	-1.0
- federal	194	0.7	672	1.3	6.1
- provincial	4,455	16.4	6,228	11.7	-1.3
Total transfers	6,228	22.9	8,476	15.9	-1.4
Total revenue	27,146	100.0	53,306	100.0	0.7

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Figure 3 presents trends in property taxes, user fees, and conditional and unconditional grants. User fees in constant dollars per capita increased the most, rising at an annual average rate of 2.0 percent while property taxes increased at a rate of 1.4 percent, rising from a level of \$492 in 1988 to a level of \$605 in 2004. General purpose transfers, on the other hand, fell by 2.7 percent and specific purpose transfers fell by an average of 1.0 percent annually.

### **Expenditure Responsibilities and Revenue Trends of the Federal and Provincial/Territorial Governments**

This section reviews the expenditures and revenues of the federal and provincial/territorial governments over the same 16-year period.<sup>9</sup>

#### **Federal and Provincial/Territorial Expenditures**

Figure 4 compares expenditures for all three orders of government over the period from 1989 to 2005. It indicates that federal expenditures per capita in constant dollars have fallen over the period, provincial expenditures have increased, and municipal expenditures have increased but at a slower rate.

<sup>9</sup> The estimates for the federal and provincial/territorial governments are from 1989 to 2005 because their fiscal year is April 1 to March 31. The year 1989, for example, thus refers to 1988/89.

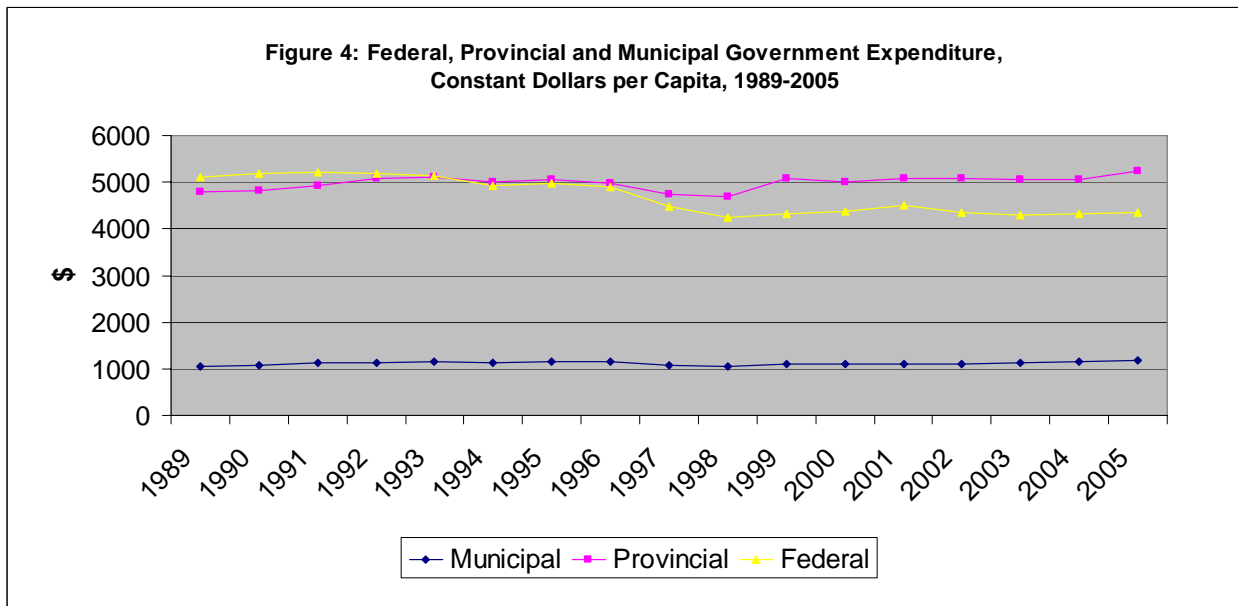
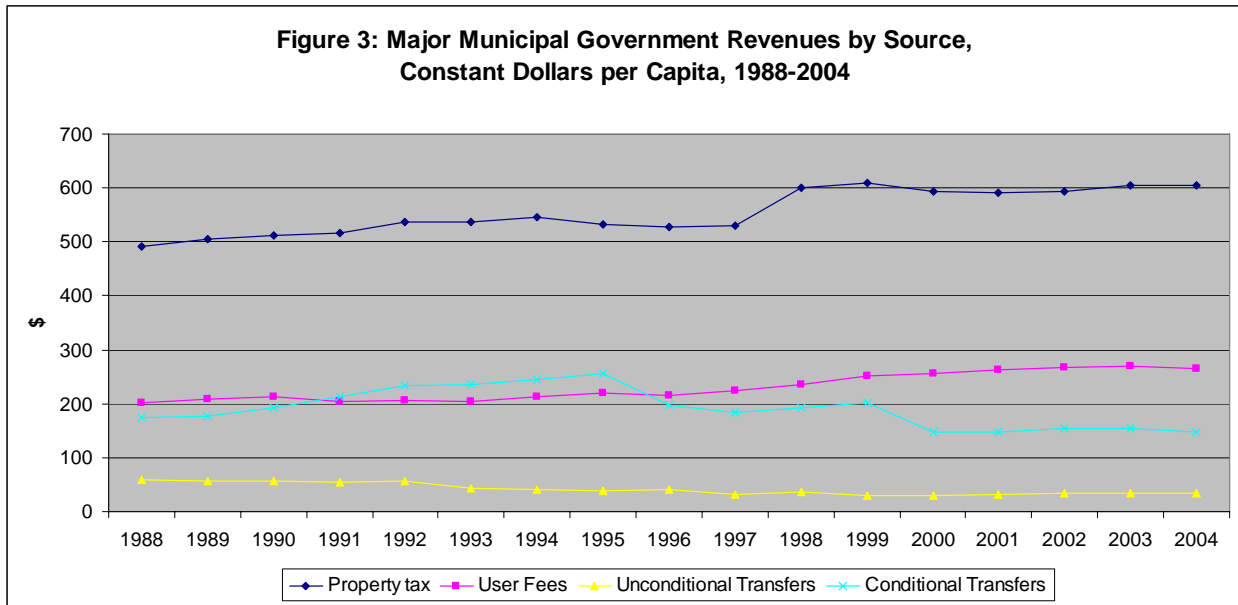
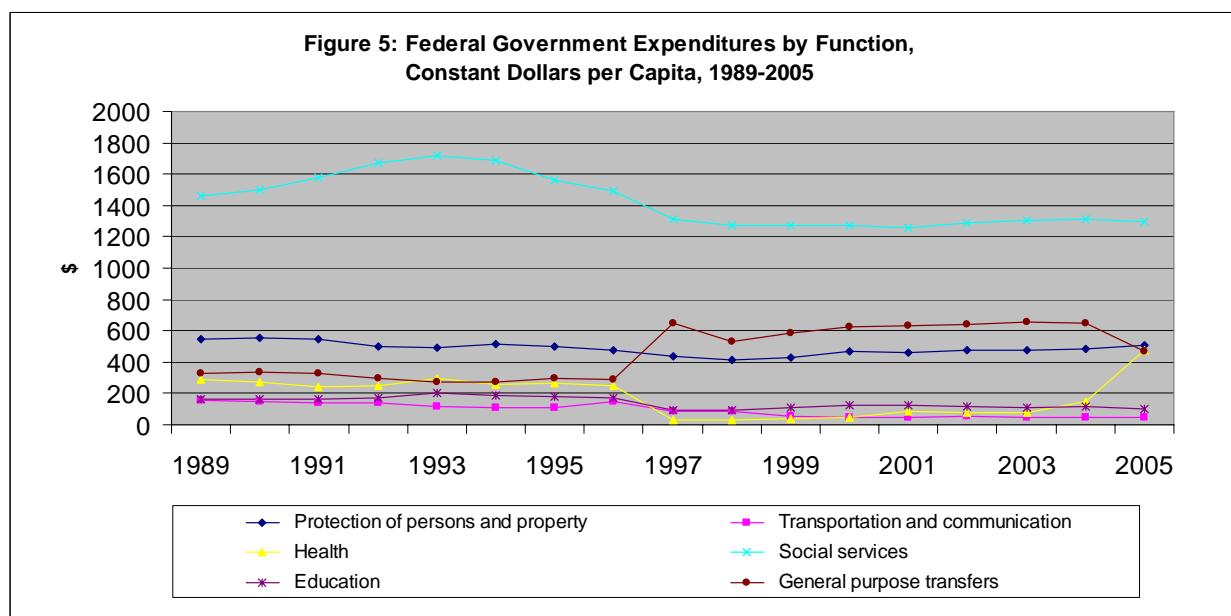


Table 3 indicates that the largest proportion of federal government expenditures is on social services followed by debt charges, protection (policing), health, and transfers to provincial governments. Over the 16-year period, debt charges have declined, in part, because interest rates have fallen but also because the federal government has been running a surplus and using some of it to pay down the federal debt. Figure 5 shows that transfers to the provinces have increased

**Table 3: Distribution of Federal Government Expenditures by Category, Canada 1989 and 2005**

	1989		2005		Annual average growth rate in per capita constant \$
	(\$millions)	% of total expenditures	(\$millions)	% of total expenditures	
General government services	4,425	3.2	7,501	3.7	-0.2
Protection	14,758	10.8	23,861	11.7	-0.5
Transportation	4,249	3.1	2,314	1.1	-4.3
Health	7,723	5.7	22,377	10.9	4.1
Social services	39,209	28.7	60,789	29.7	-0.7
Education	4,491	3.3	4,938	2.4	-2.3
Resource conservation	8,150	6.0	8,027	3.9	-2.7
Environment	600	0.4	1,929	0.9	5.2
Recreation and culture	2,381	1.7	4,093	2.0	-0.1
Labour/employment/immigration	1,938	1.4	2,739	1.3	-1.2
Other	6,675	4.9	10,474	5.1	-0.7
General purpose transfers	8,763	6.4	21,988	10.8	2.7
Debt charges	33,190	24.3	33,324	16.3	-2.7
Total expenditures	136,559	100.0	204,382	100.0	-0.9

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)



and federal expenditures on social services have fallen (although not as a proportion of total federal expenditures). In 1997, the Established Programs Financing (EPF) and the Canada Assistance Plan (CAP) were replaced by the Canada Health and Social Transfer (CHST). This change explains the increase in transfers and reduction in social service expenditures at the federal level. At the same time, federal expenditures increased for health and the environment as did transfers to provincial governments. Overall, federal government expenditures per capita in constant dollars fell at an average annual rate of 0.9 percent over the 16-year period.

The distribution of provincial/territorial government expenditures is set out in Table 4. The largest provincial government expenditures both in 1988 and 2005 were for health, education, social services, and debt charges. Over the 16-year period, health expenditures as a proportion of total provincial government expenditures increased significantly. Transfers from the provinces to municipalities, on the other hand, fell at an annual average rate of 3.7 percent over the 16-year period.

**Table 4: Distribution of Provincial/Territorial Government Expenditures by Category, Canada 1989 and 2005**

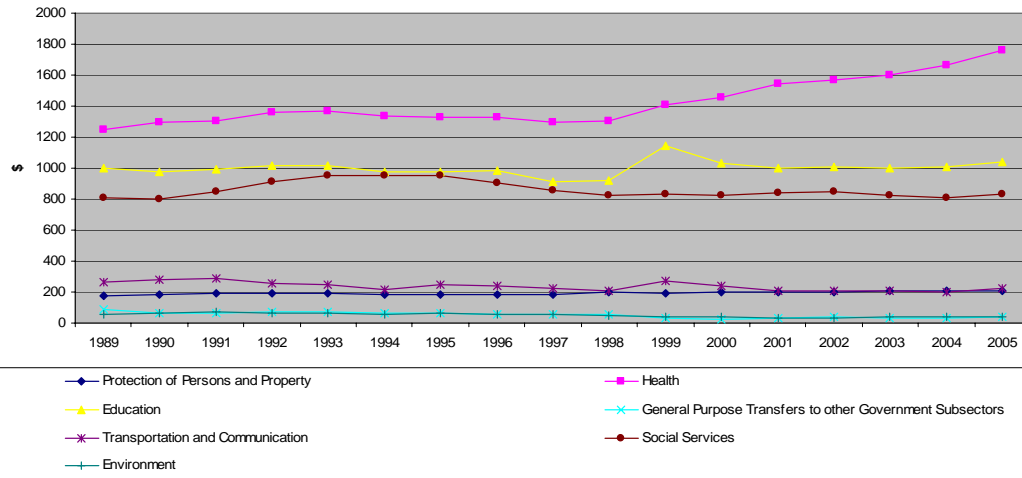
	1989		2005		Annual average growth rate in per capita constant \$
	(\$millions)	% of total expenditures	(\$millions)	% of total expenditures	
General government services	2,499	1.9	4,622	1.9	0.3
Protection	4,802	3.7	9,941	4.0	1.1
Transportation	7,074	5.5	10,367	4.2	-1.0
Health	33,449	26.0	82,648	33.6	2.6
Social services	21,646	16.8	39,158	15.9	0.2
Education	26,778	20.8	48,978	19.9	0.3
Resource conservation	7,489	5.8	11,414	4.6	-0.8
Environment	1,588	1.2	1,873	0.8	-2.0
Recreation and culture	1,554	1.2	2,747	1.1	0.1
Other	3,480	2.7	6,343	2.6	0.2
General purpose transfers	2,452	1.9	1,746	0.7	-3.7
Debt charges	15,768	12.3	26,384	10.7	-0.3
Total expenditures	128,577	100.0	246,224	100.0	0.6

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

Figure 6 shows the trends in provincial government expenditures from 1989 to 2005. By far the most striking feature of this graph is the increase in provincial health expenditures. Overall, provincial expenditures per capita in constant dollars increased at an annual average rate of 0.6 percent per year.



**Figure 6: Provincial Government Expenditures by Function, Constant Dollars per Capita, 1989-2005**



### Federal and Provincial/Territorial Revenues

Tables 5 and 6 show the distribution of revenue for the federal and provincial governments, respectively from 1989 to 2005. The largest sources of revenue for the federal government are personal income taxes, consumption taxes, and corporate income taxes. Over the 16-year period, revenues from both personal and corporate income taxes have increased at the federal level; consumption tax revenues have fallen. Overall, federal government revenues per capita in constant dollars have increased at the annual average rate of 0.6 percent at the same time that expenditures were falling at the annual average rate of 0.9 percent.

**Table 5: Distribution of Federal Government Revenues, Canada, 1989 and 2005**

	1989		2005		Annual average growth rate in per capita constant \$
	(\$millions)	% of total revenues	(\$millions)	% of total revenues	
Personal income taxes	47,750	43.5	97,488	45.9	1.0
Corporate income taxes	11,730	10.7	30,372	14.3	3.0
Consumption taxes	26,375	24.0	47,126	22.2	0.1
User fees	3,858	3.5	6,705	3.2	-0.1
Investment income	5,523	5.0	6,208	2.9	-2.2
Other	379	0.3	1,163	0.5	4.7
Total own-source revenue	109,519	99.7	211,499	99.7	0.6
General purpose transfers	328	0.3	590	0.3	0.2
Specific purpose transfers	45	0.0	84	0.0	0.4
Total transfers	373	0.3	674	0.3	0.2
Total revenue	109,892	100.0	212,173	100.0	0.6

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

In terms of provincial/territorial revenues, the largest sources are personal income taxes and consumption taxes (see Table 6) followed by transfers from the federal government. Another major source of revenue at the provincial level is investment income, driven primarily by their importance in provinces heavily endowed with natural resources - Saskatchewan (over 20 percent of provincial revenues), Alberta (almost 40 percent of provincial revenues), and British Columbia (almost 17 percent of provincial revenues). Although provincial property taxes only account for a small proportion of provincial revenues, they did increase over the 16-year period, largely because most provinces have taken over the education portion of property taxes. At the moment, school boards in Manitoba and Saskatchewan are the only ones that have local taxing power, a vast change from the beginning of the period when school boards in almost every province had taxing authority (new Brunswick was an exception). New Brunswick is the only province that has a province-wide provincial property tax for general purposes, although most provinces have collected property taxes for general purposes in unorganized territories and districts for some time.

**Table 6: Distribution of Provincial Government Revenues, Canada, 1989 and 2005**

	1989		2005		Annual average growth rate in per capita constant \$
	(\$millions)	% of total rev.	(\$millions)	% of total rev.	
Personal income taxes	31,099	25.0	56,693	23.0	0.2
Corporate income taxes	5,876	5.0	15,416	6.0	3.1
Consumption taxes	28,114	23.0	56,836	23.0	1.0
Property taxes	3,607	3.0	9,488	4.0	3.1
User fees	3,601	3.0	6,405	3.0	0.1
Investment income	12,527	10.0	27,602	11.0	1.6
Other	14,446	12.0	28,128	11.0	0.7
Total own-source revenue	99,270	80.0	200,568	81.0	1.0
General purpose transfers	9,209	7.0	26,174	11.0	3.9
Specific purpose transfers	15,697	13.0	19,607	8.0	-1.8
Total transfers	24,906	20.0	45,781	19.0	0.3
Total revenue	124,176	100.0	246,349	100.0	0.8

Source: Statistics Canada, Financial Management Systems (FMS) (mimeograph, May 2006)

This increase in the relative importance of provincial property taxes may not seem significant in total but it may be important at the margin because it might be crowding out a municipality's desire to raise property taxes for municipal purposes. A study in Ontario in the early 1990s (when school boards had taxing powers) concluded that local school property taxes crowded out municipal property taxes.<sup>10</sup> We may still be seeing this impact with provincial education property taxes.

<sup>10</sup> Wade Locke and Almos Tassonyi. "Shared Tax Bases and Local Public Expenditure Decisions", (1993), vol. 41, no. 5, *Canadian Tax Journal* 941-57.

Finally, federal transfers to the provinces accounted for 19 percent of provincial revenues in 2005, a slight increase over the period. Overall, the annual average growth in provincial revenues in constant dollars per capita over the 16-year period was 0.8 percent, which is somewhat greater than the rate of growth in expenditures (at 0.6 percent).

### Comparative Analysis of Revenue-Raising Capacity of the Federal, Provincial/Territorial and Municipal Governments

Figures 7 to 11 compare the revenues for the federal, provincial/territorial and municipal governments from 1989 to 2005. Figure 7 compares total revenues per capita in constant dollars for each of the three orders of government. It shows that, on a per capita basis, provincial/territorial governments raise the most revenues. Moreover, both federal and provincial/territorial government revenues are considerably larger than municipal government revenues and they have increased over the 16-year period; the increase in municipal government revenues has been much more modest.

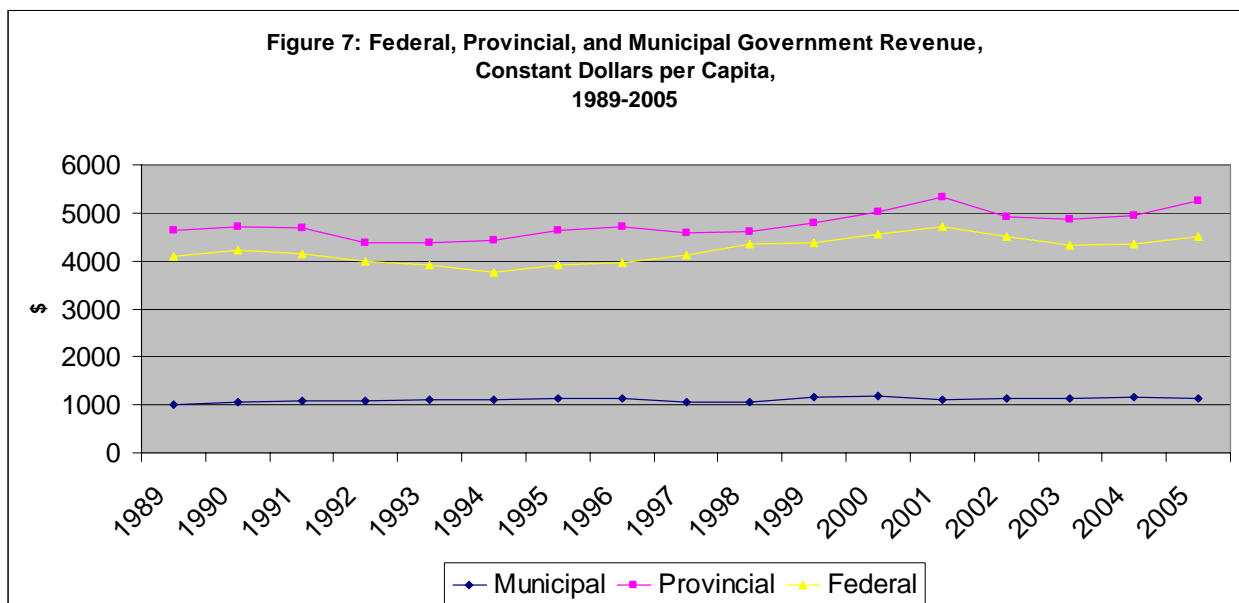


Figure 8 compares revenues relative to Gross Domestic Product (GDP) for each order of government. As a percentage of GDP, revenues of all orders of government have fallen over the 16-year period. This finding should not be interpreted as government revenues falling; in reality, they have risen quite noticeably over the period. Rather, this result mainly reflects that GDP has risen much faster than government revenues over the period. Provincial/territorial revenues as a percentage of GDP started to increase in 2005.

Figure 9 shows the revenues of each order of government as a proportion of the consolidated revenues of all governments. Provincial/territorial governments account for the largest proportion of consolidated revenues; municipal governments account for the smallest proportion.

Moreover, there does not appear to be much change over the period in the proportion of revenues of each order of government.

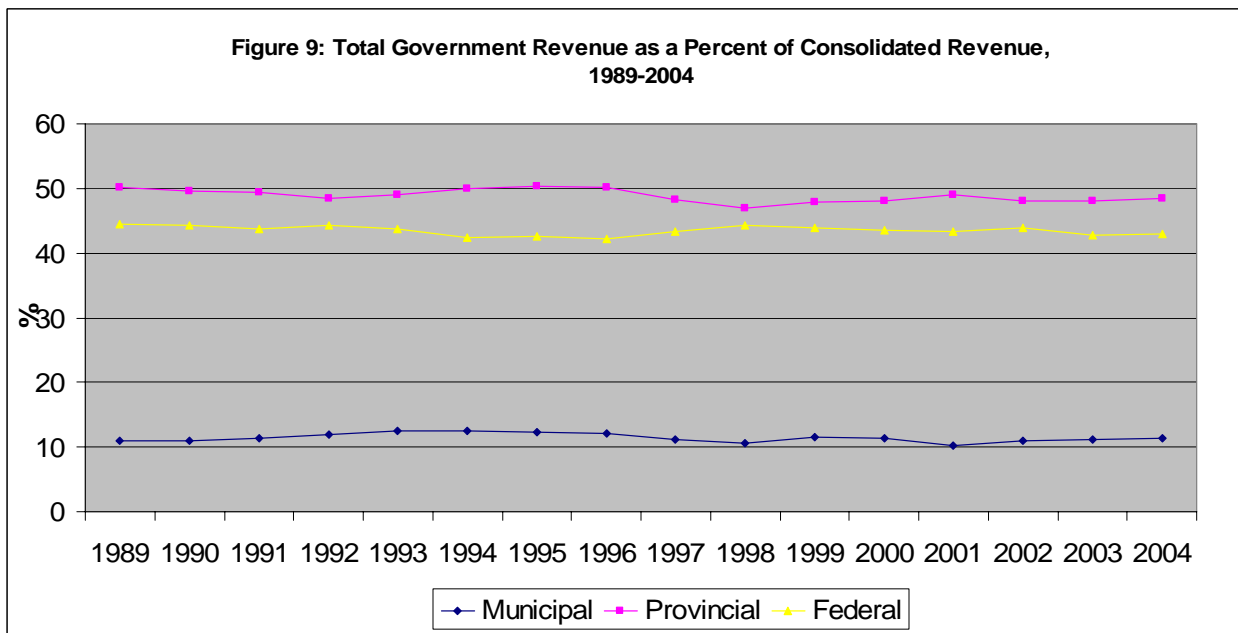
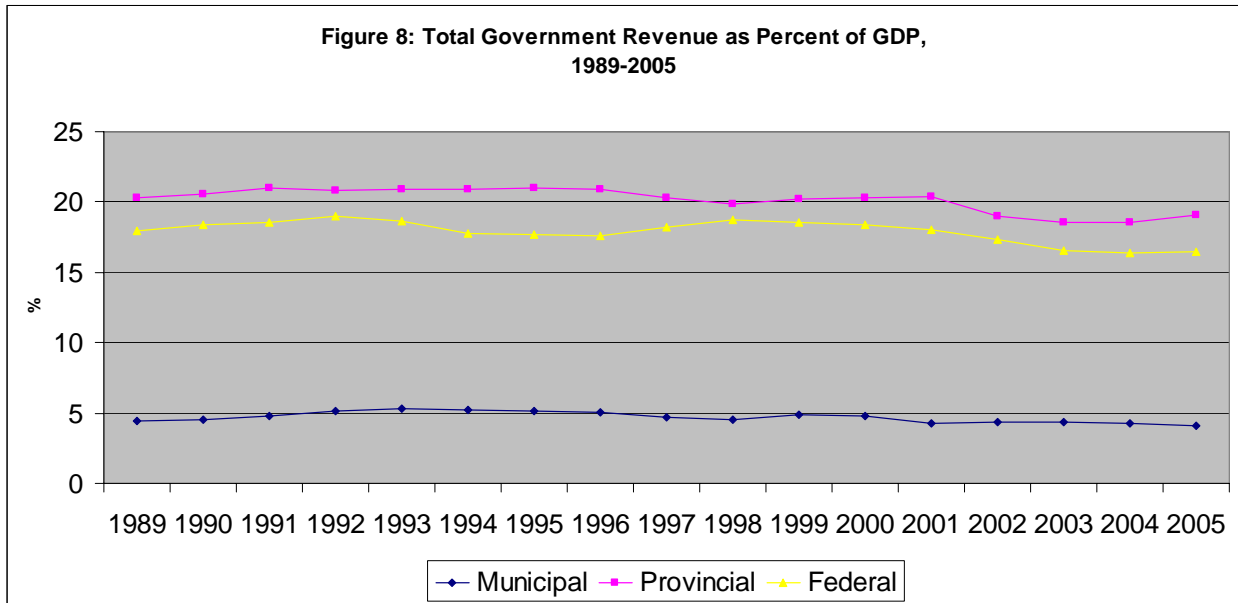
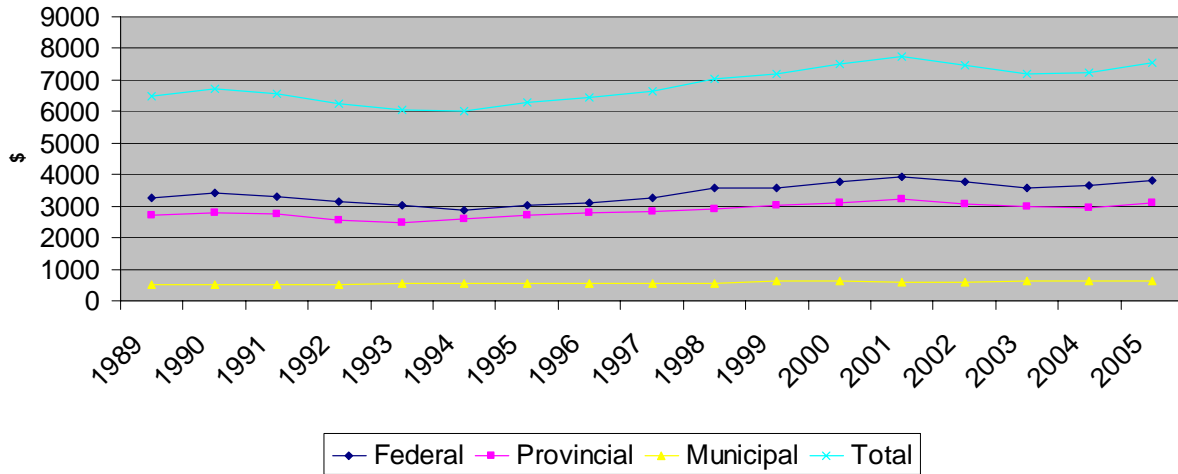


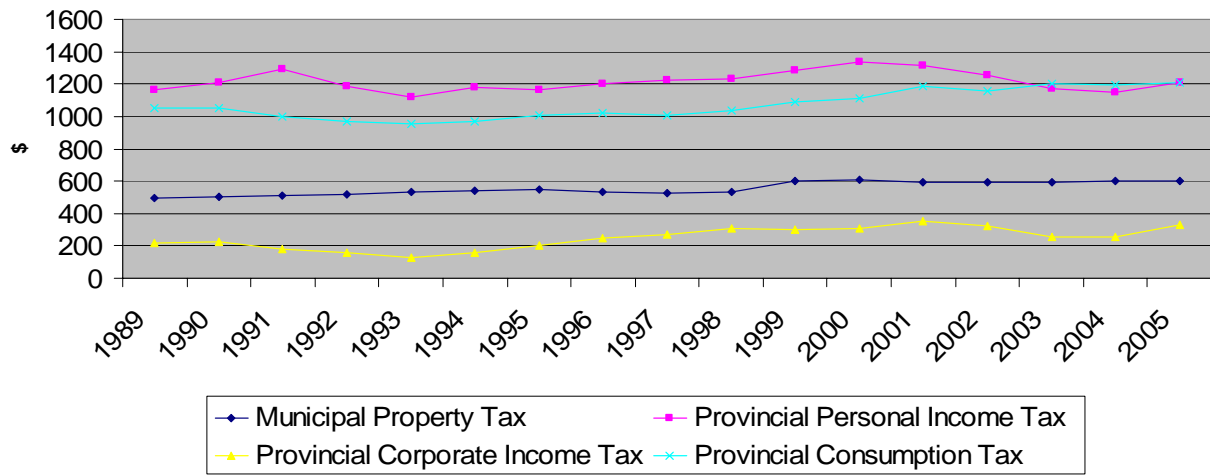
Figure 10 compares tax revenues for each order of government over the 16-year period. Total tax revenue per capita in constant dollars shows an increase over the period as do federal and provincial tax revenues. Municipal tax revenues remained fairly flat throughout the period.

**Figure 10: Total Tax Revenue Per Capita in Constant Dollars, 1989-2005**



Finally, Figure 11 compares selected provincial and local taxes per capita in constant dollars from 1989 to 2005. Provincial personal income taxes and corporate income taxes have increased; provincial consumption taxes have increased even more. Local property taxes have also increased over the 16-year period.

**Figure 11: Local and Provincial Taxes Per Capita in Constant Dollars, 1989-2005**



## Summary of Findings and Implications for Municipal Fiscal Imbalance

The major findings of the comparative analysis of revenues and expenditures for all three orders of government suggest the following:

- Federal government expenditures in constant dollars per capita have been declining while their revenues have been increasing. Provincial/territorial government expenditures have been increasing at somewhat slower rate than revenues. Only municipal government expenditures have been increasing at a faster rate than their revenues.
- Local government expenditures have been increasing more rapidly than either federal or provincial government expenditures. The annual average growth rate in revenues, however, has been highest for the provincial/territorial governments.
- The pattern of local government spending changed over the 16-year period with a growing emphasis on environmental and protection services at the expenses of roads and public transit.
- Federal and provincial tax revenues in constant dollars per capita increased over this 16-year period, while local tax revenues remained fairly flat.
- Federal and provincial/territorial governments rely on personal income taxes, corporation income taxes, and consumption taxes as well as other tax and non-tax revenues. Some provincial governments also levy a property tax. Municipal governments, on the other hand, largely rely on one tax –the property tax – and user fees and provincial and federal transfers. These findings suggest that it may be more difficult to prove that there is a fiscal imbalance at the provincial/territorial level than at the local level because provincial/territorial governments have the same revenue-raising tools as the federal government.
- A greater increase in the relative importance of provincial property taxes for education and a relatively smaller increase in municipal property taxes may suggest some crowding out of municipal property tax room by the provincial property tax in some provinces.

Overall, these findings tell us little about municipal fiscal imbalance except to note that expenditures have been rising more quickly than revenues at the municipal level and that municipal governments have fewer revenue-raising tools than the federal and provincial/territorial governments to carry out their responsibilities. A simple comparison of municipal revenues and expenditures, however, does not reveal a significant imbalance because municipalities are not permitted under provincial/territorial legislation to run a deficit in their operating budget. Few municipalities, if any, have borrowed excessively to pay for capital expenditures because the amount of borrowing is also constrained by provincial governments and because municipalities have been reluctant to borrow.

From a fiscal perspective, Canadian municipalities appear to be healthy. The overall health of municipalities, however, has less to do with balancing their budgets (which they are required to

do by law in any event) than with the adequacy of the services being provided and the current state of municipal infrastructure. Unlike the fiscal measures set out in this paper, the state of service delivery and infrastructure are both difficult to measure and are thus often ignored in the debate over fiscal imbalance. Although there is likely room for municipalities at least in some provinces to increase residential property taxes and user fees, it is not clear that such actions would be sufficient to solve the problems of under-investment in infrastructure.