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Strengthening Fiscal Responsibility Through Decentralization

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About the author

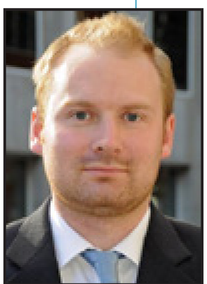

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Table of Contents

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Executive Summary

- Canada's constitution lays out a division of powers between the federal and provincial governments. However, there are many policy areas that fall under provincial jurisdiction where the federal government has taken an active role. Similarly, provincial governments delegate certain functions to municipal governments, and both provincial and federal governments often intervene in these areas. This overlap creates redundant bureaucracies and weakens political accountability. When more than one level of government has some responsibility for a program area, it is often unclear who ought to be held accountable for mistakes and praised for success. To increase efficiency and accountability, the federal government should end its role in areas of provincial and municipal responsibility.
- While simple in theory, eliminating the federal role in these areas would require a rebalancing of fiscal capacity in the country. Because the federal government collects more revenue than would be required were it to terminate its involvement in areas such as health and education, lower levels of government have a diminished capacity for revenue generation. There is only so much that people are willing to pay in taxes. To devolve its responsibility successfully, the federal government would need to pare back its revenue collection to allow lower levels of government to raise more revenue.

Key findings

- In 2009, the federal government controlled 43.33 per cent of government spending, leaving 40.69 per cent for the provinces and 15.87 per cent for the municipalities.
- Because the federal government controls such a large proportion of spending, federal intervention is rampant in areas of provincial responsibility such as health care and education, as well as municipal areas such as roads, water treatment and public transit.
- In many cases, all three levels of government provide funding for the same project.
- These point to a fiscal imbalance between the federal and provincial governments as well as between the provincial and municipal governments.
- Federal involvement in areas of provincial and municipal responsibility creates more opportunities for politicized spending decisions.

Recommendations

- Revenue generation needs to be more closely tied to spending.
- One level of government should take exclusive control over each spending area, except for those areas in which constitutional responsibility is divided.
- Eliminating the federal role in areas of provincial and municipal responsibility would reduce federal spending by 33.89 per cent.
- To allow provincial and municipal governments to increase revenue to make up for the elimination of federal spending in these areas, the federal government should transfer all GST revenue to the provinces and all fuel taxes to the municipalities on a per capita basis.

Decentralization is not an ideological notion. There are many advocates for decentralized decision-making from competing points on the political spectrum. Devolving fiscal power and responsibility would give local residents greater control over policies that directly affect their lives and would allow for greater policy experimentation that would help establish best practices for service delivery.

Introduction

Coming out of the recession, Canada's short-term fiscal situation looks quite sound in comparison with the rest of the developed world. Despite the bravado from our politicians, Canada also faces serious economic challenges in the short and long terms. As of June 6, the national debt exceeds $587-billion—more than $16,933 per person—and is growing by more than $80-million per day.[1] Including provincial and municipal debt, gross government debt stood at $1.865-trillion as of the fourth quarter of 2011—more than $53,500 per Canadian.[2] In other words, gross government debt stood at 108.5 per cent of GDP. Meanwhile, baby boomers are getting ready to retire without having adequately financed entitlement programs. The cost to taxpayers will increase dramatically as the number of people in the workforce plummets relative to those who have retired. To maintain the country's current standard of living, Canadian governments need to find more-efficient ways to deliver services.

If the picture at the federal level is worrisome, it does not look much better at the provincial and municipal levels. Infrastructure has been severely underfunded for several decades to the point where some analysts estimate that we have an "infrastructure deficit" estimated at $123-billion dollars as of 2007.[3] While other analysts dispute the specifics of this estimate, Canada's cities are all in need of expensive infrastructure repairs and expansions. Despite the fact that the three levels of government consume roughly 40 per cent of GDP,[4] urban Canadians have grown accustomed to crumbling infrastructure, grinding traffic congestion and an ever-increasing tax bill. Clearly, something has gone wrong.

Part of the problem is a lack of accountability. This is not to say that governments do not have proper oversight or that public servants are shirking their duties. Rather, government decision-making processes have become so complex and bureaucratic that many citizens may not know who to hold accountable when things go wrong. This has to do with how large government has become. The more the government does, the harder it is to keep track of its activities. However, the biggest obstacle to accountability is that the three levels of government do not adhere to clearly delineated responsibilities.

The constitution lays out a division of responsibilities between the federal government and the provinces. The municipalities are purely creatures of the provinces. For this reason, the division of responsibilities between provinces and municipalities often overlaps. Funding for public transportation is a prime example where at least two levels of government are often involved in making funding decisions.

There are also areas where the provincial and federal government have joint responsibilities, but we should avoid having more than one level of government involved where the constitution clearly allocates responsibility to one level.

Overlapping responsibilities make it difficult to determine which level of government the citizens can hold accountable for projects, and they make it too convenient for one level to blame the other when things go wrong. For example, healthcare is a central issue in both political and federal elections. Outside of elections, premiers routinely blame the federal government for what ails their health-care systems. Given the complexity of a policy area such as healthcare, voters can be excused for not knowing whether their provincial or federal government is to blame for poor outcomes. This can obfuscate responsibility and distract from other important issues.

In the case of projects that involve all three levels of government, assigning responsibility is even harder. The constant bickering among the federal, provincial and federal governments about infrastructure issues is the prime example. It is hard to decide which level of government to praise or blame for a water-treatment project funded by all three levels of government.

Moreover, in these situations of multiple government involvement, decisions become far more dependent on political calculations. Since the link between payment and services is severed, politicians are tempted to use transfers to lower levels of government or direct spending in areas of municipal and provincial responsibility as a tool for winning votes in key ridings. Meanwhile, voters do not have a clue where their tax dollars are spent.

In addition to the lack of accountability, there are direct costs to involving several levels of government. There are administrative costs each time one level of government transfers money to another. When a senior level of government gets involved in funding services at lower levels, it needs to spend money on conducting its own studies, which leads to redundancy.

Establishing a clear division of responsibilities among the three levels of government for key issuescould significantly reduce the cost of service delivery while improving the quality. Although it is a simple concept, the details need fleshing out. This paper aims to provide an outline of how specific government responsibilities ought to be allocated and financed. Concrete proposals will be restricted to how the federal government ought to apply these principles to its financial relationships with lower levels of government. These principles are equally applicable to the provincial governments when they deal with their municipalities, though this paper will refrain from providing specific proposals for the provinces.

> ***"Overlapping responsibilities** make it difficult to determine which level of government the citizens can hold accountable for projects, and they make it too convenient for one level to blame the other when things go wrong.*

The role of the three levels of government

The constitutional division of powers

Sections 91 and 92 of the *Constitution Act, 1982,* lay out a seemingly clear division of responsibilities between the provincial and federal governments in most policy areas. This apparently clear division is then blurred by some overlapping responsibilities. Agriculture, pensions and immigration are all areas of concurrent provincial and federal responsibilities.

These areas of shared responsibility can create tension between federal and provincial governments, but short of amending the constitution, there is little that can be done. While some conflict is inevitable in a federal system, reducing or eliminating overlaps that are not constitutionally required can minimize this conflict.

In addition, provincial responsibilities have been blurred by federal legislation such as the *Canada Health Act.* Section 92(7) of the *Constitution Act, 1982* clearly indicates that hospitals are a matter of provincial jurisdiction (with the exception of marine hospitals). Yet, through the *Canada Health Act,* the federal government has given itself the ability to indirectly dictate provincial health policies. While it does not explicitly forbid the provinces from disobeying federal diktats, the *Act* gives the provinces a powerful incentive to comply, since they are so heavily reliant on the Canada Health Transfer to fund their provincial healthcare programs.

The relationship between the provinces and the municipalities

The authority of the provinces under our constitution creates municipalities. Given this subordinate role, municipal powers are constrained by provincial governments. Each province's municipal act governs all powers held by the municipalities. Their powers are the product of provincial devolution, which means that they do not have constitutional standing as such, and these powers can be easily reshaped or taken away by the provinces. Given their subordinate role, municipal powers are therefore curbed by the provincial governments. Cities are typically given responsibility for local policing, municipal roads, trash collection, snow removal and other day-to-day concerns specific to local communities. To fund these functions, the provinces give municipalities specific taxation powers, which usually involve only the ability to collect some user fees and to levy a property tax. Some were also granted the ability to levy a business tax, and a few municipalities (Toronto is an example) were given other taxation powers. They are able to exercise these powers if they choose, but the provincial governments can revoke them.

TABLE 1 **Division of Powers, *Constitution Act, 1867***

Area	Level of Government	Area	Level of Government
Public Debt and Property	Federal	Citizenship	Federal
Regulation of Trade/ Commerce	Federal	Marriage/Divorce	Federal
Employment Insurance	Federal	Criminal law, including criminal procedure	Federal
Direct/Indirect Taxation	Federal	Penitentiaries	Federal
Postal Service	Federal	Works connecting provinces, beyond boundaries of one province; within a province but to the advantage of Canada and/or more than one province	Federal
Census/Statistics	Federal	Direct taxation within province	Provincial
Defence	Federal	Management/Sale of public lands belonging to the province	Provincial
Navigation/Shipping	Federal	Prisons	Provincial
Quarantine	Federal	Hospitals	Provincial
Sea Coast and Inland Fisheries	Federal	Municipalities	Provincial
Ferries (Interprovincial/ international)	Federal	Formalization of Marriage	Provincial
Currency/Coinage	Federal	Property and Civil Rights	Provincial
Banking/Incorporation of Banks/Paper Money	Federal	Administration of Civil/ Criminal Justice	Provincial
Weights and Measures	Federal	Education	Provincial
Bankruptcy	Federal	Incorporation of Companies	Provincial
Patents	Federal	Natural Resources	Provincial
Copyrights	Federal	Matters of merely local or private nature	Provincial
Indians/Indian Reserves	Federal		

Despite the general division of service delivery that occurs between provinces and municipalities, there is still a good deal of provincial involvement, particularly on the funding side. Provinces routinely fund infrastructure projects such as transit improvements or recreational facilities. They are also becoming increasingly involved in matters such as land-use planning and extending environmental regulations. In several provinces, municipalities have lost most of their autonomy over these areas. Although municipal governments are typically best placed to deal with the issues pertaining to cities, they are increasingly hampered by expanding provincial governments. This situation significantly undermines local autonomy, and it shifts power over local decisions into the hands of the broader electorate, who are understandably neither well informed nor concerned about local issues in communities where they do not reside and which are often far away. This is detrimental to local democracy, and it leads to imposing bad decisions from afar onto municipalities. A perfect example is the tendency of provinces such as Ontario and Alberta to inflict rigid land-use regulations on communities without the consent of the local electorate.

> ***“Although municipal governments** are typically best placed to deal with the issues pertaining to cities, they are increasingly hampered by expanding provincial governments. This situation significantly undermines local autonomy...*

The current state of the division of powers

Our top-heavy tax system

At present, the federal government reaps the biggest slice of the public purse. If governments strictly followed the constitutional division of powers, the size of the federal government would decrease relative to the size of the provincial and municipal governments. In 2009, the federal government controlled roughly 43.44 per cent of spending among all levels of government. Provincial governments controlled 40.69 per cent, leaving a paltry 15.87 per cent for municipalities.[5] Consider that health, education and social services alone (which are primarily provincial responsibilities) consumed nearly 65 per cent of all government spending in 2009.[6] The top-heavy tax system creates a situation in which provincial and municipal governments have to collaborate with the federal government, and in the case of the municipalities, often with both higher levels in order to deliver the services they are expected to provide. While lower level governments can theoretically raise taxes, a crowding-out effect often prevents them from doing so. Because only so much tax revenue can be collected, when one level of government takes more, another must take less. In a Department of Finance Canada working paper, Ann Cavlovic and Harriet Jackson found evidence that the federal government crowds out provincial corporate taxes.[7] They did not find a similar crowding-out effect on personal income taxes, though a later study by Howard Chernick and Jennifer Tennant found that when the data is broken down by income groups, there is a crowding-out effect on the upper 25 per cent of income earners in both Canada and the United States. In other words, the more the federal government taxes high-income earners, the less the lower levels of government can.[8]

Federal-provincial-municipal projects

Projects requiring three levels of government funding have become quite common, particularly in Ontario. The most prominent examples are in Toronto. During the 1990s, the City began construction on an Eglinton subway line. When the Harris government came to power, it filled in the hole the Toronto Transit Commission had already dug.[9] The City is only now building a light rail transit line along Eglinton, and the hotly debated specifics of the project are still contingent upon provincial approval. Meanwhile, the provincial government funded the relatively useless stub known as the Sheppard line, which is considerably north of downtown in North York. Another battle is raging over whether to extend it. Unsurprisingly, the City looked to the provincial government for funding, though it is unclear whether the project will be built.

The federal government also plays a major role in funding Toronto's transit system. It is currently contributing some $700-million to the $2.6-billion extension of the Spadina subway line all the way north to Vaughan.[10] There is good reason to suspect that this project received priority funding due to the competitiveness of the federal and provincial ridings through which the line will pass. After all, the 905 region surrounding Toronto has become one of the most electorally important terrains in the country.

The entire strategic direction of Toronto's transit system is contingent on capital funding from the upper levels of government. There are ways that the City could generate sufficient revenue to undertake these projects, such as toll highways, but it is far easier from a political standpoint to go cap in hand to upper levels of government.

While some might argue that this is a Toronto-centric problem, this type of scenario occurs throughout the country. Examples of these multi-level spending projects include:

- The federal government allocated $450-million to the $2-billion Canada Line addition to Vancouver's SkyTrain network in 2004.[11] The rapid transit line runs from downtown Vancouver, through Richmond to the Vancouver International Airport. The project also received funding from the province of British Columbia, the Greater Vancouver Transportation Authority, Vancouver International Airport Authority and the City of Vancouver.
- In 2009, the federal government contributed $350-million to the billion-dollar Pipeline Renewal Program in Quebec. The province of Quebec also contributed $350-million to this program, which transfers money to municipalities to build and repair water and waste water infrastructure. Some of the funds went to firms that are now facing fraud and conspiracy charges. In reaction to these revelations, the federal government insisted that the oversight of municipal contracts is not a federal responsibility.[12]
- The City of Collingwood, Ontario, undertook a $7-million downtown revitalization project in 2009. The federal, provincial and municipal government each contributed $2-million, while the downtown business improvement association added $1-million.[13]
- In 2009, the federal government announced $130-million toward a $404-million project to build electricity transmission lines in Northwest British Columbia.[14] The project is a partnership between BC Hydro, BC Transmission Corporation, AltaGas (all Crown corporations) and the Tahltan Nation. The rationale for the project is to facilitate the development of renewable energy.[15]
- The federal government announced a $100-million contribution toward a waste water treatment project in Hamilton, Ontario. The provincial government also committed $100-million, and the City of Hamilton is responsible for the balance of the estimated $456-million.[16]
- The Winnipeg Convention Centre will be undergoing a $149-million expansion. The federal government is contributing $46.7-million, while the City of Winnipeg and the province of Manitoba are each contributing $51-million.[17]

Overlapping departments

Healthcare is an example of a responsibility clearly allotted to provincial governments. However, the *Canada Health Act* has blurred the division, which restricts the ways in which healthcare can be provided and financed. In addition to wading into regulatory issues, the federal government has created a large healthcare bureaucracy. Some spending, such as health spending on the armed forces, is constitutionally mandated and distinct from provincial health responsibilities. Some health research and regulations are best handled at the federal level, since it would be redundant to have 10 provinces replicate the same work. Nevertheless, one-fifth of the health department's expenditures do not fit into either category. Were the fiscal capacity shifted to the provincial level, governments there would have more money to spend on service provision, as there would be a need for only one bureaucracy rather than two to deal with the portfolios that the federal government would vacate. Such a transfer would not be a panacea for our healthcare system, but it would be an improvement. Freeing up resources by reducing overlapping bureaucracies and placing accountability for healthcare exclusively with one level of government should lead to better outcomes.

Higher education is another area in which there is unnecessary overlap between provincial and federal departments. Human Resources and Skills Development Canada is involved in higher education funding. The loans and grants offered to students through the department could easily be provided by provincial student-loan departments.

Administrative costs of intergovernmental transfers

Every time one level of government transfers money to another level, there are administrative costs. After all, transfer levels are negotiated and bureaucrats are needed to process the paperwork. It is more labour intensive when municipalities are required to fill out grant applications for provincial funding. Even though such costs are difficult to quantify, their existence means there is less money available to spend on program delivery. It is difficult to imagine anyone without a stake in higher expenditures who does not want more value from tax dollars. Eliminating these administrative redundancies and stakeholders can help to reduce the cost of service delivery by freeing up existing human resources in the public sector and reduce the need for further hiring. Devolving taxation powers is one of the few ways governments can actually cut spending without reducing services.

Consider the following assessment of intergovernmental transfers in the United States, which was offered by a former high-ranking politician who undertook a National Performance Review during his time in office:

> Considered individually, many categorical grant programs make sense. But together, they often work against the very purposes for which they were established. When a department operates small grant programs, it produces more bureaucracy, not more services. Thousands of public employees—at all levels of government—spend millions of hours writing regulations, writing and reviewing grant applications, filling out forms, checking on each other, and avoiding oversight. In this way, professionals and bureaucrats siphon money from the programs intended customers: students, the poor urban residents, and others. State and local governments find their money fragmented into hundreds of tiny pots, each with different—often contradictory—rules, procedures, and program requirements.[18]

That statement was by former vice-president Al Gore. Gore is not exactly a gung-ho free market capitalist, but he recognized that administrative transfers reduce the amount of money available to deliver services. The more complicated governments get, the greater number of departments required to haggle over minute details to ensure that regulations are met; the more special interest groups to listen to and to appease; the more politicians can rig the process to benefit their local constituents. When there are three levels of government involved in a project, it gets worse.

The fiscal imbalance(s)

A vertical fiscal imbalance is a situation in which a lower level of government has insufficient resources to accomplish the tasks for which it is responsible, while a higher level government has more resources than necessary (or vice versa). When Canadians hear the words "fiscal imbalance," they think of the acrimonious debates between Quebecois sovereigntist politicians and the federal government. These debates figured prominently in the national political discourse during the last few years of the Chretien-Martin era. The issue gained prominence following the 2002 Seguin Report. The report's fundamental concern was that while the federal government was downloading spending responsibilities to the provinces, it collected budget surpluses.

Since there is only a limited amount of taxes that governments can collect from a jurisdiction, the higher level government "crowds out" the ability of the lower level government to collect revenue. While the reverse could happen in theory, this is the outcome seen in Canada. While the federal government was running surpluses during the 1990s and early 2000s, the provinces were unable to meet some of their obligations.

The federal-provincial fiscal imbalance

The fiscal imbalance between the federal and provincial governments largely stemmed from the fiscal reforms that began with the 1995 Federal Budget. The 1995 budget began a retreat from federal-provincial cost-sharing programs toward block grants (whereby provinces receive money from the federal government and have the discretion to spend on a policy area as long as they meet specific guidelines). The federal government reduced transfers to the provinces from $29.3-billion in the 1996-1997 budget to $25.1-billion in the 1997-1998 budget. This $4.2-billion savings helped to return the federal budget to a surplus position. Its rationale was that the old cost-sharing program gave the provinces an incentive to overspend, since the federal government would pay up to half the amount the provinces spent on social services. As such, there was little incentive to spend money efficiently.[19]

While observers generally recognize that the fiscal reforms undertaken by the Liberals in the mid-90s were essential, many detractors pointed out that the federal government downloaded the responsibility for the financing of many services to the provinces. Although they used the pejorative term “downloading,” in reality, this was a good example of decentralization. Despite the fact that the federal government ran budget surpluses between 1997-2008, the provinces argued that they could not fund their obligations. It is a contentious point, but whether their existing revenue was sufficient, the provinces had little ability to increase revenue through taxation without the federal government simultaneously reducing its taxation levels.

The fiscal imbalance issue seems to have gone dormant, largely due to a number of side deals with Quebec, Ontario and Newfoundland that were entered into to assuage their fiscal concerns. These deals are yet another example of how the federal government can use its ability to redistribute funds to its political advantage. Given the projected need for spending increases in provincial and municipal areas, particularly healthcare and infrastructure, the respite will likely be short-lived.

Provincial-municipal fiscal imbalances

The fiscal imbalance that has become most prominent in recent years is at the municipal level, particularly with respect to large cities. Many big-city mayors, as well as groups such as the Federation of Canadian Municipalities, have argued that cities simply do not have the fiscal capacity to maintain existing infrastructure, let alone to fund new infrastructure. The cities have differing funding relationships with their provinces, but none has access to sales and income taxes. Cities are almost entirely reliant on property taxes and transfers from other levels of government to provide services. Unfortunately, as Calgary Mayor Naheed Nenshi often observes, property taxes are essentially the worst way to fund services. They are inflexible and inefficient, largely because property values do not correlate well with income. If a homeowner experiences a rapid increase in home value without a corresponding increase in income, he or she may not have the means to pay the additional tax—particularly when it comes to retirees who have lived in their homes for decades. This does not occur with a tax that has a direct relationship to earnings or consumption. Because of their dependence on property taxes, cities have a hard time increasing revenue without seeking money from senior governments. This fiscal imbalance is in large part responsible for the underfunding of municipal infrastructure in Canadian cities.

The provinces that downloaded spending responsibilities to municipalities in reaction to the declining federal transfers but did not transfer fiscal capacity exacerbated the municipal fiscal imbalance. This led to perpetual calls for increased funding by senior governments, increased taxation powers or both. Toronto is one of the few municipalities that was granted additional taxing powers, but it is still barred from taxing income or sales. Instead, it levied a land transfer tax and a vehicle registration tax. The vehicle registration tax has since been eliminated, and the current administration is committed to eliminating the land transfer tax. These examples illustrate the problem with the provinces dictating how municipalities raise revenue. If the methods used are inefficient or politically unpopular, they will simply fall into disuse. Until municipalities gain access to more-efficient fiscal tools such as sales and income taxes, they will continue to be reliant on upper levels of government for funding capital expenditures.

> ***"Cities are almost entirely reliant on property taxes and transfers** from other levels of government to provide services. Unfortunately, as Calgary Mayor Naheed Nenshi often observes, property taxes are essentially the worst way to fund services.*

The political economy of intergovernmental co-operation

Local knowledge and centralized decision-making

As a rule, people closer to an issue have more information about it than do people further away. There are exceptions, but this is generally the case. In addition to their overall knowledge of policies, people tend to have their own particular knowledge that can help them make better policy decisions. Economists refer to this as the "local knowledge problem." For example, while an expert on transit policy might be able to give great abstract advice on how to provide transit for an area, there are thousands of minute factors involved that only people who ride the transit system or live in the area would know. In many cases, the aggregation of these small nuances can make the difference between a successful transit system and a failed transit system. If policy-makers had perfect knowledge, it would not be an issue. However, as we all know from the existence of bad transit decisions, this is not the case. This is the reason it is so important to ensure that decision-making occurs at the lowest government level possible. This principle is subsidiarity.

Pork-barrel politics

The inverse of subsidiarity is a hierarchical system in which a centralized bureaucracy determines how to allocate resources. Though our system of intergovernmental finance is not entirely top down, there is enough funding directed from the higher to the lower levels of government to allow them to buy votes in particular ridings and regions. While politicians do not necessarily want to distribute tax dollars unfairly, there is a tendency for parties to spend more in the ridings that they control and in ridings that they can pick up more easily than in ridings that they have no hope of winning. After all, each party believes that its overall policy aims are superior and is willing to grease the wheels a little bit to ensure that it has the opportunity to implement its broader goals. However, from the perspective of individual MPs, the incentives get worse, since every MP wants to appear to be responsible for getting many tax dollars into his or her community. Because voters do not know how much their communities are getting back from higher levels of government relative to what they are paying in taxes, voters everywhere are easily convinced that they are being ripped off.

Intergovernmental haggling

Politicians at the municipal and provincial levels understand the incentives they face. People pay a lot in taxes, so they want to see something in return. The easiest way for politicians to convince their constituents that they are getting their money's worth from their tax dollars is by gaining visible concessions from higher levels of government. And what is more visible than massive infrastructure programs? Since taxpayers see taxes as a sunk cost (money they will never get back), they are often happy just to get something back. Constituents will cheer on projects that are more lavish than they would prefer but that are better than getting nothing back for their provincial and federal taxes. This web of circumstances can lead to the construction of infrastructure that cities cannot afford to maintain in the long run. Motohiro Sato from the Department of Economics at Hitotsubashi University describes the dynamic as follows:

> When local governments spend what local residents view as other people's money, citizens are unlikely to put much pressure on politicians to use funds efficiently. They mistakenly perceive the grants as free lunches, even though they are financed by national taxes that they pay. Indeed, empirical studies of intergovernmental transfers reveal that lump-sum grants lead to disproportionately large increases in local spending.[20]

In other words, grants from one level of government to another lead to the recipient government spending more money than it would if the money were raised from its local constituents. In part, the reason is that when senior levels of government are on the hook for funding, recipient governments view the amount of the transfer as a "soft" budgetary constraint. Michael Smart and Richard Bird of the University of Toronto point out that the provinces treat federal transfers like common pooled resources. They argue that the situation is far worse when the federal government cuts deals with various provinces: "Like all poorly managed common property resources, the result is an inevitable tendency to over-exploitation. We end up with a race among provincial governments to exploit taxpayers who reside in other provinces through federal transfer negotiations."[21]

Recipient governments have little incentive to keep projects costs down, because they know they can simply demand more money from upper levels of government. In fact, their incentive is to overstate the relative needs of their constituents so that they can garner more "free money" from outside their electoral base. When upper levels of government contribute operating funds, local governments have the even more perverse incentive to keep taxes lower than expenditures and to lobby for increased provincial or federal operating funds. However, if local taxpayers were on the hook entirely, it would be harder to convince them to accept the higher price tag. This would give local politicians more incentive to find more cost-effective solutions.

The flypaper effect

Intergovernmental transfers are prone to the flypaper effect: When one level of government receives transfers from another, the money sticks where it lands. It tends to be spent on things other than offsetting the missing fiscal capacity that was used to justify the transfer in the first place. Recipient governments use transfers as an excuse to avoid making the tough decisions that would make their jurisdictions more competitive. Perversely, many transfer programs reward this type of behaviour.

The most prominent Canadian intergovernmental transfer is the equalization system. While equalization is intended to ensure that all provinces provide a similar level of services, it actually enables poorly performing jurisdictions to spend more on those services than wealthy provinces do.[22] Consequently, those poorly performing provinces have the ability to use the public sector to create jobs and compensate the unemployed. While this sounds like a reasonable use of public funds, what it actually does is give incentives to governments to create a bloated public sector and no incentive to create a favourable policy environment for private sector growth. After all, if the private sector does better in have-not provinces, the government loses money through the equalization formula. Equalization punishes provinces that make good decisions and rewards governments that make bad ones. This results in the recipient provinces having higher tax rates on weaker tax bases.[23]

Moreover, equalization makes it easier for regions with high unemployment to provide generous unemployment to the chronically unemployed and underemployed. This lessens incentives for workers to move from regions of high unemployment to regions of low unemployment. This disincentive to move for work costs all levels of government potential tax revenue. Since this subset of people is not earning income, its members are not paying income taxes, and they are paying less in consumption and property taxes. Equalization creates a vicious cycle that harms all concerned, save for politicians and bureaucrats.

A similar logic applies to provincial-municipal transfers. The rationale behind them has typically been that provinces do not have access to more-efficient methods of taxation such as income and sales taxes. One could argue that the efficiency loss from transferring money from the provinces is outweighed by the municipalities not having to raise property taxes, which are regressive.[24] Concerns over potential revenue loss from tax competition between municipalities are also sometimes used to justify fiscal transfers from upper levels of government.[25] While an examination of the relative merits of various types of taxes would be outside the scope of this paper, it is worth pointing out that increasing the taxation powers that are available to cities can alleviate this concern.

The incentive under the current arrangement is to seek federal and provincial money at every opportunity. Toronto's current budget crisis illustrates this perfectly. The Toronto Board of Trade estimates that the City will have a structural deficit of $823-million by 2020 if it maintains its current trajectory. This has led to calls from municipal politicians for the provincial government to upload services to the provincial government. There appears to be no political will from council to make tough decisions. It is easier to put off solving the problem and hope that provincial or federal government will see an electoral benefit in throwing money at the City. While Toronto is an extreme case, Canada's other big cities are also dependent on provincial and federal governments to provide municipal services. Calgary, for instance, relies heavily on upper levels of government to fund its capital budget. The City is funding 51.5 per cent of its 2012-2016 capital budget, while the provincial government is contributing 43.2 per cent, and the federal government is contributing 5.3 per cent.[26] Another example is the City of Winnipeg, which received 19.1 per cent of its 2012 capital funding from the provincial government and 15.8 per cent from the federal government.[27]

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Principles for successful devolution

Which level of government should provide which services?

To enhance political accountability and increase public sector efficiency, the government of Canada should move toward further decentralizing fiscal capacity. Though this sounds simple in the abstract, some general principles ought to be followed when considering which level of government ought to be responsible for funding and providing various services.

A guiding principle is that the lowest possible level of government should fund and provide programs, but there are two caveats. First, programs with benefits that spill over jurisdictions should be pushed to higher levels of government to ensure that there are no free riders. It is impossible to charge people for public goods, since benefits to the individual cannot be quantified, and everyone receives the benefits even if he or she wants to opt out. The classic example is national defence. After all, people receive protection from foreign invasions whether they want it or not, and there is no way to determine how much each individual ought to pay for national defence. Hence, it makes more sense to finance the military through federal tax revenue.

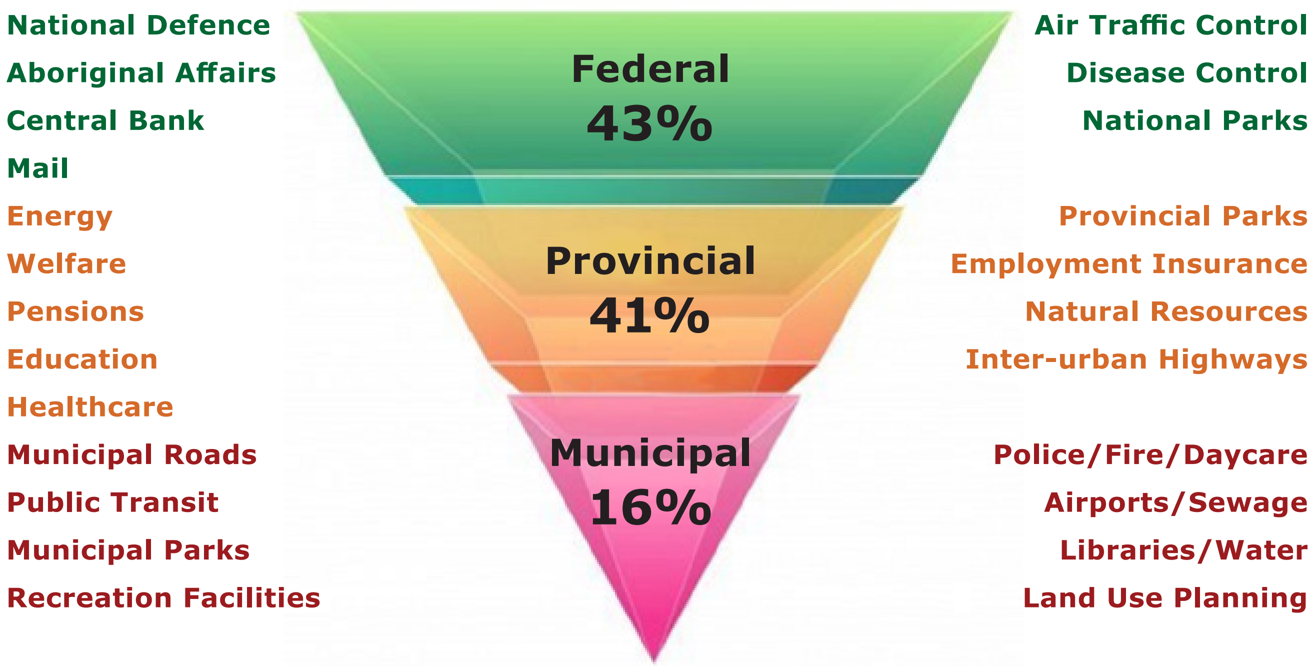
Second, costly administrative redundancies need to be avoided. Although they do not qualify as public goods, there are many services for which the costs of administration are more effectively spread over a large population. However, this needs to be balanced against the benefits from competition between jurisdictions. There are instances where the benefits of competition outweigh the cost of redundancies.

Healthcare provides a useful example of how to evaluate the above two principles in concert. While it would be possible for every municipal government to have its own healthcare system, having the provincial government oversee the system reduces the administrative costs. After all, there would be spillover effects among municipalities if each had its own healthcare system. Having access to a healthcare system in a neighbouring municipality would be a significant spillover benefit, since many non-residents would profit from its services (presuming that hospitals did not turn non-residents away). While it makes sense to have one provincial healthcare system rather than one for each municipality, it also makes sense to have each province provide its own healthcare system rather than have one national system. Because there are no spillover effects from one province's healthcare system to another's, delivering healthcare at the sub-national level meets the first principle. Hence, the provincial level seems to be the level at which healthcare ought to be delivered and can be delivered without creating free riders.

Administrative redundancies are slightly more difficult to deal with, and must be weighed against the benefits of competition. While administering programs such as healthcare at the federal level could theoretically reduce administrative redundancies, there are advantages from having several competing systems. The fact that each province runs its own healthcare system allows jurisdictions to experiment with various methods of service delivery. This helps to determine best practices, which other governments can emulate. The competition between governments means that if one jurisdiction attempts to impose bad policies, people can vote with their feet and leave. The competitive arrangement puts pressure on governments to provide services efficiently. This is why it is important to keep program delivery at the lowest level possible as long as the spillover effects can be minimized and the benefits from competition are greater than the cost of administrative redundancies.

Chart 1

Top Heavy



Matching revenue to expenditures

All governments should strive to match revenue to expenditures in order to ensure that services are sustainable. The best method, where practical, is direct user fees such as toll roads. Other fees that are not directly proportionate to usage, such as gasoline taxes, are a reasonable substitute when the more-direct fees are not a viable option. Wherever possible, funds should be earmarked for a specific use rather than funnelled into general revenue. Creating as direct a link as possible between taxation and spending ensures that the beneficiaries of the spending can see the value they get for their money and can determine whether the program in question is administered well or whether reform is necessary. It also reduces the ability of some segments of the population to pass on the cost of their choices to others. For instance, there is no compelling reason for non-drivers to pay taxes out of general revenue to fund roads that they benefit from less directly than drivers do. While they purchase goods and services that are transported via the road network and they may use public transportation, non-drivers still do not make use of as many vehicle kilometres of roadway per year as automobile drivers do. They benefit less from the roads than drivers do, and they already pay their share when they purchase goods and services (since fuel taxes are subsumed into prices). If the revenue generated is not sufficient to pay for roads, fuel taxes and user fees should increase. Where possible, the same logic ought to apply to other spending areas.

While rate setting and expenditure decisions ought to be undertaken by the lowest level practicable, there is a good case for harmonizing tax collection upwards. Harmonizing sales taxes, for instance, has been quite successful. The federal government could collect sales taxes for municipalities and provinces more efficiently than having two or three levels of government involved in tax collecting. Tax collection is just another service, and the federal government appears to be the most efficient level to undertake this function. Since there is no way in which to foster competition among jurisdictions in terms of tax collection, it makes sense to take advantage of the efficiency gains from having one rather than eleven departments collect taxes.

Rebalancing the federation

The theory behind decentralizing many services is sound. However, it would be a complicated undertaking, given the size and complexity of many spending programs. Despite the difficulty, it could be accomplished by shifting some taxation power downward while transferring some federal revenue to the provinces and municipalities and eliminating direct federal spending in areas of provincial and municipal responsibility.

The Canadian Centre for Policy Studies recently released a study written by David Murrell, which calculated the level of savings that could be achieved by eliminating spending that is not explicitly required of the federal government under the constitution. The study found that the resulting savings would have been just under $44-billion for the 2009-2010 fiscal year.[28] If the federal government continued funding programs that have interprovincial linkages or that are more efficiently run at the federal level (e.g., disease control), the savings would be just over $37-billion.[29] That would account for a 13.55 per cent reduction in federal spending. We will use this scenario with some modifications for our calculations.

What the scenario we have chosen does not exclude, which ought to be excluded from a subsidiarity perspective, are the three main transfers from the federal to the provincial governments: equalization, the Canada Health Transfer and the Canada Social Transfer (CST). These amounted to $14.9-billion, $25.6-billion and $11.2-billion respectively in 2009-2010.[30] There were also a number of smaller transfers, many of them one-off payments that can be eliminated from the calculation. The federal goverment allocated $250-million to provinces to reduce wait times for medical procedures, $161-million in subsidies to encourage provinces to eliminate capital taxes, and $3.8-billion to compensate provinces for adopting the HST all fall under that category and can be removed.[31] Subtracting the above from the previous total yields a reduction of $93-billion in federal expenditures. Under this hypothetical situation, the result would be a reduction of 33.89 per cent for the 2009-2010 fiscal year.

To stay consistent with the saving estimates above, the fiscal year 2009-2010 is used as a baseline for calculation purposes. The projected savings are applied to the projected revenue and spending assumptions that the Parliamentary Budget Office (PBO) published for 2015-2016.[32] The savings were calculated by applying the aggregate savings as a percentage of the budget in our hypothetical 2009-2010 scenario rather than attempting to determine what the specific level of spending by department will be in 2015-2016.

Applying the hypothetical 33.89 per cent savings level to the PBO's 2015-2016 spending projection of $296.5-billion would reduce federal expenditures by roughly $100.5-billion. Of course, the provinces and municipalities would need to pick up the slack. To give lower levels of government the fiscal capacity to fund their new-found obligations without raising the overall taxation level, the federal government would have to agree to download fiscal capacity. Part of the solution could be to transfer to the provinces and cities the revenue from two existing taxes, the GST and the fuel tax.

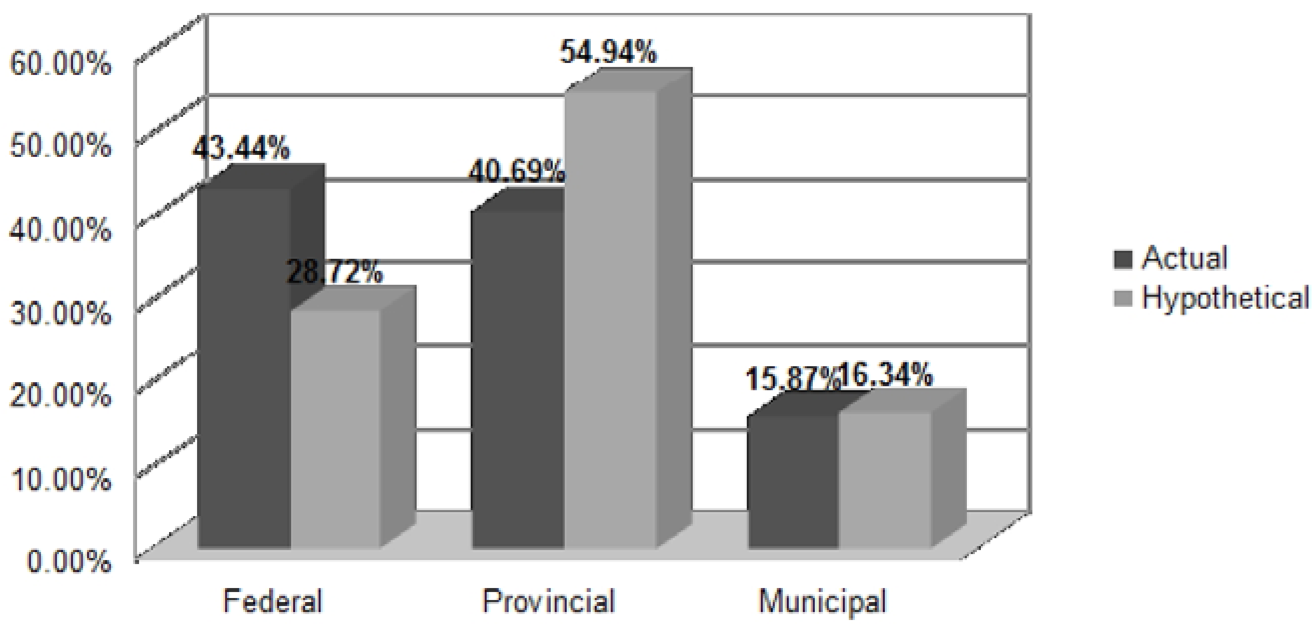
In 2009-2010, the federal government collected just under $27-billion through the GST. The PBO projects that the GST will generate $34.5-billion by 2015-2016.[33] Assuming that the federal government transferred the entirety of the GST to the provinces, the federal government would have approximately $66-billion in net savings. Transferring the GST to the provinces would allow it to cover much of its added costs. To put this in perspective, it would more than make up for the elimination of equalization and the CST. Moreover, transferring the GST would go some way toward equalizing provincial revenue without the built-in disincentives of equalization. After all, provinces would not get less in GST revenue for strengthening their economies or vice versa, but they would receive baseline funding that would be equal across provinces on a per capita basis.

The federal government also collects about $5-billion in fuel taxes per year.[34] It currently transfers $2-billion into the Gas Tax Fund for the provinces, and the federal government has committed to making this arrangement permanent. The provinces in turn allocate the Gas Tax Fund to the municipalities. Since the Gas Tax Fund is counted on the federal expenditure side of the ledger, transferring the entire amount would result in a net revenue loss for the federal government of $3-billion, leaving its net savings at roughly $63-billion. While maintaining the fund's structure would be an option, it would be preferable to transfer the revenue directly to the municipalities on a per capita basis, even though simply increasing the existing fund would still be an improvement over the status quo.

After transferring these two taxes, the federal government would have $63-billion in savings. Adding in the PBO's projected $2.4-billion surplus for 2015-2016, the federal government would have $65.4-billion more revenue than it would require. Meanwhile, lower levels of government would need substantially greater revenue. It is difficult to determine what level of revenue would be necessary to make up for the provincial shortfalls. As discussed above, there is good reason to believe that most, if not all, provincial governments could provide the services downloaded under this scenario more efficiently. The best way to allow the provinces to collect an adequate amount of revenue would be to reduce federal income and corporate taxes and allow the provinces to choose how they would like to fund the additional spending they would require. With the federal government taking in $65.4-billion less, the provinces could simply opt to increase their provincial income taxes to a level that would keep the combined federal and provincial income and corporate taxes paid by their citizens similar. They could carry out some combination of increasing provincial income taxes and sales taxes to generate similar revenue. They could also decide to set the rates at a revenue target that is lower than the combined tax bill would have been otherwise. This type of experimentation is a good thing. Having 10 different laboratories for policy experimentation helps to determine best practices, so giving the provinces even more autonomy may allow for better policy outcomes in the end.

Chart 2

Spending Before and After Devolution



This paper will refrain from speculating as to how the provinces ought to alter their fiscal arrangements with their cities, since provinces have varying arrangements with their cities, and different cities have different needs. Ideally, however, the provinces would give the cities far greater autonomy over infrastructure funding while removing the restrictions on revenue generation. The principles laid out above create a road map for how to reform the relationship between cities and provinces, but it is beyond the scope of this paper to provide costed proposals for specific cities.

Conclusion

The recommendations outlined in this paper might seem like a jarring shift. Critics might claim that the plan is to gut the federal government. In reality, it would not require any substantive changes to the services currently provided. Lower levels of government could decide to allocate roughly the same amount of money toward programs and deliver them in the same manner as they are currently delivered, minus the redundancy of having other levels of government involved. Alternatively, they may opt to experiment with different service-delivery models. This would be up to the electorate to decide. Decentralization is not an ideological matter. There are good reasons for people from either side of the political spectrum to support moving decision-making power closer to the voters. Politicians from provinces that receive transfers in excess of what they currently pay out to the federal government have historically been resistant to such changes, because they fear that they do not have the capacity to fund projects on their own without raising taxes. In a sense, they are right. If spending levels stayed the same, have-not provinces would have to raise taxes. However, a single level of government would finance and deliver services more efficiently. Moreover, competition between jurisdictions would help to determine best practices for service delivery and financing. There is good reason to believe that this approach would result in substantial savings for program delivery. The old tax and transfer model provides little accountability and gives little incentive for provinces to deliver services efficiently. The proposed model would create more accountability and better incentives.

While it is unlikely that this proposal would be fully implemented in the near future, moving in the direction of more decentralization would still be a significant improvement. The principles outlined above are a guidepost. The federal government does not necessarily have to go all the way, but following the direction of decentralization would strengthen accountability and provide Canadians with better governance. Given the instability in the global economy and our impending demographic challenges, it is more important than ever to get the most out of every tax dollar. Devolving decision-making and reducing redundancy between levels of government would create better incentives for governments to deliver services efficiently.

“ ***Decentralization is not an ideological matter.*** ***There are good reasons for people from either side of the political spectrum to support moving decision-making power closer to the voters.***

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