

# **Expenditure Needs Measures in Provincial/Territorial Unconditional Grants to Local Governments in Canada**

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## **A. Introduction**

Local governments include municipalities and schools. Local governments in Canada finance their expenditures from own source revenues (property taxes and user fees mainly) and intergovernmental grants, mainly from provincial/territorial governments. All sources of revenue are important for financing local needs and responsibilities, however, the focus of this paper is on the way in which local government expenditure needs or requirements are treated or not treated in provincial/territorial unconditional grants to municipalities and provincial/territorial grants for funding local schools.

The paper is both prescriptive and descriptive. It is prescriptive in that it compares and evaluates a range of grant formulas, most of which include a measure of expenditures. It is descriptive in that it: i) describes the range of unconditional grants that are currently used by each province and territory in providing financial assistance to municipal governments; and ii) it briefly reviews the range of provincial/territorial education grants used across the country.

To gain some idea of the relative importance of grants for funding local governments, Part B identifies the relative importance of each revenue source for funding municipalities and schools by province and territory. Part C concentrates on the design and use of unconditional or equalization grants that municipalities could and do use. This discussion begins with a conceptual analysis of the strengths and weaknesses of a range of potential grant formulas. This is followed by a description of actual unconditional and equalization grants used in each province and territory. Part D reviews school grants in the same manner – a conceptual analysis of potential types of grants followed by a brief discussion of what is done in each province and territory. Part E discusses the measure of expenditure needs. Part F identifies a few things from the range of provincial/territorial local government unconditional grant programs that may be of use in designing a federal/provincial and territorial equalization grant program.

## **B. Relative Importance of Grants**

The discussion in this section is divided into two parts; first, a quick summary of the relative importance of municipal grants as a revenue source; and second, a summary of education grants as a revenue source for school boards. Here, it should be noted that grants for education are conditional in the sense that they must be spent only on education services or on specific education programs. Generally, they are intended to cover pre-established cost components of specific programs. Conditional grants to municipalities must be spent on specific programs and services while unconditional grants to municipalities may be spent in whatever fashion the municipality chooses.

### ***B.1 Municipalities***

Table 1 (at the end of this paper) illustrates the relative importance of each municipal revenue source by province and territory for 2003. For all of Canada, local property taxes accounted for more than 53 percent of all revenues with user fees adding more than 23 percent. Own source revenues in total, accounted for 84 percent. The remaining 16 percent came from federal and provincial grants with 3 percentage points being unconditional (equalization) and 13 percentage points being conditional.

An interprovincial comparison of the reliance on the municipal reliance on provincial/territorial grants reveals the following.

- Unconditional grants are more important than conditional grants as a revenue source in three provinces only – New Brunswick, Manitoba, and Saskatchewan. Conditional grants are more important elsewhere.
- Unconditional grants account for 3 percent or less of all municipal revenue in Prince Edward Island (3.2 percent), Nova Scotia (2.9 percent), Quebec (3.1 percent), Ontario (2.8 percent), Alberta (0.7 percent), and British Columbia (1.3 percent).
- Unconditional grants are most important as a revenue source in Manitoba (13.4 percent), New Brunswick (11.2 percent) and the three Territories (from 13.1 percent to 15.6 percent).
- All unconditional grants come from provincial and territorial governments.

### ***B.2 Public Schools***

The Constitution Act, 1867 (formerly the British North America Act) defines education as being the responsibility of provinces and territories. Each province and territory, then, has its own elementary and secondary education system. In all provinces and territories with the exception of the Yukon and Nunavut, local school boards are responsible for managing local schools, appointing teachers, purchasing equipment, and preparing budgets. School boards are required to finance schools within their jurisdiction from one or more of the following revenue sources: provincial grants; local property taxes; and miscellaneous revenues, including federal government contributions, fees, rental income, and various sundry sources. The federal government is responsible for Aboriginal (Indian and Inuit) elementary and secondary school education, armed forces personnel and their families, and inmates of federal penitentiaries.

From Table 2 (at the end of this paper) and a summary of the literature, the following may be noted.

- For all of Canada, local property taxes accounted for 23 percent of all school board revenue in 2003 with provincial funding accounting for more than 71 percent. This figure overstates, however, the ability of school boards to use local property taxes; for example, in Ontario, local property taxes fund local schools (included in the 23 percent) but the local board has no control over the tax rate because it is set by the province.
- School boards are not permitted to use property taxes for funding elementary and secondary schools in seven provinces and territories - Newfoundland, Prince Edward Island, Nova Scotia, New Brunswick, Ontario, Yukon, and Nunavut.
- Manitoba and Saskatchewan are the only two provinces where local school boards are able to set local education property tax rates to fund a reasonable portion of local schools. Quebec school boards are permitted to use local property taxes to fund up to fifteen percent of local education costs.
- Elector approval to use local school taxes exists in British Columbia, New Brunswick where they have seldom been used; Alberta where the tax may not exceed three percent of a school boards budget; and Prince Edward Island where it has never been used.
- Saskatchewan is the only province where more than 40 percent of public school revenues still come from locally set property taxes, a considerable change from one decade ago.

### **C. Municipal Unconditional Grants**

This section is divided into four parts. First, the principles that should be achieved in designing an unconditional grant formula are outlined. Second, these principles are used to evaluate the strengths and weaknesses of a range of potential grants, most of which include an expenditure measure. Third, the unconditional grants used in each province and territory are described. Fourth, a summary of the discussion is provided.

#### ***C.1 Principles***

Well-designed provincial-municipal unconditional grants attempt to achieve the following principles.

***Fairness*** is achieved when municipalities with equal fiscal need are treated equally. Fiscal need is a measure of a municipality's expenditure needs relative to its ability to raise its own revenues. Fairness across municipalities is achieved when the revenue raising capability of a municipality is consistent with its expenditure responsibilities and needs. For example, a municipality that has large expenditure needs but has an inadequate revenue base requires a grant to meet its expenditure needs.

***Economic (allocative) efficiency or choice-neutrality*** is achieved when a grant does not influence the expenditure patterns of a recipient government unless, of course, there is some reason to alter expenditure patterns to correct for distortions that already exist in expenditure

practices. For a grant to be efficient, a municipality should not be able to influence the grant that it receives by manipulating its expenditure decisions.

**Predictability, stability, and flexibility** of a grant is important because municipalities need to be able to budget and plan for the future. For this purpose, grants need to be predictable and stable. At the same time, they need to be flexible so that they can respond to changing economic circumstances.

**Accountability** frequently means something different for donor and recipient governments. If the recipient spends grant funds (without strings attached by the donor) on local services, local residents can hold local government accountable for spending decisions and accountability at the local level should be enhanced. The donor government, however, does not have the same degree of accountability if the funds are merely given to municipalities without conditions.

**Transparency** is achieved when stakeholders (donor and donee governments, and the general public) have information that permits one party to hold the other party or parties accountable for their actions. A transparent grant system minimizes the risks of corruption and reduces the opportunities for one level of government to abuse the grant system to achieve self-serving goals or objectives.

## ***B.2 Types of Unconditional Grants***

There are three generic types of unconditional transfers that may be used depending on the principles to be emphasized. These include a per capita grant; a fiscal capacity equalization grant; and an expenditure/fiscal capacity equalization grant.

### ***a. Per Capita Grant:***

A per capita grant provides the same amount of revenue per capita to each municipality. The larger is the municipality's population, the larger is its total grant. Generally, its purpose is to close the fiscal gap or reduce the vertical fiscal imbalance. It is a block grant that is not designed with an equalization component, but it may have an equalizing effect on the ability of municipal governments to deliver comparable levels of service.

A per capita grant is neutral (allocatively efficient) in its effect on expenditures because it does not distort the relative prices of providing local services. Per capita grants are predictable to the extent that population is predictable, but they are not necessarily flexible. For example, a municipality may lose population and still have the same expenditure requirements, but its grant will diminish. Per capita grants are easy to understand and simple to administer. Like all unconditional grants, they may lack accountability in relation to the donor but not in relation to the donee.

In summary, per capita grants are relatively easy to administer but deficient in a couple of important ways. They are based on population, and since population does not reflect expenditure

need, the grant does not reflect it either. Furthermore, grants of this kind do not take account of a municipality's ability to raise revenues from its own sources.

***b. Fiscal Capacity Grant:***

This grant is designed to assist a municipality whose tax base per capita is less than some 'standard'. This standard may be defined as the average tax base (assessment) per capita, the tax base per capita in the municipality with the highest tax base per capita, or some other measure. The most commonly used measure is the average tax base per capita.

A fiscal-capacity grant is equal to the difference between the revenues that would be collected if the standard tax rate were applied to the standard tax base and the revenues obtained by applying the standard tax rate to the actual tax base. If a municipality's tax base per capita is less than the standard, the municipality receives a grant; otherwise, it does not.

The formula for a fiscal-capacity grant is:

$$GR^i = t^*[(B/P)^* - (B/P)^i]P^i$$

where:  $GR^i$  = grant to municipality i  
 $t^*$  = standard tax rate  
 $(B/P)^*$  = standard tax base per capita  
 $(B/P)^i$  = tax base per capita in municipality i  
 $P^i$  = population in municipality i

This type of grant is generally preferred to a per capita grant, since the calculation of the grant includes a measure of fiscal capacity. It does not, however, include a measure of expenditure needs. A fiscal-capacity grant is neutral or efficient, since municipalities cannot influence the amount of the grant by altering their expenditure or tax decisions. The grant amount is predictable to the extent that the tax base is predictable, and it is flexible in the sense that the grant provides increased assistance if the tax base per capita falls relative to the standard. Because the tax base is uniform, the grant is fairly simple to administer. It is as accountable and transparent as the per capita grant.

This grant does not recognize expenditure needs, therefore, it is frequently deemed to be inferior to one that considers expenditure needs.

***c. Expenditure/Fiscal capacity Equalization Grant***

Grants that include a measure of fiscal capacity and expenditure need can be designed to ensure that every municipality is able to provide at least a standard level of service by levying a standard tax rate. In the absence of the grant, some municipalities may fall short of this goal because of a lower fiscal capacity and/or because needs and costs are greater.

The general formula for capturing both expenditures and fiscal capacity is:

$$GR^i = [(E/P)^* - t^*(B/P)^i]P^i$$

where:  $(E/P)^*$  = standard expenditures per capita

This grant allocates funds to municipalities so that they can provide a standard level of expenditures at a standard tax rate. It is fairer than a fiscal capacity grant, since unlike the latter it takes into account the cost of services provided (as measured by expenditures). Expenditure/fiscal capacity grants do not reward inefficiency, but neither do they assist municipalities in meeting needs or costs that exceed the standard needs or costs. The grant amounts are predictable to the extent that the tax base and expenditures per capita are predictable. The grant is flexible – that is, the amount of the grant will change as the municipality’s fiscal position changes. As long as the calculation of expenditures and fiscal capacity are done in a manner that is open and transparent, the grant scores high on accountability grounds. Finally, the expenditure component of this grant can be as comprehensive (see discussion below) as one wishes.

There are a variety of expenditure measures that may be used in this formula. Possible measures include standard expenditure per capita as measured by the average expenditure per capita for all services; standard expenditure per capita only if it exceeds actual expenditure; standard expenditure per capita weighted by a factor that captures the conditions or circumstances (such as population density, etc.) that lead to higher costs; standard expenditure per capita as measured by average expenditure per capita for municipalities grouped by similar characteristics (large urban versus small urban versus rural or even small urban of a particular type versus small urban of another type); and standard non-discretionary expenditures per capita. Each of these is addressed briefly.

The use of *standard expenditures as measured by average expenditures for all municipalities* ensures that every municipality, regardless of its tax base, has the capacity to fund average expenditures per capita without having to levy a tax rate that is higher than the average tax rate. The grant covers expenditures up to the average amount. The municipality has to fund any additional expenditure from locally generated revenues. On the other hand, if a municipality currently spends less than the average amount, using average expenditures in the formula means that it might receive more than its expenditure needs.

Average expenditures ensure that each municipality has sufficient resources to meet this level of spending. It does not reward inefficiency. At the same time, however, neither does it assist municipalities with greater than average needs or costs. Finally, a major advantage is that it generally satisfies fairness and efficiency objectives.

To address the situation in which *actual expenditures are less than the average expenditure*, the formula could be modified by using actual expenditures per capita  $(E/P)^i$  rather than the average expenditure per capita  $(E/P)^*$  for those municipalities spending less than the average. The problem with this is that it creates an incentive for municipalities that are currently spending less than the average to spend more. As well, it complicates the formula, and it does not recognize the various factors that cause differences in expenditures across municipalities.

One way in which differences between municipalities may be handled is through the use of a *weighting factor*. This could be included in the formula and it could account for specific characteristics of a municipality that affect its expenditure needs or costs. This is done in New Brunswick (described in next section). Quebec does not have an expenditure component in its equalization formula, but it applies a weighting factor to its measure of revenue capacity for municipalities. A weighting factor on the expenditure side may be applied in the following way. As an example, if lower density leads to higher costs (more kilometres of roads per capita to maintain, for example), then a measure of density would provide additional grants to low-density municipalities. If, on the other hand, higher density meant higher costs, a density measure could capture this.

With a weighting factor, the grant formula becomes

$$GR^i = [(E/P) * w^i - t * (B/P)^i] P^i$$

where  $w^i$  is the weighting factor in municipality  $i$ .

Differences across municipalities could also be addressed by grouping municipalities *according to characteristics that reflect similarities*. For example, the needs and costs of large cities and metropolitan areas are different from those of small urban and rural areas; the needs and costs of municipalities that are adjacent to large cities and metropolitan areas may be different from those of isolated municipalities of comparable size; and the needs and costs of densely populated municipalities may be different from those of sparsely populated municipalities. Thus, one might appropriately group municipalities for grant purposes according to size, location, spending responsibilities, expenditure needs, and tax base, among other characteristics.

In calculating grants on this basis, it is assumed that all municipalities within a group have similar needs and costs. If a municipality spends more than the standard (average) for the group, the grant will not compensate it. To the extent that expenditures above the standard reflect inefficiency, they should not be rewarded. On the other hand, the additional expenditures may reflect other uncompensated differences within the group.

Organizing municipalities according to groups (by population size, tax base, expenditure needs, geographic location, and so on) is the best way to compare them in terms of costs and needs for the purpose of calculating grants. Once the groups are determined, it should be fairly simple to administer the grant. Since the group approach treats similar municipalities in a similar fashion, it is fair; since it does not allow a municipality's expenditures to influence the size of the grant, it is efficient. As with other expenditure needs/fiscal capacity grants, it is stable, predictable and flexible. Grouping of municipalities for grant purposes is the current practice in the provincial municipal equalization programs in New Brunswick, Nova Scotia, and Quebec (described in next section).

The expenditure/fiscal-capacity formula could also use *actual expenditures* instead of standard expenditures. This approach would ensure that each municipality could provide its current level

of expenditures by levying an average tax rate. Substituting actual expenditures for standard (average) expenditures, the formula becomes

$$GR^i = [(E/P)^i - t^*(B/P)^i]P^i$$

where  $(E/P)^i$  = actual expenditures per capita

The advantage of using actual expenditures is that the formula for each municipality reflects that municipality's particular needs and costs. In other words, it is assumed that actual expenditures reflect what municipalities need to spend. The disadvantage of using actual expenditures is that it discourages both local revenue-raising effort and local expenditure restraint because the largest transfers are given to those municipalities with the highest expenditures and lowest taxes. As well, if differences in actual expenditures across municipalities reflect municipal inefficiency, the formula may perpetuate that inefficiency. For this reason, this grant is generally rejected.

Instead of calculating grants on the basis of actual expenditures, *expenditures on non-discretionary services* could be used. The case for equalization is far weaker for discretionary spending than it is for non-discretionary spending. Discretionary spending refers to expenditures, such as those for recreation, culture and libraries, over which municipalities have a reasonable amount of control, or which could be provided by the private sector, or volunteer sector, or which are not as essential as other municipal services. Although there is often disagreement over what should be included, essential services probably should include police protection, fire protection, water and sewerage services, and transportation. The grant calculation, however, should *exclude* spending on services that ought to be funded or partially funded by user fees. This includes water and sanitary sewerage, public transit and recreation. Finally, debt service charges should be excluded because they may have been incurred to fund capital projects such as recreational facilities and administration buildings – capital expenditures over which the municipality may have had considerable discretion. Debt service charges for water and sewer should be funded from user fees applied to these services. Equalizing for non-discretionary spending within each group of municipalities is the current practice in Nova Scotia (described in next section).

A potentially serious problem in including specific expenditures in the grant formula surfaces when municipal accounting practices differ. For example, some municipalities may allocate a portion of general government expenditures to some or all of the specific expenditure functions while others may not. Indeed, there would be an incentive to alter accounting or recording practices to include as many expenditure components as possible in those services used to determine the grant. If this method of calculating grants is used, it is important to ensure that all municipalities follow proper and similar accounting practices.

### ***C.3 Description of Unconditional Grants***

The following is a brief description of unconditional grant programs in each province and territory. Most of these or components of these fit into one or other of the grant types described in the preceding section.

**Newfoundland:** There are four components to the operating grants program for municipalities. First, equalization is tied to the municipal assessment base relative to the provincial average. If a municipality's assessment base is less than the provincial average, a grant is given to bring revenue up to some percentage of the provincial average. Second, local revenue needs are based on revenue per household. If a municipality's revenue per household is below the threshold, the municipality gets a percentage of the difference. Third, a grant of \$85 per household is provided to every municipality. Fourth, a road subsidy of \$500 per kilometre is distributed to every municipality.

**Prince Edward Island:** The province has an equalization scheme (the Municipal Grant Support Program) that is based on per capita assessment. Each municipality with an assessment base per capita that is below the average receives grant funding to bring it up to the average. Rural municipalities also receive additional grants that are determined on the basis of a fixed dollar amount per kilometer of roads and fixed dollar amount per capita for police. These grants, however, are not tied to specific expenditures on roads and police. Urban municipalities do not receive the grant for roads or for police. Instead, the province rebates to each urban municipality a portion of the provincial property tax – this rebate is not available to the rural municipalities.

**Nova Scotia:** Unconditional grant funding is in the form of an equalization grant. It is based on a measure of local expenditure need and local revenue base. For the purpose of calculating grants, the province groups municipalities into two classes.

- Class I includes regional municipalities and towns.
- Class II includes county and district municipalities.

Expenditure need is measured by standard expenditure per dwelling unit by class of municipality for basic services per dwelling unit multiplied by the number of dwelling units. The standard expenditure per dwelling unit for each class of property is calculated as the average operating expenditure estimates per dwelling unit for each class. This standard is based on the estimated operating cost of providing the following services: police protection; fire protection; other protective inspections; transportation services excluding public transit; and 50 percent of garbage collection and disposal; and storm sewage collection and disposal, excluding sanitary sewerage. The formula excludes municipal expenditures for recreation and culture and debt service. The intention is to equalize only for services that are essentially non-discretionary and necessary for a functioning municipality.

The province calculates the revenue base by taking uniform assessment per dwelling unit and multiplying it by a standard tax rate and then by the number of dwelling units. The standard tax rate for each class of municipalities equals the total standard expenditures for all municipalities within the class divided by the total uniform assessment for the same municipalities within the class.

Each municipality's equalization entitlement is the difference between standard expenditures (the product of standard expenditures per dwelling unit times the number of units in each

municipality) and standard revenues (the product of the standard tax rate and uniform assessment in each municipality).

**New Brunswick:** The unconditional grant formula has the following features. First, municipalities are divided into six groups configured to reflect their characteristics, expenditure pressures, and service requirements. For example;

- Group A includes three metropolitan centres (Moncton, Saint John and Fredericton). These municipalities have a full range of municipal services and have a strong commercial/industrial and residential tax base.
- Group B includes the remaining urban centres (six smaller cities and towns ranging in population from 5,000 to 20,000) with per capita spending patterns and service responsibilities that are similar to group A, and with a relatively strong residential and commercial/industrial tax base.
- Group C includes large towns (population from 5,000 to 10,000) that are not located close to urban centres identified in groups A and B. Here, the level of service provided is lower than municipalities in groups A and B. As well, the tax base is characterized by a much stronger residential than commercial base although both exist.
- Group D includes suburban communities. These are located near a metropolitan or urban centre (ranging in population from 700 to 10,000) and often serve as a residential district or suburb to the larger neighboring community. Because residents of these communities benefit from services provided by the larger urban neighbors, their per capita expenditures tend to be lower and their tax base is primarily residential.
- Group E represents growing communities that can offer a full range of services to residents but have a small population base (600 to 3,500). They also tend to sprawl out over a large geographical area.
- Group F covers the smallest communities (population from 225 to 1,900), but this group includes the largest number of municipalities. For the most part, they offer a limited number of services to their residents and they are spread over large geographic areas. They have a very small commercial tax base and many of their services are contracted out or provided by another order of government. Finally, they are often removed from any larger community and surrounded by a large unincorporated area.

Second, the grant formula uses average expenditure for each group of municipalities to reflect expenditure need. Third, as a measure of fiscal capacity, the formula uses the tax base of individual municipalities with an average tax rate for the group to determine the amount of funds required to fund the standard level of expenditures. Fourth, a weighting factor is incorporated into the formula to account for specific characteristics of a municipality in terms of its density as measured by population per kilometer of roads. Fifth, to ensure that the unconditional grant does not provide funding to an individual municipality that may establish its tax rate at an unreasonably low level, a threshold (or average) tax rate is incorporated into the formula.

The unconditional grant formula is designed to enable each municipality (regardless of the size of its tax base) to provide an average level of service (when compared with other municipalities within each group) without levying a tax rate that is higher than the average for the group. Where a municipality spends more than the average for standard expenditures, its grant funding is based

on the average. Conversely, if a municipality's expenditure is below the average, it is awarded a grant based on the average. Inclusion of the actual tax base of the municipality in the calculation provides equalization on fiscal capacity. The density measure ensures that those municipalities with a large geographic area and dispersed properties are provided additional funding to reflect greater expenditure pressures arising from this (lack of) density. This factor is particularly significant in some of the smaller villages with very large geographic areas and lots of roads to maintain.

**Quebec:** About two-thirds of unconditional grants in Quebec are used for equalization purposes. The equalization grant for a municipality is determined by a formula that provides funds to a municipality whose tax base is lower than a standard tax base as determined by the province. Within this grant formula, municipalities are grouped according to population into four categories with a different standard tax base for each category. Finally, a weighting factor is applied to the grant formula with the weight varying by the poverty level of the regional municipality (the higher the poverty level index, the larger the weight which varies from .05 to 0.3). There is no expenditure component in the equalization formula and no standard tax rate is applied.

**Ontario:** In 1998, the provincial government implemented the Local Services Realignment (LSR) program. This involved the transfer of a number of additional spending responsibilities to municipalities. The province also took over property tax funding for education and created additional property tax room for municipalities by reducing the local education property tax by about fifty percent on residential properties. The province simultaneously reduced or eliminated almost all existing conditional grants and replaced all unconditional grant programs with a new unconditional grant called the Community Reinvestment Fund (CRF). The CRF is designed to fill the gap between each municipality's local service realignment costs net of savings targets prescribed by the province and its local tax room. The CRF is an unconditional grant since recipient municipalities may use these funds in what ever manner they choose. Although this grant provides some equalization in the sense that proportionately more money goes to poorer municipalities, it is not based on a fiscal capacity or expenditure/fiscal capacity formula as described above, nor is it a per capita grant or a lump sum grant.

**Manitoba:** There are two unconditional grant programs in Manitoba, both in the form of revenue sharing arrangements. Under each of these schemes, Winnipeg is treated differently than the rest of the province under each of these grants. .

Under the Provincial-Municipal tax sharing program, the total amount of money is determined by the provincial Department of Finance (in this sum is the revenue from 2.2 percentage points of provincial personal income tax revenue and 1.0 percentage point of corporate income tax revenue). The amount of this total that goes to Winnipeg is determined by taking the population of Winnipeg as a percent of the total population in the province. If, for example, Winnipeg's population is 30% of the provincial population, Winnipeg gets 30% of this sum. The residual is distributed to the remaining municipalities in Manitoba on a per capita basis.

In addition, the Province gives Winnipeg an unconditional operating grant (General Support Grant) to assist it with its general financial obligations, by providing an approximate offset to the Provincial Health and Post-Secondary Education Levy (payroll tax). The calculation is based on a percentage of the City's eligible payroll costs in the previous year. The Province gives other municipalities that have payrolls exceeding one million dollars an unconditional Municipal Support Grant, to assist in meeting their general financial obligations.

Video Lottery Terminal (VLT) revenue is a second form of unconditional grant. It is allocated as follows: Winnipeg gets 10% of net VLT revenue generated within Winnipeg. Municipalities in the rest of the province get 10% of net VLT revenue generated in the remainder of the province. This sum of money for the remainder of the province is distributed in two parts – first, a fixed sum of \$5,000 per municipality and second, a per capita grant for the remainder. An additional 25% of VLT revenues generated in Winnipeg is used to further economic development in Winnipeg and approximately \$1.0 million is given unconditionally to address similar needs in smaller communities..

***Saskatchewan:*** For unconditional grant purposes, there are two scenarios - rural revenue sharing and urban revenue sharing.

Under rural revenue sharing, there are two components to the unconditional grant: first, a transportation component: and second, a services component. The transportation component is directed at rural roads. A road classification system is used and adjustments are based on the taxable assessment per kilometer and the relative cost of road construction in each rural municipality; that is, there is an adjustment based on expenditure need relative to fiscal capacity among rural municipalities.

The services component is based on a three-year rolling average of actual net expenditures (gross expenditures less associated revenues) of each rural municipality for protective services, environmental health services, environmental development services, recreation and cultural services, and public health and welfare services. An adjustment is made based on taxable assessment per capita, to equalize the fiscal capacity of each rural municipality to provide such services.

Organized hamlets receive a basic grant and a per capita grant like those paid to urban municipalities. If an organized hamlet is located within a rural municipality, payments to the hamlet do not affect the grant eligibility of the rural municipality.

The urban revenue sharing grant is made up of three components. First, it includes a basic grant of \$1,350 for each community. Second, it includes a per capita grant of \$15.62 per capita. Third, there is a foundation grant or an equalization grant. This grant is calculated by comparing recognized revenues and recognized expenditures in each municipality. The data are adjusted to provide standardized figures for municipalities of similar size. Recognized revenues include taxes, grants in lieu of taxes, licences and fees, electrical surcharges, utility surplus (or deficit) and other own source revenues. Recognized expenditures include the cost of policing,

transportation, environmental health, public health and welfare, environmental development and culture and recreation.

If recognized expenditures exceed recognized revenues, a foundation grant component is paid. The size of the grant depends on the shortfall and is a percentage of the shortfall – 16.45% at the moment. If recognized revenues exceed recognized expenditures, no foundation grant component is paid.

**Alberta:** The unconditional municipal grant was established in 1994 by combining a number of grant programs from other departments into one grant. The portions of the now existing grant include the Police Assistance Grant, the Public Transit Operating Assistance Grant and the Urban Parks Operating Grant. The grant components are based on per capita formulas.

**British Columbia:** Unconditional grants consist of the small community protection grant - this is an unconditional grant to municipalities to assist them in providing basic services. Grant amounts are based on a formula that factors in base amount, population and assessment values. These grants generally apply to municipalities with populations up to 18,000.

The regional district basic grant is an unconditional grant available to regional districts to assist with administration costs. This grant is based on regional district population; under 50,000 population, \$120,000; 50,000 to 100,000 population, \$110,000; above 100,000 population, zero. Each regional district receives an additional \$2,500 for each local community in the regional district.

A third unconditional grant is made up from traffic fine revenues. The total amount of this grant is a budget allocation and its distribution is based on a municipality's policing costs as a percent of total municipal policing costs for the province. The Ministry of the Attorney General is responsible for documenting the police costs and providing them to the Ministry of Municipal Affairs.

**Northwest Territories:** The allocation formula for unconditional grants is based on three factors: population which accounts for at least 75% of the total; assessed value of all properties within a community boundary or where assessment is not done, an estimate of assessment; and a factor designed to account for cost differentials in providing government services across communities in the NWT.

**Nunavut:** The grant is needs based and includes a vast number of factors (somewhere around fifty-seven) that reflect the cost of providing municipal services in communities.

**Yukon:** The Territorial government provides a basic unconditional grant to all eight incorporated municipalities. Whitehorse receives the largest amount at \$1 million annually and in 2005/06, the other seven municipalities will each receive \$650,000 annually.

#### ***C.4 Summary:***

Unconditional grants are used to close a municipality's fiscal gap and to reduce disparities among municipal governments in their ability to provide local services (equalization). At the moment, there are a variety of provincial/municipal unconditional grant programs in use. Some are simple while others are more complicated. Some provinces provide per capita grants. At least one territorial government provides a lump sum grant. Some provinces/territories allocate grants to municipalities with inadequate or insufficient fiscal capacity. Still others take into consideration expenditure needs and the municipality's ability to raise its own revenues. Some provinces pool municipalities into different groups – arranged by population, functions or services provided, rural versus urban and so on. Two provinces use a weighting factor to differentiate the treatment of municipalities. Finally, some provinces have more than one unconditional grant program. About the only thing that is common across all provinces and territories is the lack of federal involvement in unconditional grant programs.

#### **D. Public School Grants**

This section is divided into three parts. First, the strengths and weaknesses of the types of grant formulas that are used in Canada are discussed. Second, characteristics of the education grants used in each province and territory are highlighted. The third part summarizes the discussion.

##### ***D.1 Main Types of Grants***

As noted in section B, provincial grants are used to fund 100 percent or close to 100 percent of all education costs in many provinces and territories, and considerably less in a few. Although differences exist in the major provincial and territorial grant programs, they may be classified as flat grant plans, foundation grant programs, and resource costing models. In addition, provinces generally have a variety of special purpose grants covering things such as special education, language skills, geographic circumstances, learning opportunities, continuing education, teacher qualifications, early learning, transportation, declining enrolments, and school board administration and governance.

##### ***a. Flat Grants***

Flat grant plans provide a fixed dollar amount per student to a school board, district, or division, regardless of the capacity of the board, district, or division to generate local revenues. Given the fixed nature of this type of grant, rich school boards, districts, or divisions receive the same dollar value per student as poor school boards, districts, or divisions. While such a grant may be deemed to be unfair, because it ignores differences in each school board's capacity to generate local revenues, it provides a form of equalization if it constitutes a larger proportionate increase for poor boards than for rich boards.

A grant of this type is used mainly in instances where a province pays the full cost of specialized programs, or where the programs extend beyond the local financing jurisdiction.

### *b. Foundation Grants*

Some provinces have introduced funding programs that have characteristics, more or less, of a foundation grant program. The foundation grant program is based on the premise that it is the province's responsibility (1) to provide a desirable and realistic level and range of programs and services without unduly high local taxes; (2) to enable school boards, districts, or divisions to retain local autonomy; and (3) to avoid undue hardships for school systems affected by circumstances beyond their control, such as enrolment fluctuations or geography. It functions as a grant that is based on shared funding between the province and local school board.

Structuring a foundation grant involves a number of common steps, with some wrinkles introduced to reflect the peculiarities of a particular province. First, the basic or foundation level must be established; this may be done by ranking all school boards or districts from highest to lowest in per pupil expenditures before any provincial grant support, and then by defining the foundation level as that which exists, say, at the 75th or the 85th percentile. There is nothing magical or unique in the choice of this percentile. It may reflect nothing more than the amount of money the province is willing to spend. Alternatively, the foundation level may be estimated as the cost of resources necessary to fund a particular program. The cost could be estimated on the basis of the average pupil-teacher ratio and average teacher's salary, and for a desired range of academic, technical, and vocational courses.

Second, since the foundation level of expenditures is funded jointly by the province and the local school board, the local property tax (mill) rate must be set. For grant determination purposes, this rate must be presumed to be the same in every municipality within the province. The following formula illustrates the calculation of grant revenue for each school board:

$$G_i = (E - t \cdot B_i)P_i$$

where  $G_i$  is the grant to the  $i$ th school board,  $E$  is the foundation expenditure level per pupil,  $t$  is the property tax (mill) rate that the province expects the schools to impose on the local property assessment base,  $B_i$  is the property assessment per pupil in the  $i$ th school board, and  $P_i$  is the student population in the  $i$ th school board.

The application of this formula to the hypothetical example in the table below illustrates the operation of a foundation grant program in two municipalities that are similar in every respect except for the assessed property values per student. Municipality A has an assessment base per pupil of \$125,000 while municipality B has an assessment base of \$75,000. The level of grant support per pupil for each municipality is determined by subtracting the amount of local tax revenue generated per pupil from the foundation grant per pupil. For municipality A, the grant amounts to \$250 per pupil, and for municipality B it amounts to \$1,750 per pupil. The total grant revenue for each municipality is obtained by multiplying the per pupil grant by the total number of students.

Some implications of this grant are worth noting. First, if the uniform tax rate (3 percent in the example) is mandatory, it is a province-wide property tax rather than a local property tax. Thus, no local autonomy can be exercised in the application of this portion of the property tax. If it is optional, local school boards may not impose it, especially if they are satisfied with a lower level of service than is envisioned in the foundation grant (\$8,000 in the above example) or if they wish to reduce local taxes. For example, assume that the residents of municipality B are satisfied with a level of service that could be secured for \$6,000 per pupil. Since their grant has been set at \$3,500 per pupil, their local tax rate would have to raise only the remaining \$2,500. This could be done with a tax rate of 1.67 percent instead of 3 percent. While an optional tax rate provides some local autonomy because it gives the local municipality a choice over the level of education service that it wishes to fund, it may violate the underlying principle behind the foundation program in the first place—that is, it may preclude the achievement of a uniform quantity and quality of education service for each student.

A Hypothetical Example Illustrating the operation of a Foundation Grant Program		
	Municipality A	Municipality B
Number of Students	3,000	3,000
<i>Dollars</i>		
Assessment base per pupil	250,000	150,000
Foundation level of support per pupil	8,000	8,000
Local property tax <sup>a</sup>	7,500	4,500
Per pupil grant <sup>b</sup>	500	3,500
Total grant <sup>c</sup>	1,500,000	10,500,000
<sup>a</sup> Assumes a local property tax rate of 3 percent applied to the assessment base per pupil to determine the amount of local revenue that could be generated from the local tax base for funding education. <sup>b</sup> The per pupil grant is calculated by subtracting locally raised revenues from the foundation level of support. <sup>c</sup> Estimates the total grant funding for each municipality by multiplying the per pupil grant by the number of students.		

Second, under the foundation grant plan, local school boards are able to spend more than the foundation level but they must raise those additional revenues locally. There is no mechanism for equalizing expenditures above the foundation level, nor should there be. If school boards want to exercise their local autonomy and offer a higher quantity and quality of service, they should have the opportunity to do so as long as the local community is paying for it. In other words, if some boards want premium services, they may have them as long as they pay for them.

Third, shifting enrolments may affect either the local tax burden or provincial grants. Returning to the above example, let us assume that every municipality is spending at the foundation level (that is, \$8,000 per pupil). Let the enrolment in municipality A increase by 2,000 students (from 3,000 to 5,000) while the local assessment base remains constant. Assessment per pupil, then, falls from \$250,000 to \$150,000 (the same as in municipality B). Municipality A now receives

the same grant per pupil as municipality B; that is, \$3,500 [ $\$8,000 - (0.03 \times \$150,000)$ ]. This enrolment shift will have no impact on the local tax base; the province will fund the extra cost. Enrolment declines have the opposite effect. Here, the municipality incurs the extra costs while the province reaps the entire savings.

To offset the increasing expenditures per pupil that frequently arise in periods of declining enrolment, provinces may make adjustments to the foundation grant program to spread out the impact of this decrease in enrolment over a number of years. These adjustments could include the use of weighting factors that may be applied to the foundation grant (to raise it) or to the assessed value per pupil (to lower it). In either case, the province contributes to the local cost of declining enrolment. This adjustment gives school boards more time to adjust to the realities of the time.

A further way of adjusting the grants is to use weighted rather than actual numbers of students. Weighting could be applied in one of the following ways. Either it could be used to increase the dollar value of the foundation grant, or it could be used to increase the number of students, which would in turn lower the equalized assessment per pupil. In either case, the size of the grant would increase.

In short, the foundation program has a number of positive features. First, in its simplest form, it is easy to understand and implement. Second, it assists the poorer boards, allowing them to provide a level of service that would not otherwise be possible. Third, it gives a local board the option of exercising its autonomy by providing a level of service in excess of the foundation level.

There are, however, two perceived problems with the foundation grant program. First, these programs have been criticized by local administrators and citizens because the foundation level has not kept pace with the cost of delivering educational services, especially during inflationary periods. While this may be nothing more than a cry for more provincial funding, to allow local boards, districts, or divisions to increase their spending, it has been used as an argument for moving away from the foundation program. Second, vast differences in equalized property values per pupil across a province have meant that some school boards have opted to provide a level of service higher than the foundation grant. While a local board's ability to exercise its autonomy through increasing local expenditures on education should be supported, such action has been criticized on grounds of unfairness because the poorer boards, where they have the power to tax locally, do not have the resources to offer those higher levels of educational service unless they impose higher property tax (mill) rates.

### *c. Resource Cost Model Grants*

The resource cost model is a financing model that contains three basic elements: (1) program and service specifications from the provincial level, (2) student enrolment patterns from the school board level, and (3) resource price and cost data from a "cost of education index." To fund a particular program - for example, the early intermediate program (grades 4 to 7) - the resource cost model works as follow and has been used for some time in British Columbia. The provincial

service level is represented by an average number of students per class. The costs of funding that class are then determined by summing the average employee's compensation package (for example, a teacher's salary, including benefits such as extended health care, and statutory payments such as pensions and unemployment insurance) and an amount to cover the cost of classroom supplies. The size of the grant for each school district for the early intermediate program is thus determined by such factors as enrolment levels and teachers' salaries. The eligible grant for each of the many other services or programs would be estimated using a similar procedure.

The operating grant, as determined using this resource cost model, is designed to reflect intra-provincial differences in the cost of delivering provincially mandated programs. If it is more expensive to offer identical programs in some areas of the province than in others, because of differences in, for example, transportation costs, school size, class size, salary costs, secretarial assistance, and school administration, such cost differences would be captured in the grants.

The evaluation of a resource cost model must address certain issues. First, to ensure accountability and efficiency, the determination of the costs of an average employee's compensation package and of school supplies is critical. This cost may not be the price currently paid by the school board but it should be an average that reflects market prices for comparable services and supplies. Otherwise - that is, if school boards were free to quote any price - there would be little incentive for being efficient and getting the best deal; higher prices would be covered by higher grants. At the same time, school boards that show great efficiency, in being able to employ staff for lower than average salaries or to buy supplies at prices below the average, should be rewarded for their efforts. While correct (market) prices are easily established for school supplies (through local market surveys, for instance), they are more difficult to judge in the case of compensation costs for employees, especially where local school boards bargain independently of each other. The electorate is likely to ask if the local school board was too lenient in bargaining with teachers, and if it thus settled for wages that are higher than necessary. To avoid such challenges, should the average wage level for all school boards be the accepted value? More generally, what benchmark should be used in setting the appropriate price? While answers to these questions are frequently difficult, the practice has sometimes emphasized control of staffing ratios rather than the elimination of any extra expense brought about by above-market salaries.

Second, because the province determines the budget for each school board (at least for the provincially mandated programs), resource cost models have been criticized because they lead to centralized budgetary decision making and to greatly reduced local autonomy when compared with other more de-centralized funding models.

Third, resource cost models tend to be complex, reflecting the many differences in a provincial education system. The model can encompass over 50 different services organized in a number of broad areas: instruction, district administration, operations and maintenance, transportation, and other, for example.

In spite of some potential difficulties that must be resolved in structuring a resource cost model, it offers several advantages over other grant programs. It is based on the actual costs of delivering education in different parts of the province. Greater provincial accountability is secured because provincial funding is tied to approved programs. Finally, as long as local districts or boards have sufficient power to augment provincially mandated programs with revenues collected from local sources, local autonomy can be exercised.

## ***D.2 Funding by Province***

This section summarizes the characteristics of education grants in each province and territory.

***Newfoundland:*** Operating funds come from provincial grants with very small sums of money raised through local donations and fundraising activities. Provincial funding for kindergarten to grade 12 is provided for instruction, school building operations, janitorial and maintenance services, secretarial support, administration, repairs and maintenance. Within each of these categories, funding is based on a variety of factors that affect cost such as student population, school building size, weighted average wage rates, and number of schools. The province also funds the approved costs of school bus transportation (both contracted and school board operated) and school insurance.

***Prince Edward Island:*** The province funds 100 percent of public education costs from general revenue. This includes revenue from a uniform provincial property tax to cover a basic standard of elementary and secondary education from kindergarten to grade twelve. These revenues, however, are not earmarked specifically for education. The *School Act* contains a provision allowing the regional administrative units to levy and collect a local tax for supplementary programs (upon approval by the ministry and by a plebiscite), but that power has never been used.

***Nova Scotia:*** Public schools are financed from general revenues of the province (there is no provincial property tax) and municipalities. The municipal portion, less than twenty percent of total education revenues, comes from a uniform property tax rate set by the province. At the moment, the rate is \$0.351 per \$100 of uniform assessment. In addition, municipalities may provide supplementary funding to school boards for funding optional programs.

The bulk of provincial grant funding is in the form of an operating grant – over 90 percent of total funding – with smaller amounts coming from a series of restricted grants. The latter cover costs associated with special education, learning materials, and school bus purchases.

***New Brunswick:*** All public education costs are funded from general provincial revenues. Included in these revenues is a provincial property tax on all properties, however, the property tax is not earmarked specifically for schools. Legislative provision for using local property taxes to raise revenue for supplementary programs is permitted but seldom used.

Operating budgets are financed from a formula that is based largely on historical cost. Professional salaries are financed on the basis of standards that relate to required school programs and school organization.

**Quebec:** About eighty-five percent of all school costs are funded from provincial grants and roughly fifteen percent from locally set property tax rates. The locally set property tax rate cannot exceed \$0.35 per \$100 of standardized assessment unless referendum approval is obtained from the taxpayers within the school district. Provincial revenues do not include a provincially set property tax rate.

**Ontario:** Education is funded from a combination of provincial grants and an education tax rate on property that is set by the province, collected by the municipality and remitted to school boards. The provincially set education tax rate on residential/farm and multi-residential properties is uniform across the province. The province also establishes the amount of education tax revenue that is to be raised by a property tax on commercial and industrial properties. Local school boards have no taxing power.

There are two types of grants. The first is a general grant and is calculated by subtracting local property tax revenues collected by the municipality and forwarded to the board, from the board expenditures as determined by the provincially set 'Student Focused Funding Model'. Second, there are a series of special purpose grants for funding individual and board-specific needs such as special education, secondary language education, transportation, and additional costs faced by school boards that cover large rural or isolated geographic areas.

**Manitoba:** The public school system is funded by a combination of provincial and local revenues. Provincial funding comes from the general revenues of the province and from the proceeds of a province-wide property tax for education. The provincial tax rate applied to residential property is lower than the rate assigned to other properties. Farm properties (land and buildings) are exempt from the province-wide education tax. In 2002, Manitoba reduced the provincial education property tax on residential property by 10 percent. This tax is to be completely removed from all residential properties by 2007.

Local revenues are almost entirely derived from property taxes on both commercial/industrial and residential property. Local school boards have the power to set local tax rates to fund school expenditures.

Provincial grants to school divisions are largely based on per pupil grants; however, over the past two years, more equalization funds have been provided for school divisions with higher tax rates and lower average property assessment.

**Saskatchewan:** Elementary and secondary schooling is funded by provincial grants and local property taxes. Provincial funding to school divisions is provided through a foundation grant program. The grant is determined by subtracting recognized locally raised revenues from recognized provincially determined schooling expenditures. Recognized expenditures include standard amounts per enrolled student, weighted to reflect cost differences between various

grade levels and school locations (whether the school is in a rural or an urban division); disbursements for services for special needs students, allowances for student transportation in rural areas, and expenses for other items such as room and board provided to certain students in lieu of transportation.

Recognized local revenue is the amount that would be raised if a standard property (mill) tax rate were applied to local property assessed values, plus fees received from other school systems, the federal government, and individuals. The value of the grant is not affected by expenditure levels or tax rates set by individual school boards.

**Alberta:** The province is responsible for funding elementary and secondary education. About half of its funding requirement is supported from general provincial revenues and the remainder from a uniform province-wide tax rate on residential and non-residential (commercial and industrial) property. The residential property tax rate is lower than the commercial/industrial property tax rate.

The provincial funding framework provides money to school boards through three block grants: instruction, support, and capital. The instruction block covers instructional programs and services, which include basic and special instruction, early childhood services, home education, learning resources, native education, and regional assessment services. The support block covers student transportation, related equipment and facilities, and board governance and central office administration. The capital block finances school building projects.

**British Columbia:** Schools are funded entirely by provincial block grants generated from provincial government revenue that includes provincially imposed non-residential (commercial and industrial) and residential property taxes. These taxes are collected by the municipalities and remitted to the province. Although the provincial government sets the rate for school property taxes, there is no necessary connection between school property taxes and provincial grants to school districts. Everyone within a school district pays the same residential tax rate, but the province varies the rate between districts in order to moderate the effects of differences in assessed values across the provinces. If school boards wish to spend more than their provincial grant, the board must seek local taxpayer approval through a referendum for additional expenditures to be financed through local property taxes. This has seldom been used.

The provincial allocation is intended to provide equal access to educational services across the province and recognizes the relative costs of providing programs in each district. Most of this funding is in the form of a common core grant, which allocates a standard base amount to each district, each student based on grade level, and each elementary and secondary school. Variations across districts are recognized in specific district grants. These reflect differences in student makeup such as the number of students enrolled in special needs (high cost) programs such as English as a second language and special education; variation in teachers salaries attributed to salary grid and experience; district size and remoteness; and variations in board spending patterns primarily caused by differences in the cost of operations, maintenance, and transportation.

**Northwest Territories:** Education funding comes from the Territorial government in the form of grants and from local property taxes. Territorial grants include revenue from a territorial school levy that goes into general funds. These grants are for operational expenses and are allocated by a formula that is based primarily on student enrolment. Local property taxes on assessed properties within each school district (where there is a property assessment base) constitute the remainder of the funds, about 20 percent of the total, on average.

**Nunavut:** Public schools are funded under the formula that was used in the Northwest Territories at the time Nunavut was created. Proposals for a unique Nunavut funding formula are under discussion.

**Yukon:** The Yukon government levies a territory-wide school tax on assessed property values. This revenue is added to the consolidated revenue fund of the territorial government, and it is this consolidated revenue fund that is used to finance expenditures.

### ***D.3 Summary***

While provincial and territorial grant programs differ, they have elements of flat grant programs, foundation grant programs, and resource costing models.

The flat grant program amounts to a fixed dollar amount per student, with the revenues generally allocated to specific programs or expenditures. Per student grants are a component of grant programs in most provinces and territories but dominate in Manitoba and the Northwest Territories.

A foundation grant has a number of advantages in provinces and territories where both the province and school boards share in funding elementary and secondary schooling. It is relatively easy to understand and implement. It provides proportionately more assistance to poorer boards and allows them to provide a level of service that would not otherwise be possible. It also has another advantage in that it can be designed to allow local boards some autonomy (through local taxation powers) in providing a level of service that exceeds the foundation level.

The resource cost model offers a number of advantages. First, the cost of delivering a prescribed province-wide standard of service is derived on the basis of local conditions. Second, greater accountability is achieved because funds are tied to approved programs. Third, as long as the local board has access to a local revenue source for services over and above those funded by the province, local autonomy can be exercised. Unfortunately, a major drawback with this program is the potential complexity that may be encountered in administering it. Elements of a resource cost model now exist in most provinces, however.

Of these grant programs, which of them (or which combination) is most appropriate? There is no uniform and widely accepted answer. Per student grants are simple to administer but have some deficiencies. Resource cost models have considerable merit although they are often more complicated to administer. Foundation program grants based on provincially mandated levels of education and shared provincial/local funding have much to offer. Provincial accountability is

secured if there is a reasonably close link between the cost of local delivery and provincial funding. Local autonomy is exercised as long as local boards have the power to set local tax rates to fund a level and range of expenditures that reflect the community's desire.

### **E. Measuring Expenditure Needs**

The inclusion of an expenditure needs measure in an equalization formula is often not without controversy. The trick is to employ an expenditure measure that minimizes (ideally eliminates, but this may not be entirely possible) the opportunity for donee governments to manipulate their spending decisions or choices in order to increase their grants. Here, some expenditure measures or approaches are preferred over others.

For education, provincial and territorial grants tend to fund a provincially mandated level of elementary and secondary schooling entirely, or they are designed to fill the gap between the costs of a provincially mandated level of elementary and secondary schooling, and the tax capacity of the local school board/district to support this level of education. The greater the tax capacity of the local school board or district, the smaller the per student grant; the smaller the local tax capacity, the higher the per student grant. The measure of expenditure need, here, is the actual cost of providing a provincially mandated level of education. This measure, while potentially more complicated to administer because it requires a determination of costs that are likely to vary across a province or territory, is probably the best indicator of education needs as reflected in costs. It essentially eliminates the opportunity for local school districts/boards to manipulate their expenditure decisions to maximize grant support. If local school boards/districts were also permitted to set local tax rates to enhance local programs (this can't be done in most provinces, as was noted above), this scheme would generate considerable local autonomy for local school boards and districts, and permit local citizens to satisfy their wishes for a better quantity and quality of education if they so desired. Principles of fairness, efficiency, accountability, stability, predictability, and transparency could be achieved in such a scheme, or at least achieved better than under alternative measures.

For the current range of provincial/territorial-municipal equalization schemes, expenditure needs can be measured by actual expenditures of the municipality, or average expenditures of all municipalities for the entire province/territory, or average expenditures of all municipalities within a group. If actual expenditures are used, a municipality can engineer its spending decisions to maximize its grant support. This is why this measure is seldom, if ever, used. If average spending for all municipalities or for a group of municipalities is used as a measure of expenditure need, a municipality's actual spending could only affect its grant if its spending affected average spending – an outcome that is unlikely to happen or if it does happen, to be minuscule in its impact.

While a measure of average spending is not a precise measure of expenditure needs, it is probably as close a proxy as one can get for equalization purposes. Equalization grants at the provincial-municipal level differ from provincial-local education grants. The latter are designed to fund some or all of the actual costs of a provincially mandated program. The former are not

designed to fund specific services - these are supported from local own source revenues and/or by conditional or specific purpose grants. Unconditional or equalization grants have a different purpose. They are designed to assist municipalities that are deemed to be poor. A measure of average spending is probably an appropriate proxy for measuring expenditure needs and satisfying the principles for an efficiently designed unconditional grant. Differences in expenditure needs across municipalities, as reflected in spending, has been appropriately handled by grouping municipalities in 'like categories', by using weighting factors within each group to handle differences in needs, and where possible, by including only non-discretionary spending as a measure of needs.

## **F. Are There Lessons for the Federal/Provincial Equalization Program?**

Are there any lessons to be learned from provincial/territorial grants that might be of use in designing and structuring a federal/provincial equalization grant program? Perhaps, there are a few points of relevance.

1. At the local level, equalization grants that include both a measure of fiscal capacity and expenditure needs seem to be superior to those that include a measure of fiscal capacity only. This is almost certain to be true for the federal/provincial and territorial equalization grant, as well.
2. The data and methodology exist for measuring expenditure needs or a reasonable proxy for it. The best examples of provincial/municipal equalization programs based on both fiscal capacity and expenditure needs are in New Brunswick and Nova Scotia.
3. All provinces and territories have considerable experience in measuring the needs of school boards, school districts, or school divisions in order to calculate education grants. Many of these grants have an equalization component because their value per student depends, partially at least, on the local tax base's capacity to generate revenue for local schools.
4. Weighting factors to capture inter-municipal cost differences and needs have been used successfully in a couple of provinces. Weighting factors could also be used to capture provincial and territorial cost differentials attributed to a variety of things; for example, the differential costs of providing services in remote versus urban areas, or densely populated versus sparsely populated areas, or north versus south because of cost of living differentials, or for other cost factors that may be relevant.
5. The most successful (efficient, fair, accountable, and transparent) provincial and territorial municipal and education grants with an equalization component are formula driven as opposed to being 'ad hoc' and discretionary in nature. Any federal/provincial and territorial equalization grant program should be formula driven, as well.

Table 1: Distribution (in percent) of Municipal Government Revenue by Province and Territory, 2003

Revenue Source	Nfld.	Prince Edward Island	Nova Scotia	New Brun. Brun.	Quebec	Ontario	Manitoba	Sask	Alberta	B.C.	Yukon	NWT	Nun.	Canada
Property Taxes	56.5	68.0	72.7	56.3	65.6	49.0	44.0	53.4	45.3	56.8	39.9	25.7	4.9	53.2
Other Taxes	1.1	0.8	0.5	0.5	0.5	1.3	2.5	6.2	1.8	2.8	1.1	1.7	0.3	1.4
User Fees	20.7	22.2	16.4	25.8	16.2	23.6	23.5	25.2	31.7	27.9	19.0	29.9	33.5	23.4
Investment Income	1.3	0.9	1.9	0.6	2.1	4.0	6.6	3.9	9.1	7.8	2.1	0.0	0.0	4.5
Other	0.7	1.4	0.6	0.4	2.2	1.4	0.8	1.0	1.9	0.5	0.4	0.0	0.0	1.4
Own Source Rev.	80.4	93.4	92.2	83.6	86.3	79.2	77.4	89.7	89.8	95.8	62.5	59.7	40.1	84.0
Unconditional Grants	5.0	3.2	2.9	11.2	3.1	2.8	13.4	5.6	0.7	1.3	15.6	15.5	13.1	3.0
Conditional Grants	14.6	3.4	4.9	5.2	10.6	17.9	9.2	4.6	9.5	3.0	21.8	24.9	46.8	13.0
Federal	0.6	0.5	0.8	1.1	0.2	2.0	1.4	1.9	1.0	0.8	6.8	1.0	0.9	1.4
Provincial	14.0	2.9	4.1	4.1	10.3	15.9	7.8	2.7	8.5	2.1	15.1	23.8	45.8	11.6
Total Grants	19.6	6.6	7.8	16.4	13.7	20.8	22.6	10.3	10.2	4.2	37.5	40.3	59.9	16.0
<b>TOTAL</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

- Property taxes: taxes on real property, developers contributions and lot levies, special assessments, grants-in-lieu of taxes and business property taxes.
- Other taxes: amusement taxes, licences and permits.
- User Fees: water and sewage, public transit, public recreation, rentals, concessions and franchises.
- Investment Income: profits from own enterprises, interest and penalties from taxes.
- Other: fines and penalties

Source: Calculated from Statistics Canada data, Financial Management Systems (FMS), mimeograph, May, 2005.

Table 2: Distribution (in percent) of School Board Revenue by Province and Territory, 2003

Revenue Source	Nfld.	Prince Edward Island	Nova Scotia	New Brun. Bruns.	Quebec	Ontario	Manitoba	Sask	Alberta	B.C.	Yukon	NWT	Nun.	Canada
Property Taxes	0.0	0.0	0.0	0.0	13.3	39.1	33.0	50.5	4.4	0.0	0.0	20.3	0.0	23.1
User Fees	0.8	0.3	2.7	0.0	10.3	2.3	2.8	3.3	4.2	4.0	0.0	2.7	0.0	4.6
Investment Income	0.0	0.1	0.2	0.0	0.0	0.1	0.2	1.0	0.6	0.6	0.0	1.2	0.0	0.2
Other Revenue	0.1	0.0	0.1	0.0	0.0	0.1	0.0	0.0	0.1	0.2	0.0	0.2	0.0	0.1
Total OSR	0.9	0.3	2.9	0.0	23.6	41.6	36.0	54.9	9.4	4.8	0.0	24.5	0.0	27.9
Grants:														
Federal	0.7	0.1	0.0	0.0	0.2	0.4	0.2	0.0	0.0	0.3	0.0	1.4	0.0	0.3
Provincial	98.5	99.6	79.3	0.0	76.1	58.1	63.8	45.1	90.5	94.9	0.0	74.2	0.0	71.4
Municipal	0.0	0.0	17.8	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.4
Total Grants	99.1	99.7	97.1	0.0	76.4	58.4	64.0	45.1	90.6	95.2	0.0	75.5	0.0	72.1
<b>TOTAL</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Calculated from Statistics Canada data, Financial Management Systems (FMS).