Innovations in Transfer Payments to Local Governments: The Case of the Gas Tax Fund

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Introduction

The gas tax transfer marked a new beginning of sustained federal engagement with the issues facing municipal governments after a long period of only sporadic interest. As such, it is interesting to examine from at least a couple of perspectives. First, the reengagement itself speaks to new federal policy thinking about inter-governmental relations and about the roles of the municipalities in the country's economic growth and environmental health. Second, the structure of the new program in some ways marks a departure from established forms of transfer programs.

In this paper we first review the rationales for and the taxonomy of inter-governmental fiscal transfer. We then provide a brief overview of the gas tax fund and locate it within the taxonomy of transfers. We conclude by pointing out some of the new departures that the program represents.

Intergovernmental Fiscal Transfers in Canada

Intergovernmental transfers have been historically a dominant feature of the highly decentralized Canadian fiscal framework. While their number, size, and nature have changed through the years since Confederation, these public financing instruments have been consistently used as a way of "facilitating the achievement of the advantages of decentralization while minimizing its adverse consequences for national objectives" (Boadway R. W., 2007, p. 55). According to the Public Sector Accounting Board, intergovernmental fiscal transfers are transfers of monetary assets to another level of government for which the government making the transfer does not: "(a) receive any goods or services directly in return, as would occur in a purchase/sale or other exchange transaction; (b) expect to be repaid in the future, as would be expected in a loan; or (c) expect a direct financial return, as would be expected in an investment" (2007, p. 1). In 2006-2007 intergovernmental transfers in Canada amounted to approximately $125 billion dollars (Public Works and Government Service Canada, 2007). Of this, approximately $1.8 billion was allocated to Infrastructure Canada, of which $590 million represented the Gas Tax Fund (GTF) transfer.

The provisions and practices that guide the use of these transfer payments in Canada have their origin in the notion known as *spending power*, and the Constitution Act, 1867, including its successive amendments. Spending power has been defined as the "power of Parliament to make payments to people, institutions or provincial governments for purposes on which Parliament does not necessarily have the power to legislate" (Trudeau, 1969, p. 4). While not explicitly referred to in the Constitution Act, 1867, it is inferred from the outline of the distribution of legislative power contained in sections 91 (Powers of Parliament), and 92 (Exclusive Powers of Provincial Legislatures):[2]

- Section 91 grants Parliament the power to make "Laws for the Peace, Order, and good Government of Canada," and Section 106 grants it the right to appropriate funds from the Consolidated Revenue Fund of Canada for the "Public Service." Both of these have been used as a justification for spending measures, like transfers, that serve the national interest.

- Section 91(1A) grants Parliament the power to legislate in relation to "the public debt and property," while section 91(3) grants it the power to legislate in relation to "the raising of money by any mode or system of taxation." These provisions provide Parliament with the sources of revenue necessary to support its spending decisions.

- Section 92 (2) grants Provincial Legislatures the power of "direct taxation" in order to raise revenue for provincial purposes. With a few exceptions, like the federal right over custom duties and the provincial right over mineral resources, with this provision both levels of government have concurrent jurisdiction over common tax bases. In practice this means that both levels of government must negotiate the tax room that each can occupy to avoid taxing the same base excessively, and this can result in a vertical fiscal imbalance that, in the past, has been addressed with intergovernmental transfers.

- Section 92 (8), which is the base for the popular conceptualization of cities as 'creatures of the province,' grants Provincial Legislatures exclusive power over making laws in relation to municipal institutions. This provision means that they alone can "create municipalities, allocate powers to them, and prescribe or proscribe their behaviour," but, notwithstanding the political realities, it "fails to restrain the federal government for transferring funds to municipalities, or from spending and otherwise acting within those boundaries" (Sancton & Young, 2004, p. 31).

Furthermore, as Boadway and Hobson argued (1993, p. 6), Schedule B of the Constitution Act, 1982, contained several provisions with "potentially important implications for federal-provincial fiscal relations," including furthering the justification of the use of the spending power. For example:

- Part III (Equalization and Regional Disparities), Section 36(2), establishes the commitment to "the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." This provision directly outlines the continuing obligation of the federal government to make equalization transfer payments to the provinces.

- Section 36(1), establishes that "(a) promotion of equal opportunities for the well-being of Canadians; (b) furthering economic development to reduce disparity in opportunities; and (c) providing essential public services of reasonable quality to all Canadians," as national objectives for which the federal government and the provinces are jointly responsible.

[2] For the full text of the Constitution Act, 1867 and 1982, see: Deparment of Justice Canada (2008)

> While the use of equalization and other transfer payments precedes the Constitution Act, 1982, this provision allows the achievement of these objectives to be used as concrete rationales for different kinds of transfer payments to the provinces for services related to areas such as health, education, and welfare.

This legislative framework, in conjunction with the political and socio-economic environment, guides the transfer payment agenda in Canada. To decide whether an intergovernmental transfer is the appropriate policy instrument to address the identified problem, and to choose the appropriate level and type of transfer, the donor government evaluates, among other things, the fiscal capacity, the need, and the tax effort of the recipient government (Oates W. E., Fiscal Federalims, 1972, p. 86).

Rationale for the use of Intergovernmental Transfers

The literature on fiscal federalism suggests several rationales for intergovernmental transfers, and in practice transfers might full-fill more than one of these objectives.[3]

Closing the fiscal gap

A vertical fiscal gap exists when there is a difference between the constitutionally assigned expenditures responsibilities and own-source revenues at different levels of government. According to Shaw, reasons for this fiscal gap include inappropriate expenditure and tax assignment, limited or unproductive tax bases available to lower levels of government, regional tax competition, and limited revenue-raising potential due to the level of federal government taxation (1994, p. 42). The result can be an inadequate provision of public goods and services.

Equalization

Besides addressing the vertical imbalance, transfers are also used to address the differences between the resources available to governments at the same level, which is referred as a horizontal imbalance. As Ma explained, the difference in fiscal capacities can be the result of, for example, one province or municipality having access to a tax base not available to the others, having a population with higher income levels, or having extraordinary expenditure needs based on their location and their population (1997, p. 2). The result is unequal living conditions, opportunities, and quality of services available for persons in like circumstances in different provinces.

Under this rationale, the goals of the unconditional transfer are: (1) achieving a national minimum level of service, and (2) equalization across jurisdictions of the fiscal effort required to provide these minimum program levels (Oates W. E., Fiscal Federalims, 1972, p. 87). The grant formulas used are carefully design to reflect both the recipients' needs and fiscal capacities to avoid discouraging local revenue-raising effort and local expenditure restraint. The merits of this

[3] See: Bahl (2000**);** Bird & Smart (2001)**;** Boadway R. W. (1980); Boadway & Hobson (1993); Ma (1997); and Shah (1994)

rationale, and the formulas used to allocate the equalization transfers are subject to intense debate both academically and in practice.[4]

Addressing inter-jurisdictional spillover effects

Benefits from the provision of public goods or services, like pollution-abatement measures and inter-regional highways, can cross jurisdictional boundaries. Since local governments only feel politically responsible for serving their residents, and since non-residents enjoy the benefit without contributing to the costs, they tend to provide lower than optimal levels of these goods and services. To address this under-provision, higher levels of government use matching conditional transfers as a practical mean of encouraging expenditures in the desired areas in order to alleviate the inefficiencies created.

Addressing political imperatives and furthering central government's policy goals

Central governments also use intergovernmental fiscal transfers as a way of addressing political challenges and for priority setting in lower-levels of government. For example, a central government might be forced to make a transfer payment to a jurisdiction that might not require the funds, in order to make it politically feasible to make a transfer to other jurisdictions in need (Bird & Smart, 2001, p. 9), or it might direct transfers to politically powerful jurisdictions to get support from its voters (Sato, 2007, p. 174). At the same time, the government might use the conditions set-out in the transfer agreement to leverage the actions of a lower-level government towards achieving policy goals that will fulfill the central government's priorities.

Achieving coordination and efficiency

Another justification is that, compared to local governments, the central government has a greater capacity to assess and collect certain taxes in a cost-efficient manner which can then be redistributed in the form of intergovernmental transfers. In a federation, as Shah stated, "mobility of factors severely limits the redistributive role of local governments" (1994, p. 42). At the same time, this capacity to redistribute resources can be used to achieve coordination and minimum standards for public services. This could avoid disjointed actions and differing levels of efforts at the local government level which can produce uneven outcomes. Furthermore, national standards contribute to the free flow of goods, services, labor, and capital; reduce wasteful interjurisdictional expenditure competition; improve the gains from trade from the internal common market; and serve national equity objectives (Shah, 2006, pp. 35-36). In this case, output-based (performance-oriented) grants should be used to encourage compliance with the standards specified by the federal government.

[4] For an example of a position against equalization payments see Courchene (1978), pp. 145-186.

Taxonomy of Intergovernmental Transfers

Transfers are classified in different categories depending on the restrictions on the purpose to which the recipient government can use the transfer (see Figure 1).[5] According to the conditionality clause, transfers can be either *unconditional* or *conditional*. While there might be conditions that the recipients must meet to receive the transfer, in the case of unconditional transfers they can use the money in any way they choose. Conditional transfers, on the other hand, have to be spent on the specified eligible expenditures, and they may be *matching* or *non-matching*. With matching grants the recipients most cover a specific percentage of the expenditures. Matching transfers can be *open-ended*, where the donor will continue to provide funds without limit as long as the recipient covers its share, or *close-ended*, where the recipient is aware of what the maximum contribution from the donor will be.

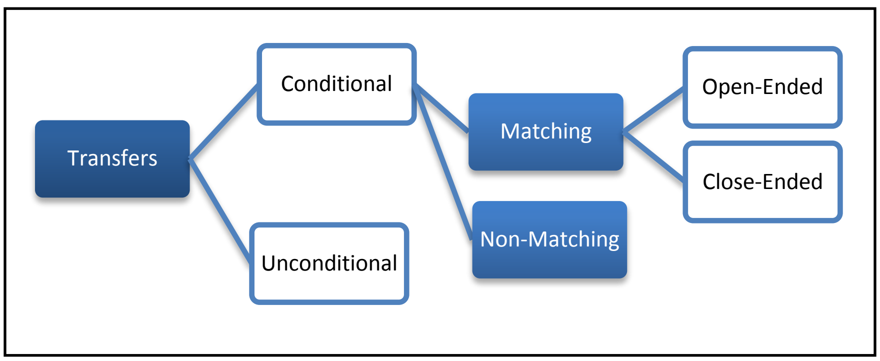

Figure 1_Taxonomy of Intergovernmental Transfers

Unconditional Transfers

Unconditional transfers by imposing no restrictions on the use of the money are flexible by design. They preserve local autonomy allowing recipients to pursue those objectives that will ultimately maximize their own welfare (Shah, 2006, p. 6). As Figure 2[6] illustrates, this type of transfer shifts the recipient's budget line, BB', upwards and to the right, becoming (B+T)(B'+T) where T equals the amount of the transfer. This shift indicates an income effect, but since marginal cost of the public good remains unchanged there is no substitution effect. Assuming that private consumption and public goods are normal goods, with the grant the utility maximizing equilibrium would be e^1, the government expenditures would rise to G^1, and private consumption would be at C^1. Econometric studies of unconditional transfers have found that the typical quantitative effect in spending is less than \$0.50 for each additional \$1 received (Shah, 2006, p. 4). This has led researchers to theorize that the failure of this kind of transfer to

[5] See: Boadway R. W. (1980); Kitchen (2003); Ma (1997); Shah (2006); and Shah (1994)

[6] Adapted from Bruce (2001), p.568. This graph, and the other ones in this section, uses the community preference model. This model represents the preferences of the residents of the recipient community in a series of indifference curves, and the objective is to maximize their utility subject to a budget constraint that changes in the presence of a transfer payment.

stimulate bigger spending might result from the recipient's tendency to use the bulk of the funds as tax relief, either by avoiding a tax increase or by lowering them.

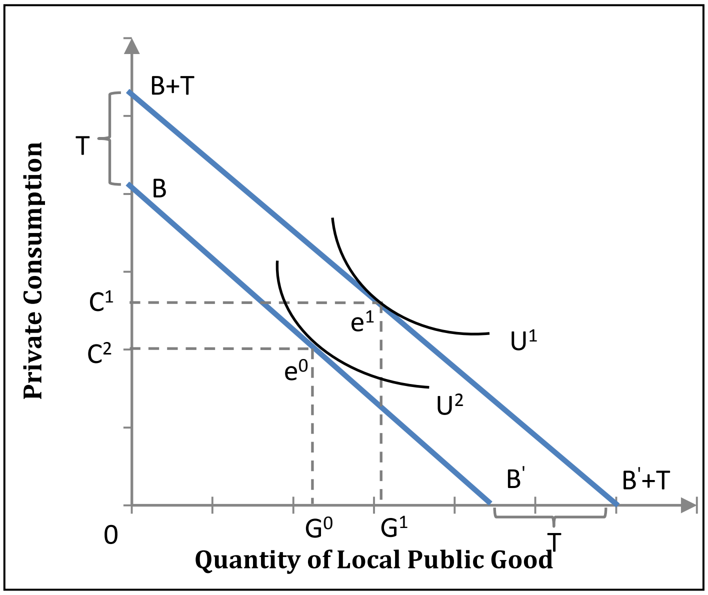

Figure 2_Effect of an Unconditional Transfer

Conditional Transfers

Conditional transfers are "one of the government's key instruments in furthering its broad policy objectives and priorities," because they are designed to incentivize recipients to spend on specific functional areas, such as infrastructure and health (Treasury Board of Canada Secretariat, 2008). The conditionality clause might be attached to the type of expenditure that can be financed (input-based conditionality) which, as Shah (2006, p. 5) explained, can be "intrusive and unproductive," or to the attainment of specific outcomes (output-based conditionality) which "can advance grantors' objectives while preserving local autonomy." In either case, these transfers involve strict accountability frameworks that might result in recipients dealing with bureaucratic red-tape.

Non-Matching (Bloc Transfers)

Similarly to the unconditional transfer, as showed in Figure 3[7], a non-matching transfer shifts the recipients' budget line (BB') upwards and to the right becoming BN(B'+N). In this case, because of the conditionality, the new budget line is truncated above the amount of the transfer (BN). This means that spending northwest of point N cannot be funded with the grant which guarantees that at least 0N of the assisted public good will be provided. These kinds of transfers are "best suited for subsidizing activities considered high priority by a higher-level government but low priority by local governments [...] without distorting local priorities among

[7] Adapted from Bruce (2001), p. 567

alternative activities or inducing inefficient allocations in the targeted expenditure area" (Shah, 2006, p. 6).

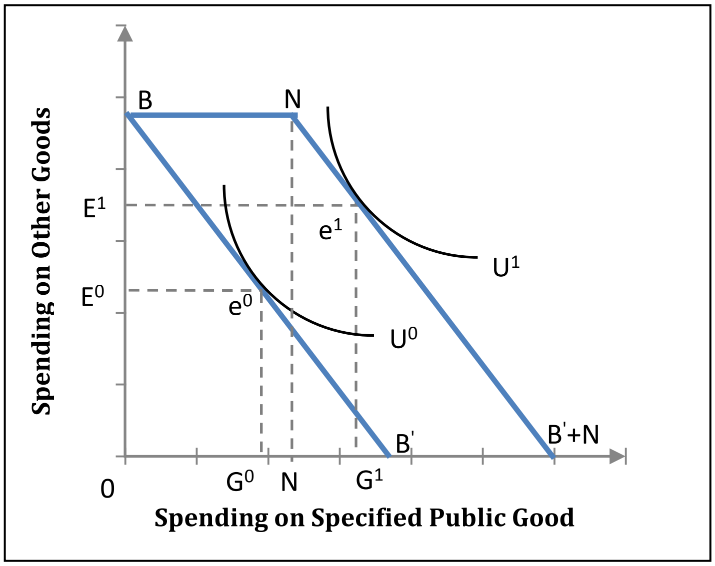

Figure 3_Effect of a Non-matching Transfer

In relation to the effect of this transfer on spending, there has been a lot of theorizing and research done.[8] In theory, despite the accountability requirements, because money is fungible (i.e. interchangeable) even with this kind of transfer the recipient government might reduce its spending on the specified public good, partially or in full, liberating funds for other purposes. This unintended consequence might potentially reduce the intended incremental spending effect of the transfer. The level of fungibility will depend "on both the level of spending on the assisted public service and the relative priority of such spending (Shah, 2006, p. 8)." For example, if the recipient government did not use any of its own resources in the specified public good there could not be a diversion of the funds. According to Oates (1972, p. 77), this potential leakage of funds makes these transfers inadequate for achieving efficient levels of output of specific public goods, but he believes that they should be effective in inducing recipient governments to adopt certain desired practices, like certain budgetary and planning procedures.

Matching

Under a matching transfer, the recipient must spend from its own resources a specified amount, i.e. the match rate (*m*). Because of this, they might be motivated to be more involved in the definition of the purpose of the transfer, as well as to be more efficient and effective on the expenditure of the funds. With the transfer, the tax priced to local residents of government spending on the specified purpose is $1/(1+m)$ per dollar. In theory, the required matching rate, as Bird & Smart (2001, p. 8) argued, faced by the recipient would be: (1) higher the greater the degree of the donor's interest in the specified good or service, and (2) lower the expected degree of local enthusiasm (price-elasticity) and ability (income-elasticity) to support that good or service. In practice, this information might not exist, or it might be difficult to access, making its exact identification a difficult task.

[8] See: Fisher (1982); Hines & Thaler (1995); Shaw (2005); and Wyckoff (1991)

Unlike the previous kinds of transfers, a matching conditional transfer has both an income and a substitution effect. The transfer increases the available resources to the recipient government, and it reduces the relative price of the funded public good allowing the recipient to acquire more of the specified goods (G) for a given budget. The sum of these two effects can be seen in the graph on the left of Figure 4[9], where the original budget line (BB') pivots outwards becoming BM. G^1 and E^1 should theoretically be determined by the strength of each of these effects, where a stronger substitution effect leads to increase spending in G and a stronger income effect might lead to an increase in E. Quantitative studies in this area, as Shah (1994, p. 40) observed, have showed that spending in G increases by less than the amount of the grant, with the remainder going towards other goods (E).[10]

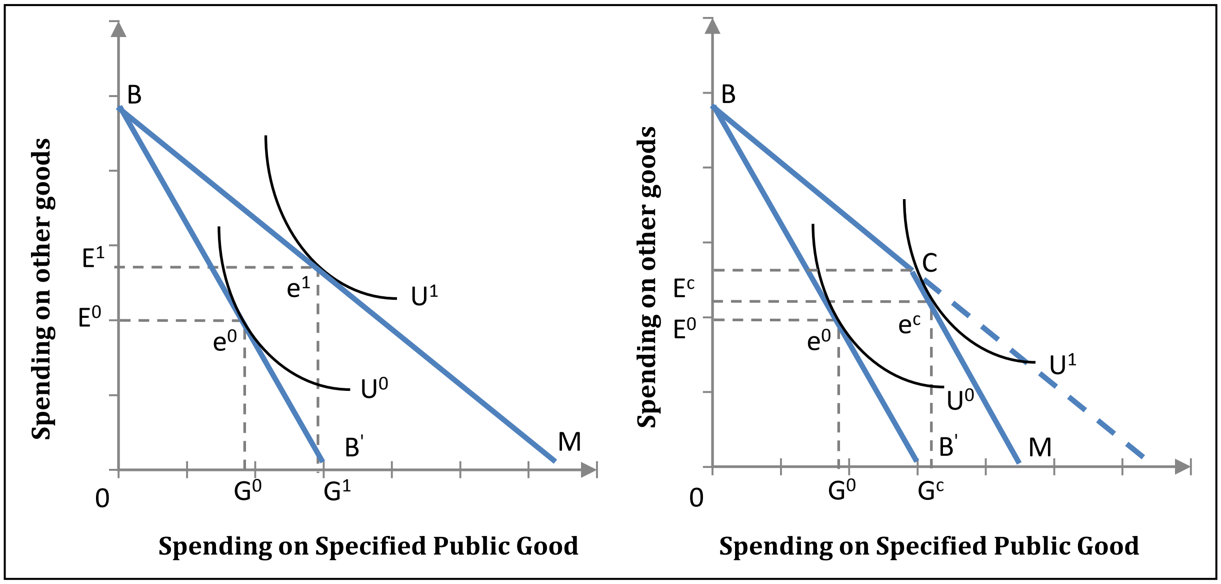

Figure 4_ Effect of an Open-ended and Close-ended Matching Transfer

Matching grants can also be close-ended which allow the donor government to properly budget its resources because they are predictable. From the point of view of efficiency the drawback is that it can lead to the distortion of local priorities. This can result in overspending on the specified activity, and the funding of capital−intensive alternatives because capital outlays are usually subsidized while operating costs are not. The effects of this transfer, as seen on the graph on the right of Figure 4, shows that the maximum value that the government is willing to transfer imposed on spending makes the new budget line BCM kinked at the point of the cap (C). The effect of C on total spending will depend on the level of provision of the good, and in this case the utility maximum equilibrium (e^c) is at a lower point that it would had been in the absence of the cap (e^1). This means that in theory there should be a smaller provision of the specified public good (G^c). If the amount spent falls below C the effect matches that of an open-ended grant, if the recipient spends more than C the effect replicates that of a non-matching grant. Empirical studies in this area have found that "the estimated response to an additional

[9] Adapted from Bruce (2001), p.572; and Boadway & Hobson (1993), p.98

[10] To review some of these studies see: McMillan, Shah, and Gillen (1980); Shah (1986); Shah (1989)

$1.00 of this kind of grant is typically $1.50" which, when compared to an open-ended transfer, implies a larger stimulation of expenditures (Shah, 2006, p. 8).

The Effect of Transfer Payments

As previously outlined, each type of transfer is expected to have a different effect on local expenditures. This effect, as illustrated in Figure 5[11], can range from complete substitution to stimulation (Boyne, 1990, p. 210). In the case of *complete substitution* expenditures are unresponsive to changes in the value of the grants because the money is used to cut local taxes. When the increase in spending is less than the full amount of the grant there is *partial substitution*, where a portion of the money is allocated to cut local taxes. In theory, both of these effects should only be seen in the case of unconditional transfer, but because money is fungible it can also happen under conditional transfers. *No substitution* occurs when the full amount of the grant increases general spending, in the case of unconditional transfers, or is allocated for the intended expenditure, in the case of conditional transfers. With no substitution a change in the value of the grant will directly affect the level of investment. The final effect is *stimulation*, predicted for matching transfers, results in a level of expenditure that is higher than the amount of the transfer.

From an economics perspective the effects of a shift in the value of the transfer will vary according to the type of transfer. On the other hand, from a political perspective, as Boyne (1990, pp. 209-210) argues, the impact could be mediated by: (1) local financial circumstances, (2) the prior size of the transfer, (2) the sensitivity of local authorities to the anticipated reaction of the electorate if taxes levels are increased to compensate for reductions in the level of funding, and (3) the local priorities for spending and tax reduction.

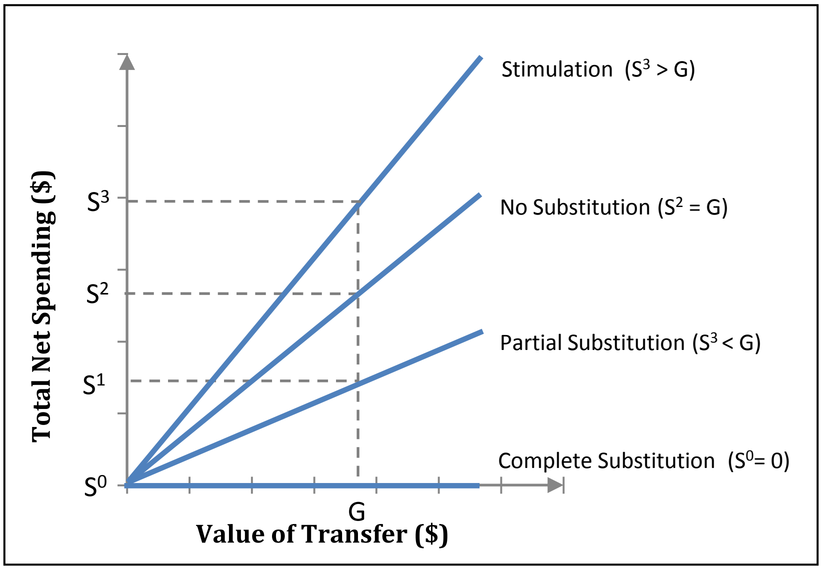

Figure 5_Effects of Grants on Spending[9]

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[11] Adapted from Boyne, G. (1990), p.210

The Case of the Gas Tax Fund

From Advocacy Efforts to 13 Signed Agreements

By the mid-1990s considerable pressures were mounting for the federal government to at least direct fiscal resources to the assistance of municipal governments. These pressures came from several quarters. Interest groups, academics, think-tanks, media outlets, municipal and city employees, among others, developed different channels of advocacy that constantly reminded the federal government that: a) Canada is now one of the most urbanized countries in the world, b) many cities are singularly ill-equipped to cope with the responsibilities downloaded to them, and c) there are a whole range of federal policy concerns including economic innovation, competitiveness, and the quality of the environment that inevitably have an urban dimension (Anderson, 2002, pp. 4-6). Likewise, this policy community focused on critical transit, water, and sewage cases that captured the public's attention because they knew that politicians like to be seen taking action to address very visible problems.

Discussions of Canadian economic growth and productivity increases in a global era focused increasingly on the importance of cities as the foci of economic activity. Well-functioning cities were seen as the key to economic success, and that in turn required renewed infrastructure, human capital investment, and culturally rich environments. Large investments were required to make leading Canadian cities competitive. Other arguments pointed to the impact of federal, and provincial, policies on municipalities and municipal budgets. A prime example was immigration which imposed costs on municipalities for settlement programs, education, public health programs, and in some cases even on demands on basic infrastructure. The cities argued that the higher orders of government should assume responsibility for these costs and increase the financial resources available to the cities. These arguments were even more sharply stated in the case of Ontario, where the downloading of the Harris Conservative government in the late 1990s increased the fiscal straits of the municipalities.

By the early 2000s, the federal government seemed ready both financially and in principle to embrace a new urban strategy. Pressured by a group within government that had been pushing for a city agenda, Prime Minister Jean Chrétien, while still hesitant to move forward on this file, created a Caucus Task Force on Urban Issues (chaired by MP Judy Scgro), in 2001, to identify ways in which the government could better focus its efforts in cities to sustain and enhance their quality of life (Randa, 2001). By 2002, Finance Minister Paul Martin was recognizing publicly that cities were entitled to a new deal in order to address their shortcomings and to be prepared for the economic challenges and transformations brought on by globalization (CBC News, 2002). At the same time, the Task Force released its final report that produced clear evidence that there was a need for federal assistance in municipal infrastructure renewal.[12] Despite these developments, the move from policy promises to implementation were delayed, first, by the uncertainty brought by the Liberal leadership race that culminated at the end of 2003, when Martin succeeded Chrétien becoming Prime Minister, and then by the 2004 elections that yielded a minority government in which the Liberals remained in power.

[12] See: Prime Minister's Caucus Task Force on Urban Issues (2002)

As Prime Minister, Paul Martin was committed to moving forward, and after the election of 2004 the cities and communities agenda was placed front and center. First, Martin asked former British Columbia Premier Mike Harcourt to head an advisory committee to, among other things, “develop a long-term vision on the role that cities and communities should play in sustaining Canada’s quality of life, enrich the discussion of policy options, and provide advice on how to best engage provincial, territorial and Aboriginal governments” (Infrastructure Canada, 2006). Then, the government used the February Speech from the Throne to officially introduce what Martin had been promising on the campaign trail: a New Deal for Cities and Communities (ND). The Speech highlighted that this deal would target the infrastructure needed to support quality of life and sustainable growth; would help communities become more dynamic, more culturally rich, more cohesive, and partners in strengthening Canada’s social foundations; and would deliver reliable, predictable and long-term funding (Clarkson, 2004). Moreover, while Paul Martin had rejected the proposals that called for a share of the gas tax in 2001, because he believed that dedicated tax schemes lead to distortions of taxation and spending (Mohammed, 2002), the Speech acknowledged the government’s intent to set-up the agreements to transfer funds that were at least nominally linked to the gas tax to municipalities.

At this point, stakeholders were hoping that the sharing of the Gas Tax (GT) would be scheduled in the 2004-05 fiscal year, but due to financial and administrative challenges the government was unable to do so. According to John Godfrey, who was first appointed parliamentary secretary with responsibility for urban affairs and then named Minister of State (Infrastructure and Communities), it was important to “find some new incremental source of money – not just re-announced old money – and do it in a way that was clean administratively,” and which would not “come back an embarrass us because we did not figure out how to do it right” (CBC News, 2004).

The government was determined to avoid federal-provincial fights that always are in danger of erupting whenever it ventures into an area that impinges on provincial jurisdiction. For this reason the Martin Liberals did not want to become involved with vetting individual projects; nor were they attracted to traditional forms of conditional grants, the history of which is not uniformly happy and squabble-free. At the same time, in the environment of the “sponsorship scandal” the new religion in Ottawa was accountability. The government sought a regime that would assure them that the money they were prepared to transfer to municipalities for infrastructure would indeed be used for that purpose.

The 2004 Budget and the creation of the Ministry of Infrastructure and Communities was a promising move from rhetoric to action. As soon as he was appointed, Minister Godfrey went across the country to consult with mayors, councillors, and relevant provincial ministers about what such a new deal might look like. After this journey he revealed, in front of the Canadian National Summit on Municipal Governance, the first details of the GT transfer. He mentioned that the total sum over a five-year period would be between $4 to $5 billion, and explained the challenges of designing the transfer in order to ensure that: (a) it was sufficiently simple that municipalities could understand the rules; (b) provinces did not claw back their current level of support; (c) the money went to the municipalities and that it was spent in some measurable incremental fashion on sustainable infrastructure; and (d) it met the needs of the smaller communities, as well as the largest cities, in ways which were relevant (2004a).

After long consultations with key players, like the FCM, city mayors, and councillors, and internal discussions between the Ministry of Infrastructure and Communities, Cabinet and Treasury Board, the government was ready to finalize the details of the ND. These details were revealed in several communications in 2005 and subsequently made official in the 2005 Budget. With this announcement, there was no longer a doubt that the government was finally making public policy with an urban lens. Compared to the other two components of the ND, the full refund of the Goods and Services Tax and the intent to establish a new relationship with the municipalities as recognized governing bodies, the gas tax became the most tangible policy. In May 2005, Alberta signed the first agreement, and after just 7 months 12 of the 13 agreements had been signed by the other provinces and territories (Newfoundland and Labrador signed in August 2006).

A new approach to a conditional non-matching closed-ended transfer

As explained before, to decide whether an intergovernmental transfer was the appropriate policy instrument to address the identified problem, and to choose the appropriate level and type of transfer, the government evaluated among other things, the fiscal capacity, the need, and the tax effort of the municipalities. In the case of the GT transfer, the government had to make an aggregated assessment that recognized the limited fiscal capacity of Canadian municipalities to raise revenues to fund infrastructure projects, and the crumbling state of infrastructure across Canada. The policy in this case had to be successful in closing the fiscal gap while, at the same time, addressing the ND's political imperatives and furthering the federal government's policy goals.

Before choosing this delivery mechanism the government explored other options (Infrastructure Canada, Cities and Communities Branch, January 2007). One of the options considered was a contribution agreement which involved reimbursing the money for funds spent on projects through an application process. The perceived weakness of this approach was that it would have not solved the fiscal capacity problems facing municipalities. Another alternative was a 'vacating tax room' which would have allowed the provinces to increase taxes and, subsequently, increase available funds for the municipalities. The constraint of this approach was that it would have eliminated and/or limited the federal government's ability to influence national issues occurring in the municipalities. The last option considered was a trust fund, proposed by Finance, which involved transferring the money immediately to a special off-budget account from which it would be transferred to municipalities and/or provinces over the designated time period. Due to the loss in control, and the inability to advance federal policy objectives, Infrastructure Canada and the Prime Minister were opposed to this option.

The final decision to choose this transfer arrangement was based on issues of flexibility, constitutional responsibility, and accountability. The set-up of the program had to address, among other thing: (a) the concerns that Treasury Board and Finance had over the fiscal details, (b) the fact that the provinces had to receive the money before giving it to the municipalities, (c) the fact that the municipalities were allowed to choose the projects, (d) the possibility of it becoming continuous/permanent after five years, and (e) the flexibility of allowing municipalities to pool, bank and borrow against this funding.

The GT transfer is a conditional transfer because it was designed to incentivize municipalities to invest in environmentally sustainable infrastructure investments. In this case, the conditionality clause was represented by the list of projects that could be founded, and the list of approved types of expenditures. For example, municipalities can only use the funds to cover capital costs, and cannot use then for maintenance costs, operating costs, debt reduction, or replacement of existing municipal infrastructure expenditures. Understanding the current fiscal capacity of the municipalities, the federal government chose not to require a matching contribution to access the funds.

At the same time, as the transfer payment theory predicts, the expected effect of the GTF on municipal infrastructure spending could range from complete substitution to stimulation. In order to avoid the possibility of substitution the federal government added an incrementality clause in the agreements, where municipalities agreed to not claw-back their infrastructure spending with respect to an agreed time period previous to the implementation of the program. In theory, based on this clause, there should only be 'no substitution,' where spending (S) equals the amount of funds received (G), or 'stimulation,' where spending exceed the amount received (as depicted in Figure 5 in the previous section).

A Hybrid Transfer

While the GT transfer is just one of many transfer payments made by the federal government each year, it is considered innovative because of the way it was set-up, i.e. as a hybrid between a grant and a contribution. According to the current Policy on Transfer Payments, contributions are conditional transfer payments "for a specified purpose pursuant to a contribution agreement that is subject to being accounted for and audited," while grants are unconditional transfer payments which "are not subject to being accounted for or audited but for which eligibility and entitlement may be verified or for which the recipient may need to meet pre-conditions" (Treasury Board Secretariat, 2000).

The GT has some characteristics of a contribution agreement because it contains a complex accountability framework that includes an annual expenditure report, an outcomes report, and an audit report. At the same time, it has characteristics associated with grants because the funding is given up-front, and, while the agreements specify eligible categories (like public transit, water and wastewater infrastructure, community energy systems, the management of solid waste, and local roads and bridges), the federal government is not involved in the selection of specific projects. As Godfrey explained, while it was important for the federal government to focus their attention on a critical issue, environmentally sustainable municipal infrastructure, they knew that setting the criteria by which projects qualify for funding, and allowing municipalities to set the individual priorities for those projects, would avoid the problem of meeting everyone's expectations and needs (CBC News, 2004). Unlike grants the GT Fund was based on a formula, which required annual appropriations, that was determined for the five years funded under the original agreements (2005 to 2010).

Based on these characteristics the Treasury Board ended up characterizing the GT Fund as an "other transfer payment," which are defined as transfer payments "based on legislation or an arrangement which normally includes a formula or schedule as one element used to determine the expenditure amount; however, once payments are made, the recipient may redistribute the funds among the several approved categories of expenditure in the arrangement" (Treasury Board Secretariat, 2000).

A Transfer with Ambitious Objectives

The design of the GT transfer reflected the four key elements of the ND, and complied with the four-pillar model of sustainability in which the ND was based. The fact that Infrastructure Canada had been part of the Environment Canada portfolio (December 2003-June 2004), and the existence of national and international environmental commitments, such as those defined in the Kyoto Protocol, resulted in the emphasis of the program goals on green projects and sustainability. On the other hand, the emphasis on hard infrastructure was the result of an overwhelming municipal consensus that emerged during the consultations. While there was pressure from key stakeholders to earmark the money for big cities, the GT transfer was designed with the belief that no municipality or project was too small. Overall, what characterized the ND was an attempt to "consider communities as a whole -- one that takes each piece of the puzzle and considers how it fits with others to create the big picture" (Godfrey, 2004b). More than money, it called for government players to become more aware of the effects of government programs and policies at the local level.

The first element of the ND was an overarching vision of where Canadian cities and communities of all sizes should be in 30 years. To achieve this vision, the government established the improvement of the quality, efficiency, effectiveness and sustainability of environmental municipal infrastructure as general goals of the GT transfer, as well as cleaner air, cleaner water and the reduction of green house gas emissions as specific outcomes. The second element was money, and the government saw the transfer of the GT as a viable, politically appealing, option to address the need for stable, predictable, long-term funding for municipalities. The third element was utilizing an urban lens when designing policies which would require the involvement of all levels of government with the cities and communities. Prior to the signing of the agreements municipal leaders were part of the negotiating process, and their needs were reflected in the emphasis that the goals placed on the funding of hard infrastructure, and the abandonment of the cultural aspect that was, in principle, part of the ND. Finally, the fourth element was building new relationships with municipalities based on responding to local needs and with the provinces and territories because they have the jurisdiction. To this end, the GT transfer created purposeful partnerships and emphasized flexibility based on the belief that municipalities know what is better for them and will use the money accordingly.

The framework in which the choice of these elements was based rested on a model of sustainability that depends on four interlinked dimensions: environmental responsibility, economic health, social equity, and cultural vitality. Since the early 90s, sustainable development has become a key goal of public policy, within Canada and internationally.

Understanding that there is a connection between quality of life and human health, social equity, long-term planning and integrated decision-making, resource efficiency, technological development, governance and institutional change, the federal government saw the ND as a viable way of moving forward with the sustainability and green agenda (Godfrey, 2004b). This commitment is expressed in the preamble of the GT agreements where the government establishes that the program should:

- foster vibrant, creative, prosperous and sustainable cities and communities across Canada; and enable all Canadians to achieve a higher quality of life and standard of living;
- develop environmentally sustainable municipal infrastructure (i.e. things like urban transit, water projects that pay for themselves, new garbage disposal systems and for some small communities, the rehabilitation of roads and bridges, and community energy systems), and enhance existing infrastructure to aid in their economic, social, environmental and cultural development;
- recognize that all orders of government must work together collaboratively and in harmony to ensure that investments in communities are strategic, purposeful and forward-looking; and
- recognize that open communication with the public will best serve the right of Canadians to transparency, public accountability, and full information.

Additionally, to "accelerate the shift in local planning and decision-making toward a more long-term, coherent and participatory approach to achieve sustainable communities" under the agreements the signatories are required to ensure that municipalities, or some higher level of agglomeration, develop Integrated Community Sustainability Plans (ICSPs) (Planning for Sustainable Canadian Communities Roundtable, 2005). These plans, which required members of the community to integrate and share knowledge and solutions, are expected to allow cities, communities, and First Nations to better understand their future and work collectively towards achieving their goals. With an ICSP they should be able to be chose project priorities, manage efficient and effectively their resources, deliver required services, and monitor their progress towards achieving desired outcomes.

An Allocation-driven, Predictable, Long-term transfer

The GT Fund is closely linked to the federal revenues from the excise tax on gasoline. This is intuitively appropriate. The tax is collected from drivers and vehicles impose considerable costs on municipalities for road construction, maintenance, snow clearing, and policing. Thus, linking this revenue to infrastructure investment seems logical. But in fact, there is no specific link. The federal excise tax on gasoline generates about $4 billion per year. The amount of the federal transfer does not depend on collection levels and does not vary if collection levels increase or decrease. Rather, the program is financed through a charge against the government's Consolidated Revenue Fund (CRF), initially amounting to $5 billion over 5 years.

After the federal government decided to disregard the particular needs of each of the recipients, it chose an equitable allocation formula that distributes to money local governments based on their population[13]. As can be seen in Table 1, the bulk of the funds were scheduled for

[13] To ensure that the less populated province, Prince Edward Island, and the territories received and adequate level of funding, the Federal government set a base amount of $37.5 million. Likewise, it set a base amount for First Nation communities of $62.55 million.

the concluding years, ending at $2 billion in the fifth year[14]. The reasons for this were two-fold: the government, and in particular the Department of Finance, wanted to push the major commitments further into the future; and secondly, it was believed that back-end loading would give the municipalities time to formulate better investment plans.

Table 1: Allocation of Gas Tax Funds (millions of $) from 2005-2010 by province and territory.

		Fiscal Year					Total (millions)	% Of $5 Billion
		05-06	**06-07**	**07-08**	**08-09**	**09-10**		
Provinces and Territories	**Alberta**	$57.2	$57.2	$76.3	$95.4	$190.8	**$476.9**	9.54
	British Columbia	$76.3	$76.3	$101.7	$127.1	$254.2	**$635.6**	12.71
	Manitoba	$20.1	$20.1	$26.8	$33.5	$66.9	**$167.3**	3.35
	New Brunswick	$13.9	$13.9	$18.6	$23.2	$46.4	**$116.1**	2.32
	Newfoundland and Labrador	$0.0	$19.7	$13.2	$16.5	$32.9	**$82.3**	1.65
	Northwest Territories	$4.5	$4.5	$6.0	$7.5	$15.0	**$37.5**	0.75
	Nova Scotia	$17.4	$17.4	$23.2	$29.0	$58.1	**$145.2**	2.90
	Nunavut	$4.5	$4.5	$6.0	$7.5	$15.0	**$37.5**	0.75
	Ontario	$223.9	$223.9	$298.5	$373.1	$746.2	**$1,865.6**	37.31
	Prince Edward Island	$4.5	$4.5	$6.0	$7.5	$15.0	**$37.5**	0.75
	Quebec (not incl. Bill C-66)	$138.1	$138.1	$184.2	$230.2	$460.4	**$1,151.0**	23.02
	Saskatchewan	$17.7	$17.7	$23.6	$29.5	$59.1	**$147.7**	2.95
	First Nations	$7.5	$7.5	$10.0	$12.0	$25.0	**$62.6**	1
	Yukon	$4.5	$4.5	$6.0	$7.5	$15.0	**$37.5**	0.75
	Reported Total	**$600.0**	**$600.0**	**$800.0**	**$1,000.0**	**$2,000.0**	**$5,000.0**	**100.00%**

In the provincial agreements, while there are some exceptions, funds for municipalities are allocated on essentially a per-capita, entitlement basis with some minor adjustments to ensure that the smaller communities receive a base amount. These allocations are subject to change as new Census data become available. One of the exceptions is BC, which for the delivery of the resources created three funds (Community Works, Strategic Priorities, and Innovations), and divided its municipalities into three tiers based on differing community characteristics including population density, degree of urbanization, adjacency of communities to urbanized areas and the need for intra-regional infrastructure. Each tier was then allocated a different percentage of the resources. Another exception is Nova Scotia that created an allocation formula that gives municipalities a percentage of the total allocation depending on their number of dwelling units, their population, and on their five year rolling average of standard expenditures.

In 2007, the Harper Conservatives, re-branded the GT Fund under the Building Canada initiative and extended the funding from 2010 to 2014 at $2 billion per year. Then, in response to

[14]The payments for 05-06 and 06-07 are equal representing 12% of the total allocated amount, and then they increase progressively each year: 16% in 07-08, 20% in 08-09, and 40% in 09-10. The exceptions are Newfoundland and First Nations that signed the agreement in August 2006 and October 2007 respectively.

ongoing requests for stable, long-term funding, the 2008 Budget announced that the GTF would be extended at $2 billion per year beyond 2014 becoming a permanent measure.

A Precedent Setting Transfer?

While more definitive assessments much await future developments, the GT program may be citied in future years as establishing some important precedents.

First, the modified contribution agreement model may prove an attractive option for future federal-provincial fiscal arrangements. It is notable that the federal government was able to conclude agreements with all the provinces and territories without stirring up defensive reactions from the provinces seeking to protect their constitutional turf. Of course, the fact that Ottawa was distributing money without requiring any matching fiscal commitments from the recipients undoubtedly helped; free money is seldom unwelcome.

This approach essentially involves negotiating contracts with the provinces individually to fund a program of mutual interest. Because they are individual contracts, they open the possibility that each one could be substantially different from province to province in order to meet specific needs, although it is interesting that in the case of the GTF the contracts were remarkably similar across provinces. This model also creates a means to conditionalize grants to the provinces without raising provincial concerns of jurisdiction, though whether these (or indeed any) conditions are binding on provincial spending decisions is open for investigation. The fact that a similar set of agreements were concluded by the Martin government in the field of child day care suggests that the model may be more than a one-off set of arrangements for the gas tax.[15]

Second, at least some federal political and bureaucratic officials believe, and hope, that this initiative has established a basis for future direct relationships between the federal government and municipalities. At least in part this belief follows from the fact that the City of Toronto was a direct signatory to an agreement and that it reports directly to the federal government. In part it comes from the series of consultations that Minister Godfrey conducted with mayors and other municipal officials in the early stages of the process. And in part it comes from the linkage to the two municipal organizations in Ontario and BC that are serving as administrators in their respective provinces.

In the view of some, the gas tax program has opened a door to the eventual de facto recognition of a “third order” of government that can relate to the federal level much as provinces do now. In our view, this is reading too much into a more modest initiative. It has opened a more focused federal policy commitment vis a vis municipal issues, and that in itself is important. The nature of future federal-provincial-municipal relations, however, is unlikely to change dramatically in the foreseeable future.

[15] The fact that these agreements were cancelled by the Harper government does not negate this point. They were cancelled because of the type of child care arrangements they embodied, not because of the form of the agreement. Harper kept the gas tax agreements and later extended them.

Finally, a third observation relates to the use of non-government organizations as delivery vehicles for the distribution of funds and the accountability for the use of those funds. These agencies are not NGOs in the usual sense in that they are associations of municipal governments. But they themselves are not governments, and Ottawa's placing them in such a central delivery role is an interesting development.

Conclusion

The design and implementation of intergovernmental transfer payments, as Shah (2006, p. 1) has argued, create incentives that can have "strong implications for national, regional, and local fiscal management; macroeconomic stability; distributional equity; allocative efficiency; and public services delivery." While this overview of the Gas Tax Fund was not intended to be exhaustive nor comprehensive, it highlighted: (1) some of its innovative features, including its hybrid design, its ambitious objectives, and the fact that it is a predictable source of funding for municipalities, and (2) their possible impacts, including allowing municipalities to make long-term plans, choose the type of green infrastructure projects that best suit their needs from the eligible categories, and have a closer relationship with the federal government.

At the same time, we raised the possibility that the gas tax transfer represents a new federal direction in at least two dimensions. First, it possibly marks a reengagement with municipal and urban affairs on an ongoing basis. Second, it may be a pilot for a new form of grants to the provinces, with provinces and the federal government relating more as independent contractors and with the possibility of province-specific provisions within a national umbrella program.

It is, of course too early to conclude that either of these possibilities is determined. The history of federal involvement in urban affairs is much too uneven to know at this stage whether the basis has been found for a long-term federal presence. Similarly the history of federal-provincial fiscal arrangements has been too contentious to conclude that this will be a new model that will dampen the conflicts of the past. But on both fronts, it will be interesting to watch as this unfolds.

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