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Good Housekeeping: The Provincial Imposition of a Hard Budget Constraint on Ontario Municipalities In the Great Depression

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Introduction

Canadian sub-national governments have never been short of challenges or opportunities. Canadian provincial governments have considerable authority to react to challenges and changing environments in contrast to local governments. Despite being the level of government charged primarily with service provision, with limited access to fields of taxation and subject to a hierarchical relationship with senior levels of government, municipalities in Canada have and are expected to respond dynamically to uncertainties in both the political and economic environment. The ability to respond has always been affected by exposure to exogenous economic shocks.[1] The ability to respond in a dynamic fashion has and continues to be impaired by a limited set of fiscal instruments.

Provincial intervention in the 1930s was motivated first by the multiple bankruptcies of municipalities, large and small, unable to cope with the fiscal exigencies created by the Great Depression**.** This intervention was institutional in nature which has been long-lasting and with economic consequences that have yet to be explored. This paper consists of four major sections. The salient facts related to the crisis in local finance are summarized in this section**.** The provincial effort to shore up municipal finance and to control the fiscal decision-making process at the local level in hierarchical manner is also discussed. The legal and administrative mechanics of the constraints are also described**.**

Section .xx contains a review of the most relevant recent literature that reflects the shift from the "fiscal federalism" model of an all powerful national or federal government in the first

[1] See Stiglitz (2002), O'Rourke and Williamson (1999), and Taylor (2003) for discussions of historical and current features of globalization, including the timing and impact of factor flows and financial crises.

generation (FGT) literature to the “federal finance” model of powerful sub-national governments (Bird and Chen (1998) and Oates (2005)), stressing the importance of asymmetries in information and power in the second generation (SGT) literature. The concept of the hard budget constraint as featured in SGT is combined with the concept of “good housekeeping” borrowed from the literature on the gold standard and sovereign borrowing.

At the same time as the provincial-municipal relationship was being redefined by events, the relationship between the federal government and Ontario was also under stress as the economic crisis worsened during the 1930s. The second part of this section examines the federal-provincial relationship confronted by the budget constraint conundrum. The contribution of the acrimonious discourse that characterized federal-provincial relations to the provincial decisions taken with respect to local fiscal matters will be highlighted here. While there is a little evidence of bailout expectations, as will be seen, there is evidence that the senior levels of government did not trust the sub-national level to behave appropriately either.

Section xx a discussion of the indicators of municipal fiscal health for defaulting and non-defaulting municipalities. *Data* To the extent that the statistical analysis confirms the relationship assumed by contemporaries, the imposition of the hard budget constraint would seem to be justified. Section xx concludes.

Thus, this essay furthers the contribution of Bird and Tassonyi (2003) to our understanding of the role of budget constraints in the development of Canadian intergovernmental fiscal relations. It also brings into question the merit of continuing to constrain municipal decision-making within hard hierarchical rules as opposed to letting the market constraint prevail.

Section 1-Fiscal Federalism/Budget Constraints: Hierarchies and Markets: The Hard Budget Constraint (HBC) as a "Good Housekeeping" Rule

The concept of the budget constraint is a key concern in both the literature of fiscal federalism and historical sovereign borrowing. The commitment to no bail outs and the maintenance of independent sub-national taxing powers is at the heart of financial arrangements in a federal system. (Rodden, 2006) While the notion of the soft budget constraint (SBC) was initially devised to describe the context for firms' behaviour in socialist economies in path-breaking work by Kornai,[2] the relative hardness and softness of the constraint is a seminal concern in the literature of the second generation theory (SGT) of fiscal federalism (Oates 2005), describing the implications of the actions of governments at various levels of the governmental hierarchy on each other's fiscal capacity. The development of SGT has been accompanied by a re-examination of the historical development of sub-national public finance, particularly in the United States. (Wallis 2005, Engerman and Sokoloff ***date***)[3] Further, the recent literature that has revisited the implications of the gold standard in the late nineteenth and early twentieth century for sovereign borrowers and defaulters relies on measures that proxy measures of the budget constraint and local fiscal capacity.

Following the seminal publication of North and Weingast (1989), which linked the Glorious Revolution (accountability of the monarch to Parliament) to the enhancement of England's ability to borrow, there has been a considerable scholarly effort re-examining the concomitant development of political arrangements and fiscal systems. The notion that the allocation of taxing and borrowing powers in constitutions can be judged to be "market-

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[2] Kornai, Maskin and Roland (2003) provide a recent survey of the influence of the concept.

[3] For Europe, see Cardoso and Lains (2010).

preserving" has been considered central to the development of credible commitments to repay sovereign debt and to not give rise to confiscatory and arbitrary taxation regimes.[4]

Dyck (1999) makes an effort to place the development of Canada's federal-provincial fiscal framework from 1840 to 1867 into this context. He, however, argues that the debate over the form of the Canadian federal state was more concerned with meeting the demand for the protection of the French-speaking collectivity, relegating market preservation to the provinces. Further, during the pre-Confederation period, implicit imperial guarantees appear to have been the mechanism to provide credibility for loan repayments. After Confederation, the Dominion government would have to address the credibility issue.

Bird and Tassonyi (2001 and 2003) explore the development and workings of the hard and soft budget constraint as a feature of the intergovernmental fiscal arrangements at both levels of sub-national governments. They demonstrate that both market and hierarchical constraints operate in the Canadian context and have seemingly prevented crises in sub-national finance since the Great Depression.

It is not clear that continuing to impose the 1930s straight jacket on municipalities is warranted. Kneebone (2006) also provides evidence that while transfer shocks have had an adverse impact on the ability of Alberta municipalities to smooth taxing decisions, the municipal response has been to reduce borrowing well below sustainable long-run levels and existing limits on debt service.

First and Second Generation Fiscal Federalism

The key elements of FGT have been derived from Oates' "Decentralization Theorem" whereby:

[4] More recently see Dincecco (2011) and Stasavage (2011).

> "local governments can provide levels of public outputs that meet the demands of the residents of their respective jurisdictions. Such an outcome with local outputs tailored to the demands (and particular conditions) of each jurisdiction will clearly provide a higher level of social welfare than one in which a central government provides a single, uniform level of public output in all jurisdictions."

FGT "envisioned a setting in which governments at different levels provided efficient levels of outputs of public goods for those goods whose spatial patterns of benefits were encompassed by the geographical scope of their jurisdictions." Geographical spillovers could be handled by matching grants to a decentralized level of government to allow for the internalization of benefits within a local geographic area. The primary roles for the central government would be the establishment of an equitable distribution of income and the maintenance of high levels of employment with price stability. In FGT, the issue of the budget constraint is recognized explicitly in the early treatments of the tax assignment problem and local capacity to export taxes.

Bird and Chen (1998) usefully distinguish between the concept of "federal finance" and "fiscal federalism" in Canadian context. In the 'federal finance' model, both levels of government are acting as principals with defined sets of authority to accomplish what may be similar goals such as distribution or stabilization. In general the result is a need for conflict resolution entailing processes of negotiation rather than legislative fiat. Given, the extent of decentralized powers over various fields of taxation and expenditure, the Canadian federal-provincial relationship as an example of federal finance has been continuously transformed depending on the relative degree of power. By contrast, Bird and Chen point out that the provincial-municipal relationship fits the "fiscal federalism" concept wherein there is a principal-agent or centre-margin relationship. Within that relationship, the centre sets the rules and in view of this hierarchical pattern of authority, a persistence pattern has been predominant in the provincial-municipal relationship. (See Easterbrook 1990 on these patterns historically.)

Building on empirical work related to decentralization in unitary and federal states in transitional economies and recognizing the role of the budget constraint as an element affected by the realities of intergovernmental fiscal relations, Oates (2005) and Wildasin (2004) summarized the elements of a second-generation theory (SGT) (after Oates) of fiscal federalism. The emergence of the SGT is characterized by ideas drawn from public choice literature and the "expansive" literature on problems of asymmetric information.[5] Oates describes this as a "new" literature on fiscal federalism that "examines the workings of different political and fiscal institutions in a setting of imperfect information and control with a basic focus on the incentives that these institutions embody and the resulting behaviour they induce from utility-maximizing participants." This formulation places various levels of government into the position of principal and agent but it is never entirely clear as to which level is which and also what the direction of causality has been in terms of the visible policy results.

Oates stresses that there is a connection between his work on the merits of decentralization, the analysis of the risks in the evolution of decentralized fiscal systems and the relative hardness of the budget constraint. Risk in this context may be a "pervasive, practical problem" with the "system itself inducing irresponsible behaviour: it is *endogenous* to the system." (Italics in the original).[6] Using these words, Oates sounds rather like Canadian Prime Ministers contemplating the intergovernmental terrain, as we shall see later.

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[5] Oates (2005, 356-357).

[6] Oates (2005, 361). Oates here is following the analysis provided in the various country case studies in Rodden et al. (2003).

Following the insight provided by Kornai's pathbreaking work on the soft budget constraint, Inman in Rodden et al. (2003) provides a simplified version of the sequential game of the soft budget constraint problem.[7] The principal elements of this sequence are:

> "A key feature of the game is that the local governments do not have complete information about the centre's payoffs. The centre may be one of two types-committed or not- and the sub-national governments make assessments about the probability that it is the committed type. In the first stage of the game, the central government sets up its institutions and announces its co-financing and regulatory policies regarding sub-national governments. At this stage, the central government will announce that it is committed to a policy of *never* bailing out profligate sub-national governments. The sub-national government then examines the centre's institutions, policies and statements to assess the credibility of this commitment, making its move at the second stage of the game in light of these assessments. At this stage, it can either spend and borrow within reasonable limits, or attempt to shift costs onto others by borrowing to adopt an unaffordable policy that provides local benefits. If it chooses to spend within its means, the game ends."[8]

Subsequently, after a careful review of the American experience, Inman suggests the following as the lessons learned:

> "Lesson 1: Strong Executives and National Political Parties are Required for Efficiency; Lesson 2: Constitutional Regulations Require Clean Guidelines to Acceptable Legal Behaviours; Lesson 3: A Mature Banking System, Efficient Capital Markets, and a Well-Administered Fiscal System are Needed to Check Bailouts; Lesson 4:A Constitutional Bankruptcy Standard Requiring Local Debt Repayment is Essential; Lesson 5: A Competitive Local Bond Market Disciplines Defaulting Local Governments and Discourages Strategic Borrowing; Lesson 6: With Appropriate Incentives, Local Governments will Borrow Efficiently; Lesson 7:Land Markets May be a Less Effective Check on Inefficient

[7] Inman's chapter provided the theoretical framework for the multi-country study of the problem of the hard budget constraint in the context of fiscal decentralization, which included Bird and Tassonyi, (2003) as one of the country case- studies.

[8] Rodden et al (2003, 8-9). This scenario is also summarized in Vigneault (2006) and Oates (2005).

> Local Borrowing; Lesson 8: Balanced Budget Rules Enforced by a Politically Independent Court Can Control Inefficient Local Borrowing."[9]

Inman concludes that for the most part American local governments face a reasonably hard constraint, largely as a result of balanced budget rules but he does note that subnational governments have "extracted inefficient intergovernmental transfers and obtained access to "inefficient taxation of non-resident incomes and assets."[10] Some of these features existed in Ontario by the 1930s.

Goodspeed (2002) views the soft budget constraint as a form of punishment. His model of the interaction between a central government and regional governments given tax pooling arrangements shows that transfers may reduce the opportunity cost for borrowing by regional governments. If, however, the central government increases grants to other regional governments, the borrowing region will recognize that it will pay for a portion of the resultant tax increases. He suggests that "it is possible for the central government to punish the borrowing region by increasing grants to other regions enough to deter excessive borrowing by any region."[11] This insight is similar to the reality of the relationship among the provinces and the federal government, especially in the Hepburn years as we shall see later.

While there is evidence of an intergovernmental game in Canada between the federal government and the provinces, there is little evidence of municipal borrowing being predicated on a bailout from the Province, at least in Ontario. There is however some evidence of the behaviour modelled by Wildasin (2004). Working from Inman's insights, Wildasin provides a

[9] Inman (2003, 54-68) provides the written argument explaining these lessons in the US context in more detail.

[10] Inman (2003, 70).

[11] Goodspeed (2002, 419) Recently, Besfamille and Lockwood (2007) have argued that a hard budget constraint may have discouraged some investment unnecessarily but conclude that the empirical work has yet to be done.

formal diagrammatic treatment of the budget constraint in the context of local governments and higher levels of government. The discussion turns on the extent to which local or non-residential preferences prevail and the extent to which shifting the budget constraint by intergovernmental transfers is just a normal feature of intergovernmental fiscal arrangements in contrast to “bail-outs.” Essentially, this provides a formal analysis of the commitment problem noted by Rodden(2006).

Wildasin notes that local preferences may prevail with a consequent unwillingness to relinquish control over the delivery of public services. He readily admits that the simple model does not have the time and the political dimensions that need to be taken into account to understand the development of regulatory and contractual rules to deal with fiscal collapse. In summing up a short discussion of appropriate expenditure and revenue assignments, he notes the possible need for “institutional restructuring in order to arrive at sustainable arrangements.”[12] Wildasin concludes with an argument favouring further empirical examination of the workings of bailouts and budget constraints.

Goldenberg (1939) writing the background report on municipal finance for the Royal Commission on Dominion-Provincial Relations was prescient in the following comment:

> “In short, matters of more than local interest not only ought not but cannot be left to a major degree in the field of municipal government; to the degree that they remain a municipal obligation the interests of the province as a whole are injured by the sheer inability of some municipalities to raise the same revenue as others in proportion to population and the amount of expenditure required not to mention the obstacles to provincial uniformity arising from the deliberate adoption by a municipality of a lower standard than that desired as a matter of provincial policy.”[13]

[12] Wildasin (2004, 263).

[13] Goldenberg (1939, 31).

The Budget Constraint and Sovereign Borrowing

Ultimately, the point of having a hard budget constraint is to hold governments accountable for their actions, whether imposed by a senior level of government or by exogenous market forces. The confidence of lenders is increased thus providing borrowers with continuing access to capital at costs similar to those incurred by the most credit-worthy sovereign borrower. As an example of a market-driven constraint, during the late nineteenth century, the classical international gold standard provided the context for international trade and financial flows as well as domestic monetary management. As such, it has been argued that borrowing countries had an incentive to follow prudent fiscal policies and to avoid defaulting on externally held debt in order to be able to access capital at rates similar to those faced by the governments of the capital- exporting countries.

The circumstances of small debtor countries under the gold standard in the late nineteenth century and the circumstances of Ontario municipalities in the early twentieth century were somewhat similar. Both groups were price-takers in the capital market and had little independence in terms of monetary policy, (none in the case of the municipalities) with some flexibility in expenditure and fiscal policy. The literature analysing the impact of the gold standard on sovereign borrowing and sovereign defaults has sought to identify the importance of both measurable economic variables and the more intangible determinant, reputation on government action. Similar variables inform the discussion in the latter part of this essay.

In a seminal paper,[14] Bordo and Rockoff (1996) claimed that adherence to the gold standard and its principles as a sign of fiscal rectitude on the part of a sovereign borrower worked as a "good housekeeping seal of approval." The empirical testing of their model

[14] This paper has given rise to a literature reviewed in Redish (2006).

suggested that the monetary and fiscal policy (keeping the current account and the national budget in balance) that had to be pursued to remain on gold acted as a constraint on the behaviour of borrowing governments. Good behaviour was appropriately rewarded. The impact of measures reflecting domestic monetary and fiscal policy of borrowing countries on the difference in costs of borrowing funds relative to the rate on British consols was tested. Their principal findings were that the interest rates charged on long-term bonds in core capital markets during the era of the classical gold standard varied from country to country and were correlated with the level of long-term commitment to the standard.[15] Similar results were obtained for the interwar period (Bordo, Edelstein and Rockoff 2003) when, even with a weaker institutional construct, the gold exchange standard acted as both a system of information and a constraint on the behaviour of borrowers. Adherence to the gold standard principles seems to have resulted in favourable treatment in the capital markets.

Obstfeld and Taylor (2003) extended the basic Bordo and Rockoff model and sample to twenty-six countries and analyzed the sample in terms of core, periphery and British Empire effects on yield spreads relative to the British consol benchmark. Their results provide corroboration of the earlier work. With respect to the period before the Great War, they conclude that the gold standard "did indeed confer a "seal of approval" whereas two key macro fundamentals, the public debt and terms of trade, seem to have mattered little." By contrast, based on a broader sample, adherence to gold was no longer as rewarded during the interwar period and investors appeared to place more reliance on a country's ability to service debt as shown by the terms of trade and the earning of export revenues.[16]

[15] Bordo and Rockoff (1996, 416).

[16] Obstfeld and Taylor (2003, 265).

Flandreau and Zumer (2004) provide a cogent critique of the "good housekeeping" seal of approval provided by adherence to the gold standard. They make the case that bond prices or yield premiums reflect investors' perception of the risks of sovereign debt. They also provide evidence that contemporary creditors' behaviour was motivated by actual measures of debt burden. Flandreau (2003) estimated a replication of the Credit Lyonnais' credit rating formula as this worked to assess the credit-worthiness of sovereign borrowers in the latter years of the Belle Epoque. Using the net burden of interest service as a share of normal revenue and a "dummy" variable that captures the recent occurrence of sovereign default closely mirrors the Bank's published results of its formula (which has been lost). Again, these are variables similar in concept to the ones used in the empirical analysis which follows.

In a series of papers, Mitchener and Weidenmeier (2005, 2006 and 2007) have also explored various aspects of the sovereign debt market in the late nineteenth and early twentieth century. In particular, on the imposition of the hardest of budget constraints or in their terms "supersanctions", i.e. of the choice of mechanisms to enforce debt repayment, trade credit sanctions, seizure of debtors' assets by creditors, gunboat diplomacy, and international financial control, only the latter two were an effective mechanism for preventing future defaults or "cleansing the reputation of debtors.[17]

Mitchener and Weidenmier (2006) provide a more nuanced approach to the measurement of the impact of the gold standard on the borrowing countries using a data base of 250,000 weekly observations of bond prices drawn from contemporary sources from 1870-1914. In their conclusion, they note that the large currency risk premium in emerging markets is the likely

[17] Mitchener and Weidenmeier (2005, 26). Tomz (2007) is critical of the supersanction view.

explanation for the preponderance of sterling denominated bonds in the international capital market. The study ends with the suggestion that the economic and political determinants of currency risk should be given more consideration in future research. This point comes back to the argument made by some of the critics of the "good housekeeping approach" that the "real debt burden and the economic growth of a country were more important indicators of credit worthiness than membership in the gold club."[18]

Mitchener and Weidenmeier (2007) focuses on the impact of the "Baring Crisis" in Argentina and its implications for Latin America in the 1890s. The study uses information that would have been available to contemporary investors to construct a set of explanatory variables and indicators including macroeconomic fundamentals (a budget deficit ratio, a ratio of debt-to-revenue, a default indicator variable), trade indicators (trade balance, exports per capita), political variables (interstate and domestic conflict) and institutional variables (such as being on the gold standard). They concluded that:

> "macroeconomic indicators such as the debt burden, the budget deficit, and the trade deficit as well as the political variables were generally not very important for pricing sovereign debt during this turbulent period."[19]

By contrast, countries that suspended debt service were charged much higher interest rates in financial markets.[20] The analysis of the data also suggests that being on the gold standard offered safe haven for borrowers that committed to the policy regime during the crisis

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[18] Michener and Weidenmeier (2006, 2) citing Flandreau and Zumer (2004) and Ferguson and Schularick (2006).

[19] Michener and Weidenmeier (2007,33).

[20] English (1996) shows that the states that defaulted in the 1840 had a harder time regaining access to markets, had to issue debt at higher rates than those that had not defaulted upon re-entry into the market.

of the 1890s and that trading more with the UK increased currency risk during the crisis. However, a default had significant adverse impact on access to capital markets.

Section 2-Crises and Constraints: Early Learning – Bail Outs and Alternatives

Bird and Tassonyi (2003) summarize the early development of market and administrative constraints prior to Confederation. Financial problems, and corrective checks – in particular were experienced by provincial governments during the depression of 1875-95 (Perry 1997). As in the pre-Confederation period, many provincial difficulties were occasioned by municipal indiscretions, resulting in provincial action to implement corrective administrative measures. For example, in the early years of the twentieth century, Québec dealt with the bankruptcy of several small suburban municipalities by amalgamating them with Montreal (Poitras 1999) As the twentieth century unfolded, provincial legislative control over local governments became much more extensive, particularly after the 1930s. Most provinces created departments of municipal affairs with extensive powers to influence, and supervise local governments. Explicit provincial control was extended over a wide variety of local government functions.[21]

Borrowing and Taxation: An Intergovernmental Issue From the Beginning

Provincial decision-makers have always had a vested interest in reducing the negative impact of municipal fiscal difficulties on the provincial ability to borrow. Municipal fiscal issues were extremely delicate and momentous in early post confederation Ontario.[22] Some of the cities and towns were perceived to have been crippled by their indebtedness to the Municipal Loan Fund.[23] By 1872, the debts, including the interest owing, amounted to $12 million. “Some

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[21] Buck (1949, 328-30).

[22] Stokes (1993, 176).

[23] Evans (1992, 69).

of the municipalities, having borrowed beyond their needs and their means, could not pay off the principal and interest. It was useless to expect them to do so." Noel(1990) points out that solvent municipalities were concerned lest the government grant "unfair" subsidies, whereas from the perspective of the insolvent, there was nothing unfair in the province assuming deficits that it had implicitly or explicitly countenanced. The Province experienced the extensive use of petitions from solvent councils on this issue.(Stokes 1993)

The issue was resolved through the *Municipal Loan Fund Indebtedness Act* (1873) which "ingeniously employed the province's financial surplus to solve, in a manner both equitable and economically invigorating, the previously intractable problem of municipal indebtedness to the provincial government."[24] While Mowat redistributed provincial funds to solve a debt crisis, Premier Hepburn relied on statutory and market forces to resolve the crisis of the 1930s.

While municipal debt peaked in 1932 (Figure 1) and fell due to a combination of factors including a hard budget constraint imposed by both economic conditions and legal sanctions, provincial debt continued to increase up to 1941 and beyond.

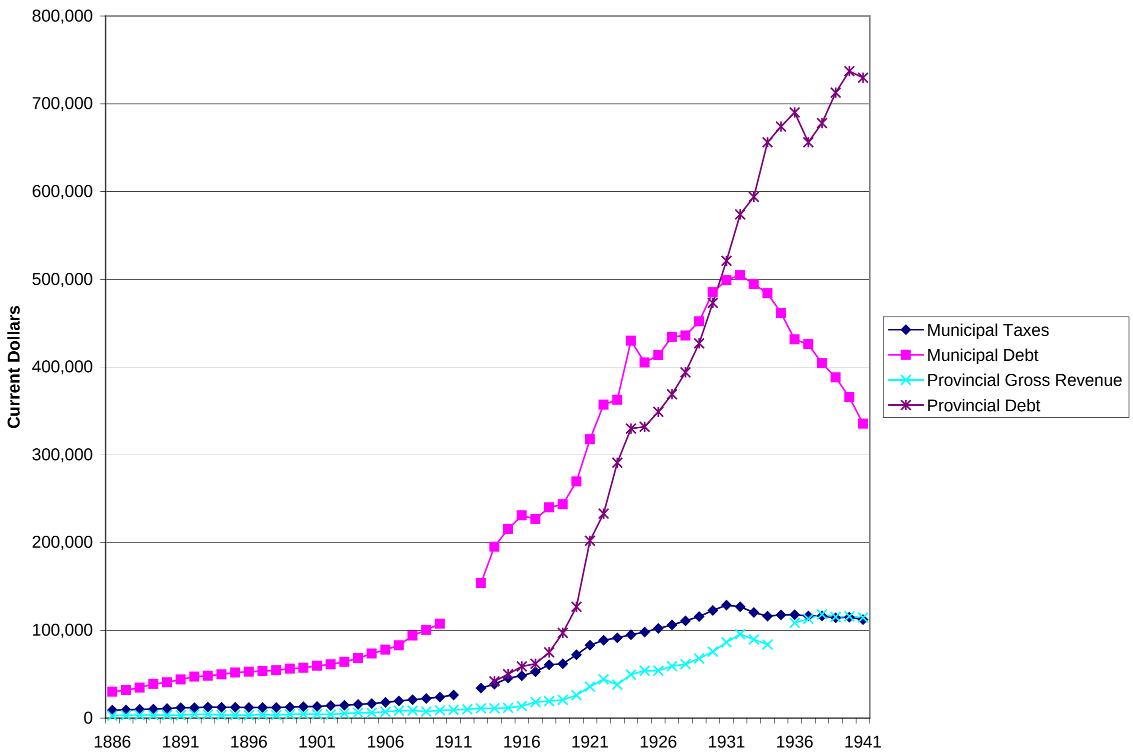
As the Smith Commission (1967) noted:

> "It is interesting to note that the persistent upward trend in Ontario's net capital debt since early in this century appears to display no marked cyclical pattern; debt has grown apace both in prosperity and depression. Thus, the periods of most rapid debt expansion have been:
>
> (1) during the early 1920's when the need for large-scale investment in social capital brought a doubling of the debt within five years;

[24] Romney, Paul, Mowat, Sir Oliver, Dictionary of Canadian Biography accessed at www. Biographi.ca/EN/ShowBioPrintable.asp?Biold=41066, p.6.

> (2) during the mid-1930's, when the catastrophic economic effects of the depression necessitated a great expansion in welfare payments."[25]

Figure 1. Provincial-Municipal Comparisons of Taxes and Debt, 1986-1941 (Current Dollars)



Source: Annual Reports of the Ontario Bureau of Industries, the Department of Municipal Affairs and Drummond (1980).

Changes in the fiscal effort of the two levels of government using the five year averages (data permitting) of the annual ratios over the period from 1886 to 1941, of local (municipal and education) and provincial taxes and debt are shown in Table 1.

[25] Ontario Committee on Taxation (1967, v. 1, 116).

Table 1. Quinquennial Average of Annual Ratios

	Local Taxes/ Provincial Taxes	Local Debt/ Provincial Debt/	Local Debt/ Local Tax	Provincial Debt/ Provincial Tax
	(1)	(2)	(3)	(4)
1886-90	2.97		3.56	
1891-95	3.27		3.96	
1896-00	3.22		4.42	
1901-05	2.85		4.39	
1906-10	2.60		4.41	
1911-15	3.31	4.48	3.57	2.02
1916-20	3.07	3.08	4.14	4.23
1921-25	2.09	1.38	4.10	6.26
1926-30	1.76	1.11	3.99	6.33
1931-35	1.39	0.82	4.01	6.62
1936-40	1.02	0.64	3.47	6.08

Source: Author's calculations.

The figures in column (1) show the relative tax effort of the two levels of government that prevailed. Until the 1920s, local taxes in aggregate were close to or over three times the level of provincial taxes, with a provincial catch-up in the latter part of the 1930s. This ratio illustrates the increasing importance of the province's fiscal effort relative to the aggregate tax effort of local governments. The rapid escalation of provincial indebtedness combined with a decline in local indebtedness is apparent in column (2) as the ratio of local to provincial indebtedness falls from 3.08 in the period 1916-1920 to 0.64 by 1936-40. By contrast, local debt compared to local tax peaked between 1896 and 1910 and remained stable from 1926 to 1935 and then fell with the reduction in municipal borrowing capacity as taxes became uncollectable and assessment bases shrank. The ratio of provincial debt to provincial taxes widened by close to half during the twenties and then increased marginally during the thirties having been almost congruent to the local ratio that prevailed on average from 1916-1920. The increase in provincial indebtedness relative to taxation is apparent in Figure 1 above, albeit the gap between debt and taxes shrank marginally from 1936 to 1940. Provincial decision-makers were well aware of the increase in indebtedness of the province and the potential risks the size of debt relative to fiscal capacity posed in terms of the need to maintain borrowing capacity. [26]

Municipalities in Crisis

The roots of the fiscal crisis that encompassed Ontario municipalities can be traced to several different fundamentals. The 1920s and early 1930s witnessed a significant increase in the indebtedness of Ontario municipalities generally. However, the combination of unsustainable urban sprawl in suburban municipalities, shoddy administrative practice, the responsibility to provide social assistance (relief), and limited access to revenues proved to be too much for some.[27] By August 1934, over 40 Ontario municipalities and school boards had defaulted on their obligations.[28] (Table 2) The majority of the defaults had occurred during 1932 and 1933.[29] Of these only four were cities. When defaults occurred, many of the municipalities were typically "working-class dormitory suburbs- i.e., the poorer residential districts of

[26] Shifting debt to the provincial level however increased the burden on all ratepayers including those in overwhelmed municipalities seeking to reduce their own debt. I am indebted to Herb Emery for this point.

[27] Harris (1996, 151) points out that City of Toronto staff argued against further annexations after 1918 on the grounds that financing infrastructure in the suburban areas was becoming too costly and impairing the city's fiscal position. This left the suburbs in the position of having to take care of themselves.

[28] See Bradshaw (1935, 123). This list is parallel to a similar list of "supervised municipalities" described in (Department of Municipal Affairs 1946, XIII). See Plate 32 – Historical Atlas of Canada, v.3 - the clustering is striking.

[29] The situation of Sturgeon Falls is described by Struthers (1994, 86) as follows: "This northern Ontario company town of about 5000 people was in a hopeless position after Abitibi Pulp and Paper, its only major employer, closed down operations near the end of 1930. Two years later, the town found itself saddled with $350,000 in debentured debt, three out of every four members of its population on relief, and a growing mountain of almost $56,000 each year in unpaid tax levies. Beginning in July 1932 the provincial and federal governments agreed to pay 85 per cent of town's relief bills to stave off municipal default, but Ontario officials soon became horrified at the way the community was spending the province's money."

metropolitan areas."[30] Some of the common characteristics of the defaulting municipalities, including a comparison of the percentage of the population on relief are also shown on Table 2.

Table 2. Defaulting Municipalities, 1931-1941

Municipality	Suburban	Auto	Pulp	Border	Default Date	1939 % of relief/pop.
Etobicoke	x				01/06/1933	9.5
Mimico	x				01/03/1933	12.6
New Toronto	x				01/10/1933	11.9
Scarborough	x				15/12/1932	14.5
North York	x				01/12/1933	9.2
Weston	x				01/07/1934	3.4
York	x				01/10/1933	14.9
Leaside	x	x			01/01/1933	0.2
East York	x				01/10/1933	13.5
Niagara Falls				x	12/01/1933	13.6
Thorold			x	x	01/09/1934	6.7
Fort Erie				x	01/08/1934	7.9
Eastview/Vanier	x					16.9
Sudbury					01/10/1933	4.8
Kingsville		x			06/01/1934	1.2
Essex		x			01/02/1933	7.1
Windsor		x		x	01/12/1932	12.1
Ford City	x	x				
Lasalle	x	x		x	01/02/1932	12.3
Riverside	x	x		x	01/12/1931	9.3
East Windsor	x	x		x	01/12/1931	
Sandwich	x	x		x	01/02/1932	
Sandwich E	x	x		x		11.0
Sandwich S	x	x		x	01/12/1931	0.5
Sandwich W	x	x		x	01/12/1931	17.1
Walkerville	x	x		x	01/09/1934	
Pelee				x		0.0
Tecumseh					01/01/1932	18.3
Dysart					01/12/1932	6.4
Pt. Edward				x	31/12/1933	5.4
Trenton					01/01/1934	14.8
Leamington					01/09/1934	1.0
Hawkesbury			x		01/10/1932	29.0
Clarence					01/09/1933	4.5
Pembroke			x		01/03/1934	7.7
Midland						22.8

[30] RCDPR (1939, Book II, 147). See the discussion in the first essay concerning the impact of sprawl on municipal fiscal health.

Municipality	Suburban	Auto	Pulp	Border	Default Date	1939 % of relief/pop.
Collingwood						16.3
Penetang						18.0
Blind River						26.9
Calvert						6.8
Sturgeon Falls			x		01/09/1933	45.2
Haileybury						3.6
Rainy River						5.1

Source: Bradshaw (1935, 123) and Annual Reports of the Department of Municipal Affairs.

"Dormitory" municipalities around Toronto and Windsor, the border towns, towns dependent on lake shipping and single-industry municipalities dependent on the pulp and paper industry were vulnerable.[31] The Commission of Enquiry into Education Costs noted that:

> … the extension of settlement beyond the boundaries of the city has been due to the migration of wage-earners in search of cheap houses. This type of movement has resulted in the rapid development of thickly populated districts with houses assessed definitely lower than the average assessment of similar houses within the city. The birth-rate in such areas has been higher than the average, usually, and the demand for educational facilities has been urgent. Because the population belongs largely to the wage-earning class, its ability to pay taxes is dependent on conditions of employment within the city. This type of district, as is illustrated in the cases of the suburban areas adjoining the cities of Toronto and Windsor, was among the first to suffer from the decline of employment in the late 1920's. Here the burden of unemployment relief became greatest, at a time when the necessity for providing facilities for education became most acute and the ability to pay taxes had reached a minimum."

Several separate school boards, (mostly in the Windsor area) were also put under supervision. (These included the Brantford, Sandwich East, Sandwich, Sandwich West, East Windsor, Lasalle, Riverside and Tecumseh boards.) As Goldenberg notes, separate boards

[31] The Commission of Enquiry into the Costs of Education (1937, 4). Bliss (1987, 419-421) provides an account of the impact of the economic collapse on various sectors of the economy, including the collapse in pulp and paper and steel production at the firm level.

collected their own taxes[32] unlike the public boards. During the slump, clearly they were unable to do so.

Coincident with the rising levels of municipal debt and debt service payments in the 1930s, Ontario municipalities faced collapses in their property tax bases. Bradshaw (1932-33) indicates that in Windsor, where the Depression hit particularly hard on the local economy:

> "unpaid taxes for 1931 represented 41.5 per cent of the total taxes levied. Of total taxes levied in other leading Ontario municipalities in 1931, Kitchener had collected by the end of the year 91.4 percent, Peterborough 91.2 percent, Ottawa, 91 percent, Hamilton, 87.8 percent, Brantford 86.2 percent, and Toronto 83 percent. Per capita arrears in [Windsor's] Municipal taxes were $12.63 in 1928, $18.04 in 1928, and reached $38.85 in 1931. This last figure compares with $4.48 for Kitchener, $5.41 for Peterborough, $5.65 for Ottawa, $8.25 for Hamilton, $8.40 for Brantford, and $12.71 for Toronto."[33]

In 1931, these arrears represented 49 percent of per capita total taxes in Windsor, 11 percent in Kitchener, 13 percent in Peterborough, 11 percent in Ottawa, 20 percent in Hamilton, 21 percent in Brantford and 22 percent in Toronto. As arrears grew, the banks curtailed short-term loans as security was impaired and the risk of default increased.[34]

The table below shows the steady progression of uncollected taxes as a percentage of taxes levied from various sources for most of the cities in the province. The improvement from 1934 in the depths of the depression to 1939 is also evident.

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[32] Goldenberg (1939, 59) and (Tassonyi 2011).

[33] Bradshaw (1932, 192).

[34] Ontario (1938b, 75) In the submission to the Rowell-Sirois Commission, the Province noted that:

"Up to that time the municipalities' bankers had made the necessary advances to meet their current requirements pending the collection of taxes. With the gradual falling off of tax collections during the depression, to all time lows, in many cases considerably less than 50% of the current year's tax levy, the banks, feeling that their security was being seriously weakened and impaired, declined to make any further advances." For an analysis of the pressures on the banking system, see Drummond (1991).

Table 3. Current Year's Tax Levy Uncollected as a Percentage of Taxes Levied at December 31

Municipality	1927	1928	1929	1930	1931	1934	1939
Toronto	16.1	14.7	14.2	15.5	17.0	21.3	11.7
Oshawa	13.4	14.2	20.9	27.4	27.2	27.8	16.1
Hamilton	13.4	11.9	10.3	11.0	12.2	20.1	12.3
Niagara Falls		17.4	21.5	22.9	29.9	31.7	16.0
St Catharines	9.9	10.0	6.8	10.8	14.6	19.8	12.8
Welland						26.2	15.0
Ottawa	8.4	8.1	8.7	8.5	9.0	17.4	9.5
Sudbury						37.3	19.0
Galt						17.2	9.5
Kitchener						16.6	11.2
Woodstock						10.0	7.6
Brantford	8.3	8.0	8.4	11.8	13.9	27.1	17.1
St Thomas	12.1	10.4	12.3	13.8	19.4	24.3	12.4
Windsor	30.4	38.7	36.4		39.4	25.7	12.8
East Windsor						28.3	
Kingston		1.3	1.7	2.4	3.9	17.9	10.2
Owen Sound							11.5
Belleville	19.9	17.7	16.8	18.4	18.6	24.7	17.4
Chatham	20.7	21.9	21.6	23.5	23.8	28.6	15.6
Sarnia						26.1	14.0
London	10.2	11.2	11.0	12.6	14.9	19.0	11.9
Stratford						23.4	13.7
Peterborough						13.9	8.6
Guelph						27.4	19.7
Sault Ste Marie						34.9	18.4
North Bay						22.4	19.4
Fort William						10.4	
Port Arthur						18.4	12.2
York Tp	30.9	27.7	27.1	31.2	35.3		24.2
East York	34.2	32.4	31.0	33.9	36.1		25.9
Average	**17.5**	**16.4**	**16.6**	**17.4**	**21.0**	**22.9**	**14.5**
St.Dev.	9.1	10.0	9.7	9.2	10.6	6.7	4.5
COV	0.52	0.61	0.59	0.53	0.50	0.29	0.31

Note: COV= Standard deviation divided by the average.

Source: Cassidy (1932, 260), Ontario (1938c, 33) and Annual Reports of the Department of Municipal Affairs (1934, 1939) and author's calculations. (Tassonyi 2011)

Data for 1921, 1933 and 1939 are available to compare the fiscal situation in municipalities in default to other municipalities. Generally, as can be expected, those in default had on average higher debts and debt service obligations and a weaker assessment base per capita. In the municipalities that defaulted on their debts, the average total (municipal and school) per capita debt went from $108 in 1921 to $215 in 1933 compared to an increase from $174 to $194 in cities generally and 1933 levels of $153 per capita for all municipalities greater than 5,000 in size and a provincial average of $152 per capita. Measured in 1900 purchasing power, the average total debt per capita in the municipalities that defaulted went from $47 per capita to $129 between 1921 and 1933; in the cities, from $75 to $117. These numbers are evidence of the greater recourse to borrowing by municipalities that ultimately ended up having their financial affairs under supervision. (Tables 4 and 5) ***insert provincial averages***

Table 4. Average Per Capita Taxes and Debts of Ontario Municipalities, (Current Dollars)

	Municipal Taxes Per Capita			**School Taxes Per Capita**			**Total Taxes Per Capita**		
	1921	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
	$	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Cities	23.85	29.37	24.87	11.81	13.27	13.62	35.66	42.64	38.29
Urban	26.57	24.67	17.81	8.91	9.59	9.74	25.48	34.26	27.56
Supervised	21.01	30.86	19.67	9.99	11.57	9.73	30.25	42.43	29.40
	Municipal Debt Per Capita			**School Debt Per Capita**			**Total Debt per Capita**		
	1921	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
	$	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Cities	149.21	157.89	107.76	23.42	35.80	27.39	172.63	193.69	134.14
Urban	64.88	106.13	72.64	17.66	29.25	16.75	79.99	134.43	86.88
Supervised	88.00	182.13	116.42	21.87	34.18	19.33	107.62	214.65	126.83
	Taxable Assessment Per Capita								
	1921	**1933**	**1939**						
	$	**$**	**$**						
Cities	916.20	1015.40	893.74						
Urban	760.55	731.80	643.31						
Supervised	806.88	798.63	630.28						

Source(Tassonyi 2011)

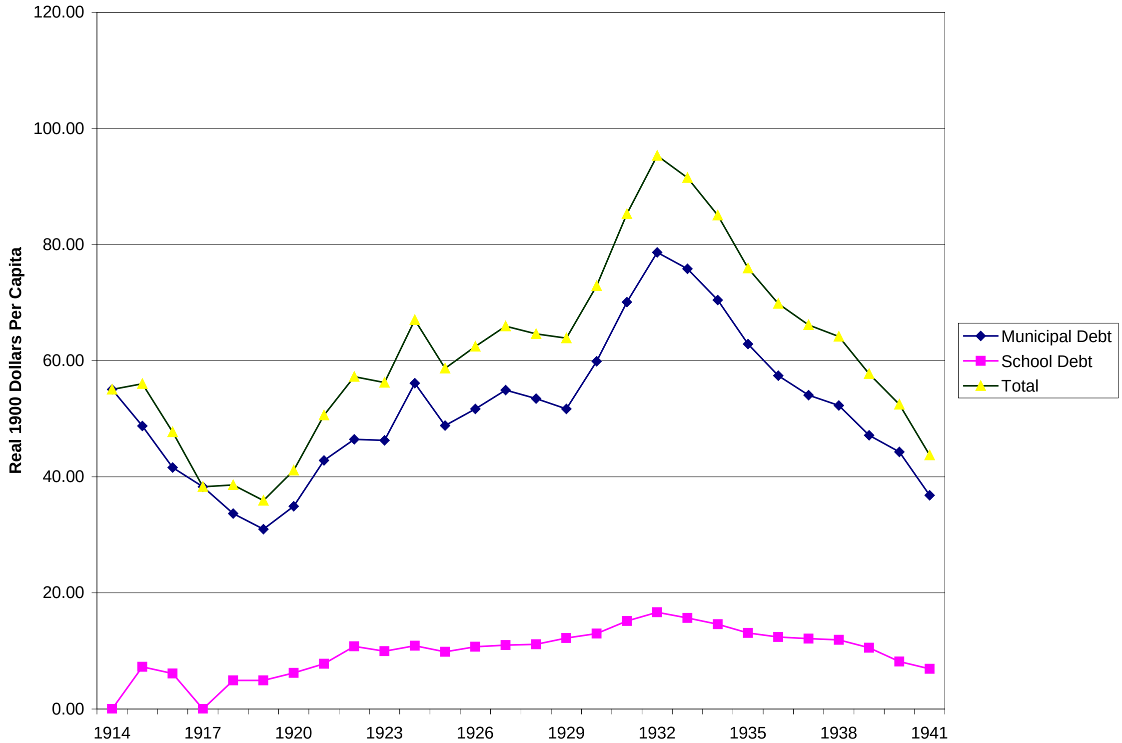
Table 5. Average Per Capita Taxes and Debts of Ontario Municipalities, ($1900s)

	Municipal Taxes Per Capita			School Taxes Per Capita			Total Per Capita		
	1921	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
	$	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Cities	10.41	17.69	12.65	5.16	7.99	6.98	15.57	25.69	19.64
Urban	7.24	14.86	9.13	3.89	5.78	4.99	11.13	20.64	14.13
Supervised	9.17	18.59	10.09	4.36	6.97	4.99	13.21	25.56	15.08
	Municipal Debt Per Capita			**School Debt Per Capita**			**Total Debt per Capita**		
	1921	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
	$	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Cities	65.16	95.11	55.26	10.23	21.57	14.05	75.38	116.68	68.79
Urban	28.33	46.34	31.72	7.71	12.77	7.31	34.93	58.70	37.94
Supervised	38.43	109.72	59.70	9.55	20.59	9.91	47.00	129.31	65.04
	Taxable Assessment Per Capita								
	1921	**1933**	**1939**						
	$	**$**	**$**						
Cities	400.09	611.69	458.33						
Urban	332.12	440.84	329.90						
Supervised	352.35	481.10	323.22						

Source: Tassonyi (2011)

The average of the taxes per capita of the defaulting municipalities was lower than the average for cities but higher than the provincial average (Table 4). Using a different indicator, on average, in the defaulting municipalities, debt was 27 percent of total assessment compared to 19 percent in cities and 11 percent province-wide in 1933, a level of indebtedness that would prove to be unsustainable. (Table 9, below)

Figure 2. Real Per Capita Debt, 1914-1941 ($1900s)



Real local debt per capita increased, from under $60 per capita in 1921 to nearly $100 per capita by 1934 (Figure 2).[35] Goldenberg(1939) suggested that the increase in debt outstanding in the 1930s was directly attributable to deficit financing and relief borrowing.[36] This statement may not be wholly correct. With respect to municipal purpose debt, borrowing for local improvements was significant and not entirely relief-related, rather, a variant of "tax-less finance" (Wallis 2005). With respect to education, as the Committee of Enquiry into Education Finance reporting in 1937 pointed out:

> "… from 1910 to 1920 the total debenture debt of municipalities, incurred for purposes of education, increased from $10.6 million to

[35] Calculated from the Annual Reports of the Department of Municipal Affairs and deflated using the Minns and MacKinnon (2007) index as adjusted. See Appendix in Tassonyi 2011 for details.

[36] Goldenberg (1939. 77).

> $40.7 million and that in the next decade it increased to $86.6 million. The debenture debt continued to increase until 1931, and during the subsequent five years, declined to the extent of more than $12 million…. From 1920-21 to 1929-30 there was a substantial increase in the cost of education due primarily to the public demand for more extensive training in secondary schools and for a type of practical training which involved the erection of new buildings and the installation of relatively expensive equipment."[37]

Most of the school debt reduction after 1929 took place in villages and towns, while rural and city indebtedness, also in decline, was less drastically reduced. Bradshaw notes the impact of school board debt in Windsor in particular as this debt was wholly financed from the general tax rate (i.e. property taxation):

> "$4,393,905 or 56% of the whole of the debenture debt, which affects the general tax rate has been incurred for educational purposes and the debt charges represent 42% of all of 1932 debt charges entering into this year's 37 mill tax rate. It is important to appreciate that Windsor's main permanent debt has been incurred for education- an investment which undoubtedly is bearing heavily upon the taxpayers just now but which no doubt may justify itself in the future."[38]

The obligation on municipalities to keep the finances of public school boards whole put additional pressure on the ability of municipalities to stay solvent.

"Municipal Maladministration"?

The severity of the crisis in many communities provoked both "creative" responses from municipal officials and, and provincial unease as to what was going on. In York Township, for example, an enquiry found that "in their desire to assist the unemployed and secure as large a payment as possible from the Governments of the Dominion and the Province, the officials

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[37] Committee (1937. 20).

[38] Bradshaw (1932, 195).

undertook works that should not have been commenced at the time. They also claimed expenditures which were not properly within the scope of the agreement with the Province."[39]

Bradshaw (1932) suggests that defaulting municipalities like Windsor suffered from a lack of diversification of revenues and insufficient economizing of expenditures:

> "It was surprising to me to learn that Windsor had no personal income tax- a tax which is very general in the more important Ontario municipalities. It is a source of considerable revenue and is regarded as both equitable and fair. I respectfully suggest that Windsor carefully look into this important source of revenue- which appears to me to have much merit and which would not discriminate against Windsor for the reason that the larger municipalities of the Province have adopted it. … "That the City of Windsor, notwithstanding the action of Border municipalities, shall at the earliest possible time assess and levy, in accordance with the Act for personal income. It is understood that of all the Cities in Ontario, Windsor and East Windsor are the only Cities which do not obtain revenue from this source."[40]

Of course, revenue diversification into local income taxation as a municipal option was removed by the provincial government, more or less coincident with the tightening of borrowing rules.

Contemporary opinion suggested that the problems faced by municipalities during the 1930's were not entirely created by the downturn in the economy. One observer wrote:

> "The consequences of extensive capital expenditure, which could only be justified by the realization of great increases in population, cannot be overemphasized. The years 1927-29 were particularly productive of debenture indebtedness arising from local improvements designed to serve larger populations than then existed."[41]

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[39] Commission of Enquiry into York Township. (1933, 9).

[40] Bradshaw (1932, 202, 214). This was prior to the abolition of the municipal authority to use income taxation.

[41] Macpherson (1935, 325). Hanson in Boothe and Edwards (2003, 83) noted: "Urban municipalities overreached themselves in the years before 1914 in terms of subsequent economic development. Edmonton was the most conspicuous example, for it paved streets, laid out street railway tracks, installed sewers, and many other

Uncontrolled development was also cited as a cause of municipal difficulty.

> "The West is not the only part of the country where one may find miles of sidewalks, pavements and water mains with no or isolated houses, the result of the unrestricted imagination of some realtor, the simplicity of some purchasers and the gullibility of municipal councils. The local improvement debenture debt in some cases has exceeded 68 percent of the total. ... The time may not be far distant when it will be legally impossible to sell any part of a sub-division until all the improvements are in and paid for." [42]

The Report of the Committee of Supervisors of the City of East Windsor had also noted:

> "The heavy capital expenditures for local improvements and schools, following a period of unwise real-estate speculation, were the main factors causing the present financial embarrassment of the city. Heavy additional tax charges which had to be levied against the properties benefited by the local improvements, and additional taxes for school purposes, proved so onerous that in many instances it was impossible for the ratepayers to meet them."[43]

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improvements in outlying sections of the city, in anticipation of a population growth that did not materialize for many years. Indeed, many of the facilities provided were not fully utilized until the 1940s. As a consequence, the city was saddled with high debt and tax burdens, and urban economic development tended to be retarded accordingly." The Bank of Canada (1937,15) commented that "The majority of the Winnipeg suburbs were caught by the depression in a vulnerable position, as a result of ambitious expansion programs, and were early forced into default."

[42] Brittain (1934, 389).

[43] Brittain (1935, 389). The point was also reiterated in the Report of the Royal Commission on Border Cities Amalgamation (1935, 4-5).

"Supplementing the patriotic desire of the civic fathers to anticipate the requirements of the rapidly growing communities was the profit-gaining motive of the real estate speculator whose object was to have city services extended to the locality in which his subdivision area was located. His interest led to an exaggeration of the necessity for the opening of streets, laying of pavements and installing other services so he, the big speculator, could in this way more surely unload at a worthwhile profit, his holdings on the little speculator. City and town councils were too easily imposed upon by propaganda emanating from such interested sources to enter on unnecessary undertakings under the local improvement system whereby vast debts were contracted under the assumption that the general taxes reaped from the subdivisions would more than take care of the corporation's share of the improvements and that the owner's share would be met by the special frontage tax.
The real estate boom having collapsed it has now developed that much of this land has <u>ceased to pay any taxes whatsoever</u> and has had to be taken over by the municipalities and is now lying barren, unproductive and unsalable, the <u>burden of both the corporation's and owner's share of local improvement debt thus falling on the overburdened shoulders of the general taxpayer.</u> To summarize the situation with respect to municipal services, it may be stated that in the area with a population of 100,000 persons, there are services fully or partially provided sufficient for a population of 200,000 a large percentage of which will, in all probability, be depreciated to the point of extinction without having served any useful purpose. (emphasis in original).

The abandonment of property was not just an issue in the Canadian context. Field has suggested that uncontrolled land development that took place during the 1920's hampered the recovery from the depression in the United States by virtue of the "physical and legal detritus" left behind.[44]

While much of the criticism of local administration was rhetoric emanating from senior levels of government, shoddy administrative and budgetary practices likely did contribute to the likelihood of default. Adequate provisions for uncollectible taxes were not made. Property was often over-assessed[45] with the intention of overstating the tax base and tax due dates were set late in the year creating forced reliance on banks for short-term loans. The Director of the Citizen's Research Institute of Canada noted:

> "A municipal system which cannot bear up under strain is not adequate. Municipalities in time of fair weather should prepare for storms, by conserving, so far as possible the tax paying power of their citizens and by giving as few hostages to fortune as possible by keeping very close to a pay-as you go policy."[46]

In a contemporary textbook, Wrenshall noted:

> "... In order to maintain control over the budget for permanent works, definite plans must be laid and carried out. A haphazard undertaking of expensive works can only result in confusion and in top-heavy financing. In many of the defaulting municipalities much of their trouble has been caused by unwise and unnecessary construction work."[47]

In summary, contemporary critics may have overemphasized "municipal maladministration" but the crisis did expose the weaknesses inherent in exclusive dependence on

[44] Field (1992, 785).

[45] Some have argued that this practice was purposefully done to evade the somewhat weak constraints on municipal borrowing. (Brittain (1934.387-388).

[46] Brittain (1934, 392).

[47] Wrenshall (1937, 53).

property taxation when owners lose the capacity to meet their obligations and when constraints on land-use are weak.[48]

Section 3 -Provincial (Over)Reaction: The Institutional Transition to a Hard Hierarchical Constraint

Implementing the Hard Budget Constraint [49]

In Ontario, the severe effects of the Great Depression on both provincial and municipal finances led the provincial government to modify drastically the existing framework for the regulation of borrowing and financial administration. In the course of the 1930's, several significant legislative and policy initiatives were taken by the provincial government in an effort to forestall a complete collapse of municipal finances throughout the province.[50] In 1932, the Province established the Ontario Municipal Board (Board) combining functions of the Ontario Railway and Municipal Board and the Bureau of Municipal Affairs. (*The Ontario Municipal Board Act*, *1932*, 22 Geo. V. ch. 27).[51] This body was given extensive power to improve the quality of administration and financial reporting and to approve the borrowing of municipalities. Specifically, the Board was given the power to validate the borrowing by-laws of municipalities, to consider the nature of the undertaking, the financial position of the municipality, its existing

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[48] Plumptre (1935, 78) in a report commissioned by the Minister of Municipal Affairs wrote: "It is no mere accident that, with the exception of the city itself and the two residential villages, every municipality in Greater Toronto has recently defaulted in its obligations… The load so lightheartedly assumed by these municipalities in good times was a direct outcome of their suburban location and their lack of strong government."(emphasis in original). Plumptre subsequently served as the Canadian executive director of the International Monetary Fund and the World Bank

[49] This section is based on Tassonyi (1994).

[50] While the Hepburn government was often critical of its predecessor in its publications, the submission to the Rowell-Sirois Commission is not particularly partisan and provides a useful summary of the views of the government with respect to the measures taken by both administrations in implementing the hard budget constraint. Ontario (1938b, 72-77).

[51] Laskin (1937) provides a comprehensive view of the Board's authority. (I am indebted to Harry Armstrong for bringing this thesis to my attention.

set of obligations and any other matters worthy of consideration. At this point, an application to the Board to secure the validity of a debenture by-law was a voluntary matter unless expressly provided for by law.

Regarding applications for debt for local improvements to be funded from charges levied on benefiting landowners, the Board was to require that statements of arrears be furnished to indicate whether the land in question was capable of bearing any further burden. With respect to additional capital expenditures that would be financed at large, the former Chairman of the Board indicated that: "the Board's concern, of course is with several factors which are elementary to all municipal officials in judging the wisdom of incurring further capital expenditures. Such factors are: the present debenture debt, the assessment, the tax rate, arrears of taxes, bank loan, and the percentage of current levy collected." (The same indicators are still prominent in the current Ontario regulations on municipal capital borrowing.) Cross also noted that: "No hard and fast rule has been laid down in connection with applications. The Board of course pays heed to the principle that the debenture debt should not exceed 12 percent of the assessment, and when tax collections fall below 85 percent it is an indication that the burden of taxation has reached a point where danger may be threatened unless the burden is relieved or tax collection methods, if lax, be improved."[52] The data on Table 5 shows solvent municipalities having debt/assessment ratios near 15-16 percent in 1933 and the municipalities under supervision with a ratio averaging 23 percent in 1933 and 22.3 percent in 1939 compared to approximately 12 percent elsewhere. (Table 15 below shows this comparison by individual supervised municipalities.)

[52] This section is based on an address given by Cross in Chatham on January 31, 1939. PAO, Dept. of Municipal Affairs, Minister's Office Files 1937-1940, Addresses- RG 19 a-1-B.

The OMB and Relief[53]

Using the authority provided by the *Unemployment Relief Act*, *1931* and *1932*, municipalities that had agreements with the Province were permitted to use debt financing to fund relief works. However, Board approval was required for the debenture by-laws. In 1933, a new version was adopted which gave municipalities the authority to provide relief directly and to borrow the necessary funds with Board approval. However, such debentures were to be limited to a five-year term. The Board, however, could, in special circumstances extend the term to a maximum of ten years. A new act was passed by the Hepburn administration which provided more power to the Lieutenant- Governor-in-Council (i.e., the cabinet) to adopt other measures, including municipalities having to seek board approval for their borrowing by-laws. In 1936, however, the Board's power under this statute was enhanced by a more stringent approval regime for municipal rating by-laws. Municipalities were required to include the current cost of funding their share of direct relief in their current estimates or obtain prior approval from the Board for any debentures funding relief and obtain approval before the adoption of the annual budget or the tax levying by-laws. If the approval was not forthcoming, municipalities were required to provide for a "sufficient appropriation for such a purpose out of current revenues." The following table summarizes the total debenture applications received by the Board. The shift to direct relief is evident in the following data.

[53] This is based on Laskin (1937, 85-86).

Table 6. Debenture Applications to the OMB

	Works	Direct Relief
	$'000's	$'000's
1931	1,384	
1932	3,086	
1933	4,953	2,432
1934	1,150	4,721

Source: Laskin (1937, 83-84).

Supervision

The Board was also given extensive powers of supervision over "defaulting" municipalities in Part VI of the *Ontario Municipal Board Act, (1932)*.[54] These powers were exercisable either at the request of council or by creditors of a municipality, representing not less than 20 percent of the indebtedness when in default or with high probability of default, requesting an enquiry. The Board was also given the power to vest the administration of the municipality in a Committee of Supervisors, including council nominees, creditor nominees and an independent board-appointed chairman.

[54] Laskin (1937, 86) The explanatory notes to this legislation state the rationale:

"Hitherto there has been no contemplation in any general statute of the province that any Ontario municipality would default in meeting its obligations, and consequently neither the Lieutenant-Governor in Council, the… Board… or any court, body or person has been clothed with any authority to deal with the situation which ensues when default occurs, as it has occurred in recent months in a few of our municipalities. The situation is too serious and the effects which may flow likely to be too disastrous if the consequences of default cannot quickly be remedied, and the results not only affect the defaulting municipality, its ratepayers and creditors, but also prejudice the whole system of municipal institutions in the province and the credit of municipalities generally… The provisions of this part of the revised Municipal Board Act will apply not only with respect to municipalities now in default but to others which may be unfortunate enough to follow so that prompt and adequate steps may be taken to prevent dangerous consequences, to put into effect proper measures of financial control, to enable refinancing schemes to be brought about and generally to ensure that the municipality will be restored to a position of soundness as quickly as possible. … drafted after …the careful study of similar legislation in force in other provinces and after consultation with the authorities who have had first-hand experience of the functioning of such legislation."(Bill No. 116, 3rd Session, 18th Legislature, Ontario 22 Geo.V, 1932 at 22).

The Committee of Supervisors was provided with the authority to manage the financial affairs of the municipality including the timely preparation of budget estimates, early in the year, approval of expenditures and ensuring their adherence to estimates, collection of revenues, the establishment of the assessment rolls, the setting of tax rates, registration of properties in arrears in preparation for tax sales, temporary borrowing and the disposal of assets. The Supervisors were also provided with the authority to consolidate indebtedness and to negotiate new terms with creditors. Any further borrowing was to be done with the approval of the Board. The statute also enshrined the further payment of monies to the county. This part of the statute also dealt with tax arrears. Authorization was provided to the supervisors to exercise compromises with ratepayers and to accept debentures of the corporation in payment of arrears. The Board also retained extensive powers to review the decisions of supervisors.

By November of 1933, the crisis in local finance was sufficiently apparent that the Henry government appointed a Special Committee of investigation. Its mandate was

> "to study the situation of the districts surrounding large cities and to report upon the advisability of setting up metropolitan areas for the betterment of conditions in relation to the development and administration of the municipalities concerned and to study the operations of municipal law in this connection."[55]

These terms of reference suggest a continuing reliance on municipal-specific solutions. Events would not however await committee findings.

By far the most serious crisis had occurred in the Windsor area (on the US border, opposite Detroit). In East Windsor, in 1931, debt service represented 45 percent of expenditures. In 1934, no payments were made, and 40 percent of the total residential value of property in the municipalities of East Windsor (Ford City), Windsor, Walkerville and Sandwich was in arrears. Committees of Supervisors were established in all these municipalities. Among the principal

[55] Motions, March 26, 1934, Ontario Legislature p. 184. Dr. Horace L. Brittain was appointed to the Committee.

problems identified were "the practices of budgeting on the basis of collecting 100 percent of the tax levy, and failing to pass the budget early in the year."[56] Two other common problems were recourse to short-term borrowing based on the notion of the unlimited power of municipalities to raise taxes and the overstatement of the revenue base through the assessment process (Brittain 1934).

For each of the Windsor area municipalities, refinancing schemes were suggested, generally to spread the retirement of the debt over forty years at rates between 3 to 3.5 percent with only interest being payable for five years. The severity of the problem in the Windsor area led to the appointment of the Royal Commission on the Border Cities Amalgamation which reported in 1935. At that time, 29 percent of the population was receiving relief, and assessments had fallen by nearly 40 percent from their peak value in 1930. The Royal Commission noted that:

> “The situation existing in the Border Area today is giving rise to a condition by which something approaching total default is threatened. The present budgets are to some extent fictitious as the provision for maintenance in every department is entirely inadequate. ... If the present scale of expenditure is continued, adequate maintenance resumed and a share of relief provided by the municipalities, there will be very little if anything, left to pay either principal or interest on the bulk of outstanding bonds. The consequence must be that the credit of the area, both public and private, will be destroyed.”[57]

In response to the continuing problems of the area, the Province used not only its supervisory power but also drastically altered the jurisdictional framework, amalgamating the cities of Windsor and East Windsor and the towns of Sandwich and Walkerville. The Windsor

[56] Macpherson (1935, 330).

[57] Royal Commission on Border Cities Amalgamation (1935, 7).

Finance Commission was also created to prepare a plan for funding and refunding the outstanding debts of the amalgamated municipalities and of the East Essex Border Utilities Commission and the East Windsor Water Commission. Debts were to be recovered from levies on the rateable properties of the former jurisdictions. The Commission was provided authority similar to that granted to the Committees of Supervision.

In 1936, the Department of Municipal Affairs, which had been established in 1934 to deal with the expanding local crisis throughout the province, took over the direct supervision of all of the insolvent municipalities in the province, replacing the Committees, which had been abolished as part of this initiative. The 1935 Budget Address[58] of the Premier attempted to address many of the criticisms of the status quo that had been raised in the Supervisors' reports and disseminated in the professional literature of the accounting profession. The Speech noted the Department's efforts to reduce tax arrears as well as to negotiate better banking arrangements. Promises were made that accounting and auditing would also be improved. The Premier also noted that:[59] "the previous forms of annual municipal financial returns have been scrapped because of the insufficiency of the information disclosed. For the purpose of returns for 1934, an improved and more complete form has been sent out and returns are now being made by the 938 municipalities in the Province." The interest of the Department, banks, investors, and ratepayers in such improvements was cited.

The Budget address also listed the defaulting municipalities under supervision. Hepburn suggested that it was the Government's hope that the new Department would be able "to effect

[58]For a justification of the use of budget speeches as evidence of the intentions of a particular government, the model advanced by Gillespie advanced in his recent study of the history of federal finance is revealing. Gillespie (1991, 4-5).

[59] Ontario (1935, 19) Hepburn was both Premier and Treasurer.

some kind of an arrangement whereby the payment of interest will be resumed, even at a lower rate. In any event, there will be closer regulation of municipal financing."[60] Thus, the broad harder constraint began.

The no bail-out position ultimately adopted also found support in Plumptre's report to the Minister. In June 1935, Arthur Plumptre, after a careful analysis of the precarious fiscal situation prevailing in the urban suburbs of Toronto[61] recommended to the Minister of Municipal Affairs that the Province "make haste slowly" in assuming the burden of relief in all Ontario municipalities. He also recommended against "permanently supporting any or all of the municipalities upon provincial credit" as being as "pernicious" as "supporting one municipal government with the credit of another" and against debt repudiation.

The new departmental legislation was adopted in April, 1935.[62] In this context, the transfer of the sections of the *O.M.B. Act 1932* entitled "Special Jurisdiction over Defaulting Municipalities" to the *Municipal Affairs Act* marked a significant and long-lasting change. (This section of the Act continues to this day. See *Municipal Affairs Act*, RSO 1990 ch.M.46, Part III). The Committees of Supervision were replaced by direct control exercised by the Department and the separate roles of the Board and the department were also set out in the legislation.[63] The jurisdiction of the Department and the Board was not open to review by any Court and coercive

[60] Ontario (1935, 21).

[61] Plumptre (1935, 133).

[62] The new Department was also invested with a general power to administer all acts in the *O.M.B Act of 1932*, e.g. the relief acts included.

[63] For example, the new legislation provided that "upon application of the Department, the council , or of creditors having claims representing 20 percent of the total debt of the municipality, O.M.B. is empowered to order control and charge over the affairs of the municipality to be vested in the Department. Such an order is effective in its application until such time as a countermanding order is issued by the Board. Such countermanding orders releasing municipalities from the Department's jurisdiction can only be made by the O.M.B., however, upon recommendation of the Department. Ontario (1938, 77).

powers were provided to the department to ensure its orders were implemented. In conjunction with this legislation, the supervision of the municipalities imposed by the amalgamation legislation in the Windsor area would continue.

In 1935, more stringent powers were also provided to the O.M.B. [64]to control capital expenditures of all municipalities including local boards. Capital undertakings that would require any borrowing for their financing were not to be initiated without prior approval. The amount that could be borrowed in any year to meet current expenditures, statutory obligations and debt repayments could not exceed 70 percent of the estimated revenues of the corporation as adopted for the year without Board approval (s.339 (2), *Municipal Act*, R.S.O.1937). Previously municipal debt had been limited by setting a mill rate limit on the amount that taxes could be increased to service debt, thereby limiting new debt issuance but municipalities *had tended to* increase their real property assessments artificially to avoid the limit.[65] Clearly, a soft budget constraint that could be evaded.

Hepburn's 1936 Budget Statement took a different tone than that of the previous year. By March 1936, the Premier and Treasurer was emphasizing the progress in developing debt restructuring and repayment plans in one-third of the municipalities. Admittedly one more municipality had been added to the list, due to the closure of the principal industry (Blind River).

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[64] This section is based on an address given by Cross in Chatham on January 31, 1939. PAO, Dept. of Municipal Affairs, Minister's Office Files 1937-1940, Addresses- RG 19 a-1-B. See also Laskin (1937, 82)

[65]Borrowing was limited to 70 per cent of estimated revenues. The limit had previously been 80 per cent for municipalities with populations greater than 100,000 and 90 per cent for the others with no approval being required. No distinction was drawn between capital and short-term borrowing. The real estate lobby also had a view:

"We have a so-called tax limit in our provincial statutes of 25 mills but this does not include the cost of education and several other less important items. We are not enthusiastic for the "Over all tax limitation." We believe that more elasticity would exist and yet the practical effect accomplished if municipalities were restricted in their borrowing powers and forbidden to issue debentures for other than capital improvement and only up to a certain percentage of the rateable property." OAREAB (1937, 22)

Decisions were made to suspend interest payments in some instances where the existing situation was exacerbated. It was also pointed out that a special levy would be included in all of the municipal budgets for at least the partial funding of interest obligations.

Hardening the constraints stands in contrast to Hepburn's rationalizations in 1936:

> "Before passing on from reference to these 32 places, may I point out two important facts. One is that, generally speaking and except for these few places representing less than 4% of all our municipalities, the municipal affairs of this Province are on a sound basis, and loose talk of general instability of municipal finances is entirely baseless….The next remark I have to make is to correct the impression created by certain statements which have gained considerable circulation that defaults among our municipalities are about 120 million dollars, or one-quarter of the total bonded debt of all municipalities. That is far from fact. .. At the end of 1935, the total debt past due and unpaid was about $16,000,000 of principal and about $5,000,000 of interest, or a total of approximately $21,000,000. That is the amount in default and the remainder of the debt of these supervised communities is not in default because the time for its payment is not yet here."[66]

In 1938, the Province continued to emphasize the success of its initiative to harden the constraints on municipalities:

> "Due to the control of capital expenditures being vested in the Ontario Municipal Board and the general supervision of the Department of Municipal Affairs, no further defaults have occurred during 1936 and 1937, and the Province may take credit for the energetic measures to deal with the alarming picture that had developed up to 1934."[67]

By 1939, the Department of Municipal Affairs had completed 15 refunding plans and six were in the process of being negotiated. These plans generally followed the pattern set in Windsor and involved negotiations with bondholders and the municipalities to obtain feasible

[66] Ontario (1936, 42).

[67] Ontario (1938b, 73).

terms of repayment of accumulated indebtedness. As late as 1944, fifteen municipalities remained under supervision, although in most cases supervision had been reduced to an approval of the annual budget and monitoring adherence.

Concomitantly, there were also initiatives aimed at the consolidation of small school board jurisdictions. In his 1938-39 report, the Chief Supervisor noted:

> "this branch is co-operating with the Department of Education in the movement towards larger units of school administration for townships, Much progress has been made in the townships under supervision in this direction. At this point it should be pointed out that in the supervised municipalities in the Toronto area steps have been taken toward the equalization of teachers' salaries."[68]

Given the Ontario submissions and experience in other provinces, it is not surprising that the Rowell-Sirois Commission also recommended provincial regulation of the borrowing powers of municipalities with a view to ensure conservative capital financing. This view found an echo in the recommendations of the Advisory Committee to the Minister of Municipal Affairs on the Provincial-Municipal Financial Relationship which reported fifty years later.

Section 4-The Search for a Solution: Soft or Hard- the Federal-Provincial Context

While provincial leaders carried a direct policy responsibility for the "creatures," every attempt was made to convince the federal government to engage in "softer behaviour" throughout the interwar period. Even as the federal government attempted to assert a no bail-out position in its general treatment of the provinces' fiscal crises, it was also clear to Ontario's political leadership that the risks posed by not solving the local crisis were high. The Province's

[68] Ontario Department of Municipal Affairs Annual Report (1938-39, 13).

credibility in its dealings with the federal government would likely be damaged without credible action.

The entanglement of provincial and municipal finance gave rise to problems in the aftermath of the First World War, owing in part to the involvement of both levels of government in the provision of "relief." Anticipating views that would be expressed a decade later, in the fall of 1920, the federal Labour Minister, Gideon Robertson noted:

> “ Municipal and provincial authorities must not be permitted to continue – as in wartime- to pass every local question on to the Federal Government to find a solution. In previous periods of depression, appeals were always made to the local authority first. We should, I think, guide all concerned in that direction, if Municipal and Provincial authorities are to properly function.”[69]

He went on to note that the federal government could not “assume obligations which properly belong to a particular municipality or province.” However, by December, 1920, the federal government introduced a one-third matching fund for emergency relief, which would become a precedent for relief later in the interwar period.

The federal position that assistance to the unemployed and destitute was a provincial and local responsibility continued to be made in the early twenties and persisted into the Great Depression, varied little between the governing parties. As Mackenzie King, then Liberal Prime Minister noted in the spring of 1922 when the crisis had eased:

> “The obligation of looking after men who are unemployed is primarily a matter for individuals in the first instance, between municipalities and the people living within their bounds in the second instance, next, between the provinces and the citizens of the respective provinces.”[70]

[69] Armstrong (1981, 137).

[70] Struthers (1983, 32).

Unemployment only became a federal problem in his view when “both the municipalities and the provinces have found it impossible to cope with a situation that is completely beyond their control.” This vein of argument continued and King, after the Dominion-Provincial conference of 1927 noted that the federal government had forestalled “any united raid on the treasury” as the premiers including Ontario Premier Howard Ferguson had expressed their dislike of Ottawa’s spending money on programs outside its jurisdiction.[71] The provincial position prior to the onset of the Great Depression reinforced the federal view that the sub-national governments must carry the burden themselves.

Relief and Fiscal Constraint

The Depression also served to highlight the inadequacies of the existing division of responsibility among governments and their access to revenues. The impact of meeting the relief needs was particularly felt in the suburbs of manufacturing towns and in single-industry towns in northern Ontario. As unemployment increased in these areas, the tax base being used to fund relief projects also began to lose its value and the ability of property owners to pay the increasing real burden of taxes was severely impaired.[72]

While the responsibility for delivery of relief remained at the municipal level throughout this period, in 1930, the federal government introduced a series of annual relief bills. The monies were transferred to the provinces to be spent on approved purposes. In spite of the lack of coherent policy, "total expenditure on public welfare programmes rose rapidly in the 1930's,

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[71] This issue is still current- see the series of papers sponsored by the Institute of Intergovernmental Relations, School of Policy Studies, Queen’s University at http://www.queensu.ca/iigr/working/spendingPower.html accessed on June 11, 2009.

[72]The intergovernmental effort to provide relief during the depression years and aspects of the policy response to the mass unemployment situation that prevailed from 1929 to 1940 are discussed in Riendeau (1979); Struthers (1983, 1991, 1992 and 1994), Taylor (1979) and MacKinnon (1990).

from less than 2 percent of GNP in 1926, to 6.6 percent in 1933 and 5.6 percent of GNP by 1939.[73] Until 1932, most of this expenditure was spent on work-relief projects. After that, with the withdrawal of federal funding for such work, direct relief became more important. Debt service burdens doubled even in some of the eastern provinces which were, in the words of one observer already "conservative by experience."[74] In 1934, after acrimonious discussions with the provinces, the Bennett (Conservative) government instituted an across-the-board cut in federal relief spending of approximately 25 percent[75] with a new system of grants-in-aid replacing the previous matching grant system. The entitlements were based on previous spending patterns. This policy was continued by the King (Liberal) government.

The deepening economic crisis highlighted the problem of an inadequate institutional structure to deal with massive unemployment. At the provincial level, the emergence of a social assistance bureaucracy was in its infancy. Municipalities had the responsibility for relief and the ability to deliver service of this kind varied considerably throughout the province.[76] The pattern of the provincial response during the early years of the depression reflected the federal response to the emerging crisis. Until late 1932, only the vaguest guidelines existed for the establishment of the municipal effort required to share in the job creation schemes that were funded by the three levels of government. At that time, the guidelines suggested that "work be distributed as widely as possible among the unemployed" and that "direct relief include food, fuel, clothing and

[73] Green and MacKinnon (1988, 385).

[74] Buck (1949, 291).

[75]For descriptions of the process see Struthers (1983, 114-117) and Thompson and Seager (1985, 254-255) Hanson deals with this change rather as a matter of fact, see Boothe and Edwards (2003, 139). More on this below.

[76]Struthers (1994, 316) notes that "out of the 901 municipalities in the province, only 206 participated in provincial relief works and direct relief in 1930-31; 341 provided direct relief in 1931-2; and 550 in 1932-3, the worst year of the depression."

shelter, only."[77] Provincial records suggest that in 1930-31, of $18.5 million spent on all forms of assistance only $2.5 million were spent on direct relief.[78] As costs escalated, in 1932, the policy of financing relief work projects as the solution was abandoned in Ontario. Between 1931 and 1932, provincial spending on relief jumped from $4.3 million to $13.5 million. The numbers on the dole went from 60,000 to 203,000.[79] After April 1932, a federal-provincial agreement shifted the effort to a direct sharing of direct relief payments among the three levels of government. Apparently, the federal government felt that there was more control in a specific conditional transfer than in more loosely controlled spending on works projects. In consequence, the Ontario government put its efforts into investigating municipal practices (or "malpractices") and a standardization of the levels of relief to be made available.

In 1932, the Henry administration appointed the Advisory Committee on Direct Relief (the Campbell Commission) to investigate the issues of the uneven distribution of relief throughout Ontario. The Commission argued for ceilings on relief expenditures and standardization as a means to achieve savings to ensure uniformity in the delivery of assistance throughout the province.[80] By the end of 1932, ceilings were imposed on municipal relief efforts and standard forms were instituted for relief investigation and food vouchers. A network of district inspectors was established to ensure that municipalities were not charging the province

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[77] Struthers (1994, 79).

[78] Struthers (1994, 316).

[79] Struthers (1994, 83).

[80] The Campbell Report called for the development of a 'permanent structure' through which the Province could exercise 'continuous supervision… of municipal administrative methods and practice in all parts of the province.' The standardized relief forms, investigation procedures, and maximum ceilings on provincial contributions that were recommended were essential "to assist...the Province in its inspection and supervision of municipal methods and policies." Struthers (1994, 86).

for expenditures above the ceilings. These measures were a clear attempt to impose a hard constraint on the independent actions of local councils that sought to extract the maximum assistance from the Province. Contemporary opinion noted that the provincial standards being imposed were inadequate at best from a nutritional and health perspective.[81]

In the insolvent municipalities placed under the supervision of the Ontario Municipal Board before 1933, the relief efforts were being funded completely by the Province. In consequence, before the election of 1934, militant local political organizations and the election of left-wing councillors pushed relief rates above the provincially set ceilings plus twenty-five percent. [82] Given provincial funding, local political will to resist pressure was weak. This episode is perhaps the most obvious example of sub-national decisions being made in expectation of bail-out. However, the bailout was not to be.

While the election of the Liberals in 1934 resulted in the extension of relief to single men and women, the Government and David Croll, the Minister of Public Welfare and of Municipal Affairs (the former Mayor of Windsor) continued the attempt to impose specific standards of eligibility for direct relief.[83] Croll's characterization of the insolvent as "pampered, inefficient, and political cry-baby municipalities" paved the way for the provincial takeover of relief administration in these municipalities. Following the example of administration in Toronto and Hamilton, provincial officials instituted various measures including systematic home investigation to detect undisclosed assets and income, work requirements for relief, detailed case files on families, and rigid adherence to Campbell ceilings. Special levies were also imposed to

[81] Struthers (1991, 51).

[82] Struthers (1994, 92) estimates that political pressure resulted in increasing rates 14 percent above the Campbell based scale.

[83] Struthers (1991, 55). The following is based on Struthers (1994).

fund municipally made relief commitments where councils were reluctant to adopt the appropriate taxing by-laws.

Unpublished estimates prepared by Drummond indicate the extent to which the "infant welfare state" had grown as a portion of total Ontario government expenditures during this period, in spite of the provincial efforts to curtail the shift. These estimates show the portion of expenditures devoted to this category, education, relief, old-age pensions and mothers allowance, increasing from $15.7 million in 1926 to $ 58.0 million by 1939 and an increased share from 24 percent to 37 percent of total provincial spending. The increased importance of federal transfers is also shown (Drummond 1980) (see Table 7).

In summary, “by...1937, Queen's Park had developed the capacity to regulate, audit, investigate, and inspect municipal relief administration and, indirectly, the lives and actions of the unemployed."[84] This was only one aspect of the establishment of hard constraints being imposed by the senior government. Even as the Province was also establishing a framework to control municipal relief efforts, it was also establishing a more directive regulatory framework for municipal finance.[85]

[84] Struthers (1994, 97)

[85] The relationship of fiscal capacity, effective size and the impact of financing relief was also commented upon by the Rowell-Sirois Commission: "the size of the municipal unit in metropolitan and rural areas is, in very many cases, no longer economic or in keeping with administrative efficiency; that local needs no longer determine municipal functions and that many functions, essentially provincial, are still left with, or have been imposed on, the municipalities; that municipal revenues are in many cases far from adequate to support municipal functions; that there is almost universal complaint across Canada of undue, or inequitable, taxation of real estate, though the complaints are not always well-founded; that although the total of municipal debt has not risen substantially through the depression, the credit of may "one-industry" municipalities, working-class "dormitory suburbs" of metropolitan areas, and metropolitan communities generally, has been severely strained, and even destroyed in some cases, because of relief costs". (RCDPR 1940, 149).

Table 7. Selected Provincial Financial Information

	Conditional Federal Transfers $'000's	Total Revenues $'000's	% Share		Infant Welfare State $'000's	Total Expenditures $'000's	% Share	Deficit $'000's
1926	50	53,991	0.1		15,680	65,399	24.0	-11,408
1927	53	59,054	0.1		16,149	69,743	23.2	-10,689
1928	0	61,415	0.0		17,194	74,315	23.1	-12,900
1929	0	67,896	0.0		17,867	82,626	21.6	-14,730
1930	3,664	75,745	4.8		25,643	100,374	25.5	-24,629
1931	8,882	86,288	10.3		38,214	115,315	33.1	-29,027
1932	15,748	95,783	16.4		49,818	127,901	39.0	-32,118
1933	18,522	89,551	20.7		54,840	137,764	39.8	-48,213
1934	18,967	83,767	22.6		82,670	175,934	47.0	-92,167
***1935**	7,619	37,032	20.6		33,236	70,353	47.2	-33,321
1936	22,657	108,383	20.9		72,279	146,314	49.4	-37,931
1937	25,584	113,130	22.6		58,855	125,650	46.8	-12,520
1938	17,013	118,347	14.4		54,117	148,113	36.5	-29,766
1939	16,787	115,341	14.6		58,064	156,727	37.0	-41,386
*	1935 – partial year. (Incomplete)							

Source: Based on estimates in Drummond (1980).

Bennett, Conservatives and the Crisis

In September 1930, the Progressive Conservatives under the leadership of R. B. Bennett defeated the Liberals. Between 1928 and 1932, Dominion revenues however fell by 23 percent. Expenditures increased by nearly 40 percent driven by the circumstances. Although surpluses had been the rule since 1921, the Dominion deficit by 1932-1933 was 34 percent of expenditures.[86] In 1931, the Dominion government used regulatory powers that permitted banks and insurance companies to use artificial values of their securities holdings for reporting purposes in order to avoid forcing customers into liquidation.[87] According to Bliss, this was motivated by the Dominion's own concerns over being able to float new debt issues in the

[86] See Drummond (1991, 241-249). The federal numbers are based on Gillespie (1991, 271).

[87] See Bliss (1987, 417-419).

domestic bond market. As well, in 1931, the Dominion government provided guarantees to the three Prairie Wheat pools to forestall forced liquidation of unsold wheat and potentially serious damage to the Canadian banking system. Concurrently, the fiscal crisis in Newfoundland was also unfolding. During 1931, the Canadian government at the behest of the British government had to intervene twice to provide assurances to the Canadian banks that the debts of Newfoundland would be serviced. Finally, in 1933 Newfoundland lost its sovereignty.[88]

As the crisis deepened and given the myriad of conflicting pressures, it is not surprising that the statements made by both Prime Minister R. B. Bennett, and his Labour Minister, attempted to rationalize the federal attempts at reducing assistance by blaming the other levels of government for "shoddy administration."[89] The Conservatives' view echoes the position taken by King earlier in the decade:

> "Under our Constitution responsibility in connection with unemployment rests primarily with the Provinces… The extent of unemployment, which is world-wide, has induced the Federal Government to treat the problem as national and assist the Provinces in the discharge of their obligations. Unless the Provinces relinquish their constitutional functions, federal action must be through their governments."[90]

By 1933, Bennett was expressing his concerns about the seeming softness of the budget constraints at the provincial-local level. Complaining that the Dominion government had "expended $13,462,000 for the relief of the people of Canada during the depression, all as payments to the provinces, without any surrender of autonomy on their part," he noted that: "The

[88] Baker (1994, 5) and Reinhart and Rogoff (2009, 81-83). Newfoundland was not yet a province.

[89] See Commission of Enquiry into York Twshp. (1933, 9).

[90] Armstrong (1981,149-152).

time has come, however, when the Dominion, jealous of its credit, must pause before it hands over any further sums not under its control."[91]

The acrimony in the relationship between the federal government and the premiers continued unabated. Bennett and his ministers used every opportunity to chastise the provincial premiers for the wasteful use of federal and matching funds. (Armstrong 1981; Struthers 1983; Bryce 1986). Further, there was no movement on shifting the constitutional responsibility for relief nor was there any federal willingness to surrender the income tax.

For the January 1934 Dominion-Provincial conference, Bennett apparently considered placing the western provinces under supervision and suggested the merger of the Maritime Provinces but decided instead to propose the withdrawal from the provision of direct relief and replacement with a public works program. In his view, "Ontario and Quebec, 'should not be receiving any assistance from the Dominion in connection with direct relief. They were rich and powerful enough to look after themselves." (Consistent with Goodspeed (2002) as summarized above).

The reaction of the western provinces was put by Alberta Premier Brownlee:

> "Given the high cost of relief, the low price of wheat and their 'primitive state of development', the western provincial governments had no choice but to appeal to Ottawa for aid. The easiest and most popular alternative was default but that 'might put them in the position of South American states, with no capital market available for further development. Further, their default might threaten the financial future of the whole country. Therefore … their financial problem could be reduced to this: they must get assistance from the only source where they could get it- the Federal Government- or else default. No other alternatives were possible."[92]

[91] Armstrong (1981).
[92] This is summarized from Struthers (1983, 110) and Armstrong (1981, 149-151).

Bennett's reaction was to disagree with the following questions in response:

> "The West was 'living too expensively.' Could it really afford four separate legislatures? Could it not discontinue expensive public services such as old-age pensions, telephones, and electric power which 'were suitable and within means of old established communities but which were difficult to justify in new ones?' Did the premiers not realize that the 'same body of taxpayers' bore the cost of relief whether it was financed by the municipalities, the provinces, or the dominion? Finally-would the continued use of federal credit to preserve provincial financial integrity 'not lead to a situation in which the dole was accepted as a fixed policy?'"

Finally, Bennett came to the essence of the dilemma posed by the budget constraint:

> "The problem was simply – could the Dominion take the risk to its credit caused by the default of a province or provinces or should the federal government remove this risk by financial assistance?"[93]

Brinksmanship continued throughout 1934 and default was averted in British Columbia by last minute federal assistance. As Struthers notes: 'With relief the largest item in provincial budgets, it was in fact if not in theory a primary federal responsibility as long as Bennett maintained that provincial and national credit were 'indivisible.' "

In June 1934, Mitchell Hepburn's Liberals were elected in Ontario. With Liberals in Nova Scotia, British Columbia, Ontario and Saskatchewan, there was politically less reason than ever for Ottawa to bail out the provinces with financial aid. The Conservative government continued its rhetoric on provincial maladministration and welfare dependency. As Wesley Gordon, Labour Minster put it:

> "If the provinces continue to maintain the sanctity of their rights under the constitution, then *faulty administration* in connection with a problem of this character, when their monies are being augmented by contributions from the federal treasury, cannot be too vigorously criticized. The only method left to the federal

[93] Struthers (1983, 111).

> government was to intimate to the provinces that contributions would cease in whole or in part."[94]

This set the stage for further acrimonious discussion as the federal government was proposing to put an end to its contributions to direct relief. In July 1934, Hepburn attempted to confirm that the federal one-third financing of direct relief would continue. In response, Bennett declared that: "Municipal programs of direct relief had become simply a "racket." The claim was made that civic officials were trying to shift the entire burden of social welfare problems onto Ottawa's shoulders by packing the relief rolls with the aged, the infirm, even children. He suggested that: "wealthy provinces like Ontario and Quebec had attempted to "scrap the constitution" by evading their responsibilities.' Citing "maladministration' as the rationale, the federal government decided that the existing system of matching grants would be dropped. Instead, each province would receive an unconditional grant, the amount fixed by the federal government, to be spent on relief at its own discretion. Every province would have to submit to a 'means test" and the sum would cover only 'proven need,' regardless of the size of the population. As Ontario Premier Hepburn put it: "In other words, Mr. Bennett says here's your alimony, now it's up to you to bring up the children."[95] By 1935, the Hepburn government was bringing up the children, having imposed the formal borrowing rules on municipalities.

The re-election of Mackenzie King and the Liberals at the federal level in October of 1935 did not appreciably shift the rhetoric. The following is completely consistent with the previous Prime Minister's statements:

[94] Armstrong (1981, 154).

[95] Armstrong (1981,154).

> "Unless we let the municipalities and the country see that we are going to cut down on these outlays there never would be a tightening up of the indiscriminate relief process."[96]

At the same time as the Liberals continued the federal effort to cut the Dominion contribution to direct relief, other measures were also considered, which would have introduced a hard hierarchical budget constraint into the federal-provincial fiscal framework.[97] Based on the model of the Australian Loan Council,[98] W.C. Clark, the Deputy Minister of Finance had proposed the establishment of a national loan council to the Bennett government late in their mandate. A revised version was brought forward for reconsideration. As a way of avoiding the risks of defaults, the federal government would become involved in the approval and guarantee of provincial borrowings.

The proposal entailed the refinancing of the outstanding debt of the provinces in most serious difficulty through new provincial issues guaranteed by the Dominion at lower interest rates. The Dominion would expect the participating provinces to jointly indemnify it for any loss it might incur in implementing the guarantee. Participating provinces would be required to pledge the subsidies payable to them under the *British North America Act* by the Dominion as security against such a loss. While Ontario was interested in refinancing the provincial debt now totalling close to $700 million and carrying an average interest rate of 5 percent to potentially save approximately $15 million annually, (with debt charges absorbing a quarter of the revenues and relief another 25 percent), there was no interest in carrying the financing of other provinces nor yielding decision- making authority. Thus, in December 1935, when the proposal was

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[96] Struthers (1983, 148).

[97] The following is based on Wardhaugh (2000), Bryce (1986), Struthers (1983) and Armstrong (1981).

[98] For a recent study of the Australian Loan Council, see Grewal (2000).

explained to the intergovernmental Permanent Committee on Financial Questions by the Finance Minister Charles Dunning, the enthusiasm of the Ontario delegation diminished rapidly (Armstrong 1981). Half the votes in the council would be held by the finance minister, the other half by the participating provinces. In the case of any default, the federal government would cover only half the loss; the rest of the guarantee would be shared among the provinces in proportion to their outstanding debts. Hepburn was not convinced: "I am not enamoured of that proposal… We pay over 40 percent of all federal taxation, and a lion's share of the other 60 percent. I do not like the idea."[99]

Dunning (the Minister of Finance) was adamantly opposed to the inclusion of federal securities in the refunding scheme. In his view, even a hint of compulsory refunding would destroy the nation's financial reputation in London and New York. He told the committee that despite Ontario's opposition, Ottawa would hold open the offer to form a loan council. Any province might join if it would pledge its subsidy payments to cover a default. Should the losses exceed that amount the other members of the council, including the federal government, would meet them jointly. However, Hepburn's initial objections had seriously damaged the prospects for a successful debt conversion scheme.

In January 1936, the proposal was reiterated, with the possibility of separate councils for each province.[100] While the probability of default of a western province loomed, the difficulty lay in persuading the provinces to agree to surrender their independent borrowing authority in return for a federal guarantee of their debts. Internal federal documents noted that:

[99] Armstrong (1981, 199).

[100] Bryce (1986, 187).

> " The only real object of the guarantee is to get control. If, therefore, control can be obtained in any other way there should be no guarantee… Control must extend to legal attachment of provincial revenues … The alternative to control is default; therefore there must be control."[101]

Dunning proposed a constitutional amendment legalizing both the sales tax and the loan council plan in an effort to win the support of the provinces. A separate loan council could be set up for each province, and all subsidies and grants-in-aid from Ottawa would have to be pledged to the council to cover any defaults. As long as the loan council scheme was not compulsory, Ontario had no opposition to such an amendment to the constitution.

In January and February of 1936, the last of the advances available to Alberta and British Columbia under Bennett's legislation to meet maturing obligations, were made, accompanied by a federal position that any further guarantees or assistance would require a provincial loan council and a pledge of federal subsidies payable as surety (an attempt at a credible threat to impose a meaningful hard constraint). Shortly afterwards, King noted,

> "that not only municipalities and provinces are tending towards bankruptcy, many of them are already bankrupt but that the Dominion will also be in the same category if the wasteful practices which have become accepted in the last two years are continued."[102]

This set the stage for perhaps the single most striking result of the crisis of the 1930s and of the acrimonious state of federal-provincial relations in the history of provincial public finance, the first and only default of provincial debt in Canadian history -- that by Alberta in 1936.[103] The newly-elected Social Credit government which had taken office in August,1935 inherited an

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[101] Armstrong (1981, 204).

[102] Wardhaugh (2000, 200-201).

[103] See Bird and Tassonyi (2003, 124), Bryce (1986, 188); Boothe and Edwards (2003, 171-183).

immediate fiscal crisis. The province's finances had been in a parlous state to begin with, and the prolonged and exceedingly acrimonious provincial-federal conflict over its initiatives did not help matters. Alberta refused to participate in a proposed loans council on the grounds that this would in effect cede control over provincial borrowing to the federal government (Wardhaugh 2000; Boothe 1995; and Bryce 1986).

The federal government flatly refused to bail out Alberta, thus forcing it to default on approximately one-third of its bonded debt (although it continued to pay a reduced rate of interest). Just a month after the Alberta default, Saskatchewan was bailed out by the Bank of Canada, with the understanding that the Bank would be repaid by a loan once a loan council was established. According to Bryce (1986), the intervention reflected the concerns of the Governor of the Bank of Canada, Graham Towers, that a second default of a province would have a significant adverse impact on the Dominion government's ability to refinance its own borrowings.

Towers and W. C. Clark had concluded that a royal commission ought to be set up to examine the balance of revenues and responsibilities within the federal system in the light of recent experience. At the National Finance Committee's only meeting in December 1936 Premier John Bracken of Manitoba made the same suggestion.

Further, as the potential for another provincial default loomed again, in 1937, the Bank of Canada noted that in Manitoba,[104] "the province was forced to borrow not only its own share of relief expenditures from the Dominion, but also to borrow from the Dominion in order to re-loan increasing amounts to the municipalities to finance their share of relief expenditures. The Bank went on to note that:

[104] Bank of Canada (1937, 15).

> "The Provincial government was affected in two ways; the principal of the debentures of many of the defaulting municipalities had been guaranteed by the province, and the province had also to provide for the bulk of the current relief expenditures. The practice of guaranteeing municipal and hospital debentures and bank borrowings, without securing control or even detailed information of budgets, proved disastrous. The guarantees came home to roost when the guarantor was least prepared to meet them, and the Manitoba practice of including payments under such guarantees under the Public Accounts heading "Public debt charges" tended to obscure the situation."

In general, provincial aversion to loan councils and King's reluctance to force a hard hierarchical budget constraint, other than through cutting spending on relief and transferring responsibility back to the provinces and municipalities resulted in expediency ruling the day.[105] The stage was set with the pressure on tax and borrowing capacity created by the world-wide slump and prairie drought as well as the opinion of the Bank of Canada for the government to establish the Royal Commission on Dominion-Provincial Relations, the Rowell-Sirois Commission. Hepburn was extremely sceptical of the Commission commenting that:

> "since 47.5 percent of federal tax revenues came from Ontario, additional transfer payments for the prairie provinces would come mainly from the pockets of Quebeckers and Ontarians"… "the more I read of the representations made by the other provinces, the more convinced I am of the necessity of Ontario and Quebec resisting together, and in no uncertain way, the ever-increasing, unreasonable and impossible demands … I can readily understand the advantage it would be to the other provinces for them to raid the Federal treasury, particularly when Ontario and Quebec contribute 80 percent of the revenue."[106]

[105] Wardhaugh (2000, 210) suggests that "King was never really comfortable with the loan council or the amendment to the British North America Act that would allow the transfer of indirect powers from federal to provincial jurisdiction. Indeed, he was relieved when the Conservative-controlled Senate voted down the amendments." Bryce (1986, 189) notes King's "immense relief" at this unfolding of events.

[106] Armstrong (1981, 209).

Given both the domestic and the international experience with defaulting sovereign borrowers during the period before and after the election of Hepburn as the Premier of Ontario, it is not entirely surprising that the government of Ontario took strong steps to control the fiscal affairs of the defaulting municipalities rather than relying on transfer payments to solve issues.[107] This followed upon the initial steps in the process of developing the hard constraint that had been taken by the previous provincial administration as the crisis unfolded. As Wibbels has noted:

> "whereas national officials responding to national electorates may place priority on a market-friendly policy such as macroeconomic stability, sub-national officials may respond to completely different electoral incentives that require heavy reliance on public spending to fund local patronage networks. …sub-national politics … are often more clientelistic than politics at the national level."[108]

Given the level of acrimony with the federal government, the continuing need to finance provincial expenditures and the perceived potential for more local fiscal failure, the imposition of hard constraints as a permanent feature of the provincial-municipal relationship is not surprising.

Section 5 - Measuring and Assessing the Rationale for and the Impact of the Budget Constraint

Introduction

By 1935, municipal spending, taxing and borrowing decisions occurred in the context of a general hard hierarchical budget constraint. In this part, municipal and market reaction to the

[107] While federal officials were apparently familiar with the Australian situation and institutional response, similar difficulties were also being experienced in Norway. Briefly, many small local governments had borrowed heavily in the first decades of the century to build hydro-electric power systems. By 1934-35, some local governments had debt-expenditure ratios of 20, making repayment difficult. A "tax-burden" committee reporting in 1932 characterised 333 of a total of about 750 local governments to be in a state of fiscal crisis. 166 had mainly a debt problem. The others had a small fiscal base. … The 'Municipal Debt Act' of 1923 created the legal basis to put local governments under direct central administration. This law was replaced by the Federal Administration Act of 1928. …The law required that financial decisions in municipalities under federal administration had to be approved by the central government. The local governments could only make proposals. Falch and Tovmo (2003, 133).

[108] Wibbels (2005, 27).

constraint are analysed using comparative fiscal indicators and statistical analysis based on current methodology and the "good housekeeping" literature pertaining to the behaviour of sovereign borrowers. ***The analysis also lends credibility to the provincial desire to contain the spread of the municipal fiscal crisis as described below.***

Did Municipal Fiscal Health Improve?

Basic indicators related to levels of taxation, indebtedness and transfer dependency have been defined by the Public Sector Accounting Board (PSAB)[109] to describe three different but interrelated characteristics of the fiscal condition of governments: sustainability, flexibility and vulnerability. Sustainability is the degree to which a government can maintain its existing financial obligations in respect of service commitments to the public and its financial commitments to creditors and employees without increasing the relative tax and debt burdens in the economy.[110] Perennial operating deficits or a trend of an increasing share of debt charges in current revenues suggest an unsustainable fiscal condition. For local governments, the ratio of outstanding debt to annual revenue[111] provides an indication of the future revenue that may be encumbered to finance past spending. The ratio of debt to taxes is used below.

Flexibility or revenue capacity is the degree to which a government can increase the relative levels of debt or taxes to meet existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others. The choice of whether to borrow or to expand taxation at the local level may be affected by

[109] PSAB (2007) The Public Sector Accounting Board is a board of the Canadian Institute of Chartered Accountants. In Ontario, municipal accounts must conform with the general accounting principles established by PSAB. Similar indicators were used in Tassonyi (1994) as measures of municipal fiscal health. These indicators are also used in Reinhart and Rogoff (2009) with respect to sovereign borrowers. See Flandreau and Zumer (2004) as well.

[110] PSAB (2007, 6).

[111] PSAB(2007, 10).

constraints imposed within the intergovernmental hierarchy, such as borrowing constraints or tax rate limits or by constraints imposed by local economic circumstances impairing the capacity of the tax base to bear either a current or future obligation. In either case, the decision may limit the future possibilities for pursuing either way to finance expenditures.

For local governments, given relatively limited access to sources of own source revenue, the relative impact of financing a given type of expenditure is better measured relative to own-source revenues rather than as a portion of current expenditures, given the stability of revenue from year to year and to exclude the impact of transfer payments. Hence, the ratio of "public debt charges to revenues"[112] is an indicator of flexibility in spending. This measure illustrates the extent to which past borrowing decisions may present a constraint to a government's ability to meet its financial and service commitments in the current period. An increase of this indicator over an extended period of time during a period of relatively stable interest rates means that the government has consistently chosen borrowing over increases in taxation or user fees to meet its financial and service commitments. Increasing borrowing will eventually affect flexibility, assuming that debt service takes priority over other mandatory expenditure commitments.[113] Flexibility is also captured by the debt to assessment ratio as a rise in the ratio suggests the impairment of municipal fiscal capacity either through a reduction in the tax base or an increase in mandatory expenditure resulting from increased indebtedness.

[112] PSAB (2007, 11).

[113] "Failing to do so would impair its future ability to borrow or to roll over its existing debt." (PSAB, 2007, 11). Also sub-national governments do not control monetary policy, precluding using inflation as an alternative to debt service.

The most frequently used measure of revenue capacity, given the overwhelming predominance of property taxation as the local source of revenue is the ratio of "own-source revenues to taxable assessment."

> "Taxable assessment is a traditional, familiar and understandable alternative that is readily available. As used here, taxable assessment is considered to be a reasonable, although imperfect, proxy measure of wealth and therefore, ability to pay."[114]

Using taxes levied as a proxy for own- source revenues results in the calculation of effective tax rates as the measure. In terms of dependence on property taxation, in 1939, the average ratio of property taxes collected to actual own-source revenues was 73.3 percent in the cities. In the municipalities under supervision, the average ratio was 68.9 percent while in the smaller urban areas the average ratio was 87.7 percent.

Lastly, the degree of vulnerability of a local government can be a function of either transfer dependency or the risks created by exogenous shocks that impact on its tax base. Dependency is usually measured by the ratio of transfers-to-total revenues; however, during this period, the extent of intergovernmental transfers was relatively small.[115] Thus, an alternative measure, the proportion of the population on relief (social assistance) has been used as a better indicator of vulnerability. This measure is also a proxy for the most significant cost-shared expenditure pressure.

Standard indicators of municipal fiscal health have been calculated from the provincially published data to compare the financial condition of the municipalities that escaped default and supervision with those whose financial affairs were taken in hand by the province. As noted the

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[114] PSAB (2007, 12).

[115] Also, there are inconsistencies in the reporting of transfers.

provincial report[116] for 1939 provides information at the municipal level for population, assessment, the municipal and school taxes imposed, tax arrears, other revenues, gross long-term debt, the average coupon rate on the debt, the percentage of the population on relief, and for the larger municipalities, a breakdown of municipal expenditures. Unfortunately, the earlier reports which provide information on all municipalities in the province are less detailed. However, for 1921 and 1933, data is available at the township, town and city level that permits a comparison with the fiscal situation in 1939, at least for the principal fiscal variables.[117]

The availability of data for 1921 is fortuitous, as a snapshot of the fiscal condition at the local level is provided before the investment boom of the 1920s and the slump beginning in 1929. Using 1933 data provides information prior to the imposition of provincial control in most of the defaulting municipalities while the 1939 data reflects the impact of coping with the effect of the depression and provincial controls before the beginning of World War II.

Table 8. Debt Per Capita (Current Dollars)

	Municipal Debt/Capita			**School Debt/Capita**			**Total Debt/Capita**		
	1921	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
Cities	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Avg.Debt/Capita	149.21	157.89	107.76	23.42	35.80	27.39	172.63	193.69	134.14
Std.Dev.	84.57	64.65	60.22	11.32	18.69	14.55	90.19	72.65	62.99
COV	0.567	0.409	0.559	0.483	0.522	0.531	0.522	0.375	0.470
Urban	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Avg.Debt/Capita	64.88	106.13	72.64	17.66	29.25	16.75	79.99	134.43	86.88
Std.Dev.	65.65	89.88	65.34	20.68	20.63	11.67	71.58	102.57	67.24
COV	1.012	0.847	0.900	1.171	0.705	0.696	0.895	0.760	0.774
Supervised	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Avg.Debt/Capita	88.00	182.13	116.42	21.87	34.18	19.33	107.62	214.65	126.83
Std.Dev.	101.13	153.56	76.19	24.04	25.59	15.79	103.79	166.54	77.92

[116] Ontario Department of Municipal Affairs (1940).

[117] Cities have populations greater than 25,000; urban municipalities have populations ranging from 5000 to 24,999.

COV	1.149	0.843	0.654	1.100	0.749	0.817	0.964	0.776	0.614
City+Urban	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Avg.Debt/Capita	91.90	122.42	83.54	19.55	31.36	20.09	110.15	153.07	101.55
Std.Dev.	82.48	85.88	65.52	18.27	20.15	13.70	89.03	97.77	69.17
COV	0.898	0.702	0.784	0.934	0.643	0.682	0.808	0.639	0.681

Note: COV=St.dev/Avg. Source: Author's calculations. (Tassonyi 2011).

During World War I, local debt per capita declined after 1914 from $55 per capita to a low point of $36 per capita in 1919, measured in terms of 1900 purchasing power. However, with the end of the war, municipalities in Ontario renewed their vigorous use of borrowed funds to finance their activities. By 1921, aggregated at the provincial level, local indebtedness per capita had increased to over $50 per capita. The average of real local debt per capita for cities was nearly $75 in 1921 while the average per capita indebtedness for the municipalities that would be under provincial supervision after 1933 was at $47 per capita, measured in $1900 purchasing power (Table 5 above). However, by 1932, the provincial average had increased to $95, the interwar peak for this measure, and in 1933 stood at $91.50. By 1933, the average real debt per capita for cities had increased to $117 per capita while the average real per capita indebtedness for municipalities in default had increased to $129 per capita during the twenties, above both the provincial average and the average for cities at this point in time. By 1939, the impact of hardening of the budget constraint generally and the supervision of defaulting municipalities specifically is evident in the decrease of this indicator to $69 for cities and $65 in the case of the latter. (Table 5 above) For the municipalities under supervision, the coefficient of variation (COV) was also reduced from 0.96 in 1921 to 0.61 in 1939 (see Table 8) for debt per capita in current dollars. In the other urban areas of the province, real debt per capita also followed the same trend as that in the supervised municipalities but less dramatically (Table 5).

Table 9. Debt/Assessment Ratio

	Municipal			School			Total		
	1921	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
Cities									
Pop.Wtd							18.2	18.1	16.3
Debt/Assmt	16.1	16.0	12.2	2.5	3.7	3.2	18.6	19.6	15.3
Std.Dev.	5.4	5.2	6.2	0.9	2.0	1.8	5.4	6.0	6.5
COV	33.9	32.5	51.0	36.3	54.4	55.2	29.3	30.5	42.5
Urban									
Pop.Wtd							11.1	22.9	19.6
Debt/Assmt	9.0	15.2	12.5	2.4	4.1	2.7	11.0	19.2	14.7
Std.Dev.	7.7	11.7	11.4	2.1	2.8	2.0	8.0	13.0	11.6
COV	86.1	76.9	90.8	85.4	67.9	74.8	72.7	67.6	79.3
Supervised									
Pop.Wtd							13.9	27.1	30.2
Debt/Assmt	10.7	23.0	22.3	3.1	4.2	3.4	13.4	27.0	24.3
Std.Dev.	6.4	11.6	12.8	2.4	2.7	2.9	6.7	12.3	13.0
COV	60.3	50.2	57.4	76.7	64.8	85.0	49.9	45.4	53.4
City+Urban									
Debt/Assmt	10.9	15.3	12.3	2.4	3.8	2.6	13.3	19.1	14.9
Std.Dev.	7.9	10.1	10.0	1.8	2.6	2.1	8.1	11.3	10.3
COV	72.3	66.5	81.7	76.8	68.2	79.3	61.2	59.3	69.2

Note: COV=St.dev/Avg. Source: Author's calculations. (Tassonyi 2011).

The average debt to assessment and debt to tax ratios also show similar patterns with the average ratios of the supervised municipalities exceeding those of other municipal categories. (Table 9 and 10) At the same time, the average assessment per capita in the defaulting municipalities in 1933 had weakened to $799 compared to the average for cities of $1,015 per capita and $971 for the province (Table 11).

Table 10. Debt/Tax Ratio

	Municipal			School			Total		
	1921	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
Cities									
Pop.Wtd							4.95	4.72	4.03
Avg.Debt/Tax	6.11	5.32	4.33	1.92	2.71	2.00	4.67	4.49	3.46
Std.Dev.	1.61	1.64	2.43	0.67	1.45	0.92	1.18	1.29	1.45
COV	0.263	0.308	0.560	0.347	0.535	0.462	0.252	0.288	0.419
	Municipal			**School**			**Total**		
Urban									
Pop.Wtd							2.63	3.61	3.22
Avg.Debt/Tax	3.42	4.15	3.68	1.70	2.92	1.69	2.77	3.66	2.85
Std.Dev.	2.73	3.77	2.96	1.62	1.83	1.19	1.87	2.73	1.90
COV	0.797	0.909	0.806	0.955	0.626	0.702	0.674	0.746	0.668
Supervised	**Municipal**			**School**			**Total**		
Pop.Wtd							3.26	4.74	5.33
Avg.Debt/Tax	3.81	6.37	5.88	2.06	2.98	1.83	3.11	5.25	4.25
Std.Dev.	2.53	4.59	3.68	1.93	1.97	1.44	1.54	3.32	2.57
COV	0.66	0.72	0.63	0.94	0.66	0.79	0.49	0.63	0.60
	Municipal			**School**			**Total**		
City+Urban	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
Avg.Debt/Tax	4.17	4.47	3.88	1.75	2.76	1.59	3.35	3.88	3.04
Std.Dev.	2.79	3.30	2.81	1.39	1.76	1.19	1.92	2.42	1.79
COV	0.668	0.740	0.724	0.794	0.638	0.749	0.572	0.624	0.589

Note: COV=St.dev/Avg. Source: Author's calculations. (Tassonyi 2011)

Table 11. Assessment Per Capita

		1921	1933	1939
		$	$	$
Cities	**Avg Assmt/Cap**	916.20	1,015.40	893.74
	Std.Dev.	267.65	322.71	229.95
	COV	0.29	0.32	0.26
Mun	**Avg.Assmt/Capita**	760.55	731.80	643.31
>5000	**Std.Dev.**	419.28	307.81	226.46
	COV	0.55	0.42	0.35
Supervised	**Avg.Assmt/Cap**	806.88	798.63	630.28
	Std.Dev.	721.27	520.88	484.45
	COV	0.89	0.65	0.77
City+Urban	**Avg.Assmt/Cap**	811	820	721
	Std.Dev.	382.62	337.58	254.46
	COV	0.472	0.412	0.353

Note: COV=St.dev/Avg. Source: Author's calculations. (Tassonyi 2011)

Table 12. Share in Municipal Debt

Year	General	Local Improvements	Municipal Utilities	Year	General	Lcl Imp.	Mun. Util.
	%	%	%		%	%	%
1924	32.2	24.7	43.1	**1932**	31.1	31.4	37.5
1925	33.9	24.7	41.4	**1933**	32.7	29.7	37.6
1926	35.0	23.6	41.4	**1934**	30.0	30.7	39.3
1927	34.8	24.3	40.9	**1935**	32.2	26.8	41.0
1928	34.4	25.2	40.3	**1936**	34.0	25.0	41.0
1929	32.6	27.3	40.2	**1939**	40.3	21.8	37.9
1930	32.1	30.1	37.8	**1940**	50.1	17.0	32.9
1931	31.1	31.7	37.2	**1941**	50.5	16.4	33.1

Source: Author's calculations. (Tassonyi 2011).

For this period, local debt can be split between municipal and school purposes. Municipal debt per capita in the supervised municipalities had increased nearly threefold and education debt per capita over two and one-half times in real terms between 1921 and 1933 (Table 8 above). By comparison, municipal debt per capita had increased by just over a third and education debt per capita doubled in the cities during the same period. Given that many of the defaulting municipalities were newly expanding suburban areas around the established centres of Toronto and Windsor, the dependence on debt is not surprising. Table 12 shows the composition of the debt by category. Local improvement and utility debt which were perceived to be self-funding and secure dominate.[118] While increasing dependence on this type of debt is consistent with the "tax-less" finance mode of thinking, it also implies that municipalities did not anticipate a need for a bail-out.

[118] The data shows a significant decline in the outstanding debt for utilities and local improvements by 1940, likely due to repayments and less debt being issued.

Using the debt/tax ratio for 1921, 1933 and 1939 as a measure of “sustainability,”[119] cities made a significant effort to improve the long-run “sustainability of their fiscal position over this time period (Table 10). This ratio falls, both as a simple average from 4.67 in 1921 to 3.5 in 1939 and from 4.95 to 4.03 from 1921 to 1939 on a population weighted basis.

Cities increased their tax effort in conjunction with the imposition of harder constraints on borrowing after 1935 and the impact of the economic crisis. In both the smaller urban areas and in the municipalities that ended the period in supervision, the ratio also increased significantly from 1921 to 1933, by 21 percent in the former and 67 percent in the latter for municipal debt/taxes. Subsequently, as both economic and legislative constraints bit, both the municipal debt/tax ratio and the overall debt/tax ratio fell from 1933 to 1939, experiencing greater declines than the city ratio and arguably improving the fiscal sustainability of the smaller urban municipalities. On an unweighted basis, the average debt/tax ratio fell for supervised municipalities but the population weighted ratio actually increased suggesting that sustainability as shown by this ratio had not overly improved in the larger supervised municipalities (Table 10)[120] The coefficient of variance (COV) in debt/tax ratios in supervised, urban and smaller municipalities is also larger than the COV for cities in this ratio. This implies that debt/tax ratios in the larger municipalities were more congruent generally.

As the ratio of debt to taxable assessment increases, a municipality’s fiscal “flexibility” is reduced.[121] In the cities that managed to avoid supervision, this ratio was 0.186 in 1921,

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[119] As property taxes were about 80 percent of own-source revenue, using taxes as a proxy seems reasonable.

[120] Reinhart and Rogoff (2009, 81) show ratios of debt to revenue for Newfoundland going from 8.4 in 1928 to 12.6 in 1933 just prior to its loss of sovereignty. They state that “the ratio of total debt to revenue at the time of external default, for an average of 89 episodes is 4.2.

[121] Debt is being used a proxy for the absence of data on debt charges.

increased to 0.196 by 1933 and fell to 0.153 by 1939 (Table 9). By contrast, in the municipalities that were provincially supervised, the ratio increased from 0.134 in 1921 (below the city average) to 0.270 in 1933 and fell to 0.243 by 1939. (The provincial average moved from 0.132 in 1921 to 0.157 in 1933 and 0.131 by 1939.) The COV for this ratio suggests that variability among municipalities of this indicator increased between 1921 and 1939 albeit with a dip in the middle. During this period, the real per capita value of the assessment base increased in the cities but declined in the municipalities under supervision and in the other urban areas of the province. While the falling real value of the assessment base can be attributed to the exogenous impact of the depression on these communities, it is also clear that municipalities were taking steps to reduce their debt issuance as well.

As unsustainable levels of debt were incurred and as flexibility was impaired prior to the imposition of the ultimate constraint, the level of taxes imposed (measured in per capita terms) increased significantly as well before the depths of the depression were reached. The average level of local taxes per capita in current dollars in the cities was $35.66 in 1921 and increased to $42.64 by 1933 with a decrease to just under $38.29 by 1939 (Table 8). The real per capita taxes show a similar pattern (Table 13) In the defaulting municipalities, the local tax per capita averaged at $30.25, again below the city average and increased to $42.43 by 1933 with a decrease to $29.40 by 1939. The attempt to increase revenue through tax imposition is also reflected by the trend of actual effective tax rates (shown on Table 14) which were increased only slightly from 1921 to 1933 and remained constant to 1939 in the cities.

Table 13. Taxes Per Capita (Current Dollars)

	Municipal Taxes			School Taxes			Total Taxes		
	$	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Cities	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
Avg Tax/Capita	23.85	29.37	24.67	11.81	13.27	13.62	35.66	42.64	38.29
Std.Dev.	8.21	5.28	4.74	2.64	2.39	2.50	8.89	6.67	6.29
COV	0.344	0.180	0.192	0.223	0.180	0.184	0.249	0.157	0.164
Urban	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Avg.Tax/Capita	16.57	24.67	17.81	8.91	9.59	9.74	25.48	34.26	27.56
Std.Dev.	6.69	11.46	7.21	3.15	4.11	3.47	8.50	13.66	9.27
COV	0.404	0.465	0.405	0.353	0.429	0.356	0.334	0.399	0.336
Supv.	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Avg.Tax/Capita	21.01	30.86	19.67	9.99	11.57	9.73	30.25	42.43	29.40
Std.Dev.	18.54	30.66	7.99	4.13	9.66	3.36	21.57	40.05	10.54
COV	0.883	0.994	0.406	0.414	0.836	0.346	0.713	0.944	0.359
City +Urban	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**	**$**
Avg.Tax/Capita	18.91	26.13	19.94	9.85	10.73	10.95	28.75	36.87	30.89
Std.Dev.	7.94	10.16	7.25	3.27	4.03	3.66	9.82	12.52	9.79
COV	0.420	0.389	0.364	0.333	0.376	0.335	0.341	0.340	0.317

Note: COV=St.dev/Avg. Source: Author’s calculations. (Tassonyi 2011).

In the supervised municipalities, the effective rate for municipal purposes was increased by forty percent between 1921 and 1933 and stayed level to 1939. However, the rate for education purposes remained constant through the 1920s and early 1930s with an increase at the end of the period. The fact that effective tax rates on property remained constant through the 1930s is evidence of a revenue hill type of constraint on municipal fiscal capacity. The fact these rates were not reduced in the face of the economic crisis and falling taxpayer income is suggestive of the lack of fiscal flexibility for the municipal sector.

Table 14. Effective Tax Rates

	Municipal Taxes			School Taxes			Total Taxes		
Cities	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**	**1921**	**1933**	**1939**
AvgETR	0.026	0.030	0.029	0.014	0.014	0.016	0.040	0.044	0.044
Std.Dev.	0.005	0.006	0.006	0.004	0.003	0.004	0.006	0.008	0.008
COV	0.194	0.209	0.210	0.303	0.205	0.223	0.148	0.188	0.189
Cities (NS)	0.026	0.014	0.040	0.030	0.014	0.044	0.029	0.016	0.045
Urban									
AvgETR	0.024	0.036	0.030	0.013	0.015	0.016	0.038	0.051	0.047
Std.Dev.	0.008	0.015	0.013	0.005	0.007	0.006	0.011	0.020	0.018
COV	0.334	0.417	0.425	0.390	0.497	0.385	0.301	0.384	0.382
Supv									
AvgETR	0.029	0.041	0.040	0.016	0.016	0.021	0.045	0.057	0.061
Std.Dev.	0.010	0.016	0.020	0.007	0.007	0.012	0.014	0.021	0.032
COV	0.364	0.400	0.503	0.459	0.427	0.593	0.324	0.372	0.523
City+Urban									
AvgETR	0.025	0.035	0.030	0.013	0.014	0.016	0.038	0.049	0.046
Std.Dev.	0.007	0.013	0.011	0.005	0.006	0.006	0.010	0.017	0.016
COV	0.293	0.387	0.376	0.363	0.435	0.345	0.259	0.352	0.338

Note: COV=St.dev/Avg
Source: Author's calculations. (Tassonyi 2011)

Despite or perhaps as a result of municipal taxing effort, the level of tax arrears also increased dramatically, through the depression years. In 1927, the average percentage of taxes remaining uncollected of the current levy for the thirteen municipalities for which data is available was 14.8 percent; for the same municipalities, this average was 23.5 and 13.5 percent in 1934 and 1939 respectively (Table 3). The average for all 28 cities in 1934 was 22.9 percent and fell to 13.7 percent during the next five years. In 1934, the provincial average level of tax arrears was $17.77 in current dollars compared to the average per capita total tax levied of $35.50. By 1939, the average per capita level of arrears was $11.65 in the cities and $18.25 in the municipalities being supervised, despite the supervisory effort.[122] The provincial average of

[122] The average total taxes per capita in 1939 for cities was $38.30 and in supervised municipalities was $29.40.

current tax collections as a percentage of current levy increased from 75 percent in 1934 to 83 percent by 1939 and 88 percent by 1941. These ratios attest to the continuing difficulty in current collections in the municipalities with a weakened fiscal base as well as an improvement in collection effort.

The combined effort of the Province in imposing hard hierarchical constraints and the efforts of municipal decision-makers resulted in reduced debt outstanding and increased tax levy and collection effort. For example, on average debt charges per capita in cities increased from $11 to $14 (current dollars) from 1933 to 1939. Thus, by 1939, the improvement to municipal fiscal capacity is discernible, particularly in the municipalities confronted by a hard constraint but having avoided default.[123] This is evident both at the individual and aggregate level, as shown on Table 8 as debt per capita levels improve after 1933.

[123] Büttner and Wildasin (2002) analyze the dynamic reaction of a large sample of cities in the United States from 1972 to 1997 to fiscal shocks using five basic variables including own revenue, vertical grants, general expenditure, debt service and a general deficit calculation. They conclude that "shocks to municipal public spending are typically followed by offsetting expenditure changes in subsequent periods, with relatively modest adjustments in other fiscal variables; by contrast, shocks to municipal revenue tend to persist and to be followed by substantial changes in municipal spending." (p. 4)

They also found that the response of large cities differs from small such that their findings cannot be generalized: "in a stochastic setting, where the local budget is subject to considerable fluctuations, governments may try to avoid a large amount of debt. This could be part of a precautionary policy which at reducing the risk of not being able to follow a certain policy agenda in the future. For these reasons, one might expect that budgetary adjustments will differ across jurisdictions depending on their initial debt burden; in particular, cities with high initial debt burdens might adjust to innovations in fiscal variables in such a way as to reduce their debt, while those with lower debt levels might have more flexibility to let expenditures rise or to let own-source revenues fall. Transfers from higher-level governments might also be more forthcoming for cities with higher debt levels, at least if municipal budget constraints are somewhat "soft". (p. 22)

Table 15. Municipalities Under Supervision, Total Debt Per Capita and Per Taxable Assessment

	1921		1933		1939	
Municipality	**Debt**	**Debt Per**	**Debt**	**Debt Per**	**Debt**	**Debt**
	Per capita	**Taxable**	**Per capita**	**Taxable**	**Per capita**	**Taxable**
		Assmt		**Assmt**		**Assmt**
	$	**$**	**$**	**$**	**$**	**$**
Etobicoke	40.25	0.09	109.92	0.21	193.33	0.42
Mimico	165.18	0.28	286.53	0.43	208.11	0.36
New Toronto	263.10	0.17	235.94	0.38	201.04	0.29
Scarborough	66.87	0.14	213.32	0.35	148.59	0.31
North York	95.90	0.08	208.88	0.25	152.67	0.25
Weston	103.93	0.14	213.64	0.24	173.73	0.23
York	76.92	0.13	187.56	0.44	167.57	0.46
Leaside	560.00	0.13	786.54	0.29	286.10	0.28
East York			145.26	0.34	138.06	0.37
Niagara Falls	125.15	0.16	174.55	0.17	114.96	0.08
Thorold	70.88	0.15	148.89	0.25	122.26	0.22
Fort Erie	33.41	0.05	329.62	0.29	229.85	0.29
Eastview	60.20	0.22	84.51	0.33	54.04	0.32
Sudbury	160.61	0.25	173.02	0.25	78.22	0.14
Kingsville	72.58	0.12	184.98	0.23	198.00	0.27
Essex	60.40	0.09	155.51	0.18	83.89	0.14
Windsor	149.95	0.12	206.15	0.15	317.94	0.35
East Windsor	192.43	0.29	438.00	0.20		
Amherstburg	80.94	0.12				
Lasalle			603.49	0.30	139.26	0.23
Riverside			525.04	0.55	218.96	0.34
Sandwich	190.72	0.16	251.48	0.22		
Sandwich E	310.40	0.15	292.07	0.54	89.32	0.29
Sandwich S	52.38	0.21	54.03	0.06	24.77	0.03
Sandwich W	30.54	0.01	643.75	0.54	254.47	0.46
Walkerville	289.43	0.19	269.31	0.16		
Pelee	82.61	0.13	157.51	0.24	142.57	0.09
Tecumseh	80.31	0.08	165.31	0.24	72.18	0.16
Dysart	1.31	0.00	18.91	0.05	8.77	0.03
Pt. Edward	16.18	0.05	49.25	0.07	17.37	0.03
Trenton	72.60	0.12	148.13	0.26	103.50	0.22
Leamington	94.10	0.14	165.04	0.24	123.42	0.18
Hawkesbury	77.97	0.18	74.19	0.19	35.12	0.09
Clarence	7.74	0.03			3.79	0.01
Pembroke	71.84	0.14	83.55	0.13	71.54	0.15
Midland	82.55	0.13	189.43	0.22	188.68	0.24
Collingwood	63.31	0.09	185.99	0.26	165.97	0.23
Penetang	46.72	0.14	45.14	0.15	47.58	0.17
Blind River	4.74	0.02	152.67	0.32	117.71	0.34

	1921		1933		1939	
Municipality	**Debt Per capita**	**Debt Per Taxable Assmt**	**Debt Per capita**	**Debt Per Taxable Assmt**	**Debt Per capita**	**Debt Taxable Assmt**
	$	**$**	**$**	**$**	**$**	**$**
Calvert			83.86	0.36	76.38	0.45
Sturgeon Falls	74.27	0.13	68.52	0.12	38.71	0.59
Haileybury	63.55	0.14	184.12	0.38	69.65	0.16
Rainy River	105.46	0.21	106.87	0.25	68.49	0.18
Avg. Per Capita	**107.63**	**0.13**	**214.65**	**0.26**	**126.83**	**0.24**
Total Per Capita	101.43	0.14	191.74	0.25	177.50	0.29
City Per Capita	281.63	0.14	234.74	0.18	182.02	0.16
Province	115.98	0.15	151.78	0.16	112.75	0.13

Source: Annual Reports of the Department of Municipal Affairs and Author's Calculations.

Section 6-Good Housekeeping: Imposition and Impact: Empirical Tests

After 1934, the Province improved the quality of the provincial reports of municipal fiscal data. A database of the principal and most consistent indicators of tax effort and borrowing activity has been assembled for a sample of 103 Ontario municipalities (1939), including those with population over 5,000 and smaller municipalities under provincial supervision. Of the 39 municipalities still under supervision in 1939 (Table 1*)*, 28 had population greater than 5,000. For 1939, data on population, assessment, the municipal and school taxes imposed, tax arrears, other revenues, gross long-term debt, the average coupon rate on the debt, the percentage of the population on relief, and for the larger municipalities, a breakdown of municipal expenditures is available. [124] Unfortunately, the earlier reports which provide information on all municipalities in the province are less detailed with the exception of the fiscal variables including taxes levied, assessment data and indebtedness.

[124] Ontario Department of Municipal Affairs (1940).

Table 16. Average of Arrears, Relief, and Municipal Coupon Rates

	1939	1939	1939
	Arrears/Taxes	**Relief/ Pop.**	**Coupon Rate**
	%	**%**	**%**
Cities	11.65	7.40	4.80
Municipalities>5000	13.17	6.57	5.32
Supervised	18.36	11.62	5.40
Supervised <5000	20.14	11.58	5.21

Source: Author's calculations.

Table 16 provides a comparison of the average levels of arrears as a percentage of taxes levied, the share of the population on relief and the coupon rate on borrowings for 1939. From this table, it is clear that on average, the supervised municipalities had higher levels of current taxes in arrears, population on relief and faced more expensive costs of borrowing.

Default and Supervision: The Hardest Constraint and the Cost of Borrowing

A priori, both fiscal decisions made by municipal decision makers as well as exogenous factors should impact on the cost of borrowing at the local level. In the eyes of investors in the municipal credit market, the relative ability of a municipality to borrow and to repay a debt is measured in terms of the coupon rates it can negotiate for its debts in the market. Given that these bonds were not always traded regularly, such that actual yields or yield spreads[125] can be calculated for comparison purposes, the coupon rate remains the best proxy of a measure of risk as well as an indicator of the relative cost of borrowing for a municipality.

Table 17 shows the average provincial coupon rates from 1906 to 1936 as calculated by the Province.[126] The bump in rate levels at the beginning of the slump likely influenced the provincial imposition of rules on municipal borrowing.

[125] See Mitchener and Weidenmier (2007, 25) where they state that consistent with other gold standard literature, they calculate "the current yield on a sovereign bond by dividing the coupon by the price of the debt security."

[126] Tomz (2007, 103) estimates that the average bond yield for Canada was 4.8 percent for 1931-1933 in the depths of the depression.

Table 17. Ontario Coupon Rates in Percentages

Year	Rate	Year	Rate
1906	3.50	**1925**	4.50
1909	4.00	**1927**	4.50
1911	4.00	**1928**	4.50
1914	4.50	**1929**	5.00
1920	6.00	**1931**	5.00
1921	6.00	**1932**	5.50
1922	5.50	**1933**	4.50
1922	5.00	**1934**	4.50
1923	5.00	**1934**	4.75
1924	4.50	**1936**	3.10

Source: Ontario Budget, 1939. In 1922 and 1934, two rates are shown reflecting the issuance of two tranches of debt.

Consistent with the literature, it would seem probable that the average coupon rate of on a municipality's debentures would reflect the relative risk as perceived by investors. The perception of the risk of investing in any individual municipality should then reflect the perceived fiscal capacity as measured by relative tax effort, the tax base and effectiveness of tax collection as well as indicators pertaining to an existing default/workout scheme and the general economic circumstances of a community.

Provincial policy in respect of constraints on borrowing (imposed in 1934 and 1935) and the legal and institutional framework for borrowing was of universal application. There were no distinctions in terms of municipality size, although the conditions imposed by supervisors may have varied somewhat. The equation is similar to the tests used to assess the gold standard and defaulting sovereign borrowers in the "good housekeeping seal of approval literature" summarized above.

The basic empirical equation testing the relative influence of fiscal variables on coupon rates is as follows:

COUPON RATE$(1939)_i = \beta_i + \beta_1$SUPERVISION$_i$ $+\beta_2$DEBT/CAPITA(1939)+

β_3DEBT/CAPITA1933)$_i$ + B_4DEBT/ASSMT$(1939)_i$ + β_5DEBT/ASSMT$(1933)_i$

$+\beta_6$TAX/CAPITA$(1939)_i$ $+\beta_7$TAX/CAPITA$(1933)_I$ + β_8EFFECTIVETAX$(1933)_i$+

β_9EFFECTIVETAX$(1933)_i$ + β_9ARREARS$(1939)_i + \varepsilon_i$.

COUPON RATE$_i$ is the average coupon rate for long-term debt incurred by municipalities for an individual municipality as calculated and reported by the Ministry of Municipal Affairs in 1939.[127]

SUPERVISON$_i$ is a binary variable with a value of unity if a municipality was under supervision by the Province at any time between 1931 and 1941. See Table 2 for a list of the municipalities.

ARREARS$_i$ is the amount of taxes in arrears per capita in each municipality in 1939.

RELIEF$_i$ is the percentage of a municipality's population on relief in 1939 as reported by the Ministry of Municipal Affairs.

DEBT/ASSMT$_i$ is the ratio of total gross local long-term debt including debt incurred for general municipal purposes, local improvement debt and municipal debt as well as education purposes outstanding in a year divided by the total assessment base either in 1933 or 1939.

DEBT/CAPITA$_i$ is the ratio of total gross local long-term debt including debt incurred for general municipal purposes, local improvement debt and municipal debt as well as education purposes outstanding in a year divided by the population of a municipality either in 1933 or 1939.

[127] Where the data was missing, an average rate has been calculated using the debt outstanding and the debt charges reported by the Ministry, assuming a ten year period. The results are consistent with reported rates.

DEBT/TAX$_i$ is the ratio of total gross local long-term debt including debt incurred for general municipal purposes, local improvement debt and municipal debt as well as education purposes outstanding in a year divided by the total local (municipal and school) taxes imposed either in 1933 or 1939.

EFFTAX$_i$ is the effective tax rate calculated as the total local (municipal and school) taxes imposed divided by the total assessment reported by the Ministry of Municipal Affairs for an individual municipality in 1933 or 1939.

TAX/CAPITA$_i$ is the ratio of total local (municipal and school) taxes imposed divided by the population of a municipality either in 1933 or 1939.

Variation in Coupon Rates

Did supervision or provincial or municipalities' own actions to ameliorate their fiscal condition affect the cost of borrowing? Following the intuition that coupon rates on debt issued at the municipal level may be affected by either political circumstances, investor perception of risk or fiscal circumstances as described by the chosen indicators, the relationship between the average coupon rates in 1939 and various indicators was tested using OLS regressions for urban municipalities (87 in 1939) and adding the sixteen small supervised municipalities (103). The results are summarized on Table 18.

The coefficient for the binary variable indicating whether or not a municipality had been under supervision during the period from 1933 to 1939 was consistently positive and significant. Specification (1) on Table 18 shows the results of testing the data for the municipalities with population greater than 5,000. In this case, of the fiscal variables, the coefficients on debt per capita measures and the effective tax rate for 1933 are statistically significant. The negative coefficient on 1939 debt per capita is perhaps counterintuitive relative to coupon rates except perhaps that it may suggest that municipalities that were able to borrow were borrowing again. The positive coefficient on 1933 debt per capita is consistent with an interpretation that suggests that high levels of debt in earlier period would likely result in a higher borrowing rates in a subsequent period. The positive and significant coefficient on 1933 effective tax rates suggests that municipalities with higher coupon rates would also have had to impose relatively higher effective tax rates to meet their financial commitments. The coefficient on ARREARS(1939) is small and statistically insignificant.

Table 18. Influence on 1939 Coupon Rate, Population Greater than 5000 and smaller Supervised Municipalities

Variable	**(1)**	**(2)**
Supervision	**0.3289**	**0.3699**
	(0.1779)*	**(0.0314**)***
Debt/Capita (1939)	**-0.0073**	-0.0015
	(0.0045)*	(0.0025)
Debt/Capita (1933)	**0.0054**	**0.0031**
	(0.0030)*	**(0.0017)***
Debt/Assmt (1939)	2.0524	**-2.2992**
	(2.8969)	**(1.4219)***
Debt/Assmt (1933)	-2.1739	0.0259
	(2.1015)	(1.4683)
Tax/Capita (1939)	0.0081	-0.0026
	(0.0197)	(0.0125)
Tax/Capita (1933)	-0.0137	-0.0094
	(0.0149)	(0.0060)
Eff Tax Rate (1939)	-4.4844	-2.3358
	(8.3925)	(6.0526)
Eff Tax Rate (1933)	**20.3622**	**18.5611**
	(7.2284)***	(6.6621)***

Arrears (1939)	0.0002	-0.0032
	(0.0098)	(0.0104)
Intercept	**4.5689**	**4.6835**
	(0.2892)***	**(0.2873)*****
R Square	0.3349	0.2465
Adjusted R Sq	0.2474	0.1646
Observations	87	103

(Standard error in parenthesis)
denotes P-value less than 10%;** denotes P-value less than 5%; *** denotes P-value less than 1%.

Extending the sample to include the smaller supervised municipalities enhances the statistical significance of the coefficient on the debt/assessment ratio for 1939 and changed the coefficient from positive to negative, suggesting that a higher ratio was correlated with a lower coupon rate, at least in the larger sample. The coefficient on SUPERVISION also increased.

Table 19 shows the results of regressions using the fiscal indicators and the coupon rates for the municipalities that were supervised. The coefficient on the debt/assessment ratio was consistently statistically significant in these regressions, whether as levels or testing the difference. Again, these results support the conclusion that efforts to reduce the debt/assessment ratio could influence the relative coupon rate on local borrowing.

Table 19. Influence on Coupon Rate, Supervised Municipalities

Variable	**(1)**	**(2)**	**(3)**	**(4)**	**Variable**	**Coefficient**
Arrears(1939)	-0.0098	-0.0214			**Diff in Debt/Assmt**	**-3.7539**
	(0.0195)	(0.0172)			(1939-1933)	**(1.3584)*****
Relief (1939)	0.0063	-0.0025				
	(0.0188)	(.0172)				
Debt/Capita (1939)	0.0028					
	(0.069)					
Debt/Capita (1933)	0.0039					
	(0.0030)					

Debt/Assmt(1939)	-7.2393	**-4.9574**	**-3.7097**	**-3.9997**		
	(4.2716)	**(1.9504)*****	**(1.5180)****	**(1.5042)****		
Debt/Assmt(1933)	2.0308	**5.0682**	**3.7938**	**3.5074**		
	(2.8584)	**(1.6715)*****	**(1.4925)****	**(1.4791)****		
Tax/Capita (1939)	0.0036					
	(0.0323)					
Tax/Capita (1933)	-0.0154					
	(0.0112)					
Effective Tax (1939)	11.2284	6.9779				
	(12.0710)	(6.0750)				
Effective Tax (1939)	21.7777					
	(13.6747)					
Intercept	**4.1719**	**5.1909**	**5.2877**	**4.8195**	**Intercept**	**5.309**
	(0.8451)***	**(0.4368)*****	**(0.3408)*****	**(0.4556)*****		**(0.1444)*****
R Sq	0.3134	0.2366	0.1712	0.2217	R Sq	0.1711
Adjusted R Sq	0.0682	0.1233	0.1252	0.1550	Adjusted R Sq	0.1487
Observations	39	39	39	39	Observations	39

Standard error in parenthesis) * denotes P-value less than 10%;** denotes P-value less than 5%; *** denotes P-value less than 1%.

Conclusions

Canadian governments at all levels have generally been bound by constraints and maintained their fiscal health. As noted in earlier work:

> "One reason may perhaps be because the hardest budget constraint is one that is forged in the fires of experience rather than one imposed from above, or from outside. Countries (or, more accurately, such institutional manifestations as political parties and governments) may, like individuals, learn from experience and gradually inculcate norms of behaviour that constrain their actions even when none of the more obvious forms of hard budget constraint would seem to be applicable at the margin."[128]

[128] Bird and Tassonyi (2003, 87).

In the 1930s, the Hepburn government imposed a long-lasting hard budget constraint on Ontario municipalities. Given the information available to the legislators and also given the statistical testing, it is not surprising that there were concerns that the fiscal crisis could spread without drastic action. The imposition of supervision improved the fiscal circumstances of municipalities as shown by the standard tax and debt indicators and likely reduced the cost of borrowing for others. This action, while spurring reduced borrowing activity on the part of municipalities seems to have had the effect of spurring more provincial borrowing thus widening the actual impact of taxation and indebtedness[129]. While the Province did not "bail-out" the defaulting municipalities, the imposition of supervision may have been perceived by creditors as an implicit guarantee that debts would be repaid. The taxpayers in a municipality however did not escape the obligations created.

While debt per capita and as a percentage of the assessment base increased dramatically in these municipalities until the slump, municipalities in general increased the level of taxes imposed (measured in per capita terms) significantly as well – forced by a combination of institutional constraints on running deficits as well as the need to fund mandated expenditures. Thus, "tax-less" finance gave way to the need to tax. The concerted reduction in debt/assessment ratios even as the value of the assessment base fell is directly related to the relative costs of municipal borrowing. This effort however was not limited to just municipalities under supervision.

It is not clear that the maintenance of the hard constraint on municipalities is warranted. Even in the 1930s, the evidence is suggestive that alternatives such as more provincial or federal support for funding redistributive programs would have been at least as efficacious in preventing

[129] An analysis of the incidence of this policy regime awaits further research.

the local fiscal collapse as a blanket hard constraint. The relative extent of the population on relief definitely affected the probability of falling under provincial supervision. It also seems likely that the hardness of the constraint has biased both municipal taxing and borrowing behaviour since that time. It is not clear that this has been entirely optimal either but that is another story.

Further, there is the intergovernmental issue. While there is no evidence that municipalities expected bailouts but rather were taken by surprise by the impact of world-wide events on their fiscal situation, it would appear that Premier Hepburn in the 1930s like Premier Mowat in the 1880s wanted to clear the decks in order to be in a stronger negotiating position with respect to the federal government. It is clear that the Province wanted to avoid impairing the Ontario capacity to borrow.

Ultimately, the imposition of the hard hierarchical budget constraint combined with constraints imposed by the bond markets has resulted in a generally fiscally prudent municipal sector. Whether the sector is too prudent is an open debate that cannot be settled here. That the constraints should be loosened further in an effort to allow the “creatures” more nutrition is supported by the evidence that even the municipalities not under supervision actively took steps to improve their fiscal position in the midst of the crisis.

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