RECENT TRENDS IN CANADIAN FEDERAL-PROVINCIAL FINANCIAL RELATIONS[1]

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INTRODUCTION

The purpose of this paper is to present recent trends in Canadian fiscal federalism. This is the topic assigned to us by the conference organizers. We interpret recent to mean the last twenty years or so since it allow us to examine how the federal transfer system dealt first with a large central government deficit then with a surplus before entering anew a deficit era in 2008-2009.But to understand these trends one must have some background on the drivers of decentralization. Thus the first part of the paper provides this background; the second discusses changes over the last twenty years and presents current arrangements and spending levels; the last one speculates on where federal provincial financial relations may be headed in the post great recession era.

1 CANADA: THE CONTEXT

The degree and nature of decentralization that best fits the needs of a given country at a point in time is unique to this country (Bird and Vaillancourt, 1998). Various factors will help determine this with the weight of a given factor varying

[1] Paper prepared for The new Financing Model for the Spanish Autonomous State – International Perspectives"seminar organized by the Forum of Federations, the Gimenez Abad Foundation (Saragossa) and the Centre for Constitutional and Political Studies (Madrid) in Saragossa, October 2009. We thank Jamie Ronson and David Guimond for their research assistance and George Anderson for his comments.

over time for a country and of course between countries. Drawing on our knowledge of decentralization in various countries, we have identified (Vaillancourt, 2008a), five important determinants of decentralization: geography, history, demography, economics and politics. We would argue that they should be examined in that order, from greater to lesser degree of permanence, when studying the path or level of decentralization of a given country, if only to rule them out as unimportant.

Geographical issues encompass issues of size, topography, climate and location with respect to other units such as countries or ethno linguistic groups

Historical issues that matter are mainly linked to the nature of the agreement entered into when a country was created and / or decentralized. History often repeats itself. Hence conflicts between groups that played out 100 hundred years ago and that may be forgotten can reemerge if for efficiency reasons one undoes (or attempts to) part of the power sharing arrangements implicitly or explicitly arrived at then to settle these conflicts.

Demographic issues that matter from a decentralization perspective are: 1) the existence or not of major differences along the lines of ethnicity (skin color/race), language or religion in a given country; 2) the degree of region/group overlap amongst these different groups and 3) whether there are important differences in birthrates or mortality and thus in ageing between these groups. The second point is of particular importance since demand for decentralization in a country with for example five groups each with 20% of the population will probably be greater if each group occupies a specific territory than if are intermingled over the whole country. In that second case, the presence of groups in central institutions, the use of their language in that public administration and so on will be the salient issues, not demands for decentralization.

Economic issues that matter are linked to the geographical distribution of various sectors of activities, their vulnerability to outside pressure and shocks and their dependence

Political issues that matter are the existence or not of autonomist/secessionist movements in parts of a country and the existence or not of national parties at the central level.

GEOGRAPHIC ISSUES

Canada is the second largest country in the world, with an area of 10 million sq. km. This varied territory may roughly be divided into five regions˜ the Atlantic coastal area (which in turn is divided into four small population wise provinces-Newfoundland and Labrador and the three Maritime provinces-Prince Edward Island, Nova Scotia and New Brunswick), the central heartland along the St. Lawrence River and the upper Great Lakes (divided between the central provinces of Québec and Ontario), the great plains (beginning in the province of Manitoba and extending through Saskatchewan to Alberta), the mountain region ending on the coast of British Columbia and, finally, the great northern expanse, extending from the northern sectors of most provinces (except the three small Maritime Provinces) into the treeless reaches of the three sparsely populated northern territories. Despite this vast territory, however, most Canadians live within a few hundred kilometers of the US border and have important cultural (such as TV viewing habits in English Canada) and economic ties – for example, 75% of exports – with the US. They mainly live in urban areas, particularly in such major metropolitan areas as Montréal, Toronto and Vancouver.

One notes that the colder part of the country is divided into three territories that are not provinces. Thus climate has had an impact on the institutions of the federation through the intermediation of scarce population and little economic activity.

HISTORICAL ISSUES

Canada was created in 1867 by the union of three British colonies: Nova Scotia, New Brunswick, and Canada. The former colony of Canada was divided into two provinces: Ontario (the former Upper Canada) and Québec (Lower Canada). Three other British colonies soon joined the new country: Manitoba (the Red River colony) in 1870, British Columbia in 1871, and Prince Edward Island in 1873. In 1905, two new provinces, Saskatchewan and Alberta, were created out of federal lands.[2] Finally, Newfoundland, since 1933 again a British colony following a short-lived period of independence, joined Canada in 1949.

While there is some debate on this point among historians, it seems fair to state that the drafters of the Canadian Constitution (the British North America Act or BNA Act) intended to create a strong central government, largely in reaction to the recent Civil War in the United States and the perceived threat to Canada arising from that war.[3] The new Government of Canada was, for example, given sole possession of the key revenue source at that time, customs duties, and made responsible for economic development (banking, railways, tariffs, etc.), while the new provinces were left to handle such local matters as education, health and social services which were not very important in the 19th century. To further reinforce central power, the federal government was also permitted, in certain circumstances, to disallow provincial legislation and to declare certain "local works" of national interest – an example was uranium mining during World War II.[4]

During the 1920s and 1930s a series of decisions by the Judicial Committee of the Privy Council in London (which remained Canada's final court of appeal until 1949) reserved the field of transfers to individuals (workers compensation, welfare, unemployment insurance, old age pensions) for the provinces. As a result of these decisions, explicit constitutional amendments were required to allow for the creation of federal programs of unemployment insurance (in 1940) and old age pensions (in 1951).[5] These amendments were made with the assent of all provinces. Despite this judicially imposed restraint, however, the

[2] The area of a number of other provinces, notably Ontario and Québec, was also expanded considerably in 1912 by the inclusion in their jurisdiction of former federal lands in their northern reaches.
[3] This threat may be inferred from both American political rhetoric and, more concretely, incursions into Canada by Union veterans in upstate New York – the "Fenian raids" (so called because most of those involved were violently anti-British Irish immigrants).
[4] The disallowance power was last used in the depression years with respect to some financial laws introduced by Alberta's Social Credit government.
[5]Curiously, no amendment was used for the introduction of federal family allowances in 1944 (during WWII).

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federal government clearly remained dominant and fairly assertive in its relations with the provinces through both the depression of the 1930s and the succeeding war years.

Indeed World War II raised centralization, in fiscal terms, to a new height. In the ensuing decades, the federal government used its new fiscal power to intervene decisively in such constitutionally provincial fields as welfare, health which was mainly privately provided until 1957 and post-secondary education. This is discussed in detail in the second part of the paper.

DEMOGRAPHIC ISSUES

The following three issues are of importance e

First as shown in Figure 1 there are changes in the relative demographic weight of provinces in the last 25 years or so. Overall, population has become more concentrated in three provinces –Ontario, Alberta and British Columbia- out of ten, going from 56% to 62% from 1981 to 2006 while Québec drops from 26 to 23%.

Second and perhaps more important the age composition of the population of these provinces is not evolving at the same speed nor is it converging as shown in Figures 2a-2c. There is significant aging and it is accelerating in the four Atlantic Provinces and Québec. In the rest of Canada, a combination of attracting immigrants and an important aboriginal population is slowing this down except in BC a retirement destination. We come back to this in the financing arrangements discussion.

Third about 22 % of its population is of French mother tongue (francophones), living mainly in Québec where they account for 85% of Canadian francophones and 80% of Québec's population. A key fact is that 60% of Québec francophones speak only French and are thus confined to the Québec labour

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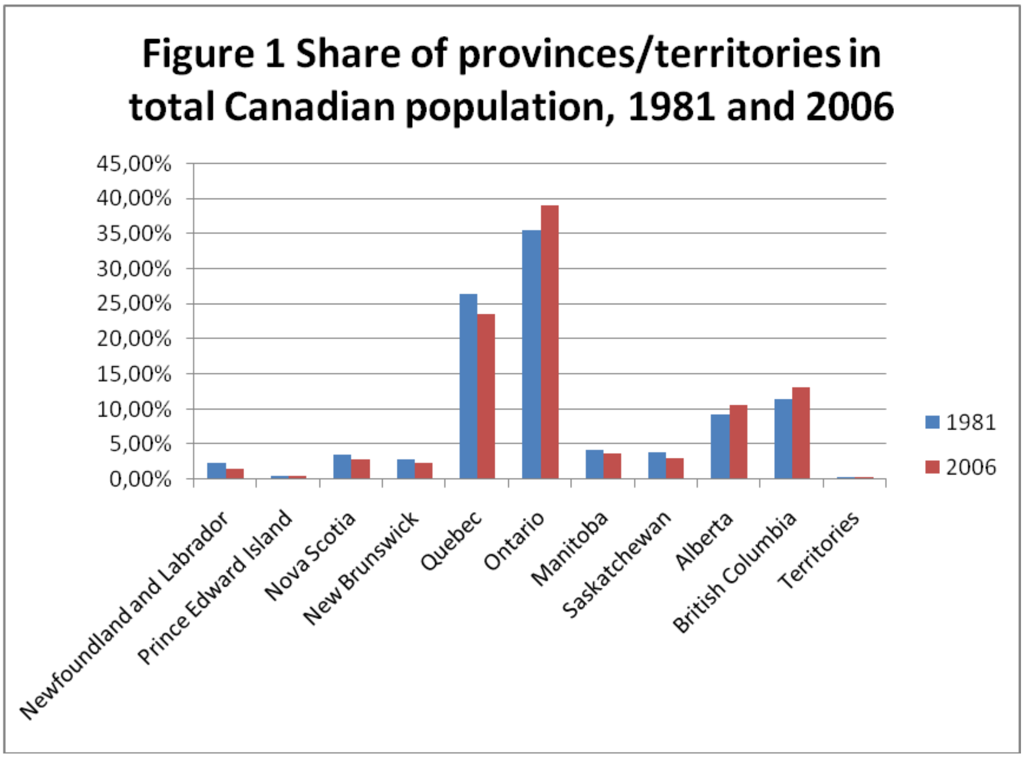
market[6]. This lack of mobility has consequences on their standard of living since they cannot use geographical mobility to adapt to economic shocks.



Source: CANSIM data Table 051-0001 and calculations by the author.

[6] 2006 Census data

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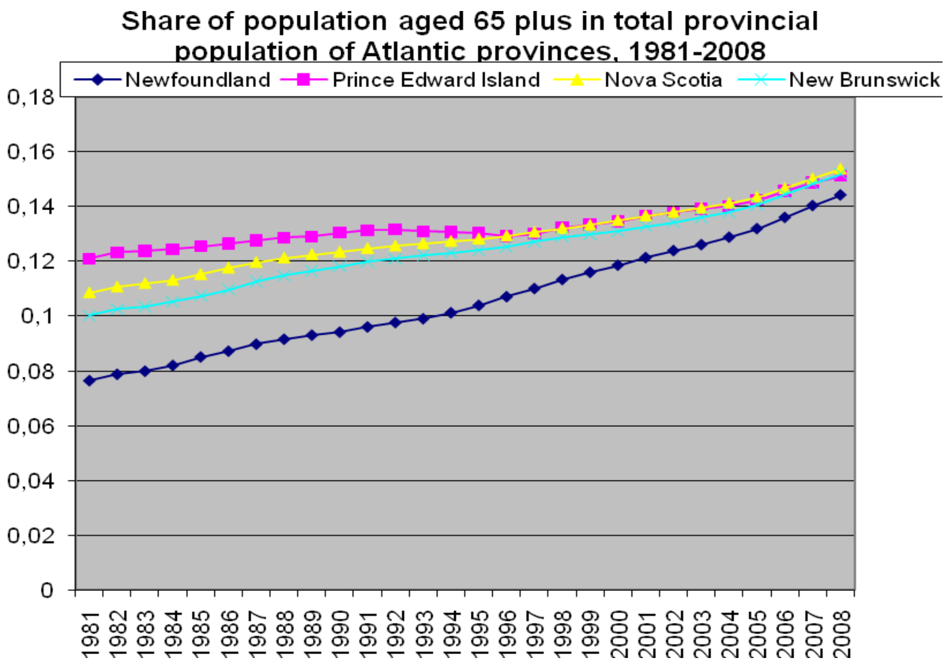
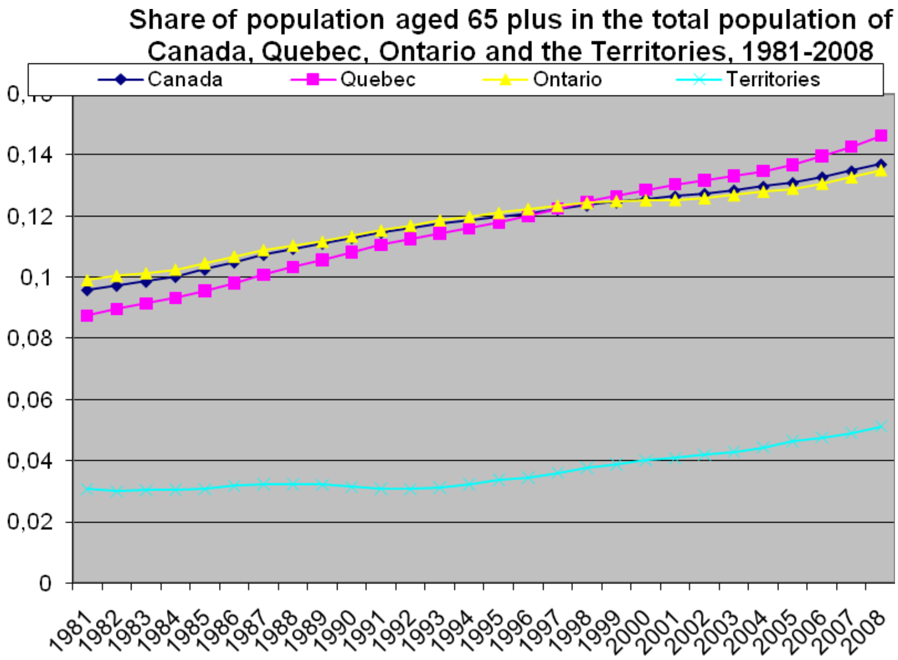
Figure 2a



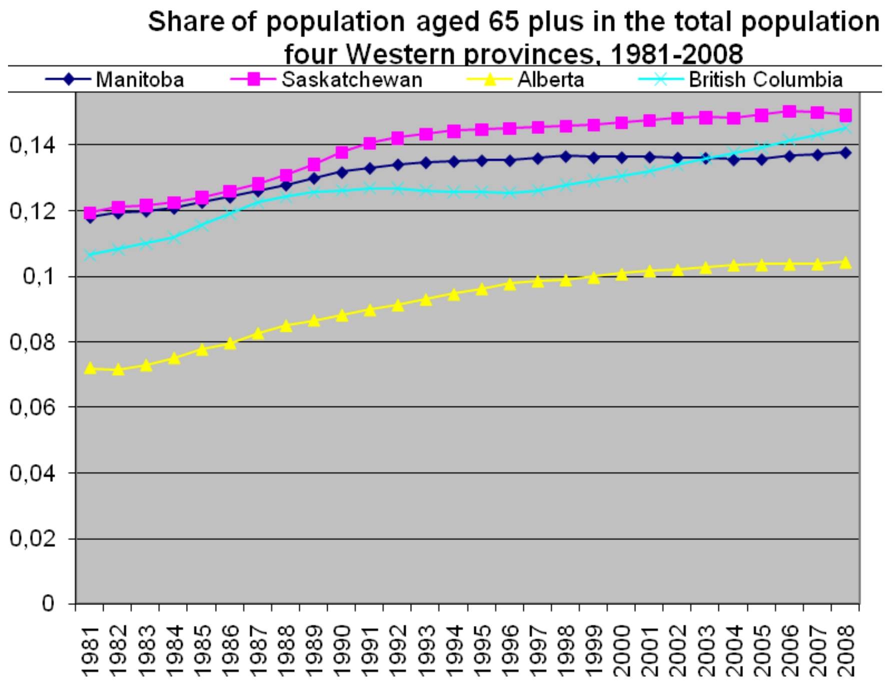
Source: CANSIM data Table 051-0001

Figure 2b



Source: CANSIM data Table 051-0001

Figure 2c



Source: CANSIM data Table 051-0001

ECONOMIC ISSUES

The following issues are relevant .First and foremost, the disparity in GDP per capita between provinces and the recent evolution of these disparities. Leaving aside the Territories, one sees in Figure 3 that in both 1981 and 2008 the lowest GDP per capita is found in Prince Edward Island and the highest in Alberta with a ratio of 2.5 to 1 in both years. In so far as there is a national constitutional commitment[7] to ensuring that provinces can provide comparable levels of services at comparable levels of taxation, this disparity in potential tax bases will require important transfers between regions. But focusing on these two end points is somewhat misleading as the ratio is only 1.6 in 1995 the mid point of the interval. This leads us to our second point which is the role of the distribution of natural resources across provinces. Oil and gas were highly concentrated in Alberta in the early part of the period while Newfoundland

[7] Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." (Subsection 36(2) of the Constitution Act, 1982)

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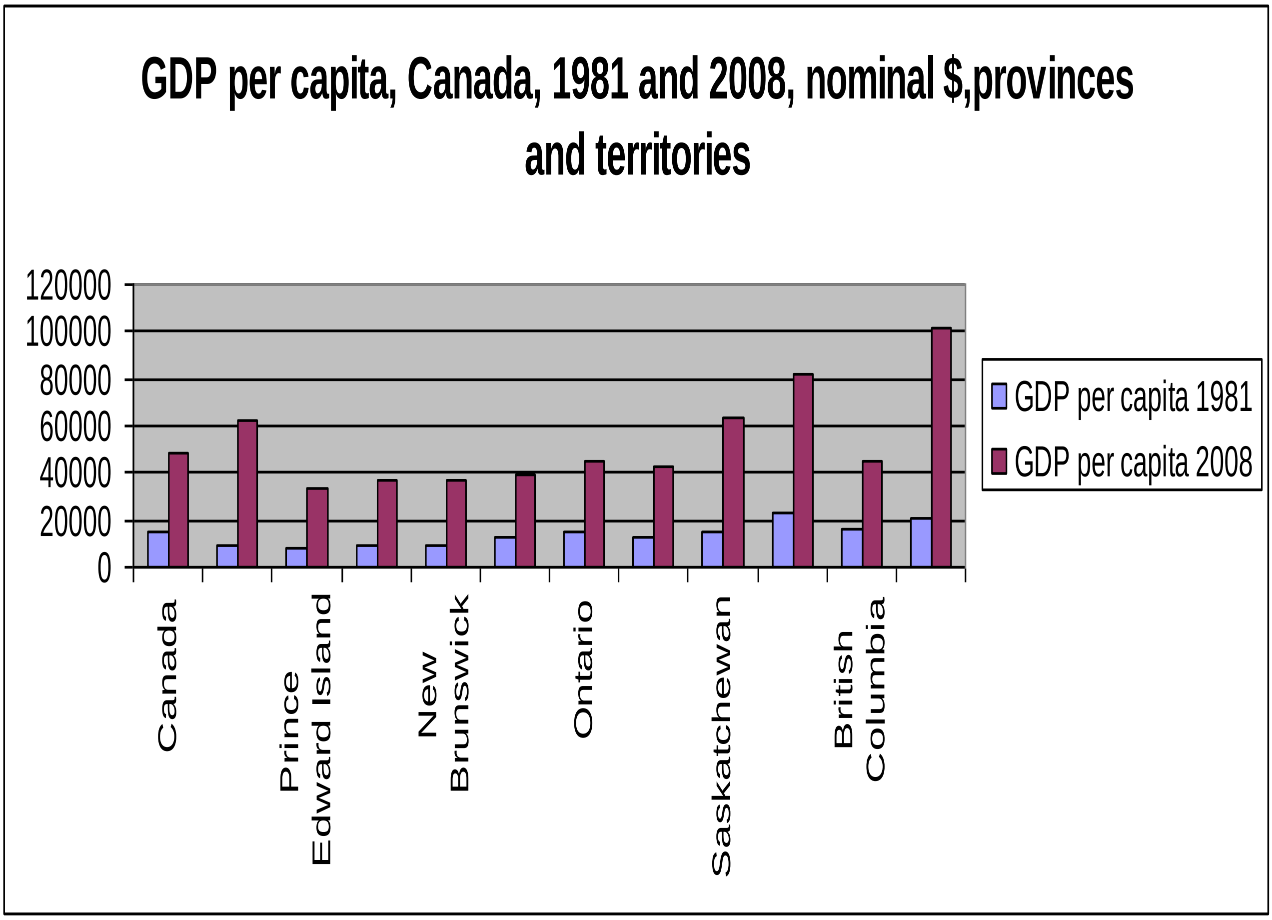
became an important producer in recent years. This explains the recent growth in the GDP of these two provinces as oil and gas prices peaked in 2008.

Changes in GDP per capita (4a) and in population shares both have an impact on the relative economic weight of the provinces which are presented in Figure 4b. The key points are:

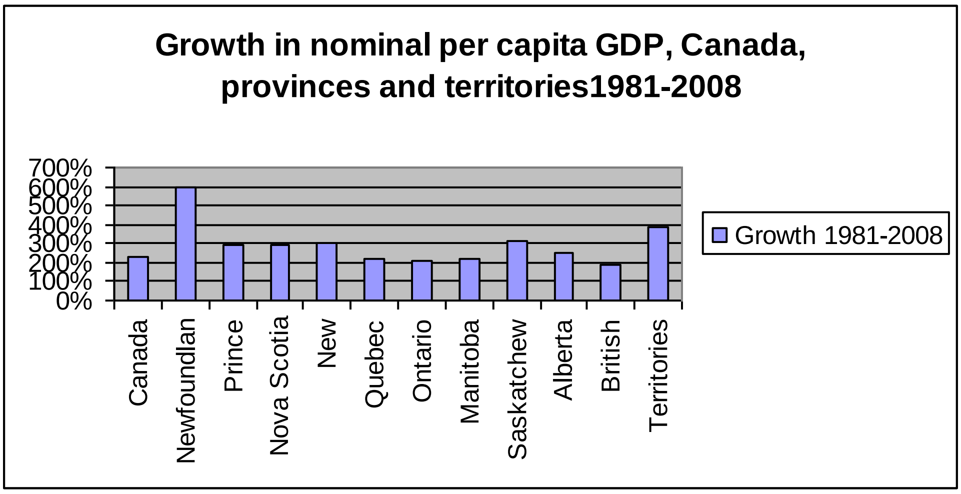
- the relative economic irrelevance of the Territories, the four Atlantic provinces and the two eastern Prairie provinces, all with less than 5% (2.5% in Atlantic Canada) of Canada's GDP;
- the slow but inexorable decline of Québec's share of Canada's GDP
- the rise then decline of Ontario's share mirrored by the decline then rise of Alberta's share of Canada's GDP

Figure 3



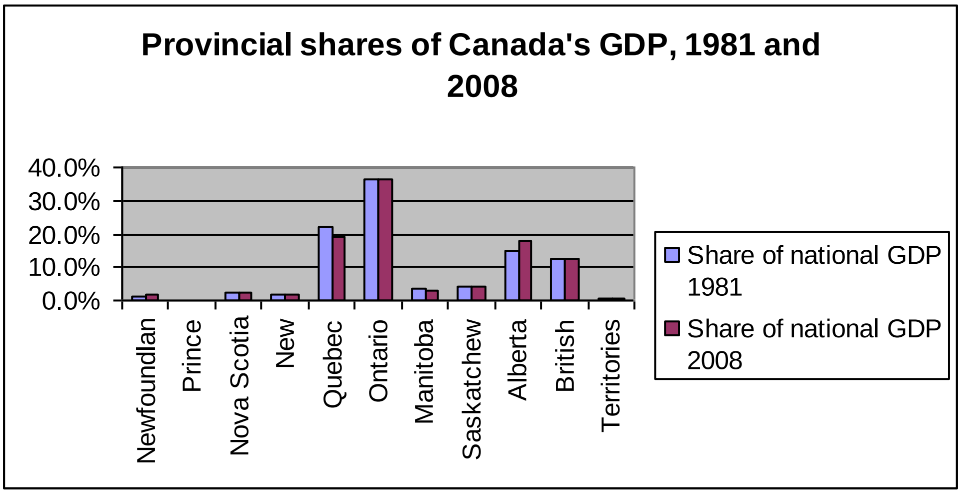
Source: CANSIM data Table 384-0001

Figure 4a



Source: CANSIM data Table 384-0001

Figure 4b



Source: CANSIM data Table 384-0001

POLITICAL ISSUES

There is an independence (sovereignist/ secessionist/separatist) movement in Québec. The Rassemblement pour l'Indépendance Nationale(RIN)[8] led by Pierre Bourgault contested the 1966 election, along with another sovereignist party, the Rassemblement National(RN)[9]; together ,they obtained about 9% of

[8] http://en.wikipedia.org/wiki/Rassemblement_pour_l%27ind%C3%A9pendance_nationale
[9] http://en.wikipedia.org/wiki/Ralliement_National

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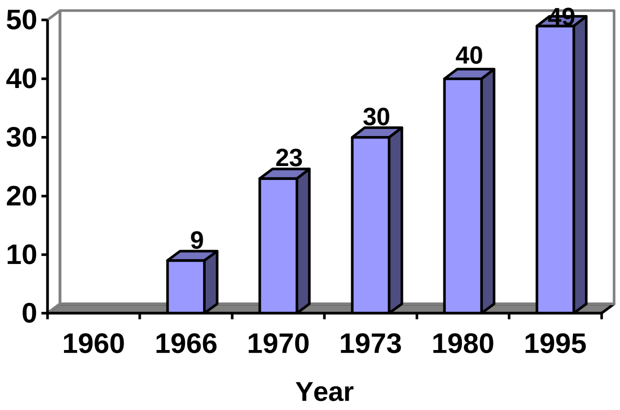
the votes. In 1967, René Lévesque split from the federalist liberal provincial party and founded the Mouvement Souveraineté Association[10] that transformed itself in the Parti Québécois (PQ) in 1968 with a merger with the RN and the dissolution of the RIN. The PQ contested the 1970 provincial election, obtaining 23% of the votes and the 1973 provincial election obtaining 30% of the votes[11]. It had promised in these two elections that if it won, it would proclaim independence. In 1976, it ran promising good government and a referendum on independence and won with 41% of the votes. The referendum was held in 1980 and lost with 40% of the votes in favor of independence. The PQ was reelected in 1981, defeated in 1985 and 1989 and elected in 1994.It held a second referendum in 1995 which it lost with 49% of the votes in favor of independence. It was reelected in 1998, defeated in 2003 and was not elected in 2007 or 2008. It is thus useful to examine the strength of support for sovereignty over the last 40 years or so, as done in Figure 5. It has been increasing steadily over time. Evidence from poll data shows that a majority of francophone voters (55% or so) supported sovereignty in 1995; the support for sovereignty has been at or above 40% over the last 30 years as current survey results (44% in June 2009[12]).

FIGURE 5 Support for Québec's Independence, 1966-1995



% of Québec Voters Supporting Sovereignists

[10] http://en.wikipedia.org/wiki/Mouvement_Souverainet%C3%A9-Association
[11] http://en.wikipedia.org/wiki/Parti_Qu%C3%A9b%C3%A9cois
[12] http://www.legermarketing.com/documents/pol/096301FR.pdf

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Sources: 1966: % voting for the RIN and the RN; 1970 and 1973: % voting for PQ; 1980 and 1995:% voting Yes in the referendum.

The strength of the support for sovereignty depends, in good part, on what the choices are. In both referendums, the other option was existing federal arrangements to be modified if the No side won. After 1980, the Canadian Constitution was amended without the agreement of the Québec government and with the clear intent of reducing its powers in language matters. A series of constitutional negotiations followed referred to as the Meech (1987) and Charlottetown (1992) accord (Bird and Vaillancourt, 2006). After 1995, the Constitution remained unchanged and the recognition of Québec as a "distinct" society by the House of Commons (1995) has had, in practice, no consequences nor has the November 2006 adoption by the House of Commons of a motion indicating that *this House recognize[s] that the Québécois form a nation within a united Canada*.[13].

2- FISCAL FEDERALISM IN CANADA -1989-2009

Before turning to fiscal federalism in Canada as such, we want to discuss what economists have in mind when they refer to a federal state.From an economic perspective, the inclusion or not of the word federal in the constitution of a sovereign state does not make it federal. Hence Spain is as much an economic federation as Germany and more so than Mexico both legally federal states: indeed Canada is formally a dominion, not a federation. What matters is the existence of a sub-national level of government that is larger than municipalities or towns, such as autonomous communities (AC), cantons, Landers, provinces or states (constituent entities: CEs) with elected decision makers. CEs can act in 1) an autonomous manner in raising some revenues and making some spending decisions, and/or 2) can have as a group substantial influence on the decisions of the federal government through their presence in central decision-making bodies. This is an imprecise criterion reflecting the fact that federal arrangements are quite different from one country to another.

[13] http://en.wikipedia.org/wiki/Quebec#Quebec_as_a_nation

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Autonomous fiscal choices criterion

Turning initially to 1), the *autonomous fiscal choices criterion,* one probably needs to define CEs as weak or strong along several continuums (summarized in Figure 6) as follows:

First, size matters. If CEs are a very small part of the public sector, they cannot have much of an impact on economic activity in a given country, however, high their degree of autonomy. The size can either be measured by spending or by revenue as a % of the total for all levels of governments. This will neglect the regulatory activities of CEs, but these are likely to be linked in terms of size to their spending responsibilities.

Second, tax freedom matters in the case of the revenue-raising continuum. The freedom or not of CEs to set their tax rates, tax bases and collect their own taxes are three indicators of this freedom. The larger the share of private resources affected, the more the progressivity of the personal income tax or the level investment incentives offered to businesses through the corporate income tax are the result of decisions made by CEs.

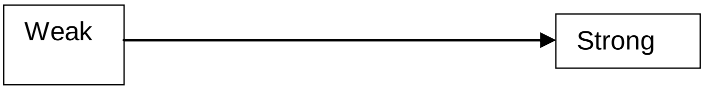
Third, with respect to spending, CEs can have various types of powers. They may set the salaries (prices) of inputs/outputs, they may set the quantities used/provided or they may set the quality of inputs/outputs.

Influencing central decision criterion

Let us now examine 2), the *influencing central decision criterion.* This is often done in democracies by having a second house, often referred to as the upper house, in contrast to the first or lower house (Bundestag/Bundesrat; House of Representatives/Senate). In that case, one can think of various degrees of representations of CEs in the central decision making process through that second house:

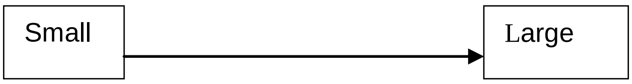
- No representation as such: This is the case in Canada, for example, where the Senate is appointed by the Prime Minister Note that this could be partly alleviated by the presence of regional parties in the lower house;
- Representation by elected members, such as the US or Swiss senators, which have the interest of their state/canton at heart;
- Representation by senators elected by municipal/departmental/regional councillors such as in France. These are not CEs, but are local governments;
- Representation by senators appointed by the CE government or legislature. This is the case of German Landers where state premiers and ministers (mayors and senators for city-states) represent their land in the Bundesrat.

FIGURE 6 Power Continuums, Autonomous Fiscal choices, CEs



- **The size continuum**

Size of all CEs in the public sector

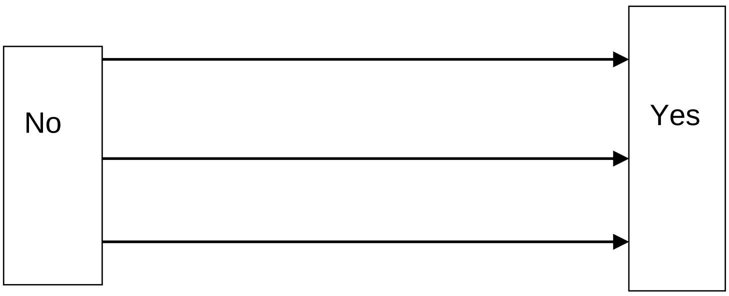


- **The revenue continuum**

Tax rate setting

Tax base setting

Tax collection



Share of total subnational revenues raised by CEs

Low → High

The spending continuum

Quantity setting

Price setting

Quality setting

No → Yes

Source: author

Turning to the fiscal context, from 1974 on, the federal government ran an annual budgetary deficit that by 1993 had reached 5% of GDP, with an important accumulated gross debt. Such a situation was unsustainable. In the second half of the 1990s, however, the combination of strong economic growth and tighter federal fiscal policy with both increases in taxes and cuts in spending, including cuts in transfers to provinces, turned things around. From 1997 until the advent of the great recession in 2008, the federal government has been in a budgetary surplus position and has been paying down debt. Although most provinces also eliminated or reduced their deficits, they did so with more difficulty in part owing to the nature of their expenditures and in part because of the federal transfer cuts. This divergent recent experience has led some to reopen the question of the appropriateness of the current assignment of revenues and expenditures in Canada. We return to this in the last part of the paper

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What do governments spend on and how do they finance themselves in Canada? Table 1 for a mid point year in the last decade and Figures 6 and 7 show some relevant information

Table 1 indicates that spending on social services which includes a universal pension scheme financed from general federal revenues, unemployment insurance, welfare and so on accounts for 25 % of government spending in Canada. This is followed by health and education spending. While the federal government plays an important role in the area of social spending (62%), it accounts for only 7% of both of education and health spending. In the case of education, it offers support for research activities in universities while in the case of health it is directly responsible for aboriginals and armed forces.[14] Given the aging of the population shown in figure 2, this has implications for federal-provincial financial relation we return to later.

[14] The public health system in Canada is a single payer system by province and not nation wide; hence there are ten similar public health plans in the ten provinces

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TABLE 1

Spending % by Type for Each Level of Government and by Level for Each Type, Canada, 2004

	General Services (1)	Protection of Persons & Property (2)	Transport. & Communication. (3)	Health (4)	Social Services (5)	Education (6)	Transfers to Other Governments (7)	Debt Charges (8)	Other (9)	Total $000 000
	% of each type of spending for each level of government									
All governments	3.59	8.32	4.18	18.93	25.65	15.41	_	10.58	0.39	471 615
Federal	3.97	11.03	1.08	3.38	37.29	2.57	14.71	11.81	0.036	201 436
Provincial	1.70	3.69	3.56	33.05	16.75	23.32	0.52	8.96	0.68	258 677
Municipal	8.87	15.90	15.86	1.58	4.95	17.35	_	5.43	0.022	53 938
	% for each level of government for each type of spending									
% Federal	47.13	56.65	11.01	7.62	62.09	7.13	98.92	47.68	4.00	201 436
% Provincial	26.01	24.34	46.72	95.76	35.82	82.98	4.50	46.45	95.45	258 677
% Local	28.22	21.87	43.40	0.95	2.20	12.88	_	5.86	0.65	53 938

Source: Cansim II, Tableau 385-0001, http://estat.statcan.ca/cgi-win/CNSMCGI.EXE

Figure 6 shows that the main source of autonomous revenues for all levels of government is the personal income tax which accounts for more than twice the share of any other tax with 30-35 % of own revenues thus raised. It is followed by two sources in the 10-15% range ; contributions to social security plans and general sales taxes .The property tax which accounts for about 10% of revenues is collected almost exclusively by local government , that is municipal bodies and school boards. Finally the corporate income tax follows the level of economic activity accounting for between 5 and 10% of revenues for a given year.

Taxes presented in figure 6 account for 2/3rds of own revenues of all governments. Other key items are investment income and sales of good and services which together account for 15% of revenues; the rest is miscellaneous taxes

Figure 7 shows the share of the federal government in the three major tax fields. It occupies:

- 60-70% of the corporate income tax field , making its revenues more vulnerable to economic downturns than provinces;
- 50-60% of the personal income tax field, a buoyant source of revenues;
- 40-50% of the general sales tax field, with the recent drop in this share associated with a drop in the GST (VAT) rate from 7 to 5% from 2006 to 2008.

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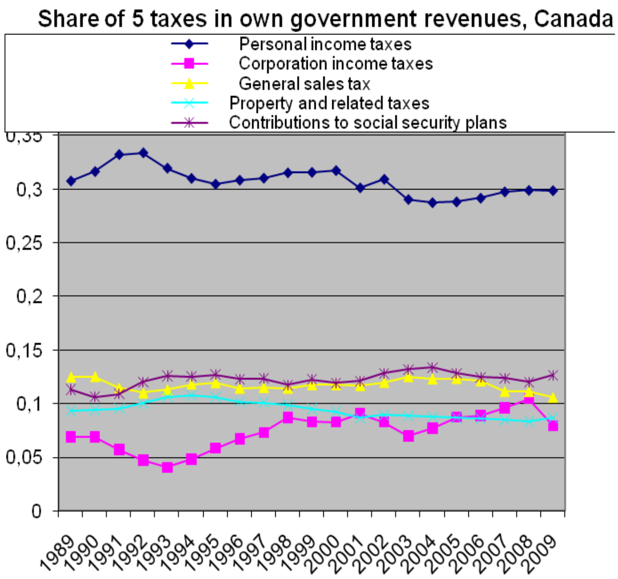
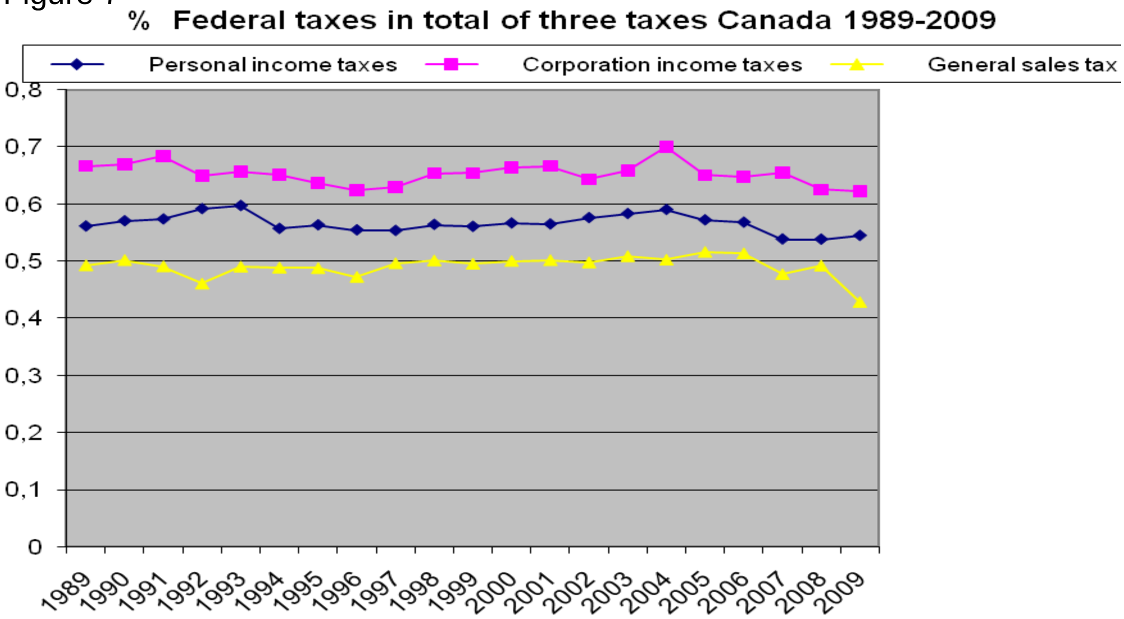
Figure 6



Source: CANSIM, table 385-0001

Figure 7



Source: CANSIM, table 385-0001

There are in 2009 five sources of transfers to provinces from the federal government. They are: payments from federal foundations, small cost sharing transfers, infrastructure transfers, block grants for social and health purposes and equalization. The last two are the major ones but should briefly describe the other ones.

Payments from federal foundations

Beginning in the late nineties the federal government began using foundations as a way to set aside budget surpluses for future spending since by law any surplus unspent by March 31st, the end date of the federal and provincial fiscal years had to be used to pay down the debt. When funds are transferred to a foundation under the control of the federal government, the funds are deemed to have been spent. Some of these foundations were and are used to make payments to provinces.

Small cost-sharing transfers

There are numerous cost sharing transfers between the federal and provincial programs. The main ones are in the area of social housing, agricultural insurance, official languages teaching and legal aid; Vaillancourt (2000) examines them in more detail.

Infrastructure funds

The federal government introduced these programs in 1993 to contribute to the costs of renewing various items of infrastructure particularly municipal infrastructure; Bojorques, Champagne and Vaillancourt (2009) examine these tripartite programs

Social and health policy transfers

Before turning to a description of the current health and social federal-provincial transfers, we briefly summarize the post WWII history of federal-provincial transfers in that field. The main points are:

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- The 1950s and 1960s witnessed the introduction of conditional grants and federal-provincial cost-sharing programs for hospitals, health insurance, post-secondary education (PSE) and welfare (transfers and services). More specifically:

  - **Post-Secondary Education**: In 1967, a federal-provincial cost-sharing program for 50% of university operating costs was introduced, replacing direct subsidies to universities introduced in the fifties.

  - ***Hospital Insurance and Diagnostic Services Act***: From 1957, each participating province received from the federal government 25% of the provincial cost of its hospital insurance program and 25% of the national average costs.

  - **Canada Assistance Plan:** In 1966, this program replaced various federal-provincial cost sharing programs with a 50-50 cost sharing scheme for admissible welfare expenses.

  - ***Medical Care Act***: Introduced in 1966 and taken by all provinces by 1970, this was an open-ended federal matching grant, with each province receiving 50% of the national average cost of paying for doctor services.

- The 1970s and 1980s saw:

  1) in the 1970s, a replacement of the health and PSE cost-sharing programs by one block grant called Established Programs Financing (EPF) in 1977, with per capita amounts set by the federal government , not linked to spending levels (no relationship to needs) and paid out on an equal per capita basis as of 1982 across provinces. Cash transfers to each province depend on three items: the level of the per capita transfer set at the federal level; the provincial population and the value of tax points transferred to provinces in 1977. The notion of transferred tax points is a Canadian invention that goes back to 1966 when Québec was allowed to opt/contract-out of federal transfers, with the federal government reducing the amount of personal income tax it collected in that province. This allowed that province to collect more provincial PIT

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without increasing the overall PIT burden on residents of Québec.[i] In 1977, all provinces saw a reduction in federal PIT and cash transfers and could increase provincial PIT to make up for the reduced transfers. Thus tax points refer to the tax room vacated by the federal government for the provinces. They are worth more per capita in provinces with higher income. 2) in the 1980s, a unilateral federal reduction in real terms of the envelope of the EPF through numerous changes in the indexing formula[15].

2) The 1990s saw EPF and CAP merged in 1995 in the Canada Health and Social Transfer (CHST). The new block funding represented the federal government's contribution to the three major social policy areas: health, post-secondary education and social assistance. This was done in a context of a smaller overall transfer envelope; the federal government reduced cash transfers for social programs by about one – quarter from 1995-1996 to 1997-98. Also payments to each province were unequal since CAP was not on a per capita basis. As of 2001-2002, these inter-provincial disparities no longer existed; each province was entitled that year to $1,075 per capita in total, broken down into cash and the so-called tax point transfers.[16] With respect to national standards, the requirements of the *Canada Health Act* introduced in 1984 and the prohibition of minimum residency requirements in providing social assistance were maintained.

3) The decade starting in 2000 is marked by 1) a period of flux in the funding of health and 2) by the CHST being broken out into two components starting in 2004 -2005: the CHT (Canada Health Transfer) and the CST (Canada Social Transfer), with the breakdown between the two determined on the basis of the share of health spending (62%) in total social spending by the provinces.

[15] A list is found in Vaillancourt (2000a) and in http://www.fin.gc.ca/fedprov/his-eng.asp
[16] Department of Finance (2002), *Canada Health and Social Transfer: Third Estimate 2001-2002*, Table 1A. This amount excludes CHST Trusts from the 1999 Budget and the 2000 Health Agreement.

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Between 1999 and 2004, the federal funding for health entered a state of flux. Five changes were made. We present them to show the reader how even in a mature federal system short term often unsound measures can occur

- The 1999 federal budget made a then one-time commitment to health care: $11.5 billion over five years would be added to the health component of the CHST
- The 2000 budget added another supplement of $2.5 billion over a four-year period for the purposes of health care and post-secondary education.
- In September 2000, the federal Medical Equipment Fund and the Health Transition Fund were established with $1 billion and $800 million respectively.
- In February 2003, the Health Care Renewal Accord was reached between the federal government and the provinces. In terms of federal-provincial relations, the key aspects are:
    - The division of the CHST into a Canada Health Transfer (CHT) and a Canada Social Transfer (CST) as of 2004-2005,
    - The creation of the health reform fund targeted at primary health care, home care and catastrophic drug costs.
    - An one –off payment of up to 2 billion in 2003-2004, conditional on the existence of a surplus above the normal Contingency Reserve ($3 billion), with this surplus established in January 2004. Ex post, one knows that the federal surplus at 9.1 billion was more than was necessary to make the payment[17].

- In September 2004, a new accord, A Ten Year Plan to Strengthen Health Care, was reached. Its goals were the same as the 2003 Accord[18], but one notes:

[17] Government of Canada Records Seventh Consecutive Surplus at http://www.fin.gc.ca/news04/04-065e.html
[18] For the text of the 2003 and 2004 accords and the Romanow report: http://www.hc-sc.gc.ca/english/hca2003/fmm/releases.html

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- An increase in the base funding of the CHT in 2004-2005 (1 billion) and 2005-2006 (2 billion);
- An additional 500 million in 2005-2006 for home care and catastrophic drug coverage in the CHT base funding;
- A base of 19 billion for the CHT to be escalated by 6% a year. This brings back the use of an escalator that was present in the EPF transfers but suspended in 1990.

So in 2009-2010 we have:

a **Canada Health Transfer** whose main characteristics are:[19]

- a transfer in 2009-2010 of 24 billion in cash along with 13.9 billion in provincial personal income tax revenues taken into account into the calculations of said cash transfers;
- an unequal distribution between provinces of the cash component to compensate for the unequal value of tax points;
- an escalator of 6% per year of the cash until 2013-2014 the end year of the current ten-year health accord while tax transfers vary with the economy;
- a commitment to have equal cash transfers in the new agreement starting in 2014-2015[20]

a **Canada Social Transfer** whose main characteristics are [21]

- a transfer in 2009-2010 of 10.9 billion in cash
- an equal distribution between provinces of the cash component
- an escalator of 3% per year of the cash until 2013-2014 the end year of the current ten-year health accord while tax transfers vary with the economy;
- a notional breakdown between support for children (10%) post secondary education (30.%) and social programs (60%)[22]

[19] See http://www.fin.gc.ca/fedprov/cht-eng.asp
[20] See http://www.budget.gc.ca/2007/speech-discours/speech-discours-eng.html
[21] See http://www.fin.gc.ca/fedprov/cst-eng.asp
[22] %s in brackets are rounded

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Equalization

Following WWII and the tax rental agreements between the federal government and the province, equalization was introduced in 1957 to facilitate the reintroduction by provinces of personal income taxes, corporate income taxes and succession duties since the expected yields by province of these taxes for one tax point differed. Equalization in Canada since its beginning is a vertical scheme funded by the general revenues of the federal government; there are no province to province transfers. Equalization uses a representative tax system (RTS) approach and does not take into account differences in expenditures, needs or costs. The formula is set by a federal law after technical and political discussions with the province; there is no input from a specialized advisory body as none exist[23]. In 1982, the principle of equalization was included in the Constitution but not the parameters of the formula. Federal-provincial agreements on equalization usually run for five years.

From 1957 until 1967 the fiscal capacity of British Columbia and Ontario (then the two richest provinces) was the standard of comparison. In 1967, the standard was modified and became the national average fiscal capacity. Finally in 1982, the standard used in the formula was changed to the average of five so-called representative provinces (Québec, Ontario, Manitoba, Saskatchewan and British Columbia); this remained the standard until the current system was introduced in 2007. The 1982 change occurred because of the concentration in Alberta of the production of petroleum, the price of which was high and expected to grow in 1982. Alberta being a part of the standard would have raised the amount of equalization the other provinces were entitled to by making them relatively poorer.

Over time, the list of revenues included in the equalization program has been broadened (to 33 by 2003) to take into account both older types of provincial revenues (e.g. sales taxes, liquor revenues) and new forms of revenue (e.g. gambling). The three major revenue sources determining equalization payments are, in decreasing order, the PIT, property taxes and sales taxes.

[23] Fora discussion of how the federal equalization scheme is revised see Guy Gilbert and François Vaillancourt 'La péréquation financière au Canada et en France : mécanismes d'évaluation'' *Revue Française des finances publiques* 99 2007 75-92

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The equalization payment for a given revenue source is equal to the difference between the per capita revenue yield that a particular province would obtain using the average provincial tax rate (defined as taxes collected/tax base) and the average per capita revenue yield in the five 'representative' provinces.[24]

Hence, the following is calculated for each of the income sources used:

Equalization Right province j	=	[(	Fiscal capacity norm(10 provinces)	-	Fiscal capacity province j	)	*	Average tax rate	]	*	Population province j

The sum of equalization rights for each of the sources used gives the equalization payment the province j is entitled to receive for a given year. Provinces that end with a negative amount do not need to pay; they simply do not receive any equalization. This is referred to a as a gross as opposed to a net equalization scheme.

There was until 2004 no set total amount: the total payment to a province was established by summing the deficiencies and gains associated with the various taxes and revenue sources accounted for, using the RTS approach). From 2004 to 2007, equalization saw a minimum total amount introduced.

This is the result of a federal decision to counteract the drop from 2000-2001 to 2004-2005 in provincial revenues from equalization. Recipient provinces felt shortchanged, loosing through this program gains made under other transfers.[25]. This was the result of the workings of the formula. It happened because the amount of equalization paid to a recipient province depends then on the difference between the (per capita) value of revenue bases for that province and for the nom (then the so-called five representative provinces). Hence, if one large province in the norm does not do as well as expected, then even if a recipient province does not see any change in the absolute value of its tax bases, it will receive less since the difference has diminished. Note that

[24] In practice, until 2007, some of the revenue sources were replaced by various proxy measures. Since 2007, their number has been reduced drastically.
25 See Finance Canada Equalization - Current System October 2004 http://www.fin.gc.ca/FEDPROV/eqcs_e.html

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equalization revenues will also drop if the relative values of tax bases in a recipient province go up but in that case, this is compensated by an increase in provincial revenues.

Hence an explicit amount of equalization payments was set at 10 billions (average last five years) for 2004-2005 (rather than the projected 9.5) with no province receiving less than the amount in the federal estimates for that year. The 2005-2006 amount was set at 10.9 billions (highest past nominal amount until that year) to grow by 3.5% per year from 2005-2006 until 2009-2010.

In addition, since February 2005, one also has seen a modification in the treatment of offshore oil revenues for Nova Scotia and Newfoundland. They receive additional offset payments to the province in respect of offshore-related Equalization reductions, effectively allowing them to retain the benefit of 100 per cent of their offshore resource revenues, continuing through 2011-12, the annual offset payments shall be equal to 100 per cent of any reductions in Equalization payments resulting from offshore resource revenues. A successor arrangement would be put in place for the period 2012-13 to 2019-20 if either province qualifies for an Equalization payment in 2010-11 or 2011-12 and its *per capita debt servicing charges* for Newfoundland and its *per capita net debt* for Nova Scotia has not become lower than that of at least 4 other provinces.

A federal *Expert Panel on Equalization and Territorial Formula Financing was* created in March 2005 and it published its report in 2006[26]. Changes were implemented in 2007 to both the territorial financing formula and the equalization formula. Boothe and Vaillancourt (2007) discuss these changes.
The **equalization** system in place in 2009-2010:

- uses a national standard based on the average fiscal capacities of all 10 provinces;
- includes only 50 percent of provincial resource revenues in calculations of the national standard;

[26]See *Achieving a National Purpose Putting Equalization Back on Track* at http://www.eqtff-pfft.ca/english/EQTreasury/index.asp

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- is now based on only five taxes: personal income tax, business income tax, consumption tax, property tax and natural resources. Each acts as a measure for its own base and as a proxy for one or several bases. A departure form this base rule is that fiscal capacity from natural resources is measured using actual revenues.
- revenues from user fees are excluded from the calculations;
- annual equalization amounts are set using a three-year weighted moving average of provincial fiscal capacity, lagged two years to increase the stability and predictability of payments
- a fiscal capacity cap is applied to ensure that equalization payments do not raise a receiving province's total fiscal capacity above that of any non-receiving province[27].Since 2009, this has been revised to the average of the receiving provinces
- a cap on the growth of equalization payments equal to growth in nominal GDP has been introduced as of 2009[28]In 2009-2010 , it will grow in total by 4.2%.To ensure this, payments to receiving provinces are reduced by an equal per capita amount; this results in different percentages of reduction between provinces. But this amount is also a floor for future years and no province will see a decline in equalization from 2008 to 2009 even if it is warranted by a change in economic circumstances. Thus the 10 province standard is no longer applied and one is back to the 2004-2007 system of a fixed framework

W e have now summarized the existing system of federal provincial transfers in Canada .table 2 presents what is paid out in 2009-2010,small transfers are not included. Figure 8 presents the evolution of federal transfers over the last twenty years

[27] The definition of total fiscal capacity for the purpose of the cap will include fiscal capacity for non-resource revenue sources, 100 per cent of natural resource revenues and Equalization offset payments made pursuant to the Offshore Accords with Newfoundland and Labrador and Nova Scotia

[28] *The Evolution of Federal Transfers since the O'Brien report* Michael Smart, 2009 http://www.chass.utoronto.ca/~msmart/wp/jdi09-v2.pdf

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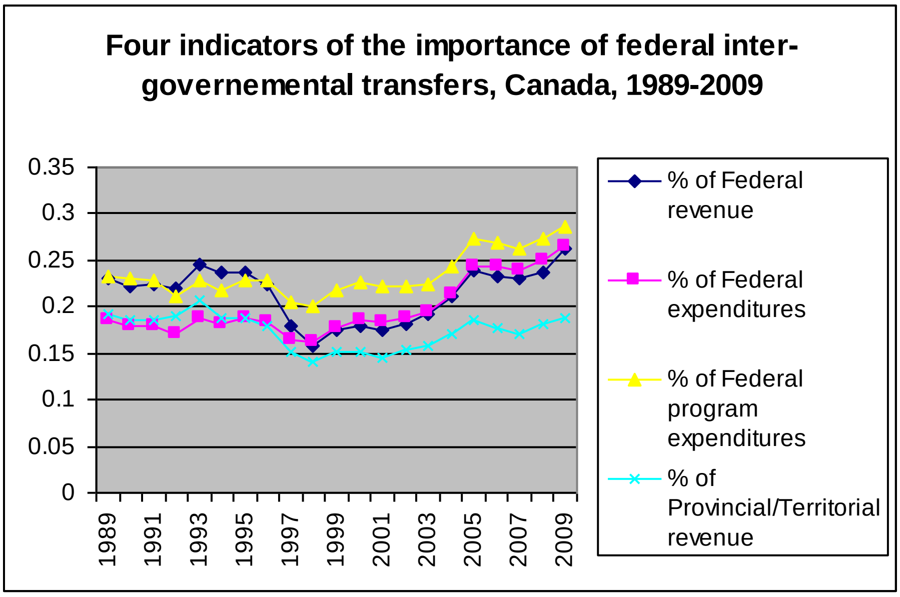
Table 2 Federal transfers, Canada, 2009-2010		
Federal transfers to other levels of governments	000 000 $	% of total
Canada health transfer	23 987	39.6
Canada social transfer	10 868	17.9
Equalization	14 185	23.4
Infrastructure	2 820	4.7
Territorial Financing Formula	2498	4.1
Total (includes other amounts)	60 601	__

http://www.fin.gc.ca/fedprov/mtp-eng.asp

Figure 8 allows us to see that federal transfers to provinces first dip reaching a minimum in 1998 when they account for only 16.3% of federal expenditures down from 18.7% in 1989 then rise again to 26.4% of total federal expenditures and 28.6% of program spending. From the recipient's perspective, transfers went from 19.3% of their revenues in 1989 to a peak of 20.6% in 1993 to a through of 14.4% in 2001 back to 18.8% in 2009. We discuss the outlook in the next part of the paper.

Figure 8



Source CANSIM table 385-0001

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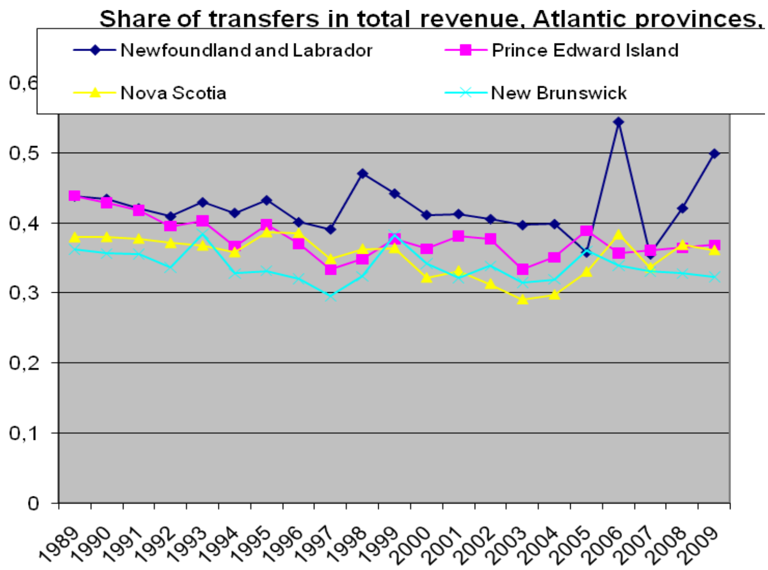
These transfers vary greatly in importance across recipients. One indicator of this is the amount of transfers per capita. The Territories receive extremely high transfers per capita both because they have less access to own revenues and because the cost of providing services in these remote ,large and sparsely populated harsh climate parts of Canada are very high. Other provinces receive transfers that range from 1000$ per capita (Alberta) to 3000$ (Atlantic).

Another aspect one can examine is the distribution across provinces of transfers, comparing it to say the distribution of GDP or population. This shows that Atlantic Provinces receive a higher share while Alberta for example receives a lower share. But in terms of federal-provincial relations, the most relevant indicator is the importance of these transfers in the revenues of each specific province which indicates their dependence on federal revenues. We do this in Figure 9. In 2008, the dependency ratio varies from 10% to 50% across provinces and has increased in recent years for some of them.

Figure 9a



Source: CANSIM Table 385-0001

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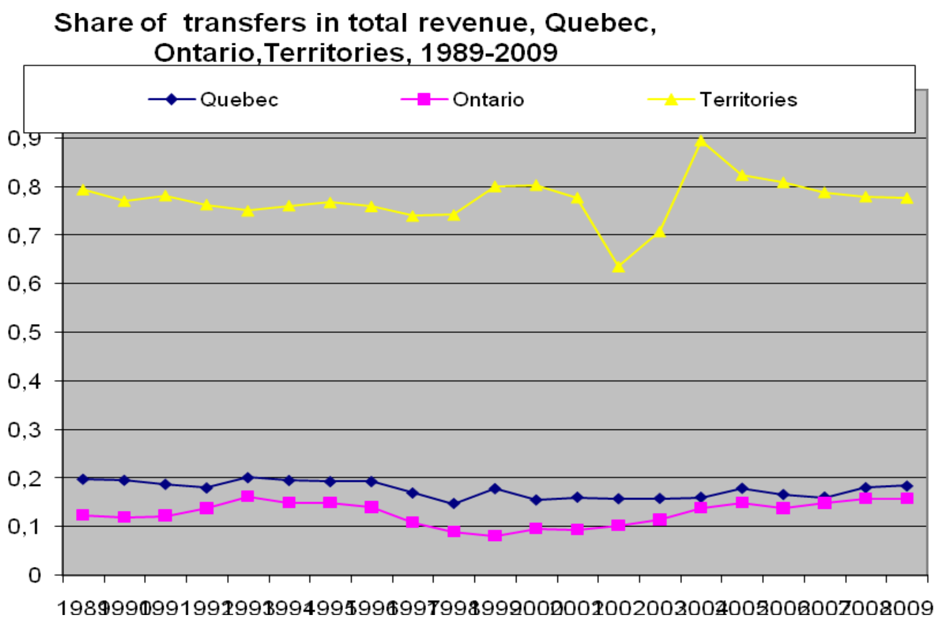
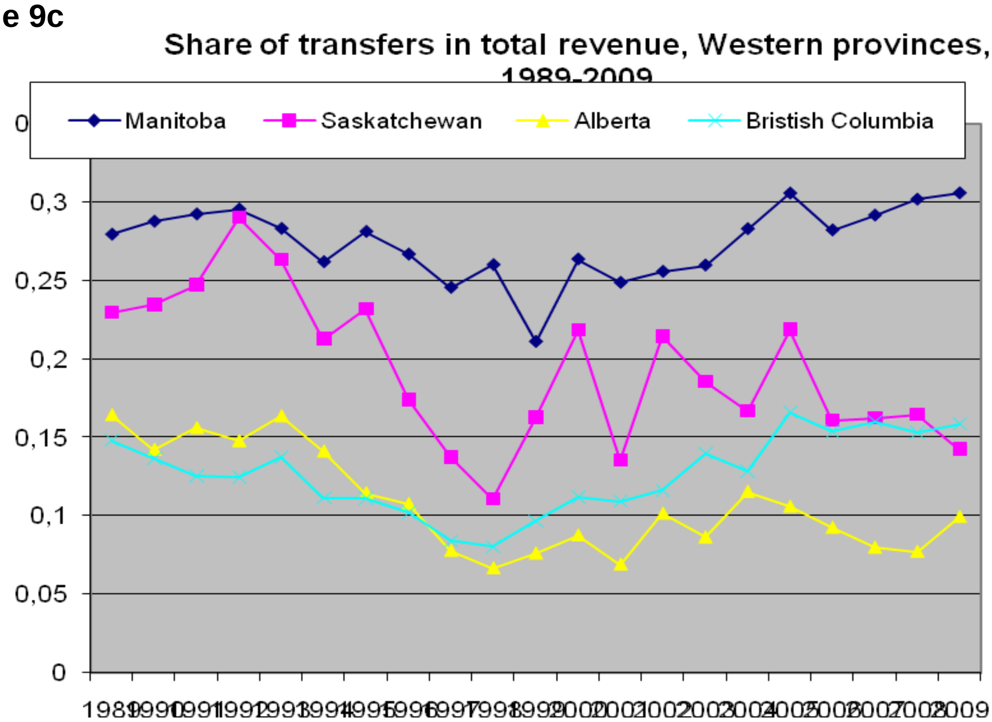
Figure 9b



Source: CANSIM Table 385-0001

Table 9c



Source: CANSIM Table 385-0001

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3 FISCAL FEDERALISM IN CANADA; THE ROAD AHEAD (2010-2020)

How can we expect fiscal federalism to evolve in Canada in the next ten years? If we turn first to our five drivers, the following seems plausible:

1. Geography will be evolving slowly as climate change linked to global warming makes itself felt. One possible outcome is a drying out of the Prairies and a possible northward drift of the frost line. This would open up new agricultural land but in sparsely populated areas with new infrastructure spending required to make use of it .Diefenbaker's vision of the North would come to pass more than fifty years after it was first enunciated. Another change would be the opening of the Northern passage to more navigation. This would also require a northern shift in public spending and may create more demand for some of the Northern resources while at the same time existing infrastructure in the region became damaged by climate change(permafrost issues for example)[29]. This could reduce the need for transfers to the Territories if they are allowed to retain the associated revenues. Finally, an agreement to reduce global warming may reduce the attractiveness of oils sands as a source of hydrocarbons. .That along with the new capacity to extract shale natural gas may reduce economic activity in Alberta.
2. History The relative importance of the francophone population in Canada will continue to diminish, making the historical compact of 1867 less relevant over time particularly to new Canadians. In so far as the equalization system plays an important role in financing the provision of government services by the Québec government in French to an immobile French speaking population, this may be challenged. At the same time, the share of first nation's population will increase over time, making their residence on reserves for some and the lack of settled land claims for others more salient issues. The fiscal arrangements with such nations will become more important from a public policy perspective.

[29] See *True North Adapting Infrastructure to Climate Change in Northern Canada* National Roundtable on the Environment and the Economy Ottawa 2009 http://www.nrtee-trnee.com/eng/publications/true-north/true-north-eng.pdf

3. Demography The aging of the population will continue albeit at differentiated rates across provinces. This will lead to increased demand for health services and thus increased provincial spending in this field. Differences in provincial drug coverage or in the availability of specific diagnosis tools or treatment options may lead to a demand for more uniformity from the electorate at least in English Canada, attained with or without more federal involvement.
4. Economics Our major market, the USA appears likely to contract since its current high public deficit is unsustainable. One possibility is that Canada becomes a low tax jurisdiction compared to the USA, attracting human and financial capital. Another is that we suffer a permanent drop in real income and that this drop is particularly felt in Ontario with an economy heavily dependent on manufacturing exports to the USA.
5. Politics The sovereignist threat appears to be dormant but it also appeared so from 1980 to 1990.But in 1995, sovereignty almost won that referendum. In the provincial election of 2007, the Parti Québécois finished third and one could perhaps have forecasted its eventual disappearance but in the election of 2008 it was again elected as the official opposition .Thus, the threat remains.

So what are the key issues in federalism in Canada in 2010? We would argue that they are:

1. A non recognition of the distinct nature of Québec as a province ;
2. An improper division of powers between the federal and provincial governments
3. Following from the two above , an improper set of financial arrangements

1) The non recognition of Québec as a distinct society creates a basis for continuous demands for more powers (liberal party)/ autonomy (ADQ)/sovereignty (PQ); this does not facilitate reaching a consensus on public policy in Canada. It also means that Québec wants both more powers and more money from Canada to finance the use of such powers. A proper pricing of distinctiveness has not been implemented.

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2) The tendency since 2000 to see increases in federal transfers to provinces as the appropriate way to fund provincial spending, particularly in the health sector, has several consequences. This weakens provincial autonomy in fields of provincial responsibility by making it easier for the federal government to require more or less binding conditions. This may be desired by those who believe that the federal government should be more present in these areas of public policy. We believe that this weakens the Constitution .If a majority of Canada's population wants a greater role for the federal government in health, this should be made explicit by amending the Constitution to modify the constitutional division of powers. Or the use of a reference to the Supreme Court to clarify the possibility for the federal government to intervene in a given field could be envisaged. This is what is being done in 2009 in the case of the federal decision to unify the 13 existing SECs. Here we have an appropriate modernization of the Constitution that reflects the evolution securities markets from local organizations mobilizing local financial resources for local businesses to organizations that are part of a global market.[30]

This also weakens the interest of provinces in ensuring proper management of public funds. One should recall that the transfer system put in place in 1997 to fund social programs, which used so called "block grants" that are set in terms of per capita amount with no links to spending, was introduced to replace funding of health expenditures based on 50/50 sharing between the federal government and the provinces. Such a system was seen as generating 50cents$ with the provinces knowing that any increase in expenses that brought them the benefits of public acclaim was financed for a half by a silent partner, that is, the federal government. Why should we go down that road again with guaranteed increasing federal funds come what may that, if spending grows at less than the 6 % transfer growth, will amount to 100cents financing of an extra $ of spending. Especially as it makes it more difficult for the electorate to hold accountable the proper level of government and thus may make the electorate less interested in the democratic process?

[30] The most recent report on this topic is found at http://www.groupeexperts.ca/eng/index.html

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Finally, it makes a mockery of the term condition. Examining the various federal programs we argue that one should distinguish among six types of conditions. The first three types are *economic* conditions directly applicable by the granting government to the spending by the recipient governments:

- micro conditions: these specify precise items (lists of items, technical conditions, etc) that funds can be spent on by recipient governments;
- meso-conditions[31]: these specify broad policies that must be respected by recipient governments for funds to flow to them ;
- macro-conditions: these set the overall amount of spending in a given area by recipient governments.

The other three conditions are more *political* in nature:

- labeling conditions: this is when a transfer is given a name such by the granting government, with or without the agreement of the recipients, but nothing is done to insure that it is spent on the labeled item as such;
- linking conditions: these occur when direct spending on one item by one order of government is linked to direct spending on another item in the same policy area by another order of government;
- reporting conditions; these occur when the recipient of a transfer must provide information to receive it.

Recent Canadian transfers have been using labelling and reporting conditions. While these may look good in the press, they have no impact on behaviour as such

3) So the current financial arrangements see an increasing share of federal spending going to federal provincial transfer and provinces deriving an increasing share of their revenues from such transfers. This is the reverse of the arrangements that accompanied the increase in federal transfers of the 1957-1967 period or that followed it (1972-1977). One possible justification for preferring equal per capita transfers to the shifting of tax points is that they are implicitly equalizing in nature. We argue that for the reasons raised above,

[31] Meso–economics examines issues between single unit (individual, firm…) and aggregate levels; we thus by analogy, label as meso conditions that are between micro and macro.

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increases in these transfers should be reined in by a new distribution of the PIT field between provinces and the federal government, which, coupled with more generous equalization, will make provinces responsible for raising the highest possible share of the monies they spend.

More generous equalization requires changing its financing. As noted above, equalization in Canada is funded entirely out of federal general revenues. There are no province–to-province transfers. As a result and contrary to good economic policy, natural resource revenues (royalties) and particularly oil and gas revenues which are provincial revenues are not available to the federal government to fund equalization. We say contrary to good policy since this induces more migration to revenue rich provinces than economically appropriate since this is the only way to benefit from such wealth. Yet permanently higher (in real terms) oil and gas revenues will lead to larger disparities between Alberta and other provinces in terms of the capacity to self-finance public services. This will lead to more demands for federal transfers from provinces while the federal share of public revenues will have dropped. It would be appropriate to include a share (50%?) of provincial natural resource revenues, which in practice means mainly oil and gas royalties from Alberta, in the equalization pool from both an economic efficiency and from an equity (inter-temporal sharing of risk) perspective.

CONCLUSION

The current inter-governmental financial arrangements in Canada are becoming difficult to sustain due to the economic weakening of the largest province Ontario, the most important source of federal revenues. The equalization payments growth cap introduced in 2009 is one indicator of this. Currently, the possibility of reducing the escalators of the CHT-6% and CST-3% is not envisaged at least publicly. But while federal politicians have promised not to reduce federal-provincial transfers to reduce in part the federal deficit, they may well want to freeze them in nominal terms starting in 2014-2015. Given that health care costs are unlikely to remain unchanged in nominal terms, this would

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require provinces to increase their own revenues. But is that not how a government responsible for a service should finance itself?

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flows, 'balance-sheet' federalism and the stability of federations symposium, Barcelona, IEB, June 2008

November 30th 2009

[i] In operational terms, this means that Québec residents calculate federal income tax payable like all other Canadians (same exemptions, deductions, rates and so on) but reduce the amount of taxes to be paid by 16.5%.