COMPARATIVE FISCAL FEDERALISM PROJECT
Final Report – Canada

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a) Goals of the existing system, according to existing legal order, design and/or tradition

Basic Logic

The original division of powers and fiscal responsibilities in Canada's Constitution (the *British North America Act (B.N.A.A.)* of 1867) reflects a compromise between a desire for a strong federal government and provincial governments with power over local matters. Health, education, the administration of justice, and property and civil rights were all made provincial responsibilities, while international and inter-provincial trade, criminal law, banking, currency, and defense were all made federal responsibilities. Fiscal powers are nearly unlimited at the federal level, as is the ability to borrow and manage monetary policy. The provinces initially had more limited taxation powers (for example, they were excluded from levying excise duties and tariffs), although in practice today provincial governments have full jurisdiction to raise revenue through taxes on income and local consumption.

The original intent and logic behind this design was, to the extent possible, to limit the need for inter-provincial transfers whereby higher income provinces would directly fund public services delivered to residents of lower income ones. Explicit transfers from the federal to provincial governments have always existed and were necessary to compensate provinces for giving up their tariff revenues to the federal level. Over time, as the nature of government evolved and taxation on income and consumption grew larger following the Second World War, Canada's modern transfer arrangements developed to ensure provinces could deliver on their expensive areas of responsibility, especially health and education. Today, there are three major federal transfer programs: equalization, the Canada Health Transfer (CHT) and the Canada Social Transfer (CST).

Equalization

The general objectives of the equalization program are enshrined in the Canadian Constitution. Section 36 (2) of the *Constitution Act, 1982* states that "[P]arliament 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." In other words, the aim of the federal equalization program is to reduce the consequences for citizens of territorial economic disparities among the ten provinces and to promote equality of opportunity. From a political perspective, equalization is sometimes presented as "the glue that holds the federation together" (Boadway and Shah, 2009: 552). It represents a tangible display of country-wide solidarity orchestrated by the Government of Canada in the context of a decentralized and multinational federation.

The Canada Health Transfer and the Canada Social Transfer

The objective of the CHT is to provide "long-term predictable funding for health care" and to support "the principles of the *Canada Health Act* which are: universality;

comprehensiveness; portability; accessibility; and, public administration" (Government of Canada, 2011a). In other words, the CHT provides partial financing for the ten provincial health care systems.

The objective of the CST is to support "post-secondary education, social assistance and social services, and early childhood development and early learning and childcare" (Government of Canada, 2011b). The CST provides partial financing for provincially run higher education and childcare systems as well as for provincial social assistance benefits and services.

The funds linked to each program are allocated across provinces on an equal per-capita basis. They differ only in how they increase over time, with the CHT indexed to nominal GDP growth with a 3% minimum growth rate, while the CST increases at a fixed 3% growth rate.

Federal Spending Power

While taxation and equalization have clear constitutional footholds (section 91(3) of the *Constitution Act, 1867* and section 36 of the *Constitution Act, 1982*, respectively), the legal basis for federal transfers to provinces, local organizations and individuals is less clear and, in some quarters, highly contested (Kellock & Leroy, 2007; Quebec, 2002 and 2004). The federal government can of course spend where it has legislative jurisdiction (e.g. in relation to Indigenous peoples); it is the power to spend in relation to matters over which it *may or may not* have jurisdiction (Trudeau, 1969: 4) that gives rise to controversy. The concept of the "federal spending power" refers to spending in this uncertain sphere.

Despite the ongoing controversy, the key constitutional actors – the courts and a majority of politician – appear to accept the existence of a federal spending power. What is the basis for this acceptance? Federal power to legislate regarding spending is said to be based on a number of heads of power: sections 91(1A) (the public debt and property), 91(3) (the raising of money by any mode or system of taxation), s. 106 (appropriations by Parliament) and, to the extent that no other provision refers to spending specifically, the residual power (known as the peace, order and good government power) (*YMHA*; *CAP Reference*; *Finlay*).

In terms of spending by the executive (necessarily, in the British tradition, on the basis of a parliamentary appropriation), the Crown either derives its powers from primary legislation or from the Crown prerogative. It is sometimes also said that the Crown has the same powers as an individual, including the power to contract, purchase *and spend* (Scott, 1955, *Verreault*).

Finally, the courts accept the existence of a federal spending power (*Winterhaven* and *CSN Arvida* at the Court of Appeal level, and *YMHA*, *Finlay*, *Eldridge*, *Chaouilli* at the Supreme Court of Canada level). The courts seem to distinguish between permissible federal spending and impermissible attempts to actually regulate provincial matters through spending (*YMHA, Finlay, Eldridge*), though the courts have shown a distinct unwillingness to act as arbiter on matters of spending (*Reference re Canada Assistance Plan*), the real purposes of spending being so hard to gauge in any event.

b) How has the system emerged over time and what were the major bones of contention?

Canada's system of fiscal arrangements has evolved slowly, but this evolution has also been punctuated by periods of rapid change. Three factors have shaped this process: (1) the constitutional responsibility of the provinces for delivering many public services, though generally without sufficient revenues; (2) the significant diversity of interests and capabilities

between provinces, as well as cultural, linguistic and identity differences between Québec and the other provinces, all of which involve preferences for decentralization; and (3) pressure, in the name of equality, for uniform (or near uniform) treatment of federal fiscal arrangements across provinces and, in the name of fairness, for ensuring a minimum level of financial capability for all provinces. Importantly, governments navigate such forces within highly centralized political systems that concentrate significant power within federal and provincial executives.

Originally, the constitutional design of the Canadian federation was intended to produce provinces with limited own-source revenue. The development of federal transfers stemmed in large part from the reality of provincial governments having to deliver public services with limited financial resources. Section 118 of the *Constitution Act, 1867* specified yearly sums to be transferred from the federal government to each of the original four provinces. In 1869, the federal governments consented to offering "Better Terms," in the form of an additional grant, to the province of Nova Scotia, where opposition to the new Canadian federation was strong. This grant represented an important precedent for federal transfers beyond what was constitutionally specified (Stevenson, 2006), and, accordingly, it was hotly contested in Parliament (Canada, 1869: 723 *et seq*). The Opposition in Parliament took the view that any federal transfers to provinces beyond those that had been provided for in the 1867 Act were unconstitutional (Canada, 1869: 727 (Blake)). The Government countered with an argument that not only won the day in 1869 but influenced federal government behaviour from that point on: Parliament could only *legislate* within the limits set by the constitutional division of powers, but it could *spend* as it wished (Canada, 1869: 742 (Macdonald)).

In the first few decades after the creation of the federation in 1867, federal transfers were unconditional, "but their modest value meant that they did little to mitigate the fairly centralized nature of Canada's original fiscal arrangements" (Lecours, 2019:62). Provinces, including new provinces added in the years after 1867, regularly petitioned the federal government for federal subsidies, either to keep up with the cost of running the province (e.g. in the case of Manitoba (Canada, 1882: 720)) or by way of compensation for segments of rail incorporated into the national network (e.g. Canada, 1884: 1521 *et seq*). The *ad hoc*, unprincipled and expedient nature of these subsidies was a regular source of political tension. In 1907, in the wake of the addition of a further two provinces (Alberta and Saskatchewan joined the federation in 1905), the federal government initiated federal-provincial discussions, leading to a new constitutional settlement regarding provincial subsidies: The *Constitution Act, 1907*. However, even the debates leading up to the 1907 amendment acknowledged that this new settlement would reduce the need for, but not eliminate, ongoing federal subsidies over and above the constitutionally mandated amounts (Canada, 1906-7: 5308 (Laurier)).

The federal government instituted an income tax in 1917, a measure enacted as part of the war effort and initially deemed to be temporary, but which would later become permanent. Beginning in 1919, transfers, which "covered vocational education, highway construction, employment offices, and venereal disease prevention" (Perry 1997: 79), involved a sharing of costs between the federal and provincial governments. The Great Depression led to more significant taxation by the federal government (personal, corporate and sales). Most provinces, then in a particularly difficult fiscal position, followed suit. In 1940, the provincial and federal governments unanimously agreed to transfer legislative jurisdiction for unemployment insurance, over one of the largest new public policy responsibilities, to the federal Parliament (*Constitution Act, 1940*).[1]

[1] Further constitutional amendments were to follow in order to create concurrent jurisdiction (with provincial paramountcy) over pensions (in 1954) and supplementary benefits (in 1964).

We see in the first three-quarters of the twentieth century the emergence of themes that are still relevant today: regular federal spending in areas that may be outside its constitutionally-mandated non-spending powers, and resulting lack of alignment between the locus of spending and the locus of democratic accountability. By the middle of the twentieth century, Canada was in the process of moving beyond an early, rigid conception of federalism (often conveyed by the phrase "watertight compartments") to a more flexible, interconnected conception, where overlap and coexistence were the norm.

World War II served to centralize fiscal federalism in Canada as provinces "rented" their personal and corporate income tax fields to the federal government in exchange for fixed, yearly, unconditional grants. These "tax rentals" remained in place after the end of the war. The Québec government fought against the post-war tax rental system in the name of provincial autonomy and re-established its own income taxation in 1954.[2] Breaking Québec's isolation within Canadian fiscal federalism was one of the motivations for creating the equalization program in 1957, as was the desire to reduce the consequences of territorial economic disparities in the context of a developing welfare state (Janigan, 2020). The post-World War II years also saw the federal government develop its practice of running so-called shared-cost programs, which "obliged the provinces to satisfy federal criteria if they wished to receive federal funding" (Perry 1997: 173).

In the 1960s, Québec's so-called Quiet Revolution brought major transformations to Canada's only predominantly French-speaking province. The transition in Québec from a defensive nationalism content with protecting provincial autonomy to a much more assertive nationalist movement seeking to build a strong provincial state within the federation (if not to outright secede from it) altered the political dynamics of fiscal federalism in Canada, as successive Québec governments would, from this moment on, struggle for greater fiscal decentralization. In the aftermath of the Quiet Revolution, the first targets of Québec governments were the shared-cost programs, which were viewed as centralizing forces because they took the form of highly conditional grants. In 1965, federal legislation allowed, in the words of one commentator,

> any province to 'opt out' of health insurance and an assortment of other shared cost programs, meaning that federal grants to the province will be terminated and replaced by reductions in federal direct taxation within that province, provided the province agrees to continue a comparable program. As anticipated, Quebec 'opts out' of all the programs but no other province takes advantage of the legislation" (Stevenson, 2006: 4).

Thus, shared-cost programs remained a significant component of Canadian fiscal federalism. The *Canada Assistance Plan* (CAP), created in 1966, was one such program, whereby the federal government would "match" provincial spending in the area of welfare services. In 1977, shared-cost programs in education and health care were replaced by a less conditional block grant structure called Established Program Financing. In 1982, in the only major constitutional reform in the country's history, the federal government's responsibility to make equalization payments became part of Canada's Constitution. Discussions around the constitutionalization of equalization quickly found unanimity amongst Canada's ten provinces (even from the Alberta government, which has since become a strong critic of the program), a rare moment of agreement in an otherwise fractious constitutional negotiation (Romanow, Whyte and Leeson, 1984). In the mid-1990s, the federal government was extremely worried about its large

[2] The "tax rentals" were terminated for all provinces in 1962.

budgetary deficits. Cost-sharing programs were identified as a major culprit because they forced the federal government to match provincial spending in specific social policy areas. The 1995 federal budget marked the transition from EPF and CAP to a block grant called the Canada Health and Social Transfer (CHST), which was divided into the CHT and CST in 2004.

The Canadian Federation Today

Canada is one of the most decentralized federations in the world from both a legislative and a fiscal perspective (Dardanelli *et al.*, 2019). In the fiscal sphere, since 1867, "the proportion of provincial own-source revenues out of total provincial revenues has increased (indicating some decentralization) and the degree of conditionality for grants has diminished (also indicating decentralization)" (Lecours, 2019: 63). Complete provincial autonomy to borrow has remained, as has the absence of federal restrictions on provincial spending. Canadian provinces are strong political communities (Black and Cairns, 1966; Paquet, 2019), equipped to defend and even further their autonomy, legislative and fiscal, within the federation. Their unconstrained access to many revenue sources, including from their (onshore) natural resources (which they own), puts them in a good position to stand up to the federal government. As a consequence, even when such exogenous shocks as the Great Depression and World War II hit Canada, the initial centralization of the federation was opposed, eventually successfully, by the provinces, led by Québec (and its powerful nationalist movement) and Alberta (with significant regionalist sentiments).

The Canadian parliamentary system, both at the federal and provincial level, exhibits majoritarian democratic practices structured by very strong party discipline. The use of the uninominal majoritarian electoral system (so-called first-past-the-post) most often yields parliamentary majorities to one party. Thus, parliamentarism in Canada involves an overwhelming concentration of power in the executive and, within the executive, in the position of Prime Minister and (provincial) Premier (Savoie, 1999). Moreover, the Canadian Senate is a body whose members are appointed by the Canadian Prime Minister, which means it does not effectively speak for provinces at the federal level. These structures condition the governance of the federation, which is driven by the executive branches at the federal and provincial level (so-called executive federalism). Fiscal federalism fits into this structure of inter-governmental relations. Fiscal arrangements and transfers are ultimately the sole purview of the federal government but provinces demand to be consulted (with varying degrees of success) for the sake of predictability in their own budgeting.

It is within this political structure that pressures for provinces to be treated equally while being provided with sufficient financial resources to offer public services to their residents occur. Fiscal arrangements simultaneously seek to ensure provinces have enough capacity to deliver most of these public services but significant heterogeneity in treatment is often a source of regional tension. Historically, perceptions of differential treatment motivated sometimes substantial reforms. Even the original "Better Terms" described above was partly motivated by a view that New Brunswick received better initial transfers in the *Constitution Act, 1867*. The 1907 constitutional amendment was also partly a reaction to highly generous treatment of Alberta and Saskatchewan when they became provinces. More recently, Budget 1995 put Canada's federal budget on a path to balance but shrank the size and increased the inequality in allocation of federal transfers. This ultimately helped lead to the CST and CHT becoming equal per-capita transfers (by 2007 and 2014, respectively), leaving equalization as the only major transfer program to support lower income provinces.

c) What are the distribution mechanisms for revenues and expenditures?

Distribution of Government Revenue

Most tax and revenue instruments are available to both the federal and provincial governments. Provinces are excluded from certain taxes, such as customs and import duties on international and interprovincial trade. And in practice, the federal government does not levy property taxes or levy royalties on natural resource extraction activities, except for resources extracted offshore. Among the most important revenue sources – taxes on personal and corporate income, taxes on production and sales, excise taxes on various products, and payroll taxes on labour – both the federal and provincial governments have autonomous taxes levied on (largely) shared tax bases. In this section, we briefly review the historical development and functioning of these revenue arrangements, paying closer attention to taxes on income and sales. We describe the functioning of major revenue tools and expenditure areas for each level of government.

For much of Canada's early history, provinces were restricted in their ability to raise revenue through taxation and their autonomy was limited. The original *Constitution Act, 1867,* restricted provincial governments to direct taxation only. Indirect taxes, such as customs duties, excise or even sales taxes were unavailable to provincial (or local) governments. Prior to the First World War, customs duties were the primary source of government revenues and therefore this was a substantial restriction on provincial fiscal capacities. The federal government, meanwhile, had power to raise revenues "by any Mode or System of Taxation" (section 91(3)) of the *Constitution Act, 1867*). The original motivation for this – at least as stated by some of the framers of Canada's Constitution – was a desire to reduce provincial revenues to "the lowest possible limits" and provide not "one shilling more than the necessities of their respective communities absolutely demanded."[3] In providing for only direct taxation — which were then, as now, unpopular — provinces would be largely reliant on a system of fiscal transfers from the federal government.

The original structure of these federal transfers, or Statutory Subsidies, was simple, and remains largely in place today. At first, they were fixed in nominal terms at no more than 80 cents per person up to 400,000 persons. This provided a relative advantage to the smaller Maritime provinces of New Brunswick and Nova Scotia, as both Ontario and Québec had populations above the cap. There were also modest lump-sum transfers to support the operation of government and legislatures, which again provided a relatively larger benefit in *per capita* terms to smaller provinces. Despite their limited size, they were the single most important source of provincial revenues. For perspective, in the original four provinces, such transfers in the year after the creation of the Canadian federation accounted for roughly half of provincial revenue, and just over 60% of revenue in the case of Nova Scotia.[4] Over time, however, as provincial revenue needs increased, reforms to the Statutory Subsidies were required. In the constitutional amendment of 1907, the population cap was eliminated and replaced with a smaller per person subsidy of 60 cents per person above 2.5 million and remained 80 cents per person below that threshold. By this time, federal transfers accounted for between one-quarter and one-third of provincial revenues. Today, these Statutory Subsidies remain in place, but are insignificant at $42.5 million and account for less than 0.01% of total provincial revenues.

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[3] To quote Alexander Galt in "Parliamentary debates on the subject of the confederation of the British North American provinces," *3rd Session, 8th Provincial Parliament of Canada* at 69. Available at: http://www.canadiana.ca/view/oocihm.9_01461/78?r=0&s=2.

[4] See Table 3 of "Dominion subsidies to provinces; including other transfers." *Reference book for Dominion-Provincial Conference on Reconstruction.* Compiled under the direction of the Secretariat of the Cabinet Committee on Dominion-Provincial Relations (Ottawa, Canada: 1945).

Given their constitutionally entrenched formula, the federal government has limited autonomy to change these amounts.

As provincial expenditure needs increased, especially during the Great Depression, so too did their use of own-source revenues and taxes. Between 1867 and World War 1, provincial own-source revenues were roughly one-fifth of federal revenues (varying between 15-25%, depending on the year). But this soon changed. By 1933, provincial own-source revenues increased substantially to roughly two-thirds of total federal revenues. During the two decades following the First World War, the provinces gradually increased their presence into income taxes (both personal and corporate), gasoline taxes, and some even introduced sales taxes. Although both British Columbia and Prince Edward Island had income taxes prior to the war, most provinces introduced their own income tax systems in the early- to mid-1930s. For example, Ontario and Québec both introduced corporation income taxes in 1932, and personal income taxes in 1936 and 1939, respectively. Alberta introduced both forms of income taxes in 1932. Alberta also introduced Canada's first provincial sales tax in 1936, although it was repealed shortly afterwards. Constitutionally, income taxes are a direct tax and there was therefore no question as to whether provinces could enact them. But sales taxes are traditionally seen as indirect taxes, which raised a question of whether provinces could enact them. A 1943 decision by the UK's Judicial Committee of the Privy Council – the highest judicial body for Canada at the time – ruled that sales taxes were, constitutionally, direct taxes and therefore available to provincial governments (*Atlantic Smoke Shops*). By 1961, all provinces except Alberta had introduced sales taxes.

Other critically important developments in the distribution of government revenue responsibilities occurred in the two decades following World War II. During that war, provinces repealed their personal and corporate income taxes to make room for large increases in rates federally under the Wartime Tax Agreements. They, in effect, transferred their tax points to the federal government to support the war effort. In exchange, the federal government provided transfers that were, for the most part, either the amount provinces raised prior to repealing their income taxes or whatever amount was necessary to meet their debt obligations, which were rather large following the Great Depression. After the war, the federal government sought to centralize income taxation authority at the federal level and offered generous transfer payments to provinces that agreed to remain vacated from these fields. There was no constitutional authority for the federal government to prevent provinces from levying their own income taxes once again, so it opted for ever more generous transfers to reach agreements with the provinces. Initially, all but Ontario and Québec agreed, though by 1952 even Ontario accepted the arrangements. With no prospect for a Québec agreement, which opposed centralizing fiscal authority in principle and which re-introduced its own system of provincial personal income taxes in 1954, the federal government gradually agreed to cede income tax space to the provinces and by 1961 all provinces re-imposed such taxes. Steadily over this two-decade post-war period, the size of provincial own-source revenues gradually increased from one-quarter of federal revenues at the war's end to 55% by the mid-1960s.

The strong degree of autonomy of provincial governments over major revenue instruments makes coordinating tax policy across Canada challenging, but not impossible. In practice, there is significant harmonization of income taxes across Canada's provinces. Starting in 1961, all provinces (except Québec, which maintains its own separate system) agreed to effectively delegate administration and collection of taxes to Ottawa, even though they remain provincial taxes. Provinces may set their own overall rates, and the federal government remits the appropriate amount of revenue to provincial governments. Taxpayers file one set of documents through the federal government, rather than two if there were separate systems as in Québec. This minimizes administrative costs for governments and taxpayers alike and

ensures broad harmonization of tax bases across Canada. Tax credits and deductions are largely (but not exclusively) determined by the federal government. And prior to 2001, even marginal tax rates and brackets were determined by the federal government and provinces chose their tax as a proportion of total federal income tax revenue raised from taxpayers in their province. This is known as the "tax-on-tax" system. In 2000, for example, Ontario's tax on federal income taxes was set at 38.5% -- meaning Ontario levied 38.5 cents per dollar of federal taxes owing. These "basic rates" ranged from Ontario's low of 38.5% to a high of 69% in Newfoundland and Labrador. After the 2000-2001 reform, provinces moved to a "tax-on-income" approach and defined their own tax rates applied to individual taxable income. There remains a meaningfully degree of harmonization of tax bases across provinces, however, whereby the federal government determines most credits and deductions, but provinces have some flexibility there as well. Overall, aside from the voluntary delegation of personal income tax administration to the federal government, provinces have full autonomy to design and implement their own tax regimes. In short, income tax bases are shared but revenues are not.

Corporate income taxes are also an area of taxation in which there is a high degree of harmonization in practice, but where federal and provincial governments have authority to act autonomously. Eight provinces delegate responsibility for administration of corporate income taxes to the federal government, and therefore tax bases and overall structures are harmonized across those jurisdictions. Provinces are free to set their own rates of taxes on corporate income, and these are added to the federal governments tax rate to determine total amounts owing by a corporation. As with personal income taxes, Québec maintains and administers its own separate system. Alberta is the only other province that maintains its own corporate income tax system. It ended its tax collection agreement with the federal government and re-introduced its own tax collection administration for corporate income taxes in 1981. But while it administers and collects these taxes through the provincial government, Alberta too has chosen to harmonize much of its corporate tax base with the federal corporate tax system by default. Historically, Ontario also administered its own corporate income tax system – even following the Second World War – but opted to enter a tax collection agreement with the federal government in 2009.

Finally, sales taxes are another important source of government revenue in which each level of government is autonomous. They account for over 10% of total government revenue, and both federal and most provincial governments levy them. Federally, Canada has a 5% value-added tax. It is broad-based, though there are several important exemptions where this Goods and Services Tax (GST) does not apply, including basic groceries, health services, and financial services. Provincial sales taxes vary in their structure. In three provinces (British Columbia, Saskatchewan, and Manitoba) they are provincially administered retail sales taxes. In five provinces (Ontario, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland and Labrador) they are fully harmonized sales taxes, whereby the federal government administers and collects sales taxes for each province by, effectively, levying a higher GST rate in the province. In Ontario, for example, the Harmonized Sales Tax (HST) rate is 13%, the revenue from which is split 5/13 to the federal government and 8/13 to the provincial government. Provinces with this arrangement have full autonomy to decide on their sales tax rate, but they piggy-back on the federal GST base. Finally, Québec's sales tax system is also (largely, but not exactly) harmonized with the federal sales tax, although administered separately by the provincial government. Alberta and the three territories do not levy sales taxes.

Overall, Canada's fiscal federalism features almost complete autonomy of provincial and federal governments to levy taxes in a wide variety of areas. Where they are harmonized and revenue explicitly shared, this is the product of voluntary agreements between the governments to improve administrative and economic efficiency.

Distribution of Expenditure

The primary responsibility for public service delivery rests with provincial governments. They are responsible for healthcare, education, post-secondary education, child and social services, the administration of justice, policing, and municipal governments, among other things. Federally, most expenditures are transfers – either to individuals, provincial governments, or other entities. In recent years, roughly one-third of federal spending has been on operations and public services. Federal transfers to individuals are dominated by elderly benefits, through a means tested program that aims to reduce seniors' poverty (the Old Age Security and the Guaranteed Income Supplement), unemployment benefits, and child benefits to support families with young children. Federal transfers to provincial governments are dominated by the CHT, the CST, and equalization. The first two are equal *per capita* cash transfers. The latter is an unequal cash transfer that aims to supplement provincial own-source revenues in provinces where yields on taxes are below the national average.

Equalization is central to fiscal federalism in Canada. Its specific formula has evolved significantly since it was established in 1957, and the federal government has full autonomy over program design. Today, the formula measures provincial "fiscal capacity" as the product of each provincial tax base and the national average tax rate, aggregated across almost all provincial sources of revenue. Specifically, it estimates the national average tax rate for personal income taxes, corporate income taxes, consumption taxes (including excise, sales, and more), and property taxes. The size of each province tax base is determined by estimating provincial total household taxable income, corporate taxable income, household consumption expenditures and business input expenditures, and property assessment values. National average tax rates are determined, for each of the four tax categories, as the ratio of total revenues across all ten provinces to each total tax base across all provinces. Provinces whose measured fiscal capacity falls below the national average will receive an equalization payment equal to the difference between their capacity and the national average. Mathematically, it is straightforward to express a province's basic equalization entitlement as the difference between the size of the province's population compared to its tax bases. That is, a province will receive an equalization payment E_i according to

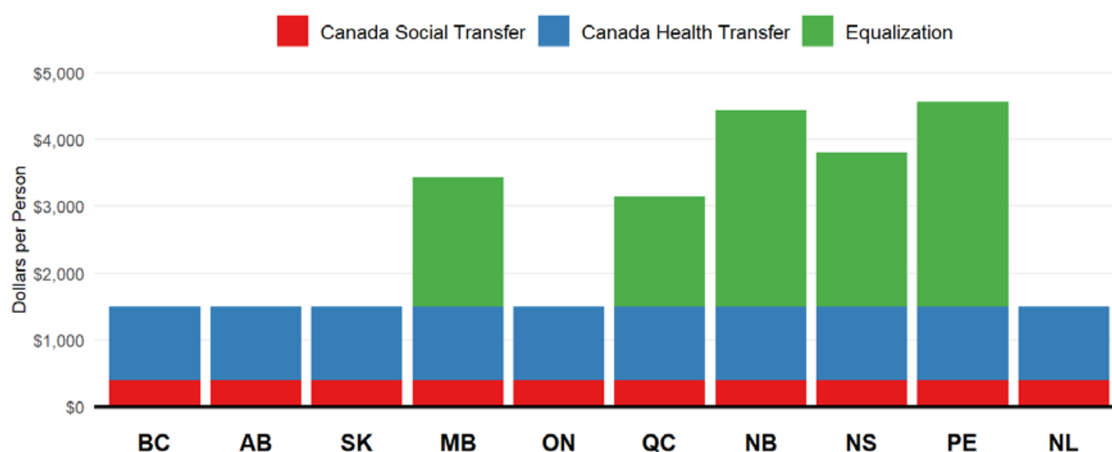
$$E_i = \sum\nolimits_j \left(p_i - f_i^j\right) \times R^j,$$

where p_i is the province's share of the national population, f_i^j is its share of the national tax base for tax instrument j, and R^j is the total revenue for that tax instrument in all ten provinces. Provinces that tend to have smaller economies will have lower incomes, lower consumption spending, and lower property values. This causes their share of the national taxes base to be smaller than their share of the national population, and therefore $p_i > f_i^j$ in the above expression. Beyond this basic entitlement, there are some important complications. First, natural resource revenues are only partially included. Provincial fiscal capacity is estimated based on the better of 0% inclusion or 50% inclusion, whichever results in a higher equalization entitlement. Second, equalization payments cannot bring a province's total fiscal capacity including natural resource revenues above any province not receiving equalization. This is possible since basic equalization entitlements are calculated based only on a fraction of total resource revenues that are earned by a province. Third, and finally, the total aggregate amount of equalization payments made by the federal government is fixed in nominal terms at roughly 0.85% of national GDP.

Visual Representation of Canada's Major Transfer Programs

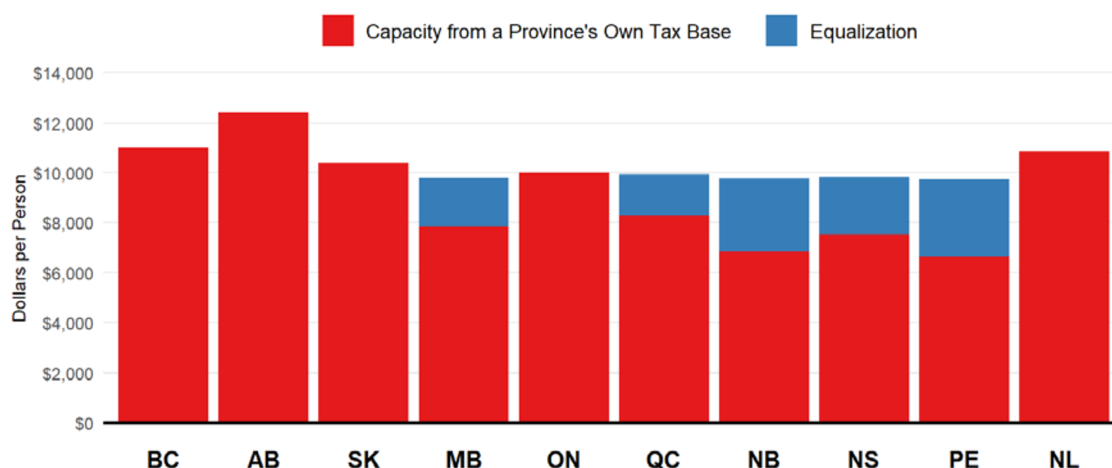
(a) Per Capita Transfers, 2020/21

Per-Capita Federal transfers to provinces, `Major Transfers` only.
Source: https://www.fin.gc.ca/fedprov/mtp-eng.asp.



(b) Equalization and Fiscal Capacity, 2020/21

Displays each province's own fiscal capacity (its revenue at "average" tax rates) and equalization payments per capita.



Canada has seen various explicit cost sharing arrangements. Currently, the federal and provincial governments have only a limited number of programs for which costs are shared between governments – mostly *ad hoc* arrangements for labour training, mental health programs, agricultural subsidies, French language promotion, nature conservation, and so on. Historically, however, cost sharing arrangements played a larger role. In the early 1960s, prior to the major reforms to federal-provincial fiscal arrangements described above, the federal government shared in the cost of providing health insurance to Canadians. The basis for federal transfers to a province was 25% of the average national per capita costs plus 25% of the provincial per capita costs. By 1966, this arrangement evolved into a program of federal cost sharing of physician services only. This was not to last, however. Starting in 1977, these cost-sharing arrangements were replaced with a cash and tax-point transfer under the Established Programs Financing arrangement that lasted until the mid-1990s. Today, only the equal *per capita* cash transfer under the CHT program remains and this program is disconnected entirely from the actual cost of healthcare delivery. The same applies to the CST which, like the CHT, is allocated on an equal *per capita* basis. Overall, this means that federal transfers today are strongly deferential to provincial expenditure autonomy.

Although the primary responsibility for delivering public services rests with provincial governments, the federal government plays a central role in social security, which involves transfers to individuals and families. The two main social security benefits in Canada are Employment Insurance (EI) and old-age pensions. On the one hand, EI is a purely federal social insurance program financed through the payroll contributions of workers and employers. Benefits are modest by international standards and many unemployed people fail to qualify due to rather stringent eligibility criteria. Interestingly, these criteria and the duration of benefits vary across the more than 60 EI regions, so that people living in areas of the country facing higher levels of unemployment have enhanced access to cash benefits. The federal government also operates a multi-pillar old-age pension system where three programs complement one another. First, the quasi-universal Old Age Security (OAS) flat pension is financed through general revenues. Second, the income tested Guaranteed Income Supplement (GIS) is a social assistance program also financed through general revenues. Finally, the Canada Pension Plan (CPP) is a social insurance program offering earnings-related benefits financed through payroll contributions paid by both workers and employers. Québec opted out of the CPP in the mid-1960s when the Québec Pension Plan was created. The Québec Pension Plan offers similar benefits to older people who have worked in the province and contributed to this social insurance program, which is very similar to the CPP. Finally, from a regional standpoint, all three main federal pension programs listed above are redistributive in nature because some provinces have more older people on average than others.

d) How are fiscal mechanisms related to the distribution of 'substantive' competences?

There is a long history of the federal government spending in areas of provincial responsibility, and thus outside of the heads of power allocated to it under the Constitution. Today, the dominant view is that such spending is constitutionally permissible, though there is considerable overlap and therefore uncertainty about the demarcation of responsibility, as well as disagreement about the formal source(s) of the federal government's spending power (Hogg, 2020; Kong, 2017). There is also a range of views about the limits, if any, on the spending power, and the legitimacy of the broad power to spend the federal government enjoys (Kong, 2017; Frédéric, 2016).

A 1969 Working Paper on the Constitution provided what is now a widely accepted definition of the federal spending power (Trudeau, 1969): "Constitutionally, the term 'spending power' has come to have a specialized meaning in Canada: it means the power of Parliament to make payments to people or institutions or governments for purposes on which it (Parliament) does not necessarily have the power to legislate." This definition was criticized by Driedger, who noted, among other things, that the division of powers is concerned with "classes of subjects" rather than with legislative purposes (Driedger, 1981). The constitutionality of the federal spending power tends to be justified on the basis that there is an important distinction between regulating in a particular area and merely spending in it (Hogg, 2020; Driedger, 1981). While the Constitution reserves a list of exclusive legislative responsibilities to the provinces (absent concurrent jurisdiction), it does not limit spending across the jurisdictional divide. Furthermore, in the modern era of "flexible" federalism, it is common for exclusive federal and provincial powers to regulate the same activities. The general permission to spend applies equally to unconditional grants and to conditional grants, on the theory that provincial governments are not compelled to accept such grants (Hogg, 2020; Scott, 1955; Kong, 2017).

The Supreme Court of Canada has recognized the existence of the federal spending power, although not always as part of the essential reasoning of a case (Lajoie, 2006), and it

has suggested that its scope is quite broad (*YMHA*; *Reference Re Canada Assistance Plan*; *Finlay*; *Eldridge*; *Chaouilli*; Hogg, 2020; Kong, 2017). However, the Court has yet to rule definitively on the source of this power or to specify its precise contours. The spending power is not mentioned in the text of the *Constitution Act, 1867* or the *Constitution Act, 1982* (Lajoie, 2006). As a result, its source has generally been "inferred" from a range of provisions of the constitutional text, as well as from the preamble of the *Constitution Act, 1867* (Hogg, 2020; Kong, 2017; Lajoie, 2006). As discussed earlier, scholars have proposed possible sources, including the federal taxation power found in s. 91(3) of the *Constitution Act, 1867*, the federal power in relation to the public debt and property found in s 91(1A), and the federal appropriations power found in s. 106 (Driedger, 1981; Jackman, 2000; Magnet, 1978; Hogg, 2020). The peace, order and good government (POGG) residual power has also been suggested as a possible source of the federal spending power, given that the ability to regulate the modalities of spending would seem to be an essential governmental power (Hogg, 2020).

Other scholars argue that its source is to be found in the prerogative power and the common law (Scott, 1955; Hogg, 2020). At the time FR Scott suggested the prerogative as the source of the federal spending power, these powers were considered non-justiciable. This argument as to source mapped conveniently onto the view that the spending power is largely governed by political rather than legal considerations, and by extension, by political actors rather than courts (Scott, 1955; Driedger, 1981). The legal position regarding the justiciability of matters arising under the prerogative has shifted since Scott first advanced his argument, with the result that all but the most political decisions are now considered justiciable (*Attorney General of Canada v Inuit Tapirisat,* 1980).

Prerogative powers refer to the residue of powers formerly exercised by the British sovereign that have not since been claimed by Parliament. However, some take the view that the term "prerogative" applies to powers that only a sovereign could exercise, such as issuing passports and declaring war. A power such as spending would not be a prerogative power on this view, but rather a common law or third-source power, on the basis that the Crown (government) can spend just as any other person can spend (Harris, 1992). This view has considerable purchase in the UK and Canada (in the UK as the Ram doctrine (Weait & Lester, 2003) and in Canada as the *Verreault* doctrine), but it has recently been questioned in Australia (*Williams v Commonwealth,* 2012). Countries in the Westminster tradition tend to keep an eye on the evaluation of law and doctrine in comparable jurisdictions.

The upshot of all this is that if the federal spending power is not a common law or third power, then it must be granted as a specific constitutional power, delegated by legislation or rooted in the prerogative, and on each account the spending decisions could now be considered justiciable, in contrast to the long history of treating the exercise of the spending power as a political matter.

There are a range of views on the limits on the federal spending power. Some adopt the position that the authority to spend is unlimited, provided that it does not cross the line between spending and regulation (*Unemployment Insurance Reference*, 1937, Kerwin J). Kong argues that s. 36(1) of the *Constitution Act, 1867,* which provides the constitutional basis for equalization payments, imposes limits on the spending power because it lists three purposes for which federal spending may be advanced: promoting equal opportunities for the well-being of Canadians, furthering economic development to reduce disparity in opportunities, and providing essential public services of reasonable quality to all Canadians. Purposes other than those listed are impliedly prohibited (Kong, 2017). Realistically, however, these limits would place at most minimal constraints on the federal government's spending decisions.

Scholars writing in Québec tend to suggest that much more significant limits on spending ought to be recognized. Some writers argue for a strict interpretation which would prohibit spending outside of areas of clear federal legislative authority (Séguin Commission, 2002). This is a difficult argument to make, particularly since it does not map onto federal spending practice or the preponderance of the case law (Petter, 2008). Other Québec scholars highlight the negative impact on provincial autonomy which results from aggressive spending in areas of provincial jurisdiction and advocate for constitutional reforms or intergovernmental agreements (IGAs) which would apply some ground rules to the exercise of the federal spending power (Leclair, 2005), such as a requirement of greater cooperation or consent (Hogg, 2020; Leclair, 2005).

These or similarly inspired proposals appeared in the reform packages proposed at Meech Lake and Charlottetown, two failed rounds of constitutional negotiations in the late 1980s and 1990s (Leclair, 2005; Hogg, 2020; Petter, 2008). A provision in each of those accords would have required the federal government to pay "reasonable compensation" to provinces that opted out of a cost-sharing program so long as "the province carries on a program or initiative that is compatible with the national objective" (cited in Leclair, 2005). More recently, successive speeches from the throne by the Harper government spoke of a plan, never implemented, to enact legislation mirroring these requirements. The Charlottetown Accord would have also "established a mechanism according to which IGAs could be constitutionally protected, for a – renewable – period of five years, against unilateral legislative intervention" (Leclair, 2005).

Scholars who argue for limits on the federal spending power tend to highlight concerns about its legitimacy. For example, Andrée Lajoie argues that the justifications offered in support of the federal spending power do not "stand[] up within the context of a federation" (Lajoie, 2006). Scholars outside Québec also identify concerns from the standpoint of the unwritten constitutional principle of democracy (Petter, 2008; Kong; 2017). Federal spending in areas of provincial jurisdiction can create a situation in which individuals are unable to "determine which order of government was ultimately responsible for policies directly affecting their interests. As a result of this confusion," it is easier for governments to evade responsibility for their choices (Kong, 2017).

The view which is most compatible with the Supreme Court of Canada case law is that Parliament (and the executive acting under proper legal powers) can make payments to people or institutions or governments with respect to items over which it does not necessarily have the power to legislate directly, provided that that legislation is really about spending as opposed to regulation (Oliver, 2022). Two additional points need to be made. First, there would appear to be a spectrum between federal legislation dealing with simple expenditure and constraining regulation regarding items normally under provincial jurisdiction (*Confédération des syndicats nationaux*); and with that spectrum in mind, there would seem to be a distinction between (permissible) federal conditions that clarify the modalities, terms and conditions of spending (including a desire to encourage and promote provincial compliance with federal objectives), and (impermissible) federal conditions designed to dictate the precise terms of provincial legislation (*Finlay*, 78). While the highest courts have struck down federal legislation on the basis that it was constraining regulation regarding matters under provincial jurisdiction (*Unemployment Insurance Reference* (JCPC)), they have not yet struck down federal legislation for excessive conditionality. As the above account has already indicated, there was a time when federal legislation and programs regularly employed conditions, including the use of shared-cost programs. Second, due to the Supreme Court's attitude in the modern era, federal legislation may be valid even though it could be characterized as having both a spending and a regulatory aspect (regarding a provincial item or matter). In other words, as already suggested,

it is no obstacle to the validity of federal legislation dealing with the modalities, terms and conditions of spending that that same legislation at the same time has a regulatory purpose, provided that the latter is not dominant. (Oliver, 2022).

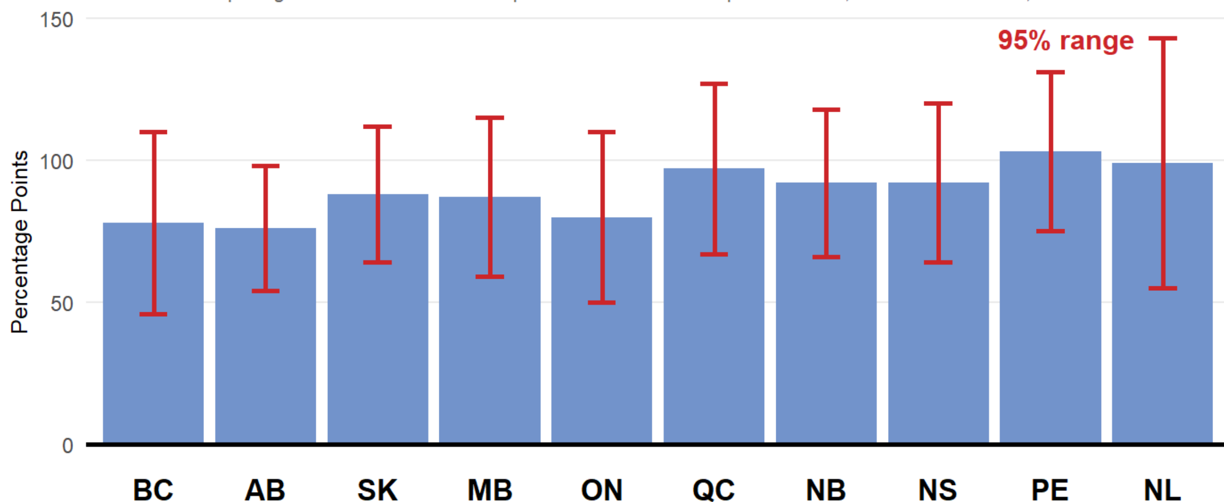
Finally, with regard to the scope and limits of spending by provincial governments, much the same analysis applies as in the federal context, that is to say, there is nothing to prohibit the provincial government from spending across jurisdictional lines (Hogg, 2020, *Lovelace*). As Hogg points out, however, there is far less interest in the provincial spending power, because it has a much smaller impact on federal dynamics than the federal spending power (Hogg, 2020).

e) How is control of financial stability exercised on the various levels?

As discussed above, Canadian provinces enjoy unfettered fiscal autonomy within their constitutional areas of responsibility. Taxation rates and structures are set by provincial governments, as are expenditures across the range of public services they are responsible for. This autonomy also extends to provincial borrowing to cover their own budget deficits. Legally, there is no role for federal oversight of provincial fiscal decisions and no formal mechanism to coordinate across provinces. Provincial debt accumulation has, in recent years, risen markedly and now surpasses total federal debt. In 2018, according to the most recently internationally comparable data from the OECD, Canada's sub-national government debt exceeding that of the federal government and approached 63% of total general government debt, which is also a higher share than any other OECD country. For comparison, the average OECD country's sub-national government debt accounts for 18% of the general government total. In the EU-28, the share is 14%.[5]

With provincial borrowing autonomy comes a lack of formal guarantees for creditors by the federal government. Only *ad hoc* arrangements exist to support provincial governments experiencing insolvency or liquidity pressures. There are numerous instances of such federal support to provinces in need, and therefore markets generally view provincial bonds as at least partially, although implicitly, guaranteed by the federal government. Yet, risk remains, and market rates currently reflect this situation. The following figure reports the difference in borrowing rates between provincial and federal government 10-year bonds. While there is material variation over time, provincial bonds typically come with borrowing rates roughly one percentage point higher than federal bonds. For highly indebted provinces with low fiscal capacity, such as the Atlantic provinces (especially Newfoundland and Labrador), the provincial borrowing rates are typically even higher.

[5] Organization of Economic Cooperation and Development, "Public Finance and Economics", *Government at a Glance 2019*. Data available online. Accessed 20 August 2020 from https://stats.oecd.org/index.aspx?queryid=82342. The EU-28 composition of general government debt is from authors' calculations using Eurostat series gov_10dd_cgd, goc_10dd_slgd, and gov_10dd_logd.



Even during periods of particularly acute financial crisis, Canada has grappled with the tension between provincial autonomy and ensuring that financial shocks in one region do not negatively affect the whole country. The Great Depression illustrates the challenge of this feature of Canadian fiscal federalism. In Canada, as elsewhere, pressure mounted in the early 1930s due to rising spending on unemployment relief while government revenues collapsed along with the economy. Federal support initially took the form of cost-sharing arrangements whereby unemployment relief spending was split between the two levels of government. This provided for a previously unprecedented increase in federal transfers to the provinces, but for some provinces it was still insufficient. This was especially true for the two Prairie provinces of Alberta and Saskatchewan. When liquidity constraints became acute, especially as previously issued bonds approached their maturity dates, the federal government would occasionally provide provincial governments advances on those relief funds. By late 1935, however, the province of Alberta appeared close to defaulting on numerous bond issues coming due and pre-payments on the federal share of unemployment relief was no longer an option.

There were attempts to reform fiscal federalism arrangements to address some of these challenges. Early after the formation of a new Liberal government under Prime Minister King in 1935, the federal government considered following Australia by establishing a national loan council. Such a body would take collateral and establish other conditions on provincial finances in exchange for federal guarantee of provincial bonds. This guarantee would allow provincial governments to borrow at lower rates in times of crisis. There were intense discussions between the federal and provincial governments between December 1935 and March 1936, but no agreement could be reached on how to proceed. Without an agreement over federal support, Alberta defaulted on a $3.2 million bond maturing on April 1, 1936. It subsequently unilaterally reduced interest payments on other bonds, defaulted on yet more as they came due, and was no longer able to access international credit markets. It remains the only episode of a provincial default in Canadian history.

Other provinces have also faced extreme fiscal pressure. At the same time as Alberta defaulted, the province of Saskatchewan was facing an imminent default on a $3 million bond maturing on May 1, 1936. Unlike Alberta, the government of Saskatchewan was willing, at least in principle, to accept federal conditions through a loan council, such as provinces committing their Statutory Subsidies as collateral and having provincial borrowings approved

by the Council.[6] The legislative authority to establish such a council was not yet in place, however, so the newly formed Bank of Canada lent Saskatchewan the money directly on the understanding that it would be repaid once a Council was established and Saskatchewan could borrow the funds. Interestingly, the legislation that would have established a loan council was defeated in Canada's Senate after it passed in the House of Commons against the strong opposition of former Prime Minister Bennett and his Conservative Party. The Conservatives still held a majority in the Senate at the time. As an alternative mode of support, beginning in 1937, the federal government extended special temporary unconditional cash subsidies to Saskatchewan.

This episode is more than an interesting historical anecdote, as it reveals the institutional autonomy that provincial governments have in Canada, which they guard closely. It also reveals the legal limits to federal powers over provincial finances. In fact, the loan council legislation of 1936 would have required an amendment to the *Constitution Act*, 1867. Until 1982, such amendments were made by the Parliament of the United Kingdom, acting on the request of Canada's federal government. Today, the general amending formula would require the consent of seven provinces representing 50% of the population of all the provinces– a fairly high bar when it comes to constitutional reform. For all these reasons, federal involvement in provincial borrowing is a limited feature of Canada's fiscal federalism.

Following the Second World War, the dramatic expansion of health and social services by provincial governments ushered in a period of equally dramatic increases in federal transfers. As discussed above, these transfers now take the form of the CHT, the CST, and constitutionally-mandated Equalization. Currently, Canada has two programs that support provincial governments during periods of fiscal strain. First, the federal Disaster Financial Assistance Arrangements provide for federal funding to provincial governments that experience sharp increases in expenditures because of natural disasters. The details of this program are determined largely by internal administrative guidelines within Public Safety Canada, as the relevant legislation (the *Emergency Management Act*) leaves significant discretion to the Minister of Public Safety and Emergency Preparedness to provide financial assistance when requested by a province. Under the current guidelines, disaster costs are initially born by provincial governments, with federal contributions increasing as costs escalate. In 2020, disaster costs below $3.25 per person are fully borne by provincial governments. The next $6.51 per capita are split 50/50 between provincial and federal governments. The next $6.51 are split 25/75, with the larger share borne by the federal government. For all costs beyond that, the federal government covers 90% of incremental disaster costs. This program ensures provincial governments are largely insulated from unpredictable expenditure needs due to natural disasters. However, only certain types of expenditures qualify for payments, and DFAA funds must be used for those approved uses.

There is a second program that aims to support provincial governments when revenues decline suddenly and sharply, such as typically occurs during periods of economic recession. The federal Stabilization Program was created in 1967 to provide something akin to revenue insurance for provincial governments. If provincial revenues decline by more than 5% in one fiscal year relative to the previous fiscal year, then the federal government provides support for all excess revenue declines. That is, if provincial government revenues decline by 8% then the province absorbs the first 5% drop while the federal government covers the remaining 3%. This is an unconditional grant that, in effect, provides a way for the federal government to absorb some of the fiscal shock that would otherwise have been absorbed by provincial borrowing. Several reforms to the program since its inception have limited its scale and scope, however.

[6] For a more detailed treatment of this and other episodes, see Bryce, 1986.

Today, resource revenues (such as from royalties on oil and gas extraction) are covered when they fall more than 50% from one fiscal year to the next, while non-resource revenues are covered when they fall more than 5%. There is a limit to the Stabilization Program payments, however, and no province may receive more than $60 per capita in Stabilization payments. This limit corresponds roughly to 1% of provincial revenues, which means this program provides only minimal support to provincial governments during periods of sharp revenue declines. The program does allow the Federal Minister of Finance to extend unlimited interest-free loans to provincial governments for a period of five years, although this feature of the program has never been used.

Finally, no discussion of how Canada's fiscal federalism respond to periods of fiscal strain is complete without considering the country's central bank: The Bank of Canada. Since its inception in 1935, the Bank has had the authority to provide direct term-limited loans to provincial governments, and to purchase their bonds. As we discussed, this authority was first exercised in 1936 in support of Saskatchewan. Recently, the Bank of Canada directly purchased provincial government bonds in large quantities during the COVID-19 pandemic and associated economic disruption. This ensured that provincial governments could borrow at low rates during the crisis, although much uncertainty remains over how the Bank of Canada might unwind its position later. The Bank of Canada's support for provincial governments is therefore also somewhat of an ad hoc feature of fiscal federalism in Canada and, since the Bank operates independently of the federal executive, this support is deployed at the discretion of the Bank's Governors. The federal Minister of Finance has formal authority to order the Bank to engage in bond buying activities through the issuance of a publicly written Minister's Directive. However, such a directive has never been issued as, in practice, the independence of the central bank is a well-established norm of Canadian governance.

f) What is the role of the concept of solidarity?

An important challenge in federal systems is the risk that, as a result of decentralization, residents of poorer constituent units may have to settle for lower quality services and/or have to pay disproportionally high taxes for the same basic services provided in wealthier constituent units. This challenge, which is stressed in section 36(2) of the *Constitution Act, 1982* discussed above, is directly related to notions of social citizenship and territorial solidarity, which closely intersect in federal countries like Canada. Although these two concepts, especially solidarity, are not widely used in the Canadian political discourse (Arban, 2017) they are at the centre of the normative foundations of fiscal federalism and, especially, equalization policy (on social citizenship and solidarity in Canada, see Brodie, 2002; on solidarity and fiscal federalism, see Béland and Lecours, 2015).

Social citizenship refers to the welfare rights of citizens as they relate to universal social programs such as health insurance. For instance, in Canada, access to health care is a right of citizenship that also extends to permanent residents. Simultaneously, access to public education is also a right of citizenship. Yet, education falls within provincial jurisdiction, and health care is primarily under the control of the provinces and territories. Here, there is a potential tension between the universalist creed of social citizenship and the existence of significant territorial economic and fiscal disparities within the Canadian federation. Because political decentralization is strong in so many policy areas, the risk from a fiscal federalism standpoint is that the quality of public services such as health care and education can vary greatly from one constituent unit to the next, a situation that would undermine the idea of universal social rights embedded in citizenship and permanent residency. At the same time, in a country prone to regionalism and, in the case of Québec, sub-state nationalism, such disparities could also

weaken national unity over time. In this context, horizontal territorial redistribution as operated by equalization is a powerful yet politically contested political imperative in Canada.

At the centre of this imperative lies the concept of solidarity, which legitimizes horizontal redistribution by stressing the need for greater federal support to poorer provinces in order to avoid penalizing their residents with lower-quality services or higher taxes simply because of where they live. In Canada, solidarity provides legitimacy to the territorial redistribution involved in equalization, which works on reducing inequalities that can potentially weaken social citizenship and/national unity. The national unity aspect is especially crucial regarding Québec, something that became apparent during the creation of the equalization program in 1957. At the time, Québec had already opted-out of the tax-rental agreements between Ottawa and the provinces initially signed during World War Two. This move by the Québec government weakened existing fiscal arrangements that had provided horizontal fiscal redistribution to the province. In this context, the creation of equalization served as a national unity tool aimed at resetting horizontal fiscal redistribution to Québec, among other things (Bryden, 2009).

The importance of solidarity as a value in the Canadian federation is balanced by the weight of another important value held by provinces: autonomy (Béland and Lecours, 2011). Unlike equalization in other federations like Australia, the Canadian equalization system considers only provincial fiscal capacity, not provincial needs. Although discussed at the birth of equalization and a few times thereafter (Janigan, 2020), needs assessment for the purpose of equalizing was always rejected because provincial governments did not want it. It was not so much that a needs assessment required deeper solidarity but rather that it was deemed by provinces to be too intrusive and, therefore, that it threatened to undermine their autonomy. The equalization program as constituted has been the object of criticism by various provinces at different times but, with the partial exception of the current Alberta government, provincial governments have not called for its outright abolition, something that is helped by the existence of a constitutional responsibility for the federal government to make equalization payments. The constitutionalization of that responsibility in 1982 was remarkably consensual amongst Canada's governments (Romanow, Whyte and Leeson, 1984), a demonstration of the underlying solidarity that makes equalization possible.

Of course, provinces that were, at different points in time, non-recipient have generally been less supportive of equalization than recipient provinces. At the onset of the program, Ontario was hesitant, as it would be a non-recipient province for the foreseeable future. Alberta, which has not been a recipient province for nearly sixty years as a result of wealth generated from oil and gas exploitation, has since then been the most vocal critic of the program, typically finding it too generous. In recent years, criticism of equalization by the Alberta government has both increased and changed. The context for this change is a slowdown in the province's economy since 2014, when the price of oil started declining. The Alberta government attributed the slowdown in large part to the lack of pipeline infrastructure to transport the oil of the landlocked province to the Canadian East and West Coast, where it could then be taken to the European and Asian markets respectively. Opposition to pipeline expansion in other provinces, most notably British Columbia and Québec and amongst many Indigenous peoples, combined with the federal Liberal government's commitment to aggressively fight climate change, resulted in only one new pipeline development in recent years (TransMountain), much to the disappointment and anger of Alberta.

The Alberta government then made a case for the unfairness of a situation whereby provinces such as Québec block pipeline expansion yet receive equalization payments, whereas Alberta does not despite the economic slowdown (its fiscal capacity remaining above the pan-

Canadian average). In other words, the government of Alberta targeted equalization in a form of rhetorical retaliation for the rest of the country's mostly negative position on pipeline expansion. Alberta Premier Jason Kenney will hold a referendum on equalization in his province as he deemed progress on pipelines to be unsatisfactory. Of course, Alberta cannot change, let alone withdraw from, equalization, which is mandated by the Constitution, but Premier Kenney seems to be hoping that Albertans formally expressing their desire to take out references to equalization in the Constitution would put pressure on the federal government to reform program. Yet, there is no conceivable change to the program which would make Alberta a recipient province in the immediate term, which is why Alberta, tellingly, does not propose any specific reform. In sum, Alberta's contemporary criticism of equalization involves the notion of unfairness linked, among other things, to the difficulty of pipeline development. In this vein, in 2019, the Alberta government created a "Fair Deal" Panel, whose mission was to make recommendations to help Alberta get a better 'deal' in the federation. One of the Panel's recommendations was for the Alberta government to go ahead with a referendum on equalization (2020: 7), demonstrating the rhetorical weight of equalization criticism in Alberta.

g) A "One Size Fits All" Monetary Policy: Does it Exist?

In Canada, monetary policy is conducted by its central bank: The Bank of Canada. Created during the Great Depression, its primary purpose was originally "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment" (*Bank of Canada Act*, 24-25 George V, 1934). In a country as diverse as Canada — where the sectoral composition of economic activity varies widely across provinces — these objectives have always been a challenge. Today, they remain so.

After many years of gradual change in the conduct of monetary policy, there are now two pillars of Bank of Canada policy: an inflation target and flexible exchange rates. Inflation targeting has proven successful in many countries, Canada included, in helping stabilize macroeconomic fluctuations. And a flexible exchange rate is at the core of *how* Canada, as a country with open capital markets, can have an independent monetary policy at all. Were it not for a flexible exchange rate, Bank of Canada interest rate and money supply decisions, for example, would be used to maintain the currency value rather than stabilize inflation. It is not possible to achieve both an inflation target and an exchange rate target simultaneously without implementing broad restrictions on the flow of international capital, which is difficult for an internationally-integrated market-oriented economy such as Canada's to do.[7] These two pillars, while highly effective from a macroeconomic perspective for these reasons, create challenges in the Canadian federation.

Inflation targeting generates challenges when some provinces are experiencing a recession while others are not, which is increasingly common in the Canadian federation. The target is, after all, national in scope, and the Bank of Canada focuses on it rather than on counterbalancing regional economic shocks. We have a long history with this policy, so some of its effects can be explored here.

The inflation target policy was announced in late February 1991, making Canada only the second country to implement the now-dominant policy (following New Zealand, which

[7] In general, the "Mundell-Fleming Trilemma", as it is known, notes that a country can only achieve (at most) two out of the following three policy objectives: free capital flows, fixed exchange rates, or independent monetary policy. Canada chose the first and third of these. Countries joining the Euro, meanwhile, are choosing the first and second.

implemented it a year earlier). The Governor of the Bank of Canada and the Minister of Finance jointly established targets of 3% inflation by the end of 1992, 2.5% by the middle of 1994, and 2% by the end of 1995. Regularly reviewed and renewed, inflation targeting remains in place today and is normally appropriate for all provinces, but there are occasionally situations where the uniform conduct of monetary policy is not optimal. Consider recent episodes of strong growth in Alberta, which prevailed in the years leading up to the 2008 financial crisis due to rising natural gas prices and strong development of oil sands operations in the province. Between 2000 and 2009, inflation in Alberta averaged 3% compared to an average of 2% in the rest of the country. This is a meaningful difference. Sustained over those nine years, prices increased by nearly 10% in Alberta compared to the rest of the country. More restrictive monetary policy (such as through higher interest rates) would (potentially) have been a better policy for Alberta during these years. Alberta's neighboring province of British Columbia, meanwhile, experienced lower inflation than the national average, especially after 2010. These price changes matter for cost of living, costs of business inputs, business competitiveness, migration decisions, firm investment decisions, and so on. Annual inflation rates are also less correlated in peripheral regions (western provinces and the Atlantic provinces) to the national average than Ontario and Quebec inflation rates are. This is a natural consequence of their size but illustrates the challenge for a national institution with aggregates targets to tailor its policy to regional developments.

Flexible exchange rates may pose a more substantial challenge for monetary policy in a country as diverse as Canada. To be clear, there are strong reasons to favor a flexible currency as Canada has long had. But we should be aware of challenges stemming from a flexible currency across provinces. Increasingly, energy exports and volatile commodity prices create these difficulties. Energy exports are a large share of Canada's total trade, rising from 11% of exports in 2000 to 25% by the end of 2019 despite low oil prices. Two thirds of these energy exports are from Canada's major oil producing province of Alberta. Given the large weight of energy in Canada's overall trade, changes in the price of oil can have meaningful effects on the value of Canada's currency. Prior to the financial crisis, for example, when oil prices rose rapidly from roughly $60 per barrel in early 2007 to well over $130 per barrel by summer 2008, the Canadian dollar appreciated by roughly 15% relative to the US dollar. When oil prices fell, so too did the dollar. And as oil prices gradually rose, the dollar once again reached parity with the American dollar. Recent declines have continued this pattern, including the precipitous decline that followed economic disruptions from COVID-19.

A flexible currency buffers an economy from external shocks.[8] For example, if international energy prices rise by 10% in US dollar terms but the Canadian dollar rises by 10%, then the domestic price of energy remains unchanged and the domestic economy is therefore fully buffered from the shock. But energy price shocks largely only affect the three oil producing provinces of Alberta, Saskatchewan, and Newfoundland and Labrador. Flexible exchange rates are therefore helpful for these provinces in the face of volatile energy prices, but such currency moves can negatively affect other provinces. Ontario and Québec manufacturers, for example, may be adversely affected by a rising Canadian dollar as this makes their exports more expensive for foreign buyers. Exchange rate volatility is regularly cited as a challenge for these two provincial economies. In the years prior to the recent energy price decline that began in 2014, the concerns were very forceful and references to 'Dutch Disease' — the situation where expanding commodity sectors will cause a shrinking manufacturing sector — were frequent.

[8] In addition to allowing independent monetary policy, providing a buffer to external shocks is the other principle benefit of a flexible exchange rate. For a detailed examination of Canada's experience, see Schembri, 2008. Available online at https://www.bankofcanada.ca/2008/03/spring-2008/.

This is not to say that monetary policy in Canada is flawed. Indeed, the Bank of Canada's international reputation is strong, its recent Governor Mark Carney, for example, being appointed Chairman of the Financial Stability Board from 2011 to 2018 and Governor of the Bank of England from 2013 to 2020. But it is to say that monetary policy in Canada is challenging, and increasingly so. In Canada, provincial economies are subject to their own unique economic shocks more so now than in prior decades. One measure of such differences is the average gap between provincial growth rates and the national average growth rate.[9] In the 1960s, the average gap was one quarter of the national growth rate. That is, for each 1% that Canada grew the average differential between provincial growth rates and this national average rate was 0.25%. In the 2010s, that average gap increased to over 0.64%.

The challenges this creates for monetary policy are the same in Canada as in any monetary union where economic shocks have different impacts across the territory. Yet, other policies and institutions may help compensate. There are (typically) four conditions cited in the literature on "optimal currency areas" that are helpful to consider.[10] These are: labour mobility across regions, open and flexible capital markets, fiscal transfers to pool risk, and the similarity of business cycles. Canada enjoys the first three, but the fourth may be increasingly problematic. Policies to further improve Canada's interprovincial labour mobility, the functioning of capital markets, and enhancing fiscal transfers are options to shift burdens associated with province-specific economic shocks in ways that Bank of Canada monetary policy cannot.

h) Merits and Deficiencies of Canadian Fiscal Federalism

Impact of Equalization in the Federation

There are numerous macroeconomic implications of fiscal arrangements in Canada, some of which benefit the overall economy while others detract from it. Therefore, one must weigh those costs against equity benefits. We review the major macroeconomic benefits and costs of Canada's fiscal arrangements here and quantify the potential equity gains that they achieve.

Canada's equalization program, which is the only major federal fiscal transfer program that does not provide all provinces with the same per capita allocation, deserves particularly close attention. As discussed earlier, the stated goals of the program are found within Section 36(2) of the *Constitution Act*, 1982:

> 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.

[9] Formally, this measure is the average relative mean deviation of annual GDP growth rates.
[10] This is a long literature pioneered by Robert Mundell, 1961. This work, and much subsequent effects, improved our understanding of policy questions such as the formation of the Euro-zone and (in part) lead to him being awarded the Nobel prize in 1999. Interestingly, Canada's move to a flexible exchange rate is what motivated Mundell to begin his extensive academic research in this area. The economics community's understanding of monetary and fiscal policy therefore gained much from Canada's experiment.

The commitment to ensure that public services and tax rates are comparable is not only an issue of equity across individuals living in different regions, as there are also important implications for Canada's overall macroeconomic and aggregate productivity.

Consider first the effect of the federal equalization program on tax rates. Without equalization payments, tax rates would need to be significantly higher in lower income provinces than in higher income provinces. This matters for aggregate economic efficiency, because variation in tax rates across provinces can distort investment, employment, and migration decisions of individuals and businesses. In addition, the economic distortions that tax rates create are increasingly large as tax rates increase. So, increasing tax rates in already high-tax regions (which correspond to Canada's lower income provinces) will come with larger economic costs than an equivalent tax increase in low-tax regions would cause.

Macro-Economic Effects on the Federation and its Entities

Equalization helps even out tax rates and therefore improves macroeconomic efficiency. For perspective, equalization payments (to lower income provinces) in 2018/19 totaled $19 billion. This is equivalent to over one-fifth of own-source revenues for those provinces and roughly one-quarter of taxation revenues. And for some recipient regions, such as Prince Edward Island and New Brunswick, equalization payments exceeds 50% of their own-source taxation revenues. Absent such payments, in these provinces, tax rates would need to be significantly higher. In Prince Edward Island's case, to make up for lost revenues, the provincial sales tax rate would need to be roughly 14 points higher – more than doubling to 24% from its current 10%. To fund all the equalization payments, meanwhile, the federal government requires just over 2.25 points on its sales tax. The trade-off is for modestly higher federal tax rates to prevent significantly higher tax rates in lower income provinces.

One can quantify the macroeconomic implications of this using estimates of Canada's "marginal cost of public funds" (MCPF). This is a measure of the economic costs on the private-sector economy for each $1 in taxation revenue. If the MCPF is 1.1, for example, then efficiency losses from the tax are $0.10 per $1 raised in revenue. Estimates of the MCPF vary, but recent estimates presented in Dahlby (2012)[11] suggest the most efficient tax sources (sales taxes) in lower income provinces have MCPF values averaging around 1.35. Federally, the MCPF for sales taxes are not precisely estimated or reported by Dahlby, but the estimate for federal personal income taxes is 1.17. A reasonable MCPF for sales taxes, which are generally more economically efficient than income taxes, may be roughly 1.1. Raising a dollar in revenues federally, therefore, comes with a smaller economic cost than raising a dollar in lower income provinces. To illustrate, using Prince Edward Island's MCPF value of 1.42, were it to raise on its own the $419 million in equalization payments it received in 2018/19 the economic efficiency loss would be nearly $1,150 per capita — or 2.5% of its economy. Among all recipient provinces, we estimate the overall efficiency loss at nearly $6.3 billion or 0.3% of Canada's economy. To raise the necessary revenues to fund equalization, meanwhile, the 2.25 points on the federal GST carries an efficiency loss of potentially $1.9 billion ($50 per capita) or less than 0.1% of the national economy. Thus, the macroeconomic net benefit of equalization is the difference between these two measures: roughly $4.4 billion. Though only 0.2% of the national economy, which may appear small, this represents over 23% of the total cost of the equalization program. By reducing tax differentials, the macroeconomic benefits of the federal equalization program may therefore be relatively large per dollar spent.[12]

[11] Dahlby, 2012.
[12] The benefits from this channel would be lessened to the extent that equalization itself might distort provincial taxation decisions. There is evidence, for example, that equalization may lower the cost of raising taxes in recipient provinces, since payments offset for shrinking tax bases. For example, Smart, 2007.

To be sure, because recipient provinces would not likely raise revenues dollar-for-dollar to make up foregone equalization payments, public service spending would also probably decline. Equalization payments to lower income provinces average one-sixth of total program spending in 2018/19 or over one-third of total healthcare spending. The macroeconomic implications of lower quality public services in those regions are difficult to quantify but are surely non-trivial. Healthcare and education enhance productivity by improving human capital, increasing employment rates, and so on. And as individuals move across regions, those benefits may accrue to other regions.

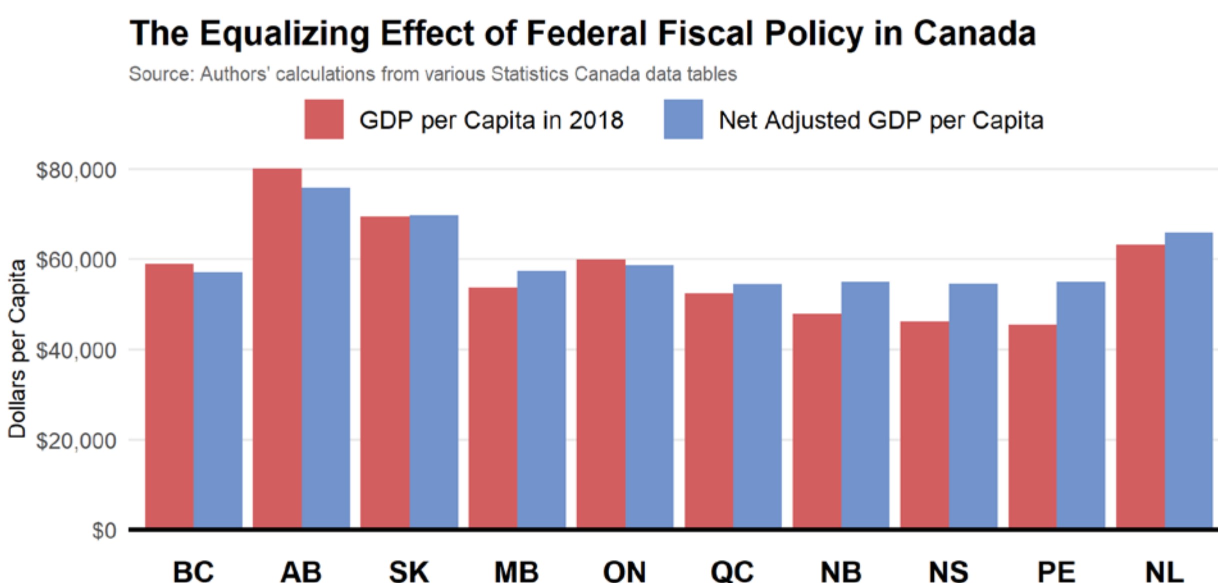
But migration matters for another reason, and one that can be quantified. Some provinces have access to revenue sources for which residents do not pay. These "source-based revenues," as they are known, include natural resource revenues (which accrue to provincial governments for the most part), investment income, corporate income taxes, property taxes by non-residents, and so on. There is significant variation in these source-based revenue sources in Canada. Tombe (2018) documents that over the past decade, these revenues in Alberta were equivalent to $2,700 higher per person than the national average. Meanwhile, in Prince Edward Island, such revenues were $1,000 per person below the national average (Tombe, 2018). These values have changed in recent years due to lower oil prices, but even in 2018, source-based revenues in Alberta approached $2,300 per capita, compared to barely $500 in Manitoba, an equalization-receiving province.

An individual living in provinces without access to such revenues could benefit by moving to one that does. These benefits, averaging a few thousand dollars per capita for most moves, would take the form of lower tax rates or higher levels of public services in the region with large source-based revenues. And, at the margin, such a move may be rational for the individual even if their productivity and pre-tax incomes would fall somewhat. Estimates of the distortionary effect of this are difficult to quantify but recently published work by Tombe and Winter (2020) estimate that equalization may induce roughly one percent of workers to have moved across provinces — with the largest flows occurring between Ontario and Quebec — and, as a result, aggregate productivity declines by 0.14% (Tombe and Winter, forthcoming). Although this is negative, it does not imply equalization detracts from overall productivity. Their estimate, for example, does not included the potentially positive gains from evening out differences in tax rates across provinces that we discussed earlier.

Beyond equalization, other federal transfer programs have significant macroeconomic implications. For instance, although the CHT and CST are equal *per capita* transfers and, thus, do little to address horizontal fiscal imbalances among provinces, they potentially improve macroeconomic outcomes by centralizing more revenue collection with the federal government. Personal and corporate income taxes are potentially more efficient when collected by the federal government, as provincial income tax rates may induce tax bases to shift across regions. Empirical estimates support this claim (Dahlby, 2012).

Yet, other minor transfer arrangements, which account for roughly one-fifth of total federal transfers to provincial governments, are not equally distributed. Some, such as transit funding, is allocated based on ridership, for example. In 2018, these non-equalization transfers varied from $1,200 per capita more than average in Prince Edward Island and Newfoundland and Labrador, to $425 less than average in Quebec (although a tax point transfer known as the Quebec Abatement offsets this).

Beyond transfers, federal taxes levied on income and consumption may also distort economic activity across regions.[13] Combining all aspects of federal fiscal policy, Tombe and Winter (2020) estimate a potentially negative effect on aggregate productivity of between 0.8 and 1.2 per cent due to a distortion of individual migration decisions. One must weigh against this potentially negative overall effect on aggregate productivity the substantial increase in inter-regional equity that Canada's fiscal arrangements help achieve. In 2018, for example, GDP per capita in Alberta exceeded $80,000 but in Prince Edward Island it was barely over $45,500. This nearly two-to-one gap in economic activity is compensated for by federal fiscal policy. Federal spending in Prince Edward Island exceeded federal revenue raised in that province by over $9,500 per capita in 2018, for example, which boosts living standards there. Comparing the variation in GDP/capita net of federal fiscal redistribution — specifically measured through the variance of log values — we find regional income inequality is nearly 60% lower than it would be otherwise.[14] We illustrate this in the figure below. Broadly speaking, Canada's overall fiscal arrangements are effective in materially reducing economic disparities across regions.



Legitimacy, Efficiency of Conflict Resolution, and Control

Most conflicts regarding fiscal federalism are dealt with at the political level. When disputes regarding the exercise of the federal spending power cannot be resolved through political channels, they may end up in court. In *Reference Re Canada Assistance Plan (B.C.)* (1991), for example, the Province of British Columbia sought an advisory opinion from the British Columbia Court of Appeal on the lawfulness of the federal government's decision to decrease the level of funding provided under the *Canada Assistance Plan*, the country's major health and social transfer, without first seeking provincial consent. The Court of Appeal concluded that British Columbia had a legitimate expectation that consultation would precede any changes to compensation arrangements under the Plan. The Attorney General of Canada appealed to the Supreme Court of Canada. The Supreme Court rejected the view that consent was a legal requirement, and generally took a dim view of the invitation to "supervise

[13] Albouy, 2012 with updated data for the Canadian context in Tombe, 2018.
[14] These results are broadly substantiated using a rich general equilibrium model of Canada's economy in Tombe and Winter, forthcoming.

the federal government's exercise of its spending power" (*Reference Re Canada Assistance Plan (B.C.)*, 1991).

As we have noted, the Supreme Court has yet to rule definitively on the nature and limits of the federal spending power. However, its general statements on the power suggest that there are few limits on the federal government's ability to spend outside of its sphere of legislative competence and to impose conditions on such spending (*YMHA Jewish Community Centre of Winnipeg Inc. v Brown*, 1989; Frédéric, 2016; Hogg, 2020; Oliver, 2022). This means that the remedies in such disputes are likely to be political, with courts playing at most a minor role to play in policing the "boundaries" of the federal spending power. Given the quintessentially political nature of spending decisions, moreover, there are strong institutional reasons for courts to decline a robust role in adjudicating disputes over how the federal spending power is exercised (Kong, 2017).

This assessment of the role of courts in reviewing federal spending in areas of provincial jurisdiction is consistent with broader trends in Canadian federalism jurisprudence. In the past few decades, the Supreme Court's federalism caselaw has been characterized by the development of doctrines, such as the double aspect doctrine, the ancillary powers doctrine, and the paramountcy doctrine, that are intended to foster cooperation between orders of government (Oliver, 2011). Most scholars are of the view that Canada has for some time now been operating within a paradigm of flexible or "cooperative federalism" (Oliver, 2011; Wright, 2018) According to the Centre for Constitutional Studies (2021),

> Courts have developed the idea of cooperative federalism into a legal principle to reject strict approaches to interpreting the division of powers. Cooperative federalism reflects the realities in society that often require the federal and provincial governments to establish coordinated efforts. The more flexible approach to interpreting the division of powers makes it easier for collaboration between governments. Courts prefer to allow laws enacted by both levels of government to operate in order to promote cooperative federalism.

In order to avoid confusion with competing understandings of "cooperative federalism" in other jurisdictions, it may be more helpful to use the Supreme Court of Canada's more recent alternative formulation, that is, "flexible federalism" (Boudreault, 2020).

In the modern era, then, the concept of watertight jurisdictional compartments carries far less purchase. As noted, it is acknowledged that both the provincial and federal governments have overlapping jurisdiction in a range of areas, and that both orders of government can usually legislate in those areas without infringing the jurisdiction of the other. Courts continue to hear federalism disputes, of course, but the trend has been not to intervene to invalidate legislation except in clear cases of overreach (Oliver, 2011). This more modest judicial approach is also likely to apply to challenges to federal spending in areas of provincial jurisdiction.

The System's Democratic Legitimacy

There is considerable variation in how the federal spending power is exercised, each with different implications for democratic accountability. Sometimes federal spending is used to fund projects that are co-developed between federal and provincial governments. The spending dictates neither the fact nor the content of the program. Other times, a program is largely developed at the provincial level, with the federal involvement being limited to

spending. In still other circumstances, a program may be largely spurred on by federal funding – but for the federal contribution, the program would not have been initiated by the provinces. Other programs lie between these points on the spectrum (see generally Hogg, 2020; Leclair, 2005; Kong, 2017).

In each of these cases, the execution of the program at the provincial level may give the impression that the program is primarily or exclusively provincial in nature. This may lead voters to view the provincial government as the order of government to be held accountable for the program, even if it is partly or even primarily an initiative of the federal government. In other words, the federal government's ability to spend across jurisdictional lines may create "confusion" about which level(s) of government is (are) responsible for a given policy initiative, thus hampering democratic accountability (Kong, 2017; Leclair, 2005). Where the federal government has used its spending power to incentivize provinces to develop programs it would not otherwise have adopted, this distortion may be particularly problematic.

While the potential for confusion is not ideal, further analysis is required before concluding that these types of arrangements lack legitimacy. Cooperation on policy initiatives is now a fact in the Canadian federation. This cooperation is viewed as being both necessary and salutary. While there have been political and putative constitutional proposals to limit federal spending to areas of federal jurisdiction, or to impose further limits on or pre-requisites to the exercise of the federal spending power, these proposals come with costs as well as benefits. The modest increase in transparency these limits would provide would likely make cooperation across jurisdictional lines more difficult.

While cooperative or flexible federalism practice may make it more challenging to hold a single level of government directly responsible for its policy choices, governments still have tools at their disposal to explain the rationale for their decisions. It is open to provincial governments to provide clarity on the collaborative nature of a policy or program, as well as the role that federal spending has played in the development of a program. Thus, some measure of accountability is still possible.

i) Dos and Don'ts: What Can the EU Learn from Fiscal Federalism in Canada?

If an example were required to resist the assumption that federalism in general, and fiscal federalism in particular, is a delicate structure requiring precise alignment according to the constitutional equivalent of rigorous engineering principles, then Canada might be that model. From the outset of the Canadian federation, provinces were provided with insufficient funds to conduct the basic business of government, with the result that they required regular, if frequently *ad hoc*, transfers from the fiscally more secure federal authorities. As a consequence of this unbalanced state of fiscal affairs, there has always been a lack of alignment between constitutional jurisdiction, spending and political accountability. This lack of alignment was particularly striking in an era of Canadian federalism (roughly 1867 to, at the latest, 1949) characterized by an attempt to demarcate in fairly rigid fashion the exclusive legislative jurisdiction of federal and provincial legislators. However, as Canada moved into an era of flexible federalism, the simultaneous presence of laws enacted by both levels of government became the rule rather than the exception. With overlapping and blurred jurisdictional lines the norm, the lack of alignment between constitutional jurisdiction, spending and political accountability has become less anomalous. This situation is not without its Canadian critics, but it is hard to argue that Canadian federalism, and with it fiscal federalism, is an example of functionally misguided constitutional engineering.

Any attempt to draw lessons from fiscal federalism in Canada for the EU has to come with some important caveats. Although both Canada and the EU are federal, Canada is a federation (a state where power is constitutionally-divided between levels of government) whereas the EU is not. Since its birth in 1867, Canada has engaged in nation-building (albeit mediated by the existence of provincial governments that have become increasingly powerful over the decades) by which the federal government has used its powers of taxation to develop national social programs and norms that have strengthened the Canadian national identity and solidarity. In turn, these elements of identity and solidarity, although limited in many ways, have allowed the federal government to use all of the levers of taxation. As a result, its revenues have often exceeded spending commitments in its constitutionally-specified fields of jurisdiction, which has left Ottawa with financial resources to transfer to provinces for running expensive programs such as health care, education and social services. At least since the turn of this century, these transfers are overwhelmingly unconditional as the federal government is fairly unconcerned about so-called moral hazards, or perhaps simply politically unable to do anything about them. Provincial governments credibly argue that the money the federal government transfers to them comes in large part from their own residents and that, therefore, these residents can (and should) be the ones who ultimately hold provincial governments accountable for their spending. In other words, from this perspective, parliamentary and extra-parliamentary scrutiny (from experts, the media, etc.) *within* a province offer protection against frivolous government spending, with provincial elections representing the ultimate process of accountability. Of course, some of the money transferred by the federal government to some provinces (the poorer provinces) in fact comes from residents of other provinces. However, Canadian identity and solidarity are strong enough for residents of these provinces to refrain from pushing the federal government for conditionality in transfers (and, of course, conditions could not politically be imposed upon only one or selected provinces; all provinces would have to live with conditionality and none of them really want that). Moreover, there is, overall, a strong enough trust in the democratic processes of all provinces for Canadians to think that these processes represent an effective check on frivolous funding. Of course, it helps that the province with the distinct national identity (Québec) is overall a net beneficiary of Canadian fiscal federalism. If Québec were a net contributor, the weaker Canadian identity (and solidarity) in the province would most likely lead the Québec government to be concerned about moral hazards in the spending of other provincial governments that are net beneficiaries of fiscal federalism.

As the earlier account of the federal spending power in Canada indicated, as a legal and constitutional matter, the courts have provided no clear guidance regarding at what point on the spectrum of conditionality those conditions become tantamount to impermissible regulation of provincial matters. However, such case law as exists indicates that the courts are prepared to go a long way to accepting that conditions are about federal spending rather than a constitutionally illicit attempt to regulate provincial matters. Furthermore, those same courts appear disinclined to translate into legal terms that which is, in their view, essentially political and economic pressure. In other words, they are not inclined to treat the pressure of conditionality as justiciable (CAP 1991, [84]). It would be a mistake, however, to conclude from this that conditionality is a non-issue in Canada. Far from it. On a political (as opposed to a legal) level, one need hardly begin to mention conditionality before it becomes politically fraught. It is for this political reason, rather than an obvious legal or constitutional constraint, that conditionality has become less and less acceptable in Canada. Nonetheless, in certain political circumstances a certain level of conditionality can be acceptable even in political terms. For example, when the international response to the 2008 global economic crisis necessitated specific levels of expenditure by Canada and other countries, it was also necessary

to ensure a specific level of provincial contribution, and this was done by means of shared-cost mechanisms (Canada, 2012), without any notable level of provincial pushback.

In sum, fiscal federalism in Canada is predicated on checks inherent to parliamentary government and democratic practices rather than conditionality, targeting, and accountability between levels of government. This is possible because most provincial governments vigorously defend a non-hierarchical view of federalism (whereby the federal government is not superior to provincial governments) and also because there is a pan-Canadian identity and solidarity just strong enough to tolerate the spending choices of other provincial governments, whatever they may be.

In contrast to the Canadian federation, the *sui generis* nature of the EU involves a combination of significant supra-national regulatory authority and weak extractive powers. The nature of the European identity (i.e. explicitly non-national) presents a first, and fundamental, hurdle for any kind of territorial redistribution, as the strong national identity of countries that are net fiscal contributors to the EU naturally leads to concerns about how money is spent in countries that are (or are viewed) as net fiscal beneficiaries within the EU. Contrary to Canada, there also tends to be in some net contributing member states concerns about the quality of democracy and of parliamentary (as well as extra-parliamentary) mechanisms of accountability in some net fiscal beneficiary member states. National communities tend to portray themselves as communities of redistribution (Béland and Lecours, 2008) and, indeed, extending redistribution outside the boundaries of national communities (as defined by their elites and understood by their members) without mechanisms of accountability dictated by the states that are net contributors is politically challenging, perhaps impossible. With no short-term prospect for any kind of European national identity, such mechanisms of accountability (which are mostly absent in Canada) will likely remain a political objective for many member states.

To conclude, we may summarize concisely a small set of "dos" and "don'ts" to inform policy reform options in the European Union. No set of considerations can be exhaustive, to be clear, but Canada's current and previous experience with various forms of fiscal arrangements may be informative. Indeed, both Canada and the EU are broad and diverse polities integrated through various fiscal, political, economic, and social connections (although territorial economic discrepancies between EU member states are greater than between Canadian provinces) Balancing pressures to centralize in some areas that may improve efficiency while maintaining regionally decentralized systems has been at the core of Canada's experience. Moderate success tends to accompany reforms that ensure intergovernmental fiscal transfers are (1) based on transparent and predictable formulae, (2) allow for broad discretion over the specific disposition of those funds by individual provinces. In some circumstances, the use of tools of asymmetric federalism, such as opt outs, can help manage difference and the desire for greater provincial autonomy. Simple block grants, allocated according to only a few criteria, such as with the Canada Health Transfer and Canada Social Transfer, have proven to be a resilient approach for nearly the past quarter century and, broadly, appears stable going forward even following COVID-19. Uniform treatment is also a successful approach to many of Canada's transfer arrangements. Population-based allocation rules, for example, dominate. Redistributive programs have considerable merit, but that role is fulfilled by clearly defined and specifically designed transfers.

Turning to these redistributive programs, which is perhaps more relevant for the EU, we distinguish mechanisms that bridge differences between higher- and lower-income provinces from those that support economies experiencing sudden and sharp economic disruptions. Canada's Equalization program supports lower-income provinces through a relatively complex though conceptually simple arrangement, and provides informative lessons

for the EU. First, simplicity and transparency have considerable value. Second, collaborative approaches to explore program reforms based on independent expert reviews has also proved successful. Third, the unconditional nature of such transfers has been a central feature of the program from its very inception. A clear formula based on simple macroeconomic summary statistics, such as per capita levels of gross domestic product, which would mirror the way major EU revenues are raised from member countries, may be worth considering to achieve similar ends.

Although the federal government has ultimate decision-making power on all aspects of fiscal federalism in Canada, its management occurs within an intergovernmental framework whereby provincial governments may be consulted and may express a preferred position. Generally speaking, significant consultation with provinces renders fiscal federalism decisions more politically palatable and fiscal arrangements more durable. The further development of fiscal federalism in the EU s should therefore be embedded in an intergovernmental network, perhaps the Economic and Financial Affairs Council (Ecofin).

In terms of supporting economies experiencing sharp and sudden declines, Canada has adopted several approaches to pooling this risk throughout the federation. Federal unemployment benefits are the most significant measure to achieve this objective. Absent a significant reform to the distribution of responsibilities between member states and the EU, this may not be feasible for the EU in the short-term. It took the Great Depression and the near bankruptcy of several provinces, and the actual bankruptcy of one, to cause Canada to shift unemployment benefits to the federal level. But considering predictable and formula-based fiscal supports to economies experiencing sharp recessions may be feasible. Ad hoc approaches are challenging politically, as experience in both Canada and the EU have demonstrated in recent decades. This may be an example of how not to approach such support. But to the extent that EU-wide unemployment benefit schemes are considered, using formulae that are transparent and simple would avoid some of the challenges Canada has experienced with its Employment Insurance arrangement.

j) COVID-19 and Fiscal Federalism in Canada

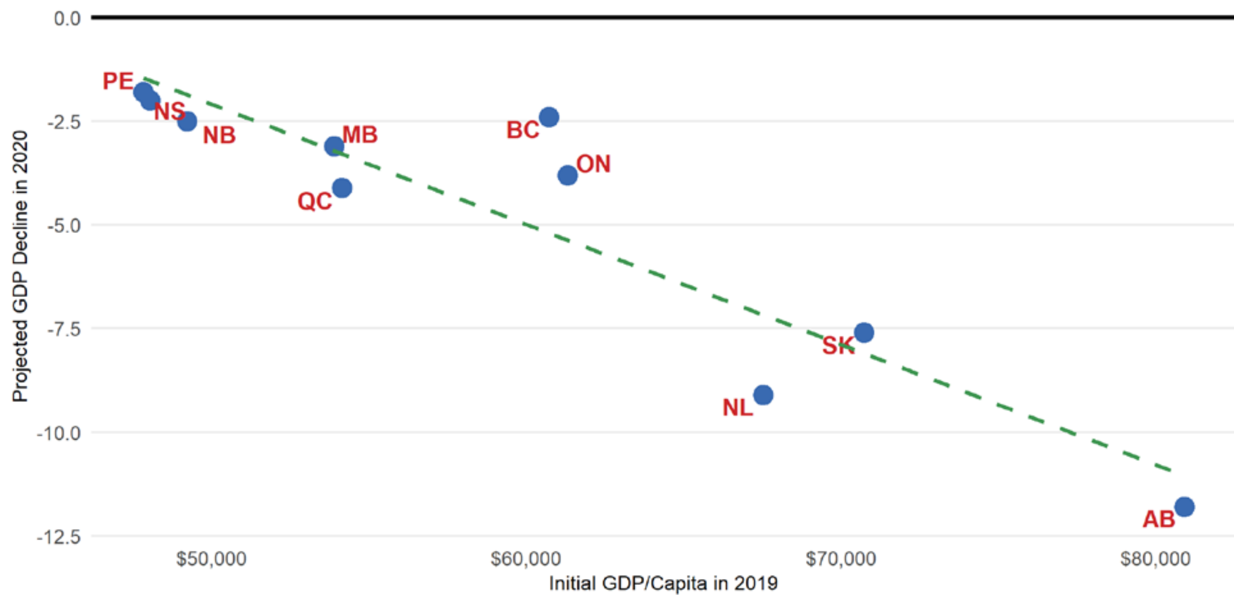
The COVID-19 pandemic, which struck Canada particularly hard through 2020 and the first half of 2021, has challenged pre-existing fiscal federalism arrangements in the country through both direct effects on health systems and indirect effects resulting from the large and uneven economic disruptions across Canada's provinces and territories.

In terms of the direct effects, primary responsibility for healthcare delivery and financing lies with provincial and territorial governments. The direct costs of responding to the pandemic therefore fell overwhelmingly on provincial governments. The federal government does play a role in terms of vaccination research, approval, and procurement — no small effort, to be sure — but costs of staffing, equipping, and delivering critical treatments to patients afflicted with COVID-19 falls on provincial governments. Currently, healthcare financing is not responsive to expenditure needs in health systems. Instead, as explained previously, the federal government provides per-capita block grants through the CHT to provincial and territorial governments that, nominally, support the financial costs associated with healthcare. These amounts grow gradually over time through a formula-based escalator index to a three-year moving average of nominal GDP with a minimum increase of 3 per cent. In the short-term, the large-scale economic disruptions from COVID-19 will lower this rate of growth to the 3 per cent floor.

The indirect effects of the pandemic result primarily from large and uneven levels of economic contraction that occurred through 2020. In the early stages of the pandemic, the federal government responded with a range of economic measures designed to lessen the impact of the lockdown on individuals and businesses, including wage subsidies, rent subsidies for businesses, assistance for students, and monthly lump sum payments for individuals who had lost their jobs (MacDonnell, 2020; Government of Canada, 2021). The provinces also enacted economic measures of their own, including benefits for children and families, energy subsidies, and protection for renters (Ontario, 2021; Nova Scotia, 2021; British Columbia, 2021). There was a relatively high degree of coordination between the federal government and the provinces on the pandemic response. As the pandemic wore on, however, some of this initial cooperation evaporated. For example, as calls for paid sick days grew in Ontario, the province insisted that it was the federal government and not the provinces that should expand their supports. Ontario eventually capitulated and funded three days of sick leave for individuals showing symptoms of COVID-19 (Ontario, 2021). Tension between the provinces and the federal government was also high in the early stages of the vaccine rollout, when infection numbers were at their highest point in the pandemic and the number of doses arriving in the province were low.

In the figure below, we plot the projected change in each province's nominal GDP (that is, approximately, total income) against the pre-pandemic level of per capita economic activity. Higher-income provinces, which are primarily the oil producing provinces, shrank a disproportionately large amount relative to other provinces. The lower-income provinces in the Maritime region of Canada on the Atlantic coast experienced the smallest contractions. The uneven depth of the COVID recession is driven by two factors. First, global energy prices declined significantly through 2020, which affects higher-income oil-producing provinces more than others. Second, policy responses to contain the pandemic also varied across Canada and provinces with better public health outcomes also experienced better economic outcomes. The three Maritime provinces of Prince Edward Island, Nova Scotia, and New Brunswick enacted some of the more robust and stringent public health responses in Canada and were largely spared the worst of the pandemic. Their economies outperformed most others through 2020. Whatever the underlying cause, the uneven distribution of economic disruptions matters for Canadian fiscal federalism due to the way it interacts with federal transfer programs that seek to bridge horizontal differences between higher- and lower-income provinces. In addition, the large-scale income support programs to bridge individuals and businesses through the pandemic were beyond the fiscal capacity of most provincial governments in Canada.

Figure 1: Change in Nominal GDP/Capita by Province vs 2019 Level



Source: Royal Bank of Canada Provincial Economic Forecasts, June 9, 2021.

Both challenges motivated significant policy reforms over the course of the pandemic and raised several questions regarding potential future challenges Canadian governments may confront. First, the federal government provided provinces and territories with numerous *ad hoc* one-time fiscal transfers. These included $1 billion to assist in vaccination efforts and $4 billion to offset direct healthcare system costs during the 2020/21. In future years, there will be additional supports for reopening, long-term care facilities, mental health supports, and other programs. Through COVID-19, the federal government is estimated to have provided 82% of the total fiscal supports — totaling over $500 billion. The bulk of this spending took the form of transfers to individuals and businesses, but well over $20 billion was provided to provincial and territorial governments to offset expenditure pressures stemming from the pandemic.

Second, the differential magnitude of economic contractions — due to the way in which the shock disproportionately affected higher-income provinces — has dramatically lessened horizontal fiscal imbalances in Canada. Depending on future energy prices, this effect may persist for some time. The major transfer program that aims to bridge these imbalances is Equalization. For perspective, though the official data is not yet available, 2020 may have the lowest degree of fiscal capacity inequality across provinces ever recorded in Canada since the modern approach to equalization began in 1967.

This has created two main challenges for fiscal arrangements in Canada. First, there is a political challenge. Higher-income provinces (notably Alberta and Newfoundland and Labrador) are experiencing heightened levels of grievance towards the federal government. As noted, Alberta is holding a referendum in October 2021 on whether to remove the principle of equalization from the *Constitution Act, 1982*. A key concern in Alberta is that federal arrangements are not sufficiently responsive to changing economic circumstances. There are also grievances about the equalization program's specific formula. The size of the program is pre-determined and is indexed to a three-year moving average of national nominal GDP growth. Falling inequality with an un-indexed formula would have meant a shrinking program. The result that will potentially appear in the coming years is an increasing number of "adjustment payments" whereby residual dollars not paid out through the program's formula is distributed to recipient and certain non-recipient provinces. Canada may soon see payments

flowing to Ontario (the most populous province) for the first time since the 2008 financial crisis. Yet, unlike what happened during that crisis, these dollars will be entirely adjustment payments. This challenge from COVID-19 may motivate reforms to the design of equalization or, if not, may further exacerbate regional grievances about this federal program.

Related to the concern over the responsiveness of fiscal arrangements, economic disruptions have already led to substantive reforms to an important — though not often used — transfer program in Canada. The COVID-19 pandemic caused employment, personal incomes, corporate profits, and so on, to fall sharply in 2020. This shrank the size of important tax bases for provincial governments, and thereby shrank their total revenues. Federal income support programs to individuals and businesses (primarily through the Canada Emergency Response Benefit and the Canada Emergence Wage Subsidy) cushioned some of the potential revenue decline because these benefits are taxable income for provincial governments. Yet, revenues in many provinces are still likely to fall significantly. The federal Fiscal Stabilization Program, described earlier in more detail, provides a kind of insurance to provincial governments whose revenues decline more than five percent. Since 1986, however, total payments to provincial governments had been capped at $60 per capita — today roughly equivalent to less than one percent of provincial revenues. This limited federal insurance to provincial revenues is immaterial. In response to so many provinces potentially qualifying for payments and reaching the cap, the federal government boosted the cap to nearly $170 per capita and indexed it going forward to nominal GDP growth. Though still a limited program, this is a multi-billion dollar increase in support to provincial government budgets. Except for the oil producing provinces, it may very well cushion most (if not all) of the COVID-19 related revenue declines beyond the first five percent that provinces must cover on their own.

Canada's municipal governments also experienced significant fiscal disruptions through the pandemic. Overall, municipal governments — established under the constitutional authority of provincial governments — have access to $200 billion in revenues (approximately 9% of GDP), one third of which is from locally raised property taxes, one third in transfers from provincial governments, and the remaining third from sales of goods and services. The latter source of revenues largely evaporated early in the pandemic as public transit systems, recreational facilities, and various other cities services closed. Compounding this sudden loss of revenues is an important fiscal constraint faced by municipalities: they (normally) cannot run deficits. Lower revenues would necessarily and automatically result in higher property taxes or in lower spending on city services. Given the prospect of rising property taxes at a time of significant economic challenges for individuals and businesses, this was not an option for most municipalities. Federal and provincial governments responded with temporary measures to allow for municipal deficit financing or by accelerating transfer payments to cities that are normally spread more gradually over time. These *ad hoc* responses were generally successful and worst-case scenarios projected early in the pandemic were largely avoided. Yet, COVID-19 has significantly raised awareness of the lack of fiscal tools available to municipal governments to address sudden and dramatic changes in circumstances.

Finally, and beyond the fiscal responses, COVID-19 led to significant monetary policy responses with important implications for not only the economy broadly but also for fiscal federalism in Canada. Early in the pandemic, the Bank of Canada and other central banks around the world lowered their policy interest rate and began large-scale asset purchases. In Canada, these interventions meant the central bank increased in total asset holdings from $123 billion (roughly 5% of GDP) immediately before the pandemic to a peak of over $576 billion a year later. This monetary stimulus is equivalent to over one-fifth of Canada's GDP and accounts for a substantial majority of government bond issuances over the period. Importantly, the Bank of Canada also expanded the range of bonds it purchased to include, in a highly

atypical move, provincial government bonds. By May 2021, the central bank owned nearly $20 billion in provincial government debt. For many provinces, especially those with relatively high-debt levels already, intervention by the central bank proved to be crucial to lower yields and therefore borrowing costs. Though not a direct fiscal transfer, this monetary policy intervention lowered debt service costs, eased budget pressures, and ensured uninterrupted cash flows to provincial governments, especially early in the pandemic. Canada's system of fiscal federalism does not include explicit debt guarantees for provincial governments by the federal government. Bank of Canada purchases of provincial bonds represents one of the few mechanisms whereby provinces in challenging fiscal circumstances can borrow even without access to credit markets. The full implication of this intervention is yet to be determined, though may represent an important new precedent in Canada's monetary policy responses to economic and fiscal crisis.

k) *Conclusion*

To summarize, fiscal federalism in Canada:

- must be understood in the context of Canada's broader constitutional arrangements, which are increasingly characterized by flexibility and overlapping jurisdictions.
- includes a broad federal power to spend in areas of provincial jurisdiction (as well as to impose conditions on how federal funds will be spent by the provinces) so long as those conditions do not amount to the regulation of provincial matters.
- takes place in a political context that is opposed to the imposition of conditions regarding federal spending
- is currently based largely on unconditionality in transfers, and provincial governments are considered to be ultimately accountable to their residents for the use of the transferred money rather than to the federal government.
- is structured and circumscribed by the principles of solidarity and provincial autonomy.
- uses tools of asymmetric federalism, including opt-outs, to manage difference and the desire for greater provincial autonomy.
- involves federal and provincial governments that can act unilaterally in many fiscal spheres, and neither order is directly liable for debts accumulated by the other.
- features federal and provincial governments having access to similar income sources, but with provinces bearing responsibility for the most expensive programs (namely health care and education).
- involves two major federal per-capita transfers (CHT and CST) to mitigate the potential ensuing vertical fiscal imbalance.
- confronts significant differences in economic and fiscal strength across provinces, and increasingly divergent patterns of economic growth.
- features an equalization program that provides payments to provinces with a fiscal capacity falling below a national average in order to take them to that average and, as a complement to this program, features stabilization policies that provide modest support to provinces experiencing sharp recessions.
- provides for only a very limited role for Canada's central bank to support government finances, especially for provincial governments.

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