

Canadian Fiscal Federalism and Fiscal Pressures

Presentation by George Anderson, Forum of Federations
for the Conference:

Recovering Together? Fiscal Pressures, Federalism and Social Policy

Queen's University School of Policy Studies,
Kingston, August 17, 2010

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Canada is economically strong but faces major challenges of fiscal federalism

- It is a highly decentralized federation with growing structural issues amongst its provinces
- Key issues will include:
 - The response to the economic slowdown
 - The growth and conditions of major transfers
 - The future of equalization
 - The treatment of natural resource revenues
 - The policy response to climate change
- Provincial interests vary considerably on these issues, which are inter-related.



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Canada in a comparative context

- Highly decentralized
- Low levels of dependence on federal transfers
- Very little conditionality
- Equalization regime entirely funded by federal government
- Equalize up not down
- Important role of resource wealth in regional disparities



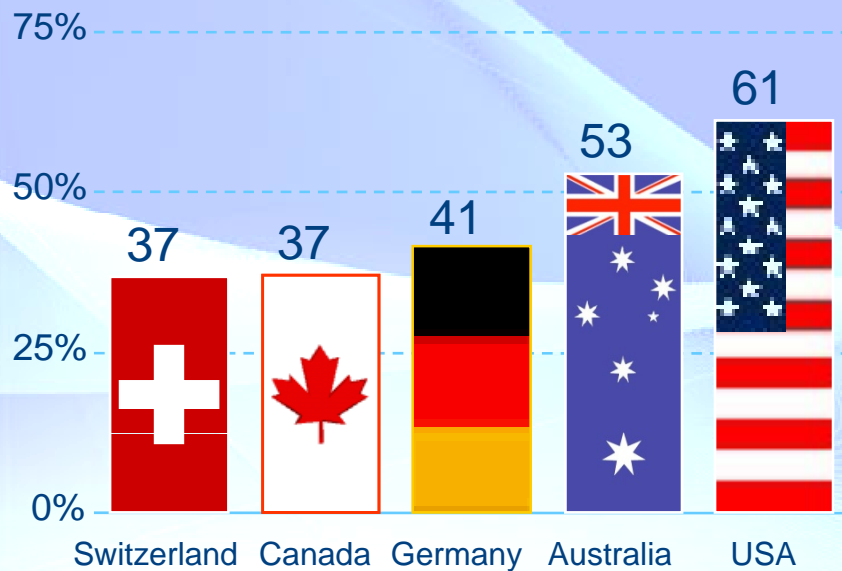
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Canadian provinces have a high degree of autonomy including significant fiscal resources and independence

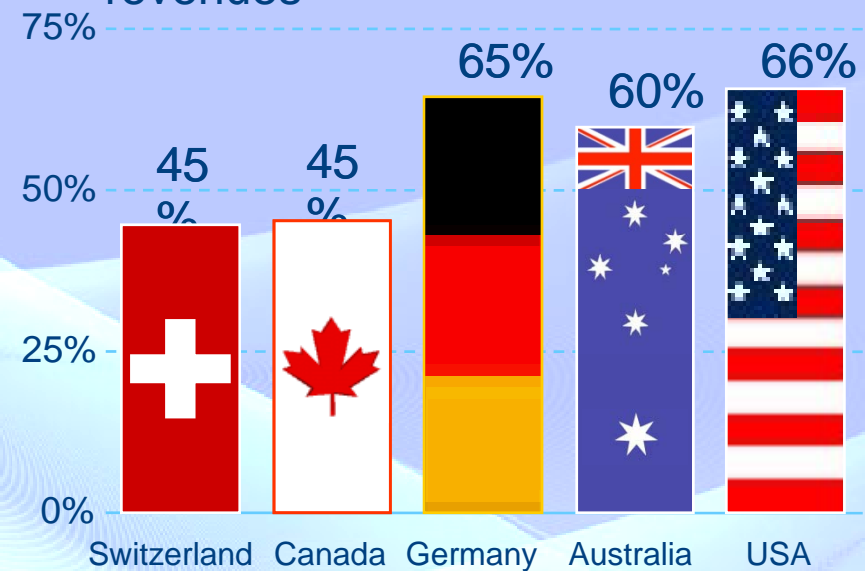
Expenditures

Federal share of direct spending



Revenues

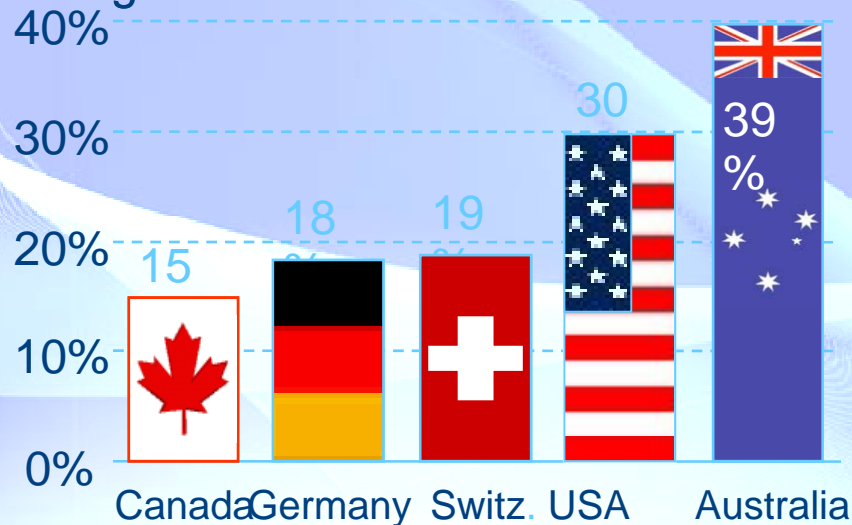
Federal share of own-source revenues



The particularly high degree of autonomy exercised by Canadian provinces reflects:

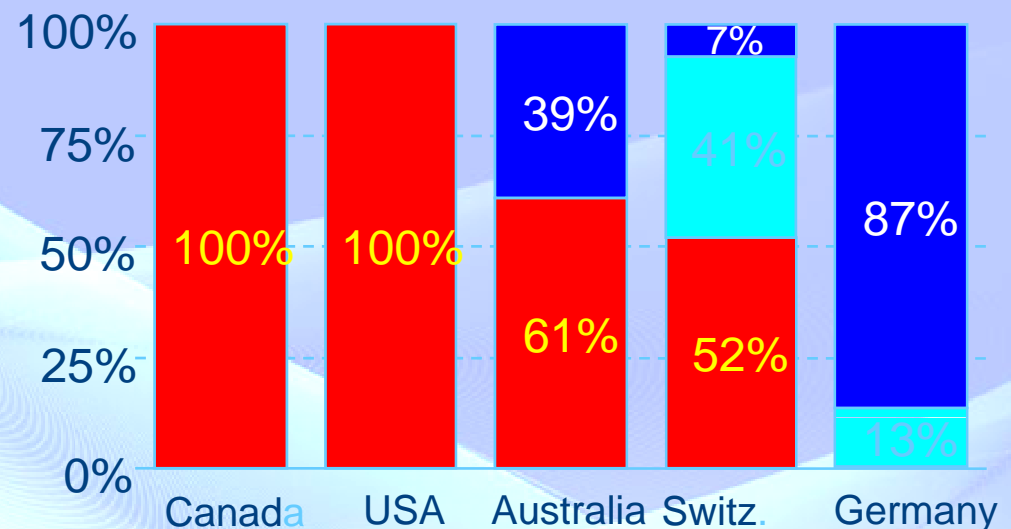
Their low dependence on federal transfers...

Federal transfers as a % of total revenues of other levels of government

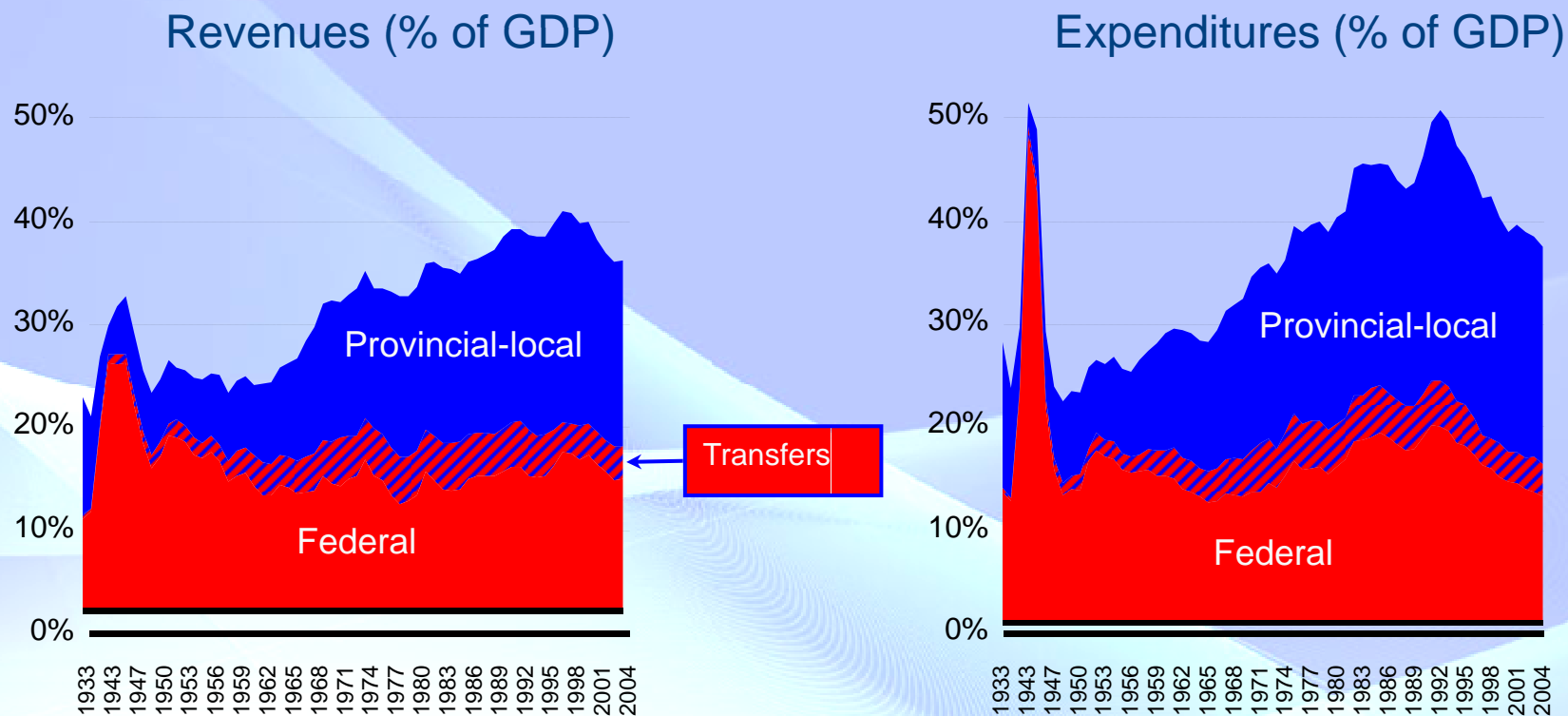


...and significant control over their own-source revenues

Non-federal own-source revenues, by degree of fiscal control



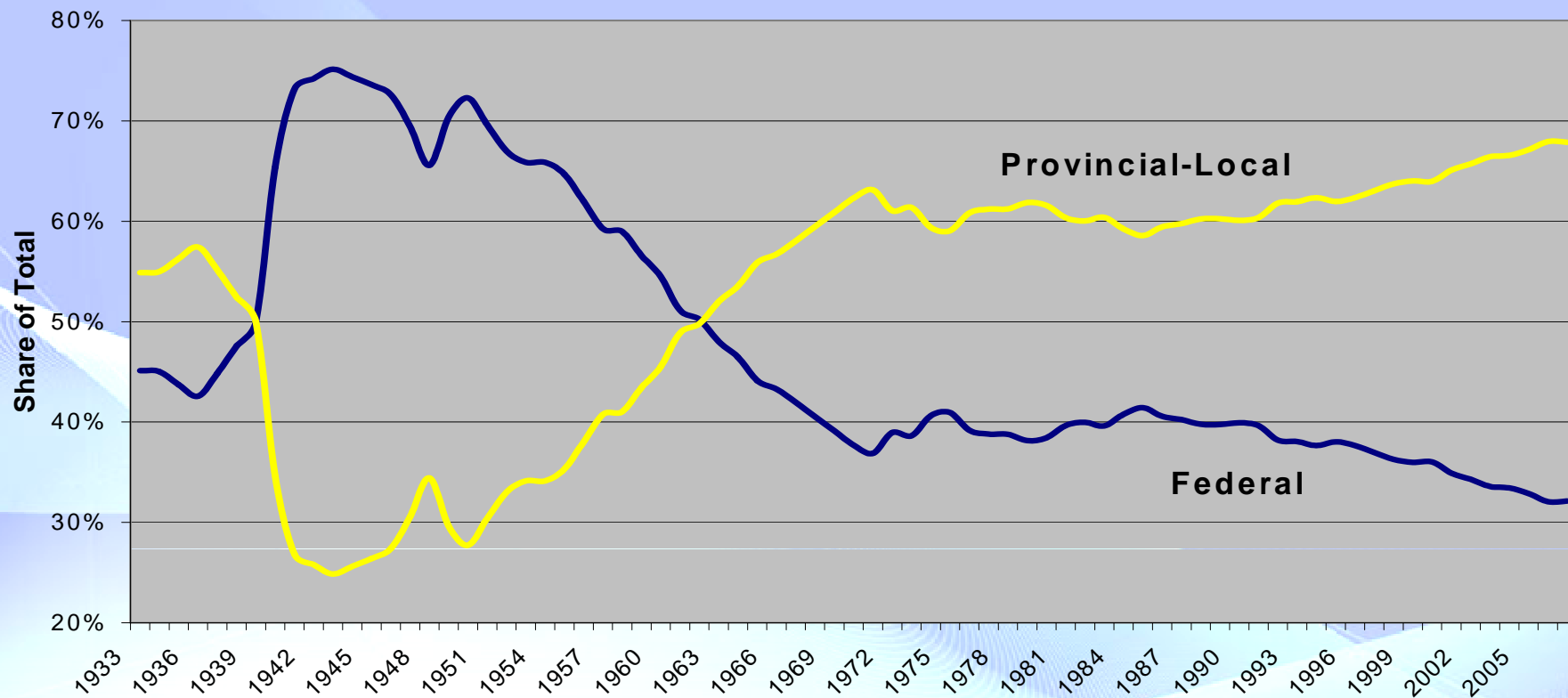
There is a long history of fiscal decentralization in Canada going back to the post-war period. It has been driven by provincial powers and responsibilities and Canada's political dynamics



Source: Statistics Canada

The federal share of government spending after transfers is exceptionally low

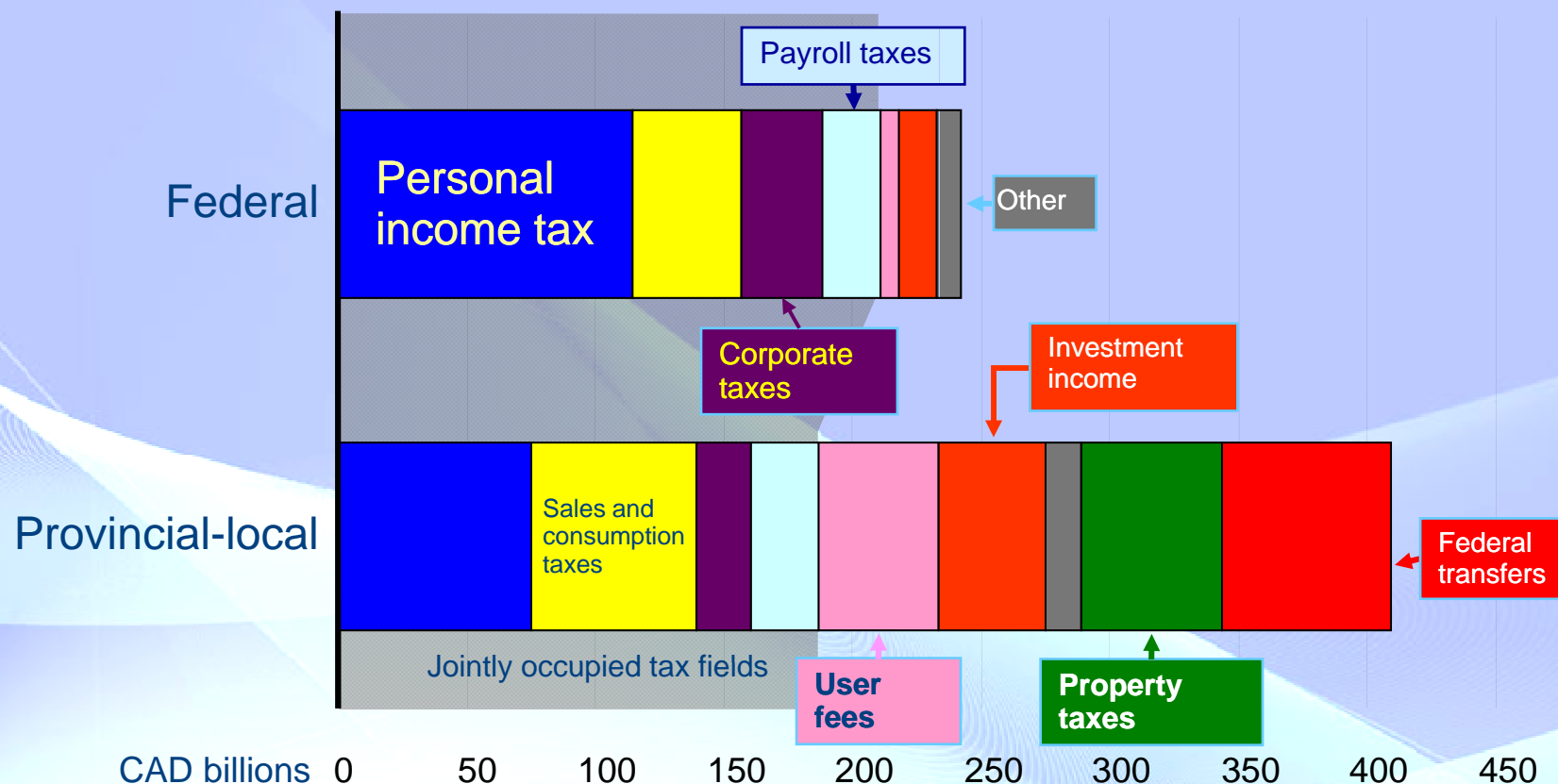
Federal and Provincial-Local Shares of Government Expenditure, Excluding Inter-Governmental Transfers



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The provinces have virtually unlimited powers to tax, through joint occupancy of major tax fields.

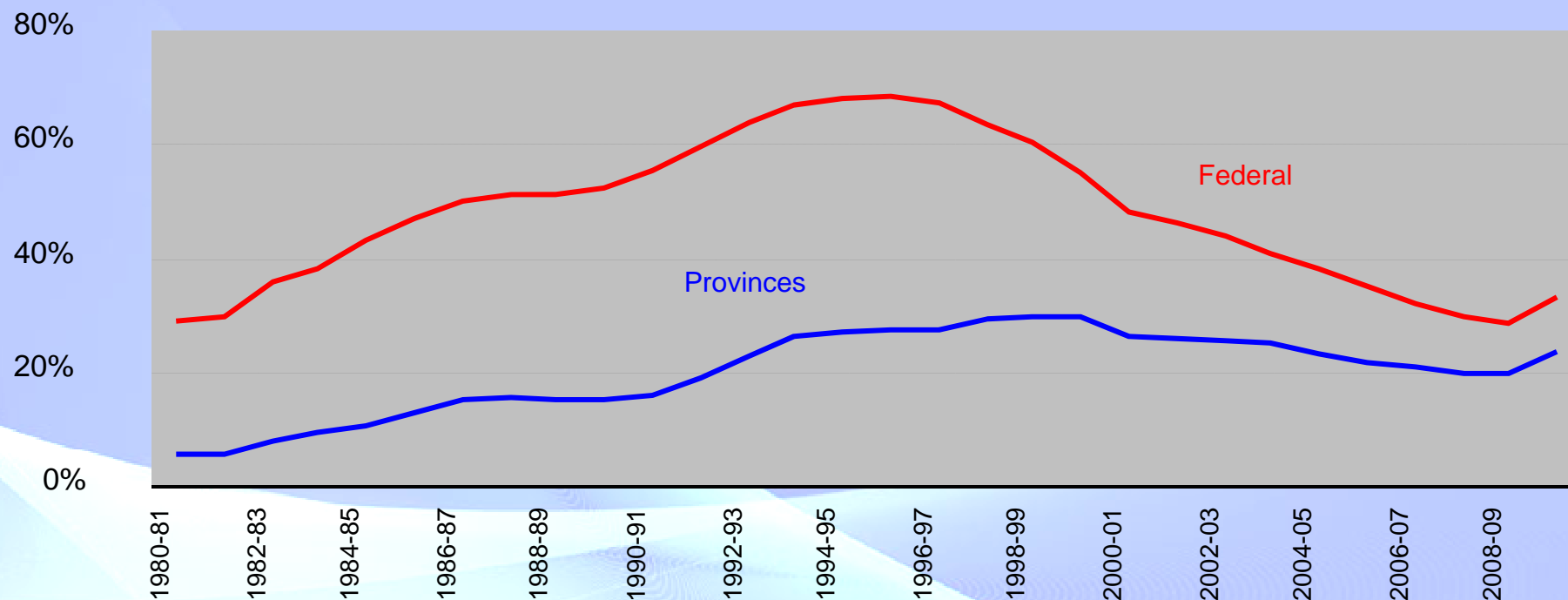


Source: Statistics Canada (2009)

The recession

- Gross government debt (82%) average in OECD, net debt (28%) very low; better forecasts than for most countries

Federal and provincial debt-GDP ratios



Source: Finance Canada

- Total projected deficits smaller than past peaks (9.1% in 92-3 vs. 5.4% in 09-10).

But there has been growing differentiation in provincial situations

- In early 90s all provinces running large deficits (totalling 3.5% of GDP in 92-3)
- This time total provincial deficits smaller (1.9% in 09-10) and heavily concentrated in Ontario (3.8% in 09-10). Alberta and Saskatchewan in surplus.
- Total provincial debt returning to levels of mid-90s (about 28%), but varies from Alberta with net savings to Quebec (minus 49% of GDP) and Ontario (minus 37%)
- Some provinces have had larger debts in past, but central and Maritimes provinces face much tougher challenge than Western provinces and NL



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Debt management

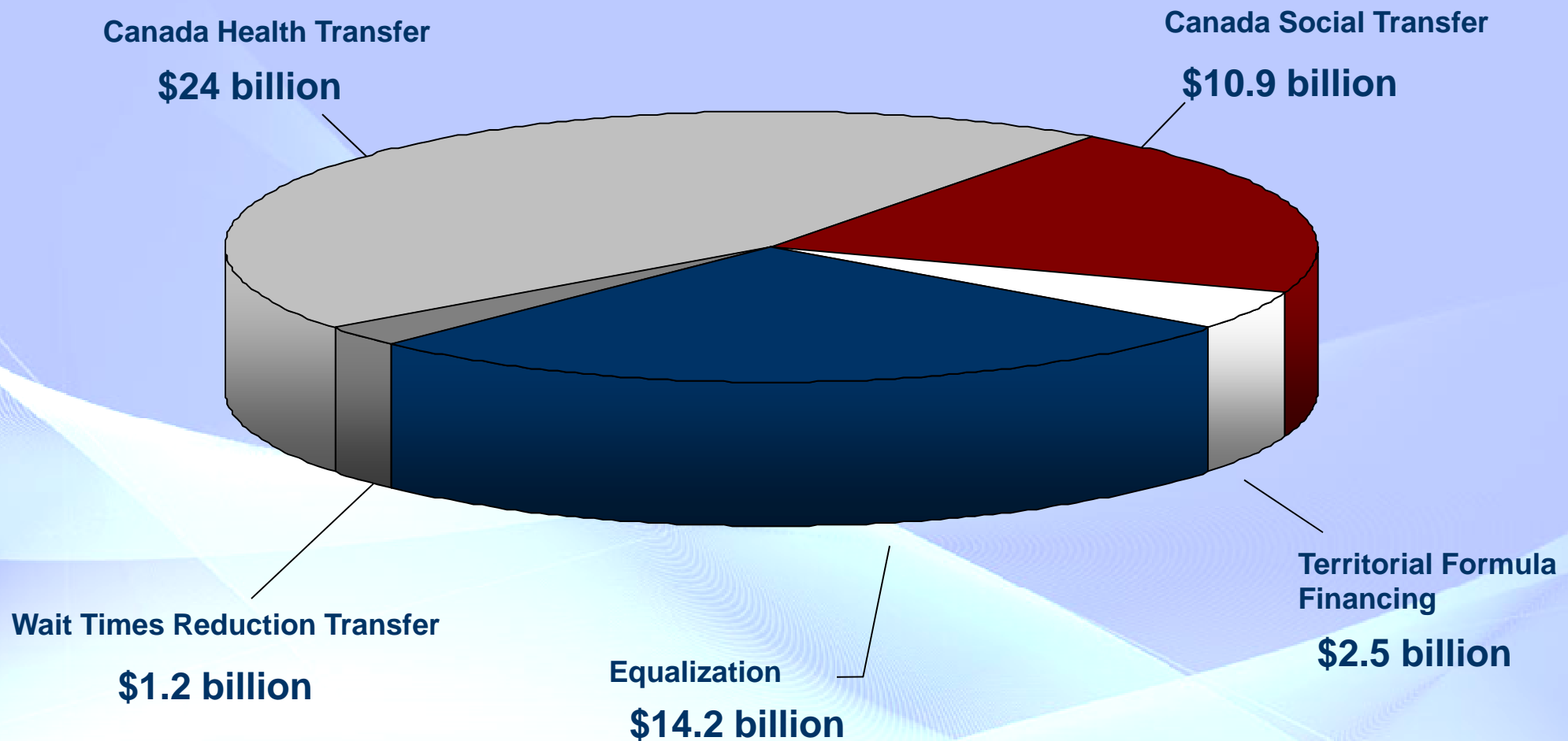
- Canada has no federal controls on provincial debt.
- Many federations do. EU does too.
- Provincial fiscal discipline largely because of need to raise taxes or cut programs if necessary
- Markets provide some discipline, but not fully costed, which suggests markets assign an implicit federal backstopping role.



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Major transfers to provinces and territories total \$53.7B in 2009-10



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Transfers per capita vary enormously by province

- Major transfers of \$53B represented 19% of provincial revenues in 2009-10
- In addition, there were targeted transfers of \$9.5B in 2009-10, mainly for infrastructure
- Total transfers: \$ per capita:
 - BC 1,400 -Ont 1,400 -PEI 4,300
 - Alta 1,100 -Que 2,400 -NL 2,500
 - Sask 1,500 -NB 2,400 -Territories 21-39,000
 - Man 3,100 -NS 3,200



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Current regime reflects series of marginal decisions, not integrated architecture

- Major transfers have different growth rates to 2014: CHT 6%; CST 3%; Equalization “nominal growth of GDP”
- Increasing costs of provincial programs about double increases in revenues. Issue of sustainability.
- Current total transfers per capita do not reflect the relative fiscal capacities of provinces, e.g. Ontario gets considerably less than NL
- System due for major review in 2014—discussions sooner



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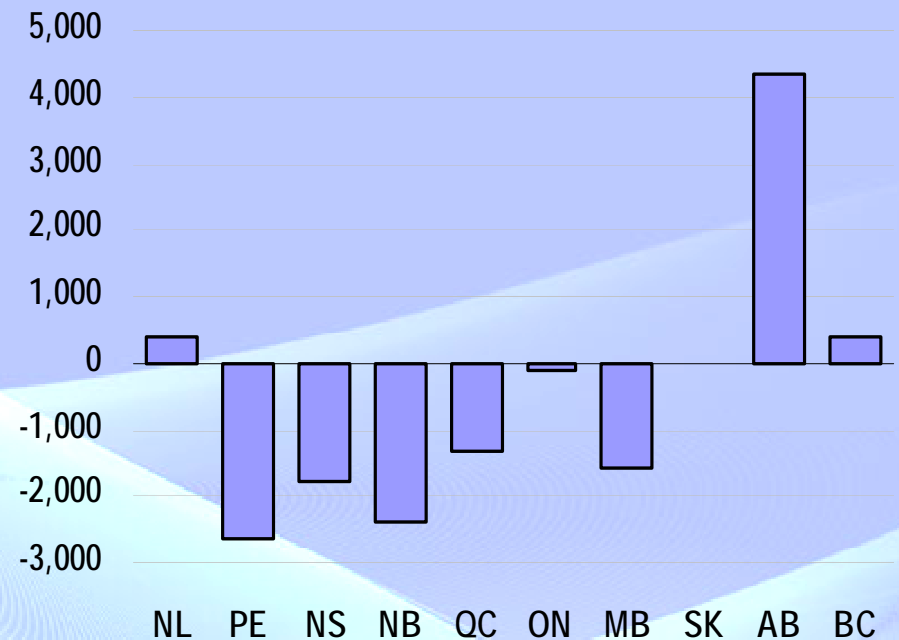
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Equalization: Economic and fiscal disparities in Canada are relatively large by OECD standards

GDP disparities (in \$ per capita)



Fiscal disparities (in \$ per capita)



The Equalization Program

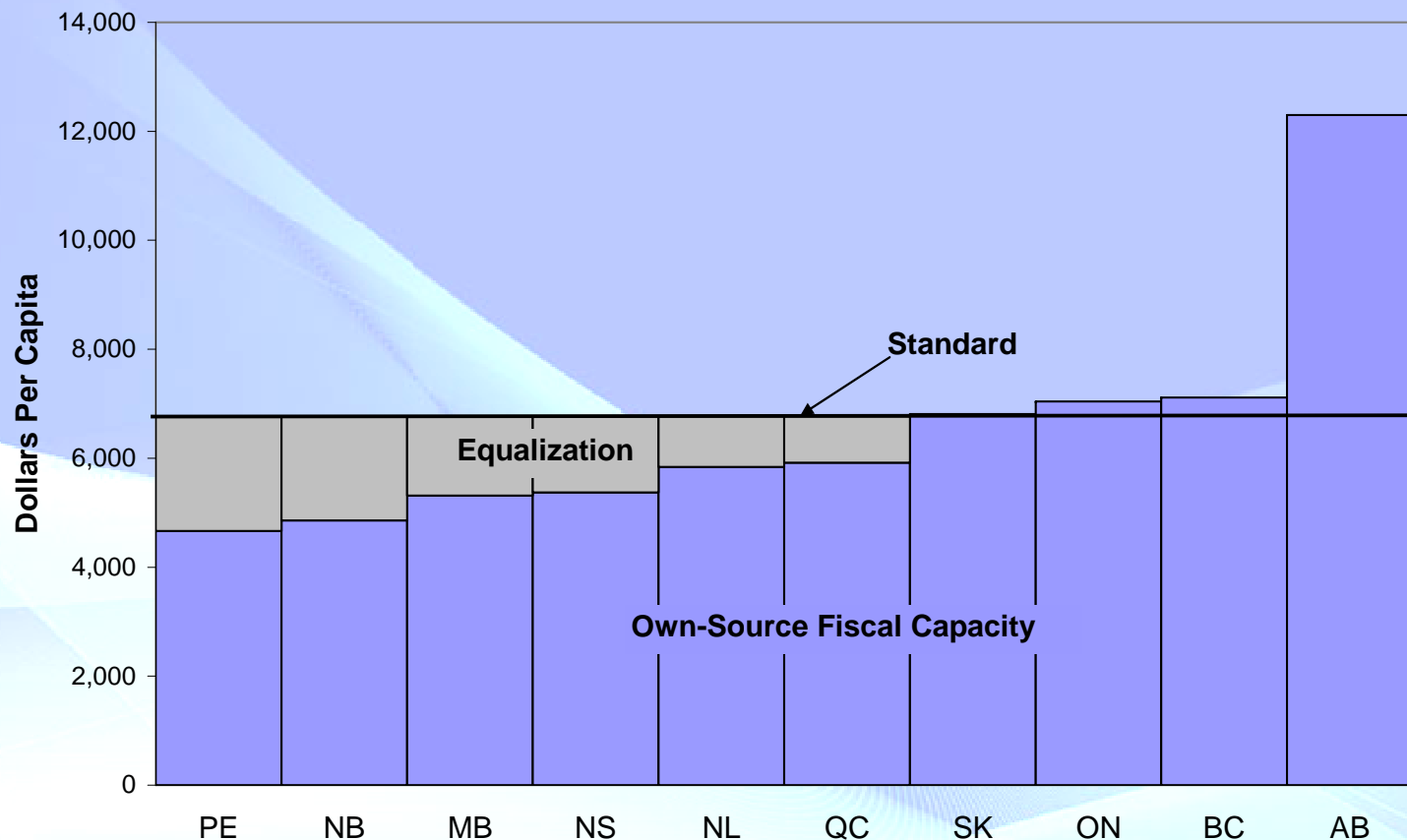
- ▶ Program was launched in 1957 in conjunction with a major tax decentralization for personal and corporate income taxes and inheritance taxes. Program made the devolution of tax shares to provinces acceptable to revenue-poor provinces.
- ▶ Program “equalizes up”, not down.
- ▶ Entirely financed from federal general revenues
- ▶ Program has looked at fiscal capacity, not need.



The Equalization Program

- This graph shows the basic mechanics of the program as it has operated throughout most of its history

Equalization: Illustrative Example of Basic Mechanics



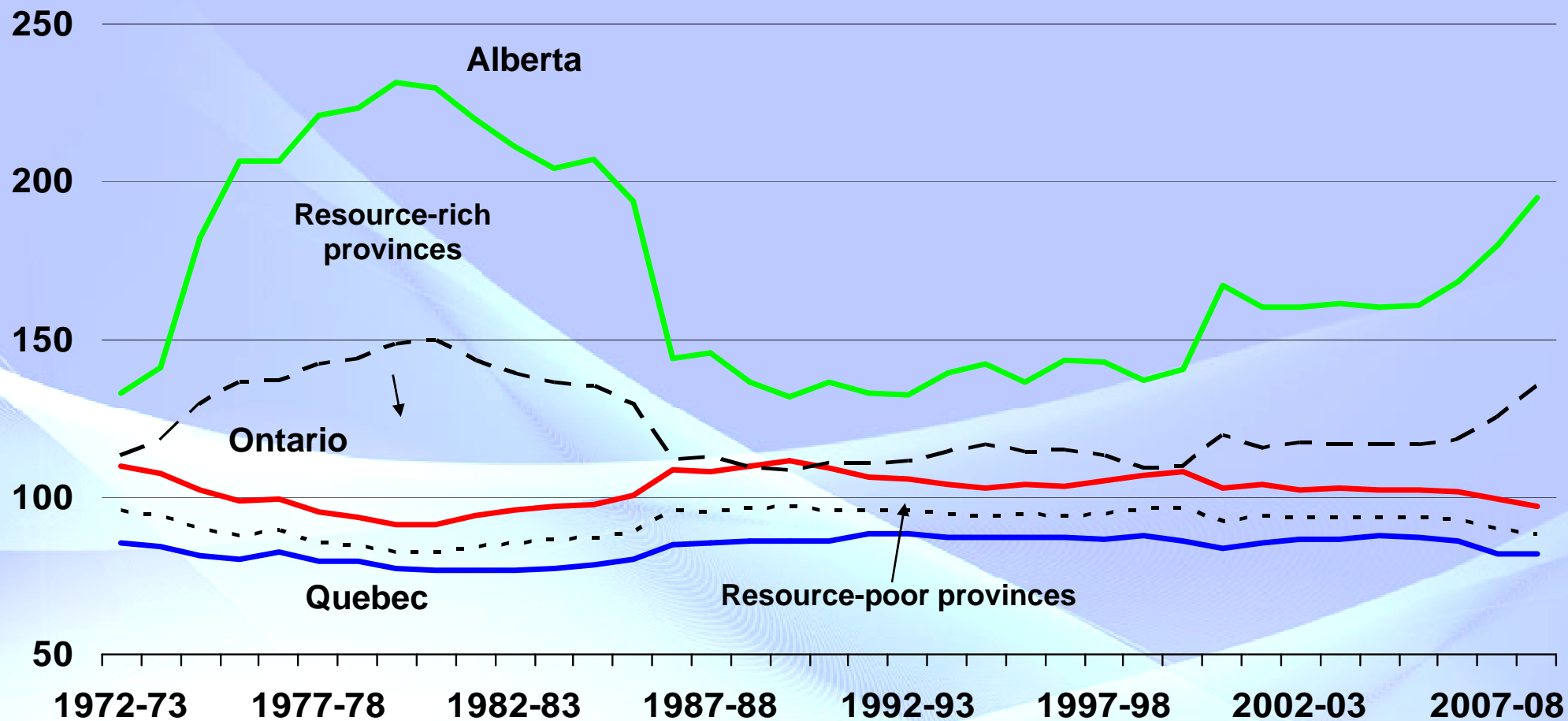
Program has shifted from an equalization standard to a fixed pool

- The Equalization standard has changed several times throughout the history of the program: top-2 province standard (1957), 10-province standard (1962), 5-province standard (1981).
- Martin government moved off fixed standard to pool. Harper government moved back to a standard but after two years went to pool approach. 2007 bargain: more for equalization in exchange for other transfers moving to a straight per capita cash basis. (Potentially over \$700MM for Alberta in 2014.)
- Pool approach reduces overall volatility of program, but Ontario being in adds somewhat to volatility for other equalization receiving provinces (7 cents on the dollar).



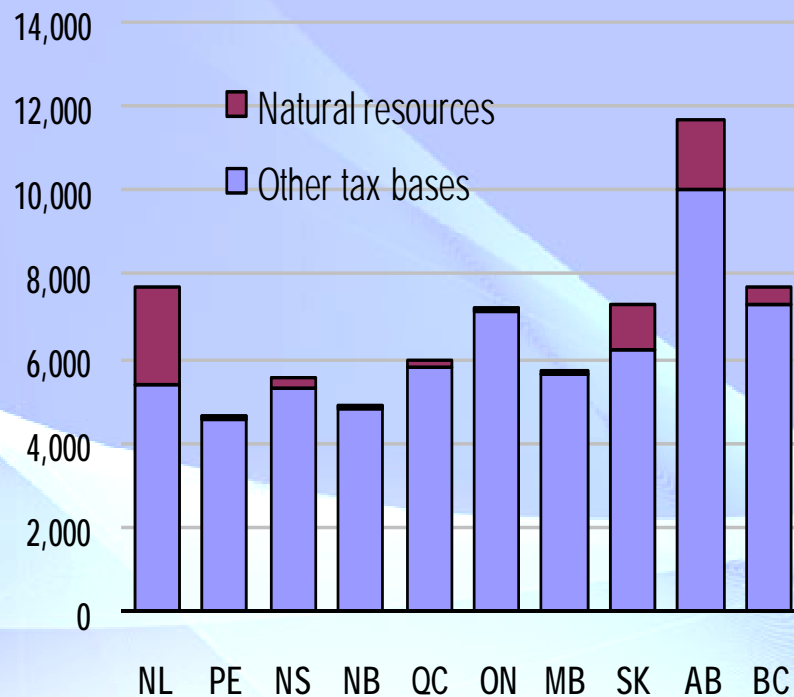
Natural resource revenues have played a key role in the history of Equalization

Relative Per Capita Fiscal Capacity, 1972-73 to 2007-08

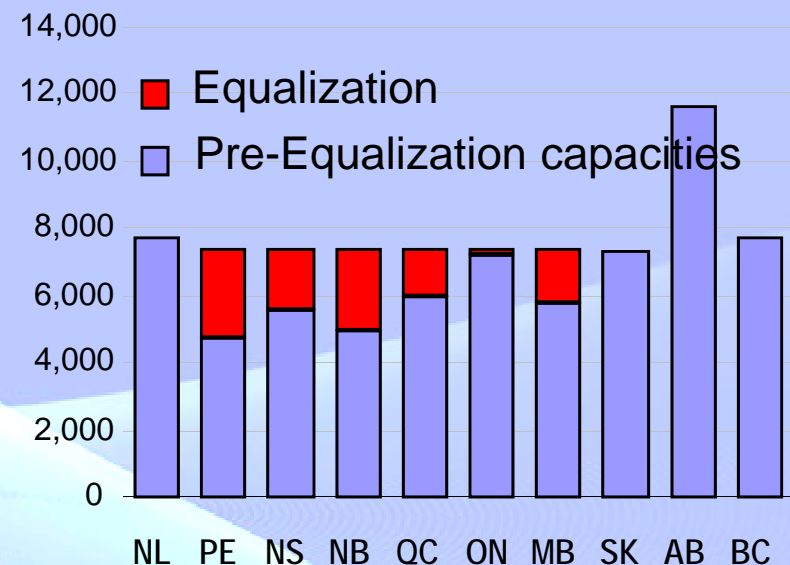


As well, provincial fiscal disparities significantly reflect the unequal distribution of natural resources...

Fiscal capacities (in \$ per capita)



Pre- and post-Equalization capacities



-Alberta long an outlier (200% of average fiscal capacity) but NL, Saskatchewan and BC becoming increasingly resource-rich too.

Provinces choose to impose substantially different tax rates...

Provincial-Local Fiscal Capacity, Own-Source Revenue, and Tax Effort, 2006-07

	Fiscal Capacity Per Capita	Own-Source Revenue Per Capita	Tax Effort
NL	\$6,250	\$6,728	107.6%
PE	\$4,864	\$5,162	106.1%
NS	\$5,637	\$5,800	102.9%
NB	\$5,152	\$5,282	102.5%
QC	\$6,117	\$7,079	115.7%
ON	\$7,273	\$7,310	100.5%
MB	\$5,519	\$5,982	108.4%
SK	\$7,681	\$8,863	115.4%
AB	\$12,765	\$9,833	77.0%
BC	\$7,121	\$7,073	99.3%

... and to provide significantly different levels of government services.

Total Expenditures of Provincial-Local Government Sector, 2006-07

	Provincial-Local Government Expenditure (\$ Per Capita)	Percent of Average
NL	\$11,051	103.7%
PE	\$10,002	93.8%
NS	\$10,564	99.1%
NB	\$10,045	94.2%
QC	\$11,931	111.9%
ON	\$10,107	94.8%
MB	\$10,842	101.7%
SK	\$11,625	109.1%
AB	\$10,751	100.9%
BC	\$9,664	90.7%

Why equalization? How much?

- Federations vary from the highly equalizing to no equalization. All OECD federations except the US have equalization, but programs vary in richness and design
- Why? Economists worry about “fiscally induced migration” and the inefficient allocation of resources. Larger political issues of community and sharing.
- How much? No technical answer. Australia virtually full equalization; Germany also considerable including direct transfers from rich länder to poor. Switzerland brings all cantons up to a significant level, based on fixed schedule of transfers. US has no system and transfers reflect politics more than any principled architecture.



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The sustainability of the Canadian major transfer regime

- Transfers growing faster than revenues so key issue for provinces is cost control.
- Question of diminishing fiscal weight of federal government.
- Equalization had provinces with 34% of population; now 73%. Payments to other provinces, always sensitive to Ontario's fiscal capacity, now more so. Ontario will take bigger share in 2011-12 (2-year lag/3-year average).
- Affordability to federal government. As designed, yes, but if Ontario's need grew?



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Issue: what to do about resource revenues?

- Major source of fiscal disparities amongst provinces and an exceptionally sensitive issue.
- Within equalization, should resource revenues have the same weight as others in calculating entitlement of equalization receiving provinces. And they should have full weight in establishing standard (comprise of 50% before pooled approach)
- Most federal governments have a significant role government in resource management and revenues. Should federal government have any access to resource revenues?
- What about big subsidies to electricity consumers in Quebec and Manitoba? Imputed lost revenues of \$5B in Quebec.



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Issue: what to do about Climate Change

- Highly related to resource revenue issue. Any national program to price carbon inevitably lowers provincial disparities and provides a source of federal revenues.
- The federal government's target is 20% reduction in GHG emissions by 2020 relative to 2007 (subject to US action). One estimate is that this would lower Canada's GDP growth by 1.5% by 2020 (Alberta by 8.5%; Sask by 2.8%; BC by 2.5%) and general revenues from a carbon tax of \$40B a year in 2020.
- The stakes of the climate change debate are enormous, both globally and within Canada. It is highly emotional and regionally very divisive.



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Issue: What to do about other design elements of the transfer regime?

- Rebalance shares going to per capita transfers versus equalization? A totally integrated major transfer program?
- Hypothecate a major tax source (as in Australia) for transfers?
- Top up equalization with direct transfers from rich provinces to poorer ones (as in Germany)?
- Consider not just different fiscal capacities but also different cost drivers in equalization? (Ontario advantage)
- Balance of focus and funding between dealing with current regime and funding new initiatives: will federal government sponsor new social programs (day care? pharmacare?) and if so how: directly or through shared-cost programs?



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A Word on Process

- Fiscally federalism is notoriously opaque, but it is fundamentally important.
- Canada faces large issues regarding the sustainability and suitability of the country's fiscal architecture. Will this highly divisive issue get the consideration it deserves if it is handled in the usual way—largely through confidential discussions amongst governments?
- Some federations (Australia, India) have arm's length bodies to prepare serious analysis and recommendations regarding fiscal arrangements. Canada did once too: the Rowell-Sirois Commission. Might it again be time for such an approach in Canada and, if so, with what mandate?



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Conclusions

- The recession poses fiscal challenges for Canada, especially in some provinces, but the bigger issues relate to the longer-term fiscal architecture of the country.
- The current major health and social transfers and equalization all face major questions of sustainability and design.
- Growing issues around treatment of resource revenues: sharing and climate change policy.
- Question of what new programs might emerge and implications for fiscal regime.
- Political management will be hugely challenging and require creativity on both the process and substance of reform.



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