Reforming fiscal federalism and equalization: Lessons from the Canadian experience

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There is no want for expert opinion on how best to reform fiscal federalism. Why is it, then, that researching agreement on a solution, let alone making that solution palatable to all the subnational governments involved, is so difficult? Presumably, the reason is that political interests diverge widely, especially when copious sums of money are involved. On the one hand, the more affluent regions that contribute to such schemes are concerned about their own well-being, how funds are spent, on what, and about setting the wrong incentives for recipient regions. Ergo, they tend to advocate reform. On the other hand, relatively deprived regions that benefit from the redistribution of funds tend to fear that they will end up getting short changed in any reform. Ergo, they tend to resist reform. The question, then, is whether it is actually possible to reframe fiscal-federalism reform as a positive-sum game for all those governments which are affected by it.

One country that recently embarked on a holistic review of its equalization program and subsequently revamped it considerably is Canada. The Canadian case is particularly informative and relevant because, in the words of a leading economist at the World Bank, Canada is renown for having

> "maintained one of the simplest, most elegant, principled, and purpose-driven intergovernmental finance systems in the world."[1]

This chapter will examine the impetus for change, the process by which change was implemented, how it was possible to implement change in the first place, the type of change, and the prospects for success of the new equalization formula. The paper will then examine which of these determinants and variables are particular to Canada and which lessons might be applicable more generally to other federations.

1. The catalyst for change

The literature often suggests that wholesale political change is difficult unless a crisis is looming. Canada's fiscal equalization system had been in crisis. But how is that possible? The first lesson to draw from the Canadian experience is that economic growth and surpluses are no panacea. As a matter of fact, they may actually make matters more difficult as they exacerbate horizontal and vertical fiscal gaps.

Canada's federal government balanced its budget in 1995 and has now had budget surpluses for ten years straight. Its economic fundamentals continue to be strong with economic growth pegged at or well above 2.5% annually and fairly stable inflation.

1 *Shah, Anwar* 2008 (forthcoming): Rethinking Fiscal Federalism in Canada: A Local Government Perspective, in: *Leuprecht, Christian/Courchene, Thomas J./Allen, John (eds.)*: Canada: The State of the Federation 2006. Fiscal Federalism and The Future of Canada, Montreal/Kingston.

Unemployment is at a 33-year low which means a reduced strain on social programs and a lower expense-to-GDP (Gross domestic product) ratio. Corporate profits as well as per capita earnings have been on the rise, as has government revenue. Windfall surpluses have allowed the government to reduce corporate and private income and value-added taxes (VAT) and to repay some of the federal debt. The debt-to-GDP ratio – which means debt in relation to the size of the economy – is projected to fall below 25% by 2011/2012 which is the lowest debt burden since the late 1970s and an impressive reduction of almost two-thirds since it peaked at almost 70% as late as 1995/1996. Canada's debt burden has thus declined from the second-highest among the G7 countries (behind Italy) to the lowest. As a result, Canada's fiscal outlook is far brighter than that of any other G7 country since its surplus is expected to hover around 0.75% of GDP, as opposed to an average deficit of about 2.3% among the other G7 countries. Similarly, while the average net debt – the measure of total government liabilities versus assets – among the G7 remains above 50%, Canada's has declined to 30.2%. Among industrialized federations, however, Canada lags behind Australia which has already eliminated its net financial liabilities completely.

Where fiscal federalism is concerned, however, Canada's fortunate fiscal position has been a mixed blessing. After years of belt-tightening there is a perceived fiscal neglect that spans everything from health care via education to deferred infrastructure maintenance. In Canada, most social responsibilities fall under provincial jurisdiction. Canadian provinces (along with Swiss cantons) collect a greater proportion of own-source revenues than the subnational units of just about any other federation (see Table 1). Furthermore, Table 2 shows that a considerable portion of transfers they receive is unconditional – and the parameters of most of the conditional grants are quite broad and elastic.

Arguably, then, Canadian provinces enjoy greater fiscal autonomy than the constituent units of just about any other federation in the world. Still, as Table 3 summarizes, the federal government continues to collect substantially more tax revenue than is required to fund program spending in its jurisdiction.

Canada's provinces perceive the existence of this phenomenon – where the expenditure obligations of provinces exceed their own-source fiscal capacity – as a vertical fiscal imbalance.[2] That perceived imbalance has become highly politicized since the 1995 federal budget where the provinces perceived the federal government to have been balanced its books on their back. Figure 1 lends at least some credence to that argument.

2 The qualifier "perceived" is deliberate. While the broad facts are not in dispute (that is, the amount the federal government "owes" the provinces is controversial, but that the federal government takes in more than it spends on its own program needs is not), not everybody – including some of the federal parties albeit not the incumbent Conservative minority – agrees on the existence of the phenomenon.

Table 1: Conditional transfers as a percentage of federal transfers (2000–2004)

United States	100.0
Austria	78.9
Switzerland	73.1
Spain	66.1
Canada[1]	64.9
Germany	64.5
Mexico	55.5
Australia	40.9
India	40.7
Malaysia	39.3
Brazil	25.0
South Africa	11.5
Russia	9.0
Belgium *(Communities 5.0 / Regions 6.1)*	5.7

Note: Depending on source, figures are the latest available between 2000 and 2004.

1) The Canada Health Transfer (CHT)/Canada Social Transfer (CST) is included here as conditional; if treated as unconditional, because of the very general nature of the conditions, the figure for Canada would be 26.8%.

Source: *Watts, Ronald L.* 2008 (forthcoming): Comparing Federal Systems, 3rd ed., Montreal/Kingston.

Table 2: Federal conditional transfers as a percentage of total provincial/state government revenues (2000–2004)

Mexico	48.8
Spain	41.9
Austria	37.4
United States	25.6
India	18.7
Australia	18.6
Switzerland	17.0
Canada[1]	14.1
Malaysia	12.0
South Africa	11.0
Germany	9.8
Belgium	9.7
Brazil	7.5
Belgium *(Communities 4.8 / Regions 3.5)*	4.0
Russia	2.5

Note: Depending on source, figures are the latest available between 2000 and 2004.

1) The CHT/CST is included here as conditional; if treated as unconditional, because of the very general nature of the conditions, the figure for Canada would be 3.7%.

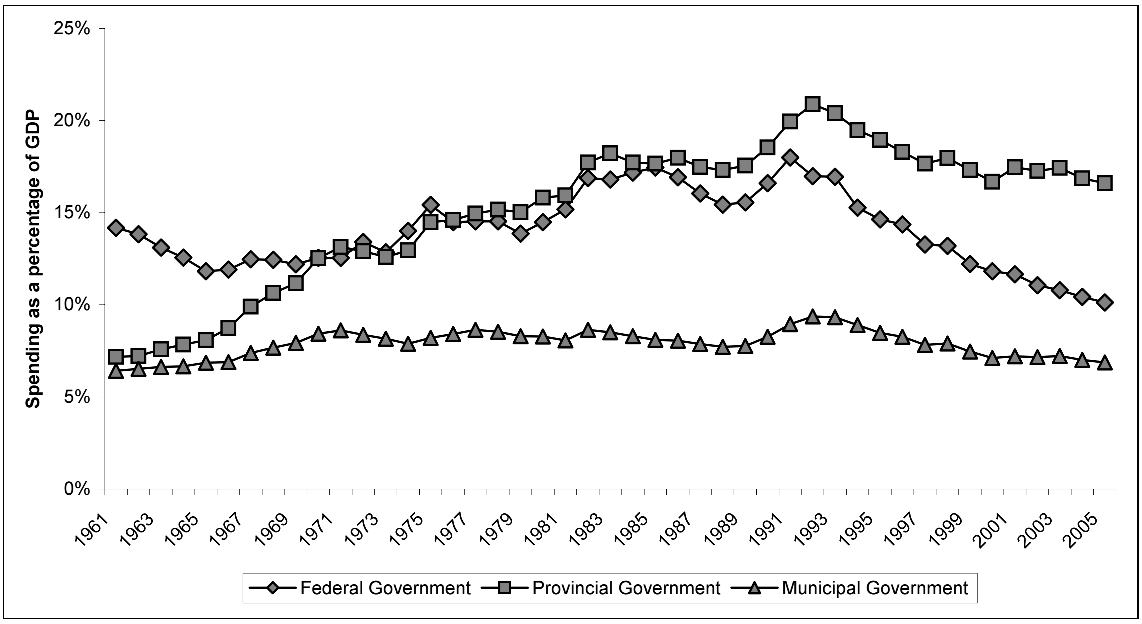
Source: *Watts* 2008 (Table 1).

Table 3: Vertical fiscal gap in Canada (2005)

	Revenue Share	Expenditure share	Fiscal Gap
Federal	0.46	0.36	–0.10
Provincial/State	0.44	0.52	0.08
Local	0.10	0.12	0.02

Source: *Boadway*, *Robin* 2007: Fiscal Federalism in Canada, in: *Shah*, *Anwar (ed.)*: The Practice of Fiscal Federalism, Montreal/Kingston, pp. 98ff.

Figure 1: Government spending as a percentage of GDP



Source: Statistics Canada.

Until 1995, the federal government's choice to occupy a large share of tax room, create a sizeable fiscal gap, and exercise a strong spending power was generally viewed as legitimate by Canada's provinces. The federal government's unilateral cuts of 30% in cash transfers to the provinces and territories for health and social spending in the 1995 federal budget forfeited that legitimacy.

If there was only a perceived vertical fiscal imbalance, then the provinces would have a strong incentive to form a common front vis-à-vis the federal government. It is in the nature of every country's economy, however, that some regions are more affluent than others. But affluence can have different causes which, in turn, affect a sub-national entity's perception of federal fiscal arrangements.

Canada' equalization program,[3] the federal government's system of unconditional payments for fiscally weak provincial governments – hereinafter referred to as Equalization – is based on per capita fiscal capacity. In other words, Canada equalizes

3 For an excellent and readily understandable history of the program, its evolution, its purposes, and its impact, see *Stevenson, Garth* 2008 (forthcoming): Fiscal Federalism and the Burden of History, in: *Leuprecht/Courchene/Allen (eds.)* 2008 (Fn. 1).

solely as a function of revenue. Expenditures and differences in rent, that is, differentials in the cost of service delivery across provinces that take into account cost of living, for instance, are not factored into the equation. As a result, Equalization “over-equalizes” on the top end. This can be thought of as problematic. The cost of service delivery in poorer regions is usually cheaper than in more affluent ones, since wages and the cost of social and educational services tend to be lower, as the incentive for immigrants to settle in such areas is lower. The Australian experience with its Commonwealth Grants Commission, however, has shown that need can be difficult to assess which makes needs-based equalization inherently controversial and wrought with discontent. Revenue-based equalization may simplify the redistribution of funds across the country, but it also distorts the fiscal picture to the detriment of well-heeled regions. That, however, has always been the case and would, in and of itself, not be a cause for reform.

In Canada, as elsewhere, the determinant of reform is revenue (or, rather, lack thereof and/or differences therein). In particular, the high price of oil, along with a rise in the price of other natural resources, has been aggravating the horizontal imbalance across Canada. First, it has lead to the ascendancy of those regions which are rich in non-renewable energy sources and, to a lesser extent, precious metals. This has precipitated to a sudden and dramatic differentiation in fiscal capacity across Canadian provinces. Alberta’s GDP per capita is now two-thirds higher than Ontario’s GDP per capita. Prince Edward Island, which in 2006 had the lowest GDP of any province per capita, has less than half of Alberta’s GDP per capita (see Table 4).

These differences are much greater than those found in most advanced federations (except for the United States where the differences are even more pronounced, for it capitalizes 100% for rents, i. e. it does not have a formal equalization program). In Germany, for instance, fiscal capacity per capita among the poorest Länder (in the East) approaches 85% of that in the West.

Under the previous equalization formula, Canada bore witness to the rise of a bizarre fiscal asymmetry. The previous formula calculated provincial revenue according to 33 sources. Natural resources, however, were excluded from that source calculation. The predicament facing the Paul Martin Liberal minority government (2004–2006) was what to do about the relatively poorer Atlantic provinces of Newfoundland[4] and (to a lesser extent) Nova Scotia which have been equalization-recipients ever since the program’s inception in 1957, but whose provincial coffers were now also benefiting from rising oil (and some gas) revenues. Compounding the predicament were dire fiscal circumstances in Newfoundland. Then Prime Minister Martin, in effect, opted for a bailout of sorts for Newfoundland by agreeing to an offset arrangement that let Newfoundland retain its equalization payments and all of its natural resource revenues.[5]

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4 Newfoundland is technically the province of Newfoundland and Labrador. For the purpose of this paper, however, I shall simply refer to it as Newfoundland.

5 However idiosyncratic and whimsical, the decision has an extensive historical antecedent dating back some 30 years. Discussions about the impact of prospective oil revenues and how they ought to be handled date back well over a decade. For a contextualization, rationalization, and thorough

Table 4: A consolidated table listing total GDP (expenditure based), population and per capita GDP

explanation see *Feehan, James* 2008 (forthcoming): Equalization 2007: Natural Resources, the Cap, and the Offset Payment Agreements, in: *Leuprecht /Courchene/Allen (eds.)* 2008 (Fn. 1).

Province or Territory	GDP (million $, 2006)	Population (2006)	GDP per capita ($, 2006)	Equalization (million $, 2007–2008)	Per capita Equalization ($, 2007–2008)	Ratio to Mean (%, 2005 GDP per capita by province)
Alberta	235,593	3,375,800	69,789	0	0	157.3
British Columbia	179,701	4,310,500	41,689	0	0	93.6
Manitoba	44,757	1,177,800	38,001	1,826	1,543	83.8
New Brunswick	25,221	749,200	33,664	1,477	1,968	75.9
Newfoundland and Labrador	24,897	509,200	47,520	477	938	98.6
Northwest Territories	4,103	41,900	97,923	N/A	N/A	N/A
Nova Scotia	31,966	934,400	34,210	1,465	1,564	79
Nunavut	1,213	30,800	39,383	N/A	N/A	N/A
Ontario	556,282	12,687,000	43,847	0	0	101
Prince Edward Island	4,332	138,500	31,278	294	2,118	71.2
Quebec	284,158	7,651,500	37,138	7,160	931	85
Saskatchewan	45,051	985,400	45,718	226	230	102.3
Yukon	1,596	31,200	51,154	N/A	N/A	N/A
CANADA	**1,439,291**	**32,623,500**	**44,118**	**12,925**	**N/A**	**N/A**

Source: Statistics Canada: GDP (totals), Population; Finance Canada.

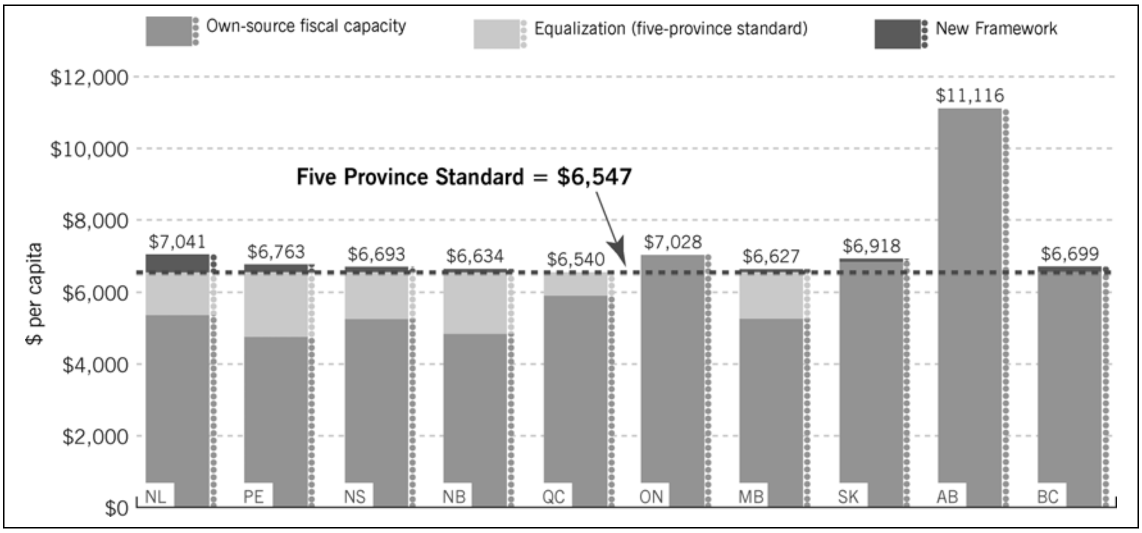
The perverse result was a per capita fiscal capacity in Newfoundland – which has been a "have-not" province ever since Equalization's inception – that exceeded the fiscal capacity of the lowest province that was not entitled to equalization payments. That "have" province is Ontario. It is home to almost 40% of Canada's 32.5 million inhabitants and produces about 40% of Canada's GDP. Yet, in 2006, its per capita GDP was $43,847 while Newfoundland's was $47,520. Due to demographic decline in Newfoundland and growing oil revenues, that gap is unlikely to diminish. Quite to the contrary, rising offshore oil revenues due to greater capacity and the high price of oil coupled with population decline in Newfoundland furthermore meant that the gap in per capita GDP between Newfoundland and Ontario was likely to widen.

In 2006, by contrast, per capita GDP for all of Canada came in at $44,118. As a result of Prime Minister Martin's decision to let the province keep all its formal equalization payments Newfoundland had become the only province whose per capita fiscal capacity exceeded the Canadian norm and that of the poorest non-receiving province (Ontario). Nova Scotia got the same deal, that is, it, too, was allowed to keep its offshore revenues and equalization. This was not as big an issue, however, as Nova Scotia, despite these measures, was still below the Canadian norm and well below Ontario's per capita GDP.

In fact, in 2006 only three provinces had per capita GDPs above the Canadian norm and above Ontario's: Alberta, Newfoundland, and Saskatchewan. Yet, the special treatment that Newfoundland and Nova Scotia received was not extended to Saskatchewan. The issue at stake here is what is known as the "claw-back" effect: For every dollar of revenue exceeding the national average (calculated according to the five-province standard) the province's equalization entitlement falls – other things being equal – by approximately one dollar.[6] The logic behind this measure is that over-equalization that results in overall fiscal capacity greater than average allows a province to offer more public services and/or lower taxes than other jurisdictions. That might cause labour to migrate from other provinces. Such an inflow would be economically inefficient since it would be the result of a transfer payment from the federal government rather than being based on greater economic opportunities. There is also a case to be made that for reasons of interprovincial equity no equalization-receiving province ought to have a post-equalization per capita fiscal capacity that is greater than that of any non-recipient province. By virtue of having per capita GDP above the Canadian norm, both Newfoundland and Saskatchewan would have lost all their Equalization payments under the "claw-back" provision. In practice, however, that provision ended up applying only to Saskatchewan. The bizarre results from this idiosyncratic approach to Equalization whereby after Equalization Newfoundland ends up with a fiscal capacity per capita greater than that of Ontario are depicted in Figure 2.

6 *Courchene, Thomas J.* 2004: Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues, in: Choices, vol. 10, no. 2, pp. 1-39.

Figure 2: Fiscal capacity and Equalization (2005–2006)



Source: Finance Canada; *Expert Panel on Equalization and Territorial Formula Financing* 2006: Achieving a National Purpose: Putting Equalization Back on Track, Ottawa, p. 24.

Aside from Saskatchewan being aggrieved by this outcome, the two provinces which are the most affected by this disequilibrium are Ontario and Alberta. For all intents and purposes, they are the two major contributors to Equalization. Yet, Alberta's ability to raise revenues per capita is twice that of Ontario. No wonder then that Ontario perceived this outcome as deeply inequitable. Unlike Alberta, Ontario's economy is heavily manufacturing-based. As the manufacturing sector suffers due to a high Canadian dollar and broader macro-economic adjustments that are part and parcel of a globalizing world, Ontario's economy is projected to suffer and Ontario may even end up becoming a "have-not" province. In other words, Ontario is seriously concerned about the possible inefficient consequences of asymmetric province-building that follow from the disparities that have been occasioned and exacerbated by the resource boom.

In short, abrupt and dramatic territorial differentiation in per capita fiscal capacity across Canada resulted in disparities far greater than the ones which the formal equalization formula had been designed to mitigate. Political decisions further aggravated a difficult situation. By creating an uneven playing field, where the inclusion of natural resources in the calculation of formal equalization transfers is concerned, the system became unsustainable. The basis on which the equalization scheme was meant to function had thus been destroyed. The formal equalization program no longer functioned the way it had been intended to work.

There is a lesson here. Canada had no say in the unequal endowment of natural resources across the Canadian territory. Nor has it control over exogenous shocks such as fluctuations in the price of oil. Under such challenging circumstances, however, it is all the more important not to fan the flames of the fire through unprincipled decisions.

2. The process of reform

A new minority government came into power in January 2006. Two of the pillars on which it was elected were to fix the fiscal imbalance by injecting more money into the equalization program and to return to a principled, formula-based approach. The new Conservative government also had the advantage of two recent panel reports on Equalization, one commissioned by the provinces,[7] the other by the federal government.[8] These panels had already framed and curtailed the debate.

In other words: under the new government, the existence of a vertical fiscal imbalance was no longer controversial – only how best to fix it was. The government had three basic options at its disposal: maintain the status quo by keeping stable the proportion of provincial spending relative to fiscal transfers, turn over tax room to the provinces while reducing federal transfers, or increase transfers to the provinces which can mean increasing the federal government's tax share.

Since the government had committed itself to increasing transfers to the provinces, it only had options two and three from which to choose. The second option has advocates in the form of turning over the Goods and Services Tax (GST) – Canada's federal VAT[9] – to the provinces.[10] There are three main arguments in favour of turning over sales-tax room to the provinces: accountability, safeguarding provincial autonomy, and encouraging the provinces to harmonize their sales taxes. First, increasing the amount of own-source revenue is thought to decrease the soft-budget constraint hazard by making provincial governments more accountable for the money they raise and spend. Michael Smart, for instance, is concerned that growing transfers translate into a commitment failure which, in an effort to attract ever greater transfers, may end up incenting provincial governments to over-expand, thus providing a disincentive for sound fiscal management.[11] Second, by curtailing the federal government's tax room, its use of the federal spending power would be curbed which would reduce the federal government's leverage over provincial spending priorities. But, of course, this point is controversial. The optimal fiscal gap is a function of what one perceives to be the appropriate role in economic and social policy for the federal and provincial governments in pursuing objectives of redistribution, and how much influence the federal government should exert over program areas that fall under provincial jurisdiction. The more paramount

7 *Advisory Panel on Fiscal Imbalance* 2006: Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance, Ottawa.

8 *Expert Panel on Equalization and Territorial Formula Financing* 2006: Achieving a National Purpose: Putting Equalization Back on Track, Ottawa.

9 In addition to the Goods and Services Tax (GST), all provinces except Alberta have a provincial sales tax. It is harmonized with the GST in the four Atlantic provinces (i. e. New Brunswick, Newfoundland, Nova Scotia, and Prince Edward Island), but varies throughout the rest of the country from a low of 5% in Saskatchewan to a high of 8% in Ontario.

10 *Commission on Fiscal Imbalance (Séguin Commission)* 2002: A New Division of Canada's Financial Resources, Final Report, Québec; *Poschmann, Finn/Tapp, Stephen* 2005: Squeezing gaps shut: responsible reforms to federal-provincial fiscal relations, C.D. Howe Institute Commentary no. 225, Toronto; *Smart, Michael* 2005: Federal Transfers: Principles, Practice, and Prospects, Toronto.

11 *Smart* 2005 (Fn. 10).

considerations of equity among all citizens and harmonization of policies are, the greater a role the federal government will need to play and the larger the fiscal gap will need to be. Third, the federal government could horse-trade more provincial tax room for a country-wide harmonized sales tax. This sort of harmonization has been a long-time objective of the federal government since the current asymmetry creates sub-optimal macro-economic outcomes.[12]

However, as Robin Boadway points out, there are also good counterarguments to these three points.[13] While the accountability argument is a favourite with economists, there is no good evidence to suggest the argument actually obtains. As a matter of fact, provinces are more accountable for their expenditures when they have to report back to the federal government, either by having their latitude for expenditure curtailed by conditional grants in the first place and/or for having to meet specific benchmarks that may be associated with a given transfer. Similarly, far from harmonizing sales taxes, Boadway argues that it may actually make harmonization more difficult, for revenue sources that are concentrated at the provincial level have tended to be the most disharmonized.[14] So, there is no good reason to presume provinces would actually harmonize their sales taxes. While it is theoretically possible to run a decentralized yet harmonized sales-tax scheme, administratively it is sub-optimal, as centralizing collection would minimize the cost of raising revenue. Furthermore, taxation distorts the behaviour of economic agents and these distortions impose efficiency costs on the economy. Smaller federal-provincial transfers would render the spending power less effective, thus reducing the federal government's key social-policy instrument. This may be a moot argument since most transfers in Canada are already unconditional. However, Boadway contends that the mere existence of transfers gives the federal government important leverage to coordinate and harmonize policies across the country.[15]

Concomitantly, the gradual reallocation of tax room from the federal government to the provinces increases fiscal disparity and makes the Equalization system less affordable. As Table 5 shows, for precisely this reason, tax collection tends to be fairly centralized in most federal systems.

In other words, it is not inherently problematic that expenditure responsibilities are more decentralized than taxation. At the same time, however, local governments are generally better able to accommodate local preferences and needs. Ergo, there are efficiency rationales for a relatively high degree of expenditure decentralization. Most federal subunits, therefore, are fairly heavily dependent on fiscal transfers from the centre (see Tables 6 and 7).

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12 For a more detailed discussion see *Boadway, Robin* 2006: The Principles and Practice of Federalism: Lessons for the EU?, in: Swedish Economic Policy Review, vol. 13, no. 1, pp. 9-62.

13 *Boadway, Robin* 2008 (forthcoming): Natural Resource Shocks and the Federal System: Boon and Curse?, in: *Leuprecht /Courchene/Allen (eds.)* 2008 (Fn. 1).

14 Ibid.

15 Ibid.

Table 5: Federal government revenues before intergovernmental transfers as a percentage of total (federal-state-local) government revenues (2000–2004)

Nigeria	98.0
South Africa	95.0
Mexico	91.3
Russia	91.0
Malaysia	86.9
Australia	74.8
Belgium	71.0
Spain	69.2
Brazil	69.0
Germany	65.0
Austria	61.8
India	61.1
United States	54.2
Canada	47.2
Switzerland	40.0

Note: Revenue shares are before intergovernmental transfers and represent 'own-source' revenues. In cases of revenue sharing, revenue sources have been allocated according to the government that has the power to levy and set rates (usually the federal government). Depending on source, figures are the latest available between 2000 and 2004.

Source: *Watts* 2008 (Table 1).

Table 6: Federal government expenditures after intergovernmental transfers as a percentage of total (federal-state-local) government expenditures (2000–2004)

Malaysia	84.3
Brazil	64.0
Nigeria	59.7
Australia	59.3
Mexico	58.7
Austria	55.0
Spain	51.0
South Africa	50.0
Russia	46.0
United States	45.9
India	44.6
Belgium	38.1
Germany	37.0
Canada	37.0
Switzerland	32.0

Note: Expenditures are after transfers of shares of federal taxes and grants to state and local governments. Depending on source, figures are the latest available between 2000 and 2004.

Source: *Watts* 2008 (Table 1).

Table 7: Intergovernmental transfers as a percentage of provincial or state revenues (2000–2004)

South Africa	96.1
Nigeria	89.0
Mexico	87.4
Spain	72.8
Belgium *(Communities 96.5 / Regions 57.4)*	68.0
Austria	47.4
India	46.0
Australia	45.6
Germany	43.8
Malaysia	30.4
Brazil	30.0
Austria	27.3
United States	25.6
Mexico	25.4
Russia	25.0
Switzerland	24.8
Canada	12.9

Note: Depending on source, figures are the latest available between 2000 and 2004.
Source: *Watts* 2008 (Table 1).

In Canada, for instance, transfers and federal government expenditure after intergovernmental transfers are already comparably low. As a result, if tax room is turned over to the provinces, the federal government's capacity to equalize fiscally across the country is necessarily reduced, as is the insurance effect the program offers to provinces against asymmetric economic shocks and its ability to preempt fiscally induced migration.[16]

The federal government, however, found itself in the fortunate position of having the option of investing monies from the federal budget surplus in Equalization. In the end, that is precisely what the federal government ended up doing. That, in and of itself, however, would not have meant a return to a principled, formula-based system.

To achieve that goal while at the same time accommodating concerns about the way resources revenues would be counted for purposes of Equalization, the Conservative minority government resorted to a bifurcated approach. It introduced two new formulas between which provinces would now get to choose. One path includes 50% of natural resource revenues, the other excludes them altogether. In the first path, the sum of the fiscal capacities, calculated as the sum of 50% of a province's per capita natural resource revenues and its per capita tax yields from four other major revenue sources (taxes on personal income, taxes on business income, consumption taxes, and property

16 Unless, of course, one introduces some means of direct horizontal transfers between subnational entities. Germany is the only federation in the world that has such a mechanism. It has proven controversial since its relatively-deprived Länder feel somewhat patronized by the direct transfers from more affluent Länder.

taxes)[17], of all ten provinces is divided by their total population.[18] The second path uses the same standard per capita and fiscal capacity per capita, but fully excludes natural resource revenue from both. A province might receive equalization payments as long as fiscal capacity per capita is less than the per capita standard. The new formula, then, introduces several innovations: it finds a way of including natural resources in the eligibility-calculation for equalization, it reduces the revenue bases used in the calculation of equalization from 33 to 5, it reintroduces a standard whose calculation is based on all ten provinces, and it softens the impact and possible aberrations by using a calculation for the variables which is time-lagged and averaged over three years.

But there is a hitch. Now there are two possible ways of calculating the payment a province receives. The exact details of the calculation shall not detain us here.[19] The new system introduces a cap whose character has been the source of political and scholarly debate:[20] no province can receive equalization payments in excess of the fiscal capacity of the poorest non-receiving province. In effect, that means no province can receive equalization payments that would raise its fiscal capacity above that of Ontario.

Since Alberta is so far above the threshold that it would not receive any equalization payments anyway, this provision really only affects three provinces: Newfoundland, Nova Scotia, and Saskatchewan. The federal government also introduced a transition scheme to soften the blow for the two affected Atlantic provinces.[21] The essence of the arrangement is that offset payments to Newfoundland and Nova Scotia would continue under the previous formula until 2012 or until a province no longer qualifies for equalization in which case the province defaults to the new formula. Yet, none of the provinces was happy. Saskatchewan was upset that it was excluded from the transition scheme and that it was still subject to a dollar-for-dollar "claw-back". Newfoundland and Nova Scotia deemed the accord unjust. Nova Scotia was eventually appeased by tweaking the transition scheme (which was practically possible because its energy revenues are currently too small for the confiscatory fiscal cap to take effect), but Newfoundland remained profoundly aggrieved.

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17 The tax yields are based on the revenue the province would have if it applied national average tax rates to its corresponding tax bases.

18 For an explanation of the rationale behind including natural resources at 50%, see *Feehan* 2008 (Fn. 5).

19 I refer the interested reader to *Feehan* 2008 (Fn. 5) for a lucid yet detail explanation of the economics of the formula or to the actual budget document *Department of Finance* 2007: Budget 2007, Restoring Fiscal Balance for a Stronger Federation, Ottawa. http://www.budget.gc.ca/2007/themes/bkrfbse.html (11.12.2007).

20 Cf. *Drummond, Don* 2007: The Equalization Standard, in: *Boothe, Paul/Vaillancourt, François (eds.)*: A Fine Canadian Compromise: Perspectives on the Report of the Expert Panel on Equalization and Territorial Funding Financing, Edmonton, pp. 13-23; *Smart, Michael* 2007: Equalization and Resource Taxation, in: *Boothe/Vaillancourt (eds.)* 2007, pp. 25-42; *Courchene, Thomas J.* 2007. A Blueprint for Fiscal Federalism, in: Policy Options, vol. 28, no. 4, pp. 16-24; *Feehan* 2008 (Fn. 5).

21 See *Feehan* 2008 (Fn. 5) for details.

In addition to these changes, the new equalization scheme also made significant changes by converting what had hitherto been vertical transfers into equal per capita cash transfers (which are not subject to “claw-back” provisions). This is an important part of the compromise which goes significant lengths to make the package more palatable, especially to Ontario. It increases the Canada Social Transfer (CST) and turns it back into a genuine per capita transfer. It also introduces new per capita post-secondary, infrastructure, and labour-market transfers. Moreover, these transfers are budgeted to increase annually over the coming years. However, the provinces’ most lucrative “conditional” transfer – even though those are technically conditional transfers, the latitude with which provincial governments can spend these funds is substantial compared to tied transfers in most other federations – will, under the current scheme, not be calculated fully on a per capita basis until 2014. That is a legacy arrangement which dates back to an accord the previous federal government signed with the provinces. The explanation for this holdout is that it would simply be too expensive for the federal government to make this a fully per capita transfer immediately.[22] Additionally complicating this matter is a calculation that has to take into account the 1977 transfer of equalized personal-income (13.5 percentage points) and corporate (1 percentage point) tax points.[23] The beneficiaries are the two provinces which are the richest in terms of tax points: Ontario and Alberta. They are also disproportionately populous; so, they benefit disproportionately from per capita transfers.

The compound effects on actual aggregate transfers from the federal government to the provinces is complex, substantial, and surprising. According to budget tables, formula-driven equalization, for instance, will increase by $1.486 billion from fiscal year 2006/2007 to 2007/2008 and by a further $1.636 until 2008/2009. Yet, Quebec’s total increase amounts to $2.123 billion. That is, Quebec’s increase exceeds the overall formula-driven increase by nearly *one-third*. How is this possible? The formula generates reductions in equalization for selected provinces, such as Newfoundland.

3. Implications, Discussion, and Conclusion

The Quebec effect is not only intentional, it is also instructive. Initially, Quebec championed remedying the perceived vertical fiscal imbalance of which Quebec would have received its share of the population, that is, 24 cents on the dollar. However, as Courchene observes, high energy prices meant that provinces that had hitherto received Equalization, such as British Columbia, Saskatchewan, and Newfoundland, would presently become “have” provinces (along with Alberta and Ontario).[24] As “have” provinces, they still benefit from vertical transfers but they no longer benefit from

22 The cost to Ontario alone of not having the Canada Health Transfer turned into an equal per capita cash transfer exceeds $1 billion annually.

23 For details on these transfers, their rationale, and the amounts of money involved, see *Courchene* 2007 (Fn. 20).

24 Ibid.

horizontal Equalization. By shifting its emphasis to horizontal transfer, Quebec ends up with more than 70 cents of every new equalization dollar.

In federations, less prosperous subnational entities tend to be the most vociferous opponents of reform because they feel they risk losing out disproportionately. Quebec's tactical priorities are instructive for them. They stand to benefit disproportionately from transfers that are calculated based on asymmetric horizontal fiscal capacity. The way to win them over, then, is to entice them by focusing on horizontal transfers. More populous provinces, by contrast, stand to gain the most from vertical per capita transfers.

This realization certainly helped seal the recent "deal" in Canada. Since the government can set equalization unilaterally, it is not a genuine deal. However, the new scheme seems to enjoy greater legitimacy in the eyes of provincial governments than the arrangements between 1995 and 2006. So, it is fair to say that this is a deal insofar as most provinces seem to condone it, albeit in some cases begrudgingly. Of the three outliers – Newfoundland, Nova Scotia, and Saskatchewan – Nova Scotia was eventually contented by sweetening the transition deal, and Saskatchewan's displeasure could have been allayed quite readily with a simple maneuver (i. e. a "claw-back" that is less than dollar-for-dollar). Whether there was any equitable and macro-economically sensible solution that would also have kept Newfoundland happy is questionable. In the end, transitioning from a scheme with which just about every provincial government was unhappy to one with which only one is not on side, is, by any measure, a pretty successful political outcome. The fact that the scheme also is reasonably justifiable macro-economically makes it all the more successful (assuming, of course, that there is a macro-economic case for equalization to be made in the first case).

Of course, horizontal balance has not been restored. And by increasing (largely) unconditional transfers, the federal government also ends up forsaking some of equalization's traditional role as the glue that binds highly disparate provinces together as a country. Still, the federal government was able to return to a principled, formula-driven equalization scheme that redressed provincial concerns about a perceived fiscal imbalance while respecting the constitutional division of powers and without compromising its electoral promises. As such, the changes to Canada's equalization scheme that were undertaken by the Conservative minority government in the 2007 federal budget were not just a reform of Canadian fiscal federalism. Their implementation, as Courchene has argued, actually amounts to a principled political philosophy of federalism.[25] That is, it repositions Canadian federalism within a framework of fiscal, institutional, and political principles. Given the aura of mistrust that had characterized federal-provincial relations since the advent of the 1995 federal budget, this is no small feat.

Federal money, so it seems, can begin to heal wounds just as quickly as it inflicts them. Even when fiscal-federalism reform appears to bear all the hallmarks of a stalemate, the Canadian experience suggests that it always has the inherent potential to be turned into a positive-sum game. The Canadian story suggests that equalization is

25 Ibid.

prone to being held hostage by unprincipled pragmatism. Similarly, the key to overcoming an apparent impasse are principles. These must transcend fiscal logic. Instead, they need to cohere and coincide at the fiscal, institutional, and political levels. So, while the intricacies of Canada's recent fiscal-federalism reform may be particular, there seems to be a universal story and lesson here about the enduring salience of an underlying, coherent, and principled theory of federalism. The content of any such theory may be politically contingent. Its overarching salience in the process of reform transcends any particular ideological orientation. Fiscal-federalism reform is *not* a chicken and egg problem. To the contrary, the lesson from the recent Canadian experience is not only that the debate must be framed by theory but also that theory must precede details, not vice versa. If fiscal-federalism reform is, first and foremost, a deductive process, not an inductive one, then the lesson from the Canadian experience is that, for a reform to be accepted as legitimate by the governmental actors that are party to the reform, it must be predicated on at least an implicit yet reasonably broad agreement – albeit not necessarily a consensus – on the principles that shall govern the fiscal-federal arrangement they intend to share.