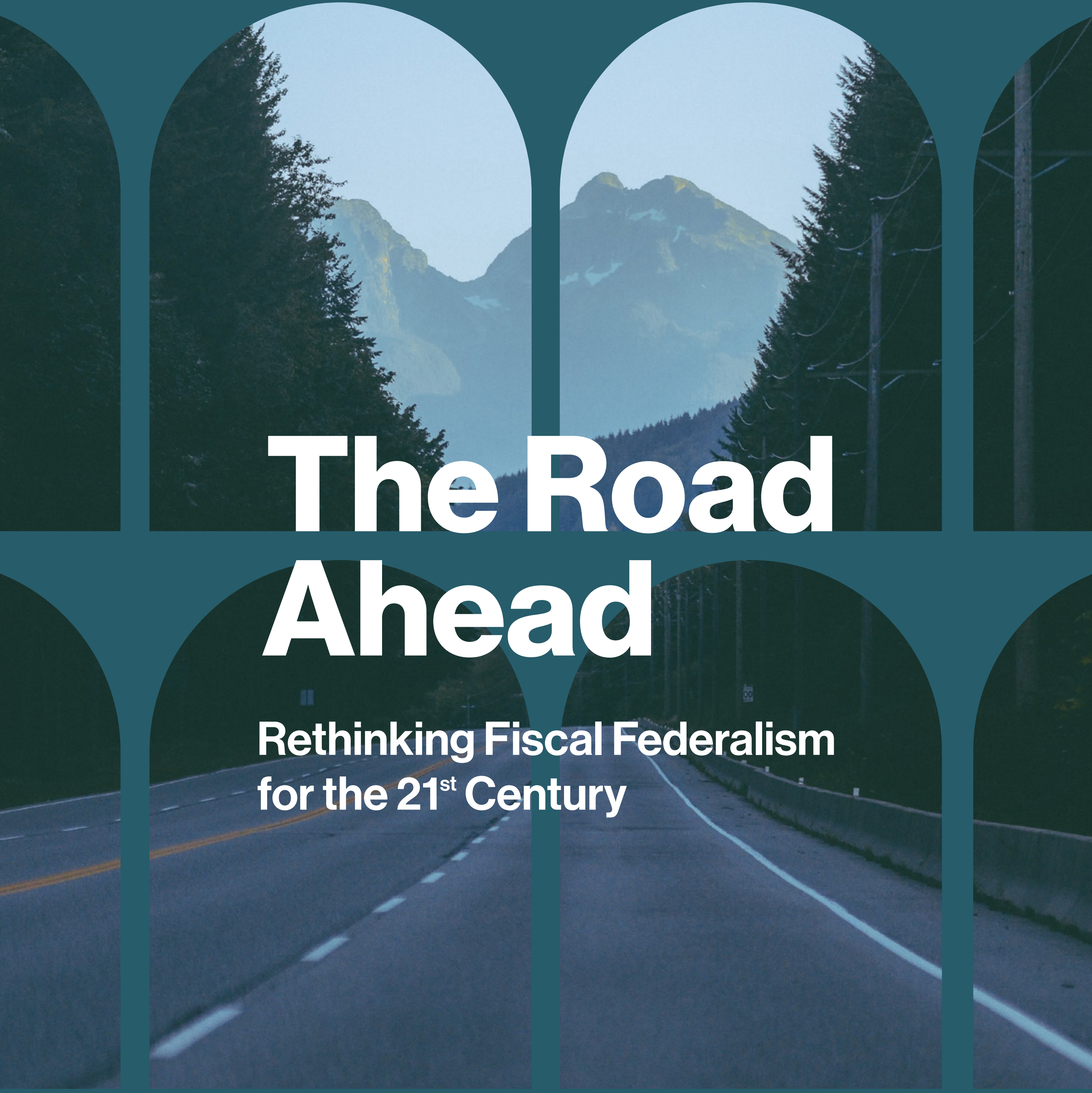

The Road Ahead

Rethinking Fiscal Federalism for the 21st Century

FFPN
Fiscal Federalism Policy Network

June 2023

About the Fiscal Federalism Policy Network (FFPN)

An independent team of academic experts and policy practitioners from a variety of disciplines across the country will recommend practical reforms to the system of intergovernmental fiscal relations in Canada. Like a Royal Commission, it will take a coordinated deep dive into complex questions; unlike a Royal Commission it would be independent of government appointments or political priorities. The Network will publish research papers, policy briefs and op-eds and make recommendations for the reform of fiscal relations among the federal, provincial and municipal governments within the framework of the existing Canadian Constitution.

The Fiscal Federalism Policy Network

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Executive Summary

Canada's fiscal arrangements are at a crossroads. The immediate challenges from COVID-19 and the resulting fiscal and economic disruptions have amplified pre-existing pressures in several ways. And the importance of addressing future challenges in a sensible and prudent manner – before pressures build and crises arrive – is increasingly clear. Canada cannot effectively function as a disjointed and divisive federation. COVID-19 has shown us the best and worst of what a loose federation can offer. Effective fiscal relations will need to have a more integrated strategy that embraces open discourse and includes key partners in shaping the future of the country. Successful efforts to sustainably reform federal arrangements cannot only be top-down, but may require the public's understanding, involvement, and support. To that end, the Fiscal Federalism Policy Network will spearhead efforts to investigate, analyse, and communicate to all Canadians the challenges, opportunities, strengths, and weaknesses of Canada's current system of fiscal arrangements.

Improving how our federation operates will be at the heart of any successful effort to secure Canada's future prosperity. Canada, after all, is not run by a single government in Ottawa, nor by thirteen provincial and territorial capitals. Instead, thousands of individual governments – each have distinct responsibilities, authority, governance structures, financial resources, and connections to Canadians – make this country run. All must work together for the country to succeed. This is especially true for challenges that transcend the ability of any individual government to address, many of which are becoming more significant by the day. Climate change, aging populations, global pandemics, energy transitions, technological advancements, natural disasters, economic volatility, rising perceptions of unfairness in the federation, and so much more will require much of Canada's highly decentralized system of government. Who should do what (and who should pay for what) are central questions that we need to get right and that we need to adapt when necessary. Throughout our history, changing social, economic, technological, and political environments necessitated that our intergovernmental arrangements – and fiscal arrangements in particular – evolve. There is perhaps no more pressing critical juncture for Canada and Canadians in recent memory than ensuring that as we come through the other side of COVID-19, we think deeply about how we approach the countless other challenges on the horizon. Research, analysis, and above all a broad understanding of what we face and what we can do about it are needed.

The central objective of the Fiscal Federalism Policy Network is therefore to rethink the architecture of Canadian fiscal federalism in a post-COVID-19 world. Like a Royal Commission, we will take a coordinated deep dive into complex questions.

In this paper, we describe several of these challenges that Canada will soon face. Some result from external developments, such as a rapidly aging population, climate change, an energy transition that will alter the global demand for fossil fuels, and rising economic volatility in Canada. Others stem from deliberate internal policy choices, sometimes compounding over years. Rising levels of provincial debt raise long-term sustainability concerns, while recent moves by the federal government – accelerated by the pandemic – to increase involvement in areas traditionally under provincial jurisdiction, and the changing role of municipal governments in Canada are all areas where reforms may be necessary. And yet others reflect entrenched political dynamics that ebb and flow throughout Canada's history and warrant special attention. Understanding how the federation operates today, and how these developing pressures challenge our current arrangements, requires rigorous and thoughtful analysis.

The central objective of the Fiscal Federalism Policy Network is therefore to rethink the architecture of Canadian fiscal federalism in a post-COVID-19 world. Like a Royal Commission, we will take a coordinated deep dive into complex questions. Unlike a Royal Commission, we are independent of government appointments or political priorities. We believe that this is the only way to provide evidence-based research, analysis, and advice in order to strengthen and modernize Canada's intergovernmental fiscal relations. To achieve this objective, we will be guided by a set of four interconnected principles:

01

Work within Canada's existing constitutional framework. Much can be done within the existing constitutional framework, which has proven to be remarkably flexible in accommodating the evolution of the federation. While not recommending changes to the constitution we recognize the need to involve municipalities more fully.

02

Retain Canada's fiscally decentralized federation. A decentralized federation fosters innovation and accommodates regional differences while providing the benefits of a centralized federal government and pan-Canadian coordination of efforts. Provinces and municipalities should have sufficient fiscal capacity to deliver critical public services.

03

Promote fiscal transparency and accountability. Clear and transparent connections between revenue and spending can enhance accountability and hold each order of government responsible for outcomes. Disentangling overlapping tax and expenditure powers will improve transparency and accountability.

04

Create an efficient, sustainable and fair fiscal federation. Increasing the efficiency and effectiveness of the federation improves productivity and fosters greater economic growth and prosperity. Growth supports the financing of public services and policies to address income disparities and promotes social cohesion. An efficient and fair federation requires a sustainable approach to addressing vertical and horizontal fiscal imbalances.

As a starting point, over the next three years, the Network will tackle these issues with a series of in-depth research papers, broadly accessible briefing notes, public events, and a host of other activities to elevate the public debate and understanding of these critical issues. Given the significant challenges facing Canada, we need to stress test how our existing institutions can effectively deal with these issues in a highly competitive global economy. Do we have effective and resilient decision-making structures to guide Canada during these unprecedented times? Do we need new coordinating efforts to challenge the status quo and innovate as a federation? How can we realign intergovernmental roles and responsibilities to improve our quality of life and global competitiveness? These are some of the important questions that the Network will address. Our future prosperity depends on getting this right.

Introduction

Canada's fiscal arrangements are at a crossroads. The immediate challenges from COVID-19 and the resulting fiscal and economic disruptions have amplified pre-existing pressures in several ways. And the importance of addressing future challenges in a sensible and prudent manner – before pressures build and crises arrive – is now increasingly clear.

Improving how our federation operates will be at the heart of any successful effort. Canada, after all, is not run by a single government in Ottawa, nor by thirteen provincial and territorial capitals. Instead, thousands of individual governments – each have distinct responsibilities, authority, governance structures, financial resources, and connections to Canadians – make this country run. And all must work together for the country to succeed. This is especially true for challenges that transcend the ability of any individual government to address, many of which are becoming more significant by the day. Climate change, aging populations, global pandemics, energy transitions, technological advancements, natural disasters, economic volatility, rising perceptions of unfairness in the federation, and so much more will require much of Canada's highly decentralized system of government. Who should do what (and who should pay for what) are central questions that we need to get right and that we need to adapt when necessary. Throughout our history, changing social, economic, technological, and political environments necessitated that our intergovernmental arrangements – and fiscal arrangements in particular – evolve. There is perhaps no more pressing critical juncture for Canada and Canadians in recent memory than ensuring that as we come through the other side of COVID-19, we think deeply about how we approach the countless other challenges on the horizon. Research, analysis, and above all a broad understanding of what we face and what we can do about it are needed.

Canada is not alone, to be clear. Countries around the world are experiencing similar pressures from not only the pandemic, but also from aging populations, technological developments, climate change, and much more. Some countries, unlike Canada, have central governments responsible for the overwhelming majority of public services and functions. In these unitary or near-unitary states, intergovernmental negotiations and arrangements are not an issue. But in countries like Canada, federal systems often demand complex coordination between central and sub-national governments. The distribution of revenues and expenditures across governments, even if well-designed initially, drift apart. Such countries – which include Canada, Australia, the United States, Switzerland, and many others – require disciplined and ongoing attention to intergovernmental arrangements. Efforts to ensure well-coordinated policy making prevails in a federation is therefore critically important. But it isn't easy, especially in a country like Canada that lacks institutional arrangements to coordinate policy making.

Though more complex and challenging to navigate, federal systems of government come with many benefits. The greater degree of policy flexibility they allow for across regions means local tastes and circumstances may be better satisfied and adapted to. And with policy making and implementation around key functions of government handled closer to individuals, accountability and transparency may be enhanced. There are also important political considerations motivating federal systems. Decisions by governments in one part of a country do not cost taxpayers in another if funded from locally levied taxes, for example. Federally delivered programs, in contrast, may raise questions around the equitable distribution of costs and benefits. Indeed, recently rising sentiment in Alberta around federal programs like equalization is a good illustration of this political challenge.

Such concerns around fair treatment within the federation are not new. From “Better Terms” advocated by Anti-Confederates in Nova Scotia shortly after Canada was formed, to Alberta’s equalization referendum in 2021, provincial leaders regularly raise concerns with the operation of Canada’s federal arrangements. Indeed, similar disputes pre-date Canada itself, with George Brown’s concerns over implicit redistribution between Canada West and East or the decades-long dispute between Upper and Lower Canada over how to share import duties. A country as large and as diverse as Canada, where populations and economies differ significantly, will inevitably require redistribution and this will lead to concerns of ill-treatment. Balancing divergent regional interests with the broader interest of the whole country is necessary and must be done with care.

But even in the context of provincial and local government jurisdiction in key areas, there are benefits from having overarching mechanisms to coordinate, address spillovers, share risks, maximize economic efficiency, mitigate regional inequalities, and fund public services with broader national benefits. A national military, for example, is more appropriately funded through taxes on all Canadians. Certain types of infrastructure and capital projects too can have benefits beyond a single province’s borders. Risk pooling through the federal government ensures the costs of localized disasters, for example, are spread broadly. However, national programs that provide a social safety net result in redistribution from high average-income regions to lower income regions.

Economic inequality across regions of Canada is one of the central challenges fiscal arrangements must overcome. This has always been the case. From the early negotiations between the British colonies to modern First Ministers’ conferences, balancing the interests of diverse provinces is difficult. Alberta’s gross domestic product (GDP) per person – a broad measure of economic activity roughly equal to total income – was nearly $81,000 in 2019. In the next highest province, Saskatchewan, it was $71,000 and the national average level was less than $62,000. At the other extreme, Prince Edward Island had a GDP per person of barely $48,000. While these differences are lower than they have been historically, it makes it difficult to ensure equity of treatment of Canadians in similar circumstances across the country. To balance their provincial budgets, lower income regions will either need to raise taxes above normal levels or endure fewer (or lower quality) public services. Canada’s equalization program hopes to bridge these gaps for this very reason. Indeed, a commitment to the principle of equalization has now been enshrined in the Constitution. It provides such a commitment to “ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation” (section 36(2) of the Constitution Act 1982). Although this section has not received much attention, it does articulate the purpose of equalization and should guide any analysis of equalization. This is not easy, and changing economic, social, and political circumstances require Canada's equalization program to adapt and evolve.

In this paper, we describe several challenges that Canada's fiscal arrangements will face in the coming years. All require careful attention and require thoughtful reforms to ensure Canadian prosperity continues to grow. Some pressures are fundamental, resulting from external or exogenous developments. These include a rapidly aging population, climate change, an energy transition that will alter the global demand for fossil fuels, and rising economic volatility in Canada. In addition to these, other pressures stem from deliberate internal policy choices, sometimes compounding over years. Rising levels of provincial debt raise long-term sustainability concerns, while recent moves by the federal government – accelerated by the pandemic – to increase involvement in areas traditionally under provincial jurisdiction, and the changing role of municipal governments in Canada are all areas where reforms may be necessary. Finally, other pressures reflect entrenched political dynamics that ebb and flow throughout Canada's history and warrant special attention. The increasingly challenging grievances raised by governments of producing regions – such as Alberta's equalization referendum and other "Fair Deal" initiatives – demand attention.

The public only sees the tip of the iceberg in federal, provincial, and territorial government relations when First Ministers or Finance Ministers meet. In fact, there are numerous intergovernmental committees that help to coordinate fiscal policy and arrangements in Canada, including First Ministers, Council of the Federation, Finance Ministers, Continuing Committee of Officials, and Fiscal Arrangement Committee, plus a plethora of subject-specific committees and working groups. Important as these committees are, there is essentially no integrated strategy, no public discourse or no third-party engagement or validation. These committees operate as an exclusive club that exclude key partners such as First Nations and other Indigenous groups, municipalities and third-party experts.

In a rapidly changing world, Canada cannot effectively function as a disjointed and divisive federation. COVID-19 has shown us the best and worst of what a loose federation can offer. Effective fiscal relations will need to have a more integrated strategy that embraces open discourse and expands key partners in shaping the future of the country. Successful efforts to sustainably reform federal arrangements cannot only be top-down, but may require the public's understanding, involvement, and support. To that end, the Fiscal Federalism Policy Network will spearhead efforts to investigate, analyse, and communicate to all Canadians the challenges, opportunities, strengths, and weaknesses of Canada's current system of fiscal arrangements.

Renewing Fiscal Arrangements with Indigenous Governments

The Fiscal Federalism Policy Network will work to rethink the architecture of Canadian fiscal federalism in a post-COVID-19 world, but with a focus on federal, provincial, and local governments. Fiscal arrangements with Indigenous governments in Canada are also critically important and in need of reform, but a review of Canada's fiscal relationship with Indigenous governments is already underway through bodies such as the Joint Advisory Committee on Fiscal Relations and the work of the Yellowhead Institute. In mid-2016, a Memorandum of Understanding was signed between the Government of Canada and the Assembly of First Nations to initiate a joint process for collaborative reform. Significant work was undertaken in subsequent years, most recently captured by the Joint Advisory Committee on Fiscal Relations in a June 2019 interim report. The Committee made several recommendations to guide the design and implementation of improved fiscal relations with First Nations in Canada, including the creation of a First Nations Fiscal Policy Institution to research, evaluate, report, and help continuously improve these fiscal relationships. Achieving these improvements will require a multi-year endeavour that is best overseen and coordinated by Indigenous institutions. The FFPN can add little to this process. But by focusing on the three other orders of government, we will complement this ongoing work with Indigenous governments to improve overall fiscal federalism in Canada.

Given the significant challenges facing Canada, we need to stress test how our existing institutions can effectively deal with these issues in a highly competitive global economy. Do we have effective and resilient decision-making structures to guide Canada during these unprecedented times? Do we need new coordinating efforts to challenge the status quo and innovate as a federation? How can we realign intergovernmental roles and responsibilities to improve our quality of life and global competitiveness? These are some of the important questions that the FFPN will be addressing as it studies Canada's fiscal relations in a post-COVID-19 world. We begin that work here, starting with a high-level summary of where we stand today with Canada's current federal-provincial arrangements.

01
Canada's Federal Arrangements Today

To better appreciate the current arrangements between Canada's federal and provincial and territorial governments, and the challenges that we must overcome, this section briefly summarizes where we are today and, very importantly, how we got here. This is not a comprehensive analysis of all government finances in Canada, but provides an important high-level summary of key features of Canadian fiscal federalism and governance.

As has occurred throughout Canada's history, federal-provincial arrangements and institutions respond to the circumstances of their time. Ever evolving economic, political, and social pressures mean that what worked once may not any longer. Before identifying Canada's key challenges over the coming decades, we have to appreciate where we are now and how the pillars of Canadian fiscal federalism operate. We begin with the foundation of it all: the Constitution.

Canada's Constitutional Arrangements

Political scientist Richard Simeon wrote in 2005 that you "will only get a partial picture of 'who does what' if you read the Canadian Constitution Act of 1867".[1] This remains true. The constitutional framework of Canada's federation is constantly evolving. Although there have been very few formal changes to the written words of the initial deal, the evolution of the caselaw and a practice of intergovernmental arrangements have operated as a source of constant contextual adaptation and reformulation.

Federalism is a power sharing agreement between regional and central governments. In Canada, the regions (provinces) are not subordinate to the central government; they are fully autonomous. There is a list of subject matters assigned to one level or the other, with an arbitrator to determine who can do what. The powers assigned to the provinces and to the federal government in 1867 have not changed much since then (except for a few constitutional amendments), however, judicial interpretation has given a large measure of flexibility to the original arrangement. This trend of flexible judicial interpretation will remain as it has become clear that the Canadian constitution is difficult to amend since the enshrinement of the amending formula in 1982. This strain will continue to require a flexible approach from the courts, a constant characteristic of our constitutional history.

From Confederation to 1949, the Judicial Committee of the Privy Council in England – the ultimate arbiter of constitutional conflicts until the Supreme Court of Canada was made so – created theories of interpretation that sought to limit the power of the federal government, despite what was generally understood to have been the wishes of the framers. John A. Macdonald and his colleagues thought that they were designing a "strong" federal power with weak provinces, contrary to their American counterparts. The Judicial Committee of the Privy Council tampered with that ambition. Several theories exist as to why the Privy Council was so quick to interpret restrictively the broad terms by which the Constitution Act 1867 assigned powers to the federal government. Many English Canadian authors lament that the Privy Council wanted a weak central government, perhaps to prevent a stronger

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1 Richard Simeon, "Canada: Competition within Cooperative Federalism", Raoul Blindenbacher and Abigail Ostien, *Dialogues on Distribution of Powers and Responsibilities in Federal Countries*, (McGill Queens' University Press, 2005), p. 12.

Canada from breaking away from the British Empire. Québec and francophone constitutional scholars, on the other hand, laud the way in which the Judicial Committee of the Privy Council ensured sufficient provincial sovereignty to preserve and protect cultural differences.

Federal and Provincial Constitutional Powers

Federal Powers Include:

- Peace, order, and good government
- Trade and commerce
- Banking (chartered and savings banks), currency and coinage, interest
- Bankruptcy and solvency
- Patents and copyright
- Defence, army, navy
- Shipping, fisheries, navigation, marine hospitals
- Criminal law and penitentiaries
- Marriage and divorce
- Indians and land reserved for Indians
- Any mode of taxation
- Residual power (to over turn legislation of provinces)
- Unemployment insurance (1940)
- Old Age Security (1951)
- Joint administration of Canada pension plan (1964)

Provincial Powers Include:

- Direct taxation to raise revenue for provincial purposes
- Management and sale of public lands
- Public and reformatory prisons
- Hospitals, asylums and charities
- Business licensing (and revenues)
- Municipal institutions
- Property and civil rights
- Incorporation of companies with provincial objects
- Administration of justice
- Solemnization of marriage within the province
- Matters of local and private nature in the province
- Natural resources (92A)
- Education (93)

The abolition of appeals to the Privy Council in 1949 made the Supreme Court of Canada the ultimate arbiter of federalism disputes. The Supreme Court quickly moved away from some of the Privy Council decisions and was seen as generally favouring federal assertions of powers. With the advent of Québec nationalist movements, and the constant criticism of this trend, case law became more nuanced. In the 1960s and 1970s, the Supreme Court became “pro government” in a way. To the extent that one level could tie its legislative ambitions to the 1867 list of powers, it could strive to accomplish its goals even if in doing so, it encroached on the other level’s powers. This is the doctrine of “ancillary powers.” Each level has the ancillary powers necessary to exercise fully the jurisdiction conferred to it in 1867. Needless to say, this leads to many areas of overlap between the two levels. If the federal government can regulate false advertisement under its trade and commerce power and the provinces have generally the power to deal with consumer protection under their own property and civil rights powers, business owners will have to follow two sets of rules. The Court is also willing to let this overlap persist, unless there is a real conflict between the two sets of rules. In this area of “cooperative federalism,” citizens may be overly regulated and have to follow the most exigent rules. The Court sees it as the price to pay for a peaceful federation. This “cooperative federalism” leaves the two levels of governments with the obligation to collaborate in most areas of public regulation in order to harmonize regulations and recognize their interdependence.

That the law is not static is amply demonstrated by the recent Supreme Court decision on greenhouse gas pricing. The Court found that the federal backdrop scheme of imposing minimum standards was constitutional under the federal power to make laws for the “peace, order and good government of Canada,” the boundless expression found in the Constitution Act 1867. Like always, the Court recognized the necessity of responding to national issues such as climate change, but worried about the impact it would have on the “state of the federation.” Dissenting judges, for the most part, emphasized the impact of ambitious federal interventions on the delicate balance of the constitutional arrangement.

The courts’ constant concern is that the federation is fragile and that Québec’s identity particularly, and willingness to stay within the federation, could be thwarted by aggressive federal interventions. Current feelings of alienation from Western provinces could also find expression in courts’ language and analysis. The final arbiter in a federation always worries whether or not the federation will be maintained.

It is not as though the federal government is without ability to intervene in a wide range of policy sectors. It does so regularly through its spending power. The spending power of the federal government is its ability to spend money through various programs in areas of provincial jurisdiction. It remains a contested sphere in constitutional discussions. Some argue that federal spending in areas of provincial jurisdiction is indirectly doing what could not be done directly through legislation; that is, modifying provincial priorities and autonomy through financial incentives or pressures. Nevertheless, the courts have recognized the constitutionality of the federal spending power and have, to date, refrained from disciplining it. Some suggest that section 36 of the Constitution Act 1982 should be interpreted as a limit to the exercise of that spending power, which could then be used only to “promote equal opportunities,” “further economic development to reduce disparities” and provide “essential public services of reasonable quality to all Canadians”.[2]

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[2] Hoi Kong, “The Spending Power in Canada”, in Peter Oliver, Patrick Macklem and Nathalie Des Rosiers, *The Oxford Handbook of the Canadian Constitutional Constitution*, (O.U.P, 2017), pp. 433 et seq.

The advent of the Charter in 1982 has been another tool of policing the federation. There have been claims that courts have been more interventionists in correcting and overruling governments under the Charter than they have been on federalism grounds. The matter is constantly debated, but there are a couple of reasons for courts to feel more comfortable in intervening in Charter cases: Courts are experts in rights definitions and the Charter allows the government to explain and justify, through evidence, rights infringement under section 1 of the Charter. This evidentiary burden is an institutional tool that courts feel competent in managing as opposed to protecting the vague "delicate balance of the federation," which they assess as being within the competence of political actors. It is noteworthy that in the recent greenhouse gas pricing reference, the Court insists that the federal government must bring *evidence* of provincial inability and a superior national interest to establish its authority to act.

New governance challenges, including recognizing Indigenous self-government, managing the expanded role of cities or responding to global pandemic threats will certainly bring about changes in assertions of authority by the provincial and federal governments alike and will alter the constitutional framework.

Courts will continue to empower governments to act provided that such action does not unduly rock the "constitutional balance" of the country. This concern has been at the core of judicial interpretation for more than a century. The vagueness of the expression allows the courts to discipline overbroad federal ambitions that could threaten the fragile equilibrium within the federation. It is this delicate balance that continues to animate judicial reasoning that, on one hand, wants to provide latitude to governments (of both levels) to implement their policies while attempting to be sensitive to the constantly evolving state of frictions within the federation.

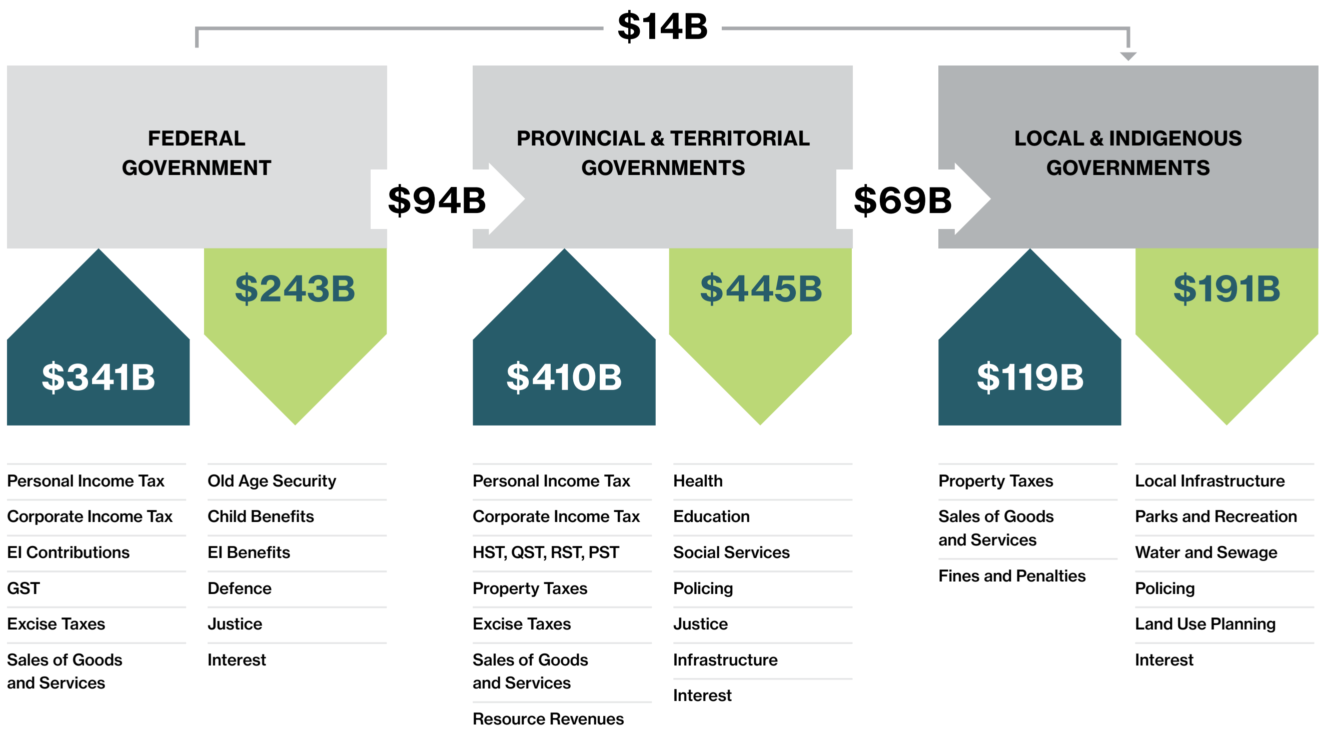
Therefore, contrary to how it may appear, flexibility is a core aspect of the Canadian federation. Although the list of powers established in 1867 could be read as creating a rigid, stable and immovable constitutional framework, it is far from that. A long time ago, courts determined that the Canadian constitution was a "living tree" that had the potential to evolve. It dismissed any originalism theory of our constitutional framework. In the context of analyzing fiscal imbalances, it will remain important to take into account this on-going flexibility in the constitutional framework.

The Canadian federation needs to achieve the delicate balance of empowering governments to implement their respective policy agendas that reflect the country's cultural, economic, and political diversity. The evolution of the Canadian federation frames and acknowledges the interdependency between levels of governments; it also requires levels of co-operation and coordination commensurate with the dynamic forces that shape the country.

Financing Canada's Orders of Government

With this comprehensive review of Canada's constitutional evolution in hand, a brief exploration of our current fiscal arrangements is instructive.

Figure 1: Fiscal Flows of Canadian Governments (Pre-COVID, 2019)



Source: Authors' calculations from Statistics Canada data table 36-10-0450-01

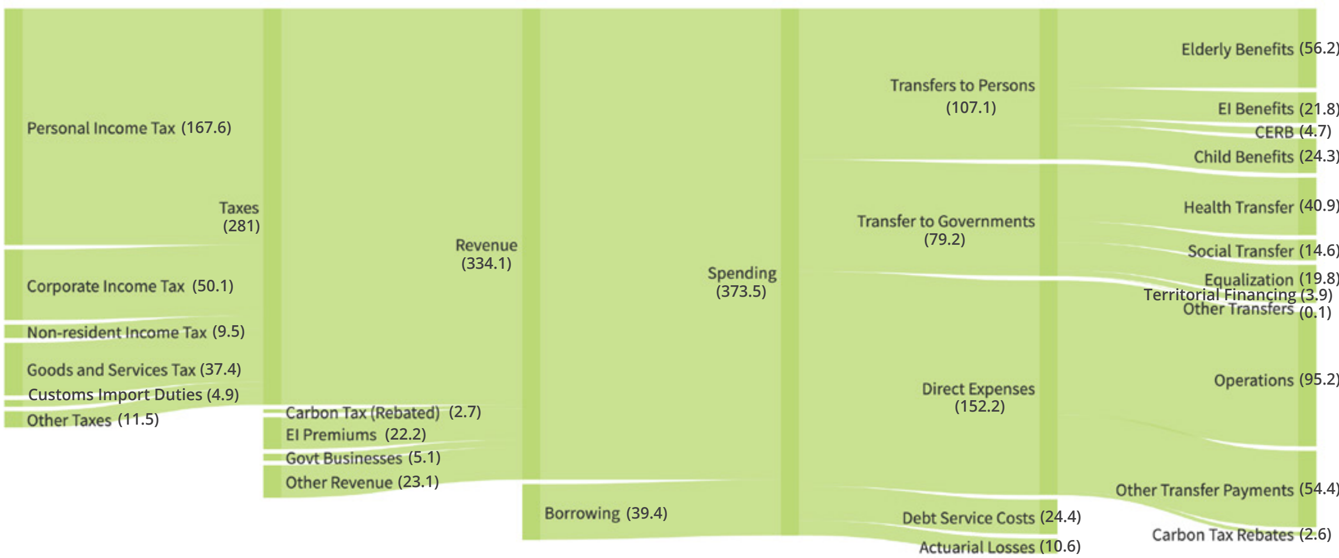
The Constitution specifies that the federal government has the power to raise money by any means, giving the federal government considerable revenue raising powers. Provinces are restricted by the Constitution to imposing direct taxes within the province. In practice, however, this restriction has not been very limiting. Today, provinces utilize the same major taxes as the federal government and have access to some tax bases that the federal government does not (resource royalties and property taxes, for example). Revenue raising has become considerably more decentralized in the post-war period and, as Figure 1 shows, provinces (and territories) collectively raise more revenue than does the federal government.

Before diving into specific details for each order of government, a broad summary of the inflows and outflows of each is in order. The main sources of revenue vary in important ways across governments. The federal government relies heavily on taxes on income and consumption. Provincial and territorial governments do as well, but to a lesser extent given that revenues from property, sales of goods and services, resource revenues, and transfers from the federal governments are substantial. Local governments raise revenues largely from property taxes, sales of goods and services, and large transfers from provincial governments. Expenditure responsibilities also vary widely. It's worth unpacking each in greater detail.

FEDERAL GOVERNMENT FINANCES

The fiscal responsibilities and powers of Canada's federal government are broad. It levies taxes on a wide variety of activities and has access to "by any mode or system of taxation" (s. 91). Historically, much of its revenues were derived from taxes on international imports. But today, the picture is very different and an overwhelming majority of federal revenues flow from taxes on income (both personal and corporate) and on consumption (including the GST and various excise taxes on specific products). We illustrate this in Figure 2.

Figure 2: Federal Budget Flows for Fiscal Year 2019/20 ($B)



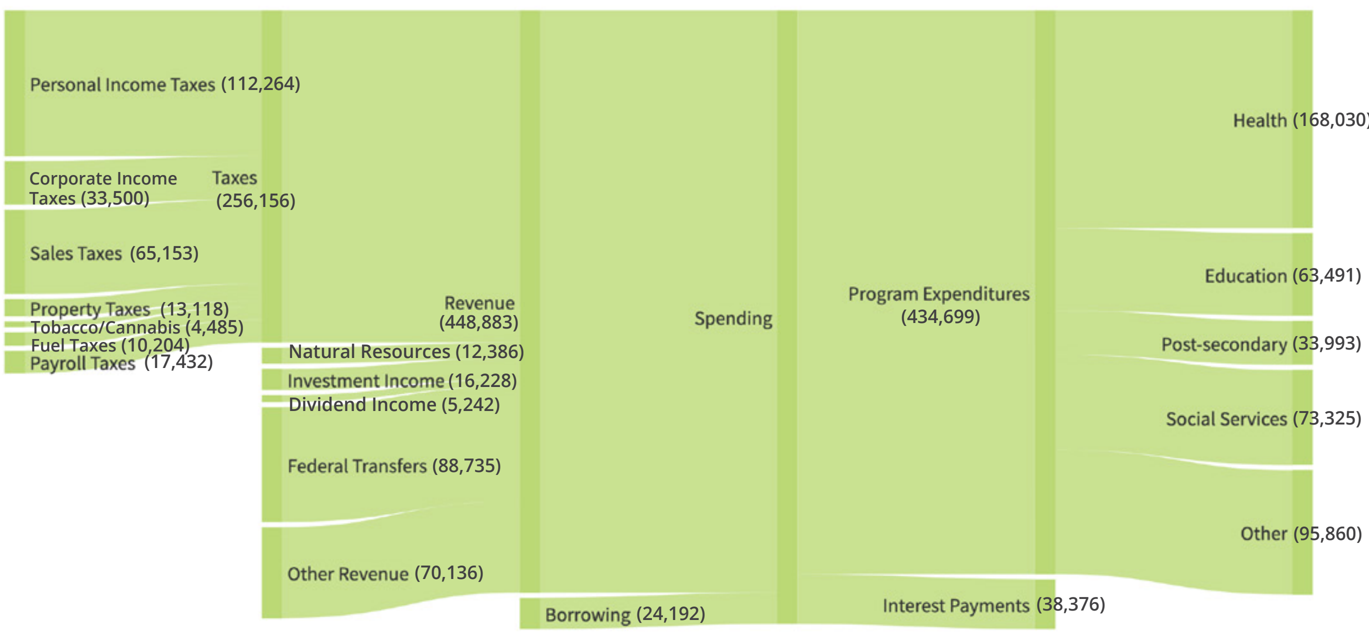
In terms of program expenditures, the federal government is not directly involved in most areas of public services. It primarily undertakes to redistribute funds through various transfer programs. These transfers include transfers to persons (through elderly benefits, employment insurance benefits, or child care benefits), transfers to governments (through health transfers, social transfers, equalization payments, territorial financing, and a wide variety of other smaller programs), and transfers to other entities (such as subsidies to business or support to non-governmental organizations). Overall, less than one-third of overall federal spending is on direct operations or program delivery.

As our focus is on fiscal federalism in Canada, a closer look at the various transfer programs to other governments is appropriate. These transfers to governments, as indicated in Figure 2, account for roughly one-quarter of overall federal expenditures – a similar share to what prevailed over 150 years ago when Canada was founded. Two programs – the Canada Health Transfer and the Canada Social Transfer – are the largest, but also the simplest. They provide payments to provinces and territories, nominally to support healthcare and social services, based on population alone. If one province is twice as large as another, then it receives twice the dollars as the other. A third major transfer program, Equalization, is not so straightforward. This program aims to provide lower-income provinces with additional support to compensate for their weaker economies that generate less income, less consumption, and therefore lower provincial revenues. One point of income taxes, after all, yields substantially more dollars in a higher-income region than in a lower-income one. Rounding out this picture are a wide variety of minor transfer arrangements – from municipal infrastructure and public transit support, to job training programs – that come on and off Canada's fiscal scene as the expediency of the moment demands.

PROVINCIAL GOVERNMENT FINANCES

Unlike the federal government, Canada's provinces are primarily responsible for delivery of core public services such as healthcare and education. But they fund these services with a substantially smaller share of revenues coming from income or consumption taxes. As illustrated in Figure 3, approximately half of provincial revenues are from such taxes while the other half is from a variety of sources. Chief among the non-tax-revenue sources for provincial governments are federal transfers, mainly under the Canada Health Transfer, Canada Social Transfer, and Equalization. On the program expenditure side of provincial budgets, the four main activities of healthcare, education, post-secondary education, and social services account for the large majority of provincial activities.

Figure 3: Aggregate Provincial Budget Flows 2019 ($M)



Provinces are also responsible for a third order of government in Canada: municipalities. Given their rising importance and the complexity of this space, we are careful to separate municipal governments in the following section. The Network will pay close and careful attention to the unique challenges facing Canada's municipal governments and the mounting need for innovative solutions to them.

TERRITORIAL GOVERNMENT FINANCES

Canada's three northern territories share important similarities and differences with provinces, and face uniquely challenging circumstances that must be considered and addressed separately. They each possess the same taxation and spending powers as the provinces, although these are delegated through federal legislation rather than entrenched in the Constitution. Federal legislation has also transferred to the Northwest Territories and Yukon the authority to manage and levy royalties on most onshore non-renewable resources, and Nunavut has reached an Agreement in Principle with Canada on the eventual devolution of these powers. Federal legislation also imposes limits on the amount of debt each territory may incur.

The territories also differ from the provinces in that they are much more dependent on federal transfers to fund their operations and deliver programs and services, with transfers representing approximately 80 per cent of total territorial revenues. This is largely because the territories' per capita revenue bases are not sufficient to meet their very high per capita expenditure needs, which in turn are driven by remoteness, harsh climate, lack of infrastructure, small and dispersed communities, and challenging social conditions. Therefore, territorial fiscal arrangements differ from those in the provinces, with Territorial Formula Financing arrangements replacing the federal Equalization program as the mechanism for addressing unique northern circumstances.

Similar to the provinces, though, the territories allocate most of their budgets to healthcare, education, social support and housing.

MUNICIPAL GOVERNMENT FINANCES

There are approximately 3,750 local governments in Canada. Local governments do not have independent status in the Constitution. Rather, provincial governments have the exclusive authority to make laws in relation to municipal institutions. In terms of municipal finances, provinces determine which expenditures local governments are responsible for, what revenues they can raise, and how much they can borrow.

Local governments make expenditures on a wide range of services, including water, sewers, and waste management; transport (roads and transit); fire and police protection; public health; social services and housing; recreation and culture; and planning and development (see Table 1(a) for the distribution of expenditures by function). There are notable differences across provinces in terms of the distribution of municipal expenditures. In Ontario, for example, local governments spend one-quarter of their budget on social services whereas municipalities in most other provinces spend little or nothing on social services because the provincial government is responsible for paying for those costs. Ontario municipalities also stand out because they spend more on health than municipalities in other provinces, with the exception of Nova Scotia. Municipalities in Quebec and Alberta spend over 25 percent of their total expenditures on transportation, which is considerably more than the average of 18 percent for the country. British Columbia local governments spend relatively more on recreation and culture than local governments in other provinces.

Table 1: Distribution of Municipal Revenues and Expenditures in Canada (2019)

(a) Expenditures by Function	
Function	Share of Total
General Public Services	**16.0**
Public Order and Safety	**18.5**
Police services	11.0
Fire protection services	5.8
Other	1.7
Economic Affairs	**19.4**
Transport	18.1
Other	1.3
Environmental Protection	**9.8**
Waste management	4.1
Wastewater management	4.6
Other	1.1
Housing and Community Services	**9.1**
Housing and community development	3.3
Water supply	4.9
Street lighting	0.7
Other	0.2
Health	**2.9**
Outpatient services	1.6
Public health	1.1
Other	0.2
Recreation and Culture	**11.1**
Social Protection	**13.3**
Old age	1.9
Family and children	2.7
Housing	3.4
Social exclusion	4.7
Other	0.6
Total municipal expenditures	**100.0**

(b) Revenues by Source	
Source	Share of Total
Recurrent property tax	46.0
Other taxes on property	1.5
Taxes on goods and services	0.7
Lot levies and motor vehicle taxes	7.2
User fees	22.7
Other revenue	3.3
Total own-source revenue	**81.4**
Intergovernmental transfers	**18.6**
Total revenue	**100.0**

In terms of municipal revenues, Table 1(b) provides a breakdown of the main sources for local governments in Canada. In 2019, property tax accounted for 46 percent of revenues, on average, across the country followed by user fees at almost 23 percent, and provincial and federal transfers at less than 20 percent. As with municipal expenditures, there is a wide variation in the sources of revenue across Canadian local governments. User fees represent a somewhat smaller percentage of municipal revenues in Quebec, where property taxes (not user fees) are largely used to pay for water. Provincial and federal transfers range from a low of less than 9 percent of revenues in BC municipalities to a high of 47 percent in Prince Edward Island. Transfers account for more than 20 percent of total municipal revenues in Ontario, where social services are cost-shared with the provincial government. Lot levies (also known as development charges), which are used to pay for growth-related capital costs associated with new development, are significant in Ontario, Saskatchewan, Alberta, and BC. Land transfer taxes (included in property-related taxes) are levied by municipalities in Quebec and Nova Scotia, and by the City of Toronto. Some local governments have been given additional taxing powers such as accommodation and vehicle taxes, but these represent a relatively small proportion of revenues.

Current Fiscal Arrangements in Canada

We have described how the Constitution sets out the parameters of Canadian federalism and how interdependent orders of government are, even within a highly decentralized federation. As the previous section made clear, nowhere is this more evident than in government finances. We therefore turn to current fiscal arrangements that govern these relationships in Canada.

OVERALL INSTITUTIONAL SETTING

Canada's tight interdependency between governments also requires a high level of cooperation and coordination across orders of government. Yet one of the main organizational features of intergovernmental relations in Canada is a reliance on mostly ad hoc informal networks (Bolleyer 2009), and fiscal relations are no exception. However, the lack of a formalized process for fiscal relations and intergovernmental relations more generally does not mean that cooperation and coordination are impossible. Factors highlighted before such as a highly decentralized federation and broad federal spending powers have made Canada one of the champions of intergovernmental agreements (Parker 2014).

These agreements have not been the product of – or led to – long-lasting institutional arrangements. Instead, there are numerous intergovernmental committees that help coordinate fiscal policy and agreements. At the highest level, the First Ministers meetings include all provincial and territorial premiers as well as the Prime Minister. These meetings are not held at regular, scheduled intervals, but convened at the behest of the Prime Minister who also sets the agenda. In part as an attempt to better control the intergovernmental agenda and to speak as a more cohesive voice, the provincial and territorial premiers formed the Council of the Federation in 2003, and while this body might have helped institutionalize relations between provinces, it has not had the same effect on relations between the provinces and the federal government (Wallner 2017).

To complement these higher-level meetings there are also meetings of Finance Ministers, Continuing Committee of Officials, Fiscal Arrangement Committee, plus a plethora of subject-specific committees and working groups. However important these committees are, they are not constituted in any kind of integrated way and there is no process enabling third-party engagement or validation. As a result, intergovernmental fiscal relations in Canada remain the preserve of the executive and senior officials of the federal, provincial, and territorial governments, and exclude key partners such as Indigenous governments, municipalities, and third-party experts.

The absence of an institutionalized process to engage with the larger community and the reliance on informal networks have led many important actors to criticize the lack of transparency of the intergovernmental fiscal relations ecosystem. This criticism is not only coming from actors that are left out of the process but also by some that are part of it. For instance, Quebec's Seguin Commission, which explored the issue of fiscal imbalance, recommended 20 years ago that federal-provincial analysis of fiscal balance and transfer programs be made more transparent, and that efforts should be made to "establish with the other provinces a genuine, permanent and effective process of exchanges and discussion between the two orders of government on intergovernmental fiscal relations" (Commission Séguin 2002, p.xv). Part of the reason for this recommendation was that, from the province's standpoint, a more transparent, institutionalized process also represented a more predictable one.

The Expert Panel on Equalization and Territorial Formula Financing (often referred to as the O'Brien report) came to a similar conclusion about the equalization program. Remarking that while the process had worked well to date, the panel noted that changes "to the design and implementation of the program have been made through a series of intergovernmental consultations and processes, primarily between finance officials, held behind closed doors and rarely involving public scrutiny" (p. 65). As a result, the Expert Panel recommended that a better process be put in place with the aim of improving transparency, communications, and governance. In the views of the Panel, a more transparent process for equalization was also a more democratic and a more educational one. Given the importance of the program in Canada, it was essential that the public be more aware of the process and that it be more heavily scrutinized.

TAX COLLECTION AGREEMENTS

A high level of revenue decentralization combined with the fact that federal and provincial governments co-occupy most of the major tax bases give rise to some particular challenges. Differences in provincial governments' abilities to generate revenues to finance their expenditure requirements lead to a horizontal fiscal imbalance. This imbalance is the reason behind the federal government's Equalization program, discussed below. Provinces are free to design their own tax systems, but differences in these systems can interfere with an efficient allocation of resources if provincial tax decisions distort the interprovincial flow of goods, services and factors of production. Provinces may engage in harmful tax competition, using corporate income tax policies, for example, to encourage business and investment to relocate from one province to another. Differences in provincial sales tax systems can distort consumption and investment decisions across borders. Issues can also arise when provincial and federal tax systems differ. Uncoordinated systems can lead to higher administrative costs and increased compliance burdens for taxpayers. Additionally, a vertical tax externality can arise if one level of government fails to take into account the effects of their tax rate choices on the other level of government's revenues.

The main tools used in Canada to improve tax coordination and harmonization both vertically and horizontally are voluntary, bilateral agreements between the federal government and the provinces and territories. The federal government has signed Tax Collection Agreements (TCA) with all provinces and territories except Quebec in the case of personal income taxes and with all provinces and territories except Alberta and Quebec for corporate income taxes. The federal government administers and collects provincial personal and corporate income tax systems virtually free of charge on behalf of provinces with TCAs. In exchange, these provinces agree to impose their provincial tax rates on the federal income tax base. Provincial tax credits can and do differ across provinces and between provinces and the federal government. In the case of general sales taxes, the federal government has signed Comprehensive Integrated Tax Coordination Agreements with several provinces to implement the harmonized sales tax (HST) and with Québec to harmonize the QST with the GST with certain limited exceptions. The HST consists of the federal goods and services tax (GST) plus a provincial tax component, both levied on (more or less) the same federally defined GST base. In Quebec, the provincial government administers the GST/HST on behalf of the federal government.[3] The degree of harmonization of income and sales taxes has certainly changed over time.[4] In 1962, for instance, personal income tax systems were considerably more harmonized than they are now as provinces imposed a single tax rate on the amount of federal tax owing for a given taxpayer. Still, the current level of harmonization (in terms of the use of a common tax base) is relatively high for income taxes.

MAJOR FEDERAL TRANSFERS

Federal transfers are among the most important components of fiscal federalism in Canada. Transfers address both vertical and horizontal fiscal imbalances in the federation. There are four major federal transfer programs in Canada: Canada Health Transfer (CHT), Canada Social Transfer (CST), Equalization, and Territorial Formula Financing (TFF). In addition to the four major transfers, there is a smaller federal transfer program called the Fiscal Stabilization Program. This program helps provinces and territories that experience large revenue declines for reasons other than provincial tax changes (Tombe 2020).

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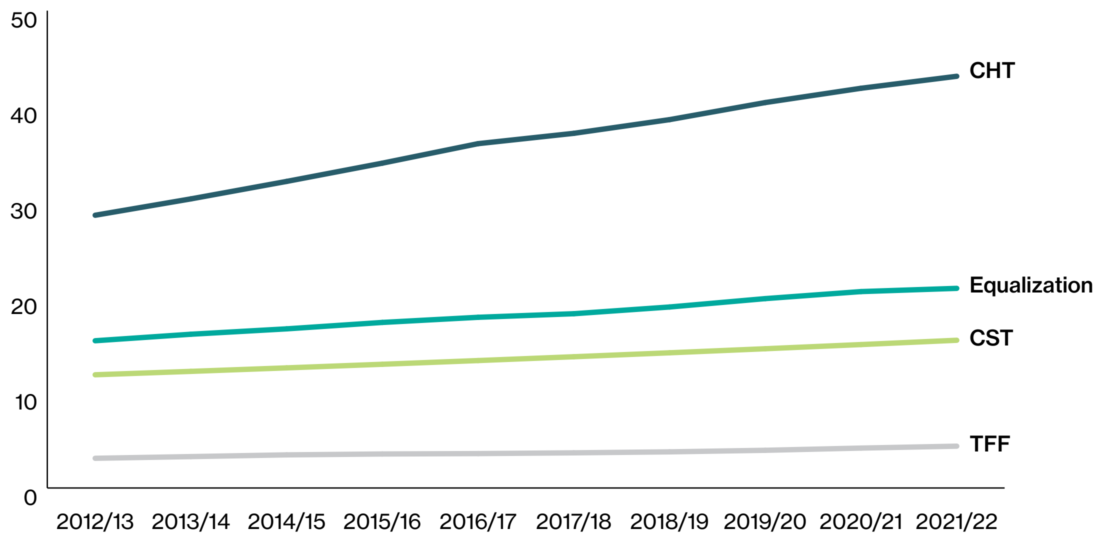
3 See Bird (2012) for a summary of the evolution of the GST, the HST and sales tax harmonization in Canada.

4 See Smith (1998) for a thorough history of tax coordination in Canada.

Figure 4: Major Federal Transfers in Canada (Billions of Dollars)



Source: Government of Canada (2021)

Federal transfer programs are not the only channel through which the federation distributes income to provinces and territories. Implicit income redistribution can occur in every federal revenue raising and spending practice. The federal government collects taxes from all provinces and territories and spends on various federal programs. Notable examples include federal income taxes and the Goods and Services Tax, Employment Insurance, national pension programs, and federal skills development and job training programs (Hartmann and Thirgood 2017). What a province or territory contributes to the federation may not necessarily be equal to the benefit that it receives. Although a complete calculation of net contributions or benefits to the federation includes all these national programs, due to their complexity these programs are seldom considered in the assessment of fiscal imbalances.

The following section focuses on the four major federal transfer programs: CHT, CST, Equalization, and TFF. Figure 4 shows the total amount of the four major transfers in the last decade. In 2021-22, provinces and territories will receive $83.9 billion through the four major transfers. CHT is the largest federal transfer, amounting to $43.1 billion in 2021-22. Equalization is the second largest, totaling $20.9 billion. CST will amount to $15.5 billion and TFF $4.4 billion.

Equalization

Equalization is an unconditional, general-purpose federal transfer. Equalization is available to the 10 provinces and not the three territories. The three territories are eligible for Territorial Formula Financing instead. Equalization payments can be spent on any area according to the provinces' own priorities.

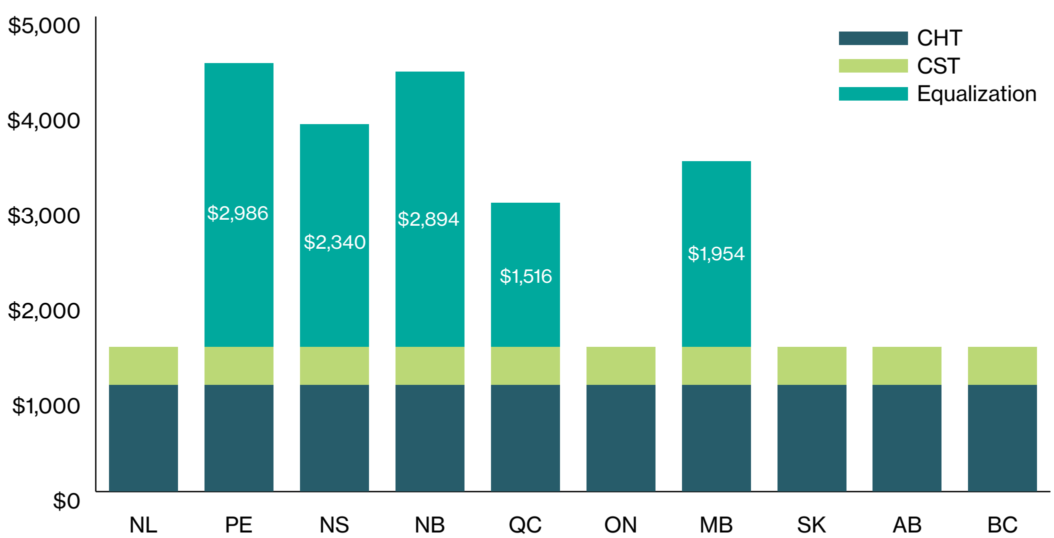
Equalization is the major federal transfer that addresses the horizontal fiscal imbalance in the federation. The purpose of Equalization was enshrined in the Canadian Constitution in 1982:

"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." (Subsection 36(2) of the Constitution Act, 1982)

The Government of Canada allocated $20.9 billion in 2021-22 to the Equalization program. The fund is legislated to grow at the rate of a three-year moving average of GDP growth. The current allocation of Equalization payments is based on a comparison of the revenue-generating capacity of a province against the average fiscal capacity of the 10 provinces. At national average tax rates, if a province's estimated fiscal capacity is below the 10-province average, the province is entitled to receive the difference between the national average fiscal capacity and its own estimated fiscal capacity. On top of this standard formula, there are three adjustments to the amounts that a province receives: First, natural resource revenues may be fully excluded from the calculation of fiscal capacity or excluded by 50%; second, there is a fiscal capacity cap that after equalization the fiscal capacity of a receiving province cannot, typically,[5] exceed the fiscal capacity of the poorest of non-recipient provinces; third, adjustments are made to ensure total equalization payments are no more than the legislated total amount for Equalization.

The per capita amounts of Equalization, CHT, and CST that each of the ten provinces will receive in the 2021-2022 year are summarized in Figure 5. In 2021-22, all provinces will receive the same per capita amount of CHT ($1,121) and CST ($402). Five provinces also receive Equalization payments: New Brunswick ($2,894 per capita), Prince Edward Island ($2,986 per capita), Nova Scotia ($2,340 per capita), Manitoba ($1,954 per capita), and Quebec ($1,516 per capita).

Figure 5: Per Capita Amount of Major Federal Transfers for the Provinces, 2021-22



Source: Government of Canada (2021)

[5] If equalization receiving provinces comprise more than fifty percent of the population, then the cap is set at the average per capita fiscal capacity among recipient provinces.

Health and Social Transfers

Some of the most important functions of government involve health and social services. In Canada, these are almost entirely administered by provincial and territorial governments. To support them in this function, the federal government provides targeted support through two conditional block transfers: the Canada Health Transfer (CHT) and the Canada Social Transfer (CST). Though these receive less public attention than other transfers like Equalization, they are among the largest. Indeed, the CHT is the largest federal transfer, totaling $43.1 billion in 2021-22, while the CST will total $15.5 billion in 2021-22, making it nearly as large as Equalization.

Though large, these programs are also simple. Both are allocated across provinces and territories in a fully equal per capita manner. A province with twice the population receives twice the dollars. But to qualify for full payments, provinces and territories must meet certain broad conditions. The CST, for example, prohibits minimum residency requirements for certain social programs to ensure portability of benefits for Canadians across jurisdictions. For the CHT, provinces and territories have to support the five principles of the Canada Health Act: universality, comprehensiveness, portability, accessibility, and public administration. Finally, both transfers grow over time according to a simple pre-specified formula. The CST grows at a fixed 3 percent per year while the CHT grows according to a three-year moving average of nominal GDP (subject to a minimum growth rate of 3 percent).

To be clear, these are not the only transfer programs that support provincial health and social programs. In addition to the CHT, the federal government has implemented conditional transfer programs that target specific health care areas. Beginning in 2005-06, the federal government committed to providing $5.5 billion to the Wait Times Reduction Fund over ten years. In 2017, the federal government made a similar commitment – $11.5 billion over ten years starting in 2017-18 – to improve home and community care and mental health and addiction services. We'll return to some other new transfer programs recently implemented by the federal government later in the report.

Territorial Formula Financing

The unique circumstances of Canada's three northern territories – Nunavut, the Northwest Territories, and Yukon – require special arrangements beyond those available to provinces. In particular, they do not participate in Equalization; instead, the Territorial Formula Financing (TFF) program provides them with annual unconditional transfers. TFF entitlements to the three territories are estimated to be $4.38 billion in 2021-22 – an average of nearly $35,000 per capita.

The key principle behind the TFF is similar to that underlying Equalization – that less-well-off jurisdictions should receive funding to allow them to "provide reasonably comparable levels of public services at reasonably comparable levels of taxation." The formula for determining TFF grants is very different from that of Equalization, however, and two stand out:

First, the TFF recognizes the much higher per capita expenditure needs of the territories; and second, each territory's TFF entitlement is determined independently of that of the other territories.[6] These differences are critically important to distinguish TFF from Equalization, and each ultimately stems from the grant's goal to fill the gap between expenditure needs and fiscal capacity.

The TFF formula is straightforward. A proxy for a territory's expenditure needs (which is called the Gross Expenditure Base or GEB) is calculated, from which an estimate of fiscal capacity is subtracted, determining the amount of the TFF grant. Roughly speaking, fiscal capacity for the territories is calculated similarly as for the provinces through Equalization, except fiscal capacity for the territories excludes resource revenues and is discounted by 30 percent (the Economic Development Incentive) that sustainably allows for below-average tax rates in a way that Equalization does not. Resource revenues are treated separately under Devolution Agreements with the NWT and Yukon.

Canada's North will be heavily affected by many challenges facing the country – especially climate change, the need for infrastructure, health care delivery, and the uncertain future of an economy tied to resource extraction. The TFF formula has many moving parts and although it is possible to forecast the direction in which each will be affected by national and provincial economic developments and policy changes, the overall effect will be more difficult to predict.

PROVINCIAL-MUNICIPAL FISCAL ARRANGEMENTS

Canadian municipalities receive, on average, 20 percent of their revenues from federal and provincial transfers. Although comparable, nation-wide data is not available that breaks down whether transfers to municipalities come from the federal or provincial governments or whether they are conditional or unconditional. The majority of transfers are from the provincial government and the bulk of them are conditional on being spent in certain ways on certain municipal services and infrastructure. For example, in 2019 Ontario municipalities received 17 percent of their revenue from provincial transfers and 4 percent from federal transfers, with the bulk of the provincial funding dedicated to shared services such as ambulance services, child care, public health, and social assistance. Both the level and the structure of transfers differ across provinces.

Provincial unconditional transfers take the form of direct grants, revenue sharing, and equalization. Direct grants are often per capita grants. In terms of revenue sharing, three provinces share provincial revenues with local governments. British Columbia shares traffic fine revenues and provincial gaming revenues; Saskatchewan shares provincial sales tax revenues with local governments on a per capita basis; and Québec shares natural resource royalty revenues with municipalities that have mining, oil, and gas production sites, and provides a share of the growth on one percentage point on Québec sales tax starting in 2021. Six provinces provide equalization grants to municipalities. In two provinces

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6 In 2004 the federal government replaced the previous TFF formula with a "New Framework" which established a funding envelope, escalated at a fixed rate, that would be allocated among the three territories, similar in concept to the envelope that is used for Equalization. This approach was opposed by the territorial governments and recommended against by the Expert Panel on Equalization and TFF on the grounds that creating a zero-sum game for funding the three territories was inappropriate, and ultimately was abandoned, and separate TFF arrangements for each territory were reintroduced in 2007-08.

(Nova Scotia and New Brunswick), the equalization formula explicitly recognizes expenditure needs and fiscal capacity. In those two provinces, equalization grants are differentiated by classes of municipalities to reflect wide divergences in expenditures and revenue-raising capacities of different types of municipalities within the province. Other provinces only take account of fiscal capacity although population size is sometimes used as a proxy for expenditure needs.

OTHER FEDERAL-MUNICIPAL TRANSFERS

The federal government gives conditional grants to municipalities and other local partners, either directly or through the provinces or municipal associations. These transfers are generally for housing, transit, economic development, climate change adaptation projects, and Indigenous services. The largest of these programs, the “Investing in Canada” plan, which began in 2015, is expected to disburse $180 billion over a decade for infrastructure. Some of these grants have gone to small projects, such as repairs and upgrades to local facilities, and some to much larger ones, such as new light-rail lines in Toronto, Calgary, and Vancouver. The federal government also funds affordable housing through a 10-year, $40 billion National Housing Strategy and it participates in “local immigration partnerships” that bring all orders of government and local service agencies together to assist in immigrant integration. Under Urban Programming for Indigenous Peoples, federal funds go to locally organized partnership organizations that set priorities and coordinate services.

The federal government provides block transfers for municipal infrastructure. The Canada Community-Building Fund (formerly known as the Gas Tax Fund) provides permanent funding for local infrastructure investments. Funds are allocated on a per capita basis with payments flowing to designated signatories – provinces, territories, municipal associations, and the City of Toronto. Few conditions are attached to these grants: funds have to be spent on municipal infrastructure, provinces cannot claw back their own funding, and municipalities are required to demonstrate progress toward meeting federal sustainability objectives. Importantly, most transfers of this kind flow through provincial and territorial governments, who are responsible for prioritizing projects and in many cases sharing costs with the federal government.

SPECIAL AD-HOC TRANSFERS TO DEAL WITH CRISES

As the pandemic made clear to all Canadians, occasional disasters require extraordinary fiscal responses. The federal capacity to absorb the shock of such events exceeds the provincial and territorial governments’ capacity, both individually and collectively. In particular, the federal government can pool risk across the federation, has greater fiscal capacity and access to a Canada-wide tax base, and can often borrow more cheaply than subnational governments. Thus, from an efficiency perspective, there may be gains from federally provided support to provinces and territories in the event of large, unexpected fiscal shocks. Two programs are highly relevant today and will become increasingly so in the future.

Fiscal Stabilization

Economies go through semi-regular periods of expansion and contraction. This business cycle affects individuals and businesses directly through changing employment and income, but it also affects government revenues. On the whole, approximately half of provincial government revenues come from taxes on incomes, profits, and consumption. And additional revenues come from selling goods and services or profits of government business enterprises. So when recessions strike and economic activity declines, the tax bases naturally shrink and therefore revenues to governments decline. Recognizing that demands for important public services such as healthcare and education do not decline during a recession – indeed, the reverse may be true – the federal government established in 1967 a program to effectively insure provincial government revenues against sharp and unexpected declines in revenues. This is the fiscal stabilization program.

Since its inception, the program has evolved into a relatively minor though simple federal transfer. If provincial revenues fall by more than five percent from one fiscal year to the next – importantly for reasons other than a tax change – and if either non-resource revenues also decline five percent or if resource revenues decline fifty percent, then the federal government will cover the excess revenue losses up to a certain maximum amount.[7] These thresholds are reached only rarely, but oil price declines starting in 2014 and more recently pandemic-related economic disruptions, have thrust this program to near the top of the federal-provincial agenda.

Natural Disaster Assistance

Natural disasters are another unforseen shock to provincial and territorial finances, but primarily on the expenditure side of their budgets rather than revenues. To help absorb such costs, the federal government established the Disaster Financing Assistance Arrangements (DFAA) program in 1970, which offers insurance-like protection to provinces and territories in the event of qualifying disasters. Extreme weather events and natural disasters, such as floods, ice storms, wildfires, and tornadoes, can cause significant damage. Individuals face financial costs from property and asset damage. There are costs associated with business interruptions, repairs to private and public infrastructure, and emergency response efforts, although lost income/profits/revenue are not eligible. Sometimes lives are lost. Provinces and territories are the first responders to a natural disaster and each has its own relief program. However, in the event of large-scale disasters, a province can request financial assistance under the federal government's DFAA program.

[7] This limit is set at $166 per capita in 2018, which increases or decreases according to national per capita nominal GDP growth from that year onwards.

The specifics of the program are fairly straightforward. The federal government reimburses provinces and territories for eligible disaster expenses above a certain population-based threshold. Eligible expenses include provincial expenditures on evacuation, emergency shelter and food, and repairs to public roads and bridges; losses that could otherwise be covered by private market insurance at a reasonable cost are not covered. The federal cost share and thresholds in effect for 2021 are shown in Table 2. The nominal thresholds, unchanged since 1970, were increased in 2015 and indexed to annual inflation moving forward.

Table 2: DFAA Cost Sharing, as of January 1, 2021

Eligible provincial per capita expenses	Federal Government's Cost Share (%)
First $3.27	0
Next $6.56	50
Next $6.56	75
Remainder	90

Source: https://www.publicsafety.gc.ca/cnt/mrgnc-mngmnt/rcvr-dsstrs/dsstr-fnncl-ssstnc-rrngmnts/index-en.aspx

The design of the program ensures that provinces bear a greater share of the response and recovery costs for smaller disasters and the federal government bears the largest burden in the case of very costly natural disasters.[8] Recent DFAA payments include $98 million for the Ontario winter ice storm in 2013 and $39 million to cover costs relating to extensive flooding in New Brunswick in 2018. Godsoe, Ladd, and Cox (2018) estimate average annual DFAA expenditures of $216 million (2016 dollars) over the period between 2005 to 2015.

The DFAA program has undergone few changes over the past 50 years but challenges on the horizon may necessitate a need to revisit possible reforms. There are concerns that ex post disaster support to the provinces can mute incentives to undertake investments in order to reduce the risk of future damages from such events. There is mounting concern, in Canada and around the world, over increasing disaster risk and the potential for climate change to increase the frequency and severity of disasters and extreme weather events. Questions over how best to manage and reduce the financial risk associated with natural disasters in Canada are likely to become more pressing. And while the DFAA does not cover pandemics, the recent COVID-19 experience has brought a heightened awareness of the role of fiscal federalism and risk sharing in the Canadian federation.

8 Recent analyses relating to the DFAA program include Davies (2020) and Parliamentary Budget Officer (2016).

02

Challenges for Canadian Fiscal Federalism

Canada's intergovernmental and fiscal arrangements have evolved over 150 years, confronting unique social, political, economic, and fiscal pressures. Looking ahead, several developments will increasingly strain our current arrangements. Some pressures are fundamental, resulting from external or exogenous developments, while other pressures stem from deliberate internal policy choices, sometimes compounding over years. Finally, other pressures reflect entrenched political dynamics that ebb and flow throughout Canada's history and warrant special attention.

Today, several pressure points are developing simultaneously but none are unmanageable. But without policy reform in several areas, the prosperity and resilience of Canada's economy may suffer. In this section, we document these pressure points and why a close and careful examination of policy options is necessary.

External Challenges

All governments must grapple with external challenges that constrain the fiscal and economic resources available to them. Canada, along with many other countries, faces a number of pressing challenges that will mount in significance over the coming decades. Many of these – aging populations, climate change, energy transitions – are already having an effect on government finances in Canada but will become significantly more pressing. Addressing these challenges today through gradual and well considered action will ensure we can continue to grow the prosperity of Canadians.

DEMOGRAPHICS

Canada, like many countries, is experiencing rapid population aging. The share of its population over age 65 is projected by Statistics Canada to increase from 18 percent currently to nearly one-quarter by 2050. In a fast-aging scenario, this share could reach as high as 27 percent. A greater challenge for fiscal federalism than overall aging, however, is the rate at which this is expected to occur in different regions of the country. Newfoundland and Labrador, for example, may see the proportion of those aged 65 and over increase from 22 percent today to over one-third by 2050. Meanwhile, in Alberta it is expected to reach 20 percent. Most significantly, the five provinces with the smallest share currently (that is, Ontario westward) will experience an average increase in their elderly populations of 5.3 percentage points. The five provinces with the highest current share (Quebec eastward) will see an increase averaging 7.7 percentage points. This will have implications for healthcare costs and rates of economic growth.

The implications for healthcare are significant. As a person ages, health challenges become more frequent and more complex. Average spending on older age individuals by provincial government health systems therefore rises rapidly as one ages. According to the latest data from the Canadian Institute for Health Information (CIHI) for 2018, provincial and territorial governments spend nearly $29,000 on average per year per individual over the age of ninety compared to between $2,000 and $3,000 per year for individuals in their twenties and thirties. More elderly individuals will almost inevitably result in higher healthcare expenditures. Indeed, we have already seen such increases. Between 1998 and 2008, for example, the CIHI estimates that nearly 1 percent per year in public-sector health spending growth was accounted for by population aging.[9] Estimates from Tombe (2020) suggest this pace of additional healthcare cost growth may continue for another quarter century – equivalent to adding potentially as much as two to three percentage points of GDP to health spending. This is significant and will undoubtedly strain provincial budgets.

The implications for economic growth and potentially widening horizontal fiscal inequalities are no less dramatic. After all, as populations age the share of working age individuals declines. For Canada as a whole, the roughly two-thirds of individuals who are of working age today is set to decline to just over 60 percent by 2050. This five percentage point decline over the span of the next fifty years is equivalent to lowering real economic growth by 0.3 percentage points per year, leaving the economy roughly 7.5 percent smaller by 2050 than it would otherwise have been in the absence of population aging. And the drag on growth is substantially larger in some provinces than in others. The annual drag for Newfoundland and Labrador may exceed 0.5 percentage points per year compared to less than 0.2 percentage points for the Prairie provinces and 0.3 percentage points for Ontario, Quebec, and British Columbia. This matters for provincial finances and fiscal federalism since slower economic growth translates into slower government revenue growth due to income and sales tax revenues in particular growing more slowly.

CLIMATE CHANGE AND CLIMATE POLICIES

Human activities, such as the burning of fossil fuels, release greenhouse gases into the atmosphere, where they remain for a long period of time. This atmospheric stock of greenhouse gases traps heat, causing an increase in average global temperature. Climate change refers to the longer-term changes in average weather and climate that are occurring as a result of this global warming effect.

Climate change is a global problem that requires cooperation on a global scale. In 2015, countries around the world committed to lowering their greenhouse gas emissions under the United Nations Framework Convention on Climate Change (UNFCCC) Paris Agreement. As part of this agreement, Canada committed to reducing its emissions by 30 percent below 2005 levels by 2030. A recent announcement by the Prime Minister indicates that the federal government intends to replace this target with a more ambitious 40 to 45 percent reduction by 2030. The scale of the problem dictates that a variety of policy tools will be needed but carbon pricing policies, like carbon taxes and cap and trade schemes, will likely play an important role given the ability of these policies to incentivize cost-effective emissions reductions. The question of what level of government in Canada has constitutional authority over policies to cut GHG emissions and mitigate climate change remains quite murky.

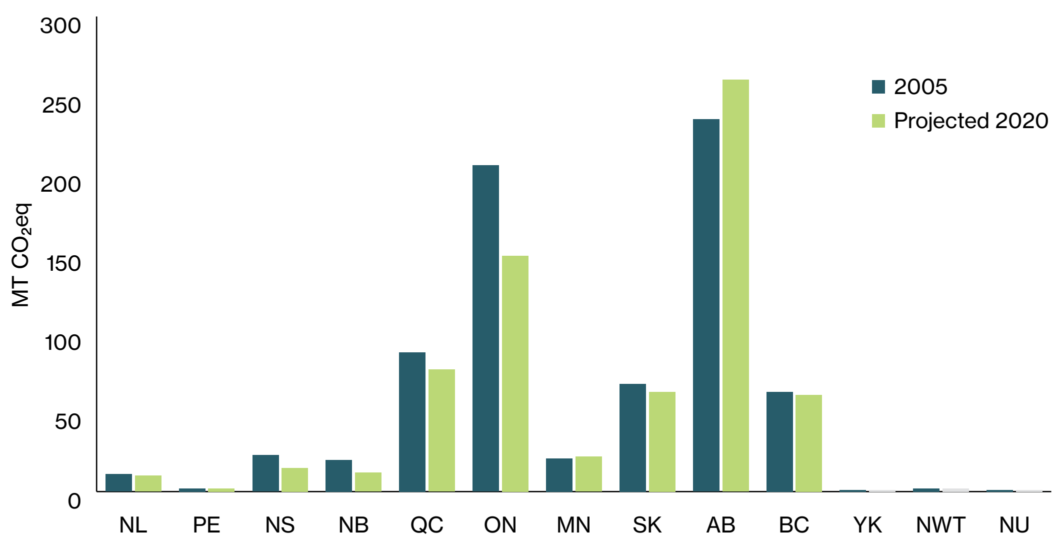
[9] health_care_cost_drivers_the_facts_en.pdf (cihi.ca)

Prior to 2018, some but not all provinces had adopted their own emission-reduction targets and a few had implemented carbon-pricing schemes. This decentralized approach had the advantage of ensuring provinces could design and implement policies suited to their own unique circumstances. But a decentralized approach to tackling climate change also came with challenges. Not all provinces chose to implement carbon-pricing policies or policies that would bring about significant emission reductions. Provinces lacked a credible mechanism for coordinating their actions and there was no guarantee that provincial actions would achieve emission reductions required to achieve Canada's national target under the Paris Agreement. Partly in response to these challenges, the federal government introduced its *Greenhouse Gas Pollution Pricing Act* (and carbon price backstop) in 2018. The legislation requires that provinces impose, on a broad base of emissions, a minimum carbon price that rises over time. If a jurisdiction does not implement a carbon price satisfying these requirements, the federal government imposes the carbon price backstop, as needed.

Ontario, Alberta and Saskatchewan challenged the constitutionality of the federal government's legislation, arguing that the provinces had authority over natural resources, but in March 2021, the Supreme Court ruled the federal carbon-pricing law was constitutional.[10] It found that because global warming causes damage that spills over provincial borders, reducing greenhouse gases was a matter of national concern and the federal government could intervene in matters that would otherwise fall under provincial jurisdiction.[11]

Figure 6: Greenhouse Gas Emissions in Canada, 2005 and 2020

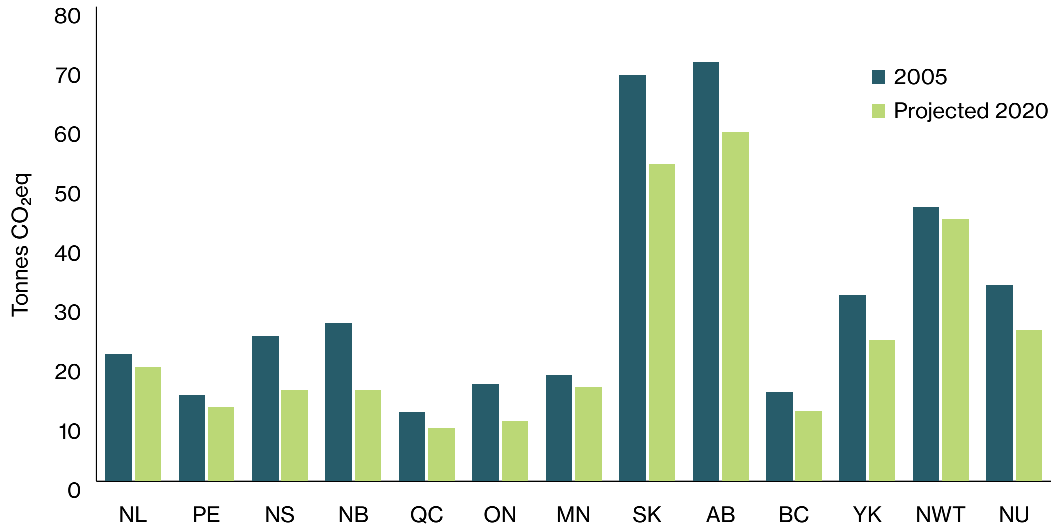
(a) Total Emissions



[10] https://decisions.scc-csc.ca/scc-csc/scc-csc/en/item/18781/index.do

[11] https://www.scc-csc.ca/case-dossier/cb/2021/38663-38781-39116-eng.aspx

(b) Emissions per Capita



Sources: Author's tabulations. GHG emissions from Environment and Climate Change Canada. Canada's Greenhouse Gas and Air Pollutant Emissions Projections 2020. Population taken from Statistics Canada, Table 17-10-0005-01, "Population estimates on July 1st, by age and sex.

The Supreme Court's decision brought clarity on the constitutional question but climate change continues to present serious challenges to fiscal federalism and fiscal relations in Canada. The federal government's carbon backstop helps to overcome the coordination challenges to implementing climate-change policies in a decentralized federation. Provinces and territories continue, however, to express concern about how the federal policy limits their autonomy and flexibility to design their own policies. The issue of interregional equity and burden sharing is particularly acute in the case of climate-change policies owing to the uneven distribution of GHG emissions across the country (see Figure 6).[12] Jurisdictions with comparatively high concentrations of emission-intensive and trade-exposed economic activity within their borders are particularly apprehensive about bearing a disproportionate burden of the costs of achieving a national emission-reduction target.[13] Climate-change policies in the form of carbon-pricing policies also have the potential to significantly impact Canada's Equalization program, an already politically charged and controversial issue in federal-provincial fiscal relations. The uneven distribution of emissions and per capita carbon-price revenues across provinces can affect both the size of the program and the allocation of payments to provinces.[14] Impacts depend on variations in provincial carbon-pricing policies and how the federal backstop is applied. Dramatic increases in the minimum carbon price, like the federal government's plan to increase the minimum carbon price from

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12 This issue is explored in Bohringer et. al. (2015). The paper investigates the role of alternative burden sharing rules in addressing interregional fairness issues that arise when achieving a national emissions reduction target using a Canada-wide cap and trade system.

13 Differences in carbon prices across emissions sources and jurisdictions can result in emissions leakage and put some sectors located in higher carbon price jurisdictions at a competitive disadvantage. Canada's Ecofiscal Commission (2015) finds the competitive pressures are comparatively small, given a Canada-wide carbon price of $30 per tonne. What is not clear is how much these pressures increase if the difference between Canada's minimum carbon price and the carbon price in the rest of the world increases significantly.

14 This issue is explored in Snoddon and Tombe (2019).

$40 to $170 a tonne by 2030, will intensify concerns over interregional burden-sharing, provincial autonomy, and equalization impacts moving forward.

NATURAL RESOURCES

Canada is one of the fortunate few countries to have well-endowed and well-managed natural resources. According to the World Bank, natural-resource rents represented 2.5 percent of Canada's GDP in 2018, with Canada ranked 14th in terms of total resource rents. Among the OECD countries, only the United States and Australia had larger resource rents; Canada tied with Mexico for third. For many countries, resource revenues have been more of a curse than a blessing, but in his review of the factors that contribute "resource curse," van der Ploeg (2011, p. 383) concludes that Canada is one of the few countries that has strong institutions for managing resources and has not experienced the "curse."

With few exceptions, the Canadian constitution vests the management of non-renewable natural resources, forestry resources, and electrical energy with sub-national governments. This includes the power to levy mining taxes and royalties. At least part of the reason for Canada's successful development of its resources has been the decentralized control of natural resources. The other large resource rich countries that have been successful in developing their resource base – Australia and the United States – are also federations where the states have substantial powers over the development of these resources and collection of royalties and severance payments. Many other countries with centralized control of natural resources have been limited in their ability to develop resources by opposition from local communities because they do not directly benefit from resource development. Some have faced violent regional conflicts and secessionist wars.

While the decentralized control of natural resources has contributed to successful resource development, it presents fiscal challenges for a federation because resource rents are often regionally concentrated. The resource-rich provinces have greater fiscal capacity from the resource rents and higher incomes generated from resource development. The resulting fiscal disparities among the provinces can lead to fiscally induced migration of labour and capital, causing unequal economic activity, as well as concerns about horizontal fiscal equity. For these reasons, most normative models of fiscal federalism recommend that the resource revenues be assigned to central governments (see Musgrave, 1983). Given that the constitution gives the provinces control over natural resources, Canada has dealt with the fiscal issues arising from provincial control of natural resources mainly through the federal Equalization program. The challenges of incorporating resource revenues in the equalization program will be discussed later in this report.

Natural resource development is now straining the relations between the federal and provincial governments, given their conflicting views on how to mitigate the environmental impacts of this development. Policies have been enacted that have severely restricted new pipelines and more onerous regulations and reviews of new investments projects have been adopted. These conflicts have economic and fiscal implications because natural resource industries have been major sources of income growth for middle-income Canadians in the last two decades.[15]

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[15] Green, Morissette, Sand, and Snoddy (2019) concluded that the resource boom was responsible for about half of the increase in average real wages in Canada after 2000.

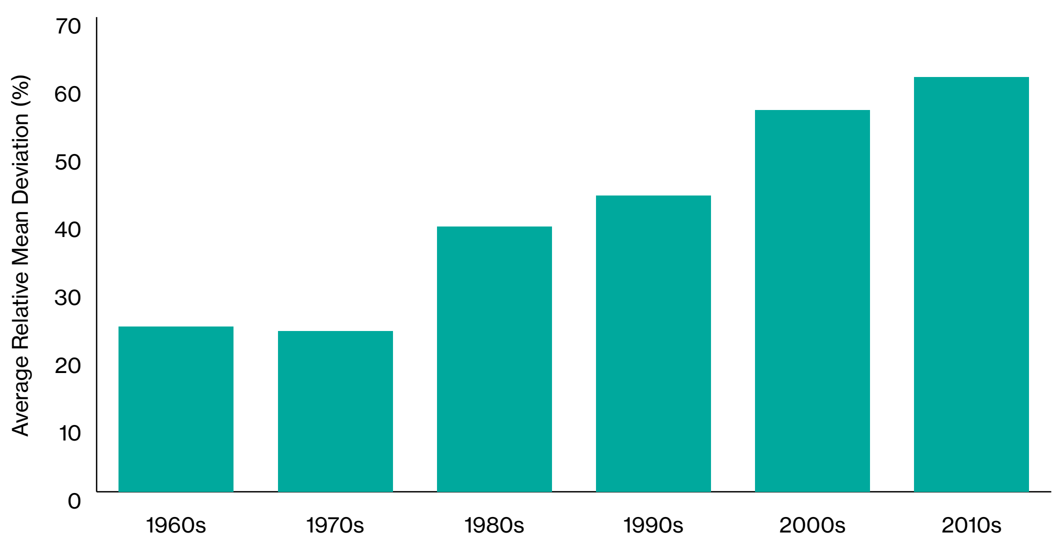
REGIONAL VARIATION IN ECONOMIC VOLATILITY

Short-run economic fluctuations such as recessions affect a variety of expenditure and revenue items at all levels of government. On the revenue side, personal and corporate income taxes, payroll taxes, and sales taxes, for instance, tend to mirror these fluctuations, while price fluctuations in the natural resources sector directly influence revenues levied on the related economic activities. On the spending side, EI and other social assistance programs act as automatic stabilizers, leading to increased spending during downturns.[16]

As both the provinces and the federal government tax the same major tax bases, they are affected similarly during general downturns. Conversely, fluctuations in resource prices tend to affect some provincial governments much more directly than they do the federal government. On the spending side, the federal government, with its responsibility for EI, is arguably affected most directly by recessions than the other levels of government.

Overall, the federal government is in the best position to pool risks across regions of the country; that is, it is able to balance, say, increases in EI in some regions with revenue increases in other regions. This "automatic" risk pooling at the federal level facilitates the continued provision of federally provided services. However, similar within-province (or *a fortiori* within-municipality) risk pooling, if it exists at all, operates on a much more limited basis and is most likely limited to the larger, most economically diverse provinces or municipalities. This is an important threat to the stable supply of public services provided at the provincial and local levels, as provinces and municipalities faced with unexpected adverse economic shocks may need to cut services as their revenues plummet (especially if they face stark borrowing constraints).

Figure 7: Variation in Provincial Economic Growth Rates, 1961-2019



Source: Own calculation from Statistics Canada data tables 36-10-0325 and 36-10-0222
Note: Displays the average absolute value of the difference between provincial GDP growth rates and the national average, expressed as a share of national growth rates.

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16 On automatic stabilizers at the federal level (EI, payroll taxes and PIT), see Fuss and Palacios (2019).

The scale of this challenge is growing larger, and current fiscal arrangements are ill-suited to this shift in Canadian regional economic volatility. Figure 7 illustrates one measure of how different provincial economic growth rates are from each other. In a typical year, some provinces are growing faster than average while others are growing slower or potentially shrinking. The typical difference between provincial growth rates and the national average growth, expressed as a share of the national growth rate, is illustrated for each decade since 1961. A value of 25 that prevailed in the 1960s and 1970s means that if national economic growth is 4 percent, then provinces typically deviated by 1 percentage point from that (25 percent). Today, this value exceeds 60, and therefore if national growth is 4 percent then provinces typically deviate by nearly 2.5 percentage points. These are large differences that many current arrangements – which are indexed to national economic growth rates and largely unaffected by provincial business cycles – do not address. The fiscal stabilization program, which is the single federal-provincial transfer that explicitly aims to pool economic risk across provinces, is heavily circumscribed.

Internal Challenges

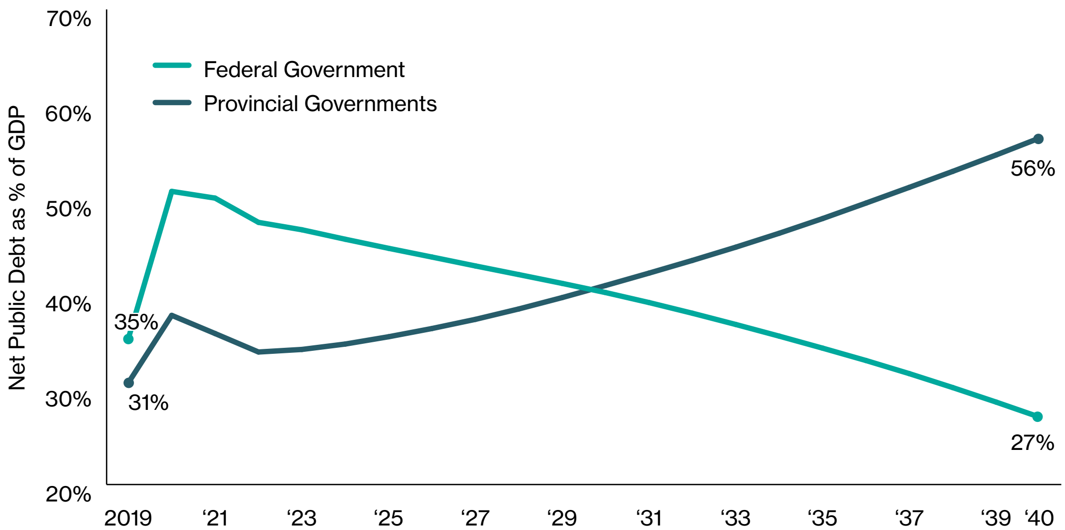
Significant external pressures are not the only challenges facing government finances. Several internal ones result from policy choices that will create escalating risks or structural imbalances in the years ahead. The rising level of provincial debt, for example, combined with long-run external sources of fiscal pressures make some government finances in Canada unsustainable. In addition, recent policy choices by federal, provincial, and municipal governments are pushing against traditional divisions of responsibility in core public services and income support programs. We shine a light on these challenges here, starting with long-run sustainability of government (especially provincial government) finances.

FISCAL SUSTAINABILITY

Rising debt levels following the COVID-19 pandemic have raised concerns around public debt sustainability in Canada and around the world. Some point to the large federal borrowing through 2020 and 2021 as concerning in that respect and others point to mounting demographic pressures facing provinces as even more so. Sustainability can mean different things to different people, but in a narrow technical sense, fiscal policy is sustainable if it can continue in the foreseeable future without requiring fiscal adjustments. If tax rates are sufficient to fund public services over the long-term, then fiscal policy is sustainable. Whether large debt levels today are unsustainable or not depends on several factors, from future interest rates and economic growth rates to future revenues and program expenditures.

The complex analysis behind debt sustainability is less important than appreciating a simple rule-of-thumb: government debt levels cannot indefinitely grow faster than the economy as a whole. At some point, it would be impossible to service and fiscal policy would require potentially dramatic adjustment. A simple guide to sustainability is therefore the trajectory of government debt-to-GDP ratios. We illustrate one set of recent estimates from Tombe (2020) in Figure 8. And the differences between the two main orders of government could not be starker.

Figure 8: Public Debt to GDP, by Order of Government



Source: Trevor Tombe, "Provincial Debt Sustainability in Canada: Demographics, Federal Transfers, and COVID-19" (2020) Canadian Tax Journal. For an interactive simulator of projected public debt levels, see Finances of the Nation, https://financesofthenation.ca/fiscal-gap-simulator/

Note: Displays projected government net debt levels from Tombe (2020), Finances of the Nation. Update from Budget 2021.

Fiscal pressures facing Canada's federal and provincial governments vary widely. As provinces are responsible for healthcare, they are differentially exposed to escalating cost pressures due to an aging population. The federal government, meanwhile, is only exposed to such demographic pressures through its income-support programs for elderly individuals, such as the Old Age Security (OAS) and Guaranteed Income Supplement (GIS) programs. And since federal revenues tend to keep pace with economic growth while provincial revenues do not, this adds to fiscal pressures facing provincial governments. This means provincial governments are more fiscally constrained and less fiscally sustainable than the federal government. In addition, as provinces have smaller and less diversified economies relative to the country as a whole, they normally face additional volatility, and therefore fiscal risk, than the federal government.

To be sure, unsustainable provincial finances are not universal. Some, such as Quebec, with its higher tax rates, appear to have sufficient revenues to meet even escalating program expenditure pressures over the long-run (PBO 2020; Tombe 2020). At the other extreme, Newfoundland and Labrador is facing the prospect of a gradually declining population and levels of economic activity, along with a more rapidly aging population. This combines with an already elevated level of public debt to make long-term fiscal sustainability a particularly difficult challenge for this province. Provincial governments, however, do have access to all the major tax bases and can determine their own rates. Increasing tax rates may be an important option for some governments to consider as expenditure pressures mount.

INCOME SECURITY PROGRAMS

The existing division of responsibilities for income security between levels of government are arbitrary, and fail to address the material needs of vulnerable Canadians under the age of 65 who cannot maintain strong attachment to the labour force. As it stands today, federal income security programs cover all Canadians aged 65 and over and the majority of working Canadians in formal employment paying into the Employment Insurance program. The provinces, and sometimes local governments, are responsible for the income security of Canadians under the age of 65 with weak attachment to the labour force, or incapacity to work for pay. As with earlier economic shocks, the COVID19 pandemic and the federal government's demonstration of its vast fiscal capacity relative to the provinces has renewed the public interest in the federal government assuming full responsibility for income security with some form of a "universal income security program."

There is perhaps no more dramatic change in the roles of the federal, provincial and local governments than with respect to income security. Prior to 1927, full responsibility for income security through "local relief" rested with local and provincial governments. Their role was providing meagre residual support after the exhaustion of personal means, charity and family support. There is little evidence available on the economic status of seniors prior to the 1927 means-tested old age pensions. Prior to 1927, paid labour played a significant role in senior income maintenance, and male labour force participation for ages 65 and older was around 60 percent. Seniors unable to earn adequate income through their labour needed to seek alternative means, such as charitable organizations and institutions, government and commercial annuity programs, and income support from children.

The first big shift in income security responsibility to the federal government was based on the ages of those in need, and shifted the income support from a residual source of income to being an income floor for those entitled by age and citizenship. Over time, changes in the age of entitlement for federal pension benefits has shifted responsibility for income security between the federal government and the provinces. By the late 1920s when average life expectancy was less than 70 years, the federal government had introduced cost-shared non-contributory senior pensions for Canadians aged 70 to relieve the fiscal burden on provinces of a perceived growing problem of poverty among the growing urban elderly population. The aftermath of the Great Depression saw full responsibility for income support for Canadians aged 70 and over move to the federal government in 1952, while the cost shared pension with provinces was extended to Canadians aged 65 to 69. By the 1960s, the federal government assumed increasing responsibility for Canadians aged 65 and over, and it enriched the income support system with the introduction of the income-tested Guaranteed Income Supplement (1967) and the contributory Canada Pension/Quebec Pension Plan (1965).

With each change to federal pension eligibility, responsibility for income security increasingly shifted from the provinces to the federal government. With each federal pension benefit enrichment, the disparity in incomes between federally supported and provincially supported citizens grew. As late as 2015, the federal government was planning to raise the age of entitlement for the non-contributory pensions (OAS and GIS) from age 65 to age 67, shifting income security responsibility of those Canadians back to the provinces.

Where federal pensions apportioned income support responsibilities between federal and provincial governments based on age, Unemployment Insurance (UI) and its successor program, Employment Insurance (EI), has shown more fungible boundaries for income security responsibility. Originally introduced in 1940 on insurance principles, UI has evolved from covering under half of the paid workforce consisting of non-government regular workers under an income ceiling and excluding seasonal and other workers most likely to experience unemployment. Over time coverage of the workforce has expanded to cover seasonal workers. The Unemployment Insurance Act of 1971 created nearly universal coverage with the inclusion of employees for whom the likelihood of unemployment was very low including public sector employees at all levels of government. The range of benefits provided expanded to cover maternity and parental leaves, short-term sickness and disability, compassionate leaves from work and training benefits. Any Canadian not covered by UI/EI and under the age of eligibility for federal pension benefits remained the responsibility of the provinces, which continued with their largely residual role in the income support system.

Economic shocks have been a major driver of the shift in income security responsibilities. The fiscal and economic devastation on public finances in the 1930s resulted in the federal government needing to bailout provinces that lacked the revenues to meet local relief obligations as local government fiscal capacity to pay income support for the unemployed were exhausted. That led to the introduction of a national Unemployment Insurance program in 1940, later reformed in the 1990s to the Employment Insurance program, which was enacted to insure the majority of working Canadians against temporary income loss due to loss, or interruption, of employment. With the extension of benefit coverage, and increased generosity of benefits after 1971, UI costs rapidly increased and were then compounded by recessions in the 1980s and 1990s. In 1996, UI was reformed and renamed Employment Insurance to address costs of the program to the federal government. The entire cost of EI since 1996 has been underwritten by employers and employees according to premiums set by the federal government. Originally contribution rates were set to cover the EI program's cumulative deficit from the 1990s but as the economy recovered those rates generated large sustained EI surpluses, which were treated as general revenue of the federal government.

The same EI reforms that enriched federal revenues also put spending pressure on provincial social assistance programs. In addition, the provincial budget crises of the 1990s associated with restrained federal transfers to provinces revealed the interaction of provincial income supports like social assistance and disability supports with federally administered EI and CPP/disability. Provinces changed their eligibility criteria for social assistance, or created training programs to shift some of their spending load from provincial programs to the federal programs.

As in the 1930s, the COVID19 pandemic revealed that the capacity of the federal government to provide emergency relief to those who cannot work and/or who are not covered by EI far exceeds that of the provinces and local governments. And not surprisingly, the pandemic spurred interest in Canada in a national minimum income/basic income as the Federal government already provides to Canadians 65 and older. Provinces have flirted with the idea of having the federal government transfer revenue to support provincial minimum income strategies (Newfoundland Royal Commission in 1986 and British Columbia in 2021) but it seems that any move toward a comprehensive, universal income security system is likely to be associated with the federal capacity to finance and deliver the program given they are already doing so for seniors and Canadians in the labour force. Effectively, a federal universal income security system would have the federal government taking the final step of taking over provincial responsibility for income security of citizens who are currently reliant on provincial social assistance and income support for those with disabilities.

THE CHANGING ROLE OF MUNICIPALITIES

Our underlying framework for the revenue powers and spending responsibilities of the federal and provincial governments was established in the nineteenth century when government was small and the national interest in spurring economic growth was based on rural hinterland resource development and production for export. Today, the roles of government in society are larger, our population is highly concentrated in cities and many contend that city focused growth is the new national interest. The difficulty with these changes in the relative role of local government is population growth, and the pressures of a growing economy are now alleged to be more of a burden for cities than a benefit under the existing fiscal framework. Mayors of cities argue that they pay for the nation's growth while senior levels of government reap the rewards. Thus, the combination of the rise in the potential political influence of urban voters and the increased reliance of cities on senior levels of government for revenue to maintain the strong growth of urban economies is creating pressure to evaluate the appropriate fiscal relationships between local governments, their provincial overseers, and the federal government.

Because they have no constitutionally designated spending or revenue responsibilities, cities are "creatures of the provinces." They are not formally a third level of government yet cities are important vehicles through which the provinces deliver a wide range of publicly provided goods and services. A century ago, cities and other municipalities were largely feral creatures as local governments were largely self-supporting, relying on their own revenues and capacity to borrow to pay for expenditures. Municipal governments in aggregate had higher revenues and higher expenditures than the provincial and federal governments despite the fact that the majority of Canadians did not live in urban communities. By the end of the Depression, provincial government spending and revenues equaled those of the municipal governments. Today, local government expenditures in Canada amount to less than one-quarter of provincial government expenditures even though the majority of Canadians live in cities.[17]

Local government's historic importance occurred when the state had less direct involvement in the economy or society. With the experience of the Depression, two World Wars, the rise of publicly provided health insurance, the growing demand for post-secondary education, and general growth of the welfare state, the demand for government involvement in the economy and society has grown enormously, and much of the growth has been in functions deemed best suited to the senior levels of government.

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17 At the time of Confederation, when most of the statutes and structures of municipal government were established, less than 20 percent of Canada's population lived in what were considered urban areas. By 1930, half of Canada's population lived in urban areas, by 1961 two-thirds did and today, three-quarters do. In the last half-century, the character of urbanization has changed as well as much of the rise of the urban population is occurring in the largest cities. The latest 2016 Census, for example, shows 36% of Canada's population lives in the country's three largest cities of Toronto, Montreal, and Vancouver.

The scale and scope of government activities have grown at both the local and provincial levels, but the growth has been much larger at the provincial and federal levels. Some of the growth of the provincial government's spending has come from taking over responsibilities such as social services from the local governments after the 1930s, but in large part it has come from the emergence of a much greater role for government in our society particularly for the payment of medical treatment, old age income supports and employment insurance. In effect, the provinces and the federal government assumed responsibilities like social assistance and pensions when they were growing, but still small, expenditures. It was under provincial, and in some cases, federal jurisdiction that these spending responsibilities grew to be large.

The urbanization of Canada's population has important implications for the changing perceptions of the ideal relationship between local and senior levels of government. In the past, provincial and federal government spending and investment in rural areas to promote agricultural, mineral, energy, timber and other resource development and production was viewed as beneficial for the urban areas that provided the goods and services for the rural population. In other words, spending to support natural resource activities had at least a potential benefit for urban populations. Primary industries and tariff-protected manufacturing offered relatively well-paid jobs to lower educated workers in both rural and urban areas.

Over the past decade or more, Canadian economic growth has primarily been seen as urban economic growth driven by large cities with a knowledge economy sector. The labour market has shifted away from providing stable jobs for lower-educated, lower-skilled workers while increasing the returns to urban-dwelling, higher-educated, higher-skilled workers, creating new challenges with a growing economically disadvantaged population congregating in cities. Mayors argue that senior levels of government in Canada reap the public revenues associated with urban economic activity of the knowledge-based economies, but the local governments get the responsibilities for accommodating the growth of the economy and population as well as the social costs of the post CUSFTA/NAFTA economic transition.

With these changes in Canada's economy and society, how urban voters view provincial spending on rural priorities has changed as well. Much of the shifting relative importance of local public capital in the public discourse reflects that much of the economic growth in Canada over the past few decades has been urban growth and development – less around hinterland resource development with spillovers to urban areas that was a more prominent focus for the federal and even provincial governments. Of late, many of the infrastructure investments that are demanded by urban voters have localized benefits, often non-pecuniary (quality of life) as opposed to broader pecuniary benefits beyond the locale. From this perspective, spending in rural areas on declining resource and agricultural sectors is rivalrous spending for the industrial and service sectors located in urban areas. To some extent, maybe the relevance of the provincial governments for urban dwelling Canadians is in question given the belief of urban voters that most economic growth and activity in Canada today is caused by cities and could be supported directly by the federal government.

Mirroring the fiscal federalism debates around the division of powers and revenues between the federal and provincial governments, local governments are calling for changes in their relationship with the provincial governments so that they would have the necessary revenues to finance infrastructure needs, addressing urban social challenges like homelessness, while maintaining their political and fiscal autonomy. Is it a good idea to have a greater share of senior levels of government revenue go to cities? When considering this question, one must not neglect that over the last century, provinces have given birth to many other creatures that must also be fed from the treasury. Spending on health care, education, economic development, the environment and other provincial responsibilities benefit residents of cities.

INFRASTRUCTURE

Public infrastructure – the transportation, environmental, educational, and recreational facilities that are provided by governments – contributes to the quality of life and the productive capacity of Canadians. Approximately 60 percent of public infrastructure is owned and maintained by local governments, and most of the remainder is owned by provincial governments and territories. Although the federal government is responsible for only a small share of the public infrastructure in Canada, over the last two decades it has established a series of infrastructure grant programs for the provincial and municipal governments – federal infrastructure grants that have become a permanent feature of Canada's fiscal transfer system.

The rationale for federal involvement in financing provincial-municipal infrastructure is often based on four factors – inter-provincial infrastructure benefit spillover, federal revenues from productivity-enhancing infrastructure, the federal government's superior fiscal capacity, and the pursuit of national objectives. The first three factors provide a rationale for matching infrastructure grants that incentivize provincial and municipal governments to undertake specific projects with these features (see Dahlby and Jackson, 2015). The fourth rationale, pursuit of national objectives, provides the federal government with carte blanche to intervene in the provision of provincial and municipal infrastructure and expand the role of federal government in areas of provincial responsibility.

Unfortunately, the federal government has used this rationale to fund a large number of small projects that only benefit local communities. Given the significant administration and coordination costs of infrastructure grants that involve two and sometimes three levels of government, federal funding of small projects is very difficult to justify.

For large projects with national benefits, priority setting and coordination requirements are crucial. The failure to agree on a list of priority long-term projects in favour of "shovel-ready" stimulus spending leads to long delays in the approval and implementation of the projects and discourages complementary investment by the private sector (e.g., ports, airports, railways, terminals). Based on the World Economic Forum rankings, Canada has fallen out of the top ten to 26th overall and 32nd for transportation infrastructure. Some have also raised concern for Canada's reputation over independent project assessments, which is especially important when infrastructure planning and decision-making operate on far longer time horizons than the typical electoral cycle. Australia and, more recently, the UK have established national infrastructure commissions that include significant subnational and private sector involvement (Canada West Foundation, 2022).

The PBO (2020) has raised concerns about data gaps on federal transfers, lower than anticipated economic impacts, and the absence of incremental spending by provincial governments. Increases in block transfers to the provincial governments could simplify the process and directly address the concerns regarding provincial and municipal government capacity to finance public infrastructure for projects that do not require the degree of coordination of major national infrastructure.

Federal-Provincial Political Dynamics in the Federation

Finally, Canada is experiencing rising regional and political tensions that, while a regular feature throughout Canada's history, require careful consideration. In addition, several of the above challenges may exacerbate ongoing debates around imbalances – real or perceived – between orders of government.

FAIRNESS AND THE EQUALIZATION DEBATE

In Canada, complaints about the fairness of fiscal federalism are hardly new. In fact, we can say that controversies about whether fiscal arrangements treat all the provinces fairly is as old as Canada and the debate over "better terms" for Nova Scotia in the late 1860s. Considering the sheer size of the country and the existence of strong regional and provincial identities, fairness concerns can rapidly become political, as elected officials claim their province is disadvantaged by existing fiscal arrangements. Certainly, equity is a key issue as far as fiscal federalism is concerned, regardless of the program at hand. This is why, in recent years, fairness issues have been raised in areas as different as health transfers and fiscal stabilization, among others.

A striking example of grievances about the fairness of fiscal federalism is the ongoing debate about the federal equalization program, which has faced criticism from wealthier provinces since its inception in 1957. This reality stems from the simple fact that equalization payments only go to provinces located below a national average for fiscal capacity while the other provinces do not. Such a situation creates tensions in and of itself, as provinces that do not receive benefits may find equalization payments excessive and unfair, a theme central to the grievances expressed by the Ontario government since the creation of the program in 1957. Yet in recent years, two factors have been especially likely to trigger political complaints about the fairness of equalization policy. First, when provinces that currently receive equalization are at risk of losing these transfers because their relative fiscal capacity is increasing and/changes to the equalization formula are enacted, they are likely to decry the program as unfair, as both Saskatchewan and Newfoundland and Labrador did in the mid-2000s. In both cases the issue of how natural resources play a role in equalization policy shaped some of the grievances over the loss of equalization payments.

The fairness of equalization policy has become a key policy issue in both Alberta and Saskatchewan in the broader context of growing economic anxieties and policy disagreements with Ottawa that fuel intergovernmental conflict, in which fiscal federalism and horizontal redistribution remain front and centre.

Second, provinces that do not receive equalization payments while facing major fiscal and economic hardships at home are likely to stress the seemingly unfair nature of equalization, as their taxpayers help finance equalization during a downturn while the province does not receive a penny from it because of the way the program is designed. This sense of unfairness is exacerbated by more general political and economic grievances about the federal government and other specific federal policies, and by the perception that equalization has been used by federal politicians to “buy” votes in other parts of the country. This is especially true when these other regions do not seem to share the economic and environmental vision articulated by the governments of provinces that are struggling but do not receive equalization payment. The criticisms of equalization that are currently articulated by the governments of Alberta and Saskatchewan illustrate this reality. This quote from the May 2020 report of the Alberta Fair Deal Panel illustrates grievances about equalization in the province: “Many Albertans raised the inherent unfairness in the equalization formula and the whole concept of equalization within a federation like Canada. While most people do not disagree with the merits of sharing with other Canadians, the way this equalization of opportunity was achieved across Canada seems unfair, even punishing, to Albertans” (p. 6). This sense of unfairness extends beyond equalization to include how Alberta is treated by the federal government in a more general manner, especially the relationship between the high amount of federal taxes paid by Albertans and the comparatively low federal transfers and investments the province receives from Ottawa.

The perspective of the Saskatchewan government is similar, as grievances about equalization also reflect broader concerns about federal policies toward the province, a situation amplified by policy disagreements with Ottawa over energy and environmental policies, including pipeline projects, in a context of regional economic downturn stemming from lower commodity prices, especially oil prices. Considering this, the fairness of equalization policy has become a key policy issue in both Alberta and Saskatchewan in the broader context of growing economic anxieties and policy disagreements with Ottawa that fuel intergovernmental conflict, in which fiscal federalism and horizontal redistribution remain front and centre.

VERTICAL FISCAL GAPS AND FISCAL IMBALANCES

Fiscal federalism in Canada, as in most federations, has long exhibited a vertical fiscal gap. That is, federal revenues exceed federal spending on its own programs, whereas for the provinces and territories it is the reverse. In the absence of borrowing, the resulting gap in provincial and territorial budgets is filled by federal transfers.

Figure 9: Provincial Own-Source Revenues as a Share of Total Provincial Expenditures, 1966-2020

Source: Own calculations from Finances of the Nation government revenue and expenditure data

In 2018-19, provincial, territorial, and local governments received $97.8 billion in transfers on a consolidated basis, equal to 16.6 percent of their total revenues. Expressed differently, provincial and territorial revenues that they raised for themselves account for roughly 80 percent of total expenditures, as illustrated in Figure 9. This fiscal gap is larger than it was in the late 1990s and early 2000s, following the reforms to equalization and health transfers by the Martin and Harper governments; but it is smaller than in the more distant past, prior to the tax points transfers under the Established Programs Financing Act of 1977.[18] It is difficult to compare fiscal gaps across countries, because provincial and local governments in many countries are assigned shares of federal taxes, blurring the line between grants and tax powers (Blöchliger, 2015). But it is safe to say that provincial governments in Canada have access to own-source tax revenues that are substantial, so that fiscal gaps here are smaller by international standards.

[18] These data are drawn from the Finances of the Nation fiscal database, available at https://financesofthenation.ca/data/, and are for consolidated provincial-territorial general governments, which include municipalities, school boards, hospitals, and other entities in the broader public sector.

Vertical fiscal gaps arise because, for constitutional, political, and economic reasons, revenue assignment in a federation often favours central governments, whereas a greater share of expenditure responsibilities are decentralized to provincial and local governments. Central governments may be better placed to levy taxes, particularly on tax bases that are mobile within the federation, whereas provincial, territorial, and local governments may be better able to deliver public services in a way that responds to the diverse needs of local residents. This asymmetry between revenue and expenditure assignment is especially apparent in Canada's highly decentralized federation, where provincial-territorial and local spending now exceeds federal spending on its own programs by a wide margin. A large or a small fiscal gap need not be problematic, as long as revenue and expenditure assignment are handled correctly, and fiscal transfers respond passively to fill the resulting gaps.

In contrast, we may say that a vertical fiscal imbalance exists in a federation when provincial governments do not have and cannot raise sufficient revenue – from their own sources or from transfers – to finance their desired expenditure levels.[19] Viewed in this way, a fiscal imbalance is inherently problematic, calling for reforms to fiscal arrangements to rebalance the federation by reassigning tax powers and expenditure responsibilities, or by adjusting the level of intergovernmental transfers. While the concept of fiscal imbalance in this sense should be clear, identifying whether one exists may not be, given that it depends on one's view of the desired amount of government spending and revenue collection by each order of government.

In the Canadian federation, provincial governments have an extraordinary level of autonomy in setting tax rates, and all major tax bases (including income and sales taxes) are co-occupied by federal and provincial governments. Given tax base co-occupancy, it is difficult at first glance to understand how a fiscal imbalance could arise in Canada. If provincial governments regard federal transfers as inadequate to their needs, then why do they not simply raise their own tax rates on the shared tax bases?

We believe that the answer lies in a complexity of economic and political factors. In some circumstances, subnational governments may be less able to raise tax rates on shared tax bases because of economic pressures arising from tax base mobility and tax competition among provinces, or because of political pressures arising from yardstick competition. Political incentives may also be distorted by weaker accountability that result from overlapping tax bases, shared expenditure responsibilities, and fiscal illusions resulting from grants. Put baldly, subnational governments may prefer to eschew tax increases and call for higher federal transfers, if voters do not "see through" the federal budget constraint. At the same time, as argued by the Québec Commission on Fiscal Imbalance among others, federal governments may succumb to the temptation to use the federal spending power to attain their own objectives, so that federal transfers distort provincial spending priorities, rather than merely filling the gap between revenue and expenditure. The result of all these competing pressures may therefore be a suboptimal allocation of revenues and expenditures across orders of government. These complex issues remain to be explored in the Commission's future work.

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19 Boadway (2004) suggests a related but slightly different distinction between the concepts of fiscal gap and fiscal imbalance. Likewise, the Québec Commission on Fiscal Imbalance in its 2002 report defined imbalance as a mismatch between a province's desired expenditure needs and its revenue potential, rather than as a gap between actual expenditures and revenues. In contrast, some authors use the two terms interchangeably.

03

Canada's Next Steps & The Network's Role

The central objective of the Fiscal Federalism Policy Network is to rethink the architecture of Canadian fiscal federalism in a post-COVID-19 world. Like a Royal Commission, it will take a coordinated deep dive into complex questions; unlike a Royal Commission it is independent of government appointments or political priorities. We believe that this is the only way to provide evidence-based research, analysis, and advice in order to strengthen and modernize Canada's intergovernmental fiscal relations.

To achieve this objective, the Network will be guided by a set of four interconnected principles.

01

Reform intergovernmental fiscal relations within Canada's constitutional framework. Reforming tax powers, expenditure responsibilities, and intergovernmental transfers can be done within the existing constitutional framework, which has proven to be remarkably flexible in accommodating the evolution of the federation. We are not recommending changes to the Canadian constitution but recognize the need to involve municipalities in future fiscal discussions.

02

Retain Canada's fiscally decentralized federation. Canada's decentralized federation has served the country well by fostering greater innovation and reflecting regional differences while providing the benefits of a centralized federal government and pan-Canadian coordination of efforts. Provinces and municipalities should have substantial tax revenues and expenditure responsibilities to deliver critical public services.

03

Promote fiscal transparency and accountability. Clear and transparent connections between revenue and spending can enhance accountability and hold each order of government responsible for outcomes. Disentangling overlapping tax and expenditure powers will improve transparency and accountability.

04

Create an efficient, sustainable and fair fiscal federation. Increasing the efficiency and effectiveness of the federation improves productivity and fosters greater economic growth and prosperity. Growth supports the financing of public services and policies to address income disparities and promotes social cohesion. An efficient and fair federation requires a sustainable approach to addressing vertical and horizontal fiscal imbalances.

IMPORTANT QUESTIONS

Do we have effective and resilient decision-making structures to guide Canada during these unprecedented times?

Do we need new coordinating efforts to challenge the status quo and innovate as a federation?

How can we realign intergovernmental roles and responsibilities to improve our quality of life and global competitiveness?

These principles will also serve as a basis to evaluate current fiscal arrangements, identify where they may be lacking and, when applicable, propose solutions and reforms.

As a starting point, over the next three years, the Network will tackle these issues with a series of in-depth research papers, broadly accessible briefing notes, public events, and a host of other activities to elevate the public debate and understanding of these critical issues. Given the significant challenges facing Canada, we need to stress test how our existing institutions can effectively deal with these issues in a highly competitive global economy. Do we have effective and resilient decision-making structures to guide Canada during these unprecedented times? Do we need new coordinating efforts to challenge the status quo and innovate as a federation? How can we realign intergovernmental roles and responsibilities to improve our quality of life and global competitiveness? These are some of the important questions that the Network will address. Our future prosperity depends on getting this right.

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The Fiscal Federalism Policy Network (FFPN)

An independent team of academic experts and policy practitioners from a variety of disciplines across the country will recommend practical reforms to the system of intergovernmental fiscal relations in Canada. Like a Royal Commission, it will take a coordinated deep dive into complex questions; unlike a Royal Commission it would be independent of government appointments or political priorities. The Network will publish research papers, policy briefs and op-eds and make recommendations for the reform of fiscal relations among the federal, provincial and municipal governments within the framework of the existing Canadian Constitution.

FFPN Fiscal Federalism Policy Network