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Canadian Fiscal Federalism

Presentation for the Conference:

Federalizing Processes in Italy – International Perspectives

Rome, February 19-20, 2010

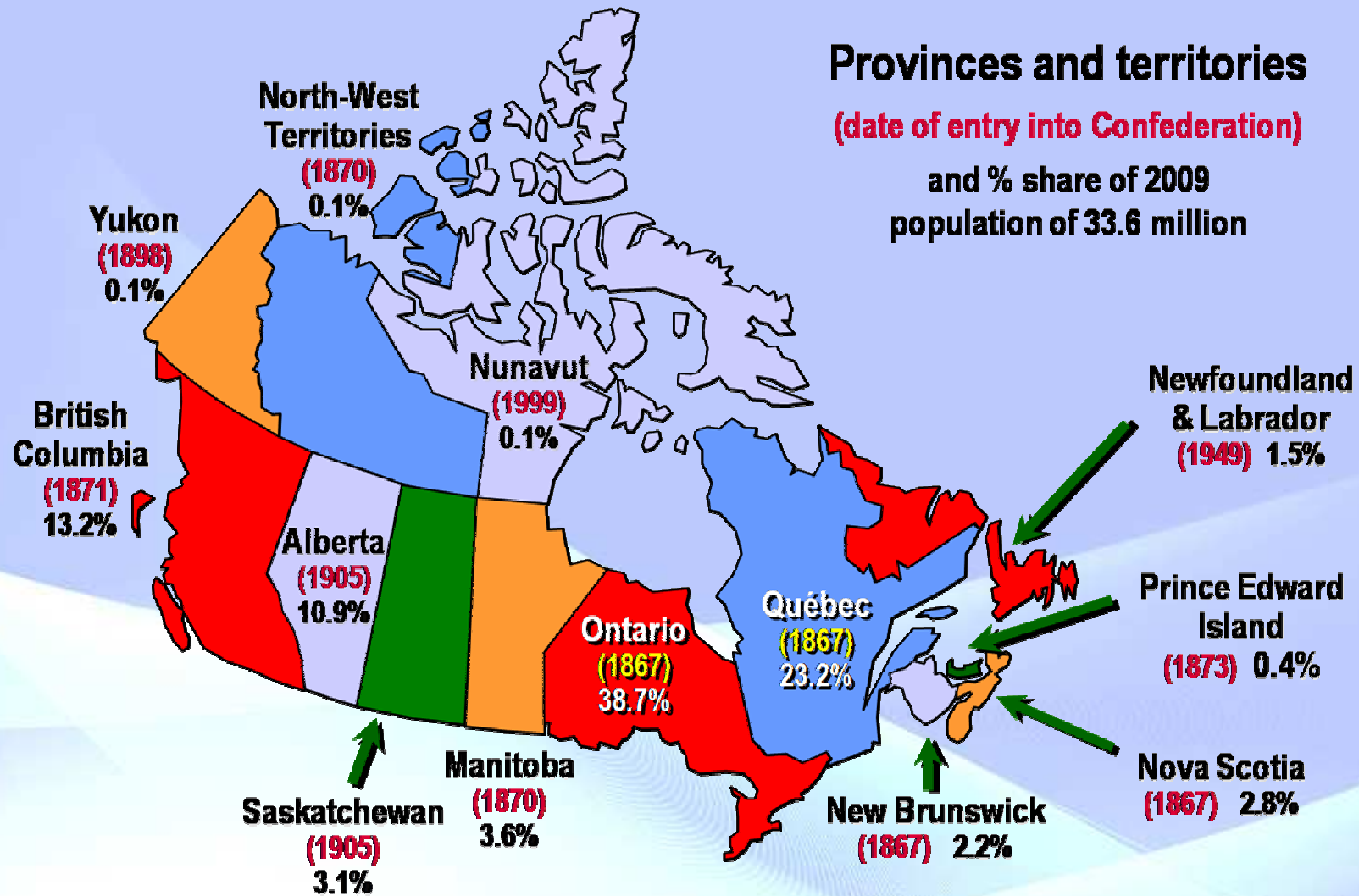
With thanks to David Peloquin



Forum of Federations

THE GLOBAL NETWORK ON FEDERALISM

A quick overview of Canada



Forum of Federations

THE GLOBAL NETWORK ON FEDERALISM

Canada's provinces have “critical political mass” that makes them particularly autonomous

- Long history of uninterrupted self-rule from colonial times (1840s) through to the present:
 - provinces are Canada's original political units and still command significant (sometimes dominant) allegiance of residents
 - provinces have very substantial policy and administrative capacity
 - long-established habits of managing high provincial autonomy:
 - inter-governmental compromise / accommodation / cooperation
 - accountability to informed and engaged electorates and media
 - provincial spending (and borrowing) closely tied to provincial taxation

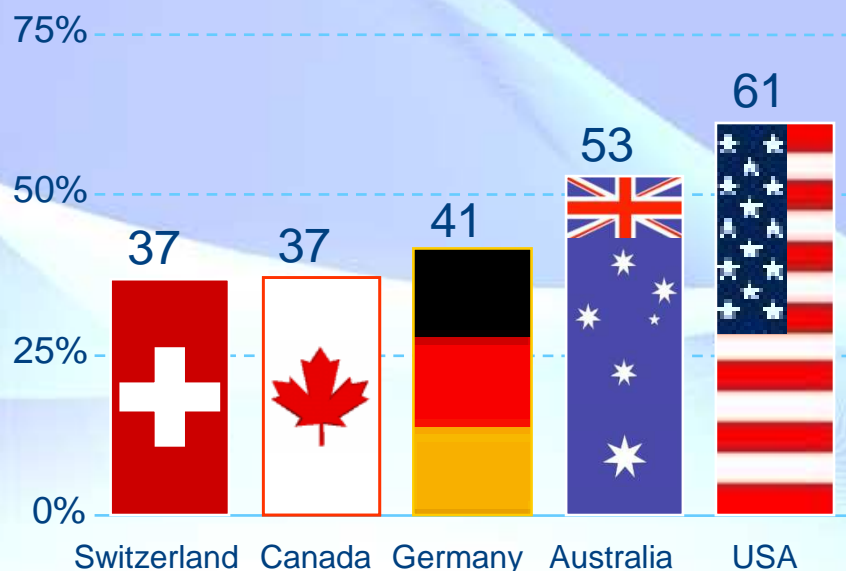


The particularly high degree of autonomy exercised by Canadian provinces reflects:

The high degree of fiscal decentralization in Canada

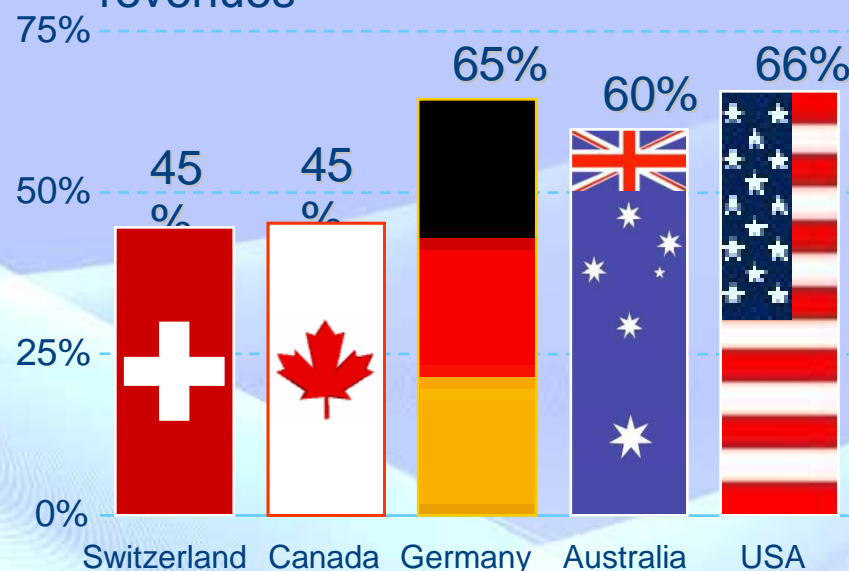
Expenditures

Federal share of direct spending



Revenues

Federal share of own-source revenues



Result:

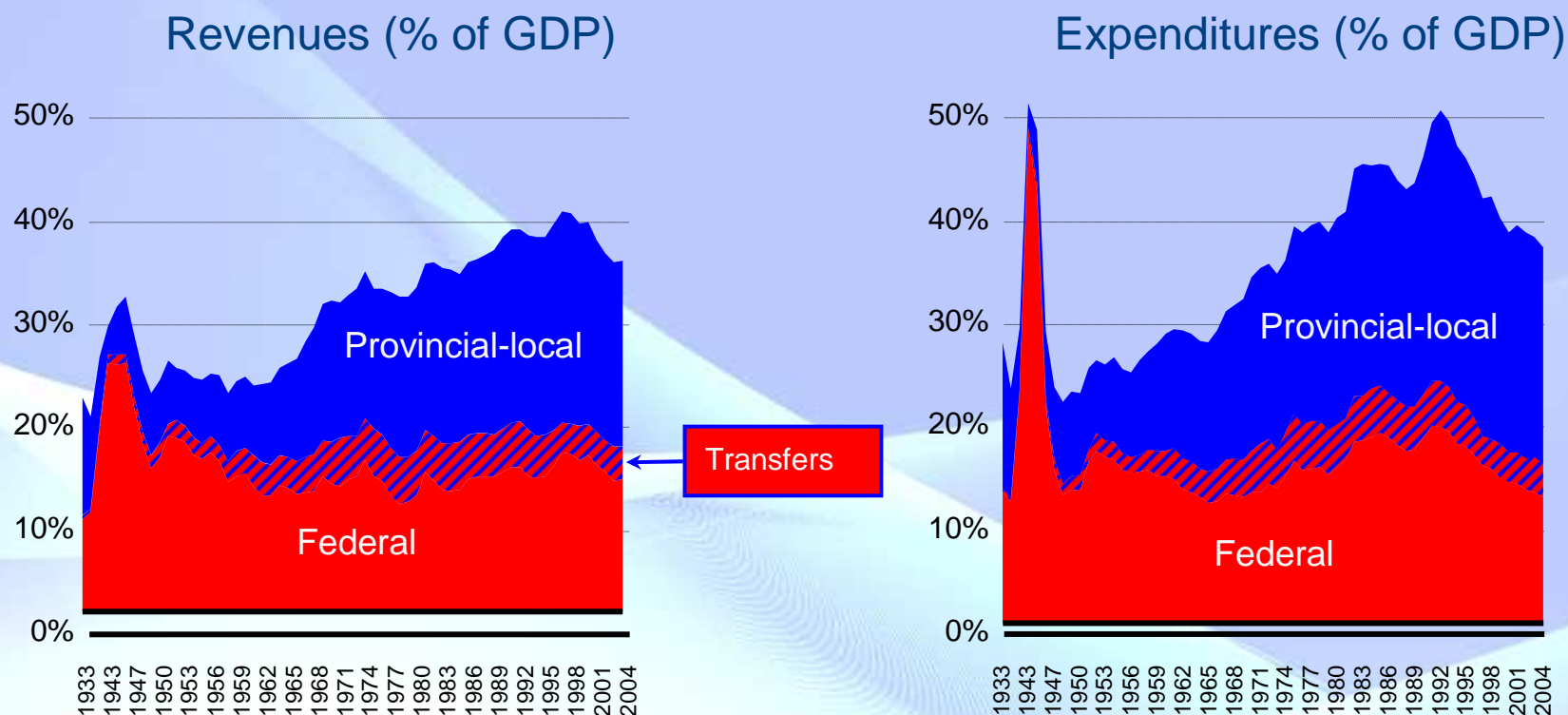
Centralization historically in *principle*, but not in current *practice*

- Design of founding *Constitution Act, 1867* had envisaged:
 - “watertight” federal and provincial powers (with few exceptions)
 - dominant federal government (both fiscally and legislatively)
- In practice, Canada has evolved toward:
 - typically overlapping (or “entangled”) legislation/regulation and (especially) spending powers
 - joint occupancy of all major direct and indirect tax fields
 - relatively “equal partnership” of federal and provincial governments (or “vertical competition between equally-matched competitors”?)



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

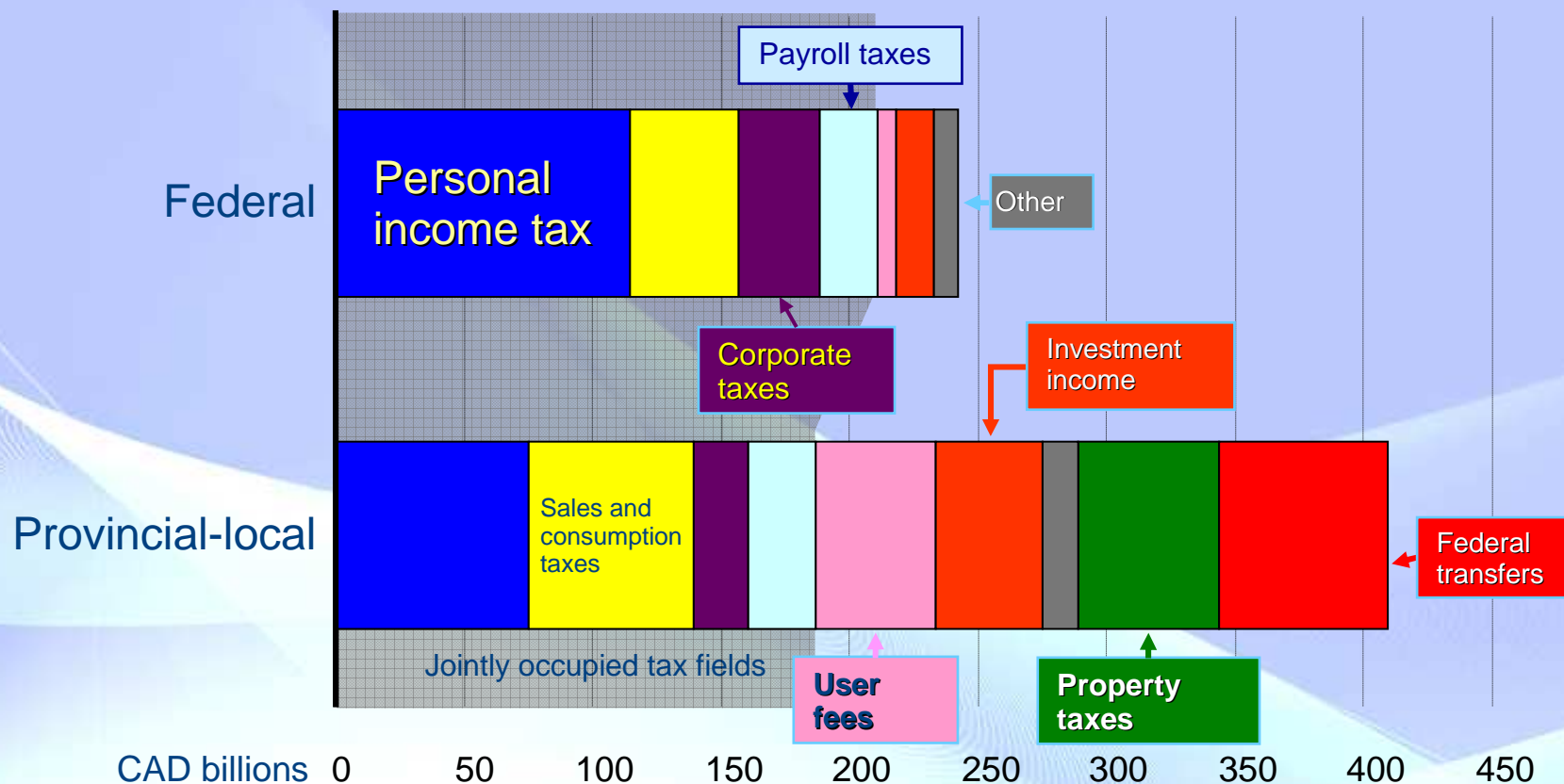
The long history of fiscal decentralization in Canada



Source: Statistics Canada

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

... as well as joint occupancy of major tax fields



Source: Statistics Canada (2009)

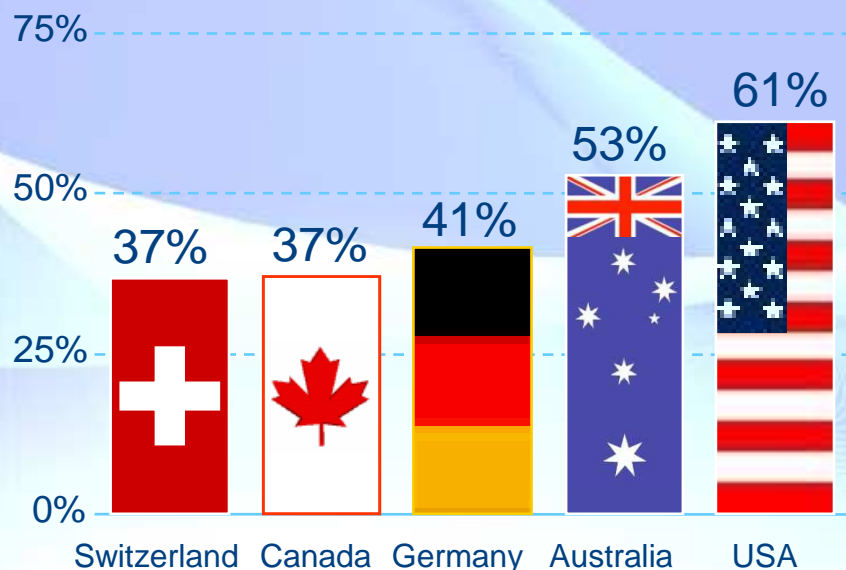
The particularly high degree of autonomy exercised by Canadian provinces reflects:

Their low dependence on federal transfers...

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

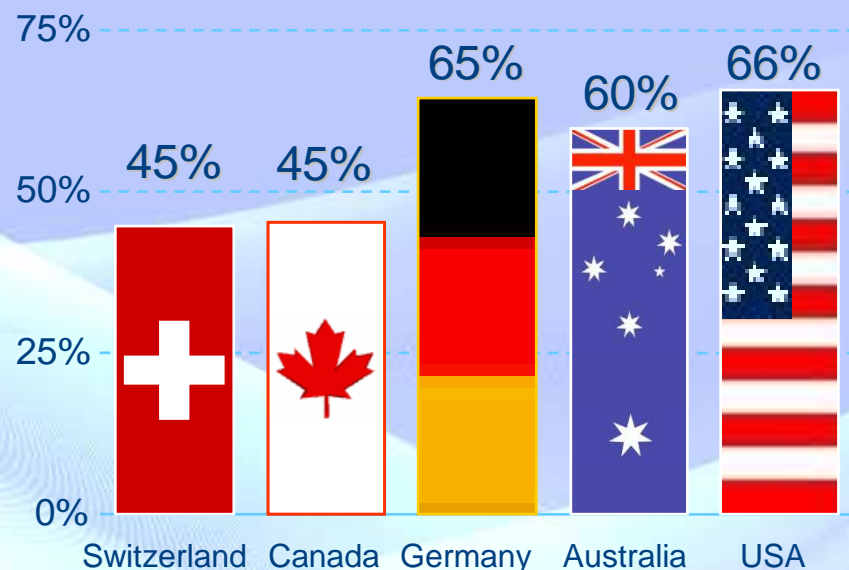
Expenditures

Federal share of direct spending



Revenues

Federal share of own-source revenues



Managing these entanglements is an ongoing challenge for Canadian fiscal federalism

- Desirability of / need for coordination and harmonization in relation to:
 - the power to tax – where state power to compel citizens is strongest (and need to minimize compliance costs is greatest)
... hence a commitment to tax harmonization / joint tax collection in Canada
 - the power to spend – where power to compel is largely absent (though still a need to avoid confusion on the part of citizens and ensure effective spending)
 - the power to borrow – where a government's credit-worthiness affects those of others



Entanglements are typically managed through elaborate structures of “executive federalism”

- In most policy areas, federal and provincial ministers and officials meet regularly:
 - many standing federal-provincial committees to discuss areas of common interest (sometimes meeting several times a year)
- Meetings on fiscal/budgetary and related matters (e.g. health care) are frequently high-profile and raise significant controversy:
 - both federal-provincial and inter-provincial tensions often surface
 - fiscal issues have on occasion been settled at the level of “First Ministers” (federal Prime Minister and provincial Premiers)



Revenue-raising discipline is achieved largely through voluntary tax harmonization

- As noted above, both federal and provincial governments have effectively unrestrained access to all major tax bases
 - In most major tax bases, joint occupancy is the rule, but:
 - **NO** revenue sharing (i.e. unlike Brazil, there is virtually no formula-based sharing of revenues levied by one level of government – typically the federal – with governments at the provincial or local level)
 - instead: federal and provincial governments independently levy own taxes...
- ... though they do not necessarily collect them (i.e. in several key tax fields, most governments participate in joint “tax collection agreements”)

Revenue-raising discipline is achieved largely through voluntary tax harmonization

Tax collection agreements (frequently used in Canada)

- Compliance / collection costs minimized by joint collection
- Harmonization of tax bases
- Inter-provincial tax competition on rates and rate structure (but not base)
- Greater autonomy and clear(er) government accountability

Revenue sharing (virtually unused in Canada)

- Compliance / collection costs minimized by federal collection
- Uniform tax bases applied nationally
- Fixed rates prevent inter-provincial tax competition of any kind
- “Joint decision trap” and less transparent taxation

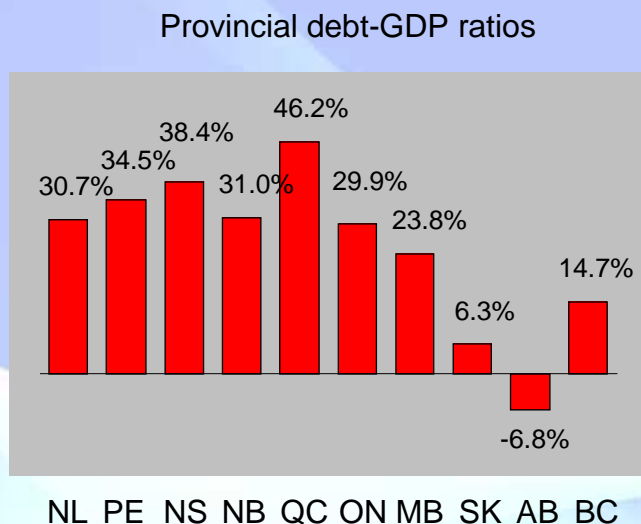
Budgetary discipline has improved in recent years

- Unconstrained spending power at both levels of government translates (on occasion) into vertical intergovernmental competition
 - i.e. in principle (and at times in practice), there is strong temptation to overspend
 - Also, very limited federal leverage over provincial spending:
 - little/no scope for conditionality of federal transfers: they are too small, there is fierce resistance to “intrusion”, and electorates often side with provinces
 - Result: (formerly) high federal and provincial debt/GDP burdens – among the highest in OECD as recently as the mid-1990s
 - However, debt burdens declined significantly in wake of mostly balanced budgets (federally and in most provinces) from the late 1990s until the recent recession...
- ... though Canadian provinces still remain among the world’s largest sub-sovereign borrowers

Where does that discipline come from, then?

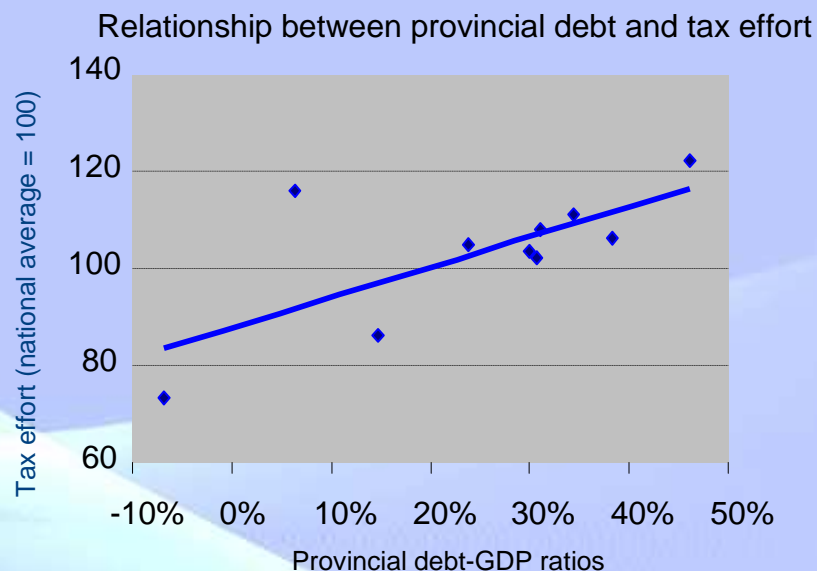
A better explanation lies in provinces' revenue-raising autonomy:

Higher provincial debt



Source: Statistics Canada

...tends to translate into higher provincial taxes



That is, provinces that take on too much debt can expect to have to raise taxes on their electors well in advance of any plausible case being made for a federal “bail-out”

Where does that discipline come from, then?

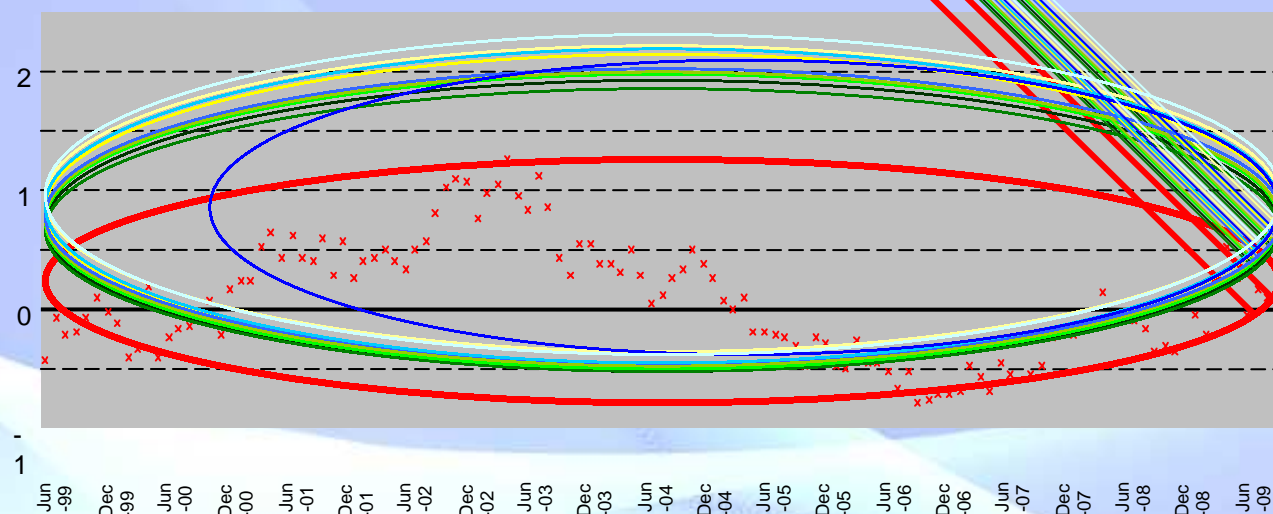
- As noted, the budgetary discipline in evidence among Canadian provinces:
 - is **NOT** due to formal budgetary / borrowing coordination
 - is **NOT** due to “hard” budget constraint imposed “from above”
 - is **NOT** due to self-imposed “balanced budget” laws
 - **MAY** be due in part to informal information exchanges and moral suasion (though with provinces as or more likely to exercise leadership)

... but such discipline is not really attributable to:

Constraints imposed by credit markets themselves

% spread over US Treasuries, 10-year bonds, Canadian federal and provincial governments
June 1999 to June 2009

Standard & Poor's
Credit Ratings
(as of June 2009)



Canada	AAA
BC	AAA
AB	AAA
SK	AA+
MB	AA
ON	AA
QC	A+
NB	AA-
NS	A+
PE	A
NL	A

Source: Finance Canada

...since it is not clear provinces face a truly “hard” budget constraint
(with an implicit federal guarantee seemingly priced into provinces’ cost of funds)

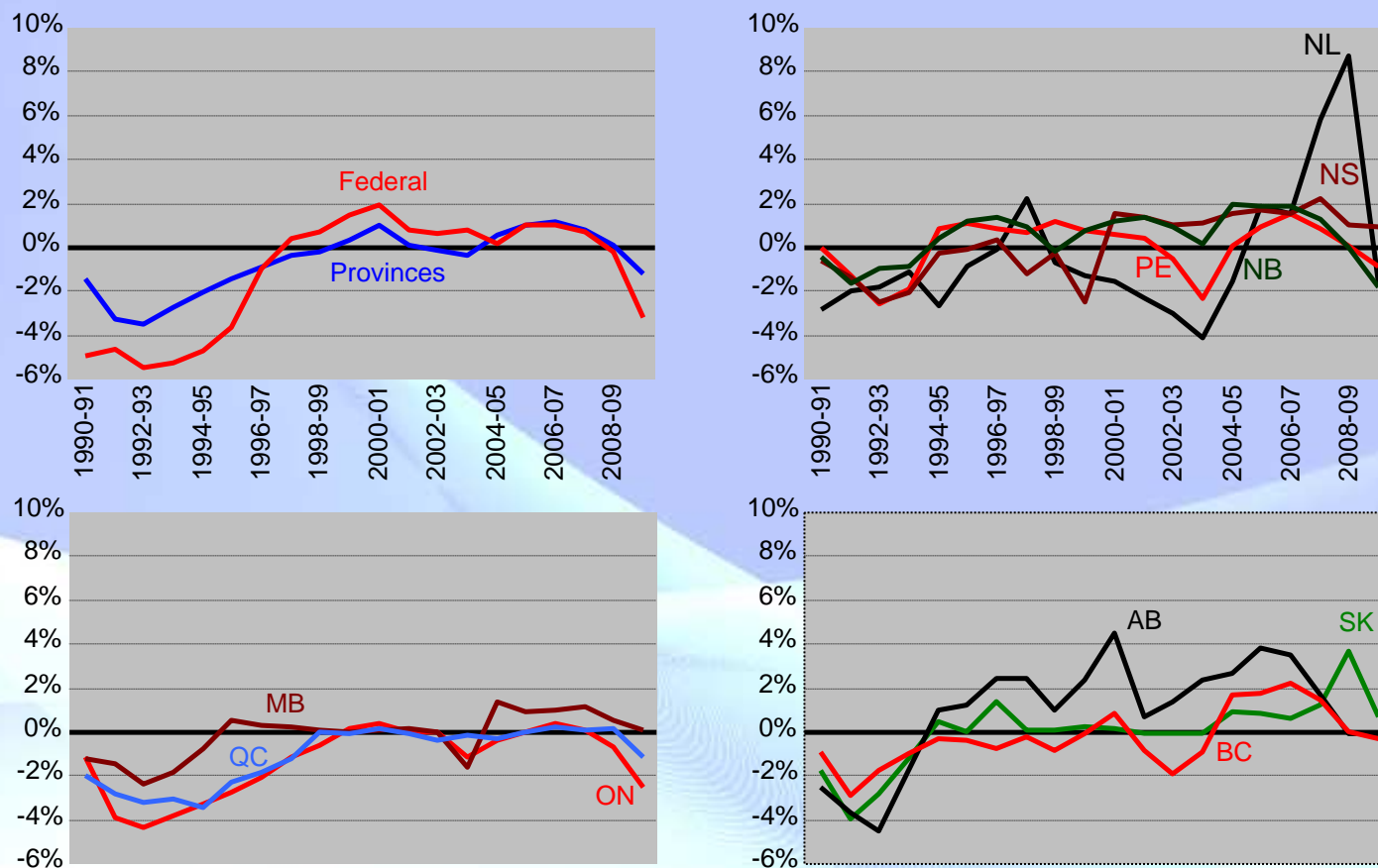
... but such discipline is not really attributable to:

Intergovernmental coordination

- **NO** formal budgetary / borrowing coordination mechanisms...
... with at most regular information sharing between federal and provincial finance officials and informal “moral suasion”
- **NO** federal government-imposed constraints on the issuing of debt by provinces:
 - on either domestic or international markets
 - in either domestic or foreign currencies

Budgetary discipline has improved in recent years

Federal and provincial budget balances (% of GDP)



Source: Finance Canada

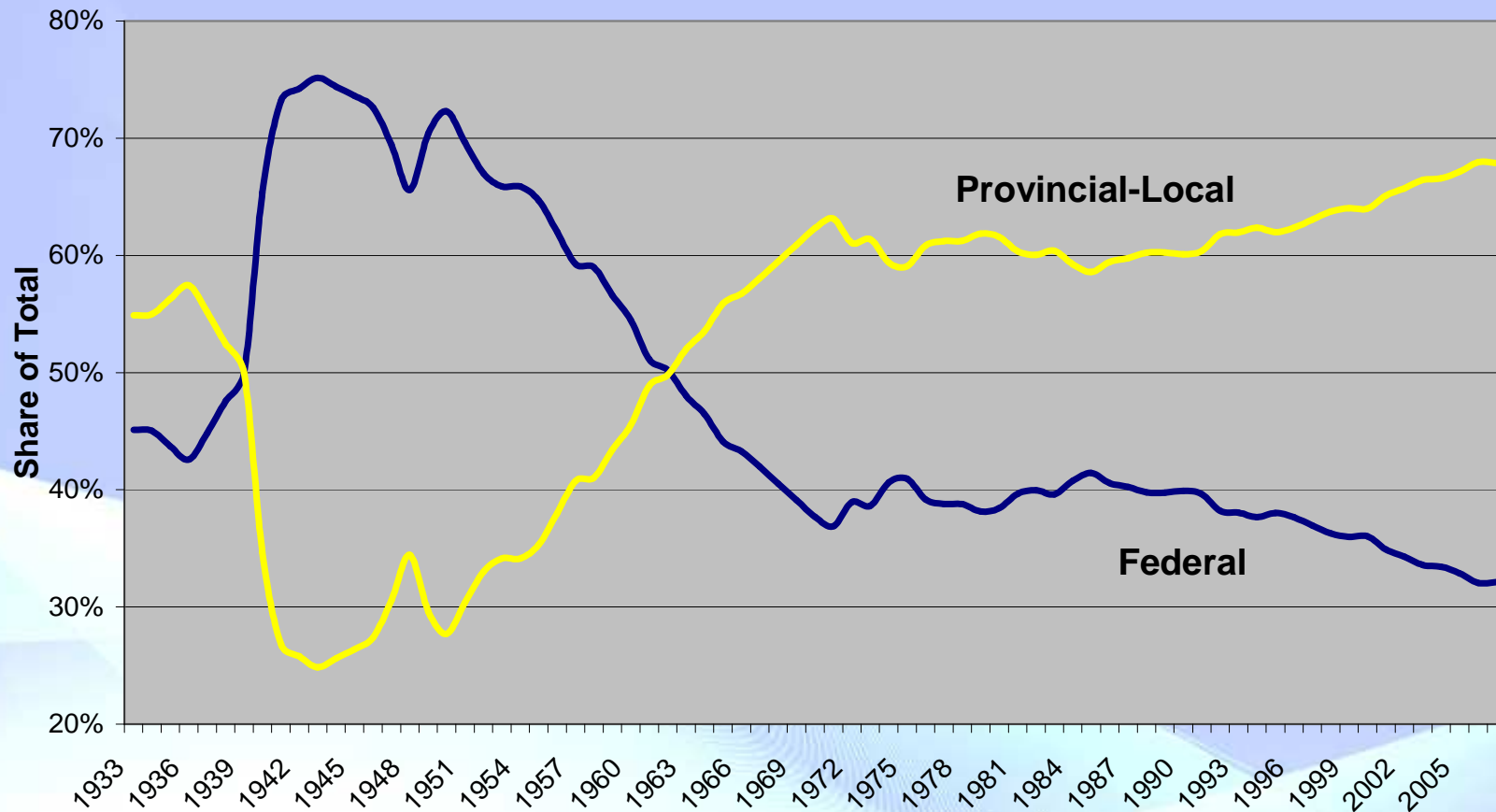
The Canadian Constitution allows for a high degree of decentralization

- ▶ The Constitution Act gives provinces
 - primary responsibility for (what have turned out to be) some of the most important expenditure areas: social welfare, health care, education, etc.
 - access to, and full discretion over, most major revenue sources: personal and corporate income taxes, sales taxes, estate taxes, natural resource taxes and royalties, property taxes, etc.



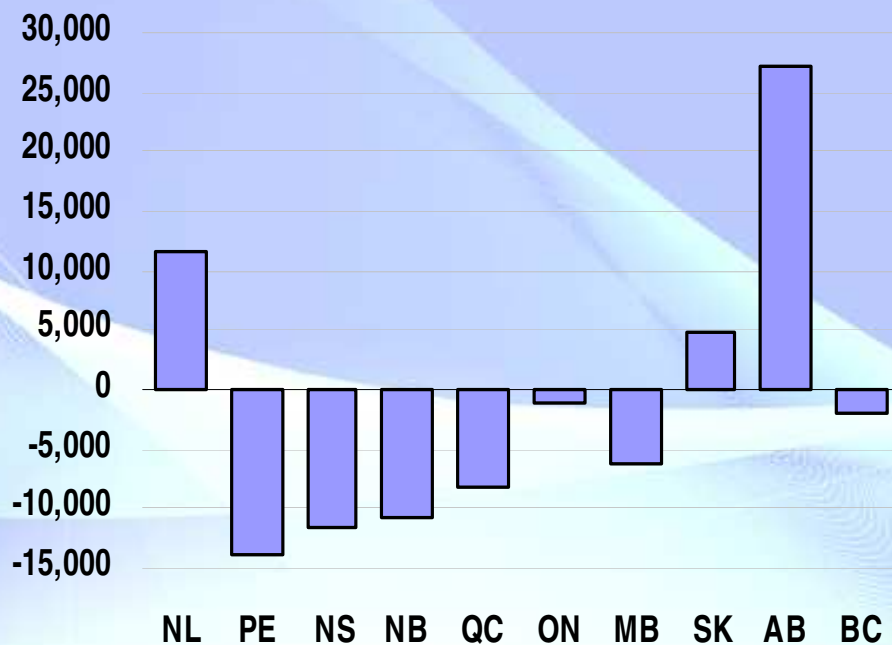
A defining feature of the evolution of the Canadian federation in the postwar period is a gradual but persistent decentralization of fiscal responsibilities

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

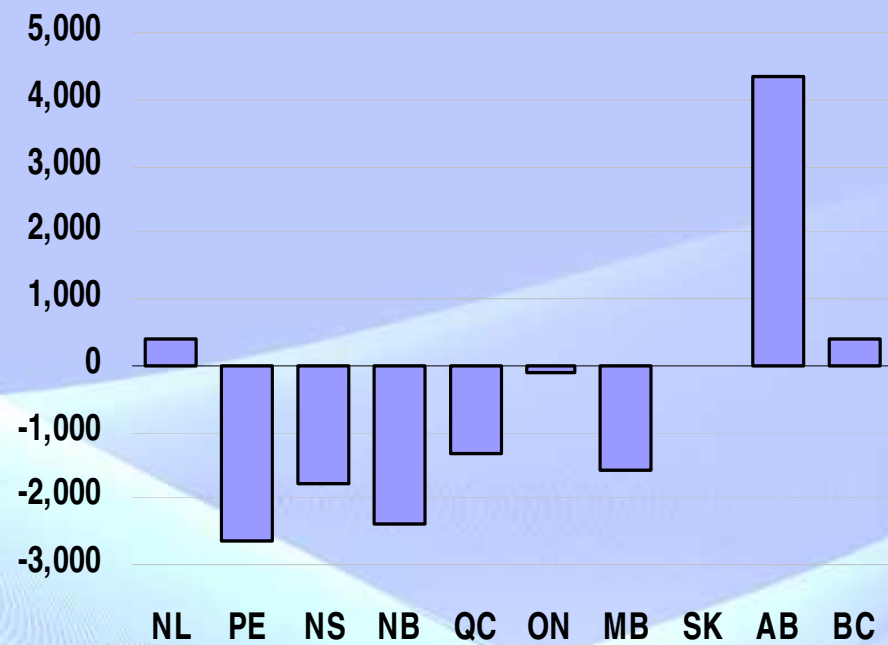


Economic and fiscal disparities in Canada are (by OECD standards) relatively large

GDP disparities (in \$ per capita)



Fiscal disparities (in \$ per capita)



From its beginnings in 1957, the Equalization program has helped to make tax-decentralization acceptable to revenue-poor provinces

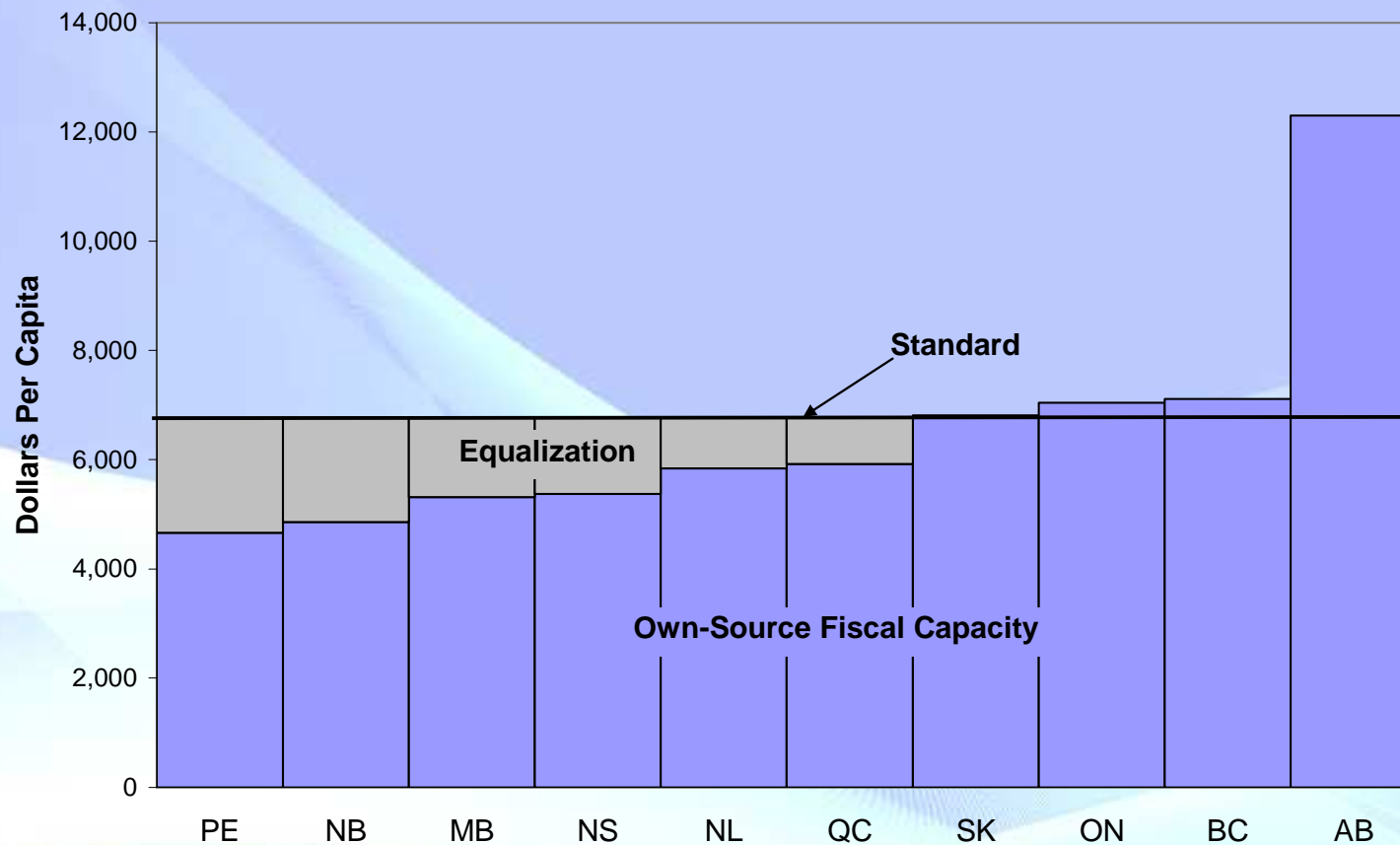
- ▶ Program was launched in 1957 in conjunction with a major tax decentralization for personal and corporate income taxes and inheritance taxes. Program made the devolution of tax shares to provinces acceptable to revenue-poor provinces.
- ▶ Program “equalizes up”, not down.
- ▶ Program has looked at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



The Equalization Program

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

Equalization: Illustrative Example of Basic Mechanics



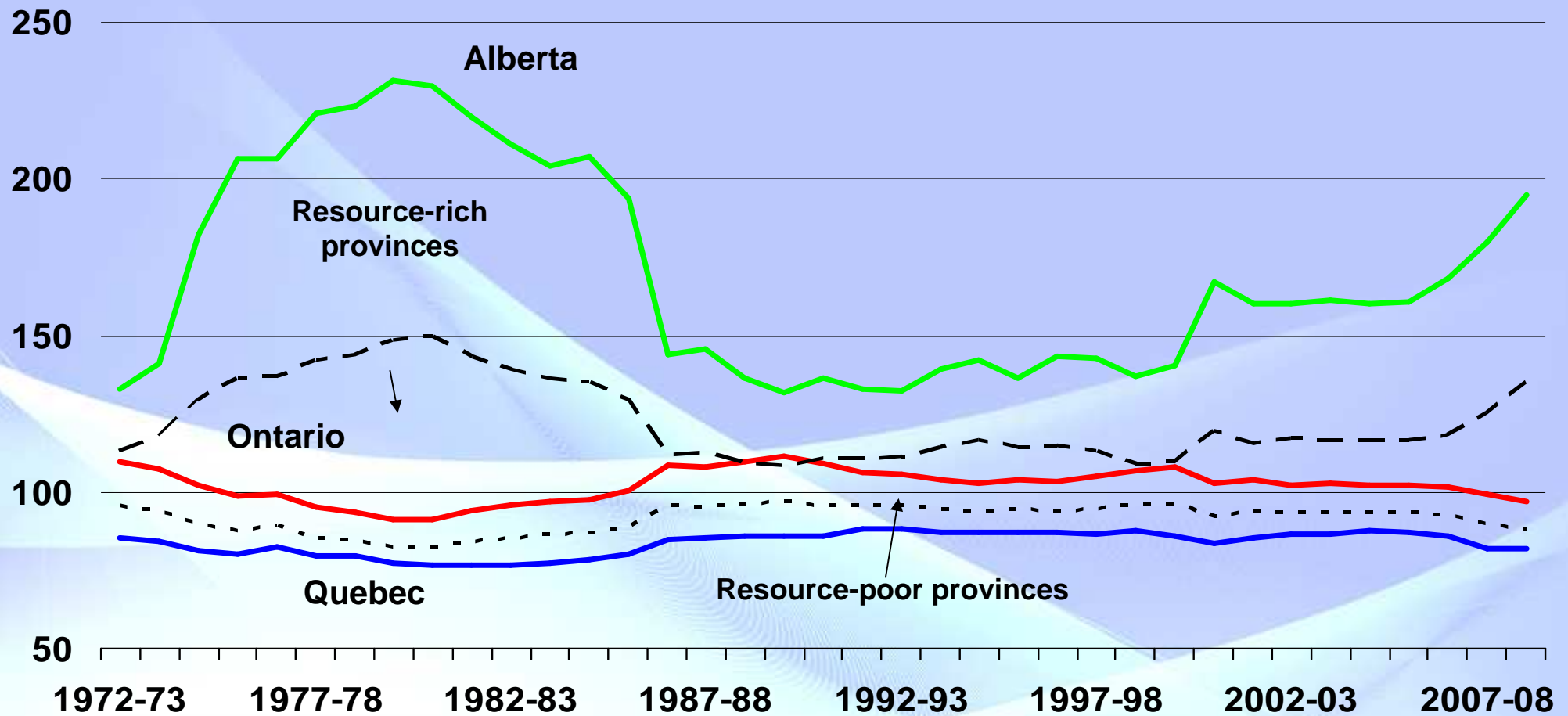
Increasing decentralization has led to a lowering of the standard

- The Equalization standard has changed several times throughout the history of the program: top-2 province standard (1957), 10-province standard (1962), 5-province standard (1981).
- With increasing decentralization, the trend towards a lowering of the standard.
- Recently, Ontario has become equalization receiving—small amount, but adds greatly to risk
- New approach is the sharing of a defined pool for equalization



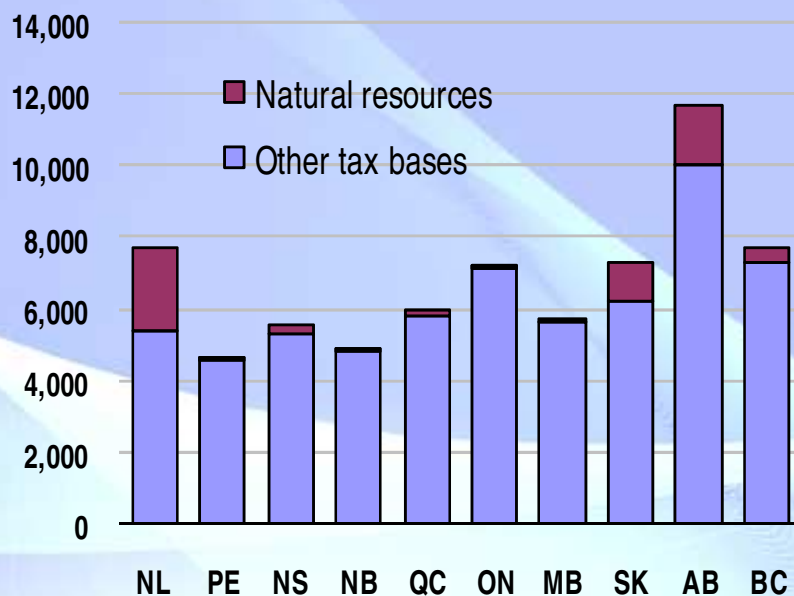
Natural resource revenues have played a key role in the history of Equalization

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

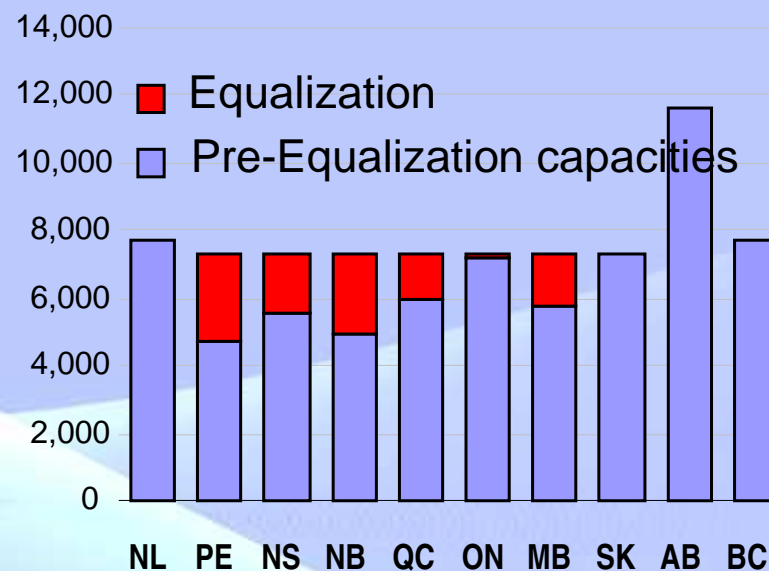


As well, provincial fiscal disparities significantly reflect the unequal distribution of natural resources...

Fiscal capacities (in \$ per capita)



Pre- and post-Equalization capacities



...disparities which federal Equalization transfers only partially fill

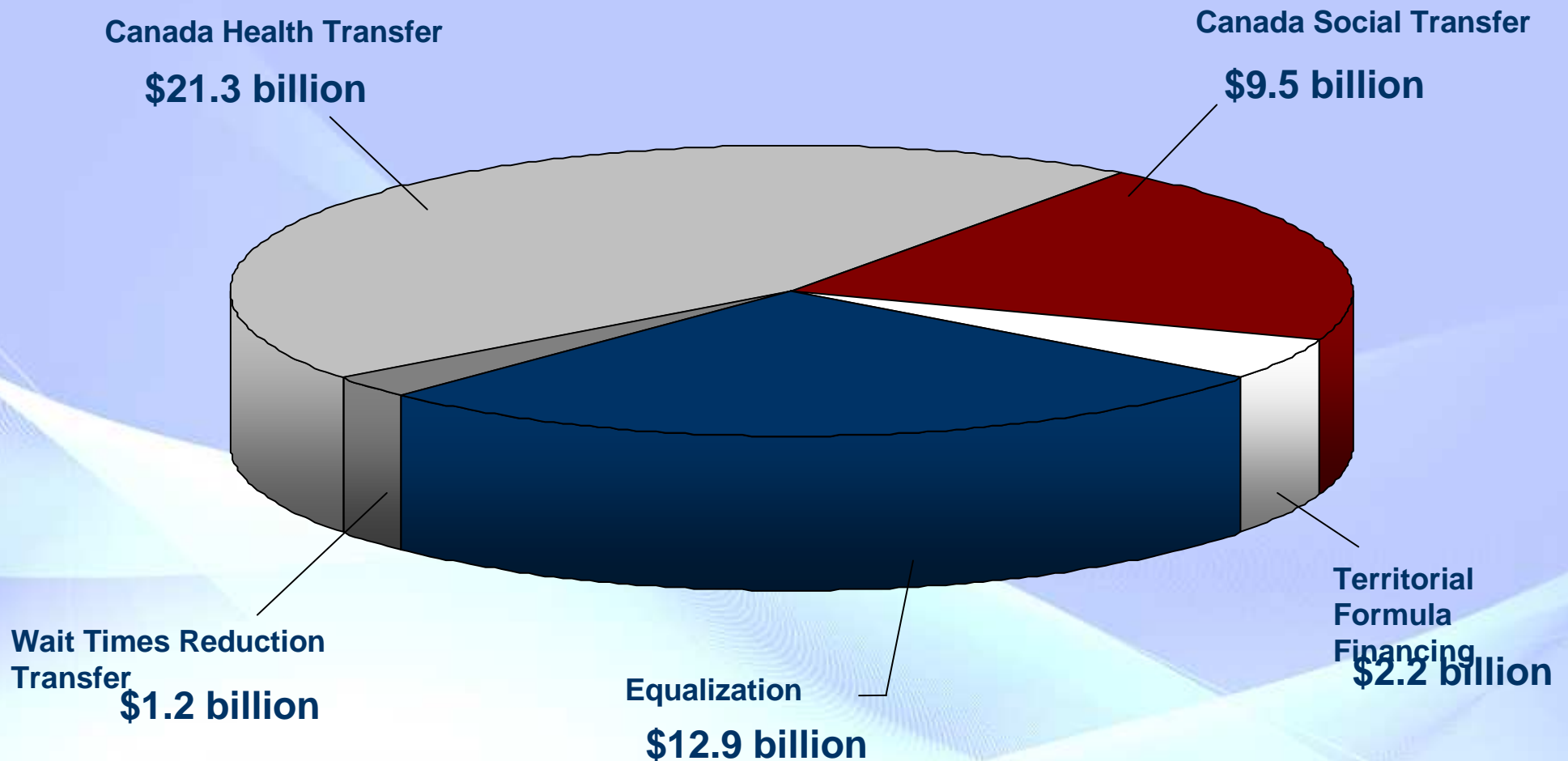
Equalization payments for 2008-09 total \$13.6 billion dollars

Equalization Payments (\$ millions)

	2004-05	2005-06	2006-07	2007-08	2008-09
Newfoundland and Labrador (NL)	762	861	687	477	158
Prince Edward Island (PEI)	277	277	291	294	322
Nova Scotia (NS)	1,313	1,344	1,386	1,465	1,465
New Brunswick (NB)	1,326	1,348	1,451	1,477	1,584
Quebec (QC)	4,155	4,798	5,539	7,160	8,028
Ontario (ON)					
Manitoba (MB)	1,607	1,601	1,709	1,826	2,063
Saskatchewan (SK)	772	89	13	226	
Alberta (AB)					
British Columbia (BC)	682	590	459		
Total	10,894	10,907	11,535	12,925	13,620

Other major transfers to provinces and territories also have important equalizing effects

Major Transfers, 2007-08



Provinces choose own levels of taxation and expenditure

- The Equalization system is meant to provide provinces with the capacity to provide reasonably comparable levels of services at reasonably comparable tax rates.
- But provinces are free to choose any actual level of taxation and any actual level of expenditure they want.
- Given their high degree of tax and expenditure autonomy, provinces in fact make significantly different choices.



Transfers go to all provinces and are largely unconditional

- Total transfers of \$47B, of which \$13B for equalization
- Other transfers started as highly conditional programs in health, social assistance and post-secondary education, but are now largely subject to only a few basic principles, especially for health
- Historically, there has been a debate over the federal spending power



Provinces choose to impose substantially different tax rates...

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

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



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

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

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

Equalization and Tax-Autonomy: Measuring Tax Disparities

- The high degree of tax autonomy of Canadian provinces poses important measurement challenges for equalization.
- Because of the high degree of tax autonomy of provinces, the use of actual revenues is not possible in Canada.
- The approach that has been used in Canada since 1967 to measure the relative fiscal capacities of provinces is the representative tax system (RTS) approach.



Representative Tax System

- The RTS approach determines fiscal capacity by measuring the per capita revenue provinces *could* (potentially) raise if they implemented a typical (“representative”) provincial tax system.
- Fiscal capacity is measured separately for each provincial and local government revenue source.
- The fiscal capacity of each province for each revenue source is measured by applying the national average effective tax rate to the representative tax base for each provinces.
- A key challenge is to define a common “representative” base for each revenue source, given that the actual tax bases of the 10 provinces may differ greatly.



Conclusions

- Canada has a highly decentralized fiscal regime.
- Provinces depend largely on their own source resources and have proven fiscally responsible
- The devolved regime has been possible because of the existence of important transfers and equalization
- Canada has achieved a reasonable degree of tax harmonization and coordinated collection
- Equalization is limited and does not equalize rich provinces down
- Some longer-term trends regarding resource disparities and growth may put the system under new pressure

