The Federal Response to Provincial Fiscal Shocks: Imperatives, Opportunities and Pitfalls

Robin Boadway
Department of Economics, Queen's University
Submitted April 2019

Paper presented at the IIGR Workshop "Stabilizing Provincial Revenues: Economic, Political and Policy Perspectives"
April 2019

Institute of Intergovernmental Relations
School of Policy Studies, Queen's University

Paper 2019-01

How, if at all, should the federal government respond to significant provincial fiscal shocks? If it does, what are the pitfalls from intervening? Those are the questions we address.

There are a number of reasons for federal intervention. First and foremost, in an economic union such as Canada, fiscal shocks in one province spill over into other provinces. Given the exposure of provinces to international markets, shocks affecting the demand for provincial products will cause the real exchange rate to adjust and that will impinge on other provinces. For example, a positive shock to oil prices causes the real exchange rate to rise, reducing its impact in oil-producing provinces and adversely affecting the competiveness of producers in other provinces. Provincial shocks will also induce movements of labour, capital, and products to or from the rest of Canada. National financial markets will also be affected by changes in interest rates induced by provincial shocks. If a shock is large enough to cause provincial fiscal distress, financial contagion can spread to other regions given the common currency and interrelated financial markets. Federal revenues and costs will also be affected through changes in common tax bases used by both levels of government, and through changes in federal transfers to residents in the province hit by the shock.

The adverse effects on a province's budget resulting from a shock will threaten the ability of the province to provide important public services. This includes social programs that are deemed to be in the national interest, such as education and health care. Recall that section 36(1) of the Constitution Act 1982 commits the federal and provincial governments to providing public services of reasonable quality and to promoting equal opportunities for Canadians. The federal government also shares an interest in the well being of individual Canadians who may be affected by an income shock. Finally, from a longer-term point of view, the federal government has an advantage at pooling national risks faced by both provinces and individualsa, and has better access than the provinces to capital markets to finance temporary interventions. In that sense, it is better able than the provinces themselves at addressing provincial fiscal shocks.

There are a number of policy instruments available to the federal government to mitigate the effect of provincial fiscal shocks. Various federal-provincial transfers insure the provinces in complementary ways. Equalization and CHT/CST transfers are both formula-based, but differ in that, unlike CHT/CST, the size of equalization is endogenous. More targeted transfers include the Fiscal Stabilization Program, which provides formula-based transfers to provinces whose non-resource revenue bases fall by more than 5 percent, and discretionary transfers, such as infrastructure, as well as federal-provincial negotiated agreements, such as the Atlantic Accords. Federal interpersonal transfers and employment insurance provide insurance to individuals affected by fiscal shocks. The federal government can also deploy countercyclical fiscal and monetary policy as well as capital market regulation to address the national effects of provincial shocks. This includes debt policy and intergenerational risk sharing. All these actions are over and above those that provinces might take to self-insure.

Federal intervention to address provincial fiscal shocks faces many challenges. The most intractable one is the inability of the federal government to commit to a hard provincial budget constraint. To the extent that provinces perceive that the federal government will come to their aid in the event that they put themselves in a financially difficult situation, the provinces will be less cautious in taking risky fiscal positions. For example, they may undertake large infrastructure projects whose costs are liable to increase, and they may incur debt to finance them. The federal government will understandably come to the aid of over-extended provinces ex post, given the interests the federal government has in the provinces' programs and in avoiding capital market turmoil. In principle, the federal government should restrict itself to assisting provinces whose financial distress is caused by factors beyond their control. However, it may be difficult to determine responsibility for a province's financial problems, thereby exacerbating the soft-budget constraint problem. The problem may be mitigated by relying on formula-based transfers, by ensuring that the provinces have sufficient access to their own revenues to address their own problems, and by allowing unfettered provincial access to capital markets. But soft budget constraints cannot be completely avoided. The federal government can, and sometimes has, overridden transfer formulas to deal with a province's fiscal exigencies. It has also negotiated side deals outside formula-based transfers to provide funds to a province in fiscal distress.

Finally, the effect of provincial financial shocks may be worsened by a number of factors. The provinces themselves face commitment problems that seemingly preclude them from self-insuring, for example, by saving natural resource revenues in a sovereign wealth fund. The federal government cannot commit to maintaining vertical fiscal balance: they may pass on the effects of fiscal shocks they face to the provinces. Policies partly designed to deal with shocks may be compromised. Discretionary federal responses suffer from lags in implementation, especially those operating on the expenditure side of the budget. Some formula-based transfers may be inadequate to deal with large fiscal shocks. For example, Fiscal Stabilization Program transfers are potentially effective for addressing provincial revenue shocks, especially since they are reasonably well insulated from provincial discretionary tax changes. But the upper bound on stabilization transfers renders them ineffective. And, while the equalization program responds reasonably well to changes in a province's fiscal capacity, albeit with a lag, it induces its own form of instability on provincial budgets since the total equalization pool is endogenous. Fluctuations in a large province's fiscal capacity, or aggregate revenue shocks across the entire federation, are spread to all provinces and lead to instability of equalization transfers.

As our discussion suggests, there is much room for revising the transfer system so that the insurance it provides against provincial revenue shocks is both more effective and timelier.

