

Fiscal Federalism in Canada

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July, 2000

* The major contributions to this project by John McLean and Jean-Francois Tremblay are acknowledged.

The purpose of this report is to explain the major dynamics affecting fiscal federalism in Canada. It is written primarily for an audience that does not have an extensive knowledge of Canada but it does make use of terms and concepts that are common in the study of fiscal federalism.

The major figures in Canadian fiscal federalism are the federal and provincial governments. Territorial governments, local governments and the newly emerging models of aboriginal self-government are significant figures in fiscal relations in Canada, and they receive some attention in the report, but the main focus of this analysis is on the relationship between the federal government and the provinces.

The content of the report combines material from the study of economics and political science to provide both a quantitative and qualitative analysis of fiscal federalism in Canada. The report focuses on explaining the current relationship between governments but in doing so a significant amount of attention is given to explaining the historical developments that have led to the current situation.

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FISCAL FEDERALISM IN CANADA

A. FEDERALISM IN CANADA: THE CONSTITUTIONAL AND POLITICAL CONTEXT

Canada is a fundamentally federal country marked by a vast territory, second only to Russia in area, and by a diverse population of over 30 million descended from immigrants drawn from many cultures around the world as well as an aboriginal population. Canada has two official languages, English and French, and the country consists of distinct economic regions. Canada became a federation in 1867 when the former British colony of Canada was split into two new provinces, Quebec with a French-speaking majority and Ontario with an English-speaking majority. Two other British colonies along the Atlantic coast, Nova Scotia and New Brunswick, were added to establish a four-province federation. In the 133 years since that time, the federation has grown to encompass most of the northern half of the North American continent stretching from the Atlantic Ocean to the Pacific Ocean to the Arctic Ocean and consisting of ten provinces and three territories. Commencing as a relatively centralized federation, Canada in accommodating the internal diversity of its population and regional economies has become one of the more decentralized federations in the world, while developing at the same time a cohesive transportation network and system of federation-wide social programs.

1. Constitutional Status of Various Orders of Government

The government structure consists of a federal government, 10 provincial governments, 3 territorial governments and numerous municipal (or local) governments. All of the federal, provincial and territorial governments are organised on the basis of the Westminster parliamentary system. There is also a newly evolving system of self-government for many of the aboriginal communities.

The Federal, Provincial and Territorial Legislatures

The fusion of the legislative and executive branches of government within the federal and provincial legislatures with executives chosen from within and responsible to the legislatures, combined with strong political conventions of party discipline, have effectively transferred legislative power in practice to the executive branches.

The Senate of Canada is the Upper House and its members are appointed by the prime minister and hold office until retirement at 75. Although the Constitution gives the Senate extensive legislative powers these are rarely fully exercised because the chamber lacks democratic legitimacy. As a result there are few checks on the power of the executive when it is supported by a majority in the House of Commons.

The House of Commons (the Lower House) of Canada is elected by a first past the post electoral system and the number and distribution of seats is based on population (giving provinces with a larger population more seats). The Canadian prime minister must choose the executive from the members elected to the House of Commons or from members in the Senate¹ and as a matter of convention the executive reflects regional, linguistic and other important interests. In order to stay in government the executive must win votes in the Lower House on issues that are considered central to their governing platform. This is usually assured by the electoral system which gives the governing party a majority of seats and the use of party discipline to ensure that members of parliament from the government's party vote in support of the executive's legislation. This ensures a very stable executive and very stable government (as long as one party holds the majority of seats) that faces few challenges from the legislature or the Upper house.

Provincial and territorial legislatures are unicameral. These legislatures are elected by the same method as the federal House of Commons and the relationship between the executive and the legislature is the same as it is in the federal House of Commons.

¹ Although members from the Senate can be appointed to the executive this is very rare.

The Courts

One institution that does have considerable power to check the power of the federal, provincial, and territorial governments is the courts. They conduct judicial review on two bases; 1) the division of powers (as it is specified in the Constitution) and 2) since 1982 on the basis of an entrenched Charter of Rights. In both of these cases the courts have the power to rule legislation null and void if it is found to violate the terms of the Constitution.

Constitutional Status of the Federal and Provincial Governments

The federal government and the 10 provincial governments are recognised and their existence is guaranteed in the Constitution (Canada Act 1867, s.1-5). The federal and provincial governments are independent of each other; there is **not** a hierarchical relationship between the two orders of government. The provincial legislatures and the federal parliament are each considered sovereign within their own constitutionally defined areas of jurisdiction.

The federal government has legislative and regulatory powers in areas that include: regulation of trade and commerce, national defence, foreign affairs, criminal law, unemployment insurance, and direct and indirect taxation. The provinces have legislative and regulatory powers in important, and costly, areas that include: education, health, social assistance, civil law (and the administration of justice), municipal affairs, licensing, and management of public lands and non-renewable natural resources and forestry resources, property law, civil law, direct taxation, “property and civil rights within a province” and other matters of a “local nature.”

Local and Territorial Governments

Canada's three territories remain under the constitutional authority of the federal government and their legal structures are specified in several federal statutes.² The territorial legislatures derive their legislative powers from the federal government. In the statutes that created the territories, the federal government delegated extensive powers to the territorial legislatures that roughly corresponds to the list of provincial powers.

Local governments (city governments, town governments, village governments, township governments, etc) are the creation of the provincial and territorial governments and are subject to regulation by the provincial and territorial governments that create them.

2. Constitutional Allocation of Revenue and Expenditure Responsibilities and Provisions related to Intergovernmental Transfers

Constitutional Allocation of Revenue

In Canada both the federal and provincial governments have broad taxing powers. The result is overlapping tax jurisdictions that make the taxation and revenue system rather complex.

The constitution gives the federal government an exclusive power to “raise money by any mode or system of taxation.”³ However, the Constitutional also gives the provinces the power to apply direct taxation in their provinces.⁴ As a result the federal and provincial governments share several of the most significant taxation powers. For example, both orders of government levy personal income taxes and general sales taxes. Table A1 indicates the various types of taxes levied by the federal and provincial governments and indicates the areas of overlap.

² The *Yukon Act*, *Northwest Territories Act*, *Nunavut Act*, *Government Organisation Act*, and the *Federal Interpretation Act*.

³ *Constitution Act, 1867*, s.91(3).

⁴ *Constitution Act, 1867*, s. 92(2).

Personal Income Taxes

The federal and provincial governments levy personal income taxes. The federal government determines the base for personal income tax and the provinces use this as the base for determining provincial personal income taxes.⁵

Corporate Income Taxes

Corporate income taxes are levied by both the federal and provincial governments. The federal government sets the basic rate and allows for an abatement of income earned in a province. This allows the provinces some tax room to impose their own taxes on corporate income earned in their province although not all of the provinces do so.⁶

Sales Taxes

General sales tax is levied by both federal and provincial governments.

⁵ Except in Quebec. The details of Quebec's tax system are covered in later sections of the paper. See Section D. Systems of Tax Harmonization and Tax Collection.

⁶ See Section D *Systems of Tax Harmonization and Tax Collection* for further details.

Table A.1: Taxes Levied by Federal, Provincial and Territorial Governments

Tax	Federal Government	Alberta	British Columbia	Manitoba	New Brunswick	Newfoundland and Labrador	Nova Scotia	Ontario	PEI	Quebec	Saskatchewan	Yukon & NWT
Personal Income	√	√	√	√	√	√	√	√	√	√*	√	√
Corporate Income	√	√*	√	√	√	√	√	√*	√	√*	√	√
Corporate Capital	√	√	√	√	√	√	√	√*		√*	√	
Customs and Excise	√											
Sales	Goods and Services	None†	Prov. Sales Tax	Prov. Sales Tax	Harmonised Sales Tax	Harmonised Sales Tax	Harmonised Sales Tax	Prov. Sales Tax	Prov. Sales Tax	Quebec Sales Tax	Prov. Sales Tax	None
Real Property	√	√	√	√	√				√			√
Tobacco	√	√	√	√	√	√	√	√	√	√	√	√
Fuel	√	√	√	√	√	√	√	√	√	√	√	
Payroll	√											
Insurance		√	√	√		√	√		√	√	√	√
Financial Institutions												
Health and Education		√	√	√			√					
Environment				√		√						
Mineral/Natural Resources		√		√	√	√	√			√		

† = has the constitutional power to levy a sales tax but does not have a sales tax

* This tax is collected by the province, not the federal government.

Constitutional Allocation of Expenditure Responsibilities

The constitutional allocation of expenditure responsibilities can be found in the sections of the constitution that divides the legislative powers and responsibilities between the federal and provincial governments (Constitution Act, 1867, ss. 91 to 95). The division of powers divides legislative responsibilities into three categories: 1) powers that are exclusive to the federal government, 2) powers that are exclusive to the provincial governments and 3) powers that are exercised concurrently by both orders of government.

In Canada almost all constitutionally specified legislative powers are exclusive powers. *De jure*, there are only four concurrent powers and they fall into the following areas: 1) exporting non-renewable natural resources, forestry resources, and electrical energy⁷, 2) old age pensions and benefits⁸, 3) agriculture and 4) immigration.⁹ All other legislative powers are categorised as exclusive powers of either the federal or provincial governments.¹⁰ Although most powers are defined as exclusive powers the use of intergovernmental transfers has meant that in many policy areas the jurisdiction is a *de facto* concurrent jurisdiction (section C *System of Intergovernmental Transfers* provides further details on the system of intergovernmental transfers).

At the time of federation in 1867 the most important priority was to promote the economic development of the new country. The building of railways, roads, canals, harbours and bridges to link the provinces with each other and with the rest of the world was the prerequisite for economic development. These duties, along with national defence were assigned to the federal government. The provinces were given other important responsibilities, such as the administration of justice, local institutions, health,

⁷ *Constitution Act*, 1867, s.92A(3)

⁸ *Constitution Act*, 1867, s. 94A

⁹ *Constitution Act*, 1867, s. 95. Both agriculture and immigration are under this provision.

education, welfare and other matters of a “local nature.” However, in 1867 the principle of laissez-faire was the dominant governing philosophy and these responsibilities were much less costly to the state than today. The initial allocation of revenue sources reflected the allocation of expenditure responsibilities.

The building of a modern industrial welfare state meant that although the federal responsibilities remain significant, the responsibilities assigned to the provinces have increased enormously in relative importance and have become the focus of major government policy initiatives.

Constitutional Provisions Related to Intergovernmental Transfers

The provinces have constitutional jurisdiction in areas that have become the most costly expenditure responsibilities but they also have access to considerable financial resources. The provinces are able to finance a large percentage of their expenditures out of their own revenues (see section B *Economic Numbers* for particular details) but there has always been a discrepancy between the provinces’ revenue capacity and their expenditure responsibilities.¹¹ The discrepancy between the provinces revenues and their expenditure responsibilities has resulted in a degree of vertical fiscal imbalance (VFI). There are also considerable differences in the size, population and economic wealth of the provinces that have resulted in horizontal fiscal imbalance between the provinces. These vertical and horizontal fiscal imbalances have led to the development of two types of transfers from the federal government to the provinces.

One set of transfers is intended to address the vertical imbalance between the federal government and the provinces. Under this system of transfers, the federal government transfers funds to the provinces that are to be spent in policy areas that are in the

¹⁰ It should be noted that although the federal government has the jurisdiction to legislate in the area of criminal law the provinces are responsible for the administration of criminal law.

¹¹ This is a slight simplification for the purposes of clarity. For full details on the tax sharing arrangements between governments see Section D.

constitutional jurisdiction of the provinces (primarily in healthcare, post-secondary education, and welfare). The federal government attaches modest conditions to these funds and the provinces must satisfy these conditions in order to receive the transfers.¹² The ability of the federal government to attach conditions to these transfers allows the federal government to influence, or in some cases establish policies that are outside its constitutional jurisdiction. All of the provinces are eligible to receive these transfers. These transfers are known as conditional transfers and they are made through the federal government's spending power. The federal government has also used its spending power to transfer funds directly to individuals or to organisations and agencies to achieve certain policy objectives (section 3 *Constitutional or Other Spending Power Provisions* provides further details on the federal government's spending power).

A second kind of transfers, known as Equalisation, was established to address the horizontal fiscal imbalance between the 10 provinces. These are unconditional transfers and only the less wealthy provinces are eligible to receive them. Currently seven provinces receive equalization transfers (section C *System of Intergovernmental Transfers* provides further details on equalization transfers).

The Canadian federal system includes an extensive and complex system of intergovernmental transfers (see the section *System of Intergovernmental Transfers* for details) but with one exception there are no constitutional provisions concerning intergovernmental transfers. The one case where the constitution does mention intergovernmental transfers is in relation to the system of equalization.¹³ These provisions were added to the Constitution in 1982 and express the commitment of the federal and provincial governments to a set of principles that are the basis of the equalization system. One of the provisions commits the federal government to “the principle of making

¹² Most conditions ensure accessibility and portability of benefits. For greater details on the conditions attached to these transfers see Section C *System of Intergovernmental Transfers*.

¹³ See the *Constitution Act, 1982* s. 36

equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”¹⁴ These provisions on equalization only represent a commitment by the respective governments to the principles behind the equalization system and there are no provisions that commit governments to contributing or receiving particular levels of funds. Although these provisions are in the constitution, leading constitutional scholars have argued that the provisions are probably too vague, and too political to be justiciable in the courts.¹⁵

3. Constitutional or Other Spending Power Provisions

The use of the federal government’s “spending power” is one of the major sources of intergovernmental transfers. These transfers are aimed at addressing the vertical fiscal imbalance between the federal and provincial governments. In Canada the meaning of the “federal spending power” refers to the ability of the federal government to transfer funds to other governments, agencies or individuals for purposes which the federal government does not have the explicit constitutional authority, or in matters where the provinces have exclusive jurisdiction. Although the federal spending power has played a critical role in the establishment and evolution of major social policies in Canada, there is no explicit recognition of the federal spending power in the Canadian Constitution. However, the Constitution as interpreted by the courts allows the federal government to spend its revenues on any matter, as long as the legislation authorising the spending of revenues does not constitute a regulatory function that falls within the provinces constitutional powers. The constitutional basis of the federal spending power is inferred from the federal government’s powers to raise taxes¹⁶ and, to legislate in relation to “public

¹⁴ *Constitution Act, 1982* s. 36(2).

¹⁵ Peter Hogg, *Constitutional Law of Canada*, 4th ed (Toronto, Carswell,1996), p. 142.

¹⁶ *Constitution Act 1867*, s. 91(3)

property,”¹⁷ and from Parliament’s authority to “appropriate” federal funds from the *Consolidated Revenue Fund*.¹⁸

In 1991 the Supreme Court of Canada’s latest decision on the constitutionality of the federal spending power made it clear that as long as the federal government does not go beyond granting or withholding money, there is no unconstitutional trespass into provincial jurisdiction.¹⁹ The court’s interpretation of the constitution has given the federal government a wide degree of discretion in how it chooses to use its spending power. In essence, there are no significant constitutional restrictions on the federal government’s ability to use its spending power in order to transfer funds to individuals, agencies or other governments for policy purposes for which it does not have explicit constitutional authority to legislate or regulate. Despite occasional objections from the provinces most of them have accepted the court’s interpretation of the spending power.²⁰

In recent years, the issue of the federal spending power has attracted renewed attention. After a period that saw the federal government make drastic reductions in transfers to the provinces, the federal government appears to be taking an interest in initiating new social programs or proposing substantial additions to existing programs (for example, adding a national home-care policy).

As a result, the use of the spending power has been a source of recent political debate that has resulted in the federal, provincial and territorial governments signing the *Social Union Framework Agreement* in February 1999.²¹ One of the sections in the agreement recognises the legitimacy of the federal spending power and in return the federal

¹⁷ *Constitution Act 1867*, s.91(1A)

¹⁸ *Constitution Act 1867*, s. 106.

¹⁹ *Re Canada Assistance Plan* [1991] 1 S.C.R. 525. For a detailed explanation of this case see Hogg, 1996, p. 149-150.

²⁰ Quebec has consistently rejected the legitimacy of the federal government’s spending power. For further details on the use of the federal spending power see Section C *System of Intergovernmental Transfers*.

²¹ The government of Quebec did not sign the Agreement.

government accepts some restrictions on the exercise of its spending power.²² The *Social Union Framework Agreement* is only an intergovernmental political agreement however. Not only does it not have any constitutional status; it is not even legally binding.

4. Political and Legal Dynamics - including the Role of Law and Role of Politics in the Decision-Making Processes

Canada is a federation that consists of two principal linguistic communities (French and English). Major formal amendment of the constitution in response to changing social and economic circumstances that meets the needs of both communities has proven to be almost impossible. The lack of major formal amendments to the constitution does not mean that significant changes have not taken place to meet new challenges facing the federation. The federation has evolved largely through the non-constitutional processes of intergovernmental relations. Negotiations between the executives from each order of government (“executive federalism”) have allowed the federal government to pursue general policy objectives while at the same time leaving the provinces a major role in designing and financing the programs that meet the federal government’s Canada-wide objectives. This process has also been flexible enough to accommodate many of the particular needs of the provinces, but the historical demands of Quebec, for a greater degree of fiscal and policy autonomy from the federal government has put a considerable strain on the process of intergovernmental relations. These demands by Quebec have made it increasingly difficult for the federal government to pursue Canada-wide policy objectives while at the same time accommodating Quebec’s pressures for greater fiscal and policy autonomy. In recent years the larger and wealthier provinces have begun to articulate a position similar to Quebec’s. As early as the 1970s Alberta argued that they needed greater fiscal and policy autonomy in order to pursue provincial economic

²² For the specific details on the use of the spending power see *The Social Union Framework Agreement*, section 5. It should be noted that one of Quebec’s reasons for not signing the Agreement concerned the provisions recognising the legitimacy of the federal spending power.

strategies. More recently the province of Ontario, and on occasion British Columbia, have made similar arguments.

Nevertheless, the informal (non-constitutional) process of intergovernmental relations has become one of the primary methods for responding to social and economic changes affecting the federation. These processes of intergovernmental relations have resulted in a complex series of fiscal arrangements between the federal and provincial governments. These fiscal arrangements, made in response to social and economic changes, have largely taken the place of formal constitutional change which has proven to be politically divisive and almost impossible to achieve.

Role of Law in the Decision-Making Process

As already indicated, the non-constitutional process of intergovernmental relations has played a central role in issues that affect federalism and fiscal arrangements between the federal and provincial governments. Although this is the primary venue for resolving disputes over issues of federalism, the courts and the formal provisions of the constitution have played, and continue to play, a significant role in affecting these disputes and how they are resolved by providing the framework within which intergovernmental relations occurs.

One of the central features of the Canadian Constitution is the division of powers contained in the Constitution Act, 1867. Since 1867 the courts have had the responsibility of interpreting these provisions and determining whether an Act or some provision of an Act is within the legislative jurisdiction of Parliament or of a provincial legislature. The courts may only intervene in a dispute over the division of powers if a case is brought before the court or when a government requests the court's opinion through a procedure known as a "reference."²³

²³ This process will be explained later in this section.

Section 91 of the *Constitution Act, 1867* specifies the list of exclusive federal powers and gives the federal government residual powers by assigning them legislative and regulatory powers that are not assigned to the provinces. It is through the provisions in s.91 of the *Constitution Act, 1867* that the federal government is said to have been assigned all residual powers except in local matters.

Although the constitution assigns residual powers to the federal government this has not resulted in an expansion of its legislative powers because the courts have given a broad and expansive interpretation to the powers of the provinces under s.92 of the *Constitution*. By giving an expansive interpretation of the provincial authority there has been very little room for the federal government to assume new legislative powers.

To summarise, the courts have played a critical role in defining the relative powers of the federal parliament and the provincial legislatures. The court's narrow interpretation of the federal government's powers and a broad interpretation of the provinces' powers has meant that the federal government has a narrower range of powers than the constitution would seem to suggest and the provinces have a much wider range of powers. However, as noted earlier, the courts have given a broad interpretation of the federal government's spending power which has allowed the federal government to significantly expand its *de facto* policy jurisdiction.

The Constitutional Amending Formula and the Difficulty of Amending the Constitution

Amending the constitution in Canada has been a politically contentious and difficult task that has, at times, seriously threatened the unity of the federation. As a result, the federation has evolved mainly through a non-constitutional process of intergovernmental agreements.

Canada's original Constitution of 1867 did not specify a process whereby the Constitution could be amended in Canada. The issue of the amending formula for the

Constitution was so politically contentious that it was the subject of over fifty years of constitutional debates between the federal government and the provinces until a formal amending process was adopted in 1982.²⁴ The 1982 amendments to the Constitution only exacerbated the Constitutional tensions, however, because Quebec refused to sign the new constitution.

A new federal government was elected in 1984 and initiated two rounds of major constitutional negotiations with Quebec and the other provinces in an attempt to get Quebec to sign the Constitution. Both of these major attempts at constitutional reform failed and further threatened the unity of the country.

The difficulty of formally amending the Constitution and the threat that constitutional negotiations pose for national unity means that the primary method of adapting to changing circumstances has been through the non-constitutional process of intergovernmental agreements and, in this regard, the instruments of fiscal federalism have played a key role.

*Reference Procedures*²⁵

An important role played by the courts in matters that affect the powers of the federal and provincial governments is their ability to provide advisory opinions to the federal and provincial governments concerning the constitutionality of legislation. The basis for this function is not found in the Constitution but is found in federal and provincial legislation.

The Supreme Court Act gives the Supreme Court the function of providing advisory opinions to the federal government on questions that it refers to the Court.²⁶ Provincial governments cannot direct a reference to the Supreme Court but all of the provinces have legislation that allows them to request references from the highest provincial court. Once

²⁴ See the Constitution Acts, 1982 ss. 38-49

²⁵ For a thorough description of this topic see Hogg, 1996, 209-214.

²⁶ *Supreme Court Act*, s.53.

a provincial court of appeal has rendered its decision on a case there is a right of appeal to the Supreme Court which has the effect of allowing the provincial governments to secure a ruling from the Supreme Court. The reference procedure has been used mainly for constitutional questions and they usually concern the constitutionality of a federal or provincial law (or a proposed law).

Appointments to the Appeal Courts

The important role played by the courts in interpreting the constitution has meant that the method of appointing judges to the courts has attracted some political attention. The Constitution gives the federal government the power to appoint all superior court judges, which includes the judges on all of the highest provincial courts and the justices of the Supreme Court.²⁷ This gives the federal government the power to appoint federal and provincial judges that are responsible for interpreting the constitution and the relative powers of the federal and provincial governments. Because of the role the courts play, especially the provincial appeal courts and the Supreme Court, in interpreting the constitution on matters that relate to federalism the appointment process has been the subject of constitutional negotiations.

There are a number of constitutional conventions that are respected in the appointment of Supreme Court judges that ensure regional and linguistic representation on the Supreme Court but these conventions are not specified in the constitution. The provinces have argued that the constitution should be amended to give them a formal role in the appointment of judges to superior courts and that there should be guarantees written into the constitution of regional and linguistic representation on the Supreme Court.

²⁷ *The Constitution Act, 1867* s.96.

Role of Politics in the Decision-Making Process

Executive Federalism

As indicated above, there is almost a total lack of attention to the issue of intergovernmental relations in the provisions of the constitution. This means that the process of intergovernmental relations is governed almost entirely by a series of conventions and informal intergovernmental agreements. In the post-war period the process of intergovernmental relations in Canada has come to be a process called “executive federalism”. Executive federalism is a process in which intergovernmental relations are carried out by the executive branches of the federal and provincial governments (this takes place at both the political and bureaucratic levels). The result is that most intergovernmental relations are conducted by the premiers and the prime minister or by ministers and officials that are under their direct control. The federal government and most of the provincial governments have separate ministries responsible for intergovernmental relations. The increasing significance of intergovernmental relations for both orders of government also means that the largest departments in the federal and provincial governments also have specific personnel, or in some cases entire bureaucratic divisions, that focus on intergovernmental issues.

The highest profile and most public meetings that take place between the federal and the provinces are the First Ministers’ Conferences that are attended by the Prime Minister and the premiers of the provinces. These meetings are called by the Prime Minister and usually concern issues that are of the greatest political concern. There are also a variety of other meetings that take place among the premiers, without the prime minister. At these meetings the premiers may discuss issues that relate to provincial or federal social and economic policies, constitutional issues, and other issues that maybe of particular concern. Examples of these meetings include: the Annual Premiers’ Conference, the

Council of Maritime Premiers, Conference of Atlantic Premiers, the Western Premiers' Conference, and the Council of New England Governors and Eastern Canadian Premiers. There are also extensive sectoral meetings (Ministerial Conferences) between cabinet ministers from the different orders of government that have responsibilities that require a great deal of intergovernmental consultation. Much more numerous are the meetings that take place at the bureaucratic level between the civil servants in the federal and provincial governments. These meetings are primarily concerned with implementing agreements that have been made at a higher level and ensuring that the necessary coordination is taking place on important policy issues.

It was the building of the modern welfare state in the immediate post-war period that initiated and accelerated the process of executive federalism. The provinces had constitutional jurisdiction in many of the policy areas that are a central part of the welfare state but, at that time, the provinces lacked sufficient financial resources to fulfil these responsibilities. Therefore the federal government, with greater fiscal resources and fewer expenditure responsibilities, took a lead role in initiating and financing new major social programs through the use of its general spending power.²⁸ As the range of social programs expanded the federal and provincial governments became more interdependent. Although the constitution assigned the provinces exclusive powers over most areas of social policy the federal government used its spending power (and the conditions which it attached to it) to help finance and influence major social policies that were in the constitutional jurisdiction of the provinces. Therefore, despite assigning most social policy powers exclusively to the provinces the significant role played by the federal government means that these are in practice concurrent powers.²⁹

²⁸ The federal government had occupied extensive tax room during World War II through a political agreement with the provinces. Once the war was over, however, the federal government was reluctant to give up significant tax room to the provinces. See Section D for further details.

²⁹ It should be noted that the federal government does have exclusive jurisdiction for the provision of unemployment insurance.

The Differences Between the Provinces

As indicated earlier, the provinces play a central role in the process of executive federalism. The provinces have constitutional jurisdiction in most social policy areas and they have access to a broad base of tax revenues. However, there is still a considerable degree of vertical fiscal imbalance between the federal government and the provincial governments (see section B). It is this imbalance that creates a role for the federal government to use its spending power to influence the design and delivery of social programs in areas such as healthcare, post-secondary education and welfare that are within the constitutional jurisdiction of the provinces. Although the data in section B (*the Economic Numbers*) indicates that the federal government's role in social policy spending has been declining over the last forty years, it was the federal government that initiated many of the programs that are now funded to a larger extent by the provinces. In addition, although the contribution of the federal government has been declining it continues to play a central role in influencing the financing and delivery of social programs at the provincial level.

One feature of Canadian federalism that has had a significant effect on the dynamics of intergovernmental relations is the asymmetry that exists between the various provinces. The data in section B provides some indication of the range in relative wealth of the 10 provinces. The relative wealth of provinces has played a role in the dynamics of executive federalism and negotiations over fiscal arrangements. The significant differences in the wealth of the provinces means that some provinces are much more dependent on transfers from the federal government than other provinces. Generally, the three wealthier provinces (British Columbia, Alberta, and Ontario) raise a higher proportion of their revenues from their own provincial sources and federal government transfers constitute a relatively small percentage of their provincial revenues (approx. 11

percent).³⁰ To varying degrees and at different times, these provinces have expressed greater concerns that the use of the federal spending power trespasses on provincial jurisdiction. They have also expressed greater concerns to varying degrees over the conditions that apply to the use of the federal spending power.³¹ For the other provinces, especially the poorer provinces, the federal government transfers account for a much larger percentage of provincial government revenues (almost 40 percent for Prince Edward Island and Newfoundland)³² and these provinces are much more dependent on these transfers as a method of funding their social policy expenditures. Because of their dependence on these transfers these provinces have generally expressed fewer concerns about the use of the federal spending power.³³

Although the spending power gives the federal government considerable power and influence in intergovernmental relations, it is the provinces that have the constitutional jurisdiction that is necessary for most social policy programs. This means that although the federal government has the ability to use its spending power to establish cost-shared programs (conditional transfers) it still relies on the cooperation of the provinces to provide similar levels of funding and implementation of these programs. Because the wealthier provinces rely on the federal government for a relatively small percentage of their total revenues they have a stronger position in negotiations with the federal government concerning the financing of jointly-financed programs. These provinces are more likely to challenge the federal government on the conditions that are attached to intergovernmental transfers and threaten the existence of country-wide programs with country-wide “standards.”

³⁰ See Table 5 in Appendix to Section B.

³¹ At present for example, Alberta and Ontario are strong critics of federal spending power, whereas British Columbia is favourably disposed to its use.

³² See Table 5 in Appendix to Section B.

³³ This statement is **not** true of Quebec.

The Role of Quebec

Quebec is not among the group of wealthy provinces but its unique status in the federation as the principal home of French speaking Canadians means that it has consistently sought much more political and fiscal autonomy from the federal government in order to preserve and promote its French language and culture. The result has been that Quebec has always been critical of the federal governments use of the federal spending power to implement policies that are within the exclusive constitutional jurisdiction of the provinces. Quebec has used its political power and significance, along with the argument of exclusive provincial jurisdiction, to negotiate a much reduced role for the federal government in influencing the development of social programs in Quebec. As early as the 1950s, the Quebec government began its opposition to federal government initiatives to establish federal programs in areas of provincial jurisdiction (such as funding for post-secondary institutions). Quebec's opposition to federal government interference in its provincial jurisdiction also meant that Quebec refused to sign tax "rental" agreements with the federal government in the 1950s and later refused to sign tax collection agreements with the federal government.³⁴ Quebec has consistently argued that these agreements interfere with the province's exclusive power over direct taxation. As a result Quebec is the only province to have its own provincial tax system (see section D *Systems of Tax Harmonisation and Tax Collection* for further details).

Quebec is also unique among the provinces in that it receives a larger percentage of its transfers from the federal government in the form of tax points rather than cash transfers. This is the result of Quebec "opting-out" of national programs established through the federal government's spending power. Instead of participating in the national programs Quebec receives cash transfers from the federal government that allow Quebec to design and deliver its own provincial programs in the areas where the federal

government has established a Canada-wide program. Because a larger portion of transfers to Quebec are in the form of additional tax points, these revenues are unconditional and provide greater discretion to the Quebec government in how they are spent. Therefore, a larger percentage of transfers to Quebec are unconditional in form than is the case for other provinces.

The constant pressure from Quebec for greater political and fiscal autonomy has presented a significant challenge to the federal government in creating new and additional social programs that achieve Canada-wide policy objectives. When the federal government initiated the creation of social programs that are the basis of Canada's modern welfare state there was little opposition from the English-speaking provinces to the use of the spending power.³⁵ After forty years of experience with the federal spending power many of these provinces, however, especially the wealthier provinces, have become more critical of the federal government's use of the spending power. When the federal government has sought to extend the use of its spending power Quebec has registered its usual objections and sought to opt-out of any new initiative while receiving compensation from the federal government. Now that some other provinces are reluctant to agree to any extension of the spending power they are also demanding the opportunity to opt-out of new programs with compensation. The result is that the federal government is finding it increasingly difficult to accommodate Quebec's demands while at the same time coming to a common agreement on financing country-wide programs with the other provinces. Furthermore, the other provinces are increasingly reluctant to agree to any extension of the spending power unless they are given the same opportunity as Quebec to opt-out of country-wide programs with compensation. However, extending this option to

³⁴ This subject is covered in greater detail in Section D.

³⁵ Richard Simeon, and Ian Robinson, *State, Society, and the Development of Canadian Federalism* (Toronto, University of Toronto Press, 1990), p. 150.

all the other provinces, or even a few of them, would undermine the objectives of a country-wide program with uniform country-wide standards.

The *Social Union Framework Agreement* is the latest attempt by the federal and provincial governments to reach an agreement on the conditions under which the federal government could extend the use of its spending power. However, Quebec did not sign that Agreement because its provisions recognised the political legitimacy of the federal spending power and did not explicitly allow provinces to opt-out of new programs (created by the use of the spending power) with compensation.

Role of the Federal Government in Intergovernmental Relations

The federal government plays a leading role in the process of intergovernmental relations. A large part of the federal government's influence in intergovernmental relations comes from its use of the spending power. The federal government's spending power is used to provide funding for major social and other programs through intergovernmental transfers to the provinces and through transfers that are made directly to individuals, or organisations. As noted earlier, there are very few restrictions on the federal government's use of the spending power, and with the exception of limitations it has accepted in intergovernmental agreements, the federal government retains unilateral decision-making power on the use of its spending-power. The use of its spending power therefore allows the federal government to influence programs delivered by the provinces by offering funding to the provinces with the requirement that programs fulfil certain conditions. Alternatively the federal government can use its spending power to transfer funds directly to individuals or organisations to create programs that will have a substantial effect on existing provincial programs.

Therefore the effects of the federal government's spending power, and its ability to make unilateral decisions on the use of the spending power,³⁶ gives the federal government a powerful role in intergovernmental relations. However, the power and influence of the federal government is constrained by the fact that it lacks the necessary constitutional jurisdiction to implement its own programs in many areas and must rely on the cooperation of the provinces to implement many policies. Therefore, the federal government must be careful not to generate disagreements with the provinces on a particular issue in case the provinces use this as a reason for not negotiating or cooperating on other policy issues.

5. Transparency and Accountability

Revenue and Expenditure Responsibilities of Governments

The complexity of the fiscal arrangements between the two orders of government and the complexity of constitutional law surrounding the division of powers (and the exercise of the spending power) means that there is very little transparency in this area. In regards to the accountability of governments in this area, the primary method of ensuring accountability is through the traditional conventions of executive responsibility to the legislature within each of the participating governments.

As described earlier, the division of powers between the federal and provincial governments is easy to identify in the Constitution but the provisions themselves are not as clear as they might seem. The constitutional division of powers concentrates on dividing legislative powers that were significant in 1867 and does not reflect the functions that are carried out by modern governments that are responsible for maintaining modern welfare states. In addition, some of the powers granted to the federal and provincial governments are of a very general nature and it is not at all clear what power is

³⁶ It is important to note the restriction the federal government has recently accepted on the use of

being allocated to the respective governments. For example the federal government's power to legislate for the "peace, order and good government of Canada" and the provinces power to legislate in regards to "all matters of a merely local or private nature in the province" have been the subject of extensive litigation by governments and have resulted in many different judicial interpretations. The language used in the division of powers and the legal complexity surrounding the interpretation of government's legislative powers have made it very difficult for ordinary citizens to determine what order of government is responsible for a particular policy or program. In fact, governments are themselves often uncertain about the extent of their legislative powers and have made use of the reference procedure to the courts to seek clarification on their powers under the Constitution.

These problems of transparency are exacerbated by the complex system of intergovernmental transfers from the federal government to the provinces. The use of the spending power, and to a lesser extent Equalization, allow both orders of government to claim a role in many of Canada's most important social policies but the use of these transfers makes it difficult for citizens to determine which government is politically responsible for a particular program or policy. As discussed earlier, the use of intergovernmental transfers makes most social policy areas *de facto* concurrent powers rather than exclusive powers as indicated in the provisions of the Constitution. In this respect the formal provisions of the Constitution can be very misleading in indicating the *de facto* responsibilities of each order of government. It is not uncommon for governments to exploit the lack of transparency and argue that the other order of government is responsible for any problems being experienced or that a decline in levels of service is the result of decisions made by the other order of government. Therefore, a

spending power in the *Social Union Framework Agreement*.

lack of transparency on government's legislative powers has undermined accountability to some extent.

The primary method of ensuring that governments are accountable in relation to the exercise of their expenditure and revenue responsibilities is through the standard parliamentary procedures of responsible government. This means that the members of the executive must be available each day in the legislature to answer questions from the opposition parties on any issue relating to the governments activities. The other aspect of accountability is that citizens are given the opportunity to judge the performance of their government in the election process. It might be added that an additional form of informal accountability is achieved through the public relations efforts of each government. Governments will seek to maximise their visibility and seek recognition for their contribution to a policy or program or attempt to blame policy failures on the other order of government. The effectiveness of these accountability measures is undermined, however, by the lack of transparency and clarity concerning the role and responsibilities of each government in a particular policy or program.

Executive Federalism

There is a low level of transparency in intergovernmental relations and the process of executive federalism. The high profile First Ministers' Meetings between the Prime Minister and the Premiers are very public affairs with governments issuing press releases indicating their positions on certain issues. Despite the public attention given to these events, and the public statements of the governments, to ensure effective negotiation the most important negotiations are carried on in closed sessions. This prevents citizens from knowing what their governments' bargaining positions are on a particular issue or what compromises their governments are making in the process of negotiations. However, these First Ministers' Meetings constitute only a very small amount of the negotiations that go on between governments and their various departments. The vast majority of

intergovernmental activity is carried out at a much lower level and receives much less, if any, public attention. Most intergovernmental meetings take place at the bureaucratic level between the public servants in the various departments of the federal and provincial governments. These are closed meetings and they receive little, if any, public attention.

There are no special accountability mechanisms to ensure the accountability of governments for the commitments they make in intergovernmental agreements. As already noted, the main methods of accountability are the standard parliamentary procedures whereby the executive must have the support of a majority in its legislature to remain in government.

Recent Developments: The Social Union Framework Agreement

The Social Union Framework Agreement is an intergovernmental agreement signed by the federal government and nine of the provincial governments early in 1999.³⁷ Some of the provisions in the Agreement attempt to address issues that relate to the lack of accountability and transparency in the intergovernmental relations process.³⁸

Although these provisions in the Social Union Framework Agreement are indicators that governments are attempting to address the issues of accountability and transparency it is important to remember that these commitments are themselves only part of an intergovernmental agreement. The Agreement is now 18 months old but as yet there are few visible signs that governments have made any progress in meeting these accountability and transparency commitments.

³⁷ Quebec did not sign the Agreement.

³⁸ See section three of the Social Union Framework Agreement, “Informing Canadians – Public Accountability and Transparency.”

B. A SUMMARY OF FEDERAL AND PROVINCIAL BUDGETARY ELATIONS IN CANADA

This section contains a description of the stylized facts of the relative magnitudes of federal and provincial fiscal responsibilities and how they have evolved over time. This includes the shares of federal and provincial governments in public spending and revenue raising, the importance of transfers between the two orders of government, and the extent of vertical and fiscal imbalance in the Canadian federation.

In Canada, there is a hierarchical fiscal relationship among the three main orders of government. The federal government deals mainly with the provinces, while the provinces deal with the municipalities within their borders. The division of fiscal responsibilities between a province and its municipalities differs considerably across provinces. As well, although the provinces are legislatively independent from the federal government, municipalities are not legislatively independent of the provinces. As already noted, the municipalities are the creation of the provinces and provincial governments exercise extensive oversight over their municipalities. This makes the provision of some important public services, such as education, welfare and health, very much subject to joint provincial-municipal decisions. For these reasons, we have aggregated provincial and municipal expenditures together, and refer to the result simply as ‘the provinces’.

For the most part, we treat the provinces as an aggregate, though presenting disaggregated data by province as well. In the following subsections, we present the shares of federal and provincial governments in total public spending; their shares in total revenues; the importance of transfers from one level to another, and the manner in which these transfers affect the vertical and horizontal imbalances that exist across jurisdictions.

1. Federal And Provincial Shares Of Total Public Spending

Table B.1 provides almost 40 years of data indicating the shares of federal and provincial governments in total public sector spending.³⁹ Since public sector spending includes transfers made to other orders of government, and those transfers go to finance programs of the latter, it would be misleading simply to record expenditure shares with those programs included. We have therefore presented two alternative calculations of shares — one with the transfers included, and one without. Recall that we have aggregated the provinces and their municipalities together, so this is really only an issue with respect to the federal government. Thus, shares of federal and provincial spending including intergovernmental transfers treat federal transfers to the provinces as a component of federal spending, while shares excluding intergovernmental transfers do not.

³⁹ The data used to obtain Tables B.1-B.7 come from the CANSIM database, which is a database of statistics about the Canadian economy produced and maintained by Statistics Canada. Tables B.8 and B.9 are based on data obtained from the Department of Finance of the federal government.

**Table B.1: Federal and Provincial Government Shares of Total Public Spending
(Percentages)**

Year	Including Intergovernmental Transfers		Excluding Intergovernmental Transfers	
	Federal	Provincial	Federal	Provincial
1961	57.4	42.6	52.7	47.3
1962	56.8	43.2	51.8	48.2
1963	55.1	44.9	50.0	50.0
1964	53.6	46.4	48.7	51.3
1965	51.7	48.3	46.1	53.9
1966	51.5	48.5	45.6	54.4
1967	49.9	50.1	44.1	55.9
1968	48.8	51.2	42.6	57.4
1969	47.3	52.7	41.2	58.8
1970	46.4	53.6	39.7	60.3
1971	46.3	53.7	38.7	61.3
1972	47.1	52.9	40.5	59.5
1973	46.2	53.8	40.0	60.0
1974	48.2	51.8	42.0	58.0
1975	48.6	51.4	42.3	57.7
1976	46.5	53.5	40.2	59.8
1977	46.2	53.8	39.8	60.2
1978	46.3	53.7	39.9	60.1
1979	45.4	54.6	39.2	60.8
1980	45.4	54.6	39.5	60.5
1981	46.0	54.0	40.6	59.4
1982	46.3	53.7	41.0	59.0
1983	46.1	53.9	40.7	59.3
1984	47.5	52.5	42.0	58.0
1985	48.1	51.9	42.6	57.4
1986	46.9	53.1	41.7	58.3
1987	46.7	53.3	41.5	58.5
1988	46.4	53.6	41.0	59.0
1989	46.3	53.7	41.1	58.9
1990	46.3	53.7	41.3	58.7
1991	45.8	54.2	41.1	58.9
1992	44.7	55.3	39.7	60.3
1993	44.6	55.4	39.6	60.4
1994	44.3	55.7	39.4	60.6
1995	44.9	55.1	39.9	60.1
1996	44.2	55.8	39.8	60.2
1997	43.2	56.8	39.3	60.7
1998	43.1	56.9	39.1	60.9
1999	43.9	56.1	39.2	60.8

Shares Including Intergovernmental Transfers

As the Table indicates, there has been a gradual decentralization of spending responsibilities from the federal government to the provinces over the post-war period. In the early 1960s, almost sixty percent of government spending was by the federal government, while by the end of the century that had been reversed. Indeed, had only goods and services been included in government spending, the decentralization would have been even more dramatic, given the relative importance of transfers as a component of federal spending.

There are a number of potential reasons for this turnaround in responsibilities. Provincial expenditure responsibilities happen to be in areas of growth in spending. Canadian provinces have exclusive legislative responsibility in the key areas of health, education and social services, and these have grown at relatively high rates in most countries. At the same time, some of the traditionally important federal spending responsibilities such as defence have not grown so rapidly, or even declined. Changes in federal transfers to the provinces might themselves be partly responsible for the decline in the relative share of the federal government. To see how important this might have been, we can contrast the results with and without intergovernmental transfers.

Shares Excluding Intergovernmental Transfers

As the table indicates, excluding intergovernmental transfers from the public sector spending enhances the share of the provinces relative to the federal government in all years. Federal shares tend to be 4-5 percentage points less and provincial shares the same amount more when intergovernmental transfers are removed. This is as expected, given that it is federal spending that is reduced by the change. The removal of

intergovernmental transfers does not itself seem to have much effect on the downward trend of the federal share: it simply increases the provincial share in all years by roughly the same amount in percentage terms.

The extent of decentralization of spending responsibilities is not unusual among other federations. Comparable spending shares of regional governments would be found such federations as Australia, Belgium and Germany. In fact, even some unitary states have reasonably high levels of spending at the regional government level, such as Japan or the Scandinavian countries. Of course, levels of spending might not be a perfect indicator of the degree of decentralization. Different degrees of discretion could be associated with decentralized spending. Moreover, these degrees of decentralization may not be found on the revenue side, to which we turn below.

Before turning to the revenue side, it is worth mentioning that the shares of federal and provincial spending actually vary considerably across provinces. As Tables 1 and 2 in the Appendix indicate, federal government shares are substantially higher in lower-income provinces than in higher-income ones. The share of federal spending including (excluding) intergovernmental transfers range from about 60 (53) in the Atlantic Provinces to 45 (41) percent in the four western provinces. It is perhaps a bit surprising that these big differences persist, given that the purpose of the transfers is to enable the provinces to provide comparable level of public services. Even when federal-provincial transfers are excluded, expenditure seems to be more decentralized in the better off provinces, perhaps reflecting greater concentrations of federal spending in the lower-income provinces.

2. Federal And Provincial Government Shares Of Total Government Revenues

Table B.2 gives federal and provincial government shares of total government revenues for the same four decades. As with spending, a distinction must be made between revenues including and excluding intergovernmental transfers. In this case, it is the recipient government that is most affected, and in particular, the provincial governments. Revenues excluding intergovernmental transfers represent only own source revenues (mainly taxation) and not the substantial transfers the provinces receive from the federal government.

Table B.2: Federal and Provincial Government Shares of Total Government Revenues (Percentages)

YEAR	Including Intergovernmental Transfers		Excluding Intergovernmental Transfers	
	Federal	Provincial	Federal	Provincial
1961	54.4	45.6	60.3	39.7
1962	50.8	49.2	56.5	43.5
1963	50.0	50.0	55.5	44.5
1964	50.7	49.3	55.7	44.3
1965	49.2	50.8	54.2	45.8
1966	48.1	51.9	53.4	46.6
1967	47.1	52.9	52.2	47.8
1968	46.2	53.8	51.4	48.6
1969	47.3	52.7	52.2	47.8
1970	45.8	54.2	51.3	48.7
1971	45.2	54.8	51.4	48.6
1972	46.0	54.0	51.6	48.4
1973	46.2	53.8	51.3	48.7
1974	47.8	52.2	53.1	46.9
1975	46.1	53.9	51.9	48.1
1976	45.1	54.9	50.7	49.3
1977	41.9	58.1	47.2	52.8
1978	40.0	60.0	45.1	54.9
1979	40.4	59.6	45.2	54.8
1980	41.1	58.9	45.8	54.2
1981	43.9	56.1	48.5	51.5
1982	42.4	57.6	47.1	52.9
1983	41.0	59.0	45.7	54.3
1984	40.8	59.2	45.7	54.3
1985	41.5	58.5	46.5	53.5
1986	42.8	57.2	47.5	52.5
1987	42.8	57.2	47.4	52.6
1988	42.4	57.6	46.9	53.1
1989	42.2	57.8	46.5	53.5
1990	42.1	57.9	46.3	53.7
1991	43.0	57.0	47.3	52.7
1992	43.1	56.9	47.6	52.4
1993	42.0	58.0	46.4	53.6
1994	41.4	58.6	45.4	54.6
1995	42.0	58.0	46.0	54.0
1996	42.7	57.3	46.2	53.8
1997	44.1	55.9	47.0	53.0
1998	44.3	55.7	47.3	52.7
1999	44.0	56.0	47.3	52.7

When intergovernmental transfers are included, the shares are remarkably similar to those for spending, which is not surprising. However, when intergovernmental transfers are excluded both on the spending and on the revenue sides, the shares of federal government revenues are somewhat higher than for the provinces. Nonetheless, the federation is highly decentralized on the revenue side, and that is one of the things that make the Canadian federation rather unique.

At the end of the 20th century, the federal government raised less revenues than the provinces (47.3 percent of the total). This is a picture that is quite different than existed in the early post-war period when the federal government raised as much as 60 percent of total revenues. As in the case of spending, there has been a gradual decentralization of spending responsibilities to the provinces.

Once again, the extent of revenue decentralization varies among the provinces, but there seems to be no systematic difference between high- and low-income provinces as Tables 3 and 4 in the Appendix show. In the case of revenues excluding intergovernmental transfers (i.e., own-source revenues), the federal government's share is roughly the same in the highest-income province, Ontario, as in the low-income provinces of Prince Edward Island and New Brunswick.

3. Transfer Payments From Federal To Provincial Governments

Table B.3 shows transfers from the federal government to the provinces as a proportion of provincial government revenues for the years 1961-1999. Table 5 in the Appendix shows the same information disaggregated by recipient province. The message here is quite consistent with that of the previous tables. The Canadian federation has gradually become quite decentralized over the post-war period. The provinces now rely

on the federal government for only 13 percent of their revenues compared with over 20 percent in the early 1960s. In fact, the pattern of decline really only began in the late 1970s, and was precipitous during the 1990s.

Table B.3: Transfer Payments from Federal to Provincial Governments as a Share of Provincial Government Revenues (Percentages)

Year	
1961	21.5
1962	20.3
1963	19.7
1964	18.1
1965	18.3
1966	19.0
1967	18.6
1968	18.9
1969	18.0
1970	19.5
1971	22.0
1972	20.1
1973	18.3
1974	19.0
1975	20.9
1976	20.2
1977	19.7
1978	19.1
1979	18.3
1980	17.8
1981	17.0
1982	17.5
1983	17.6
1984	18.2
1985	18.7
1986	17.5
1987	17.2
1988	16.8
1989	16.2
1990	15.9
1991	16.2
1992	16.9
1993	16.7
1994	15.4
1995	15.7
1996	13.4
1997	11.5
1998	11.6
1999	13.0

A number of major episodes account for this pattern. The relatively high rate of provincial dependency on federal transfers at the beginning of the period was a reflection of the situation in the Second World War when the federal government occupied all of the income tax room with the agreement of the provinces (the federal-provincial tax rental agreements). The federal government began soon after the war to turn over revenue raising responsibility to the provinces, although not at a rate that satisfied all provinces. However, in the late 1950s and the 1960s, some major shared-cost programs were introduced in the areas of health and welfare, which precipitated modest increases in the proportions of provincial revenues obtained from federal transfers (or at least postponed their decline). In 1977, these shared-cost programs were replaced with bloc transfers whose rate of increase was tied to GNP rather than program expenditures because program expenditures were rising faster than GNP. This was a major factor leading to the gradual decline of provincial reliance on federal transfers over the following two decades. The rate of decline accelerated in the mid-1990s when the federal government embarked on a major expenditure reduction program to reduce its budget deficit. A substantial amount of its expenditure reductions took the form of reduced transfers to the provinces causing an abrupt change in the proportion of provincial revenues coming from federal transfers from about 16 percent to less than 12 percent.

The aggregate data reported in Table B.3 do not tell the entire picture. As Table 5 in the Appendix shows, different provinces rely to very different degrees on federal transfers. In 1995, the latest date for which disaggregated data are available, the higher-income provinces — Alberta, British Columbia and Ontario — received 10-12 percent of their revenues from federal transfers, while the remaining provinces showed much higher

reliance. Newfoundland obtained almost 42 percent and Prince Edward Island almost 40 percent of their revenues from the federal government. This reflects a common feature of federations, the fact that different provinces have quite different abilities to provide the sorts of basic public services with which they are entrusted. The federal system of transfers is designed explicitly to compensate for these differences, as we shall see further below.

The data for the various provinces have one feature in common with the aggregate data reported in Table B.3: the share of provincial revenues obtained from federal transfers has declined in tandem over the four-decade period. All provinces are now required to raise more revenues using their own tax sources. This decentralization in revenue-raising responsibility is quite unusual among federations. The relative ease with which it has occurred in Canada reflects the fact that the provinces have access to all of the main broad-based tax sources — personal and corporate income taxes, general sales taxes and payroll taxes. Moreover, they can set their rates independently. As the federal government reduced its transfers to the provinces, the provinces in turn were able to make up their revenues needs by increasing their tax rates as required. This implies that for the main tax sources, the provinces have occupied more and more of the available ‘tax room’. While this has increased the fiscal responsibility of the provinces, it has also led to some concerns about the harmonization of the major taxes across provinces. We return to this issue in Section D.

The picture that emerges from looking at expenditure and revenue shares is one of a federation that is not only highly decentralized with respect to the delivery of public services, but also one in which the financing of those services has become highly

decentralized. From this perspective, fiscal responsibility has become much more decentralized in Canada relative to some other established federations, such as Australia and Germany, where lower level jurisdictions rely much more heavily on federal transfers than in Canada. This is documented in more detail under the next heading.

4. Vertical Fiscal Imbalances

A common way to characterize the extent of decentralization of fiscal responsibility is by using the concept of *Vertical Fiscal Imbalance* (VFI). The VFI indicates the imbalance between federal revenues and their expenditure responsibilities. A large vertical imbalance implies that the provinces rely heavily on the federal government for transfers to finance their expenditures. This is liable to detract from fiscal decentralization since transfers are often accompanied with some conditions on how they should be spent, and these may affect provincial spending priorities. In addition, provincial governments may be less accountable for the way in which they spend or the amount that they spend if they are not responsible for raising their own revenues.

As in the case of calculating spending shares, it is useful to distinguish the VFI before intergovernmental transfers with that after them. Table B.4 shows VFI calculations both excluding and including intergovernmental transfers. The VFI is defined as difference between expenditures and revenues, taken as a percentage of expenditures. This can be done for both the federal and the provincial levels of government.

Table B.4: Vertical Imbalances Between Federal and Provincial Governments
[(Expenditures - Revenues)/ Expenditures]X100

Year	Intergovernmental Transfers Excluded		Intergovernmental Transfers Included	
	Federal	Provincial	Federal	Provincial
1961	-17.1	14.3	3.3	-9.2
1962	-12.7	6.4	7.7	-17.3
1963	-16.2	6.7	5.4	-16.2
1964	-25.8	5.1	-3.0	-15.8
1965	-32.9	3.7	-6.2	-17.8
1966	-29.1	5.5	-2.1	-16.7
1967	-25.8	9.1	0.4	-11.7
1968	-29.0	9.5	-0.5	-11.6
1969	-40.3	10.1	-9.5	-9.7
1970	-35.4	15.2	-3.2	-5.3
1971	-37.3	18.0	-0.5	-5.1
1972	-30.4	16.8	0.4	-4.3
1973	-34.9	14.4	-4.7	-4.8
1974	-36.5	12.4	-6.4	-8.1
1975	-17.6	19.9	8.5	-1.1
1976	-20.5	21.0	6.7	1.3
1977	-11.0	18.0	14.6	-1.9
1978	-3.9	16.0	19.7	-3.6
1979	-7.8	15.6	16.3	-3.0
1980	-6.7	17.4	15.9	-0.2
1981	-14.6	16.7	8.0	-0.1
1982	-1.0	21.0	18.3	4.5
1983	3.1	20.7	22.0	4.0
1984	5.4	18.4	24.2	0.4
1985	6.3	19.8	24.7	1.6
1986	-0.2	20.7	18.6	4.0
1987	-4.8	17.6	15.3	0.7
1988	-7.8	15.0	13.3	-1.9
1989	-6.3	14.5	13.7	-1.8
1990	-2.9	16.0	15.9	0.2
1991	-0.3	22.1	17.2	7.2
1992	-2.8	25.5	16.1	10.5
1993	-0.6	23.7	18.1	8.7
1994	-3.6	19.1	15.3	4.6
1995	-6.5	17.3	13.2	2.3
1996	-13.1	12.9	5.6	-0.2
1997	-23.8	9.9	-5.2	-1.5
1998	-24.7	10.8	-5.9	-0.6
1999	-28.9	7.5	-6.4	-6.1

VFI Excluding Intergovernmental Transfers

When intergovernmental transfers are excluded, the VFI for the federal government is the difference between its expenditures not including transfers to the provinces and its revenues as a proportion of expenditures less transfers. It represents the conventional definition of VFI: the extent to which federal expenditure needs are less than revenues. In fact, there are two elements of this difference that are difficult to distinguish. One is the amount of deficit financing, which in this definition would contribute to an excess of spending over revenues. The other is the conventional VFI, which is the imbalance between federal expenditure responsibilities and their revenue-raising ability. Similarly, for the provinces the VFI is provincial expenditures (including those of their municipalities) less revenues net of transfers from the federal government, as a proportion of expenditures. It measures the extent to which provincial expenditures exceed own source revenues, part of which will be reflected in a budget deficit and the rest covered by transfers from the federal government.

As Table B.4 indicates, the federal vertical imbalance is negative in most years, and varies considerably over time. It is relatively low in the 1980s and early 1990s, largely reflecting the high budget deficits of those years. When the federal government responded to those deficits in the mid-1990s, the VFI took on more conventional magnitudes.

A similar picture is seen in the VFI for the provinces, though in this case, the mirror image. Provincial expenditures are significantly in excess of own source revenues during the 1980s. The differential falls rapidly in the mid-1990s, and is less than 10 percent by 1999. Table 6 in the Appendix disaggregates provincial VFIs by province.

VFI Including Intergovernmental Transfers

In this case, federal transfers are included as part of federal government expenditures and also as part of provincial revenues. Now the VFI calculated at each level of government simply reflects the extent of deficit financing. The large positive values of the federal VFI in the 1980s shows the proportion of federal spending that had to be financed by borrowing. The negative values in more recent years represent the government surplus. The same applies for the provinces.

5. Horizontal Fiscal Imbalances

Different provinces have different fiscal capacities for delivering public services to their residents — that is, there are *Horizontal Fiscal Imbalances* (HFIs). These can arise from both the revenue and the expenditure sides of the budget. With respect to revenues, different provinces have different tax capacities, that is, differences in the ability to raise revenues using a given tax effort. On the expenditure side, the need for public services of different types can differ across provinces because of different demographic make-ups of the provincial population. As well, costs of provision can differ. We begin by presenting some raw data to indicate per capita differences in public spending and revenues by province. However, these can be misleading since differences can arise not just because of differences in fiscal capacity, but also because different provinces choose to provide different levels of public services. To address this problem partly, we present some data on tax capacity differences used to determine equalization payments from the federal government to the provinces. These represent truer measure of tax capacity than simple per capita revenue differences because they abstract from difference in tax rates chosen by provinces. Unfortunately, similar data are not available on the expenditure side.

HFI of Provincial Expenditures

Table B.5 shows per capita provincial government expenditures as a proportion of the national average over all provinces for the years 1961-1995.

Table B.5: Provincial Governments Per Capita Expenditures as a Percentage of Canadian Average

Year	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	78.2	86.3	82.9	85.8	89.2	103.7	99.8	114.6	119.8	117.9
1962	86.2	68.8	82.8	84.7	93.0	103.0	98.6	112.4	115.8	112.3
1963	76.1	84.6	80.5	74.5	92.0	104.7	99.0	120.1	113.5	112.9
1964	84.3	87.9	82.2	91.7	94.1	102.3	98.4	120.6	111.1	107.1
1965	83.8	55.9	81.1	82.8	99.7	102.0	94.3	110.8	111.6	103.0
1966	88.6	92.1	82.4	81.0	100.4	99.7	93.2	110.2	119.9	99.5
1967	105.6	89.9	79.0	72.7	97.5	103.2	90.0	102.6	128.4	93.9
1968	91.5	83.1	81.4	78.7	97.1	106.8	87.8	100.1	114.1	95.2
1969	86.0	78.8	82.1	90.4	93.4	108.3	89.8	94.8	115.8	97.6
1970	81.4	79.5	88.9	71.9	96.5	109.2	90.2	89.8	110.6	94.2
1971	89.8	84.7	87.6	86.1	98.4	107.7	91.4	87.1	109.8	89.2
1972	90.6	94.1	86.9	89.6	99.0	105.3	94.6	92.6	108.4	90.7
1973	86.7	92.4	88.4	78.3	104.2	102.0	95.0	90.8	107.7	93.6
1974	91.9	97.2	87.0	80.0	101.9	100.4	103.7	96.7	107.1	97.7
1975	91.0	95.4	91.9	82.9	99.4	100.2	102.3	103.6	107.9	100.1
1976	92.9	96.6	87.8	82.2	106.4	97.3	101.1	98.6	104.5	97.6
1977	90.0	97.5	84.9	83.5	112.5	94.4	98.2	100.8	102.7	94.5
1978	95.5	88.6	92.1	81.4	110.2	93.8	94.5	101.8	106.9	97.3
1979	94.9	85.0	89.0	79.1	114.4	90.5	95.3	102.5	110.6	96.4
1980	95.3	91.0	87.2	82.5	114.1	88.4	96.1	103.6	114.3	100.1
1981	95.1	91.6	87.3	79.8	113.6	88.2	93.8	104.3	115.1	101.3
1982	93.6	85.1	87.1	88.7	112.1	86.1	100.2	108.0	123.3	99.5
1983	96.5	86.3	83.7	84.0	107.8	86.0	99.6	107.9	141.6	96.5
1984	94.3	86.7	86.4	85.8	110.1	86.9	100.7	111.3	133.0	93.7
1985	93.3	83.1	86.3	86.3	111.3	88.5	101.2	110.8	129.5	89.1
1986	93.8	81.2	86.3	85.6	110.5	88.6	103.4	109.7	129.7	90.5
1987	95.9	85.3	87.2	87.5	108.0	91.4	108.5	106.9	123.2	90.3
1988	97.2	88.7	89.0	89.4	106.9	92.6	106.7	112.2	119.3	89.0
1989	98.6	90.5	89.4	89.0	107.1	93.4	108.2	109.9	118.2	87.6
1990	100.0	91.6	89.1	89.8	106.4	94.5	105.5	115.7	115.2	87.0
1991	96.7	89.4	86.5	88.4	106.2	96.6	104.3	108.9	109.4	89.5
1992	90.9	86.7	84.7	88.6	105.4	98.0	102.0	109.4	106.9	90.6
1993	91.7	91.1	89.6	90.7	105.7	97.4	101.5	105.0	103.3	94.0
1994	94.2	90.4	84.4	92.8	108.8	96.6	104.4	104.6	94.4	96.6
1995	97.7	87.8	84.7	94.6	110.9	96.7	99.6	104.0	89.8	96.4

These data reveal some interesting differences across provinces. Over the four decades, Quebec, Manitoba, Saskatchewan and Alberta have tended to spend above average amounts on a per capita basis, while the remaining provinces have been below. Prince Edward Island and Nova Scotia have been particularly low. In the very recent past, Alberta has gone from being an above average to a below average province, a finding that is consistent with a change in its policy stance.

These systematic differences over provinces have tended to persist over the four decades. In principle, they could arise from differences in needs for public expenditures, from differences in capacity to finance public services, and from differences in preferences towards public services. It seems likely, however, that at least part is due to differences in need and cost. The equalization system serves to equalize the ability to finance a common level of public services, so that should not be a major determinant of expenditure differences. Preference differences are possible in principle, but the fact that per capita expenditure differences persist over long periods of time makes one suspicious of that being the major determinant. Therefore, it seems likely to be the case that there are systematic differences across provinces in the need for public services or in their cost.

Unlike with the revenue-raising side, there is no explicit program that equalizes the ability of the provinces to provide a common level of public services to compensate for need differences. This is in contrast to Australia where the equalization system focuses primarily on equalizing for differences in need and cost. This is not surprising given that revenue-raising capacity of the Australian states is very limited compared to their Canadian counterparts.

HFI of Provincial Taxes Before Intergovernmental Transfers

Table B.6 shows per capita own source tax revenues by provinces for the same 1961-1995 time period.

Table B.6: Provincial Governments Per Capita Revenues, Before Intergovernmental Transfers, as a Percentage of Canadian Average

Year	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	37.6	46.4	63.0	65.1	95.4	110.7	85.8	110.8	112.8	117.6
1962	41.2	48.5	65.7	62.5	90.1	113.1	85.2	114.5	114.8	120.3
1963	40.2	51.5	64.9	64.0	90.3	111.9	86.1	119.4	113.5	121.3
1964	42.9	46.7	63.4	62.6	91.2	112.1	85.7	118.1	108.6	122.8
1965	42.2	51.7	60.8	61.0	93.4	110.1	88.9	113.9	110.9	122.5
1966	44.1	46.0	59.8	61.2	95.1	111.7	83.9	111.1	105.5	118.2
1967	42.2	46.2	60.3	55.5	95.9	113.2	84.3	106.3	106.0	113.5
1968	45.2	47.1	58.9	55.9	95.2	114.4	88.5	101.7	102.5	112.6
1969	45.4	51.7	64.1	56.3	93.1	114.5	91.2	97.0	103.3	115.4
1970	48.1	48.4	65.4	58.2	93.1	116.0	92.4	91.8	107.7	105.9
1971	50.2	55.6	65.5	58.3	95.3	113.9	89.7	88.9	109.9	106.0
1972	50.4	52.2	71.4	63.3	98.9	110.0	92.5	87.1	108.4	106.3
1973	50.9	55.7	69.7	57.0	100.4	106.2	84.5	88.2	117.2	113.8
1974	54.3	52.0	65.1	60.4	98.7	101.7	87.2	103.3	139.4	110.0
1975	59.0	55.8	66.0	57.9	98.9	96.3	85.8	112.0	156.1	111.3
1976	61.0	51.9	63.4	55.7	99.1	95.7	87.8	112.5	158.6	110.5
1977	61.8	51.9	61.9	59.0	101.4	93.0	83.8	111.6	163.3	109.9
1978	61.3	49.4	61.2	58.1	99.9	90.0	76.3	112.0	181.8	110.5
1979	59.8	49.4	59.5	56.5	98.9	90.9	77.9	111.6	179.1	110.8
1980	59.9	52.6	61.2	58.3	97.6	89.0	77.1	117.9	188.3	106.8
1981	57.7	52.3	57.4	55.8	100.0	88.1	78.4	111.0	186.0	107.0
1982	56.0	52.4	59.5	55.6	102.5	87.9	80.8	104.1	184.8	102.6
1983	58.4	53.3	62.2	58.6	99.5	88.9	83.6	111.1	186.9	99.0
1984	60.3	58.6	63.1	62.4	99.2	92.0	81.9	109.0	179.5	96.2
1985	61.8	55.0	66.5	62.9	100.9	94.4	85.1	104.0	168.6	93.4
1986	64.4	57.4	68.4	68.0	105.8	100.3	88.2	91.5	132.4	93.7
1987	64.3	59.7	68.6	68.4	105.8	101.1	91.9	97.1	126.7	92.3
1988	62.6	60.0	66.6	67.7	106.2	102.1	92.2	95.8	119.9	94.9
1989	62.1	60.8	64.8	66.4	102.9	104.2	90.4	107.9	114.4	96.9
1990	65.0	61.6	68.4	67.9	103.5	101.6	88.3	107.7	119.9	98.1
1991	68.3	66.5	70.3	72.0	108.1	99.3	90.6	98.0	117.3	97.4
1992	68.4	69.3	71.0	74.7	108.8	97.3	91.8	102.9	113.5	102.1
1993	69.1	69.6	68.7	75.4	106.1	97.3	93.4	108.2	112.4	106.5
1994	69.2	69.7	69.1	77.1	103.7	97.3	94.4	108.5	113.3	109.6
1995	70.9	69.5	67.8	78.7	106.2	97.4	94.4	106.6	108.4	107.8

Again, one must be cautious in interpreting these numbers since they reflect not only differences in tax capacity, but also differences in tax policy decisions taken by the provinces. Some provinces will choose lower tax rates than others and this will affect revenues per capita. Nonetheless, the data are suggestive. They reflect the wide disparities that exist across provinces in revenue-raising capacity. Alberta, British Columbia and Saskatchewan raise 6 to 8 percent more revenue per capita than the national average. (Quebec does too, but that is a bit of an anomaly arising from the fact that for historical reasons, it occupies more of the income tax room than the other provinces and receives correspondingly lower cash transfers from the federal government.) At the other end, the four Atlantic Provinces raise only between 70 and 80 percent of national average tax revenues. Ontario is near the average, reflecting the fact that its size dominates the calculation of the average.

It is precisely these kinds of differences across provinces that motivate the use of equalization transfers. As we discuss in more detail in the next section, these transfers are designed to compensate those provinces that have below-average tax capacities.

HFI of Provincial Taxes After Intergovernmental Transfers

Table B.7 indicates provincial per capita revenues when federal-provincial transfers are included as provincial revenues.

Table B.7: Provincial Governments Per Capita Revenues, After Intergovernmental Transfers, as a Percentage of Canadian Average

Year	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	73.5	76.1	82.4	86.0	88.7	104.7	95.2	114.5	115.2	124.0
1962	81.5	79.1	83.6	82.0	90.5	106.5	89.2	117.1	112.4	113.6
1963	74.0	82.1	79.0	80.5	90.9	106.8	89.6	118.6	111.4	115.0
1964	76.0	75.1	77.3	82.5	95.0	104.8	90.9	116.7	104.6	115.1
1965	84.0	83.6	79.9	86.0	93.5	103.6	94.8	114.2	107.0	115.7
1966	80.1	78.1	82.6	83.5	94.3	105.6	93.7	113.7	102.8	111.0
1967	82.5	81.1	89.1	82.1	95.8	105.8	92.5	106.9	103.0	105.4
1968	82.5	78.6	88.1	82.1	94.9	107.7	93.8	102.4	100.0	105.5
1969	83.6	89.9	89.7	82.8	92.9	107.7	96.4	98.4	101.7	107.8
1970	85.2	84.6	84.2	81.5	94.1	108.9	98.3	94.1	104.9	99.4
1971	90.8	95.7	83.4	85.5	97.9	105.0	97.3	97.9	104.5	98.2
1972	85.4	94.2	91.7	88.7	99.0	102.8	99.5	101.5	104.0	97.3
1973	84.8	95.4	91.9	83.8	99.9	99.7	94.1	101.8	111.1	104.3
1974	89.7	91.5	86.1	85.5	99.1	95.4	94.8	108.6	135.2	101.5
1975	94.0	104.5	91.6	87.0	98.9	91.5	96.9	111.5	141.8	102.4
1976	90.4	103.5	86.2	82.1	98.3	92.5	97.0	107.0	143.6	104.0
1977	92.0	95.6	89.1	84.0	103.2	88.4	93.8	105.6	145.7	103.3
1978	94.2	92.5	86.0	85.3	103.4	85.2	87.5	109.3	160.1	102.7
1979	91.8	89.6	82.4	83.2	101.6	86.6	90.9	109.3	157.7	103.8
1980	91.0	94.0	85.7	83.1	101.0	84.7	91.2	114.1	164.9	100.4
1981	88.2	87.9	81.4	80.4	103.4	84.0	89.7	109.1	164.6	100.3
1982	88.3	91.0	82.8	82.5	107.7	81.8	91.3	102.8	165.8	96.5
1983	86.1	86.3	83.4	82.3	105.4	83.6	92.6	105.9	166.1	94.3
1984	87.3	93.8	84.3	84.7	104.1	86.5	91.9	105.4	160.6	92.3
1985	95.1	86.5	84.6	87.1	104.2	88.6	93.7	101.8	152.8	90.5
1986	96.1	87.2	86.1	90.6	107.1	93.6	95.1	92.6	123.6	91.6
1987	96.1	87.5	86.5	91.5	106.5	94.6	100.1	99.8	119.6	90.4
1988	94.8	89.5	86.6	90.7	106.6	95.1	103.3	99.1	114.5	92.0
1989	94.1	91.6	85.0	90.4	103.9	97.0	101.8	110.6	109.3	93.3
1990	98.3	93.3	88.7	92.5	104.0	94.9	100.2	114.6	113.5	93.4
1991	98.6	94.9	88.9	92.7	107.0	93.7	104.6	108.4	111.0	91.8
1992	99.2	96.1	88.7	98.9	107.9	91.9	102.6	110.4	109.9	96.2
1993	99.1	92.8	85.8	96.6	105.9	92.8	103.6	113.6	106.9	100.1
1994	98.4	95.5	88.8	96.7	103.9	92.9	105.9	113.5	106.3	102.8
1995	101.5	94.8	90.1	100.3	107.5	92.7	106.9	106.4	100.9	101.1

What is remarkable about these data is the similarity in per capita revenues across provinces once transfers are taken into account. It still remains true that there is some variability, but the range of differences is much narrower than in Table B.6.

As mentioned, these raw data are only imperfect indicators of the true differences in revenue-raising capacity across provinces. Per capita revenue differences can result not only from tax capacity differences, but also from differences in tax policies adopted by the provinces. Those provinces that have higher tax rates (perhaps to finance higher needs for public services) will on that account have higher revenues per capita. We are able to obtain a more precise measure of tax capacity differences by using data calculated for equalization purposes, to which we turn next.

Tax Capacity Differences for Equalization Purposes

The Canadian Equalization scheme bases cash transfers to the low-income provinces on a measure of their tax capacity relative to a national standard. For this purpose, tax capacity is measured for each tax base by a series of steps. First, a common tax base is defined and then its size is measured for each province. Next, a national average provincial tax rate is calculated by taking the ratio of provincial taxes collected from that source to the sum of the tax bases over all provinces. Finally, a province's per capita equalization entitlement for that base is calculated by taking the difference between the revenue raised per capita when the national average tax rate is applied to the tax base of a representative set of provinces and the revenue raised when the same national average tax rate is applied to the province's tax base. For some provinces, this will be positive and

for others it will be negative. Aggregating these entitlements over all tax bases yields net equalization entitlements.⁴⁰

The first column in Table B.8 reports one component of this equalization calculation, referred to as the *Index of Revenue Equality*. It shows the per capita tax revenues that would be raised in each province from all tax sources by applying the national average tax rate to the standardized tax base for each revenue source. Data are presented for selected years in the 1980s and 1990s.

⁴⁰ Note that this explanation is discussed more fully under Section C Nature of Programs Focussed on Horizontal Imbalances.

Table B.8: Indexes Of Revenue Equality (\$ Per Capita)

	FISCAL YEAR 1982/83			FISCAL YEAR 1985/86		
	Own Revenues (Standardized)	Own Revenues plus Equalization	Own Revenues plus Equalization, CAP, and EPF ⁴¹	Own Revenues (Standardized)	Own Revenues plus Equalization	Own Revenues plus Equalization, CAP, and EPF
NFLD	1 560	2 376	2 794	1 886	3 029	3 542
P.E.I.	1 513	2 474	2 927	1 965	3 029	3 561
N.S.	1 801	2 475	2 880	2 344	3 029	3 537
N.B.	1 732	2 430	2 888	2 178	3 029	3 603
QUE.	1 998	2 427	2 915	2 610	3 029	3 652
ONT.	2 491	2 491	2 861	3 271	3 271	3 728
MAN.	2 108	2 533	2 934	2 627	3 029	3 544
SASK.	2 763	2 763	3 209	3 368	3 368	3 955
ALTA	5 490	5 490	5 838	6 306	6 306	6 800
B.C.	2 802	2 802	3 247	3 248	3 248	3 845
10 PROV	2 602	2 800	3 217	3 256	3 461	3 995
	FISCAL YEAR 1988/89			FISCAL YEAR 1991/92		
NFLD	2 608	4 083	4 647	2 978	4 486	5 123
P.E.I.	2 705	4 083	4 670	3 063	4 485	5 136
N.S.	3 136	4 083	4 656	3 559	4 486	5 126
N.B.	3 003	4 083	4 711	3 193	4 486	5 161
QUE.	3 572	4 083	4 736	3 996	4 486	5 199
ONT.	4 574	4 574	5 084	4 807	4 807	5 366
MAN.	3 349	4 083	4 661	3 719	4 486	5 122
SASK.	3 631	4 083	4 643	4 011	4 486	5 053
ALTA	5 687	5 687	6 302	6 008	6 008	6 615
B.C.	4 389	4 389	5 028	4 912	4 912	5 520
10 PROV	4 164	4 446	5 029	4 524	4 799	5 418
	FISCAL YEAR 1994/95			FISCAL YEAR 1997/98		
NFLD	3 217	4 865	5 596	3 555	5 377	5 882
P.E.I.	3 451	4 879	5 541	3 833	5 385	5 828
N.S.	3 718	4 859	5 538	3 963	5 281	5 738
N.B.	3 652	4 877	5 537	4 032	5 391	5 834
QUE.	4 321	4 865	5 626	4 689	5 260	5 787
ONT.	5 083	5 083	5 662	5 450	5 450	5 805
MAN.	3 911	4 872	5 531	4 263	5 267	5 708
SASK.	4 545	4 953	5 576	4 919	5 105	5 521
ALTA	7 060	7 060	7 612	6 955	6 955	7 290
B.C.	5 576	5 576	6 187	5 702	5 702	6 111
10 PROV	4 949	5 244	5 884	5 251	5 552	5 969

⁴¹ Explanation of CAP and EPF is provided in Section C under Nature of Programs Focussed on Vertical Imbalances. For fiscal year 97/98 these two transfers were replaced by the CHST.

Table B.9: Indexes Of Revenue Equality (Percentages Of National Average)

	FISCAL YEAR 1982/83			FISCAL YEAR 1985/86		
	Own Revenues (Standardized)	Own Revenues plus Equalization	Own Revenues plus Equalization, CAP, and EPF	Own Revenues (Standardized)	Own Revenues plus Equalization	Own Revenues plus Equalization, CAP, and EPF
NFLD	60	85	87	58	88	89
P.E.I.	58	88	91	60	87	89
N.S.	69	88	90	72	88	89
N.B.	67	87	90	67	88	90
QUE.	77	87	91	80	88	91
ONT.	96	89	89	100	95	93
MAN.	81	90	91	81	88	89
SASK.	106	99	100	103	97	99
ALTA	211	196	181	194	182	170
B.C.	108	100	101	100	94	96
10 PROV	100	100	100	100	100	100
HIGH/LOW	3.63	2.31	2.09	3.34	2.08	1.92
	FISCAL YEAR 1988/89			FISCAL YEAR 1991/92		
	Own Revenues (Standardized)	Own Revenues plus Equalization	Own Revenues plus Equalization, CAP, and EPF	Own Revenues (Standardized)	Own Revenues plus Equalization	Own Revenues plus Equalization, CAP, and EPF
NFLD	63	92	92	66	93	95
P.E.I.	65	92	93	68	93	95
N.S.	75	92	93	79	93	95
N.B.	72	92	94	71	93	95
QUE.	86	92	94	88	93	96
ONT.	110	103	101	106	100	99
MAN.	80	92	93	82	93	95
SASK.	87	92	92	89	93	93
ALTA	137	128	125	133	125	122
B.C.	105	99	100	109	102	102
10 PROV	100	100	100	100	100	100
HIGH/LOW	2.18	1.39	1.36	2.02	1.34	1.31
	FISCAL YEAR 1994/95			FISCAL YEAR 1997/98		
	Own Revenues (Standardized)	Own Revenues plus Equalization	Own Revenues plus Equalization, CAP, and EPF	Own Revenues (Standardized)	Own Revenues plus Equalization	Own Revenues plus Equalization, CAP, and EPF
NFLD	65	93	95	68	97	99
P.E.I.	70	93	94	73	97	98
N.S.	75	93	94	75	95	96
N.B.	74	93	94	77	97	98
QUE.	87	93	96	89	95	97
ONT.	103	97	96	104	98	97
MAN.	79	93	94	81	95	96
SASK.	92	94	95	94	92	92
ALTA	143	135	129	132	125	122
B.C.	113	106	105	109	103	102
10 PROV	100	100	100	100	100	100
HIGH/LOW	2.19	1.45	1.38	1.96	1.36	1.32

As these data show, there are systematic and persistent differences in revenue-raising capacity across provinces. All provinces except Alberta, British Columbia and Ontario are below the 10-province average, and the Atlantic Provinces are well below average. The first column in Table B.9 depicts the same information as percentages of the national average. As can be seen, the Atlantic Provinces have tax capacities that at roughly 70 percent of the national average, while Alberta is well above average (owing to its large oil and gas revenue base).

The second column for each province shows what happens to the index when equalization payments are included. These payments go only to the ten below-average provinces. Not surprisingly, tax capacities are virtually fully equalized for the equalization-receiving provinces, while the three high-income provinces remain above the national average.

The final column includes the other major transfers that the provinces receive, those in support of health, welfare and post-secondary education.

C. SYSTEM OF INTERGOVERNMENTAL TRANSFERS

The system of federal-provincial transfers is part of the broader system of fiscal arrangements between the two levels of government. The fiscal arrangements includes:

1. *Bloc Transfers*. There are two major bloc transfers, Equalization and the Canada Health and Social Transfer (CHST). Equalization transfers are made unconditionally to the low-income provinces based on their tax capacities. They are intended to provide all provinces with the ability to finance some minimum national standard of public services. CHST transfers are basically equal per capita transfers that are meant to assist the provinces in financing health, post-secondary and welfare programs. They have some general conditions attached involving the design of health and welfare programs. The CHST transfers evolved from a set of shared-cost programs in each of the three general areas.
2. *Transfers for Specific Purposes*. These are much less important than the bloc transfers in terms of size, although historically they were used in shared-cost form to establish major provincial social programs in the areas of medical care, hospitals and social assistance and services. Current examples include highways and immigration services.
3. *Tax Harmonization Measures*. These are bilateral agreements that involve harmonizing the tax base and sometimes the tax rate structure, and provide for a common tax collection process. They exist for selected provinces in the areas of personal income taxation, corporate income taxation and general sales taxation.
4. *Other Negotiated Agreements*. Various other negotiated agreements exist between the federal government and the provinces that attempt to ensure that

provincial and federal fiscal policies are used in a way that is in the interest of the internal economic union. There is an Agreement on Internal Trade that sets out guidelines on government behaviour to ensure that efficiency in the internal common market for goods, services, labour and capital is not violated. The Social Union Framework Agreement (discussed above) involves the implementation of social policies whose objectives are shared by both orders of government. It is especially concerned with agreeing on the use of conditional federal-provincial transfers in areas of provincial legislative jurisdiction— the so-called federal *spending power*. There are also agreements in areas of immigration and the environment, as well as a recent agreement on the provision of transfers to families with children through the National Child benefit.

These fiscal arrangements taken together serve to facilitate fiscal decentralization and provincial accountability, while at the same time ensuring that national objectives are not compromised. Much of the literature on fiscal federalism is devoted to studying how decentralized fiscal decision-making might lead to violations of national economic objectives, such as efficiency in the internal economic union and national equity objectives. The fiscal arrangements can be seen as means by which the possibility for such violations is contained. In part, this is by preserving the ability of the federal government to oversee responsibility for national objectives, for example through its use of the spending power. But also it involves cooperative agreements between the two levels of government. These agreements may involve both negative and positive measures. Negative measures are those that require governments to refrain from policies causing damage to national goals, such as those interfering with the free flow of products

or factors of production across provincial borders. Positive measures are agreements to undertake some measures in order to attain some national objective, such as harmonizing tax or transfer policies or labour standards.

In the remainder of this section, the first two categories of the fiscal arrangements are discussed in more detail, while tax harmonization is discussed in the next section. The first two categories involve transfers between the federal government and the provinces.⁴² These transfers fulfill a number of roles, all of which contribute to the objectives of the fiscal arrangements as outlined above. Four particular roles are typically emphasized in the fiscal federalism literature.

1. *Correct Inter-Provincial Spillovers.* Provincial expenditures programs may provide spillover benefits to residents of other provinces. Education and training programs may train workers who subsequently migrate to other provinces. Highways and other public infrastructure programs may benefit non-resident households and firms. Welfare programs may attract low-income persons from other provinces. Health programs and benefits for the elderly may be available to persons whose working and taxpaying years were spent in other provinces. Federal-provincial conditional transfers are one means by which provinces can be provided with the incentive to provide public services and infrastructure that may be of general benefit to residents of the nation regardless of where they live.
2. *Close the Fiscal Gap.* Provincial spending responsibilities may exceed their revenue-raising capacities. That is, the case for decentralizing expenditure responsibilities may be greater than the case for decentralizing tax

responsibilities. Decentralizing spending may enhance the efficiency of provision by allowing provinces to cater better to the needs and preferences of their residents, while decentralizing taxation may lead to a fragmented taxation system that does not reap the advantages of a single collection system. For these reasons, it is common in federations for the federal government to retain more revenue raising than it needs for its own purposes, and to transfer the excess to the provinces. The exact balance between provincial revenue-raising ability and federal transfers is very much one of judgment, and different federations resolve it in very different ways.

3. *The Achievement of Fiscal Efficiency/Equity.* The decentralization of fiscal responsibilities typically leaves different provinces with different capacities for providing public services to their residents. If these are not corrected, incentives will exist for businesses and households to move to provinces with greater ability to provide public services at given tax rates. To the extent that migration occurs in response to fiscal incentives, efficiency in the allocation of resources in the internal economic union is compromised. To the extent that migration does not occur, households in otherwise identical circumstances will be treated differently in different provinces, leading to a violation of horizontal, or fiscal, equity. The system of equalization transfers is intended to account for this.
4. *Use of the Spending Power to Achieve National Objectives.* Some important public services, such as those in the areas of health, education and welfare, are responsibilities of provincial governments. To the extent that the design of these

⁴² Recall that we are subsuming the municipalities within provincial governments. In fact, many of the principles that apply between the federal government and the provinces also apply with respect to the

programs has implications for national economic and social objectives, the federal government has an interest in how they are delivered. The main instrument available to the federal government is the spending power, which in this case involves transferring funds to the provincial government conditional on the design of the programs.

Federal transfers influence the ability of the provinces to deliver services for which they are responsible or provide incentives for the provinces to choose certain design features. This gives rise to inevitable tensions in the federal system between the exercise of federal prerogative regarding the spending power and the fiscal independence and legislative autonomy of the provinces. Increasingly, the Canadian federation has evolved in the direction of the latter. Provincial autonomy has gradually increased, and there has been more reliance on federal-provincial consultation and agreement to resolve potential conflicts and achieve shared goals. Of course, some tensions remain. Many provinces remain very skeptical about the federal spending power, at least partly because of a perception (well-founded) that the federal government has taken some unilateral decisions in the recent past that have been unannounced and have had adverse effects on provincial finances and programs. In addition, tensions remain over the federal role in tax harmonization, a subject we return to in Section D – *Systems of Tax harmonization and Tax Collection*.

1. Nature Of Programs Focused On Vertical Imbalances

As mentioned, two transfer programs comprise the bulk of federal-provincial transfers — Equalization and the CHST. Both serve to some extent to close the fiscal

provinces and their municipalities.

gap, but the CHST is really the main vehicle for so doing. In the case of Equalization, addressing vertical imbalances is only incidental. Its primary focus is on horizontal imbalances: only the low-income provinces receive Equalization transfers.

The CHST was instituted in fiscal year 1996-97, replacing the EPF (Established Programs Financing) and CAP (Canada Assistance Plan) transfers that existed at that time. The CHST is in its early stages, so the precise formula for its evolution is not yet in place. It is an equal per capita bloc grant whose magnitude is determined not by formula but as part of the budget plan of the federal government.⁴³ The annual allotments of these transfers from 1993-94 as projected until 2003-04 and those for Equalization are as shown in Table C.1.⁴⁴

⁴³ It has become an equal per capita grant.

⁴⁴ Table C.1 is based on data presented in the budget documents that accompanied the 2000 federal budget produced by the Department of Finance.

Table C.1 Equalization and Block Grant Allotments 1993-2003

	\$billions	
	<i>EPF/CAP</i>	<i>Equalization</i>
1993-94	18.8	8.1
1994-95	18.7	8.6
1995-96	18.5	8.8
	<i>CHST</i>	
1996-97	14.7	9.0
1997-98	12.5	9.7
1998-99	12.5	9.6
1999-00	14.5	9.8
2000-01	15.5	9.5
2001-02	15.6	10.0
2002-03	15.5	10.3
2003-04	15.5	10.7

The CHST is nominally intended to support the financing of provincial expenditures in the areas of health, post-secondary education, social services and social assistance, all areas of provincial legislative responsibility. The funds are in no way tied to provincial expenditures in these areas: they are completely fungible. There are, however, some conditions that provincial programs must satisfy in order to be eligible for the full amount of the transfer. Health programs must satisfy five very general criteria. Provincial health insurance systems must be i) publicly administered, ii) comprehensive, iii) universal, iv) accessible, and v) portable. In addition, there can be no user fees, and doctors may not extra-bill patients over and above the fees paid by the public program. Violation of any of these conditions can lead to financial penalties being imposed by the federal government. Such penalties are a last resort, but from time to time they have been imposed. Given that the conditions are quite general, there are bound to be disagreements

about how to interpret them.⁴⁵ The only other conditions imposed apply to welfare (social assistance and social services). Welfare programs should not interfere with the mobility of welfare recipients across provinces. Otherwise, provinces are free to design their welfare systems as they see fit. No conditions apply to provincial post-secondary education programs.

The CHST thus provides provinces with considerable independence in determining the size and design of their social programs. The influence of the federal government exists by virtue of the fact that it provides some (conditional) financing in support of provincial programs. But this influence is limited. Not only are the conditions attached to the fund very general, but also the federal government contribution is relatively small, of the order of one-fifth of total program expenditures. This makes it difficult for the federal government to have the authority to insist on detailed design features. This is a relatively recent phenomenon. The CHST evolved from a system of shared-cost transfers in which the federal contribution was much higher.

Prior to 1977, the federal government funded approximately 50 percent of provincial health costs.⁴⁶ In the case of welfare, the federal government matched each provinces' spending on approved social assistance and social services operating costs under the

⁴⁵ The federal government interprets the principles of the Canada Health Act that imposes the conditions on these transfers.

⁴⁶ Under the *Hospital Insurance and Diagnostic Services Payments* program the federal government contributed 25% of the national per-capita cost of in-patient service and 25% of the provinces per-capita cost of approved patient services multiplied by the average number of insured persons in the province in the year. As a result of this formula the high-cost provinces receive a lower percentage of their total expenditure from the federal government that do the low-cost provinces. Under the Medicare program the federal government provided the provinces with payments that were equivalent to half the national average per-capita cost of providing insured services multiplied by the average number of insured persons in each province in the year. Therefore, provinces with per-capita costs below the national average received more than 50% of their costs, and those with costs above the national average receive less

CAP.⁴⁷ Transfers to the provinces for post-secondary education spending were based on the number of eligible students in the province. In 1977, the health and post-secondary education transfers were converted into a bloc transfer, the EPF, partly in recognition of the fact that the programs were now well ‘established’. The EPF transfer had three features that differed from the previous shared-cost programs. First, the transfer was converted fully to an equal per capita transfer.⁴⁸ Second, the rate of growth of the transfers was changed to the rate of growth of GNP rather than the rate of growth of provincial program expenditures. The implication was that the federal share of health and post-secondary expenditures was bound to fall gradually over time since program expenditure was growing in aggregate much more rapidly than GNP. Indeed, this was a major purpose of the change. Third, the equal per capita transfer was nominally divided between a cash component and a tax-transfer component. The federal government instituted the latter by reducing its personal and corporate income tax rates, thereby allowing the provinces to increase theirs. The effect of this was further to restrict federal cash contributions both initially and over time. In 1977, half of the EPF transfer took the form of cash and the rest of tax-transfers.⁴⁹ As time passed by, the tax-transfer component rose more rapidly than the total EPF allotment implying that the cash transfer as a proportion of the whole fell.

⁴⁷ In 1990 the federal government limited the increase in CAP transfers to the three wealthy provinces (British Columbia, Alberta and Ontario). Increases in CAP transfers were limited to a 5 per cent increase. In 1995, this limit on CAP transfers was made permanent when the CAP transfers were combined into the *Canadian Health and Social Transfer*. The evolution of these transfers is explained in Section C *The Nature of Programs Focused on Vertical Imbalances*.

⁴⁸ This was not a major change, given that much of the health transfer was equal per capita since it was based on national average provincial health expenditures.

⁴⁹ In the case of Quebec, the tax-transfer was more than one-half since Quebec had been allowed to opt out of some of the shared-cost programs in return for tax points.

When the CHST was instituted, the legacy of the EPF system was strongly felt. The CHST replaced both the EPF and the CAP, and in its initial years it replicated two features of those programs. First, the allocation among provinces reflected the total shares of provinces in the previous EPF and CAP systems, and this was quite different from equal per capita. Indeed, the three highest-income provinces received less per capita than the other provinces leading the former to argue that this represented an unnecessary addition to equalization. Second, the federal government continued to calculate its contribution to the CHST as including the tax-transfer that had been affected twenty years earlier. As the total CHST transfer was considerably less than the EPF and CAP programs it replaced (as part of the federal deficit reduction program) and as it was not intended to grow, the cash component of the CHST would gradually fall.

Subsequently, the CHST was reformed to avoid these problems. It was converted into an equal per capita grant in 1999, and its amount was defined fully in terms of a cash transfer. (The above table includes only federal cash contributions.) The federal government does, however, continue to count the tax-transfer as part of its contribution to federal social programs, even though these funds are now fully in the hands of the provinces as part of their own-source revenues.

2. Nature Of Programs Focused On Horizontal Imbalances

The CHST has an equalizing effect. As an equal per capita transfer financed by federal general revenues, it effectively transfers from the high-income to the low-income provinces.⁵⁰ But, the main program designed for correcting horizontal fiscal imbalance (HFI) is the Equalization program. The basic design of the Equalization system goes

back to the early post-war period, although it has undergone many changes in detail since then. As mentioned earlier, it focuses entirely on equalizing tax capacity differences across provinces. There is no equalization of provincial expenditure needs. Unlike with the CHST, equalization transfers are completely unconditional.

The Canadian equalization system is based on the *Representative Tax System* (RTS) approach. The RTS system calculates equalization transfers on the basis of a province's ability to raise revenues from a set of tax bases that represent those actually used by the provinces. It involves defining a common tax base for all tax sources used, a task that is feasible when provinces' tax bases do not differ fundamentally. Alternative approaches to equalization involve so-called *Macro Formulas*, such as one based on some aggregate measure of provincial economic activity (Provincial GDP, sales, etc.). The RTS system suits Canada well, given that provinces use a large number of different tax sources, but ones whose bases do not differ too much between provinces. Moreover, the pattern of revenue sources across provinces differs considerably. The RTS approach is a way of aggregating these differences into a single measure. An important feature of the RTS approach is that it attempts to calculate provincial allocations in a way that affects as little as possible the incentive for provinces to vary their tax policies in order to increase their entitlements. We return to this issue below.

The calculation of a province's Equalization entitlement is as follows. For each of over forty tax bases, a common tax base is defined. The common base reflects the features of bases actually used by the provinces. In many cases, this is a relatively simple task. For example, in the case of income taxes, most provinces use the same base; excise

⁵⁰ This is because taxpayers from high-income provinces pay proportionally more taxes to the federal government, per capita, than do the taxpayers from the lower-income provinces.

taxes on cigarettes and alcohol tend to be the quantities of those products sold; payroll taxes use very similar bases. In other cases, provincial tax bases differ considerably, so the representative tax base is a compromise. This is the case for provincial sales taxes, property taxes, and many resource taxes. Once the representative tax bases are defined, a national average provincial tax is calculated by taking the ratio of total provincial tax revenues to the size of the representative tax base aggregated over all provinces. Next, a per capita Equalization entitlement is calculated for each tax base and for each province. This is done by first calculating the amount of per capita revenues a province would raise by applying the national average tax rate to its own tax base. This is compared with the amount that would be raised per capita by applying the national average tax rate to the tax based aggregated over a representative set of provinces. The difference is the per capita equalization entitlement for that tax source: it may be positive or negative. The representative set of provinces includes British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec. Thus, it is referred to as a Five-Province Standard. The remaining five provinces (Alberta and the four Atlantic Provinces) are excluded from the representative set because of the special circumstances.⁵¹

This procedure is used for each of the over forty tax bases. Entitlements are summed over all tax sources for each province. Those provinces that have a positive entitlement receive a per capita transfer equal to the full amount of the entitlement. Provinces with a negative entitlement — the so-called ‘have’ provinces — receive nothing (nor do they contribute anything directly). There are currently three have provinces — Alberta, British Columbia and Ontario. There has been remarkably little variation in the set of

⁵¹ The Atlantic provinces are excluded because they are the poorest provinces and Alberta is excluded because of its enormous revenues from resources.

have provinces in the post-war period. This system is referred to as a gross system, as opposed to a net system in which transfers to the have-not provinces are fully financed by payments from the have provinces.⁵² Nonetheless, the have provinces implicitly contribute to equalization since their residents pay a relatively high share of the federal revenues used to finance the program.

There are some other detailed features of the program that might briefly be mentioned. The growth of Equalization payments is subject to a ceiling (currently \$10 billion) that escalates at the growth rate of national GNP. The ceiling has been binding from time to time. There is also a floor that shelters provinces from sudden reductions in entitlements. As well, for some revenue sources, individual provinces constitute a substantial proportion of the national base. In these circumstances, the province will have a significant effect on the national average tax rate, and this would provide the province with an incentive to vary its tax rate to affect its entitlement. In these circumstances, only a portion of the province's tax base is subject to Equalization.

The Equalization program is under continual scrutiny, and has been subject to a variety of changes in the past. The number of tax bases used has gradually expanded over the post-war period. (Initially, only income taxes were included.) The treatment of resource revenues, particularly oil and gas, has varied from time to time. For example, in the 1970s and early 1980s, only half of provincial oil and gas revenues were included. Part of the reason for this was that equalizing provincial oil and gas revenues was expensive for the federal government, which had no direct access to those tax bases for its own use. As well, oil and gas was considered to be 'property' of the provinces.

⁵² The funds are not directly transferred from the 'have' provinces to the 'have-not' provinces. The funds go to the federal government and then to the 'have-not' provinces.

Finally, the standard used for Equalization has changed over time. The five-province standard replaced a full national average standard in which all ten provinces were included. This was also partly driven by the problems arising out of the very unequal distribution of oil and gas revenues. By excluding Alberta from the base, full equalization of these revenues was effectively ruled out.

There remain a number of issues over the design of the current system. Some of the more important ones are as follows.

1. *Needs Equalization.* As we have mentioned, only differences in tax capacity are equalized, and not equalization of needs. The purpose of equalization is to enable provinces to provide comparable levels of public services at comparable tax rates. In principle, this requires that differences in the need for public services, such as those that arise from demographic differences, to be equalized. Although this poses certain measurement problems, many countries with multi-level government systems do equalize for needs. Examples include Australia, Japan, South Africa and Sweden.
2. *Incentive Effects.* Ideally, Equalization transfers should be based on a province's tax capacity independent of its actual tax policies. In practice, this is very difficult to guarantee. Equalization is based on the size of a province's tax bases relative to the national average. To the extent that provincial policies affect its tax bases, they might have an incentive to design policies that will attract more Equalization transfers. This could be important in the case of resources, where provinces may have an influence on the rate at which resources are developed.

3. *Treatment of Resources.* In addition to the potential incentive problems arising from a province's ability to influence its resource tax base, resources give rise to other problems. Some resources are distributed very unevenly across provinces, and give rise to large Equalization payments. Since the federal government does not have direct access to resource taxation, it finds the costs of equalizing resource revenues to be onerous.⁵³ As well, the measurement of potential resource tax bases can be difficult. Ideally, the capacity to tax resources depends on the rents that the resources generate. But, the bases actually used tend often to be some measure of production. This is a very imperfect measure of the capacity to tax resources, since it neglects the fact that some resources are produced at a much higher cost than others.
4. *Problems with Particular Taxes.* Some taxes give rise to special problems. Property taxes are particularly problematic since the bases are defined and measured very differently in different provinces. A relatively recent major source of revenues for the provinces is lottery revenues. It is difficult to determine what the potential tax base is for this revenue source. User fees also give rise to conceptual problems. These can be viewed as benefit taxes to a large extent. Given that, they are not a source of financing general public services, and the case for equalizing them is not strong.
5. *Macro Approaches.* Some observers have suggested that some of the problems of the existing Equalization system can be avoided by adopting a macro approach to Equalization. This would avoid most of the incentive problems. It would reduce

⁵³ The federal government can, and does, levy corporate taxes but they can not levy royalty fees on production.

the complexity of the current system. And, it would avoid the difficulties that arise in defining standard tax bases when provinces are adopting increasingly diverse tax systems. On the other hand, macro approaches would simply not provide Equalization in accordance with actual provincial tax capacities, only with a rather broad and inaccurate proxy.

6. *The Five-Province Standard.* Finally, the five-province standard can lead to levels of Equalization that do not suffice to ensure that provinces are able to provide comparable levels of public services at comparable tax rates. The main reason for this is that, since the main oil and gas-producing province (Alberta) is excluded from the base, that source of revenues is far from fully equalized. Indeed, the adoption of the five-province standard was motivated largely by the desire to avoid the cost to the federal government of equalizing oil and gas revenues.

3. Nature Of Other Intergovernmental Transfers

Equalization and the EPF now comprise the bulk of the transfers from the federal government to the provinces. Historically, considerable reliance had been placed on shared-cost conditional transfers, often using 50 percent sharing formulas. These were used to support major shared cost programs in health, welfare and post-secondary education. As mentioned above, shared-cost programs were abandoned for health and post-secondary education in 1977 and for welfare in 1996. What remains are much more specific and smaller shared-cost programs in areas like highway transportation, immigration and infrastructure.

The traditional economic argument for shared-cost or matching transfers is that some types of provincial expenditures yield spillover benefits to residents of other provinces. This rationale has been largely abandoned. It has been realized that the appropriate rate of matching from this perspective is difficult to know, and is likely to be much less than the full matching rates that have been used. In the case of the major matching transfers for health, welfare and education, the transfers served mainly as an inducement to the provinces to establish such programs. This was based less on spillover grounds than on arguments for harmonized social policy for all Canadians. Once the programs were established, the need for matching incentives became less compelling. On the contrary, the matching aspect was viewed as providing an adverse incentive to the provinces to increase their expenditures.

The use of shared-cost conditional grants has been controversial with the provinces. The major grants have been in support of expenditures in the legislative jurisdiction of the provinces. Although this use of the spending power has in the main been deemed to be constitutional, the strenuous objections of the provinces has led to the federal government agreeing not to institute them without consulting with the provinces. The recent Social Union Framework Agreement formalized this consultation. Under the agreement, the federal government has undertaken not to introduce new joint federal-provincial programs, whether shared-cost or bloc-funded, unless at least half the provinces agree. It is worth repeating that this is only a political agreement and therefore it is not legally binding.

As well as federal transfers to the provinces, there are also transfers between the federal government and the three northern territories, between the federal government

and aboriginal communities, and between the provinces and their municipalities. The structure of federal-territorial transfers is similar to those of the provinces. The bulk of their transfers are one for Equalization and a bloc grant for social programs. They obtain a larger grant per capita than the provinces, reflecting the fact that costs are much higher: populations are sparse, and transportation costs are high.

Federal transfers to aboriginal communities reflect the special fiduciary responsibility that the federal government has for First Nations with whom treaties have been signed. These transfers have traditionally been tied to the provision of particular services. They differ in a significant way from most other intergovernmental transfers. Receiving communities are accountable to the federal government for how they are spent. This reflects the fact that these communities have had little legislative responsibility. Fiscal relations with aboriginal communities are gradually changing as self-government initiatives occur. These aim to give these communities more responsibility for delivering their own services, in which case the transfers would be much less conditional.

The relations between provinces and local governments in Canadian tend to be hierarchical in nature. Under the constitution, municipal governments are the creature of and responsible to the provinces, so most of their fiscal dealings are with the relevant provincial government. The result is that while the federal government transfers funds to the provinces, the latter transfer funds to municipalities, and in some cases, to special purpose bodies like school boards. The magnitude of provincial-municipal transfers is roughly the same as federal-provincial transfers. Provincial-municipal transfers differ considerably across provinces, but they bear some similarities to federal-provincial transfers. They often tend to have an equalizing component, though not one that is as

highly developed as the federal Equalization program. They tend to have significant per capita components, which is implicitly equalizing. The transfers are typically more conditional than federal-provincial transfers and the municipalities are more directly accountable to the provinces, reflecting the fact that municipalities do not enjoy the same independence of legislative responsibility as the provinces.⁵⁴ It also reflects the nature of services delivered by municipalities. They assume some delivery responsibility for important provincial public services in the areas of education, health and welfare, with the provinces overseeing the design and standards. They also provide public sector infrastructure, such as roads, water supplies and sewage. Provinces exercise control over the capital funding required to build and maintain such infrastructure.

Municipal own revenue systems are also quite different. Property taxes on both residences and businesses are the most important tax source, with reliance also placed on fees and licenses of various sorts. There are varying degrees of harmonization of property taxes. In some provinces, there is a single system of property assessment and tax collection, with the province setting a tax rate and municipal governments having limited ability (and need) to choose their own rate. Explicit sharing of tax revenues may exist with respect to certain functions. At the other extreme, property taxes may be administered and collected at the lower level.

D. SYSTEMS OF TAX HARMONIZATION AND TAX COLLECTION

The tax system in the Canadian federation is relatively unique in the sense that not only is revenue raising highly decentralized to the provinces (as we have seen above), but also the provinces have independent access to all the main broad-based taxes. As already

⁵⁴ As indicated in Section A, municipal governments are the creation of the provinces and there is

seen, they, along with the federal government, have full access to personal and corporate income taxation, sales taxation and payroll taxation.⁵⁵ This makes the issue of tax harmonization extremely relevant. Moreover, this independent taxing authority implies that harmonization must come about via voluntary agreement with the provinces rather than being imposed by the federal government. As a result, the extent of harmonization varies considerably by tax type. Consider income, sales and payroll taxes in turn below.

1. Income Tax Harmonization

Income taxes — both personal and corporate — have been highly harmonized in Canada since the Second World War. This evolved quite naturally from a situation in which the federal government, following an agreement with the provinces, fully occupied the personal and corporate income taxes during the war as a result of the need to centralize revenue to fight the war. The system of income tax harmonization that has persisted until now has been based on bilateral *Tax Collection Agreements* (TCAs) between individual provinces and the federal government. Their structure differs slightly for the personal and the corporate tax.

Corporate Tax Collection Agreements

In the case of the corporate tax, provinces that choose to participate must abide by the corporate base as chosen by the federal government. They must also abide by an

not constitutional recognition of local government in the constitution.

⁵⁵ In fact, the Canadian constitution restricts the provinces to using ‘direct’ taxes for raising revenue for their own purposes. Although an economics interpretation of direct taxation would seem to preclude sales and excise taxation, provincial sales and excise taxes have been deemed by the courts to constitute direct taxation. This interpretation is based on the notion that retailers are the collection agents of the government and that they are merely collecting taxes that are intended to be imposed directly on consumers of taxed goods. This interpretation has been extended to include value-added taxation as well, despite the fact that tax liability can occur well before the retail stage. The argument is that ultimately the tax is intended to apply to consumers.

allocation formula for determining how the taxable income of a corporation operating in more than one jurisdiction is allocated among provinces. In most cases, it is an average of the share of sales revenues and payrolls in each province. The provinces are allowed to set their own tax rate on the base, and are able to follow the federal government in giving preferential rates to small businesses and manufacturing and processing profits. The federal government acts as the tax collector for the agreeing provinces, and is willing to administer tax credits and surtaxes introduced by individual provinces provided they do not discriminate against non-residents, do not cause inefficiency in the internal common market, and are easy to administer.

All provinces except Alberta, Ontario and Quebec currently participate in the TCAs.⁵⁶ The absence of those three provinces is a significant exception since they represent over 75 percent of the corporate tax base. In the case of Quebec, the decision not to participate is related to a more general desire to manage its own fiscal affairs separately from the federal government. Alberta and Ontario see the use of the corporate tax as a useful policy instrument that can be used to influence the pattern of private sector economic activity. Their provincial economies are large enough and concentrated in some large sectors (resource sectors in Alberta, manufacturing in Ontario) so that an independent industrial policy is considered to be feasible even in an otherwise highly open economy. But, even these non-participating provinces abide by the allocation formula to avoid double taxation. As well, their tax bases are not very different from that

⁵⁶ It should be noted that these provinces constitute 70 percent of Canada's population.

set by the federal government. The result is a highly successful and harmonized corporate income tax system in which provinces have leeway to set their own tax rates.⁵⁷

Personal Tax Collection Agreements

The method of TCAs also exists for personal taxation. In the current system, which is under revision, the federal government sets the common base, administers the tax on behalf of participating provinces, and applies a common allocation formula (essentially allocating personal taxes according to the province of each taxpayer's residence on December 31 of the tax year). The federal government also sets a progressive rate structure, which includes not only a set of brackets and rates, but also a system of non-refundable and refundable tax credits. Participating provinces select a single tax rate to apply to federal taxes payable, thereby abiding not only by the federal base but also to its rate structure — the so-called *tax-on-tax system*. The provinces effectively also abide by the non-refundable tax credits set by the federal government. As with the corporate tax, the provinces are allowed to establish their own set of credits and surtaxes to be administered by the federal government.

All provinces except Quebec participates in the personal TCAs, again leading to a highly harmonized system of personal income taxes, both with respect to the base and the rate structure. However, the system is about to change. Partly as a consequence of the growing share of personal income tax room occupied by the provinces, they have expressed a desire to have more discretion over their income tax policy. Recognizing this, the federal government in 1998 agreed with the provinces to revise the tax-on-tax

⁵⁷ Economists might argue that, given the mobility of capital, it might be preferable if the corporate tax were exclusively federal. However, given that the provinces have the right to levy income taxes, such a system could not be imposed on them.

system to a *tax-on-income system*. Provinces, should they choose, will be able within limits to set their own rate structures and their own non-refundable tax credits. This preserves the common base, while at the same time giving the provinces more discretion to implement their own preferred degrees of progressivity and to use non-refundable tax credits to achieve their own social policy objectives through the tax system. Several provinces have indicated that they intend to move to such a system in the very near future.

2. Sales Tax Harmonization

Unlike with the income taxes, sales tax harmonization is much less well-developed in Canada. Historically, the two orders of government have levied very different sales taxes. The provinces, in accordance with constitutional dictates, levied a sales tax at the retail level, while the federal government for many years levied theirs at the manufacturing level. In 1991, the federal manufacturers sales tax was replaced by a value-added tax called the *Goods and Services Tax* (GST). This was a very broad-based tax, including virtually all goods and services with relatively few exceptions. The GST was perceived as having a number of advantages in terms of economic efficiency over its predecessor, as well as over provincial retail sales taxes (RSTs). It removes taxes on business inputs, it treats domestic and foreign produced products equally, and it has a much broader base. The federal government has expressed the hope that the provinces would in time harmonize their RSTs with the GST, thereby reaping the same advantages.

Harmonization has been slow in coming. Part of the problem is that it is administratively rather difficult to harmonize a multi-stage tax system in a situation where no border controls exist, given the system of crediting that accompanies a value-

added tax. This is especially difficult where different provinces adopt different tax rates. The Quebec government was the first province to harmonize. It converted its RST into a multi-stage tax called the *Quebec Sales Tax* (QST), whose base was quite similar to that of the GST. Three features of the system are worth note. The first is that firms making purchases in Quebec would be liable for both the GST and the QST. Then, when subsequent sales are made, whether in or out of Quebec, they would be able to claim an input tax credit for both the GST they had paid and the QST. Thus, the firm would have to keep separate accounts for its transactions in Quebec from those elsewhere in Canada. Second, The GST and QST were subject to a common administration, but in this case it was the revenue department in Quebec rather than the federal government. Thus, the Quebec government would collect taxes on behalf of the federal government, the opposite of the case with income taxes. Third, Quebec retained the right to set its own QST rate regardless of rates in any other provinces.

Subsequently, three of the Atlantic Provinces — New Brunswick, Nova Scotia and Newfoundland — have fully harmonized their sales taxes, as a result of the financial incentive provided by the federal government. All have eliminated their RSTs in order to participate in the *Harmonized Sales Tax* (HST). The HST operates effectively like the GST within the three provinces except at a higher rate, which is common to all three provinces. Firms making sales in one of these three provinces are charged the HST rather than the GST, and are able to claim full credit on subsequent sales. The federal government administers the tax for all three provinces. The excess of revenues collected over and above the standard GST is distributed among the three provinces in proportion to the consumption sales in the province. Note that, unlike the QST, no province has

independent discretion over the tax rate charged (although they are jointly consulted on the rate). Thus, the system is effectively like a revenue sharing system.

The remaining provinces have shown little interest in joining the HST arrangement. Presumably they prefer to retain some discretion over their tax rates and even their base. Whether they can be persuaded to adopt a system like that of Quebec remains to be seen. An alternative would be to maintain their RSTs, but broaden their base to parallel that of the GST. That would have some of the advantages of harmonization but not all. For example, it would be impossible under a single stage system to purge all products of taxes on business inputs.

3. Payroll Tax Harmonization

Payroll taxes remain effectively completely non-harmonized. The provinces and the federal government use them to varying degrees, largely as earmarked taxes for social insurance programs (unemployment insurance, pensions, workers compensation, health care). There is no common collection agreement and all governments choose their bases separately.

Despite this, harmonization of payroll taxes is not regarded as being a high priority. Tax bases do not vary widely across provinces, which is not surprising given the common interpretation of payrolls. Rates are generally flat, though with various combinations of exemptions and upper limits. The taxes are quite easy to collect using the payroll deduction system. And to the extent that they are benefit taxes, they do not give rise to standard incentives for tax competition.

4. Other Issues In Tax Harmonization

Many observers continue to argue in favour of further enhanced, or at least solidified, tax harmonization. As we have mentioned, provincial sales taxation remains far from harmonized for most provinces. There is also always some danger that the income tax harmonization arrangements will not persist in their present form. The pressures on these arrangements have increased dramatically as the provinces have become more and more important in the income tax fields. There has been some argument for harmonization of the other taxes, such as the capital taxes that are used by both levels of governments, as well as specific excise taxes.

One institutional development might be noted which might make harmonization easier to manage in the future. The federal government has created a new tax collection agency called the Canada Customs and Revenue Agency (CCRA). Is responsible for administering all federal taxes, and is available for tax federal-provincial tax collection agreements in the future. It is also available to the provinces to collect their taxes. Presumably, this should contribute to both administrative simplicity and ease of compliance of collection.

E. ANALYSIS: ECONOMIC ASPECTS

1. Impacts On Economic Efficiency

There are two broad perspectives one can take to assessing economic efficiency in a federal setting. On the one hand, much of the case for decentralization of fiscal decision-making — or for multi-level fiscal systems as opposed to unitary systems — is based on the efficiency improvements to which it leads. One can therefore investigate whether the extent and nature of decentralization exploits all the potential efficiency gains. On the other hand, one can take as given the extent of decentralization, and investigate how that decentralization compromises economic efficiency of the national economy. In the latter case, the system of fiscal arrangements is seen partly as a means of countering otherwise adverse effects of decentralization. Consider these in turn.

Decentralization as a Source of Efficiency

The fiscal federalism literature stresses the beneficial efficiency effects of decentralizing the provision of public services to the provinces. Decentralization is thought to lead to a better matching of public services to local preferences and needs, better accountability, lower cost provision, and more innovation. It is particularly relevant for local public goods and public services delivered to households, including the key areas of health, education and welfare services. But to reap the full advantages of decentralization, provincial governments must be given effective autonomy for their fiscal affairs, including the design and delivery of these public services. They should be accountable to their own legislature rather than to the federal government, and they ought

to be have access to sufficient own source revenues to ensure independence. It is particularly important that they control revenue raising at the margin.

The Canadian federation fares well by these criteria. Provinces have exclusive legislative responsibility in areas of health, education and social services. They raise a high proportion of their own revenues. Grants from the federal government have minimal conditions attached, leaving program design solely to the provinces. And they are responsible for determining the size of their fiscal budgets at the margin.

Some observers have suggested that decentralization could go much further on the revenue-raising side, arguing that provinces should be responsible for raising virtually all their own revenues rather than being reliant on the federal government for transfers. Indeed, the main opposition party in the federal Parliament espouses this position. They argue that this would make the provinces more autonomous and therefore fully responsible and accountable for their own actions to their electorates. Such autonomy would also minimize the potential for the federal government interfering with provincial fiscal decision-making. This school of thought tends to place considerable emphasis on inter-jurisdictional tax competition as an inducement for governments to be more efficient and responsive to the preferences of their electorates. At the same time, it de-emphasizes the role of transfers in achieving national equity and efficiency objectives.

Fiscal Arrangements as Facilitators of Decentralization

Decentralization carries with it the potential for interfering with the efficiency of the internal economic union. Part of the role of the fiscal arrangements is to offset these potential inefficiencies of decentralization. There are two main dimensions to this. The

first concerns the efficiency of the internal economic union. The second concerns the effect of the provinces' fiscal position on the allocation of resources among provinces.

Efficiency in the Economic Union

Decentralized decision-making can affect the efficiency of the internal economic union by distorting the free flow of goods, services, labour and capital between provinces. Provincial tax and expenditure policies can inadvertently impose barriers to trade. Provinces may engage in explicit beggar-thy-neighbour policies to attract business and households from other provinces. Provincial policies may discriminate in favour of resident firms or households.

Various measures can be taken to mitigate the possibility that provincial policies will distort the internal economic union. Tax harmonization reduces the possibility of the tax system being used in ways that are inefficient. Conditional grants may be conditional on provincial programs being designed in ways that do not distort markets in the economic union. The political or legal systems may also be used to enforce measures that improve the efficiency of the internal economic union. Intergovernmental agreements may be negotiated that preclude provinces from engaging in distortionary or discriminatory policies. There may be constitutional provisions that preclude provincial governments from implementing such policies. Or, the federal government may have the authority to oversee provincial policies from this point of view, with enforcement coming through the power to disallow policies that violate efficiency or the power to disallow provincial legislation.

In the Canadian case, measures of varying effectiveness exist for maintaining the efficiency of the economic union. Tax harmonization is reasonably successful in the

income tax area. The equalization system removes some of the need for differential tax policies among provinces. The bloc grant system of the CHST includes some general conditions that contribute to the efficiency of the internal economic union, such as the mobility/portability provisions required of provincial health and welfare systems. But, the effect of these provisions is quite limited. For example, there is little harmonization of provincial educational programs. There are also measures that deal with the potential for provincial policies of various sorts to distort the internal economic union. The constitution itself contains very little: it does give the federal government the power to disallow provincial legislation but it has become a well established constitutional convention that this power is not used. The main vehicle for addressing efficiency in the internal economic union is an *Agreement on Internal Trade* recently signed by the federal and provincial governments. It contains provisions for both negative integration (discouraging provincial measures that distort the internal economic union) and positive integration (encouraging provinces to engage in harmonization that furthers efficiency), and covers various areas of provincial policy (e.g. procurement, labour market regulation, investment, environment). But, its effectiveness remains to be proven. Its main defect seems to be the absence of an effective enforcement and dispute resolution mechanism.

Fiscal Efficiency

Decentralization in itself inevitably leads to differences in the ability of provinces to provide public services to their residents. They will have different sizes of tax bases per capita from which to raise revenues. They will also have different needs for public expenditures since the demographic composition of their populations will differ. The consequence is that, in the absence of countervailing measures, provinces will be unable

to provide comparable levels of public services at comparable tax rates. That is, there will be different net fiscal benefits (NFBs) depending on the province of residence. This will provide a purely fiscal incentive for businesses and households to locate in provinces with higher NFBs, leading to a misallocation of productive resources across provinces. This misallocation, referred to as *fiscal inefficiency*, can be corrected by a system of equalization that makes transfers selectively to provinces such that they can, if they so choose, provide comparable levels of public services at comparable tax rates.

In Canada, fiscal inefficiency is deterred by the system of Equalization transfers. This system equalizes the tax capacity of the have-not provinces up to that of the five-province standard. The result is a reasonably complete equalization of tax capacities across provinces. There is, however, no mechanism for equalizing differences in provinces' expenditure needs. To that extent the system is imperfect.

There may be other sources of policy-induced inefficient allocations of resources. For example, in Canada some federal policies systematically favour the have-not provinces (Employment Insurance, regional development grants, agricultural subsidies, etc.). Some economists have argued that the combination of Equalization and other regionally preferred policies over-compensate have-not provinces for their NFB deficiencies. The result is that too many productive resources could be encouraged to stay in have-not provinces rather than moving to more productive use in higher-income provinces.

2. Impacts On Equity

As with efficiency, there are varying dimensions to equity. It is useful to distinguish three aspects that are particularly relevant in a federal setting. The first concerns equity

achieved through the provision of public services. These especially serve the equity objectives of equality of opportunity and economic security (social insurance). The second and third are the complementary notions of vertical and fiscal equity of the tax-transfer system.

Equity and Public Services

Important public services like education, health and social services are provided through the public sector essentially because they serve equity objectives. Otherwise, they could be left to the private sector. In many federations, these services are decentralized to lower orders of government. Yet, the federal government may have an interest in seeing that they satisfy some national standards so that citizens have comparable access to such services regardless of their province of residence. Reconciling the desire to achieve national standards with the desire to decentralize provision to the provinces is one of the most important issues that federal systems must address.

In Canada, the balance has been achieved reasonably effectively until now. The provinces have considerable independence to design these programs to suit their own perceived needs. The federal government has historically exercised some oversight via its spending power. It has financially supported provincial provision of these services with grants in return for the provinces adopting certain features in their program design. The conditions attached to the transfers have been fairly general, leaving detailed program design to the provinces (as discussed above).

There is some debate about the extent to which national standards should or could be achieved in the future. As discussed above the federal government now finances a relatively small proportion of provincial public services, and there is some issue as to

whether it continues to have the political and moral authority to enforce national standards. Some observers suggest that this is as it should be. They stress that the provinces are in a better position to set their programs to suit their residents' needs and preferences, and that any harmonization to a national standard can be achieved by inter-provincial agreement.

Vertical Equity

Vertical equity refers to the progressivity of the tax-transfer system. Value judgments are necessarily involved in choosing the degree of progressivity, and reasonable observers can disagree. In a federal context, the additional problem arises as to which level of government ought to be primarily responsible for determining the progressivity of the system. On the one hand, it can be argued that provinces can better choose tax-transfer systems that reflect the preferences for redistribution of their residents. On the other, decentralizing redistribution to the provinces can give rise to destructive tax competition (a 'race to the bottom') in which redistribution gets competed away. As well, to the extent that the federal government determines redistribution, it can ensure that all citizens are subject to the same standards of redistribution throughout the country, a property that might be compatible with notions of citizenship. Economists have tended to be somewhat agnostic about assigning the responsibility for redistribution, recognizing that while the federal government might have an interest in some minimum national standards of vertical equity, there is room for the provinces to augment that in a way that suits their constituents.

In Canada, the compromise solution has been adopted. Both the federal and provincial governments have access to the main instruments for income redistribution.

The federal government maintains a dominant share of the income tax room, and can choose its rate structure and credits to achieve the degree of progressivity that it thinks is appropriate from a national point of view. At the same time, the provinces can choose to abide by the federal government's rate structure. Alternatively, they can adopt their own income tax rate structures, even if they abide by the federal base. This seems to be a reasonable compromise.

Horizontal Equity

The criterion of horizontal equity suggests that persons who are equally well off ought to be treated the same by the public sector. It is of particular relevance in a regionally diverse economy where persons of similar real incomes might reside in different regions. In the fiscal federalism literature, the principle that otherwise equal persons ought to be treated similarly in different regions is referred to as *fiscal equity*. In a parallel way to fiscal inefficiency, fiscal inequity will occur in a decentralized setting if provinces have differing abilities to provide public services. Persons of any given level of income will receive higher NFBs in wealthier provinces than in less wealthy ones. As with fiscal inefficiency, this can be avoided if a system of equalization is in place that enables all provinces to provide comparable public services at comparable tax rates.

The use of fiscal or horizontal equity as a guiding principle of fiscal federalism and its implications for equalization may not be universally accepted. Those who advocate it see it as a basic principle of fairness or entitlement that comes with citizenship in a federation. It is the economic equivalent to the legal concept of equal treatment. Others do not support the argument that residents of one region have entitlements to the wealth

of another, especially if regions are politically distinct entities and belong to a loosely knit federation.

In practice, most countries do have equalization systems in place, reflecting at least some commitment to the national sharing of resources. In the case of Canada, the principle of equalization is embedded in the constitution. As we have seen, the Equalization system substantially equalizes provincial differences in tax capacities. But the system is not written in stone and continues to rely on political goodwill. As the federation becomes more fiscally decentralized, the demands on Equalization and the support for it could wane. So far, the system has held up well.

POLITICAL ASPECTS

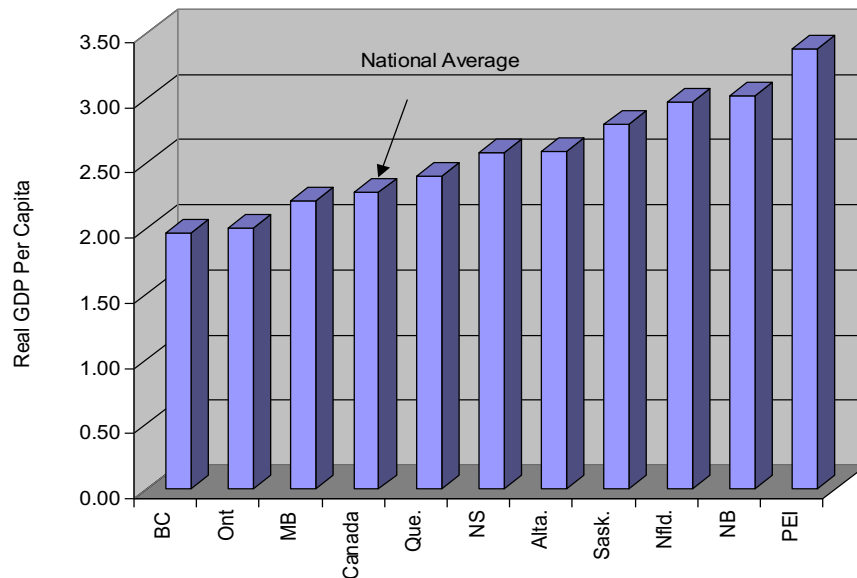
1. Impact on Stability

The processes of intergovernmental relations and fiscal arrangements have been both a stabilising influence and a source of conflict in Canada.

2. Areas of Consensus

Equalisation: One area in which there is relative political consensus is the program of fiscal equalization. All of the provinces have endorsed this system of unconditional transfers from the federal government to the seven less-wealthy provinces in order to help these provinces provide a comparable level of public services at reasonably comparable levels of taxation. Equalisation has also contributed to a narrowing of regional difference in economic conditions. Chart E-1 indicates a reduction in regional differences by comparing provincial trends in GDP per capita from 1961 to 1996.

Chart E1: Average Annual Growth Rates by Province, 1961-96



Source: Serge Coulombe, *Economic Growth and Provincial Disparity: A New View of an Old Problem*, (Toronto: C.D. Howe Institute, 1999), Table 1.

All of the provinces receiving equalization, except Manitoba, are above the national average for growth rate of GDP per capita.

The use of equalization transfers has also meant that social programs have developed as a cooperative project between the two orders of government.

3. Areas of Dispute

Ongoing Conflict with Quebec: Since the federal government initiated the use of its spending power in areas of exclusive provincial jurisdiction in the post-war period to establish many of the programs that are now the basis of the modern Canadian welfare state, the government of Quebec has voiced strong objections to this use of the spending power and to the role of the federal government in collecting provincial taxes through tax rental and tax collection agreements. Quebec has consistently argued that this use of the

federal spending power and the role of the federal government in collecting provincial taxes was an invasion of the constitutional jurisdiction assigned exclusively to the provinces. Rather than come to an intergovernmental agreement with the federal government on the implementation of national programs within Quebec, the Quebec government has instead been able to negotiate a different set of fiscal arrangements with the federal government. These agreements allowed Quebec to opt-out of some federation-wide programs but still receive funds from the federal government to implement its own programs that had objectives similar to the federation-wide programs⁵⁸. This process was also flexible enough to accommodate Quebec's desire to have its own provincial tax system. While all the other provinces signed a tax collection agreement with the federal government limiting the full exercise of their constitutional right to levy and collect corporate and personal income taxes, in 1962 Quebec chose to establish its own provincial tax system and collect its own corporate and personal income tax.⁵⁹

In this way the processes of intergovernmental negotiation between federal and provincial executives ("executive federalism") and the fiscal arrangements between the federal government and the provinces have been flexible enough to accommodate the demands of Quebec while allowing the federal government to implement federal policy objectives that would otherwise be beyond the fiscal capacity of the provinces operating on their own revenues. Intergovernmental relations have been the site for many disputes

⁵⁸ It should be noted that Quebec did not opt-out of the two largest cost-shared programs: the *Canada Assistance Plan* or the Medical/Hospital insurance programs.

⁵⁹ Both Quebec and Ontario set up their own corporate income tax in 1947 but Ontario signed the 1952-1957 Tax Rental Agreement with the federal government and abandoned its corporate tax, leaving Quebec as the only province outside the Tax Rental Agreements in 1952. In 1957 Ontario signed a new Tax Sharing Agreement with the federal government but this did *not* include corporate income taxes, resulting in Ontario re-establishing its corporate income tax. The result was that both Québec and Ontario collected their own corporate income taxes. In 1981 Alberta adopted its own corporate income tax system.

between the different orders of government (and between governments), but these processes of “executive federalism” have generally helped to maintain stability while allowing for the evolution of the federation. However, “executive federalism” and the issue of fiscal relations between Quebec and the federal government have also been the source of major political and constitutional conflicts that have threatened national unity.

Quebec’s objections to the federal use of its spending power in areas of exclusive provincial jurisdiction have translated into calls for comprehensive constitutional reform to revise the division of powers in order to provide Quebec with greater fiscal revenues and expanded legislative powers. Quebec has pressed for greater fiscal autonomy that would allow it to meet its expenditure obligations under the constitution. The federal government has been reluctant to give up revenue and its ability to implement federation-wide policies. Part of the federal government’s reluctance to meet Quebec’s constitutional demands was that by giving Quebec expanded legislative powers and additional revenues the federal government feared that this would lead only to further claims for additional powers and fuel the nationalist movement in Quebec that supported Quebec’s separation from the rest of Canada.

The differences with Quebec over fiscal and legislative powers led to a prolonged series of constitutional negotiations between the federal and provincial governments since 1967. These debates and an ongoing series of constitutional negotiations on these issues between the federal government, Quebec and the other provinces have at times fuelled the nationalist movement in Quebec and led to further tension between Quebec and the federal government and the other provinces. These tensions reached a crisis point when a separatist party was elected in Quebec in 1976 and proposed to hold a referendum in

Quebec on the issue of “sovereignty association” in 1980. The referendum failed to obtain a majority, but another round of comprehensive constitutional negotiations from 1984 to 1993 resulted in an impasse between Quebec and the rest of Canada. That led to a second referendum in 1995 that resulted a razor-thin victory against separation. Despite losing two referendums on the issue of sovereignty association and independence the Parti Québécois (the independentist party in Quebec) has won the last two elections in Quebec. The Parti Québécois has indicated that it plans to hold another referendum in the future, although some apparent decline in support for separation since 1995 has led to deferral of the proposal.

Although the efforts at constitutional reform and the processes of executive federalism and intergovernmental agreements have resulted in considerable intergovernmental conflict between Quebec, the federal government and the other provinces, nevertheless, the pragmatic processes of executive federalism and intergovernmental negotiation have provided a method by which the federation has adapted to changing circumstance, and these processes have been more flexible and less politically divisive than attempts to amend the constitution formally.

Asymmetry of Constitutional Powers: As indicated above (and in A.4) Quebec has always sought greater fiscal and policy autonomy from Ottawa than the other provinces. In recent constitutional negotiations (1985-1993) the other provinces have been unwilling to meet Quebec’s demands for greater fiscal and legislative powers that would result in increased asymmetry between the legislative and fiscal powers of Quebec and the rest of the provinces. One of the reasons that the other provinces have objected to these demands by Quebec for further asymmetry is because some of the provinces would like similar

powers for their own province and therefore have objected to special favoured treatment for Quebec. The issue of asymmetry or “special status” for Quebec has been a major roadblock to formal constitutional reform and has contributed to the tensions between Quebec and the rest of Canada. Of course these same concerns have caused disagreements between Quebec and the federal government in intergovernmental negotiations.

Extending the use of the Federal Spending Power: The federal government has used its spending power to establish social programs that are within the constitutional jurisdiction of the provinces. The provinces were unable to establish these programs on their own because they lacked sufficient revenues of their own.⁶⁰ The federal government used its spending power to share with the provinces the cost of delivering new policies in areas such as healthcare, post-secondary education, and social assistance. As described above, the initial agreements with the provinces the federal government contributed approximately half of the provinces costs for these programs. In order to receive these funds the provinces had to meet a series of modest conditions that were specified in federal legislation (there were no conditions for post-secondary education funds). In later years the amount of the transfers was subject to a formula that was determined through a process of intergovernmental negotiations.

In the years following their establishment, the costs of these cost-shared social programs increased rapidly just as governments were facing increasing financial pressures and escalating budget deficits. Both federal and provincial governments sought to reduce their expenditures while facing public pressure to maintain the level of public

services. This led to continuing disputes and ongoing tensions between the federal and provincial governments. This tension came to a head in 1995 when the federal government unilaterally cut the fiscal transfers to provinces by replacing the previous system of transfers with the Canada Health and Social Transfer (CHST) in the federal budget. The unilateral decision by the federal government to cut fiscal transfers, combined with the steady reduction in transfers to the provinces before 1995, has contributed to an atmosphere of distrust between the provincial and federal governments.

The provinces argued that the federal government was not living up to its financial obligations to finance its share of jointly financed programs, and that the federal government should restore the transfers to the provinces before financing any new policy initiatives. The federal government held that unlike the old system of transfers, the CHST was at least financially sustainable and minimised unnecessary restrictions on provinces in areas of clear provincial responsibility.

Now that the federal government has eliminated its budget deficit (that had persisted for 22 years) it has expressed an interest in extending the use of the spending power to establish new or additional programs in response to social and economic changes brought on by globalisation and increased pressures from international competition. The provinces have been reluctant to cooperate with the federal government on new or additional programs, however, because they fear that once these new programs are instituted, the federal government may at some time in the future again act unilaterally to reduce or drastically cut transfers as they have in the past. This would leave the provinces

⁶⁰ This was because the federal government collected most of the taxation revenues under tax rental and tax collection agreements they had negotiated with the provinces. See Section D for further details.

with the burden of funding programs that they lack the fiscal resources to sustain. Instead, they are pressing the federal government to restore the funds that were cut in 1995.

The signing of the Social Union Framework Agreement (SUFA) in February 1999 was an attempt by the federal and provincial governments (except Quebec) to reach an agreement on how new or additional programs might be implemented when the federal government uses its spending power. Although the signing of the Agreement indicates that some progress is being made on important issues, there are still continuing disagreements between the two orders of government that have prevented any substantial agreements on the extension of the federal spending power in areas of exclusive provincial jurisdiction.

Finally, although Quebec participated in the negotiations, Quebec did not sign SUFA because of its objections to the use of the federal spending power in areas of exclusive provincial jurisdiction and because of the lack of provisions in SUFA that would allow Quebec to opt out of new programs (financed through the spending power) and receive compensation from the federal government to implement its own provincial program. Thus, the agreement of nine provinces to the *Social Union Framework Agreement* but not Quebec has introduced a further degree of *de facto* asymmetry among the provinces.

The Introduction of New Direct Transfers to Individuals: The federal government also uses its spending power to make direct transfers to individuals and organisations for policy purposes that are within provincial jurisdiction (e.g. post-secondary education scholarships and research chairs at universities). The introduction of new direct transfers to individuals and organisations and institutions by the federal government has also been

a source of considerable conflict between the federal and provincial governments, especially the government of Quebec.

Provincial governments have objected to the introduction of new direct transfers to individuals and institutions because the federal government has spent money on *new* transfers to individuals before restoring the funds to jointly financed programs that were unilaterally cut in 1995. These types of direct transfers to individuals and institutions by-pass the provincial governments and give the federal government higher visibility with citizens. The provinces have been concerned that the federal government will in future make greater use of direct transfers in order to by-pass provinces and maximise the visibility of the federal government in the delivery of program.

Ability to Adapt to Changes

Despite the considerable achievements of “executive federalism” in facilitating intergovernmental relations, these disputes between federal and provincial governments, the federal government and Quebec, and between Quebec and the other provinces point to some weaknesses in the ability of “executive federalism” as a process to respond to the need for changes in social and economic policy.

A major challenge that is hampering the ability of “executive federalism” and the use by the federal government of its spending power to respond to changing circumstances is a lack of trust between the two orders of government. The federal government’s gradual reduction in funding of existing jointly financial programs and its unilateral decision to cut dramatically transfers to the provinces left the provinces with the burden of compensating for the reductions in federal transfers. This made it increasingly difficult for the provinces to predict and plan their budgetary revenues and expenditures. As a

result of the federal government reducing its commitment to maintain transfers for existing jointly financed programs the provinces have been extremely reluctant to enter any new joint agreements with the federal government. This stalemate between the federal and the provincial governments on the introduction of new joint programs represents a considerable constraint on the ability of the intergovernmental processes to respond to changing economic and social circumstances.

Another considerable constraint on the ability of the intergovernmental process to respond to changing circumstance is the continuing objections of Quebec to the use of the federal spending power in areas of exclusive provincial jurisdiction and its claims for additional fiscal and legislative powers. Quebec's ongoing objection to this use of the federal spending power will either have the result of extending the process of negotiations and reducing the responsiveness of the intergovernmental process or it will result in Quebec continuing to be excluded from future intergovernmental agreements (such as SUFA, the *National Children's Benefit* and the *National Children's Agenda*). A trend towards intergovernmental agreements that consistently excludes Quebec could re-enforce the arguments of the pro-separatist forces in Quebec (including the current Quebec government) that Canadian federalism cannot accommodate Quebec's cultural and linguistic needs.

Executive federalism is a process that involves a long series of complex negotiations between the federal government and ten provinces. The need for extensive consultation and cooperation among so many governments with a diverse set of interests means that "executive federalism" is a process that may be very slow to respond to the need for

changes to social and economic policies. The result is a cumbersome and complex system of negotiations that has difficulty in responding quickly enough to changing policy needs.

These problems aside, the processes of “executive federalism” have, nonetheless, achieved some considerable successes. They have allowed the federal and provincial governments to reach agreements on a series of federation-wide programs that form the basis of the modern welfare state in Canada. Furthermore, these are programs that the provinces would not have been able to implement without the financial assistance of the federal government. These grants have allowed the federal government to establish major social policies that must operate within the broad conditions set by the federal government but also allow for differences between the provinces.

For citizens many of these policies have lowered barriers to mobility within Canada and created greater equality of opportunity. These programs have also advanced the concept that citizens have social rights and contributed to a civic nationalism in Canada.

Executive federalism and interprovincial financial agreements have also been the major method through which the federation has evolved. Attempts to reform the federation through the formal amending process of the constitution have in practice proved almost politically impossible and furthermore have contributed to events that seriously threatened the unity of the country.⁶¹ The processes of “executive federalism” and the use of intergovernmental agreements have been flexible enough to accommodate Quebec’s demands for greater fiscal and political autonomy while at the same time allowing the

⁶¹ Minor amendments to the constitution have not been as controversial. Indeed, two have been passed in the last several years. Both required the support of Parliament and the province affected. The Constitution Amendment, 1997 (Québec), removed the province's requirement to provide denominational schools, facilitating the establishment of a linguistically-based system of education. A similar amendment, the Constitution Amendment, 1998 (Newfoundland Act), removed that province's requirement to provide denominational schools and enabled the province to modernize its school system.

federal government to use its spending power to achieve federation-wide policy objectives.

4. Transparency and Accountability Considerations

The lack of any formal constitutional status for “executive federalism” has raised concerns about the accountability for the decisions taken by governments that participate in this process. The premiers and the prime minister are not bound by any formal constitutional rules to submit agreements they make with other governments to their respective legislatures for approval or scrutiny.⁶² The absence of this requirement creates the impression that an agreement could have been made without consideration of important interests that are represented by other parties and interests that are democratically represented in the legislature.

One of the biggest concerns with the process of executive federalism is, therefore, is the perception that it suffers from a democratic deficit. The fact that the premiers and the prime minister negotiate among themselves intergovernmental agreements that have such wide-ranging implications for Canada’s major social and economic policies creates the impression that there is a lack of representativeness and democratic accountability in these processes.

Nevertheless, it should be noted that the premiers and the prime minister, and their governments, are elected and under the rules of the parliamentary system they are accountable to their legislatures for all of their actions. Therefore, the process of “executive federalism” is in this sense entirely consistent with the Canadian tradition of representative democracy. “Executive federalism” as a process is fundamentally based on

elite accommodation between governments. However, the legitimacy of traditional representative democracy is being challenged by a “decline of deference” towards political elites that is taking place in Canada and other western industrial democracies.⁶³ The last two rounds of constitutional negotiations (1985-1993) indicated that citizens were highly suspicious of an elite process that excluded the public. Citizens want and expect to play a larger role in a process that has such significant implications for major social and economic policy decision-making and indeed the very future of the country itself. Increased mobilisation of the public and their desire to play a role in the decision-making process has constrained the ability of government elites to broker intergovernmental agreements that involve compromises and trade-offs that may not be popular with large sections of their voters. The recent SUFA (the Social Union Framework Agreement) has also attempted to address this problem by including commitments to engagement of citizens, but so far there have been no prominent examples of such initiatives taking place as a result of SUFA.

Another problem that is associated with the processes of “executive federalism” is a lack of formal decision-making rules. In the process of negotiations, although each province is equally represented, some provinces have more political power and influence than others due to their size or wealth and this may lead some participants in the process (governments), or their supporting publics, to believe (rightly or wrongly) that other provinces’ or regions’ interests dominate the negotiations at their expense. This has the potential to exacerbate existing tensions between governments and highlight conflict rather than agreement. Related to the concern about the lack of formal decision-making

⁶² There are requirements, however, that intergovernmental agreements relating to the formal amendment process of the Constitution be submitted to legislatures.

rules is the power of the federal government to make unilateral decisions on its use of the spending power in areas of exclusive provincial jurisdiction.⁶⁴ After establishing a practice of negotiating changes to fiscal transfers with the provinces, the federal government's subsequent insensitive unilateral decision in 1995 to cut transfers to the provinces drastically, has contributed to a lack of trust that now threatens the ability of the federal government to get cooperation from the provinces on new programs that are necessary to accommodate changing social and economic circumstances.

The complexity of the system of transfers between the federal and the provincial governments and the lack of transparency that applies to intergovernmental agreements is a formidable barrier preventing public understanding of how these affect the design and delivery of public services and the development of public policies. A related issue is whether a government that imposes a particular tax should also be responsible for spending it in order to ensure a measure of financial responsibility and political accountability. However, weighed against this is the need to accomplish federation-wide policy objectives and other goals such as regional and individual equity that are achieved through the use of transfers and intergovernmental collaboration.

One implication of the principle of fiscal responsibility, i.e. that the government that raises taxes should decide how these revenues are spent, is that the government making transfers should establish conditions on how the recipient government spends these in order to ensure accountability. Thus in some federations, most notably the United States, most intergovernmental transfers take the form of conditional grants. The problems with

⁶³ See Neil Nevitte, *The Decline of Deference*, (Toronto: University of Toronto Press).

⁶⁴ This was the situation before the signing of the *Social Union Framework Agreement* (SUFA) in 1999. Under the terms of SUFA the federal government accepted some restrictions on the use of its

such grants is, however, that they undermine the autonomy and flexibility of the recipient governments. Canada has, therefore, over the last two and a half decades moved instead to heavy reliance primarily on unconditional or at most semi-conditional transfers, perhaps more so than any other federation. This has not meant a lack of accountability, however, since the provincial executives responsible for the spending of these transfers are in budgetary terms directly accountable to their legislatures under the system of parliamentary executives, and hence through their legislatures to the citizens.

5. Political Culture

Canada is characterised by regional and linguistic cleavages and the processes of intergovernmental relations and fiscal arrangements both reflect and reinforce these characteristics.

In Canada the provinces do not have any direct representation within federal government institutions. There is no direct representation of the provinces in the Senate (as there is in federations such as Germany) or even the direct election of Senators to represent the residents of the provinces (as in the United States). The lack of representation for the provinces within the federal parliament has resulted in the provincial premiers becoming the primary advocates of provincial or regional interests on the federal scene. This explains why intergovernmental meetings and the processes of “executive federalism” have become the primary methods of integrating regional and linguistic interests into the federal government’s decision-making process. Thus, the process of executive federalism and the debates it has generated between governments reflects Canada’s regional and linguistic cleavages.

spending power that may remedy this concern by the provinces. However, it should be noted that SUFA is

The fiscal arrangements between the provinces and the federal government have also had a major impact on the role of the federal and provincial governments. The rise of the welfare state in the post-war period has meant that the constitutional expenditure obligations of the provinces have become more important and provincial governments have expanded rapidly in order to deliver new services to their citizens. Many of these new programs were jointly funded by the federal government and federal funds were a major contributor to the rapid expansion of the provinces' activities and their resources. As provincial governments expanded they developed their own political priorities that reflected their regional or provincial interests. Naturally, these provincial or regional interests were expressed through the channels of "executive federalism." In this way, the fiscal transfers from the federal government to the provinces contributed to the expansion of the provincial governments and their increased role in articulating regional interests.

Despite the existence of regional and linguistic cleavages there is a high degree of consensus among Canadians on most social values. This consensus has supported the efforts of the federal government to pursue Canada-wide objectives and policies. Through the use of transfers the federal government has been able to develop a set of Canada-wide programs that are accessible by all Canadians, regardless of where they live. Compared to most federations these transfers have been largely unconditional or only semi-conditional in character and this has allowed considerable discretion in how the provinces deliver those programs. This has reflected the diverse regional and linguistic political culture of Canada while permitting the federal government to develop broad Canada-wide social programs and policies.

only an intergovernmental agreement with no formal constitutional or legal status.

APPENDIX

**Table 1: Federal Government Share of Total Public Spending Including Intergovernmental Transfers
(Percentages)**

Year	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	63.9	67.6	72.0	65.5	53.8	58.7	60.6	54.7	52.5	56.4
1962	62.2	72.4	71.2	64.6	52.9	57.6	59.6	55.4	52.2	54.0
1963	63.0	67.4	70.4	66.3	51.7	55.6	57.2	49.6	50.5	52.3
1964	59.3	66.0	69.2	61.0	50.7	54.6	56.5	47.7	49.4	52.0
1965	60.2	74.4	68.0	62.8	46.1	52.4	55.9	48.1	46.6	50.9
1966	57.6	63.2	67.9	62.5	44.9	52.6	56.6	48.4	43.5	50.1
1967	52.8	63.5	68.4	64.6	44.8	49.5	55.7	47.1	40.1	49.2
1968	54.7	64.0	67.2	60.9	44.0	47.7	54.4	46.9	42.1	47.8
1969	56.6	65.3	66.0	56.8	44.5	46.5	52.5	48.4	41.2	46.0
1970	56.4	63.8	60.7	60.5	43.4	45.1	51.6	49.9	41.3	45.9
1971	55.0	62.6	61.0	57.2	44.0	44.9	51.9	51.6	40.7	47.1
1972	55.7	61.8	62.0	57.2	45.2	46.5	51.6	52.3	41.9	47.8
1973	57.1	61.6	61.6	60.5	43.0	46.9	51.5	52.4	41.6	46.5
1974	58.8	61.2	65.3	62.8	46.8	47.3	48.8	50.8	44.1	45.9
1975	59.5	63.5	65.1	63.9	48.8	47.6	49.2	48.2	41.4	45.2
1976	55.7	63.4	65.3	62.4	44.3	46.9	48.6	45.4	41.4	45.5
1977	57.7	62.7	66.6	61.7	43.7	46.8	49.9	44.7	40.7	46.1
1978	57.3	65.3	63.9	62.6	45.3	46.3	51.4	46.8	39.4	45.5
1979	56.3	64.3	64.3	63.1	43.3	46.3	51.7	47.0	37.7	44.7
1980	56.2	61.8	66.5	66.2	43.8	46.6	51.2	44.3	35.8	43.0
1981	55.9	60.7	65.6	66.5	45.5	47.2	52.0	44.4	36.1	43.1
1982	57.7	63.8	63.8	61.2	45.5	48.4	50.7	45.4	38.9	45.5
1983	57.5	62.0	64.2	59.6	45.6	47.8	50.9	45.6	37.9	46.5
1984	58.8	64.4	64.7	60.1	45.8	48.3	51.5	48.7	42.7	48.2
1985	61.4	65.6	63.7	60.6	45.4	48.7	51.7	48.9	42.4	49.9
1986	60.0	65.4	62.3	59.4	43.8	47.2	51.0	49.4	39.0	48.8
1987	58.8	63.5	61.3	58.8	44.1	46.3	50.7	51.6	40.5	48.7
1988	58.1	63.7	61.2	58.4	44.3	45.5	51.2	48.9	41.4	48.4
1989	57.5	63.1	60.7	59.0	44.7	45.5	50.7	47.9	41.2	48.7
1990	57.6	62.6	60.9	58.7	45.0	45.8	51.0	47.5	40.5	48.4
1991	58.2	62.3	60.4	57.6	44.5	45.2	51.6	50.0	41.4	46.7
1992	59.8	62.2	59.9	57.7	43.9	43.7	49.9	47.1	41.4	45.2
1993	60.2	60.7	58.8	57.1	44.5	44.6	50.5	48.0	41.7	44.6
1994	60.2	61.4	60.8	56.4	43.4	44.6	50.2	47.5	43.2	43.4
1995	59.6	62.2	61.5	56.9	44.1	45.2	52.5	47.0	44.8	44.1

**Table 2: Federal Government Share of Total Public Spending Excluding Intergovernmental Transfers
(Percentages)**

Year	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	53.7	61.3	68.1	59.3	49.9	55.3	55.3	48.6	46.4	50.0
1962	50.0	66.1	67.2	58.3	47.6	54.5	55.4	49.9	47.5	50.4
1963	52.2	60.6	66.9	60.7	46.3	52.2	52.9	44.2	45.7	48.6
1964	47.7	59.5	65.5	54.3	44.3	51.7	51.7	42.4	45.2	48.6
1965	46.0	67.6	63.2	54.6	40.2	49.1	50.4	42.0	41.9	46.9
1966	44.5	55.2	62.5	54.8	39.1	49.0	50.3	41.8	38.5	46.1
1967	38.6	55.0	61.8	56.1	38.5	45.9	49.4	40.6	34.9	45.3
1968	40.1	55.7	60.3	51.4	37.4	43.6	48.2	40.4	36.5	43.4
1969	41.7	55.0	59.1	46.7	37.9	42.2	45.7	41.9	35.1	41.4
1970	41.0	53.7	54.0	50.6	35.7	40.2	44.1	43.2	34.7	40.9
1971	38.2	50.6	54.1	45.9	34.9	39.7	43.4	42.0	33.7	41.5
1972	42.2	50.7	54.7	47.0	37.7	41.6	43.6	42.1	35.2	43.2
1973	44.3	50.7	54.1	50.6	36.0	42.5	43.5	42.6	35.5	42.1
1974	46.8	50.5	59.3	54.2	39.9	42.7	40.9	42.5	35.4	41.1
1975	48.3	52.1	58.7	55.7	42.3	42.7	40.3	41.0	34.2	40.1
1976	44.6	52.0	59.5	54.5	37.8	41.6	40.1	39.3	34.7	39.9
1977	46.5	52.4	60.1	53.5	36.1	41.9	41.3	38.7	34.4	40.5
1978	45.5	55.4	57.4	53.8	37.5	41.6	43.2	40.3	33.5	40.5
1979	44.4	54.1	58.2	54.7	35.9	41.5	43.2	40.8	32.5	39.5
1980	45.3	50.9	60.9	60.2	36.9	42.2	42.6	38.1	31.1	38.1
1981	45.3	51.0	60.0	60.7	39.2	43.2	44.7	38.4	31.6	38.8
1982	48.0	54.7	58.0	53.9	38.6	45.2	43.9	40.2	34.4	41.7
1983	49.2	53.5	58.6	51.9	38.3	44.2	44.5	41.3	34.2	42.4
1984	50.4	56.0	59.2	52.6	38.6	44.4	44.8	44.4	38.9	43.8
1985	52.7	58.4	58.3	52.8	38.7	44.7	45.2	44.4	37.8	45.3
1986	51.3	58.5	56.8	51.6	37.6	43.5	45.3	45.1	34.6	44.3
1987	49.4	56.3	55.4	50.6	37.9	42.5	44.5	46.8	35.8	44.2
1988	48.1	56.3	54.8	50.1	38.1	41.7	44.1	43.7	36.5	43.9
1989	47.6	55.4	54.3	50.8	38.8	42.1	43.7	42.1	36.8	44.5
1990	47.8	54.7	54.5	50.5	39.5	42.5	44.0	40.9	36.2	44.7
1991	49.6	55.3	54.5	50.3	39.5	41.9	44.5	43.5	37.3	43.4
1992	51.4	55.3	53.9	49.6	38.6	40.2	43.1	40.5	36.3	41.4
1993	51.9	54.1	52.8	49.3	38.9	40.6	43.6	41.3	37.0	40.6
1994	52.2	54.3	54.4	48.8	38.0	40.7	43.0	40.8	39.0	39.6
1995	50.9	55.1	54.5	48.7	38.2	41.4	45.0	41.9	41.0	40.2

Table 3: Federal Government Share of Total Government Revenues Including Intergovernmental Transfers (Percentages)

YEAR	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	35.8	37.8	45.1	40.6	58.8	61.8	49.5	34.0	45.8	49.6
1962	31.1	30.0	41.0	37.9	55.6	58.3	46.9	30.2	42.4	48.7
1963	32.8	27.9	41.9	38.5	54.2	58.0	45.6	30.5	41.2	48.1
1964	32.5	29.5	43.2	39.2	53.6	59.3	47.4	31.6	43.2	49.1
1965	29.4	23.5	41.8	37.7	51.2	58.8	44.1	31.5	41.5	48.0
1966	29.8	28.1	40.8	37.8	49.5	57.0	44.1	31.8	42.7	47.2
1967	26.7	25.8	38.9	36.6	47.2	55.0	43.7	32.2	42.4	47.2
1968	27.4	28.6	39.2	36.3	45.9	53.7	42.7	31.4	42.7	46.8
1969	27.9	26.5	40.3	37.9	46.8	54.1	42.9	31.7	43.8	48.2
1970	26.6	27.6	41.9	38.0	45.2	51.7	41.2	31.2	42.6	47.5
1971	26.0	25.4	41.8	37.0	43.5	51.9	41.4	31.0	41.9	47.8
1972	28.5	27.6	41.3	37.6	43.1	53.0	42.0	32.1	42.9	48.7
1973	27.9	26.2	41.6	37.8	42.5	54.2	43.4	34.4	44.1	48.7
1974	27.9	28.1	43.6	38.4	42.9	54.8	44.4	41.7	53.6	48.5
1975	25.3	28.6	41.5	37.7	41.1	53.7	42.5	39.6	50.5	46.2
1976	27.2	28.9	43.1	38.7	40.9	52.6	41.5	38.5	46.3	45.6
1977	23.6	27.3	38.9	34.3	37.0	50.2	38.2	34.9	41.7	42.6
1978	21.4	25.7	38.2	32.4	35.4	49.3	37.7	32.0	35.7	41.0
1979	22.7	26.5	38.3	34.0	35.3	48.7	36.6	35.3	37.6	41.1
1980	22.9	26.2	37.8	35.1	36.7	49.9	37.5	37.0	37.4	43.2
1981	29.4	31.8	43.3	43.0	38.3	51.3	40.7	42.7	43.9	44.3
1982	27.7	31.7	41.4	37.6	32.8	50.1	39.2	41.0	44.5	42.9
1983	27.8	32.2	40.7	36.7	34.2	48.9	37.4	37.3	41.5	41.3
1984	27.9	31.1	41.3	36.0	35.4	47.8	36.6	36.9	42.0	40.6
1985	26.6	32.1	41.4	34.6	36.0	48.4	36.6	36.1	42.8	40.9
1986	28.3	37.1	42.4	37.3	38.0	50.1	38.8	37.2	41.0	42.6
1987	29.0	35.9	42.7	37.9	38.4	49.8	36.7	34.5	40.5	43.3
1988	29.2	35.5	42.9	38.2	38.0	49.5	35.4	33.5	40.6	42.6
1989	29.4	34.8	42.8	38.2	38.3	49.0	35.3	31.3	41.2	43.0
1990	29.7	35.4	42.2	38.3	38.7	48.9	36.4	31.3	41.0	43.9
1991	33.4	38.0	44.3	39.7	38.7	49.1	37.2	35.1	43.0	46.3
1992	33.4	37.7	45.0	39.8	38.8	49.4	38.1	34.5	43.2	45.6
1993	32.5	37.8	45.0	40.7	37.9	47.6	36.7	32.8	43.5	43.6
1994	32.9	37.8	43.4	40.2	37.9	47.4	36.4	33.2	43.6	42.8
1995	33.3	38.6	43.2	40.1	37.6	47.7	37.2	35.7	45.5	43.3

Table 4: Federal Government Share of Total Government Revenues Excluding Intergovernmental Transfers (Percentages)

YEAR	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	58.1	56.0	57.8	53.4	62.8	66.1	58.1	40.4	52.3	56.9
1962	52.3	46.2	52.0	49.5	60.6	61.8	53.2	35.2	46.9	52.4
1963	52.2	42.9	51.6	48.9	59.1	61.5	51.4	34.6	45.5	51.7
1964	50.8	44.8	52.8	50.6	59.2	62.2	53.5	35.5	46.9	52.1
1965	50.0	37.5	53.2	50.7	55.9	61.8	50.3	35.7	45.2	51.2
1966	48.2	44.4	53.5	50.0	54.0	60.2	51.6	36.6	46.7	50.3
1967	46.4	42.5	53.3	50.9	52.0	58.2	50.9	36.7	46.5	50.1
1968	45.7	44.9	54.1	50.5	50.8	57.1	49.0	36.0	47.1	50.1
1969	46.5	43.3	53.6	52.3	51.7	57.5	49.2	36.5	48.4	51.4
1970	44.4	45.3	53.5	51.6	50.9	55.6	48.1	36.6	47.3	51.4
1971	44.8	42.9	54.0	52.4	50.3	56.0	49.5	38.8	46.8	52.1
1972	46.0	46.5	53.4	51.7	49.0	57.2	49.6	41.1	47.6	52.4
1973	44.4	43.0	53.8	52.5	47.7	57.9	51.4	42.9	48.1	51.9
1974	44.4	46.3	56.1	52.5	48.6	58.7	52.0	48.4	58.3	52.1
1975	40.8	49.0	55.8	53.8	47.2	58.5	51.6	45.5	54.2	50.2
1976	41.2	50.6	56.5	54.1	46.4	57.5	49.8	42.9	49.7	50.0
1977	36.7	46.6	53.6	48.4	43.0	54.7	46.5	39.0	44.6	46.7
1978	34.3	44.7	52.0	46.7	41.5	53.4	46.4	36.4	37.9	44.7
1979	35.8	44.7	51.5	48.4	41.0	52.8	45.4	39.7	39.6	44.7
1980	35.7	43.8	51.2	48.7	42.5	53.8	46.6	41.1	39.1	46.8
1981	43.6	48.8	56.9	56.9	43.8	55.0	48.8	47.1	45.7	47.5
1982	42.4	49.6	54.5	52.1	38.4	53.3	47.1	45.6	46.7	46.2
1983	40.9	48.5	52.9	49.9	40.3	52.4	44.7	41.0	43.5	45.0
1984	40.8	47.0	53.6	48.4	41.4	51.5	44.4	41.0	44.3	44.7
1985	40.8	47.9	52.7	47.6	41.8	52.1	44.0	40.6	45.6	45.4
1986	41.7	52.2	53.0	49.2	43.0	53.3	45.4	42.2	44.2	46.9
1987	42.5	49.8	53.2	49.7	43.2	52.9	43.4	39.6	43.7	47.6
1988	43.0	49.7	54.1	50.0	42.6	52.4	42.5	38.6	44.1	46.5
1989	43.1	49.0	54.0	50.1	42.9	51.7	42.4	35.8	44.5	46.5
1990	43.2	49.8	53.1	50.2	43.1	51.6	43.6	36.6	44.0	47.0
1991	46.4	51.1	54.6	50.4	42.8	52.1	45.0	41.8	46.1	49.3
1992	46.8	50.3	55.2	51.4	43.2	52.7	45.4	40.5	47.1	48.9
1993	45.6	49.6	55.4	51.6	42.6	51.2	43.8	38.4	47.0	46.9
1994	45.5	49.8	54.1	50.2	42.3	50.7	43.5	38.3	46.5	45.7
1995	46.1	50.7	54.8	50.5	42.2	50.9	44.5	39.9	48.2	46.2

Table 5: Transfer Payments from Federal to Provincial Government as a Share of Provincial Government Revenues (Percentages)

Year	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	59.8	52.2	40.0	40.5	15.6	17.0	29.2	23.9	23.1	25.6
1962	58.7	50.0	35.9	37.8	18.8	13.4	22.1	20.3	16.7	13.6
1963	55.3	48.4	32.4	34.5	18.2	13.7	20.9	17.1	16.1	13.2
1964	53.2	48.4	32.1	37.2	20.4	11.3	21.8	16.1	14.0	11.6
1965	58.3	48.7	36.8	41.2	17.1	11.8	22.3	17.2	14.0	12.1
1966	54.5	51.2	40.1	39.4	16.4	12.4	25.9	19.0	15.0	11.8
1967	57.9	53.1	44.3	44.3	17.6	11.9	24.9	18.2	15.2	11.3
1968	55.1	50.9	45.2	44.2	17.8	12.9	22.7	18.6	16.0	12.5
1969	55.5	52.8	41.4	44.3	17.8	12.8	22.4	19.1	16.7	12.2
1970	54.6	53.9	37.5	42.5	20.5	14.4	24.4	21.5	17.5	14.3
1971	56.8	54.6	38.7	46.8	24.0	15.3	28.0	29.1	17.8	15.8
1972	53.3	56.2	38.5	43.5	21.0	15.4	26.5	32.1	17.5	13.6
1973	51.6	52.9	38.8	45.1	19.0	14.1	27.6	30.1	14.9	12.0
1974	51.6	54.5	39.5	43.5	20.3	14.8	26.5	23.9	17.6	13.4
1975	50.9	58.3	43.7	47.9	21.8	17.8	30.7	21.5	13.9	15.0
1976	46.6	60.3	41.8	46.3	20.3	18.1	28.4	16.8	12.6	15.9
1977	46.7	56.8	44.8	44.3	22.0	16.4	29.1	16.0	11.0	15.5
1978	47.8	57.2	42.9	45.5	22.6	15.3	30.1	17.9	9.0	13.8
1979	47.3	55.4	41.6	45.1	21.3	15.0	30.6	17.4	8.1	13.6
1980	46.4	54.4	41.9	43.0	21.3	14.4	31.2	15.9	7.0	13.5
1981	46.2	51.0	42.0	42.9	20.4	13.7	28.0	16.2	7.0	12.2
1982	47.9	52.8	41.0	44.7	21.9	11.9	27.4	17.0	8.5	12.7
1983	44.6	49.5	39.1	41.8	22.9	13.0	26.2	14.3	8.0	14.1
1984	43.9	49.2	39.1	40.1	22.5	13.5	27.5	15.9	9.1	15.3
1985	47.4	48.6	36.5	41.6	21.7	13.9	26.6	17.4	10.8	16.5
1986	45.0	46.0	34.8	38.4	18.8	12.1	23.8	18.8	12.0	15.9
1987	44.7	43.7	34.5	38.3	18.0	11.7	24.2	19.7	12.5	15.6
1988	45.2	44.4	36.3	38.1	17.4	10.9	25.9	19.8	13.1	14.4
1989	44.8	44.5	36.3	38.6	17.2	10.1	25.7	18.4	12.5	13.2
1990	44.6	44.7	35.4	38.5	16.6	10.3	26.2	21.2	11.5	11.9
1991	42.1	41.4	34.0	35.1	15.6	11.4	27.6	24.5	11.7	11.4
1992	43.0	40.3	33.7	37.5	16.6	12.3	25.9	22.9	14.5	12.2
1993	42.6	38.3	34.0	35.8	17.5	13.6	25.8	21.5	13.3	12.4
1994	41.2	39.0	34.9	33.3	16.6	12.5	25.5	20.1	10.9	10.8
1995	41.7	38.8	37.2	34.5	17.5	12.2	26.3	16.4	10.3	11.0

Table 6: Vertical Imbalance - Provincial Government, Before Intergovernmental Transfers
[((Expenditures - Transfers) - (Revenues - Transfers Received))/ (Expenditures - Transfers)]X100

Year	NFLD.	P.E.I.	N.S.	N.B.	QUE.	ONT.	MAN.	SASK.	ALB.	B.C.
1961	58.9	54.2	35.2	35.3	8.8	8.9	26.6	17.4	19.6	14.9
1962	54.8	33.3	25.0	30.1	8.4	-3.8	18.3	3.7	6.2	-1.3
1963	50.5	42.9	24.3	19.4	7.8	-0.3	18.4	6.7	6.1	-0.9
1964	52.2	50.0	27.5	35.8	8.9	-3.0	18.1	7.9	8.1	-7.9
1965	52.6	13.0	29.4	30.7	11.9	-1.5	11.4	3.3	6.6	-11.9
1966	53.7	53.5	32.5	29.8	11.9	-4.3	16.3	6.2	18.1	-10.5
1967	64.3	54.0	31.7	31.7	12.1	2.0	16.3	7.4	26.2	-8.2
1968	56.4	50.0	36.1	37.2	13.5	5.4	11.0	10.2	20.7	-4.4
1969	52.9	41.4	30.3	44.4	11.0	5.6	9.3	8.6	20.3	-5.6
1970	50.2	48.5	37.8	31.7	18.5	10.4	13.5	13.7	17.8	5.1
1971	54.3	46.3	38.9	44.6	20.8	13.5	19.7	16.6	18.1	2.9
1972	53.8	54.0	31.9	41.4	17.1	13.3	18.8	21.9	17.0	2.8
1973	50.0	48.6	32.8	38.0	18.0	11.4	24.3	17.3	7.4	-3.5
1974	48.7	53.6	35.1	34.5	15.9	12.2	27.1	7.3	-12.9	2.3
1975	48.5	53.6	43.0	44.5	20.9	23.6	33.4	14.1	-15.0	11.6
1976	47.9	57.3	42.6	46.2	26.1	21.9	31.0	9.4	-20.6	10.1
1977	43.2	55.9	39.7	41.6	25.4	18.4	29.4	8.3	-31.5	3.8
1978	45.1	52.4	43.2	39.0	22.5	18.0	31.0	6.0	-45.3	2.9
1979	45.6	49.8	42.3	38.4	25.4	13.3	29.5	6.1	-39.7	0.8
1980	47.3	51.5	41.2	40.8	28.2	15.5	32.7	4.6	-38.2	10.5
1981	48.6	51.6	44.2	40.8	25.4	15.3	29.1	9.8	-37.0	10.5
1982	51.9	50.5	45.1	49.6	26.6	17.9	35.2	22.5	-20.5	17.1
1983	52.1	51.2	41.3	44.9	27.1	18.3	33.6	18.6	-4.4	18.9
1984	47.8	44.8	40.3	40.6	26.5	13.6	33.6	20.0	-10.2	16.2
1985	46.6	46.6	37.9	41.3	26.9	14.0	32.1	24.3	-4.9	15.5
1986	45.1	43.5	36.7	36.6	23.5	9.6	31.8	33.4	18.4	17.3
1987	44.0	41.6	34.2	34.6	18.2	7.5	29.2	24.1	14.1	14.6
1988	44.3	41.5	35.4	34.6	14.1	4.6	25.2	26.2	13.1	7.7
1989	45.4	41.7	37.1	35.3	16.6	3.1	27.5	14.9	16.1	4.0
1990	44.7	42.8	34.6	35.7	17.2	8.5	28.8	20.8	11.4	4.0
1991	44.2	41.2	35.8	35.7	19.6	18.8	31.4	28.9	15.3	14.0
1992	43.3	39.8	36.8	36.5	22.3	25.2	32.2	29.1	20.0	15.1
1993	41.6	40.8	40.6	35.6	22.2	22.6	28.7	20.1	15.6	12.3
1994	39.9	36.9	33.0	32.0	22.1	17.6	26.1	15.2	1.8	7.2
1995	38.9	33.4	32.6	30.0	19.4	15.2	20.2	13.7	-1.6	5.9

