

MOWAT RESEARCH #159 | DECEMBER 2017



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Balance of Risks

Vertical Fiscal Imbalance
and Fiscal Risk in Canada

BY ERICH HARTMANN

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Acknowledgements

The author would like to specifically thank Adrienne Davidson for her research support as well as valuable feedback on this report, and Luan Ngo for his helpful comments and suggestions. The author would also like to thank Elaine Stam for her design work on this report as well as Sunil Johal, Reuven Shlozberg and Andrew Parkin for their helpful contributions.

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©2017 ISBN 978-1-77259-059-3

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**The federal
government
has managed to
insulate itself
from much
of this fiscal
risk, reserving
for itself a
considerable
degree of control
over its budget**

1 INTRODUCTION


The institution of federalism has many functions but at its core, it is a mechanism for dividing up responsibilities between orders of government. Canada’s federal system, however, has departed a long way from the era of watertight compartments, when each government carried out its taxing and spending decisions independently in its own closely-guarded jurisdictions. Instead, Canada’s federal and provincial governments are deeply entangled and share a considerable amount of policy space. While this has led to a much more complex system of governance, this intergovernmental entanglement has given rise to countless positive outcomes including important social programs.

Despite this trend towards increased entanglement, there is still considerable separation in the degree to which the federal and provincial governments are exposed to the “fiscal risk” of delivering these programs. Fiscal risk, as it will be discussed in this paper, is a measure of the degree to which government has control over a specific area of spending; more control over programmatic spending equals less risk, and vice versa.

Provinces have responsibility for delivering most of Canada’s important open-ended programs – including healthcare, social services and education – which are subject to significant demographic pressure and citizen demand. The pressures associated with these programs are only projected to mount. An aging population, for example, will strain the health care system and the increasing demand for an innovative workforce will highlight the value of education systems across the country. Provinces will face the choice to either meet these demands, or risk the alternatives. A considerable degree of provinces’ fiscal risk profile then is structural in nature.

The federal government, however, has managed to insulate itself from much of this fiscal risk, reserving for itself a considerable degree of control over its budget. Because much of the federal government’s spending profile is discretionary in nature - including federal transfers for healthcare, social services and post-secondary education - it can pick and choose the degree to which it is exposed to fiscal risk.

Furthermore, while provinces have access to a broad array of revenue streams, their tax bases are by less diversified than that of the federal government which applies its tax rates across the entire country. Provinces then, are more fiscally vulnerable to localized economic



shocks, which in turn can frustrate their ability to deliver the open-ended programs for which they are responsible.

Canada's fiscal federalism frameworks do not perform particularly well at sharing either the short-term or structural fiscal risks associated with delivering its vital public programs. The implications of this problem are not restricted to theorists or public finance specialists either. Failure to address the asymmetry in the allocation of fiscal risk between the two orders of government means that Canadians will not get enough of the services they want and need and too much of the public debt that they do not. Fiscal federalism, therefore, should be reformed to better share fiscal risk. This process need not involve a fundamental rewriting of the Constitution. Modest and immediately implementable changes to Canada's regime of intergovernmental transfers can be made to better balance the allocation of fiscal risk between the orders of government over the long term.

2 SOME CONTEXT

The division of powers between the federal and provincial orders of government set out in the Constitution Act, 1867 has made Canada as one of the most decentralized federations in the world. While this degree of decentralization may not have been the original intent of the constitutional framers, and notwithstanding significant overlap of responsibilities between the orders of government (see Figure 1 next page), the biggest ticket spending items in Canada largely reside in provincial jurisdiction. Among the more costly public services that provinces are tasked with providing are demand-driven, citizen-oriented programs such as health care, education, social assistance and social services.

Given this degree of decentralization, how have Canada's federal and provincial governments worked out how to raise the revenue to pay for all of this? First off, it is worth noting that provinces have significant revenue authority, more than most subnational governments.¹ They are free to levy direct taxes within their jurisdictions as they see fit. The list of revenue sources available to provinces includes personal and corporate income taxes, payroll taxes, sales and commodity taxes, property taxes, natural resource revenues and an almost innumerable list of user fees. Only indirect taxes such as customs duties are constitutionally unavailable to provinces. Canada's provinces are also fairly unique among federations in that they enjoy "essentially unlimited access to domestic

and international credit markets."² The broad provincial access to revenue sources, however, papers over some important nuances. The first and most relevant for the purposes of this paper is the federal dominance in many of the most lucrative tax bases, such as personal and corporate income taxes, arguably crowding the provinces out of this tax room (see Figure 2 page 6).

1 Blochliger, Hansjorg. 2013. "Measuring Decentralization: The OECD Fiscal Decentralization Database," in *Measuring Fiscal Decentralization: Concepts and Policies*, OECD.

2 Rodden, Jonathan and Erik Wibbels. 2010. "Fiscal Decentralization and The Business Cycle: An Empirical Study Of Seven Federations." *Economics & Politics*. Volume 22, March 2010, No. 1, pp. 37-67, (p. 45).

FIGURE 1

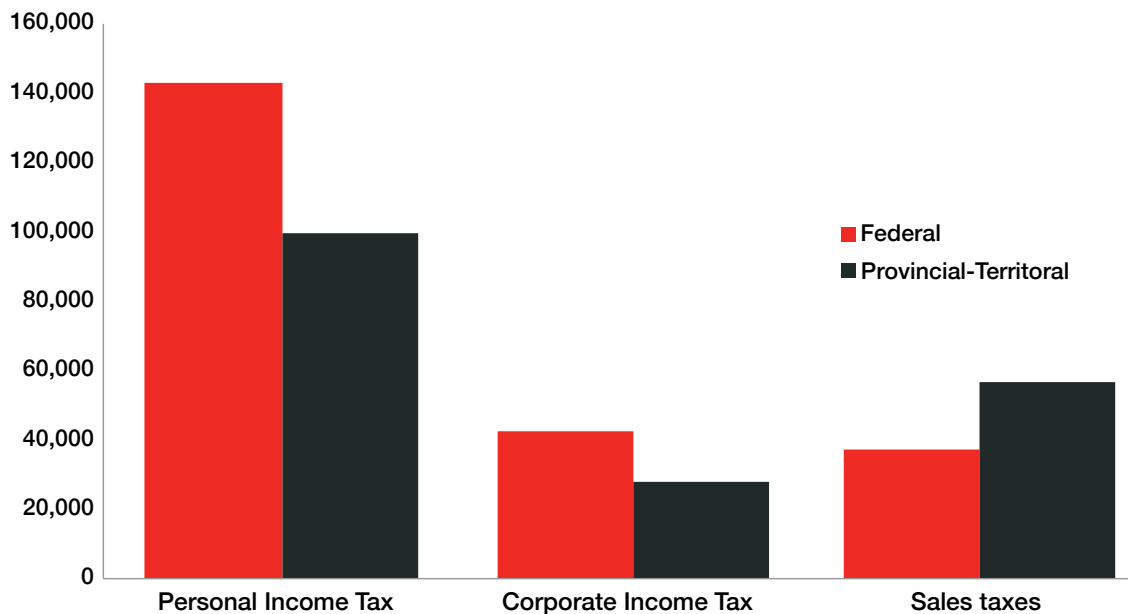
Illustrative List of Division of Powers between Federal and Provincial Orders of Government in Canada³

	Federal	Provincial
Money and banking	✓	
International and interprovincial trade	✓	
Airlines and railways	✓	
Telecommunications and broadcasting	✓	
Foreign affairs/international assistance	✓	
Defence and veterans affairs	✓	
Border security	✓	
Employment insurance	✓	
Criminal law	✓	
Fiscal Equalization	✓	
Indirect taxation	✓	
Direct taxation	✓	✓
Pensions and income support	✓	✓
Aboriginal peoples	✓	✓
Immigration	✓	✓
Agriculture	✓	✓
Industry	✓	✓
Environment	✓	✓
Policing	✓	✓
Transportation infrastructure	✓	✓
Housing	✓	✓
Post-secondary education, training and research	✓	✓
Public health	✓	✓
Primary and secondary education		✓
Health care		✓
Municipal institutions		✓
Social assistance and social services		✓
Natural resources		✓
Administration of justice		✓

³ The list in Figure 1, while not exhaustive, is reasonably illustrative of the division of powers between Canada's orders of government. This list has been reproduced from the original found in: Canada. 2006. Restoring Fiscal Balance in Canada: Budget 2006. Available at: <https://www.fin.gc.ca/budget06/pdf/fp2006e.pdf>

FIGURE 2

Federal and Provincial-Territorial Occupation of Select Tax Bases, 2016 (\$ millions)



Source: Statistics Canada. Table 384-0047 Revenue, expenditure and budgetary balance - General governments, provincial and territorial economic accounts, annual

Federal dominance in revenue-raising ability ultimately leads to a “vertical fiscal imbalance” in Canada’s fiscal federation. While the term “vertical fiscal imbalance” (VFI) is often used, “there is neither a universally accepted definition of VFI in the fiscal federalism literature nor a commonly accepted approach to measuring it.”⁴ The lack of a common definition or approach to measuring VFI may fuel much of the disagreement on the matter. Disagreement is not limited to the just the severity or implications of VFI either. On one side, doubt is cast on whether VFI is fundamentally possible (i.e. VFI cannot exist), while on the other, it is argued that VFI is more or less intrinsic to federalism (i.e. VFI must exist) (see Box 1, next page).

In the middle of these extremes, VFI is generally described in terms of whether or not there exists a structural mismatch between the revenue-raising capacity and spending responsibilities of the orders of government, with questions increasingly raised regarding the inability (or unwillingness) of the federal government to fill in these revenue gaps.

Despite these criticisms, there are a number of very good economic reasons for a strong federal role in the area of revenue raising. These include arguments about “the benefits of tax harmonization, the use of the tax system for national redistributive objectives, the costs of destructive tax competition, and the very different revenue raising capabilities of the provinces.”⁵ This last point gets to a second big issue complicating Canada’s decentralized revenue-raising story, and a second type of fiscal imbalance: a horizontal fiscal imbalance.

4 Sharma, Chanchal Kumar. 2012. “Beyond Gaps and Imbalances: Re-Structuring the Debate on Intergovernmental Fiscal Relations.” *Public Administration* Vol. 90, No. 1, 2012, pp. 99–128.

5 Boadway, Robin W. 2004. *Should the Canadian Federation Be Rebalanced?* Kingston, ON: Institute of Intergovernmental Relations, p. 4.

BOX 1

“There can be no fiscal imbalance to the detriment of one order of government when it has access to all revenue sources and even has a monopoly on such major revenue sources as lotteries and natural resource royalties.”⁷

“Fiscal imbalance exists when one order of government has revenue in excess of what it needs to fund its own jurisdictions, while inversely, the other order of government has insufficient revenue for the spending resulting from its constitutional jurisdictions.”⁸

7 Stéphane Dion. Federal Minister of Intergovernmental Affairs, Oct. 2002. In “Canada’s Fiscal (Im)balance: Both Sides of the Argument.” Parliamentary Research Branch, Library of Parliament. November 27, 2002. <https://lop.parl.ca/Content/LOP/ResearchPublicationsArchive/pdf/inbrief1000/prb0236-e.pdf>

8 Quebec. 2002. Commission on Fiscal Imbalance: A New Division of Canada’s Financial Resources. <http://www.groupes.finances.gouv.qc.ca/desequilibrefiscal/en/document/publication.htm>

In the big picture of provincial revenue raising, not all provinces are created equal. There is considerable variation across provinces in both the relative strength of their tax bases and their access to natural resources. As such, some provinces are able to raise considerably more revenue with lower tax rates than are other provinces. This unevenness in revenue-raising capacity places a theoretical upper bound on the tax efforts of ‘poorer’ provinces. If the provincial tax rates of ‘poorer’ provinces become too misaligned with that of their counterparts, it could lead to a further hollowing-out of key revenue sources through capital flight or fiscally induced migration. Thus, there is an important role for the federal government in maintaining its fiscal footing and smoothing out these horizontal imbalances. These horizontal imbalances are not unrelated to the issue of VFI, but will not be explored in depth in this paper.⁶ Suffice it to say that horizontal imbalances in Canada are a big enough issue for the principle of equalizing them through federal payments to poorer provinces is explicitly built into the Constitution.

6 For an in-depth discussion of horizontal fiscal imbalances and current issues facing the Equalization program in particular, please see: Hartmann, Erich. 2017. Ontario, Oil & Unreliable Data: The Complex Problems Confronting Equalization and Simple Solutions to Address Them. Mowat Centre. https://mowatcentre.ca/wp-content/uploads/publications/149_ontario_oil_and_unreliable_data.pdf

Despite the relatively unimpeded provincial access to most revenues sources, the federal dominance of significant portions of tax room and horizontal fiscal imbalances have contributed to the federal government collecting more money than it needs to dispense with its responsibilities, and conversely, the provinces collecting less. As outlined in Figure 3, in 2015, the federal government collected 39 per cent of total government revenue, but accounted for only 27 per cent of total government spending, net of intergovernmental transfers. Provinces and territories on the other hand, collected 47 per cent of revenues, yet accounted for 52 per cent of spending. The remaining amounts can mostly be attributed to local governments, although Aboriginal governments⁹ account for just over one per cent of spending.¹⁰

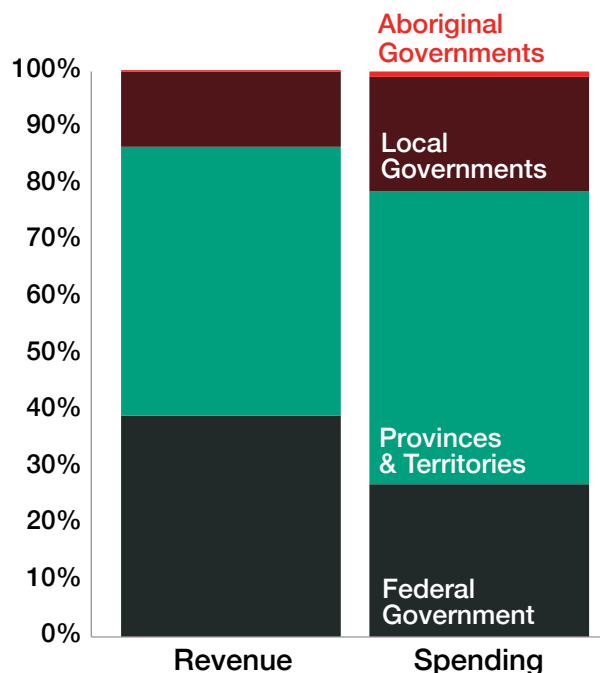
This mismatch, however, is not a problem per se. The gap can be bridged by fiscal federalism frameworks in general and federal transfers to the provinces in particular. The design of those frameworks, however, is an incredibly important matter. These frameworks can be designed to achieve outcomes such as promotion of national standards or goals or bringing about horizontal equity. The design element that this analysis will focus on is the extent to which Canada’s fiscal federalism frameworks reflect a reasonable sharing of both short-term economic risk and structural fiscal risk between the orders of government.

9 The term “Aboriginal governments” is a Statistics Canada category used for the purposes of its Government Finance Statistics data sets and is used here for the sake of consistency.

10 The mismatch between the share of revenue collected by the federal government and spending undertaken by the provinces is not a new or recent phenomenon. Aside from the period of World War II, government expenditure in Canada has always been more decentralized than revenue. For an extensive examination of the evolution of the relative spending and expenditure shares of Canada’s orders of government since Confederation, see: Di Matteo, Livio. 2017. “A Federal Fiscal History: Canada, 1867-2017.” Fraser Institute. <https://www.fraserinstitute.org/sites/default/files/federal-fiscal-history-canada-1867-2017.pdf>

FIGURE 3

Share of Federal, Provincial, Local and Aboriginal Government Revenue and Spending Net of Intergovernmental Transfers, 2015



Source: Statistics Canada. Table 384-0047 - Revenue, expenditure and budgetary balance - General governments, provincial and territorial economic accounts, annual (dollars)
 Note: excludes the Canada Pension Plan and Quebec Pension Plan

**The inability of
Equalization to
effectively deal
with economic
shocks highlights
the absence of a
well-functioning
program to
explicitly stabilize
provincial revenues
in Canada**

3 SHARING SHORT-TERM ECONOMIC RISK IN THE FEDERATION

Assessments of fiscal federalism frameworks as risk-sharing mechanisms are typically couched in strictly horizontal or inter-regional terms. The degree to which these frameworks are deemed to be successful in sharing risk are tied to either their ability to diversify subnational revenue streams enough to undermine region-specific risks or to smooth economic output and employment against idiosyncratic economic shocks. However, it is important to distinguish between the short-term stabilization and the long-term redistribution functions of federal fiscal systems.¹¹ As noted above, this paper will not delve into an in-depth discussion of the long-term inter-regional wealth redistribution or ‘equalizing’ elements of Canada’s fiscal federalism. Nonetheless, a quick survey of how effectively Canada’s fiscal mechanisms stabilize short-term risk across its regions is in order to better examine the principles of risk-sharing and federalism.

As noted above, both revenue-raising and expenditure capacities in Canada are heavily decentralized towards the provinces. While this gives the provinces a large degree of autonomy not enjoyed by subnational governments in other federations, it also leaves them more vulnerable to economic shocks as compared to other comparable subnational governments. Provincial revenues are always highly procyclical, which means that revenues reflect the overall state of the provincial economy.¹² The occurrence of an economic shock leads to reduced revenues, and is often coupled with citizen demands for countercyclical spending to stimulate demand while maintaining service

levels (take, for example, the recent case of Alberta in the face of low oil prices which resulted in considerable job loss within the province as well as lost revenues from resource development). The federal government, on the other hand, has access to a tax base that is diversified across the country. This makes its revenues far more stable than any individual province could hope to have. This stability also situates the federal government well to play a role in smoothing the impacts of short-term economic and revenue shocks in individual provinces. Whether or not it adequately leverages its own relative stability to smooth short-term economic risk in the provinces, and the fiscal risks that accompany it, is another matter.

11 Von Hagen, Jurgen. 1992. “Fiscal Arrangements in a Monetary Union - Some Evidence from the US.” In *Fiscal Policy, Taxes, and the Financial System in an Increasingly Integrated Europe*, edited by Don Fair and Christian de Boissieux. Dordrecht: Kluwer Academic Publishers, pp. 337–359.

12 Rodden, Jonathan and Erik Wibbels. 2010. “Fiscal Decentralization and the Business Cycle: An Empirical Study Of Seven Federations.” *Economics & Politics*. Volume 22, March 2010, No. 1, pp. 37-67.

According to a recent study by Balli et al, Canada's federal tax-transfer system, that is the overall system of federal taxes, spending and intergovernmental transfers, overall does play a role in stabilizing shocks to gross provincial product. However, a much greater degree of smoothing is left to market channels, either through the capital market (cross-ownership of productive assets) or credit markets (lending or borrowing). Furthermore, a significant portion of shocks are left unsmoothed.¹³ Further evidence suggests that in terms of smoothing asymmetric shocks, regional insurance in the form of payments to provinces is indeed more effective than fiscal policy at the national level.¹⁴

Much of the failure of Canada's framework of fiscal federalism to smooth region-specific, idiosyncratic economic shocks then has to do with the inadequacy of intergovernmental transfers as risk-sharing mechanisms for stabilizing provincial revenues. Moreover, not only do federal transfers to provinces not do a great job of stabilizing provincial revenues, they also tend to be procyclical, which can further exacerbate the volatility in provincial revenues and undermine long-term fiscal stability.

13 Balli et al. estimate that over the 1961-2006 period, 29 per cent of shocks to gross provincial product are smoothed by capital markets, 27 per cent are smoothed by the federal tax-transfer systems, 24 per cent are smoothed by credit markets, and the remaining 20 per cent are not smoothed. For a full discussion, see: Balli, Faruk, Syed Abdul Basher and Rosmy Jean Louis. 2012. "Channels of Risk-Sharing Among Canadian Provinces: 1961-2006." *Empirical Economics*, Volume 43, Issue 2, October 2012, pp. 763-787.

14 Bayoumi, Tamim and Paul R. Masson. 1998. "Liability-Creating Versus Non- Liability-Creating Fiscal Stabilisation Policies: Ricardian Equivalence, Fiscal Stabilisation and EMU." *The Economic Journal*, 108 (July) pp. 1026-1045. Royal Economic Society.

There is some debate about the role that the Equalization program plays in the stabilization of provincial revenues.¹⁵ This debate has been somewhat muted however, since the introduction of the use of lagged and smoothed data to calculate Equalization entitlements. By necessity, the use of lagged data in particular has reduced the responsiveness of the program to idiosyncratic economic shocks.¹⁶ This was a deliberate trade-off designed to increase the stability and predictability of payments for the provinces, which is entirely defensible since revenue stabilization is not the goal of the Equalization program. Rather, the core policy goal of the Equalization program is one of long-term horizontal redistribution meant to enable provinces to provide reasonably services at reasonable comparable tax rates.

The inability of Equalization to effectively deal with economic shocks highlights the absence of a well-functioning program to explicitly stabilize provincial revenues in Canada. While a Fiscal Stabilization Program is officially on the books, it is both dreadfully ineffective and woefully inadequate.¹⁷ In addition to being next to impossible to qualify for,¹⁸ the Fiscal Stabilization Program's maximum benefit of \$60

15 On one hand, Boadway and Hayashi (2004) argue that the equalization system can actually be destabilizing, thereby imposing on provinces volatility in their potential revenue streams that exceeds what would exist in the absence of equalization, see Boadway, Robin and Masayoshi Hayashi. 2004. "An Evaluation of the Stabilization Properties of Equalization in Canada." *Canadian Public Policy / Analyse de Politiques*, Vol. 30, No. 1 (Mar., 2004), pp. 91-109. Stable URL: <http://www.jstor.org/stable/3552582>. On the other hand, Smart (2004) disagrees arguing "the data exhibit a reasonable degree of revenue insurance through the current Equalization program, once allowance is made for the non-diversifiable component of provincial revenue risk, see Smart, Michael. 2004. "Equalization and Stabilization." *Canadian Public Policy*, Vol. 30, No. 2 (Jun., 2004), pp. 195-208. Stable URL: <http://www.jstor.org/stable/3552392>. It should be noted that whatever revenue stabilization does offer is only available to recipient provinces.

16 For a full discussion see: Hartmann, Erich. 2017. Ontario, Oil & Unreliable Data.

17 For a full discussion see: Hartmann, Erich. 2017. Ontario, Oil & Unreliable Data.

18 Between 1994 and when Alberta qualified for Fiscal Stabilization in 2016, no province received payments under the program, an era that notably included a very deep recession in 2008.

per capita has not been changed in decades. \$60 currently represents just over one-half of one per cent of the average per capita provincial own-source revenue.¹⁹

The remainder of the major federal transfers are largely procyclical. The Canada Health Transfer (CHT) currently has its annual growth rate tied to nominal growth in national GDP, with a three per cent floor. This means that provinces will see transfers increase by only three per cent in ‘bad’ economic times, while CHT transfers (and thus provincial revenues) will jump in ‘good’ economic times. A three per cent escalator also applies to the Canada Social Transfer (CST). Despite the consistency in funding promised by these frameworks, the size of the funding envelope of both of these transfers is entirely at the discretion of the federal government (more on that later). In the past, these portfolios have shown themselves to be particularly vulnerable to cuts in times of fiscal stress at the federal level, the mid-1990s serving as a stark example. Evidence also suggests that national transfers in federations are not just procyclical themselves, but may even exacerbate the procyclicity of provincial revenues.²⁰

The federal government’s approach to infrastructure stimulus funding, which requires significant cost-matching from provinces and municipalities, is an instructive example of this tendency.

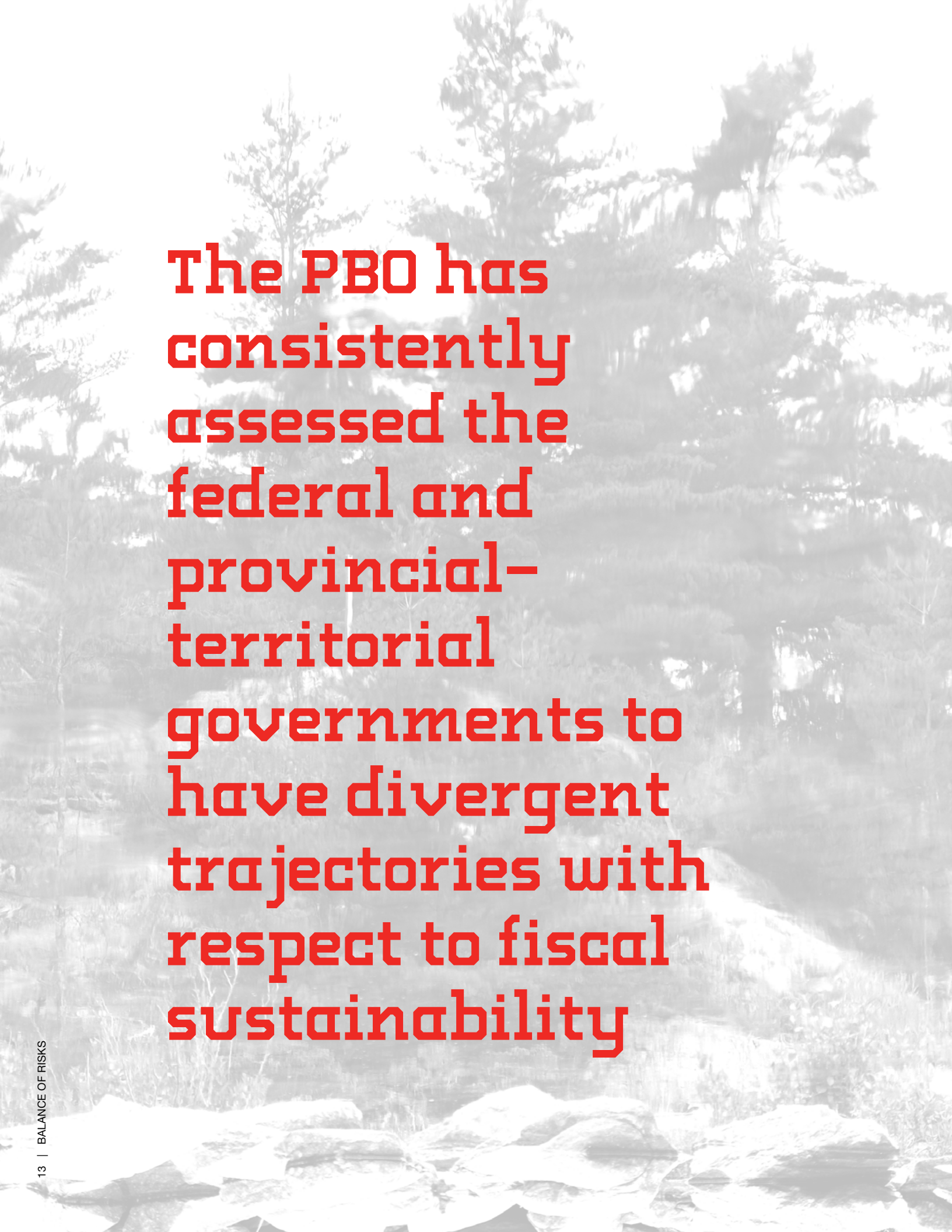
Beyond the adverse revenue uncertainty embedded in the system, the absence of an effective risk-sharing framework can be economically harmful. One consequence of poorly designed risk-sharing frameworks is that whatever modest income boost that might come from interpersonal tax-transfer policy at the national level during an asymmetric regional downturn “is completely undone by the need for provincial governments to raise taxes or cut expenditures because of flagging revenues.”²¹ Moreover, when risk is not adequately shared, provincial governments will tend to engage in fiscal retrenchment, which not only complicates efforts by the central government to generate fiscal stimulus, but “where provincial governments are responsible for social policies and poverty alleviation programs, the implications for the poor and unemployed can be severe.”²² Finally, failure to share short-term risk can lead to suboptimal borrowing, as debts accumulated at the subnational level almost uniformly face higher interest rates than does federal debt.

19 In 2015, the weighted average of provincial own-source revenue was \$9,380 on a per capita basis. Source data: CANSIM Table 384-0047.

20 Rodden, Jonathan and Erik Wibbels. 2010. “Fiscal Decentralization and the Business Cycle: An Empirical Study of Seven Federations.” *Economics & Politics*. Volume 22, March 2010, No. 1, pp. 37-67, (p. 43).

21 Rodden, Jonathan and Erik Wibbels. 2010. “Fiscal Decentralization and The Business Cycle: An Empirical Study of Seven Federations.” *Economics & Politics*. Volume 22, March 2010, No. 1, pp. 37-67.

22 Rodden, Jonathan and Erik Wibbels. 2010. “Fiscal Decentralization and The Business Cycle: An Empirical Study of Seven Federations.” *Economics & Politics*. Volume 22, March 2010, No. 1, pp. 37-67.



The PBO has consistently assessed the federal and provincial-territorial governments to have divergent trajectories with respect to fiscal sustainability

4 ASYMMETRY IN THE ALLOCATION OF STRUCTURAL FISCAL RISK

In addition to inadequately sharing short-term economic risk, this paper argues that there is a structural imbalance between the levels of fiscal risk assumed by Canada's orders of government. This asymmetry is a significant contributor to a larger VFI than may otherwise assumed to be in operation within the Canadian federation.

Despite the lack of precise agreement of how to quantify VFI (as discussed in Section 2), measurement systems are beginning to emerge that add helpful information to the debate. In the US, the concept of “trend gap” – a measure that reflects “the long-term imbalance between service demand and the revenue-raising ability of state and local governments”²³ – has begun to emerge. In Canada, much of the recent debate about VFI has benefitted from the Parliamentary Budget Office's (PBO) contribution of the measure of “fiscal sustainability” to the conversation. To arrive at their measure of fiscal sustainability, the PBO projects forward the current policy of each order of government (that is, consistent tax rates and spending profiles) over the long term to assess whether or not government debt would grow as a share of the economy, given projected economic and demographic shifts.²⁴

The outlook for the provinces is not good. The PBO has consistently assessed the federal and provincial-territorial governments to have divergent trajectories with respect to fiscal sustainability (see Figure 4). According to its latest assessment, the picture is the same. The PBO estimates that federal fiscal policy is sustainable over the long term. Subnational fiscal policy on aggregate, however, is not. While there is considerable variation by province, the PBO estimates that permanent tax increases or spending reductions amounting to 0.9 per cent of GDP, or \$18.7 billion in current dollars, would be required to stabilize the consolidated subnational government net debt-to-GDP ratio at its current level of 28.0 per cent of GDP over the long term. This contrasts starkly to the federal government which has fiscal room (shown as a negative fiscal gap in Figure 4) equivalent to 1.2 per cent of GDP or \$24.5 billion. Given current policy, the federal government would see its net debt, currently 33.2 per cent of GDP, eliminated by 2060.²⁵

23 Zhao, Bo, and David Coyne. 2017. “Walking a Tightrope: Are U.S. State and Local Governments on a Fiscally Sustainable Path?” Public Budgeting and Finance.

24 Office of the Parliamentary Budget Officer. 2017. “Fiscal Sustainability Report 2017.” Available at: http://pbo-dpb.gc.ca/en/blog/news/FSR_October_2017

25 Office of the Parliamentary Budget Officer. 2017. “Fiscal Sustainability Report 2017.” Available at: http://pbo-dpb.gc.ca/en/blog/news/FSR_October_2017

FIGURE 4

A Summary of the PBO's Fiscal Sustainability Reports' (FSR) Assessments

	Federal		Provincial-Territorial	
	Sustainable	Fiscal Gap	Sustainable	Fiscal Gap
2011 FSR	No	1.2	No	1.5
2012 CHT Assessment ¹	Yes	(0.4)	No	2.9
2012 FSR	Yes	(1.4)	No	2.0
2013 FSR	Yes	(1.3)	No	1.9
2014 FSR	Yes	(1.4)	No	1.7
2015 FSR	Yes	(1.4)	No	1.4
2016 FSR	Yes	(0.9)	No	1.5
2017 FSR	Yes	(1.2)	No	0.9

The projections of growing provincial debt contrasted with shrinking federal debt also closely mirrors the findings of Quebec's Seguin Commission on the Fiscal Imbalance from 15 years ago. While the underlying numbers have changed since then, the fundamental narrative persists. *Plus ça change*. As Seguin suggests, the misalignment of revenues and spending responsibilities is certainly part of this narrative. However, there are good reasons not to solve the issue of VFI through a fundamental reallocation of revenue-raising capacity between orders of government. As outlined in Section 2 above, Canada is already extremely decentralized with respect to revenue raising. Further decentralization of revenue raising, while likely to be autonomy-enhancing for provinces, would also subject provinces to greater fiscal risk. As similarly in Section 2 discussed above, there are good economic efficiency and equity reasons to recommend a stronger federal role in the area of revenue collection. In fact, these considerations suggest that "the federal share of the tax room should be jealously guarded and even enhanced."²⁶

Solutions to VFI need not require a rewriting of constitutional spending responsibilities either. Addressing the large asymmetry with respect to the assumption of long-term or structural fiscal risk between the orders of government offers a more effective route to get at the problem of VFI. Before examining solutions to engender a better sharing of fiscal risk, however, it would be instructive first to attempt to define what is meant by fiscal risk and then to quantify its allocation between the orders of government.

²⁶ Boadway, Robin W. 2004. Should the Canadian Federation Be Rebalanced? Institute of Intergovernmental Relations: Kingston, ON.

5 DEFINING AND ASSESSING FISCAL RISK IN THE CANADIAN FEDERATION

In defining fiscal risk, the level of risk ultimately equates to the degree to which government has control over a specific area of spending. More control fundamentally equals less risk, and vice versa. While some may rightly point out that governments theoretically have control over more or less all of their spending decisions, the variation in the level of control comes in manner of degree, not kind. For simplicity's sake, however, this paper will attempt to formulate a rough, if imperfect categorization of fiscal risk between orders of government relying upon a fairly straight-forward examination of the risk associated with their respective spending profiles.

In the context of budget-making in Canada, a distinction is often drawn between discretionary and statutory spending. The level of spending on a discretionary program at any given time is, as it sounds, discretionary. Discretionary spending items have limited total resources allocated to them, which are generally defined by annual appropriation acts. These limited allocations provide governments with greater certainty for budgeting purposes. Arguably, predictability and control are the defining features of discretionary spending.

Statutory spending programs, on the other hand, derive their budget authority from laws other than annual appropriation or supply acts. Statutory programs are often entitlement programs, with spending determined by the eligibility and benefit criteria set out in the programs' authorizing legislation. For the purposes of assessing the level of fiscal risk though, the statutory-discretionary distinction is not necessarily the most helpful one, and is perhaps overly mechanical. For example, something like "Payments under the Lieutenant

Governors Superannuation Act" might be a statutory appropriation, but not represent a large fiscal risk. Alternatively, spending subject to annual appropriations might be subject to more open-ended, citizen-driven demand and thus be subject to more fiscal risk. As such, this paper will make the distinction between "discretionary" and "open-ended" programs at either end of the fiscal risk spectrum.

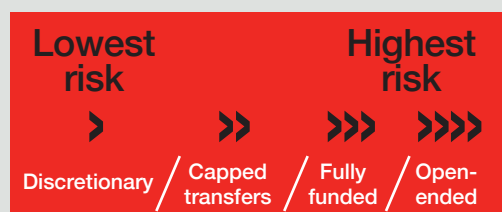
To more fully capture the fiscal risk profiles of the federal and provincial governments, two additional categories will be added to the middle points of this spectrum. Certain programs resemble open-ended programs in that they involve transfers to individuals determined by broad eligibility criteria, but are self-financing²⁷ and thus present less fiscal risk than an open-ended program that relies on general revenues for funding. The federal Employment Insurance program is a quintessential example of a "fully-funded"

27 Quebec. 2002. Commission on Fiscal Imbalance: A New Division of Canada's Financial Resources. p. 27. <http://www.groupes.finances.gouv.qc.ca/desequilibrefiscal/en/document/publication.htm>

BOX 2

Spectrum of Structural Fiscal Risk

The spectrum of risk outlined here goes from discretionary (lowest) to open (highest).



Definitions

Discretionary programs:

Spending that lawmakers control through annual appropriation acts. Governments have the greatest degree of control over these spending decisions.

Capped transfers:

Transfer payments made to other governments that either have legislated caps, or in general are not associated with the actual costs of delivering the program the transfers are meant to support

Fully-funded programs:

Share many of the characteristics of open entitlements but are legislatively or institutionally attached to a dedicated revenue source.

Open-ended programs:

Eligibility criteria set and funding levels are determined by the number of eligible recipients.

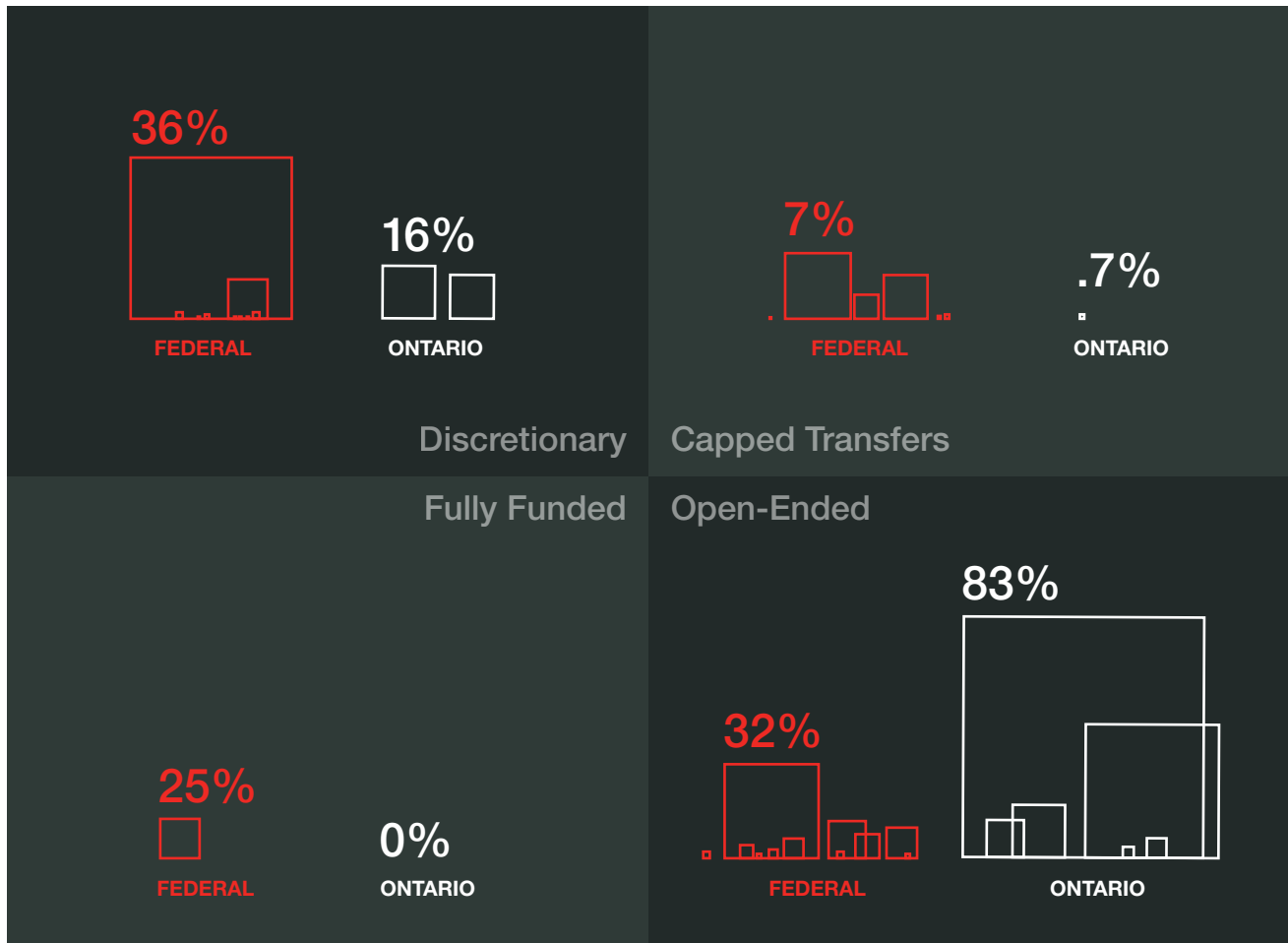
program of this nature. Towards the lower risk end of the spectrum lie many of the major intergovernmental transfers, both federal transfers to provinces and provincial transfers to municipalities. The size of these transfers is capped and therefore largely if not entirely discretionary. Because of the role they can play in sharing fiscal risk, however, they deserve special attention for the purposes of this analysis.

To examine the fiscal risk associated with federal and provincial spending profiles, this categorization framework was applied line-by-line to the 2015-16 Public Accounts of the federal government and Ontario, which will serve as a proxy for provincial governments in general for the purposes of this analysis. For a detailed discussion of the methodology behind this analysis, see the Appendix.

Overall, the contrast between the fiscal risk profiles of the two governments is quite stark. Over 80 per cent of Ontario's program spending is dedicated to open-ended programs, with health care, education and social welfare programs comprising the vast majority of spending in that category. The federal government, on the other hand, has insulated itself from much of the fiscal risk associated with running open-ended programs. While the federal government is responsible for open-ended programs such as Old Age Security, children's benefits, and support for Indigenous peoples, including First Nations and Inuit health care, these programs comprise only about a third of its program spending. Discretionary spending meanwhile makes up 36 per cent of federal program spending and if intergovernmental transfers are included in that category, that percentage goes north of 60.

FIGURE 5

The Allocation of Structural Fiscal Risk between Orders of Government: Federal Government and Ontario, 2015-16



Source: Mowat Centre calculations based on 2015-16 Public Accounts of the federal government and Ontario. For a full list of the expenses included in each category, see Appendix C.

So while there may be some disagreement about the VFI, there can be much less disagreement that the division spending profiles between Canada's orders of government represent a fundamentally imbalanced allocation of fiscal risk. Furthermore, this study's focus on Ontario as a proxy for all provinces may in fact undersell the degree to which this imbalance of fiscal risk persists across the country. Ontario has the lowest program spending and own-source revenue per capita among the provinces (see Figures 6 and 7). Other provinces with larger revenue and

spending footprints are likely to be subject to more structural fiscal risk. This would appear to align with recent analysis from the PBO which indicates that – with the exception of Quebec and Nova Scotia whose current fiscal policies are deemed to be sustainable – Ontario's fiscal policy is the most sustainable among provinces and territories, or rather, the least unsustainable.²⁸

28 Office of the Parliamentary Budget Officer. 2017. "Fiscal Sustainability Report 2017." Available at: http://pbo-dpb.gc.ca/en/blog/news/FSR_October_2017.

FIGURE 6

Per Capita Program Spending, 2015 (\$ per capita)

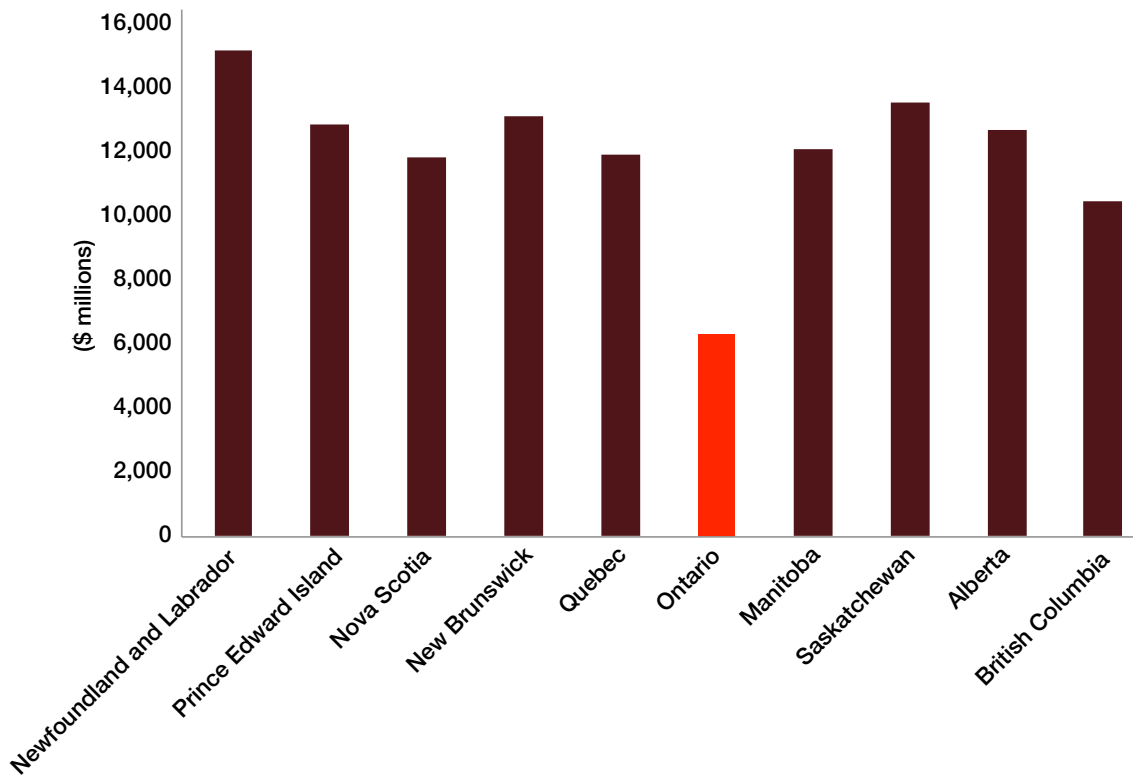
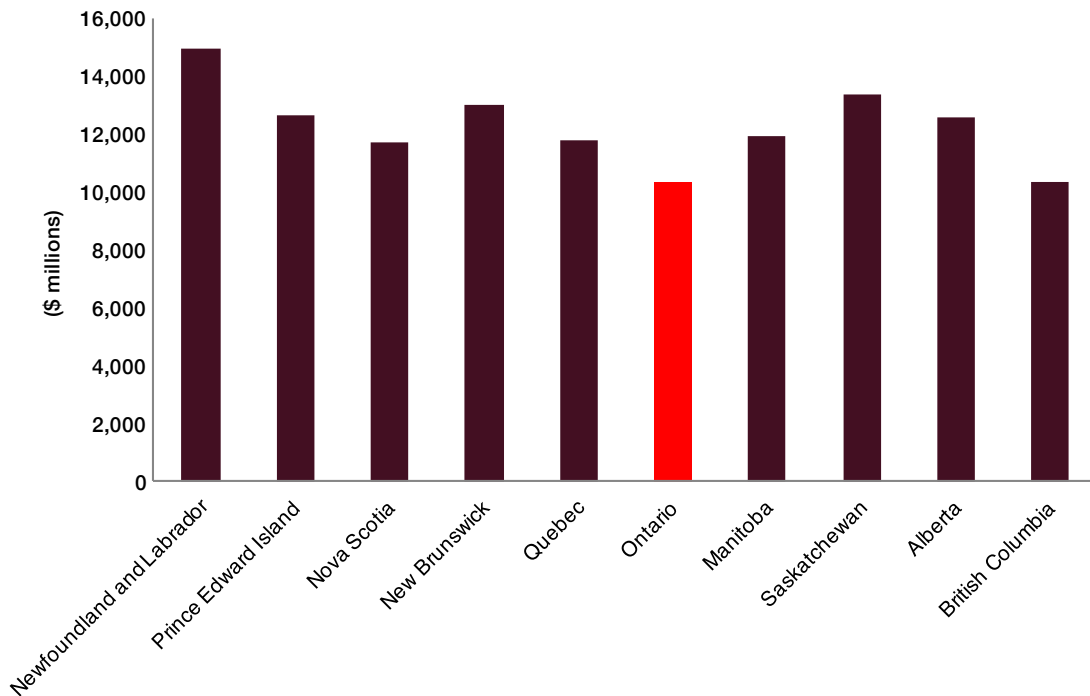


FIGURE 7

Own-Source Revenue by Province, 2015 (\$ per capita)



Source: Statistics Canada, Table 384-0047 Revenue, expenditure and budgetary balance - General governments, provincial and territorial economic accounts, annual (dollars x 1,000,000)

The consequences of leaving this asymmetry in fiscal risk unaddressed are certainly not appealing, and more importantly are entirely avoidable. As the PBO demonstrates, “from the perspective of the government sector as a whole (that is, federal and subnational governments and public pension plans combined), current fiscal policy in Canada is sustainable over the long term... However, this perspective masks unsustainable fiscal policy at the subnational level.”²⁹ Left to shoulder the majority of the fiscal risk of delivering Canada’s important social programs on their own, provinces are left vulnerable, particularly to the impact that an aging population will have on growth in health care spending. Faced with this challenge, provinces will be forced to raise taxes, make significant spending reductions, accumulate debt to unsustainable levels, or all of the above. All of these measures, however, would be unnecessary were the fiscal risk of delivering these programs shared more efficiently or effectively.

29 Office of the Parliamentary Budget Officer. 2017. “Fiscal Sustainability Report 2017.” Available at: http://pbo-dpb.gc.ca/en/blog/news/FSR_October_2017

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6 ADDRESSING THE ASYMMETRY OF FISCAL RISK: OPTIONS FOR CHANGE

The approach to better sharing fiscal risk need not involve a rewriting of the Constitution or a fundamental alteration of the allocation of tax room between governments. The solution can be as simple as reforming intergovernmental transfers to better share fiscal risk. This is a simple but important point. Currently, major transfers are completely agnostic to the costs of delivering services they are meant to support. As outlined in Section 3 above, the CHT is slated to grow in line with national GDP for the next decade, and the CST at three per cent. Altering those transfers to better reflect the fiscal risk provinces face in delivering the health care, post-secondary education and social programs they are meant to support would be a logical starting point.

The federal government has taken such an approach in the past, sharing the fiscal risk of delivering health, post-secondary education and social programs through explicit cost-sharing arrangements with the provinces. These arrangements however, led to a number of suboptimal outcomes. For its part, the federal government was subjected to unpredictable and uncontrollable costs. For the provinces, spending decisions were skewed towards programs that garnered cost-matching, often at the expense of more efficient options. Endless assessments of program eligibility for cost-matching also involved significant administrative complexity and uncertainty for provinces. Finally, an element of moral hazard associated with provinces only having to spend “fifty-cent dollars” also existed. Is it possible to make intergovernmental transfers more reflective of conditions on the ground, while avoiding these issues? A brief examination of a potential model for reforming the CHT as an example may prove instructive.

To avoid the perverse incentives that can accompany explicit cost-sharing arrangements, the first step in reform would be to maintain the largely unconditional nature of the current health transfers regime. This would permit provinces to continue to seek out efficiencies in delivery without needing to worry that federal funding might be lost as a result of a program being deemed ineligible.

Secondly, by arriving at an appropriate CHT escalator, the risk-sharing effects of cost-sharing could be achieved without the administrative complexity and uncertainty for provinces that comes with explicit cost-matching. The federal government’s current approach of tying the growth rate of the CHT to GDP growth does not reflect the fiscal risk of delivering health that the provinces assume.

To better share care between both orders of government, year-over-year growth in the CHT should be better tied to provincial growth in health spending.³⁰

While basing a CHT escalator on actual observed increases in aggregate provincial health spending might accurately reflect growth in the sector, this approach would have a number of key weaknesses. First, tying a CHT escalator to actual spending practices would necessarily involve relying on lagged data. But, lagging the data too much would sacrifice responsiveness in a situation that arguably demands it. Under such a system, it would not take long for growth rates in health and transfers to become misaligned, especially as an aging population places growing pressure on the system. Secondly, the same moral hazard arguments that might apply to explicit cost-sharing could similarly apply in such a situation. Tying the CHT escalator instead to projected growth in the underlying cost-drivers in the health sector, such as demographics, price, technology and utilization,³¹ however, would reflect the actual need in the sector that the provinces must finance. Sharing the responsibility for responding to these needs would better share the risk associated with delivering the service while not removing any incentive for fiscal responsibility on behalf of the

provinces. Finally, to depoliticize the process, projections of cost-drivers could be undertaken by a respected and independent organization such as the Canadian Institute for Health Information (CIHI) and insofar as the projections did not match with actuals, CHT growth rates could be adjusted over time to compensate for the difference.

Similar processes for measuring need and incorporating those measures into transfers growth rates could be extended to the areas of post-secondary education and social programs that are currently covered by the CST. Making these changes to the CHT and CST would in the case of Ontario add an element of federal-provincial risk-sharing to 60 per cent of the province's program spending. This would represent a significant step towards a more reasonable sharing of fiscal risk between the federal and the provinces.

In order to better address idiosyncratic, asymmetric economic shocks, Canada's fiscal federalism framework must more adequately share risk through transfers that respond to regional revenue shocks. The optimal degree of insurance for a subnational government should relate to the risk profile of that order of government.³² The vertical allocation of fiscal risk between Canada's orders of government should inform decisions regarding the optimal amount of short-term revenue insurance. As discussed, the structural fiscal risk between the two orders of government is negatively weighted to the provinces.

30 Ideally, a reform of federal transfers would also avoid making the "grandfather fallacy." Arriving at appropriate growth rates for transfers is only part of the picture. It is not necessarily correct to assume that growth rates are being applied from the right starting point. Doing so risks "grandfathering in" an inadequate starting point. For example, it has been argued that the federal government can and should do more to increase its transfers in support of health care to reflect previous intergovernmental agreements to share the costs of the program as a partnership. For a full discussion see: Hartmann, Erich and Alexa Greig. 2016. Partnership Renewed. Mowat Centre. https://mowatcentre.ca/wp-content/uploads/publications/125_partnership_renewed.pdf

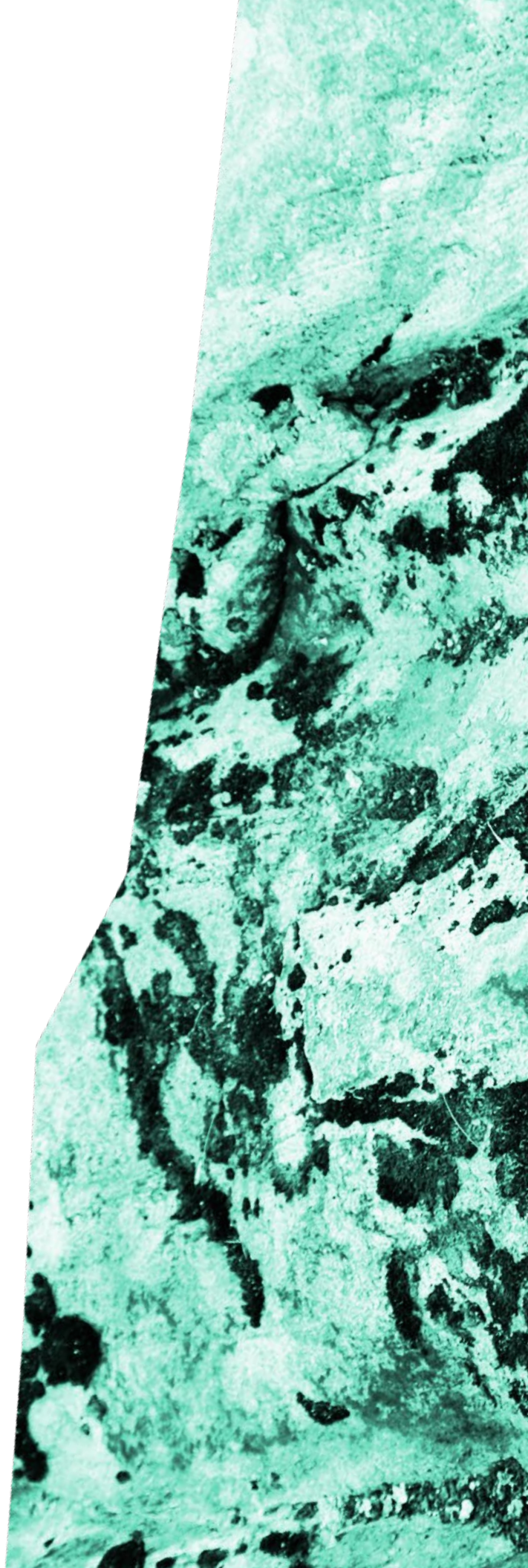
31 For a full discussion on drivers in the health sector, see: Canadian Institute for Health Information (CIHI). 2011. "Health Care Cost Drivers: The Facts." Canadian Institute for Health Information (CIHI). https://secure.cihi.ca/free_products/health_care_cost_drivers_the_facts_en.pdf.

32 Von Hagen, Jürgen. 2007. "Achieving Economic Stabilization by Sharing Risk within Countries." In *Intergovernmental Fiscal Transfers: Principles and Practice*. Edited By Robin Boadway and Anwar Shah. World Bank: Washington DC. pp. 107-132.

Given the federal government's more diversified tax base and structural risk profile, it should play a far greater role in sharing short-term risk in the federation. To start with, the federal government should reform the Fiscal Stabilization Program to make qualification stringent yet still effectively possible. Furthermore, to provide provinces with a meaningful degree of revenue insurance, the \$60 cap on payments that has been in place for 20 years should be significantly increased. If that cap had been allowed to grow with inflation, it would be worth almost double that today.³³

The federal government should also revisit its cost-sharing requirements for infrastructure stimulus funding. Mandating that federal money should only go towards projects that have not already been announced or funded, and that provinces and municipalities must share the costs of such projects in order to access the federal funds can significantly undermine the fiscal positions of provinces at their most vulnerable junctures. To counter-cyclically stimulate economic activity without bankrupting provinces and municipalities, the federal government should take on most if not all of the costs of delivering short-term infrastructure stimulus projects; a move that would still leave provinces and municipalities as the biggest spenders in infrastructure overall. These two fairly modest changes in approach would significantly strengthen the federal government's role in sharing short-term fiscal risk. Improved frameworks for sharing short-term risk would in turn better situate the provinces to manage through the long-term, structural risk they face. In times of economic stress, the federal government should leverage its broader tax base and lower structural risk exposure to aid provinces in maintaining the significant and costly programs and services they deliver.

33 Hartmann, Erich. 2017. Ontario, Oil & Unreliable Data:



7 CONCLUSION

The allocation of fiscal risk between Canada's orders of government is fundamentally out of balance. This imbalance represents an opportunity as much as it poses a challenge. The federal government can leverage its lower exposure to risk to make Canada as a whole more fiscally sustainable and resilient. Reforming federal transfers to the provinces to better reflect the fiscal risk that comes with Canada's important social programs will be a critically important step in addressing the VFI. The provinces' greater exposure to fiscal risk and vulnerability to short-term economic risk can be addressed through relatively simple reforms to Canada's fiscal stabilization and fiscal stimulus mechanisms. These reforms would affect a better sharing of both short-term economic risk and the structural allocation of fiscal risk in the federation. Federalism is not just an mechanism to decide "who does what," but should also be viewed as a way to diffuse risk.

APPENDIX A

Methodology for Categorization of Federal and Provincial Spending

The methodology behind “Figure 5: The Allocation of Structural Fiscal Risk between Orders of Government: Federal Government and Ontario, 2015-16” is outlined below.

The exercise begins with the categorization framework outlined in the box entitled “Spectrum of Structural Fiscal Risk.” To examine the fiscal risk associated with federal and provincial spending profiles, this applied line-by-line to the 2015-16 Public Accounts of the federal government and Ontario, which served as a proxy for provincial governments in general for the purposes of this analysis.

Tables breaking out federal spending are available in its Public Accounts with particularly detailed information on its transfer payments published in Volume III, Section 6 of the federal Public Accounts and are available at <https://www.tpsgc-pwgsc.gc.ca/recgen/cpc-pac/2016/vol3/s6/index-eng.html>. Ontario publishes detailed breakdowns of all of its Public Accounts data as part of its Open Data Initiative.

Categorization of the Public Accounts data above was applied according to the following methodology:

- » Spending associated with ministry administration – including categories such as salaries and wages, employee benefits, supplies and equipment, and transportation and communication - was categorized as discretionary.
- » Transfer payments subject to open-ended, citizen-driven demand were categorized as open-ended. For a high-level list of federal and Ontario transfer payments that were categorized as open-ended, see Appendix B.
- » Transfer payments that are subject to substantial governmental discretion were categorized as discretionary. These tend to be transfers in program areas such as research, heritage, global affairs and economic development. For a high-level list of federal and Ontario transfer payments that were categorized as open-ended, see Appendix B. Discretionary transfers were \$14.1 billion federally (5.2 per cent of program spending) and \$8.8 billion in Ontario (7.1 per cent of program spending).
- » Capital spending was categorized to match where its associated operating spending was categorized.
- » Intergovernmental transfers were categorized as capped transfers.

»» Federal: Canada Health Transfer, Canada Social Transfer, Equalization, Territorial Formula Financing, Contributions to the provinces for assistance related to natural disasters, labour market transfers, Gas Tax Fund.

»» Ontario: Greater Toronto Area Pooling Compensation, Ontario Municipal Partnership Fund, Special Payments to Municipalities, Municipal Public Transportation Funding.

» Only Employment Insurance was categorized as fully-funded.

Specific adjustments to federal transfers were made to account for the Quebec Abatement. The Quebec Abatement was split out into Alternative Payments for Standing Programs (APSP) and Youth Allowance components. The Youth Allowance component was categorized as discretionary. The APSP component was split between the CHT and CST according to their relative size.

FIGURE 8

Breakdown of Federal and Ontario Spending by Category (\$ billions)

	Discretionary	Capped Transfers	Fully-Funded	Open-Ended	Total Program
Federal	98.0	67.5	19.4	85.9	270.8
Ontario	19.6	0.9	0.0	102.5	123.0

The categorization for federal spending above cross-checks closely with Statistics Canada Government Finance Statistics categorization. The 36.0 per cent of federal program spending categorized as social benefits closely aligns with the 38.9 per cent of federal program spending that this report identifies as either fully-funded or open-ended.

FIGURE 9

Federal Government Expense, Government Finance Statistics, 2015 (\$ billions and per cent of program spending)

	Compensation of Employees	Use of Goods and Services	Consumption of Fixed Capital	Subsidies	Grants, Expense	Social Benefits	Other Expense
\$ Billions	37.4	20.8	9.3	2.9	89.7	93.6	6.4
Per cent	14.4	8.0	3.6	1.1	34.5	36.0	2.5

Source: Statistics Canada, Government Finance Statistics (Table 385-0032)

For the purposes of the illustration in Figure 5, both federal and Ontario spending were normalized on a per capita basis for comparability.

For a set of extremely detailed pivot tables underlying all of these calculations, please contact the author.

APPENDIX B

List of Categorization of Transfer Payments, Discretionary v. Open-Ended

Discretionary		Open-Ended	
Federal	Ontario	Federal	Ontario
Canadian Heritage Transfer Payments	Jobs and Prosperity Fund	Old Age Security	Operation of Hospitals
Global Affairs Transfer Payments	Legal Aid Fund Certificates	Children's Benefits	Payments for physicians and practitioners
Innovation, Science and Economic Development Transfer Payments	Metrolinx Operation Subsidies	Registered Disability Savings Plans	Ontario Drug Programs
Health Canada Transfer Payments (not for First Nation & Inuit Health Care)	Northern Industrial Electricity Rate Program	Registered Education Savings Plans	Long-Term Care Homes
Infrastructure Transfer Payments	Northern Ontario Heritage Fund	Student Financial Assistance	Community Care Access Centres
	Ontario Clean Energy Benefit Act, 2010	First Nation & Inuit Health Care	Cancer Care Ontario
	Ontario Innovation Tax Credit	Indian and Northern Affairs Canada	Primary and Secondary Education
	Ontario Interactive Digital Media Tax Credit	Veterans' Affairs	Child Care and Early Years
	Ontario Production Services Tax Credit	Other Open-Ended Transfers	Ontario Disability Support Program
	Ontario Research Fund	Other Tax Credits and Repayments	Ontario Works
	Ontario Trillium Foundation	Corrections	Ontario Drug Benefit Plan
	Pan/Parapan American Games	Agricultural Risk Management Programs	Child Protection Services
	Public Transit		Ontario Child Benefit
			Grants for University Operating Costs
			Grants for College Operating Costs
			Employment and Training
			Student Financial Assistance Programs
			Correctional Institutions
			Affordable Housing
			Guaranteed Annual Income System
			Agricultural Risk Management Programs

APPENDIX C

Full List of the Expenses included in Each Category for Figure 5: The Allocation of Structural Fiscal Risk between Orders of Government: Federal Government and Ontario, 2015–16

Federal							
Discretionary		Capped Transfers		Fully Funded		Open-Ended	
Item	(\$)	Item	(\$)	Item	(\$)	Item	(\$)
Other Ministry Expenses	64,688,003,676	Canada Health Transfer	31,388,066,706	EI Benefits	19,418,626,000	Old Age Security	45,460,861,000
Defense	19,299,315,000	Canada Social Transfer	11,954,980,294			Children's Benefits	18,025,400,000
Global Affairs	3,749,501,549	Fiscal Arrangements	21,344,731,000			RDSPs	433,420,312
Health	1,537,666,563	Assistance for natural disasters	139,348,326			RESPs	939,542,150
Heritage	1,056,159,890	LMA/LMAPD	722,000,000			Student Financial Assistance	1,232,464,768
Innovation, Science and Economic Development	3,592,081,870	Gas Tax Fund	1,973,269,432			First Nation & Inuit Health Care	1,531,562,148
Infrastructure	1,104,706,213					INAC	6,572,292,948
Other Discretionary Transfers	3,015,876,939					Veterans' Affairs	2,681,267,489
						Other Open-Ended Transfers	3,304,195,205
						Other Tax Credits and Repayments	3,270,489,000
						Corrections	2,408,685,731

Ontario							
Discretionary		Capped Transfers		Fully Funded		Open-Ended	
Item	(\$)	Item	(\$)	Item	(\$)	Item	(\$)
Ministry Administration	10,805,263,249	Grants to Municipalities	900,177,708			Health	50,850,832,410
Transfer Payments	8,771,694,926					Education	26,818,087,146
						Community and Social Services	10,852,410,094
						Children and Youth Services	4,046,493,182
						Training, Colleges and Universities	7,564,956,107
						Other	2,385,442,423

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