Unequal permanent austerity and the distribution of power in the Canadian federation.

Olivier Jacques, assistant professor, department of health policy management and evaluation, Université de Montréal.
Member of the CRECQ-CAP-CF

Abstract

The pressures induced by "permanent austerity" are unequally distributed between provinces and the central government in Canada. The concept of permanent austerity (Pierson 1998) has three components: 1) endogenous pressures (slower productivity growth, the maturation of welfare state commitments and population aging) increase the size of the state relative to the economy 2) while governments are unable to retrench popular welfare commitments and 3) tax revenues are stagnating. Firstly, endogenous pressures are unequally distributed between provinces and the federal government since the costs of programs under provincial responsibility, such as health care, are more likely to grow overtime, whereas the costs of federal programs are under control. Secondly, retrenchment has been easier to achieve in the federal welfare state than in the provinces since the latter are responsible for the most popular and visible programs. Thirdly, revenue constraints are more severe at the provincial level since provinces are constrained by tax competition between them while the federal government has few political incentives to raise intergovernmental transfers. Consequently, unequal permanent austerity may be constraining provinces' ability to respond to the public's policy demand, which may lead to a re-centralization of the Canadian federation via an encroachment of provincial jurisdictions by the federal government. The study concludes by discussing reform options and the political and institutional constraints preventing a departure from the status quo.

Paper presented at the International Association of Centers of Federalism Studies, Bilbao, October 27-29, 2022.

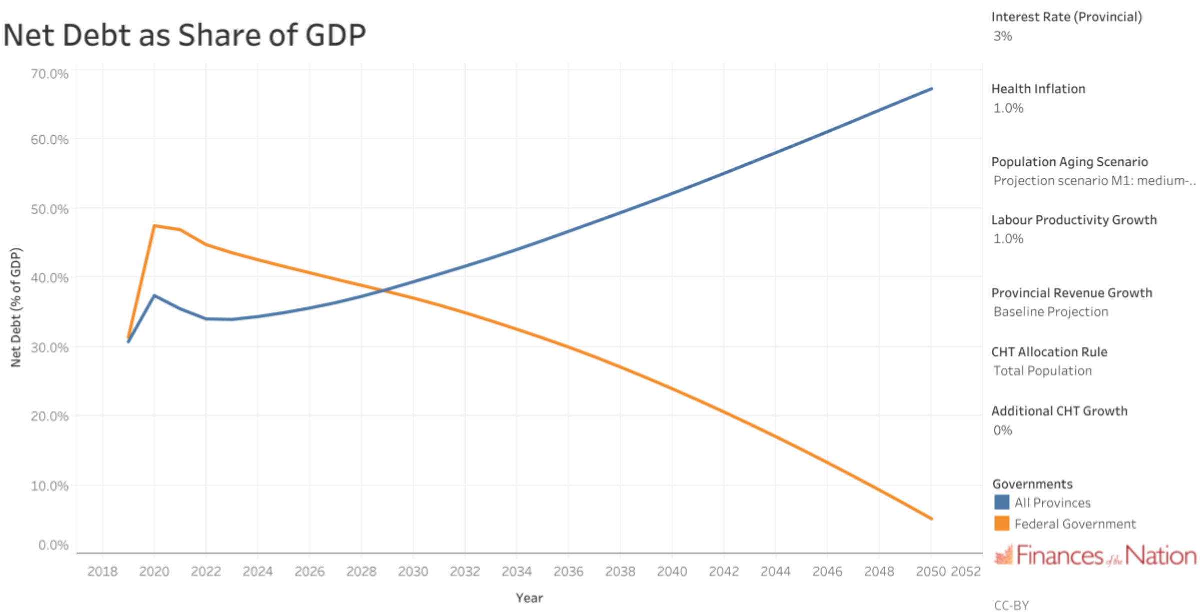
Introduction.

The Canadian federation is characterized by its high degree of decentralization towards provinces, as they control the largest proportion of revenues and expenditures of any subnational jurisdiction in the OECD (Dougherty and Phillips 2019). This situation has been celebrated as the optimal governing arrangement in a diverse country (Paquet and Hubbard 2010) or condemned for preventing the federal government from piloting national projects beneficial to the common good (DiGiacomo and Flumian 2010). Whereas many federations in advanced democracies have centralized overtime as they developed their modern welfare state, the Canadian federation decentralized in many policy fields to accommodate the territorial diversity of the country (Lecours 2019).

However, the long-term fiscal trends suggest that the balance of power of the federation may be altered. Figure 1 reveals Trevor Tombe's (2020) projections of the provincial and federal fiscal balances, assuming that current programs are maintained overtime. Whereas the federal government's net debt trends towards its elimination, the provinces' net debt doubles in less than 30 years, reaching almost 70% of GDP in 2050, from only 34% in 2022. This long-term reflects an imbalance between the revenue-raising and spending capacities of the provincial and federal governments. What are the causes of these long-term trends and their consequences in terms of the distribution of power in the federation?

We argue that this imbalance is caused by the unequal distribution of the pressures induced by "permanent austerity" between provinces and the central government. The concept of permanent austerity (Pierson 1998) has three components: 1) endogenous pressures (slower productivity growth, the maturation of welfare state commitments and population aging) increase the size of the state relative to the economy 2) while governments are unable to retrench popular welfare commitments because of self-reinforcing feedback effects generated by existing social policies and 3) tax revenues are stagnating, reflecting a decline of the "taxability" of post-industrial societies. These three factors reduce governments' fiscal room to maneuver, leading to what Pierson (1998; 2001) calls the era of permanent austerity.

Figure 1. Projections until 2050 of the evolution of federal and provincial net debt.



Source: Finances of the Nation, Fiscal gap simulator. https://financesofthenation.ca/fiscal-gap-simulator/

Endogenous pressures are unequally distributed between provinces and the federal government since health care costs grow overtime and are already representing at least 40% of provincial program expenditures. In contrast, the costs of programs under federal responsibility are significantly less likely to grow overtime. This augment is not new, as this unequal program cost growth is at the core of the fiscal projections presented in figure 1. The main contribution of the paper is to develop the second and third component of unequal permanent austerity regarding retrenchment and taxability. We show that fiscal consolidations have been larger at the federal level since cutting back transfers to provinces and means-tested benefits to individuals has been easier to achieve than cutting back the popular programs under provincial authority such as health and education. Furthermore, revenue constraints are much more severe at the provincial level: provinces are constrained by tax competition between them, and the federal government has few political incentives to raise intergovernmental transfers.

Borrowing from Jean-Jacques Rousseau (1764)[1], federalism scholars argue that "the golden rule of the federation is whoever has the gold makes the rule". It is likely that the federal government

[1] "Le riche tient la loi dans sa bourse."

will be able to impose its will on cash-stripped provinces in the future. As provinces' debt levels reach unsustainable levels, they may not be able to respond to citizens' policy demands. The federal government may use its spending power, which gives the federal government the ability to spend in areas provincial jurisdiction, to respond to the public's demand, assert its authority and re-centralize the federation. This possibility is reinforced by the absence of safeguards in the Canadian federation against a federal encroachment of provincial jurisdictions (Bednar 2009).

The contributions of this article are manifold. It relies on a classical concept in comparative political economy, permanent austerity, to explain the current situation in Canada and to reflect on the future of the federation. Studies in the permanent austerity research program are generally focusing on the national level; none of them have contrasted the level of pressure induced by permanent austerity between the jurisdictions of a federation, whereas we show that these pressures can be structurally unequal and shape the balance of power between governments. This allows us to contribute to the fiscal federalism literature by explaining the political causes of the projected fiscal gaps in the Canadian federation, notably by highlighting the greater difficulty to implement spending cuts and to raise taxes at the provincial level. Finally, the article initiates a debate by discussing five reform options to alleviate the unequal burden of permanent austerity.

Unequal permanent austerity in the Canadian federation

Unequal endogenous pressures

Pierson (1998) identifies three main endogenous post-industrial pressures that are increasing the size of the public sector in the economy: aging, the maturation of welfare state commitments, and a slowdown of productivity growth. Pierson's argument relies on the concept of the Baumol disease (1967) : the service sector, which includes the public sector, is unable to match the productivity increases of the manufacturing sector, while wages in the service sector rise in relation to overall productivity growth, not to sector-specific productivity growth. Hence, because the public sector is situated within the non-productive sector and is strongly labour intensive, the costs associated with providing public services increase more rapidly than the overall productivity growth of the economy (Baumol 1967; Hartwig 2008). Hence, the cost of labour-intensive services are more likely to be subject to the Baumol disease and to grow overtime relative to the size of the economy (Hartwig 2008), whereas transfers whose allocation can be determined in a discretionary manner. Therefore, the contrast between the service orientation of the provincial welfare states and the transfer-heavy federal state is a source of unequal endogenous pressures.

Table 1 presents a comparison of the types of programs provided by the provinces and the federal government, using the Financial References Tables (Canada 2021). Almost 50% of provinces' total expenditures are composed of wages (26.3%) and of the consumption of goods and services (23%), mostly allocated to services in the education, health, and social sectors. Wages and the consumption of goods and services represent only 20.4% of federal expenditures. In contrast, more than 27% of total federal expenditures are allocated to grants whereas they represent only 15.5% of provincial expenditures. Almost 29% of federal expenditures are allocated to social expenditures, mostly in the form of transfers to individuals rather than services.

The Financial Reference Tables also show that for the federal government in 2019-2020, transfers to other levels of government represented 22.7% of total program expenditures (excluding public debt); transfers to individuals 30.7% (of which 52.6% went to old age security; 22.7% for family benefits and 20.3% for unemployment insurance) and direct programs represented 43.6% of the total. However, a third of these direct programs are composed of other transfer payments and of the carbon tax benefits. Hence, transfer payments represent 71% of federal expenditures, relative to an estimation of around 30% in provinces (Noël 2022).

Table 1. Proportion of total expenditures of the four main categories of expenditures, Canadian provincial and federal governments, 1991-2019.

		Wages	Consumption of goods and services	Grants	Social expenditures
Provinces	Proportion of total exp.	26.3	23	15.5	9.5
Federal	Proportion of total exp.	12.3	8.1	27.1	28.8

Source : Canada 2021, Financial Reference Tables[2].

[2] The category gross fixed capital formation, subsidies, other expenditures and interest are excluded as they represent only 13% of federal expenditures and 24% of provincial expenditures.

Population aging is the second main endogenous pressure as it contributes to the growth of public expenditures as a proportion of the economy: a lower proportion of workers relative to retirees reduce growth and increases the costs of health and pension programs, the two most expensive social policies. Health care is a provincial responsibility which already represents an average of 45% of provincial program expenditures. Because of population aging and costly technological innovations, it is projected to increase to more than 60% by 2045 (Ferguson and Jacques 2019). The COVID-19 pandemic exacerbated the problem as it increased public demand for health care spending and revealed health care systems' vulnerabilities. Health inflation, defined as health care costs growth beyond the growth of the economy and above those incurred by aging, represents a substantial cause of the projected imbalance between federal and provincial net debts. In Tombe's projections (2020) presented in figure 1, when health care inflation is constrained to 0.5% per year, provincial net debt reaches an average of 49.5% in 2050. However, if it reaches 1% annually, provincial debt represents 67.3% of GDP in 2050 and reaches 87% if health inflation is 1.5% per year. Following the cutbacks in health care during the austerity period of the mid 1990s, average provincial health care cost inflation was 1.3% per year from 1998 to 2018.

Moreover, the decline of productivity growth and the intensity of population aging are not equally distributed between provinces. Some provinces, particularly in Atlantic Canada, are facing both faster population aging and lower productivity growth, which creates particularly acute fiscal pressures. Other provinces, such as Ontario, Alberta and Saskatchewan, have higher productivity growth and a younger population (Saillant 2016). In these provinces, health care cost growth, especially in relation to their capacity to create wealth, remains a less acute problem, although their fiscal policies are not necessarily sustainable over the long term either. This inequality generates divergent challenges and interests that may weaken provinces' collective action capacity.

In contrast, the programs under federal responsibility are significantly less likely to grow overtime. According to the Parliamentary Budget Office's *Fiscal Sustainability Report* (2021), the costs of federal programs are projected to be stable during the first half of the 21st century. Pierson's argument about the maturation of welfare commitment concerns pensions, a federal responsibility in Canada. However, the costs of pensions are quite low and remain under control from a comparative standpoint. The first tier of the pension system is composed of basic universal flat rate benefits called Old Age Security (OAS) and of the Guaranteed Income Supplement (GIS), a means-tested benefit for poor elderly. These two federal programs currently cost 2.4% of GDP, but their costs will only grow up to 3.1% in 2032, as baby boomers grow older, but will decline afterwards and remain sustainable (PBO 2021). The second tier of the pension system, the Canada Pension Plan (CPP), is a contributory public plan with low replacement rates and is also a federal program in all provinces, except in Quebec which manages Quebec Pension Plan. The program is not particularly costly, as replacement rates offered by the public system remain low for incomes at and above the average (Myles 2000). Under the current structure of the CPP, projected contributions and benefits are sufficient to ensure that, over the long term, the net asset-to-GDP position remains close to its initial value (PBO 2021).

The costs of the other most expensive federal programs are also under control. Children benefits' costs will also decline as children are expected to represent a smaller share of the population overtime. Unemployment insurance's costs are related to the business cycle, and as discussed in the following section, the government had no difficulty to reduce the generosity of the program when costs did not match contributions. Finally, the two most expensive transfers to provinces (Canada Health Transfer (CHT) and equalization) are capped to the growth of the economy. The smaller Canada Social Transfer is not, but is legislated to increase at 3% per year, which is far from being unsustainable. Hence, Ottawa can decide to implement new programs that may endanger its long-run fiscal sustainability, but the costs of current programs are not projected to grow (PBO 2021).

Unequal Retrenchment Capacities

To control these endogenous pressures, governments have frequently called for the retrenchment of the welfare state. However, the welfare state is a largely immovable object. Pierson (1998; 2001) suggests that public policies create self-reinforcing feedback effects: once put in place, policies structure politics and generate path dependencies, as technical and political constraints narrow the scope of potential change. Hence, although structural changes pressurize welfare states, existing social policies are broadly resilient to retrenchment, as they generate large constituencies of support that generate electoral incentives against cutbacks. I contend that welfare state retrenchment is easier to achieve at the federal level because provincial social policies are considerably more popular, visible, and supported by large and influent groups of beneficiaries than federal-level policies.

The fact that the provincial welfare state is service-heavy while the federal is transfer-oriented is also a contributing factor to these unequal retrenchment capacities. There is a debate in the comparative welfare state literature on the relative resilience to cutbacks of transfers relative to services. On the one hand, Clayton and Pontusson (1998) claim that services are easier to cut since they may be less visible to voters than transfers to individuals which involve very clear benefits for defined groups. On the other hand, transfers only involve extracting funds and allocating them, while services involve transforming money into an output, often provided by interest groups or by professionals. These providers are well organized, control the production process and have a vested interest in the continuation of the existing production mode (Jensen 2011). The influence of these interest groups may therefore help to prevent the retrenchment of services (Starke 2021). Finally, services are often composed of the wages of permanent unionized public sector employees, which tend to be easier to freeze than to cut (Forni and Novta 2014; Tepe 2009). In brief, the cost of transfers is less likely to grow overtime than of services.

In contrasts to services, transfers to other levels of government are relatively easy to compress. The largest cuts of all expenditures categories presented in table 1 happened when the federal government reduced transfers to provinces by 20% (in current dollars) in 1996 and 1997. It is relatively easy for politicians to avoid blame for cutbacks to intergovernmental transfers, even if these transfers fund popular programs like health care, since the public doesn't know how to attribute blame in complex intergovernmental fiscal relations (Cutler 2008). Blame avoidance opportunities are increased when federal-provincial responsibilities over programs are separated and one government funds programs in the jurisdiction of the other government (Jordan 2009). Governments can also compress expenditures by reducing the rate of growth of transfers in the future, which is what the Harper government did with the CHT as part of its fiscal consolidation exercise in the early 2010s, a strategy that is even less likely to attract blame since the costs of the cutbacks are delayed in time.

Moreover, programs at the federal and provincial level do not have the same degree of popularity. International evidence suggest that education, health care and pensions are the most popular social policies (Busemeyer and Garritzmann 2017). This is because they cover life cycle risks that all citizens are facing: everyone is aging, becomes sick and goes to school at some point in their life (Jensen 2012). Hence, the potential pool of beneficiaries is large and since everyone faces these risks, the perceived deservingness of the recipients is particularly high, which contributes to these programs' popularity (Jensen and Petersen 2017). In contrast, labour market risks tend to be correlated with income; the programs covering these risks, like the unemployment insurance provided by the federal government, are popular almost only among those facing labour market risks (Jensen 2012). Social benefits covering these labour market risks represent 28.75% of federal government expenditures, against 9.47% for provinces. Between two thirds and three fourth of provincial expenditures are allocated to health care and education, whereas a considerably smaller proportion of federal expenditure is allocated to pensions, the only the life-cycle risk covered by Ottawa. Moreover, health care and education are universal programs in Canada, and universal programs tend to be considerably more popular than programs that are means tested for the poor (Brady and Bostic 2015; Larsen 2008).

Table 2 confirms these expectations by comparing the popularity of provincial and federal programs, using the ISSP Role of Government survey of 2006, the last year during which Canada participated to the survey. Support for additional spending for the unemployed is considerably less popular (24.3%) than for health care, education and pensions which is supported by more than half the respondents. Moreover, only 16.3% of respondents believe that it is government responsibility to provide living standards for the unemployed, whereas two thirds believe it is government's responsibility to provide health care for the sick.

Figure 2 provides additional evidence based on the Canadian Election Study[3] of 2015. It shows that support for additional spending and public attention remains low for programs of federal responsibility (defence and crime), are also low for programs of shared responsibility like welfare and immigration, and very high for programs of provincial responsibility like education and health

[3] The 2019 survey has fewer question on social policies and the 2021 survey is not available yet.

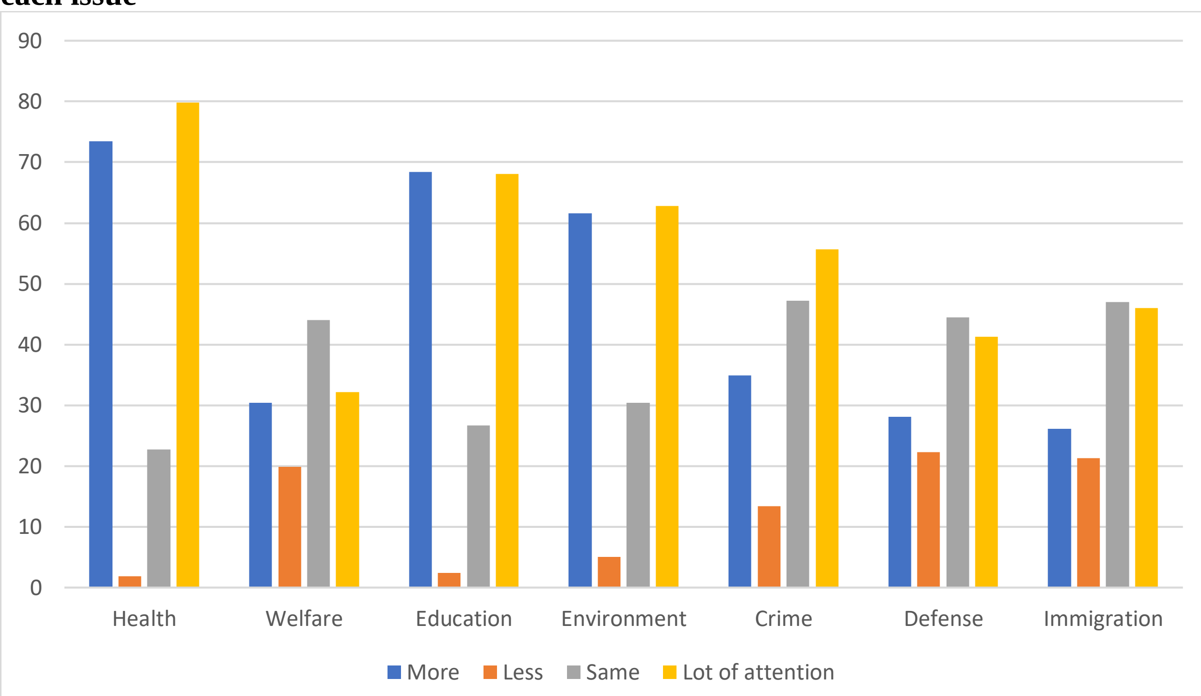
care. Support for additional spending and attention are high for the environment, but it is also a program of shared responsibility.

Table 2. Public support for additional government spending in five policy areas in Canada, ISSP 2006, provincial programs in bold

	Health care	**Education**	Pensions	Unemployment	Defence
Support for more spending	51.55%	53.7%	50.5%	24.3%	41.05%
Support for less spending	4.7%	2.5%	3.4%	16.2%	17.5%
Government responsibility (% definitely)?	66.13%		57.56%	16.3%	

Source: ISSP 2006, N=933. Government responsibility under health is: "to provide health care for the sick", for pensions it is to "provide living standards for the old" and for unemployment it is "to provide living standards for the unemployed."

Figure 2. Preferences for public spending on different types of expenditures and attention to each issue



Source: Canadian Election Study 2015.

Popularity matters because governments choose the path of least resistance when they implement retrenchment measures: they cutback less popular programs and tend to preserve the popular ones (Jacques 2021, 2020). To show that the distinct nature and popularity of provincial and federal lead to unequal retrenchment capacity, table 3 compares the size of episodes of fiscal consolidations at the federal and provincial level since 1990, the first year for which provincial data is available in the Fiscal Reference Tables (Canada 2021). Two main consolidation episodes occurred during the period at both levels of government, one in the mid 1990s and the other in the early 2010s, following two major recessions (Alesina, Favero, and Giavazzi 2019; Canada 2021). Table 3 summarizes changes to current program expenditures expressed as a proportion of GDP from the start of the consolidation period to its end. It reveals that the federal government's fiscal consolidation episodes are larger than those implemented by the provinces in absolute and relative terms.

From 1993 to 2001, public expenditures expressed as a proportion of GDP were reduced by more than 5% per year at the federal level for a 31% total reduction relative to pre-consolidation expenditure levels, against an average of 3.3% per year at the provincial level for a 23% total reduction of provincial expenditures. Federal cuts reached 4.2% per year from 2010 to 2015 (19% reduction of pre-consolidation expenditures), in contrast to only 1.97% at the provincial level (9% reduction of pre-consolidation expenditures). The federal government significantly retrenched unemployment insurance, a means tested and somewhat unpopular program in 1996 and again during the tenure of the Harper government (Béland and Myles 2012). Retrenchment is relatively easy to implement for programs that are far away from citizens' daily considerations, like defence. Interestingly, during this period, the popularity of the federal governing party increased when it implemented consolidations (Jacques and Bélanger 2022), whereas austerity generally reduces governments' popularity (Jacques and Haffert 2021). If provincial governments would have implemented cutbacks to health care and education, their popularity would probably have declined, as it was the case during the austerity measures implement by the Couillard government in Quebec (Bélanger and Chassé 2021).

Table 3. Comparison of fiscal consolidation episodes, Canadian provincial and federal governments, % of GDP.

	Average annual decline		Decline before and after consolidation		Proportion of reduction of pre-consolidation expenditures	
	Provincial average	Federal	Provincial average	Federal	Provincial average	Federal
Period 1993/4 to 2000/1	-3.25%	-5.03%	-4.8%	-5.2%	23%	31%
Period 2010/11 to 2014/15	-1.97%	-4.21%	-1.9%	-3.1%	9%	19%

Source : Finance Canada 2021. Consolidation period measured as the start of the decline of current expenditures to its end. In the first period, the last federal consolidation budget is in 1999-2000, whereas it is 2000-2001 at the provincial level.

It is worth considering alternative hypotheses for the federal-provincial differences in the size of fiscal consolidations. Government partisanship is not a valid explanation: during the first consolidation of the 1990s, provinces were evenly split between right, left and center government, whereas the federal government was led by the Liberal Party of Canada, a centrist party. During the second consolidation, the Conservative Harper government was in power in Ottawa, but the provinces were also right-leaning: the right was in power in half of provinces/years during the period, while the left governed in only 25% of provinces/years at the same time. It is also worth noting that comparative studies suggest that government partisanship has very weak effects on the size of consolidation episodes, which are rather driven by electoral considerations, economic shocks and the size of the deficit (Hübscher 2016).

The fiscal situation was worse at the federal level than at the provincial level in the years that preceded the two fiscal consolidation episodes in terms of deficits, net debt and interest payments on the public debt. This can certainly help to explain why the consolidation was larger at the federal level. However, this functionalist explanation is not sufficient to explain federal-provincial differences. The government of Canada managed one of the most successful consolidation episodes in recent decades in OECD countries (Haffert 2019) and this can certainly be explained by the fact that it retrenches relatively unpopular or invisible programs. In the counterfactual scenario in which provinces had the worst financial situation, their consolidations would not have been as large as what the federal government has been able to achieve. When the costs of replacing current health care services represents 4% higher expenditures per year, it is difficult to reduce total provincial government expenditures without facing a significant popular backlash. Provinces can only constrain the rate of expenditure growth, while the federal government has been able to reduce total expenditures.

Unequal Revenue Constraints

The third factor of permanent austerity concerns revenue constraints. Once again, there is a fundamental inequality between provinces and the federal government, as revenue constraints are more severe at the provincial level. The literature on fiscal federalism has long established that subnational taxes are subject to strong competition in a federation, especially with regards to taxes on mobile factors such as capital or highly skilled individuals (Oates 1968; Musgrave 1971). In the Canadian case, Milligan and Smart (2016) argue that reported income is very elastic for top marginal tax rates at the provincial level. They estimate that a 10% tax increase on the top 1% fillers leads to a 6.6% decrease in their taxable income, while the elasticity is much lower for lower-income individuals. This is driven by tax competition between provinces, as three quarters of this income shifting can be explained by taxpayers moving their income to lower-tax provinces (Milligan and Smart 2019). As such, increases of top marginal tax rates do not generate substantial revenues at the provincial level, unless the threshold is low and affects more than just the top centile (Milligan and Smart 2016).

Since it is fairly easy for firms to shift income to locations with lower taxes within the same country, Mintz and Smart (2004) find very large elasticity for corporate taxes at the provincial level, while Ferede and Dahlby (2016) show that corporate taxes have considerably larger elasticity in Canadian provinces than sales or income taxes. Canadian provinces are one of the subnational jurisdictions whose public budgets rely the most on corporate taxes among OECD countries. This overreliance on corporate taxes make provinces vulnerable to tax competition and to economic downturns (Tremblay 2012). While the race to bottom in corporate taxation did not necessarily occur at the provincial level (at least until the late 1990s) (McKenzie 2006), tax competition has large effects on the revenue generating capacity of taxes on mobile factors in Canadian provinces, which constrain the toolbox that governments can use to raise revenues.

The assumption of the fiscal federalism models is that capital and labor mobility is considerably lower across national level borders than between subnational jurisdictions (Oates 1999). While tax competition also poses constraints against capital taxes for the government of Canada, the federal government's corporate tax rates apply to all corporations in Canada, reducing their capacity to pit provinces against each other to obtain the lowest tax rate. Indeed, the elasticity of corporate income to provincial corporate taxes revealed by Mintz and smart (2004) and by Ferede and Dahlby (2016) is considerably higher than similar elasticity found in national level studies (Huizinga and Laeven 2008; Riedl and Rocha-Akis 2009). Hence, increasing taxes on high incomes, corporations and capital to alleviate the pressures of permanent austerity generates significantly fewer revenues at the provincial level than at the federal level. These taxes have rarely represented a significant proportion of the revenues of mature welfare states, but they can provide a marginal gain of revenues that can be useful for cash-stripped governments.

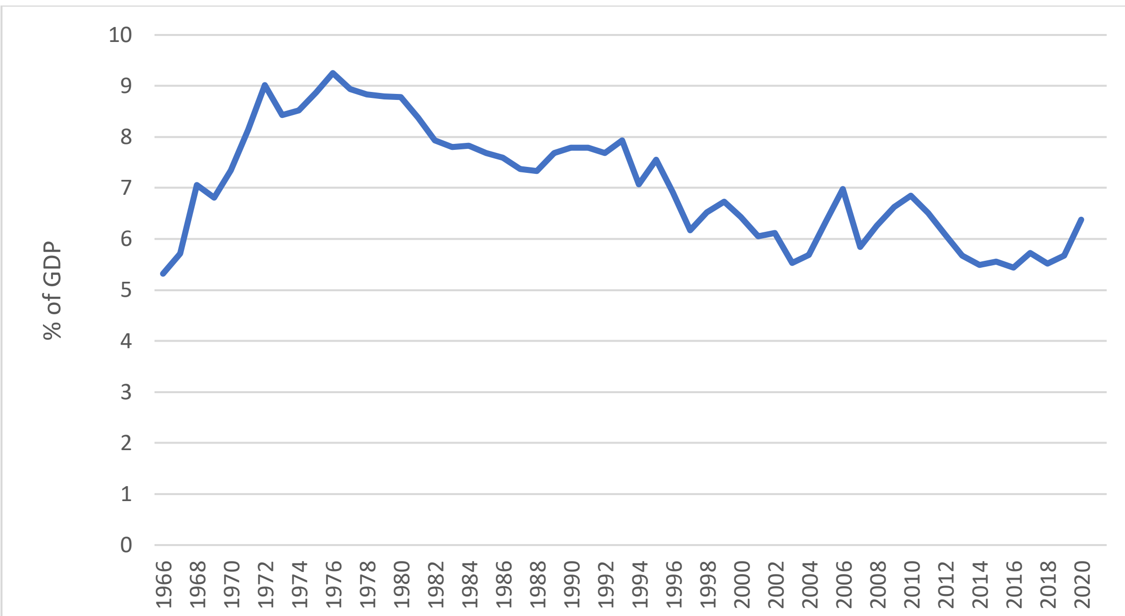
Moreover, taxes on high-income individuals and corporations are considerably more popular than alternative taxes. Workhorse models of political economy assume that voters want to reduce their own tax burden, while maximizing the size of the public benefits they receive (Meltzer and Richard 1981). This involves that most citizens prefer to shift the tax burden towards high-income citizens and towards corporations, since few individuals consider themselves to be rich (Cansunar 2021) and because the incidence of corporate tax is complex to understand for the average citizen. Moreover, citizens dislike taxes on "the middle class" and tend to consider them as too high (Barnes 2015; Cavaillé and Trump 2015). Indeed, studies on the electoral consequences of tax increase show that parties are more likely to lose votes if they increase broad based taxes than if they raise taxes on the rich (Tillman and Park 2009). Survey experiments have shown that taxes on top incomes increase public support for tax reforms whereas taxes on middle incomes decreases it (Bremer and Bürgisser 2022), while governments can increase corporate taxes without losing popularity (Bansak, Bechtel, and Margalit 2021). Increasing taxes on the rich is not necessarily easy to implement and can lead to "rich people's movements" that are often successful to block tax increases (Martin 2013), but these tax increases remain more popular than increases of taxes paid for by all taxpayers.

While all the revenues of the federal government are derived from own source revenues, provinces are dependent on intergovernmental transfers to fix the gap between their revenues and expenditures. However, there are significant political obstacles to increasing federal transfers. If Ottawa increases costly transfers, provincial governments will benefit from presumably better public services, while the party in power in Ottawa may pay the price. To increase transfers to provinces, the federal government must raise taxes, increase deficits, or cut its own programs, which could hurt the party in office in the next election. Voters do not know enough about fiscal federalism to reward the federal government for an invisible increase in transfers to the provinces. Instead, they are likely to punish the federal government for the visible costs of financing these transfers. Support for additional health care transfers is overwhelmingly high, but drops considerably when trade-off fiscal trade-offs are revealed in a survey experiment (Borwein et al. 2022).

Also, many believe that higher transfers would encourage provinces to overspend. According to the theory of "market preserving federalism" (Weingast 1995), too much dependence on transfers disempowers a province and encourages it to spend extravagantly, since expenditures are partly funded by the taxpayers of other provinces. Moreover, the current transfer architecture leaves little oversight to Ottawa to monitor how the additional funds are spent by provinces. Finally, the party system in Canada is not integrated between the federal and provincial level: parties may share the same name, but they are not the same organization and do not hesitate to blame each other (Johnston 2017), which contrast with, for example, the Republicans and Democrats and the state and federal level in the United States. Hence, a party in power in Ottawa has very few incentives to increase transfers to help their provincial-level co-partisans.

Figure 3 suggests that these political incentives constrain the level of transfer. Grants (transfers) from the federal government to the provinces are declining as a proportion of provinces' GDP from 9.25% of provinces' GDP in 1976 to 5.67% in 2019. The large growth of transfers from 1966 to 1976 corresponds to the implementation of the Medical Care Act which created a shared cost universal health care system. The costs of transfers were reduced when the federal government shifted from shared costs to block funding in 1977. Transfers were further reduced during the consolidation episode of the 1990s and remained relatively low except for a significant increase implemented by the Martin government in 2004. Federal transfers went up significantly during the COVID crisis, but these were temporary measures. In brief, provincial government face harder revenue constraints than the federal government as transfers are unlikely to increase. Moreover, the relatively popular taxes on high income and corporations do not have a significant revenue-generating capacity for provinces.

Figure 3. Federal transfers to provinces as a proportion of provincial GDP, provincial average, 1966-2020.



Source: Finances of the Nation, grants from other levels of governments, by provinces

Consequences and Reform Options

While the recent decades have been characterized as an era of decentralization of the Canadian federation, as provinces' share of total public expenditures is rising (Lecours 2019), unequal permanent austerity opens the room to a re-centralization of the federation. Provinces are trying to contain the growth of health care costs, which has an impact on access to the system and have left their health care systems particularly vulnerable to the COVID crisis. Moreover, studies have shown that provinces react to fiscal pressures by cutting back residual expenditures that are not allocated to health, education and social services. These include "core" state functions, such as the bureaucracy, the justice system, economic affairs and law enforcement, but also some more "postmodern" functions, such as culture, environmental protection and immigrant integration (Jacques 2020). As such, unequal permanent austerity may lead to provinces spending three quarters of their budget on two core functions, health and education, with few resources left to other policy fields, therefore limiting their capacity to provide new policies to respond to citizens' demand. If provinces cannot respond to the public's demands, the federal government might use its spending power to implement policies in areas of provincial jurisdiction, leading to considerations about provinces' autonomy in the federation. Since the degree of centralization of the Canadian federation evolves along with the balance of power between the constitutive units of the federation rather than by constitutional means (Banting 2005; Lecours 2019), it is conceivable that this lack of fiscal room to maneuver would tilt the balance towards a centralization of the federation.

Moreover, there are very few safeguards against the encroachment of the authority of the provinces by the federal government in the Canadian federation. In her classical study on *Robust Federation*, Jenna Bednar (2009) highlights four safeguards against opportunism by one level of government against another. None of these safeguards exist in Canada. Provinces are not incorporated in the federal decision-making process, the courts have allowed the federal government to use its spending power, the party system is not integrated and the popular safeguard doesn't exist since outside Quebec, citizens (or bureaucrats) do not have a strong federal culture that would constrain the federal encroachment of provinces' power (Fafard, Rocher, and Côté 2010). Hence, we conclude by briefly discussing reform options to alleviate the pressures of permanent austerity on the provinces and maintain the current balance of power. The consequences and political constraints of five different reform options are discussed in turn.

Reform Options

As discussed above, the option of **increasing federal transfers unconditionally** seems politically unlikely since it entails large costs for Ottawa while the benefits are allocated to the provinces. The **conditional transfer option** involves that the federal government increases transfers only for provinces implementing a specific program that respect national standards set by Ottawa. This is what happened in 2020-21 when the federal government created a shared cost program to fund the expansion of provincial child care programs. Ottawa offered a financial compensation to Quebec, the only province that already had a universal childcare system. The creation of a shared cost national drug insurance program would also fit as a policy option within this reform option. These more generous and conditional transfers are popular among left-wing voters outside of Quebec and are generally supported by the left-wing of the governing Liberal Party of Canada and by the New Democratic Party (Borwein et al. 2022). This allows provinces to fund social policy expansions in strategic areas but involves that provinces accept federal encroachment in their policy jurisdictions. It puts Ottawa as the leader in social policy expansion, although until the Trudeau government came to office, Ottawa has not been able to implement major social policy initiatives in a federation where the interests of provinces diverge between themselves and with the federal government. Both transfer-based reform options increase provinces' dependency on intergovernmental transfers, whose level remain unpredictable since they can be modified unilaterally by Ottawa.

The **cooperative option** is proposed by Daniel Béland and Trevor Tombe (2021). It involves a joint federal-provincial fiscal institution that gathers all the revenues generated by one major tax by both levels of government, such as the corporate or sales taxes, and allocates these funds to provinces on a per capita basis. This new fiscal institution would replace the Canada Health Transfer (CHT). In order to increase provinces' fiscal capacity, the total amount of revenues generated by the selected tax must be bigger than the current CHT and larger at the federal level than at the provincial level. This option's main advantage is to make federal transfers more predictable, since federal-provincial agreements would be necessary to change the amount of transfer allocated by the new fiscal institution, which is alike the current functioning of the Canada Pension Plan. Although this approach is similar to how other federations manage fiscal transfers (Shah 2007), this solution is politically difficult to implement since it involves federal-provincial agreement and entails large fiscal costs for the federal government while the benefits may be obscured by the complexity of the new system.

The **tax exchange option** is inspired by Kevin Milligan and by Jean-François Tremblay (2012). Under this scenario, the federal government fully abandons sales taxes to provincial governments, while provinces leave corporate taxation to the federal government. This reform would significantly enhance the efficiency of the taxation system by reducing its complexity, but also by allocating taxes on mobile factors to the federal level. Moreover, it confers a robust revenue base, devoid of tax competition, to provincial welfare states. This option is also politically difficult to implement since the volatility of corporate taxes involves a significant fiscal risk for the federal government and may entail large fiscal costs for Ottawa. Indeed, total provincial corporate tax revenues are currently lower than federal sales tax revenues. This imbalance would possibly need to be counteracted by a reduction of the growth of the CHT. Furthermore, the reform necessitates federal-provincial agreement and provinces may consider that because they lose control over corporate taxes, this option reduces their autonomy, even though it would significantly enhance their fiscal autonomy in the long run.

The **tax cut option** involves to reduce federal taxes so provinces can increase their own taxes to broaden their fiscal room to maneuver. The first Harper government (2006-2008) led by the Conservative Party of Canada (CPC) reduced federal sales taxes from 7% to 5% with two objectives in mind: constraining the size of the federal government and reducing vertical fiscal imbalance. However, only four provinces, all east of Ottawa, increased their provincial sales taxes by two percentage points. Indeed, provinces may prefer to pass the tax cuts to their constituents rather than solving their long-term fiscal problems. This option confers the most autonomy to provinces, but this autonomy involves that provinces may choose not to increase their fiscal capacity, which doesn't solve the problem of unequal permanent austerity for all provinces. Moreover, it is considerably less egalitarian than the two transfer-based options, since it reduces redistribution between provinces as it would constrain the federal government's fiscal capacity. This option is likely to be supported by the CPC, whose objective is to reduce taxes and "starve the beast" but would be opposed by the LPC or the NDP, who prefer a larger federal government.

In conclusion, the cooperative and tax exchange option are the most attractive theoretically since they involve reforms improving the efficiency of the allocation of resources in the Canadian federation. However, they are politically risky and complex to implement. Their occurrence is therefore less likely than the conditional transfer or the tax cut options, each of which are supported by one of the main federal parties. In any case, reforms will necessitate that policymakers at the provincial and federal levels recognize the consequences of unequal permanent austerity for the Canadian federation.

References

Alesina, Alberto, Carlo Favero, and Francesco Giavazzi. 2019. *Austerity: When It Works and When It Doesnt* (Princeton University Press).

Bansak, Kirk, Michael M Bechtel, and Yotam Margalit. 2021. 'Why austerity? The mass politics of a contested policy', *American Political Science Review*, 115: 486-505.

Banting, Keith. 2005. 'Canada: Nation Building in a Federal Welfare State.' in Herbert Obinger, Stephan Leibfried and Francis G Castles (eds.), *Federalism and the Welfare State* (Cambridge University Press: New York).

Barnes, Lucy. 2015. 'The size and shape of government: preferences over redistributive tax policy', *Socio-Economic Review*, 13: 55-78.

Baumol, William J. 1967. 'Macroeconomics of unbalanced growth: the anatomy of urban crisis', *The American economic review*, 57: 415-26.

Bednar, Jenna. 2009. 'The robust federation', *Cambridge Books*.

Béland, Daniel, and John Myles. 2012. 'Varieties of federalism, institutional legacies, and social policy: Comparing old-age and unemployment insurance reform in Canada', *International Journal of Social Welfare*, 21: S75-S87.

Béland, Daniel, and Trevor Tombe. 2021. 'Three Policy Pathways for Federal Health Care Funding in Canada', *SPP Research Papers*, 14: 36.

Bélanger, Éric, and Philippe Chassé. 2021. 'The 2018 Provincial Election in Quebec', *Canadian Political Science Review*, 15: 34-43.

Borwein, Sophie, Olivier Jacques, Daniel Béland, and André Lecours. 2022. 'National standards or territorial autonomy? The politics of fiscal federalism for health care in Canada', *Paper presented at the American Political Science Association conference, Montréal*.

Brady, David, and Amie Bostic. 2015. 'Paradoxes of social policy: Welfare transfers, relative poverty, and redistribution preferences', *American sociological review*, 80: 268-98.

Bremer, Björn, and Reto Bürgisser. 2022. 'Do citizens care about government debt? Evidence from survey experiments on budgetary priorities', *European Journal of Political Research*.

Busemeyer, Marius R, and Julian L Garritzmann. 2017. 'Public opinion on policy and budgetary trade-offs in European welfare states: evidence from a new comparative survey', *Journal of European public policy*, 24: 871-89.

Canada, Government of. 2021. 'Financial Reference Tables', Department of Finance Canada. https://www.canada.ca/en/department-finance/services/publications/fiscal-reference-tables/2021.html.

Cansunar, Asli. 2021. 'Who Is High Income, Anyway? Social Comparison, Subjective Group Identification, and Preferences over Progressive Taxation', *The Journal of Politics*, 83: 1292-306.

Cavaillé, Charlotte, and Kris-Stella Trump. 2015. 'The two facets of social policy preferences', *The Journal of Politics*, 77: 146-60.

Clayton, Richard, and Jonas Pontusson. 1998. 'Welfare-state retrenchment revisited: entitlement cuts, public sector restructuring, and inegalitarian trends in advanced capitalist societies', *World politics*, 51: 67-98.

Cutler, Fred. 2008. 'Whodunnit? Voters and responsibility in Canadian federalism', *Canadian Journal of Political Science/Revue canadienne de science politique*, 41: 627-54.

DiGiacomo, Gordon, and Maryantonett Flumian. 2010. *The Case for Centralized Federalism* (University of Ottawa Press).
Dougherty, Sean, and Leah Phillips. 2019. 'The spending power of sub-national decision makers across five policy sectors'.
Fafard, Patrick, François Rocher, and Catherine Côté. 2010. 'The presence (or lack thereof) of a federal culture in Canada: The views of Canadians', *Regional & Federal Studies*, 20: 19-43.
Ferede, Ergete, and Bev Dahlby. 2016. 'The costliest tax of all: raising revenue through corporate tax hikes can be counter-productive for the provinces', *SPP Research Paper*, 9.
Ferguson, Claude, and Olivier Jacques. 2019. 'Le financement de la santé est absent du débat électoral', *Options politiques*.
Forni, Lorenzo, and Natalija Novta. 2014. *Public employment and compensation reform during times of fiscal consolidation* (International Monetary Fund).
Haffert, Lukas. 2019. 'Permanent budget surpluses as a fiscal regime', *Socio-Economic Review*, 17: 1043-63.
Hartwig, Jochen. 2008. 'What drives health care expenditure?—Baumol's model of ‘unbalanced growth’revisited', *Journal of Health Economics*, 27: 603-23.
Hübscher, Evelyne. 2016. 'The politics of fiscal consolidation revisited', *Journal of Public Policy*, 36: 573-601.
Huizinga, Harry, and Luc Laeven. 2008. 'International profit shifting within multinationals: A multi-country perspective', *Journal of Public Economics*, 92: 1164-82.
Jacques, Olivier. 2020. 'Partisan Priorities under Fiscal Constraints in Canadian Provinces', *Canadian Public Policy* 46: 458-73.
———. 2021. 'Austerity and the path of least resistance: how fiscal consolidations crowd out long-term investments', *Journal of European public policy*, 28: 551-70.
Jacques, Olivier, and Éric Bélanger. 2022. 'Deficit or austerity bias? The changing nature of Canadians' opinion of fiscal policies', *Canadian Journal of Political Science/Revue canadienne de science politique*: 1-14.
Jacques, Olivier, and Lukas Haffert. 2021. 'Are governments paying a price for austerity? Fiscal consolidations reduce government approval', *European Political Science Review*, 13: 189-207.
Jensen, Carsten. 2011. 'The forgotten half: analysing the politics of welfare services', *International Journal of Social Welfare*, 20: 404-12.
———. 2012. 'Labour market-versus life course-related social policies: understanding cross-programme differences', *Journal of European public policy*, 19: 275-91.
Jensen, Carsten, and Michael Bang Petersen. 2017. 'The deservingness heuristic and the politics of health care', *American Journal of Political Science*, 61: 68-83.
Johnston, Richard. 2017. *The Canadian party system: An analytic history* (UBC Press).
Jordan, Jason. 2009. 'Federalism and health care cost containment in comparative perspective', *Publius: The Journal of Federalism*, 39: 164-86.
Larsen, Christian Albrekt. 2008. 'The institutional logic of welfare attitudes: How welfare regimes influence public support', *Comparative political studies*, 41: 145-68.
Lecours, André. 2019. 'Dynamic de/centralization in Canada, 1867–2010', *Publius: The Journal of Federalism*, 49: 57-83.
Martin, Isaac. 2013. *Rich people's movements: Grassroots campaigns to untax the one percent* (Oxford University Press).

McKenzie, Kenneth J. 2006. 'A Race to the Bottom in Provincial Business Taxation in Canada?' in Kathryn Harrison (ed.), *Racing to the Bottom? Provincial Interdependence in the Canadian Federation* (UBC Press: Vancouver).
Meltzer, Allan H, and Scott F Richard. 1981. 'A rational theory of the size of government', *Journal of Political Economy*, 89: 914-27.
Milligan, Kevin, and Michael Smart. 2019. 'An estimable model of income redistribution in a federation: Musgrave meets Oates', *American economic journal: economic policy*, 11: 406-34.
Milligan, Kevin, and Michael Smart. 2016. 'Provincial Taxation of High Incomes: The Effects on Progressivity and Tax Revenue.' in David A Green, Craig Riddell and France St-Hilaire (eds.), *Income Inequality. The Canadian Story* (Institute of Research on Public Policy: Montreal).
Mintz, Jack, and Michael Smart. 2004. 'Income shifting, investment, and tax competition: theory and evidence from provincial taxation in Canada', *Journal of Public Economics*, 88: 1149-68.
Musgrave, Richard A. 1971. 'Economics of fiscal federalism', *Nebraska Journal of Economics and Business*: 3-13.
Myles, John. 2000. 'The maturation of Canada's retirement income system: income levels, income inequality and low income among older persons', *Canadian Journal on Aging/La Revue Canadienne Du Vieillissement*, 19: 287-316.
Noël, Alain. 2022. 'Quand les gouvernements trébuchent', *Options politiques*, July 29th
Oates, Wallace E. 1968. 'The theory of public finance in a federal system', *The Canadian Journal of Economics/Revue canadienne d'Economique*, 1: 37-54.
———. 1999. 'An essay on fiscal federalism', *Journal of economic literature*, 37: 1120-49.
Paquet, Gilles, and Ruth Hubbard. 2010. *The case for decentralized federalism* (University of Ottawa Press).
PBO. 2021. "Fiscal Sustainability Report " In, edited by Parliamentary Budget Officer. Ottawa.
Pierson, Paul. 1993. 'When effect becomes cause: Policy feedback and political change', *World politics*, 45: 595-628.
Pierson, Paul 1998. 'Irresistible forces, immovable objects: post-industrial welfare states confront permanent austerity', *Journal of European public policy*, 5: 539-60.
Riedl, Aleksandra, and Silvia Rocha-Akis. 2009. 'Testing the Tax Competition Theory: How Elastic are National Tax Bases in OECD Countries?'.
Rousseau, Jean-Jacques. 1764. *La neuvième lettre écrite de la montagne* (Gallimard: Paris).
Saillant, Richard. 2016. *A tale of two countries: How the great demographic imbalance is pulling Canada apart* (Nimbus Publishing).
Shah, Anwar. 2007. *The practice of fiscal federalism: Comparative perspectives* (McGill-Queen's Press-MQUP).
Starke, Peter. 2021. 'The politics of retrenchment.' in Bent Greve (ed.), *Austerity, populism and the welfare state* (Edward Elgar: Northampton).
Tepe, Markus S. 2009. 'Public administration employment in 17 OECD nations from 1995 to 2005', *REC-WP Working Papers on the Reconciliation of Work and Welfare in Europe*, 12.
Tillman, Erik R, and Baekkwan Park. 2009. 'Do voters reward and punish governments for changes in income taxes?', *Journal of Elections, Public Opinion and Parties*, 19: 313-31.

Tombe, Trevor. 2020. 'Finances of the nation: Provincial debt sustainability in Canada: Demographics, federal transfers, and COVID-19', *Canadian Tax Journal/Revue fiscale canadienne*, 68: 1083-122.
Tremblay, Jean-François. 2012. *Fiscal Problems, Taxation Solutions: Options for Reforming Canada's Tax and Transfer System* (Mowat Centre for Policy Innovation).
Weingast, Barry R. 1995. 'The economic role of political institutions: Market-preserving federalism and economic development', *JL Econ. & Org.*, 11: 1.