POL224 (Canada in Comparative Perspective)

**Federal-State Fiscal Relations in Canada and the United States**

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*"Compare the balance of power between the two levels of government in Canada (federal and provincial) and the United States (federal and state) in one policy field. Is the federal government stronger in this relationship in one country than the other? Address this question in relation to recent developments [the past 10 years] in one of the following fields: the environment (especially global warming), gun control, health care or **federal-provincial [state] fiscal relations**. You may select another case with the consent of your TA."*

## Contents

Since WWII, the federal systems of the United States and Canada have moved in opposite directions; the U.S. has headed toward centralization, while the provinces in Canada have grown stronger at the expense of Ottawa (Esman, 1984). The general causes of these divergences are beyond the scope of this paper, though one of the paramount factors in this phenomenon is the transforming federal-provincial (or state) fiscal relationship. This paper seeks to compare the relationship between the federal and the sub-national government as it relates to fiscal policy, ultimately determining which country's federal government is stronger in the relationship. I submit that an analysis of recent developments, as well as general historical context, suggests that Canada and the US follow a similar fiscal relationship between the federal and subnational governments; the former has ultimate power to override and overwatch, while the latter is tasked with execution and completion. Nevertheless, to converge on a similar relationship, provinces in Canada versus states in the US had to follow inverse trajectories – states had to lose power, while provinces had to gain it from Ottawa.

The first section, *The Governance of Fiscal Relations*, provides an overview of the historical context of the relationship in both countries, and the means through which government fiscal duties are specified. *Differences in Modes of Fiscal Stimulus* scrutinizes the two tools of fiscal policy, expenditure and taxation, and introduces relevant case studies from the recent ten to fifteen years. *Implications and Future Trajectory* draws inferences from the observed dynamics in the relationship for both countries and offers insights for the future, preceding the essay's conclusion.

## The Governance of Fiscal Relations

In Canada, fiscal relations between all levels of government are specified and governed either by an act of parliament (most notably the Constitution Act of 1867) or by formal convention-based agreements. Today, all of the legal federal-provincial financial arrangements are included in the Established Programs Financing Act passed in 1977 ('Canlii', n.d.). Prior to the act, Federal funding rested on provincial conformity to federal program requirements. During the 1970s, however, such federal funding arrangements became increasingly controversial as provinces pushed for greater self-dependence and the ability to opt out of federal programs without sacrificing their share of federal revenue. The 1977 act re-arranged the federal-provincial financial relationship in response to provinces' demands, appeasing both provincial and federal administrators by granting provinces greater freedom in setting their own financial policies while also allowing the federal government to control some share of expenditure ('Canlii', n.d.).

Most recently, Canada has engaged in a quest to establish a new, refreshed and rethought fiscal relationship between the Canadian Government and the Assembly of First Nations - one that "moves towards sufficient, predictable and sustained funding for First Nations communities" ('Government of Canada':a, 2021). The signing of the Memorandum of Understanding in 2016 gave way to a process of discourse between the government and the assembly concerning the administration of financial grants, mutual accountability frameworks, and the creation of an advisory committee on fiscal relations. Thirteen First Nation Chiefs from all across the country became members of the latter committee, creating recommendations and issuing interim reports in conversation with first nation communities. Evidently, though the governance of federal-provincial fiscal capabilities and the financial authorities of each government level in Canada have been immobile since the 1980s, Canada is only now entering a phase of including Indigenous communities into the discussion. It is this process which is set to decentralize some power away from Ottawa.

Fiscal federalism in the United States originates with the founding of the Union in 1789. As opposed to Canada where provinces began gaining fiscal autonomy after about a hundred years of the nation's sovereignty, American states have enjoyed considerable financial freedom since the founding of the nation because they preceded the nation and transferred only some powers to the Union's central government (Laubach, 2005; 6). In this way, the evolution of the fiscal authority of states in the US is somewhat reversed to that of the provinces in Canada. In the dawn of the Union, the federal government depended primarily on tariffs and excise taxes for revenue while states possessed real spending and taxing power. In 1913, the sixteenth amendment authorized Congress to collect general income taxes and entailed congressional "power of the purse," predicating that the executive branch must appeal to Congress for funding ('Annenberg School,' 2019). A further series of acts and reforms throughout the twentieth century matured the federal governments' fiscal jurisdiction. For instance, the Social Security Act of 1935 added retirement and disability benefits to Washington's payroll. Other federal grant programs complementing the civil rights movement provided funding to states for education subsidies, health care, transportation, and other services (Kettl, 2000; 488). Overall, the federal-state fiscal relationship in the US complexified as the government adopted a more profound role in regulating state and local governments while accepting autonomy in certain areas like internal state distribution of funds. Nevertheless, it is a relationship continually enshrined by the constitution and legal acts. The tenth amendment of 1791 was imperative in constructing the federal-state power balance altogether, by reaffirming that the federal government possesses 'only those powers that are granted to it by the constitution, and all other powers rest within the state or the American people' (Smentkowski, 2023). That the United States possess stricter and more formal rules on the fiscal jurisdictions of both the federal and state government is no surprise; the U.S. does, after all, contain a formal separation of powers in a written constitution contrasting Canada's hybrid conventional-written constitution.

## Differences in Modes of Fiscal Stimulus

### I. Revenue

In the United States, the federal versus the state government rely on separate revenue sources. The former collects revenue through streams including personal income, corporate, and excise taxes, while the latter do so mainly through sales and property taxes, but also income taxes in certain states ('Congressional Budget Office', 2022) – whereby a discount from federal taxation can be applied. The amount of federal funding that each state receives depends on variables such as population size, average income levels, and specific requirements of the state. It must be noted that states have more freedom in administering sales taxes in the US than provinces in Canada. US states are able to set their own sales tax rates and determine which goods ought to be levied with such tax (Boadway & Watts, 2004; 13). This results in profound variation in the degree of sales tax, therefore somewhat impacting the cost of living across the nation. Canada's sales tax, by contrast, has a province-imposed HST tax differing between provinces, as well as a nation-wide GST tax.

When considering recent case studies that altered or addressed the federal-state fiscal relationship in the US, one could start with the Tax Cuts and Jobs Act of 2017: a major tax reform legislation authorized by President Trump. The reform significantly changed both federal and state taxation in the US, for instance by reducing corporate tax rates from 35% to 21% ('Tax Policy Center,' n.d.). This severely impacted state revenues since many states use the federal tax code as a basis for their own – since US states are more reliant on federal funding, changes to federal taxation policy have more notable effects on state revenue policy. The legislation also included a $10,000 limit on deductions between state and local tax, most affecting high-tax states such as New York or California (Lam, 2018; 374). The Tax Cuts and Jobs Act led to much debate and speculation on the ideal balance of power between the federal government and the states when it comes to taxation, with many experts believing that the bill undermined state autonomy on tax matters.

Another relevant example is the Wayfair v. South Dakota case of 2018, where the Supreme Court addressed the issues of sales tax collection for online purchases. Prior to the ruling, states were limited in their ability to collect sales tax from customers. The ruling allowed states to require out-of-state sellers to collect sales tax, even if the seller did not have physical presence in the state ('Cornell Law School,' n.d.). This decision had a considerable impact on state tax revenue, though it also led to some concerns about the complexity of complying with different state tax laws and the potential burden on small businesses. Clearly, federally-induced directives can inhibit states' power in the fiscal relationship by not only impacting state policy but also generating compliance challenges.

In Canada, one recent development relevant to the federal-provincial fiscal relationship is the 2016 Pension Plan Enhancement, a public pension plan that provided retirement, disability, and survivor benefits. The enhancement included increasing the amount of income subject to the Canada Pension Plan, and this required the approval of at least seven out of ten provinces (Schwanen & Wyonch, 2018; 1). In this way, since the passing of the Pension Plan Enhancement was a vote amongst provinces, provinces were able to express their disagreement through a vote (as opposed to coerced US states in previous examples). Though this is some evidence that the Canadian federal government is more considerate toward provincial dispute of policy, there is some evidence to challenge this. In 2018, Ottawa mandated a "backstop" carbon pricing system on provinces lacking it. Remaining provinces had to meet new federal base standards. Some provinces, such as Saskatchewan or Ontario, challenged the carbon pricing backstop on grounds of unconstitutionality, but a March 2021 ruling in the Supreme Court of Canada declared that the federal government's carbon pricing system was constitutional (Kramer & Scott, 2019; 266). In the end, opposing provinces were powerless in the alteration of carbon taxing, a fiscal element. This nuance brings Canada marginally closer to the US in terms of the federal government's ability to override individual or collecting sub-national disagreement or dispute.

## II. Expenditure

The direction of expenditure at the state level in the US involves substantial state liberty in design and purpose (Laubach, 2005; 6) as opposed to a simple delegation of federally-mandated or "guided" budgetary purposes. Local (e.g. municipal) governments' total expenditures have historically closely matched those of state governments, while federal expenditures were approximately twice as large. With the exception of interest payments attached to public debt, most federal expenditures in the U.S. include defence, social benefits, and grants to sub-national governments. In terms of state expenditure, grants to local governments are the largest spending sink, trailed by social services and higher education (Laubach, 2005; 8). On the local level, primary and secondary education comprises about forty percent of spending, with the rest comprising utilities and public safety. Local governments in Canada and the United States spend more than just about any other countries on primary and secondary education.

Canada, comparably to the US, finances major public services including the areas of education, health care, and social services at the provincial level (Boadway & Watts, 2004; 6). The benefits of sub-national autonomy in managing expenditure in such areas includes the erosion of top-down inefficiencies; it enables increased responsiveness of public expenditure to local preferences and more genuine political accountability via a closer connection between revenue-raising authorities and expenditure streams (Laubach, 2005; 1).

a. On Welfare and Economic Intervention

The American Recovery and Reinvestment Act (ARRA) of 2009 was a federal stimulus package designed to stimulate the economy after the Great Recession of 2008. It included $787 billion in spending on a variety of programs, including infrastructure projects, tax credits, and, importantly, social welfare programs (Paul, Darity, Hamilton, & Zaw, 2018; 52). Some of its key provisions were the expansions of the Temporary Assistance for Needy Families (TANF) program providing financial assistance and the Supplemental Nutrition Assistance Program (SNAP) providing food assistance to low-income families. These expansions as well as added spending on infrastructure and the tax credits highlighted the potent measures the federal government can take in times of crisis, how the federal government ultimately leads fiscal response during economic hardship, thus reinforcing Washington's authority in the federal-state fiscal and its responsibility to alleviate fiscal burden.

Canada's history on welfare expenditure and economic intervention during the great recession is similar. During the 2008 crisis, the federal government was proactive in implementing stabilization measures and protecting employment. The Harper government launched large-scale economic intervention plans such as the Economic Action Plan ('Infrastructure Canada,' 2011) which stabilized the national financial system and stimulated economic growth, e.g. through purchasing insured mortgages, providing liquidity to distressed financial institutions, and cutting federal taxes for businesses and individuals ('Parliament of Canada,' n.d.). The federal government also increased transfers to the provinces that were destined to help provinces and territories deal with the increased demands for social services and public funding during the recession (Baker & Gruber, 2016; 80). Meanwhile, provinces implemented their own, smaller-scale policies to alleviate the negative impact on their provincial economies. This included their own infrastructure spending programs, tax credits, and other economic incentives for businesses ('Government of Canada':b, 2009). Though localized provincial response and a large degree of provincial control ensured that provinces were able to directly match the needs and economic circumstances, without large bouts of federal support the crisis would not have been ended with such ease – Canada was the only G7 country which managed to avoid a deep recession in 2008 (Haltom, 2013). In the US, though states were largely effective in recognizing their particular needs, it was intervention from Washington that provided the backbone of recovery.

b. On Health Care and Public Schooling

Medicaid in the United States is an example of a system overseen by the federal government but executed by state with some degree of flexibility – it is therefore a system in which the two levels of government are interdependent in its administration, and the balance of power is thus split more-or-less uniformly. Medicaid provides health care coverage to families and individuals, and it is crucial for many states being able to provide health coverage for low-income residents. Though the program is jointly funded with state governments, the extent of federal funding depends on the state's per-capita income (Holahan & Haley, 2020; 2). Medicaid has been a point of contention in federal-state fiscal relations, particularly after the passing of the Affordable Care Act (ACA) by President Obama in 2010.

The ACA required all states to cover all individuals with incomes up to 138% of the federal poverty level ('RAND,' n.d). However, the US Supreme Court ruled that the federal government could not force states to participate in this expansion, leading to a division between states that chose to expand and those that did not. This suggests that while the federal government might put forward bills, acts, and reforms that aim to impact the federal-state fiscal relationship in areas like health care, it is constrained by the Supreme Court and some degree of accordance to the constitution. This is a limit on the government's power in the relationship.

The Canadian Health Transfer (CHT) is a program that subsidizes provinces and territories for health care. While the program has existed for a long time, it underwent a 2017 iteration relevant to this discussion. The federal government announced that the CHT would grow at new rates of at least 3% yearly ('Prime Minister of Canada,' 2023). This was significant because it provided provinces with more predictable and reliable funding and decreased the federal government's role in determining the size of funding for each province in each year. In this way, the federal government voluntarily gave up autonomy in directing the grants it gives to the provinces – this propped up the power of the province.

c. On Public Goods

The Infrastructure and Investment Jobs Act put forward by President Biden in 2021 supports the notion of federal-state interdependence with regard to fiscal policy. The bill distributed the responsibility of managing infrastructure projects and though these are often mandated by the federal government, the states are tasked with oversight and completion (‘ASCE,’ 2021). The bill also includes some provisions that could encourage private investment into infrastructure projects – if enforced by states, these could offset some of the costs borne by federal and state governments. Overall, the bill represents a significant investment into infrastructure but its contents will only be successfully carried out if there exists balanced cooperation between federal and state bodies.

For Canada, though there have not been any notable developments in the sphere of public goods in recent years, one could invoke the Equalization program initiated in 1957 since it is highly relevant to the topic. It is an ongoing federal program that transfers funds to less wealthy provinces so that they could provide comparable levels of public services to wealthier provinces ('Parliamentary Budget Officer,' 2018; 4). The program has historically generated much tension between the federal and some provincial governments, particularly those that are major energy producers like Alberta and Saskatchewan, which have argued that the program unfairly taxes them by neglecting the significant revenue they generate from their energy sectors (Abedi, 2018). This has led to multiple calls for reforms and even Alberta's intentions to withdraw from the program altogether. It is unable to withdraw, however, and this gives reason to believe that policies which matter the most to Ottawa can ultimately be imposed on the provinces.

## Implications and Future Trajectory

It is reasonable to state that the federal-state fiscal relationship is closely related to the overall balance of power between the federal and state governments. This general power dynamic between the two levels has certainly shifted over time, with the federal government gaining more influence through the use of its spending power – a global trend stemming from the rise of nation-state bureaucracies. Federal funding, the embodiment of this power, is often used to incentivize states to adopt certain policies or programs, potentially leading to increased federal control over state affairs. Examples of this are particularly numerous in areas such as health care or education, and can include case studies like the aforementioned ACA in America, or the Ontario Infrastructure Investment Plan in Canada. Since the amount of government spending is unprecedented in both countries ('Trading Economics,' n.d.), federal funding has more bargaining power than ever. Nevertheless, there have been some efforts to shift more power to the states in the US. Some have advocated for block grants (grants allocatable to a greater range of streams) or denounced Washington's increased fiscal authority (‘Congressional Research

Service,' 2022). Others have looked to recent evidence like the Federal Reserve's crucial intervention in the 2009-14 economic recovery and now positively assess the new power structure (Belsie, 2019).

With both the US and Canadian governments growing in size, it is likely that the authority of the federal government in fiscal and other realms will not recede. After all, a government must control for the negative externalities that might occur as a result of sub-national entities becoming too differentiated over time, either economically or socially. The federal government must ensure that all sub-national units thrive, and as such it has to manage fiscal policy and social reforms accordingly. Notwithstanding this, it could be possible for the government to accept a somewhat greater degree of state autonomy in the details of governance; perhaps a widening range of acceptable state behaviour (e.g. with regard to allocating funds from grants) could be adopted. Such continually widening range is somewhat what has been happening in Canada, as mentioned, and it is likely that the country will continue on this path.

## Conclusion

The relative success of diverse types of fiscal policy across the developed world suggests that there are no unequivocal rules that determine the extent of decentralization in a nation's fiscal operations. Insight from this paper helps to understand the federal-subnational fiscal relationship in the Canadian and American contexts. Though a similar paper focused on social policy could credibly conclude that contrary to the US, power in Canada has decentralized over time, the case studies outlined in this essay suggest that the federal governments do have ultimate authority in managing fiscal policy. However, to converge on this point today, Canadian provinces had to acquire more power while the US states had to surrender some of it to Washington.

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