

Fiscal federalism in Canada

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Fiscal federalism in Canada

The purpose of this paper is to describe the system of fiscal federalism operating in Canada; to compare it with that in Australia (see McLean 2002); and to discuss how far the Canadian arrangements could be the model for a revised intergovernmental financial arrangement in the UK.

Geography and history

Canada is the second-largest country, by area, in the world. It is normally regarded as comprising five regions:

- The Atlantic region (Newfoundland, Prince Edward Island, Nova Scotia, and New Brunswick)
- The central region (Québec and Ontario)
- The prairies (Manitoba, Saskatchewan, Alberta)
- The Pacific coastal region (BC)
- The sparsely inhabited north

Most of the population inhabit a narrow strip relatively close to the US border. It is hard to imagine Canada being governed in any other way than as a federation. The basic units of Canadian federalism are its ten provinces and three territories. Summary statistics are in Table 1.

[Table 1 here]

The two largest provinces, Ontario and Québec, contain more than half of Canada's population between them. The four small Atlantic provinces (and the three territories) together contain fewer people than each of the four largest provinces. The three territories are vast in extent but tiny in population.

The spread of GDP per head between the richest and the poorest provinces is wider than in Australia or the UK (cf McLean 2002, Table 1; ONS 2001.) Table 2 compares the three countries.

[Table 2 here]

Canadian regional GDP per head is highly skewed. In this it resembles the UK more than Australia. Only two provinces – Ontario and Alberta – have GDP per head above the all-Canada average. The three tiny-population territories have quite high GDP per head, two of them being above the Canada average. However, a great deal of that GDP accrues to capital rather than labour, being derived from resource exploitation. And a disproportionate amount of their labour GDP accrues to government employees – government being the largest employer in the territories. The GDP of government employees is, by convention, set to equal their pay. Otherwise, these territories tend to contain the poorest people in Canada. Their situation is obviously similar to that of the Northern Territory in Australia, which likewise has both high GDP per head on

the output measure, substantial resource exploitation, and very poor indigenous people.

Constitutional issues

The British North America Act (Constitution Act) 1867¹ is silent on intergovernmental fiscal matters, except that ss. 114-117 set out the liabilities of Canada and the provinces for their public debts at Confederation. S.118 provided for grants in aid from Canada to the provincial governments:

118. The following Sums shall be paid yearly by Canada to the several Provinces for the Support of their Governments and Legislatures:

	Dollars.
Ontario	Eighty thousand.
Quebec	Seventy thousand.
Nova Scotia	Sixty Thousand.
New Brunswick	Fifty thousand.
[total]	Two hundred and sixty thousand;

and an annual Grant in aid of each Province shall be made, equal to Eighty Cents per Head of the Population as ascertained by the Census of One thousand eight hundred and sixty-one, and in the Case of Nova Scotia and New Brunswick, by each subsequent Decennial Census until the Population of each of those two Provinces amounts to Four hundred thousand Souls, at which Rate such Grant shall thereafter remain. Such Grants shall be in full Settlement of all future Demands on Canada, and shall be paid half-yearly in advance to each Province; but the Government of Canada shall deduct from such Grants, as against any Province, all Sums chargeable as Interest on the Public Debt of that Province in excess of the several Amounts stipulated in this Act.

These grants were amended under the Constitution (originally British North America) Act 1907, 7 Edw. VII, c. 11, which was likewise a UK statute applying to Canada. However, the 1907 statute merely substituted a new list of fixed grants and per capita additions. Like the 1867 list it was not dynamic, and it was intended only “for its local purposes and the support of its Government and Legislature”. By s.92 of the 1867 Act, which enumerated provincial powers, the provinces had the power over

The Management and Sale of the Public Lands belonging to the Province and of the Timber and Wood thereon.

Only in 1982 was this broadened to a wider authority over natural resources, by the addition of a s.92A to the 1867 Act which states in part:

In each province, the legislature may make laws in relation to the raising of money by any mode or system of taxation in respect of

¹ The British North America Act was an Act of the UK Parliament. In Canada it was renamed in 1982 as the Constitution Act 1867.

- (a) non-renewable natural resources and forestry resources in the province and the primary production therefrom, and
- (b) sites and facilities in the province for the generation of electrical energy and the production therefrom,

whether or not such production is exported in whole or in part from the province....

The Canadian Constitution (Constitution Act 1982) states at s.36:

- (1) Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to
 - (a) promoting equal opportunities for the well-being of Canadians;
 - (b) furthering economic development to reduce disparity in opportunities; and
 - (c) providing essential public services of reasonable quality to all Canadians.
- (2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

The language of s36 is strikingly non-committal. 'Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to....' does not in fact commit anybody to anything justiciable. Thus, intergovernmental fiscal arrangements in Canada depend on convention and mutual convenience more than they do on statute.

The original federation of Canada comprised Ontario, Québec, New Brunswick, and Nova Scotia, which joined with various degrees of enthusiasm. Manitoba joined in 1870; British Columbia in 1871; Prince Edward Island in 1873; Alberta and Saskatchewan as they became fully-fledged provinces in 1905. Newfoundland did not join until as recently as 1949. Before that it was a Dominion in its own right, but its government had gone bankrupt. It was incorporated into Canada with the active (some Newfoundlanders say over-active) collaboration of the UK government, which disliked the alternatives of Newfoundland remaining independent (but bankrupt) or joining the USA.

For most of the life of the Dominion of Canada, Ontario and Québec have been the richest, as well as the most populous, provinces. Since the discovery of onshore oil reserves in Alberta in 1947, Alberta has become much the richest province. The GDP of Québec has declined relatively. The current ranking of provinces by GDP per head (Table 1) seems stable. Alberta and Ontario are the only two non-recipient provinces. They do not donate money directly to the other provinces, but money is fungible and they do not receive the equalisation grants that all other provinces do. Of the recipient provinces, BC and Québec have more diversified economies. Manitoba,

Saskatchewan, and the four Atlantic provinces are all primary producers, all of whose primary products except oil have hit hard times.

A natural question for a political scientist is: how does a federation with such disparate components cohere? As is well known, the overt threats of secession come not from the richest, nor from the poorest, but from the most culturally distinctive province, namely Québec. Twice, in 1980 and in 1995, the government of Québec promoted referendums on loosening the association with Canada to what they called “sovereignty-association” and Anglophones tended to call secession. On both occasions the proposal was defeated, although only narrowly the second time (60% against, 40% in favour in 1980; 50.6% against, 49.4% in favour in 1995). After the second defeat, the federal government made a reference to the Supreme Court to clarify the conditions under which a province could secede, and later enacted the Clarity Act 2000 (‘An Act to give effect to the requirement for clarity as set out in the opinion of the Supreme Court of Canada in the Quebec Secession Reference’). The preamble of the Clarity Act begins uncompromisingly:

WHEREAS the Supreme Court of Canada has confirmed that there is no right, under international law or under the Constitution of Canada, for the National Assembly, legislature or government of Quebec to effect the secession of Quebec from Canada unilaterally;

The Act proceeds to lay down demanding conditions for any future secession referendum to meet those requirements. The effect is to raise the threshold that a separatist movement in Québec (or Newfoundland, or Alberta, or any other province) must meet.

Nevertheless, Québec always poses a credible threat, comparable to that posed by secessionist movements in other nation-states. Probably the two most disaffected provinces outside Québec are the richest and the second-poorest, viz., Alberta and Newfoundland. But even before the Clarity Act, these two provinces posed no credible threat to the federation.

The reasons are constitutional and political. Constitutionally, a nation forged in reaction to the Union victory in the American Civil War and to a perceived threat of southern invasion was never going to make secession easy. Although the Canadian constitution, unlike that of the European Union, makes no reference to indissolubility or ever closer union, the Clarity Act has made secession yet harder. Politically, Canada shares two features with India, both explicable in terms of their British origins: a plurality electoral system in the lower house, and a weak upper house. This combination has distinctive implications.

Duverger’s Law (Duverger 1954, p. 217) states in part (the valid part): “The simple-majority single-ballot system favours the two-party system”. The intuition behind Duverger’s Law is that in the long run everyone can see that in each district (‘riding’ in Canada) there can only be one credible challenger to the incumbent. Any party that comes third or lower in a riding might as well give up, and its supporters may as well (and, in the long run, will) transfer their allegiance to another party. However, Duverger’s Law implies that in equilibrium, only two parties can credibly compete in each riding. It does not imply that only two parties can credibly compete in the nation.

The pattern of two-party competition may differ radically in different parts of the country. In Canada, it does, and the effect (as it has also been for long spells in India) is to produce just one hegemonic party – currently the Liberal Party – and a disparate group of regional challengers.

Until 1993, there were two parties with the capacity to form a single-party government in Canada: the Liberals and the Progressive Conservatives. But in that year's federal election, the Progressive Conservatives suffered the most dramatic instance ever of the fate of a declining national party with evenly distributed support in a plurality electoral system. The governing party was reduced to two seats and its leader was defeated. At no time since 1993 have the Progressive Conservatives seemed a credible national challenger to the hegemonic Liberals, although they control several provincial governments (Table 1). Two regional parties, namely the Bloc Québécois and the western party the Alliance, have vied since 1993 for the status of official opposition. Neither could plausibly form a Canada-wide bloc except in coalition with others. Tables 3 and 4 show the party composition of the Canadian House of Commons, overall and by province. The detailed consequences of this are discussed below.

[Tables 3 and 4 here]

The Canadian Senate, unlike its counterparts in Australia or the USA, is not constitutionally a house of the territories. Senators are appointed to retirement by the Governor-General on the advice of the Prime Minister. In practice each province or territory is allocated a specific number of Senators and this make-up is strictly kept. The Senate therefore naturally mimics the party composition of the House of Commons with a time-lag. Because it is wholly appointed, the Canadian Senate has been even less prone than the UK House of Lords to sustain a challenge to the elected house, as its legitimacy would be very quickly queried (see further Russell 2000). As in the UK, the government of the day usually has an interest in keeping the upper house quiescent. Therefore, moves by Alberta and others to increase the powers and the legitimacy of the Senate, by making it an explicitly territorial house elected directly or indirectly, have no foreseeable chance of success. More modest reforms, such as drawing new Senators from lists drawn up by the provincial and territorial governments, may have more chance of enactment.

It follows that disaffected provinces have no political tool with which to challenge the power of the dominant party. In India the equivalent situation has sometimes led to violence. In Canada it has not, apart from minor outbreaks in Québec between 1965 and 1970. But it means that provincial grievance has to be channelled to a large extent through the intergovernmental fiscal arrangements: and that in a state in which neither the richest nor the poorest provinces can credibly threaten to secede if they do not get their way.

Equalisation arrangements

Canada has an elaborate horizontal fiscal equalisation (HFE) programme. As in other federations, this programme aims to compensate for the lower tax capacity of the poorer provinces: in the language of s. 36 of the Constitution, to making 'equalization payments to ensure that provincial governments have sufficient revenues to provide

reasonably comparable levels of public services at reasonably comparable levels of taxation'. Note that this is equalisation for unequal resources only: Canada does not attempt to equalise for differential needs for, or cost of providing, public services in the ten provinces. (It does, however, make a needs-based grant to each of the three territories). To this extent, Canada's HFE arrangements are much more restricted than Australia's, which are perhaps the most elaborate and egalitarian in the world on the needs side. On the resources side, however, Canada's procedures are elaborate and distinctive.

Canada makes two main transfers from Ottawa to the provinces. One is called CHST (Canada Health and Social Transfer), to be split in 2004-5 into two transfers, one for health and the other for other social programmes (which in Canada are deemed to include post-secondary education). These transfers reflect the fact that Canadians see health as overwhelmingly the most important political issue for them; that there seems to be a cross-Canada commitment to nationally comparable standards and a commitment to comparable rights for all Canadians. Health is primarily a provincial responsibility², and the federal transfer to the provinces is without strings except that the federal government requires the provinces to adhere to the 'five principles of the Canada Health Act'. The Act is at <http://laws.justice.gc.ca/en/C-6/15944.html>. The five principles are:

1. Public administration (health care insurance plans to be administered and operated on a non-profit basis by a public authority);
2. Comprehensiveness (of provincial health care insurance plans);
3. Universality (all residents of a province or territory to be entitled to medically necessary health care services);
4. Portability (of cover for all Canadians anywhere in Canada); and
5. Accessibility (all Canadians to have access to insured health care services, without any barriers – particularly financial barriers). See <http://web1.liberal.ca/lpc/news.aspx?site=news&news=331>

This list serves the political need for the federal government to be seen to be guaranteeing health standards while not entrenching on the provinces' jurisdiction. Québec states that it does not accept the federal government's right to enforce the five principles, but that it accepts the principles themselves.

The transfer has in principle an equal per capita value for all provinces (thus there is no allowance for health costs to differ systematically from one province to another). It has, however, a small HFE component in that part of what the federal government describes as its transfer is a transfer of tax points to the provinces. This is explained below. The HFE effect is that it leads the cash transfer per head to be smaller in the two richest provinces, Ontario and Alberta. In 2001-02 the CHST amounted to \$1076³ per head in total, or \$ 607 per head in cash in most provinces. Of the \$46 bn of transfers to provinces and territories, CHST accounted in 2001-02 for \$33 bn, about ¾

² But the federal government has constitutional obligations for veterans and Aboriginals.

³ All monetary values in this paper are in Canadian dollars. As at 07.10.2003, CAD \$1= USD 0.75 = GBP 0.45 = AUD 1.09.

of all transfers (Canadian High Commission 2002, p. 403; Ministère des Finances, Québec 2003)⁴).

The second main transfer is the federal equalisation program, worth \$11.7 bn (about ¼ of all transfers) in 2001-02. In Canada this predates its constitutionalisation in 1982, although it does not date as far back as in Australia, where the equivalent program began in 1933. The basic idea is that the federal Department of Finance examines each tax base, estimates the average per capita yield of the tax, and compensates those provinces where the per capita yield is below the average of the five middle-income Canadian provinces. It does not withdraw funding from provinces where the per capita yield is above average (although, since money is fungible, there must be an implicit withdrawal from them). Some of the detail, however complex, must be grasped, especially:

- the exclusion of outliers when calculating a ‘standard’;
- the concept, and the implications, of ‘transferring tax points’..

From 1957 to 1962, equalisation payments applied only to three tax bases, the two main ones being personal and corporate income tax. All provinces which received less per capita from these taxes than the then-richest (Ontario and Québec) received federal equalisation. Since then, the number of provinces taken as the standard has fluctuated, while the number of tax bases to which equalisation has applied has risen steadily.

The federal Department of Finance defines the fiscal capacity of a province as its ability to raise revenues from the aggregate of 33 revenue sources – including personal income tax, corporate income tax, sales taxes, property tax, and other sources – assuming that province has average tax rates. The average fiscal capacity per head of the five ‘middle income’ provinces that make up the standard – Quebec, Ontario, Manitoba, Saskatchewan and British Columbia – is \$5924 for 2003-04 (source: Department of Finance website at <http://www.fin.gc.ca/FEDPROV/eqpe.html>). The calculations exclude the richest province (Alberta) and the four poorest (the four Atlantic provinces) from the calculation of the standard. The amounts, and amount per head, of equalisation payments that go to each recipient province are shown in Table 5.

[Table 5 here]

Some of the 33 tax bases that are used in the calculations are confined to one or a few provinces. The effects of excluding the outliers from the calculation of the standard are therefore complex. So are some related endogeneity issues. At the top end, Alberta is not in the standard. Two of the bottom four provinces (NL and NS) have significant oil royalties, as does Alberta (outside at the top) and Saskatchewan (inside the 5-province standard). The effects of an increase in either the tax base or the tax take on one of the 33 taxes that is restricted to any of those three sets of provinces are different. Consider for simplicity a tax base that is confined to a single province. If that province is inside the 5-province standard and it increases its revenue from the

⁴ The numbers here differ from those in the source because we assign the equalisation component of CHST (i.e., the difference between the cash transferred and an equal per capita transfer of tax) to equalisation rather than to CHST.

tax (by raising the rate, or by encouraging the taxable activity), the standard income for that tax will go up, and the province's equalisation receipts will go down, but by less than 100%. But if the province is outside the 5-province standard and it increases its revenue from the tax, the standard income for that tax remains at \$0, and the province's equalisation entitlement goes down by 100%, dollar for dollar. As four of the five provinces outside the standard are poor, this is perverse. The formula contains a patch known as 'the Generic Solution' (an odd name as it seems to be a very specific solution) which ensures that in those circumstances a province's receipts taper off at a maximum of 70c in the \$ (<http://www.fin.gc.ca/FEDPROV/eqgse.html>). The Department of Finance states that "Newfoundland (offshore revenues), Nova Scotia (offshore revenues), Québec (asbestos), and Saskatchewan (potash) have all benefited from the generic solution". A more truly generic solution would be to calculate the standard revenue for all tax bases over all ten provinces. As the effect of that would probably be to increase equalisation payments, it is predictably advocated by poor provinces and resisted by rich ones. It might also worsen the policy contamination of the measure of natural resource fiscal capacity (see *The special problem of natural resources* below). The federal government does not wish to move to a 10-province standard.

Tax points are another curiosity. They are used in the CHST calculation, not the Equalisation calculation, but their effect is of a slightly disguised equalisation. The tax points transfer that goes into the calculation of what is now CHST was part of a federal-provincial arrangement that took effect in 1977. The federal government then transferred 13.5 percentage points of its personal income tax and one percentage point of its corporate income tax to the provinces and territories.

This transfer of tax points is a neat solution to vertical fiscal imbalance (VFI – see Glossary), where even in 1977 and still more today it was evident that the federal government had substantial excess tax capacity and the provinces had substantial excess spending demand, especially in health. But it has two opaque consequences: the double-counting of expenditure when politicians are claiming credit, and its disguised equalisation implications.

As to double-counting, the Federal government counts the tax points transferred in 1977 as part of its CHST contribution to the provinces in all its documents. If the transferred tax points are treated as a federal transfer to the provinces, then the federal claim that VFI in Canada as a whole is close to zero is bolstered. Federal politicians claim extra credit for the amount they say they are transferring to the provinces every year, and can reiterate the five health principles on every occasion they choose to do so.

Provincial governments dissent. They argue that the points transferred in 1977 stay transferred, and that it is double counting for the federal government to count them anew every year. This enables the provinces to say that the federal government is transferring far too little to match their growing need to spend money on health.

The disguised equalisation implications have already been mentioned. As the Department of Finance explains, "Since tax points are worth more in some provinces than others, the federal government agreed [in 1977] to equalize the tax points on an on-going basis" (<http://www.fin.gc.ca/FEDPROV/aseqe.html>).

Dispersed powers to tax imply dispersed tax collection. Here Canada is intermediate between the USA and the UK. Federalism in the USA entails completely separate arrangements for assessment and collection at federal and state, and sometime municipal, levels. While this of course allows each tier of government to choose its own rates and schedules it incurs very high transaction costs. As anyone who has wrestled with US federal and state income tax returns can testify, some of these fall on the taxpayer. Even visiting university professors are caught in the net. The UK, on the other hand, is so centralised that the only tax not collected by a national agency is Council Tax. In many parts of the UK, more than one authority has the right to collect tax from householders. There may be two-tier local government, or a fire or police authority with the right to 'precept': that is, dictate to the collecting authority that it must collect such and such amount on behalf of the precepting authority. Because almost nobody in the UK is aware which authority provides which service, precepting fatally blurs accountability and responsibility for expenditure.

Multiple collection with high transaction costs is obviously bad. Precepting is obviously bad because of its anti-democratic and anti-efficiency effects. Has Canada found a happy medium? Most of the provinces have entered an agreement with the federal government to levy and collect income tax jointly. This sharply reduces transaction costs, both for government and for the taxpayer, compared with the USA. But it does limit the provinces' flexibility to set their own reliefs, exemptions, and thresholds. It may obscure citizens' knowledge of which government delivers which service. Québec does not participate in the joint collection of income tax, but it does collect GST (=VAT) for both itself and the federal government.

Tax competition is always an issue in fiscal federalism. There is limited tax competition between the Canadian provinces. Some tax bases, such as real estate and natural resources, are where they are and cannot be shifted. The most mobile tax base is the corporation. All my interviewees concurred that it is hard for corporations to shop for a jurisdiction within Canada. Corporations are taxed by the location of their activities and no order of government has an incentive to collude with a corporation to pretend that its activities are elsewhere than they truly are.

As regards competition over income tax, there is some movement of Anglophone Canadians to Alberta, the province with the lowest personal taxation. There appears to be little tax migration of francophones, although Québec has traditionally been one of the highest taxing and spending provinces. Language may explain this limited movement.

As regards sales taxes, Canada, like Australia, has a small number of geographically large jurisdictions. Unlike the USA and even more unlike the UK, there are few conurbations that straddle jurisdictional lines such that it would be worth shopping around for lower sales (or property) taxes. The only Canadian conurbation that crosses a provincial boundary is Ottawa-Hull. There are sharp differences between property tax rates in the two cities – they are much higher in Hull (which is in Quebec) than in Ottawa. However, all witnesses concurred that this effect is fully capitalised into house prices. The drop in house prices as one goes from Ottawa to Hull reflects the higher level of property (and income) taxation in Hull – and perhaps also a risk premium associated with the possibility of sovereignty.

North-south tax competition may be a more serious issue than east-west competition. Many provinces have more north-south than east-west trade. They always have done, and the North American Free Trade Agreement accentuates this. The economy of the Atlantic provinces is linked to New England, of central Ontario to Detroit and Chicago, of the Canadian prairies to the US prairies, and of the Canadian pacific region to the US Pacific North-West. Canada is a relatively high-tax country and the USA a relatively low-tax country. As a proportion of GDP, the overall tax burden in Canada in 1999 was 38.2% and in the USA 28.9% (Séguin 2002, chart 23; source: OECD). This may limit Canadian freedom to manoeuvre.

On the expenditure side, it is important to note that Canada has relatively few direct federal employees. Only the post office and the Royal Canadian Mounted Police (who supply police services under contract to some provinces) employ substantial numbers. There is no unified public sector pay bargaining in Canada. Each province negotiates its own pay arrangements with its employees. Federal pay rates are equal throughout Canada, but that has limited knock-on effects given that, typically, federal and provincial employees are in different trade unions. Consequently, provincial pay rates and hence the cost of delivering public services are lower in poor provinces than in rich ones. This seems to be one reason for the surprisingly small role of 'needs' claims in Canadian intergovernmentalism.

The special problem of natural resources

In Canada (like Australia but unlike the UK), natural resources are taxable by the provinces. Beginning in 1967, provinces' natural resource tax revenues were subject to 100% equalisation. This soon led to complaints that they were over-equalised (similar issues have arisen in Australia). In 1973 the government of Newfoundland, which had developed a very large hydro power scheme jointly with Québec and a private developer, discovered that all its resource income would be equalised away from it and it therefore threatened to expropriate the private sector partner (Feehan 2002, p.3). The sharp rises in oil prices in the 1970s had the effect of hugely stretching the range of provinces' resource tax capacities, and consequently in the federal government's equalisation liabilities. Since 1982, the natural resource equalisation formula has operated on a five-province standard. As for other tax bases, the richest province (Alberta) and the poorest four provinces (the four Atlantic provinces) are excluded from the calculation of the standard per capita receipt. In all, 14 of the now 33 revenue sources that are equalised are natural-resource related (Feehan 2002, p. 5). But this generates perverse effects both for provinces that are in, and for provinces that are outside, the five-province standard. In general, it gives them an incentive to underprice existing natural resources and to fail to develop new sources:

[W]henver a single jurisdiction dominates a particular tax base to such an extent that its tax rate becomes, in effect, the national tax rate ... , there is no incentive for an equalization-receiving jurisdiction to extract any revenues at all from the resource and maximum incentive for it to dissipate the revenues that it could raise (e.g., ... directly to consumers in the form of inexpensive hydroelectric power). (Péloquin 2003 p. 10. See also Boessenkool 2002).

All of this, with parallel evidence from Australia, suggests that natural resource tax capacity should be equalised away at a level below 100%. However strong the public finance argument for full equalisation might be, it is countered by the public choice arguments in this section. Partial equalisation is a second-best solution.

Vertical imbalance and horizontal fiscal equalisation

The Québec Government recently commissioned a report (Séguin 2002; cf also Conference Board 2002) on what it described as the ‘fiscal disequilibrium’ in Canada. Though commissioned by a Parti Québécois government, it was bipartisan in Québec politics. The chairman became a minister in the succeeding Liberal provincial government in 2003. The provinces agree that fiscal disequilibrium exists but disagree as to the remedy. The federal government denies that it exists.

All ten provinces agree that the federal government taxes more than it needs to and fails to hand the proceeds to the provinces, which expect their service delivery to continue to become more expensive, especially for health. A projection (Conference Board 2002) shows the federal government accumulating a massive surplus by 2020, while the provinces barely break even.

One might therefore expect the provinces to unite behind a demand for the federal government simply to transfer more cash to them under its equalisation programme. However, politics intervenes. Sovereignist governments in Québec could not consistently demand transfers from a federal government that they thought should have no authority in Québec. They would therefore prefer a transfer of tax points (although as explained above this also implies an increase in equalisation payments). Although the current (2003) government in Quebec is federalist, the provinces do not yet (October 2003) seem to be at one.

The federal government brusquely replies, in a Web document headed ‘The Fiscal Balance in Canada: the Facts’ (Department of Finance Canada 2003), that the most robust tax bases are open to both orders of government (Table 6) and that provincial-only sources (such as natural resource royalties and gambling taxes) are more robust than federal-only sources (such as tariffs). At Confederation, the then-dominant tax base, namely customs and excise, went to the federal level. But that tax base is now small, especially since the North American Free Trade Agreement abolished tariffs against Canada’s overwhelmingly dominant trade partner, the USA. In aggregate, the vertical fiscal gap between the federal government and the provinces is small by international standards, although the gap between the federal government and any one of the poor provinces is large. In other words, so the federal argument runs, there is no structural vertical imbalance, but there is (and probably always will be) a need for horizontal equalisation. The federal government dismisses the Conference Board projects as being inconsistent with other projections by the same body, and as unrealistically assuming no changes in policy before 2020, and the use of all federal surpluses for debt reduction. Those are some, but not all, of the facts about fiscal balance in Canada. The provinces point out that, while the Constitution grants the provinces “access” to most tax fields, simultaneous occupation of these tax fields by the two orders of government poses very severe political and economic constraints on

a government's ability to raise taxes unilaterally. Access to a tax field, if only theoretical, is of no use for funding public services.

[Table 6 here]

The surprisingly limited role of needs

Consider various dates. In 1867 no politicians acknowledged that horizontal fiscal equalisation was a role of government. Therefore nothing relating to HFE appears in the original Canadian constitution. The Australian constitution of 1900, written as socialism was becoming a mass movement, is distinctly more egalitarian. In its shadow the egalitarian Australian HFE arrangements began in 1933 (McLean 2002). The most puzzling date in the series is therefore 1982. Why does Canada's current constitution, written after four decades of the Welfare State, make only the limited and non-justiciable section 36 references to equalisation quoted above?

The 1982 text had to satisfy very diverse interests. Only what almost every province could accept would be enacted, in the special circumstances of patriation of the Constitution (although Québec steadfastly refused to sign the constitution, even when it was led by a federalist government). The failure of subsequent attempts to change the constitution by unanimity (at Meech Lake in 1987 and Charlottetown in 1992) shows what a high threshold the unanimity rule imposes. Any text empowering the federal government to make HFE payments had to satisfy the most reluctant provinces, which would probably have been Alberta (for economic reasons) and Quebec (for cultural and constitutional reasons).

Accordingly, there are needs-based payments to the three territories, which are not fully-fledged provinces, but not in any serious way to the provinces. Nor is it politically likely that the campaigns of some poor provinces for greater recognition of their needs will succeed.

The needs payments to the territories are in Table 7, which shows that they are so huge that they swamp CHST and equalisation payments. Territorial formula funding accounts for well over half of the territories' revenues, and 91% of Nunavut's.

[Table 7 here]

The formula is based on the actual expenditure in the territories in 1985, when they had much less autonomy than now, adjusted for the growth in their responsibilities and general GDP and relative population change. Thus, unlike the Australian or English regimes, it does not attempt to measure the true cost of providing public services efficiently in the territories, but is driven by the historic cost of providing them in the past.

A Martian (or Australian) would expect to find intense political pressure from the poorer provinces to be treated on a similar basis to the territories and have their higher needs acknowledged by formula. Some such pressure exists. The government of Newfoundland & Labrador wants to explore a move to a needs basis. However it is short of allies. The government of Prince Edward Island would like a recognition of the diseconomies of scale to be built into the formula, recognising the higher per capita cost of providing the full range of provincial government services in an island

with a population of only 140,000. But there seems to be no chorus of demands to move to a needs-based formula.

There appear to be various reasons for this. In contrast to both Australia and the UK, the Canadian evidence on the cost of public services does not always suggest a heavy weighting for sparsity of settlement (except in the special case of the territories). All provinces except PEI have sparsely populated hinterlands. It is open to a province to reduce the cost of public services to remote areas by encouraging migration *within* the province, as might happen anyhow for economic reasons (e.g., the migration of Newfoundlanders from ‘outports’ to the Avalon peninsula around St. Johns). Because provincial governments control their own wage bills, these are lower in low-GDP than in high-GDP provinces. So are accommodation costs. At the other tail of the distribution – congestion costs - Canada has only three metropolitan areas of comparable size to those in more populous countries, viz., Montreal, Toronto, and Vancouver. Of these, Vancouver has a highly constricted site, Toronto has a site that is constricted on one side by Lake Ontario, and Montreal has an unconstricted site. This should lead to Vancouver, and hence BC, having the highest congestion costs, but also to its having the most robust property tax base; and to the converse on both counts for Montreal.

Another possible reason for the lack of clamour for a needs assessment lies in the special position of Québec, which we should revisit.

Credible threats in Québec and Scotland

Here is a paradox. The threat of Québec separatism to the unity of the Canadian state is obvious. It is stronger on all counts than the threat of Scottish separatism to the unity of the UK. The two Québec sovereigntist parties (the Parti Québécois, which contests provincial elections, and the Bloc Québécois, which contests federal elections) have gained a plurality of the votes and a majority of the seats in Québec in several elections to each order of government. The Scottish National Party (SNP) has never won a plurality of the Scottish vote or of seats. Two referenda on sovereignty, in 1980 and 1995, each brought the sovereigntists close to a majority although both failed to produce one. There has never been a referendum on Scottish independence. The proportion of the population who favour independence is higher in Québec than in Scotland (Blais et al 2002 p. 104; Curtice 2003, Table 11.1). An obvious way for governments to buy off discontent is through public expenditure. As argued elsewhere (McLean and McMillan 2003), a plausible explanation of the unexpectedly high public transfers per head to Scotland is that Scotland has posed a threat of sorts to the Union since 1885, and a tangible threat since the emergence of the SNP as a credible electoral force in 1967. ***Why then are federal transfers per head not differentially high in Québec?***

One reason is just that Canadian fiscal federalism is not needs-based. Accordingly, it cannot be ‘needs’ based. Here, a need is what someone needs; a ‘need’ is what it is politically convenient to recognise as a need. If needs are essentially contested, there are no needs in politics, only ‘needs’. Even if that is too extreme a position, ‘needs’ are prevalent in all democratic political systems. Of course, Quebecers of both main

parties there argue that the federal government pays too little attention to the ‘needs’ of Québec. But:

1. in Canada, provincial parties are organised entirely separately from federal parties, even when they have the same name. The provincial Liberals cannot directly bring pressure on the federal Liberals. The Parti Québécois is a separate organisation to the Bloc Québécois;
2. in federal politics, sovereigntists cannot argue for more redistribution of federal funds to Québec without compromising their main position. If Québec were to become a sovereign state, their primary goal, then of course it would receive no federal transfers. Liberals are also constrained, because the federal Liberal party is an all-Canada party, and voters in the rest of Canada resent any special treatment for Québec.

An alternative lever would be the balance of power in the federal legislature. However, as noted above, the Canadian Senate is not a house of the provinces, unlike its counterparts in Australia, Germany, and the USA. Therefore no province can use it to threaten the output of the House of Commons. As to the Commons, the Bloc Québécois is in the same position as the Irish Party of Parnell and his successors between 1880 and 1914. It cannot expect and does not want to form part of the government of Canada. But, as its very name implies, it reliably holds a bloc of seats in every parliament that are inaccessible to any other party.

Such a bloc is powerful when, and only when, it holds the balance of power. The Irish Party did so from November 1885 to June 1886; from 1892 to 1895; and from 1910 until 1915. Only in those periods did the governing parties consider any concessions to Irish opinion. Unluckily for the Bloc, its prospects of being pivotal are very dim. The Liberal Party is more hegemonic in Canadian party politics than the UK’s most hegemonic parties (the Conservatives under Margaret Thatcher and New Labour) have ever been in modern times. The most recent academic evidence relates to the autumn 2000 election campaign. At that time, 26% of Canadians, and over half of those who professed any party identification at all, identified themselves as Liberals; the next largest bloc (11%) was of identifiers with the Alliance (Blais et al 2002, Fig. 8.2). Party identification does not always translate into vote, and votes do not always map to seats; but in 2000 both of these mappings worked and the Liberals secured a comfortable overall majority. Tables 3, 4, 8, 9a and 9b contain the details.

[Tables 8, 9a, 9b here]

The Anglophone opposition to the Liberals is divided three ways: to the NDP to the Liberals’ left, and two rivals (Progressive Conservative and Alliance) to their right. Accordingly, a pact on the right is a perennial Canadian talking-point. In summer 2003, the Canadian rightists were dancing a gavotte just like the British centrists in the 1980s. The Conservatives have promised to fight all 301 seats; but they and the Alliance are also discussing a pact not to oppose one another. Table 9a shows that even if such a pact is reached, the Liberals have no cause for concern. The two right-wing parties do not have exchangeable supporters. Only 38% of Alliance supporters give a second preference to the Conservatives; only 17% of Conservative voters return the favour. More Conservative supporters rank the Liberals than the Alliance in second place.

Québec, meanwhile, gives every appearance of an electorally divided society. The supporters of the two big parties there are (unsurprisingly) unwilling to support the other. But they are also relatively unwilling to support anyone else. The proportion saying 'None' in Québec is much higher than in the rest of Canada (Table 9b).

Of course, the plurality electoral system could sweep the Liberals out as it swept the Conservatives out in 1993, when they were reduced from governing status to two seats. But they are much more secure than were the Conservatives for several reasons. The Conservatives have collapsed in Québec; the divided right would deprive both right-wing parties of seats unless they agree a pact. The chances that a future leader of the Bloc Québécois could emulate Parnell and John Redmond, in extracting concessions for their territory in a hung parliament, look remote. And, as described above, the reference to the Supreme Court and the Clarity Act have raised the threshold for any future referendum on sovereignty. Thus paradoxically, the strong sovereigntist movement in Québec is weak, and the weak separatist movement in Scotland is strong.

Comparisons with Australia

Canada is more diverse than Australia, politically, socially, and economically. Whereas all the Australian states bar one (Western Australia) were enthusiasts for federation, and all had signed up to the Commonwealth within a year of its creation, the Canadian provinces joined more slowly, Newfoundland not until 1949 in a narrow referendum vote. Between Québec and its neighboring provinces (and within Québec) the faultline between Anglophones and francophones goes back to the 18th century. The range of GDP per head is considerably wider in Canada than in Australia.

The Canadian confederation was driven by defence considerations as much as by economics. The Canadian provinces decided to shelter together in the cold light of the Union victory in the American Civil War, which led Canadian politicians to fear that the resurgent US might revive earlier claims on Canada or part of it. The 1866 raids in New Brunswick by Fenians (Irish-Americans who had been Union soldiers in the Civil War) convinced the dubious politicians of that province to join. By contrast, there was no external threat to Australia in the 1890s. Federation came from a desire to make the Australian economy more efficient. The 1867 Canadian constitution predates socialism. The Australian constitution was written by politicians who already had socialist parties and a socialist vote in their states. Canada is just larger, its provinces more diverse than the Australian states, and their economies more subject to exogenous shocks (e.g., the Yukon gold rush in 1897; the discovery of oil in 1947 which turned Alberta from one of the poorest to one of the richest provinces; the collapse of the Newfoundland fisheries; long-range aircraft, which made airports and military bases in Newfoundland redundant).

Federal finance in the two countries reflects these differences. The Australian arrangements for fiscal federalism are more egalitarian than the Canadian. The Commonwealth Grants Commission attempts to equalise fully both for differences in states' resources, and for differences in their needs, where 'needs' includes both the demand for each public service and the cost per head of providing it. Canada does not equalise for needs, except to the three territories – huge in extent but tiny in

population. When equalising for resources, it uses a five province standard as a yardstick for resource equalisation, that excludes the outliers – rich Alberta and the four poor Atlantic provinces.

A feature that Canada and Australia share with each other but not with the UK is that the provinces/states have a resource tax base. In Canada this is supposed to be confined to onshore resources (Constitution Act 1982, Section 92A), but the Federal government has agreed that Newfoundland's offshore oil and Nova Scotia's offshore natural gas may be subject to provincial taxation. The resource tax base of course differs hugely between states with extensive natural resources and those with few or none. In the UK this issue was at its most prominent in the mid 1970s, when the Scottish National Party (SNP)'s demand that "It's Scotland's Oil" secured widespread support among Scots of all political persuasions. However, the UK Government of the day was fundamentally unwilling to concede any resource tax base to Scotland, and has remained so.

Lessons for the UK

To an observer from the UK, the best feature of Canadian fiscal federalism is that VFI is so low. The federal government denies that it exists at all; the provinces insist that it does. An outsider does not need to get involved in that argument. Although national governments have a comparative advantage in revenue raising and lower-level governments may have a comparative advantage in delivering services tailored to their population's needs, the most efficient government is one whose power to tax equals its duty to spend. When there is any VFI, there is an incentive for governments to shift blame to one another and to shirk doing things that may be economically efficient but politically unpopular. Where there is no VFI, and where the electorate is relatively well informed as to which order of government does what, each order of government is answerable to its own median voter for its tax and spending decisions. Each has a maximal incentive to be fiscally responsible. Canada seems to have efficient arrangements for joint collection of taxes.

One consequence which could be carried over to the UK, even if VFI is not reduced there, is that provinces are responsible for their own debt servicing. A direct incentive towards fiscal responsibility is that their sovereign (or near-sovereign) debt is rated by the debt-rating agencies. The latest available figures are in Table 10.

[Table 10 here]

Unless and until the UK reduces its VFI by giving more power to tax to devolved administrations, the prospective English regional assemblies, and/or local authorities, the Canadian HFE arrangements have less to teach policy makers in the UK. The Canadian arrangements are wholly designed to equalise for unequal taxable capacity, and not at all for unequal needs, nor unequal costs of providing public services. UK policymakers looking for possible models in these areas should look to Australia rather than to Canada. However, Canada provides a refreshing note of scepticism about needs. In a vast and diverse country, there is no significant lobby for special treatment on grounds of exceptional needs. Instead, there seems to be a widely accepted view that disadvantages of poor areas (poor health and educational status;

remoteness) are offset by lower costs of providing public services. Such scepticism is unknown in the UK.

Table 1

The units of Canadian federalism, 2002

	Nfld	PEI	NS	NB	Québec	Ont	Manitoba	Sask	Alta	BC	Yukon	NWT	Nunavut
Population, 000s (2002)	532	140	945	757	7 455	12 068	1 151	1 012	3 114	4141	30	41	29
% of total	1.7	0.5	3.1	2.5	24.1	37.8	3.7	3.4	9.7	13.2	0.1	0.1	0.1
Area, km ² x 1000	405.2	5.7	55.3	72.9	1 542.1	1 076.4	647.8	651.0	661.8	944.7	482.4	1 346.1	2 093.2
% of total	4.1	0.1	0.6	0.7	15.4	10.8	6.5	6.5	6.6	9.5	4.8	13.5	21.0
GDP per head, \$Can	22384	21696	23863	24390	27767	34451	27117	29379	39537	29489	34839	52854	27074
Index	71.3	69.1	76.0	77.6	88.4	109.7	86.3	93.5	125.9	93.9	110.9	168.2	86.2
GDP/head (Canada=100)													
Party control of provincial govt, Jun 2003	Liberal	PC	PC*	PC	Liberal	PC	NDP	NDP**	PC	Liberal	Yukon Party	Non-party	Non-party
Date of joining Confederation	1949	1873	1867	1867	1867	1867	1870	1905	1905	1871	1898	1870	1999

Sources: Statistics Canada; National Library of Canada; websites of each provincial and territorial government

* Re-elected but without an overall majority in August 2003.

** Holds exactly half of the seats in the legislative assembly

Table 2

The dispersion of regional GDP per head: Canada, Australia, and the UK

	Canada												
Provincial GDP per head 2001 (Canada=100)	Nfld	PEI	NS	NB	Qu	Ont	Man	Sask	Alb	BC	Yukon	NWT	Nunavut
	71.3	69.1	76.0	77.6	88.4	109.7	86.3	93.5	125.9	93.9	110.9	168.2	86.2
	Australia												
Gross State product per head 2001 (Australia = 100)	NSW	Vic	Qld	SA	WA	Tas	NT	ACT					
	104.2	102.8	87.6	84.1	111.4	70.7	125.3	120.9					
	UK												
Regional GDP per head 1999 (UK excl Extra Regio = 100)	NE	NW	YH	EM	WM	EE	L	SE	SW	Scot	Wales	NI	
	77.3	86.9	87.9	93.6	91.7	116.4	130	116.4	90.8	96.5	80.5	77.5	

Sources: Author's calculations, based on data from Statistics Canada; Australian Bureau of Statistics; Office for National Statistics

Table 3

The Canadian House of Commons, June 2003

Party	N. of seats	% of seats
Liberal	169	56.15
Alliance (formerly Reform)	63	20.93
Bloc Québécois	34	11.30
PC	15	4.98
NDP	14	4.65
Ind	4	1.33
Vacant	2	0.66
Total	301	100.00

Source, www.parl.gc.ca, consulted June 2003; author's calculations

Table 4

The Canadian House of Commons, by party and province, June 2003

Province	Lib	CA	BQ	NDP	PC	Ind	Vacant	Total	% of province seats held by largest party
Alberta	2	23			1			26	88.46
BC	6	26		2				34	76.47
Manitoba	5	3		4	2			14	35.71
NB	6			1	3			10	60.00
Nfld/Labrador	4				3			7	57.14
NWT	1							1	100.00
NS	4			3	4			11	36.36
Nunavut	1							1	100.00
Ontario	98	2		2	1			103	95.15
PEI	4							4	100.00
Québec	35		34		1	3	2	75	46.67
Sask	2	9		2		1		14	64.29
Yukon	1							1	100.00
total	169	63	34	14	15	4	2	301	

Source, www.parl.gc.ca, consulted June 2003; author's calculations

Table 5. Equalisation entitlements, 2003-04

	NL	PEI	NS	NB	QC	MB	SK	BC	Total
\$m	866	240	1,209	1,184	4,543	1,239	355	862	10,499
\$ per capita	1633.54	1709.94	1277.78	1564.55	608.37	1074.40	350.04	205.49	

Sources: Department of Finance, Canada; Ministère des Finances, Québec

Table 6
Revenue sources in Canada

Tax base	Available at federal level?	Available at provincial level?
Personal income tax	Y	Y
Corporate income tax	Y	Y
Sales tax	Y	Y
Payroll tax	Y	Y
Gambling tax		Y
Alcohol tax		Y
Natural resources		Y
Tariffs	Y	
Taxes on non-residents	Y	

Source: Department of Finance Canada

Table 7.

Federal transfers to the three territories, \$m, 2003-04

	Nunavut	NWT	Yukon
Canada Health and Social Transfer:			
Cash	25	22	23
Tax points	10	28	13
Total	35	50	36
Health Reform Fund	1	1	1
Territorial Formula Financing	664	581	409
Total Major Transfers	700	632	446
<i>Federal transfers as % of territory revenues</i>	<i>91</i>	<i>52</i>	<i>73</i>

Source: Department of Finance, Federal-Provincial Relations Division

Table 8

Party shares of the vote, Canada, 1997 and 2000 federal elections

Region	Liberal		Alliance (1997: Reform)		Prog Cons		NDP		Bloc		Other	
	1997	2000	1997	2000	1997	2000	1997	2000	1997	2000	1997	2000
Atlantic	32.8	40.7	9.0	10.2	33.8	31.3	23.7	16.5			0.7	1.2
Québec	46.7	44.2	0.3	6.2	22.2	5.6	2.0	1.8	37.9	39.9	1.0	2.3
Ontario	49.5	51.5	19.1	23.6	18.8	14.4	10.7	8.3			1.8	2.2
West	27.6	25.3	43.0	49.9	10.5	10.0	16.7	12.3			2.2	2.6
Canada	38.5	40.8	19.4	25.5	18.8	12.2	11.0	8.5	10.7	10.7	1.6	2.3

Source: Elections Canada; Blais et al 2002 Table 4.1

Table 9a

First and second preferences, Canada, excluding Québec, 2000

2 nd pref	Reported vote			
	Liberal	Alliance	Prog Cons	NDP
Liberal		27	45	48
Alliance	13		17	3
Prog Cons	34	38		17
NDP	24	7	14	
Other, DK, None	29	29	25	32
Total	100	100	100	100
<i>N</i>	559	455	169	160

Table 9b

First and second preferences, Québec, 2000

2 nd pref	1 st pref	
	Liberal	Bloc
Liberal		14
Bloc	16	
Alliance	16	16
Progt Cons	26	17
NDP	4	11
Other, DK, None	39	43
Total	100	100
<i>N</i>	254	280

Source: derived from Blais et al 2002 Table 4.3. Columns with fewer than 50 respondents suppressed. Columns may not total 100 because of rounding.

Table 10

Credit ratings of Governments in Canada (in basis points), 2002

	Spread on 10 years bond	Rate (S&P)
Federal government	-	AAA
Alberta	29	AA+
Ontario	38	AA-
BC	44	AA-
Manitoba	44	AA-
New Brunswick	47	AA-
Saskatchewan	45	A+
Québec	55	A+
Nova Scotia	59	A-
Newfoundland	60	A-

Source: Séguin 2002, Table 5

Appendix: interviews, June 2003

Albert	Mario	Sous-ministre adjoint, Ministère des finances, Gouvernement de Québec
Anderson	George	Deputy Minister, Natural Resources Canada
Banting	Keith	School of Policy Studies, Queen's University
Blais	André	Professor of Politics, Université de Montreal
Boadway	Robin	Professor of Economics, Queen's University
Brown	Douglas	School of Policy Studies, Queens University
Butt	Chris	Director, Fiscal Policy, Government of Nfld & Labrador
Castonguay	Yves	Directeur, Secrétariat aux affaires intergouvernementales canadiennes, Gouvernement de Québec
Conrad	Alexis	Intergovernmental Affairs, Privy Council Office
Courchene	Tom	School of Policy Studies, Queens University
Déry	Patrick	Directeur, Directions des relations fédérales-provinciales, Ministère des finances, Gouvernement de Québec
Des Rosiers	Frank	Senior Director, Natural Resources Canada
Dunnewold	Alyce	Intergovernmental Affairs, Privy Council Office
Feehan	James	Professor of Economics, Memorial University, Newfoundland
Flack	Graham	Privy Council Office
Freda	Randy	Economist, Federal-Provincial Affairs Division, Department of Finance, Canada
Lazar	Harvey	Institute of Intergovernmental Relations, Queen's University
Leslie	Peter	Dept of Political Studies, Queen's University
Mellett	Russell	Intergovernmental Affairs, Privy Council Office
Noël	Alain	Member, Commission sur le déséquilibre fiscal, Québec
Smith	Douglas	Assistant Deputy Minister, Intergovernmental Affairs, Govt of Nfld & Labrador
St-Hilaire	France	Vice-president, Research, IRPP, Montreal
Vaillancourt	François	Professor of Economics, Université de Montreal
Vanderloo	Christine	Intergovernmental Affairs, Privy Council Office
Whillans	David	Intergovernmental Affairs, Privy Council Office
Wolfe	Douglas	Intergovernmental Affairs, Privy Council Office

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Glossary

Alta	Alberta
BC	British Columbia
BQ	Bloc Québécois
CA	Canadian Alliance
CHST	Canada Health & Social Transfer
GDP	Gross domestic product
HFE	Horizontal fiscal equalisation
Lib	Liberal
Man	Manitoba
NB	New Brunswick
NDP	New Democratic Party
Nfld	Newfoundland & Labrador
NS	Nova Scotia
NWT	North West Territory
Ont	Ontario
PC	Progressive Conservative
PEI	Prince Edward Island
Que	Québec
S&P	Standard & Poors
Sask	Saskatchewan
VFI	Vertical fiscal imbalance