

**Titre:** The politics of chequebook federalism: can electoral considerations affect federal-provincial transfers?  
Title: affect federal-provincial transfers?

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**Date:** 2014

**Type:** Article de revue / Article

**Référence:** Joanis, M. (2014). The politics of chequebook federalism: can electoral considerations affect federal-provincial transfers? *SPP Research Papers*, 7(25).  
Citation: <https://doi.org/10.11575/sppp.v7i0.42480>

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## Document publié chez l'éditeur officiel

Document issued by the official publisher

**Titre de la revue:** SPP Research Papers (vol. 7, no. 25)  
Journal Title:

**Maison d'édition:** School of Public Policy, University of Calgary  
Publisher:

**URL officiel:** <https://doi.org/10.11575/sppp.v7i0.42480>  
Official URL:

**Mention légale:**  
Legal notice:



Volume 7 • Issue 25 • September 2014

# THE POLITICS OF CHEQUEBOOK FEDERALISM: CAN ELECTORAL CONSIDERATIONS AFFECT FEDERAL-PROVINCIAL TRANSFERS?†

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## SUMMARY

Canada's equalization program is supposed to ensure that provinces that lack the same ability to raise revenue as other provinces, due to economic differences, are still able to provide their residents with roughly similar levels of public service. The equalization program itself is ostensibly based on a formulaic approach, with automatic equalization payments kicking in where and when they are needed, while federal social transfers to the provinces are, at least by name, purportedly intended to support the social spending needs of those provinces. This is how things are supposed to work, anyway.

But both equalization payments and social transfers are, inevitably, arranged by federal politicians, and politicians have a natural tendency to behave politically. An analysis shows that, in many cases, the amount of money a province receives in federal transfers is correlated with the way that province voted during federal elections. In other words, when a province exhibited dominant support for the national party that controls the federal purse strings, that province often received a greater share of federal transfers. Where provinces were largely unsupportive in a federal election for the victorious party, they were more likely to see their share of federal transfers shrink.

This dynamic ultimately defeats the real purpose of federal transfers, which are intended to assist based on need, not based on political support. When transfer programs are modified for reasons other than need, one might rightly worry about suboptimal use of scarce public resources, while publicly undermining the legitimacy of what may be, in principle, worthy federal programs.

Protecting against the influence of politics in such programs is vital to maximizing their efficiency and retaining their credibility. These programs can be redesigned in ways that safeguard against political interference. Appointing an independent body to manage fiscal transfer programs could be an important first step, as would putting constraints on the ability of the federal government to impose sudden floors and ceilings on transfers, or to cut special side deals with individual provinces or regions. Politicians will always behave politically; it is important to find ways to keep them from letting politics distort the principles of federal-provincial transfers.

† For their comments on an earlier draft, thanks to Bev Dahlby, Bob Young, Alejandro Esteller-Moré, and the participants of the Equalization Grants Conference held in Calgary, Alta. on Jan. 28 and 29, 2014. Special thanks also to Ergete Ferede.

## INTRODUCTION

Equalization and other intergovernmental grants are typically allocated across jurisdictions according to a formula. This generally precludes politically induced distortions in the short run. Yet even formula-based programs may be prone to political influences, through ad hoc changes to the formula or more comprehensive modifications when the intergovernmental fiscal arrangements are renewed or undergo major reforms.

It is important for scholars of fiscal federalism to understand how political forces influence the design and evolution of transfer programs. From a positive perspective, the continuing interplay of political forces implies that the *de facto* state of fiscal federalism (intergovernmental grants, degree of expenditure and revenue decentralization, etc.) is constantly evolving, rather than being a fixed set of *de jure* institutional characteristics inherited, for instance, from decisions made at the constitutional table. From a normative point of view, politics can thus, over time, create important wedges between the *de facto* fiscal federalism and the *de jure* constitutional objectives of intergovernmental fiscal arrangements, with potentially important welfare and policy implications. For example, the proliferation of electorally motivated side deals between the central government and some subnational jurisdictions may, in the long run, undermine an equalization program's ability to equalize fiscal capacities.

The key role that the political dimension of fiscal federalism can play has been recognized by the development of theoretical models of a so-called second generation of fiscal federalism, in which the political-economy dimension is explicitly modelled. In various areas of the field, empirical research has confirmed the empirical relevance of the political dimension, making it an inescapable part of a complete analysis of policy options for reforming intergovernmental fiscal arrangements.

This paper argues that the evolution of Canada's federal-provincial fiscal arrangements under the Constitution Act of 1982 can be fruitfully analyzed through the lenses of second-generation fiscal-federalism theory. The focus is on the impact that changes in the political conditions within a province have on changes in a province's federal transfers. Despite the stability of the constitutional texts, the fiscal arrangements have gone through a long series of changes. For example, since 1982, the equalization program has been modified to include such devices as: the Atlantic Accords, floors, ceilings, changes to the representative tax system (RTS), and changes to the inclusion rate of natural resource revenues, among other devices. And over the same period, the social transfers have transitioned from the original cost-sharing approach to per capita block grants.

Fixed-effect regression results exploiting data from the 1982-2012 period show a statistically significant relationship between changes in both federal and provincial electoral variables and changes in a province's total federal transfer revenues. Perhaps unsurprisingly, changes to social transfers appear to be more reactive to changes in the political environment than do changes in equalization transfers.

The paper proceeds as follows. In the next section, it briefly reviews the second-generation fiscal-federalism literature. The section following then provides a historical overview and critical assessment of Canada's fiscal arrangements since 1982. A subsequent section reports the results of an empirical assessment of the relationship between electoral politics and federal transfers in Canada over the long run. Some policy implications and concluding remarks are provided in the final section of this report.

## THE SECOND-GENERATION PERSPECTIVE ON FISCAL FEDERALISM

Much of the theoretical literature on fiscal federalism is based on Oates's Decentralization Theorem.<sup>1</sup> But as Oates himself notes,<sup>2</sup> the Decentralization Theorem can be seen as belonging to a first-generation theory (FGT) of fiscal federalism. Its basic premise is "that government agencies, as 'custodians of the public interest,' would seek to maximize social welfare."

Models of the second-generation theory (SGT) of fiscal federalism typically depart from the assumption of benevolent government, considering explicitly the political dimension in public choices<sup>3</sup> or issues of imperfect information.<sup>4</sup> A decade ago, Wilson and Janeba<sup>5</sup> remarked that "the political economy approach to fiscal federalism remains relatively unexplored." The field has blossomed since, through both theoretical and empirical contributions.

Turning our attention to this paper's main issue of interest, intergovernmental transfers, Dixit and Londregan<sup>6</sup> were among the first to formalize the use of transfers as instruments for (re)distributive politics. An important aspect of the SGT line of research is its focus on how the political considerations at each level of government can shape policy outcomes, an area sparked by Bardhan and Mookherjee's work on relative capture at the local and central levels.<sup>7</sup> At the heart of several SGT models are intergovernmental strategic interactions and externalities that operate through the political process — both horizontal and vertical — an area pioneered by Breton's<sup>8</sup> account of competitive governments, as well as Salmon.<sup>9</sup> So far, the main focus of the SGT literature has been on horizontal interactions. For example, Besley and Coate's influential model<sup>10</sup> predicts the misallocation of public goods as a result of conflicts of interest in a centralized legislature and horizontal interactions among subnational governments. Lockwood, Wildasin, and Hindricks and Lockwood<sup>11</sup> study related horizontal considerations.

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<sup>1</sup> Wallace E. Oates, *Fiscal Federalism* (New York: Harcourt Brace, 1972).

<sup>2</sup> Wallace E. Oates, "Toward a Second-Generation Theory of Fiscal Federalism," *International Tax and Public Finance* 12 (2005): 349-373.

<sup>3</sup> For example: Barry R. Weingast, "Second Generation Fiscal Federalism: The Implications of Fiscal Incentives," *Journal of Urban Economics* 65 (2009): 279-293.

<sup>4</sup> For example: Paul Seabright, "Accountability and Decentralisation in Government: An Incomplete Contracts Model," *European Economic Review* 40 (1996): 61-89.

<sup>5</sup> John D. Wilson and Eckhard Janeba, "Decentralization and International Tax Competition," *Journal of Public Economics* 89 (2005): 1211-1229.

<sup>6</sup> Avinash Dixit and John Londregan, "Fiscal Federalism and Redistributive Politics," *Journal of Public Economics* 68 (1998): 153-180.

<sup>7</sup> Pranab Bardhan and Dilip Mookherjee, "Capture and Governance at Local and National Levels," *American Economic Review: Papers & Proceedings* 90, 2 (2000): 135-139.

<sup>8</sup> Albert Breton, *Competitive Governments: An Economic Theory of Politics and Public Finance* (Cambridge: Cambridge University Press, 1996).

<sup>9</sup> Pierre Salmon, "Decentralisation as an Incentive Scheme," *Oxford Review of Economic Policy* 3, 2 (1987): 24-43.

<sup>10</sup> Timothy Besley and Stephen Coate, "Centralized versus Decentralized Provision of Local Public Goods: A Political Economy Approach," *Journal of Public Economics* 87 (2003): 2611-2637.

<sup>11</sup> Ben Lockwood, "Distributive Politics and the Costs of Centralization," *Review of Economic Studies* 69, 2 (2002): 313-337; David E. Wildasin, "The Institutions of Federalism: Toward an Analytical Framework," *National Tax Journal* 57, 2 (2004): 247-72; Jean Hindricks and Ben Lockwood, "Decentralization and Electoral Accountability: Incentives, Separation and Voter Welfare," *European Journal of Political Economy* 25 (2009): 385-397.

The potentially negative accountability consequences of the above political-economy dimensions have received considerable attention.<sup>12</sup> For example, Brueckner refers to “partial fiscal decentralization” as a situation where spending authority is devolved to the subnational level while financing relies on transfers from the central government.<sup>13</sup> Recent contributions by Devarajan et al.<sup>14</sup> and Joanis,<sup>15</sup> among others, have highlighted the potential for such institutional arrangements (that come in various brands) to impede the ability of citizens to hold subnational and local governments accountable for budgetary allocations and their outcomes. On equalization and accountability, see Kotsogiannis and Schwager.<sup>16</sup>

A key feature of the SGT literature, as opposed to the FGT literature, is a focus on positive rather than normative predictions, thus, providing foundations for empirical research. Generally speaking, the empirical literature based on the SGT models supports the importance of politics as a determinant of the state of fiscal federalism — for instance, see Jametti and Joanis.<sup>17</sup> More specifically, a geographically diverse set of studies document the electoral determinants of intergovernmental transfers. This literature has roots in early empirical work on the New Deal.<sup>18</sup> More recent U.S. studies include Grossman<sup>19</sup> and Borck and Owings.<sup>20</sup> Influential contributions on European countries are: Case’s analysis of Albanian transfers,<sup>21</sup> Dahlberg and Johansson,<sup>22</sup> and Johansson,<sup>23</sup> on Swedish transfers to municipalities; and Solé-Ollé and Sorribas-Navarro’s work on Spanish transfers.<sup>24</sup>

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<sup>12</sup> Timothy Besley, *Principled Agents? The Political Economy of Good Government* (Oxford: Oxford University Press, 2006).

<sup>13</sup> Jan K. Brueckner, “Partial fiscal decentralization,” *Regional Science and Urban Economics* 39, 1 (2009): 23-32.

<sup>14</sup> Shantayanan Devarajan, Stuti Khemani and Shekhar Shah, “The Politics of Partial Decentralization,” in *Does Decentralization Enhance Service Delivery And Poverty Reduction?*, ed. Ehtisham Ahmad and Giorgio Brosio (Cheltenham, U.K.: Edward Elgar, 2009).

<sup>15</sup> Marcellin Joanis, “Shared accountability and partial decentralization in local public good provision,” *Journal of Development Economics* 107 (2014): 28-37.

<sup>16</sup> Christos Kotsogiannis and Robert Schwager “Accountability and fiscal equalization,” *Journal of Public Economics* 92, 12 (2008): 2336-2349.

<sup>17</sup> Mario Jametti and Marcellin Joanis, “The Rise of Partial Decentralization and Shared Responsibility Federalism,” in *World Report on Fiscal Federalism 09*, ed. Núria Bosch et Albert Solé-Ollé (Barcelona: Institut d’Economia de Barcelona, 2009); Mario Jametti and Marcellin Joanis, “Electoral Competition as a Determinant of Fiscal Decentralization,” working paper 3574 (CESifo 2011); Mario Jametti and Marcellin Joanis, “The Political Economy of Fiscal Decentralization: Evidence from the Canadian Federation,” mimeo, 2011.

<sup>18</sup> Gavin Wright, “The Political Economy of New Deal Spending: An Econometric Analysis,” *The Review of Economics and Statistics* 56, 1 (1974): 30-38.

<sup>19</sup> Philip J. Grossman, “A Political Theory of Intergovernmental Grants,” *Public Choice* 78, 3-4 (1994): 295-303.

<sup>20</sup> Rainald Borck and Stephanie Owings, “The political economy of intergovernmental grants,” *Regional Science and Urban Economics* 33, 2 (2003): 139-156.

<sup>21</sup> Anne Case, “Election goals and income redistribution: Recent evidence from Albania,” *European Economic Review* 45 (2001): 405-423.

<sup>22</sup> M. Dahlberg and E. Johansson, “On the vote-purchasing behavior of incumbent governments,” *American Political Science Review* 96, 1 (2002): 27-40.

<sup>23</sup> Eva Johansson, “Intergovernmental grants as a tactical instrument: empirical evidence from Swedish municipalities,” *Journal of Public Economics* 87, 5-6 (2003): 883-915.

<sup>24</sup> Albert Solé-Ollé and Pilar Sorribas-Navarro, “The effects of partisan alignment on the allocation of intergovernmental transfers. Differences-in-differences estimates for Spain,” *Journal of Public Economics* 92, 12 (2008): 2302-2319.

In Canada, Young and Sharman have empirically documented the relationship between provincial politics and the allocation of federal transfers across provinces.<sup>25</sup> Milligan and Smart have studied the related issue of the federal electoral determinants of federal grants for regional development (e.g., infrastructure),<sup>26</sup> while Jametti and Joanis empirically investigate the relationship between both provincial and federal politics and within-province decentralization.<sup>27</sup> On the politics of equalization and of federal-provincial negotiations, respectively, see the recent work of Lecours and Béland, and also Esselment.<sup>28</sup> But it is probably fair to say that empirical research based explicitly on an SGT framework remains scarce in Canada. This paper aims to address this relative scarcity with an empirical assessment of the influence of the provincial and federal political environments on changes to the federal-provincial fiscal arrangements.

## THE EVOLUTION OF CANADA'S FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

The last three decades have seen a series of changes to Canada's main federal-provincial transfers. This section provides a critical overview of some of these developments.

### The 1980s and 1990s

The period from the repatriation of the Constitution in 1982 to the end of the 1990s was characterized by a progressive decline of the importance of federal transfers in provincial revenues, in a context of fiscal consolidation by the federal government. On the one hand, following its inclusion in the Constitution in 1982, the equalization program's redistribution power was limited by the five-province standard<sup>29</sup> and ceiling and floor provisions. However, it must be noted that 100 per cent of oil revenues were included in provincial fiscal capacities. On the other hand, the social transfers saw a transition from a mixed model of cost-sharing (Canada Assistance Plan) and block grants (Established Programs Financing) to a block funding model with the creation, in 1995, of the Canada Health and Social Transfer (CHST).

By the end of the 1990s, with the federal government's public finances back in surplus territory, there was growing dissatisfaction among the provinces with the current state of the fiscal arrangements. To get a sense of provincial demands at the time, a useful starting point is the comprehensive review of Canada's fiscal federalism performed in 2001 and 2002 by Quebec's commission on fiscal imbalance.<sup>30</sup>

<sup>25</sup> Robert Young and Campbell Sharman, with Andrew Goldstein, "The Partisan Component in Intergovernmental Transfers," in *Reforming Fiscal Federalism for Global Competition: A Canada-Australia Comparison*, ed. P. M. Boothe (Edmonton, Alta.: University of Alberta Press, 1996).

<sup>26</sup> K. Milligan and M. Smart, "Regional grants as pork barrel politics," working paper 1453 (CESifo, 2005).

<sup>27</sup> Jametti and Joanis, "The Political Economy."

<sup>28</sup> André Lecours and Daniel Béland, "Federalism and Fiscal Policy: The Politics of Equalization in Canada," *Publius: The Journal of Federalism* 40, 4 (2010): 569-596; Anna Lennox Esselment, "Fighting Elections: Cross-Level Political Party Integration in Ontario," *Canadian Journal of Political Science* 43, 4 (2010): 871-892.

<sup>29</sup> Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.

<sup>30</sup> The commission was presided by Yves Séguin, who would go on to serve as minister of finance in former Quebec premier Jean Charest's first (Liberal) cabinet. Though the resulting report was hardly an apolitical exercise — it was commissioned by Bernard Landry's Parti Québécois government — it was well received in provincial-government circles across the country and would be an important building block of subsequent positions adopted by the Council of the Federation.

## Quebec's Séguin commission (2001-2002)

The Séguin report was tabled to the Quebec government on March 7, 2002. Its main recommendations were:<sup>31</sup>

- To address vertical fiscal imbalance, the replacement of the CHST by a once-and-for-all “tax-point” transfer, either on the personal-income-tax base (PIT) or the sales-tax base (GST/PST);
- To address horizontal fiscal imbalance, various changes to the equalization program, many of them related to the integral respect of the representative tax system (RTS); and
- Various changes to the institutional framework of the federal-provincial fiscal arrangements, mainly to reduce the federal government’s ability to arbitrarily make changes to the arrangements.

Table 1 presents the detail of the commission’s main recommendations and whether or not they have since been implemented.

**TABLE 1. FOLLOW-UP ON THE RECOMMENDATIONS OF QUEBEC'S COMMISSION ON FISCAL IMBALANCE**

<b>Recommendation</b>	<b>Implemented?</b>
Abolishing the social transfers	No Now per capita transfers
Common strategy with other provinces	Yes 2006 committee of the Council of the Federation
<b>Recommendations pertaining to equalization</b>	
10-province norm	Yes (2007)
Elimination of “ceilings” and “floors”	No Such limits remain in place
Integral respect of the RTS: including all revenue sources, new approach for property taxes, inclusion of fees	No (partially) Adoption of a five-bases RTS, new approach for property taxes, exclusion of fees and partial exclusion of natural resource revenues (2007)
No methodological or data changes between two five-year plans	No Ottawa continues to unilaterally impose changes to the fiscal arrangements

*Source: Author's compilation from Commission on Fiscal Imbalance, A New Division of Canada's Financial Resources, Final Report, Government of Quebec, 2002.*

## The fiscal arrangements after the Séguin report

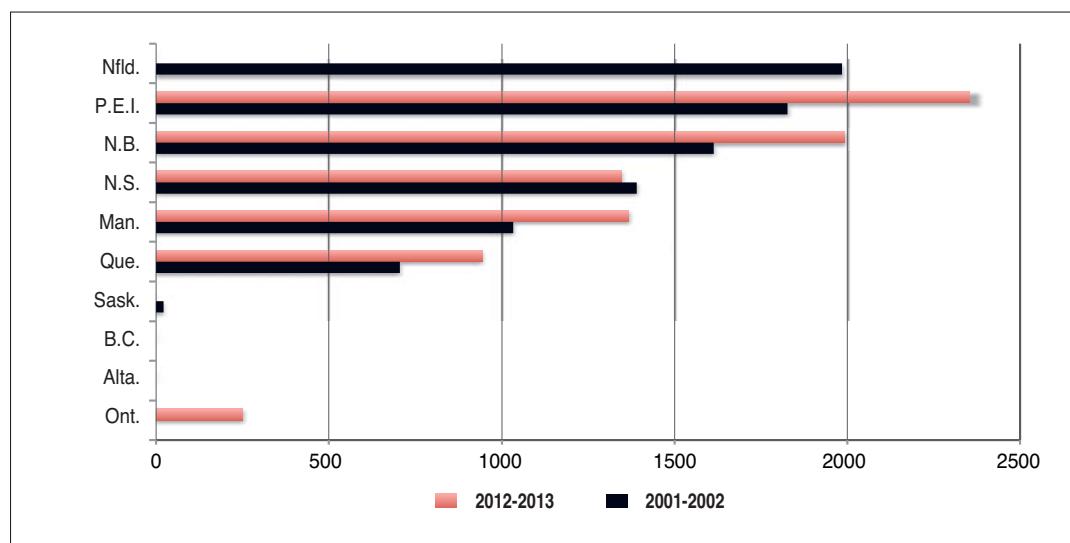
It is interesting to note, in retrospect, that issues pertaining to natural resources were almost entirely absent from the commission’s report. A noteworthy exception was a critique of the Atlantic Accords signed in the mid-’80s, between the federal government and Newfoundland and Nova Scotia, in order to protect provincial revenues derived from the ongoing development of extra-coastal oil fields until these provinces had witnessed a significant

<sup>31</sup> These recommendations were guided by three “principles of fiscal balance”: an accountability principle, a fiscal-capacity principle and an autonomy principle.

improvement of their economic situation. In the meantime, they were to keep 100 per cent of these revenues (provided that they were still equalization-receiving provinces). The commission's position was that these ad hoc deals posed equity issues among equalization-receiving provinces, and that they violated the very spirit of the program — i.e., compensating relative disparities among provinces.

The years that followed the tabling of the commission's report saw the emergence of natural resource revenues as the prominent issue related to equalization. As shown by Figure 1, Newfoundland has demonstrated, over a decade, how natural resource revenues can effectively transform a “have-not” province into a “have” province. Meanwhile, these revenues have had the tendency to foster horizontal fiscal imbalance and have led to rising pressures on the federal government from the cost of the program, pressures from which the federal government would try to isolate itself as much as possible.

**FIGURE 1. EVOLUTION OF EQUALIZATION PAYMENTS PER CAPITA SINCE 2002 (IN CURRENT DOLLARS)**



*Source: Commission on Fiscal Imbalance, A New Division of Canada's Financial Resources, Final Report (Government of Quebec, 2002); Government of Quebec, 2013-14 Budget.*

In 2004, the federal government announced a major overhaul of the equalization program. In that announcement, the government essentially ended the program's traditional functioning (in place since 1982) by adopting a fixed budgetary envelope for the program, assorting with an annual indexation factor of 3.5 per cent. This was an important departure from the principles put forth by the Séguin commission two years earlier. Furthermore, the following year, the federal government would announce that the Atlantic Accords were renewed.

In 2006, both the federal government and the provinces felt the need to rethink the equalization program once more. Two reports would eventually be produced, one by the Council of the Federation and one by the O'Brien federal task force.

## The O'Brien report and its aftermath

The O'Brien report's main recommendations, all pertaining to the equalization program, were:

- To simplify the RTS by reducing the number of tax bases from 33 to five, one of which would be devoted to natural resources;
- To adopt a 10-province standard; and
- To set the inclusion rate of natural resource revenues at 50 per cent.

While in line with the Séguin commission on the 10-province standard, the 50 per cent inclusion rate for natural resource revenues can be seen as violation of the integral respect of the RTS defended by the commission. Yet, it represented a compromise with those advocating their full exclusion on the basis that natural resources are provincially owned according to the Constitution.<sup>32</sup>

A new formula was announced in the 2007 federal budget, based on the O'Brien proposals. With respect to natural resources, provinces were now receiving the highest amount of a formula based on either 50 per cent or zero per cent of these revenues. This departure from the O'Brien report was introduced in order to fulfil the Conservative party's electoral promise to fully exclude natural resource revenues from the equalization formula.

In November 2008, Ottawa unilaterally announced the reintroduction of two ceiling-provisions to the program:

1. A province-specific ceiling: a receiving province cannot be "richer" than the average of the receiving provinces; and
2. A program-wide ceiling: the program's budget increases according to a three-year moving average of the country's nominal GDP growth.

The province-specific ceilings have been binding for some provinces. Quebec and Nova Scotia, because of their natural resource revenues, have received less than they would have received based on the 2007 formula.<sup>33</sup> Given this, it is unsurprising that Quebec demands that these ceilings be abolished in order to return to the 2007 formula.<sup>34</sup>

In the meantime, the CHST has been divided into a health transfer (CHT) and a higher-education and social-assistance transfer (CST), which are now essentially allocated among provinces on a per capita basis, whereas social transfers included an equalization portion in the past.

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<sup>32</sup> The O'Brien report reviewed a series of other arguments in favour of an intermediate inclusion rate, including considerations related to the volatility of natural resource revenues and to the disincentive effect of equalization's "tax back" of revenues accruing from the development of the natural resource industries.

<sup>33</sup> Quebec Department of Finance, 2013-14 Budget.

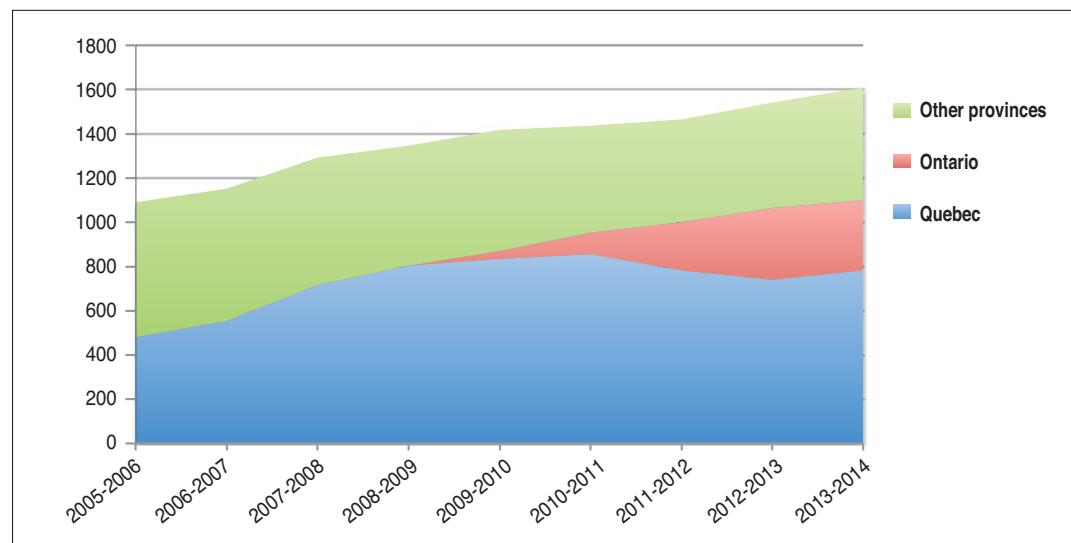
<sup>34</sup> Protection payments should remain in order to avoid a year-to-year decline in a province's equalization payments. Quebec also demands that Hydro-Québec's transportation activities be treated the same as, in Ontario, Hydro One's (by the corporate income tax base). Overall, these demands can be seen as consistent with the Séguin report's recommendations.

Generally speaking, since the Séguin commission tabled its report in 2002, the fiscal arrangements have moved in a direction opposite from its recommendations. The developments of the last decade (and more) appear to have especially steered the equalization program away from the constitutional principle of fiscal-capacity equalization:

- The Atlantic Accords have been renewed;
- The spirit of those accords has been, in a sense, generalized by the partial exclusion of natural resource revenues from fiscal-capacity calculations;
- Ceiling and floors are still in place; and
- Federal unilateralism in the program's management remains.

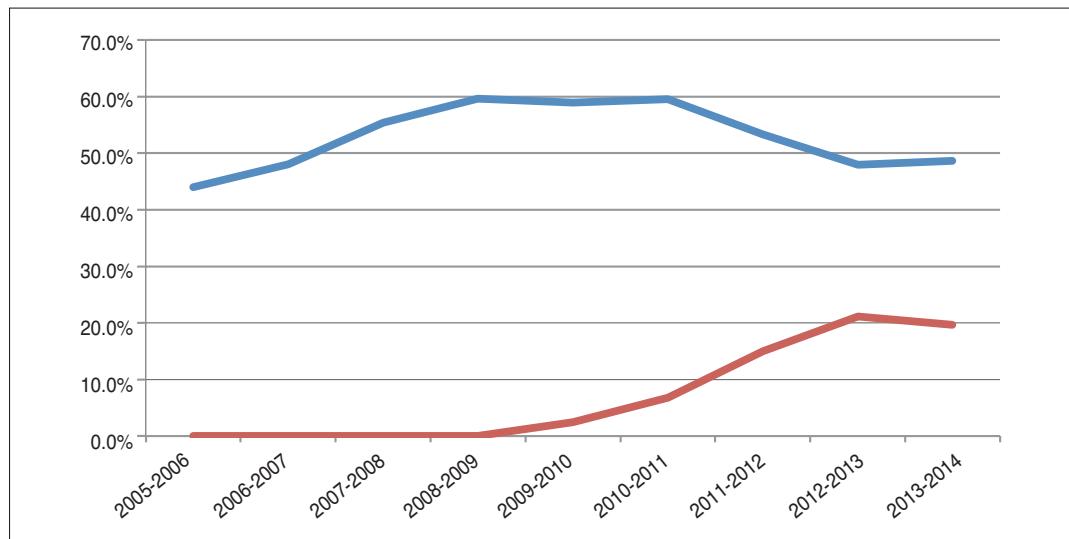
Yet, as shown by Figure 2, the equalization program increasingly benefits Central Canada (Quebec and Ontario). With the ceiling provisions currently in place, any “gain” by one province has to come at the expense of the others. Figure 3 captures that new dynamic of equalization. Since Ontario received its first equalization payments in 2009-2010, its share of the program's total envelope has already reached 20 per cent. Meanwhile, Quebec has seen its share decline by 10 percentage points.

**FIGURE 2. PROVINCIAL BREAKDOWN OF THE EQUALIZATION BUDGET (MILLIONS \$)**



Source: Finance Canada.

**FIGURE 3. QUEBEC AND ONTARIO SHARES OF THE EQUALIZATION BUDGET (%)**



*Source: Finance Canada.*

### **A SGT perspective on recent developments**

Consistent with a SGT perspective on fiscal federalism, the Canadian fiscal arrangements are the result of an ongoing trade-off between three oft-conflicting objectives:

1. Respecting the equalization program's constitutional principle;
2. Ensuring the political acceptability of all transfer programs; and
3. Respecting the federal government's budget constraints.

Objective 1 would militate, for example, against a preferential treatment for natural resource revenues. Yet, Objective 2 has tended in recent years to limit redistribution of these revenues as a response to political considerations (mostly in the West). Objective 3 supplies an additional limit to redistribution when horizontal fiscal imbalances become too important given the federal government's fiscal-policy targets. The latter has arguably dominated the federal government's choices since the mid-1990s. With the centre of gravity of federal politics having shifted westward over the last decade, objectives 2 and 3 have aligned themselves as forces acting towards limiting the extent of redistribution through the equalization program. In recent years, the pursuit of the last two objectives thus appears to have been instrumental in weakening Objective 1.

These developments suggest that political-economy considerations might be at work in shaping the fiscal arrangements. The next section further investigates the potential political determinants of federal-provincial transfers in Canada.

## ELECTIONS AND FEDERAL TRANSFERS: AN EMPIRICAL INVESTIGATION

The previous section has highlighted the recent evolution of federal-provincial transfer programs, hypothesizing that some of this evolution may be rationalized by political-economy considerations, in particular by the evolution of the country's political landscape. This section presents the results of an econometric analysis of the correlation between federal politics by province, provincial politics, and the allocation of federal transfers to the provinces, over the past three decades (1982-2012).

### Data, variables and summary statistics

The analysis exploits Finance Canada data on the yearly amounts transferred by the federal government to each province as equalization grants and as social transfers, used to construct the dependent variable in the regressions that follow. These figures are first coupled with Elections Canada data on federal electoral results by province for each election held since 1980. We thus cover four “eras” in federal politics, defined by the party in power:

1. The end of the Liberal era of Pierre Trudeau/John Turner (1982-1984);
2. The Progressive Conservative era of Brian Mulroney/Kim Campbell (1984-1993);
3. The Liberal era of Jean Chrétien/Paul Martin (1993-2006); and
4. The ongoing Conservative era of Stephen Harper (2006-2012).

The federal electoral data is used to construct the main independent variable of interest, the vote share enjoyed in each province by the *federal* party currently in power. The appendix plots, for each province, this vote-share variable (on the left axis) against the province's share of total federal transfers (the sum equalization and social transfers, on the right axis). In some provinces, upon visual inspection, a positive correlation between the two variables is striking. For example, in Newfoundland and Labrador (Figure A1), the province's share of federal transfers declines sharply from the turn of the century onward, which coincides with a decline in the province's support of the parties in power in Ottawa (an erosion of support for the Chrétien/Martin Liberals first, followed by the province's low support for the Harper Conservatives). To a large extent, the correlation between the two series is similar looking in the three Maritime provinces (Figures A2 to A4). In Quebec, the overall trend also suggests a positive correlation, with both the share of transfers and the support for the federal party in power declining over the period. It must however be acknowledged that Quebec's share of transfers has followed an uneven pattern (Figure A5): it was declining in the 1980s, rising in the 1990s before declining from the turn of the century onward (with a significant but temporary rebound in the mid-2000s). Ontario (Figure A6), by contrast, has received a growing share of federal transfers over the period, with the exception of most of the 1990s, despite the province's strong support for the then-ruling Liberal party. In the Western provinces (figures A6 to A10), the positive correlation is most striking for Alberta (Figure A9).

The other political variables are a series of dummies constructed from provincial elections data: provincial election years, minority governments, and the partisan affiliation of provincial governments. For the latter, the omitted category is always NDP government. Finally, the

partisan alignment of the federal and provincial governments in a province is captured by two additional dummies (Conservative and Liberal).<sup>35</sup> Table 2 presents summary statistics for all variables used in the analysis, including economic, demographic and fiscal control variables.

In order to go beyond visual inspection and bivariate correlations, tables 3 to 5 present the results of a series of regressions based on a 30-year panel of the 10 provinces. In each table, the dependent variable captures federal transfers (total, equalization only or social transfers only), measured as provincial shares (as in the graphs discussed above) and, in Specification (7), as a robustness check, in real per capita dollar amounts. All specifications include province and year fixed-effects, such that the estimated coefficients are always identified within province, controlling for trends that are common to all provinces — the focus is thus on the impact that *changes* in the political conditions within a province have on *changes* in a province's federal transfers. Standard errors are everywhere adjusted for within-province federal-electoral-cycle clusters to account for repeated observations within a province during a federal electoral cycle.

TABLE 2. SUMMARY STATISTICS

Variable	Obs	Mean	Std. Dev.	Min	Max
Total transfers (shares in %)	310	9.976389	10.24406	.9113534	39.25079
Equalization (shares in %)	310	9.999879	14.20616	0	59.63453
Social transfers (shares in %)	310	9.965084	11.29284	.4217021	39.41641
Total transfers (cst \$ per capita)	310	1580.526	745.3536	345.7121	2955.462
Equalization (cst \$ per capita)	310	819.3699	724.0948	0	2336.773
Social transfers (cst \$ per capita)	310	761.156	143.2848	345.7121	1052.41
Provincial vote share of the federal party in power (%)	330	41.11885	11.98568	16.5	68.8
Provincial election year (dummy)	330	.2606061	.4396319	0	1
Minority provincial government (dummy)	330	.0515152	.2213817	0	1
Conservative provincial government (dummy)	330	.4424242	.4974282	0	1
Liberal provincial government (dummy)	330	.2878788	.4534619	0	1
Parti Québécois provincial government (dummy)	330	.0454545	.2086152	0	1
Provincial government of other party (excl. NDP) (dummy)	330	.0515152	.2213817	0	1
Conservative provincial and federal governments (dummy)	330	.1939394	.3959824	0	1
Liberal provincial and federal governments (dummy)	330	.1121212	.3159947	0	1
Population (millions)	330	2.94202	3.439529	.123551	13.5059
Population share 17-	330	.2455663	.0344167	.1792294	.3708942
Population share 65+	330	.124149	.0203572	.0715073	.1716642
Unemployment rate (%)	330	9.756667	3.717547	3.4	20.2
Real GDP per capita	320	32.24559	9.495442	16.42078	67.47
Real fiscal capacity per capita	280	5.286101	1.706327	2.504063	11.87668

<sup>35</sup> For work on the importance of links between federal and provincial political parties, see: Esselment, "Fighting Elections."

## Total transfers results

In Table 3, the dependent variable is total transfers. Specification (1) is a bivariate regression mirroring the graphs discussed above. It confirms a statistically significant positive correlation between a province's share of transfers and its support for the party in power in Ottawa. In Specification (2), the effect of the vote share on the transfer share is allowed to differ in the Liberal era and in the recent Conservative era, as opposed to the pre-1993 period. The results are interesting, as they reveal differences between the Liberal and Conservative eras. The baseline correlation between votes and transfers remains positive and significant, and the Conservative era is no different than the pre-1993 period. But there is a negative correlation during the Liberal era, bigger in absolute value than the estimated baseline correlation.

TABLE 3. DEPENDENT VARIABLE: TOTAL TRANSFERS

Dependent variable	(1) Shares	(2) Shares	(3) Shares	(4) Shares	(5) Shares	(6) Shares	(7) Cst \$ p.c.
Provincial vote share of the federal party in power	.0293* (.0157)	.0632** (.0309)	.0565** (.0250)	.0349 (.0262)	-.0146 (.0152)	-.0122 (.0159)	-3.22 (3.51)
Vote share* Conservative Party in power		.0048 (.0407)	-.0307 (.0401)	-.0560 (.0403)			15.14** (7.55)
Vote share* Liberal Party in power	-.0914** (.0416)	-.1271*** (.0377)	-.0860** (.0362)				4.80 (4.23)
Population			2.36*** (.4004)	1.86*** (.3354)	1.93*** (.4928)	1.90*** (.4710)	-50.24* (29.93)
Population share 17-			-75.17*** (18.85)	-60.77*** (18.46)	-49.61*** (17.42)	-50.85*** (17.37)	-4222.02** (1962.37)
Population share 65+			-116.52*** (33.89)	-155.60*** (40.60)	-117.82*** (33.64)	-118.72*** (33.40)	-9525.26** (4125.85)
Unemployment rate			.2397*** (.0887)	.1905** (.0832)	.1984** (.0886)	.1854** (.0868)	17.44 (10.81)
Real GDP per capita			-.1459*** (.0271)		-.1273*** (.0295)	-.1324*** (.0295)	-55.52*** (7.54)
Real fiscal capacity per capita				-.9573*** (.2658)			
Provincial election year					.0234 (.1112)	.0628 (.1081)	
Minority provincial government					-.2356 (.3987)	-.3072 (.3898)	
Conservative provincial government					.1856 (.3679)	-.1940 (.4977)	
Liberal provincial government					.7686** (.3408)	1.25*** (.4750)	
Parti Québécois provincial government					3.62*** (.9818)	3.47*** (.9647)	
Provincial government of other party (excl. NDP)					.0344 (.4441)	.4458 (.5230)	
Conservative provincial and federal governments						.8388 (.5860)	
Liberal provincial and federal governments						-.9178 (.6982)	
Number of observations	310	310	310	270	310	310	310
Within R-squared (prov. fixed effects excluded)	.0291	.0828	.5403	.3863	.5477	.5567	.6870

Note: All specifications include province and year fixed effects. Standard errors (in parentheses) are adjusted for within-province federal electoral cycle clusters. Levels of statistical significance: 1% (\*\*), 5% (\*\*), 10% (\*).

This pattern is essentially unchanged when demographic and economic controls are added in Specification (3). The economic controls behave as expected: a higher unemployment rate and a lower GDP per capita are associated with a bigger share of transfers. While, as expected, an increase in population is associated with rising transfers, the coefficients on the youth and elderly population shares (both negative and significant) are more surprising. Indeed, one might expect a higher share of the young population to be positively correlated with transfers (education), the same for a higher share of the elderly (health care). But the opposite is actually observed: a negative correlation between the youth and elderly shares of the population and the share of transfers. A likely explanation for this counterintuitive result is the progressive disappearance of the cost-sharing portion of social transfers and their transformation by the end of the period into pure per capita block grants.<sup>36</sup>

In Specification (4), real fiscal capacity per capita as measured for the equalization program's purposes replaces real GDP per capita in the vector of control variables. While results are qualitatively unchanged from Specification (3), the main vote share coefficient is now statistically insignificant.

Specifications (5) and (6) introduce provincial politics in the regression. Interestingly, once these variables are included in the model, the federal vote-share coefficient is insignificant and its sign is even reversed, suggesting that federal and provincial variables are capturing similar political forces. In these specifications, two political variables are significant: the Liberal and Parti Québécois (PQ) dummies. The federal-provincial partisan-alignment dummies, added in Specification (6), are not significant here.

The last specification, (7), presents the results with the dependent variable measured in real per capita dollars. While there is still a positive and significant correlation between votes and transfers during the recent Conservative era in this specification, the main effect and the Liberal interaction are not statistically significant.

### **Equalization and social-transfer results**

Table 4 presents the results for equalization transfers only. Overall, results tend to be qualitatively and quantitatively similar to those in Table 3 but are considerably less precisely estimated. As one might expect, the results for the equalization model are dominated by the strongly significant coefficients on the GDP and fiscal-capacity variables. There are only two specifications in which a political variable is significant. In Specification (6), the Liberal dummy is positive and significant (as in the previous table). And the positive and significant correlation between votes and real transfers per capita during the recent Conservative era is confirmed for equalization by Specification (7).

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<sup>36</sup> These results show how, paradoxically, transfers seem to have evolved in the opposite direction from the share of the youth and the elderly; this is not desirable from a provincial spending-needs perspective. It might be worth revisiting the opportunity of fiscal arrangements that take into account provincial spending needs. For more on the issue of needs-based equalization programs, see, for example: Ehtisham Ahmad et al., "Why Focus on Spending Needs Factors? The Political Economy of Fiscal Transfer Reforms in Mexico," IMF Working Papers 07/252 (2007).

TABLE 4. DEPENDENT VARIABLE: EQUALIZATION TRANSFERS

Dependent variable	(1) Shares	(2) Shares	(3) Shares	(4) Shares	(5) Shares	(6) Shares	(7) Cst \$ p.c.
Provincial vote share of the federal party in power	.0210 (.0370)	.0859 (.0652)	.0200 (.0769)	.0253 (.0741)	-.0100 (.0292)	-.0008 (.0293)	-6.20 (4.07)
Vote share* Conservative Party in power		-.0763 (.0953)	-.0398 (.1000)	-.1332 (.1104)			21.30** (8.19)
Vote share* Liberal Party in power		-.0877 (.0780)	-.0378 (.0977)	-.0116 (.0867)			7.22 (4.71)
Population			1.34 (1.09)	-.1669 (.4323)	1.03 (1.16)	.9806 (1.13)	-70.71** (31.62)
Population share 17-			-23.05 (43.23)	4.59 (35.35)	-9.51 (37.33)	-10.02 (36.98)	-2100.82 (2112.56)
Population share 65+			-121.23* (65.86)	-160.50** (71.48)	-105.85 (68.22)	-97.49 (63.78)	-7406.40* (4326.20)
Unemployment rate			.0872 (.1591)	-.0065 (.1355)	.0915 (.1473)	.1253 (.1471)	5.25 (11.11)
Real GDP per capita			-.3479*** (.0676)		-.3494*** (.0705)	-.3450*** (.0691)	-54.09*** (8.29)
Real fiscal capacity per capita				-1.29*** (.4872)			
Provincial election year					.2219 (.2445)	.2441 (.2522)	
Minority provincial government					.2469 (.6769)	.3078 (.6924)	
Conservative provincial government					.6793 (.5933)	.6466 (.7771)	
Liberal provincial government					1.04 (.6549)	1.73** (.8670)	
Parti Québécois provincial government					1.61 (2.61)	1.65 (2.68)	
Provincial government of other party (excl. NDP)					.5242 (.9766)	.6368 (1.17)	
Conservative provincial and federal governments						.0133 (.9664)	
Liberal provincial and federal governments						-1.38 (1.43)	
Number of observations	310	310	310	270	310	310	310
Within R-squared (prov. fixed effects excluded)	.0052	.0190	.3190	.2159	.3259	.3335	.6465

Note: All specifications include province and year fixed effects. Standard errors (in parentheses) are adjusted for within-province federal electoral cycle clusters. Levels of statistical significance: 1% (\*\*\*)<sup>1</sup>, 5% (\*\*), 10% (\*).

Finally, the social transfers results are presented in Table 5. Here, federal politics and transfers are significantly correlated, reinforcing the total transfers results of Table 3. The baseline correlation between votes and transfers is again everywhere positive and significant (in all but two specifications), with slightly different patterns for the Liberal versus Conservative eras. Interestingly, in specifications (5) and (6), which include provincial variables, the only significant coefficient on a political variable is the PQ dummy.

Overall, the results of this section highlight statistically significant correlations between within-province trends in federal politics and trends in federal transfers received. One should, however, be careful in claiming that these results identify a causal relationship from federal

politics to transfers, as reverse causality is likely and the correlation between provincial and federal politics complicates the interpretation of results. Yet, that being said, these results confirm the general message of the previous section: political-economy considerations emerge as potentially important determinants of the provincial allocation of federal transfers in Canada, especially for social transfers and when all transfers are analyzed together. Furthermore, these results are generally in line with the typical results obtained in the empirical papers surveyed in The Second-Generation Perspective on Fiscal Federalism section of this report, found on page 2.

TABLE 5. DEPENDENT VARIABLE: SOCIAL TRANSFERS

Dependent variable	(1) Shares	(2) Shares	(3) Shares	(4) Shares	(5) Shares	(6) Shares	(7) Cst \$ p.c.
Provincial vote share of the federal party in power	.0286** (.0133)	.0623** (.0240)	.0734*** (.0182)	.0513*** (.0153)	-.0092 (.0137)	-.0069 (.0144)	2.98*** (1.02)
Vote share* Conservative Party in power		-.0054 (.0368)	-.0654* (.0341)	-.0642* (.0339)			-6.16*** (1.60)
Vote share* Liberal Party in power		-.0805** (.0321)	-.1305*** (.0265)	-.0979*** (.0254)			-2.42** (1.18)
Population			2.43*** (.1958)	2.60*** (.2216)	2.11*** (.2421)	2.09*** (.2380)	20.47** (8.40)
Population share 17-				-69.42*** (14.15)	-67.50*** (13.98)	-49.23*** (13.44)	-50.16*** (13.50)
Population share 65+				-98.46*** (27.13)	-135.90*** (29.90)	-98.59*** (31.25)	-98.69*** (30.82)
Unemployment rate				.1826** (.0741)	.1630** (.0653)	.1884** (.0734)	.1812** (.0742)
Real fiscal capacity per capita				-.0266 (.0273)		-.0230 (.0307)	-.0264 (.0302)
Real fiscal capacity					-.4964*** (.1715)		
Provincial election year						-.0423 (.0962)	-.0122 (.0963)
Minority provincial government						-.4804 (.3607)	-.5285 (.3567)
Conservative provincial government						-.1010 (.2387)	-.3789 (.3295)
Liberal provincial government						-.0959 (.2559)	.3012 (.3182)
Parti Québécois provincial government						1.97* (1.06)	1.87* (1.03)
Provincial government of other party (excl. NDP)						-.5789 (.3874)	-.2726 (.4186)
Conservative provincial and federal governments							.6103 (.4312)
Liberal provincial and federal governments							-.7577 (.4832)
Number of observations	310	310	310	270	310	310	310
Within R-squared (prov. fixed effects excluded)	.0433	.1020	.6040	.5998	.5572	.5658	.9288

Note: All specifications include province and year fixed effects. Standard errors (in parentheses) are adjusted for within-province federal electoral cycle clusters. Levels of statistical significance: 1% (\*\*), 5% (\*\*), 10% (\*).

## CONCLUSION AND POLICY IMPLICATIONS

The SGT literature on fiscal federalism has deepened our understanding of the role that politics can play as a determinant of intergovernmental transfers. Overall, the empirical results of the previous section and the anecdotal evidence from the previous one support one of the main tenets of SGT models of fiscal federalism: politics matter. Furthermore, the recent evolution of the Canadian intergovernmental fiscal arrangements emerges as a fitting application of the Second Generation framework.

From a normative point of view, future reforms to fiscal arrangements probably should take into account the reality of the political process and the potentially important wedge that political distortions can create between constitutional requirements and the *de facto* allocation of transfers. As Bednar puts it, an inherent weakness of federalism is the temptation of constituent governments to exploit the union for their own gain.<sup>37</sup> This kind of behaviour (together with trigger strategies and threats of secession) should be expected in federations, and thus, taken into account in the constitutional design rather than fought against. The federal government, which is responsible for the interpretation and practical implementation of the constitutional requirement to equalize provincial fiscal capacities, should also be expected to react to political incentives.

The following policy options can be put forward for their potential to tame the politics of intergovernmental relations.<sup>38</sup>

- A. **An independent body for managing the fiscal arrangements:** Transfer programs appear to have become a more politically charged topic in recent years. Political pressures are constantly exerted on the federal government by both the electorate and the provinces, periodically leading to ad hoc changes to the fiscal arrangements. All could arguably gain from a less political and more rational approach to the fiscal arrangements.<sup>39</sup>
  
- B. **Pre-funding the equalization program:** Should the federal government be allowed to isolate itself from cost pressures linked to the volatility of provincial fiscal capacities? It seems odd that the body responsible for administering a formula-based program — moreover, a constitutionally mandated program — can cut its costs by periodically and unilaterally imposing ceiling provisions or other changes to the program's parameters. Federal institutions should be designed in order to avoid as much as possible that sort of after-the-fact “renegotiation” of the federal pact. The current

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<sup>37</sup> Jenna Bednar, *The Robust Federation: Principles of Design* (Cambridge, NY: Cambridge University Press, 2009).

<sup>38</sup> Interestingly, while these were all considered (at least in passing) by the Séguin commission more than a decade ago, none of them made it as a recommendation in the final report.

<sup>39</sup> The Australian model is often brought forward as an interesting example, but for an empirical assessment in the Indian context see also: Stuti Khemani, “Does delegation of fiscal policy to an independent agency make a difference? Evidence from intergovernmental transfers in India,” *Journal of Development Economics* 82, 2 (2007): 464-484.

institutions have not been able to protect provinces from unilateral fiscal-policy decisions by the federal government. Together with handing over the transfer programs to an independent body, another option might be worth serious investigation: partially pre-funding the equalization program. An equalization fund with pre-determined advanced federal contributions, separate from the federal government's budget, would contribute to isolating the program from cyclical federal cost-cutting decisions while also making the program's funding more predictable for the federal government. However, such a solution would be hard to implement without an independent body (option A).

**C. A macro approach to replace equalization's RTS:** While the RTS approach is desirable in principle, the recent experience in Canada has shown how hard it is to politically enforce in its integrity (treatment of natural resource revenues, etc.). The continuing technical debates on the treatment of various special cases (hydro revenues, property taxes, etc.) creates opportunities for politically motivated side-deals and unequal treatments of equals. This adds to the well-known downside of the RTS approach: it is its opacity that makes it almost impossible for anyone outside the program's inner circle to understand its whereabouts — a problem from a political-accountability perspective. A simpler, less contentious approach should perhaps be considered given the program's recent history: a macro approach to estimating fiscal capacities based on a small number of indicators.

To many observers, Canada's system of intergovernmental grants — with its side deals, federal unilateralism, formula complexity, and so on — is broken and has turned into an assemblage that resembles a politically motivated makeshift job. Perhaps one of the most worrisome consequences of the federal unilateralism that has emerged over time in the fiscal arrangements area is the slow vanishing of what Bednar calls the “federalism consensus.”<sup>40</sup> A necessary condition for such a consensus to uphold is for the process “to spread information about common perceptions.” This is precisely what the Séguin commission argued for more than a decade ago, when it called for “a genuine process of exchanges and discussion between the two orders of government [to] be initiated on all facets of intergovernmental fiscal relations.”<sup>41</sup> That recommendation has aged rather well and, unfortunately, is more relevant today than ever.<sup>42</sup>

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<sup>40</sup> Bednar, *The Robust Federation*.

<sup>41</sup> Commission on Fiscal Imbalance, *A New Division of Canada's Financial Resources*, Final Report, Government of Quebec, 2002.

<sup>42</sup> Interestingly, while many of the recent changes to the fiscal arrangements were announced unilaterally by the federal government between five-year renewals, renewals themselves have tended, to a large extent, to confirm the status quo rather than being the occasion for full-fledged federal-provincial discussions or negotiations on reforms to the transfer programs.

## APPENDIX: PROVINCIAL GRAPHS

Atlantic Canada

— Vote share — Share of transfers

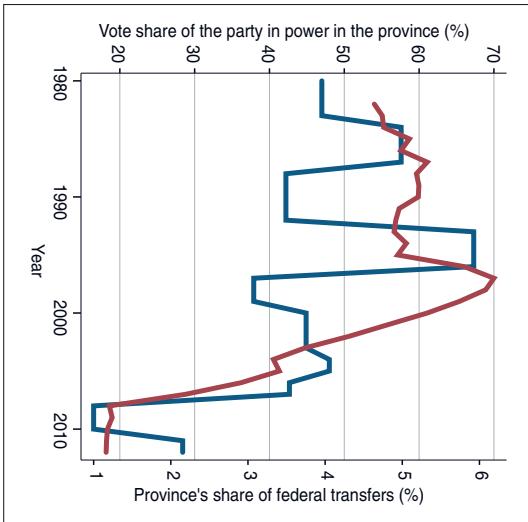


FIGURE A1. NEWFOUNDLAND AND LABRADOR

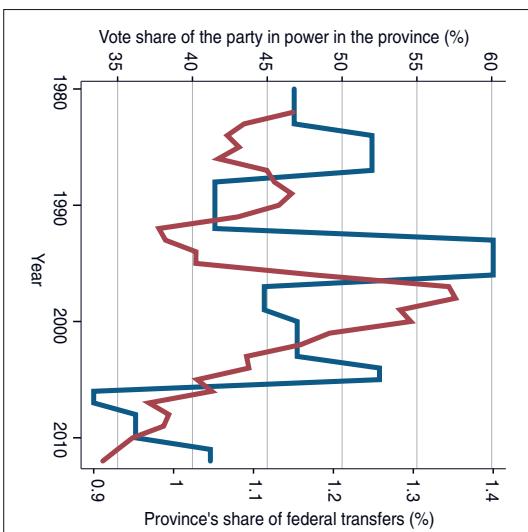


FIGURE A2. PRINCE EDWARD ISLAND

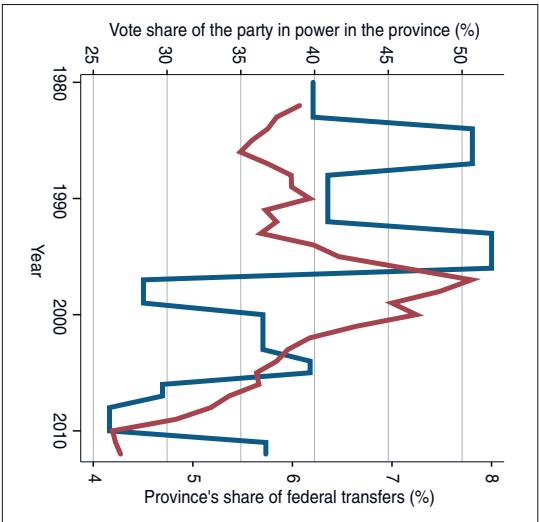


FIGURE A3. NOVA SCOTIA

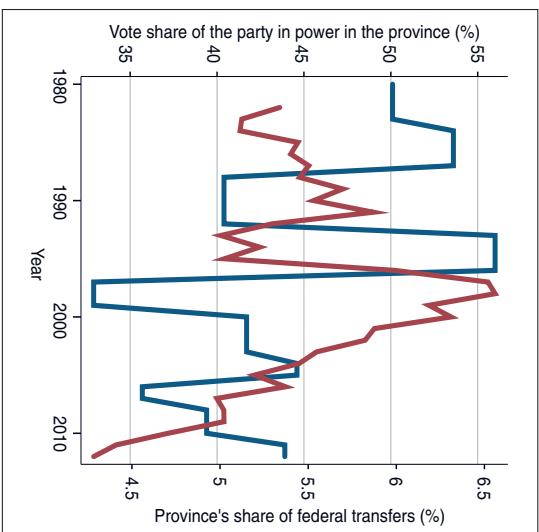
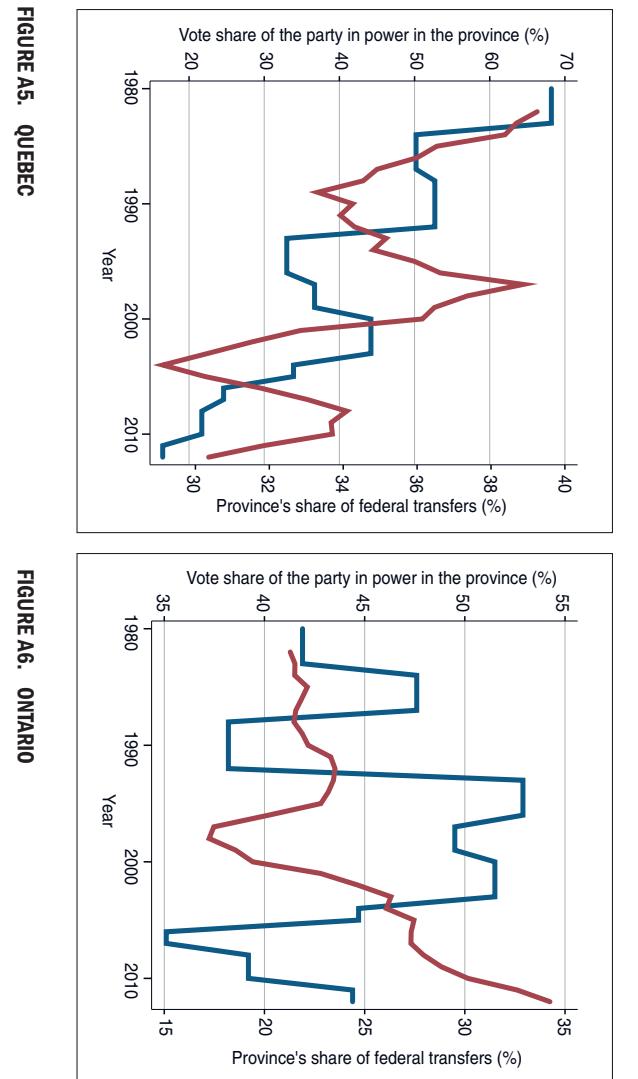
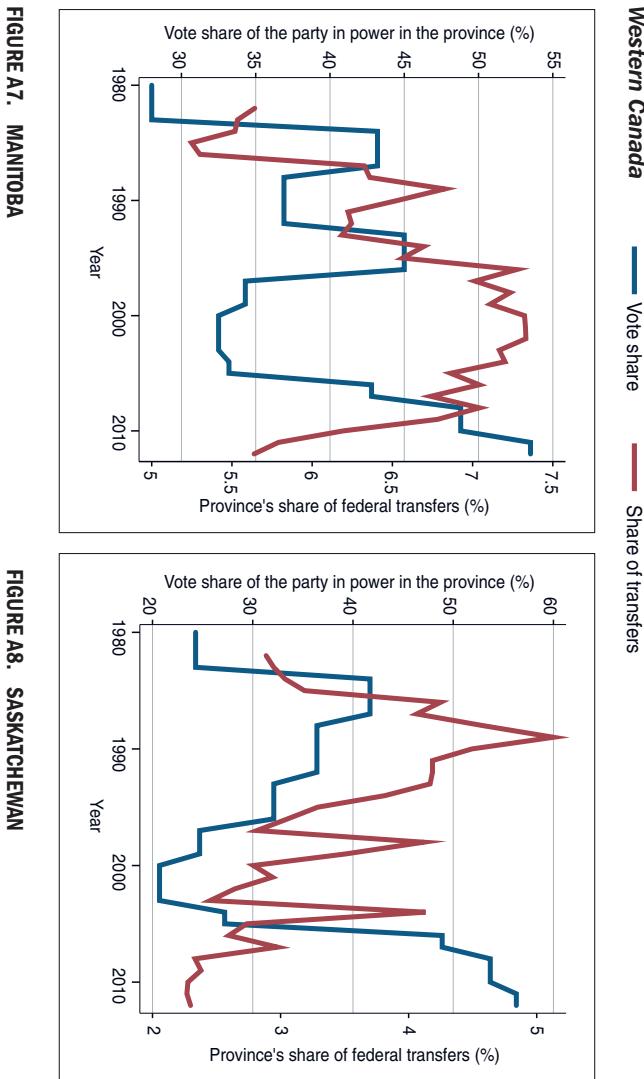


FIGURE A4. NEW BRUNSWICK



### Western Canada (cont'd)

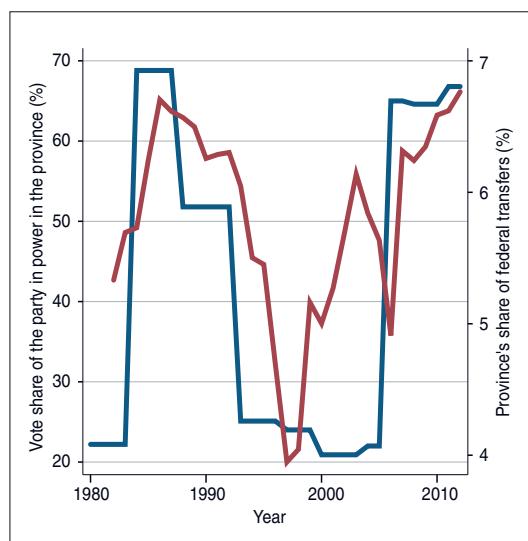


FIGURE A9. ALBERTA

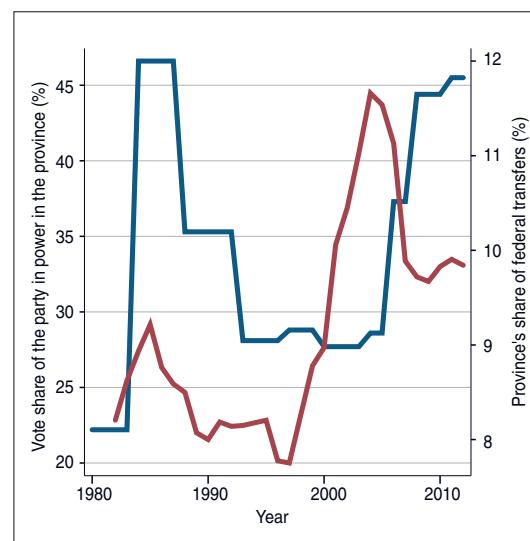


FIGURE A10. BRITISH COLUMBIA

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Marcelin Joanis is holding a Ph.D. in economics from the University of Toronto, and is an associate professor of economics at Polytechnique Montréal and a fellow of the Center for Interuniversity Research and Analysis on Organizations (CIRANO). He was previously an associate professor at the Université de Sherbrooke, where he also served as director of the Research Group in Economics and International Development (GREDI). A specialist of public economics and political economy, he has published articles in, amongst others, the *Journal of Development Economics*, *Public Choice*, *Economics and Politics*, *Economic Papers*, *Canadian Public Policy* and *Policy Options*, and a series of book chapters. Professor Joanis is the founding co-editor of the annual monograph *Le Québec économique*, published since 2009 by Presses de l'Université Laval and CIRANO. He has also worked as an economist at Finance Canada and Quebec's Commission on fiscal imbalance.

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#### ISSN

1919-112x SPP Research Papers (Print)

1919-1138 SPP Research Papers (Online)

#### DATE OF ISSUE

September 2014

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