EXECUTIVE SUMMARY

FRASER INSTITUTE

# How Provincial Governments Respond to Fiscal Shocks and Federal Transfers

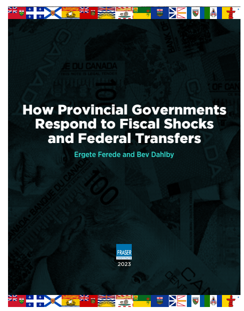
*by Ergete Ferede and Bev Dahlby*

The COVID-19 pandemic and its associated adverse economic impacts put substantial strains on governments' budgets. When governments face a sharp increase in their budget deficits, they can respond by raising taxes, reducing government spending, increasing borrowing, or some combination of these strategies. How governments respond and the timing of their responses can have a significant impact on business production and investment decisions, household spending and savings, the provision of public services, and government debt levels. Understanding how governments respond to budgetary shocks is essential for evaluating their policies and recommending fiscal policy reforms.

In this study, we investigate how Canadian provincial governments have responded to fiscal shocks, including changes in federal transfers, based on annual data spanning over half a century. We find that provincial governments have responded to a $1.00 increase in their per-capita budget deficits by cutting program spending by $0.18 and increasing own-source revenues by $0.09 the following year. As these responses only partially offset the deficit, provincial debt levels increase, and debt service costs rise. Thus, provinces that face adverse fiscal shocks and/or rising budget deficits in a given period inevitably respond by reducing program spending and/or hiking own-source revenues in future periods. This undermines the arguments advanced by some politicians and policy analysts who believe provinces can run ongoing deficits without having to "face the fiscal music" in the future.

Similarly, we find that a $1.00 increase in per-capita provincial program spending, which causes a rise in the budget deficit, results in a $0.71 decline in future program spending, a $0.26 increase in future own-source revenues, and a $0.10 increase in debt service payments, all measured in present value terms. This means that an increase in provincial program spending in the current period is not entirely offset by future spending reductions and that there will be an associated increase in the future tax burden. Thus, the impacts of fiscal shocks can reverberate for several years.

In Canada, federal cash transfers to the provinces represent a sizable portion of total provincial government revenues, particularly for provinces that receive equalization grants. This study also highlights the importance of federal grants and transfers in provincial governments' fiscal adjustments. According to the available empirical estimates, a $1.00 permanent increase in equalization grants and other federal transfers such as the Canada Health Transfer (CHT) and Canada Social Transfer (CST) causes provincial program spending to increase by $0.69 and $0.80, respectively, with no significant change in provincial governments' own-source revenue. Thus, an important policy implication of this study is that the federal government can use grants to encourage provincial governments to spend on vital public services.

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