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The Specific Role of Quebec within Canadian Fiscal Federalism

Master's thesis

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Year of the defence: 2019

Declaration

1. I hereby declare that I have compiled this thesis using the listed literature and resources only.
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3. I fully agree to my work being used for study and scientific purposes.

In Prague on January 4, 2019

Richard Bandžak

References

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Abstract

Canadian fiscal federalism is a set of complex relations on both federal and interprovincial levels. As each province faces different geographic, economic or demographic situation, federal government runs equalization program that aims to diminish potential economic gaps. Despite vaguely defined purpose, the transfers are unconditional – provinces could use them for any purpose they find appropriate. That could possibly cause distorted incentives such as *flypaper effect* in which politicians tend to adjust spending behavior according to source of income. Equalization payments are distributed based on potential capacity of each province to raise revenue. As Quebec has been the largest recipient of equalization grants with slow, if existent, convergence to the rest of provinces, it is subject of the analysis in the period from the year 1981, which marks breaking points in both Quebec and equalization system history, to 2016. Quebec tends to be blamed for taking advantage of the system by deliberately undervaluing its fiscal capacity through subsidized prices of electricity and by boosting its social expenditures. By incorporating descriptive statistics and discussion, this thesis concludes that Quebec's policymakers likely deliberately implement fiscal policies that in turn undervalue its fiscal capacity. However, their motivation has arguably been the policies' redistributive effects rather than boosting transfers from the central government. Intensive role of provincial government has presumably been a societal preference in Quebec since the Quiet Revolution.

Keywords

Quebec, fiscal federalism, Canadian federalism, equalization system, Quiet Revolution, Hydro Quebec, flypaper effect

Length of the thesis: 137 683

Název práce

Zvláštní úloha Québecu v rámci kanadského fiskálního federalismu

Abstrakt

Kanadský fiskální federalismus je souborem komplexních vztahů na federální i provinční úrovni. Vzhledem k tomu, že každá provincie čelí jiné geografické, ekonomické nebo demografické situaci, federální vláda provozuje vyrovnávací systém, který cílí na snížení možných ekonomických nerovností. I přes poněkud vágně definovaný účel, transfery jsou bezpodmínečné – provincie je mohou použít pro jakýkoli účel, který uznají za vhodný. To však může potenciálně způsobovat zkreslení účelu, jako například u flypaper effect („mucholapkového“ efektu), kde politici mají tendenci upravovat rozhodování o výdajích dle zdrojů příjmů. Vyrovnávací poplatky jsou distribuovány dle potenciální fiskální kapacity každé provincie vybírat příjmy. Jelikož je Québec největším příjemcem vyrovnávacích grantů, s nízkou, jestli vůbec existující, mírou konvergence ke zbytku provincií, je předmětem analýzy. Práce zkoumá období od roku 1981, který symbolizuje zásadní historické momenty pro Québec i systém vyrovnávacích plateb, až do roku 2016. Québec bývá nařčen ze zneužívání systému záměrným podhodnocováním své fiskální kapacity skrze dotované ceny elektřiny a nafukováním svých sociálních výdajů. Za využití deskriptivní statistiky a diskuze, tato práce došla k závěru, že québecí politici nejspíše záměrně implementují fiskální kroky, které ve výsledku podhodnocují québeckou fiskální kapacitu. Nejspíše je však jejich motivací redistribuční efekt, spíše než nafukování transferů z centrální vlády, jelikož rozsáhlá role vlády je dle všeho v Québecu celospolečenskou preferencí od dob Tiché revoluce.

Klíčová slova

Québec, fiskální federalismus, kanadský federalismus, vyrovnávací systém, Tichá revoluce, Hydro Québec, flypaper effect („mucholapkový“ efekt)

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V čem se oproti původnímu zadání změnil cíl práce?	Cílem práce je ověřit, zda systém vyrovnávacích plateb vytváří nežádoucí stimuly a to na případu québecké vlády a její energetické politiky. Předmětem výzkumu je nejen teoretické zakotvení kanadského federalismu, ale rovněž fiskálního federalismu s důrazem na druhou generaci jejího výzkumu. Dále práce analyzuje objektivní ekonomické ukazatele québecké fiskální kapacity, jež je určující pro výpočet vyrovnávacích plateb. Závěrem pak práce kriticky hodnotí specifika role státu v Québecu a její vývoj od tzv. Tiché revoluce.
Jaké změny nastaly v časovém, teritoriálním a věcném vymezení tématu?	Práce bude časově zasazena do fiskálních let 1981-2016. Ve fiskálním roce 1981-1982 jednak Parti Québécois opět zvítězila ve volbách i po neúspěšném prvním québeckém referendu o nezávislosti v roce 1980. Druhá byla systém vyrovnávacích plateb zakotven v ústavě. V otázce teritoriálního vymezení bude práce analyzovat Québec, který je zároveň dlouhodobě největším příjemcem vyrovnávacích plateb. V relevantních aspektech budou realie Québecu srovnány s dalšími provinciemi.
Jak se proměnila struktura práce (vyjádřete stručným obsahem)?	1. Úvod 2. Kanadský federalismus 3. Fiskální federalismus 4. Ekonomický stav Québecu 5. Québecká identita v rámci vyrovnávacího systému 6. Závěr
Jakým vývojem prošla metodologická koncepce práce?	Větší roli sehraje kvalitativní metoda výzkumu. Jedna kapitola ale bude ryze kvantitativní, kde bude analyzována québecká ekonomika a fiskální politika skrze deskriptivní statistiku.
Které nové prameny a sekundární literatura byly zpracovány a jak tato skutečnost ovlivnila celek práce?	

Zpracoval jsem primární data o redistribuci federálních zdrojů skrze systém dorovnávání fiskálních kapacit, či o míře veřejného zadlužení v kontextu dalších proměnných, což mi umožnilo získat lepší přehled o problematice.

Charakterizujte základní proměny práce v době od zadání projektu do odevzdání tezí a pokuste se vyhodnotit, jaký pokrok na práci jste během semestru zaznamenali (v bodech):

- 1. Získal jsem lepší přehled o reáliích souvisejících s Kanadou a mou prací**
- 2. Seznámil jsem se s rozsahem sekundárních zdrojů i s veřejně dostupnými databázemi kanadské vlády**
- 3. Pobyt na univerzitě McGill zásadně pomohl k dotvoření kontextu**

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Introduction

Canadian fiscal federalism is a set of complex relations on both federal and interprovincial levels. As each province faces different geographic, economic or demographic situation, federal government runs equalization program that aims to diminish potential economic gaps. In fact, ever since 1982 Constitution Act, *“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.”*¹ Despite vaguely defined purpose, the transfers are unconditional – provinces could use them for any purpose they find appropriate. Equalization payments are distributed based on potential capacity of each province to raise revenue. A province that does not reach nation’s average fiscal capacity receives transfer - proportionally to how much below average per capita it is. Quebec has never reached average fiscal capacity and due to its large population has been receiving large portions of the total equalization budget.² Considering its deliberately low incomes from energy production and generous social system, its continuous participation in the equalization system raises controversies and is thus subject of this research.

The most vocal opposition to Quebec supposedly taking advantage of the system to fund its cost-intensive fiscal policy arguably comes from Alberta. Local politicians or journalists typically argue that Alberta contributes the most to the system but is never compensated in case of unfavorable crude oil prices on which the provincial revenue relies. The thesis will attempt to assess the context in which these frustrations appear by discussing

¹ Government of Canada, “Constitution Act, 1982.” <https://laws-lois.justice.gc.ca/eng/Const/page-15.html#h-38>, (accessed January 1, 2019).

² Quebec received 55% of the total in the fiscal year 2015-6.

e.g. institutional and political forces contributing to regionalism in Canada, or the role of non-renewable versus renewable resources within the arbitrary equalization formula. The analyzed time period shall range from 1981 to 2016. Fiscal year 1981-2 marks two crucial turning points for Quebec and the equalization system. Firstly, the 1981 re-election of Parti Québécois in provincial general election after the first unsuccessful sovereignty referendum in the previous year. Secondly, 1982 Constitution Act that embedded the equalization payments into the supreme law. Fiscal year 2015-6 is then the latest fiscal year for which complete data were available during the process of research.

Canadian equalization system is moreover a relevant case within the fiscal federalism theory. It for instance suggests that decentralized wealth redistribution should be more effective than central as policymakers could be better monitored. That implies, politicians might hypothetically have different motivations than federal government or voters. Furthermore, unconditional federal grants could incentivize the local policymakers to boost their expenses. These concerns are applicable to any federation running a sub-central program of unconditional transfers.

The overall theme of the thesis is to grasp the complex nature of the Canadian fiscal federalism with ambition to identify and critically assess motivation of Quebec for its distinctive fiscal policies. The purpose of the following text is therefore to elaborate on the research question that becomes:

Does equalization system create distorted incentives that would motivate Quebec policymakers to pursue their own objectives, outside of the framework as defined by the federal government?

Before proceeding, it is important to get a basic understanding of the concept of the equalization system objective. There seem to be methodological limits in testing not only

the goal of the system as vaguely defined in the Constitution but also exact sources of Quebec's policymakers' motivation to pursue own fiscal actions. Therefore, the approach of this thesis is to outline possible distortions stemming from the principal-agent problem and asymmetry of information and to apply it to the specific context of Canadian federalism. The main methodological tool is the qualitative discussion analyzing the descriptive statistics of the Quebec's fiscal policy's key sectors. The data collections used for the analysis were typically *Statistics Canada*, *Institut de la statistique du Québec*, and other official governmental reports.

The structure of this thesis attempts to logically link theoretical background of fiscal federalism with application to the case study of Quebec. The first chapter critically assesses what makes Canadian federalism distinctive, what is the role of provinces in it and how conceptually works the equalization system. Second chapter elaborates on the idea that equalization transfers, as unconditional grants, may create distortions to policymakers' incentive. The third chapter analyzes macroeconomic and fiscal data to investigate whether the scope of Quebec equalization entitlements is justifiable in long run. It focuses on its macroeconomic indicators and fiscal policy in the fiscal year 2015-6. The last chapter investigates especially two fields of government involvement that determine the magnitude of the provincial involvement in the federal equalization system. It used more analytical tools to interpret the collected data. Furthermore, it provides historical foundations and contemporary thought on Quebec's priorities of fiscal revenues and expenditures.

1. Canadian Fiscal Federalism

The first chapter shall introduce some of the key specifics of Canadian federalism with focus on the equalization system. The main purpose of the following subchapter is then to outline the broader institutional, political and ideological framework of Canadian federalism. Understanding the complexity of Canadian federalism should help to grasp the political context when assessing outcomes of the equalization system.

1.1 Definition of Canadian distinctiveness

The broad term *Canadian federalism* in this work refers to the intergovernmental cooperation on both vertical³ and horizontal⁴ levels. The motivation for analyzing particularly the Canadian case is the distinctive Canadian identity, culture and values influencing those relations. Arguably, the non-economic level of the equalization system, e.g. the notion of solidarity, nationhood or unity plays a crucial role in legitimizing this or other federal programs.⁵ R. Berns-McGown contemplates the sources of political behavior and the distinctiveness of Canadian values.⁶ She argues that political culture is more relevant in predicting the political behavior than the individual or collective values. Furthermore, she provides a redefined concept of political culture. One, where individually held beliefs interact with collective memory, myths and symbols to produce a policy that becomes to be perceived as a shared value. Likewise, B. Anderson conceptualizes a nation as an imagined, socially constructed, community.⁷ There is no clear answer on what forces have been forming the potentially shifting meaning of the Canadian nationhood and identity.

³ In this case between the federal and provincial governments.

⁴ I.e. interprovincial cooperation.

⁵ W.E. Oates argues that for a policy of redistribution there must be a clear political cause. Wallace E.Oates, *The Political economy of fiscal federalism*, (Lexington: Lexington Books, 1977), 41.

⁶ Rima Berns-McGown, "Political Culture, Not Values." *International Journal*, Spring 2005, pp. 341–49.

⁷ Benedict Anderson, "Imagined Communities." *The Origins of Nationalism*, <https://www2.bc.edu/marian-simion/th406/readings/0420anderson.pdf> (accessed January 1, 2019).

G. Horowitz elaborates on the Hartzian theory that attempts to explain ideological development in the 'new' societies established by Europeans on other continents. This theory suggests that social development is based on the 'point of departure' of the Europeans settling the territory. The settlers, the theory continues, then further developed the fragment of the home country's social development that was dominant at the time of their departure. French Canada was established by settlers with the point of departure before the liberal revolution. Hence, they carried "feudal or tory values of the organic, corporate, hierarchical community".⁸ Similarly, Horowitz points out the influence of the tory loyalists⁹ on the evolution of English Canada.¹⁰ Horowitz's theory could be a part of the puzzle of what makes Canada distinctively collectivist,¹¹ together with myths and collective memory. These could be survival in the wilderness, the role of the federal government in securing western expansion and others. Nevertheless, the sense of equity and solidarity could be considered as vital for the functioning of Canadian federalism – especially the equalization system. However, the factual functioning is not as smooth as the ideological background could imply.

1.2 Role of provinces in the federation

Federalism is one of the defining features of the political system in Canada. The fragile intergovernmental relations represent persistent struggle within the defined division of power. Provinces play a strong role in the federal political process. Interestingly, based on the study conducted by A. Henderson, political attitudes seem to have a higher correlation

⁸ Gad Horowitz, "Conservatism, Liberalism, and Socialism in Canada: An Interpretation." *The Canadian Journal of Economics and Political Science*, Vol. 32, No. 2, May 1966, 143-171. 144.

⁹ American colonists escaping the American Revolution.

¹⁰ The purpose of Horowitz's work was to assess the presence of socialism in Canada and generally analyze the differences between the US and Canada's social development.

¹¹ Distinctive at least in comparison to the US individual liberalism.

with residence in a specific province than with other socioeconomic factors.¹² However, the factual decentralization with respect to legal framework, party system or division of powers has not always been the case in Canada. In fact, the British North America Act of 1867 established a highly centralized system of governance. One of the motivations to do so was for instance the pre-Civil war US decentralized constitutional system. Nevertheless, Canada is nowadays rather decentralized, with provinces on average relatively not so reliant on federal transfers.¹³ Canada's ratio of federal government revenue to total government revenues is also somewhat low.¹⁴

1.2.1 Provincial jurisdictions

Canadian provinces could be generally perceived as fiscally autonomous which coincides with the spectrum of their jurisdiction. That ranges, for instance, from collecting taxes, securing education and health care to managing non-renewable natural resources.¹⁵ Although being responsible for health care, provinces receive a conditional grant to sustain a decent level all around the country. Provinces also share numerous competences with the federal government, such as protection of the environment, or construction of infrastructure to list a few. The ten provinces have explicitly distributed presence within the central federal institutions. The Supreme Court judges are selected based on their home province.¹⁶ Similarly, the Prime Minister's Cabinet tends to be selected partly based on provincial

¹² A. Henderson arbitrarily models 9 clusters across provinces and east/west urban/rural environment based on socioeconomic indicators and tests how political attitudes predict membership in such cluster. Political attitudes better predict residence in a province (37 %) than membership in such cluster (30 %). Ailsa Henderson, "Regional Political Cultures in Canada." *Canadian Journal of Political Science* 37:3, September 2004, 595–615.

¹³ Daniel Béland et al., *Fiscal Federalism and Equalization Policy in Canada : Political and Economic Dimensions* (Toronto: University of Toronto Press, 2017), 18.

¹⁴ Ibid.

¹⁵ See the articles 92 and 92A of the Constitution Act, 1867: Government of Canada, "Constitution Acts, 1867 to 1982." <https://laws-lois.justice.gc.ca/eng/const/page-4.html>, (accessed January 1, 2019).

¹⁶ Out of the 9 judges, it is required that 3 would come from Quebec, because of the different legal framework; others are then by convention: 3 from Ontario, 2 from the Western provinces and 1 from the Atlantic provinces. The Supreme Court of Canada, "History." <https://www.scc-csc.ca/court-cour/info/eng-eng.pdf> (accessed January 1, 2019).

division of power. Arguably, the equitable division of offices based on a territorial key might help to represent interests of all provinces. On the other hand, it simultaneously highlights the differences and specific characteristics of each province.

1.2.2 Forces contributing to regionalism

There are political and institutional forces that systematically contribute to the question of Canada's regionalism and potentially even alienation. Considering the legal framework, the patriation of the Constitution in 1982 had an immense impact on regionalism in Canada. Not only did it constitutionalize equalization payments but also contributed to the feeling of alienation in Quebec. Both shall be assessed more closely later in this work. There are features within the federal legislative and respectively executive branches that in fact represent some of the systematic forces that could be avoided or altered and yet arguably contribute to regional division.

Firstly, the institutional framework is in some cases old-fashioned and does not correspond to the current demographic or economic situation. The most evident example of regionally skewed central institutions is the Senate. Its representation is far from reflecting contemporary demographic reality. In fact, especially British Columbia and Alberta are extremely underrepresented which besides other factors contributes to the notion of the so-called *western alienation*. Representation in the Senate is divided into 4 'regions', each represented by 24 senators.¹⁷ The four 'regions' are Quebec, Ontario, Maritime¹⁸ provinces and western¹⁹ provinces. Under the given constellation both Nova Scotia and New Brunswick are each represented by 10 senators with a combined population of only around 1.7 million. Whereas BC with a population of ca. 4.6 million is represented only by

¹⁷ Plus, the territories and Newfoundland and Labrador are represented by the total of 9 senators.

¹⁸ In this context i.e. New Brunswick, Nova Scotia and Prince Edward Island.

¹⁹ In this context i.e. Manitoba, Saskatchewan, BC and Alberta.

6 senators.²⁰ In per capita figures, one senator from BC represents ca. 750 000 citizens, whereas a New Brunswick senator only ca. 75 000. Although the Senate ought not be represented based on population proportionality, the current regional distribution is not up to date either. Not to overestimate the factual role of the Senate, but at least the symbolical level of the (old)²¹ core-periphery dynamics is self-explanatory in this case.

Secondly, the party and electoral system together play a significant role in developing the notion of regional differences. Canadian general elections are based on the *first past the post* plurality rule electoral system. One candidate with the most votes wins the single electoral district seat and every other candidate in that district loses. This possibly creates distortions with respect to the proportion of votes received and seats won. The system benefits the winner, which is usually rewarded by a disproportional number of seats.²² In theory, the total amount of received votes is not as important as its distribution. The less spread out the received votes are, the more seats might result from them. This gives a chance for small parties with a strong support in a certain region to enter the House of Commons. On the other hand, small regionally supported parties might then tend to support regionally-skewed policies.²³ Similarly, larger parties would also tend to prioritize campaign in regions and districts with a higher chance of winning, as it is the desirable goal. Any other result is ultimately a waste of resources. The strategic decisions on which districts concentrate their effort and which ones to abandon are crucial. This process might also then lead to the shifts

²⁰ Richard Foot, "Senate of Canada." *The Canadian Encyclopedia*, last edited November 18, 2016, <https://www.thecanadianencyclopedia.ca/en/article/senate> (accessed January 3, 2019).

²¹ Whether the core (Ontario + Quebec)-periphery (the rest of Canada) distribution is still valid might be a subject of discussion.

²² In the last general election in 2015, Liberals received 39.5 % of votes and Conservatives 31.9 %. However, the resulting number of seats in the House of Commons was 54 % and only 29 % respectively. CBC News, "Federal election results 2015: Justin Trudeau's Liberals to form majority government." <http://www.cbc.ca/news2/interactives/results-2015/> (accessed January 1, 2019).

²³ Bloc Quebecois might be one of the federally fairly successful small parties that have however strongly concentrated support in one province.

in partisan policymaking and political agenda towards the interests of provinces and districts with firm partisan support.

Despite initial attempts for a centralized system of governance, the Canadian federation could be considered as rather decentralized and regionalized. Elements accenting different interests of provinces are embedded in the federal system as they are represented e.g. by the constitution of the Senate or federal electoral system. There are also remarkable economic gaps among the provinces. The equalization program indirectly aims to reduce them.

1.3 Equalization in Canada

This subchapter aims to explain and critically assess the equalization system's principles and to discuss its common misperceptions and misleading interpretations. The equalization system is frequently subject to public debates for its discussable fairness and effectiveness. The principle of solidarity in compensating either for unfavorable prices of commodities or generally for more difficult situations in gaining revenue is key in the equalization system. It was launched in 1957 in a form principally close to the current one. However, by the Constitution Act of 1982 the equalization system became an embedded part of the Canadian supreme law. The Subsection 36(2) of the Constitution Act, 1982 reads: "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."²⁴ Even though the expressed commitment is somewhat vague, the main message might be interpreted as a promise to reduce the horizontal fiscal gap as much as could be reasonably expected.

²⁴ Government of Canada, "Constitution Act, 1982."

1.3.1 Horizontal fiscal gap

Horizontal fiscal gap is a difference in provincial capacities to raise revenue from own sources. The capacity to raise revenue and to provide a comparable level of public service is always partly outside of the provincial control. For instance, local geographic conditions, abundance of natural resources or demographic structure could all influence costs of public service and level of collected income. The permanently wide horizontal gap might be detrimental for several reasons. Firstly, it might undermine cohesion in any federation and especially in one with evident regional disparities. Chronic provincial disability to reach the decent level of public service without notably raising taxes may evoke feelings of resentment and alienation.²⁵ Secondly, major gap in fiscal capacities may evoke inefficient migration. Béland et al. analyze the effects of the fiscally induced migration. They are aware of the mixed results with respect to its existence and effects.²⁶ However, in theory, migration that is motivated by net fiscal benefits in the form of better public services per tax dollar is inefficient; in contrary to migration in the direction of higher productivity.²⁷ The theory suggests that net fiscal benefits would cause inefficient allocation of labor causing harm to overall national output. To face the issue of horizontal fiscal gap, federal government operates system of equalization payments.

1.3.2 Federal transfers

The equalization payments are the second largest federal transfer to provinces in Canada. Canada Health Transfer (CHT) and Canada Social Transfer (CST) are the first and third respectively. In the fiscal year 2016-17 the total amount of federal transfers

²⁵ Daniel Béland et al., *Fiscal Federalism and Equalization Policy in Canada : Political and Economic Dimensions*, 13.

²⁶ *Ibid.*, 62.

²⁷ *Ibid.*, 57.

to provinces accounted for nearly 67.3 billion CAD²⁸ that represented approximately 22%²⁹ of the total federal expenses. For comparison, the major federal transfers to persons combined (i.e. elderly benefits, employment insurance and children's benefits) constituted ca. 29 %³⁰ of the total federal expenses in the same fiscal year. Out of the 67.3 billion CAD, the pie was split in the following manner: CHT – 53.6 %³¹, CST – 19.8 % and equalization system – 26.6 % (i.e. 17.9 billion CAD).³² CHT and CST are purpose-specific contrary to the equalization system which is unconditional. Therefore, the receiving provinces are not legally obliged to use the equalization payments for any specific purpose. That creates a paradoxical situation. The federal government is committed to the principle of securing provincial governments to have enough resources to provide public services at a reasonably comparable level at reasonably comparable taxation. However, provincial governments do not have an obligation to spend the equalization payments on increasing the level of public service. Similarly, the entitlement to the equalization payment is not based on the needed resources, but solely on the province's capacity to raise revenue. The unconditionality and calculation based on capacity rather than needs has its origins in the unwillingness of provinces to involve federal government in their budgetary policies and to keep fiscal autonomy. The provincial autonomy had been a vocal argument in the debates prior to the implementation of the program. On the other hand, the federal government has the authority to modify the system which also creates space for politicization. Alternatively, the program

²⁸ Department of Finance Canada, "Federal Support to Provinces and Territories." February 2, 2017 <https://www.fin.gc.ca/fedprov/mtp-eng.asp> (accessed January 1, 2019).

²⁹ Department of Finance Canada, "Annual Financial Report of the Government of Canada Fiscal Year 2016–2017." September 19, 2017 <https://www.fin.gc.ca/afr-rfa/2017/report-rapport-eng.asp> (accessed January 1, 2019).

³⁰ Ibid.

³¹ The proportion of CHT on the federal transfers to provinces has been growing. In absolute numbers, the CHT grew by 52 %, whereas the other two major transfers to provinces 'only' by slightly less than 30 % in the period from the 2009-10 to 2016-17.

³² Department of Finance Canada, "Federal Support to Provinces and Territories." February 2, 2017 <https://www.fin.gc.ca/fedprov/mtp-eng.asp> (accessed January 1, 2019).

could operate under the competences of an arms-length independent body as is the case of Australia.³³

1.3.3 Controversy and politicization

The politicization of the issue affects intergovernmental relations on both vertical and horizontal levels. Equalization payments are another piece of the mosaic not only within the western alienation issue. The sentiments about the system are especially strong in rich oil-producing Alberta. The Albertans paying for Quebec's reckless spending rhetoric is not rare and not only in the Albertan political discourse.³⁴ Similarly, B. L. Crowley and B. O'Keefe imply that receiving provinces are 'over-equalized' at the expenses of the non-receiving ones.³⁵ They claim that receiving provinces might tend to inflate wages of public servants or size of the public service and debt. The authors calculate the after-the-equalization per capita revenue and public spending adjusted for local prices in each province. The results indicate that equalization payment receiving provinces end up in some cases with a significantly higher real amount to spend on public service per capita than the non-receiving ones. Furthermore, Ontario occupies the last position in their calculation of real capacity to provide public service. However, small population of Atlantic³⁶ provinces distort per capita statistics, especially in relation to public service expenditures. Arguably, for some types of public service, the marginal costs for an extra citizen might be

³³ Daniel Béland et al., *Fiscal Federalism and Equalization Policy in Canada : Political and Economic Dimensions*, 23.

³⁴ For instance, the former leader of Albertan opposition B. Jean writes in his op-ed: "Why should Albertans continue to pay into a system that subsidizes cheap daycare and tuition for Quebec, while Quebec politicians actively engage in blocking critical pipeline infrastructure for our province?" Brian Jean, "Canada's equalization system is broken, and we need to fix it." *Calgary Herald*, October 28, 2016, <https://calgaryherald.com/opinion/columnists/jean-canadas-equalization-system-is-broken-and-we-need-to-fix-it> (accessed January 1, 2019).

³⁵ Brian Lee Crowley, Bobby O'Keefe, "Why Some Provinces Are More Equal than Others a Bad System Worse." *AIMS Special Equalization Series*, no. 1, June 2006, 1-7. and Brian Lee Crowley, Bobby O'Keefe, "The Flypaper Effect Does Equalization Really Contribute to Better Public Services, or Does It Just 'Stick to' Politicians and Civil Servants?" *AIMS Special Equalization Series*, no. 2, June 2006, 1-11.

³⁶ Common reference to New Brunswick, Newfoundland and Labrador, Nova Scotia and Prince Edward Island.

considerably low or non-existent. That might be an example of a good for which two provinces would pay the same amount, however, when accounted for by population, smaller province would have paid more per capita.

Moreover, the authors provide what they suggest is interprovincial purchasing power parity index.³⁷ Assuming that these data reflect reality, Atlantic provinces would have lower price levels than the Canadian average. Hence, having a lower price index, statistically they would also have higher real resources available for public service.³⁸ This fact, the authors imply, causes over-equalization as in real terms, some of the *have-not*³⁹ provinces would have more to spend per capita than some of the *have* ones. That would be contrary with the principle of the equalization system, as the *have-not provinces* should be equalized at most to the level of the *have province* with the lowest fiscal capacity. A possible solution is to consider capitalization of differences in fiscal capacities in wages or other costs of the public services. It means that although a province has a lower fiscal capacity to generate revenue to provide a service, it also faces lower costs to do so. Hence, the capitalized fiscal capacity would potentially represent more reliable and truthful reflection of reality and thus more effective use of federal resources. Furthermore, the source of financing is also one of the frequently misinterpreted features of the equalization system.

1.3.4 Source and formula of the equalization payments

The equalization payments are funded by the general revenue of the federal government. That means that the equalization payments are not in any sense direct transfers between provinces or from provincial budgets. On the contrary, they are a part of federal

³⁷ The authors proxied price level by business costs in the province's largest city. The source of data: KPMG, "Competitive Alternatives." 2016, <https://assets.kpmg/content/dam/kpmg/pdf/2016/04/competitive-alternatives-2016-summary-report.pdf> (accessed January 3, 2019).

³⁸ Available sources divided by price index that is lower than 1 (or 100 % = average) would virtually increase the value of the money, as theoretically more could be bought with it.

³⁹ The provinces receiving equalization payments.

budget and thus under federal jurisdiction. The principle by which a province is entitled for payments is simple. Any province which fiscal capacity per capita is lower than national average receives payments, those above the average do not receive them. The formula of calculating the fiscal capacity is not only frequently changing but is also very technical and thus hardly accessible to the public. It reflects the provincial tax base in terms of average national tax rate. However, the notion of what to include into the tax base, or how to calculate the national tax rate has been shifting. The most discussed part of the formula has been the question of whether and to which extent to incorporate the incomes from the non-renewable natural resources.

Management of non-renewable resources is fully under provincial jurisdiction. However, the uneven distribution of the non-renewable resources and fluctuation of their prices on world markets represents a threat for politicization. The rationale behind the inclusion or exclusion of the non-renewable resources is as follows. If all incomes from these resources were to be included, then the national average fiscal capacity and equalization payments respectively would skyrocket. On the other hand, exclusion of these revenues would distort the picture of fiscal capacities in certain resource-rich provinces. Alberta expects to receive ca. 5 billion CAD on revenues from non-renewable resources in the fiscal year 2018-19.⁴⁰ If these revenues were not considered at all, Alberta would thus seem for the purposes of the equalization system considerably poorer than it is. Moreover, the inclusion of incomes from the non-renewable resources into formula might diminish the incentive of provinces to develop those resources as they would lose part of the payment.⁴¹ Generating income from the non-renewable natural resources might then in turn reduce the reliance

⁴⁰ Alberta, "Revenue: Table 2: Non-renewable resource revenue." <https://www.alberta.ca/budget-revenue.aspx> (accessed January 1, 2019).

⁴¹ Ken Boessenkool, " Why natural resources don't belong in equalization." in *Ideas matter*, ed. Jan Matthews (Halifax: Atlantic Institute for Market Studies, 2002), 7-8.

of the provinces on the equalization system. Nevertheless, there are trade-offs specific for each province whether to pursue the production of non-renewable resources. Quebec could for instance reduce its reliance on the equalization system by exploiting its gas reserves. Natural resources and their incorporation into the equalization formula also create tension between provinces for another reason. Some provinces, e.g. Manitoba and Quebec tend to underprice their water-rental revenue or subsidize this form of energy production in other ways. In that case not only would their residents buy cheaper energy, which generates political points, but also their fiscal capacity would be artificially reduced. The provincial subsidy for energy production would be then in fact carried out by the entire country through the equalization payment.

1.4 Conclusion

The equalization program is a form of federal transfer aiming to compensate interprovincial fiscal gaps. These gaps are detrimental in long-term as they could e.g. evoke inefficient migration or endanger federal cohesion. On the other hand, malfunctioning equalization system arguably just as well compromises Canadian federal unity. The equalization transfers would therefore be counterproductive and eventually a waste of federal resources. Measuring the success of the system is however somewhat problematic. For instance, Quebec has never reached the nation's fiscal capacity average which hypothetically would not necessarily mean failure of the program as closing the gap is in fact not its primary purpose. Due to its large population, Quebec has been the largest total recipient of the equalization money which considering its fiscal policies raise controversies. Additionally, it has been accused of manipulating its fiscal capacity in order to maximize its revenues from the equalization system.⁴² For these reasons, Quebec will be the subject

⁴² E.g. through its energy policies, more to be discussed in chapter 4.

of research in assessing whether equalization payments, as an unconditional grant, create distorted incentives to the provincial policymakers. Local officials' motivations have been under scrutiny by the fiscal federalism second-generation scholars.

2. Fiscal Federalism

The term *fiscal federalism* might be subject to multiple understandings and definitions. On one hand, economists could base their study e.g. on efficient allocation of resources within eventually any type of a multilevel government. Whereas political scientists may tend to adopt institutionally and constitutionally more nuanced approach to e.g. analyze institutional flaws of centrally-governed policies within federations.⁴³ Considering the variety and magnitude of country-specific features of *fiscal federalism*, this chapter will provide a brief review of the evolving main concepts within the relevant literature and the context of Quebec and Canada.

2.1 First Generation

Fiscal federalism developed as a subfield of public economics in the middle of the twentieth century. The continuing research in the subfield and especially the shift in the conceptual focus has caused the more recent findings and respective scholars to be referred to as the *second generation*. The first generation's key aim had arguably been to assess the assignment of functions to each level of government. Generally, the role of the government had been perceived as twofold. Firstly, a government would be understood as responsible for the redistribution of resources to secure an equitable distribution of income and provision of public goods. Secondly, its role would be stabilizing – keeping employment high at stable prices or correcting market failures. The latter function had been viewed as the domain of the central government.⁴⁴ The theory would not perceive subcentral (in our case provincial) government as influential in constituting macroeconomic stability due to its lack of monetary

⁴³ Samuel H. Beer, “A political scientist's view of fiscal federalism.” in *The Political Economy of Fiscal Federalism*, ed. W.E. Oates, (Lexington: Lexington Books, 1977), 21.

⁴⁴ Opposing views could be seen within the second generation framework, e.g. here: Anwar Shah, “Fiscal Federalism and Macroeconomic Governance: For Better or for Worse?,” *World Bank*, 1999, 1–48, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=597215 (accessed January 1, 2019).

tools or power considering the openness of provincial markets. On the other hand, the assignment of resource redistribution to a specific level of government had been a subject of discussion among scholars. W.E. Oates articulated the *Decentralization Theorem* in 1972 that suggested each level of government to maximize social welfare within its own jurisdiction.⁴⁵ Therefore, provincial government should provide *local* public goods as it has both the best knowledge and executive capabilities in the constituency. According to Oates, uniform levels of output to each province would be an alternative to decentralized distribution. Uniformity of output distribution, unless assuming perfectly homogeneous preferences and needs in all provinces, would likely not be more effective than distribution from the respective provincial authority. More specifically, there is a trade-off between advantages of economy of scale or coverage of interjurisdictional externalities and more effective allocation of resources into local communities. The central government, the rationale goes, would face both information issues and interlinked political constraints that would prevent it from providing more resources to one region than to another.⁴⁶ The first generation viewed government as a black box with benevolent officials whose actions would be defined by what is best for the respective administrative unit. With the arrival of the second generation of scholars, more precise point of view as for the motivations and incentives that the government and its officials face has been delivered. They incorporated some of the firm-level concepts into the public economy that helped to more accurately understand the public policy decision-making process.

⁴⁵ Wallace E. Oates, *Fiscal Federalism*. New York: Harcourt Brace Jovanovich, 1972.

⁴⁶ Wallace E. Oates, "Toward a Second-Generation Theory of Fiscal Federalism," *International Tax and Public Finance*, Volume 12, Issue 4, August 2005, 349–373. <https://doi.org/10.1007/s10797-005-1619-9>, 353, (accessed January 1, 2019).

2.2 Second Generation

Wallace Oates reflected the conceptual changes to be stemming from two sources. First, from the scholarship on public choice and the implied broader role of political economy approach to the academic work on the problems of information has evolved together with application of firm-level rationale to public economics.⁴⁷ The most significant shift from the first generation could be observed as a tendency to assume non-aligned objective functions of officials and voters. The incentives of the respective stakeholders have moved up the priority list of scholarly interest. Within the problem of the objective alignment, the theory offers the principal-agent problem.

2.2.1 Principal-agent problem

Agents should act in the interest of the principal, but due to the asymmetry of information, principal cannot monitor that agent does so. Hence, the agent has an incentive to follow his own objectives. It is not intuitive who could be considered as principal and agent in the center-province-voter scenario. Federal government delegates some of its powers to the provincial government which also has the mandate from its voters. Therefore, within this theory, the provincial government would be the agency acting in favor of a principal. Then, depending on the context, central government or voters would be the principal.⁴⁸ In the case of the equalization system, the federal government provides means to a province but cannot directly influence their usage. Central government, however, decides the granted amount of money. Hence indirectly ensures provinces would follow the delegated objectives. Simultaneously, provincial policymakers are more directly accountable to the local electorate. The accountability and monitoring are crucial elements

⁴⁷ See e.g. Yingyi Qian, Barry R Weingast, "Federalism as a Commitment to Preserving Market Incentives." *Journal of Economic Perspectives*, Volume 11, Number 4, Fall 1997,83-92.

⁴⁸Wallace E. Oates, "Toward a Second-Generation Theory of Fiscal Federalism," 358.

of the local governance and of the fiscal federalism efficacy debate. One of the major assumptions within the Oates' Decentralization theorem was that central government would tend to distribute wealth in equal levels among its constituencies not being able to account for the actual local needs. The second-generation scholars however point out that even in the case of homogeneous preferences across the country (in which case central government would benefit from the economies of scale), the redistribution of the outputs should be executed on local level precisely for enhanced accountability of the elected officials and greater transparency within the centers of decision making.⁴⁹ This rationale leads to the assumption that voters would attempt to secure objective alignments of their provincial policymakers. In contrast to the federal government whose objective could be monitored with difficulties due to the vague definition of the equalization program.

2.3 Incentive distortions within fiscal federalism

Central government therefore in sake of efficiency passes grants onto provincial governments. There are however some unintended inefficiencies that tend to occur in the case of intergovernmental transfers. Some of the most relevant ones within the scope of this thesis are the following. Firstly, non-matching grants such as the Canadian equalization payment seem to stimulate public spending more than revenues from private income. This phenomenon is usually dubbed the *flypaper effect*. Secondly, the *soft budget constraint*, where central government would tend to bail out subcentral (provincial) government. This action may in some cases implicitly incentivize irresponsible fiscal decision-making. Lastly, the so-called *welfare trap* that explains intentional dependency on intergovernmental payments.

⁴⁹ Anwar Shah, "Fiscal Federalism and Macroeconomic Governance: For Better or for Worse?" 21.

2.3.1 Flypaper effect

While extensive research has been conducted on the topic, there is no clear consensus on the explanation, extent or even existence of the flypaper effect. E. Becker finds no statistical evidence of the phenomenon.⁵⁰ Moreover, she argues that evidence of the flypaper effect is as a result of inappropriate functional forms. Similarly, J. Hines and R. Thaler consider it an empirical anomaly.⁵¹ In their view the effect could be explained by an error within the model specification or by erroneous behavior of voters. The voters might confuse marginal and average price effects of the non-matching grants and thus expect more governmental spending. R. Inman tests what he considers the four most common explanations behind the flypaper effect.⁵² He verifies the following problems: data; econometric; specification and political. Only the last one he argues might be a reliable explanation. Inman perceives the flypaper effect as an “outcome of political institutions and the associated incentives of elected officials.”⁵³ The incentives of the officials to maximize their budgets, has been one of the most discussed explanation within the scholarship.⁵⁴ L. Crowley and B. O’Keefe claim that unconditional grants would even motivate the officials to indebt their constituency.⁵⁵ The differing objective function between politicians and voters seem to be interlinked with another common argument explaining the flypaper effect. The voter’s misunderstanding of who shall bear the costs of the public service provision – the so-called fiscal illusion.⁵⁶

⁵⁰ Elizabeth Becker, “The Illusion of Fiscal Illusion : Unsticking the Flypaper Effect.” *Public Choice*, 86, no. 1, 85-102, <http://www.jstor.org/stable/30027070> (accessed January 1, 2019).

⁵¹ James R Hines, Richard H Thaler, “Anomalies: The Flypaper Effect.” *Journal of Economic Perspectives* 9, no. 4, 1995, 217–26, <https://doi.org/10.1257/jep.9.4.217> (accessed January 1, 2019).

⁵² Robert P Inman, “The Flypaper Effect,” *National Bureau of Economic Research Working Paper Series* 9, December 2008, 217–26, <https://doi.org/10.3386/w14579> (accessed January 1, 2019).

⁵³ *Ibid.*, 217.

⁵⁴ Hammed Amusa et al., “Fiscal Illusion at the Local Sphere: An Empirical Test of the Flypaper Effect Using South African Municipal Data.” *South African Journal of Economics* 76, no. 3, 2008, 443–65, <https://doi.org/10.1111/j.1813-6982.2008.00205.x>. (accessed January 2019).

⁵⁵ Lee Crowley, Bobby O Keefe, “The Flypaper Effect Does Equalization Really Contribute to Better Public Services, or Does It Just ‘Stick to’ Politicians and Civil Servants?”.

⁵⁶ Stanley L. Winer, “Some Evidence on the Effect of the Separation of Spending and Taxing Decisions.” *Journal of Political Economy*, Vol. 91, No. 1, 1983, 126-140 and David L. Hammes, Douglas T. Wills,

Fiscal illusion is commonly accounted to imperfect information, although Baekgaard et al. recently argued that political and media framing work as the defining mechanism behind it.⁵⁷ Framing refers to intentional attempt to sway public approval on an issue. For instance, framing the military deployment in foreign country by focusing on possible casualties and costs or contrary on fairness and higher good may affect the same voter to oppose or support such issue respectively. Under any mechanism, the implications of the fiscal illusion suggest that voter's perception as to the cost and benefits of public programs is distorted.

Canada's *first past the post electoral system* helps create the concept of the median voter, whose preference is the most common one and closest to the center. Median voter preference is usually one parties attempt to observe and fulfill. The lump sum grant would initiate the growth of the local expenditure although the tax payments of a median voter would remain the same. Hence, the median voter might believe tax price declined as public service levels increased although his or her tax payments remained stable. He or she may consequently demand even more services and expenditures for not being fully aware of the grant's effects.⁵⁸ Similarly, the voters' poor knowledge of the public service costs might contribute to inefficient public spending. Not only because public spending could not be properly monitored, but also because voters might demand irrelevant levels of such service. Aligned with the latter concept, Kneebone elaborates on the influence of governmental revenue source to its expenditure. By investigating the public health care in Canada,

"Fiscal Illusion and the Grantor Government in Canada." *Economic Inquiry* 25, no. 4, 1987, 707–13, <https://doi.org/10.1111/j.1465-7295.1987.tb00771.x>. (accessed January 1, 2019).

⁵⁷Martin Baekgaard, et al. "Causes of Fiscal Illusion: Lack of Information or Lack of Attention?," *Public Budgeting and Finance* 36, no. 2, 2016, 26–44, <https://doi.org/10.1111/pbaf.12091>. (accessed January 2, 2019).

⁵⁸B. Heyndels, C. Smolders, "Fiscal illusion at the local level: Empirical evidence for the flemish municipalities." *Public Choice*, 80, 1994, 325-338 and Stanley L Winer, "Some Evidence on the Effect of the Separation of Spending and Taxing Decisions." *Journal of Political Economy*, Vol . 91 , No . 1, Feb ., 1983, 126-140. Hamed Amusa et al., "Fiscal Illusion at the Local Sphere: An Empirical Test of the Flypaper Effect Using South African Municipal Data." *South African Journal of Economics*, Vol. 76:3 September 2008, 444.

he concludes that the intensity of governmental spending correlates with its source in line with the flypaper effect theory.⁵⁹

2.3.2 Soft budget constraint

The soft budget constraint is another concern that helps to complete the picture of distortions possibly stemming from fiscal federalism. The concept refers to a situation in which central government is ready to fill the gaps in the sub central entity's budget. The motivation of not accounting with possible consequences of failure are tested by game theory models. The elimination of incentive to avoid mistakes and waste is arguably the key distortion stemming from the soft budget constraint.⁶⁰ The decision makers implicitly count with possible compensation by partners within the federal system, or by future generation.⁶¹ Quebec is well-known in the Canadian context for its relatively large public sector and generous social system. Arguably, the equalization payments might have partly incentivized such fiscal strategy, as extensive costs would be to some extent carried by the federal government. The detrimental effects of the soft budget constraint have been articulated also within the context of the former East bloc countries and centrally planned economies.⁶² The centrally-planned production would not necessarily strive to be cost efficient, because its management would count with possible bailout. More recently, a similar issue arguably occurred during the euro zone crisis. Some of the eurozone members likely took advantage of credibility and solvency of other members such as Germany in acquiring cheaper loans.

⁵⁹ Government would tend to spend more with income coming from intergovernmental grants. Ronald Kneebone, "How You Pay Determines What You Get: Alternative Financing Options as a Determinant of Publicly Funded Health Care in Canada." *The School of Public Policy*, Vol. 5, 21, 2012, 1-27.

⁶⁰ Yingyi Qian, Barry R Weingast, "Federalism as a Commitment to Preserving Market Incentives," *Journal of Economic Perspectives* 11, no. 4, 1997, 83–92, <https://doi.org/10.1257/jep.11.4.83>, 3, (accessed January 1, 2019).

⁶¹ Ronald Kneebone, "How You Pay Determines What You Get: Alternative Financing Options as a Determinant of Publicly Funded Health Care in Canada." 24.

⁶² Yingyi Qian and Gérard Roland, "Federalism and the Soft Budget Constraint." *American Economic Review* Vol. 88, No. 5 (1998) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=149988 (accessed January 1, 2019).

However, this phenomenon is not limited to intergovernmental relationships only. The “too big to fail” that had accompanied the subprime mortgage financial crisis in the United States is analogical. There might be far-reaching consequences stemming from the decision to let subcentral governments, bank institutions or for that matter key employers to go bankrupt. Thus, central government attempts to prevent them.

2.3.3 Welfare trap

The notion of the welfare trap in the context of fiscal federalism could be perceived as analogical to the welfare program recipient’s dilemma. Support that a person in need receives is usually conditional – based on his or her level of income. Therefore, that person could in theory not be motivated to increase own sources of income if that would not outweigh the loss stemming from the decreased welfare support. Potentially, the dilemma on whether to rely more on governmental support or own resources is a short-term effect decision. The less one is sure about his or her career or other prospects, the less one can afford to risk the drop of support. Moreover, the extra effort that could arguably lead to higher long-term chances of improving one’s life would be a suboptimal choice as compared to decreasing welfare in the short term when a person is income-sensitive. Therefore, the welfare trap is not always a matter of choice as corresponsive risks of getting out might be potentially unbearable in short term. The question whether this analogy is relevant for the fiscal federalism and whether its actors are consciously and even willingly welfare-trapped is crucial for further equalization debates. Dahlby argues that deliberate actions adjusting fiscal policies to maximize equalization revenues may result in setbacks.⁶³ These would be likely long-run effects resulting from lower rates of investments and possible propensity to spend money on rather consumptive goods as the concept of fiscal illusion might explain.

⁶³ Bev Dahlby, “The Incentive Effects of Fiscal Equalization Grants; Equalization: Welfare Trap or Helping Hand?” *Atlantic Institute for Market Studies*, Conference Paper, 2002, 1-14, 13.

2.4 Conclusion

The key mutual characteristics of the outlined flaws is information asymmetry and the principal-agent problem. The former one providing the fuel to the latter one. The more imperfectly monitored agents are, the higher incentive they might have to follow their own objective unaligned with their principal's. Due to the monitoring options rooted in the principle of the equalization system, Quebec would likely tend to align objectives with its citizens rather than with the federal government. Therefore, in this case, Quebec's citizens should monitor that their policymakers secure public services at reasonably comparable levels of taxation. The theoretical possibility of officials following own objective and motivations is a shift from fiscal federalism first-generation scholarship that considered benevolence and objective-alignment of the policymakers as fixed. Critical assessment on whether equalization payments tend to distort Quebec policymakers' incentives will follow.

3. Economic position of Quebec

This chapter aims to analyze the current macroeconomic and fiscal situation of Quebec. It focuses on equalization payments revenues, the evolving role of manufacturing and fiscal policymaking. Despite never reaching the average level of federal fiscal capacity as measured for the purposes of equalization payments, Quebec has arguably been macroeconomically and fiscally in fairly good shape in the past years. It has been able to continually maintain a balanced budget since the fiscal year (FY) 2015-16 and even to reduce its public debt.⁶⁴ Although there are significant factors limiting Quebec's ability to increase its fiscal capacity, there are as well steps that could be taken by the provincial government to reduce dependency on the federation.

3.1 Equalization payments in Quebec

Considering the complex nature of the equalization system, finding satisfactory metric system for quantitative analysis seems to be a challenging task. The system functions in a highly diverse environment where grant recipients could utilize the money for any desirable purpose. Therefore, tracking where the equalization money was specifically used and whether it contributed to the intended purpose seems to be merely impossible. Applying uniform economic indicators to measure success of the program might be hence inappropriate, reflecting that each province could have differing governance objectives. For instance, a province might prefer environmental protection over resource exploitation. The decision to choose the latter over the former would come at potential opportunity costs of missed GDP growth, increased employment or potentially lower energy prices.

⁶⁴ Finances Québec, "Québec by the Numbers: Budgetary Balance." <http://www.budget.finances.gouv.qc.ca/quebec-en-chiffres/index201803.html#/budget/solde> (accessed January 1, 2019) and Finances Québec, "Québec by the Numbers: Economic Forecasts." <http://www.budget.finances.gouv.qc.ca/budget/2017-2018/quebec-en-chiffres/#/dette> (accessed January 1, 2019).

A province might be willing to deny the environmentally detrimental source of income, as it would be substituted by another source – the equalization payment. The extent to which provinces should rely on federal transfers in the long term is however problematic. Especially if such province is perceived by other provinces to be unrightfully receiving grants at their expenses.⁶⁵ The following section will focus on analyzing the equalization system's descriptive statistics in order to assess Quebec's involvement in it.

The role of Quebec in the equalization system shall be analyzed in FY 1981-2016. The verge of the 1970s and 1980s in Quebec history symbolizes the explicit demand for sovereignty articulated mainly by Rene Levesque's Party Quebecois (PQ) which won the provincial general election in 1976 for the first time. The year 1981 marks the re-election of PQ after an unsuccessful referendum on sovereignty-association of Quebec in the previous year 1980. Moreover, patriation of the Constitution in 1982 not only started new conflict between Quebec and the rest of Canada, but equalization payments became embedded in Canada's supreme law.⁶⁶ Hence, as the FY 1981-82 could be considered a breaking point in the modern history of Quebec and the equalization system, it was chosen as the beginning of the analyzed time framework. Due to the availability of complete statistical data throughout thesis research, the fiscal year 2015-6 closes the analyzed time period.

⁶⁵ See e.g. Brian Jean, "Canada's equalization system is broken, and we need to fix it." or Ted Morton, "Equalization payments have always been about keeping Quebec happy." *Calgary Herald*, April 7, 2018, <https://calgaryherald.com/opinion/columnists/morton-equalization-payments-have-always-been-about-keeping-quebec-happy> (accessed January 1, 2019).

⁶⁶ Quebec denied endorsing the Constitutional amendments fearing redistribution of powers in favor of central government. Series of unsuccessful negotiations symbolized by two failed constitutional accords (Meech Lake 1987 and Charlottetown 1992) culminated the Quebec frustration that led to the second sovereignty referendum in 1995.

3.1.1 Quebec never reached the nation's average fiscal capacity

Quebec's average entitlement to the equalization payments in the period from 1981-82 to 2015-16 was \$918⁶⁷ (in 2016 CAD)⁶⁸ per capita. Payments provided to Quebec were rather stable in 2016 CAD, with only several deviations as explained further below:⁶⁹

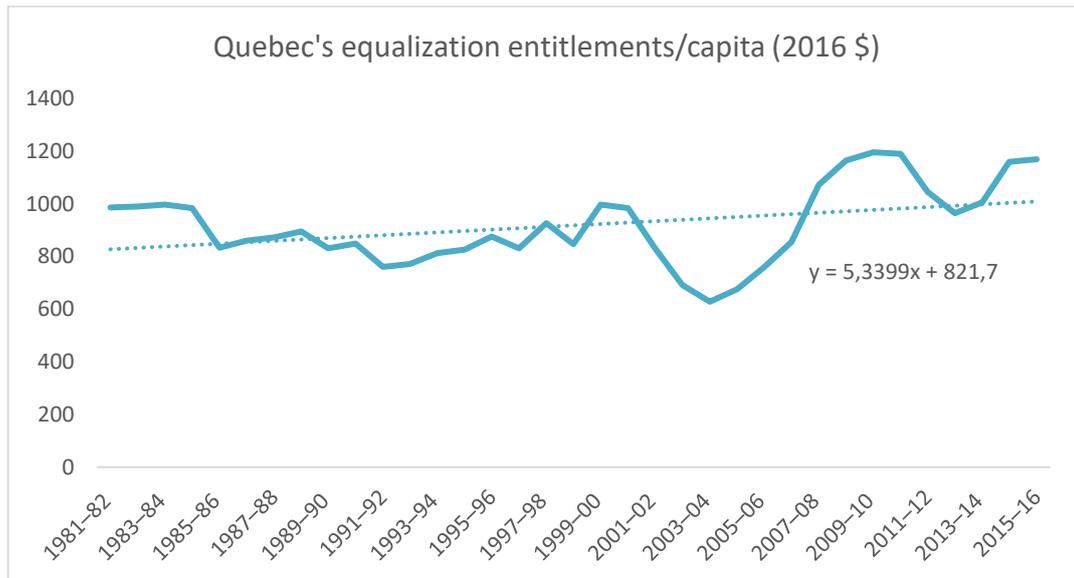


Figure 1 Quebec's equalization entitlements per capita were rather stable over time.⁷⁰

Equalization formula has been shifting throughout time. Thus, different count of resource revenues or average standard distorts comparison between individual FY.⁷¹ On the other hand, Quebec does not seem to have been approaching the average fiscal capacity – zero level on the figure above – at all. Despite comparably low per capita, due to Quebec's large population its entitlements equaled to a considerable part of the total equalization budget. In FY 2015-16, it received slightly over \$9.5 billion CAD, which represented 55% of the

⁶⁷ Adjusting to eliminate the effects of the outliers, median value was \$875 in 2016 CAD per capita.

⁶⁸ Statistics Canada, "Consumer Price Index, annual average, not seasonally adjusted." *Table: 18-10-0005-01 (formerly CANSIM 326-0021)*, <https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1810000501> (accessed January 2, 2019).

⁶⁹ Predicting trend would need extra econometric work, such as adjusting outliers, or incorporating more variables.

⁷⁰ Author's figure, data from: Daniel Béland et al., *Fiscal Federalism and Equalization Policy in Canada: Political and Economic Dimensions*, Appendix Table A.2, 119-120.

⁷¹ Notion whether equalization formula should rely on average (standard) of only five or all provinces has been changing.

total equalization budget.⁷² Having a highly-populated province to receive equalization payments represents a significant burden for the federal system. That has been apparent ever since Ontario became a *have-not* province in FY 2009-10.⁷³ Nevertheless, the per capita approach helps to secure the comparable perspective which is key to the system. Even the calculation of the fiscal capacity itself relies on the average of capacities across provinces. Therefore, if a province received higher or lower transfer in a particular year might theoretically reflect ‘only’ more intensive dynamics in other provinces.

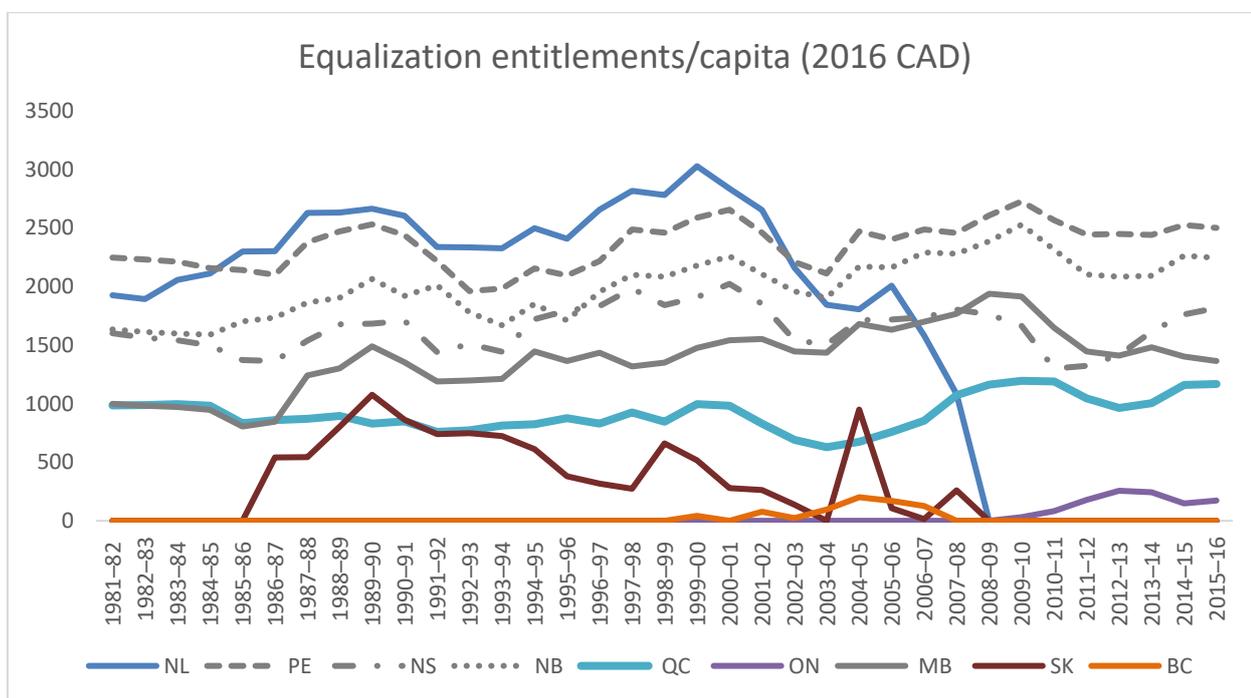


Figure 2 All entitlements are co-dependent.

Within the analyzed period, Quebec received the second lowest payment per capita in FY 2004-5. That likely coincided with low fiscal capacities of other provinces. Saskatchewan entitlement skyrocketed, and British Columbia experienced peak within the analyzed time period. Both provinces rely on production and export of raw materials which

⁷² Author’s calculations, source: Ibid.

⁷³ In FY 2015-6 Ontario received only \$173 CAD per capita in equalization money. However, being the most populated province in Canada, it resulted in \$2.3 billion CAD; equaling to 13.5 % of the total. Ontario was the second largest recipient after Quebec that FY.

were subject to multiple shocks in 2003.⁷⁴ Agricultural ones such as mad cow disease and SARS or forest fires in Western Canada.⁷⁵ Hence, both provinces gained part of the equalization pie, leaving less for Quebec. A similar dynamic arguably contributed to Quebec's largest entitlements in the period from 2008-9 as Newfoundland and Labrador (NL) reached its peak in oil revenues to become a *have* province for the first time in history.⁷⁶

In comparison to federal average, Quebec does not seem to be improving its fiscal capacity over time. The key question is whether the fact that Quebec's fiscal capacity had never reached the Canadian average represents a problem. Does it reflect worse a living standard or a lower level of public service in Quebec? The potential disparities among provinces are methodologically difficult to measure due to high level of cultural, geographical, economic or even political diversity. Hence, does Quebec really lag the rest of Canada and should it be compensated for it? Does low fiscal capacity stem from factors that cannot be easily "fixed" in short-term such as demographics or exogenously caused structural changes in economy? Or does the equalization system provide distorted incentive to keep the fiscal capacity low?

3.2 Manufacturing

A significant part of a province's fiscal capacity is determined by the state of its economy and success of its businesses. They directly provide the government with taxes, secure employment that in turn increases personal and consumption tax revenues. The government has a somewhat indirect role in securing higher fiscal capacity in this segment.

⁷⁴ Jean-Thomas Bernard, "The Canadian Equalization Program: Main Elements, Achievements and Challenges." *Department of Economics University of Ottawa*, December 2012 <http://ideefederale.ca/documents/Equalization.pdf> (accessed January 1, 2019).

⁷⁵ Saskatchewan Bureau of Statistics, "Economic Review 2004." Number Fifty-Eight, December 2004 <http://publications.gov.sk.ca/documents/15/100203-ER%202004.pdf> (accessed January 1, 2019).

⁷⁶ In fact, NL used to be one of the traditionally largest per-capita recipients until 2008-2009. Data on NL booming oil revenues: Newfoundland Labrador Canada, Finance, "Economic and Project Analysis: Oil Production Down 2.9% in September." <https://www.economics.gov.nl.ca/EB-oil.asp> (accessed January 1, 2019).

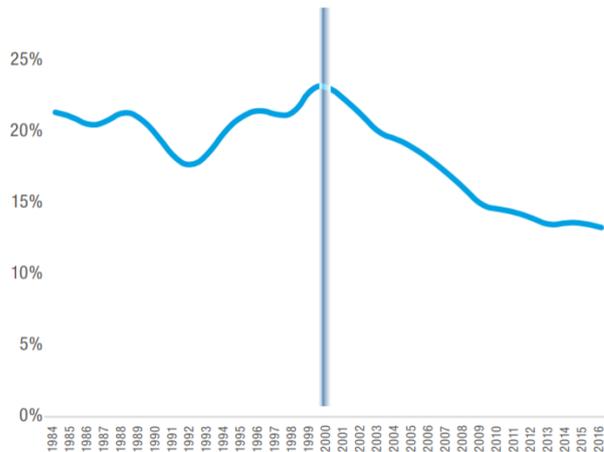


Figure 3 Since the early 2000s, role of manufacturing in Quebec has been rapidly decreasing in terms of GDP.

Considering the openness of Quebec’s economy, many factors are outside of policymakers control. These could be unfavorably shifting exchange rate of the dollar, demand for local goods abroad, foreign competition and obviously many others. Hence, their role is rather to create investment incentives, favorable

business environment or fundaments for growth e.g. through education.

3.2.1 Shifting role of manufacturing in Quebec’s economy

The role of manufacturing in Quebec’s economy has been notably and constantly deteriorating ever since the early 2000s as Figure 3 shows.⁷⁷ Between 2000 and 2016 the overall performance of Quebec’s manufacturing sector decreased by 14%, whereas total GDP grew by 28% in the same period.⁷⁸ That resulted in the share of manufacturing on GDP to drop by approximately 6.5-10 percentage points in this period.⁷⁹ The beginning of the decrease could be linked to technology bubble burst causing a recession in the USA and economic downturn in the rest of Canada.⁸⁰ In fact, the connection with the US economy is important due to the traded volumes. Desjardins analysis estimated that 20% of Quebec’s

⁷⁷ Jonathan Deslauriers et al., “Productivité et prospérité au Québec – Bilan 2017.” *Centre sur la productivité et la prospérité, Fondation Walter-J.-Somers, HEC Montréal*, February 2018, 19 <http://cpp.hec.ca/en/wp-content/uploads/sites/2/2018/02/PP-2017-01.pdf>.

⁷⁸ Author’s calculation based on annualized data adjusted for inflation and seasonality from: Institut de la Statistique du Québec, “Produit intérieur brut par industrie au Québec.” September 2018 <http://www.stat.gouv.qc.ca/statistiques/economie/comptes-economiques/comptes-production/pir/pir-201809.pdf> (accessed January 1, 2019).

⁷⁹ The HEC Montreal report indicates that manufacturing dropped from 23 to 13 % of GDP, author’s calculation based on official statistic data offer another estimate – decrease from 20 to 13.5 % of Quebec GDP.

⁸⁰ Philippe Kabore et al., “Special study: Economic history of Quebec over the past six decades.” *Desjardins Economic Studies*, November 2014, <https://www.desjardins.com/ressources/pdf/pv1411e.pdf>, 10 (accessed January 1, 2019).

GDP depended on the USA in 2016, with predominantly energy and low to medium-technology manufacturing exports.⁸¹ In fact, exports to the USA have roughly equaled to the trade with all other Canadian provinces combined in 2016.⁸²

The composition and sophistication level of Quebec's manufacturing sector have arguably strongly contributed to its deteriorating dynamics. A great part of this decline could be linked to low-technology manufacturing, which has historically played a significant role in Quebec's economy. Nevertheless, this type of industry tends to be vulnerable to exchange rates fluctuations due to exposure to competitiveness of developing countries. As the following Figure 4 indicates, a low-technology manufacturing sector elastically reacted to appreciation or depreciation of the Canadian dollar by shrinking or expanding respectively. The influence of exchange rates on manufacturing has interesting interprovincial implications.

⁸¹ François Dupuis, Joëlle Noreau, "Trade between Quebec and the United States: Banking on each party's strengths." *Desjardins Economic Studies*, January 2017

<https://www.desjardins.com/ressources/pdf/per0117e.pdf> (accessed January 1, 2019).

⁸² See: Statistics Canada, "Interprovincial trade flows." <https://www150.statcan.gc.ca/n1/pub/13-607-x/2016001/1059-eng.htm> (accessed January 1, 2019) and Institut de la Statistique du Québec, "Québec's international exports up in 2017." http://www.stat.gouv.qc.ca/salle-presse/communique/communique-presse-2018/fevrier/fev1828_an.html (accessed January 1, 2019).

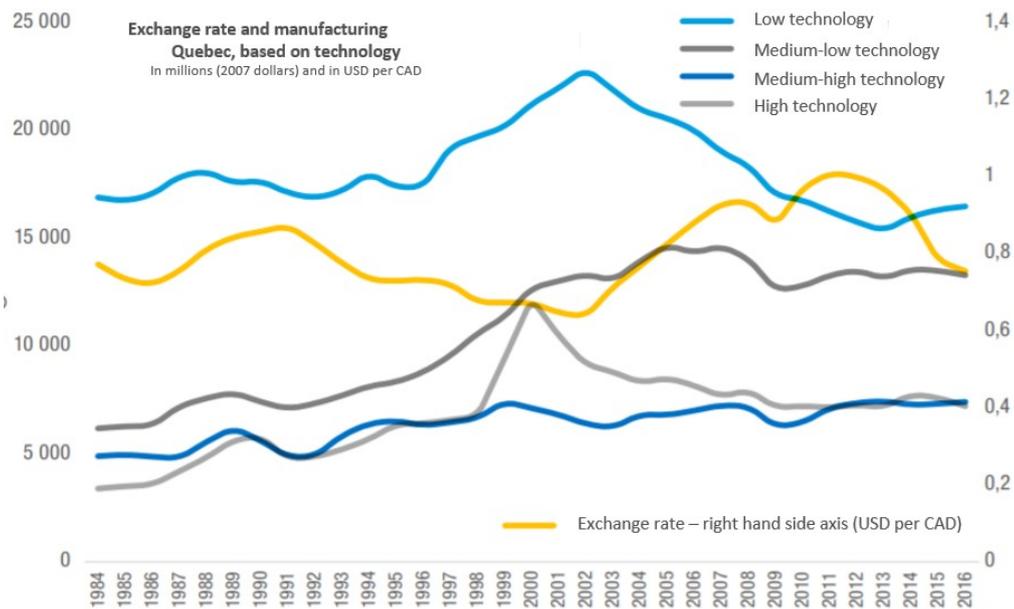


Figure 4 Low-technology manufacturing sector elastically reacted to appreciation or depreciation of Canadian dollar by shrinking or expanding respectively.⁸³

Assumedly, a high value of the Canadian dollar has detrimental effect on Quebec’s low to medium technology manufacturing. Considering the role of oil industry in Canadian economy, the occurrence of the so-called *Dutch disease* might be suspected.⁸⁴ It refers to unintended effects originating from high increases in local currency value. That is typically linked to vast volumes of natural resources sales that push the currency to appreciate. Once the value of the currency is high, manufacturing exports become more expensive and vice versa imports become cheaper. Which in the long run might result in growing unemployment as decreased manufacturing production, its weight would move abroad. There are signs that would suggest existence of such effect in Canadian economy such as visually similar trends

⁸³ Translated into English by author. Jonathan Deslauriers et al., “Productivité et prospérité au Québec – Bilan 2017.” 21.

⁸⁴ Sum of *conventional oil and gas extraction* and *non-conventional oil extraction* equaled to 5,2 % of Canadian GDP in 2006. Author’s calculation based on: Statistics Canada, “Gross domestic product (GDP) at basic prices, by industry, annual average, industry detail (x 1,000,000).” *Table: 36-10-0434-06*, <https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610043406> (accessed January 1, 2019), and Statistics Canada, “Gross domestic product (GDP) at basic prices, by industry, annual average, industry detail (x 1,000,000).” *Table: 36-10-0434-03*, <https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610043403> (accessed January 1, 2019).

between world crude oil price⁸⁵ and CAD/USD exchange rate⁸⁶ (see Figures 5 and 6).



Figure 5 Crude oil prices 1980s – present.

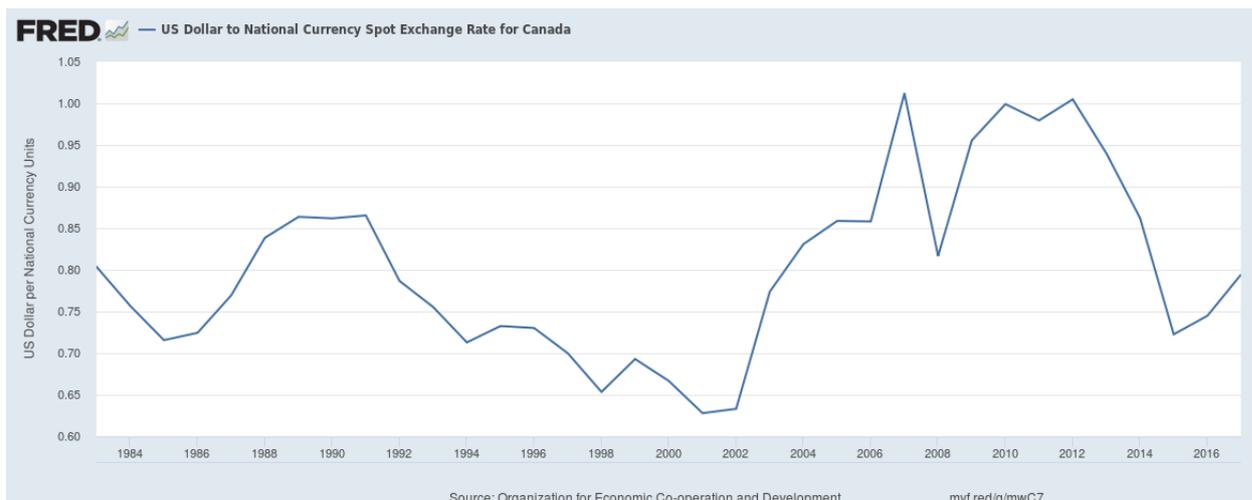


Figure 6 CAD/USD exchange rate seems to follow similar trend to crude oil price.

Certainly, this comparison is simplistic and to some extent misleading, as for instance the relation of US dollar and world prices needs to be taken into consideration.⁸⁷ It is well beyond the scope of this work to investigate the existence of Dutch disease in Canada.

⁸⁵ Macrotrends, “Crude Oil Prices - 70 Year Historical Chart.” <https://www.macrotrends.net/1369/crude-oil-price-history-chart> (accessed January 1, 2019).

⁸⁶ FRED Economic Data, Economic Research, “US Dollar to National Currency Spot Exchange Rate for Canada.” <https://fred.stlouisfed.org/graph/?id=CCUSSP01CAA650N> (accessed January 1, 2019).

⁸⁷ See e.g. this study Michel Beine et al., “Does the Canadian Economy Suffer from Dutch Disease?” *Resource and Energy Economics* 34, 2012, 468-492, <https://vdocuments.mx/does-the-canadian-economy-suffer-from-dutch-disease.html>, (accessed January 3, 2019).

However, the point is that manufacturing losses in Quebec could be – at least in public debate – tracked to Alberta and oil extraction.⁸⁸ In this perspective, the equalization payments could work as compensation for high values of the dollar disabling price competitiveness of Quebec’s manufacturing exports.

3.2.2 Some of the other factors deteriorating Quebec’s fiscal capacity

High exchange rate and other exogenous factors deteriorating Quebec’s manufacturing are not only problems lowering its fiscal capacity. Lagging labor productivity and aging population seem to significantly diminish economic performance as well.

Firstly, labor productivity in Quebec has been relatively low compared to the rest of Canada and other countries of OECD as the Figure 7 illustrates.⁸⁹

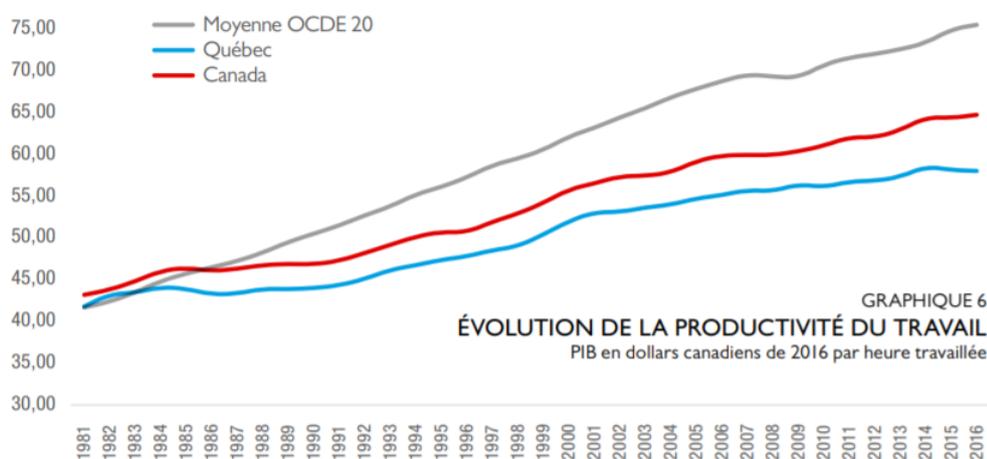


Figure 7 Quebec’s labor productivity is lagging the federal average.

Moreover, Quebec’s labor productivity does not seem to be converging toward the nation’s average. In comparison of OECD countries indicate that higher productivity is correlated to

⁸⁸ See e.g. Mark Gollom, “Is Canada suffering from 'Dutch disease'?” *CBC News*, May 2012 <https://www.cbc.ca/news/canada/is-canada-suffering-from-dutch-disease-1.1140014> (accessed January 1, 2019).

⁸⁹ Jonathan Deslauriers et al., “Productivité et prospérité au Québec – Bilan 2017.” 12.

GDP growth.⁹⁰ Case study of Finland demonstrates that tackling low productivity by investments to education or research and development could also lead to higher real wages and thus hypothetically higher quality of life in long run.⁹¹ Identification of what causes Quebec's relatively-to-other-provinces low labor productivity is worth separate research. Some role could arguably play migratory limitations due to language specifics. Relatively low labor productivity might be hence identified as one of the issues preventing Quebec from reaching federal fiscal capacity average.

Secondly, the population aged over 65 years represented 18.3 %⁹² of the Quebec's population in 2016, whereas 14.3 %⁹³ in 2006. Even in the context of other Canadian provinces, Quebec's population is aging, see the Figure 8.⁹⁴ This trend might be linked to the Quiet Revolution, which shall be also analyzed later in this work, or insufficient migration that might be partly caused by Quebec's cultural and linguistic specifics within the North American region. The decreasing ratio of the productive population not only results in lower revenues from e.g. income or consumption taxation, but also causes higher social expenses.

These were some of the factors objectively causing troubles to Quebec's economic condition. They contribute to lowered fiscal capacity. Depending on the extent of these systematic economic distortions in relation to other provinces, they should constitute valid reasons for receiving equalization transfers.

⁹⁰ Ibid., 11.

⁹¹ Ibid., 17.

⁹² Statistics Canada, "Census Profile, 2016 Census: Quebec [Province] and Canada [Country]." <https://www12.statcan.gc.ca/census-recensement/2016/dp-pd/prof/details/Page.cfm?Lang=E&Geo1=PR&Code1=24&Geo2=&Code2=&Data=Count&SearchText=Quebec&SearchType=Begins&SearchPR=01&B1=All&GeoLevel=PR&GeoCode=24> (accessed January 1, 2019).

⁹³ Statistics Canada, "Focus on Geography Series, 2011 Census: Province of Quebec." <https://www12.statcan.gc.ca/census-recensement/2011/as-sa/fogs-spg/Facts-pr-eng.cfm?Lang=Eng&GK=PR&GC=24> (accessed January 1, 2019).

⁹⁴ Source: Ibid.

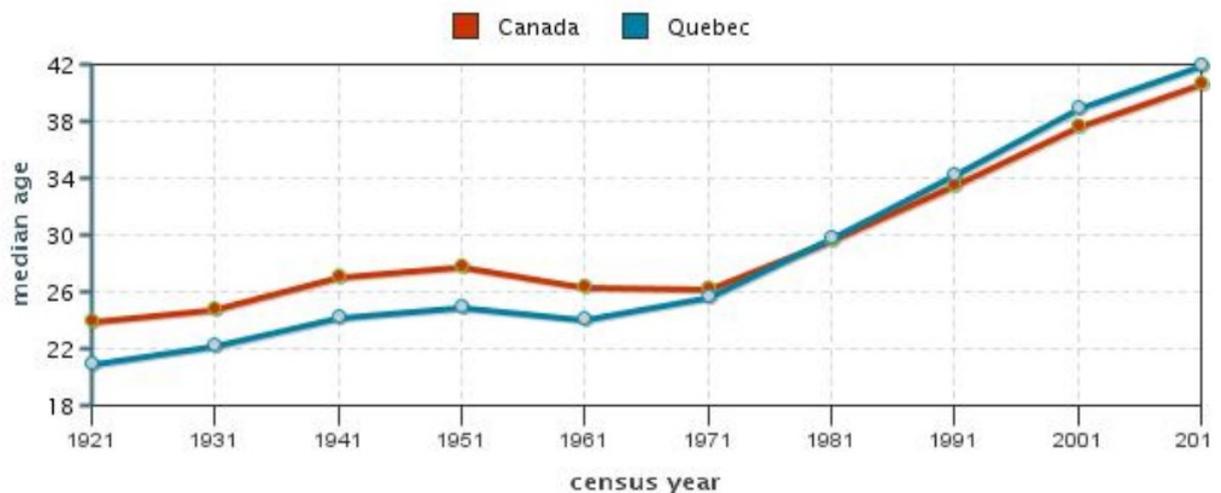


Figure 8 Québec's population is aging.

3.3 Quebec's fiscal policy

Quebec faces a series of unfavorable factors that has objectively been slowing down its growth and fiscal capacity. The relatively low labor productivity, downfall in manufacturing production in the past two decades, or aging population. These factors should reflect in provincial fiscal policy. The following subchapter will attempt to assess motivations of Quebec's officials within the fiscal policy framework with focus on 2015-6 budget, social security and energy policy. Thus, to critically evaluate whether Quebec's budgetary policy indicates incentives distorted by the equalization payments system.

3.3.1 Overall fiscal condition of Quebec

In the period from 1981-2016, Quebec ended the FY with a surplus 9 times more.⁹⁵ Those being FY 1998-2002, 2005-9 and 2015-16 which imply a countercyclical budgetary policy as the first two periods correspond to pre-crisis bubbles. In Canadian context that is an average amount of periods, with e.g. Ontario having one more FY with deficit than Quebec. Moreover, Quebec's budgets following FY 2015-16 have also been in surplus or

⁹⁵ Data based on the analysis from Royal Bank of Canada, "Canadian Federal and Provincial Fiscal Tables." February 2018, http://www.rbc.com/economics/economic-reports/pdf/provincial-forecasts/prov_fiscal.pdf (accessed January 1, 2019).

are planned to be balanced.⁹⁶ On the other hand, Quebec has in the observed period always belonged to the most indebted province, peaking in the aftermath of the latest financial crisis. Its debt accounted for almost 50% of GDP from 2009 to 2015 when it began to decrease.⁹⁷ In 2016-7, Quebec debt to GDP ratio equaled to 46.3% with projections for further debt reductions. Currently, Quebec is the most indebted province in Canada followed quite closely by Atlantic provinces and Ontario.⁹⁸

Another macroeconomic indicator relevant for interprovincial comparison of fiscal capacity is the size of government. One of the means of determining the size of government is to weigh its expenses in terms of GDP. Although being in an upper half of provinces with comparatively high expenses to GDP in 1980s⁹⁹, Quebec has managed to cut its expenditure ratio to 19.1 % in 2015-6.¹⁰⁰ It was the third lowest ratio in Canada after Alberta and Ontario respectively that FY. Observing basic fiscal macroeconomic indicators in the period from 1981 to 2016, Quebec does not seem to be extraordinarily different from other provinces in terms of debt, budget deficit or size of government in terms of its expenditures to GDP. Especially the latter is somewhat surprising, considering that Quebec tends to be known for its large government and generous social system.

3.3.2 Expenditure policies

The theory discussed in chapter 2 suggests that in the case of equalization payments spending, Quebec's policymakers would tend to align objectives with its citizens rather than federal government. Thus, possibly redefining federal objective of the program – to secure

⁹⁶ Ibid., “Provincial budget balances” table.

⁹⁷ Ibid., “Net debt to GDP ratio” table.

⁹⁸ Ever since early the 1990s, Ontario kept its debt quite stable around 30 % of its GDP. It has experienced similar dynamics as Quebec after 2009 and peaking its debt in 2014-5 with 39.2% of provincial GDP.

⁹⁹ With ca. 25% of GDP in the first half of 1980s and ca. 23% of GDP in the second.

¹⁰⁰ Ibid., “Total expenses relative to GDP” table. However, there is a time lag between fiscal results and equalization payment calculation. The point here is that, based on the main macroeconomic indicators, Quebec's policymakers do not seem to dramatically differ from other provinces in key fiscal results.

comparable level of public service at comparable rate of taxation. Nevertheless, due to the information asymmetry issues, voters might expect higher rates of expenditure as they possibly do not fully perceive the effects of federal grant. Quebec's expenses in terms of GDP do not exceed nationwide provincial average now. A closer look into Quebec's budget might help in identifying the province's preferences and objectives which local policymakers would tend to pursue. In comparison with another province, this might in turn uncover possible distortions caused by the equalization system payments.

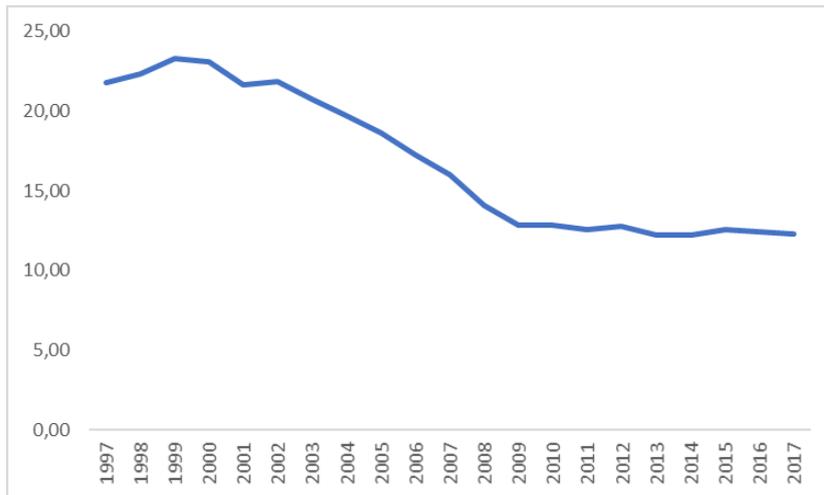
The sum of *Health and Social Services* and *Support for Individuals and Families*¹⁰¹ represented 53,7% of Quebec 2015-6 budget total expenditure.¹⁰² In Canada, education, the social security system and health care fall within the provincial jurisdiction. Health care and social security are part of the federal purpose-specific transfers to the provinces. Federal government also runs some other social security programs, but overall, provincial government carries the main responsibility. The health care system in Canada is famously known to resemble the essence of the European systems, especially in contrast with the United States. However, it has not always been the case.¹⁰³ Due to its size and nature, these groups of expenditure might be a suitable adept for testing overspending and possibly distorted incentives of policymakers. One way of investigating the relationship of equalization payments to health and social expenses could be by comparing case of Quebec with a control province that would have similar characteristics.

¹⁰¹ Together with equivalent types of expenditure to be referred to as *health and social* expenses.

¹⁰² Excluding debt service. Education and Culture equaled to 24 %; Economy and Environment to 14 %; Administration and Justice to 8.3 %. Author's calculations based on: Finances Québec, "The Québec Economic Plan – March 2016." *Budget 2016-2017*, <http://www.budget.finances.gouv.qc.ca/budget/2016-2017/en/documents/EconomicPlan.pdf>, A10 (accessed January 2, 2019).

¹⁰³ The acknowledgment of accessible and universal healthcare had grown after an example of the system first implemented in Saskatchewan by the premier and founder of NDP Tommy Douglas in the early 1960s.

Ontario might arguably fit the purpose. It not only has a relatively large population,



but more importantly has also significantly relied on manufacturing and has experienced its downfall similarly to Quebec.¹⁰⁴ Moreover, it had not received

Figure 9 Share of manufacturing on Ontario GDP dropped significantly since early 2000s.

equalization payments

prior to 2009. The analysis of the proportion of health and social expenses to total expenses aimed to capture present fiscal policy of Ontario in context with the preceding FY.¹⁰⁵ Not surprisingly, Ontario expenditures in terms of GDP increased rapidly with the financial crisis which coincides with it becoming a *have-not* province in 2009. Its unemployment rate that same year jumped up by 2.2 percentage points.¹⁰⁶ Prior to 2007, its health and social expenses in terms of total provincial expenditures had been stable and excluding debt service roughly around 49 %.¹⁰⁷ Then in 2007 the Ontario government increased the proportion of

¹⁰⁴ See the Figure 9. Ontario manufacturing sector followed the same path – Author’s graph; data from Statistics Canada, “Gross domestic product (GDP) at basic prices, by industry, provinces and territories, percentage share.” *Table: 36-10-0400-01 (formerly CANSIM 379-0028)*, <https://www150.statcan.gc.ca/t1/tbl1/en/cv.action?pid=3610040001#timeframe> (a

¹⁰⁵ The analysis investigated period from 1997-8 to 2015-6 due to data availability. Unfortunately, comparison of historical data might generate imprecisions mainly due to administrative issues. For instance, expense line being moved under jurisdiction of another ministry and aggregated with different lines than previously. Author’s calculations, data come from Ontario budgets and public accounts reports: Ontario, Ministry of Government and Consumer Services, “Ontario Budgets, 1956-2016.” http://www.archives.gov.on.ca/en/historical_documents_project/ontario_budgets.aspx (accessed January 1, 2019) and Ontario, “Public Accounts of Ontario: past editions.” <https://www.ontario.ca/page/public-accounts-ontario-past-editions> (accessed January 2, 2019).

¹⁰⁶ Statistics Canada, “Supplementary unemployment rates, annual.” *Table: 14-10-0078-01 (formerly CANSIM 282-0086)*, <https://www150.statcan.gc.ca/t1/tbl1/en/cv.action?pid=1410007801#timeframe> (accessed January 2, 2019).

¹⁰⁷ Based on calculations of data from Ontario, “Public Accounts of Ontario: past editions.” and Ontario, “2007 Ontario Budget: Budget Papers.” *Queen’s Printer for Ontario, 2007*, 168, http://www.archives.gov.on.ca/en/historical_documents_project/7-11/ONTARIO_2007_BUDGET.pdf (accessed January 1, 2019).

health and social expenses with 60% peak in 2009. Ontario's total spending in terms of GDP has generally tended to decrease since 2009 with only 0.5 % of GDP deficit in 2015-6.¹⁰⁸ Also, its unemployment rates returned to pre-crisis levels. However, the proportion of health and social spending remained relatively high after 2009 at seven-years average of 53.8 % and 54.5 % in 2015-6.¹⁰⁹ It might be hasty to confirm the existence of the flypaper effect as further research is necessary. However, the fact that ever since Ontario began receiving equalization payments, its health and social expenses noticeably grew and remained higher even when e.g. employment returned to its pre-crisis levels, raises suspicion.

3.3.3 Revenue policies

Although wasteful spending could be a more intuitive means of investigating distorted incentives, the revenue aspect of fiscal policy might be just as well influenced by unconditional grants. Even if Quebec decided to set unreasonably and thus ineffectively high tax rates, it would not directly affect the equalization system payments.¹¹⁰ Discussion in subchapter 3.3.1 suggested that Quebec does not seem to have a larger government than other provinces based on its expenditures. It however could be considered as sizable in terms of taxation¹¹¹ and the general level of redistribution¹¹² it pursues. Quebec has one of the most progressive approaches toward income taxation among the provinces.¹¹³ As the taxation

¹⁰⁸ In the following year, Ontario was even closer to balanced budget with 0.1 % of GDP deficit.

¹⁰⁹ Author's calculations, data come from Ontario budgets and public accounts reports: Ontario, Ministry of Government and Consumer Services, "Ontario Budgets, 1956-2016." and Ontario, "Public Accounts of Ontario: past editions."

¹¹⁰ Ergete Ferede, "The Incentive Effects of Equalization Grants on Tax Policy," *Public Finance Review* 45, no. 6, 2017, 723–47, <https://doi.org/10.1177/1091142116666316>, 744 (accessed January 2019).

¹¹¹ In FY 2015-6, Quebec collected \$28.4 billion CAD on personal taxes (35.4 % of total revenues); \$18.4 billion CAD on consumption taxes (22.9 % of total revenues). Whereas, from corporate taxes it collected \$6.4 billion CAD and from government enterprises 'only' \$5 billion CAD. For comparison, sum of total revenues from federal sources was \$19 billion CAD. Gouvernement du Québec, "Budget 2016-2017 The Québec Economic Plan." March 2016 <http://www.budget.finances.gouv.qc.ca/budget/2016-2017/en/documents/EconomicPlan.pdf>. (accessed January 1, 2019).

¹¹² See Figure 10. English translation by author. Source: Jonathan Deslauriers et al., "Productivité et prospérité au Québec – Bilan 2017." 37.

¹¹³ See Government of Canada, "Canadian income tax rates for individuals - current and previous years." <https://www.canada.ca/en/revenue-agency/services/tax/individuals/frequently-asked-questions-individuals/canadian-income-tax-rates-individuals-current-previous-years.html#provincial> (accessed January

rates are already among the highest in the country, its further expansion might be problematic both politically and economically.¹¹⁴ Looking at the other sources of revenue there are two lines that require further attention. Firstly, immense proportion of federal transfers on total budget revenues. It made the second largest part of revenues being higher than e.g. consumption tax revenues in 2015-6. It is however necessary to add that over half of the federal transfers in that FY originated from Canada Health and Social Transfers respectively.¹¹⁵ These are purpose-specific, each province receives based on its population.

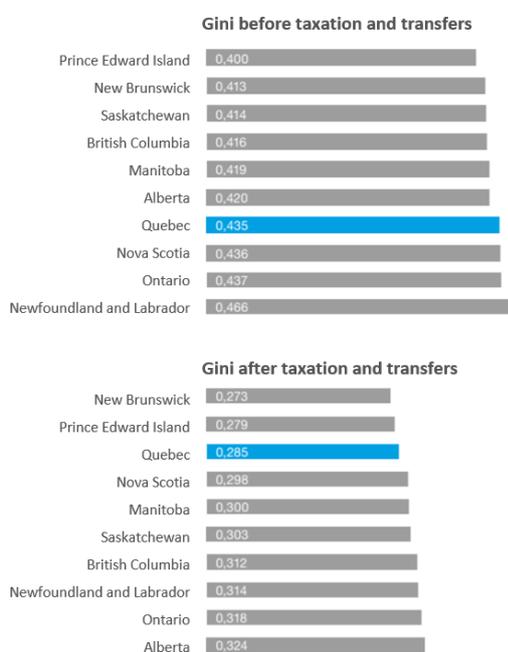


Figure 10 Québec reduces social inequality through wealth redistribution.

Secondly, incomes from provincial enterprises accounted for \$5 billion CAD in 2015-6, out of which, \$2.75 billion were revenues from Hydro Quebec – province-owned

1, 2019) and Revenu Québec, “Income tax rates.” <https://www.revenuquebec.ca/en/citizens/your-situation/new-residents/the-quebec-taxation-system/income-tax-rates/> (accessed January 1, 2019) and Gouvernement du Québec, “QUÉBEC'S PERSONAL INCOME TAX SYSTEM.” September 2014, 15 http://www.groupe.finances.gouv.qc.ca/examenfiscalite/uploads/media/AUTEN_Volume2_PersonalTaxSystem.pdf (accessed January 1, 2019) Quebec income tax rate in 2018 was 15-25,75 % depending on yearly income.

¹¹⁴ Laffer curve describes relationship in which increasing rates of taxation may have negative impact on marginal revenue.

¹¹⁵ Government of Canada, Department of Finance Canada, “Federal Support to Provinces and Territories: Federal Support to Quebec.” <https://www.fin.gc.ca/fedprov/mtp-eng.asp#Quebec> (accessed January 1, 2019).

energy producing monopoly.¹¹⁶ There is arguably room for boosting these revenues as electricity prices in Quebec have been considerably below the levels of other provinces and surrounding US states.¹¹⁷ The following graph indicates that electricity prices have tended to grow at slower pace than inflation.¹¹⁸

Inflation and trends in energy prices in Québec

All customer segments combined, 1963-2017

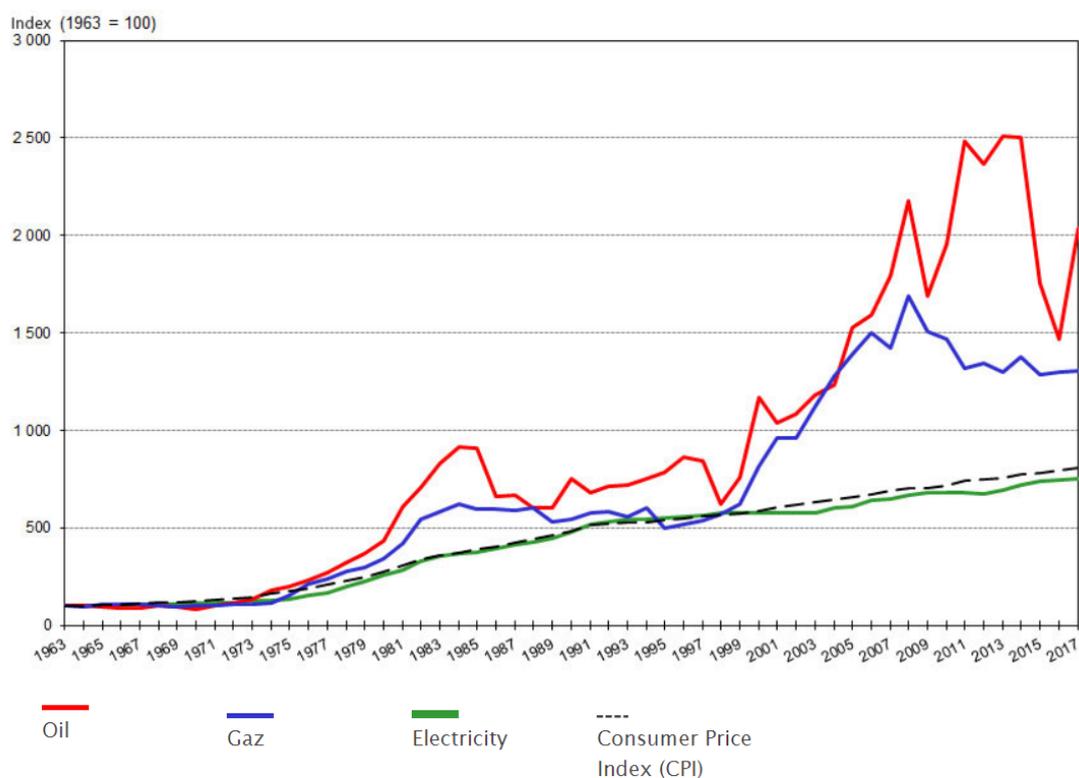


Figure 11 Price of electricity grew slower than Consumer Price Index.

The continuous gap between the CPI and energy rates results in energy becoming relatively cheaper over time. That does not necessarily mean that they would be therefore more

¹¹⁶ Revenues from *Loto-Québec* and *Société des alcools du Québec* equaled to \$1.1 billion and \$1 billion CAD respectively. Data from: Gouvernement du Québec, “Budget 2016-2017 The Québec Economic Plan.” March 2016, D12, <http://www.budget.finances.gouv.qc.ca/budget/2016-2017/en/documents/EconomicPlan.pdf> (accessed January 1, 2019).

¹¹⁷ Hydro-Québec, “Comparison of electricity prices.” <http://www.hydroquebec.com/residential/customer-space/account-and-billing/understanding-bill/comparison-electricity-prices.html> (accessed January 1, 2019).

¹¹⁸ *Ibid.*

accessible to citizens of Quebec, as all customer segments are incorporated¹¹⁹ in the calculation and disposable incomes are not. *Large industrial segment* low rates might arguably serve for attracting investors. The largest portion of revenues represent those flowing from residential users.¹²⁰ The average rate of residential segment was only \$79.2 CAD/1000 kWh.¹²¹ Average elsewhere was e.g. \$107 CAD in Vancouver or \$178 CAD in Toronto.¹²² Exports to other provinces and United States represented 28% of Hydro Quebec's total net income.¹²³ It could be intuitive to conclude that Quebec could rise electricity rates, generate more income and eventually increase its fiscal capacity.¹²⁴ On the other hand, Quebec's households already have comparatively low disposable income when adjusted for costs of life.¹²⁵ In my opinion, considering the level and progressivity of Quebec's income taxation, low prices of electricity could be perceived as an indirect subsidy by the provincial government and thus as a form of wealth redistribution. The government's opportunity costs are arguably carried not only by provincial taxpayers but by federal taxpayers as well in the form of substitutive income – the equalization payment. Therefore, it might be discussed that partly relying on external sources of revenue, Quebec could pursue its favorable energetical policy, keep its redistributive policy with balanced budget when possible. This perception would be in line with the assumption that Quebec even in the case

¹¹⁹ Large industrial segment rates tend to be significantly lower than residential ones. In FY 2015-6 it represented 31.6 % of sales volumes*, however generated only 19.6 % of sales revenues*. *Realized in Quebec. Calculation done by author, based on data from Hydro Quebec, „Annual Report 2016.“ 35.

¹²⁰ Residential segment represented 38.5 % of sales volume* and 44.5 % of sales revenues*. To provide complete information, last segment is *Commercial, institutional and small industrial*. It equaled to 26.9 % of volumes* and 33.2 % of revenues*. * Realized in Quebec. Calculation done by author, based on data from: Ibid.

¹²¹ This rate was calculated by dividing total revenues from residential segment by total sales volume for the same segment.

¹²² Report indicates the average rate in Montreal being \$72/1000kWh. Hydro Quebec, „Annual Report 2016.“<http://www.hydroquebec.com/data/documents-donnees/pdf/annual-report-2016.pdf>, 9 (accessed January 2, 2019).

¹²³ I.e. \$806 million CAD. Ibid., 30.

¹²⁴ Calculating possible increase in revenues is not so straightforward as demand elasticity needs to be taken into account.

¹²⁵ Quebec ranked on 7th place with only 3 Atlantic provinces (excl. NL) below. Source: Jonathan Deslauriers et al., “Productivité et prospérité au Québec – Bilan 2017.”, 35.

of equalization payments align its objective with its voters, who expect a large role of its government on societal functioning. That approach is likely linked with Quebec's social evolution since the World War II and especially the verge of 1950s and 1960s.

3.4 Summary

This chapter analyzed Quebec's macroeconomic conditions in the context of equalization payments in the period from 1981-2016 with further focus on fiscal policy in 2015-6. Quebec has never reached average fiscal capacity and neither has it seemed to be converging toward it. This phenomenon could be partly explained by objective macroeconomic and demographic factors, such as declining role of manufacturing, relatively low productivity or aging population. Nevertheless, Quebec's overall fiscal conditions appeared to be in fairly good shape as in 2015-6. Money dedicated to health and social purposes represented the largest part of total expenses. For that and as health and social expenses tend to be perceived as prone to overspending, they were investigated further. The case of Ontario implied that equalization payments might have boosted social and health expenditures. They became and remained considerably higher in terms of total expenditure after Ontario began to receive equalization transfers. Furthermore, the final part suggested that revenue might be also influenced by distorted incentives stemming from unconditional grants. The case of low electricity prices demonstrated that Quebec's fiscal capacity is likely undervalued which enables it to receive more equalization money.

4. Quebec's identity and equalization system

4.1 Quiet Revolution

The pivotal moment of Quebec's modern history and present day's situation had been the so-called Quiet Revolution. It marks the progress following the end of the conservative and traditionalist government of Union Nationale's leader Maurice Duplessis in 1959. There are various historiographic interpretations of when the liberalizing and modernizing process in Quebec started or of its eventual benefits for the province.¹²⁶ No matter whether the process had started already with the end of World War II or after the death of premier Duplessis, the 1960s symbolize far-reaching and genuinely revolutionary changes in the Quebec's society. The Duplessis' era could be characterized, for the contrast with the current situation, by the defining role of the Catholic Church. In fact, prior to 1960s the Church to a large extent administrated education, social services and health care. All of which had been inaccessible to a large portion of the population who had not disposed with means. Medical care had been operated by religious communities that were often poor and under equipped.¹²⁷ There had not been a ministry of education that would manage the educational standards across the province. The patriarchal societal values were strictly traditional with emphasis on religion with divorce rates and contraceptive use at rock bottom. Understandably, the birth rate had gradually decreased after the dissolution of this social model.¹²⁸ The new, younger generation not only of scholars and intellectuals rejected the ongoing social values and called for secularism and statism.¹²⁹ The latter presumably defines the Quebec's

¹²⁶ Michael D. Behiels, Matthew Hayday, *Contemporary Quebec*, (McGill-Queen's University Press, 2011)

¹²⁷ Denis Latulippe, "Social Security in Quebec: History and Related Issues." <http://www.cia-ica.ca/docs/default-source/2017/217129e.pdf>, 13, (accessed January 2, 2019).

¹²⁸ Institute de la statistique du Québec, "Naissances et taux de natalité, Québec, 1900-2017." <http://www.stat.gouv.qc.ca/statistiques/population-demographie/naissance-fecondite/401.htm> (accessed January 1, 2019)

¹²⁹ John A. Dickinson, Brian J. Young, *A Short History of Quebec*, (McGill-Queen's University Press, 2002), 305.

governmental apparatus nowadays with a considerable level of bureaucratization and provincial government's influence on everyday life of its citizens.

The era of the 1960s also arguably contributed to the notion of collectivity which likely helped to drive the sovereignty movements in the following decades. The idea stems from the desired recognition of Quebec's distinction within Canada. Acknowledgment of the distinctive culture, history and the general position of Quebec would shift from the individual level to the collective one.¹³⁰ That means that on top of recognizing French Canadians as equal and fundamental part of Canada, now Quebec collectively would have held a unique position. Not surprisingly, neither federal government nor other provinces wanted to grant any province special treatment or explicit rights to veto collective decisions. That gradually led to the outcomes of the Constitution conference's failures. However, looking into the motives of Quebec's demands, there are some long-term frustrations that need to be considered.

Identification with English Canada or loyalty towards the United Kingdom had always been very low in Quebec. It even led to many tense interactions between French Canadians and the federal government – i.e. the conscription crisis of 1917 was one of the most explicit denial of alignment with the rest of Canada by French Canadians who refused to join the army to fight overseas during the World War I. The more Quebec symbolized the personification of the collective struggle within a predominantly English country, the arguably more have French Canadians felt as systematically suppressed. There are scholars who connect the Quiet Revolution with the context of decolonization that had been largely taking place at the similar time period all around the world.¹³¹ Emancipation with emphasize

¹³⁰ Claude Bélanger, "Jean Lesage and the Quiet Revolution (1960-1966)." *Department of History, Marianopolis College*, 1998 <http://faculty.marianopolis.edu/c.belanger/quebechistory/readings/lesage.htm> (accessed January 1, 2019).

¹³¹ E.g. David Pettinicchio, "Migration and ethnic nationalism: Anglophone exit and the 'decolonisation' of Québec." *Nations and Nationalism*, 2012, 1-25,

on the specifics of own cultural, linguistic and historical evolution together with economic interests outside of anglophone businesses had been crucial for rebuilding Quebec's identity newly without the Church's key role.¹³² Especially the protection of the French language happened to become the defining factor of nationalism, putting aside even the Quebec-specific civil code legal system.¹³³ Nevertheless, the qualification and power to self-maintain and manage own challenging economic objectives has also defined the post-Duplessis Quebec. Within the variety of gigantic projects of world importance such as hosting Expo 1967 or Olympic games in 1976. This era is undeniably linked with the high-level engineering and self-reliance through province-owned energy production.¹³⁴ Therefore, Quebec had experienced a significant shift in the notion of its identity especially in the context of the Canadian federation.

4.2 Social System

The Federal government attempts to propose and implement nationwide social security programs had been present ever since the end of the World War II. Premier Duplessis strongly opposed such initiatives as he was not a supporter of the post-war tendency for social reformism and federal interventionism.¹³⁵ Moreover, letting federal government influence the social policy would undermine the then current political culture, social structure and the role of the Church.¹³⁶ Before the Quiet Revolution health care, social

<https://pdfs.semanticscholar.org/382a/46b08bbc6a61abaf4cdd2f818fd55e659453.pdf> (accessed January 1, 2019).

¹³² Michael D. Behiels, Matthew Hayday, *Contemporary Quebec*.

¹³³ *Ibid.*, 305-6.

¹³⁴ Donald Cuccioletta, Martin Lubin, "The Quebec Quiet Revolution: A Noisy Evolution." *Québec Studies*, Vol 36, Fall 2003/Winter 2004, <https://online.liverpooluniversitypress.co.uk/doi/pdf/10.3828/qs.36.1.125> (accessed January 1, 2019).

¹³⁵ The Beginning of a New Era, "The Advent of the Welfare State." <http://larevolutiontranquille.ca/en/rise-of-the-welfare-state.php> (accessed January 1, 2019).

¹³⁶ Daniel Béland, André Lecours, "Sub-state Nationalism and the Welfare State: Québec and Canadian Federalism." *Nations and Nationalism*, Volume 12, Issue 1, January 2006, Pages 77-96 <https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1469-8129.2006.00231.x>, 81 (accessed January 1, 2019).

system and education were operated predominantly by the Church. Although their operation was subsidized by the provincial government, there were huge disparities in quality and access to these services based on location and mainly wealth.

With political culture and social structure shifting during the so-called Quiet Revolution, the approach towards social and public healthcare systems had changed. However, opposition against the federal programs and centralization of social programs had not. Quebec's governments tended to negotiate the right to 'opt-out' of the federal programs. However, while obtaining fiscal compensation.¹³⁷ Moreover, Quebec's governments would tend to install similar but own programs to keep control of its identity-building.¹³⁸ The latter illustrates the crucial symbolism social system has played within Quebec's identity which is not a coincidence. Béland and Lecours elaborated on this idea and highlighted a link between Quebec's sub-state nationalism and welfare state. They suggest that both rely on the notion of solidarity and 'national', respectively, 'social' community. National community could be perceived as a community constructed and conceptualized by the (sub)state leaders, whereas the social community represents the consensual redistributive solidarity among the members of society. Both nationalism and welfare state could well serve as potential identity building blocks as they are typically highlighted by collective symbols, principles and motivation for mobilization.¹³⁹ The welfare state as a symbol of Quebec's identity has been present up until present days. On the other hand, it has also been strongly linked with the demographic necessities – for instance the proportion of people aged 65 or more is steadily growing in Quebec and is expected to grow further.¹⁴⁰

¹³⁷ Ibid, 82.

¹³⁸ Ibid.

¹³⁹ Ibid.

¹⁴⁰ Institut de la Statistique du Québec, " Le bilan démographique du Québec, Édition 2017.", *Démographie*, <http://www.stat.gouv.qc.ca/statistiques/population-demographie/bilan2017.pdf#page=17>, 30 (accessed January 2, 2019).

4.3 Energies

4.3.1 Hydro Quebec as a symbol

Quebec's welfare system has helped in building national identity by symbolizing social progressivism and egalitarianism – the key values of the post-Duplessis social evolution. Similarly, Hydro Quebec has contributed to the promotion of the francophone enterprise and developed engineering. Symbolically, it has helped to embody the emancipation represented by the 'philosophy' of *maîtres chez nous*¹⁴¹ or *masters in our own house*.¹⁴² The motto arguably characterized the movement's essence mainly within the economic dependence on the rest of Canada and the United States. As already discussed, the social evolution occurring during the Quiet Revolution and power resources nationalization per se could be perceived to a large extent as an attempt to get loose of English Canadian and eventually even the American commercial dominant position.¹⁴³ It resulted in the nationalization of power resources and thus birth of industrial emancipation symbol.

The project of the public means of energy production began in 1940s by expropriation of Montréal monopoly power provider and creation of the company named Hydro Quebec. However, the energy production system became almost fully public in 1963 during the premiership of Jean Lesage and patronage of the Minister of Natural Resources and future Parti Québécois premier - René Lévesque. The public ownership and operation of the rich provincial hydro endowments were to secure accessibility of energy at uniform rates to boost modernization and industrial development of Quebec. The rates were set to

¹⁴¹ Radio Canada.ca, „1962 : « Maîtres chez-nous ».“ *Archives de Radio Canada*, <http://archives.radio-canada.ca/sante/elections/clips/14280/> (accessed November 21, 2018).

¹⁴² David Sherman, „Hydro-Quebec, a symbol of French pride.“ *The Star*, March 30, 2012, https://www.thestar.com/news/canada/2012/03/30/hydroquebec_a_symbol_of_french_pride.html, (accessed January 3, 2019).

¹⁴³ Mr Caners' Class: 2016-2017, “THE BIRTH OF MODERN QUEBEC 1960-1970.” <http://mrcaners.weebly.com/the-birth-of-modern-quebec-1960-1970.html> (accessed January 1, 2019).

basically only cover the investment and operational costs of the company.¹⁴⁴ The engineering development also correspondingly gave impulse to the technical higher education in French language. Moreover, the provincial government, with broad public support, demonstrated the possibilities of the province by building massive dams and hydro-power constructions. When inaugurated in 1968, the Daniel Johnson dam was in fact the world's largest dam.¹⁴⁵

Hence, Hydro Quebec has played a strong symbolic role in Quebec. Especially within the context of societal emancipation and extensive role of government in society. Hence, federal transfers per se probably have not played key role in pursuing hydro energy policies which arguably undervalue Quebec's fiscal capacity. On the other hand, The Canadian form of federalism and Quebec's historical position in it is likely to have extensively contributed to the Quiet Revolution.

4.3.2 Fracking vs hydro and the perception of other provinces

As parts of Quebec have vast non-renewable resources, shale gas development has been a vividly discussed issue not only in Quebec but nationwide. Quebec is currently reluctant to pursue exploitation of such resources through potentially environmentally dangerous processes of hydraulic fracturing or *fracking*.¹⁴⁶ On the other hand, *have* provinces argue that if Quebec has a chance to enlarge its fiscal capacity and to 'escape' the equalization system, it should do so. Again, even in this case, Quebec's government aligns objective with its voters as environmental concerns outweigh possible economic gains. Extraction of gas through injecting chemicals underground in the area of St. Lawrence

¹⁴⁴ Robert Clark, Andrew Leach, "Energy Regulation in Québec." *Burgundy Report* December 2005, 23 <https://www.cirano.qc.ca/files/publications/2005RB-03.pdf> (accessed January 1, 2019).

¹⁴⁵ ¹⁴⁵ John A. Dickinson, Brian J. Young, *A Short History of Quebec*, 350.

¹⁴⁶ The stricter regulations and virtually conditional ban of fracking in Quebec was announced in June 2017. Source: Global News, "Quebec to ban shale fracking, limit oil-and-gas exploration." <https://globalnews.ca/news/4257905/quebec-ban-shale-fracking-limit-oil-gas-exploration/> (accessed January 1, 2019).

Lowlands with the population of around 2 million people and rich resource of arable land is currently not preferable for Quebec voters.¹⁴⁷ Official statement of the Quebec environmental bureau also does not view economic benefits to be outweighing the environmental costs.¹⁴⁸ The economic gains would however reduce Quebec dependency on federal transfers. This argument is more common in other provinces, rather than in Quebec itself.¹⁴⁹ Similarly to Hydro Quebec controversy, Quebec may afford not to pursue significant resource of revenues partly for the factual indirect compensation through unconditional federal transfer. The ideological and symbolical levels are not as strong as in case of Hydro Quebec. However, motivation for not pursuing growth of revenues arguably also stem rather from internal sources whereas equalization payments may serve as a safety net, reducing the urge to gain more money at own social or environmental costs.

4.4 Summary

Quiet Revolution symbolizes crucial changes in the functioning of the Quebec society and its position within Canadian federalism. The process is apparent since the 1960s contributed to the notion of Quebec's collectivity which likely helped to drive the sovereignty movements in the following decades. The idea stems from the desired end of

¹⁴⁷ Youri Chassin, "Equalization: Towards a Formula that Promotes Further Resource Development." *Economic Note*, June 2012, pp.3 http://www.iedm.org/files/note0712_en.pdf (accessed January 1, 2019).

¹⁴⁸ The Globe and Mail, Energy and Resources, "Fracking dealt another setback by Quebec report." December 2014 <https://www.theglobeandmail.com/report-on-business/industry-news/energy-and-resources/bape-says-shale-gas-production-not-advantageous-for-quebec/article22096203/> (accessed January 1, 2019). The report: Bureau d'audiences publiques sur l'environnement, "Rapport 307: Les enjeux liés à l'exploration et l'exploitation du gaz de schiste dans le shale d'Utica des basses-terres du Saint-Laurent." November 2014 <http://www.bape.gouv.qc.ca/sections/rapports/publications/bape307.pdf> (accessed January 1, 2019).

¹⁴⁹ However, based on the pre-election statements, the CAQ (Coalition Avenir Québec) that recently - in October 2018 - won the provincial elections is expected to reopen the debate to possibly lift the ban. Before elections, CAQ even publicly expressed intention to reduce dependency on federal transfers. Sources: Cecilia Keating, "Open letter rails against Coalition Avenir Québec's fracking comments." *National Observer*, September 2018 <https://www.nationalobserver.com/2018/09/24/news/will-fracking-become-socially-acceptable-quebec> (accessed January 1, 2019) and Paul Wells, "Quebec without equalization?" *Macleans*, November 2017 <https://www.macleans.ca/news/canada/quebec-without-equalization/> (accessed January 1, 2019).

cultural and economic oppression and recognition of Quebec's distinction within Canada. In this context, the welfare state has arguably helped to build the feeling of own social community where redistribution and thus extensive role of government played a key role. Moreover, Hydro Quebec is perceived as a symbol of French-Canadian know-how and capability of being *masters in their own house*. Considering the strong symbolic level of Hydro Quebec and the redistributive role of Quebec's government, it does not seem that the electricity pricing policy would be motivated primarily by the existence of equalization payments. On the other hand, as the case of fracking demonstrates, equalization payments might indirectly function as a safety net. Securing Quebec's desirable energy policy while keeping own fiscally redistributive model with a possibly balanced budget.

Conclusion

Canadian federalism has distinctively collectivist characteristics stemming e.g. from the ideological background of first settlers or collective memory interpreting western expansion. Despite initially established with centralized federal government, there have been strong political and institutional forces contributing to decentralization and regionalism in Canada. Interprovincial wealth gaps have potentially detrimental effects in the long run as among other things, they might undermine federal cohesion or evoke inefficient migration. Hence, The Canadian federal government has operated an equalization system aiming to secure reasonably comparable levels of public services at reasonably comparable levels of taxation throughout all provinces. The system is dedicated to provinces that do not have at least an average federal fiscal capacity to raise enough revenues to secure those comparable public services. Such provinces would receive unconditional grants which may be used for any purpose they find appropriate. Quebec has always been a *have not* province, receiving a large proportion of the whole equalization budget. Some representatives from typically *have* provinces, such as Alberta, tend to blame Quebec for deliberately taking advantage of the equalization system. They for instance argue that Quebec funds its generous welfare programs with money coming from their provinces. The source of the money is however purely federal. Moreover, the central government does not incorporate conditions for use of the money arguably in line with the fiscal federalism theory that considers decentralized redistribution of resources to be more efficient than the centralized.

Study of fiscal federalism has shifted from perception of government as a black box with benevolent officials whose actions would be defined by what is best for the respective administrative unit. The succeeding second generation of scholars suggest that policymakers might create decisions based on own motivations and level of monitoring by their

principal.¹⁵⁰ Unconditional grants might motivate local politicians to maximize their budgets also as median voters might not be fully aware of the grants' effects and could demand more spending. Moreover, with equalization system, provinces could lose incentive to raise their own fiscal capacity as it could lead to the loss of federal transfers. Finally, counting with federal bailout, provincial policymakers could have a higher tendency to waste resources. Nevertheless, due to monitoring options rooted in the principle of the equalization system, Quebec would likely tend to align objectives with its citizens rather than with the federal government.

Third chapter analyzed Quebec's macroeconomic conditions in the context of equalization payments in the period from 1981-2016 with further focus on fiscal policy in 2015-6. Quebec has never reached average fiscal capacity and neither has seemed to be converging toward it. This phenomenon could be partly explained by objective macroeconomic and demographic factors, such as declining role of manufacturing, relatively low productivity or aging population. Nevertheless, Quebec's overall fiscal conditions appeared to be in fairly good shape as in 2015-6. Money dedicated to health and social purposes represented the largest part of total expenses. For that and as health and social expenses tend to be perceived as prone to overspending, they were investigated further. The Case of Ontario implied that equalization payments might have boosted social and health expenditures. They became and remained higher in terms of total expenditure after Ontario began to receive the equalization transfers. That resembles behavior defined as *flypaper effect* which assumes that money originating from outside of the province would incentivize higher spending than tax money. Quebec's case of low electricity prices

¹⁵⁰As the principal-agent problem theory would imply.

demonstrated that its fiscal capacity is likely undervalued which enables it to receive more equalization money.

However, the precise motivation of the Quebec's policymakers to possibly deliberately decreasing their own fiscal capacity is difficult to measure. Therefore, historical foundations and contemporary thought on priorities of fiscal revenues and expenditures were incorporated to discuss the potential motivation. The Quiet Revolution symbolizes crucial changes in the functioning of the Quebec society and its position within Canadian federalism. The process apparent since the 1960s contributed to the notion of Quebec's collectivity which likely helped to drive the sovereignty movements in the following decades. The idea stems from the desired end of cultural and economic oppression and recognition of the Quebec's distinction within Canada. In this context, welfare state has arguably helped to build the feeling of own social community where redistribution and thus extensive role of government played a key role. Moreover, Hydro Quebec is perceived as a symbol of French-Canadian know-how and capability of being *masters in own house*. Considering the strong symbolic level of Hydro Quebec and the redistributive role of Quebec's government, it does not seem that the electricity pricing policy would be motivated primarily by the existence of equalization payments. On the other hand, as the case of fracking demonstrates, equalization payments might indirectly function as a safety net. Securing Quebec's desirable energy policy while keeping own fiscally redistributive model with possibly balanced budget.

Decentralized wealth redistribution is assumed to be more efficient than centralized as the policymakers could be more easily monitored and should have a more precise knowledge of local needs. However, the success of the equalization system is difficult to

prove for its vague purpose. Hence, as the federal framework does not provide a concrete purpose – only the principal - provincial policymakers would tend to follow objectives aligned with local voters. It is discussable whether voters, due to asymmetric information not being aware of the equalization grants effects, would demand more public services and thus causing distortions. On the other hand, historical perspective of Quebec's social evolution, better explains the undervalued fiscal capacity through energy policy, as it could be perceived, in my point of view, factually as a redistributive policy. Therefore, if Quebec's voters prefer redistributive fiscal policies, then it could not be perceived as distortion stemming from the equalization payments.

More research needs to be conducted on the federal political players and expressed ideology within the equalization payments. I assume that ideological or federal political preferences would follow the regional line as outlined in the subchapter 1.2.2. Hence, in my opinion, the more federal electoral system will favor regionally skewed parties and policies, the more regionalism will be reflected in federal politics.

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