

# Canadian Fiscal Arrangements:

What Works, What Might Work Better

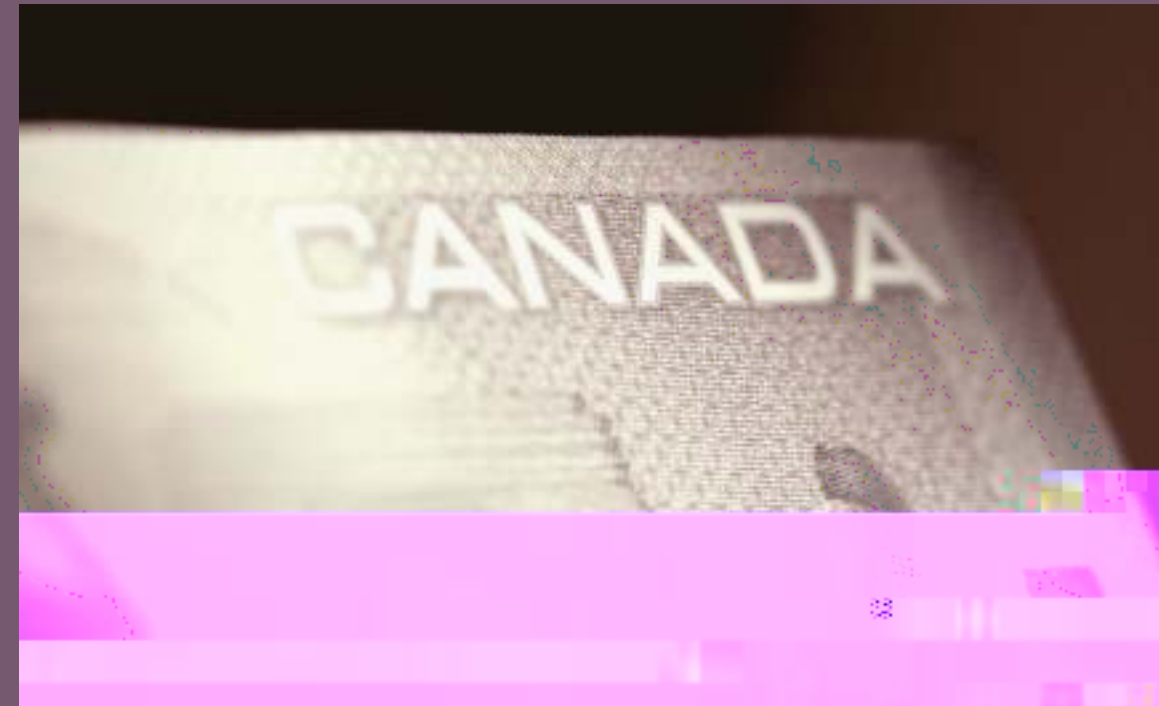
Edited by Harvey Lazar

Following the 2004 federal general election, Canadians had a freshly elected Prime Minister and also a large number of relatively newly elected provincial governments and Premiers. The new personalities have made a difference that is affecting the dynamics of the federation.

But structural realities and political ideas also influence intergovernmental relations. They show up most clearly in the fiscal arrangements among federal, provincial and territorial governments. These arrangements are being re-negotiated. This was reflected initially in the September 2004 new long-term intergovernmental fiscal arrangements for health care. It is also reflected in ongoing negotiations about the future of the Equalization Program and the struggle about fiscal balance or imbalance among governments. This struggle affects the future funding of social programs, cities

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Current research interests include fiscal federalism, the social union, health policy, the reform of federal political institutions and the machinery of federal-provincial relations, Canadian federalism and the global economy, and comparative federalism.

The Institute pursues these objectives through research conducted by its own staff and other scholars, through its publication program, and through seminars and conferences.

The Institute links academics and practitioners of federalism in federal and provincial governments and the private sector.

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## II Debating Fiscal Balance and Imbalance

## FOREWORD

This volume is being published in the midst of a major revival of political controversy within Canada about the main elements of our system of fiscal federalism. The issues under debate include: vertical fiscal balance or imbalance; horizontal fiscal balance or imbalance and the kind of Equalization system Canada needs; the funding of cities; and Aboriginal financing. Although these issues are often debated in the arcane vocabulary of fiscal federalism, in substance, they are not remote from the

## PREFACE

This volume reports on results of the Fiscal Arrangements Conference organized by the department of Finance of the Government of Manitoba and the Institute of Intergovernmental Relations at Queen's University in May 2002.

In the months leading up to the conference, Manitoba officials believed that the Equalization Program and other aspects of the federal-provincial fiscal relationship would likely be subject to periods of intense scrutiny and change in the period that was ahead. The conference itself was held May 16 and 17 in Winnipeg, Manitoba. It was scheduled to start the day after a meeting of the federal-provincial finance officials who deal with fiscal arrangements. The result was that many federal and provincial finance officials were able to attend the conference.

The Manitoba government was of the view that while much of the federal-provincial fiscal partnership works reasonably well, there was also scope for the arrangements to work much better. This theme is reflected in the title to this volume – Canadian Fiscal Arrangements: What Works, What Might Work Better.

Much has happened in federal-provincial fiscal relations since the conference was held. Many of the chapters have been revised to reflect developments in the intervening period. Even those papers that have not been revised are timely, particularly as a federally appointed panel is now reviewing aspects of the Equalization Program, and aims to complete its work by the end of 2005.

The papers presented in this volume are the views of the authors alone. It should not be assumed that they reflect the views of the Government of Manitoba or of the Institute for Intergovernmental Relations.

Canadian fiscal arrangements are a central theme in Canadian federalism. Public debate and interest in such issues as Equalization, the issue of fiscal balance/imbalance and related issues like the funding of health care, social programs, Aboriginal programs, and cities is high. It is hoped that conclusions in the chapters here will contribute to the intergovernmental debates that now face the country, in particular with respect to the constitutional commitment under Section 36(2).

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# A FRAMEWORK FOR ANALYSIS

1

TRUST IN INTERGOVERNMENTAL

These instruments are used most effectively when there is a significant measure of societal consensus or at least intergovernmental consensus on policy goals and the efficacy of the tools to advance those goals.

For the last quarter century, unfortunately, such a consensus has been noticeably absent in Canada. Canada's post-war agreement on policies of macro-economic stabilization and welfare state growth lasted until the late 1970s or perhaps a little longer.

S

for public health insurance and post-secondary education into a very large single block that subsequently became the Canada Health and Social Transfer (CHST), he declared: "It is now time to complete the gradual evolution away from cost-sharing to block funding of programs in areas of provincial responsibility" (Department of Finance Canada 1995a, 52-53). He continued: "The new transfer will end the federal intrusiveness of cost-sharing and reduce the federal-provincial entanglement that has been a source of irritation with current shared-cost arrangements" (Ibid.). This new transfer, he informed the public "represents a new approach to federal-provincial relations marked by greater flexibility and accountability for provincial governments" (Department of Finance Canada 1995b).

Yet in the 2000 and 2003 federal-provincial health accords, Ottawa negotiated with the provinces that its increases in health transfers be targeted on agreed priority areas by the provinces "in a position that, whatever its intrinsic merits, did not jibe with the previously heralded "greater flexibility." And in its 2004 election platform, Mr. Martin and his colleagues stated that the federal government would continue to support the provinces in their efforts to improve the quality of health care. (Pada 1 .006(g)-)dw [(1)-245 H)14(iou.3







Figure 1  
Government Program Spending as a Share of GDP  
(Excluding Intergovernmental Transfers)

Source: Statistics Canada, National Income and Expenditure Accounts STC 13-351 (data prior to and including 1961) and CANSIM II matrices 3800033, 3800034 and 3800035 (data post-1960)

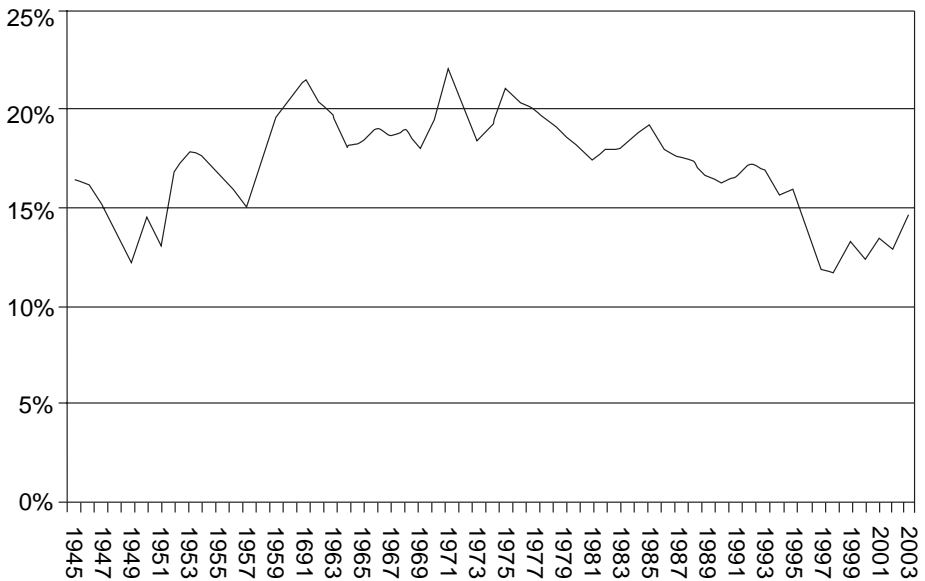
Note that methodological differences exist between the two data sets.

As a part of this exercise, federal cash transfers to the provinces also fell in part because these transfers were simply too large to escape the federal knife during a period of cost cutting. While the reduction in the late 1970s was associated with replacement of federal cash transfers with transfers, the subsequent cuts must be associated with the federal deficit reduction strategy. This trend is reflected in Figure 2.



Figure 2

Federal Cash Transfers to Provincial/Local Government as a Share of Provincial/Local Revenue (Excluding Transfers Between Provincial and Local Governments)



Source: Statistics Canada, National Income and Expenditure Accounts STC 13-351 (data prior to and including 1961) and CANSIM II matrices 3800033, 3800034 and 3800035 (data post-1960)

Note that methodological differences exist between the two data sets.

In turn, these developments — the overall large reductions in state spending and the cutbacks in federal transfers to provinces — have helped to fuel a number of controversies in Canadian politics. One is the charge that they have favoured the federal government at the expense of the provinces and municipalities resulting in a vertical fiscal imbalance. A second has to do with whether fiscal restraint has disproportionately disadvantaged poorer provinces. Both of these issues, at least when couched in terms of imbalances rather than in programmatic terms, are quasi-constitutional in that they relate to the character of the federation itself and the institutions that govern it.

The other controversies are linked more to the instrumental effects. Perhaps the major one in Canada for close to a decade has been the effects of intergovernmental fiscal relations on the efficiency and sustainability of Canadian health care. Another has been the effects on provincial programs of last resort — especially social assistance and services. More recently, there has been a focus on the adequacy of the funding of large cities. Less visible has been the ways in which intergovernmental fiscal relations affect the workings of the tax system and the stability of provincial revenues. Both these sets of issues — the quasi-constitutional and instrumental — are considered below.

## QUASI-CONSTITUTIONAL EFFECTS:

### THE ISSUE OF VERTICAL FISCAL IMBALANCE

Elsewhere in this volume, Alain Noël and Stéphane Dion present the case for and against the idea that Canadian federalism is characterized by vertical fiscal imbalance. As for the basic facts, provinces and local governments raise about 54-55 percent of total government revenues and have done so for the last quarter century with remark-





them. For example, some federations provide, either by constitutional law (e.g.,

There is no easy way of principle to choose between these two sets of considerations. Both have substantive merit. Context, however, helps; and part of that context is the magnitude of the current vertical gap in Canada. And by international standards, the current gap is small, as shown in Figure 4 below. That is to say, in recent years provinces and local governments have in aggregate received less than 20 percent of their revenue from the federal government, which is considerably less than in most federations (Watts 2004).

Figure 4  
Central Transfers as Percent of Total Constituent Unit (States and Local) Revenues

If, in practical terms, conditional transfers are the only kind of cash transfer the federal government is likely to consider, it is also important to observe that conditions can vary enormously – all the way from the federal government micro-managing provincial programs to conditions as light as Ottawa requiring that provinces spend transferred funds in some broad policy domain like health care or social services but with Ottawa retaining little practical ability to enforce that provision.

One way of classifying conditions is on the basis of whether they relate to inputs or outputs or outcomes. When the federal government, for example, transfers health care money to provinces on condition that it be used for certain types of supply factors (more on equipment but not on practitioners, more on additional practitioners but not on practitioners' salaries, more for nurse practitioners or whatever), it is imposing its view of how provinces should manage their health care systems. In some cases, the imposition is more apparent than real since the federal condition is effectively based on a consensus worked out with provincial line departments following expert studies and extensive intergovernmental discussion. Nonetheless, the appearance to the public is that Ottawa is co-managing the provincial systems. This has downsides. It reduces the pressures on the provinces to be fully accountable for results. For similar reasons, it creates confusion in the minds of the public about who to hold accountable. It also leaves the impression that Ottawa actually has the cure for the ailments of the various provincial health care systems and that its cures will work all across the federation, when in fact what Canada may need most is a variety of innovations with close monitoring for effectiveness. This approach of managing inputs also comes close to effectively overriding the division of legislative power in the 1867 pact that is the bedrock of the

their jurisdiction, that discourage provincial innovation and experimentation, and that effectively run roughshod over the constitutional division of legislative competencies, are neither a good idea in policy terms nor politically viable in large parts of the Canadian federation.

This conclusion is not a breakthrough in understanding how federal and provincial governments should relate to one another in respect of intergovernmental transfers. Rather, it reflects the kinds of considerations that federal and provincial governments took into account in the 1999 Social Union Framework Agreement (SUFA). It will be recalled that SUFA anticipates the Government of Canada working collaboratively with all provinces and territories to identify Canada-wide priorities and objectives and pursuing such initiatives only when it has secured the agreement of a majority of provinces. It further provides that each provincial and territorial government will determine the detailed program design and mix best suited to its own needs and circumstances to meet the agreed objectives. Under SUFA, each government also commits to monitor and measure outcomes of its social programs and report regularly to its constituents on the performance of these programs and to work with other governments to develop, over time, comparable indicators to measure progress on agreed objectives.

In other words, Canada already has a framework agreement that sets out guidelines for the way in which intergovernmental transfers should be used and the assessment here is that the framework agreement strikes a fair and reasonable balance among competing viewpoints and considerations when deciding what to do about the vertical fiscal imbalance. Increasing federal transfers to the provinces on the basis of the guidelines of SUFA is thus one appropriate structural approach for responding to the issue of vertical fiscal imbalance. The formalities of how to manage this are complicated by Quebec's decision not to sign on to the framework agreement. But the spirit and provisions of SUFA can in all likelihood be made acceptable to the Government of Quebec on a file-by-file basis.

The argument to this point is that the federation is adversely affected by a vertical fiscal imbalance that favours Ottawa and while there are in theory several instruments that can be used to rectify it, most fail either a policy test or a political one. But larger federal cash transfers to the provinces are one reasonable method of reducing the imbalance so long as the conditions attached to the transfers are SUFA-friendly and thus respectful of provincial legislative competence under the Constitution.

This still leaves open one other approach to dealing with the issue of vertical fiscal imbalance, namely, having the federal government assume directly some of the spending obligations of the provinces. In principle, this can happen in either of two ways. It can happen when the federal government identifies a policy priority that is to one degree or another within provincial legislative competence under the Constitution, and to advance that priority, transfers money to individuals or organizations (such as universities), in some cases through refundable tax credits. In so doing, it may attempt to ensure that each of its additional dollars is incremental spending in the subject area



by negotiating with the provinces that they will not reduce their planned expenditures in that same area. In other words, if the federal government increases its transfers to, for example, post-secondary students by  $\$x$  dollars, the province may be asked to agree not to reduce its grants or loans to that same target group so that the net increase in benefits to the post-secondary students is  $\$x$ . This is in fact what the federal government attempted to do in the case of the Millennium Scholarship Program. In the case of the National Child Benefit, provinces were free to reduce social assistance payments to low-income families but were expected to reinvest  $\$x$  in child-related programs. In practice, however, it may not always be possible for the federal govern-

eral Equalization payments, and partly due to recent unexpected fluctuations in the Program, more attention has been given to this Program especially by the governments of Equalization-recipient provinces.

The technical aspects of Equalization have been subject to intense debate among experts in recent years. This volume contributes to that discussion in chapters by Paul Boothe (the stabilizing properties of the Equalization Program), James Feehan (ways

Figure 5

Percentage Difference Between Provincial Nominal GDPs Per Capita and National  
No

The result is thus that the public is left without any clear indicator of whether constitutional objectives, or proxies for those objectives, are being met. There are available data from the federal Ministry of Finance, of course, that are used for calculating Equalization entitlements. But some provincial revenues are treated idiosyncratically for Equalization purposes as Feehan discusses in his chapter on natural resource revenues. Indeed, the five-province standard, which replaced the ten-province standard in the early 1980s, appears to be on the statute books mainly to control costs rather than for reasons related to constitutional objectives.

There is a danger in the federal and provincial governments avoiding the kind of analysis that should help shape the future of the Equalization Program. There is a danger in governments treating constitutional provisions lightly. The danger is that competing feelings of "unfairness" can mount in provinces that have different interests. On the one hand, to the extent that the Program is and remains divorced from hard analysis against established objectives, it risks being seen as an "entitlement" Program in re

The trouble with the current federal position is that it imposes a much weaker standard for evaluation on this \$10 billion Program than other government programs. It may encourage the kind of entitlement-boondoggle dichotomy alluded to above. It allows intergovernmental positioning without rigorous analysis. The risk in the status quo is that a Program that has been a centerpiece of social justice in the workings of the federation for decades will cease to be linked in the public's mind with some overarching national purpose. National purpose in turn may be what is ultimately jeopardized.

### POLICY-SPECIFIC ISSUES

It was suggested at the outset that the tools of fiscal federalism have both quasi-constitutional and functional effects. The discussion of vertical and horizontal fiscal imbalances has focussed on the quasi-constitutional or federalism side of things. For much of the Canadian public, however, it is the functional or policy dimension that appears most tangible. In this brief section, the text discusses three policy areas — namely health care, child care and the funding of cities — as illustrative of the kinds of issues now facing governments and the public.

The future of the Canada-wide publicly insured health care system has been front and centre for several years. Elsewhere, the case has been made that there is a need to reconstruct the federal-provincial health care partnership (Lazar, St-Hilaire and Tremblay 2003). At one level, the deterioration of the partnership may seem surprising since all provincial governments claim to support the five principles of the Canada Health Act. But there are problems on the ground and many Canadians are worried that the system will not be there to serve them in the future. From the intergovernmental perspective, health care has played out mainly as a fiscal issue, with provinces correctly criticizing Ottawa for contributing too little to provincial health care systems and on a basis that is too arbitrary and unpredictable. Indeed, health care is the poster child for what happens when federal and provincial line ministries, in this case, health care ministries, are pursuing common policy objectives while their finance ministries are attempting to disentangle. The result is dysfunctional.

What needs to be done? Writing in the days immediately preceding the September 2004 federal-provincial-territorial health care agreement, I argued for several elements in a new intergovernmental health accord. First, for reasons of fairness, the federal government should increase its cash contribution from the currently estimated 18-19 percent of total provincial-territorial health care spending to 25 percent. Second, that 25 percent should be maintained through the choice of an escalator that is designed to grow at a rate that more or less reflects the kind of cost pressures provinces are experiencing. While the federal government may be nervous about such a commitment as being too open-ended, Ottawa is much less at risk than the provinces as they still would bear the lion's share of unexpected high costs. Third, the federal government should contribute beyond the above amounts if there are to be extensions to the Canada-wide publicly insured system on home care and pharmaceuticals, as all governments appeared to agree to in the 2003 First Ministers' Health Accord. (The mid-

2004 provincial Pharmacare proposal to the federal government was noted above.)

parents, potentially stimulating for young children and in any case better than some of the alternatives that families have struggled with in recent years. On equity grounds, there is much to be said in its favour. The Liberal platform pledged to contribute new funds of \$5 billion over the next five years for the program.

Unfortunately, the document provides no data on how far the \$5 billion Liberal financial promise would go in meeting its own universal goal, nor is it even clear what "universal" means in this context. The current close-to-\$2 billion annually that the Government of Quebec spends on child care is suggestive. It does not come close to meeting the demand in that province for child care spaces; and yet Quebec is among the most advanced among the provinces when it comes to accessible child care. Moreover, the Liberal financial commitment runs for five years only. (Perhaps the ten-year federal financial commitment for health care will find its way into the federal position on child care when federal-provincial negotiations begin on this topic.)

On the more favourable side, the Liberal platform committed Ottawa to working with the provinces using the principles of SUFA as its guide. As suggested above, SUFA is the appropriate vehicle for federal-provincial negotiations on this topic.

appears to be that the federal government would use some of its financial flexibility to enhance the financial position of the apparently cash-starved municipal sector in the main by providing, for the benefit of municipalities, a share of the federal gas tax (or its financial equivalent). The Liberal platform goes on to promise that the tax sharing will begin in 2005 (in addition to the existing elimination of the GST) with a target of \$2 billion annually within the next five years. Whether there is such a shortfall at the municipal level is at least open to debate. However, in one view, the vertical fiscal imbalance in Canada is felt most at the municipal level, with Ottawa enjoying robust finances, the provinces keeping their heads above water (barely), and achieving this in part by downloading costs onto the local sector.

The case for such federal leadership, however, is difficult to understand, especially when analyzed in terms of the usual nation-building criteria of equity, efficiency and nation building. In the case of equity, it is worth recalling that the big cities were originally the targets and they are not the economically deprived centres of the federation even if they carry a disproportionate burden of migration settlement.

Nor is it obviously a nation-building motivation in the sense of enhancing the attachment of all Canadians to Canada. To the contrary, this policy thrust was initially divisive which is probably why the focus has shifted from big cities to all communities.

On the other hand, by investing in big cities in particular, Ottawa would be supporting those parts of the country that will determine Canada's economic and cultural future — investing in the real engines of economic growth and cultural diversity. And there will be positive externalities that will benefit many parts of Canada.

Nonetheless, the fiscal proposals raise serious questions. In particular, they obscure the fact that it is the provincial order of government that is constitutionally responsible for the municipal sector. If Ottawa does transfer revenues to communities on an ongoing basis (as opposed to time-limited project funding), it will be open to the provinces to offset the federal initiative by reducing their own transfer payments to these same communities. Equally important, the federal Liberal fiscal proposals create an expectation among municipalities that they should look to the federal government for ongoing funding whereas it is the provincial governments that are responsible for rectifying funding shortfalls. If the federal government persists in this endeavour, it will help confuse the public about which government is accountable for the municipal sector. Moreover, the confusion about accountability appears to have no offsetting benefits, from a nation-building, equity or even efficiency viewpoint.

The point here is not that big cities do not need larger and secure ongoing funding. It is that the federal government cannot do this alone and arguably should not do it at all. This is a role for the provinces and one that they might find it easier to address if the issue of federal-provincial vertical fiscal imbalance were resolved.



## REBUILDING TRUST

In their news release following their 29-31 July 2004 meeting of the Council of the Federation the provincial and territorial leaders appeared to call on Ottawa to improve the Equalization Program by moving back from the five-province to a ten-province standard that recognizes the volatility around resource revenues. Such an improvement could add several billion dollars annually to the close to \$10 billion in estimated federal program spending for fiscal year 2004/05 depending on prices for oil and natural gas. The premiers also front-end loaded their demand by calling on Ottawa to increase its payments by \$3.7 billion annually at once.

In the same news release, the Council of the Federation also demanded that the federal government immediately begin paying a cash transfer for health care equal to 25 percent of total provincial and territorial health care costs. This would have added around \$5 billion to the annual federal outlays that had already been legislated. The Premiers also called for a National Pharmacare Program to be operated and fully paid

for the 2004-05 fiscal year. The federal government has agreed to increase its payments to the provinces and territories by \$3.7 billion annually starting in 2004-05. This increase is front-loaded, meaning that the federal government will pay \$4.5 billion in 2004-05 and \$3.7 billion in 2005-06 and subsequent years. The federal government also agreed to pay 25 percent of the total provincial and territorial health care costs starting in 2004-05. This would have added around \$5 billion to the annual federal outlays that had already been legislated. The Premiers also called for a National Pharmacare Program to be operated and fully paid

1977 Ð a period characterized by large ongoing federal fiscal deficits. As the federal fiscal position improved, however, in the period from the late 1990s to 2004, Ottawa began once again to reassert its social policy influence. This was reflected, for example, in its attempts to expand and strengthen the Canada-wide health care system, to concentrate new resources on children, to create new programs for post-secondary education and, more modestly, to focus at least some attention on homelessness and affordable housing. But the federal government's renewed policy reach was not, at least initially, accompanied by commensurate financial commitments. Ottawa was seeking to steer Canada-wide social policy without jeopardizing its much improved finances. Protecting its strengthened fiscal status remained priority one.

By the end of 2004, the case for vertical fiscal imbalance may have lost much of its salience (for reasons that will be discussed below). Yet there were few signs that the intergovernmental jockeying for fiscal advantage would disappear soon and be replaced by a more policy-oriented intergovernmental dialogue. From one perspective, there was just not enough public consensus about the broad directions of public policy to ignite such a public discussion. From a second, there also remained layers of mistrust, especially between provincial authorities and their federal counterparts that needed addressing.

This mistrust between federal and provincial governments on fiscal matters is the legacy of the deficit decades. The pattern of intergovernmental fiscal negotiation that prevailed from 1940 through to 1977 was one of tough bargaining but few arbitrary actions. That was breached in 1982 when provinces, which then enjoyed a vertical fiscal imbalance at the expense of Ottawa, were unable to reach agreement with the federal authorities about federal reductions to its fiscal transfers. Ottawa, faced with daunting budgetary deficits at that time, decided to act unilaterally. This set a precedent that was subsequently repeated on a number of occasions culminating with the cap on the Canada Assistance Plan and the cost cutting associated with the introduction of the Canada Health and Social Transfer. From a provincial viewpoint, Ottawa was no longer a reliable or predictable fiscal partner although this situation might have evolved differently had provinces come to an accommodation at the table in 1982.

In any case, the need now is to restore trust and this is no easy task. And while there is no intention here to suggest a silver bullet, there are a number of ideas worth pursuing. All will require strong leadership from First Ministers and especially the Prime Minister.

First, as just noted, between the late 1990s and 2004 there was an imbalance between the policy role that the federal government was pursuing in areas of provincial legislative competence and the amount and predictability of the fiscal resources Ottawa was transferring to the provinces for those purposes. In particular, the federal government was pressing provinces to take on new ongoing program commitments without firm commitments to ongoing federal funding. Given past federal cutbacks in planned levels of transfers to the provinces, provincial mistrust was more than understandable. In this regard, the amount, form of and reliability of ongoing federal transfer payments

for health care as set out in the 15 September 2004 intergovernmental health agreement among First Ministers is arguably a major first step in dealing with this intergovernmental mistrust.<sup>4</sup>

Federal transfers to provinces are normally based on provinces undertaking program commitments that are at least, in some sense, open-ended. For example, when the economy turns down, social assistance costs normally rise. Since the end of formal federal-provincial cost sharing for large established programs, the result has been to add more to the financial risks borne by provinces than those carried by Ottawa. Without returning to all of the bureaucracy of formal cost sharing, it should be possible for governments to secure a fairer way of distributing the risks of an uncertain future. In this regard, the escalator provision in the just-mentioned 2004 health agreement is helpful in that it would assure a guaranteed level of federal cash transfers in a period of economic slowdown thus playing a stabilizing role.

At the same time, there is nothing constitutional that would prevent the federal government from again renegeing on its longer-term fiscal health care commitments to the provinces in the event of a fiscal downturn, as it did repeatedly in the 1980s and 90s. Consideration might be given, therefore, to adding a clause to the September 2004 intergovernmental health agreement and future similar agreements that, in the event of a fiscal force majeure, federal reductions in cash transfer payments to the provinces will not be proportionately greater than federal cutbacks to its own programs. This kind of provision was missing during the 1995 CHST debate and helped create the current measure of mistrust. While this kind of provision would also lack constitutional protection, it would be an important political barrier to any unfairness by the federal authorities.

Second, and returning more generally to the mistrust issue, the remaining vertical fiscal imbalance (as of late 2004) should be rectified, through some combination of intergovernmental transfers and direct spending initiatives. As of late 2004, the re

few years ago were suggesting the appropriate number was barely over ten percent and neither was factually wrong given its assumptions? The decomposition of CHST into two separate transfers is a positive step from a transparency perspective. But much more is needed.

Making the objectives of the Equalization Program more transparent would also serve the public interest. While most observers, myself included, consider this Program an important part of the glue that binds Canadians to one another, there are dangers in having the negotiations that surround the Program turn into a bargaining bazaar that is too remote from its original public purpose and the related constitutional provisions that help to give the program its legitimacy.

Indeed, perhaps the time has come for Canada to establish an independent finance commission, as in Australia, India and South Africa, so that governments and the public can receive an arm's length view of the numbers and analysis that underpin the intergovernmental fiscal relationship. The terms of reference of such a commission would be controversial as would the method of its appointment. The assumption here, however, is that the appointments would be made by the federal government after formally enlisting provincial opinion. The commissioners themselves would be appointed for fixed terms to ensure their independence (which might run for five to seven years). The range of tasks assigned to the commission would include:

1. To review the current arrangements for the equalization of provincial per capita income and to report on the results of the review.

into account. This implies accepting some limitations on the autonomy of governments as the price of a well-functioning partnership. This is what Canadians expect in their international partnership arrangements, and there is no reason that the same rule of thumb should not apply domestically. For the federal government, in particular, it requires a much better understanding of how its actions may affect the role of provinces, individually and collectively. And this applies to the federal finance ministry as well as other government departments.

Fiscal federalism in Canada today is too much about government and fiscal jockeying and not enough about people and policy. Until trust among governments is enhanced, the situation is unlikely to improve. Improving trust must thus become a first priority for all governments.

## Notes

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<sup>1</sup> For a more elaborate discussion of this perspective, see chapter 2 of this volume by Banting.

<sup>2</sup> See, for example, 2003 First Ministers' Accord on Health Care Renewal and chapter 3 of 2003 federal Budget Plan.

<sup>3</sup> See <http://www.pco-bcp.gc.ca/aia/default.asp?Language=E&Page=relations>.

<sup>4</sup> See, for example, statement by Prime Minister Mackenzie King (1946, 6).

<sup>5</sup> According to Marianne Vigneault (2003), "The problem arises because, with decentralization, the central government has limited control over subnational government spending and borrowing, but it maintains a strong interest in the affairs of lower-level governments. In this setting, soft budget constraints arise when subnational governments perceive that they will receive additional resources from the central government in the event of financial difficulty. This perception leads subnational governments to behave strategically in selecting spending and borrowing levels, and this may precipitate a crisis and a request for more resources or even a bailout from the central government," p. 1.

<sup>6</sup> For a succinct argument in favour of a tax point transfer, see Mintz and Smart (2002, 37-38).

<sup>7</sup> See chapters 5 and 6.

<sup>8</sup> I understand that there have been increases in federal transfers since the late 1990s. However, federal transfers to provinces as a share of GDP are lower in 2004 than they were in the 1970s.

<sup>9</sup> See, for example, Bird and Tarasov (2004).

<sup>10</sup> For a fuller discussion of the relationship between vertical fiscal imbalance and vertical fiscal gap, see Lazar, St-Hilaire and Tremblay (2003, pp. 145-151).

<sup>11</sup> See Conference Board of Canada (2004).

<sup>12</sup> For a full discussion of this approach, see Lazar, St-Hilaire and Tremblay (2003).

<sup>13</sup> The rapid rise in the federal surplus beginning around 2009/10 appears to be influenced in part by assumptions regarding the future of what used to be known as the

Canada Health and Social Transfer. The content in the 2004 First Ministers' Health Care Agreement suggests that the Conference Board of Canada (2004) assumptions were too pessimistic in respect of federal expenditure growth in this program area. Taking account of the 2004 First Ministers Health Care Agreement, the vertical fiscal imbalance will be considerably reduced.

<sup>14</sup> The data for Figure 4 are from the Government Finance Statistics Yearbook (produced by the International Monetary Fund.) All data are based on 2000/01 figures except for the U.S. (based on 1995/96), Germany (1995/96), and Canada (1993). The Canadian value in this figure is slightly higher than the corresponding value in Figure 2 due to factors such as methodological differences between the data sets and data revisions since the publication of the Yearbook.

<sup>15</sup> For a more detailed and somewhat different analysis of federal conditions on transfers, see Laurent and Vaillancourt (2004, 7).

<sup>16</sup> Quotations from A Framework to Improve the Social Union for Canadians (1999, section 5).

<sup>17</sup> Ibid., section 3.

<sup>18</sup> The most recent evidence of this is the 2004 agreement between the Canadian and Quebec Governments related to the 15 September 2004 intergovernmental health care arrangements.

<sup>19</sup> Council of Federation News Release, 31 July 2004.

<sup>20</sup> The 1997 Report of the Auditor General of Canada-April, in chapter 8, provides an evaluation of the Equalization program and is generally supportive of the idea that the program supports constitutional objectives. However, the analysis in the Auditor General's chapter does not deal with the issues raised in this paragraph.

<sup>21</sup> Since Ottawa is unable to tax Alberta's hydrocarbon revenues directly it has decided not to equalize the large differences in the fiscal capacity of provinces associated with that revenue stream.

<sup>22</sup> My calculation called for a slightly higher number than did Commissioner Romanow's. He excluded some provincial and territorial costs that I thought should be included.

<sup>23</sup> All references and quotations are from the 2004 federal Liberal election platform, chapter 2.

<sup>24</sup> Ibid.

<sup>25</sup> Kitchen (2004).

<sup>26</sup> See, for example, Bird and Mintz (2000).

<sup>27</sup> See, for example, Courchene (2004a).

<sup>28</sup> <http://www.councilofthefederation.ca/pdfs/HealthEng.pdf>.

<sup>29</sup> Ibid.

<sup>30</sup> For a comparable but even larger set of numbers see Quebec (2004); for a critique of the Quebec Finance position, see MacKinnon (2004).

<sup>31</sup> See chapter 5.

<sup>32</sup> For a fuller statement of this view, see Courchene (2004b, pp. 12-17).

<sup>33</sup> For a contrary viewpoint, see Parliamentary Task Force on Federal-Provincial Fiscal Arrangements (1981, 193). The fuller argument in support of the position developed here can be found Lazar, St-Hilaire and Tremblay (2003, 173-180).

<sup>34</sup> First Ministers' Meeting, 13-15 September 2004. *ÒA 10-Year Plan to Strengthen Health Care.Ó*

<sup>35</sup> For a discussion of the role of independent commissions, see R.L. Watts, 2005.



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## COMMUNITY, FEDERALISM AND FISCAL ARRANGEMENTS IN CANADA

Kéith Banting

### INTRODUCTION

For the vast majority of Canadians, debates about federal-provincial fiscal arrangements have a highly soporific quality. Part, people are turned off by the technical nature of the discussions and the complex language in which they are conducted. But in part, the public is bored because intergovernmental fiscal controversies appear on the surface to be animated by little more than an endless fight about money and power. Canadians have repeatedly made clear their impatience with intergovernmental jousting that seems to contribute little to solving the substantive problems that confront the country.

Yet underlying debates about fiscal arrangements are complex value choices on issues about which Canadians do have strong views. In revising our fiscal arrangements, we are inevitably making choices that touch core features of our political culture: our values about social policy, our values about democratic government and our sense of community. Intergovernmental fiscal arrangements have a powerful influence on our health and social programs, through which Canadians gTJ -1.804pre671FJ -1.804

define the social programs to which we are committed, the nature of democracy that we are going to practice, and the conception of community we are going to reinforce. The issues may be technical, and in some immediate sense the debates are inevitably about money and power. But our fiscal arrangements also embody big choices about the kind of country we want to be.

In these comments, I concentrate on the final set of values, those relating to the conception of political community in Canada. This focus is not meant to imply that social policy values or democratic values are secondary to choices about fiscal arrangements. However, this focus does reflect a conviction that too often the implications of fiscal arrangements for our conceptions of community tend to get ignored when governments gather around the bargaining table. In the charges and countercharges about who is or is not paying their share, and the alarms over conflicting policy agendas, we often seem to lose sight of the role of fiscal arrangements in giving expression to, and reinforcing our conception of, political community. These linkages do not disappear simply because they are not discussed. The danger is that we will make critical decisions without consciously reflecting on their implications for who we wish to be as a people, and the mix of communities in which we wish to live.

## SOCIAL POLICY AND COMMUNITY IN FEDERAL STATES

In democratic societies, social programs are rooted in a sense of community.

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the entire country: persons in similar circumstances would receive similar treatment

countrywide standards with respect to the benefits and services that should be available. As a result, horizontal equity would apply nationwide, and common standards of vertical equity would apply.

The predominant provincial version leaves full scope for provincial governments to chart distinctive trajectories in social policy. Countrywide sharing in this case is limited to redistribution among provinces to ensure that each province has the potential to provide comparable overall levels of public services and redistribution, if they so choose. This conception of the sharing community therefore does incorporate the principles that underlie the current Equalization system, according to which the federal government provides transfers to provinces with lower revenue-raising capacities so as to enable them to raise some minimum national standard of tax revenues per capita at national average tax rates. However, this conception of the sharing community does not incorporate other features of the countrywide version. Different levels of vertical equity would undoubtedly emerge across the provinces, and horizontal equity would not apply across the country as a whole. The whole point of this approach is to create room for diversity of approaches to equity across the country.

These two versions of the sharing communities serve as useful benchmarks, but obviously they do not exhaust the possibilities. For some, the predominant provincial version does not leave enough room for Canadians to decide collectively to establish a common approach to social benefits, one reflecting a sense of social solidarity spanning the country as a whole. For others, the predominant Canada-wide version seems to require redistribution standards resembling those one might expect in a unitary state, and to give too little scope to the regional diversities that also define Canada. Not surprisingly, much effort has been devoted to finding an intermediate position on the spectrum that balances the community of all citizens and the diversity of regional communities. One such intermediate position would involve a countrywide framework that defines some basic parameters of major social programs including health care, but which leaves room for provincial variation in program design and delivery mechanisms that are consistent with the framework. In terms of substance, this intermediate position, which Figure 1 calls a dual sharing community, promises a modified form of social citizenship, with citizens across the country being assured of comparable, as opposed to identical, social benefits and services. In terms of process, the dual sharing community commits Canadians to engage in two political debates about the future of social policy: the community of citizens across the country as a whole, and the community of residents of their own province.

The range of potential options is increased further by the possibility that the sense of attachment to the countrywide and provincial communities might differ across regions. While much of the country might prefer the dual model, for example, one regi





¥ In Belgium and Germany, the policy parameters are defined in a highly centralized and corporatist process. The federal legislature incorporates the resulting agreements

## DEFINING THE SHARING COMMUNITY IN CANADA

How do Canadians think of the sharing community in areas such as health care? Canadians live in multiple political communities, and the relative strength of their attachments to regional and pan-Canadian political communities is important to the federal-provincial balance. Are citizens more strongly attached to their local and regional communities, and do they seek to manage public programs that matter to them at those levels? Or are they strongly committed to the pan-Canadian community, and do they wish to debate and define core public programs with fellow citizens from coast to coast to coast?

Fortunately, we have evidence on these issues. Surveys of public attitudes and values confirm that Canadians have a sense of attachment or belonging to multiple communities, including both to Canada and to their province, and see no reason to choose definitively between them. Given their allegiances to both political communities, it is perhaps not surprising that, by wide margins, Canadians want the federal and provincial governments to collaborate in the management of the health care system. Surveys regularly find that Canadians see health care as a countrywide program. They endorse an active federal role, a preference that seems to have strengthened over the 1990s, and expect the federal government to be involved in maintaining the system and ensuring standards. Moreover, they are uneasy about cuts in federal fiscal transfers to provinces. In addition, public attitudes toward the Equalization Program suggest reasonably strong support for the idea of pan-Canadian sharing. This commitment to a countrywide conception of health care, and the engagement of both federal and provincial levels in the sector, suggests an underlying pan-Canadian sharing community, and is consistent with what we have termed a dual sharing community and a modified conception of social citizenship.

This dual sharing community conception seems also to accord with the realities of social policy as conducted by the federal government and the provinces up to the present time. The provinces are largely responsible for legislating and delivering important public services in the areas of health, education and welfare. At the same time, the federal government intervenes in a number of ways that lead to reasonably comparable pan-Canadian standards of redistributive equity being achieved. The Equalization Program goes a long way to giving provinces the potential to provide comparable levels of these public services using comparable tax rates. The dominant role of the federal government in the income tax system allows it to achieve reasonably uniform standards of vertical equity in after-tax incomes. This is reinforced by the fairly recent federal system of refundable tax credits that extends national vertical equity standards to those with low levels of income. There is an even higher degree of national sharing for the unemployed and the elderly through federally delivered programs such as employment insurance and public pensions. Finally, elements of a countrywide framework in health care have always existed through the broad conditions that have been attached to the original cost-shared and more recent bloc grants for provincial health programs.



health care, which took the form of reasonably comparable health services for all Canadians and represented an element of social solidarity across the country as a whole. However, it is important to recognize the limits of the Canadian approach here. In comparison with other federations, the Canadian system of health care is decentralized, and the Canadian model of sharing is more fragmented, especially outside the range of services covered by the Canada Health Act. Moreover, these limits are growing. The increasing role of health instruments that fall outside the Canada Health Act represents a quiet narrowing of social citizenship in Canada.

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Understandably, specialists in the field of intergovernmental fiscal relations are

## Notes

<sup>1</sup> For a more fully developed version of the essential points made in this paper, see Keith Banting and Robin Boadway, "Defining the Sharing Community: The Federal Role in Health Care," in Harvey Lazar and France St-Hilaire, eds., *Money, Politics and Health Care: Reconstructing the Federal-Provincial Partnership* (Montreal: Institute for Research on Public Policy, 2004).

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# 3

## THE VERTICAL FISCAL GAP: CONCEPTIONS AND MISCONCEPTIONS

Robin Boadway

### INTRODUCTION

The notion that there might be a vertical fiscal imbalance in the Canadian federation has been front and centre in recent years. The immediate source of the concern is the fallout from the unsustainable debt levels reached by both federal and provincial governments by the late 1980s. In particular, the precipitous and unanticipated reduction in cash transfers to the provinces constituted a pre-emptive move by the federal government that re-aligned rather abruptly the relative fiscal positions of the two orders of government. It also called into question the reliability and trust that could be placed on the federal government as a partner in the delivery of social policies in the federation.

poses, it is useful to refer to them as ~~simple~~ <sup>distinct</sup> concepts. The traditional meaning of a VFG comes from the fiscal federalism literature. It refers to the idea that the ideal degree of decentralization of expenditure responsibilities exceeds that of revenue-raising responsibilities for reasons to be discussed below. The counterpart to the VFG is a

## CONTEXT

To make sense of the case for and against a VFG, it is useful to remind ourselves of some key features of the institutional and policy setting in Canada.

### Stylized Facts

The Canadian federation has gradually evolved into one of the most decentralized in the world, including those federations with diverse cultural and linguistic communities. The provinces have legislative responsibility for delivering many of the key public services enjoyed by Canadians, especially those in the areas of health, education and social welfare. Provincial and municipal expenditures together especially those on goods and services exceed those of the federal government, and are growing more rapidly. Provinces have independent access to all the main tax bases used by the federal government, and more. There has been a gradual increase in the share of tax room occupied by the provinces, and they have gradually increased the proportion of expenditures financed by own-source revenues.

The flip side of this is that federal transfers have progressively contributed less and less as a proportion of provincial expenditures, and considerably less than is the norm among other OECD federations. The bulk of the transfers consist of Equalization and the CHT/CST. The conditions attached to the CHT/CST are fairly general, but are

tax bases, but also subject it to shocks arising from changes in other province's bases as well as tax rates. It turns out that the latter two have dominated the former, rendering the Equalization system a source of instability for provincial revenues.

### The Evolution of the Federal Spending Power

Much of what is at stake in the size of the VFG is the use of the spending power by the federal government. Although this is at the core of our later discussion, it is worth highlighting a few important ways in which the spending power has evolved. The first concerns the gradual change in the use of the spending power from an instrument used to induce provinces to establish major social programs to its use as an instrument for maintaining national standards in the programs thus established. In the former role, the spending power was used to induce provinces to initiate programs like Hospital Insurance, Medicare and the Canada Assistance Plan. This role involved both a substantial sharing of the costs by the federal government and some direction about the basic structures of the universal plans being touted. Once the relevant programs were established, the transfers were only required to sustain general features of the programs, and their magnitude gradually fell. Part of the issue discussed below with the VFG is whether such a sustaining role is warranted any longer, and if so, what sizes of transfers are needed to validate it.

## The Constitutional Setting

It should not be necessary to reiterate the various elements of the Constitution Act, 1982 that have a bearing on fiscal federalism. However, since they are all too often ignored, they bear repeating. The following list summarizes the most relevant of them for our purposes.

## Division of Responsibilities

Sections 91 and 92 of the Act set out the areas of exclusive legislative responsibilities. The interpretation of these sections leads to the view that the provinces have exclusive legislative responsibilities for education, social services, hospitals, and contributory schemes of social insurance. However, federal transfers to individuals, targeted or not,

## Redistributive Equity

Economists have a habit of evaluating all things of a policy nature according to the two criteria that inform reasoning about economic policy more generally: equity and efficiency. Moreover, seminal works on fiscal federalism relied on these notions to guide them in determining the ideal assignment of economic functions in a federal system of government. It is therefore natural to look for confirmation of how these play out in the Constitution. While there is no general statement of the role of equity and effi-

equity and efficiency objectives are satisfied. To the extent that the federal government has a role in addressing these nationwide objectives, and our argument is that such a role can be viewed as legitimate, the only reliable policy instrument available to it is the spending power. The key to the use of the spending power in areas of provincial responsibility, and the single most important challenge involved in resolving the VFG debate, is the guarantee that the manner in which it is used does not involve intrusiveness, arbitrariness, or unwelcome surprise. The elimination of the VFG implies the abrogation of a federal role, implying in turn that national equity and efficiency objectives are either set aside or are resolved through the unlikely vehicle of intergovernmental agreements.

### WHAT GOVERNMENTS ACTUALLY DO

Arguments about the VFG turn on which level of government should be responsible for which functions. This in turn depends on the role of the state in the first place. In fact, if one looks carefully at the budgetary expenditures of government, a high proportion of government fiscal policies — especially those that are the most controversial — can be viewed as being aimed at fulfilling a redistributive role broadly defined. Governments are largely institutions for redistribution. These include three general types of redistribution, all of which are interdependent.

#### Addressing Inequalities

The first is to counteract the unequal outcomes that are generated by the market economy. These arise because persons have differing income-earning capacities and different endowments. The main policy instrument for achieving this objective is the tax-transfer system, including the income tax and its associated refundable tax credits, the welfare system and various targeted transfers.

#### Equality of Opportunity

While the first motive can be thought of as an ex post form of redistribution, equality of opportunity occurs ex ante. This involves policies that put households on a more even playing field for participating in the market economy. Education is the most important such policy, but one can view health care and various social services as also contributing to this aim.

#### Economic and Social Security

The third redistributive objective is to compensate households for misfortunes and bad luck that are beyond their control. This could include unemployment, ill health, accident, and more generally circumstances such as the date of birth or location of residence. Social programs such as public health insurance, disability pensions, public pensions and unemployment insurance are programs that are intended to address various forms of economic insecurity. Programs of this sort are commonly called "social insurance" programs in recognition of the fact that they are intended i) to compensate



for misfortune (hence "insurance") and ii) intended to insure for misfortunes that would otherwise not be privately insured (hence "social"). In fact, one can interpret social insurance broadly to include ex post redistribution to the extent that it compensates for different endowments of productive ability.

There are a number of important features of redistributive programs that are used in practice to address these various types of redistribution. First, a variety of different instruments is used. These range from income-tested cash transfers financed by redistributive taxation, to transfers targeted on other features of the recipient, to transfers contingent on certain events (e.g., unemployment), to public insurance schemes, to the provision of public services.

Second, some of these programs are delivered by the provinces (health insurance, education, and social assistance and services), while others are delivered by the federal government (unemployment insurance, pensions, income-tested transfers). Roughly speaking, federal redistributive programs involve mainly transfers to individuals, while provincial transfer programs also include substantial in-kind transfers via the provision of goods and services.

Third, all redistributive programs involve what might be termed community sharing. That is, there will be beneficiaries and contributors within the community in which the program is being applied, and in budgetary terms, the net contribution of the contributors will just equal the net receipts by the beneficiaries. If programs were fully national in nature, the sharing community would be the nation as a whole. Persons of given circumstances would be treated identically regardless of their province of residence. On the other hand, if programs were fully provincial, the sharing community would be the province. All persons of given circumstance would be treated identically no matter where they resided in a given province, but they might be treated differently than like persons in different provinces.

As discussed in Chapter 2 by Keith Banting, a key distinguishing feature of a particular federation is the extent to which the relevant sharing community for redistributive programs is considered to be the nation as a whole as opposed to the province. It is useful to think of the potential sharing communities in a federation as lying along a continuum. Between the extremes of a national sharing community and provincial sharing communities, one can have mixed cases in which there is some national and some provincial sharing. A particularly relevant type of combined provincial-national sharing might be where resources are divided among provincial governments such that each has the potential to achieve common standards of redistributive equity, but each can choose to deviate from a national norm. This would be the case where national sharing embedded in the fiscal arrangements entailed full equalization alone. The greater the resources the provinces have, and the more leeway they have to use them with discretion, the greater differences can exist among provincial redistributive programs. When such differences exist, otherwise identical persons residing in different provinces would not obtain the same benefits from redistributive programs, unless by chance all provinces adopted similar redistributive programs. Lesser forms of

national sharing might then entail less complete equalization than above. Greater forms might combine equalization with additional fiscal arrangements embodying some national norms or standards to which provincial redistributive programs should conform.

The extent of the sharing community can differ from one type of redistribution to another. Thus, there may be more of a consensus for national sharing with respect to, say, social insurance or equality of opportunity than with respect to reducing income inequality. (An interpretation of the principles of Section 36(1) might lend support to this.) Sharing communities might also be asymmetric, in principle. That is, there might be a consensus that common standards of redistribution should apply across some provinces, but not all. Where a society chooses to be along the spectrum will be an important consideration in determining the size of the VFG as well as the nature of the policy instruments (transfers) used to close the VFG. This is a matter of community consensus, not a matter for economic principles, to decide.

The notion of the relevant sharing community is closely related to the economist's technical concept of horizontal equity and its fiscal federalism extension, referred to as fiscal equity. In the study of public finance, horizontal equity is the principle that persons in like circumstances should be treated in like ways by the public sector. Its extension to a federal setting suggests that persons of like circumstances no matter in which province they reside should be treated in like ways by the combined public sectors at all levels. The concept of horizontal equity has typically been used in the context of income redistribution and social insurance, but there is no reason why it should not also apply to equality of opportunity policies as well. Taken to the limit, full horizontal equity implies that the relevant sharing community should be the nation as a whole. Technically speaking, full horizontal equity is a consequence of the idea that all persons should count equally in society's social welfare function. Weaker notions of community sharing would have horizontal equity applying at the provincial level, but not fully at the national level.

It is also worth mentioning the relationship of community sharing with vertical equity. The latter refers to the amount of redistribution that takes place from more to less needy or deserving persons. Different degrees of vertical equity can apply within any given community, whether it is the nation as a whole or each province (or group of provinces) taken separately. If the nation is the sharing community, similar standards of vertical equity apply nationwide whatever those standards might be. The extent that provinces are separate sharing communities, they might choose different degrees of redistributive equity.

The distinction between vertical and horizontal equity is relevant for the discussion of VFG below. The ideal VFG is rw (lt)Tj 0.cuss

is viewed as being the sharing community, there will be limited need for a VFG no

## ARGUMENTS FOR A VFG

This lengthy background discussion was intended to highlight some features of the redistributive role of government. Redistribution must be put front and centre for a number of reasons. First, much of what governments do is redistributive in nature. Second, most of the concern about the role of government revolves around its redistributive role, especially the extent to, and means by which, redistribution ought to be pursued. Third, much of this concern spills over into the fiscal federalism area. The main source of overlap between federal and provincial responsibilities involves their joint concern for redistribution. Finally, and most important for our purposes, redistribution is at the heart of the debate over fiscal decentralization, and by extension the ideal VFG. Given the obvious value judgments involved in deciding on matters of redistribution, it is apparent that economic reasoning alone cannot resolve them. In the end, one must fall back on the consensus that the society forms about the appropriate amount of redistribution that governments should pursue, and about the extent to which the relevant community for redistribution should be the province or the nation as a whole. That consensus may be difficult to know, and may well change over time. That is what makes to topic of VFG a challenging one.

Given this background, we can now address the topic of this paper – what determines the ideal VFG and how it ought to be closed? It is useful to distinguish two perspectives on this issue, both of which contribute to its understanding. In discussing these alternatives, it ought again to be emphasized that the ideal VFG is inherently an elusive concept. Neither of these arguments will lead to a precise empirical measure of the VFG. And even if it did, it is not obvious how the ideal VFG should be implemented, since the actual VFG is determined jointly by the actions of both levels of government.

### Perspective I: Assignment Mismatch

The traditional argument for a VFG in the fiscal federalism literature is based on the argument that the case for decentralizing expenditure responsibilities is stronger than that for decentralizing revenue-raising responsibilities. Decentralization of the provision of public services, local public goods and targeted transfers to lower levels of government induces more efficient delivery for a variety of reasons. There is a better matching of services provided to local needs and preferences. Lower governments have better information about local circumstances that affect the cost of delivery. Costs of bureaucracy and management are lower with decentralized provision. Innovation and cost competition are likely to be enhanced if several lower-level governments provide a service than if a single national government does. And, there may be better accountability if lower governments provide a public service, since for example local decision-makers may be in a better *posito* to respond to citizen concerns.

These kinds of arguments are widely perpetrated and accepted. Their relevance is reflected in the reality observed in most federations, and even unitary states with local governments. The provision of important public services and targeted transfers is typically decentralized to subnational governments. The exceptions are instances

where there is some national advantage, such as economies of scale or national risk-sharing. Moreover, federal constitutions typically reflect these considerations.

Two features of the decentralization ought to be noted. The first is that the relative importance of expenditures suitable for decentralization is both large and growing. The main sectors involved – especially health, education and welfare – are of such importance that expenditures of lower-level governments are in most federations of comparable magnitude to those of the national level. The second is that many of the expenditure programs that are suitable for decentralization also fulfil redistributive functions of the types earlier discussed. To the extent that redistribution is of national interest, issues of co-responsibility arise, as discussed below.

The standard argument for a VFG then arises because the case for decentralizing taxation powers is not regarded to be as powerful as that for decentralizing expenditure responsibilities. For broad-based taxes, there are economies associated with having a single tax-collecting authority with a harmonized base. As well, there are various externalities associated with decentralized tax setting. To the extent that tax bases are mobile, provincial taxes can distort the allocation of the base among provinces simply through the choice of different tax rates. Tax competition itself might lead to beggar-thy-neighbour policies. Compliance and collection costs can increase if provinces have different tax systems. As well, even though tax decentralization might serve to allow provinces to choose tax structures that reflect the preferences of their citizens, tax competition can vitiate this as well by inducing a race to the bottom.

While these arguments are on the surface plausible, and have been heavily relied on in the fiscal federalism literature to make the case against revenue-raising decentralization, there are a number of caveats that call this justification for the VFG into question. These caveats all rely on the fact that in the Canadian federation, unlike, say, Australia, there are very few constitutional limitations on the ability of the provinces to raise revenues from virtually all the main tax sources. For one thing, there are broad-based taxes that could be decentralized to the provinces without running into insuperable problems of tax competition. Of the three main broad-tax bases – income, payroll, sales – the latter two apply on relatively immobile tax bases, so do not give rise to the usual concerns about tax competition. Indeed, the payroll tax is in many ways an ideal revenue source for provincial jurisdictions. Unfortunately, despite its attractiveness as a general revenue source, the payroll tax has been typecast as a contributory tax for various social insurance programs.

The option of the sales tax as a major revenue source for the provinces is the one seized on by the Szeguin Commission. For this to be an efficient outcome, provinces would presumably have to adopt efficient tax systems. This suggests value-added tax (VAT) forms, like the GST, the Quebec Sales Tax (QST), and Harmonized Sales Tax (HST). The issue of whether a VAT is a reasonable type of tax for provinces in a federation is still an open question. The issue is how well a tax levied on a destination



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## Inefficiency in the Internal Economic Union

Efficiency in the internal economic union involves the free and undistorted flow of goods, services, labour and capital among provinces. Fiscal decentralization can entail distortions to the extent that provincial tax and spending provide either incentives or barriers to cross-border flows. On the tax side, this can be addressed best by harmonizing provincial tax systems, by measures such as the Tax Collection Agreements. The tax system, as well as subsidies, might also be used as a vehicle for attracting businesses at the expense of other provinces. Transfers are not likely to be very useful at addressing these problems. Intergovernmental agreements such as the Agreement on Internal Trade are more likely candidates. On the expenditure side, inefficiencies can arise because public services are used to attract desirable factors of production, or repel undesirable ones. An obvious case of this is residency restrictions imposed on the use of public services. Imposing conditions on transfers to preclude such restrictions is a reasonable policy response. However, this rationalization is itself unlikely to be a sufficient justification for introducing major transfers in the first place.

## Fiscal Inefficiency

The most compelling efficiency reason for a VFG results from the fact that fiscal decentralization entails that different provinces will have different fiscal capacities to deliver public services. As is well known, this sets up the possibility that individuals and businesses have an incentive to choose their province of residence partly on the grounds of the relative fiscal benefits provided by alternative provinces rather than on productivity considerations. There is a large literature on the source of the so-called net fiscal benefits (NFBs) that cause fiscally induced migration.



How much of a VFG would be called for would depend on how extensive the equalization system should be. To replicate the Canadian system whereby only have-not provinces are equalized up would require a minimal VFG. To replicate a net system of equalization such that have provinces are also implicitly equalized down would require a larger VFG. To incorporate needs considerations as well as revenue consid-

a whole in one province compared with another. A system of equalization would give all provinces the capability of providing comparable levels of public services at comparable tax rates, to paraphrase Section 36(2) of the Constitution Act, 1982.

#### Public Services as Instruments for Redistribution

Some of the most important policy instruments in the hands of the provinces are those that are important for achieving redistributive objectives in the broader sense that we have outlined earlier. These include those in the three major spending areas of









path of expenditures at the two levels of government, and treat the means of financing  $\bar{D}$  taxes, transfers, deficit  $\bar{D}$  as balancing items. And, we suppose that the federal government has the "first-mover" advantage and so can pre-emptively determine the VFI.

This view of treating the level of transfers as being determined by one's view of the ideal VFG, and the tax room allocation as be



There would then be no need to decentralize revenue raising further, which has its own problems in terms of maintaining a harmonized tax system that does not damage the internal economic union.

Second, the choice of eliminating the GST as the means of affecting the transfer of tax room to the provinces is reasonable in the case of Quebec, but problematic for other provinces. This choice between the GST and personal income tax points was partly driven by the fact that the latter would have entailed somewhat more Equalization costs to the federal government (since personal income is more unevenly distributed than sales of consumption goods and services). However, there are various problems with eliminating the GST. Quebec is the only province that administers its own VAT system at the moment. Five provinces retain retail sales taxes, which are well known to be inefficient. If they were to make up the lost revenue by increasing their sales tax revenues, inefficiency would rise considerably. On the other hand, if they were to revert to pe

some provinces would be more likely to use the PIT (especially, but not solely, Alberta). Two concerns might arise with this. First, there would be a change in the overall tax mix from indirect to direct taxes, which would not necessarily be in the national interest. Second, the increasing provincial reliance on PIT would put further pressure on the integrity of the tax collection agreement system, which becomes more tenuous as provinces occupy a larger and larger share of the tax base. The alternative of turning over PIT points to the provinces would avoid the change in the tax mix mentioned above, but would in turn threaten the system of income tax harmonization even more. In either case, there would be concerns about the maintenance of an efficient nationwide tax system. This would be an inevitable consequence of the initial choice of a VFG based on current level of Equalization and CHST/CHT/CST trans-

## Notes

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<sup>1</sup> See, for example, Ruggeri (2000), Matier, Wu and Jackson (2001), and Conference Board of Canada (2002).

<sup>2</sup> Thus, the transfer of GST tax room to the provinces would be worth about \$26 billion in 2002/03, of which about \$8 billion would compensate for the current VFI and the remainder would adjust the VFG more to their liking.

<sup>3</sup> See Boothe (2001), who studied the instability of Equalization revenues in Saskatchewan, and Boadway and Hayashi (2004) and Smart (2004), who studied the instability of Equalization entitlements arising from selected taxes for all provinces.

<sup>4</sup> See the comprehensive survey of the use of the spending power in Watts (1999).

<sup>5</sup> For this view, we rely on Hogg (1996).

<sup>6</sup> The concepts of horizontal and fiscal equity are by now well-established concepts in the literature and in the policy debate on Equalization. A survey of them may be found in Boadway (2000). Their role in rationalizing Equalization is not without its detractors, of whom a prominent one is Usher (1995).

<sup>7</sup> On this, see Kesselman (1997).

<sup>8</sup> See, for example, Bird and Gendron (2001).

<sup>9</sup> There is also the countervailing point emphasized in the economics literature that joint occupation of a tax base leads to a form of vertical fiscal externality, whereby provinces underestimate the incremental costs of raising revenues, since part of the distortionary effect is foisted off on the federal government in the form of reduced revenues. See, for example, Dahlby (1994). To the extent that this exists, it serves to mute the tax competition effect. In fact, tax competition gets muted even more for Equalization-receiving provinces once it is recognized that revenue losses due to changes in a province's own tax base are largely offset by changes in Equalization entitlement, as discussed by Smart (1998).

<sup>10</sup> We are presuming that it is unlikely that interprovincial compacts can be made that will result in a harmonized income tax system. There are just too many pitfalls in provinces coming to unanimous agreements. Arguments in favour of the use of interprovincial compacts can be found in Courchene's (1996) ACCESS proposal, which is assessed in Institute of Intergovernmental Relations (1997).

<sup>11</sup> Again, we are assuming that the transfers are matters of federal choice rather than being the outcome of a compact among provinces and the federal government. In fact, much of the argument for a VFG would survive if provinces were involved in decision making, as likely or unlikely that might be.

<sup>12</sup> It might be noted in passing that in the health area, 50-50 sharing grants were not really fully matching at the provincial level since the sharing was based largely on nationwide provincial spending.

<sup>13</sup> The arguments are summarized in Boadway (2000).

<sup>14</sup> In theory, if Equalization were based solely on efficiency considerations, have provinces might willingly make transfers to have-not provinces, as Myers (1990) has shown. That is because both would gain from a more efficient allocation of labour.

<sup>15</sup> The case for basing Equalization on actual provincial behaviour rather than on some notion of fiscal capacity is discussed in Boadway (2002).

<sup>16</sup> In fact, what is meant by full Equalization in a world in which the provinces own the property rights to resource revenues is itself a difficult question. The Economic Council of Canada (1982) recognized this years ago when they distinguished between broad and narrow notions of horizontal equity depending on whether one assigned resource property rights to provincial residents. See also Usher (2002) on this.

<sup>17</sup> We are implicitly assuming that the national standards would have to be imposed and enforced by the federal government. It is conceivable that the provinces themselves could implement a national sharing outcome through an interprovincial accord. However, this might be difficult because of the usual problems with achieving a unanimous consensus, especially where there will be redistribution among the provinces under national redistribution standards. It is also possible that common standards of redistribution would be chosen by all provinces acting independently, so no federal intervention is required.

<sup>18</sup> These are obviously strong assumptions. Economic analysis would assume that all elements of the budget are determined jointly at each level of government. The overall outcome then would depend on whether the two levels acted simultaneously, or whether one had the advantage of acting first. Those who hold the federal government responsible for any VFI that exists might suppose that it had the strategic advantage. This is typically what is assumed in the literature, and it seems to be implicitly assumed in the Canadian policy debate. In fact, the full theory of VFI is yet to be worked out, despite the numerous attempts to estimate it empirically.

<sup>19</sup> Of course, if an asymmetric federalism option were acceptable with the CHST/CHT/CST applying only outside Quebec, the SŽguin Commission solution would be an ideal way to achieve it.



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## II

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# DEBATING FISCAL BALANCE AND IMBALANCE



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## THE EVOLUTION OF PROVINCIAL RESPONSIBILITY

Joe Ruggeri

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### INTRODUCTION

The Canadian federation has grown and prospered for 135 years because of the flexibility of its institutional arrangements and of the actual formulation and implementation of public policy. This flexibility is being tested by the forces of the globalization and information revolution. The winds of change are blowing from opposite directions. The shift in trade patterns from east-west within Canada to north-south between Canada and the United States and to other international destinations brings pressures for decentralization of decision making. The emergence of human capital as the engine of growth, and its impact on productivity and the distribution of income, brings pressures in favour of co-ordinated action between different orders of government. Success or failure in balancing these conflicting forces will determine the future of Canada in the new millennium. Since *Those who ignore history are condemned to repeat it,* it may be useful to briefly review the major historical developments of the Canadian federation, in order to gain some insights into its future. Unable to claim any expertise in historical analysis, I will use existing historical accounts to identify major signposts in the evolution of fiscal federalism in Canada. ~~the~~ In the end, I will provide a personal interpretation of what these signposts may ~~te~~ tell about future relations between federal and provincial governments.

## THE BEGINNING

The debates that led to the creation of the Canadian nation were not about fiscal federalism. They were about nation building and involved some commonality of interests by three major groups of players: (a) Great Britain (b) the political leaders of United Canada (Ontario and Quebec) and (c) the political leaders of the Maritime Provinces. The driving forces were the expansion of trade for Great Britain, the consolidation of the United States, and the desire for a northern empire by some visionaries in the British North America colonies.

By the mid-1800s, the winds of change that were blowing over the oceans cleared protectionist clouds and ushered in the open skies of free trade. By that time, the British North America colonies had acquired responsible governments and, south of the border, a powerful country had been consolidated. Within the new economic environment, the colonies had become a burden. Providing neither a necessary source of raw materials, nor a market for manufactured products, their costly administration generated a net loss to Great Britain. Moreover, the long border with the United States could not be defended successfully with the troops stationed in the colonies. It was understood that the burden on Great Britain would be lifted if all British North America colonies joined into a Confederation. The prospects of these colonies becoming independent and self-reliant were viewed as a welcome development in Great Britain, a view clearly expressed in the Edinburgh Review of January 1865.

... we accept, not with fear and trembling, but with unmixed joy and satisfaction, a voluntary proclamation, which, though couched in the accents of loyalty, and preferring an enduring allegiance to our Queen, falls yet more welcome on our ears as the harbinger of the future and complete independence of British North America.

The legislative union in 1839 of Canada West (Ontario) and Canada East (Quebec) into the province of United Canada was not built on permanent foundations. From the very beginning, it was under the pressures of profound differences in language, religion and institutions. Within a couple of decades of existence, it had to face the pressures of demographic changes. Starting with a higher population in Quebec, it was soon evident that Ontario would become the most populous part because of its faster population growth. Indeed, the surpass took place in the 1850s and by 1861, according to the census of that year, the population of Ontario exceeded that of Quebec by 285,000. This population differential resulted in under-representation by Ontario compared to over-representation by population. By 1861, each Member of Parliament from Ontario represented an average of 21,000 people compared to the average of 17,000 by a member from Quebec.

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representation (c) dissolution of the Union (d) transformation of the legislative Union into a federation of Ontario and Quebec and (d) formation of a Confederation of all the colonies. Some of the solutions were transformed into political proposals by the various parties. As the 1850s waned, political support for the idea of a Confederation of all colonies gained strength. The Conservatives included a proposal for Confederation in their 1858 program. The Rouges and the Reformers were suspicious of such a grandiose scheme and preferred the more modest scheme of a federation of Quebec and Ontario. On June 22, 1864, the Conservatives were able to form a coalition with the Reformers and the Confederation plan suddenly became a practical political option. Work began in

In Charlottetown, the way for the delegates to the Canadian Union was cleared by the decision taken at the very beginning of the conference to defer discussion of a Maritime Union. The delegates from United Canada were given four days to make their case for Confederation. They started their arguments on Friday, September 2 and concluded on September 6, when they provided details of the proposed structure of the Confederation. The same day, the Maritime delegates made it known that they consid-

sterile coasts of Newfoundland to the noble hills and peaceful heavens of Vancouver's Island.

Although the allocation of taxing powers and spending responsibilities enshrined in the BNA Act has shaped intergovernmental fiscal relations to this day, the fiscal preoccupations of the delegates were more modest and focussed on the short term. They involved the granting of sufficient fiscal powers to the central government to ensure the survival of the Dominion and the provision of sufficient funds to the provinces to finance their very limited spending responsibilities. The financial terms negotiated at the birth of the federation contained four elements, in addition to the allocation of taxing powers and spending responsibilities: (a) the debt allowance

### Special Grants

The New Brunswick delegates made convincing arguments that the government of the new province could not function with the funds from the above two grants. The special grant of \$63,000 per year for ten years received by New Brunswick reinforced a principle of flexibility that has guided intergovernmental relations ever since.

Figure 1

Initial Statutory Subsidies, BNA Act Provinces, in Thousands of Dollars

	80 cents per Capita Subsidy	Grants in Support of Government	Special Grants	Total
Nova Scotia	264	60	-	324
New Brunswick	202	50	63	315
Quebec	890	70	-	960
Ontario	1,116	80	-	1,196
Total	2,472	260	63	2,795

Source: Perry (1955), Vol. I, table I, p. 45

This brief historical excursion into the origins of Canada leads to two main observations: (a) the fiscal focus of the Fathers of Confederation was on the immediate needs of the two orders of government and (b) the debate between tax point transfers and grants, which is currently associated with the issue of health care financing, is as old as Confederation. The short-term focus of the initial fiscal arrangements and the absence of a clear vision of the fiscal dynamics of the federation had a major impact on the future developments in fiscal federalism. They left the evolution of fiscal arrangements to the ingenuity of future politicians in forging compromise solutions to the challenges arising from demographic, economic and social developments, internally and from abroad. A profound impact on future fiscal relations was also exercised by the initial use of federal transfers to make up the revenue shortfall experienced by the provinces.

The choice of intergovernmental grants over the transfer of tax room was at odds with the common practice among existing federal states.

...the accepted practice has been to require the local governments to contribute to the support of the central authority, should the latter find itself in financial difficulties....It was flying in the face of all precedents for the Canadians to adopt just the reverse policy and to require that their Dominion Government should annually assist in lightening the financial burdens of the different provincēs.

According to Perry (1955, p. 46), "the adoption of these subsidies has exerted an important influence on tax history in Canada." I consider the initial choice of using

intergovernmental transfers as the preferred method for correcting vertical fiscal imbalances to be my first signpost because, in my view, it established a practice that will be used repeatedly in future arrangements and contains two main elements: (a) a

The boom and bust cycles that characterized the performance of the Canadian economy during the first 60 years of Confederation and the outbreak of World War I had a profound effect on the fiscal structure of federal and provincial governments and on intergovernmental fiscal relations.

The war and the economic see-saw placed heavy strains on federal government budgets. Federal Ministers of Finance learned early in the life of the federation the





married couple) and (b) a "supertax" with graduated rates ranging from 2 percent to 25 percent applied to gross income. Experimenting with the new tax toy became an irresistible attraction and the first results became evident in the following Budget. That Budget raised the corporate tax rate to six percent and extended the tax to companies with a capital in excess of \$25,000. The PIT had a major overhaul in its first year: the personal exemptions were reduced to \$1,000 for a single taxpayer and \$2,000 for a married couple, but an exemption of \$200 per dependent child was introduced; the basic tax now had two rates, the graduated supertax was retained and a new surtax on the sum of the basic tax and supertax was introduced. Indirect taxes did not escape the attention of the federal Minister of Finance as additional customs duties were levied on a variety of consumer goods and new excise taxes were introduced. The relative position of income taxes in the federal tax mix was strengthened in the first post-war Budget when moderate reductions in tariffs were followed by substantial

That Budget 238(w had tw)10.8(o r)educrr8(v)15.9((tax wc 0.0255 0.000(ir7-11.1(r)11 (

A chronology of the evolution of the federal tax mix during the period from 1868 to 1930 is contained in Figure 2 while the major components of the federal revenue structure are shown in Figure 3. It is evident that the tariff was the predominant revenue source until 1913 when it accounted for nearly four-fifths of the total revenue. Taxes became an increasingly important revenue source in the twenties. They generated 25 percent of total revenue in 1921 and 30 percent in 1930 when they raised more than half of the revenue from the tariff.

Figure 3  
Federal Government Revenue for Selected Years from 1868 to 1930,  
in Millions of Dollars

Source: Perry (1955), Vol. II, table 6, pp. 624-27

This brief history of federal revenue changes in the first six decades of Confederation

1882 through the imposition of a variety of taxes on businesses. This time the Privy

Despite this expansion of provincial taxation, provinces found themselves with a severe structural imbalance at the end of the war. The expansion of their spending responsibilities, created by the expanded use of motor vehicles and the associated need for provincial highways combined with the increased involvement of local governments in social programs generated fiscal pressures that could not be met by the existing revenue structure. With most provinces still unwilling to tap personal income taxation, their attention turned to the taxation of motor fuel and liquor. The lead was taken by Alberta which in 1922 imposed a gasoline tax of two cents per gallon. Alberta's lead was followed by Manitoba and British Columbia in 1923, Prince Edward Island and Quebec in 1924, Ontario and Nova Scotia in 1925, New Brunswick in 1926 and Saskatchewan in 1928.

The other new major source of revenue resulted from the monopoly sale of liquor. This source of revenue, which during the prohibition years had been negligible, by 1930 contributed twenty cents out of each dollar of provincial revenue. Important developments took place also in other tax fields. The introduction of the federal Income War Tax Act in 1917 facilitated the expansion of provincial personal income taxation. Prince Edward Island and British Columbia, which already levied such a tax, restructured it along federal lines and introduced graduated rates. Nova Scotia imposed a personal income tax in 1919 and Manitoba followed suit in 1923. During this period, all provinces also expanded their revenues by raising the rates of existing taxes and expanding their bases.

Figure 4

Provincial Governments Current Account Revenue for Selected Years from 1874 to 1930, in Millions of Dollars

	Grants	Tax Revenue	Non-Tax Revenue	Total Revenue	Tax Revenue as Percentage of Total Revenue
1874	3.8	-	2.9	6.7	-
1896	4.3	1.0	4.7	10.0	10.0
1913	13.7	9.3	21.9	44.9	20.7
1921	14.4	35.3	40.7	90.4	39.0
1930	16.3	77.7	79.8	173.8	44.7

Source: Perry (1955), Vol. I, table VII, p. 123 and table XVIII, p. 238





## DEPRESSION, WAR AND POST-WAR

The period from 1930 to 1956 witnessed major changes in economic conditions, tax policy and intergovernmental affairs. Two major phases of this period can be identified: (a) the depression and (b) the war and post-war period.

### The Depression

Canada had already experienced two major depressions in the first 60 years of its existence. Neither of them, however, was comparable in intensity to what would be experienced in the 1930s. Exports fell by two-thirds between 1928 and 1932; construction contracts dropped by 80 percent from 1929 to 1933; agriculture was decimated by a combination of falling grain prices and the drought in the West; and national income was cut in half from 1928 to 1933. The economic collapse created a disaster for public finances.

At the federal level, the collapse of tariff revenues, which sank by 65 percent from 1929 to 1934, was associated with increased demands for federal assistance to cash-strapped provinces and municipalities and direct federal involvement in relief programs, marketing and price support for Western grain production, and the debt of Canadian National Railways. These fiscal pressures came at a time when the federal surplus had turned into a deficit and when the prevalent economic philosophy favoured balanced budgets. In this environment, the collapse of tariff revenues had to be compensated through large increases in other taxes. The corporate income tax rate, which stood at 8 percent in 1928, was raised to 10 percent in 1930, to 11 percent in 1931 (plus a 5 percent surtax), to 12.5 percent in 1932, to 13.5 percent in 1934, to 15 percent in 1935 and to 18 percent in 1940. The personal income tax was also raised. In 1931, the planned 20 percent reduction was repealed, personal exemptions were reduced and the 5 percent surtax was re-introduced. Personal exemptions were again reduced in 1932 and tax rates increased. Finally, in 1934, the federal government introduced a graduated rate tax on unearned income in excess of \$5,000. On the consumption tax side, the sales tax rate which had been cut to 1 percent in 1930, was raised to 4 percent in 1931 and to 8 percent in 1936. There were also increases in existing excise tax rates and the introduction of new excises.

A major expansion of taxation also took place at the provincial level. In 1929 only Prince Edward Island and British Columbia imposed corporate income taxes. Within ten years all provinces had entered that tax field, starting with Manitoba (1931) and then continuing with Quebec, Ontario, Saskatchewan and Alberta (all in 1932), New Brunswick (1938) and Nova Scotia (1939). Moreover, the initial rates of the early entrants were raised substantially in the 1930s. At the beginning of the 1930s, only British Columbia (1876), Prince Edward Island (1894) and Manitoba (1923) imposed personal income taxes at the provincial level. By the end of the decade, personal income taxes were part of the tax system also in Saskatchewan (1932), Alberta (1932), Ontario (1936) and Quebec (1939). Starting in the later 1930s, collection of personal income taxes in four of the above provinces — Ontario, Prince Edward Island,



Manitoba and Quebec D was facilitated by agreements under which provincial taxes we

## Figure 8

Federal Grants to Provinces Between 1930 and 1938, in Millions of Dollars

Source: Moore, Perry and Beach (1966), Table 2, p. 16

The developments of the 1930s shook the very foundations of the Canadian federation from several sides. First, the fiscal pressures on governments raised questions about the financial viability of the nation. Second, the expanding scope and increasing burden of taxation became to be viewed as a major obstacle to economic recovery. Having resisted the imposition of income taxes for a long time, taxpayers now found themselves under the burden of income taxes from more than one government.

The worst of the bad features of the tax structure attributable to overlapping jurisdictions were probably three in number: first, the multiplicity of forms, rat



Moreover, among the tax sources, the most suitable for stabilization purposes are the income taxes. It would follow logically, therefore, that control of income taxes should be given to the order of government responsible for counter-cyclical fiscal policy. The provinces' views on this matter were not unified. Prince Edward Island and Saskatchewan were not opposed to the transfer of income taxes to the federal government; New Brunswick's position was ambiguous; Quebec did not make a presentation to the Commission; Ontario argued that provinces and municipalities have the moral

the forces that made for federal occupancy during the war would not be spent after the war, that taxpayers might wish to retain the luxury of one law and one return, and that those provincial governments which received more by way of subsidy than from provincial collections might prefer to continue the agreements.

And so it was. The tax rental agreements were renewed, in revised form, for two more five-year terms and then replaced by a tax-sharing arrangement for the 1957-62 period. The 1952-57 tax rental agreements inaugurated a shift in the federal government's approach to intergovernmental fiscal relations. Unable to obtain a unanimous agreement on its proposals, the federal government abandoned the search for collec-

accepted the federal proposal. In April 1957, Ontario signed an agreement renting the PIT to the federal government, but retained provincial taxation of corporate profits and succession duties. The structure of own-source revenues for federal and provincial governments in 1946 and 1961 is shown in Figure 9.

Figure 9

Distribution of Federal and Provincial Own-Source Revenues by Major Source, 1946 and 1961, in Percentages

	1946		1961	
	Federal	Provincial	Federal	Provincial
Personal Income Tax	22.6	-	33.2	3.8
Corporate Income Tax	22.9	-	21.0	11.8
Succession Duties	0.8	8.5	1.4	2.9
Sales Tax	10.0	6.2	16.9	15.7
Custom and Excise Duties	22.2	-	18.7	-
Motor Fuel Tax	1.2	18.4	-	19.8
Real Property Tax	-	1.7	-	0.4
Other Taxes	1.9	6.0	1.8	11.0
Total Tax Revenue	81.6	40.8	93.0	65.4
Motor Vehicle Licenses and Fees	-	9.5	-	8.0
Natural Resource Revenues	-	10.6	0.1	13.1
Government Enterprises	1.6	26.0	2.0	9.0
Other Revenue	16.8	13.1	4.9	4.5
Total	100.0	100.0	100.0	100.0

Source: Leacy, Urquhart and Buckley (1983), Section H

The dominance of the federal government in the tax field is quite evident. In 1946, more than four-fifths of federal revenue came from taxation. Perhaps more importantly, nearly two-thirds of federal revenue originated from the three general taxes — personal and corporate income taxes plus general sales taxes. By contrast, the provincial governments appear as lower level governments with most of their revenues coming from non-tax sources — primarily natural resource revenues, liquor profits and motor vehicle licenses. On the tax side, by far the largest revenue source was motor fuel taxes which generated nearly three times the revenue of provincial sales taxes. The dominant federal position was still in existence in 1961. By this time 93 percent of federal revenue came from taxes and the three general taxes accounted for close to three-quarters of the total. The share of tax revenue increased to two-thirds for the provinces, but motor fuel taxes still generated more revenue than any of the three general taxes.

The evolution of federal transfers to provinces from 1945/46 to 1961/62 is shown in Figure 10. Inspection of this Figure leads to two main observations. First, on average during the war and post-war period up to 1961/62, federal transfers accounted for about one-third of provincial revenue. Given the revenues from natural resources, the

cost of a dollar of provincial spending to provincial taxpayers was less than 60 cents. No wonder that eight out of ten provinces were regularly ready to sign the tax arrangements offered by the federal government. Second, federal transfers as a proportion of provincial revenue followed a u-shaped pattern during the above period, falling from 1945/46 to 1951/52 and then rising again. In 1961/62, they represented 40 percent of provincial revenues, a share slightly higher than it was in 1890. The increased share of federal transfers in provincial revenue was largely due to new programs partly or wholly financed by the federal government. A list of these programs is shown in Figure 11.

Figure 10

Federal Transfers to Provinces, 1945/46, 1951/52, 1955/56, 1961/62,  
in Millions of Dollars

	1945-46	1951-52	1955-56	1961-62
Specific Purpose Transfers				
Old Age Pensions	42.8	83.3	33.5	51.3
Health	0.2	24.3	33.5	332.9
Education	0.3	4.4	16.1	36.2
Unemployment Assistance	-	-	-	92.0
Other	0.2	18.7	6.4	93.2
Subtotal	43.5	130.7	89.5	605.6
General Purpose Grants				
Statutory Subsidies	14.5	20.1	20.3	23.5
Tax Agreements	94.3	96.9	319.6	311.6
Equalization	-	-	-	164.7
Other	3.7	10.4	11.6	43.6
Subtotal	112.5	127.4	351.5	543.4
Joint War Programs	6.5	-	-	-
Total	162.5	258.1	441.0	1,149.0
Percentage of Federal Revenue	6	7	9	18
Percentage of Provincial Revenue	38	24	27	40

Source: Perry ( 1997), tables A.4-A.20, pp. 284-304

Figure 11

## Consolidation of Federal Spending Powers: 1941-62

<b>Unemployment Insurance</b>	
1940	Unemployment Insurance Act is passed; provinces agree to constitutional amendment
1946	Coverage is extended to include seasonal workers
1950	Supplementary benefits introduced for those not qualifying for regular benefits
1955	Eligibility test is relaxed
1956	Special program of benefits for self-employed fishermen is introduced
<b>Old Age Security</b>	
1951	Provinces agree to constitutional amendment of the BNA Act; Parliament is authorized to make laws in relation to old age pensions in Canada; the federal government introduces the Old Age Security Act
1952	Payment of pensions begins
1957	Pensions are increased in July and then again in November
<b>Health Care</b>	
1948	The federal government starts giving grants to the provinces for eight health services programs
1949	Expanded federal grants
1957	The federal Hospital Insurance and Diagnostic Services Act is passed
1958	The above Act takes effect
<b>Social Services</b>	
1956	The federal Unemployment Assistance Act is passed; the federal government provides grants to the provinces to help them pay for programs aimed at unemployed employables
<b>Equalization</b>	
1957	It is formally introduced in the Federal-Provincial Tax-Sharing Arrangements Act, 1956, implemented in 1957.

This brief review of the main fiscal developments during the 1930-1961 period leads me to identify the following three signposts. The first signpost is the shift in the federal strategy from general agreements with all provinces to selective agreements with co-operating provinces. This shift, in my view, was facilitated by the absence of a formal institutional mechanism for developing and presenting a unified and coherent provincial position on major issues. The second signpost is the provincial abdication



of its constitutional spending responsibilities through the willingness to support constitutional amendments that shifted responsibility for unemployment insurance and old age pensions to the federal government. The third signpost is the revealed preference of provincial governments to be spenders rather than tax collectors. Whenever possible, provincial political leaders opted for raising as little as possible from the taxation, especially direct taxation, of the voters who decided their political future. It seems that the main objective was the minimization of the political cost of each dol-

taxes for a three-year period, and for a fee in the case of estate taxes, for those provinces without the necessary collection machinery and (c) it provided federal

Figure 12

Distribution of Federal and Provincial Own-Source Revenues by Major Source, 1966 and 1976, in Percentages

	1966		1976	
	Federal	Provincial	Federal	Provincial
Personal Income Tax	30.6	20.5	43.6	28.4
Corporate Income Tax	19.1	11.2	15.2	8.9
Succession Duties	1.1	2.1	-	0.6
Sales and Excise Taxes	25.0	34.2	15.0	27.7
Custom and Excise Duties	13.2	-	8.7	-
Oil Export Tax	-	-	2.1	-
Levies for Unemployment Insurance, Workers Compensation and Health Insurance	3.7	7.6	7.5	8.7
Real Property Tax	-	0.4	-	0.4
Other Taxes	0.2	3.0	0.3	2.3
Tax Revenue	92.9	79.0	92.4	77.0
Motor Vehicle Licenses and Fees	-	4.8	-	2.7
Royalties	-	4.7	-	5.7
Remittances from Government Enterprises	1.6	6.8	0.7	9.8
Other Revenue	5.5	4.5	6.9	4.8
Total	100.0	100.0	100.0	100.0

Source: Statistics Canada, National Income and Expenditure Accounts, various issues

Figure 13  
Expansion of Social Programs, 1962-76

<b>Health</b>	
1966	Establishment of the Health Resources Fund to assist provinces in financing health-related capital costs
1968	Introduction of national Medicare; the federal government offered to pay 50 percent of the national cost of physicians' services if provincial programs met four conditions: comprehensive scope, universal coverage, public administration, portability. Saskatchewan and British Columbia joined in 1968; all provinces were on board by 1971.
<b>Post-Secondary Education</b>	
1967	Federal per capita grants to universities were replaced by a cost-shared program with the provinces. Federal grants would be equal to the greater of 50 percent of eligible operating costs or a fixed amount equal to \$15 per person in the initial year with some escalation based on costs.
1972	The original five-year program was extended, first for two years and then until 1977; the growth rate of payments was limited to 15 percent but the PIT abatement was raised.
<b>Social Assistance</b>	
1966	Several small programs were consolidated into a single program called the Canada Assistance Plan (CAP). The federal government agreed to pay 50 percent of eligible costs. The program was open-ended and provinces could set their rates of assistance.
<b>Pensions</b>	
1965	Starting age for receiving benefits being reduced until it reached 65 years in 1970
1966	Introduction of the Canada Pension Plan (CPP)
1967	Introduction of the Guaranteed Income Supplement (GIS)
1968	Indexation of OAS and GIS benefits
1974	Full indexation of CPP benefits
1975	Introduction of Spouse's Allowance (SPA)
<b>Unemployment Insurance</b>	
1965	Expanded coverage
1971	Major reform: coverage extended to almost all employees
<b>Regional Development Programs</b>	
1962	Introduction of the Agricultural Rehabilitation and Development Act. The federal government paid between one-third and two-thirds of projects designed to stimulate the growth of rural areas.
1965	The program was extended to include fishing and mining projects.
1966	Full federal funding through the Fund for Rural Economic Development (FRED).
1969	Creation of the Department of Regional Economic Expansion (DREE).

Figure 14

Federal Transfers to Provinces, 1966/67, 1971/72 and 1976/77, in Millions of Dollars

Source: Perry (1997), Tables A.25-A.35, pp. 314-335

### Opting Out

As pointed out by Perry (1997), opting out could take three forms: (a) exchange of cash under a federally financed program for tax abatements (the case of university grants) (b) opting out of a federal contributory scheme to set up its own scheme (the Quebec Pension Plan) and (c) exchange of cash under a conditional grant or cost-shared program for tax abatements. A first and important step in the evolution of opting out was taken with federal grants to universities. When the government of Quebec ordered its universities to refuse the federal per capita grants, it pursued direct negotiations with the federal government that led to the granting of an abatement equal to one percent of corporate taxable income in 1960. Quebec agreed to raise its corporate income tax rate by one percentage point and to use the additional revenue for university financing. The importance of this opting out case is that it was unconditional and it involved the replacement of an unconditional grant. Quebec pursued the opting out

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points, the associated Equalization and an adjustment grant that, during the first three years of the program, would make up the difference between the value of the equalized tax points and the federal share of actual costs. For future years, the adjustment payments would grow at a rate unrelated to the growth of program costs. None of the provinces accepted the federal offer. The offer remained open during the process of federal income tax reform, but the provinces' lack of interest did not change.

Opting out arrangements were designed to accommodate the desires of both federal and provincial governments. The federal government wanted uniform standards of a variety of programs, but was concerned about the escalating burden of cost-shared programs, especially in the case of open-ended

the previous 20 years. Inflation became such a concern that the federal government appointed first a Prices and Incomes Commission (1969-72) and later an Anti-Inflation Board (1975-78), and introduced a voluntary wage restraint program (the 6 and 5 program) in the 1982 Budget. In the early 1970s, accelerating inflation was associated with strong economic growth. This combination was disrupted by the oil crisis: in the second half of the 1970s, while inflation continued at a fast rate, the growth rate decelerated considerably. Inflation was slowly brought under control in the 1980s, but economic growth remained sluggish and averaged 3.1 percent per year during the 1975-80 and the 1980-90 periods. This growth rate was insufficient to generate employment growth matching the growth of the labour force; as a result, the unemployment rate kept rising through the 1970s and 1980s, moving from 5.9 percent in 1970 to 7.5 percent in 1980 and 8.5 percent in 1990.

Figure 16

Average Annual percentage Change in the CPI and Real GDP, Selected Years

Source: Statistics Canada, National Income and Expenditure Accounts and Historical Labour Force Statistics

A major fiscal development in this period was the indexing of the PIT for inflation, introduced in 1974. This measure reduced considerably the potential growth rate of PIT revenue for both the federal government and the nine provinces tied to the federal PIT system through the Tax Collection Agreements. The mix of high inflation, high unemployment, low economic growth and an indexed PIT formed a lethal combination for the fiscal system. High inflation and rising unemployment put pressures on government spending, partly because some of the programs were indexed for inflation, while low growth and indexing put the breaks on the growth of revenues. Structural changes to the fiscal structures of both orders of government were needed to restore fiscal sustainability, but neither federal nor provincial government had a taste for administering tough medicine. Instead they opted for passing the buck to future generations by presenting deficit budgets year after year and accumulating public debt. The evolution of deficits and debt for selected years during the 1970-90 period is shown in Figure 17. During the post-war period up to 1974, the federal government ran small budgetary deficits, and occasionally small surpluses. Starting in 1975, one year after the indexation of the PIT, these deficits became larger. A balanced



budget in 1974 was turned into a deficit of \$5.2 billion in 1975, \$12.5 billion in 1980 and \$33.3 billion in 1990. For provincial and territorial governments, a surplus of \$1.3 billion in 1974 was transformed into deficits of \$1.7 billion in 1975, \$2.7 billion in 1980 and \$8.4 billion in 1990. These deficits had a dramatic effect on the size of the public debt. The federal net debt, which stood at less than \$30 billion in 1974, rose to over \$90 billion in 1980 and nearly \$400 billion in 1990. The debt of provincial and territorial governments had reached \$18 billion by 1980 and rose to over \$100 billion in 1990.

Figure 17

Federal and Provincial Deficits (-) and Debt, 1980 and 1990 (NIA)

Source: Department of Finance, Fiscal Reference tables, 2001

These escalating deficits and mushrooming debts did not imply that no fiscal action at all was taken by governments during the last two and a half decades of the twentieth century. In fact, the federal government took major steps to restore fiscal sustainability on the revenue side and intergovernmental grants. On the tax side, the first step was an attempt at capitalizing on the oil crisis by securing a transfer of wealth from oil-producing provinces. When OPEC nearly tripled the price of oil in 1973, the federal government froze the price of domestic oil and introduced an oil export tax. Half of the revenue from this levy was returned to the producing provinces and half was used to subsidize Eastern refineries. As the price of oil continued to rise, the federal government introduced in 1980 a National Energy Program (NEP) for the purpose of (a) achieving security of supply (b) increasing Canadian ownership of oil and gas pro-

quarter of the total federal transfers to provinces during the same period. When this major revenue source vanished with the end of the program in 1985, replacement rev-



were equalized to the national average while the cash grant per capita was allowed to grow at the rate of a moving average of the growth of per capita GDP.

The cash component of the package provided the federal government with sufficient flexibility to retreat from its commitment at the birth of those programs. That flexibility was used extensively over the next 15 years. When new arrangements were made in 1982 for the following five years, the cash payment, which originally was independent of the tax point component, became a residual. Total per capita entitlements were equalized across provinces and escalated at the rate of growth of GDP, and the cash amount for each province was calculated as the total entitlement minus the value of the tax points. Since the value of the tax points was expected to increase at a faster rate than GDP, this change ensured a steady decline in federal cash contributions over time and their eventual elimination. For the 1987-92 arrangements, the growth of cash payments was further reduced by lowering the escalator to two percentage points lower than the growth of GDP. In 1989, the escalator was further reduced to three percentage points less than GDP growth and the 1990 per capita cash payments were frozen for the 1990/91 and 1991/92 fiscal years.

Major changes were also made to Equalization. For the 1977-82 arrangements, the total number of revenue sources to be equalized was raised to 29 and included half of the revenues from non-renewable natural resources subject to a limit. For the 1982-87 arrangements, the number of revenues was increased to 33, but the standard was changed from the national average per capita yield to the average of five provinces (Alberta and the four Atlantic provinces being excluded).

The above changes to federal transfers had a major impact on the importance of intergovernmental transfers in the budgets of federal and provincial governments. As shown in Figure 19, in 1980/81, federal transfers represented 26 percent of federal revenue and 21 percent of provincial revenue. By 1990/91, these ratios had been reduced to 22 percent and 19 percent, respectively.

Figure 19

Federal Transfers to Provinces, 1980/81 and 1990/91, in Millions of Dollars

Source: Perry (1997), Tables A-39 and A-49. (a) Youth Allowance Recovery

In my view, the main signpost during the 25 years from the mid-1970s to the early 1990s was the retrenchment on the part of the federal government from its original commitment to the financing of two major national programs: health care and post-secondary education. By strengthening its fiscal structure, partly through downloading of its responsibilities, the federal government sowed the seeds of vertical fiscal

between EI contributions and benefits turned a deficit of \$730 million in 1992 into a surplus of over \$9 billion in 1997. On the spending side, the major change was a cut-back of \$6 billion in federal transfers to provinces.



## A TIME FOR PROVINCIAL LEADERSHIP

Traditional wisdom holds that, in the globalization age, governments will lose their traditional power over economic policy. The shift from multinational to transnational enterprises has produced a transfer of powers (and sovereignty) from the national to



responsibilities from the federal to the provincial governments has not been matched by a transfer of financial resources. Provincial governments, therefore, have been left with the task of reforming their social programs primarily for the purposes of reducing costs. In an environment of international and interprovincial competition in the taxation of mobile factors and voters' resistance to increased taxation, this process is likely to lead to a deteriorating quality of social programs. This potential development would impact economic performance as well as redistribution. The emergence of human capital as the primary engine of growth has blurred the distinction between economic and social policy (Laroche, Merette and Ruggeri (1999), Ruggeri and Yu [2001]). The production, retention and effective utilization of human capital is an ongoing process involving individuals throughout their entire lifetime. It cannot be partitioned arbitrarily and allocated in bits and pieces to different orders of government. A federal policy that increases direct spending on the acquisition of human capital, but minimizes its contribution to provincial policies aimed at the production and healthy development of human capital will lead to inefficient policies that will hamper Canada's economic potential in the long run.

Provincial leaders seem to be well aware of the consequences of federal retrenchment in the social policy area and have started to develop and strengthen new mechanisms of collective decision making. The Ministerial Council on Social Policy Review and Reform set up by the Premiers in 1995 prepared a report in 1996 which identified as overarching objectives of social policy: (a) accessibility (b) individual and collective responsibility (c) affordability, effectiveness and accountability and (d) reasonable comparability across Canada. At the 1997 APC meeting held in St. Andrews, New Brunswick, the Premiers endorsed the recommendations contained in the paper on *New Approaches to Canada's Social Union: An Options Paper* offered options for dispute resolution and joint decision making. One year later, the Premiers endorsed the Calgary Declaration, which, while stressing equality of all provinces, opened the door to asymmetric federalism. At the 1998 meeting in Saskatoon, the Premiers affirmed their collective interest in all aspects of social policy by releasing a variety of papers on various aspects of the social union. In 2000, they highlighted the growing vertical fiscal imbalances in the Canadian fiscal system and negotiated a five-year agreement on CHST, and in 2001 made a collective agreement to seek reforms of the health care system independent of federal initiatives.

Federal retrenchment and provincial ascendancy need not lead to a federation of *two solitudes*. The new economy is driving intergovernmental relations in two opposite directions. Globalization and changes in the direction of trade, north-south rather than east-west, are generating forces toward greater economic and fiscal independence among provinces. The emergence of human capital has heightened the need for greater co-operation and policy co-ordination between federal and provincial governments. In my view, provincial ascendancy will be helpful in restructuring intergovernmental relations for the purpose of striking a balance between these two opposing forces because it will provide the opportunity for joint decision making by two equal

partners. The successful achievement of this objective, however, requires that some important conditions be met: (a) recognition by the provinces that the major responsibility for social policy has been thrust upon them and the willing acceptance of this responsibility (b) provincial leaders must transcend the limits imposed by regional interests and ideologies and embrace a national vision (c) provincial leaders must become collective gatekeepers of the caring and sharing values which have been the defining characteristics of Canada (d) federal leaders must treat provincial leaders as equal partners and (e) the increased fiscal responsibility thrust upon provincial governments must be accompanied by the appropriate transfer of fiscal resources. The extent to which these conditions are satisfied will determine the future of Canada as a federation.

## Notes

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<sup>1</sup> Quoted in Waite (1962, 20).

<sup>2</sup> Buck (1949, 2).

<sup>3</sup> Waite (1962, 88).

<sup>4</sup> Quoted in Waite (1962, 102).

<sup>5</sup> Villard and Willoughby (1918, 279).

<sup>6</sup> Pery (1955, 194).

<sup>7</sup> Pery (1955, 55).

<sup>8</sup> Pery (1955, 155-56).

<sup>9</sup> Pery (1955, 122).

<sup>10</sup> Moore, Perry and Beach (1966, 121).

<sup>11</sup> Moore, Perry and Beach (1966, 125).

<sup>12</sup> As pointed out by Pery (1955, 302).

<sup>13</sup> Pery (1955, 303-4).

<sup>14</sup> Pery (1955, 286).

<sup>15</sup> Pery (1955, 293).

<sup>16</sup> Pery (1955, 295).

<sup>17</sup> Pery (1955, 313).

<sup>18</sup> Moore, Perry and Beach (1966, 18).

<sup>19</sup> Pery (1997, 210).

<sup>20</sup> Pery (1997, 221).

<sup>21</sup> Ruggeri (2001).

<sup>22</sup> Courchene (2001): quotes from pages 18 and 21, respectively.

<sup>23</sup> ÓGanada, in the millennium, will be largely defined by its social infrastructure, Ó Courchene (1994, 322).

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## ÒREPORT THAT ALMOST NO ONE HAS DISCUSSEDÓ EARLY RESPONSES TO QUEBECÓ'S COMMISSION ON FISCAL IMBALANCE

Alain Noël

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Acknowledgement: The author was a member of QuebecÓ's Commission on Fiscal Imbalance. The views presented here reflect the conclusions of the Commission, but the interpretation is his own. He thanks Harvey Lazar and Francois Vaillancourt for their comments and suggestions.

In an open letter sent to newspapers October 11, 2002, the federal Minister of Intergovernmental Affairs, StŽphane Dion, dismissed the very idea that a serious discussion could be under way, in Quebec and in Canada, on the division of financial resources in the federation. ÓThe fiscal imbalance,Ó he wrote, referring specifically to Quebec, Óexists because everyone says it does, and this on the basis of a report that almost no one has discussed.Ó ÓToo often,Ó Dion added in a sharp dismissal, Óthis is how consensus is forged among our political and media elite.Ó ÓFortunately,Ó he concluded, ÓQuebecers are not buying the ÓconsensusÓ of the day.Ó

The idea that Quebec elite live by myths that they alone believe unanimously, and otherwise have Ótrouble keeping upÓ with a changing world and with wiser citizens, has a long pedigree in Canadian intellectual discourse, in part because it provides federal politicians - somehow not included ~~in~~ Óour political and media eliteÓ - with a claim as the only true representatives of ~~the~~ Ócitizens. This well-rehearsed construct, however, always demands some faith and imagination. Consider the case at hand, fiscal imbalance. First, Quebec citizens apparently do ÓbuyÓ the Óconsensus of the day.Ó As a matter of fact, well before a consensus emerged among political parties and social movements, 71 percent of Quebecers already considered that there was a fiscal imbalance in the Canadian federation. ÓSecond, a social and political consensus did not emerge spontaneously, following the release of a report Óthat almost no one has discussed.Ó This consensus was built gradually, first through the public hearings held by the Commission on fiscal imbalance, and later through deliberations among political parties and social actors. The three parties represented in the National

Assembly agreed on a joint motion in June 2002, and the main socio-economic organizations joined this consensus in October of the same year, following a National forum on the question. Third, this was not simply an issue for our political and media elite, more or less out of touch with reality. The Premiers of all the provinces and territories also agreed on the need to address the current fiscal imbalance in the federation.<sup>3</sup> The influence of what Dion called "pseudo science" and the reach of our elite were, to say the least, remarkable.

Dion had a point, however, but not for Quebec, when he deplored the lack of attention initially given to the actual content of the Commission on Fiscal Imbalance report. This report was the first extensive public effort in a long time to consider Quebec's situation entirely in a pan-Canadian context. The conclusions were not options for Quebec alone, but propositions for the federation. Yet, at the outset, the report remained largely unnoticed by the media and scholars in English Canada. One reason for this early lack of attention may be the rigid stance adopted by the federal government. Before the report was even released, indeed written, the Intergovernmental Affairs Minister was already making presentations to explain why it was wrong. The federal government never treated this report as a serious contribution to public policy, and did not consider the possibility of a genuine pan-Canadian debate. Accordingly, the English-Canadian media first made the whole question an internal Quebec matter.

Whatever the immediate media attention, the fiscal imbalance question was there to stay, because it addressed powerful trends in the federation and core issues for Canadians. Intergovernmental fiscal problems simply cannot be removed from the political agenda, even if the federal government wishes to do so. It is therefore useful to consider carefully the initial responses and non-responses of experts, commentators, and government

Nicolas Marceau, D partement des sciences  conomiques, Universit  du Qu bec   Montr al; Alain No l, D partement de science politique, Universit  de Montr al; and St phane Saintonge, associate attorney, Legault-Joly-Tiffault. The Commission had its own staff, but also benefited from the support of Quebec's Minist re des Finances. The Commission's secretary and assistant secretary, Mario Albert and Patrick D ry, were from the Minist re. The Commission released preliminary documents in June 2001, held public hearings in November and December 2001, and presented its final report, entitled *A New Division of Financial Resources in Canada*, on March 7, 2002.

The first task of the Commission was to define and operationalize the notion of fiscal imbalance. Various indicators already suggested that there was fiscal imbalance in the Canadian federation, but a clear and workable definition had to be put forward to make the analysis solid and fruitful. At the outset, one definition, common in econom-

quate and enable governments to cover necessary expenditures; and transfers are unconditional, unless there is a valid agreement to that effect. Put negatively, there is fiscal imbalance if the vertical fiscal gap is too wide, if transfers are inadequate, or if transfers are conditional.

Compared to the conventional notion of vertical fiscal gap, this understanding of fiscal imbalance has the disadvantage of being more complex and difficult to operationalize.<sup>11</sup> There is no simple measure and no definitive threshold to account for fiscal imbalance. This definition, however, is a much more satisfactory representation of intergovernmental relations in a federation, for at least two reasons. First, as mentioned above, in a federation there is always a vertical fiscal gap, and this may not be a problem. If the gap is not too wide and if transfers are adequate, a vertical fiscal gap is indeed compatible with what the Commission defines as a situation of fiscal balance. To make sense, the notion of fiscal imbalance must refer to something more than a fiscal gap, to a situation that is detrimental to the federal principle and demands correction. Second, a vertical fiscal gap may also exist in a unitary state, between the central government and local administrations for instance, without creating a situation of fiscal imbalance. In a unitary situation, when a vertical fiscal gap becomes important, it may become a matter of concern, but the stakes are different, because the context is not federal. Local governments, or even local administrative entities such as school boards and hospitals, may be concerned by a lack of



Here is how Dion defined federalism, quite appropriately, in a June 2000 speech:

Federalism may be defined as a system in which two orders of government possess constitutional powers. Each order of government is sovereign within its own legislative sphere, in the sense that the Constitution recognizes it as the only one empowered to legislate in that sphere.

Now,

The Commission on Fiscal Imbalance started from a definition anchored in the federal principle and sensitive to the real world of fiscal federalism. Then, it had to make it operational, to evaluate the current situation in Canada. Like most social phenomena, fiscal imbalance cannot be measured directly, in a simple fashion. In part, this is so because governments adjust their policies to the existing distribution of revenues in the federation. Provincial governments, for instance, may spend less on health care services than they should, because they have adjusted to reduced federal transfers. If this is the case, simply looking at revenues and expenditures would make us miss an important manifestation of fiscal imbalance. More generally, quantitative measures cannot capture the full institutional implications of a fiscal gap, or of inadequate or conditional transfers. There is simply no useful quantitative shortcut, explains Richard Bird, by which analysts can avoid the painstaking work really needed to understand the federal fiscal system of any one country. We can only work with indicators, and then consider one by one the different factors that contribute to fiscal imbalance.

The most telling, and most noted, indicator developed by the Commission of Fiscal Imbalance is a projection of future federal and provincial budgetary balances provided by the Conference Board of Canada. Using conservative economic assumptions and assuming unchanging revenues and expenditures policies, the Conference Board estimated that the Quebec government would constantly face deficits over the coming years, while the federal government would realize increasingly large surpluses. Figure 1, below, presents these projections.

Fig,

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One reaction to these indicators, stated as well by Dion, consisted of denying any validity to an analysis that assumed constant policies and made projections for upcoming years. Policies will change, argued Dion, and projections are notoriously unreliable.

This argument is not worth a long discussion. Of course, policies will change and projections will be more or less off the mark. Projections are not made to predict the

fields. Hence, nearly half of federal revenues (46 percent in 2000/2001) are drawn from personal income taxes, compared to a third for the Quebec government. Because they are progressive, income taxes grow faster than the gross domestic product and than most other sources of revenue. The relatively rapid growth of this tax field explains in part why federal revenues increase more rapidly than those of the provinces. Provincial governments, of course, also rely on transfers from the federal government, a source of revenue that has declined over the years and remains uncertain. In 1985/1986, federal transfers accounted for 25 percent of the Quebec government's revenues; by 2000/2001, they had fallen to 16 percent.

Figure 3  
Program Spending of the Federal and Quebec Governments, 2000/2001

Source: Commission on Fiscal Imbalance;  
Program spending does not include public debt charges.

In 2000/2001, health and social services accounted for 40 percent of the Quebec



likely to increase more rapidly than provincial revenues. These conclusions are compatible with the projections of the Conference Board, but they were drawn in a different way, on the basis of a close analysis of the revenues and expenditures of each order of government. They allowed the Commission on Fiscal Imbalance to conclude that there was a tendency towards an excessive vertical fiscal gap in Canada, contributing to a fiscal imbalance in the federation.

The second component of the Commission's definition of fiscal imbalance has to do with transfers as such. There is fiscal imbalance if transfers are inadequate given the existing vertical fiscal gap. This was certainly the case with the CHST, but Equalization payments were not without problems either.

Consider, first, health and social transfers. With the creation of the CHST in 1995, the federal government combined together its main social transfers to the provinces and reduced significantly the level of these transfers. Figure 4 indicates how sharp the decline of the federal contribution was in the mid-1990s.

Figure 4  
Federal Cash Transfers to the Quebec Government, 1985/1986 to 2019/2020,  
As a Percentage of the Quebec Government's Total Revenue

Source: Commission on Fiscal Imbalance

of health, education and social spending in the provinces. By 2001/2002, it covered only 14.1 percent of these expenditures. Only for 2001/2002, this represented a budgetary shortfall of \$5.2 billion for the provinces, and of \$2.2 billion for Quebec. After 2001, the impact fell disproportionately on Quebec because of the introduction of new distribution rules, based less on social needs and more on a per capita basis.

Acknowledging in practice what it has steadfastly denied in principle, the federal government has increased transfers to the provinces in recent years. Public concerns about health care, in particular, have favoured important additions to the CHST and the creation of health-related earmarked funds, which were announced in 1999, in September 2000 and, more recently, in February 2003 and January 2004. However significant, these additional transfers fall far short of the objective of a 25 percent federal contribution recommended by the Commission on the Future of Health Care in Canada (Romanow Commission). In fact, they leave the federal share of spending well below the 18.1 percent of 1994/1995.

Insufficient, this additional funding also fails to address the deficiencies of the CHST, a transfer that imposed conditions in areas of provincial jurisdiction, and remained largely unrelated to provincial social needs or to the overall evolution of costs. The CHST was not governed by an explicit formula, it did not include an escalator mechanism, and it only weakly took into account the distributive implications of social and economic differences across provinces, to the detriment of wealthy provinces. Hence, the country's major social transfer was not adequate, and it was also set on a unilateral basis by the federal government, in a more arbitrary fashion.

In this respect, the program appears much more satisfying, because it is an unconditional transfer program that falls clearly within the federal government's exclusive jurisdiction. The Program has a clear purpose, enshrined in the



Figure 5  
Fiscal Capacity of the Provinces Before and After Equalization, 2001/2002,  
in Dollars Per Capita

Source: Commission on Fiscal Imbalance

Second, the federal government applied, until the 2002/2003 fiscal year, an arbitrary ceiling on Equalization, to limit even further the level of equalization, for the most populated provinces in particular. Third, the representative tax system approach used to calculate fiscal capacity is not applied consistently, which creates important distortions. This is the case, for instance, with the property tax base, which is not estimated on the basis of real property values. This distortion alone deprives the Quebec

The "spending power" is not mentioned in the Canadian Constitution whereas it is in the constitution of many federations and it has never been recognized by jurisprudence. Indeed, entrenching and limiting this "power" was precisely an objective of the constitutional discussions of the 1980s and 1990s. These discussions, however, failed.

To sum up, there is fiscal imbalance in the Canadian federation because there is a tendency towards an excessive vertical fiscal gap, because transfers are inadequate, and because the federal government regularly invokes its "spending power" to impose norms and conditions in areas of provincial jurisdiction. The consequences of such an imbalance are significant. The Commission's public hearings and a pan-Canadian opinion survey confirmed that a strong majority of citizens consider that needs are not met adequately and that more resources should be devoted to health care, education, and social programs. Fiscal imbalance also creates inefficiencies and uncertainty in the financing of social programs, and makes innovation more difficult. Conditional transfers and the federal use of the "spending power" also pose problems in terms of public accountability, because citizens cannot easily know which order of government can be blamed or credited for social programs. Finally, fiscal imbalance detracts from the federal principle and limits the autonomy of the provinces, a problem particularly important for Quebec, since Quebecers have distinct collective preferences and orientations and specific approaches and policies that they wish to preserve and enhance.

## THE COMMISSION'S RECOMMENDATIONS

The Commission's work on fiscal imbalance was not simply an evaluation of the current and future distribution of financial resources in the country. It built on an understanding of the federal principle that stressed the centrality of the division of powers between the two orders of government and the importance of a corresponding division of financial resources. Accordingly, the Commission's recommendations were not simply financial. They entailed major transformations in the country's intergovernmental arrangements, to better respect the logic of federalism. First, the Commission recommended establishing fiscal balance in the federation through a new division of tax room between the two orders of government. Second, it proposed a series of improvements to the Equalization Program. Third, the Commission reaffirmed the importance of counteracting the federal "spending power." Fourth, it suggested mechanisms to respond on a continuing basis to future causes of fiscal imbalance.

To reach fiscal balance in the federation, the Commission estimated that in the short term the provinces would need additional revenues of at least \$8 billion. For Quebec alone, these revenues would amount to \$2 billion annually. The Commission also recommended the First3( y10.3(e [(ac(al-0.f-7(me295.2e log)6e.8(e)-7(vs8 Tw)-0.1( larg095 Te295.-11pol re





Mr. ChrŽtien's Minister of Intergovernmental Affairs expressed the same idea in a

## Notes

<sup>1</sup> Dion (16 October 2002).

<sup>2</sup> According to a pan-Canadian survey conducted in January 2002. In the rest of Canada, 64 percent of respondents were of the same opinion. Commission on Fiscal Imbalance (2002, 181). A Quebec poll conducted by CROP in September and October 2002 yielded similar results, with 67 percent of respondents agreeing that there was a fiscal imbalance between Ottawa and Quebec. CROP (15 December 2002).

<sup>3</sup> First Ministers (1 August 2002).

<sup>4</sup> Except, of course, for the contributions to this volume, first presented in May 2002. See also Mintz and Smart (2002), and the very thorough analysis presented by Lazar, St-Hilaire and Tremblay (2004).

<sup>5</sup> Pratte (17 February 2002).

<sup>6</sup> In April 2003, Yves SŽguin became Minister of Finance in the new Quebec govern-

<sup>14</sup> Kitchen and McMillan (1985, 220); Bradford (June 2002, 55).

<sup>15</sup> Dion (16 October 2002).

<sup>16</sup> Commission on Fiscal Imbalance (2001, 35-36).

<sup>17</sup> Norrie and Wilson (2000, 82).

<sup>18</sup> Dion (16 October 2002).

<sup>19</sup> Bird (1986, 402).

<sup>20</sup> The Conference Board later produced an analysis for the provincial and territorial governments, which confirmed and generalized these findings. See: Conference Board of Canada (March 2002 and July 2002).

<sup>21</sup> Dion (27 March 2002).

<sup>22</sup> Department of Finance (30 October 2002, 64-81).

<sup>23</sup> Ibid., 70; Conference Board of Canada (July 2002, 44). These projections were later revised downward by the Department of Finance (November 2003) with an estimated budgetary surplus of \$9.5 billion for 2008/2009, compared to \$12.9 billion in Conference Board; Department of Finance (November 2003, 95).

<sup>24</sup> Department of Finance (30 October 2002, 57); Ministère des Finances, de l'Économie et de la Recherche (30 October 2002); Cornellier (2 November 2002).

<sup>25</sup> Norrie (2002, 32)

<sup>26</sup> «La situation financière du gouvernement canadien est meilleure, c'est parce qu'il y a eu une meilleure administration à Ottawa qu'ils n'en ont eu au cours des dernières années au Québec.» Jean Chrétien, quoted in: Sansfaçon (11 October 2002, A8). A contrary argument, with evidence, is presented in: Comité de révision des programmes fédéraux (January 2004, 31).

<sup>27</sup> In Quebec, between 2000/2001 and 2003/2004, these expenditures are expected to increase by almost 16 percent, to come to account for as much as 41.7 percent of total program spending. Ministère des Finances (December 2003, 53).

<sup>28</sup> Myles (2000).

<sup>29</sup> Auditor General of Canada (24 October 2002, 1.33).

<sup>30</sup> Commission on the Future of Health Care in Canada (2002).

<sup>31</sup> Lazar, St-Hilaire and Tremblay (2004, 215). The Canadian Health Coalition estimates that the federal share will rise to about 16 percent; see Canadian Health Coalition (6 February 2003).

<sup>32</sup> On 1 April 2004, the CHST was replaced by the Canada Health Transfer (CHT) and the Canada Social Transfer (CST); these two programs are likely to keep most of the characteristics of the CHST.

<sup>33</sup> Following the February 2003 First Ministers' meeting on health care financing, the Equalization ceiling was abolished, 2002/2003 and subsequent fiscal years.

<sup>34</sup> A conditional transfer could be made valid if all provinces formally accepted it as legitimate.

<sup>35</sup> The federal government has tended to interpret broadly the meaning of these amendments. In January 2004, the Quebec Court of Appeal ruled that the federal government's parental and pregnancy benefits under the Employment Insurance Act were unconstitutional because they constituted "une incursion par le Parlement canadien dans un domaine qui est réservé aux provinces, alors qu'aucune modification constitutionnelle n'a été faite depuis 1940 la permettant." Québec (Procureur général) c. Canada (Procureur général), 2004, para. 101.

<sup>36</sup> See also Centre for Research and Information on Canada (January 2004, 3-4).

<sup>37</sup> The Commission on the Future of Health Care in Canada, for instance, briefly reviews the arguments of the provincial and federal governments on the financing of health care to conclude that "whatever the actual value of the federal contribution, it certainly is extremely difficult to calculate by both governments and the general public, and lacks clarity and predictability." Commission on the Future of Health Care in Canada (2002, 67). See also Lazar, St-Hilaire and Tremblay (2004, 206-214).

<sup>38</sup> Commission on the Future of Health Care in Canada (2002, 69-71).

<sup>39</sup> There is an implicit Equalization mechanism in a transfer distributed per capita, but if equalization is the goal, it would be preferable to improve the Equalization Program itself.





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# 6

## FISCAL BALANCE IN CANADA

Stéphane Dion

### INTRODUCTION

This chapter outlines the Government of Canada's position on the charge from the provincial governments that a vertical fiscal imbalance exists in Canada, and that it works to their disadvantage. Before explaining why the Government of Canada does not subscribe to this fiscal imbalance theory, three preliminary remarks will be made.

First, the existence of a federal budget surplus is good news for all Canadians. That our federal finances are now showing a surplus, after having been in deficit for so long, and that at the same time our provincial governments have succeeded in putting their finances in order, when all were in the red in 1993, is a recovery we can all rejoice in and congratulate ourselves on, because it is the result of our efforts in recent years.

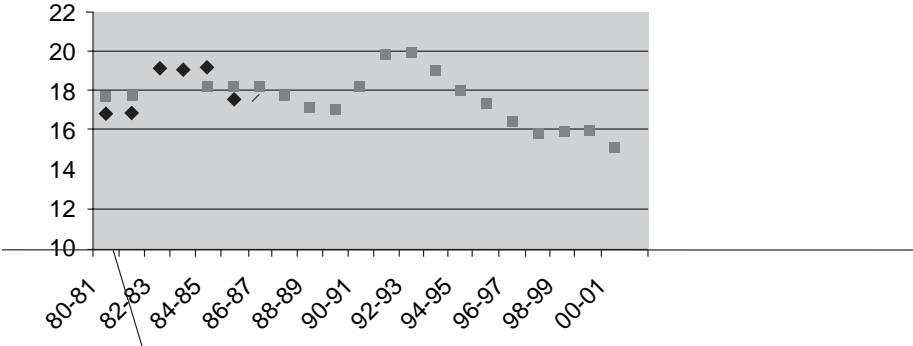
Second, it is normal for us to have different views on how this budget surplus ought to be used. This is a usual debate in any federation: how best to allocate tax dollars between the orders of government. It is normal for us to have different views on this issue, including between political parties that believe in Canadian unity. What is abnormal is for some people to try to use this debate to justify secession. When the







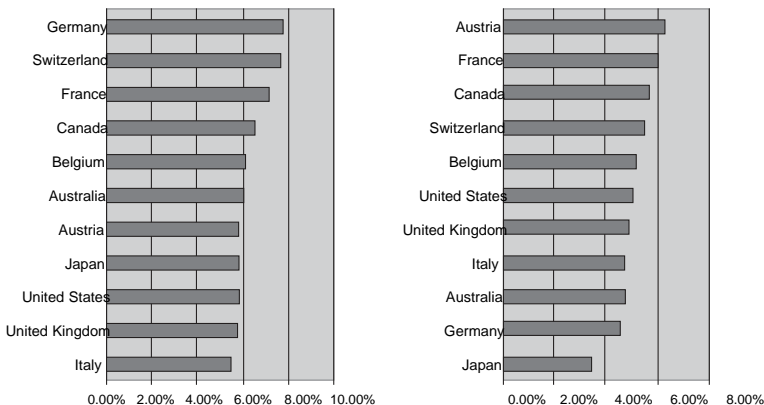
Figure 2  
Evolution of Spending



Sources: Federal and Provincial Public Accounts and Federal and Provincial Budget data as of March 2002

Health and education are by far the two main sources of spending for provincial governments. But, there is no indication of any sort of financial strangulation that would be depriving them of the means to fulfill these responsibilities within our federation. Canada is a country that has invested a great deal in health and education. OECD data proves that our federation has been perfectly capable of providing an appreciable financial effort for these two priorities.

Figure 3  
Public Spending on Health and Education, 1998, as Percentage of GDP



Source: OECD comparison of health and education spending in developed countries www.oecd.org: 2002

While it is true that spending in the health field has increased considerably in recent years, it nevertheless represents a proportion of provincial revenues and the economy that is comparable to the situation in the 1980s. Canada, as in other countries, growing health spending is due mainly to the higher number of drugs and new med-

Figure 4  
Evolution of Budget Balances

Sources: Federal and Provincial Public Accounts and Federal and Provincial Budget data as of March 2002

Furthermore, the debate on the alleged fiscal imbalance has appeared only recently, in the past few years, by chance at the same time that federal finances ceased to be in worse shape than those of the provinces. In all the years when the federal government was running substantially higher deficits than did the provinces, no one talked about a fiscal imbalance to the detriment of the federal government.

As economics professor Jean-Yves Duclos of Université Laval has noted, the gap between the federal surplus of \$17 billion in 2001 and the \$12 billion combined surplus of all the provinces is small despite appearances. Indeed, it could be closed, for example, by an increase of less than one percent in provincial sales taxes.<sup>[1]</sup> The provincial governments have chosen instead to cut taxes since 1994/95, which re

rec ve have been more than restored to their 1994/95 levels (Figure 5). I want to make it clear that I am not reproaching the provinces for cutting their taxes, any more than I am recommending that they raise them. I am merely saying that the fact that these provincial governments are choosing to cut taxes is one of the signs that demonstrate there is no fiscal imbalance in Canada.

Figure 5

Federal Cash Transfers and Provincial Tax Cuts 1994-2003, \$ billions

Sources: Finance Canada  The Facts : 2002 Provincial Public Accounts and Provincial Budgets, various years

There is no more of a fiscal imbalance today than in the past. There is only good news: our federation s public finances are now in order. But this turnaround has required a draconian reduction of the weight of spending by our governments in the economy, so that now strong pressure is being exerted on them to reinvest in all areas.

### The Projections

But the cornerstone of the S guin report is a projection by the Conference Board. According to this projection, in 2019/20, federal surpluses would reach \$87.8 billion, while the Government of Quebec would have a deficit of \$4.8 billion. But the much-denounced fiscal imbalance would be on its way, but is not, however, here just yet. The Conference Board itself projected very small federal surpluses for the next five years.

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## Figure 6

Budgetary Balances that Would Have Been Recorded if No Decision Had Been Taken Since 1997, in Billions of Dollars

Sources: Finance Canada *The Facts*: 2002

Finance Quebec *Supplement to the Government's Budgetary Policy*: 2002

But there is no need to go back five years, as Quebec's former Finance Minister herself demonstrated that such projections cannot be relied on for even one year. Indeed, only 12 days after the SŽguin report was tabled, Ms. Marois produced a budget statement which shows a balanced budget for the Government of Quebec in 2001/02, whereas the Conference Board study instead had projected a \$600 million<sup>42</sup> deficit.

So this methodology is unreliable. One cannot project governments' budget balances in such a mechanical and linear fashion, not only because their revenues and spending fluctuate in accordance with events and economic conditions, but also because governments act, and their actions alter the course of events. I will never be dissuaded that governments cannot make a difference depending on whether their policies are good or bad.

If there is one thing we must certainly not do, it is to implement the recommendation of the SŽguin Commission: abolish the Canada Health and Social Transfer in exchange for transferring the GST to the provinces, accompanied by an Equalization

It is understandable that the Szeguin Commission is shocked at its own recommendations to the point that it suggests they be applied ~~gradually~~ with no further clarification. It must be clearly understood that, in the real world, as opposed to abstract projections, repeated federal deficits would have negative effects on confidence in the Canadian economy and undoubtedly on interest rates as well, which would adversely affect provincial government finances.

The Liberal government, for its part, has maintained its disciplined management, which makes it possible to pay down the debt, cut taxes and make strategic investments. From that perspective, it is determined to help its constitutional partners, the provincial governments, as much as it can. Indeed, the Government of Canada increased its transfers to the provinces as soon as its budget situation allowed it to do so.

Accordingly, total transfers to the provinces will increase by an average of 6.1 percent per year until 2005/06, whereas anticipated federal revenue growth will be only 1.9 percent.<sup>13</sup> In 2001/02, of the \$11.2 billion in increased program spending, the federal government will allocate \$4.4 billion, or 40 percent, to increase the transfers to the provinces.

Rather than being a sign of a fiscal imbalance, the current surpluses of the federal government are, just like the improved finances of the provincial governments relative to previous years, the result of a necessary discipline that must be maintained. In spite of all the progress made in recent years, the fact remains that Canada's debt level remains high (66 percent of GDP) in relation to other G7 countries.

Is the Federal Government too Big Compared to Provincial Governments?

In point of fact, it is the federal sphere that has shrunk in recent decades, not that of the provinces. Whereas federal program spending accounted for half of all government spending in the early 1950s, it now accounts for only one third. As a percentage of GDP, federal program spending dropped to 11.3 percent in 2000/01, the lowest level recorded since 1948/49! That percentage is 5 percentage points lower than that of 1993/94.



Among federations, not only is it in Canada that one finds the constituent entities with the largest share of tax revenues, but our provinces also have complete autonomy over this exceptional fiscal weight. In fact, they set their own tax rates, a degree of fiscal autonomy equalled only by the American states (see Figure 8). And that's not all: own-source revenues, as a portion of total provincial revenues, are very high, in comparison both with past practice in Canada and with what exists in other federations, shown in Figure 9. And not only do our provincial governments depend relatively little on federal transfers, but also those transfers come with relatively few conditions. They are less conditional than in the past and less so than what we see in other federations.

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Figure 9

It was not my role, as Minister of Intergovernmental Affairs, to criticize the budgetary choices made by the provincial governments. I am simply saying that in our decentralized federal system, a provincial government has the capacity to make its own fiscal and budgetary decisions and to be accountable for those decisions to its voters. The Quebec government spent much more than the governments of other provinces, and it spent in its own way, according to its own priorities. It had to justify the extra fiscal load it was imposing on Quebecers and the way it was using it. It is too easy to blame the federal government all the time: with 27 percent of all federal cash transfers, the Quebec government was receiving assistance from the federal government that was higher than the provincial average.

#### Are Transfers too Conditional?

It is true that even in Canada federal transfers are not completely unconditional. For its part, the SŽguin Commission states that in a good federation, transfers of funds from the federal government to the provinces ought to be unconditional. The problem with such a position is that, in one stroke, all federations in the world become

But it is not just because a measure is constitutional that it is indeed desirable; it  
m

## CONCLUSION

Fiscal imbalance is a myth. The facts show that the federal surpluses are small in relation to past deficits; that all governments face pressures; that all governments have



## Notes

<sup>1</sup> Audet and Chambre de Commerce du Quebec (2002).

<sup>2</sup> Union des municipalitŽs du QuŽbec. 2002. *Annuaire prŽsentŽ ^ la Commission sur le dŽsŽquilibre fiscal*. 28 September.

<sup>3</sup> OECD comparison of health and education spending in developed countries. <http://www.oecd.org>.

<sup>4</sup> Federal and Provincial Public Accounts and Federal and Provincial Budget data as of March 2002.

<sup>5</sup> Finance Canada (2002). This 40 percent figure is made up of 14 percentage points for CHST cash transfers, 15 points for CHST tax point transfers, and 11 percentage points from Equalization and other federal programs.

<sup>6</sup> Federal and Provincial Public Accounts and Federal and Provincial Budget data as of March 2002.

<sup>7</sup> SŽguin Commission (2002, p. 8 of the summary).

<sup>8</sup> SŽguin Commission (2002, p. vii of the summary).

<sup>9</sup> Congressional Budget Office (March 2002).

<sup>10</sup> Congressional Budget Office (March 2002).

<sup>19</sup> Provincial Public Accounts and Provincial Budgets, various years.

<sup>20</sup> Ekos Research Associates Inc. and the Centre for Research and Information on Canada (October 2001).







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## THE STABILIZATION PROPERTIES OF CANADA'S EQUALIZATION PROGRAM

Paul Boothe

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### INTRODUCTION<sup>1</sup>

It is commonplace in Canada that whenever federal and provincial finance ministers meet, a discussion of Equalization – the Program at the centre of Canadian fiscal federalism – cannot be far behind. Recent years have been no exception with both provincial and federal politicians engaging in a public and sometimes acrimonious debate over Equalization.

A number of issues have been raised as part of the public debate. The first has to do with the growth and coverage of the Equalization Program itself. Provincial and Territorial Finance Ministers have been urging the removal of the Equalization ceiling and for a return to a ten-province rather than the current five-province standard. The fiscal capacity of the receiving provinces and how they will cope if Alberta and Ontario continue to reduce taxes is another issue being discussed. Finally, Nova Scotia, and more recently Newfoundland and Labrador, and Saskatchewan, have argued for an ad hoc change to the Program to allow them to benefit more fully from offshore energy development.

Parallel to the political debate has been a debate among academics and other policy analysts concerning the incentives inherent in the Equalization Program and the transparency and accountability properties of the Program. Research on the so-called macro approach to replace the current representative tax system (RTS) approach has been aimed at addressing some of these perceived shortcomings.

To foreign observers, it may seem odd that in all these discussions relatively little attention has been paid to the stabilization properties of Equalization. In Europe, for example, mainly as a result of ongoing integration and the inauguration of the European Monetary Union, there is growing literature on the risk sharing properties of interregional transfers.

However, in Canada it has been generally taken for granted that, in addition to addressing ongoing deficiencies in fiscal capacity, the Equalization Program will also be responsive to short-run fluctuations in revenues and, other things equal, contribute to enhanced stability of provincial government revenues. Indeed, its responsiveness to revenue fluctuations is sometimes identified as one of the key features of the Program.

Actual experience suggests that Equalization transfers may not be responsive to provincial revenue fluctuations. Therefore, the purpose of this paper is to examine whether Equalization actually contributes to the stability and predictability of provincial government revenues. The remainder of this chapter is organized as follows. In the next section, we develop a simple model of the interaction between Equalization and provincial own-source revenue. Two propositions relating to revenue volatility and predictability are derived. In the third section we describe and analyze the revenue data by statistically testing the two propositions. This chapter concludes with a brief summary and discussion of policy implications.

## THE MODEL

Although in practice, the Canadian Equalization Program is quite complex, based on a representative tax system with 33 bases, a five-province standard and a number of ad hoc arrangements, the theoretical representation of Equalization entitlements is relatively simple.

$$(1) E_i / N_i = t [B_s / N_s - B_i / N_i]$$

Where:

$E_i$  is Equalization to province  $i$ ,

$N_i$  is the population of province  $i$ ,

$t$  is the national average tax rate,

$B_s$  is the standard provinces' tax base,

$N_s$  is the population of the standard provinces, and

$B_i$  is the tax base of province  $i$ .

For

From equation (1) it is clear that, other things equal, an increase in the size of a province's tax base will cause its entitlement to decline. If the negative covariance between tax base and entitlements is sufficiently large, other things equal, the variance of own-source revenue plus Equalization will be smaller than the variance of own-source revenue alone. A further implication is that, for similar reasons, the variance of budget forecast errors should be smaller for own-source revenue plus Equalization than the variance for forecast errors related to own-source revenue alone.

In summary, we derive two testable predictions from the model. The first is that if Equalization is indeed stabilizing, the volatility of own-source revenue plus Equalization will be smaller than the variance own-source revenue alone. The second is that the predictability of own-source revenue plus Equalization should be greater than the predictability of own-source revenue alone.

## DATA AND ANALYSIS

All revenue data analyzed in this paper were assembled from provincial budgets and public accounts with the help of provincial and federal government finance officials. Adjusted revenue for province  $i$  ( $AR_i$ ) is defined as the difference between total revenue and Equalization cash transfers.

Figure 1  
Descriptive Statistics for Deviation from Trend Measures

Deviations from Trend AR

	Mean	Median	Min.	Max.	Std. Dev.
SK	0	-27.68	-390.78	300.53	180.44
MB	0	1.55	-270.64	373.11	183.43
QB	0	119.88	-3,695.27	1,969.76	1,290.29
NB	0	35.88	-479.10	280.58	196.73
PE	0	-5.70	-59.49	51.82	26.98
NS	0	-37.44	-367.07	369.12	232.75
NF	0	-31.81	-154.95	122.84	85.51

Deviations from Trend AR+E

	Mean	Median	Min.	Max.	Std. Dev.
SK	0	21.18	-426.38	342.24	225.01
MB	0	-119.85	-281.41	472.07	227.16
QB	0	356.01	-3,979.09	2,710.59	1,479.99
NB	0	17.33	-320.41	329.56	198.97
PE	0	-5.67	-60.39	55.86	30.27
NS	0	24.77	-330.80	425.62	219.93
NF	0	21.96	-176.75	260.31	122.47

Figure 2 presents the measure of volatility based on first differences. Here the results are more mixed. In four of seven provinces the first difference of AR+E is more volatile (i.e., had a larger standard deviation). Exceptions are Manitoba, New Brunswick and Nova Scotia. In addition, five of seven provinces' first differences for AR+E have a larger range. Exceptions are New Brunswick and Nova Scotia.

Figure 2  
Descriptive Statistics for First Difference Measures

First Difference of AR

	Mean	Median	Min.	Max.	Std. Dev.
SK	215.35	299.35	-164.95	545.7	235.3
MB	193.05	187.0	-186.0	540.0	188.73
QC	1,626.1	1,576.5	-674.0	3,727.0	1,078.67
NB	123.92	106.1	-206.4	471.2	155.61
PE	21.65	21.8	-15.9	59.3	19.63
NS	128.95	159.5	-.14.0	339.0	134.62
NF	58.8	68.0	-154.0	124.0	59.47

First Difference of AR+E

	Mean	Median	Min.	Max.	Std. Dev.
SK	217.46	273.79	-332.61	645.36	288.94
MB	239.85	249.0	-163.0	652.0	182.83
QC	1,816.25	1,747.5	-893.0	4,883.0	1,078.67
NB	164.77	167.4	3.5	351.9	118.96
PE	30.66	31.95	-23.6		

Figure 3 presents descriptive statistics for budget forecast errors. Looking first at mean forecast errors, we see that for three of seven provinces the forecast errors of AR+E are larger than those for AR alone. Six provinces have a larger range of forecast errors for AR+E than AR alone. Four provinces have larger standard deviations of forecast errors for AR+E than AR alone.

Figure 3  
Descriptive Statistics for Budget Forecast Errors

Formal tests of the hypotheses are straightforward. In Figure 4 we present the results of tests for the equality of variances of the deviations from trend AR and trend AR+E, as well as the equality of the variances of first differences of AR and AR+E in Figure 5. Using either measure of volatility, it is not possible to reject the hypothesis of equality for any province at standard confidence levels.

Turning to the hypothesis regarding forecast errors, results are presented in Figures 6 and 7. Looking first at the test of the hypothesis of equality of means, we see once again that we cannot reject the hypothesis of equality of mean prediction errors for AR and AR+E for any province. Figure 7 presents the results of tests of the equality of variances of forecast errors. We can reject the hypothesis of equal variances for two provinces (PEI and Newfoundland), but in both cases the variances are larger for prediction errors of AR+E than AR alone.

Figure 4  
Test for Equality of Variances Between Trend AR and AR+E

F-Tests			
	DF	Value	Probability
SK	(14,14)	1.56	0.42
MB	(20,20)	1.53	0.35
QC	(20,20)	1.32	0.55
NB	(20,20)	1.02	0.96
PE	(20,20)	1.26	0.61
NS	(20,20)	1.12	0.80
NF	(20,20)	2.05	0.12

Figure 5  
Test for Equality of Variances Between D(AR) and D(AR+E)

F-Tests			
	DF	Value	Probability
SK	(13,13)	1.51	0.47
MB	(19,19)	1.07	0.89
QC	(19,19)	1.58	0.33
NB	(19,19)	1.71	0.25
PE	(19,19)	1.82	0.20
NS	(19,19)	1.18	0.72
NF	(19,19)	1.62	0.30

Figure 6  
Test for Equality of Means Between AR and AR+E Forecast Errors

T-Tests			
	DF	Value	Probability
SK	28	0.09	0.93
MB	40	1.03	0.31
QC	40	0.39	0.70
NB	40	0.32	0.75
PE	40	0.46	0.65
NS	40	1.21	0.23
NF	40	1.14	0.26

Figure 7  
Test for Equality of Variances Between AR and AR+E Forecast Errors

F-Tests			
	DF	Value	Probability
SK	(14,14)	1.30	0.63
MB	(20,20)	1.44	0.42
QC	(20,20)	1.68	0.26
NB	(20,20)	1.13	0.79
PE	(20,20)	3.14	0.01
NS	(20,20)	1.08	0.86
NF	(20,20)	3.87	0.00

### SUMMARY AND POLICY IMPLICATIONS

The results of the study are easily summarized. Using budget and public accounts data for own-source revenue and Equalization for the period 1981/82 to 2000/01 for seven Equalization-receiving provinces, we tested the propositions that Equalization reduced the volatility and improved the predictability of provincial government revenues. Based on an examination of both changes in revenue and deviations from trend



revenue, we found that the volatility of revenues were often actually larger for AR+E than for AR alone. Statistically, we could not reject the hypothesis that the variances of the two series were equal. We therefore conclude that Equalization did not contribute to reducing revenue volatility in the receiving provinces over the period 1981/82 to 2000/01.

Regarding the predictability of revenue, we examined budget forecast errors for AR+E and AR alone. For three provinces, average forecast errors were larger for AR+E than for AR over the period. The standard deviation of forecast errors was also larger for AR+E than AR alone for four provinces. Using formal statistical tests, we could not reject the hypotheses that the means or variances of both sets of forecast errors were equal, except when the variance of AR+E was actually larger than the variance of AR alone. Therefore, we find no evidence that Equalization improved the predictability of total government revenues for the receiving provinces over the sample period.

At least two policy implications flow from these results. The first is that Equalization does not contribute to reducing the volatility of provincial revenues and therefore provincial governments may need other mechanisms to manage revenue volatility. Indeed, to this end a number of provinces have moved to create reserves or explicitly smoothed revenue forecasts to mitigate the impact of volatility and make revenues more predictable. To be fair, it is important to remember that reducing the volatility of provincial revenues has never been stated as a goal of Canada's Equalization Program. Thus, any increases in revenue volatility as a result of Equalization transfers should be viewed as an unwanted side effect rather than a failure of the Program.

The second policy implication relates to the Equalization Program itself. Some proponents of the current RTS system have argued that one of its benefits is its respon-



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## EQUALIZATION AND THE PROVINCES NATURAL RESOURCE REVENUES: PARTIAL EQUALIZATION CAN WORK BETTER

James P. Feehan

### INTRODUCTION

A theoretical and empirical minefield. That is how Thomas Courchene, a leading expert on Canada's Equalization Program, has described the debate over the treatment of natural resources within that program. There are many aspects to this debate. On the one hand, Equalization is a costly federal government Program that transfers funds to provincial governments with weak per-capita revenue-raising capacities. On the other hand, natural resources are owned by the provinces in which they are located, cause the financial cost of Equalization to be higher than otherwise, and should be priced appropriately to ensure that they are not exploited in a wasteful manner.

As a starting point this paper accepts the constitutional provisions on natural resource ownership and on Equalization. As of 1982, a federal government Program of Equalization payments to provincial governments has been mandated by Section 36 of the Constitution Act, 1982. In addition, Section 92A clearly allocates non-renewable natural resources as well as the renewable natural resources of forestry and hydro power to the provinces. Indeed, as pointed out by White, it was agreed at Confederation in 1867, and recognized in the Constitution, that the original four founding provinces (Ontario, Quebec, New Brunswick and Nova Scotia) would own their resources and have freedom to tax them by whatever means they chose. When, decades after Confederation, the federal government granted Ontario and Quebec their vast northern territories, ownership of natural resources was included. When British Columbia and Prince Edward Island joined Confederation, they too retained ownership of the same natural resources as the original four. To the provinces that were created within Canada, namely Alberta, Saskatchewan and Manitoba, resource ownership was extended in 1930. Newfoundland also had the same owner-

Even within this constitutional reality, the challenge of how to incorporate provin-

annual average of provincial government revenues from their natural resources, both renewable and non-renewable. Courchene reports that this latter move was designed primarily to ensure that Alberta would no longer qualify for Equalization payments. Perhaps one could interpret these early modifications to the Equalization formula by the federal government as the beginning of ad hoc adjustments; alternatively, one might see them simply as part of a maturation process in developing a better measure of fiscal capacity.

In 1964 the federal government amended the 1962/63-66/67 formula. It reverted to the two-province standard, reflecting acquiescence to provincial governments' requests to do so. It coupled that measure with a provision that provinces which received natural resource revenues in excess of the per capita national average would have any Equalization entitlement reduced by 50 percent of that amount. This was to ensure that Alberta and British Columbia would not receive payments.

The next five-year version of the Equalization formula, covering 1967/68 to 1971/72, was a major step forward in its evolution, a critical milestone and a major watershed according to Courchene and the Economic Council of Canada, respectively. The number of tax sources to be equalized was increased from four to sixteen and there was a return to the use of the national average per capita revenue as the standard for determining a province's Equalization entitlement for each revenue source. This applied to natural resource revenues as well, so that, for the first time, 100 percent of such revenues were subject to Equalization.

Despite these variations in their treatment, natural resource revenues did not prove to be an especially problematic or controversial aspect of Equalization up to 1972. However, it was not long thereafter for troublesome and costly implications to arise.

The oil crisis of 1973 is often cited as the starting point for problems concerning the treatment of natural resource revenues in Equalization formulas. However, there may be an earlier example. In the 1960s Quebec, Newfoundland, and a private corporation, Brinco, entered into an arrangement to develop the Upper Churchill River in Labrador. In 1972 that enormous hydro project, one of the world's largest, began operating. At the same time, and even before the world oil crisis, the Newfoundland government realized that it would lose financially as a result of this development and provincial revenues would be lost on a dollar-for-dollar basis, or worse, through the Equalization formula at the time. These losses were part of the impetus for Newfoundland's decision to use the threat of expropriation to purchase Brinco's interest in the development, since public ownership shielded some of the revenues from Equalization. This is a fabulous example of how Equalization considerations can influence provincial policy decisions regarding natural resources.

Nevertheless, it was the oil price shocks of the 1970s that were at the heart of changes to the Equalization formula since the early 1970s. The essential problem, from the federal government's perspective, was one of volatility and, especially, cost. Oil and gas resources, in per capita terms, are distributed far more unevenly across the



A hypothetical example will help illustrate the workings of this formula. Suppose the revenue source is forestry revenues, as derived from stumpage fees and related provincial taxes. Across all ten provinces, assume that the national tax rate is \$15 per thousand cubic metres of wood, so  $T = \$15$ . For the five provinces in the standard, assume that the amount of wood that is harvested is 3.2 thousand cubic metres per capita for the year in question. Suppose, however, that the province for which the calculation is being done has a relatively small forestry industry and the amount of wood harvested there is 1.2 thousand cubic metres per capita. If that province has a population of one million people then its Equalization entitlement associated with forestry revenues would be:

$$\begin{aligned} & \$15 \times (3.2 - 1.2) \times 1 \text{ million} \\ & \text{which is } \$30 \text{ million.} \end{aligned}$$

Under the former ten-province standard, the national average tax rate,  $T$ , would also be used but the per capita reference base would include all ten provinces rather than just the five selected by the federal government. In essence then the formula in (1) is more of a hybrid than a true five-province standard because it retains the national







average tax rates. A similar interpretation applies to the figures for the other three resource-rich provinces. An immediate implication is that if resource revenues were not equalized at all then the three resource-rich recipient provinces, namely, Newfoundland and Labrador, Saskatchewan and British Columbia, would have benefited; although, the benefit to Newfoundland and Labrador for that year would have been very small since it is only slightly, i.e., \$43.49, above the per capita revenue associated with the five-province standard.

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migration is inefficient because the resource revenues are merely shared among more people while the movement of workers causes labour productivity to fall. The policy conclusion, therefore, is that a system of transfer payments to the resource-poor provinces is needed in order to reduce this incentive to migrate from them.

The Boadway-Flatters theory is both eloquent and, given its underlying assumptions, logically flawless. However, an application of Canadian data to that theory concluded that the Boadway-Flatters efficiency gains are not. Subsequent theoretical contributions point out that reasonable changes in the assumptions underlying their theory can reverse the theoretical predictions of efficiency gains. On the contrary, other arguments can be invoked to buttress the efficiency arguments. For instance, Br

In the former case, such a provincial government does not have an incentive to col-

processing, that reduce the resource tax base but generate other benefits such as increased resource-related employment. If those conditions are not met sufficiently by a development proponent then the province could decide not to allow new resource developments, especially ones that are capital intensive projects with relatively little employment benefits. The royalty revenue that it would forgo would not be a concern since they would have been offset fully by Equalization losses. Such disincentive effects have been recognized for some time.

The extent to which provincial governments adopt resource policies primarily based on the Equalization consequences is open to debate. However, it seems inconceivable that Equalization implications never influence major natural resource decisions, especially in recipient provinces. Whatever the motives, there is evidence that natural resources are underpriced across the country. And the Equalization Program can act to cushion the provincial governments from the costs of such inefficient policies.

It is revealing that the federal government has apparently recognized that these efficiency problems are more than theoretical possibilities. The generic solution was introduced to address the incentives that would have caused some provincial governments to adjust their tax rates as a means of gaining more Equalization payments. Of course, this is also consistent with the federal government's main motivation of

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per capita forestry tax base were to increase. More so, if the Alberta forestry tax base went up, there would be no gain for either Quebec or New Brunswick, because Alberta is not in the formula's five-province base. In light of these considerations, it is not surprising that so many commentators are critical of the five-province standard and support a return to the ten-province one.

There is another equity argument, which is along constitutional lines and has been endorsed by important federal institutions. The Constitution Act, 1982 affirmed provincial ownership of their natural resources. This was no new innovation. As mentioned in the Introduction, it has been a consistent feature of Confederation. In addition, Section 125 of the Constitution Act, 1982 precludes the two levels of government from taxing one another's lands or property, so that the federal government cannot tax provinces' resources. Yet, what the Equalization Program does is to reduce provinces' entitlements, often on nearly a dollar-for-dollar basis, in accordance with any growth in their per capita resource revenue bases. In a sense then recipient provinces lose their resource revenues to the federal government through the workings of Equalization, but the have provinces do not. The dilemma appears to be a clash between one constitutional provision, i.e., Equalization, and another, i.e., provinces' entitlement to their resources. A compromise is called for.

It is especially noteworthy that, in recognition of the constitutional consensus over natural resource ownership, a federal institution, namely the Economic Council of Canada, articulated the rationale for subjecting only a modest fraction of resource revenue to the federal government. The rationale is that the federal government should not be a net contributor to the resource revenue of the provinces.





## EQUALIZATION AND THE PROVINCES'S NATURAL RESOURCE REVENUES: PART

### Return to a Ten-province Standard

Most commentators agree that a ten-province standard is more appropriate than the current five-province standard. The most likely dissenter is the federal government, which would be concerned over the cost implications. However, to avoid asymmetric and, therefore, unfair treatment of provinces the ten-province standard is superior. While this is not specific to natural resources, a return to the former standard is nevertheless desirable in their regard. And it may not be the case, given other components of this proposal, that the federal government would have to pay substantially more than currently. More so, the federal government can always prorate entitlement payments according to the funds it decides to allocate to the Program.

### Replace National Average Tax Rates on Natural Resources with Potential Rates

Provinces, for reasons related to industrial or employment policy and perhaps sometimes influenced by the workings of the Equalization formula, may not be collecting revenues consistent with the value of their natural resources. As argued earlier, to the extent that this occurs, it is unfair to other provinces and it leads to national inefficiency. Therefore, to offset this, it could be helpful if the Equalization formula used a national tax rate that was related to the resource's economic rent rather than continuing the practice of using the national average tax rate, which may be too low in some cases.

This is a far-reaching proposal. It would provide substantial incentives for provincial governments to charge royalties, even to their own resource-related Crown corporations such as hydro companies, so that they would come closer to reflecting the resource's values. The environmental and efficiency gains might be substantial. This effect would likely vary. For some resources and in some provinces, royalties might already be quite close to capturing the resource rents. In other cases, the deviation from the appropriate rates could be substantial.

There is no doubt that there would be practical problems in determining what the rent-capturing rates might be. The work of Zuker and Jenkins and other Canadian economists provide methodologies to estimate the appropriate royalty rates for collecting resource rents. As for estimating the value of the resource bases, as mentioned earlier, changes introduced by the federal government in the 1999/2000-2004/05 Equalization formula included the use of measures that are better, although not perfect, indices of economic rent. That was an important development that is consistent with this proposal. Nevertheless, there would almost certainly be arguments over what rates ought to apply to various resources across the provinces. Reasonable rules of thumb, reflective of economic analyses, would be a realistic solution.

### Equalize Twenty-Five Percent of Natural Resource Revenues

Through its actions, the federal government has effectively admitted the undesirability of including 100 percent of natural resource rents in a five-province average, let alone a ten-province one. It has entered into Offshore Accords and adopted the generic solution. But these are limited and rather ad hoc measures. They fail to address

the problems posed by new resource developments in provinces that do not have more than 70 percent of the total resource base, whether it be a new hydro project in north-

## A Longer-Term Commitment

Large scale resource development is a substantial and long-term undertaking. The

than-average resource wealth, would have substantially larger entitlements than under the status quo. Overall, total payments would be somewhat higher than under the status quo, \$11.9 billion versus \$10.3 billion with practically all of the extra funds going to those two provinces.

It is critically important to recognize that the figures in Case C do not represent the end of the story as far as this paper's proposals are concerned. There are two other key considerations that need to be taken into account. One of them is the use of rent-capturing rates in place of the national average rates for natural resources. To the extent that rents are not fully collected by resource royalties, such an adjustment is likely to reduce total payments and reduce entitlements to provinces that tend to be both resource rich and undercollect relative to others. Thus, the total payout would probably be somewhat smaller than the total shown in the Case C column, with perhaps Saskatchewan and British Columbia receiving less than indicated in that column but still significantly more than under the status quo. As a caveat, even this speculation is problematic since different provinces' resource royalties may vary considerably so any adjustments could be proportionally more or less across provinces and resources.

The other key consideration is that while the total payout might still be higher than under the status quo arrangements, the federal government would be shielded from the effects of a major oil price shock since only 25 percent of (potential) resource revenues would be included. Thus, while it is possible that this package might result in an upward cost-shift for the federal government, the problem of volatility due to resource price shocks would be largely eliminated. There may not even be any extra cost to the federal government, since, as mentioned earlier, it can prorate recipient provinces' entitlements, however calculated, to match the budget it decides to allocate to the Program.

Beyond the issues of payments, under this proposal there would likely be efficiency gains. Any province that is well-endowed in a particular natural resource would have a much greater incentive to design royalties to capture the economic rent. That would reduce resource misallocation and allow for a shift of some of the general tax burden from less efficient bases. The gains here are not just to the individual province but also to the national economy.

## CONCLUSION

This paper developed a reasonable approach for dealing with the Equalization of natural resource revenues. The design of this approach largely echoes, reflects and complements recommendations that have been made elsewhere, including major reports by the federal government's own institutions. Importantly, this proposal package requires something of the provinces; they must accept some mechanism for estimating what the rent-capturing tax rates ought to be as well as the use of those rates for Equalization of resource revenues. In return, the federal government should return to a ten-province standard and move to offset the disincentive effects related to resource revenues by making a long-term commitment to equalize a portion of resource revenues, where that portion is consistent with efficiency and equity objectives. While, at

the federal government's discretion, that might add somewhat to the Program's cost, there would be gains to the national economy and the problem of cost volatility associated with a ten-province standard would not arise.

In sum, there are four main facts that ought to be taken into account in deciding on the treatment of resource revenues in the Equalization Program. First, there is the constitutional provision for equalization payments and the generally accepted use of the representative tax system as the basis for such payments. Second, there are the constitutional provisions that give provinces specific control and authority over their resources, and there is no reason to believe that the Equalization provisions dominate these. Third, there is also the practical and legitimate issue of cost. Indeed, because of cost the federal government has often adopted changes to the Equalization formula that treat natural resource revenues differently from revenues from other sources. Finally, but not less importantly, the appropriate pricing of natural resources is required to avoid inefficient utilization. What is needed is a reasonable balancing of all four of these considerations.

## Notes

<sup>1</sup> Courchene (1998, 32).

<sup>2</sup> Whyte (1982).

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<sup>13</sup>For further protection on costs, the federal government imposed a ceiling on increases in total Equalization payments so that any proportional increase in total Program C

<sup>22</sup> See Usher (1995) and Courchene (1998).

<sup>23</sup> Breton (1985).

<sup>24</sup> The term "competitive cost" means that the cost of these inputs is measured using the wages and returns that they would have earned elsewhere in the economy under competitive, i.e., non-monopoly, conditions.

<sup>25</sup> See Bernard (1993).

<sup>26</sup> See Economic Council of Canada (1982).

<sup>27</sup> See, for example, Boadway, Flatters and LeBlanc (1983), who argued for Equalization of 25 percent of natural resource revenues under a ten-province standard.

<sup>28</sup> The generic solution is not sufficient to eliminate the inefficiency associated with provincial royalty regimes. It applies only to a few cases, namely, those where a province has extraordinary scope to manipulate the national average tax rate  $\bar{\tau}$  since it would have 70 percent or more weight in its determination and would likely have a base hugely greater than the five-province standard. The generic solution, for instance, is ineffective in handling the underpricing of hydro and other natural resources as documented by the Economic Council of Canada (1982).

<sup>29</sup> It is possible that the low tax rates might induce a greater amount of resource  
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<sup>35</sup>Royal Commission on the Economic Union and Development Prospects for Canada (1985, 195).

<sup>36</sup>Zuker and Jenkins (1984).

<sup>37</sup>The Senate's Standing Committee on National Finance (2002) recommended that the generic solution be made more **generous** in relation to non-renewable natural resources.

<sup>38</sup>Economic Council of Canada (1982).

<sup>39</sup>Since the provinces average tax rates on resource bases would not differ significantly from the federal rate, the provinces would not be able to raise significant additional revenue from resource taxes.

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EQUALIZATION IN CANADA:  
REFORM OF THE REPRESENTATIVE TAX SYSTEM  
OR MOVE TO A MACRO APPROACH?

REFLECTIONS IN CONSIDERATION  
OF RECENT DEVELOPMENTS

Ronald H. Neumann

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INTRODUCTION

The Equalization Program in Canada has been in place since 1957. It has become, in the words of a recent report from the Standing Senate Committee on National Finance,

an essential element of federal provincial fiscal arrangements in Canada. Its importance has increased over the years, so that it is now an integral part of the economic and social fabric of the country.

It has also been regarded as successful, passing scrutiny of many observers. In 1997, the Report of the Auditor General of Canada stated:

Virtually all who have looked at this program (Equalization), ranging from parliamentary committees to royal commissions, have pronounced it one of the main successes of the federation.

The key element of the Equalization formula and its successful operation is the Representative Tax System (RTS). The RTS is a hypothetical tax system that is intended to be representative of the actual systems of the separate provinces. Its purpose is to provide an accurate and comparable measure of the relative ability of provinces to raise revenues to support public services.

Few programs of this magnitude could pass repeated scrutiny so well. However, the Senate Committee found that there were a number of advocates for change and strengthening of the Equalization Program. Some of those voices advocate for some reform of the Representative Tax System (RTS), currently in use, while others propose that Equalization in Canada be based on a macro approach to calculation of entitlements. A macro approach would seek to measure the relative ability of provinces to raise revenues based on some single measure of ability to pay, such as gross domestic product (GDP), personal income (PI) or personal disposable income (PDI).

The purpose of this chapter is to reflect on some major issues that arise with respect to the macro approach, and to examine some recent developments that have impacted on Equalization for the insights they provide with respect to the advantages or disadvantages of using a macro approach as compared to the RTS.

This examination concludes that:

- ¥ a macro approach is not able to accurately capture relative fiscal capacities of the provinces,
- ¥ use of a macro measure for Equalization would introduce greater volatility in payments, and
- ¥ introduction of a macro approach would destabilize the finances of some recipient provinces.

¥ the RTS better reflects the tax capacity available to provinces when considering the forces and constraints on provincial decisions made in the real as compared to the theoretical world of public finance, specifically because measurement of fiscal capacity should reflect actual tax practices, consumer and investor preferences, and the exportation of taxes;

¥ the macro approach disguises the complexity inherent in developing the particular macro-measure chosen;

¥ the disincentive issue is not proven and is secondary to the efficiency gains of Equalization inherent in the Equalization of net fiscal benefits;par el1 0 10.5 64 4



The RTS approach would derive a standard by taking the sum of the national average tax rates applied to national income in each category. The standard would be multiplied by the number of people in the province, and the actual revenue raised by Province B at national average tax rates would be subtracted to derive the Equalization entitlement. In this case, the calculation would be:

Figure 2  
Calculation of the RTS Standard

The RTS would pay Province B the difference between the national average tax per capita, times the population, less the actual tax Province B could raise with its capacity at national average (progressive) tax rates. Equalization would be  $[(\$4,650 \times 100) \text{ minus } \$380,000]$  or \$85,000. This compares with \$42,300 under the macro approach.

Of course, there are those who would wish to impose a flat tax on all incomes, and, in such a world, there would be no difference between Equalization under a macro approach and under the RTS. However, the Equalization Program should reflect the reality of current tax practice, not some artificial simplification which states that every dollar in citizens' hands is equally available to be taxed.

It can be seen from the above that a simple macro measure of fiscal capacity is inadequate to take account of even such a basic feature of taxation as the progressive income tax system. This is true whether the macro approach uses GDP, personal income or some other macro measure. It is also true whether provinces use a tax-on-income or tax-on-federal-tax approach. It would be even more problematic if there were a desire to reflect some tax preferences, for example, with respect to the exclusion of food from the retail sales tax base. There are myriad tax differentials and preferences in the tax systems of Canada's provinces which can be and are accommodated in the RTS system for calculating Equalization payments.

One might then suggest that a stratified income approach could satisfy the need to take account of some of these differentials. However, as <sup>1</sup>Barro pointed out, the more a macro approach is modified and adjusted to take these realities into account, the closer it comes to being similar to the RTS. Furthermore, complexity is added, to



## Implications for the Equalization Formula with Respect to Personal Income Taxes, Arising from the Mutual Fund Trust Refunds Error

The conclusion above, of course, contains within it the requirement that the RTS system be kept in properly functioning order. In 2002, it was discovered that the payments made to provinces under the Tax Collection Agreements had been miscalculated for approximately 20 years. The federal government collects personal income taxes on behalf of the nine provinces, excluding Quebec, and remits the proceeds to provinces. A miscalculation was made with respect to personal income taxes paid by mutual fund trusts. These payments are later refunded to the trusts, when remittances are made from the trust to the accounts of individuals. However, the refunds had not been deducted from payments to provinces. The largest mutual fund operations are hosted in Manitoba and Ontario, and by virtue of this fact, these two provinces were most impacted by the error. Provinces did not realize that this was occurring due to the lack of information provided to them, and perhaps, due also to some overconfidence in the work of the federal Auditor General.

The error was primarily a tax collection concern. However, the calculation of Equalization entitlements of all provinces was impacted by the error because the RTS system is based on actual tax receipts of the provinces. Advocates of a macro system for Equalization might suggest that the error was compounded by the use of the RTS system for Equalization calculations. However, a full analysis shows that the distortions of this error (and its subsequent correction) would have been far more damaging if the RTS had not been in use.

The tax capacity of provinces for Equalization of personal income taxes under the RTS system is derived from the Personal Income Tax (PITAX) model constructed by The Canada Revenue Agency (CRA), formerly The Canada Customs and Revenue Agency (CCRA), formerly Revenue Canada, and Finance Canada. As the error occurred within an RTS system, an offsetting amount was generated for Equalization-recipient provinces, because the RTS system was in use. The offset would not have been generated under a macro approach. Provinces without large mutual funds operating in their jurisdiction received some Equalization which kept their fiscal capacity equal to that of Manitoba. Manitoba was unknowingly receiving more in personal income tax remitted from the federal government under the Tax Collection Agreement, but that additional revenue was being mostly offset through lower Equalization entitlements than it would have received if the error were not occurring.

Upon discovery of the error, the net amount (tax less Equalization) owed was the basis for the settlement of the error. If the RTS system had not been in use, Manitoba would have received both the higher payments from the Tax Collection Agreement error and full Equalization. Any settlement would have had a much more devastating effect on Manitoba's finances. The stabilization effects of the RTS-based Equalization were effective, because the Equalization formula was based on actual tax receipts of the provinces.

The error raises questions as to whether other refunds and credits are properly accounted for in the PITAX model. The model was adjusted to exclude the refunds to mutual fund trusts. At the same time the treatment of all other refunds and credits should be examined. Some of these are in the nature of expenditures provided through the tax mechanism, while others are a reduction of effective tax rate. The entire model has been reworked to reflect the tax-on-income approach to setting of provincial tax rates. While this added a degree of complexity to the calculation of Equalization, it also should provide a more accurate calculation of fiscal capacity. Furthermore, it will add a degree of comfort to the entire system of income tax collections and transfer payments. Tax bases and tax rates under the RTS must be measured accurately.

However, the error should engender further reflection and caution for those advocating a macro approach. As noted, there would have been greater instability of total provincial revenue in Manitoba ifais0T\* -0.d.6(e the sr(a)0.1i(a)0.1(t)t)8.6(ed,)-(y oF298.

Figure 3  
Differences Between a GDP (Market Prices) Macro Method and Current RTS  
(Five-Province Standard, No Floor or Ceiling, \$ Thousands)

Source: Senate Committee on National Finance Ð Appendix B Ð Series 1, Table 3

The analysis above with respect to measurement of the income tax base under a progressive income tax system provides a significant part of the explanation for differences in results from the two approaches. Exportation of resource taxes and the impacts of the financial industries on measured income under a macro approach are two other major distortions, which must be addressed.

The mutual fund trust refunds are a good illustration of the distortions which may arise under a macro approach. A macro measure may place the financial activity within the jurisdiction of the head office, or it may inaccurately portray the fiscal capacity residing in a jurisdiction as a product of the activity merely headquartered in the jurisdiction. Certainly, in the case of the mutual fund trust error, the impacts on Manitoba's revenue under both income taxes and transfers were large. However, these impacts resulted from a set of transactions which, with proper treatment of refunds, would have resulted in no revenue to the Province. Mutual fund trusts do not ultimately pay any personal income tax. Payments by the funds are all refunded to them. Taxable income from income earned in a mutual fund trust ultimately is only paid by individual trust unitholders. These individuals may be resident anywhere in Canada. However, under a macro approach, the income may be ascribed to the province in which the mutual fund operates, rather than to the provinces in which the tax is ultimately paid by individuals.

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Manitoba remains an outlier with respect to differences between Equalization entitlements calculated under the RTS versus entitlements under macro measures for a number of reasons, including:

- ¥ the effects of a progressive income tax system in a province with lower than national average incomes;
- ¥ a strong financial sector, which generates significant returns as measured by a macro approach, without a corresponding increase in taxable activity within the province;
- ¥ the lack of strength in natural resource revenues (in particular, oil and gas) which have high returns to provincial governments relative to the economic activity as measured under a macro approach; and
- ¥ a high proportion of Aboriginal people whose incomes are tax exempt (as a result of federal, not provincial, discretionary policy).

#### Instability Generated by Use of Economic Rent for Calculation of Entitlements Under the Mining Tax Base

A departure from the RTS approach was introduced in 1999 for calculations under the mining tax base. The former approach attempted to mimic actual tax practice as applied to value or volume of mining revenue on different types of mining activity (potash, asbestos, metals, coal, etc.). The new approach correctly recognized that the underlying tax base for most mining taxation was mining profits, which may be considered to be equivalent to the capture of economic rents. Statistics Canada input/output data was to be used to calculate economic rent available for capture. This solved several problems in the measurement of fiscal capacity related to mining. Specifically, it allowed for combining mining sources and virtually eliminated the need to resort to the "generic solution" with respect to high levels of "tax back," overcame the problem with respect to use of value or volume as the underlying capacity on which tax rates were applied, and recognized the differential in costs of production, not only of different mining activities which had been resolved by the use of different mining bases, but also of different mines within the same category.

The "generic solution" is used whenever a province has more than 70 percent of a given tax base. In such a situation, only 70 percent of the revenues are incorporated into the Equalization formula. This is to ensure that an appropriate incentive remains for the province to tax the base and avoids the potential for moral hazard arising should there be little or no net revenue after Equalization from taxing the base. The economic rents approach allowed the combining of different mining resource bases (metals, potash, asbestos, coal, etc.) which had very different potential taxation patterns when the base was volume or value of production, as had been the case in the past.

What was not carefully considered at the time was that Statistics Canada data would yield some anomalous results. When exploration and development costs were deduct-

provinces might be receiving revenue. In other cases, the data were poor and resulted in substantial obvious errors in what might be available to be taxed. A large available economic rents in Prince Edward Island, for example, perhaps related to some Statistics Canada sampling of peat and gravel operations. With experience and effort, these anomalous results can be eliminated or overcome. Some steps have been taken in the 2004 renewal.

However, another problem arose. The data are not available from Statistics Canada until the third year after the year in review. As the mining tax base is one of the most unstable in terms of provincial shares of the activity, this causes a large problem. To illustrate in general terms, assume that the economic rent available for capture by Province A, and its actual revenue receipts, leapt by \$25 million in year 0 only to return to the normal level and share in the subsequent year. Ideally, the increase in fiscal capacity would be recognized in the Equalization Program in the same year, and, for the purposes of our illustration, might generate a reduction in entitlements of \$20 million. Province A would have a revenue gain of \$5 million, net of Equalization change. However, under the arrangements in effect through 2004/05, because of the delay in availability of data, Equalization entitlements would not be adjusted until year

Figure 4  
Mining Tax Base for Province A

Unfortunately, this is not really just a hypothetical example. In 1999, Saskatchewan enjoyed exceptional mining tax revenue of approximately \$200 million. It was not until fiscal 2002/03 that its exceptional share of the mining tax base in 1999 was recognized in the Equalization Program. Saskatchewan was facing a situation in which its Equalization entitlements would drop by roughly \$400 million. It would have been



demographic, economic and fiscal data over a period of "open" years). The delays in obtaining data, as illustrated with the mining tax issue noted above, exacerbate the problem by virtue of cascading effects over entitlements for several "open" fiscal years. This cascading effect is reduced, but not eliminated, by virtue of use of a three-year rolling average for entitlements, which will be in effect beginning in 2005.

The experience with the methodological change to the valuation of net residential capital stock gives further impetus to an already growing preference for the use of the actual market value tax base for the calculation of property taxes in the RTS system. The elements related to a macro approach in the proxy base, using one or a few data points, disguises or hides the many assumptions, extrapolations and interpretations which go into the development of any numbers which would be used in a macro approach. With the 2004 renewal of the Equalization Program, phase-in of the market value approach to Equalization of the property tax base and phase-out of the proxy base, will occur over the subsequent eight years.

## CONCLUSIONS

Criteria identified for evaluation of moving to a macro approach from the RTS for Equalization include accuracy of measurement, simplicity and stability.

This chapter has illustrated that there may be negative consequences with respect to accuracy of measurement of tax bases using a macro approach. The change to a tax on income (TONI) structure for provincial income taxes does not change its basic feature of progressivity. A macro approach would generate lesser Equalization entitlements for provinces with lower average incomes than would be generated under the RTS system. The purported accuracy of the macro approach must be tested against the realities of provincial tax room to determine if a measure truly represents the provinces' tax bases. In this respect, the macro approach fails to recognize progressivity – a basic feature of all Canadian and most other personal income tax systems.

There are significant differences in entitlements generated under the RTS and macro approaches. Exportation of taxes and limitations on taxation of various factors included in income data must be considered. The concept of total taxable resources (TTR) has been advocated as an approach for dealing with these matters. However, the starting point for the development of a TTR approach is not clear and inherent problems in the data may not be apparent. The mutual fund trust error raises questions as to the treatment of financial activity within GDP by province. A thorough review of the data incorporated within the macro or TTR figures should be undertaken prior to consid-



While some commentators suggest that a macro approach would increase stability of entitlements, this has not been tested on a real time basis. The delays in data, such as occur with respect to the calculations under the economic rent approach to mining

## Notes

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<sup>1</sup> Senate Standing Committee on National Finance (2002, 25).

<sup>2</sup> Auditor General of Canada (1997, Section 8.147).

<sup>3</sup> Ibid. Section 8.45

<sup>4</sup> This is the basis for criticism of the Equalization program by Usher (1995) in *The Uneasy Case for Equalization*.

<sup>5</sup> As promoted by critics of the Equalization Program in Boessenkool (2002) and Smart (2001).

<sup>6</sup> See Boessenkool (2002) for a succinct summary of this argument.

<sup>7</sup> As argued in Grubel (2002).

<sup>8</sup> As suggested may be possible in the discussion of the stabilization properties of the Equalization Program in Boothe, 2001 and in his chapter in this volume.

<sup>9</sup> Some of these matters are discussed in Boadway (2001) and Barro (2001).

<sup>10</sup> See for example, the discussion by Selinger and Neumann in Chapter 11 of this volume.

<sup>11</sup> For elaboration see Boadway and Flatters (1982).

<sup>12</sup> For example, as discussed by Boadway and Hobson (1998).

<sup>13</sup> Senate Standing Committee, *op cit.* p. 25.

<sup>14</sup> Barro (1986).

<sup>15</sup> Bird and Slack (1990).

<sup>16</sup> For example Smart (2001) and Boessenkool (2002).

<sup>17</sup> As addressed by Barro (1986).

<sup>18</sup> Ibid.

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## STRENGTHENING INTERGOVERNMENTAL FISCAL ARRANGEMENTS IN CANADA

Honourable Greg Selinger and Ronald H. Neumann

### CURRENT CONTEXT FOR INTERGOVERNMENTAL FISCAL ARRANGEMENTS

All federations must come to terms with assignment of responsibilities between orders of government. Program delivery responsibilities are often best fulfilled when they are decentralized and can therefore be tailored to respond to local preferences and circumstances. Revenue responsibilities are often more efficient, with less economic distortion, if taxes are raised nationally. The division of these responsibilities varies among nations and follows patterns established from historic, cultural and socio-economic roots. Jurisdiction may lie exclusively with one order of government or be shared between them. The need to balance expenditure responsibilities against revenue capacity creates a need for appropriate intergovernmental fiscal arrangements. The division of responsibilities and the authority and responsibilities with respect to transfer payments are often reflected in the constitutions and other laws, which enable

growth, stability and the reduction of regional economic disparities is a further prior-







Strong instruments of fiscal federalism have been developed in the past. These include, in particular, the Equalization Program and the Canada Health and Social Transfer (CHST), including its predecessors, Established Programs Financing (EPF) and the Canada Assistance Plan (CAP). Federal-provincial fiscal arrangements were severely impacted during the period of fiscal restraint in the 1990s. The 1995 federal Budget proposed reducing the CHST by one-third. The loss of the CAP is lamentable. Nobody ever talks about the Canada Assistance Plan any more, but when the economy experiences periods of decline, potentialists for higher unemployment and for people to come on to the social assistance roles. With the abandonment of the CAP, incremental service costs became provincial responsibilities, rather than shared responsibilities between the federal and provincial governments, as they were in the past.

While much attention has been placed on the CHST/CHT/CST, they are not the only programs experiencing strains. Equalization payments have dropped precipitously and have become a further source of instability in provincial finances. In the past they could be both a source of stabilization and of volatility for Manitoba finances. The Fiscal Stabilization Program now provides virtually no protection for provinces from declines in their total revenues. A move to strengthen fiscal arrangements should recognize and address the greater potential for instability of provincial finances as compared to the federal situation.

It is not necessary to look to the past as the 'Good Old Days.' It probably was not that good for several reasons. However, we should look at how various fiscal instruments served us historically and how they can be revitalized and reformed to serve us as we go forward into the future. One vital lesson is that federal-provincial fiscal instruments need to be reviewed as a package.

With appropriate commitments from both the federal and provincial-territorial governments, Canada can have a strong economy, healthy communities and a sense of social citizenship that is equal for all Canadians and unequalled in the world.

## THE POSITION OF THE GOVERNMENT OF MANITOBA

It is appropriate that the position of the Government of Manitoba be stated up front.

First, there is, and will continue to be, a fiscal imbalance in Canada, unless the program delivery, revenue-raising or transfer arrangements between the federal and provincial governments are changed. This is true in spite of the fact that the provinces have broad responsibility and authority with respect to both expenditures and revenues.

Second, transfers from the federal government to the provinces are too low. Federal transfers in Canada provide the lowest percentage of subnational government revenue among the major federations of the world — 12 percent versus a range upward to 80 percent elsewhere, and over 30 percent in the United States. Medicare and Medicaid are primarily federal government responsibilities. Maintenance of the Canadian system requires that the federal expenditure be higher, without such conditionality of transfers which would be tantamount to the federal government's assumption of provincial jurisdiction.

Figure 2  
Indicators of Fiscal Autonomy in Selected Federal Countries

Source: PŽloquin, David and A. Chong (2003) 4

Third, a balance must be restored specifically with respect to financing ongoing and re

## PURPOSE OF FISCAL ARRANGEMENTS

At the 2002 conference that led up to this volume, there was discussion of the context within which our federation evolves, and the values that are the foundation of fiscal arrangements in Canada. Other chapters in this volume provide greater detail on the evolution of fiscal arrangements, their impact on the fiscal circumstances facing the two orders of government, and on their ability to provide necessary and quality public services to all Canadians.

Decentralization and federalism are mechanisms which reflect and encourage diversity, experimentation, and the tailoring of government to meet different needs of citizens in various regions of the country. However, decentralized forms of government



As a result, the fiscal imbalance in Canada continues to grow. The answer to the problem lies in ensuring adequate federal support for all major social programs in Canada. A plan which trades increased funding for one program for reduced federal funding for others is unacceptable. The federal government needs to restore funding for post-secondary education and social services through the CST, while meeting its commitments to funding increases for health.

#### STRENGTHENING EQUALIZATION

All provinces also agree that the Equalization Program should be strengthened. Recently, the Standing Senate Committee on National Finance joined in the call for a strengthening of the Equalization Program. The Committee's Report concluded:

Many of the companies just mentioned originated in Manitoba. Our success in building, attracting and retaining these industries, and having them grow here in Manitoba, attests to the fact that we have been and must remain an attractive place to live, work, raise a family, and do business. Educational opportunities leading to a highly skilled work force, affordable land and housing, cultural and community life, and excellent and affordable health care, together with a host of other factors, all play a role in making this an attractive place for people and for business. Without these industries, Manitoba would lose, and Canada would lose.

That is why the Equalization Program, designed to allow us to provide reasonably

co

Given this development and the measured success of the Equalization Program, it is time to take new steps to strengthen the Program and ultimately provide further returns both with respect to equity and to efficiency for Canadians and the economy across the country. The position of the Government of Manitoba, supported by other provinces and the Senate Committee, is that Equalization should be strengthened. Four proposals we have put forward to date include:

- ¥ removing the ceiling provision (done as part of the First Ministers' Arrangement);
- ¥ moving to a ten-province standard;
- ¥ fully including all revenue sources, including resource revenues, taxes and fees; and
- ¥ retaining the representative tax system for calculation of fiscal disparities.

Recently, proposals have been advanced for the exclusion, in whole or in part, of revenues from non-renewable natural resources from the formula for calculation of Equalization entitlements. This would increase the cost of the Equalization Program,

lection and transfer arrangements have occasionally worked to destabilize provincial revenues. The causes of such destabilization are varied, and include: unilateral federal action based on federal budget priorities, without due regard for the fiscal needs of provinces providing the front line services; the system of advance payments and subsequent balancing to reflect actual income tax assessments and the demographic, economic, and fiscal data which go into transfer payment calculations; "game playing," often resulting in inaccurate and usually low initial estimates for transfer payments (the federal government's tendency to underestimate revenues and surpluses is one example); changes in methodologies and formulas; and misguided and ineffective



per capita revenue between five percent (as the Stabilization Program kicks in) and six percent (when the Program maximum is reached).

For most provinces, this Program is unlikely to provide support even in the event of a significant economic downturn. However, for Alberta and perhaps British Columbia, it could perhaps provide a small benefit to partially offset the revenue decline following a resource revenue "spike." It is highly unlikely that a nominal five

### Smoothing Payments

In 2004, a measure was implemented to smooth Equalization payments and to reduce volatility. This involves using a three-year moving average of entitlements. However, this smoothing comes at the cost of reduced responsiveness of Equalization payments to changes in relative provincial fiscal capacity. Responsiveness is important when provincial revenues are volatile. A focus on stability of total revenue flows would be preferable to simply smoothing Equalization payments or other transfers.

### Improve Forecasting

Perhaps the most important reform would be to improve forecasting for income tax collections and Equalization. This is the source of much volatility for most of the provinces which are in the Tax Collection Agreements and are in receipt of Equalization payments. The lack of responsiveness of these Programs to actual conditions prevailing as initial payments are made, results in large revisions which cascade over several fiscal year entitlements and delay and magnify volatile effects of the current system of advance payments and adjustments.

## Annex 1

### History of Fiscal Arrangements Since 1950

Transfer payments from the federal government have been a part of financing provin-

Additionally, in 1982, the federal government implemented a number of changes to the Equalization Program – a five-province standard rather than the ten-province representative tax system standard and a ceiling on payments – that have significantly hampered the Program’s ability to reduce fiscal disparities among provinces and assist them in providing key social programs.

Recent changes to financing arrangements (primarily the CHST) resulting from the 2000 and 2003 health financing arrangements represent positive steps toward restoring the federal-provincial partnership in funding major social programs in Canada. However, financing arrangements remain inadequate for sharing the costs of provid-

## Notes

<sup>1</sup> The Conference Board of Canada (2004).

<sup>2</sup> The federal share is calculated based on projections of the Conference Board of Canada (2004) and the transfer schedule from the First Ministers' 2003 Health Financing Arrangement.

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STRIVING FOR FAIRNESS:  
FIRST NATIONS, CURRENT REFORMS AND  
PROVINCIAL INTERESTS

Kathy L. Brock

INTRODUCTION<sup>1</sup>

Too often discussions of policy reform occur in silos. Financial experts devise new and complicated fiscal formulas while policy experts create complex programs for better service delivery. Subsumed by the immediate demands of their functions, too few experts in either field pause to consider the implications of one realm of activity on the other. Policy incoherence and spillover effects across jurisdictional lines are the result. This chapter attempts to cross that divide by imagining the cross-jurisdictional fiscal dimensions of a political reform proposed within the jurisdiction of the fed-

and their implications for the provinces. Given the growing importance of First Nations to the national and provincial economies, provincial governments have a strong incentive to observe any future political changes closely and then to use this knowledge to participate in the development of more effective fiscal arrangements for the First Nations and Aboriginal population more generally.

#### DRIVING THE FIRST NATIONS GOVERNANCE INITIATIVE

In spring 2001, the federal government announced a new initiative called First Nations Governance under the Indian Act. FNGI was part of a series of reforms to the Indian Act that were intended to provide communities with the political and fiscal levers to enhance their control over their futures and to improve their living conditions. Although the fiscal levers included such proposals as a First Nations fiscal institute and greater authority over lands, the political reforms were the ones that were most likely to affect provincial interests although their implications were not readily apparent. To understand fully the potential impact upon the provincial interests of the reforms, it is necessary to begin by examining the five driving forces behind the FNGI.

First and foremost, the Supreme Court of Canada decision in *Corbiere v. Canada (Minister of Indian and Northern Affairs)* provided an immediate impetus for changing the Indian Act. Corbiere dealt with one of the effects of the 1985 Bill C-31 that had reinstated status for Indians who had lost it either through marriage or other means. The reinstatement of status meant that these individuals would be registered with Indian Affairs Canada and thus entitled to the benefits and recognition provided to

relied on an on-reserve constituency in the past had due cause for concern. These concerns were most readily apparent in the area of financial resources. By holding First Nations governments accountable to both on-reserve and off-reserve populations through elections and even office

The provinces stood to benefit from this change. Currently, the status of First Nations governments and individuals varies across provincial jurisdictions according to the whims of the courts, thus affecting the provincial-First Nations political and legal relationship. The contractual liability and obligations of First Nations governments are hazy at best. This renders them less attractive for business ventures or public-private partnerships. Under the new arrangements, the legal standing of First Nations governments would have been clarified thus enabling them to enter into business negotiations and ventures or to underwrite First Nations business initiatives whether within particular provinces or across provincial boundaries. As First Nations become more fully integrated into the local economies and their businesses mature, the provinces are likely to reap the benefits of the economic activity as well as of a reduction in social costs.

Third, media and academic reports questioning the accountability of First Nations governments and leadership provided an important context and impetus to the reforms.<sup>8</sup> Since the early 1990s, media reports on abuses of power and financial mismanagement within First Nations communities have led to calls for reform in the governance structures. Particularly sensational cases like the ones involving the Stoney First Nations in 1997/98, and the Manitoba Aboriginal Health Centre and Human Resources Development Canada stoked the fires of reform. These calls for reform over the years were given additional credibility when joined by criticisms and personal testimonials from First Nations members and women's organizations. Two books released in 2000 fuelled this public debate over the direction of First Nations policy and governance. An unusual degree of attention and legitimacy were accorded Alan Cairns' *Citizens Plus: Aboriginal Peoples and the Canadian State* and Tom Flanagan's *First Nations Second Thoughts*.<sup>9</sup> Not confined to academic campuses, the debate



in federal transfers would need to compensate for this difference. And yet, education is key to improving the economic conditions of First Nations and is an important component in improving quality of life for individuals and communities. Given the growing percentage of Aboriginal peoples as part of the labour force in the West especially, reforms like this one seem even more pressing in building a productive and effective future labour force. The high incarceration and social dysfunction rates among urban and on-reserve First Nations populations only heightens the urgency of reforms, particularly for the provinces which bear many of the current and future costs of this loss. Finally, the lack of progress on issues like health, education and housing creates an image of First Nations that overshadows the significant contribution to provincial social and economic life that Aboriginal peoples do make.

Associated with the conditions on reserves is the antiquated nature of the band governance legal regime. As INAC declares: "Given its colonial orientation and that it was passed in an era when bands were not managing multi-million dollar budgets, the Indian Act is silent on financial management and accountability." The FNGI was intended to provide members of communities with more access to their governments, more accountability, and more control over decisions with a social and economic impact on their communities. Updated governance regimes would provide First Nations with the mechanisms to address community challenges more effectively, thus strengthening the communities as participants in national and provincial life. As the case of Opaskawayak First Nation and the contiguous community of The Pas reveals: when a First Nation is governed well, the neighbouring communities benefit whether through services (the mall operated by the First Nation) or increased affluence (through retail and controlled gambling) or more effective policing of both communities.

Fifth, reinforcing the above considerations was the public commitment of the Prime Minister of the day, The Right Honourable Jean Chrétien, and his Minister of Indian and Northern Affairs Canada to reforming the Indian Act. The January 30, 2001 Throne Speech pledged that the federal government would strengthen its relationship with Aboriginal peoples and support First Nations in improving governance "to develop stable, healthy and sustainable communities." The Prime Minister let it be known that improving the lives of First Nations and Aboriginal peoples more generally was one of his targets before leaving office. Still a proponent of the liberal equality approach advocated by the 1969 White Paper, the Prime Minister advocated change to the Indian Act as part of his commitment to social progress. His Minister, Honourable Robert Nault, followed suit, and was visible in the communities, launching the FNGI in Alberta, making speeches, responding directly to the concerns of the Assembly of First Nations, appearing at conferences to speak directly to concerns with the FNGI. The INAC Web site featured the FNGI prominently. And while the newly acclaimed Prime Minister, The Right Honourable Paul Martin, acquiesced to First Nations concerns with the FNGI and discontinued it, he has made First Nations issues a priority in his government.



Just as the ChrŽtien government elevated First Nations governance on the political agenda, the Paul Martin government has indicated its intent to do the same. While the process is different in the two cases, future reforms are compelled by the drivers outlined above. Significantly, one of the first acts of the Paul Martin government was to announce the creation of a First Nations governance institute run by First Nations as a means of driving reforms forward. Similar institutes for fiscal and economic matters are in the works. As the provinces develop their own plans for Aboriginal communities, possible federal policies and future directions are too important to be overlooked.<sup>21</sup> But to understand more fully the impact of federal policy change on the fiscal position of the provinces, it is necessary to understand how broader political reforms could affect provincial interests. For this, a brief examination of the failed FNGI is useful.

#### DEFINING THE FIRST NATIONS GOVERNANCE ACT AND INITIATIVE

From the outset, the governance reforms were circumscribed. Defined as "the rules and practices by which decisions are made and a community is governed" governance is much narrower than "self-government" which would include more than the political and administrative decision-making apparatus and raise issues of sovereignty. Three general subject matters under the Indian Act are affected: legal standing and capacity including the capacity to make contracts, borrow, sue and be sued, appeal mechanisms for council decisions, ticketing and by-law enforcement.

When proposing the reforms, INAC Minister, Honourable Robert Nault maintained that the legislation was needed and welcome within the communities and cited the extensive consultations, a joint ministerial advisory committee report and surveys of members of First Nations living on reserve. In the wake of serious opposition among First Nations leaders and the emergence of a new Prime Minister, the FNGI languished. However, the principles of the FNGI have been resurrected in a process of reform that engages the First Nations leadership more effectively.

Why was this change in tactics necessary? The process associated with the FNGI was convoluted, controversial and protracted. Early on, suspicion surfaced that the federal government was attempting to undermine First Nations' status and to off-load financial responsibilities onto the First Nations communities and provincial governments. Despite repeated assurances to the contrary by the Minister himself and an open and extensive public hearings process and interactive Web site, unease persisted with many Chiefs and councils refusing to allow consultations within their territories. These difficulties were not soothed by either a brief moratorium on the hearings while the federal government and First Nations officials attempted to resolve the difficulties or the recommendations of a Joint Ministerial Advisory Committee comprising representatives from national Aboriginal organizations and the federal departments of Justice and Indian Affairs. In the midst of controversy, the First Nations Governance Act was introduced in the House of Commons in June 2002, reinstated in October 2002, vetted in committee from October to May 2003 with the report back to the House of Commons containing numerous small and a few larger amendments, was scheduled to proceed in fall of 2003 with implementation in 2004, when it failed.

#### ASSESSING THE FNGI: LINKING THE NATIONAL AND PROVINCIAL

What can the provinces glean from this failed initiative? While the political and financial lessons are multiple, four are especially important in the intergovernmental context. Each lesson impacts on the ability of the three levels of government to develop fiscal arrangements that work to the benefit of Aboriginal peoples, the provincial governments and the federal government. The importance of this mutual benefits approach is that it ensures a greater degree of commitment from all three parties — an important condition of longer-term success in policy reform.

The first lesson concerns what is omitted from the FNGI. Despite the emphasis on governance and self-sufficiency, the proposed legislation was silent with respect to the determination of Indian status and membership and did not pledge any further resources to communities to deal with the added population in First Nations communities as a result of the Bill C-31 amendment reinstating status for First Nations individuals. Many communities do not have the resources (housing, employment opportunities, school spaces) to admit the reinstated individuals to their band lists, and thus these individuals are left in a legal limbo. As an additional complication, the Bill C-31 amendments selectively restored status which has been a source of contention: the grandchildren of people who had lost status prior to 1985 were not reinstated. As

a result, if current rates of intermarriage continue, then some communities will lose official Indian status in the next 50-75 years. More generally, the portion of First Nations members who are ineligible for registration will increase significantly at the same time that the general Aboriginal population is projected to increase significantly. For example, in Manitoba a random sample of five First Nations communities revealed that in three generations at the current rates of fertility and intermarriage, 20-30 per cent of First Nations members will be ineligible to register. In sum, the registered Indian population is projected to decline under the current rules of registration.

The ramifications for the provinces of this omission in the FNGI are serious. Both the off-reserve status Indian population and the non-status Indian population are likely to increase significantly in the next 50-75 years. As mentioned in the first section above, the federal government acknowledges political but not actual fiscal responsibility for these people. For example, the INAC information on governance ambiguously states: "Off-reserve Status Indians, like all other Canadians, receive basic government services through municipal and provincial governments."

to support the First Nations' position in negotiations with Ottawa. The provinces also have an interest in seeing the First Nations communities strengthened economically and socially in the longer term. The common interests between the three levels of government offer significant potential for creative collaborative action between the three levels of government. Fairness dictates no less.

governments while the fiscal reforms expanded the taxation powers of those governments. How will this augmentation of powers affect adjacent non-Aboriginal communities? If there is a conflict in taxation rates that has a differential impact on the deci-

The governance legislation proposed adding clarity to the law. Bands would have been able to enter into agreements with more certainty. Investors would have been more likely to view First Nations more favourably than in the past since there would have been recourse other than to the Minister of Indian Affairs should a contract fail. Similarly, provincial residents who are not First Nations members but live within First Nations communities would be able to hold band governments accountable for their actions rather than appealing to the federal government. Recognition of the legal capacity and standing of First Nations governments would enhance local control over their affairs thus providing an important tool to community economic development. Clarified legal standing and status of First Nations provide a strong basis for improved

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level, the provinces have a vested interest in the outcomes. All participants should be **are** of the broader effects of the reforms. Future fiscal arrangements at both the federal and provincial levels of government will require co-operation of all three levels of



## Notes

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<sup>1</sup> I would like to thank Leanne Matthes, John Ronson, Alan Cairns and Harvey Lazar for their comments on earlier drafts of this chapter.

<sup>2</sup> See Indian and Northern Affairs Canada (April 2001).

<sup>3</sup> (1999) 239 N.R. 1, 173 D.L.R. (4th) 1 (SCC).

<sup>4</sup> See Stilman (1987).

<sup>5</sup> See Alan Cairns (2000).

<sup>6</sup> The question of financial obligation is symbolized in the following two cases. First, according to the federal government Web site: "The federal government has constitutional, political and legal responsibilities for First Nations, Inuit and northerners. Indian and Northern Affairs Canada is the government department primarily responsible for carrying out this function." However, the next paragraph clarifies that: "The Department ensures that Status Indians (those recorded in the Indian Act register) living on reserves have access to basic services comparable to those available to other Canadian residents from provincial, territorial and municipal governments. These services include education, housing, community infrastructure, social assistance and social support services. [emphasis mine, see [http://142.206.72.67/04/04a/04a\\_005\\_e.htm](http://142.206.72.67/04/04a/04a_005_e.htm)]. Similarly, while there is a Minister of Indian Affairs, there is an "Interlocutor" for Metis and Non-Status Indians. Both indicate the equivocal position of the federal government to a broad interpretation of its obligations to Aboriginal peoples.

<sup>7</sup> Indian and Northern Affairs Canada (2001b, 4).

<sup>8</sup> See the November-December 2001 series of articles in the *Globe and Mail* by John Stackhouse profiling Aboriginal communities as an example of the media contributing to the debate over change.

<sup>9</sup> See Cairns (2000).

<sup>10</sup> Flanagan (2000).

<sup>11</sup> Indian and Northern Affairs Canada (2001b, 4).

<sup>12</sup> [1999] 3 S.C.R. 456 (SCC), reconsideration refused [1999] 3 SCR 533 (SCC).

<sup>13</sup> For a discussion of current pressures and the aftermath of Marshall, see Coates (2001).

<sup>14</sup> See Indian and Northern Affairs Canada (2003).

<sup>15</sup> See for example Statistics Canada (2002).

<sup>16</sup> See Assembly of First Nations (18 February 2003).

<sup>17</sup> Patricia Monture-Angus (2001) explicitly connects these conditions to a lack of political power.

<sup>18</sup> See Indian and Northern Affairs Canada (2001a).

<sup>19</sup> See McCarthy (2001). Within government circles, this view was controversial. Some people alleged that the Prime Minister signalled strong support for the FNIGI by not intervening, others argued that the Prime Minister had to be pulled in the direction of supporting these reforms and initiatives like the Reference Group of Aboriginal Ministers.

<sup>20</sup> See, for example, Governor General (2 February 2004).

<sup>21</sup> For example, in 1994 Ron Irwin former Minister of Indian Affairs and Phil Fontaine then Grand Chief of the Assembly of Manitoba Chiefs negotiated the 'Framework Agreement' proposing the restoration of jurisdiction to First Nations and the dismantling of Indian Affairs in Manitoba. This proposed system change would have affected the functioning of First Nations in the province with direct implications for provincial areas of jurisdiction such as child welfare, education and fire services as well as the broader provincial-First Nations relationship.

<sup>22</sup> Indian and Northern Affairs Canada (2001b, 5).

<sup>23</sup> *Ibid.*, p. 6; see also Indian and Northern Affairs Canada (Spring 2001c).

<sup>24</sup> See Indian and Northern Affairs Canada (Spring 2001b). Other communities have their own customary rules or self-government legislation supplanting these Indian Act provisions.

<sup>25</sup> Indian and Northern Affairs Canada (Spring 2001a).

<sup>26</sup> INAC Minister Nault as quoted by Simon Tuck (17 June 2002).

<sup>27</sup>Indian and Northern Affairs Canada (18 April 2002).

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<sup>37</sup> See Bish (n.d.).

<sup>38</sup> See General (12 June 2003).

<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

<sup>41</sup> See Coon Come (17 April 2002).

<sup>42</sup> Montana Band v. R 140 F.T.R. 30, sub, nom, Montana Band v. Canada [1998] 2 F.C. 3 (Fed. T.D.).

<sup>43</sup> For a discussion of cases see Imai (1999).

<sup>44</sup> Aboriginal Affairs and Northern Development Alberta (2003).

<sup>45</sup> British Columbia (2003).

<sup>46</sup> lop T8 (Br1)-1Saske13163-244,1 Tc 04(282-3,1 Tc 04(311-26 0 10.5 55.2432 3292 [

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## CONCLUSIONS