

Fiscal Federalism and the Future of Canada
Selected Proceedings from the Conference – September 28-29, 2006

**Reconciling the Irreconcilable Addressing
Canada's Fiscal Imbalance**
CONCLUSION*

Foreword

In September of 2006, Queen's Institute of Intergovernmental Relations hosted *Fiscal Federalism and the Future of Canada*, a conference organized by the then IIGR Director Sean Conway, Peter Leslie and Christian Leuprecht. Given that several of the conference presentations dealt with the future of equalization and given that the 2007 federal budget will outline the Harper government's preferred future for equalization, the Institute felt it appropriate to publish these contributions in working paper format prior to the federal budget.

Appropriately this working paper series begins with brief summaries of the two commissioned reports on equalization and territorial formula financing – one by the Council of the Federation's Advisory Panel on Fiscal Imbalance and the other by the federal Expert Panel on Equalization and Territorial Formula Financing. These will be followed by analyses by other conference participants whose contributions will relate to these two proposals as well as to the larger fiscal federalism issues now in play. The views expressed in these working papers are those of the authors, not those of the Institute of Intergovernmental Relations.

As the only organization in Canada whose mandate is solely to promote research and communication on the challenges facing the federal system, we are pleased to introduce these working papers into the public debate on equalization and fiscal imbalance

Thomas J. Courchene
Acting Director, February 2007

The Council of the Federation established the Advisory Panel on Fiscal Imbalance in May 2005 with a mandate to:

- look at the underlying causes of fiscal imbalance;
- review a full range of mechanisms to address fiscal imbalance; *and*
- make recommendations on ways to restore fiscal balance.

We talked with citizens, political leaders, government officials, and experts in the field. We commissioned studies and a public dialogue. We undertook extensive analyses of our own, modelling different policy alternatives and assessing their impact.

The Report addresses the three elements of the mandate we received from the Council of the Federation. Throughout, we have been guided by the premiers' considered position that fiscal relations in this country need to be guided by clear principles of transparency, accountability, adequacy, predictability, equity, and fairness. We have examined the evolving position of the territories in Confederation. We have examined the evolving position of the territories in Confederation. We have discussed the nature, origins, and impact of fiscal imbalance, both horizontal and vertical, and have evaluated the policies that Canada has developed over the years to address them. We have reflected on how these issues are managed and negotiated, and we have concluded that improving the institutions and processes of fiscal governance is

*This is the conclusion to the Advisory Panel's report to the Council of the Federation, with the recommendations attached in an Annex. Included also is a link to the Advisory Panel co-chair Robert Gagne's power point presentation at the conference.

as important as fixing the substance of the fiscal arrangements themselves.

The Panel has made four sets of recommendations, each of which bears on an element of our mandate. There are recommendations on the territories (*Chapter 4*), vertical fiscal imbalance (*Chapter 5*), horizontal fiscal imbalance (*Chapter 6*), and governance (*Chapter 7*). [These appear in the attached Annex]

Chapter 4's recommendations relating to the territories are intended to place Canada's three northern territories on a secure financial footing, recognizing that treating Canadians living in the North fairly requires that their special needs and circumstances be addressed. Fairness calls for a two fold approach. First, the fiscal transfer arrangements must be conceived and implemented with the particular needs of Northerners clearly in mind. Second, the capacity of the three territories to develop their own economies must be strengthened and confirmed – in particular, by ensuring that key development decisions are made by Northerners themselves and that main benefits of the development of natural resources remain with Northern communities.

Our recommendations in *Chapter 5* – to separate out the equalization associated with the 1977 transfer of tax points and to include it along with supplemental equalization in a separate envelope which the Panel labelled "Tax Point Adjustment" would make it possible to separate out equalization from the cash transfer program. The associated equalization and the supplemental equalization implementation by the federal government would now be transparent and would stand alone.

The Panel also recommends strongly that the cash transfer program should be disentangled from the transfer of tax points in 1977 and should be governed by the principle of equal per capita transfers to all provinces. With respect to federal transfer programs relating to health, postsecondary education, and social assistance, where the costs of offering the service are related to the number of people being served, the grants received by the provinces will be linked directly to population size. These equal per capita

transfers should be untied from a tax point transfer that was made nearly thirty years ago. This separation of the tax point transfer from equal per capita transfers would end much of the unproductive discussion between the two orders of government regarding how much of the program each government supports. The numbers will now speak for themselves. It will also make any future transfer of tax points clearer and more transparent. This recommendation speaks to the principles of fairness and transparency – principles that Canadians reiterated again and again.

The recommendations in *Chapter 6* on horizontal fiscal imbalance are designed to improve the way the Equalization program works so that it clearly addresses the central principle which gives it life – namely, that provincial governments must be endowed with sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Recent amendments to the Equalization program have moved it away from its original purpose. Our recommendations are designed to bring it back to that central objective. We understand that adherence to principle needs to be set in the context of what is reasonable and affordable. Having ourselves wrestled with the challenge of striking the right balance, we realized that this program will always require periodic review and adjustment. We believe that the changes we recommend in this report will address the principle while meeting the needs of today as effectively as possible. We also feel strongly that the horizontal transfer arrangements can and must be restructured to render them more transparent, fair, and intelligible to all Canadians, and more flexible as circumstances change.

Finally, on governance, we propose two institutional innovations. The first is the establishment of a First Ministers' Fiscal Council that would meet regularly, commission work as needed, and generally develop a stable, ongoing intergovernmental relationship. This in turn would reduce the likelihood of abrupt changes of course, arbitrary actions on either side, and unpleasant surprises. The Panel sees this as a long overdue part of the maturing process of the Canadian federation. Second, the

Panel, taking a leaf from the book of the Canadian Institute of Health Information (CIHI), proposes the creation of a similar body, the Canadian Institute of Fiscal Information (CIFI). The Panel believes that an organization with the credibility to produce authoritative public data and information about Canadian fiscal arrangements would bring real benefits, both to concerned citizens and to their federal, provincial, and territorial governments. For too long, Canadians have lived in an intergovernmental world in which the two orders of government systematically disagree on the facts and on the flows of resources among governments. It is natural in federal-provincial disputes that each side will make the best case it can to Canadians, but this does not excuse the wilful obscurantism of the present system, where for example, tax points transferred thirty years ago are claimed – or denied – to be a continuing part of federal accounting was largely unknown to the provinces. The Panel believes that an institute to analyze intergovernmental data could over time establish a shared, authoritative information base to inform public discussions.

While the four sets of recommendations are presented in four chapters, the Panel insists that they are all interrelated. We have tried to make that clear at several points in the Report, but it is worth repeating again. Any significant adjustments in equalization payments will have, in aggregate, an impact on vertical fiscal imbalance. Granting the territories control over their natural resources will affect, in ways no one today can precisely forecast, their position in the Canadian system of interregional redistribution. It will also foster the continued evolution of the territories towards a status more closely equivalent to that of their provincial counterparts. And governance affects everything; the process through which agreements are reached matter. The institutions that the Report proposes will shape the approaches that Canadian governments take to the fiscal challenges they face, and will shape the manner in which those challenges are addressed.

There is one final issue we want to speak to here. Some people, reading this report, will say: “Ah, there they go again. The one thing the provinces can agree on is demanding more

money from the federal government. And their Panel is running true to form, proposing to raid the federal treasury for billions of dollars.” We submit that this argument is mistaken and misguided. Is there a fiscal imbalance? The provinces and territories say there is. Righting the balance by definition involves shifting some financial resources from the Government of Canada to the provincial and territorial governments. Whether we have identified the right amount and described the best means to correct the imbalance will be for the premiers, the prime minister, and Canadians to judge, but the Panel’s recommendations should not come as a surprise.

The Advisory Panel has tried to be sensitive to the needs and concerns of the Government of Canada. We believe that we have proposed a set of policy instruments that would allow Canada’s political leaders to put the country’s fiscal arrangements on a more solid, more intelligible, and more transparent footing. We believe that the principles that shape the analysis in this Report are fair and will be seen as fair by both orders of government and by Canadians. The implementation of the proposed new arrangements would do credit to the national government. The Panel’s governance proposals open the door to a much more collaborative and mutually respectful system of intergovernmental relations.

Canada is entering the twenty-first century rich in resources, rich in people, and rich in talent, yet our governments are struggling with a fiscal architecture designed for the last century. Making our fiscal system more transparent and more accountable is an essential first step. So is making our system as fair as possible. We need effective institutions to govern our fiscal system and to enable it to work better. The recommendations in this report are respectfully designed to accomplish these objectives.

*****LINK TO ROBERT GAGNE
POWERPOINT PRESTATION – FROM OUR
WEBSITE.

ANNEX A – Reconciling the Irreconcilable

RECOMMENDATIONS

4.1 The Panel recommends that the New Framework for financing territorial governments be replaced by a formula-based financing mechanism based on expenditure need and eligible revenue of each territory, as was the case under previous Territorial Formula Financing.

This new formula should include the following features:

- Eligible revenues should be simplified from the previous TFF, eliminating the Tax Effort Adjustment Factor and including only the most significant tax and revenue sources.
- The initial GEBs [Gross Expenditure Bases] should be based on the funding levels established for 2006-07. Future GEB adjustments should include those indicated by adequacy review, program transfers, and new obligations stemming from Aboriginal Rights agreements.
- Escalators should be linked for each territory to per capita territorial expenditure changes and relative population growth.
- Volume growth in eligible revenues should be subject to an appropriate incentive. However, a decline in eligible revenues should not result in a corresponding penalty.

4.2 The Panel recommends that the Government of Canada and the territorial governments expedite negotiations to conclude agreements where territories assume province-like authority and responsibility for management of lands and natural resources and become the principal beneficiaries of revenues and royalties derived from these resources. Arrangements must take into account Aboriginal rights, needs, and participation.

4.3 The Panel recommends that the special needs and circumstances of the territories be provided for in such specific federal program transfers. Specifically, the Panel believes that

- Funding for territories should be based on actual demand and cost rather than on per capita allocations.

- The terms of cost-shared programs should recognize the limited revenue capacities of territorial governments.
- All such program funding should be excluded from TFF calculations.

4.4 The Panel recommends that Nunavut receive extraordinary investment in the areas of housing, infrastructure, and economic and social development.

Chapter 5: Addressing Vertical Fiscal Imbalance

5.1 The Panel recommends the creation of a fully transparent Tax Point Adjustment (TPA) program.

5.2 The Panel recommends that the per capita amount under the CHT and CST be increased from \$807 to \$960. This new money should be allocated to the Canada Social Transfer to correct the vertical fiscal imbalance as it relates to postsecondary education and social assistance.

5.3 Looking forward, the Panel supports the federal government's commitment to an assured growth rate of 6 percent per year of the CHT until fiscal year 2013-14. It recommends that an assured growth rate of 4.5 percent per year be established for the CST over the same period.

Chapter 6: Horizontal Fiscal Balance: Reforming the Equalization Program

6.1 The Panel recommends that the Equalization program be based on a ten-province standard and comprehensive revenue coverage with the inclusion of 100 percent of natural resource revenues.

6.2 The Panel also recommends a smoothing mechanism: a three-year moving average on all revenue bases, lagged two years, in order to provide provinces with single-point estimates for their equalization payments.

6.3 The Panel recommends that concerns about affordability on the part of the federal government be addressed by scaling back the standard established by Recommendations 6.1 and 6.2. The degree of scaling should be

negotiated between the two orders of government.

Chapter 7: The Governance of Fiscal Federalism

7.1 The Panel recommends that the federal, provincial, and territorial governments together establish a First Ministers' Fiscal Council (FMFC) as the principal institution in Canada for dealing with intergovernmental fiscal issues.

7.2 The Panel recommends that the federal, provincial, and territorial governments together establish a new body, the Canadian Institute for Fiscal Information (CIFI).

Links:

To the Advisory Panel Reports

http://councilofthefederation.ca/pdfs/Report_Fiscalim_Mar3106.pdf

http://www.conseildelafederation.ca/pdfsfrancais/Rapport_Fiscal_31mars06.pdf

To Co-Chair Robert Gagné's Power Point Presentation at the IIGR Fiscal Federalism Conference September 28-29, 2006

<http://www.iigr.ca/site/iigr/files/gogoPage/CFpresentation.ppt>