

WORKING PAPERS ON THE FEDERAL SPENDING POWER

*The Federal Spending Power is now Chiefly for
People, not Provinces*

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Some people reject the evidence that man-made emissions are increasingly changing the climate. Some lawyers and academics deny the existence of the federal spending power. Nevertheless, in both cases, the practical issue is not whether to act. It is how to act.

The spending power is the ability to use tax money for objectives outside the scope for which the federal government can itself deliver public services. Like all power, it can be misused. Its proper use is essential to the Canadian federation. Otherwise, many necessary public services could not be equably and efficiently provided.

One major use of the spending power is not open to any debate. Since 1982 it has been required by the Constitution. Ottawa must spend federal money to help some provinces finance activities in their jurisdiction. Specifically, *“Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”*

Strict “equalization” would at present require Ottawa to transfer to all other provinces enough money to enable them to provide the Alberta level of services at the Alberta level of taxation. So massive a transfer is out of the question. Albertans, and many others, would rise in revolt against paying the federal taxes required. Well short of that point, federal politicians would be driven to desperation by the taxation needed to finance both their own responsibilities and massive transfers for provincial politicians to spend.

Consequently, while for fifty years equalization has been part of the glue for Canada’s federal union, it is necessary but far from sufficient. As much as is politically possible should be done to finance, by a principled equalization program, provincial services that are not unreasonably diverse. But that leaves much else to be done, by other federal-provincial collaboration for which other uses of the spending power are required.

Those other uses are the topic of this paper. Its thesis can be summarised in four statements. First, in the 1960s it was essential that we find ways to deploy the federal power for social purposes, to build a modern welfare state throughout Canada. If we had not done so, it is questionable whether our political union would have survived the twentieth century.

The main method then used was cost-sharing. That is, Ottawa reimbursed provincial treasuries for part (broadly, 50 percent) of the costs they incurred in delivering certain defined services. Cost-sharing worked well, for a time; so well, indeed, that advocates of good causes that are provincial responsibilities still almost automatically demand it as the way to get things done. They are calling in vain. My second statement is that cost-sharing is now an instrument broken beyond repair, broken not by wish of the provinces but by federal politicians.

Nevertheless, extensive deployment of the spending power is more needed than ever. It is still needed for social purposes. My statement three is that it is now essential also for the productivity and resilience of the economy. However, the uses of the spending power that fit contemporary circumstances are transfers not to provincial treasuries but to individuals and organizations. Their nature is to empower civil society in a market economy. That is the fourth statement which I hope to justify.

Federalism distinguishes separate activities for two orders of government. Today those activities in total are far more intensive than they were in 1867, but even then the BNA Act recognised that the division of powers could not be absolute. For agriculture and for immigration, jurisdiction was made concurrent, though with firm federal precedence: provincial legislation "*shall have effect in and for the Province as long and as far only as it is not repugnant to any Act of the Parliament of Canada*". Again, provincial power to legislate on "Local Works and Undertakings" was made subject to specific restrictions and, more generally, it excludes "*Such works as, though wholly situate within the Province, are before or after their Execution declared by the Parliament of Canada to be for the general Advantage of Canada or for the Advantage of Two or more of the Provinces*".

Nevertheless, despite such qualifications, the Constitution is considerably more precise about a division of powers than of the resources needed to exercise them. Since the law lords of the British Privy Council contrived to interpret provincial "direct taxation" so that it includes what might in ordinary usage be considered indirect, there is effectively no division of taxing power. The tariffs that provinces cannot impose are now unimportant as sources of money. Otherwise, Ottawa and the provinces have the same access to revenue, except that all provinces have prior claim to raise it from natural resources within their borders.

What is different between the two orders of government is the use they can make of money. A province is limited to spending on its own activities. It may impose "*Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes*". The federal Parliament, by contrast, can legislate for "*The raising of Money by any Mode or System of Taxation*". There is no restriction of purpose. Ottawa is not limited to spending on its own activities. It can subsidise provincial governments. It can provide money to individuals and to organizations of all kinds, on such terms as Parliament legislates.

Public spending is not solely the writing of cheques. It includes measures that forego taxes in order to encourage or assist people in defined ways. In the form of refundable credits, such tax expenditures can powerfully redistribute income to people in need. Most of those now operative, however, have a different motive. Many are directed to business activities. Others serve purposes as diverse as subsidising savings for retirement; encouraging charitable giving and small donations to political parties; helping to pay for health care not covered by provincial programs and for the day care of children of working parents. The

characteristic common to many of these measures is that the benefit is greater the higher one's income.

The tax expenditures of more recent times are thereby in contrast with the earlier uses of the federal spending power in the dominant programs of the 1940s-60s period. The first of those was the Family Allowance: a universal payment of great significance to low-income mothers and especially to those too poor to pay taxes. Old Age Security, originally introduced thanks to the 1951 constitutional amendment, has equally rested on the spending power since it was freed from the pretence of being a contributory pension by having specific taxes dedicated to it.

The emphasis in deployment of the spending power soon shifted, however, from direct federal programs to cost-sharing. There are still politicians and propagandists who like to represent this as power-hungry Ottawa using its money to barge into the jurisdiction of reluctant provinces. That is not at all the way it was. The impulse came, naturally, from the provinces. They were the seducers, Ottawa initially a slow respondent.

Saskatchewan started the affair by introducing its own hospital insurance. People liked it. Other provinces came under strong pressure to save their citizens from the high costs of going to hospital. Their politicians were held back by a little ideological and much financial concern. They looked to Ottawa for help. The St-Laurent government, by then tired and complacent, resisted, until the Conservative government of Ontario was particularly insistent. Even so, the federal legislation provided for cost-sharing to begin only when a majority of provinces had adopted the program. It was not until the arrival of the Diefenbaker Conservative government that this barrier was lifted and any province got federal money as soon it started hospital insurance.

With that, the key to the federal treasury was indeed turned. It had to be. In the late 1950s, after two decades of remarkable economic growth had replaced the great depression, Canadians generally were eagerly ready for the welfare state. The provinces were too diverse in fiscal capacity to proceed at anything close to comparable speed. The Canada-wide welfare state could come only with federal cost-sharing. That intervention was inherent in the politics of the federal-provincial relationship that was emerging.

But was not, in 1958, quite there. In Quebec's *ancien regime* social affairs were still the business of the church more than of the state. Diefenbaker's move could have produced a deep division in the federal union. Fortunately there came the quiet revolution. With the Lesage government of 1960 Quebec soon replaced Saskatchewan as the most activist of provincial administrations. It was in the forefront of wanting medicare and the rest. It sought more room for provincial taxes to pay for them. But Lesage was an economic realist as well as a social reformer. He wanted to do things Quebec's way but he knew it must be much the same as the rest of Canada's way. In particular, Quebec taxes should not be far out of line with the rest. He was therefore all for use of the federal spending power to share costs.

There was, however, a condition. Earlier cost-sharing had been appropriately labelled as the conduct of “joint” programs. Hospital insurance, categorical social assistance, the short-lived technical and vocational training program, had all been provincial services operated according to provisions stipulated in the federal legislation that authorised sharing of their costs. Such compromise of provincial jurisdiction had been acceptable in the continuing aftermath of war-time centralisation. Fifteen years on, it was unacceptable in Quebec and resented everywhere.

Nevertheless, it was thanks to federal taxes providing half of the costs that medicare was instituted nation-wide; post-secondary education was vastly extended; social services were sophisticated; social assistance according to need, without discrimination according to cause, was made universal. The triumph of cooperative federalism in the 1960s was to achieve all this without compromise to the constitutional division of powers. Federal legislation did not prescribe provincial programs. It stated only broad principles which would enable Ottawa to contribute half of their costs. Provinces separately legislated everything else. National finance simply made it all possible.

There was still some debate, and grumbling. It is not in the nature of provincial politicians to give much credit to feds. The Social Credit government of Alberta disliked medicare in principle. Conservative governments saw political Machiaevellianism in federal Liberal policy. But there was no word of objection to the spending power as such, from the provinces or from the federal Conservatives who voted for all the 1960s social legislation.

A similar consensus secured nation-wide contributory pensions. Lesage wanted to exercise the primacy of provincial jurisdiction. He badly needed pension capital to modernise Quebec’s infrastructure and industry. But again he recognised that a big difference from the rest of Canada would spell trouble. In practice we were able to agree on identical plans.

In sum, Canada’s social programs were not created by federal dominance over provincial jurisdiction. They were created by federal and provincial governments in a consensus driven by democratic will, by a tide of public opinion. Some governments rode the surf with pleasure and skill. Some were more like drifters with the tide. But all ended on the same shore and found it, for a time, smooth and warm.

Not, however, for long. Within a decade, the political foundations of cost-sharing had cracked. The cause was not in the provinces. They did not turn against the federal spending power. Ottawa did. It let the provinces down. It reneged on the promises with which the programs began.

The reason was simple and is enduring. The politicians of the 1960s had known the stagnation of the great depression and experienced the role of federal leadership in war and in the postwar economy. Though the new social programs

were run by the provinces, Ottawa was confident of receiving its due credit for them. It misjudged the changing times. A new generation, less aware of the contrast with depression and war, soon took the welfare state for granted. Precisely because it went well, the committed fiscal transfers that under-pinned it became routines of no public interest. Credit for them disappeared. A new set of federal politicians quickly came to resent raising taxes for provincial politicians to spend and get the credit.

The initial break, the 1977 legislation on the financing of established programs, was accompanied by flim-flam about the provinces getting more program flexibility in exchange for imposing the taxes that Ottawa graciously ceded to them. In fact, public opinion ensured that the reduced transfer was increasingly used to meet the rising costs of medicare, at the expense of using less for post-secondary education. The flexibility was that the provinces shuffled the federal purposes for the transfer.

Through the 1980s, as the federal government increasingly failed to manage the economy, mounting interest costs became mounting excuses to renege further on the cost-sharing with which the programs had been started. Finally, the 1995 budget ended all vestige of federal commitment to a defined share in costs. The spending power is still used to transfer federal revenue to provincial treasuries. But these “health and social” transfers are block amounts fixed by political pressures and the state of federal finances. They are subsidies that owe their survival to a different past.

The 1995 slashing of transfers profoundly changed the federal-provincial relationship. Morally and politically, Ottawa was put on the defensive. The provinces thereby gained a much stronger hand in negotiations. They promptly used it. They formulated their agreed ideas about federal money, ideas embodied in the Social Union Framework Agreement (SUFA) that Ottawa had to sign in 1999. It established rules for future intergovernmental transfers. They are to be conditional on nothing tighter than “an agreed Canada-wide objectives framework”, which each province can meet in its own way and thereby be entitled to its share of Ottawa’s money.

That was a brilliant way to write an obituary without declaring death. If provincial programs need to be no more than vaguely similar, supporting them with its money would yield neither influence nor political benefit for Ottawa. Only the most short-sighted of governments would use its taxes that way. It is true that the Martin government proposed to do so, in its late, despairing days. It offered block grants extending for some years as the way to kick-start wider provision of early childhood care. It negotiated with the provinces individually in a hasty, disjointed improvisation that would have created too many anomalies to survive. The Harper government immediately cancelled the program, without political pain.

There will no doubt continue to be federal transfers to particular provinces for particular projects, notably the infrastructures that appeal to politicians of all stripes for the photo-ops they provide. But thoughts of continuing transfers for new

programs are ghosts from the past. In light of SUFA, block funding is ruled out equally with cost-sharing. It is not in any event a sound base for an effective, steady program. It cannot be believably offered for the long term. It is even more exposed to being cut, if attitudes change or Ottawa is in financial trouble, than cost-sharing proved to be. Provincial governments will foolishly take the risk only if tempted by very lavish terms in the short run, while the federal government invites future trouble for only short-term political benefit. Any such program would be a measure of desperation, not use of the spending power for the efficient, stable collaboration good federalism requires.

For that, we now need to look to the other use of the spending power. The SUFA obituary was strictly for new program transfers to the provinces. It was not for the spending power. On the contrary, SUFA fully recognises its direct use, for individuals and organizations, as a federal right. *“Another use of the federal spending power is making transfers to individuals and to organizations in order to promote equality of opportunity, mobility, and other Canada-wide objectives.”* Such programs are not hedged by the conditions attached to transfers to the provinces. The only restraint is that before implementing *“new Canada-wide initiatives funded through direct transfers to individuals or organizations”* the federal government will *“give at least three months notice and offer to consult”*.

Constitutionally and practically, the federal government thus has full scope to establish a national framework of social policy, a framework on which provincial governments can build as they choose. The instrument is the spending power used directly to help Canadians individually. That use is not limited either by the Constitution or by provincial opposition. The limits are set by considerations of practicality and sustainability, by finance and by the collaborative spirit within federalism.

In that spirit, this paper briefly reviews a broad range of possible programs from which to choose priorities.

The first, in my view, is a basic measure of family income support. At present low incomes are taxed too much. I have suggested that the basic allowance should be increased and that a substantial part of it – say, initially, \$10,000 for one person, a combined \$15,000 for a couple – should become a refundable credit. The Canada Child Tax Benefit should be at a corresponding level of \$5,000 for the first two dependants, somewhat lower for larger families. The result would be to establish, in effect, a modest guaranteed income of, for example, \$15,000 for a childless couple and for a single parent with one child, \$25,000 for a couple with two children (adjusted, of course, for increases in the cost of living). That would be below the poverty level, particularly in large cities, but it would be a solid national base to which provinces and municipalities could add, for example, housing allowances, health benefits not covered by medicare, other social services and assistance.

A second major program would be a return, in a sense, to a brief period in the past. Ottawa should take clear, country-wide responsibility for upgrading the skills of unemployed and under-employed Canadians. It should support them by allowances while they take training courses; it should ensure that courses are available by standing ready to purchase them from appropriate sources, which in addition to provincial colleges and schools may include various kinds of private agencies.

Such a program is a major part of the “investment in human capital” now recognised to be crucial to a productive economy. Another component is post-secondary education. The present confusion, of provincial financing, erratic loans and bureaucratically variable repayments, is in urgent need of reform. It could best be replaced by interest-bearing advances of up to the full costs of taking diploma, bachelor and graduate courses. (Doctoral studies fit better with research financing.) Repayment would be income-contingent; that is, through a graduated surtax on subsequent income above, say, the national average of individual full-time earnings.

It must be noted, however, that some graduates are internationally mobile and will be increasingly so. While this is entirely desirable, the incidental effect is to enlarge opportunities for tax avoidance. Countering it requires a legal base we have not established but the United States has. American citizens have the same liability to pay American taxes wherever in the world they live. Canada can follow the good example. The major reason for doing so is to combat tax evasion generally, but it is of some special importance that working abroad should not enable people to avoid repayment of public investment in their post-secondary education. Such financing should therefore be available only to citizens, not other residents.

The other two priority uses of the spending power apply, however, to all children resident in Canada. Early childhood education is at last widely recognised as an essential investment in our most important, and increasingly scarce, resource. In most of Canada it is gravely deficient. Much of the organised child care available is little more than baby-sitting and even so is too expensive for many parents. There are other considerable obstacles. Long bus journeys are not how pre-school children should spend their time. The ideal child centres, with extensive services and adequate numbers of professional staff, are therefore impracticable outside cities and sizeable towns. Everywhere there are parents who want to keep their offspring at home or just down the street.

In time a lower entry age for compulsory schooling may become acceptable, but the time is not now. Meanwhile, and probably for the foreseeable future at ages below four, the appropriate public policy is to finance the consumer demand. It is strong. The role of government is to make it effective. The need is country-wide and urgent. It will not be well met by provincially operated programs, however financed. The way that would be more democratic, fairer and faster is for the federal government to reimburse parents, on a sliding scale related to income, for fees paid for the kind of early educational care they choose for their children. Municipalities with under-used school space now on their hands, as well as community groups and

non-profit agencies, would be eager to respond. While competition as well as public spirit would do much to ensure adequate standards, fee scales would be agreed with provinces and paid only for services licensed and supervised by them.

Public opinion would ensure that the needed close collaboration was willing collaboration. Both orders of government would have everything to gain by it, not only initially but permanently. Ottawa would get continuing political credit for its cheques going to people, and the provinces could be sure that the feds would never get away with renegeing on kids as they did on obscure transfers to provincial treasuries. While this paper is not the place to attempt to discuss all the careful detail required for such a program, the main point is surely clear. The federal spending power is the appropriate instrument available for this major national purpose, provided it is deployed not to finance provinces but to empower people

That applies equally for my fifth suggestion. Canada's medicare is, despite its weaknesses, a fine public service to cherish. But in one respect it has stayed too close to its origins. It began because the costs of being treated for illnesses were often impossible for many people and financially disastrous even for the well-to-do. But, to quote Tommy Douglas, the goal of public policy is healthy people, "not just patching them up when they're sick".

Medicare, however, was geared up to do the patching, and medical science makes it increasingly able to do the job. More and more sicknesses can be more effectively treated – at higher and higher costs. The financial strain encourages sticking with the established job. Measures to prevent sickness, to foster good health, are crowded out. Though preventing is not only better than curing but also cheaper, that is in the long run. In the short run, preventive measures are an additional expense. They are not, of course, ignored. There are some improvements. But inevitably they take second place to the immediate needs within a system that cannot afford all it could do to patch up the sick.

The dilemma is plain. The longer we are deficient in preventing sickness, the more the costs of treating it increase, the harder it becomes to find the money for prevention. It will not come, anywhere near sufficiently and quickly enough, from within the present process. It will not come from the federal government increasing its health transfer to the provinces, as it did in 2000, 2003, 2004. That may shorten some wait times for some treatments. It will not lessen sicknesses.

The need is for a break from the old way, a different kind of initiative to put new vitality into the noble work of building a healthy community.

Measures to promote good health are more effective the earlier in life they begin. The best initiative would be to mount a comprehensive range of services for child health. But if that were attempted by putting more money into the existing health transfer, much of it would inevitably be lost amid all the pressing demands that medicare puts on provincial treasuries. The effective initiative would be to make children truly the priority. Additional federal action should now be directed

specifically and firmly to them. Later, the whole federal health transfer, which in its present form runs to 2014, will require reformulation by careful consideration and thorough consultation. It should aim at the fullest practicable reimbursement of the costs of preventive services, especially in youth.

The transfers for which the federal spending power is needed now are not only to individuals but also to some organizations. Much of our industry is deficient in its research and development. While post-secondary education is best served by financing the students, universities also have a major role in research. For that federal funding is now significant but not sufficient.

The more controversial organizational funding is for industrial reconstruction and development. It will come to the fore in recession. The grants and easy loans that government has traditionally provided are often wasted. In our financial system it is not only some business investors and private consumers who get funding all too easily. So often do established corporations, especially for mergers and acquisitions. Capital for innovation and for the growth of small businesses is much scarcer, even in the recent times of so much financial splurging.

The requirement is for risk capital, and that is what government aid should be. The appropriate contribution through the spending power is not to make grants or easy loans but to provide additional equity for industrial enterprise. Public money should share both in the risk and in the return from venturing. It should not, however, buy power to interfere in private management. Government capital in industry should be in the form of special shares, carrying a normal right to dividends but not to voting in company business. Responsibility would then be properly shared through a public-private partnership in enterprise.

The initiatives I have briefly outlined here are in my view important policies, but their merits or demerits are incidental to this paper. They are examples to illustrate what I think to be the central truth for Canadian federalism today. For a generation, half a century ago, the federal spending power was used to share, nation-wide, the provinces' costs of instituting new programs that transformed our society. In that form, it was the right instrument for the times. In that form, it has had its use. It does not fit the present times. But it is only the form that is outmoded. The spending power is as essential as ever. It is essential to our economic as well as social betterment. This time, however, it has to be used primarily for transfers to people.

The change is appropriate to the spirit of the century, to the widening opportunities of the information society, to the increasing independence of individual choice that advancing technology makes possible. Broadening freedom for all requires, however, a reliable framework of public policy. Transfers between government treasuries proved to be unreliable. Transfers that go directly to people are transfers not easily chopped and changed in the manoeuvres of politics. The spending power so used for all Canadians can be a sustained expression of

democratic will, and thereby a firm assertion of the stable collaboration between governments that is essential to our federalism.