

# 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 and Aboriginal programs, among other things – all items that matter to Canadians.

This volume brings together both governmental and academic authors tackling these very issues - including the future of Equalization and the dispute about fiscal balance - in a timely fashion. These issues are now front and centre in Canadian public policy and federation management. The authors come at these issues from different and at times competing perspectives. The result is a rich analysis that will help to animate policy discourse around fiscal federalism, public finance and social programs in the years to come.

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Harvey Lazar

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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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## FOREWORD

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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 interests of all Canadians, relating as they do to issues like fairness, opportunity, community and political stability.

This volume is the product of a partnership between Manitoba's Department of Finance and the Institute of Intergovernmental Relations at Queen's University. I want to thank the Honourable Greg Selinger, Minister of Finance for the Province of Manitoba, and Ronald H. Neumann, formerly of Manitoba Finance, for their foresight in encouraging the publication of this timely volume. Manitoba Finance provided the financial support for the conference that preceded this volume, as well as for the production of the volume itself.

Staff and former staff of Manitoba Finance played a considerable role in the production of this volume. Beatrice Miller and Jeannette Gelmich proofed and copy-edited the original documents, while Ruth Madeleine Hodder played a significant role in overseeing the preparation of the chapters for publication. At Queen's University, Valerie Jarus provided advice and valuable feedback at various stages of the pre-publication process. I thank them all for their role in making this volume possible.

Harvey Lazar  
May 2005

## PREFACE

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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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**I**

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**A FRAMEWORK  
FOR ANALYSIS**

## TRUST IN INTERGOVERNMENTAL FISCAL RELATIONS

*Harvey Lazar*

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Writing more than two decades ago, the 1981 Parliamentary Task Force on Federal-Provincial Fiscal Arrangements provided, among other things, a brief history of federal-provincial revenue sharing, fiscal equalization, the financing of provincial programs of national interest, and fiscal and economic co-ordination. The Task Force also assessed the merits of the arrangements it had described declaring: “We are agreed that the programs examined in the course of our work are serving vital social needs and merit undiminished support” (Parliamentary Task Force on Federal-Provincial Fiscal Arrangements 1981, 193). It then explicitly recommended against reductions in federal transfers for major social programs.

If a similar Parliamentary task force had been appointed at any time in the 1990s or early 2000s, it would not have found Canadian fiscal federalism in as good shape as did the 1981 report. Intergovernmental fiscal arrangements had become more rancorous and solutions more contentious. And yet the hypothetical new task force would have also probably found the fiscal arrangements no less important than its 1981 predecessor in terms of the programs they support and the values that underlie them. The title of this volume, *Canadian Fiscal Arrangements: What Works What Might Work Better*, thus captures this idea. That is, while the history of the fiscal arrangements of the last two decades is a less positive story than what came before, there is still much in the financing arrangements that has worked and continues to work well. At the same time, there is also much room for improvement and this volume is intended to focus on how things might be made to work better.

In the main, fiscal federalism is about how expenditure and revenue-raising responsibilities are allocated among the different orders of government in a federal political system. In so doing, it is both instrumental and quasi-constitutional in its effects. Fiscal federalism is instrumental in the sense that it enables governments to pursue the public interest and related policy goals by virtue of what is in its tool kit – tools such as intergovernmental transfers and tax or revenue-sharing arrangements.

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. Since then Canadian politics has been marked by an ongoing struggle between a market-oriented or neo-liberal perspective that views government as part of "the problem" (too inefficient, too bloated, distorting incentives) and more centrist and social democratic viewpoints that continue to perceive government as an effective instrument for the pursuit of the common weal – "the solution." The result of this struggle is that public policy has vacillated and this vacillation has been reflected in the way Canadian fiscal federalism has evolved.

Fiscal federalism is not only instrumental. It is also quasi-constitutional in that it helps to shape the institutions that govern the federation and the way in which the roles of the different orders of government evolve. This too is contested territory. For some, Canada in its entirety is the basic political unit of the federation and an expansive role for the federal government is a natural corollary of Canadian nation-building. For others, provincial communities are the fundamental building blocks of the federation and expansive interpretations of the federal government's constitutional powers are therefore illegitimate if not unconstitutional. When the tools of fiscal federalism are adjusted to accommodate changing needs and circumstances, apart from their instrumental effect, the result may also privilege one view of the Canadian federation over others.<sup>1</sup> The 1867 pact was itself a compromise between sharply different constitutional visions of the federation. And reflecting on the recent past, the differences of opinion about the nature of the federation were arguably more muted in the early post-war years than they have been since the 1970s.

Opinion within Canada is, of course, more nuanced than the simple division between the political right and political left, on the one hand, or the divide between those who would privilege the federal government and others who would privilege provinces, on the other. Identity politics, in particular, influences both of these divisions. The place of French-speaking Quebec within the federation and the evolving role of Aboriginal peoples are two obvious examples of this complexity.

Whether one views Canadian politics through the lens of a simple two by two matrix – right/left and Canada-centric/province-centric – or a more complex and fine-grained analysis, the result is similar. It has become increasingly difficult to find an overarching vision about the appropriate role for the state or about the nature of the federation that commands widespread public support.

The absence of such a consensus is reflected in the real political world and not surprisingly, therefore, in intergovernmental fiscal relations. Thus, in the 1995 federal Budget Speech, when Minister of Finance Paul Martin announced the merger of the federal cost-shared transfer for social assistance and services with the block transfer

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 – a position that, whatever its intrinsic merits, did not jibe with the previously heralded "greater flexibility."<sup>2</sup> And in its 2004 election platform, Mr. Martin and the federal Liberal Party went a lot further in matters of provincial jurisdiction, committing to a National Waiting Times Reduction Strategy (The Liberal Party of Canada 2004, 5). The document explained:

First, the federal government will work collaboratively with provinces and territories, the medical profession and patient groups to define reasonable and medically appropriate waiting times, and to identify the places where they are unacceptably long. Teaching hospitals and regional health authorities – which play such a critical role in the system – will also be asked to contribute to the process. The new Waiting Times Reduction Fund of \$4 billion will be available to help provinces and territories eliminate the gap between current performance and appropriate waiting time targets. As the complex process of gathering comparable waiting time data unfolds, a medical expert panel working with the newly-established Health Council will determine whether any cases exist of waiting times causing significant clinical concerns. In such cases, extraordinary efforts will be made on an urgent basis to bring these times down to a medically appropriate level. Canadians need to see real evidence of early action on waiting times. In some cases, we already know the waiting times are too long and what needs to be done to bring them down (Ibid.).

The point here is not that the federal Liberal Party and Mr. Martin have not always been consistent. The same is true of many political leaders of different stripes. In the 2004 federal election campaign, for example, the leader of the new Conservative Party, Steven Harper, embraced the 2003 federal-provincial health accord, a position that seemed a long way from some previous declarations on his part. Rather, the point is that in 1995 and 2004 the federal Liberals were reacting to the exigencies of the moment without the benefit of a broader consensus within Canadian society about the appropriate role of the state or of the nature of the federation. In 1995, energetic

fiscal restraint was required and Mr. Martin delivered in spades, extolling at that time a “new vision of the federal government’s role in the economy” that, among other things, entailed a less intrusive involvement in areas of provincial jurisdiction. Less than a decade later, with the polling data showing that health care was “top of mind” for Canadians, Ottawa was becoming far more intrusive, reflecting a more optimistic view of what the state could achieve on waiting lists, among other things, and a more muscular role for the federal government to that end.

The above examples of public policy moving one way and then the other and of federal-provincial relations moving one way and then the other are not the exceptions that prove the rule. In the last couple of decades they have been the rule. Ottawa has been “in” and then “out” of public housing and then back “in.” It has reduced transfers for post-secondary education and social assistance and then implemented a number of programs in the areas of post-secondary education and income support. Both these examples reflect the vacillation about the appropriate role for the state and about the federal role in the federation. Stated differently, there has been a tendency for the federal government to mobilize public opinion in support of great Canada-wide goals but to subsequently lose some interest leaving provinces with more of the ongoing financial responsibility than they had originally bargained for. This has made Ottawa an uncertain partner for the provinces.

The idea that policies and programs change over time and that governments react to short-term pressures is neither surprising nor in itself a bad thing. What is questionable is how compatible these kinds of changes are with a system of governance that is heavily dependent on effective intergovernmental relations, including fiscal relations. And one of the central arguments of this introductory chapter is that there has been a structural incoherence in the way federalism has been practiced in Canada over the last decade and possibly much longer. More precisely, Canadian federalism places great weight on the effective management of interdependence among governments. In developing its proposals for managing Canadian intergovernmental relations, for example, the Macdonald Royal Commission declared: “We wish to facilitate management of interdependence in the federal system, for Canadians cannot recreate the classic watertight compartments of federalism” (Royal Commission on the Economic Union and Development Prospects for Canada 1985, III-271). In this regard, even a cursory examination of the way federal and provincial line ministries relate to one another today shows that there are ongoing and often close relations between federal and provincial ministries with overlapping mandates (ministries of economic development, natural resources, social services, skills development, health, environment, law enforcement and so on).<sup>3</sup> There is thus a lot of intergovernmental traffic to manage. And much of that management has a fiscal dimension to it. Yet, notwithstanding this large and possibly growing interdependence among line ministries, the trend among finance ministries has been in the opposite direction to greater independence (Meekison, Telford and Lazar 2004, 19-21; and Leslie, Neumann and Robinson 2004). Federal-provincial macro-economic co-ordination has declined

over the last several decades; pre-budget intergovernmental co-ordination has eroded in recent years; provincial autonomy in income tax matters has grown since the mid-1970s; provincial reliance on federal transfers has dropped; and the conditionality attached to federal transfers has weakened since the early to mid-1970s (at least that was the case through to the early years of the 21st century). Whether this growth of autonomy of finance ministries is a good or bad thing may be a matter for debate if thought of as a free-standing trend. But it is the hypothesis here that this trend toward fiscal autonomy is incompatible with the idea of a large measure of interdependence among federal and provincial line ministries – especially when federal money is often an essential lubricant to the interdependent relationship. When federal and provincial line ministries are highly interconnected, as in health care where the federal government administers the *Canada Health Act* and the provinces oversee the design and delivery of services, while federal and provincial finance ministries are disentangling, the risks of unplanned and unfortunate developments are real. And the situation in health care since the mid-1990s has arguably stemmed in considerable measure (by no means exclusively) from this very incompatibility.

### ASSESSING FISCAL FEDERALISM

In the economics literature, the goals of fiscal federalism have been associated mainly with the ideas of economic efficiency and equity. In the early post-World War II decades, the use of intergovernmental transfers to create Canada-wide programs for the financing of social assistance, medical and hospital services, and post-secondary education, and many smaller transfers were to varying degrees thought to serve both equity and efficiency objectives well. Equalization and tax-sharing (subsequently tax collection) agreements were seen in a similar light (Boadway and Hobson 1998; and Royal Commission on the Economic Union and Development Prospects for Canada 1985, III-192-197 and 222-250). During this period, the instrumental role of fiscal federalism scored well.

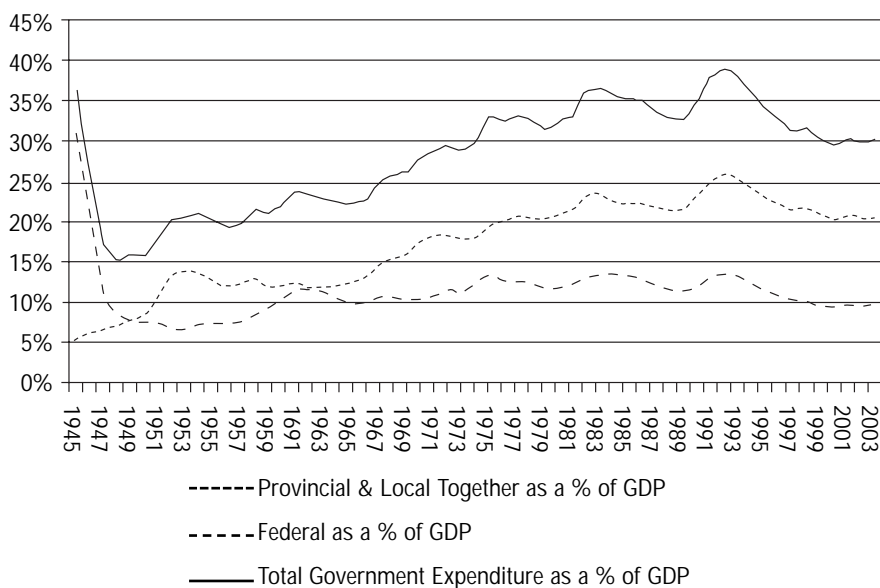
Fiscal federalism also had a third goal during that early post-war period – the building of a sense of Canada-wide community, a political state in which a sense of belonging was shared by citizens from all regions of Canada.<sup>4</sup> The creation of the joint programs referred to immediately above, and Equalization, as well as many other initiatives in the early post-war decades did much to advance this goal – a goal that can be seen as more quasi-constitutional in impact. The initial result may have been a vision of the federation that gave relatively more stature to Ottawa than the provinces. But since the federal government was only able to advance some of its social policy goals by working with and through the provinces, a subsequent result was a huge increase in the role of provincial governments in the lives of their residents. And as will be seen below and as I have discussed elsewhere, by the end of the 1970s the impact of the welfare state growth was to enhance hugely the roles of both federal and provincial governments in the society and economy relative to what they had been in the decades before World War II with little evidence that one order of government had made long-term gains at the expense of the other (Lazar 2000, 3-39).

This positive assessment of the fiscal arrangements weakened in the 1980s and 90s, in the face of slow economic growth, ongoing governmental deficits, and mounting public debt. The criticism linked the two divides noted above. First, from a policy or functional perspective, the presumed efficiency benefits associated with the large federal transfers to the provinces (discouraging inefficient interprovincial mobility and other externalities) were seen as outweighed by the concern that such “soft budget constraints” on the provinces were leading to inefficient resource allocation.<sup>5</sup> This concern was reinforced by the criticism that the transfers muted accountability to the public for key public services. Second, from a federalism or quasi-constitutional perspective, there was a growing view that the federal transfers had become too intrusive in relation to program areas that were matters of provincial legislative competence under the Constitution.<sup>6</sup> In practice, of course, these arguments were often merged, with more market-oriented provincial governments more likely to play the jurisdictional card than provincial governments that were more centrist or social democratic in orientation. (The Quebec position will be touched on below.) These pressures to restructure the fiscal arrangements were heavily reinforced by the frequent more or less arbitrary cutbacks in Ottawa’s planned level of transfer payments to the provinces during the 1980s and 90s in the face of large and ongoing fiscal deficits.

The outcome of the politics associated with these change pressures was reflected in many ways. For example, the Canadian state was reduced dramatically in the 1990s. Federal program spending (including intergovernmental transfers) dropped from a peak of just over 18 percent of gross domestic product (GDP) in the mid-1970s and again in the mid-1980s to about 12.5 percent in the year 2000; and provincial/local spending fell from 30 percent in 1992 to 23 percent in 2003.

Figure 1 shows federal and provincial spending but this time with intergovernmental transfers excluded. On this basis, the combined federal-provincial-local state (total government program spending as a share of GDP) shrank from a high of 39 percent in 1992 to 30 percent in 2003. The solid line in Figure 1 below reflects the latter data. The dotted lines show federal and provincial/local spending excluding intergovernmental transfers.

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

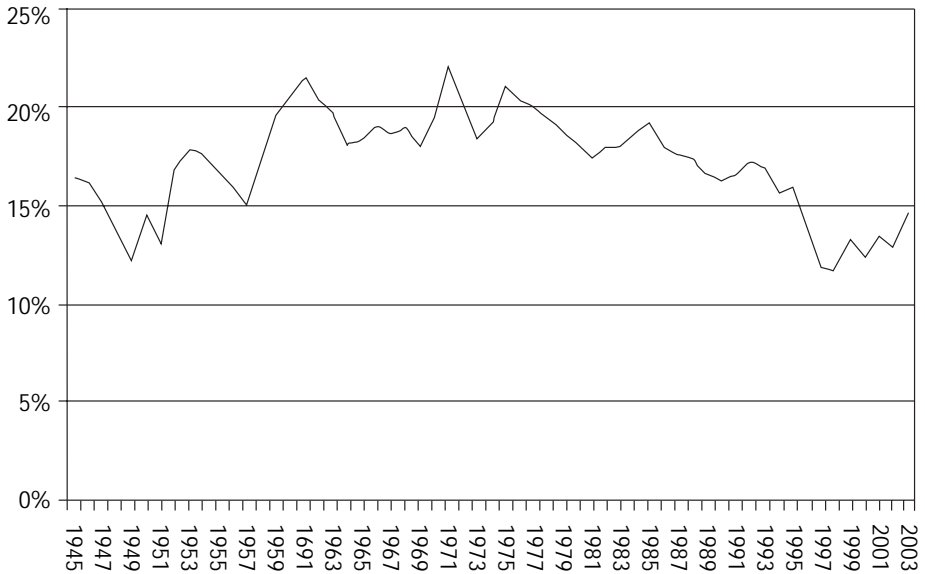


*Source: Statistics Canada, National Income and Expenditure Accounts STC 13-351 (data prior to and including 1961) and CANSIM II matrices 3800033, 3800034 and 3800035 (data post-1960)*

*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 tax 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.*

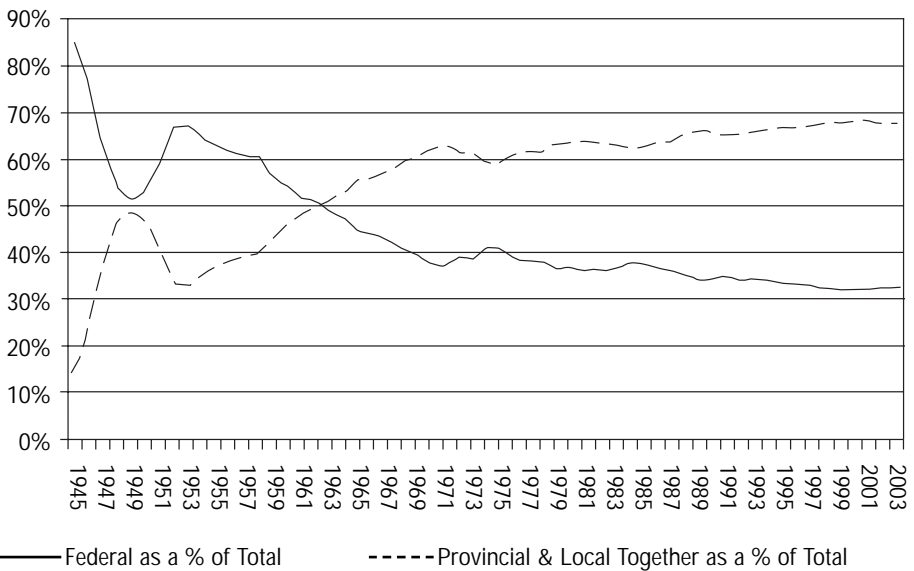
In turn, these developments – the overall large reductions in state spending and the cutbacks in federal transfers to provinces – have helped to fuel a number of controversies in Canadian politics. One is the charge that they have favoured the federal government at the expense of the provinces and municipalities 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.<sup>7</sup> 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 remarkably little variation. They also account for about 67-68 percent of total government spending (excluding intergovernmental transfers), a proportion that climbed from under 40 percent in the early and mid-1950s to a 61-63 percent share in the late 1970s (see Figure 3).

**Figure 3**  
**Total Government Spending (Without Debt Service or Intergovernmental Transfers) Proportioned by Government Level**



*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.*

Assuming that the growing share of provincial and local expenditure in total government spending since the late 1970s was a faithful reflection of citizens' preferences (for example, relatively more social spending and relatively less defence spending), one of two things might have been expected to occur. Either the provincial/local sector would increase its share of total "own source" government revenues or the federal government would increase its cash transfers to the provinces. But since the federal transfer

of tax room in 1977, neither has happened. The provincial/local sector has not increased its share of total tax revenues nor has the federal government increased its cash transfers.<sup>8</sup> The argumentation of both federal and provincial governments has been outlined and analyzed elsewhere (Lazar, St. Hilaire and Tremblay 2003, 141-144). Suffice it here to say that the heart of the case supporting the allegation of vertical fiscal imbalance is that the federal government enjoys revenues that are larger than its expenditure obligations whereas the opposite is the case for provinces and local governments. And this is the definition of vertical fiscal imbalance that is adopted here.

For some analysts, the idea that the federal government taxes more than it requires for its own spending purposes is evidence of vertical imbalance whether or not the "excess" federal revenue is transferred to provincial and local governments.<sup>9</sup> That is not the position here. If the provincial/local sector has adequate funds, either through own-source revenues or federal transfers, to meet its expenditure obligations there is no imbalance. There is a vertical fiscal gap, not an imbalance, and the federal transfers are a measure of the magnitude of the gap.<sup>10</sup>

Moreover, virtually all federations have a vertical fiscal gap. That is, their federal governments collect more revenues than they need relative to their direct spending obligations and they transfer some of their revenues to regional and local authorities. There are a number of reasons this is done. One is to create and maintain a degree of nationwide programming for some combination of equity and efficiency reasons and/or to strengthen citizen attachment to the federation as a whole. A second is that federal authorities may wish to avoid harmful tax competition among regional and local governments and to do so they need to occupy a relatively large share of key tax bases. There are also large administrative efficiencies in centralized revenue collection while the benefits of centralized expenditure programs are more variable.

There are as well important arguments against vertical fiscal gap, associated mainly with two considerations. The first is that governments that spend without having to tax may spend more than is economically efficient. The second is if a regional or local government is required to spend in a certain way by federal conditions on its transfers, it is harder to hold the regional or local government accountable for results than if it has had exclusive responsibility for its expenditures.

In any case, to repeat, the view here is that a vertical fiscal imbalance can be said to exist when one order of government has less revenue than it requires to meet its spending obligations, whether from own-source revenues or intergovernmental transfers, and the second order of government is in the opposite situation. Indeed, federal transfers are a standard way of reducing a vertical fiscal imbalance.

There are also two sets of considerations linked to an assessment of whether or not there is a vertical fiscal imbalance. One set is technical and measurable. The second relates to policy and political judgment. Whether or not a vertical imbalance exists requires both kinds of analysis.

In Canada, the technical arguments are generally linked to calculations, by the Conference Board of Canada and/or by Professor Joe Ruggeri.<sup>11</sup> Assuming constancy

in federal and provincial expenditure and revenue programs, both have estimated federal and provincial revenues and expenditures stretching out for the next 20 years. While their calculations differ in the detail, both produce results that suggest large and growing federal surpluses going forward but much more precarious provincial finances.<sup>12</sup> In concrete terms, in mid-2004 (before the First Ministers' Meeting of 13-15 September 2004) their projections were suggestive of the idea that the federal government had annual revenues that were in the order of \$10 billion greater than it required to meet its spending obligations, and that this excess of revenue would remain more or less constant for the next five years, and then begin to grow rapidly. In contrast, provinces were generally anticipated to be in a deficit position but not a large one.<sup>13</sup>

At least equally pertinent to a judgment about whether or not the federation has a vertical imbalance is the fact that a very high proportion of incremental federal spending in recent years has been targeted to areas of provincial legislative competence under the Constitution and that current federal spending priorities continue to emphasize these policy domains. If the federal government were to decide that threats to Canadian security require an additional \$8-10 billion annually for defence, security and foreign aid, and then added those amounts to federal expenditures, this would effectively end the debate about vertical fiscal imbalance as anticipated federal surpluses would disappear for the next several years and possibly much longer. But when Ottawa is adding or considering further cash transfer payments of \$5 billion annually or indeed more for health care, child care and cities – all of which are exclusively or mainly the constitutional responsibility of the provinces – and relatively little new spending for program items that are clearly within its constitutional mandate, the provincial argument about vertical fiscal imbalance carries more weight. Indeed, despite its rhetoric, and the very cogent argument presented by Dion in this volume, federal government actions indicate that Ottawa does accept that there is a vertical fiscal imbalance. In what other way can one explain the large increases in its cash transfers to the provinces over the last several years with promises of further augmentations to come?

Assuming the vertical imbalance exists, this still leaves open the question of what should be done about it. In theory, there are several ways it can be rectified: by the federal transfer of tax room to the provinces (whether explicitly or indirectly); by new revenue-sharing arrangements between federal and provincial governments; by re-assigning tax bases among governments to secure a better match between revenues and expenditures; by unconditional cash transfers; by lightly conditioned cash transfers (e.g., targeted in a general way); or by highly conditioned cash transfers. It can also be rectified by new or expanded direct spending initiatives by the federal government which has the effect of reducing expenditure pressures on provinces. Each option has different functional and quasi-constitutional effects.

As noted above, there are a number of policy options for rectifying a vertical fiscal imbalance. For better or worse, however, Canada has little experience with some of

them. For example, some federations provide, either by constitutional law (e.g., Germany, India and South Africa) or by statute (e.g., Australia and Spain), for their national governments to collect all of the revenue from a particular tax base (such as income or value added) and then distribute the proceeds based on an allocation formula that is not readily altered by year-to-year politics. This approach provides the benefits of centralized revenue collection, including discouraging race-to-the-bottom tax competition (e.g., Ontario trying to keep up with Alberta personal and corporate income tax cuts in the 1990s), while allowing for a distribution that corresponds to domestic exigencies. It has the downside, however, of enabling regional and local governments to spend funds that they have not raised. While, on balance, this model has intriguing features, in a Canadian context it appears to be impractical politically. For one thing, it would require provinces to give up tax bases that they would not cede to Ottawa without assurances that their revenue stream would otherwise be constitutionally protected. To secure such protection would require that the revenue shares be constitutionally mandated and this implies too much rigidity in revenue allocation. Alternatively, it requires periodic federal-provincial agreements about allocation with such agreements having some form of constitutional protection (from arbitrary action by the federal government) but, unfortunately, there is no provision now in the Constitution that can be invoked to afford this kind of protection. Re-assigning revenue bases among federal and provincial governments (e.g., more mobile bases to the federal government and less mobile to other levels of government structured so that there is a better match between revenue and expenditure responsibilities for each order of government), while offering a different mix of benefits and costs than revenue sharing, is no more likely to be practical politically.

It appears therefore that there are only three ways of rectifying the vertical fiscal imbalance – a tax transfer from Ottawa to the provinces, additional cash transfers from federal to provincial governments, or the federal government absorbing directly some of the spending obligations of provinces.

The above discussion outlined arguments in favour of and against a vertical fiscal gap (that is, federal cash transfers to provinces). These considerations have obvious relevance to making a decision about how the Canadian vertical fiscal imbalance is to be handled and in particular to an assessment of the relative merits of federal tax transfers to the provinces relative to federal cash transfers. If the second set of considerations (related to economically inefficient spending and muted accountability) is weighted more heavily, the most logical choice would be a shift of tax room from the federal to the provincial authorities (incidentally leaving to the provinces the role of rectifying any shortfalls at the local level). Conversely, if the first set of factors (related mainly to national programming, equity considerations, and economic and administrative efficiency in revenue collection) is given more weight, increasing federal cash transfers to the provinces is the obvious way to go. In this latter choice, however, there remains the second decision of whether the transfers should be conditional and the extent of any conditions.

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).<sup>14</sup>

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

Country	Total Transfers
<i>Mature Federations:</i>	
Australia	45.3
United States	29.6
Germany	43.8
Canada	19.8
Switzerland	24.8
<i>Transitional Federations:</i>	
Spain	72.8
South Africa	96.1
Brazil	30.0
India	46.0

*Source: Ronald L. Watts "Autonomy or Dependence: Intergovernmental Financial Relationships in Eleven Countries." Working Paper Series, Kingston: Institute of Intergovernmental Relations, 2005.*

The comparative perspective suggests that incremental cash transfers from the federal to provincial governments may be at least a partial solution to rectifying the imbalance. This comparative perspective is reinforced by the belief that the federal government must retain enough fiscal flexibility to propose or improve on Canada-wide programs periodically, both for equity and nation-building reasons. It is further supplemented by a concern that if incremental tax room were to be transferred to provinces in this already decentralized federation, this might erode current tax harmonization arrangements that afford efficiency benefits; and the erosion might also encourage an unhealthy "race to the bottom."

The part of the solution of the vertical imbalance issue that involves cash transfers raises the question of whether such transfers should be conditioned and, if so, in what way. While the federal government was, only a decade ago, extolling the idea of enhanced provincial flexibility, as observed above it has reversed itself more recently and been adding conditionality to its transfers. Moreover, most indications are that it is becoming more entrenched in the idea that an enhanced focus on conditionality is the appropriate path ahead.

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 federation.

Alternatively, conditions can be related to measuring outputs or more ambitiously outcomes. In this perspective federal and provincial governments would agree on broad goals, acknowledge provincial freedom to pursue those goals according to their best judgment but with the condition that provinces report publicly and regularly on progress toward their goals on the basis of appropriate and comparable indicators of output or outcome. To the extent that some provinces may achieve their goals more effectively than others, the available data will make that clear and create an incentive for lagging provinces to learn from the achievements of the more successful, or provide a rationale for improved redistribution of resources. In such an approach, Canada-wide goals can still be developed to achieve equity or nation-building objectives but without overriding provincial constitutional authority and without losing the benefits of provincial innovation and experimentation or indeed clear provincial accountability.<sup>15</sup>

In summary, the gist of argument here is that another large federal transfer of tax room to the provinces would reduce further the benefits of centralized revenue collection, encourage unhealthy tax competition, weaken equity goals, and make it unduly difficult to develop Canada-wide programs. At the same time, conditions on federal transfers to the provinces that mute provincial accountability for programs within

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.”<sup>16</sup> 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.”<sup>17</sup>

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.<sup>18</sup>

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 “savings” in child-related programs. In practice, however, it may not always be possible for the federal government to negotiate as effectively with the provinces in such cases as it would wish and there may therefore be a measure of leakage or displacement (federal spending displacing provincial spending thus allowing provinces to “save” some money). To the extent that such displacement occurs, the vertical fiscal imbalance is reduced. Perhaps more important, as such agreements stretch out over time, it is hard to know what would have otherwise happened to provincial spending in the relevant area, and the extent of net fiscal gains for the provinces.

The second approach is for the federal government to spend directly in an area of provincial legislative competence but, using the above hypothetical example, spending “x” dollars but seeking to have only 50 percent of the “x” as incremental dollars for students and the remaining half consciously aimed at reducing vertical fiscal imbalance. For such a course to be followed, however, it is necessary for the federal government to acknowledge, even if only implicitly, that an element of vertical imbalance exists. Initiatives linked to such items as early childhood development or Pharmacare could be managed in that way, with federal spending intended to serve both an explicit policy goal and a reduction in vertical imbalance. This indeed was a large part of provincial government bargaining strategy in the second half of 2004 (as this volume was being completed), when provinces called on the federal government to fund fully and administer a new Canada-wide pharmaceutical program (with provision for Quebec to opt out with full financial compensation).<sup>19</sup>

A vertical fiscal imbalance is a tricky concept. Judging whether it exists and its size is as much art as science. If it does exist, however, the imbalance distorts the way the federation functions and inevitably introduces an unhealthy tension into Canada’s federalism pact. The current imbalance should be rectified and the tools to do it are at hand.

#### **QUASI-CONSTITUTIONAL EFFECTS:**

##### **THE ISSUE OF HORIZONTAL IMBALANCE**

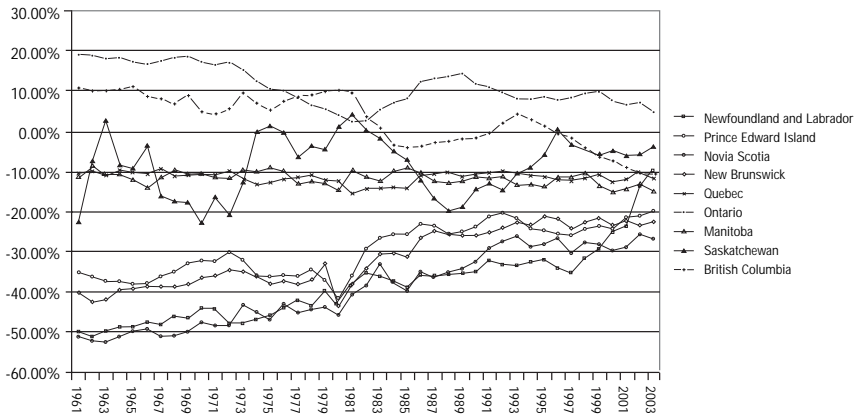
From the viewpoint of the state of the federation, the issue of vertical imbalance has been more central to public dialogue over the last decade than the matter of horizontal imbalances – the differing capacity of provinces to provide roughly comparable public services to their residents at roughly comparable tax rates. In the last couple of years, however, partly because of the longer-term reductions in the relative size of fed-

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 of tackling resource revenues in the context of the program), and Ronald Neumann (new reflections on the advantages of the representative tax system relative to macro approaches for determining provincial entitlements). The main question considered here therefore is whether the relative decline in the size of the Program over the last couple of decades is an indicator of the Program reaching its goals – that is, that there is a lesser need for it in the early 2000s than was the case three or four decades ago – or whether this relative decline is for other reasons. One difficulty in answering this question is that there has been no systematic effort to evaluate the Program's effectiveness relative to its objectives. Indeed, the objectives themselves are not precise. Part I of the *Federal-Provincial Fiscal Arrangements Act* sets out the formula for Ottawa's fiscal Equalization payments to the provinces but nowhere does it specify the broad goals of that Program. In the absence of statutory goals, it seems reasonable to fall back on the provisions of Section 36 of the *Canadian Constitution Act 1982, Part III* (especially 36(2)) which commits Parliament and the federal government 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."<sup>20</sup>

Assuming these are the objectives of Equalization, it remains the case that there is a paucity of evidence as to whether the Program is meeting them. To be sure, differences in GDP per capita among provinces have declined significantly over the last four decades even when Alberta (and its huge but erratic stream of hydrocarbon revenues) is included. In the early 1960s, the Atlantic provinces had levels of GDP per capita that ranged from 35 to 50 percent below the national average. In 2003, the comparable figures were 10 to 27 percent. Conversely, Ontario's GDP per capita exceeded the national average by over 19 percent 40 years ago but had dropped to less than half of that by the beginning of the 2000s. Other things being equal, this is suggestive of the possibility of a narrowing of differences in public services and taxation levels among provinces.

**Figure 5**  
**Percentage Difference Between Provincial Nominal GDPs Per Capita and National Nominal GDP Per Capita Over Time**



*Source: Statistics Canada, CANSIM II matrices 3840035 (data prior to and including 1980) and 3840013 (data post-1980). Note that methodological differences exist between the two data sets. Alberta is removed for visual effect.*

But other things are not equal! The traditional Equalization-recipient provinces have been declining as a share of the population and economy for many years, with immigrants settling disproportionately in the more prosperous provinces of Ontario, Alberta and British Columbia. Internal migration has also been directed at these same provinces. This suggests that there may be little or no progress in meeting other provisions of the Canadian *Constitution Act, 1982* that entail commitments to, among other things, “...reduce disparity in opportunities” (Section 36(1)) assuming that this provision refers at least in part to disparities from one region to another.

Of course, the mobility rights that enable Canadians to move from one province to another are a value in their own right, and the freedom of people from Equalization-recipient provinces to move elsewhere may well be a significant factor in helping in the efficient allocation of labour, possibly to the benefit of all regions on a per capita basis. It is also possible that the narrowing of differences in per capita income would be smaller in the absence of Equalization.

In any case, neither the narrowing of interprovincial differences in GDP per capita (the seeming good news) nor the contrary trend in population flows (the seeming bad news) speaks directly to the issue of comparability of public services or of taxation levels. And while it is true that provincial governments need not actually provide reasonably comparable services at reasonably comparable tax levels for the Section 36(2) objective to be met – only that they have revenues that are close enough to one another that they have the capacity to do so – in practice it seems sensible to at least consider comparative provincial performance on both taxation and level of services for some assessment of whether the objectives are being satisfied.

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.<sup>21</sup>

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 recipient provinces. In turn, governments of those provinces may look for ways of calculating fiscal capacity so as to increase the dollar flow to them and justify their claims on loosely defined equity grounds. At present there is no objective measure to dissuade them from so doing. For the very same reason, there is the danger that the Program may over time come to be seen as a “boondoggle” in the wealthier provinces. Happily, as Equalization is a valued Program, public debate has not descended yet to that unconstructive level (O’Neil 2002, and Parliamentary Task Force 1981, 2-3). At the same time, the absence of firmly established objectives and agreed performance indicators adds to that risk. Indeed, as the October 2004 First Ministers’ Meeting on Equalization was being prepared, there was evidence that some provincial proposals for Equalization were becoming progressively more difficult to reconcile with constitutional provisions (*The Globe and Mail* 2004, 1, 6).

If the federal government is to adhere clearly to the Section 36(2) provisions, it will have to pay attention not only to differences in fiscal capacity among provinces but also to differences in service needs (for example, whether the costs of providing public services are greater in provinces with older or more rural populations). The federal authorities may be of the view that the current calculation of fiscal capacity, whatever its warts, is a pretty good estimate of underlying economic reality. The federal authorities may also judge that engaging in technical analysis about the costs of service delivery from one province to another is not worth the candle – that the differences in service costs are not large enough for such a big bureaucratic exercise. And if this speculation is true, it is understandable that they resist. Yet as long ago as 1985, the Macdonald Royal Commission argued that “the idea of considering fiscal needs or the costs of providing services should receive careful attention” (Royal Commission on the Economic Union and Development Prospects for Canada 1985, III-196).

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 unexpectedly 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 for 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.) The amount of this additional federal contribution will have to be negotiated given that provinces are already spending heavily, if unevenly, in these areas. Fourth, conditions associated with additional transfers should be SUFA-friendly, both on paper and in the negotiating process. The 2003 federal-provincial health accord was consistent with SUFA on paper but the process for getting there was not. Finally, and perhaps most importantly, there is a need for the federal government to share in the risks, political as well as fiscal, associated with the publicly insured system. Needless to say, given the earlier discussion of vertical fiscal imbalance, such fiscal actions by the federal government would be a major step to reducing the vertical fiscal imbalance that exists.

The September 2004 federal-provincial-territorial agreement goes a long way to meeting these criteria. It provides a federal cash contribution close to 25 percent of total provincial-territorial health care costs.<sup>22</sup> It provides a predictable escalator that is to run for ten years (a considerably longer federal financial commitment than previous health accords) and that will grow considerably faster than the expected growth rate of GDP. It thus removes some of the financial risks and uncertainties provinces have been absorbing. Whether sufficient funds have been included by Ottawa to cover home care and catastrophic drug costs is harder to calculate but it does appear that the standard set by Mr. Romanow has been met. The conditions attached to the transfer also appear SUFA-friendly. Whether they are biting enough to achieve the desired health care goals will be seen over time but, from both a federalism and fiscal arrangements perspective, this new agreement is encouraging. This is reinforced by the side agreement with Quebec, which has apparently been welcome by all provinces and all federal political parties. Whether this all adds up to a new political partnership remains to be seen, but as of October 2004, the Prime Minister and Premiers have gotten off to a promising start.

With health care as the priority issue in federal-provincial relations in recent years, the federal cash contributions to provinces for social assistance and social services have declined. In part, the small federal cash share has been replaced by direct transfers to low-income families with children (National Child Benefit) and intergovernmental transfers for early childhood development and related programs that focus on the very young. These have been supplemented by federal-provincial initiatives related to affordable housing and homelessness but the dollar amounts are small.

For a number of years now, the federal Liberal Party has made public commitments to the idea of a pan-Canadian program of child care. This undertaking was found in the Liberal election program for the 1993 federal election campaign and again in 2004. In the 2004 document, the Liberals stressed that the “case is compelling for investing in high quality early learning and care.” The Liberal vision is for a universal (available to all pre-school children) program, that is accessible, that has a developmental component, and that is provincially regulated (for safety and to ensure an appropriate complement of professionally qualified staff). Publicly provided child care, in an age of two-earner and single-parent families is good social policy – good for stressed-out

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 dialogue on this kind of issue. The platform also proposed that provinces individually be invited to pass child care legislation embodying four principles – quality, universality, accessibility and developmental (given the acronym QUAD) – that the Liberals set out. While there is much that remains unknown about the details, this appears to open the possibility that the federal cash transfer program would not be based exclusively on federal framework legislation – like the *Canada Health Act* – but rather at least in part on similar but not necessarily identical provincial laws. Indeed, the flexibility associated with the September 2004 intergovernmental health care agreement suggests that Ottawa could approach its child care proposal with similar flexibility. From an intergovernmental relations perspective, this could turn out to be a step forward.

Equally interesting, although the Liberal platform expresses the hope “that provinces will also contribute additional funds beyond those that they are already spending on early learning and child care,” it also declares that even “if they do not, the federal government will provide a per capita share of funds to support existing provincial or territorial programs that embody the QUAD principles.”<sup>23</sup> This suggests that the federal government will seek to maximize the policy goal by encouraging additional provincial capacity in child care and development. But it also leaves the federal government with flexibility and the outcomes could include a mix of program gains and some displacement (of provincial spending). Presumably, this will be subject to intergovernmental negotiation. On the whole, except for the five-year limit on funding, the tone of the Liberal commitment appears province-friendly.

The idea that there is a physical infrastructure deficit, especially in Canada’s larger cities, caught the attention of Prime Minister Martin before he won the leadership of the federal Liberal Party and was carried forward in the party’s 2004 election platform.<sup>24</sup> While the details of what the federal government had in mind subsequently evolved to include cities and communities (a more diffuse focus), the bottom line

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.<sup>25</sup> 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.<sup>26</sup>

The case for such federal leadership, however, is difficult to understand, especially when analyzed in terms of the usual evaluation 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.<sup>27</sup>

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.<sup>28</sup>

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 by the federal government. If accepted by Ottawa, this would have removed at least \$8 billion annually from provincial expenditures and added an even larger amount to Ottawa’s spending (the provinces appeared to be demanding that the federal government take on Pharmacare program responsibilities that exceeded those they were then carrying).<sup>29</sup> The effect of such fiscal actions – for Equalization, core health care funding and pharmaceuticals – would have cost the federal government \$15-20 billion annually. This was well beyond reasonable estimates of the current vertical fiscal imbalance.<sup>30</sup> At the same time, it is understood that from a provincial perspective, these fiscal demands may have simply been a bargaining position influenced in part by the recent federal record of underestimating federal revenues.

The fiscal actions of federal and provincial governments and interactions between them help to shape the way in which the Constitution operates in practice. When both federal and provincial governments have the fiscal autonomy and capacity to use their constitutional powers, the situation is much different than when one order of government has such autonomy and capacity and the other order does not or when some provinces have that capacity and others lack it. In this quasi-constitutional context, a vertical fiscal imbalance may have serious implications for the real world of politics by creating an unhealthy tension in the federation. This imbalance may make it difficult for provincial governments to meet their existing program and policy obligations without adding to the total taxpayer burden – an undertaking they may shy away from if they believe Ottawa is already overtaxing.<sup>31</sup> It may also tempt Ottawa to use the imbalance to impose new priorities on the provinces in areas of provincial legislative competence even when Ottawa is arguably underfunding old commitments, such as social assistance, health care and post-secondary education.<sup>32</sup> In this regard, the pressure may be most severe on the least wealthy provinces – those where the horizontal imbalances are greatest.

In fact, recent history supports this view. Conditionality on federal transfers and federal government social policy influence declined in the two decades that began in

1977 – 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.<sup>33</sup>

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>34</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 remaining imbalance can be measured in billions of dollars, not tens of billions, so the imbalance has become a relatively small part of intergovernmental fiscal relations. In this connection, anticipated increases in Equalization, while intended mainly to reduce horizontal imbalances, will have the effect of reducing federal surpluses. The federal government is also expected to improve funding for communities and while this chapter has expressed the view that this should be done via the provinces, rather than directly, in either case the vertical imbalance will shrink. The federal Liberal child care initiative could also have the effect of helping with vertical imbalance. In short, thus, as the vertical fiscal imbalance disappears as an issue, trust should improve.

Third, there is a need for greater transparency in the way both orders of government behave, relative to one another and the public. The unproductive exchange of "clever" positions between governments, over the last several years, about how much the federal government contributes to provincial health care programs, was a culmination of this growing mistrust. What is the public to think when Ottawa claims to pay for more than 40 percent of provincial and territorial health care costs and the provinces only a

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 such a commission could run from the modest (an annual analysis of the financial position and outlook of federal and provincial governments, a reporting on how much the federal government contributes to provincial coffers etc.) to the ambitious (e.g., reporting annually on progress in meeting constitutional objectives under Section 36 of the Charter, recommending revisions to the design of the Equalization Program or to its allocation). Given the lack of trust among governments, such an institution is worthy of serious consideration.<sup>35</sup>

The trust issue would be easier to tackle if Canadians were rallying around a new policy paradigm that commanded wide public support. Such transformations are most likely to occur, however, in the aftermath of war, depression or some other cataclysmic event. Happily, none of these has been part of the recent Canadian experience. For that reason, the public agenda for the years ahead is probably unlikely to be much different than recent experience, entailing trade-offs between socially progressive and fiscally conservative proposals. Policy is likely to reflect factors related to individual files rather than some overarching plan, and in the short run also to be subject to the vagaries of minority government in Ottawa. In turn, this may make policy developments relatively difficult to predict, which can be a particular strain on intergovernmental relations in a world of extensive intergovernmental interdependence.

At the outset of this chapter, there was reference to inconsistencies in federal policy. Inconsistency is not surprising in politics nor is it necessarily a bad thing (especially when surrounding conditions change). But when actions by one partner can badly destabilize the programs and finances of the other, there is a need for governments to plan for the unexpected – to ensure that as political and other pressures push them in one direction and then another, the interests of partner governments are taken fully

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. "A 10-Year Plan to Strengthen Health Care."

<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

*Keith Banting*

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### INTRODUCTION

For the vast majority of Canadians, debates about federal-provincial fiscal arrangements have a highly soporific quality. In 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 give expression to their sense of equity and to their sense of the distinctiveness of their country. Fiscal arrangements also have important implications for the type of democracy we practice. The transparency of government decision making, the openness of governments to citizen input, and the effectiveness of accountability mechanisms are all influenced by the fiscal arrangements we establish. Finally, our fiscal arrangements reflect choices about the nature of political community in this country. More precisely, intergovernmental fiscal relations reflect the prevailing balance between two different conceptions of community: one vision which celebrates Canada as a community embracing all citizens from one side of the country to the other, and the second which celebrates Canada as an interlinked set of regional communities or a community of communities. Seen in this light, our fiscal arrangements represent one of the ways in which we

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 alarums 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.<sup>1</sup> The willingness to pool resources with others in order to provide collectively for important social and health needs, and the willingness to redistribute toward poor and vulnerable individuals both depend on a sense of belonging to a larger group, a sense of common identity, a collective feeling of solidarity and responsibility for each other. This sense of a sharing community underpins key features of both the substance of social policy and the process through which it is defined. In substantive terms, the sharing community defines who is part of the network of shared obligation, for whom considerations of horizontal and vertical equity are relevant. Within the sharing community, the norm of horizontal equity applies; all individuals in similar circumstances are to be treated similarly with respect to social programs. The sense of community and solidarity also sustains support for vertical equity, to be pursued through vertical redistribution toward the poor. In process terms, the sharing community also defines the group within which political debates over the future of social policy occur and decisions are taken. Communities need not reflect a consensus on social policy; indeed, vibrant communities tend to be marked by active internal debates about the appropriate level of pooling and redistribution. But in a democratic society, the sharing community determines the domain within which the issues are engaged and the policies are defined.

The close relationship between social policy and community was given early expression by the British sociologist T.H. Marshall, who wrote during the expansion of social programs after the Second World War.<sup>2</sup> Marshall saw the welfare state adding a social dimension to the concept of citizenship, which he defined as a status granted to those

who are full members of a community. Marshall argued that over time the status of citizen in Britain – and by extension in other Western countries – had been invested with a formidable array of rights. In the 18th century, citizenship was associated with civil rights, such as liberty of the person, freedom of speech, thought and faith, the right to own property and conclude valid contracts, and the right to justice. Beginning in the 19th century, the rights of citizenship were extended to incorporate political rights, including the right to vote and the right to stand for office. Finally, in the 20th century, citizens acquired an increasingly broad array of social rights, represented in concrete terms by the social benefits and public services inherent in the welfare state. Marshall saw social citizenship as deeply related to the emergence of a shared sense of community. In his interpretation, the expansion of the meaning of citizenship was part of a powerful historical process of social integration, which was steadily incorporating emerging social classes into a national community. While social benefits did not eliminate the economic differences among citizens, they did generate a new equality of status, a symbolic moral order that would mitigate the divisiveness of economic inequalities. The relationship between citizenship and community was reciprocal. In part, the rights of citizenship reflected the emergence of an underlying national consciousness, a growing sense of a common identity. But citizenship rights, once established, in turn reinforced this growing sense of community, serving as an instrument of social integration in divided societies.

In focussing on his native Britain, especially in the mid-20th century, Marshall was writing about the experience of a highly centralized, unitary state. The relationship between social citizenship and community is more complicated in federal systems, where citizens are simultaneously members of two political communities: the community of all citizens across the country as a whole, and the community of residents of the region in which they live. The basic purpose of federal institutions is presumably to create room for regional communities to make different choices about programs that matter in people's day-to-day lives. At first blush, therefore, the logic of social citizenship and the logic of federalism would seem to stand in tension with each other. The promise of social citizenship is the equal treatment of all citizens of the country. The promise of federalism is regional diversity in public policies, reflecting the preferences of regional communities and cultures. Stripped to its core, the logic of social citizenship holds that a sick baby should be entitled to public health care on the same terms and conditions wherever he or she lives in the country. Stripped to its core, the logic of federalism holds that the public health benefits to which a sick baby is entitled also depend significantly on the region in which he or she resides. Establishing a balance between these two logics is a central task in federal welfare states.

There is a spectrum of possible choices here (see Figure 1, p.48). At one extreme, the entire country might be viewed as the exclusive community for redistributive purposes. In this case, social programs would apply nationwide as in a unitary state, and decisions about the extent of that redistribution would be made by the political representatives of the country as a whole. The norm of horizontal equity would apply across

the entire country: persons in similar circumstances would receive similar treatment irrespective of the region in which they live. And the extent of vertical equity pursued would depend upon the national political consensus about how much support should be provided to poor and vulnerable groups.

At the other extreme, one might think of the region as being the exclusive sharing community. According to this view, redistribution would occur among residents in each state or province. The extent of vertical redistribution, and the concept of horizontally equitable treatment, would both apply at the regional level, and each regional government would define the scope of redistribution separately. In this case, there would likely be considerable variation across states or provinces. Different regions tend to have different fiscal capacities for achieving redistributive goals; they have different demographic and geographic structures; and their citizens may well reach different consensuses on redistribution.

The exclusive countrywide and the exclusive regional communities represent two extreme poles in the spectrum of choices facing a federation. We can virtually rule out both extremes in the case of the Canadian federation. The exclusive countrywide case would be incompatible with any provincial differences in social policy, which is inconsistent with the constitutional and political realities of Canada. The exclusive provincial case would rule out any role of the federal government in redistribution; it would preclude, for example, equalization of the fiscal capacity of provincial governments, as well as any effort to design federal taxes so as to accomplish redistributive goals. It is necessary therefore to consider cases in which the two communities co-exist, with some degree of countrywide sharing co-existing with different degrees of sharing within provinces. Indeed, one might argue that this is the nature of a federation. Countrywide sharing would reflect the idea that citizenship in a country entails some expectation of comparable treatment in social policies. But the federation itself is made up of separate regional communities, some of which might have greater feelings of solidarity than others, giving rise to diversities in social policies.

As a result, the realistic range of options is better illustrated by the three positions between the poles of the spectrum in Figure 1: predominant Canada-wide sharing; predominant provincial sharing; and dual sharing. The *predominant Canada-wide* version takes the country as a whole as the primary sharing community, and defines the extent of redistribution or social justice in countrywide terms. In this version, all citizens enjoy an approximation of full social citizenship in the Marshallian sense, that is, they enjoy similar social benefits no matter in which province they reside. This vision of countrywide sharing implies that political representatives from across the country as a whole establish a comprehensive blueprint for social benefits. Putting it into place then depends on a mix of federal and provincial action, with some components perhaps being delivered directly to citizens by the federal government and other components by the provincial governments. Those components delivered by provincial governments, however, are accompanied by full fiscal redistribution between provinces, to equalize the fiscal capacity of rich and poor provinces, and strong

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 region might prefer predominant Canada-wide sharing and another the predominant provincial model. The possibility of regional differences in the sense of attachment to community raises the possibility of asymmetrical relationships between the federal and provincial governments in a federation. Asymmetry has been a recurring feature



of constitutional discourse and to some extent policy practice in Canada. The history of our constitutional debates of the last half century is replete with proposals which, while differing in their specifics, sought to recognize Quebec as a distinct society, with a different sense of attachment to the wider Canadian federation. All of these proposals sparked opposition rooted in an insistence that all provinces are equal, and none survived the political battles over constitutional reform. In practice, however, important elements of asymmetry have become part of Canadian social policy over the years through the fiscal arrangements or policy decisions, such as those surrounding the Canada and Quebec Pension Plans.

In summary, intergovernmental relations in a federal welfare state are deeply entwined with the underlying sense of community, and the social context within which individuals feel a shared sense of obligation for each other's well-being. Where a federation chooses to locate itself along the spectrum has powerful consequences for the role of the federal and provincial governments, and the design of fiscal arrangements between levels of government. Once in place, an intergovernmental fiscal arrangement both reflects and reinforces a distinctive sense of community in the country.

### **DEFINING THE SHARING COMMUNITY IN FEDERATIONS**

Federations locate themselves in different places along the spectrum in Figure 1. This variation can be illustrated briefly for the case of health care.<sup>3</sup> Interestingly, most federations in practice give substantial weight to the idea of countrywide sharing in health policy.<sup>4</sup> To be sure, virtually all federal states engage both the central government and provincial or state governments in health care, making multi-level governance the norm in the sector. Nevertheless, federal countries also tend to organize themselves so as to achieve a significant element of countrywide sharing. Typically, legislation passed by the central government sets a general policy framework that defines key parameters of the health care system for the country as a whole. In many federal countries, the central government also delivers large health care programs itself, dealing directly with citizens and service providers. Moreover, where state or provincial governments manage elements of the system, they typically operate within broad parameters defined for the country as a whole by the central government. And they normally rely for an important part of their financing on federal transfers, transfers which incorporate a significant element of interregional redistribution. Figure 2, (p.48) provides a summary of the relative strength of the central policy frameworks and the interregional redistribution in a selection of federal states.

Although the balance between levels of government does differ significantly from one federation to another, the central government in major federations plays a larger role than in Canada. Following are some examples.

- In Belgium and Germany, the policy parameters are defined in a highly centralized and corporatist process. The federal legislature incorporates the resulting agreements in framework legislation that specifies in detail key features of the system for the country as a whole. Program delivery then proceeds on a decentralized basis through networks of social funds.
- In Switzerland, health insurance is a federal responsibility. Federal legislation establishes a universal obligation on all residents to insure themselves with a private company, and specifies the package of services that companies must include in the basic health insurance scheme. Federal legislation also establishes a risk-equalization scheme designed to offset skimming by companies; and federal-cantonal transfers compensate for the impact of insurance premiums on low-income individuals.
- In Australia, the Commonwealth government plays the dominant role in two ways. First, it takes direct responsibility for major parts of the Medicare system, providing for access to doctors, pharmaceuticals and nursing homes through programs that are administered by federal agencies operating on similar terms and conditions across the entire country. Second, the Commonwealth provides a special purpose transfer to state governments to support public hospital care, and attaches highly detailed requirements concerning targets and auditing with which states must comply. The result is a national health care system that operates on a similar basis across the country as a whole.
- In the United States, public health programs represent a bipolar case. Medicare, which covers elderly and disabled Americans and represents two-thirds of total public health expenditures, is a purely federal program. Congress determines the basic policies, and a federal agency delivers the program across the country as a whole. The federal government also provides significant health services directly to military personnel and veterans. Support for poor Americans, however, represents a sharp contrast. Medicaid and the State Child Health Insurance Program are federal-state programs supported by federal conditional grant programs. Federal conditions are very general, and state programs here vary considerably in eligibility, service coverage, utilization limits, provider payment policies and spending per recipient.

Overall, as Figure 2 indicates, federal states have tended to approach a countrywide sharing community in health care, such that a sick baby in one region receives health care on comparable terms and conditions as a sick baby in another region. The one partial exception among the five major federations surveyed here concerns coverage for poor American families and children. Otherwise, the primary form of territorial variation in health services in federations tends to be urban/rural differences rather than regional differences, as is the case in unitary states. That is, differences between urban and rural areas within regions tend to be much greater than differences between regions.

## 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.<sup>5</sup> 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.

In the specific case of health care, the countrywide framework is less detailed than in other federations. In contrast to Australia and the United States, the federal government does not provide health coverage directly to citizens generally; in comparison with many other federations, the conditions attached to intergovernmental transfers are less detailed; and the shift to bloc funding largely eliminated day-to-day federal scrutiny of specific provincial decisions. In comparative terms, the Canadian health system is clearly more decentralized, and is best thought of as an interlocked series of provincial and territorial health care systems. The five principles of the *Canada Health Act* and the interregional transfers embedded in our fiscal arrangements do sustain reasonably comparable standards in key health services across the country as a whole, but interregional variation is greater than in other federations. Provinces vary at the margins in the range of services that are deemed medically necessary from one province to the next. There is also variation in the mix of doctors, nurses and hospital beds provided across the country.

Nevertheless, the importance of the *Canada Health Act* is highlighted by the much greater regional differences in services that fall beyond its ambit, such as home care and drug therapy outside hospitals. Drug insurance differs sharply across the country. Provincial programs tend to cover low-income senior citizens and social assistance recipients in all regions, but coverage of other citizens varies considerably, with substantial gaps remaining, especially in Atlantic Canada. There are no public drug plans to cover the entire population in this part of the country, and private coverage also tends to be more restricted.<sup>6</sup> In addition to such gaps in coverage, many more Canadians and their families are under-insured, in the sense that they can be placed in financial jeopardy by catastrophic drug costs. Home care also varies greatly across the country. Although each province and territory offers some form of home care, there are major differences in eligibility, the proportion of those needing care who are covered, the range of services provided, and the level of user fees. All jurisdictions offer services such as assessment, nursing care and home support for those they deem eligible. But only some provincial programs provide physiotherapy, speech therapy and respiratory therapy.<sup>7</sup>

The growing importance of these services that fall outside the *CHA* umbrella raises important questions about the future definition of the sharing community in Canada. When the countrywide framework was established in the postwar decades, hospital and physician services represented the core instruments in health care. In the contemporary period, however, drug therapies and home care are rapidly growing components of the sector. The fact that they also fall outside the pan-Canadian policy framework means that the model of social citizenship that applies in health care is more heavily modified with each passing year.

In summary, Canadians have long been committed to sharing both within their regional communities and across the country as a whole, and they expect both levels of government to respond to important social needs such as health care. During the postwar era, Canada established its own version of a dual sharing community in

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.

## COMMUNITY, FEDERALISM AND FISCAL ARRANGEMENTS

In federal systems, every generation must judge anew the relative strength of their attachments to the different political communities in which they live. In the Canadian context, these reassessments are conducted in part through the periodic revisions to the fiscal arrangements between our federal and provincial governments. So it is in the current period. The issues on the intergovernmental table all touch in some way on the prevailing conception of the sharing community, and virtually all of the proposals being advanced with vigour on the various sides have the capacity to shift Canada in different directions along the spectrum in Figure 1. In this field, an agnostic approach to community is impossible. There is no safe domain of purely technical adjustments. Indeed, as we have seen, even inaction in a world of changing social needs is consequential.

The implications for the balance of communities can be illustrated by reference to several key debates over fiscal arrangements in general and in the area of health care in particular. One example is the debate over vertical fiscal imbalance. Other chapters in this volume assess the contending views of whether there is or is not a vertical fiscal imbalance in Canada. However, if one assumes for a moment that the fiscal pressures are currently more severe at the provincial level and that the federal government should respond, then the nature of its response is critical. Some approaches would significantly reduce the commitment to Canada-wide sharing. For example, some have suggested converting bloc funding into a straight tax point transfer to the provinces. The main recommendation of the Séguin Commission in Quebec was to abolish what was then the combined CHST and have the federal government transfer the GST as an own-revenue source to the provinces.<sup>8</sup> Such recommendations represent more than technical adjustments to intergovernmental finances. They represent a different conception of the nature of the country. In the terms developed here, such a proposal, if adopted, would shift health care from the dual sharing model to the predominantly provincial conception of the sharing community.<sup>9</sup> In terms of substance, it would spell the end of a countrywide policy framework, which establishes five basic principles of health care provision and ensures a broadly comparable approach to health services across Canada. In terms of process, it would spell the end of the need to engage with Canadians from coast to coast to coast in a countrywide debate about the future of health care.

If Canadians wish to maintain some form of dual sharing communities in health care, then cash transfers to provinces are the critical instrument. To be effective, this approach requires sufficiently strong federal funding to ensure that federal policy parameters are credible and effective. Some commentators have proposed a return to a global cost-sharing approach, perhaps at the level of 25 percent of aggregate provincial health expenditures. Others have suggested the reinstatement of an automatic escalator for the Canada Health Transfer (CHT). Such proposals would go an important distance to reinforcing the moral and political credibility of the federal government to sustain a meaningful countrywide framework through the *CHA*. Both the level and the predictability of federal funding are important. As in the case of interpersonal trust, nurturing intergovernmental trust requires transparency and predictability in relationships.

A second issue in the current debate also illuminates the importance of a clear-sighted assessment of the implications of the design of funding arrangements for an underlying sense of community. As we have seen, the growing importance of Pharmacare and home care represent a slow, quiet narrowing of the dual sharing model, with its promise of a modified social citizenship in health care. Inaction is a recipe for a slow but steady narrowing of the role of social citizenship in Canadian life. However, incorporating these increasingly important instruments into the dual sharing model cannot be accomplished by simply increasing transfers flowing through the CHT. Creating a countrywide set of policy parameters in this area – and thereby adding these programs to the modified social citizenship that shapes the traditional components of health care in this country – would require repeating the precedent established for hospital and medical services. At the outset, this would involve new transfer programs, with a stronger shared-cost component than is currently embedded by the CHT. When established, these programs might then be incorporated into the general bloc fund transfer mechanism.

## CONCLUSIONS

Federal states such as Canada must decide on the boundaries of the community within which the pooling and sharing of resources take place. While the programs that implement such decisions are often extremely complex, the underlying questions that drive the decisions are actually very simple. Are our commitments to each other bounded by the pan-Canadian community of all citizens, the community of people living in our own province, or a mix of both? Or to pose the questions in other words: is the goal to establish social benefits as an element of “social citizenship” such that all citizens receive benefits on the same terms and conditions irrespective of where they live? Or is the goal simply to ensure that all regions have the potential to establish the same level of social programs if they wish? Or is the goal somewhere between these two poles, reflecting a dual sharing community that promises comparable but not identical programs across the country as a whole?

Understandably, specialists in the field of intergovernmental fiscal relations are often uncomfortable with such large, messy questions about the nature of their country. They can certainly be forgiven if they secretly yearn for a world in which debates about fiscal arrangements were truly devoid of such questions, and concentrated solely on more easily managed technical questions and adjustments. But alas, there is no escape. The complex set of fiscal arrangements between the federal and provincial governments, and the billions of dollars that flow through them every year, give expression to a uniquely Canadian blend of communities. As a result, the processes of reforming those arrangements is inevitably about the nature of the country, and the ways in which that blend of communities is to be nurtured and altered in the years and decades to come.

**Figure 1**  
**Choices of Sharing Communities in a Federation**

- 
- |   |   |   |   |   |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|
1. Exclusively countrywide
  2. Predominantly countrywide
  3. Dual sharing
  4. Predominantly regional
  5. Exclusively regional

**Figure 2**  
**Interregional Variation in Health Care: Instruments and Outcomes**

Country	Instruments: Specificity of Policy Framework	Interregional Transfers	Outcomes: Interregional Differences in Health-Care Systems
Belgium	high	high	low
Germany	high	high	low
Australia	high	high	low
United States	medium	low	medium
Canada	low	medium	medium

*Source:* Keith Banting and Stan Corbett, "Health Policy and Federalism: An Introduction," in Keith Banting and Stan Corbett, editors, *Health Policy and Federalism: A Comparative Perspective on Multi-Level Governance* (Kingston and Montreal: Institute of Intergovernmental Relations and McGill-Queen's University Press, 2002), Figure 2.

Notes

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<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, editors, *Money, Politics and Health Care: Reconstructing the Federal-Provincial Partnership* (Montreal: Institute for Research on Public Policy, 2004).

<sup>2</sup> T.H. Marshall, "Citizenship and Social Class," in T.H. Marshall and T. Bottomore, editors, *Citizenship and Social Class* (London: Pluto Press, [1950] 1992).

<sup>3</sup> For a fuller assessment that captures variation across federations in both income transfers and health care, see Herbert Obinger, Stephan Liebfried and Francis Castles, editors, *Federalism and Social Policy: Comparative Perspectives on the Old and New Politics of the Welfare State* (Cambridge: Cambridge University Press, forthcoming).

<sup>4</sup> See Keith Banting and Stan Corbett, editors, *Health Policy and Federalism: A Comparative Perspective on Multi-Level Governance* (Kingston and Montreal: Institute of Intergovernmental Relations, Queen's University and McGill-Queen's University Press 2002), especially chapter 1.

<sup>5</sup> The next two paragraphs draw on the survey data on public attitudes to be found in Mendelsohn 2001.

<sup>6</sup> Standing Senate Committee on Social Affairs and Technology, *Issues and Options*, vol. 4 of *The Health of Canadians: The Federal Role. Interim Report* (Ottawa: Queen's Printer for Canada, September 2001), table 1, p. 75.

<sup>7</sup> Standing Senate Committee, 2001, vol. 4, p. 81.

<sup>8</sup> Quebec Commission on Fiscal Imbalance (Séguin Commission), *A New Division of Canada's Fiscal Resources* (Quebec: 2002).

<sup>9</sup> It is arguable that this degree of tax transfer would also make it difficult to preserve even the minimal level of countrywide sharing implicit in the predominantly provincial conception by making it difficult to sustain a robust Equalization system. See Banting and Boadway, "Defining the Sharing Community," p. 68.



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## THE VERTICAL FISCAL GAP: CONCEPTIONS AND MISCONCEPTIONS

*Robin Boadway*

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### 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. The fiscal arrangements are now at a crossroads. What has been put in place has evolved more or less by default and is clearly transitory in nature. No firm formula exists for the evolution of the Canada Health and Social Transfer (CHST) which as of 2004 is split into the Canada Health Transfer (CHT) and the Canada Social Transfer (CST). Equalization has been under unparalleled scrutiny as it came up for renewal. Seemingly contradictory views inform the role of the federal government in the financing of health care. Various parties have put their cards on the table about where the system of fiscal arrangements is, and where it should be heading. The gauntlet has been thrown down by the report of the Séguin Commission (Commission on Fiscal Imbalance 2002), which effectively challenges us to justify even the seemingly innocuous CHT/CST. It is clearly timely to have yet another fresh look at the balance of spending, taxing and transferring powers that exist in the Canadian federation, lest it all be settled by a continuing series of cumulative moves taken more or less without debate in the confines of offices of officials at both levels of government engaged in budget preparations.

It is worth at the outset sorting out some semantics. The terms “vertical fiscal gap” (VFG) and “vertical fiscal imbalance” (VFI) have been used in various contexts, often interchangeably. They seem to mean different things to different persons. For our pur-

poses, it is useful to refer to them as distinct 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 system of transfers from the federal government to the provinces, which themselves serve a useful purpose. Of course, the VFG defined in terms of ideal or optimal differences between expenditure and revenue-raising responsibilities is itself far from a precise concept. This is because arguments about the optimal degree of decentralization are themselves not precise, and moreover are subject to much disagreement.

The term VFI implies more than a gap: it seems to imply that the gap is not being adequately filled. The existence of a VFG need not necessarily mean that there is an imbalance. Only if federal-provincial transfers differ from the ideal VFG is there an imbalance. Moreover, the imbalance can go in favour of either the federal or provincial governments. If federal transfers fall short of the optimum, provinces will end up with some combination of expenditures that are too low, taxes that are too high, and deficits that are too high; and the opposite applies for the federal government. Obviously it is very difficult to measure whether there is a VFI or not, and if so, in which direction it runs. To do so one needs to start with ideal levels of expenditure of the two levels of government. Given these, the division of tax room and the size of transfers must be such that both levels of government can just finance their spending. The existence of debt makes matters difficult, since one also has to specify optimal debt levels relative to, say, GDP, for both levels of government. Moreover, one must separate transitory from long-term effects, and take account of the possibility of policy changes into the future. These are very difficult tasks, and ones that we shall make no attempt to undertake or evaluate. It is certainly not surprising that different authors come up with different estimates.<sup>1</sup>

Our focus will be more on the VFG, especially on arguments for and against the existence of larger versus smaller levels of VFG. The substance of many concerns with the so-called VFI is at least in part over the ideal VFG. The arguments of the Séguin Commission are instructive in this regard. Their main proposal of replacing the CHT/CST with a transfer of Goods and Services Tax (GST) room to the provinces is intended both to eliminate what they estimate to be the current VFI and at the same time to move the system to what they regard as the appropriate VFG (one that eliminates the ability of the federal government to use the spending power as a device for influencing the design of provincial spending programs).<sup>2</sup> Their VFI estimate is for the short run alone; over the longer run, it would grow continuously given the current set of policies. To the extent that their calculation of the VFI is reasonable – which it does seem to be – it would presumably have to be addressed one way or the other in the coming years. What is more contentious is their argument that the ideal size of transfers should be minimal. This is an argument about the optimal VFG. We shall set aside disagreements about the size of the VFI, and concentrate on the more substantial issue of what considerations lead to different views about the VFG.

## 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, constitutional 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 nonetheless significant in their consequences (arguably much more significant than the actual conditions might imply). The federal government's influence over provincial behaviour is, however, much less intrusive than in most other federations. There are no mandates, major matching grants or legislative oversights, such as one finds in countries like Australia, Germany and the United States. The Equalization system is not unique, except in the specifics of its design. Apart from the United States, most federations (and even unitary states) have well-developed Equalization programs. Even the United States achieves considerable indirect Equalization through its conditional grant system.

Provincial-municipal fiscal arrangements parallel in some respects those at the federal-provincial level, but diverge in others. There is a sizeable VFG between provinces and their municipalities, which is again reflected in transfers. And, provincial-municipal transfers contain both equalizing and conditional elements. However, in other ways the municipalities are much more reliant and dependent on the provinces than are the provinces on the federal government. Their discretion to raise revenues is limited, and their expenditures are much more constrained and influenced by their provincial governments. They, too, are subject to the whims of their provincial governments, and from time to time are subject to unanticipated shocks.

The unpredictable nature of federal-provincial or provincial-municipal transfers is not due solely to the discretionary actions of the granting government. Recent studies have shown that the Equalization system, while an essential instrument for fiscal equity, is a significant source of instability in provincial government revenues.<sup>3</sup> A given province's entitlements not only insure a province against adverse changes in its own

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 second feature of the evolving federal role, and one that is presumably not unrelated to the first, is the growing tendency of the federal government to engage in direct transfers to households rather than to provincial governments. Examples of this include the system of refundable tax credits that complements provincial social assistance schemes by redistributing directly to the needy, and direct transfers to students in post-secondary education institutions that affect the provincial role as supplier of university education. Schemes such as these can, in part, be viewed as alternatives to conditional transfers to the provinces.

Finally, one other feature of the current system of transfers is distinctive, and that is the role of discretion in determining the size of transfers and their growth. It has been a feature of the CHST/CHT/CST that its rate of change over time has not been determined by an objective escalator, but is chosen by the federal government presumably on the basis of affordability. It is true that the federal government has announced allocations for future years. It is also true that escalation rates of previous transfer systems (including EPF and Equalization) have sometimes been honoured in the breach. But formula-driven transfers, if adhered to by the federal government, have the advantage of predictability (at least to the extent that the growth of the escalator is itself predictable). It is instructive to note that the projections of the Séguin Commission that were used to predict the evolution of the VFI were based on an assumption of constant real per capita CHST/CHT/CST transfers, that being their view of current federal policy.

## 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, are apparently legitimate. One feature of the division of powers is important to note: both levels of government are heavily involved in programs of redistribution. In the case of the federal government, this includes its responsibility for unemployment insurance, its ability to make targeted transfers, its shared jurisdiction over pensions, and its ability to implement a progressive income tax system. At the same time, provincial responsibilities in the areas of health, education and welfare, as well as their increasing importance in the income tax field, make them comparable partners in achieving the redistributive equity objectives of the modern welfare state. This co-responsibility for redistributive matters will be of great importance to our discussion of the rationale for a VFG.

### The Spending Power

The ability of the federal government to use the spending power to make conditional transfers to the provinces in areas of exclusive provincial jurisdiction has been upheld repeatedly. Where the spending power has been overturned has been in cases where it was part of a program of social insurance in which benefits were related somehow to contributions – unemployment insurance and contributory pensions. The spending power is in fact a widely used policy instrument in federations around the world, and its use in Canada is actually much more innocuous than elsewhere.<sup>4</sup> The main objections to its use are political rather than legal.

### Equalization

Section 36(2) of the Act famously commits the federal government to the “principle” of making Equalization payments to the provinces so that they are able to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. The vagaries of this commitment are well known. The clause may not be justifiable.<sup>5</sup> The inclusiveness of the meaning of public services is not clear, nor is the interpretation of the adjective “reasonably.” Nonetheless, Section 36(2) embodies a concept of societal sharing that, as we shall argue, has important implications for the broad design of the fiscal arrangements, and the place of the federal government in them.

### **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 efficiency in the Canadian federation, there is a potentially powerful pronouncement of the former in Section 36(1) of the Act, usually taken to be a poor cousin of Section 36(2). This clause jointly commits the federal and provincial governments to such important equity objectives as equality of opportunity for Canadians, reduction in regional disparities, and the provision of essential public services of reasonable quality to all Canadians. While this admits of a variety of interpretations, the thrust of Section 36(1) seems clear. It is a statement of the aspiration of Canadian society to put all Canadians on an equal footing with respect to at least some of the important public services that are provided. What is important to note for our purposes is that some of the important public programs that would presumably naturally fall within the purview of Section 36(1) are the responsibility of the provinces, yet the federal government has a commitment in principle to see that they are delivered at a reasonable quality level to all Canadians. As with Section 36(2), the imperatives of Section 36(1) are far from definitive. Yet, they also lend support to the notion developed below that a nationwide notion of community sharing is an accepted feature of the Canadian policy landscape.

### **Efficiency**

Unlike the case of equity, there is little guidance in the Act about the role of the federal and provincial governments with respect to efficiency. There is a relatively weak internal trade clause (Section 121), but no general statement of principles along the lines of Section 36. Yet, the objective of efficiency in the internal economic union and the special interest the federal government has in fostering it are seemingly widely accepted. Previous rounds of constitutional negotiation, as well as provincial proposals, have often elevated the matter to a constitutional principle. And, those elements of conditionality that reflect efficiency considerations – such as mobility and portability requirements for provincial social programs – are much less controversial than those based on equity criteria.

One of the consequences of the *Constitution Act, 1982* and the way its interpretation has developed over time is that there is an inevitable overlap of interests between the federal government and the provinces. Important public services are rightly decentralized to the provinces. Yet their provision has a bearing on equity and efficiency objectives that are of national interest. The fiscal arrangements can be seen as a device for facilitating the decentralization of fiscal responsibilities so as to achieve the most efficient provision of public services, while at the same time ensuring that national

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.

#### Redressing 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 insurance (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 to 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*.<sup>6</sup> 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*. To 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 related to the extent to which the nation is the sharing community rather than the provinces, that is, the extent to which common standards of redistribution should apply nationwide. It is not primarily related to the progressivity of the redistribution system per se. That is, it is a consequence of the application of the principle of horizontal equity rather than vertical equity. If the province

is viewed as being the sharing community, there will be limited need for a VFG no matter how progressive or regressive are provincial tax-transfer systems. Now, it may well be the case that national sharing entails more redistribution than provincial sharing, for example, because of interjurisdictional competitive pressures that exist at the provincial level. But, the intention of a VFG is not primarily to generate more redistribution. Rather it is to apply a common extent of redistribution, and the horizontal equity that entails, nationwide.

Equity is not the only economic consequence of the choice of sharing community, although we would argue that it is the main one. Efficiency considerations apply as well. It is well known that decentralization can induce both efficiencies and inefficiencies in resource allocation. Efficiencies might arise from the Tiebout (1956) sorting mechanism, whereby individuals migrate to communities that offer the mix of public goods, public services and taxes that best suits their preferences, including presumably their preferences for redistribution. At the same time, inefficiencies arise because of differences in net fiscal benefits that different communities are able to provide. To the extent that the nation is the sharing community, inefficiencies of the latter sort are avoided since comparable packages of taxes and benefits await a person no matter where they reside. But, there is then no scope for different community preferences for redistribution that would satisfy Tiebout efficiency. The latter could only be achieved by allowing for some provincial sharing. A compromise that took advantage of Tiebout sharing while minimizing the inefficiencies of migration that would otherwise occur would be to have a full system of equalization that equalized the potential for equal net fiscal benefits to be provided in all provinces.

The importance of these efficiency considerations for designing the fiscal arrangements turns on: i) whether there is enough migration to make a difference, and ii) whether persons migrate to satisfy their preferences for policy mixes as opposed to purely financial stimuli. The empirical evidence on this is rather inconclusive. Until recently, it has been argued that migration responses were not of sufficient magnitude to warrant concern about fiscally induced migration. However, Wilson (2003) has recently called that into question. He has argued convincingly that once one treats migration as a stock rather than a flow concept, fiscally induced migration can be a significant source of inefficiency unless offset by an appropriate equalization system.

Finally, before turning to the arguments for and against a VFG, one further ingredient into the outcome of government decisions might be added. One's views about the division of responsibilities, especially given the importance of the redistributive role of government, will be heavily influenced by one's views of how governments behave. Are they benevolent in the sense that their decisions faithfully reflect the consensus views of their constituents? Or are they self-serving and subject to undue influence from special interests, bureaucracies, and particular elements of their voters? To the extent that one views governments as non-benevolent, decentralization may serve as a device for disciplining lower-level ones. As well, considerations of accountability may well take on extra importance.

## 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 position 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,<sup>7</sup> 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 Séguin Commission. For this to be an efficient outcome, provinces would presumably have to adopt efficient sales 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 basis and including virtually all market transactions can be administered in a setting with no border controls. The seeming success of the QST has led some observers to

suggest that it is a feasible option.<sup>8</sup> The QST is able to circumvent the border control problem by a combination of zero-rating of exports from the province and deferred tax payments on imports into the province. Whether this would remain administratively feasible if all provinces adopted VAT systems is an open question (especially if the administration were all done at the provincial level as in the case of the QST). The HST is more attractive from an administrative point of view, but effectively sacrifices provincial revenue-raising authority. It is more like a revenue-sharing scheme for participating provinces since they do not have independent tax-setting authority.

Perhaps the most important caveat to the argument that decentralized revenue raising is unlikely to suffice to finance provincial spending responsibilities is the seeming ability of the federal and provincial governments to share the lucrative income tax base without jeopardizing the integrity of a harmonized system. As long as a harmonized base and a single tax-collecting authority remain intact, the simultaneous tapping of that base by provincial and federal governments affords ample opportunity for both levels to assume responsibility for raising their own revenues in a way that respects the efficiency of the internal economic union. It is true that there are a number of potential problems with joint federal-provincial access to the income tax, especially as the share of the tax room occupied by the provinces increases. Under the new tax-on-income variant of tax harmonization, provinces may well engage in competition in rate structures.<sup>9</sup> Moreover, they may find that even the strictures imposed by the tax-on-income system may give them too little policy leeway, tempting them to opt for their own separate income tax systems. This would be a potentially significant blow to the efficiency of the internal economic union, given the ability of provinces to use the income tax system to draw businesses and talented persons from each other.

These considerations suggest that for the current system to remain viable, the federal government must continue to occupy a significant portion of the income tax room, although just how significant is not clear. A dominant federal position is one way to make it more likely that the Tax Collection Agreements will be perpetuated, with a common federal tax base and a single tax-collecting authority.<sup>10</sup> This will also allow the federal government the leeway to affect its chosen standards of redistributive equity in the income tax system, including the important element achieved by refundable transfers. (This, of course, presumes one wants there to be national standards of redistributive equity to begin with, which is addressed further below.)

Despite the presumed limitation on the amount of tax room one would want to devolve to the provinces, the combination of provincial access to the three main broad tax sources would seem to suffice now and for the foreseeable future to provide provinces with enough revenue-raising ability such that a VFG is not absolutely necessary. There would be a danger that ultimately the tax harmonization that we have come to take for granted would be sacrificed. Whether that by itself would be enough to warrant a positive VFG in the absence of other arguments is not clear. Therefore, we should look elsewhere for a more solid justification for the VFG.

### **Perspective II: The Role of Federal-Provincial Transfers**

Under the first perspective, a VFG is not useful in its own right, but arises only as a consequence of a presumed mismatch of expenditure and revenue-raising assignment. The second perspective views the VFG as useful and necessary in and of itself. The argument is that federal-provincial transfers are important policy instruments for the federal government to use to achieve legitimate objectives of a national nature.<sup>11</sup> The general argument is that while decentralization achieves important efficiencies in the way in which public services, targeted transfers and local public goods are delivered, it also leads to potential inefficiencies and inequities in the national economy. Federal-provincial transfers can serve as an antidote, in fact, the only feasible antidote given constitutional and political restrictions on other possible federal policy instruments (such as mandates, disallowance, regulation, etc.). Indeed, the existence of federal-provincial transfers is a necessary complement to fiscal decentralization.

It is useful to distinguish between national efficiency objectives and national redistributive equity objectives. The role of the federal government addressing the former is both less controversial and less important than the latter. Apart from the standard efficiency – or market failure – arguments that motivate government intervention in a market economy, there are three particular types of efficiency consequences for the national economy that arise in a federal setting. Each of these has potential implications for federal-provincial transfers.

### **Interprovincial Spillovers**

The classic argument for matching conditional grants arises from the idea that spending programs in one province yield spillover benefits to neighbouring provinces. The analogy with externalities led economists to suggest that matching provincial program expenditures at a rate equal to the size of spillover would appropriately “internalize” them and ensure efficient provision. As seductive as this argument has been to economists, it seems unlikely to account for the extensive use of matching grants in the past (and their continued use in other jurisdictions). The use of matching grants in areas like health, welfare and post-secondary education, as well as in specific areas like transportation, can more readily be rationalized on a couple of other grounds. First, the matching component might have been viewed as necessary to induce provinces to institute programs that they might not otherwise have instituted. Once the programs were in place, matching grants were often converted to bloc arrangements designed to maintain the then-established programs.<sup>12</sup> Second, matching grants, at least in the case of welfare, could be viewed as reflecting the needs of provinces, thereby adding an element that would otherwise have been missing from the Equalization program. The matching was ultimately scrapped because it was recognized that it was quite unnecessary on spillover grounds, and caused unwanted incentive effects. In short, the spillover argument cannot be used as a serious argument for the VFG.

### **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.<sup>13</sup> Suffice it to say that a strong case can be made for full equalization of all provincial revenue sources, and perhaps also of differential provincial expenditure needs resulting from demographic characteristics. The strength of the efficiency case for equalization depends upon how much interprovincial mobility there is. However, as is also well known, the case for equalization need not rest on efficiency considerations alone. If it did, the case would be less compelling than it is in practice. In any case, Equalization can be used as an argument for a VFG, but of indeterminable size. In fact, no VFG is needed in principle to achieve the objectives of equalization; a system of net equalization in which transfers to the have-not provinces are financed by payments by the have provinces with no federal revenue required would do the job. However, such a system might be difficult to sustain, since it would require that some provinces be compelled to transfer funds to others.<sup>14</sup> There are examples of net equalization systems in Germany and Sweden, but such systems are sustained by political systems in which higher levels of government have considerably more influence over lower-level governments than is the case in Canada, and in which larger VFGs also exist. In the more likely event that equalization must be a gross system, a VFG would be called for simply to finance the scheme.



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 considerations might require more transfers if needs were inverse correlated with revenue-raising ability. To secure political legitimacy and permanency (and maybe even to preclude the requirement to decentralize tax room to the provinces on grounds of harmonization considerations) might require an even larger VFG. An important point to note is that a transfer scheme such as the CHST is effectively a form of equalization in two senses. First, by retaining enough federal tax room to finance CHST-type transfers, NFB differentials that would otherwise arise and have to be equalized are reduced. Second, the structure of CHST payouts can be designed to reflect needs. Even the current equal per capita payout does that to a certain extent.

The considerations that we have focused on so far do not yet in themselves provide a compelling rationale for a VFG. To do so, we must turn to redistributive arguments. We have already suggested that governments are, to a large extent, institutions for redistribution in all its forms. It should not be surprising that this spills over to the fiscal arrangements in a compelling way. There are a variety of ways in which fiscal decentralization to the provinces can affect redistributive equity. Three important ones, which parallel the sources of inefficiency listed above, are as follows.

### **The Race to the Bottom**

To the extent that provinces have responsibility for achieving redistributive equity, interprovincial competition may provide an incentive for them to offer less generous levels of redistribution than the consensus of their citizens might warrant. This can arise from the mobility of either high-skilled or low-skilled residents, and also from the mobility of businesses that employ skilled workers. The result can be transfers to the needy that are too low, tax systems that are less progressive, and in-kind transfers that are less generous than would be the case in the absence of such competition. These competitive pressures apply less at the national level than at the provincial, implying that more redistributive equity might be pursued nationally than provincially even if the two levels of government had similar attitudes toward the value of redistribution. To offset this, the federal government might offer transfers with conditions that induce the provinces to maintain some minimum standards of redistribution.

### **Fiscal Inequity**

Fiscal inequity is the mirror image of fiscal inefficiency. To the extent that fiscal decentralization leaves different provinces with different fiscal capacities to provide given levels of public services, persons in one province would obtain systematically lower NFBs than in another. If mobility is costly, the implication is that horizontal equity could not be achieved; persons of a given type would be treated differently by the public sector as

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 health, education and welfare. Public-sector involvement in each of these three areas can be justified largely on redistributive grounds. Taken together these policy instruments are crucial for achieving equality of opportunity and social insurance, and for targeting public services to the neediest members of society. If left to themselves, provinces might well provide quite differing standards and mixes of public services, perhaps even at inadequate levels because of interprovincial competition. This would result in different standards of redistributive equity nationwide, which would violate the equal-treatment-of-equals (horizontal equity) principle. And, the level of redistribution itself might be regarded as inadequate. To the extent that the federal government was considered to have a role in fostering national standards of redistributive equity, a case can be made for using federal-provincial conditional transfers as a means of carrying out that obligation. Indeed, given exclusive provincial legislative responsibility in these expenditure areas, the use of conditional transfers represents the only constitutional means available to the federal government for so doing.

The case for the federal government using its spending power to make transfers to the provinces to achieve redistributive objectives then turns on the extent of the federal government's responsibility for redistributive equity relative to that of the provinces. Roughly speaking, the more the nation is regarded as being the relevant community for redistributive purposes – the sharing community – the larger will be the VFG required to achieve national sharing objectives.

An economist might look at it conceptually using the notions of horizontal and vertical equity. If the nation were the sharing community, common standards of vertical equity would apply nationwide, implying that so would horizontal equity. Persons in identical circumstances would receive the same NFBs from government no matter where they resided in the nation. For example, uniform national systems of public health or unemployment insurance would apply; a person with a given income, demographic characteristics, living status (urban versus rural), health status and employment history would receive comparable benefits – whatever they might be – in all provinces. This would be the case whatever standards of vertical equity were chosen. In a federation like Canada, where the provinces are actually responsible for delivering some of the public programs that address redistributive concerns, it is apparent that a substantial VFG would be required to induce them to design their programs so that full horizontal equity applies nationwide. The size of transfers, and the federal share of income tax room, must be large enough such that provinces' tax-transfer

systems were equally progressive, and that provinces were induced to design their programs of health insurance, education and social assistance to abide by uniform national standards. Clearly, this is only a benchmark, since it would be essentially both practically and politically infeasible to achieve such uniformity.

At the other extreme, if the provinces were the sole sharing communities, vertical redistribution would be a matter for provinces to decide within their own borders. It would be as if different provinces were different "nations." There would be no need on equity grounds for the federal government to be involved in redistribution, not even between provinces. Obviously in this case, horizontal equity would not be expected to apply, especially given the differences in fiscal capacity among provinces. In this extreme case, the VFG would be minimal, perhaps even zero. The only need for federal-provincial transfers would be for efficiency reasons. Of course, like the pure national sharing version, this extreme case is a fictitious one as well. Given the current constitutional arrangements, it is hard to avoid national redistributive standards in some domains. The federal government is responsible for unemployment insurance and for pensions, and uses progressive taxation to raise general revenues. Unless somehow it were coerced into adopting different standards for different provinces, there would necessarily be some national standards of redistribution. But there would be no need for a VFG.

In between these two extreme cases of full national redistributive or vertical equity standards and full provincial redistributive standards, one can imagine conceptually a spectrum of combinations of national and provincial redistributive standards. The spectrum is only conceptual since there are a number of different dimensions along which redistributive standards can apply, but it is a useful conceptualization nonetheless. To be a bit more precise, one can imagine what might be regarded as the relevant range along the spectrum encompassing the options that might conceivably reflect the Canadian consensus, given our constitutional and political realities.

At the lower bound, one might have the *pure Equalization regime*. In this case, there would be no national standards for spending programs in provincial jurisdiction. National sharing would take the form of Equalization that allows all provinces to have the potential to choose comparable redistribution standards, but does not compel them to do so. Moreover, the norm used for Equalization would be based on tax and expenditure choices actually made by the provinces, rather than being some nationally determined norm.<sup>15</sup> It could be argued that a fiscal arrangements regime that restricts itself to Equalization alone would be compatible with the principles outlined in both Sections 36(1) and 36(2) of the *Constitution Act, 1982*. The federal responsibility in Section 36(1) for equality of opportunity, providing essential public services of minimal quality, and fostering regional development would be discharged by ensuring that the provinces have the wherewithal to adopt comparable programs in these areas. This would also satisfy those who took the view that the use of the spending power to influence provincial decisions in areas of purely provincial legislative responsibility is a violation of the spirit of the *Act*, albeit one that the courts have condoned.

Even for this pure Equalization regime, the size of the VFG would be ambiguous and a matter for judgment. For one thing, as we have mentioned, the amount of VFG needed to sustain a full Equalization regime is unclear.<sup>16</sup> It could take a CHST-type transfer alongside Equalization but without the associated conditions to ensure that provinces have a reliable and stable source of funding. For another, the federal role in redistributing through the tax-transfer system would have to be decided. To the extent that it was legitimate for there to be federal sharing of this form, and clearly that would be well within the constitutional jurisdiction of the federal government, there might be some minimal amount of tax room occupied by the federal government. This would be reflected in the size of the VFG.

At the upper bound would be the *strong national standards regime*. The purpose of the national standards would be to induce provinces to maintain redistributive spending programs that provide comparable degrees of redistributive equity nationwide. That is, horizontal equity would apply at least to some rough degree; persons of comparable circumstances would have access to comparable public services at comparable terms no matter where they resided. This upper bound is again only a limit in conceptual terms. What seems clear is that the VFG would have to be substantially larger than in the pure Equalization regime. The federal government would have to have enough financial clout to have the moral and political authority to impose and enforce the conditions required to achieve rough horizontal equity nationwide.<sup>17</sup> The strength of these conditions would also depend upon the amount of vertical equity that was implicit in the national standards. Presumably, the more redistribution sought, the larger the VFG would have to be. For the strong national standards regime to apply, there would presumably have to be a strong national consensus that the relevant sharing community is the nation as a whole rather than the provinces. Moreover, the cost of implementing this regime would have to be accepted, in particular the stifling of the ability of the provinces to design programs to suit their own needs, and perhaps to be innovative in so doing.

In between the pure Equalization and strong national standards regimes, one can have varying degrees of national sharing applied to provincial programs. There could be broad national standards applied that leave leeway for the provinces to design their own programs. There could be minimum standards meant to ensure comparable treatment for the most needy. There could be differential levels of standards applied to different types of programs, some being based on national sharing principles and others being based on provincial sharing. The size of VFG would reflect the transfers deemed necessary both to fulfil the Equalization objective and to enable the federal government to sustain whatever amount of national sharing is deemed appropriate.

The current regime of (reasonably complete) Equalization, the CHST/CHT/CST with fairly minimal conditions, and federal dominance of the income tax field constitutes a mix of federal and provincial sharing communities that is part way along the spectrum. One can reasonably argue that the existing level of transfers is not adequate to legitimize the amount of sharing embodied in the *Canada Health Act, 1984* (CHA),

that is, that the optimal VFG is larger than the existing balance of spending and revenue-raising responsibilities. It is possible to imagine there being either more or less national sharing. Abandoning the conditions of the CHA would be consistent with a more restricted conception of the appropriate extent of national sharing. The CHT would then fulfil largely an Equalization function. Alternatively, increasing the extent of national sharing could be achieved by broadening the CHA conditions to include, say, quality conditions, extending the CHA to include other health services such as prescription drugs or home care services, imposing further conditions on the transfer for welfare, or even introducing conditions on provincial education programs. All of these could be interpreted as being consistent with the federal interest in redistributive objectives such as equality of opportunity, providing essential public services of minimal quality or providing social insurance. Finally, a case for a larger VFG can also be supported by arguing that there are strong national sharing arguments, augmented by harmonization arguments, for maintaining a dominant share of the income tax field in the hand of the federal government.

Whether the system of fiscal arrangements should move in the direction of more or less national sharing, or neither, is not a matter of economics. What is the relevant community for redistributive purposes, or for applying the equal treatment principles of horizontal equity, is a matter to be determined by consensus among Canadians. Economic argument alone cannot be used to define the appropriate extent of national sharing, and therefore the appropriate size of the VFG, despite the impression one might get from economic policy literature. Our main purpose was to make the argument that, roughly speaking, the more is the nation regarded as being the relevant sharing community, the greater should be the VFG.

## ARGUMENTS AGAINST A VFG

The above arguments were intended to set out the considerations that should be most relevant in establishing arguments about the size of the VFG. Our emphasis was on the role of VFG as a means of incorporating national sharing elements into programs that are in provincial jurisdiction, but that fulfil redistributive objectives. Those who argue that there should be no VFG, or at most a minimal one, typically combine a number of arguments.

First, they agree with the judgment that a mismatch of assignment (Perspective I above) cannot account for a substantial VFG. Provinces have access to all the main revenue sources of the federal government and more, and it is possible for them to have access to these sources in ways that do not jeopardize the functioning of the national economy. This is taken to be the case despite the large and growing expenditure responsibilities of the provinces.

Second, they argue further that the VFG detracts from accountability, and that it might be worth sacrificing some national efficiency for the sake of retaining accountability. Accountability is typically not carefully explained. Rather, it is taken as a given that accountability is sacrificed to the extent that provincial expenditures are not financed by own-source revenues. It is not at all self-evident that accountability

requires full self-financing. If provinces are required to raise revenues at the margin, they can determine the size of their budgets, and can presumably be held accountable for that. Simply because some expenditures are financed out of transfers from the federal government does not imply that their spending is not subject to scrutiny. Accountability may become more of an issue where decision making over program design is unclear. If the federal government imposes conditions on provincial programs, it may be more difficult to hold the provincial government accountable for design or delivery flaws, or for inefficiencies in the operation of the program. This is a legitimate concern that arises whenever two levels of government share responsibilities for a given program area. It also seems to be an inevitable consequence of decentralizing programs of national interest to the provinces to design and deliver.

Third, critics of VFG discount the arguments on which Perspective II is based, that is, that considerations of national sharing or horizontal equity should play a key role in determining the optimal VFG. They are willing to tolerate national redistribution in areas of federal responsibility (pensions, unemployment insurance, the income tax-transfer system), and with respect even to Equalization, but they would argue that for programs in which provinces have exclusive legislative jurisdiction, sharing standards should be determined exclusively by them. There is no legitimate role for the spending power to influence provincial jurisdiction. They would argue for at most what we have termed the full Equalization regime.

This is a legitimate position to hold to the extent that it represents the consensus of the citizens. But to take it as an absolute position based on first principles seems to be inconsistent, as well as not being a necessary interpretation of the constitutional power of the federal government and its legitimate national objectives. It is arbitrary to suppose that national sharing is reasonable with respect to certain components of redistributive policy (those that do not require the use of the federal spending power to make conditional grants to the provinces), but not with respect to others.

### **VFG VERSUS VFI: ALTERNATIVE APPROACHES**

The fact that the VFG is an ambiguous concept makes its use for policy purposes fraught with difficulties. It also makes the concept of VFI a difficult one, since the existence or otherwise of a VFI depends on what one interprets the proper VFG to be. Moreover, contemplating policy options depends on how one obtains empirical estimates of both the VFG and the VFI.

Conceptually, one way to proceed is as follows. There is ultimately interdependence among the taxes, expenditures, transfers and deficits of the two levels of government; budgets at both levels must simultaneously be satisfied, and they are connected by the size of transfers. Some elements can be interpreted as balancing items, given choices of all others. How one decides on the pre-determined items in the budget and on the balancing items partly determines one's views of the VFI. However, one's view of which level of government is primarily responsible for the VFI is also important. Given our above discussion, we would argue that it is reasonable as a first pass to take as given the

path of expenditures at the two levels of government, and treat the means of financing – taxes, transfers, deficit – as balancing items. And, we suppose that the federal government has the “first-mover” advantage and so can pre-emptively determine the VFI.<sup>18</sup>

Next in order of importance might be the level of transfers. In estimating whether there is a VFI, one can take as given the current transfer policy, somehow appropriately projected into the future. This is consistent with the view outlined above that transfers are not determined as a residual between assigned expenditure responsibilities and assigned taxes, but that they are a federal policy instrument determined separately and on the basis of spending power objectives. The amount of transfers may or may not accord with one’s view of the ideal VFG, giving rise to a consideration of alternative scenarios.

Finally comes the means of financing the difference between expenditures and transfers at the two levels of government, given the projected values of these already chosen. Assuming for the moment that there should be no deficit financing at either level of government, there would be a division of tax room between the two levels of government that just suffices to ensure that budget balance is achieved. The issue then is whether this balance has been achieved in practice. If, assuming that it has first-mover advantage, the federal government occupies too much tax room, it will have a tendency to run budget surpluses, and the provinces will have a tendency to run deficits. The tax room allocation would have to be adjusted to accommodate the differential debt financing needs of the two levels of government, presuming that there is a case for both to move to desirable levels of debt. The imbalance between the tax room allocation and that needed to finance expenditure requirements given the size of transfers is a measure of the VFI.

The story is somewhat more complicated in the presence of debt. It may be the case that the two levels of government have very different debt-to-GDP ratios. In those circumstances, it may be desirable for the two levels of debt to be adjusted by having one side run a larger surplus than the other. This will further affect the calculation of the misallocation of tax room, or the VFI. It might also condition one’s view about the path of the optimal VFG; there may be an argument for balancing the debt-to-GDP ratios partly by changing the level of transfers rather than the tax room. In this case, the VFG would reflect not only spending power priorities, but also fiscal priorities. This obviously leads to a further source of ambiguity in the choice of an optimal VFG.

According to this conceptualization, one can come to a view about how the current level of transfers compares with an ideal VFG, and given that, whether the tax room being taken by the federal government is suitable. If the level of transfers is taken to be about right, there will be a VFI to the extent that the tax room allocation is not that required to sustain the level of transfers. If the level of transfers is also judged to differ from the optimal VFG, there is a further policy requirement that may involve changes in both the level of transfers and the tax room allocation. Over the longer run, there will have to be continual adjustment in the system as the expenditure responsibilities of the two higher levels of government evolve.

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 being residually determined to finance the optimal VFG is consistent with the argument made above that the optimal VFG is not determined mainly by a mismatch of tax and expenditure assignment. It is determined by the usefulness of transfers as a policy instrument in the hands of the federal government. Given the provinces' unrestricted access to the major tax sources, tax room can always be found for the provinces to finance whatever own revenues they need. Of course, it is possible that the decentralization of certain forms of tax room can have deleterious effects for efficiency in the internal economic union and for tax harmonization. But this is not the primary consideration in determining the optimal VFG. It may well, however, be a secondary consideration, especially as provincial expenditure requirements grow relative to those of the federal government.

This conceptual procedure for determining the VFG and VFI corresponds well with the methodology followed by the Séguin Commission in coming to its recommendations. Although they did not make a distinction between the VFG and VFI, the sense of their proposal effectively did. Essentially, their methodology amounted to rebalancing the federal fiscal financing arrangements such that the VFG was defined by eliminating the CHST, and the tax room was adjusted so that both levels of government could finance their expected expenditure responsibilities, whose paths were taken as given. It turned out, fortuitously perhaps, that the combination of federal abandonment of the GST and elimination of the CHST would just suffice to accomplish these objectives in the short run. Of course, as time goes by, further adjustment of tax room would be required to ensure that VFI does not re-emerge.

To complete our discussion, it is useful to consider briefly the Séguin Commission proposals and some alternatives. We take as given the rough validity of their projections that under the set of fiscal transfers that existed when they reported in 2002 (assuming that the CHST per capita transfer would remain constant in real terms over the longer run) there was a current VFI of about \$8 billion. Suppose initially that one adopts their view that the VFG should reflect what we have termed the pure Equalization regime; the only role for federal transfers is Equalization. They interpret this to mean that the CHST should be abolished, and a tax transfer of the federal GST would just suffice in the short term to compensate for this loss of transfers plus make up for the VFI that is calculated to exist. The following points can be made about this proposal.

First, the appropriate size of the VFG even under the full Equalization regime does not necessarily imply simply abolishing the CHST/CHT/CST. The CHST/CHT/CST is in a sense an ideal form of equalization since it applies both to have and have-not provinces alike. It could in principle be changed from a per capita form to one that takes needs into account. Moreover, support for Equalization might be made more tenuous by eliminating the CHST/CHT/CST. Any decentralization of tax room, including by a GST transfer, will increase the costs to the federal government of financing Equalization. The objectives of the Séguin Commission could readily be achieved simply by eliminating all conditions on the CHST/CHT/CST transfer.



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 personal income tax revenues, that would have the adverse Equalization consequences that the Commission was trying to avoid. An option would be for the provinces to adopt VAT taxes themselves. Even if this were to occur, it is not at all clear that running a VAT at the provincial level in a federation would be workable. While such a system seems to work reasonably well in Quebec, it is not clear that that success can be extrapolated to others, especially when there is no tax at the federal level.<sup>19</sup> Apart from the purely administrative costs associated with collection and compliance, the possibility of harmonizing the various provincial VATs would be difficult.

Finally, ruling out all but the current Equalization transfers has longer-term implications as well. As the projections of the Commission indicate, provincial expenditures will increase relative to those of the federal government into the more distant future. To avoid further VFI development, more and more tax room would have to be occupied by the provinces relative to that of the federal government. At some point, fragmentation of the tax system becomes a major concern if federal transfers other than Equalization continue to be ruled out.

The Séguin Commission proposals largely rely for their coherence on the full package being accepted, especially the fact that the GST transfer just offsets the combination of the CHST/CHT/CST plus what they estimate to be the VFI. Once one adopts a different view about the VFG, this happy coincidence no longer applies. Suppose, for example, that one adopts the view that there is no VFG; the current size of the Equalization transfer plus the CHST/CHT/CST is the appropriate VFG for satisfying the federal government's spending power objectives. In this case, a VFI according to the Commission's estimates would currently equal \$8 billion. This would have to be closed by a reallocation of tax room. The main options would be to vacate partially GST room or personal income tax (PIT) room, leaving it to the provinces to increase their own tax room. There are advantages and disadvantages to each.

Suppose a reduction in the GST rate is used. If the provinces respond by increasing their sales tax rates, this will lead to an overall increase in the inefficiency of the tax system, given that provincial sales taxes are much less efficient than the GST. At least

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 transfers. Moreover, in the longer run, the need for provincial revenues would gradually increase even further implying a continuing need to transfer tax room to the provinces. Ultimately, the consequences for the combined federal-provincial tax system would be adverse.

The only alternative to the above scenario (and to the even more decentralizing scenario of the Séguin Commission) is for the VFG to be larger. The case for this would have to be based on one of two grounds. First, it could be argued that the current size of CHST/CHT/CST is insufficient to enable them to induce provinces to abide by whatever national standards are thought to be justifiable for programs financed out of the CHST/CHT/CST. A reasonable case could be made that the size of the transfer is insufficient to provide the authority to enforce the current terms of the CHA. It is conceivable in the future that further conditions might be added, such as those involving quality of service or those involving more than hospital and medical services. It is also conceivable that the spending power could be used in other areas such as post-secondary education or welfare.

The second argument for a larger VFG, especially over the medium and longer term, would be to maintain the integrity of the national tax system. A good case could be made that further sacrifice of PIT room would compromise both the harmony of the existing system and the ability of the federal government to affect redistributive equity at the national level through the tax-transfer system. Some would argue that that point has already been reached. Simply to maintain intact the current federal share of tax room would require a gradually increasing VFG, given the relatively greater rate of growth of provincial relative to federal expenditures.

Of course, all these arguments are contingent on the current level of benefits provided by social programs remaining as they are in the future. Virtually all discussions of the VFG or VFI take that as a given. Perhaps the real danger for the federation is that the arithmetic of the VFG will force provinces to adopt much less generous social programs as time goes by. That is more likely to occur in our federal system than in a unitary state.

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 Séguin 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. In the end, I will provide a personal interpretation of what these signposts may tell us 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.<sup>1</sup>

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 "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.

Various solutions to the Ontario grievances about under-representation were considered. They included: (a) a move to full proportional representation (b) granting a few more seats, thus honouring the principle but not the substance of proportional

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 above 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 earnest to develop the details of a proposal that later that same year won the day at the Charlottetown Conference. On Monday, August 29, 1864, eight of the twelve members of the cabinet of United Canada embarked on the Queen Victoria at Quebec and began the trip down the St. Lawrence with Prince Edward Island as final destination. Three days later, they had reached Charlottetown to join the delegates from Nova Scotia, New Brunswick and Prince Edward Island.

The Confederation option was not strongly favoured in the Maritimes. As pointed out by Waite:

Confederation in the Maritimes was the remedy for no particular evils, the solution of no particular difficulties. It offered material advantages perhaps, but it offered few enough answers for maritime political problems.

The alternative, a Maritime Union, did not command greater favour. It was strongly supported only by Nova Scotia, which saw it as an opportunity to restore its original boundaries before the separation of Prince Edward Island and New Brunswick nearly a century earlier. New Brunswick had stronger economic ties with the U.S. Northeast than with the other Maritime Provinces, while Prince Edward Island was reluctant to give up its legislative powers. Although both options were largely viewed as unattainable political dreams, Confederation seemed to offer greater prospects. The Confederation option received a boost from the Civil War in the United States.

...an immediate stimulus to the Canadian federation came from the American Civil War...relations between the United States and Great Britain were already strained owing to the latter's policy of openly favouring the South....If Great Britain became directly involved in this conflict, Canadians realized that they would be the immediate sufferers. Federation, therefore, offered some prospect of home defense and perhaps the ability to hold on to a vast Canadian area that stretched westward to the Pacific, which the Americans had been longingly looking at for some time<sup>2</sup>

In Charlottetown, the way for the delegates of 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 considered Confederation "highly desirable, if satisfactory terms were agreed on." The first big practical step toward the creation of the Canadian nation had been taken. The next step would be taken a month later in Quebec through a conference convened to work out the full details. Thirty-three delegates – twelve from United Canada and the rest from the four Atlantic Provinces – got together in Quebec on October 10 and worked behind closed doors until October 28 to draft 72 resolutions that formed the basis for the British North-America (BNA) Act, 1867. After a gestation period of 30 months, during which the Charlottetown-Quebec plan was discussed by the provinces involved, the Canadian federation – the Dominion of Canada – was born on July 1, 1867.

Built on compromise, the structure of the new federation had to be constructed of flexible fibre in order to accommodate different visions and the stresses of future, and yet unforeseen, developments. Centralists counted on the power of centripetal forces – such as the role of a strong central government in international relations, national development policies and redistribution – to maintain the supremacy of the federal government. Others saw the constitutional recognition of separate powers for provincial legislatures as sufficient safeguards against excessive centralization. The political history of Canada has been shaped by the pull of these two opposing forces.

Fiscal arrangements were an important component of the final agreement, but at no time in the discussions leading to Confederation were they a major determining factor. By the time the delegates met at Quebec, the fundamental driving force was a new sense of national pride.

A powerful nationalism pervaded the Conference. The ambitions called into existence by the Charlottetown Conference were now aroused; provincial horizons began to melt away, and there appeared the breathtaking possibility that a transcontinental nation might be created by the colonists themselves, upon their own initiative, by their own energy, and with their own resources.<sup>3</sup>

The spirit of nationalism is highlighted by the following statement from a correspondent of the Halifax *Morning Chronicle* two weeks before the Quebec Conference.

...the task to which these Provinces are called is no light or unimportant one; – they are now laying the foundations of Empire, of an Empire that may last as long as the human race and whose bounds shall extend from the cold and

sterile coasts of Newfoundland to the noble hills and peaceful heavens of Vancouver's Island.<sup>4</sup>

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 (b) per capita grants (c) grants in support of government and legislation and (d) a special grant for New Brunswick. These fiscal benefits to the provinces, shown in Figure 1, were granted in exchange for the transfer to the federal government of exclusive power over tariffs, the major source of revenue at the time.

### **The Debt Allowance**

Having acquired the predominant revenue-raising capacity, the federal government took over the outstanding debt of the provinces. The amount of debt taken over for each province equaled \$25 times that province's population in 1861. The per capita grant for provinces with higher (lower) per capita debt than the standard \$25 was adjusted based on a five percent interest paid to or paid by the federal government on the difference from the standard debt.

### **Per Capita Grants**

Relief from interest payment on the debt was not a sufficient offset for giving up custom duties. The provinces needed some other source of revenue to replace the tax room vacated for the federal government. Two choices were available: (a) the transfer to the provincial governments of a share of indirect taxes or (b) the federal retention of full taxing powers and the provision of grants to the provinces. The federal government chose the latter option and offered equal per capita grants in each province. Initially, the grant in each province was fixed at \$80 times the population in 1861. At the London Conference in 1866, the grants to the Maritime Provinces were allowed to increase with the population until the population in each of those provinces reached 400,000.

### **Grants in Support of Government**

The two Maritime Provinces present at the London Conference – Nova Scotia and New Brunswick – argued that the per capita grants were insufficient to finance their spending responsibilities. It was finally agreed to provide grants “in support of government and legislation” to all four provinces, but in a manner that provided greater per capita benefits to Nova Scotia and New Brunswick.

### 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 provinces.<sup>5</sup>

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 preference by provincial governments for cash transfers and (b) final decisions in the hands of the federal government.

### **TOWARDS FISCAL INDEPENDENCE, 1868 - 1930**

During the first six decades of its existence, the Canadian federation faced a variety of economic and fiscal challenges. The promise of a bright future envisioned by the fathers of Confederation soon began to fade as the world economy was gripped by a prolonged depression that started in the early 1870s and lasted for 30 years, with a brief interruption in the early eighties. The tide suddenly turned in the mid-1890s. Signs of economic expansion were found everywhere. Capital expenditures increased rapidly, the population grew at a fast pace, the West saw major growth in the number of new farms and new urban centres, and manufacturing production more than doubled in ten years. There was also a boom in the discovery and development of natural resources, including gold in the Klondike, silver in Cobalt and lead and copper in Southern British Columbia. This boom also came to pass and was followed by another depression, starting in 1912, largely caused by a sharp rise in interest rates in the London market. These higher interest rates stemmed the flow of funds that had helped finance the major capital expenditures in Canada during the previous decade and increased the cost of servicing the public debt. The depressed economic activity reduced the demand for Canadian natural resources thus weakening their prices. This depression may have lasted a long time had it not been interrupted by the outbreak of World War I. Although the effect of the war was not immediate, the demand for goods and services that it generated resulted in higher prices and higher employment. The stimulus effect of the war continued past the end of hostilities, driven largely by pent-up consumer demand. The adjustment to a peacetime economy, however, was neither smooth nor uniform across the country. Particularly affected were the Prairie Provinces and the Maritimes because of rigid price structures and the lack of substitutes for war-related economic activities. A worldwide revival of capital investment facilitated the adjustment to a peacetime economy and a new economic expansion took hold in the mid 1920s. The major contributing factors to this economic boom in Canada were:

...new industrial techniques, the increasing use of the motor-car and the advent of the radio, above-average yields of wheat on the Prairies, the discovery and exploitation of new mineral resources, the continued expansion of the pulp and paper industry, the rapid extension of electrical power in home and industry, the heavy expenditures on residential properties, and the rapid growth of metropolitan areas, particularly in Quebec and Ontario.<sup>6</sup>

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 shortcomings of relying almost exclusively on a single source of revenue (tariffs), which fluctuated with the business cycle. The fiscal problem created by this unreliable revenue source was compounded by the capital spending obligations undertaken by the federal government for building the physical infrastructure necessary to hold the new nation together, primarily the construction of railways and canals. Another problem was created by the refusal of the U.S. government to renew the Reciprocity Agreement abrogated in 1866. This refusal threatened the future prosperity of the new nation, which had been predicated on the expansion of free trade internally and south of the border.

These developments tended to strengthen the protectionist sentiments that were developing in certain parts of the country, particularly among the leaders of the young manufacturing industries in Ontario. The abrogation of the Reciprocity Agreement and the unilateral decision of Canada not to retaliate by imposing higher tariffs left the infant manufacturing industries exposed to American competition and cut off from the American market. This situation was unsustainable, as indicated by Sir John Rose, the first federal Minister of Finance, in the 1869 Budget.

...the time may soon come when we may require to have a national policy of our own, no matter whether that national policy may sin against this or that theory of political economy.<sup>7</sup>

While considering protectionist moves, the federal government also gave serious consideration to the introduction of direct taxes. It was dissuaded from pursuing this action by two main factors: (a) political difficulties arising from the claim by provinces to exclusive occupancy of that tax field and (b) the widespread use of this revenue source by the municipalities.

With revenue falling due to the depression, the U.S. government unwilling to renegotiate a free-trade agreement, and entrance to the direct tax field prevented by political land mines, the federal government had very limited fiscal options. In 1879, the newly elected Conservatives introduced the protectionist "National Policy". Although initially the National Policy involved moderate increases in tariffs, it signaled a major shift in federal policy toward national economic development. The early emphasis on trade as the engine of growth was replaced by a policy of industrialization through protection of manufacturing industries, especially the textile industry and the iron and steel industry. Over time the average tariff rate was raised on more than one occasion and reached its peak in the first half of the 1890s. No major changes in federal revenue policy took place before the outbreak of World War I.



Initially, the war effort was financed through increases in the existing tariff and excise duties. It soon became evident that the war may not have an early ending and that tariff increases would be unable to provide the required revenues. Therefore, in the Budget of 1915, tariff increases were supplemented by the introduction of new taxes. They included levies on the gross revenue of trust and loan companies and the premiums of insurance companies other than life plus a host of excise taxes. The federal reluctance to impose income taxes was overcome in the next Budget. It had become evident that war-induced rising prices and military contracts had enriched a variety of businesses and there was public resentment against wartime profiteering. The government responded by introducing the excess profits tax in the 1916 Budget. This tax, applied retroactively to 1915, was levied at the rate of 25 percent of the profits of a corporation in excess of 10 percent of its capital and at 7 percent of the excess profits of unincorporated businesses, with an exemption for small firms (capital less than \$50,000) not involved in war contracts or war supplies. This new tax did not quell public dissatisfaction with a perceived inequality of sacrifice as the poor contributed bodies while the rich contributed funds by purchasing war bonds with income partly generated through war-created earning opportunities. There was public outcry for "conscription of wealth" through income taxation to parallel military conscription. Demands for the introduction of income taxation were particularly vocal on the part of Western farmers.

The federal government resisted these demands and in the April 1917 Budget confined its revenue-raising measures to a large increase in the rates of the excess profits tax. In July of the same year, however, there was a complete reversal as the Minister of Finance introduced the *Income War Tax Act* in connection with the call to arms of an additional 100,000 men. The equity rationale for the introduction of income taxation at the federal level was explained directly by Sir Thomas White, Minister of Finance.

Apart from this necessity from a financial standpoint, there has arisen, in connection with the Military Service Bill, both in the house and in the country, a very natural and, in my view a very just, sentiment that those who are in the enjoyment of substantial incomes should substantially and directly contribute to the growing war expenditures.<sup>8</sup>

This quote serves as a reminder that, as in the case of the introduction of the Personal Income Tax (PIT) into the U.S., the PIT in Canada was largely justified on equity grounds. In addition to raising revenue, its main purpose is to offset the regressivity of the other taxes.

The *Income War Tax Act* introduced two new taxes. The first was a flat tax of four percent on corporate profits. It was a form of minimum tax payable only to the extent that it exceeded the excess profits tax. The second tax was a Personal Income Tax with a double-rate structure applied to two different bases: (a) a basic four percent rate on income net of the personal exemption (\$1,500 for a single taxpayer and \$3,000 for a

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 increases in the corporation tax rate (up from 6 percent to 10 percent), a doubling of the basic tax rate under the PIT and substantial increases in the surtax.

The war-time tax changes had laid the foundations for a more flexible and sustainable federal revenue structure. Income taxes were well entrenched and three successive rate increases made it clear that they were here to stay. One more step was needed to complete the fundamental structure of the federal revenue structure, namely, a general sales tax to complement the miscellaneous excise taxes introduced in the recent past. This step was initiated in the May 1920 Budget with the introduction of “a tax of one percent on the sales of all manufacturers, wholesale dealers, jobbers and importers,” in addition to a plethora of excise taxes to keep in check “extravagant and luxurious expenditure.” This tax was overhauled over the next three years and in January 1924 became a tax on the manufacturer’s price of goods imposed at the rate of six percent. This basic structure of the federal sales tax, with periodic adjustments to coverage and rates, remained in place until 1991 when it was replaced by the Goods and Services Tax (GST).

**Figure 2**  
**Selective Chronology of Taxation in Canada, 1868-1930**

	Year of Introduction by the Federal Government	Provinces Levying Major Taxes in 1930
Personal Income Tax	1917	Manitoba, Prince Edward Island, British Columbia
Succession Duties		All
Corporation Taxes	1916	All
Corporation Income Taxes	1917	Prince Edward Island, British Columbia
Sales Tax	1920	-
Gasoline Tax	1942	All

Sources: Moore, Perry and Beach (1966), table 26, p. 114  
Perry (1955), Vol. II, Appendix C

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**

	Custom Duties and Excises	Other Taxes	Total Revenue	Tariffs as a Percentage of Total Revenue
1868	11.6	0.1	13.7	84.7
1874	19.9	0.2	24.5	81.2
1896	27.7	0.1	36.6	75.7
1913	133.2	1.7	168.7	79.0
1921	200.2	108.6	436.9	45.8
1930	244.4	134.5	453.0	54.0

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

This brief history of federal revenue changes in the first six decades of Confederation leads to two observations. First, by 1930, the federal government had built the basic revenue structure that is still standing to this day. Second, by the end of the period under consideration, the federal government had established dominance of the income tax field, a tax field originally considered to be the exclusive domain of the provinces.

The limited responsibilities of the provinces did not change much during the first two decades of Confederation. Therefore, the provinces did not see the need to diversify their revenue base and continued to rely almost entirely on federal grants and receipts from natural resources. Some experimentation with new taxes took place in British Columbia, Prince Edward Island and Quebec. In the first two provinces, tax experimentation was made necessary by the absence of municipal governments, which left those provinces responsible for the provision of services generally supplied by municipalities. Prince Edward Island imposed a land tax and a poll tax in 1877. Similar taxes had existed in British Columbia since 1869. Soon after joining Confederation in 1871, British Columbia started introducing a variety of taxes including a wild lands tax (1873) and a personal income tax (1876). Of greater significance for the future evolution of provincial taxation was Quebec's experiment with a tax on life insurance premiums in 1875. This tax was challenged by the insurance companies and was declared by the Privy Council to be an indirect tax and therefore outside the constitutional powers of provinces. The Quebec government returned to this field in

1882 through the imposition of a variety of taxes on businesses. This time the Privy Council upheld the constitutionality of the new taxes and so Quebec opened the door to corporate taxation, a door through which all provinces lined up to pass.

Unlike the first two decades of Confederation, the period from 1890 to 1912 saw major changes in the role of provincial governments. Improved economic conditions and population growth required the expansion of public facilities. In addition to their involvement with the federal government in railway financing, the provinces launched a variety of new projects including hydro, telephones, roads, bridges, universities and hospitals. New revenue sources were needed to finance all this new public activity and the provinces ventured into the field of direct taxation. Quebec's introduction of taxes on corporations in 1882 was followed by New Brunswick in 1892, Prince Edward Island in 1894, Ontario in 1899, Manitoba in 1900, British Columbia in 1901, Saskatchewan and Alberta in 1907, and Nova Scotia in 1912, after a tentative experiment in 1903. Perhaps of greater significance for future developments was the introduction by Ontario of succession duties in 1892 which, unlike corporation taxes, were direct taxes on the wealth of individuals. Ontario's example was quickly followed by all other provinces.

A variety of other taxes were introduced by the provinces during the 1890-1912 period. The most significant ones were new taxes on mining – some on output, others on the acreage of mining properties and still others on mining profits – and special levies to finance selective public works and public services. In the Maritimes, Prince Edward Island was the most audacious province: it introduced a personal income tax in 1894 and took the lead in levying special taxes for road construction. The most active province in the design of a comprehensive tax structure, however, was British Columbia. Just before the outbreak of World War I, this province had

... taxes on real property, personal property, wild lands, timber lands, coal lands, and mineral output, and special taxes on fish canneries and on coal and coke. It also has succession duties, gross and net income taxes on corporations, a poll tax, an income tax on individuals, and a few other miscellaneous imposts.<sup>9</sup>

The search for new revenue sources by provinces continued during the war period, partly in response to the revenue loss caused by prohibition. A new source of taxation was the widespread adoption of provincial real property taxes; another was the imposition of amusement taxes. Initiated by Quebec, Ontario, Manitoba and Alberta in 1916, it soon became a common revenue source in all other provinces. Motor vehicle licenses, which had been introduced in all provinces before the war, were turned into a major revenue source during the war. Substantial rate increases were also applied to succession duties and corporation taxes.

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

**Figure 5**  
**Distribution of Federal and Provincial Own Source Revenues by Major Source, 1930, in Percentages**

	Federal	Provincial
Personal Income Tax	6.3	1.3
Corporate Income Tax	9.7	11.8
Succession Duties	-	13.2
Real Property Tax	-	4.3
Custom Duties and Excises	56.4	-
Sales Tax	10.2	-
Gasoline Tax	-	14.9
Other Taxes	4.9	3.9
Motor Vehicle Licenses plus Other Fees	-	19.0
Liquor Control Revenue	-	19.7
Post Office	7.8	-
Other Revenue	4.7	11.9
Total	100.0	100.0

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

A brief chronology of major provincial taxes during the 1868-1930 period is shown in Figure 2. The major components of provincial revenue are shown in Figure 4 and a comparison of tax field occupancy by federal and provincial governments is shown in Figure 5. Figure 4 shows the increasing importance of tax revenues in the provincial revenue mix as time progressed from 1868 to 1930. Making no contribution in the early years of Confederation, by 1930 taxes contributed nearly half of the total provincial revenue. Figure 5 shows that, by 1930, the federal government had effectively developed a tax mix that still exists today by staking major claims on income taxes and general sales taxes. At the provincial level, there is wide variation among provinces and a lack of consolidation of revenue sources, primarily because of the provincial reluctance to enter the personal income tax field.

The evolution of federal and provincial revenue structures took place within an ideological framework that favoured the separation of fiscal responsibilities by the two orders of government. When fiscal pressures started to mount even in the early days of Confederation, the natural inclination of provincial leaders was to ask for increased federal grants. These requests were unsuccessful for two reasons. First, the federal government did not have the fiscal capacity to accommodate the provincial requests and, second, the federal government held the view that the provinces should be responsible for meeting their fiscal needs. This view was expressed very clearly by Sir Wilfrid Laurier who stated in 1887 that "The principle by which one government collects the revenues and another government spends them is wholly false."

This view was echoed by The Right Honourable Mackenzie King who, in a 1929 address to the House of Commons stated that

...everyone who has given any attention to public finance will agree that it is a thoroughly vicious system to have one body raise taxes and another body expend the money thus secured....It is a bad system, a thoroughly vicious system.<sup>10</sup>

The above views of fiscal federalism are consistent with an interpretation of the initial arrangements which limited the scope of federal grants to the replacement of the provincial revenue lost due to the transfer of tariffs to the federal government. In addition to the above federal grants, provinces were given specific powers of taxation as empowerment to finance future increases in spending responsibilities. This view was expressed very clearly by the Honourable Maurice Duplessis, Premier of Quebec at the 1955 Federal-Provincial Conference.<sup>11</sup>

With federal grants to provinces based largely on population growth, the view of independent fiscal systems naturally led to a declining importance of federal grants as a component of federal spending or provincial revenues. As shown in Figure 6, these grants accounted for more than half of provincial revenues in the first ten years of Confederation and represented close to 20 percent of federal spending. By 1930, their contribution to provincial revenues had dropped to less than 10 percent and their claim on federal expenditures had fallen to less than four cents per dollar of spending.

**Figure 6**  
**Grants as Percentage of Federal and Provincial Revenues for Selected Years between 1868 and 1930**

	Grants as Percent of:	
	Federal Revenue	Provincial Revenue
1868	20.4	-
1874	15.5	56.7
1896	11.7	43.0
1913	12.3	30.5
1921	3.3	15.9
1930	3.6	9.4

*Source: Moore, Perry and Beach (1966), table e, p. 16 and Figures 3 and 4 in this paper*

From my viewpoint, this brief historical journey identifies two major signposts. The first is a set of fiscal arrangements based on independent fiscal systems. The second is the unwillingness of provinces to occupy the personal income tax system that led to federal supremacy in this field at a very early stage. The first signpost did not lead to a permanent direction in the evolution of fiscal federalism. The second signpost was a harbinger of things to come.

## 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 – was facilitated by agreements under which provincial taxes were collected by the federal Department of National Revenue. Alberta ventured into the sales field in 1936, but retreated the following year. Saskatchewan, however, was not deterred by the developments in the neighbouring province and introduced a 2 percent sales tax, known as the education tax. No other province followed Saskatchewan's example in the 1930s. Only minor adjustments were made to a variety of excise taxes.

**Figure 7**  
**Distribution of Federal and Provincial Own-Source Revenues by Major Source, 1939, in Percentages**

	Federal	Provincial
Personal Income Tax	8.8	5.1
Corporate Income Tax	14.9	4.7
Succession Duties	-	11.9
Sales Tax	26.1	1.3
Custom Duties and Excises	37.0	-
Motor Fuel Taxes	-	22.4
Real Property Taxes	-	2.5
Other Taxes	2.5	11.0
Licenses and Permits	0.6	11.9
Natural Resource Revenues	-	10.2
Other Revenues	10.1	19.0
Total	100.0	100.0

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

Figure 7 shows that, by the end of the 1930s, there was considerable joint occupancy of the major tax fields. More importantly, however, the federal government had established a predominant position in the area of general income and sales taxes. Provinces also entered those tax fields, but reluctantly and timidly. Their revenue-raising preferences still remained entrenched in favour of natural resources revenues, succession duties and excise levies. In my view, this preference has played a major role in the evolution of intergovernmental fiscal relations in Canada.

Major changes took place in this period also in the area of intergovernmental fiscal relations. The federal government became heavily involved in providing grants for old age pensions and relief. As a result, federal grants to provinces increased more than six-fold between 1930 and 1938. Their share of provincial revenues jumped from 9 percent in 1930 to 36 percent in 1938 (shown in Figure 8).

**Figure 8****Federal Grants to Provinces Between 1930 and 1938, in Millions of Dollars**

Year	Statutory Subsidies	Special Grants	Conditional Grants			Total Grants	Total Grants as % of:	
			Old Age and Blind Pensions	Relief	Other Revenue		Federal Revenue	Provincial Revenue
1930	12.5	1.6	1.5	-	0.7	16.3	4	9
1935	13.8	1.6	14.9	43.4	0.3	74.0	20	46
1938	13.7	8.1	28.7	53.1	0.7	104.3	20	36

*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, rates, and bases of calculations under the personal income tax; second the conglomeration of taxes on corporations, with the Dominion, the provinces and the municipalities all severally applying whatever method of extraction appealed to their self-interest or fancy, in a maze of forms, statements, rates, and bases that spelt not only confusion but often inequity as well; and, third, the complexities and unfairness produced by the conflict between situs and domicile in the provincial succession duties.<sup>12</sup>

Taxpayers had accepted federal income taxes as war financing measures. They found it difficult to accept the additional burden of provincial income taxes and the associated complexities, regardless of their constitutional legitimacy. Third, the lack of cooperation among governments cast doubts over the viability of the existing fiscal arrangements. Attempts at restructuring the fiscal side of the federation were made through a series of Dominion-Provincial Conferences, but no success. At the 1935 Dominion-Provincial Conference several suggestions were discussed.

1. That the Dominion should abandon the field of income taxation, leaving this field solely to the provinces,
2. That the Dominion should continue to impose a sales tax but should turn over to the provinces all or part of the proceeds of this tax earmarked for unemployment relief,
3. That the Dominion

should upon request of any province assume responsibility for the collection of the provincial tax on individual incomes; the Dominion to collect the tax for the provinces on the basis of rates fixed by the provinces and to remit such taxes to the provinces, 4. That a study should be made of the possibility of unified collection by the Dominion of succession duties.<sup>13</sup>

These issues were taken up by a permanent committee of Dominion-Provincial Finance Ministers, but all that they could accomplish was an agreement on the federal collection of provincial personal income taxes. In the meantime, demands for a complete review and possible overhaul of the system of taxation and intergovernmental fiscal relations intensified. The government response was the establishment in August 1937 of the Royal Commission on Dominion-Provincial Relations, commonly known as the Rowell-Sirois Commission, with the following mandate:

(a) to examine the constitutional allocation of revenue sources and governmental burdens to the Dominion and provincial government...; (b) to investigate the character and amount of taxes collected from the people of Canada... and to determine whether taxation as at present allocated and imposed is as equitable and as efficient as can be devised; (c) to examine public expenditures and public debts in general...; (d) to investigate Dominion subsidies and grants to provincial governments.

The Commission's recommendations, formally presented in May 1940, were influenced by changing views on the role of government and the relationship between federal and provincial governments. The fiscal philosophy that prevailed during the first 60 years of the nation's life was one stressing the necessity of balanced budgets, regardless of the state of the economy. As was made clear by Sir John Rose, the first Dominion Minister of Finance, in the 1868 Budget speech: "it is of the utmost importance to our future that we should recognize and act on the principle that we will not allow even the possibility of a deficiency arising between the revenue and expenditure."<sup>14</sup> This balanced budget philosophy was still prevalent in 1933 when Mr. Rhodes, federal Minister of Finance, justified increased taxation on grounds that "...it is of paramount importance that as to current expenditures at least we should live within our means."<sup>15</sup> The depression, and the writings of J.M. Keynes, produced a reversal of this fiscal philosophy and fostered the acceptability of temporary deficits during recessions. By the time the 1939 federal Budget was delivered, the Minister of Finance was able to endorse this new view when he stated that "in these days, if the people as a whole, and business in particular, will not spend, government must. It is not a matter of choice but of sheer social necessity."<sup>16</sup>

The new fiscal orthodoxy had important implications for intergovernmental fiscal relations. If the role of government is expanded to include counter-cyclical fiscal policy, the prominent role in this new function will fall on the central government.

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 and equitable right to priority in income taxes and all other direct taxes"<sup>17</sup> because they have a major responsibility for hospitalization, education and a variety of other "social programs;" Manitoba suggested that the federal government be given sole responsibility for the collection of succession duties; Alberta proposed that provinces be given the power to levy indirect taxes and that the joint occupancy of the income tax field be formalized through reciprocal arrangements; and British Columbia argued for the retention of joint occupancy of income taxes and the expansion of the taxing authority of the provinces, including indirect taxes.

Given the new philosophy about the role of fiscal policy, the complaints by businesses about the complexity and heavy burden of income taxation and the lack of unity among provinces, it is not surprising that the Commission recommended that personal and corporate income taxes plus succession duties be imposed exclusively by the federal government. In addition the Commission recommended that the federal government (a) take on the responsibility for unemployed employables (b) assume the outstanding provincial debt and (c) make "national adjustment grants," a form of unconditional subsidy aimed at equalizing provincial fiscal capacity. To a certain degree, the Commission's recommendations paralleled the fiscal arrangements at Confederation: the federal government would acquire the major potential source of provincial revenue and in exchange would provide subsidies to the provinces and clear their debts.

### **War and Post-War**

Eager to see the Commission's recommendations implemented as soon as possible, Prime Minister King convened a federal-provincial conference in January 1941. Although no agreement was reached, because of the opposition by Ontario, Alberta and British Columbia, there was a general understanding that the provinces would cooperate in the war effort. The door had been opened for the wartime tax rental agreements. Having failed to secure a permanent fiscal arrangement with the provinces, the federal government offered a "temporary wartime experiment" involving a variety of federal payments in exchange for exclusive power to levy income and inheritance taxes. All provinces accepted the federal proposal and signed the initial tax rental agreement that lasted from 1941 to 1947. Although the federal government promised "to reduce its rates of taxes by such an amount as will enable the provinces again to use the income tax and corporation tax fields," astute observers, such as J.A. Maxwell (1948) realized that

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.<sup>18</sup>

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 collective agreements through federal-provincial conferences and negotiated individually with each province. The notion of two orders of government negotiating as two separate entities was dead. It was replaced by a system whereby a dominant order of government would deal separately with ten separate political units, whose fiscal power had been severely clipped during the wartime period. This new approach to federal-provincial fiscal arrangements led to a renewal of the wartime arrangements with eight provinces between 1947 and 1952. Under the 1947-52 agreements, the participating provinces agreed to abstain from imposing personal income taxes and to limit the rate of corporate income taxation to 5 percent. Only Ontario and Quebec refused to join. However, neither province imposed a personal income tax and their corporate income tax rate was 8.5 percent compared to 5 percent for the agreeing provinces. When time came to renew this agreement for the 1952-57 period, Ontario decided to join the other eight provinces, thus leaving only Quebec on the outside.

As the time for renewal approached, the need for major changes to the existing agreements became evident. Three areas were particularly important. First, it was deemed desirable to include Quebec. However, since Quebec had re-introduced a personal income tax in 1954, convincing Quebec to join would require the offer of adequate PIT points to all provinces. Second, with wartime financing being replaced by peacetime social spending by provinces, it was necessary to offer provinces more tax room in general. Third, the historical commitment of federal assistance to the less affluent provinces needed strengthening. The federal government tried again the federal-provincial conference approach, but the October 1955 conference adjourned without a general agreement. The federal government shifted to the one-to-one negotiation approach and in 1956 presented a proposal for an agreement that would run from 1957 to 1961. This proposal was incorporated into the *Federal-Provincial Tax Sharing Arrangements Act, 1957* and contained three elements: (a) federal payments or abatements equal to 10 percent of the federal personal income tax (later raised to 13 percent for the period from 1958 to 1961), 9 percent of taxable corporate profits (later raised to 10 percent) and 50 percent of federal succession duties (b) Equalization payments based on the standard of the two provinces with the highest per capita yields and (c) stabilization payments. Eight provinces – all except Ontario and Quebec –

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
<b>Total Tax Revenue</b>	<b>81.6</b>	<b>40.8</b>	<b>93.0</b>	<b>65.4</b>
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
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

*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
<i>Specific Purpose Transfers</i>				
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
<b>Subtotal</b>	<b>43.5</b>	<b>130.7</b>	<b>89.5</b>	<b>605.6</b>
<i>General Purpose Grants</i>				
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
<b>Subtotal</b>	<b>112.5</b>	<b>127.4</b>	<b>351.5</b>	<b>543.4</b>
Joint War Programs	6.5	-	-	-
<b>Total</b>	<b>162.5</b>	<b>258.1</b>	<b>441.0</b>	<b>1,149.0</b>
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 dollar spent on provincially delivered programs.

## PROSPERITY AND THE EXPANSION OF SOCIAL PROGRAMS

After tackling three major depressions and two wars, Canada welcomed the dawning of the sixties which brought a long period of peace, stability and sustained growth. Three major developments took place on the fiscal federalism front in the 1962-76 period: (a) the Tax Collection Agreements (b) expansion of social programs and (c) the federal offer for opting out.

### Tax Collection Agreements

With the federal government unburdened of wartime financial commitments, its fiscal dominance was no longer justifiable. Therefore, steps were taken to overhaul the existing fiscal arrangements. Three federal-provincial conferences were held within the span of nine months, two in 1960 and one in 1961. Provincial requests to regain the use of income tax room were met by a new federal plan that included four elements: (a) making tax room available to the provinces (over a five-year period) by reducing the federal corporate income tax by nine percentage points and the personal income tax by 16 points (eventually to 20 points) (b) giving a province without an estate tax 50 percent of the federal estate tax collected in that province (c) federal collection of provincial taxes at no cost and (d) changes to the Equalization formula by adding 50 percent of resource revenue to the taxes subject to Equalization but changing the standard from the average of the two revenue-rich provinces to the average of all ten provinces. The new fiscal arrangements were incorporated into the *Federal-Provincial Fiscal Arrangements Act*, 1961, which covered the period from April 1962 to March 1967. All provinces except Quebec signed the agreement with respect to the PIT and all provinces except Quebec and Ontario signed the agreement with respect to the corporate income tax. Over the next ten years, changes to the agreements were introduced primarily for the purpose of increasing provincial policy flexibility.

After a set of interim extensions of the initial agreements, while waiting for the report of the Royal Commission on Taxation (the Carter Commission), a new five-year agreement covering the 1972-77 period was worked out at a series of conferences in 1971. *The Federal-Provincial Fiscal Arrangements Act*, 1972, included the following changes: (a) Manitoba and Ontario were allowed, as part of the new tax collection agreements, to introduce income tax credits for residential property tax (b) the federal government withdrew from the estate and gift tax field, but agreed to collect those

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 guarantees for the effects of PIT reform on provincial revenues, but this guarantee did not cover the indexation of the PIT introduced in 1974. The federal government also increased the flexibility of provincial income tax policy by offering to administer a variety of provincial credits for a fee of 1 percent of the value of those credits.

During this period there were major changes in the revenue structure of both orders of government. Faced with federal offers that were considered inadequate to meet their spending pressures, provincial governments took steps to increase their tax revenue. New Brunswick and Nova Scotia introduced personal income taxes in 1961 and Ontario imposed a sales tax in the same year. The other provinces raised their sales taxes and their gasoline taxes. Two major developments took place at the federal level: (a) the reform of the PIT in 1972 which implemented some of the Carter Commission's recommendations and (b) the indexation of exemptions and brackets for changes in the consumer price introduced in 1974. Both changes reduced the revenue potential of the PIT during inflationary periods for both the federal government and the provinces involved in tax collection agreements. By the end of the period both orders of government had developed a co-ordinated joint occupancy of most tax fields (Figure 12). The federal government still received most of its revenue from taxation and income taxes accounted for nearly half of federal revenue. For the provinces, tax revenue amounted to more than three-quarters of own-source revenue and income taxes made up nearly half of tax revenue.

### **Expansion of Social Programs**

This period witnessed a major expansion of social programs. Some were shared-cost programs which raised spending by both federal and provincial governments. Others were strictly federal programs such as those involving Unemployment Insurance, Old Age Security and the Canada Pension Plan. A summary of the major developments is found in Figure 13.

The expansion of cost-shared programs had a significant impact on intergovernmental grants. The values of federal transfers to provinces for fiscal years 1966/67, 1971/72 and 1976/77 are shown in Figure 14. Federal transfers increased nearly six-fold over the ten-year period from 1966/67 to 1976/77. The share of federal transfers in provincial revenue which had fallen to 23 percent in 1966/67 from the 40 percent level in 1961/62 because of the transfer of tax room, increased to 27 percent by 1971/72 and was still at that level five years later.

**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, Worker's 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
<b>Tax Revenue</b>	<b>92.9</b>	<b>79.0</b>	<b>92.4</b>	<b>77.0</b>
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
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

*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**

	1966/67	1971/72	1976/77
<b>Specific Purpose Grants</b>			
Old Age Assistance	38.1	-	-
Health	480.7	1,520.2	3,018.0
Unemployment Assistance	143.3	-	-
Education	235.9	610.2	648.7
Canada Assistance Plan	-	654.1	1,378.8
Other	265.8	258.1	922.1
Subtotal	1,163.8	3,042.6	5,967.6
<b>General Purpose Transfers</b>			
Statutory Subsidies	23.6	25.8	25.8
Tax Arrangements	72.9	65.9	953.8
Equalization	316.4	1,052.5	2,086.6
Other	51.4	65.4	69.6
Subtotal	464.3	1,209.6	3,184.6
<b>Total</b>	<b>1,628.1</b>	<b>4,252.2</b>	<b>9,152.2</b>
Percentage of Federal Revenue	17	25	26
Percentage of Provincial Revenue	23	27	27

*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 avenue more vigorously when Premier Lesage in 1960 proposed opting out with tax room transfers for conditional grants. The leader of the Liberal Party, Lester Pearson, endorsed the Quebec proposal and, during the 1963 federal election campaign, proposed that:

If some provinces wish, they should be able to withdraw, without financial loss, from joint programs which involve regular expenditures by the federal government and which are well established. In such cases, Ottawa will compensate the provinces for the federal share of the cost, by lowering its own direct taxes and increasing Equalization payments.<sup>19</sup>

When the Liberals won the election, the above proposal became a federal commitment. However, only Quebec pursued actively the opting out avenue and entered into bilateral negotiations with the federal government which led to a federal offer incorporated into a letter of August 15, 1964 from Prime Minister Lester Pearson to Premier Lesage. The interim arrangement, which was extended to all provinces, included the opting out provisions shown in Figure 15.

**Figure 15**  
**Opting Out Provisions under the Federal Offer of 1964**

Program	PIT Point Transfer	Expiry Date
Hospital Insurance	14	December 31, 1970
Old Age Assistance and Blind and Disabled Persons Allowance	2	March 31, 1970
Unemployment Assistance to Unemployables (Welfare)	2	March 31, 1970
Vocational Training	1	March 31, 1967
Health Grants	1	March 31, 1967
<b>Total</b>	<b>20</b>	

Source: Perry (1997), pp. 213-14

The proposals were incorporated into the *Established Program Interim Arrangements Act*, 1965. Only Quebec took advantage of this legislation. Over the following decade, the agreements for health grants and vocational training were allowed to expire, and the other agreements with Quebec were extended to March 31, 1977. In 1966, the welfare grants were replaced by the Canada Assistance Plan (CAP). Quebec maintained its opting out status and retained the four-point abatements for the welfare and old age, blind and disabled persons assistance programs.

Opting out provisions were also made available before the introduction of the Canada Pension Plan in 1966. The federal proposal was initially introduced in 1964 and allowed any province to choose between participation in the federal plan or setting a similar plan under provincial jurisdiction. Again, only Quebec chose to opt out of the federal plan.

A new opting out proposal for the three major social programs – hospital insurance, CAP and the national health grants – was advanced by the federal government in 1966. Under this proposal, the federal government would remove the federal conditions applied to these programs and replace its grants with the transfer of 17 PIT

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 ones. The federal objective was to minimize its cost. Having participated actively with the provinces in the introduction of national programs, the federal government was convinced that these programs would be maintained even without federal financing because "once major programs like these have been established no government would discontinue them, because of the needs they fill and the public support they command."<sup>20</sup> The provinces were also concerned about the complexities and costs of the cost-shared programs and wanted more flexibility, even on the financing side, but not the complete financial responsibility that would have been associated with a shift from cash co-payment to extra tax room. Moreover, among provinces, the smaller ones were afraid that the transfer of too many PIT points to the provinces would reduce the ability of the federal government to finance programs of interprovincial redistribution, such as Equalization and regional development programs. The divergence of interests between federal and provincial governments was still too wide to allow an agreement. We had to wait until 1977 to reach such an agreement.

In my view, the main signpost from this period is the unwillingness of the provinces to take full responsibility for the national programs that they agreed to introduce together with the flexibility to design those programs collectively and in a sustainable manner. It seems to me that, to paraphrase Robert Frost, whenever provincial leaders were confronted with a fork in the federal-provincial road, they "took the road *most* traveled by," in an effort to minimize the political costs of provincial spending "and that has made all the difference."

### UNWILLINGNESS TO PAY

The economic background to the negotiations leading to the 1977 fiscal arrangements were quite different than what supported the expansion of the cost-shared national programs. The 1950s and 1960s were periods of relative price stability. From 1950 to 1970, the average annual growth of CPI was 2.5 percent. Economic growth was vigorous, though interspersed with some business cycles. Real GDP increased at an annual rate of 5.0 percent during the same period. This situation turned around in the 1970s. In the first five years of the 1970s, the CPI increased by a total of 42.6 percent (7.4 percent per year). By 1980 it was 2.2 times higher than it had been ten years earlier. In the ten years between 1970 and 1980, the CPI increased by 85 percent more than during

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

	Average Annual Percentage Change		
	CPI	Real GDP	Unemployment Rate, in Percentage
1950-60	2.5	5.0	3.6-5.9
1970-75	7.4	5.0	5.9-6.9
1975-80	8.7	3.7	6.9-7.5
1975-80	8.7	3.1	6.9-4.5
1980-90	4.8	3.1	7.5-8.5

*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)**

	1980	1990
Deficit, in \$ billion		
Federal	-12.5	-33.3
Provincial/Territorial	-2.7	-8.4
Deficit, Percent of GDP		
Federal	4.0	5.0
Provincial	0.9	1.3
Net Debt, \$ billions		
Federal	91.9	390.8
Provincial	18.8	108.6
Net Debt, Percent of GDP		
Federal	29.7	58.4
Provincial	6.1	16.2

*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 production and (c) providing a scheme of oil pricing and revenue sharing which distributed the effects of higher oil prices among consumers, producers and governments. Without minimizing the energy policy aspects of the NEP, one cannot overlook the revenue implications for the federal government. Over the five-year period of its existence, this program raised \$20 billion for the federal government, equivalent to one-

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 revenues were needed. As a first step, the federal government restored within a couple of years the rate reductions in the Manufacturer's Sales Tax (MST) that had been implemented in 1978. At the same time (1985), the federal government introduced a partial de-indexing of the PIT. It then embarked on a major reform of the personal and corporate income tax system, implemented in 1988. Finally, in 1991 it replaced the MST, whose rate had been increased several times in the meantime, with a form of value-added tax called the Goods and Services Tax (GST).

Provincial governments also scrambled for new revenue in order to keep in check deficits that were being aggravated by reductions in federal grants (to be discussed later). All these revenue adjustments produced major changes in the revenue mix of federal and provincial governments. Four major sources of revenue made up nearly four-fifths of federal revenue in 1980: personal income taxes (39 percent), corporate income taxes (17 percent), sales and excise taxes (13 percent) and custom and excise duties (9 percent). By 1990, the share of personal income taxes had risen to 47 percent while the share of corporate income taxes had been cut in half. In that year, nearly three-quarters of federal revenue was composed of personal income taxes, sales and excise taxes and unemployment insurance contributions. In 1980, half of provincial revenues were made up of personal income taxes (30 percent) and sales and excise taxes (21 percent). By 1990, these two revenue sources accounted for nearly two-thirds of provincial revenue.

**Figure 18**  
**Percentage Distribution of Federal and Provincial Own-Source Revenues,**  
**1980 and 1990**

	1980 Federal	1980 Provincial	1990 Federal	1990 Provincial
Personal Income Tax	39.4	30.2	47.1	38.2
Corporate Income Taxes	17.4	8.5	9.4	4.7
Succession Duties	-	0.2	-	-
Sales and Excise Duties	12.8	21.4	16.1	23.4
Custom and Excise Duties	8.5	-	5.1	-
National Energy Program Taxes	3.3	-	-	-
Levies for Unemployment Insurance, Workers Compensation and Health Insurance	6.4	6.7	10.5	5.2
Real Property Tax	-	0.2	-	1.4
Other Taxes	2.5	3.5	1.8	5.4
<b>Tax Revenue</b>	<b>90.3</b>	<b>70.7</b>	<b>90.0</b>	<b>78.3</b>
Motor Vehicle Licenses and Fees	-	2.8	-	2.0
Royalties	-	12.2	-	4.0
Remittances from Government Enterprises	1.6	4.6	2.7	4.4
Other Revenue	8.1	9.7	7.3	11.3
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

*Source: Statistics Canada, Provincial Economic Accounts, Various Issues*

Within the environment of stagflation and escalating spending on cost-sharing programs, the major thrust of federal-provincial fiscal relations was for the federal government to maintain some control of national programs while reducing its contribution, and for the provinces to gain some flexibility on cost control without losing federal contributions. A convergence of interests occurred in 1977 after a series of federal proposals and provincial counter-proposals. The new agreement, which covered the 1977-82 period, replaced the existing cost-shared programs for hospital insurance, medicare and post-secondary education with a combination of tax points and cash, neither component being tied to the actual costs of these programs. The new arrangements for Established Programs Financing (EPF) involved the transfer to the provinces of 13.5 personal income tax points and one corporate income tax point plus a cash contribution equivalent to the revenue from these tax points. The actual tax point transfer was 9.143 personal income tax points because 4.357 PIT points and one CIT point had been transferred in 1967 for post-secondary education. The tax points

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**

	1980/81	1990/91
<b>Specific Purpose Grants</b>		
Health	3,980.3	6,033.0
Education	1,605.0	1,861.5
Canada Assistance Plan	1,973.3	5,966.9
Other	1,009.0	3,275.2
Subtotal	8,567.6	17,136.6
<b>General Purpose Transfers</b>		
Statutory Subsidies	34.1	35.9
Tax Arrangements	334.1	483.5
Equalization	3,856.7	9,319.4
Other (a)	-163.4	-383.0
Subtotal	4,061.5	9,455.8
<b>Total</b>	<b>12,629.1</b>	<b>26,592.4</b>
Percent of Federal Revenue	26	22
Percent of Provincial Revenue	21	19

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 imbalances that still affect federal-provincial relations today. Perhaps federal politicians got tired of bearing the political cost of raising revenue that would be used partly for the political benefit of provincial politicians.

### Retrenchment

As shown by Ruggeri, Van Wart and Howard (1993), by the beginning of the 1990s the federal government had established a fiscal structure that, under moderate economic growth, would lead automatically to the gradual elimination of the deficit as long as there was moderate economic growth. There was no need for further fiscal restraint unless one wanted a faster elimination of the deficit. The federal government decided to speed up the return to balanced budgets and used fiscal restraint as an opportunity to restructure its role in economic and social policy. On the tax side, the major thrust was to set the stage for shifting the burden of taxation from personal and corporate income taxes to other revenue sources. Major candidates for rate increases were the payroll taxes used to finance social insurance programs. The rates of CPP contributions were increased substantially and the rates of EI contributions were not reduced enough to match the falling benefits resulting from program changes and improved economic conditions. As shown by Ruggeri and Yu (2001a), the mismatch

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.

The provinces also introduced fiscal restraint measures, but their efforts at balancing budgets were made more difficult by federal cutbacks. The time path of federal and provincial deficits for selected years is shown in Figure 20. This Figure shows the dramatic improvement in federal finances that occurred in the 1990s. A deficit of \$37 billion in 1992 was transformed into a surplus of \$6 billion in 1997 and \$19 billion in 2000. The provincial situation also improved, but at a slower pace. They still had a combined deficit in 1997 and the surplus in 2000 was largely due to unusually high natural resource royalties. The different patterns of fiscal balances for federal and provincial governments affected the relative evolution of the public debt. From 1992 to 2000, the federal debt increased by \$81 billion or 17 percent. This increase was less than the growth of GDP, therefore, the debt to GDP ratio fell from 66.7 percent at the beginning of the period to 52.6 percent at the end of the period. During the same period, the provincial debt increased by \$77 billion or 48 percent which mirrored the growth of GDP. As a result, the debt to GDP ratio for all provinces and territories combined was virtually the same in 2000 and in 1992 (23 percent).

**Figure 20**  
**Federal and Provincial Surplus or Deficit (-) and Debt, 1992 and 2000 (NIA)**

	1992	1997	2000
Deficit, \$ Billion			
Federal	-37.2	6.5	19.4
Provincial-Territorial	-28.2	-3.2	10.9
Deficit, Percent of GDP			
Federal	-5.1	0.7	1.8
Provincial	-3.9	-0.4	1.1
Net Debt, \$ Billion			
Federal	466.2	579.7	547.4
Provincial	161.0	247.9	237.8
Net Debt, Percent of GDP			
Federal	66.7	66.0	52.6
Provincial	23.0	28.2	22.9

Source: Department of Finance: *Fiscal Reference Tables, 2001*

Federal fiscal restraint reduced the burden of intergovernmental transfers on federal finances and their contribution to provincial budgets. As shown in Figure 21, the share of those transfers in federal revenue dropped from 22 percent in 1994/5 to 16 percent in 2000/01. During the same period, their share of provincial revenues dropped from 20 percent to 15 percent. The importance of these reductions becomes more significant when we focus on the transfers for the programs that were consoli-

dated into the CHST. From 1994/95 to 2000/01, provincial spending on health care, post-secondary education and social assistance increased by \$13 billion while federal cash transfers for those programs actually fell by \$2 billion. During that period, the provinces paid the full bill for the increasing costs of national programs and absorbed the cut in federal contributions. The federal contribution to these programs is scheduled to increase until 2005/06 according to the September 2000 federal offer. This offer represents a two-thirds solution. I estimate that, even under conservative assumptions, provincial expenditures for national programs will increase by over \$20 billion by 2005/06. The six billion dollar increase in federal contributions for the same year represents 29 percent of the additional cost. Compared to the 50 percent cost-sharing of expenditures on national programs, a 29 percent contribution represents less than two-thirds of the target.

**Figure 21**

**Federal Transfers to Provinces: 1994/95 and 2000/01, in Billions of Dollars**

	1994/95	2000/01
EPF	10.1	–
CAP	7.3	–
CHST	–	15.5
Equalization	9.7	11.2
Other	4.9	4.9
Total	32.0	31.6
Total as % of Federal Revenue	22	16
Total as % of Provincial Revenue	20	15

*Source: Department of Finance, Federal Budgets, and Fiscal Reference Tables, 2001*

For the 25 years from the mid-1970s to the end of the 1990s I have identified two major signposts. The first signpost is the creation of vertical fiscal imbalances. The second signpost is the shift of focus by the federal government from social policy to economic policy. The restructuring of the federal fiscal system and the retrenchment from federal commitments to the financing of national programs has created substantial vertical fiscal imbalances, which were only dented by recent reductions in income tax rates. Since this issue has been addressed in other papers,<sup>21</sup> I will not elaborate further here except to say that the future of the Canadian federation depends partly on how these imbalances are redressed. At the federal level, retrenchment was associated with a fundamental shift in the federal role. Fiscal sustainability was not a goal in itself, but part of a package designed to strengthen the competitive position of Canada in the new world order. This meant a shift of focus from social policy to economic policy and a consequent reduction in the importance of redistribution. This changing role of the federal government had opened the door to the exercise of provincial leadership, an issue that will be discussed in the next section.

### 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 the supranational level.” At the same time “powers are also being passed downward from central governments of nation-states, especially from central governments in federal nation-states.”<sup>22</sup> If central governments are stripped of power from above and below, they may have limited room for economic policy. Being left with limited flexibility in the economic policy arena, it is argued that they should concentrate on social policy. If, in a federation like Canada, social policy must be used to hold the country together against the centrifugal forces of globalization, it would seem that the federal government should play the prominent role. Under this view, one would expect to see globalization being accompanied by a shift of emphasis by the federal government from economic to social policy. The evidence indicates that the policy shift is going in the opposite direction.

In the knowledge-based age, a country can prosper only to the extent that it expands the production and effective utilization of human capital and creates the conditions for the growth of innovative activity. In meeting these conditions, nation-states are challenged by international competition arising from the increasing mobility of capital and labour. This international competition for productivity-enhancing factors of production has led to a worldwide attack on income taxes. Concerned about the unenviable productivity record of the Canadian economy, the federal government has made productivity growth its main policy objective and has pursued it through increased spending on “knowledge-based activities” and through reductions in personal and corporate income tax rates. It has also increased its direct involvement in the component of social programs – post-secondary education – which is closely related to the knowledge-based economy. The costs of these tax and spending programs were recovered through increases in other taxes – primarily an excess of contributions over benefits under the EI program – and reductions in transfers to provinces. On the traditional social policy side, the federal strategy has been to maximize the leverage it can get from its fiscal contribution, a policy I call leveraged unilateralism.

I have interpreted the developments that have taken place over the past decade as an indication that the federal government is trying to hold together the economic side of the country. The task of developing social policy has been vacated to the provinces, which remain largely responsible for the social responsibilities originally thrust upon them by the founding fathers. And so it seems that we have come full circle.<sup>23</sup> I argue that the task of building that infrastructure has been left to the provinces through the unilateral retrenchment from traditional commitments by the federal government. Whether this realignment of responsibilities will strengthen or weaken the federation will depend on how they affect the structure of intergovernmental relations.

If this shift in federal priorities ultimately leads to federal and provincial unilateralism, it will impair the economic and social health of the nation. The shift of social



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* which 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> Perry (1955, 194).

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

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

<sup>9</sup> Perry (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 Perry (1955, 302).

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

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

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

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

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

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

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

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

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

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

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

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**“A REPORT THAT ALMOST NO ONE HAS DISCUSSED”  
EARLY RESPONSES TO QUEBEC’S COMMISSION  
ON FISCAL IMBALANCE**

*Alain Noël*

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*Acknowledgement: The author was a member of Quebec’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 on October 11, 2002, the federal Minister of Intergovernmental Affairs, Stéphane 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. “The fiscal imbalance,” he wrote, referring specifically to Quebec, “exists because everyone says it does, and this on the basis of a report that almost no one has discussed.” “Too often,” Dion added in a sharp dismissal, “this is how consensus is forged among our political and media elite.” “Fortunately,” he concluded, “Quebecers are not buying the ‘consensus’ of the day.”<sup>1</sup>

The idea that Quebec elite live by myths that they alone believe unanimously, and otherwise have “trouble keeping up” 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 within “our political and media elite” - with a claim as the only true representatives of Quebec citizens. This well-rehearsed construct, however, always demands some faith and imagination. Consider the case at hand, fiscal imbalance. First, Quebec citizens apparently do “buy” the “consensus of the day.” 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.<sup>2</sup> Second, a social and political consensus did not emerge spontaneously, following the release of a report “that almost no one has discussed.” 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.<sup>4</sup> 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.<sup>5</sup> 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 governments in light of the actual analysis put forward by Quebec's Commission on Fiscal Imbalance. This is what is proposed in this chapter. The first section presents the Commission's definition and indicators of fiscal imbalance; the second, the factors behind fiscal imbalance in Canada; and the third, the solutions proposed by the Commission. Each section considers these contributions in reference to early responses to the report. The conclusion broadens the perspective, to discuss the difficulty of even thinking about change in the contemporary Canadian federation.

## **WHAT IS FISCAL IMBALANCE?**

Created by the Quebec government to analyze the causes and consequences of fiscal imbalance in the federation and to propose solutions to correct the situation, the Quebec Commission on Fiscal Imbalance started its work at the beginning of May 2001. The Commission was chaired by Yves Séguin, president of Groupe Marine Inc. and former Revenue Minister in the Bourassa government between 1987 and 1990,<sup>6</sup> and included six other members: Anne-Marie D'Amours, president of Capimont Technologies; Renaud Lachance, professor, École des Hautes Études commerciales, Université de Montréal; Andrée Lajoie, Faculté de droit, Université de Montréal;

Nicolas Marceau, Département des sciences économiques, Université du Québec à Montréal; Alain Noël, Département de science politique, Université de Montréal; and Stéphane Saintonge, associate attorney, Legault-Joly-Tiffault. The Commission had its own staff, but also benefited from the support of Quebec's Ministère des Finances. The Commission's secretary and assistant secretary, Mario Albert and Patrick Déry, were from the Ministère. 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 economics, was discarded as unhelpful for the task at hand. This definition equates fiscal imbalance with a vertical fiscal gap, a gap between an order of government's own-source revenues and its expenditures, which requires transfers from another order of government. The definition has the advantage of being easy to operationalize, transfers between governments being the direct measure of the fiscal gap. Such a definition leaves open, however, the real question of imbalance, a situation where the vertical fiscal gap, which always exists in a federation, becomes problematic.<sup>7</sup> To address this question, at the core of its mandate, the Commission started not from the distribution of financial resources between orders of government, but rather from the federal principle and its implications.

In a federation, the powers of the state are divided between two orders of government that are interdependent but also autonomous in their areas of jurisdiction. This division of powers is constitutional and must be respected by both orders of government. This arrangement, however, cannot rest solely on legal grounds. To be effective, the constitutional division of powers must be anchored in a roughly parallel division of financial resources, to protect the autonomy of each order of government and preserve the federal principle. "Both general and regional governments," wrote K. C. Wheare in a classic statement of this idea, "must each have under its own independent control financial resources sufficient to perform its exclusive functions."<sup>8</sup>

A perfect correspondence between own-source revenues and expenditures is, of course, rarely possible, and transfers between governments are normally used to prevent a vertical fiscal imbalance (and sometimes to redistribute revenues horizontally within the federation). The vertical fiscal gap, however, should never be so wide as to make the autonomy of one order of government illusory. When they complement own-source revenues, transfers should also be adequate, and allow governments to cover the expenditures associated with their powers. Finally, transfers should be unconditional, unless there is a valid agreement to that effect between the governments.<sup>9</sup> These are the three conditions of fiscal balance in a federation: own-source revenues are sufficient to allow each order of government to be autonomous and accountable in its fields of jurisdiction; own-source revenues plus transfers are ade-

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.<sup>10</sup>

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 resources or by the uncertainty of future funding, but they are not vested with constitutional autonomy and powers. In such a case, an inadequate division of financial resources may be an administrative and political problem, but it does not raise constitutional and federal issues. Hence, the argument that Canadian cities suffer from fiscal imbalance with respect to provincial governments may have some rhetorical appeal, but it is basically a misunderstanding that confuses the situation of local entities in a unitary context with that of member states in a federation. A fiscal imbalance is only possible in a federation, because it requires a constitutional division of powers between two orders of government, and a shared commitment to the autonomy and accountability of each of these orders of government. What is at stake in this case is not simply the financing of various activities, but the adequate workings of the federation.

In his speeches on the question, Dion addressed the issue in exactly the opposite way. The City of Montréal, he claimed, "may be in a fiscal imbalance, insofar as its revenue sources are too limited in relation to its responsibilities," but "there can be no imbalance to the detriment of one order of government when it has access to all revenue sources."<sup>12</sup> There are, in this argument, two basic errors. One is associated with a disregard for the federal principle, the other with a disregard for reality.

Consider, first, Dion's disregard for federalism. The parallel he drew between municipal governments and provinces was convenient for his argument and it could make sense for someone perceiving federalism as simply a decentralized form of public management, but it was odd coming from a politician who had made himself into a champion of federalism.



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.<sup>13</sup>

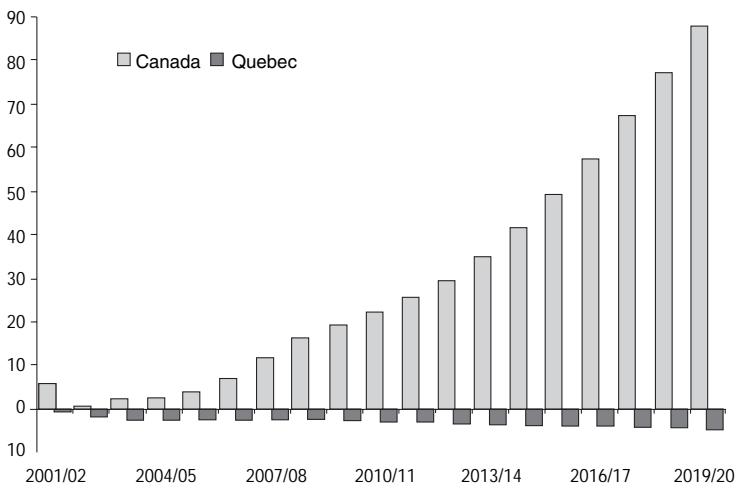
Now, in Canada, as in most federations, municipalities do not form an order of government with constitutional powers. They have, in fact, no constitutional standing and can be created or abolished at will by provincial governments.<sup>14</sup> There may be a vertical fiscal gap between municipal and provincial governments but not a fiscal imbalance. The federal principle is not at stake. This is not simply a matter of small differences in definitions. Comparing the relationships between the two constitutional orders of government in the federation to those between cities and provincial governments is equivalent to denying the constitutional sovereignty of provincial governments. Unlike the Minister of Intergovernmental Affairs, the Commission on Fiscal Imbalance assumed that there was something distinctive and important about federalism, and analyzed fiscal balance in this context.

In the same argument, Dion added that, in any case, “there can be no imbalance to the detriment of one order of government when it has access to all revenue sources.”<sup>15</sup> This was his primary and most important argument, because it stated that in the Canadian federation a fiscal imbalance was simply impossible, no matter what was the budgetary and intergovernmental context. One wonders, in fact, why he went on, in the same letter, arguing about budgetary prudence, federal transfers, and health and education expenditures. Why did he raise budgetary issues if they had no relevance in a discussion of fiscal balance? The fact of the matter, of course, is that these issues are of obvious relevance in the real world of fiscal federalism. Just as he forgot the federal principle when he compared provinces to municipal governments, the Minister forgot reality when he claimed that provincial governments had “access to all revenue sources.” From a purely legal perspective, this statement was almost true (but not quite; provinces cannot collect indirect taxes such as customs and excise duties).<sup>16</sup> The real question, however, as Kenneth Norrie and L. S. Wilson put it, was “whether provinces and territories are constrained in their access to the main revenue sources in fact, if not in principle.”<sup>17</sup> Unless one thinks that there are simply no limits to the revenues a government can raise, access to revenues must be considered in a context where the prior occupancy of tax fields matters. There is little point in assessing fiscal imbalance in light of what could be in a world without constraints. The purpose of a study of fiscal imbalance is to find out what actually happens, in a real world defined by the prior occupancy of tax fields, changing revenues and expenditures, and evolving transfers. Stéphane Dion unwillingly conceded this when he raised issues of budgetary prudence and argued that the federal government was “helping the provinces as best it can under the circumstances.”<sup>18</sup>

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 wide 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."<sup>19</sup> 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.<sup>20</sup> Figure 1, below, presents these projections.

**Figure 1**  
**Projections of the Budgetary Balances of the Federal and Quebec Governments, 2001/02 to 2019/20, in \$ billions**



Source: *Commission on Fiscal Imbalance*

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.<sup>21</sup>

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 future. They are used as a decision tool, to highlight the forces at work in the current situation. Pondering the consequences of unchanged policies is precisely the point of the exercise. In its October 2002 *Economic and Fiscal Update*, the federal Department of Finance made fiscal projections to 2007/2008 in exactly the same manner, on a "status quo policy basis."<sup>22</sup> Noticeably, these projections indicated a five-year cumulative federal surplus more than two times larger than the surplus forecasted by the Conference Board of Canada for the same period. For the fiscal year 2007/2008, the Department of Finance foresaw a budgetary surplus of \$21.6 billion, compared to \$9.7 billion for the Conference Board. Even when it subtracted \$7.0 billions for economic prudence and for a contingency reserve, the Department of Finance still got a surplus significantly larger than that estimated by the Conference Board (\$14.6 billion compared to \$9.7 billion).<sup>23</sup> The Department of Finance did not present projections for the provinces and territories, but foresaw a total deficit of about \$300 million in 2001/2002 for the provinces and territories.<sup>24</sup> Skeptics who do not like the projections of the Conference Board can use those of the federal Department of Finance, which are not very different.

Kenneth Norrie raised a more relevant point when he noted that actual and projected budgetary balances cannot measure the fiscal imbalance that exists in the Canadian federation.<sup>25</sup> Norrie was right, insofar as budgetary balances may result from a variety of factors and do not capture perfectly the different dimensions of a fiscal imbalance. This is why the Commission on Fiscal Imbalance treated the Conference Board projections as indicators rather than as measures of fiscal imbalance. These indicators, however, are telling because they are striking manifestations of an underlying problem, which is analyzed at length in the report of the Commission. To this analysis, we now turn.

## THE CAUSES OF FISCAL IMBALANCE IN CANADA

The definition of fiscal imbalance presented above has three dimensions. There is fiscal imbalance if the vertical fiscal gap becomes too large, if transfers are inadequate, and if transfers are conditional. These different dimensions of fiscal imbalance are analyzed at length in the report of the Commission.

The tendency towards an excessive vertical fiscal gap appears clearly in the budgetary balance projections of the Conference Board presented in Figure 1, and it is confirmed by projections from other sources, including the federal Department of Finance. In part, this tendency can be attributed to the division of revenues between the two orders of government. There are no constitutional constraints limiting a government's access to most tax fields, but the logic of prior occupancy implies that the two orders of government effectively rely in different proportions on the various

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.

Over time, federal revenues are likely to grow faster than provincial revenues, and this accounts, in part, for the tendency towards an excessive fiscal gap between the two orders of government. The main factors explaining this tendency, however, are on the expenditure side. The preponderance of expenditures in the explanation appears clearly in Figure 2, which presents the Conference Board’s estimates of total revenue and total spending growth for the federal and the Quebec governments over the 2000/2001 to 2019/2020 period.

**Figure 2**

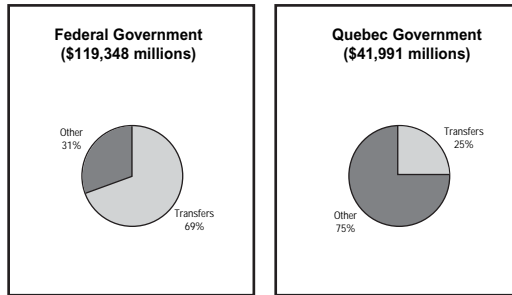
**Growth of Total Revenue and Spending of the Federal Government and the Quebec Government, 2000/2001 to 2019/2020, in percentages**

	Federal	Quebec
Growth of total revenue	3.2	3.1
Growth of total spending	2.1	3.6
Difference between revenue and spending growth	+1.1	-0.5

*Source: Commission on Fiscal Imbalance*

The difference in the past and expected growth of federal and provincial expenditures is not related to a gap in public management quality between Ottawa and Quebec, as Jean Chrétien suggested in October 2002.<sup>26</sup> It stems from fundamental differences in the expenditures of each order of government. As Figure 3 indicates, the federal government spends mostly on transfers, and the provinces mostly on programs with important fixed costs.

**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 government's program expenditures, and education and culture for another 26 percent. An important proportion of these expenditures was devoted to direct services and entailed fixed costs that could not be modified easily. Health expenditures, in particular, are bound to increase in the coming years. In Quebec between 1985/1986 and 2000/2001, in spite of a budgetary context that was often difficult, these expenditures have risen by an annual average of 5.1 percent. A similar pattern, driven by technological progress, population aging, and a rising demand for health services, holds in the other provinces and in other advanced democracies. For the coming years, program spending for health services will continue to rise and it will exert a strong pressure on provincial budgets.<sup>27</sup> The evolution of education expenditures is likely to be less dramatic because the size of the younger cohorts will decrease, but fixed costs and contemporary requirements for training and education will prevent spending from decreasing significantly. Overall, the trend is clear: dominated by program spending and driven by the rising cost of health services, provincial expenditures are bound to increase over the years, as they have in the recent past.

For the federal government, the situation is quite different. Defense, the most important federal program in terms of expenditures, accounted in 2000/2001 for only 8.1 percent of total program spending. Between 1985/86 and 2000/2001, defense expenditures only increased at an average rate of 0.6 percent per year. The new commitments announced following the events of September 11, 2001 will only raise this rate by about two percent for the following six years, and there are also additional revenues associated with these new expenditures. Similar observations could be made for other programs, of less importance. Program spending in Ottawa simply does not compare to the situation in the provinces. Federal programs associated with direct services to citizens are much smaller and they tend to be characterized by more time-limited, less rigid expenditure patterns.

With respect to transfers – to persons and to provincial governments – federal spending is much more important, and to some extent more constrained, but there are no internal pressures that impose continuous growth. Transfers to individuals represent about a third of federal spending programs. Old Age Security benefits are by far the most important of these transfers and account for 20 percent of total program spending, followed by employment insurance benefits (10 percent of the total) and transfers to Native peoples (four percent). Even with population aging, however, these federal transfers to individuals are not likely to grow very strongly over the coming years. In fact, the growth of Old Age Security benefits has decreased gradually in the last twenty years, because these programs are no longer universal. Benefits are now adjusted to the income of the recipients, and this feature of the programs will become very significant in the future, because the coming cohorts of retirees are expected to be more affluent and better protected by the public and private pension plans created in the 1960s and 1970s. By international standards, the Canadian system of income security for seniors is remarkably sustainable. The costs are modest and under control, and the system is relatively effective in preventing poverty.<sup>28</sup> Expenditures for employment insurance are also unlikely to increase dramatically. Demographic trends do not suggest important rises in the unemployment rate, and the program has been transformed significantly in recent years to limit accessibility and reduce benefits. Far from being a budgetary constraint, the employment insurance program has become a major source of revenue for the federal government, to the point that the Auditor General has repeatedly raised "concerns about the Government's compliance" with the *Employment Insurance Act*, and noted in October 2002 that she was "unable to conclude that the setting of premium rates for 2001 and 2002 observed the intent" of the Act.<sup>29</sup> Transfers to Native peoples may increase over time, but given their share of total program spending (four percent), they would have to grow at a spectacular rate to affect the overall budgetary balance of the federal government.

Major transfers to the provinces represented, in 2000/2001, 20 percent of federal program spending: 11 percent for the Canada Health and Social Transfer (CHST) and nine percent for Equalization payments. More will be said on transfers below, but it can already be noted that transfers were almost entirely under the control of the federal government, and largely unrelated to social needs or economic growth. For the CHST, there was no formula to govern the evolution of spending and no federal commitment beyond the 2005/2006 fiscal year. With Equalization, the formula also tended to prevent total payments from growing faster than the gross domestic product.

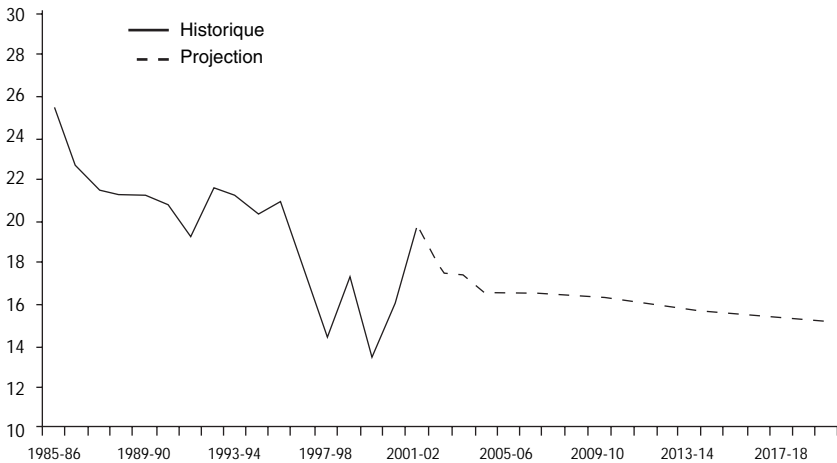
The federal government simply does not face constraints associated with growing system costs or rising social demands comparable to the pressures experienced by the provinces. This is not a question of good management, but rather a simple effect of the constitutional division of powers between the two orders of government. Driven by health care and social services, expenditures will rise inexorably in areas of provincial jurisdiction, while they will be relatively steady in domains of federal jurisdiction. The growth of revenues will not match these trends. In fact, federal revenues are

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*

The impact of the cuts in transfers associated with the CSHT can be measured in a variety of ways. When the evolution of transfers is compared with what would have happened with the 1994/1995 status quo, we find a cumulative revenue shortfall of \$24.4 billion for the provinces, between 1994/1995 and 2001/2002 (\$8.7 billion for the Quebec government). If we take into account the growth of social expenditures during the same period, the cumulative shortfall rises to \$36.9 billion (\$12.0 billion for the Quebec government). In 1994/1995, the federal government financed 18.1 percent

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.

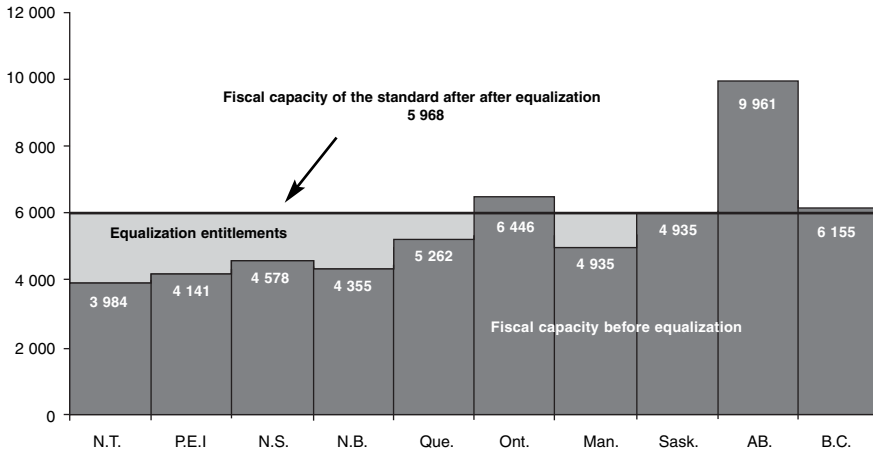
Acknowledging in practice what it has steadfastly denied in principle, the federal government has increased transfers to the provinces in recent years. Public concerns about health care, in particular, have favoured important additions to the CHST and the creation of health-related earmarked funds, which 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).<sup>30</sup> In fact, they leave the federal share of spending well below the 18.1 percent of 1994/1995.<sup>31</sup>

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 the less 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 or less arbitrary fashion.<sup>32</sup>

In this respect, the Equalization 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 *Constitution Act, 1982*, Section 36(2): "...to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." Equalization payments are also governed by an explicit formula that is periodically revised. The problem, in this case, is that the Program does not meet its objectives fully, and is not managed correctly. Regarding the Program's objectives, a number of restrictions prevent their complete fulfillment. First, Equalization is calculated by comparing a province's fiscal capacity to that of five, and not ten, provinces (Quebec, Ontario, Manitoba, Saskatchewan, and British Columbia). As a result, as can be seen in Figure 5, significant differences in fiscal capacity remain after Equalization.



**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.<sup>33</sup> 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 government of about \$800 million each year. These limitations are compounded by the fact that the Program is governed in an opaque way, with little transparency or input from the public, independent experts, or provincial governments.

The last major cause of fiscal imbalance is associated with the use by the federal government of what it calls its “spending power.” The centrality of the “spending power” in federal policy is a clear manifestation of a third dimension of fiscal imbalance, the use of non-valid conditional transfers.<sup>34</sup> The CHST, a conditional transfer explicitly designed to intervene in areas of provincial jurisdiction, is the primary federal instrument in this respect. Other measures include transfers to persons, as well as direct and fiscal expenditures in domains of provincial competence. In every case, the federal government uses the superior financial resources it has by virtue of the fiscal imbalance to introduce conditions and norms in fields that are not within its jurisdictions, without having to obtain a constitutional amendment to do so. In the past, for unemployment insurance and old age security, constitutional amendments were sought to allow such federal interventions.<sup>35</sup> For many years now, the simple evocation of the “spending power” has been deemed sufficient. The report of the Commission demonstrates that, in fact, the constitutionality of this “power” has never been established.

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.<sup>36</sup> 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.<sup>37</sup> 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, and to \$3 billion in the medium term. These amounts are large, but they are in line with the imbalance that has appeared over the years between reduced federal transfers and growing social needs. They are also compatible with the maintenance of balanced federal budgets. Indeed, for health care alone, the Commission on the Future of Health Care in Canada recommended additional federal transfers of \$6.5 billion by 2005/2006.<sup>38</sup>

These new resources should not be allocated through the existing social transfers, because the CHST (or the CHT/CST) remains a discretionary and conditional transfer that offers no guarantee of long-term stability. Since this transfer is not allocated on the basis of needs or resources, it is in fact very hard to justify. Why should the federal government collect revenues so that it can give it back to the provincial governments, almost on a per capita basis, for the purpose of spending in their own fields of jurisdiction?<sup>39</sup> The Commission recommended the abolition of this transfer, and its replacement by new tax room for the provinces, a solution that would improve accountability, predictability and transparency in the country, and be more compatible with the federal principle.

For many years, the Quebec government has sought such increased tax room through a new division of the personal income tax field. The Commission carefully considered this option, along with another possibility the reallocation to the provinces of the Goods and Services Tax. Both options could lead, if the CSHT were abolished, to a situation of fiscal balance. The Commission expressed a preference, however, for sales taxes, because GST revenues are more evenly distributed than income tax revenues across the Canadian provinces. Whereas a new division of the income tax field would have a major impact on Equalization payments, the provincial appropriation of the GST would not. If Quebec, for instance, controlled 58 percent (rather than the current 41 percent) of the income tax field and received no CHST revenues, it would gain \$2.7 billion in additional annual revenues over the 2005-2010 period, but more than half of this gain would come from higher Equalization payments. With the GST scenario, only a small fraction of the gain would be a result of higher Equalization payments. The GST scenario thus seemed preferable because it increased more, and more equally, the autonomous revenues of the provinces. The occupation of an entire tax field by the provinces would also make its gradual re-occupation by the federal government less likely. In either case, the Commission estimated that a new division of financial resources was feasible without compromising the fiscal position of the federal government, especially if the transition was made gradually.

With respect to Equalization, the Commission proposed to eliminate the distortions that detract from the Program's stated objectives. First, the federal government should go back to the ten-province standard and eliminate the floor and ceiling provisions, so as to allocate financial resources on the basis of the actual horizontal distribution of revenues.<sup>40</sup> Second, the representative tax system approach should be used rigorously, for all tax fields. Adopting other approaches and indicators for specific tax fields, such as the property tax field, is not justifiable. Third, new methods or data should be submitted to the provinces and subject to careful study before being implemented. Revisions should not be made unilaterally during the five-year period between each program renewal. Moving to a ten-province standard and applying the representative tax system approach systematically could increase the cost of Equalization significantly, but the Commission considered that it would be better to follow a rigorous formula and state publicly that Equalization objectives cannot be met fully in a given year, rather than hiding cost considerations in the formula.

While fiscal balance in itself would go a long way toward restraining the use of the federal "spending power," the Commission also reaffirmed that there was no constitutional basis for this "power" and proposed that the Quebec government maintains its traditional demand for a right to opt out with financial compensation of any program implemented by the federal government in a field of provincial jurisdiction.

Finally, the Commission recommended a more transparent and open intergovernmental relations process, where the federal government would offer more information and work more closely with the provinces. It also suggested a more thorough monitoring of the situation in Quebec, as well as improved collaboration with other provincial governments.

## CONCLUSION

The issues raised by the Commission on Fiscal Imbalance are not issues for Quebecers alone. Nor are they purely intergovernmental matters. They concern public finances, the sustainability of social programs, the workings of the federation and, more broadly, democratic transparency and accountability. Indeed, the Commission on the Future of Health Care in Canada revisited most of these issues, and often reached similar conclusions.

The federal government, wrote Thomas Courchene in a 2002 paper, "set its own fiscal house in order on the fiscal backs of the provinces."<sup>41</sup> Now that federal budgetary surpluses are recurrent, important, and growing, the imbalance created by this approach should be addressed and corrected. At stake, beyond the obvious financial implications of the situation, is the effective working of our democratic and federal institutions. In Canada as in many other countries, citizens are increasingly preoccupied by democratic governance, and they seek greater public accountability, as well as institutions and practices that generate certainty and foster trust.<sup>42</sup> In the country's intergovernmental relations, however, uncertainty and distrust tend to prevail.<sup>43</sup> This is not merely a matter of personalities, leadership, or lack of good will, but rather an historical outcome and an institutional feature of the federation. Indeed, trust requires reliable rules. In a brief written for the World Bank, Richard Bird explains that in a federation "the key to effective accountability is to set out the rules clearly and to make relevant comparative information publicly available."<sup>44</sup> This is precisely the problem with Canadian intergovernmental relations. The major transfer programs are largely discretionary and they lack transparency, stability, and predictability. The CHST is a case in point. The evolution of this transfer program, critical to sustain social services across the country, was simply not governed by rules. The country's core social transfer contained no mechanisms to respond to the growth of needs and costs, and no guarantee of sustainability for upcoming years. In January 1999, Jean Chrétien summarized the situation in these terms: "I can get up Monday and say to myself that I will raise transfers to the provinces, and the next day, I decide to reduce them. We will see at the time of the budget."<sup>45</sup>

Mr. Chrétien's Minister of Intergovernmental Affairs expressed the same idea in a more generous way when he stated, in reaction to the Commission's report, that the federal government "is determined to help its constitutional partners, the provincial governments, as much as it can."<sup>46</sup> The finances of a federation should not rely on "help," however much the federal government is "determined" or able. Good governance requires clear rules.

In most federations, fiscal arrangements are an object of careful scrutiny and they are regularly debated and revised.<sup>47</sup> "Good tax systems," writes Richard Bird, "like good government, require careful cultivation, and continuing attention."<sup>48</sup> There are such discussions in Canada as well, with respect to health care transfers and Equalization payments in particular. Proposals for more fundamental reforms, however, tend to be rejected off-hand, as simple posturing, or as unhelpful and self-interested. This is perhaps a consequence of the concentration of power in Canadian politics.<sup>49</sup> A recent study of Latin-American federations suggests indeed that the countries that have the most centralized and discretionary fiscal arrangements are also those where partisan systems are the least competitive and where central governments appear less concerned by democratic accountability.<sup>50</sup>

Canada, of course, has a solid democratic tradition and well-established institutions. It is difficult, however, not to see the link between, on the one hand, the current state of our fiscal arrangements and the federal government's denial that this is even a matter for serious public deliberation and, on the other hand, the sorry state of political competition in this country. For Canadians, as well as for Quebecers, the problem of fiscal imbalance is more than a budgetary issue. It concerns the quality of governance in the country, the effective working of our democratic institutions, and the concrete realization of the principle upon which the federation was built.

Notes

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<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 Séguin became Minister of Finance in the new Quebec government led by Jean Charest.

<sup>7</sup> "To sum up, the size of the current vertical fiscal gap (that is, the level of intergovernmental transfers) does not tell us whether it is adequate or appropriate. And it tells us even less about whether there is a vertical fiscal imbalance above and beyond the observed or even desired level of VFG. And this is what is at issue in the current debate." Lazar, St-Hilaire and Tremblay (2004, 151).

<sup>8</sup> Wheare, quoted in Bird (1986, 397).

<sup>9</sup> "Transfers to redress VFI should be unconditional. In effect, the jurisdiction with the superior revenue-raising ability is acting as tax collector for the other jurisdictions." Norrie, in Brown (ed.) (2002, 25-26).

<sup>10</sup> *Commission on Fiscal Imbalance, A New Division of Financial Resources in Canada*, (2002, 14).

<sup>11</sup> The same point is made in Boadway, this volume, and in Lazar, St-Hilaire and Tremblay (2004, 149-51).

<sup>12</sup> Dion (16 October 2002).

<sup>13</sup> Dion (11 June 2000).

<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> "Si 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, for 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.



<sup>40</sup> The Equalization ceiling was abolished following the February 2003 First Ministers' meeting on health care financing.

<sup>41</sup> Courchene (July 2002, 23-24 and 33).

<sup>42</sup> Bricker and Greenspon (2001, 6 and 316-17); Stein (2001); Roese (2002, 149-63); Warren (2002).

<sup>43</sup> Lazar (2000, 32-34); Cameron and Simeon (2002, 68); Noël (2003, 47-68).

<sup>44</sup> Bird (7 September 2000).

<sup>45</sup> La Presse (16 January 1999, B3). My translation.

<sup>46</sup> Dion (March 27, 2002)

<sup>47</sup> Commission on Fiscal Imbalance (2002, 120).

<sup>48</sup> Bird (2000).

<sup>49</sup> Savoie (1999).

<sup>50</sup> Garman, Haggard, and Willis (2001).

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## FISCAL BALANCE IN CANADA

*Stéphane Dion*

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### 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 former Premier of Quebec, Mr. Landry, depicted the Séguin report as "*a powerful educational tool for sovereignty*", what he was saying was disconnected from reality: countries do not break up over budget surpluses.

Public finances often spark heated discussions in all countries. In the United States, the states now find themselves with an unexpected deficit of over US\$50 billion and they are reproached with having reduced their taxes too much. This debate, which is similar to ours, is not of course creating any separatism in the United States.

In Germany, the wealthy *Länder* have almost threatened to go on strike in terms of equalization and have gone to court and have obtained less demanding equalization rules. This very complex and arduous debate is not causing any separatist tension in Germany.

And I could also refer to the situation in Belgium, where, to convince the Flemish government to further assist the Belgian French community in its very precarious financial situation, a series of concessions had to be made that, according to some, resulted in a weakening of the linguistic protections hitherto enjoyed by municipalities that offer services in French to the Francophones of Flanders. As we can see, the debate on the fiscal capacity of the orders of government exists in other federations as well, and often raises greater difficulties than is the case here.

My third preliminary remark is that the argument of the “consensus” should in no way be a barrier to individual thought: we can all reach our own conclusions. It is true that many people in Quebec and elsewhere in Canada believe that a fiscal imbalance exists to the detriment of the provinces. But for one thing, this consensus pertains to a very complex issue and does not rally all the experts, far from it. It does not include Quebec business leaders, nor does it include the many financial analysts who regularly congratulate Canada’s Finance Minister for his financial discipline.<sup>1</sup> Moreover, it is normal for provincial political parties to continually call for more money from the federal government, just as it is normal for our municipalities to believe that *“the needs are in the municipalities and [...] the money is in Quebec City.”*<sup>2</sup>

Above all, we cannot rule out the possibility that a consensus can be forged on the basis of a misconception. There is no need to hark back to Duplessis to find examples of this in Quebec. In the early 1990s, there was a “consensus” that the federal budget deficit, which at that time was very substantial, was the result of tens of billions of dollars in unnecessary duplication between federal and provincial programs. Job training alone was supposed to cost us hundreds of millions of dollars in duplication, it was widely rumoured. “Studies” were supposed to prove this. *“Release those studies,”* [Translation] Mr. Parizeau roared in a televised debate with Mr. Daniel Johnson during the 1994 provincial election campaign. Of course, once in power, Mr. Parizeau found only a pile of documents that proved nothing. The “consensus” was based on a misconception.

This time, however, the Government of Quebec has released a study: the Séguin Commission report. The argumentation in this report can be summed up in a single sentence: the federal government is piling up surpluses that it uses in large part to invade provincial fields of jurisdiction, while the provinces are lacking own-source revenues to fulfill their own responsibilities, such as in the health field. The Séguin Commission thus amalgamates two debates.

The first is a financial one: do federal surpluses prove there is a fiscal imbalance to the detriment of the provinces?

The second is a constitutional one: is the federal government using its budgetary latitude to invade provincial legislative jurisdictions?

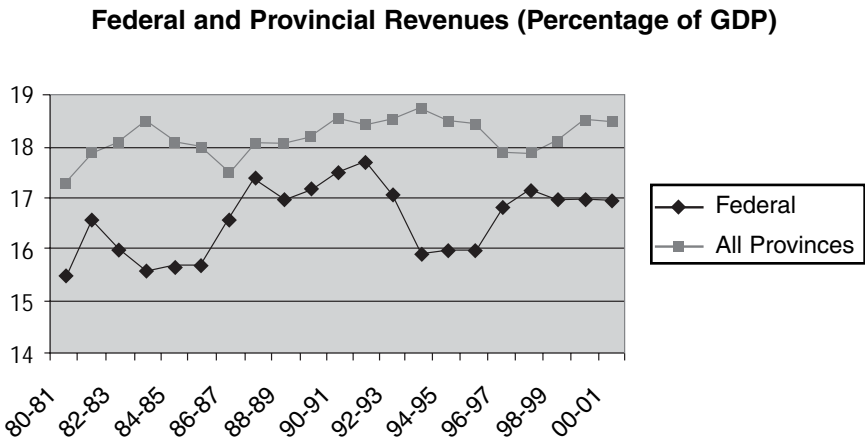
## THE MYTH OF FISCAL IMBALANCE

To gauge the balance of our public finances, we first need to be backed up by the facts, specifically, on the historical evolution of three key variables: revenues, spending and surpluses. Once this historical foundation is laid, we can then look at projections.

### The Facts

Figures 1 and 2 show it is inaccurate to claim that the money is in Ottawa while the needs are in the provinces. Figure 1 shows that, taken as a whole, provincial revenues have long outstripped federal revenues, and there is no indication of a future reversal of that situation. In fact, the federal tax cuts announced in the 2000 Budget and the October 2000 economic statement – totalling \$100 billion over five years (three quarters of which are on personal income tax) – have reduced federal revenues even further.

**Figure 1**  
Evolution of Revenues

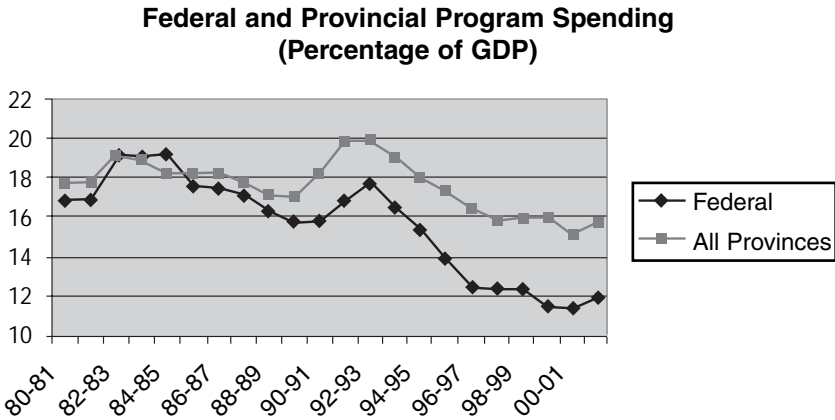


*Sources: Federal and Provincial Public Accounts and Federal and Provincial Budget data as of March 2002*

Figure 2 shows that program spending by both orders of government has grown less quickly than the economy. To put their finances in order, our governments have considerably reduced the weight of their spending in the Canadian economy since 1993, which explains the strong pressures being exerted on them now to reinvest in all areas: economic development, health, education, income security, research and development, culture, environment, security, social housing, infrastructure, and so on. These pressures are being exerted on the federal and provincial governments alike.



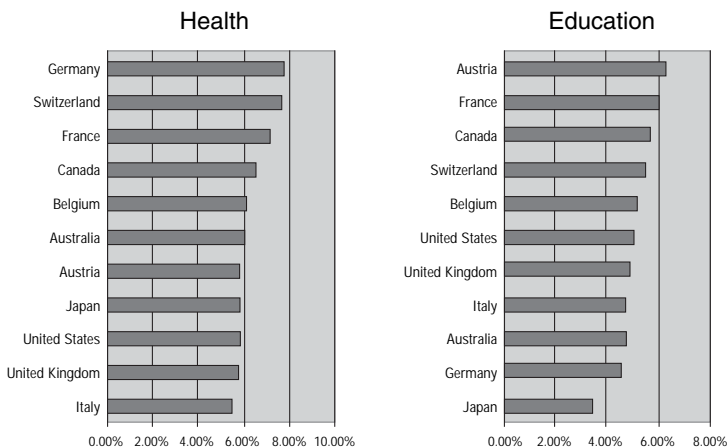
**Figure 2**  
Evolution of Spending



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.<sup>3</sup>

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

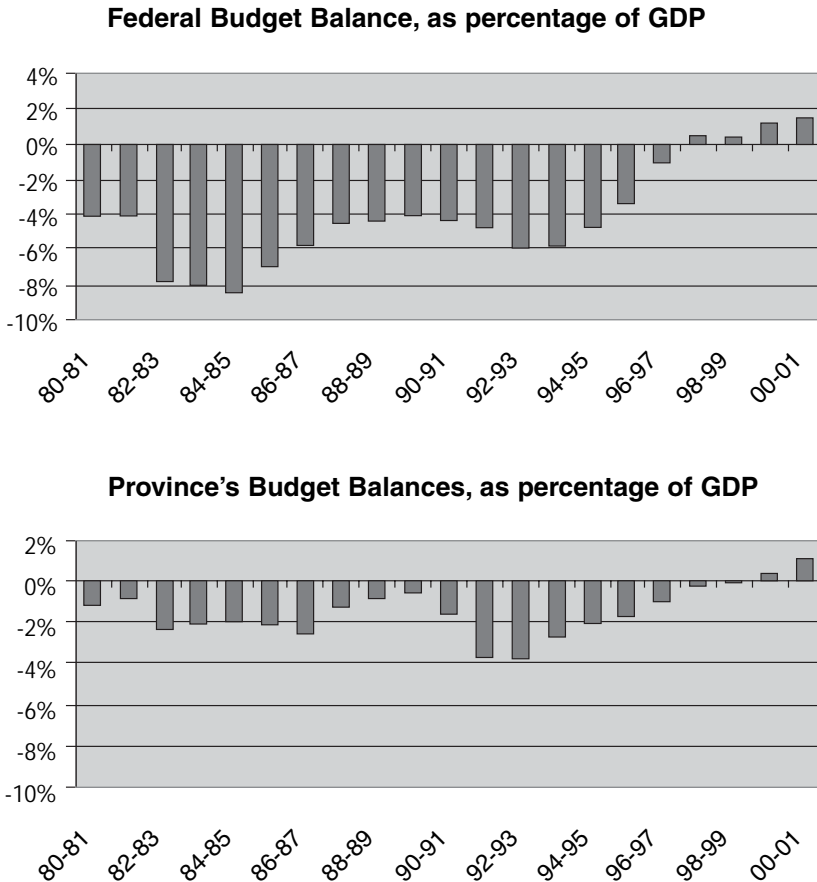


Source: *OECD comparison of health and education spending in developed countries www.oecd.org: 2002*

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 1980's.<sup>4</sup> In Canada, as in other countries, growing health spending is due mainly to the higher number of drugs and new medical technologies, and to the aging population (which is just beginning to be felt). A number of opinion leaders, including Mr. Landry, have already stressed that it is not merely a question of money but also of how things are done. A number of commissions have examined this issue, including those by Mr. Clair in Quebec, Mr. Fyke in Saskatchewan, Mr. Mazankowski in Alberta, Mr. Léger in New Brunswick, and Mr. Romanow at the federal level. The Government of Canada is determined to continue to do its share, both through increased funding – it contributes approximately 40 percent of public health spending – and through the search for better policies and practices.<sup>5</sup>

Now let us look at the evolution of budget surpluses. For two decades, federal deficits were much larger than those of the provinces. If federal surpluses in recent years have been larger than those of the provinces, the fact remains that those surpluses have still been very small in relation to the deficits that preceded them – and in relation to the debt these deficits left to us. Surpluses of the provincial governments are smaller than that of the federal government, but the provincial deficits that preceded them were also much smaller. Consequently, debt servicing costs are roughly twice as high for the federal government (23.6 cents on each dollar of revenue) as for the provincial governments (11.5 cents on each dollar of revenue).<sup>6</sup>

**Figure 4**  
**Evolution of Budget Balances**



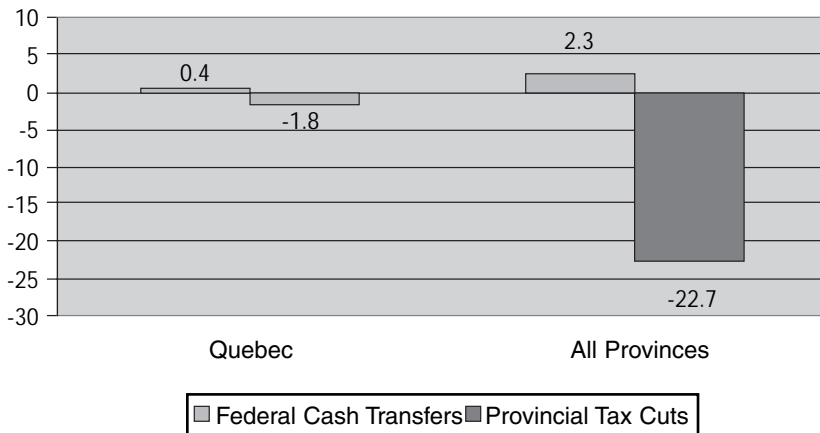
*Sources: Federal and Provincial Public Accounts and Federal and Provincial Budget data as of March 2002*

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."* [Translation] The provincial governments have chosen instead to cut taxes since 1994/95, which represents \$22.7 billion in lost revenue for 2002/03, while the federal transfers they

receive 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 Séguin 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 dollars.<sup>7</sup> So the much-denounced fiscal imbalance would be on its way, but is not, however, here just yet. The Conference Board itself projected only very small federal surpluses for the next five years.<sup>8</sup>

When he was Minister of Finance, Paul Martin, declared that it would be irresponsible to establish our budgetary policies on the basis of 10- or 20-year projections, when economists cannot even predict the beginning or end of a short-term recession. Mr. Martin cited the example of the United States, where projections changed radically because of events and economic conditions.<sup>9</sup>

As Federal Finance Minister, Mr. Martin was sometimes reproached with making budget forecasts that underestimated the surpluses actually obtained by the Government of Canada. In light of the vanishing of the US surpluses,<sup>10</sup> one would be more likely to congratulate our Finance Minister for having erred “in the right direction” by relying, it should be stressed, on private-sector projections. The financial experts had good reasons for calling on him to maintain this healthy prudence. In point of fact, the few billion dollars in surpluses that Canada’s federal government now enjoys would melt like snow in the sun if it relaxed its budgetary discipline even a little. Pendulum effects in this area are devastating, as we are reminded once again by the American example.

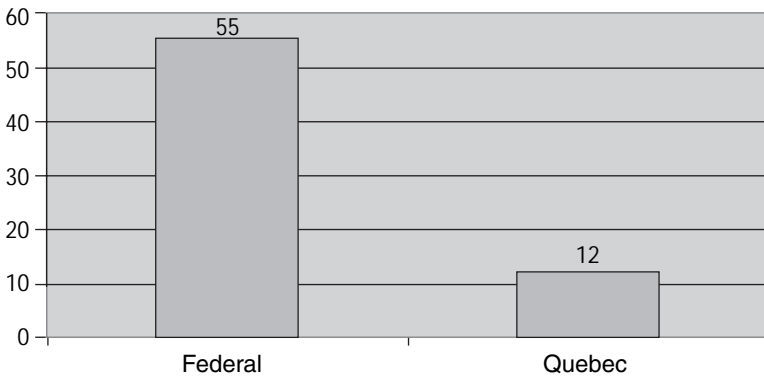
Though we ought not to rely on long-term projections, let us nevertheless look at the methodology through which the Conference Board arrived at its projection of an \$87.8 billion budget surplus for the federal government in 2019/20, compared with a \$4.8 billion deficit for the Government of Quebec. The fiscal imbalance theory would suggest that such a gap would result from the Government of Canada’s revenues growing more quickly than the Government of Quebec’s, and its spending growing less quickly. But the Conference Board contradicts these assumptions. Its calculations lead it instead to project that own-source revenues and program spending by both governments will evolve at the same rate.<sup>11</sup> Rather, the gap between the budget balances of the two governments will widen, according to the Conference Board, because of the automatic dynamic of the debt repayment: it assumes that the federal government will introduce no new measures and will allocate all its latitude to debt repayment.

So, the key hypothesis of the Conference Board is that governments would not undertake any new spending or introduce any new measures affecting revenues throughout the entire period. In other words, it is basically assumed that governments would put themselves on auto-pilot and take a 20-year vacation. Of course, as the Conference Board itself specified, “*the exercise is purely hypothetical.*” That is not the way things happen in the real world. Governments – especially when their approach is a balanced one – allocate only a portion of their latitude to debt repayment. Another portion goes to tax cuts and another to program spending.

Well, federal tax cuts free up tax room that the provincial governments can choose to occupy. Federal program spending obviously includes higher transfers to the provinces.

When you make projections assuming that governments put themselves on “auto-pilot,” you get results that are far removed from reality. Let us see for ourselves by imagining that we had undertaken this exercise in 1997. At that time, we would have projected a \$55 billion federal surplus in 2001/02 and a \$12 billion surplus for the Government of Quebec!

**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 Séguin 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 deficit.<sup>12</sup>

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 Séguin Commission: abolish the Canada Health and Social Transfer in exchange for transferring the GST to the provinces, accompanied by an Equalization increase that would help offset the lower return that this tax transfer would cause for Quebec and the other less well-off provinces. As the Séguin Commission itself acknowledged, such a reform, if applied immediately, would plunge the federal government back into deficit for several years.

If you add in the cost of another of the Commission's recommendations, that of replacing the current standard for calculating Equalization based on the fiscal capacity of five provinces with a standard taking into account the fiscal capacity of ten provinces, you would have the effect of increasing Equalization payments by \$2.9 billion in 2002/03 alone, giving us a bottom line which is even more negative for federal finances. Even the methodology of the Conference Board study, which the Séguin Commission asks us to rely on, leads us to this conclusion.

It is understandable that the Séguin Commission is shocked at its own recommendations to the point that it suggests they be applied only “*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.<sup>14</sup>

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.<sup>15</sup> As TD Bank Financial Group Chief Economist Don Drummond warns us, “there is definitely still a vulnerability.”

### THE MYTH OF A CENTRALIZING FEDERALISM

The Séguin Commission states that the Government of Canada is using its surpluses to invade the legislative jurisdictions of the provinces.<sup>16</sup> That statement is inaccurate and, incidentally, is not proven by the Commission.

It must be said that the Séguin Commission is quick to see “invasions” where none exist. For the Commission, then, a federal initiative such as the Canada Foundation for Innovation is an invasion of a provincial jurisdiction. But just where is it written in the Constitution that research is an exclusive provincial jurisdiction? Does anyone know of a single modern federation in the world where the federal government does not support university research? Such a conception is irrational from an economic standpoint and has nothing to do with good federalism.

More generally, reading the Séguin report gives one the impression that Canada’s federal government is abnormally big, and that its presence spills over into provincial territory. The Séguin Commission also reproaches the federal government with attaching certain conditions to a portion of its transfers to the provinces. It believes such conditional transfers are contrary to the spirit of federalism. Is the federal government too big? Are its transfers to the provinces too conditional? Let us look at the reality.

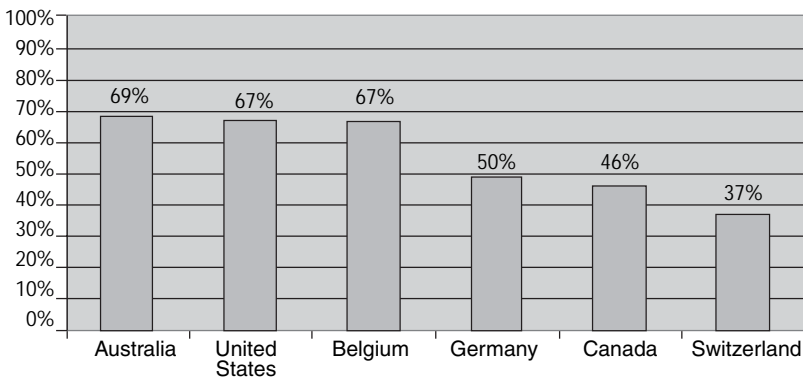
### Is the Federal Government too Big Compared to Provincial Governments?

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.<sup>17</sup>

This federal government that is reproached with being too big actually looks quite svelte when its size is compared with that of federal governments in other federations. In fact, the federal government's share of total own-source government revenues is smaller in Canada than in any other federation but Switzerland, according to the Séguin Commission's own data, shown in Figure 7. Even in Switzerland, cantons do not have the fiscal weight our provinces do; it is rather the Swiss communes that receive a much larger share of revenues than do our municipalities: 29 percent as opposed to 12 percent.

**Figure 7**

#### Federal Share of Revenue, as Percentage of Total Government Revenue



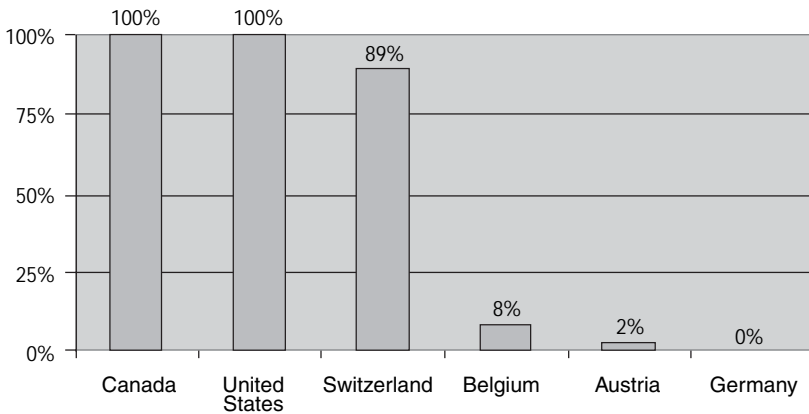
*Source: Séguin Commission and Statistics Canada*

The fact is that the provincial share of government revenues is higher in Canada than in other federations. This can be explained in large part by the fact that in our federation the two main orders of government, federal and provincial, have access to the four main tax bases: individual income tax, corporate income tax, sales taxes and payroll taxes. This is not the case with our third order of government, municipalities; indeed, the mayors of our larger cities complain that their tax base is too small for their responsibilities. Moreover, our provincial governments are the only ones in Canada with access to natural resource royalties. This gives them a monopoly over that tax base that is not found in other federations with abundant natural resources like our own. In the United States, for example, it is the federal government that collects such royalties.

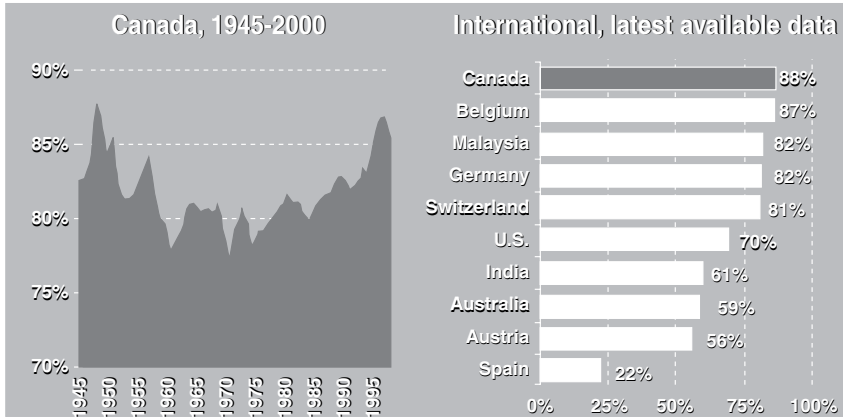


Among federations, not only is it in Canada that one finds the constituent entities with the largest share of tax revenues, but our provinces also have complete autonomy over this exceptional fiscal weight. In fact, they set their own tax rates, a degree of fiscal autonomy equalled only by the American 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.

**Figure 8**  
**Constituent Unit's Control over their Tax Bases and Tax Rates**



Source: OECD, "Taxing Powers of State and Local Governments": 1999

**Figure 9****Own-Source Revenues as a Percentage of Total Provincial-Local Revenues**

Sources: *Statistics Canada (2001) and Watts (1999)*

In fact, it is in Canada that federal transfers are the least coupled with conditions. In the United States, for example, 100 percent of federal transfers are conditional. In comparison, if we look at our two main transfers, we see that Equalization is completely unconditional and the Canada Health and Social Transfer – through which the Government of Canada helps provincial funding for health, social assistance and post-secondary education – has only very modest conditions in comparison with current practice in other federations. As a study by Professor Keith Banting of Queen's University has concluded that:

The politics of the Canadian federation ensured from the outset that the conditions attached to federal transfers were less specific than in other federations; and the shift from conditional grants to block-funding for health care in 1977 largely eliminated day-to-day federal scrutiny of specific provincial decisions.

All of this shows that in the world of federations our provinces are leading in all categories in terms of fiscal capacity, from the viewpoint of share of government revenues, access to tax bases, freedom to set their own fiscal policies, proportion of own-source revenues to their total revenues, and the importance of conditions that accompany federal transfers.

The accumulated decisions made by past Quebec governments have left Quebecers with a debt load and a fiscal burden much higher than those of their fellow citizens in the other provinces. In return, their provincial government has spent more on average than the other provinces.<sup>18</sup> The fiscal burden, for individuals as well as corporations, is 40 percent higher in Quebec than elsewhere in the country.<sup>19</sup> Choices were made. Priorities emerged.

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 Séguin 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 unacceptable, because they all have conditional federal transfers. To find a federation answering to the Séguin Commission requirements, one would have to look on another planet. Or else agree that the most acceptable one of all is still the Canadian federation.

Jean Chrétien, that alleged great centralizer, considerably reduced the conditionality of federal transfers to the provinces. Whereas the conditions used to be included in the cost control process, since 1995 they have been linked only to compliance with the five main principles of the *Canada Health Act* (public administration, comprehensiveness, universality, portability and accessibility) and to a ban on residence requirements in a province or Canada for eligibility for social assistance.

Such conditions, modest as they are, are still contrary to the federalist spirit according to the Séguin Commission, which goes so far as to question their constitutionality. In fact, the federal spending power is recognized in our case law just as it is recognized in the Constitution or the case law of other federations. Similarly, the conditions attached to the Canada Health Act are fully compatible with the legal framework. *Eldridge v. B.C. (Attorney General)* [1997] 3 S.C.R. 624, at par. 25 states that:

The federal Parliament [has played] a leading role in the provision of free, universal medical care throughout the nation. It has done so by employing its inherent spending power to set national standards for provincial medicare programs [...] The constitutionality of this kind of conditional grant, I note parenthetically, was approved by this Court in reference to the Canada Assistance Plan.

But it is not just because a measure is constitutional that it is indeed desirable; it must also contribute to citizens' well-being. Is it desirable for the Government of Canada to provide assistance through its transfers to ensure that Canadians are eligible for social assistance throughout Canada and that access to health services does not depend on the size of the patient's wallet? I say it is, for at least four reasons.

First of all, the modest conditions accompanying the *Canada Health Act* are in no way a "straitjacket;" they do not prevent the provinces from innovating. In reading the report by the Clair Commission, for example, I do not see anything that is contrary to the *Canada Health Act*.

Second, all of the premiers and territorial leaders have expressed their approval of the principles of the *Canada Health Act* on many occasions. The debate among governments does not pertain to these principles as such, but rather to how they are defined and applied and to how intergovernmental conflicts should be resolved. And such conflicts are rare: the Government of Canada has only very rarely reduced its transfers because of non-compliance with these principles by a province. The total funding withheld since 1984 has been only \$8.3 million, and no funding has been withheld from Quebec, as noted by the Séguin Commission itself.

Third, in a federation, the federal government, just like the governments of the constituent entities, receives its mandate from the people, through direct election to the federal Parliament. Well, in the 2000 federal election, Canadians had to choose between the Day approach and the Chrétien approach, and they re-elected a Liberal government determined to enforce the main principles of equity in the Canada Health Act, and may do so again in 2004. If one wanted to free the federal government from this commitment, one would need to go back to the Canadian people, one could not do it in response to provincial study commission. It is a question of democracy. And the polls confirm that Quebecers, just like other Canadians, want our governments to work together in the health field as in other areas.<sup>20</sup>

Fourth, Canadians are right in wanting to maintain a federal role in the health field. We are not in Europe where social programs are relatively similar from one country to another, but rather alone in the face of an American giant that treats health care quite differently. The number of Americans without health insurance is greater than the total number of Canadians. We need cooperation and discipline by all our governments to protect ourselves against rampant Americanization of our health policies. This must not prevent us from examining how we define and apply these main principles, as the Romanow Commission did. But it does mean that health is attached to a sort of right of citizenship that extends to all Canadians, whereby everyone has access to the solidarity of all when struck by illness.

To rise to current and future challenges in the health field and in other sectors, Canada, like other countries, will need to unite its forces. The governments of our federation will have to work together, both on cost-sharing and on developing better policies, while respecting their constitutional powers and responsibilities.

## 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 access to the revenues they need to fund their spending; and that the recommendations by the Séguin Commission would return federal finances to the cycle of deficits.

The invasion of provincial jurisdictions by the federal government is also a myth. The facts show that federal program spending is at its lowest level since 1948; that the provinces have access to the same revenue sources as the federal government and federal transfers have few conditions attached; that the Government of Canada respects the Constitution; and that Canadians, including Quebecers, want their governments to work together.

In closing, I would like to make a further comment on the current debate about the alleged fiscal imbalance. This comment pertained to a possible referendum on the recommendations of the Séguin Commission. Mr. Landry and his party seemed to have flirted with this idea for a while – a truly absurd proposition.

Holding such a referendum would have been an utter waste of taxpayers' money, as would any future referendum of that kind. The federal government would be obliged to declare that it would not be bound by the results, for as soon as it declared itself bound to act on the results of a referendum in a province, it would have to acknowledge the same obligation in the case of other possible referenda in other provinces, on budgetary or other issues: the death penalty, for example. Some of those referenda, by the way, could have negative consequences for Quebec (a reduction in Equalization, for example).

The Séguin Commission provides one such example. In its report, it expresses its opposition to the bilateral agreements that the Government of Canada has signed with Newfoundland and Labrador and Nova Scotia which have resulted in a downward adjustment in Equalization entitlements for those provinces because of new offshore oil and gas resource development: *"The Commission believes that such ad hoc solutions raise problems of equity among the recipient provinces."* Among the recipient provinces the Séguin Commission believes are harmed by these agreements is, of course, Quebec. Well, I can guarantee that if the premiers of Newfoundland and Nova Scotia were to hold referenda on strengthening those agreements, they would win with over 90 percent. Accordingly, the federal government should not be bound by such referenda, whether in those provinces or in Quebec.

No federation could govern itself in such a fashion. If those referenda pertain to provincial jurisdictions – such as lotteries, to use Mr. Landry's example – there is no problem. But once it involves a federal jurisdiction with implications for all the provinces, a provincial referendum is a dead end, a false emergency exit which is really a side track for broken-down separatists.

In the 1993 federal election, Mr. Lucien Bouchard, then head of the Bloc, campaigned using the argument of budget deficits to persuade Quebecers to leave Canada: *"If they (the rest of Canada) are intent on going bankrupt, let them go. But we're going to save our skin,"* he said on August 14, 1993. That was the era of federal deficits.

Several years later, Mr. Landry wanted to re-launch his referendum machine by denouncing federal surpluses. Whether the federal government has a surplus or a deficit, it will always be in the wrong as far as the secessionist leaders are concerned.

The fact remains that the Séguin Commission addressed a normal problem in any normal country: how best to allocate budgetary resources. The Commission on Fiscal Imbalance concludes unremarkably that there is a fiscal imbalance. I hope I have shown that this conclusion is erroneous.

There is no fiscal imbalance, but there is an obligation for the governments of our federation to help each other out, while respecting the role of each, and within a permanent framework of necessary budgetary prudence.

Notes

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

<sup>2</sup> Union des municipalités du Québec. 2001. *Mémoire présenté à la Commission sur le déséquilibre 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> Séguin Commission (2002, p. 8 of the summary).

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

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

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

<sup>11</sup> Conference Board (February 2002).

<sup>12</sup> Finance Quebec (2002).

<sup>13</sup> Finance Canada (2002).

<sup>14</sup> Finance Canada (2002).

<sup>15</sup> Finance Canada (2002).

<sup>16</sup> Séguin Commission (2002, p. x of the summary).

<sup>17</sup> Finance Canada (2001, 55).

<sup>18</sup> Provincial Public Accounts and Provincial Budgets, various years.

<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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# III

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## SOME ISSUES OF EQUALIZATION AND FAIRNESS

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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.<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup>

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.<sup>6</sup> 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 simplicity, we assume a single tax base, say income tax. If the per capita base for the standard provinces is greater than the per capita base for a particular province, that province qualifies for Equalization payments equal to the national average tax rate applied to the deviation from the standard provinces' per capita base.<sup>7</sup> In other words, provinces with a per capita base below the standard are "levelled up."

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.<sup>8,9</sup> 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.<sup>10</sup>

$$(2) AR_i = TR_i - E_i.$$

Two measures of volatility are constructed. The first is the residuals from the regression of  $AR$  and  $AR+E$  on a linear time trend. The second is simply the first difference of  $AR$  and  $AR+E$ . A measure of predictability is constructed as the difference between predicted (in the provincial budget) and actual (subsequent public account)  $AR$  and  $AR+E$ . Descriptive statistics for the period 1981/82 to 2000/01 are presented in Figures 13.<sup>11</sup>

Looking first at Figure 1 and the volatility measure based on residuals from the trend  $AR$  and trend  $AR+E$  equations, we see that in six of seven cases,  $AR+E$  residuals are more volatile than  $AR$  residuals (i.e., have a larger standard deviation). The exception is Nova Scotia. Six of seven provinces' residuals also have a larger range. In this case, the exception is New Brunswick.

**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
PEI	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
PEI	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	82.0	26.46
NS	176.3	203.0	-171.0	389.0	123.94
NF	37.05	100.5	-107.0	207.0	75.78

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**

## AR

	Mean	Median	Min.	Max.	Std. Dev.
SK	175.84	171.32	-623.63	693.51	344.54
MB	28.33	10.00	-229.00	307.00	132.71
QC	660.43	195.00	-262.00	4198.00	1209.14
NB	-12.28	-0.50	-297.70	166.40	127.96
PE	8.30	2.80	-24.90	66.80	19.91
NS	80.70	104.00	-214.00	358.00	138.46
NF	4.76	-4.00	-63.00	112.00	46.73

## AR+E

	Mean	Median	Min.	Max.	Std. Dev.
SK	165.00	127.87	-455.07	755.41	301.79
MB	75.05	20.00	-221.00	430.00	159.12
QC	829.48	305.00	-970.00	5857.00	1566.48
NB	0.01	4.00	-320.80	189.90	120.35
PE	12.38	6.40	-47.20	81.00	35.28
NS	30.00	25.00	-239.00	296.00	133.18
NF	30.33	25.00	-119.00	215.00	91.30

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 responsiveness to changes in provincial revenues. Based on the evidence presented in this study, this benefit appears to have been largely illusory. Thus, when considering future changes to the Equalization Program, whether they are fundamental (i.e., moving to a macro formula) or administrative (i.e., changing the timing of the release of data), it will be useful to consider the stabilization properties of the proposed system.

The results presented in this paper suggest further areas for study. In considering the design of the Equalization Program in the future, it would be useful to understand the reasons that the current Program fails to reduce the volatility and improve the predictability of revenues. At least three possibilities exist. The first is that movements in the formula's variables other than the individual province's tax base dominate the formula. Other variables include tax rates and the standard tax base. The second is that prior-year adjustments, which make up the difference between entitlements and cash actually received, and are largely related to the lagged release of data, are responsible. Finally, it may be that the ad hoc features of the program such as floor and ceiling payments and tax-back arrangements have diminished the stabilization properties of the Program. Each of these possibilities warrant further investigation to determine what role, if any, they play in reducing the stabilization properties of Equalization.

Notes

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<sup>1</sup> This is a revised and expanded version of an earlier paper entitled "The Stabilization Properties of Equalization: Evidence from Saskatchewan" presented at the Fiscal Arrangements Committee Conference on Equalization, Charlottetown, August 2001.

<sup>2</sup> Of course, Equalization is always a subject for debate among Canadian academics as well. For a classic work on Equalization, see Courchene (1984). For a recent volume extolling the virtues of the current system, see Boadway and Hobson (1998). A recent call for reform is contained in Boothe (1998).

<sup>3</sup> See Provincial and Territorial Finance Ministers (2001).

<sup>4</sup> See Hamm (2001).

<sup>5</sup> A recent example is Von Hagen and Hammond (1998).

<sup>6</sup> An exception is Smart (2001).

<sup>7</sup> For simplicity, in this discussion we ignore the impact of floor payments, ceilings and other ad hoc features of the program.

<sup>8</sup> This follows because the variance of a sum of random variables is equal to the sum of the variances plus two times the covariance.

<sup>9</sup> Of course, in reality, other things may not be equal. As we see from equation (1) Equalization entitlements may also vary as a result of fluctuations in provincial or national tax rates, populations or the standard provinces' tax base. As well the ad hoc features of the program discussed in endnote 7 may cause entitlements to differ from actual transfers.

<sup>10</sup> In the case of Saskatchewan, an additional adjustment was made. Transfers from government entities were subtracted from total revenue because it has been the practice in Saskatchewan to use transfers from entities such as the Saskatchewan Liquor and Gaming Authority and Crown Investments Corporation to smooth revenues and protect against negative revenue shocks. In fact, this practice was formalized in 1999/2000 with the establishment of Saskatchewan's Fiscal Stabilization Fund. Provincial officials from other provinces stated that such discretionary transfers were not made in their provinces.

<sup>11</sup> The Saskatchewan data begins in 1986/87 to obtain uninterrupted series. Saskatchewan did not receive Equalization transfers for the period 1983/84 to 1985/86.

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

*James P. Feehan*

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### 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.<sup>1</sup> 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 Whyte,<sup>2</sup> 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.<sup>3</sup> In addition, 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 ownership rights when it entered Confederation in 1949.<sup>4</sup> In the constitutional debates of the 1980s the consensus persisted that the provinces ought to have ownership of their natural resources, hence the inclusion of Section 92A.<sup>5</sup>

Even within this constitutional reality, the challenge of how to incorporate provincial natural resources into the Equalization Program is formidable. For most of the life of the Equalization Program, the treatment of resource revenues has proven to be problematic and controversial. Thomas Courchene has concluded that this issue is one that "one copes with rather than solves."<sup>6</sup> As insightful as that remark may be, this paper's hypothesis is that there is scope for coping better. A six-point proposal is developed that includes two crucial recommendations. The first is that substantially less than 100 per cent of natural resource revenues be equalized; and second, for Equalization purposes, natural resource revenues be measured not necessarily by actual revenues collected but by the potential revenues that would accrue if the resources were priced to reflect their underlying scarcity. The first of these two recommendations has already been well articulated<sup>7</sup> and endorsed by the 1985 Royal Commission on the Economic Union and Development Prospects for Canada, better known as the Macdonald Commission after its chair, former federal Minister of Finance, and also of Energy, Mines and Resources, Donald Macdonald. The second recommendation, which complements the first, is based on an efficiency rationale. It relates to how the Equalization formula could be changed to remove disincentives for proper pricing of natural resources. For a market economy to be well functioning it is necessary that prices generally, and including natural resources prices, reflect relative scarcity. If provincial governments, as resource owners, charge royalties below the true value of the resources then the resources are unlikely to be utilized in the most economic manner.

The remainder of this paper is organized as follows. The next section provides a historical sketch of how natural resources have been treated over the years. The third section turns to the current arrangements, discussing the criticisms and recommendations for reform. The fourth section offers rationales for treating natural resource revenues in a distinct fashion. The fifth section elaborates more fully on this paper's proposal for handling natural resource revenues. Section six concludes.

## **SOME HISTORY**

The federal government's Equalization Program began in the fiscal year 1957/58, before it was constitutionally mandated. Since that time, payments have been based on a series of five-year formulas. The first formula included only three revenue sources: provincial personal income tax, corporate income tax and succession duties. A provincial government received Equalization payments from the federal government to the extent that its per capita revenue from those three taxes yielded less than the average of the corresponding per capita revenues of the two top provinces, then being Ontario and British Columbia. All provinces, except Ontario, qualified for and received Equalization payments. Natural resource revenues, like all the other remaining provincial revenue sources, were not subject to Equalization at the time.

For the 1962/63 to 1966/67 formula, the federal government initially replaced the two-province average with the average of all ten provinces for its standard. At the same time it added a fourth revenue source to the formula: 50 percent of the three-year

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.<sup>8</sup> 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.<sup>9</sup> 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.<sup>10</sup> 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.<sup>11</sup> 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 provinces than most other provincial revenue sources. When oil prices escalated great-

ly, the cost of Equalization to the federal government rose substantially. To deal with this problem, the federal government imposed a number of measures during the next two five-year versions of the formula: 1972/73-1976/77 and 1977/78-1981/82. The main ones were:<sup>12</sup>

- in 1974, only one-third of a province's oil and gas revenues resulting from higher prices was subject to Equalization;
- in 1977, the formula was changed so only 50 percent of the revenue from provinces' non-renewable natural resources were included in the Equalization formula; and
- in 1978, despite the inclusion of only half the revenue from non-renewable resources, because of rising oil and gas prices the federal government acted to prevent Ontario from becoming eligible for Equalization payments; it did so by adding a clause that precluded payments to a province with above average per capita personal income.

The effect of these sorts of changes was to curtail what otherwise would have been an explosion in the federal government Equalization payments. However, they amounted to stopgap moves without much convincing policy basis. For instance, why distinguish between renewable and non-renewable resources in 1977, what was the basis for choosing the 50 percent figure for the amount of non-renewable revenues to be equalized, and why exclude Ontario if it indeed had per capita revenues below the national average? It seems that these actions all were simply expedient measures taken whenever the estimated costs of the program rose too quickly for the federal government.

For the 1982/83 to 1986/87 formula, the federal government introduced a more effective means of controlling for the effects of rising provincial oil and gas revenues. It dropped the limitation of including only 50 percent of non-renewable resource revenues and returned them to being on a par with renewable resources and all other revenue sources, but moved to a five-province standard. That standard has remained a feature of the formula up to the current 1999/2000-2003/04 version. Therefore, it is worth illustrating. For each revenue source to be equalized, a province's entitlement is given by:

$$(1) T \times (B5 - BP) \times POP$$

where "T" denotes the national average tax rate corresponding to this revenue source; "B5" denotes the per capita tax base of the five provinces that the federal government has chosen to be included in the standard; "BP" denotes the per capita tax base in the province for which the calculation is being undertaken; and "POP" denotes that province's population.<sup>8</sup>

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 rate rather than replacing it with the average tax rate of the five provinces.

Crucially, the so-called five-province standard does not include Alberta as one of the five used to establish a province's fiscal gap; it also excludes the four Atlantic provinces, but that is not so crucial. As a result of excluding Alberta, when calculating a province's entitlement for the various oil and gas revenue sources, any entitlement based on (1) would be smaller than it would have been had the ten-province figure been used. The effect of the federal government's five-province formula is to reduce the Program's cost from that of the ten-province standard and to cushion that cost from any sharp increases in oil and gas prices.<sup>13</sup> Essentially, the five-province standard is the means by which the federal government ensures that natural resource revenues, oil and gas revenues in particular, are not problematic for Program costs.

The history of Equalization has been dominated by federal government cost containment efforts, largely through distinct treatments of natural resource revenues. However, there have been other resource-related measures that apparently have had other motivations. Consider the federal government's Offshore Accords with Newfoundland and Labrador, and with Nova Scotia in the mid 1980s.<sup>14</sup> Those agreements, while different in details, both provided for federal compensation to those two provincial governments to offset a portion of the reductions in their Equalization entitlements due to new revenues from offshore oil and gas developments. Nevertheless, even with that partial compensation, which is not an element of the Equalization Program, the reductions in Equalization were frustratingly high from those provinces' points of view.<sup>15</sup>

A somewhat less arbitrary measure, but one similar in spirit to the Offshore Accords, is the so-called "generic" solution, which the federal government incorporat-



ed into the Equalization formula proper in 1994. The generic solution counts only 70 percent of a province's per capita base from a specific revenue source in the Equalization formula if that province has 70 percent or more of that revenue base. In practice, this generic solution applies to only some natural resources, although in principle it is applicable to all bases. It has applied to offshore oil and gas for Newfoundland and Labrador, potash for Saskatchewan, asbestos for Quebec, and offshore oil and gas for Nova Scotia.<sup>16</sup>

These special measures are additional examples of how the federal government has treated natural resource revenues differently from other provincial revenue sources for Equalization purposes. However, what is interesting is that cost containment, the dominant federal motivation for many of its changes to the Program, is not the rationale for these special arrangements. While political expediency may have been at play, there are clear efficiency and equity reasons for them. For the generic solution, the federal government recognized that a province with most of a revenue base could control the national average tax rate and consequently would have an incentive to change its tax rate in order to gain more of an Equalization entitlement. For the Offshore Accords, one might suggest a similar efficiency rationale but there is likely an equity consideration also at play. Both Nova Scotia and Newfoundland and Labrador are so-called "have-not provinces," and without the Accords they would have stood to have their offshore oil and gas royalties offset by declines in Equalization payments on a dollar-for-dollar basis. It would hardly seem fair that these two "have-not provinces" would have huge new natural resource developments and yet have no net increase in revenues from them.

Few other significant changes occurred in the Equalization Program in the 1990s, so attention can now turn to the formula for 1999/2000–2003/04.

### **THE 1999/2000–2003/04 FORMULA**

By the time of the 1999/2000–2003/04 formula, revenue sources to be equalized had increased to thirty-three.<sup>17</sup> Of that number, 14 were natural resource related. They include: forestry revenues; new oil revenues; old oil revenues; heavy oil revenues; mined oil revenues; third-tier oil revenues; heavy third-tier oil revenues; natural gas revenues; sales of Crown leases; other oil and gas revenues; mineral resources; water power rentals; and shared revenues for offshore activities in Newfoundland and Labrador and Nova Scotia.

Importantly, the division of oil revenues into so many categories reflected the reality that potential revenues from oil vary with the cost of extraction and, in turn, that cost varies with the type of oil: on-land, heavy, offshore etc. Since those costs are not deducted from the revenues, these revenue numbers still do not coincide with actual resource rents (i.e., the contributions of the resources to profit), but are now more closely correlated with those rents than previously. Similarly, the measure for forestry revenue bases was improved.<sup>13</sup> Also, with the 1999/2000–2003/04 formula, provinces' mineral tax bases are defined in terms of mining companies' profits, rather than the

previous practice of using either volume or gross sales.<sup>18</sup> Again, this is another improvement in that it comes closer to reflecting the economic rent arising from the natural resource.

Otherwise, the 1999/2000-2003/04 formula retained the features introduced in the 1980s and 1990s, including the five-province standard and the generic solution. By 2001/02, payments to the recipient provinces totalled approximately \$10.3 billion. Figure 1 provides estimates of Equalization entitlements, in total and per capita terms, and the portion of those payments attributable to the 14 natural resource categories. The last two columns illustrate the relevance of natural resource revenues to provinces' entitlements. Four provinces have negative per capita natural resource revenue entitlements: Newfoundland and Labrador, Saskatchewan, Alberta and British Columbia. Thus, these provinces might be labelled "resource rich" in the Equalization context.

**Figure 1**

**Estimates of Equalization Entitlements for 2001/02, based on the 1999/2000-2003/04 Five-Province Standard Formula**

Province	Total Entitlement (millions)	Per Capita Entitlement	Amount of Per Capita Entitlement Due to Natural Resource Revenues
Newfoundland and Labrador	\$1,043.8	\$1,954.47	-\$43.49
Prince Edward Island	253.8	1,832.79	164.46
Nova Scotia	1,323.4	1,404.11	148.55
New Brunswick	1,193.7	1,577.62	81.88
Quebec	4,786.5	646.24	55.01
Ontario	-6,478.6	-546.55	133.47
Manitoba	1,178.1	1,024.57	58.52
Saskatchewan	404.0	397.50	-586.86
Alberta	-9,369.0	-3,062.03	-2,000.84
British Columbia	110.0	26.89	-356.83

*Source: Department of Finance, Government of Newfoundland and Labrador, estimates as of February 2002. (Calculations based on the assumption that April 1, 1999 regulations applied for the full fiscal years. Actual entitlements may be slightly different.)*

*Note: Figures are not adjusted for floor and ceiling provisions.*

What is interesting from Figure 1 is the extent to which natural resources affect various provinces' Equalization entitlements. For instance, the -\$586.86 figure for Saskatchewan's per capita resource revenue entitlement means that, overall for that year, Saskatchewan's per capita natural resource revenue bases were sufficiently higher than the five-province standard's, so that an extra \$586.86 per person could be generated in that province if it taxed those resources at the corresponding 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.

At this stage one might reasonably ask, why consider excluding these revenues but not other revenue sources? After all, those other revenues are potentially available to these provinces. Herein lies the crux of the matter. To treat the provinces' natural resource revenues differently requires that there be something special about them. In fact, many participants in the Equalization debates agree that this is the case. And by its actions, e.g., generic solutions, excluding Alberta from the standard, and offshore accords, the federal government implies that it shares that opinion. What is the most appropriate treatment for natural resources is the subject matter of the next section.

### **THE CASE FOR DISTINCT TREATMENT**

For most of the history of the federal government's Equalization Program the provinces' natural resource revenues have been treated differently from other revenues. Sometimes included, sometimes excluded, sometimes 50 percent included, sometimes with payments limited depending on resource revenues, sometimes not equalized to the operative standard when higher revenues are due to higher prices, sometimes with non-renewable resources treated differently, and even the five-province standard. All of these measures seem to be driven to keep the cost of Equalization payments in line with what the federal government is prepared to spend. At the same time, special but piecemeal arrangements, e.g., the Offshore Accords and the generic solution, have been introduced to address the most obviously extreme inefficiencies and inequities associated with Equalization of resource revenues.<sup>19</sup>

The thesis of this paper is that natural resources do deserve distinct treatment in the Equalization formula. However, federal government cost containment, while an important consideration, ought not to be the primary basis for such treatment. There are both efficiency and equity concerns that ought to be taken into account.

#### **Efficiency**

In a seminal contribution, Boadway and Flatters provided a powerful theoretical efficiency rationale for including all natural resource revenues in a system of Equalization payments.<sup>20</sup> The basis of their influential contribution was the idea that an excessive number of people would migrate to resource-rich provinces in order to obtain the benefits of those resource revenues, through lower personal taxes and/or more public expenditure programs. The number of migrants would be "excessive" in the sense that their productivity elsewhere may have been higher, but they moved from their home regions to obtain the fiscal benefits of another region's resource revenues. This sort of

migration is inefficient because the resource revenues are merely shared among more people while the movement of workers causes overall 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 tiny.<sup>21</sup> Subsequent theoretical contributions point out that reasonable changes in the assumptions underlying their theory can reverse the theoretical predictions of efficiency gains.<sup>22</sup> On the contrary, other arguments can be invoked to buttress the efficiency arguments. For instance, Breton points to Equalization as a means of fostering intergovernmental competition, which he argues, like market competition in the private sector, leads to long-term efficiency gains.<sup>23</sup> Equalization payments may do this by bringing provincial governments' revenue resources up to comparable levels, and thereby ensuring that even those provinces with weaker economies have the ability to develop and offer social and economic policies that could be superior to those elsewhere.

Those theoretical and empirical doubts about the efficiency of Equalization are general. What is relevant here is whether the inclusion of 100 percent of resource revenues in Equalization tends to enhance or reduce the chances of such gains. To set the stage, it is important to recognize that natural resources are ideal revenue sources. Natural resources are not mobile, so those who exploit them cannot avoid the royalties or taxes on them. In contrast, taxes on labour and capital income can be avoided by movement to a lower-tax jurisdiction. Because of resources' immobility, it is possible for governments to price them so as to capture all the rent that they generate. Natural resource "rent" refers to the difference between what the harvested resource sells for and the competitive cost of labour, capital and other inputs required in the harvesting process.<sup>24</sup>

If the rents from exploiting a natural resource are fully captured by the resource owner through appropriate royalties, there is no efficiency loss. Efficiency loss, or what economists also refer to as "excess burden," is loss of economic gains associated with a change in an activity due to distorted prices. For example, higher taxes on earnings might induce people to work less or move to another jurisdiction. If a resource's rent is fully captured by its owner, then the capital used in harvesting it receives the appropriate rate of return so that there will be no incentive to take that capital, or associated labour, out of that activity. On the contrary, if resources are undercharged relative to the underlying rent, the resource will be overexploited. Too much capital and/or labour will be allocated to harvesting it. The result is an efficiency loss to the economy.

With this background proposition in mind, consider the incentives faced by Equalization-recipient provincial governments when natural resource revenue is offset on a dollar-for-dollar basis through a reduction in Equalization. There is a two-fold efficiency problem. One aspect of the problem applies to revenues from resources that are currently being harvested and the other to potential resource developments.

In the former case, such a provincial government does not have an incentive to collect royalties from (i.e., to price) their natural resources at rates that reflect their true economic values. Indeed, this lack of incentive, plus other considerations such as industrial policy, might induce a provincial government to underprice its resources. The collective effect of this occurring across all recipient provinces would be national average royalty rates that are too low. A case in point is hydro power. Zuker and Jenkins, and Bernard show that hydro resources are substantially underpriced.<sup>17</sup> Provinces, by underpricing these resources, effectively give subsidies to households and energy-intensive industries to overconsume a scarce resource. These implicit subsidies may come at a high cost in terms of long-term efficiency. A number of other economists point out that such pricing, while favouring certain industries, is damaging to overall national economic efficiency by causing a misallocation of labour, capital and natural resources, as well as slowing the incentive to develop and apply new technology.<sup>25</sup> Moreover, the Economic Council of Canada concluded that there has been substantial undercollection of natural resource rents generally, not just hydro rents.<sup>26</sup> In terms of equation (1), the implication of resource underpricing is to make the national average tax rate,  $T$ , lower than is needed for efficient use of natural resources.<sup>18</sup>

A similar concern arises with respect to the development of new resources. In this case, it is the province's per capita base that would increase. Referring again to the current formula given by equation (1), a new resource development raises the province's per capita base. If a recipient province allowed a development to proceed and charged the national average tax rate and was not one of the provinces included in the standard, it would lose Equalization on a dollar-for-dollar basis. To illustrate, return to the hypothetical example used to illustrate the workings of the Equalization formula. In that example, the per capita forestry base in a province was assumed to be 1.2 thousand cubic metres. Suppose that this province's forestry industry were to grow substantially and its per capita base rose to three thousand cubic metres. If this province was not one of the five included in "B5," the per capita base in the five reference provinces, then the application of (1) would see this province's Equalization entitlement fall from \$30 million to \$3 million. Of course, its own revenues would rise by \$27 million, and that would mean a net revenue gain of nothing.

Quite arbitrarily, and inequitably, if this recipient province had been in the five-province standard it would lose on a less than dollar-for-dollar basis, although its losses would likely still be substantial. Again, referring to the same example, if this province is one of the five, then the expansion of its forestry industry from 1.2 thousand to 3.0 thousand cubic metres per capita leads to an increase in the B5. Suppose that B5 rose from 3.2 to 3.6 thousand cubic metres per capita. Again, using the formula in (1), this province's Equalization can be determined and would now be \$9 million.

In either case the province sees a substantial reduction in its Equalization entitlement. Thus, an equalization-recipient province, especially one that is not one of the chosen five, has an incentive not to allow development of its resources in the manner that is most efficient. It may attach conditions to resource exploitation, e.g., local

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.<sup>27</sup>

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.<sup>28</sup> Of course, this is also consistent with the federal government's main motivation of cost containment. Nonetheless, efficiency considerations appear to be among those that induced the federal government to include less than 100 percent of the natural resource revenues that even the five-province formula would otherwise include. The issue then is one of finding the appropriate fraction. Doing so must also take account of equity issues.

### **Fairness**

There are a number of equity rationales in favour of equalizing a fraction of provincial natural resource revenues.

First, recall the preceding suggestion that provinces generally undercollect resource rents and that there are unintended incentives built in to the Equalization formula for recipient provinces to undercollect and allow rent dissipation. The result is that there is less resource revenue to equalize. That is not fair to resource-poor provinces. If rents had been collected appropriately then the national average tax rate would be higher than otherwise. As a result, provinces with per capita resource bases lower than the corresponding standards would have larger Equalization payments entitlements.<sup>29</sup> Compounding this issue are the side arrangements such as the Offshore Accords and generic solutions, whereby certain provinces are equalized differently than others.

A second inequity relates to the five-province standard and applies to all tax bases, but it is worthwhile to highlight its effect in the natural resource context. As mentioned earlier, the treatment of a province differs depending on whether it is in that standard or not. For example, New Brunswick, not being one of the five provinces in the standard, loses dollar-for-dollar if its per capita forestry tax base increases; but Quebec, which is in the standard, would lose on a less than dollar-for-dollar basis if its

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.<sup>30</sup>

There is another equity argument, which is along constitutional lines and has been endorsed by important federal institutions. The *Constitution Act, 1982*, re-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 revenues to Equalization.<sup>31</sup> The Council considered two notions of horizontal equity in assessing what would be appropriate treatment of natural resources and other revenues in Equalization.<sup>32</sup> Horizontal equity refers to the treatment of individuals by government and reflects the principle that similar people should be treated by government in similar fashion. Their deliberations were between two notions of such equity: broad and narrow. The broad notion of horizontal equity, as applied to a federation, is that two individuals who are alike before government spending and taxes ought to be in equal positions after taxation and spending by both levels of government. The implication is that if the two individuals live in different provinces with different policies, then the federal government has to undo the effect of the differing provincial policies, as well as treat the two equally under its own policies. The narrow notion of equity is that the federal government ought to ignore any unequalizing effects of provincial policies but ensure that its own policy is consistent with horizontal equity.

The Economic Council of Canada opted for the broader notion of equity as a general principle of fiscal federalism but recognized that it ought not to apply to natural resources. It concluded that the narrower concept of equity was the more appropriate way to treat natural resources. Specifically, the Economic Council of Canada stated that:

...the amount of provincial natural resource revenue that is subject to equalization should approximate the federal taxes that would be paid, on average, if resource revenues were distributed to provincial residents and treated as personal income.<sup>33</sup>

The reason for the use of the federal income tax rate as the percentage of resource revenue to equalize is fairly straightforward. Consider two individuals in two provinces. One has an income of \$60,000. The other also has \$60,000 in income, but also has \$2,000 in extra fiscal benefits, which could be in the form of lower provincial taxes or public services, due to provincial resource revenues. Under the narrow notion of horizontal equity, that extra \$2,000 should be taxed at the personal federal tax rate, just as if the second person had an income of \$62,000. The more extreme measure of having the federal government take \$1,000 of it and turn it over to the other person would be an application of the broader notion of horizontal equity. As suggested by Courchene, such an extreme redistribution is effectively a unitary-state outcome, i.e., what would occur if there were no federation or provinces but just a central government.<sup>34</sup> Adopting that notion completely undermines the constitutional provision of provincial natural resource ownership.

Another important federal body, the Parliamentary Task Force on Federal-Provincial Fiscal Relations (1981), also suggested that it was appropriate to include a fraction of, rather than all, natural resource revenues in calculation of Equalization entitlements. The recommendations of this Parliamentary Task Force and the Economic Council of Canada then received a powerful endorsement from another federal entity. Taking into account the theoretical basis of the Economic Council's analysis as well as other views, the Royal Commission on the Economic Union and Development Prospects for Canada reached the following thoughtful conclusion on the need for a compromise:

A portion of resource revenues - greater than zero but significantly less than 100 per cent - must be included in Equalization. There is no magic figure, but the 20 to 30 per cent range seems an appropriate compromise between the extremes of theoretical purity and political reality. This sort of proposal has been endorsed by the Task Force on Fiscal Arrangements of 1981, the Saskatchewan government of the same year, and the Economic Council of Canada in its 1982 report.<sup>35</sup>

## **A PROPOSAL**

Drawing on the preceding discussion, what follows is an integrated six-part proposal for the treatment of natural resources.



**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 resources' 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.<sup>36</sup> 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 northern Quebec or a mineral discovery in Manitoba.

Through the generic solution arrangement the federal government has taken 70 percent as a figure for revenue to be equalized.<sup>37</sup> That is rather arbitrary. In contrast, the Economic Council of Canada gave a well-articulated rationale for subjecting only about 15 to 20 percent of resource rents to Equalization, within a ten-province standard.<sup>38</sup> There is little in the literature that presents a convincing argument for going below that rate. Recognizing the constitutional assignment for natural resources as well as other considerations, the Macdonald Royal Commission suggested a 20 to 30 percent range as a practical policy.<sup>39</sup> Thus, 25 percent, a figure also put forward by Boadway, seems to be reasonable.<sup>40</sup>

### **No Distinction between Renewable and Non-renewable Natural Resources**

Provinces own both renewable and non-renewable resources. At one time, the federal government did treat the two differently, equalizing 50 percent of non-renewable resource revenues but 100 percent of renewable natural resource revenues. It no longer makes a distinction, nor should it. The case for partial Equalization of natural resource rents applies equally to both categories of natural resources. Indeed, one can argue that, as a revenue source, a non-renewable resource can effectively be made into a source of ongoing revenue by selling it, putting the funds from that sale into a heritage fund, and creating a perpetuity of payments from interest earnings. Moreover, some renewable resources can be depleted, as we see with some fisheries, forests and wildlife. Perhaps most importantly, there is no basis to believe that the efficiency or equity arguments for distinct treatment of provincial resources applies more or less to one or the other of those resources whether they be forestry and oil, or natural gas and water power.

Thus, the propositions for excluding one type of natural resource, such as oil and gas as suggested by Martin, or the entire set of non-renewable resources, as proposed by Boessenkool, are unconvincing.<sup>41</sup> The efficiency and equity, including the constitutional, considerations apply equally to all. Therefore, the provinces' revenues from natural resources, whether renewable or not, should be treated the same within the Equalization formula.

### **Eliminate the Generic Solution and Offshore Accords**

With resource rents being equalized at 25 percent, or a similar fraction, there would be no need for "special deals" such as the Offshore Accords, which make Equalization adjustments outside the formula, or the generic solution. All parties should agree to drop such measures insofar as they relate to Equalization and also agree in principle against future provisions of this sort.

### **A Longer-Term Commitment**

Large scale resource development is a substantial and long-term undertaking. The five-year life cycle of Equalization formulas does not reflect that fact. Therefore, it is highly desirable that it be agreed that the share of resource revenues to be equalized be permanently within a certain range, e.g., 20 to 40 percent. Swinging from 50 percent to 0 to 100 percent over a series of five-year formulas creates unnecessary uncertainty that can lead to poor policy decisions by provinces. The greater the risk of future losses of resource rents, the more likely a province is to adopt rent-dissipating policies.

It is not possible to ascertain the overall impact of this proposal on the cost of the Equalization Program or the payments to the individual provinces. However, some suggestive figures can be cited for elements of it. Figure 2 provides a partial picture of the impact. Case A in that Figure is simply the estimates for the status quo for 2001/02. The figures in the column corresponding to Case B show only the impact of moving to a ten-province standard with elimination of the generic solution. This measure, by itself, costs the federal government more since every recipient province gains.

**Figure 2**

**Estimates of Equalization Entitlements Under Different Arrangements: 2001/02**  
(All figures are in millions of dollars)

Province	Case A	Case B	Case C
Newfoundland and Labrador	\$1,043.8	\$1,140.0	\$1,080.6
Prince Edward Island	253.8	278.7	241.7
Nova Scotia	1,323.4	1,489.8	1,251.6
New Brunswick	1,193.7	1,330.0	1,174.6
Quebec	4,786.5	6,120.3	4,748.6
Ontario	-6,478.6	-4,343.8	-7,236.6
Manitoba	1,178.1	1,385.2	1,169.4
Saskatchewan	404.0	569.4	883.6
Alberta	-9,369.0	-8,817.1	-4,666.6
British Columbia	110.0	847.4	1,353.2
Total Payment before adjustments	\$10,293.3	\$13,160.9	\$11,903.3

*Case A: Status Quo arrangements, based on April 1999 regulations.*

*Case B: Case A with a ten-province standard and without generic solution.*

*Case C: Case A with a ten-province standard with 25 percent of natural resource revenues equalized and without generic solution.*

*Source: Department of Finance, Government of Newfoundland and Labrador*

The next step changes the story somewhat. Case C shows the entitlements when, in addition to Case B, 25 percent of natural resource revenues are equalized. Interestingly, most recipient provinces would have entitlements similar to the status quo, except for Saskatchewan and British Columbia, which, reflecting their higher-

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

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

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

<sup>3</sup> This ownership provision was stated in Section 109 of the *British North America Act, 1867*, now known as the *Constitution Act, 1867*.

<sup>4</sup> If Newfoundland had been expected to surrender ownership of its natural resources, given the close vote in the 1948 referendum on Confederation with Canada, it is very likely that Confederation would have been defeated. Indeed, at the time, if Newfoundlanders had a clearer idea of the extent to which they were giving up ownership of their offshore fisheries, the vote might have also gone against Confederation. Similarly, if British Columbia had been expected to cede its natural resources to federal ownership, would it have joined in 1871?

<sup>5</sup> Section 125, an original constitutional provision of 1867, which prohibits the federal government from taxing provincial lands and property, was also retained. That retention is further evidence of the intent to make provincial ownership of resources meaningful.

<sup>6</sup> Courchene (1998, 32).

<sup>7</sup> See Economic Council of Canada (1982) and Boadway, Flatters and LeBlanc (1983).

<sup>8</sup> Courchene (1984, 41). While Alberta lagged the average of Ontario and British Columbia in terms of the three original tax bases, it had much more natural resource revenue per capita.

<sup>9</sup> See Economic Council of Canada (1982, 13).

<sup>10</sup> See Courchene (1984, 45) and the Economic Council of Canada (1982, 13).

<sup>11</sup> In part, these losses were the results of arrangements and lease terms that were established prior to the inclusion of 100 percent of resource and other revenues in the Equalization formula in 1967/68. Thus, it was not possible for Newfoundland to change royalty and other arrangements when the Equalization implications became known. See Crosbie (1997, 129) and Smith (1975, 361).

<sup>12</sup> See Economic Council of Canada (1982, 14-15).

<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 cost cannot exceed the percentage increase in national gross domestic product. This measure, however, is a general one, not being linked to resource revenues per se.

<sup>14</sup> Offshore oil and gas revenues were added to the list of revenue sources included in the Equalization formula. Two were added, one for Newfoundland and one for Nova Scotia. Since the five provinces in the standard have none of either base, the per capita five-province base is zero. Therefore, any oil and gas revenue going to either province would be completely offset by an equal decrease in Equalization unless special provisions, such as in the Offshore Accords, are in place.

<sup>15</sup> See Nova Scotia (2001) and Newfoundland and Labrador (2001).

<sup>16</sup> In the case of Newfoundland and Nova Scotia, in any one year each provincial government has the option of electing to apply the generic formula or its respective accord with the federal government. As time passes, the generic formula tends to be more advantageous, meaning a 70 cent loss in Equalization for each dollar of offshore revenue, as long as these provinces remain recipients of Equalization.

<sup>17</sup> The number of revenue sources had generally increased since the 1967 arrangements, having the effect of providing a better and more comprehensive picture of the provinces' revenue raising capacities. See Zuker and Jenkins (1984) and Bernard (1993).

<sup>18</sup> In 1999/2000, potash and asbestos were amalgamated into the mineral resources category, the effect of which is that the generic solution ceases to be applicable to them.

<sup>19</sup> Another such arrangement, one undertaken for equity reasons, was the move to allocate the hydro-electric power, which is what is used as the measure of the tax base for water power rentals, from the upper Churchill River according to the provinces in which it is consumed rather than produced. That allocation recognizes that the power is almost entirely exported to Quebec from Newfoundland and Labrador at an extremely low long-term contractual price. If the power were allocated according to place of production, Newfoundland and Labrador's base would appear to be very large and its total Equalization entitlement reduced accordingly.

<sup>20</sup> See Boadway and Flatters (1982a).

<sup>21</sup> See Watson (1986).

<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 – 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 exploitation. If this happens to a sufficient extent then the amount of revenue could rise. If such an effect did occur then it would weaken this argument. On the other hand, such an effect would reinforce the argument that underpricing of natural resources leads to excessive exploitation of them.

<sup>30</sup> See, e.g., Standing Senate Committee on National Finance (2002), Courchene (1998), Boessenkool (2001), New Brunswick (2001), and the Macdonald Royal Commission Report of 1985.

<sup>31</sup> See Economic Council of Canada (1982).

<sup>32</sup> Boadway and Flatters (1982b) is a crucial contribution to the literature on the equity rationale for Equalization payments.

<sup>33</sup> Economic Council of Canada (1982, 122).

<sup>34</sup> Courchene (1998).



<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 no longer apply but be replaced by estimates of the rates needed to capture the rents, it would follow that equalizing say 25 percent of the rents would amount to more than 25 percent of currently collected revenues.

<sup>40</sup> See Boadway et al. (1983).

<sup>41</sup> See Martin (2001) and Boessenkool (2001).

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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.<sup>1</sup>

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.<sup>2</sup>

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.<sup>3</sup>

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.

Thus the paper supports the conclusion of the Auditor General that the RTS is a key element in the success of the Equalization Program.

### **Assumed Advantages of a Macro Approach**

Advocates of a macro approach to Equalization assume a number of advantages. Major among these are that:

- a macro approach may better reflect the “actual” tax base which they believe to be income and ability to pay;<sup>4</sup>
- a macro measure is simpler to apply and provides for greater transparency and accountability;<sup>5</sup>
- a macro approach removes disincentives for development, in particular with respect to natural resources;<sup>6</sup>
- a macro approach reduces issues of tax-back and moral hazard with respect to tax decisions of recipients;<sup>7</sup> and
- a macro approach provides greater stability.<sup>8</sup>

### **DEFENDING THE REPRESENTATIVE TAX SYSTEM**

Defenders of the RTS system reject arguments for use of the macro approach and believe that the RTS is superior for a number of reasons, including that:

- 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;<sup>9</sup>
- the macro approach disguises the complexity inherent in developing the particular macro-measure chosen;<sup>10</sup>
- the disincentive issue is not proven and is secondary to the efficiency gains of Equalization inherent in the Equalization of net fiscal benefits;<sup>11</sup> and
- the moral hazard issue similarly is unproven, and empirical study suggests either that there is no moral hazard with respect to operation of the program or that the effects on decisions are small.<sup>12</sup>

## REFLECTIONS ON RECENT DEVELOPMENTS

It is not the purpose of this chapter simply to review again arguments already made with respect to the choice between a macro and the RTS system. To review those arguments, readers are encouraged to review the argumentation made in the references cited in the bibliography. The Senate Committee reviewed the issue and provided the recommendation that, "The federal government should not adopt at this time a macro formula to determine the entitlements of the provinces under the Equalization Program."<sup>13</sup>

Recent developments impacting on the Equalization Program provide additional insights with respect to the argumentation for the use of a macro approach, or for improvement of the RTS approach. Some specific developments that will be considered are:

- the implementation of a "tax on income" system, rather than a "tax on federal tax", for provincial personal income tax purposes;
- a federal accounting error with respect to personal income tax capital gains refunds for mutual fund trusts, which had been longstanding and was discovered and resolved in 2002 and 2003;
- the instability in payments that were caused by the introduction of a macro-based (economic rents) approach to the calculation of entitlements from the mining tax base; and
- a change in 2002 to the methodology of Statistics Canada in the valuation of net residential capital stock.

This chapter will examine the implications of those developments with respect to the accuracy of measurement of the tax base, the simplicity of measurements and the stability of entitlements.

**Using a Macro Approach Applied to a Progressive Personal Income Tax System**

Some advocates of a macro approach believe that personal income might be a good basis for calculation of Equalization entitlements. The advocates of this position might argue that the switch to a tax-on-income (TONI) system, rather than a tax on federal tax system, supports the conceptual argument that the underlying tax capacity is net income of individuals. However, this ignores the fact that, despite the ability under TONI to apply a flat tax to all individual income, the reality is that all provincial systems, and most other personal income tax systems throughout the world, have progressive features.

A macro approach overestimates the tax capacity of a progressive tax system in a province with incomes below the national average. A simple illustration shows why this is so. Assume that Province A has 100 people, 40 citizens who earn \$50,000 annually, which is subject to a 20 percent tax rate (after all credits and other deductions); 50 citizens who earn \$30,000, subject to a 10 percent tax rate; and 10 citizens who earn \$10,000 and pay no tax. Province B also has 100 people, but is less well off, and the proportions are 20 percent earning \$50,000; 60 percent earning \$30,000 ; and 20 percent earning \$10,000. Province B taxes at exactly the same “national average tax rates” as Province A. The Figure below indicates the resulting revenue.

**Figure 1**  
**Hypothetical Example of Effects of Macro System Relative to RTS**

Category in \$	Province A in \$		Province B in \$	
	Income	Tax	Income	Tax
50,000	2,000,000	400,000	1,000,000	200,000
30,000	1,500,000	150,000	1,800,000	180,000
10,000	100,000	0	200,000	0
Totals	3,600,000	550,000	3,000,000	380,000

Per capita income in Province A is \$36,000, while in Province B it is \$30,000. National average per capita income is \$33,000. Per capita tax in Province A is \$5,500, while in province B it is \$3,800. Overall, the national tax rate on income is 930,000/6,600,000, or 14.1 percent.

A pure macro approach to Equalization based on personal incomes, which equalizes to the national average, would pay Province B the difference in per capita income (that is, the difference between the per capita national income and its own per capita income), times the national average tax rate, times the number of people in the province. That is, \$3,000 x 14.1 percent x 100 or \$42,300.

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**

	National Totals	
Income level in \$	Total Income in \$	Tax in \$
50,000	3,000,000	600,000
30,000	3,300,000	330,000
10,000	300,000	0
Totals	6,300,000	930,000
Standard tax per capita		4,650

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 x 100) 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 Barro<sup>14</sup> has 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, together with a requirement for even greater discretionary judgement, than in using the RTS system. Perhaps, it is best to return to the conclusion reached by Bird and Slack,<sup>15</sup> that political acceptability is important, that "If it ain't broke, don't fix it." The RTS "ain't broke" and it gets the job done, despite some admitted problems.



### **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 if the RTS system had not been in use. Furthermore, if there was such a significant error in the compilation of income tax collection data, one must consider how much more distortion and inaccuracy there might be in a macro measure, the elements of which have never been thoroughly and rigorously tested. How much distortion in the measure of fiscal capacity could be generated through inappropriate treatment of elements of the data, which together form the GDP, PDI or other measures used in a macro approach? The answer is that we simply do not know and perhaps could never find out. Most macro measures may be quite adequate for the purposes for which they are currently used, but may not be sufficiently reliable for use in distributing tens of billions of dollars in transfer payments

### **Reasons for Differences Between a Macro Approach and the RTS Approach**

Some observers might suggest that the complexity of the RTS lay behind the erroneous results in calculating transfer payments as a result of the federal income tax error. Is this complication in calculation of Equalization then a reason to move toward a macro model? Alternatively, do the biases in a macro approach far outweigh even the serious impacts of the error?

Advocates of a macro approach have on occasion suggested that results under a macro approach and the RTS are not substantively different for most provinces.<sup>16</sup> However, they usually have to have some qualifying remark with respect to results for the Provinces of Manitoba and New Brunswick, in particular. On the other hand, the Senate Committee accurately noted that results under the two approaches are really quite startlingly different.

**Figure 3**

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

	NF	PE	NS	NB	QC	MB	SK	BC	Recipient Provinces
1992/93	57,596	21,611	-26,824	-8,163	-375,964	-201,767	173,438	0	-360,073
1993/94	82,255	7,591	74,650	-60,185	-448,165	-176,896	94,353	0	-426,399
1994/95	41,666	11,619	72,599	-68,682	-70,218	-304,268	267,320	0	-49,962
1995/96	56,516	15,416	17,325	-130,984	-347,856	-343,336	144,719	0	-588,200
1996/97	-89,726	-35,091	-7,627	-224,624	43,944	-553,703	-88,141	190,239	-764,728
1997/98	-135,018	-53,897	-81,605	-255,567	-440,231	-461,995	-52,180	563,577	-916,917
1998/99	-107,857	-4,443	69,100	-161,966	226,094	-351,443	-164,114	937,328	442,700
Total	-94,568	-37,195	117,618	-910,170	-1,412,397	-2,393,408	375,396	1,691,144	-2,663,579

*Source: Senate Committee on National Finance – Appendix B – 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.<sup>17</sup>

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.

Any system of Equalization purporting to offset fiscal capacity disparities must be able to remove such distortions in the measurement of fiscal capacity. The mutual funds trust error has illustrated the magnitude of distortions which may be generated by the unequal distribution of the financial services industry in Canada.

Barro has proposed that the concept of total taxable resources (TTR) of a state or province is the most appropriate macro measure,<sup>18</sup> but the development of a broadly accepted TTR has not yet been achieved.

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.

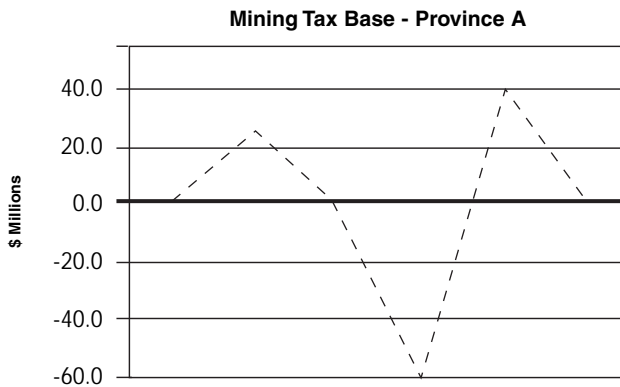
The “generic solution” is used whenever a province has more than 70 percent of a given tax base. In such a situation, only 70 percent of the revenues are incorporated into the Equalization formula. This is to ensure that an appropriate incentive remains for the province to tax the base and avoids the 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 deducted, the mining tax base would be negative for several provinces, even though those

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 – 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 “t” 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  $t+2$ . At that time there would be an adjustment to three years of entitlements ( $t$ ,  $t+1$  and  $t+2$ ). Province A would then lose \$60 million in entitlements in year  $t+2$ . Meanwhile its mining revenue would have returned to the normal level and therefore Province A would suffer a shortfall from its normal track of \$60 million. Furthermore, its revenue would be \$85 million below the level it was at two years previous. Of course, in year  $t+3$ , the normal level would again be reflected in Equalization entitlements for years  $t+1$ ,  $t+2$  and  $t+3$ . The province would enjoy positive adjustments to prior years’ entitlements of \$40 million. Over the entire four-year period, Province A would have had a net gain of \$5 million from the one-time “shock” in year  $t$  from its mining tax base. However, its total revenue, net of Equalization, would have been destabilized. Revenue in year  $t$  would have been \$25 million above the norm. In year  $t+1$ , it would have been at a normal level. In year  $t+2$ , it would have been \$60 million below normal. And in year  $t+3$ , it would have been \$40 million above normal.

**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 approximately \$600 million, if the change to the economic rents approach had not been phased in. By introducing an estimate of mining tax shares for 2000, and introducing this share into calculations for the 2000/01, 2001/02 and 2002/03 fiscal years, the federal government was able to ameliorate the situation for Saskatchewan. However, this last minute “fix” for Saskatchewan simultaneously caused a totally unpredictable drop in entitlements and reduced Manitoba’s revenue by \$84 million, with only six weeks to go in the 2002/03 fiscal year.

This instability generated by the new approach to calculation of the mining tax base had to be overcome. Earlier availability of data from Statistics Canada or a system of estimates based on available information from provinces should be considered. Instead federal officials have introduced a system of rolling averages to be used for payments. While this could improve the stability of Equalization entitlements and might, in some instances, improve stability of total provincial revenues, it will also remove responsiveness from the Program. This lack of responsiveness will, in other instances, cause greater instability in total provincial revenue than if a rolling average were not in use.

This illustrates problems which could be the result of moving to a macro approach, in which data availability of reasonable quality are often delayed. The RTS system has the ability to capture movements in real revenues of provinces on a more timely basis. Indeed, it should be possible to capture those movements even earlier than is currently achieved in the operation of Canada’s RTS Equalization system.

### **Lessons from the Methodological Change to the Valuation of Net Residential Capital Stock with Respect to the Property Tax Base Under a Macro Approach or the RTS**

Over the years, the measurement of fiscal capacity with respect to the property tax base has been one of the more difficult and contentious elements of the current Equalization Program. Perhaps this is due to the fact that, though it is placed within the RTS system, the calculations for the base have not been based on actual tax practice. Rather, a proxy base has been used, with some elements more akin to the application of a macro approach than to an RTS approach. Elements as diverse as personal income, net residential capital stock, demographic change, weightings of farm, residential and commercial property and the like have been part of the calculation of the base.

In large part, a proxy base has been used for Equalization calculations due to the fact that provinces did not, in the past, use a common methodology for deriving their property tax assessment roles on which mill rates were applied. It should be noted that this situation is now quite different, with virtually all jurisdictions basing property taxes on a market value approach. The differences in parameters for developing market value are not much different in complexity than the differences in developing personal taxable income.

Given these developments, using a market value approach to the calculation of entitlements under the property tax base is feasible and would better reflect the concept of the RTS.

In 2001, Statistics Canada made a change in methodology for its measurement of net residential capital stock. The change was simply to use provincial prices rather than national prices to calculate replacement costs of housing stocks within provinces. However, this change had significant impacts on Equalization entitlements and these impacts were very different for individual provinces.

This development should give real pause for thought to those who would advocate for a macro approach. A macro approach, particularly if based on GDP, would have literally hundreds of elements, with change in measurement impacting entitlements in a significant manner. Methodological change, added to the already dramatic changes in entitlements which would occur from routine changes to estimated values of the macro measure, would inject a great degree of instability into the Equalization calculations. Furthermore, the instability would not be linked to actual economic circumstances in the provinces. This would severely damage the credibility of the Equalization formula.

Why has this phenomenon of increased instability not been sufficiently considered by the advocates of a macro approach? Primarily, it is because the analysis of macro measures is usually done on “vintage” data, which has a consistent series, not subject to change within the time period under examination. “Real time” use of a macro measure would have quite different dynamics at play. While a thorough examination of the phenomenon is not presented here, preliminary examination of the issue suggests that instability under a macro approach would be far greater than under the RTS, all other things being equal (e.g., the use of advance estimates and adjustments to reflect actual

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 consideration of the merits of such alternatives to the RTS.

Under a macro approach, calculations appear to be simplified. However, behind the data lie many complexities. The change in the value of the residential stock points to the type of complications and resultant consequences which may arise when a macro approach is used. The task of identifying consequences for using such data for Equalization calculations has not been fully explored.



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 tax base calculations, raise a red flag in this regard. Responsiveness to actual tax base movements in provinces could be lost or severely diminished. This may destabilize total provincial revenue after Equalization.

Examining a macro approach through light cast by recent developments suggests that considerably more analysis needs to be undertaken before further consideration is given to replacing the RTS with a macro approach.

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*

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### 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 and restrict the latitude within which the orders of government operate.

Canada needs appropriate fiscal arrangements between the federal government and the provincial and territorial governments. Provinces have the constitutional responsibilities for health care, education, social services and other important public programs. They also have access to broad taxing powers. However, this provincial capacity is unevenly distributed. Also, at the present time, the federal government has the capacity to run large fiscal surpluses over the foreseeable future without having to resort to additional taxation.<sup>1</sup> On the other hand, without the benefit of adequate federal transfer payments, the majority of the provinces face the prospect of either reducing public services below the standards expected by Canadians, or resorting to increases in taxes or fees. These are the two problems of fiscal imbalance – horizontal and vertical – which can and must be addressed through appropriate federal-provincial-territorial fiscal arrangements. The orientation of economic policy toward providing

growth, stability and the reduction of regional economic disparities is a further priority within those arrangements.

The provinces are currently hard-pressed to meet the demands of health care, education and infrastructure – most notably health care – and at the same time to do so while maintaining a balanced budget and a commitment to competitiveness on taxes. For provincial Ministers of Finance, that circle gets increasingly more difficult to square every year, particularly when the economy slows, or events such as those that took place in New York in September 2001, add new concerns and demands. As will be discussed later in this paper, growing fiscal disparities between provinces, arising primarily from the value of resource revenues and their treatment within the Equalization Program, are also creating additional pressures.

While some intergovernmental fiscal issues impact many provinces in a similar manner, there are concerns which impact one or a few of the provinces more greatly than others. In the case of Manitoba and Ontario, we have had to deal with significant impacts of a federal accounting error with respect to income taxes collected by the federal government on our behalf and remitted to the provinces. The correction of this error resulted in a large one-time repayment to the federal government and a permanent adjustment to our base of revenue. Other provinces are now coping with substantial reductions in their revenue tracts due to the incorporation of population revisions arising from the 2001 Census. Good public policies and practices must be able to respond to unforeseen contingencies while continuing to focus on longer-term goals. Financial arrangements can, and should, increase stability and provide the means through which governments can continue to provide vital public programs in the face of immediate challenges.

All of those things pose enormous challenges when governments are simultaneously trying to provide quality public services, balance a budget, continue taxation reduction strategies, and maintain a commitment to paying down the debt. They are matters that all provinces face, and they face them with the federal government. Today, by a large margin, the primary issue facing the country is how to continue to provide a universally accessible, comprehensive, publicly administered health care system that meets the needs of Canadians in a cost-effective manner. In Manitoba, health care is 41 percent of our Budget now and in some provinces it is an even greater proportion. There is little doubt that Canadians want even more from their health care system. Researchers have examined the cost drivers in health care, related not just to competition in remuneration for health care providers, but also to prescription drugs, new technology, and to public expectations regarding the quality of service they should receive. Attempts to manage the system through restricted access to what some might regard as “less vital health care services” face strong community resistance.

Other priority programs such as education must be financed adequately if Canadians are to be prepared to take advantage of the opportunities of the 21st century and the age of technology. Ministers responsible for health, education and other programs try to find ways to respond to cost pressures, while Ministers of Finance

look at the other side of the equation, which involves financing, lowering taxes and making sure that businesses will invest and grow. Economic growth provides the resources for public programs. Public programs provide the supportive environment for people and business to achieve greater economic growth. Fiscal arrangements provide the mechanisms through which the federal government can play an important role in providing resources to ensure that Canadians everywhere have adequate and comparable public programs and can provide a comparable economic environment to attract and maintain people and economic activity. A comprehensive approach to these interlocking issues is essential.

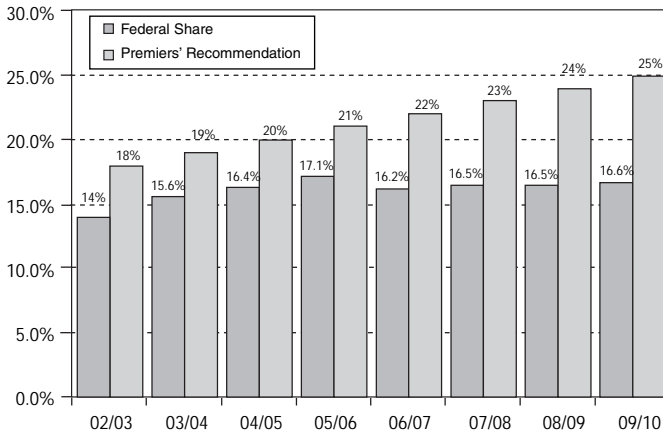
Canada is a very decentralized nation and there is a need for a federal role in fiscal arrangements. Our nation has very few significant programs for transfer payments. Therefore, as we rely on them so greatly, the Equalization Program, the Canada Health Transfer and the Canada Social Transfer must be strengthened to address issues of both equity and adequacy which arise in the Canadian Federation.

#### **A BRIEF HISTORY OF MODERN FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS**

Provinces carry the responsibility for providing the essential components of Canada's social programs. What is the federal role in helping to finance those services?

Historically, when innovations were introduced at the national level through the leadership of Premiers such as Tommy Douglas, and Prime Ministers, such as John Diefenbaker and Lester B. Pearson, there was a fifty-fifty cost-sharing arrangement for the basic services that were insured. **Annex 1** provides a short history of fiscal developments since 1950. We are a long way from that fifty-fifty partnership now. The provinces note that the direct cash contribution from the federal government to health, education and social services has been raised from just over 13 percent in 2001/02 to just in the order of 16 percent after the 2003 First Ministers' Health Arrangement. The Premiers of the provinces and territories have taken the position that the federal share should rise to 25 percent by 2010.

**Figure 1**  
**Federal Transfers as a Share of Provincial/Territorial Health, Social and Education Spending**



Source: Conference Board of Canada (2002); January 2003, Premiers' Meeting on Health Financing<sup>2</sup>

The federal government uses different calculations. It has argued that tax points transferred to provinces in 1976 should be counted, Equalization should be counted, and the base upon which the calculation is done should be different. Unfortunately, these federal calculations ignore the fact that then the base comparison would also change. Tax room returned to provinces in 1977 is a part of that which was originally ceded by the provinces to the federal government. Equalization was introduced in 1957 and existed prior to the implementation of many of the social safety net programs. Fifty-fifty financing was instituted when provinces were already in receipt of Equalization. Indeed, many provinces would not have been able to take appropriate advantage of cost-shared programs, if their own-source revenues had not been augmented by rising tax shares and Equalization payments.

However, these different interpretations of financial data lead to public confusion and annoyance. It is necessary to bring some clarity to the discussion. This is not for the purpose of creating political debating points. Rather it is to ensure that appropriate fiscal mechanisms are in place and that Canadians are informed about the decisions being made with respect to financing their current public services and those which they want for the future. Fiscal arrangements contribute toward a quality of service and a degree of equity of services across the country, such that the notion of citizenship is roughly equivalent across the country. That notion of citizenship, regardless of what province or region one lives in, is fundamental to the ability of the federation to function effectively in the future.



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, potential exists 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.

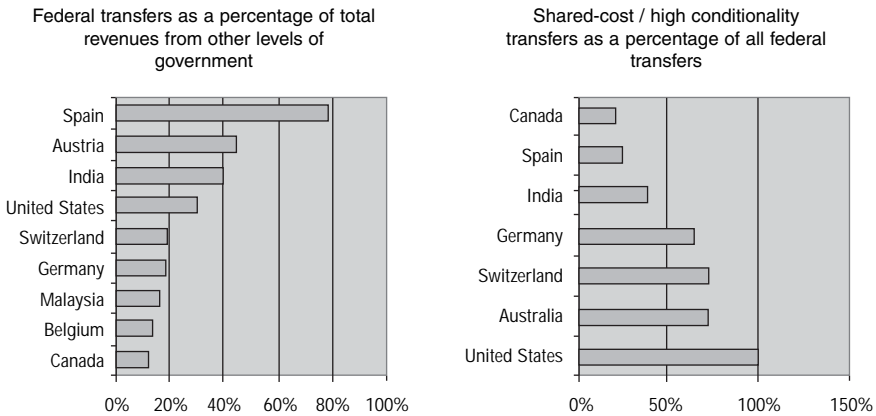
With appropriate commitments from both the federal and provincial-territorial governments, Canada can have a strong economy, healthy communities and a sense of social citizenship that is equal for all Canadians and unequalled in the world.

## 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.<sup>3</sup> 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.<sup>4</sup> 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: Pélouquin, David and A. Chong (2003) 4*

Third, a balance must be restored specifically with respect to financing ongoing and reform initiatives for social programs, especially for health care, with the federal government once again playing a greater role. The 2003 First Ministers' Health Agreement was a good step forward. However, provinces are concerned that not only was there insufficient funding for health care reform, as recommended by the Romanow Commission, but the federal plan reduces funding for education and social services when the CHST is split into the CHT and CST in 2004.

Fourth, the current Equalization arrangements work, but must be strengthened. The introduction of the Equalization Program in 1957 heralded the beginning point for several decades in which a more equal playing field provided greater equity in terms of the social services that were available to citizens across Canada, as well as a more even distribution of economic growth. Per capita fiscal disparities between provinces have narrowed.<sup>5</sup> However, in recent years, the federal government's commitment to Equalization has been weak, the program as a percentage of GDP has fallen markedly, and there are signs that fiscal disparities between the provinces are widening, leading to dislocation of people and skewing business decisions based on assessments of net fiscal benefits – tax loads and service levels – rather than underlying economic fundamentals.

Fifth, when Canada relies so heavily on only two major programs, Equalization and the CHST/CHT/CST, those programs must be strong and the formulas must work correctly, such that the provinces are able to carry out their responsibilities and provide comparable services to Canadians in all of the provinces.

Sixth, greater attention should be paid to ensuring stability of revenues for provinces, which are responsible for providing the major portion of services upon which Canadians rely. Stability has been a problem with respect to tax collection and transfer arrangements for many years.

## **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 also contain the seeds of potential problems. In particular, the question emerges of the best means to maintain equitable standards for programs, which are regarded as basic rights of Canadian citizenship. The development of appropriate intergovernmental fiscal arrangements is important to ensure equity without sacrificing the efficiency and effectiveness gains resulting from decentralized delivery of services.

The Manitoba Government believes that social progress and economic progress go hand-in-hand. Education, health and security for our citizens are fundamental to our way of life. Our strong and stable economy relies on our Government's ability to keep Manitobans here and to attract new immigrants to the province from elsewhere in Canada and from abroad. Fiscal arrangements are extremely important to Manitoba from both social and economic perspectives. Virtually every issue of debate on fiscal arrangements, discussed at the 2002 Conference and examined in this volume, resonates in Manitoba.

## **FISCAL IMBALANCE IN CANADA: RESOLUTION NEEDED TO SUSTAIN HEALTH CARE**

Vertical fiscal imbalance in Canada was a major theme running throughout the Conference agenda. The federal government may not wish to portray the situation in Canada as one of vertical fiscal imbalance. Furthermore, some federal ministers may believe that citizens do not care about mechanisms for fiscal federalism, as long as their issues are addressed. However, the federal government has begun to take pragmatic measures which show that it agrees with provinces that fiscal re-balancing is necessary, and now agrees that this balancing should involve greater federal funding to meet the health care needs of Canadians.

In recent budgets and in the Manitoba Government's presentation to the Romanow Commission, it was argued that the sustainability of health and other social programs requires a resolution to the fiscal imbalances that exist between the federal government and the provinces, as well as those that exist among the provinces.

We want to retain the efficiencies of a public health care system that is administered by provincial governments and responsive to our citizens. The per capita costs of our provincial health care systems, when converted to U.S. dollars, are not much more than one half of those in the United States. In the United States, the system is mostly private

delivery, with federal administration of a health entitlement program. Our health outcomes in Canada, in many respects, are better than those in the United States. We have to preserve our universal public health care system to retain these advantages.

Provinces are doing the job of meeting the growing challenges resulting from an ageing population, advances in medical technology and increasing expectations. However, costs are growing more rapidly for health care than for other public programs in every province in Canada. We need a reliable federal partner and appropriate fiscal arrangements to maintain services now, while we reform the system and control costs over the longer run.

Whether the issue of fiscal imbalance is approached from a theoretical or a pragmatic perspective, the answer to the problems surrounding the financing of health care will be the same. We must continue to contain costs. But at the same time, more federal funding is required to sustain universally accessible, quality, public health care programs across Canada. While the 2003 health financing arrangement committed more federal funding for health care, most of the new money flowing to provinces and territories is tied to expanded services related to health care reform and was not permanent funding. Therefore, while the CHST cash supplements will provide some temporary relief, the arrangement itself will do little to address the underlying fiscal imbalance or the sustainability of our health care system.

With the recent focus on the sustainability of Canada's health care system, it is sometimes easy to overlook an equally important issue – that of ensuring adequate funding for post-secondary education and social services in Canada. Provinces, faced with the challenge of adequately funding all of the major social programs on which Canadians rely, know too well that one program area cannot be sacrificed for another. All of these challenges must be met concurrently.

It is within this context that Manitoba and other provinces expressed concern about the manner in which the federal government proposed, in its 2003 Budget, to split the CHST into separate health and social program transfers. While Manitoba supports the principle of splitting the CHST in order to improve accountability and transparency to the public, the federal government's decision about how to execute the split creates a significant problem for provincial and territorial governments, and for their citizens.

Against the advice of the Romanow Commission and Premiers, the federal government announced it will fund post-secondary education and social services under the new CST, at a level significantly lower than it did in 1994/95. This decision means that the increase in funding for health care that resulted from the 2003 health financing arrangement comes in part at the expense of existing funding for post-secondary education and social services. In fact, almost 60 percent of the 2004 increase in federal support for health care comes at the expense of the federal government's commitment to social services and post-secondary education. All the while, expenditure pressures faced by provinces and territories in funding post-secondary education and social services continue to grow.

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.<sup>5</sup> The Committee's Report concluded:

Equalization has become 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... Like the Premier and Finance Ministers of the provinces who appeared during the hearings, the Committee believes that the program requires strengthening, and not a complete overhaul.

Reading the popular media, Canadians might believe that the Equalization Program is a "welfare trap" for provinces. Nothing could be further from the truth and the example of Manitoba proves this point. Manitoba has one of the most stable and diverse economies in Canada and our growth rate in recent years has exceeded the Canadian average. Winnipeg has become a diversified manufacturing centre. For example, it is the leading city in North America for the production of urban transit and intercity buses. Winnipeg also has a large aerospace sector, which is diverse enough to have, to a great extent, withstood the recent troubles in the airline industry. Two of the largest Canadian financial services organizations operating in Canada and the United States, Great-West Life and Investor's Group, are both headquartered in Winnipeg. Manitoba also plays a leading role in medical research. Agricultural production and processing in Manitoba have shown tremendous growth. Manitoba Hydro exports were valued at close to \$600 million in 2000 – 83 percent of which went to the United States. Manitoba's unemployment rate is consistently among the lowest in the country.

What this illustrates is that Manitoba has many strengths and its people are industrious and resourceful. Arguments that Equalization is a type of "welfare trap" which prevents economic initiative and growth simply do not stand up to scrutiny.

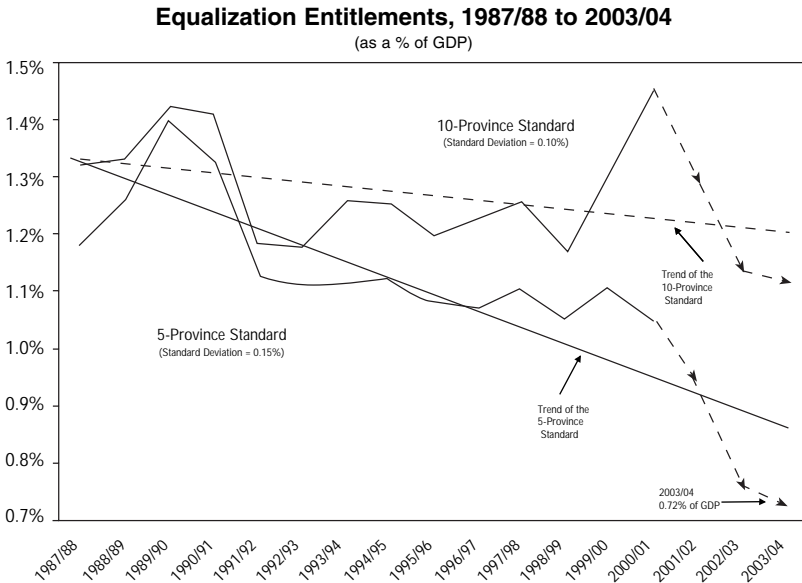
However, we need to develop and showcase our skilled work force and our quality of life. And we need to stay competitive on taxes and costs. If we do not, we know we may lose some of the manufacturing and service activity we now enjoy, despite our Hydro and other advantages. This is because many locations compete for the plants that produce buses, furniture and aircraft components, and financial, media and other service industries are equally, or more, sought after than manufacturing facilities.

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 comparable levels of public services at reasonably comparable levels of taxation,” is important to us, both as Manitobans and as Canadians.

The Equalization Program has been a success in levelling the playing field (or balancing the “net fiscal benefits,” as the economists would say) and has allowed economies in all parts of Canada to grow. Some commentators continue to talk of a “welfare trap” of Equalization – apparently unaware of the fact that per capita incomes and per capita GDP in the recipient provinces have closed the gap on the Canadian average.<sup>6</sup> This narrowing of disparities has had an added cost advantage. Equalization Program costs over the past two decades have fallen, as a percentage of GDP, by about one-third.

**Figure 3**  
**Equalization as a Percentage of GDP**



Sources: Federal Department of Finance, Statistics Canada

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, but in a manner which would not be equitable. Nor would it be justifiable under the Constitution provision governing the Equalization Program. The Constitutional provision states that the Government of Canada is committed to the principle of making Equalization payments, such that provinces may provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Clearly, this provision governing Equalization would be lost with a Program which allows exclusion from the calculations of significant revenues available to some provincial governments. There is no justification for making Equalization payments to provinces above that required such that they have sufficient revenues to provide reasonably comparable services at reasonably comparable tax rates. A formula which incorporates comprehensive revenue coverage achieves that purpose. On the other hand, a formula which excludes revenues may be counter-productive, as those provinces with revenues from non-renewable natural resources could enjoy similar per capita revenues despite having lower tax rates, creating a second tier of provinces with fiscal advantages, based in part on the continuing transfer of federal revenues. By way of example, Saskatchewan could receive much larger Equalization payments if their resource revenues were not recognized in the formula. The total of their own-source revenues, including that from non-renewable resources, plus Equalization could enrich that province such that its fiscal capacity on a per capita basis would exceed that of Ontario, a non-recipient province. Strengthening the Equalization Program must involve raising the standard in a formula which incorporates full revenue coverage.

#### **IMPROVING REVENUE STABILITY**

Fiscal arrangements should provide stable funding for provinces to provide basic public services to acceptable standards. However, over the past number of years, tax col-

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 ceiling and floor provisions.

There has been a virtual abandonment of meaningful fiscal stabilization arrangements within the current fiscal arrangements agreements. The federal government has traditionally had a stabilization role in responding to the impacts that a recession or other adverse events have on provinces and territories. However, the federal role in economic and fiscal stabilization has been reduced significantly in recent years.

The distribution of spending responsibilities between the federal and provincial/territorial governments has led to an increase in the share of responsibility for providing public services to the provinces/territories, and decrease in that of the federal government. Provinces/Territories, including local governments, now account for almost two-thirds of direct public expenditures in Canada. At the same time, federal transfer payments, as a proportion of the revenue of other orders of government, is only 12 percent. Provinces/territories are therefore highly dependent on own-source revenues for funding a large proportion of public expenditures.

The Canada Assistance Plan, which was responsive to increasing social assistance caseloads and costs during a downturn, was folded into the CHST, which is not sensitive to changes in expenditure need. Furthermore, prior to 1991, negative Census adjustment impacts on prior year entitlements under the Established Programs Financing and Equalization Programs were forgiven. This protection was removed from 1991 forward. The delayed payment scheme put in place in 1993 does not rebalance revenues in recognition of reduced transfers resulting from Census changes. The Fiscal Stabilization Program was also amended to provide protection only in extreme cases of declining provincial revenue.

### **The Current Fiscal Stabilization Program (FSP)**

The *Federal-Provincial Fiscal Arrangements Act* provides for a transfer to provinces in the event that total provincial own-source revenues plus Equalization declines by five percent or more from the previous year's revenues (adjusted to remove the effect of provincial tax changes). Resource revenues must fall by 50 percent to be factored into the calculation. The maximum payment is \$60 per capita.

It is important to note that a level of protection of \$60 per capita is less than one percent of the total average revenue per capita of provinces and territories. Therefore, the FSP effectively provides protection for revenue drops only in the band of nominal



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 percent drop in revenue would occur in an Equalization-recipient province. The territories are not covered under the program.

#### The Equalization Program Floor

The floor provision of the Equalization Program provides that Equalization entitlements may not drop more than 1.6 percent of the per capita standard or approximately \$100 per capita from the previous year’s entitlement. However, the protection often is paid long after the drop in provincial revenue occurs. It provides “protection” after a province’s own-source fiscal capacity has increased. And it alters the equity of the Equalization Program among recipient provinces.

### ALTERNATIVES

There are several ways to improve the stability of provincial revenue. Following are some alternatives.

#### **Strengthening the Current Fiscal Stabilization Program (FSP)**

Prior to 1995, the FSP was triggered when provincial revenue fell by any amount in nominal terms (i.e., there was no 5 percent threshold). As in revised legislation, only one-half of the drop in resource revenue was included and the maximum payment is \$60 per capita. However, strengthening the current FSP would become significantly more costly for the federal government and would most likely continue to provide most of its benefits to resource-rich provinces.

#### **Improving the Equalization Floor Provision**

While the floor provision has limited stabilizing properties, alternative ways of calculating the floor, related to maintaining the standard for all provinces, rather than stabilizing entitlements of individual provinces, could be considered.

#### **Creating a New Fiscal Stabilization Plan (NFSP)**

A New Fiscal Stabilization Plan could be constructed on the basis of appropriate principles, including: revenue to flow when total provincial revenue, including transfers, is falling (excluding windfall revenues); protection scaled to provide provinces with a lower fiscal capacity with more assistance than to those provinces whose capacities are stronger; provisions added to ensure federal affordability; and dropping both the floor and ceiling provisions of the Equalization Program.

**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 "open" fiscal year entitlements and delay and magnify volatile effects of the current system of advance payments and adjustments.

**SUMMARY AND CONCLUSIONS**

Maintaining and improving fiscal arrangements in Canada is essential to maintaining the federation. Our nation has developed a small number of effective programs to overcome horizontal and fiscal imbalances which arise with the distribution of taxation and expenditure responsibilities of the two orders of government. We can use those to resolve future problems, whether or not there are shifts in the distribution of taxation and expenditure responsibilities. Immediate challenges to be addressed include: improved support for maintaining and reforming health care through the Canada Health Transfer; adequate support for education and other social programs through the Canada Social Transfer; a strengthened Equalization Program to ensure that the social benefits of Canadian citizenship are available to all across the country and that a level playing field is created such that economic opportunities are not skewed; and providing effective stabilization against volatility, instability and unpredictability in total revenues.

Polling evidence indicates that citizens are very strong supporters of the Equalization principle. Clearly, Canadians want every province and all its citizens to have an equal opportunity to prosper. Adequate and equitable fiscal instruments make that possible. History shows they work. Therefore we must move forward by strengthening these programs to the benefit of all Canadians.

## Annex 1

### History of Fiscal Arrangements Since 1950

Transfer payments from the federal government have been a part of financing provincial programs since Confederation. However, the modern transfer payments programs have their roots in the expansion of social programs after the Second World War.

Canada's Equalization Program was introduced in 1957 to reduce disparities in provincial fiscal capacity so that Canadians have access to "reasonably comparable services at reasonably comparable levels of taxation" no matter where they live in Canada. All provinces, except Ontario, have received payments under the Program. These payments are based on the relative capacity of provinces to raise personal and corporate income taxes and succession duties.

With the development of the Equalization Program as the backdrop, throughout the 1950s and 1960s, the federal, provincial and territorial governments also became partners in forging health and other social programs in Canada. The Canada Assistance Plan was passed in 1966, and most social assistance programs became eligible for 50/50 cost-sharing. Programs for hospital and physician services, in addition to post-secondary education support were implemented and expanded in partnership, with the federal government usually providing about 50 percent of the costs.

In 1966, the Canada and Quebec Pension Plans were introduced as an important pillar of our retirement income system, so that all working Canadians provide for their retirement through their own contributions (as well as those of their employers). The development of the CPP/QPP was another example of federal-provincial partnership in developing Canada's social safety net, with both levels of government acting as stewards of the Plan.

As new services were added to the original cost-shared programs, provinces wanted greater flexibility in order to achieve greater efficiencies, while the federal government wanted to reduce its exposure to rising costs. The Established Programs Financing Arrangement (EPF) replaced the health and post-secondary education programs, while the Canada Assistance Plan (CAP) for social services remained cost-shared between the federal and provincial governments.

In the 1980s and early 1990s, however, the federal government began to reduce its commitment to these essential public services – first through reducing the growth rate of transfers and then through caps on its expenditures. This federal withdrawal culminated in 1996/97 when EPF and CAP were collapsed into the Canada Health and Social Transfer (CHST), and federal support was cut drastically. Within three years of the implementation of the CHST, annual cash transfers to provinces and territories in respect of health, post-secondary education and social services were cut by one-third, or \$6.2 billion.

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 providing Canadians with their most valued public services. Manitoba maintains that the federal government missed an opportunity with these arrangements to fully strengthen its role as a constructive partner in funding key social programs.

## Notes

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<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.

<sup>3</sup> See, for example, conclusions drawn by the Conference Board of Canada (2002 and 2004) and Ruggeri (2000).

<sup>4</sup> Figures reproduced with permission of authors from unpublished paper by Péroquin and Chong (2003).

<sup>5</sup> Standing Committee on National Finance (2002).

<sup>6</sup> Analysis drawn from Bird and Vaillancourt (2001).

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

*Kathy L. Brock*

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### 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 federal government, the First Nations Governance Initiative (FNGI). The underlying assumption is that if Canadian fiscal arrangements are to work to the benefit of Aboriginal Canadians, the federal government and the provinces, then both the symbiotic relationship between good governance and healthy economies and the ancillary effects of federal First Nations policy must be understood. Policies in this area must be understood as polycentric if they are to succeed in the future.

This chapter argues that the recent efforts by the federal government to reform governance structures in First Nations communities reveal not only the intimate connection between political and economic reforms but also the extent to which the provinces are implicated in future attempts at change. As the reforms to First Nations governance and economic and fiscal matters become more comprehensive, provincial interests also increase. Provincial governments can no longer afford to be passive observers but should listen carefully to the federal government dialogue with First Nations, speaking up where their interests are neglected or potentially adversely affected. To capture the economic and fiscal interest of the provinces in future negotiations between the federal government and First Nations over governance reforms, this chapter explores the recent ill-fated First Nations Governance Initiative (2001-03). The argument is divided into three sections: the drivers for reform, the proposed reforms,

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, *Communities First: First Nations Governance under the Indian Act*.<sup>2</sup> The 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)<sup>3</sup> 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.<sup>4</sup> 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 Indians under the *Indian Act*. Until *Corbiere* many of the reinstated individuals lived off reserve and were denied office and voting rights in their First Nations communities under the *Indian Act* (S. 77.1) and band election regulations. In this complex judicial decision that balanced on-reserve and off-reserve First Nations interests, the Supreme Court found that denial of the right to vote in band elections and to hold office violated the Canadian Charter of Rights and Freedoms (S. 15). However, the Court allowed that the different interests and concerns of on-reserve and off-reserve band members could justify a more limited form of discrimination, just not the complete denial of the rights (S. 1). The federal government, in consultation with the national First Nations leadership, revised the Indian Band Election Regulations to comply with the Court's decision but realized that further revisions to the *Indian Act* would be required. Included in the list of outstanding issues were the *Indian Act* procedures for leadership selection and voting rights, the implications for and standing of customary governments, as well as accountability to diverse constituencies.

*Corbiere* and the political response to it had immediate financial as well as political implications. On the political front, the decision had the effect of expanding the pool of electors and office holders in First Nations communities by including the off-reserve populations. The increased political involvement of off-reserve members of First Nations would allow off-reserve issues to surface more centrally in elections and at council meetings than previously had been the case. Chiefs and councillors who had

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, *Corbiere* provides a basis for First Nations individuals living outside their communities to argue for the improvement and extension of benefits to them from band communities. Band resources tabulated in the past using full band membership, but often expended on the on-reserve populations primarily, would have to be reallocated. Given the inadequacy of financial capacity in these communities, band governments would be further stressed in attempting to meet the needs of their increasingly diverse membership.

This change is important for the provinces. As Alan Cairns has ably documented, the trend among First Nations is away from their communities and toward urban areas, with as high as 50 percent of the Aboriginal population living in urban centres.<sup>5</sup> Although many off-reserve members retain close ties with their communities or plan to return in the future, the number of First Nations members living off reserve is growing proportionately higher than those choosing to remain on reserve. The off reserve dwellers are caught in a financial morass. Financial responsibility for individuals living outside their communities has always been an object of dispute between the federal and provincial governments and with First Nations governments.<sup>6</sup> The federal government has limited its expenditures on off-reserve populations while the provinces have increasingly absorbed the social and health costs associated with this population. Although the size of the expenditures remains in question, the provinces have traditionally argued that what compensation they receive from the federal government remains low compared to the costs. As these costs rise, the provinces have a direct interest in the federal government assuming more of the responsibility. Therefore, if off-reserve members can pressure their governments to assume more responsibility for these populations and if their governments in turn pressure the federal government to increase their payments for this portion of their population, then the onus shifts from the provinces to the First Nations and federal governments. The potential for more effective funding formulas to deal with the costs of servicing this portion of the general population increases. The provinces can only stand to benefit.

Second, *Corbiere* was only one of a series of cases before the courts challenging various provisions of the *Indian Act*.<sup>7</sup> Gauging by past decisions, the judicial legacy on the *Indian Act* and First Nations rights would likely continue to be unpredictable and to lack policy coherence. By initiating a process addressing key problems in First Nations governance, the federal government was pre-empting court action and in a better position to set the policy framework for Indian governance. In addition to being proactive, the FNGI was intended to address the existing inconsistent and confusing set of judicial decisions on Indian governance by offering clear statutory guidelines on matters such as the legal status and standing of First Nations governments, accountability issues, voting and taxation, among other things. Clarity of the law was an important driving force behind the FNGI.

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*,<sup>9</sup> and Tom Flanagan's *First Nations Second Thoughts*.<sup>10</sup> Not confined to academic campuses, the debate inspired by these two mainstream and prominent academics extended into popular media through talk shows and newspaper editorials, articles and reviews.

Policy makers at both the provincial and federal levels have been listening to these calls for reform as they have been attempting to develop more productive relationships with communities within their jurisdictions. In particular, provincial and federal officials emphasize accountability, transparency and performance measurement in the expenditure of public monies. This should improve public administration within First Nations communities with the longer-term goal of serving First Nations members better. So, for example, cost-sharing arrangements between a First Nations government and a contiguous municipality for fire or ambulance services for their populations would be more likely to occur were both governments openly accountable for their shares of the costs. As these types of agreements expand and become more effective through rigorous monitoring, efficiencies for both municipal and First Nations governments could result. As the prime funder of local governments, the provincial governments would benefit from these efficiencies.

Fourth, First Nations leaders and members have been pressing for changes to the *Indian Act* for some time.<sup>11</sup> The consultations following Corbiere on the election

regulations highlighted the need for broader reforms. Slow progress on land claims and self-government negotiations have necessitated government action to encourage these negotiations and to show good faith. Clashes between the state and First Nations (e.g., Burnt Church, logging disputes) particularly in the aftermath of the Supreme Court's decision and clarification in *Marshall v. Canada*<sup>12</sup> provided cause for immediate action.<sup>13</sup> First Nations have made it clear that they are frustrated with the Indian Act and have had enough. The current leadership has indicated that the next generation will not be as patient as they are. Further, the members want real change not just rights and land claims talk. They want tangible results in their daily lives.

The frustration of First Nations with the federal government's response to their socio-economic situation has a direct impact on provincial interests. Protests, blockades and other forms of civil disobedience have economic consequences for the local communities, both Aboriginal and non-Aboriginal. Threats of direct and escalating protests have an impact on provincial citizens and require provincial involvement especially through police or prosecutorial action with the attendant costs. Furthermore, the lack of resolution on claims and of effective remedies for the impoverished conditions of First Nations has spillover effects for the provinces in terms of lost economic activity, such as mining or housing development, as well as longer-term social costs. And in this process of irresolution, tensions mount between Aboriginal and non-Aboriginal citizens requiring greater expenditures on the promotion of good citizen relations as well as human rights. While many of these costs are hidden, the interest of the provinces lies in seeing longstanding disputes settled amicably and equitably.

In the area of socio-economic conditions, the effects are both visible and hidden. The health of First Nations communities and their growing populations as a proportion of the total Canadian population has provided direct impetus for progress on First Nations issues to both the federal government and First Nations leadership. According to the department Report on Plans and Priorities tabled as part of the 2003/04 Estimates, "The mission of Indian and Northern Affairs Canada (INAC) is to facilitate a better quality of life for First Nations, Inuit and Northerners."<sup>14</sup> Specifically, INAC aims to reduce the disparity in socio-economic conditions between the First Nations population and the general Canadian population. Housing, health and education are all closely interrelated and are substandard in First Nations communities as surveys and census data regularly reveal and is commonly acknowledged.<sup>15</sup> As a tip of the iceberg, currently there is a 10,000 person backlog for federal government post-secondary funding for First Nations.<sup>16</sup> Aboriginal peoples experience among the worst living conditions in Canada.<sup>17</sup>

The deprivation of First Nations has a direct impact on the provinces since it limits their contribution to provincial economies and social life. For example, were the backlog to university to be corrected, then federal transfers to both the First Nations and the provinces and provincial funding formulas for universities would need to reflect this difference. In the Western provinces where the impact is likely to be more significant given the higher percentage of Aboriginal peoples in the population, an increase

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."<sup>18</sup> 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.<sup>19</sup> 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.<sup>20</sup>



Just as the Chrétien 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 run,”<sup>22</sup> 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 enactment and enforcement, and so on;<sup>23</sup> leadership selection and voting rights for both on- and off-reserve community members under Sections 74-80 of the *Indian Act* and the *Indian Act* Band Regulations governing 263 of the 612 First Nations communities;<sup>24</sup> and financial management and accountability to First Nations including political decisions, administrative decisions, codes of ethics and conflict, provision of essential services and the use of public funds.<sup>25</sup> The basic principles underlying governance reforms are transparency, disclosure and redress (or openness and fairness). Under the Chrétien reforms, accountability to community members would have increased but First Nations governments would have remained accountable to the federal or other governments for monies transferred from those governments.

The governance reforms were part of a series of policy initiatives designed to provide First Nations with the “modern tools” to participate fully in the economy.<sup>26</sup> These measures include the creation of the Canadian Centre for the Independent Resolution of First Nations Specific Claims to expedite negotiations on land and property claims, a National Working Group on Education to foster excellence in education in First Nations schools, a panel opening up negotiations on revisions to the 1999 *First Nations Land Management Act*, and the First Nations Fiscal and Statistical Management Consultation Bill and including a tax commission, finance authority, financial management board and statistical institute.<sup>27</sup> Together, these measures constituted sweeping reforms to the conduct of politics, education and business by the First Nations, providing the basis for raising the quality of life within communities.

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.<sup>28</sup> 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's 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.<sup>29</sup> 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,<sup>30</sup> and 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. To add 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.<sup>31</sup> In sum, the registered Indian population is projected to decline under the current rules of registration.<sup>32</sup>

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."<sup>33</sup> The formula and rates of reimbursement from the federal government to the provinces for such services remain disputed. Prince and Abele explain this dichotomy in federal policy even more sharply:

At the level of high policy, the federal government through the Ministry of Indian Affairs and Northern Development recognizes that Metis, non-status, and status people living off-reserve, are all Aboriginal People who are entitled to certain specific services, just as are status Indians living on reserves.... At the level of active program development and service delivery, with a very few exceptions, the Department of Indian Affairs and Northern Development continues the longstanding practice of funding services on reserves and for Inuit, only.<sup>34</sup>

The bottom line is that the provinces will increasingly bear the fiscal responsibility for these populations in practice despite the federal constitutional responsibility for Indians, Inuit and Metis.<sup>35</sup> Given the higher rates of social expenditures required for these populations, the rising costs to the provinces could be significant at a time of increasingly constrained resources. As the population numbers rise, the provinces may become less willing to shoulder the costs. Ultimately, the citizens lose.

The current fiscal arrangements are not working in practice. If not reformed, the situation is likely to deteriorate with real costs to Aboriginal peoples. Thus, not only must political reforms, like a future governance initiative address the concerns associated with the definition of status, any new fiscal arrangements should incorporate this consequence of the political reforms. With escalating health costs and the current state of health generally within the Aboriginal community, the provincial interest in federal acknowledgement of responsibility for on- and off-reserve members is even more pressing than in the past. Provided that there is no corresponding decrease in fiscal transfers from Ottawa to the provinces, the provincial governments would be wise

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.

The second lesson for the provinces is that any future governance reforms should be viewed in the context of a larger agenda of reforms for First Nations that contribute to the improved well-being of communities. Good governance is not enough; a sound economic foundation is also essential "to give First Nations people real choices for the future."<sup>36</sup> As mentioned above, the governance reforms were accompanied by reforms involving land management, specific claims resolution, and fiscal and statistical management reforms. In his analysis of the fiscal legislation proposed concurrently with the governance legislation, Robert L. Bish, a leading expert on First Nations taxation and property issues, argued that the reforms were initially driven by the First Nations, were sophisticated and promised a major role for First Nations "to oversee financial management, cooperative debt finance, and the publication of financial information." In particular, he commended the federal government's proposal to appoint members to the Tax Commission since it would provide independence from the communities where tax policies were in conflict and from the federal government since that relationship would be arm's length. In his view, these institutional arrangements promote independence, fairness, impartiality and accountability in fiscal reforms consistent with the objectives of the governance legislation.<sup>37</sup>

From a different perspective, the integrated nature of the governance and fiscal reforms posed problems. Reading before the House of Commons Standing Committee on Aboriginal Affairs, on behalf of Chief Roberta Jamieson, David General, a councillor of the Six Nations of the Grand River, stated, "We are opposed to Bill C-19 because it links to the government's larger objective. As the minister told the committee on Monday, Bill C-19 plays a key role within the government's larger strategy, along with the First Nations Governance Act."<sup>38</sup> Among the myriad of problems with the federal government strategy were: the creation of institutions with directors appointed by and responsible to the Minister not the communities; the underlying assumption that the powers of First Nations governments would be of a municipal order only and the accompanying assumption that legislation was necessary rather than just recognition of the power to create these institutions and exercise the powers of government as inherent; and inadequate resourcing both for proper governance and for the four new institutions.<sup>39</sup> In addition to remaining vague on its financial commitments to the governance regimes and on land claims, INAC costed the four new institutions at \$10 million whereas the official Web site of the institutions places the costs at \$25 million.<sup>40</sup>

In any future proposals for reform, the provinces would be wise to consider the entire package and the joint effects of reforms. So for example, it might be argued that the governance reforms increased the autonomy and authority of First Nations

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 decisions of businesses to locate in those communities, what recourse does the province have if it deems its municipalities are disadvantaged? How will different tax rates affect the neighbouring communities? Will provincial citizens living in communities with a higher tax rate than the adjacent First Nation feel aggrieved? How will this affect the ability of the First Nation and municipality to co-operate on shared services? One important factor in resolving disputes like this will be to ensure that both the First Nations and non-Aboriginal government decision-making processes are transparent, accountable and equitable. In a similar vein, provinces would have an interest in seeing the clarification in legal standing for First Nations linked to greater financial powers. For example, under the combined governance and fiscal reforms, First Nations would be able to arrange debt financing to collaborate with adjacent Metis or non-Aboriginal communities in local economic development. Given that First Nations communities are often located in more remote areas where it is difficult and expensive for the provinces to engage in service delivery and economic development, joint community-based initiatives are a promising means of elevating the standard of living of the region as a whole. Further, linking governance reforms to the creation of a statistical institute could provide the needed information to produce a more accurate and efficient deployment of federal funds to benefit the First Nations citizens living on and off reserve. But above all, the provinces would be wise to ask whether disparate federal reforms have adequate financing both individually and collectively. Otherwise, the costs might be displaced onto the First Nations communities within their borders and ultimately on them. More effective future fiscal arrangements involve thinking holistically about political, economic and fiscal reform.

The third lesson relates to the ability of the First Nations to engage in prudent fiscal management. The courts have been recognizing the legal capacity and standing of bands within a wider range of circumstances in recent years. Indeed, the national Chief maintains that "First Nations can enter into contracts, and sue or be sued."<sup>41</sup> However, the extent and nature of these powers remain unclear since they are not specified in statutory form.<sup>42</sup> For example, since bands have not been accorded the same status as natural persons, there has been some confusion regarding the right of bands to represent themselves in legal cases. To some extent, the courts have resolved this issue by allowing bands to file claims as class actions. Although the courts have been inferring from the Indian Act provisions that a band has the right to sue or be sued, it is not clear whether the bands should be treated as analogous to corporations, unincorporated associations, persons or another entity and for what purposes. For example, courts in Manitoba and Quebec differ over whether or not band corporations are taxable or exempt since bands may be considered "Canadian municipalities." The ability of individuals to sue a band for perceived wrongs is also unclear.<sup>43</sup>

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 fiscal arrangements with the provinces. A sample of provincial Aboriginal policies reveals this link. Under its Aboriginal policy framework, the Alberta government recognizes the primary relationship of the federal government to the First Nations but includes First Nations in its instructions to ministers and departments to include partnerships with First Nations in their business plans and any progress in their annual reports. The Alberta government pledges to “work in partnership with First Nations” to facilitate their participation in the life and economy of the province.<sup>44</sup> Similarly, the British Columbia government is proposing new economic alliances and business development initiatives with First Nations as part of their plan to improve conditions for First Nations citizens. The new Aboriginal Directorate is charged with increasing “First Nations participation in government policy and [creating] new economic opportunities for First Nations communities.”<sup>45</sup> The Saskatchewan government is interested in strengthening the relationship with First Nations communities.<sup>46</sup> The Ontario Aboriginal Policy Framework emphasizes economic and community development as the most effective means of fostering First Nations self-reliance and responsibility and reducing dependency on transfers. According to the Framework, two of the challenges to public-private-Aboriginal partnership are: “Legal barriers such as the Indian Act provisions that limit the use of collateral on-reserve for loans;” and, “complex application of laws and legal regimes (federal, provincial or First Nations) to business.”<sup>47</sup> Given the current emphasis of provincial Aboriginal plans on private sector alliances, community economic development and business initiatives, a clarification of legal standing and the financial rights of First Nations could provide a stronger basis for more extensive federal-provincial-First Nations government co-operation than in the past.

The fourth lesson from the FNGI illuminates the process for achieving more effective fiscal arrangements for First Nations that the federal government and provinces would do well to heed. In *Restructuring the Relationship*, the Royal Commission on Aboriginal Peoples (RCAP) called for more transparent government, improved fiscal accountability, and national standards for communities much like the FNGI.<sup>48</sup> However, RCAP suggested means that were quite different from the FNGI. **Negotiations** were envisioned by the RCAP not **consultations**. The former respects the inherent right of self-government and right to self-determination of Aboriginal peo-

ples while the latter treats First Nations as unequals and “wards” of the federal government by leaving the locus of decision making and legislative drafting within the federal government offices.<sup>49</sup> Negotiations are more likely to result in principles and definitions of accountability and standards that are more consistent with First Nations practices than reflective of Canadian or Western liberal democratic principles and practices. Similarly, the policy thrust of the FNGI is more consistent with the recognition of a municipal form of government than respect for the self-determination of First Nations. The RCAP approach promotes a package of reforms aimed at First Nations self-sufficiency, social stability, economic growth, and the eventual termination of the *Indian Act*, while the FNGI approach aims at similar objectives but updates the *Indian Act* thus removing the immediate need for its abolition. The RCAP recommendations have more legitimacy and resonance in the communities because they are seen as defined through the communities rather than within INAC. Future policy reform at either level of government or an intergovernmental process of reform aimed at securing more effective fiscal arrangements for First Nations would have more legitimacy if they followed the principles endorsed by the RCAP rather than the FNGI.

## CONCLUSION

The FNGI was a failed policy initiative that illuminates the way into the future of more effective fiscal arrangements for Canadian First Nations. First, the study of the drivers for reform indicates that the pressures are unlikely to lessen. Change is necessary if First Nations and Aboriginal peoples are to exercise more positive control over their political, social and economic destinies. Second, the FNGI demonstrated the polycentric nature of Aboriginal policy. A change in the political status of First Nations governments had unintended policy consequences in other areas and across jurisdictions. Third, to achieve the objective of improving the well-being of First Nations, the federal government has to engage in a comprehensive set of reforms that tie political, fiscal and economic reforms together. Political reforms cannot be viewed as separate from economic or fiscal changes. Fourth, the interests of the provinces are implicated in such a process of reform. Communities are no longer distinct entities but share interests and impact each other through their decisions. The decisions of First Nations governments influence the well-being of adjacent communities. Similarly, provincial agendas for reform involving Aboriginal communities, influence and are influenced by the economic well-being and health of First Nations. These relations then impact upon federal policies. Finally, federal policies for Aboriginal peoples have a tangible effect on provincial fiscal plans. The FNGI demonstrated this effect through its impact on non-status and off-reserve Indian populations.

If Canadian fiscal arrangements for First Nations and Aboriginal peoples are to work better in future, then policymakers must consider the ramifications of internal policies for the other levels of government. First Nations should lead in any future process of reform and renewal but the federal and provincial governments should be active in the process. As future attempts at governance reform unfold at the federal

level, the provinces have a vested interest in the outcomes. All participants should be aware 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 government to achieve the maximum results for improving the quality of life for Aboriginal peoples and First Nations in Canada. Fairness requires that all three levels of government be vigilant in defending and supporting First Nations in their goal of becoming economically self-sufficient. To do less, would be to face failure once again.



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 to 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 FNGI 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).

<sup>28</sup> See Indian and Northern Affairs Canada (14 June 2002) and Indian and Northern Affairs Canada (19 June 2002).

<sup>29</sup> In a letter to Consultation Participants dated 14 May 2001, Minister of Indian Affairs and Northern Development Robert Nault affirmed that: "There is no secret agenda, no predetermined outcome. The purpose of this initiative is not to off-load the government's responsibilities or change the special, historic relationship between First Nations people and the federal government. This is your opportunity to share your thoughts and ideas on matters affecting your life. This is your chance to shape governance in your community, to create a governance system which is stable and which provides your Chief and Council with the right tools to do business with the public, private and financial sectors, all of which will benefit your community."

<sup>30</sup> Of the 199 amendments proposed in the House of Commons committee review, only two were reported back to the House of Commons: the non-derogation clause to protect Aboriginal rights, and the extension of the two-year compliance period for First Nations to three years. The Government introduced two further amendments at second reading stage proposing a First Nations Ombudsman and a governance centre to assist in the implementation of the FNCA.

<sup>31</sup> These numbers are crude estimates based on fertility and intermarriage rates but not including other factors such as migration rates, mortality, proclivity of next generations to marry status or not etc. I appreciate the efforts of Jessalynn Scott in collecting and tabulating this data. These rates correspond approximately to INAC projections that place the ineligibility to register at approximately 27 percent in three generations.

<sup>32</sup> One band administrator termed this the new form of "cultural genocide" under federal policies in a private conversation with the author reviewing the FNCA.

<sup>33</sup> Indian and Northern Affairs Canada (2001-2).

<sup>34</sup> See Prince and Abele (2000, 352).

<sup>35</sup> Throughout the constitutional negotiations on self-government in the 1980s and 1990s, the provinces were arguing for such an acknowledgement of federal responsibility to ease their social services load but did not receive one; see Brock (2000).

<sup>36</sup> Indian and Northern Affairs Canada (2003); see also Indian and Northern Affairs Canada (18 April 2002, 2).

<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> *Government Relations and Aboriginal Affairs Saskatchewan* (2003).

<sup>47</sup> *Ontario Native Affairs Secretariat* (1996).

<sup>48</sup> See *Royal Commission on Aboriginal Peoples* (1996, 163-244, 282-3, 311-26).

<sup>49</sup> See for example, the criticism voiced by Eldon Weaselchild as quoted *Melting Tallow* (June 2001, 31). At the December 2001 meeting of the Assembly of First Nations, the Chiefs voted not to co-operate with the implementation of the communities first governance legislation despite offers from Ottawa to fund related consultations and activities. See also *First Nations Messenger* (June 2001, 1, 31).

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## CONCLUSIONS