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The Art of the Impossible

Fiscal Federalism and
Fiscal Balance in Canada

By Hugh Mackenzie



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Introduction

Fiscal imbalance has become a Canadian political classic: a term which is equally useful to people and interests who don't actually agree about what it means, much less what should be done about it. Depending on who is talking and for what purpose, fiscal imbalance can refer to:

- the division of powers between the federal government and the provinces;
- the fact that the federal government has been running surpluses since 1999 while some provincial governments have been running deficits;
- a mismatch between revenues and expenditure responsibilities;
- inequities among provinces in their ability to generate sufficient revenue to meet public services needs;
- the balance, province-by-province, between federal government revenue and expenditures;
- and so on.

In the fog created by the inter-provincial and federal-provincial rhetorical wars, it is easy to lose

track of the issue that lies behind the fiscal imbalance debate, however fiscal imbalance is defined: how do our fiscal arrangements affect our ability to pay for the public services we want?

The purpose of this paper is to confuse this overheated and often misleading debate with some facts. It explores the data that describe the development and financing of public services in Canada. Using statistics from Canada national accounts data, it tracks key measures of public revenue and expenditures at all three levels of government as a share of the total economy (GDP).

In the course of this exploration, it exposes critical misconceptions about the development of the Canadian public economy — misconceptions that are leading us to avoid the real issues.

It is commonly believed that the federal government was primarily responsible for the development of the modern Canadian public economy through the exercise of the federal spending power in areas of provincial jurisdiction.

The data show that, while growth in federal government transfers may have served as a catalyst for increased provincial government expenditures, the principal driver of the growth of the

Canadian public economy from the mid-1960s to its peak in the early 1990s was the willingness of provincial governments to tax their own citizens to pay for improvements in public services.

It is commonly believed that one of the reasons we currently face fiscal pressures on public services is that Canada didn't pay for these services as they were being developed, relying instead on deficit financing. The data do not support this view. Most of the growth in public services as a share of the economy had taken place before deficits began to emerge as a major public issue.

It is clear from the evidence that the growth in deficits and debt service costs can be attributed to the recessions of 1981 and 1991, together with the 20-year period of high real interest rates that began in 1981. It is also clear that, just as economic recession and high real interest rates were responsible for the growth of the deficit, economic recovery and lower real interest rates were responsible for its decline.

The data also support a contrarian view of what happened to the financing of public services in Canada in the late 1990s. The cuts in federal government transfers to provincial governments in the 1990s were matched almost exactly as a share of GDP by cuts in transfers from provincial governments to local governments.

In other words, at the same time as they were complaining bitterly about federal government transfer payment cuts in the second half of the 1990s, provincial governments were insulating themselves from those cuts by reducing their own transfer payments to local governments.

The real force behind the fiscal pressures currently faced by provincial governments is competitive tax-cutting by provincial governments intent in getting ahead in the race to the bottom. Just as increases in provincial own-source revenue as a share of GDP were the principal drivers of the growth in the Canadian public

sector between 1975 and 1995, reductions in own-source revenue as a share of GDP as a result of tax cuts have created the fiscal pressures provinces now face.

Fiscal imbalance, defined as a shortfall of revenue raising capacity relative to spending responsibility, is largely a problem inflicted by the provinces on themselves through tax competition.

In fact, the data demonstrate that the real fiscal imbalance involves local governments, not provincial governments.

These conclusions have significant implications for the current debate. They suggest that the fundamental issue facing Canadian federalism today is not a decline in federal government transfers to provinces, but the erosion of provincial fiscal capacity as a result of negative tax competition among provinces. None of the recent public reviews of federal-provincial fiscal relationships addresses this issue. The report of the Council of the Federation's Panel on Fiscal Imbalance at least acknowledges the issue but then ignores it in its recommendations. The Canadian Council of Chief Executives "Bronze to Gold" report from February 2006 ignores the issue entirely and makes recommendations virtually guaranteed to make the situation worse.

Recommendations for change that avoid the issue of interprovincial tax competition are doomed to fail. This paper concludes with suggestions for change in fiscal arrangements to strengthen provincial fiscal capacity and to address the issue of fiscal imbalance involving local governments.

It also suggests an approach to fiscal equalization to shift the debate away from the interprovincial revenue squabble that it has become to a focus on the program's real purpose — to ensure an acceptable standard of services under provincial jurisdiction for all Canadians.

Fiscal federalism in historical context

It is often said by Canadian constitutional scholars comparing the federalisms of Canada and the United States that the framers of the U.S. constitution set out to create a highly decentralized system of government and ended up with a highly centralized system, whereas the “fathers of confederation” set out to create a centralized system of government and ended up with a highly decentralized one.

At Confederation, the responsibilities assigned exclusively to the federal government were considered at that time to be the most important, and the revenue source — indirect taxation — assigned exclusively to the federal government was statistically the most important source of government revenue in Canada.

The evolution of Canadian federalism from a structure seen to be centralist to one seen to be decentralist has been driven by a number of factors. Judicial interpretation of the British North America Act tended towards a decentralist construction of our formal constitutional arrangements, as contrasted with the evolution of judge-made constitutional law in the United States. For example, the broad reading of the power to regulate interstate commerce in the

United States — a reading that supported federal government activities in spheres ranging from labour and securities market regulation to the creation of the Interstate Highway system — had no counterpart in Canadian constitutional interpretation.

Residual powers — those not specifically itemized in the constitution — have also been treated differently in Canada and the United States. In Canada, constitutional interpretation of provincial powers over property and civil rights has effectively created a second residual clause encompassing matters similar to others under provincial jurisdiction alongside the general federal residual clause. In the United States, jurisdiction over issues not thought of by the framers of the constitution has generally come down on the side of the federal government.

The fact that the U.S. federal government retained ownership and control of public lands as the United States expanded westward is of fundamental importance in explaining differences in the evolution of the federalisms of the two countries.

Furthermore, the impetus towards decentralization in Canadian federalism driven by Québec

nationalism stands in contrast to the resolution in the Civil War of the issue of competing nationalisms within the United States.

Constitutional arrangements and their interpretation are not responsible by themselves for the differences in the role of the federal governments of Canada and the United States. What is expected of government in the 21st century is dramatically broader than what was expected in the 19th century. And whereas in the United States the federal government found itself with either exclusive constitutional authority or the right to pre-empt state authority in many if not most of the spheres of government activity whose importance grew during the 20th century, in Canada growing spheres of activity generally fell within provincial jurisdiction.

The constitutional weakness of the federal government in the face of changing demands for public services became clearly evident in the period between World War I and World War II, when the inability of the federal government to respond to the poverty, economic insecurity, and dislocation caused by the Great Depression of the 1930s became a significant public issue.

In an atmosphere of both national and individual economic crisis, Canadian federalism sailed into what amounted to a constitutional perfect storm. Canadians needed and increasingly demanded a public policy response to the crisis of the Depression, and looked to the activist role played by the federal government in the United States as a model. Federal policies modeled on the American “New Deal” were ruled “ultra vires” by the courts. Yet, having succeeded in defending their jurisdiction in the courts, the provinces failed to fill the resulting public policy gap. Indeed, their own finances had been so substantially weakened in the Depression that several were on the brink of insolvency.

The Depression set the stage for a broader debate over the appropriate role for the federal government in provincial finance in general, and in areas of provincial jurisdiction in particular,

through the establishment of the Royal Commission on Dominion-Provincial Relations in 1937 (the Rowell-Sirois Commission).

The Commission reported in 1940, recommending sweeping changes which, taken together, would have shifted Canadian federalism towards a radically more centralized model. It recommended constitutional changes to permit the establishment of a national system of unemployment insurance and a national pension system. More controversially, it recommended that the federal government assume responsibility for taxation of income at both the corporate and individual level. In return for provinces giving up this constitutional jurisdiction, the federal government would assume responsibility for existing provincial public debts, serve as a vehicle for future provincial borrowing, and establish programs for revenue-sharing with the provinces. These would include both general revenue-sharing measures to enable provinces to finance programs within their jurisdiction and fiscal equalization measures designed to offset differences in fiscal capacities among provinces. It was noteworthy that, while the Commission focused on the need to ensure a common basic standard for services under provincial jurisdiction across Canada, it chose to base its equalization recommendation on relative fiscal capacities rather than on provinces’ ability to raise the revenue needed to pay for a specified standard of service.

These recommendations were the focus of a federal-provincial conference in Ottawa in January 1941. The conference failed to get an agreement from the provinces on a plan of action in response to the Rowell-Sirois recommendations, but the report still had a profound impact on Canadian fiscal arrangements for a generation after its publication.

Two major issues were resolved through constitutional amendments authorizing the creation of national pension and unemployment insurance systems: the first (unemployment insurance) in 1940; the second (pensions) in 1950. With re-

spect to federal-provincial fiscal relationships, while the provinces were unable to agree on a constitutional arrangement for change, fiscal and political reality in practice trumped constitutional principle.

Thanks to the need to raise additional revenue to finance the war effort and post-war reconstruction, the federal government emerged from World War II with a revenue system that was significantly more robust than that of the provinces. That reality, coupled with political demands for expanded public services, led to the establishment of federal-provincial financial arrangements that mimicked many of the more controversial recommendations of Rowell-Sirois.

The device of tax rental agreements for personal and corporate income tax between the federal government and provinces served as a substitute for the formal jurisdictional transfer and revenue-sharing recommended by Rowell-Sirois. The principle of fiscal equalization among provinces was established in the 1950s. The rules have been changed repeatedly since then in response to changing fiscal and economic circumstances, but the fundamental point of departure — equalization of revenue-raising capacity as opposed to service provision capacity — has remained unchanged to this day.

What is noteworthy is that, in a political system that has frequently resorted to Royal Commissions as a way to attack difficult issues and bridge public policy gaps, and in a political and economic environment in which federal-provincial financial relationships consistently dominate the political agenda in Canada, there has been no systematic study of federal-provincial fiscal relationships since Rowell-Sirois.

During that period of 60+ years, federal-provincial fiscal relationships have evolved through three phases in which the Government of Canada played distinct fiscal roles.

In the first phase, the federal government acted as a fiscal enabler, using tax rental agree-

ments to protect fiscal room from which provinces could finance services under their jurisdiction, and fiscal equalization to offset inter-provincial disparities in revenue-raising capacity.

In the second phase, the federal government acted as a policy initiator and banker, using its spending power and its substantial fiscal capacity to initiate the development of the social programs that formed the foundation for the modern Canadian state.

In the third phase, the federal government adopted a strategy of fiscal disengagement. Hallmarks of this role were:

- withdrawal from formal cost-sharing reduced funding for programs under provincial jurisdiction and elimination of conditions with respect to the use of that funding;
- use of the tax system to deliver programs in areas of provincial jurisdiction directly to individuals and families, bypassing provinces and their institutions;
- substantial weakening of the tax system design requirements for provincial participation in tax collection agreements thereby weakening those agreements' moderating impact on tax competition among provinces; and
- reduced federal fiscal capacity through tax cuts for individuals and corporations as a response to emerging budgetary surpluses.

The culminating act in the era of federal government disengagement was the \$100 billion tax cut announced by then Finance Minister Paul Martin on the eve of the 2000 federal election. Coming at a time when all of the major services under provincial jurisdiction — health, education, social insurance, and public infrastructure — were under extreme financial pressure, that dramatic cut in federal fiscal capacity was an eloquent declaration that the federal government had no interest in assisting provincial

governments in the funding of services under their jurisdiction.

The era of disengagement ended — at least temporarily — with growing pressure for national action in response to the financial crisis facing health care, but no coherent successor role for the federal government has emerged. In some respects, the strategy of the federal government from 2000 to 2006 resembled the policy initiator and banker role which dominated federal-provincial fiscal relationships in the 1970s, withered during the 1980s, and died in the early 1990s. The Martin government's attempts to establish national standards for health care and to establish a national early childhood education system are cases in point. In other respects, however, elements of the enabler role and of disengagement persist. While the government's political rhetoric stressed the importance of national standards

for health care and early childhood education, the series of bilateral arrangements with individual provinces fell far short of the rhetoric, resembling more closely the enabling role of the 1950s and early 1960s. Furthermore, even as the federal government talked of re-establishing national programs and priorities, elements of disengagement persisted as successive federal budgets proposed further tax cuts, and thereby further reductions in federal fiscal capacity.

The election in January 2006 of a Conservative minority government has given new impetus to a strategy of disengagement and reducing the size and role of the federal government — a strategy that was pursued with vigor by the Liberal government in the 1990s, continued only inconsistently in the early 2000s, and finally abandoned by the Liberals in the minority Parliament of 2004–5.

Fiscal imbalance

The post-war eras in federal-provincial financial relations that began with the federal government as fiscal enabler in the 1950s and continued with the federal government as policy initiator and banker in the 1960s and 1970s may be seen, with hindsight, as strategies for dealing with what is now labeled as “fiscal imbalance.” The policy of disengagement that characterized the 1990s reflected either a denial of the existence of fiscal imbalance or a willingness to live with the negative consequences of a failure to deal with it.

Before analyzing the post-war experience in that light, however, some conceptual issues must be addressed.

First, fiscal imbalance, properly understood, is a relative term. It refers to a mismatch between governments’ revenue-raising capabilities and their public policy responsibilities. The fiscal balance changes in response to changes in both the revenue-raising environment and public policy spending expectations. Federal-provincial financial arrangements became important in the middle of the last century because provincial governments’ spending responsibilities had grown relative to the capacities of their revenue-raising systems, not because of any change in either rev-

enue or spending capacities and responsibilities in isolation from one another.

Second, while the question of fiscal imbalance clearly has its roots in constitutional arrangements, the evolution of the issue has more to do with economic and political considerations than with the Constitution *per se*. The requirement that provincial governments raise revenue only from direct forms of taxation imposes no meaningful constitutional limit on the ability of provincial governments to raise revenue. So, from a constitutional perspective, there is no meaningful fiscal imbalance as between the federal government and the provincial governments. Provincial governments are free to make decisions in their areas of public policy jurisdiction and to determine for themselves how to raise the revenue needed to pay for programs to implement those decisions.

Provincial governments face practical limits on their ability to raise revenue to the extent that their revenue needs exceed those of other provinces. These limits may be political, as provincial governments encounter resistance to levels of taxation which exceed those in other jurisdictions, and which are not associated with iden-

tifiable differences in public services. The limits may also be economic. In varying degrees, depending on the nature of the tax base, taxpayer and tax base mobility within Canada may limit the ability of any province to generate additional revenue from taxes which exceed the norm.

Taken together, these factors contribute to a kind of political-economic “prisoner’s dilemma” for provincial governments. While the best solution for all provinces might be to raise taxes to the level needed to meet their public policy obligations, the political and economic pressures experienced by each individual province make it impossible for any province to reach that solution. The political and economic interplay among provinces means that differences in revenue-raising capacities relative to costs of service delivery among provinces will translate directly into differences in public service levels.¹

The national political and economic perspective on fiscal imbalance arises in part from the provincial prisoner’s dilemma outlined above. The federal government may not have the constitutional authority to establish public policies in areas under provincial jurisdiction, but it does have the ability to resolve the prisoner’s dilemma that would otherwise lead each provincial government to spend less on the programs within its jurisdiction than it should. As the national government, it also has the ability to address the public service consequences of inter-provincial economic differences.

That, however, is only part of the national political-economic story. Political engagement is not constrained by constitutional law. The fact that criminal law is a federal responsibility does not prevent the issue of safety on the streets of our major urban areas from becoming an issue in local elections. Likewise, the fact that the federal gun registry is an exercise of the constitutional authority of the federal government does not prevent it from becoming a provincial political issue. And, by the same token, constitutional law cannot and does not prevent the de-

velopment of national public policy projects. If an issue is considered to affect the national interest — even if it is exclusively under provincial jurisdiction — Canadians will generate political pressure on the federal government to act in the national interest.

Consequently, even if there were no equivalent to a prisoner’s dilemma influencing provinces’ ability to act, and even if there were no issue of differences in provinces’ ability to pay for public services, national public policy projects that arise from national political considerations would raise the question of fiscal balance.

Third, fiscal balance is not simply an issue between the federal government and provincial governments. The growing economic role of cities and the corresponding expansion in the relative importance of their governments ranks along with the expansion of the public economy generally as the most important structural changes in Canada since Rowell-Sirois. Canada is far more urban today than it was in the 1940s. And the economic role of cities has changed just as dramatically. Cities may have been seen in the past as existing to serve the needs of the wealth-generating hinterland (in the case of resource industries) or as merely the places where wealth-generating activity takes place (in the case of traditional manufacturing industries), but that view is out of date. Canadian cities are viewed as the engines of Canada’s future economic growth; our public policy view of cities has barely changed from the days when cities were where farmers, fishermen, forestry workers, and miners did their shopping.

All of the considerations addressed above with respect to the relationship between the federal government and provincial governments apply with equal or greater force to relationships between local and provincial governments and between local governments and the federal government.

Beyond that, there are particular issues of fiscal imbalance that apply to local governments

alone. The fact that local governments are, constitutionally, “creatures of the provinces” means that, in principle, fiscal imbalance should not be an issue for local governments. In practice, the temptation to use local taxes and fees as revenue sources — for which they do not have to take political responsibility — is too great for provincial governments to resist. Indeed, when one considers the restrictions on local revenue-raising capacity imposed by provincial legislation across Canada, increasing demands for lo-

cal public services driven by urbanization and provincial downloading of financial responsibility, local governments have a much stronger case with respect to fiscal imbalance than do provincial governments.

Fiscal imbalance is meaningful only in the context of the evolution of the public economy in Canada and the development and maintenance of the fiscal capacity required to fund the public services Canadians want.

Fiscal federalism and the development of the public economy

This conceptual framework set out in the previous section gives rise to a series of questions related to the development of Canada's public economy and the role of fiscal federalism in that development:

- How has Canada's public economy developed, in the aggregate?
- What role has each of the orders of government played in that development?
- What policy areas have been the major drivers of that development?
- How has the development of the public economy been funded?
- How have the major sources of revenue for the public economy changed?
- What roles have transfer payments between governments played in the development of the public economy?

These questions are addressed in the next four sections of this paper. The first looks at the development of the modern public economy in Canada through the lens of the National Accounts government sector accounts for the pe-

riod 1961 to 2005. That overview identifies the early 1990s as a pivotal period in the development of the public economy. The second section narrows the focus to the period from 1990 to 2003, during which the momentum behind the development of the public economy died and shifted into reverse, and explores possible explanations for the change. The third section provides a critical analysis of three recent interventions into the debate over "fiscal imbalance": Ontario Premier Dalton McGuinty's campaign against the so-called "\$23 billion gap" between federal government revenue from Ontario and federal government expenditures in Ontario; the Canadian Council of Chief Executives' call for a devolution of revenue-raising capacity to the provinces as its solution to the problem of fiscal imbalance; and the report of the Advisory Panel to the Council of the Federation on fiscal imbalance. The final section draws on the conclusions from the analysis in the paper to explore options for the renewal of the fiscal side of Canadian federalism.

Data used in this analysis are drawn from two primary Statistics Canada data sources: government sector accounts in the National Accounts,

from 1961 to the present; and detailed government revenue and expenditure data, by order of government, covering the period from 1989 to

the present. Gaps in data from these main series are supplemented by data from Historical Statistics of Canada, 1983.

The development of the modern public economy in Canada, 1961 to 2005

In this analysis, the term “public economy” refers to all of the activities of government, including program spending — direct expenditures on goods and services, transfers to persons, transfers to business, and transfers to other orders of government, the capital investment activities of government and interest payments on the public debt on the expenditure side and direct and indirect taxation, transfer payments from other orders of government and sales of goods and services on the revenue side. It does not include transactions related to the Canada and Quebec Pension Plans.²

Following the convention used traditionally in international comparisons and by the Government of Canada, the size of the public economy is measured in relation to GDP.

How did program spending grow?

Chart 1 shows program and capital spending by all three orders of government in Canada combined, as a share of GDP.³

Program spending began to grow as a share of GDP in the mid-1960s, from 28% in the early 1960s to a high of just over 40% in the early

1990s. It expanded rapidly between 1965 and 1975, and then stabilized in the range 35% to 37% for nearly 15 years before it spiked to over 40% in the recession of the early 1990s. Program spending currently represents 32% of GDP.

How did we pay for that growth?

Chart 2 shows revenue for all three orders of government as a share of GDP for the period 1961 to 2005. Revenue increased steadily as a share of GDP from the mid-1960s to the early 1990s. The increase in revenue as a share of GDP was sufficient to pay for the expansion in the program spending over that period.

Beginning in the mid-1970s, however, a growing share of the costs of program expansion was paid for through deficit financing.

Chart 3 shows the combined fiscal balance for all three orders of government over the period.

After fluctuating between an overall balance and a deficit of 2% of GDP from 1961 to the mid-1970s, the deficit increased to 4% of GDP, jumping to 9% of GDP at the deepest point of the recessions of the mid-1980s and the early 1990s,

CHART 1 Total program spending, % of GDP, 1961–2005 (all government excluding CPP)



CHART 2 Own-source revenue, % of GDP, 1961–2005 (all government)

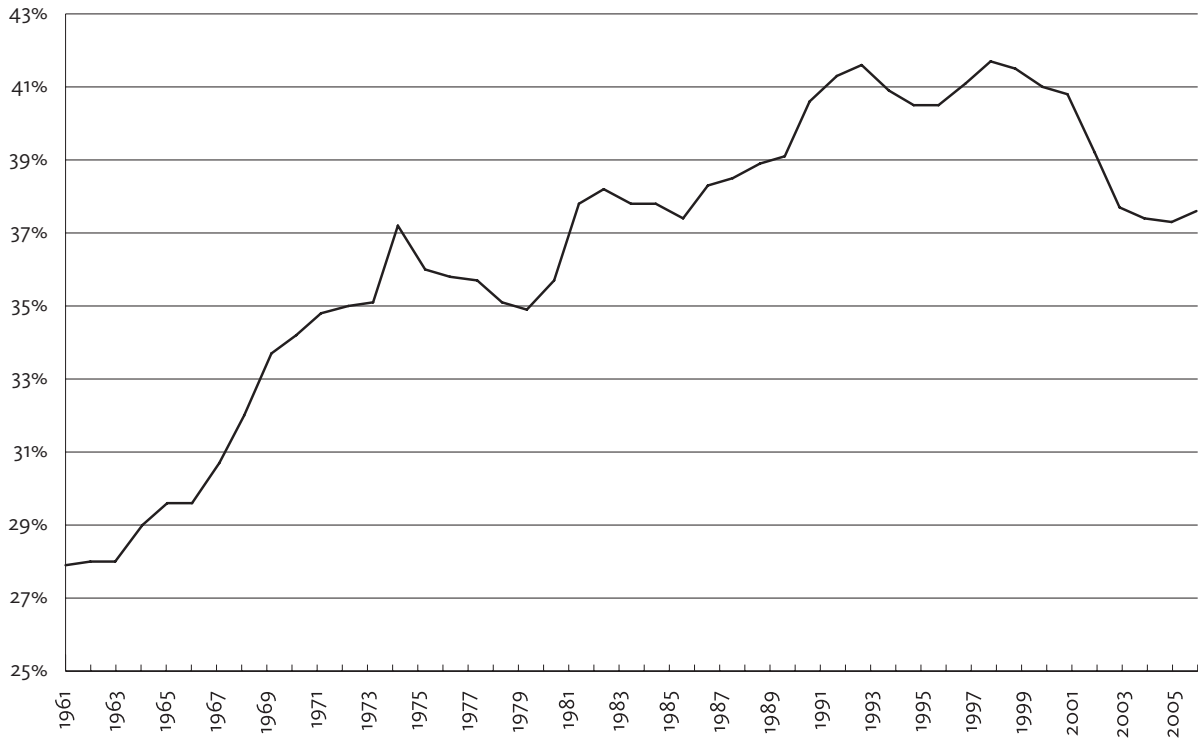


CHART 3 Balance, total government, % of GDP, 1961–2005 (surplus/[deficit])

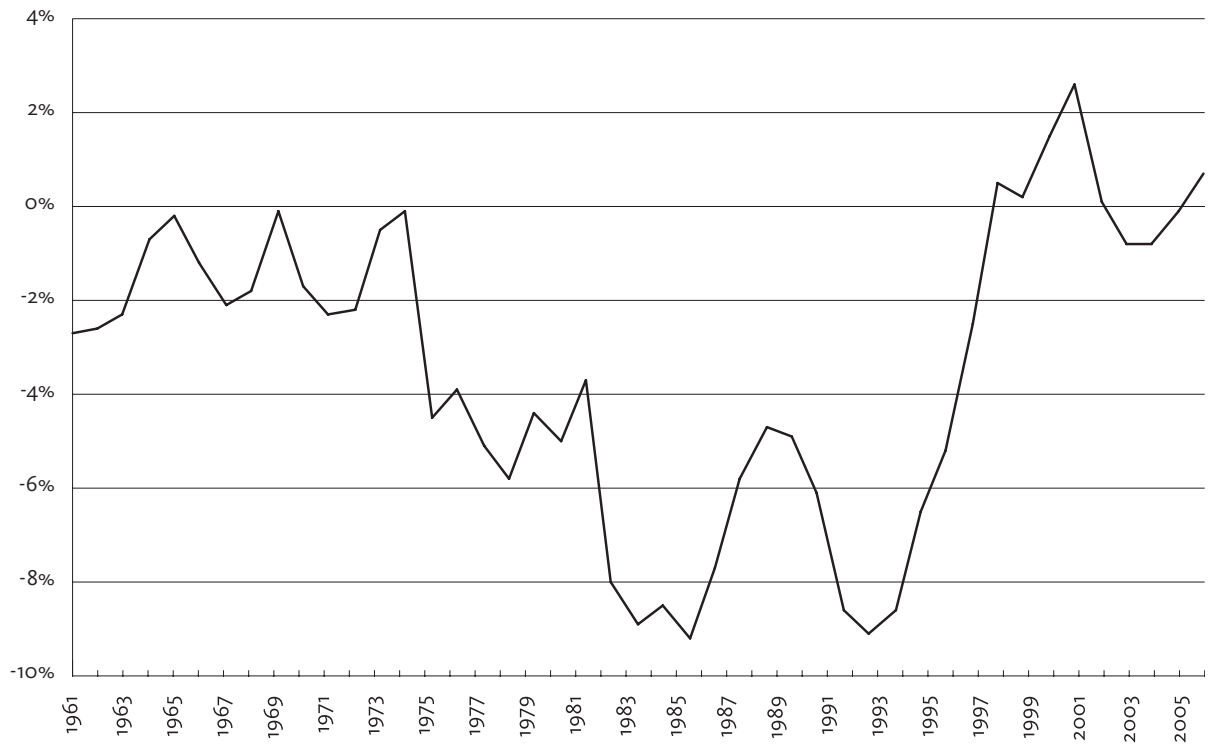
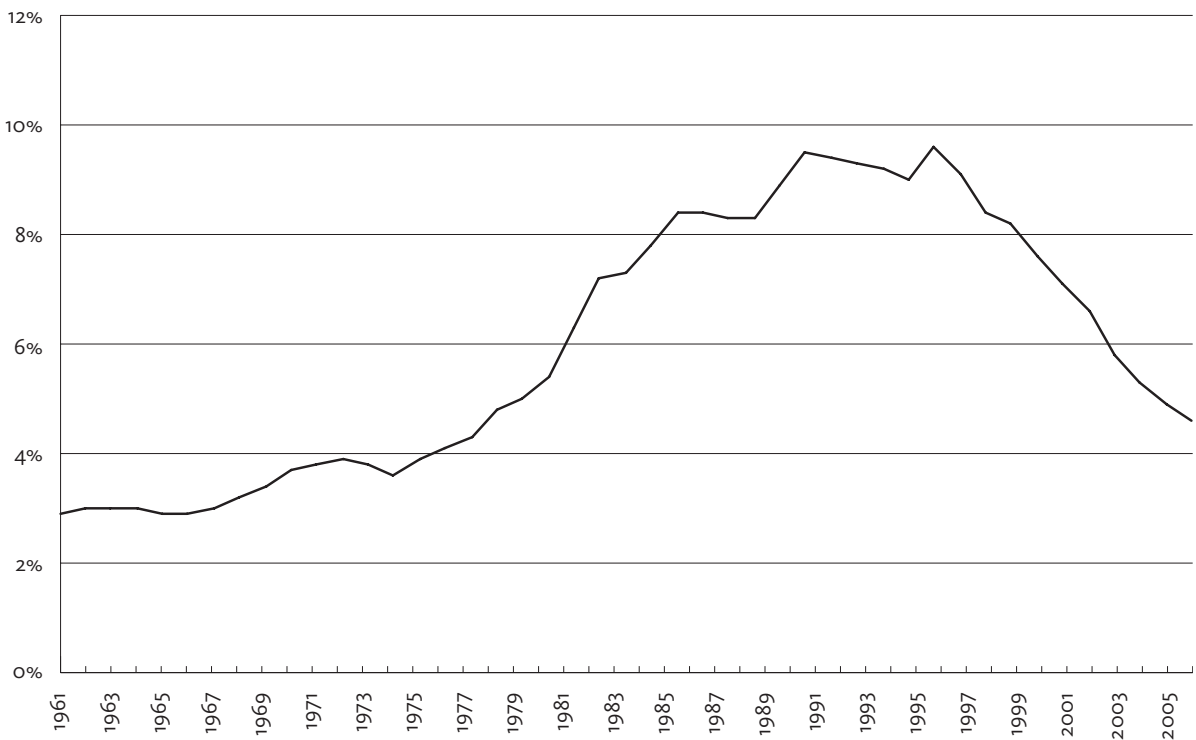


CHART 4 Debt service costs, % of GDP, 1961–2005 (all government)



rebounding to surplus over a two-year period between 1995 and 1997.

Chart 4 helps to explain the development of the deficit in the 1980s. It shows public debt service costs as a share of GDP.

Driven initially by deficit funding of public services in the late 1970s and then by the interaction of growing deficits and the historically unprecedented period of high real interest rates in the 1980s and early 1990s, debt service costs increased from 4% of GDP in the mid-1970s to more than 9% of GDP at their peak between 1991 and 1995.

In the aggregate, then, the fiscal crunch of the early 1990s was not caused by a failure of government revenue to keep pace with increases in the costs of delivering public programs; it was caused by the fact that the revenue-raising system was not enhanced to reflect the increased costs of financing the public debt. That failure fed on itself through the accumulation of further deficits, which in turn were financed at high interest rates.

Chart 5 shows the development of the major components of the public economy over the period.

Direct program expenditures and transfers to persons followed essentially the same pattern, expanding steadily from the mid-1960s to 1990 and then declining rapidly thereafter. Debt service costs followed a similar pattern, reflecting growing reliance on deficit finance after the mid-1970s, historically high real interest rates in the 1980s and early 1990s, and the impact of the precipitous drop in program spending after 1993.

One exception to this pattern was in transfers to business, whose decline as a share of GDP began in the early 1980s as active business subsidies fell out of favour ideologically and began to run afoul of international trade agreements.

The most notable exception to the pattern, however, is in non-financial capital acquisition, which declined steadily as a share of GDP

throughout the period under study. Whereas the overall public services crunch in Canada begins in the 1990s in the aftermath of the recession, the widely-acknowledged crisis in public infrastructure in Canada had its origins nearly three decades before.

Chart 6 presents the sum of the same data as in Chart 5.

Intergovernmental features of the development of the public economy

Although the aggregate data help in understanding the overall development of Canada's public economy since the 1960s, they mask significant trends in the relative importance of the three orders of government and the role played by inter-governmental transfer payments.

A comparison of the evolution of the public economy across the three orders of government in Canada requires that inter-governmental transfers be taken out of the calculation. One approach is to focus on the direct program activity of each order of government, excluding transfer payments to other governments from expenditures. This provides a measure of the evolution of program delivery responsibilities.

Chart 7 shows spending on programs and capital as a share of GDP, net of transfer payments to other orders of government.

This chart highlights a number of significant trends in the public economy over the past 40+ years.

First, the provincial governments collectively have eclipsed the federal government as the order of government with the most significant direct program delivery responsibilities. From an opening position substantially larger than the provinces as a group, the position of the federal government has declined to the point where its direct program delivery responsibilities — including transfers to persons — are barely 1.7 percentage points of GDP greater than those of local governments as a group.

CHART 5 Distribution of total expenditures, % of GDP, 1961–2005

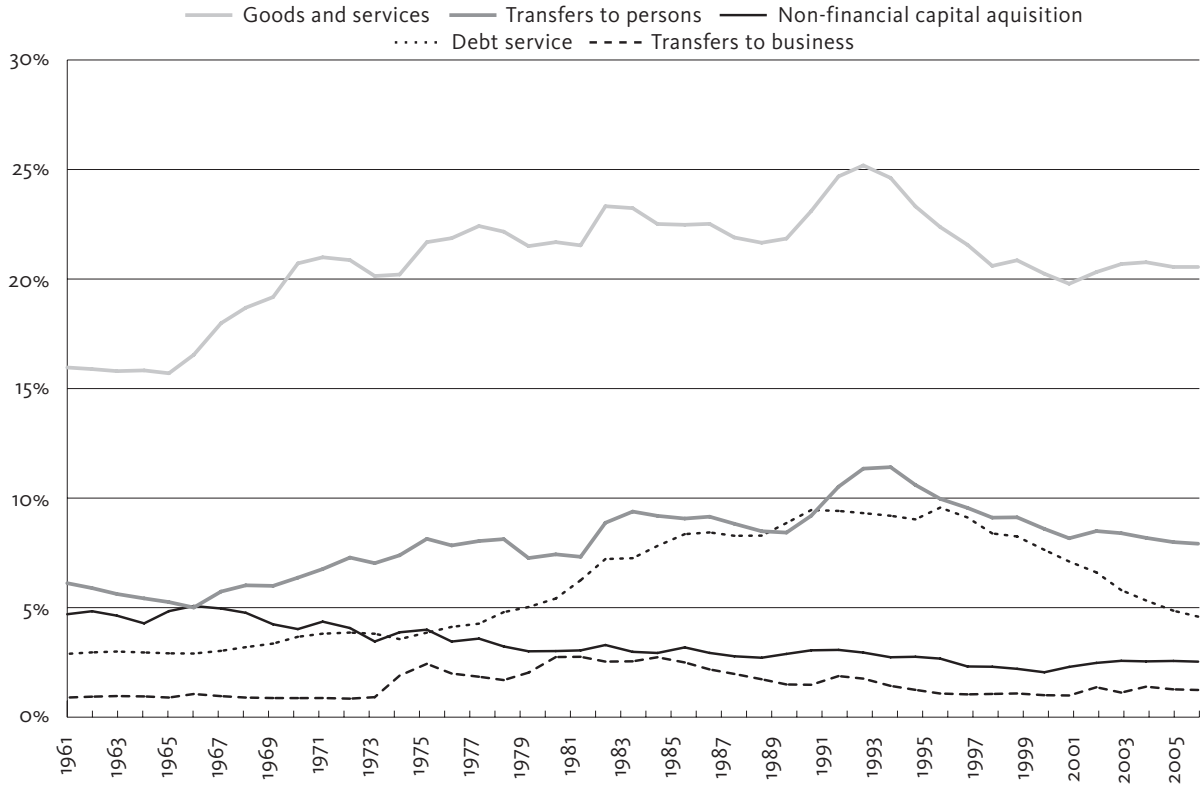


CHART 6 Distribution of total expenditures, % of GDP, 1961–2005

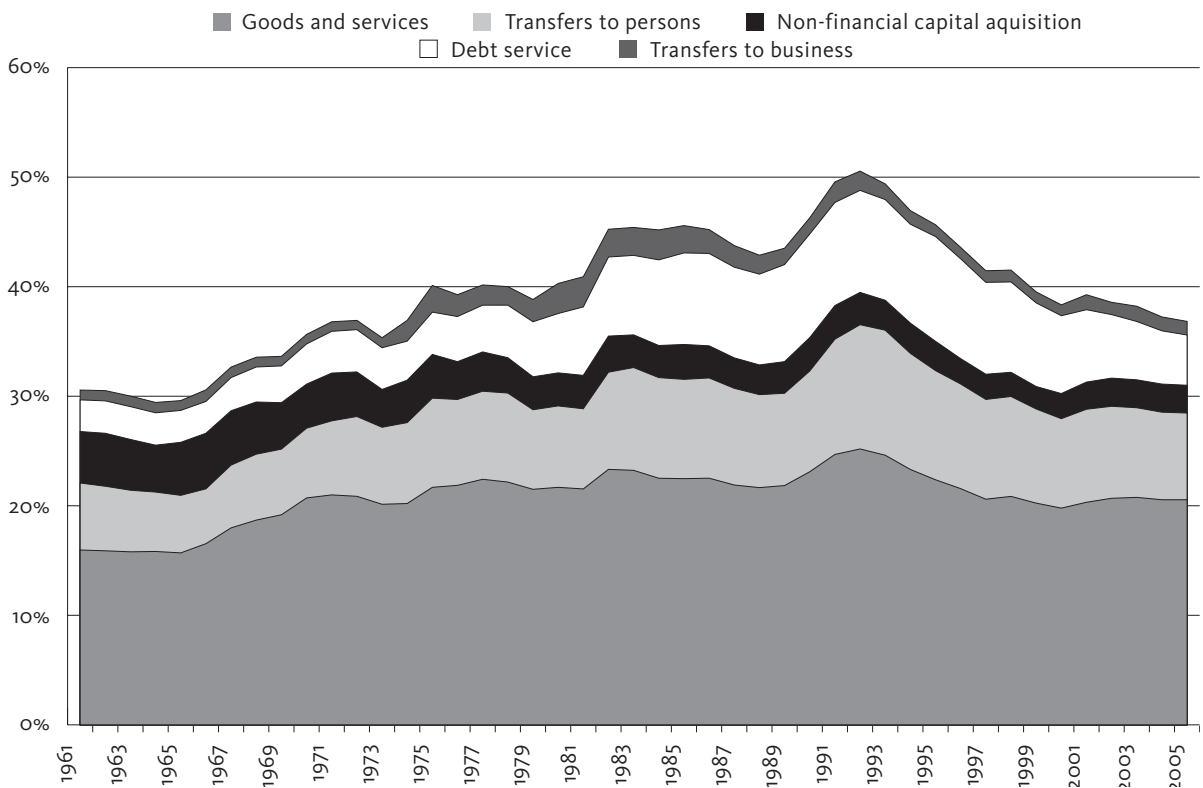


CHART 7 Program net of intergovernmental transfers, % of GDP, 1961–2005

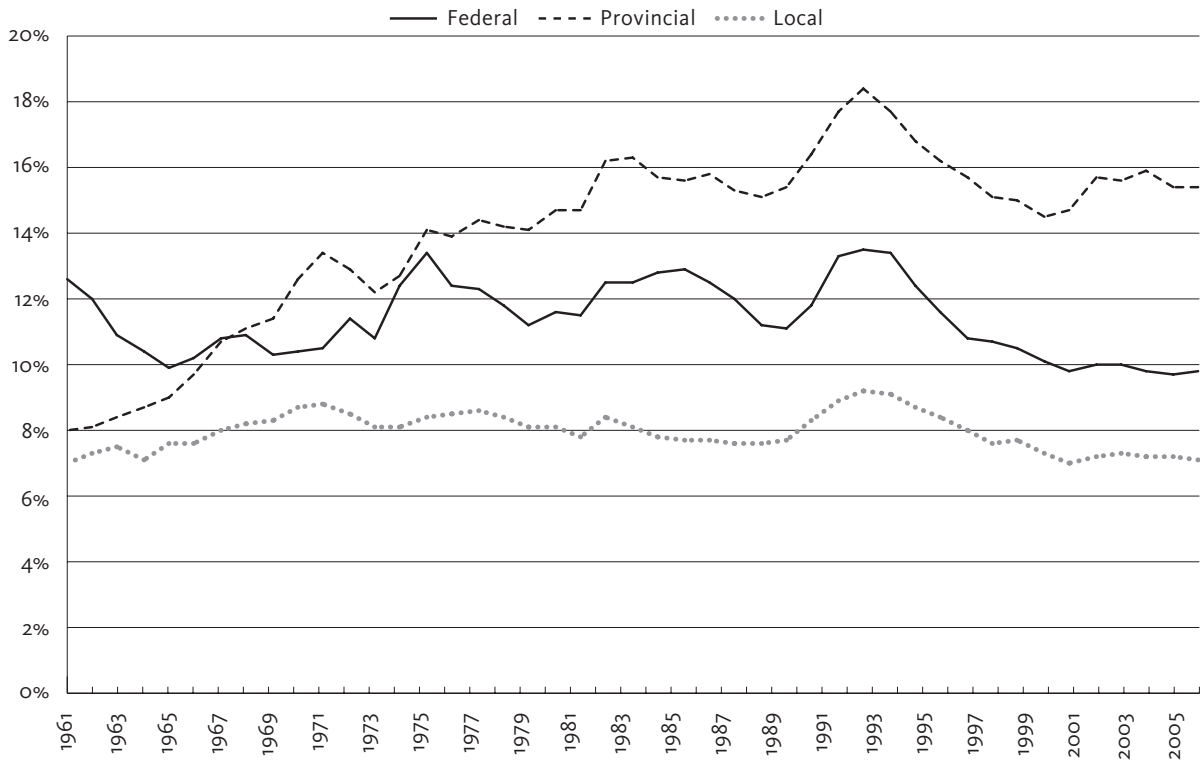
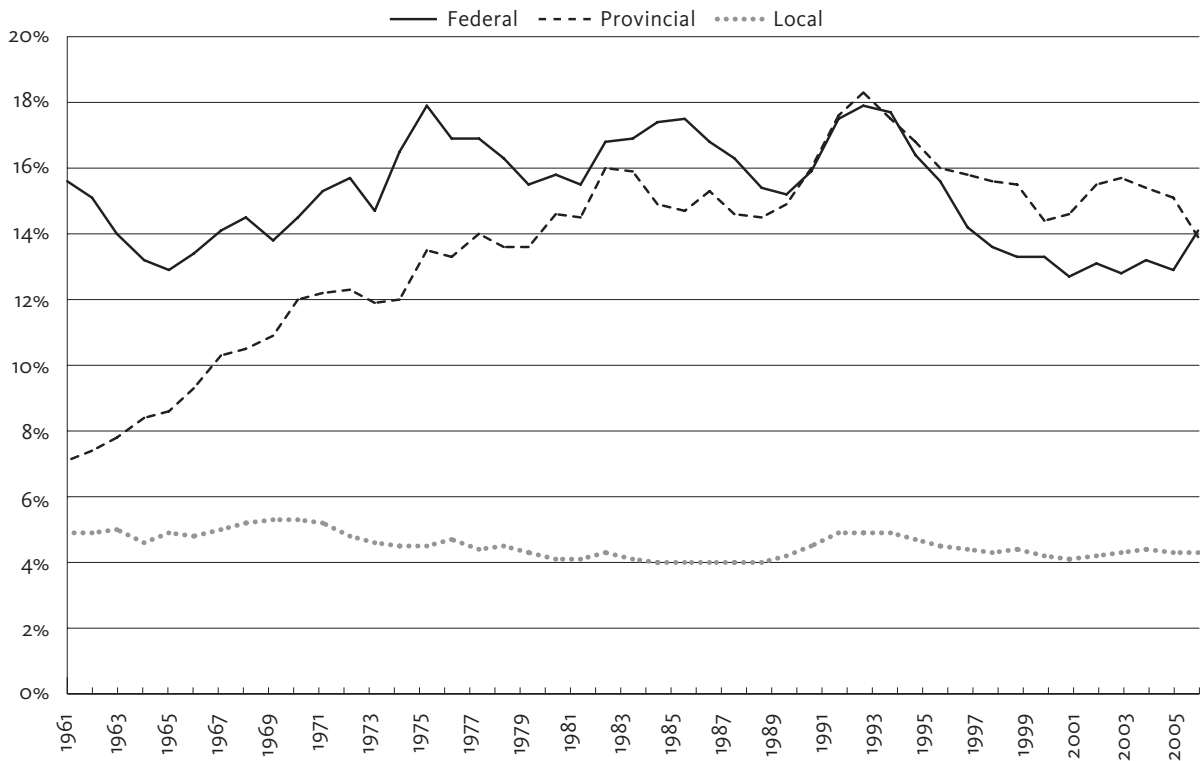


CHART 8 Program funded from own-source, % of GDP, 1961–2005



Second, while only the provincial governments gained consistently as a share of GDP over the period from 1961 to 1991, all three orders of government saw their program expenditures (other than transfer payments to other governments) decline as a share of GDP in the 1990s.

Another treatment of transfer payments is to credit inter-governmental transfers to the order of government making the payments. This produces a measure of expenditure activity of each order of government financed by that order of government's own revenue sources and its own debt.

Chart 8 presents program spending financed from own-source revenues and debt for each order of government, from 1961 to 2005.

Because transfer payments generally run from the federal government to the provinces and from provinces to local governments, the picture changes somewhat in that the provincial public economy does not surpass the federal public economy until the mid-1990s, while the local public economy financed from its own sources has changed relatively little since 1961.⁴

Chart 9, which shows inter-governmental transfers as a share of GDP over the period, offers further clarification.

Over the period from 1961 to 2005, provincial transfers to local governments as a share of GDP tracked federal government transfers to provinces. Direct transfers from the federal government to local governments remained trivial throughout the period.

Indeed, despite constant provincial government complaints about the fiscal pain caused by the Chrétien-Martin cuts in federal government transfers in the mid-1990s, provincial governments essentially neutralized those cuts by matching them with corresponding cuts in provincial transfers to local governments. And it is worthy of note that provincial governments have not responded to the most recent upturn in federal government transfers by increasing their transfers to local governments.

A second conclusion of interest is that federal government transfers peaked as a share of GDP in the early 1970s at just over 4.5% of GDP, and fluctuated in the range of 4% to 4.5% of GDP consistently until the mid-1990s when they collapsed to a low of 2.8% of GDP in 1997.

How we paid for the growth of the public economy

In essence, the difference between the two ways of looking at the public economy by order of government set out above is that one looks at transfer payments as an expenditure item, while the other looks at transfer payments as a source of revenue.

In aggregate, the other sources of revenue for each order of government are own-source revenue — taxes, sales of services, profits from government enterprises — and debt.

Chart 10 shows own-source revenue (revenue not including transfer payments) as a share of GDP for each of the three orders of government.

Provincial government revenue increased as a share of GDP continuously over the period from 1961 to the mid-1990s. Federal government revenue increased from the mid-1960s to the mid-1970s, from less than 15% of GDP to a peak of nearly 19% of GDP, and then stabilized in a range between 17% and 18% until the late 1990s, when it dropped abruptly to 16% of GDP.

Own-source revenue of local governments peaked in 1993, and has declined continuously ever since. Local governments responded to the downward trend in provincial transfer payments, not by increasing revenue to replace the lost transfer payment income, but by reinforcing the negative impact of transfer payment cuts through own-source revenue reductions relative to GDP.

The third principal source of financing for public services is the issuance of debt.

CHART 9 Intergovernmental transfers, % of GDP, 1961–2005

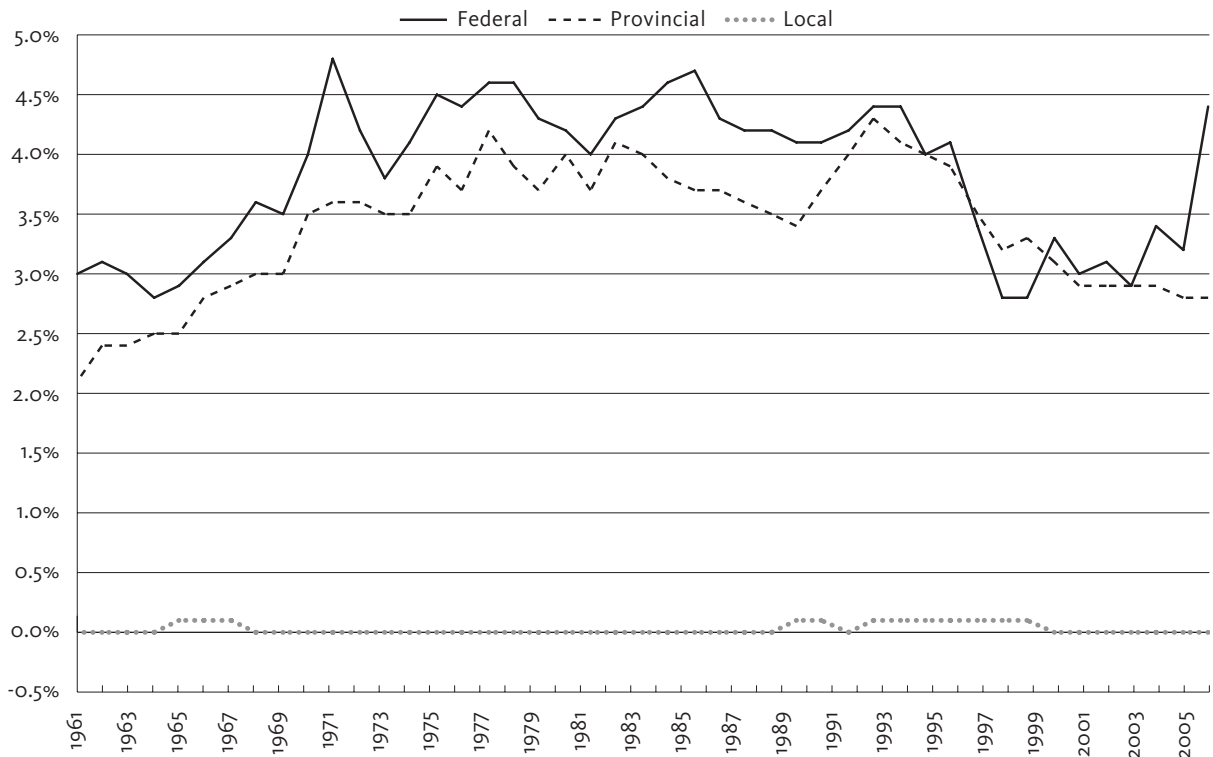


CHART 10 Own-source revenue, % of GDP, 1961–2005

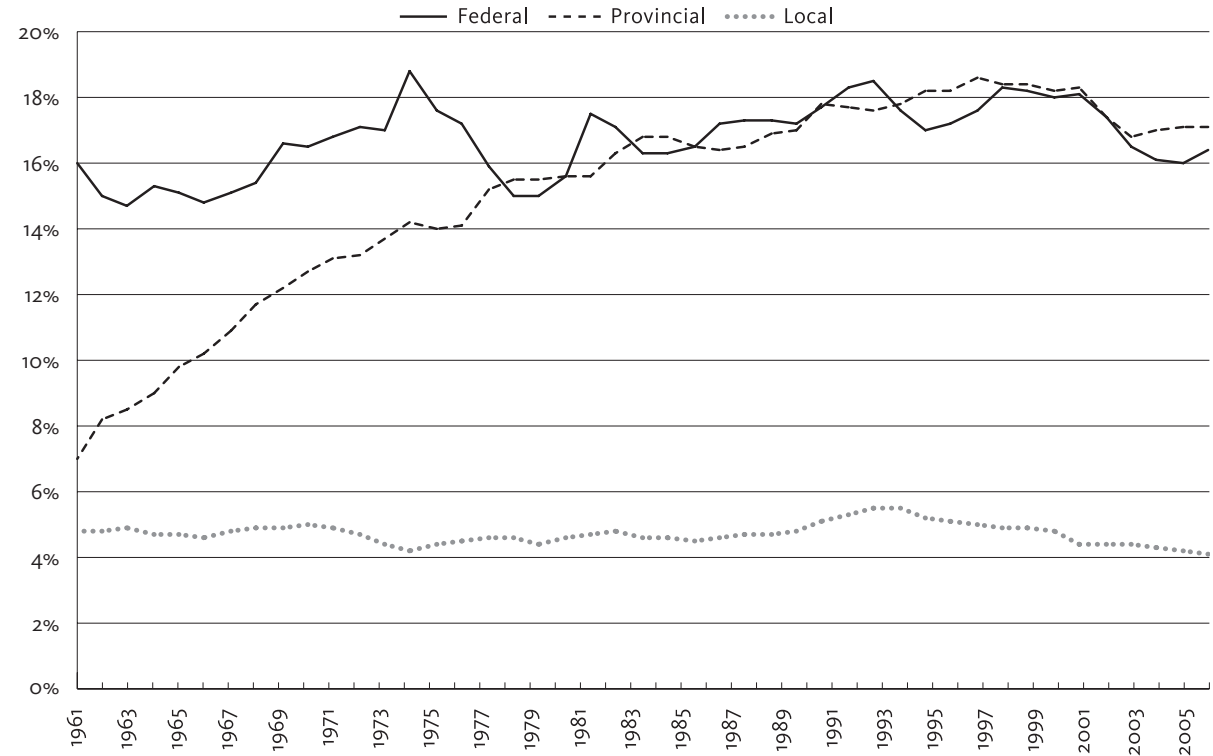


CHART 11 Surplus/(deficit), % of GDP, 1961–2005

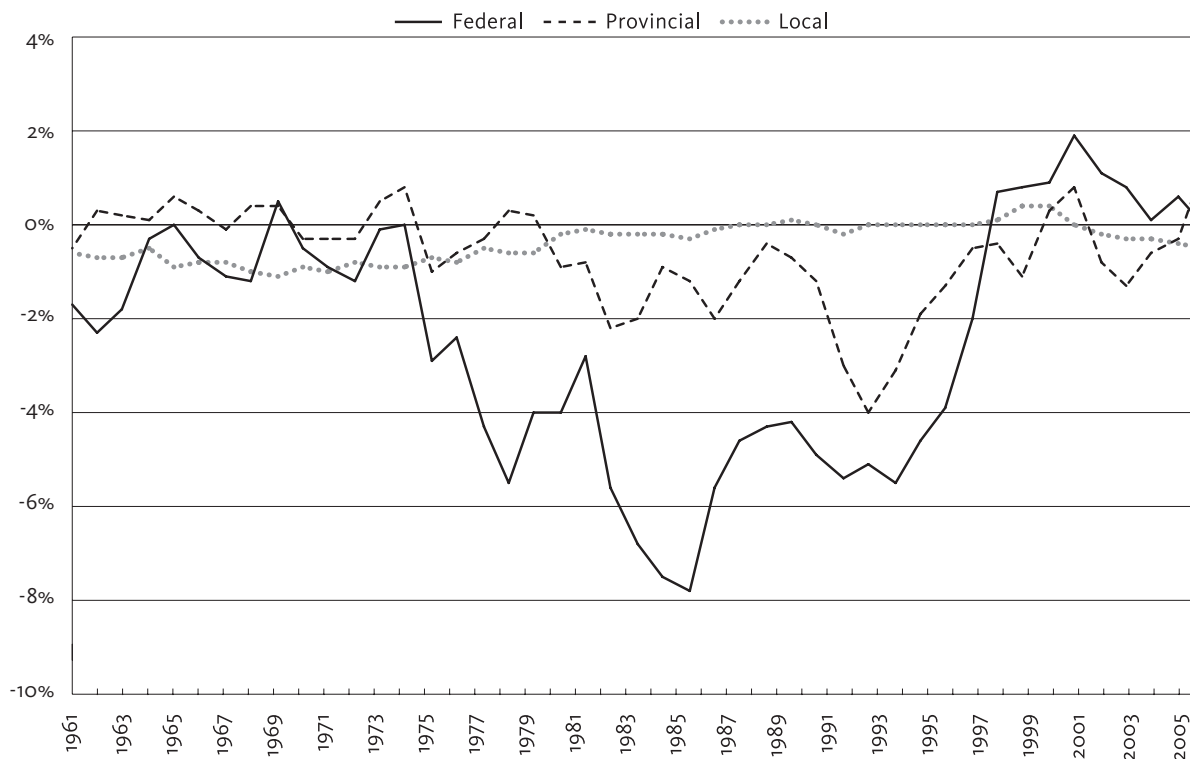


Chart 11 shows deficit financing by each order of government as a share of GDP for the period 1961 to 2005.

Several interesting observations flow from this picture. First, contrary to the impression created by the federal deficit fighters of the 1990s, the federal government's deficit peaked as a share of GDP in 1985 and had been cut in half as a share of GDP by the beginning of the 1991 recession.

Second, it is evident in comparing Charts 11 and 12 that the triggering factor in the growth in the federal government's deficit was a sharp reduction in the federal government's own-source revenue in the late 1970s caused by a combination of federal government tax cuts and the transfer of tax points to the provinces. That period featured an equally sharp increase in the federal deficit as a share of GDP.

In combination with substantially higher real interest rates in the 1990s, that initial defi-

cit led to a substantial increase in debt service costs which, in turn, placed increased pressure on the public economy.

The high and persistent deficits at the federal level from 1975 to 1997, and at the provincial level beginning in the late 1980s, are incessantly cited as the poster children for fiscal mismanagement. The rhetoric, however, ignores the fact that this situation was by no means unique to Canada and that, during this anomalous period of extremely high real interest rates, large deficits occurred in almost every country. Indeed, in the absence of those deficits, public services would have suffered and Canada's recovery from the 1981 recession would have been delayed at great cost to our economy.

Chart 12 shows debt service costs, broken down by order of government.

The third general conclusion that can be drawn from these charts concerns local government. Local governments' reliance on borrowing — which

CHART 12 Debt service costs, % of GDP, 1961–2005

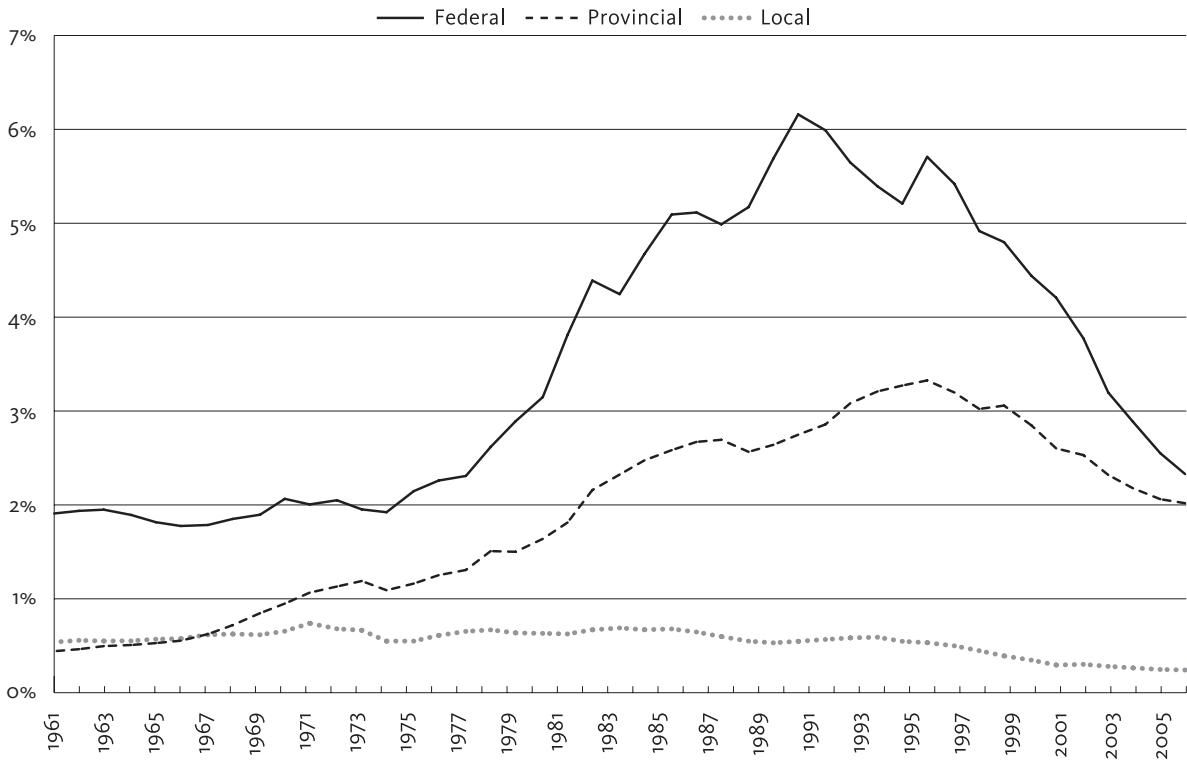
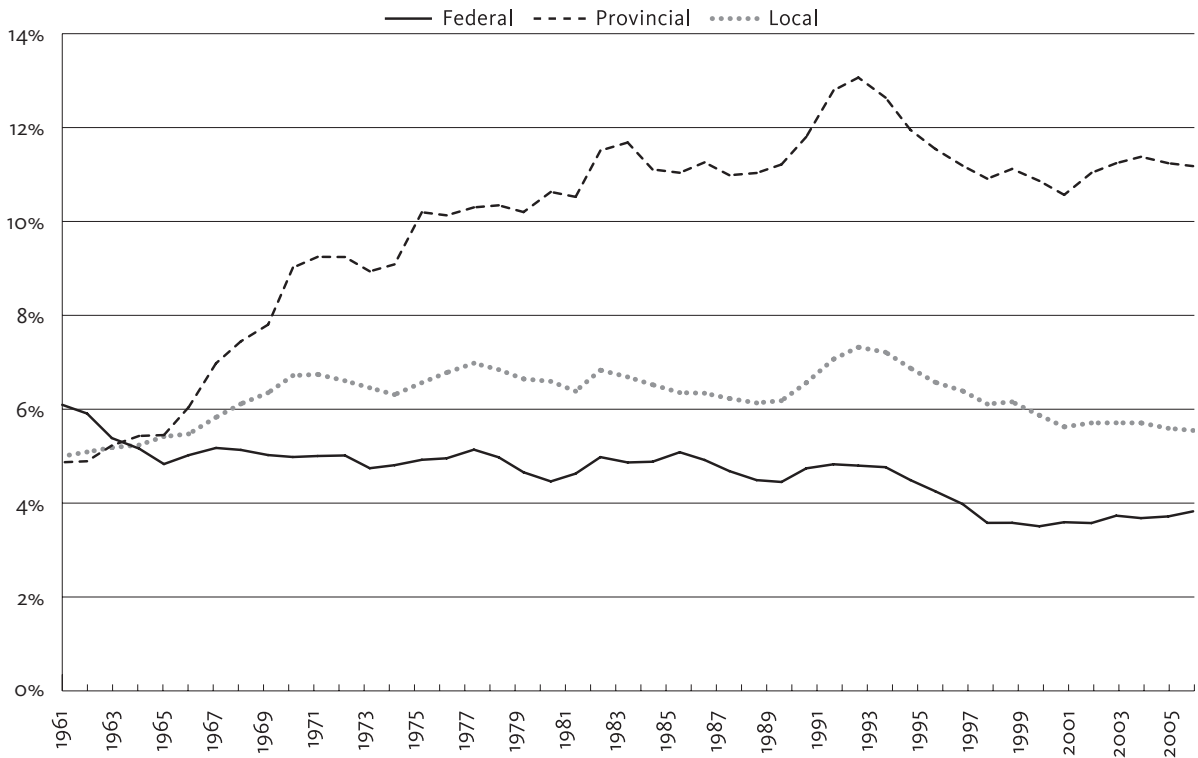


CHART 13 Goods and services, % of GDP, 1961–2005



by law in most jurisdictions in Canada can only be for capital financing — has declined steadily since the 1960s from a peak of approximately 1.1% of GDP in the early 1970s to essentially zero for most of the 1980s and 1990s.

So far, we have looked at two of the major components of public expenditure broken down by order of government: inter-governmental transfers and debt service costs. Charts 13–16 break down the other major components: purchases of goods and services (direct program delivery); transfers to persons; transfers to business; and non-financial capital acquisition.

Chart 13 — Direct Program Expenditures

As the data show clearly, virtually all of the growth in direct program expenditures as a share of GDP in the period 1961 to 1991 was provincial and local. Provincial and local governments' direct program delivery expenditures surpassed those of the federal government as a share of GDP in the mid-1960s and are now substantially higher as a share of GDP than the federal government's. Direct program expenditures dropped in all three orders of government after 1991, although the relative decline was greatest at the local level.

Chart 14 — Transfers to Persons

Transfers to persons increased steadily as a share of GDP at both the federal and provincial levels from 1961 to 1991, and increased sharply at all three orders of government during the 1991 recession. Since that recession, federal government transfers to persons have dropped to levels not seen since the 1970s. Provincial government transfers to persons have dropped to the levels of the mid-1980s.

Chart 15 — Transfers to Business

As one might expect, given the trend against subsidies in international trade agreements, transfers to business have declined as a share of GDP since their heyday in the 1980s. Interestingly, however, that decline has been entirely at the federal government level. Subsidies to business at the provincial level have already recovered

fully to their pre-1991 level — the only segment of program expenditure to have done so. As we will discuss in more detail later, this phenomenon may be driven by the same inter-provincial competition that is leading to competitive tax cuts at the provincial level.

Direct transfers to business by local governments are prohibited by law in most jurisdictions in Canada. Consequently, such transfers at the local level continue to be insignificant.

There would appear to be a downward trend in transfers to persons and to a lesser extent in transfers to businesses. Furthermore, evidence on the program side — most notably cuts in EI at the federal level and in social assistance benefits at the provincial level — would tend to support that conclusion. However, the close relationship between the tax and transfer systems complicates the analysis, particularly as it relates to the federal government for transfers to persons and to both the federal and provincial governments for transfers to business. Benefits which are delivered through the tax system perform exactly the same function economically as direct transfers. Examples include the refundable credits for post-secondary education and contributions to registered charities in the personal income tax, and various credits and allowances available as tax expenditures in the corporate income tax. Thus, it is likely that the decline in the federal government's transfers to persons is not as steep as the transfer data alone would suggest. Similarly, the use of the tax system to deliver subsidies to business has undergone a resurgence in recent years for both federal and provincial governments, after nearly 20 years in which the prevailing policy objective was to reduce the use of tax-delivered subsidies.⁵

Chart 16 — Capital Expenditures

One look at a chart showing government acquisition of non-financial capital assets as a share of GDP, and the explanation of Canada's multi-jurisdictional infrastructure funding crisis is apparent. Governments in Canada have been

CHART 14 Transfers to persons, % of GDP, 1961–2005

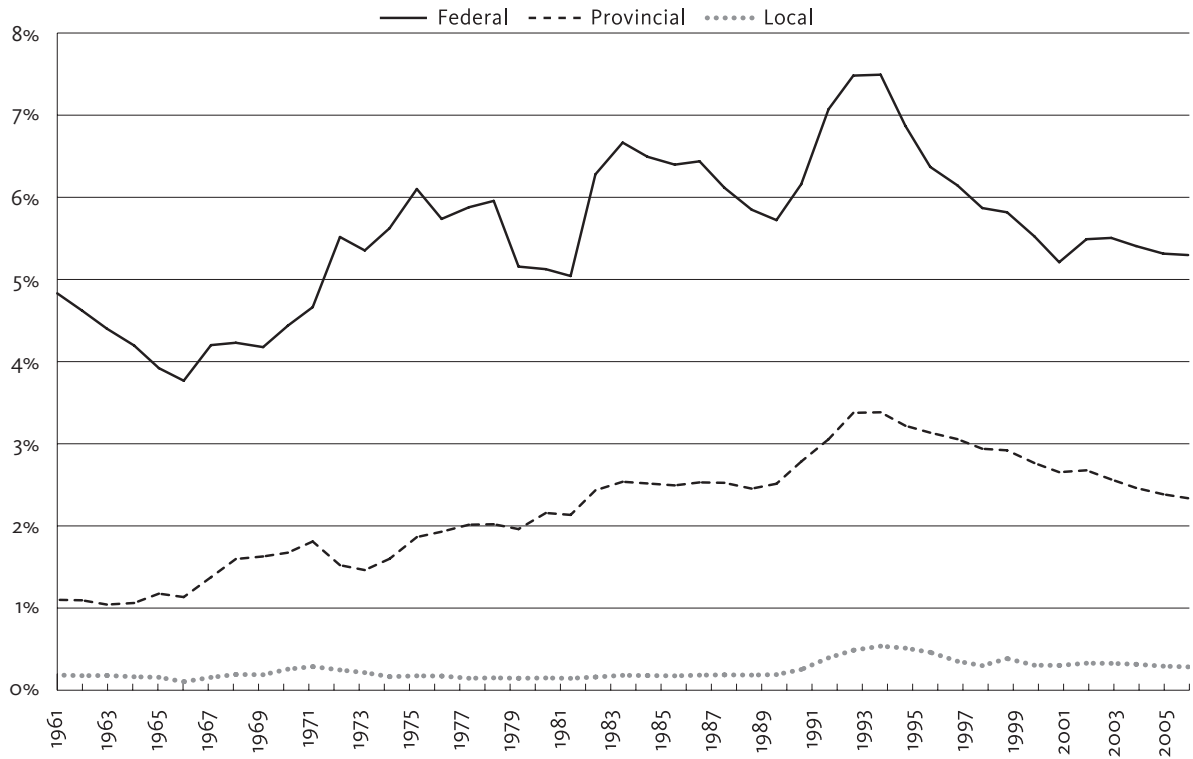


CHART 15 Transfers to business, % of GDP, 1961–2005

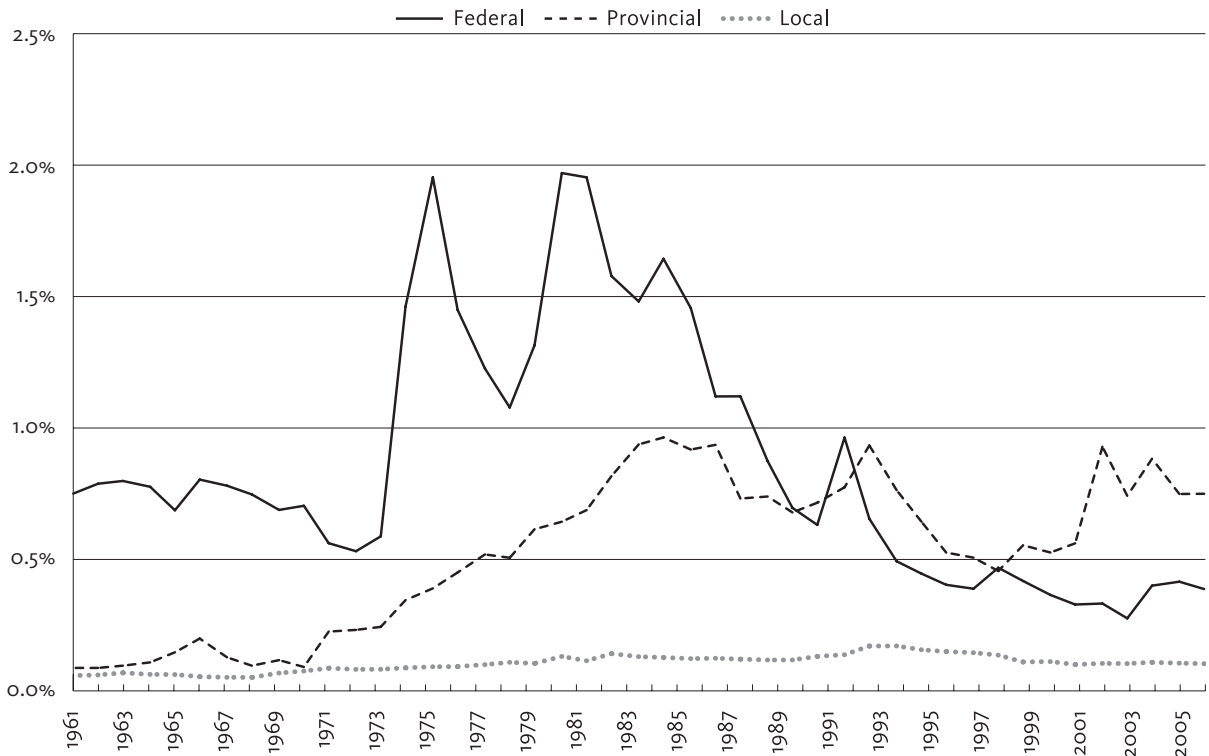


CHART 16 Capital spending (non-financial capital acquisition), % of GDP, 1961–2005

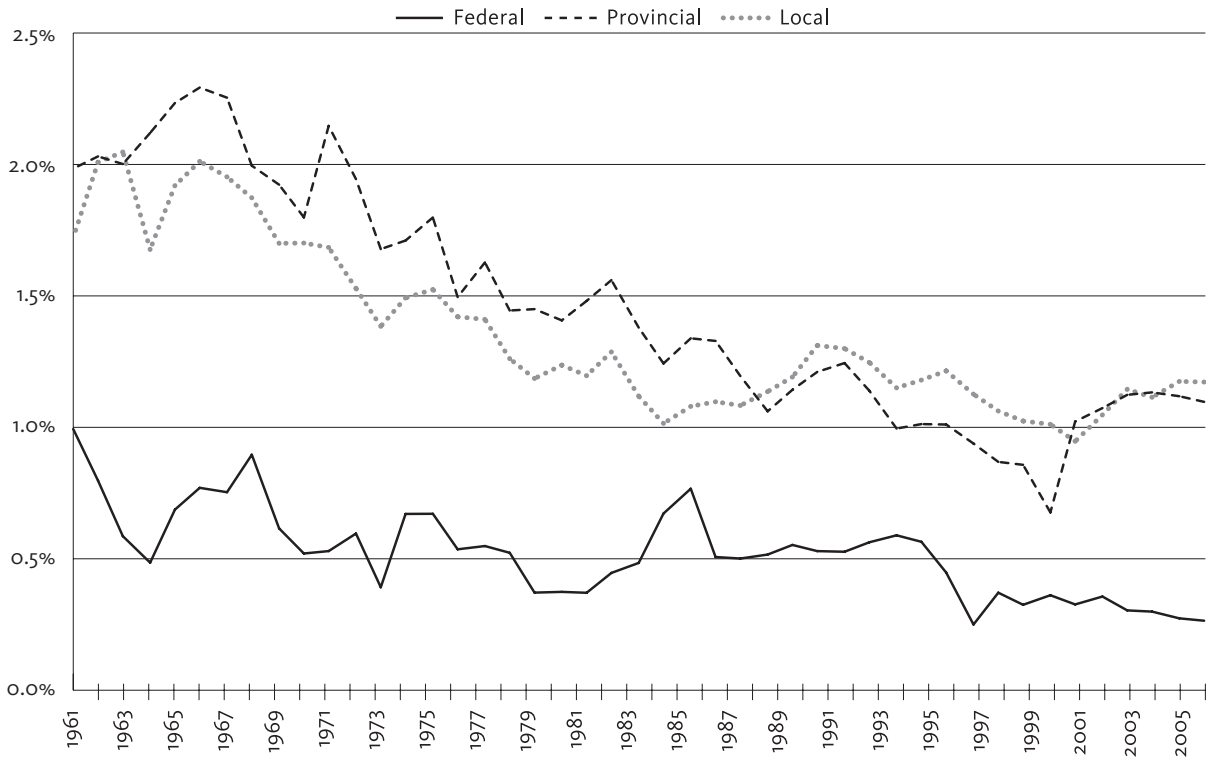
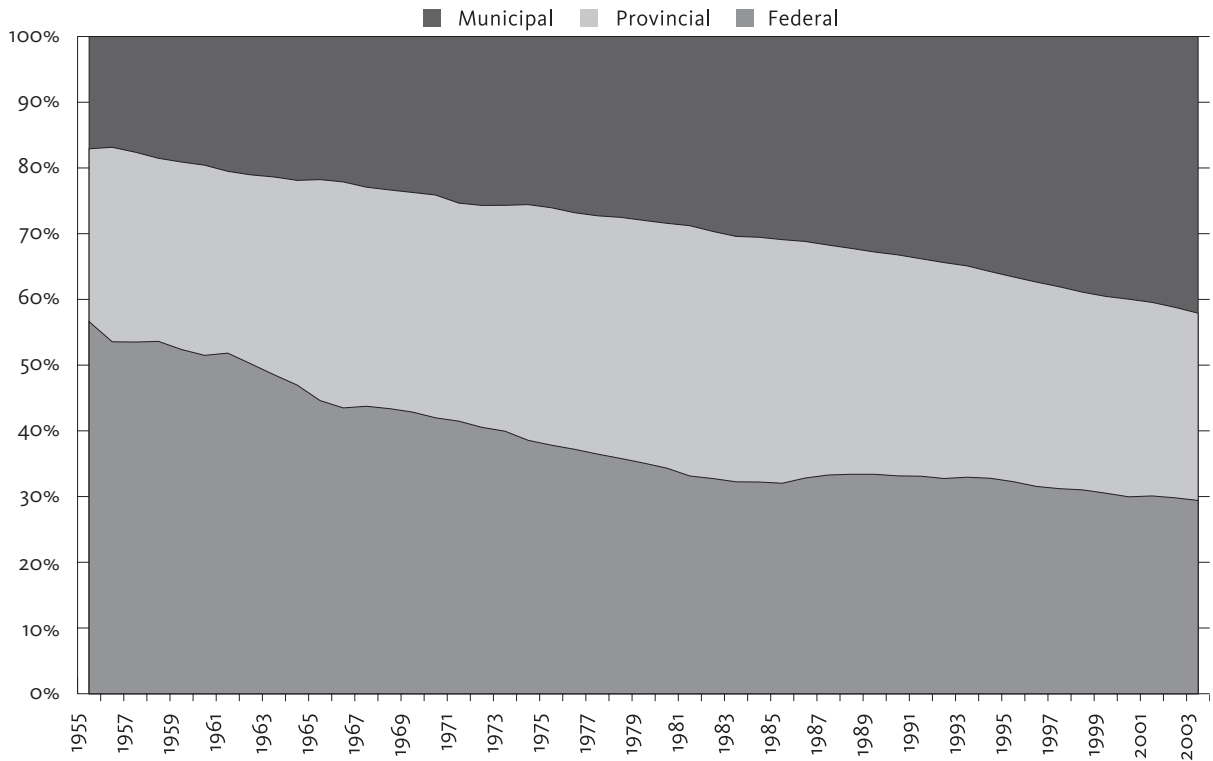


CHART 17 Shares of net capital stock, 1955–2003



investing less in physical infrastructure. Moreover, the decline in investment in physical assets as a share of GDP is not a phenomenon of the 1990s, although the downward trend certainly continued in the 1990s. The three orders of government bear a shared responsibility for a marked decline in infrastructure investment.

Investment in public capital as a share of GDP reached its peak in the late 1960s, reaching 4.78% of GDP in 1967. After the 1967 peak, public capital investment declined steadily as a share of GDP, with its most precipitous drop occurring in the 1970s. After a brief period of growth in the GDP share in the early 1980s (the result of counter-cyclical investment during the 1981 recession), public capital investment resumed its relative decline in the early 1980s, albeit at a lower rate. The recovery between 1999 and 2003 merely brought the share back to the downward trend line after its abrupt drop between 1993 and 1999.

While the percentages involved do not look large, the aggregate implications are substantial.

The difference between the 4.5% of GDP range that was typical of the 1960s and the 2.5% range that has become the norm in the late 1990s represents \$24 billion in missing annual investment in public capital.

The difference between a capital stock valued at 45% of GDP, as would have been typical from the mid-1960s to the mid-1970s, and the 30% figure we see today represents missing public capital with a current value of \$180 billion.

The problem of public infrastructure financing in Canada is tied closely to the problem of financing local government.

Chart 17 shows the evolution of the share of the public sector capital stock owned by each of Canada's three orders of government between 1955 and 2003.

It reveals a remarkable pattern. In 1955, the federal government owned 57% of the Canadian public capital stock; the provinces owned 26%; local governments 17%. In 2003, the federal gov-

ernment and local governments had virtually reversed their positions. The federal government owned 30% of the stock; the provinces 29%; and municipalities 41%.

This shift has had a profound effect on our ability to sustain funding for public infrastructure. Responsibilities for public capital have been shifting steadily from the federal level of government (with the most robust and flexible revenue system) to the local level of government (with the weakest and least flexible revenue system). Furthermore, much of the capital investment responsibility of provincial governments is exercised through agencies — universities, colleges, regional health authorities, hospitals and school boards — operating with varying degrees of independence from those governments but with limited access to revenue from sources other than transfer payments.

Changes in accounting rules have eliminated the irrational bias against capital spending for governments' direct capital expenditures by requiring governments to amortize capital spending over the useful life of the asset rather than charging it as a current expense. However, the fact that all transfer payments are treated as current expenditures means that governments continue to treat transfer payments for capital projects as if they are current expenditures. This accounting practice acts as a political dead weight against attempts to support the renewal of public infrastructure through transfer payments.

For most of the period during which public capital has been in decline, the political atmosphere in Canada has been hostile to the deficit financing that traditionally provided the funding for capital investment at all levels of government. The emergence of local governments as the most important providers of public infrastructure exacerbated the problem. Senior governments have had powerful political incentives to cut back on the transfer payments to local governments needed to compensate for the shift in responsibility to the local level.

Implications of the 1961–2005 overview

The period from the early 1960s to the early 1990s covers essentially the entire period of the development of the modern Canadian public economy. Program and capital spending combined increased from less than 30% of GDP in 1961 to more than 40% by the early 1990s. Although the government sector account data confirm the institutional history of the period in broad strokes, they also call into question some of the assumptions that are often made about how the Canadian public economy grew.

First, it is apparent from the data that, while increasing federal government transfers to provincial governments clearly served as a catalyst for the development of the modern Canadian public economy, they cannot be said to have been the engines of its growth throughout the period. Federal transfer payments increased sharply as a share of GDP from the late 1960s to the mid-1970s. But after that initial period of growth, federal transfers stabilized as a share of GDP. The fiscal capacity to support the development of Canada's public economy came from a steady but continuous growth in provincial own-source revenue as a share of GDP from the 1960s to the early 1990s.

Second, it is also apparent from the data that deficit financing of the growth in public services did not play an important role in the early development of Canada's public economy and was not an important causal factor in the fiscal problems that came to dominate public debate by the early 1990s. It is evident from the data that fiscal deficits grew as a consequence of the economic recessions of 1981 and 1991 and unprecedented high real interest rates between 1981 and 1996.

Third, over the period, the federal government lost its position of leadership among the orders of government in direct program delivery responsibilities. It is now the smallest of the three orders of government as measured by the share of GDP represented by their direct program delivery responsibilities. When transfers to persons and transfers to business are taken into account, the federal government moves into second place. Only if transfer payments to other governments are taken into account does the federal government approach the program expenditure scale of the provinces, collectively.

Fourth, the expenditure pattern with respect to capital spending on public infrastruc-

ture is quite different from the pattern for current program spending. Capital spending has been in a period of steady relative decline since the mid-1960s at all three orders of government. Canada's infrastructure funding crisis is not of recent origin.

Fifth, it is clear from the data that a fundamental shift took place in the mid-1990s. Governments generally did not respond to the fiscal squeeze created by high interest rates and the recession of 1991 the way they had responded to the previous recession in 1981. Revenue was not increased. Instead, all orders of government reduced both program spending and transfers payments. And when lower interest rates eased the budgetary impact of debt service costs, governments used the fiscal room to cut taxes rather than to recover lost ground in public programs.

Finally, the pattern of aggregate spending by the federal government on transfers to the provinces, and by the provinces on transfers to local governments, calls into question some common assumptions. The data show clearly that, over the first 35 years of the period from 1961 to 2005, changes in federal government transfers to

provincial governments were closely matched by changes in provincial transfers to local governments. This suggests that the fiscal room created by increases in federal transfers in the 1970s was used largely to increase support for local public services rather than to provide core financial support for provincial public services.

It also undermines the complaints from provinces concerning the decline in federal government transfers after 1995, since those cuts were almost perfectly matched by cuts in provincial transfers to local governments. And, notably, the increase in federal government transfers since the late 1990s has not been matched by increases in provincial transfers to local governments — the most significant departure from pattern in more than 40 years. Dog chases cat. Cat eats mouse. Mouse has run out of options. Just as the data on public capital investment dispel any mystery surrounding our infrastructure funding crisis, the data on provincial transfers to local governments should dispel any mystery as to why local governments are under more financial pressure than either the federal or provincial governments.

The post-1991 meltdown

The preceding overview of the period from 1961 and 2005 points to the years following the 1991–4 recession as pivotal in the development of Canadian public services and in the fiscal relationship between the Federal Government and the provinces.

This section focuses in more detail on that important period.

It is clear from the general overview that the critical changes over the post-1991 period took place at the provincial level and in the fiscal relationship between the provinces and the Federal Government.

Chart 18 presents program expenditures for the 10 provinces as a percentage of GDP for the period 1989 to 2004.

Program spending declined as a percentage of GDP from a peak of 22.6% in 1992 to 18.1% in 2004.

Debt service charges shrank from a peak of 3.1% of GDP in 1995 and 1996 to 1.8% of GDP in 2004.

Total revenue is included as a reference point.

Chart 19 presents own-source revenue and federal government transfers as a percentage of GDP for the same period.

Own-source revenue dropped from a peak of 18.5% of GDP in 1991 to 16.3% of GDP by 2004, a decline of 2.2% of GDP.

Federal transfers dropped from 4.7% of GDP in 1993 to a low of 3.0% of GDP in 2000 and had rebounded to 3.2% of GDP by 2004.

As was noted above, provincial transfers to local governments tended to follow the pattern of federal transfers to the provinces.

Chart 20 focuses specifically on taxation revenue for the 10 provinces as a group. From a high of 12.2% of GDP in 1992, taxation declined as a share of GDP in the 10 provinces to 10.3% in 2004.

Chart 21 shows Federal Government transfers to the provinces and local government transfer payment revenue, essentially all of which is from provincial governments.

Transfers to local governments dropped from a peak of 4.3% of GDP in 1993 to a low of 2.8% of GDP in 2004.

Of particular note is the extent to which provinces moved together on these measures,

CHART 18 Total revenue, program expenditures and debt service charges, 10 provinces, % of GDP, 1989–2004

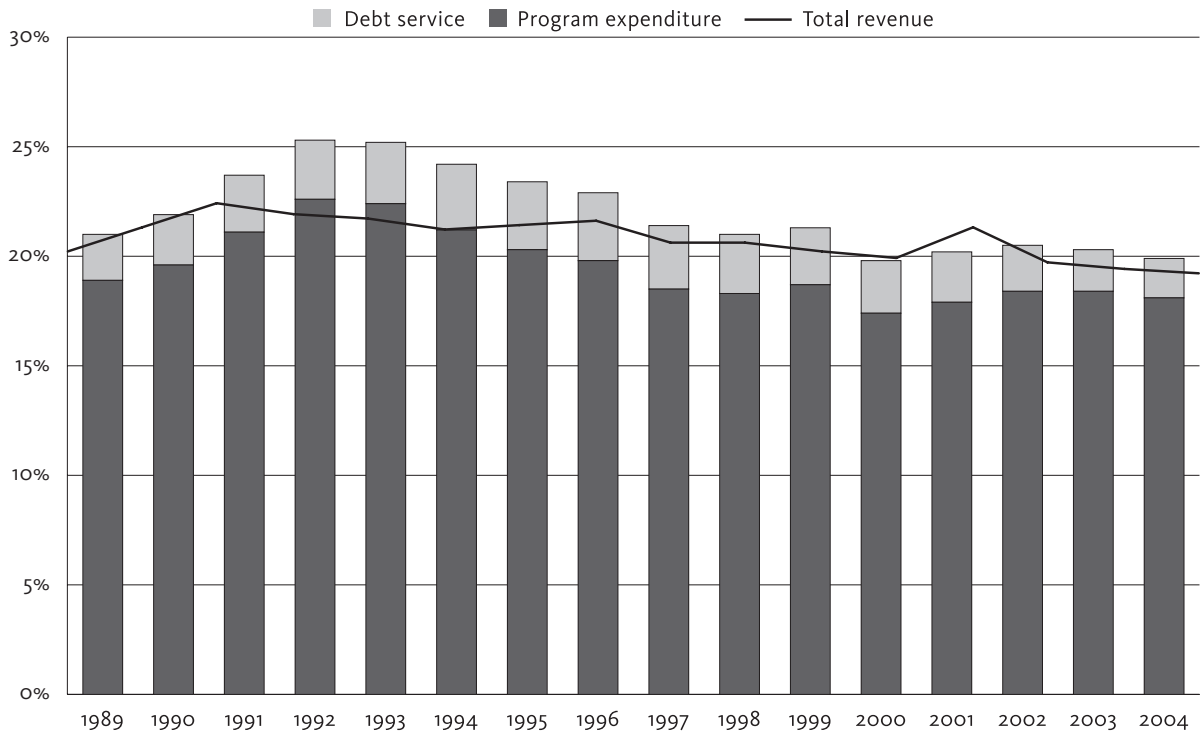


CHART 19 Federal transfers, own-source revenue and total expenditures, 10 provinces, % of GDP, 1989–2004

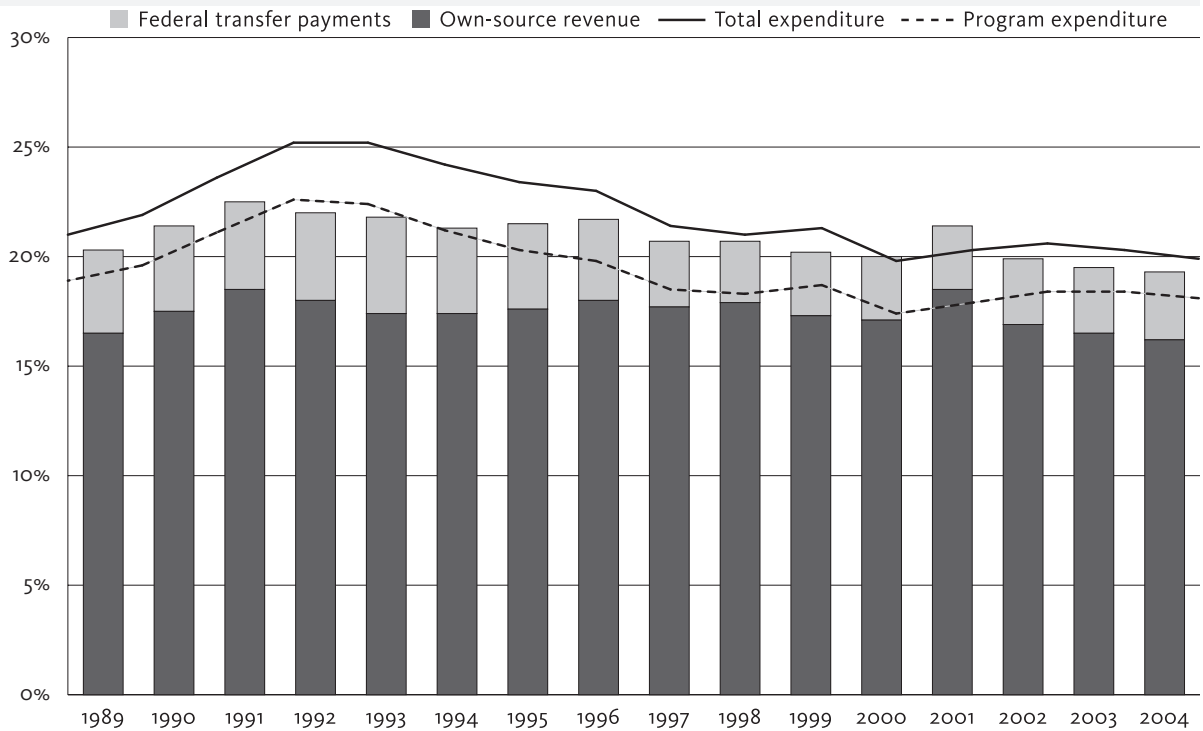


CHART 20 Taxation revenue as % of GDP, 10 provinces, 1989–2004

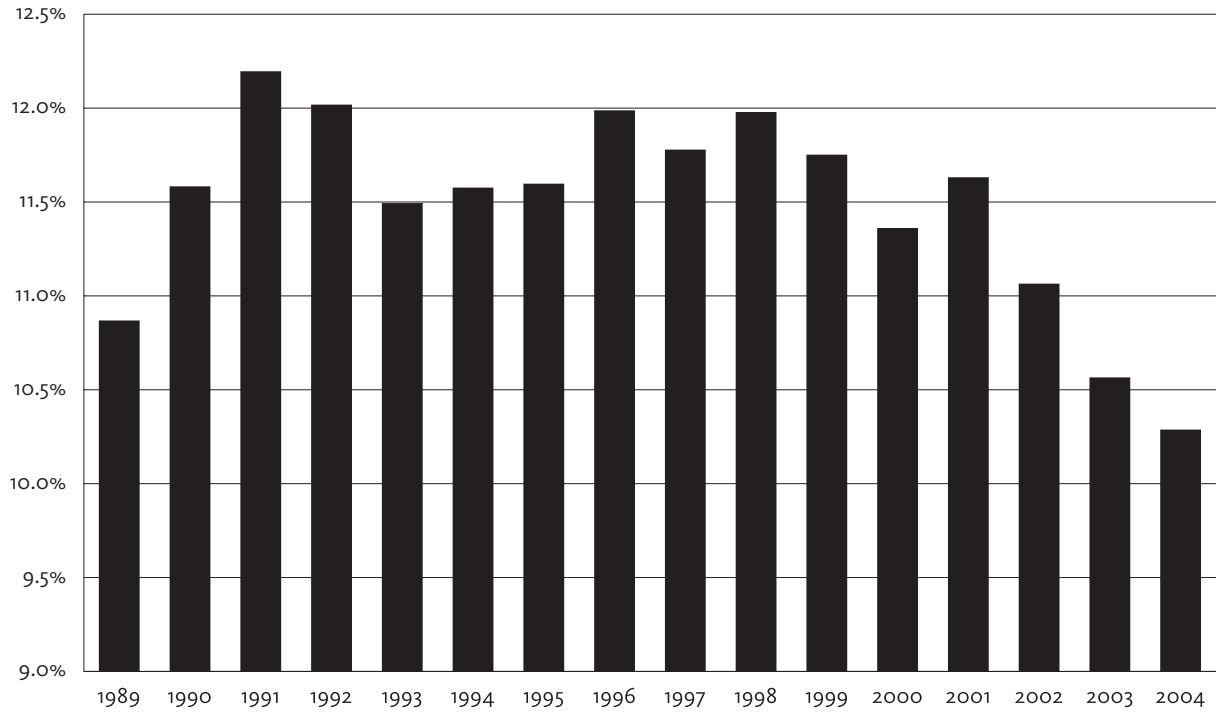


CHART 21 Transfers from federal government and transfers to local government, 10 provinces, % of GDP, 1961–2005

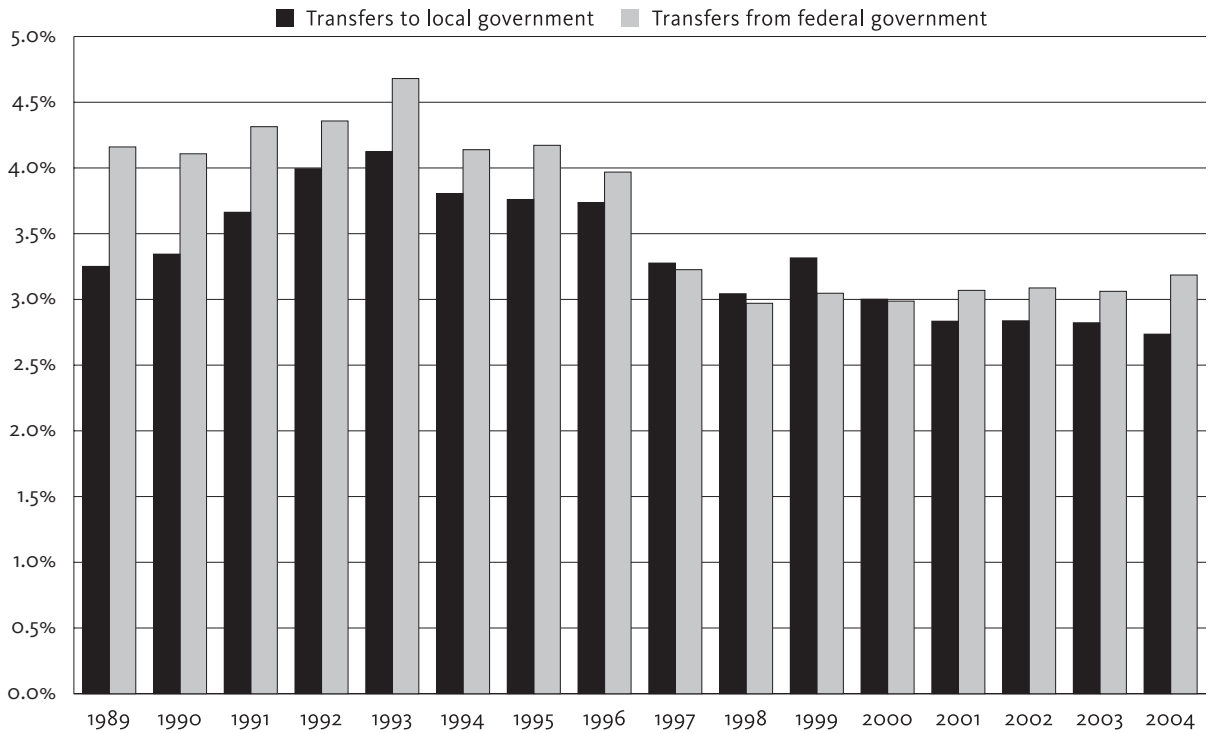
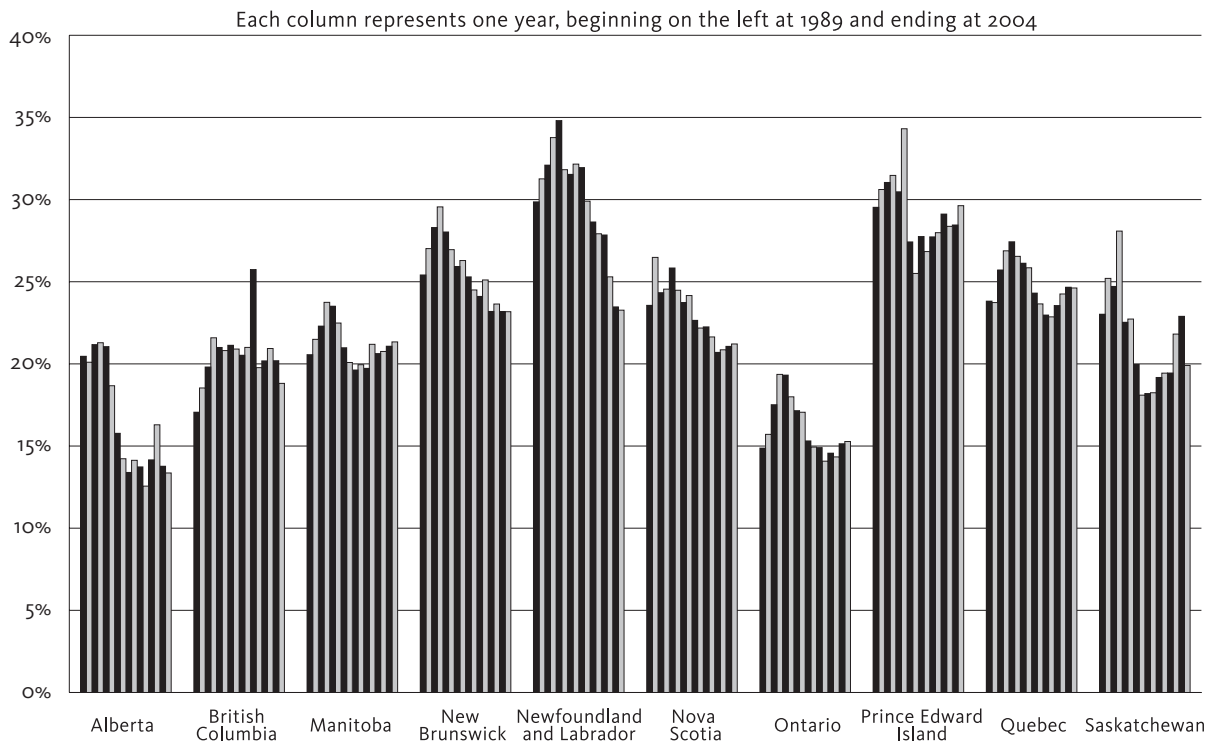


CHART 22 Program expenditures as % of provincial GDP, 1989–2004



despite marked differences in economic circumstances, the political orientation of their governments and their fiscal position at the beginning of the period.

In this analysis, we focus on three key variables in relation to GDP: program expenditures; taxation revenue; and transfers to local governments.

Chart 22 shows program expenditure as a percentage of GDP, from 1989 to 2004.

All provinces reduced program spending as a share of GDP. Most provinces showed a rapid decline in program spending as a share of GDP in the second half of the 1990s followed by a modest upturn in 2003 and 2004. There were, however, notable differences in timing. The rebound in program spending as a share of GDP started earlier and was somewhat greater in PEI, Manitoba, Quebec and Saskatchewan. The share has not rebounded in Alberta, British Columbia and Newfoundland and Labrador.

Chart 23: Own-source revenue

In all provinces, with the exception of Quebec and Nova Scotia, own-source revenue (i.e. revenue excluding transfers from the Federal Government) has been reduced substantially as a wave of revenue cuts swept through the provincial order of government. On this measure, there were significant differences in timing, with Ontario, Alberta and New Brunswick on the leading edge, and British Columbia, Manitoba and Saskatchewan following.⁶

The changes in taxation revenue in particular are most apparent in the post-1996 period. In chart 24 we see clearly the two solitudes in Canada's fiscal environment. With the exception of Newfoundland and Labrador, where other factors are clearly influencing the data, the provinces east of the Ottawa River have tended to maintain their tax revenue relative to GDP over the period, whereas the provinces west of the

CHART 23 Own-source revenue as % of provincial GDP, 1989–2004

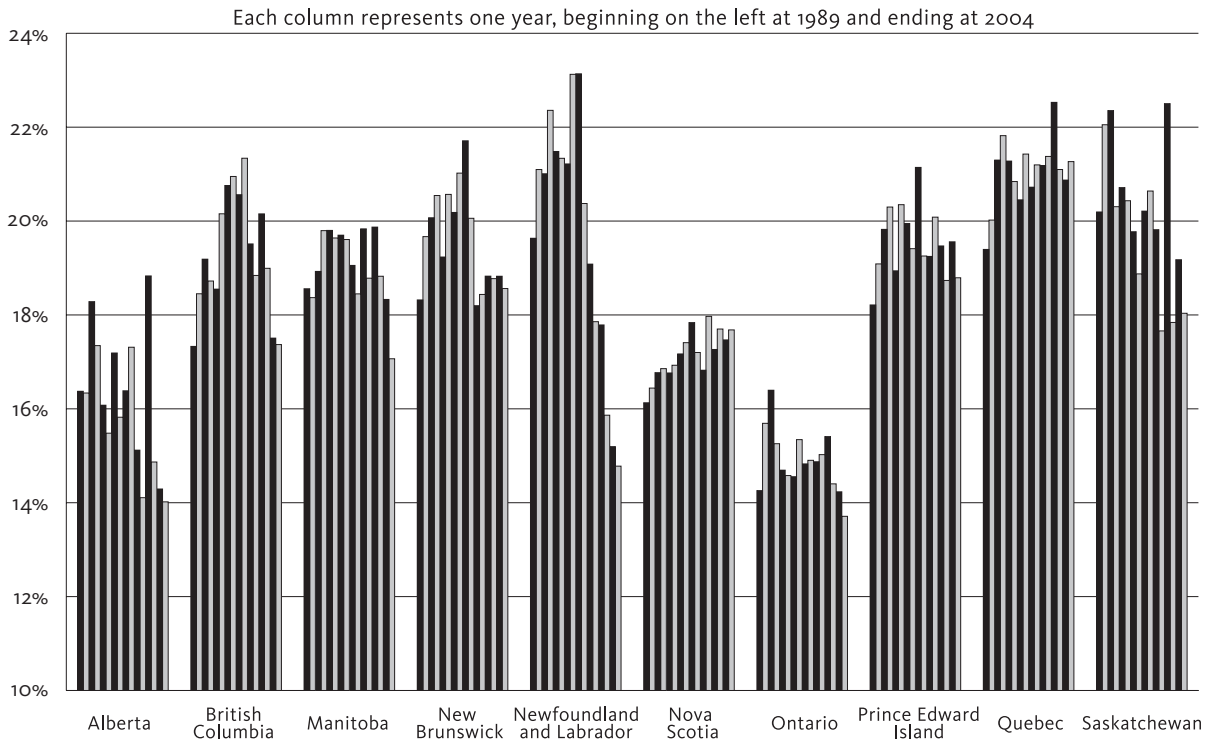


CHART 24 Taxation revenue as a share of GDP, 1989–2004

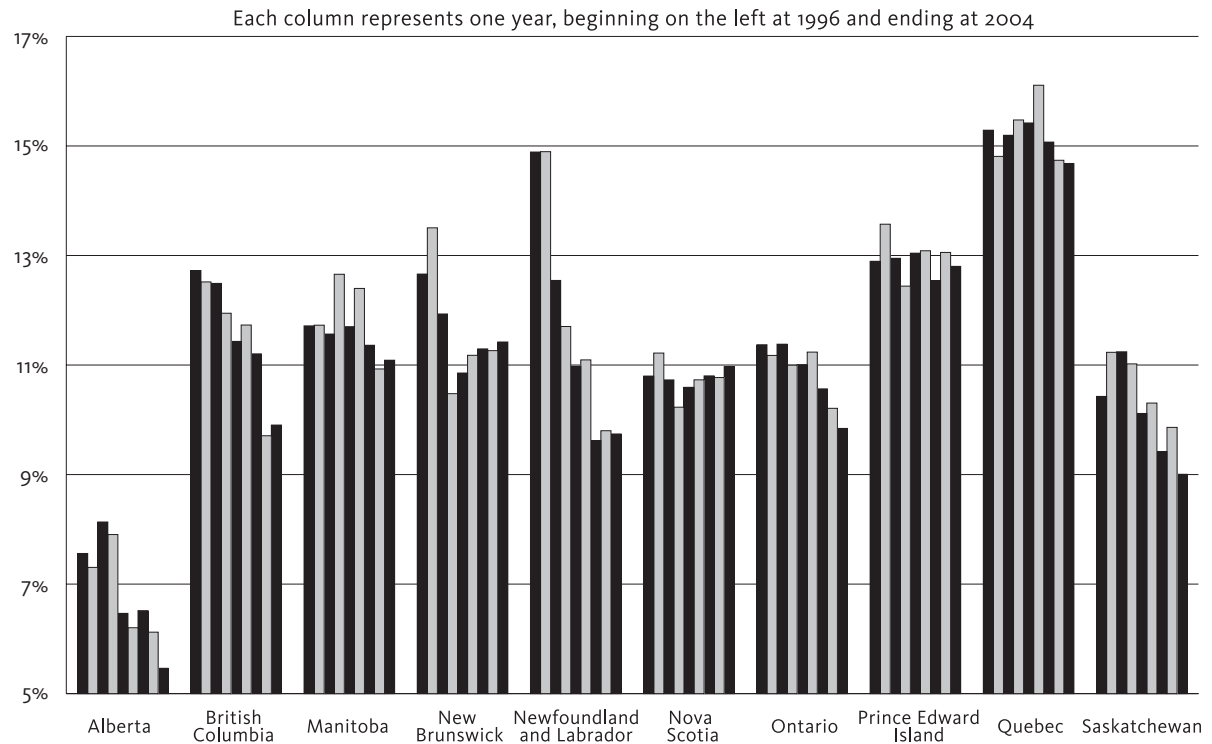
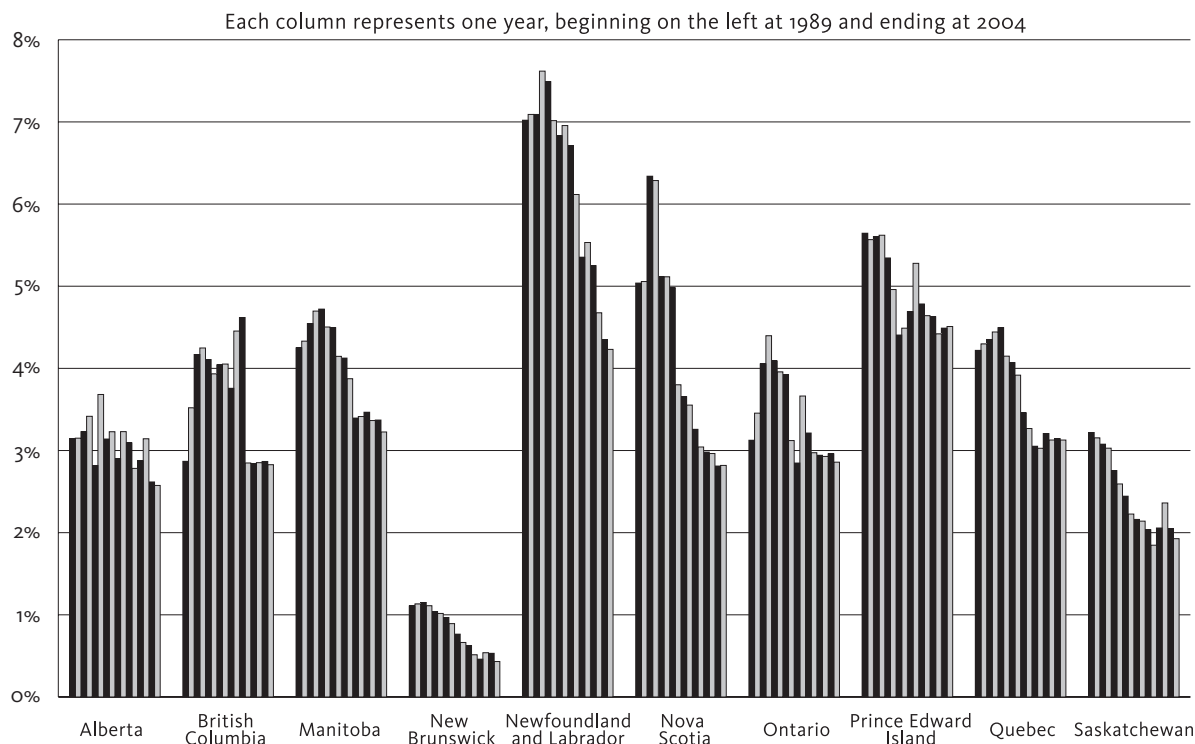


CHART 25 Transfers to local government as % of provincial GDP, 1989–2004



Ottawa River have reduced their tax revenue in relation to GDP.

Despite the widely differing responsibilities of local governments from province to province, there was a remarkable degree of similarity among provinces in the behaviour of their transfer payments to local governments during this period.

Chart 25: Provincial transfers to local governments

All reduced their transfers to local governments as a share of GDP, beginning in the early 1990s, effectively shifting the impact of reduced Federal Government transfers to local governments. And while Federal Government transfers recovered somewhat in the early 2000s, provincial governments generally did not follow suit with increases in their transfers to local governments.

Looking specifically at provincial tax systems, income taxes — both corporate and per-

sonal — are the most vulnerable to inter-provincial competition because the personal and corporate income tax bases are the most mobile within Canada.

To focus on the impact of structural changes in the tax systems of the provinces on provincial revenue-raising capacities, an October 2002 analysis by the federal Department of Finance estimated the revenue losses from corporate and personal income tax cuts, province-by-province, for the period from 1996 to 2002, and projected those losses forward to 2006.

Table 1 reproduces the Department of Finance's estimates of revenue losses from implemented and announced tax cuts as of October 2002.

Table 2 expresses these estimated revenue impacts in as a percentage of the actual personal income tax revenue received by the province in each year.

The pattern in these data is clear. Ontario took the lead in implementing substantial income tax

TABLE 1 Value of PIT Measures introduced by Provincial Governments, 1996 to 2005

	1996-7	1997-8	1998-9	1999-00	2000-1	2001-2	2002-3	2003-4	2004-5	2005-6
Alberta	-8	-33	-198	-246	-1108	-2063	-1823	-1941	-2070	-2210
British Columbia	-68	-155	-201	-340	-647	-1,889	-2,275	-2,409	-2,570	-2,744
Manitoba	-3	-6	-37	-106	-173	-272	-332	-363	-387	-411
New Brunswick	0	-37	-66	-87	-135	-193	-222	-236	-252	-269
Newfoundland	25	26	28	14	-28	-55	-51	-55	-58	-62
Nova Scotia	0	-43	-56	-60	-72	-75	-78	-214	-226	-241
Ontario	-1,085	-2,900	-4,523	-6,543	-6,826	-8,004	-8,874	-9,710	-11,307	-12,129
Prince Edward Island	0	2	0	-3	-13	-17	-18	-19	-20	-22
Québec	4	-56	-255	-588	-1,652	-3,830	-4,434	-4,737	-5,053	-5,395
Saskatchewan	-55	-58	-90	-110	-325	-417	-503	-591	-630	-673
TOTAL	-1,191	-3,259	-5,400	-8,070	-10,980	-16,814	-18,609	-20,273	-22,573	-24,155

TABLE 2 PIT Measures as a Percentage of Actual Revenue, 1996 to 2005

% impact PIT

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Alberta	0%	-1%	-5%	-5%	-22%	-48%	-40%	-40%	-44%	-47%
British Columbia	-1%	-3%	-4%	-6%	-11%	-31%	-41%	-56%	-51%	-53%
Manitoba	0%	0%	-2%	-6%	-10%	-15%	-19%	-21%	-22%	-22%
New Brunswick	0%	-4%	-8%	-11%	-15%	-21%	-24%	-25%	-26%	-27%
Newfoundland	5%	4%	5%	2%	-5%	-9%	-8%	-8%	-8%	-8%
Nova Scotia	0%	-4%	-6%	-6%	-6%	-6%	-6%	-15%	-16%	-16%
Ontario	-6%	-17%	-26%	-37%	-36%	-41%	-45%	-50%	-59%	-56%
Prince Edward Island	0%	1%	0%	-3%	-8%	-12%	-12%	-11%	-12%	-12%
Québec	0%	0%	-2%	-4%	-10%	-21%	-26%	-29%	-30%	-30%
Saskatchewan	-5%	-5%	-7%	-8%	-22%	-33%	-42%	-41%	-51%	-51%

TABLE 3 Corporate Income Tax⁸

CIT measures by province, 1996 budgets onward

	1996-7	1997-8	1998-9	1999-00	2000-1	2001-2	2002-3	2003-4	2004-5	2005-6
Alberta	0	0	0	0	0	-248	-327	-405	-552	-565
British Columbia	-20	-29	-37	-108	-182	-188	-378	-418	-450	-461
Manitoba	-7	-2	-2	-7	-14	-28	-42	-55	-69	-81
New Brunswick	0	0	0	-5	-14	-27	-36	-66	-71	-73
Newfoundland	0	0	0	0	0	0	0	0	0	0
Nova Scotia	0	-22	-23	-23	-24	-23	-21	0	0	0
Ontario	4	-151	-277	-454	-1,172	-1,558	-2,116	-2,610	-3,334	-3,978
Prince Edward Island	0	1	1	1	2	2	2	2	2	2
Québec	189	-5	-92	-169	-349	-1,173	-332	-996	-1,073	-1,099
Saskatchewan	0	0	0	0	0	-14	-32	-35	-38	-39
TOTAL	167	-208	-430	-764	-1,752	-3,258	-3,282	-4,583	-5,586	-6,294

TABLE 4 CIT Measures as % of Actual Revenue**% impact CIT**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Alberta	0%	0%	0%	0%	0%	-12%	-15%	-20%	-33%	-24%
British Columbia	-2%	-2%	-3%	-10%	-19%	-17%	-23%	-62%	-54%	-34%
Manitoba	-4%	-1%	-1%	-3%	-5%	-6%	-13%	-32%	-22%	-19%
New Brunswick	0%	0%	0%	-4%	-9%	-15%	-20%	-47%	-64%	-42%
Newfoundland	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Nova Scotia	0%	-15%	-17%	-17%	-13%	-13%	-9%	0%	0%	0%
Ontario	0%	-3%	-5%	-8%	-18%	-21%	-35%	-52%	-64%	-54%
Prince Edward Island	0%	4%	4%	6%	10%	4%	6%	7%	6%	7%
Québec	12%	0%	-4%	-8%	-15%	-44%	-13%	-39%	-37%	-37%
Saskatchewan	0%	0%	0%	0%	0%	-4%	-22%	-21%	-12%	-15%

cuts, beginning in 1996, with other provinces following over the next few years. Alberta kicked off another wave with substantial cuts in 2000 and 2001. B.C. followed in 2001 and 2002. Other provinces responded with lesser cuts. Over a 10-year period, according to the Department of Finance projections, personal income tax cuts took \$24 billion out of provincial fiscal capacity.

These results are broadly similar to the results of an analysis using Statistics Canada's Social Policy Simulation Database and Model in a paper on tax cuts and fiscal imbalance from the B.C. office of the Canadian Centre for Policy Alternatives.⁷

Table 3 reproduces the Department of Finance data for corporate income tax cuts.

Table 4 expresses the revenue impacts, year-by-year, as a percentage of actual corporate income tax revenue in that year.

Except for the special case of Nova Scotia, which introduced substantial corporate tax cuts in 1997 and then reversed them in 2001 and 2002, the race for corporate tax cuts had the same leader — Ontario — as the PIT cut race. However, the pattern was not the same among other provinces. Alberta and B.C. did not match the Ontario cuts, whereas Quebec and New Brunswick were more enthusiastic participants in the CIT cut race to the bottom than in the PIT cut race.

Taken together, the CIT and PIT measures captured in the Department of Finance analysis had removed, as of 2005, over \$30 billion in annual provincial fiscal capacity — a cut in fiscal capacity in these two taxes alone amounting to 2.2% of GDP.

Another way to look at the same question is to compare revenue raised by provincial govern-

CHART 26 Personal and corporate income tax, 1996–2001, 10-province revenue vs. federal revenue



ments and the federal government from the personal and corporate income tax systems.

Chart 26 shows 10-province personal and corporate tax revenue as a percentage of federal revenue from the corresponding tax base for the critical 1996-to-2001 period preceding the implementation of the federal tax cuts after 2000.

Despite having to absorb the substantial cuts in federal government transfer payments about which they legitimately complained, the data show provincial revenue from income taxes shrinking as a percentage of federal revenue from the same tax bases.

Lessons from the post-1989 period

By the time the combined effect of the 1991 recession and the persistence of record-high real interest rates had begun to squeeze provincial fiscal balances in the early 1990s, federal government transfer payments had long since ceased to be a major driving force behind the development of Canada's public economy.

While it is undeniably true that the substantial cuts in federal transfer payments that began to take hold in 1996 came as a shock to an already-weak provincial fiscal system, provincial governments collectively responded by shifting the burden of the cuts downwards through cuts in their transfers to local governments. And, just as the real driver of the growth of Canada's public economy in the 1970s and 1980s had been a steady growth in provincial own-source revenue as a share of GDP, the real driver of the provincial fiscal squeeze that has been labeled "fiscal imbalance" was an equally steady reduction in provincial own-source revenue as a share of GDP, in turn driven by substantial cuts in personal and corporate income taxes at the provincial level.

To say that the provinces collectively caused the fiscal imbalance over which they are now complaining does not, however, mean that the provinces are able, on their own, to resolve it.

It is clear from the revenue data in general, and from the data on personal and corporate income tax cuts in particular, that provincial revenue is extremely vulnerable to downward pressure on tax rates coming from other jurisdictions. It is clear from the data that the large personal and corporate income tax cuts in Ontario had an appreciable negative effect on income tax policies in other provinces. Even provinces which could not reasonably be said to share the ideological perspective of the Ontario Conservatives faced competitive pressure to reduce their tax rates.

It is also clear from the data that provincial government policies with respect to transfers to local governments have materially worsened the only real fiscal imbalance in Canada's three orders of government — the imbalance between responsibilities and revenue sources for local governments.

Current misconceptions of “fiscal imbalance”

Shortly after he “discovered” that the Conservative governments of Ernie Eves and Mike Harris had been shading the truth when they claimed that Ontario’s budget was balanced, Ontario Premier Dalton McGuinty also “discovered” what he claimed was a \$23 billion gap between what the federal government takes from Ontario in revenue and what it returns to Ontario in spending.

The Business Council on National Issues — reincarnated as the Canadian Council of Chief Executives — weighed in early in 2006 with its own take on fiscal imbalance with its proposal to resolve the problem by transferring billions in revenue-raising capacity from the federal government to the provinces.

And in March 2006, the Advisory Panel on Fiscal Imbalance offered its own prescription based on an unconditional acceptance of the provincial perspective on imbalance.

None of these interventions is particularly helpful in understanding the current issues in federal-provincial fiscal relations. Indeed, each of these suggestions, in its own way, has the effect of diverting attention away from the underlying

causes of the fiscal predicament facing Canada’s public economy.

Ontario’s \$23 billion gap

Premier McGuinty’s \$23 billion gap is based on a projection from relatively straightforward National Accounts data for 2001. Statistics Canada reports that, in 2001, the federal government raised \$83.5 billion from Ontario. It spent \$59 billion on goods and services. And it invested \$1.8 billion in fixed capital and inventories in Ontario, for a difference between revenue and expenditures of \$22.7 billion.

It turns out, however, that, when you look at the numbers more closely, Premier McGuinty’s claim doesn’t really hold up.

In the first place, on a National Accounts basis, the federal government ran a \$17 billion surplus in 2001. That amounts to a gap nationally between revenue and expenditure. It is money that was raised by the federal government that was not spent. Anywhere. Ontario’s per-capita share of the surplus is about \$6.9 billion, so \$6.9 billion of the \$23 billion as explained by the federal surplus in 2001.

CHART 27 Ontario's federal revenue/spending imbalance: Understanding what lies behind it

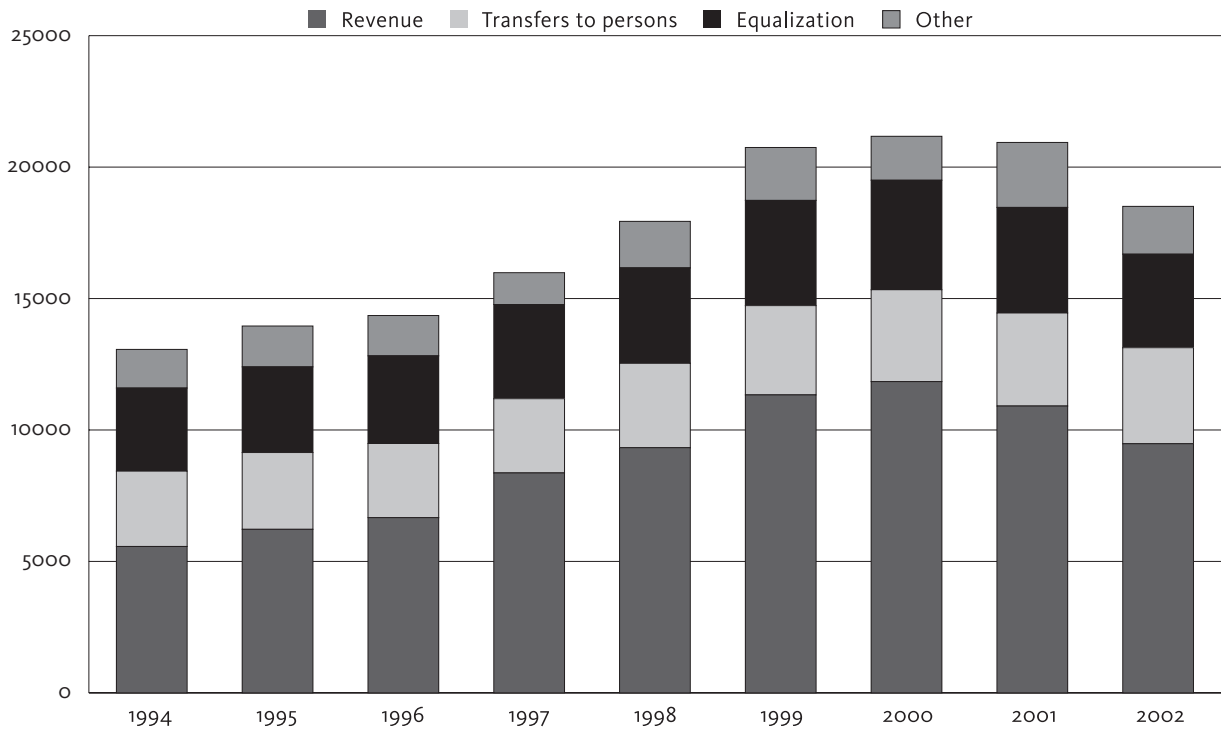
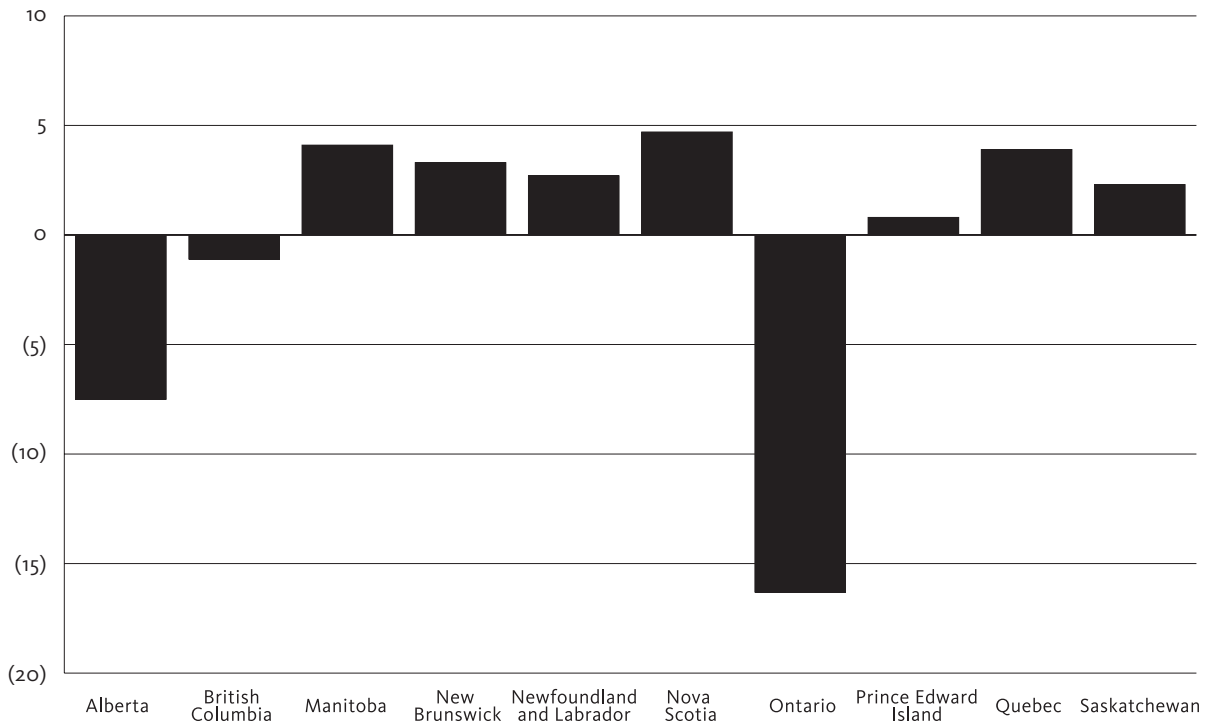


CHART 28 Estimated provincial "fiscal gap": Federal government expenditure minus federal government revenue, by province



Indeed, the changing surplus/deficit balance of the federal government is responsible for most of what Premier McGuinty claims is an increase in the fiscal gap between 1996, when it was \$5.9 billion, and 2001, when it was \$22.7 billion. In 1996, there was a \$12 billion deficit, on a National Accounts basis. Ontario's share of the deficit was about \$4.8 billion. So, when you take the federal government's fiscal position into account, on a comparable basis the gap increased from \$10.7 billion in 1996 to \$15.8 billion in 2001. Much less dramatic.

But, even when you put the numbers onto a comparable basis, the concept behind the \$23 billion gap is slippery, to say the least.

An analysis based on 2003 data prepared for the 2006 Ontario Alternative Budget found a gap, after allowing for the federal surplus, of \$17.9 billion. Half of that gap was attributable to the fact that Ontario contributes more than its per-capita share to federal government revenue. Why? Because Ontario has a higher per-capita income than the rest of Canada, and that higher income, in a progressive tax system, generates proportionately more revenue. Another \$3.4 billion comes from the formal provincial fiscal equalization program — no surprise there, and no suggestion from Premier McGuinty that equalization should be abolished. A further \$3.7 billion is in federal government transfers to people, an imbalance that is created by demographics and individual incomes (in the case of programs like Old Age Security and the Guaranteed Income Supplement) and by the interaction of program design and the structure of the economy (for Employment Insurance). While it is evident from other sources that Ontario does have a legitimate complaint about EI coverage of the unemployed in Ontario⁹, the appropriate response from Ontario would be to call for reform in the EI program, which Premier McGuinty is not doing.

Indeed, of the \$18 billion gap in 2003 that was not explained by the federal government's surplus, only \$2 billion cannot be attributed to

differences in revenue and transfers to people or to the formal equalization program.

Chart 27 shows the attribution of the difference between federal government revenue and expenditure in Ontario from 1994 to 2002. Most of the variation is attributable to the federal revenue system, which in turn is responsive to differences in economic performance between Ontario and Canada as a whole.

Indeed, Ontario is not unique in experiencing a gap between federal government revenue and expenditure within its borders. Not surprisingly, all three of the higher-income provinces in Canada show a revenue-expenditure gap. In 2003, for example, Alberta showed a \$7.5 billion gap and B.C. \$1.1 billion.

Chart 28 shows the balance of federal expenditure and revenue — the “gap” as measured by Ontario — for all ten provinces for 2003.

Premier McGuinty's \$23 billion has become an iconic number — repeatedly quoted and unquestioningly accepted. The \$23 billion gap, however, is more than a particularly effective piece of political communication. It is also a classic example of political misdirection, intended to deflect attention away from the fact that the real gap — between the public services that Premier McGuinty's constituents expect and the provinces fiscal capacity to provide them — is entirely attributable to Ontario's own tax cuts.

The Council of Chief Executives and the GST

Canada's most well-heeled big business lobby grabbed the headlines in February with a proposal to resolve the issue of “fiscal imbalance” by transferring responsibility for the GST from the federal government to the provinces, or, less adventurously, by earmarking GST revenue for federal government transfers to the provinces in areas of provincial jurisdiction.¹⁰

The problem with this proposal is that it does not respond to the competitive tax cut environ-

ment at the provincial level that is the underlying cause of what is being called ‘fiscal imbalance.’ In its more moderate form, it simply earmarks the GST for transfer payments, with no impact on fiscal capacity. In its more extreme form, in which the federal government would vacate tax room and end transfer payments, the proposal would serve to exacerbate the inter-provincial tax competition which is at the root of the problem, while doing nothing to increase the overall capacity of provincial governments to fund the services for which they are constitutionally responsible. And, by replacing equalized program-related transfers with non-equalized tax room, it would drive an increase in equalization payments as an offset.

It would reduce the fiscal capacity of the federal government without increasing the fiscal capacity of provincial or local governments. In fact, in the more extreme version in which tax room is vacated by the federal government, it would almost certainly lead to a reduction in total (federal and provincial combined) fiscal capacity as provinces continue to compete to lower tax rates. In the process, it would also eliminate any leverage the federal government might have to establish national standards for programs in provincial jurisdiction.

The fact that a proposal from Canada’s dominant big business lobby group would threaten the fiscal capacity of governments in Canada is not surprising, given the organization’s political perspective. But it is not a solution to fiscal imbalance. It is not a solution to the gap between fiscal capacity and public services requirements. It is a

“solution” only in that it supports the achievement of the organization’s political objectives.

“Reconciling the Irreconcilable”: The Agenda of [some of] the Provinces

The report of the Advisory Panel on Fiscal Imbalance, released in March 2006, was intended to form the basis for a unified provincial position in negotiations with the federal government over fiscal arrangements.¹¹ Instead, it has had the opposite effect, driving a wedge between “have” and “have-not” provinces, offering up a basis for a politically convenient but highly divisive enhancement of the equalization system, and contributing little of value to a real understanding of the issue.

The root of the problem with the Advisory Panel’s proposal is in its curious approach to the very existence of fiscal imbalance. The Panel rejects the position of the previous Liberal federal government that fiscal imbalance does not exist because provincial governments have the constitutional authority to raise taxes to pay for more public services if they wish. In defence of its view that this position is unrealistic, the Panel points to downward pressure on tax rates created by inter-provincial tax competition. But, having effectively acknowledged that what it calls fiscal imbalance has in large part been created by provincial fiscal policies, it proceeds to ignore the tax competition issue entirely in its recommendations, leaving itself with nothing useful to say about the very issue it was created to study.

What's on the agenda?

Fiscal imbalance, defined as a shortfall of revenue raising capacity relative to spending responsibility, is largely a problem inflicted by the provinces on themselves through tax competition. There is no legal or constitutional impediment to the provinces raising the revenue required to pay for the services that fall under their jurisdiction. Furthermore, the data show that reductions in federal transfer payments to the provinces have not even been the principal driver of the gap between the current provincial revenue base and the revenue that would be required to pay for the services Canadians demand.

Federal government transfer payments clearly played a role in the provinces' fiscal problems in the 1990s. Just as expanding federal transfers in areas of provincial jurisdiction played an important role as a catalyst for the development of the modern Canadian public economy at the provincial level in the late 1960s and early 1970s, the cuts in federal government transfers to the provinces in the mid-1990s may have been a catalyst for provincial spending cuts.

However, two key conclusions from the data undermine completely the suggestion that the responsibility for the provincial fiscal crunch lies

entirely with the federal government. First, both in the aggregate and on a province-by-province basis, provincial governments responded to the cuts in federal government transfers as a share of GDP by cutting their own transfers to local governments, effectively insulating their fiscal balances from the federal cuts. Second, in the aggregate and in most provinces, the revenue loss from cuts in federal government transfers is dwarfed by the revenue loss from provincially initiated tax cuts. Indeed, for the federal government transfers to offset fully the provincial revenue loss would require federal transfers to the provinces to rise to a share of GDP that is unprecedented in Canadian fiscal history.

This is not to say that there are no issues in the Canadian federal-provincial fiscal environment. Far from it. Among the major issues highlighted by this analysis are:

- equalization;
- protecting provincial fiscal capacity;
- financing local government;
- providing a basis for national political projects;

- making the federal government a reliable fiscal partner; and
- funding public infrastructure.

In what follows, this paper explores some potential directions and options for change as a counterpoint to the current conventional wisdom — a conventional wisdom which features a drift towards a decentralized, undersized, and underfunded public economy unable either to meet the political expectations of Canadians or to advance Canada’s national economic, social, and political interests.

Equalization

There are significant differences among provinces in the extent to which they are fiscally dependent on transfer payments from the federal government. The data show that, if equalization were to collapse, so would the system of public services in many provinces. Any substantial weakening of equalization would have a profound impact on what Canadians understand to be the foundations of our public economy.

The problem is that the current equalization system, with its exclusive focus on revenue, fails to deliver on its promise of pan-Canadian service levels, and is so seriously flawed that it runs the risk of losing the political credibility upon which it depends.

As Queen’s University economist Robin Boadway points out,¹² because the current equalization system ignores differences in the costs of providing services in different jurisdictions, it cannot pretend to be assuring that provinces are able to provide a common standard of public services in Canada. This idea is pursued further in a paper by another Queen’s economist, Tom Courchene, which demonstrates that, under some scenarios, our current approach to equalization could have the unexpected impact of providing for higher levels of service for the same fiscal effort in “have-not” provinces than

in “have” provinces.¹³ Whatever one’s view might be of the appropriateness of that potential outcome, it would be unlikely to strengthen the political support in the “have” provinces on which the viability of the system depends.

Integrating delivery costs and measures of service adequacy into equalization measures is complex, but it is neither unprecedented nor impossible. Most provinces take precisely these kinds of features into account in the design of their equalization grants programs for local governments. At the very least, equalization payments should be adjusted to reflect the costs of service delivery in the jurisdiction.

Introducing measures of service adequacy would address another critical problem with the equalization system. Because the equalization revenue targets are based on average tax rates in the reference provinces, tax reductions in those provinces have a ripple effect on equalization payments to the “have-not” provinces. Establishing a targeted financial capacity that is independent of individual provincial tax policies would address this problem. Reference tax rates would be the rates required to raise a target amount of revenue in the reference provinces.

The equalization issue that has received the most attention in recent months concerns the treatment of revenue from resources. At present, revenue from resources is counted for equalization purposes in some provinces, but is effectively excluded in others. Resource revenue is counted in the revenue base in the reference provinces (which, under the current six-province standard, do not include Alberta). This creates both equity and feasibility problems. In principle, it is difficult to justify including resource revenue in some provinces but not in others. But consistent treatment does not fully resolve the equity arguments. Including resource revenue creates the situation in which resource revenue in “have-not” provinces is seen to have been “clawed back” by the federal government through the equalization program. Excluding resource revenue cre-

ates another set of equity issues, in that “have” provinces that do not enjoy a significant resource industry tax base could find themselves with lower revenues than “have-not” provinces with significant resource tax bases.

Including resource revenue also raises issues of affordability and equity. Equalization is not a national program; it is a federal program. Accordingly, the revenue base from which equalization is funded is the federal revenue base. Since the federal government does not tax resources directly, including resource revenue in the calculation of entitlements to equalization would lead to the federal government having to generate revenue from tax bases unrelated to resources in order to compensate provinces with relatively low levels of resource revenue. High resource revenues drive up the equalization target and therefore the total cost of the equalization program. That cost must be funded from taxes on bases other than resources, nearly 70% of which come from provinces whose economies are not benefiting directly from the oil price boom.

Even if resources were not included in the equalization formula, higher resource revenues will have an indirect impact on the program. To the extent that resource-rich provinces use their resource-related fiscal capacity to reduce taxes in other areas, higher resource revenues will lead to reductions in average tax rates, thereby reducing the equalization target.

Equalization based on the cost of providing a basket of provincial public services, rather than on revenue, would address the problem of affordability. It would also make it unnecessary for the federal government to use transparent fiddles of the system, such as using six provinces rather than all ten as the standard for the program.

The equity issue is not so easily resolved. The root of the problem is that revenue from natural resources is not current revenue in the sense that income and sales tax revenue is current revenue. It is revenue derived from the sale of an asset. That makes resource revenue highly variable and

potentially insecure, since it is tied to the economic life of the underlying assets.

Conceptually, this points toward a more nuanced approach to the treatment of resource revenue in equalization. One approach might be to address the issue of fluctuations in resource revenue directly by using an averaging formula to measure resource revenue over an extended period of time. Another might be to base the treatment of resource revenue on a test that combines income/expense and asset/liability considerations. For example, resource revenue could be excluded from equalization to the extent that it is used to pay down liabilities to a level defined in relation to a national liability standard.

It has also been suggested that resource revenues be dealt with through a separate system in which provincial resource revenues would be pooled among the provincial governments.¹⁴ Since this suggestion could only be implemented through a consensus among the provinces under which resource-rich provinces agree to transfer funds to resource-poor provinces, its practical value is limited.

The contribution to this debate by the Expert Panel on Equalization and Territorial Formula Financing is a mixed blessing.¹⁵ In recommending that the program be based on a 10-province standard and driven by a uniformly-applied formula, it calls for a shift away from the “let’s make a deal” policymaking that dominated equalization policy in the period after 1995. It also rejects design fiddles from the 1980s and 1990s which were intended to maintain the fiction that the basic program was unchanged while reducing its impact on the federal budget. Both suggestions would be substantial advances over the current system.

However, two other key recommendations will do little to advance the credibility of the system and threaten to derail the debate into a zero-sum game between the provinces that benefit from one recommendation or the other and the provinces whose citizens will be called

upon to pay the net additional costs. The report rejects any departure from the program's focus on equalizing fiscal capacity without reference either to standards of public services or to the costs of providing those services. As a result, the debate will inevitably be about money for provinces rather than the guarantee of an acceptable standard of public services for Canadians, which is what the program is supposed to be about. Add to that the report's preoccupation with the treatment of resource revenue in the formula, and the recipe is in place for a full-out squabble among provinces which will be resolved — as usual — based on the federal government's calculation of its political interest.

The emphasis on resources complicates matters in a number of ways. First, as everyone in Canada found out virtually the instant it came out, it purports to undo the special arrangements made after 1995 for Newfoundland and Labrador and Nova Scotia. Second, because the distribution of equalization funding among have-not provinces is quite different depending on whether and to what extent resource revenue is included, it sets the terms quite explicitly for the zero sum debate referred to above. And third, because the report backs away from establishing a standard based on services rather than revenue, it entrenches a scenario under which the total costs of the program will be driven by expanding resource revenues in a small number of provinces while its costs are paid from federal tax bases that do not include resources and whose revenue is generated from the citizens of provinces that do not have substantial resource revenues themselves.

Protecting provincial fiscal capacity

Canadians are mobile. Taxpayers are mobile. And, even when taxpayers are not mobile, to varying degrees tax bases may be. Tax base mobility provides fertile ground for lowest-common-denominator tax competition to flourish. It creates

the fiscal prisoner's dilemma referred to earlier in this paper. Each province operates in an environment in which tax cuts are rewarded and refusing to play the tax cut game is penalized, while at the same time all provinces collectively would be better off — and indeed we would not be facing the current fiscal squeeze — if they could all agree not to play the tax cut game.

This is not to say that provinces should be prevented from choosing to reduce the size of government in their jurisdiction, if they have the support of their electorate in doing so. But the absence of any mechanism to protect provincial governments from the impact of lowest-common-denominator competition means that provinces that choose to cut services can effectively impose that choice on other provinces.

Again, the data tell a very clear and compelling story. Almost all provinces cut personal and corporate income taxes in the late 1990s and early 2000s. But it is clear from the data that the process was led by Ontario, and followed in varying degrees by the other provinces. For the less affluent provinces, competitive downsizing of tax systems led by wealthier provinces has a double impact. Not only does it create political pressure to reduce their own taxes, but by lowering average tax rates used in the equalization formula, it also puts downward pressure on equalization payments.

There are a number of potential approaches to this problem.

One would be to reallocate tax responsibilities so that those tax bases which are less mobile would be assigned to the provinces while tax bases which are more mobile and more difficult to defend against avoidance would be assigned to the federal government. This is precisely the approach that most Canadian provinces take with respect to financing local government. Property taxes and user fees — the dominant sources of revenue for local governments — have the virtue of being difficult to avoid.

Tax base realignment was one of the central recommendations of the Rowell-Sirois Report of 1940. A similar idea was proposed in the Carter Commission on taxation in the 1960s, which recommended that the federal government assume responsibility for corporate income taxation, coordinate and collect personal income taxes for both orders of government, and cede responsibility for sales taxes to the provinces.

One problem with this approach is that it implicitly assumes that expenditure responsibilities will match the fiscal capacity of “appropriate revenue sources.” Just such a mismatch lies at the root of the issue of local government finance across the country. Depending on how responsibilities ended up being divided, trading of tax jurisdiction might create a situation of constitutional fiscal imbalance as opposed to the current political fiscal imbalance.

Another problem is that jurisdictional division of tax responsibilities is not a complete answer to the problem of lowest-common-denominator competition at the provincial level. While it may lessen the economic pressure for competitive tax reductions, it will do nothing to ease the political pressure to keep up with the race to the bottom.

As a result, the similar-sounding idea of transferring a major revenue source from the federal government to the provinces as a “solution” to fiscal imbalance could actually make matters worse. This idea has surfaced most recently in a publication of the Canadian Council of Chief Executives, a major lobby group created to promote the interests of big business in Canada. In the name of solving a problem — an imbalance of taxation powers between the federal and provincial governments — that does not exist, it would take a real problem — downward pressure on provincial fiscal capacity from lowest-common-denominator tax competition — and make it much worse.

It would simultaneously raise the stakes in the inter-provincial tax competition that is at

the root of the issue and reduce the fiscal capacity of the federal government to assist in offsetting the problem. Its only certain outcomes are a reduction in the federal government’s ability to lead change in programs under provincial jurisdiction, and a reduction in the fiscal capacity of government to fund public services — which, of course, is the whole point from the CCCÉ’s perspective.

Another approach would be to adopt an inter-provincial tax treaty that would set floors below which provincial governments could not lower taxes on selected mobile tax bases. The European Union already has such agreements dealing with value added taxes, and has been working — unsuccessfully — for many years on a similar treaty dealing with corporate taxation. Such an approach would preserve these taxes as provincial revenue sources, but would protect provincial fiscal capacity by preventing them from being competed out of existence.

A similar approach — albeit not negotiated — is used in local government finance in most jurisdictions in Canada. In most provinces, local governments are prevented by anti-“bonusing” rules from establishing preferential tax rates for businesses. In addition, provincial governments commonly mandate the relationship between residential and non-residential property tax rates as a way to avoid tax competition.

Such an agreement, however, would be difficult to establish and maintain because it would require ongoing and continuous unanimity among the provinces — a very tall order in Canada.

As an alternative, the federal government could play a direct role in protecting provincial revenue in key highly-mobile tax bases by establishing what might be called “umbrella” taxes. Acting within its sole jurisdiction, the federal government would establish national tax systems in the tax bases most vulnerable to competitive fiscal capacity reduction and/or tax evasion and avoidance by individual taxpayers.

In the income tax system, for example, the federal government would establish a tax design and rate structure that would apply uniformly across the country. The structure would permit the deduction from federal taxes of provincial taxes paid, up to a maximum that would be specified in the system.

This would have the effect of protecting from competition provincial revenue from the tax up to the maximum deduction, since provinces would have nothing to gain by reducing their taxes below the deduction permitted in the federal tax. And nothing would prevent provinces from increasing their taxes above that deductible amount.

In corporate income taxation, for example, the federal government would set a national tax rate of (say) 36%. Provincial taxes up to 15% would be deductible from federal corporate income taxes payable. Provinces could levy corporate taxes at the 15% rate without fear of being undercut by competition from other provinces, because there would be nothing to be gained by doing so.

In addition to protecting provinces from the negative effect of tax competition on their fiscal capacity, this approach would have the added advantage of improving the effectiveness of tax administration in Canada by giving the federal government a key role in defending mobile tax bases against evasion and avoidance.

An approach like this has been used in the United States to protect state revenue from estate taxes and succession duties. Federal taxes permit the deduction of state taxes, thereby eliminating much of the political benefit to a state government from reducing or eliminating the tax.

Interestingly, the precise opposite of this happened with respect to estate taxes in Canada. When the Government of Canada eliminated estate taxes at the national level in the early 1970s, some provinces attempted to continue with their taxes at the provincial level. One-by-one, provincial governments were forced to eliminate their

estate taxes, the last being Quebec, which eliminated its estate tax in the mid-1980s.

Sustaining local government

Local government is the one example of real fiscal imbalance in Canada's governmental structure. Local governments have no control over the responsibilities assigned to them and are limited by provincial legislation essentially to user fees and taxes on real property as revenue sources. Furthermore, in varying degrees there are mismatches between revenue sources and program responsibilities at the local level in every province that tend to put downward pressure on revenue and exacerbate the fiscal problems.

The basic mismatch applies generally to local governments. Unlike income and sales taxes, whose bases expand automatically with costs in the economy, the property tax and user tax bases do not. This means that, to keep up with increased costs, local governments are required to raise tax rates annually.

In provinces in which local governments have been assigned responsibilities which bear no economic relationship at all to the property tax base, those mismatches further exacerbate problems. For example, in Ontario, local governments pay all or part of the cost of social assistance benefits, social housing and ambulance services despite having absolutely no control over the rules that govern the delivery of the service.

Part of the answer is to address the most obvious of the mismatches of revenue and responsibility at the local level.

But, even if the obvious policy mismatches are addressed — and particularly if they are not — local governments need access to a broader range of revenue sources than are currently available to them. As the data show, measured by direct program delivery responsibility — i.e., excluding transfer payments to governments, individuals and businesses — local governments

collectively in Canada are larger than the federal government.

While it would seem obvious that local governments need access to a broader range of revenue sources — one that is more responsible to changes in the economy than the current local revenue base — it is much tougher to imagine how a new broader tax regime would be implemented. Local governments are far more vulnerable to tax rate competition than provincial governments.

If additional revenue is to be made available to local governments, it must be done so in a way that does not open the floodgates to more tax competition and avoidance.

The traditional approach taken by most provincial governments in Canada has been to supplement property tax revenue with general or special-purpose grants. The major problem with grants as a local revenue source is that they are provided entirely at the year-to-year discretion of provincial governments. Both the aggregate data and the province-by-province data on provincial transfer payments to local governments underline how easily and quickly provincial governments were able to pass federal government transfer payment cuts in the 1990s down to local governments.

One variant of the grants approach is to earmark revenue from a particular tax base for general transfers to municipalities. The federal “new deal for cities” policy that transfers 2 cents per litre of the gasoline tax to local governments is one example of an earmarked transfer. The amount transferred to any individual local government bears no relationship to the amount of gasoline tax collected within its borders, or within the province, but the global amount available for transfer under the formula is pegged at 2 cents of the federal 10-cents-per-litre gasoline tax. From the perspective of the individual local government, it is no different from any other transfer payment program: the amount received depends on the transfer payment formula. The difference

is that the linkage to the gas tax gives the appearance of a firmer guarantee of the transfer payment’s continued availability.

The primary obstacle to taking the next step and providing local governments with direct access to tax bases other than real property is the risk either that tax competition will limit take-up or that differences in take-up will create incentives for tax avoidance. One way to avoid the take-up problem would be to transfer tax points to local governments through umbrella tax mechanisms like those discussed above. In this scenario, specified points of either federal or provincial taxes could be made available to local governments on an opt-in basis. Where local governments did not opt in, the revenue would flow back to the taxing jurisdiction — either the federal or provincial government. One variant might be to adopt a matching system. For example, access to provincial or federal sales tax revenue might be made conditional on the local government setting and taking political responsibility for a local incremental sales tax.

Another way to reduce the tax competition problem would be to make the increased funding available on a broader regional basis, or to provide much more limited access to a variety of different tax bases.

Reliable fiscal partnership

The data for the period 1961 to 2005 tend to support the provinces’ claim that the federal government has not been a reliable fiscal partner, either in areas of provincial jurisdiction or in areas of overlapping jurisdiction. Data on federal transfers show that, after an initial boost in transfers in the late 1960s and early 1970s, federal governments turned the heavy lifting in the development of the modern Canadian public economy over to the provinces. After that period of growth in federal transfers, it was growth in provincial own-source revenue that fuelled the development of the Canadian public sector. And, when

it came to addressing its deficit problem in the 1990s, the federal government acted unilaterally to pass the hot potato on to the provinces.

In the major area of shared jurisdiction, income security, the federal government was able to cut Employment Insurance benefits but not the problems EI was supposed to be addressing. By default, those problems were passed on to the provinces.

In more recent experience, provinces are entitled to be more than a little unhappy to see funding for child care — a new national program in provincial jurisdiction with long-term fiscal implications — eliminated after only a year of operation.

The “solution” of ending shared cost programs in provincial jurisdiction or making all funding unconditional is convenient to conservatives who would like to see the public sector shrink and to radical decentralists who would like to see the federal government marginalized. But it is not a solution for the vast majority of Canadians, who support the idea of national projects. And it is not a solution for Canada in an international environment that demands coherence in the policy areas under greatest decentralist pressure.

If the federal government is to become a reliable fiscal partner in national projects within provincial jurisdiction, two fundamental problems must be addressed. First, the federal government is a government, not a bank. There cannot be, and indeed should not be, an expectation that programs established by one government should bind forever all future governments. With respect to child care, for example, the Harper Conservative party made it clear in the 2006 election campaign that it intended to take a different approach to child care funding than that taken by the previous government. One may disagree with the policy, and one may legitimately question an electoral system that gives a party that received far less than 50% of the vote the power to overturn policies supported by all of the other parties, but in principle it is difficult

to argue in a democracy that governments should not be permitted to change policies.

On the other hand, from the provinces’ perspective, if the expectation is that funding can be yanked at any time without meaningful notice, no reasonable province would be prepared to make commitments to shared-cost programs with longer-term implications. A middle ground must be found: perhaps through a requirement for an extended period of notice in advance of material reductions in federal transfer payment programs. A notice requirement of five years might be appropriate, in that for practical purposes a government seeking to cancel or substantially cut back on a major transfer payment program would have to be re-elected to implement the cut.

The second fundamental problem concerns the political viability of ongoing federal government transfer payment programs in areas of provincial jurisdiction. The practical reality is that governments are reluctant to take actions for which they pay a political price but get little or no political credit. For new programs, this is not a particularly serious problem. The publicity surrounding the development, promotion, and implementation of a new initiative provides enough political credit to go around. The problem is with the funding of established programs. Because these programs are delivered by the government receiving the transfer payment funding, that government gets the political credit associated with program delivery. The obverse is also true, as the behaviour of various federal governments over the past three decades makes clear. Once programs are established and running, transfer payments can be reduced with little political visibility. For example, under Paul Martin’s leadership as Minister of Finance in the mid-1990s, established program financing was abolished and replaced by much lower comprehensive transfer payments. The impact on programs was substantial, but it was experienced in program delivery, at the provincial level.

The strategy of the governments of the Chrétien-Martin era was to shift towards transfers directly to individual Canadians, largely through the personal income tax system.

The key both to sustaining the commitment of the federal government to reliable fiscal partnerships and to continuing the development of national political projects is to devise programs that allow explicitly for the federal government to earn political credit for its involvement. To ignore that political reality — to treat the federal government as if it were a bank whose only function is to provide no-strings-attached funding to the provinces — cannot be a viable long-term basis for fiscal federalism.

One approach may be to design cost-sharing programs to build in an explicit and visible federal government involvement. For example, the offer by the provinces prior to the most recent round of health care funding talks of a direct federal role in drug insurance was an important missed opportunity. In post-secondary education, one could envisage a direct federal role in funding college- and university-based research and in student financial support. Recently, interest has been expressed in a broader role for the federal government in income security programming, building on the federal government's current responsibilities for employment insurance and old age security and the foundation of the national child benefit.¹⁶

National public policy projects

Governments may be required to respect constitutional limitations or to find creative ways to work around them, but the people who elect them, and the political forces they set in motion, are not. In spite of the best efforts of provincial governments to defend their jurisdiction, Canadians have not lost their appetite for national political projects. Canadian federalism demands credible mechanisms through which national public policy projects can play out.

There is no magic formula for success in developing national projects. Their origins are, almost by definition, political rather than constitutional or administrative. Constitutional limitations and the realities of federal-provincial relations mean that national projects will always pose significant political challenges. Their success will always require extraordinary political will.

But it is simply unacceptable to suggest that there can and should be no national political projects in Canada unless they are entirely within the jurisdiction of the federal government. Canadians will have no patience or respect for opposition to national projects that falls back on constitutional niceties as a substitute for debate on merits.

Funding for public infrastructure clearly qualifies as a national project. As the data show, the weakness of Canada's investment in public capital is a problem of long standing. In particular, it is not a phenomenon that emerged for the first time in the deficit-obsessed mid-1980s.

Despite the fact that it now has jurisdiction over only a small fraction of public infrastructure in Canada, the federal government has a key role to play in a national infrastructure funding strategy. The federal government is able to finance infrastructure borrowing at interest rates 25 to 75 basis points lower than rates paid by provincial governments, at least 100 basis points lower than rates paid by local governments, and at least 250 basis points lower than the rates paid by public private partnership (P3) projects.¹⁷ It does not make economic sense to refrain from using the federal government's borrowing power as the engine of Canadian infrastructure renewal.

Furthermore, infrastructure is one area in which there is a tradition going back for many decades of federal government involvement both with provincial governments and directly with municipal governments.

The problems of transfer payment accounting and deficit phobia can easily be avoided by creating a series of federal-provincial infrastructure

funding agencies — one for each province — that would borrow the funds necessary for the funding of public infrastructure projects and lease the projects back to the appropriate agency, playing a role that in the private sector is commonly played by banks.

Borrowing costs would be kept to a minimum. Accounting rules will permit the agency that is borrowing the money to amortize the costs. And the budgetary cost would be spread out over the life of the assets.

Notes

1 In the classic prisoner's dilemma, each of two prisoners is presented with three scenarios.

- If you confess and implicate the other prisoner while the other prisoner remains silent, you will be released and the other will be convicted and receive the maximum sentence.
- If you remain silent while the other prisoner confesses, you will receive the maximum sentence and the other prisoner will go free.
- If both you and the other prisoner confess, you will both be convicted and receive less than the maximum penalty.
- And if both of you remain silent, you will be subject only to a minor penalty.

The "prisoner's dilemma" is that, while each prisoner's individual interest would lead him or her to confess, both would be better off if they both remained silent. Translated to the world of inter-provincial tax competition, the prisoner's dilemma suggests that all provinces would be better off both economically and politically if they did not compete to reduce taxes, but each

province thinks it can advance its own interests by cutting its taxes.

2 Source: Statistics Canada, Government Sector Accounts, CANSIM #381-000.

3 Program and capital spending is estimated from National Accounts data as the sum of: current spending on goods and services net of capital consumption allowances; transfers to persons, businesses and non-residents; and non-financial capital acquisition. It does not include interest payments on public debt. Inter-governmental transfers are netted out in the consolidation of data for the three orders of government.

4 The 2005 spike in federal program funding from own-source revenue as a share of GDP and the drop in provincial program funding from own-source revenue as a share of GDP are both attributable to the front-end loading of federal transfer payments arising from the 2004 health accord and other federal-provincial agreements and changes in the timing of other transfer payments. This is evident in the corresponding spike in Chart 10 in net federal government transfers to provincial governments.

5 For a coherent expression of that prevailing policy objective, see the Report of the Technical Committee on Business Taxation, Department of Finance, Government of Canada 1998. The Committee, chaired by tax economist Jack Mintz, recommended the removal of a wide range of tax-delivered subsidies from the corporate income tax. Since then, the trend towards tax simplification that dominated Canadian tax policy for 30 years has been reversed as both federal and provincial governments resort to the tax system for the delivery of subsidies to business.

6 The extraordinary size of the decline in own-source revenue as a share of GDP in Newfoundland and Labrador is attributable largely to the combined effect of the shift in the structure of GDP in that province towards offshore oil and gas and the fact that the province's revenue structure does not appear to be well-suited to capturing revenue from that source.

7 Marc Lee, Tax Cuts and the "Fiscal Imbalance," *CCPA B.C.*, May 2006.

8 Projections for 2004–5 and later for Ontario have been adjusted downwards to reflect the fact that corporate tax cuts scheduled by the Harris Government in the early 2000s were not implemented by the successor McGuinty Government.

9 Report of the Task Force on Modernizing Income Security for Working Age Adults (MISWAA), Toronto City Summit Alliance and St. Christopher House, May 2006.

10 From Bronze to Gold: A Blueprint for Canadian Leadership in a Transforming World, Canadian Council of Chief Executives, February 2006.

11 "Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance", report of the Advisory Panel on Fiscal Imbalance, Council of the Federation, March 2006, Robert Gagné and Janice Gross Stein, co-chairs.

12 Boadway, Robin "How well is the equalization system reducing fiscal disparities?", prepared for the Government of Prince Edward Island, October 2004.

13 Courchene, Thomas "Vertical and Horizontal Imbalances: an Ontario Perspective", presentation to the Standing Committee on Finance and Economic Affairs, May 4, 2005.

14 See, for example, Courchene, Thomas "Resource Revenues and Equalization" Institute for Research on Public Policy, IRPP Working Paper Series no. 2005–4 (Revised). p. 28 ff.

15 "Achieving a National Purpose: Putting Equalization Back on Track", Expert Panel on Equalization and Territorial Formula Financing, Finance Canada, May 2006.

16 The Task Force on Modernization of Income Security for Working Age Adults (MISWAA) in its May 2006 report recommended both a reinvigoration of the employment insurance system, strengthening of the national child benefit and the introduction of a comprehensive income security program for working age adults.

17 For a more complete discussion of the issues in public infrastructure funding see Hugh Mackenzie, "Financing Canada's Hospitals: Public Alternatives to P3s", Ontario Health Coalition, October 2004.



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