



The Art of the Impossible

Fiscal Federalism and Fiscal Balance in Canada

By Hugh Mackenzie

IF ITS FIRST SIX MONTHS are any indication, 2006 will turn out to be the year of fiscal imbalance in Canada. The provincial heavyweights are in full cry. Dalton McGuinty's \$23 billion gap campaign is moving full steam ahead. Quebec's definition of fiscal imbalance has repeatedly been the theme of Premier Jean Charest's frequent meetings with Prime Minister Harper. And Ralph Klein can be counted on to ratchet up the rhetoric — on opposite sides — whenever anyone breathes the word “resources” in the equalization debate.

The debate has had no shortage of third party helpers. The Canadian Council of Chief Executives, the Council of the Federation and the Expert Panel on Equalization and Territorial Formula Financing — all have weighed in with reports related to the issue.

Overlaid on this very active background is a minority Conservative federal government for

which the fiscal imbalance issue may be one of the keys to the additional seats it needs to win a majority.

The purpose of this paper is to confuse this overheated and often misleading debate with some facts by exploring the data that describe the development and financing of public services in Canada. Using Statistics Canada's 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 econo-

my through the exercise of the federal spending power in areas of provincial jurisdiction.

As the data presented in chart 1 show, however, 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.

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

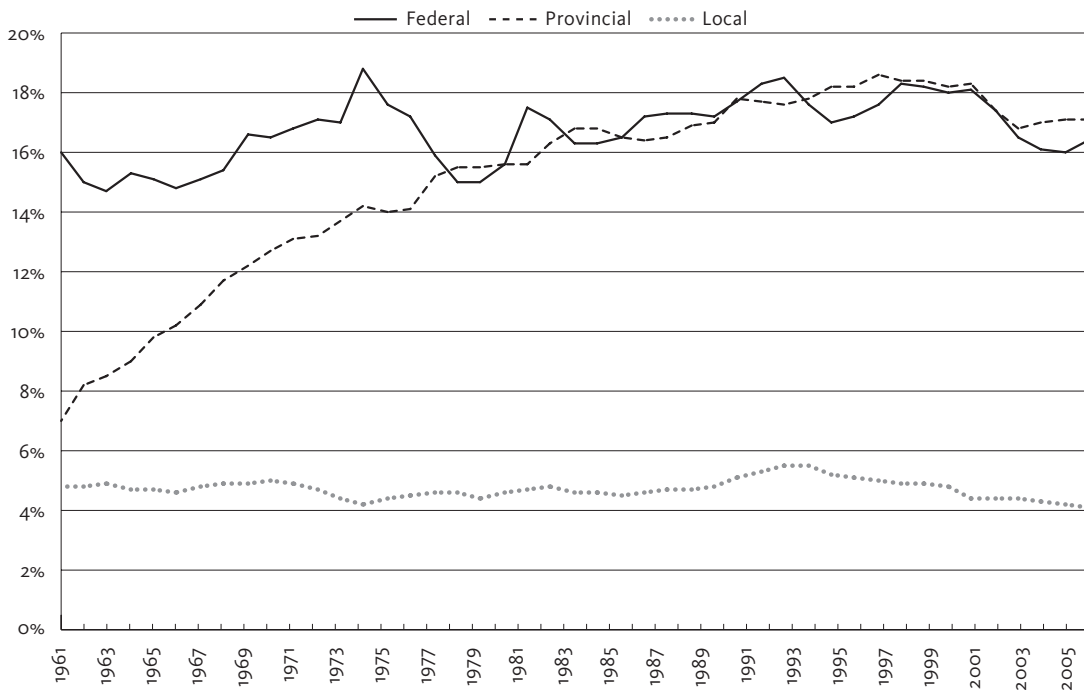
themselves from those cuts by reducing their own transfer payments to local governments. And it is noteworthy that the recent increases in federal transfers to the provinces have not been matched by corresponding increases in provincial transfers to local governments.

Chart 2 demonstrates how closely provincial-local transfers have tracked changes in federal-provincial transfers.

What this means is that cuts in federal government transfers are not primarily responsible for the fiscal pressures faced by provincial governments. Provincial governments' responses to those cuts, however, are responsible for the fiscal predicament faced by local governments in Canada.

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

CHART 1 Own-source revenue, % of GDP, 1961–2005



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

Chart 3 shows taxation revenue as a share of GDP for the ten provinces combined.

This trend is confirmed both in data prepared by the Finance Canada in 2002 and in a recent report analysis by the BC office of the Canadian Centre for Policy Alternatives. The Finance Canada data show that the combined effect of the tax cuts introduced by provincial governments since 1995 is a reduction in collective provincial fiscal capacity by more than \$30 billion annually.

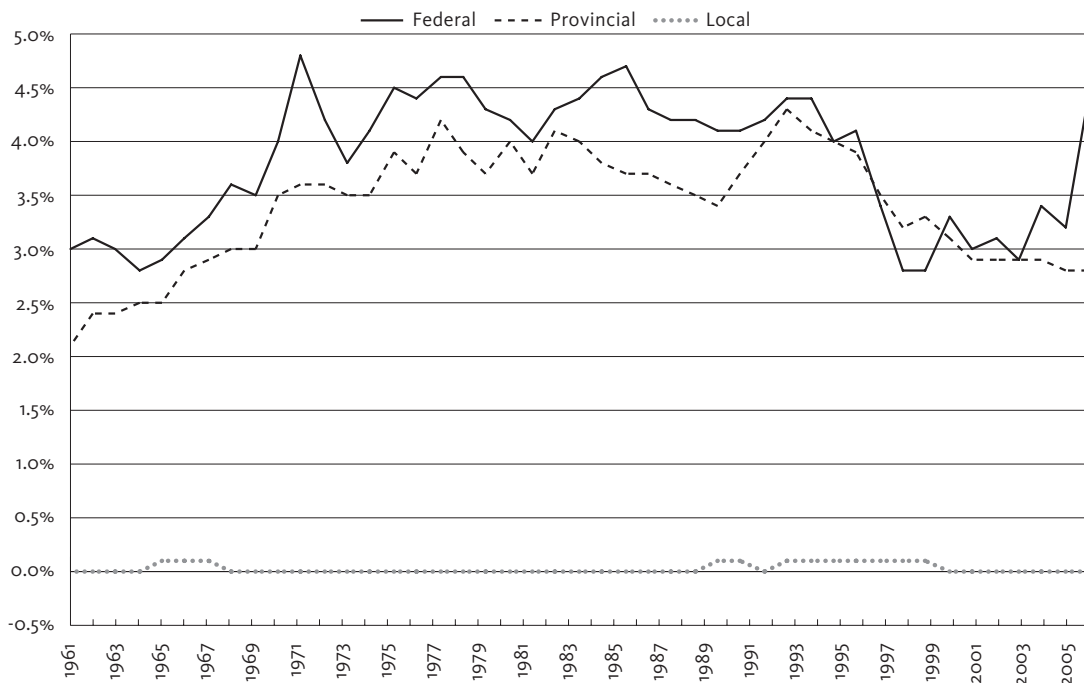
Fiscal imbalance, defined as a shortfall of revenue raising capacity relative to spending responsibility, is largely a problem inflicted by the provinces on themselves through tax competition. The data suggest that the real fiscal imbalance is between local governments and the federal and

provincial governments, not between provincial governments and the federal government.

None of the proposals for change in federal-provincial fiscal relationships is responsive to the underlying causes of the fiscal difficulties currently being experienced by provincial governments. The report of the Advisory Panel to the Council of the Federation acknowledges the problem of interprovincial tax competition, and then proceeds to ignore it in its recommendations. The report of the Canadian Council of Chief Executives would make the problem worse by shifting more taxing power to the provinces without establishing any mechanism for protecting the fiscal capacity being transferred.

Dalton McGuinty's \$23 billion gap campaign confuses the issue by including differences in federal government revenue and expenditure that are related not to federal policies but rather to differences in Ontario's income, wealth and demographic characteristics compared with the rest of Canada. It muddies the debate, fostering

CHART 2 Intergovernmental transfers, % of GDP, 1961–2005



the impression that the Ontario government, rather than Ontarians as citizens of Canada, are paying for programs like fiscal equalization. Most important, it follows the general pattern in ignoring the role that ill-advised Ontario tax cuts in the 1990s played in creating Ontario's current fiscal problems.

The fact that the federal government is not primarily responsible for the fiscal pressures that have given rise to the debate over fiscal imbalance does not, however, mean that the federal government has no role to play in addressing the problem — for a number of reasons.

First, by setting in motion the fiscal pressures that led provincial governments to take the path of least resistance and cut their transfer payments to local governments, the federal government is indirectly responsible for the fiscal squeeze faced by local governments.

Second, the fact that competition among provincial governments to lower taxes in the 1990s is significantly responsible for the fiscal pressures they now face does not mean that provincial

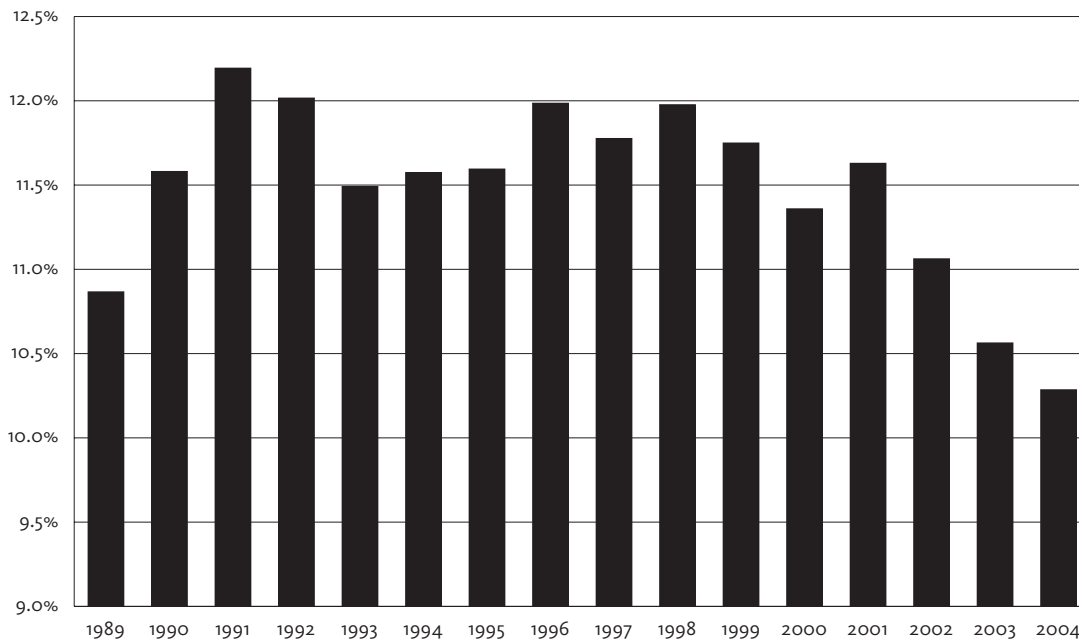
governments are able, on their own, to get out of the mess that they have collectively created. Provincial governments are caught in a kind of political/fiscal prisoners' dilemma in which no individual province has an incentive to take an action — protecting revenue — which would benefit all provinces if they all did it. There is clearly a role for the federal government here.

Third, addressing the weaknesses in the fiscal equalization program — a federal program for which the federal government has a constitutional responsibility — will be critical to any solution to the provincial fiscal capacity problem.

Finally, to the extent that provincial fiscal capacity problems undermine the ability of provincial governments to deliver services that are central to national political projects, federal government action is a political imperative.

The fact that the data point towards a role for the federal government in addressing issues of provincial fiscal capacity does not, however, mean that we are back where we started from. Just as the data run counter to commonly-held

CHART 3 Taxation revenue as % of GDP, 10 provinces, 1989–2004



beliefs about the current situation, they also have implications for our policy response.

Local government finance must be part of the debate over sustaining sufficient fiscal capacity to meet our public policy needs.

We need to ensure that local governments have the resources they need to fulfill their service delivery responsibilities. Although much of the discussion has focused on new revenue sources for local governments, simply ensuring that local governments have exclusive access to the property tax base and realigning funding responsibilities to provide alternative revenue sources for services not appropriately funded from property taxes would make a substantial difference. A coherent and reliable national funding framework for public infrastructure would also serve to alleviate financial pressures on local governments.

The answer to provincial fiscal capacity problems is not simply to increase federal government transfer payments. If the federal government were to take on that task of offsetting provincial tax cuts, it would require levels of federal Government transfers as a share of GDP that are unprecedented in our history.

Similarly, it is not by itself an answer to provincial fiscal capacity problems to transfer tax points from the federal government to provincial governments. In the absence of other measures to support the efforts of provincial governments to defend their tax bases, a transfer of tax points would simply expand the field of lowest-common-denominator tax competition among provinces. It would invite a re-run of the events of the 1990s which led to a reduction in total fiscal capacity in Canada. A transfer of tax points may help to disguise federal government transfers, but it does not deal with the political/fiscal problem that is the real threat to fiscal capacity.

The creation of new national mechanisms to protect provincial fiscal capacity from destructive tax competition is fundamental to any so-

lution to the fiscal capacity problem. One approach would be to reassign tax bases, so that provinces generate a larger proportion of their revenue from taxes that can be better defended at the provincial level. Tax responsibility realignment was proposed in the Rowell Sirois report in 1940 and again by the Carter Commission in the 1960s, but was a political non-starter then and is likely even more so today.

Another approach would be to establish a Canadian internal tax treaty to remove inter-provincial tax competition in areas where the tax base is mobile out of the equation along the lines of the agreements in place and under development in the European Union.

A third approach, outlined in the paper, would be for the federal government to act directly to protect provincial income tax revenue in particular by levying national income taxes at both the personal and corporate level against which provincial taxes, up to a maximum amount, would be credited.

We have to renew our approach to fiscal equalization so that it speaks directly to the objective of ensuring that all Canadians have access to an acceptable standard of public services. The current system, with its ad hoc arrangements and its focus on revenue rather than services, is rapidly losing credibility. The report in May 2006 of the Expert Panel on Equalization and Territorial Formula Financing has been profoundly unhelpful. It dismisses out of hand suggestions that standards of service and the costs of providing that standard be brought explicitly into the formula and instead makes recommendations with respect to the treatment of resource revenue in the formula that guarantees that the debate will continue to be a zero-sum squabble among provincial governments for federal cash — a debate that is completely disconnected from the purpose of the equalization program itself; a debate from which most Canadians feel themselves excluded.

Fiscal arrangements must allow for a role for the federal government as the facilitator of national political projects, from sustaining Medicare to developing a coherent early childhood education system to providing the financing needed

to renew our public infrastructure. Provincial governments, protecting their jurisdictional turf, may be unprepared to recognize this need, but Canadians, through their support for initiatives like the Canada Health Act, beg to differ.



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