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Tax Cuts and the "Fiscal Imbalance"

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Summary

The term "fiscal imbalance" is a loaded one, a pejorative used to imply that balance must be restored to Canadian federalism. To date, the issue has revolved around provinces seeking more money from Ottawa. Moving forward, the waters of the alleged "fiscal imbalance" are muddy — it means different things to different people due to federal-provincial squabbles, party politics, academic analyses, and the somewhat blurry filter of the media.

This study is concerned about more radical proposals to shift responsibilities to the provinces in areas where the national interest necessitates a federal presence. With the small-government Conservatives seeking to appease separatists in Quebec, the ingredients are on the table for a major restructuring of the Canadian federation.

Solving the "fiscal imbalance" runs the risk of becoming a downsizing exercise for the federal government. Some prominent and influential commentators, including a Quebec government commission, the C.D. Howe Institute, and the Canadian Council of Chief Executives, are calling for radical change: massive federal tax cuts, paid for by eliminating the major transfers to the provinces for social programs, the Canada Health Transfer (CHT), and the Canada Social Transfer (CST).

But a careful look at Canadian history and other federations worldwide suggests that Canada does not have deep structural problems that need to be fixed. It is not obvious that the present situation constitutes an "imbalance," nor that "empowering the provinces" is the answer in a federation that is already one of the most decentralized in the world:

- Provincial governments have almost identical powers of taxation as the federal government.
- Provincial governments have exclusive domain to draw royalties from natural resources, including oil and gas, timber, and minerals. Indeed, different revenue-raising capacities of provincial governments arising from resource royalties does represent a *real imbalance* that should be, but is not, currently on the table.
- Other provincial revenue bases include lotteries, gaming and liquor profits, and

property taxes — each of which has been growing in recent years.

What is being called an imbalance is, in fact, a relatively normal state of affairs in federal systems. Canada has used federal taxes to fund transfers to the provinces in pursuit of national objectives. A number of benefits result, including regional development, greater tax harmonization, the efficiency gains of a single administrative system, and common standards and levels of service.

History demonstrates the importance of a strong federal role in the development and expansion of social programs and the achievement of national standards. For example, the federal government played an essential role in the battle over hospital user-fees and extra-billing by doctors in the early 1980s.

The problem with fiscal federalism over the past couple of decades has been the adverse consequences of federal withdrawals from the "cooperative federalism" model, plus increased tax competition among the provinces.

Provinces have rightly criticized the federal government for cuts to transfer payments in the mid-1990s, amounting to approximately $6 billion per year. However, in response to provincial lobbying, these transfers have recovered most of the lost ground.

To the extent that provincial finances are in bad shape, provincial governments deserve much of the blame due to tax cuts over the past decade:

- Using Statistics Canada's Social Planning Simulation Database and Model (SPSD/M), the loss to provincial treasuries of personal tax cuts is estimated to be $23.4 billion in 2005 ($18.4 billion adjusted for inflation).
- An analysis by the Privy Council Office estimated the cost to be $30 billion when corporate tax cuts were included.
- These amounts dwarf the original loss of federal transfers in the mid-1990s.

Proposals that would see the federal government cut its taxes so that provinces can raise their own taxes may well be a mirage, and would actually worsen regional inequality in Canada. Smaller and poorer provinces would be the losers because they would have to raise their taxes much more to provide public services equivalent to richer provinces.

Moreover, in a climate of tax competition, provinces will be disinclined to raise taxes if some provinces, like Alberta, can rely on underlying budget surpluses arising from resource royalties without needing to raise their taxes.

Rather than decentralization, this study recommends uploading of some provincial responsibilities that would benefit from a national approach to the federal government. These include Pharmacare, social assistance and labour market training, areas where the federal government could reinforce its existing activities and programs, and that could benefit from a more coordinated national approach.

If current levels of transfers to the provinces were maintained, uploading would also provide a windfall to the provinces that could be used to reinvest in other provincial programs.

Introduction

For several years running, provincial governments have claimed that there exists a “fiscal imbalance” in the Canadian federation. The federal government, it is argued, is taking in too much money relative to its spending needs, the provinces too little. To date, this has played out as a series of high-level “new deals” that have increased federal transfers to the provinces, mostly in the name of “saving” health care. In an April 2006 report, the Council of the Federation’s Advisory Panel on Fiscal Imbalance, reporting to the Premiers, calls for a further increase in both program-related transfers and equalization transfers.

Provincial governments would, of course, welcome new money from Ottawa, preferably without any strings attached. But it is not clear that the coming round of negotiations over federalism will be more of the same. Prime Minister Harper is promising fundamental change, and the make-up of the new Parliament offers the possibility of more radical alternatives. The Harper Conservatives have made the loosely-defined issue of “fiscal imbalance” one of the federal government’s top priorities. In a pre-budget speech, Harper called for “open federalism” and “autonomy” — defined as “respecting areas of provincial jurisdiction” and “limiting the use of federal spending power.”[1]

A federal discussion paper tabled with the 2006 Budget is coy about the position of the Harper government. On the one hand, it calls for taking “action to refocus federal efforts . . . in core areas of federal responsibility,” such as national defence, foreign affairs, immigration, and national policing, and clarifying “federal and provincial-territorial roles and responsibilities.” But the discussion paper also hedges its bets by calling for “action to lay the foundations for a return to predictable long-term fiscal arrangements in Canada within the coming year,” signaling federal support for transfers for health care, post-secondary education, cities and equalization.[2] The discussion paper is a curious blend of rhetoric arguing that there exists a “fiscal imbalance” with plenty of evidence that there is not (most of which resembles the arguments by the previous Liberal government that there was no “fiscal imbalance”).

Following a round of workshops this summer, First Ministers will roll up their sleeves in Fall 2006 to negotiate the future of fiscal federalism. There are divisions among the provinces about how fiscal relationships might be restructured. Irrespective of the negotiations, there is much the federal government can do unilaterally. Paired with the separatist Bloc Québecois — who are supporting the 2006 Budget and favour decentralization of federal authority to Quebec — the ingredients are on the table for a major shift in federal-provincial relations.

Solving the "fiscal imbalance" runs the risk of becoming a downsizing exercise for the federal government. Some prominent and influential commentators, including a Quebec government commission, the C.D. Howe Institute, and the Canadian Council of Chief Executives, are calling for radical change: massive federal tax cuts, paid for by eliminating the major transfers to the provinces for social programs, the Canada Health Transfer (CHT), and the Canada Social Transfer (CST). The provinces, it is argued, would simply take over the "tax room" the feds give up, and nothing would change from the perspective of the average citizen, except for greater lines of accountability over how public funds are spent.

In the wake of large tax cuts at the provincial level over the past decade, there is little reason to believe that provincial governments will behave this way. Decentralization means that the fight for tax cuts (also known as the fight against social programs) can be won in numerous smaller battles, where provinces are pitted against one another to be the most "competitive." Thus, further decentralization of powers is a good guard against a new national child care program, and is a good way of accelerating the growth of private health care.

So what is this so-called "fiscal imbalance"? Does it really exist? And if so, what should be done about it? The waters of this debate are muddy. The term "fiscal imbalance" means different things to different people because it involves federal-provincial squabbles over money, party politics, academic analyses, and the somewhat blurry filter of the media. As the analysis in this paper will show, it is not clear that the present situation constitutes an "imbalance," nor is it obvious that "empowering the provinces" is the answer in a federation that is already highly decentralized.

This paper probes these questions and issues. In the next section we review how we have gotten to this state of affairs, and critically consider what is meant by "fiscal imbalance." We then look at the often-neglected matter of provincial tax cuts, and how they relate to the debate. The paper concludes with a review of the options for moving forward, and recommends a stronger — not weaker — role for the federal government.

Is There a "Fiscal Imbalance"?

The term "fiscal imbalance" is a loaded one, a pejorative implying that the system of federal transfers to the provinces in support of social programs that has been in place since the 1950s is dangerously out of kilter. By framing the issue as an imbalance, it follows that balance must be restored.

What is being called an "imbalance," however, is a relatively normal state of affairs in federal systems because it is generally seen as good policy to have more centralized revenue collection but more decentralized delivery of public services. To this end, senior governments in all federal systems provide transfers to state/provincial governments. Some academics, such as Queen's University's Robin Boadway, call this break between revenue collection and service delivery in federal systems a "fiscal gap," and save the term "imbalance" for situations where the senior government is not providing sufficient transfers to bridge the gap.

The academic literature also distinguishes between a "vertical fiscal imbalance" — to refer to a mismatch between *levels* of government (usually federal-provincial but also provincial-municipal) — and a "horizontal fiscal imbalance" — to refer to differences in the ability to raise revenues among the provinces themselves. The system of federal transfers to the provinces for programs (most recently the CHT and CST) has evolved to address the vertical issue, while the Equalization program has evolved to address the horizontal issue.

The provincial governments have used "fiscal imbalance" to charge that Ottawa's finances are in better shape than those of the provinces, reflected in surpluses federally and deficits provincially. Defined in this manner, there is a "fiscal imbalance" projected into the future because of continued federal surpluses coexisting with a more precarious situation for the provinces. The Advisory Panel on Fiscal Imbalance, in its report for the Council of the Federation, makes this case using estimates by the Conference Board of Canada.[3]

This approach, looking for deficits and surpluses, can be misleading. Five years ago, it was certainly the case that most provincial governments were in deficit while the federal government was in surplus. At the time of writing, as budgets for 2006/07 were being tabled, provincial finances appear in much better shape, with projected surpluses across the board (Ontario is an exception, but its projected deficit is very small relative to its GDP, so it too may end the fiscal year in the black). Comparing federal and provincial deficits/surpluses also neglects to consider levels of debt relative to GDP, with higher federal debt compared to provincial debt.

At least part of the problem is due to fears of deficits and the resulting bias of budgeting practice towards surpluses. The federal government has led the way in the adoption of conservative budgeting practices such as the inclusion of generous forecast allowances and understated revenue projections. While final audited statements show a string of federal surpluses, we should remember that at budget time these were tabled as balanced budgets.

A key aspect of the provincial argument is that provinces have the responsibility for delivering most social programs, the cost of which (health care, in particular) in the future is assumed to outpace the growth of the economy and associated provincial revenue bases. Such estimates are very sensitive to assumptions about growth of public spending — in particular, the assumption that health care spending will outpace economic growth over the next few decades. Health care is most often cited in the provincial arena due to the demographic pressures of an aging population, but the federal government, with primary responsibility for income transfers to seniors, also faces those pressures. And absent from the projections is the fact that governments will react to and shape how these pressures will play out in the future. Recent history demonstrates that the federal government, while protective of its surpluses, has made a policy decision to allocate those surpluses through tax cuts and increased transfers to the provinces.

An important consideration about a "fiscal imbalance" is that provincial governments have almost identical powers of taxation as the federal government, with only a few small differences. This is highly unusual in most federations, where sub-national governments typically have access to poorer-quality tax bases.[4] The federal government has sole access to revenue from taxes on Canadian residents abroad, and from customs duties. The latter were an important source of tax revenue a century ago, but in the world of NAFTA and the WTO, customs duties are quite small, about one-tenth the size of the GST revenues.

Provincial governments, on the other hand, have exclusive domain to draw royalties from natural resources, including oil and gas, timber, and minerals. These revenues are substantial, especially for provinces like Alberta, where resource royalties financed about 40% of provincial expenditures in 2004/05. Other provincial revenue bases are lotteries, gaming, and liquor profits, and property taxes — each of which has been growing in recent years. Because the provinces have access to these revenue bases, they have the capacity to meet their revenue needs (and balance their budgets) by raising taxes, although politically it is much easier to seek additional revenues from the federal government. Provincial governments can also engage in tax competition by cutting their taxes, which will adversely affect their fiscal situations.

As a federation, Canada is already a highly decentralized nation by international standards. A comparative study by Ronald Watts of eleven nations with federal (or quasi-federal) structures found that Canada was the most decentralized federation next to Switzerland, due to the relatively strong taxation powers of provinces and the largely unconditional nature of federal transfers.[5] He points out that all eleven countries studied had some form of "vertical fiscal imbalance" (defined as the sub-national governments' share of total expenditures less the sub-national share of total revenues), and that most countries have larger imbalances than Canada. That is, an imbalance (so defined) is not an aberration to be fixed but a relatively normal state of affairs in federations:

> [I]t has usually been found desirable to allocate the major taxing powers to the central governments because they are closely related to central policies for stabilization, development, and regional redistribution within an economic union, while some of the most expensive expenditure responsibilities, such as health, education and social services have usually been considered best administered and delivered on a state and local basis where differing regional and local circumstances can be taken into account.

Thus, like other federations, we have used federal transfers to meet national objectives. Arguably, a number of benefits flow from this state of affairs, as having more revenues and transfers flow through the federal government serves national purposes, including regional development, greater tax harmonization, the efficiency gains of a single administrative system, and common standards and levels of service.[6] Canada is more than a collection of provincial fiefdoms; there is a national interest that necessitates collective action at the federal level, even if it offends a strict interpretation of the division of powers.

This leads to another definition of "fiscal imbalance" as the use of federal spending power in areas of provincial jurisdiction. For Quebec separatists, the very existence of (non-equalization) transfers is evidence of a "fiscal imbalance," reflecting a belief that federal revenues exceed what is necessary for the federal government to discharge its responsibilities, whereas the provinces do not have enough revenues to meet theirs.

Sorting out the respective roles of federal and provincial governments is constitutional in nature. The impetus for a diminished federal role comes from a strict reading of Sections 91–95 of *The British North America Act* (also known as *The Constitution Act, 1867)*, which set out the division of powers in terms of expenditures and revenues. However, there is also Section 36 of *The Constitution Act, 1982* to be considered:

> (1) Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to
>
> > (a) promoting equal opportunities for the well-being of Canadians;
> >
> > (b) furthering economic development to reduce disparity in opportunities; and
> >
> > (c) providing essential public services of reasonable quality to all Canadians.
>
> (2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

Section 36(2) is recognized as the basis of the Equalization program. Section 36(1) is more controversial. As Robin Boadway points out:

> Section 36(1), however, is the main source of conflict between provincial legislative jurisdiction and federal responsibilities. The commitments listed are all those that are addressed by provincial spending programs, including important social programs in the areas of health, education and welfare. To the extent that these commitments are taken seriously, they imply some federal influence over provincial spending programs.

This paper will not resolve the constitutional conflict. But it is worth emphasizing that claims by provinces (Quebec, in particular) and conservatives that the federal government needs to get out of provincial jurisdiction are not as straightforward as one might be led to believe. Change over time in response to technology and economic forces must also be considered. For example, given the need to respond to the "knowledge-based economy" rather than a traditional resource economy, there may well be a more compelling case for national action in promotion of human capital development today than in decades past.

To summarize, "fiscal imbalance" is in the eye of the beholder. It is used as a pejorative term, but upon analysis is synonymous with Canadian federalism or, more narrowly, the system of federal transfers in support of social programs. The way the term frames the debate implies that radical measures are required to restore balance, but it is not at all clear that this need be the case.

This is not to deny that changes to federalism could be made that meet national economic and social objectives; only that naming the current situation an "imbalance" is not particularly helpful. But before we look to the future of federalism, in the next section we first review the past to give deeper context to the debate.

Fiscal Federalism: A Short History

The modern era of fiscal federalism came about after the Second World War, although its roots go back to the Great Depression.[7] In the early years of Confederation, federal transfers were an important source of revenue for the provinces, but federal transfers were subsequently reduced substantially as a percent of provincial revenues by 1930. The Great Depression, with its adverse impact on provincial finances, prompted a Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission), which set the table for a stronger federal role in economic and social policy. In its 1940 report, the Commission noted that:

> The quality of education and welfare services is no longer a matter of purely provincial and local concern. In Canada today, freedom of movement and equality of opportunity are more important than ever before, and these depend in part on the maintenance of at least minimum national standards for education, public health and care of the indigent. The most economically distressed areas are the ones least capable of supporting these services, and yet are also the ones in which the needs are likely to be greatest.[8]

In the decades after the Second World War, the federal government used its taxation power to set a national social agenda, including cost-shared programs in health care, post-secondary education, and social welfare. Much of Canada's social infrastructure to this day is rooted in a few decades of productive cooperation between federal and provincial governments. Tax-sharing agreements were also reached in this period.

By the 1970s, and the advent of annual budget deficits, the federal government sought to limit its contributions to cost-shared programs, which had budget implications beyond its control. In 1977, the federal government converted half of its transfers into a cash component and the other half into tax points equivalent to 13.5 percentage points of federal personal income tax and one percentage point of corporate income tax.[9] These tax points are still in place today and are rightfully considered to be provincial own-source revenues, although the Chrétien and Martin governments argued that they constituted part of the federal contribution to the provinces.

Within the cash component, a new block transfer, called Established Programs Financing (EPF), was created that ended cost-sharing for health care and post-secondary education. The cash component also included the remaining cost-shared transfer, the Canada Assistance Plan (CAP), for social welfare. This lasted until 1995 when the federal government rolled EPF and CAP into a single block transfer, the Canada Health and Social Transfer (CHST), thereby ending federal cost-sharing of programs with the provinces.[10] The new CHST was reduced in absolute dollar terms by about one-third as part of federal deficit-cutting.

Thus, there are legitimate grounds for the provinces to be concerned about the reliability of the federal government as a partner. The CHST cuts in effect passed federal deficits onto the provinces. Since the late-1990s, however, the federal government has come back to the table, increasing the size of the CHST. In 2004/05, the CHST was split into two transfers, the Canada Health Transfer and the Canada Social Transfer. The Martin government also created smaller conditional transfers for health care waiting lists, medical equipment, and child care.

Because of the differences in provincial income levels and tax bases, the Equalization program emerged in tandem with program-related transfers. Equalization addresses a real imbalance among the provinces in terms of their ability to deliver comparable services, given available revenues. Federal transfers for Equalization began in 1957. At that time, only Ontario did not receive any payments under the program. The formula for determining equalization has been changed several times over the past five decades, and is currently under review by an Expert Panel on Equalization and Territorial Formula Financing, due to report this year. Most proposals to address the "fiscal imbalance" are focused on the CST/CHT rather than Equalization, although there are linkages between these broad transfers.

Recent provincial developments have upped the ante for equalization. In 2004/05, the Alberta government received just shy of $10 billion in resource royalties, equivalent to two-fifths of Alberta's budget expenditures. Without resource royalties, Alberta's $5 billion budget surplus would have been a $5 billion deficit. Thus, royalties have been a powerful tonic for Alberta's fiscal situation. Unlike other provinces, Alberta has not needed to institute a provincial sales tax. Alberta has been able to afford the right's dream of a flat income tax. More recently, Alberta's surpluses have paid down its provincial debt. And, to top it off, Alberta can afford to pay top dollar to attract public service professionals, such as doctors, nurses, and teachers.

What is of concern for the rest of Canada is that Alberta is engaging in what economists call "beggar-thy-neighbour" policies with regard to taxes. As Alberta drives tax rates down, other provinces feel compelled to follow, so that businesses are not lured away to the oil patch. The flip-side is that, to stay "competitive," they risk seriously underfunding public services.

While resource royalties are perhaps the major source of imbalance, the fact that they are not part of the federal revenue base makes it challenging to fully address through equalization. In an ideal world, provinces might pay a percentage of their resource royalties into a national equalization fund that would then be available for redistribution. It is unlikely, to say the least, that Alberta would agree to such a plan.

It is worth recalling that, four decades ago, Alberta was among those who received equalization payments, and that Alberta's fiscal crisis in the 1930s was a key reason why we have an Equalization program. Arguably, these contributions and other federal infrastructure investments helped shape today's Alberta. Sharing the wealth made sense back then, and in the name of national unity, it still makes sense today.

Federal Transfers

History demonstrates the importance of a strong federal role in the development and expansion of social programs and the achievement of national standards. The federal government played an important role in the battle over hospital user-fees and extra-billing by doctors in the early 1980s. It was the potential loss of federal transfers that made the provinces act to end these practices (reflected in the *Canada Health Act)*. Without national standards linked to federal dollars, many of Canada's social programs would likely be a patchwork of programs that vary widely from province to province (as is the case today for programs like child care or health care services not covered by the CHA, such as long-term care and prescription drugs).

Unfortunately, the federal role in setting national standards has been greatly weakened by its own actions — in particular, the end of cost-sharing programs and unilateral cuts to transfer payments. The end of CAP is associated with adverse changes to provincial social assistance programs, which got the short straw after the introduction of the CHST in the mid-1990s.[11]

It is fair to say that the provinces have been successful in campaigning for an increase in federal transfers, although more could be done to restore them to levels seen before 1995. As documented by the House of Commons Standing Committee on Finance, federal program-related transfers to the provinces[12] declined from about 2.6% of GDP between 1981/82 and 1994/95 to 1.4% in the late-1990s. Since 2000/01, transfers have steadily increased as a share of GDP, to 2.1% in 2005/06, a significant recovery but a level still below previous historical amounts. Likewise, equalization transfers fell from an average of 1.1% of GDP between 1981/82 and 1999/00 to 0.8% in 2005/06.[13]

At Canada's current level of GDP, it would require an additional $7.2 billion in CST/CHT transfers to get back to 2.6% of GDP, and an additional $4.3 billion in equalization to get back to 1.1% of GDP. This mirrors, to some extent, the recommendations of the Advisory Panel on Fiscal Imbalance, which may be as close to consensus as possible for the provincial and territorial governments. Based on more complex calculations, the APFI recommends an increase in CHT/CST transfers to the provinces of $4.9 billion per year, plus $5.7 billion in additional equalization.[14]

Provincial Tax Cuts

To the extent that provincial finances are in bad shape, fingers should also be pointed back at the provinces themselves, not just the federal government. Provincial governments zealously pursued tax cuts in the period after cuts to federal transfer payments, thereby exacerbating their fiscal situations. Provincial governments have seen this as a means of enhancing their "competitiveness." This aspect of the "fiscal imbalance" debate has largely been ignored to date.

In recent years, provincial governments have gained greater control over the personal income tax base.[15] They thus have a greater capacity to adjust their tax systems to local needs. This has led to greater differences among provinces, from Alberta's 10% flat income tax to more progressive income tax structures elsewhere. It also means that provinces can use income tax rates to better compete with one another to attract investment or skilled labour.

We can estimate the impact on provincial budgets of tax cuts using Statistics Canada's Social Planning Simulation Database and Model (SPSD/M).[16] Table 1 presents the results for two scenarios. Scenario one asks how much higher provincial revenues would be if provincial tax brackets and credits in 2005 were the same as they were in 1995.[17] The first column shows that provincial governments would have a total of $23.4 billion in additional revenues to meet the needs of their citizens.

Because scenario one does not adjust brackets and credits for inflation, we add an additional scenario that does. This understates the additional tax revenues due to the fact that indexation was only restored to the income tax system for the 2000 tax year; brackets and credits were not indexed between 1986 and 2000. On this basis, provincial governments would have an additional $18.4 billion in revenues.

These estimates are for personal tax cuts only, and does not include corporate tax cuts. An estimate from the Privy Council Office put the loss of tax revenues in 2005/06 due to provincial tax cuts at just over $30 billion.[18] And, while federal transfers have recovered (if not completely), provincial tax cuts represent an ongoing and growing loss of fiscal capacity.

These numbers are substantially larger than the loss of federal transfer revenue over the same period. Thus, provincial governments are responsible for the majority of any imbalances they

TABLE 1 The Cost of Provincial Tax Cuts

	Forgone revenues due to provincial tax cuts (millions of dollars)		Average tax cut this represents (dollars)	
	Scenario 1 1995 tax brackets and credits	**Scenario 2** 1995 tax brackets and credits adjusted for inflation	**Scenario 1**	**Scenario 2**
Newfoundland	113	72	215	137
PEI	24	14	167	99
Nova Scotia	166	76	175	80
New Brunswick	211	151	281	201
Quebec	4,965	3,098	666	416
Ontario	14,025	12,035	1,117	958
Manitoba	142	3	128	3
Saskatchewan	374	258	381	263
Alberta	519	295	163	93
BC	2,852	2,337	666	545
Total	23,392	18,338	733	574

SOURCE Author's calculations using Statistics Canada's Social Planning Simulation Database and Model.

purport to be feeling (results will vary by province), although the revenue impact of tax cuts was, at the time, moderated due to the cyclical impact on budgets of strong economic growth in the late-1990s.

This is not to argue for or against provincial tax cuts *per se*. In some provinces, tax cuts were targeted to low-income earners, while in others high-income earners received a disproportionate share. The point is that, in all provinces (except Manitoba), choices were made that stand in contrast to fiery rhetoric about "fiscal imbalances."

The above analysis casts doubt on proposals that would see the federal government cut its taxes so that provinces can raise their own taxes: this may well be a mirage. The provincial response may be to not raise taxes at all and address any resulting deficits through spending cuts, or to raise taxes by less than the "tax room" provided. In a climate of tax competition, provinces will be disinclined to raise taxes if some provinces, like Alberta, can rely on underlying budget surpluses arising from resource royalties without needing to raise taxes. We now take a closer look at those proposals.

Bad Ideas for Fiscal Federalism

In response to the "fiscal imbalance," some prominent commentators have taken the opportunity to call for more radical measures to "fix" Canadian federalism. These proposals are for unilateral federal income tax cuts and/or GST tax cuts in order to eliminate transfers for CST and CHT. They are based on a fundamentalist interpretation of the division of responsibilities found in the Constitution, backed up with some dubious claims about economic benefits.

The Government of Quebec's Seguin Commission (2002) argued that federal transfers should only be used to fund Equalization and not social programs. It recommended that the federal government eliminate the CST/CHT transfer and turn over the GST to the provinces.[19] The Seguin Commission perspective was recently echoed by the Canadian Council of Chief Executives. They also urged the federal government to eliminate CST/CHT transfers, abolish the GST, and give this "tax room" to the provinces, arguing that this would make provincial governments more accountable for the tax dollars they spend. As a less radical Plan B, the CCCE recommended maintaining current transfers, but tying their growth to that of GST revenues.

In December 2005, the C.D. Howe Institute released an action plan that pays for eliminating the CST/CHT by lowering the GST to 5% (consistent with the federal Conservative platform) and adding personal income tax cuts of three percentage points in each bracket.[20] Provinces would then be able to increase taxes and reform their tax systems as they see fit to meet perceived expenditure needs.

While billed as providing closer lines of accountability, these plans do little to address the democratic deficit at either provincial or federal levels. Rather, they are recipes for a radical downsizing of government in Canada. Ultimately, there would be no onus on provincial governments to do anything. Indeed, given recent thrusts of governments in B.C., Alberta, and Quebec to explore greater private health care options, a federal withdrawal at this point would take away any ability the federal government has to keep a lid on privatization (arising from fears about loss of federal funds).

The C.D. Howe Institute also speaks of economic benefits arising from their plan. The evidence presented, however, is sketchy at best, drawing largely on their own analyses that find that Canada's taxes are too high and too inefficient and must be reformed in the name of economic growth. Recalling the appalling record of previous campaigns that promised more economic growth (all based on more substance than this), there is a rather large credibility gap in their plan.

The likely consequence of decentralization as advocated above is a further reduction in the size of government, directly at the federal level, and indirectly through tax competition at the provincial level. It is worth recalling that one of the reasons for a stronger role by the federal government stems from tax competition among provinces in the 1930s when each province attempted to win an advantage over its "rivals." A more national tax collection system is more efficient, both economically and administratively.

A simplistic tax-cut mentality underlies the C.D. Howe plan. Just as high-income people may complain that they pay more in taxes than they get in services, so do high-income provinces. In this case, it is Ontario that has been complaining, arguing that it pays more in taxes to Ottawa than it gets back in transfers. This is, of course, true because Ontario is a rich province. For there to be "have-nots" that are net recipients of funds from Ottawa, there must be "haves" such as Ontario that are net contributors. But the Ontario government does not directly contribute anything to federal coffers; rather, Ontarians, on average, pay more in federal taxes because there are relatively more high-income people in Ontario.

It is from federal revenues, based on taxation structures applied nationally, that transfers are provided to provinces on a per-capita basis in support of programs that have some degree of national standards. This is an essential part of Confederation. For Ontario to get back from the federal government as much as it contributes — the position of Ontario Premiers McGuinty, Harris, and Rae — would be tantamount to abandoning Section 36 of the Constitution.

Federal tax cuts matched by cuts in program-related transfers in the name of fixing a phony "fiscal imbalance" would actually worsen regional inequalities. This is because poorer provinces would need to raise taxes higher in order to generate the same amount of per capita revenues as a richer province. In this event, there would be major implications for the Equalization program, which would have to do more heavy lifting to fulfill constitutional obligations.

Reviving Federalism: What are the Options?

There is good reason to believe that, in the interests of regional development and national standards, Canada should continue to have a fiscal system where the federal government takes in more revenues than it needs for its own direct expenditures and reallocates the difference to provincial governments. This state of affairs should not be pejoratively characterized as a "fiscal imbalance." It is merely fiscal federalism as we have known it for half a century. This system has, by and large, served Canada well. Over these decades, Canada has developed a robust mixed economy that blends the market orientation of the U.S. with the social systems of Europe, with the result that Canada sits close to the top of most major indicators of well-being (such as the UN's Human Development Index).

The problem with fiscal federalism over the past couple of decades has been the adverse consequences of federal withdrawals from the "cooperative federalism" model, plus increased tax competition among the provinces. It is hard to see how a much more fundamental federal retrenchment from areas of national concern, as advocated by proponents of the "fiscal imbalance," would improve the current situation. A restoration of cooperative federalism is a better path. Ultimately, the right answer depends on how much centralization one is comfortable with: what value is placed on the entity called Canada; to what degree national standards, common public programs, equality of opportunity, and regional development are seen as important priorities.

Moving forward, there are three broad options available to the federal government (the outcome may well be a mixture of the three). Fundamentally, any decision must be negotiated carefully with the provinces rather than based on unilateral action by the federal government. The Advisory Panel on Fiscal Imbalance and other academic commentators have called for new and better federal-provincial governance institutions to manage this relationship; the process is as important as the finances. The federal government must recognize the provinces' need for stable revenues over time. And, in exchange, provincial governments should be more open to adhering to national standards, while preserving the ability to respond to local needs.

Option 1: Do Nothing

The federal government has no obligation to spend anticipated surpluses in support of social programs in provincial jurisdiction, and could instead use surpluses to lower federal taxes, reduce federal debt, or increase spending in areas of federal jurisdiction, such as national defence. Indeed, the Harper Conservatives made such items part of their election campaign. The 2006 federal budget was a step in this direction, with $20 billion in tax cuts over two years, plus some modest spending increases, including the creation of a new family allowance (dubbed the "Universal Child Care Benefit"). The Budget also earmarks $3 billion per year for debt reduction.

Prime Minister Harper recently added: "There is also a fiscal imbalance between Ottawa and every taxpayer in the country. And we will address this by cutting taxes in our mandate — not just the GST, but personal taxes, business taxes, capital gains taxes."[21] By the time this is done, there may be no surplus left for the provinces to fight over. But the presence of federal surpluses is but one definition of "fiscal imbalance"; the real issues are deeper and cut to the core of the responsibilities and relationships between the federal government and the provinces.

Given the needs for re-investment in social programs, from health care to education to social welfare, and the contribution these make to national economic and social objectives, there is a compelling case for the federal government to instead use its spending power to enhance Canada's social infrastructure and raise national standards. The Conservative promise to develop a national plan for the reduction of health-care wait times is an example of an area where the federal government can play a leadership role (and is at odds with decentralization rhetoric).

Option 2: Increase Transfers

The status-quo option would be to continue to increase federal transfers to the provinces for health care, post-secondary education, and social services. As presented above, a restoration of transfers to the provinces, in line with historical amounts relative to GDP, would cost an additional $7.2 billion per year for CHT/CST and $4.3 billion for Equalization, or a total of $11.5 billion. Increasing transfers is also the recommendation of the Advisory Panel on Fiscal Imbalance. It recommends boosting federal transfers for the CST and CHT by $4.9 billion, and transfers for equalization by $5.7 billion.

By amassing surpluses that provincial governments want, the federal government has leverage to impose conditions on those transfers in order to achieve national standards and other policy goals. However, to the extent that the federal government continues to provide program-related transfers to the provinces, it appears that they will not be subject to any conditions.

A similar but weaker option would see the federal government transfer equalized tax points to the provinces (similar to the 1977 creation of tax points). Joe Ruggeri (2002) argues for such a scheme, but with an important caveat: that the revenue from these tax points would be put into a fund jointly administered by federal and provincial governments, and that national standards would be negotiated, with penalties imposed on provinces that contravene these standards.[22]

Option 3: Expand Federal Programs

There is a final option that has had little discussion outside of academic circles. This is for the federal government, with the agreement of the provinces, to directly deliver services in areas of provincial jurisdiction. The Advisory Panel on Fiscal Imbalance calls this approach "one among several options that merit future consideration in order [to] better align responsibilities and revenues between the orders of government,"[23] then drops the subject to return to a call for increased federal transfers.

A few examples of where uploading responsibilities would be of benefit are worth considering. Take the case of a national Pharmacare program. The federal government already has control over drug approvals and patent legislation (and could restore compulsory licensing to enable greater generic production for the Canadian market), could engage in bulk purchasing, and determine a common formulary that would be covered in all provinces. Dr Joel Lexchin estimates that a national Pharmacare program would cost $6.1 billion per year, or about $3.2 billion more than existing public expenditures.[24] The federal government would be able to set national standards without much difficulty, and would not lose control over expenditures, as was the case with cost-shared programs. The provinces, concerned about health care costs, would see the federal government take over the segment of health care with the fastest growing costs. The premiers made such a recommendation in 2004, but the federal government balked at the time.

Another possibility would be for the federal government to take over social assistance delivery. Most major income support programs, such as unemployment insurance, child tax benefits, and seniors' benefits, are already federal in nature. With the addition of social assistance, the federal government would control all of the key elements of income support in Canada, perhaps in some form of "guaranteed annual income." By acting nationally, income support for the poorest could be delivered more efficiently, bypassing competitive pressures among the provinces, and eliminating provincial bureaucracies. It is hard to imagine that the federal government could do worse than the dismal performance we are seeing at the provincial level right now, and arguably the federal government shoulders some of the blame due to the end of CAP in 1995. The total social assistance bill across all provinces was $10.3 billion in 2002/03, with a peak of $14.3 billion in 1993/94.[25]

An area that might also meet this test is labour market training, particularly in relation to the annual surpluses (excess premiums over benefits amounted to $2.6 billion in 2004/05) in the Employment Insurance program.

In each of these three cases, negotiation would be required as these programs are being delivered provincially but funded in part by federal contributions. If the federal government were to agree to take on these programs, while maintaining the levels of existing transfers to the provinces, provincial governments would receive a windfall that could be re-allocated to other provincial services.

Epilogue: The Other Imbalances

In order to strengthen federalism and Canada's existing social infrastructure, the third option above merits serious consideration. It would build on the transfers of cash made to the provinces in support of existing programs, while relieving areas of financial pressure that they have difficulty addressing on their own. There is good reason to believe that provincial governments (with the exception of Quebec) would support such a proposal.

But this should not be the last word in fiscal federalism. The federal government needs to revisit the role of equalization in addressing the "horizontal fiscal imbalance" among the provinces due to Alberta's surge in resource wealth. One answer to this problem is to have some part of equalization financed among the provinces themselves through a resource-sharing pool. Another would be to re-institute national policies in areas such as energy so that all households and businesses can benefit from Canada's natural resources. These are difficult political questions that go beyond the scope of this paper.

An important linkage in the context of the discussion in this paper is that efforts to address a spurious "vertical imbalance" through federal tax cuts may exacerbate the real "horizontal imbalance" among the provinces themselves (the Alberta problem). This could necessitate a major increase in the size of the Equalization program; otherwise there would be serious consequences for the ability of provinces across Canada to deliver services at the same standard. In any event, political resources should be focused on this legitimate fiscal imbalance among the provinces, not the phony one alleged between the federal government and provincial governments.

Finally, while not explicitly addressed in this paper, there is a strong case to be made that there is a "fiscal imbalance" between provincial governments and major cities, who have only limited tax bases upon which to support local expenditures.[26] In this area, the federal government could negotiate with the provinces some form of transfer mechanism to cities, perhaps financed equally by both orders of government.

A key point of this paper is that, as framed, the "fiscal imbalance" rhetoric is targeting the wrong issues. With talks about to begin in earnest this Fall, they should not be limited to a narrow federal-provincial tug-of-war over transfer payments nor should they be an exercise in downloading of federal responsibilities. Rather, they should consider options that increase and consolidate federal responsibilities in certain areas, address the horizontal imbalance among provinces, and meet the challenges faced by cities. Federalism has always been as a work in progress, changing with the times. This paper has suggested ways for federalism to be retooled for the 21st century.

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Notes

1 Speech to the Board of Trade of Metropolitan Montreal, April 20, 2006.

2 Citations from Government of Canada, 2006, pages 58, 59 and 64.

3 For simplicity's sake, we do not consider the territories in this paper. Some of the issues are similar for the territories but there are also unique issues due to constitutional status and the geography that they face.

4 See Watts, 2005. Note that we do see this dynamic in Canada in the relationship between provincial governments and municipal governments. The latter is by and large limited to property taxes as its revenue base.

5 These countries are Canada, the United States, Germany, Australia, Switzerland, Spain, Brazil, India, South Africa, Sweden and Japan.

6 Also, if provinces have business cycles that are not totally synchronized, the equalization program (and federalism more generally) functions as a form of risk-pooling, which smoothes cyclical provincial revenue fluctuations.

7 The review in this section is informed by more extensive historical overviews of fiscal federalism by Hobson and St-Hilaire (2000), Lazar (2000) and Ruggeri (2006). For a detailed statistical overview of the evolution of fiscal federalism, see a forthcoming CCPA paper by Hugh MacKenzie (2006).

8 Rowell-Sirois Commission (1940), p. 128. Thanks to Lars Osberg for pointing out that financial and fiscal crisis in Alberta, then a poor province, underpins the modern federal transfer system, including Equalization.

9 Paid to provinces on a per capita basis, the tax point transfer is "equalized". The report of the Advisory Panel on Fiscal Imbalance (2006) uncovers some strange federal accounting to this end, and some double-counting of transfers under program-related transfers and equalization transfers.

10 Previously, in 1990, the federal government enacted the "cap on CAP", which limited the growth of CAP expenditures to 5% per year in Ontario, BC and Alberta. In the same budget EPF transfers were frozen.

11 See Osberg, 2000.

12 That is, CHST equivalents: EPF plus CAP pre-1995; CST and CHT post-2004; cash transfers only. Equalization and Territorial Formula Financing are not included in this measure.

13 Non-equalization transfers from chart 8, p. 13. Equalization transfers from chart 4, p. 6.

14 The APFI makes these recommendations on top of some changes to make federal transfers more transparent, and to more clearly distinguish between CHT/CST and Equalization in federal accounting. They also suggest that the Equalization amount could be proportionately scaled back based on budget circumstances.

15 Provinces have moved away from a system that set provincial taxes as a percentage of federal income tax owing, and now set their own income tax rates, brackets and credits (called a "tax on income" system).

16 The assumptions and calculations underlying the simulation results were prepared by the author and the responsibility for the use and interpretation of these data is entirely that of the author.

17 In 1995, provincial personal income tax was still calculated as a proportion of federal income tax, so in order to approximate provincial tax brackets, the proportion was multiplied against the federal brackets, with the 1995 tax credits applied.

18 Levesque, 2002.

19 A wrinkle is that in Quebec and the Atlantic provinces the provincial sales tax is harmonized with the GST. For other provinces this is not the case, so implementing this proposal would require restructuring of provincial sales tax systems.

20 Poschmann and Tapp, 2005.

21 Harper, 2006.

22 There is also a case to made for tax point transfers directly to municipalities to address the pressing needs in areas such as housing, addiction services, infrastructure and so forth. But as municipalities are constitutionally "creatures of the provinces", technically speaking, any such transfers would have to funneled through the provinces in the absence of constitutional changes.

23 APFI (2006), p. 61.

24 Lexchin, 2001. Figures derived from 1996 drug cost data and are not adjusted for inflation.

25 Figures are unadjusted for inflation. Source: Social Development Canada, Social Security Statistics, Canada and the Provinces, 1978/79 to 2002/03, Table 438.

26 See MacKenzie (2006) for more on the history of federal-provincial-municipal financial relationships.

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