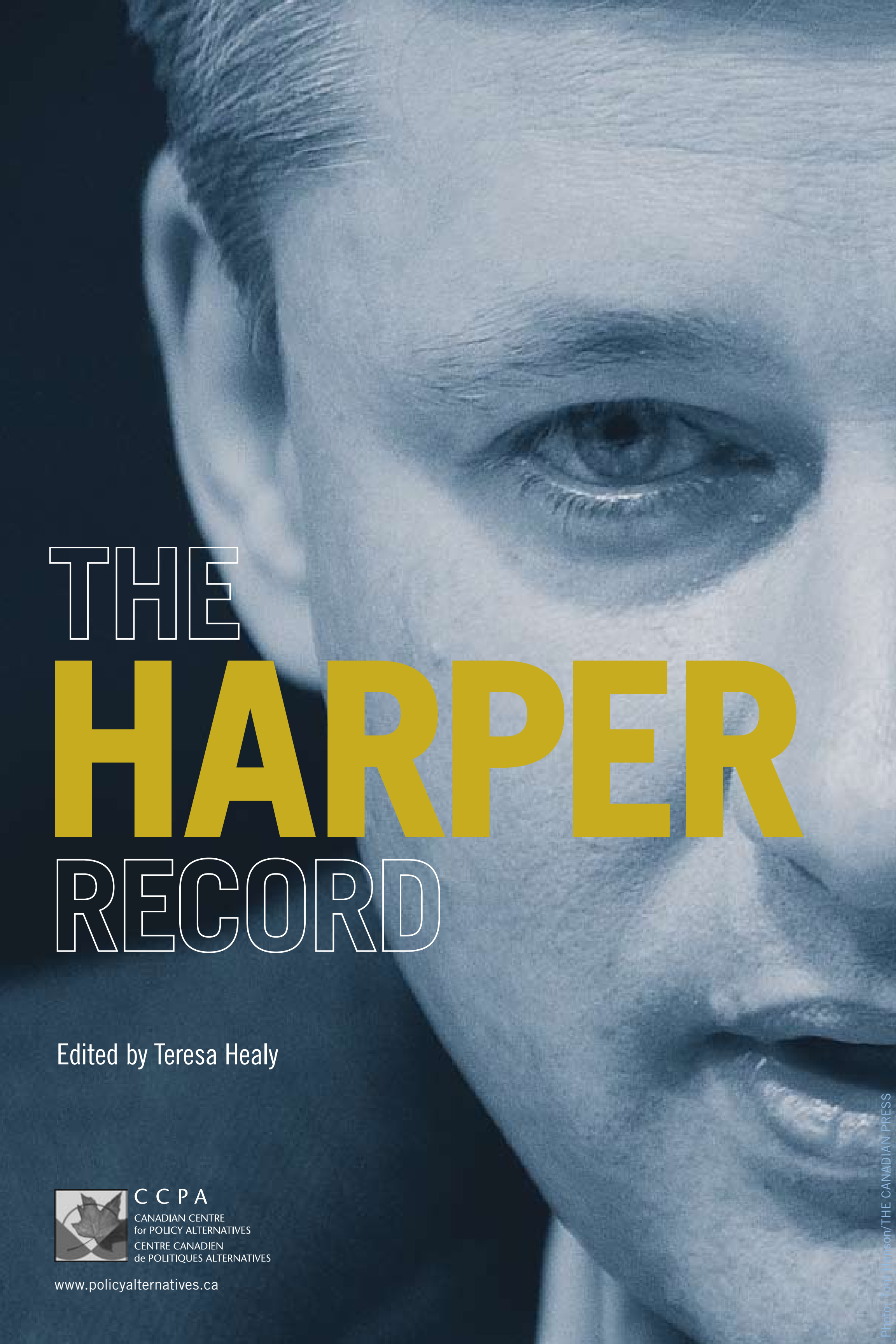

THE HARPER RECORD

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The Harper Government and Federal-Provincial Issues

Turning out the lights in the "fiscal cafeteria"

Hugh Mackenzie

STEPHEN HARPER MAY not have started the book, but he is certainly writing an important chapter in the sad story of the federal government's descent over the past 20 years into irrelevance to the day-to-day lives of Canadians.

Take Harper's belief that the federal government should restrict its activities to its own constitutional responsibilities, add an ideological predisposition against any measure that smacks of social justice (like fixing the broken EI system), and fold in the tried and true right-wing mantra of tax cuts as the solution to every conceivable problem, and you have the perfect recipe for a federal government in decline.

A brief pre-Harper history of fiscal federalism

Historically, Canadian federal governments have had to be both creative and aggressive in carving out a positive role for themselves as leaders on issues of national concern. That is because, in the division of authority between the federal government and the provincial governments in Canada's Constitution, the provinces ended up with exclusive jurisdiction over most of the major social policy issues of importance to Canadians in the 21st century.

As interpreted by the courts over the years, the Constitution confers on the provinces exclusive power over health, social services, education, housing, labour relations, and most economic activities that are not explicitly interprovincial, including transportation and communication.

Federal government powers have been construed much more narrowly in Canada than in other federal systems. For example, there is no constitutional feature in Canada that corresponds to the "interstate commerce" provision of the United States constitution. Provincial governments' taxing powers are limited in that they are prohibited from levying indirect taxes like customs duties, but in practice the scope of provincial revenue-raising power is as broad as that of the federal government.

Significantly, in light of Canada's large and rapidly growing urban population, provincial governments have exclusive control over local governments, to the point where municipalities are characterized as "creatures of the provinces." The federal government acquired two key areas of responsibility as a result of constitutional amendments: old age security and unemployment insurance.

The significance of the constitutional background is that it underlines two key facts about Canadian social and economic policy: 1) the provinces have most of the on-the-ground responsibility and most of the on-the-ground relationship with Canadians when it comes to these issues; and 2) it requires an act of political will to engage the federal government with the key issues that matter most to Canadians.

It also requires a willingness to pursue highly-nuanced strategies that accommodate simultaneously the political imperative for truly national program standards as virtually a right of citizenship and Québec's desire for self-determination and vigorous defence of its constitutional prerogatives. The extent to which federal governments have been able or willing to muster up that political will is perpetually in play.

The constitutional weakness of the federal government was exposed in the 1930s in the face of a national and international economic calamity. The experience was nearly disastrous. As a consequence, the period from the end of World War II until the mid-to-late 1970s was characterized by growing and deepening federal-provincial partnerships in areas of public policy constitutionally under provincial jurisdiction. In this period, the provinces generally performed much of the heavy lifting in the growth of Canadian health, social service and education programs. The federal government, however, played a key role as a catalyst for the development of national social programs, in establishing national standards for those programs, and in ensuring that differences in provincial fiscal capacity would not prevent Canadians from enjoying the benefits of those public services.

The dynamic began to shift in the late 1970s as a growing concern with fiscal issues led the federal government to close off its open-ended fiscal commitments to the provinces. That process continued in the 1980s under the Mulroney government and, as a consequence, the share of the federal government in the funding of what had been cost-shared programs continued to decline. By and large, provincial governments stepped into the gap left by federal funding limits.

The next major change was ushered in by Paul Martin's "come hell or high water" anti-deficit campaign, much of which was funded by cuts in federal transfer payments to the provinces, along with cuts to unemployment insurance benefits. Federal transfers were reduced and de-conditionalized. Federal transfer payments to the provinces dropped dramatically as a share of GDP from the mid-1990s to the early 2000s. While this change had relatively little impact on the fiscal balances of the provinces — in the aggregate, provincial governments simply passed on the pain to local governments by reducing provincial-local transfer payments — it had a significant impact on the federal government's credibility as a fiscal partner of provincial governments in areas of provincial jurisdiction.[1]

The loss of federal credibility was most notable in health care. Federal transfers for health care had been folded into the Canada Health and Social Transfer in the mid-1990s, wiping out the specific link between federal funding and health care spending, and as provincial health care budgets came under increasing economic pressure, the resulting political pressure on the federal government reached a critical level, forcing an about-face in the early 2000s.

Over a four-year period after 2000, federal transfer payments to the provinces recovered, reaching a share of GDP that was actually higher than at the beginning of the period of fiscal constraint in the mid-

1990s. While the amounts recovered, however, the ability of the federal government to use those transfer payments as a policy lever in areas of provincial jurisdiction did not. In part, the gap between funding and influence resulted from the fact that increased federal transfer payments flowed to provincial governments, not under a single national program umbrella (in some cases with an opt-out provision for Québec) as had been the case in the past, but as a series of one-on-one deals with individual provincial governments. In effect, Martin and Chrétien addressed Québec's desire for less federal interference in areas under its jurisdiction by extending the opt-out framework to all provinces, creating an approach to fiscal federalism that has been characterized elsewhere by the author as a "fiscal cafeteria."[2]

Even in the period of transfer payment cuts in the late 1990s, however, the federal government did not abandon its efforts to make policy in areas of provincial jurisdiction. It simply backed away from the previous strategy of using federal provincial agreements on the use of the federal spending power as the vehicle for doing so. In particular, under Finance Minister Paul Martin, the federal government resorted increasingly to the tax system as a social policy delivery vehicle in areas of provincial jurisdiction.

The signature initiative of this type was the Child Tax Benefit/National Child Benefit Supplement system, which delivered income-tested benefits directly to low-and-moderate-income Canadians through the tax system rather than indirectly through the provinces using programs like the Canada Assistance Plan.

Harper's federal government: Going out of business, right down to the fire sale

When the Harper government was elected with its declared intention of getting the federal government out of the business of the provinces and focusing on the federal government's constitutional responsibilities, it inherited a long list of multi-year agreements and political commitments from the outgoing Liberal government. The agreements emanated from a variety of different sources. By far the largest of these flowed from federal-provincial conferences on health care funding in 2001 and 2002, which committed the federal government to a multi-year funding schedule. Other agreements arose from the election platform commitment of the Martin minority government for a national child care program and from the NDP-Liberal budget agreement in 2004 which provided for increased housing, public transit, and post-secondary education funding. In addition, the Martin government had committed the federal government to a program of gradual improvements to child benefits.

The Harper government has proceeded, selectively, to unwind or undermine many of these commitments. While it has avoided the political hot potato of health care, it has been anything but quiet on every other front. It killed the national child care strategy, redirecting the funding to a non-targeted tax break. It ignored the child benefit system as a delivery mechanism for its family-based policies, creating its own program-specific delivery mechanisms instead.

While it has followed through on the housing funding commitments it inherited, it has cancelled all the remaining national housing programs and signaled its intention to wind up the Canada Mortgage and Housing Corporation and sell off its mortgage portfolio, effectively taking the federal government out of the housing business. Pre-existing transit funding commitments survived, but the Harper government flatly rejected the calls from municipal leaders for a share of GST revenue, moving instead to cut the GST and challenge the provinces to move into the tax room thus created if they wanted additional funding.

With respect to post-secondary education, the message from the government has been inconsistent. On one hand, it identified post-secondary education as one of the few areas of provincial jurisdiction in which it sees the federal government as playing a role. At the same time, it is allowing the 2004 Budget's funding for post-secondary to expire without replacement and has announced that the Millennium Scholarship Foundation will be wound up in 2010 with no sign of a replacement.

Child care is a non-starter. Post-secondary education seems to have fallen off the radar screen. The federal government is completing an exit from the housing business that started when Paul Martin canceled the non-profit and cooperative housing program in 1995. The attempt to carve out a role for the federal government in national family income security policy seems to have collapsed as the government has bypassed its own child benefit system as a delivery vehicle for assistance to families. Support for local government is winding down, and infrastructure funding is now little more than a lever to try to force other governments into more P3s (so-called public private partnerships). Even in health care, although the funding is still there, any commitment to use that funding as a lever in support of national program standards has evaporated.

Rather than use its constitutional jurisdiction over unemployment insurance and old age security as leverage for a greater role in employment policy and income security, the Harper government is continuing the devolution of labour market policies that had been delivered through employment insurance back to the provinces and cutting the revenue base of the EI program down to size.

One of the more insidious of the Harper government's strategies has been to cut the revenue base of the federal government down to its (reduced) size on the program side of the ledger. Having recognized that burgeoning federal surpluses amount to an invitation to the federal government to expand its programs, the Harper government has effectively wiped out the surplus by ramping up spending on its priority areas of core federal responsibility and introducing substantial tax cuts.

Not only has the Harper government moved to shrink the role of the federal government in Canadian public policy, but it has done so in a way that puts a huge political barrier — the need to raise taxes — in the way of any future federal government seeking to reverse that policy.

Fiscal equalization — Harper's single new initiative — wrong policy, wrong time

Fiscal equalization is one of the few areas of any significance in which the Harper government has departed from the trend established in the early years of the Chrétien government. As a political response to two decades in which the program was periodically re-designed to limit costs and then turned into a series of one-off deals with provinces to limit the political fallout, the Conservatives made election commitments to reform the system in Québec, Atlantic Canada, and Saskatchewan. Postelection, the Harper government responded to recommendations from a review of equalization — known as the O'Brien Report — that had been commissioned by the Martin Liberals.

In essence, Harper's new deal on equalization restored the ten-province standard for equalization (reduced to six provinces as a money-saving measure in the 1980s and 1990s), mandated the inclusion of 50% of resource revenues in fiscal capacity calculations, and imposed a cap on equalization payments such that a province receiving equalization could not end up with greater total fiscal capacity than the non-recipient province with the lowest fiscal capacity.

While the new policy had the virtue of being rules- and principles-based, overriding the special deals that had cluttered up the program over the previous 20 years, it turns out to have been the right policy only for a context of low resource prices and a currency priced internationally to enable Canadian industries to compete. It may have been the right policy for the first five years of the 21st century, but it does not work now. Higher resource prices both push up measured average fiscal capacity and create significant fiscal capacity gaps among the non-receiving provinces. Although any revenue increase will raise the equalization base, the emergence of resource industries as the revenue growth driver in Canada means that the equalization base has been increasing without any corresponding increase in the revenue base in non-receiving provinces without significant resource revenues, most notably Ontario.

The prospect that Ontario might become a "have-not" province has become popular speech fodder for Conservative critics of the Ontario government. But it is also a huge problem for the federal government. In the current equalization configuration, with Ontario as the non-receiving province with the lowest fiscal capacity, Ontario's fiscal capacity caps the equalization payments of the resource-rich receiving provinces at a relatively low level. If Ontario becomes a receiving province, the non-receiving province with the lowest fiscal capacity becomes British Columbia, at a much higher level of fiscal capacity. That will create a flow of equalization cash into Ontario. It will also markedly increase the flow of cash into resource-rich receiving provinces as the cap level increases.

It is a myth that equalization involves wealth-sharing among provincial governments. Equalization is a federal government program funded from federal general revenues. That highlights the other major problem with running a federal equalization program in an era of high resource revenues. Higher resource revenues drive equalization program costs up. But the federal government does not have access to that resource revenue base. That is a provincial revenue base. The result is that higher resource revenues will put greater pressure on other sources of federal government revenue — more than half of which is raised in Ontario. Ironically, if Ontario achieves "have-not" status, rising resource revenues, the result will be greater fiscal transfers from the federal government's Ontario revenue base to resource-rich have-not provinces.

And what about the federal government's own responsibilities?

The underlying cause of that mess — regionally unbalanced economic growth in Canada — highlights another area in which the Harper government has abandoned a traditional federal government role. Regionally imbalanced growth is not a new phenomenon in Canada. In an economy as resource-price sensitive and as open as Canada's, one of the critical tasks of the federal government has been to establish policies to manage regional economic fluctuations. The equalization program itself is one of those policies. The federal government's responsibility for economic stabilization — a responsibility abandoned in the Martin-Chrétien era's deficit fight and buried under Harper — is another.

In the past, the Bank of Canada's exchange rate policy also played a role. Before it redefined its mandate to focus exclusively on domestic inflation, the Bank of Canada monitored the international exchange rate and intervened to moderate upward pressure on the currency that would damage the competitive position of Canadian exporters. The Bank effectively abandoned exchange rate management as a policy goal in the 1990s and, despite the clear problems for manufacturers and exporters created by an over-valued, resource-inflated currency, the Harper government has done nothing to change that.

The Harper government is presiding over a particularly dark period in Canadian federal-provincial fiscal history. It is in the process of completing the job of getting the federal government out of program areas under provincial jurisdiction. Where it is politically impossible not to pay, it will pay, as is the case with health care; but (no pun intended) it will not prescribe. Where it feels it can extricate itself completely with little political damage, it is getting out entirely, as is the case with housing.

As far as the other side of the Harper government's syllogism is concerned — focusing on the responsibilities of the federal government — ideology trumps all. Canada's international expenditures, on both defence and international development assistance, have been reoriented towards United States' military priorities. The government has essentially washed its hands of the employment insurance program, ignoring the widespread complaints that the sharply-reduced program is out of touch with the realities of today's labour market.

It has fumbled so badly on the greenhouse gas emissions policy that provinces are lining up to implement their own policies, leaving Canada with a hodge-podge of inconsistent policies that exposes this country to justified international criticism. As of the summer of 2008, for example, the main potential driver of policy dealing with emissions from Alberta's tar sands appears to be the Congress of the United States.

Furthermore, the Harper government's new expenditures have worked in concert with its aggressive tax cut policies to limit the fiscal capacity of a future federal government to move in a different direction.

What this means is that, in the areas of public policy with which Canadians are most directly concerned — health care, education, social services, infrastructure, employment and local government — the federal government under Stephen Harper has become largely irrelevant.

The federal government's role in perspective

The absence of the federal government is clearly not a good thing, but it is important to put that absence into perspective. There is no question that federal government programs have served Canadians well in the past in dragging reluctant provincial governments into national social programs and in establishing standards for those programs. The data show clearly, however, that provincial governments were both the main drivers of the relative expansion of the public economy in Canada from the 1960s to the 1990s, and the main drivers of its relative shrinkage after the mid-1990s. The public economy grew not because the federal government transfer payments paid the bills, but because provincial governments were prepared to increase their taxes to pay for public programs that delivered on national objectives. It shrank because provincial fiscal capacity spiraled downwards in the late 1990s in an orgy of competitive tax cutting.[3]

Chart 1 highlights the evolving roles of the federal and provincial governments in Canada's public economy.

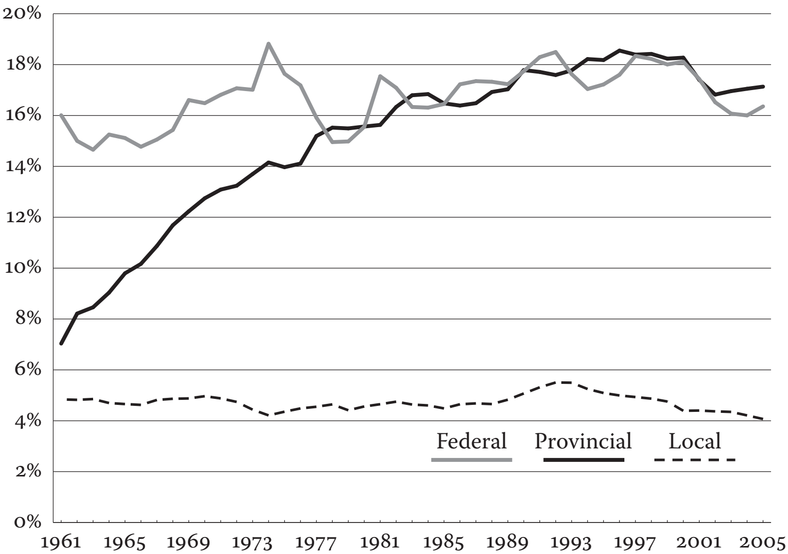
In the period 1961 to the mid-1990s, provincial governments' own source revenue increased steadily as a share of GDP as the public economy continued to expand. That trend reversed itself dramatically in the mid-1990s as provincial governments across Canada engaged in competitive tax-cutting. By contrast, the federal government's own source revenue as a share of GDP remained relatively stable, except for the period at the end of the 1970s when it both cut taxes and transferred tax points to the provinces.[4]

The use of the word "national" rather than "federal" is important. The development of national programs in Canada has never been a simple matter of the federal government using its constitutional power or its spending power in areas of provincial jurisdiction to impose those programs nationally. National programs have tended to develop in a dynamic between provinces and the federal government, driven by a national public opinion that is not particularly interested in which government thinks it has jurisdiction, but always respectful of the sometimes nuanced differences in perspective between Québec and the rest of the country.

It is worth remembering:

- that Medicare got its start as a program of the Government of Saskatchewan;
- that the movement towards national Medicare would never have reached critical mass had the Quiet Revolution not taken place in Québec;

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



- that Ontario joined Medicare after the then Progressive Conservative government of Bill Davis lost a by-election in a safe seat over that issue; and
- that it was Alberta's public opinion and not the federal government that stopped Ralph Klein's flirtation with two-tier medicine in the early part of this century.

In the uniquely Canadian dynamic that creates our national social policy framework, there have been periods in the past in which the federal government has been largely absent from the debate, and equally periods in the past in which pressure from the federal government has been critical to social policy development.

In the Harper era, Canadians are living through one of those periods of federal absence. That doesn't mean, however, that national social policy projects should grind to a halt. The federal government cannot prevent provincial governments from making progress in their jurisdiction. The federal government cannot even prevent provinces from attempting to fill the policy vacuum it leaves behind, as the output from recent meetings of the provincial/territorial Council of The Federation demonstrates. Federal cuts in taxes and transfer payments to the provinces have not eliminated the revenue base; it is there for provinces to use to support the programs Canadians want.