

## *Fiscal Federalism and the Future of Canada*

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### **Fiscal Federalism and the Burden of History**

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Can anything be done to end the intergovernmental disputes over fiscal federalism? Thousands of Canadians have probably asked themselves this question since Sir John A. Macdonald's government offered "better terms" to a discontented Nova Scotia in January 1869, an initiative which provoked perhaps predictable complaints (and demands for compensation) in the legislative assembly of Ontario.<sup>1</sup> Although the fiscal structure of the Canadian state has actually changed beyond recognition over nearly a century and a half, the continuity of provincial discontent with our intergovernmental fiscal arrangements, and of the rhetoric with which it is expressed, is certainly impressive. Only the weather has been as durable a source of Canadian unhappiness, and even that may decline in importance with global warming.

The controversy over "fiscal imbalance" which has persisted for much of the first decade of the twenty-first century, and the seemingly

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admitting that the source of the province's problems might lie within its own borders, or even within the walls of its legislature. Thus it is unlikely that provincial grumbling over fiscal federalism would ever cease, even if the system were to approach perfection.

This having been said, it does not follow that efforts to improve the system are pointless. Accountability, simplicity, efficiency, equity, and fairness as between the various governments of our federation are goals worth pursuing, whether or not those who would benefit from progress towards these goals appear to be grateful. But to understand the current state of fiscal federalism and the direction in which it should go, one must understand where it came from. This paper will begin with a sketch of the origins and development of the institution which we call fiscal federalism, will consider recent proposals for reform, and will conclude by suggesting how the system might be improved. The paper will deliberately avoid the question of whether municipal government should be recognized as a third order of government with guaranteed access to certain kinds of revenue, not because the question is unimportant, but because it should be the subject of another paper.

#### **HOW WE GOT HERE**

In his book *Politics in Time*,



legislation.

1967: The federal government begins to pay grants to the provinces for post-secondary education, rather than making grants directly to the colleges and universities.

1977: The federal grants in aid of health insurance and post-secondary education are replaced by a singularly complex arrangement known as Established Programs Financing (EPF) which consists of tax abatements and cash grants in roughly equal proportions. Federal income and corporation taxes are

Likewise there have been numerous changes in the system whereby the major direct taxes (on incomes and corporations) are shared between the two levels of government. Up to and including 1977 the changes mainly took the form of reducing federal taxes so that the provinces could occupy a larger share of the revenue source in question. After 1977 this practice was abandoned, largely because of a series of fiscal deficits at the federal level which lasted until almost the turn of the century. Instead, the provinces have been allowed increasing flexibility in imposing their taxes, in an effort to prevent them from collecting the taxes on their own behalf, so that the relationship between provincial and federal taxes has become increasingly tenuous, and the paperwork imposed on the taxpayer increasingly onerous. Why the federal government wishes to continue collecting taxes for the provinces is not entirely clear, but it has largely succeeded in its objective. Only Quebec collects its own personal income tax (as it has done without interruption since 1954) and only Quebec, Ontario and (since 1981) Alberta collect their own corporation taxes. However, at the end of the twentieth century the provinces stopped calculating their provincial income tax as a percentage of the federal tax, forcing their long-suffering taxpayers to do all the mathematical calculations twice. The federal government continued to collect the taxes for them nonetheless.

These incremental changes in policy have taken place, of course, against a massive backdrop of social and economic change, including a nearly ten-fold increase in the population, the shift from an economy largely of self-employed farmers and fishers to an industrial, and now increasingly post-industrial, economy of wage and salary earners, the development of the welfare state, and in recent years a rapidly aging population. In the process of all these changes the major items of state expenditure have shifted dramatically since the Second World War from infrastructure and defence to health care, education, welfare and pensions. Interest on the substantial public debt, of course, also accounts for a large share of state expenditures at both levels.

A few conclusions can be drawn from the history summarized above. First, the system has

evolved through a series of incremental changes, most of them at the behest of the federal government although some of them in response to complaints by one or more provinces. Second, there has hardly ever, in 1867 or later, been any serious effort to treat all the provinces alike or according to a fixed set of principles and standards. Third, the changes have made the system increasingly complex and difficult to understand, which has reduced accountability and had a detrimental effect on the quality of public debate about fiscal federalism. Fourth, since the changes have been made in response to short-term problems or concerns, it is impossible to identify any consistent purpose or direction behind the evolution of fiscal federalism or indeed any consistent set of outcomes, apart from making the system more complex and increasing the elements of asymmetry among the provinces. Fifth, most of the changes have resolved one problem but at the expense of creating one or more new problems.

The untidy and seemingly directionless evolution of Canadian fiscal federalism tends to confirm Pierson's generalizations about the slow and incremental way in which institutions evolve, as well as their failure to conform to any long-term goals and expected outcomes that might have existed at the beginning. The conclusions of the preceding paragraph also give credence to the concept of path dependence. Path dependence occurs because the costs of changing an existing pattern of behaviour appear to be greater than the costs of staying the same, even when staying the same has obvious disadvantages. It is particularly characteristic of fields, such as federal-provincial relations, in which change requires co-ordinating the behaviour of several distinct actors.

All of the characteristics of Canadian fiscal federalism outlined above—incrementalism, asymmetry, excessive complexity, short-term orientation, and the tendency of one “solution” to create a new problem—became evident at a very early stage in its development. To some extent they were inherent in the fiscal provisions of the British North America Act, and they were decisively and perhaps irreversibly reinforced by the “better terms” given to Nova Scotia when the ink was scarcely dry on the original document. One of the early students of Canadian fiscal federalism, James Maxwell, asserted long ago

that the “better terms” of 1869 “made a breach in





imbalance between spending responsibilities and sources of revenue, inadequate intergovernmental transfers, and the federal tendency to use its “spending power” in areas of provincial jurisdiction. The last of these factors would seem to be more a consequence than a cause of the federal government’s greater affluence, but the commission argued that it was a cause because it distorted provincial priorities, had a destabilizing

Paul Martin, largely defused the “fiscal imbalance” issue, at least in its original form, by unveiling what was billed as “A 10-year plan to strengthen health care”, reversing the cuts to federal health care spending which he had imposed as minister of finance almost a decade earlier and promising increased funding for health care in future.<sup>15</sup> As part of this package the CHST was divided into a Canada Health Transfer and a Canada Social Transfer, with the former scheduled to increase significantly in size over the next decade. This initiative deprived vertical fiscal imbalance of much of its importance as a political issue, at least outside of Quebec and to some extent even there. Yves Séguin was dropped from the Quebec cabinet in a shuffle a few months later. However the Council of the Federation, a permanent interprovincial body recently established at the initiative of Quebec’s Liberal Premier Jean Charest, appointed an Advisory Panel on Fiscal Imbalance to investigate the issue in 2005.

provincial revenues in relation to GDP since the 1990s, largely because of federal tax reductions. It also pointed out, as Stéphane Dion had done earlier, that the provinces had access to virtually every significant source of revenue and that their share of total state revenues exceeded that of the

#### **A NEW GOVERNMENT AND A SERIES OF REPORTS**

The issue of fiscal imbalance was given a new lease on life by the federal Conservative leader, Stephen Harper, who promised during the election campaign of 2005-06 to do something about it if his party was elected to office. This promise received some of the credit for the Conservative victory, and particularly for the unexpected election of ten Conservative members of Parliament from Quebec.

Yet, after he became Prime Minister, Harper and his minister of finance, Jim Flaherty, began to soft-pedal the issue, despite the fact that Flaherty had held the same office in the provincial government of Ontario a few years earlier. A lengthy document released with Flaherty’s first budget in 2006, which promised to maintain the increases in health care funding promised earlier by the Liberals, convincingly refuted most of the arguments in the Séguin report.<sup>16</sup> It asserted that Quebec’s deficit was expected to disappear in the current fiscal year, that the fiscal balances of the federal and provincial levels of government had followed very similar trends since 1995-96, that federal transfers for health care were growing faster than provincial spending on health care, and that federal revenues had declined more rapidly than

recipient of equalization, it would get about half of any additional equalization forthcoming from the federal government, but only about a quarter of any additional funds made available by surrendering tax room to the provinces.<sup>17</sup> But there were other reasons as well why the issue of horizontal imbalance began to occupy the centre of the stage, almost before the ink was dry on the Séguin report. First, Ontario in 2003 elected a Liberal provincial government headed by Dalton McGuinty. The new premier charged that Ontario as a rich province was being unfairly discriminated against in the allocation of federal funds, particularly the block grants for health and post-secondary education. His government began a campaign for “fairness”, complete with its own website. McGuinty also complained on more than one occasion that Ontario and Alberta taxpayers contributed most of the revenue that supported the equalization program, and that Ontario taxpayers could not afford to make the program any more generous.<sup>18</sup> While more subtle than Premier Mitch Hepburn’s complaint in the 1930s that Ontario was “the milch cow of the Dominion”, the message was essentially the same.

Second, in 2004 the federal Liberal government announced controversial changes in the equalization program, described as “A New Framework for Equalization”, almost simultaneously with the more popular increases in health care funding.<sup>19</sup> Although the Liberals implied that the new approach would make equalization more generous, the reality was that a cap was placed on the amount of equalization to be paid each year, with a fixed rate of increase in subsequent years. This was similar to the arrangement for health and social transfers, but totally unprecedented for equalization. The press release promised that the allocation of this fixed amount among the provinces would eventually be determined by the recommendations of a “panel of experts”, rather than by the formula that had been in use for more than twenty years. Pending the receipt of those recommendations, it would be on a per capita basis, which seemed to make little sense if the purpose of the program was to counteract horizontal fiscal imbalance.

Finally, Prime Minister Martin, about a year before leaving office, made an ill-advised agreement known as the Atlantic Accord with the

premiers of Newfoundland and Labrador and Nova Scotia. This provided that any revenues received by those provinces from offshore oil and gas would have no effect on the size of their substantial equalization payments. (Saskatchewan and British Columbia, which would have benefited from a similar arrangement for their non-renewable resources, received nothing in return.) Newfoundland and Labrador would also receive a payment of \$2 billion to retire a portion of its debt.<sup>20</sup> This politically-motivated agreement, which seemed like a return to the era of “better terms” before formal equalization was established, bequeathed a political hot potato to Stephen Harper, who had further muddied the waters himself by an ill-advised promise that non-renewable natural resource revenue bases would be excluded from the calculation of the equalization formula.<sup>21</sup>

2006 saw the publication of three major reports on fiscal federalism, one of which was devoted entirely to equalization while the two others devoted considerable attention to it. A fourth report, on the economic prospects and financial needs of Canadian cities, appeared early in 2007. The first off the mark, in March 2006, was the report of the Advisory Panel on Fiscal Imbalance, which bore the rather unfortunate title *Reconciling the Irreconcilable*.<sup>22</sup> Co-chaired by Robert Gagné, an economist nominated by the Premier of Quebec, and Janice Gross Stein, a political scientist nominated by the Premier of Ontario, the five-member panel also included a Conservative senator from Nova Scotia, a former Deputy Minister of Intergovernmental Affairs from Alberta, and a former Minister of Finance from the Northwest Territories. Like the Séguin commission, it argued that vertical fiscal imbalance was a genuine problem, although its forecasts regarding federal surpluses were considerably more conservative than Séguin’s. However, it did not recommend any transfer of tax room to the provinces. Instead it proposed changes to the CHT and CST which would abandon the fiction that the tax abatements of 1977 were part of the federal contribution, increase the size of the cash grants, give the same per capita cash grant to each province, and thus remove the unequal treatment of rich provinces of which Premier McGuinty had complained.

As regards equalization, the panel suggested

a more generous formula which would be based on a ten-province rather than the five-province standard established in 1982 and would include

McGuinty expressed dissatisfaction with the report of the Advisory Panel on Fiscal Imbalance, which he had helped to establish, and continued to claim that Ontario's contributions to federal revenues exceeded by \$23 billion, or almost \$2000 per capita, the benefits it received from federal spending.

Newfoundland and Labrador, which has surrendered the unenviable distinction of being the poorest province to Prince Edward Island without losing any of its customary truculence, was mainly concerned to ensure that its offshore oil and gas revenues would continue to have no impact on its equalization payments, as promised by former Prime Minister Paul Martin. Premier Danny Williams, who at one point in 2004 had ordered the Canadian flag removed from provincial government buildings as a symbolic protest against the federal Liberals, denounced the O'Brien report, whose recommendations would have resulted in a net loss to his province. Although bearing a Conservative label himself, he warned that the federal Conservatives would lose all three of their Newfoundland and Labrador ridings if they cancelled the Atlantic Accord.<sup>27</sup>

Saskatchewan, a significant producer of oil, argued that non-renewable resource revenues should not be taken into account in calculating equalization. Alberta, which has no direct interest in the equalization formula since no conceivable formula could make it a recipient of equalization, took the same position. (This has been a time-honoured, \$475 TD(\$2000 per iort)11 vr TD139(\$2008.4(w{to clai)-5.6(m)8( that Ontala einof rsc Accbn f





