



Fiscal Federalism in Canada



Norman Betts, PhD, FCA
University of New Brunswick
Fredericton, NB, Canada
March 30, 2005

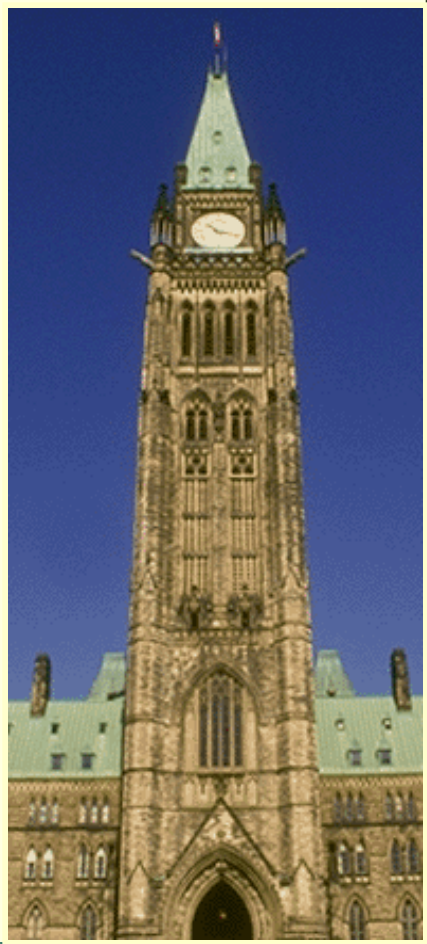
Presented at: Roundtable on Division of Revenues between the Levels of Government in Federal Countries and Fiscal Equalization

Location: Brasilia, Brazil

Date: March 30 & 31, 2005

.....An event co-organized by the Forum of Federations

Outline of presentation



1. Overview of Canadian federalism

2. Federal Transfers to Provinces

3. Key issues

4. Conclusion

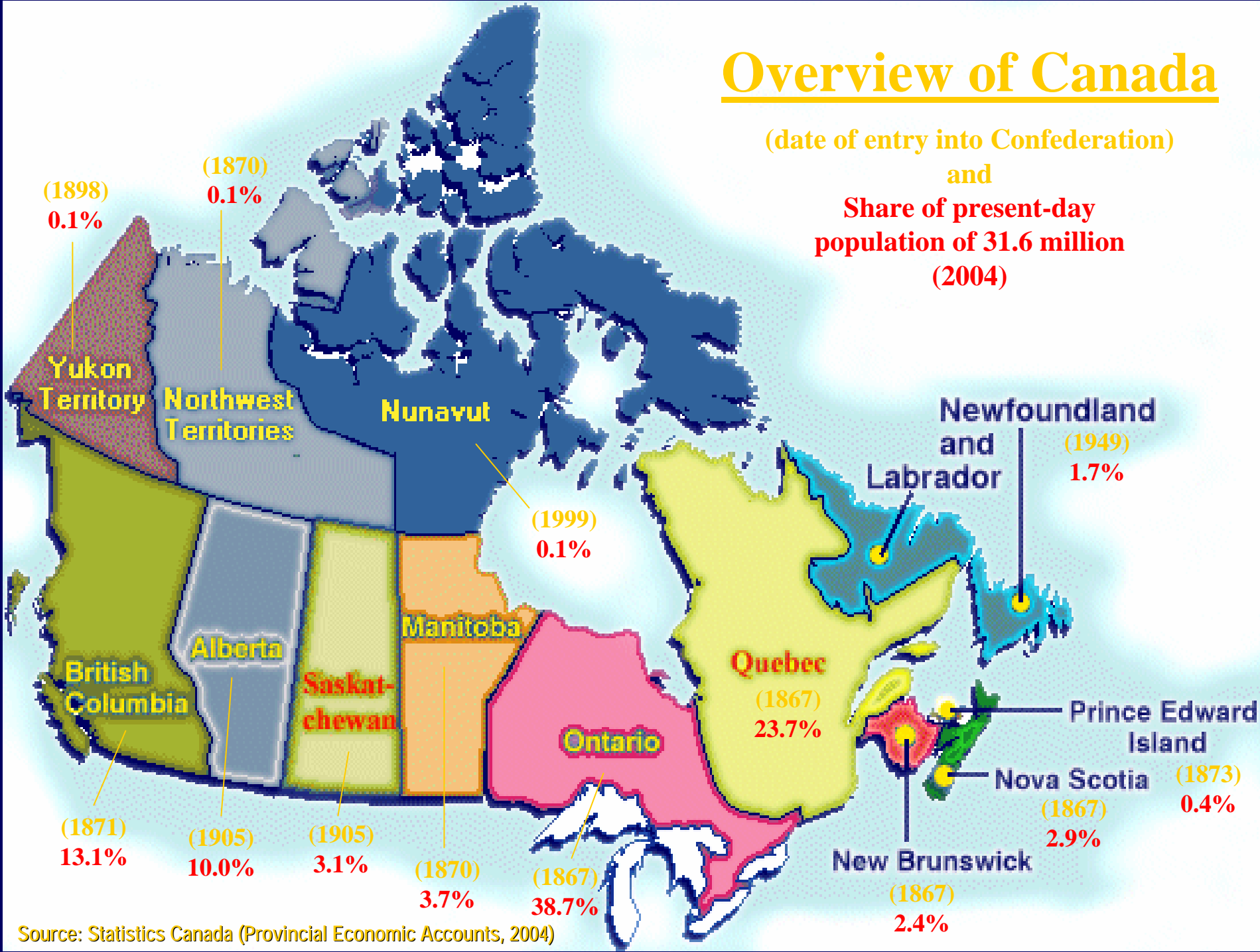
Overview of Canada

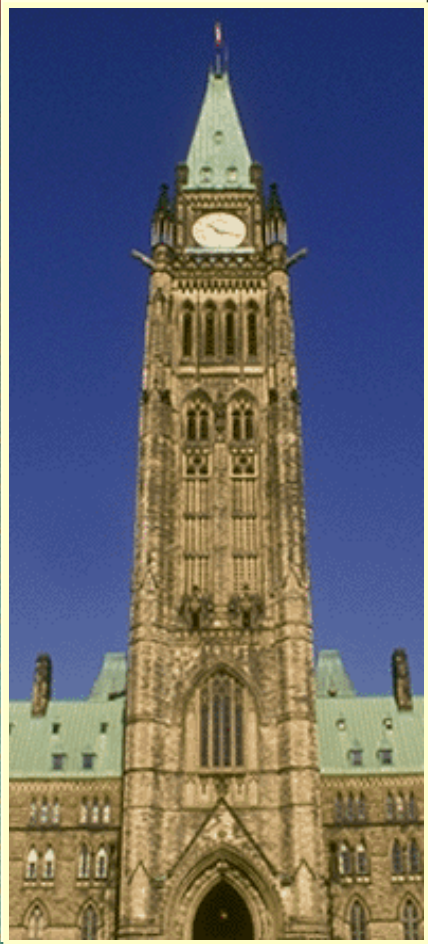
(date of entry into Confederation)

and

Share of present-day
population of 31.6 million

(2004)





1. Overview of Canadian Federalism

- Division of revenue and expenditure responsibilities



1.1

Division of powers

- Federal and provincial governments have independent constitutional basis of authority
- Few / no constraints on spending / taxation powers or ability to borrow
- Federal and provincial have extensive areas of separate legislative powers
- Strong executives at both federal and provincial levels

1.2

Access to tax bases

Traditional tax bases
are shared by Ottawa
and the provinces

Provincial-only tax
bases

Federal-only tax bases

Common revenue sources

	<u>Federal</u>	<u>Provincial</u>
Personal income tax	✓	✓
Corporate income tax	✓	✓
Sales taxes	✓	✓
Payroll taxes	✓	✓

Provincial-only revenue sources

	<u>Federal</u>	<u>Provincial</u>
Gambling, sale of alcohol		✓
Property taxes		✓
Natural resource revenues		✓

Federal-only revenue sources

	<u>Federal</u>	<u>Provincial</u>
Customs tariffs and import duties	✓	
Taxes on non-residents	✓	

1.3

Expenditure areas

- Few concurrent powers (agriculture, pensions, immigration)
- Residual power lies with federal level
- Much interdependence in practice
 - areas where jurisdiction is not clear or overlaps
 - through use of the spending power and transfers to provinces

Provincial spending pressures

Health care	✓
Education	✓
Social services	✓

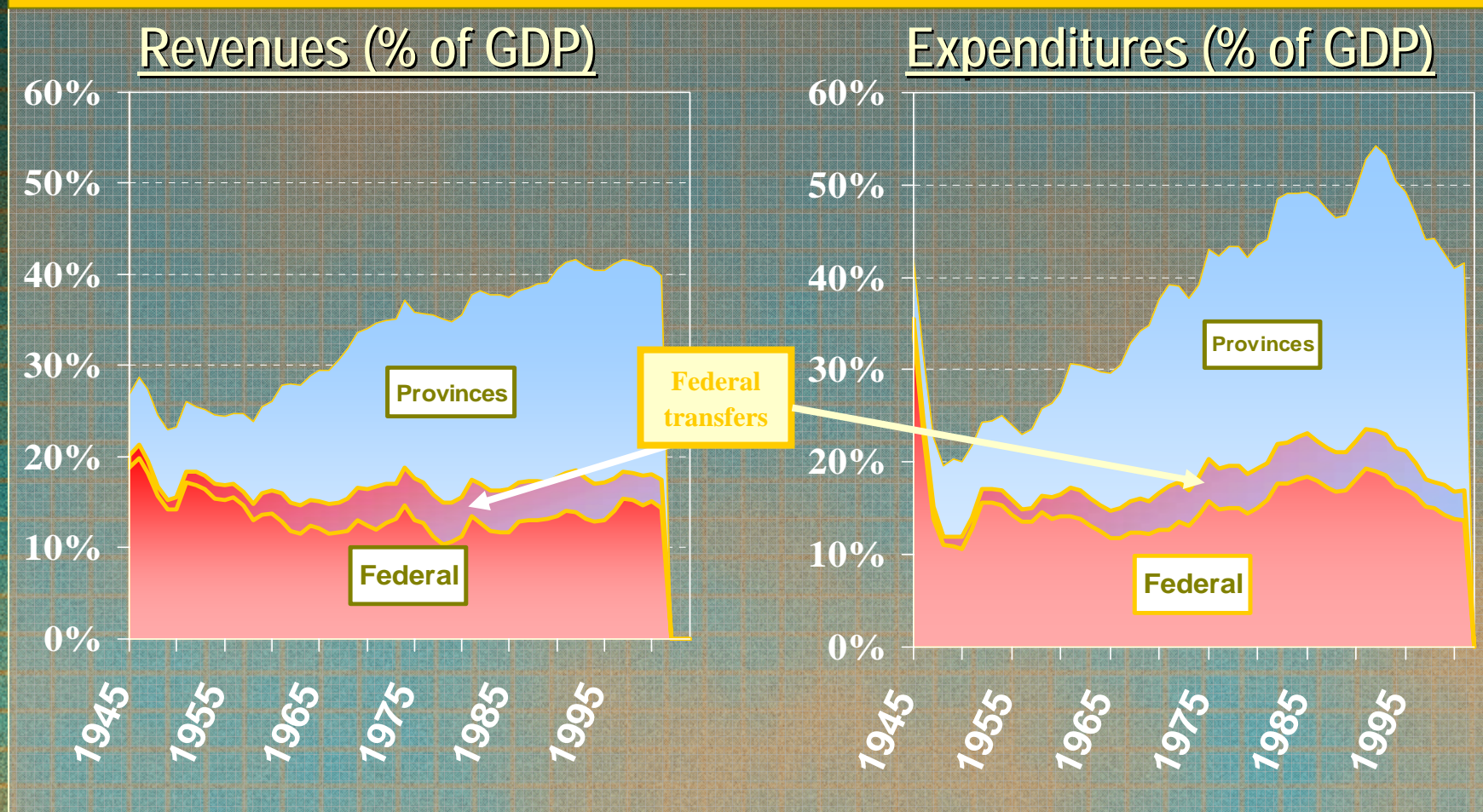
Federal spending pressures

Security and national defence	✓
Seniors' benefits	✓
Aboriginal people	✓
R&D and skills	✓
Transfers (CHST, Equalization)	✓

1.4

Decentralisation in Canada: historical trends

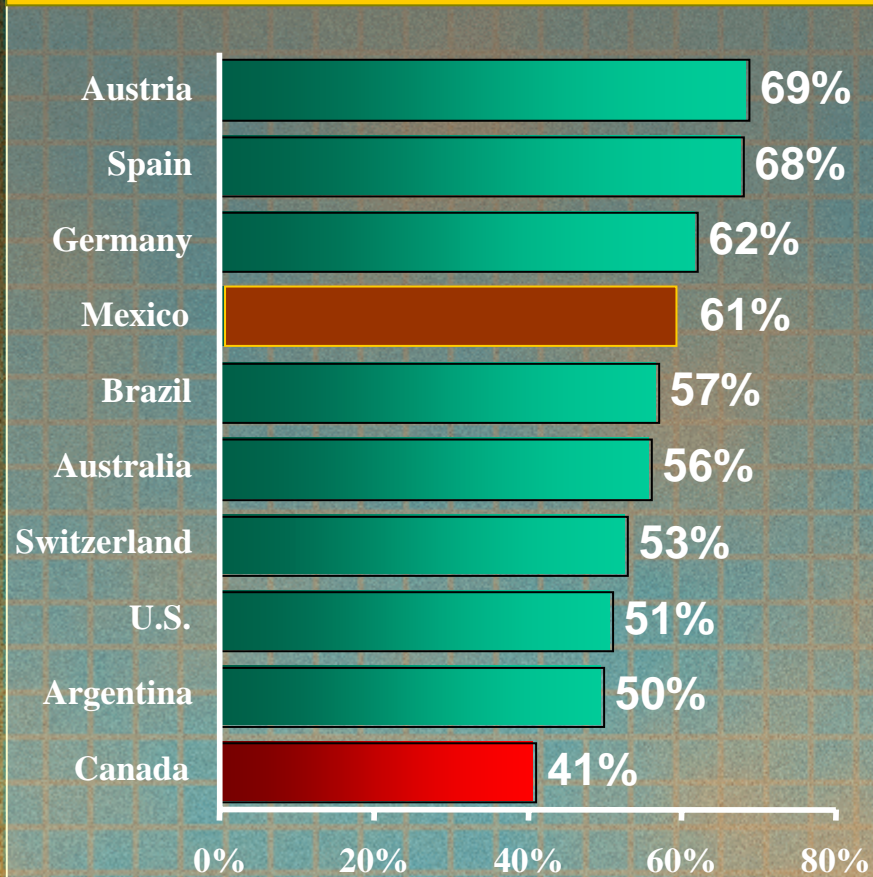
Evolution of government revenues and expenditures 1945-2001



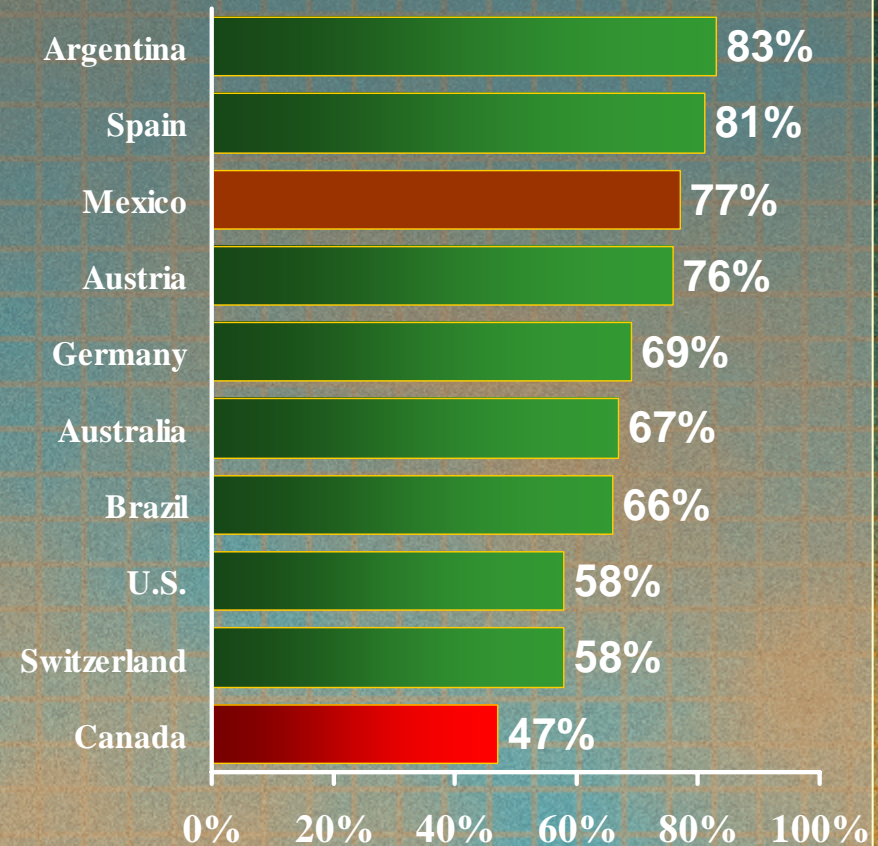
1.5

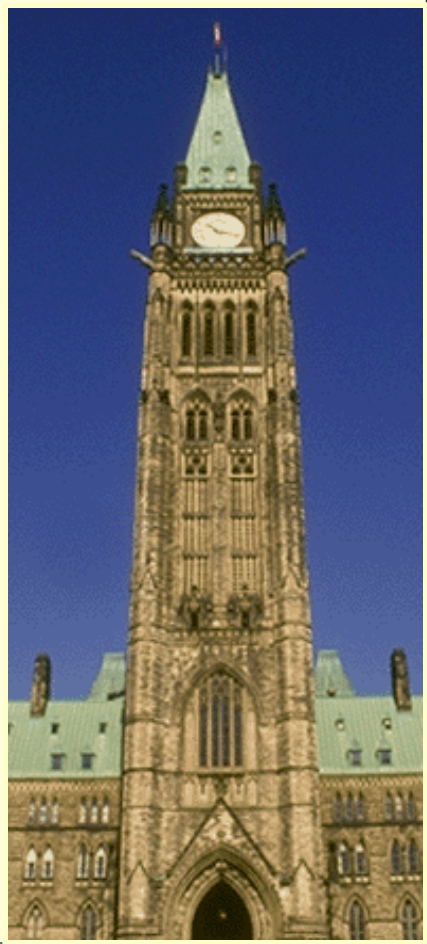
Canada: a decentralised federation

**Federal share of
direct spending (1998)**



**Federal share of
tax revenues (1998)**



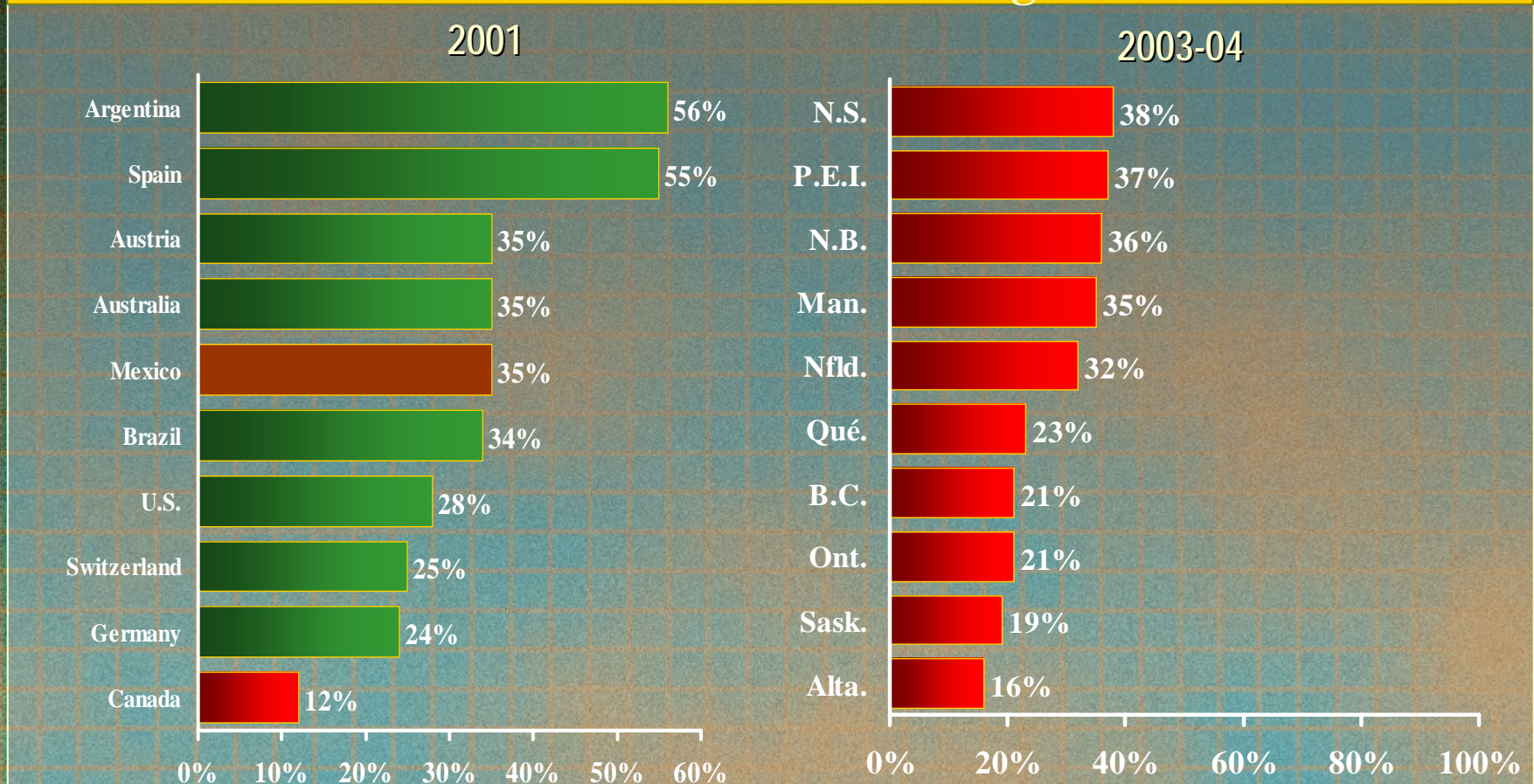


2. Federal Transfers to Provinces

2.1

Canadian provinces relatively autonomous

Federal transfers as a % of total revenues of other levels of government

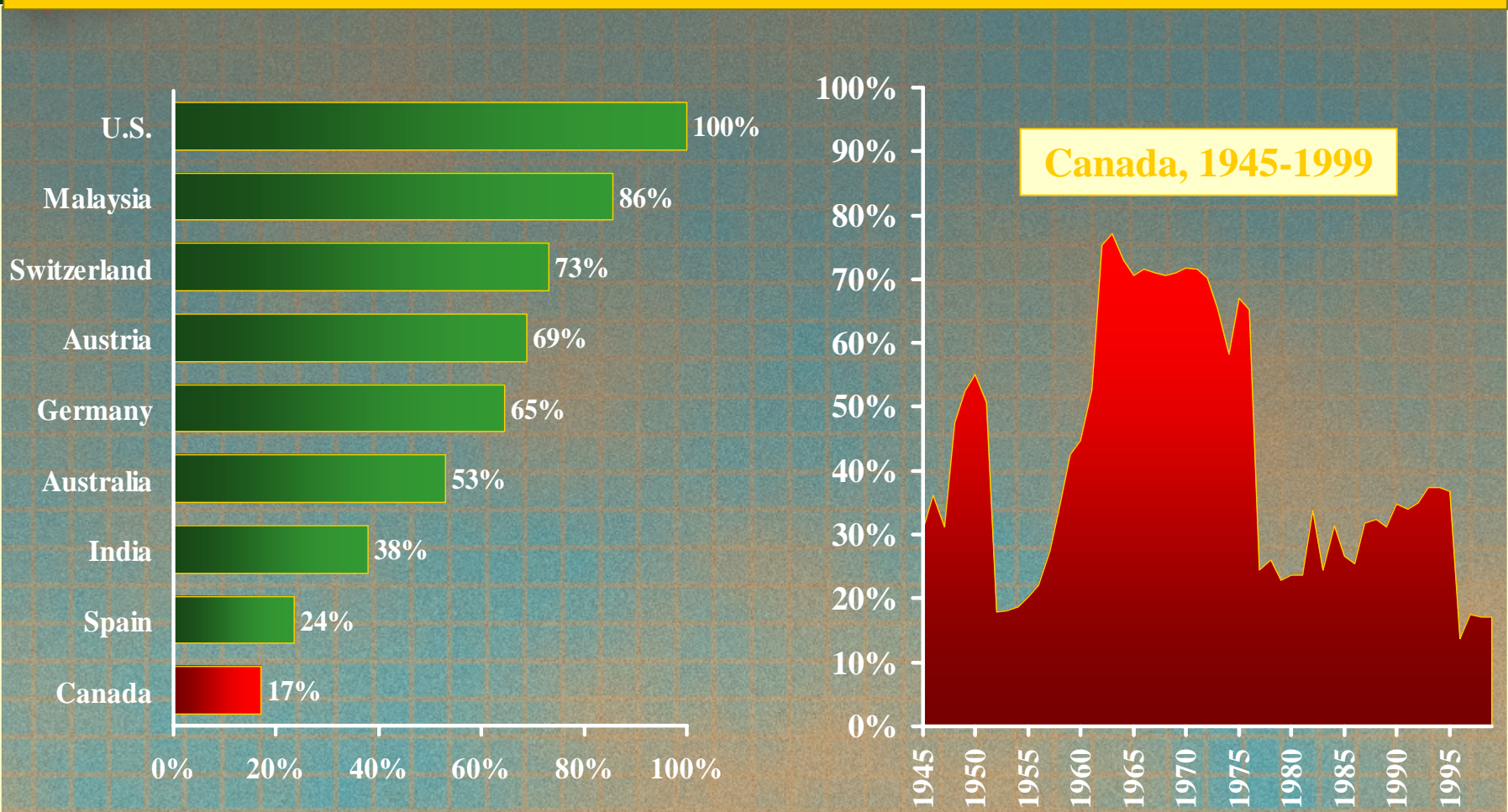


Sources: World Bank, Fiscal Decentralization Indicators, March 2001 (based on IMF's Government Finance Statistics); Finance Canada; Inter-American Development Bank

2.2

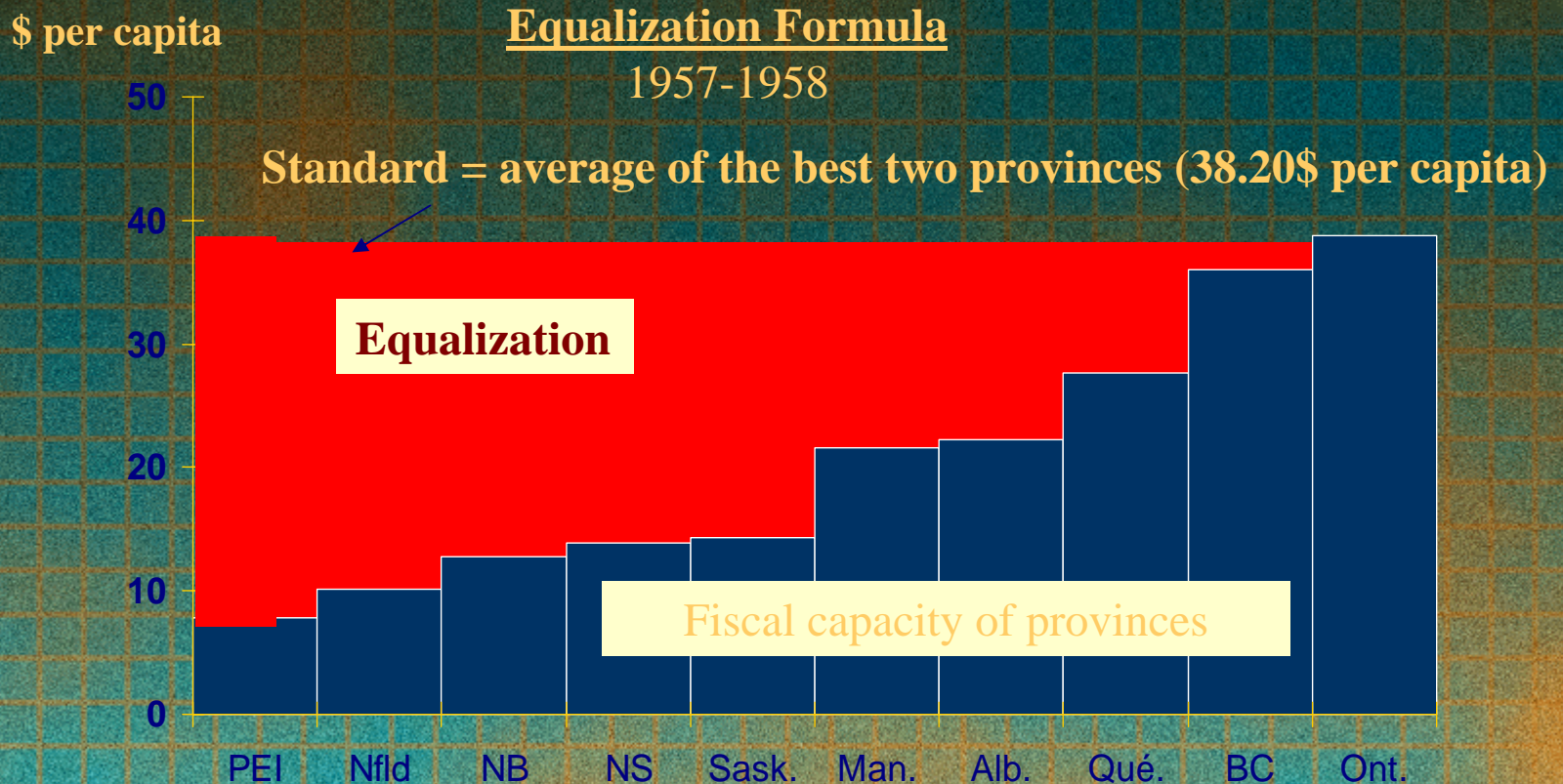
Canada: transfers mostly unconditional

Shared-cost/high-conditionality transfers (% of total transfers)



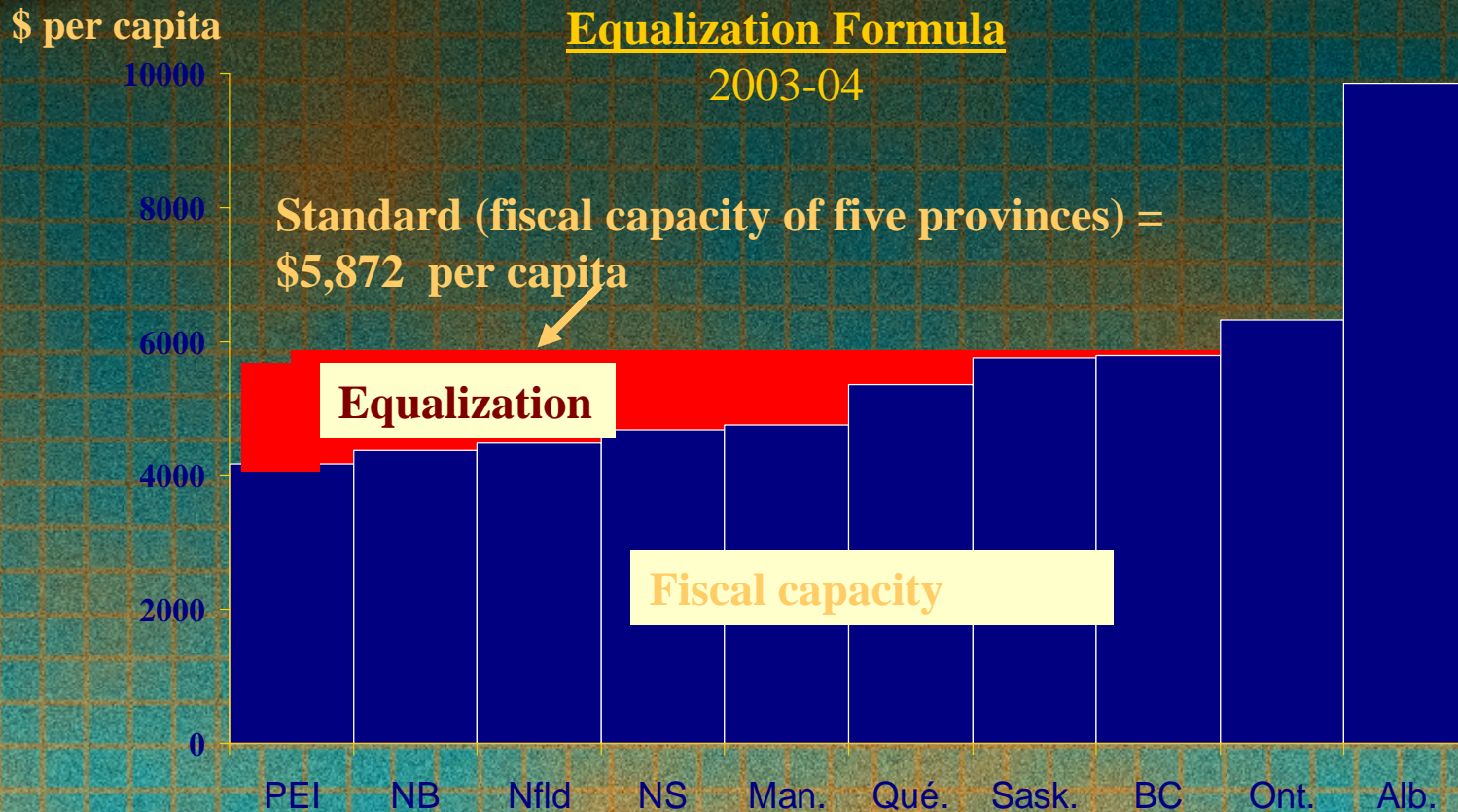
2.3

The Equalization program was created in 1957 to equalize provincial fiscal capacity



The equalization program was created by the Liberal government of Prime Minister St-Laurent just before his defeat at the hands of the Progressive Conservatives under Diefenbaker

The Equalization program was significantly modified in 1982 with the introduction of a 5 province standard



Equalization transfers are completely funded by the federal government, i.e., the program is financed by the citizens of all provinces



The Canadian Constitution (1982)

PART III: Equalization and Regional Disparities

- 36.(1) without altering the legislative authorities of Parliament or of the provincial legislatures, or the rights of any of them with respect to their legislative authority, Parliament and the legislatures are committed to:
- (a) promoting equal opportunities for the well being of Canadians
 - (b) furthering economic development to reduce disparities in opportunities; and
 - (c) providing essential public services of reasonable quality to all Canadians
- 36.(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 (emphasis added).

The Evolution of the Equalization Program from 1957 to today

Years	Sources of Revenue Coverage				Standard	Other
	Tax Revenue	Natural resources	Other	Revenues of local govt's		
1957-58	Income tax	None	None	None	Two Best Provinces	
1962-63	Income tax	Partial	None	None	National Standard	
1964-65	Income tax	Partial	None	None	Two Best Provinces	
1967-68	All	All	Nearly all	None	National Standard	
1973-74	All	All	Nearly all	Education	National Standard	
1974-75	All	Restricted	Nearly all	Education	National Standard	
1977-78	All	Restricted	Nearly all	Education	National Standard	
1982-83	All	All	All	Education/property	5 Provinces	Ceiling/floor
1987-88	All	All	All	Education/property	5 Provinces	Revised ceiling/floor
1992-93	All	All	All	Education/property	5 Provinces	Revised ceiling/floor
1994-95	All	All	All	Education/property	5 Provinces	Revised ceiling/floor
1999-00	All	All	Nearly all**	Education/property	5 Provinces	Revised ceiling/floor
2003						Ceiling eliminated
2004	New Framework for equalization***					

** User fees excluded

*** In October of 2004 equalization entitlements were capped at \$10B for 2004-05 and \$10.9B for 2005-06

Example of How Equalization is Calculated

Sales Tax Base, Fiscal Year 1998-99

	RTS Tax Base (\$ 000)	Revenues Subject to Equalization (\$ 000)	National Average Tax Rate (NATR)	Yield of Tax Base at NATR (\$ 000)	Population	Per Capita Yield of Tax Base at NATR (\$)	Per Capita Deficiency (+) or Excess (-) (\$)	Equalization Entitlement ¹ (\$ 000)
Nfld.	4,369,156			352,066	545,895	644.93	169.77	92,678
P.E.I.	1,129,907			91,048	136,690	666.09	148.62	20,314
N.S.	8,927,787			719,400	935,824	768.73	45.97	43,022
N.B.	6,743,880			543,421	753,450	721.24	93.46	70,419
Que.	67,837,649			5,466,351	7,322,579	746.51	68.20	499,402
Ont.	119,533,186			9,631,973	11,372,301	846.97	(32.26)	(366,885)
Man.	10,708,732			862,909	1,137,434	758.65	56.06	63,766
Sask.	9,927,311			799,942	1,024,158	781.07	33.63	34,446
Alta.	42,868,533			3,454,342	2,900,034	1,191.14	(376.43)	(1,091,666)
B.C.	43,262,652			3,486,100	3,995,759	872.45	(57.74)	(230,729)
Total	315,308,793	25,407,553	8.058%	25,407,553	30,124,124	843.43		
Standard²	251,269,530			20,247,275	24,852,231	814.71		

\downarrow NATR = Total Revenues/Total Tax Base
 \downarrow Standard to which provinces are compared

1. Provinces having a negative equalization entitlement for the sum of all 33 revenue sources are not eligible for equalization since they have a fiscal capacity that is higher than the standard.

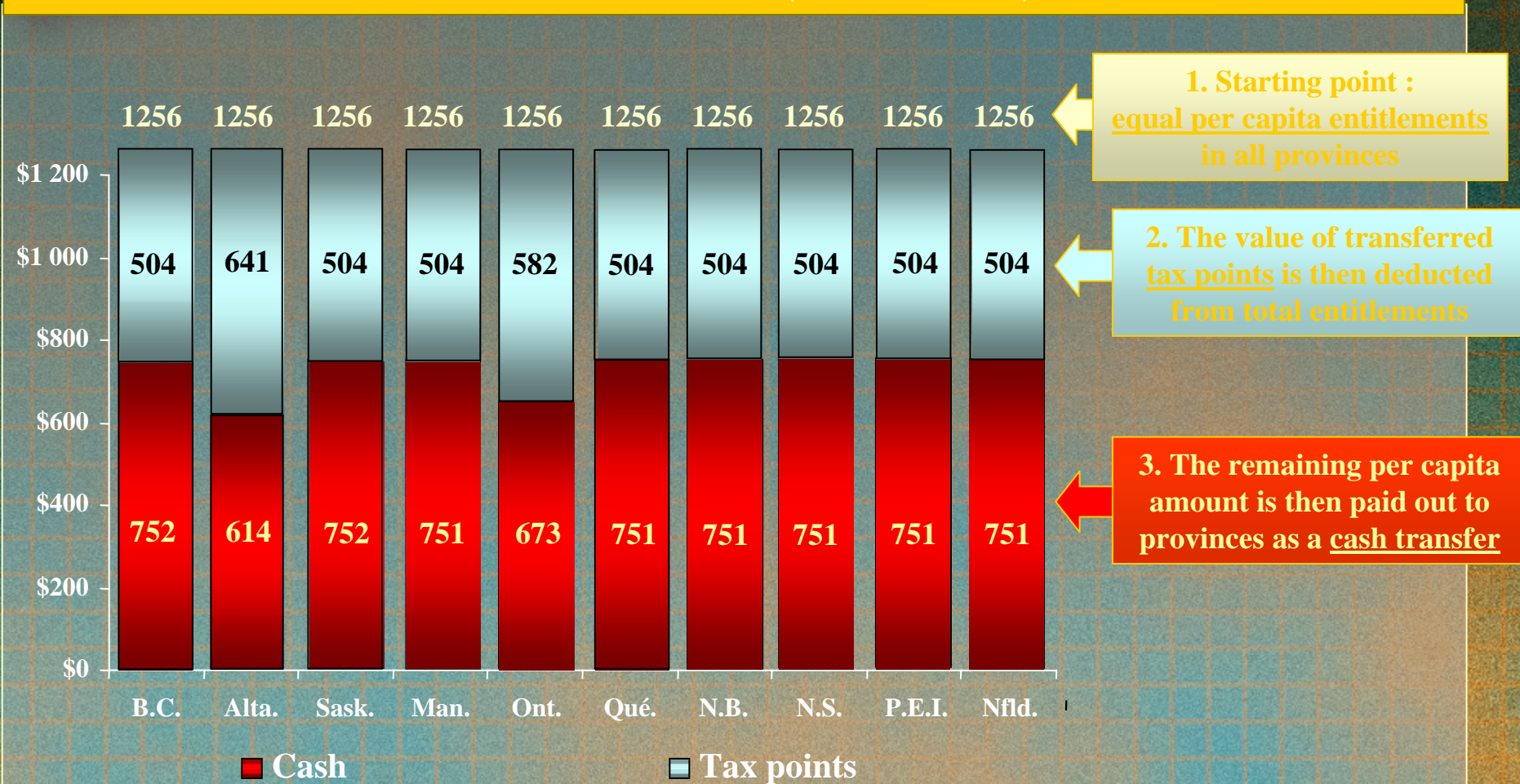
2. The standard is made up of Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.

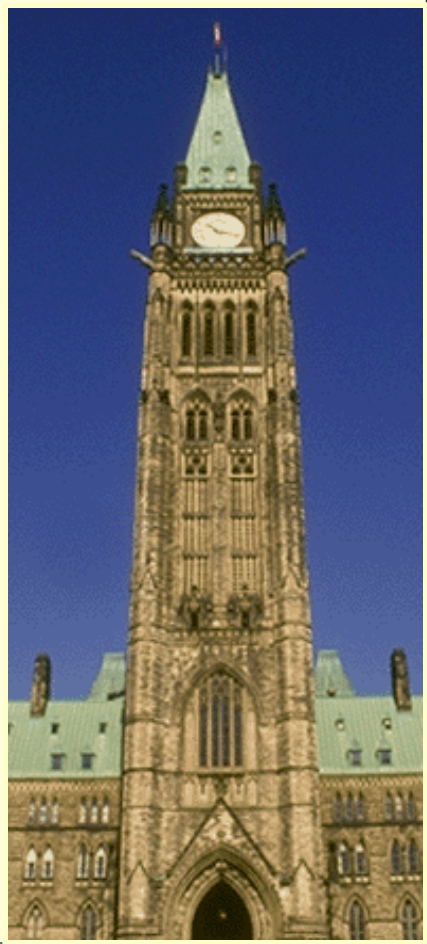
Source: Federal Department of Finance, Final Estimate of 1998-99

2.4

The Canada Health Transfer and Canada Social Transfer

CHT and CST (2004-2005)



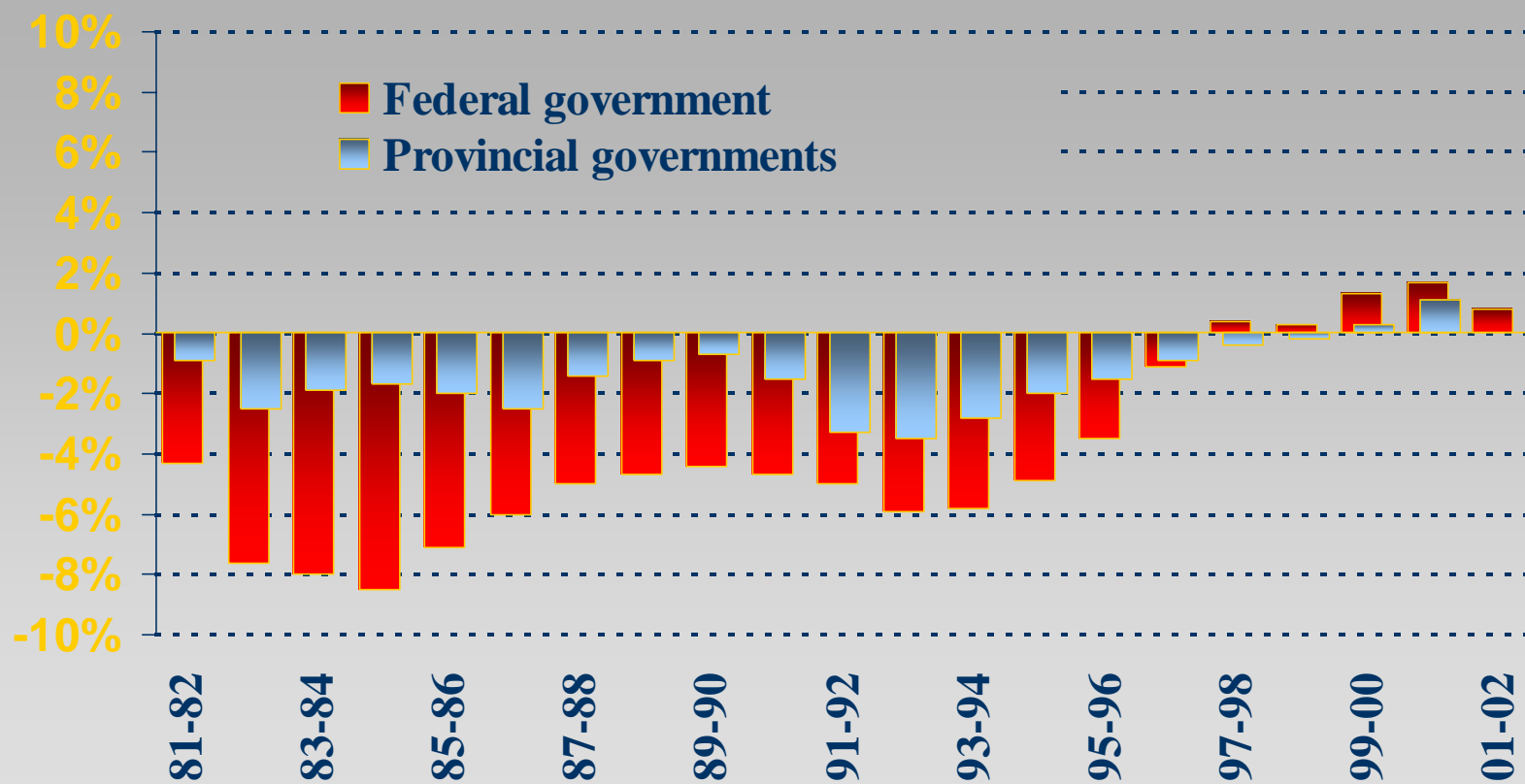


3. Key Issues

3.1

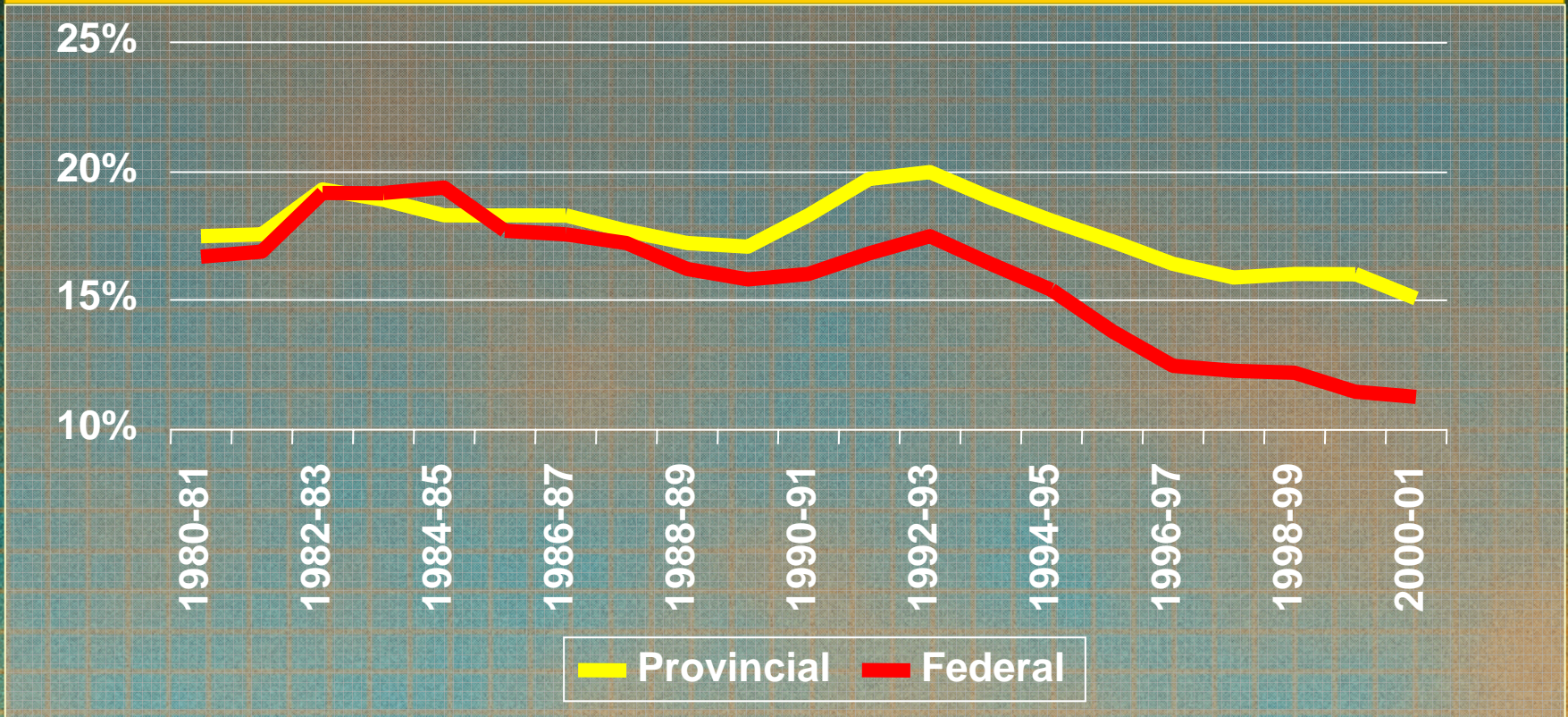
Fiscal recovery in the late 1990s

Federal and provincial governments fiscal balance, % of GDP
(1981-82 to 2001-02)

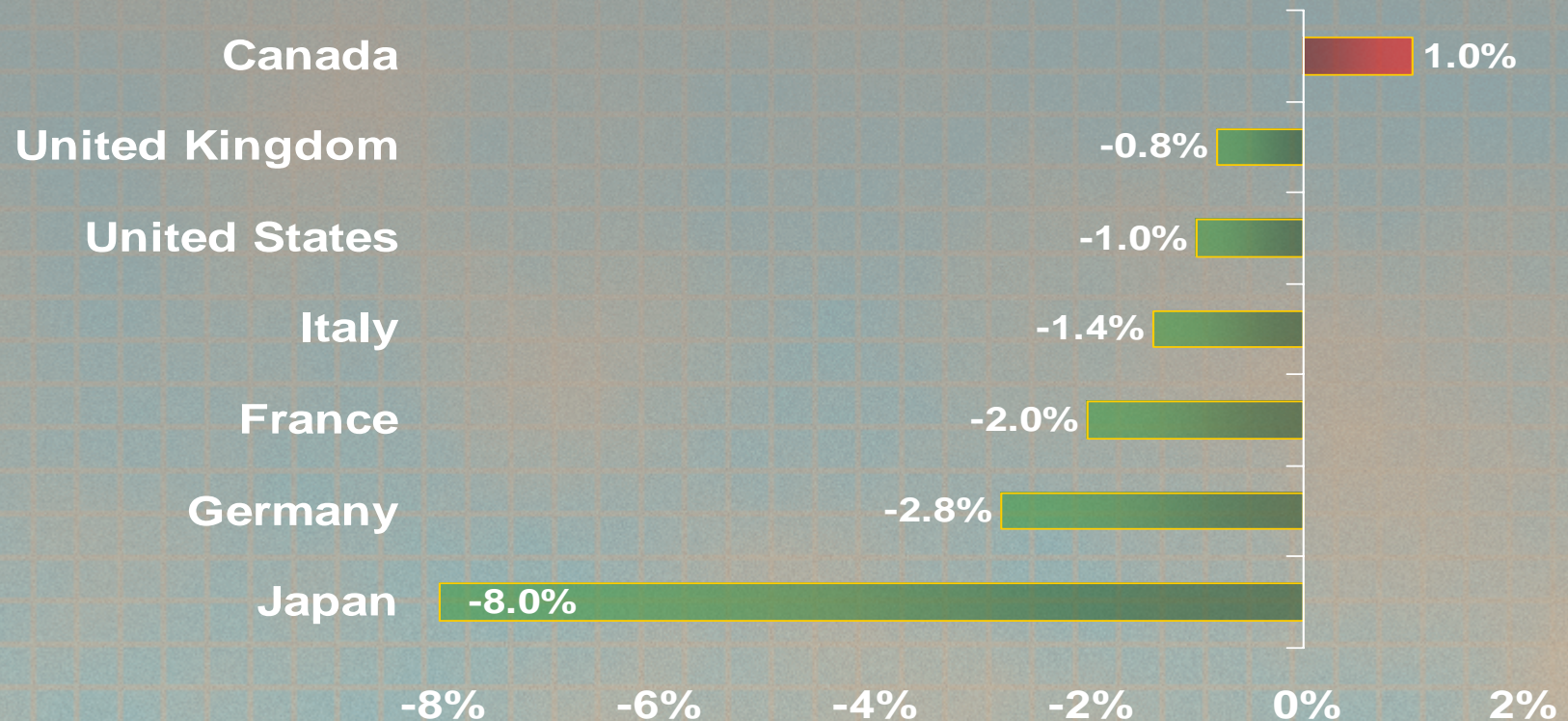


3.3 *Program expenditures significantly reduced*

Federal and provincial program spending (% of GDP)



3.2

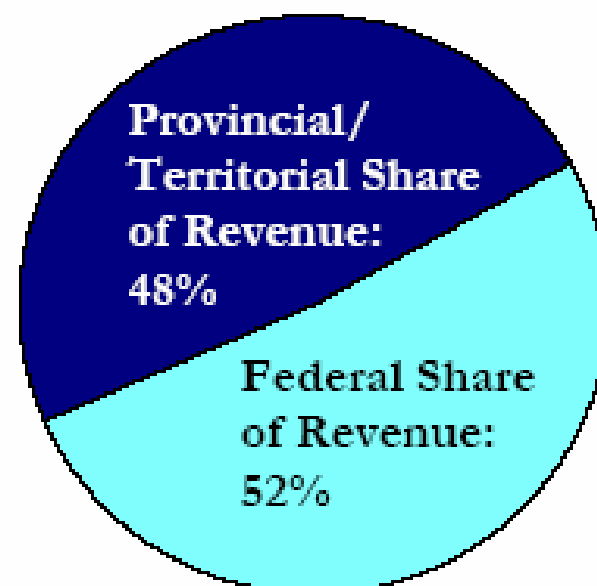
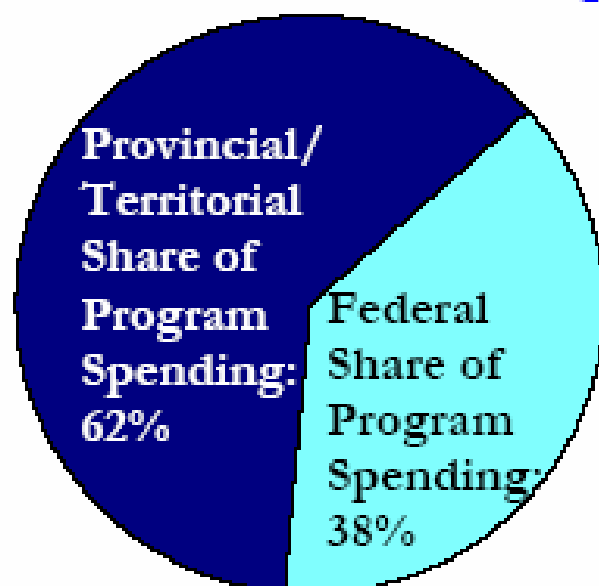
*Canada in good fiscal shape today***Total Government Budget Balances, 2002 Projection (% of GDP)**

Source: OECD Economic Outlook (June 2002)

Vertical Fiscal Gap (VFG)

- VFG means that federal own-source revenues are greater than federal direct spending
- VFG reflects policy choices
 - Degree of centralization
- Transfer issues related to VFG
 - Size
 - Conditionality
 - Regional distribution

Provinces and Territories Provide the Lion's Share of Canada's Public Programs.....

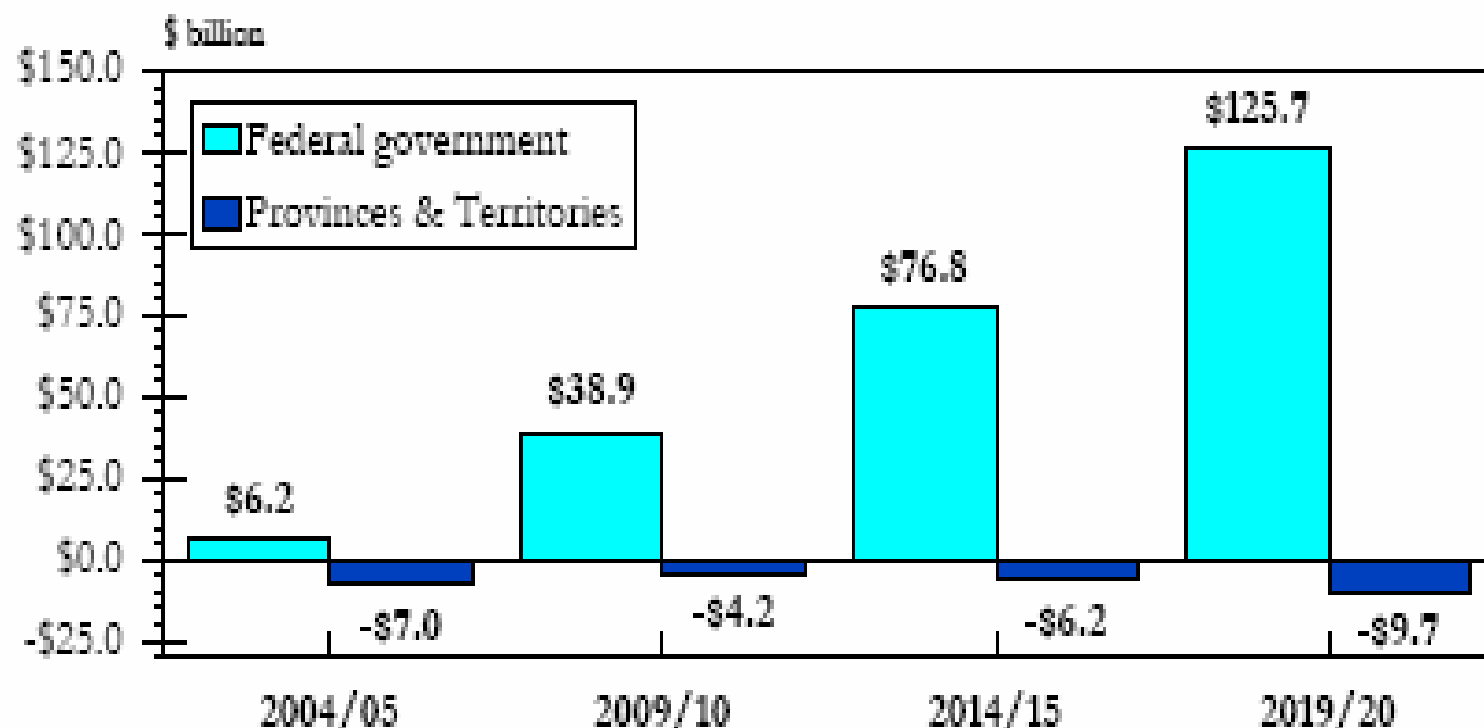


.....While Collecting a Smaller
Share of Revenue than the
Federal Government

Data reflect 2001/02. Spending data excludes transfers.
Revenue data refers to "own source" revenue.
Source: Public Accounts.

Buoyant Federal Outlook Has Scope for Stronger Federal Support of Health & Social Programs

In contrast, future provincial & territorial fiscal situation is precarious



Source: G.C. Ruggieri, *A Federation Out of Balance*, June 2001.

The Conference Board of Canada
Insights You Can Count On



Vertical Fiscal Imbalance July 2002



Fiscal Prospects for the Federal and Provincial/Territorial Governments

Excerpts:

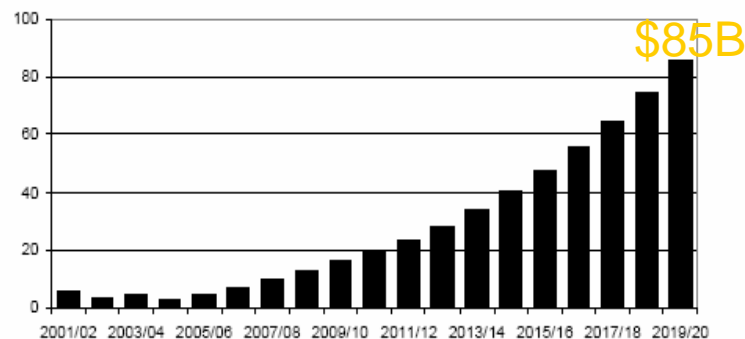
- This study examines the issue of vertical fiscal imbalance between the federal and provincial governments over the long term.
- It answers the basic question: is there an imbalance between the budgetary leeway of the federal government and that of the provincial and territorial governments in Canada?
- Based on a projection of the fiscal and budgetary status quo, the answer is definitely yes.
- Under current revenue and spending structures, the federal government is forecast to achieve multi-billion-dollar surpluses large enough to virtually eliminate its interest-bearing debt by 2019/20.
- On the other hand, the aggregate provincial net debt will increase by 54 per cent to reach \$386.9 billion.
- In contrast, the provinces and territories will have no leeway to implement new policy initiatives over the next two decades. On aggregate, they will neither be able to increase spending nor cut taxes without falling more into deficit.

Canadian Federal vs Provincial Fiscal Projections 2001-2020

Chart 1

Federal government budgetary balance

(\$ billions)

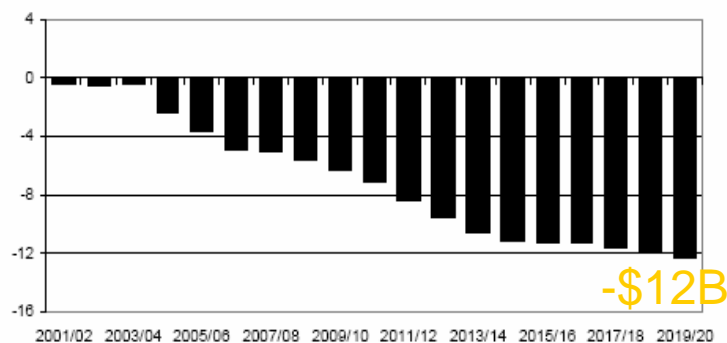


Source: The Conference Board of Canada; Finance Canada

Chart 4

Provincial/territorial government budgetary balance

(\$ billions)

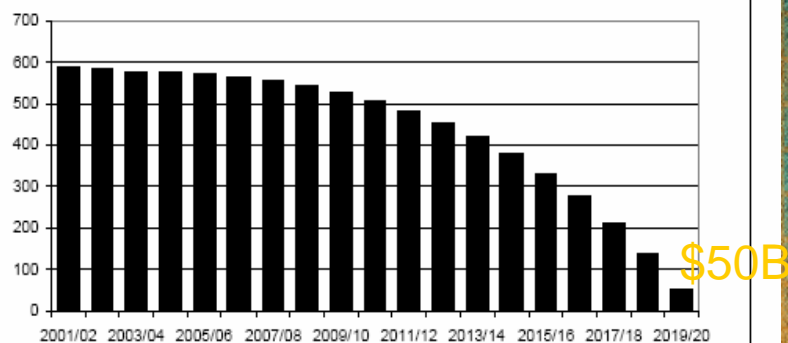


Source: The Conference Board of Canada; Provincial/territorial budget documents

Chart 2

Federal government interest-bearing debt

(\$ billions)

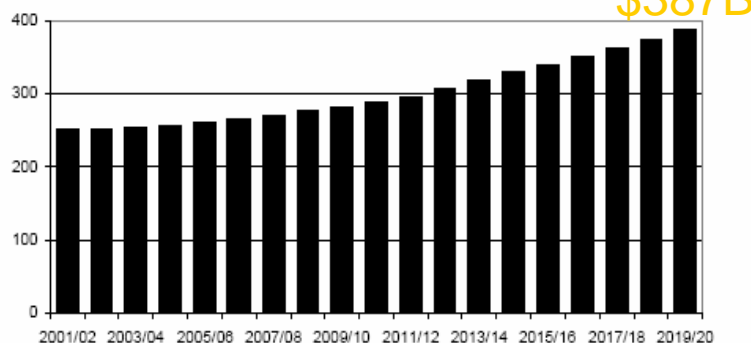


Source: The Conference Board of Canada; Finance Canada

Chart 5

Provincial/territorial government net debt

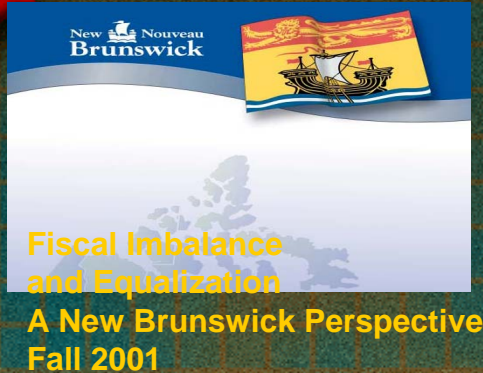
(\$ billions)



Source: The Conference Board of Canada; Provincial/territorial budget documents

Principles vs Practice

The Barriers

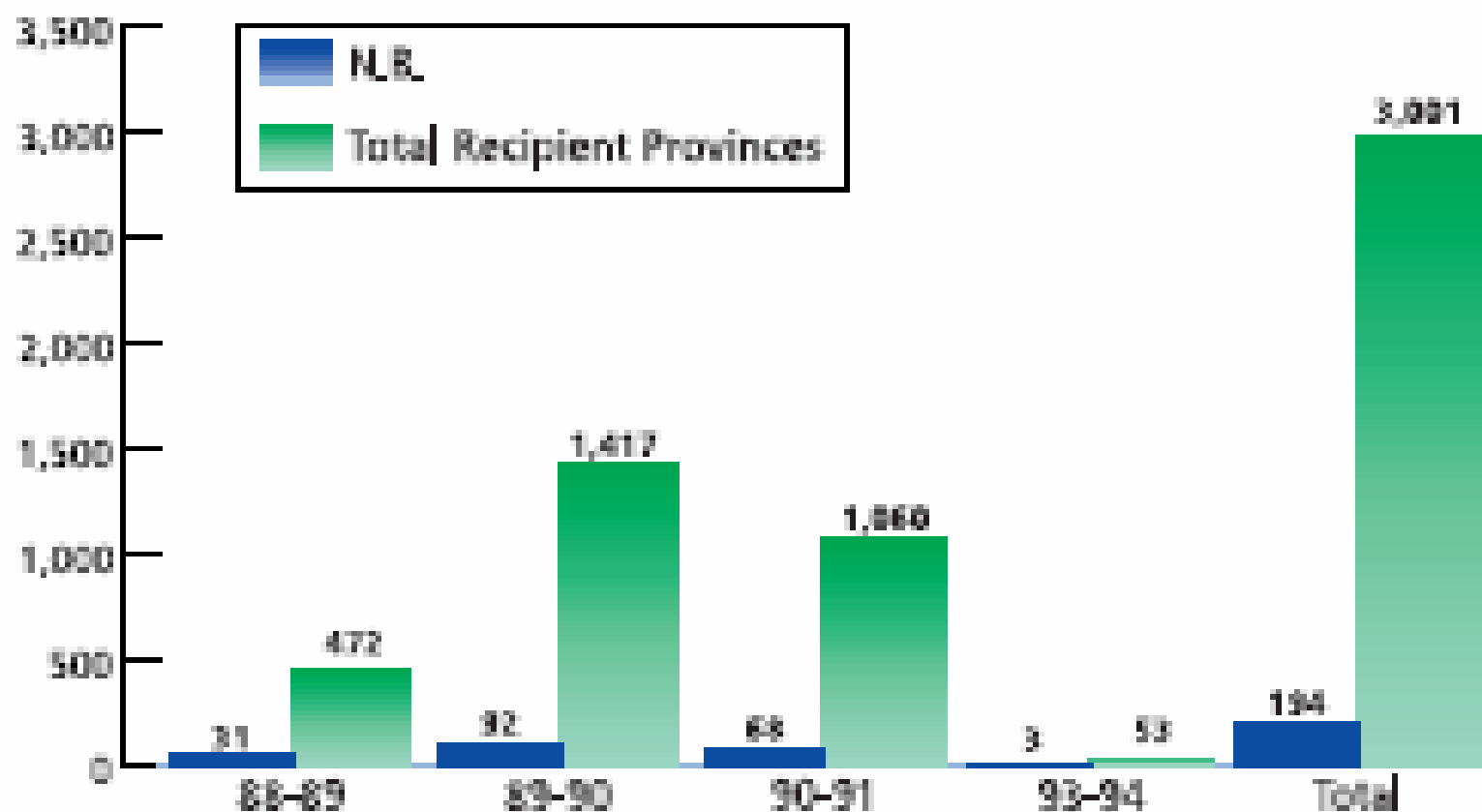


- Whether the Equalization Program is upholding the constitutional commitment has been the source of considerable debate. It is undeniable that equalization has contributed to a narrowing of relative fiscal disparities. However, it is debatable whether provinces have the ability, after Equalization, to provide reasonably comparable levels of public services and taxation (pg 10).

- Barriers
 - Ceiling
 - 5 Province Standard
 - Non-inclusive revenue coverage
- Solutions
 - Remove ceiling
 - National Standard
 - Comprehensive revenue coverage

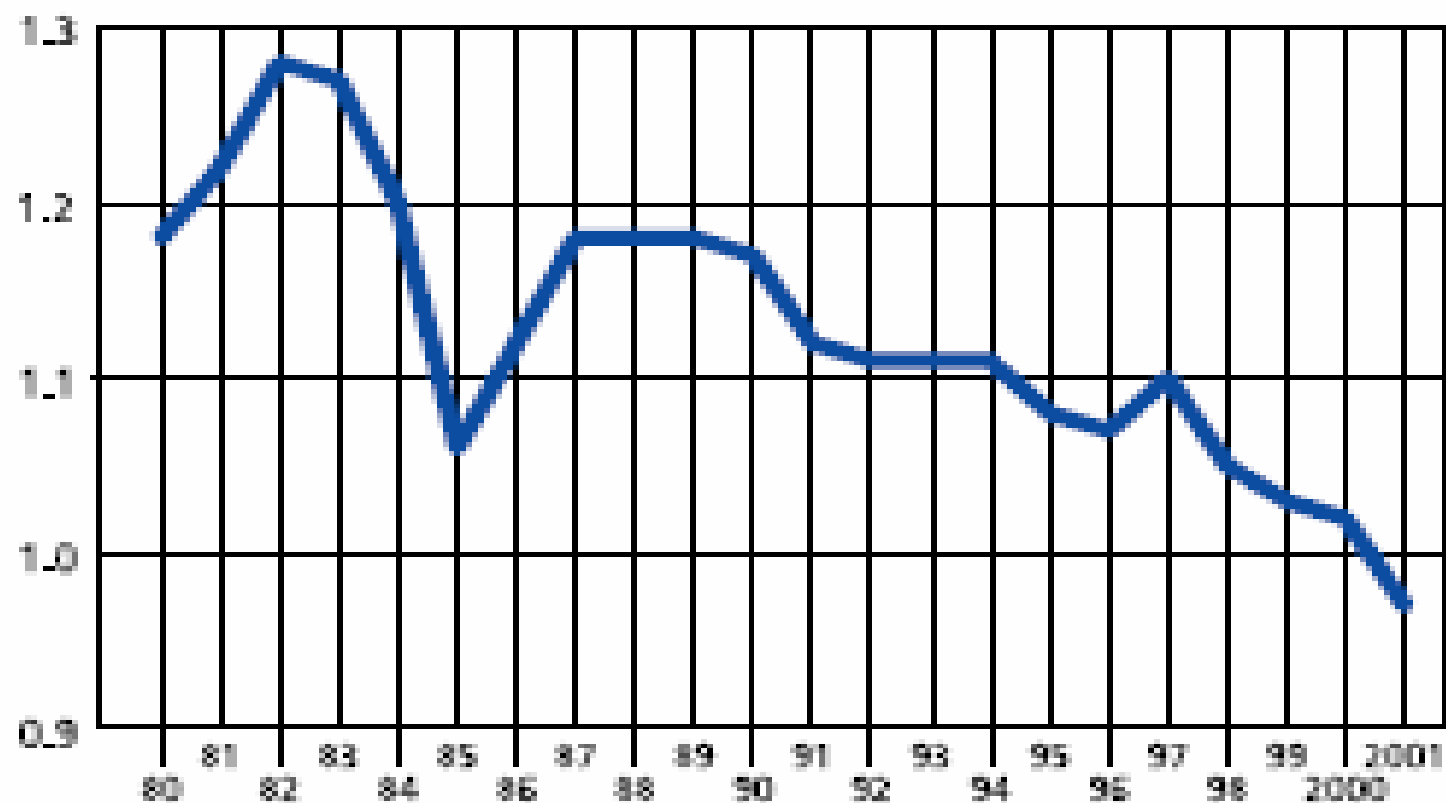
Chart 9, Cost to Recipient Provinces of Ceiling on Equalization

\$ millions



Source: Federal Department of Finance

Chart 3, Equalization Entitlements in Canada
as a percentage of GDP, 1980 to 2001



Source: Federal Department of Finance and Statistics Canada

Re-Balancing Solutions





Executive Federalism in Canada

- **First Ministers**

- The Prime Minister of Canada meets with Premiers of the Provinces and Territories, but there is no set schedule for these meetings
- Used for Constitutional and Fiscal Issues and for Program Coordination
- Premiers have pressed for more regular F/P/T meetings
- They have also recently established a “Council of the Federation” to discuss and coordinate their positions on issues which might be raised with the Federal Government
- There are also regional meeting of Premiers in the Western provinces and territories, in Atlantic Canada and in central Canada.

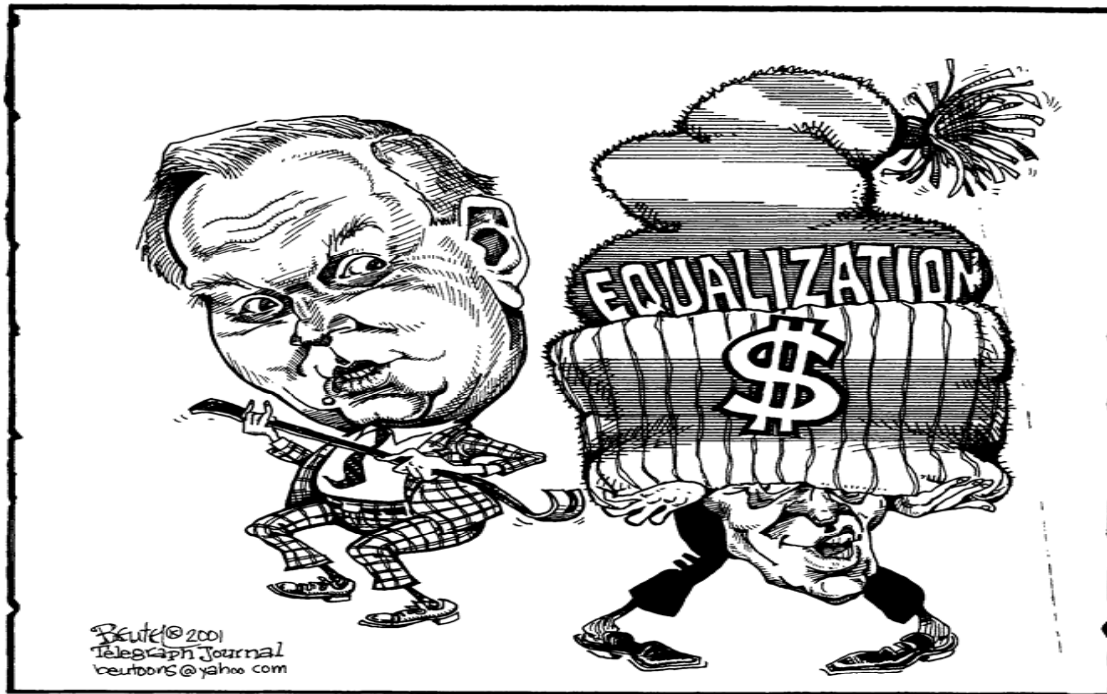


Executive Federalism in Canada

- **Ministers of Finance**

- Ministers of Finance of the provinces and territories traditionally meet with their federal counterpart twice annually, before and after budget “season”
- They are supported by a number of committees of officials, who provide common briefing notes on economic and fiscal data and projections, tax coordination, fiscal arrangements and the CPP/QPP
- The Governor of the Bank of Canada often is invited to attend a portion of the pre-budget meetings.

Executive Federalism



The Telegraph Journal
April 28th, 2001

Executive Federalism



The Telegraph Journal
February 26, 2000
2001

Feb 26, 2001

More Executive Federalism



The Times & Transcript
February 27th, 2001

Feb 27, 2001



Recent Developments

In 2004 a new framework for equalization was put in place

- A new ceiling of \$10 billion for 2004-05
- Protection for the provinces against reductions globally or individually
- A new ceiling of \$10.9 for 2005-06
- Creation of a five person independent expert panel to review the equalization program



What have we learned?

Maintaining Fiscal Balance

- ✓ Ensure the principles are “entrenched”
 - ❖ Balance fiscal capacity; do not reward inefficiencies
- ✓ Ensure the practical application (the formula) captures the principles
- ✓ Differentiate between horizontal and vertical transfers
- ✓ Differentiate between equalization responsibilities and economic development responsibilities
- ✓ Ensure the authority over re-balancing the formula is not biased to one level of government
 - ❖ An entrenched co-operative process
 - ❖ An independent process

QUESTIONS?

- Links to source information:

<http://www.gnb.ca/0024/reports/index.asp>

- My Email:



betts@unb.ca