

## Canada: Emerging Issues in a Decentralized Federation

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For many observers, Canada epitomizes the classical system of fiscal federalism. Autonomous provincial governments are responsible for the provision of many important public services. They enjoy unfettered access to all the major tax sources and are responsible for raising a high proportion of their own revenues. Federal transfers to the provinces are fairly non-intrusive. The two main forms of transfers – unconditional equalization transfers and equal per capita bloc transfers to support provincial social programs – facilitate effective decentralized decision making by ensuring that provinces have comparable capacities for delivering important public services and by encouraging them to provide health, social assistance, and post-secondary education programs that meet minimal nationwide criteria. Federal–provincial agreements have led to textbook forms of income tax and sales tax harmonization and have established the rules of the game for an efficient internal economic union and for a fair and equitable social union. Additional transfers are made to the three northern territories to allow them to deliver public services to small, dispersed populations and to recognize their relatively weak fiscal capacity.

Yet, new challenges are pending. Fiscal decentralization combined with the increasing demand for health care and education, which constitute a large proportion of the public services provided by provinces, has brought with it the prospect of fiscal imbalance, both vertical and horizontal. This challenge extends to municipal governments and to self-governing Aboriginal communities, where some of the need is greatest.

Issues frequently stem from two seemingly contradictory elements of the Canadian federation. The first difficulty is that while the Constitution gives provinces exclusive legislative responsibility in the important areas of health, education, and welfare, the federal government shares a constitutional commitment to provide essential public services of reasonable quality and to promote equal opportunities for all Canadians. Since the public services that are most critical for fulfilling this commitment are provincial responsibilities, the policy instruments left to the federal government are conditional transfers both to governments and to individuals, elements of the so-called “spending power,” which is the federal government’s ability to provide and earmark funds for spending in specific areas of provincial jurisdiction.

The second issue is that provinces own the natural resources within their boundaries and have the right to tax their use. But the Constitution commits the federal government to the principle of making equalization payments so that all provinces have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Given that a substantial source of fiscal disparity among provinces comes from natural resource endowments, some argue that the fulfillment of the equalization commitment implicitly contradicts the provincial ownership of revenues from natural resources.

The key features of fiscal federalism in Canada are clear. The federal government takes on typically national functions, such as defence, foreign affairs, and the monetary system, as well as national social insurance programs and transfers to the provinces. The provinces and their municipalities are responsible for major public services in health, education, and welfare, as well as matters of provincial and local interest. As a result, federal and provincial program spending are comparable, but a high proportion of federal spending consists of transfers to the provinces. Still, the provinces have gradually assumed larger and larger responsibility for raising their own revenues, and do so using all the major taxes. The income tax system is selectively harmonized,

with the federal government collecting taxes on behalf of the several provinces that agree to abide by the federal tax base, but are otherwise free to set their own tax rates. Harmonization also exists in the sales tax area with the four provinces that have adopted value-added sales tax systems. Federal-provincial agreements exist in which the provinces recognize the role of the federal government in the design of important public service programs delivered by the provinces, while the federal government agrees to consult with the provinces before undertaking new spending power initiatives.

The result is that the Canadian federation has evolved into a highly decentralized one that at the same time has a reasonably harmonized tax system. This results in the provinces providing comparable programs in areas like health, education, and welfare, while at the same time allowing them to choose the specific features of program design to reflect their diverse needs and preferences.

Some recent events and trends have put strain on the system. **Faced with what it thought was an unsustainable debt, the federal government dramatically cut its cash transfers to the provinces for social programs** and instead consolidated them into a single bloc transfer. There was little consultation prior to the cuts, and the provinces argued that it effectively transferred part of the federal debt to them. In turn, the provinces cut transfers to their municipalities. This problem of alleged vertical imbalance is exacerbated by a growing horizontal imbalance, which is partly a natural consequence of decentralizing revenue-raising to the provinces and the rise in resource revenues for some but not all provinces..

Many observers have suggested that the federal government has lost its sense of national purpose. Others argue that it has ceased to deal with the provinces in an open, cooperative, and predictable manner. Tension has been heightened by the federal government's use of accumulated fiscal surpluses for direct spending programs rather than to restore transfers to the provinces. In response, the provinces and territories have strengthened their ability to speak with one voice by setting up an inter-provincial institution, the Council of the Federation.

These same concerns also affect municipal governments and Aboriginal communities, albeit in different ways. The fiscal imbalance felt by municipal governments needs to be addressed so that they can provide the necessary public services to ensure that their citizens are cared for and their businesses are competitive in an increasingly globalized world. The financial problems facing Aboriginal communities are even more immediate. These are communities whose residents are among the poorest in the country, and who in many cases lack basic public services. The challenge here is not just a matter of financing; it is also a matter of service delivery as the transition is made from a system in which the federal government had a very hands-on paternal approach to one where the communities themselves take on more and more responsibility. Both of these remain items of unfinished business, and ones that will occupy tax policy-makers in the coming years.