Notes for Presentation by George Anderson
President, The Forum of Federations

Canadian Fiscal Federalism
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A. Context

1. Constitutional:
    - Largely distinct federal and provincial powers: few concurrent
    - Provinces have big spending areas of health, social policy and education
    - Federal both direct and indirect; provinces only direct
    - Provinces own resources
    - Federal spending power
    - Ten provinces: two very large
    - Parliamentary system with “strong governments”: executive federalism
2. Societal
    - Continental scale
    - Quebec: linguistically distinct; highly protective of its autonomy
    - Ontario: 40% of country
    - Eastern four: relatively poor
    - West: resource based economy; Alberta energy
    - Consequence: truly federal society

B. Revenue Arrangements

1. Early fiscal history:
    - Early Confederation: federal dominant but growing provincial role
    - 1930s
        - balanced federal and provincial-municipal spending and each order essentially self financing
        - major fiscal disparities between provinces
        - "tax jungle"
        - Depression
        - First federal-provincial tax agreements for federal government to income taxes for provinces
        - Royal Commission leads to constitutional amendments re unemployment insurance (1940) and old age pensions (1951)

2. War: King government
    - "Tax rental agreements": federal government takes over personal and corporate income taxes and succession duties and agrees to set payments to provinces
    - By 1945, federal government over 80% of spending and about 80% of revenues

3. Early Post-war to 1962
    - Federal government renegotiates tax rental agreements but Quebec withdraws: other provinces continue to get share of federal tax
    - To avoid double taxation in Quebec, where province must raise rates to cover loss of tax rental revenues, federal government introduces "tax abatement" in Quebec : i.e. it vacates tax space equivalent to what would have been Quebec's provincial share of transfers
    - Federal share of revenues slowly declines to 60% and of expenses to 50% through 50s and 60s
    - Equalization program introduced 1957
    - "Tax abatement" also used as a mechanism for Quebec retreat from federally supported programs: but subject to conditions that have Quebec maintaining largely similar programs

4. 1962: Tax collection agreements: Diefenbaker government
    - Federal government vacates some tax room in favour of provinces
    - Federal government collect will collect provincial taxes for free. Condition: Provincial taxes must be a "tax on tax" on personal income tax and on federal definition of "taxable income" for corporate tax. Maintains strong elements of unified tax regime.
    - Quebec out; Ontario out of corporate

5. Oil shocks: late 70s early 80s: Trudeau government
    - National Energy Program: major federal intervention in oil and gas sector: export taxes; export controls; "made in Canada price"; incentives for federal lands
    - Western accord: NEP undone; federal government limited to corporate tax on petroleum
    - East coast provinces get access to offshore revenues

6. Tax reform: Mulroney government, late 80s, early 90s
    - End of Manufacturing Sales Tax: replaced with Goods and Services Tax (VAT)
    - Four provinces agree to harmonize provincial sales taxes with GST: big federal incentives
    - Federal government lets Quebec collect GST in Quebec

7. Federal tax hikes: Chrétien government
    - 1996: part of federal measures to address major deficits
    - Most provinces do not follow; some cut taxes, led by Ontario

8. 2000: Tax on income
    - New system of tax on income (not tax on tax) provides greater flexibility for provinces
    - Also, protects provinces from impacts of federal measures
    - New joint revenue agency for collection of taxes: variable arrangements with provinces

- Federal government provides incentives (free collection) for provinces not to vary from federal tax structure, even if rates and brackets differ (thus provinces must pay to be different)

9. Era of surpluses: Chrétien and Martin governments
    - 1999
    - Federal tax rates start coming down

C: Transfer arrangements

1. Areas of federal transfers (2006)
    - Health: $25B
    - Education and PSE: $15B
    - Equalization: $11B
    - Small programs for housing, agricultural incomes, official languages, young offenders: about $2B

2. Equalization
    - Introduced in 1957
    - Originally “10” province formula of national average fiscal capacity of all provinces
    - Based on “fiscal capacity”, not revenue or need
    - 1982: five province standard because of Alberta at 190% fiscal capacity: excludes richest (Alberta) and poorest (Atlantic) provinces to calculate standard—effectively a few per cent less than a national average, but more stable
    - 2004: value of program delinked from five province standard in that there is now a guaranteed floor value with an annual escalator: this enriches program
    - As well, federal government agrees to some special side deals with particular equalization receiving provinces: Saskatchewan protected from what should have been a large reduction in 04-05; East Coast

provinces protected from “clawback” (reduction in equalization transfers) because of non-renewable resource revenues

- Gives rise to major issue: whether and how to include non-renewable resource revenues; Ontario increasingly attacks regime because equalization receiving provinces can end up with higher fiscal capacity than Ontario
- Longer-term issue: equalization program does not equalize down and Alberta’s growing fiscal capacity is putting it at a strong advantage to other provinces: it has low taxes and high spending; potential distortion effects on real economy
- Program becoming more controversial

3. Social programs

- Variety of health, education and social welfare programs
- 1950-70 all of these programs started as “shared cost” but all moved to per capita “bloc transfers” for “established programs” over time
    - Quebec “opted out” of programs, but did so subject to conditions that maintained a large measure of comparability in actual programs (Quebec got “abatements” or additional transfers)
    - Move to bloc transfers permitted greater provincial flexibility in program design and less federal exposure to cost pressures
    - But provinces carry more risk for cost pressures and health a big driver of government spending
    - Move to bloc transfers based on population hit poorer provinces harder because welfare programs disproportionately expensive for them
- Health insurance program became a bloc transfer but subject to five conditions which federal government monitored: occasionally federal transfers reduced because of lack of respect of these conditions, but the amounts were typically small; over time, health becomes largest transfer
- Starting in 1980s federal deficits led to progressive chipping away at these major transfers

- 1994 budget: major federal cuts equal one-third of health, education and social transfers as of 96-97 (also major cuts in federal own spending)
- Extremely negative reaction from provinces
- Federal government moves quickly from major deficits to period of large surpluses: begins major federal "reinvestments" in health, with federal government getting some new program undertakings from provinces (e.g. re integrated national health information system)
- Federal government also introduces major new program of tax credit for low income families with children, relieving provinces of some welfare expenses; soft undertaking by provinces to "reinvest" savings.
- By 2006, federal health transfers more than make up earlier cuts, but social assistance transfers and post-secondary transfer still not back to previous peak levels; issue most acute in post-secondary area where cost pressures are strong

4. Some observations

- Canadian transfers relatively small compared to total government spending in most federations and with relatively few conditions
- Macro-fiscal environment has had major impact on transfers story, with ups and downs reflecting federal fiscal priorities and balances
- All governments at or near surpluses now
- Federal government engages in extensive consultations and shared technical work with provinces: this sometimes leads to agreed "deals", other times to unilateral federal decisions
- Federal-provincial agreements are not legally enforceable
- Transfers system has been through great stress because of various cuts, cost pressures, and some special deals
- Generally, Canadian system works:
    - High level of public services
    - Tax system and major social programs reasonably coherent across country, with large measure of integrated tax collection
    - Provinces ample space for experimentation, initiative and competition

- o Fiscal situation, which was serious, now extremely healthy
- o But some aspects of transfer regime have become more controversial, especially equalization which has been subject to controversial special deals

This presentation was made the day after the new federal budget in Ottawa. It does not include any references to measures in that budget. These are available on the Finance Canada website.