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Backgrounder

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Recalibrating the Federal Balance

Federal-Provincial Fiscal Priorities for 2006 and Beyond

Finn Poschmann

The Backgrounder in Brief

The May 2, 2006, federal budget posed questions about fiscal priorities and the role of the federal and provincial governments. The response to those questions should include a package of tax, transfer, and regulatory reforms aimed at strengthening the economic union, with a focus on areas where the federal government is capable of acting while respecting its constitutional role.

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The tenor of federal-provincial relations has occupied tremendous space on the public policy agenda since the start of January 2006 federal election campaign.[1] The Conservative Party campaign document had promised to address the "fiscal imbalance," described there as an excess of revenue in federal hands and a relative shortage in the provinces' grasp, by working "with the provinces in order to achieve a long-term agreement which would address the issue of fiscal imbalance in a permanent fashion" (Conservative Party of Canada 2006, 43).

Accordingly, the May 2 federal budget, Finance Minister Jim Flaherty's first, included a background document called "Restoring Fiscal Balance in Canada — Focusing on Priorities," which outlined the new government's views on possible directions for federal and provincial policy and raised specific questions on which the government sought comment (Canada 2006a). The main questions: How should Ottawa manage future federal surpluses, and should they contribute to the Canada/Quebec Pension Plan funds? What are sensible, formula-based reforms of equalization and Territorial Formula Financing? And what stable, long-term arrangements should be put in place to manage federal support for postsecondary education, training, infrastructure, and other elements of the economic union where there are overlaps in federal and provincial responsibility?

To help address these questions, the C.D. Howe Institute in June 2006 convened a panel of experts in federalism and federal-provincial relations (see Box 1); this *Backgrounder*, on a not-for-attribution basis, seeks to reflect their discussions.[2] Among their observations:

- The federal government should contemplate tax arrangements that better align the revenue needs and spending responsibilities of each order of government.
- Changes to federal and provincial taxing powers could help respond to the fiscal and political pressures those governments face; some options, such as reforms to provincial sales taxes, could offer benefits to Canada's economic union. Some panelists, on the other hand, emphasized the federal government's role in revenue-raising and support of provincial social program financing.
- More stable arrangements for federal transfers to the provinces would likewise benefit the economic union.
- A comprehensive package of economic reforms would offer good benefits, but would also increase the difficulty of achieving consensus where such was required among more than a few provinces.
- The foregoing implies that success will require deft handling by Ottawa to assemble a package that achieves federalism's aims while maintaining political support among the provinces.

1 As a point of reference, for the first half of 2006, fpinfomart.ca reports 993 instances of the phrase "missile defence" among all news stories, and 2,967 instances of "fiscal imbalance."

2 I extend profound thanks to Reid S. Adrian, Manning Centre Fellow at the C.D. Howe Institute, Ben Dachis, C.D. Howe Institute Fellow, and Saroja Kuruganty, Max Bell Foundation Fellow at the C.D. Howe Institute, for their efforts in support of this project.

Box 1: *Participants in the C.D. Howe Institute's June 19, 2006, Panel, "Fiscal Priorities: Budget 2006 and the Future of the Economic Union"*

- *Brian Lee Crowley, Atlantic Institute for Market Studies*
- *James Davies, Department of Economics, University of Western Ontario*
- *Janice MacKinnon, Department of History, University of Saskatchewan*
- *Douglas May, Department of Economics, Memorial University*
- *Al D. O'Brien, Institute for Public Economics, University of Alberta*
- *Michael Smart, Department of Economics, University of Toronto*
- *Tracy Snoddon, Wilfrid Laurier University*
- *Dan Usher, Economics Department, Queen's University*
- *Anwar Shah, World Bank Institute*
- *John Richards, Master of Public Policy Program, Simon Fraser University*

From the C.D. Howe Institute:

- *Jack M. Mintz, President and Chief Executive Officer; William Robson, Senior Vice-President and Director of Research; Finn Poschmann, Associate Director of Research.*

From the Privy Council Office, Ottawa:

- *Sylvie Daigneault, Louis Lévesque, Alfred MacLeod, Kevin Page, Anne Scotton*

From the Department of Finance, Ottawa:

- *Barbara Anderson, Peter Berg-Dick, Glenn R. Campbell, Chris Forbes, Frank Vermaeten*

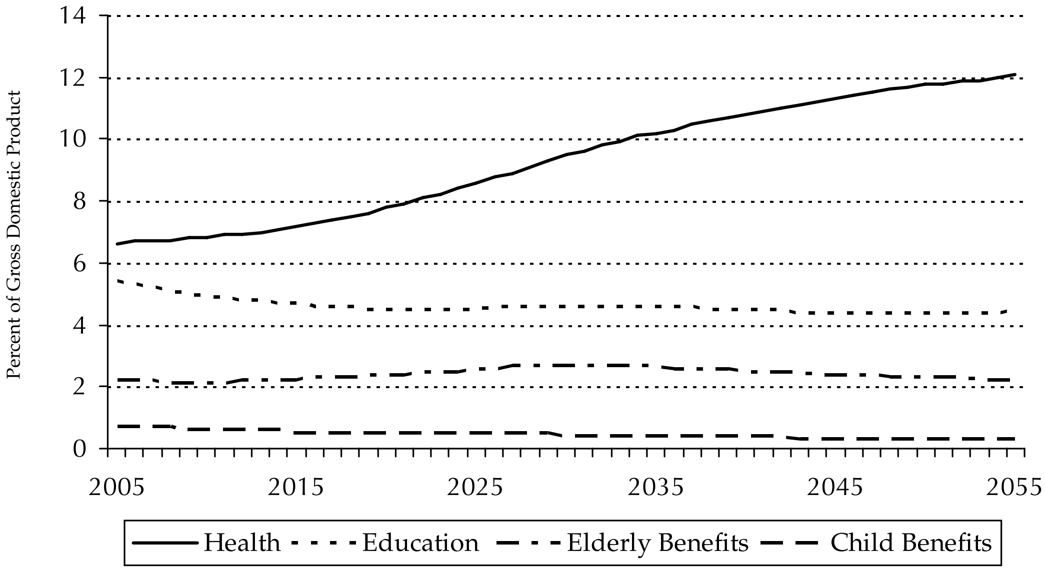
The Federal-Provincial Fiscal Outlook

To discuss fiscal reform in Canada sensibly first requires an overview of the federal and provincial fiscal outlook and, in this context, an understanding of the implications of demographic change.

Canada's population, though not as old as, say, Japan's or Italy's, is in the throes of demographic aging. The spending areas driven most by demography are health, education, and elderly and child benefits. Hence, while spending requirements driven by child benefit programs and educational needs are gradually declining, owing to Canada's relative shortage of children, those driven by elderly benefit programs and, especially, health spending are occupying a relentlessly larger share of the national economy (see Robson 2005).

What is also unavoidable is that most of this burgeoning, demographically driven program spending lies in areas of provincial, not federal, responsibility.

Figure 1 *Major Demographically Driven Government Spending Programs as a Share of Gross Domestic Product, Projected, 2005–2055*



Source: William Robson, C.D. Howe Institute.

This reality has increased the pressure on federal transfer payments to the provinces in recent years, and threatens to continue to do so (see Figure 1).

Policy Implications

The implications of this reality for federal policy are complicated by the differing capacities of the provinces to respond to demographic pressures. Combined with regional politics, the result has been a history of ad hoc fiscal responses and continuing entanglements of federal and provincial responsibilities for financing social programs, with concomitant political rancour. The solution, given that these entanglements will not unravel themselves, is to pursue financing systems that are robust to these pressures and that, on the view of some observers, would emphasize matching revenue and program accountability.

Does this solution imply clear consensus about the direction for policy? Perhaps not: governments may be tempted to think too much about the design of transfer programs, when the source of trouble is lack of control over spending. However, the preceding observations are consistent with a decentralist policy thrust, because over-reliance on federal taxation and transfers to the provinces does not encourage managerial accountability. According to this view, federal transfers have a corrosive effect on the line of accountability between the voters who pay taxes and the public agencies that deliver the services the taxes are intended to finance.

Panelists discussed the contention that incremental reforms would achieve little — as with recent ad hoc increases in federal transfers — and that a larger package of changes would make it possible to address core issues.[3] Change would emphasize rules-based mechanisms, with the aim of stabilizing the federal-provincial relationship and enhancing the predictability of social program financing.

As for devoting a portion of federal surpluses to the CPP and QPP funds, panelists discussed the federal government's proposal to opportunistically build up pension prefunding. On one view, this would improve the current generational imbalance, whereby younger Canadians otherwise stand to receive a poorer deal, *vis-à-vis* the federal government's past fiscal choices, than does the current generation of older Canadians.

Moreover, a rule directing federal surpluses into the Canada and Quebec pension funds would offer some insulation against political pressure to spend all available funds on transient priorities. One objection, however, is that politically driven decisions to steer surplus money into pension prefunding could foreshadow politically driven decisions to fund deficit spending out of future pension fund accumulations, which would undermine the fund's principled independence from the political process (Robson 2006).

An Overview of Federal and Provincial Program Spending Responsibilities

To lend some clarity to policy questions, it may be useful to step back to ask what exactly it is that governments should do to help their citizens.

The observation that fiscal arrangements are not a zero-sum game suggests that the federal government should focus on reforms that make the economy work better overall and that reduce negative interactions among the provinces. However, built-in problems follow from Canada's constitutional environment. For example, Ottawa's lack of a clear capacity to enforce the equivalent of US federal protection of interstate commerce — arguably a benefit to the US economic union — limits Canada's ability to reduce provincial protectionism in various goods and labour markets.

Meanwhile, it was clear to panel participants that the welfare state matters to Canadians, and that there is a role for government in addressing perceived market failures and promoting citizens' welfare. Some panelists found it notable, however, that Ottawa has had difficulty both defining its role in this context and sticking to it. In their view, political exigencies have led Ottawa to pay too much attention to areas of provincial or shared program responsibility and too little to those of clearly federal responsibility.

The foregoing would militate for an energetic federal agenda, and in the view of some panelists this implied more federal attention to defence and, in the social realm, aboriginal welfare, particularly education, both on- and off-reserve. As to areas of provincial constitutional responsibility or devolved federal responsibility, panelists felt that the appropriate federal role should be to set standards for

3 As a pragmatic policy prescription, some panel participants felt that cooperation and compromise would form a surer route to incremental gains, in light of the likely opposition to reforms that would generate significant winners and losers among the provinces.

service delivery and establish robust, medium-term mechanisms for ensuring those standards are met; one recurring issue was the federal role in postsecondary education.

Interestingly, globalization will help sort through these choices, because the pressure of global interaction tends to limit the power of the federal government. And while the federal government has a strong part to play in enhancing national competitiveness, the business of matching local needs and wants is inherently local — perhaps the issues here are not federal-provincial questions. In economic terms, voters act as principals in local government decisions and, on this view, in policy areas where choices can be settled at the local level — a level of government without constitutionally recognized status and relatively undeveloped in Canada compared to other Western nations — both Ottawa and the provinces ought to consider taking a back seat.

The 2006 Budget and Taxing Powers: How to Balance Fiscal Capacity and Accountability

The text of the May 2006 federal budget included extended discussion of matching revenue-raising capacity with spending needs. This speaks directly to the question of taxing powers, and how to ensure that the level of government that spends the money bears suitable accountability for raising it. Yet, there is a more basic question: do economic rationales militate for a given tax being levied by one level of government as opposed to another? Does the risk of tax-base flight — ever present at the international level and perhaps even more difficult to manage at the local level — bear messages for tax design? What taxes might migrate from the federal to the provincial level or vice versa?

When looking for candidates for the provinces to take on, some panelists saw the economic logic as clear with respect to property, payroll, and excise taxes. Such taxes may be efficiently levied at the provincial level, in the sense that negative spillovers are few, and they pose few equity issues if provinces levy them. Compliance costs are not necessarily higher when these taxes are set at the provincial as opposed to the federal level, and provinces are relatively free to choose how to set them and at what rate — a plus from the perspective of devolving authority.

The same comments hold, if less forcefully, with respect to value-added (consumption) taxes, such as the goods and services tax, and to personal taxes on labour income (wages). Provinces do, of course, levy such taxes, and in the view of many observers they should take over a larger share of them from the federal government. The federal government's contribution would then be to define and administer them, with the aim of lowering compliance and efficiency costs.[4]

Taxes that the provinces should avoid are those on capital income, whether levied directly on individuals or via taxes on corporate income. Capital income is far too mobile, not just interprovincially but internationally, to form a good base for growing provincial taxes. As matters stand, levying taxes on corporations is an

4 This interpretation of the federal role implies that the federal government would not vacate these fields entirely.

expensive undertaking for provinces; consequently, a shift to a fully coordinated federal corporate base looks more likely than a shift in the opposite direction.

What would make sense, in the view of some panelists, is for the provinces to cede the collection of corporate income tax — and, therefore, the definition of the corporate tax base — to the federal government and instead to take up consumption tax room, including perhaps some excise or "sin" (alcohol, tobacco, and gambling) taxes.[5]

The economic benefits of a reorganization in tax collection would be especially large for provinces that currently use retail sales taxes and that agreed instead to levy a VAT or harmonized sales tax. Retail sales taxes place a heavy burden on incremental business investment in local activities because they do not permit the full tax paid on business inputs to be deducted (or credited). VATs, in contrast, can be made neutral with respect to business investment, implying that a federal-provincial shift in (and reform of) tax-collection mechanisms would be an important growth-enhancing change. One important feature of provincial VATs is that the many benefits could be achieved without full harmonization, and this would militate for Ottawa's being flexible in negotiating a collection agreement, potentially accommodating some provincial variation in VAT rates and bases.

The possible political dynamics of reform divided panel participants. Some felt that incrementalism would rule out the major changes that Ottawa might promote as part of a program aimed at improved competitiveness and management of the national economic space. Others felt that steady reforms to provincial and federal taxes were part of a natural "re-vamping" process and could avoid long blockages, such as those that followed the general failure, amid federal-provincial bickering, of the mid-1990s' sales tax harmonization initiative.

Federal-Provincial Transfers and the Economic Union

A clear consensus emerged for the restoration of a rules-based mechanism for managing federal-provincial fiscal equalization and other transfers. A smoothly functioning equalization system would become even more important to the social and economic union if more revenue-raising capacity were placed in provincial hands.

Some participants felt strongly that the equalization mandate, as expressed in section 36(2) of the Constitution, requires equalizing provincial revenues down as well as up, if the aim is truly to deliver comparable levels of public service at comparable levels of taxation. Furthermore, goes this argument, the concept of the level of taxation would equate to taxes as a share of income, on which score the historical equalization formula's "representative tax system" fails.[6]

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5 Consumption taxes, including excise and sin taxes, are suitable provincial taxes because they cause less economic harm than do, say, corporate income taxes.

6 The representative tax system determines equalization entitlements based on provincial per capita deviations from a national standard for revenue-raising (fiscal) capacity per head; the formula sets the standard as the national average tax rate times a five-province standard tax base, expressed in per capita dollars. It is not intended to ensure that all provinces' residents pay similar tax rates.

One implication of this latter point could be that equalization's intent would be best served by a "macro formula" that established provinces' entitlements to receive or obligations to fund equalization payments according to disparities in provincial income. The mechanism would not distinguish whether such income accrued in its first instance to residents or to the provincial government. In such a system, resource revenue would be shared across the country in the same way that personal income is shared by way of federal income tax payments that underwrite spending and transfer programs — such as equalization.

The recommendations of the report of the Expert Panel on Equalization and Territorial Financing — the O'Brien Panel (Canada 2006b) — do not reflect these views. That report recommends retaining the representative tax system method for determining equalization entitlements, with numerous small changes and four major ones:

- the standard per capita tax base should be a ten-province rather than five-province measure of average fiscal capacity;
- the multitude of renewable and non-renewable resource revenue categories should be collapsed, and 50 percent of total resource revenue included in the measure of fiscal capacity;
- actual provincial resource revenue, rather than potential revenue (or fiscal capacity), should be used in defining the national standard; and
- a relative cap on payments would ensure that a province's receipt of equalization would not cause it to have higher fiscal capacity than a non-equalization receiving province.

Much of the O'Brien Panel's approach is reminiscent of the system's functioning through the 1970s. It would use the 50 percent inclusion rate for natural resources to strike a balance between equalizing resource revenues and recognizing provincial control over resources — it would also limit the extent to which the program's size was driven by disparities in access to resources. Further, a multi-year averaging mechanism would shrink the volatility in entitlements that would arise from swings in commodity and energy resource prices.

The O'Brien Panel's recommendations do not, however, propose a fundamental restructuring of the equalization program. The general mechanism would continue to compensate provinces for revenue losses due to economic declines, whether as a result of external forces or poor policy choices. And while the 50% exclusion of resource revenues could enhance development incentives, using actual revenues to measure fiscal capacity could create an incentive for provinces to underprice access to domestic resources.

Finally, some observers (see, for example, Mintz and Poschmann 2004) espouse "cash flow" equalization, whereby changes to a provincial government's net financial position — say, by drawing down assets or incurring debt to fund services — would be an equalizable source of fiscal capacity, while increasing provincial financial assets would generate deductions from fiscal capacity. Thus, a province that collected energy royalties would not see those flows counted as fiscal capacity, and hence they would not be subject to equalization, to the extent that they financed increases in the province's assets net of liabilities. The primary concern about cash flow equalization is with respect to incentives for provinces to pursue off-balance sheet financing for public projects.

On equalization, the C.D. Howe Institute's June 2006 panel generally agreed that the push for stable, rules-based financing mechanisms was on target, and that the O'Brien Panel's recommendations might prove a politically tractable compromise for enduring political and economic conflicts. There was less agreement about the merit of the ten-province standard, or whether it was possible and practical for the federal government to equalize resource revenues, given that it has no direct access to them.

Making the Package Work

There was general support among the June 2006 panel participants for the federal notion that lower levels of government can be entrusted with responsibility for program delivery and matching revenue authority, as long as they agree to pursue national economic and social goals. Compared to other federations, the Canadian federal project arguably works exactly because, in the more populous provinces at least, revenue-raising and spending are reasonably closely matched. That said, attempts to strengthen the economic union are often steered off-course by the wide disparities in the provinces' capacities to fund public services. Hence the need, according to some observers, for innovative approaches, such as federal matching support for infrastructure spending, with the matching rate keyed to the province's fiscal capacity.

The proper aim of action on the part of the federal government, however, is to strengthen the forces of economic union and mitigate those of disunion wherever it is capable of acting, while respecting its constitutional role. For example, some panelists saw federal action as appropriate on aboriginal schooling, where a focus on outcomes would better inform board management; and on postsecondary education, where poorer provinces' investments in human capital are often lost when students move elsewhere for work.[7]

More generally, the preceding perspective suggests a principles-based approach for federal action to strengthen the economic union. On this view, other federal priorities should include reforms to pension regulation and the encouragement of strong and flexible capital markets[8] and of mobility in labour markets. Coincident action should also be taken to mitigate the forces of economic disunion, such as provincial and local restraints on procurement, provincial and national agricultural marketing boards that fragment the economy, and employment insurance benefits that are available to the unemployed on unequal regional terms.

In sum, there is much to be done.

The proper *scope* of federal action, as distinct from its *aims*, is a pragmatic question. A broad scope, which seemed to find support among panelists, would

7 One solution would be to steer a portion of federal personal income tax revenue to the province where the degree was obtained.

8 Some observers believe this militates for an activist federal role in promoting a single securities regulator.

increase Ottawa's degree of freedom in negotiations with the provinces and increase the likelihood of achieving more sweeping reforms, but with heightened risk that elements of the package would generate fatally damaging opposition. A narrower scope of incremental reforms would stand a better chance of achieving its more limited aims, but at the risk of missing good opportunities to improve Canada's economic prospects. The choice is a political one.

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