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The Federal Provincial Fiscal Balance

Teetering on the Edge of Incoherence

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The rhetorical heat surrounding recent changes in federal-provincial fiscal arrangements is remarkable for its intensity. This heat is welcome if it is accompanied by light — light that shines a path to coherence and sustainability in federal fiscal relations.

Coherence and sustainability are threatened when the provinces commit themselves to delivering services for which they do not collect the required funding, and the federal government collects money to provide services it is not responsible for delivering, and for which it cannot ensure delivery. However, coherence and sustainability are likely outcomes when provinces assume responsibility for raising tax revenues that roughly match their spending commitments, and when the federal government adopts the more limited role of filling in gaps in provinces' abilities to finance the services that are their responsibility.

Fiscal imbalance, if it means anything, describes what happens when one government collects tax revenue to finance spending by another, or when the provinces deliver services without being politically accountable for financing them. Canada, in that sense, has always been in a state of imbalance: The federal government has made payments to other levels of government since Confederation.

However, through most of the 1990s, while total government revenue stayed constant as a share of the economy, growth in federal transfers slowed as Ottawa pushed its budget into balance. Provinces necessarily increased the portion of total revenue contributed by their own tax collections. This strained provincial finances — and that strain has been worsened by demographic pressure on education and health spending, two huge components of provincial outlays. Demographics is already lightening the pressure on education spending, but as populations age, and in provinces where the elderly are already numerous compared to working age residents, the stress from health spending will get much, much worse.

Meanwhile, owing to reasonably robust national economic growth, federal revenue has marched ever upward, rising much faster than spending requirements in areas of federal responsibility.

For all these reasons, the current provincial discontent is easy enough to understand. What is harder to grasp, and frankly disturbing, is the federal response — tractor loads of cash — and the result: Weak accountability and looming incoherence in the federal provincial transfer system, with collateral damage to fiscal policy in general.

Teetering on the Edge

Take healthcare, for example. Tractor loads of dollars for health followed by more for Equalization funding are damaging to provincial and federal spending management and tax policy.

More transfers to provinces for health does not buy reform: Money delays change. Federal money puts off the inevitable day when provinces have to confront their priorities and allocate scarce funds among facilities, staff wages, diagnostics and therapies according to regional needs and willingness to fund their priorities. *Ad hoc* cash fuels delay.

At the same time, provinces must be accountable for their choices and able to justify them to their taxpayers. Voters understand perfectly well that governments do not always make wise choices in managing money, and they deserve to see how their tax dollars match up with the uses for which they understood the taxes were levied in the first place.

The summer 2004 health accord sought to convey an image of accountability through reporting requirements and federally-assigned priority treatment areas. Yet that rhetoric was no substitute for the genuine accountability that federalism in practice could have delivered — still could, in fact. Blunt federal mandates cannot address provincial and regional differences in demographics and needs: Younger communities need more GPs and Ob/Gyns; older ones need more hip replacements, and others need to better handle diabetes. These variations could be easily handled by regions and provinces — and if they failed to deliver on these needs their taxpayers would know exactly who to hold responsible. Right now they do not.

Generally speaking, the federal cash is disturbing because in the recent past and for the near future — but not forever — the better alternative is squeezed out. As long as Ottawa keeps transfers high, and offers the prospect of more of them in future, there is little room for lower federal taxes, less room for higher provincial taxes, and little incentive for many provinces to push for change.

The recent changes to Equalization push us further toward incoherence. The new annual escalator and frozen floor disconnect the program from its Constitutional mission: facilitating reasonably comparable social program delivery at reasonably comparable provincial tax rates. The changes hobble the program's ability to equalize provincial fiscal capacity, in part because the floor prevents entitlements from declining as they should when a province rises toward the provincial average revenue level.

The hobbled Equalization program for the moment, therefore, cannot do the job that it should when federally vacated tax room is taken up, to different degrees, by the provinces. The hasty changes to Equalization will inhibit needed shifts in the tax shares taken up by Ottawa and the provinces, making it financially and politically harder for provinces to adopt the needed reforms in health care financing and delivery. We are in a fine mess.

Lighting the Way Back to Coherence

Canada's fiscal system is headed to messy incoherence, but we are not lost yet.

For one thing, we know what the problem is. Ottawa collects far more tax revenue than it knows what to do with; if, instead, provinces were responsible for raising more of the money needed to address their responsibilities, expenditure management and accountability would be much better served.

And there are many reasons for optimism. For one thing, we have been here before, and more than once have federal/provincial negotiations resulted in a formal transfer of tax room. For another, nothing in logic requires a formal agreement: Ottawa can simply lower taxes, and provinces that see fit may step into take up some, all, or more than all of the vacated room, as their voters see fit. As well, if Ottawa lowered taxes, a politically attractive move in itself, the potential federal surplus would shrink, and the federal government would be less inclined to fling money about willy-nilly.

There is more. The changes I describe are not only possible, they are happening, as shown in two admittedly flawed examples.

The first — deeply flawed — case is federal gasoline-tax funding for regional infrastructure. The idea is right but the implementation, with Ottawa simply collecting the same money and transferring it to lower-level governments, retains almost all the flaws of the prior system. It would be simple enough, politically and administratively, for the federal government simply to reduce the fuel excise tax, and for the provinces to allow municipalities to choose what fuel tax rate, if any, to charge their residents. Accountability for taxing and spending would be restored, and there would be no bickering over what city or region was owed what share of the revenue.

A much better example is last week's *Canada Quebec Agreement on the Quebec Parental Insurance Plan*. The background is that Ottawa collects far more money than needed to run employment insurance as an insurance program, and uses the surplus EI premium revenue to finance numerous federal expeditions in areas of provincial jurisdiction. This is of doubtful legality, on which we presently await the Supreme Court of Canada's final word.

What the federal and Quebec governments have achieved in the parental insurance plan, perhaps sidestepping the legal issue, is the outline of a solution, a partial solution, to the fiscal imbalance. Ottawa will continue to collect EI premiums in the amount required to operate the core insurance program, while Quebec will collect the share required to run the parental leave program that the province will administer, and which will be as generous as the province's voters want it to be — provided they do not choose a plan less expansive than federal parental leave benefits.

While the agreement imposes unnecessary constraints, it offers a sharp improvement in program design. Its improvement to accountability arises because Quebec's workers will see on their pay stubs and on their T4s the premiums collected to run Ottawa's insurance program and the taxes collected to run Quebec's parental leave program. Without this feature, the agreement would have been as limp as the gas tax-sharing plan.

More Heat, More Light

A new direction in fiscal arrangements is clearly due, and the correct direction is in plain sight. The inflammatory rhetoric surrounding Equalization and interprovincial money flows will have served a useful purpose if it redirects Ottawa and the provinces toward a smarter division of tax collection, one that better matches their division of responsibilities.

More tax revenue would flow to provincial governments in support of provincial spending priorities, and less would end up in Ottawa for recycling into the confusing and conflict generating web of federal provincial tax and spend agreements. And Canadians could see more clearly to whom they pay their taxes and for what.