IMPROVING THE COMPETITIVENESS AND STANDARD OF LIVING OF CANADIANS

Common Position of Provincial and Territorial Finance Ministers

December 1999

Key messages

- In the wake of freer trade and strong export growth, bolstering Canada's competitiveness is, more than ever, essential in order to create lasting jobs, improve our standard of living, and maintain the social safety net that Canadians cherish.

- Governments must support the efforts of the private sector to make the Canadian economy more competitive by striking an appropriate balance between tax reductions and reinforcing social programs.

- Governments' respective contribution to this balanced approach should reflect Constitutional responsibilities and financial flexibility. In this regard:

  — The Constitution assigns to provinces and territories the responsibility for programs such as health, education, income security, infrastructure which are, in many ways, key tools for improving Canada's competitiveness.

  — The Fall Economic and Fiscal Update projected federal surpluses of $95 billion over the next five years.

  — Meanwhile, provincial-territorial governments do not have such a large financial leeway given strong pressures on their programs and the impact of cuts in federal transfers, particularly to the CHST.

- In this context, the Provincial and Territorial Finance Ministers stressed the need for tax competitiveness; and the immediate full restoration of Canada Health and Social Transfer funding (CHST) with an appropriate escalator in concert with the removal of the ceiling on Equalization payments. Therefore, the upcoming federal budget should focus on:

  — Reducing the tax burden and introduce significant personal income tax reductions;

  — Designing those tax cuts in a way that respects the fiscal autonomy of the provinces and territories and, above all, maintains their ability to finance and improve social programs;

  — Restoring CHST cash funding to its 1994-95 level of $18.7 billion by 2000-01, with an appropriate escalator in concert with a strengthening of the federal government's commitment to Equalization by the removal of the ceiling on Equalization payments.

- Finally, given the importance of maintaining and developing a strong infrastructure base for a competitive economy, the federal government and the provinces and territories should immediately undertake discussions on a new infrastructure program with the objective of announcing the broad outlines of this program in the upcoming federal budget.

Introduction

At their annual meeting in Québec City last August, the Premiers and Territorial Government Leaders agreed, in the context of the significant growth in international trade, that priority must be given to improving the competitiveness of the Canadian economy.

Accordingly, they called upon the federal government to introduce a balanced action plan including tax reductions and full restoration of the federal cash transfer for social programs in general, including health, post-secondary education and social assistance programs, through the existing channel of the Canada Health and Social Transfer (CHST). Premiers also agreed that quality infrastructure is one of the basic components of a competitive economy. Therefore, they instructed their Ministers of Finance to initiate discussions with their federal counterpart to examine infrastructure development options. Lastly, the Premiers reiterated the importance of Equalization, as stipulated in the Constitution.

This paper summarizes the views of provincial and territorial Ministers of Finances and, with the approach of the next federal budget, submits a concrete action plan for the implementation of the balanced strategy advocated by Premiers.

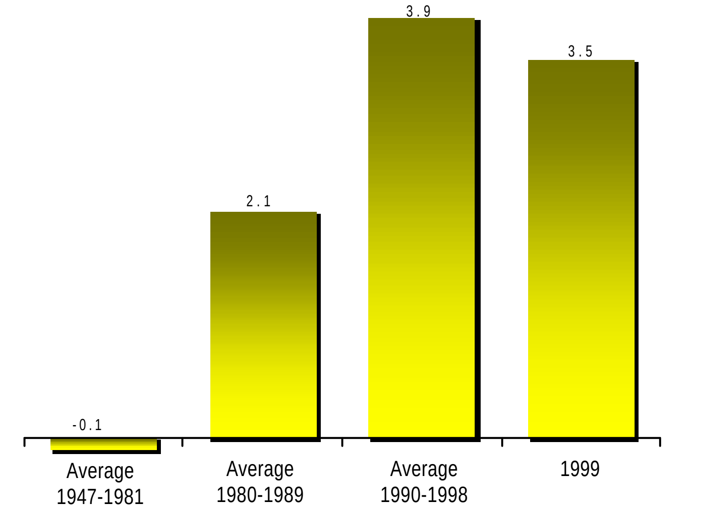
The challenge of competitiveness

Although the Canadian economy has achieved substantial progress over the past years, major challenges remain. For instance:

- Even though Canada is enjoying one of its longest cycles of expansion, with growth averaging 2.8% a year over the past seven years, in 1999, its per capita GDP remains 30% lower than in the United States, whereas in the 1980s the difference was only 20%.

- Despite the fact that, since 1993, the Canadian unemployment rate has fallen by three percentage points, in 1999 it remains 3.5 percentage points higher than in the United States. Historically, unemployment rates in Canada and the United States have been on par.

Difference in Unemployment Rate
Canada – United States
(percentage points)



Sources: Statistics Canada, U.S. Bureau of Labor Statistics

Difference in Real Per Capita GDP
United States – Canada
(in percentage)

Sources: Statistics Canada, U.S. Department of Commerce

These developments have occurred in a context of more open markets and exceptional export growth. Thanks to NAFTA, among other factors, Canada's exports as a percentage of GDP have grown by almost two thirds in 10 years, rising from 25.7% in 1989 to 41.3% in 1998. Canada's economic performance depends, more than ever, on its competitiveness in foreign markets.

In this new environment, Ministers of Finance are of the view that governments' actions must be geared towards bolstering the competitiveness of the Canadian economy in order to stimulate the creation of permanent jobs, create the wealth that is necessary to improve the standard of living of Canadians and, thereby, maintain the social safety net that Canada has developed over the last 40 years.

There are many ways that governments can act to support and encourage the efforts of the private sector to make Canada's economy more competitive. A competitive tax burden and quality social and physical infrastructures must support more targeted initiatives focusing, for instance, on the development and distribution of new technologies in Canadian companies.

A balanced strategy

At the same time, governments' actions must remain financially responsible and focused on priorities. They must not jeopardize the major gains achieved in terms of improved public finances in recent years. Furthermore, each order of government must contribute according to its financial leeway.

In this regard, it must be pointed out that the federal government has much more financial leeway than do the provinces and territories. The Economic and Fiscal Update 1999 recently projected a cumulative $95 billion federal surplus over the next five years. The federal government's fiscal strength was also revealed in the recent Throne Speech in which the federal government announced its intention of putting forward a host of new initiatives, many of them in provincial jurisdictions.

The emergence of large and growing federal surpluses reflects, to a considerable degree, a fiscal imbalance in the Canadian federation. The Constitution makes the provinces responsible for delivering programs subject to the greatest demand and cost pressure and for which taxpayers have the highest expectations: health, education, social assistance, infrastructures. These programs are also key tools for improving competitiveness. And yet, taken together, the provinces have less revenue than the federal government to fulfil these responsibilities. Moreover, the federal government has the greatest share of the revenue sources with the highest growth potential, particularly personal income tax of which the federal government collects over 60% of total revenues.

GROWING FISCAL IMBALANCE

PROVINCES	**FEDERAL**
• Health	• Old age security
• Education	• Employment insurance
• Income security	• Transfers to the provinces
• Public infrastructure	• Defence
Own-source revenues: $141 billion	***Revenue: $157 billion***

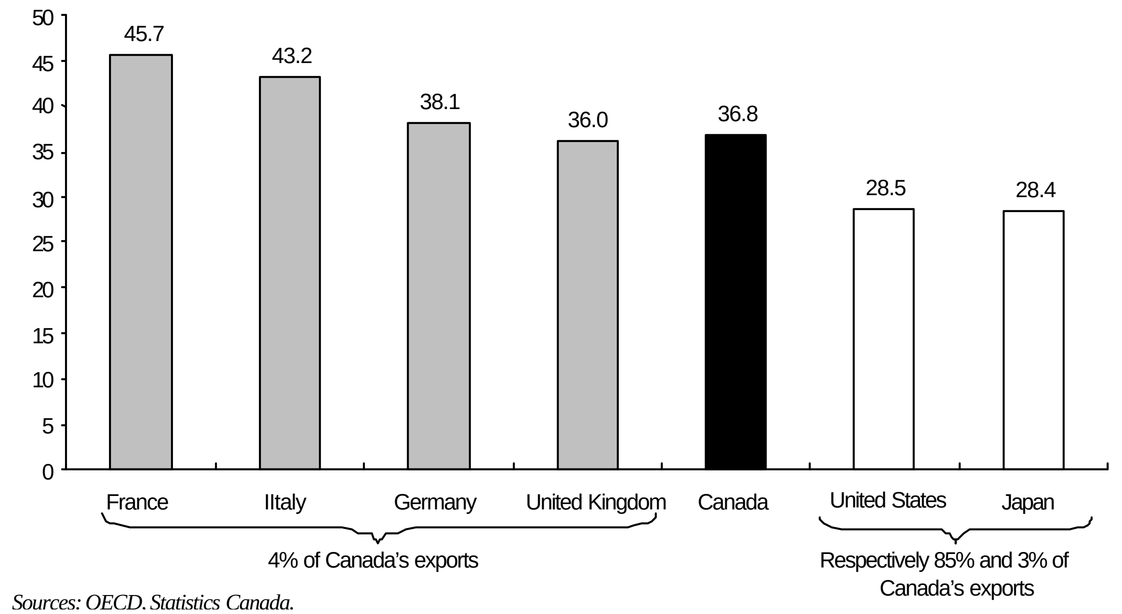
In addition, the major cuts to transfers to the provinces and territories in recent years have aggravated this imbalance. Since 1994-1995, the federal contribution to funding provincial social programs under the CHST has declined by $6.2 billion. The increases announced in the last federal budget offset only part of these cuts. Accordingly, it is forecast that CHST transfers for all of Canada will be $15 billion in 2003-2004, which is $3.7 billion less than in 1994-1995. Yet, during this period, the pressure on the provinces' and territories social spending will have risen considerably.

The large and growing federal surplus provides an opportunity to make an important contribution to improving the competitiveness of Canada and the well-being of Canadians. The federal government should pursue these goals through a balanced approach: reducing taxes and strengthening social programs through an increase in the CHST.

Improving competitiveness by reducing taxes

Canadians bear a relatively heavy tax burden compared with that of our main trading partners. Canada's tax burden is eight percentage points higher than that of the United States, where 85% of our exports are shipped. About half of this Canada–United States differential reflects the provision of public social programs in Canada which Americans pay for privately. However, a significant difference in tax burden remains even when an allowance is made for this situation.

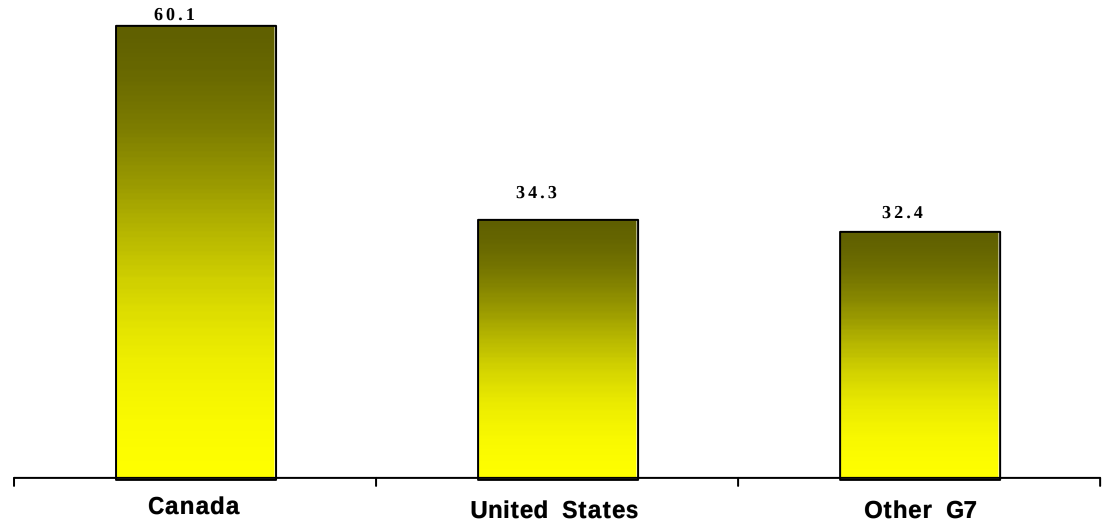
Total Tax Burden, G7 Countries, 1996
(as a percentage of GDP)



Sources: OECD. Statistics Canada.

In addition, a heavy tax burden reduces taxpayers' disposable income. In this regard, taxation has absorbed 60% of the increase in gross national product in Canada between 1980 and 1996, compared with 34% in the United States and 32% in the other G7 countries excluding Canada.

Proportion of the Increase in GDP Absorbed by Taxation
(as a percentage, 1980-1996)



Sources: OECD. Statistics Canada.

Tax cuts and strong job creation increase consumer confidence. Lower taxes also create the incentive for people to work harder and longer to earn more income. Confident consumers with higher disposable income are more likely to spend, thereby stimulating job creation and revenue growth for governments. In addition, lower personal income taxes are important factors in business location decisions involving highly skilled workers and may help reduce the size of the underground economy. In a similar way, lower business taxes contribute to a more competitive cost structure for firms and help stimulate investment, a key factor for job creation. Consequently, reduced taxes would bolster the potential of the Canadian economy, contribute to lower business costs and allow a rise in Canadians' purchasing power.

All governments in Canada have acknowledged that a sustainable reduction in the tax burden must be a priority. In fact, since 1996, all governments have reduced taxes. However, since the federal government enjoys substantial financial leeway, it is in a position to effect considerably larger tax reductions.

A coordinated approach

Provincial and territorial Ministers of Finance are of the view that Canada's economy has a need for significant personal income tax reductions and they expect the federal government to announce such measures in its next Budget.

Furthermore, they also insist on the need for the federal government to coordinate its action in this field with the provinces and territories. Under the Tax Collection Agreements, personal income tax in all provinces and territories, with the exception of

Québec, is calculated as a fraction of basic federal tax, generally tying provincial and territorial taxes automatically to the federal tax.

Discussions should begin immediately between the federal government and the provinces and territories to find the best way to prevent federal tax reductions from aggravating the existing fiscal imbalance between the two levels of government, and limiting the autonomy of the provinces and territories in the conduct of their fiscal policy. The federal government is asked to consider as options federal income tax rebates and accelerating the potential starting date for the administration of tax on income for provinces and the territories into 2000.

Improving competitiveness by reinforcing social programs

Healthy, well-educated workers are essential to a competitive economy. A recent study[1] by the *Conference Board of Canada* confirmed that Canada's publicly funded health care system provides a competitive advantage to firms in this country. Furthermore, other studies[2] have also confirmed the close link between a country's competitiveness and the skills of its labour force. In addition, the statistical evidence shows that individuals with more educational qualifications are more likely to find a job and to have higher earnings than people with fewer qualifications.

As was indicated above, health, education and social assistance, according to the Canadian Constitution, are provincial and territorial responsibilities. Because of the major fiscal imbalance in the Canadian federation and the significant cuts to federal transfers to the provinces and territories, these programs have come under heavy pressure.

The CHST is the primary instrument used by the federal government to narrow the gap between provincial and territorial revenues and responsibilities in this regard. The CHST was instituted in 1996-1997 as a block transfer to replace the Canada Assistance Plan (CAP) and Established Programs Financing. Recent experience clearly shows that the CHST is not playing its role. Even with the partial restoration announced in the last federal budget, CHST cash transfers will continue to fall in the medium term as a proportion of provincial and territorial spending they help fund. In 2004-2005, it is expected that CHST cash transfers will account for no more than 11.2% of provincial social spending, i.e. 6.6 percentage points less than ten years earlier, in 1994-1995.

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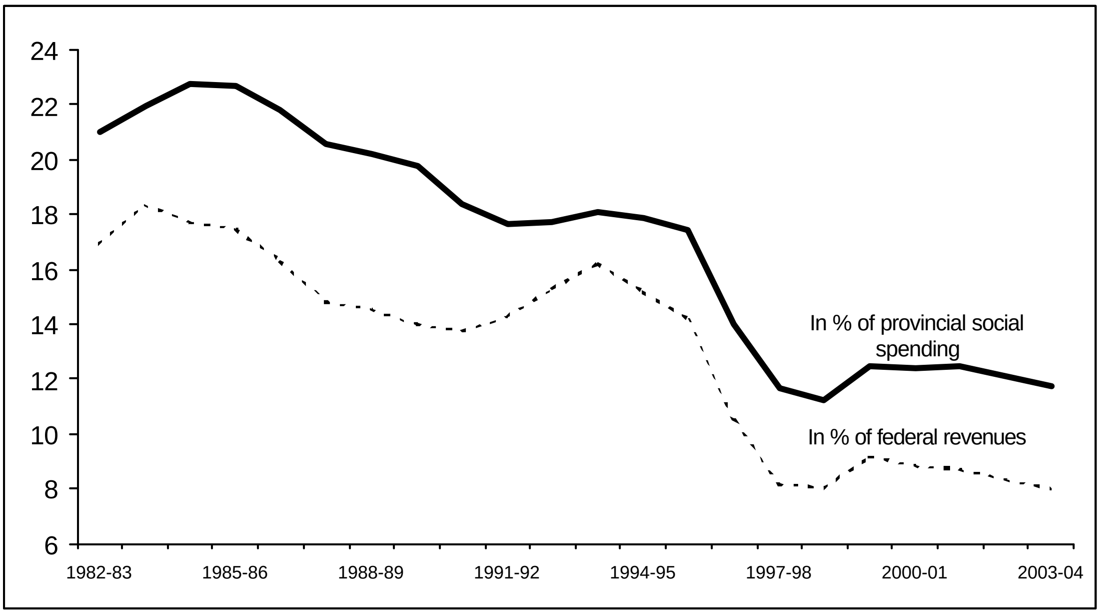
1 *Corporate Health Care Costs in Canada and the US. Does Canada's Medicare System make a Difference?* Conference Board of Canada. (March 1999)

2 The House of Commons Standing Committee on Productivity noted in a recent report (June 1999) that education and human capital developement are important in terms of improving Canada's standard of living.

In addition, federal CHST transfers make up a declining percentage of federal revenue. Accordingly, in spite of federal pretensions that health and post-secondary education are priority fields, the federal government is allocating a shrinking share of its revenue to them allowing it, in particular, to increase its financial leeway and its capacity to intervene with new programs.

CHST Cash Transfers as a Proportion of Provincial Social Spending[(1)] and Federal Revenues
(in percentage)



Sources: Federal and provincial Budgets, 1999 Economic and Fiscal Update
(1) Spending on education, health and social services.

In this context, it is particularly troubling to note that the last Speech from the Throne announced a plethora of interventions in areas of provincial jurisdiction – home care, drug insurance, national children agenda, and skills and youth programs – instead of reinvestments in core social programs via the CHST. This approach will divert financial resources which otherwise should be directed to those core programs for which the provinces and territories are responsible.

Provincial and territorial Ministers of Finance firmly believe that Canadians would be better served if social programs were to continue being delivered through a focused, integrated system by the level of government that is responsible for them, namely the provinces and territories. Costly duplication and overlap following federal interventions would then be avoided.

Full restoration and a plan to escalate the CHST cash transfer

Provincial and territorial Ministers of Finance are of the view that in the field of social programs, the federal government should direct new spending initiatives to basic programs administered by the provinces and territories, by means of the CHST, programs that are, as indicated earlier, under considerable pressure.

In this regard, they consider that the next federal budget should include:

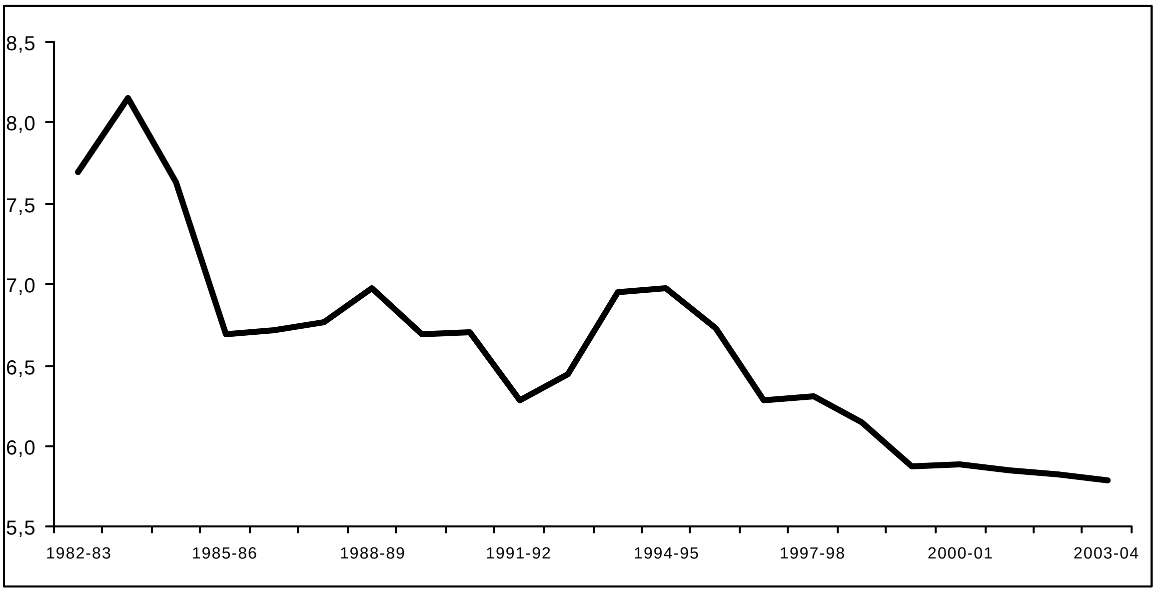
- full restoration, by 2000-2001, the CHST to its 1994-1995 level ($18.7 billion);
- a plan to introduce an appropriate escalator for the CHST cash transfer in order to secure adequate, growing funding for provincial social programs in the medium term.

Improving competitiveness through the Equalization program

At their annual Conference last August, the Premiers reaffirmed the importance of the Equalization program in ensuring that all regions of Canada can both contribute to and benefit from the improvement in competitiveness.

Producers and employees in less affluent regions of the country cannot maintain their presence in international markets if they face a heavier tax burden than similar firms or individuals in provinces with deeper fiscal pockets. Alternately, all Canadians must receive a comparable standard of public services, health and education included. The Constitution commits the federal government to achieving this outcome although Equalization payments, as a percentage of federal revenues, have been declining for the past twenty years.

Equalization as Percentage of Federal Revenues
Canada, 1982-1983 to 2003-2004
(in percentage)



Source: Federal Budgets, 1999 Economic and Fiscal Update

The purpose of Canada’s Equalization program, as set out in section 36(2) of the Constitution Act of 1982, is to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. The principle of Equalization is also reflected in the Formula Financing Agreements for the territories, which are designed to address the Territories’ limited fiscal capacity.

Provincial and territorial Ministers of Finances note that some parameters of the program may limit its ability to achieve its Constitutional objectives, in particular the presence of a ceiling on payments. Accordingly, they ask the federal government to strengthen its commitment to Equalization and announce in its upcoming Budget the elimination of the ceiling of the program in concert with the restoration of CHST funding and the introduction of an escalator for the CHST. This would parallel, to a degree, recent federal action to reverse constraints affecting more affluent provinces under the CHST, namely the removal of the “cap” on Canada Assistance Plan payments.

Improving competitiveness by investing in infrastructure

Quality public infrastructure is a basic feature of a competitive economy. For instance, in the context of rapid growth of international trade and market globalization, a company’s ability to obtain supplies and, especially, gain quick access to foreign markets for its products is crucial.

In this regard, improving the highway system is a key element. However, other elements, such as the development of port and airport infrastructures, intermodal facilities and public transit systems, as well as other types of infrastructure such as telecommunications, are also important. The presence of transportation infrastructure is especially important for northern and remote regions.

At their annual Conference last August, the Premiers and territorial Government Leaders asked the Ministers of Finance to work with their federal counterpart to examine infrastructure development options. They also agreed on principles to guide these discussions (see appendix). These principles underscored the importance of focussing on strategic investments, under a plan that would be flexible enough to respect the autonomy of provinces and territories and that would comply with their existing budgetary frameworks.

The Ministers of Finance have discussed these principles. They also noted the federal government’s commitment stated in the Speech from the Throne to work with the provinces and the private sector to agree, by the end of 2000, on a five-year plan to improve physical infrastructure in urban and rural zones.

They also pointed out that their priorities for improving competitiveness as part of the next federal budget are, first of all, a reduction in the tax burden, the action plan for the restoration of federal funding to the CHST with an appropriate escalator in concert with the removal of the ceiling on Equalization payments. However, given the financial leeway available to the federal government, provincial and territorial Ministers of Finance are of the view:

- that discussions on the development of a new infrastructure program should begin immediately, with the objective of announcing the broad outlines of the program in the next federal budget;
- that the new, multi-year program should be at least equal in value to the original program;
- that the distribution of federal funds among provinces and territories should be equitable. Furthermore, special consideration should be given to the needs of the territories in developing funding arrangements.

Conclusion

The rapid growth of international trade in Canada in the wake of NAFTA and, more generally, freer trade throughout the world, have made improved competitiveness a crucial objective for all governments in Canada. The creation of lasting jobs, the improvement of our standard of living and our wealth and, ultimately, the continuation and improvement of the social programs that we have developed over the last 40 years depend, more than ever, on our ability as a society to meet this challenge.

Each government must address this challenge. But the federal government currently has the most financial leeway while the provinces, who are responsible for programs that are likely to contribute most to improved competitiveness, in particular education, health and infrastructures, have the least.

In this context, the Ministers of Finance of the provinces and territories invite their federal counterpart to act on this balanced strategy to improve the competitiveness of Canada's economy that could be implemented in the next federal budget. They stress the need for tax competitiveness; and the immediate full restoration of Canada Health and Social Transfer funding (CHST) with an appropriate escalator in concert with the removal of the ceiling on Equalization payments. Therefore, the upcoming federal budget should focus on:

- Reducing the tax burden and introduce significant personal income tax reductions;
- Designing those tax cuts in a way that respects the fiscal autonomy of the provinces and territories and, above all, maintains their ability to finance and improve social programs;

- Restoring CHST cash funding to its 1994-95 level of $18.7 billion by 2000-01, with an appropriate escalator in concert with a strengthening of the federal government's commitment to Equalization by the removal of the ceiling on Equalization payments.

Finally, given the importance of maintaining and developing a strong infrastructure base for a competitive economy, the federal government and the provinces and territories should immediately undertake discussions on a new infrastructure program with the objective of announcing the broad outlines of this program in the upcoming federal budget.

Appendix

Principles for a New Infrastructures Program

At their annual Conference last August, the Premiers and Territorial Leaders asked their Ministers of Finance to work with their federal colleague to examine infrastructure development options. They also agreed on principles to guide these discussions:

- Investments in infrastructure should be based on concrete strategic criteria, including return on investment, prospects for long-term economic growth and enhanced competitiveness.

- Each provincial or territorial government must be able to select and approve the appropriate projects that best build on their competitive strengths. It must be consistent with provincial or territorial infrastructure priorities. Provinces and territories would assume full management.

- The approach must be flexible enough to address both hard infrastructure needs (e.g. international gateways, urban transportation, highways), soft infrastructure and strategic investments in telecommunications infrastructure (e.g. environmental services, information technology, health and education equipment, communications).

- The approach must also be flexible enough to allow for the participation of other sectors, including innovative private-public partnerships and, as appropriate, for varying degrees of municipal participation determined by provinces and territories.

- Funding arrangements should be consistent with existing provincial fiscal plans – the investments that provinces and territories have already made in their regular budgets for infrastructure would be accounted for as part of their contribution.

- Federal funding must be allocated equitably among provinces and territories.