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IN BRIEF

Stephen Laurent
27 November 2002

Canada's Fiscal (Im)balance: Both Sides of the Argument

Where Are the Needs and Who Has the Money? A Fundamental Issue

The concern about vertical fiscal imbalances is not a numbers game, but an issue that strikes at the very heart of the Canadian federation.

G. C. Ruggeri
Professor of Economics,
University of New Brunswick, December 2001

The debate over the distribution of revenues and spending responsibilities between Ottawa and the provinces is an old one. Today, provincial governments feel that they face a desperate situation: increasing cost pressures are straining provincial finances. Provinces such as Quebec are vigorously studying the question of a Vertical Fiscal Imbalance (VFI) through government commissions and forums and have demanded that the federal government redress the situation.

The Provincial Point of View

The needs, and they are significant, are with the provinces, but the means, and they are significant, are in Ottawa.

Bernard Landry
Premier of Quebec, May 2001

According to the provincial and territorial premiers, Canada has lost its fiscal balance: while provincial and territorial governments struggle to meet their spending responsibilities, particularly in health care and education – areas with the fastest growth rates among public expenditures – the federal government has just announced its fifth consecutive budgetary surplus and projects continued fiscal strength. Supported by a number of recent reports and background papers, the provinces argue that, since the creation of the Canada Health and Social Transfer (CHST) in the 1995 Budget,

and the cuts in federal transfers that accompanied it, the financial framework of the Canadian federation places them at a severe disadvantage. Premiers are calling for increases in federal funding through the CHST and Equalization and for additional transfers in tax points, giving them a greater share of major tax bases.

The Séguin Commission and the Conference Board of Canada

The situation can be summed up fairly easily: the federal government occupies too much tax room compared to its responsibilities....If the federal government gives Quebec the GST, we solve the problem of health care financing.

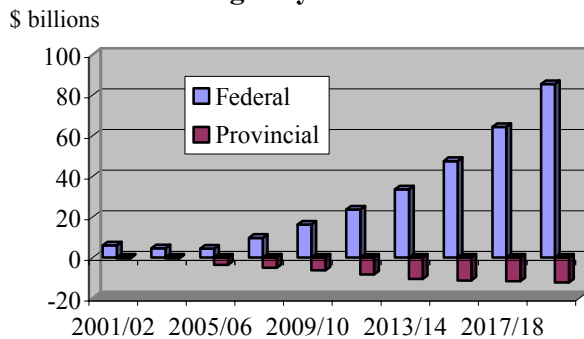
Yves Séguin
President of the Commission on Fiscal Imbalance,
March 2002

The Quebec government has been the busiest of the provinces in its study of fiscal imbalance, creating the *Commission on Fiscal Imbalance* (the Séguin Commission) in March 2001 and hosting a *Fiscal Imbalance Forum* in October 2002.

The Séguin Report has become the Quebec government's bible in its dispute with Ottawa over VFI. The Commission determined that the provinces need additional financial resources. In order to restore fiscal balance to the federation, it recommended that the CHST be eliminated and that the entire Goods and Services Tax (GST) be transferred to the provinces. According to the report, this new division of tax room would involve approximately \$27 billion annually (roughly \$8 billion more than the provinces currently receive from the CHST). The system of calculating Equalization payments would also have to be revised so that less affluent provinces would not be placed at a disadvantage by any new division in tax resources.

The Conference Board of Canada, which prepared the fiscal projections for the Séguin Commission, expanded its study to include all provinces. It concluded that, assuming there were to be no changes in the level of taxes or of spending, federal government surpluses will rise steadily over the next two decades, while the provinces and territories will collectively be in a deficit position between 2001-2002 and 2019-2020.

Projections: Federal and Provincial Budgetary Balances



Source: Conference Board of Canada, *Fiscal Prospects for the Federal and Provincial/Territorial Governments*, Ottawa, 2002.

However, the Conference Board of Canada's projections met with considerable criticism over the study's key hypothesis – that for a 20-year period the federal government would not alter spending in any way nor introduce any changes in taxes. As federal Intergovernmental Affairs Minister Stéphane Dion put it, “when projections are made assuming that future governments are on ‘auto-pilot’ for 20 years, it produces results that are far from reality.”

The Federal Perspective

There can be no imbalance to the detriment of one order of government when it has access to all revenue sources and even has a monopoly on such major sources as lotteries and natural resource royalties.

Stéphane Dion
Federal Minister of Intergovernmental Affairs,
October 2002

In the view of the federal government, both Ottawa and the provinces have full access to all current major revenue sources; therefore, the concept of VFI does not apply to Canada. Moreover, provinces have exclusive

access to tax bases such as resource royalties, gaming and liquor profits, and property taxes. To the federal government, the fact that virtually all provinces have chosen to reduce taxes in recent years seems to indicate that they believe that they have sufficient revenues to manage their spending pressures. Furthermore, federal transfers in the form of cash (\$30.7 billion in 2002-2003) and tax points (\$16.6 billion), which help to support provincial social programs, are expected to grow at an annual rate that is more than three times the growth rate of the federal government's own revenues. And as for provincial deficits being proof of a fiscal imbalance, Ottawa points out that throughout the years of considerable federal deficits, there was no talk of the federal government being a victim of VFI.

On the expenditure side, the federal government feels that it faces a much greater fiscal constraint than the provinces as a result of its large debt burden. Debt charges consumed about 24% of federal revenues in 2000-2001, compared to an average of about 11% for the provinces. The federal government also faces growing spending pressures in areas such as benefits for seniors, Aboriginal peoples, research and development, skills and learning and, more recently, security.

Finally, very little is mentioned about the VFI that exists between provincial governments and municipal governments. Many major cities have revenue sources that are too limited in relation to their responsibilities. For instance, the city of Montréal generates 80% of its revenues from one source – property taxes.

Not Just a Canadian Issue

Canada is not the only country involved in debates over the fiscal balance of the federation. Federal governments in Australia, the United States, Switzerland, and Germany are all constantly being challenged by states, cantons and lander concerning the division of fiscal authority and responsibility.