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THE FEDERAL-PROVINCIAL FISCAL (IM)BALANCE IN CANADA: WHERE ARE THE NEEDS AND WHO HAS THE MONEY?

Stephen Laurent
Economics Division

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HIGHLIGHTS

- The term "vertical fiscal imbalance" (VFI) describes a situation in which there is a mismatch between the fiscal capacities of different levels of government and their spending responsibilities.

- The provinces, supported by studies such as the Séguin Report, feel that they are the victims of VFI, because they are struggling to meet intense and rising cost pressures (notably in the area of health care) while the federal government recorded its fifth consecutive budget surplus in 2002 and is expected to show continued fiscal strength in the future.

- The federal government argues that there can be no VFI when the provinces have access to all revenue sources and even have a monopoly on lotteries and natural resource royalties.

- Initially (before the distribution of federal transfers to the provinces), there is a VFI between expenditures and revenues: the federal government collects more in revenue than it spends, while the provinces' own-source revenues are not quite sufficient to cover their expenditures. To address this gap, the provinces receive transfers from the federal government that amount to roughly 18% of their direct expenditures.

- Both the federal government and the provinces raise most of their revenues from the same sources, namely, taxes on income and sales. Both levels of government are also free to determine their own tax rates and tax bases.

- While VFI is conventionally defined as a "mismatch" between revenues and expenditures at different levels of government, there is no universally accepted definition in the economic literature. Most economists feel that simply comparing budget balances is insufficient. A meaningful analysis must consider the broader aspect of fiscal sustainability, which includes a government's level of debt as well as its spending obligations.

- Canada is not the only country involved in a debate over the best assignment of revenues and expenditures. A number of other countries with federal systems of government, including the United States and Australia, are also reviewing this issue.

- The 2003 First Ministers' Accord on Health Care Renewal, which resulted in a federal investment of $34.8 billion over the next five years, responds to immediate cost pressures in health care and should lessen the urgency of the VFI debate, at least in the short term.

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THE FEDERAL-PROVINCIAL FISCAL (IM)BALANCE IN CANADA: WHERE ARE THE NEEDS AND WHO HAS THE MONEY?

INTRODUCTION

Canada is currently in the midst of a debate over the financial framework of the federation. The provinces and territories have complained that they lack sufficient revenues to meet their spending responsibilities; the federal government counters by arguing that both levels of government have access to all major revenue sources. While the debate over the distribution of revenues and spending responsibilities between Ottawa and the provinces/territories is an old one, provincial and territorial governments feel that increasing cost pressures – notably in the area of health care – have put a new strain on provincial finances. In fact, over the last two years, provinces such as Quebec have been vigorously studying the question of a "vertical fiscal imbalance" through government commissions and forums, and have demanded that the federal government address the issue immediately. Even after a significant federal investment in transfers to the provinces for health care and social programs in February 2003, Quebec premier Jean Charest has made it clear that a top priority for his government will be to renegotiate the federal-provincial sharing of financial resources.

A vertical fiscal imbalance (VFI) exists when there is a mismatch between the fiscal capacities of different levels of government and their spending responsibilities. Does a VFI exist in Canada? In other words, are provincial governments having to respond to increasing fiscal pressures, such as health care, with inadequate fiscal resources? And, if this is the case, are federal-provincial fiscal arrangements the cause?

The fiscal imbalance debate is also inherently linked to a fundamental issue in all federal countries: how to achieve a balance between national solidarity (as manifested in national standards for public services) and provincial autonomy.

This paper has four objectives:

- to highlight the main arguments of both the provincial and federal governments, with reference to two reports that have had a considerable impact on the debate: the report of the Séguin Commission and the Conference Board of Canada study;
- to examine the economic arguments related to the concept of VFI;
- to review the division of fiscal resources and spending responsibilities between the federal and provincial governments in Canada; and
- to look at international experiences with VFI. Are other federal countries involved in the same debate?

BOTH SIDES OF THE ARGUMENT

There is heated debate between the federal government and the provinces/territories as to whether a VFI exists in Canada. On one hand, the provinces (led by Quebec) have produced several reports and recommendations on the topic; on the other, the federal government did not even mention the issue in the September 2002 Speech from the Throne. While the February 2003 injection of federal funds into transfers to the provinces was intended to respond to provincial calls for immediate assistance with increasing cost pressures, provincial premiers claim that more will be needed in the long term.

This section begins by presenting the provincial point of view and summarizing the results and recommendations of two influential reports: the final report of the Séguin Commission on Fiscal Imbalance (released in March 2002) and the Conference Board of Canada study (released in July 2002). The federal government's arguments against the existence of VFI in Canada will then be presented.

A. The Provincial Perspective

> *The needs, and they are significant, are with the provinces, but the means, and they are significant, are in Ottawa.*
>
> Bernard Landry, former premier of Quebec, May 2001

According to the provincial and territorial premiers, the Canadian federation has lost its fiscal balance. In their view, provincial/territorial governments are struggling to respond to intense and rising cost pressures (notably in the area of health care), while the federal government recorded its fifth consecutive budgetary surplus in 2001-2002 and is expected to run large and growing surpluses in coming years. The provinces point out that not only do they provide funds for 62% of all program spending in Canada,(1) they are responsible for the fastest-growing programs – social programs such as health care and education.

For the most part, the provinces agree that some degree of intergovernmental fiscal imbalance is to be expected. Federal transfers, which supplement provincial own-source revenues, are designed to provide the provinces with adequate funding and offset the initial imbalance. However, the provinces claim that this goal has not been achieved. They argue that over the last two decades there has been a significant erosion in federal support, which has undermined the provinces' ability to deliver the expected quality of services.(2) Provincial promotional material states that the federal share of health and social spending has fallen to 14 cents on the dollar (see Figure 1).

This claim highlights an important aspect of the argument between Ottawa and the provinces: the tax point component of Canada's largest intergovernmental transfer, the Canada Health and Social Transfer (CHST). (See Appendix A for an overview of Canada's two major transfers: the CHST and the Equalization Program.) The provinces claim that the tax point transfer occurred only once – in 1977, with the introduction of Established Programs Financing (EPF) – and does not constitute an annual federal contribution.(3) From this perspective, the federal contribution to provincial health and social spending consists of only the cash transfer portion of the CHST, which amounts to 14% of total spending.

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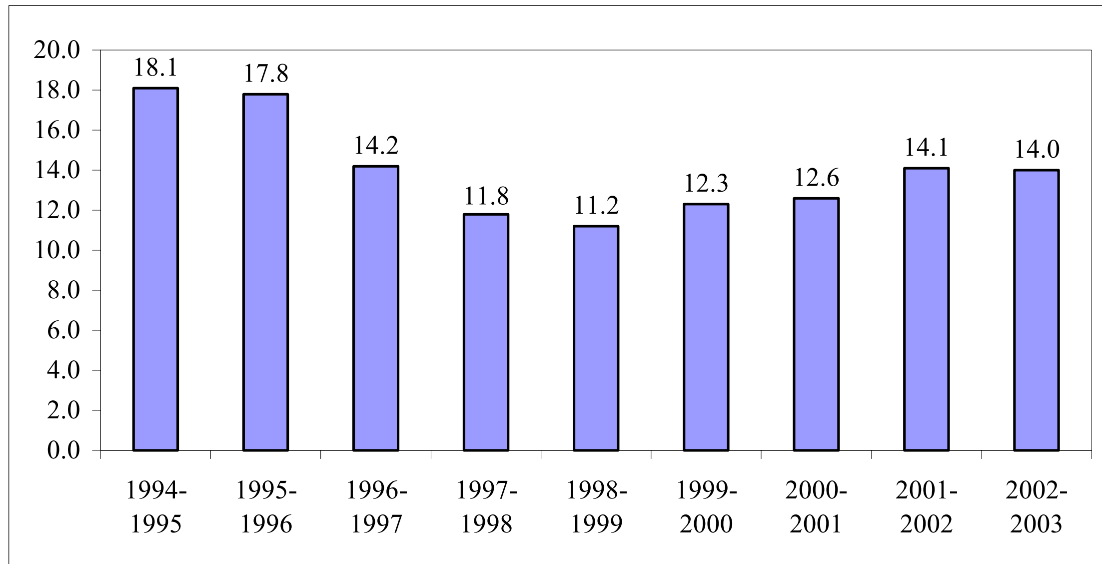
(1) Provincial and Territorial Ministers of Finance, *Canada's Fiscal Imbalance*, 2002, p. 2; available on-line at http://www.gnb.ca/0160/budget/buddoc2002/FiscalImbalanceE.pdf.

(2) *Ibid.*

(3) For an explanation and review of cash transfers and tax point transfers under the CHST, see Odette Madore, *The Transfer of Tax Points to Provinces Under the Canada Health and Social Transfer*, BP-450E, Parliamentary Research Branch, Library of Parliament, Ottawa, 1997.

FIGURE 1

Federal CHST Cash Transfers as a Percentage of Provincial Health and Social Spending



Source: *Addressing Fiscal Imbalance*, Report of Provincial and Territorial Finance Ministers, prepared for discussion at the 2001 Annual Premiers' Conference, Victoria, B.C., August 2001, p. 6.

CHST: Canada Health and Social Transfer.

In order to correct the fiscal imbalance, provincial and territorial premiers recommend that:

- Canada's Equalization Program be strengthened. This would involve removing the program's ceiling,(4) considering the possibility of moving to a ten-province standard, and including all revenue sources in the program's formula;(5)

- federal funding through the CHST be restored to cover at least 18% of program costs, and an appropriate escalator be introduced to maintain the CHST's value in the future; and

- the possibility of tax point transfers be considered as an alternative to the current CHST transfer.

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(4) As part of the 2003 Budget, the federal government agreed to permanently remove the Equalization ceiling.

(5) For an in-depth treatment of this provincial recommendation, known as the "Victoria Proposal," see Michael Holden, *Equalization Reforms: Potential Impact*, PRB 02-15E, Parliamentary Research Branch, Library of Parliament, Ottawa, 2002.

Provincial/territorial premiers have long criticized the arbitrary manner in which the CHST is calculated. The amount of the transfer is determined by the federal government without any reference to economic growth or the spending patterns of the provinces. The premiers have asked that a mechanism be put in place to make the transfer stable and predictable.

1. The Séguin Commission

> *The situation can be summed up fairly easily: the federal government occupies too much tax room compared to its responsibilities.*
>
> Yves Séguin, Quebec Finance Minister and former president of the Commission on Fiscal Imbalance, March 2002

Quebec has been the most active of the provinces in studying fiscal imbalance. In March 2001, it created the Commission on Fiscal Imbalance (commonly known as the Séguin Commission, after its president and now Quebec Finance Minister, Yves Séguin). The Commission's mandate was to:

- identify and analyze the basic causes of the fiscal imbalance between the federal government and Quebec;
- determine the actual consequences of the imbalance; and
- find practical solutions to correct the imbalance.

a. Key Findings of the Commission

The Séguin Commission's final report, released in March 2002, has ostensibly become the bible for the Quebec government in its debate with Ottawa over VFI.(6) According to the Séguin Report, the fiscal imbalance between the federal government and the Government of Quebec stems from three main causes: the structural imbalance between spending and access to sources of revenue; the inadequacy of intergovernmental transfers from the federal government; and the "federal spending power."

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(6) Commission on Fiscal Imbalance, *A New Division of Canada's Financial Resources*, Government of Quebec, Québec, 2002; available on-line at http://www.desequilibrefiscal.gouv.qc.ca/en/pdf/rapport_final_en.pdf.

1) Structural Imbalance

The Commission determined that the vast majority of provincial program costs are subject to demographic changes, which are not easily controlled. Therefore, the provinces are subject to the greatest cost pressures. Working against this spending dynamic, revenue division favours the federal government in two ways: first, the federal government occupies more of the Personal Income Tax field; second, the federal government controls part of the provinces' revenues through the transfers it pays them.

2) Intergovernmental Transfers

The Commission concluded that federal transfers are inadequate and problematic. Canada's largest intergovernmental transfer, the CHST, applies conditions to fields of provincial jurisdiction and limits the provinces' decision-making and budgetary autonomy. That autonomy is further reduced by the arbitrariness of the CHST: the federal government has complete discretion in setting the amounts paid to the provinces. The amounts transferred under the CHST are related neither to the level of economic activity in Canada or the provinces, nor to the cost of the provincial programs they help fund.(7) The report also maintains that the federal government, in its effort to put federal finances on a sustainable course, has used this discretion to make disproportionate cuts in transfers to the provinces. As for Canada's second major transfer program, Equalization, it does not completely eliminate disparities in fiscal capacity to the detriment of the less affluent provinces. This is due to the use of a five-province standard instead of a ten-province standard, entitlements being subject to a ceiling,(8) and the incompleteness of the tax bases used to calculate payment entitlements. On the whole, the Commission concluded, "intergovernmental transfers are inadequate in many regards, and this inadequacy is the second cause of the fiscal imbalance that currently exists to the detriment of the provinces."(9)

3) "Federal Spending Power"(10)

The Commission stated that "the problem of the 'federal spending power' is closely tied to fiscal imbalance, and its use is underpinned by the surplus funds that the federal

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(7) *Ibid.*, pp. 73-74.

(8) This is no longer the case; see note 4, above.

(9) Commission on Fiscal Imbalance, p. 108.

(10) For a discussion of the federal spending power, see Mollie Dunsmuir, *The Spending Power: Scope and Limitations*, BP-272E, Parliamentary Research Branch, Library of Parliament, Ottawa, 1991.

government controls." The Séguin Report identified the conditional nature of the CHST as the most vivid illustration of the federal spending power. However, other examples of that power exist and are also causes of fiscal imbalance, since they all limit the provinces' decision-making and budgetary autonomy in fields of provincial jurisdiction. The Commission made a list of federal initiatives in provincial fields of jurisdiction and found that this aspect of federal spending power totalled $15 billion for the provinces overall between 1997 and 2000. These federal initiatives are shown in Table 1.

TABLE 1

Federal Initiatives in Provincial Fields of Jurisdiction, 1997-2000

Federal Initiatives	Cost ($ millions)	Total Cost ($ millions)
Health and Social Services		**3,279**
Medical Equipment Fund	1,000	
Health Transition Fund	800	
Information Technologies in Public Health	500	
Other: Canadian Institutes of Health Research, etc.	979	
Education, Research and Development		**5,994**
Canada Millennium Scholarship Foundation	2,500	
Canada Foundation for Innovation	1,900	
Canada Research Chairs Program	900	
Other: Genome Canada, etc.	694	
Family Policy		**3,750**
Canada Child Tax Benefit	2,850	
Extension of Parental Leave under Employment Insurance	900	
Income Security		**753**
Supporting Communities Partnership Initiative	753	
Miscellaneous		**2,041**
Environment, youth employment, Canadian cultural content on Internet	2,041	
Total		**15,817**

Source: Commission on Fiscal Imbalance (2002), Table 19.

b. Séguin Conclusions and Recommendations

The Séguin Commission concluded that fiscal imbalance has a significant impact on provincial government operations and, accordingly, the delivery of public services. It also held that, due to the federal encroachment on provincial decision-making and budgetary autonomy, the choices of provincial residents are not taken into account. Therefore, in order to eliminate this "dysfunction of the federal system," major transformations in intergovernmental fiscal relations are needed, not only to restore fiscal balance within the federation but also to respond to any new causes of imbalance. According to the Commission, achieving fiscal balance implies that "the provinces must have additional financial resources, that the terms and conditions under which resources are currently divided must be changed, that the operation of the equalization program must be improved and that the 'federal spending power' must be countered."[11]

The Commission argued that the provinces must have additional financial resources to address the needs within their fields of jurisdiction. Such resources were estimated at $2 billion for Quebec and $8 billion for the provinces overall. In order to accomplish this, it was recommended that the CHST be eliminated and replaced by a new division of tax room. Such an arrangement would assure the provinces of a predictable and unconditional source of funds – a situation that, according to the report, does not exist under the CHST.

The Commission expressed a preference for an occupation of the Goods and Services Tax (GST) field by the provinces. It was estimated that, if the federal government relinquished the entire GST in favour of the provinces, this new division of tax room would provide the equivalent of $26 to $27 billion for all provinces, which would be equal to the amount of the existing CHST cash transfer ($18.3 billion) plus the additional financial resources needed by the provinces ($8 billion).

The Commission's next recommendation was that the Equalization Program be improved by: moving to a ten-province standard instead of the current five-province standard; eliminating the Equalization "ceiling" provision (already realized as part of the 2003 federal Budget); and using a more comprehensive list of tax bases in calculating Equalization entitlements.

In addition, the Commission pointed out that the recommended division of financial resources would counteract the federal spending power by limiting the federal government's ability to launch future initiatives in areas of provincial jurisdiction.

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(11) *Ibid.*, p. 131.

c. Criticism of the Séguin Report

The Séguin Commission's final report received criticism both from within Quebec and from the federal government. The Conseil du patronat du Québec noted that the Commission's mandate was flawed from the beginning because the report begs the question of whether Canada even suffers from VFI. Instead of investigating whether a fiscal imbalance actually exists, the Commission accepted a hypothesis formulated by the Quebec government. Given the false premise, the Conseil argued, false conclusions were inevitable.(12)

The Quebec Chamber of Commerce was critical of the Commission's suggestion that tax room be transferred to the provinces. The Chamber of Commerce maintained that Quebec suffered more from an imbalance of wealth than a fiscal imbalance and that, since a tax point raises more revenue in wealthier provinces, a transfer of tax points would only penalize the provinces with lower fiscal capacity, including Quebec.(13)

On behalf of the federal government, Intergovernmental Affairs Minister Stéphane Dion was quick to point out that the Séguin Report's recommendations would lead the federal government back into budget deficits. It was estimated that eliminating the CHST, transferring the GST to the provinces, and adopting a ten-province Equalization standard would cost the federal government approximately $11 billion per year and would result in federal deficits until 2013.(14)

2. Conference Board of Canada Study

> *Is there an imbalance between the budgetary leeway of the federal government and that of the provincial and territorial governments in Canada? Based on a projection of the fiscal and budgetary status quo, the answer is definitely yes.*
>
> Conference Board of Canada, *Fiscal Prospects for the Federal and Provincial/Territorial Governments*, July 2002

In May 2002, the provincial and territorial ministers of finance asked the Conference Board of Canada to extend the study it had prepared for Quebec's Commission on Fiscal Imbalance to cover all provinces and territories. The long-term projections in the study

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(12) Conseil du patronat du Québec, "Déséquilibre fiscal : Le CPQ estime qu'il s'agit d'un faux débat," News Release, 7 March 2002 (http://www.cpq.qc.ca/francais/medias/frmedia.htm).

(13) Quebec Chamber of Commerce, "Le rapport de la Commission Séguin : Des propositions à explorer dans un contexte canadien," News Release, 7 March 2002 (http://www.ccq.ca/).

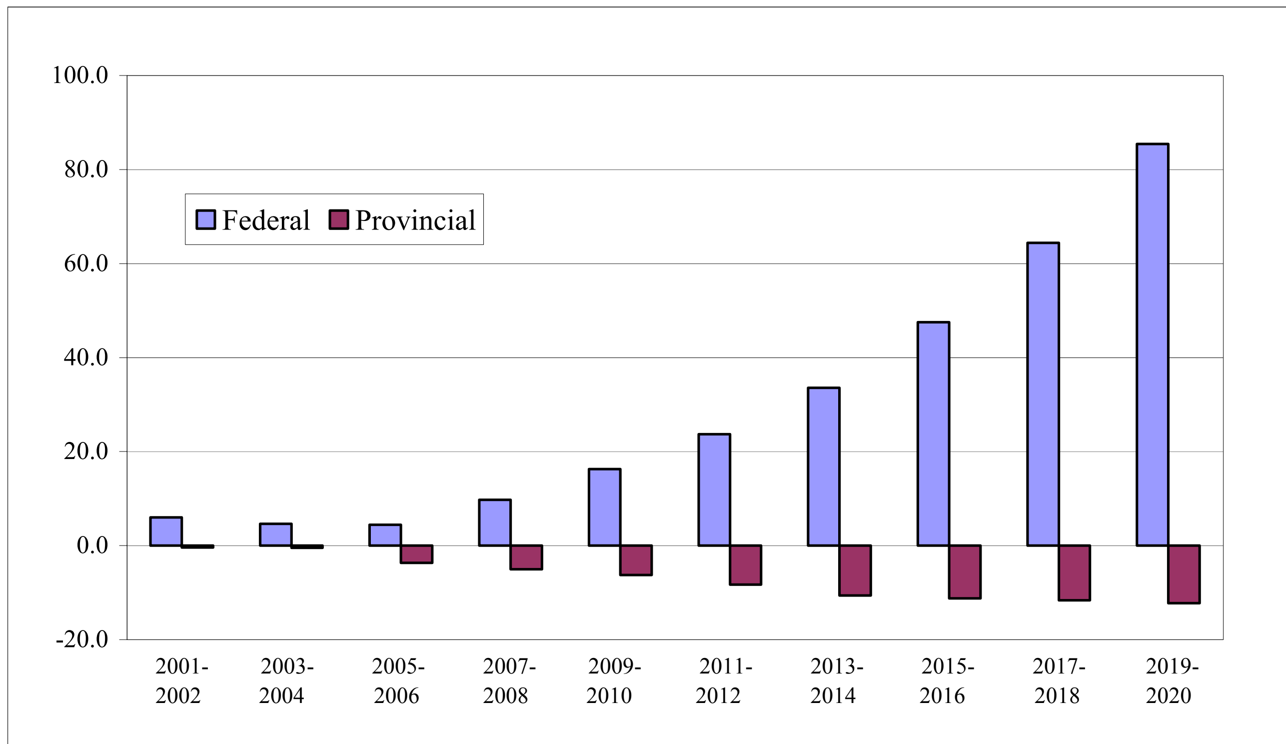
(14) The Hon. Stéphane Dion, "Fiscal balance in Canada," Speech to the Saint-Laurent Chamber of Commerce, 27 March 2002 (http://www.pco-bcp.gc.ca/aia/default.asp?Language=E&Page=pressroom&Sub=Speeches&Doc=20020327_e.htm).

were based on maintaining the status quo with respect to fiscal and budgetary policy. In other words, the study was based on the assumption that all federal and provincial/territorial tax rates would remain at current levels and that no new government spending would be introduced. Furthermore, it presupposed that all budgetary surpluses in a given fiscal year would be earmarked exclusively for debt reduction.

The study shows that fiscal prospects for the federal government are in sharp contrast with those for the provincial/territorial governments. The federal government's surpluses are projected to rise steadily over the next two decades, reaching $85.5 billion in fiscal year 2019-2020. Based on the projections, these multi-billion-dollar surpluses will be large enough to virtually eliminate all interest-bearing debt (from $589.2 billion in 2000-2001 to $52.7 billion in 2019-2020). Meanwhile, it is forecast that the provinces and territories will collectively be in a deficit position throughout the period and that their net debt will increase by 54%, reaching $386.9 billion in 2019-2020. (In 2000-2001, total provincial/territorial net debt stood at $251.5 billion.)

FIGURE 2

Projections: Federal and Provincial Budget Balances ($ billions)



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

Hence, assuming a continuation of the current fiscal regimes, the Conference Board of Canada predicts that the vertical fiscal imbalance will widen progressively, as only the federal government will have the financial capacity to pay down its debt or implement new fiscal initiatives.

Criticism of the Conference Board's projections focussed on the study's key hypothesis: that for a 20-year period the federal government would not alter spending in any way, nor would it introduce any changes in taxes. As the federal Minister of Intergovernmental Affairs put it, "when you make projections assuming that governments put themselves on 'auto-pilot' [for 20 years], you get results that are far removed from reality."(15) Federal Finance Minister John Manley pointed out that, when economists have difficulty predicting the beginning or end of a recession in the short term, it would be irresponsible to establish budgetary policy based on 20-year or even 10-year projections. For instance, the United States had anticipated having a surplus in excess of $200 billion, but now has a deficit of over $165 billion.(16)

3. Quebec Forum on Fiscal Imbalance

The Forum on Fiscal Imbalance hosted by the Government of Quebec in October 2002 was the most recent attempt to convince the federal government of the existence of a fiscal imbalance and its harmful effects on Quebec. The forum was attended by 29 groups, including officials from the Government of Quebec, public finance experts and leaders of the main opposition parties, as well as federal observers and researchers. The goal was to build a solid consensus around the premise that Quebec was being fiscally penalized by the federal government. At the end of the two-day forum, all 29 groups agreed (some reluctantly) to a declaration that requested that the federal government recognize and correct the fiscal imbalance as noted by the Séguin Report, but in a way that would not entail federal budgetary deficits.

B. 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.*
>
> The Hon. Stéphane Dion, federal Minister of Intergovernmental Affairs, October 2002

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(15) *Ibid.*

(16) The Hon. John Manley, *Hansard*, 2nd Session, 37th Parliament, 1142 (19:1435).

In the view of the federal government, both it and the provinces have 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 natural resource royalties, gaming and liquor profits, and property taxes. The provinces also have full control over their tax bases and tax rates, giving them considerable freedom in achieving their own policy objectives. According to the federal government, the fact that virtually all provinces have chosen to reduce taxes in recent years seems to indicate that they believe they have sufficient revenues to manage their spending pressures.

Those who have argued that the provinces are the victims of VFI state that the existence of federal surpluses coupled with provincial deficits is proof of a fiscal imbalance. However, federal representatives have pointed out that if budget balances are to be used as a measure of VFI, why then, throughout the years of considerable federal deficits, was there no talk of the federal government being victim of a fiscal imbalance? In fact, in the early 1980s, federal claims of a fiscal imbalance in favour of the provinces were dismissed, largely due to provincial arguments against the existence of a VFI. A 1982 Economic Council of Canada study supported the provincial arguments:

> [The federal] Minister of Finance contended that the surplus position of the provinces in contrast to the substantial deficit position of the federal Treasury was evidence of a "fiscal imbalance" between the two levels of government … The argument that there is a fiscal imbalance in the Canadian federal system might have merit if, for instance, it could be shown that there was a structural obstacle in our federation that barred access by federal or provincial governments to the revenues needed to fulfill their constitutional responsibilities. Since both federal and provincial governments in fact have access to all major revenue sources, the Council sees no evidence that such a structural imbalance exists in our federal system. The mere existence of deficits at one level of government does not indicate the existence of such a structural imbalance nor does it mean that such deficits have to be rectified at the expense of another level of government.(17)

The federal government maintains that the federal budget surpluses of the past five years are the result of government prudence and a remarkable economic turnaround. Moreover, compared with past deficits, recent federal surpluses are small. Figure 3 compares the evolution of budget balances of the federal and provincial governments from 1980-1981 to 2001-2002.

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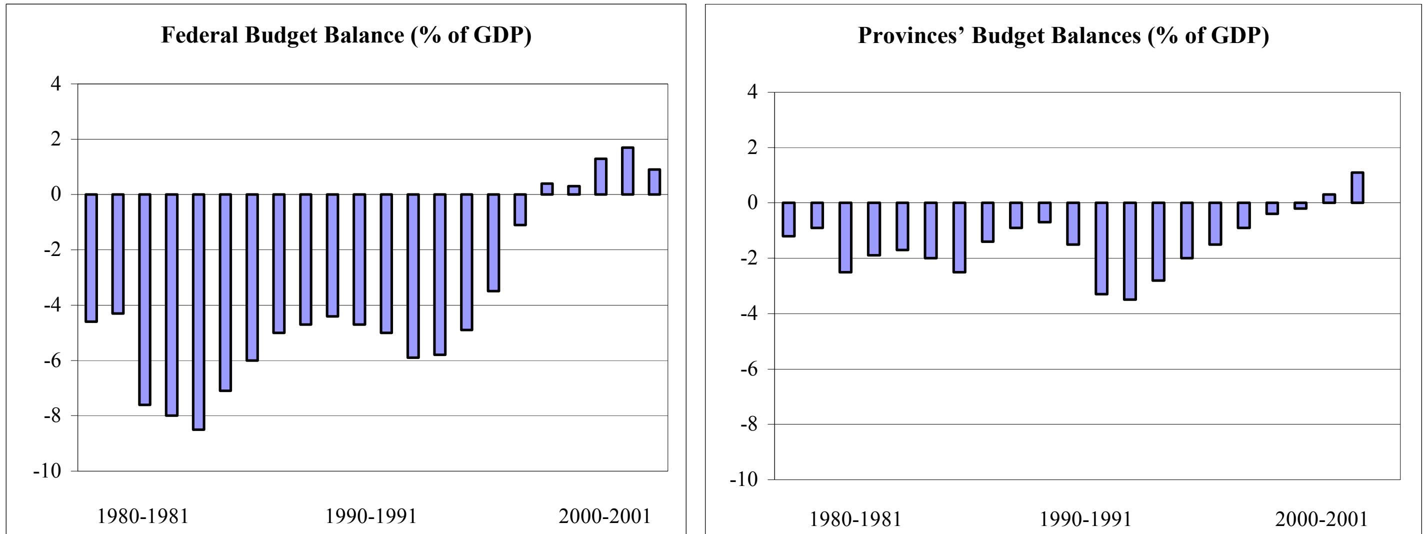
(17) Economic Council of Canada, *Financing Confederation: Today and Tomorrow*, Minister of Supply and Services Canada, Ottawa, 1982, p. 58 and p. 118.

FIGURE 3

Evolution of Federal and Provincial Budget Balances



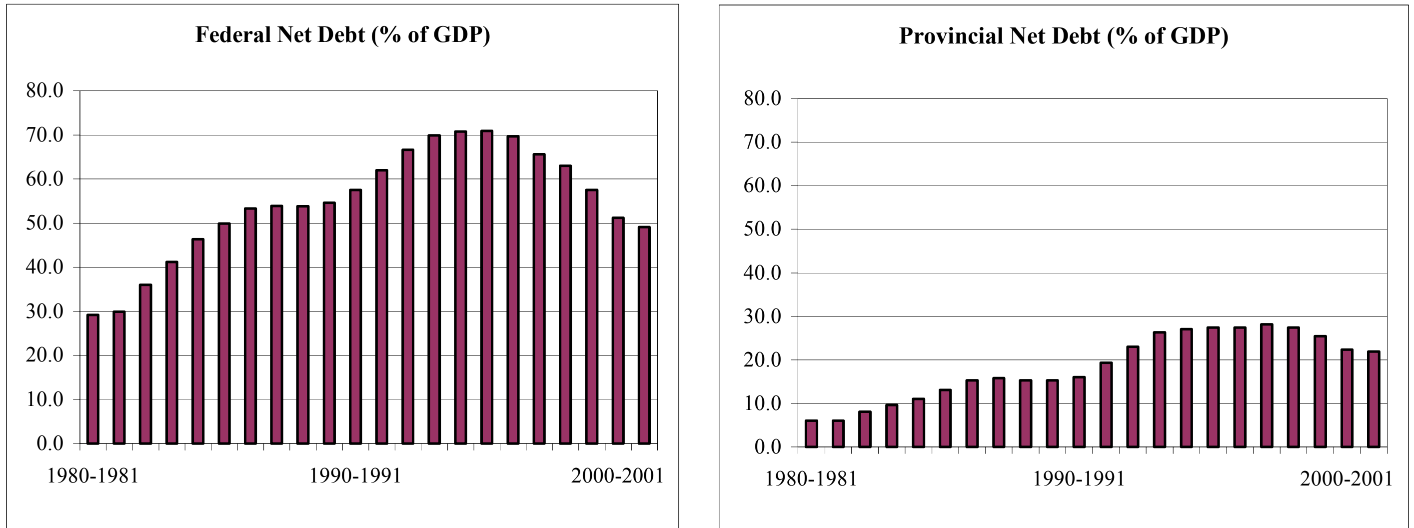
Source: Department of Finance, Fiscal Reference Tables, 2002, Tables 2 and 31.

The federal government also faces a much greater fiscal constraint than the provinces as a result of its larger debt burden. Figure 4 compares the net debt of both levels of government between 1980-1981 and 2001-2002. Debt charges consumed about 23 cents of every federal revenue dollar in 2000-2001, compared to an average of about 11 cents for the provinces.[18] The federal government paid $42 billion in interest costs, compared to about $22 billion for all the provinces combined. The federal government argues that its higher debt burden reduces its fiscal room in managing its own responsibilities, and makes it more vulnerable to volatility in global interest rates. It insists that the best support it can provide the provinces is in the form of good economic health for the nation.

(18) Department of Finance, *The Fiscal Balance in Canada: The Facts*, October 2002, www.fin.gc.ca.

FIGURE 4

Federal and Provincial Net Debt



Source: Department of Finance, Fiscal Reference Tables, 2002, Tables 2 and 31.

Finally, the federal government argues that if a VFI does exist in Canada, it is not a federal-provincial VFI but a provincial-municipal VFI. Canadian municipal governments are able to rely only on property taxes and provincial transfers to finance their significant expenditures.

THE DIVISION OF REVENUES AND RESPONSIBILITIES

A. Taxation, Expenditures and Transfers

Generally speaking, from the perspective of efficient and effective government, the basic principles of tax assignment are simple:

1. each governmental unit (e.g., federal or provincial) should have adequate revenues to cover its expenditures; and

2. each should also be able to affect its revenues by its own actions (e.g., altering tax rates or tax bases).

However, fiscal balance does not mean that provincial governments necessarily have to collect tax revenues that are exactly equal to their expenditures. For reasons of

efficiency and equity, most federations have found it advantageous to have a relatively centralized tax system and a relatively decentralized system of expenditures. Having the federal government take the greatest responsibility for taxation fosters greater tax harmonization and reduces economic distortions,[19] while provincial control of expenditures better accommodates local needs and preferences. Such an arrangement necessitates the transfer of funds from the federal government to provincial/territorial governments in order to fill the fiscal gap. It may also require additional transfers to provinces with low fiscal capacities (e.g., Equalization).

1. Cash Transfers

Intergovernmental transfers have been justified on grounds of both equity and efficiency. In terms of equity, it is argued that the federal government is in the best position to provide a more equal distribution of income since it taxes the resources of citizens nationwide. With this revenue, the federal government may then equalize provincial fiscal capacities through Equalization payments, or ensure that similar essential services are available across the country through transfers such as the CHST.

With respect to efficiency, economists refer to what are known as "benefit spill-overs." The hypothetical argument proceeds as follows: Provincial programs such as education provide benefits for the entire country. However, if a province finds that many of its educated residents migrate to other provinces to find work – which has happened notably in Saskatchewan and Newfoundland, with residents migrating to Alberta and Ontario – that provincial government may no longer be willing to spend as much on education. In economic terms, the province is unable to capture the benefits from spending on education, while other provinces profit from the *benefit spill-overs*. Federal transfers are intended to encourage individual provinces to maintain spending on education by providing "compensation" for the loss of educated residents to other provinces.

Yet, while intergovernmental transfers are supported on the basis of equity and efficiency, they have been criticized for reducing the accountability of governments. A first line of criticism focuses on the distortions in the spending priorities of recipient governments. This critique applies to conditional transfers (such as federal transfers for official language education

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(19) These economic distortions are primarily due to the high mobility of individual and corporate tax bases. Economists argue that differences in provincial tax rates can distort the location of investment and labour.

programs), where the federal level of government is involved in determining spending priorities. A second line argues that the separation of expenditure and taxation decisions is an incentive to fiscal irresponsibility on the part of recipient governments. For instance, a provincial government that receives a portion of its budget in federal transfers does not have to weigh the extra benefit from spending an additional dollar on a public service against the additional cost of raising it through the provincial tax system; some of that province's spending is financed by taxpayers across Canada. The result could be excessive government spending at the provincial level. Such fiscal "dependency" could also lead to confusion over which level of government is responsible for financing and delivering key programs.

2. Tax Point Transfers

As an alternative to federal cash transfers, some have proposed the transfer of tax points from the federal government to provincial governments.[(20)] Such a transfer would involve a reduction in federal tax rates and a corresponding increase in provincial tax rates, thus giving provincial governments greater control of tax revenues relative to the federal government.[(21)]

However, while a transfer of tax points would allow provincial governments to be more "self-financing," differences in their capacities to raise revenues would affect tax burdens and exacerbate regional inequality. Simply put, one point of tax raises more revenue in a rich province than in a poor one. Economists Jack Mintz and Richard Bird have estimated the increase in provincial Personal Income Tax (PIT) revenue following a hypothetical 11.5 tax point transfer to the provinces and found that there would be significant disparities.[(22)] While Ontario's and Alberta's PIT revenues could be expected to increase by between 26% and 28% in 2003 as a result of such a transfer, Quebec and the Atlantic provinces would see a smaller increase in revenues of between 17% and 21%. In the past, the federal government compensated for this inequality by increasing its cash transfers to the poorer provinces while reducing them to

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(20) The provincial and territorial premiers, led by Quebec, have raised the idea on a number of occasions. See also Jack Mintz and Michael Smart, "Why Quebec's tax-point transfers are a good idea," *National Post*, 25 March 2002, FP15; and François Vaillancourt, "Alter the Federal-Provincial Powers Mix to Improve Social Policy," *Policy Options*, November 1998.

(21) While "tax point transfer" is the term commonly used in public finance, it is perhaps more accurately described as "making tax room available." Of course, nothing prevents the federal government from raising its tax rates following a tax point transfer – that would simply result in higher overall taxes for Canadians.

(22) Richard Bird and Jack Mintz, "Tax Assignment in Canada: A Modest Proposal," in H. Lazar, ed., *Toward a New Mission Statement for Canadian Fiscal Federalism*, Queen's University, Kingston, 2000, p. 269.

Ontario and Alberta. But if tax point transfers were to replace federal cash transfers, it would be difficult to recover the additional revenues from the richer provinces and redistribute them to the poorer provinces. Moreover, since tax point transfers represent a permanent loss of revenue for the federal government, they also represent a loss of federal control in enforcing national standards in the areas of health care, education and social assistance.

B. The Fiscal Setting in Canada: Where Are We Now?

In Canada, provincial and municipal governments are not entirely self-financing. Before the distribution of intergovernmental transfers, there is a significant vertical imbalance between expenditures and revenues at all levels of government. Table 2 depicts revenues and expenditures at the three levels before transfers. Generally speaking, the federal government collects about 3% to 4% more of gross domestic product (GDP) in revenues than it spends, other than on intergovernmental transfers, while the provinces as a whole collect an amount not quite sufficient to cover their expenditures, net of transfers. To fill this gap, the provinces receive roughly 18% of their net-of-transfer expenditures in transfers from the federal government. The municipalities depend on transfers for more than 40% of their expenditures.

TABLE 2

Own Revenues and Expenditures by Level of Government, 2001

	Own Revenues	**Direct Expenditures**	**Own Surplus**	**Transfers Received as % of Expenditures**
Level of Government	(1)	(2)	(3)=(1)-(2)	(4)
	(% of GDP of Canada)			(%)
Federal	17.46	13.78	3.68	n/a
Provincial	17.32	17.77	-0.45	17.58
Municipal	4.39	6.95	-2.56	40.82

Source: Based on Department of Finance, Fiscal Reference Tables, October 2002, National Accounts.

Note: Expenditures identified in (2) and (4) are net of transfers.

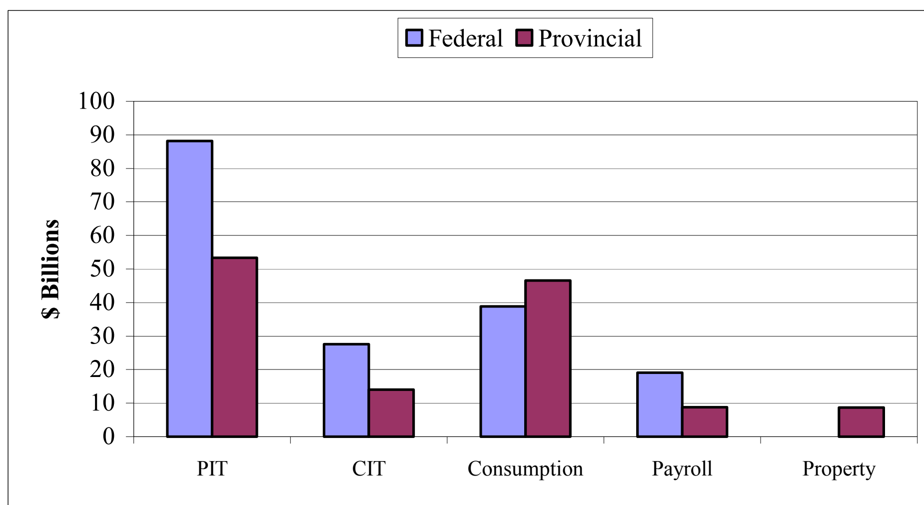
1. Revenues

Figures 5 and 6 and Table 3 focus solely on the revenue side of the equation. In the area of taxation, both the federal and provincial governments have access to the major revenue sources. Provincial legislatures are technically restricted by the constitution to “direct

taxation within the province" – taxes imposed directly on individuals and corporations, as opposed to the taxation of a purchase made by an individual.[23] However, provincial retail sales taxes (PST) have withstood challenges of being an indirect tax through carefully worded legislation, which stipulates that the tax is being placed directly on the purchaser. Hence, the provinces raise most of their revenues from the same sources as the federal government, namely, taxes on income and sales. Provinces are also free to determine their own tax rates and tax bases (the second basic principle of tax assignment). However, despite having equal access and fiscal autonomy, the two levels of government do not occupy the same share of the various tax fields (see Figure 5).

FIGURE 5

Federal-Provincial Share of Taxes, 1999-2000



Source: Statistics Canada, CANSIM II, Table 385-0002.

Notes:
- CIT = Corporate Income Tax.
- Consumption taxes include general sales taxes (GST, PST, the Harmonized Sales Tax [HST]) and excise taxes.
- While some property tax is collected by provinces, it is used, for the most part, to finance the activities of municipal governments.

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(23) See Section 92(2) of the *Constitution Act, 1867*. A 1982 constitutional amendment has permitted the provinces to levy indirect taxes on natural resources. Provincial governments are still prohibited from taxing international or intraprovincial trade.

For both the federal government and the provinces, the PIT is the most important source of revenue. (See Appendix B for a discussion of the federal/provincial division of this tax.) The PIT is a valuable revenue source because it can generate revenues at a faster rate than GDP. From 1989 to 2001, for example, the average annual growth rate of PIT revenues was approximately 5.1%, compared to roughly 4.3% for GDP.(24) The federal government dominates this tax field in all provinces except Quebec; residents of Quebec pay a greater portion of PIT to their provincial government than to the federal government. (See Appendix B for an explanation of this arrangement.)

In 2000-2001, the federal government generated almost half of its total budgetary revenues from the PIT.(25) In the same year, only one-quarter of total provincial/territorial revenues came from the PIT.(26) Table 3 lists the major sources of revenue for both levels of government for the 2000-2001 fiscal year.

TABLE 3

Federal and Provincial Revenues, 2000-2001

Revenue Source	Federal		Provincial	
	Amount ($ billions)	% of Total Revenue	Amount ($ billions)	% of Total Revenue
Personal Income Taxes	88.2	46.3	53.3	25.0
Corporate Income Taxes	27.6	14.5	14.0	6.5
Consumption Taxes(1)	38.8	20.4	46.6	21.8
Social Insurance/Payroll	19.1	10.0	8.8	4.1
Property and Related Taxes	0.0	0.0	8.7	4.1
Other Taxes	0.5	0.3	15.0	7.0
Sales of Goods and Services	4.3	2.2	7.6	3.5
Investments and Royalties	6.6	3.5	26.8	12.6
Intergovernmental Transfers(2)	0.6	0.3	31.7	14.9
Other Revenues	4.7	2.5	0.9	0.4
Total Revenue	190.4	100.0	213.4	100.0

Source: Statistics Canada, CANSIM II, Table 385-0002.

(24) Based on Statistics Canada, CANSIM II, Tables 385-0001 and 380-0001.

(25) Department of Finance, Fiscal Reference Tables, 2002, Table 5, Public Accounts.

(26) *Ibid.*, Table 38, National Accounts.

Notes: Statistics Canada uses the Financial Management System (FMS) to produce government financial statistics. FMS standardizes individual government accounts to provide consistent and comparable statistics. As a result, FMS statistics may differ from the figures published in government financial statements.

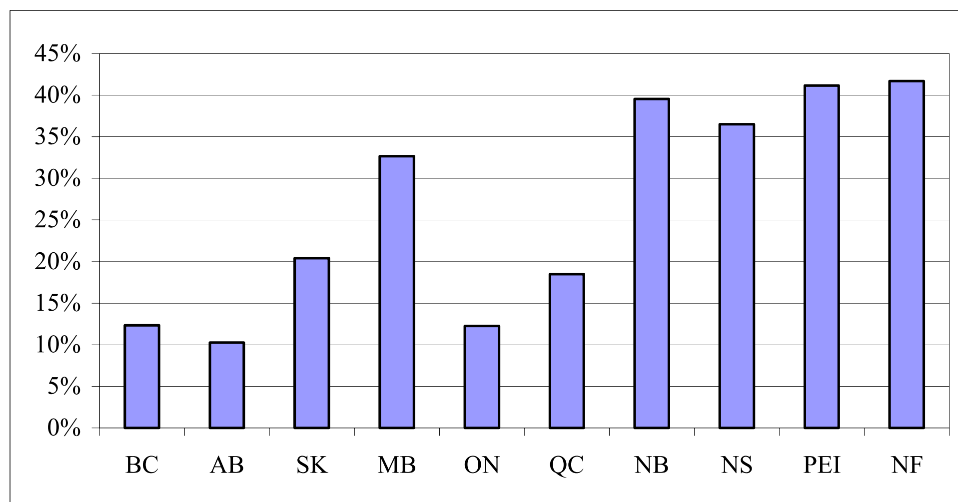
(1) Consumption taxes include general sales taxes (GST, PST, HST) and excise taxes.

(2) Intergovernmental transfers received may also include payments for general government services.

In general, tax revenues account for a much larger portion of total revenue at the federal level (91.5%) than at the provincial level (69%). However, non-tax revenues such as the sale of goods and services, investment income, and natural resource royalties hold greater importance for the provinces. Also, to help in the financing of programs and services, provinces receive a significant portion of their total revenues from transfers from the federal government. Figure 6 shows that this portion varies from province to province. In 2001-2002, the federal portion ranged from 41.7% of total revenues in Newfoundland to 10.3% in Alberta.

FIGURE 6

Federal Cash Transfers as a Percentage of Total Provincial Revenues, 2001-2002



Source: Department of Finance, Fiscal Reference Tables, 2002, Provincial and Territorial Governments, Public Accounts.

2. Expenditures

In terms of expenditures, the provinces are constitutionally responsible for the areas of education, health, and social services. These responsibilities account for the vast majority of provincial spending. The federal government also shares in the direct provision of social services in addition to its spending on protection, defence, transportation, communications, resource conservation, industrial assistance, and transfers to the provinces. Both levels of government must also make public debt payments. Table 4 lists the most significant expenditures at the two levels of government.

TABLE 4

Federal and Provincial Spending, 2000-2001

Expenditure	Federal		Provincial	
	Amount ($ billions)	% of Total Spending	Amount ($ billions)	% of Total Spending
Health	2.9	1.6	61.6	30.5
Social Services	51.6	28.4	31.8	15.7
Education	4.8	2.7	40.6	20.1
Transportation/Communication	2.0	1.1	8.5	4.2
Labour/Immigration	2.3	1.3	1.1	0.5
Recreation/Culture	3.1	1.7	2.0	1.0
Resources/Industry	5.7	3.2	8.1	4.0
Environment	1.5	0.8	1.6	0.8
Protection/Defence	19.2	10.6	7.1	3.5
General Government Services	8.4	4.6	3.2	1.6
Other Expenditures	8.7	4.8	5.8	2.9
Intergovernmental Transfers	25.8	14.2	1.6	0.8
Debt Charges	45.0	24.8	28.8	14.3
Total Expenditures	181.3	100.0	201.8	100.0

Source: Statistics Canada, CANSIM II, Table 385-0002, April 2003.

Note: Intergovernmental transfers listed above represent general-purpose transfers only. They do not include such federal shared-cost conditional transfers as bilingualism education and the gross revenue insurance plan for agriculture.

Health care expenditures are the largest item of provincial spending. Measuring the federal share of health care expenditures, however, is more difficult. Federal health expenditures listed in Table 4 do not include financial support for provincial health care costs under the CHST (the cash portion of this transfer is included under "Intergovernmental Transfers"). Since the CHST is a block transfer, the provinces themselves determine the amount of the transfer to be allocated to health care. Equalization-receiving provinces may also apply a portion of the Equalization transfer to health care expenditures. However, with the introduction of the Canada Health Transfer in 2004-2005 (see Appendix A), it should be possible to measure the federal share of health care expenditures more accurately.

With regard to direct federal spending on health, the federal government is responsible for providing health services for military personnel and veterans, and for First Nations and Inuit. The federal government also conducts health research, and provides quarantine and immigration health services.

In the area of social services, the provinces are responsible for providing social assistance while the federal government is responsible for Employment Insurance (EI), income security programs (such as Old Age Security, and the Guaranteed Income Supplement), child benefits and programs for veterans, First Nations and Inuit, as well as assisting the provinces through the CHST. As for education, each province is responsible for its own education system. The federal government, in addition to providing support for education through the CHST, is responsible for the education of First Nations and Inuit, armed forces personnel and penitentiary inmates. As of 2004-2005, the federal government will assist the provinces in their expenditures on social services, social assistance, and post-secondary education through the new Canada Social Transfer (see Appendix A).

C. Measuring Vertical Fiscal Imbalance

How do we know whether a country suffers from a vertical fiscal imbalance? VFI is conventionally defined as a "mismatch" between actual revenues and expenditures at different levels of government during a specific period of time. However, there is no universally accepted approach to measuring the concept of VFI in the economic literature. Should we compare federally controlled and provincially controlled revenue? What size of ratio signals a fiscal imbalance? Do deficits, or changes in deficits, indicate that a VFI exists?

Comparing the size of budget balances across levels of government over time provides one indicator of VFI. However, many economists believe that an approach focussed entirely on the relative size of budget balances is static and insufficient;(27) a meaningful analysis must consider the broader aspect of fiscal sustainability. In other words, considering (1) its spending obligations and (2) its level of debt, how much fiscal "breathing room" does a government have? Is it able to cut taxes or will it be forced to raise them in order to meet budget requirements? These are all aspects that must be considered in the continuing debate on VFI.

INTERNATIONAL COMPARISONS

Canada is not the only country involved in a debate over the fiscal balance of its governments. A number of federal countries and their sub-national governments are currently reviewing the assignment of taxation and expenditure functions among governments, and the appropriate size and type of intergovernmental transfers. This section outlines the experiences of the United States and Australia.

A. United States

The United States is engaged in an ongoing debate about the best assignment of expenditures and revenues across levels of government.(28) Over the last 50 years, decentralization of the U.S. government structure has been reflected in the increasing shares of expenditures and revenues that are under state/local government control. The federal revenue share has fallen, however, because of an increase in the share of GDP paid in state/local taxes, not because of a significant reduction in federal taxes as a share of GDP or by an obvious shift of authority from the federal to state and local government.(29) Much of the growth in state expenditures is in response to federal matching programs over which states have limited

(27) C. Matier, L. Wu and H. Jackson, "Analysing Vertical Fiscal Imbalance in a Framework of Fiscal Sustainability," Department of Finance Working Paper, No. 2001-2023, Ottawa, 2001, p. 5.

(28) For a concise survey of the American situation, see Commission on Fiscal Imbalance, *Intergovernmental Fiscal Arrangements: Germany, Australia, Belgium, Spain, United States, Switzerland*, Government of Quebec, Québec, 2001, Chapter 5; and William F. Fox, "Decentralization in the United States: Where has the Country Headed?," paper prepared for the International Symposium on Fiscal Imbalance, Québec, 2001. Both are available on-line at www.desequilibrefiscal.gouv.qc.ca.

(29) Fox (2001), p. 1.

control.[30] As the federal government provides more and more money to states in the form of grants-in-aid, state governments must spend more and more money to comply with program mandates. And while the federal and state governments generally have considerable independence in their ability to raise revenues, federal control over state revenue authority, in the form of limiting the states' ability to tax interstate commerce, is effectively growing.

Table 5 depicts revenues and expenditures at the three levels of government in the United States for 1999. In general, the revenue-raising ability and the spending power of the American federal government is substantial. Compared to the Canadian provinces, the U.S. states play a much less active role in the federation; a substantial portion of sub-national activity is assumed by local governments, which have the power to raise revenue through income and sales taxes, in addition to property taxes.

TABLE 5

Own Revenues and Expenditures by Level of Government, United States, 1999

Level of Government	Own Revenues	Direct Expenditures	Own Surplus	Transfers Received as % of Expenditures
	(1)	(2)	(3)=(1)-(2)	(4)
	(% of GDP of U.S.A.)			(%)
Federal	19.65	15.44	4.21	n/a
State	9.67	7.46	2.21	36.58
Local	6.72	9.99	-3.27	35.27

Source: Based on David Hoffman, *Facts and Figures on Government Finance*, 36th Edition, Tax Foundation, Washington, 2002, Tables A10, C1, C11, E1, and F1.

Note: Expenditures indicated in (2) and (4) are net of transfers.

(30) Matching programs involve state/local governments contributing a portion of their own funds to a specific program in order to receive a federal contribution. Medicaid, the United States' largest grant program, is an example of a matching program: for the 10 states that receive a 50% matching rate, these state governments must "match" (dollar for dollar) the federal contribution for health insurance for low-income Americans. States with lower fiscal capacities receive more favourable matching rates (up to 83%) – i.e., the federal government puts up more of the money.

However, the states' image as the "weak link" in the federation may be changing. The "devolution revolution" of 1995 – a plan to shift certain federal responsibilities for welfare to the states – helped to change the relative role of state governments within the U.S. federal system. With the federal government now shifting its priorities in the wake of the terrorist attacks of 11 September 2001 (towards combating terrorism, military action in Iraq, etc.), the states could very likely be called upon to shoulder significantly wider domestic fiscal responsibilities.[31] The question is whether they possess revenue systems that will enable them to meet these responsibilities effectively.

Recently, the fiscal situation of the states has deteriorated significantly. State governments are now facing budget shortfalls that may reach as high as $80 billion in the 2004 fiscal year – the worst fiscal conditions facing the states since World War II. Two long-standing structural problems are the major causes: sharply declining state revenues and the explosion in health care costs. On the revenue side, state governments depend heavily on uncertain flows of financial assistance – which, due to matching requirements, bring added costs – from the federal government. The states are also heavily dependent on personal income taxes and general sales taxes – two revenue sources that suffered badly during the 2001 recession. States have been forced to raise taxes on everything from personal income to cigarettes. As for spending, the Medicaid program (health insurance for low-income Americans) is crushing state budgets; state governments have called on Congress to either reform Medicaid or assume a greater portion of health care costs. In the short term, however, states have no option but to reduce recipient benefits in order to balance their budgets (which in most states is required by law).

States are now facing what some American analysts are calling a "perfect storm": deteriorating tax bases, an explosion of health care costs, and a collapse of important revenue sources. In the short run, they have no alternative but to cut spending drastically.[32] The problem, however, appears to be structural and may lead to a federal-state confrontation over revenues and responsibilities in the near future.

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(31) Robert Tannenwald, "Are State and Local Revenue Systems becoming Obsolete?," *National Tax Journal*, Volume LV, No. 3, September 2002, p. 487.

(32) Some state governors have even ordered the release of many "non-violent" offenders from state prisons in an attempt to cut costs. See "Inmates go free to help states reduce deficits," *New York Times*, 19 December 2002.

B. Australia

Australia claims to have the greatest degree of VFI of any federal country.(33) As Table 6 shows, Australia's states have relatively large constitutionally assigned spending responsibilities but few own-source revenues, while the reverse is true at the Commonwealth (federal) level. The Commonwealth government has exclusive control over several major sources of revenue, including personal and corporate income taxes. The states are left with a "range of relatively unsatisfactory taxes," such as financial taxes, stamp duties, payroll tax, gambling taxes, land taxes, and motor vehicle taxes.(34) Not surprisingly, therefore, the Australian states are highly transfer-dependent.

TABLE 6

Own Revenues and Expenditures by Level of Government, Australia, 2000

Level of Government	Own Revenues	Expenditures Less Transfers	Own Surplus	Transfers Received as % of Expenditures
	(1)	(2)	(3)=(1)-(2)	(4)
	(% of GDP of Australia)			(%)
Federal	25.28	18.38	6.90	n/a
State	9.48	13.56	-4.08	36.99
Local	2.17	2.25	-0.08	12.45

Source: Based on figures from the Australian Bureau of Statistics.

Note: Expenditures indicated in (2) and (4) are net of transfers.

Australia's system of intergovernmental grants also reflects the centralization of the federation. Over one-half of the cash transfers to the states are in the form of conditional grants, which, in turn, enhance both centralization and uniformity.(35)

(33) Richard Webb, *Public Finance and Vertical Fiscal Imbalance*, Research Note No. 13 2002-2003, Department of the Parliamentary Library, Canberra, 2002, available on-line at http://www.aph.gov.au/library/pubs/rn/2002-03/03rn13.htm.

(34) David J. Collins, "The 2000 Reform of Intergovernmental Fiscal Arrangements in Australia," paper prepared for the International Symposium on Fiscal Imbalance, Québec, 2001, p. 2.

(35) Thomas J. Courchene, "Federalism and the New Economic Order: A Citizen and Process Perspective," address prepared for the Forum of Federations Conference on Federalism in the Mercosur: The Challenges of Regional Integration, Porto Alegre, Brazil, 2002, p. 3.

The VFI issue has become even more prominent in Australia with the introduction of a national Goods and Services Tax (GST) in 2001, the revenues from which are transferred to the states as part of an agreement that also saw state governments abolishing or reducing some of their own taxes. While the agreement has reduced the states' own-source revenues, the transfer of GST revenues ensures that the states receive stable funding. The agreement also gives them a right to veto any change in the GST and, consequently, a veto over any change affecting the volume of transfers.

Australian fiscal federalism had a remarkably similar history to that of Canada until World War II. From that time, the two took different paths: Australia became fiscally more centralized, while Canada became more decentralized. The Australian states have less tax autonomy than the Canadian provinces, and are therefore heavily dependent on federal transfer payments. The GST reform is expected to increase that dependency, though it is still too early to assess the impact.

CONCLUSION

A vertical fiscal imbalance exists when the expenditure responsibilities of different levels of government do not match their revenue-raising powers. The federal and provincial governments are currently debating whether this is the case in Canada and, if so, whether the country's financial framework needs to be modified.

The Canadian federation is highly decentralized in terms of both expenditures and taxes. The provinces set their own tax rates and bracket structures in terms of personal and corporate taxes, and levy their own sales taxes; in general, they control the natural resources within their borders and are responsible for health, welfare, and education, among many other areas. Over the years, the Canadian system of intergovernmental transfers has been shaped to accommodate this decentralization. Equalization payments are wholly unconditional, while the transfers used to fill the gap in own-source revenues and expenditures have moved from the shared-cost, conditional variety to block-funding, guided by a set of social policy principles.

While there is no universally accepted definition of VFI in the economic literature, provincial governments argue that the needs are in the provinces but the money is with the federal government. Some studies have shown a contrast in the fiscal prospects of the two levels of government: the provinces are expected to face intense and rising cost pressures while

the federal government is projected to run large and growing surpluses. The report of Quebec's Commission on Fiscal Imbalance (the Séguin Commission), perhaps the leading analysis in favour of the provinces, contends that intergovernmental transfers have failed as a mechanism of assistance to the provinces, and that the federal government should surrender revenue sources to the provinces.

On the opposite side of the debate, the federal government argues that there can be no fiscal imbalance when the provinces have access to all revenue sources and even have a monopoly on such major sources as lotteries and natural resource royalties. According to the federal government, the fact that virtually all provinces have reduced taxes in recent years seems to indicate that they believe they have sufficient revenues. Furthermore, the federal government argues that it is pointless to simply compare federal and provincial budget balances, and contends that it faces a much greater fiscal constraint due to its larger debt burden. Indeed, economists studying the question of VFI acknowledge that a meaningful analysis must consider the broader aspect of a government's relative fiscal sustainability.

Finally, Canada is not the only country involved in the VFI debate. A number of federal countries and their sub-national governments are currently reviewing the assignment of revenues and expenditures across levels of government. International comparisons, however, may be of limited value since the fiscal structure in any federal country is unique, reflecting the historical, social and cultural evolution of the society. While the dilemmas of fiscal federalism may exhibit broad patterns such as the inadequacy of provincial/state own-source revenues and the heterogeneity of provincial/state governments, it will be impossible to transplant generic solutions from one country to another.

CHRONOLOGY

July 1958: The *Hospital Insurance and Diagnostic Services Act* takes effect. The federal government provides the provinces with a grant equal to 25% of per capita provincial costs plus 25% of per capita national average costs. All provinces joined the program by 1961.

April 1965: Instead of a cash payment, Quebec receives a Personal Income Tax (PIT) abatement of 3 percentage points of federal tax for its Youth Allowance Program.

July 1966: The Canada Assistance Plan (CAP) is introduced as a comprehensive public assistance program. The federal government pays 50% of eligible costs, with provinces free to set their own rates of assistance.

April 1967: The federal government finances 50% of operating costs of post-secondary educational institutes by transferring 4 percentage points of PIT and 1 percentage point of Corporate Income Tax (CIT), with associated equalization, to the provinces.

July 1968: National medicare begins. The federal government helps to support eligible provincial medicare programs with a financial contribution equal to 50% of the national cost of a program covering all physicians' services.

January 1974: Quebec's Youth Allowance Program is discontinued. The abatement of 3 PIT points is left in place, but the federal government recovers an equivalent amount from other payments to the province.

April 1977: Established Programs Financing (EPF) is introduced to help the provinces finance post-secondary education, hospital insurance, and medicare. As part of the arrangement, the federal government makes 9.143 PIT points of additional tax room available to the provinces.

February 1982: Federal claims of a vertical fiscal imbalance in favour of the provincial governments are dismissed by an Economic Council of Canada study.

June 1995: Bill C-76, establishing the Canada Health and Social Transfer (CHST), receives royal assent.

April 1996: The CHST comes into effect, replacing transfers to the provinces under EPF and CAP arrangements.

March 1998: The federal government records its first budgetary surplus since 1970.

September 2000: The federal government announces $23.4 billion of new federal investments over five years to support agreements by First Ministers on Health Renewal and Early Childhood Development.

March 2002: The Commission on Fiscal Imbalance, chaired by Yves Séguin, releases its final report, *A New Division of Canada's Financial Resources*.

March 2002: The federal government records its fifth consecutive budgetary surplus.

October 2002: The Government of Quebec hosts the Forum on Fiscal Imbalance.

February 2003: Following the First Ministers' Accord on Health Care Renewal, the federal government will increase its support for health care by $34.8 billion over five years.

April 2004: The federal government will replace the CHST with two new transfers: a Canada Health Transfer (CHT) and a Canada Social Transfer (CST).

APPENDIX A

THE EQUALIZATION PROGRAM AND THE CANADA HEALTH AND SOCIAL TRANSFER

The Canadian system of intergovernmental transfers has been shaped over the years to accommodate the fiscal autonomy of the provinces. Figure A-1 provides a brief history of the evolution of major transfers since 1947. Canada now essentially has two major transfers: the Equalization Program and the Canada Health and Social Transfer (CHST).

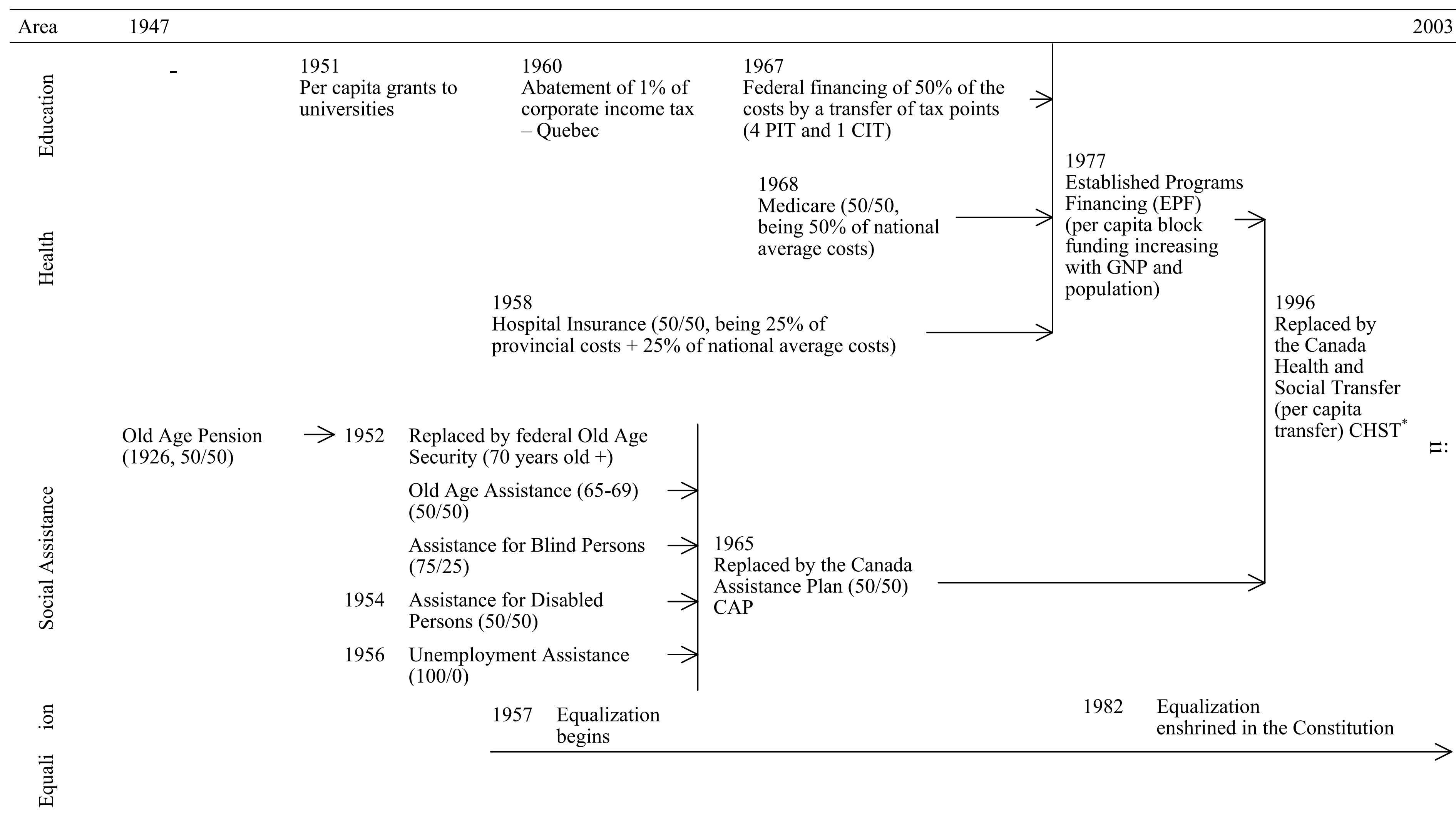
Canada's Equalization Program focuses on enabling all provinces to provide "reasonably comparable levels of public services at reasonably comparable levels of taxation"[(1)] – in other words, Equalization addresses Canada's horizontal fiscal imbalance. This is done by providing equalization payments to the poorer provinces in order to bring their per capita revenues up to the so-called "five-province standard."[(2)] These equalization payments are wholly unconditional, meaning that the receiving provinces may spend the funds however they wish.

(1) *Constitution Act, 1982*, Section 36.

(2) The standard measures the average fiscal capacity of the five "middle-income" provinces: Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.

FIGURE A-1

Evolution of Major Transfer Programs in Canada: Education, Health, Social Assistance and Equalization, 1947-2003



Source: Adapted from François Vaillancourt, *Les transferts fédéraux-provinciaux au Canada, 1947-1998 : évolution et évaluation*, paper prepared for the Association des économistes québécois, Montréal, 1999.

Notes: Cost sharing is listed as % federal/% provincial.

* CHST is to be split into the Canada Health Transfer (CHT) and the Canada Social Transfer (CST) on 1 April 2004.

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Federal funds to assist the provinces in financing the "established programs" – health, education, social assistance and social services – are rolled into the CHST, a single block-fund. CHST money can be spent as the provinces wish (within the "established programs" area). The provinces must, however, adhere to a set of social policy principles. These include the five principles of the *Canada Health Act* and the no-residency requirement for social assistance.

TABLE A-1

Equalization and CHST Cash Transfers

Year	EQUALIZATION			CHST			
	Amount ($ millions)	As % of GDP	As % of Federal Spending	Amount ($ millions)	As % of Total CHST Entitlements	As % of GDP	As % of Federal Spending
1992-1993	7,784	1.11	6.35	17,916	n/a	2.55	14.62
1993-1994	8,063	1.11	6.72	16,830	n/a	2.31	14.02
1994-1995	8,607	1.11	7.25	17,331	n/a	2.24	14.60
1995-1996	8,759	1.08	7.82	16,790	n/a	2.07	14.99
1996-1997	8,959	1.07	8.55	14,742	54.80	1.76	14.06
1997-1998	9,738	1.10	8.95	12,500	48.38	1.41	11.49
1998-1999	9,602	1.05	8.62	12,500	46.57	1.36	11.22
1999-2000	10,900	1.12	9.75	14,500	48.16	1.49	12.97
2000-2001	10,861	1.03	9.10	15,500	48.61	1.47	12.99
2001-2002	10,218	0.94	8.07	18,300	53.43	1.69	14.45
2002-2003	10,348	0.91	n/a	19,100	53.48	1.67	n/a

Source: Transfers: Department of Finance, Federal-Provincial Relations Division.
GDP: Statistics Canada, CANSIM II, Table 384-0002.
Federal Spending: Department of Finance, Fiscal Reference Tables.

Notes:
- Federal spending is federal program spending. In other words, it excludes public debt charges.
- Total CHST entitlements include CHST cash and CHST tax points.
- Before 1996-1997, the CHST amount is the sum of Established Programs Financing (EPF) and Canada Assistance Plan (CAP).

In order to improve the transparency and accountability of federal support to provinces and territories, the CHST is to be restructured. Effective 1 April 2004, the federal government will create two new transfers:

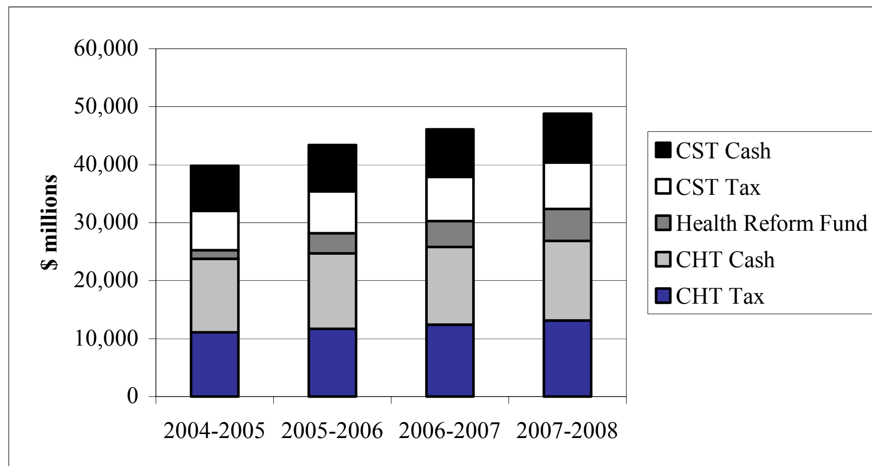
1. the Canada Health Transfer (CHT) in support of health; and

2. the Canada Social Transfer (CST) in support of post-secondary education, social assistance and social services, including early childhood development.

The existing CHST cash and tax points will be apportioned between the CHT and the CST (see Figure A-2). The percentage of cash and tax points apportioned to the CHT will be 62%, reflecting the percentage of health spending within overall provincial spending in the health care and social sectors that is currently supported by federal transfers. The remaining cash and tax points will be allocated to the CST.

FIGURE A-2

New Canada Health Transfer (CHT) and Canada Social Transfer (CST)



Source: Department of Finance Canada, *Budget 2003: Investing in Canada's Health Care System*, Table 5.

Note: Does not include a $2.5-billion CHST cash supplement, which may be drawn down by the provinces between 2003-2004 and 2005-2006.

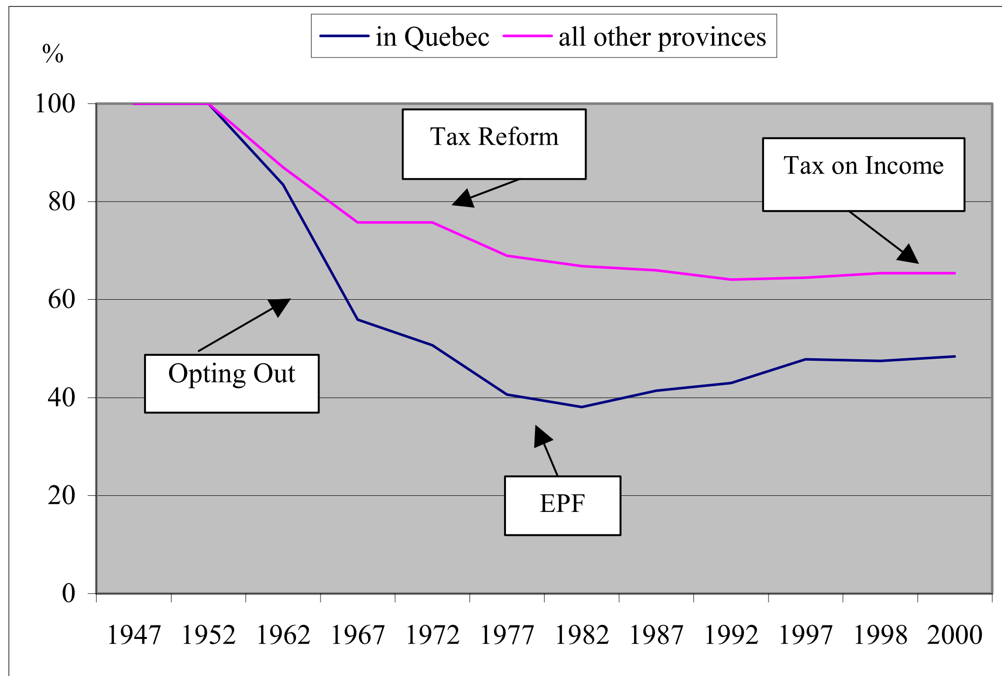
APPENDIX B

THE "PIT" AND THE PENDULUM: FEDERAL-PROVINCIAL DIVISION OF THE PERSONAL INCOME TAX

The Government of Quebec is the only provincial government to occupy a greater share of the Personal Income Tax (PIT) field than the federal government. Figure B-1, below, shows the federal share of the PIT field in Quebec and in the rest of Canada between 1947 and 2000.

FIGURE B-1

Federal Share of Personal Income Tax Revenues



Sources:
- 1947-1967: Statistics Canada, CS11-516F, 1983, "Historical Statistics of Canada," Tables H53, H76.
- 1972-1982: Statistics Canada, 13-213S, "Provincial Economic Accounts – Historical Issue, 1961-1986," Table 9.
- 1987-1998: Statistics Canada, CANSIM labels D26728 and D26731.
- 2000: Department of Finance, Fiscal Reference Tables, Tables 32 and 35; and Commission on Fiscal Imbalance (2002).

Canada's history of the PIT field can be divided into five periods: the tax rental agreements during and following World War II (1941-1962), opting out (1962-1967), tax reform (1972), Established Programs Financing (1977), and the move to tax on income (2000).

A. 1941-1962: Tax Rental Agreements

During World War II, the provinces agreed to surrender ("rented") all rights to impose income taxes to the federal government in exchange for fixed annual payments. Hence, individual and corporate income taxation was solely under federal jurisdiction from 1941 to 1946. Further rental agreements were negotiated between the two levels of government during 1947-1962.

B. 1962-1967: Opting Out

In the early post-war period, the provinces' concern was to recover a share of the PIT field in order to finance their rapidly growing expenditures in education, health care, and social services. While the federal government was anxious to retain enough of the PIT field to allow it to use income taxation to ensure national standards in public services and to finance the growing equalization and conditional grants programs, federal PIT abatements in the early 1960s recognized the provinces' need for tax room.

Another important change during the 1960s was the introduction of "opting out." Provinces that wished to do so could receive additional PIT "tax room" from the federal government – that is, the federal PIT in those provinces would be reduced – in lieu of transfers, provided they agreed to maintain the same programs as those financed by transfers. Only Quebec proceeded to "opt out" of programs for hospital insurance, welfare and health programs. Consequently, as Figure B-1 shows, the federal share of PIT in that province is lower than in the rest of Canada.

C. 1972: Tax Reform

As part of the 1972 tax reform, the abatement system was abandoned and the federal government lowered its tax rates to make room for higher provincial taxes. All provinces were now free to set their own tax rates with no implicit norm (the abatement level) set by the federal government. However, provinces still had to calculate taxes as a percentage of the

federal tax – thus using not only the same base but also the same progressive rate schedule – if the federal government was to continue to collect provincial PIT on the provinces' behalf.

In 1974, Quebec's Youth Allowance Program was discontinued. The introduction of this program in 1965 had allowed Quebec to receive an additional abatement of 3 PIT points from the federal government; with its termination, the opting-out provision and related abatement no longer applied. However, to avoid disrupting Quebec's income tax structure, the federal government agreed to continue the abatement; in return, a corresponding amount was (and still is) deducted from federal cash payments to the province.

D. 1977: Established Programs Financing and the Tax Point Transfer

Established Programs Financing (EPF) replaced the previous conditional grants for health care and post-secondary education in 1977. As part of the realignment of provincial and federal fiscal responsibilities associated with this change, the federal government once again withdrew to some extent from the PIT field in order to provide more tax room for the provinces. This transfer of tax points continues under the current Canada Health and Social Transfer (CHST). The calculation of cash and tax point transfers under EPF, and now under the CHST, has been a contentious issue for some time between the provinces and the federal government. In the federal government's view, its support for the EPF and CHST programs consisted of both the tax point transfers and cash payments. Once transferred, however, the tax points were no longer under the control of the federal government, and the provinces quickly ceased to regard them as a form of federal support.

E. 2000: Tax on Income

When Canada Customs and Revenue Agency (CCRA) replaced Revenue Canada in 1999, the federal government agreed to collect provincial PIT with provincially determined rates as long as the provinces used federal taxable income as a base. The previous "tax-on-tax" approach was thus replaced by a "tax-on-income" approach, allowing provinces to determine the progressivity of their own PIT rather than accepting that set by the federal tax schedule. Alberta took advantage of this opportunity by immediately introducing a 10% flat tax.

F. The Result: Fiscal Asymmetry

There is considerable unevenness in the PIT field in Canada (see Figure B-1 and Table B-1). Stemming from the opting-out arrangements of 1965, Canadians living in Quebec pay lower federal PIT than Canadians living in other provinces. (Table B-1 shows that federal rates in Quebec are 16.5% less than in the rest of Canada.) As of 2000, the federal government occupied 48% of the PIT field in Quebec while its share was roughly 65% in the rest of Canada.

TABLE B-1

Federal PIT in Quebec and in the Rest of Canada, 2002

		Federal Brackets			
		$0 to $31,677	**$31,677 to $63,354**	**$63,354 to $103,000**	**More Than $103,000**
Other than Quebec	Marginal Rate	16%	22%	26%	29%
	Federal tax on income below bracket (before credits)	$0	$5,068	$12,037	$22,345
Quebec	Marginal Rate (before credits)	13.36%	18.37%	21.71%	24.22%
	Federal tax on income below bracket (before credits)	$0	$4,232	$10,051	$18,658

Source: PricewaterhouseCoopers, *Tax Facts and Figures for Individuals and Corporations – Canada 2002*, p. 4.