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Fiscal Imbalances and the Financing of National Programs

There is a major difference of opinion between the federal government and the provinces and territories on the state of government finances in Canada. The premiers are concerned about a growing fiscal imbalance between the two orders of government, commonly known as vertical fiscal imbalance (VFI). They see growing federal surpluses, which provide the federal government with ample policy flexibility, while most of them must perform juggling acts just to keep their budgets in balance. The federal government's view – as expressed, for example, by the Minister of Intergovernmental Affairs – is that Canada is a fiscally balanced federation because, according to that view, both federal and provincial/territorial governments have sufficient revenues to meet their spending responsibilities over the long term. This difference of opinion may arise from two sources: (a) facts about fiscal balances, and (b) interpretation of those facts.

The Facts

Two recent studies have looked at vertical fiscal imbalances [Matier, Wu and Jackson 2001; Ruggeri and Howard 2001]. Despite some methodological differences in the estimation of projected trends in government revenues and expenditures, these two studies are in complete agreement on the federal fiscal position. Both studies come to the conclusion that in the absence of discretionary policy measures, the federal fiscal structure will generate surpluses that will increase in magnitude over time. For the fiscal position of provincial/territorial governments, the two studies derive similar results in scenarios that incorporate similar assumptions. For example, if cost pressures in health care spending are moderate and CHST cash payments increase in line with the growth of nominal GDP, the provinces and territories as a group would experience potential surpluses in the future, but much smaller than federal surpluses.

The Senate Standing Committee on Social Affairs, Science and Technology has identified a number of factors that are likely to accelerate the growth of health care spending, such as population aging, drug costs, new technology, health research and growing public expectations. If these cost pressures lead to higher levels and growth of health care spend-

ing, provincial and territorial governments will experience budget deficits in the absence of higher federal contributions that rise at a faster rate than under current arrangements.

The Interpretations

Given the general agreements on 'the facts,' and in the absence of new discretionary policies, the federal government can expect large and increasing surpluses while the provinces and territories may have small surpluses or deficits depending on cost pressures in health care – the different views represent different interpretations of these facts. One interpretation, which represents the federal view, is that there are no fiscal imbalances as long as the provinces and territories have sufficient funds to finance their expenditures, regardless of the size of the federal surplus. An alternative interpretation, which represents the provincial/territorial view, is that there are fiscal imbalances because the provinces and territories have the spending pressures while the federal government has the excess revenue.

The debate about fiscal imbalances is not about numbers, but about the very nature of the Canadian federation. The solutions to this debate will determine the future of Canada as a federal state.

The federal interpretation of fiscal imbalances is consistent with a federation composed of fiscally independent jurisdictions, in the sense that each jurisdiction finances its spending entirely through own-source revenues. In the federal view, the provinces and territories have sufficient revenue-raising capacity to finance their spending responsibilities. If spending pressures increase, they can raise revenues from their diversified revenue structure.

This federal position has evolved over 25 years of fiscal retrenchment which started with the Established Programs Financing arrangements of 1977. The cash component of this arrangement provided the federal government with the necessary flexibility to reduce its contributions to the financing of health care and postsecondary education. That flexibility was exercised in the 1980s through unilateral changes in the formula that determined federal cash payments. This approach was refined during the fiscal restraint period of the 1990s into what may be called 'leveraged control.' The federal government consolidated the original three large cost-shared programs – the Canada Assistance Plan (CAP), health care and postsecondary education – into a single block grant (the Canada Health and Social Transfer or CHST) and reduced its total contribution, thus trying to obtain policy leverage at reduced financial cost. The additional funds provided under the arrangement of September 2000 simply restored some of the cuts that had been implemented in previous years.

The position of the provinces and territories is that *the federal government has the financial capacity within its existing fiscal structure* to fulfill its historical commitment to a substantial share of the cost of social programs. It should honour that commitment or transfer an appropriate amount of tax room to the provinces and territories. The policy of leveraged control is unsustainable: It disrupts provincial/territorial decisions while leaving provinces and territories with an overwhelming fiscal burden.

In my view, the provincial/territorial position is well rooted within the historical developments of fiscal federalism during the last half century. During the Second World War, the provinces and territories surrendered the

income tax field to the federal government in exchange for certain payments and guarantees. Over time, these arrangements were modified to accommodate increasing provincial/territorial autonomy and expanding provincial/territorial responsibilities in the social policy area.

One could argue that the federal primacy over income taxes, particularly personal income taxes, was conditional on the federal government's contribution to social programs in the form of intergovernmental transfers. This conditionality was evident in the opting-out option offered by the federal government in 1964. At that time, the federal government offered to transfer 20 personal income tax points if the provinces and territories took full responsibility for hospital insurance, old age assistance and blind and disabled persons allowances, unemployment assistance to unemployables (i.e., welfare) and vocational training, and if they would forgo health grants. With this opting-out offer, Ottawa seems to have acknowledged that at least the number of income tax points to be transferred were not viewed as permanent federal tax room, but as provincial/territorial tax room used by the federal government for the purpose of financing the federal share of social programs.

This view of the conditionality of a portion of the personal income tax room used by the federal government was reinforced in 1977 with the Established Programs Financing (EPF) arrangement. The number of personal income tax points actually transferred under this arrangement was less than under the 1964 offer for two reasons: (a) the EPF arrangement covered a small number of programs, and (b) the federal government remained a partner through a cash contribution equal to the value of the tax point transfer. In effect, the federal government transferred half of the income tax points that would have been necessary under full provincial/territorial responsibility for health care and postsecondary education because the other half was needed by Ottawa for the purpose of financing its cash contribution.

Federal unilateral reductions with respect to its cash contributions during the 1980s and 1990s, which in effect shifted to the provinces and territories a portion of the federal responsibility for the financing of social programs, were not accompanied by a corresponding shift of income tax room. One could argue, therefore, that the amount of tax points equivalent to the difference between the current cash payments and the cash payments that would have been forthcoming under the original agreement should not legitimately be treated as federal revenue. They are more in the nature of joint federal/provincial/territorial tax room, originally reserved for the financing of shared-cost programs and assigned to the federal government in support of its cash contribution. In this historical contest, federal surpluses cannot be treated as independent of provincial/territorial spending commitments to the financing of national programs – namely health care, education and social services. The provinces and territories have a legitimate claim to a share of the federal surpluses because those surpluses are generated partly by federal tax room that represented a form of revenue-sharing with the provinces and territories for the financing of national programs.

The Transfer of Tax Points

Greater balance in the relative contribution of federal and provincial/territorial governments to the financing of national programs could be restored by increasing the level and future growth rate of federal contributions. The experience of the past 25 years, however, has shown that the federal government is not a reliable partner when it can take unilateral actions. Therefore, some provinces and territories are showing a preference for the transfer of tax points. Recently, the Séguin Commission in

Quebec evaluated two tax options for the transfer of tax points: personal income tax points or the transfer of the Goods and Services Tax (GST) to the provinces and territories.

The GST transfer is not a long-term solution. Because its revenue is expected to grow at a lower rate than spending on national programs, particularly health care, it will result in a declining share of provincial/territorial spending on those programs over time. These revenue shortfalls must be offset by increases in other provincial/territorial revenues, reduction in other provincial/territorial expenditures or new federal cash payments. These cash transfers would have to grow at a faster rate than provincial/territorial spending on social programs in order to relieve the fiscal pressures generated by the relatively low growth of GST revenues.

The transfer of personal income tax points may eliminate the revenue shortfall issue as revenues from this source are likely to grow in line with provincial/territorial spending on national programs. This option, however, also has some drawbacks. If the points transferred are not equalized, the richer provinces and territories will gain more than the other provinces and territories over the long run because they receive a higher per capita revenue from each personal income tax point. If the tax points are equalized, the federal government will face a substantial increase in equalization payments. These drawbacks can be eliminated by an option that contains a *notional transfer of personal income tax points.*

The Notional Transfer of Personal Income Tax Points

Under this proposal, the revenue from a selected number of personal income tax points still would be collected by the federal government, but would not remain under federal control. Instead, it would be dedicated to intergovernmental transfers for the purpose of financing national programs. The proposal contains the following elements. First, the current level of CHST cash payments would be increased by an amount necessary to restore balance between federal and provincial/territorial contributions to the financing of national programs. Suggestions by Mike Harris, ex-Premier of Ontario, the Senate Standing Committee on Social Affairs, Science and Technology, and the Séguin Commission indicate that the re-balancing amount would be in the range of $5-$10 billion per year. Second, this new level of CHST cash payments would be transformed into equivalent federal personal income tax points under the current income tax structure. Third, the revenue from these tax points in each year would be placed in a *national programs fund* jointly administered by the federal and provincial/territorial governments. Fourth, the revenue deposited in this fund would be distributed annually among provinces and territories on an equal per capita basis.

For this proposal to be effective, the following three conditions must be met:

1. The provinces and territories must reach an agreement on common standards regarding the main elements of the health care delivery system within the framework of the Canada Health Act. The federal government could play an important role in facilitating this agreement.

2. The joint commission administering the national programs fund must have the power to impose penalties on provinces and territories that contravene the provincial/territorial agreement on standards.

3. The legislation that allows the notional transfer of tax points must be structured in a

manner that prevents unilateral federal action with respect to the number of tax points notionally transferred and the formula that determines the cash value of those points over time.

The two point transfer options – GST or notional PIT points – need not be viewed as mutually exclusive options. Within a framework of asymmetric federalism, Quebec could have the choice between the two options under two conditions: (a) both options incorporate the principle of portability for health care services, and (b) no additional federal transfers would be required over time to adjust for the different revenue growth potentials of the two options. I believe that this choice would be a meaningful one because it involves a trade-off between provincial/territorial autonomy and revenue transfer. The notional transfer of PIT points would offer less provincial/territorial policy flexibility compared to the GST transfer, but would provide greater revenue growth at given tax rates. The GST transfer would confine the limitations on provincial/territorial policy flexibility to portability, but would provide a slower growing revenue source.

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