Reconciling THE Irreconcilable

Addressing Canada's Fiscal Imbalance

THE COUNCIL OF THE FEDERATION · LE CONSEIL DE LA FÉDÉRATION

Advisory Panel on Fiscal Imbalance **Comité consultatif sur le déséquilibre fiscal**

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March 31, 2006

Honourable Ralph Klein
Chair, Council of the Federation and Premier of Alberta
307 Legislature Building
10800-97 Avenue
Edmonton AB T5K 2B7

Dear Premier Klein:

We are pleased to submit, *Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance*, the Report from the Advisory Panel on Fiscal Imbalance. The Report contains twelve recommendations for the consideration of the Council of the Federation. The panelists are unanimous in their support of these recommendations.

The title of our report, *Reconciling the Irreconcilable*, focuses attention on the multidimensional character of fiscal imbalance and the challenges associated with securing a consensus among the members of the Council themselves and between the Council and the Government of Canada. The subject of fiscal relations among the federal, provincial, and territorial governments is as old as Confederation itself. The recommendations reflect the fiscal circumstances that exist in Canada and the provinces at this time and their future prospects. In addition, the Report includes recommendations with respect to the structures and processes the Panel believes necessary so that intergovernmental discussion and collaboration on fiscal federalism is ongoing and not episodic.

While the recommendations need to be reviewed individually, they also need to be considered collectively as vertical fiscal imbalance, horizontal fiscal imbalance, and governance are inextricably interrelated.

The Panel strongly believes that a window of opportunity exists for the federal, provincial, and territorial governments to reach agreement on these matters which are of great importance to all Canadians. We consider it a privilege to have been asked to undertake this work and hope that the Report is of assistance to the Council, both in clarifying the challenges and in proposing pathways to reform.

Respectfully submitted,

Robert Gagné
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Introduction

On May 27, 2005, the Council of the Federation established an independent Advisory Panel on Fiscal Imbalance with a mandate to examine the vertical and horizontal fiscal balances among Canada's federal, provincial, and territorial governments and to make recommendations as to how any fiscal imbalances should be addressed. The Panel was instructed to examine the current health and social transfer system, the Equalization program, Territorial Formula Financing, and other major federal transfers to provinces and territories and to review a full range of mechanisms aimed at redressing fiscal imbalances between governments. The Panel's full mandate can be found in Appendix 1.

This Report, presented to premiers, sets out specific recommendations to address Canada's fiscal imbalance and to provide for more effective governance of fiscal federalism. It offers new analysis and assessment of the issues following the Panel's extensive consultations with all provincial and territorial governments, the federal government, and several of Canada's academic and public policy experts. It also incorporates the thoughts of Canadians who considered these issues during a series of regional and national dialogues.

The Panel's report deals specifically with the issue of fiscal imbalance between the federal and provincial/territorial governments and across provincial and territorial governments. It considers (a) how well fiscal arrangements are working and (b) whether those arrangements are effectively structured and funded to meet the national and regional economic and social challenges facing Canadians.

At stake are not simply accounting questions such as "How much money should be transferred?" and "Who should get it?" These questions led us to ask whether Canadians everywhere in this country are able to receive the public services they need; whether our country is making the necessary investments in human capital and infrastructure to meet and master global competitive challenges; and whether economic and social disparities between regions of the country are being reduced.

The critical questions at the outset were these: "Does a vertical fiscal imbalance exist?" "If it does exist, how is it best understood?" The debate over its existence has been central to federal/provincial/territorial relations for the past decade.

During our work, we heard two conflicting views. The provinces and territories believe firmly that a vertical fiscal imbalance exists, whereas the federal government – at least until the election of a new government on January 23, 2006 – has been adamant that it does not. Reconciling the two views once and for all through a single report is a practical impossibility. With this in mind, the Panel considered the merits of each perspective, recognizing that fiscal imbalance has political as well as financial dimensions. It also commissioned independent financial forecasts for the purpose of making recommendations on both finance and governance.

The horizontal fiscal imbalance is also a serious issue for the federation. The principle of equalization is constitutionally entrenched, requiring the Parliament of Canada and the federal government to make equalization payments to provincial governments so that they may provide "reasonably comparable levels of public services at reasonably comparable levels of taxation." These payments are the principal instrument for addressing horizontal fiscal imbalances in Canada. Nevertheless, as with vertical fiscal imbalance, views differ regarding how these constitutional objectives and obligations are to be fulfilled. There is widespread support for equalization and for its continuance in the form of unconditional grants; however, the traditional political consensus supporting the Equalization program appears to have diminished in some parts of the country.

Given the eroding support for the Equalization program, the Panel believes that equalization needs to be returned to first principles. Its inclusion in the *Constitution Act, 1982* speaks powerfully to a core Canadian value of sharing. The Panel believes strongly in a formula that is more effective and transparent. A formula must be fair to all provinces, not just recipient provinces.

Constructing a Positive Fiscal Federalism Dynamic

A unique feature of Canadian fiscal federalism has been its flexibility – that is, its ability to adapt and evolve to changing circumstances and needs. But flexibility cannot be a one-way street. The obvious success of Canada as a federation, from the original Confederation bargain to the establishment today of both orders of government as equal partners, neither subordinate to the other and each sovereign within its own areas of jurisdiction, has not been achieved in a vacuum. It was not an accident but

neither was it preordained. It is the product of active and continuous cooperation and collaboration. Over time, mechanisms and processes evolved to facilitate these developments. It is not apparent to the Panel that this remains the case today.

There are no clear "rules of the road" to facilitate the functioning of fiscal federalism at a time when the federal government has both the resources and the inclination to spend on matters that are constitutionally the responsibility of provinces. The federation's ability to evolve and adapt to changing circumstances and needs has served it well in the past. This can be the case again. But at present the federal government does not appear to be working with the provincial and territorial governments collectively in their own areas of jurisdiction to develop effective new mechanisms and solutions to meet these changed circumstances.

Beyond just sharing money, the federal government must fundamentally "share the risk" with provinces and territories by ensuring that its participation is more long-term, stable, and consistent. This is a far stronger and more durable notion of partnership in a federation like Canada's, and one that we believe will find much favour among Canadians. As part of this, the provinces and territories should acknowledge more directly and formally the role of the federal government in advancing a stronger economic and social union in Canada. The federal government should be given visibility and credit where appropriate.

The Panel's report comes at a time of new opportunity for reconsidering the issue of fiscal imbalance. The Panel is hopeful that the recent federal election, together with the pending release of a related report by the federally appointed Expert Panel on Equalization and Territorial Formula Financing, will allow for greater dialogue between the two orders of government to consider anew how fiscal arrangements in our country can best serve Canadians and their needs.

Fiscal imbalance is not an accounting discussion. It shapes the types and quality of services Canadians receive and the amount of tax they pay. It speaks to how Canadians see their country and to their collective notion of citizenship.

Our Report

This introduction summarizes the main themes addressed in our Report. *Chapter 1* begins our diagnosis of the core issues and challenges that have emerged within Canadian fiscal arrangements. *Chapter 2* takes a more detailed look at the recent history of federal/provincial/territorial fiscal relations and how we got to where we are. *Chapter 3* sets out what we heard during our consultations with governments, with some of Canada's leading experts on fiscal federalism, and with representative groups of Canadians. *Chapter 4* begins the main recommendations section of our Report by focusing first on the special case of the Northern Territories. The Panel is determined that the issues and challenges facing this important and often neglected part of Canada be seen as central to our Report. We have set out the territories' story separately in the hope that it will catch the attention of all governments and citizens. *Chapters 5* and *6* set out the recommendations dealing with vertical fiscal imbalance and horizontal

fiscal imbalance respectively. *Chapter 7* is about the governance of fiscal federalism and includes our recommendations about its mechanisms and processes. *Chapter 8* concludes the Report with a summary of recommendations. The appendices provide additional background that support the recommendations.

We thank the Council of the Federation for the opportunity to do this work. We were privileged to meet elected leaders and public officials in every province and every territory across the country. We are grateful to officials from the federal Department of Finance for sharing their views with us. We also thank those citizens who gave freely of their time to participate in dialogues across this country, as well as those experts who came together in a round table and enriched our thinking.

We are especially grateful to the Government of the Northwest Territories, and to Rose McConville, who provided space for us to meet and who worked so hard to accommodate our every need, reasonable or not. We thank David McLaughlin, who served as Executive Director throughout most of our work and who was tireless in his efforts to inform our discussions. Luc Bussière, our Director of Research, was unflagging in his efforts to provide us with the best empirical analysis. Janice Currie looked after us, our travels, our round tables, meetings, and citizens' dialogues, and our logistical needs with unwavering good cheer. We are especially grateful to David Cameron, Andrew Gamble, Harvey Lazar, and François Vaillancourt for their advice and assistance in preparing this Report. They challenged us to think harder and dig deeper. A special word of thanks to David Cameron for his wisdom, his literacy, and his dedication in the final stages of this project. The Panel takes full responsibility for the analysis and recommendations.

Chapter One

Canadian Fiscal Federalism at Risk

Money is the life's blood of governments. If the flow of financial resources among Canada's governments is constrained or distorted, or if the channels that feed resources to parts of the system become blocked, the health of the country is compromised. Canada's system of fiscal federalism has fallen into disrepair. Left unreformed, it will be a growing irritant among federal, provincial, and territorial governments. The friction produced will in time begin to shape the attitudes of Canadians and heighten the tensions among Canada's regions and communities. Perhaps it has done so already. Left unattended, the deficiencies we identify below will compromise the contributions that Canadians and their governments might otherwise make to our collective well-being; they will stunt our national economic capacity and our international competitiveness.

What Are the Problems?

- ***Vertical fiscal imbalance.*** For almost a decade the federal government has been running budgetary surpluses and has been spending significantly in areas that the Constitution of Canada assigned to the provinces. The federal government has more money than it requires to discharge the functions for which it is responsible. The governments of the provinces have insufficient resources to accomplish the tasks for which they are constitutionally responsible. This is known as vertical fiscal imbalance (VFI).

- ***Horizontal fiscal imbalance.*** There is great disparity in the ability of individual provinces and territories to deliver comparable levels of services at reasonably comparable rates of taxation. The need for social services is much the same, wherever in the country one lives; but the

capacity to raise revenues varies substantially among provinces. This is known as horizontal fiscal imbalance (HFI).

Canada's Equalization program addresses this issue. The federal government redistributes funds to provincial governments that have relatively weaker fiscal capacity. In 2004, however, the federal government abandoned a long-standing formula-based approach to allocation and introduced a fixed pool of funds for distribution. This new approach no longer responds to the relative fiscal capacities of recipient provinces.

- ***The territories.*** The current financial arrangements that shape the life of Canada's three northern territories inhibit their capacity to serve their communities as they should and to contribute fully to the country as a whole. The new Territorial Formula Financing (TFF) transfer introduced in 2004, at the same time as changes to the Equalization program, no longer reflects its original principle, which took into account the difference between the expenditure needs and the revenues of territorial governments. As with the Equalization program, the federal government replaced the formula-based approach with a fixed pool of funds. In addition, despite their emergence as organized political communities, the three territories, unlike the provinces, do not have full access to their natural resource revenues.

- ***How we manage the system.*** The Government of Canada's practice of making unilateral decisions that have a powerful impact on provincial governments corrodes the relationships of trust and the networks of collaboration and mutual respect that are so vital to the healthy functioning of the federation. Not only that, but a system of intergovernmental transfers that rests on the will of only one partner (the federal government) undermines the responsible and positive role that the others in the relationship might play. The unfettered and unduly privileged position of the Government of Canada in intergovernmental fiscal relations undermines the system's stability and predictability, the capacity to fashion appropriate rules of conduct, and a willingness to live by those rules.

Each of these is a problem in its own right; furthermore, all are tangled together in ways that make our fiscal circumstances still more complicated and problematic. Thus, while we will of necessity discuss these problems separately, we are mindful that they are all linked; that addressing one will have effects on the others; and that attention needs to be paid to them all as a whole, as well as to each individually. We frame our recommendations and proposals with this in mind.

Vertical Fiscal Imbalance and Federal Transfers

The Advisory Panel has no doubt that a vertical fiscal imbalance has existed for almost a decade.

The new Government of Canada appears to share the Panel's view. Stephen Harper, as leader of the Conservative Party, acknowledged the existence of the fiscal imbalance in a letter dated January 12, 2006, to Premier Ralph Klein of Alberta, Chair of the Council of the Federation. He wrote:

> *Immediately upon being elected, my government will begin consultations with the provinces and municipal representatives with the intention to reach a long-term, comprehensive agreement, addressing both the vertical and horizontal fiscal imbalance. This will be a major priority of our government and has to be resolved so that other levels of government can operate without the accumulation of debt. The fiscal imbalance problem has allowed federal mismanagement of taxpayers' money totalling billions of dollars.*
>
> *The Conservative Party of Canada has long recognized the existence of a fiscal imbalance between the federal and provincial governments. The present government denies the existence of the fiscal imbalance, despite the fact the provinces are struggling to deliver essential services such as health and education while the federal government accumulates record surpluses through over-taxation. The current imbalances are not fair and not right, and are incompatible with the healthy evolution of our federation.*[1]

The previous government denied the existence of a fiscal imbalance (See Appendix 2). In a letter to this Panel dated November 28, 2005, and signed by the then Ministers of Finance and of Intergovernmental Affairs, the Government of Canada noted that its position concerning "the so-called fiscal imbalance" was well known:

> *The Government does not believe in the existence of a fiscal imbalance between the federal and provincial governments in Canada. Both orders of government have access to all the major sources of tax revenues and have complete autonomy in setting their tax policies to address spending pressures related to their respective responsibilities.*

If provinces did not have enough money to discharge their responsibilities, this letter implied, then all they had to do was raise taxes.

The issue of fiscal imbalance is not about abstract access to taxation fields; rather, it is about the availability of adequate resources to allow both the federal government and the provincial and territorial governments to discharge their constitutional responsibilities. The debate has persuaded us that questions as to whether the fiscal imbalance exists are as much about judgment and balance as about numbers. Our view is that there *is* a fiscal imbalance in our federation.

1 The full text of this letter can be found on the website of the Council of the Federation, www.councilofthefederation.ca .

Vertical Fiscal Gap and Vertical Fiscal Imbalance

Vertical Fiscal Gap (VFG)

The Constitution assigns revenue sources and expenditure responsibilities to the two orders of government. Both orders of government in Canada have broad access to the major forms of taxation; however, their expenditure responsibilities are quite different.

Many economists believe that there are political and economic advantages in having expenditure responsibilities relatively decentralized and revenue-generating responsibilities relatively centralized. In a federation this creates a fiscal gap between the two orders of government (VFG). Ideally, according to this view, the federal government would raise more money than it needs, and the provincial governments less, and the former would transfer funds to the latter to make up the difference. Establishing the ideal arrangement with any precision, however, is not, practically speaking, possible, because the optimal levels of relative decentralization cannot be determined with any precision and because there is in any case inevitable disagreement about what they might be.

Vertical Fiscal Imbalance (VFI)

A vertical fiscal imbalance (VFI) exists when one order of government has more fiscal resources than it requires relative to its expenditure responsibilities while the second order of government has too few fiscal resources relative to its spending responsibilities even after federal–provincial fiscal transfers are taken into account. An imbalance can run both ways.

VFG and VFI

If the federal government's cash transfers to the provinces are smaller than the VFG, then there is a VFI. The VFI can be reduced through an increase in cash transfers to the provinces and/or through a reduction in the VFG, through further revenue decentralization with tax transfers or through a realignment of spending responsibilities.

Fiscal imbalance is not a permanent feature of the Canadian federation. Like federalism itself, it changes as Canada's society and economy evolve, with war and recession, with technological change, and with the expectations of citizens. Sometimes the imbalance tilts in favour of the provinces; today, it has clearly tilted towards the Government of Canada. The story is never fixed and finished and therefore requires periodic attention and adjustment. That is the reality in which Canada's federal system finds itself today. There is a fiscal imbalance, but this time it is the provinces that have inadequate resources to do the job that the Constitution and citizens expect of them.

The Panel does not accept the argument that vertical fiscal imbalance cannot exist, because both orders of government have access to all important sources of revenue. This argument ignores the consequences of vertical imbalance for horizontal fiscal imbalance, ignores the continental and global setting, and ignores the substantive issues that make fiscal imbalance important to Canadians.

- ***Implications for horizontal fiscal imbalance.*** Even if the provinces, or some of them, did increase tax rates, the yield would differ greatly among them: from a single point of the personal income tax, the highest-income provinces obtain about twice as many dollars as the lowest-income provinces. The capacity of provinces to raise revenue varies greatly – an indicator of horizontal fiscal imbalance. Some provinces have clearly reached the limits of their taxing capacity, even if one disregards the political costs of tax increases. Increasing tax rates may simply drive people into the underground economy, where they pay no taxes at all. Higher taxes may also depress investment or induce investors to go elsewhere. These considerations apply even more strongly to the territories, where fiscal capacity relative to need is far smaller than that of the provinces.

- ***The continental and global setting.*** The distorting effect of tax increases takes on added importance in the contexts of continental trade and investment and of globalization. Differences in tax rates have a powerful effect on the location of investment, both among provinces and between Canada and other countries. North American free trade has intensified tax competition both within Canada and internationally. North–south trade and investment flows keep provincial leaders focused as well on neighbouring states to the south. This places economic limits on taxable capacity.

- ***Financial management of provinces and territories.*** Fiscal imbalance is important to Canadians for at least two reasons: its effects on economic behaviour and future growth and prosperity, and its effects on the quality and accessibility of public services. The argument that provinces that run deficits have only to cut services or raise taxes ignores the negative impact on the country's economic health, on the adequacy and accessibility of public services, and on national cohesion.

For close to a decade the federal government has been consistently running budgetary surpluses and has been using these to increase its spending in areas of provincial responsibility under the constitutional division of legislative powers. In doing so the Government of Canada has in effect acknowledged that it has more fiscal resources than it requires for its own spending programs and that that money is needed by the provinces and territories. In addition, in recent years the Government of Canada has been increasing its spending on its own programs and activities at a rate that far exceeds the rate of inflation and the growth of GDP.

For all these reasons we believe that there is ample evidence to support the premiers' position that there is a vertical fiscal imbalance in the federation.

Horizontal Fiscal Imbalance and the Equalization Program

Next we consider horizontal fiscal imbalance (HFI) by examining the Equalization program and its territorial equivalent, Territorial Formula Financing (TFF). These two programs are the main instruments used in Canada to address HFI.

In almost every country, federal or not, there are regional differences in wealth, levels of economic activity, and distribution of natural resources. In Canada the pattern of relative wealth and poverty has shifted over time and from region to region. These changes, unpredicted and unpredictable, have created a horizontal fiscal imbalance and explain why Canadians believe in offering one another mutual support and assistance.

This horizontal fiscal imbalance is a troubling but inevitable reality. Canada's Equalization program was put in place to address the fact that the provinces differ in their capacity to provide comparable public services. The principle of the program, which has existed in one form or another for almost fifty years, is neatly summed up in Section 36(2) of the *Constitution Act, 1982*:

Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

Horizontal Fiscal Imbalance and Equalization

Horizontal Fiscal Imbalance

Horizontal fiscal imbalance (HFI) is the difference in the ability of individual provinces and territories to raise revenues. The provinces and territories differ in their capacity to deliver reasonably comparable services at reasonably comparable levels of taxation.

Equalization

The federal government established an Equalization program in 1957. It finances this program fully from its general revenues. In 1982, Parliament and the Government of Canada committed themselves in the Constitution to making equalization payments to the provinces. These payments are unconditional.

Territorial Financing Formula

Although the provisions in the Constitution for equalization make no reference to the territories, the TFF is a parallel program, also financed from general revenues.

This constitutional principle is grounded in widespread public support for the notion that the benefits of Canadian citizenship should be comparable across the country no matter which province a person lives in.

The system is administered and controlled entirely by the federal government, which raises money for equalization through general taxation and redistributes the funds to provincial governments. The ultimate decisions about levels of transfers and the allocation among provinces lie with the federal government. The aggregate transfer in 2005-06 was $10.9 billion; the territorial equivalent, the TFF, was almost $2 billion.

The Equalization program has recently come under attack. Why has this happened?

- The federal government's 2004 New Framework for Equalization is a marked departure from the basic principles that have shaped the Equalization program in Canada.
- Rising oil and natural gas revenues are placing a few provinces in a much more fiscally advantageous position relative to the others.
- The 2005 offshore accords with Newfoundland and Labrador and with Nova Scotia have drawn attention to the linkage between support for economic development under Section 36(1) of the *Constitution Act, 1982* and the Equalization program.

The New Framework for Equalization

Until 2005–06 the Equalization program was driven by a formula. This formula established the amount of money to be allocated and how it would be distributed among recipient provinces. Since 1957, when the Equalization program began, the formula has been changed many times. All of these changes were consistent, however, with the overarching principle of the Equalization program – to equalize the relative fiscal capacity of the provinces so that provincial governments could provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

In October 2004, however, the Government of Canada announced that the existing formula would be replaced; a base of $10.9 billion would be established and the total amount would be increased by an escalator of 3.5 percent until 2013–14. A $10 billion floor was established to protect provinces against any overall decline in payments; individual provinces were guaranteed that their payments would not fall below the levels established in the 2004 budget. A federal panel on equalization was established to advise on the distribution of funds to individual provinces within this fixed envelope.

This new approach abandoned one of the key attributes of the Equalization program. The fundamental principle that equalization payments to a province were to be determined by its fiscal capacity relative to other provinces disappeared. What had been a potentially or actually expanding pool of funds, based on calculations of fiscal capacity, was now a fixed pool. The result was a zero-sum game in which an increase in the amount one province received automatically came at a cost to others.

The Impact of Rising Oil and Natural Gas Revenues

Canada's substantial oil and natural gas resources are concentrated primarily in one part of the country. The volatility of oil and natural gas prices is having a significant impact on the relative fiscal capacity of provinces and on the Equalization program.

Since the oil embargo of 1973, in response to fluctuations in the prices of oil and natural gas, the federal government has periodically adjusted the equalization formula. These changes were also designed to limit the financial exposure of the federal government.

The Newfoundland and Labrador and Nova Scotia Accords

As a consequence of assurances offered by former Prime Minister Paul Martin during the 2004 federal election, the Government of Canada entered into negotiations with Newfoundland and Labrador and with Nova Scotia about the distribution of benefits derived from the exploitation of offshore natural resources. Newfoundland and Labrador and Nova Scotia signed agreements with the federal government almost twenty years ago. According to the terms of the 1985 Canada-Newfoundland Atlantic Accord and the 1986 Canada-Nova Scotia Offshore Petroleum Resources Accord (the Atlantic Accords), the federal government was to control the offshore resources but

the two provinces were to be the principal beneficiaries of the revenues derived from their exploitation until they had substantially improved their economic position. This meant that their resource revenues would be partially excluded from the calculation of their equalization entitlements.

More recently these two provinces pressed the federal government for a new arrangement that would allow them, during an extended transition period, to retain 100 percent of the offshore revenues without any reduction in their equalization payments. Agreements were reached with Nova Scotia on January 28, 2005, and with Newfoundland and Labrador on February 14, 2005. These agreements met those demands and in each case included substantial advance payments.

The two provinces take the position that these agreements are amendments to the Atlantic Accords. Given the slow pace of development of their offshore resources and the need to preserve the incentives of the arrangements, these agreements are meant to reflect the intent of the earlier commitments. Both provinces argue that the impact on the Equalization program is at best indirect. Moreover, they associate the agreements not with Section 36(2) of the *Constitution Act, 1982*, which refers directly to the principle of equalization payments, but with Section 36(1), which speaks of the commitment of Canadian governments and legislatures to "furthering economic development to reduce disparity in opportunities."

Others see it differently. They argue that as provincial revenues go up, equalization payments should go down; and they believe that even temporary exclusions undermine the program's rationale. The controversy has made the return to a rules-based system of redistribution all the more compelling if we are to maintain the political consensus that has sustained the concept of equalization for half a century.

The combined effect of these three factors has been to raise questions about the objectives that the Equalization program has served in Canadian fiscal arrangements for many years. The federal government's 2004 New Framework for Equalization, with its fixed pool of money and fixed escalator, has broken the link between the redistribution of equalization funds and the relative fiscal capacities of provincial governments. The dramatic run-up in the price of oil and natural gas has had a major impact on how we think about Canada's system of regional redistribution, not least the equalization formula. The bilateral arrangements with Nova Scotia and with Newfoundland and Labrador have drawn criticism because they seem to guarantee transfers regardless of enhanced fiscal capacity. All in all, it is fair to conclude that the Equalization program has drifted from its principles and must be tied back to the basic purposes for which it was developed.

The Territories

Canada's three northern territories present unique challenges of finance and governance that require the serious attention of the federation as a whole. Our future sovereignty, security, and economic development are bound up in the future of the territories.

Yukon, Nunavut, and the Northwest Territories represent 40 percent of Canada's land mass, yet with just over 100,000 people they account for only 0.3 percent of Canada's population. The territories have higher birth rates and correspondingly lower median ages than the provinces. In all three territories the Aboriginal population is significantly higher than in the rest of the country. Measures of health, education, housing, and crime indicate that social conditions in the territories are much more difficult than in the rest of Canada.

The evidence suggests that the territories will continue to require fiscal arrangements different from those of the provinces. At one time these differences were reflected in the TFF. Unlike the provinces, the territories do not own their non-renewable resources. There is no dispute that the territories should manage these resources; the critical question is how the fiscal benefits are to be shared.

How We Manage the System

Canadians consistently declare that they want the federal and provincial governments to get along, yet Canadian governments just as consistently quarrel with one another. Why is that?

It is only partly true that provincial and federal governments quarrel all the time. Canada's governments also display a considerable capacity to cooperate in the service of Canadians. Much of the time, in a wide range of activities and policy fields, collaboration and coordination are the order of the day. Indeed, the federation could not function if that were not the case. In Canada, as in other federal systems, the political forces of conflict and cooperation are mediated through the institutions and processes of the federation. One of the tests of these institutions and processes is their capacity to foster collaboration, to accommodate conflict, and to resolve those disputes which impede the effective functioning of the system.

The Panel believes that in the area of fiscal federalism, intergovernmental relations have too often been characterized by ongoing corrosive intergovernmental disagreements that undermine productive policy development and improved services for citizens. The Panel further believes that this unhappy characteristic of our federation arises not out of the bad will or inadequacies of our political leaders or senior civil servants, but rather out of an institutional weakness in our governing arrangements. Consider the federal spending power, the most powerful instrument of fiscal federalism.

The Spending Power of Parliament

The federal spending power is not provided for explicitly in the Constitution. It has been inferred as an authority of Parliament that derives from, among other things, its right to create a Consolidated Revenue Fund and its broad taxing powers. Court decisions suggest that the Government of Canada has the authority to spend money on any object whatsoever, including matters relating to the provincial powers listed in Sections 92 and 93 of the *Constitution Act, 1867*, provided the legislation authorizing the expenditure does not amount to a regulatory scheme falling within provincial powers.

The spending power has two components. The first is cash transfers from the federal government to the provinces in areas of provincial jurisdiction, with or without conditions. The second is cash transfers from the federal government directly to individuals or to institutions.

The federal spending power has been the subject of controversy in Canada's constitutional and political debates for decades. Some consider the federal spending power a positive expression of the federal government's responsibility to create national programs with national standards to build and strengthen Canada as a viable political entity and to redistribute resources within the country. Others insist that the federal spending power, while not illegitimate in principle, makes a mockery of the division of powers and of the basic logic of a federal system when the federal government uses it to invade provincial constitutional competence without provincial consultation or consent.

The federal government's return to a fiscal surplus in the late 1990s marked a material change in the country's fiscal dynamics and relationships. It has remained in surplus since that time, and there is every indication that it will remain so for years to come. It is in this context that it has been making extensive use of its spending power, both through transfers to the provinces and through direct cash transfers to individuals and institutions. Some transfer arrangements have been generally well received by the provinces; others – principally the direct transfers to individuals and institutions – have been less welcome, in part because they have often been at the expense of direct transfers to provincial governments.

It is indisputable that the exercise of the federal spending power has contributed historically to much that we value in our country. The postwar construction of the Canadian welfare state – the array of social programs that equalize opportunity and support those in need – depended heavily on the Government of Canada's ability to help finance the development of a range of social programs that fell within provincial jurisdiction. The national character of our Canadian health care system could not have developed without the use of the federal spending power, although we would not have had the health care system we have without the innovative leadership of Saskatchewan in the early postwar years. But it is equally indisputable that the federal spending power has been the source of nagging frustration and discontent and that it is at the heart of unproductive intergovernmental conflict.

Why is this so?

While intergovernmental fiscal transfers are one of the structural realities of Canada's federal system, their management lies ultimately in the hands of the federal government. The primary instrument that our country utilizes to shape the common business of the federation is the Government of Canada's autonomous capacity to spend or not to spend on provincial and territorial transfers, as it sees fit. So far, the federal government has largely been able to retain its freedom of action. The advantage of this freedom of action to the federal government became clear in the dramatic fiscal retrenchment of the 1995 federal budget, which demonstrated that it was

possible for the federal government to shift the spending power into reverse – that is, to abruptly and unilaterally reduce its transfers to the provinces and territories. The provinces were badly burned by this experience.

The issue, therefore, is not just financial resources, but governance.

These, then, are the four interrelated issues that we have identified as central to our mandate and critical for our Report: vertical fiscal imbalance; horizontal fiscal balance and equalization; the special challenges the territories face; and the way we manage our intergovernmental affairs.

What Must Be Done?

The Panel concludes that despite the comprehensive and beneficial nature of the current federal/provincial/territorial transfers and recent federal replenishments, these transfers are on the whole insufficient to address the vertical and horizontal fiscal imbalances that exist now and that are forecast to persist in the future. This is a question not just of more money, but also of how these transfers are to be structured. Specifically, the Panel believes that important changes to the Equalization and Territorial Formula Financing programs are required to make them more adequate, effective, and fair. We believe that the current per capita transfer programs, such as the Canada Health Transfer and the Canada Social Transfer, have certain structural inequities that must be corrected. Moreover, these transfers are collectively inadequate to meet the growing costs of our health care system associated with a significantly aging population, the needs of postsecondary education for young Canadians who must compete in the global economy, and the extensive infrastructure requirements at the provincial, territorial, and municipal levels.

More fundamentally, the Panel believes that our fiscal arrangements need to be renewed on a principled basis grounded in core Canadian values of sharing, fairness, and accountability, to make them more durable and effective. Furthermore, fiscal arrangements need to be supported by a new governance framework for fiscal federalism that places federal/provincial/territorial relations on a more respectful, cooperative, and predictable basis.

In *Chapter 2* we discuss how we got to where we are today.

Chapter Two

How We Got Here

A Historical Sketch of Fiscal Canada

Since Confederation in 1867, Canada's economy, society, and culture have been transformed through industrialization, secularization, war, technological change, urbanization, and globalization. These powerful modernizing forces have brought about remarkable change in our country. Our politics, governments, and public life have altered dramatically.

The Constitution reserved the most important matters of state and the most lucrative revenue sources for the federal government. The division of powers between the federal and provincial governments was conceived in the image of "watertight compartments," with each order of government enjoying exclusive power over discrete, unconnected jurisdictions. The federal government enjoyed unlimited taxing authority, while the provinces were restricted to direct taxes.

How things have changed. The watertight compartments are no more. The "merely local" matters of health and education, which in 1867 were left to the provinces, have grown into the largest and most costly government responsibilities. The most lucrative taxation field in 1867 – customs and excise taxes – which was assigned for that reason to the Government of Canada, has now dwindled into insignificance.

In 1867 the Fathers of Confederation sought to allocate legislative responsibilities clearly and distinctly to one jurisdiction or the other. This division may have worked when government was small and education and social services were delivered mainly by the family, the local community, and the church. Local services were no longer the dominant pattern by the mid-twentieth century, when the Canadian welfare state was being constructed. In the past fifty years or so it has been universally acknowledged that entanglement, overlap, and interdependence better describe Canada's reality. These seismic shifts are mirrored in the evolution of the country's fiscal relations.

The Fiscal Picture to the End of World War II

The *Constitution Act, 1867* gave the federal government the right to raise money "by any mode or system of taxation." In contrast, the provinces had access only to "direct taxation." They were excluded from indirect taxation, then by far the most important revenue source. Both orders of government possessed the authority to impose personal income tax, corporate income tax, and other direct taxes such as succession duties.

The Constitution included a series of guaranteed federal financial subsidies to the provinces. These grants were an important source of provincial revenue. Section 118 of the *Constitution Act, 1867* spoke of them as being "in full settlement of all future demands on Canada." Just twenty years later, at the very first interprovincial conference, the provinces pressed the federal government to increase these grants, which they considered inadequate. In 1907 a constitutional amendment was enacted that increased the grants. While the sums involved were modest compared to the intergovernmental transfers of today, this early example underscores that the challenges of fiscal federalism began right after Confederation and continue to this day.

The provinces were kept out of the field of indirect taxation. It was direct taxation, however, not customs and excise taxes, that turned out to have a future. In the years following Confederation the provinces started to develop their direct taxing authority. The federal government got into the direct taxation field during the First World War; in 1917 it established federal personal and corporate income taxes as a temporary wartime measure.

By the 1930s, federal, provincial, and municipal governments were imposing a bewildering array of taxes and tax rates. For the taxpayer these displayed little logic; in fact, they were referred to as a "tax jungle." In 1937 the Government of Canada established a Royal Commission, the Rowell-Sirois Commission, to examine fiscal federalism and to make recommendations. In their 1940 report the commissioners recommended that the federal government exclusively occupy the personal, corporate, and inheritance tax fields and in return should assume all provincial debt and provide what the commission called "national adjustment grants" to financially disadvantaged provinces. This report was rejected, owing largely to the opposition of British Columbia, Ontario, and Alberta, which would not have received grants.

Despite the rejection of the commission's recommendations, at a federal-provincial conference in 1941 the provinces temporarily relinquished their access to personal, corporate, and inheritance taxes in recognition of the Government of Canada's need

to occupy those tax fields to finance the war effort. In return, the provinces received grants from the federal government. This wartime experience moved the country into a system of federal-provincial fiscal interdependence – a system that has been central to Canadian federalism ever since.

The Postwar Evolution of Fiscal Canada

The decades following the end of the Second World War were marked by several features relevant to understanding today's system of fiscal federalism. First, it was during this period that the basic institutions of the welfare state were founded. Massive expenditures on health, postsecondary education, and social security supported the development of a wide range of new social programs demanded by Canadians. The development and financing of these programs was the dominant feature of federal-provincial relations during these decades.

Second, the period was marked by both collaboration and vigorous competition between the Government of Canada and the provincial governments. The federal government had emerged from the war in control of the lion's share of fiscal resources and was determined to play a central role in the provision of social services to Canadians, even though many of the relevant programs were under provincial jurisdiction. During these years the federal government established a wide range of shared-cost or conditional grant programs with provincial governments, typically on a fifty-fifty basis. Such programs included the *Hospital Insurance and Diagnostic Services Act*, the *Medical Care Act*, the Canada Assistance Plan, and the funding of postsecondary education. In 1957 it also established an equalization program, which is discussed separately below.

Although these shared-cost initiatives were important in furthering the development of Canada's social programs, there were problems associated with this exercise of the federal spending power. A frequent criticism was that these federal programs distorted the provinces' spending priorities. With such programs there is always a degree of uncertainty as to both their permanence and their level of funding. Programs start out as open-ended; then as costs go up the

The Federal Spending Power

Given the often creative but also highly controversial capacity of the federal government to spend its money on areas that lie within provincial competence, one might assume that the federal spending power must be mentioned in the Canadian Constitution. In fact, it is not. Nowhere in the *Constitution Act, 1867* can one find a power titled 'The Federal Spending Power.' Yet whatever its legitimacy, clearly it exists and is at the very centre of the country's intergovernmental fiscal arrangements.

The spending power is inferred from the existence of several stipulated federal powers in the Constitution: the power to levy taxes (Section 91[3]); the power to legislate in relation to "public property" (Section 91 [1A]); and the power to appropriate federal funds (Section 106).

Some constitutional lawyers and academics have contended that the use of the federal spending power is constitutionally limited to areas of federal legislative competence; the other view – which reflects actual practice – insists that the federal government may spend or send its funds to any government or institution or individual it chooses, for any purpose it chooses. It may also attach to any grant any conditions it chooses.

federal government imposes ceilings on its contributions. The problem for the federal government was that it had virtually no control over cost increases, and in these shared-cost programs the provinces may have been less inclined to contain them. An even more worrisome problem, this one for provincial governments, was that the federal government could terminate a given program, leaving the provinces with 100 percent of the costs.

At the same time, many of the provinces wished to recover the fiscal leverage they had lost during the Second World War and to exercise themselves the responsibilities assigned to them under the Constitution. The tensions among governments were deepened in the 1960s by Quebec's quest for a redefinition of its position in Confederation and then in the 1970s by federal and provincial responses to the energy crisis and the important role of oil and natural gas in the Canadian political economy. These postwar decades saw a gradual but pronounced decentralization in the Canadian federation.

Canadians' demand for social services remained high, and governments continued to respond. But at the same time, the Government of Canada, facing deepening public sector indebtedness and inexorable growth in social spending, began to overhaul its fiscal relationship with the provinces. This transformation began in 1976 with the federal proposal on Established Program Financing (EPF)[1].

In 1977, following a series of intensive intergovernmental negotiations, the federal and provincial governments reached agreement on a fundamental overhaul of fiscal arrangements. One reason given by the federal government for this new approach was to address the problems associated with shared-cost programs. The new program was the EPF. The established programs consisted of the following shared-cost programs: hospital insurance (1958), medicare (1968), and the 1967 funding arrangements for postsecondary education. Each of these programs had been basically funded on a fifty-fifty cost-sharing arrangement between the federal and provincial governments. One major shared-cost program remained outside EPF: the 1965 Canada Assistance Plan.

With EPF the three shared-cost programs were terminated. The 50 percent share of program funding then borne by the federal government was replaced by block funding – a combination of tax points and cash transfers. The federal government created "tax room" for the provinces by reducing its personal and corporate income taxes. The quantification of this "tax room" was implemented through a transfer to the provinces of 13.5 points of personal income tax (PIT) and 1 point of corporate income tax (CIT). The tax points were equalized. The cash payment required to equalize the tax point transfer became known as "associated equalization" to distinguish it from payments made to provinces under the Equalization program. The 50 percent federal share was itself split into two equal shares – the tax point transfer and the cash transfer. The tax point transfer meant that after 1977, the provinces rather than the federal government became responsible for raising those revenues, and the actual federal contribution to these programs dropped to approximately 25 percent. This agreement broadly shaped

1 Prime Minister Pierre Trudeau tabled the federal government's position paper, "Established Program Financing: A Proposal Regarding the Major Shared-Cost Programs in the Fields of Health and Post-Secondary Education," at the First Ministers' Conference held in Ottawa, June 14–15, 1976.

the transfer arrangements until 1995, when they were replaced by the Canada Health and Social Transfer (CHST).

The cash transfer was unconditional, although there was a very clear understanding that both the tax points and the cash transfer were to be used for these established programs. In 1984, Parliament enacted the *Canada Health Act*, which once again introduced a degree of conditionality to the cash transfers.

EPF was a per capita transfer that grew at the rate of GDP. This arrangement gave funding predictability to the federal government and greater freedom of action on the expenditure side to provincial governments; however, it also broke the link between actual provincial expenditures and the size of the transfers. Since provincial expenditures in these fields were growing faster than the growth in GDP, EPF worsened the financial situation of the provincial governments, which struggled to contain the expanding costs of these important social services. Pressures on the provinces were exacerbated in the early 1980s, when the federal government, responding to inflation and increasing deficits, began to reduce the growth rate of these transfers.

In the 1995 budget, the federal government, for the first time, actually put the spending power in reverse. It did this by combining transfers for health, postsecondary education, and social assistance into a new program, the CHST, and then cutting the total amount for these programs from $18.5 billion to $12.5 billion over two years – a reduction of one-third, or $6 billion. Altogether, between 1983–84 and 1998–99, federal cash contributions to the provincial financing of health, education, and social services dropped from 22.7 percent of total provincial spending to 11.2 percent. Ironically, as a result of the *Canada Health Act, 1984*, this withdrawal was combined with a vigorous assertion of federal control over provincial conduct. More say for less pay.

Federal Transfers

The federal government, using its spending power, transfers money to the provinces to assist them in mounting or maintaining provincial programs. There are several ways in which this can be done.

Shared-cost programs. Here the federal government agrees to match at some level the money that provincial governments allocate to a specific provincial program. Most often this is done on a fifty-fifty basis, meaning that for every dollar a province spends on the given program, the federal government will contribute a dollar.

Conditional and unconditional grants. A federal contribution in support of a provincial program is conditional when its receipt by the province depends on the program meeting certain conditions stipulated in the agreement, such as the right of Canadians, regardless of origin or place of residence, to have access to the program anywhere in the country. Unconditional grants have no such stipulations.

Block funding. Transfers are made to the provinces, often with some general purpose in mind, such as health care. However, the provinces are under no formal obligation to spend the money in that area or indeed to further any specific or general objective.

The special case of equalization. The vast majority of intergovernmental fiscal transfers have to do with the vertical federal-provincial/territorial relationship. The purpose of equalization is to address horizontal fiscal issues – that is to say, disparities among the provinces, or horizontal fiscal imbalance (HFI). Sometimes an equalization component is embedded in a vertical transfer program – for example, when transferred tax points are equalized to some standard.

Equalization: A Special Kind of Cash Transfer

Canada's Equalization program – an unconditional cash transfer to those provinces with lower fiscal capacity – was launched in 1957. It is a federal program, but it addresses fiscal disparities among the provinces. Since the program's inception, intergovernmental discussions of equalization have concentrated for the most part on three issues: (a) the list of revenues to be equalized, (b) the standard to which revenues are equalized, and (c) the treatment of resource revenues.

In 1957 the Equalization program included only three revenue sources: personal income taxes, corporate income taxes, and succession duties. These revenue sources were equalized to a high standard – namely, the weighted average of the per capita revenue of the two richest provinces (at the time Ontario and British Columbia), based on tax rates determined by the federal government.

In 1962, 50 percent of natural resource revenues were added to the list of revenues to be equalized; the same year, the standard was changed to the average of the ten provinces. The inclusion of natural resource revenues disqualified Alberta and British Columbia from receiving equalization payments. After the 1963 federal election, the incoming Liberal government changed the formula and returned to the weighted average of the top two provinces. Resource revenues were no longer included. However, 50 percent of natural resource revenues were deducted from the equalization payments, once again eliminating Alberta and British Columbia as recipient provinces.

The formula for determining equalization payments was overhauled yet again in 1967 when the fiscal arrangements were renewed for another five years. First, there was a major expansion – from four to sixteen – in the number of revenue sources included in the formula. Second, the revenues to be equalized were the actual revenues collected by each province. Third, the standard was changed once again from the average of Ontario and British Columbia to the average of the ten provinces.

Between 1972 and 1981 a number of ad hoc adjustments to the formula were introduced, largely for the purpose of dealing with volatile oil revenues. Increasing oil prices raised equalization payments, creating a fiscal problem for the federal government. It was time to rethink the program, and the time for action came in 1982, when the fiscal arrangements were renegotiated.

The revisions to the equalization formula followed the format already employed in 1967. First, the list of revenues to be equalized was substantially expanded to thirty. Through this broad coverage of provincial revenues, the equalization formula was based on a "representative tax system" (RTS). Second, since it was based strictly on relative revenue capacity, the equalization formula implicitly assumed that the per capita provincial and local government expenditures financed by these federal transfers were equal across the country. Third, the standard was further modified by equalizing the per capita yields of the provincial revenues to the average of five provinces: Ontario, British Columbia, Saskatchewan, Quebec, and Manitoba – the five-province standard. The exclusion of Alberta from the standard eliminated the problem created by the inclusion of natural resources. The Atlantic provinces, which had no oil revenue at that time, were excluded as a counterbalance to the exclusion

of Alberta; a wealthy province was offset by a less affluent region with a comparable population. This formula, with some adjustments made over time, served as the foundation for equalization payments from 1982 until the 2005–06 fiscal year. In 2004 the federal government announced that the formula-based approach to equalization, which had lasted for almost fifty years, would be terminated.

Conclusion

Fiscal arrangements have been central to the capacity of the Canadian federation to respond to the changing needs of Canadians. Making these arrangements work has always been a challenge and has depended heavily on the willingness of federal, provincial, and territorial governments to collaborate. There has been a good deal of intergovernmental innovation and flexibility over the years, reflected in the incremental adjustments that have been introduced to resolve problems as they arise.

At the same time, there have been significant tensions and frustrations. Some of this is inevitable and natural where money and jurisdiction are centrally involved. But it is the view of the Panel, confirmed by the consultations we have held with government representatives, that the levels of tension and frustration have risen and that trust among the players has declined. In light of the story we have just told in this chapter, it would be surprising if that were not the case. Clearly, as a country we have not yet found a way to address the fiscal arrangements so critical to our collective well-being in a sensible, step-by-step way. It is difficult to discern in this story any orderly progress towards agreed-upon, practical, and achievable goals. The problem may lie not only with what governments are doing, but also with the way they are doing it – that is, the manner in which they conduct their intergovernmental business. We shall return to this question later in the Report.

Chapter Three

Values and Views

Hearing from Canadians and Their Governments

Fiscal federalism is shaped by Canadian values. Its forms and practices reflect basic, underlying notions and views of what type of country we want. It is deeply rooted in the historical, constitutional, and political evolution of the country itself and of the people who live in it. Specific fiscal arrangements, therefore, are informed at their core not by the "value" of any particular fiscal instrument, but rather by the "values" that give rise to those instruments. In essence, these values are the financial and political expression of ideals that Canadians hold about country, community, and citizenship. Additionally, they flow from the choices that successive federal and provincial governments have made over many decades with regard to sharing or redistributing wealth, fulfilling constitutional obligations, addressing regional grievances, and fostering unity. Assessing the worth of any one transfer separately from its linkage to the underlying value would therefore miss an essential perspective about fiscal imbalance.

Yet some caveats are in order here. Some values conflict with others that are just as deeply held. It follows that an appeal to values does not always result in an obvious solution for an issue as complex and difficult as fiscal imbalance. Importantly as well, perspectives on values may vary among regions. Those who have less may perceive fairness as wealth redistribution and sharing; those who generate the wealth may be more concerned about sustaining the conditions that create wealth. The search for national standards in social programs may conflict with respect for regional diversity and the constitutional division of powers. Clearly, values provide an important context when we come to consider fiscal imbalance and fiscal federalism.

The Panel's Consultation Process

The Panel was mandated to consult with provincial and territorial governments, to seek the views of the federal government, and to consult experts as required. We did all three, and more.

We met with elected officials and senior public servants in all provincial and territorial governments, including many premiers, ministers of finance, and ministers of intergovernmental relations. We received presentations and documents from each government to help us consider the relevant issues. The Panel also met with senior officials from Finance Canada.

We received advice from leading academics and public policy experts in the field of fiscal federalism at a two-day round table. More than twenty national experts examined specific issues surrounding vertical fiscal imbalance, horizontal fiscal imbalance, Canada's transfer system, and the governance of fiscal federalism. This round table was held in partnership with the Institute of Intergovernmental Relations of Queen's University. The Panel also received advice directly from academic and public policy experts.

The Panel sought the views of Canadians through a series of independent regional dialogues conducted by the Canadian Policy Research Networks. These took place in Halifax, Montreal, Toronto, Edmonton, Vancouver, and Ottawa. The purpose of these dialogues was to find out from citizens which basic values they want to see guiding decisions about sharing public funds between the federal and provincial/territorial governments. A summary of the process can be found in Appendix 3. This dialogue was an important additional source of information for us to consider as we developed our recommendations.

This chapter summarizes the views and issues presented to the Panel during consultations with each of the following: provinces and territories, the federal government, experts, and individual Canadians.

Provincial and Territorial Governments

The Panel held meetings with each provincial and territorial government in their respective jurisdictions from September to November 2005. To provide each government with a focus for discussions, we prepared and sent out in advance an Issues Paper that set out the main themes, issues, and questions being considered by the Panel (see Appendix 4).

Territorial Governments' Views

The first consultations undertaken by the Panel were held with the three northern territories, which agreed to meet collectively and individually in Yellowknife. A round table with Aboriginal and community representatives was also held. The Panel

listened to a joint presentation from all three governments, as well as to individual assessments from each jurisdiction of the unique needs and challenges they faced.

While the issues and challenges facing the northern territories regarding fiscal arrangements are set out in greater detail in *Chapter 4*, it is important to note here that the three territorial governments face enormous difficulties in providing not just adequate but even basic public services to their residents. The realities of "life in the North" were represented clearly to the Panel, as were the differences among each of the three territories. Far-flung geography, an often inhospitable climate, and high transportation and communications costs were cited as major challenges in delivering services in the North. There are also important social issues. Inadequate housing, lower high school graduation rates, and higher rates of both disease and violent crime relative to the rest of Canada all take their toll. Regional disparities exist not just between northern and southern Canada, but across the region itself.

No discussion of the North can ignore the Aboriginal fact. Nunavut's population is 85 percent Aboriginal. There are four official languages in that territory. Fifty percent of the NWT's population is Aboriginal, and they speak eight official languages. Yukon's population is one-quarter Aboriginal. A traditional lifestyle is part of the northern culture. People remain close to the land, and many households rely on country food. The transition to a wage economy has been slow and only relatively recent. Self-government is developing, albeit slowly. Each of these important realities was discussed by the territorial and Aboriginal governments and by individual Northerners.

The territorial governments depend heavily on financial transfers from the federal government – specifically, on the Territorial Formula Financing (TFF) program, which represents between 70 and 90 percent of annual revenues. Until 2004 the TFF used a "needs based" formula to fill the gap between "expenditure needs" and "revenue-raising ability." It had been in place since 1985.

The territories unanimously oppose the 2004 changes in the TFF imposed by the New Framework for Equalization. They do not support the creation of a fixed territorial pool; an increase in one territory's allocation comes at the expense of the others. Nor do they support any move away from the use of a needs-based formula to determine payments. They also view the 3.5 percent escalator as inadequate.

The territories proposed to the Panel a return to a formula-based approach to territorial financing, such as the previous TFF. They asserted that a formula-based approach was both more flexible and more relevant to their circumstances. Additionally, they called for any new formula to include appropriate incentives to promote economic growth and development. Under the TFF, as own-source revenues grew, transfers were reduced. This was a disincentive to economic development. This concern goes directly to the issue of natural resource ownership and revenue sharing. None of the territories owns its natural resources, and only Yukon has a negotiated agreement on sharing resource revenues (an agreement viewed as inadequate and as a poor model for both Nunavut and the NWT). The territories consider it vital to address this issue along with the TFF. The three territories share common goals: to achieve economic self-sufficiency, to reduce dependency on the federal government, and to maximize the retention of benefits from resource development.

Provincial Governments' Views

The Panel received information and background from each of the provincial governments during the consultations. Many provinces provided important economic and social contextual information as well, to complement their financial data and analyses. There was general agreement among the provinces about the existence and causes of fiscal imbalance. The provinces outlined the challenges they faced in meeting their expenditure responsibilities and the growing and changing needs of their residents. For some provinces the priority was to find solutions to vertical fiscal imbalance; for others the horizontal fiscal imbalance was more urgent. Notwithstanding the differences in emphasis, there was a common view that an effective response to the issue of fiscal imbalance on the part of the federal government was central to Canada's future. Yet at the same time, the provinces recognized that there could be no single or simple solution to the problem.

The Panel was neither surprised nor discouraged by the divergent views among the provinces with respect to vertical and horizontal fiscal imbalance. Some of their positions reflected long-standing historical, cultural, and political circumstances extending well beyond the current debate. Others reflected current economic and financial conditions that responded to global economic competition and therefore transcend issues of fiscal federalism. Still others flowed from relative assessments of their fiscal and economic strengths or weaknesses and from the imperative to find sufficient resources to improve services for their residents. Even so, key areas of consensus among the provinces emerged from our consultations.

All provinces emphasized four main concerns regarding the current state of fiscal federalism and fiscal arrangements. First, they identified the realities of provincial expenditure pressures and the inadequacy of the current transfer arrangements for meeting provincial needs. Second, they criticized the federal government's use of its spending power in areas of exclusive provincial jurisdiction as an interventionist tool without due regard to provincial priorities; in their view, this inappropriate use of the federal spending power resulted in significant additional financial pressures and obligations on provincial governments. Third, they deplored the current ad hoc nature of intergovernmental relationships and arrangements and the lack of ongoing mechanisms for dialogue. Fourth, they expressed a variety of views about the equalization arrangements. We discuss each of these in turn.

VFI and Current Transfer Arrangements

There is no question that all provincial governments have concluded that there is a vertical fiscal imbalance between the federal and provincial orders of government. The Council of the Federation defines it this way:

> *Vertical fiscal imbalance refers to a gap between revenue sources and spending responsibilities between orders of government. It means that one order of government collects more tax dollars than it needs to support its responsibilities, crowding out the ability of the other order of government to raise the revenue it needs to fund its responsibilities.*[1]

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1 Council of the Federation, "Media backgrounder," May 27, 2005.

Here, they pointed to the rising federal surpluses and contrasted these with the more tenuous financial situation most provinces face.

The provinces rejected the federal argument that they should simply raise taxes to meet any revenue shortfalls. They pointed out the realities of interprovincial tax competitiveness, and they noted that the ability to raise revenues through taxation varied considerably among provinces. They also pointed out that provincial expenditures on social programs were growing faster than federal cash transfers.

All provinces referred to the significant and unilateral cuts to cash transfers for social programs in the 1995 federal budget as the underlying cause of the current VFI. The rising costs of health care have placed a significant burden on all provincial governments and, by extension, on taxpayers, who must make up the shortfall. As a result, virtually all other items in provincial budgets (such as environmental programs and the administration of justice) have had to be either scaled back or kept constant in order to free sufficient resources to keep up with the growing costs of health care.

There was a clear consensus among the provinces that federal transfers for health care and postsecondary education (PSE) needed to be increased. The federal government had addressed health care in recent years, but this was partly at the expense of postsecondary education, so the provinces gave priority to increased federal spending on PSE. They also emphasized the importance of postsecondary education to competitiveness. Different suggestions about the best way to increase spending on PSE were made to the Panel. For the most part, the provinces preferred increased federal transfers through the Canada Social Transfer (CST), rather than federal spending directed to institutions and individuals. Without diminishing the significance of direct transfers, they noted that these transfers added to the operating costs of postsecondary institutions and had been made at the expense of the core transfer for postsecondary education. There were differing views on whether a separate PSE transfer should be created.

For the most part, the provinces favoured an increase in federal transfers to reduce the overall vertical fiscal imbalance. Some considered it feasible to transfer tax points as a means of correcting the vertical fiscal imbalance, but only if those tax points were equalized to ensure that horizontal fiscal imbalance was not increased. Additional direct federal spending was viewed more positively as long as it was linked to provincial priorities, did not necessarily require matching provincial dollars, and was undertaken in a coordinated and collaborative manner.

Use of the Federal Spending Power

All provinces expressed concern about the recent use of direct federal spending. Such spending, the Panel was told, resulted in the skewing of provincial spending priorities to bring them into line with federal spending priorities. This generated direct additional costs that many provincial treasuries found difficult to meet. Many provinces cited examples of "one time" direct federal spending that then lapsed, leaving provinces in the position of having to make up the shortfall. Several provinces referred to federal "boutique" programming – that is, programs developed to address

specific issues or federal political priorities in areas of provincial jurisdiction that were not funded through established transfer programs. In addition, provinces complained that federal funding was becoming increasingly conditional.

Provinces also raised the issue of asymmetric arrangements. Many provinces expressed a desire for a more flexible, responsive federalism that would more directly address their unique needs and circumstances. The Panel was reminded several times that regional, social, and financial circumstances differ across provincial jurisdictions and that "one size doesn't fit all."

There was a general consensus among the provinces on problems associated with the recent use of the federal spending power. The provinces considered it important to find ways to restrict its use.

Intergovernmental Relations

Many provinces spoke to the Panel of a decline in trust and collaboration between the two orders of government. The sudden cuts in transfer payments in the mid-1990s, coupled with several difficult negotiations at the political and official levels on health, social services, and equalization transfers, had taken their toll. All expressed concern about the current ad hoc approach to developing federal/provincial agreements. Many felt that previously well accepted principles in transfer programs and federal/provincial agreements were either being ignored or, at the very least, significantly compromised by the federal government. Predictability and stability in federal funding had only recently reappeared under the 2004 Health Accord. Many provinces felt that this could not be said of other federal/provincial funding arrangements.

Central to these problems, the Panel was told, was a lack of ongoing dialogue and mechanisms for collaboration. Irregular first ministers' meetings called by the federal government and last-minute negotiations on major issues had created a climate of conflict. Some provinces contended that the federal government had sometimes resorted to a deliberate wedge strategy of trying to divide the provinces. All felt that the public had grown weary of the fractious nature and conduct of intergovernmental relations. In their view, the holding of regular first ministers' meetings would be a far more positive and effective approach to managing the federation.

Yet several provinces said they understood the federal government's desire for recognition and visibility for its transfers. Some suggested that this was not unreasonable and that with more trust and cooperation on all sides, the federal need for greater visibility could be accommodated. They accepted that the federal government has a legitimate and understandable obligation to explain and promote its own programs and initiatives to all Canadians. They urged that ways be found to give appropriate profile and visibility to the federal government's contributions in areas of social and economic development and that this be done in a more collaborative manner.

HFI and the Equalization Program

All provinces recognized the existence of horizontal fiscal imbalance (HFI) within the federation as well as the need for an equalization program, which they saw as the principal instrument for addressing HFI. The Council of the Federation defines HFI as follows:

> *Horizontal fiscal imbalance refers to the differences in the ability of provinces/territories to raise revenues to meet the needs of their citizens. It means there is some disparity in the ability of individual provinces and territories to deliver comparable, high quality services.*[2]

Views on how to address the specific shortcomings in the Equalization program varied among the provinces. Some stated unequivocally that the program was doing an inadequate job of helping recipient provinces meet their growing need to provide public service and that as a result, interprovincial disparities were increasing. Unilateral changes by the federal government to make the program more "affordable" by manipulating the formula every few years had contributed to a sense that the program was not a true "equalization" program. Predictability and stability had been enhanced under the New Framework; however, several provinces felt that this had been at the expense of the adequacy of the program.

Others felt that the main issue was the formula itself. Depending on how revenues were calculated, what was included and what was excluded, there was potential for anomalies that were patently unfair. Were a province that receives equalization to have a higher fiscal capacity than a province that does not receive equalization, the fundamental principles of the program would be compromised.

The treatment of natural resource revenues in the calculation of equalization payments was a central issue, given their volatility, their significance as a revenue source for some provinces, and their uneven distribution across the country. Provinces differed on how non-renewable natural resource revenues should be treated in the Equalization program; some urged 100 percent inclusion while others recommended that resource revenues should be excluded. All the provinces urged, however, that the basic principles of the Equalization program be reaffirmed, particularly in light of the federal government's New Framework.

Several provinces raised the distinction between Section 36(1) of the *Constitution Act, 1982* (regional disparities) and Section 36(2) (Equalization). Section 36(1) states:

> *...Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to:*
> *(a) promoting equal opportunities for the well-being of Canadians;*
> *(b) furthering economic development to reduce disparity in opportunities; and*
> *(c) providing essential public services of reasonable quality to all Canadians.*

The provinces pointed out that equalization payments were not meant to redress regional disparities. This was the purpose of Section 36(1), which commits the federal

2 Council of the Federation, "Media Backgrounder," May 27, 2005.

and provincial governments to do so. In the context of economic development, agreements with a single province, a cluster of provinces, or all provinces were seen as perfectly justifiable.

A number of approaches to improving the Equalization program were suggested to the Panel. These included discontinuing the five-province standard and returning to a ten-province standard; including all revenue sources, even natural resources; and adding some form of "needs-driven" component that recognized differential costs in providing public services. Other solutions included making the Equalization program under Section 36(2) the only equalizing transfer, moving to equal per capita cash transfers for social programs, and eliminating equalized tax point transfers for those programs.

Federal Government Views

The Panel met with senior Finance Canada officials in January 2006. The federal Minister of Finance and Minister of Intergovernmental Relations did not accept the Panel's invitation to meet with it due to the federal election then under way. Instead, their letter, dated November 28, 2005, that set out the position of the federal government, was sent to the Panel co-chairs. The government then in power took the position that vertical fiscal imbalance did not exist in Canada:

> *The Government does not believe in the existence of a fiscal imbalance between the federal and provincial governments in Canada. Both orders of government have access to all the major sources of tax revenues and have complete autonomy in setting their tax policies to address spending pressures related to their respective responsibilities.*

Finance Canada officials provided useful data and background information to the Panel. In their presentation they pointed out that both orders of government had access to all major sources of tax revenue, including personal income tax, corporate income tax, sales taxes, and payroll taxes. The provinces also had other revenue sources such as natural resource royalties, property taxes, and gaming and liquor profits. They pointed out that federal revenues were at a historic low of less than 15 percent of GDP. Moreover, recent federal tax cuts had created a substantial amount of tax room for the provinces. They noted that the provincial and territorial governments had cut their own taxes and, consequently, there was room for them to raise those taxes again. Also, federal and provincial/territorial fiscal circumstances had improved in the previous five to ten years. While the federal debt was decreasing faster than the combined provincial/territorial debt, it remained higher as a percentage of GDP (roughly 37 percent in 2004–05 for the federal government, compared to 21 percent for the provinces and territories). With respect to transfers, federal officials noted that health and social cash transfers had increased significantly and would total about $28 billion in 2005–06 compared to about $13 billion in 1998–99. Equalization and TFF payments were projected to increase from $10.9 billion in 2004–05 to just under $16 billion in 2011–12. In their view, this placed total federal cash transfers on a path of predictable growth.

Academics and Public Policy Experts

At a special national round table, the Panel consulted some of Canada's leading academics and public policy experts in the field of fiscal federalism to help it identify the issues and their possible solutions. The participants in this forum are listed in Appendix 5. The Panel also benefited from the submissions provided to the Federal Panel on Equalization.

At the round table on fiscal imbalance, held in partnership with the Institute of Intergovernmental Relations of Queen's University on November 21–23, 2005, the Panel considered four main themes: first, "Setting out the Problem: What Are the Underlying Causes of Fiscal Imbalance?"; second, "Canada's Sharing Community: How Much Equalization?"; third, "Mechanisms for Addressing Fiscal Imbalance: Which Option Is Best for Canada?"; and fourth, "Fiscal Federalism Mechanisms and Processes: Is There a Better Way?"

The purpose of the first theme was to outline the core definitions as well as the context required to analyze vertical and horizontal fiscal imbalance, and the vertical fiscal gap, and to begin discussion of specific issues and policy options. The round table considered vertical fiscal imbalance (VFI) in the context of a vertical fiscal gap (VFG) to determine the adequacy of transfers from the federal government to the provincial and territorial governments. It was suggested to the Panel that an effective transfer system must address four main issues: the stability and predictability of transfers over time, the number and size of transfers, the extent and nature of transfer conditionality, and the matching requirements placed on transfers.

When it came to horizontal fiscal imbalance and the role of the Equalization program, experts suggested that it was important to distinguish between "consumption" and "investment." Some linked the Equalization program to a longer-term convergence of provincial fiscal capacities, whereas others focused on disparities in public services. Participants noted that no objective criteria exist for evaluating the effectiveness of the Equalization program. Looking ahead, several experts pointed to the increasing interprovincial disparities associated with Alberta's growing oil and natural gas wealth, while others noted that demographic issues – particularly an aging population in Atlantic Canada – would continue to exacerbate fiscal disparities between this region and other parts of the country.

The second theme focused more specifically on equalization and its effectiveness in addressing HFI. Experts considered three main questions:

1) Are the objectives of equalization under Section 36(2) of the *Constitution Act, 1982* adequate for moving forward?
2) What recommendations should be made about equalization outside of the formula?
3) Which is preferable – a five- or ten-province standard? And should natural resource revenues be included in the equalization formula?

Views on these questions ranged widely. Academic experts preferred a ten-province standard as a more principled approach. They suggested that there was a need for a return to a more principled or 'rules based' framework for determining equalization entitlements, away from the federal government's New Framework established in 2004.

The third theme focused on solutions to vertical fiscal imbalance. Participants identified three possible mechanisms to address VFI: increase federal cash transfers; create new spending arrangements by realigning program responsibilities between the federal and provincial governments; and seek new revenue arrangements with the federal government. Under the first mechanism, experts discussed the use of the federal spending power, block transfers versus direct and conditional transfers, and a separate PSE transfer. With respect to the second mechanism, the prevailing view was that the provinces were better at designing and delivering local services and programs to people whereas the federal government was better at more broad-based program delivery such as income support. This kind of division should be considered in any realignment of program responsibilities. Experts suggested therefore that the Panel examine issues of federal/provincial program disentanglement as a means of addressing not just VFI but VFG as well. On the third point, several options for new revenue arrangements were suggested to the Panel: tax point transfers, tax field transfers, and vacating tax room to the provinces. Among these three options, the experts considered tax point transfers the best option. The objective was to increase the provinces' fiscal capacity to fund services for which they are constitutionally responsible.

The fourth and final theme focused on ways to improve fiscal federalism, or governance. Two main questions were considered:

1) How can governments improve the processes through which intergovernmental fiscal relations are negotiated?
2) What institutions should be in place to facilitate these processes?

Experts suggested to the Panel that it seriously consider recommending new governance measures to foster a more effective fiscal federalism. A rules-based system was seen as crucial to restoring trust and confidence in intergovernmental fiscal relations, eliminating federal unilateralism, and reducing fractiousness between orders of government.

Citizens

Citizens' values and choices help define the policy space available to governments. For that reason, the Panel sought the views of individual Canadians through a series of citizen dialogues organized by Canadian Policy Research Networks. The purpose was to identify the basic values that Canadians consider important in relation to the sharing of public funds between the federal and provincial/territorial governments. These dialogues would also help to identify trade-offs that citizens would accept when governments formulated policies on fiscal arrangements.

This process engaged people as individuals, not as members of a particular stakeholder or advocacy group. The participants were recruited by a professional polling firm to reflect a cross-section of voting-age adults. They were a diverse and representative group of men and women.

The participants made several important points about fiscal federalism and transfer arrangements. A strong sense of "being Canadian" was apparent in every region, as was the desire for a national vision and national approaches. Instead of "reasonably comparable standards" of services, participants suggested a more rigorous determination of the "same acceptable standards" across the country. More than anything else, the participants wanted fairness and equal opportunity for everyone, regardless of where they lived in the country. They wanted public funds to be shared to promote fairness. Additionally, they wanted both orders of government to focus on what is good for Canadians as a whole and for Canada on the world stage.

From the citizens' perspective, services were considered more important than fiscal formulas. They saw the country as a whole and wanted both orders of government to work collaboratively and to develop more common standards of services. They emphasized how important it was to be able to access services across the country. Based on their own experiences, they felt that services were more portable in theory than in practice. They spoke, for example, of encountering difficulties and delays in obtaining health coverage when they crossed provincial boundaries for work. Reflecting today's "sandwich" generation, they also spoke of the barriers and challenges confronting aging parents and their adult children in trying to obtain seniors' health care, home care, and housing services when moving from province to province.

"I found [it] quite surprising that with the diversity here, with so many ages, and communities, that even in the early stages, there was consensus. It was a lot more difficult than I thought, but we experienced a wonderful discovery of shared principles."

– Montreal participant
national session (translation)

"To the people who are making the decisions, I would just ask you to please listen ... People like to be asked what they think. After all, it's our money."

– Vancouver session

Citizens were practical in their observations. They acknowledged the high cost of delivering services in rural and remote areas, and they talked about the need for governments and for regions within provinces to collaborate to offer specialized services in more cost-effective ways.

> **"Canadians deserve and I sense demand that governments are accountable and transparent in their service."**
>
> – Toronto participant
> national session

The need for more transparency and accountability from governments was emphasized repeatedly. The need for transparency was linked directly to low levels of trust, not only between governments but also between Canadians and their governments. The participants wanted to see more citizen-centred government that would ensure a focus on outcomes. They wanted progress towards achieving standards to be measured and reported in order to hold governments accountable. They expressed a preference for more conditional transfers to foster greater accountability from governments. But their call for greater accountability extended beyond governments. They emphasized the need for greater responsibility and accountability of everyone, including individuals and institutions who receive public funding. They expressed significant frustration with intergovernmental bickering, which they felt led to duplication and inefficiency and compromised the development of a national vision.

> **"I would like to see a national vision in Canada ... more cooperation and collaboration among provinces and regions and national standards that enable every Canadian to be truly Canadian"**
>
> – Edmonton participant
> national session

Citizens saw the federal government as having an important role to play in ensuring Canada-wide approaches to developing and delivering programs and services. But they also recognized that the provinces needed to have some flexibility when it came to tailoring these programs to their unique needs.

Five key values and principles came to the fore as citizens considered the issues:

- ***Fairness.*** Canadians need to share to achieve a national vision; there should be the "same acceptable standards" across the country, especially for health and education.
- ***Access.*** Canadians deserve access to the same acceptable levels of service across the country; mobility is an important principle (and fact of life) that should be recognized in ensuring such access.
- ***Transparency and accountability.*** Progress in achieving results or standards should be measured and reported by governments to their citizens to ensure transparency and accountability in transfers; processes should be established to ensure citizen input; provincial flexibility to meet Canadians' needs is acceptable.

- ***Sustainability.*** Fiscal arrangements should be financially affordable for both governments and citizens; there should be continuity across changes of government.
- ***Efficiency.*** Governments should avoid duplication and share best practices; interprovincial collaboration and coordination of services across provinces to meet needs should occur; interprovincial barriers to work and education should be removed; efficiency in transfers is necessary to improve Canadian competitiveness in the global economy.

Conclusion

The Panel heard directly from all provincial and territorial governments, the federal government, academics and public policy experts, and representative groups of Canadians. We found obvious areas of agreement and consensus in many areas and, just as obviously, not in others. It is worth reminding ourselves that until this year, the two orders of government did not agree that a vertical fiscal imbalance existed. It is no surprise, nor should it be, that differences in perspective exist across the country and across governments. That said, all who spoke to us emphasized the importance of getting fiscal arrangements right for Canada's future growth and prosperity, as well as meeting core Canadian values of fairness and sharing. Despite several recent federal/provincial/territorial agreements reached at the highest levels, the view persists among Canadians and their governments that the nature and conduct of fiscal federalism is "not quite right." Debating fiscal federalism provides a clear opportunity for a more fundamental debate about the nature of Canada and the type of sharing community we want to be.

The Panel considered all that it heard from participants carefully, and benefited enormously from their wisdom, insight, and experience.

Chapter Four

Canada's Northern Territories

A Special Responsibility

The vast region that was once the North-West Territories has given birth to the provinces of Alberta, Saskatchewan, and Manitoba and allowed the expansion of Quebec, Ontario, and Labrador (Figure 4.1). Today, Yukon, Nunavut, and the Northwest Territories still make up 40 percent of Canada's land mass (Figure 4.2).

The three territories share many of the typical characteristics of frontier regions and retain many of the vestiges of colonies within Canada. They have small, dispersed populations, developing economies, underdeveloped infrastructures, high living costs, and evolving political systems. The territorial governments do not have the full rights and responsibilities enjoyed by provincial governments. Their resource economies are "boom and bust," with most decisions made outside. When there is development, a disproportionate share of the benefits flow south. As a consequence, the territories remain relatively weak and dependent on fiscal transfers.

Few Canadians have visited the territories, and still fewer live there. Even so, most Canadians share a sense of ownership and national pride in these northern regions. We know that the lands and their resources are the envy of other nations, and we claim sovereignty over Arctic lands and waters. We depend on Northerners as stewards and custodians of our North, yet we do not give Northerners a fair share of the wealth that comes from the land on which they dwell. The dream of a Northwest Passage was pursued for centuries. That dream is now upon us. Canadians and their governments recognize the strategic importance of this northern frontier. Yet the social, economic, and political challenges facing the territories and their people are complex and daunting.

Source : http://www.collectionscanada.ca/confederation/023001-2101.6-e.html

Source : http://www.collectionscanada.ca/confederation/023001-2101.12-e.html

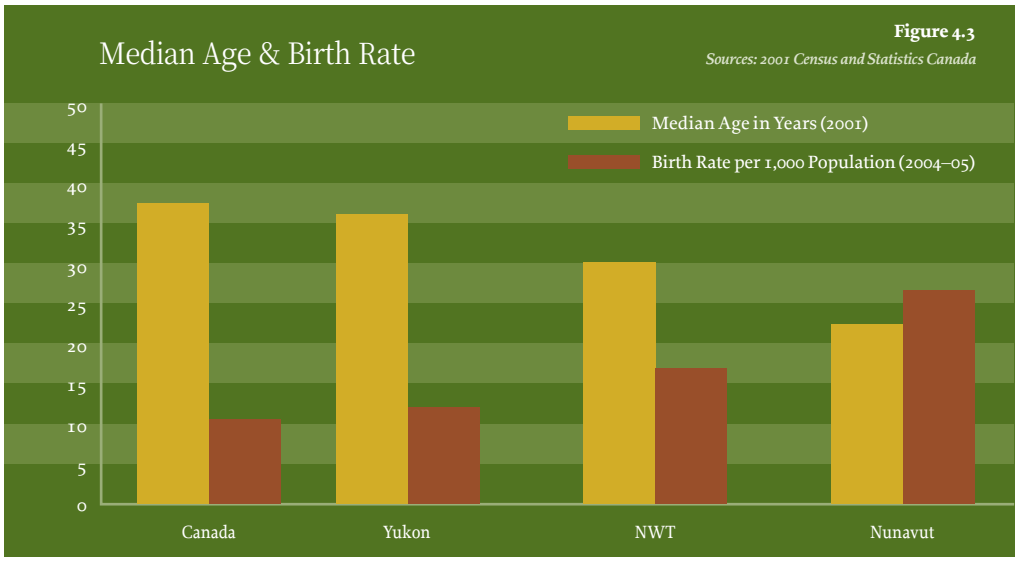
Investment in the North is an investment in the unfinished business of nation building. The territories and their people must take their place as full, contributing partners in the federation.

The Context

Canada's three northern territories are very different from the provinces; they are also quite distinct from one another.

People

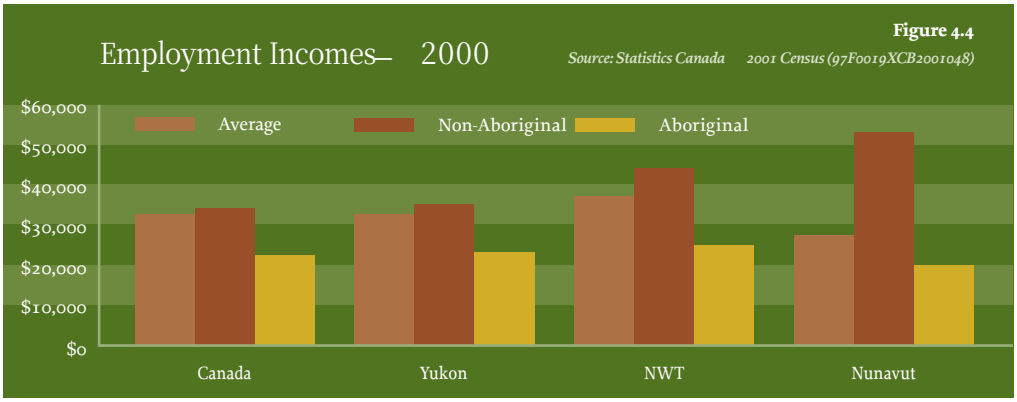
With just over 100,000 people in eighty-three communities, the territories account for only 0.3 percent of Canada's population. The average population density of the ten provinces is about two hundred times greater than that of the three territories.



The people of Nunavut have the highest birth rate and the lowest median age of any jurisdiction in Canada, provincial or territorial (Figure 4.3). About 85 percent of Nunavut's people are Aboriginal; the corresponding figures are 50 percent for the NWT, 23 percent for Yukon, and 3 percent for Canada as a whole.

Social conditions in the territories are much more challenging than in the provinces. Infant mortality rates in Yukon and Nunavut are double and triple (respectively) the rates in the rest of Canada. Average life expectancies are lower in the territories – as much as ten years lower in Nunavut. Education levels are significantly lower for Aboriginal people. Suicide rates in Nunavut are seven times the national average. The rates of violent crime in the territories are four to eight times the national rates.

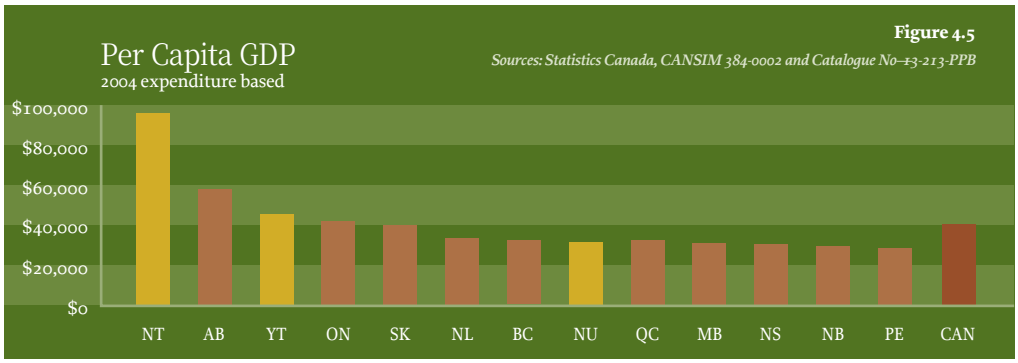
The cost of living in Nunavut is around 64 percent higher than in southern Canada; in the Yukon, the cost of living is 40 percent higher, and in the NWT, 30 percent higher. And costs are higher still for the smallest and most remote communities.



Employment incomes are higher than the Canadian average in the NWT and lower in Nunavut (Figure 4.4). In all three territories there are significant gaps in employment and income between Aboriginal and non-Aboriginal people. These gaps widen as one goes from west to east. The employment rate in the NWT in 2004 was 84 percent for non-Aboriginals compared to 53 percent for Aboriginals.

Economy

The per capita GDP in the NWT in 2004 far exceeded that of any province, including Alberta (Figure 4.5). Furthermore, its GDP is growing faster than that of even the best-performing province, Newfoundland and Labrador (Figure 4.6). This growth is almost entirely due to increased mineral (diamond) production. Economic growth in Yukon and Nunavut has been nearer to the national average.



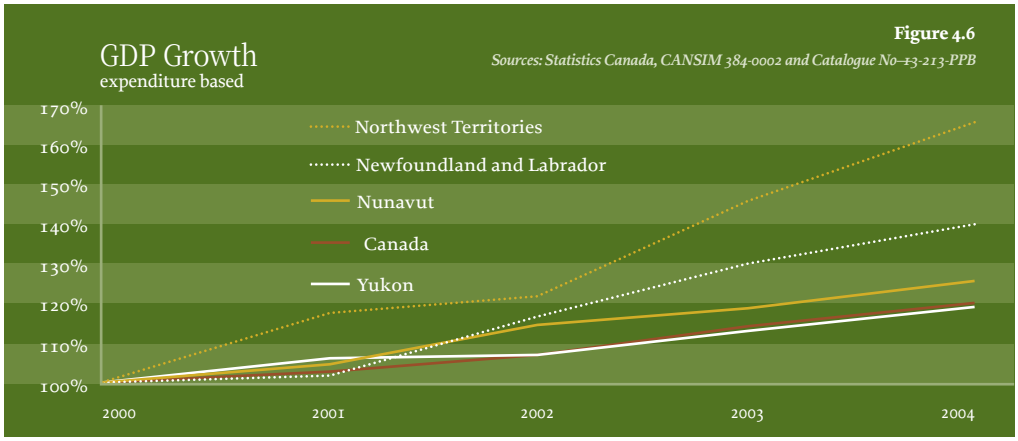
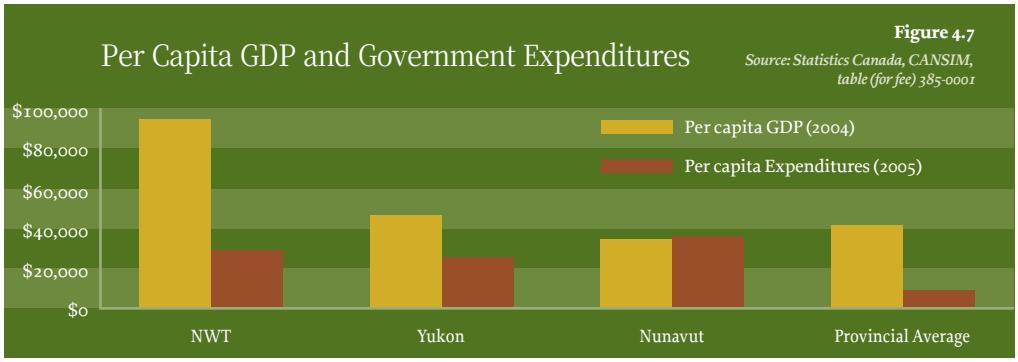


Figure 4.7 compares per capita GDP and per capita government expenditures for the three territories to the provincial averages. Government expenditures have long been the stable economic base of all three territories; they still account for more than half the economies of Nunavut and Yukon.



Non-renewable resource activity has been a "boom and bust" source of investment and exports, and it continues to represent the greatest economic potential for the territories. The NWT is currently enjoying a boom in diamonds and is on the verge of a major investment in the Mackenzie Valley natural gas pipeline. Both Nunavut and Yukon have suffered downturns in mineral production in recent years. However, both have enormous potential for future development of non-renewable resources, including oil and gas, gold, diamonds, and base metals.

The territories are continuing their efforts to expand other sectors of their economies, particularly renewable resources, tourism, and arts and crafts. These sectors do not have the same huge potential for investment and export value as non-renewable resources, but they are more sustainable and tend to create more local jobs and income per dollar of GDP.

Public Government

The evolution of "Home Rule" for the territories is ongoing. The Yukon Territory was created in 1898, during the Klondike Gold Rush. For decades its Executive Council was largely appointed by Ottawa. Not until 1979 did Yukon elect a legislature with ministers and a government leader.

The seat of government for the NWT was moved from Ottawa to Yellowknife in 1967. By 1976 its Legislative Assembly was fully elected; in 1986 its commissioner was replaced as Chair of the Executive Council by an elected government leader. Nunavut was created through a division of the NWT in 1999 as a direct consequence of the Nunavut Comprehensive Land Claim Agreement.

The territorial governments have gradually assumed responsibility for the delivery of most provincial-type programs "devolved" from federal departments, such as health, education, social services, housing, and transportation. Even though territorial governments have assumed these new program responsibilities, they have not been given access to what could become their most important source of revenues: the revenues from natural resources.

The territories do not own their own land or resources. Only Yukon has completed the devolution of both. However, devolution did not include the transfer of ownership; the Yukon is limited to the right to manage these resources on behalf of Canada.

The territories do not have the status of provinces under the Constitution and cannot become provinces without the approval of Parliament and two-thirds of the provinces representing at least 50 percent of the Canadian population. The Acts ("constitutions") governing all three territories are federal legislation, and unlike the provinces, the territories cannot change their "constitutions." Also, they can only borrow money with federal approval and within federally set limits.

Aboriginal Rights

The Aboriginal peoples of the North are distinct nations and peoples. They occupied the land and governed themselves for centuries before Europeans began to explore and colonize North America.

Section 35 of the *Constitution Act, 1982* recognizes existing Aboriginal and treaty rights. In the past few decades, Canada and its Aboriginal peoples have been negotiating title to land and resources in the form of comprehensive land claim agreements. A second set of negotiations has focused on self-government based on federal acknowledgment that Aboriginal peoples have the inherent right to self-government. These negotiations are taking place throughout Canada and in some cases have been concluded successfully.

In Yukon, ten such agreements have been finalized and four more are being negotiated. In the NWT, three comprehensive land claims have been completed and negotiations over self-government have commenced. A fourth combined land claim and self-government agreement has been finalized. Negotiations have commenced in all the remaining regions.

The Nunavut Land Claims Agreement covers the entire territory (20 percent of Canada). This claim includes Inuit title over a land area within Nunavut that is six times the size of Nova Scotia. The creation of Nunavut with a public government was a direct consequence of this agreement. Because Nunavut's population is 85 percent Inuit, the territory has de facto Inuit self-government, with Inuktitut and Inuinnaqtun as two of its official languages.

For the most part, the Aboriginal governments in the two western territories are assuming province-like responsibilities of the kind now being exercised by the territorial governments. As a result, each of these territories has a unique and complex governing structure that includes both public and Aboriginal governments.

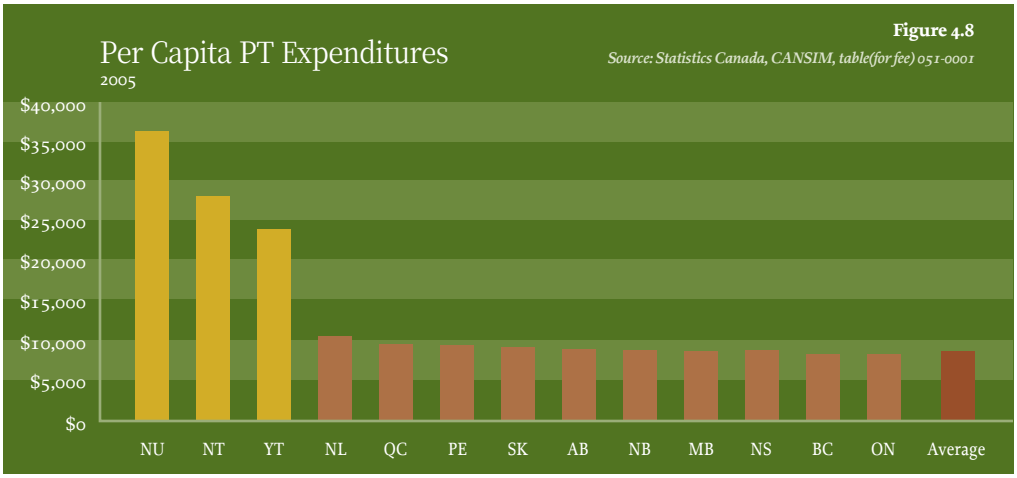
Aboriginal people in the territories share many of the challenges faced by all Aboriginal people in Canada. The relatively larger Aboriginal populations have also given Aboriginal people a stronger voice in public governments in the North. Aboriginal governments are now able to enter into agreements with the territorial governments for the delivery of services. Once the remaining land claim and self-government agreements in Yukon and the NWT are concluded, and are fully implemented and funded, Aboriginal governments in all three territories will be able to provide services to their own people.

In the NWT and Yukon, Aboriginal self-government agreements require that jurisdiction be shared in many key program areas. The result has been additional costs for establishing Aboriginal governing institutions and structures. Current funding levels do not allow the territorial governments to contribute to these costs without compromising their capacity to maintain public services. At the same time, those governments are being asked to share tax room and other revenue sources with Aboriginal governments. It is obvious to the Panel that federal–territorial financing arrangements should fully recognize the obligations and costs of Aboriginal rights agreements and remove any fiscal disincentives for territorial governments to conclude the remaining agreements.

Financing Territorial Governments

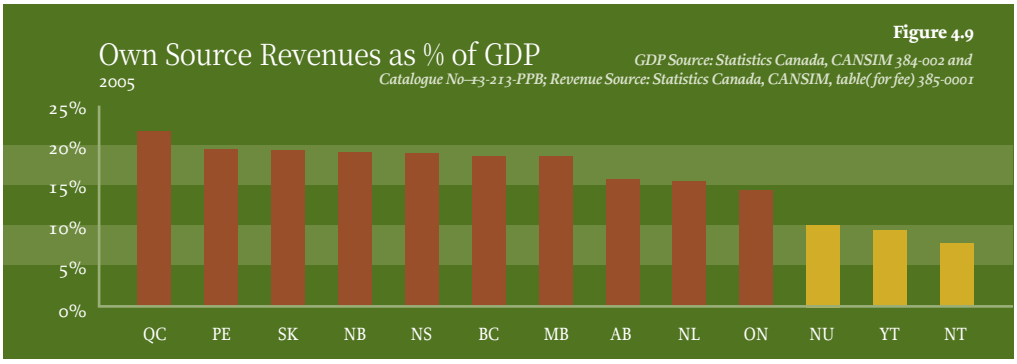
Territorial Expenditure Needs

Territorial governments spend three to five times per capita what the provinces spend (Figure 4.8). The relatively poorer health, housing, education, and employment status of territorial residents has resulted in a higher per capita need for services.

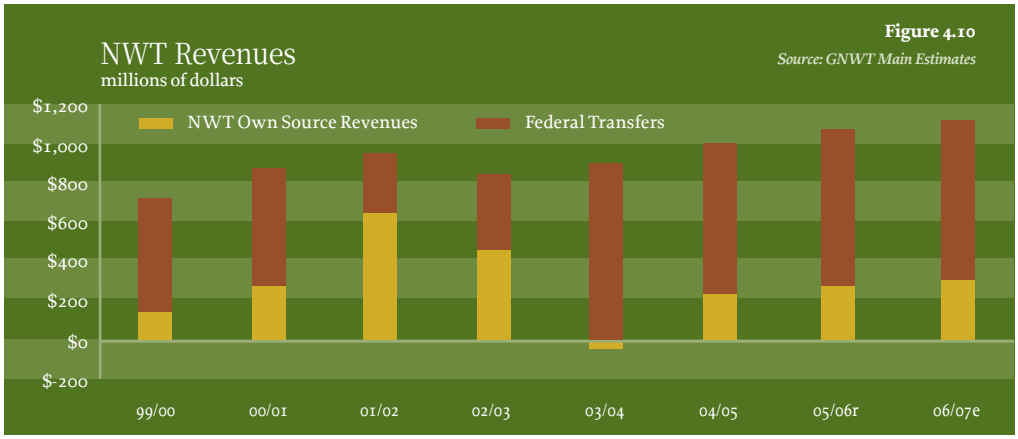


The higher costs in the territories for labour, transportation, construction, and utilities have resulted in higher per unit costs for providing government services. The small population is thinly dispersed over vast areas, so there are fewer opportunities for economies of scale in the provision of services. Residents must travel south for many services such as specialty medical treatment and postsecondary education. The smaller communities have very small tax bases and depend on the territorial governments to provide basic municipal infrastructure.

Figure 4.9 compares own source revenues as a percentage of GDP. Despite higher tax rates, the NWT's revenues are only 8 percent of GDP, compared to about 16 percent for Alberta. This suggests why, under current arrangements, the territories remain financially dependent even when their economies are booming. Oil and natural gas exports are boosting the GDP, yet there is relatively little tax-generating employment in the North. Mining creates more ongoing employment, but a large proportion of mine workers are rotational and non-resident workers who spend their incomes and pay their taxes in the south. The NWT keeps none of the royalties from these resources.



For all three territories, the modest contributions that own source revenues make to total revenues mean that raising tax rates would have proportionately less impact. For example, Ontario or Quebec could realize a 1 percent increase in total revenues with an income tax rate increase of about 3 percent; Nunavut would require a 30 percent rate increase.



Own source revenues for Nunavut and Yukon have been relatively stable; however, NWT revenues show significant volatility, because of recent development of resources and fluctuations in corporate income tax. As shown in Figure 4.10, these effects have been smoothed by federal transfers under the TFF.

Territorial Formula Financing Arrangements

Before 1985 the territorial governments were funded in much the same way as federal government departments. Budgets were developed for each program and submitted for approval in federal Estimates (under the Department of Indian Affairs and Northern Development). Funding was provided each year to make up the "deficit" between this approved budget and actual own source revenues.

Territorial Formula Financing (TFF) was introduced in 1985 to provide the territories with greater certainty, flexibility, and accountability. The financial assumption underlying the TFF was that provision of public services is considerably more expensive in the territories than they are in the provinces. The formula provided an unconditional annual grant to fill the gap between own source revenue capacity and the Gross Expenditure Base (GEB) for each territory.

The GEB was adjusted each year based on relative changes in provincial and local government expenditures, as well as population changes. An arbitrary 5 percent base reduction was imposed in 1995. Eligible revenues included most territorial taxes and other own source revenues, as well as certain federal transfers. These were adjusted to reflect relative tax effort and an Economic Development Incentive. Table 4.1 shows the GEB, eligible revenues, and resulting grant for each territory in 2003–04.

Territorial Formula Financing 2003/04 (millions) **Table 4.1**

	Nunavut	NWT	Yukon
Gross Expenditure Base	764	774	512
Less **eligible revenues**	72	148	78
Equals **TFF Grant**	692	626	434

Source: Joint Submission to the Expert Panel on Equalization and Territorial Formula Financing – Nunavut, NWT, and Yukon (June 29, 2005)

The New Framework

In October 2004 the federal government announced a New Framework for Equalization and TFF. The negotiated TFF agreements were suspended and replaced by federally legislated grants.

For 2004–05 and 2005–06, payments are fixed for each of the three territories. The amounts for these years are based on (but higher than) previous years' grants under the former TFF (Table 4.2). For the following eight years, total payments to the three territories are to grow at 3.5 percent. Each territory's share of this total remains to be determined.

For 2005–06 the per capita grants are about $26,600 for Nunavut, $16,600 for the NWT, and $15,700 for Yukon. Under the New Framework, changes to provincial-local spending, own source revenues, population, and tax effort will not affect the total grant to the territories, although they may be factors in the allocation among them after 2005–06.

Transfers under the New Framework (millions) **Table 4.2**

	Federal Grants				
Year	**Nunavut**	**NWT**	**Yukon**	**Total**	
2003–04	692	626	434	1,752	TFF
2004-05	756	678	466	1,900	New Framework
2005-06	799	714	487	2,000	New Framework
2006-07	Allocation to be determined			2,070	Increase by 3.5%/yr
2007-08	Allocation to be determined			2,142	

Source: Finance Canada

Challenges and Recommendations

The Panel's recommendations on territorial fiscal arrangements have two principal objectives: first, to ensure that the territories have sufficient revenues to provide citizens with reasonably comparable levels of public services; and second, to provide the territories with the tools and incentives to expand their economies and tax capacities and reduce their long-term dependence on federal transfers.

The New Framework prescribes a fixed territorial pool and fixed escalators that do not respond to fluctuations in the territories' population growth, costs, or own source revenues. Owing to limited and more volatile own source revenue capacities, we can no longer ensure that territorial governments will have sufficient revenues to provide essential public services to their people.

A return to a formula based on expenditure need would restore the responsiveness of federal transfers. The formula must include an adequate base that takes into account obligations to implement Aboriginal rights agreements. It must also include appropriate escalators and fiscal incentives for economic development.

Recommendation 4.1

The Panel recommends that the New Framework for financing territorial governments be replaced by a formula-based financing mechanism based on expenditure need and eligible revenue of each territory, as was the case under the previous Territorial Formula Financing.

This new formula should include the following features:

- Eligible revenues should be simplified from the previous TFF, eliminating the Tax Effort Adjustment Factor and including only the most significant tax and revenue sources.
- The initial GEBs should be based on the funding levels established for 2006–07. Future GEB adjustments should include those indicated by adequacy review, program transfers, and new obligations stemming from Aboriginal Rights agreements.
- Escalators should be linked for each territory to per capita territorial expenditure changes and relative population growth.
- Volume growth in eligible revenues should be subject to an appropriate incentive. However, a decline in eligible revenues should not result in a corresponding penalty.

Natural resources represent the greatest potential for economic growth for all three territories. The orderly and responsible development of these resources requires that decisions be made in the North and that Northerners realize a fair share of the benefits. Development requires investment in infrastructure, geoscience, training, and environmental protection. It also requires investment in (a) preparing Northerners to participate in the opportunities, and (b) mitigating the resulting pressures on infrastructure and social programs.

Revenues from resource development are more than adequate to meet these needs. Development in the NWT alone promises hundreds of millions of dollars per year in new revenues, including federal and territorial income taxes and royalties. However, under current arrangements in the NWT and Nunavut, the federal government will net more than 95 cents of each new dollar, while the territorial governments keep less than 5 cents.

Yukon is the only territory to have negotiated the devolution of management (not ownership) of non-renewable resources. Under the mineral agreement, the Yukon keeps only the first $3 million in royalties, with any amount above this offset by 100 percent. For oil and natural gas, the first $3 million are also excluded; amounts over this are offset on a sliding scale, increasing from 60 percent. At current levels of production in the Yukon, the stakes are not high. However, with significant new development in Yukon (similar to that in the NWT), this formula would result in a net fiscal benefit in the range of only eight to ten cents on the dollar. The Panel believes that this agreement should be reopened.

Despite almost two decades of federal political commitment to concluding devolution, the issue of a fair share of resource revenues remains unresolved between the NWT and the federal government. As leader of the Conservative Party, the Hon. Stephen Harper affirmed his unequivocal agreement with the principle that "northerners should be the primary beneficiaries of the revenues generated by resource development in the Northwest Territories similar to other jurisdictions in Canada".[1]

The Panel believes that it is in the national interest to ensure that Northerners are the primary decision makers and the principal beneficiaries of northern resource development.

Recommendation 4.2

The Panel recommends that the Government of Canada and the territorial governments expedite negotiations to conclude agreements where territories assume province-like authority and responsibility for management of lands and natural resources and become the principal beneficiaries of revenues and royalties derived from these resources. Arrangements must take into account Aboriginal rights, needs, and participation.

Territorial governments receive specific program transfers outside territorial financing arrangements, such as the Canada Health Transfer (CHT) and the Canada Social Transfer (CST). To be truly national, such programs must be designed to take into account the special needs and circumstances of the territories. Often they do not.

Per capita program transfers do not adequately address the financial needs of the territories. Some transfers are included as eligible revenues and offset in grants. Some transfers are capped, while corresponding territorial expenditure obligations are not. In cost-shared programs, the territories are less able to raise their share from limited revenue bases.

1 Letter from Stephen Harper to Premier Joe Handley, January 6 2006 in response from a letter from Handley to Harper, December 13, 2005.

Recommendation 4.3

The Panel recommends that the special needs and circumstances of the territories be provided for in such specific federal program transfers.

Specifically, the Panel believes that:

- Funding for territories should be based on actual demand and cost rather than on per capita allocations.
- The terms of cost-shared programs should recognize the limited revenue capacities of territorial governments.
- All such program funding should be excluded from TFF calculations.

All three territories lag behind the provinces in the development of infrastructure and in most social and economic indicators. Nunavut, created less than a decade ago, faces extraordinary deficits in housing, health status, education, transportation, and municipal infrastructure.

A transitional implementation fund for start-up of the new government along with the initial expenditure base was negotiated before Nunavut came into existence, but with no solid evidence or history to determine its adequacy. It is doubtful that the current fiscal arrangements in Nunavut are sufficient to maintain even the status quo. Accordingly, it is particularly important to review this expenditure base.

It is clear to the Panel that the long-term development of Nunavut will require a considerable catch-up effort to provide the most basic social and economic infrastructure. Strategic investments, outside the TFF, will be required to help Nunavut and its people begin to narrow the gap and reduce dependence on the federal government over the long term.

Recommendation 4.4

The Panel recommends that Nunavut receive extraordinary investment in the areas of housing, infrastructure, and economic and social development.

Chapter Five

Addressing Vertical Fiscal Imbalance

The Panel has concluded that there is currently a vertical fiscal imbalance in the Canadian federation, that it is in favour of the federal government, and that it is of sufficient magnitude to warrant the attention of citizens and policy makers alike. It emerged in the latter part of the 1990s and is associated with the dramatic improvement in the Government of Canada's financial position. This improvement was due to a substantial degree to the drastic cuts in fiscal transfers to the provinces, which the Government of Canada imposed earlier in the decade. It is associated as well with the inexorable expenditure pressures the provinces and territories are experiencing, particularly in the area of health care, pressures that are greater than any facing the Government of Canada in its areas of expenditure responsibility.

The Government of Canada's Return to Fiscal Health

Supported by a buoyant economy, federal policy succeeded beyond expectations in turning federal finances around, definitively and quickly. Remarkably, three years after then Finance Minister Paul Martin's critical February 1995 budget, the federal government had wiped out its deficit. With a $2.1 billion surplus in 1997–98, the Government of Canada returned to a surplus position for the first time in 28 years, and it has not looked back since. Just over one-third of the $45.5 billion turnaround came from cuts to program spending, including transfers to the provinces; the balance came from revenues generated by economic growth. Between fiscal years 1997–98 and 2004–05, the federal government accumulated more than $60 billion in surpluses. Federal program spending in 2000–01 ($118.7 billion) was at virtually the same level as in 1992–93 ($117.9 billion), while federal revenues increased by 50 percent over the same period, leaving the federal government with very substantial fiscal room to manoeuvre.

Serious progress has been made in reducing the Government of Canada's accumulated debt. By 2004–05, it had dropped by $54.3 billion from its peak of $609 billion in 1996–97. With the buoyant growth of the Canadian economy, that has meant that the federal government's debt has declined from 72.6 percent to 38.7 percent as a proportion of GDP during the same period.[1]

But what is perhaps most striking to Canadians in recent years is the dramatic increase in new federal spending initiatives and commitments. Federal program spending increased by $44 billion between 2001–02 and 2004–05. A substantial portion of that has been spent in areas of provincial jurisdiction, either through transfers to provinces or through direct spending sent to individuals or institutions. The three largest items have been in the areas of health, postsecondary education, and children's services.

Spending the Federal Surplus, 1997-2005: Health, Postsecondary Education, and Children

Health

From 1995 to 1999, health funding was provided through the CHST. Starting in 1999, federal funding for health began a significant process of change.

First, the 1999 federal budget made what was then a one-time commitment to health care: $11.5 billion over five years would be added to the health component of the CHST. This was the first time since the establishment of Medicare that federal funding had been explicitly assigned to this specific policy area. This was done by committing money from future budgets and by allocating entrusted funds from the surplus from the 1998-99 fiscal year.

The second development occurred when the 2000 budget added another supplement of $2.5 billion over a four-year period for the purposes of health care and postsecondary education.

Then a third step was taken when, as part of the agreement reached by the first ministers in September 2000, two health funds were created; the federal Medical Equipment Fund and the Health Transition Fund were established at $1 billion and $800 million respectively. Under the agreement, the provinces were free to use the money as they wished in the general areas of new medical equipment and primary care.

Fourth, in February 2003 the federal government and the provinces reached the Health Care Renewal Accord. The key aspects of the Accord were:

- The division of the CHST into a Canada Health Transfer (CHT) and a Canada Social Transfer (CST) as of 2004–05. The breakdown between the two was determined by the share of health spending as a proportion of total

1 For a full discussion, see Thomas J. Courchene, *Accountability and Federalism in the Era of Federal Surpluses: The Paul Martin Legacy*, Part II, IRPP Working Paper Series, no. 2006-01. Montreal, Quebec.

provincial social spending. The share of provincial health spending in total provincial spending in the social-policy field was estimated at 62 percent. In the 2003 federal budget, this percentage was used as the guide to divide the CHST into two separate components in 2004–05. The second part of the transfer was to be devoted to postsecondary education and social assistance and services (including early childhood education).

- The creation of a Health Reform Fund targeted at three specific policy objectives. The first objective was primary health care, with the intent of increasing the use of multidisciplinary teams and with the specific goal of 50 percent coverage of the population on a 24/7 basis by 2011. The second objective was to improve home care – in particular, acute care for mental health and end-of-life care. The third objective was to provide catastrophic drug care, to be implemented by the end of 2005–06.

- An additional payment of up to $2 billion in 2003-04, conditional on the existence of a surplus above the normal Contingency Reserve ($3 billion), with this surplus to be established in January 2004. This was the object of much public discussion in the fall of 2003; some feared that this payment would not be made. The federal government confirmed in February 2004 that this $2 billion would in fact be paid,[2] even if the Contingency Reserve requirement was not respected; the provinces, which in most cases had already booked these funds in their revenues, were relieved. The actual surplus at $9.1 billion that year was more than was necessary to make the payment.[3]

Fifth and finally, in September 2004 a new accord, A Ten Year Plan to Strengthen Health Care, was reached. Its goals are the same as the 2003 Accord. However, there is:

- an explicit recognition of the "Romanow gap" of $1 billion in each of 2004-05 and 2005–06, adding $2 billion to CHT base funding;

- an additional $500 million in 2005-06 for home care and catastrophic drug coverage, to be added to CHT base funding; and

- the establishment of a base of $19 billion for the CHT, to be escalated by 6 percent a year. This brings back the use of an escalator that was present in the EPF transfers but suspended in 1990.[4]

The 2004 Accord reiterates the objectives of the 2003 Accord, such as improvements in access to primary care and home care. In addition, it contains an explicit financial commitment to reduce waiting times for specific services.

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2 See http://www.fin.gc.ca/news04/04-010e.html .

3 Government of Canada Records Seventh Consecutive Surplus at http://www.fin.gc.ca/news04/04-065e.html.

4 The EPF escalator was modified throughout the 1980s.

It should be readily apparent that the Government of Canada has been engaged in a substantial reinvestment in the health sector since the imposition of the cuts in federal transfers in the mid-1990s. Its contribution has been clarified as a result of the creation of a dedicated transfer, the Canada Health Transfer. In 2005–06, federal cash transfers to the provinces under CHT stood at $19 billion. In addition, the Government of Canada has introduced some much-needed stability to the system by committing itself to a 6 percent annual escalator in the health transfer until 2013–14, bringing the total amount at the end of the period to $30.3 billion. While provinces have expressed some concern about the escalator being lower than the expected rate of increase in health costs, the federal government's commitment to a predictable, multiyear financing framework for health is very welcome.

Postsecondary Education

Federal support for postsecondary education since 1997–98 has been provided in three ways.

The first is through federal-provincial transfers. Until the introduction of the CST in 2004-05, funding for postsecondary education (PSE) flowed through the CHST, as did federal support for health and social assistance. Since it was a consolidated transfer, the proportion of federal support for PSE was not explicit, although the working assumption, based on the proportionate allocations rooted in the EPF transfer in 1977–78, was that the PSE portion was about 25 percent.

When the CHST was split into two component parts, spending on both postsecondary education and social programs suffered in order to increase spending on health care. Health care spending has systematically crowded out spending on postsecondary education and social assistance.

The federal government also supported postsecondary education through direct transfers to the universities. Building on the Government of Canada's historic involvement in the funding of academic research, the 2000 federal budget created the Canada Research Chairs Program at a cost of $900 million. The program provides the funding for some salaries and research costs of university chairs across Canada. One of the goals of the program is to attract and keep top researchers in Canada.

Finally, the federal government established foundations that could make grants to postsecondary institutions. The foundations are at arm's length from the federal government; nevertheless, they are very much creatures of the federal government because of their funding and governance arrangements. Since 1996–1997, the federal government has transferred approximately $8 billion to nine foundations, of which almost 80 percent goes to foundations in the area of postsecondary education, providing either research support or scholarships.

The Canada Foundation for Innovation (CFI) was created to make strategic infrastructure investments for Canadian research. Effectively, the CFI acts as a cost-sharing program for postsecondary institutions, research hospitals, and other non-profit research organizations in the areas of science, engineering, health, and the

environment. The CFI provides a maximum of 40 percent of the required funds for a project. The Canada Millennium Scholarship Foundation (CMSF), for the 2000-10 period, provides funds for students via existing provincial student aid programs.

Federal support of postsecondary education, then, is composed in part of federal transfers to provincial governments to assist them in the financing of PSE. This support directly addresses the issue of fiscal imbalance. Then there is the direct spending – loans, grants, scholarships, research funding, tax measures – some of it coming from federal foundations, that goes to individuals and institutions. The second category is now more important than the first. Indeed, in recent years federal direct spending in postsecondary education has been more than twice the amount of the cash portion of the CST transfer.

Direct federal spending obviously supports higher education and needs to be factored into any discussion of fiscal imbalance. However, since these financial resources are not flowing directly to provincial governments, their impact on federal-provincial fiscal imbalance is more complex than is the impact of straightforward federal-provincial transfers.

First, it cannot be assumed that all such direct spending helps provinces maintain the postsecondary systems that lie within their responsibility. Some does and some does not. A grant to support the overhead or the indirect costs associated with research clearly does provide infrastructure assistance to the academic institution receiving the grant, and relieves the pressure on the provincial government. But a grant to support the direct expenditures associated with research – the support of the postdoctoral students, the hiring of research assistants, the purchase of new equipment, and so on – does not offer similar relief; in fact, it increases the infrastructure pressure on the academic institution and indirectly on the provincial government. New staff need offices and research space, labs must be built, equipment must be housed and maintained – and all of these additional expenses come with a direct-cost research grant.

What are the additional costs to the provinces of federal direct spending on postsecondary education? One-quarter, one-third, one-half of the $4.7 billion? This is difficult to quantify, but certainly some of the federal direct spending has created institutional costs and increased rather than relieved the fiscal pressure on provincial governments. All of this direct federal spending is term-limited; none of it is permanent or vested in endowments. Provinces are understandably uneasy about many of these federal initiatives, since they must meet the demand once expectations have been raised. Provinces are consequently bearing almost all the risk.

Second, it is difficult for provincial governments, which have primary management responsibility for the postsecondary system, to cope with abrupt federal interventions in higher education that are frequently the subject of little prior consultation and no significant federal-provincial negotiation. In some areas of higher education, such as research support, the Government of Canada has played for years a significant and beneficial role, and federal and provincial programs have become reasonably well aligned. But in others, this is not the case. The Canada Millennium Scholarship

Foundation, which expended $300 million in 2003–04, is an example. It appears to have been conceived more with an eye to giving the federal government greater visibility than with a view to addressing in the most efficient way a concrete need in the system. It was announced suddenly with much fanfare but no prior discussion with provincial governments, and no serious consideration was given in advance as to how its form of student aid would be fitted into the already existing patterns of student assistance across the country. It took months of discussions with the provinces for arrangements to be worked out so that the program could go forward. Any objective assessment of the millennium scholarship process would conclude that much time, money, and energy was wasted to achieve a goal that could have been reached much more efficiently, had the provinces been consulted at the beginning. It is this kind of experience that explains why provincial political leaders want a better, rules-based process to support the federal government's exercise of its spending power in areas of provincial jurisdiction.

Third, direct federal expenditures in postsecondary education often needlessly complicate policy making, and create a patchwork of programs and initiatives that waste resources and frustrate students, faculty, and public servants. What is more, they do little to enhance the values of efficiency, transparency, and simplicity that should shape public policy making and program delivery. Federalism is by its nature a complex multigovernance structure; its leaders should be trying to reduce rather than magnify complexity.

This discussion of postsecondary education highlights an important gap. There is a deficit in contributions from the federal to the provincial governments in support of higher education, even after taking into account the impact of the Government of Canada's direct PSE payments to individuals and institutions. The federal government rightly has emphasized the importance of education in improving productivity and competitiveness in the global economy. It has spent significantly in the past several years on research and development, on innovation, and on improving scientific infrastructure in Canada. This kind of spending speaks more to the federal government's overall responsibility for the health of the economy. The Panel feels strongly that this spending – as important and necessary as it is – should be in addition to, not a substitute for, transfers to provinces to support postsecondary education.

Children

The National Children's Agenda (NCA) was announced as part of the 1997 Speech from the Throne. The National Child Care Benefit was the first program put in place to move the new agenda forward. The National Child Care Benefit is not the usual federal-provincial conditional transfer; rather, it is a federal transfer to individuals that allows the provinces to redirect funds to targeted needs in this field.

The federal government also made conditional transfers to provinces as part of this new agenda. In September 2000 the federal government reached agreement with nine of the provinces and the three territories. This agreement was negotiated at the same time as the September 2000 Health Accord. The Early Childhood Development (ECD) agreement provides for a federal-provincial conditional transfer to increase and

expand provincial programs for young children and their families. As part of the initiative the federal government agreed to add $2.2 billion to the CHST between 2001–02 and 2005–06.[5] The federal government made special, asymmetrical arrangements for Quebec.

In the 2003 federal budget, an additional amount of $900 million for 2003–08 was set aside for early learning and child care (ELCC); the federal budget of 2004 added $75 million per year for 2004–05 and 2005–06. In November 2004, governments, with the exception of Quebec, agreed on shared principles to guide the development of a new national system of early learning and child care. In the 2005 budget, an amount of $700 million was made available to provinces and territories on a per capita basis.[6] Following the 2006 election, the new federal government announced that it intended to cancel the agreements that had been reached with the provinces and substitute direct transfers to families with children under six years of age.

This review of federal spending in areas of provincial jurisdiction reveals a number of deficiencies directly related to governance. Too frequently, federal initiatives occur with virtually no warning. They are often advanced with only minimal discussion with provincial governments, and their impact on existing provincial programs and activities is sometimes disruptive. There has also been a gradual increase in the conditionality of federal transfers. It is not difficult to see why for decades, provincial governments have tried to impose a degree of control on the exercise of the federal spending power in areas of provincial jurisdiction. We return to this subject in *Chapter 7*.

The Panel also considered another policy option, which we did not have enough time or resources to develop in the Report, namely, the uploading of provincial responsibilities to the federal government. If the Government of Canada were to deliver directly programs that would otherwise be the responsibility of the provincial and territorial governments, this would also reduce vertical fiscal imbalance.

The federal government is experienced in delivering certain types of direct transfer programs, particularly income support programs, such as employment insurance. It might be possible for the provinces and the territories to upload to the Government of Canada social programs that relate directly to income support, thereby relieving some of their fiscal pressures. Uploading is a sensitive issue, both politically, and – potentially – constitutionally, but it might well provide some important benefits. It could permit a consolidation of currently dispersed federal-provincial/territorial program activity and their rationalization and integration into a coherent whole; it could facilitate transparency and accountability by strengthening the relationship between the particular expenditure programs and revenue generation; and it could offer the federal government increased visibility and credit for its activities. On the other hand, any consideration of uploading must take into account the fact that the Canadian constitution does not permit the delegation of legislative powers from one order of government to the other. Within this constraint, however, uploading of social programs is one among several options that merit future consideration in order better to align responsibilities and revenues between the orders of government.

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5 An open-ended annual commitment of $500 million is included in the Canada Social Transfer. As part of the 2003 budget, this agreement has been extended past 2005-2006.

6 http://www.fin.gc.ca/budget05/bp/bpc4ae.htm#early.

Another potentially interesting option leading to the reduction in the vertical fiscal imbalance would be the harmonization, by those provinces that have not already done so, of their provincial sales tax with the GST. The wider base would in itself produce added revenues for the participating provinces. The Panel is aware that this idea has come up from time to time but we have not had the time or resources to examine it in all of its implications. However the Panel does consider this worthy of study by the provincial and federal governments together as they think about the future fiscal architecture of Canada.

Federal, Provincial, and Territorial Fiscal Prospects

To assist in assessing the extent of fiscal imbalance in Canada, the Panel commissioned the Conference Board of Canada to project the federal and provincial/territorial public accounts to fiscal year 2024–25.[7] The main objective of the Conference Board's analysis for the Panel was to evaluate the degree of fiscal latitude available to governments to continue to invest in health, education, and other priorities, given the demographic changes and economic outlook over the next twenty years. More precisely, it was to measure the financial health not just of both orders of government, but of each of the provinces and the three territories combined, and to assess their respective fiscal pressures over the short and long term.

The Conference Board's analysis addressed the question of what the fiscal prospects would be for the federal, provincial, and territorial governments in the absence of any significant changes in policy out to 2024–25. The status quo assumption with respect to budgetary and fiscal policy means that current revenue and expenditure patterns are maintained over the long term.

Satellite models for public health care and education spending were also developed to assess the principal cost drivers in each of these key expenditure responsibilities of provincial/territorial governments and determine expected spending growth in the future.

Great care was exercised in choosing all of the underlying assumptions required for this analysis to ensure they were realistic and prudent. The fiscal prospects presented below are the most probable under the status quo assumption, and in light of the information available at the time the analysis took place. Federal and provincial/territorial budget estimates for the current fiscal year 2005–06 were used as starting points, followed by model-driven projections over the rest of the forecast period.

Federal Fiscal Prospects

The Conference Board's analysis shows that the federal government's overall financial position will remain healthy over the next twenty years. Federal government surpluses are forecast to increase from $10.2 billion in 2005–06 to $23.7 billion in 2024–25 under

7 This project builds on earlier work that the Conference Board did for the Council of the Federation. The objective of this study was to quantify the fiscal prospects over the next twenty years for the federal government and each of the provinces and the three territories combined in order to forecast the fiscal status of each jurisdiction. For the purposes of these forecasts, the territorial data were aggregated because of data limitations.

the important assumption that only the contingency reserve of $3 billion will be used to pay down debt in every year. The annual surpluses in excess of this contingency reserve are assumed to be available for new spending or tax initiatives.

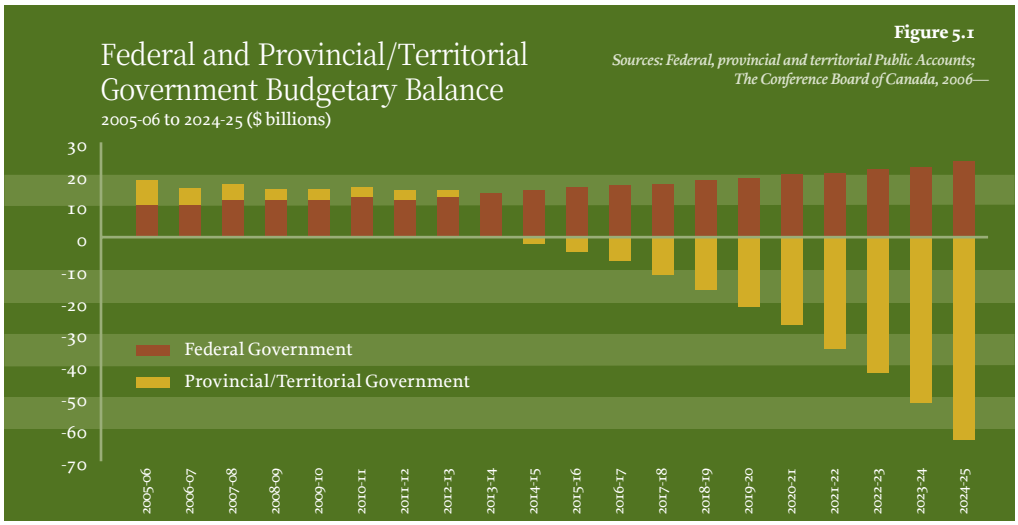
An improvement in the operating balance is largely responsible for the growing budgetary surplus at the federal level. Budgetary revenues are forecast to post an average annual compound growth rate of 3.9 percent over the forecast horizon, roughly in line with growth in nominal GDP. Excluding debt service charges, federal program spending is expected to increase by 4.2 percent per year on average. Even though the growth in program spending is slightly higher than that of revenues, the operating balance still increases by $14.5 billion from fiscal years 2005–06 to 2024–25. Total budgetary expenditures are expected to increase by 3.7 percent per year on average over the forecast period, reflecting little growth in public debt costs.

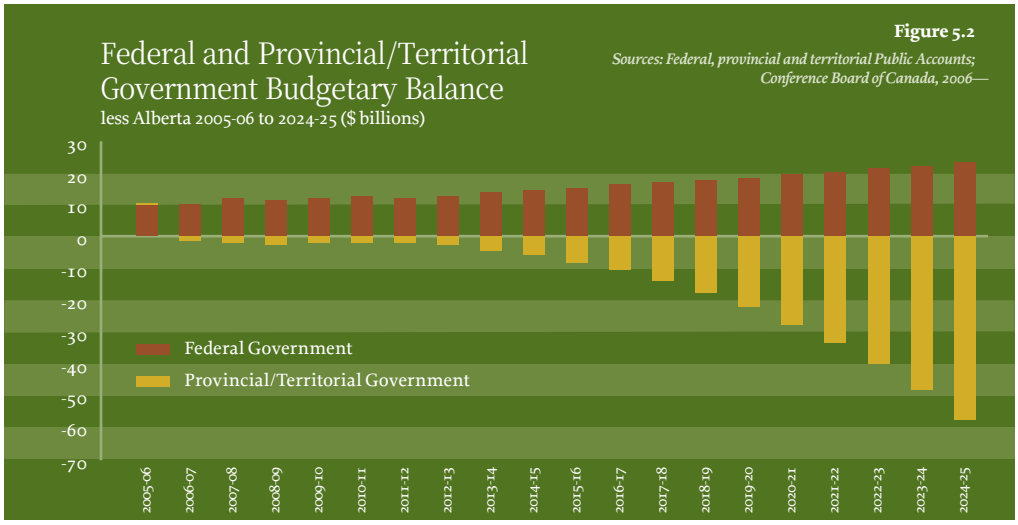
Federal government debt measured as the accumulated deficit as a percentage of GDP falls from 36.1 percent in 2005-06 to 14.8 percent in 2024–25, surpassing the federal government's target of 25 percent. Although interest bearing debt is assumed to be declining by $3 billion per year, federal public debt charges actually increase slightly because of rising interest rates.

If, however, the entire budgetary surplus – as opposed to only $3 billion of the surplus in each year – were to be used exclusively for debt reduction and not allocated to any new spending or tax initiatives, the federal government would post a surplus of $48.1 billion in 2024–25. The decline in public debt charges as a result of this debt reduction – from $34.3 billion in 2005–06 to $10.9 billion in 2024–25 – is responsible for this higher budgetary surplus. This is known as the "virtuous circle" of debt reduction, in which surpluses increase over time as debt is reduced, thus reducing interest costs and generating ever higher surpluses. Under this assumption, the federal debt falls from $489.6 billion in 2005–06 to only $9.5 billion in 2024–25. This helps illustrate the wide fiscal latitude the federal government enjoys and will enjoy in the future.

Provincial/Territorial Fiscal Prospects

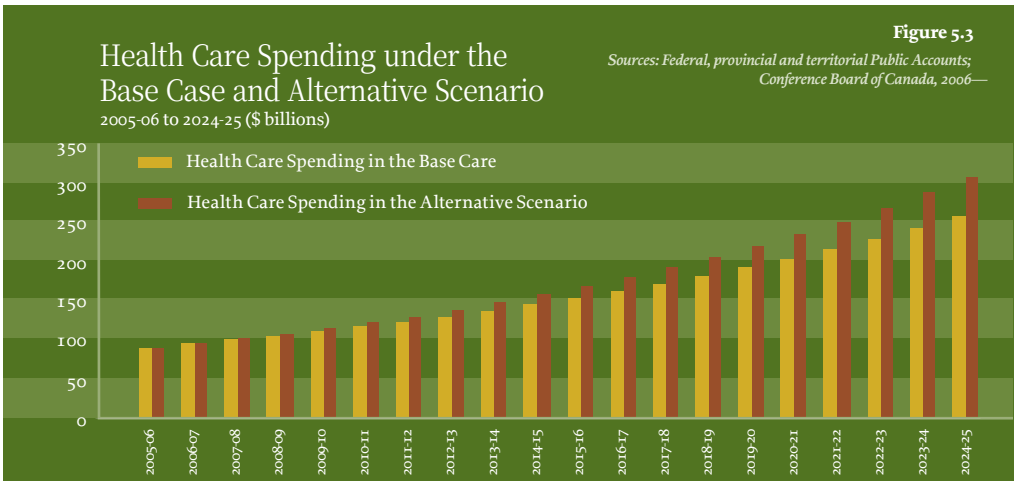
By contrast, the fiscal prospects at the provincial/territorial level look much less promising when compared to those of the federal government. Starting in 2005-06 with a surplus of $7.8 billion, the overall fiscal prospects for the provinces and territories are forecast to worsen each year, with a small deficit appearing in fiscal year 2013–14, growing to a deficit of $63.5 billion in fiscal year 2024–25. This compares to a projected surplus of $23.7 billion at the federal level (see Figure 5.1). However, Alberta's unique financial situation caused by robust oil and natural gas revenues and increasing investment income masks an even tighter fiscal reality for the rest of the provinces and territories (see Figure 5.2).



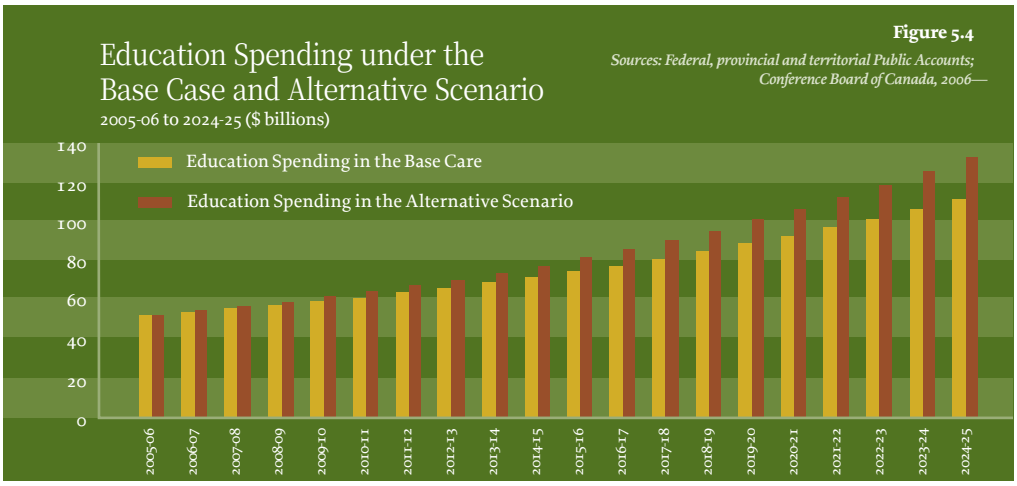


On average, provincial and territorial government revenues are forecast to grow by 3.8 percent per year between 2005–06 and 2024–25, roughly in line with growth in nominal GDP in Canada. This compares with 4.7 percent growth in total program spending over the same period. Given the outlook for revenues and expenditures the provincial and territorial governments will be unable to balance their books by 2013–14.

For all the provinces and territories, total health care expenditures are expected to grow by 5.7 percent per year on average over the forecast period 2005–06 to 2024–25 (see Figure 5.3 and Table 5.1). This compound growth rate is significantly lower than the average annual rate of increase of 7.5 percent recorded in public health care spending over the recent period 2000–01 to 2004–05, and is therefore quite conservative. Based on this relatively modest compound rate of 5.7 percent, health care spending will rise nonetheless to represent 52.6 percent of provincial revenues in 2024–25, compared to 37.0 percent in 2005–06 (see Table 5.2). This reinforces the enormous cost burden to provinces and territories of funding increases in health care services. Principal cost drivers include Canada's aging and growing population, as well as a higher inflation rate for health care costs compared to the costs of other public services.



Education spending, meanwhile, is forecast to rise from its current 21.5 percent of revenues to 22.8 percent in fiscal year 2024-25 (Figure 5.4). This is consistent with an average annual growth rate for total provincial education spending of 4.1 percent over the forecast period. Average annual growth for elementary and secondary school spending is forecast at 3.8 percent per year and postsecondary spending is forecast at 4.5 percent per year over the forecast period. Demographic changes are placing significant pressure on the health system; however, the opposite is true in the education system, especially at the elementary and secondary levels.



The fiscal projections generated by the Conference Board demonstrate the sensitivity and vulnerability of provincial and territorial balances to the expenditure pressures associated with health care and education.

Projected Provincial/Territorial Health Care and Education Spending and Budgetary Balances Under Base Case and High Growth Scenarios ($ billions)

Table 5.1

	2005-06	Base Case 2024-25 (growth rate)	Base Case plus 1% Scenario 2024-25 (growth rate)
Health Care	89.7	256.8 (5.7%)	307.1 (6.6%)
Education	52.1	111.5 (4.1%)	132.6 (5.0%)
Budgetary Balance	7.8	-63.5	-200.1

Sources: Federal, provincial and territorial Public Accounts; Conference Board of Canada, 2006.

Note: For each variable, the first line represents the level in billions of dollars; the numbers between brackets in the second line represent average annual compound growth rates over the period in consideration.

Projected Provincial/Territorial Health Care and Education Spending as a Percentage of Government Revenues

Table 5.2

	As a Share of Revenues in Base Case (percent)		As a Share of Revenues in Base Case plus 1% Scenario (percent)	
	2005-06	2024-25	2005-06	2024-25
Health Care	37.0	52.6	37.0	64.0
Education	21.5	22.8	21.5	27.6
Health Care and Education Combined	58.5	75.4	58.5	91.6

Sources: Federal, provincial and territorial Public Accounts; Conference Board of Canada, 2006.

If costs in those fields were to increase by only 1 percent over our forecast, total provincial/territorial deficits would reach $200.1 billion in fiscal year 2024–25 rather than the base case level of $63.5 billion. As shown in Table 5.2, under this high-growth scenario where spending increases by only 1 percent, health care and education spending combined would represent 91.6 percent of total provincial/territorial revenues by the end of the forecast period and 76.2 percent of the total provincial/territorial program spending.

While governments will in all likelihood alter their policies and programs in ways that these scenarios do not capture, the picture is still arresting. First, it tells us that the federal government is almost certainly going to be in a significantly better fiscal position than almost all the provinces. Second, it shows that the fiscal position of the federal government is sufficiently secure that it could, if it chose, make long-term commitments to address the federal-provincial/territorial fiscal imbalance. Finally, it reveals just how dependent the fiscal situation of the provinces is on their successful

containment of costs in the health and education sectors. Even though both orders of government have access to growing revenues, provincial/territorial expenditures are forecast to grow at a much faster rate.

Vertical Fiscal Imbalance: Summary of the Panel's Position

The Panel makes the following summary observations about vertical fiscal imbalance:

1. Vertical fiscal imbalance as a contemporary phenomenon emerged in the mid-1990s, primarily as a result of the federal government's drastic cost-cutting measures.

2. When the Government of Canada returned to fiscal health, it did not put back into the federal-provincial transfer system what it had taken out, and some of what it put back was in a form designed more to give the federal government visibility and credit than to alleviate the fiscal pressures facing provincial governments.

3. Even the most conservative forecast of the fiscal prospects of the two orders of government, from 2005–06 to 2024–25, shows the federal government with substantial surpluses, while the governments of the provinces and territories in deficit.

4. The federal government has been very active in recent years, spending in areas of provincial jurisdiction. That is, on its face, clear evidence of a fiscal imbalance; if there were no imbalance, why would the federal government persist in spending in fields of provincial responsibility?

5. Raising provincial and territorial taxes substantially to increase revenues is not a serious option, because it would sharply increase horizontal fiscal imbalance, and because national, continental, and global tax competition imposes practical constraints on tax increases.

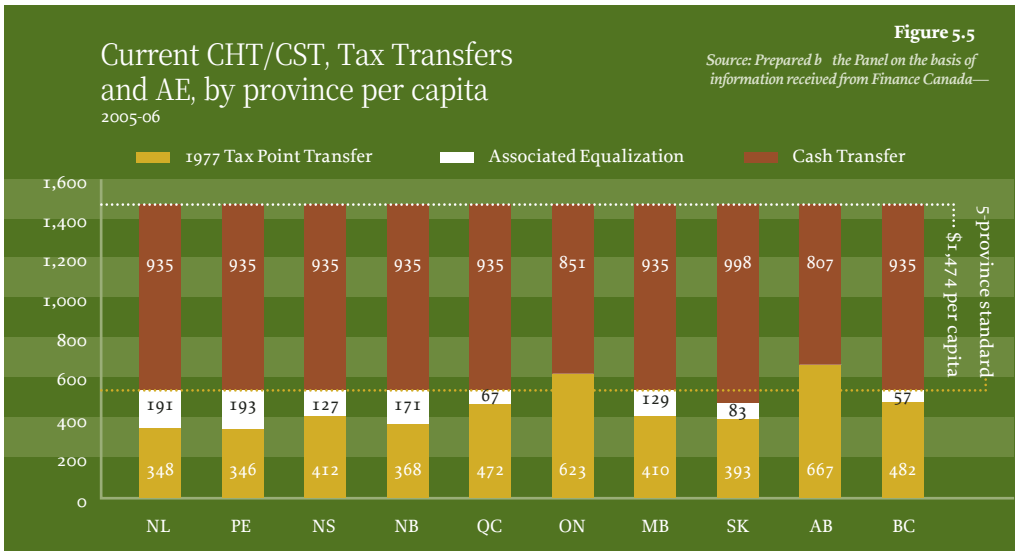
6. Equally, cutting services substantially is not a realistic alternative. All provinces are struggling to contain costs, but the costs of health care are gradually crowding out all other provincial expenditure fields, including education, training, research, cities, and infrastructure, which are crucial to maintaining a competitive economy.

The Panel believes that the Canadian federation is at an important turning point. If long-term, stable fiscal arrangements can be put in place, which are consistent with the respective revenue and expenditure realities the two orders of government face, Canada and Canadians will be well positioned for the challenges that lie ahead. If squabbling, ad hoc tinkering, and short-term thinking continue, our political leaders will come back to these issues again and again in the coming years, dissipating our collective energies and undermining Canadians' confidence in the capacity of their leaders to manage their country's finances in a responsible, transparent, and fair way.

The recommendations we make will, in our view, help put in place a responsible, transparent, and fair set of fiscal arrangements. These arrangements are the first steps towards building a much stronger foundation for Canada's fiscal architecture.

Recommendations

We turn now to the Panel's recommendations designed to address the federation's vertical fiscal imbalance. In our view, the following recommendations will make the transfer system fairer, more transparent, more flexible, and more adequate, taking into account the revenue position of the federal government and the expenditure needs of the provinces. Figure 5.5 shows the actual CHT/CST entitlements per capita for fiscal year 2005-06. It illustrates the three main components of the CHT/CST transfers to the provinces, as represented by the federal government: tax points, associated equalization, and a cash component.



First the value of total health and social transfers is established in the federal budget. In the 2005 budget plan, the amount was $47.9 billion. This amount is then divided by the Canadian population of 32.6 million to arrive at the per capita amount of $1,474. In the federal government's view, all provinces then receive $1,474 per capita, comprising the current value of the tax points transferred in 1977, associated equalization, and cash.

What makes the calculation complex is the tax component, which, as we have explained earlier in the Report, involved a transfer in 1977 to the provinces of 13.5 points of personal income tax (PIT) and 1 point of corporate income tax (CIT). The 1977 Established Programs Financing (EPF) arrangements reduced federal cash transfers to the provinces for health and postsecondary education, but compensated them for that loss by also reducing federal taxes by an equivalent amount, thereby allowing the provinces to increase their taxes in order to replace the lost federal revenue.

The value of a point of personal or corporate income tax varies by province. If a province has more higher-income taxpayers or more corporate head offices, its yield from a single point of taxation will be higher than that of provinces which have fewer. As can be seen in Figure 5.5, the value of the EPF tax transfer ranges from a high of $667 per capita for Alberta to a low of $346 per capita for Prince Edward Island. As part of the negotiations for EPF in 1977, it was agreed that the tax point transfers would be equalized to compensate those provinces which would otherwise be disadvantaged. Today these tax points are equalized under the most recent standard of the general Equalization program, the five-province standard.

The amount paid to equalize the tax points is called associated equalization (AE), and it is shown in Figure 5.5. In 2005–06 the aggregate value of associated equalization was $1.3 billion. This amount is calculated and is then added to the equalization payment and transferred to provinces through the general Equalization program. Two provinces, Alberta and Ontario, did not receive associated equalization as their fiscal capacity was above the five-province standard in 2005–06.

Although these payments exist to equalize tax points, they are in fact included as part of the general Equalization program. As a consequence the federal government includes associated equalization both in the CHT/CST account – as part of the $1,474 per capita that it claims to transfer to every Canadian – and in the $10.9 billion Equalization program, although it is actually paid only once, in the general Equalization program. In other words, the federal government records associated equalization both in the transfer program and in the general Equalization program. It claims twice, but pays only once. This presentation is both opaque and confusing. One of our recommendations focuses explicitly on eliminating this confusing presentation.

Each province's per capita cash transfer is then determined on a residual basis, calculated as the difference between the total per capita amount that all provinces receive ($1,474 in 2005–2006) and each province's own equalized tax transfer. As can be seen in Figure 5.5, the per capita cash portion varied from $807 in Alberta, to $851 in Ontario, to $998 in Saskatchewan and $935 in the rest of the provinces.

An equalization-receiving province's total entitlements include associated equalization. For example, in 2005–06 Manitoba's total per capita entitlements include a $410 per capita tax point transfer, $129 per capita in associated equalization, and a $935 per capita cash transfer in 2005–06 ($1,474 - $410 - $129 = $935).

Ontario receives neither equalization nor associated equalization. Thus, in 2005–06 Ontario's per capita CHT/CST entitlement includes a $623 per capita tax point transfer and an $851 per capita cash transfer($1,474 – $623 = $851).

As one can see in Figure 5.5, Saskatchewan is in a special position. It does not receive the full amount of associated equalization to which it would seem to be entitled. This is explained by the fact that associated equalization cannot be greater than a province's equalization entitlement. In 2005-06 the value of Saskatchewan's associated equalization was $144 million, greater than the value of its equalization

entitlement of $82 million. Therefore, its associated equalization was capped at $82 million, resulting in a total equalized tax transfer below the standard ($83 per capita for its population of just over one million). This meant that Saskatchewan received additional per capita CHT/CST cash to ensure that its total per capita tax and cash entitlement was the same as that of the other provinces ($1,474).

This describes how the federal government makes its calculations. It continues to claim that the tax point transfer, made almost thirty years ago, is still a federal contribution to the provinces, even though for three decades the provinces, and not the federal government, have been collecting the taxes. Combining the current value of the 1977 tax transfer, associated equalization and the cash transfer allows the Government of Canada to claim that it is providing an equal per capita CHT/CST transfer to the provinces of $1,474.

From a provincial perspective, the situation looks very different. The 1977 tax point transfer has long since ceased to be a federal contribution to provincial social expenditures. Those tax points have been an integrated part of provincial tax regimes for years. If there is a political debate within a province about excessively high tax levels, those tax points are simply part of the overall tax burden the province's residents are shouldering. The political responsibility of imposing these taxes rests unequivocally with the provincial governments, not the Government of Canada. When provincial governments look at the CHT/CST transfer, they see the cash payments they receive. Thus what the federal government claims to be an equal per capita program is – for at least some of the provinces – an unfair program in which some provinces receive more per capita than others.

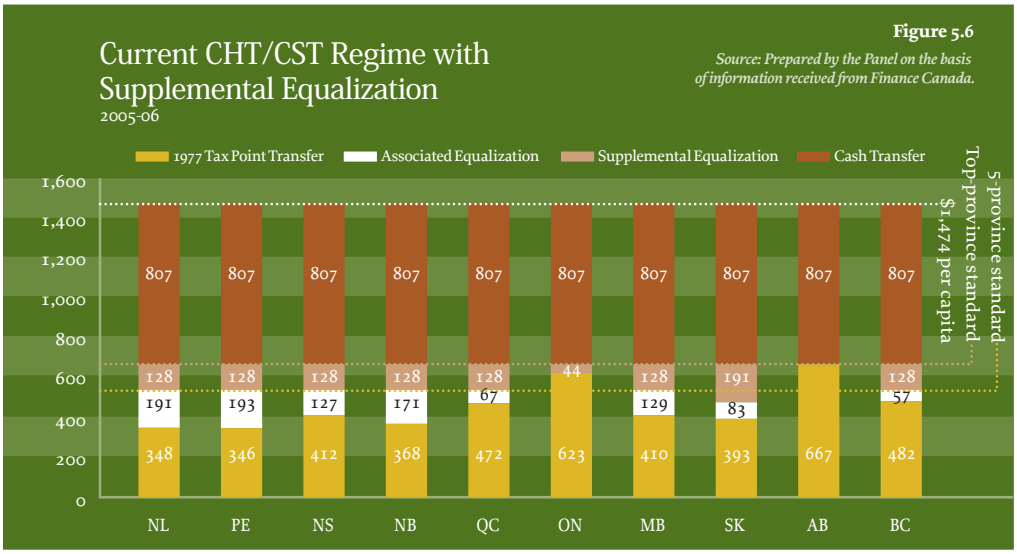
This system has negative consequences. It is virtually impossible for an ordinary person to understand, particularly when one order of government claims that it is contributing almost $48 billion to the costs of health care, postsecondary education, and social assistance, and the other order of government asserts that the federal contribution is less than $30 billion. Neither the principle of transparency nor that of accountability is well served.

It is also difficult to persuade a province that it is being treated fairly when it receives proportionately less per capita for sustaining exactly the same programs in health, postsecondary education, and social assistance.

There is another difficulty. In the course of its work, the Panel discovered a supplementary program of equalization. Figure 5.6 shows that the current CHT/CST regime involves two steps. First, as we have described, there is associated equalization, with the tax points equalized through the application of the five-province standard that governs the equalization formula. Finance Canada then takes a second step. It equalizes again, this time to the top-province standard.

The Panel is not certain that this second-level equalization to the top-province standard has ever been explained to the provinces. The area immediately below the top-province line in Figure 5.6 displays this second-level program of equalization. It has no name and in fact does not appear in federal government accounts and tables

representing the transfer system. The Panel calls it supplementary equalization (SE) for the purposes of discussion. Figure 5.6 displaying this supplemental equalization, was prepared by the Panel based on information received from Finance Canada.



That second tier of equalization of the tax points smoothes out the remaining disparities in the cash allocations to the provinces, and creates an equal per capita cash transfer to all provinces of $807. By identifying and removing supplemental equalization as well as associated equalization from the calculation, the federal government is in a position to argue that all provinces receive a residual equal per capita cash transfer of $807. They can also demonstrate that there is an equal per capita tax point transfer. Since the equalization of the tax points is to the top province standard – Alberta – Ontario receives supplementary equalization.

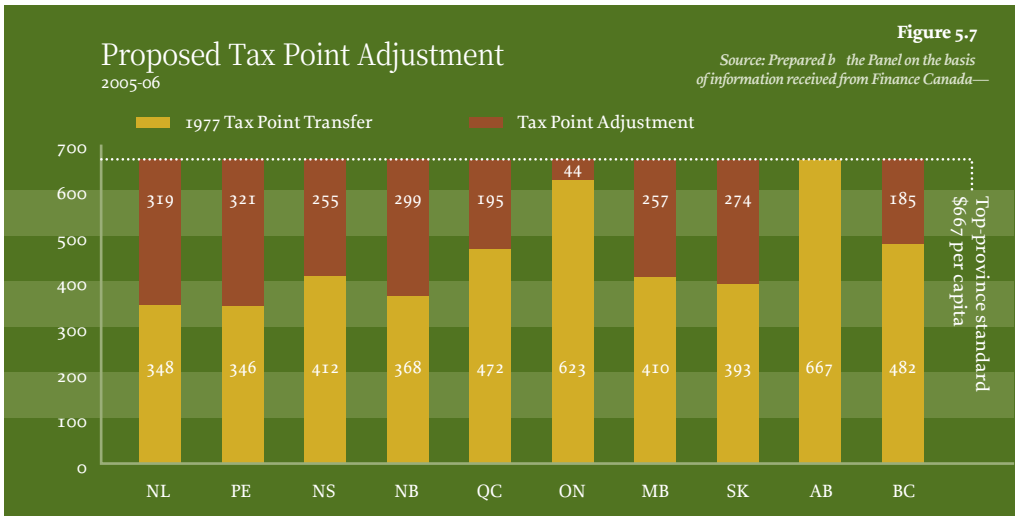
Recommendation 5.1

The Panel recommends the creation of a fully transparent Tax Point Adjustment (TPA) program.

The Panel considers that embedding equalization within other transfer programs is confusing and damaging to the general Equalization program. We think it is important that the multiple strands of equalization that are currently outside the general Equalization program be brought together and consolidated in a single, separate, identifiable, and transparent fund that we call the Tax Point Adjustment (TPA) program.

As illustrated in Figure 5.7, the proposed TPA program would combine both the associated equalization and the supplemental equalization embodied in the current regime. Because this would simply involve separating and segmenting existing federal cash that is already being distributed to the provinces, the TPA program would be cost neutral to the federal government and would have no impact on what each province

currently receives. The amount of existing cash that would be identified in this way in 2005–06 is just over $4 billion ($1.3 billion in associated equalization and $2.7 billion in supplemental equalization). This would definitively shift the money out of the CHT/CST transfer regime, thereby moving it out of a conditional program (CHT/CST) and into a transfer program (TPA) with no strings attached. While the general Equalization program has no strings attached, the equalized tax point transfers were originally intended to be spent on health and postsecondary education.



Why is this recommendation important? There are five reasons.

1. It would distinguish the program of associated equalization from the general Equalization program. The two are not really connected. The true cost of the Equalization program would therefore be visible and transparent to the provinces and to citizens. All accounts and tables showing equalization currently include $1.3 billion of AE money in their accounting, increasing the apparent size of the program. The federal government shows the amount of the Equalization program to be $10.9 billion, instead of $9.6 billion, which is the amount after AE has been removed. Since under the TPA the $1.3 billion would already be counted, it would be incorrect to show it twice – as the federal government currently does – and include it within the Equalization program. The creation of the TPA program should end this confusion, once and for all.

2. Current CHT/CST transfers include two distinct components of equalization, as well as two standards – the five-province standard (AE) and the top-province standard (SE). The Panel feels strongly that these equalization programs should be removed from the cash transfer program and put into a separate tax point adjustment program (TPA). Reconciling this program (the TPA) to bring some coherence should be negotiated between the two orders of government. The Panel urges, however, that whatever arrangements are made in the future be transparent to all provincial governments and to Canadians.

3. The creation of the TPA makes it possible to break, once and for all, the connection between the 1977 tax point transfer and the CHT/CST cash currently going to the provinces. The Panel feels strongly that the continuing claim of a tax point transfer that is almost thirty years old and the associated claim of a federal contribution of $1,474 per capita to health, postsecondary education, and social programs is misleading and should not continue.

4. It would place current CHT/CST transfers on an equal per capita basis, and it would ensure that all such future transfers adhere to the same principle. The Panel feels strongly that the transfer program must be principled and fair, and must be seen by Canadians to be fair. The core principle that should govern this program is equal per capita transfers, separated from any hidden equalization or any other arrangements.

5. It would make it easier for there to be future tax point transfers without the confusion created by the EPF tax transfer arrangements. Tax point transfers, of course, remain a viable option, and provinces would need to negotiate any equalization arrangements of new tax point transfers with the federal government.

The principles of transparency and accountability would be well served by this reform that would disentangle and clarify the multiple purposes the current regime serves, and make it clearer who is accountable for what.

Recommendation 5.2

The Panel recommends that the per capita amount under the CHT and CST be increased from $807 to $960. This new money should be allocated to the Canada Social Transfer to correct the vertical fiscal imbalance as it relates to postsecondary education and social assistance.

Financial Impact of CHT/CST Recommendations in 2005-06

Table 5.3

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	CAN
CURRENT CHT/CST REGIME											
CHT/CST Per Capita Cash											
Millions of dollars	418	111	756	606	6,082	9,985	943	803	2,579	3,382	25,667
Dollars per capita	807	807	807	807	807	807	807	807	807	807	
Associated Equalization (AE) (5-province standard)											
Millions of dollars	99	27	119	128	505	0	151	83	0	239	1,350
Dollars per capita	191	193	127	171	67	0	129	83	0	57	
Supplemental Equalization (SE) (top-province standard)											
Millions of dollars	66	18	120	96	965	544	150	190	0	536	2,685
Dollars per capita	128	128	128	128	128	44	128	191	0	128	
Total Cost of Current Regime											
Millions of dollars	583	155	995	831	7,552	10,529	1,244	1,076	2,579	4,157	29,702
Dollars per capita	1,126	1,128	1,062	1,106	1,002	851	1,064	1,081	807	992	
CHT/CST RECOMMENDATIONS											
Tax Point Adjustment (TPA=AE+SE) (top-province standard)											
Millions of dollars	165	44	239	225	1,470	544	300	273	0	775	4,035
Dollars per capita	319	321	255	299	195	44	257	274	0	185	
CHT/CST Equal Per Capita Cash											
Millions of dollars	497	132	900	721	7,235	11,878	1,122	955	3,068	4,023	30,533
Dollars per capita	960	960	960	960	960	960	960	960	960	960	
Total Cost of Proposed Regime											
Millions of dollars	662	176	1,139	946	8,705	12,423	1,423	1,228	3,068	4,798	34,568
Dollars per capita	1,279	1,281	1,215	1,259	1,155	1,004	1,217	1,234	960	1,145	
COST OF RECOMMENDATIONS											
Millions of dollars	79	21	143	115	1,153	1,893	179	152	489	641	4,866
Dollars per capita	153	153	153	153	153	153	153	153	153	153	

The Panel believes that the Government of Canada has made real strides through the CHT in correcting the fiscal imbalance as it relates to the financing of health care. As already noted, this has been done partly at the expense of the programs covered by the Canada Social Transfer, postsecondary education, and social assistance. It is important to remember that the $807 per capita for all provinces shown in Figure 5.6 is cost neutral, and neither it nor the TPA increases the total cost to the federal government of the CHT/CST transfer.

As shown in Table 5.3, the proposed increase from $807 to $960 would increase the federal contribution via the CHT/ CST transfer by $4.9 billion or $153 per capita for all provinces. These numbers use 2005–06 figures, the latest data available when this Report was being written. This increase would restore the CST support of post-secondary education and social programs to their 1994–95 levels, adjusted for inflation.

In 1994–95, total EPF/CAP in cash was $18.7 billion. This was allocated in the following way: $10.8 billion for Established Program Financing and $7.9 billion for the Canada Assistance Plan. The health share for EPF was $8.1 billion. The balance of $2.7 billion was devoted to postsecondary education. Accordingly, the corresponding amount for postsecondary education and social assistance would be $10.6 billion, the sum of EPF postsecondary education funding at $2.7 billion and CAP at $7.9 billion. In the federal budget for fiscal year 2005–06, the CST cash transfer is $8.4 billion.

To bring the transfer back to the 1994–95 amount would require an additional $2.2 billion ($10.6 - $8.4 = $2.2 billion). When the $10.6 billion figure is adjusted, using the annual inflation rates over the last eleven years, the level of funding of the CST should be $13.3 billion, an increase of $4.9 billion ($13.3 - $8.4 = $4.9 billion), or $153 per capita.

Recommendation 5.3

Looking forward, the Panel supports the federal government's commitment to an assured growth rate of 6 percent per year of the CHT transfer until fiscal year 2013-14. It recommends that an assured growth rate of 4.5 percent per year be established for the CST transfer over the same period.

The Panel considers the CHT escalator to be adequate, given that it is in line with the average annual compound growth rates for spending on health care estimated by the Conference Board for the next twenty years.

As for the CST, in the 2005 federal budget, cash levels were legislated until 2007–08 and were anticipated to grow by 3.3 percent per year on a planning basis to 2010–11. The current 3.3 percent escalator for CST is inconsistent with the spending projections for postsecondary education and social programs forecast by the Conference Board, projections that call, in the most conservative estimates, for an average growth rate of 4.5 percent. Keeping up with inflation is one thing. Innovation in postsecondary education to improve productivity and recognize long-life learning would suggest that an escalator of 5 percent would be more appropriate.

The Panel believes that to ensure stability and predictability, the CST transfer arrangements should be extended to 2013–2014, matching the federal commitment to the CHT transfer.

Chapter Six

Horizontal Fiscal Imbalance

Reforming the Equalization Program

In all countries, there are regions enjoying greater wealth and regions that are, relatively speaking, less prosperous. In a unitary state, the national government is able to ensure directly that public goods and services are made available to citizens equitably, no matter what part of the country they live in. In a federation, provinces and states have a constitutional responsibility to deliver many of these goods and services, yet they typically vary in their economic strength and prospects. The economically disadvantaged provinces are less able to raise the necessary revenues through their own tax efforts than are other provinces that are better off. This creates a horizontal fiscal imbalance (HFI), which, in almost all federations, gives rise to some form of program designed to help the less prosperous provinces provide adequate public services to their residents. The program is almost always run by the federal government.

Canada's Equalization program reflects the Canadian values of sharing and mutual support. It is grounded in the recognition that the fortunes of the various provinces in the Canadian federation have shifted dramatically over the decades, and will almost certainly continue to do so in the future. Those who are prospering today may require assistance tomorrow. Most parts of the country, at one point or another, have needed help adjusting to changing patterns of international trade, the shifts in the value and availability of regional resource endowments, and the impact of technological innovation.

What is the relationship between horizontal fiscal imbalance and regional economic inequality? They are distinguishable, but they usually exist together. Regional economic inequality refers to the differences that exist in the economic structures, wealth, and productivity of the different parts of the country. Horizontal fiscal imbalance points to the fact that provincial governments differ substantially in their revenue-raising capacity and therefore in their capacity to provide their residents with health care, education, social assistance, and all the other services that citizens in modern society have come to expect. Fiscal capacity is in large part a function of the vitality of the regional economy. If there are few private-sector corporations in the region and their profits are small; if there is severe unemployment and the wages of those who are working are comparatively low – then the capacity of the provincial government to raise revenues will be correspondingly limited. In 2005–06, one point of personal income tax raises $21 per capita in Prince Edward Island and $38 per capita in Ontario. One point of corporate income tax raises $23 per capita in Newfoundland and Labrador and $65 per capita in Alberta.

For almost half a century, Canada has had a formal equalization program designed to address horizontal fiscal imbalance. The principle of equalization was embedded in Section 36 (2) of the *Constitution Act, 1982*:

> *Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

This is a federal, not an intergovernmental, program. It is financed out of general federal tax revenues. The Government of Canada, through its national tax collection efforts (personal income tax, corporate income tax, the GST, and so on), raises the revenues it needs to carry on the business of government. These revenues support the full range of federal programs. The Equalization program is one of these. The Government of Canada places before Parliament a measure authorizing the expenditure of funds in support of that program, and, through this legislation and related regulations, makes arrangements to distribute the funds to those provinces that qualify. In 2005–06, eight provinces received equalization payments, and two (Ontario and Alberta) did not. The payments are made to provincial governments and are unconditional, that is, the recipient provinces are free to spend the funds on public services according to their own priorities. Although it is a federal program, provincial governments obviously take an intense interest in the Equalization program.

Chapter 1 of this Report discusses the current equalization arrangements, and *Chapter 2* includes a brief history of equalization. The Equalization program was protected from the cutbacks imposed on other fiscal transfers by the federal government in the 1990s. Unlike vertical fiscal imbalance, which is contested and controversial in this country, no one questions or denies the existence of horizontal fiscal imbalance. The extent of the national consensus is reflected in the 1982 constitutional provision. Given, however, that there are serious concerns about the New Framework for Equalization, the Panel reviewed a number of alternatives and proposes a new approach.

Options

As we have seen earlier in the Report, in the fall of 2004, first ministers agreed to the New Framework for Equalization. A funding base of $10.9 billion was established for 2005–06, with a growth escalator of 3.5 percent per year to 2013–14. The Government of Canada appointed an independent panel to advise on the distribution of this fixed pool of funds among recipient provinces; it is expected to submit its final report in the spring of 2006.

In *Chapter 5*, we recommended that the associated equalization component of $1.3 billion be removed from the general Equalization program. Table 6.1 illustrates the effect of this recommendation. This table also shows the total and per capita distribution by province.

While the New Framework provides stability and moderate growth over the life of the agreement, it has a critical deficiency, which we outlined in *Chapter 1*. This new approach, which is based on a fixed pool with a fixed escalator, abandons a key feature of Canada's Equalization program – namely, the principle that equalization payments to a province are to be determined by its fiscal capacity relative to that of a standard. What had been an expanding or diminishing pool of funds, based on calculations of provincial fiscal capacity, is now a fixed pool. How are funds allocated under the New Framework? In a laddering process, the least well-off province is first raised to the level of the next in line. These two in turn are both raised to the level of the next province in line, until the funds within the fixed pool are exhausted. Prior to the introduction of the New Framework, the Equalization program had a fixed standard and a floating pool. Currently, the program has a fixed pool with a floating standard.

Equalization Payments and the New Framework[1] — Table 6.1
2005–06

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
New Framework											
Millions of dollars	861	277	1,344	1,348	4,798	0	1,601	82	0	590	**10,900**
Dollars per capita	1,670	2,006	1,433	1,792	632	0	1,360	83	0	139	
Associated Equalization											
Millions of dollars	98	26	158	95	497	0	150	82	0	230	**1,337**
Dollars per capita	190	192	169	126	66	0	127	83	0	54	
New Framework without AE											
Millions of dollars	763	251	1,186	1,253	4,301	0	1,451	0	0	360	**9,564**
Dollars per capita	1,480	1,815	1,264	1,666	566	0	1,233	0	0	85	

1 Note: All the tables in *Chapter 6* were developed by the Panel using Provincial Fiscal Equalization data from Finance Canada, Second Estimate, 2005–06.

The Panel believes that a better approach to allocation can be designed, one that would be more stable and predictable but at the same time more faithful to the spirit of this historic Canadian program and to the principle embedded in Section 36(2) of the *Constitution Act, 1982*.

Analysis of the Options

The Panel examined a wide range of alternative allocation mechanisms for establishing the overall amount to be transferred as well as its distribution among recipient provinces. The objective was to design a formula to replace the New Framework for Equalization. We tested each option we considered against the principles of fairness, transparency and affordability.

The Panel concluded that the more comprehensive and inclusive the formula was, the better it would meet the tests of fairness and transparency. We wanted the fairest possible mechanism of allocation, and we concluded that the inclusion of all ten provinces and all revenue sources in the calculation would be optimal.

In our analysis of options, we use the five-province standard (FPS: Quebec, Ontario, Manitoba, Saskatchewan and British Columbia) as our reference point for purposes of comparison. Because it is formula driven, we chose for our base case the five-province standard that preceded the New Framework. Moreover, the final allocation mechanism under the New Framework has yet to be determined and is currently being reviewed by a federally appointed expert panel.

The five-province standard appears as the top three lines in Tables 6.2, 6.3, 6.4, 6.5 and 6.6. Provinces with revenue-raising ability, or fiscal capacity, below the standard amount receive equalization payments in order to bring their capacity up to that standard. The fiscal capacity of a province is a measure of its ability to raise revenues from each of thirty-three revenue sources – including personal income tax, corporate income tax, sales taxes, property tax, natural resources, and other sources – assuming that province has average tax rates. This is referred to as the Representative Taxation System.

As shown in Table 6.2, the equalization formula based on a five-province standard ensures that all provinces would have had access to revenues of $6,542 per resident to fund public services in 2005–06. The five-province standard would have resulted in equalization payments of $9.4 billion. Note that this formula-driven amount is very close to the fixed pool of $10.9 billion imposed by the federal government when we subtract associated equalization ($10.9 - $1.3 = $9.6 billion).

Based on a ten-province standard (TPS), we explore five options in the tables below. The options differ only in the rate of inclusion of natural resources: 100 percent, 70 percent, 50 percent, 25 percent, and 0 percent. Of the thirty-three revenue bases currently used in the equalization formula, fourteen are related to natural resources, and, of these, nine are energy revenue bases. There are only two renewable resources: forestry and water power rentals. All the others are non-renewable.

Our first option is presented in Table 6.2 below. It shows the impact of including all revenue sources (the thirty-three revenue bases) in the formula.

Option 1 – Ten-Province Standard and 100% Inclusion of Resource Revenues in 2005–06 Table 6.2

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
FPS & 100% revenue coverage ($M)	588	249	1,247	1,257	4,235	0	1,467	0	0	348	**9,391**
Measured fiscal capacity ($pc)	5,402	4,740	5,212	4,871	5,985	7,009	5,297	6,752	11,158	6,460	**6,542**
Equalization payments ($pc)	1,140	1,803	1,330	1,671	558	0	1,246	0	0	82	
TPS & 100% revenue coverage ($M)	775	299	1,588	1,530	6,991	0	1,894	152	0	1,890	**15,120**
Measured fiscal capacity ($pc)	5,402	4,740	5,212	4,871	5,985	7,009	5,297	6,752	11,158	6,460	**6,905**
Equalization payments ($pc)	1,503	2,166	1,693	2,034	921	0	1,609	153	0	445	
Change in Equalization payments ($M)	187	50	340	273	2,757	0	427	152	0	1,542	**5,729**
Change in Equalization payments ($pc)	363	363	363	363	363	0	363	153	0	363	

In 2005–06, fiscal capacity in option 1 runs from a low of $4,740 per capita in Prince Edward Island to a high of $11,158 in Alberta. At $7,009 per capita, Ontario's measured fiscal capacity would remain above that of the ten-province standard in 2005–06, but only by $104 per capita. The ten-province standard would have yielded an average $6,905 per capita in 2005–06, compared with an average $6,542 per capita for the five-province standard. Collectively, compared with the five-province standard, the provinces would have gained $363 per capita ($6,905 - $6,542) under option 1 in 2005-06. Of this $363 per capita, $292 per person is attributable to natural resource revenues, and the remaining $71 per person to all non-resource revenue bases.

The ten-province or national average standard with comprehensive revenue coverage provides the most accurate and the fairest measurement of fiscal disparities. It is the only way to equalize fully fiscal capacity across provinces. In terms of transparency and fairness, the ten-province standard works best, as will become clear when we consider the other options.

Yet affordability is always an issue for the federal government. The cost of the program is potentially forbidding, especially in an era of high energy prices; the shift from a five- to a ten-province standard with comprehensive revenue coverage increases the overall cost of the program over the base case scenario by $5.7 billion. The inclusion of 100 percent of resource revenues also makes the formula more volatile. We deal with both affordability and volatility at the end of this chapter when we discuss our recommendations.

Let us now explore the options entailing partial inclusion of natural resource revenues. Four alternative inclusion rates of resource revenues (RR) are reviewed here: 70 percent in Table 6.3, 50 percent in Table 6.4, 25 percent Table 6.5, and 0 percent in in Table 6.6.

An argument for partial inclusion of resource revenues is the need to give provinces appropriate incentives to develop and price their natural resources. A second reason is that there are costs associated with the development of these resources. A third is the need to make the Equalization program affordable for the federal government. Indeed, the lower the inclusion rate, the lower the cost for the federal government.

Option 2 – Ten-Province Standard and 70% Inclusion of Resource Revenues in 2005–06

Table 6.3

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
FPS & 100% revenue coverage ($M)	588	249	1,247	1,257	4,235	0	1,467	0	0	348	**9,391**
Measured fiscal capacity ($pc)	5,402	4,740	5,212	4,871	5,985	7,009	5,297	6,752	11,158	6,460	**6,542**
Equalization payments ($pc)	1,140	1,803	1,330	1,671	558	0	1,246	0	0	82	
TPS & 70% revenue coverage ($M)	797	278	1,457	1,433	6,091	0	1,756	445	0	2,030	**14,286**
Measured fiscal capacity ($pc)	5,208	4,737	5,200	4,849	5,952	6,994	5,263	6,306	10,222	6,276	**6,754**
Equalization payments ($pc)	1,546	2,017	1,553	1,905	802	0	1,491	448	0	478	
Unequalized RR capacity ($pc)	194	3	12	22	33	14	34	446	936	184	
Overall fiscal capacity ($pc)	6,948	6,756	6,765	6,776	6,787	7,009	6,788	7,200	11,158	6,938	
Change in Equalization payments ($M)	209	30	209	176	1,856	0	289	445	0	1,682	**4,896**
Change in Equalization payments ($pc)	406	214	223	234	244	0	245	448	0	396	

Partial inclusion of resource revenues means that revenues, and thus, associated fiscal disparities, are not fully equalized within the equalization formula. It is then crucial to introduce the concept of overall fiscal capacity to determine the true fiscal capacity of all provinces. As shown in Table 6.3, overall fiscal capacity is defined as the sum of: (1) measured fiscal capacity, (2) equalization payments, and, (3) unequalized resource revenue capacity. As is apparent, when resource revenues are only partially included, an equalization-receiving province may have a higher overall fiscal capacity than a non-recipient province. The Panel considers that such a situation would compromise the fairness of the program.

Compared to the five-province standard, under option 2 the overall change per capita under a ten-province standard and 70 percent inclusion of natural resource revenues is $212 ($6,754 - $6,542). The impact on individual provinces is highly variable, ranging in 2005–06 from a low of $214 per capita in Prince Edward Island to a high of $448 per capita in Saskatchewan. Taking into account unequalized fiscal capacity, Saskatchewan's overall fiscal capacity would reach $7,200 per capita in 2005–06, a level higher than that of Ontario, a non-equalization receiving province. The unequalized capacity reflects the 30 percent of natural resource revenues that are excluded from the calculation of provincial fiscal capacity but that need to be added back to determine the overall fiscal capacity of a province.

Compared with the total cost of the base case scenario of $9.4 billion, the equalization payments under option 2 would increase by $4.9 billion to reach $14.3 billion in 2005–06.

Option 3 – Ten-Province Standard and 50% Inclusion of Resource Revenues in 2005–06

Table 6.4

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
FPS & 100% revenue coverage ($M)	588	249	1,247	1,257	4,235	0	1,467	0	0	348	**9,391**
Measured fiscal capacity ($pc)	5,402	4,740	5,212	4,871	5,985	7,009	5,297	6,752	11,158	6,460	**6,542**
Equalization payments ($pc)	1,140	1,803	1,330	1,671	558	0	1,246	0	0	82	
TPS & 50% revenue coverage ($M)	812	265	1,369	1,368	5,491	0	1,663	640	0	2,123	**13,730**
Measured fiscal capacity ($pc)	5,079	4,735	5,193	4,834	5,930	6,985	5,240	6,009	9,598	6,153	**6,653**
Equalization payments ($pc)	1,574	1,917	1,460	1,819	723	0	1,413	644	0	500	
Unequalized RR capacity ($pc)	323	4	19	37	55	24	56	743	1,560	307	
Overall fiscal capacity ($pc)	6,976	6,657	6,672	6,690	6,708	7,009	6,709	7,396	11,158	6,960	
Change in Equalization payments ($M)	224	16	122	111	1,256	0	196	640	0	1,775	**4,340**
Change in Equalization payments ($pc)	434	115	130	147	165	0	167	644	0	418	

In option 3 (described in Table 6.4), with an inclusion rate of 50 percent, the overall per capita payment compared to option 2 (with a 70 percent inclusion rate) diminishes again for all equalization-receiving provinces. Compared to the five-province standard, however, the average per capita payment increases by $111 ($6,653 - $6,542). As the inclusion rate drops from 70 to 50 percent, equalization payments to British Columbia, Saskatchewan, and Newfoundland and Labrador increase, while payments to the Maritime provinces, Quebec, and Manitoba decrease.

The overall cost of the Equalization program under this option would increase by $4.3 billion compared with the base case scenario of $9.4 billion, to a total of $13.7 billion in 2005-06.

Turning now to option 4 (Table 6.5), which has natural resource revenues included at the level of 25 percent, one can observe the same trends continuing, albeit in more accentuated form.

Option 4 – Ten-Province Standard and 25% Inclusion of Resource Revenues in 2005-06

Table 6.5

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
FPS & 100% revenue coverage ($M)	588	249	1,247	1,257	4,235	0	1,467	0	0	348	**9,391**
Measured fiscal capacity ($pc)	5,402	4,740	5,212	4,871	5,985	7,009	5,297	6,752	11,158	6,460	**6,542**
Equalization payments ($pc)	1,140	1,803	1,330	1,671	558	0	1,246	0	0	82	
TPS & 25% revenue coverage ($M)	830	248	1,260	1,287	4,741	0	1,548	884	0	2,239	**13,035**
Measured fiscal capacity ($pc)	4,917	4,733	5,183	4,816	5,902	6,973	5,212	5,638	8,818	6,000	**6,527**
Equalization payments ($pc)	1,610	1,793	1,344	1,711	624	0	1,314	889	0	527	
Unequalized RR capacity ($pc)	485	6	29	55	82	36	85	1,114	2,340	461	
Overall fiscal capacity ($pc)	7,012	6,533	6,556	6,582	6,609	7,009	6,611	7,641	11,158	6,987	
Change in Equalization payments ($M)	242	-1	13	30	506	0	81	884	0	1,891	**3,645**
Change in Equalization payments ($pc)	469	-9	13	39	67	0	69	889	0	445	

Again, with option 4 (25 percent inclusion of resource revenues), British Columbia, Saskatchewan, and Newfoundland and Labrador receive more than they would under option 3 (50 percent inclusion of resource revenues), while the others receive less. All provinces are still better off with option 4, compared to the base case scenario of a five-province standard, with the exception of Prince Edward Island, which would lose about $1 million.

Compared with the total cost of the base case scenario of $9.4 billion, total equalization payments under this option would increase by $3.6 billion to $13 billion in 2005–06.

The Panel also analyzed a final option in this scenario, a ten-province standard with the total exclusion of resource revenues from the equalization formula.

Option 5 – Ten-Province Standard and 0% Inclusion of Resource Revenues in 2005-06 — Table 6.6

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
FPS & 100% revenue coverage ($M)	588	249	1,247	1,257	4,235	0	1,467	0	0	348	**9,391**
Measured fiscal capacity ($pc)	5,402	4,740	5,212	4,871	5,985	7,009	5,297	6,752	11,158	6,460	**6,542**
Equalization payments ($pc)	1,140	1,803	1,330	1,671	558	0	1,246	0	0	82	
TPS & 0% revenue coverage ($M)	848	230	1,151	1,206	3,991	0	1,432	1,128	0	2,355	**12,341**
Measured fiscal capacity ($pc)	4,755	4,731	5,173	4,797	5,875	6,961	5,184	5,266	8,038	5,846	**6,400**
Equalization payments ($pc)	1,645	1,669	1,227	1,603	526	0	1,216	1,134	0	554	
Unequalized RR capacity ($pc)	647	8	39	74	110	48	113	1,486	3,121	614	
Overall fiscal capacity ($pc)	7,047	6,409	6,439	6,474	6,510	7,009	6,513	7,886	11,158	7,015	
Change in Equalization payments ($M)	260	-18	-97	-51	-244	0	-34	1,128	0	2,007	**2,950**
Change in Equalization payments ($pc)	505	-134	-103	-68	-32	0	-29	1,134	0	472	

The same trend that we have identified in options 2, 3, and 4 is more strongly evident here.

Evaluation of the Options

The Panel believes that these outcomes do not pass the test of reasonableness or fairness. Partial inclusion rates of natural resource revenues (renewable and non-renewable) make horizontal fiscal imbalance worse rather than better and compromise the fairness of the program.

Reducing the inclusion rates also reduces the total cost of the Equalization program and the draw on federal revenues. However, the Panel believes that there is a better way to address the affordability issue.

The Panel believes that the fairest and most transparent formula for determining the overall level of equalization and for allocating payments among the provinces is option 1 – the ten-province standard with comprehensive revenue coverage (inclusion of 100 percent of natural resource revenues). It is the option that best

measures overall fiscal capacity and relative fiscal capacity and makes the fairest allocation of the funds available.

It is, however, the most costly option. If fully implemented, it would increase the cost of the Equalization program by $5.7 billion from the base case of $9.4 billion, to $15.1 billion. Clearly, the question of affordability must be addressed. As well, this option, because it includes all natural resource revenues in its calculation, is the most vulnerable to volatility, arising in particular from rapid changes in the prices of oil and natural gas. We now deal with the questions of volatility and affordability.

Volatility and Affordability

What of the problem of volatility? The previous regime, which was formula driven, involved multiple estimates spread over four years. In fact, most tax revenue statements were preliminary estimates, subject to revisions in the first two years before becoming actual data. The difficulty in getting hard data quickly injected an element of unpredictability into the system and at times produced unwelcome surprises for some provinces. Thus, in proposing to replace the New Framework with a new formula-driven regime (option 1), the Panel needed to consider the question of volatility.

The application to our proposed option 1 of a three-year moving average on all revenue bases, lagged two years, would provide provinces with single-point estimates for their equalization payments. The Panel believes that this smoothing mechanism would allow governments to anticipate and plan more effectively. It is important to note that averaging and lagging would have no impact over the long term on the financial position of the provinces, although it would in the short term. These arrangements would provide no guarantee against changes in the equalization pool as a result of the changing economic fortunes of provinces; they would simply smooth out the peaks and valleys en route.

Calculation of a Three-Year Moving Average, Lagged Two Years, for 2005–06, Based on Fiscal Capacity Data by Province from 2001–02 to 2003–04 — Table 6.7

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	standard
2001-02	4,184	4,179	4,681	4,348	5,324	6,494	4,768	5,752	9,979	5,893	**6,234**
2002-03	4,299	4,148	4,666	4,343	5,329	6,310	4,739	5,894	9,878	5,850	**6,160**
2003-04	4,533	4,219	4,702	4,388	5,406	6,350	4,759	5,935	10,103	5,832	**6,227**
2004-05	5,239	4,590	5,115	4,726	5,837	6,853	5,145	6,616	11,135	6,346	**6,769**
2005-06	5,402	4,740	5,212	4,871	5,985	7,009	5,297	6,752	11,158	6,460	**6,905**
Calculation of the 3-Year Moving Average, Lagged 2 Years, for 2005-06											
	Example with the standard: 6,207 = (6,234 + 6,160 + 6,227) / 3										
2005-06	4,339	4,182	4,683	4,359	5,353	6,385	4,755	5,860	9,987	5,858	**6,207**

Table 6.7 shows how the averaging and lagging is done. The payment in any given year – 2005–06 in Table 6.7 – is calculated by averaging the payments made in three previous years. The years used for this averaging calculation are lagged two years; this

means that the years used for averaging do not include the previous two years, but the three years before that (see the boxed years in Table 6.7). Therefore, for the year 2005–06, the years used for the averaging calculation are 2001–02, 2002–03, and 2003–04. Thus, in any given year, provincial governments would know what their equalization payments would be; and, by assessing the current economic climate, they would be able to anticipate the general evolution of equalization payments in coming years.

Ten-Province Standard and 100% Inclusion of Resource Revenues under a Three-Year Moving Average, Lagged Two Years, on All Revenues, 2005–06 — Table 6.8

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
FPS & 100% revenue coverage ($M)	588	249	1,247	1,257	4,235	0	1,467	0	0	348	**9,391**
Measured fiscal capacity ($pc)	5,402	4,740	5,212	4,871	5,985	7,009	5,297	6,752	11,158	6,460	**6,542**
Equalization payments ($pc)	1,140	1,803	1,330	1,671	558	0	1,246	0	0	82	
TPS & 100% revenue coverage & 3-Year MA, Lagged 2 Years ($M)	963	280	1,429	1,390	6,487	0	1,710	345	0	1,483	**14,086**
Measured fiscal capacity ($pc)	4,339	4,182	4,683	4,359	5,353	6,385	4,755	5,860	9,987	5,858	**6,207**
Equalization payments ($pc)	1,869	2,025	1,524	1,848	854	0	1,452	347	0	349	
Change in Equalization payments ($M)	376	31	182	133	2,252	0	243	345	0	1,135	**4,696**
Change in Equalization payments ($pc)	728	223	194	176	297	0	206	347	0	267	

Table 6.8 illustrates the impact of applying a three-year moving average, lagged two years, on all revenue sources. Under the smoothing mechanism, it would have cost the federal government $14.1 billion in 2005–06, instead of the $9.4 billion under the five-province standard (or the $9.6 billion under the New Framework for Equalization, excluding associated equalization). The introduction of the smoothing mechanism would reduce the current-year cost of option 1 by about $1 billion, compared to that option without the smoothing mechanism. However, one could anticipate that equalization payments would rise somewhat in future years as the effects of the strong contemporary economy enter into future calculations.

Should the federal government determine that the increase of $4.7 billion shown in Table 6.8 above was unaffordable, what would be the simplest, most effective, most transparent, and fairest way to reduce the cost of the program? The Panel believes that the best course in these circumstances would be to scale back the standard. Reducing the overall cost in this way would not change the distribution of fiscal resources among the provinces; it would simply lower on an equal per capita basis the amount all received.

To illustrate how scaling would work, Table 6.9 shows the impact of a scaling rate of 1 percent – that is to say, a 1 percent reduction in the per capita amount generated by the ten-province standard subject to a three-year moving average, lagged two years. In 2005-06, the standard would have been reduced from $6,207 to $6,145, or by $62 per capita in all equalization-receiving provinces. This would reduce the total cost of the program from $14.1 billion to $13.1 billion.

The scaling rate can be set at any level to address federal concerns about affordability, without compromising the fairness or the transparency of the system. No matter what the level of scaling, all provinces remain in the same position relative to one another.

Ten-Province Standard and 100% Inclusion of Resource Revenues under a Three-Year Moving Average, Lagged Two Years, on All Revenues, Subject to a 1% Scaling of Standard, 2005–06 — Table 6.9

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
TPS & 100% revenue coverage & 3-Year MA, Lagged 2 Years ($M)	963	261	1,429	1,390	6,487	0	1,710	345	0	1,483	**14,067**
Measured fiscal capacity ($pc)	4,339	4,182	4,683	4,359	5,353	6,385	4,755	5,860	9,987	5,858	**6,207**
Equalization payments ($pc)	1,869	2,025	1,524	1,848	854	0	1,452	347	0	349	
1% scaling of standard											
TPS & 100% revenue coverage & 3-Year MA, Lagged 2 Years ($M)	931	271	1,371	1,343	6,015	0	1,637	283	0	1,219	**13,071**
Measured fiscal capacity ($pc)	4,339	4,182	4,683	4,359	5,353	6,385	4,755	5,860	9,987	5,858	**6,145**
Equalization payments ($pc)	1,806	1,963	1,462	1,786	792	0	1,390	285	0	287	
Change in Equalization payments ($M)	-32	10	-58	-47	-471	0	-73	-62	0	-264	**-996**
Change in Equalization payments ($pc)	-62	-62	-62	-62	-62	0	-62	-62	0	-62	

The fundamental purpose of the Equalization program is to ensure that those provinces whose fiscal capacity is lower than others nevertheless can provide reasonably comparable public services at reasonably comparable levels of taxation. If the Canadian economy suffers a serious downturn or if the price of natural resources drops dramatically, this will be automatically and appropriately reflected in equalization payments. The Panel believes that any equalization formula must be flexible and capable of responding to changes in the economic environment.

Recommendation 6.1

The Panel recommends that the Equalization program be based on a ten-province standard and comprehensive revenue coverage with inclusion of 100 percent of natural resource revenues.

Recommendation 6.2

The Panel also recommends a smoothing mechanism: a three-year moving average on all revenue bases, lagged two years, in order to provide provinces with single-point estimates for their equalization payments.

Recommendation 6.3

The Panel recommends that concerns about affordability on the part of the federal government be addressed by scaling back the standard established by Recommendations 6.1 and 6.2. The degree of scaling should be negotiated between the two orders of government.

In its efforts to address horizontal fiscal imbalance, the Panel has presented an equalization proposal that would replace the existing, flawed New Framework for Equalization. The Panel believes that this proposal meets the standards of fairness, transparency, and affordability set out earlier in the chapter.

The Panel's equalization option – a ten-province standard with comprehensive revenue coverage – fully and effectively addresses the core principle of sharing that lies at the heart of the Equalization program. The mechanism of a three-year moving average, lagged by two years, helps smooth out sudden variations in the size of the equalization payments to provinces. The fact that the standard can be scaled back to align the size of the program with available federal resources, while maintaining the fairness of the system, introduces the necessary fiscal flexibility without unwanted distributional distortions.

In *Chapter 4* on the territories, in *Chapter 5* on vertical fiscal imbalance, and in *Chapter 6* on equalization, the Panel has made a series of recommendations designed to improve the substance of fiscal federalism in Canada. Next, in *Chapter 7*, we discuss, not the "what," but the "how" of fiscal federalism – not the substance of fiscal imbalance, but the mechanisms, procedures and institutions that Canadian governments use as they conduct the country's fiscal business.

Chapter Seven

The Governance of Fiscal Federalism

Managing the Finances of the Federation: The Importance of Rules

If there is something wrong with the equalization formula, how does it get fixed? If the financial arrangements that have been put in place for the territories don't work very well, how are they to be improved? If the money the Government of Canada transfers to the provinces for health or postsecondary education is inadequate or poorly directed, what process should Canada use to address the problem? Above and beyond the Equalization program, or federal fiscal transfers to the provinces, or the territorial financing arrangements for Canada's three territories, there is an issue that is even more important for the long-term health of the federation – namely, the intergovernmental process by which these matters are decided.

It is the Panel's view that there is a flaw in the design of the Canadian federal system that this country's governments should take steps to correct. At its core, we have a governance problem: the institutions and processes we use to manage the fiscal arrangements of the Canadian federation are inadequate to the task, and they are a good deal weaker than those of almost every other modern federation in the world. More than that, this institutional inadequacy has undermined the intergovernmental trust on which the system depends and has obscured the accountability relationship between citizens and their governments.

For years, Canadians and their political leaders have tried to correct this deficiency; reform efforts have spanned decades, so far without success. Yet the need for change has not diminished – if anything, it has become even more pressing. Indeed, more important to the way a federation works than any specific program or fiscal arrangement is agreement among the orders of government on the norms, rules, and institutions that shape the manner in which they relate to one another and manage policy differences. At least in the international arena, the Government of Canada has demonstrated that it understands this issue very well.

Historically, the Government of Canada has led the international discussion on the importance of rules-based regimes in the management of global public policy. It was a leading player at the creation of the United Nations. It has been an innovator ever since in the creation and design of new formal and informal institutions to manage global policy issues.

It was Canada that insisted on a dispute resolution mechanism when it was negotiating free trade with our neighbour to the south. It is Canada that has insisted for years that the United States follow the rules and abide by the judgments of the NAFTA panels. Canadian governments of all political stripes have long argued that rules-based regimes, with integrated dispute resolution mechanisms, are needed to regulate international relations. These kinds of regimes are particularly important in shaping the relationships that smaller states have with larger and more powerful countries. Framing the conditions in which international actors are willing to come to the table and negotiate differences is an essential lubricator of a well-functioning global political order. Canada, more than any other state of its size and strength, has opposed unilateral action. Historically, our federal government has been both a rule maker and a rule taker. It is how Canada has defined its global personality.

Yet at home our federal governments have historically behaved very differently. They have entered into the jurisdiction of provincial governments without first consulting those governments. They have made unilateral decisions about federal spending in areas of provincial responsibility. They have more than once abrogated agreements when it suited their purposes to do so. And they have repeatedly resisted binding dispute resolution mechanisms. When they finally did agree to a mechanism to resolve disputes within the ambit of the Social Union Framework Agreement (SUFA), they never used the process they had agreed to, but systematically worked outside SUFA.

It is difficult to integrate these two faces of the federal government into a coherent whole. The discordance between the voice of the Government of Canada abroad – rule maker, rule follower, negotiator, mediator, enabler, facilitator – and the voice of that same government at home – rule breaker, non-negotiator, unapologetic unilateralist – is stunning. The federal government at home behaves much like those governments it roundly and repeatedly scolds abroad.

Yet Canada's prescriptions for a properly functioning global political order make just as much sense for a well-managed federation, particularly for a highly decentralized one. Indeed, with Canada and the provinces becoming more deeply engaged in the

global economy and in global society, it has become more and more important that our federation be governed by the same commitment to negotiated rules that we urge abroad. It is important that we bring the two faces of Canada together.

On all the evidence, this is what Canadians want. Survey after survey has revealed a strong, consistent desire by citizens that their governments work effectively together in an orderly and responsible fashion. They are not amused by what they perceive as pointless intergovernmental squabbling, and they are inclined to indiscriminately blame all of the country's political leaders for the quarrelling. All governments not only share the blame, but also pay the price in lost confidence and lowered expectations. The Canadian Policy Research Networks-led Citizens' Dialogue on Sharing Public Funds identified a strong commitment to shared or common standards. Those who participated in the dialogues believed that these national approaches should be developed collaboratively with the involvement not only of governments but also of citizens. There was real frustration with the perpetual bickering among governments, as well as a belief that it likely leads to inefficiency and waste. The participants placed heavy emphasis on trust, both among governments and between governments and citizens. Mutual respect, fair dealing, and reciprocity were seen as essential values in Canadian intergovernmental fiscal management.

How Do Other Federations Manage Their Fiscal Relations?

Each order of government in a federation is assigned specific responsibilities, but does it have the resources to carry them out? If money is the life's blood of a federation, financial relations are its muscles and sinews; when money is not properly aligned with policy responsibility, the capacity of the jurisdiction assigned to do the job is compromised. If one government is given the job, and the other, the money, where does one look for democratic accountability? As the Council of the Federation stated in its communiqué of August 12, 2005, there needs to be a balance between expenditure responsibilities and the ability to fund the services resulting from these responsibilities.

Other federal countries have faced these challenges. In most successful federations there are well-developed mechanisms and institutions that help governments adjust their fiscal relations to the changing realities they face. These usually involve one or more of the following three arrangements.[1] First, some countries use expert commissions. An ongoing or occasional commission of experts and prominent national leaders is assigned the task of recommending to the federal government an adjustment in the allocation of revenues to the subnational governments. Versions of this arrangement are used in South Africa, India, and Australia. Second, there are intergovernmental councils. With this approach, a constitutionally mandated council, comprising federal and provincial representatives, is given the responsibility to negotiate modifications to the prevailing financial relations between the two orders of government. Malaysia and Pakistan use this approach. Third, in some

1 See Ronald L. Watts, *Comparing Federal Systems*, 2nd ed. (Kingston and Montreal: McGill-Queen's University Press, 1999), pp. 53-55. See also Watts, "Processes for Adjusting Federal Financial Relations: Examples from Australia and Canada," in *Fiscal Relations in Four Countries: Four Essays*, ed. Paul Boothe (Ottawa: Forum of Federations, 2003), pp. 21-22.

countries financial allocations to the provinces or states are determined by the central legislature, which has effective representation in its upper house from provincial or state governments, legislatures, community councils (in the case of Belgium), or electorates. Variations on this pattern can be found in Austria, Belgium, Germany, Switzerland, and the United States.

Canada employs none of these arrangements. Instead it uses a fourth approach – unilateral action by the central government. The federal government, using its authority under the spending power, determines the level and nature of the financial transfers to provinces unilaterally, sometimes after discussions with the provincial governments. There is no effective provincial government representation in the national legislature, no expert commission, no institutionalized first ministers' council. Canada employs this lopsided system to determine the vast majority of its major financial arrangements, including the equalization formula and tax point and cash transfers to the provinces for a wide variety of purposes.

Canada, then, is unusual, if not unique, in the extent to which the processes it uses for managing intergovernmental fiscal relations are informal, dominated by the central government, and weakly institutionalized. What is more, one cannot find, elsewhere in the Canadian political system, institutions and processes that compensate for this deficiency by fostering integration and by facilitating the productive management of conflict.

The Struggle to Control the Federal Spending Power

This defect in our federal system has been recognized for some time, as can be seen in political and constitutional discussions going back to at least the 1960s. A number of proposals have been made to regulate the use of the federal spending power in areas of provincial jurisdiction, to establish a higher level of stability for federal-provincial agreements, and, more comprehensively, to develop institutions and processes that would provide for more predictable, more orderly, and more balanced relations between the federal and provincial/territorial governments when it comes to managing the business of the federation.

The unsuccessful Victoria Charter of 1971 contained a provision obliging the federal government to give the provinces ninety days' notice before introducing legislation in the policy fields of family, youth, and occupational training allowances. Also, proposals – not ultimately adopted – were made during the Patriation debates of 1980–82 to restrict the exercise of the federal spending power. The ill-fated Meech Lake Accord of 1987 contained a constitutional amendment relating to the federal spending power that would have required the federal government to compensate a province that chose to opt out of a new national shared-cost program in an area of provincial jurisdiction so long as it carried on a program compatible with the national objectives.

The 1992 Charlottetown Accord, which was turned down by Canadians in referendums in October of that year, more or less repeated the spending power provision contained in Meech Lake. It also proposed a mechanism that would

have constitutionally protected designated intergovernmental agreements from unilateral change. Proposed changes to the section of the Constitution relating to equalization included the requirement that the federal government engage in meaningful consultation with the provinces before introducing legislative changes to the system. Finally, the Charlottetown text would have entrenched first ministers' conferences in the Constitution and would also have required the prime minister to convene a meeting at least once a year.

More recently, the Social Union Framework Agreement (SUFA) continued the quest for more balanced and institutionalized intergovernmental practices in the field of social policy. Initiated by the provinces and signed by the federal and provincial/territorial governments (except for Quebec) in February 1999, it addressed the spending power in detail. The SUFA called for the following: federal consultation with the provincial and territorial governments prior to major changes in existing social transfers, and notice provisions for new social transfers; the consent of the majority of provincial governments for any new social transfer initiatives in health care, postsecondary education, social assistance, and social services; flexibility in provincial and territorial implementation of these programs within an agreed-upon accountability framework; and the requirement that the federal government notify the provinces before introducing direct spending initiatives aimed at individuals and organizations in the specified social policy fields.

The SUFA also committed the signatory governments to the principle of dispute avoidance and to the development of a framework for dispute resolution. After pressure from the provinces, the two orders of governments also agreed on a dispute resolution mechanism. Yet after all this, as the Panel's consultations with governments have confirmed, after seven years of existence the SUFA has become a dead letter.

So far, then, Canada's governments have not been able to achieve significant and effective intergovernmental agreement on the control of the federal spending power or on collaborative intergovernmental fiscal arrangements. On several occasions, political leaders have reached important agreements on the spending power and related matters in the context of larger packages of constitutional reforms; but when the larger constitutional packages sank, so did all the proposals. Thus the widely acknowledged deficiency in Canada's federal design remains, as does the intergovernmental conflict it generates.

Yet some modest progress has been made in Canada in recent years, primarily at the provincial/territorial level. The provinces and territories have developed an increasing capacity to work together in an orderly and businesslike fashion, gradually institutionalizing the Annual Premiers' Conference (APC) and increasing the significance of the work these meetings do. This process culminated in December 2003 with the transformation of the APC into the Council of the Federation. The Council's members are the premiers of the provinces and the territories, who make their decisions by consensus. The Council is supported by a steering committee composed of deputy ministers and has a small secretariat in Ottawa. This institution has done much to help the provinces and territories work productively together; but there is no equivalent institution or mechanism that brings the Government of Canada together with its provincial and territorial counterparts.

We would suggest that the lack of progress on governance is the result of three main factors. The first, mentioned earlier, is that several of the reform proposals were advanced as part of more comprehensive packages of amendments, which then failed because of ultimate disagreement among governments or popular opposition, or both. The second factor has to do with the provinces and territories: they find it difficult to reach a substantial agreement about the federal spending power and governance institutions in the federation, given the diversity of their interests and the differing degrees to which they seek to protect their autonomy. The third factor relates to the Government of Canada: it is simply not in the direct self-interest of the federal government to support most of the reform proposals, since they involve limiting its freedom of action with respect to the exercise of the federal spending power.

Why should it be any different this time around? First of all, there is nothing in this Report that suggests or requires constitutional amendment. Everything the Panel thinks should be done can be done by intergovernmental agreement or by the passage of legislation. Second, the growing intergovernmental capacity of the provinces and territories, as exemplified by the creation of the Council of the Federation, could readily serve as the platform on which to build new intergovernmental fiscal institutions with the federal government. Third, the arrival in Ottawa of a new government that acknowledges the reality of fiscal imbalance has provided a fresh opportunity for institutional reform. The long-standing federal resistance to modest structural innovation may be in abeyance for a time.

Recommendations

We make two recommendations here for improving Canada's capacity to manage its intergovernmental fiscal relations effectively.

First Ministers' Fiscal Council (FMFC)

In a parliamentary and federal system such as Canada's, power tends to be concentrated in the executive authority in both federal and provincial governments, making executive federalism the dominant characteristic of intergovernmental relations. The relationships established among first ministers, ministers, and officials provide the channels for managing the business of the federation. In Canada the principal mechanism is meetings between the prime minister and the provincial premiers – First Ministers' Conferences (FMCs) or First Ministers' Meetings (FMMs). That is where we will start in our recommendations.

For years there has been a concern among many provinces and academic observers about the haphazard and casual way in which meetings of the country's most senior leaders are called and conducted. At present, the convening of FMCs and FMMs is at the sole discretion of the prime minister. These gatherings have often been viewed unfavourably by prime ministers as opportunities for the provinces and territories to attack the federal government, preferably on national television.

We believe there is some merit in these reservations, which are often expressed by federal politicians and civil servants. However, we disagree with the usual remedy, which is to hold very few such gatherings and to make them as brief, as small, and as casual as possible – a quick dinner for premiers at 24 Sussex Drive when you absolutely have to, and then get them out of town as quickly as you can. Keep the agenda loose, the discussions private and informal, the presence of officials to a minimum, the record of the discussion non-existent, the link between one meeting and the next obscure. Make no commitment to a future sequence of meetings; do not commission work to be done and brought back to the group, as would be normal with a continuing body. There is a logic to this approach if the federal government's intent is to retain maximum freedom of action to do what it wants with as little restraint as possible.

But it is counterproductive if the goal is to make structural improvements to the way in which the Canadian federation does business. If that is the ambition, then it would be preferable to institutionalize, or normalize, ongoing interactions with provincial and territorial governments in a structured, predictable, businesslike setting in which all participants are encouraged to assume responsibility for their individual actions and for the decisions they make as a collective. This is not a radical or dangerous idea; this is how other federations normally approach their collective affairs.

Proposals to institutionalize FMCs were, in one form or another, part of the 1971 Victoria Charter, the 1987 Meech Lake Accord, and the 1992 Charlottetown Accord, as well as a number of other intergovernmental agreements. For example, this approach was agreed to at the 1985 First Ministers' Conference on the Economy in Regina. It has been advanced by many academics and former practitioners. In fact, Quebec's initial proposal that a Council of the Federation be established called for the prime minister to be a council member as well; this would have in effect made it an institutionalized FMC. We believe, then, that there is an opportunity today to improve the governance of our fiscal arrangements.

Recommendation 7.1

The Panel recommends that the federal, provincial, and territorial governments together establish a First Ministers' Fiscal Council (FMFC) as the principal institution in Canada for dealing with intergovernmental fiscal issues.

The FMFC would be constituted as the summit forum on Canadian fiscal federalism with a mandate to review, discuss, and negotiate the country's fiscal arrangements – that is to say, the health and social transfers, the Equalization program, the Tax Point Adjustment, and any proposed tax point transfer arrangements. This forum would also review proposals for new federal spending in areas of provincial responsibility relating to, for example, student aid, social housing, social assistance, and support to municipalities.

The FMFC would receive and discuss reports from the proposed Canadian Institute for Fiscal Information (CIFI; see below) and would negotiate the fiscal architecture of the federation on that common empirical foundation.

The FMFC would be designed to introduce greater stability and predictability to the process; furthermore, that process would be subjected to rules agreed on in advance. Fiscal arrangements would be clearly established in a stable five-year cycle, with regular periods for renegotiation and renewal, probably starting in the third year. The cycle's operations would include provision for legislative review and input, both in Parliament and in the provincial and territorial legislative assemblies. This would inject an element of executive accountability to the country's legislatures – something that is sorely lacking in the current arrangements. As well, it would make fiscal arrangements far more transparent to citizens.

The FMFC would be the creation of Canada's governments acting together and would be staffed and financed by them. It would be composed of first ministers and co-chaired by the prime minister and the chair of the Council of the Federation.

The first ministers would be supported by their finance ministers, by other ministers as necessary, and by their officials. There would be a small secretariat to manage the council's business. This secretariat could be staffed by seconded federal and provincial civil servants. The FMFC's budget would be generated by proportional levies on all participating governments.

The FMFC would meet annually on a regular schedule, probably in October, after the summer meeting of the Council of the Federation and before the federal and provincial budget cycles commence. The co-chairs would act as its Executive Committee, determining the agenda, reviewing progress on the preparation of materials for upcoming meetings, settling budgetary and administrative matters, and so forth. As with other Canadian intergovernmental forums, the decision-making rule would be consensus, with an option for opting out of specific agreements. Dispute avoidance and dispute resolution arrangements could be built into the council's mandate.

Canadian Institute for Fiscal Information (CIFI)

In the ongoing Canadian debate over finances and responsibilities, each government advances those analyses and data which are most consistent with its own interests and aspirations. Predictably, the numbers do not add up, and the public is utterly confused, because the assumptions on which the numbers are based vary. There is no impartial third party with the role and stature to gather information, undertake analyses, prepare reports, and offer recommendations to all governments on the operations of the system as a whole. These are the tasks that the Canadian Institute for Fiscal Information (CIFI) would perform. For it to be useful, it would have to have buy-in from the governments that created it so that its data and reports would be credible. It would need to supply high-quality, independent data and analyses to inform the process. In the health field, the Canadian Institute for Health Information (CIHI) has already developed a strong reputation for data collection and

analysis, to the benefit of both governments and the public. The CIFI's reports and observations would provide common ground for informed intergovernmental discussion.

Recommendation 7.2

The Panel recommends that the federal, provincial, and territorial governments together establish a new body, the Canadian Institute for Fiscal Information (CIFI).

The CIFI would, at the direction of the FMFC, undertake analyses and gather quantitative information relating to the full range of intergovernmental fiscal arrangements, and produce common data and a common information base on which discussions of policy would proceed. It would also have the capacity to initiate studies with the First Ministers' Fiscal Council's consent. Finally, it could make recommendations to the FMFC relating to the CIFI's central role of providing timely, accurate, and authoritative information about Canada's intergovernmental fiscal arrangements. Its studies and reports would be made public in order to help Canadians understand the fiscal dimension of their federation. It would supply the necessary data and information to support the annual meetings of the FMFC, and it would prepare a major report prior to the commencement of intergovernmental negotiations leading up to the five-year review. Its work would be tabled and considered in Parliament and in the provincial and territorial legislatures in order to foster broader comprehension and engagement among Canadians and their elected representatives.

The CIFI should have a board with members drawn from different regions of the country and from a variety of professional backgrounds and perspectives. This board would be supported by an executive director and a small staff, with provision for the temporary secondment of federal and provincial officials. The CIFI would be established and funded by the FMFC and would be a continuing body.

Role of the Council of the Federation

The Council of the Federation is the most substantial institutional innovation in Canadian federalism in recent memory. This body is strengthening the collective institutional capacity of the federation; as such, its evolution is clearly consistent with the direction recommended by this Report. Provincial and territorial premiers have replaced the Annual Premiers' Conference with a body that is stronger and more capable of playing a leadership role in the federation. Indeed, it is already doing so. With the establishment of a small secretariat to give it administrative support, the council is now able to develop an orderly, predictable work plan that allows it to build consensus and to develop and pursue longer-term policy initiatives. That it has established the Advisory Panel on Fiscal Imbalance is a clear indication that it intends to play a larger role in intergovernmental matters. As its work proceeds and as

the demands placed on it grow, council members may find it useful to develop some guidelines for making decisions instead of simply relying on consensus.

Given what the provinces and territories have accomplished on their own in constructing the Council of the Federation, they are well positioned to initiate a discussion with the federal government on institutional reform. The recognition by the recently elected federal government that fiscal imbalance exists and its announced determination to do something about it present a window of opportunity that ought not to be missed. What is more, Stephen Harper, in his letter of January 12, 2006, to the chair of the Council of the Federation, declared that he intended to begin an era of "open federalism," one that would "involve working more closely and collaboratively with the provinces and the Council of the Federation to develop Canada's economic and social union, to clarify appropriate federal and provincial responsibilities, and to resolve the fiscal imbalance between the federal and provincial-territorial governments."

In a speech in Quebec City on December 19, 2005, Mr. Harper strongly criticized the abuse of the federal spending power, which he saw as a serious threat to the future of the federation. He added: "The fiscal imbalance is not just a budget problem – while a lot of money is involved, the functioning and the very spirit of the Canadian federation are at stake."

The Panel believes that Mr. Harper's "open federalism," which combines mutual respect for federal and provincial jurisdictions with collaboration in areas in which the interests and responsibilities of both orders of government are engaged, is entirely consistent with the governance reforms proposed here.

Implementation

The creation of an FMFC and a CIFI may be a good idea in the abstract, but how would one secure agreement from governments to establish these bodies? And even if the necessary agreement were forthcoming, how – given the experience with the SUFA – could one ensure that these new organizations worked as intended? The autonomy of the governments of the Canadian federation is the main reason why such innovations have not succeeded in the past, and there is no guarantee whatsoever that the same fate would not await any fresh reform proposals. Yet the Panel's terms of reference, which call on it to "review a full range of mechanisms to address fiscal imbalance," suggest that provincial and territorial leaders are ready to consider how they might join with the Government of Canada in managing the fiscal business of the federation more effectively. These proposed institutions could provide an opportunity for collaboration between the provinces and territories and the federal government as they conduct the country's intergovernmental fiscal business. Our proposals speak not to the substance of fiscal federalism, but to its structure and pattern of operation.

The proposed reforms are a particular challenge for the Government of Canada. An FMFC could constrain the federal government's freedom of action. What might encourage the federal government to agree to such a proposition?

- It is realistic to hope that these reforms would achieve better collaboration, rebuild trust, and cool the temperature of intergovernmental debate, and in this way benefit the federal government.
- The proposed institutions would be designed to regulate the behaviour of all the players in the system, including the provinces and territories.
- Citizens consistently declare that they want their governments to get along and to solve Canada's practical problems in a businesslike and orderly way.

Canadians surely know enough now about the way the country manages its intergovernmental fiscal relations to acknowledge that improvements can and must be made. Canada's political leaders have been generally unreceptive to institutional innovation and have appeared reluctant to take advantage of a broad range of available reforms that are non-constitutional. In recent years, however, the premiers have shown the way, by establishing of the Council of the Federation. It is now time to take the next step in strengthening intergovernmental relations in this country. The Panel believes that its two recommendations on governance, if accepted, would provide just that strength.

Chapter Eight

Conclusion

The Council of the Federation established the Advisory Panel on Fiscal Imbalance in May 2005 with a mandate to:

- look at the underlying causes of fiscal imbalance;
- review a full range of mechanisms to address fiscal imbalance; *and*
- make recommendations on ways to restore fiscal balance.

We talked with citizens, political leaders, government officials, and experts in the field. We commissioned studies and a public dialogue. We undertook extensive analyses of our own, modelling different policy alternatives and assessing their impact.

The Report addresses the three elements of the mandate we received from the Council of the Federation. Throughout, we have been guided by the premiers' considered position that fiscal relations in this country need to be guided by clear principles of transparency, accountability, adequacy, predictability, equity, and fairness. We have examined the evolving position of the territories in Confederation. We have discussed the nature, origins, and impact of fiscal imbalance, both horizontal and vertical, and have evaluated the policies that Canada has developed over the years to address them. We have reflected on how these issues are managed and negotiated, and we have concluded that improving the institutions and processes of fiscal governance is as important as fixing the substance of the fiscal arrangements themselves.

The Panel has made four sets of recommendations, each of which bears on an element of our mandate. There are recommendations on the territories (*Chapter 4*), vertical fiscal imbalance (*Chapter 5*), horizontal fiscal imbalance (*Chapter 6*), and governance (*Chapter 7*).

Chapter 4's recommendations relating to the territories are intended to place Canada's three northern territories on a secure financial footing, recognizing that treating Canadians living in the North fairly requires that their special needs and circumstances be addressed. Fairness calls for a twofold approach. First, the fiscal transfer arrangements must be conceived and implemented with the particular needs of Northerners clearly in mind. Second, the capacity of the three territories to develop their own economies must be strengthened and confirmed – in particular, by ensuring that key development decisions are made by Northerners themselves and that the main benefits of the development of natural resources remain with Northern communities.

Our recommendations in *Chapter 5* – to separate out the equalization associated with the 1977 transfer of tax points and to include it along with supplemental equalization in a separate envelope which the Panel labelled "Tax Point Adjustment" would make it possible to separate out equalization from the cash transfer program. The associated equalization and the supplemental equalization implemented by the federal government would now be transparent and would stand alone.

The Panel also recommends strongly that the cash transfer program should be disentangled from the transfer of tax points in 1977 and should be governed by the principle of equal per capita transfers to all provinces. With respect to federal transfer programs relating to health, postsecondary education, and social assistance, where the costs of offering the service are related to the number of people being served, the grants received by the provinces will be linked directly to population size. These equal per capita transfers should be untied from a tax point transfer that was made nearly thirty years ago. This separation of the tax point transfer from equal per capita transfers would end much of the unproductive discussion between the two orders of government regarding how much of the program each government supports. The numbers will now speak for themselves. It will also make any future transfer of tax points clearer and more transparent. This recommendation speaks to the principles of fairness and transparency – principles that Canadians reiterated again and again.

The recommendations in *Chapter 6* on horizontal fiscal imbalance are designed to improve the way the Equalization program works so that it clearly addresses the central principle which gives it life – namely, that provincial governments must be endowed with sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Recent amendments to the Equalization program have moved it away from its original purpose. Our recommendations are designed to bring it back to that central objective. We understand that adherence to principle needs to be set in the context of what is reasonable and affordable. Having ourselves wrestled with the challenge of striking the right balance, we realize that this program will always require periodic review and adjustment. We believe that the changes we recommend in this report will address the principle while meeting the needs of today as effectively as possible. We also feel strongly that the horizontal transfer arrangements can and must be restructured to render them more transparent, fair, and intelligible to all Canadians, and more flexible as circumstances change.

Finally, on governance, we propose two institutional innovations. The first is the establishment of a First Ministers' Fiscal Council that would meet regularly, commission work as needed, and generally develop a stable, ongoing intergovernmental relationship. This in turn would reduce the likelihood of abrupt changes of course, arbitrary actions on either side, and unpleasant surprises. The Panel sees this as a long overdue part of the maturing process of the Canadian federation. Second, the Panel, taking a leaf from the book of the CIHI, the Canadian Institute of Health Information, proposes the creation of a similar body, the Canadian Institute of Fiscal Information (CIFI). The Panel believes that an organization with the credibility to produce authoritative public data and information about Canadian fiscal arrangements would bring real benefits, both to concerned citizens and to their federal, provincial, and territorial governments. For too long, Canadians have lived in an intergovernmental world in which the two orders of government systematically disagree on the facts and on the flows of resources among governments. It is natural in federal-provincial disputes that each side will make the best case it can to Canadians, but this does not excuse the wilful obscurantism of the present system, where, for example, tax points transferred thirty years ago are claimed – or denied – to be a continuing federal contribution to the provinces, and an equalization program introduced into federal accounting was largely unknown to the provinces. The Panel believes that an institute to analyze intergovernmental data could over time establish a shared, authoritative information base to inform public discussions.

While the four sets of recommendations are presented in four chapters, the Panel insists that they are all interrelated. We have tried to make that clear at several points in the Report, but it is worth repeating again. Any significant adjustments in equalization payments will have, in aggregate, an impact on vertical fiscal imbalance. Granting the territories control over their natural resources will affect, in ways no one today can precisely forecast, their position in the Canadian system of inter-regional redistribution. It will also foster the continued evolution of the territories towards a status more closely equivalent to that of their provincial counterparts. And governance affects everything; the process through which agreements are reached matters. The institutions that the Report proposes will shape the approaches that Canadian governments take to the fiscal challenges they face, and will shape the manner in which those challenges are addressed.

There is one final issue we want to speak to here. Some people, reading this report, will say: "Ah, there they go again. The one thing the provinces can agree on is demanding more money from the federal government. And their Panel is running true to form, proposing to raid the federal treasury for billions of dollars." We submit that this argument is mistaken and misguided. Is there a fiscal imbalance? The provinces and territories say there is. The Advisory Panel says there is. And Prime Minister Stephen Harper says there is. Righting the balance by definition involves shifting some financial resources from the Government of Canada to the provincial and territorial governments. Whether we have identified the right amount and described the best means to correct the imbalance will be for the premiers, the prime minister, and Canadians to judge, but the Panel's recommendations should not come as a surprise.

The Advisory Panel has tried to be sensitive to the needs and concerns of the Government of Canada. We believe that we have proposed a set of policy instruments that would allow Canada's political leaders to put the country's fiscal arrangements on a more solid, more intelligible, and more transparent footing. We believe that the principles that shape the analysis in this Report are fair and will be seen as fair by both orders of government and by Canadians. The implementation of the proposed new arrangements would do credit to the national government. The Panel's governance proposals open the door to a much more collaborative and mutually respectful system of intergovernmental relations.

Canada is entering the twenty-first century rich in resources, rich in people, and rich in talent, yet our governments are struggling with a fiscal architecture designed for the last century. Making our fiscal system more transparent and more accountable is an essential first step. So is making our system as fair as possible. We need effective institutions to govern our fiscal system and to enable it to work better. The recommendations in this report are respectfully designed to accomplish these objectives.

Terms of Reference

Purpose

Recognizing that Canada is a federation in which federal, provincial and territorial governments are each responsible for their own respective areas of jurisdiction;

And recognizing the importance of ensuring that there is a balance between each order of government's constitutional responsibilities and its capacity to raise revenue to provide services to citizens;

PREMIERS HAVE AGREED to establish an independent panel to examine the vertical and horizontal fiscal balances among federal, provincial and territorial governments in Canada, and to make recommendations as to how any fiscal imbalances that exist should be addressed.

Mandate

Without limiting the scope of the panel's inquiries, the panel will:

- review the full range of issues that underlie fiscal imbalance;
- review federal programs and policies that affect the fiscal capacity of provinces and territories including, but not limited to, the Equalization program, Territorial Formula Financing, the Canada Health Transfer, the Canada Social Transfer (transfers in respect of postsecondary education and social services) and other major programs, such as transportation infrastructure programs;
- review other mechanisms that affect the fiscal imbalance including, but not limited to, tax point transfers and the realignment of tax fields;
- review options for Equalization for the fiscal year 2006 and beyond, consistent with Section 36(2) of the *Constitution Act, 1982*;
- review options for Territorial Formula Financing for the fiscal year 2006 and beyond, consistent with the principle that territorial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation; and
- review a full range of mechanisms to address fiscal imbalance and make recommendations.

Work plan

Without limiting the scope of the Panel's work, the Panel will:

- directly consult all provincial and territorial governments;
- seek the views of the federal government;
- be authorized to commission relevant research;
- undertake roundtable forums with invited experts in selected centres across the country (number to be determined); and
- take the steps necessary to ensure the performance of its mandate in French and English.

Federal Letter to the Panel

November 28, 2005

Mr. Robert Gagné, Co-Chair
Ms Janice Gross Stein, Co-Chair
The Council of Federation
Advisory Panel on Fiscal Imbalance
1002-350 Sparks Street
Ottawa, ON K1R 7S8

Dear Mr. Gagné and Ms. Gross Stein:

Thank you for your letter of October 3, 2005, inviting us to meet with the Council of the federation's Advisory Panel on Fiscal Imbalance. Unfortunately, we will be unable to meet with the Advisory Panel, but have asked Finance Canada officials to meet with you to convey the Government of Canada's perspective on the issues raised in your paper.

The position of the Government of Canada concerning the so-called fiscal imbalance is well known. The Government does not believe in the existence of a fiscal imbalance between the federal and provincial governments in Canada. Both orders of government have access to all the major sources of tax revenues and have complete autonomy in setting their tax policies to address spending pressures related to their respective responsibilities.

The Government of Canada recognizes, however, the growing fiscal pressures of the provinces and territories and is cooperating closely with them on priorities of Canadians. In this regard, over the last few years, the Government has made important changes to its major transfer programs in consultation with provinces and territories. Examples of this include the 10-Year Plan to Strengthen Health Care, which will provide incremental funding of $41.3 billion over ten years to the provinces and territories, and the New Framework for Equalization and Territorial Formula Financing that will provide $33.4 billion more to Equalization-receiving provinces and the territories over ten years. When recent federal investments in areas such as the New Deal for Communities, a new Early Learning and Child Care initiative are included, the Government of Canada will be contributing over $100 billion in additional funding over the next ten years. Supporting these priorities benefits all Canadians.

In addition to these important investments, the Government of Canada has also provided substantial tax reductions, including $100 billion in tax cuts announced in Budget 2000, and a further $30 billion in tax reductions announced in the 2005 Economic and Fiscal Update. This has reduced federal tax revenues from 17 percent of GDP in fiscal year 2000-01 to an estimated 14.9 percent in 2005-06 and has increased the tax room available to provinces.

While recognizing the fiscal pressures of the provinces and territories, it is important to note that the Government of Canada has significant funding pressures of its own. For example, security and defence, the environment, communities, elderly benefits, strengthening Aboriginal communities, and debt repayment. The Government of Canada's strong fiscal and economic performance of recent years has allowed for significant investments in all of these priorities areas.

The Expert Panel on Equalization and Territorial Formula Financing and the Council of the Federation's Advisory Panel on Fiscal Imbalance are expected to provide their respective final reports in spring 2006. We anticipate that federal, provincial, and territorial governments will have the opportunity for fulsome discussions concerning issues raised by both panels in their final reports.

Thank you once again for inviting us to meet with the Advisory Panel. Please be assured that the Government of Canada will continue to work in partnership with provinces and territories to enhance the quality of life for all Canadians.

Yours sincerely,

Ralph Goodale Lucienne Robillard

Citizens' Dialogue on Sharing Public Funds for a Better Canada

Executive Summary

Judy Watling, Judith Nolté, Mary Pat MacKinnon

March 2006

The Citizens' Dialogue on Sharing Public Funds for a Better Canada is an initiative of the Advisory Panel on Fiscal Imbalance established by the Council of the Federation led by Canada's Premiers. At the request of the Advisory Panel, Canadian Policy Research Networks (CPRN), an independent national not-for-profit think tank, led a dialogue with Canadians to seek their views on how best to share public funds between the federal and provincial governments to allow each to provide quality services to citizens; invest in future growth; and improve competitiveness.

Participants and Methodology

Ninety-three randomly selected Canadians participated in professionally facilitated day-long regional dialogue sessions in Halifax, Toronto, Montreal, Edmonton, and Vancouver in December 2005. A national session, involving 21 participants drawn from the regional sessions (reflecting a diversity of backgrounds and perspectives) was held in January 2006 to further explore issues that emerged from the regional sessions. A participant workbook described the dialogue process, laid out the ground rules for dialogue and provided key facts and background on the sharing of public funds between the federal and provincial governments. This background included: current positions of governments on vertical and horizontal imbalance (with an explanation of these terms), seven principles currently at play in transfer programs, an overview of four approaches (see Chart 1) used by the federal government to share funds and two case studies used in the dialogue (access to postsecondary education as an example of vertical imbalance and the Equalization program as an example of horizontal imbalance).

Four Approaches to Sharing Public Funds	Chart 1
Approach 1: Provinces / territories get tax points	
Approach 2: Provinces / territories get federal cash transfers without conditions	
Approach 3: Provinces / territories get federal cash transfers with conditions	
Approach 4: Federal government provides more direct spending to citizens and institutions	

In the opening session, participants completed a pre-questionnaire designed to rank their individual support for each of the four approaches. Working in plenary with the aid of a facilitator and supported by policy experts, participants discussed the four approaches to sharing funds, identifying what they liked and disliked

about each approach and why. They agreed on their common ground and differences, probed tensions among competing values and determined the tradeoffs that they were prepared to make. Through this process they identified the values and principles that they want to see guide the sharing of funds in Canada. In the second part of their dialogue, they moved into small pre-selected groups to further discuss, in the context of the two case studies, the possible approaches to transfer funds, applying the values that they had identified. They then reconvened in plenary to report back and explore common ground and differences. Before concluding with their individual key messages to decision makers, participants completed the post-questionnaire to again rank the four approaches.

Values and Principles

Chart 2 synthesizes the values and principles that emerged from the regional sessions and which were reinforced in the national session. Participants are looking to decision makers to be guided by these values as they negotiate the terms for sharing public funds.

	Chart 2
Fairness	• Promote shared national standards / goals to ensure the 'same acceptable standards' for all Canadians
Access	• Canadians deserve access to the same acceptable level of service across the country • Support mobility of people to move across the country
Transparency & Accountability	• Promote greater trust of governments • Measure progress and report to Canadians • Enhance accountability between governments and to citizens • Provide a process to ensure citizen input
Sustainability	• Embrace a long-term vision for Canada • Provide continuity of services across changes in government • Ensure affordability
Efficiency	• Collaborate to avoid duplication, reduce waste and share best practices • Coordinate services across provinces • Remove interprovincial barriers • Enable skilled newcomers to work in their field • Improve Canada's competitiveness

Participants' Advice to Decision Makers

The following five points summarizes participants' advice to decision makers.

1. Create a national vision and define the same acceptable standards for all Canadians

- Replace the notion of minimum standards with 'same acceptable standards'.
- As all Canadians are equal, essential programs and services must be accessible regardless of jurisdiction.
- Common standards for essential services such as education and health help to strengthen our competitive position in the global market.
- Canadians are mobile and want to be able to move across the country to pursue education and jobs or to retire without facing barriers.
- Provinces can move beyond the acceptable standard if that is where their populations choose to invest resources.
- Provinces should exercise their authority within a common framework of services across the country, recognizing the need for provincial flexibility to tailor programs to meet specific needs.

2. Define the vision and standards in a collaborative way

- It is the responsibility of the federal government, working in close collaboration with the provinces/territories, to articulate and implement a national vision and standards. This does not mean giving the federal government free rein.
- Include all levels of government, citizens and stakeholders in developing the vision and standards
- Governments need to move beyond outmoded territorialism and collaborate on programs to reduce inefficiencies and duplication of effort.

3. Set standards first and then determine the transfer formula

- The Equalization program is an important and necessary part of fair federalism but it is not the best vehicle to address the growing horizontal imbalance.
- The current fiscally-driven formula should be replaced with one that is driven by what we want to achieve. We need to focus on outcomes rather then inputs.
- Affordability and avoiding increases in our national and provincial debt are important and must be considered when designing mechanisms to achieve new standards.

4. Preference for conditional transfers in addressing fiscal imbalance

- This is a better and fairer way to achieve the 'same acceptable standards' across Canada while giving provinces some flexibility in how to best meet the needs of their citizens.
- Improved monitoring against standards and transparent reporting will provide Canadians with better tools to hold governments to account for how public funds are spent.

5. Support direct federal spending with some conditions

- This approach is well suited to help address the special needs of both individuals and institutions.
- Direct federal funding facilitates mobility and portability for individual Canadians.
- Some conditions should apply (e.g. institutions to report in a transparent way what has been achieved with funds spent; students must successfully complete their program).

CPRN Observations

The dialogue results demonstrate that Canadians from a wide variety of backgrounds can understand these complex issues and determine what is most important to them in making decisions for designing how we share public funds in Canada. The strong message that Canadians have an appetite to become more involved in thinking through how best to deal with these challenging issues as a country should be encouraging for all governments.

In addition to the clear advice from dialogue participants, CPRN offers the following observations on the dialogue results:

Pan Canadian perspective: Participants' thinking isn't limited to their geographic location in deciding on how to best share funds. Their sense of Canada is broad and they don't want barriers to inhibit their movement whether for school, work or retirement. Transfer programs should support a stronger, more competitive Canada which will benefit all regions.

Desire for politicians to focus on the best interests of citizens: Jurisdictional arguments that prevent progress in addressing the needs of Canadians are a source of real frustration to people. Participants are looking for politicians to promote a long-term vision that can move beyond the rigidities of the Constitution to address today's realities.

Trust and accountability are both part of the problem and part of the solution: If trust in governments is to increase, we need better accountability mechanisms that proactively engage the public in choosing meaningful indicators and the means to assess progress in ways that will influence future actions.

Start with what we want to achieve as a country: Participants took to heart the constitutional commitment to 'reasonably comparable services at reasonably comparable rates of taxation'. But they want the design of transfer programs to first reflect what we want to achieve as a country and then to assess what each province needs to attain the desired standards.

There is an opportunity for leadership: Moving ahead, there is a tremendous opportunity for all governments to work together to shape a national agenda through collaborative efforts to develop common standards for key social and economic policies. The Council of the Federation is well positioned to exercise leadership in developing a vision and standards as a way to stop the steady decline in public confidence in their governments, but it will require governments to think beyond their own provincial borders and work in the best interests of all Canadians.

In essence, this representative group of citizens has provided the roadmap for governments to rebuild public trust.

Addressing Canada's Fiscal Imbalance

Issues and Questions, September 2005

Introduction

The Council of the Federation was created by the governments of the provinces and territories in 2003, to build a more constructive and cooperative federal system through new forms of intergovernmental collaboration and coordination. It was formed on the basis that Canada's two orders of government are of equal status, neither subordinate to the other; each sovereign within their own areas of jurisdiction, and each having adequate resources to meet their responsibilities. Accordingly, the Council believes that addressing Canada's fiscal imbalance is critical to ensuring a strong, well-functioning federation that meets the current and future needs of all Canadians.

The Council of the Federation has established an independent Advisory Panel on Fiscal Imbalance to examine the vertical and horizontal fiscal balances among federal, provincial and territorial governments in Canada, and to make recommendations as to how any fiscal imbalances that exist should be addressed.

In doing so, the Panel will examine the current health and social transfer system, the Equalization program, Territorial Formula Financing, and other major federal transfer programs to provinces. The Panel will study mechanisms aimed at redressing the fiscal imbalance, including improvements to the Equalization program and the Territorial Financing Program, tax point transfers and realignment of tax fields, and others.

The Panel will be consulting all provincial and territorial governments as well as seeking the input of the federal government. It will consult academic and public policy experts in the fields of fiscal federalism and fiscal imbalance. It will commission original research & data to ensure a strong research and analytical base to its work. Interested persons and groups will be invited to provide the Panel with their views on this important issue.

The Panel will report to the Council by March 2006.

Context

The Council of the Federation has defined fiscal imbalance in this manner:

> **Vertical fiscal imbalance** refers to a gap between revenue sources and spending responsibilities between orders of government. It means that one order of government collects more tax dollars than it needs to support its responsibilities, crowding out the ability of the other order of government to raise the revenue it needs to fund its responsibilities.

Horizontal fiscal imbalance refers to the differences in the ability of provinces/territories to raise revenues to meet the needs of their citizens. It means there is some disparity in the ability of individual provinces and territories to deliver comparable, high quality services.

As part of its consultation with provincial/territorial governments and others, the Panel is interested in considering fiscal imbalance within the broader issue of our fiscal arrangements overall in Canada today. Addressing the fiscal imbalance requires a consideration of what it means, how it affects Canadians and their governments, and determining solutions to resolve it for the future.

Accordingly, the Panel is interested in hearing from the provincial/territorial and federal governments generally on:

- what they mean by "fiscal imbalance", and to what extent there now exists vertical and horizontal fiscal imbalances;
- what they believe the consequences will be if vertical fiscal imbalance is allowed to persist and perhaps even to enlarge;
- what the implications to Canada are of a potentially growing horizontal fiscal imbalance;
- what specific economic and social challenges Canada faces in the future that will be affected by the fiscal imbalance;
- what approaches are most promising in addressing vertical and horizontal fiscal imbalance, ensuring economic prosperity and social progress for Canadians, and will result in a stronger, more effective federation.

Vertical Fiscal Imbalance & Vertical Fiscal Gap

Addressing the vertical fiscal imbalance requires a consideration of the concept of vertical fiscal gap. Every federation has what is called a vertical fiscal gap (as distinct from vertical fiscal imbalance) between the central and provincial or state governments. It is a function of the degree of centralization of revenue-raising capacity and decentralization of expenditure responsibilities.

A vertical fiscal gap exists when the central government has greater revenue-raising authority or fiscal capacity than necessary to meet its expenditure responsibilities, while the provincial governments have less revenue-raising authority or fiscal capacity to meet their corresponding expenditure responsibilities. Transfers from the federal to the provincial/territorial governments are then put in place specifically to bridge this fiscal gap. The larger the vertical fiscal gap, the larger the amount of transfers required to fill it. If federal transfers are sufficient to bridge this gap, then there is no vertical fiscal imbalance. If not, then a vertical fiscal imbalance does exist.

One characteristic of a vertical fiscal gap is centralized revenue-raising capacity. This can be viewed as beneficial in a federation because it allows the federal government to pursue certain national and regional policy objectives by giving it sufficient fiscal capacity to raise revenue from across the country and redistribute it to provincial governments and individuals to meet various national and regional equity goals. It also creates for greater tax harmonization across the country, making revenue-raising more efficient and less costly for

taxpayers. Similarly, it can result in greater economic efficiencies and fewer economic distortions leading to an enhanced economic union.

A second characteristic of a vertical fiscal gap is decentralized expenditure responsibilities. This is viewed as beneficial because it allows these governments to better respond to locally inspired needs, priorities, values, and approaches but – most importantly - with sufficient revenue to do so.

Under this concept fiscal imbalance exists when intergovernmental transfers are too small to fill a vertical fiscal gap. If too small, then provincial/territorial governments are forced to do one or more of three things:

1. run budgetary deficits and therefore increase public debt;
2. raise taxes;
3. cut expenditures.

There are important consequences of any and all of these actions to a jurisdiction's ability to provide quality public services to people, invest in future growth and development, and enhance competitiveness.

What is ultimately at question, therefore, is what should be the optimal vertical fiscal gap in a federation such as Canada? It is both a value-based question revolving around the type and extent of a "sharing community" citizens want and will accept, and a political question as to how it is practically determined between two orders of government.

For its part, the federal government has indicated that there is no vertical fiscal imbalance because both orders of government have access to all important sources of revenue, and each government decides on its own how much to spend, and how much to tax. Those governments who believe they have insufficient revenue to fund their expenditure responsibilities may raise taxes or generate revenue on their own accord based on their own determination of need. The Panel is interested in the views of governments on this position and the extent and implications of provincial/territorial tax increases that would result. This will help determine the extent of the vertical fiscal imbalance in Canada today and the feasibility of mechanisms to address it.

Fiscal Imbalance & the Constitution

The Constitution Act, 1982, provides an important context when considering issues of fiscal imbalance and fiscal federalism. There are four main aspects:

1. Division of powers between the federal and provincial/territorial governments, the expenditure responsibilities that go with these powers.
2. Federal spending power, the type and range of transfers made through it to provinces and territories, and any rules or mechanisms surrounding its use.
3. Equalization under Section 36(2) with the ongoing commitment by Parliament and the government of Canada to the principle of making equalization payments to provinces "...to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

4. Implied redistribution under Section 36(1) with the references to both orders of government being committed to "(a) promoting equal opportunities for the well-being of Canadians (b) furthering economic development to reduce disparity in opportunities; and (c) providing essential public services of reasonable quality to all Canadians."

Mechanisms to Address Fiscal Imbalance

The Panel's mandate includes instructions "to review a full range of mechanisms to address fiscal imbalance and make recommendations." Generally speaking, three possible mechanisms to alleviating fiscal imbalance exist:

1. Increase federal transfers to provincial/territorial governments. Envisioned here is an expansion of payments to provincial and territorial governments, either through larger unconditional grants, or through new or larger specific-purpose transfers, or both.

2. Decentralize fiscal authority to provinces/territories. Fiscal decentralization increases the fiscal resources ("own-source revenues") available to provinces and territories, relative to those of the federal government. There are two possible ways of doing this. One is to transfer certain tax fields, in their entirety, to the provinces and territories. A second means of decentralizing fiscally is to share revenues from joint tax fields in a different way, allocating to the provinces and territories a larger share of major taxes (e.g. tax point transfers as was done in 1977).

3. Increase federal direct spending. "Federal direct spending" refers to direct federal spending aimed at reducing the fiscal burden on provincial and territorial governments. This could take the form of the federal government assuming responsibility for provincial/territorial expenditures in a given policy or program area (catastrophic drug coverage, for example).

The Panel is interested in hearing from provincial/territorial governments on which mechanism, either singly or in combination, would best address the fiscal imbalance.

The Prosperity Imperative

Underlying the design of fiscal arrangements, and policy choices on the subject of reducing fiscal imbalance, is what might be called "the prosperity imperative". Our fiscal arrangements as a country should contribute to a more prosperous Canada and greater economic and social well-being for Canadians wherever they live. Shortfalls in relation to meeting this prosperity imperative – a growing, internationally competitive economy – reduces the potential for generating wealth that allows governments to meet important equity and fairness goals achieved in part through fiscal redistribution. This means that attention must be paid to the limits of taxable capacity across Canada as a whole and in each of the provinces and territories individually. Similarly, our fiscal arrangements should not act as a constraint on development; rather they should encourage investment and competitive capacity in key areas of future economic success and social progress.

Four Challenges

Four main challenges are apparent in considering changes to Canada's fiscal arrangements:

First, providing quality public services to Canadians. Do the current fiscal arrangements help ensure people receive quality public services where they live that are reasonably comparable to those received by all other Canadians?

Second, sharing and redistributing wealth fairly and efficiently. Do the current fiscal arrangements redistribute wealth fairly and efficiently across the country?

Third, reducing regional economic & social disparities. Do the current fiscal arrangements help reduce economic and social disparities for Canadians across the country?

Fourth, striking the right balance between shared purpose & diversity. Do the current fiscal arrangements help encourage governments to work well together on behalf of all Canadians, help us achieve important national goals, yet respect and encourage the essential diversities and differences founded in the initial Confederation bargain of two orders of government of equal status, neither subordinate to the other, and each sovereign within their own areas of jurisdiction?

The Panel is interested in provincial/territorial governments' views on these four challenges and the role of fiscal arrangements in meeting them.

Questions

The following questions are set out as a guide to assist governments in providing the Panel with information and comments on meeting each of the challenges listed above.

Providing Quality Public Services to Canadians

1. Which of the three main mechanisms to address fiscal imbalance noted earlier would be most effective (either singly or in combination) in ensuring provinces and territories are able to provide quality public services: increasing federal transfers, decentralizing fiscal authority to provinces and territories, or increased direct federal spending?
2. Which specific federal transfers should be increased and to what extent? Should new transfers be considered and, if so, what kind?
3. Which form of fiscal decentralization would be more effective: transferring whole tax fields to the provinces and territories or allocating a larger share of joint fields (such as PIT) to the provinces and territories? How would this affect horizontal fiscal imbalance?
4. What kinds of direct federal spending should be considered, in which priority areas, and under what conditions? Could any provincial/territorial programs be "uploaded" to the federal government and under what circumstances?
5. How can stability and predictability in federal transfers be more assured?

Sharing and Redistributing Wealth Fairly and Efficiently

1. What are the main issues and concerns of the New Framework for Equalization for your jurisdiction?
2. Should the current five-province standard be changed to a ten-province standard and, if so, how should this be defined?
3. Is the current Representative Tax System (RTS) an effective measure of a province's revenue capacity? What alternative measures, such as macro indicators, should be considered instead? Should expenditure need be considered as a factor in determining fiscal capacity and if so, how?
4. To what extent should natural resource revenues be considered when determining a province's fiscal capacity and its equalization entitlement? What kind of distinction should be made between renewable and non-renewable resources?
5. What is the appropriate balance between redistributing wealth for national sharing and generating that wealth in those economic sectors and regions necessary for our future competitiveness and prosperity?

Reducing Regional Economic and Social Disparities

1. What changes to the fiscal arrangements are required to more effectively reduce regional economic and social disparities across Canada, and what indicators of progress should be used?
2. To what extent is the current Equalization program fulfilling the Constitutional commitment as set out under Section 36(2) and how could this be measured?
3. Should the Equalization program and Territorial Formula Financing be modified or restructured to become the only mechanism for redistributing wealth and reducing regional economic and social disparities across the country?

Striking the Balance between Shared Purpose and Diversity

1. Do the current fiscal arrangements encourage governments to work together, yet still respect and encourage the essential diversities and differences that formed the basis of the original Confederation bargain, which provides for two orders of government with equal status, neither subordinate to the other, and each sovereign within its own areas of jurisdiction?
2. To what extent should asymmetrical arrangements be adopted under fiscal arrangements to meet differing provincial and regional priorities, needs, and circumstances?
3. What has been the effect of the federal spending power in recent fiscal arrangements for provinces and territories, and what rules or mechanisms should be placed around its use?
4. Are there new mechanisms that should be considered, or existing ones that could be more effectively deployed (such as SUFA), for encouraging federal/provincial/territorial coordination, extending horizontal cooperation among the provinces and territories, sharing information among governments, and shaping future changes on an ongoing basis to Canada's fiscal arrangements?

Territorial Formula Financing (TFF) & the North

Canada's Territorial Formula Financing is the principal source of revenue for the three territories. Economic opportunities and social needs in the North are quite different from the rest of Canada. As well, there are important differences between each territory; in their populations, economic potential, and state of infrastructure. Population centers are widely dispersed with less than 50,000 people in each territory. Aboriginal peoples make up a significant portion of the territories' overall population.

TFF is an arrangement of federal cash transfers to territorial governments aimed at allowing them to offer their residents basic services which are reasonably comparable to those available to other Canadians, taking into account the territories' spending requirements and the higher costs of delivering public services in the North. Distinct from the Equalization Program, however, TFF is based on an approximation of expenditure need for each territory.

In 2005–06, TFF will pay out approximately $2 billion to the three territories. This represents between 71 percent and 86 percent of territorial revenues. As part of the "New Framework" and similar to Equalization, TFF grants will grow at 3.5 percent per year. Individual territories will now receive fixed shares, as determined by the relative sizes of the grants each territory received over three fiscal years from 2001–02 to 2003–04. A future allocation formula will be determined later by the federal government.

1. What is the most important economic and social development issues facing governments and residents in the three northern Territories?
2. What is the prospective fiscal capacity of each of the territorial governments?
3. Does TFF, as currently designed, meet the particular needs and situation in each of the three Territories?
4. To what extent does the TFF act as a constraint on economic development and investment?
5. What are the implications of the New Framework for TFF in terms of future revenue growth and the ability of the Territorial governments to meet public service needs and invest in future development?
6. Are the definitions of expenditure need, gross expenditure base, and eligible revenues in the TFF appropriate?
7. How should the question of transferring control over non-renewable resources for the territories be addressed?

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Expert Roundtable on Fiscal Imbalance, November 21-23, 2005

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