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| Federal Provincial Fiscal Transfer Relations |
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| **This paper addresses direct transfers of monies from the federal government to the provinces. The current federal-provincial-territorial fiscal transfer system is haphazard, uncooperative and destined to create continuing strife among jurisdictions. It is on a wobbly cliff, to use U.S phraseology.** |

**Federal-Provincial Fiscal Transfer Relations**

**1. Introduction**

Any federal system of government requires a significant amount of cooperation between the orders of government to function satisfactorily. There is no more important extant area between the federal government and the provinces than fiscal transfers. This paper addresses direct federal fiscal transfers from the federal government to the provinces; direct transfers of monies to individuals is not a subject here, albeit certainly relevant to the absolute personal needs and security of Canadians. The current federal-provincial-territorial fiscal transfer system is haphazard, uncooperative and destined to create continuing strife among the jurisdictions. In U.S. phraseology, it is on a cliff, a very wobbly one.

The major transfers are the following: The Canada Health Transfer(CHT), Canada Social Transfer(CST) and the Equalization Program. Other transfers such as Labour Market Training etc. should be noted , but are insignificant in terms of dollars relative to the aforementioned programs. The need for such transfers has always been obvious: provinces lack the fiscal means to carry out the constitutional responsibilities due to their citizens in provinces’ critical jurisdictional fields(mainly health care, education, and social services).

Metamorphosis is normally a term limited to the scientific world of insects, animals and plants. The changing of one thing into another is always a marvel: cocoon to butterfly, polliwog to frog, seed to sunflower. There is a certain order to such changes and evolution usually works very slowly, except maybe for bacteria and viruses.

Such is not the case with fiscal transfers in Canada. Changes have often been made willy-nilly and without the consent, and sometimes even consultation, of the provinces. They are conditioned by a centralist logic in Ottawa based on personalities and financial coffers, but always motivated by the political arena and ultimately re-election. Winning, after all, is the ultimate raison d etre of any political party in power.

There is a distinct motivation on the part of the federal government to limit fiscal transfers as a means of increasing its own taxation largesse. This can then be distributed as it sees fit. Put simply, transfers to provinces do not create visibility and credit. Direct transfers to individuals and institutions through existing and new programs get noticed.

Of course, ballooning federal deficits and accumulated debt during recessions drive a significant portion of the federal economic agenda. In bad economic times, when revenues fall precipitously, pleas from provinces that their cost expenditures are often inelastic (health, for example), fall on deaf ears.

The fiscal transfer system in Canada for health, post-secondary education and social services has no long term stability or evolution to it. It has morphed from a cost-shared system in the mid-fifties(a dollar raised=a dollar received) to a block-funded system in 1976-77(no conditions on transfers for Health and Post-secondary education- Established Programs Financing(EPF) and the Canada Assistance Plan (CAP), to a cap on CAP, to the more recent Canada Health Transfer(CHT) and Canada Social Transfer, a block-fund which under Prime Minister Martin at least guaranteed stable six percent yearly increases in funding for ten years ending in 2014.

With absolutely no negotiations with provinces and only superficial consultations, the federal government, under Prime Minister Harper, has limited growth in the CHT from 2016 to nominal GDP growth(economic growth, including inflation). Growth in this transfer could be as low as 2% yearly even though health care expenditures continue to advance at least 6% in some provinces.

The separate Equalization Program, now ensconced in the Constitution Act 1982, provides no conditions on funding for those provinces deemed unable to provide comparable services to their citizens at comparable rates of taxation. It is a straight transfer from the Consolidated Revenue Fund of the federal government to eligible provinces. The program started in 1957 and has always been geared to what the federal government Finance Department thought the government could afford, rather than the needs of the receiving provinces. In other words, Equalization formulae have been based on an exercise in fiscal manipulation. Quebec has persistently had a dominant impact on negotiations as it always receives well over half of national Equalization payments due to population, even though on a per capita basis Quebec receives much less than a province such as Prince Edward Island. The latest redo of the program has reduced the sources of revenue to five, includes all provinces and determines amounts given according to the original national average standard. The program has always been about jigging the revenue amount available to satisfy federal budgetary decisions. Courchene unabashedly states, “...equalization has resumed its unenviable state as an accident waiting to happen.” ( Policy Options May 2010 p.38) But it has been no accident. It has been about the failure of successive federal governments, Liberal and Conservative, to engage in serious negotiations with provincial governments about fiscal capacities and consequent needs.

 **2.Vertical Imbalances**

The following chart shows the distribution of federal transfers to provinces and territories for the fiscal years 2011-2014 as adapted from the Department of Federal Finance: (fin.gc.ca/fedprov/mtp-eng.asp)

|  |  |  |  |
| --- | --- | --- | --- |
| **$Billions(rounded)**  | **2011-2012**  | **2012-2013**  | **2013-2014**  |
| Canada Health Transfer(CHT)  | $26.9  | $28.5  | $30.3  |
| Canada Social Transfer(CST)  | $11.5  | $11.8  | $12.2  |
| Equalization  | $14.6  | $15.4  | $16.1  |
| Territorial Financing  | $2.8  | $3.1  | $3.3  |

The amounts transferred seem staggering(around $62 billion for 2013-2014) but, put in the context of own source provincial revenues garnered and spending required, the sums are paltry.

After all, the marquis financing deal in 1976-1977 under Established Programs Financing entailed 50-50 spending for health and post-secondary education. As well, the Canada Assistance Plan paid dollar for dollar funding of social services. There was a sense of stability in the transfer system and provinces did well by it until the federal government made systematic financing changes beginning in 1982 which always ended in reduced growth, and sometimes year over year reductions, in payments to the provinces. Reduced fiscal transfers were occurring at the same time as national health care expenditures were accelerating by double digits yearly.

Perhaps 1995 marked the nadir year in relations between the federal government and the provinces with respect to fiscal transfers. As part of the process of addressing its own growing budget deficits, Ottawa unilaterally reduced transfers significantly. This, of course, resulted in financial instability in provincial expectations, making their budgetary decisions trying. Transfers were cut in excess of $5.7 billion from 1996-1998 (Budget papers 1997.B.C. Report G CHST)and , as Courchene has noted, this was more an exercise in the “federal savings power” rather than anything else. (Reflections on the Federal Spending Power-IRPP Working Paper no. 2008-01, June 2008,p.16)

In a May 2005 media backgrounder, the Council of the Federation described the fiscal imbalance between the two orders of government this way: “ Vertical fiscal imbalance refers to a gap between revenue sources and spending responsibilities....it means one order of government collects more tax dollars than it needs...crowding out the ability of the other order of government to raise the revenue it needs to fund its responsibilities."

Acrimonious federal-provincial fiscal relations, a series of unilateral changes since 1982, and a total mismatch of constitutional responsibilities versus fiscal capacity to carry out those responsibilities have all played a part in effecting a very discordant confederation in Canada. In an apparently futile attempt to address these serious issues, in 2006, an Advisory Panel on Fiscal Imbalance produced a report to the Council of the Federation(Premiers and Territorial Leaders) entitled, **Reconciling the Irreconcilable**. The title itself is foreboding and suggests an “oxymoronish” outcome. Indeed, nothing has been reconciled and the Harper government refuses to meet with Premiers to discuss this central issue of confederation, even as he made time in early 2013 to meet First Nations leaders for an entire day.

 As the following table demonstrates, federal fiscal transfers are only a small portion of total provincial revenues in most provinces:

 **Federal-Provincial Transfer Data**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Provinces  (All numbers rounded)  | Federal Transfers ($B) (2011-2012) 1. | Revenues ($B) 2. | Transfers As % of Revenues  | GDP By province ($B) 3.  | Transfers as % of GDP  | Federal Transfers as % total CHT, CST, Equalization Payments ($54.9 Billion) (2011-12) | Population by Province (M)(2012)4. | Transfers per capita ($)  |
| BC  | 5.3  | 42  | 13  | 217  | 2  | 10  | 4.62  | 872 |
| Alberta  | 3.4  | 39  | 9  | 296  | 1  | 6  | 3.9  | 872 |
| Saskatchewan  | 1.2  | 11  | 11  | 75  | 2  | 2  | 1.08  | 1111  |
| Manitoba  | 3.4  | 14  | 24  | 56  | 6  | 6  | 1.27  | 2677 |
| Ontario  | 17.4  | 110  | 16  | 655  | 3  | 32  | 13.5  | 1289  |
| Quebec  | 17.2  | 65.5  | 26  | 346  | 5  | 31  | 8.05  | 2137 |
| Nova Scotia  | 2.6  | 8.6  | 30  | 37  | 7  | 5  | 949  | 2740 |
| New Brunswick  | 2.5  | 8  | 31  | 32  | 8  | 5  | 756  | 3309  |
| PrinceEdward Island  | .5  | 1.5  | 33  | 5.3  | 9  | 1  | .146  | 3427  |
| Newfoundland  | 1.1  | 8.3  | 13  | 34  | 3  | 2  | .513  | 2144 |

1.Federal Support to Provinces and Territories, Dept. of Finance 30/10/12

2.Data provided by Public Accounts each province and assembled by Dept. of Finance(2012)

3.Stats. Canada , CANSIM Table 384-0038(2011)

4.Stats. Canada, CANSIM Table 051-0001 (2012)

At the low end, transfers only represent 9% of Alberta's revenues; at the high end a significant 33% of PEI's revenues. Clearly, a wealthy province like Alberta does not receive nearly its percentage share of transfers as most other provinces. This may change if oil and natural gas prices stay low. It's as if some provinces get a whole cake and some get a cupcake!

 Another indicator of reliance is the relationship of federal transfers to GDP. Alarmingly, in five provinces, transfers amount to a negligible 1% to 3% of GDP. The column on federal transfers as a % of total transfers is indicative of the disparities among the provinces. Ontario and Quebec garner 63% of transfers, close to their percentage of population, while British Columbia and Alberta account for only 16% even though their share of total population is 24.3%, 50% less than their share of population.

The final column reveals Transfers per capita($). In 2011-2012, British Columbia and Alberta received $872 per capita, while the average per capita transfer was $2058. Clearly, most of the difference in federal transfer shares is due to the Equalization Program, although Alberta, Ontario and B.C. have been shortchanged in CHT and CST calculations as one time tax points(the EPF tax transfer in 1977) are calculated prior to the cash component. This irritation finally gets rectified in 2014.

There is indeed a dramatic fiscal imbalance, given that provinces and territories are responsible for funding the most important spending fields of health, education and social services. As an example, Alberta is spending about $16.6 billion on health care in 2012-13 but only receives $2.3 billion in federal fiscal transfers or about 14% for this program area. Under the original Established Programs Financing Agreement 1976-1977 the province received roughly 50%. This dramatic decline in federal financing is yet another indicator of dysfunction in the federation; there can be no “reconciling the irreconcilable” without a fundamental reordering of the taxpayer system.

This historical offloading of the federal deficit onto the provinces has, of course, resulted in increased provincial deficits and debt in most provinces since 1982. Cooperative fiscal federalism disappeared in that year. Animus could well have been expected with unilateral federal decision-making and “going through the motions” non-negotiations.

In the Report to the Council of the Federation cited above, provinces cited the following concerns about the state of fiscal federalism:

1.The realities of provincial expenditure pressures and inadequacy of financial arrangements to meet provincial needs;

2. The unwarranted use of the federal spending power in areas of exclusive provincial jurisdiction, disregarding provincial priorities and placing additional financial pressures on provincial governments;

3. The lack of mechanisms for dialogue and the ad hoc nature of intergovernmental relationships and arrangements. (Reconciling the Irreconcilable p.32)

 The federal government has abandoned its original commitments due to its own perceived financial pressures, needs, responsibilities and political agenda. There is no doubt that the federal government is responsible for some key areas, including foreign affairs and defense, the treasury, critical direct transfers to citizens, including OAS, GIS etc. And addressing federal debt issues is a persistent concern. However, it needs to be pointed out that the Harper political decision to reduce the GST to 5% from 7% costs its consolidated revenue fund about $14 billion yearly. Even if half of those monies had been plowed back into fiscal transfers would have gone far in reducing the pressures on provinces' constitutional responsibilities, particularly health care and education.

 **3. Redressing the Imbalance**

Nonetheless, provinces’ expenditure responsibilities for health , education, social services, seniors, infrastructure, municipalities and so on far outstrip the federal government’s own responsibilities. Federal-provincial fiscal relations are only likely to become more disharmonious without substantive changes transferring adequate taxpayer dollars commensurate with provincial responsibilities.

There are only a few means to realize such a transfer. 1. Cost-sharing arrangements (a dollar spent in a province results in an additional dollar received); 2. Block-fund (as per the CHT and CST arrangements where there are few or no conditions); 3. Tax transfer(where the federal government cedes tax room to the provinces and the provinces swallow up this room so that the taxpayer is left in virtually the same situation as before except more goes to provinces). As an illustrative example, dropping the Goods and Services Tax rate to 5% from 7% left open room for some provinces to occupy that room and increase their provincial sales taxes.

The only scenario which results in a permanent transfer over which future federal governments would have no control is the last one. But is it a possibility that a federal government would transfer tax room again? No. The major transfer of tax room (13.5% personal income tax points and 1% corporate tax room) as part of the 1976-77 Fiscal Arrangements is very unlikely to recur. Even though the provinces simply received back a portion of what they gave up to the federal government during WWII, the federal governments own financial requirements and recession cycles have partially dictated its federal-provincial fiscal transfer decisions.

Moreover, and much more importantly, transfers of tax room would loosen the power of the federal government to direct provincial spending decisions. Tax transfers automatically equate to less control and the federal government understands this well. By definition, any federal government perceives itself as an overseer of the federation. This means central direction and nationally imposed programs.

But the stubbornness of holding on to extra tax room even though the provinces constitutional responsibilities clearly require such room are stressing the federation to the point of fiscal transfer meltdown. This vertical imbalance is unsustainable.

 **4. Horizontal Imbalances**

Another central part of the problem of fiscal transfers is that there is a horizontal fiscal imbalance in the Canadian federation as vividly expressed in the above chart as analyzed. A horizontal imbalance, unlike the artificial , vertical one, is endemic to any federation where wealth is distributed totally disproportionately according to the available revenue sources of each unit. These include personal income taxes, corporate taxes, sales taxes, natural resource revenues and a myriad of other sources, including lottery revenue, tobacco taxes, gas taxes etc. This is essentially what each province produces and the consequent income garnered.

The Equalization Program is the principal means of rectifying such balances but the program, as noted, is ad hoc and subject to the whims of the Department of Finance. Other means of rectifying the imbalance, while appropriate or not, include disparate Employment Insurance requirements from province to province and various programs to address regional disparities, which, after all, is also included in the Constitution Act, 1982.

Currently, all provinces except B.C., Alberta, Saskatchewan and Newfoundland receive equalization payments. Alberta has not received payments since the mid-60‘s and Newfoundland is a recent addition to the “have” club due to its offshore oil. Ontario is a recent addition to the “have not” club, even with its over powering manufacturing base relative to all other provinces. Saskatchewan has drifted in and out of equalization entitlements, but its natural resource base would seem to ensure its non-receiving status.

Issues arise both between 1) equalization receiving provinces versus non-receiving provinces as well as 2) among the receiving provinces themselves. As to the first situation, Alberta and now B.C. and Saskatchewan are arguing that its taxpayers are indirectly over- equalizing to the receiving provinces. It is important to note that the Equalization Program is solely a federal program; monies are transferred directly from its Consolidated Revenue Fund to the eligible provinces. Transfers are absolutely not from the treasuries of have provinces to have not provinces.

The argument that over-equalization prevails is that some of the receiving provinces have, as an example, more doctors, nurses and teachers per capita than the ‘donor’‘ provinces. Alberta has never pressed this issue very far in finance venues when the equalization program is up for re-negotiation for obvious reasons: No province wants to appear to be greedy, particularly Alberta which for many, many years has had a fiscal capacity per capita far in excess of any other province. Nonetheless, doubts are now being raised about the amounts of equalization being divvied out yearly. Alberta has generally taken the high road, the better part of valour. However this is a systemic source of dysfunction and is likely to be exacerbated now that Ontario qualifies and receives substantial payments.

The Constitution Act, 1982 entrenches equalization payments. The problem is that what is in the Act bears no causal relationship to what is paid out. The key condition in the act, providing ‘reasonably comparable services at reasonably comparable rates of taxation’‘, is nebulous. What counts as reasonably comparable services? All provinces are different in terms of their requirements and needs. If Quebec decides to have a cadillac day care system, and Alberta opts to provide significantly more benefits to its senior citizens, then does that mean that ALL provinces should be provided with the financial means to support such programs? Should equalization be used to fund extra programs, such as Quebec's? Is there any way to establish criteria to match comparable services with comparable rates of taxation?

The equalization gnomes in Ottawa may very well be able to compute or manipulate the meaning of comparable rates of taxation at the front end, but are severely ill-equipped to determine comparable services at the delivery end. Those decisions are made in the provinces based on citizens needs and their own political agendas.

There are also issues among the receiving provinces. There is a general feeling that Ontario should not be entitled to Equalization because its per capita personal income tax is higher than other receiving provinces(Ontario was eliminated before when just such a proviso was placed into the formula). Various transition arrangements for Newfoundland and Labrador and Nova Scotia have strained relations with some other receiving provinces. It is a fixed pot and if more goes here than there, then some are going to get less. Saskatchewan has certainly made arguments that it has been adversely affected through such arbitrary changes. Haggling over limited federal dollars for equalization payments may work delightfully to the benefit of the federal government; divide and conquer is stone age power politics and economics, for that matter. It does little to keep the federation together.

There is one other way to look at inflows and outflows. This is essentially what flows out of each province and what comes back to it in terms of fiscal transfers etc. The following table, adapted from Mansell and Schlenker, illustrates the point perfectly:

 Total and per capita fiscal balances(1961-1992)

|  |  |  |
| --- | --- | --- |
| **Province** | **Balances(1994 dollars ,billions)** | **Per capita**  |
| *B.C* | -6.1 | -11 |
| Alberta | 139 | 2.1 |
| Saskatchewan | -36 | -1.2 |
| Manitoba | -50 | -1.5 |
| Ontario | 45 | 183 |
| Quebec | -168 | -803 |
| New Brunswick | -63 | -2.9 |
| Nova Scotia | -95 | -3.5 |
| Prince Edward Island | -15 | -3.9 |
| Newfoundland | -56 | -3.2 |

(Robert Mansell and Ronald Schlenker, The Provincial Distribution of Federal Fiscal Balances,Canadian Business Economics, Winter 1995, p. 6

Their work is eye-popping, brilliant and has never been contested. While the data is dated, it indicates the extent of the imbalances in this federation. Between 1961-1992 Alberta has been a net contributor of $139 billion while Quebec has been a net receiver of $168 billion. Only Alberta and Ontario have been net contributors to the federation during this period. No doubt, the NEP period added to these numbers substantially, but the fact remains that Alberta is the big revenue lifter within Canada and this is causing rifts within the nation. The continuing net contributions from the big "giver" provinces does not auger well for the federation ,if indeed, economics is a large determiner of political futures.

 **5.Conclusions**

The fiscal transfer cliff in Canada has little to do with a lack of federal revenues. It is a system that is broke because the provinces lack the fiscal capacity to carry out their critical constitutional responsibilities in the major spending areas of health , education and social services(over 80% of total expenditures in some provinces). That the federal government is prepared to go over the cliff to satisfy and satiate its own obfuscated agenda is telling. Canadians are slowly, but surely, losing their most cherished social programs and they may not always understand why. As the Caledon Institute put it recently, "Canada is no longer a practicing fiscal union, at least in respect of using fiscal federalism to mitigate fiscal imbalance."( "Is Canada (still)a Fiscal Union" Michael Mendelson, Caledon Institute of Social Policy, 2012,p.7)

Harold Lasswell`s 1940 U.S. Political Science classic, "Who Gets What, When, How,`` is as appropriate today as ever. Politics, indeed, is largely about the distribution of economic goods and power. Canada is no exception to this concept, even if it seems self-serving and greedy. There is a power struggle to obtain access to tax revenues.

 The problems with Canada's fiscal transfer system are numerous: 1. There is no **transparency** to the system as only a small cohort of federal and provincial finance officials have a real understanding of it, particularly the Equalization Program. 2. There is no **accountability** to the public largely due to the first point. 3. There are no **negotiations**. A full negotiations process, resulting in the typical five year agreement, has been replaced with a partial consultative process.4. **Vertical inequities**(the unwillingness of the federal government to address the fiscal imbalance between its revenues and provincial constitutional responsibilities). 5. **Horizontal issues**(who is over and under compensated).

That none of these issues is being addressed at all does not bode well for the future of Canada. After all, economic matters do have an overpowering reach within this country on everything else.