HOUSE OF COMMONS
CANADA

STANDING COMMITTEE ON FINANCE

THE EXISTENCE, EXTENT AND ELIMINATION OF CANADA'S FISCAL IMBALANCE

Report of the Subcommittee on Fiscal Imbalance

Yvan Loubier, M.P.
Saint-Hyacinthe—Bagot, Québec
Chair of the Subcommittee

and

Vice-Chair of the Standing Committee on Finance

June 2005

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Available from Communication Canada — Publishing, Ottawa, Canada K1A 0S9

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THE STANDING COMMITTEE ON FINANCE

has the honour to present its

THIRTEENTH REPORT

Pursuant to its Order of Reference of Tuesday, November 2, 2004 and pursuant to Standing Order 108(1), a subcommittee of the Standing Committee on Finance was established to study the question of fiscal imbalance and to propose tangible solutions for addressing it.

The subcommittee examined the subject matter, as charged, and agreed to present the following report to the Committee, entitled: *The Existence, Extent and Elimination of Canada's Fiscal Imbalance.*

Your committee has adopted this report, which reads as follows:

House of Commons
Canada

Tuesday, November 2, 2004

EXTRACT,--

BUSINESS OF SUPPLY

At 6:15 p.m., pursuant to Order made Thursday, October 28, 2004, the House proceeded to the taking of the deferred recorded division on the motion of Mr. Loubier (Saint-Hyacinthe—Bagot), seconded by Ms. St-Hilaire (Longueuil—Pierre-Boucher), — That this House regrets the attitude of the Prime Minister of Canada at the First Ministers' Conference on October 26, 2004, and that it call on the federal government to recognize the existence of a fiscal imbalance in Canada and that, to this end, the House ask the Standing Committee on Finance to strike a special subcommittee to propose tangible solutions for addressing the fiscal imbalance, and that its report be tabled no later than June 2, 2005.

The question was put on the motion and it was agreed to on the following division: YEAS: 165, NAYS: 128.

ATTEST

Audrey O'Brien

Acting Clerk of the House of Commons

House of Commons
Canada

Tuesday, May 31, 2005

EXTRACT,--

MOTIONS

By unanimous consent, it was ordered, — That, notwithstanding the Order made Tuesday, November 2, 2004, the Standing Committee on Finance be authorized to present its Report on the study of fiscal imbalance by Friday, June 17, 2005, instead of Thursday, June 2, 2005.

ATTEST

Acting Clerk of the House of Commons

FOREWORD BY THE CHAIR

The Subcommittee on Fiscal Imbalance had the mandate to determine whether there is a nationwide consensus on the existence of this dysfunction in the federal fiscal system, to measure its size and consequences, and to propose long-term corrective measures to ensure that the provinces/territories have sufficient financial resources to carry out their constitutional responsibilities.

To this end, the Subcommittee held a number of hearings in Ottawa, crisscrossed the country, and welcomed a wide range of witnesses at its hearings, including provincial government representatives, ministers and premiers, academics, union representatives, business people and private citizens. The Subcommittee also received analyses and opinions from witnesses who were unable to appear in person. I would like to thank all these witnesses for taking part and for their excellent contributions.

I would also like to thank all my fellow members of the Subcommittee on Fiscal Imbalance for their diligent and unbiased work, the quality of their contributions and their tremendous tact, which has enabled us to carry out our work in perfect harmony, itself a sign of their great ability as parliamentarians. These members are Rona Ambrose of the Conservative Party, Judy Wasylycia-Leis of the New Democratic Party, Don Bell of the Liberal Party of Canada and Guy Côté of the Bloc Québécois.

I would also like to commend the Clerk of the Subcommittee, Richard Dupuis, and his entire team for being so professional, pleasant, efficient and patient, as well as the fine analyses and opinions offered by Alexandre Laurin and June Dewetering of the Library of Parliament's Parliamentary Information and Research Service, the admirable work of the interpreters and all those who contributed to the success of the undertaking.

And it has undeniably been a success.

I am proud to present to our fellow citizens from Quebec and Canada a majority Subcommittee report containing four key recommendations to correct the fiscal imbalance. This consensus report also includes supplementary opinions from the Bloc Québécois, the Conservative Party and the NDP, as well as a dissenting opinion from the Liberal Party, the only party that denies the existence of a fiscal imbalance.

An initial consensus clearly emerges in light of the analysis presented in this report. In the members' opinion, there is a vertical fiscal imbalance, which means that the provinces/territories have insufficient resources to offer basic services to their citizens, such as health care, post-secondary education and social services. Conversely, the financial capacity of the federal government greatly exceeds its

responsibilities, resulting in budgetary surpluses every year. In the meantime, most of the provinces/territories are in a deficit situation or are facing spending pressures that could quickly lead to a deficit.

The Subcommittee is also of the opinion that there is a horizontal fiscal imbalance, which means there are inequalities among the provinces/territories as to their ability to offer comparable services right across the country, with comparable fiscal power. The members also agreed that this imbalance cannot be corrected by the outdated Equalization formula, whose principles were in fact flouted last fall by the solution imposed on the provinces.

This fiscal imbalance is not static. It changes over time according to the provinces'/territories' socio-economic needs and parameters (demographics, aging population, change in economic conditions, …). For this reason, the Subcommittee considers it absolutely essential that this problem be included on the agenda of the Standing Committee on Finance so its evolution can be tracked over a three-year period, as the Committee does in its regular work on various matters, and that this be done in cooperation with the Council of the Federation. The purpose of this review would be to prevent critical problems in the future with the underfunding of public services and to prevent serious dysfunction in the system such as can be observed today.

In the Subcommittee's opinion, the federal government concludes piecemeal agreements and specific agreements with the provinces that serve to exacerbate the horizontal fiscal imbalance.

Finally, the Subcommittee proposes a way to gradually correct the vertical fiscal imbalance while maintaining a balanced budget policy. This solution involves, first of all, restructuring the Canada Social Transfer by creating two separate federal transfers: one for post-secondary education and one for social assistance and social services.

Once this restructuring has been completed, the Subcommittee is of the opinion that each transfer should be increased over four years, as is the case with federal health transfers. This is, in fact, what the Romanow Report recommended with respect to federal health transfers. According to the members of the Subcommittee, this solution would provide a means to correct the vertical fiscal imbalance for a number of years.

Although I am pleased with the major consensus we reached on these matters, as Chair I would have liked to see the members support three supplementary recommendations which would in a way have closed the loop to achieve a more lasting solution. Unfortunately, this support was not forthcoming.

There is no doubt in my mind that the Subcommittee's majority recommendations represent progress in the debate on the fiscal imbalance. I therefore invite the federal

government, and anyone else interested in this important matter — including the Council of the Federation — to draw on our work. The fruit of our labour is now in your hands.

Yvan Loubier, MP for Saint-Hyacinthe—Bagot, Québec
Vice-Chair of the House of Commons Standing Committee on Finance
Chair of the Subcommittee on Fiscal Imbalance

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INTRODUCTION

In February 2005, the Subcommittee on Fiscal Imbalance of the House of Commons Standing Committee on Finance commenced cross-Canada public hearings on the vital issue of the fiscal imbalance — vertical and horizontal — within the Canadian federation. The Subcommittee began its study assuming that both types of fiscal imbalance exist in this country, and that they must be corrected for the benefit of the single taxpayer. There is, after all, only one taxpayer, who pays taxes to both orders of government and rightfully expects high-quality public services from them.

For many — if not most — provinces/territories, the ability to provide the high-quality public services expected by Canadians is compromised by rising fiscal pressures. Many of these pressures result from areas in which public service costs are growing most rapidly, notably health care, but also in other areas that are under the exclusive constitutional jurisdiction of the provinces/territories. At the present time, federal transfers to the provinces/territories are insufficient to allow them to provide the services their residents expect, and they are unable — for a variety of reasons — to increase tax rates. Provinces/territories are, in essence, being squeezed: rising costs for public services on the one hand, and an inability to raise taxes to finance these rising costs on the other hand.

The Subcommittee believes that there is an urgent need to revisit current federal-provincial/territorial fiscal arrangements, and to take the actions needed to rebalance the federation. Action must be taken now for taxpayers: they want, and deserve, high-quality public services from both orders of government. Action must be taken for governments: they should be able to fund the public services that are within their constitutional responsibilities without imposing unduly high taxes. These actions must address both the vertical and horizontal fiscal imbalances that exist in Canada, and should ensure that the resulting fiscal arrangements respect the following principles: adequate, sustainable, equitable, efficient, transparent, accountable, and consistent with constitutional responsibilities.

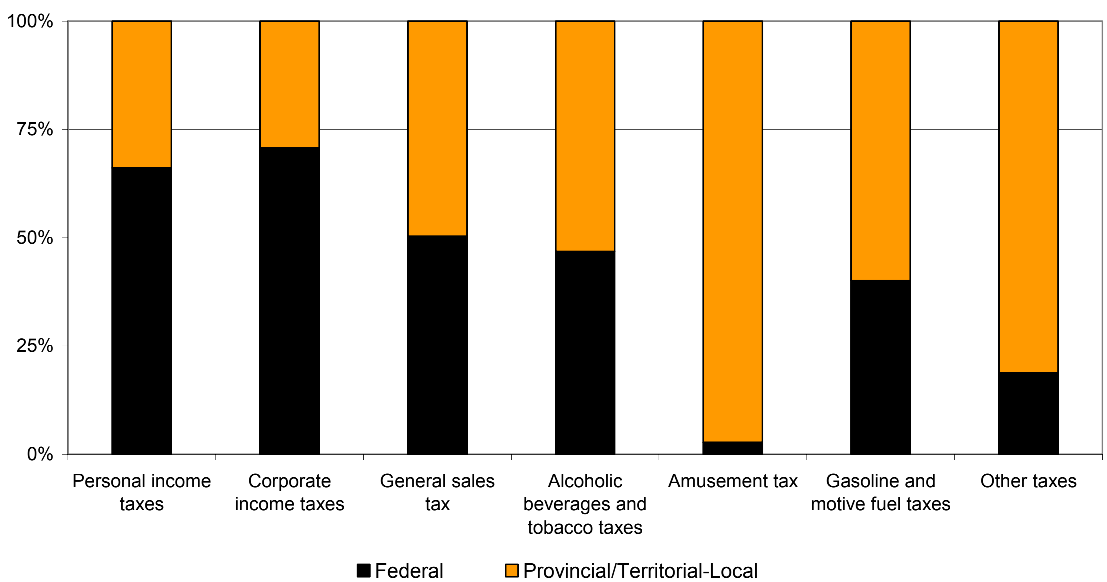
This report summarizes the range of views presented to the Subcommittee by witnesses across Canada. They spoke about the vertical and the horizontal imbalance, and shared with us their thoughts about the existence and extent of, as well as solutions to, these imbalances. It is our hope that, building on the recommendations made by witnesses, the solutions proposed by us in our recommendations will — once implemented — result in the changes needed to rebalance the federation for the benefit of the single taxpayer.

TAXES PAID AND TRANSFERS MADE: WHAT AND HOW MUCH?

A. The Types and Value of Taxes Collected

Federal and provincial/territorial governments have access to many of the same sources of revenue: personal income taxes, corporate income taxes, sales taxes and payroll taxes. Each jurisdiction has complete autonomy in setting its own tax policy in each of these areas. In addition, the provinces/territories have exclusive access to resource royalties within their jurisdiction, gaming and liquor profits and property taxes (municipal taxation). Moreover, the federal government has exclusive jurisdiction over customs import duties and taxes on non-residents.

CHART 1
Distribution of Tax Revenues from Shared Tax Bases between Orders of Government, Fiscal Year 2003-2004 (%)



Note: Personal income tax figures adjusted for Québec abatement.
Sources: Statistics Canada; computations by the Library of Parliament.

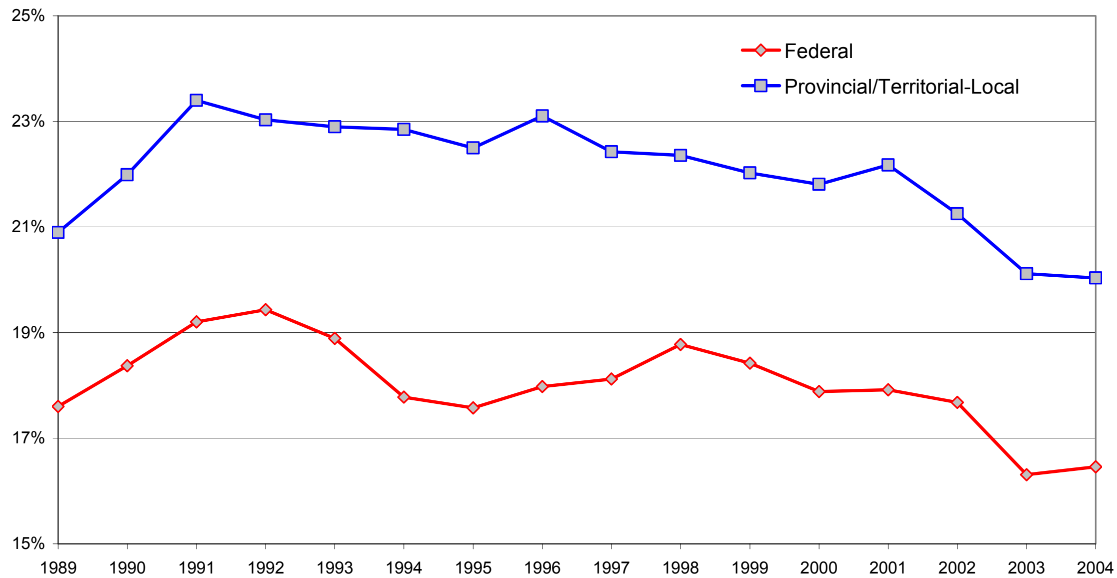
Chart 1 shows that, in 2003-2004, the federal government collected about 66% of total personal income taxes, approximately 71% of total corporate income taxes, roughly 50% of total general sales tax, and just under 50% of total alcoholic beverages and tobacco taxes in Canada. Provincial/territorial and local governments, on the other hand, collected approximately 97% of total amusement tax, about 60% of total gasoline and motive fuel taxes, and roughly 81% of revenues from any remaining shared tax bases.

The chart does not show tax revenues that are exclusively collected by either the federal government or provincial/territorial and local governments. As noted

earlier, these exclusive tax bases include taxes on non-residents and customs import duties for the federal government, and property-related taxes, natural resources taxes and licences for provincial/territorial and local governments.

When the revenues from all tax bases are considered, both those that are shared and those that are exclusive to each jurisdiction, the allocation of revenues between the two orders of government was essentially equal in 2003-2004.

CHART 2
Own-Source Revenues as a Percentage of GDP,
Fiscal Years 1988-1989 to 2003-2004

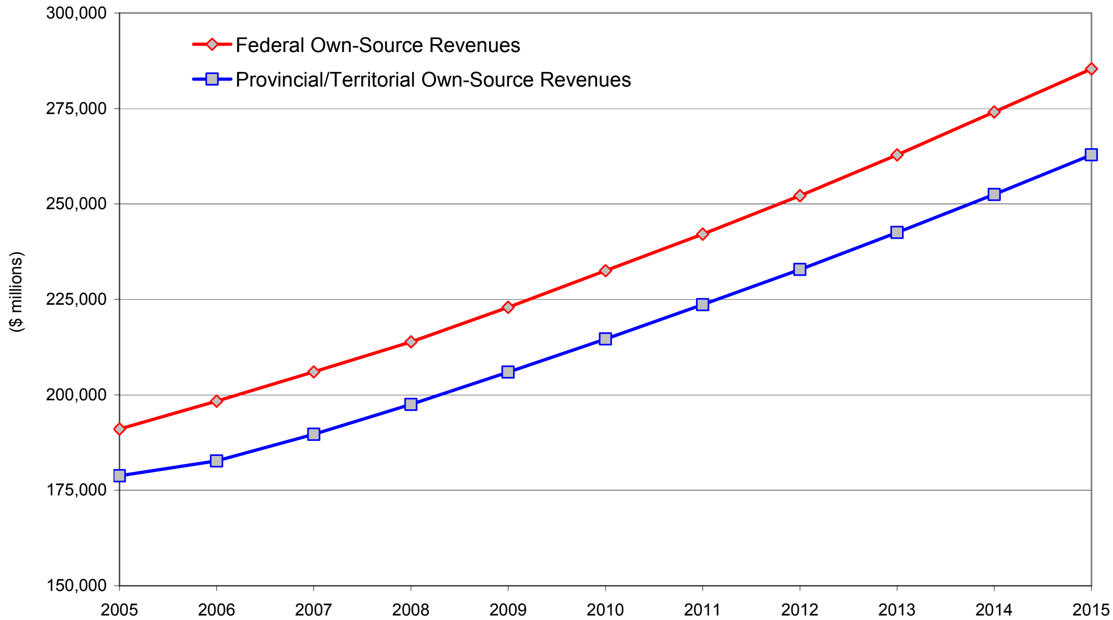


Note: Personal income tax figures adjusted for Québec abatement.
Sources: Statistics Canada; computations by the Library of Parliament.

Chart 2 shows own-source revenues (i.e., revenues excluding transfers) for the federal government and provincial/territorial and local governments, respectively, as a percentage of gross domestic product (GDP) over time. Between 1988-1989 and 2003-2004, this ratio has varied for both orders of government. The chart reveals that while federal own-source revenues as a percentage of GDP remained between 16% and 20% over the 1988-1989 to 2003-2004 period, own-source revenues of provincial/territorial and local governments averaged 4 percentage points higher than the federal ratio over the period.

The difference between the federal government and provincial/territorial and local government own-source revenues as a percentage of GDP is almost entirely the result of the own-source revenues of local governments, primarily derived from property and related taxes. If local government own-source revenues are excluded, the ratios for the federal government and provincial/territorial governments converge.

CHART 3
Projections for Federal and Provincial/Territorial Own-Source Revenues, 2005 to 2015



Source: Appendix A, Tables 2 and 3, *Fiscal Prospects for the Federal and Provincial/Territorial Governments*, The Conference Board of Canada, Update August 2004.

Chart 3 shows projected growth in federal own-source revenues and in provincial/territorial own-source revenues over the next 10 years. The chart reveals that the revenues of the two orders of government are expected to grow at a relatively similar rate, although federal revenues are predicted to increase at a slightly greater rate over the 2005-2015 period. Since the provincial/territorial forecasts are presented on an aggregate basis, the experience of individual provinces/territories will vary.

B. The Types and Value of Federal Transfers to the Provinces/Territories

1. Equalization and Territorial Formula Financing

The Equalization program and Territorial Formula Financing (TFF) are designed to correct horizontal fiscal imbalances. The purpose of the Equalization program is to reduce fiscal inequities among the provinces by increasing the revenues of the less wealthy provinces. To achieve this goal, unconditional federal payments are made to recipient provinces in order that they can offer relatively comparable public services without having to levy excessively high taxes. The Equalization program is renewed every five years to ensure the integrity of the formula on which payments are based.

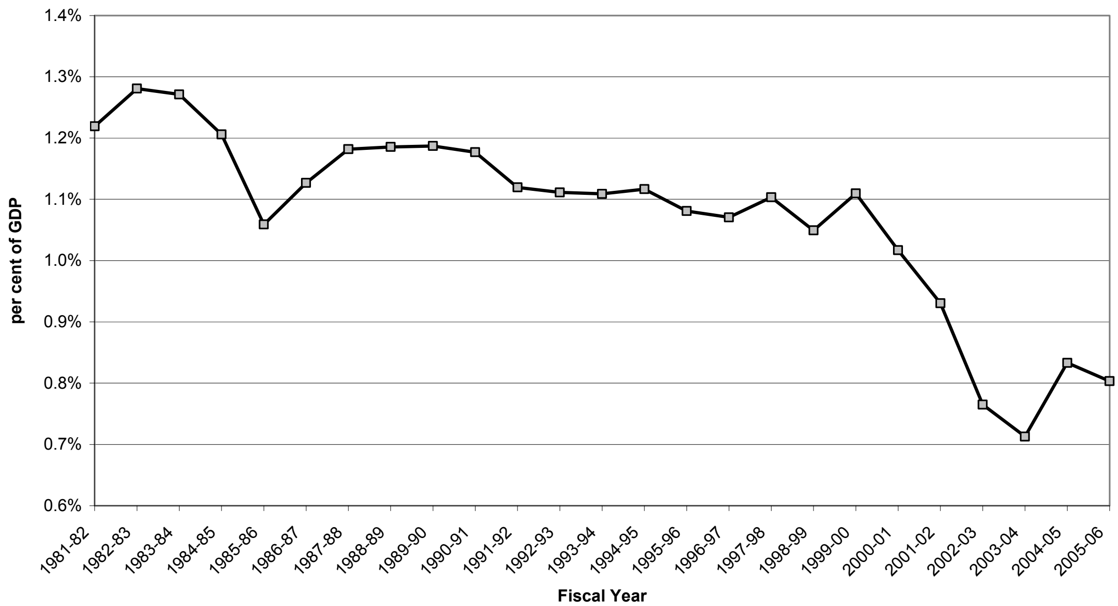
The territories are involved in Territorial Formula Financing, through which they receive unconditional federal grants. The fiscal capacity of the territories, as well as the higher costs and unique circumstances in Northern Canada, are considered. Like the Equalization program, a review occurs every five years.

The first formal Equalization program was introduced in 1957. At that time, the program consisted of equalizing provincial per capita fiscal capacity for three tax bases — individual income tax, corporate income tax and succession duties — to the average of the two wealthiest provinces, Ontario and British Columbia. Consequently, all provinces except Ontario, which was the wealthiest province, were eligible for Equalization payments.

Over time, the Equalization program has gradually become more complicated. Since 1967, the measurement of provincial fiscal capacity has been based on the Representative Tax System (RTS). The RTS applies average tax rates to various revenue sources in the Equalization formula to assess a province's potential fiscal capacity without being influenced by provincial fiscal policy decisions. The number of revenue sources has increased over time from 16 to the 33 sources presented in Appendix A.

From 1967 to 1982, the estimated fiscal capacity of each province was compared to the national average, or what is known as the ten-province standard. In 1982, the federal government excluded Alberta and the Atlantic provinces from the standard, with the result that the standard is now the average fiscal capacity of the five remaining provinces, which is known as the five-province standard.

CHART 4
Total Equalization Entitlements as a Percentage of Gross Domestic Product (GDP), Fiscal Years 1981-1982 to 2005-2006

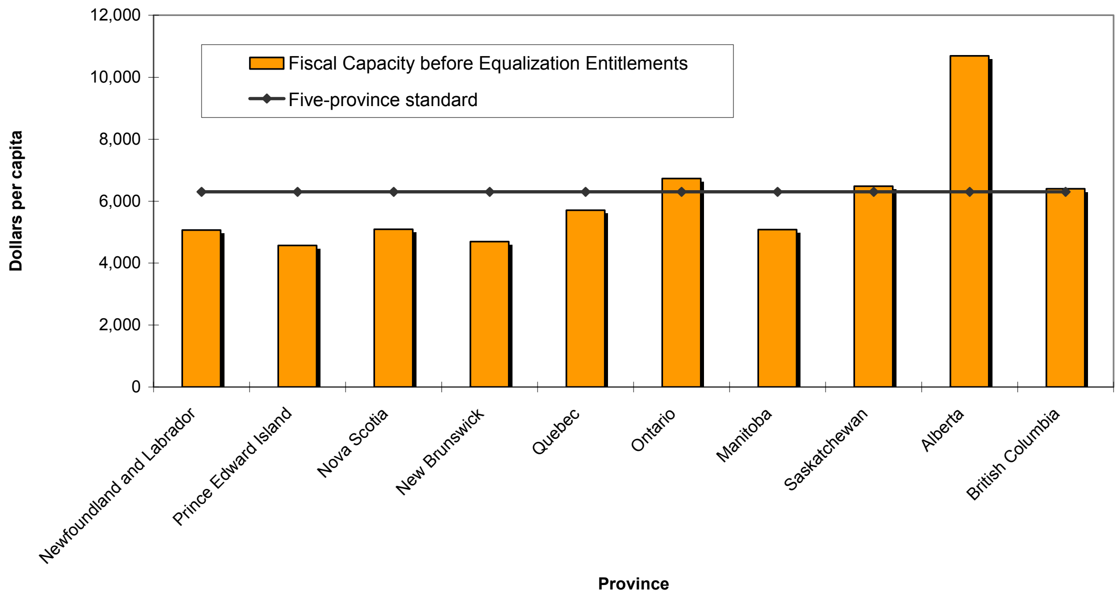


Sources: Department of Finance and Statistics Canada; computations by the Library of Parliament.

Chart 4 shows total Equalization entitlements as a proportion of GDP from 1981-1982 to 2005-2006. Equalization entitlements as a proportion of GDP started a downward trend in 1982 when the fiscal capacity of Alberta and the Atlantic provinces were excluded from the calculation of the Equalization standard. The decline has been particularly abrupt since 2000. In general, this downward trend may be the result of three factors:

- a steady reduction in provincial fiscal disparities (i.e., the economy and tax bases of the recipient provinces have grown relatively more than that of non-recipient provinces);
- reductions in provincial tax rates; and/or
- changes in the Equalization formula and policies.

CHART 5
Disparities in Provincial Fiscal Capacities Before Equalization Entitlements, Fiscal Year 2004-2005



Data source: Submission by Professor Courchene of Queen's University to the Subcommittee on Fiscal Imbalance of the House of Commons Standing Committee on Finance on 4 May 2005.

Chart 5 shows the disparities in provincial fiscal capacity as estimated by the current Equalization formula. Fiscal capacity varies relatively widely among provinces and, to a certain extent, among regions of the country. The provinces in Atlantic Canada, for example, have a fiscal capacity ranging from about $4,500 to $5,000 per capita, while Ontario's fiscal capacity is about $6,700 per capita and that of Alberta exceeds $10,500 per capita. The figures in the chart do not, however, reflect the new Equalization framework adopted in October 2004, which has moved away from strict application of the Equalization formula to determine the Equalization entitlement for a particular province. As well, agreement has been reached on Equalization entitlements for 2004-2005 and 2005-2006.

The legislation to implement the new Equalization and Territorial Formula Financing framework reached by First Ministers in October 2004 received Royal Assent in March 2005. According to this framework, "[o]ver the next 10 years, and subject to a review after five years, the new framework provides $33 billion more in Equalization and TFF payments to the provinces and territories than the annual amounts for 2004-2005 that were estimated in the February 2004 budget."[1] The aim of the new framework is to guarantee increasing, stable and predictable funding to recipient provinces/territories.

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1 Department of Finance, "Minister of Finance Tables Legislation Implementing New Equalization and Territorial Formula Financing Framework," News Release, 23 November 2004. Available at: http://www.fin.gc.ca.

Specifically, for 2004-2005, the framework:

- sets total Equalization payments at a minimum of $10 billion and total TFF payments at a minimum of $1.9 billion, which represents an increase of about $600 million over the total Equalization and TFF payments estimated in the February 2004 federal budget and an increase of about $1.2 billion over October 2004 estimates; and

- guarantees that Equalization and TFF entitlements will be no lower than the levels predicted in the February 2004 federal budget for individual provinces and territories.[2]

For 2005-2006 and beyond, the framework:

- sets the Equalization and TFF payments to the provinces and territories for 2005-2006 at $10.9 billion and $2 billion respectively; and

- provides that the aggregate Equalization and TFF payments to the provinces and territories will increase annually by 3.5% over the immediately preceding year, starting in 2006-2007.

Also, the framework establishes an independent advisory panel of experts to provide advice on how the Equalization and TFF payments determined in the new framework should be allocated in 2006-2007 and beyond. In particular, the review will, among other things,

- evaluate the current practices used to measure fiscal disparities among provinces and territories;

- examine alternative approaches, such as those based on aggregate macroeconomic indicators (e.g. GDP, disposable income) or expenditure needs;

- review the evolution of fiscal disparities among the provinces, and the costs of providing services in the territories, to help governments and citizens evaluate the overall level of support for Equalization and TFF; and

[2] Based on October 2004 estimates, the provinces of Saskatchewan and British Columbia would trigger this individual protection, representing about $774 million in total additional Equalization payments.

- advise whether the federal government should establish a permanent independent body to advise it on the allocation of Equalization and TFF within the framework of legislated levels.[3]

Moreover, the advisory panel will address unresolved issues related to both the allocation of Equalization payments among provinces and the treatment of provincial natural resource revenues in the Equalization formula.

On 28 January 2005, the federal government reached an agreement with the provinces of Nova Scotia and Newfoundland and Labrador that would ensure that these provinces would be entirely protected against offshore oil and gas revenues triggering reductions in Equalization payments. Previously, the Canada-Nova Scotia Offshore Accord and the Canada-Newfoundland Atlantic Accord — which were signed in the mid-1980s — included provisions to offset some of the reductions in these provinces' Equalization payments that would otherwise occur as offshore revenues increased. The legislation to implement these agreements — Bill C-43 — is currently being considered by Parliament.

The January 2005 agreement with these two provinces extends until 2012, with a possible extension to 2020. The federal government agreed to provide an up-front payment of $2.0 billion and $830 million, respectively, to Newfoundland and Labrador and Nova Scotia. It is expected that the agreement would provide, over time, approximately $2.6 billion to Newfoundland and Labrador and $1.1 billion to Nova Scotia in total offset payments.

Offshore oil and gas revenues also benefit from the "generic solution" treatment in the Equalization program, an ongoing measure that was introduced in 1994. The generic solution provides 30% protection to Newfoundland and Labrador and Nova Scotia from declines in Equalization payments from offshore revenues. Each year, these provinces have the option of choosing either the Accord protection or the generic solution protection offered in the Equalization program.

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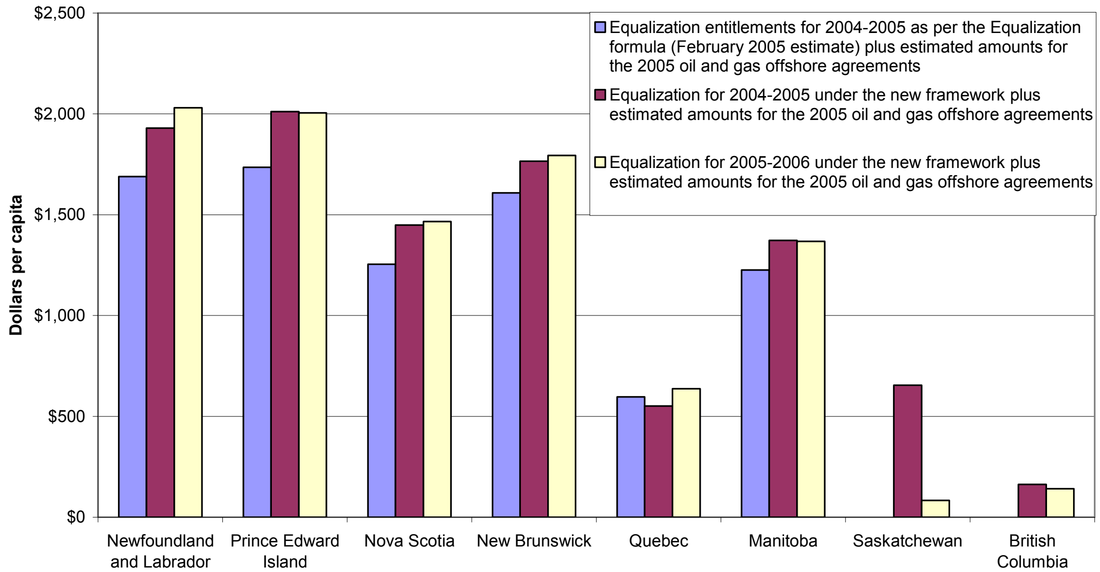
3 Office of the Prime Minister, "Prime Minister Announces New Equalization and Territorial Funding Formula Framework," News Release, 26 October 2004. Available at: http://www.pm.gc.ca.

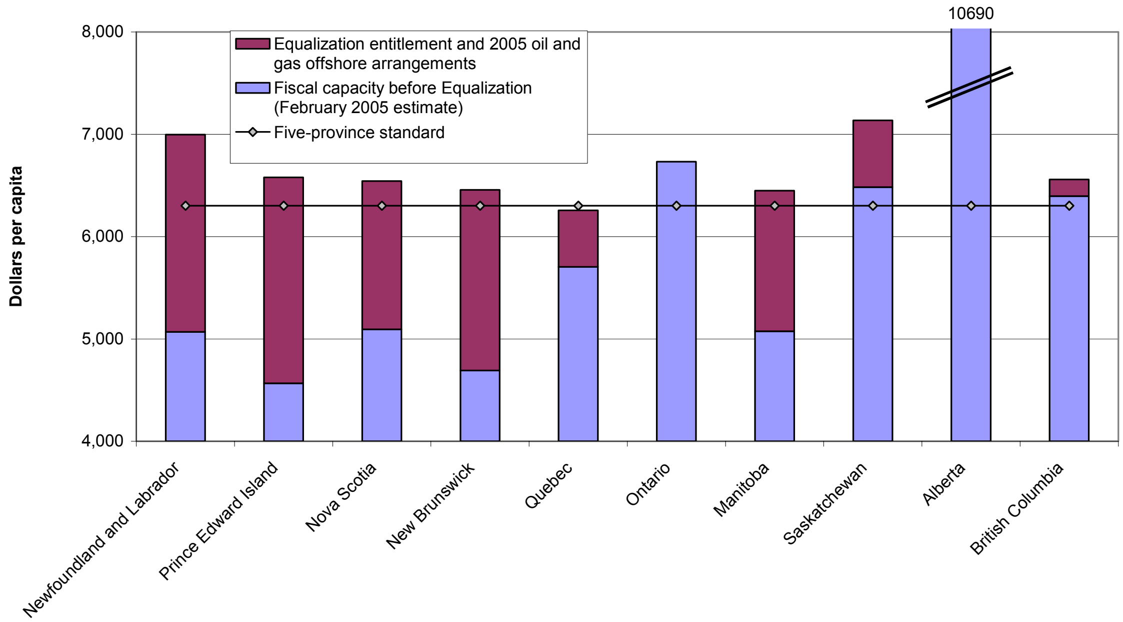
CHART 6
Equalization Entitlements Under the New Framework for 2004-2005 and 2005-2006 and Equalization Entitlements for 2004-2005 as per the Equalization formula (February 2005 estimate), including estimated amounts for the 2005 Offshore Agreements



Sources: Department of Finance, Statistics Canada and submission by Professor Courchene of Queen's University to the Subcommittee on Fiscal Imbalance of the House of Commons Standing Committee on Finance on 4 May 2005; computations by the Library of Parliament.

Chart 6 shows Equalization entitlements under the new framework on Equalization for 2004-2005 and 2005-2006 compared with the Equalization entitlements that the formula would have yielded for 2004-2005 based on February 2005 estimates. In addition, the entitlements in the chart include the estimated amounts for the proposed Nova Scotia and Newfoundland and Labrador oil and gas offshore agreements, which are currently being considered by Parliament as part of Bill C-43. All recipient provinces except Québec will receive more in 2004-2005 under the new framework than they would have been eligible to receive under the old Equalization formula. In particular, Saskatchewan and British Columbia would presumably not have qualified for Equalization payments under the old formula.

CHART 7
Fiscal Capacity after Equalization Entitlements and 2005 Oil and Gas Offshore Agreements, by province, fiscal year 2004-2005



Sources: Department of Finance, Statistics Canada and submission by Professor Courchene of Queen's University to the Subcommittee on Fiscal Imbalance of the House of Commons Standing Committee on Finance on 4 May 2005; computations by the Library of Parliament.

Chart 7 shows provincial fiscal capacity for 2004-2005 after Equalization entitlements under the new framework and the implementation of the 2005 oil and gas offshore arrangements. Substantial variations in provincial fiscal capacity remain even after Equalization entitlements and other amounts. In particular, the fiscal capacity of Newfoundland and Labrador and of Saskatchewan in 2004-2005 exceeded that of Ontario, a non-recipient province. Also, Québec's fiscal capacity in 2004-2005 is below the five-province standard, based on February 2005 estimates.

2. Major Conditional Transfers

Some federal conditional transfers are designed to finance the difference between provincial/territorial own-source revenues and provincial/territorial expenditures, thereby mitigating vertical fiscal imbalances. The federal government has shared in the cost of Canada's major social programs since their establishment. At present, the provinces/territories receive conditional transfer payments from the federal government through the Canada Social Transfer (CST) and the Canada Health Transfer (CHT), formerly the Canada Health and Social Transfer (CHST).

The September 2004 agreement reached with provincial/territorial First Ministers on a ten-year plan to strengthen health care provides for federal

government increases in the value of transfer payments (cash portion) under the CHT of 6% annually starting in 2006-2007. Over the 2004-2005 to 2013-2014 period, the plan will transfer $35.3 billion in additional CHT funds to the provinces/territories. As well, an additional $5.5 billion is directed to reductions in wait times and $500 million is allocated for diagnostic and medical equipment.

Before 1977, the cost of Canada's main social programs — hospital and health insurance, post-secondary education and the Canada Assistance Plan (CAP) — was shared, with the federal government covering 50% of most costs of these programs provided the provinces/territories respected a set of federal conditions.

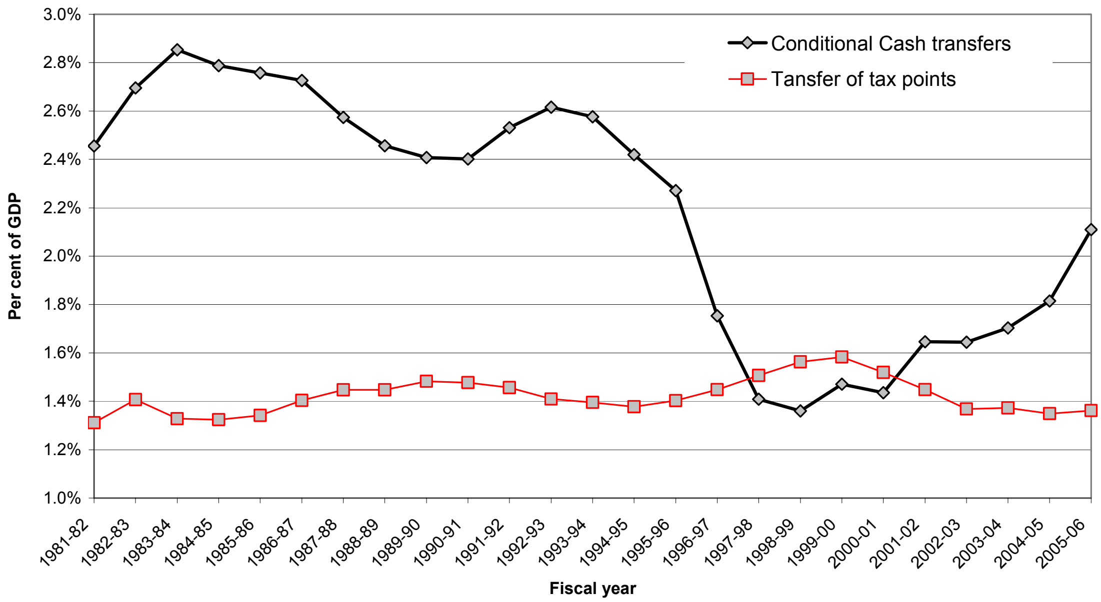
In 1977, the system of cost-sharing grants for health and hospital insurance, and post-secondary education, was converted into block funding under Established Program Financing (EPF), and federal contributions for these established social programs were no longer tied to provincial/territorial expenditures on the basis of cost-sharing formulae. Approximately 50% of the value of the federal transfer was shifted permanently to the provinces/territories as equalized tax points, and the remaining 50% remained as a per capita cash transfer. The CAP was not consolidated into EPF; instead, it remained a cost-shared program.

In 1995, the CAP and EPF were combined to form the Canada Health and Social Transfer (CHST), a block funding arrangement. As well, the CHST was revised so that the CAP portion of the transfer, previously distributed on a needs basis, was allocated on a per capita basis, like the EPF. Beginning in 2001-2002, the entire CHST cash payment was allocated based on provincial/territorial demographic weights.[4] Consequently, provinces/territories in which needs per capita for social assistance exceeded their demographic weight experienced reduced funding, while those in which their demographic weight exceeded per capita needs benefited from increased funding.

Finally, in April 2004, the CHST was divided into two separate transfers, the CHT and the CST.

[4] The 1999 federal budget changed the allocation formula to an equal per capita basis by 2001-2002. Before 1999, the social assistance portion of the CHST continued to be allocated on a needs basis.

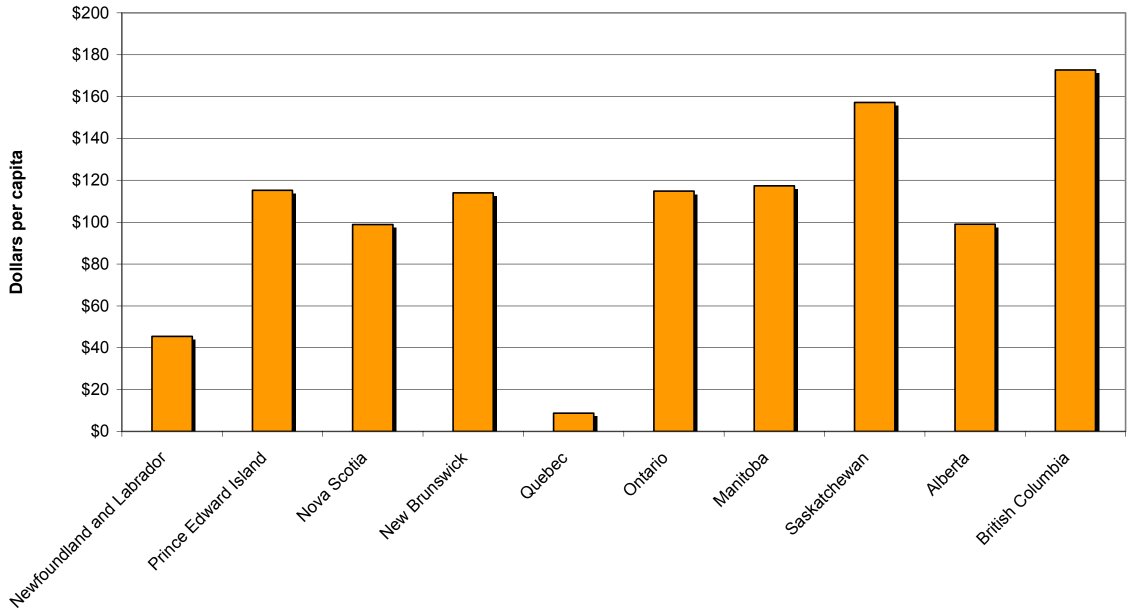
CHART 8
Major Federal Conditional Transfers as a Proportion of Gross Domestic Product (GDP), 1981-1982 to 2005-2006



* Major conditional transfers refers to EPF cash plus CAP for the period 1981-1982 to 1995-1996, CHST cash for the period 1996-1997 to 2003-2004 and CHT cash plus CST cash for the period 2004-2005 to 2005-2006.
Sources: Department of Finance and Statistics Canada; computations by the Library of Parliament.

Chart 8 shows major federal conditional transfers to the provinces/territories as a percentage of GDP from 1981-1982 to 2005-2006. The value of the tax points grew, to some extent, at the same rate as GDP growth during the period. The cash portion of the conditional transfers as a proportion of GDP, however, declined in every year except two during the 1983-1984 to 1998-1999 period. The cash portion fell particularly abruptly from 1994-1995 to 1997-1998, declining from about 2.6% of GDP to approximately 1.4%. Since 2000-2001, the cash portion of the conditional transfers as a proportion of GDP has been increasing at a relatively rapid rate, but it is below its 1993-1994 level.

CHART 9
Increase in Major Federal Conditional Cash Transfers by Province, from 1994-1995 to 2004-2005



* Major conditional transfers refers to EPF cash plus CAP for the fiscal year 1994-1995 and CHT plus CST for the fiscal year 2004-2005.
Sources: Department of Finance and Statistics Canada; computations by the Library of Parliament.

Chart 9 shows that, over the 1994-1995 to 2004-2005 period, major federal cash transfers for health, post-secondary education, social services and social assistance have increased at varying per capita rates among the provinces. In particular, there was a very small increase in Québec and in Newfoundland and Labrador; per capita increases were much higher in Saskatchewan and British Columbia over the period.

3. Other Transfers and Spending

In addition to Equalization/TFF and major transfers for health, post-secondary education and social programs, there are a number of bilateral agreements between the federal government and provincial/territorial governments related to the delivery of public services. These agreements cover such areas as immigration settlement, infrastructure, agricultural spending, employee training and student loans, among others.

The federal government also provides direct funding and tax expenditures in such areas as the Canada Child Tax Benefit, homelessness and affordable housing, and municipal infrastructure. For example, since the mid-1990s, the federal government has invested about $12 billion in cost-shared infrastructure programs. As well, in the 2004 federal budget, the government introduced a full rebate of the

Goods and Services Tax (GST) for municipalities, which is expected to yield more than $7 billion for municipalities over 10 years. In the 2005 budget, the government confirmed its commitment to share a portion of gas tax revenues with cities and communities, which will total $2 billion annually — the equivalent of 5 cents per litre — by 2009-2010.

The 2005 federal budget also announced a $5 billion commitment, over five years, to build the foundation of an early learning and child care initiative — in cooperation with the provinces/territories — based on the principles of quality of care, universality, accessibility and developmental learning. Support for families is also provided through such tax measures as the Canada Child Tax Benefit, the National Child Benefit supplement and the child care expense deduction.

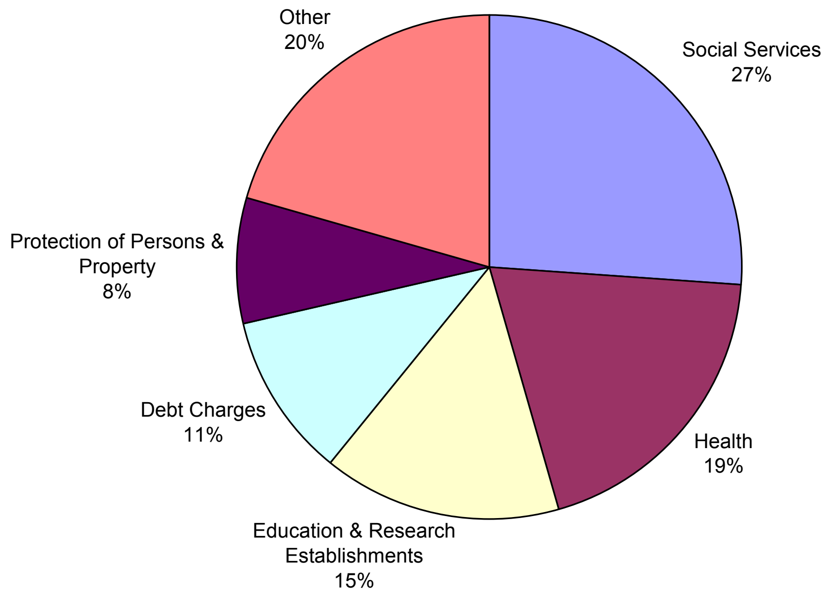
In addition to the CST, the federal government supports access to post-secondary education through such measures as Registered Education Savings Plans, the Canada Student Loans Program, the Canada Education Savings Grant, the Canada Learning Bond and the Millennium Scholarship Foundation, among other initiatives. Federal support for research in post-secondary institutions occurs through the federal granting councils, the Canada Research Chairs, the Canada Foundation for Innovation and Genome Canada, for example. The government also provides direct expenditures for social housing and health research.

Prior to the mid-1990s, the federal government rarely engaged in direct program spending in fields of provincial/territorial jurisdiction, a situation that has changed in recent years. In the past, federal direct involvement in unemployment insurance in 1940 and in old age security in 1951 required a constitutional amendment to legally sanction the federal intervention.

SERVICES DELIVERED: TAXES AND TRANSFERS FOR WHAT?

Citizens pay taxes in order to finance public services. In some cases, public services delivered by an order of government are financed by revenues entirely collected by it; in other cases, public services will also be financed by another order of government through transfers.

CHART 10
Breakdown of Total Government Expenditures by Category, 2003-2004

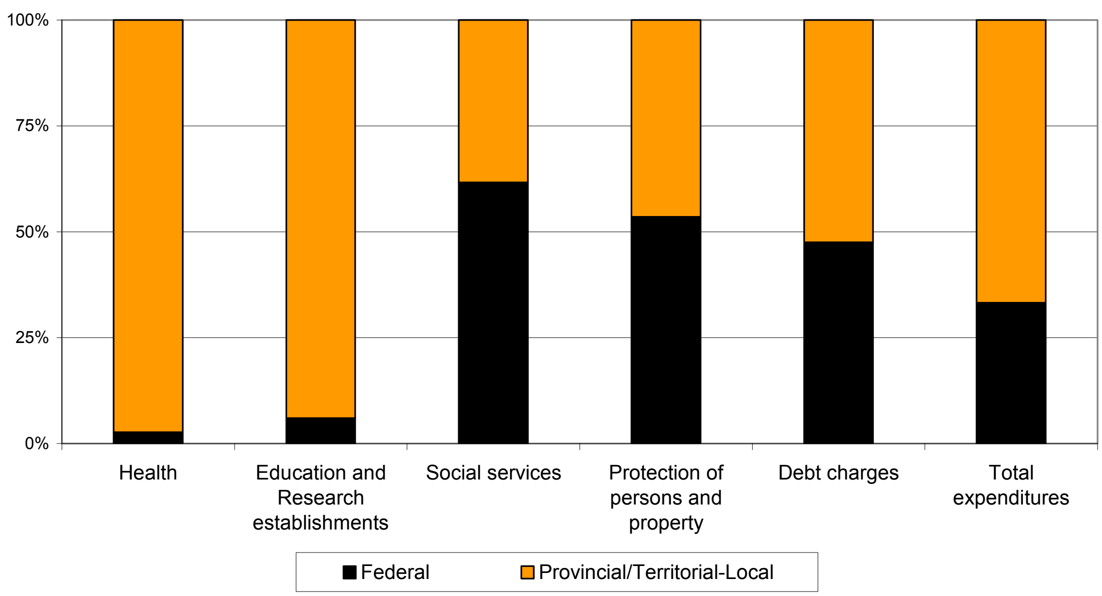


Sources: Statistics Canada, *Public Sector Statistics*; computations by the Library of Parliament.

Chart 10 shows the allocation of total consolidated — federal-provincial/territorial-local — government expenditures in Canada among public services. In 2003-2004, the largest share of funding — 27% — was dedicated to social services. Health — at 19% — and education and research establishments — at 15% — accounted for the second and third largest portions of the total cost of providing public services in that year. Other expenditures, which comprised 20% of the total, include such public services as: transportation and communication; resource conservation and industrial development; general government services; recreation and culture; the environment; foreign affairs and international assistance; housing; labour, employment and immigration; and regional planning and development.

Chart 11 presents more detailed information for each of the five largest expenditure categories: social services, health, education and research establishments, debt charges, and protection of persons and property. The chart shows the breakdown of government expenditures on major public services by the order of government providing the services.

CHART 11
Delivery of Major Public Services by Order of Government, (2003-2004, as a percentage of total consolidated cost of providing the service)



Sources: Statistics Canada, *Public Sector Statistics*; computations by the Library of Parliament.

Provincial/territorial-local governments are the main providers of health and education services, whereas the federal government has the largest share of social and protection services. Overall, in 2003-2004, about one-third of all expenditures incurred by all orders of government on public services — including debt charges — was allocated to services delivered by the federal government. The largest share of expenditures — about two-thirds — was allocated to public services delivered by the provincial/territorial and local governments.

The vast majority of health services are provided by the provincial/territorial-local order of government. These services range from hospital and medical care to such related services as grants to health-oriented organizations, training, ambulance services and health administration costs. The federal government provides limited health services, including health care services for Aboriginal Canadians and veterans, and such other health-related functions as public health, health protection programs and health research.

Although the federal government provides minimal health care services, it does contribute to the financing of health care through fiscal transfers — mainly the CHT — and other targeted health funding, such as the Diagnostic/Medical Equipment Fund.

Like health care, the majority of education and research establishments' costs was allocated to services occurring at the provincial-territorial and local

governments level. Expenditures on education, for example, finance the development and operation of the primary, secondary and post-secondary education system, and the provision of specific education services. The federal share mostly pertains to the National Research Council Canada and other organizations whose primary purpose is research and the promotion of developments resulting from such research activities. Also included are refundable tax credits for research and development. As is the case with health services, the federal government also funds some of the provincial/territorial-local costs of post-secondary education and research through fiscal transfers.

The federal government has the largest share of social services, with about two-thirds of all social service expenditures. Programs such as Employment Insurance, Old Age Security, the Guaranteed Income Supplement, the Canada Child Tax Benefit, employee pension plan benefits, veteran's benefits and others are included in the federal share of social services. The provincial/territorial-local share includes such services as social assistance, workers' compensation benefits, employee pension plan benefits, family allowances, motor vehicle accident compensation and others, such as child care. In addition, the federal government also finances part of the provincial/territorial-local costs of providing social assistance and other social services through fiscal transfers.

The share of the cost of providing protection services is about evenly distributed between the federal government and the provincial/territorial-local governments, with a 54% and 46% share respectively. These costs are allocated to such public services as national defence, policing, courts of law, correction and rehabilitation, and other related services.

Regarding debt charges, provincial/territorial-local governments and the federal government paid about 52% and 48% respectively of all governments' debt charges in 2003-2004. This situation is a significant change from 15 years ago, when the federal government accounted for the largest share of total governments' debt charges, at 61%.

Table 1 — Other Government Expenditures, by Order of Government, 2003-2004

Other Expenditures	Federal Share	Provincial/ Territorial & Local Share
Transportation & Communication	10%	90%
Resource Conservation & Industrial Development	36%	64%
General Government Services	45%	55%
Recreation & Culture	28%	72%
Environment	15%	85%
Foreign Affairs & International Assistance	100%	0%
Housing	18%	82%
Labour, Employment & Immigration	70%	30%
Regional Planning & Development	18%	82%
Miscellaneous	0%	100%
Total Other Expenditures	**31%**	**69%**

Sources: Statistics Canada, *Public Sector Statistics*; computations by the Library of Parliament.

Chart 10 included an "Other" category, which accounted for 20% of total government expenditures in 2003-2004. Table 1 provides details about the types of expenditures included in this category and the relative importance of each order of government in providing these public services.

Overall, provincial/territorial-local governments accounted for approximately 69% of expenditures in these categories, while the federal share was approximately 31%. Provincial/territorial and local governments accounted for more than 50% of the costs of public services included in Table 1, with the exception of foreign affairs and international assistance, and labour, employment and immigration services.

FISCAL IMBALANCES: WHAT IS THE EXTENT?

The current debate about whether a fiscal imbalance exists in the Canadian federation — and, if so, the nature and extent of that imbalance — can be divided into two parts: horizontal fiscal imbalance and vertical fiscal imbalance.

A horizontal fiscal imbalance exists when provinces/territories differ in their fiscal capacity to provide similar levels of public services to their citizens at similar rates of taxation. A vertical fiscal imbalance exists when the fiscal capacity of one order of government is insufficient to sustain its spending responsibilities while the fiscal capacity of another order of government is greater than is needed to sustain its spending obligations, while both orders of government provide public services to the same taxpayer.

A. What the Witnesses Said

Professor Emeritus Ronald Watts, of Queen's University, presented a comparative analysis of intergovernmental financial relations in 11 countries. In his study of vertical and horizontal fiscal imbalances in Canada, the United States, Germany, Australia, Switzerland, Spain, Brazil, India and South Africa — which are federations — and Sweden and Japan — which are decentralized unitary systems — Professor Watts identified the virtually universal existence of a mismatch between own-source revenues and expenditures of central and sub-central governments. In his view, the fiscal imbalance in Canada is not unique to this country: every country studied has some form of vertical fiscal imbalance — defined as the gap between an order of government's own-source revenues and expenditures — and Canada is among the countries where this imbalance is the least pronounced.

Professor Watts also observed that, with the exception of Switzerland and among the countries he studied, Canada is more decentralized than any other federation in terms of revenues and expenditures. Moreover, he concluded that all of the countries studied have significant horizontal fiscal imbalances that, in all countries except the United States, are equalized to some extent by intergovernmental transfers. Professor Watts also noted that Canada, Germany and Sweden are the only 3 countries among the 11 studied that have an equalization mechanism distinct from other conditional or unconditional transfers.

Professor Watts also informed the Subcommittee that Australia, India and South Africa have expert commissions, established by the central government, that determine distributive formulae. Similarly, a former Minister of Finance for the Province of Manitoba indicated the experience of these countries, and urged the Subcommittee to consider the establishment of a similar independent expert commission adapted to Canadian needs. Both witnesses stressed the importance of clearly establishing the independence of such a commission in order to ensure effectiveness.

According to Professor Watts, experiences in other federations reveal that the existence of a vertical fiscal gap — defined as the difference between provincial/territorial and local expenditures and own-source revenues — does not, by itself, imply that a federation is out of balance. At a minimum, as long as there are horizontal disparities in the ability of provincial/territorial governments to deliver substantially similar public services at similar levels of taxation, intergovernmental transfers are required, if only for redistribution within the federation.

Other considerations in determining whether a structural fiscal imbalance exists include: what public services it is believed governments should deliver; which level of government should be responsible for their delivery; and how those services should be financed. Several witnesses noted that these considerations involve

individual subjectivity and are political in nature. Professor Watts remarked that the concept of fiscal imbalance has an element of subjectivity: the appropriate levels of government expenditure and revenue are not objective, but are the product of political will and political decisions about what each order of government should do.

Witnesses told the Subcommittee about their concerns regarding the considerable financial pressures faced by public service providers; in particular, the burden of growing health care costs on provincial/territorial budgets was often identified as a concern. In the view of some, greater health care spending is compromising the funding of other public services provided by provincial/territorial governments. For example, this view was shared with the Subcommittee by Professor Paul Thomas, of the University of Manitoba, who said that while health care is the most important policy concern of Canadians and while there are societal forces and organized interests driving increased spending, health care spending is crowding out expenditures on education, social services, municipal governments and the environment.

Witnesses, including the Minister of Finance for the Province of Manitoba, often shared the view that, in the future, the greatest cost pressures will occur in areas that are under provincial/territorial jurisdiction. The Conference Board of Canada and the C.D. Howe Institute were among the witnesses who stressed to the Subcommittee that the expected cost of health care will rise as the population ages.

The Subcommittee heard from a number of witnesses, including the Finance Critic for the New Democratic Party of Ontario and the Conference Board of Canada, that the recent federal trend of addressing the fiscal problems of provincial/territorial governments on an ad hoc basis, or outside the sphere of federal-provincial/territorial arrangements more generally, must not continue. In their view, the federal government should adopt a comprehensive, predictable framework for addressing funding issues, and should avoid ad hoc arrangements on an issue-by-issue or province/territory-by-province/territory basis. They indicated that ad hoc arrangements — while useful in resolving specific issues — ignore the broader, longer-term perspective, have a destabilizing effect and result in less effective delivery of public services.

The Provincial Treasurer for the Province of Prince Edward Island, for example, told the Subcommittee that rather than providing long-term, thoughtful solutions, the federal government has used its fiscal power to make ad hoc decisions and to conclude bilateral deals. He indicated that the appropriate fiscal balance must be restored across Canada and must take into account both vertical and horizontal imbalances. Professor Watts also commented on this issue, and informed us that international experience suggests that addressing such issues as financing the rising cost of health care and other social services on an ad hoc basis is a "slippery slope." He urged a global, systematic approach to resolving these types of issues, rather than solutions based on ad hoc, temporary political

expediency, and commented that while ad hoc arrangements reduce the vertical imbalance, they seem to have a destabilizing effect. Similarly, the Leader of the Progressive Conservative Party of Ontario shared his view that an ad hoc approach is wrong for Canada: Canada is a partnership, a federation, and partners should not make limited deals amongst themselves.

Finally, some witnesses suggested that ad hoc arrangements affect the balance that was achieved when federal-provincial/territorial arrangements were concluded. According to Professor Robin Boadway, of Queen's University, ad hoc arrangements may put the process into disrepute.

B. What the Subcommittee Believes

The Subcommittee recognizes the comments made by some witnesses that the decisions made by provincial/territorial governments are the product of political will and political decisions. As such, these governments are "masters of their own destiny" and are free to set fiscal policy to meet their needs. Nevertheless, we believe that there is a clear indication that intergovernmental fiscal arrangements — in Canada, as in any other federation — play an important role in financing essential public services. They compensate for differences among provinces/territories in their fiscal capacity and, since the establishment of Canada's major health and social programs, have helped to finance part of provincial/territorial expenditures.

Moreover, the Subcommittee believes that fiscal decisions made by one order of government affect the fiscal decisions made by another order of government, in the same way that decisions made by one provincial/territorial government affect decisions made by other provincial/territorial governments. This notion is true, in part, because there is only one taxpayer, who pays taxes to both orders of government. We feel that there must be an appropriate balance between revenues and expenditures for each of the orders of government, and that this balance must be reached on a priority basis, given that provinces/territories have very different fiscal prospects and that the aging of the population is likely to place increased fiscal pressure on many areas of public services — notably health care — that are within the constitutional jurisdiction of the provinces/territories.

In the Subcommittee's view, one order of government should not be enjoying significant budgetary surpluses and steadily reducing its debt-to-GDP ratio to 25% over 10 years if the other order of government is on a fiscal path that is not sustainable. What is needed is a long-term, sustainable fiscal framework that considers the needs of both orders of government: a federal-provincial/territorial fiscal framework that is responsive to needs and circumstances as they change over time. The Subcommittee believes that horizontal and vertical fiscal imbalances

exist in Canada, and that they require detailed and on-going examination. For these reasons, the Subcommittee recommends that:

RECOMMENDATION 1:

The House of Commons Standing Committee on Finance, in collaboration with the Council of the Federation, examine the evolution in the relative fiscal capacity of the federal and provincial/territorial governments with a view to ensuring that both orders of government are able to fulfill their constitutional responsibilities. This examination should occur on a triennial basis, following which the Committee should report to the House of Commons.

The Subcommittee also believes that the federal government should not make ad hoc, short-term bilateral arrangements with individual provincial/territorial governments. Instead, a comprehensive approach to addressing provincial/territorial needs within federal-provincial/territorial arrangements should be adopted. In our view, the existence of different expenditure priorities among provincial/territorial governments with respect to public services does not support an ad hoc, bilateral approach. We feel that this type of approach is destabilizing and leads to less effective delivery of public services. Consequently, the Subcommittee recommends that:

RECOMMENDATION 2:

The federal government take a comprehensive approach to federal-provincial/territorial arrangements, and minimize the practice of concluding ad hoc arrangements with provincial/territorial governments.

THE VERTICAL FISCAL IMBALANCE: WHAT AND HOW MUCH?

A. What the Witnesses Said

Although the majority of the Subcommittee's witnesses believed that some form of structural vertical fiscal imbalance exists, this opinion was not held universally. For example, the Atlantic Institute for Market Studies and the Canadian Centre for Policy Alternatives commented that there can be no structural fiscal imbalance as long as provincial/territorial governments have the authority to determine their own fiscal policies. This authority allows provinces/territories to raise taxes in order to finance the public services they deliver, and the Institute suggested that provincial/territorial governments have the ability to do so.

Similarly, Professor Emeritus Rodney Dobell, of the University of Victoria, claimed that there is no structural vertical fiscal imbalance. He identified — as the basic argument against the claim that such an imbalance exists — the fact that provinces/territories have access to all significant tax bases, and have exclusive access to such rapidly growing bases as natural resource rents and gaming revenues. In his view, the choice about whether to levy taxes can be made by each provincial/territorial government, and a decision to reduce taxes must be seen to have consequences for the level of expenditure that can be supported.

Moreover, Professor Dobell remarked that, with the authority to determine its own fiscal policy, each province/territory has the right to be different, and can select the combination of expenditures and taxation that it considers will be supported by its electorate. He argued that many commentators talk about the "fiscal imbalance" as a situation in which provincial/territorial governments are unable to fund the programs for which they have constitutional responsibility. He believes the case has not been made that the provinces/territories are unable to fund these programs. The Atlantic Institute for Market Studies, the Caledon Institute of Social Policy and the Canadian Centre for Policy Alternatives offered a similar view.

Professor Dobell also presented an historical perspective on the issue of vertical fiscal imbalance. He noted that, in the early 1980s, the federal government allegedly had significant structural deficits while the provinces/territories received substantial fiscal transfers and some provinces/territories had substantial budgetary surpluses. At that time, it was argued that no fiscal imbalance existed. He indicated that the situation is reversed today, with long-term projections of federal budgetary surpluses occurring alongside provincial/territorial deficits, and a fiscal imbalance is said to exist. In his view, the balance has shifted substantially with shifting times.

Several witnesses disputed the argument that provincial/territorial governments can raise their taxes in order to correct any vertical fiscal imbalance. For example, the Minister of Finance for the Province of Québec remarked that the federal government's argument that both orders of government have access to essentially the same revenue sources is disingenuous. He suggested that while it is true that, with the exception of customs and excise taxes, both orders of government do have access to the same sources of revenue, there is only one taxpayer: this taxpayer pays taxes to both orders of government, and his or her ability to pay has limits. In the Minister of Finance's view, beyond some point, taxation results in reduced consumption and reduced national economic output; as well, the ability to raise taxes is limited by the need to ensure a tax system that is competitive with other provinces/territories and with the United States. Other witnesses also offered a similar view, including the Minister of Finance for the Province of Ontario, the Atlantic Provinces Economic Council and the Canadian Tax Foundation.

A number of the Committee's witnesses, including the Minister of Finance for the Province of Ontario, referred to a Conference Board of Canada study that, based on projections for revenue and expenditures at the federal and provincial/territorial levels, anticipates steady increases in federal budgetary surpluses between 2004-2005 and 2014-2015. According to the study, however, the provinces/territories will — in aggregate — have budgetary deficits over the same period, peaking in 2006-2007 and returning to their 2003-2004 level by 2014-2015. Since the provincial/territorial forecasts are presented on an aggregate basis, however, the experience of individual provinces/territories will vary.

For these witnesses, these projections indicate that the fiscal situation of recent years, where the federal government had relatively substantial budgetary surpluses while some provincial/territorial governments were unable to balance their budget — with the result that health, post-secondary education and social programs were underfunded — will deteriorate over time from the perspective of these governments. For them, this situation is evidence of an imbalance that needs to be corrected. According to the Premier of Saskatchewan, something is wrong when the provinces/territories have responsibility for delivering the social programs that are the most important to Canadians — health and education — and they are trying to do so with very tight finances while federal budgetary surpluses are growing.

According to most witnesses, including the Conseil du patronat du Québec and the Fédération étudiante universitaire du Québec, the vertical fiscal imbalance originated in the 1990s with the unilateral reduction in federal cash transfers to provincial/territorial governments for health and social programs — which can be seen in Chart 8 — at the same time that costs in these areas were increasing. Several witnesses argued that the federal government achieved its budgetary surpluses through reducing such transfers. In their view, with rising program costs and reduced federal transfers, provincial/territorial finances were negatively affected. According to the Minister for Canadian Intergovernmental Affairs for the Government of Québec, rapid federal revenue growth allowed the federal government to operate its regular programs, pay its debt servicing costs, lower taxes, reduce the accumulated federal deficit and spend in areas within provincial/territorial jurisdiction. He indicated that the provinces/territories have had to reduce spending in some areas in order to finance rising costs in other areas, particularly health care. The Minister also said that the provinces/territories have been limited in their ability to introduce new programs, reduce taxes or pay down their debt, a view shared by Professor Luc Godbout, of the University of Sherbrooke.

Chart 12, which appears in Appendix B and shows the federal cash contribution as a percentage of provincial expenditures for health and social programs over the 1982-1983 to 2009-2010 period, was presented to the Subcommittee by the Minister of Finance for the Province of Québec. The federal share of the provincial costs of providing these programs declined relatively

substantially from 1985-1986 to 1999-2000. Since then, the federal share has increased relatively considerably for health spending, with cash contributions by the federal government financing about 22% of provincial health costs. Federal cash contributions for education, social assistance and other social programs have not increased, however, since 1999-2000, and currently represent approximately 11.5% of provincial spending in these areas. Many witnesses, including the Centrale des syndicats du Québec, recommended that the federal government restore its contribution to major social programs to historical levels.

With tight provincial/territorial finances, a number of witnesses — including Professor Godbout — commented on the use of federal spending power to increase direct program spending in areas of provincial/territorial jurisdiction. Professor Boadway remarked that the federal government should not engage in direct spending in areas of provincial/territorial jurisdiction, but should instead use transfers. Moreover, in his view, the federal government has introduced too many programs in areas like post-secondary education, where it makes transfers directly to individuals rather than to them through the province/territory.

Witnesses who expressed concern about the creation of federal programs and initiatives in areas of provincial/territorial jurisdiction found it ironic that this increased spending happened at a time when the federal government was reducing its contribution to major health and social programs. For a number of witnesses, this situation, in some way, proves the existence of some form of structural imbalance.

Professor Harvey Lazar, of Queen's University, offered a similar view. He defined the term "vertical fiscal imbalance" as a situation in which one order of government has more fiscal resources than it requires to meet its spending obligations, while the other order of government has inadequate resources to meet its responsibilities. In his view, a case can be made for the existence of some degree of vertical fiscal imbalance in the federation: if there is no imbalance, the federal government would not have been increasing its funding to the provinces/territories, since they presumably have sufficient resources to meet their obligations. Professor Lazar also pointed out, however, that with increased federal cash transfers to the provinces/territories for Equalization, health care, communities and other initiatives, any fiscal imbalance that might have existed in recent years is likely smaller today.

B. What the Subcommittee Believes

The Subcommittee understands the argument that, in theory, provincial/territorial governments can increase their taxes in order to finance their constitutional responsibilities. If this argument is accepted, the question becomes one of whether governments have the political will to raise taxes to finance their responsibilities, and to be accountable to the electorate for the choices they make.

In practice, the Subcommittee agrees with many of our witnesses: there is only one taxpayer and there are limits to the tax burden that this taxpayer is willing — and able — to bear. What may be possible in theory may not be possible in practice. Moreover, provincial/territorial governments want to adopt policies that promote economic growth. A provincial/territorial tax system that is uncompetitive, with respect to other provinces/territories or internationally, hinders growth. Many provincial governments told us that, with rising cost pressures for health care, post-secondary education and social services, expenditure restraint is not a feasible option. Provincial/territorial governments find themselves in a difficult position: they believe that they cannot raise taxes and they feel that they cannot constrain spending on the public services within their constitutional jurisdiction.

The Subcommittee recognizes the point made by some witnesses that the Canadian federation has probably never been in "fiscal balance," and that — perhaps — the notion of fiscal balance is not consistent with the notion of a federation. We believe, however, that changes in federal-provincial/territorial fiscal arrangements have led to a situation within the federation where the fiscal balance is increasingly unbalanced. We believe that the current vertical fiscal imbalance — the extent of which cannot be precisely measured, and which will vary among provinces/territories and over time — is a direct consequence of the unilateral decision by the federal government to reduce its financial participation in major health and social programs.

The Subcommittee finds the projections contained in the Conference Board of Canada study compelling. We believe that federal budgetary surpluses will continue, and that provincial/territorial governments will face increasing cost pressures for health care and in other areas within their jurisdiction. Clearly, a problem exists. Whatever the term used, the fact remains that now — and in the foreseeable future — the federal government will have more resources than it needs to meet its responsibilities while the provinces/territories will have inadequate resources to meet their obligations. Clearly, a rebalancing is needed. We must act now for the benefit of the single taxpayer, who must pay taxes to both orders of government and expects — rightfully so — high-quality public services from both.

THE VERTICAL FISCAL IMBALANCE: WHAT SOLUTIONS?

A. What the Witnesses Said

The Subcommittee was presented with essentially two solutions to correct the vertical fiscal imbalance: increase federal cash transfers to provincial/territorial governments; or reduce the federal tax room and make the room vacated available to the provinces/territories — a tax point transfer — either by having the federal government share a fixed percentage of its revenues from a defined tax base with the provinces/territories, or by having the federal government permanently reduce

its tax rates to make room for the provinces/territories to increase their rates correspondingly, if they so choose.

Witnesses who supported increased federal cash transfers pointed out the need for sufficient federal tax revenues to ensure that national programs of redistribution are available and that the federal government can meet its constitutional obligations. Professor Boadway's preferred solution was increased cash transfers — rather than tax point transfers — since, in his view, governments largely are institutions for redistribution, and the federal government undertakes policy initiatives that reflect national equity objectives. He believes that the existence of the federal income tax, employment insurance system and pension schemes recognize a legitimate federal role in pursuing redistribution objectives nationwide.

Some witnesses opposed tax point transfers because these transfers are more advantageous to the provinces/territories with the highest fiscal capacity. A transfer of tax points would lead to a more fragmented tax system favouring the richer provinces/territories, and would worsen the problems of interprovincial disparities in fiscal capability. The greater is the provincial/territorial tax room, the greater is the importance of the Equalization program and the greater is the cost of the program to the federal government. Tax points have a higher value for provinces/territories that have residents earning higher incomes; provinces/territories with residents earning relatively lower incomes would have to raise their tax rates relatively more in order to raise an equal amount of tax revenues from the tax room transferred. In any event, the fiscal capacity of provinces/territories with residents with relatively lower incomes would now be even relatively lower, which means greater Equalization entitlements in total.

Several witnesses argued that it is easier for the federal government to maintain national standards if a substantial portion of its contributions for health, post-secondary education and social programs occur in the form of cash transfers. This view was shared by the Premier of Saskatchewan, who said that his concept of Canada is one in which, as a resident of Saskatchewan or a resident of Prince Edward Island, he has some expectation of reasonable access to a service or program. In his opinion, that access can only be achieved through, for example, national standards in such areas as access to health care, and could not be guaranteed with a transfer of tax points.

Witnesses who favoured a transfer of tax points maintained that the current system of cash transfers creates a lack of accountability, since one order of government is spending money raised by another order of government. They argued that transferring tax room to provincial/territorial governments to finance their constitutional responsibilities would strengthen accountability within the federation.

According to the C.D. Howe Institute, the Fraser Institute and the Business Council of British Columbia, with the current system, taxpayers lack clarity about

which order of government is responsible for any given public service; consequently, the taxpayer does not know which order of government to hold to account. In the C.D. Howe Institute's view, coherence and sustainability are threatened when provinces/territories commit themselves to delivering services for which they do not collect the required funding; at the same time, the federal government collects revenue and funds services for which it is not responsible and for which it is unable to ensure delivery. The Institute believes that coherence and sustainability are likely outcomes when provinces/territories assume responsibility for raising tax revenues approximately equivalent to their spending commitments and when the federal government adopts the more limited role of filling in the gaps in provincial/territorial ability to finance the services for which the provinces/territories are responsible.

Another advantage of a tax point transfer, according to witnesses, is that their value increases with economic growth, resulting in more predictable funding for provincial/territorial governments. As well, by reducing reliance on federal transfers, the provinces/territories are able to avoid the possibility of future unilateral federal changes in fiscal arrangements.

The Saskatchewan Institute of Public Policy supports the transfer of tax points as the only effective tool remaining to restrain the unilateral use of federal spending power in areas of provincial/territorial jurisdiction. In the Institute's view, the tax room currently occupied by the federal government is the source of the fiscal imbalance: the solution lies in reducing that tax room to a level at which both orders of government have an appropriate fiscal capacity to fulfill their constitutional responsibilities once the Equalization program equalizes interprovincial disparities.

In speaking about the federal spending power, the Minister of Finance for the Province of Québec told the Subcommittee that by spending in such areas as social services, health care, post-secondary education and municipalities, and by creating councils and/or institutions that deal specifically with issues falling within the responsibility of the provinces/territories, the federal government distorts provincial/territorial decision making and budgetary choices. Consequently, unilateral federal use of its spending power must end. This view was also strongly advocated by the Parti Québécois in its presentation to the Subcommittee.

B. What the Subcommittee Believes

The Subcommittee recognizes that a problem as complex as the vertical fiscal imbalance is unlikely to have one easy solution that will fix all problems. But a solution clearly is needed, and there are a limited number of tools that might be used. Regardless of whether the vertical fiscal imbalance is "solved" through a transfer of tax room from the federal government to provincial/territorial governments or through increased federal cash transfers, we believe that a

precondition to the implementation of either option must be a significant increase in federal funding for post-secondary education, social assistance and social services.

In 1977, when the EPF block funding arrangement replaced cost-sharing programs for health and post-secondary education, the federal cash contribution for post-secondary education and social assistance — the latter provided under the Canada Assistance Plan — represented approximately 34% of the provincial/territorial costs of these programs, while the federal cash contribution for health represented about 25% of total eligible provincial/territorial health expenditures. The value of the transferred tax points was roughly equal to 25% of eligible provincial/territorial health and post-secondary education expenditures.

The Commission on the Future of Health Care in Canada recommended — in its report *Building on Values: The Future of Health Care in Canada* — that, at a minimum, the federal cash contribution for health be restored to its past cash commitment of approximately 25% of provincial/territorial costs for services covered under the *Canada Health Act*. With the federal funding associated with the February 2003 First Ministers' Accord on Health Care Renewal and the September 2004 Agreement on a Ten-Year Plan to Strengthen Health Care, the total federal cash contribution for health services is now approaching 25% of provincial/territorial health expenditures.

Federal cash support for social assistance, social services and post-secondary education under the CST is, however, considerably lower. The Subcommittee believes that the federal government has increased its investment in health care, and this investment must be repeated with respect to post-secondary education, social assistance and social services.

The Subcommittee feels that the federal contribution to the provincial/territorial cost of delivering post-secondary education, social assistance and social services should be higher. We believe that the federal government can afford reinvestment, particularly if it is phased in over time. In fact, we feel that the government cannot afford *not* to take this action, and must make the needed investments for Canadians. From this perspective, the Subcommittee recommends that:

RECOMMENDATION 3:

The Canada Social Transfer be restructured into two separate transfers: a transfer to support post-secondary education and a transfer to support social assistance and social services.

RECOMMENDATION 4:

The federal cash transfer to provincial/territorial governments for each restructured component of the Canada Social Transfer be increased such that the federal contribution occurs at a rate comparable to that allocated for health care in recent years. This increase should be phased in over a four-year period and without compromising the current federal policy of balanced budgets.

The Subcommittee is concerned about unilateral federal use of its spending power in areas of exclusive provincial/territorial constitutional jurisdiction. We believe that it is the existence of the vertical fiscal imbalance that allows the federal government to intervene unilaterally in areas which are the exclusive jurisdiction of the provinces/territories, such as infrastructure, education and communities. This intervention results in distortions in provincial/territorial policy making, and creates uncertainty — and possibly fiscal pressures — for the provinces/territories should the federal government reduce its support for these initiatives. Elimination of the vertical fiscal imbalance in the manner we recommend would reduce the opportunity for such federal intervention.

THE HORIZONTAL FISCAL IMBALANCE: WHAT AND HOW MUCH?

A. What the Witnesses Said

The Subcommittee's witnesses held a consistent view about the existence of a horizontal fiscal imbalance: it exists, and its correction is the reason for the Equalization program and Territorial Formula Financing. A number of witnesses pointed out that, in a federation, there will always be some regions that are richer than others. We were reminded that the fundamental principle underlying the Equalization program is contained in section 36(2) of the *Constitution Act*, which requires Equalization payments to be made to provincial governments to ensure they have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Our witnesses supported continuation of this fundamental principle.

Some witnesses, however, expressed concerns that inter-provincial economic and fiscal disparities are growing, rather than decreasing. Several witnesses, including the Caledon Institute of Social Policy and the Leader of the Liberal Party of Manitoba, commented that the fiscal imbalance in Canada is horizontal —among provinces — rather than vertical — between the federal and provincial governments. The Subcommittee was told that the horizontal fiscal imbalance is an important issue for the country, and that an adequate Equalization program is important to correct the imbalance. Professor Richard Bird, of the

University of Toronto, commented that while the Equalization program does not level the playing field, it does ensure that no province is in a “big hole.” In his view, the program provides a base on which all provinces can compete fairly, and is — to some extent — the glue that holds the country together. Nevertheless, he warned that, if improperly used or pushed too far, the “glue” may turn into a “solvent.”

Many witnesses, including the Ministers of Finance for the Provinces of Ontario, Manitoba and Québec, informed the Subcommittee that, in its current form, the Equalization framework adopted in October 2004 no longer equalizes inter-provincial fiscal capacities. This notion is revealed in Chart 7. Witnesses mentioned that, with the new framework, the fiscal capacity of some provinces receiving Equalization payments exceeds that of some provinces not receiving payments.

B. What the Subcommittee Believes

The Subcommittee recognizes the existence of horizontal fiscal imbalances among the provinces/territories, and fully supports Territorial Formula Financing and subsection 36(2) of the *Constitution Act*, which says:

> 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.

In the Subcommittee’s view, the Equalization program and Territorial Formula Financing play an indispensable role in the Canadian federation, and help to ensure that every Canadian — regardless of where he or she lives — can receive similar levels of public services from his or her provincial/territorial government at similar levels of taxation. We believe that the redistribution of revenues from the richer provinces/territories to those that are less wealthy is a fundamental role of the federal government. Moreover, the unconditional payments given by the Equalization program and Territorial Formula Financing allow the federal government to fulfill this redistributive role without intervening in areas of provincial/territorial jurisdiction.

THE HORIZONTAL FISCAL IMBALANCE: WHAT SOLUTIONS?

A. What the Witnesses Said

Some of the Subcommittee’s witnesses argued that the new Equalization framework should be abandoned. For example, Professor Godbout believed that

the new framework moves the Equalization program farther away from its constitutional objective. Moreover, with total Equalization entitlements being pre-determined, the floor — which is supported by some — might also be viewed as a ceiling; in either case, entitlements under the program are not based on real differences in fiscal capacity among the provinces, according to Professor Godbout. He also commented that while annual indexation of 3.5% may seem attractive, this indexation factor is below the growth rate of federal revenues, of federal expenditures and of GDP. In his view, in the long term, the relative size of Equalization payments can only diminish. The same issue was raised by the Minister of Finance for the Province of Manitoba and the Atlantic Provinces Economic Council.

A number of witnesses, including the Leader of the Saskatchewan Party, informed the Subcommittee that the Equalization program must be reformed. Professor Bird believed that the Equalization formula, as well as related arrangements, must be examined. Similarly, the Premier of Saskatchewan recommended a comprehensive review of both the existing Equalization program and other ways in which inter-provincial fiscal disparities might be addressed.

Despite broad support for reform, witnesses held many different views on how best to reform the Equalization program. A prevalent view was a return to the ten-province standard in calculating average fiscal capacity since, in the opinion of some witnesses, the result would be greater fairness. Most provincial governments, and such other witnesses as the Leader of the Progressive Conservative Party of Manitoba and the Leader of the Action Démocratique du Québec, argued that the 1982 unilateral decision by the federal government to use a five-province standard to establish average fiscal capacity has artificially reduced the Equalization entitlements of recipient provinces. The Subcommittee was also told that a return to the ten-province standard would reduce volatility in Equalization entitlements, which are currently disproportionately affected by the relative performance of the Ontario economy, and that only a ten-province standard is fully compliant with section 36(2) of the *Constitution Act*.

Witnesses presented conflicting points of view on the inclusion — or exclusion — of non-renewable resource revenues in the calculation of fiscal capacity. Some believe that all provincial revenue sources — without exception — must be included in the calculation of provincial fiscal capacity. For example, Professor Boadway and the former Director of the Intergovernmental Finance Branch for the Province of Manitoba maintained that section 36(2) of the *Constitution Act* cannot be entirely satisfied if revenues from non-renewable resources are excluded from the calculation. The Subcommittee was informed that the objective of the Equalization program, as set out in the *Constitution Act*, is to equalize inter-provincial fiscal capacity. Some witnesses argued that if the federal government wishes to pursue other policy objectives in a province, such as encouraging the economic development of a region, mechanisms other than the Equalization program can be used.

Others witnesses held the opposite view, and advocated exclusion of non-renewable resource revenues from the calculation of fiscal capacity, since there is a fundamental difference between non-renewable resources whose value is permanently depleted once extracted and other sources of government revenue that are ongoing and renewable. Moreover, the Premier of Saskatchewan argued that his province is being treated unfairly under the current scheme because of the recent offshore agreements reached with the provinces of Newfoundland and Labrador and Nova Scotia, which will effectively result in each dollar of oil and gas revenues in these two provinces not being considered in the calculation of fiscal capacity. He believes that Saskatchewan is being treated unfairly, since for each dollar of non-renewable oil and gas resource revenues raised, the Equalization entitlement is being reduced by at least one dollar. The Leader of the Saskatchewan Party raised the same issue.

Professor Tom Courchene, of Queen's University, proposed a variation on the ten-province standard that would include at least some revenues from all sources. He explained that a return to the ten-province standard would lead to large increases in Equalization entitlements, primarily resulting from Alberta's oil and gas revenues; however, these oil and gas revenues do not really contribute to federal government revenues. Alberta's oil and gas revenues are an exclusive provincial revenue source, and the federal government cannot impose resource royalties. Professor Courchene proposed the adoption of the ten-province standard, and the inclusion of all non-resource revenue sources and 25% of energy revenues in the Equalization formula.

Several witnesses argued that the Equalization formula is overly complex, is understand fully by only a small number of experts, and should be simplified.

Finally, several witnesses observed that the Equalization program is one of a number of tools that can be used by the federal government to reduce disparities among provinces in their fiscal capacity. For example, the Subcommittee was told that federal programs and investments designed to encourage economic development in less wealthy provinces contribute to reduced inter-provincial economic and fiscal disparities. As well, Professor Boadway pointed out that federal transfers for health and social programs are effective equalization mechanisms, since the federal government raises revenue nationwide and redistributes it on an equal per capita basis to all provinces/territories.

The Subcommittee heard diverse opinions on the expert panel established pursuant to the new Equalization and Territorial Formula Financing framework. Several witnesses expressed concerns about the nomination process to appoint members of the panel, and we were told that some of the nominees lack expertise in the area of Equalization or had already expressed strong opinions on the program. Concern was also expressed about the lack of provincial/territorial representation on the panel, and about the panel's limited mandate, which they

believe should also include examination of the appropriateness of the 3.5% escalator.

Other witnesses were more supportive of the expert panel and its work. They hoped that the panel would be able to recommend a long-term solution, although there was some concern that the federal government is not required to adopt the panel's recommendations.

B. What the Subcommittee Believes

The Subcommittee shares the view of those witnesses who believe that the new Equalization and Territorial Formula Financing framework — particularly the 3.5% escalator — does not allow the federal government to fulfil adequately its redistributive role under the *Constitution Act* and does not contribute to equalized provincial/territorial fiscal capacity. With witnesses presenting a broad range of views about the Equalization program and the manner in which it should be reformed, we are convinced that — notwithstanding the examination by the expert panel — an in-depth review of the Equalization program and possible reforms must occur. Consequently, we look forward to conclusions on the Equalization program and Territorial Formula Financing that will be contained in the forthcoming report of the Council of the Federation Advisory Panel on Fiscal Imbalance.

CONCLUSION

As identified above, most of the Subcommittee's witnesses believe that the Canadian federation is unbalanced, and needs re-balancing. Vertical fiscal imbalances exist, and the horizontal fiscal imbalance is not being resolved adequately by the new Equalization and Territorial Formula Financing framework. The federal government is collecting more tax revenues than it requires to meet its constitutional obligations, and the provinces/territories have too few resources to meet their responsibilities.

Earlier, the Subcommittee identified a number of principles that we believe should be respected by federal-provincial/territorial fiscal arrangements: adequate, sustainable, equitable, transparent, accountable and consistent with constitutional responsibilities. We believe that any changes made to the federation's fiscal arrangements must — without exception — meet these principles.

All citizens want — and deserve — high-quality public services, and they want to enjoy those services without having to pay excessively high taxes. Often, taxpayers consider their aggregate taxes paid, and do not distinguish between federal taxes paid, provincial/territorial taxes paid, and the exact public services provided by each order of government in relation to those taxes. In the Subcommittee's view, this situation creates a lack of transparency and accountability, both of which could — we believe — be enhanced if federal and provincial/territorial governments spend within their jurisdictions as outlined in the *Constitution Act*, which is a third principle. Moreover, transparency and accountability would be enhanced if the Canada Social Transfer were split into two transfers: one for post-secondary education, and one for social assistance and social services. With these changes, two of the six principles that we believe are important would be respected.

Moreover, the Subcommittee believes that the final three principles — adequate, sustainable and equitable — would be met by ongoing review of provincial/territorial fiscal capacity and an examination of the level of federal transfers needed to ensure that citizens across Canada can enjoy high-quality public services. Since, in our view, ad hoc arrangements potentially compromise these principles, and also are destabilizing and distort provincial/territorial decision making, we believe that the federal government should not conclude such arrangements with the provinces/territories on a bilateral basis. Indeed, what is needed for the future of the federation — and for the benefit of the single taxpayer — is a comprehensive approach to federal-provincial/territorial fiscal arrangements that meets the needs of everyone.

The Subcommittee also recognizes the presentations made by the Department of Transport for the Province of British Columbia regarding a

transportation infrastructure imbalance, by the Union des producteurs agricoles and the Premier of Saskatchewan regarding support for agriculture, and by a number of witnesses about the imbalance between the provincial/territorial and municipal orders of government. While valid points were made in each of these areas, we do not make recommendations in this report, which has a somewhat different focus. We do, nevertheless, encourage relevant parties to take action in each of these areas in order to enhance the prosperity of Canada.

The Subcommittee believes that full and timely implementation of the recommendations made by us in this report would have many benefits: the federation would receive the re-balancing it needs; the six core principles of transparency, accountability, constitutional responsibility, adequacy, sustainability and equity would be respected; and actions would have been taken for the benefit of the single taxpayer. The fiscal imbalance exists. The need for re-balancing is urgent. The time for action is now.

LIST OF RECOMMENDATIONS

RECOMMENDATION 1:

The House of Commons Standing Committee on Finance, in collaboration with the Council of the Federation, examine the evolution in the relative fiscal capacity of the federal and provincial/territorial governments with a view to ensuring that both orders of government are able to fulfill their constitutional responsibilities. This examination should occur on a triennial basis, following which the Committee should report to the House of Commons.

RECOMMENDATION 2:

The federal government take a comprehensive approach to federal-provincial/territorial arrangements, and minimize the practice of concluding ad hoc arrangements with provincial/territorial governments.

RECOMMENDATION 3:

The Canada Social Transfer be restructured into two separate transfers: a transfer to support post-secondary education and a transfer to support social assistance and social services.

RECOMMENDATION 4:

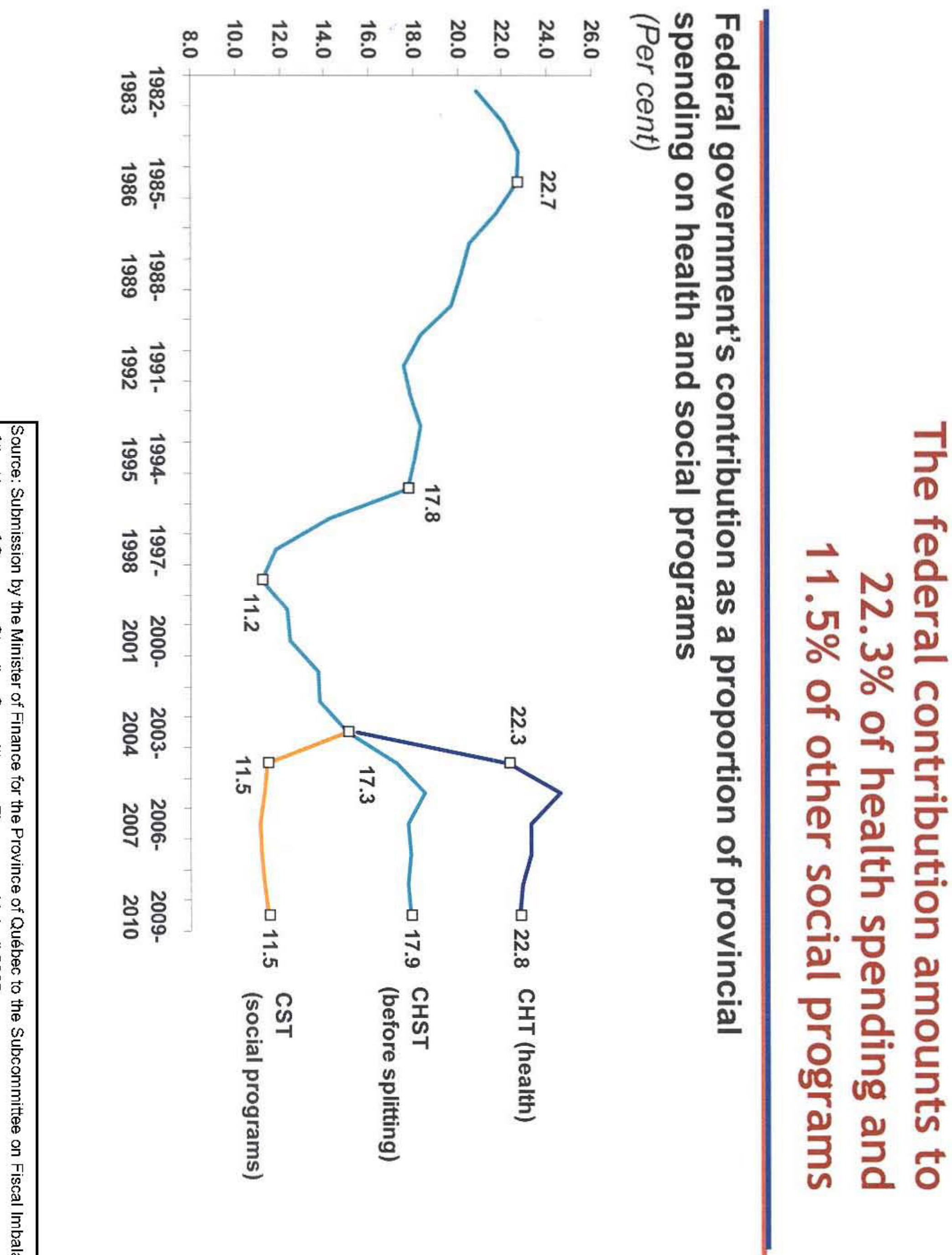
The federal cash transfer to provincial/territorial governments for each restructured component of the Canada Social Transfer be increased such that the federal contribution occurs at a rate comparable to that allocated for health care in recent years. This increase should be phased in over a four-year period and without compromising the current federal policy of balanced budgets.

APPENDIX A
REVENUE SOURCES INCLUDED IN THE CALCULATION OF THE REPRESENTATIVE TAX SYSTEM

1. Personal income tax revenues
2. Business income tax revenues
3. Capital tax revenues
4. General and miscellaneous sales tax revenues
5. Tobacco tax revenues
6. Gasoline tax revenues
7. Diesel fuel tax revenues
8. Non-commercial vehicle licence revenues
9. Commercial vehicle licence revenues
10. Alcoholic beverage sales revenues
11. Hospital and medical insurance premium revenues
12. Race track tax revenues
13. Forestry revenues
14. New oil revenues
15. Old oil revenues
16. Heavy oil revenues
17. Mined oil revenues
18. Third-tier oil revenues (light and medium)
19. Third-tier oil revenues (heavy)
20. Natural gas revenues
21. Sales of Crown leases
22. Other oil and gas revenues
23. Mineral revenues
24. Water power rental revenues
25. Insurance premium revenues
26. Payroll tax revenues
27. Provincial-local property tax revenues
28. Lottery ticket revenues
29. Other games of chance revenues
30. Miscellaneous provincial-local taxes and Revenue
31. Shared revenues: Offshore activities/Newfoundland and Labrador
32. Shared revenues: Offshore activities/Nova Scotia
33. Shared revenues: Preferred Share Dividends

Source: Department of Finance, *Provincial Fiscal Equalization*, February 2004.

APPENDIX B
CHART 12



Source: Submission by the Minister of Finance for the Province of Québec to the Subcommittee on Fiscal Imbalance of the House of Commons Standing Committee on Finance on 11 April 2005.

APPENDIX C
LIST OF WITNESSES

FRIDAY, FEBRUARY 18, 2005
HALIFAX (N.S.)
Meeting No. 4

Atlantic Institute for Market Studies
Brian Lee Crowley, Economist

Atlantic Provinces Economic Council
David Chaundy, Senior Economist

Government of Prince Edward Island
Hon. Mitchell Murphy, Provincial Treasurer
John Palmer, Director, Economic and Statistics, Federal Fiscal Relations

FRIDAY, MARCH 11, 2005
TORONTO (ONT.)
Meeting No. 5

Progressive Conservative Party of Ontario
John Tory, Leader

University of Toronto
Prof. Richard Bird, International Tax Program, Joseph L. Rotman School of Management

Canadian Tax Foundation
David Perry, Senior Research Associate

Government of Ontario
Hon. Greg Sorbara, Minister of Finance
Mike Colle, MPP, Eglinton—Lawrence and Parliamentary Assistant to the Minister of Finance

Ministry of Finance
Colin Andersen, Deputy Minister
John Whitehead, Director, Personal Income Taxation and Fiscal Arrangements Branch, Office of the Budget and Taxation Economist

Meeting No. 6

Legislative Assembly of Ontario
Michael Prue, MPP, Finance Critic, New Democratic Party

C.D. Howe Institute
Finn Poschmann, Associate Director of Research

MONDAY, MARCH 21, 2005
REGINA (SASK.)
Meeting No. 7

Government of Saskatchewan
Hon. Lorne Calvert, Premier
Dan Perrins, Deputy Minister to the Premier
Ron Styles, Deputy Minister of Finance

Legislative Assembly of Saskatchewan
Brad Wall, MLA and Leader of the Official Opposition Saskatchewan, (Saskatchewan Party)
Ken Cheveldayoff, MLA
Iain Harry, Director of Policy Development, Saskatchewan Party Caucus

Meeting No. 8

Saskatchewan Institute of Public Policy
Ian Peach, Director

MONDAY, APRIL 4, 2005
VICTORIA (B.C.)
Meeting No. 9

The Fraser Institute
Fred McMahon, Director, Centre for Globalization Studies
Niels Veldhuis, Senior Research Economist

As Individual

Prof. Rod Dobell**,** Emeritus Professor of Public Policy**,** University of Victoria

Business Council of British Columbia

Jock Finlayson, Executive Vice-President, Policy

Government of British Columbia

Dan Doyle, Deputy Minister, Transport

WEDNESDAY, APRIL 6, 2005
OTTAWA (ONT.)
Meeting No. 10

Conference Board of Canada

Paul Darby, Deputy Chief Economist

Caledon Institute of Social Policy

Michael Mendelson, Policy Analyst

Canadian Centre for Policy Alternatives

Hugh Mackenzie, Research Associate

MONDAY, APRIL 11, 2005
QUÉBEC (QC.)
Meeting No. 11

Centrale des syndicats du Québec

Pierre Séguin, Vice-President

Pierre Beaulne, Economist

As Individuals

Prof. Luc Godbout, Professor of Fiscal Policy, Research Chair on Taxation and Public Finance, University of Sherbrooke

Karine Dumont, Researcher, Research Chair on Taxation and Public Finance, University of Sherbrooke

Government of Québec

Michel Audet, MLA and Minister of Finance

Bernard Turgeon, Associate Deputy Minister, Department of Finance

Patrick Déry, Director, Federal-Provincial Relations Directorate, Department of Finance

Jean Séguin, Political Attaché, Office of the Minister of Finance

Benoît Pelletier, MLA and Minister for Canadian Intergovernmental Affairs

Camille Horth, Associate Secretary General, Secrétariat aux Affaires intergouvernementales canadiennes

Yves Castonguay, Deputy Secretary, Secrétariat aux Affaires intergouvernementales canadiennes

Québec National Assembly

Mario Dumont, MNA and Leader of the Action démocratique du Québec

Marc Picard, MNA and Finance Critic of the Action Démocratique du Québec

Union des producteurs agricoles du Québec

Laurent Pellerin, President

Serge Lebeau, Senior International Trade Advisor and Assistant Director, Agricultural Studies and Policies Department

Meeting No. 12

Conseil du patronat du Québec

Gilles Taillon, President

Quebec Federation of University Students

Guillaume Lavoie, Vice-President, International and Federal Affairs

Québec National Assembly

François Legault, MNA and Critic of the Official Opposition on economic development and finance (Parti Québécois)

Fédération des travailleurs et travailleuses du Québec

Pierre Dupuis, Vice-President

Monique Audet, Advisor

As Individuals

Léa-Cadieux Mathieu

Pierre Laval Mathieu

WEDNESDAY, APRIL 13, 2005
OTTAWA (ONT.)
Meeting No. 13

Queen's University

Prof. Robin Boadway, Sir Edward Peacock, Professor of Economic Theory, Fellow of the Institute of Intergovernmental Relations

Prof. Ronald Watts, Principal Emeritus, Professor Emeritus of Political Studies, Fellow of the Institute of Intergovernmental Relations

MONDAY, APRIL 18, 2005
WINNIPEG (MAN.)
Meeting No. 14

Legislative Assembly of Manitoba

Jon Gerrard, MLA and Leader of the Opposition (Liberal Party)

Stuart Murray, MLA and Leader of the Official Opposition, Progressive Conservative Party

Gerald Hawranik, Finance Critic, Progressive Conservative Party

Government of Manitoba

Hon. Greg Selinger, Minister of Finance

Ewald Boschmann, Deputy Minister of Finance

Jim Eldridge, Special Adviser on Intergovernmental Relations

Meeting No. 15

As Individuals

Vic Schroeder

Ronald Neumann, CIDA Advisor to the Ministry of Finance and Economic Planning, Government of Ghana

Prof. Paul Thomas, Duff Roblin Professor of Government, University of Manitoba, St. John's College

WEDNESDAY, MAY 4, 2005
OTTAWA (ONT.)
Meeting No. 16

Queen's University

Prof. Thomas J. Courchene, Jarislowsky-Deutsch Professor of Economic and Financial Policy, Senior Scholar, Institute for Research on Public Policy

Prof. Harvey Lazar, Director, Institute of Intergovernmental Relations, School of Policy Studies

Copy of the relevant Minutes of Proceedings (*Meeting No. 66*) is tabled.

Respectfully submitted,

Massimo Pacetti, M.P.
Chair

Standing Committee on Finance
The Conservative Party of Canada:
The Only Federalist Solution to the Fiscal Imbalance
Supplementary Opinion of Subcommittee on Fiscal Imbalance

Rona Ambrose, M.P.
Edmonton-Spruce Grove

June 2005

Federal-provincial fiscal arrangements play a fundamental role in the delivery of the most important priorities of Canadians: health, education and social services. However, the Liberal approach has served to undermine the very social and political fabric of Canada, endangering future funding for social programs and jeopardizing federalism.

The Conservative Party of Canada believes that any proposed solutions to the fiscal imbalance and changes to the equalization formula must be made with the following principles in mind:

- **Leadership with a national, federalist vision;**
- **Collaboration to ensure that changes to the equalization formula or proposals to address the fiscal imbalance are done in consultation with the provinces and municipalities;**
- **The right of all Canadians to quality healthcare, education and social services — regardless of where they live;**
- **Equality of all provinces;**
- **Respect for the unique needs of Quebec within a collaborative federalist framework;**
- **The belief that Canada's most essential national program, equalization, should be used for what it was intended, 'neighbours helping neighbours in times of need.'**

It was stated clearly by a majority of witnesses that both the vertical fiscal imbalance and the horizontal (equalization) fiscal imbalance are being badly managed by the Federal government. Many witnesses also demonstrated that the fiscal imbalance is negatively affecting the provinces and municipalities, a majority of whom are struggling to meet the core service needs of their citizens.

“New Brunswick is facing a serious structural imbalance…it will face increasing deficits…[and] it can pretty much struggle through the next decade, but is going to face increasing deficits after that, largely as a result of its rising health care expenditures driven in large part by its aging population.”

Mr. David Chaundy — (Senior Economist, Atlantic Provinces Economic Council)

“…my belief is that it's the fiscal imbalance that's behind this inability to really grapple with a number of important issues, most particularly health care…” Mr. Fred McMahon (Director, Centre for Globalization Studies, The Fraser Institute)

The Conservative Party of Canada agrees with the majority report submitted by the Subcommittee on Fiscal Imbalance which concludes that the fiscal imbalance exists and is a growing problem for all orders of government. The Conservative Party of Canada (CPC), the New Democratic Party and the Bloc Quebecois have unanimously agreed to a number of recommendations.

We do not, however, believe the report goes far enough in proposing concrete solutions to the vertical fiscal imbalance and horizontal fiscal imbalance. This supplementary report will address a number of the important points missing from the main report and outline the Conservative Party of Canada’s solutions to the challenges of fiscal federalism.

The Conservative Party of Canada has long acknowledged the existence of the fiscal imbalance and problems with the equalization formula. We recognize that the fiscal gap between the federal government, which is experiencing yet another unprecedented surplus, and the provinces, which are facing increasing fiscal pressures to deliver core social services, is being perpetuated by the Liberals inability to articulate a national vision for fiscal federalism.

In a rush to buy votes before the next general election, the Liberals have abandoned any commitment to multilateral negotiations, disrespected the need for a collaborative and comprehensive approach to fiscal federalism and undermined the security of important social programs.

The Liberal solution to the fiscal imbalance continues to be to deny it exists and a reliance on a quick fix of patchwork federalism. The Liberals have abandoned fiscal federalism in the name of political expediency by signing a series of side deals and bilateral agreements with no national vision.

By signing ad-hoc, bilateral side deals with provinces outside the fiscal framework of the equalization program, the Liberals are ruining equalization: the most ‘*essentially Canadian*’ national program.

By abusing their federal spending power, disrespecting the Constitution, and approaching negotiations with provinces in an unfair and inconsistent manner, the Liberals have engendered mistrust between all orders of government and turned their back on collaborative federalism. The Liberals have pitted province against province, Canadian against Canadian. By neglecting the emerging fiscal imbalance between provinces and municipalities, and the increasing pressure on provinces and municipalities to deliver core social services, the Liberals have set cities against provinces, mayors against premiers.

The Conservative Party of Canada believes there is nothing more Canadian than “neighbour helping neighbour” and that all Canadians believe that the equalization program should be there to ensure that every Canadian, regardless of where they live, can count on quality healthcare, education and social services.

The NDP proposal to the fiscal imbalance oversimplifies the issue by suggesting that increasing federal transfers will solve the concerns of the provinces and municipalities. Throwing money at the problem does not address the need for more accountability and transparency in federal transfer mechanisms. In addition, the NDP rejects Quebec’s desire for flexibility and autonomy within the federation.

The Bloc Quebecois proposal to the fiscal imbalance is unacceptable as it excludes the need for a national, comprehensive approach to the problems of fiscal federalism. A solution to a national problem proposed in a vacuum is not a solution that works for Quebec or the rest of Canada. All provinces should be treated equally and Quebec’s unique needs are easily addressed in a collaborative federalist framework and will only serve to strengthen Canadian federalism.

After consideration of the testimony presented to the Fiscal Imbalance Sub-Committee, the Conservative Party of Canada has compiled a number of recommendations to address both the vertical and horizontal (equalization) fiscal imbalances.

Horizontal Fiscal Imbalance — Equalization:

The Conservative Party of Canada agrees with the report’s definition of equalization and the problems the program currently faces, however the CPC does not believe the report went far enough to stress the importance that the program is essential to Canada’s nation building efforts. Equalization attempts to reduce fiscal disparities among provinces and ensure “that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation,” and the CPC

believes that in order for Canada's provinces to grow and prosper, it is important that a strong and effective Equalization program be in place.

The Conservative Party of Canada welcomed and encouraged amendments to the Atlantic Accord, an agreement which has essentially allowed the provinces of Newfoundland/Labrador and Nova Scotia to retain 100% of their oil and gas revenues, and 100% of their equalization payments until 2012. However, the Conservative Party of Canada believes that the agreement was an admission that the transfer methods used by the Liberals are flawed; had the Liberal Party taken a more wholesale approach to the changes with the Equalization formula the side-deal would have been unnecessary. The majority of witnesses felt that ad-hoc side deals are an inappropriate manner with which to address the fiscal imbalance.

> *"I would say that experience elsewhere suggests that trying to deal with these issues by ad hockery, whether you call them side deals or what have you, is a very slippery slope downwards." Professor Ronald Watts (Principal Emeritus, Professor Emeritus of Political Studies and Fellow of the Institute of Intergovernmental Relations, Queen's University)*

> *"I think the one-off approach has created some serious problems now where everybody wants a one-off deal and they all develop a unique rationale why they should get a one-off deal. And everybody is squabbling and fighting and that sense of common citizenship is being eroded as a result of that..." The Honourable Greg Selinger (Minister of finance, Government of Manitoba)*

The CPC believes that future changes must be made in a manner that benefits all provinces, and which considers any potential long-term impacts. In addition we note that the recent ad-hoc side deals which were reached under the auspices of solving inequities have served only to create grosser inequities between the provinces. These side-deals are destabilizing the balance of the federation and have created a situation which serves only to pit province against province.

The Conservative Party of Canada recommends to the federal government that any changes made to the equalization formula involve the input of all provinces; so that they are treated in an equal and fair manner.

The Conservative Party of Canada believes that the federal government must ensure that no province is adversely affected by changes to the equalization formula. In addition, our party believes that equalization should be the principle vehicle for redistributive financing.

As noted above, a number of provinces, for example Saskatchewan, have asked for a deal similar to that reached with the provinces of Newfoundland/Labrador and Nova Scotia.

> *"Our request is…Let us retain the revenues from energy development for reinvestment in our province. Don't treat them as just another revenue source, as there is a fundamental difference between non-renewable resources whose value is permanently depleted once extracted from the ground and other sources of government revenue that are ongoing and renewable..."* Hon. Lorne Calvert (Premier of Saskatchewan)

In addition, the committee heard from witnesses who argued that the equalization formula must be revisited. A number of issues must be addressed including the impact of the floor/ceiling stipulated in the new Equalization framework reached in October 2004 and the treatment of resource revenues in the fiscal framework of equalization. Therefore,

The Conservative Party of Canada recommends that non-renewable natural resource revenues be removed from the equalization formula in order to encourage the development of economic growth in the non-renewable resource sectors across Canada.

The Conservative Party of Canada recommends that the federal government take a multilateral approach in examining the horizontal fiscal imbalance and equalization framework. Building upon the framework and resources already established by the provinces through the Council of the Federation, we support the development of a consultative process which also includes representatives from the Federal and Municipal orders of government.

Vertical Fiscal Imbalance:

Most provincial governments clearly stated that the vertical fiscal imbalance has made it increasingly difficult for the provinces to engage in long term financial planning and to guarantee essential health and social programs. In addition, a number of witnesses, including argued that the reliance on federal transfers to provide balance to fiscal federalism has resulted in a lack of transparency and accountability whereby the taxpayer does not know which order of government is accountable for the majority of programs.

> *"Coherence and sustainability are threatened when provinces commit themselves to delivering services for which they don't collect the required funding and the federal government collects money to provide services it is not responsible for delivering and for which it can't ensure delivery. However, coherence and sustainability are likely outcomes when provinces assume responsibility for raising tax revenues that roughly match their spending commitments and when the federal government adopts the more limited role of filling in the gaps in provinces' abilities to finance the services they are responsible for."* Mr. Finn Poschmann (As an individual)

> *"I would argue that the biggest problem with the current system of intergovernmental transfers in Canada is not really whether a fiscal imbalance exists, but it lies rather in the impact of the current system on transparency and accountability."* Mr. Jock Finlayson (Executive Vice-President, Policy, Business Council of British Columbia)

The Conservative Party of Canada recommends that in order to help correct the vertical fiscal imbalance, that the federal government conduct an in depth review of all tax fields, federal fiscal transfer mechanisms and consider transferring an appropriate level of income tax points to the provinces.

Many witnesses argued that as a result of the vertical fiscal imbalance the Federal government has been able to spend in areas of exclusive provincial jurisdiction.

> *"The federal government's ability to spend in our areas of jurisdiction is directly fueled by the fiscal imbalance."* Mr. Benoît Pelletier (Minister for Canadian Intergovernmental Affairs, Government of Quebec)

The Conservative Party of Canada recommends that if the federal government initiates new spending in areas of exclusive provincial/territorial Constitutional jurisdiction they should have agreement from the majority of the provinces to proceed, and that provinces should be given the right to opt out of the federal program and continue to receive federal funding, so long as the province offers a similar program with similar accountability structures.

BLOC QUÉBÉCOIS SUPPLEMENTARY OPINION

In recent months, the House of Commons Subcommittee on Fiscal Imbalance has been going across Canada, from east to west, listening to dozens of witnesses tell us about the fiscal imbalance problem.

The Bloc Québécois unreservedly supports the Subcommittee's finding that recognizes the existence of a fiscal imbalance in Canada. The Bloc Québécois also supports the report's four recommendations:

That on a triennial basis, the House of Commons Standing Finance Committee, in cooperation with the Council of the Federation, review the changes in the respective fiscal capacity of the federal government and the provincial and territorial governments so that each order of government is able to carry out its constitutional responsibilities. The House of Commons Standing Committee on Finance will have to report on these changes to the House of Commons once every three years.

That the federal government adopt comprehensive measures to respond to the needs of the provinces and territories through federal-provincial territorial agreements and minimize the use of ad hoc agreements with the governments of the provinces and territories.

That the Canada Social Transfer be restructured and include two separate transfers: a transfer to support postsecondary education and a second transfer to support social assistance and social services.

That the cash transfer from the federal government to the provincial/territorial governments, under each restructured component of the Canada Social Transfer, be increased so that the federal contribution attains a rate comparable to that given in recent years for health care. This increase should be instituted gradually over a period of four years, without compromising the current federal balanced budget policy.

This final recommendation indisputably confirms the desire to see the federal government increase its transfers to the provinces in the education and social programs sector to a level of 25%, as the Romanow report on healthcare recommended and as the agreement reached in September confirmed.

The Bloc Québécois also feels that we must push the logic of reform and allow Quebec and the provinces to exercise their full autonomy in their jurisdictions. Therefore, we propose:

RECOMMENDATION 1

That the provinces and territories have the choice, after the four-year period, of continuing to receive cash transfers or withdrawing from ***the three transfers — health, postsecondary education, and social assistance and social services*** *— in exchange for complete compensation in the form of a transfer of tax points on individual income tax or for other tax bases (right of withdrawal with full compensation).*

RECOMMENDATION 2

The Bloc Québécois feels that respect for jurisdictions should guide the federal government's future decisions accordingly, as a rule, the federal government should stop spending in areas that are the exclusive jurisdiction of the provinces and territories under the Constitution, failing which the provinces and territories would be authorized to withdraw from such federal programs, ***without conditions and with full compensation.***

The Bloc Québécois feels it is necessary to correct not only the vertical fiscal imbalance, that is, the fiscal imbalance between Ottawa and Quebec and the provinces, but also the horizontal fiscal imbalance, that is, the wealth gap between the provinces themselves. That is why in order to correct the fiscal imbalance in a lasting manner, the Bloc Québécois feels it is necessary to undertake a fundamental reform of the equalization formula and additionally recommends:

RECOMMENDATION 3

That a working group, composed of representatives of the Council of the Federation and one representative of each political party recognized in the House of Commons, be formed. The mandate of this working group will be to propose new ways to thoroughly rework the Equalization Program and will to that end:

- *take account of the principle of equalization set out in subsection 36(2) of the Constitution Act;*
- *consider the elimination of the floor/ceiling stipulated in the new equalization framework implemented in October 2004;*
- *consider the re-establishment of the ten-province standard for calculating average fiscal capacity;*
- *consider revising the methods for calculating the estimated performance of a number of tax bases, particularly property tax, so that the methods used better reflect the provinces' real fiscal capacity; and*
- *take account of any other relevant factor*

The working group will have one year, from the date it is established, to carry out its mandate*.*

Liberal Dissenting Opinion — June 2005

1. The Subcommittee on Fiscal Imbalance of the House of Commons Standing Committee on Finance, in its majority report of June 2005, claims that there is an urgent need to revisit current federal-provincial/territorial fiscal arrangements, and to take the actions needed to re-balance the federation. We, the Liberal Minority on the committee, fundamentally disagree.

2. The main point of our disagreement lies with the fundamental flaws inherent in the report. First, we take issue with the basic assumption that the report makes: that there is a vertical fiscal imbalance. Secondly, we take issue with the over-reliance on testimony of certain witnesses over others, particularly those that supported the existence of a fiscal imbalance. Finally, the subcommittee ignores the desire of Canadians for national standards that they can rely on regardless of where they live.

3. Firstly we take issue with the existence of a vertical fiscal imbalance. The majority report of the sub-committee included a statement by Professor Emeritus Ronald Watts, of Queen's University that "the concept of fiscal imbalance has an element of subjectivity: the appropriate levels of government expenditure and revenue are not objective, but are the product of political will and political decisions about what each order of government should do." By maintaining that there is a fiscal imbalance, the subcommittee has taken a subjective view about the existence of an imbalance and elevates this assumption to iron clad objectivity.

4. Furthermore, the Subcommittee recognizes that when the revenues from all tax bases are considered, both those that are shared and those that are exclusive to each jurisdiction, "the allocation of revenues between the two orders of government was essentially equal in 2003-2004." Moreover, it has been noted by Professor Emeritus Rodney Dobell, of the University of Victoria, "that provinces/territories have access to the same significant tax bases as the federal government, and have exclusive access to such rapidly growing bases as natural resource rents and gaming revenues."

5. Professor Dobell also remarked that "each province/territory has the **RIGHT** to be different, and can select the combination of expenditures and taxation that it considers will be supported by its electorate." Professor Dobell stated that the "case has not been made that the provinces/territories are unable to fund programs … for which they have Constitutional responsibility." His opinion is supported by witnesses from the Atlantic Institute for Market Studies, the Caledon Institute of Social Policy, and the Canadian Centre for Policy Alternatives.

6. Provincial governments — like all governments — are required to make political choices about the tax revenues they are willing and able to raise in order to pay for the services that they want to offer their citizens. The federal government must make the exact same decisions. Within this decision-making process, federal governments over the past decades have made a conscious decision to transfer money to the provinces. These transfers broadly fall into two categories:

7. (1) The Equalization Program — it is explicitly intended to decrease the disparity between provinces, and ensure that all provinces are able to provide reasonably comparable services at reasonably comparable levels of taxation.

8. (2) Transfers aimed at ensuring that the provinces are able to offer services at a higher level than would otherwise be possible. The Canada Health Transfer and Canada Social Transfer both fall into this category. These Transfers are provided on an equal *per capita* basis and are therefore not intended to "close the gap" between provinces, but rather to improve services equally across the country.

9. In this way, the federal government has built-in transfers which ensure that there is an equality in the services that citizens across the country can expect to receive (through the Equalization Program) and also that in certain priority areas, such as health, education and social services, the services across the country are better than if the provinces funded them without federal support.

10. It is clear that transfers to provinces have increased dramatically in the past number of years. In fact, the First Ministers' Meeting on Healthcare in September 2004 committed an additional $41 billion into the healthcare over the next ten years. In a separate First Ministers' Meeting in October 2004, an additional $33 billion was committed to the Equalization system over the next 10 years. These are significant new, incremental investments that flow from the federal government to provinces.

11. It is important to remember that the concept of "balance" is both subjective and political — a fact which seems to have been overlooked by the Majority Report. There was a public debate about "fiscal imbalance" in the 1980's but at that time it was believed that the fiscal situation was tilted in favour of the provinces. Circumstances change over time.

12. The most significant factor in this turn-about has been the decision by the federal Liberal government of the 1990's — under the stewardship of the current Prime Minister — to finally put the finances of the federal government in order.

13. This Subcommittee has failed to explain how any of the Recommendations put forward in the Majority Report will improve the life of a single Canadian. There has been absolutely no attempt by this Subcommittee to explain how increasing the transfers — or increased provincial taxation — will improve any service.

14. There is no inherently correct structure or "balance" between taxation and spending, or transfers between levels of government. There are only political choices to be made by elected officials, who then must stand before the electorate and defend their choices.

15. It was presumptuous and inappropriate for this Subcommittee to begin its study with a prior assumption that a fiscal imbalance exists, and to then hold hearings hoping to gather opinions and "facts" that would bolster the original assumption. Hence, the conclusions should come as no surprise.

16. Despite starting with the preconceived notion that a vertical fiscal imbalance exists, this committee has failed to prove that assumption.

    There was considerable testimony from expert witnesses not representing provincial governments, who have an obvious bias, that the differing levels of fiscal pressures faced by the federal and provincial/territorial governments are subjective, and directly linked to political priorities and choices, rather that to a systemic fiscal imbalance. Therefore, as the Liberal Member of the Subcommittee, and on behalf of those Members of my party who substituted for me at some of the hearings, we reject the Majority Report, its findings and its Recommendations.

Don Bell, MP
North Vancouver
Liberal Member of the Subcommittee on Fiscal Imbalance

New Democratic Party Dissenting Opinion to the Finance Subcommittee on Fiscal Imbalance,

June 2005

The New Democratic Party believes that equalization and social transfer programs embody the spirit of equality and cooperation that form the very heart of Canadians' social and economic values. That we have strayed so far from a position of federal-provincial-territorial balance that these programs are being undermined threatens not only the programs, but Canada itself. Careful consideration of this imbalance by the Finance Subcommittee at this time has been especially useful and timely. We would like to acknowledge the contribution of Subcommittee members and the witnesses who appeared.

While the Subcommittee's main report has been extremely useful in identifying the issues that need to be addressed, and while there is merit in its recommendations regarding Parliamentary accountability, minimizing ad hoc agreements, splitting the Canada Social Transfer and increasing the federal share of social program funding, <u>New Democrats cannot accept any suggestion that opting out of cash transfers in favour of tax points is a viable proposition. Such a move only opens the door to the fragmentation and eventual disintegration of our highly valued social programs.</u> Given our commitment to cooperative federalism and the importance we attribute to the issue of fiscal arrangements, we have therefore undertaken a minority report.

Urgent resolution needed

We cannot overemphasize the importance and urgency of resolving what has become an open wound at the heart of the Canadian federation.

Fed by a mistrust of the federal government following a series of unilateral cutbacks and changes to contributory programs with enormous implications for provinces and territories and the recent politicization of the equalization process through a series of bilateral side-arrangements, the level of dysfunction, tension and negative rhetoric around fiscal arrangements has risen to an unprecedented level. For the first time, both "have" and "have-not" provinces alike are challenging the validity of the federal position. The concept of equalization itself is being undermined.

The federal Liberal government now stands alone in denying the existence of a fiscal imbalance and therefore of the need to actively and urgently search for a new solution.

Horizontal Imbalance: The Need for a Workable Equalization Formula

Although the official call for "national adjustment grants" dates back to the 1940s, the equalization program itself was put in place in 1957.

There is no single "fiscal arrangements" budget line either federally or provincially that can be pointed to as either "account owing" or "account paid". Yet it is hard to conceive of any single area of the relationship between government jurisdictions in Canada that carries more direct impact on the well-being of Canadians.

Indeed, the Task Force on Federal-Provincial Fiscal Arrangements in 1981 referred to equalization as "the glue that holds confederation together" and the Senate Committee on National Finance has called it "a defining national program".

That the principles of fairness and equality embodied in equalization are at the heart of how we define ourselves as Canadians was made clear when, in 1982, equalization was enshrined in Section 36(2) of the Canadian Constitution: "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 service at reasonably comparable levels of taxation."

Despite its vital importance to Canadians, as reflected in its constitutional status, equalization adjustment and reform has been neglected by this federal government and treated as its exclusive purview. The federal government has given serious attention to equalization only when required to by legislation, otherwise giving it only arbitrary and occasional attention. For many, the recent treatment by this government is reminiscent of 1982 when the Liberals unilaterally resorted to a 5-province standard to determine equalization levels to lower federal payments adding stress and resentment to the system.

Equalization payments had dropped significantly as a percentage of GDP over the 15 years before the 2004 changes — from close to 1.4 percent in to 0.7 percent (over 40 percent). Yet the differential from province to province remains with the per capita GDP in Prince Edward Island just over 50 percent of the per capita GDP of Albertans. Equalization payments account for almost a quarter of Atlantic provinces' budgets and roughly 10 percent of Quebec's.

Because of the diverse population and resource bases of provinces and territories, provincial and territorial economic capacity varies and will continue to vary into the future. Inter-provincial disparity or 'horizontal imbalance' constantly needs adjustment.

In 2003, when negotiations were compelled by the 5-year legislative review requirement, the provinces and territories brought a consensus position to the table. It called for a return to the 10-province standard, the inclusion of all provincial revenues including user fees in equalization calculations, the minimizing of unpredictable factors through the forgiveness of census-related losses and the taking into account of any dramatic changes to provincial and territorial tax bases.

Despite the need to stablize equalization payments and increase predictablity for provincial planning purposes, the federal government failed to resolve outstanding issues by the April 2004 deadline.

It finally countered in the fall of 2004 with its own “solution” which it then put to the provinces and territories as a virtual take-it-or-leave-it proposition. However, if there is one item where most witnesses before the Committee agreed, it would be that this November 2004 agreement is inadequate.

Vertical Imbalance: A Need for Reliable and Significant Transfers

Service and cost demands in areas of provincial responsibility like health and education have grown considerably and continue to grow both in absolute terms and in relation to the demands on federal responsibilities. Federal financial support through the development of cost-shared social programs was needed and welcomed. By 1977 a system of federal transfers for health, post-secondary education and social assistance had been incorporated into the Established Programs Financing arrangements. The Canada Assistance Plan (CAP) helped fund a broad range of provincial income support efforts.

The dramatic reconfiguring of fiscal arrangements that set the stage for today’s heightened tension came at the hands of the Liberal government in 1995 with the creation of the Canada Health and Social Transfer (CHST) and accompanying billions of dollars in transfer cutbacks.

At the very moment when the combination of an aging population and industrial realignment in the new global economy were exerting extreme new demands on provincial and territorial services, the federal government chose to dramatically reduce its transfers by roughly 1/3. In so doing, it launched a fiscal attack not only against provinces and territories but against the Canadians in greatest need of help. With the CHST, it eliminated CAP, the one program offering some income security, leaving provinces scrambling to fill the need on their own. It even went so far as to compound the hardship for Canadians a year later with changes to make access to unemployment insurance more difficult. It had already pulled out of social housing by this time.

It is astonishing that, despite federal government surpluses in the last eight years, federal contributions to provinces and territories for social services and post-secondary education remain 30 percent lower than in 1995-96 totalling barely 11.5 percent of provincial spending in these areas. The 38 percent contribution under CAP has been reduced to a 23 percent contribution under CST. For education, the funding has dropped from 15 percent to an estimated 7 percent. Even as some money is restored to health with great fanfare, it should be noted that an estimated 60 percent of the new 2004 federal money came from funding otherwise headed to social services and education.

There is no doubt that several provinces have aggravated their funding shortfall with spending on tax cuts. For example, the Canadian Centre for Policy Alternatives has calculated that had all the Ontario Conservative government's tax cuts been implemented, by 2004-05 Ontario's revenue potential would have been reduced by $15.5 billion. But federal claims that higher provincial tax rates are the solution to fiscal imbalance obscure the equality issue. Just as tax points do not resolve the horizontal imbalance between provinces and territories, neither will individual provincial tax increases. This federal spin simply adds to the cynicism about federal sincerity in achieving a fair and lasting solution.

NDP response promotes Canadian values

The NDP recognizes that, particularly due to dramatic transfer reductions by the Liberal government, provincial and territorial governments have borne an increasing burden for funding historically cost-shared programs. We seek to remedy this growing inequality by restoring the federal government's contributory role in funding health care, post-secondary education and social assistance programs, while at the same time seeking broad national objectives respecting the principle of asymmetry.

This approach is consistent with our constitutional vision of Canada — a vision of a responsive federalism, a co-operative federalism emphasizing co-decisionmaking, and an asymmetrical federalism that accommodates the uniqueness of Quebec.

A concrete example of our position can be seen in the NDP 2005 budget changes that channel $4.6 billion in federal surplus dollars to investments in education, housing and the environment.

Reliable and significant federal funding through cash transfers, not tax points, is critical for both national unity and equality of condition objectives. The Romanow Commission thoroughly reviewed the use of tax points as a substitute for cash payments and its rejection of the tax point option was unequivocal. Romanow reminded Canadians that the effect of substituting tax points for cash transfers runs counter to the objectives of equalization: a tax point yields less revenue in a

low-income province than in a high-income province. The use of tax points began as a way of adding to provincial capacity to generate revenue for participation in shared social program funding. Their consideration as an option today is largely a product of the failure of the federal government to deliver the cash transfers it should. Encouraged by corporate think tanks, some provinces may view tax points as ‘better than nothing’. We can do much better.

We have also heard corporate think tanks call equalization a ‘welfare trap’ for recipient provinces. Yet the Manitoba government showed the Subcommittee that it has built a stronger economy with the support of federal transfers, maintaining dynamic communities and providing the social infrastructure to attract investors.

Corporations have argued that transfers impede ‘the market’ from dictating economic development patterns. With Alberta’s fiscal capacity nearly twice that of provinces like Prince Edward Island, Canadian values dictate that we make every effort to increase provinces’ capacity to deliver services rather than abandoning the Canadians who live there.

Canadians have seen through these thinly disguised attempts to add to corporate profits through the private takeover of public programs. The Fraser Institute has called equalization “an elaborate system of bribes” for governments. The corporate alternative, apparently, is an unconditional porkbarrel to raise private corporate profits at the public’s expense.

Recommendations:

1. Equalization Reforms

The equalization program is in urgent need of reform. There must be a renewed commitment to equalization as a national program vital for the shared goals of national unity as well as for social and economic equality between regions and among Canadians. As well, the equalization provisions of the Constitution must be respected. The October 2004 equalization plan must be seen as a temporary inadequate arrangement in urgent need of replacement.

An independent Commission should be established to take the findings of the Expert Panel, the advice of the Council of the Federation and the fiscal forecasts of the federal government and develop a new equalization formula taking into serious account the following:

- removal of the floor/ceiling stipulated in the Oct. 2004 equalization framework;

- a return to the 10-province standard for the calculation of average fiscal capacity;

- recognition of all forms of revenue including the phased-in incorporation of revenues from all non-renewable natural resources,

- an escalator provision for equalization rate increases tied to increases in economic performance.

2. Significant and Reliable Cash Transfers for Health, Post-Secondary Education and Social Programs

Cash transfers are vital to the preservation of national programs like Medicare and the avoidance of a patchwork approach to economic and social equality goals. We support increasing the federal share of funding for social programs with provision made to ensure payments grow with population and economic growth. However, the concept of opting out of cash transfers in return for tax points must be rejected because this will only lead to a patchwork of programs across Canada.

It is imperative that attention be given to fixing the social transfer by separating post-secondary education funding from social service funding to increase transparency and accountability and creating a separate child care envelope to better coordinate transfers in this important area. We recognize that there may be a need for new national cost-shared programs as a coordinated federal-provincial-territorial response to a national matter and that such programs should be developed on the basis of a provincial consensus. Clearly such a cooperative approach to federalism, along with significant improvements in the transfer system, as well as strategic federal investments in such areas as housing and the environment is a viable alternative to the tax point transfer option and puts us on target for addressing the fiscal imbalances in Canada today.

3. Renewed Cooperative Federalism

Current fiscal imbalances and tension in the federation need urgent attention. The spirit of cooperative federalism needs to be nurtured. While changes in the equalization formula and improvements in cash transfers are part of the solution, there needs to be a renewed emphasis on federal/provincial/territorial relations and on revitalizing structures and mechanisms supporting negotiations on intergovernmental fiscal issues such as:

- Regular and substantive meetings of First Ministers, Finance Ministers, their officials and continuing committees;

- A Federal-Provincial-Territorial Fiscal Secretariat created to coordinate ongoing research and analysis of the equalization program and to recommend modifications, as needed, reporting regularly to each level of government and subject to Parliamentary scrutiny. The Secretariat would, further, set up mechanisms to develop common principles and objectives for social transfers that would be agreed to by all parties through a broad discussion and engagement with Canadians in an attempt to avoid a race to the bottom on social standards across the country.

MINUTES OF PROCEEDINGS

Thursday, June 2, 2005
(*Meeting No. 18*)

The Subcommittee on Fiscal Imbalance of the Standing Committee on Finance met *in camera* at 9:14 a.m. this day, in Room 237-C Centre Block, the Chair, Yvan Loubier, presiding.

Members of the Subcommittee present: Rona Ambrose, Don H. Bell, Guy Côté, Yvan Loubier and Judy Wasylycia-Leis.

Other Member present: Hon. John McKay.

In attendance: *Library of Parliament*: June Dewetering, Principal; Alexandre Laurin, Analyst.

Pursuant to the Order of Reference of Tuesday, November 2, the Subcommittee resumed its study on Fiscal Imbalance.

The Subcommittee resumed consideration of a draft report.

It was agreed on division, — That the Draft Report be adopted, as amended, as the First Report of the Subcommittee.

It was agreed, — That the title of the report be:

THE EXISTENCE, EXTENT AND ELIMINATION OF CANADA'S FISCAL IMBALANCE.

It was agreed on division, — That the Subcommittee append to its report dissenting or supplementary opinions from the opposition parties provided that they are no more than five pages in length and submitted electronically to the Clerk of the Subcommittee, no later than 12:00 o'clock p.m., Monday, June 6, 2005.

It was agreed, — That the Chair, Clerk and researchers be authorized to make such grammatical and editorial changes as may be necessary without changing the substance of the report.

It was agreed on division, — That the Chair be instructed to present the Report of the Subcommittee to the Standing Committee on Finance.

It was agreed, — That the Subcommittee print 550 copies of the Report in English and in French.

At 11:00 a.m., the Subcommittee adjourned to the call of the Chair.

Tuesday, June 7, 2005
(*Meeting No. 66*)

The Standing Committee on Finance met *in camera* at 11:07 a.m. this day, in Room 253-D Centre Block, the Chair, Massimo Pacetti, presiding.

Members of the Committee present: Rona Ambrose, Don H. Bell, Guy Côté, Charles Hubbard, Yvan Loubier, John McKay, Maria Minna, Massimo Pacetti, Brian Pallister, Charlie Penson, Monte Solberg and Judy Wasylycia-Leis.

In attendance: *Library of Parliament*: June Dewetering, Principal; Alexandre Laurin, Analyst.

The Committee proceeded to the consideration of matters related to Committee business.

The Committee considered the Report of the Sub-Committee on Fiscal Imbalance.

It was agreed on division, — That the Report be adopted.

ORDERED, — That the Chair present the Report to the House.

At 11:38 a.m., the Committee adjourned to the call of the Chair.

Richard Dupuis
Clerk of the Committee