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A REPORT CARD ON CANADA'S FISCAL ARRANGEMENTS

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A Report Card on Canada's Fiscal Arrangements
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Every year, the federal government gives the provinces approximately $50 billion through the Canada Health Transfer (CHT), the Canada Social Transfer (CST) and Equalization. Additional billions are allocated through other targeted transfers. These funds help provinces and territories deliver the services Canadians count on, including health care and education. The major agreements that underpin these transfers expire in 2014.

This gives the country just over three years to question, discuss, debate and build consensus toward a new set of arrangements that will help sustain the high-quality public services Canadians expect.

Three years is not a long time. Historically, these discussions have been some of the most drawn out and contentious in Canadian politics. Many experts expect that the negotiation of a new transfer system this time around will be especially acrimonious because the stakes are high.

First, there is an underlying fear that the federal government will resort to actions it took in the mid-1990s—resolving its own fiscal problems by dramatically cutting transfers to the provinces and territories. Unilateral federal cuts this time around could push many provinces to the financial precipice.

Second, there is broad recognition that our fiscal transfer system does not serve Canadians as well as it could. The experts consulted for this *Report Card* conclude that the system is not performing to the standard Canadians deserve, receiving a grade of 'C' overall—**average is not good enough**.

While Canada performs relatively well on the benchmark of "autonomy," it performs relatively poorly on the benchmarks of "accountability" and "transparency." Our score on revenue adequacy is resoundingly average.

Clearly there is work to be done. This is why the Mowat Centre is undertaking this exercise—responding to the need for change by highlighting strengths and weaknesses in our transfer system—and pointing to potential solutions. These options will provide a way forward for the design of the transfer system, and a platform for a detailed set of recommendations that the Mowat Centre will propose in the summer of 2011.

While the experts surveyed did not agree on all issues, many focused on transformative rather than incremental changes to Canada's transfer system. Experts did not weigh in on long-standing technical disputes such as whether Equalization should be calculated using a 5 or 10 province standard. Many pointed to more innovative and principled options, often inspired by international practices that approach the issue of inter-regional sharing in very different ways.

The desire to break free from some of Canada's traditional ways of approaching these transfers is in part inspired by the recognition that Canada's economic foundations have shifted. Ontario is no longer significantly more prosperous than other provinces and will be unwilling to support inter-regional redistribution at historic levels. Just as importantly, natural resource revenues account for a greater share of provincial revenues; they are unevenly distributed across the country, are unavailable to the federal government for inter-regional sharing, and have a growing importance in the national economy. All of this suggests that a different approach to federal fiscal transfers is warranted.

Moving this agenda forward will be difficult. Instead of unilateralism and intergovernmental conflict, Canada requires a principled discussion. We need to summon the collective will to solve an admittedly difficult problem—how to fund the programs that matter to Canadians in a way that is *equitable, predictable and transparent* while ensuring that these transfers do not undermine economic *efficiency*. Fiscal transfers need to work in a way that keeps governments *accountable* and gives them *adequate revenues* and *autonomy* to fulfill their responsibilities.

There are some built-in tensions that need careful balancing. A perfectly efficient system may sacrifice equity, possibly violating a key principle in the Constitution. A system that is highly equitable may be inefficient and drag down the federation's economic growth. Reconciling these tensions is difficult, but necessary in designing a fiscal transfer system.

The system we are currently dealing with is not the product of deliberate design aimed at reconciling these benchmarks, but an aggregation of one-off and ad hoc decisions driven by the politics of the day. Its current structure and design should not shape Canada's consideration of where to go from here.

This *Report Card* is a first step in starting a principles-based conversation that will lead us to strike the best balance for Canada.

WHAT WE DID

We asked Canada's foremost experts on federalism to respond to a questionnaire that assesses the performance of Canada's transfer mechanisms against seven benchmarks. The experts represent a cross- section of experience, regions and political beliefs. We surveyed economists, political scientists and former senior government officials. We sent out 35 questionnaires and 28 were completed, for a response rate of 80 per cent.

The benchmarks we used are based on a 2007 World Bank study, *Intergovernmental Fiscal Transfers: Principles and Practice*, edited by Robin Boadway and Anwar Shah. We also asked the experts to identify potential reforms to areas where Canadian performance was found to be wanting.

The goal of this Report Card is not to provide a rigorous examination of Canadian fiscal transfers. It is instead intended to identify areas of strength and for improvement against commonly agreed upon and international best practices.

Our aim is to start a conversation and an informed public dialogue in the run up to the renegotiation of the CHT, CST and Equalization, among others.

We invite your comments: **fiscal@mowatcentre.ca**

The Results

Benchmark	Mean Score (out of 5)	Letter Grade*	Reasons Cited
Equity	3.3	C+	Transfers do not adequately account for the different needs of provincial populations.
Efficiency	2.8	C-	The impact of the transfer system on Canadian competitiveness, prosperity and productivity has never been measured.
Transparency	2.7	D+	The allocation of federal transfers is opaque and confusing for citizens and even for governments.
Predictability	3.0	C	Unilateral federal actions limit the ability of sub-national governments to plan ahead.
Autonomy	4.1	B+	Provinces enjoy a very high level of independence.
Accountability	2.6	D+	Canadians have a hard time following the money and knowing which government to hold accountable for successes or failures.
Revenue Adequacy	3.1	C	The cost of programs is outpacing the growth of transfer payments. There is a mismatch between the responsibilities and revenues of federal and provincial governments.
Overall	***3.1***	***C***	***Expert consensus is that Canada's fiscal arrangements underperform.***

*for a detailed description of how mean scores were converted to letter grades, please consult the appendix.

THE TRANSFERS

WHAT ARE THE MAJOR FISCAL TRANSFERS? HOW ARE THEY ADMINISTERED? WHAT ARE THEY FOR?

Equalization

An important feature of most federal systems is horizontal fiscal equalization, usually in the form of fiscal transfers designed to address uneven revenue generating capacity among sub-national governments in federal systems such as Canada. This uneven capacity results in differing abilities to provide comparable services at comparable rates of taxation.

"Equalization is the Government of Canada's transfer program for addressing fiscal disparities among provinces" (Department of Finance). Equalization payments in Canada do not perfectly equalize provincial revenue. Rather, the payments are intended to achieve the more modest goal of "reasonable comparability." This principle has been enshrined in the country's Constitution, which states:

"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" (Constitutional Act 1982: Subsection 36[2]).

To fulfill this obligation, the federal government currently transfers a portion of its own tax revenue to those provinces that fall below the average fiscal capacity of provincial governments. In 2010-11, six provinces will receive Equalization payments totaling $14.4 billion (Department of Finance).[1] The Constitution specifies no particular method for calculating equalization payments.

Canadian Health Transfer (CHT)

At $25.4 billion in 2010-11, the CHT is a block transfer and represents the lion's share of federal transfers. The CHT is intended to fund provincial and territorial health care systems. These funds are subject to the conditions of the *Canada Health Act* (CHA) (Department of Finance). Since 2009, the CHT has been provided mostly on a per capita basis (e.g. Alberta does not receive a per capita allocation).

Canada Social Transfer (CST)

The CST, valued at $11.2 billion for 2010-11, is a federal block transfer intended to fund provincial and territorial education and social programs. These include universities and colleges, primary and secondary education, social assistance and social services. As of 2007, the CST has been provided on an equal per capita basis.

Other Intergovernmental Transfers

In addition to the above transfers, the federal government also provides direct transfers to the provinces, territories and municipalities. These can be in the form of support for cost-shared programs or conditional transfers to fulfill a public purpose important to the federal government, but one that requires other governments to deliver programs. Given their importance to provincial and territorial economies and Canada's overall social union, they must be considered as part of the transfer system. These transfers are addressed below where relevant.

BENCHMARK 1
EQUITY (FAIRNESS)

THE SCORE

MEAN = 3.3

C+

EQUALIZATION GRANTS SHOULD BE CALCULATED AND DISTRIBUTED ACCORDING TO FISCAL NEED AND INVERSELY WITH THE TAX CAPACITY OF EACH JURISDICTION. ALL OTHER TRANSFERS SHOULD BE BASED ON A PER CAPITA OR PER TARGETED POPULATION BASIS.

Why it Matters

Equity is a core Canadian value, so much so that it is enshrined in the Constitution. However, the definition of equity and the lengths Canada should go to achieve it are contested and will dominate much of the discussions in the renegotiation of the fiscal arrangements. While Canada scores a C+, it is striking how divided experts are on ways to improve Canada's performance on this benchmark.

Analysis

EQUALIZATION IS NOT EQUITABLE ENOUGH...

While most experts consulted agree that equity is a fundamental element of the transfer system, they differ in how they define it and in their recommendations to achieve it. For example, is "reasonable comparability of access to services" the right goalpost in the pursuit of equity? If so, how can Canada achieve this goal and measure success?

Some critics allege that the current system "under-equalizes" based on need (Robin Boadway, Peter Graefe). That is, the Canadian Equalization formula does not take into account the relative need for and cost of providing public services across different regions (Boadway and Shah 2007, p.19). In this respect, the system is inequitable.

Critics of the existing system point out that it may cost more to deliver services on a per unit basis in small provinces that do not benefit from economies of scale (Jennifer Smith). On the other hand, some point out that the cost of providing services is usually higher in those provinces that do not receive Equalization because

What the Experts Say

"Unlike Australia, the Canadian system does not equalize according to both fiscal capacity and fiscal need. Consequently, the current articulation of equity that underpins Canadian fiscal federalism is rather thin."
– Jennifer Wallner

"Using fiscal need (as Australia does) is unwise. It will ultimately result in further national government intrusion into provincial responsibility."
– Ken Boessenkool

"Revenue from non-renewable resources (oil and gas) should not be included in the Equalization formula."
– Garth Stevenson

"...natural resource revenues are under-equalized..."
– Robin Boadway

"Considering Canadian realities, including differences between provinces, I think the current system does not do a bad job."
– André Juneau

salaries and land are more expensive in Toronto, Vancouver and Calgary than in the cities of traditionally receiving provinces. Some provincial populations are aging more quickly than others, placing greater demand on local services and shrinking the tax base.

According to the needs-based perspective, the current program should be adjusted to factor in the specific needs of Canada's diverse regions. However, some experts have noted that measuring and calculating need for the purposes of equalization is difficult and would complicate and politicize the process even more (Mel Cappe, Ken Boessenkool).

...EQUITY IS DIFFICULT BECAUSE THE FEDERAL GOVERNMENT HAS NO ACCESS TO RESOURCE REVENUES TO REDISTRIBUTE...

Note that the current formula equalizes 50 per cent of resource revenues, meaning that resource revenues only account for half as much as other revenues in calculating Equalization payments.

The last effort to reform Equalization was dominated by debates about if and how much resource revenue should be factored into the Equalization formula. The federal government decided fifty per cent resource inclusion was a palatable and expedient compromise. Many of the experts surveyed remain unsatisfied with the result.

Some experts suggest that natural resource revenues be equalized to a greater degree (Robin Boadway). Unless resource revenues are fully incorporated into the formula, Canada will continue to underperform on the equity benchmark. The inequity in provincial fiscal capacity will continue to grow as commodity prices and resource revenues increase, leaving some provinces behind and their populations with comparatively poorer services.

However, a more complete incorporation of natural resource revenues into the existing formula that calculates entitlements is unlikely to solve equity problems: the federal government simply has no access to natural resource revenues and those provinces with high resource revenues will continue to be able to provide their residents with better-funded public services.

It would be difficult to argue that Canada is fulfilling its constitutional commitment to ensuring that provinces have sufficient revenues to provide reasonably comparable levels of public services. For example, a provincial government that has fiscal capacity significantly higher than the average can provide better-funded services to their residents.

Measuring Program Comparability

"Canada has only one third the metrics needed for a fair system of transfer payments. It has measures on fiscal capacity but nothing related to population need. It also takes no steps to measure program comparability....without them, the Canadian system of regional subsidies is unprincipled and excessive."

- David MacKinnon

At present, the federal government does not attempt to measure Equalization's impact on program comparability. The result is that Canadians have little understanding of whether the Equalization objective has been achieved—the provision of *reasonably comparable* levels of public services. There is a growing chorus that suggests Equalization is having the opposite impact than is intended. That is, residents of the net recipient provinces benefit from better services than residents of non-receiving provinces (MacKinnon 2008). At a minimum, the Government of Canada should publicly report on Equalization's outcomes.

…WE ARE GETTING BETTER WITH RESPECT TO "OTHER TRANSFERS", BUT THERE ARE STILL PROBLEMS…

According to this benchmark, non-equalization grants should be based on a per capita or per targeted population basis. Starting in 2007 and 2009 respectively, federal funds for the Canada health and social transfers are distributed on a per capita basis (with the exception of the CHT for Alberta). Since then Canada has, for the most part, performed much better.

Equitable funding formulae—such as per capita or per client allocations—are an important component of Canada's commitment to inter-regional redistribution. Because they allocate transfers to provinces equitably, all Canadians—regardless of whether they live in a more or less wealthy province—are offered comparable levels of support from the federal government.

However, experts point to a number of areas where the federal government adds an equalization element to other transfers—engaging in so-called "back door" equalization. For example, labour market training funds flow disproportionately to some regions. Some infrastructure transfers allocate each province a base payment before they are otherwise distributed. Similarly, some provinces enjoy greater per immigrant funding for settlement services than others.

It may be possible that allocation formulae other than per capita or per client are appropriate in certain instances, but these would need to be justified based in principle and on a case-by-case basis. That does not happen in Canada. More and more allocation formulae have moved toward equitable and principled allocations, but many exceptions remain and are not explained or justified.

The inequity in some funding pools (particularly when it seems ad hoc and unprincipled) contributes to public cynicism about the fairness of the system and a lack of trust between governments.

The Way Forward?

Critics of the needs-based approach point to its potential to hurt Canada's performance across other benchmarks. Introducing a litany of additional variables into the formula would make the transfers too complicated, further compounding the transparency and accountability problems that are addressed below (Ken Boessenkool, Mel Cappe).

On balance, however, expert responses point overwhelmingly to the need to, at a minimum, engage in a serious examination of needs-based Equalization. One expert consulted suggests testing the arguments by "attempting to [model] an expenditure-need-augmented Equalization system for discussion at the next round of transfer negotiations" (Peter Gusen).

In part, support for a new model may rest on one's commitment to simplifying the system or tolerance for an even more complex system. This is a key threshold question for decision-makers.

The Australian system of intergovernmental transfers is also worthy of examination. Transfers for social, education and health programs are bundled and equalized. A bundled transfer offers potential improvements to transparency. Bundling may also lead to a simplified process for measuring revenues and achieving equity. It may also allow the federal government to help smooth inter-regional differences accounted for by the uneven distribution of natural resource wealth in Canada, without the federal government attempting to access resources and revenues owned by provinces.

Aside from being simpler from an administrative point of view, an all-in transfer ensures that funding streams are coordinated.[2] At present, there are separate formulae to calculate the CHT/CST and Equalization, with no coordination between them. Other federal transfers smooth inequities in the federation, but these are not accounted for in the Equalization system.

All of this speaks to the need to consider new models for Canada's federal fiscal transfers and processes for inter-regional redistribution. Debates in Canada over the past half century have focused on the same narrow band of issues—such as the 5 versus 10 province standard—which are arcane, technical and are now less relevant given new Canadian economic realities.

These debates fail to consider the possibility that governments will generate carbon revenues. In what manner should these be accounted for?

The more important questions have been largely obscured: how do we ensure that all Canadians have comparable access to social programs at comparable levels of taxation? And how do we know if we've achieved this objective? Now may be the time to look for something that comes closer to achieving our equity objectives.

Next: Efficiency →

Reconsidering Equity in the CHT, CST

Although the health and social transfers are considered transfers of general application, it may be worthwhile to include an assessment of need in their allocation. This benchmark "may need to be rethought in order to take account of differences in economic performance (incomes, poverty, unemployment) and hence social need across the country" (Peter Graefe).

"Some transfer programs, such as the social assistance part of the CST, are too often based on a per capita basis that has little in common with the actual need of the province" (Luc Turgeon).

BENCHMARK 2
EFFICIENCY

THE SCORE

MEAN = 2.8

C-

TRANSFERS SHOULD PROMOTE ECONOMIC GROWTH AND PRODUCTIVITY AND PRODUCE INCENTIVES FOR JURISDICTIONS TO STRIVE FOR GREATER PROSPERITY.

Why it Matters

If the transfer mechanisms undermine productivity, there will be less wealth to fund social programs. If some provinces believe that transfers are hurting their economic prospects, the transfers will lose their political legitimacy. Canada's fiscal transfer system scores a C- on this benchmark, suggesting that there is considerable room for improvement.

Analysis

OUR FISCAL TRANSFERS SUPPORT THE SOCIAL UNION...

As a number of experts pointed out, there is a very real tension between economic efficiency and equity. Too much of one can undermine the other.

Canadians made the choice long ago to institutionalize a system of fiscal transfers to correct the economic forces that would otherwise result in geographic inequity in access to social programs. This was viewed as necessary to ensure that a federation like Canada could strive for equality of opportunity and shared social citizenship that unitary states can produce more easily.

Some experts describe the Equalization program as being a "relatively modest" program and that any small loss of efficiency is more than compensated for by the positive impact on equity and national unity (Daniel Béland, André Lecours, Luc Turgeon).

...BUT CRITICS ARGUE THAT TRANSFERS ARE INEFFICIENT AND HURT GROWTH...

Others see Equalization and the overall system of transfers as a

What the Experts Say

"Economic growth and productivity are crucial issues but it would be dangerous to reduce fiscal federalism to issues of economic efficiency."

– Daniel Béland, André Lecours

"The [transfer] system may discourage resource development because of the consequences for Equalization."

– Robin Boadway

"I've never bought the idea that Equalization is a disincentive [to economic development]. This is taking an assumption about welfare recipients [that welfare discourages people to search for work] - already empirically problematic - and extending it to the behaviour of governments, where it is pretty much manifest nonsense."

– Peter Graefe

"...the system is grossly inefficient and is likely a major contributor to Canada's poor productivity performance."

– David MacKinnon

drag on Canadian prosperity. For example, in compensating for geographic inequalities that would otherwise occur, Equalization reduces the incentives for citizens to move from one part of the country to another (Boadway and Shah 2007, p.20).

Equalization (both equalizing grants and the back-door equalization of other transfers) can also hurt growth, for example, by withdrawing capital from regions where it can be used more efficiently and productively.

"Transferring $50 to $70 billion annually from high productivity jurisdictions to jurisdictions with between 10% and 30% less productivity, guarantees ultimate competitive failure in world markets for all sectors except resources" (David MacKinnon).

As one expert noted, promoting economic efficiency within a system designed to prevent it is a potentially divisive and difficult task (Anonymous Expert). How and to what extent should economic efficiency be expected of a system that transfers wealth from our most productive regions, to regions with high unemployment and low growth?

In our attempts to balance the tension between the efficiency and equity benchmarks, the pendulum, according to these experts, has swung too far to the latter, compromising the longer term prosperity of Canadians.

The Way Forward?

On this note, the reform of the transfer system to gain greater efficiency implicates the tax system. If the tax room was transferred to the provinces to replace the CHT, CST and other programs administered at the federal level but in provincial jurisdiction, the system would gain both administrative and economic efficiency (Ken Boessenkool, Courchene 1998).

Transferring this tax room to the provinces would enable more prosperous provinces to keep more of their own fiscal resources, allowing them to invest in their competitiveness and the future prosperity that will continue to generate wealth.

However, this could open the door to harmful tax competition. It could also undermine the social union by swinging the pendulum too far away from the equity principle.

As an alternative, experts also identified tax swaps as an option for reform, whereby the federal government vacates tax space (such as the GST) and takes over corporate income tax (Garth Stevenson).

The equity-efficiency trade-off will be forefront in the debate over the fiscal arrangements. When the transfer system was designed, Canada was largely a closed economy, protected from global competition. However, now the Canadian economy is subject to global pressures and prosperity can no longer be taken for granted.

The extent to which Canadians are prepared to accept a transfer system that smoothes the capacity of provinces to provide services but may hurt our global competitiveness is unknown. At this stage, a reasonable estimation of the cost and benefits is near impossible because there has been no attempt to measure the economic impact of the current design of the fiscal transfer system.

Next: Transparency →

BENCHMARK 3
TRANSPARENCY

THE SCORE

MEAN = 2.7

D+

BOTH THE FORMULAE AND THE ALLOCATIONS SHOULD BE PUBLIC AND DISSEMINATED WIDELY IN ORDER TO ENCOURAGE ACCOUNTABILITY AND FAIRNESS IN TRANSFERS.

Why it Matters

The major transfers distribute over 50 billion taxpayer dollars. Transparency is necessary for the Canadian public to follow the money trail and hold governments to account. Experts give Canada's transfer system a D+ on this benchmark, suggesting that this is one area where governments in Canada have much to do to improve.

Analysis

EXPERT OPINIONS ON THE TRANSPARENCY OF FISCAL TRANSFERS DEPEND ON HOW THEY DEFINE IT...

There is tension between those who believe it is necessary for the public to comprehend the specifics of a complicated system, and those who believe that the public only needs to understand that the basic principles are fair.

The view from 30,000 feet suggests that the basic principles of Equalization and the CHT and CST are easily understood by the average Canadian. According to one expert, if the focus is on the outcome of transfer payments (e.g. fair vs. unfair) the complexity of the system should not really matter (Ken Boessenkool).

...UNFORTUNATELY, EVEN WITH A MORE MODEST GOALPOST, THE SYSTEM DOES NOT SCORE WELL...

Polling commissioned by the Mowat Centre demonstrates that Canadians in all regions except Quebec (where opinion is almost evenly split) feel that their province is short-changed in fiscal transfers (Mendelsohn and Matthews 2010). That Canadians

What the Experts Say

"I doubt if even one Canadian out of every thousand could explain how the system works in even the most general terms."

– Garth Stevenson

"...only a slice of the attentive public pays attention to the details. You could plaster them in subway stations and no one would be the wiser."

– Jennifer Smith

"One should be realistic about this principle...The public can understand the underlying principles without getting all the mechanics of the formula."

– Douglas M. Brown

"Transparent and principles-driven approaches to funding are critical to maintain public confidence in government and to build relationships of trust between the key federal-provincial political leaders, as well as between their public service counterparts."

– Tony Dean

in every region believe they are treated unfairly speaks to a general lack of understanding of both the formulae and actual allocations in the transfer system.

The system appears complex to the average citizen because the "approaches to fiscal transfers have evolved over time based partly on public policy and partly on political exigencies" (Tony Dean).

Side deals, such as the Atlantic Accords, further muddy the waters of fiscal federalism because they often deviate from agreed upon principles. Meanwhile, transfers to support infrastructure, training, and immigrant settlement services are negotiated on a bilateral basis between the federal government and provinces.

The allocation formulae used differ from one transfer to another, often with little principle-based explanation for these differences. In many cases, it is unclear who is getting what. When allocations are known, their rationale is not consistent or formula-based.

...AND A LACK OF TRANSPARENCY CREATES CYNICISM AND PUBLIC DISCONTENT...

Citizens, therefore, often have very little basis to evaluate their respective province's deal, often making it easy for provincial politicians to call foul and whip up local resentment. "This has given rise to a high level of cynicism and mistrust across the federation and increasingly on the part of citizens" (Tony Dean).

The Way Forward?

The complexity of the Equalization formula spurred some to claim that governments should develop an education campaign targeted at ordinary Canadians to explain the basics of the system (Daniel Béland, André Lecours).

Others suggested that an independent commission be established, reflecting the international trend toward de-politicizing allocations in fiscal transfer programs and making transfer mechanisms more transparent and predictable (Robin Boadway, Douglas M. Brown, David Cameron, Patrick Fafard).

Others argue that the elimination of transfers would solve the transparency problem, providing greater clarity on the allocation of tax dollars (Ken Boessenkool). As noted elsewhere, there are potential equity costs to this approach.

Perhaps easiest of all, publicly identifying and explaining allocation forumlae in all transfers would improve intergovernmental trust and Canadians' confidence that all provinces are being treated fairly.

Next: Predictability →

BENCHMARK 4
PREDICTABILITY

THE SCORE

MEAN = 3.0

C

THE GRANT MECHANISM SHOULD ENSURE THE PREDICTABILITY OF GRANTS TO SUB-NATIONAL GOVERNMENTS.

Why it Matters

Predictable fiscal transfers are necessary for the provision of consistent, reliable public services that Canadians can count on. The fiscal transfer system scores a C on this benchmark, largely due to the susceptibility of the transfer system to unilateral federal decision-making.

Analysis

UNILATERAL FEDERAL BUDGET ACTIONS UNDERMINE THE PREDICTABILITY OF FISCAL TRANSFERS...

The budget planning processes of provinces, territories and municipalities are significantly hampered by the federal capacity to make unilateral changes to the transfer system.

The 1995 cuts to the federal health and social transfer go a long way to explaining Canada's mediocre performance on this benchmark. Fiscal pressures in the mid-1990s fueled a desperate political search for budgetary balance. The federal government undertook significant cuts to its own programs, while also making unilateral cuts to transfers to provinces. While these cuts helped the federal government return to balanced budgets, they downloaded difficult budgeting decisions to provincial governments without their consent.

These unilateral cuts have had a lasting impact on the culture of federal-provincial relations in Canada and partly explain the country's mediocre performance on this benchmark. The political cost to the federal government when it unilaterally cut transfers was small given the generally high level of support for deficit reduction at the time. The cuts to its own programs, such as unemployment insurance, had a much higher political cost.

What the Experts Say

"We need more long-term fiscal transfer arrangements that cannot be unilaterally terminated or changed. On the other hand, as fiscal circumstances change (i.e.: with a recession), there still needs to be flexibility to renegotiate even long-term agreements."

– Grace Skogstad

"For both political and governance reasons, cuts in social transfers like the ones enacted as part of the 1995 federal budget should be avoided, as they have negative implications in terms of policy development and even national unity."

– Daniel Béland, André Lecours

"...the unilateral authority of the Government of Canada to decide needs to be reigned in."

– David Cameron

"Predictability is provided better now than ever... Of course, there could be more predictability, but it is not likely to be provided without further hampering other objectives."

– Mel Cappe

Arguably, the same conditions exist today. The federal government is again posting large deficits, provoking fears among the experts surveyed that the federal government will again unilaterally make cuts to the major transfers (Daniel Béland, André Lecours). This time, however, unilateral cuts may push provinces to the fiscal brink.

...IMPROVEMENTS HAVE BEEN MADE, BUT UNPREDICTABILITY STILL EXISTS...

Some experts noted recent improvements to the predictability of transfers. The automatic six and three per cent escalators of the CHT and CST respectively, and the implementation of a 10-year health accord introduce a much needed element of stability to the system (Peter Gusen, Grace Skogstad).

But, despite the commitments in the Social Union Framework Agreement, these improvements do not necessarily address the root cause of unpredictability: the ability of the federal government to make changes to the system with only a few months warning (Jennifer Wallner).

The propensity of the federal government to make unilateral program cuts, to walk away from programs that it initiated and to cut side deals, makes it difficult for provinces and territories to plan beyond the short-term (Diane Gray, Luc Turgeon).

Perhaps more importantly, the unpredictability of the transfer regime undermines the goodwill of the players, resulting in less cooperative intergovernmental relationships and more public cynicism about the intergovernmental process.

As one expert noted: "Provinces and territories do not want to embark on new spending commitments, only to be later abandoned by the federal government. This lack of funding predictability is a major disincentive for sub-national governments to cooperate" with federal initiatives (Tammy Findlay).

...AND UNPREDICTABILITY HURTS CANADA'S PERFORMANCE ON OTHER BENCHMARKS...

A lack of predictability may have consequences for some of the other benchmarks as well. How autonomous are sub-national governments in setting priorities if they are dependent on the short-term funding decisions of the federal government? How equitable is a system that encourages bilateral agreements like the Atlantic Accords?

The Way Forward?

Some experts identified that the equity of fiscal transfers is contingent on their predictability, and on the exercise of federal political will to resist making side deals with recalcitrant provinces. For

The Social Union Framework Agreement (SUFA)

In response to provincial backlash over the unilateral federal budget cuts to the CHST in 1995, the federal government negotiated the Social Union Framework Agreement (SUFA) with the provinces and territories (save for Quebec) in 1999.

SUFA commits the federal government to predictable and transparent funding and information sharing. The federal government is also obliged to consult with the provinces and territories before spending money in provincial/territorial jurisdictions.

SUFA represents a positive step forward. However, in some instances it has been narrowly applied. For example, in 2006, the provinces received six-month notice that the federal government was introducing the Targeted Initiative for Older Workers (TIOW), a two year training program initially targeted at older workers in smaller communities. Provincial concerns regarding the program (e.g. not enough provincial flexibility and fit with provincial programs) were unheeded.

the sake of predictability and equity, "the transfer renewal discussion should seek to work towards restoring the principle of identical rules for all provinces for the main transfer programs" (Peter Gusen).

Failing this, another solution would be to reduce the scope for unilateral federal action by transferring a portion of its current fiscal resources to the provinces directly through a tax swap or tax point transfer (options identified in the equity section). This would go a long way to solving the "side deal" and "unilateral action" problems.

A less contentious option would be to create an independent advisory council that would advise and report on intergovernmental transfers (Robin Boadway), perhaps creating an incentive for the federal government to consult and structure transfers on a more principled basis.

Next: Autonomy →

BENCHMARK 5
AUTONOMY

THE SCORE

MEAN = 4.1

B+

SUB-NATIONAL GOVERNMENTS SHOULD HAVE INDEPENDENCE AND FLEXIBILITY IN SETTING PRIORITIES AND DESIGNING PROGRAMS.

Why it Matters

Autonomy enables provincial governments to tailor programs to suit local needs and to innovate and experiment (Mendelsohn, Hjartarson and Pearce 2010). As the order of government responsible for delivery, it needs to have autonomy over program design and delivery choices in order to be held accountable for its performance by voters. Canada's fiscal transfer system performs well on the autonomy benchmark, scoring a B+. However, experts identify areas for improvement.

Analysis

EXPERTS AGREE THAT CANADIAN PROVINCES ENJOY CONSIDERABLE AUTONOMY...

The experts praise the Canadian transfer system for its promotion of provincial independence and subsidiarity, allowing provinces to design programs that meet local needs.[3] The degree of autonomy enjoyed by provinces is unparalleled internationally. In the major transfers, funds are absorbed into the provinces' general revenues, virtually without conditions.

...BUT FEDERAL INTERVENTION IN PROVINCIAL JURISDICTION IS PROBLEMATIC...

Experts flagged one primary concern: the tendency of the federal government to intervene into provincial jurisdictions via its use of the federal spending power.

The federal spending power is the conventional mechanism through which the federal government enters provincial jurisdiction, often in the pursuit of national standards and the preservation of the social union

What the Experts Say

"The Government of Canada wishes to be present in the lives of individual Canadians and thus cannot resist the urge to use its spending power to transfer funds to institutions and individuals in areas of provincial jurisdiction."

– Patrick Fafard

"...sub-state governments have plenty of autonomy in Canada. Preserving this autonomy is a major imperative of our federal system, and attacks against this provincial autonomy are both illegitimate and dangerous."

– Daniel Béland, André Lecours

Health care is the most commonly cited example, but there are others. The federal government imposes conditions on a range of transfers, from infrastructure and labour market programming to social housing and French language services. Some experts argue that these federal conditions hamper provincial capacities to innovate and meet local needs.

...FEDERAL PROGRAMS CAN DISTORT PROVINCIAL PRIORITIES AND MUDDLE ACCOUNTABILITY...

Federal "boutique" programs in areas of provincial jurisdiction (such as HPV funding) can create fiscal pressures on the provinces, particularly if the federal government backs away from the program after it is initiated.

As one expert noted: "Once established, (federal) programs create new clientele that will expect the continuation of the program; however, once federal interests shift, Ottawa can easily cut the program, leaving the provinces in the wind" (Jennifer Wallner). For example, provinces are expected to continue to fund day care spaces as part of a vacated federal early childhood education program.

In addition, some major federal transfers remain subject to elaborate federal-provincial agreements. For example, transfers for infrastructure require complex and lengthy negotiations before construction can proceed. For many, these transfers, like the CHT and CST, should flow without conditions (Snodden 2010).

The predictability and autonomy benchmarks are closely linked. Unless the federal spending power is completely done away with, sub-national autonomy will always be subject to the political priorities of the federal government. The potential for federal actions to distort provincial spending priorities will always exist.

The Way Forward?

Despite the relatively high performance rating, many experts agree that Canada's fiscal transfer system would benefit from even greater autonomy.

According to one expert, "this is probably the most important principle of all. If taken to its extreme it would mean that all jurisdictions should have the capacity to raise taxes that match their spending" (Ken Boessenkool).

In practical terms, this could mean the transfer of tax room from the federal government to the provinces and territories so that they could independently fund the programs and services under their jurisdiction. While this would enhance the capacity of provincial governments to tailor programs and innovate, it would likely exacerbate inter-provincial inequality, compromise the social union and stoke disunity.

A less contentious solution would be for the federal government to be more careful in its use of the federal spending power in areas of provincial jurisdiction and approach spending in these areas with greater flexibility and appreciation for the reality of provincial situations. Provinces would then be better positioned to tailor programs to suit local conditions and the potential for intergovernmental discord would be minimized.

Under both scenarios, Canada's performance on the accountability benchmark would also improve. If the federal government were to vacate provincial jurisdictions, citizens would have a clearer understanding of who to blame and credit for program outcomes. (This point is taken up below).

On the other hand, provinces already enjoy unparalleled autonomy compared to subnationals in other federations and some of the experts surveyed believe that Canada's fiscal transfer system already provides too much autonomy for provinces. They would see the way forward as a reassertion of a stronger federal role to ensure common social opportunities and outcomes across the country (Tammy Findlay).

Next: Accountability →

BENCHMARK 6
ACCOUNTABILITY

THE SCORE

MEAN = 2.6

D+

FUNDING SHOULD TAKE PLACE IN A MANNER THAT MINIMIZES BLAME-SHIFTING BETWEEN GOVERNMENTS AND ALLOWS CITIZENS TO HOLD GOVERNMENTS TO ACCOUNT FOR THEIR PERFORMANCE.

Why it Matters

Democracy rests on the ability of citizens to hold their governments to account. In Canada, the transfer system incents governments to dodge blame, point fingers and take credit when none is deserved, perhaps explaining why Canada's transfer system performs worst on this benchmark, receiving a D+.

Analysis

ACCOUNTABILITY ISSUES ARE COMMON IN ALL FEDERATIONS…

Any federal system will always suffer from accountability issues (Grace Skogstad). Unless intergovernmental transfers are eliminated entirely—as some experts and politicians consider ideal —there will always be some conflict over who gets faulted or credited for program outcomes.

For example, in health care, provinces blame the federal government for providing too little funding in the CHT. The opposing federal response would be to point out that provinces are ultimately responsible for spending the largely unconditional CHT as they see fit (Peter Gusen).

This intergovernmental back-and-forth confuses citizens about which order of government to ultimately hold accountable.

…AND INTERGOVERNMENTAL ACCOUNTABILITY IS ONEROUS AND INEFFICIENT…

One expert expressed the opinion that more tied transfers would strengthen the accountability relationship between the provinces

What the Experts Say

"Blame shifting is a national pastime in Canada that rivals hockey."
– Tammy Findlay

"The bulk of the transfers are unconditional, which leaves the onus of accountability to the provinces."
– Robin Boadway

and the federal government. “I don’t believe that accountability can be achieved without ensuring that the piper-payer calls the tune” (Mel Cappe).

However, rigid reporting requirements often associated with intergovernmental (i.e. federal-provincial) accountability hurts government responsiveness. They “detract from the ability of public officials to carry out their substantive tasks and address the key problems of the day...” (Jennifer Wallner).

Numerous federal programs in the same areas of provincial jurisdiction compound the accountability problem. For example, the federal government has at least six agreements with Ontario on labour market training, each with overlapping reporting requirements (Anonymous Expert). A similar situation exists in the social housing policy field. Efficiency (from an administrative standpoint) suffers as a result.

...THEREFORE, ACCOUNTABILITY TO CITIZENS TAKES PRECEDENCE...

Other experts disagree with the basic premise of government-to-government accountability, pointing out that “provinces and the federal government are equal orders of government and have strong reporting requirements and accountability mechanisms to their respective citizens” (Anonymous Expert).

With a few exceptions, expert consensus seems to converge on the idea that the accountability relationship between governments and citizens should take precedence over intergovernmental (government-to-government) accountability.

The Way Forward?

Some experts suggest that the federal government should add more accountability provisions and conditionality on provincial governments in order to achieve national outcomes.

Most, however, highlight the need to either eliminate transfers entirely (replacing them with taxation power) or simply eliminate any hint of conditionality (Peter Graefe).

Transferring taxation power to the provinces so that revenues are raised and spent by the same order of government would promote transparency and clarify accountability. As one expert put it, “if the vertical fiscal imbalance is zero, you will solve the accountability problem” (Ken Boessenkool). However, for reasons cited above, ending conditionality may be more politically feasible.

Next: Revenue Adequacy →

BENCHMARK 7
REVENUE ADEQUACY

THE SCORE

MEAN = 3.1

C

SUB-NATIONAL GOVERNMENTS SHOULD HAVE ADEQUATE REVENUES TO CARRY OUT DESIGNATED RESPONSIBILITIES.

Why it Matters

Revenue adequacy is an essential aspect of any federal system. Without adequate revenues, governments cannot fulfill their duties. On the revenue adequacy benchmark, Canada's fiscal transfer system scores a C, highlighting the mismatch between provincial responsibilities and the revenues they have to fulfill them.

Analysis

COMPARED TO OTHER FEDERATIONS, CANADIAN PROVINCES HAVE GREATER REVENUE RAISING CAPACITY...

Provinces have access to all the major tax bases and have the authority to raise and lower tax rates at their discretion (Robin Boadway). In the division of tax authority, Canada is the most decentralized federation in the world.

However, while provinces enjoy access to a broad range of revenue streams, there is only so much tax space that can be occupied by governments, especially in a globalized world where countries compete for financial and human capital (Anonymous Expert). Who occupies the existing tax base is therefore contentious.

...BUT THERE IS A FISCAL IMBALANCE THAT IS SET TO GROW...

At present, the federal government occupies more space than it needs in order to fulfill its obligations, creating a fiscal imbalance between the orders of government. This imbalance is, in part, the result of previous federal cuts to the health and social transfers that were not off-set by a transfer of tax room (Robin Boadway).

What the Experts Say

"[Revenue adequacy] remains the most essential aspect of the Canadian system, for autonomy can be meaningless without adequate resources."

– Daniel Béland, André Lecours

"Provinces clearly lack the revenues to deal with burgeoning health care costs. Post-secondary education is clearly underfunded as well. New intergovernmental agreements are needed to rectify these two problems."

– Grace Skogstad

"If federal funding fails to keep pace with the growth in expenditures, there will be significant issues with respect to the adequacy of revenues provincial governments have to carry out their designated responsibilities."

– Anonymous Expert

"Many of the programs in provincial jurisdiction, such as health care and education, are driven by citizen demand and are expected to grow more quickly than federal responsibilities or provincial revenues in the future" (Anonymous Expert).

Canada's Parliamentary Budget Officer notes that provinces face greater challenges in balancing their budgets due to demographic pressures and rising health care costs that are crowding out other provincial programs (Askari, et al 2010, p.20). The structural deficits facing most provinces, combined with mounting program costs, suggest that the provinces will push hard to address the revenue adequacy problem during the upcoming renegotiation of the fiscal arrangements.

...WITH NEGATIVE IMPLICATIONS FOR EQUITY IN THE FEDERATION...

As costs escalate, provincial fiscal capacities to deliver health care will begin to diverge—'have' provinces can raise more tax dollars than can 'have-not' provinces (Douglas M. Brown). Inadequate revenue capacity will lead to inequitable service levels across the country, and will no doubt cause political controversy.

...BOUTIQUE FEDERAL PROGRAMS COMPOUND THIS PROBLEM...

The issue of "boutique" programs raised earlier was highlighted by several experts because it has an impact on the revenue adequacy of provincial governments. When the federal government unilaterally introduces programs in provincial jurisdiction, or creates cost-shared, bilateral programs, only to pull out of these programs later, the provinces are left to satisfy newly created public expectations on their own. The money for these programs takes a considerable toll on provincial budgets and can distort provincial priorities (Diane Gray).

The Way Forward?

The debate over revenue adequacy will be acrimonious and will likely centre on health care costs. Even with an automatic six per cent escalator, the CHT will not be large enough to plug the funding gap in provincial health systems (Anonymous Expert). Experts are united in their call for big changes, even if they do not agree on what those changes should be. One expert suggested that tax room transfers would give some provinces more fiscal capacity to address funding shortfalls in health care and education (Anonymous Expert). However, other provinces with smaller tax bases would not enjoy a substantial increase in revenues, thereby putting further pressure on the equity benchmark and potentially unraveling the fabric of the social union.

Other experts favour a return to previous federal funding levels (Diane Gray, Luc Turgeon). "The answer to this problem is not to transfer further tax [room] to the provinces and territories - it is to restore federal funding to historic levels" (Diane Gray).

Other options that should be considered include a federally run pharmacare program and/or a social insurance system funded by direct citizen and employer contributions for pharmaceuticals. This could allow the federal government to play an important but clearly defined role in the health care system in an area important to Canadians and one where the pressure on provincial budgets is growing. More contentiously, some suggest eliminating the *Canada Health Act* altogether and allowing greater provincial experimentation with delivery models.

Despite the absence of consensus on the way forward, there are two certainties with respect to the debate over revenue adequacy. First, the status quo is unsustainable, particularly on the health care side. Second, debates about how to move forward will be far more productive if approached from the perspective of the citizen rather than from institutional interests of governments.

Next: Conclusion →

CONCLUSION

Canadian governments are grappling with record deficits and rising program costs. The burden of delivering services in times of financial uncertainty will only get heavier as the population ages, placing greater demand on the programs Canadians count on. These pressures will be felt most acutely by provinces and territories.

These programs are dependent on the federal transfers that fund them—Equalization, CHT, CST and other federal transfers—which are set to expire in 2014. This leaves Canadians with just over three years to engage in an honest debate over the future of the intergovernmental transfer system, and how it can be improved.

In the past, discussions over fiscal transfers have sometimes deteriorated into acrimonious intergovernmental conflict. That may happen again. But it is the hope of our experts that governments will remember to keep focused on how to best deliver funds to support the programs and services on which Canadians rely. In the end, the funds in fiscal transfers do not belong to the federal government or provincial governments—they belong to Canadians, and governments should work to find the best way to allocate those funds on behalf of Canadians.

It is also time to think beyond the narrow parameters of the traditional debates on fiscal federalism. And it would be a mistake to think that the existing framework for fiscal transfers should structure and set the terms of debate for upcoming discussions.

Open global markets, the regional concentration of natural resource revenues unavailable for redistribution, the possibility that carbon revenues will be generated by governments, and the inability of Ontario's manufacturing base to support huge interregional transfers may all suggest a re-think to the basic structure of fiscal federalism.

This *Report Card* is merely the beginning of a conversation that will continue to heat up as we approach 2014. Canada's experts do not all agree on their assessment of the current system, but certain broad patterns are clear: there is consensus that our major transfers provide provinces with significant autonomy, while some of the transfers, such as the Equalization formula, lack transparency. Likewise, Canada's experts do not agree on the path forward, but they do agree that finding some balance between the various benchmarks will be challenging but possible. Canadians should feel optimistic that, with goodwill and evidence-based public dialogue, balance can be struck

The Mowat Centre is using the data from this Report Card as a platform to launch research into specific reform proposals. This research will be published in Summer 2011. In the meantime, we invite your comments and suggestions: **fiscal@mowatcentre.ca**. MC

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Douglas M. Brown, St. Francis Xavier University
David Cameron, University of Toronto
Mel Cappe, former Clerk of the Privy Council
Sujit Choudhry, University of Toronto
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Tony Dean, former Secretary of Cabinet, Ontario
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Peter Gusen, former Director of Federal-Provincial Relations, Finance Canada
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Anwar Shah, World Bank
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Michael Smart, University of Toronto
Jennifer Smith, Dalhousie University
Garth Stevenson, Brock University
Luc Turgeon, University of Ottawa
Jennifer Wallner, University of Regina

APPENDIX

Experts responded to a questionnaire consisting of two parts. In Part A, experts scored Canada's performance for each benchmark based on a five point scale, ranging from very poor (1) to very good (5). The following question was asked for each:

In your opinion, how do you rate Canada's performance with regard to realizing this benchmark/principle of federal fiscal transfers?

For each question, we calculated a mean score and assigned a letter grade based on the following scale.

>4.75 = A+
>4.5 = A
>4.25 = A-
>4 = B+
>3.75 = B
>3.5 = B-
>3.25 = C+
>3 = C
>2.75 = C-
>2.5 = D+
>2.25 = D
>2 = D-
<2 = F

In Part B, respondents were asked to indicate areas for improvement, citing specific reforms that should be considered. Experts were encouraged to consider the range of intergovernmental transfers to provincial and territorial governments, including: the health and social transfers, Equalization and other transfers such as those to support infrastructure and labour market training.

ENDNOTES

1. The six receiving provinces are: Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia and Prince Edward Island. The three territories do not receive Equalization payments, but are instead provided an unconditional transfer called Territorial Formula Financing (TFF), valued at $2.7 billion in 2010-11 (Department of Finance).

2. Little attention is given to how transfers interact. For example, provinces with populations that receive comparatively generous direct transfers to individuals from the federal government (such as Employment Insurance benefits) will likely spend less on social assistance. This again may be one reason why it may be necessary to include an assessment of needs in the calculation of Equalization entitlements, which could encompass inclusion of federal transfers in a more global assessment of fiscal capacity.

3. The subsidiarity principle states that the level of government closest to the recipient of a service should provide that service.

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The Mowat Centre for Policy Innovation is an independent, non-partisan public policy research centre located at the School of Public Policy and Governance at the University of Toronto.

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