by G.C. Ruggeri

VERTICAL FISCAL IMBALANCES AND RENEWED FEDERALISM

On peut s'attendre à ce que l'excédent budgétaire fédéral augmente rapidement. Le gouvernement fédéral semble disposé à utiliser cette nouvelle marge de manœuvre financière pour court-circuiter les provinces et renforcer ses liens directs avec la population. La création de la Fondation canadienne des bourses d'études du millénaire en est un exemple parmi tant d'autres. Cette approche serait légitime si elle se traduisait par une équité et une efficacité accrues. Or, selon l'auteur, rien n'indique que ces objectifs seraient effectivement atteints. À son avis, la nouvelle marge de manœuvre financière devrait servir à rétablir une partie des transferts aux provinces et à convertir le Transfert canadien en matière de santé et de programmes sociaux en points d'impôt sur le revenu des particuliers. Le gouvernement canadien devrait promouvoir une meilleure coordination des politiques fédérales et provinciales plutôt que d'imposer des solutions centralisatrices.

Introduction

What a difference six years make! In 1992, the federal government was fighting an apparently unshakable deficit and a growing debt, "digging holes and hitting walls" as Bill Robson put it. In 1998, the federal cabinet is discussing options for disposing of a budget surplus that, under an unchanged federal fiscal structure, is forecast to grow rapidly. But growing surpluses are as unsustainable as growing deficits. Sooner or later they require redressing.

In a unitary state, the imbalance would be eliminated through a combination of lower taxes and increased spending. In a federal state, the adjustment process must incorporate the relative fiscal positions of federal and provincial governments. In Canada, this adjustment is more complex because the federal fiscal imbalance is associated with a growing vertical fiscal imbalance between the federal and provincial governments. I argue that the current federal fiscal situation offers the opportunity to strengthen the Canadian federation by rebalancing the fiscal systems of both orders of government.

The past

Vertical fiscal imbalance (VFI) is not a novelty, but an enduring feature of the Canadian federation. One can safely state that Canada was born as a fiscally unbalanced nation. Early in our history, the role of government was limited and the task of nation building required primarily the construction of the physical infrastructure — roads, bridges, waterways — which would link the various regions and facilitate interprovincial trade. This task could be more effectively performed by the central government; therefore, the federal government acquired the major source of revenue at the time: tariffs and custom duties. The role of provinces was even more limited as government was not yet involved in education, health care and social services. But even with limited spending responsibilities, provinces were left with insufficient revenue.

Their revenue shortfall was corrected by subsidies from the federal government through a form of tax rental agreement. The central government collected most of the revenue from sources vacated by the provinces, paid for the major public works and transferred a share of the revenue to the provinces. Although these subsidies were relatively large, representing 20 percent of federal and 54 percent of provincial revenue in 1868, they were not intended to be a permanent feature. The prevailing political philosophy was that each order of government should finance its own spending. Sir Wilfrid Laurier stated in 1887 that "the principle by which one government collects the revenues and another government spends it is wholly false." The Right Hon. Mackenzie King added in 1929: "I believe that ... it is a thoroughly vicious system to have one body raise taxes and another body expend the money."

This philosophy was very much in practice during the early part of the 20th century. When economic development and increasing urbanization raised the demand for provincial services, the additional expenditures were financed by new provincial taxes and fees, primarily liquor profits, automobile licences and gasoline taxes. By 1920, federal transfers to provinces amounted to 3 percent of federal and 15 percent of provincial revenue. By 1930, they represented 4 percent of federal and 9 percent of provincial revenue.

However, this virtual separation of spending and taxation by the federal government and the provinces did not last. What Mackenzie King considered "a vicious system" became a virtuous principle in the eyes of subsequent federal governments who, through VFIs created by chance or by design, were able to exercise substantial control over provincial spending.

Four major events have shaped the evolution of VFIs: World War I, the Great Depression, World War II, and the war on the deficit. The need to finance the war effort mollified the opposition of Canadians to income taxation and weakened provincial resistance to the federal intrusion into a tax area generally considered an exclusive provincial domain. Initially, direct income taxation represented a small share of federal revenue because of the continued federal reliance on consumption taxes. However, its early introduction by the federal government laid the foundations for VFIs for years to come. The greater reliance on income taxation gave the federal government a source of revenue with the potential to grow faster than personal income and preempted a similar provincial foray, thus establishing federal predominance in this tax field.

The Great Depression produced two developments that had an impact on VFIs. First, it exposed the vulnerability of provincial finances to business cycles and ushered a major federal intrusion into areas of provincial jurisdiction, such as social services and unemployment relief. In assisting provinces, the federal government relied heavily on special purpose grants. Second, it produced a scramble by both orders of government for revenue, which generated an uncoordinated joint occupancy of the major tax fields. This tax jungle was to be remedied through increased federal control of the major tax sources, a move precipitated by a third major event: the Second World War. Needing substantially higher revenue to finance the war effort, Ottawa convinced the provinces to exit the income tax field and rent it to the federal government in exchange for a share of the revenue. These arrangements, tax renting and tax sharing, which continued until 1961, consolidated the federal dominance of income taxation and set the stage for future VFIs. Even when income tax room was transferred to the provinces in 1962, it was insufficient to eliminate VFIs.

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The final development affecting VFIs was the recent war on the deficit. In this period, the federal government expanded its tax room by raising excise taxes and increasing its role in direct consumption taxes with the GST. It also dramatically reduced intergovernmental transfers in the name of fiscal restraint and subsequently launched new spending initiatives. By expanding its revenue-raising capacity while reducing transfers to provinces, Ottawa increased VFIs on both the revenue and spending side. Unlike the 1920s, when provinces financed higher spending with new taxes, this time they could not do so because of taxpayer resistance caused partly by higher federal taxation. The exercise of fiscal restraint and its manner of implementation — higher taxes and lower intergovernmental transfers — aggravated VFIs.

Present and future

To a certain extent, we have come full circle in federal-provincial fiscal relations. In 1868 the federal government transferred 20 percent of its revenue to provinces through unconditional grants. One hundred and thirty years later, the same share of federal revenue is transferred through unconditional grants. Unlike 1868, the federal government is now deeply involved in social programs that originally were an exclusive provincial responsibility. Further expansion of federal involvement seems likely. By reducing transfers to provinces, the federal government hampered their ability to meet their spending responsibilities in a fiscally responsible manner. Short of cash, provinces curtailed their financing of education, health care and other social programs. Canadians attach high priority to these programs and demand restoration of acceptable standards. The federal government can use its greater spending capacity to meet those demands directly. The federal government seems intent on using this new spending power to boldly go beyond past incursions by bypassing the provinces to expand its partnership with individuals. Examples of this new direction include: the Millennium Scholarship Endowment Fund; the matching grant for Educational Saving Funds and tax-free RRSP withdrawals for lifelong learning in the area of post-secondary education; tax assistance to health home care plus tax breaks for the self-employed for supplementary health coverage; a proposed universal drug plan; and greater federal involvement in the financial support of families through the National Child Benefit. In my view, this new move toward fiscal centralization is laden with risks. It will reduce program coordination, result in higher combined levels of taxation and put additional stress on federal-provincial relations.

This approach might be justified if it produced large equity and efficiency gains, but there is no evidence of such potential gains. Take the case of the new direct federal involvement in higher education. If the new federal programs are financed through reduced transfers to provinces, all students will face lower quality of primary and secondary education and increasing costs of post-secondary education (PSE). The three new federal programs for PSE represent a form of cost sharing with individuals and families. Those families who have the means and the will to save for their children's higher education will get federal financial assistance. Families with insufficient resources will be left out of the programs. For example, tax-free RRSP withdrawals will benefit middle- and high-income Canadians because those with low income have neither the means nor the incentive to save in tax-sheltered forms. The Millennium Scholarship Fund is aimed at low- and middle-income Canadians. This targeting will be very difficult in practice. Young people with a potential to excel that remains unfulfilled for reasons beyond their control — such as limited family resources, an environment not conducive to learning, the need to work rather than attend special educational programs, and enrollment in a low quality public school — will not meet the "merit" criterion and will not share the federal largesse. The net result is likely to be less equity and lower efficiency. Government subsidies to higher education will shift from lower- to middle- and higher-income Canadians. At the same time, underfunded public education and increasing costs of higher education will deter the children of low-income families from acquiring further education. The pool from which human capital is developed will shrink both in size and quality, thus reducing economic potential while increasing social divisions along class lines.

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Policy implications

In my view, the Canadian federation will be strengthened if the provinces gain greater financial autonomy through the restoration of fiscal balance at both federal and provincial levels. In that respect, I suggest the following two changes. First, the federal government should use the fiscal dividend to partly restore the reduction in its transfers to provinces. The expanded CHST should then be transformed into a transfer of personal income tax (PIT) points. Second, the federal government should expand its role in facilitating the efficient coordination of federal and provincial policies rather than imposing centralist solutions. These two policy changes would produce a variety of beneficial effects. The closer match between provincial revenues and expenditures would strengthen the political process by increasing public accountability. It would also improve the efficiency of public policy by providing a closer link between public spending and revenue raising activities. The transfer of PIT points would provide the necessary growth in revenue to finance provincial spending programs likely to grow most quickly, particularly health care spending. By eliminating the need for increases in federal grants, this tax transfer would reduce the degree of federal-provincial dissension. It would also allow provinces to utilize more flexibility in the design of their programs in accordance with their needs to adjust to changing world economic structures. The move from federal control to federal coordination would help strengthen mechanisms of interprovincial cooperation. When standards of national programs are not imposed by the federal government but must be negotiated among provinces, provinces are forced to develop more effective institutions of conflict resolution. The federal government could play a very important role in this area and the net result would be more uniform standards with a higher degree of self-enforcement.

Conclusions

Two major conclusions arise from the foregoing discussion. First, the anti-deficit policy of the past decade has exacerbated vertical fiscal imbalances. Second, the federal government plans to use VFI to increase fiscal centralization through a new creative twist on spending powers: reduced partnership with provinces and increased partnership with Canadians. In my view, this new direction in federal policy is ill-timed and ill-conceived. It operates against underlying forces for decentralization and will create additional tensions in federal-provincial relations. Broad spending controls by a federal government may be justified during the early stages of a federation when nation-building requires emphasis on defense, the justice system and the construction of the physical infrastructure. It may make sense also in a closed economy when economic policy can be pursued independently of world events. However, Canada is a mature federation with a small, open economy in a competitive world market. These conditions require flexible fiscal arrangements which help each province develop its potential.

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