

# WHAT A TANGLED WEB WE WEAVE

Don Drummond

The debate around the fiscal imbalance and Ontario's \$23 billion campaign may have muddied the issue of fiscal federalism, writes the senior vice-president and chief economist of TD Bank Financial Group, Don Drummond, but it did "raise some legitimate points that must be considered in any changes to fiscal federalism." Notably, the situation in Ontario reminds us that redistribution in a federation cannot be considered solely from the perspective of the beneficiaries. In fact, he says, fairness and the new global and ultra-competitive economic context calls for a limit on the amount that can be redistributed. In this article, he reviews the arguments and takes a stab at predicting how negotiations will unfold in the fall. In short, he says, there will be no "big bang" agreement, but there will be — Canadian style — incremental progress that leaves many unsatisfied.

Le débat sur le déséquilibre fiscal et la campagne ontarienne de 23 milliards de dollars ont sans doute brouillé l'enjeu du fédéralisme fiscal, écrit Don Drummond, premier vice-président et économiste en chef de TD Bank Financial Group, mais « ils ont également soulevé des questions légitimes qu'il faudra examiner avant d'apporter toute modification au fédéralisme fiscal ». La situation de l'Ontario, notamment, rappelle que la redistribution au sein d'une fédération ne peut se faire du seul point de vue de ses bénéficiaires. En fait, la simple équité mais aussi la nouvelle économie mondiale ultra concurrentielle nécessitent d'imposer une limite aux montants à redistribuer, estime l'auteur, qui passe en revue les éléments du débat et pronostique le déroulement des négociations de cet automne. Celles-ci ne donneront lieu à aucun « big bang » prédit-il. Mais d'une manière typiquement canadienne, on enregistrera sans doute de légers progrès qui en laisseront plusieurs insatisfaits.



**D**ebating fiscal federalism is all the rage these days. In part this is because the new federal Conservative government has promised to fix the federal-provincial "fiscal imbalance." It is not exactly clear, however, what they intend to fix or even what they think is broken. More generally, it is not clear exactly what is meant by fiscal federalism, because it can be interpreted very broadly. The only thing that is clear is that it is very complex, and that any changes will be highly controversial.

At its most general level fiscal federalism refers to the fiscal, and possibly economic, arrangements among the levels of Canadian government. In the past we might have considered it to be a matter between the federal and provincial governments. But the important role of local governments has been receiving more attention, and their arrangements with both the federal and provincial governments are evolving.

The heart of fiscal federalism is federal transfer payments. The Canada Health Transfer has been enriched several times in recent years and presumably will be left on its present course for the time being. While the Canada Social

Transfer is another block payment that can conceivably be used by the provinces for anything they wish, a concerted effort is being made by both the federal and provincial governments to link it to post-secondary education. The provinces are applying pressure to have this transfer enriched, and the federal government has indicated it has an open mind on the issue. Ottawa now also has a major role in infrastructure undertakings in federal, provincial and local government jurisdictions. It seems likely they will bundle their contributions to other levels of government and label this bundle a third major federal transfer payment. It amounts to about \$5 billion per year.

Equalization and territorial formula financing have been the subjects of recent advisory/expert panel reports commissioned by the Council of the Federation (COF) and the federal government respectively. Traditionally equalization has been debated from the perspectives of the receiving provinces and its affordability for the federal treasury. The current round of debate quite reasonably injects considerations of the fairness and affordability for the taxpayers of

the non-recipient provinces, namely Ontario and Alberta. This sharply increases the dissent, because it naturally pits the non-receiving provinces against the recipients.

Going beyond federal transfers, we can think of fiscal federalism as including the roles and responsibilities of the federal, provincial and local governments. The background document accompanying the 2006 federal budget attempted to define the issue as the need to clarify these roles and responsibilities and then make the supporting financing arrangements more stable. In particular, it could be argued that accountability is weakened when the roles and responsibilities are not clearly defined and when more than one jurisdiction can be called upon for financing. Health care is a good example. There the provinces have less incentive to curtail cost increases when, as in recent years, they can turn to the federal government for more contributions.

Fiscal federalism could also include the allocation of taxation powers across governments. There is a legitimate argument that the most mobile forms of income, such as corporate profits, should be taxed at the federal level to avoid a counter-productive race to the bottom among the provinces. Consumption taxes, on the other hand, could conceivably be levied entirely by the provinces. Local governments are largely confined to raising revenue through property taxes and user fees. They would find it difficult to capture highly mobile forms of income, but the provinces could grant them more latitude to levy various excise and consumption taxes. Greater control over their sources of funding would make municipalities more accountable.

In its broadest form, fiscal federalism could be thought of as encompassing fiscal and economic policies of any jurisdiction that impact other jurisdictions and the country as a whole. Some discussed in the federal budget

background document include the remaining inter-provincial trade barriers, multiple securities regulators, and various harmful provincial policies such as high capital taxes and taxation of capital under retail sales taxes.

As if fiscal federalism were not already sufficiently complex, the public debate has been confused by the notion of a federal-provincial “imbalance” and the Ontario government’s “\$23 billion campaign.” A conventional perspective of the imbalance is that the federal government has revenues vastly in excess of its legitimate spending needs, while the provinces are not able to raise sufficient revenue to match their needs.

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The federal budget projections and consideration of the respective federal and provincial revenue sources undermine the credibility of any such notion. After paying off \$3 billion a year toward debt, the 2006 federal budget shows surpluses of only \$0.6 billion this year and \$1.4 billion next year. The planning surpluses could grow modestly in later years, but much of that would go toward funding the promised second point reduction in the GST rate.

The provinces have access to virtually every form of taxation except (the stagnant) customs import duties as they have stopped declining recently. They are free to set the tax rates they deem necessary to finance their spending needs. Of course, they confront eco-

nomical and political challenges in doing so. But given that most provinces have cut tax rates in recent years, it would appear the political challenges dominate. As such, the “fiscal imbalance” is more of a political issue than an economic or fiscal one.

Ontario estimated that for 2004-05 the federal government took \$23 billion more out of the Ontario economy than it put back through spending in the province. The figure was based on the latest actual data at the time, which showed a net federal withdrawal of \$21.8 billion for 2002-03. More recently, Statistics Canada has released the 2003-04 figure, which shows a net federal withdrawal of \$18.2 billion. So the

Ontario projection is likely on the high side. But more troubling is that the \$23 billion campaign has left the impression that this entire amount represents some form of federal “discrimination” against Ontario through the design of federal taxation and spending. In fact, most of the net federal take simply reflects the interaction of national taxation and spending parameters with Ontario’s above-average income bases.

The conventional view of “fiscal imbalance” leads to a call for the federal government to transfer tax points to the provinces. Yet the federal budget projections suggest that under current spending plans this would risk a return to deficit. A mere one percentage point transfer to the provinces for all four personal income tax rates would deprive the federal treasury of more than \$5.5 billion per year. Tax point transfers face a political challenge at the federal level as well.

When the federal government made a large tax point transfer (offset by reductions in cash transfers) in 1977-78, the provinces refused to acknowledge it as part of the federal contribution to health care and social policies. Surely this experience dulls the federal incentive to transfer more points.

One possibility for a tax point transfer is the promised second point reduction in the GST rate. This could be co-ordinated with the provinces so that they pick up a point on their consumption taxes. If this does occur, hopefully it will be in the context of provincial sales tax reform that puts all provinces under a value-added structure and ends taxes on business inputs and capital.

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The Ontario government’s conclusion from its “\$23 billion campaign” was that the federal government should increase its per capita transfers to the provinces. This is an odd call, because it seems to contradict the very core of its own imbalance complaints. Namely, if the federal government increases per capita transfers, Ontario residents might receive the per capita share of 39 percent, but they will likely implicitly finance the transfer at Ontario’s 43 percent share of federal revenues. The gap would simply widen. A more logical conclusion is that it is in Ontario’s interest to receive an unequalized transfer of tax points from the federal government.

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This clouds accountability for programs and puts the provincial and local

governments in a vulnerable fiscal position should federal budget pressures arise or budget priorities alter. Ontario’s campaign has brought to the surface some areas of federal spending that don’t work well for its residents. An example is employment insurance. The tight link between labour market conditions and employment insurance eligibility and Ontario’s above average share

of the self-employed and immigrants — groups not typically covered by insurance — means that less than one-third of the province’s unemployed draw benefits. This may not be “discrimination” per se, but it does suggest that employment insurance is not relevant to the current structure and dynamics of Ontario’s labour market. Ontario has also been getting less than its per capita share in areas such as immigration settlement services, affordable housing and labour force training. A case has been made for infrastructure as well. The previous federal Liberal government promised to examine these issues, and the Conservatives are honouring that notion. They recently signed a federal-Ontario agreement on immigration settlement services that rectifies the under-funding.

Underlying both the “fiscal imbalance” and the Ontario “\$23 billion campaign” issues is the point that changes in fiscal federalism should start with an examination of federal spending. Should the federal government exit substantial areas of provincial and local jurisdiction? If it did, the cost savings to the federal treasury could then finance a significant tax point transfer. For example, the federal government could eliminate its cash

transfers for health and post-secondary education and transfer the equivalent funding through tax point transfers. Instead of notionally tying the infrastructure transfer to municipalities (it is notional in that all forms of federal revenue are fungible, so there is no way of determining which revenue source the federal money comes from), the federal government could simply lower its gasoline excise tax rate and allow the provinces or municipalities to pick up the difference.

The fact that Ontario’s campaign has been misinterpreted by some does not deny that it raises some valid points in addition to highlighting particular federal initiatives that do not serve

Ontario residents well. The net federal take from Ontario represents a huge fiscal drag, and that makes it difficult for the Ontario economy to compete within and outside Canada. Further, it points to some elements of federal transfers that could be seen as unfair to Ontario taxpayers. Similar points could be made about Alberta, but as that province is enjoying much greater prosperity, the beleaguered Ontario economy will be used to highlight the arguments.

When Equalization began some 50 years ago, Ontario’s industrial base operated behind a high international tariff wall. A good part of the monies the federal government distributed to other provinces flowed back to Ontario, as the receiving provinces bought Ontario’s goods and services. But the tariff wall is now gone, and most of Canadian trade goes north-south rather than east-west. Transfers out of Ontario now tend to leak away. This raises the question of how much redistribution an economy can afford in an ultra-competitive world economy.

The \$18.2 billion net federal withdrawal of money out of the Ontario economy in 2003-04 represented 3.7 percent of Ontario’s GDP. In contrast, the other provinces, excluding Alberta, had a net federal injection of 3.9 percent of

their GDP. Canada is, of course, not alone in having sizeable internal redistribution of funds. The federal budget background document shows that, if there were a federal budget balance in the United States, the extent of redistribution away from high-income states such as New Jersey would be even greater than is the case with Ontario. Still, the US federal government, like most central governments around the world, is in huge deficit. While there may be such a fiscal drag in future, it does not exist at the moment, while Ontario's does. So federal redistribution away from Ontario imperils its ability to compete at home and abroad.

Ontario receives about \$1,200 less per capita in federal transfers than the all-province median, partly because it receives less than its per capita share of cash transfers for social programs due to the higher value of income tax points in Ontario, but largely because it receives no equalization at all. In a balanced-budget world, it must make up for this \$1,200 relative shortfall through higher own-source revenues, or lower expenditures relative to the provincial median. Ontario's own-source revenues are considerably above the provincial median for non-resource taxation. This is a result of significant Ontario tax effort and above-average tax bases. Yet because it collects so little from resources, its total own-source revenues come in virtually bang on the provincial median. That can only happen while maintaining a balanced budget if it spends below the provincial median, which is exactly the case. Paradoxically, then, the province that finances the largest share of equalization ends up with the lowest per capita spending. A recent study by the Atlantic Institute for Market Studies concluded that after factoring in Ontario's above-average costs, its real provision of public services falls even further below those of other provinces.

To some degree Ontario's spending is low relative to that of other jurisdic-

tions because the province has passed some social responsibilities on to the local level. As well, it has been suggested that Ontario's spending must necessarily be low because of the personal income tax reductions introduced by the Harris government. Ontario's personal income tax rates are below those of some equal-

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ization-receiving provinces such as Newfoundland & Labrador and Quebec, but not out of line with the average for all provinces.

**B**ased on the need for competitiveness and fairness, it is clear that there needs to be a limit on the amount a federal government can redistribute in the modern global context. There is, however, no obvious way from this rather casual examination to determine whether current schemes go too far. The examination does, however, suggest that distribution cannot be considered solely from the perspective of the receiving provinces. The ability of above-average provinces to continue to generate wealth and provide their citizens with reasonably comparable services must also be considered.

The COF's advisory panel and the federal expert panel both recommend that the equalization standard should go from the current 5 provinces (BC, Saskatchewan, Manitoba, Ontario and Quebec) to 10 provinces. Inclusion of Alberta raises the standard and hence the overall cost of equalization. The COF's report also recommends 100 percent inclusion of resource revenues in the standard, whereas the federal expert panel recommends 50 percent. The lower cost of the expert panel's recommendation is more likely to suit Ottawa, Ontario and Alberta, and fits better with

the conclusion reached above that care must be taken to limit increases in the cost of equalization. Both reports made similar and sound recommendations for making payments more predictable.

A 10-province standard seems perfectly logical on the surface. Indeed, it would be the only logical basis if

Equalization were a net system whereby funds were actually taken from the wealthier provinces and given to the poorer. However, Equalization is a system where the federal government provides the funding directly to the poorer provinces. There is a less compelling case for a particular standard in this situation. Further, there is again a troubling aspect from the Ontario perspective. Inclusion of Alberta raises the standard, but in good part this is due to Alberta's wealth of resource revenues. Alberta also has higher-than-average revenues per capita from income taxes, so this is only a partial explanation. Yet the federal government does not directly tax Alberta's resources — although it does collect incremental taxes as this wealth filters through other tax sources. So to a degree it is Ontario taxpayers that would finance the conversion to a 10-province standard.

Partial inclusion of resource revenues would mean that some provinces could have a higher fiscal capacity after equalization than does Ontario. The expert panel recommends a cap so that this cannot happen. In essence, equalization payments would be "clawed back" at 100 percent above Ontario's fiscal capacity.

The recommendation seems fair, and indeed necessary, from an Ontario perspective. Yet it brings back the dispute

between Newfoundland & Labrador and Nova Scotia on one side and the federal government on the other. The cap would also hurt Saskatchewan, and in future could hurt British Columbia as well. The expert panel does not provide a specific recommendation as to what should be done with the accords that protect Newfoundland & Labrador and Nova Scotia from such a clawback of resource revenues. The equalization-receiving provinces with non-renewable resource revenues could argue that some of the reasons that led the expert panel to suggest only 50 percent inclusion of resource revenues — such as the cost of developing the resource — should equally apply to protecting some of the other revenues from clawback. The expert panel acknowledges this point. Some tweaking of the cap may be required.

Fiscal federalism is complex and the debate has been confused. But progress is being made. Most parties have moved beyond the simple notion that the only requirement is a transfer of tax points from the federal government to the provinces or an increase in federal cash transfers. Ontario's "\$23 billion campaign" did a wonderful job of raising the profile of some legitimate issues and facilitated constructive analyses. Local governments' needs are finally receiving attention. The recommendations of the expert panel on Equalization unambiguously represent a substantial improvement over the current equalization regime. Finally, the federal government has helped by throwing some important economic union considerations onto the table.

Will this all come together in a "big bang agreement" that will shake up fiscal relations and leave all parties happy? Not likely. The interests are too disparate, the appetite for radical change limited and the federal government doesn't have a large enough fiscal carrot to entice the provinces. Most likely change will be more Canadian

— incremental steps that will leave some parties grumbling and anxious to come back for more rounds.

The first knock against a sweeping agreement is the very process of the debate itself. Most analyses have only examined individual programs. Few attempt to look at holistic reform. Indeed, the last formal exercise that broadly examined this was the Macdonald Commission some two decades ago. Few individual researchers or research institutes have waded into the debate with big ideas. As such, there is no comfort level with the idea of a substantially different form of fis-

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cal federalism. Indeed, the public debate was quickly ramped up to first ministers. As a result, it is highly charged politically, and the provinces express outrage at anything that might damage their particular interests. This environment makes it difficult to have a level-headed debate on sweeping reform that might require trade-offs to achieve a greater common good.

The second knock against the probability of a "big bang agreement" is that the federal government is unlikely to exit substantial areas of provincial or local government jurisdiction. First, there is the weight of history. One could speculate that the new Conservative government might not have offered the infrastructure transfer to municipalities

implicitly linked to the gasoline excise tax. But they probably won't abrogate the deal the Liberals made. Ultimately any federal politicians will want to be seen as having close ties to the keenest interests of their constituents, and this argues for staying in fields such as health care. Whether under the guise of fiscal federalism or the internal cost-cutting exercise promised in the budget, the federal government will exit some areas of overlap with the provinces. But the magnitudes will not be large. Hence, there will not be scope for a major federal transfer of tax points. Besides, the Conservatives are students of economic history and will see that the Liberals did not get the credit they expected from the transfer in 1977-78.

The third knock is that the federal government lacks the fiscal capacity to bribe, entice or bully the provinces into various quid pro quos. And even if it had, substantial federal enrichment of its programs such as Equalization would meet resistance from Ontario and Alberta, who see through federal financing and realize that their taxpayers will ultimately foot the bill.

The federal government will likely leave the Canada Health Transfer on its current course. There will be some enrichment of the Canada Social Transfer. Over time it will increasingly be linked to post-secondary education. The Canada Child Tax Benefit will implicitly represent the federal government's contribution to other social policies. Associated equalization, whereby higher-income provinces receive less than their per capita share of federal cash transfers, will likely be phased out over several years. Equalization and territorial formula financing will be adjusted along the lines of the expert panel recommendation, with some possible tweaking to the cap provision. Together these programs will drive federal costs up by more than \$1 billion per year. The federal government will make more of an effort to bundle its various infrastructure

initiatives and cast the amount provided to provinces and municipalities as one of the major transfers. The federal government will likely offer to share with the provinces surpluses above the \$3 billion annual debt repayment, especially given the frost reception to the idea of putting surpluses into the Canada/Quebec Pension Plans.

Progress will continue on the economic union front, but likely not explicitly linked to the fiscal federalism file. Recent agreements between British Columbia and Alberta (on several fronts) and between Ontario and Quebec (on labour mobility) offer hope of renewed provincial interest in ending the embarrassing inter-provincial trade barriers. Sadly, agreement on a single securities regulator does not appear likely any time soon. Many provinces have recently reduced or eliminated their

capital taxes, although in some cases they have unwisely excluded financial services. The greatest hope for harmonization of retail sales taxes to a value-added structure is through the promised second point rate reduction to the GST. It was most unfortunate that the first point reduction effective July of this year was not leveraged as part of harmonization. The same mistake should not be repeated. Yet orchestrating the second GST point as a tax transfer would alienate the Conservatives' tax reduction constituency. Ultimately the federal government might have to entice the provinces to harmonize through up-front payments, as was done for the three Atlantic provinces that harmonized with the GST in 1997.

Finally, with growing labour shortages, an increased need for labour mobility and sweeping changes to the structure of the labour market, there

has never been a greater need to reform programs like employment insurance. Indeed, with so few of the country's unemployed being covered in regions of low-to-moderate unemployment while less-than-full attachment to the workforce is essentially subsidized in other regions, this is one of the largest federal redistribution tools. Hopefully sensible reforms can be achieved under the competitiveness/productivity agenda Finance Minister Jim Flaherty promised for the 2007 budget.

So, in conclusion, no "big bang" and no "agreement." But progress nonetheless. But not so much that issues of fiscal federalism are going to go away. It is the Canadian way to leave the web tangled.

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