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Fiscal Federalism and You

What is Fiscal Federalism?

At first glance, it may appear contradictory to join in one phrase the terms 'fiscal federalism' and 'you.' Most Canadians would be hard-pressed to explain what is meant by 'fiscal federalism' – let alone to describe how it touches their lives. Yet fiscal federalism affects all Canadians in significant ways.

While fiscal federalism sounds like a daunting term, it is a simple concept. It refers to the various financial arrangements between the federal and provincial governments that define the ways in which they collect revenues and share the costs of public programs.

Few Canadians realize that the recent changes to fiscal arrangements in some way lie behind many of their everyday problems and frustrations. These include the queue for affordable child care, the long wait for cancer treatment, the huge classes in university undergraduate programs, the freeze on public sector wages in some provinces, the lack of homemaker services for elderly persons and attendant services for persons with disabilities, the cutbacks in municipal services such as snow clearance and garbage collection, and even the introduction of user fees for recreation such as swimming and skating.

Four key arrangements constitute the backbone of fiscal federalism: equalization payments, Established Programs Financing (EPF), the Canada Assistance Plan (CAP) and the federal-provincial Tax Collection Agreements. The first three schemes represent different ways in which the federal and provincial governments share costs. The Tax Collection Agreements, by contrast, set out how the federal and provincial governments collect income taxes.

But cost is not the only consideration. Fiscal arrangements support the services – such as medicare, postsecondary education and child care – that are so important to Canadians. These services are increasingly vulnerable because they are caught in an ever tightening squeeze caused by rising demand and declining revenues.

To some extent, the problem is one of dollars – or lack thereof. But equally important is the issue of appropriate federal and provincial roles: who is expected to do what, for whom and with which funds? These questions were debated during the constitutional discussions but they remain largely unresolved.

One of the most serious problems is the fact that the governments expected to deliver most public services – provinces and municipalities – cannot raise the funds to meet large and growing demands. They can generate revenue only in certain ways. To some extent, federal transfers are intended to offset these fiscal limitations. Yet these federal transfers no longer represent a secure source of income because Ottawa is cutting them back.

Equalization Payments

Equalization payments refer to money that the federal government transfers to the poorer provinces to help equalize their financial capacity. In 1993-94, these payments will amount to an estimated $8.4 billion.

The basic principle underlying equalization payments is to enable all provincial governments to provide public services at the level of the national average without having to resort to unusually high taxes of their own. Equalization payments make up the difference between a province's revenue and the national average. [1]

Ontario, Alberta and British Columbia do not get equalization payments because their respective revenues are above the national average. As a result, they are referred to as the 'have' provinces compared with the seven 'have not' provinces that receive equalization payments.

The equalization formula was altered in 1982 as a result of an imbalance related to energy revenues. Because of the large increases in oil and gas revenues in the Western provinces, the federal government changed the method for calculating equalization payments. Previously, the equalization formula took into account the revenue-raising capacity of all the provinces. Alberta's revenues were dropped from the equation in order to remove the distortions introduced as a result of the big gains in energy revenue. To offset this change, the Atlantic provinces were eliminated from the base calculations as well. Moreover, the growth in total federal payments was capped; it could not rise above the level of equalization payments in the 1982-83 fiscal year by more than the increase in Gross National Product (GNP).

This description no doubt begs the question: "But how does equalization affect me?"

Equalization payments play an important stabilizing role in Canada; they guarantee that all regions of the country have relatively equal ability to finance basic services. Equalization ensures that all provinces can support the infrastructure – including roads, sewers, garbage collection, police and fire services – required to build and maintain a minimum standard of public services in both urban and rural communities. By significantly reducing the disparities in the fiscal capacity of provincial governments, these payments help minimize the extreme disparities in services that likely would occur in the absence of the equalization program.

The authority to pay equalization is now entrenched in the Constitution, thereby making these payments an integral part of the Canadian 'fabric.' Equalization payments effectively help bind together the various parts of the country. Yet the fabric soon ay be wearing very thin.

There are serious pressures on equalization from two sources: an actual implicit cut and possible explicit cut. The implicit cut, worth close to $1 billion in payments over four years from 1990-91 through 1993-94, will result from the sheer mathematics of the equalization formula. Because the gap between the economic performance of the 'have-not' provinces and the 'have' provinces of Ontario, Alberta and British Columbia has narrowed, the amount that the former receive from equalization payments will go down.

The reduction is not due to a unilateral federal decision to cut transfers – but rather to a downturn in the economy which has weakened governments' revenue-generating capacity in all provinces, including the better-off ones, and thus lowered the national average for calculating equalization. The cuts are an inherent consequence of the equalizing formula, but will be devastating nonetheless for the recipient provinces; they will have to raise taxes or cut services to offset the substantial loss. Yet the cuts are troubling from another perspective as well. They essentially reflect the fact that Ontario – the key 'have' province – is experiencing serious financial difficulty. When the 'economic engine' of the nations is in trouble, the whole country has to be concerned about the fiscal health.

The explicit pressure on equalization comes in the form of a possible five-year freeze that Ottawa is said to be considering for all federal transfers to the provinces, including equalization payments, in order to help reduce the near-$46 billion deficit. The equalization agreements come due in March 1994 and must be renewed. Such a freeze would result in federal savings worth several billions of dollars over the next five years – which would send a chill through all provincial capitals and would put social programs, in particular, on ice. The federal government also will be under pressure to cut its own programs – notably direct transfers to individuals in the form of unemployment insurance benefits and old age pensions – in an effort to bring down spending.

Established Programs Financing

Established Programs Financing (EPF) is the second major component of fiscal federalism. This is the arrangement under which the federal government transfers tax points and cash to the provinces and territories as contributions for their health care and postsecondary education systems. [2]

In the area of health care, provinces must adhere to the principles set out in the Canada Health Act in order to receive the full amount of federal cash transfers. These principles ensure that Canada has a universally accessible, comprehensive and publicly administered health care system for all citizens – regardless of age, residence or level of income. In short, this funding arrangement provided the foundation for medicare – Canada's best known and popular social program.

Ironically, medicare now is threatened by the very funding arrangement that supports it.

As part of its efforts to reduce the deficit, the federal government announced in 1986 that would limit the indexation of EPF transfers to the rise in Gross National Product less two percentage points (prior to the announcement, federal transfers were adjusted by the full increase in GNP). The payments were curbed once again in 1989 when Ottawa restricted indexation to the rise in GNP less three percentage points. The Minister of Finance went even further and froze federal transfers for 1990-91 and 1991-92; after which the GNP-less three percentage points formula will kick in. These unilateral moves have generated a substantial decline in the cash portion of the EPF entitlement. [3]

Federal cash transfers will end in some provinces at the close of the decade and will disappear completely by early in the next century. The end of cash transfers will erode, if not remove entirely, Ottawa's ability to enforce the conditions of the Canada Health Act – and thereby protect medicare. There will be no financial leverage to block user fees, to guarantee that Canadians receive medical coverage if they visit or move to other parts of the country, or to ensure that an essential core of health care services remains publicly supported. Unless the federal government stops bleeding funds from the EPF transfers, the prognosis for medicare is very poor.

Canada's health care system is struggling to cope with cost pressures arising from such factors as an aging population, high-tech medicine and great faith on the part of patients in the healing capacity of modern medicine. The rapid decline of federal funding is making matters all the worse. Provinces are being forced to raise taxes, consider charging user fees or cut back on insured health services to offset the shortfall. For example, various provinces no longer pay for such services as basic vision assessment, the removal of impacted wisdom teeth, fluoride treatment for children up to age 4 and the cost of insulin for diabetics.[4]

Ottawa claims that the threat to medicare is unfounded – that it simply will reduce other forms of transfer payments to the provinces in order to ensure adherence to the Canada Health Act. The problem is that the federal government already has cut other transfers – notably those paid under the Canada Assistance Plan.

Canada Assistance Plan

The Canada Assistance Plan (CAP) represents the third essential building block in the country's fiscal foundation. It is the funding arrangement that allows Ottawa to share with provinces and territories the costs of social assistance (commonly known as 'welfare') and social services. The latter include child care; homemaker assistance; child welfare services (e.g., foster care, adoption); and individual, marital and family counselling. CAP also shares the costs that some Canadians may incur for special needs such as drugs for medical problems, wheelchairs and other technical aids for disabling conditions or transportation for health-related care. Ottawa will transfer $7.2 billion to the provinces and territories under CAP in 1993-94.

In 1991-92, 63 percent of the funds that the federal government shared with the provinces and territories under CAP went toward the costs of social assistance. [5] As a result, many Canadians may think that CAP does not affect them because they are not welfare recipients.

While CAP does not provide direct assistance to everyone, it nonetheless matters to all Canadians. It acts as a safety net for families and individuals who, for whatever reason, lack an income from the usual sources such as employment and other social programs. It funds the services that assist many people with various personal, economic or social needs, such as child care. It supports the programs that provide help in the vent of child abuse, family violence, separation or divorce, and other stressful circumstances.

In an effort to reduce the deficit, the federal government announced in 1990 that it would limit federal CAP payments to Ontario, Alberta and British Columbia to an annual increase of five percent for 2990-91 and 1991-92. The following year, the freeze was extended through 1994-95.

The effect of the ‘cap on CAP’ has been devastating – particularly for Ontario which has experienced high rates of unemployment and skyrocketing welfare rolls as a result of the recession and economic restructuring, which hit the manufacturing sector particularly hard. Ontario claims that it has lost more than $3.3 billion as a result of this cost-sharing ‘amendment.’ [6]

Yet the cap on CAP has been painful not only with respect to its impact on the so-called ‘have’ provinces. The unilateral move by Ottawa sent shock waves throughout all provincial capitals which worried about the security of other financial agreements into which they had entered in good faith with the federal government. The extent to which the shattered trust also affected the constitutional talks never will be known for certain. It is likely, however, that this harsh lesion in fiscal federalism could only have detracted from the cooperative federalism that built some of Canada’s major social programs in the past.

The cap on CAP is due to expire in 1994-95. It is unlikely that the federal government will return to the former 50-50 cost-sharing arrangement, given the dramatic rise in welfare costs which soared from $1.7 billion in 1958-59 to $10 billion by the late 1970s and to $17.6 billlion by 1990.91. [7] We may see a fundamentally different CAP in the future.

In short, both the status and the welfare of CAP are uncertain. It is possible that the Canada Assistance Plan itself soon may be in need of assistance.

Tax Collection Agreements

The federal-provincial Tax Collection Agreements represent the fourth key component of fiscal federalism. These agreements set out the terms for determining the base (including deductions and exemptions) upon which personal income taxes are levied by the federal government as well as non-refundable credits, tax brackets and rates, and indexaton factors. [8] Provinces then levy their respective personal income tax, which is similar in design to the federal income tax.

The Tax Collection Agreements help promote fiscal ‘harmony’ I the country by preventing the double taxation of income by Ottawa and the provinces and ensuring that income does not escape taxation. While there may be fiscal harmony in theory, the federal-provincial relations around these agreements are far from harmonious in practice.

Federal moves in the income tax field have a significant impact on provincial finances. Yet provinces are expected to play a largely reactive role vis-à-vis their most important revenue source. In the May 1995 Budget, for example, Ottawa announced a $500,000 lifetime capital gains exemption, which subsequently was reduced to $100,000, except for farm property and small business shares, for which the lifetime limit remains $500,000. Overall, the provinces lost about $1 billion in their income taxes in 1989 as a result of Ottawa’s decision to create a capital gains exemption.

What is Wrong with This Picture?

Fiscal federalism forms the framework that determines how public funds are collected and spent in Canada. It constitutes the economic foundation upon which pubic services – including several major social programs – are built.

Despite the importance of social programs and the fiscal arrangements that support them, there is very little public dialogue on the future of these arrangements. Fiscal federalism is considered the purview – and indeed has become – the exclusive territory of a handful of bureaucrats, constitutional experts, political scientists and economists specializing in public finance. The 'debate' on fiscal federalism takes place for the most part behind closed doors, at 'high levels' and in meetings rarely shared with the public.

Fiscal federalism appears to have taken on a life of its own. Changes to the underlying finding arrangements are reshaping fundamentally Canada's social programs. The changes have occurred in the absence of public debate about what objectives we are trying to achieve through various programs and what type of fiscal arrangements are required to meet those objectives.

Typically, changes made to fiscal arrangements are announced in Budgets with little public knowledge, understanding or discussion. Even provincial treasurers largely have been shut out of decision-making processes. On federal Budget day, they get the news like all other Canadians. They turn on their TVs and anxiously wait to see how federal changes will affect their respective budgets. [9] The lack of information only contributes to the fundamental problem noted earlier: the discrepancy between the responsibilities and expectations placed upon provincial and municipal governments to deliver certain services ad their ability to raise the funds to pay for these services.

Fiscal federalism probably never will be a household word. Yet the financial arrangements it entails have a profound effect upon every household. For that reason alone, it is important for Canadians to understand the financial underpinnings of our country. We then will be in a better position to ensure that the relevant financial arrangements are either preserved or modified to help support the programs and services that we want to protect.

At best, Canadians must be more actively involved in steering the financial course. At the very least, we must have greater say in the direction that the fiscal ship should take. Moreover, the country needs unprecedented federal and provincial cooperation in these tough economic times. Ottawa must get the provinces on board top ensure that all parties agree on how to chart the way through some very rough waters. The tensions that underlie fiscal federalism can be resolved only through cooperative federalism.

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Endnotes

1. For a more complete description, see Peter M. Leslie, "The Fiscal Crisis in Canadian Federalism." In Peter M. Leslie, Kenneth Norrie and Irene K. Ip. *A Partnership in Trouble: Renegotiating Fiscal Federalism*. (Toronto: C.D. Howe Institute, 1993), pp. 31-35.

2. The federal contribution originally was based on the 1975-76 national average per capita costs escalated by population and GNP growth to a current value. In 1977-78, the federal government reduced its income tax rates so that the provinces could raise theirs (at no cost to the taxpayer). The value of this 'tax transfer' is deducted from the total estimated entitlement and the remainder is paid in cash.

3. National Council of Welfare. Funding Health and Higher Education: Danger looming . (Ottawa: Minister of Supply and Services Canada, 1991), pp. 19-23.

4. Pran Manga. "Health Economics and the Current Health Care Costs Crisis: Contributions and Controversies." *Health and Canadian Society*. Vol. 1, No. 1 (1993), p. 190.

5. Canada. Health and Welfare Canada. *Canada Assistance Plan: Annual Report 1991-92*. (Ottawa: Minister of Supply and Services Canada, 1993), p. 18.

6. Ontario. Ministry of Community and Social Services. *Turning Point: New Support Programs for People with Low Incomes*. (Toronto, 1993), p. 9

7. Ken Battle and Sherri Torjman. *Opening the Books on Social Spending*. (Ottawa: Caledon Institute of Social Policy, 1993), p. 18.

8. Allan M. Maslove. "Fiscal Harmonization and the Tax Collection Agreements." Paper presented at the seminar on Fiscal Federalism for the 21st Century organized by the Caledon Institute of Social Policy. (Ottawa, October 16, 1993), p. 4.

9. Michael Mendelson. "Fundamental Reform of Fiscal Federalism." Paper presented at the seminar on Fiscal Federalism for the 21st Century, organized by the Caledon Institute of Social Policy. Ottawa, October 16, 1993, p. 2.

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