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AN OVERVIEW OF CANADIAN FISCAL FEDERALISM: CURRENT ISSUES AND PROSPECTS FOR REFORM

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1. INTRODUCTION

The fiscal arrangements between Ottawa and the provinces are one of the most important features of the Canadian federal system. They are sometimes referred to as the `glue' that binds the Canadian federation. The most recent re-negotiation of fiscal transfers between federal and provincial governments was completed in 1987 and was to cover a period of five years. The so-called `fiscal arrangements' were extended for one year in 1992 and will probably be near the top of the new federal government's agenda.[1]

Fiscal transfers have assumed a special importance in recent years as both federal and provincial governments struggle to reduce budget deficits. The so-called `major transfers' are an important part of expenditures to the federal government and an important source of revenue to the provinces. Recent measures taken by the federal government in the name of deficit control have had a significant impact on provincial deficits and these measures have been a source of political friction between the two orders of government.

In addition to major transfers, the Canadian federal system includes a number of other federal programs which by their nature result in major redistributions of resources between regions. These programs, such as Unemployment Insurance, have important effects on economic activity and government budgets in different regions.[2]

Finally, the Canadian fiscal system also encompasses taxation -- with both orders of government jointly occupying the major tax fields. Thus, tax measures by one order of government, in the name of deficit control or justified by other reasons, have impacts on the

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other, and these again have led to frictions between Ottawa and the provinces.

The purpose of this paper is to provide an overview of the current state of the Canadian fiscal system, including major transfers, other federal programs and taxation, and to enumerate some of the proposals for change which are being discussed in anticipation of the next round of negotiation between federal and provincial governments. The plan of the paper is as follows: In the next section we briefly outline the recent history of the Canadian fiscal system, quantify the flow of resources between regions and governments and discuss how these flows have changed over time. In Section 3, we present, without evaluating, the proposals for change being discussed and also lay out a framework for organizing and summarizing the alternatives. The final section of the paper briefly outlines our own view as to an appropriate process for considering fiscal reform.

2. Fiscal Transfers Today

An important component of Canadian fiscal federalism has been, and continues to be, the interprovincial and interregional reallocation of resources undertaken through federal government programs. This has been accomplished to a large extent through a complicated federal fiscal system that includes major transfers to provinces, other federal programs delivered directly to persons and to business entities and taxation.

Major Transfers

The three major redistributive programs that provide federal government transfers to provinces are equalization, the Established Program Financing grants (EPF) and the Canada Assistance Plan (CAP).

The equalization program is designed to transfer revenues to provincial governments from the federal government to redistribute resources from more-affluent to less-affluent provinces so as to enable provincial governments to meet their expenditure responsibilities. The existence of this program has been justified on the grounds that an unequal distribution of tax bases across provinces is inequitable since all provinces face similar expenditure responsibilities and this unequal distribution could lead to inefficiencies through fiscally-induced migration.

Equalization entitlements are unconditional transfers based upon the legislated formula set out in the *Federal-Provincial Fiscal Arrangements and Established Program Financing Act* of 1977 and its subsequent amendments. These unconditional grants are not open-ended as a result of two constraints placed on entitlements. Since 1982-83, overall growth in total equalization payments has been constrained so as not to exceed the rate of growth of GNP. Also, the extent to which any province's equalization payment can be reduced in any given year is limited and dependent on the province's revenue-raising capacity relative to the national average.

To calculate a province's entitlement to equalization under the formula, its revenue-raising capacity is first determined using the Representative Tax System (RTS), which consists of thirty-three sources of tax revenue available, in principle, to each of the provinces. A province's potential revenues are calculated as the revenues that could be generated had the national average tax rate for a given tax source been applied to the province's tax base for that source. Potential revenues from each of the thirty-three tax sources are summed to obtain total provincial revenue capacity. A revenue standard, or benchmark, is necessary to determine if a province's potential revenues are adequate and, if not, to determine the size of the equalization transfer. Since 1982, benchmark revenues for each tax source have been calculated using the national average tax rate and the five-province (Ontario, Manitoba, British Columbia, Quebec and Saskatchewan) average tax base for each tax source. Summing benchmark revenue over all revenue sources yields standard total revenues for each province.

If per capita benchmark revenue exceeds a province's potential revenue per capita, that province qualifies for an equalization entitlement equal to this difference multiplied by its population. If potential revenue per capita exceeds the per capita benchmark revenue the equalization entitlement is zero. Thus, the system of equalization payments does not equalize revenue capacity across provinces but rather provides recipient provinces with a minimum revenue capacity defined in terms of the five-province average.

EPF transfers are a block grant system in which entitlements and conditions are governed by the *Federal-Provincial Fiscal Arrangements* and *Federal Post-Secondary Education and Health Contributions Act*. EPF transfers were designed to assist provincial governments in the funding of hospital and medical care and post secondary education. They consist of a cash payment and a notional transfer of tax room from federal to provincial governments, which, since 1982, have been combined to ensure that the per capita entitlement was the same for all provinces. To determine the actual cash payment under EPF, the equalized value of the notional tax transfer is deducted from the global entitlement and the remainder is paid as a cash transfer.

EPF transfers are not open-ended grants. In 1977 growth in annual payments to the provinces by the federal government was constrained by the growth in per capita GNP. This original allowable rate of acceleration has been modified several times since 1977. Growth in payments for post-secondary education was constrained to 6% in 1983 and 5 percent in 1984, with the shortfalls recovered in the 1985 payments. In 1985 the general rate of acceleration with respect to GNP was reduced by two percentage points (percentage growth in GNP minus two). Per capita EPF entitlements were frozen in 1990 and in 1991 the federal government extended this freeze to 1994-95, at which time payments will be allowed to grow at the rate of GNP growth minus three percentage points.

The Canada Assistance Plan was enacted in 1966 to assist provinces and territories in providing social assistance and welfare programs. Under the plan, the federal government is responsible for 50 percent of the costs of provincially- or municipally-provided programs for individuals in need and 50 percent of the costs of provincial programs designed to improve the employment opportunities of persons who are in need of such assistance. In this form, these transfers are open-ended, conditional matching grants available uniformly across all provinces.

In 1990 the federal government sought to restrain the growth in CAP payments by imposing a limit of 5 percent growth in 1990-91 and 1991-92 payments to provinces not entitled to equalization payments in those years. In 1991, this "cap" on CAP was extended to the 1994-95 fiscal year. The federal government continues to share 50 percent of the provincial program costs in equalization-receiving provinces. This financing change effectively converts the transfer for non-equalization receiving provinces into a close-ended grant while maintaining the open-ended nature of the transfer for those provinces entitled to equalization. Additionally, it causes transfer payments under CAP to behave more like equalization payments in that "need" as defined by the equalization system becomes a criterion for transfers under the CAP program.

Tables 1A and 1B[3] provide data on the magnitude and distribution across provinces of federal transfer payments under the equalization, EPF and CAP programs for the fiscal years 1982-83, 1986-87 and 1991-92. Current dollar values are presented in Table 1A and per capita, constant dollar (current dollar values deflated by the GDP implicit price deflator, 1986 = 100) figures are presented in Table 1B. As the data in these tables reveal, EPF grants are the dominant vehicle through which, in aggregate, resources are transferred from the federal government to provincial governments, accounting for over 40 percent of total cash payments in each of the observation years. This aggregate, however, does mask differences at the provincial level as equalization is the primary source of resources from the federal government for each of the Atlantic provinces in each of the sample years. In terms of magnitude, Ontario and Quebec received over 50 percent of total funds transferred by the federal government in each of the observed fiscal years. However, most of this share can be explained by population. On a per capita

Table 1A: FEDERAL PAYMENTS TO PROVINCES UNDER EQUALIZATION, EPF AND CAP PROGRAMS (in millions of dollars)

	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
1982-83											
Equalization	463.90	118.00	574.00	488.20	2782.00	0.00	439.10	0.00	0.00	0.00	4865.20
EPF	140.44	31.56	221.32	177.80	1094.60	2181.59	273.70	272.02	526.85	652.36	5572.24
CAP	65.96	86.47	86.47	107.69	807.83	742.25	91.75	119.89	305.66	473.77	2819.60
Total	**670.30**	**167.89**	**881.79**	**773.69**	**4684.43**	**2923.84**	**804.55**	**391.91**	**832.51**	**1126.13**	**13257.04**
1986-87											
Equalization	607.60	123.60	560.60	575.90	2681.70	0.00	415.30	231.80	0.00	0.00	5196.50
EPF	226.62	50.18	346.56	288.78	1814.93	3220.02	423.19	409.31	829.28	1220.33	8829.20
CAP	85.48	19.78	124.41	145.11	1545.80	1132.21	154.58	160.71	426.27	632.10	4426.43
Total	**919.70**	**193.56**	**1031.57**	**1009.79**	**6042.43**	**4352.23**	**993.07**	**801.82**	**1255.55**	**1852.43**	**18452.13**
1991-92											
Equalization	766.80	165.10	760.20	849.10	2906.30	0.00	719.10	338.70	0.00	0.00	6505.30
EPF	224.29	50.46	351.28	281.53	1519.60	3523.84	428.32	370.45	959.60	1091.68	8801.05
CAP	132.86	34.76	217.72	206.94	1546.50	2158.85	253.13	177.04	623.28	747.34	6098.40
Total	**1123.95**	**250.32**	**1329.29**	**1337.57**	**5972.40**	**5682.69**	**1400.55**	**886.19**	**1582.88**	**1839.02**	**21404.75**

*EPF cash transfer

basis, the provinces of the Atlantic region are the largest recipients of these transfers. Clearly the financial importance of these three programs differs among provinces. In 1986 (a "non-recession" year in Canada) the provincial governments of the Atlantic region received, on average, 43 percent of their revenue through these federal transfer payments. In contrast, these payments accounted for only 18 percent of the revenue of the Alberta provincial government.

The data in Tables 1A and 1B can also be used to identify some trends in the behaviour of these federal transfer programs over time. With the exception of Saskatchewan, the pattern of equalization payments to the provinces has remained relatively constant over the observation period. Ontario, Alberta and British Columbia were ineligible for equalization in 1982-83 and continued to be so in 1991-92. In total dollar terms, Quebec was the largest recipient of equalization in 1982-83 while the Atlantic region provinces received the largest per capita payments. This continued to be the case in the 1991-92 fiscal year. Two changes in federal transfer payment behaviour are also observable during the sample period. First, the relative size of the payments under CAP has increased markedly. In 1982-83, CAP payments accounted for 21 percent of the total transfers under these programs. By 1991-92, this figure had grown to 28 percent of the total. Second, the growth path of these transfer payments appears to be different between the 1982-83 to 1986-87 period and the 1986-87 to 1991-92 period. Over the *four*-year period from 1982-83 to 1986-87, total real per capita transfers from the federal government to the provincial governments expanded by 18.6 percent (about 4.4 percent per year average growth). Over the *five*-year period from 1986-87 to 1991-92, total real per capita transfers declined by 10.7 percent (about 2.0 percent per year average decline). Thus, a substantial decline of these programs has occurred during the latter part of the 1980's likely as a result, in part at least, of the constraint initiatives introduced by the federal government during this time period.

Table 1B: FEDERAL PAYMENTS TO PROVINCES UNDER EQUALIZATION, EPF AND CAP PROGRAMS (per capita in constant 1986 dollars)

	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
1982-83											
Equalization	932.44	1100.36	768.25	796.85	489.78	0.00	483.59	0.00	0.00	0.00	225.80
EPF	282.28	294.30	296.22	290.21	192.71	285.21	301.43	316.75	258.91	266.20	258.62
CAP	132.58	170.93	119.75	175.77	142.22	97.04	101.05	139.60	150.21	193.32	130.86
Total	**1347.30**	**1565.59**	**1184.22**	**1262.83**	**824.71**	**382.25**	**886.07**	**456.35**	**409.12**	**459.52**	**615.28**
1986-87											
Equalization	1069.72	973.23	642.15	809.99	410.05	0.00	387.77	229.50	0.00	0.00	205.58
EPF	398.98	395.12	396.98	406.16	277.52	353.34	395.14	405.26	349.17	422.41	349.30
CAP	150.49	155.75	142.51	204.09	236.36	124.24	144.33	159.12	179.48	218.80	175.17
Total	**1619.19**	**1524.10**	**1181.64**	**1420.24**	**923.93**	**477.58**	**927.24**	**793.88**	**528.65**	**641.21**	**730.05**
1991-92											
Equalization	1095.89	1041.84	692.92	958.12	348.31	0.00	538.24	278.69	0.00	0.00	198.31
EPF	320.55	318.42	320.19	317.68	182.12	291.82	320.59	304.81	312.13	278.73	268.30
CAP	189.88	219.35	198.45	233.51	185.34	178.78	189.47	145.67	202.74	190.81	185.91
Total	**1606.32**	**1579.61**	**1211.56**	**1509.31**	**715.77**	**470.60**	**1048.30**	**729.17**	**514.87**	**469.54**	**652.52**

*EPF cash transfers

OTHER FEDERAL PROGRAMS

The federal government also redistributes resources inter-provincially and inter-regionally through its direct transfers to persons and to businesses. These programs include Old Age Security, Family Allowances (which have been replaced in 1993 with child tax credits), Unemployment Insurance and a variety of subsidies and capital assistance programs to agricultural and non-agricultural firms. The interprovincal redistribution that occurs through these programs is partly deliberate (through such program features as regionally-based components of Unemployment Insurance and regional diversification elements of subsidies to business enterprises), but much is simply a side-effect of interprovincial and interregional differences in population age and gender, family composition, industrial structure, labour mobility and retirement location decisions.

Federal transfers to persons through Old Age Security, Family Allowances and Unemployment Insurance are presented in total current dollar terms in Table 2A and in per capita constant dollar terms in Table 2B. By comparing the data contained in Table 2A with that of Table 1A, it can be seen that these transfers to persons are larger than federal government cash transfers to provincial governments. Of the three programs summarized in Table 2A, Old Age Security and Unemployment Insurance payments are roughly of similar size, while payments through the Family Allowance program have been much smaller in total. Comparing Tables 1B and 2B we see that the interprovincial variation in federal transfers to provinces is also similar in pattern and size to that of federal transfers to provinces. The largest recipients on a per capita basis are residents of the Atlantic provinces. Finally, Tables 1B and 2B reveal an important difference in the time series behaviour of federal transfers to provinces and to persons. Federal per capita constant dollar transfers to persons rose by 26.5 percent between 1982 and 1991 (or by 18.6 percent if Unemployment Insurance payments are excluded) while per capita constant dollar transfers to provinces increased by 6.1 percent over the same period. While there has been an absolute real increase in both types of federal transfer, there has clearly been a relative substitution away from transfers to provinces and towards transfers to persons.

Table 2A: FEDERAL TRANSFERS TO PERSONS UNDER OLD AGE SECURITY, FAMILY ALLOWANCES AND UNEMPLOYMENT INSURANCE
(in millions of dollars)

	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
1982											
Old Age Security	218.0	67.0	403.0	312.0	2443.0	3184.0	479.0	461.0	624.0	1104.0	9295.0
Family Allowance	66.0	12.0	79.0	69.0	569.0	755.0	95.0	95.0	218.0	237.0	2195.0
UI	379.0	67.0	347.0	382.0	2859.0	2347.0	247.0	167.0	489.0	1146.0	8430.0
Total	**663.0**	**146.0**	**829.0**	**763.0**	**5871.0**	**6286.0**	**821.0**	**723.0**	**1331.0**	**2487.0**	**19,920.0**
1986											
Old Age Security	311.0	91.0	557.0	464.0	3430.0	4494.0	657.0	631.0	905.0	1594.0	13134.0
Family Allowance	71.0	14.0	89.0	76.0	622.0	879.0	111.0	113.0	260.0	278.0	2513.0
UI	614.3	120.1	489.8	545.6	3186.2	2482.7	320.9	280.8	983.3	1451.2	10474.8
Total	**996.3**	**225.1**	**1135.8**	**1085.6**	**7238.2**	**7855.7**	**1088.9**	**1024.8**	**2148.3**	**3323.2**	**26,121.8**
1991											
Old Age Security	406.0	112.0	713.0	573.0	4750.0	6210.0	844.0	818.0	1277.0	2231.0	17934.0
Family Allownace	67.0	15.0	93.0	78.0	685.0	1016.0	121.0	117.0	293.0	327.0	2812.0
UI	987.0	189.0	763.1	802.2	5360.3	5362.4	493.1	367.9	1202.0	2104.6	17631.8
Total	**1460.0**	**316.0**	**1569.1**	**1453.2**	**10,795.3**	**12588.4**	**1458.1**	**1302.9**	**2772.0**	**4662.6**	**38,377.8**

Table 2B: FEDERAL TRANSFERS TO PERSONS UNDER OLD AGE SECURITY, FAMILY ALLOWANCES AND UNEMPLOYMENT INSURANCE
(per capita in constant 1986 dollars)

	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
1982											
Old Age Security	438.18	624.78	539.38	509.25	430.10	416.26	527.53	536.81	306.65	450.49	431.40
Family Allowances	132.66	111.90	105.74	128.94	100.17	98.70	104.62	110.62	107.13	96.71	101.87
UI	761.79	624.78	464.43	623.51	503.34	306.84	272.02	194.46	240.31	467.63	391.26
TOTAL	**1332.63**	**1361.46**	**1109.55**	**1261.70**	**1033.61**	**821.80**	**904.17**	**841.89**	**654.09**	**1014.83**	**924.53**
1986											
Old Age Security	547.53	716.54	638.03	652.60	524.46	493.14	613.45	624.75	381.05	551.75	519.60
Family Allowances	125.00	110.24	101.95	106.89	95.11	96.46	103.64	111.88	109.47	96.23	99.42
UI	1081.51	945.67	561.05	767.37	487.19	272.43	299.63	278.02	414.02	502.32	414.40
TOTAL	**1754.04**	**1772.45**	**1301.03**	**1526.86**	**1106.76**	**862.03**	**1016.72**	**1014.65**	**904.54**	**1150.30**	**1033.42**
1991											
Old Age Security	580.24	706.76	649.90	646.57	569.27	514.27	631.73	673.06	415.38	569.62	546.71
Family Allowances	95.75	94.66	84.77	88.01	82.09	84.38	90.57	96.27	95.31	83.49	85.72
UI	1410.59	1192.65	695.56	905.20	642.41	444.08	369.08	302.71	390.98	537.19	537.50
TOTAL	**2086.58**	**1994.07**	**1430.23**	**1639.78**	**1293.77**	1042.73	**1091.38**	**1072.04**	**901.67**	**1190.30**	**1169.93**

The data provided in Table 3 summarize federal transfers to business enterprises in both total current dollar and per capita constant 1986 dollar terms. As these data reveal these transfers have behaved much differently than those to provincial governments and to persons. First, these payments have been considerably smaller than the federal payments arising from the other transfer programs. Second, in real per capitaterms, total transfers to businesses have declined since 1982. Third, business transfers exhibit more cross-province variation over time than do transfers to provincial governments or to persons.

INTERPROVINCIAL REDISTRIBUTION THROUGH FEDERAL TRANSFER PROGRAMS

The net interprovincial redistribution of resources through federal transfer programs occurs through a combination of the pattern of expenditures across provinces on these programs as detailed above and the pattern of revenue collection to finance these programs. Each of the transfer programs, with the exception of Unemployment Insurance, is financed entirely through the general revenues of the federal government. Unemployment Insurance payments are financed through a combination of premia paid by employers and employees and general revenues when these

Table 3: FEDERAL TRANSFERS TO BUSINESS

	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	TOTAL
1982											
millions of dollars	295	39	583	574	2218	1480	252	590	1116	468	7615
per capita, constant 1986 dollars	592.95	363.68	780.30	936.89	390.49	193.49	277.53	687.02	548.43	190.97	353.43
1986											
millions of dollars	479	37	315	144	1307	1512	480	1212	846	354	6686
per capita, constant 1986 dollars	843.31	291.34	360.82	202.53	199.85	165.92	448.18	1200.00	356.21	112.53	264.51
1991											
millions of dollars	181	84	233	240	1783	2472	649	1429	1185	628	8884
per capita, constant 1986 dollars	258.68	530.07	212.38	270.82	213.69	204.71	485.77	1175.80	385.45	160.34	270.83

Source: Provincial Economic Accounts

Table 4: NET REDISTRIBUTION AMONG PROVINCES FROM FEDERAL TRANSFERS TO PROVINCES, PERSONS AND BUSINESS
(per capita in constant 1986 dollars)

	NFLD	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC
1982										
Transfers to Provinces	1107.51	1193.61	718.73	873.24	410.38	-328.41	419.60	-98.97	-672.27	-157.10
Transfers to Persons	906.51	792.63	394.83	626.77	336.44	-232.58	162.99	30.28	-839.36	82.43
Transfers to Business	454.26	149.20	515.29	713.28	142.43	-214.67	8.81	367.96	-72.73	-163.22
TOTAL	**2468.28**	**2135.44**	**1628.85**	**2213.25**	**889.25**	**-775.66**	**591.40**	**299.27**	**-1584.36**	**-237.89**
1986										
Transfers to Provinces	1327.46	1094.49	611.68	953.59	303.06	-451.88	376.28	318.81	-248.00	-23.19
Transfers to Persons	1241.20	1118.11	465.06	811.53	195.57	-405.35	173.67	299.01	-184.00	196.26
Transfers to Business	737.68	133.86	153.49	33.76	-25.08	-170.85	248.37	1027.72	74.53	-118.03
TOTAL	**3306.34**	**2346.46**	**1230.23**	**1798.88**	**473.55**	**-1028.08**	**798.32**	**1645.54**	**-357.47**	**55.04**
1991										
Transfers to Provinces	1209.08	1173.72	626.20	1026.84	159.04	-305.75	551.64	270.71	-153.53	-208.09
Transfers to Persons	1334.85	1211.59	402.88	731.20	263.78	-316.01	151.94	235.32	-316.17	-18.64
Transfers to Business	94.33	359.69	-30.99	69.96	-17.38	-117.51	279.94	985.73	107.99	-121.02
TOTAL	**2638.26**	**2745.00**	**998.09**	**1828.00**	**405.44**	**-739.27**	**983.52**	**1491.76**	**-361.71**	**-347.75**

premia are insufficient to meet benefit payments. Estimates of these net redistributions through federal transfers are provided in Table 4.

To obtain these estimates of net interprovincial redistribution, it was necessary to determine each province's share of the cost of the transfer programs. For each program, other than UI, this share was calculated as the province's share of federal general tax revenue. For UI the share is composed of UI premia collected in the province plus the province's share of general tax revenue required to finance payments above premia collection (UI expenditures exceeded premium collections for each of the three years summarized in Table 4). A province's contribution to the cost of a federal transfer program is calculated as the proportion of federal revenues generated from that province multiplied by total program expenditures. Thus, the calculations are based upon a "balanced budget" restriction being imposed on federal expenditures.

Table 4 provides estimates of net interprovincial redistribution in per capita constant 1986 dollar terms. These data are consistent with previous studies of regional disparities and federal transfers. The Atlantic provinces are consistently large net recipients of redistribution. Manitoba and Saskatchewan have benefitted from increased net transfers of resources over the time series of observations.

These net redistributions have typically been away from Ontario, Alberta and British Columbia.

Two characteristics of these redistributional data may be worth noting. First, the federal programs for a given province do not all transfer resources in the same direction. There are cases where provinces receive a net inflow of resources under one set of federal transfers and a net outflow under another set. This lack of consistency is particularly apparent in the case of net transfers to business. Second, the cross-province variation in per capita real net redistribution has declined over time. The standard deviation of net total per capita transfers was 1296 in 1982, 1241 in 1986 and 1170 in 1991.

TAXATION

Most major tax fields in Canada are jointly occupied by federal and provincial governments. As deficit pressures increased, both orders of governments have taken a number of measures which limit the room to manoeuvre for their co-occupant. An example of this is the replacement of the Manufacturers' Sales Tax with the Goods and Services Tax by the federal government in 1991. This was perceived as a major incursion into a hitherto solely provincial tax field. Interestingly, some of the perceived wisdom regarding the sharing of tax fields is not borne out by the data. In Table 5 we present the federal shares of selected tax fields for three years[4]: 1982, 1986 and 1991. We can see that since 1986, the federal presence in the two fields in which it is dominant: direct personal tax and direct corporate tax, has declined by 2 and 9 percentage points respectively. The federal presence in the indirect tax field has risen by only 1 percentage point, while the federal government's share of total tax has risen by only 1 percentage point – just about equal with the provinces' share.

In Table 6 we see that provincial governments have come to rely much more heavily on direct personal tax and indirect tax, increasing their contributions to total provincial revenue by 6 and 4 percentage points respectively. Since 1982 the provinces have seen a steady decline in federal transfers (3 percentage points) and in the residual category which includes natural resource revenue (7 percentage points). In an important sense, the Canadian federation has become less-centralized as provinces now rely less-heavily on federal transfers to fund their spending. Of course, these aggregate numbers obscure some very different effects for particular provinces (especially in the area of indirect taxes and federal transfers) and this has led to differential pressures on provincial budgets.

Table 5: FEDERAL SHARES OF CANADIAN TAX FIELDS

Year	Direct Personal Taxes	Direct Corporate Taxes	Indirect Taxes	Other	Total
1982	0.59	0.78	0.50	0.28	0.47
1986	0.62	0.71	0.45	0.35	0.48
1991	0.60	0.69	0.46	0.40	0.49

Table 6: SOURCES OF PROVINCIAL REVENUE (shares)

Year	Direct Personal Taxes	Direct Corporate Taxes	Indirect Taxes	Federal Transfers	Other
1982	0.30	0.03	0.24	0.21	0.22
1986	0.30	0.04	0.27	0.20	0.18
1991	0.36	0.03	0.28	0.18	0.15

3. CURRENT ISSUES

A number of forces are contributing to the growing strain on the fiscal system which supports the Canadian federation. The most important force comes from the needs of both orders of government to control and ultimately reduce their deficits. Another is the normal competition between the federal government and of the larger provinces to play a dominant role in a particular region. Finally, although they play a much less important role than deficit pressures, are concerns relating to the competitiveness and efficiency of the Canadian economy. With these forces in mind, in this section we will briefly outline some of the current issues being raised in discussing the need to reform the current fiscal system. As in Section 2, we will present these issues under three main headings: Major transfers, Other Federal Programs and Taxation.

MAJOR TRANSFERS

The first of the explicit major transfer programs we consider is CAP. The main issue identified with this program is the 1990 decision by the federal government to limit the growth of this cost-shared transfer program for the three provinces which do not receive equalization. In the middle of a deep recession, with social assistance costs rising rapidly, this federal measure had a significant effect on the revenues and deficits in at least two of the provinces. In addition, the measure marked a fundamental change in the fiscal system – for the first time, the federal government treated social assistance recipients differently depending on their province of residence. As we noted above, previously this was an open-ended transfer program which depending on caseload and the benefit levels set by provinces – an obvious concern to a deficit-conscious federal government. Now, at least, program growth is limited in three of the provinces.

The second major transfer program we consider is EPF. The key issue here is the current reductions in EPF cash transfers which have been ongoing for the past several years. The federal government insists that the sum of the original tax point transfer plus cash transfer continues to grow. Provinces respond that taxes they collect themselves can hardly be considered an ongoing transfer from the federal government and thus, the declining cash is the issue.[5] Again, with health and post-secondary education costs rising, federal support in these areas is declining.

The final major transfer program is equalization. The key issue here is the federally-imposed limit to growth in equalization payments. This limit resulted in a substantial reduction in revenue to provinces receiving equalization. In 1992, the federal government agreed to `rebase' equalization payments to what they would have been without the limits. The provinces countered that this move did not replace foregone revenue and, in any case, the limit remained on future equalization growth.

OTHER FEDERAL PROGRAMS

Since the failed constitutional round of 1992, there has been little discussion of the federal programs which contain important implicit transfers between regions. There has been some movement to integrating unemployment insurance and training in Quebec which was announced in a meeting between Prime Minister Campbell and Premier Bourassa. However, the magnitude of the intended changes is unclear as yet. It may be that more of these programs will be scrutinized following the next federal election in October.

TAXATION

A number of issues have surfaced over the last several years related both to sales and income taxation. On the sales tax side, the federal government moved in 1991 into the retail sales tax field when it replaced the Manufacturers' Sales Tax (MST) with the Goods and Services Tax (GST). This was viewed by provinces as an incursion into a tax field which they had regarded as their own, and federal expectations that provinces would soon harmonize their tax systems with the GST proved to be unfounded. In addition to replacing the MST, the GST was designed to raise an additional 25 percent more revenue to pay for its administration and to combat its regressivity with low-income tax credits delivered though the federal income tax.

On the income tax side, provinces have pressed the federal government for several years to move from the current system where (except for Quebec, which collects its own income tax) provincial tax is calculated as a percentage of federal tax to one where provincial tax is calculated directly as a percentage of taxable income. Currently, changes in federal tax policy impact immediately on provincial tax revenue unless a province takes explicit steps to offset the federal measure. Last year, the federal government released a discussion paper which considered a move to `tax on income'. Some of the Western provinces have threatened to administer their own personal income tax (as Quebec does) unless they gain the added flexibility inherent in tax on income.

4. PROPOSALS FOR REFORM

Keeping in mind the issues discussed in the previous section, what proposals are being considered to reform the Canadian federation's fiscal system? Proposals for reform come from a number of sources including working groups of government officials[6], politicians and academics. In this section, we outline some of the proposals and suggest an overall organizing framework within which to compare them. Again we consider Major Transfers, Other Federal Programs and Taxation in turn.

MAJOR TRANSFERS

Many of the recent changes to the major transfer programs have been driven by deficits at the federal level, and have, in turn, exacerbated provincial deficits. Thus, it is not surprising that most of the proposals for reform seek to alleviate these problems either for the federal or provincial governments. The first of the major transfer programs, CAP is a good example of the pressures on the federal government. As it stands, the federal government has converted the open-ended commitment of this cost-shared program to a more- manageable one with the five-percent limit on CAP growth for the three provinces ineligible for equalization. The open-ended commitment remains for the other seven provinces. To further control the growth of its commitment, it has been proposed to convert the program entirely to block funding. However, this still leaves open the question of how fast the program would be allowed to grow.

While some provinces would like CAP restored to a full cost-shared program, others have proposed that the federal deficit problem could be alleviated by changing the cash transfer to tax points. This option would remove CAP's ongoing claim on federal revenues, but would reduce federal presence in this social policy field. An additional question for CAP reform is whether the `equalization' feature recently introduced by the federal move to limit CAP growth for some provinces and not others, should be eliminated or preserved in a reformed program.

The second major transfer program, EPF, is currently block funded, and thus represents a closed-end (in fact, declining) commitment for federal tax revenue. While some provinces seem to be arguing for a return to pre-1977 cost sharing for this program, others have argued strongly for converting the currently declining cash transfers to tax points. Provinces receiving equalization would, understandably, argue that these tax points should be equalized. To date, there has been little public discussion on alternative means of limiting future contributions to the federal government from this transfer program. For example, it might be useful to consider defining the growth rate of EPF (and CAP as well) as a function of federal revenue rather than GDP.

Discussions surrounding the reform of equalization have mostly centred around the equalization ceiling, and with the recent `rebasing' of equalization by the federal government, the importance of this issue has declined for the present. Ongoing discussions have looked at the technical aspects of the equalization program such as the composition of the base subject to equalization and measures to make equalization payments more predictable. Some provinces have argued that equalization should be based on need rather than the current standard, but provinces not eligible for equalization have not been enthusiastic about this proposal. There has been little discussion outside academic circles of more sweeping reforms such as moving to a system of net transfers, perhaps with equalization explicitly administered by the provinces.[7]

OTHER FEDERAL PROGRAMS

Since the failure of the Charlottetown Accord, there has been little discussion of reforming the federal programs which imply large inter-regional transfers. While there has been some minor overall tightening of the UI provisions, little has changed. Many academics has argued for stripping UI of its current role of providing general welfare to some regions of Canada and returning it to a true insurance scheme. However, the political cost of these changes, especially in Atlantic Canada, have, to date, dissuaded any government from tackling this issue. It is noteworthy that the federal government is turning to UI as its principal method of dealing with the (probably long-term) close of Atlantic fisheries. As mentioned above, Ottawa and Quebec have had some discussions regarding integration of federal and provincial programs on job training, and presumably this would also be integrated, at least to some extent, with UI.

TAXATION

Provinces, especially those in the Western Canada, have pressed for some time for reform of the personal tax system which would allow provincial tax on taxable income rather than federal tax. This would insulate provincial tax revenues from changes in federal tax policy and give provinces additional flexibility to use tax policy. In 1992, the federal government released a discussion paper which seemed to indicate some willingness to move in this direction if provinces were willing to impose limits on their ability to use the added flexibility. With respect to the other major tax issue, outside Quebec, little has been done to harmonize provincial sales taxes with the GST.

As with major transfer reform, academics have considered more sweeping changes to the tax system. Recent papers have argued for moving away from joint occupancy of tax fields and the assignment of some the major tax fields either to federal or provincial governments.[8] Although academics do not all agree on how the fields should be assigned, it will be interesting to see whether this debate reaches the political level.

A FRAMEWORK FOR ORGANIZING REFORM OPTIONS

With the bewildering array of reform options to consider, it is useful to attempt to classify them in a framework which allows them to be more easily compared. Any number of possible classification schemes are possible, but none are likely to be wholly satisfactory. One approach is to return to the three forces we earlier identified as underlying much of the current dissatisfaction with the Canadian fiscal system: deficit pressures, inter-governmental competition and concerns regarding competitiveness. It is clear that unless there is a fundamental change in the level of government services that are ultimately delivered (or the method for delivering them), the process of cutting transfers or shifting program responsibility will have no net effect on the combined deficits of both orders of government. Clearly, most of the proposals discussed by governments (with some exceptions) do not represent this kind of fundamental reform and thus organizing them according to their impact on federal or provincial deficits is unhelpful.

If impact on deficits is not a useful organizing framework, the alternative is to return to a well-worn framework for organizing issues in Canadian federalism:

Table 7: FRAMEWORK FOR ORGANIZING REFORM OPTIONS			
	Major Transfers (CAP, EPF, Equalization)	**Other Federal Programs (eg. UI, tax credits)**	**Taxation**
More-centralized federation	- return EPF and CAP to to full cost-share - full cash transfer (eliminate tax points) - all transfers equalized - gross equalization	- maintain/increase fed regional programs - more fed social policy through tax system	- more fed social policy through tax system - resist provincial differences - feds dominate joint fields
Less-centralized federation	- block fund CAP - full tax point transfer (eliminate cash) - net equalization	- devolve fed regional programs - less fed social policy through tax system	- less fed social policy through tax system - change transfers to tax points - net equalization

the competition between Ottawa and the provinces to be the dominant force in providing government services. In Table 7 we look at the proposals regarding our three components of the fiscal system, Major Transfers, Other Federal Programs and Taxation in terms of whether they will lead to a more-centralized (bigger role for Ottawa) or decentralized (bigger role for provinces) federation.

Beginning with proposals regarding Major Transfers, a move to return EPF and CAP to full cost-sharing would reinforce the declining federal presence in these areas, and in the interest of deficit control, would probably have to give the federal government a voice (if not a veto) in deciding how these programs would be designed and allowed to grow in the future. This more-centralized alternative can be contrasted with one which would move CAP to block funding or one in which both EPF and CAP became a sole provincial responsibility accompanied by an appropriate one-time transfer of tax room. On the equalization front, the current system of gross equalization (administered by the federal government) could be maintained or expanded to account for fiscal need in a more-centralized federation or transformed to a system of net equalization funded by provincial revenues in a less-centralized federation.

Turning to Other Federal Programs, a more-centralized federation would be enhanced by maintenance or enlargement of UI or federal regional development programs, and the direct delivery of more federal social policy, for example a national day-care scheme or national education initiative. A less-centralized federation would be enhanced by a diminished federal presence in UI and regional development, and less direct federal social policy.

Finally, under the heading of Taxation, proposals consistent with a more-centralized federation would include delivering more programs in the areas of traditional provincial responsibility through the tax system, resisting provincial efforts to levy differential taxes and moving to dominate jointly-occupied tax fields. Proposals consistent with a less-centralized federation would include less reliance on the tax system to deliver federal social policy, and transferring more tax room to the provinces both to fund social programs (in the place of the current federal cash grants) and to implement a scheme of net equalization.

Of course, the impact these different proposals would have on the federal and provincial deficits depends on their details and the particular bundle of proposals considered. However, it is probably fair to say that most of the proposals (without additional fundamental changes) which move Canada to a less-centralized federation tend to reduce the federal deficit and increase provincial deficits, while the opposite is true (other things equal) of the proposals which would lead to a more-centralized federation. This is not surprising given our finding, in Section 2, that the federation was, in fact, becoming less-centralized over the period in which federal deficit reduction was a stated priority.

5. An Alternative Approach to Fiscal Reform

As we have seen, many of the recent changes to the Canadian fiscal system have been driven by the pressure to reduce budget deficits. To date, this has mostly been a zero-sum game in which any declines in federal deficits have translated directly into increases in provincial ones. Most of the proposals likely to be considered by governments in the upcoming round of negotiations will continue in this vein. The federal government will seek ways to control its expenditure and yet maintain its policy influence, while provinces will seek to protect their revenues and (in some cases) maintain or recover their dominance in their traditional areas of jurisdiction. One worrisome side-effect of current trends is the tendency for two mutual-interest coalitions to form among the equalization-paying provinces and the equalization-receiving provinces (plus the federal government). Given this dynamic, it is hard to see how the upcoming negotiations will reduce the growing strain on the Canadian federation.

To conclude this overview, we offer a few brief observations on an alternate approach to the process of reforming the Canadian federal fiscal system. Our approach is practical in the sense that it recognizes the pressures exerted by deficits. However, it is optimistic in that is requires political leaders and public servants to consider defining their roles and responsibilities according to a new set of principles instead of the historical struggle between federal and provincial governments.

We begin by stating two (perhaps, self-evident) facts. The first is that while deficit pressures may be the catalyst to reforming the fiscal system, their elimination is *not* the goal of fiscal reform. Rather, budgetary balance should be a constraint placed on the design of a fiscal system whose goal is to finance the delivery of the appropriate bundle of government services to citizens as efficiently and equitably as possible. The second fact is that a bias toward larger government and, perhaps, larger deficits is inherent in the current system. This bias comes from the perverse incentives built into some programs like UI, but also from the fiscal illusion and loss of accountability which occurs when most federal programs are expected to redistribute income as well as provide government services.

With these facts in mind, our alternative process for reforming the fiscal system proceeds in three steps. In the first step, it is necessary to consider what governments do, and decide, according to some rational principles, how these functions should be allocated among federal, provincial and municipal governments.[9] These principles might include accommodating differences in citizens' preferences, dealing with externalities, and accounting for economies of scale. The magnitude of this task is difficult to overestimate. Luckily for us, it should be possible to accomplish it without attempting to change the Constitution.

The next step in the process is to deal with issues relating to redistribution. Clearly, a major feature of our federation is the redistribution of income among regions as well as individuals. Questions regarding redistribution to whom and by how much cannot be avoided. However, it will be important, wherever possible, to separate redistribution for the provision of government services, both because this separation allows citizens to make informed decisions regarding size and direction of the redistribution, and because it may help to avoid the perverse incentives and rent-seeking which characterize some current federal programs.

The final step in the process is to use the allocation of spending responsibilities as the *primary* guide[10] to the allocation of tax fields. Most of the services provided by government are essentially private in nature and thus, leaving aside income redistribution, the cost should be borne as nearly as possible by the recipients of the service. This means if the benefits of a government service accrue mostly within a given region, then the residents of that region should bear the cost. When the recipients of government services bear the cost, it become easier to determine the appropriate size of government: it is the size that citizens are willing to pay for. This re-establishment of the link between benefits and cost of government will make an important contribution to designing a fiscal system which respects the budget-balance constraint.

Of course, this process for designing a new fiscal system for Canada is much more ambitious than the traditional approach of having working groups of public servants make private recommendations to politicians. At a minimum, it will require public debate and consultation at a regional and national level. A great deal of costly effort and political will would be required. For Canada, the cost of not making fundamental changes in the current system may be much greater.

NOTES

1. For a recent look at the history of fiscal federalism, See Norrie (1993).
2. See Courchene (1978) for a discussion of the effects of some of these programs.
3. The tables that follow update the work of Reid and Snodden (1992).
4. These data are reported from calendar rather than fiscal year because they are derived from national accounts sources.
5. For a discussion of this issue, see Boothe and Johnston (1993).
6. Federal and provincial officials from finance ministries began meeting to consider changes to the major transfer programs well in advance of the initial expiry date of 1992.
7. For discussions of provincially-administered equalization schemes, see Courchene (1984) and Dahlby and Wilson (1993).
8. See, for example, Dahlby (1992), Ip and Mintz (1992) and Ruggeri et. al. (1993)
9. A recent attempt at this is found in Boothe (1992).
10. We recognize that other considerations, such as the mobility of tax bases, may also need to be considered.

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