

# A New Division of Canada's Financial Resources

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Report

*COMMISSION ON FISCAL IMBALANCE*

*A NEW DIVISION OF CANADA'S  
FINANCIAL RESOURCES*

*REPORT*

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## **PREFACE FROM THE PRESIDENT OF THE COMMISSION**

*Less than a year ago, the Québec government set up a commission to study the fiscal imbalance between the federal government and Québec. The Commission on Fiscal Imbalance has now completed its work and the results are contained in this report.*

*Fiscal imbalance is a difficult concept, encompassing complex issues tied to established fiscal relations between the federal government and the provinces, with both qualitative and quantitative dimensions. Its very definition had to be clarified, and of course, the Commission had to be in a position to assess and analyse the phenomena tied to fiscal imbalance with the necessary depth and rigour.*

*The Commission adopted an approach based primarily on deepening its understanding and analysis, extending the studies and assessments already available, and systematically examining the hypotheses submitted to it, all the while avoiding any a priori positions in its deliberations. At the same time, the Commission tried to remain as close as possible to the practical issues, since fiscal imbalance directly concerns Quebecers, and the Commission had no intention of losing sight of this reality at any time.*

*Specific studies were undertaken to answer certain precise questions. The Commission received analyses from many experts, including specialists from other countries. Public hearings also provided an opportunity to hear the views of many spokespersons of various groups and citizens interested in the debate.*

*In addition to confirming the existence and showing the scope of the fiscal imbalance, the Commission's work produced a set of recommendations to correct the situation.*

*The recommendations were formulated constructively, from a practical concern to advance the debate. They are important recommendations that outline what could become a new structure of financial and fiscal relations within the Canadian federation. At the same time, the Commission has examined ways of responding in the future to any new cause of fiscal imbalance and has made a number of suggestions in this respect.*

*Now that the Commission has concluded its work, I want to acknowledge the remarkable cooperation and contribution of each commissioner and the secretariat staff. The Commission on Fiscal Imbalance consisted of people from very different backgrounds, but experts in their respective fields. The report is the result of a joint effort stemming from approaches and concerns that often differed, but were always relevant, contributing to its depth and its interest.*

*The Commission is convinced that it has at least shed light on key facets of a topic as complex and important as fiscal imbalance and that it has fulfilled its mandate.*

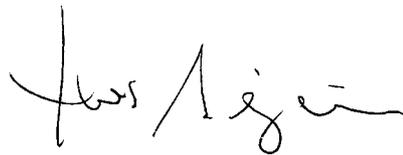
**YVES SÉGUIN**

*President of the Commission on Fiscal Imbalance*

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## SIGNATURES OF THE COMMISSIONERS

Signatures of the members of the Commission on Fiscal Imbalance.



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Yves Séguin, President



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Anne-Marie D'amours



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Renaud Lachance



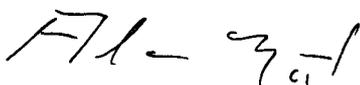
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Andrée Lajoie



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## SUMMARY

The Québec government formed the Commission on Fiscal Imbalance on May 9, 2001 to identify and study the causes of fiscal imbalance between the federal government and Québec, its actual consequences and the practical solutions that could be implemented to correct it.

The Commission's report deals with these issues first by confirming the existence and scope of fiscal imbalance. The Commission considered that its deliberations were situated within the current constitutional framework, and that when relevant and possible, the analysis had to be broadened to all provinces of Canada.

### **Nature of the problem**

Fiscal imbalance has been one of the major issues of the Canadian federation since the mid-1990s. At that time, the federal government made major cuts to payments under the Canada Health and Social Transfer (CHST), while provincial social spending was rising sharply.

#### *Broad consensus on its existence*

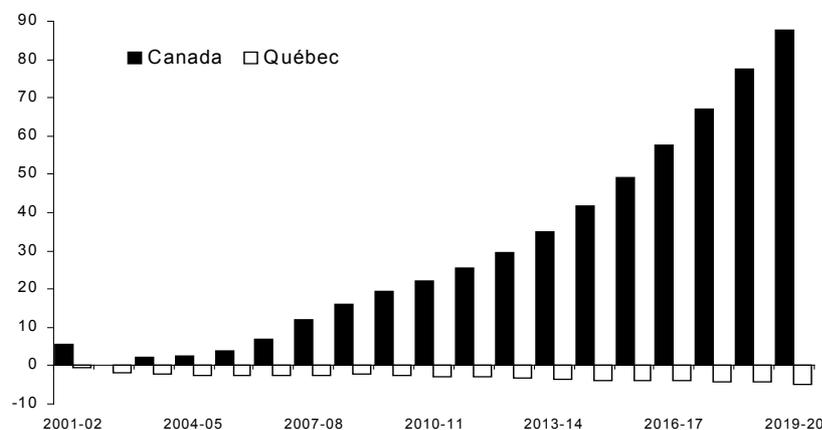
Though the federal government disputes the existence of fiscal imbalance, the public hearings held by the Commission confirmed a broad consensus in Québec in this regard. A survey conducted on the initiative of the Commission in Québec and in Canada as a whole confirms this fact: the public and the players most directly involved in the debate are aware that there is a significant fiscal imbalance to the detriment of the provinces.

#### *Projections by the Conference Board of Canada*

The current and projected budget balances of the two orders of government provide an initial direct expression of this imbalance and its scope. The study carried out by the Conference Board of Canada at the Commission's request is revealing in this regard: according to these projections, if current revenue and program structure is maintained, the Québec government would post recurring deficits averaging \$3 billion each year until 2019-2020. At the same time, the federal government would achieve ever-greater surpluses reaching almost \$90 billion in 2019-2020.

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**BUDGET BALANCE OF THE FEDERAL GOVERNMENT AND THE QUÉBEC GOVERNMENT, 2001-2002 TO 2019-2020**  
(billions of dollars)



Source: Conference Board of Canada.

### The causes of fiscal imbalance

The fiscal imbalance between the government of Canada and the Québec government and, more generally, between the federal government and the provinces, stems essentially from three separate causes, namely imbalance between spending and access to sources of revenue, the inadequacy of intergovernmental transfers from the federal government to the provinces and the “federal spending power.”

#### Imbalance between spending and access to sources of revenue

In its study, the Conference Board of Canada explicitly identified the first cause of fiscal imbalance: there is a structural difference between the federal government and the Québec government from the standpoint of revenue and spending.

- ◆ In the case of the federal government, the current positive discrepancy between revenue and spending will grow steadily because of the debt repayment that the discrepancy will make possible.
- ◆ For Québec, the balance between revenue and spending is much more precarious, which explains why the government cannot reduce its debt and the projected budgetary balance is negative throughout the forecast period.

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**TOTAL REVENUES AND EXPENDITURES OF THE FEDERAL GOVERNMENT  
AND THE QUÉBEC GOVERNMENT, 2000-2001 TO 2019-2020**  
(average annual change in per cent)

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	Federal Government	Québec
Total revenues	3.2	3.1
Total expenditures	2.1	3.6
<b>Discrepancy between growth in revenues and expenditures</b>	<b>1.1</b>	<b>-0.5</b>

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Sources: Conference Board of Canada.

A more detailed, systematic analysis of the main categories of expenditures and revenues of the two orders of government confirms that the provinces are subject to considerable pressure as regards spending, while the division of revenue does not reflect this dynamic.

Furthermore, debt service and repayment, which the federal government often mentions to justify its budget surpluses, in fact exacerbate fiscal imbalance by allowing the federal government to increase its leeway year after year.

*Inadequate intergovernmental transfers*

Transfers between the federal government and the provinces, the second cause of fiscal imbalance, explain many of the problems currently plaguing the Canadian federation in terms of fiscal relations among governments.

- ◆ The CHST is the most problematic transfer program. It applies to fields of jurisdiction attributed to the provinces, and its attendant conditions, as well as its defining terms, clearly limit the provinces' decision-making and budgetary autonomy in these fields of jurisdiction. The federal government's cuts in recent years confer a particular dimension on these difficulties.
- ◆ Equalization, whose purpose is to reduce disparities in fiscal capacity among the provinces, fails to eliminate major differences in the fiscal capacities of the provinces because it applies a five-province standard. The ceiling on equalization entitlements imposes an arbitrary limit on payments, further impeding it from achieving its objective. The formula for allocating the impact of the ceiling on equalization payments is inequitable and particularly penalizes Québec.

The tax bases used to determine equalization entitlements are ill-defined or incomplete. For instance, the property tax base is calculated using a formula that does not correspond to the actual situation of property values, which deprives Québec each year of about \$800 million. Equalization payments sometimes vary considerably over time and this variability is

caused in part by the mechanics of revising the data and technical changes, which is difficult to accept. Furthermore, “tax-back,” with which the Commission dealt specifically, can exacerbate fiscal imbalance for the provinces concerned.

The “federal spending power”

Conditional transfers, such as the CHST, are one expression of the “federal spending power” the federal government invokes to intervene in provincial fields of jurisdiction.

- ◆ Given the amounts in question, federal intervention through the “federal spending power” has a considerable impact on provincial policy in the provinces' fields of jurisdiction. This impact had a destabilizing effect when the federal government withdrew from several programs or, more broadly, when it reduced social transfers overall.

This impact is likely to recur in new sectors of federal government intervention, for example, in health care and education, where direct, one-off, visible expenditures are preferred to system-wide expenditures, which are largely the provinces' responsibility.

In a broader perspective, federal initiatives distort the provinces' budgetary choices by favouring certain sectors or approaches to the detriment of other options.

- ◆ Federal government initiatives in conjunction with “federal spending power” in the provinces' fields of jurisdiction are, ultimately, only possible because of the resources available to the federal government, which exceed those that it needs to assume its jurisdiction.

The “federal spending power” is therefore directly tied to the division of tax fields between the two orders of government. A fiscal gap in favour of the federal government can only aid and abet intervention in the provinces' fields of jurisdiction since it can mobilize substantial resources and allocate them at its discretion in fields that it deems strategically or politically worthwhile.

Québec's traditional responses to the “federal spending power” reflect the logic of fiscal balance and the means by which the current fiscal imbalance could be brought to an end.

## **Consequences of fiscal imbalance**

Fiscal imbalance, because of its scope, has a significant impact on provincial government operations and accordingly the delivery of public services. Furthermore, the practical result of the encroachment on the provinces' decision-making and budgetary autonomy is that in the provinces, the choices of people are not taken into account precisely where they should be.

### *Needs are poorly addressed*

During its public hearings, the Commission heard many accounts that confirm the impact of the fiscal imbalance and the resulting lack of resources for Québec, as far as the addressing of needs is concerned.

### *Less efficient delivery of services*

However, the consequences of the fiscal imbalance are not measured solely in terms of unaddressed or poorly satisfied needs. The various dysfunctions in fiscal relations between governments mean that the delivery of public services is less efficient than it could be.

The definition, administration and delivery of social programs and public services suffer directly from the problems identified, particularly the operating terms and conditions of transfer programs.

- ◆ There is uncertainty concerning the size of the amounts transferred.
- ◆ Some transfer payment procedures introduce a dynamic that distorts the prioritization of needs.
- ◆ Federal interventions in provincial fields of jurisdiction are costly in terms of efficiency because of the resulting duplication. The Commission places particular emphasis on the problem of accountability raised by the simultaneous presence of two orders of government in the same field of intervention.

### *Compromised decision-making and budgetary autonomy*

At an even more basic level, fiscal imbalance raises the whole question of respect for the provinces' decision-making and budgetary autonomy, and accordingly of people's capacity to make their own choices in fields defined by the Constitution – which is the very basis of federalism.

Québec, with its specific needs and collective preferences tied to its unique situation in North America, is obviously very sensitive to the ability to make its own choices in such basic areas as health, education and social assistance.

## Recommendations

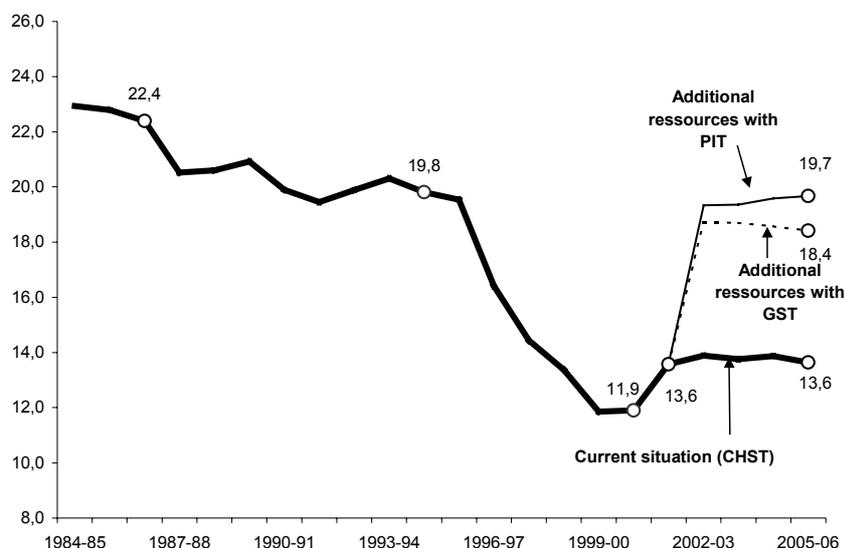
Fiscal imbalance thus constitutes a dysfunction of the federal system. To eliminate it, major transformations are needed in intergovernmental fiscal relations within Canada. The transformations identified by the Commission provide a blueprint of what would be a Canadian federation that respects more closely the principles of federalism, in the short and medium term.

### Restore fiscal balance within the federation

- ◆ The provinces must have additional financial resources to address the needs within their fields of jurisdiction. In Québec's case, such resources are estimated at an annual \$2 billion in the short term, \$3 billion in the medium term, and at least \$8 billion for the provinces overall.
- ◆ The terms and conditions governing the existing division of resources must be changed, by eliminating the CHST and freeing a new tax room for the provinces.
  - The Commission recommends the elimination of the CHST and its replacement by a new division of tax room, because of the assured and predictable nature of the source of funds to which the provinces would have access, its unconditional nature and the greater accountability that would result.
  - The Commission expresses its preference for an occupation of the GST field by the provinces. In light of the financial objective adopted, the federal government should entirely relinquish the GST in favour of the provinces. However, the Commission does not wish to reject the scenario calling for a new division of the personal income tax field.
  - In both instances, the new division of tax room would focus on the equivalent of between \$26 and \$27 billion for Canada as a whole, i.e. the amount of the existing CHST, to which would be added the additional financial resources freed for the provinces.
  - The Commission believes that the new division of taxation must not lead to federal government deficits. This is possible if the new division is implemented gradually and account is taken of actual federal government surpluses. Priority should be given to allocating future surpluses to the new division of tax room in favour of the provinces.

The new division of tax room the Commission is recommending would restore funding previously supplied by the CHST: the tax room Québec would obtain would represent from 18.4% to 19.7% of funding for health, post-secondary education and income security in 2005-2006, whereas the CHST provided 19.8% of this funding in 1994-1995, subsequently falling to 11.9% in 2000-2001.

**CURRENT CHST AND ADDITIONAL FINANCIAL RESOURCES QUÉBEC WOULD GAIN AS A PROPORTION OF ITS SPENDING ON HEALTH, EDUCATION AND SOCIAL SERVICES, 1984-1985 TO 2005-2006**  
(as a percentage)



Note: CHST including special Québec abatement and excluding federal trust accounts.

Sources: Commission on Fiscal Imbalance; Gouvernement du Québec, 2002-2003 budget; Conference Board of Canada.

- ◆ The equalization program must be improved.
  - The Commission is of the opinion that equalization payments must be defined using a standard that reflects the average fiscal capacity of all of the provinces, i.e. the ten-province standard, which would replace the existing five-province standard. The shift to the ten-province standard should be effected gradually to allow for the impact of this change on federal public finances and prevent it from leading them into deficit. However, the federal government should clearly consider the ten-province standard as the objective to attain by indicating the percentage of equalization paid in relation to the amount that would result from its full application.
  - The Commission recommends the elimination of the “ceiling” and “floor” provisions so that the equalization program can satisfy its objective more adequately and to improve its equity.
  - The Commission requests total compliance with the representative tax system approach, which is the very basis for the measurement of the provinces’ fiscal capacity. At the next renewal of the equalization program, fiscal capacity for the property tax base must be measured on the basis of property assessment rolls. Similarly, the full amount of

revenue from the sale of goods and services must be subject to equalization.

- The Commission recommends that any new method or data be submitted to the provinces and subjected to satisfactory study before being applied. No change in methodology or data should be implemented during the five-year period following a renewal of the equalization program.
- ◆ To counteract “federal spending power.”
  - The Commission wishes to emphasize that the new division of financial resources that it recommends would limit future federal government initiatives under the aegis of “federal spending power” by reducing the financial leeway available for this purpose.
  - The Commission also recommends that:
    - Québec vigorously reiterate its traditional stance concerning the absence of a constitutional basis for “federal spending power” since this “power” does not respect the division of powers stipulated in the Constitution;
    - Québec maintain its demand to exercise an unconditional right to opt out with full financial compensation in respect of any program implemented by the federal government in a field falling under provincial jurisdiction.

*Respond to all new causes of imbalance*

Fiscal imbalance hampers in the functioning of a federation. For this reason, procedures must be implemented to respond rapidly to new causes of imbalance.

- ◆ We must engage in an ongoing, reliable assessment of the conditions surrounding financial relations between the two orders of government.
  - The Commission recommends that the federal government significantly enhance the information available to the public concerning fiscal balance in the federation and intergovernmental fiscal arrangements.
  - The Commission is of the opinion that, given the issues at stake, the federal-provincial analysis of fiscal balance and transfer programs should be revitalized and made much more transparent.
  - The Commission believes that the National Assembly should engage in systematic monitoring of various facets of fiscal imbalance through discussion by a parliamentary committee of a report submitted

annually by the Minister of Finance and including the advice of a Committee of experts.

- ♦ A genuine process of exchanges and discussion between the two orders of government should be initiated on all facets of intergovernmental fiscal relations. The Commission recommends that the Québec government pursue its efforts to ultimately establish with the other provinces a genuine, permanent and effective process of exchanges and discussion between the two orders of government on intergovernmental fiscal relations.

The Commission is convinced the recommendations it has formulated would correct the fiscal imbalance that is currently a feature of intergovernmental fiscal relations within the Canadian federation.

The restoration of fiscal balance will directly benefit individuals since they will receive from the provinces an adequate level of services in sectors they consider a priority. Moreover, it will fully enable them to make the choices to which they are entitled in the fields stipulated by the Constitution as under provincial jurisdiction.

The ability to make choices in clearly identified fields is at the very heart of the federal system. It is a cornerstone of federalism, to which Quebecers are especially sensitive. The restoration of fiscal balance in Canada through a new division of financial resources must respect and guarantee it.



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## INTRODUCTION: THE COMMISSION'S MANDATE AND ITS APPROACH

The Prime minister of Québec, Bernard Landry, announced the creation of the Commission on Fiscal Imbalance in the *Inaugural Speech* to the National Assembly on March 22, 2001.

On May 9, 2001, Cabinet passed the order-in-council officially setting up the Commission, defining its membership and fixing its mandate.<sup>1</sup> The order-in-council announced that the Commission would consist of seven commissioners, namely the President, Yves Séguin, Anne-Marie d'Amours, Renaud Lachance, Andrée Lajoie, Nicolas Marceau, Alain Noël and Stéphane Saintonge.<sup>2</sup>

The order-in-council specified that the Commission's mandate was to:

*identify and analyse the basic causes of the fiscal imbalance between the federal government and Québec;*

*solicit and receive opinions and suggestions from experts and stakeholders in Québec and elsewhere regarding:*

- *the actual consequences of this imbalance;*
- *practical solutions to put forward to correct this imbalance.*

### The Commission's work

To fulfil its mandate, and in accordance with the indications mentioned in the order-in-council, the Commission had detailed studies carried out, sought contributions from outside experts and held a public consultation.

- ◆ The Commission had a number of **detailed studies** carried out on many of the points it was to examine.
  - The Commission wanted a projection of the financial frameworks of the federal and Québec governments. To do so, it sought the cooperation of the Conference Board of Canada.<sup>3</sup> The study carried out by this body is released concurrently with this report.<sup>4</sup>

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<sup>1</sup> See *Appendix 1* for a copy of order-in-council 533-2001 concerning the constitution of the Commission on Fiscal Imbalance and its subsequent amendment.

<sup>2</sup> *Appendix 2* lists the members of the Commission while *Appendix 3* describes the resources of the Secretariat.

<sup>3</sup> The Conference Board of Canada, thereafter referred to as "Conference Board", is a non-profit organization based in Ottawa that produces economic analyses and forecasts on key Canadian public policy issues. The Conference Board is especially noted for the quality of its economic forecasts and is regularly consulted by the federal government when the latter develops its medium and long-term economic projections.

<sup>4</sup> CONFERENCE BOARD OF CANADA, *Fiscal Prospects for the Federal and Québec Governments*, 2002.

- The Commission specifically studied four subjects, namely federal transfer programs, the effective division of tax fields, a history of fiscal imbalance in Canada and the analysis of the factors relating to the “federal spending power.” The results of the work on the first two subjects were released in June 2001.<sup>5</sup> The history of fiscal imbalance and the analysis of the “federal spending power” are two of the supporting documents published with the Commission’s report.<sup>6</sup>
- ◆ The Commission sought **external contributions** for specific expertise on some of the issues it had to deal with.

To structure and ensure the distribution of these contributions, the Commission had planned to hold an International Symposium on the main issues relating to fiscal imbalance and intergovernmental fiscal arrangements. To facilitate discussion, the Commission published a background paper describing the situation in six of the countries.<sup>7</sup> The symposium was to have been held in Québec City on September 13 and 14, 2001, but had to be cancelled because of the September 11 attacks.

Nevertheless, a number of meetings were held with some of the invited experts and the Commission was able to make use of all the papers prepared for the symposium. These papers are collected in one of the three supporting documents released by the Commission at the same time as this report.<sup>8</sup> The individuals the Commission met with in the course of its work are listed in an appendix to this document.<sup>9</sup>

- ◆ The **public consultation** consisted of a call for briefs followed by hearings held in Montréal and Québec City between November 21 and December 4, 2001.<sup>10</sup> The Commission received 45 briefs from as many groups, organizations and individuals, greatly assisting the Commission in its deliberations.

The Commission immediately wants to acknowledge the depth and relevance of this contribution to its work, as will be evident from reading the report. It also commissioned a survey, covering Québec and Canada as a whole, that brought public perceptions of the issues raised by the debate on fiscal imbalance into sharper focus.<sup>11</sup>

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<sup>5</sup> COMMISSION ON FISCAL IMBALANCE, *Federal Transfer Programs to the Provinces*, Background Paper for public consultation, 2001. COMMISSION ON FISCAL IMBALANCE, *Effective Occupation of Taxation Fields in Québec*, Background Paper for public consultation, 2001.

<sup>6</sup> COMMISSION ON FISCAL IMBALANCE, *Fiscal Imbalance in Canada – Historical Background*, Supporting Document 1, 2002. COMMISSION ON FISCAL IMBALANCE, *The “Federal Spending Power”*, Supporting Document 2, 2002.

<sup>7</sup> COMMISSION ON FISCAL IMBALANCE, *Intergovernmental Fiscal Arrangements: Germany, Australia, Belgium, Spain, United States, Switzerland*, Background Paper, 2001.

<sup>8</sup> *Texts Submitted for the International Symposium on Fiscal Imbalance*, Supporting Document 3, 2002.

<sup>9</sup> The list of experts consulted by the Commission is given in *Appendix 4*.

<sup>10</sup> *Appendix 5* gives the list of briefs submitted and the full schedule of public hearings.

<sup>11</sup> *Appendix 6* gives the complete results and methodology of this survey whose main conclusions are used for the purposes of this report.

To give its approach due transparency, the Commission set up a website<sup>12</sup> on which all the relevant information concerning the progress of its work and the various documents published were made available.

In June 2001, and to help participants in the public consultation to prepare their work, the Commission explained its understanding of the problems and issues at stake in fiscal imbalance. In the document it released at that time,<sup>13</sup> the Commission set out the results of its ongoing deliberations, of which this report is the direct extension.

### **The Commission's report**

In the order-in-council defining the Commission's mandate, the government asked the Commission to reflect on the causes of the fiscal imbalance between the federal government and Québec, its actual consequences and practical solutions to put forward to correct it.

For the Commission, answering these questions meant, first, clearly elucidating the reality and scope of the fiscal imbalance between the federal government and Québec so that it could be more readily understood and analysed.

In addition, and right from the outset, the Commission considered that its deliberations were situated within the current constitutional framework,<sup>14</sup> and that consequently, the analysis had to be broadened to all provinces of Canada, whenever both relevant and possible.

Prepared from this standpoint, the Commission's report is in three parts:

- ◆ In the first part, the Commission examines the **nature of the problem**, which prompted it to define and quantify fiscal imbalance.
- ◆ The second part of the report concentrates on the **causes of fiscal imbalance** – causes tied to spending and revenue, to the definition of transfers and to the “federal spending power.”
- ◆ In the third part of the report, the Commission identifies the **consequences of fiscal imbalance to be taken into consideration** and **proposes solutions**. These solutions in fact constitute the recommendations the Commission puts forward as a result of its work.

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<sup>12</sup> The address of the Commission's website is [www.desequilibrefiscal.gouv.qc.ca](http://www.desequilibrefiscal.gouv.qc.ca)

<sup>13</sup> COMMISSION ON FISCAL IMBALANCE, *Fiscal Imbalance: Problems and Issues*, Background Paper for public consultation, 2001.

<sup>14</sup> *Fiscal Imbalance: Problems and Issues*, *op. cit.*, note 13, p. 14.



# **PART ONE**

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## **THE NATURE OF THE PROBLEM**



## **DEFINITION AND SCOPE OF FISCAL IMBALANCE**

When considering the question of fiscal imbalance, an initial observation is inescapable: the theme of fiscal imbalance has been at the heart of intergovernmental relations in Canada for many years now. At the same time, the existence of a fiscal imbalance that penalizes the provinces is publicly contested by one of the orders of government involved, namely the federal government.

Any consideration of fiscal imbalance therefore presupposes that its very existence can be confirmed. On the basis of the current debate, what we understand by fiscal imbalance must be clearly defined and some indication of its scope is needed.

Accordingly, the Commission began its work with an examination of three points.

- ◆ As will be shown below, fiscal imbalance is one of the major issues of the Canadian federation and the fact that the federal government contests its existence confirms its importance.
- ◆ With the significance of what is at issue noted, agreement is needed on what could be a broadly accepted definition of fiscal imbalance. That is what the Commission attempted to do by proposing such a definition, in full awareness of the difficulty of the exercise: fiscal imbalance is a complex concept and it must be related to the actual operation of institutions.
- ◆ The Commission then noted that it is possible to examine an initial indication of fiscal imbalance through the current and projected budget balances of the other provinces, Québec and the federal government. The Commission carried out this examination using both existing data and projections. In the latter case, the Commission specifically asked for the cooperation of the Conference Board of Canada, whose overall conclusions in this regard will be studied.

## 1. A MAJOR ISSUE

### One of the major issues of the Canadian federation

Since the mid-1990s, fiscal imbalance has gradually re-emerged as a major issue in the Canadian federation.<sup>15</sup> Three phenomena have converged to bring the problem of fiscal imbalance to the forefront of intergovernmental discussions:

- ◆ During this period, the federal government has intensified its cuts to cash transfers to the provinces, especially with the implementation of the Canada Health and Social Transfer (CHST).<sup>16</sup>
  - For instance, between 1994-1995 and 1997-1998, the CHST fell from \$18.7 billion to \$12.5 billion, a drop of almost one third.
  - Beginning in 1998-1999, the CHST has risen, but it has yet to reach its 1994-1995 level. The CHST was set at \$17.3 billion for fiscal year 2001-2002. According to federal announcements, funding for this program will not exceed its nominal level in 1994-1995 until 2003-2004, i.e. after close to ten years. Had the CHST kept pace with health spending, the federal government would have had to pay \$26.1 billion in 2001-2002.
- ◆ The cuts were made unilaterally by the federal government, as were the decisions affecting the allocation of the CHST among the provinces.
- ◆ The federal decisions, especially the substantial cut in the CHST, were all the more difficult to deal with since they coincided with the sharp increase in provincial social spending, particularly in the health field.
  - In spite of the measures to limit its increase, spending on health, education and social services for the provinces as a whole rose 26% between 1994-1995 and 2001-2002. In Québec, the increase was 15%.
  - Health spending alone surged 40% over this period for the provinces as a whole, the increase for Québec being 29%.

Overall, during the period from 1994-1995 to 2001-2002, the proportion of health, education and social services spending financed by federal funds fell substantially, from 18.1% to 14.1%. In 1984-1985, it stood at 23%.

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<sup>15</sup> See *Fiscal Imbalance in Canada – Historical Background*, *op. cit.*, note 6, for a historical look at fiscal imbalance.

<sup>16</sup> In 1996, the CHST replaced Established Programs Financing (EPF) and the Canada Assistance Plan (CAP). *Fiscal Imbalance in Canada - Historical Background*, *op. cit.*, note 6, gives an account of how it was implemented by the federal government.

During the same period, the federal government has accumulated sizeable budget surpluses, which obviously supplied the provinces with another argument: the total federal surplus between 1997-1998 and 2000-2001 reached \$35.8 billion.

That is why, for the past several years, the issue of fiscal imbalance has been a regular item on the agenda of meetings of Prime ministers and Ministers of Finance. Since 1997, fiscal imbalance has been discussed at each of these meetings and has been the subject of common positions taken by provincial Prime ministers and by Ministers of Finance.

### **An imbalance contested by the federal government**

This fiscal imbalance, which the provinces have constantly decried, is denied by the federal government. The federal government invokes a set of factors to support its position<sup>17</sup> that can be summed up in the following points:

- ◆ The federal government's debt places it under a major constraint.
- ◆ The federal government's recent surpluses are small compared to the deficits of the past.
- ◆ The provinces can increase their revenue if they feel they do not have sufficient resources to fund their responsibilities.
- ◆ The federal government's spending is under as much pressure as that of the provinces, in particular because of the population ageing and the costs of citizens' security.
- ◆ Real increases in transfers to the provinces have been made and have been announced.
- ◆ Lastly, the provinces have exclusive access to growing tax fields, such as gambling and lotteries.

As will be seen throughout this report, the Commission has attentively examined each of these arguments to analyse their grounds. It has concluded that these arguments do not stand up, casting doubt neither on the existence nor the scope of the fiscal imbalance to the detriment of the provinces. The very definition of fiscal imbalance and the symptoms that can be pointed out, in terms of budget balances, provide the initial components of a refutation of the federal position. It must also be agreed that in Québec as throughout Canada, the understanding of the current situation among the public and the stakeholders most directly involved in the debate is appreciably different from that of the federal government.

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<sup>17</sup> See in particular GOVERNMENT OF CANADA, *The Fiscal Balance in Canada: The Facts*, 2002.

**Fiscal imbalance on the agenda of Interprovincial Meetings of  
Prime ministers and Ministers of Finance<sup>18</sup>**

August 1997 (Prime ministers)

*Premiers agreed that as roles and responsibilities are rebalanced in non-social policy areas, appropriate resources need to be transferred between governments.*

August 1998 (Prime ministers)

*Premiers underscored the need to ensure that provincial and territorial governments have the resources to carry out their responsibilities, especially the delivery of social programs and directed their Finance Ministers to continue work on redesigning current arrangements to achieve this goal.*

August 1999 (Prime ministers)

*The premiers and territorial leaders stressed that Ottawa now enjoys considerable and increasing budgetary surpluses, reportedly more than \$10 billion this year. Federal tax revenue is growing faster than federal expenditure responsibilities, which is not the situation at the provincial level.*

November 1999 (Ministers of Finance)

*The Ministers called it "common sense" that the governments with the responsibility for the provision of services have the necessary funding to deliver those services.*

August 2000 (Prime ministers)

*Premiers remain very concerned about the current and growing imbalances between the federal and provincial/territorial governments' ability to finance their respective program responsibilities. Efficiency and equity in the provision of programs and services imply that both the long-term vertical fiscal imbalance, between the federal government and provinces and territories, and the horizontal fiscal imbalance, among provinces and territories, need to be addressed.*

December 2000 (Ministers of Finance)

*There is a growing imbalance between the cost and tax pressures felt by provinces and territories and those felt by the federal government.*

August 2001 (Prime ministers)

*Premiers acknowledged that the challenge of coping with rapidly rising costs has been compounded by a growing demand for health services that has outstripped the rate of revenue growth from economic growth and from federal transfer payments. This fiscal imbalance suggests two issues: a revenue problem and a cost-management challenge.*

<sup>18</sup> Press releases of meetings of Ministers of Finance and provincial Premiers. These press releases are available on the website of the Canadian Intergovernmental Territorial Conference Secretariat ([www.scics.gc.ca](http://www.scics.gc.ca)).

## Broad consensus on the existence of fiscal imbalance

The public hearings held by the Commission are revealing in this regard. The interest raised by the public consultation on fiscal imbalance provides an initial idea of the position of the players in Québec society on the existence of a fiscal imbalance. As has been pointed out above, close to fifty organizations and individuals, representing various segments of Québec society, participated in the debate initiated by the Commission. This is a significant number in a field that is not readily accessible. There can be no doubt that the main spokespersons in Québec society felt concerned by the issue of fiscal imbalance, in spite of its complexity, and the message they conveyed is an excellent indicator in this regard.

The participants explicitly dealt with the issue of the existence of a fiscal imbalance either in their briefs or during the public hearings. A broad consensus on its existence emerged. Virtually all participants, including the representatives of the three political parties represented in the National Assembly and those of two of the parties in the House of Commons clearly expressed their conviction that there is a significant fiscal imbalance to the detriment of the provinces.<sup>19</sup>

### Participants at the public hearings and the existence of a fiscal imbalance

At the public hearings held in the fall of 2001, representatives of the three political parties in the National Assembly and two of the parties in the House of Commons clearly expressed their position on the existence of a fiscal imbalance to the detriment of the provinces, within the Canadian federation.

*When I met with [...] the provincial premiers, [...] everyone agreed that the existing fiscal arrangements are dysfunctional [...] everyone agreed that the existing system is inadequate [...] I can assure you that [the other premiers] also want a durable solution to the problem of fiscal imbalance. [Our translation] (Jean Charest, Québec Liberal Party, during an appearance before the Commission on November 21, 2001).*

*This issue is fundamental, [...] it should be more widely known, people should be better informed on the problems stemming from this fiscal imbalance. [Our translation] (Yvan Loubier, Bloc québécois, speaking to the Commission on November 27, 2001).*

*Even before considering decentralizing the federation, it is imperative to point out the existence of a substantial fiscal imbalance between Québec and Ottawa. [Our translation] (Brief of the Action démocratique du Québec, p. 6; the brief was presented to the Commission by Mario Dumont on November 27, 2001).*

*We feel the question [...] you are investigating, the issue of fiscal imbalance, is of the greatest importance [...] everything relating to the issue of fiscal imbalance has repercussions on what happens in our society on a daily basis. [Our translation] (Marie Malavoy, Parti Québécois, speaking to the Commission on November 28, 2001).*

*It is this kind of playing with the numbers to suit Ottawa's needs rather than playing by the agreed rules that undermines provincial confidence in federal commitments and makes long-range planning by the provinces on the basis of those commitments hazardous. (Brief of the Canadian Alliance, p. 6; the brief was presented to the Commission by Scott Reid and Michel Rivard on December 4, 2001).*

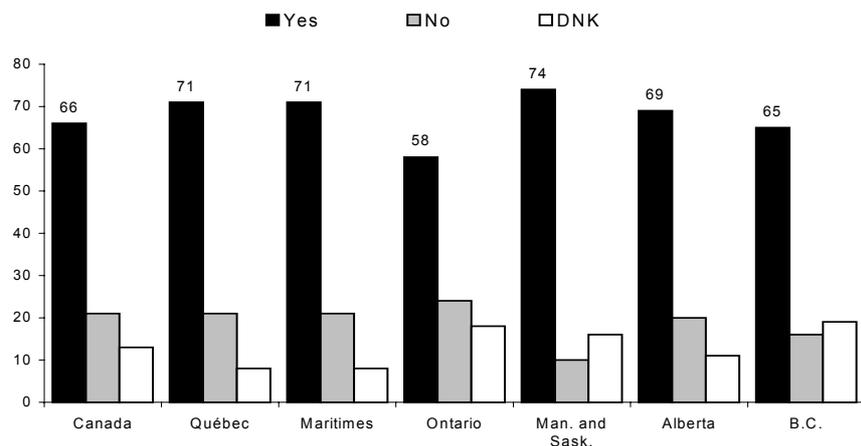
<sup>19</sup> Very few interveners called into question the existence of fiscal imbalance between the federal government and the provinces, although mention should be made of the Conseil du patronat du Québec.

January 2002, the Commission ordered a survey to find out the opinions of Quebecers and of Canadians as a whole on the issues related to fiscal imbalance. Concerning the very existence of this phenomenon, the result is clear: 66% of Canadians and 71% of Quebecers believe there is currently an imbalance in the finances of governments in Canada, i.e. – as the question was put – “the Federal Government has too much revenue for the responsibilities it has while the provincial governments lack revenues to fulfil their responsibilities.”<sup>20</sup>

**CHART 1**

**OPINION OF QUEBECERS AND CANADIANS ON THE EXISTENCE OF A FISCAL IMBALANCE**

The question: « Do you think that the finances of the Canadian Government are currently out of kilter, that is to say, do you think that the Federal Government has too much revenue for the responsibilities it has while the provincial governments lack revenues to fulfil their responsibilities ? » (responses in per cent)



Source: Commission on Fiscal Imbalance.

The existence of this broad consensus is clearly not enough, on its own, to confirm the existence and scope of a fiscal imbalance to the detriment of the provinces. However, it does provide very significant indications on popular sentiment in this regard.

To obtain such confirmation, the Commission wanted to clearly establish, as a prerequisite to its work, what a fiscal imbalance between two orders of government is, then illustrate a number of quantifiable manifestations using current and projected budget balances. The results of this analysis will now be given.

<sup>20</sup> The complete results of the survey are given in Appendix 6, as well as a description of the method used.

## 2. THE NOTION OF FISCAL IMBALANCE

One of the problems in the debate on fiscal imbalance stems from the complexity of this notion. The Commission felt it was essential to agree at the outset on a clear, concrete and broadly accepted definition of fiscal imbalance, from which it would be possible to assess the scope of the phenomenon, then enter into an in-depth discussion of its causes, its consequences and how to respond to it.

### The federal principle

An initial point must be emphasized: the notion of fiscal imbalance, as understood by the Commission, is bound intrinsically to federalism. In other words, the question of fiscal imbalance would not arise if Canada were a unitary state, just as the debate on fiscal imbalance is pointless within a single province.

In a unitary state as within a province, revenue and jurisdictions are not permanently divided by the Constitution. Consequently, they cannot be in a condition of fiscal imbalance as understood by the Commission. It should indeed be noted that most commissions charged with studying the workings of federalism in Canada have in fact been brought to deal with the issue of fiscal imbalance.<sup>21</sup>

In 1956, one of these commissions – the Royal Commission of Inquiry on Constitutional Problems (Tremblay Commission) – defined what it called at that time the “federative principle” in terms that are more relevant than ever:

*The federative principle requires the division of government powers among political units that are both inter-related and independent one from the other. [...] Consequently, we may in turn define the federative system in the strict sense as the system of association between states in which the exercise of state power is divided between two orders of government, coordinated but not subordinate between themselves, each enjoying supreme power within the sphere of activity assigned to it by the constitution.*<sup>22</sup>

The Canadian federation was built on this principle as defined above. In terms of the fiscal relations between the two orders of government, the federal principle as specified by the Tremblay Commission has a number of implications that can be clarified using the notion of fiscal balance.

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<sup>21</sup> See in particular the ROYAL COMMISSION ON DOMINION-PROVINCIAL RELATIONS (Rowell-Sirois Commission), *Report of the Royal Commission on Dominion-Provincial Relations*, vol. I, 1940.

<sup>22</sup> ROYAL COMMISSION ON INQUIRY ON CONSTITUTIONAL PROBLEMS, *Report of the Royal Commission of Inquiry on Constitutional Problems*, vol. II, p. 98. Our translation.

## Fiscal balance in a federation

In a federation such as the Canadian federation, fiscal balance exists when three conditions are satisfied:

- ◆ First, sources of own-source revenue are allocated to each government, the resulting division of tax fields allowing each order of government sufficient financing to be accountable before its citizens for the decisions it has taken in its fields of jurisdiction.

This initial principle was stated with great clarity by the Tremblay Commission:

*In a federative state, all the constituent parties must be able, of their own initiative and under their own responsibility, to obtain through taxation the financial resources needed to exercise their respective powers, failing which the system loses its federative character.*<sup>23</sup>

- ◆ Second, total revenue, i.e. own-source revenue plus transfers, must enable each order of government to effectively cover the expenditures resulting from all the jurisdictions to be assumed.<sup>24</sup>
- ◆ Thirdly, transfers from the federal government to the provinces must not limit the decision-making and budgetary autonomy of the provinces within their fields of jurisdiction, because of the conditions that accompany them or the way they are defined.

This means that transfers should be unconditional<sup>25</sup> unless the members of the federation have validly agreed to conditional transfers, for instance to promote the efficient operation of the federation.<sup>26</sup>

When these three conditions are satisfied, the federation is in fiscal balance. The following diagram illustrates this situation.

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<sup>23</sup> Report of the Royal Commission of Inquiry on Constitutional Problems, *op. cit.*, note 22, Volume III, p. 204. Our translation.

<sup>24</sup> This principle is, in essence, enshrined in the constitution of another federation. Section 106-3 of Germany's Basic Law (*Grundgesetz*) stipulates a mechanism to rebalance current revenue and necessary spending of the two orders of government to maintain fiscal balance in the federation (See *Texts submitted for the International Symposium on Fiscal Imbalance, op. cit.*, note 8).

<sup>25</sup> Unconditional transfers are generally paid by the federal government to offset at least part of the fiscal disparities among the provinces. This is done to counterbalance what is called the "horizontal fiscal imbalance" that eventually arises among the provinces within the federation. In Canada, equalization is an example of such transfers.

<sup>26</sup> This type of transfer validly agreed between the orders of government is designed to allow an efficient allocation of resources in a federation, in view of the impacts of the activities of one federated entity upon the rest of the federation. For instance, in Switzerland there are "inter-canton concordats" regarding higher education under which the cantons receive compensation for services provided to residents of other cantons.

**DIAGRAM 1**

<b>FISCAL BALANCE</b>		
	<b>Federal</b>	<b>Provinces</b>
	Own-source revenue	Own-source revenue
	less	less
	Direct spending <sup>27</sup> within its fields of jurisdiction	Direct spending within their fields of jurisdiction
<b>Fiscal gap</b>	(positive)	(negative)
	less	plus
	Transfers	Transfers
<b>Fiscal balance</b> (final balance)	Total = 0	Total = 0

In a situation of fiscal balance, there can be a fiscal gap between own-source revenue and spending of each order of government. The fiscal balance illustrated above corresponds to a situation where the positive fiscal gap achieved by the federal government enables it to pay transfers to the provinces, the final balance being zero for the two orders of government.

A federation's fiscal balance is normally reflected in the budgetary balances of each order of government. However, in reality, some factors explain why the two notions can differ. For instance, such is the case of needs a government is unable to address because of the existence of a fiscal imbalance, and which do not show up in the budgetary accounts.<sup>28</sup>

<sup>27</sup> Direct spending includes a government's overall budgetary spending including debt service, but excluding transfers to other orders of government.

<sup>28</sup> This refers to the notion of "unaddressed needs". See the sidebar, p. 17.

## **Fiscal imbalance**

A situation of fiscal imbalance arises when one of the three conditions mentioned above is not satisfied.

From the illustration shown and in the situation it depicts, fiscal imbalance can arise from the following circumstances:

- ◆ Basically, there is a fiscal imbalance if the fiscal gap between provinces' own-source revenue and their direct spending is too great, because such a difference threatens to subordinate the provinces in relation to the federal government, which is contrary to the federal principle. This fiscal gap between the revenue and spending of the provinces is normally made up by transfers from the federal government, in a situation of fiscal balance. Accordingly, there is an imbalance if the total revenue of the provinces, i.e. their own-source revenue plus the transfers they receive from the federal government, is less than the spending they have to assume in their fields of jurisdiction.
- ◆ Even if the final balance is zero – transfers from the federal government offsetting the fiscal gap – fiscal imbalance also occurs if the transfers limit the decision-making and budgetary autonomy of the provinces in their fields of jurisdiction, because of the conditions that accompany them or the way they are defined.
- ◆ Lastly, fiscal imbalance also exists when the federal government invokes a “spending power” to intervene in the provinces' fields of jurisdiction. This power limits the decision-making and budgetary autonomy of the provinces, has a direct influence on their level of spending and is facilitated, in practical terms, by excess revenue of the central government in relation to its spending within the jurisdictions allocated to it by the Constitution.

This definition implies that fiscal imbalance is tied to the size of the fiscal gap between own-source revenue and spending, to the inadequacy of transfers to make up this difference, to the very characteristics of these transfers and to the “federal spending power.”

### Two approaches to the issue of fiscal imbalance

Specialists who have written on the issue of fiscal imbalance essentially speak of two approaches to the interpretation of the concept.

- ◆ According to the first approach, a fiscal imbalance exists whenever there are intergovernmental transfers. Their presence means that there is a fiscal gap to the detriment of an administrative structure, namely a gap between its spending and its own-source revenue. The size of the fiscal imbalance corresponds to the size of all transfers between administrations. This approach helps provide a simple quantification of the phenomenon. Note that it leads almost automatically to the conclusion that a fiscal imbalance exists, regardless of the context in which the analysis is applied, because transfers are part of the current operation of countries with several categories of administrations – whether unitary states or federations.

This approach causes problems in the case of federations. In this case, and this is particularly true for the Canadian federation, it suffers from the major disadvantage of not stressing what is one of the true sources of the problem, namely the constitutional division of powers and of tax fields. In addition, it leads to paradoxical conclusions: according to this approach, cutting federal transfers would reduce the fiscal imbalance in Canada.

- ◆ According to a second approach, the notion of fiscal imbalance is intrinsically tied to the existence of a structural gap between the revenue and spending of orders of government. According to this approach, fiscal imbalance stems from inadequate coordination of the division of powers and tax fields between orders of government, and it includes the dysfunctions of the mechanisms structuring intergovernmental fiscal arrangements. For instance, fiscal imbalance exists when one order of government has revenue in excess of what it needs to fund its own jurisdictions, while inversely, the other order of government has insufficient revenue for the spending resulting from its constitutional jurisdictions. According to this approach, a reduction in transfers received by one order of government may lead to under-funding of programs, and thus aggravate the fiscal imbalance.

The Commission has adopted the second approach. It corresponds to the rules that have arisen in the Canadian federal structure. However, it is more demanding in terms of measurement, since the simple presence of transfers is not enough to confirm the existence of fiscal imbalance and quantify it. Accordingly, it requires a dynamic analysis of the problem that takes into account the impact of fiscal imbalance on the budgetary choices of the two orders of government to determine their medium and long-term sustainable nature. This approach leads to an analysis of the ultimate impact of the existing structure of spending, revenue, transfers and their predictable relative growth, to measure the scope of fiscal imbalance.

### 3. THE CURRENT AND PROJECTED SCOPE OF FISCAL IMBALANCE

Once the phenomenon of fiscal imbalance has been clarified, it is possible to analyse an initial direct expression of it by examining the current budget balances of the two orders of government involved and how they are projected to change.

- ◆ The analysis of past and current budget balances indicates the leeway available to each order of government. This leeway is a very good indicator of the existence of a fiscal imbalance and of its size.
- ◆ In addition, as mentioned above, projecting budget balances over a long period is the best way to isolate structural trends affecting the budgets of the two orders of government. Such a projection makes it possible to take into consideration the budget choices resulting from the fiscal imbalance by testing whether they are sustainable in the medium and long term.

#### Fiscal balance and budget balance

The budget balances of each order of government help illustrate the quantitative expression of fiscal imbalance. However, one must be aware of the fact that the notions of fiscal balance and budget balance are not perfectly equivalent.

- ◆ Because of short-term economic fluctuations, the levels of revenue and spending of each order of government vary in the short term and may hide longer-term trends resulting from fiscal imbalance.
- ◆ Features specific to each province – natural resource endowment, public preferences within a province, for instance – have a direct impact on the budget situation, regardless of phenomena related to fiscal imbalance.
- ◆ The very existence of a fiscal imbalance may prompt provinces to hold spending at a level below their needs, in view of the lack of financial resources available to them. Accordingly, there can be “unaddressed needs” that must be taken into account in assessing fiscal imbalance, but which do not show up in the budgetary accounts.

#### Budget balances since 1997

An analysis of the actual budget balances of the two orders of government shows that since the mid-1990s, year after year, the federal government has achieved significantly greater leeway than the provincial governments.

In relation to the provinces as a whole, the difference in situation is clear:

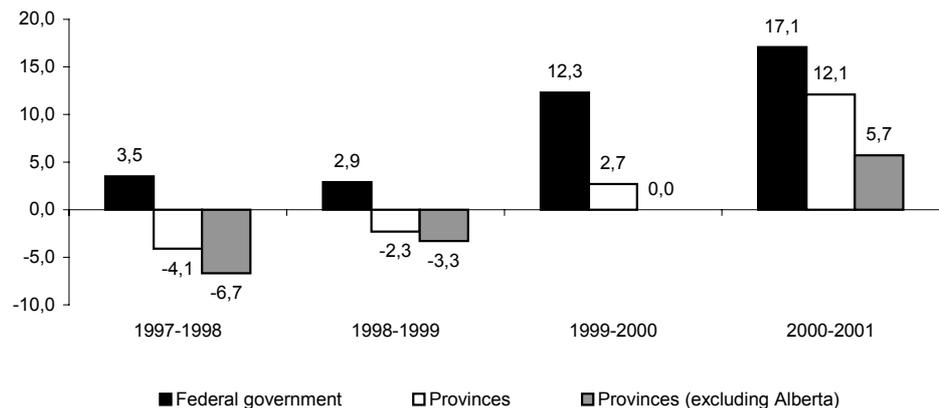
- ◆ Since 1997-1998, the federal government’s budget balance has always been positive, ranging from \$2.9 billion in 1998-1999 to \$17.1 billion in 2000-2001.
- ◆ It was not until 1999-2000 that the provinces as a whole achieved a positive budget balance, amounting to \$2.7 billion. This balance reached \$12.1 billion in 2000-2001.

- ◆ When Alberta's budget balance is excluded, because of the province's special situation in terms of its natural resource endowment and the resulting impact of crude oil prices, the provinces' leeway is seen to be singularly limited. For the period 1997-1998 to 2000-2001, the provinces' budget balance was clearly positive only for the last fiscal year, i.e. in 2000-2001, when it stood at \$5.7 billion.

A simple analysis of the budget balances in recent years thus confirms the scope of the leeway the federal government currently enjoys, compared with what the provinces are able to achieve.

## CHART 2

**BUDGET BALANCE OF THE FEDERAL GOVERNMENT  
AND THE PROVINCES, 1997-1998 TO 2000-2001**  
(billions of dollars)



Sources: Federal and provincial budgets; Commission on Fiscal Imbalance.

### The Conference Board's assessment

To test the structural nature of the trends observed since the mid-1990s, the Commission undertook a projection of the budget balances of the governments of Québec and of Canada over a long period. To this end, the Commission turned to the Conference Board of Canada, asking it to carry out a detailed analysis of the revenue and spending of the two orders of government as far as 2020. The Commission is releasing the Conference Board's study at the same time as this report.

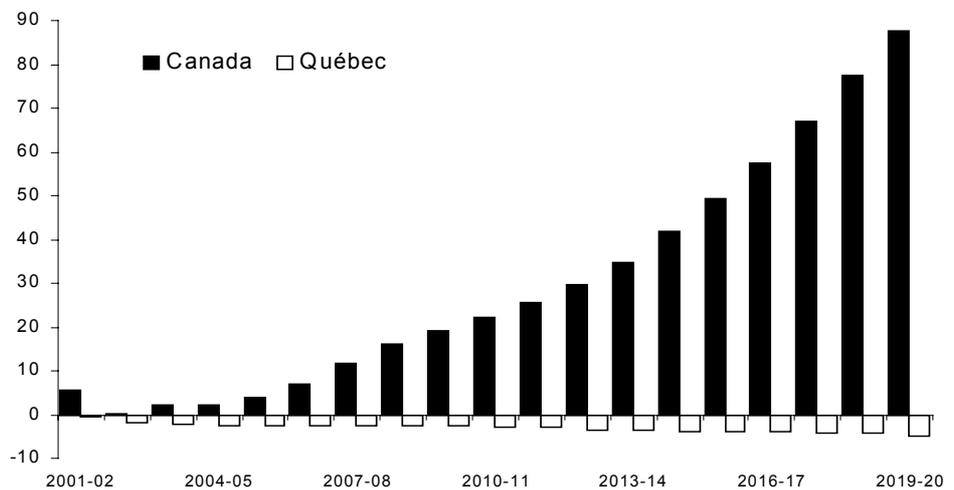
The Conference Board’s overall conclusion is very clear:

*This study seeks to ascertain whether this much talked about fiscal imbalance actually exists. Projecting forward the public accounts, under the assumption of the status quo for fiscal and budgetary policy, the answer is unquestionably yes.<sup>29</sup>*

*While the Québec government will post an average annual deficit of \$3 billion over the forecast period, the budget surplus of the Government of Canada will reach \$87.8 billion in 2019-2020.<sup>30</sup>*

**CHART 3**

**BUDGET BALANCE OF THE FEDERAL GOVERNMENT AND THE QUÉBEC GOVERNMENT, 2001-2002 TO 2019-2020**  
(billions of dollars)



Source: Conference Board of Canada.

According to the Conference Board, if current program characteristics are maintained, the Québec government would post recurring deficits over the next twenty years, while the federal government, in contrast, would achieve ever-greater surpluses reaching almost \$90 billion in 2019-2020. To illustrate the size of this imbalance, the federal government’s budget balance will grow, on average, by \$5.2 billion annually beginning in 2003-2004, while the budget balance of the Québec government will deteriorate by an average of \$175 million a year.

<sup>29</sup> *Fiscal Prospect for the Federal and Québec Governments, op. cit. note 4, p. i.*

<sup>30</sup> *Fiscal Prospect for the Federal and Québec Governments, op. cit. note 4, Cover (Highlights).*

### The Conference Board of Canada's study

The study of the financial frameworks of the federal and Québec governments by the Conference Board of Canada reflects the budget choices made since the September 11, 2001 events, because it incorporates the budgets tabled during the fall by the federal and Québec governments.

The study was very detailed. In particular, it takes into account economic growth, inflation, demographic growth and the maintaining of social programs in its assessment of the financial frameworks of the federal and Québec governments.

*This study projects the public accounts of the federal and Québec governments up to the year 2019-2020 with an emphasis on determining the impact that demographic changes will have on the cost of health care and education. The findings are presented on a public accounts basis for the two governments. The results rely on long-term Conference Board of Canada forecasts that are essentially based on projections of potential output, i.e. the level of long-term sustainable economic activity if all factors of production are fully and efficiently utilized.*

*These projections are based on maintaining the status quo with respect to fiscal and budgetary policy. Thus, unless otherwise indicated, federal and Québec taxation rates only change according to the fiscal measures already announced in the latest round of budgets. No other measures have been incorporated into these scenarios.*

*The projection assumes that government surpluses in any given fiscal year will be used entirely to repay the debt. Consequently, this approach makes it possible to evaluate the manoeuvring room available to each level of government in terms of budgetary policy. Thus, it gives some indication of the means available to each one to implement new initiatives or, conversely, the budgetary actions needed to achieve fiscal balance.<sup>31</sup>*

The Conference Board's analysis thus highlights the ultimately unsustainable nature of existing budgetary structure. These results confirm the earlier work of Professor G.C. Ruggieri, which predates the budgets tabled in the fall by the Québec government and the federal government.<sup>32</sup> As will be shown in the second part of the report, the Conference Board's estimates were very useful in the analysis of the causes of fiscal imbalance.

<sup>31</sup> *Fiscal Prospect for the Federal and Québec Governments, op. cit.*, note 4, Note to the reader.

<sup>32</sup> In August 2001, Professor G.C. Ruggieri, from the Department of Economics of the University of New Brunswick, estimated the expected size of the budget balances of the two orders of government. He found that the budget balance of the federal government would rise continuously over the next twenty years, from \$6.3 billion in 2004-2005 to \$126.2 billion in 2019-2020. During the same period, the budget balance of the provinces as a whole would remain close to zero, and be limited to \$5.5 billion in 2019-2020. See RUGGERI G.C., *A Federation out of Balance Update*, 2001.

### **First conclusion**

Thus fiscal imbalance, the central theme of Canadian intergovernmental relations since the mid-1990s, is not a “myth” as purported by the federal government in certain documents.<sup>33</sup>

In fact, the fiscal imbalance phenomenon is closely tied to how federations operate. An analysis of existing and projected budget balances gives an indication of its scope in the Canadian federation, as it is currently evolving. The very concept of fiscal imbalance, though admittedly complex, can be appreciated relatively clearly from its essential components, namely the size of own-source revenue, the gap between the revenue and spending of each order of government, the characteristics of the transfers made between the federal government and the provinces and the “federal spending power.”

Having thus clarified the nature of the problem raised by fiscal imbalance, we can proceed to investigate its causes.

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<sup>33</sup> “Ottawa se prépare à faire éclater le “mythe” du déséquilibre fiscal” in *La Presse*, January 25, 2002, A1.

# **PART TWO**

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## **THE CAUSES OF FISCAL IMBALANCE**



The fiscal imbalance between the Government of Canada and the Québec government and, more generally, between the federal government and the provinces, stems from three causes:

- ♦ First, an imbalance has been noted in respect of each order of government between expenditures and access to sources of revenue.
- ♦ Second, intergovernmental transfers from the federal government to the provinces are inadequate.
- ♦ Third, “federal spending power,” to which the federal government resorts extensively, is contributing directly to fiscal imbalance and has encouraged the federal government to engage in conditional spending in fields under provincial jurisdiction.

The chapters in this section will focus on these causes.



## **IMBALANCE BETWEEN EXPENDITURES AND ACCESS TO SOURCES OF REVENUE**

In its report, the Conference Board explicitly pinpointed the primary cause of the existing fiscal imbalance between the federal government and the provinces. In light of its evaluation of the federal and Québec governments' budgetary balances, the Conference Board made the following observation:

*The fiscal prospects of the federal and provincial governments are changing in markedly different ways. One of the main causes of this divergence is the spending structure of the two levels [orders] of government. A large part of the federal government's expenditures consists of transfers to the provinces and to individuals, which usually follow changes in economic or population growth. Some programs, such as employment insurance, are self-financing. The expenditures of the provincial governments, including those of Québec, mainly cover the delivery of goods and public services, in particular, health care and education, expenditures that are strongly influenced by demographic change and are hard to reduce.<sup>34</sup>*

The Conference Board suggests that there is a structural difference between the federal government and the Québec government from the standpoint of revenues and expenditures.

- ◆ In the case of the federal government, the current positive discrepancy between revenues and expenditures will grow steadily because of the debt repayment that the discrepancy will make possible.
- ◆ The balance between Québec's revenues and expenditures is much more precarious, which explains why the government cannot engage itself into a debt reduction plan, and the projected budgetary balance is negative throughout the forecast period.

Moreover, according to the Conference Board's projections, the federal government's budget surpluses will grow steadily throughout the period and approach \$90 billion for the year 2019-2020 alone. To the contrary, Québec's budgetary balance would remain negative over the next 20 years and the deficit would then stand at nearly \$5 billion in 2019-2020.

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<sup>34</sup> *Fiscal Prospect for the Federal and Québec Governments, op. cit.*, note 4, Detailed tables. The Conference Board's data and results quoted in this chapter are drawn from the detailed tables of this document.

**TABLE 1**

**CHANGE IN THE FINANCIAL POSITION OF THE FEDERAL AND QUÉBEC  
GOVERNMENTS, 2000-2001 TO 2019-2020**  
(as a percentage)

	<b>Fédéral</b>	<b>Québec</b>
<b>Revenues (average annual percentage change)</b>		
– Own-source revenues	3,2	3,2
– Federal transfers	N/A	2,9
– Total	<b>3,2</b>	<b>3,1</b>
<b>Expenditures (average annual percentage change)</b>		
– Program spending	3,7	3,7
– <i>Per capita</i>	2,9	3,4
– Debt service	-14,3	3,0
– Total	<b>2,1</b>	<b>3,6</b>
<b>Budgetary balance (in millions of dollars)</b>		
– In 2000-2001	17 148	502
– In 2019-2020	87 776	- 4 764
<b>Debt (in millions of dollars)</b>		
– In 2000-2001	589 232	102 741
– In 2019-2020	28 199	161 303
<b>Debt (as a percentage of GDP)</b>		
– In 2000-2001	58,0	45,6
– In 2019-2020	1,7	35,8

Notes: N/A: not applicable. Interest-bearing debt in the case of the federal government and gross debt in the case of Québec.

Source: Conference Board of Canada.

### The Commission's analysis

The Commission conducted a more detailed, systematic analysis of the main categories of expenditures and revenues of the two orders of government in order to pinpoint the causes of the current situation and, consequently, the fiscal imbalance attributable to the discrepancy between expenditures and revenues.

As we will see, this discrepancy stems from three factors:

- ♦ First, the provinces are subject to considerable pressure as regards spending.
- ♦ Second, the sharing of revenues between the two orders of government does not reflect this spending dynamic.
- ♦ Third, as the Conference Board study clearly shows, the balance of revenues and expenditures is allowing the federal government to obtain growing leeway that it is earmarking for repayment of the debt, which the provinces cannot do. Debt service and repayment, which the federal government often mentions to justify its current budget surpluses, are exacerbating fiscal imbalance.

## **1. THE PROVINCES ARE SUBJECT TO CONSIDERABLE PRESSURE IN RESPECT OF SPENDING**

The Commission's analyses confirm what the provinces have emphatically maintained for several years, i.e. that the provinces are subject to considerable pressure in respect of spending and that the health care sector, in particular, is responsible for such pressure.

In order to fully understand the structural sources of the pressure exerted on the provinces and the reasons for which the federal government is facing a different situation, we must first remind the basis on which the two orders of government intervene.

One of the characteristics of the Canadian federation is the division of powers between the federal Parliament and the provinces. The fields of jurisdiction for which each order of government is responsible are essentially separate, as defined by the Constitution. This division is a fundamental, since it dictates the responsibilities assumed by the two orders of government.

### **Separate fields of jurisdiction**

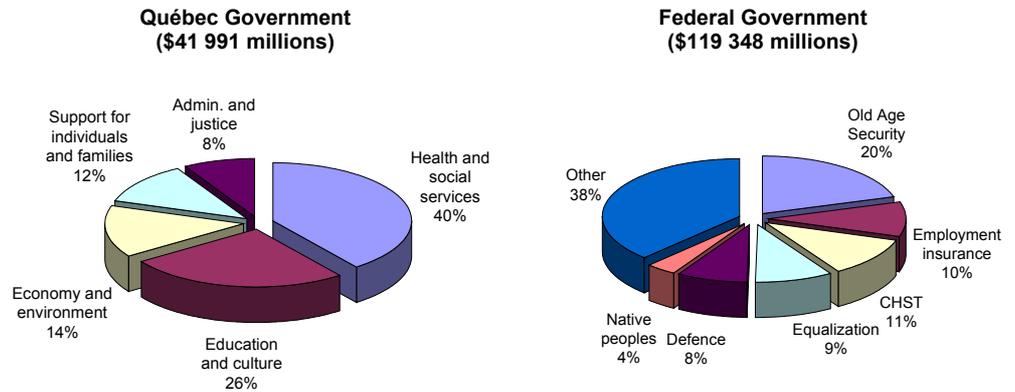
The current division of federal and provincial program spending reflects the division of powers stipulated in the Constitution.

- ◆ The two main fields of provincial jurisdiction, i.e. health care and education, alone account for two-thirds of program spending, which, combined with expenditures pertaining to support for individuals and families, represent nearly 80% of Québec program spending, a situation similar to that prevailing in the other provinces.
- ◆ The breakdown of the federal government's responsibilities is markedly different. Old age security accounts for 20% of federal programs spending while its other responsibilities are much more fragmented: 11% of program spending for the CHST, 10% for employment insurance, 9% for equalization, and 8% for defence.

From the standpoint of other program spending, only Indian and Northern Affairs Canada mobilizes over 4% of federal program spending. Other expenditures are divided among a large number of responsibilities, the most important of which are assumed by the Canada Customs and Revenue Agency (3.7%), the Treasury Board (3.5%), Industry Canada (3.4%), and Foreign External Affairs and International Trade Canada (3.1%).

**CHART 4**

**BREAKDOWN OF QUÉBEC AND FEDERAL GOVERNMENT PROGRAM SPENDING, 2000-2001**



Note: The special Québec abatement is included in "Other federal government expenditures."

Sources: *Comptes publics du Québec (2000-2001)*; *Public Accounts of Canada (2000-2001)*.

**The Canadian Constitution and the division of legislative powers between the two orders of government**

Sections 91 to 95 of the *Constitution Act, 1867* contain the key provisions that stipulate the division of legislative powers.

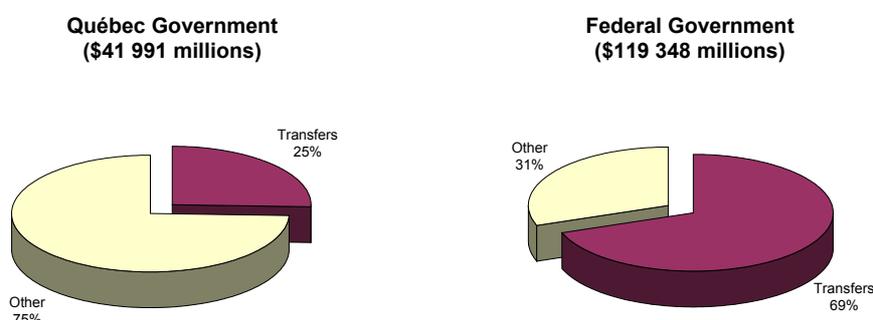
- ♦ Section 91, entitled "Powers of the Parliament," attributes to the federal government 29 fields of jurisdiction, including public debt and property, unemployment insurance, defence and quarantine, to which must be added a general residual power and a general power "to make Laws for the Peace, Order, and good Government of Canada," attributed in the preamble of the section. The federal government is also responsible for old age pensions, included in 1951 in section 94A, which nonetheless gives precedence to provincial legislation in this respect (*"but no such law [adopted by Parliament] shall affect the operation of any law present or future of a provincial legislature in relation to any such matter."*) The federal government's share of jurisdiction over natural resources, inserted into section 92A in 1982, gives the federal authorities precedence with respect to out-of-province exports.
- ♦ Section 92, entitled "*Exclusive powers of provincial legislatures,*" lists 16 fields of jurisdiction, including civil law, the establishment, maintenance, and management of hospitals, asylums, charities, and eleemosynary institutions in and for the province, and a residual power specific to its sphere of jurisdiction generally covering all matters of a purely local and private nature in the province. To this list must be added education, covered by section 93, and the provinces' share of jurisdiction over natural resources stipulated in section 92A.
- ♦ Account must be taken of the joint fields of jurisdiction stipulated in section 95, i.e. immigration and agriculture, in which the federal government predominates.

## Transfers and direct service delivery

It is immediately apparent that this division of program spending reflects another reality: from the standpoint of spending, 69% of federal government expenditures are transfers, while for Québec, transfers account for a small portion of program spending compared with the amounts devoted to direct service delivery. Transfer expenditures account for 25% of Québec's program spending (the remaining portion taking the form of direct service delivery).

### CHART 5

#### BREAKDOWN OF QUÉBEC AND FEDERAL GOVERNMENT PROGRAM SPENDING, 2000-2001



Sources: *Comptes publics du Québec (2000-2001)*; *Public Accounts of Canada (2000-2001)*.

This distinction between transfers and direct service delivery is very important, since it provides a key to the existing situation.

- ◆ The term “transfers” encompasses all government contributions in the form of cash payments, e.g. transfers to the provinces in the case of the federal government, transfers by the provinces to the municipalities, or transfers by the federal and provincial governments to businesses, individuals and families. In the latter instance, the transfers take the form of a cheque sent to the beneficiary.
- ◆ Direct service delivery is relatively more complex in that it refers to services offered by governments, usually through public networks of varying sizes, e.g. health and education in the case of the provinces and defence and foreign affairs in the case of the federal government.

### **Different pressures stemming from this situation**

The two types of spending differ in terms of their nature and engender separate challenges from the standpoint of government management.

- ♦ Transfers are distributed in the form of payments to beneficiaries and the amount of such transfers is determined by criteria controlled more or less completely by the government concerned. The beneficiaries of the transfers attempt sometimes to intervene in order to define such criteria.
- ♦ In the case of direct service delivery, the government must establish and manage often extensive networks. Changes in spending stemming from direct service delivery depend both on beneficiaries' needs and the networks' operating and administrative costs (the so-called "system costs").

As we will see below, the provinces are subject to considerable pressure as regards direct service delivery, mainly because of precipitous growth in health care needs and costs. However, in terms of transfers, which account for the major part of federal government program spending, pressure is more limited and is attributable solely to beneficiaries' needs (system costs play a less important role).

#### **1.1 Service delivery: the provinces are bearing the pressure**

The provinces are unquestionably bearing the brunt of pressure exerted by service delivery and such pressure is attributable to rising health care costs. Health care needs are growing steadily and affect a mission that already accounts for nearly 40% of Québec's program spending.

It is true that needs in respect of education, the provinces' second most important mission, should grow less rapidly than in the past due to demographic context. However, it has been noted that this relative slowdown in growth is apparently insufficient to offset accelerated growth in health care spending. The Conference Board's highly cautious projections<sup>35</sup> concerning future growth in health care and education spending are very convincing.

The federal government is subject to pressure in respect of defence, the main field in which it ensures service delivery. Pressure is also exerted in respect of an array of missions, although they are much less important in terms of total spending. Their impact on the federal government's overall budgetary position is fairly limited.

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<sup>35</sup> As indicated in the conclusion of its study (*Fiscal Prospects for the Federal and Québec Governments*, *op. cit.*, note 4, p. 33), the Conference Board decided to present a conservative portrait of potential changes in the finances of the federal and Québec governments: "[...] we have always exercised caution in adopting our hypotheses in order to shed the best possible light on the financial frameworks of the Québec and federal governments. The CBoC believes that the results presented in this study are the most probable, in light of the information available when the study was prepared."

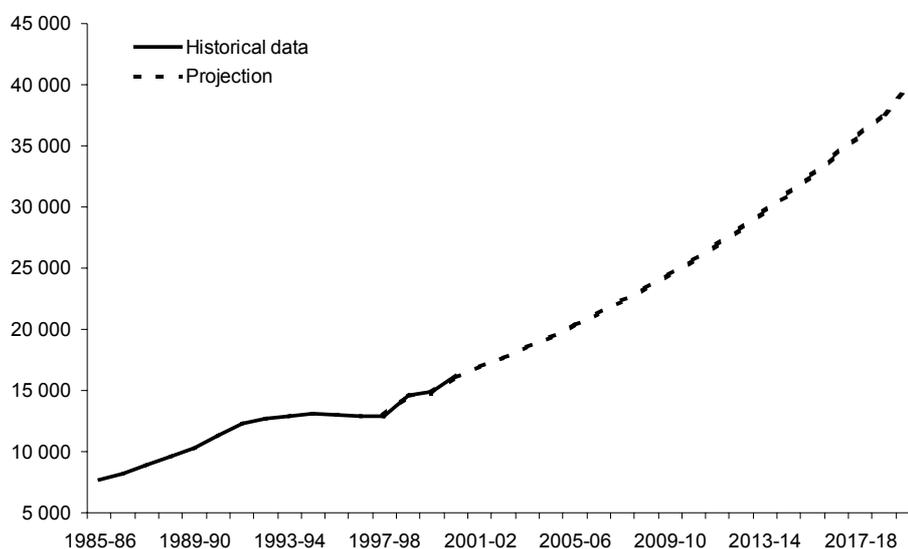
### 1.1.1 Health care

Growth in health care spending is by far the biggest source of pressure now exerted on the provinces and this trend will obviously continue.

Between 1985-1986 and 2000-2001, the funding allocated by Québec to health and social services increased, on average, by 5.1% per year, equivalent to the doubling in fifteen or so years of the overall budget.

#### CHART 6

**HEALTH AND SOCIAL SERVICES SPENDING IN QUÉBEC,  
1985-1986 TO 2019-2020**  
(millions of dollars)



Sources: *Comptes publics du Québec*; Conference Board of Canada.

The figure is striking, since it includes the period 1991-1997, when services were streamlined significantly in order to balance the budget. A strong return to growth in spending has been noted since 1997-1998: over the past three years, Québec's health care spending has risen, on average, by 7.8% per year.

In its study, the Conference Board emphasizes the budgetary challenge stemming from growing health care needs by even presenting an outlook for the very long term.

The CBoC's report notes:

*Strong growth in health care spending risks exerting even greater pressure on public finances after 2020. Baby boomers will still not be at the top of the age pyramid as they will still be aged under 74 (most of them will not even have reached the age of 65). They will then gradually enter the more costly*

age groups in terms of health care. Consequently, the Québec government's financial outlook could deteriorate further after the 2019-2020 fiscal year.<sup>36</sup>

For example, we have implicitly taken it for granted that the government will not take charge of any new areas of health care, such as home care provided by family members. We are also assuming that inflation in the health care sector will not exceed inflation in the economy overall. If this were the case, government spending in this sector would be underestimated.<sup>37</sup>

### A widespread phenomenon in the industrialized nations

It should be noted that marked growth in public health care spending is not unique to Québec, as it affects all of the industrialized nations.

Growth in Québec's public health care spending since the mid-1980s has been moderate. According to data compiled by the CIHI and OECD, per capita health care spending increased by 4.4% per year in Québec between 1985 and 1998, compared with more 5% in the main countries of Europe, 7.1% in Japan, and 7.8% in the United States.

**TABLE 2**

**PUBLIC HEALTH CARE SPENDING IN QUÉBEC, CANADA AND CERTAIN OECD COUNTRIES, 1985 AND 1998**  
(in US dollars per capita and as a percentage)

	1985	1998	Growth rate
United States	701	1 866	7.8 %
Switzerland	827	2 087	7.4 %
Japan	579	1 408	7.1 %
United Kingdom	574	1 258	6.2 %
France	833	1 588	5.1 %
Italy	642	1 227	5.1 %
Germany	961	1 790	4.9 %
Canada	910	1 663	4.7 %
<b>Québec</b>	<b>929</b>	<b>1 622</b>	<b>4.4 %</b>
Denmark	1 008	1 746	4.3 %
Sweden	1 059	1 451	2.5 %

Notes: In purchasing-power parity (\$US PPP). Average annual growth rate.

Sources: Canadian Institute for Health Information; Organization for Economic Cooperation and Development.

<sup>36</sup> *Fiscal Prospects for the Federal and Québec Governments*, op. cit., note 4, p. 27.

<sup>37</sup> *Ibid.*, note 4, p. 29.

## Causes

An analysis of the causes of growth in health care spending confirms the magnitude and durable nature of such growth. The Commission is of the opinion that the Conference Board has been fairly conservative in this regard and that real growth in health care spending will likely exceed the Conference Board projections.

This growth is attributable, by and large, to three factors, i.e. rising drug costs, the impact of technological advances, and the population aging.

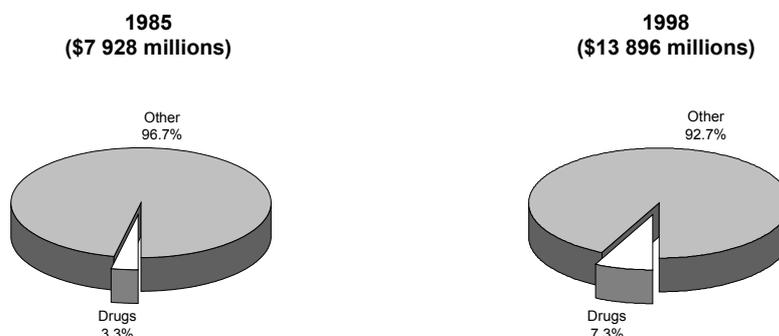
### Rising drug costs

In Québec, increases in health care costs stem primarily from rising drug costs. In 15 years, the relative proportion of spending on drugs in relation to overall public health care spending more than doubled, from 3.3% in 1985 to 7.3% in 1998.

The trend toward rising drug costs is also a durable one for reasons similar to those affecting health care costs in general: drug consumption is increasing, notably because of population aging, and the price of drugs is rising since substantial investments must be made to make the products more effective.

## CHART 7

### IMPORTANCE OF DRUGS IN THE QUÉBEC HEALTH CARE SECTOR (as a percentage of public health care spending)



Source: Canadian Institute for Health Information.

### The impact of technological advances in the health care sector

Technological advances are not confined to drugs. New diagnostic technologies, especially medical imaging techniques, are making it possible to intervene more rapidly and effectively to detect diseases. Considerable progress has been made in respect of actual treatment, in particular through endoscopy and robotics. More effective, and costlier, therapies are appearing regularly.

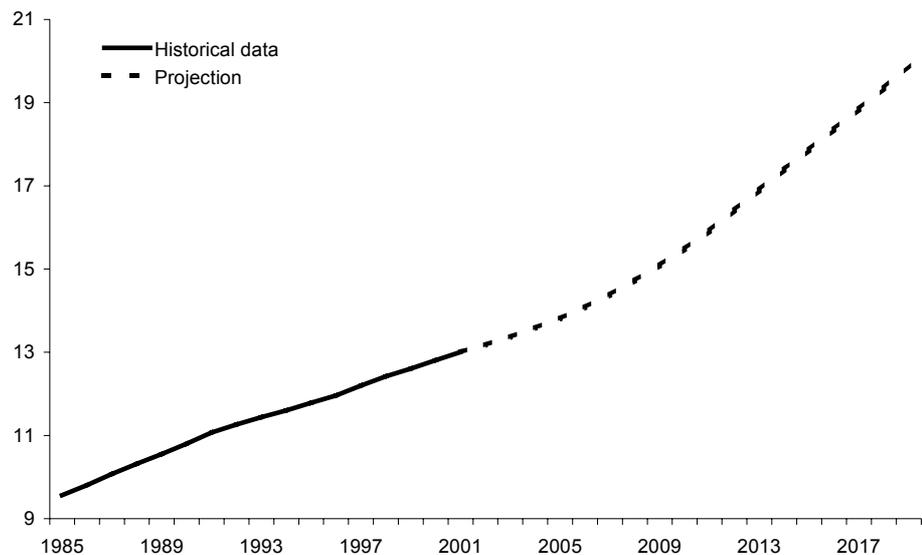
At the same time, the health care sector is benefiting from new information and communications technologies, which will ultimately lead to enhanced efficiency in organizations and could engender savings. However, the introduction of these new technologies requires substantial, immediate investment in order to computerize all establishments and implement more efficient communications networks. Such investment is concomitantly increasing pressure on provincial government programs spending.

### Population aging

It should be noted that the population aging in itself is an important cause of growth in health care spending, one that is of particular concern to Québec. According to the demographic scenario considered by the Conference Board, the proportion of individuals 65 and over in Québec will rise from 13% in 2001 to nearly 20% in 2019.

## CHART 8

**PROPORTION OF INDIVIDUALS 65 AND OVER IN QUÉBEC'S TOTAL POPULATION, 1985-1986 TO 2019-2020**  
(as a percentage)

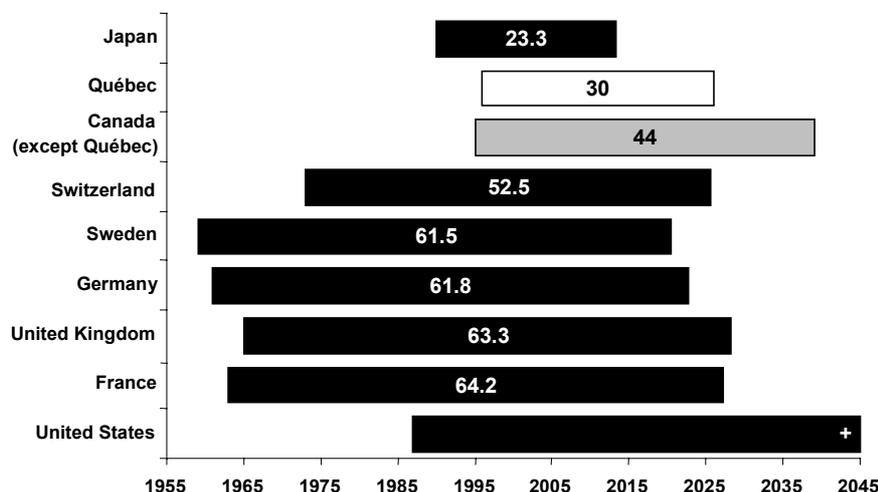


Sources: Statistics Canada; Conference Board of Canada.

The relatively rapid pace at which its population is aging sets Québec apart from the other provinces and industrialized nations. The proportion of the population 65 and over will double in Québec in 30 years, compared with 44 years in the rest of Canada, 62 years in Germany, 63 years in the United Kingdom, and 64 years in France, when baby boomers enter the 65-and-over cohort. This situation explains the extent of the pressure related to the aging of the population that Québec will face in the next half century.

**CHART 9**

**NUMBER OF YEARS UNTIL THE PROPORTION OF INDIVIDUALS 65 AND OVER INCREASES FROM 12% TO 24% IN QUÉBEC AND CERTAIN OECD COUNTRIES**



Sources: Statistics Canada; United Nations.

Since health care costs rise markedly with age, the health care budget is affected directly by the population aging.

**TABLE 3**

**PUBLIC HEALTH CARE SPENDING IN QUÉBEC, BY AGE AND SEX**  
(dollars per capita)

	2000-2001		2019-2020	
	Men	Women	Men	Women
0 to 14	898	813	1 527	1 403
15 to 24	750	1 141	1 481	2 252
25 to 34	760	1 430	1 160	2 180
35 to 44	850	1 137	1 247	1 686
45 to 54	1 241	1 416	1 846	2 108
55 to 64	2 333	2 257	4 243	3 966
65 to 74	4 980	4 329	11 155	9 676
75 to 84	9 051	8 389	17 350	16 761
85 and over	16 181	16 000	24 535	24 942
<b>All ages</b>	<b>1 687</b>	<b>2 176</b>	<b>4 103</b>	<b>4 958</b>

Note: The direct expenditures of the federal government, the municipalities and workers' compensation boards are excluded.

Source: Conference Board of Canada.

Indeed, the Conference Board estimates that the population aging alone explains in the case of Québec an average annual increase of 1% in health care spending over the next 20 years.

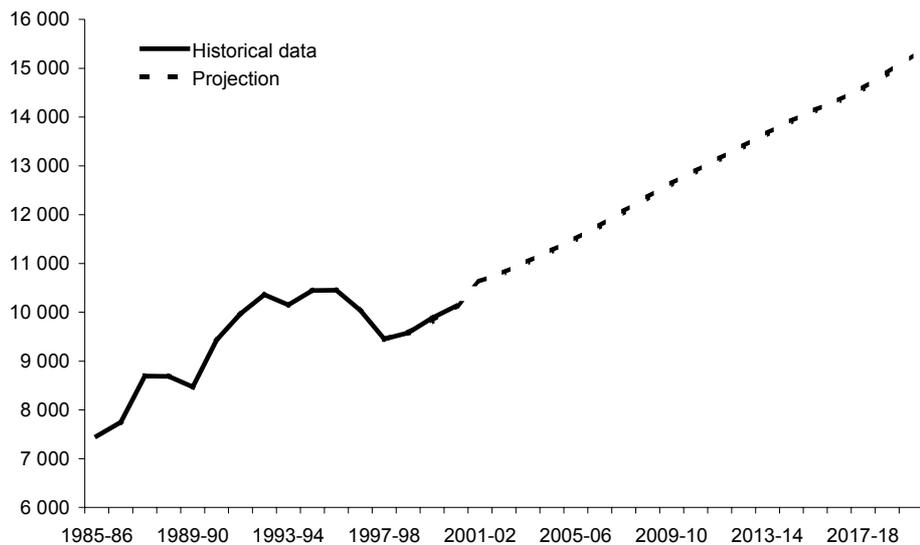
### 1.1.2 Education and training

Education and training, the second most important field in which the provinces deliver services, unlike health care, should exert less pressure in light of demographic change. However, even bearing in mind the Conference Board's very conservative projections in this respect, the reduced pressure will be insufficient to offset higher health care spending.

Between 1985-1986 and 2000-2001, education spending in Québec rose, on average, by 2.1% per year. Indeed, growth in such spending was very rapid until 1992-1993, when it stood at 4.8% per year. During the period in which budgetary balance was achieved, spending declined in absolute value, then rose again over the past three years, at an annual rate of 2.3%.

**CHART 10**

**EDUCATION SPENDING IN QUÉBEC, 1985-1986 TO 2019-2020**  
(millions of dollars)



Sources: *Comptes publics du Québec*; Conference Board of Canada.

Impending change will stem from several contradictory factors:

- ◆ Demographic change will lower education costs, mainly at the elementary and secondary levels. According to the Conference Board, the population under 15 years of age should also decline by 1% per year, on average, by 2019.<sup>38</sup> This demographic change will obviously reduce demand for education services in respect of this age group.

However, at the same time, other factors should nudge upward education needs, e.g. the increase in the proportion of individuals engaged in study and in the average length of each individual's training.

<sup>38</sup> *Fiscal Prospects for the Federal and Québec governments, op. cit.*, note 4, p. 18.

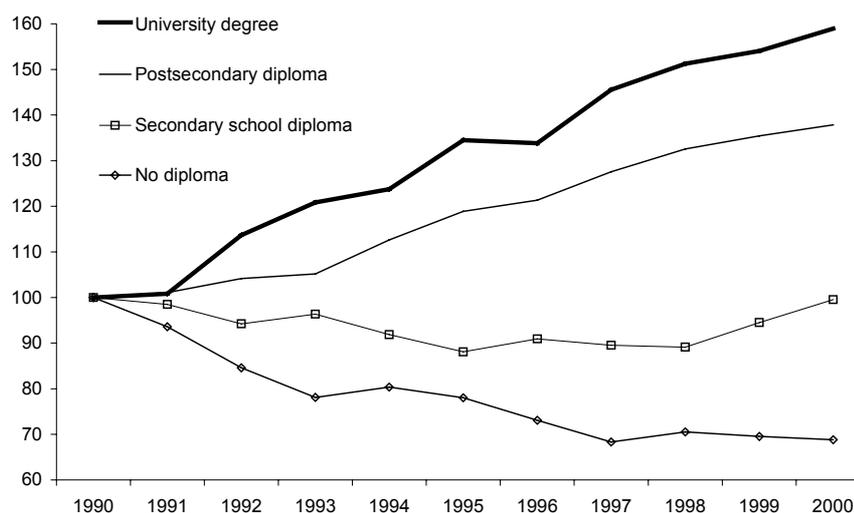
- ♦ Over the past 20 years, educational enrolments have grown rapidly, which in itself is very positive: the proportion of 17-year-old Quebecers without a high school diploma and who were not in school fell from 26.2% in 1979-1980 to 10.4% in 1999-2000.
- ♦ A child entering elementary school in 1999-2000 will spend, on average, 15.3 years in the education system, nearly one year more than was the case in 1988-1989. All gains over this period are attributable, either to adult education or to post-secondary education.

These factors reflect new labour market conditions. Since 1990, the proportion of workers who possess at least a bachelor's degree has risen almost 60%, while the proportion of workers who do not possess a high school diploma has fallen more than 30%. The total cost of training a high school graduate is roughly \$83 500, that of a Cegep technical training graduate, \$135 500, and that of an undergraduate, \$165 000.<sup>39</sup> In a report published in 2001, the OECD noted:

*A conjunction of economic and social forces underpins the current impetus to lifelong learning in OECD countries. Whether these circumstances are historically unprecedented is debatable. However, except in the unlikely event of these trends reversing themselves of their own accord, lifelong learning represents probably the most effective way of offsetting some of the more harmful effects of the interrelated forces of technological change, globalisation and sectoral shifts in consumption and production.*<sup>40</sup>

## CHART 11

EMPLOYMENT IN QUÉBEC BY LEVEL OF EDUCATION, 1990 TO 2000  
(1990 index = 100)



Source: Statistics Canada.

<sup>39</sup> 1999-2000 data from the ministère de l'Éducation du Québec.

<sup>40</sup> ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *L'apprentissage tout au long de la vie: aspects économiques et financiers*, 2001, p. 13.

While its extent is hard to predict, there is no doubt that, from the standpoint of pressure on the education sector, training needs stemming from the new realities of the labour market will have the opposite effect of demographic trends.

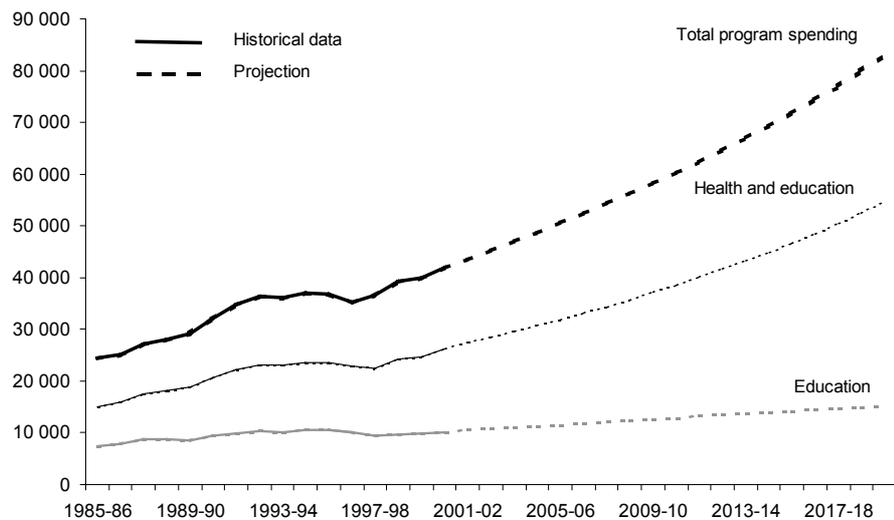
### Health and education

Broadly speaking, it seems certain that a slowdown in the growth of education spending will not offset the increase in health care spending.

The Conference Board draws a similar conclusion in that it maintains that the proportion of health care and education spending in Québec's program spending should increase from 62.5% in 2000-2001 to 66% in 2019-2020.

## CHART 12

**QUÉBEC GOVERNMENT HEALTH CARE, EDUCATION AND PROGRAM SPENDING, 1985-1986 TO 2019-2020**  
(millions of dollars)



Sources: *Comptes publics du Québec*; Conference Board of Canada.

### 1.1.3 Defence

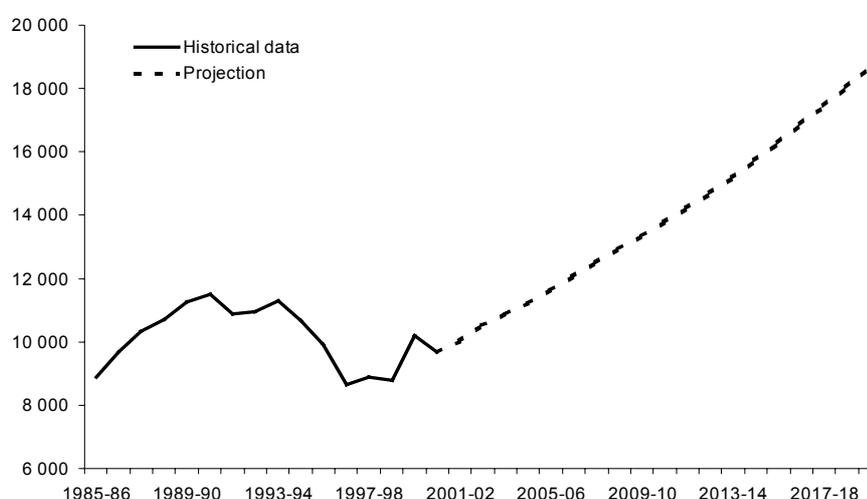
Compared with the pressure on health care and education spending facing the provincial governments, the impact of growth in needs with which the federal government must contend is more limited with regard to service delivery under its jurisdiction. As we saw earlier, defence is the biggest program of this nature from a financial standpoint in that it accounts for 8.1% of federal government program spending. It is also the program that the federal government mentions to show that it, too, is facing considerable pressure. For this reason, the Commission wished to shed special light on the matter.

## A contrasting situation

Over the past 20 years, defence spending, the leading federal government program under which it delivers services, has changed in a contrasting manner: until 1990-1991, defence spending increased, on average, by 5.3% per year, after which spending levelled off, then decreased. It began to grow again recently. All told, between 1985-1986 and 2000-2001, federal government defence funding rose, on average, by 0.6% per year.

### CHART 13

**FEDERAL GOVERNMENT DEFENCE SPENDING, 1985-1986 TO 2019-2020**  
(millions of dollars)



Sources: *Public Accounts of Canada*; Conference Board of Canada.

## New needs

The September 11, 2001 events marked a turning point in the federal government's defence policy. In order to respond to new security needs and combat terrorism, the federal government announced in its 2001 budget a \$1.2 billion increase in defence spending over six years, equivalent to an annual increase of roughly 2%.<sup>41</sup>

In its study, the Conference Board hypothesized that defence spending would rise by 3.5% per year until 2019-2020. Applied to defence spending, the hypothesis is generous insofar as it assumes more rapid growth than announced by the federal government for the next five years, in the wake of the September 11, 2001 events.

## The context differs from that surrounding health care and education

It must be emphasized that, federal government service delivery in the defence sector is not subject to the same management constraints as the

<sup>41</sup> DEPARTEMENT OF FINANCE CANADA, *2001 Budget*, p. 99.

health care and education sectors. Spending does not depend directly on a clientele’s needs but is essentially tied to international initiatives in which the federal government decides to take part.

The pressure that the federal government faces in this sector is occasional. The federal government enjoys leeway that is not available to the governments responsible for managing health care and education networks, which are subject to structural, recurring pressure.

**Limited impact on the overall budgetary position**

Overall, unlike the situation that Québec is facing, anticipated growth in defence spending should only have a limited impact on the federal government’s budgetary position because such spending is limited in relation to total program spending. For example, according to the Conference Board’s projections, the share of defence spending in overall program spending should fall from 8.1% to 7.9% between 2000-2001 and 2019-2020.

**CHART 14**

**DEFENCE SPENDING AS A PROPORTION OF FEDERAL GOVERNMENT PROGRAM SPENDING, 1985-1986 TO 2019-2020**  
(as a percentage)



Sources: *Public Accounts of Canada*; Conference Board of Canada.

**1.1.4 Other spending**

It should be noted that the federal government delivers services in other fields, although they are much less extensive than defence. All in all, such service delivery now accounts for a little more than 30% of federal program spending and it does not exert pressure of the magnitude that Québec is facing in the health care sector.

## 1.2 Transfers exert limited structural pressure

As we saw earlier, transfers account for 69% of federal government program spending, compared with 25% of such spending in Québec.

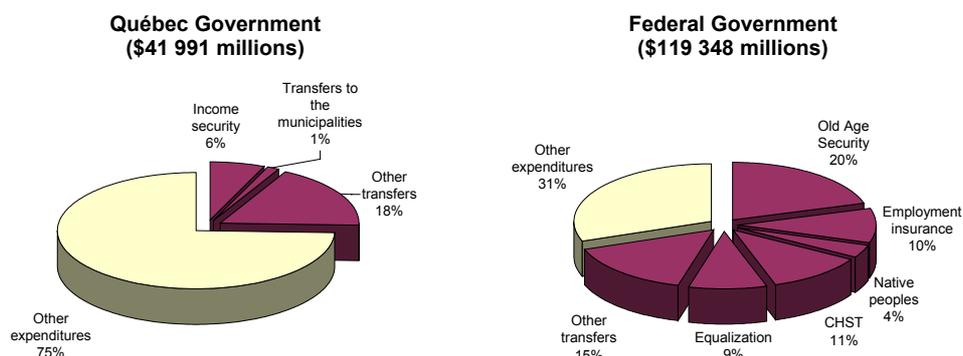
The principal federal government transfers are indicated below.

- ◆ Transfers to individuals account for more than half of all transfers and more than a third of program spending. They essentially comprise Old Age Security benefits, employment insurance benefits, and transfers to the Native peoples.
- ◆ Transfers made to the provinces account for 21% of program spending and comprise almost exclusively the CHST and equalization payments.

Income security is the only transfer of financial significance to Québec from the standpoint of program spending.

### CHART 15

#### BREAKDOWN OF QUÉBEC AND FEDERAL GOVERNMENT PROGRAM SPENDING, 2000-2001



Note: "Other transfers" include the other transfers to individuals and to other public administrations.

Sources: *Comptes publics du Québec (2000-2001)*; *Public Accounts of Canada (2000-2001)*.

In order to ascertain the pressure that they exert on the budgets of the governments concerned, the Commission analysed four of these transfer programs, i.e. Old Age Security, employment insurance, transfers to the provinces in the case of federal government and income security in the case of Québec.

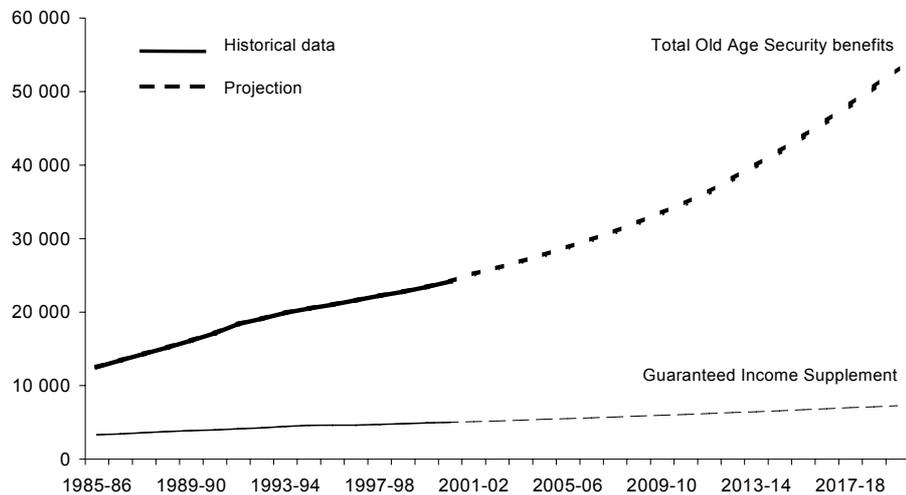
As we will see, this analysis leads to an important conclusion: rising structural pressure is more limited in respect of transfer expenditures, which benefits the federal government above all, given the importance of transfers in its programs spending.

### 1.2.1 Limited pressure on federal Old Age Security programs

Federal Old Age Security programs essentially encompass two kinds of benefits, i.e. the basic Old Age Security pension and the Guaranteed Income Supplement, which, in 2000-2001, accounted for 78% and 21%, respectively, of overall federal Old Age Security programs.<sup>42</sup> The cost of the programs increased from \$13 billion in 1985-1986 to \$24 billion in 2000-2001, equivalent to average annual growth of 4.5%. The Conference Board anticipates that such growth will slow in the future and reach 4.2% per year over the next 20 years.

**CHART 16**

**OLD AGE SECURITY BENEFITS, 1985-1986 TO 2019-2020**  
(millions of dollars)



Notes: Total Old Age Security benefits include the basic Old Age Security benefit (\$18 765 million in 2000-2001), the Guaranteed Income Supplement (\$5 020 million in 2000-2001), and the spousal allowance (\$386 million in 2000-2001). Sources: Human Resources Development Canada; Conference Board of Canada.

The slower growth of Old Age Security benefits projected by the Conference Board merely prolongs a trend noted since the early 1980s, which stems from several factors.

- ◆ First, Old Age Security programs are indexed to inflation and do not, therefore, undergo any real increase.
- ◆ The basic Old Age Security program was originally a universal program. In 1989, the federal government ended the program's universality and implemented a tax back mechanism.<sup>43</sup> Through this tax recovery, the

<sup>42</sup> The third program, the spousal allowance, accounted for less than 2% of overall federal Old Age Security programs.

<sup>43</sup> Since then, taxpayers whose income exceeds a certain threshold must repay, through the taxation system, as much as 100% of their federal benefit. In 1999, this tax recovery was worth \$577 million, equivalent to 3.2% of the benefits paid and applicable to 5.8% of beneficiaries.

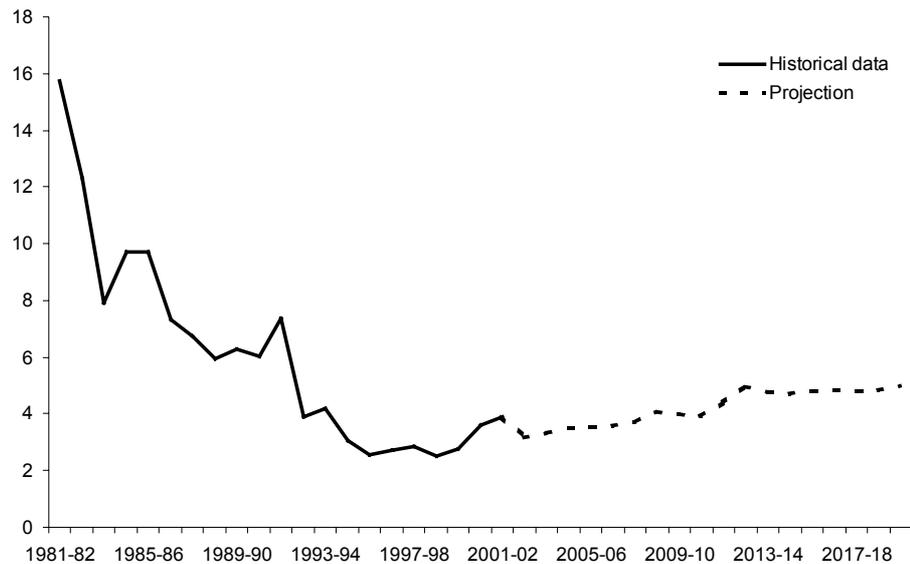
federal government has significantly limited pressure on its financial framework from the biggest federal Old Age Security program.

- ♦ Slower growth in needs with regard to the Guaranteed Income Supplement is directly attributable to the improved financial position of the elderly, which in turn results directly from the implementation in the 1960s and 1970s of public and private pension plans.

All in all, a steady slowdown has occurred in the growth of Old Age Security benefits, despite the population aging and the attendant increase in the number of beneficiaries. Such growth, which stood at 15.7% per year in 1981-1982, had fallen to 3.6% in 2000-2001. According to the Conference Board, this growth will be an average 4.2% over the next 20 years. It would indeed appear that the federal government has managed to limit the pressure exerted by these programs.<sup>44</sup>

**CHART 17**

**ANNUAL GROWTH RATES OF OLD AGE SECURITY BENEFITS,  
1981-1982 to 2019-2020  
(as a percentage)**



Sources: Human Resources Development Canada; Conference Board of Canada.

<sup>44</sup> This conclusion is confirmed by the analysis conducted by specialists. According to John Myles, "Canadian public expenditures on income security for seniors are modest by international standards and are projected to peak at levels well below those anticipated by most other Western nations in the next century." (*The maturation of Canada's retirement income system: income levels, income inequality and low income among the elderly*, 2000, p. 1).

### 1.2.2 Employment insurance is subject to less extensive structural pressure

Employment insurance benefits are the second biggest transfer program to individuals administered by the federal government. In 2000-2001, such benefits accounted for 9.6% of overall federal government spending programs.

These benefits usually depend directly on the unemployment rate. Unlike other spending programs, they are not funded through taxes but by means of employment insurance contributions, which the federal government treats, in practice, like tax revenues.

#### Conference Board projection

In light of demographic change, we will witness in the coming years a reduction in the number of people entering the labour market and an increase in the number of retirements, a twofold trend that should make it possible to achieve a structural reduction in the unemployment rate.

**CHART 18**

**UNEMPLOYMENT RATE IN CANADA, 1985-1986 TO 2019-2020**  
(as a percentage)



Sources: Statistics Canada; Conference Board of Canada.

The Conference Board predicts average annual growth in employment insurance benefits of 4.2% and that contributions will grow at the same pace starting in 2006, following a downward adjustment to absorb the current discrepancy between contributions and benefits. Moreover, the Conference

Board emphasizes that a structural reduction in the unemployment rate should occur on the labour market:

*If participation rates by age group and growth in productivity remain in line with those observed historically, Canada could lack nearly 1 million workers by 2020.<sup>45</sup>*

### Reforms that reduce risks

During the 1990s, the federal government initiated a series of reforms of the employment insurance program that at least partly severed the link that had existed until then between changes in the unemployment rate and the total benefits paid. By modifying the program's parameters, the federal government succeeded in largely isolating the impact that economic fluctuations would normally have on spending related to this program.

The reforms have directly affected the provinces' income security spending since the beneficiaries who are excluded from the federal program are often referred to provincial social aid programs.<sup>46</sup>

#### The latest employment insurance reforms<sup>47</sup>

During the 1990s, the employment insurance program (formerly unemployment insurance) underwent four reforms.

1. **The 1990 reform:** the number of weeks worked to ensure eligibility for benefits was increased; the maximum duration of benefits was reduced in regions with low unemployment; and the benefit rate was reduced in the event of voluntary departure, misconduct or refusal to work.
2. **The 1993 reform:** the benefit rate was reduced; and eligibility for benefits was eliminated in the event of voluntary departure, misconduct or refusal to work.
3. **The 1994 reform:** the benefit rate and duration of benefits were again reduced and the number of weeks worked to ensure eligibility was once again increased.
4. **The 1996 reform (*Employment Insurance Act*):** the variable entrance requirement (formerly in weeks) was converted into hours; the eligibility of new entrants on the labour market was reduced; the maximum benefit was reduced; and the "intensity rule" was introduced (the benefit rate was reduced by one percentage point per 20 weeks of normal benefits received during the five preceding years; the provision was abolished in 2000). It should be noted that the 1996 reform also shifted to the provinces most of the costs arising from Part II of the Act (worker training).

<sup>45</sup> *Fiscal Prospects for the Federal and Québec Governments, op. cit.*, note 4, p. 5.

<sup>46</sup> In 1997, economist Pierre Fortin estimated that the latest employment insurance reforms meant that nearly 200 000 unemployed Quebecers resorted to income security, which represents a recurring additional cost for the Québec government of \$845 million. While these findings may be somewhat imprecise, their scope was corroborated the following year by another study, focusing on all the Canadian provinces, conducted by Philippe Arnau, Pierre-Yves Crémieux and Pierre Fortin (*The Determination of Social Assistance Rates: Evidences from a Panel of Canadian Provinces 1977-1996*, 1998).

<sup>47</sup> HUMAN RESOURCES DEVELOPMENT CANADA, *Chief Actuary's Report on Employment Insurance Premium Rates for 1999*, 1998.

**Native peoples: pressures with limited financial consequences**

Aside from defence, the federal government also mentions its responsibility in respect of the Native peoples as a major source of pressure on its expenditures.

In 2000-2001, the budget of Indian and Northern Affairs Canada stood at \$5.1 billion. Transfer payments account for 88% of the department's spending. To such spending must be added \$1.3 billion from the Health Canada budget earmarked for health in aboriginal communities, which brings to some \$6.4 billion federal spending in this sector, equivalent to 5.3% of overall federal program spending in 2000-2001.

In its study, the Conference Board estimates at 3.5% per year, on average, growth in various expenditures that include spending allocated to Native peoples. Even if growth in future spending exceeded this estimate, it would not significantly affect the federal government's budgetary balance. Spending on Native peoples is fairly limited in terms of overall federal expenditures. The Québec government budget is, by way of comparison, much more sensitive to an increase in health care and education spending.

- ♦ A 1% increase in health care and education spending engenders, overall, a 0.6% increase in Québec program spending.
- ♦ The same 1% increase applied to defence spending and funding allocated to Native peoples would lead to an increase of only 0.1% in overall federal government program spending.

**1.2.3 Transfers to the provinces are designed to limit pressure on federal spending**

Transfers to the provinces are a key factor in the worsening fiscal imbalance in Canada stemming from the discrepancy between revenues and expenditures. Indeed, such transfers have a twofold impact, since they are expenditures for the federal government and revenues for the provincial governments. This section examines the question from the federal perspective.

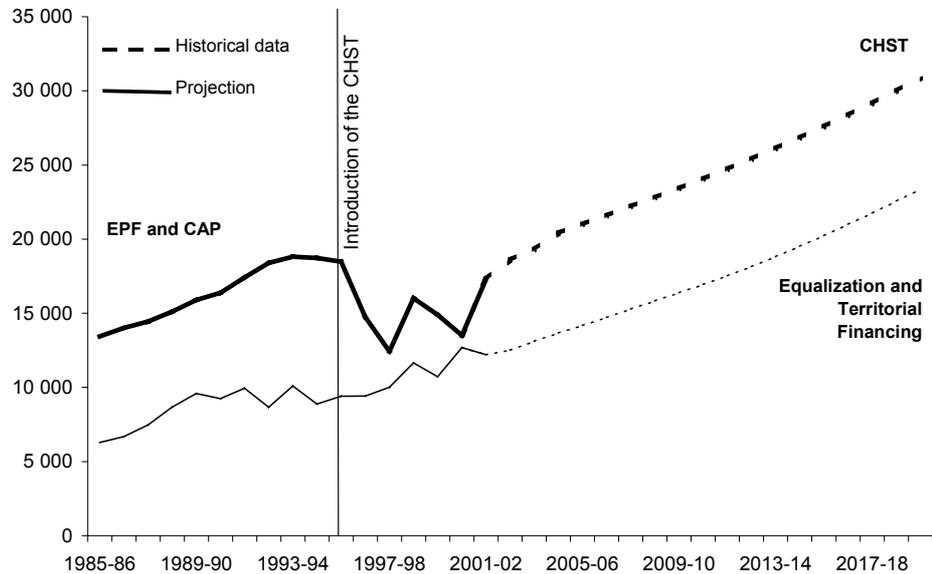
**Changes in federal transfers**

Between 1985-1986 and 2000-2001, transfers to the provinces increased at an average annual rate of 1.8%.

This rate reflects two separate changes: while equalization increased at a fairly constant pace during the period, the same is not true of the CHST and the two programs that it replaced. In the case of these transfer programs, the amounts transferred grew steadily in the early 1980s, followed by an abrupt reduction and a partial recovery.

**CHART 19**

**FEDERAL CASH TRANSFERS, 1985-1986 TO 2019-2020**  
(millions of dollars)



Note: Amounts in respect of the EPF and CHST include the special Québec abatement, trusts funds and attendant amounts.

Sources: *Public Accounts of Canada*; Conference Board of Canada.

Chapter 3 examines the definition of the CHST and the unilateral nature of the changes made by the federal government. The Commission simply wishes to emphasize here that the cuts made by the federal government in the CHST account for over half of the cumulative cutbacks that it effected in its program spending between 1994-1995 and 2001-2002. Indeed, changes in the CHST illustrate the federal government's ability to radically alter the parameters of the main transfer program to the provinces in order to obtain budgetary leeway.

In its study, the Conference Board adopted a hypothesis concerning future growth in the CHST that takes into account inflation and population growth. As for equalization payments, the Conference Board has assumed growth based on GDP that would reflect the program's behaviour over the past 20 years. All told, according to the Conference Board projection, transfers to the provinces should increase by 3.7% per year between 2000-2001 and 2019-2020.

- ♦ The Commission wishes to point out that the federal government has made no commitment beyond the 2005-2006 fiscal year. The CHST, as it is now defined, is under the complete control of the federal government, which can set the amounts transferred according to its budgetary priorities. The Conference Board had to adopt its own growth hypothesis for the purpose of its study since existing legislation makes no provision for an indexing mechanism or, indeed, any payment after 2005-2006.

- ♦ As Chapter 3 reveals, equalization payments are subject to a ceiling and may not increase faster than GDP. The threshold at which this mechanism applies has been considerably reduced in conjunction with successive five-yearly renewals of the program.

### **Limited pressure from transfer programs**

It is thus apparent that the three main federal government transfer programs, devoted to the elderly, the unemployed and the provinces, are subject to relatively limited pressure. Above all, the federal government has shown, in the case of transfers to the provinces, that it is capable of unilaterally redefining the parameters of these programs despite the provinces' objections when its financial objectives spur it to do so.

#### *1.2.4 Income security*

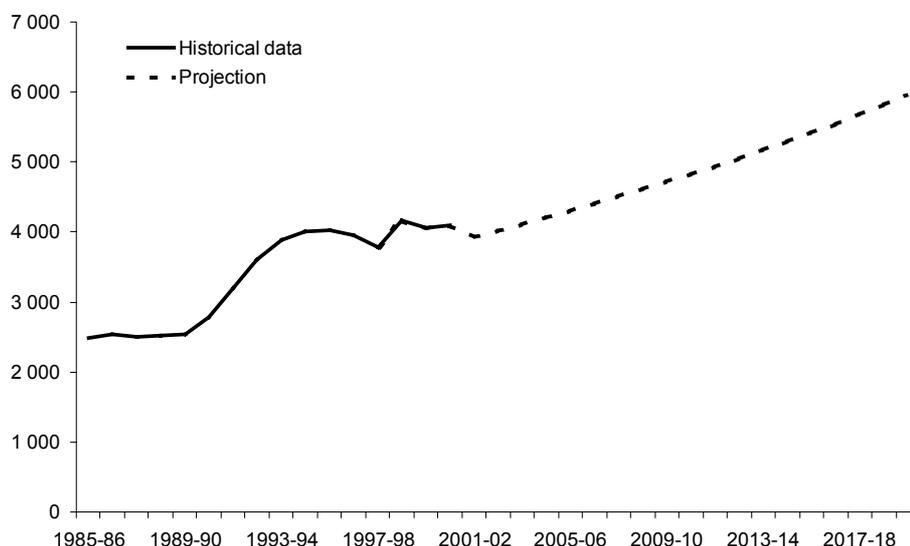
The main transfer program administered by Québec is aimed at individuals and, while its name has changed over the years, it is usually called the income security program. Lately, this program has been the key component of an array of assistance programs aimed at ensuring income security and formerly grouped under social aid.

As is the case with the federal government, the Québec government has been able to limit pressure from its main transfer program, aided by favourable economic conditions. Between 1989-1990 and 1994-1995, Québec income security aid expenditures rose sharply, followed by a period of relative stability.

In its projection, the Conference Board hypothesized that average annual growth in the program would reflect population growth and inflation and stand at 2.0%. Consequently, income security expenditures are not expected to exert considerable pressure on Québec's program spending. However, the Commission wishes to point out that, unlike employment insurance, this program is a form of last resort assistance, which, in practice, limits Québec's leeway when it defines its commitments.

**CHART 20**

**INCOME SECURITY EXPENDITURES IN QUÉBEC, 1985-1986 TO 2019-2020**  
(millions of dollars)



Note: The expenditures illustrated in this chart are based on the spending structure of the ministère de l'Emploi et de la Solidarité sociale in 2000-2001.

Sources: *Comptes publics du Québec*; Conference Board of Canada.

**The Commission's conclusion**

The analysis of the federal and Québec governments' main spending programs explains why, overall, the provinces are subject to strong pressure.

- ◆ In the case of service delivery, it is the provinces and not the federal government that must respond to what are deemed priority needs, mainly in the realm of health care, which are rising rapidly because of durable trends.
- ◆ As for transfer expenditures, both the Québec and federal governments have been able to limit the pressure to which they are subjected. The federal government's advantage stems from the much greater importance of transfer expenditures in respect of its program spending.

## 2. REVENUE DIVISION DOES NOT REFLECT THE SPENDING DYNAMIC

In light of this spending dynamic, revenue division in the Canadian federation generates revenues that do not allow Québec and the other provinces to fund the responsibilities that they have to assume.

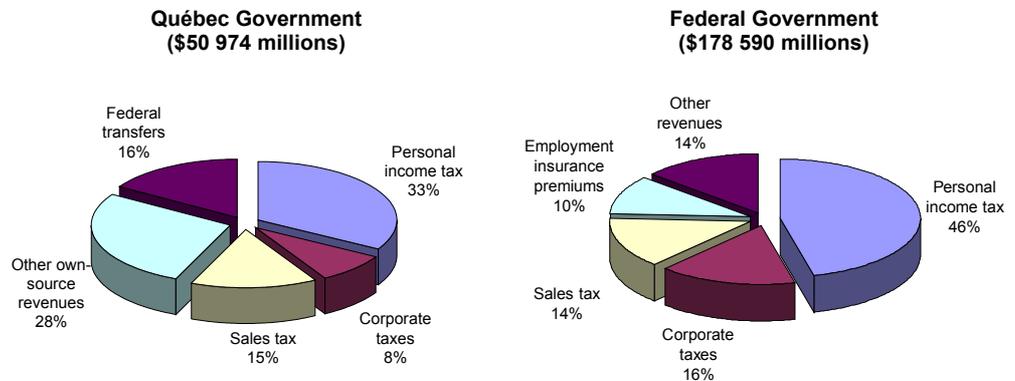
The Constitution stipulates the taxation fields of the two orders of government. Contrary to expenditures, there is no compartmentalized breakdown of these taxation fields between the federal government and the provinces, except for excise tax and customs duties, which are reserved for federal authorities.<sup>48</sup> The federal government and the provinces occupy, in reality, the same taxation fields in proportions that vary according to the field. In the case of the provinces, federal transfers are added to own-source revenues to make up total revenues.

### A differing breakdown of revenues

In practice, the breakdown of revenues differs significantly depending on the order of government.

**CHART 21**

### BREAKDOWN OF QUÉBEC AND FEDERAL GOVERNMENT REVENUES, 2000-2001



Sources: *Comptes publics du Québec (2000-2001)*; *Public Accounts of Canada (2000-2001)*.

- ◆ In the case of the federal government, nearly half of the revenues are derived from personal income tax (46% in 2000-2001). Corporate tax (16% of revenues), sales tax (14%) and employment insurance contributions (10%) are other sources of revenue, which, as we saw earlier, the federal government treats as tax revenue.
- ◆ Québec personal income tax is also the main source of revenues, although it is relatively less important than in the case of the federal

<sup>48</sup> Since 1982, the Constitution has granted the provinces explicit taxing power in respect of natural resources.

government. In 2000-2001, personal income tax accounted for one-third of Québec government revenues and the sales tax, 15%.

It should be emphasized that, in the case of Québec, “other own-source revenues,” mainly natural resource royalties and revenues from government-owned corporations, account for over one-quarter of total revenues. Transfers from the federal government make up 16% of Québec government revenues.

**The Canadian Constitution and the division of jurisdiction over taxation between the two orders of government**

Section 91(3) of the *Constitution Act, 1867* stipulates that the Canadian Parliament may legislate on “*the raising of Money by any Mode or System of Taxation.*” The only restriction on the federal government’s taxing authority is found in section 125, which states that “*No Lands or Property belonging to Canada or any Province shall be liable to Taxation.*”

Provincial tax jurisdiction has a varied foundation.

- ◆ First, section 92(2) of the *Constitution Act, 1867* attributes express jurisdiction to the provinces over “*Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes.*”
- ◆ Section 92A governing natural resources, introduced into the Constitution by the *Constitution Act, 1982*, attributes to the provinces an explicit power to tax natural resources.
- ◆ Moreover, the courts have established a jurisprudential definition of direct and indirect taxes, in light of which they have declared as direct taxes personal income and estate taxes, property taxes and sales taxes. They have deemed to be indirect taxes excise taxes, customs duties and *ad valorem* wholesale taxes.

**The revenue dynamic favours the federal government**

All in all, the sharing of revenue by the two orders of government does not reflect the expenditure dynamic, as described earlier, for two reasons:

- ◆ First, the existing occupation of taxation fields by the two orders of government puts the federal government at an advantage.
- ◆ Second, the federal government controls part of the provinces’ revenues through the transfers it pays them. As we have just noted, such control became one of the direct causes of fiscal imbalance when the federal government substantially pruned transfers to the provinces, starting in the mid-1990s. The cutbacks deprived the provinces of a substantial portion of their revenues at the very time that their expenditures were subject to considerable pressure.

A distortion is apparent in the Canadian federation between the expenditure dynamic, in which the provinces must address priority, growing needs, and the revenue dynamic, which puts the federal government at an advantage. The result is substantial federal government surpluses.

As it has done in respect of expenditures, the Commission has specifically analysed this revenue dynamic by focusing precisely on the two factors that explain its nature, i.e. the occupation of taxation fields that gives the federal government an advantage and the impact of federal control over part of the provinces' revenues.

### **2.1 An occupation of taxation fields that puts the federal government at an advantage**

Personal income tax now accounts for 46% of federal government revenues. Over the past 20 years, the revenues that the federal government has derived from this form of taxation have risen at an average annual rate of 7.4%.

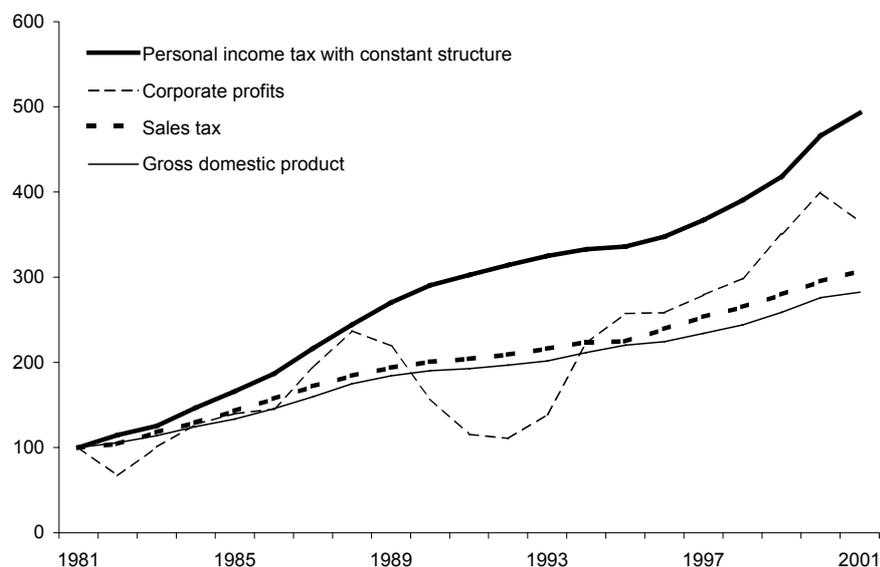
According to the Conference Board's projections, average annual growth in federal personal income tax should reach 3.8% over the next 20 years. However, starting in 2005-2006, the figure should stand at 4.5%, since the impact of the tax reductions announced will no longer be felt.

Rapid growth in the federal government's personal income tax revenues is attributable to the nature of this tax.

- ◆ Personal income tax revenues are rising much more rapidly than gross domestic product because of the progressive nature of such revenues. The tax is collected at several rates that rise as taxable income increases.
- ◆ The marked growth in sales tax revenues over the past 20 years is due, by and large, to major changes in the definition of the tax, which became a value-added tax when the GST was introduced. When its structure remains unchanged, the sales tax base reflects, usually, fairly closely general growth in the economy.
- ◆ In comparison, corporate tax revenues are highly volatile, while contribution ceilings limit growth in payroll taxes in most plans.

**CHART 22**

**GROWTH IN THE MAIN TAX BASES AND PERSONAL INCOME TAX WHEN THE STRUCTURE REMAINS CONSTANT, QUÉBEC, 1981-2001**  
(1981 index = 100)



Notes: "Personal income tax" refers to the tax yield; "Corporate profits" refers to the tax base in respect of corporate income tax; "Sales tax" refers to final taxable consumption excluding, in particular, food and rent, and bearing in mind other exemptions.

Sources: Commission on Fiscal Imbalance; Statistics Canada.

**Impact on growth in revenues**

The federal government's predominant position in the most lucrative taxation fields introduces a dynamic that explains the marked growth in federal revenues observed in recent years. Such growth will continue in the future.

A simulation of theoretical growth in the revenues of the federal and Québec governments, when the taxation system remains constant, reveals that the federal government's revenues increase more rapidly, even when revenues from each of the tax bases increase in the same way in respect of both orders of government.

- ◆ Overall growth in federal government revenues, when the taxation system remains constant, would stand at 4.1%, compared with 3.7% for the Québec government, a discrepancy that may seem small. However, it means that, over a period of five years, the Québec government would have at its disposal an additional \$1 billion in revenues had it experienced the same growth rate as the federal government.
- ◆ In this simulation, the discrepancy is solely attributable to the composition of the revenues of the two orders of government. The federal government more extensively controls the tax bases on which revenues grow the fastest.

**TABLE 4**

**POTENTIAL GROWTH OF REVENUES LEVIED IN QUÉBEC BY THE FEDERAL AND QUÉBEC GOVERNMENTS, BASED ON THE BREAKDOWN OF 2001-2002**  
(as a percentage)

	Share of revenues		Growth rates
	Federal	Québec	
<b>Personal income tax</b>	45.9	33.1	4.8
<b>Non-resident tax</b>	1.3	-	4.8
<b>Corporate tax</b>			
Income tax	16.5	5.2	4.0
Tax on capital	0.4	6.3	4.0
	16.9	11.5	
<b>Taxes and duties on goods and services</b>			
General sales taxes	14.6	19.6	4.0
Fuel	2.4	4.1	1.9
Tobacco	1.7	1.9	1.9
Alcoholic beverages	0.7	1.1	1.9
Customs duties	1.5	-	1.9
	20.9	26.7	
<b>Payroll taxes</b>			
Employment insurance	10.3	-	3.6
Health Services Fund	-	11.6	3.6
Commission de la santé et de la sécurité au travail	-	4.2	3.6
Commission des normes du travail	-	0.1	3.6
	10.3	15.9	
<b>Other revenues</b>			
Lotteries and gambling	-	3.4	1.4
Other	4.7	9.4	1.4
	4.7	12.8	
<b>Total revenues</b>	<b>100.0</b>	<b>100.0</b>	
<b>Growth rate resulting from the composition of revenues</b>	<b>4.1</b>	<b>3.7</b>	

Notes: The portions indicated in this table differ from those appearing elsewhere in this section. The differences stem from certain characteristics of the analysis whose results are presented here: the base year is 2001-2002, only own-source revenues are indicated (excluding transfers between orders of government) and federal revenues reflect simulations based on the Québec economy. Hypotheses: 4% growth in GDP; personal income tax elasticity to GDP of 1.2; growth in specific taxes at the same pace as the CPI (1.4%) and population (0.5%); employment insurance revenues increase at the same pace as salaries and wages (3.6%); revenues from lotteries and gambling increase at the same rate as inflation.

Source: Commission on Fiscal Imbalance.

- ◆ This simulation makes it possible to examine the federal government's argument, put forward to mitigate the impact of a dynamic that gives the federal government an advantage. The federal government maintains that its absence from the lottery and gambling taxation field, in which revenues are growing rapidly, and its exclusive presence in a declining taxation field, i.e. customs duties, will put it at a disadvantage in the future. These two taxation fields account, respectively, for 3.4% of

Québec government revenues and 1.5% of federal government revenues and are thus too limited in the overall revenue structure to alter the latter's dynamic.

### Problems stemming from tax reduction

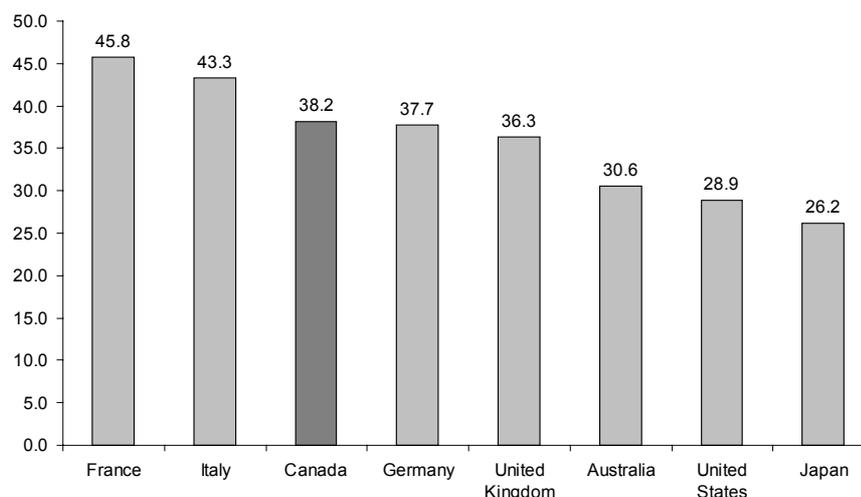
The reduction in personal income tax initiated by both orders of government introduces a specific dynamic that interferes with the problem of fiscal imbalance.

- ♦ The tax reductions reduce the weight of personal income tax in the revenues of both orders of government without truly altering the overall revenue dynamic.
- ♦ The federal government points to tax reductions in the debate on fiscal imbalance and maintains that the tax reduction implemented by the provinces proves that there is no fiscal imbalance. Moreover, the federal government claims that a reduction in federal taxes affords the provinces an opportunity to more extensively occupy the personal income tax field and to obtain a transfer of tax points.

In order to appreciate the value of these arguments, we must first bear in mind the comparative fiscal environment of Canada and the leading industrialized nations. According to OECD data, Canada now ranks among the industrialized countries with very heavy overall tax burdens. In 1999, the tax burden accounted for 38% of GDP, a level similar to that in the European countries but much higher than in the United States, Canada's principal economic partner.

### CHART 23

**OVERALL TAX BURDEN IN CERTAIN OECD COUNTRIES, 1999**  
(as a percentage of GDP)



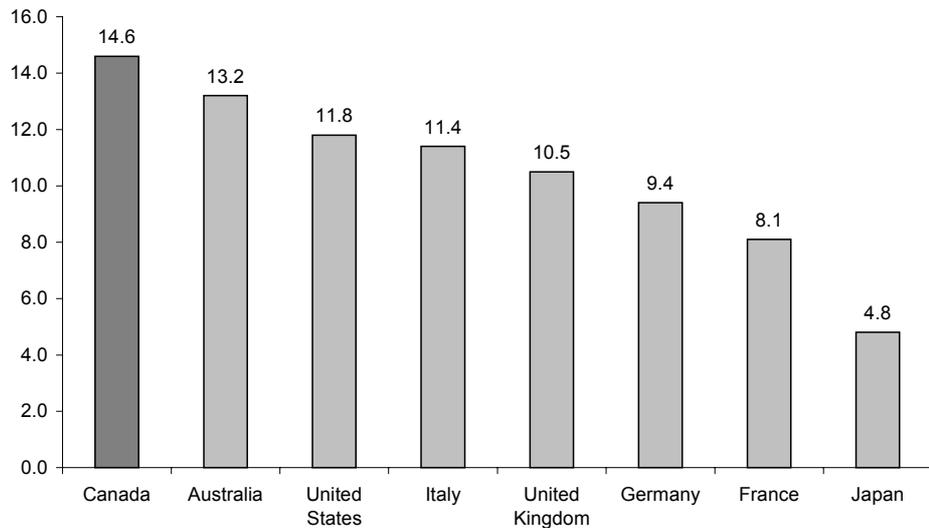
Source: Organization for Economic Cooperation and Development.

### The unwieldiness of personal income taxation

This comparison of fiscal environments was even more disadvantageous for Canada with respect to personal income tax. According to OECD compilations, in 1999, Canada had the highest personal income tax to GDP ratio among the main industrialized nations.

**CHART 24**

**PERSONAL INCOME TAXES IN CERTAIN OECD COUNTRIES, 1999**  
(as a percentage of GDP)



Source: Organization for Economic Cooperation and Development.

### Reasons for tax reductions

The federal and provincial governments are under considerable pressure to reduce the tax burden and more specifically the personal income tax. In recent years, such pressure has been especially high since taxpayers have directly contributed to re-establishing budgetary balance. It seemed obvious that once this balance was achieved, governments would reduce the tax burden.

It is against this backdrop that the federal government has reduced taxes. We can only express astonishment at the federal government's current claims that the provinces could have used these tax reductions to occupy the taxation field vacated by the federal government. Had the provinces done so, it would have meant offsetting a federal initiative that was in no way connected to the existing fiscal imbalance.

The Commission believes that a transfer of tax points, since that is what is in question, is clearly only conceivable in a coordinated manner independently of the initiatives launched by the two orders of government in order to reduce the tax burden. When the federal government reduced personal income tax, it

never announced that it was doing so to allow a new division for the benefit of the provinces of the taxation field. It is, therefore, curious that the federal government is now suggesting that the provinces should have diverted the federal tax reduction from its objective in order to initiate such a change in the division of the taxation field.

Given the discrepancies in the fiscal capacities of the provinces and the inability of the existing equalization program to eliminate these gaps, an uncoordinated transfer of tax points risks increasing tax competition between the provinces, which would run contrary to the objective of enhancing the funding of provincial social programs.

#### Transfers of tax points

A “tax point” is a percentage point of the tax base occupied by a government. The value of a tax point therefore varies with the value of the tax base to which it refers. For example, a federal personal income tax point was worth \$937 million in 2000-2001, equivalent to 1% of basic federal tax, total revenues from which then stood at \$93.7 billion.

A “transfer of tax points” occurs when one order of government reduces its taxes to enable the other order of government to increase taxes by the same proportion so that the overall tax burden remains unchanged.

## **2.2 Federal government control over the provinces’ revenues**

The provinces are facing a different situation from the standpoint of revenues stemming from the control that the federal government exercises over part of their resources. Such control became one of the direct causes of the existing fiscal imbalance when the federal government unilaterally reduced transfers to the provinces, thus widening the existing gap between the provinces’ revenues and expenditures.

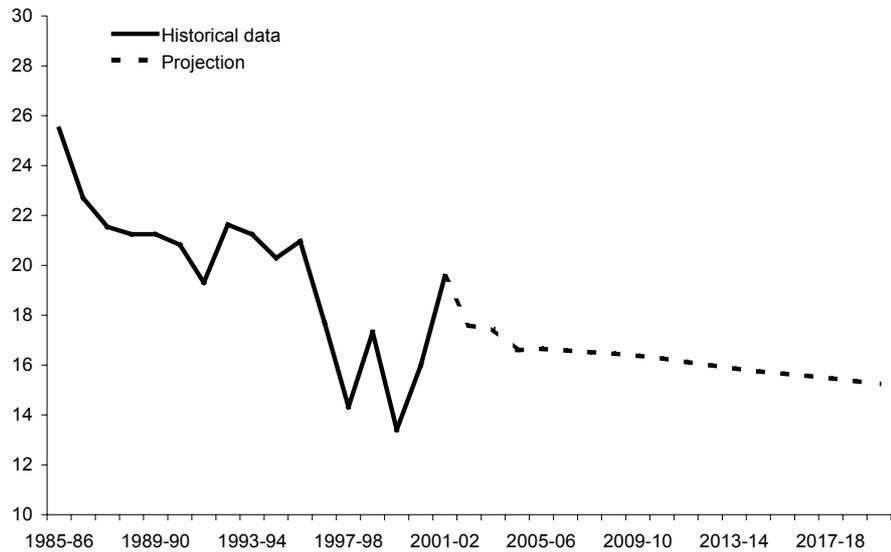
- ◆ Overall, federal transfers as a proportion of Québec government revenues have fallen steadily since the mid-1980s, from 25% in 1985-1986 to 16% in 2000-2001.
- ◆ As we explained earlier, in its projections, the Conference Board has assumed that the CHST will increase over the next 20 years at a rate tied to inflation and population growth, i.e. an average annual increase of 4.4%.<sup>49</sup> As for equalization payments, the Conference Board has assumed that the increase will be tied to growth in GDP that reflects the program’s behaviour over the past 20 years.

The Conference Board’s projection means that the proportion of federal transfers in Québec’s revenues would continue to decline during the period under study, from 16% to 15% between 2000-2001 and 2019-2020.

<sup>49</sup> Growth stands at 2.8% over the 2005-2006 to 2019-2020 horizon.

## CHART 25

### FEDERAL CASH TRANSFERS TO QUÉBEC, 1985-1986 TO 2019-2020 (as a percentage of Québec's total revenues)



Source: *Comptes publics du Québec*; Conference Board of Canada.

### Cuts in transfers exacerbate the gap between revenues and expenditures

Far from offsetting the distortion between federal government revenues and the provinces' expenditures, the federal government's transfers are actually widening the gap.

- ◆ In recent years, federal government cuts in transfers have destabilized provincial funding of the public services that the provinces are responsible for delivering.
- ◆ In the medium term, even optimistic projections confirm that, under the existing rules, the provinces can hardly rely on federal transfers to address the needs under their jurisdiction.

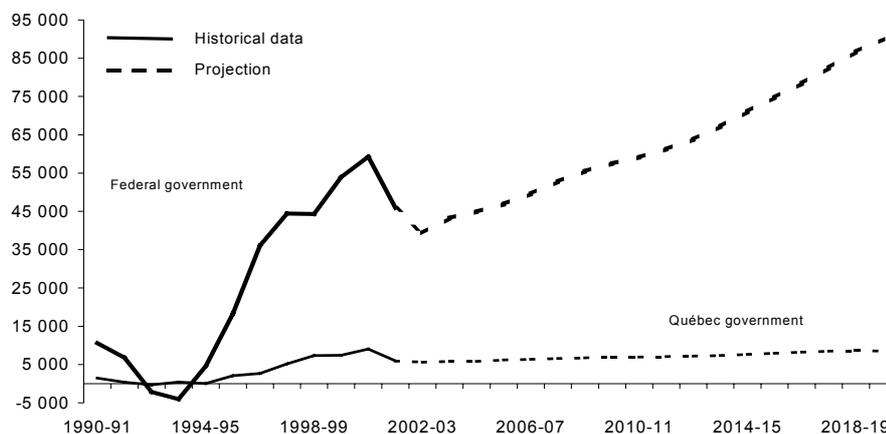
### The federal and Québec governments' operating balance

The provinces, and Québec in particular, are subject to greater pressure than the federal government with regard to spending. Far from remedying this imbalance, revenue sharing between the two orders of government is exacerbating such pressure.

These two factors mean that the operating balance, i.e. the difference between the budgetary revenues and the program spending of both orders of government, will move in opposite directions over the next 20 years if the existing situation is not remedied in any way.

**CHART 26**

**OPERATING BALANCE OF THE QUÉBEC AND FEDERAL GOVERNMENTS,  
1990-1991 TO 2019-2020**  
(millions of dollars)



Sources: *Comptes publics du Québec*; *Public Accounts of Canada*; Conference Board of Canada.

As we noted earlier, according to the Conference Board's projections, the federal government's operating balance will increase from \$39 billion in 2002-2003 to \$90 billion in 2019-2020, while the Québec government's operating balance will never exceed \$9 billion during the same period.

As we will see below when we specifically analyse debt service and repayment, a substantial operating balance would allow the federal government to quickly repay a significant portion of its accumulated debt, thus enabling it to rapidly reduce its debt service. Québec's operating balance would not allow it to engage in analogous plan. The gap between revenues and expenditures and the attendant fiscal imbalance are inevitably exacerbated by the problem of the debt and its repayment.

### 3. DEBT REPAYMENT AND FISCAL IMBALANCE

The Commission deemed it essential to specifically examine the problem of the debt and its repayment in conjunction with the analysis of the existing imbalance between expenditures and access to revenues.

- ◆ Debt service is a very important item in the budgets of the two orders of government. In 2000-2001, debt service in Québec accounted for 15.3% of total expenditures. Debt service is the federal government's main budget item. In 2000-2001, debt service accounted for 26.1% of total federal government spending.
- ◆ Debt repayment is a key factor in the debate on fiscal imbalance. The federal government regularly insists on the need to free up budget surpluses in order to reduce its accumulated debt.

The Commission quickly became convinced that the debt and its eventual repayment would be an essential variable in future change in fiscal imbalance, but contrary to the arguments put forward by the federal government. Data from recent years and the results of the Conference Board's projections confirm this conviction: the debt repayment dynamic, made possible by the federal government's operating balance, is one of the keys to explaining the anticipated extent of fiscal imbalance in Canada.

#### Recent changes in debt service

Over the past 10 years, both the Québec and federal governments have reduced the weight of debt service in respect of their budgetary revenues, although the reduction has been much more significant in the case of the federal government.

- ◆ Between 1990-1991 and 2000-2001, debt service as a proportion of total federal government revenues dropped from 35.7% to 23.6% as a result of lower interest rates and the first significant repayments of the accumulated debt.

This reduction in debt service has allowed the federal government to broaden its budgetary leeway. According to the federal government,<sup>50</sup> the \$35.8 billion reduction since 1996-1997 in the net debt has saved it \$2.5 billion per year on debt service, equivalent to 6.9% of debt service in 2002-2003.

- ◆ The Québec government's debt service has stabilized in recent years. Since 1995-1996, it has accounted, on average, for 15% of total expenditures. The Québec government, like the federal government, has benefited from lower interest rates. The return to a balanced budget has made it possible to halt growth in the accumulated debt, although the

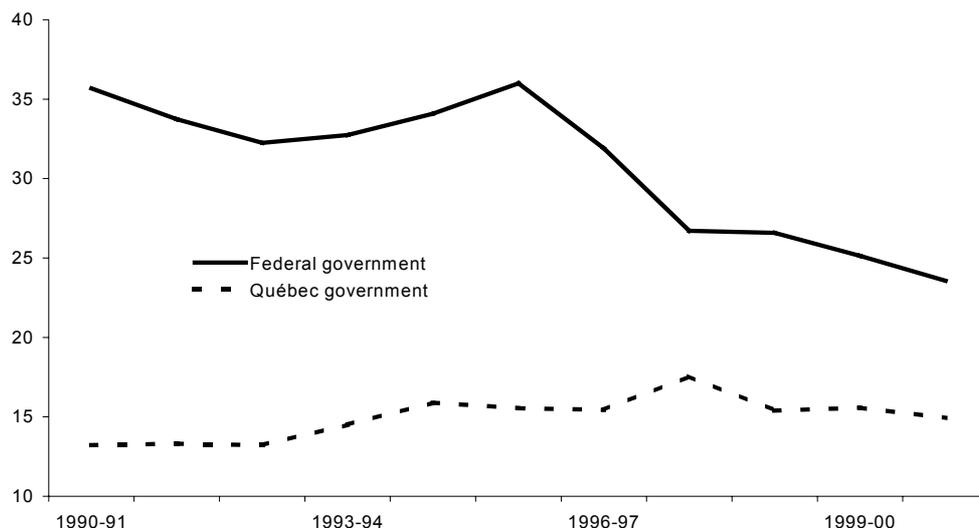
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<sup>50</sup> DEPARTMENT OF FINANCE CANADA, *Budget 2001*, p. 13.

Québec government has been unable to allocate significant amounts to debt repayment as its budget surpluses are insufficient to do so.

### CHART 27

**FEDERAL AND QUÉBEC GOVERNMENT DEBT SERVICE,  
1990-1991 TO 2000-2001**  
(as a percentage of total revenues)



Sources: *Comptes publics du Québec; Public Accounts of Canada.*

- ◆ Of the two governments, the federal government alone has been able to start significantly repaying its debt and thus benefit from a reduction in the weight of debt service in its total expenditures.

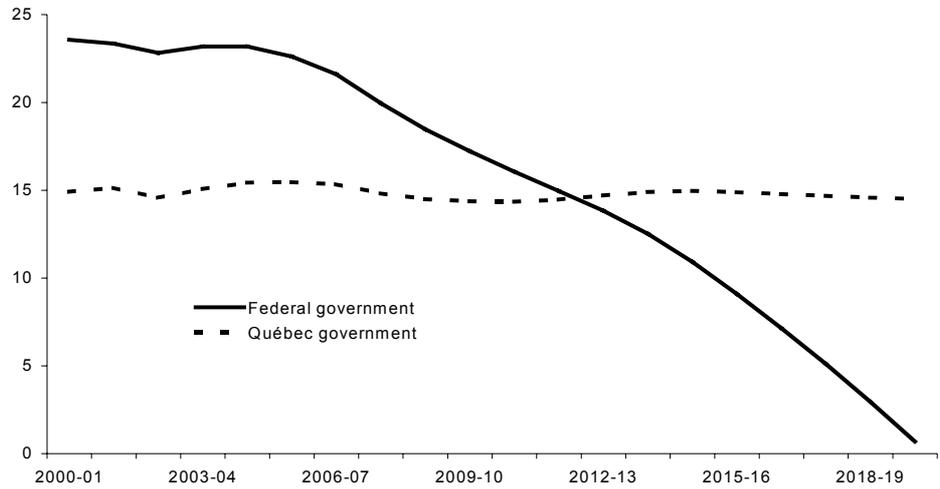
#### The Conference Board's projections

The Conference Board's projections reveal that debt repayment introduces an additional dynamic into the revenues and expenditures of the two orders of government that will appreciably affect future fiscal imbalance.

- ◆ By achieving surpluses and using them to repay its debt, the federal government would enjoy additional leeway each year of \$2 billion and it would largely repay its debt by 2019-2020, which explains 40% of the average annual increase in its budgetary surplus, estimated at \$5 billion.
- ◆ The opposite is true of the Québec government. The Conference Board's projections indicate the reappearance of budget deficits. Far from reducing its accumulated debt, the Québec government would be obliged to further increase it and, of course, allocate additional resources to pay interest on it, thereby reducing its leeway.

**CHART 28**

**PROJECTION OF FEDERAL AND QUÉBEC GOVERNMENT DEBT SERVICE, 2000-2001 TO 2019-2020**  
(as a percentage of total revenues)

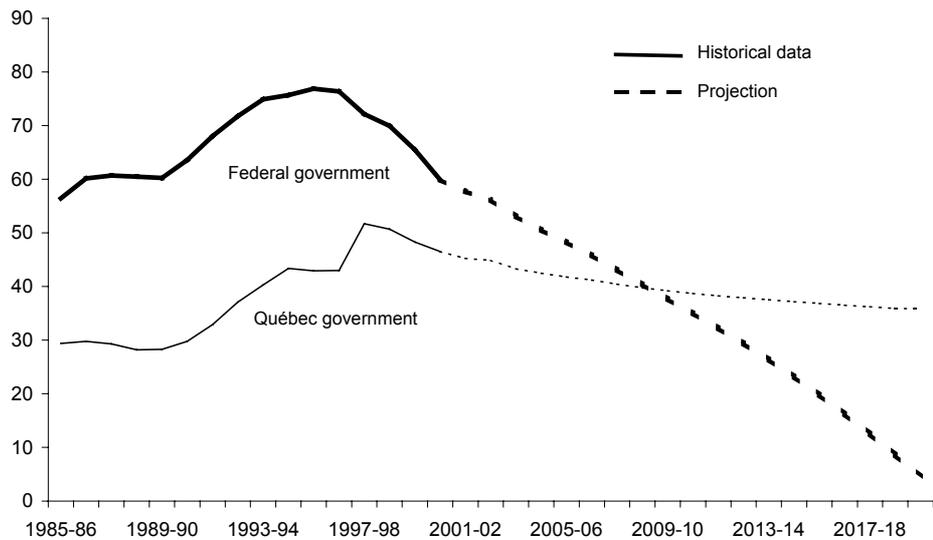


Source: Conference Board of Canada.

According to the Conference Board, the Québec government debt to GDP ratio will be higher than the federal government ratio starting in 2009-2010.

**CHART 29**

**GROSS DEBT OF THE FEDERAL AND QUÉBEC GOVERNMENTS, 1985-1986 TO 2019-2020**  
(as a percentage of GDP)



Sources: Comptes publics du Québec; Public Accounts of Canada; Conference Board of Canada.

The Conference Board's conclusion is clear: all things being equal, if the federal government repays its debt while Québec is prevented from doing so, the fiscal imbalance between the two governments will grow significantly. In its report, the Conference Board notes:

*As a result, by 2019-2020, the federal government will be able to maintain its current spending structure while repaying almost all of its debt, while the Québec government sees its total expenditures increase by 57% over the same period.<sup>51</sup>*

#### Debt repayment in a federation

Independently of the impact of debt on fiscal imbalance, the Commission wishes to emphasize that, from the standpoint of the sound management of public finances, it is not normal for the federal government to be virtually the only government in Canada in a position to repay its accumulated debt.

Insofar as debt repayment is indeed a priority for taxpayers, the Commission believes that the provinces, whose debt is financed at higher interest rates, should also be in a position to repay their debt and possibly be the first to do so.

**TABLE 5**

#### CREDIT RATINGS OF GOVERNMENTS IN CANADA (in basis points)

	Spread on 10 years bond	Rate (S&P)
Federal government	—	AAA
Alberta	29	AA+
Ontario	38	AA-
British Columbia	44	AA-
Manitoba	44	AA-
New Brunswick	47	AA-
Saskatchewan	45	A+
<b>Québec</b>	<b>55</b>	<b>A+</b>
Nova Scotia	59	A-
Newfoundland	60	A-

Notes: Spread in relation to federal bonds. S&P: *Standard and Poor's*.  
Source: Ministère des Finances du Québec.

<sup>51</sup> Projected financial frameworks of Federal and Québec governments, *op. cit.*, note 4, p. ii.

## The first cause of fiscal imbalance

The pressure exerted on the provinces in terms of expenditures, the distortion between this situation and the revenue dynamic and the effect of debt repayment clearly explain the existing imbalance between the expenditures and access to sources of revenue of the two orders of government.

The Conference Board's projections provide us with a numerical assessment of the first cause of fiscal imbalance.

- ◆ Over the next 20 years, the Québec government's budgetary revenues will grow at a rate 0.5 percentage points below growth rate in spending. Were this imbalance in the Québec government's revenue and expenditure dynamic to persist, the Conference Board predicts a budget deficit of nearly \$5 billion in 2019-2020 and an accumulated deficit over 20 years of more than \$57 billion.
- ◆ The opposite is true of the federal government's revenue and expenditure dynamic: according to the Conference Board, growth in revenues will be 1.1 percentage points higher than growth in expenditures over the next 20 years and the federal government is headed for a budget surplus on the order of \$88 billion in 2019-2020.

**TABLE 6**

**FEDERAL AND QUÉBEC GOVERNMENT TOTAL REVENUES  
AND EXPENDITURES, 2000-2001 TO 2019-2020**  
(average annual change)

	Federal	Québec
Total revenues	3.2	3.1
Total expenditures	2.1	3.6
<b>Discrepancy between growth in revenues and expenditures</b>	<b>1.1</b>	<b>-0.5</b>

Source: Conference Board of Canada.

This leading cause of fiscal imbalance is aggravated by the nature and method of effecting intergovernmental transfers, whose inadequate nature must now be examined.

## **INADEQUATE INTERGOVERNMENTAL TRANSFERS**

Transfers between the federal government and the provinces, the second cause of fiscal imbalance, explain many of the problems currently plaguing the Canadian federation in terms of fiscal relations among governments.

- ♦ The CHST, the largest intergovernmental transfer program in Canada, is also the most problematic. It concerns a provincial field of jurisdiction and its attendant conditions, as well as its defining terms, clearly limit the provinces' decision-making and budgetary autonomy in their fields. The federal government's cuts in recent years confer a particular dimension on these difficulties.
- ♦ As for equalization, the other major transfer program, the Commission's view is more qualified: in this case, what is at issue is essentially the program's terms, because this unconditional program does respect the decision-making and budgetary autonomy of governments benefiting from the program.
- ♦ Lastly, it must be noted that for fiscal relations between the federal government and the provinces overall, the process of discussion among the governments concerned raises many questions. The Commission paid special attention to the information available to the public and the efficiency of the existing intergovernmental process.

The Commission will now set out the results of these analyses.

## Federal transfers to Québec

In 2001-2002, the Québec government received \$9.7 billion in cash transfers from the federal government. Data published in the *2002-2003 Québec Budget* show that these transfers are broken down as follows:

- ♦ \$2.9 billion paid under the CHST, or 30% of total transfers;
- ♦ Transfers under equalization amounted to \$5.8 billion, accounting for 60% of federal transfers;
- ♦ The remaining transfers essentially consist of programs relating to bilateral agreements.<sup>52</sup>

**TABLE 7**

**FEDERAL TRANSFERS TO QUÉBEC, 2001-2002**  
(millions of dollars and as a percentage)

	Amount	%
CHST	2 915	30.2
Equalization	5 777	59.8
Sub-total	8 692	90.0
Other programs	953	9.9
Other transfers tied to the fiscal arrangements		
Fiscal Stabilization Program	—	
Payment for the tax on preferred share dividends	15	0.1
Sub-total	15	0.1
<b>Total</b>	<b>9 660</b>	<b>100.0</b>

Note: Amounts paid under the CHST exclude the value of the special Québec abatement but include amounts in the federal trust accounts and attendant amounts.

Source: Ministère des Finances du Québec, *2002-2003 Budget*.

It should be pointed out that the federal government and Québec have different ways of accounting for transfers of funds under the CHST. The federal government incorporates the “special Québec abatement” in the determination of the CHST paid to Québec, so that for the federal government, the amount paid under the CHST in 2001-2002 reached \$4.4 billion. For the Québec government, the revenue corresponding to the special abatement is included in personal income tax revenue.<sup>53</sup>

<sup>52</sup> The background paper published by the Commission in 2001, *Federal Transfer Programs to the Provinces*, *op. cit.*, note 5, provides a detailed analysis of these various transfer programs and how they work.

<sup>53</sup> See *Appendix 7*, calculation of the CHST, for a discussion of these two methods of accounting and their implications.

## **1. THE CANADA HEALTH AND SOCIAL TRANSFER**

From the federal standpoint, the Canada Health and Social Transfer (CHST) is the chief transfer program to the provinces. In 2001-2002, this program amounted to \$17.3 billion for the provinces as a whole.

As the name indicates, the CHST refers to a mission, health and social programs, that under the Constitution falls within provincial jurisdiction. Accordingly, by its very definition, the CHST is an encroachment on the jurisdictions of the provinces, which of itself is a cause of fiscal imbalance. This question raises the entire issue of the “federal spending power” and its constitutionality, which will be considered in greater detail in chapter 4 of this report.

- ◆ The conditions accompanying the CHST illustrate this encroachment on the fields of jurisdiction allocated to the provinces. They directly limit the provinces’ decision-making and budgetary autonomy.
- ◆ The terms of application of the CHST are another source of difficulty in this regard.

The Commission studied the operation of the CHST from these two angles before concretely illustrating the problems identified by quantifying the extent of the federal withdrawal the provinces have suffered from over the last few years.

### **1.1 A conditional transfer program**

The CHST represents the current form of transfer programs the federal government implemented in the 1950s and 1960s to financially assist the provinces to provide health, post-secondary education and income security services.<sup>54</sup>

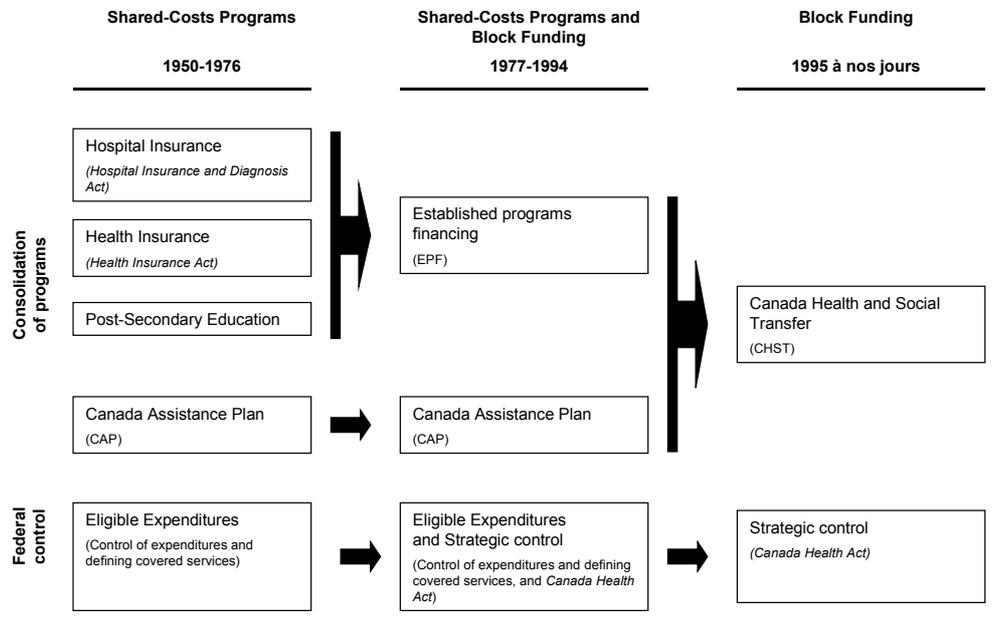
- ◆ At the financial level, the federal government gradually changed the cost-sharing rules. There has been a slow movement from a system in which the two orders of government shared the costs and the risks to a “block funding” system in which the transfer amount does not depend on provinces’ spending but rather on a variety of parameters, or even decisions under the sole control of the federal government.
- ◆ The conditions imposed by the federal government have always existed, but their form has changed. In earlier transfer programs, federal control was exercised through the definition of spending eligible for cost-sharing. With the CHST, the federal government’s control is strategic, i.e. it applies through the definition of broad principles with which the provinces must comply.

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<sup>54</sup> See *Fiscal Imbalance in Canada – Historical Background*, *op. cit.*, note 6, pp. 38 and 52.

**DIAGRAM 2**

**CONSOLIDATION PROCESS OF CONDITIONAL FEDERAL TRANSFER PROGRAMS 1950 TO PRESENT**



Notes: *Health Insurance Act* (S.C. 1966-67, c. 64). *Hospital Insurance Act* (S.C. 1957, c. 28). *Canada Assistance Plan* (S.C. 1966-67 c. 45). *Federal-Provincial Fiscal Arrangements and Established Programs Financing Act* (S.C. 1976-77, c. 10). *Federal-Provincial Fiscal Arrangements Act* (S.C. 1995, c. 17). *Canada Health Act* (S.C. 1984, c. 6).

Source: Commission on Fiscal Imbalance.

**Conditions attached to the CHST**

Although the federal government’s control is more general, it still exists, unquestionably making the CHST a conditional transfer. More specifically, payment of amounts under the CHST is subject to two constraints imposed by the federal government.

- ◆ First, the provinces must comply with the conditions in the *Canada Health Act*.

The act stipulates:

*In order that a province may qualify for a full cash contribution referred to in section 5 [the CHST] for a fiscal year, the health care insurance plan of the province must, throughout the fiscal year, satisfy the criteria described in sections 8 to 12 respecting the following matters: a) public administration; b) comprehensiveness; c) universality; d) portability; e) accessibility.<sup>55</sup>*

- ◆ Second, the provinces are banned from imposing a minimum period of residence in a province or in Canada, as an eligibility condition for social assistance.

<sup>55</sup> *Canada Health Act* (1984, c. 6, s. 7).

If a province violates any of these conditions, the federal government can reduce its payments to the province under the CHST by the amount it deems appropriate. The federal government may even apply financial penalties through other transfer programs.

In practice, since the *Canada Health Act* was passed in 1984, the federal government has threatened to withhold a total of \$255 million from the provinces, and has actually withheld \$8.3 million. These amounts are small, especially compared to the size of the transfers at issue.

However, that does not mean that the conditions attached to the CHST are symbolic and have no practical importance. On the contrary, the conditions governing payments made under the CHST are currently at the very heart of the debate over health sector administration. The federal government invokes them regularly to emphasize that it has the possibility of making cuts to this transfer program, in order to impose compliance with the *Canada Health Act*.

**TABLE 8**

**SUMMARY OF WITHHOLDINGS, BY PROVINCE,  
SINCE THE ADOPTION OF THE CANADA HEALTH ACT IN 1984**  
(millions of dollars)

	Announced withholding	Actual withholding
Newfoundland	0.3	0.3
Prince Edward Island	—	—
Nova Scotia	0.3	0.3
New Brunswick	6.9	—
<b>Québec</b>	<b>14.0</b>	<b>—</b>
Ontario	108.7	—
Manitoba	3.3	2.1
Saskatchewan	2.1	—
Alberta	32.6	3.6
British Columbia	86.8	2.0
<b>Total</b>	<b>255.0</b>	<b>8.3</b>

Sources: Commission on Fiscal Imbalance; Health Canada.

**The Commission's conclusion concerning the conditions attached to the CHST**

For the Commission, it is clear that the CHST is a conditional program that limits the decision-making and budgetary autonomy of the provinces in the fields it funds – fields that are incontestably within provincial jurisdiction. As a conditional transfer, the CHST does not satisfy the federal principle and accordingly does not fulfil the conditions of fiscal balance between the two orders of government.

## 1.2 A program whose terms create problems

The CHST, a conditional program by definition, is also a program whose terms are open to criticism. These terms raise two types of problems:

- ♦ First, the CHST allows the federal government considerable discretion, which it uses arbitrarily in determining the amounts paid to the provinces.
- ♦ Second, the CHST is allocated among the provinces according to rules that penalize the less affluent provinces.

### 1.2.1 The federal government's arbitrariness

The federal government's arbitrariness in determining the amounts paid under the CHST has been pointed out by the Prime Minister of Canada himself, in a statement that received widespread media coverage.

In 1999, Jean Chrétien told a group of reporters:

*I can get up Monday and say to myself that I will raise transfers to the provinces, and the next day, I decide to reduce them. We will see at the time of the budget.<sup>56</sup>*

Using a colourful language, the Prime Minister of Canada was only underscoring a state of fact: the federal government does indeed have complete discretion in setting the amounts paid to the provinces, discretion it uses arbitrarily, which is contrary to the federal principle. This arbitrariness limits the decision-making and budgetary autonomy of the provinces, in the funding and administration of programs within their jurisdiction.

#### Arbitrariness confirmed in recent years

The arbitrary nature of the definition of the CHST has been confirmed in recent years, to the extent that the federal government has been careful not to give any long-term undertaking regarding the amounts distributed.

- ♦ The amount of cash transfers that will be paid under the CHST until 2005-2006 is identified in part V of the *Federal-Provincial Fiscal Arrangements Act*. This federal statute stipulates no formal indexation mechanism. The amounts to be transferred are related neither to the level of economic activity in Canada or the provinces, nor to the cost of the provincial programs they help fund.
- ♦ In 1998-1999 and 1999-2000, the federal government wanted to use part of its year-end surplus to increase the amounts transferred to the provinces through the CHST. Rather than giving a lasting commitment

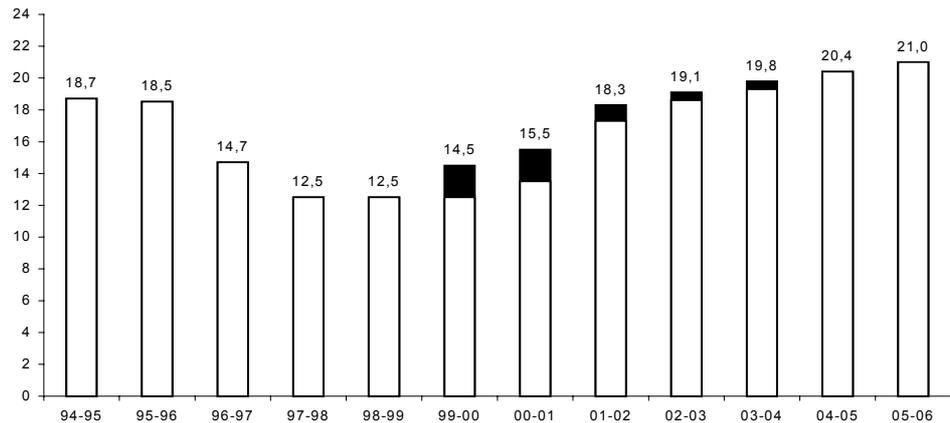
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<sup>56</sup> In *La Presse*, January 16, 1999, B3. Our translation.

and permanently increasing the CHST fund, the federal government preferred to proceed through trust accounts.<sup>57</sup>

### CHART 30

**CHST CASH TRANSFERS IN CANADA INCLUDING TRUST ACCOUNTS  
(SHADED AREA), 1994-1995 TO 2005-2006**  
(billions of dollars)



Note: Amounts stipulated in part V of the *Federal-Provincial Fiscal Arrangements Act* to which are added the amounts in the trust accounts. The amounts of the trust accounts (shaded areas of the chart) are shown according to the year they were entered in the federal calculations. The amount of \$1 billion stipulated for the last trust account is not shown since it was treated differently by the federal government.

Source: Commission on Fiscal Imbalance.

By thus avoiding any long-term commitment concerning the amounts allocated to the CHST, the federal government confirmed the leeway it has available and which it intends to use in the future. In addition, the creation of the trust accounts added a problem of transparency and accountability. It left the false impression that Québec and the other provinces had large sums available to set up new programs or substantially improve existing ones, particularly in the health sector, which is under especially heavy pressure, whereas the amounts are non-recurring.

The polemic unleashed in Québec in March 2000 concerning these trust accounts and how they were used by the Québec government, is a characteristic example of the confusion the federal trust accounts created among the media and the public.

<sup>57</sup> In its 1999 budget, the federal government placed \$3.5 billion in trust, to be drawn no later than March 31, 2002. In its 2000 budget, the federal government created a new trust account with \$2.5 billion, from which funds can be withdrawn no later than March 31, 2004. Lastly, following its announcement in September 2000, the federal government deposited \$1 billion in a new trust account to fund medical equipment, from which withdrawals must be made no later than March 31, 2002. The amounts paid to the provinces through these trusts are non-recurring. Once a province has exhausted its share, it cannot obtain new funds from the federal government to maintain its spending level.

**TABLE 9**

**AMOUNTS ENTERED IN FEDERAL CHST TRUST ACCOUNTS IN CANADA,  
1999-2000 TO 2003-2004**  
(millions of dollars)

	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Total
<b>Withdrawal timetable proposed by the federal government</b>						
CHST trust account #1: \$3.5 billion	2 000	1 000	500			3 500
CHST trust account #2: \$2.5 billion		1 000	500	500	500	2 500
<b>Total CHST trust accounts</b>	<b>2 000</b>	<b>2 000</b>	<b>1 000</b>	<b>500</b>	<b>500</b>	<b>6 000</b>
Trust account for medical equipment		500	500			1 000
<b>Total federal trust accounts</b>	<b>2 000</b>	<b>2 500</b>	<b>1 500</b>	<b>500</b>	<b>500</b>	<b>7 000</b>

Sources: Department of Finance Canada, *1999 and 2000 Budgets*.

### 1.2.2 The CHST allocation penalizes the less affluent provinces

The overall amount of the CHST is accordingly set arbitrarily by the federal government. This amount is allocated among the provinces according to certain rules, which have been substantially changed in recent years, that in practice penalize the less affluent provinces and accordingly exacerbate the fiscal imbalance as far as they are concerned.

- ♦ From the late 1980s until 1995-1996, the federal government imposed a ceiling on transfers paid under one of the two programs of which the CHST is the current successor, the Canada Assistance Plan (CAP). The ceiling applied to the more affluent provinces, namely Alberta, Ontario and British Columbia.<sup>58</sup> It was designed to limit the growth in the costs of the program for the federal government, stemming mainly from the steep rise in social assistance costs in Ontario.
- ♦ In 1996-1997, when the CHST was introduced, the federal government announced that it intended to completely abandon the shared-cost approach with the provinces. Following many changes,<sup>59</sup> the federal government finally decided in February 1999 to establish a CHST allocation formula based solely on population – and therefore independent of the needs in question.<sup>60</sup>

<sup>58</sup> According to this ceiling, the CAP paid to the more affluent provinces could not increase more than 5% a year.

<sup>59</sup> In 1996-1997, the first change to the allocation formula stipulated that both population and the amounts distributed up to then were to be taken into account. See *Fiscal Imbalance in Canada – Historical Background*, *op. cit.*, note 6, p. 57.

<sup>60</sup> In fact, the allocation of total entitlements under the CHST on an equal per capita basis does not result in perfectly identical per capita transfers for all the provinces. In this formula and as is explained in *Appendix 7*, the federal government takes into account the value of tax points transferred in 1977. Since this value differs from province to province, the provinces where it is higher receive a per capita amount of CHST that is a little lower. Accordingly, in 2001-2002, the basic entitlement for all provinces amounted to \$1 081 per capita. After deducting the value of the 1977 tax points, the actual cash payments amounted to \$589 for provinces receiving equalization, \$641 for British Columbia, \$553 for Alberta and \$497 for Ontario.

In practical terms, the change to the allocation formula had a major financial impact. Provinces that, like Québec, had proportionately greater needs than their demographic weight suffered a substantial decline in their share of federal funding. For instance, Québec's share of the CHST fell by 3.5 percentage points between 1994-1995 and 2001-2002. Applying an allocation formula based solely on demographic weight resulted in a revenue shortfall of \$705 million in Québec for 2001-2002 alone. Calculated per social assistance recipient, federal funding for 2001-2002 was nearly four times greater in Alberta than in Québec.

**TABLE 10**

**QUÉBEC'S SHARE OF THE CHST CASH TRANSFERS, 1994-1995 TO 2001-2002**  
(as a percentage of the total)

	Year	Health	Post-secondary education	Income security	Total	Population share
CAP and EPF	1994-1995	24.9	24.9	34.1	27.4	24.9
	1995-1996	24.7	24.7	34.1	27.2	24.7
CHST	1996-1997	—	—	—	27.2	24.5
	1997-1998	—	—	—	26.8	24.4
	1998-1999	—	—	—	26.4	24.2
	1999-2000	—	—	—	24.9	24.1
	2000-2001	—	—	—	24.6	24.0
	2001-2002	—	—	—	23.9	23.9
<b>Change: 2001-2002 versus 1994-1995</b>					<b>- 3.5</b>	<b>- 1.0</b>

Source: Commission on Fiscal Imbalance; Department of Finance Canada.

**An inequitable formula**

The Commission insists on the inequity of the current allocation formula, with regard to the fraction of the CHST corresponding to social programs funding. By ignoring the real needs of provinces in this regard, the allocation formula produces a situation in which the more affluent provinces, precisely the ones with fewer poor people compared to total population, receive a per capita transfer amount equivalent to the amount paid to the provinces where the needs are greater.

The federal government itself seems very conscious of this situation. In 1995, the Minister of Intergovernmental Affairs had suggested that in addition to implementing the new CHST allocation formula, the equalization program be improved. Referring to the allocation formula considered, the Minister, Marcel Massé, said:

*This would be the most unfavourable situation possible for Québec, so unfavourable that, in my view, it doesn't make sense that this would be the solution. [...] [What's needed instead is a solution] that would improve the equalization formula to prevent the transition period from becoming a massive transfer of money from Québec to Ontario.<sup>61</sup>*

In fact, the federal government did not select that approach. In February 1999, when the implementation of the new allocation formula was announced, the equalization program was not improved.<sup>62</sup> The government simultaneously announced an additional payment to Québec of \$1.5 billion under equalization, but this was just a one-time adjustment arising from the operation of the program.

### **A curious coincidence**

The coincidence between the two announcements seems curious, to say the least. Everything occurred as though the federal government wanted to give citizens the impression that Québec was being compensated for what the new CHST allocation formula would cost it.

In an article published in *La Presse* on February 23, 1999, economist Pierre Fortin wrote:

*Giving this impression may be good political strategy, but has no logical basis. First, the amount was due to Québec under the normal calculations of equalization, whether the CHST was changed or not. [...] Second, equalization payments vary widely from one year to the next. Québec could very well lose the \$1.5 billion in a little while. That has happened previously: from 1988 to 1990, its equalization payments were cut by \$1.8 billion.<sup>63</sup>*

### **An additional cause of fiscal imbalance for the less affluent provinces**

The fact is that the federal government's new CHST allocation formula cost Québec a total of \$1.8 billion in revenue compared with what it would have received under the previous formula, between 1998-1999 and 2001-2002. During the same period, Ontario and Alberta received a cumulative increase under the CHST of \$1.0 billion and \$500 million respectively, again compared with what these two provinces would have received under the former allocation formula.

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<sup>61</sup> In *Le Soleil*, March 4, 1995. Our translation.

<sup>62</sup> The opposite occurred. The ceiling on equalization was made more restrictive, to the detriment of the less affluent provinces. See below, Chapter 3, p. 94.

<sup>63</sup> In *La Presse*, February 23, 1999, p. 26. Our translation.

The new CHST allocation formula thus amplified the fiscal imbalance that penalizes the less affluent provinces. In addition, it has probably had the indirect result of increasing the pressure on provinces such as Québec in terms of tax competition: the more affluent provinces have additional resources to accentuate their initiatives in this regard.

### ***1.3 A program from which the federal government has disengaged***

The arbitrary application of the CHST and the changes to many of its terms have had, in the final analysis, a major financial impact: they have enabled the federal government to significantly reduce its financial commitments vis-à-vis the provinces under this transfer program.

#### **Federal disengagement: a major phenomenon**

The federal disengagement from funding health, post-secondary education and income security is a major phenomenon over the last decade. As has been seen previously, this disengagement was highly destabilizing for the provinces, causing a substantial reduction in a significant part of their revenue. At the same time, this disengagement allowed the federal government to improve its own budgetary situation since it had a major impact on the amount of and growth in its spending.

- ♦ As part of its analysis of the CHST and the problems that can be identified with it, the Commission wanted to evaluate as rigorously as possible the size of the federal disengagement since 1994-1995. This disengagement is an integral part of the debate on fiscal imbalance, and there is even controversy between the two orders of government on the size of the cuts.
- ♦ The Commission also specifically wanted to study the arguments advanced by the federal government: while it does not deny its disengagement, the federal government minimizes its size and uses its own budget situation to justify the initiatives it has taken in this regard. It was important that the Commission consider these arguments and assess their validity.

#### ***1.3.1 Evaluation of the size of federal disengagement***

To determine the size of the federal disengagement, an initial point of reference is needed, so that the disengagement can be measured regardless of how the CHST is accounted for.

In this regard, three reference points can be used:

- ♦ The current situation can be compared with the structure of the programs as it was in 1977.
- ♦ The size of the federal disengagement can also be analysed with reference to the amount of federal transfers paid in 1994-1995.
- ♦ Lastly, the federal disengagement can be estimated in relation to the growth in spending that federal transfers are designed to fund.

As will be seen, each of these analyses leads to the same conclusion: since the mid-1990s, the federal government has effected a major disengagement in relation to the financial responsibilities it assumed until then regarding health, post-secondary education and income security, and this disengagement is a central component of the fiscal imbalance.

### **Disengagement in relation to the 1977 program structure**

The first way to assess the size of the federal disengagement is to examine the impact of the changes made by the federal government to the structure of the programs in 1977, i.e. the implementation of Established Programs Financing (EPF).

- ♦ The federal government has made cumulative cuts of \$44.9 billion in Québec alone during the period as a whole, including \$6.4 billion for 2001-2002.
- ♦ Starting in 1997, the federal government began to reinvest, but these reinvestments are still far from offsetting the prior years' cuts. The reinvestments increased transfers to Québec by \$1.7 billion in 2001-2002 and by \$4.3 billion for the period 1997-2001. These reinvestments amounted to only 27% of Québec's shortfall for 2001-2002 and 10% of the federal cuts made in Québec since 1982-1983.
- ♦ Overall, and including the reinvestments made since 1997, the changes made to transfer programs since the early 1980s have deprived Québec of the equivalent of \$4.7 billion in revenue for 2001-2002 alone, and \$40.7 billion for the entire period.

**TABLE 11**

**IMPACT IN QUÉBEC OF MEASURES AFFECTING THE MAIN TRANSFER PROGRAMS  
TO THE PROVINCES – 1982-1983 TO 2001-2002**  
(millions of dollars – accrual basis)

Year	Measures	2001-2002	Cumulative 1982-1983 to 2001-2002
<b>CUTS</b>			
<b>a) Established Programs Financing (EPF)</b>			
1982	End of compensation for the elimination of the revenue guarantee	- 609	- 8 293
1983	Growth in contribution for post-secondary education limited to 6% and 5% in 1983-1984 and 1984-1985	- 110	- 1 950
1986	Total contribution indexing factor reduced by 2 percentage points	- 2 263	- 16 870
1989	Total contribution indexing factor reduced by an additional 1 percentage point	- 693	- 4 151
1990 & 1991	Per capita contribution frozen in 1990-1991 and 1991-1992, then extended to 1994-1995	- 55	- 1 651
1994	Total contribution for post-secondary education restored to 1993-1994 level in 1996-1997	- 268	- 856
	<b>Sub-total</b>	<b>- 3 998</b>	<b>- 33 771</b>
<b>b) Canada Assistance Plan (CAP)</b>			
1994	Total contribution restored to 1993-1994 level in 1996-1997	- 624	- 2 299
<b>c) Canada Health and Social Transfer (CHST)</b>			
1996	EPF and CAP replaced with CHST	- 1 318	- 7 743
1999	Allocation rule adopted in 1999 Budget	- 464	- 1 129
<b>Total cuts</b>		<b>- 6 404</b>	<b>- 44 942</b>
<b>REINVESTMENTS</b>			
<b>a) Canada Health and Social Transfer (CHST)</b>			
1997	Increase in CHST floor (\$11 to \$12.5 billion)	358	1 695
1999	1999 federal Budget:		
	- Trust account	119	840
	- Increase in funding	477	717
2000	Trust account announced in 2000 federal Budget	119	359
	Federal health announcement	668	668
<b>Total reinvestments</b>		<b>1 741</b>	<b>4 279</b>
<b>NET IMPACT</b>		<b>- 4 663</b>	<b>- 40 663</b>

Note: The withdrawal schedule for the trust accounts used for the purposes of this analysis is the one proposed by the federal government.

Source: Commission on Fiscal Imbalance.

### Disengagement in relation to transfer payments in 1994-1995

Some analysts disagree with the estimate of the size of the federal disengagement shown above. They say it is not realistic, because the structure of federal transfer programs in place in the early 1980s was not financially viable in the long term.

There is some merit to this analysis. The Commission accordingly decided to assess the size of the federal disengagement in relation to another reference point, namely the amount of federal transfers in 1994-1995, when they began to decline in absolute value. This approach has the disadvantage of not taking into account the change in the cost of needs to be funded, but applied over a short period, it provides useful benchmarks.

This second assessment method was used on many occasions by the provincial Ministers of Finance when they demanded, on behalf of their governments, an increase in payments from the federal government. The provincial-territorial meeting on November 15, 1999 concluded with a resolution that “*unanimously advocated the immediate full restoration of CHST payments to their 1994-95 levels of \$18.7 billion.*”<sup>64</sup>

This method of estimating the size of the federal disengagement produces the following results:

- ◆ Between 1994-1995 and 2001-2002, the provinces suffered a cumulative revenue shortfall of \$24.4 billion, including \$0.4 billion in 2001-2002.
- ◆ In Québec, the cumulative shortfall amounted to \$8.7 billion for the entire period, and \$1 billion for 2001-2002.
- ◆ Beginning in 2001-2002, the impact of the federal cuts in Québec is proportionally greater than the impact of these cuts for Canada as a whole. This is attributable to the impact of the changes the federal government made to the CHST allocation formula.

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<sup>64</sup> *Provincial and Territorial Finance Ministers Stress the Need for Federal Tax and Social Program Competitiveness*, Press release, Provincial-Territorial Meeting of Finance Ministers, Toronto (Ontario), November 15, 1999, p. 1.

**TABLE 12**

**SHORTFALL SUFFERED BY QUÉBEC AND THE OTHER PROVINCES REGARDING  
FUNDING FOR SOCIAL PROGRAMS, IN RELATION TO AMOUNTS RECEIVED IN  
1994-1995, 1994-1995 TO 2001-2002**  
(billions of dollars and as a percentage)

	Provinces as a whole			Québec			Dif. i/r to 1994-1995 (Annual) Québec/Canada %
	CHST amount \$ billion	Dif. i/r to 1994-1995		CHST amount \$ billion	Dif. i/r to 1994-1995		
		Annual \$ billion	Cumulative \$ billion		Annual \$ billion	Cumulative \$ billion	
1994-1995	18,7	—	—	5,6	—	—	—
1995-1996	18,5	- 0,2	- 0,2	5,5	- 0,1	- 0,1	28,4
1996-1997	14,7	- 4,0	- 4,2	4,5	- 1,1	- 1,2	26,1
1997-1998	12,5	- 6,2	- 10,4	3,9	- 1,7	- 2,9	26,5
1998-1999	12,5	- 6,2	- 16,6	3,9	- 1,7	- 4,6	27,1
1999-2000	14,5	- 4,2	- 20,8	3,9	- 1,7	- 6,3	38,0
2000-2001	15,5	- 3,2	- 24,0	4,2	- 1,4	- 7,7	43,2
2001-2002	18,3	- 0,4	- 24,4	4,6	- 1,0	- 8,7	226,7

Note: The table includes the amounts in the trust accounts. The withdrawal schedule for the trust accounts used for the purposes of this analysis is the one proposed by the federal government.

Source: Commission on Fiscal Imbalance.

### Disengagement in relation to the evolution in provincial social spending

The third way to measure the size of the federal disengagement is to assess the provinces' shortfall in relation to the real change in provincial spending on health, education and income security. Using the same reference date, 1994-1995, the method measures the change in the share of this spending funded by the CHST.

The provincial Prime ministers and Ministers of Finance have used this approach since June 2001. It has the advantage of taking into account the growth in provincial social spending and thus the increase in needs such transfers must help address.

This approach produces the following results:

- ◆ In 1994-1995, the CHST funded 18.1% of provincial spending on health, education and income security. By 2001-2002, this proportion had fallen to 14.1%, representing a shortfall of \$5.2 billion for the provinces as a whole and \$2.2 billion for Québec for that year alone.
- ◆ Cumulatively, for the period running from 1994-1995 to 2001-2002, the shortfall amounted to \$36.9 billion for the provinces overall, and \$12.0 billion for Québec.

- ◆ This method of calculating the federal disengagement also isolates the relatively greater impact of this disengagement in Québec, in recent years, which is attributable to the changes made to the allocation of the CHST. In 1996-1997, Québec absorbed a little over one quarter of the federal disengagement. In 2001-2002, its share rose to 43%.

**TABLE 13**

**SHORTFALL SUFFERED BY QUÉBEC AND THE OTHER PROVINCES REGARDING FUNDING FOR SOCIAL PROGRAMS, IN RELATION TO THE SHARE OF PROVINCIAL SPENDING FUNDED BY THE FEDERAL GOVERNMENT IN 1994-1995**  
(billions of dollars and as a percentage)

	Provinces as a whole				Québec		Dif. i/r to 1994-1995 (annual) Québec/Canada %
	Federal contribution (CHST) %	Dif. i/r to contribution in 1994-1995 %	Shortfall		Shortfall		
			Annual \$ billion	Cumulative \$ billion	Annual \$ billion	Cumulative \$ billion	
1994-1995	18.1	—	—	—	—	—	—
1995-1996	17.8	- 0.3	0.3	0.3	0.1	0.1	33.3
1996-1997	14.2	- 3.9	4.0	4.3	1.1	1.2	27.5
1997-1998	11.8	- 6.3	6.6	10.9	1.8	3.0	27.3
1998-1999	11.2	- 6.9	7.6	18.5	2.1	5.1	27.6
1999-2000	12.3	- 5.8	6.7	25.2	2.3	7.4	34.3
2000-2001	12.7	- 5.5	6.6	31.7	2.3	9.7	35.4
2001-2002	14.1	- 4.0	5.2	36.9	2.2	11.9	42.3

Note: The amounts in the federal trust accounts and attendant amounts are included in calculating the federal share.

Source: Commission on Fiscal Imbalance.

**The Commission's conclusion concerning the size of the federal disengagement**

In the final analysis, regardless of the reference used, the conclusion is the same: the federal government has significantly disengaged from funding health, post-secondary education and income security, starting in the mid-1990s, by making major cuts to payments under the CHST.

This federal disengagement has reduced the provinces, and especially Québec's, capacity to effectively deliver services in their fields of jurisdiction. The federal disengagement is accordingly one of the direct causes of the current fiscal imbalance.

### 1.3.2 The federal government's point of view

The federal government has not really denied its disengagement from funding provincial health, post-secondary education and income security programs. In delivering the 1996 Budget, on March 6, 1996, federal Minister of Finance, Paul Martin, underscored the necessity for everyone to take part in the improvement of federal public finances, including the provinces:

*Such funding levels represented a reduction in transfers. The provinces were being asked to help cut the deficit. Transfers, given their size, could not escape unscathed.*<sup>65</sup>

The federal government preferred to stress the following two points:

- ♦ First, according to the federal government, the cuts were required given its budget situation. They were indispensable if recurring deficits were to be eliminated and public finances restored to health.
- ♦ Second, these cuts were not as deep as they appear because of the increase in the value of tax points transferred to the provinces in 1964 and 1976-1977.

The Commission wished to examine these two arguments closely.

#### **The provinces have absorbed more than their fair share of federal cuts**

Regarding the federal government's budget situation in the mid-1990s and the need to improve it, the Commission can only underscore the seriousness of the problems facing the central government's public finances at the time. The budget deficit was too high, and was probably unsustainable in the medium and long term, which is not the case today.

However, it must be admitted that to resolve this difficult situation, the federal government made disproportionate cuts in transfers to the provinces.

- ♦ Between 1994-1995 and 1997-1998, the period during which the federal government succeeded in balancing its budget, the major cash transfers to the provinces dropped by \$5.4 billion. During the same time, the federal government reduced its other program spending by \$4.5 billion.

Cuts to transfers to the provinces thus accounted for over half of the reduction in program spending during the period when the budget deficit was eliminated. That is over twice the share of transfers to the provinces in program spending: in 1994-1995, these transfers accounted for 21.5% of federal program spending.

- ♦ Once the federal budget was balanced, the provinces did not benefit from reinvestments proportionate to the cuts that had been made. In

<sup>65</sup> DEPARTEMENT OF FINANCE CANADA, 1996 *Federal Budget*, p. 61.

2001-2002, federal transfers to the provinces are \$300 million<sup>66</sup> less than they were in 1994-1995. During the same time, other program spending has risen by \$12.1 billion. Transfers to the provinces have accordingly fallen from 21.5% of total federal program spending to 19.3% in the space of seven years.

The figures are very clear: the provinces have borne the brunt of the effort to restore order to federal finances, but have shared only to a secondary degree in the leeway thus restored.

**TABLE 14**

**FEDERAL PROGRAM SPENDING, 1994-1995, 1997-1998 AND 2001-2002**  
(billions of dollars and as a percentage)

	1994-1995		1997-1998		2001-2002		
		Amount	Diff. i/r to 94-95		Amount	Diff. i/r to 94-95	
	\$ billion	\$ billion	\$ billion	%	\$ billion	\$ billion	%
Equalization	8.6	9.7	+1.1		10.4	1.8	
CHST	16.9	10.4	-6.5		14.8	-2.1	
<b>Sub-total</b>	<b>25.5</b>	<b>20.1</b>	<b>-5.4</b>	<b>54.5</b>	<b>25.2</b>	<b>-0.3</b>	<b>-2.5</b>
Other program spending	93.2	88.7	-4.5	45.5	105.3	12.1	102.5
<b>Total program spending</b>	<b>118.7</b>	<b>108.8</b>	<b>-9.9</b>	<b>100.0</b>	<b>130.5</b>	<b>11.8</b>	<b>100.0</b>

Notes: The cash CHST excludes the special Québec abatement. Figures rounded to the nearest hundred million.  
Source: Federal public accounts.

**It is wrong to consider tax points transferred to the provinces as a federal contribution**

The federal government’s second argument is to minimize the size of the federal cuts by including the value of tax points transferred in 1964 and 1976-1977 in the federal contribution.

This is not a convincing argument for two reasons.

- ◆ First, including tax points in the assessment of the federal contribution does not change the size of the cuts. The quantifications given above were carried out in relation to certain reference situations, all subsequent to the transfers of tax points. Accordingly, the results are the same regarding the size of these cuts, whether they are calculated on the basis of cash transfers alone or with reference to “total entitlements” including the tax points transferred in 1964 and 1976-1977.
- ◆ Second, the very concept of a transfer of tax points implies that the tax points transferred to the provinces henceforth belong to them and that

<sup>66</sup> For calculation purposes, the federal CHST trust fund amounts are spread over time according to the cashing schedule proposed by the federal government.

they can indeed use them to maintain the level of their social programs. In the case of the transfer of tax points in 1976-1977 of which all the provinces availed themselves, the case seems closed: these tax points are treated as own-source revenue of the provinces, in the budgets of the provinces, and the federal government does not identify them in its own budget as spending. Inclusion of these tax points and the future growth in their value to increase the share of the federal contribution in the funding of provincial social programs is accordingly more akin to an attempt to massage the figures than a serious effort of analysis.

**Inclusion of tax points transferred to the provinces in the federal contribution:  
what the experts say**

**The National Forum on Health**

The National Forum on Health, set up by the Federal government, issued a public opinion on the question of the inclusion of tax points in the federal contribution to provincial social programs. This opinion also addresses the federal government's claim that it allocates equalization to social programs funding.

In February 1996, the National Forum on Health stated as follows:

*[...] what matters is the federal cash contribution dedicated to health, not other cash payments to provinces such as equalization, nor the artificial notions of entitlements and tax transfers.*

*Since all provinces do not receive equalization payments, it is difficult to imagine how it could serve as a basis to uphold national health care principles.*

*[The tax points] do, however, provide [the federal government with] a convenient shield for the federal government to reduce its cash outlays while claiming that overall entitlements are only frozen or marginally increasing. For these reasons, the Forum considers the inclusion of tax points in the federal contribution to be confusing and unhelpful.<sup>67</sup>*

**Robin Boadway (professor at Queen's University)**

*The decision to fold in the CHST with the EPF program and to allow the resulting to be comprised partly of a tax-point transfer dating back to 1977 completely defies reason, in my view. There is no rationale given for doing this; indeed, I would say that this is the ultimate in dishonesty to do so.<sup>68</sup>*

**Paul Boothe (professor at the University of Alberta)**

*It is bizarre for the federal government to claim that it is "giving" the provinces [...] this tax revenue each year. In the interest of common sense (and of making some sense of the real disagreements), future discussion... should focus exclusively on cash transfers.<sup>69</sup>*

<sup>67</sup> NATIONAL FORUM ON HEALTH, "Maintaining a National Health Care System: a Question of Principle(s) ... and Money," February 1996.

<sup>68</sup> 1998 Budget of Alberta, p. 394.

<sup>69</sup> Taken from "Federal Budgeting in the 1990s: The End of Fiscal Federalism" in Thomas J. Courchene and Martin F.J. Prachowny (editors), *The February 1992 Federal Budget*, 1992, p. 39.

## **The Commission's conclusion concerning the CHST**

The Commission's conclusion concerning the CHST is very clear: regardless of the constitutionality of this transfer, which will be examined in the study of the "federal spending power," the CHST is a program that allows the federal government to set conditions and define terms of application that directly limit the decision-making and budgetary autonomy of the provinces in their fields of jurisdiction.

Furthermore, regardless of how it is assessed, the federal government has indeed significantly disengaged itself from funding social programs administered by the provinces. By making deep cuts in transfers paid under the CHST, the federal government has deprived the provinces of part of the financial means they relied on to maintain delivery of public services. The reinvestments in recent years have only partially compensated for the cuts in the mid-1990s.

Accordingly, the causes of the current fiscal imbalance are to be found largely in the CHST, as the federal government defined and administered it.

## **2. EQUALIZATION**

Equalization, the second-largest transfer program, is a key component in the fiscal balance of the less affluent provinces. In Québec's case, for instance, equalization payments in 2001-2002 accounted for 59.8% of transfer revenue.

As with the CHST, the Commission examined the true situation of the equalization program to see whether the program, as it is conceived and applied, constitutes a limit on the autonomy of recipient provinces.

### **An unconditional program in accordance with the Constitution**

As for the constitutionality of the program itself, the answer is simple: unlike the situation with the CHST, federal administration of an equalization program falls within the exclusive jurisdiction of the central government, and is clearly identified in the Constitution accordingly.

Note that the equalization program is designed to reduce disparities in fiscal capacity among the provinces.<sup>70</sup> To this end, the federal government makes payments to the less affluent provinces to provide them with the means to offer public services comparable with those of the more affluent provinces without having to raise taxes too high.

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<sup>70</sup> All industrialized countries with a federal system have an equalization program, with the exception of the United States where, nonetheless, certain federal transfer programs effectively reduce fiscal capacity disparities among the States. As in the Canadian federation, the principle of equalization is written into the constitution in Germany and Switzerland. For more information, see *Intergovernmental Fiscal Arrangements: Germany, Australia, Belgium, Spain, United States, Switzerland*, *op. cit.*, note 7.

The commitment in principle regarding such equalization payments is enshrined in the *Constitution Act, 1982*. Section 36(2) stipulates that:

*Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

Equalization is paid by the federal government in accordance with an exclusive jurisdiction stipulated in the Constitution. Furthermore, the payments made by the central government are unconditional. Whether one considers the constitutionality of the program or the lack of conditions attached to the payments, it is clear that equalization is a transfer that fully respects the decision-making and budgetary autonomy of the provinces that receive it and, for this reason, satisfies the federal principle.

### **The terms by which equalization is defined**

It remains to examine the terms that define equalization, and in this regard, certain significant problems emerge that constitute a cause of fiscal imbalance.

- ◆ The rules used to set the amounts of equalization include certain provisions whose effect, once equalization has been paid, explains why disparities in fiscal capacity to the detriment of the less affluent provinces persist.
- ◆ Equalization payments sometimes vary considerably over time. This variability is a problem when it is attributable to non-economic factors
- ◆ The Commission wished to look into a problem that is less directly tied to fiscal imbalance, but which may lead to substantial distortions in provinces' economic decisions: we are referring to tax-back, whose implications were mentioned to the Commission during the public hearings.

The Commission's work regarding equalization therefore covered these three series of questions, and led to certain conclusions and observations that will now be discussed.

### Calculation of equalization entitlements

#### The equalization formula

The equalization formula, renewed at five-year intervals, determines the amounts provinces are entitled to for a given year. The amounts actually paid also depend on the revision of entitlements for prior years resulting from updated data.

The formula is based on the principle of the representative tax system (RTS). Under the RTS, the definition of revenue sources must be representative of the taxation practices in effect in the provinces and cover all sources of revenue, otherwise disparities in fiscal capacity would be measured incorrectly and distortions introduced.<sup>71</sup>

#### Three stages in the calculation, for a given province and year

- ♦ **Stage one:** measure the per capita fiscal capacity of the province and compare it with that of the five provinces that make up the standard (Québec, Ontario, Manitoba, Saskatchewan, British Columbia). This comparison is made for 33 different revenue sources. Since in each case the tax base may vary from one province to another, the establishment of fiscal capacity depends on the notion of a RTS reflecting the taxation practices of the provinces.
- ♦ **Stage two:** offset disparities in fiscal capacity. The equalization entitlements of the province for a certain tax base are obtained by multiplying the disparity obtained in stage 1 by the average tax rate for all provinces, then by the province's population. Entitlements are negative if a province has excess fiscal capacity for a given source and are positive if the province shows a deficiency.
- ♦ **Stage three:** add up the province's equalization entitlements. The total of the equalization entitlements calculated for the 33 sources of revenue subject to equalization constitutes the equalization entitlements for the province. If this sum is less than zero, the province receives no equalization. It does not have to pay money to the federal government because the program is funded from federal revenue and not by means of a direct contribution from the more affluent provinces.

#### Calculation of entitlements: typical formula for one of the 33 tax bases

$$\text{Equalization entitlements for a source of revenue in a province} = \left[ \text{Fiscal capacity of the standard (per capita tax base of the provinces that make up the standard)} - \text{Fiscal capacity of the province (per capita tax base of the province)} \right] \times \text{Average tax rate of the 10 provinces} \times \text{Population of the province}$$

<sup>71</sup> For more information, see *Federal Transfer Programs to the Provinces, op. cit.*, note 5.

## **2.1 Terms of application that prevent the program from fulfilling its objective**

The Commission's analysis concerning the definition of equalization proceeds from one observation: equalization, in its current form, does not completely eliminate disparities in fiscal capacity to the detriment of the less affluent provinces, essentially for three reasons:

- ◆ Equalization is calculated with reference to the situation in five of the ten provinces of Canada.
- ◆ Equalization entitlements are subject to a ceiling.
- ◆ More technically, the tax bases used to calculate equalization are poorly defined or incomplete and do not make it possible to fully satisfy the representative tax system approach.

### **2.1.1 The current standard is not satisfactory**

Equalization is currently calculated using a five-province standard. That means that the payments to the less affluent provinces are calculated by comparing the per capita fiscal capacity of a given province with that of the five provinces that make up the standard, namely Québec, Ontario, Manitoba, Saskatchewan and British Columbia.

For 2001-2002, for instance, the calculation based on the five-province standard means that the fiscal capacity of each province was compared with the average fiscal capacity of the five provinces, which was then equal to \$5 968 per person.<sup>72</sup> For the same year, the average fiscal capacity in Canada in fact amounted to \$6 237 per person.

### **The program falls far short of achieving its objective**

Accordingly, after applying the five-province standard, there remains a significant fiscal disparity among the provinces. For instance, the fiscal capacity of Ontario is 8.0% greater than that of Québec, after equalization. The current equalization program, based on the five-province standard, thus allows major differences among fiscal capacities of the provinces to persist.

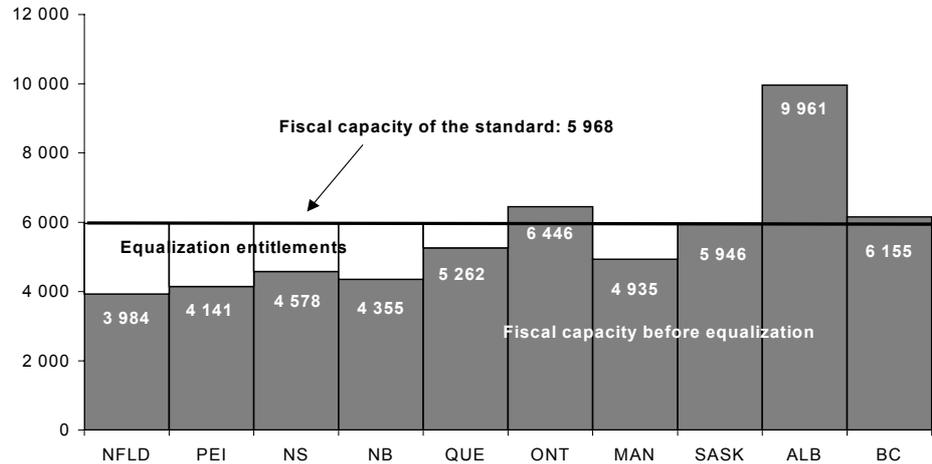
The less affluent provinces then have no other choice but to raise their taxes to offer a level of services comparable to what people in other provinces enjoy, or accept a lower level of services for their citizens. Quite obviously, that does not correspond to the very objective of the equalization program, namely, in the words of the Constitution, that "*provincial governments [...] provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*"<sup>73</sup>

<sup>72</sup> This is the per capita amount of revenue obtained by applying, to all the tax bases of the representative tax system of the five provinces of the standard, the average tax rates in Canada to each of these tax bases.

<sup>73</sup> *Constitution Act, 1982*, section 36 (2), previously quoted in full.

**CHART 31**

**FISCAL CAPACITY OF THE PROVINCES BEFORE AND AFTER EQUALIZATION, 2001-2002**  
(dollars per capita)



Sources: Commission on Fiscal Imbalance; Department of Finance Canada, fiscal year 2001-2002 (2nd estimate).

**2.1.2 The ceiling on equalization entitlements**

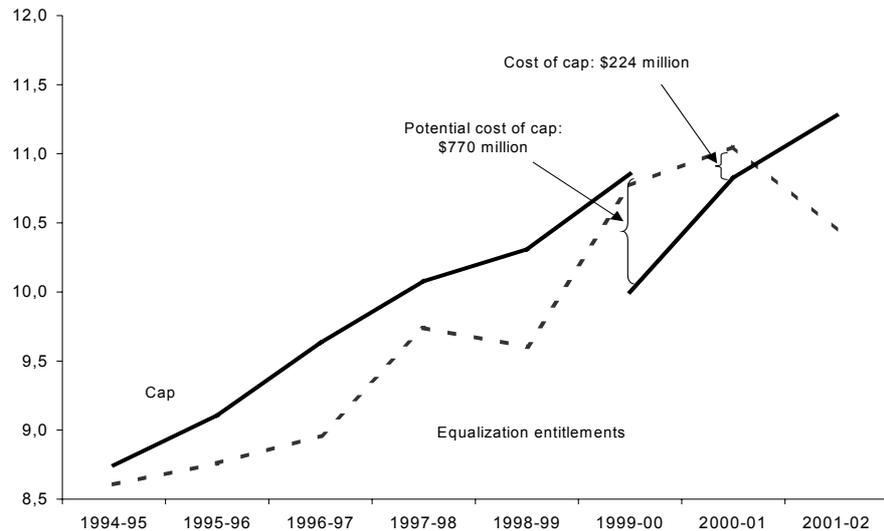
Since 1982, the federal government has imposed a ceiling on total equalization entitlements, regardless of the standard used to calculate the amount of entitlements. In 1999, the ceiling was arbitrarily set at \$10 billion and has since been indexed to the growth in nominal GDP.

- ◆ Normally, in 1999-2000, application of this ceiling would have produced a cut of \$770 million in equalization payments. In response to requests from the provinces, the federal government suspended the application of the new rule that year.
- ◆ However, the ceiling applied fully in 2000-2001, depriving recipient provinces of \$224 million.<sup>74</sup>

<sup>74</sup> Calculations based on the 2000-2001 4<sup>th</sup> estimation, October 2001, Department of Finance Canada.

**CHART 32**

**IMPACT OF THE MORE STRINGENT CEILING PROVISION SINCE THE 1999 RENEWAL, 1994-1995 TO 2001-2002**  
(billions of dollars)



Sources: Commission on Fiscal Imbalance; Department of Finance Canada.

### Québec is doubly penalized

The ceiling is accompanied by a mechanism that allocates the cuts to equalization made as a result of the ceiling. Under this mechanism, the cuts to equalization entitlements are not allocated in proportion to the entitlements of each recipient province, as would be logical, but in proportion to its demographic weight among recipient provinces. This means that the greater the population of a recipient province, the larger the cut arising from the ceiling.

Accordingly, Québec is doubly penalized by the ceiling:

- ◆ The ceiling limits the amount of entitlements paid to recipient provinces to a maximum currently defined according to the growth in GDP.
- ◆ In Québec's case, the allocation of the ceiling means that, when the ceiling applies, payments received are not level, but decline: each dollar of equalization entitlement in excess of the ceiling reduces payments to Québec by about 12 cents, which corresponds to the difference between Québec's demographic weight among the recipient provinces (62%) and the proportion of payments to Québec in total entitlements paid (close to 50%).

Since 1982, the ceiling has been applied five times, depriving recipient provinces of a total of \$3.2 billion. The shortfall for Québec is close to \$2.0 billion. Of this amount, about \$530 million is attributable to the rule that allocates the cuts resulting from the ceiling.

**TABLE 15**

**REDUCTION IN EQUALIZATION ENTITLEMENTS ARISING FROM THE  
APPLICATION OF THE CEILING SINCE 1982**  
(millions of dollars and in per cent)

	Allocation according to the population shares					Total		If allocation according to the entitlement shares applies	Difference
	88-89	89-90	90-91	93-94	00-01	\$ million	%		
NFLD	- 24	- 73	- 54	- 3	- 10	- 164	5.1	- 384	- 220
PEI	- 5	- 17	- 12	- 1	- 3	- 38	1.2	- 82	- 44
NS	- 38	- 113	- 85	- 4	- 18	- 258	8.0	- 390	- 132
NB	- 31	- 92	- 68	- 3	- 14	- 208	6.4	- 370	- 162
<b>Québec</b>	<b>- 284</b>	<b>- 855</b>	<b>- 644</b>	<b>- 33</b>	<b>- 139</b>	<b>- 1 954</b>	<b>60.6</b>	<b>- 1 424</b>	<b>+ 530</b>
Man.	- 46	- 139	- 103	- 5	- 22	- 315	9.8	- 388	- 73
Sask.	- 43	- 129	- 94	- 5	- 19	- 290	9.0	- 188	+ 102
<b>Total</b>	<b>- 471</b>	<b>- 1 417</b>	<b>- 1 060</b>	<b>- 53</b>	<b>- 224</b>	<b>- 3 225</b>	<b>100</b>	<b>- 3 225</b>	<b>-</b>

Note: Figures have been rounded off, so the columns may not add up to the totals shown.

Source: Department of Finance Canada.

### Equalization entitlements and GDP

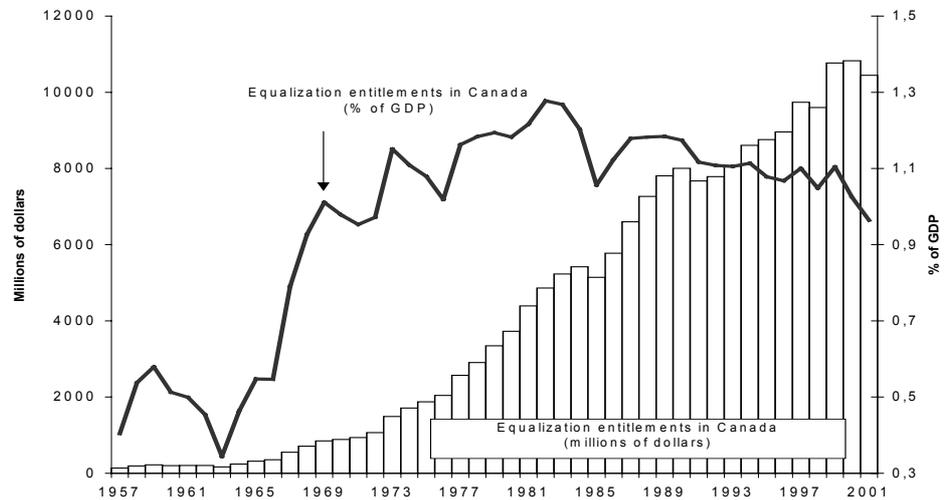
The formula allocating the impacts of the ceiling on equalization payments is therefore inequitable, and penalizes Québec in particular, as well as Saskatchewan. In addition, the ceiling rule itself, as currently defined, is difficult to defend.

The purpose of the rule is to protect federal public finances against annual changes in equalization entitlements in excess of growth in GDP. In reality, equalization entitlements have been gradually falling, as a percentage of GDP, for twenty years. In 2001, equalization entitlements amounted to 1.0% of GDP, compared to 1.3% in 1982.

It is therefore difficult to believe, as the federal government maintains, that the equalization program places significant pressure on federal finances. In fact, the ceiling imposes an arbitrary limit on equalization payments that limits this program's capacity to reduce disparities in fiscal capacity among the provinces.

**CHART 33**

**EQUALIZATION ENTITLEMENTS IN CANADA, 1957-1958 TO 2001-2002**  
 (as a percentage of GDP and millions of dollars)



Sources: Commission on Fiscal Imbalance; Department of Finance Canada; Statistics Canada.

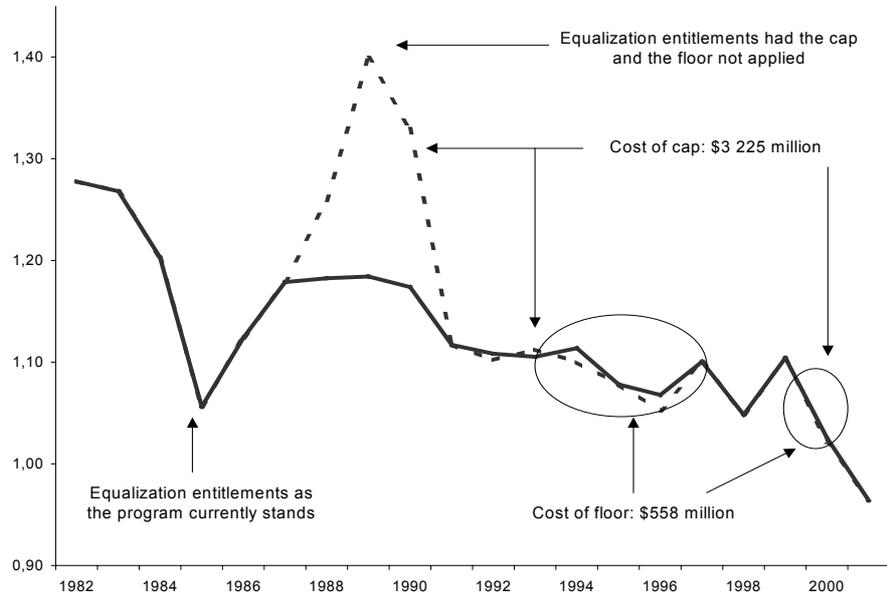
**Asymmetry between the impacts of the ceiling and of the floor**

Since 1982, the equalization program has also included a “floor provision” designed to protect recipient provinces from a major and sudden decline in payments to them.

The Commission notes an asymmetry between the protection afforded the federal government through the ceiling rule and the protection the provinces enjoy as a result of the floor. Since 1982, the ceiling has deprived the provinces of a total of \$3.2 billion, while the floor has cost the federal government only \$558 million. Québec has never received payments under this provision.

**CHART 34**

**EQUALIZATION ENTITLEMENTS IN RELATION TO GDP, 1982-2001**  
(as a percentage)



Sources: Commission on Fiscal Imbalance; Department of Finance Canada.

**The Commission’s conclusion concerning the ceiling on equalization entitlements**

The Commission concludes that the “ceiling rule” and the way its impact is allocated, in Québec’s case, compound the effect of the five-province standard to limit equalization payments. These rules cause transfers to the less affluent provinces to decline, in relation to the payments that would enable the equalization program to more effectively achieve the objective for which it was implemented.

These defining terms of equalization accordingly have an impact on the fiscal imbalance of the less affluent provinces.

**2.1.3 Tax bases that are poorly defined or incomplete**

The equalization entitlements of a given province are defined using the “representative tax system” approach, which has two implications:

- ◆ Entitlements are calculated for 33 tax bases, each faithfully reflecting the taxation practices actually in effect in the provinces.
- ◆ The representative tax system also assumes that all revenues of the provinces are included in the measurement of fiscal capacity.

In reality, the current equalization program sometimes strays from these principles. The Commission mentions two examples of such anomalies whose impacts are by no means negligible.

### First example: the property tax base

In all the provinces, property tax revenue results from applying a tax rate to an assessment of the value of properties. Accordingly, the equalization formula should use assessed value of properties as the basis for the calculation of the tax base, since it is the only non-arbitrary and representative measure of this tax base.

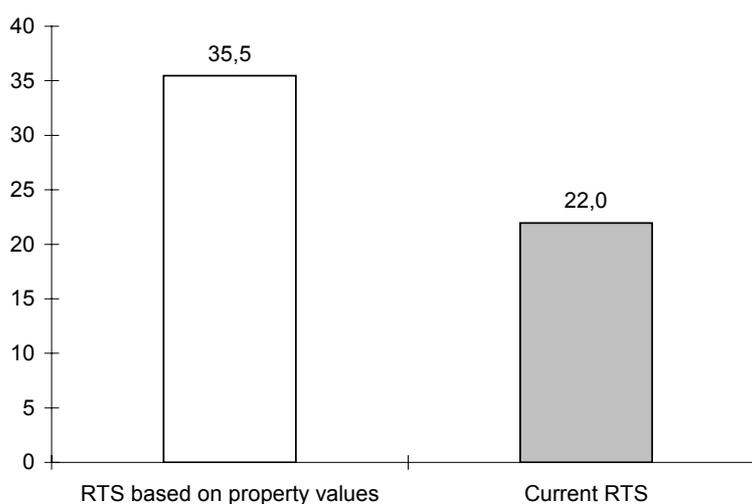
However, that is not what happens. Under the tax base, for the residential portion of property taxes, is calculated using the change in a set of economic variables, in particular the replacement value of the stock of buildings and an estimate of land values, that arbitrarily combines measures of income, urbanization and population change.

#### A substantial impact

As a result of the base used to measure the provinces' property tax fiscal capacity, equalization targets an arbitrarily selected measure of fiscal capacity rather than disparities in property values. Accordingly, it bears no resemblance to actual property taxes and the disparity it measures is not the one that actually exists among the provinces for this type of tax.

### CHART 35

**AVERAGE FISCAL CAPACITY DISPARITY OF THE PROVINCES IN RELATION TO THE CANADIAN AVERAGE MEASURED BY THE RTS MODEL FOR THE PROPERTY TAX BASE**  
(as a percentage)



Note: The RTS based on property values was estimated using data from the 1996 census Canada.  
Sources: Commission on Fiscal Imbalance; Department of Finance Canada; Statistics Canada.

The impact of this anomaly is substantial for Québec: the fiscal capacity obtained from the calculation of this tax base is relatively similar from one province to another, while in fact, significant disparities. These disparities are attributable first to very dissimilar property values. According to an estimate carried out by the Commission, Québec loses about \$800 million each year in equalization entitlements because of the non-representative nature of the tax base used for property taxes.<sup>75</sup>

### **Second example: revenue from sales of goods and services**

Even according to the approach of the representative tax system, the calculation of equalization payments should include all the revenue of the provinces. And in fact, the appearance of new revenue sources periodically leads to changes in the program's calculation methods.<sup>76</sup>

The Commission wishes to mention that the lack of certain revenue in the calculation also leads to anomalies, whose repercussions on the final amount of equalization entitlements are far from negligible. In the tax base concerning sales of goods and services, for instance, certain fees under provincial jurisdiction, such as tuition fees, are excluded, while since 1999, revenue is included only up to 50%. For 2001-2002, this method of calculation deprived Québec of an estimated \$102 million in equalization entitlements.<sup>77</sup>

### **The Commission's conclusion regarding tax bases**

The selection of tax bases included in the calculation of equalization entitlements, as well as how these bases are measured, are highly technical questions that, nevertheless, are of considerable importance in the determination of the entitlements finally allocated to a province.

The Commission has doubts regarding the frequently arbitrary nature of some of the definitions used, and wishes to emphasize the direct impact of these technical considerations on the fiscal imbalance of the provinces concerned.

## **2.2 The variability of equalization payments**

Partly because of the rules used to set their amount and the changes frequently made to these rules, equalization payments vary widely over time, and this variability seems to have grown in recent years.

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<sup>75</sup> This estimate was obtained by calculating entitlements regarding the property tax base using, for the definition of the tax base, data from the census of Canada on home values in the ten provinces.

<sup>76</sup> When the equalization program was implemented, in 1957, only three tax bases were covered, namely personal income tax, corporate income tax and estate taxes. As has already been mentioned, the current equalization program covers 33 sources of revenue.

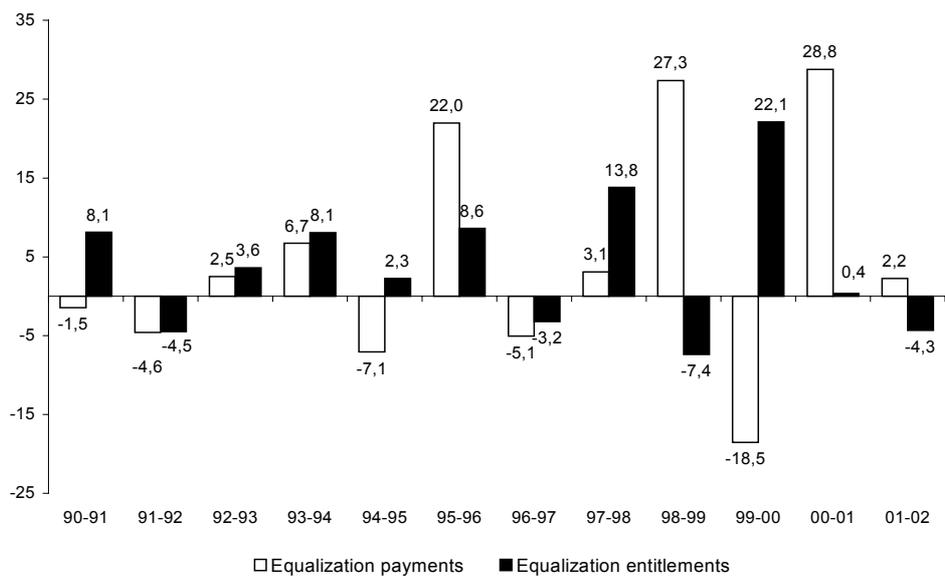
<sup>77</sup> The main changes made in 1999 to the calculation of equalization entitlements are being implemented only gradually. The shortfall of \$102 million represents only 60% of the full impact of the change to the formula, which would have reached \$170 million for this tax base for Québec.

- ◆ For instance, equalization entitlements rose 13.8% in 1997-1998 then fell 7.4% the following year, jumped again by 22.1% in 1999-2000 and remained relatively stable in 2000-2001.
- ◆ Similar changes can be noted for the payments themselves: equalization payments rose 3.1% in 1997-1998, 27.3% in 1998-1999, then dropped 18.5% the following year and increased by 28.8% in 2000-2001.

It is difficult for the provinces that by definition are less affluent and whose overall revenue often depends to a significant extent on payments under this program to manage such erratic changes. The Commission felt it was important to study the cause of this variability in equalization entitlements and payments to see whether it was not partly attributable to deficiencies in the program's calculation methods.

### CHART 36

**CHANGE IN EQUALIZATION ENTITLEMENTS AND PAYMENTS TO QUÉBEC,  
1990-1991 TO 2001-2002**  
(as a percentage)



Sources: Commission on Fiscal Imbalance, Department of Finance Canada.

The equalization payments a province receives in a given year depend on three factors, namely the economic situation, the mechanics of revising the data defining equalization entitlements for prior years and technical changes made to the calculation of the data.

- ♦ The economic situation has a direct effect on certain tax bases. Economic growth increases the tax revenue subject to equalization, while significant changes in the price of oil will also cause changes in the determination of equalization entitlements.

It is normal that business cycles and changes in the economic situation affect equalization entitlements and payments. The program's purpose is not to dampen business cycles and accordingly, it faithfully reflects the impact of the economic situation on the fiscal capacity of the provinces.

- ♦ The second factor in the variability of equalization, namely the mechanics of revising data, is much more difficult to accept. For a given year, equalization entitlements can be changed substantially as the data used to calculate entitlements are revised. In Québec's case, equalization entitlements for 1997-1998 varied by close to \$1 billion between the first estimate in February 1997 and the last estimate thirty months later, in September 2000.

**TABLE 16**

**ESTIMATE OF EQUALIZATION ENTITLEMENTS FOR QUÉBEC, 1997-1998**  
(*millions of dollars*)

<b>Estimate</b>	<b>Amount</b>
1st estimate (February 1997)	3 878
2nd estimate (October 1997)	3 988
3rd estimate (February 1998)	4 059
4th estimate (October 1998)	4 177
5th estimate (February 1999)	4 820
6th estimate (October 1999)	4 673
7th estimate (March 2000)	4 747
Final estimate (September 2000)	4 745

Source: Department of Finance Canada.

This process can lead to spectacular variations. In February 2001, for instance, the federal government released the third estimate of entitlements for 2000-2001 and the fifth estimate for 1999-2000. These updates produced an increase of \$1.8 billion in equalization payments compared to the October 2000 estimate, with Québec's share being \$1.5 billion.

- ♦ Completely unexpected technical changes can also add to the uncertainty resulting from the economic situation and revisions to the data. Recently, the provinces were informed of such an incident: for technical reasons,

the data used to calculate the sales tax and property tax bases were modified, which will produce an unexpected and significant reduction in equalization payments for this year.

### **The Commission's conclusion regarding the variability of equalization**

Of course, such variability in payments equalization entitlements is a source of difficulty in itself, which the governments of the recipient provinces must be in a position to manage. When such variability is caused not by the economic situation but by deficiencies in revision or calculation methods, it is clearly unacceptable.

The brutal increases and reductions announced at regular intervals by the government that administers the program and attributable to more or less obscure calculations or estimates place the recipient provinces in a difficult position. The Commission sees this as a technical problem, as well as a lack of transparency in the calculations.

### **2.3 Tax-back**

In studying the terms and conditions under which equalization is defined, the Commission specifically wanted to analyse the "tax-back" effect. Its impacts may aggravate the fiscal imbalance of the provinces concerned.

The tax-back effect refers to the distortions in provincial government decisions that may be caused by the existence of an equalization program. Tax-back receives a lot of attention in public discussions and was explicitly mentioned by many intervenors at the Commission's public hearings. For this reason, it seemed important to deal with this question in this report.

Tax-back has two forms:

- ◆ An increase in economic activity in a province normally results in reduction in the equalization payments it receives, other things being equal. This is the "base tax-back" which can affect the content and priorities of provincial economic policy, and accordingly the province's revenue and its fiscal imbalance.
- ◆ A change to a province's tax rate affects the equalization entitlements it receives, either up or down. This is the "rate tax-back." In this case, the provincial government's fiscal policy may be influenced.

The Commission studied each of these two phenomena to analyse the potential and actual impact.

### 2.3.1 Base tax-back

The base tax-back resulting from sustained economic development is far from being negligible, its size depending directly on the rules defining the equalization program.

#### Non-negligible impact

In the current program, in which the standard for the calculation of equalization entitlements includes only five of the ten provinces, the scope of tax-back depends on whether or not the province is included in the standard. Tax-back is at its maximum if the province is not one of the five included in the standard, and even more so if the economic weight of the province is limited.

In Québec's case, a 1% increase in salaries would generate an increase in own revenue from personal income tax of \$218 million, which is then slashed by 44% because of the resulting reduction in equalization entitlements. This "tax-back" would be 36% in the case of an increase in the general sales tax base, and 62% following a rise in revenue from corporate income tax.

**TABLE 17**

#### EQUALIZATION TAX-BACK FOR QUÉBEC (millions of dollars)

Tax base	Trigger event	Impact on own-source revenue	Impact on equalization	Tax-back percentage
Personal income tax	Salaries rise 1%	218	- 96	44 %
Corporate income taxes	Taxable corporate income rises 1 %	45	- 28	62 %
General sales taxes	Total consumption rises 1 %	75	- 27	36 %

Notes: Fiscal year 2001-2002 (2<sup>nd</sup> estimate).

Sources: Commission on Fiscal Imbalance; Department of Finance Canada.

#### The example of the Atlantic Provinces and the resulting problems of equity

A long-standing debate concerns the impact of tax-back on economic development in the Atlantic Provinces, in particular on natural resource development. The decision not to develop the Voisey's Bay mineral deposits is often mentioned as an example of the disincentive effect of equalization.

The Commission considers it would be restrictive to think that governments seek only to maximize their revenue. Provincial economic development policies, beyond their direct impact on public finances, are designed first and

foremost to create jobs, increase human capital and generate wealth for the community.

Nonetheless, the Commission notes that the expected impact of tax-back on the incentive to develop offshore resources prompted Nova Scotia and Newfoundland to sign bilateral agreements with the federal government that reduce the decreases in equalization entitlements that the development of offshore resources may trigger. This same expected impact led to the definition of a so-called “generic” solution.

The Commission believes that such ad hoc solutions raise problems of equity among the recipient provinces and run counter to the very spirit of the program that offsets relative disparities among the provinces. Accordingly, it is normal and desirable that when the relative position of a province improves, its equalization entitlements should decline.

#### **The agreements reached with Nova Scotia and Newfoundland on offshore resources**

The *Canada-Nova Scotia Offshore Petroleum Resources Accord* grants Nova Scotia transitional protection whereby a percentage of the revenue it earns from offshore resources is protected from reductions in equalization entitlements. The Accord was signed in August 1986 and provides protection for ten years. The protection is triggered when daily production reaches at least four million cubic metres of natural gas. The protection was triggered in 1993-1994 because of the development of the Cohasset Panuke deposit. Nova Scotia may also opt for the “generic solution” that applies to revenue from offshore resources under the equalization program. Nova Scotia can opt for the protection under the Accord or the “generic solution.” In effect, this means that at least 30% of the revenue it earns from offshore resources is permanently protected from the repercussions on its equalization payments.

The *Canada-Newfoundland Atlantic Accord* provides Newfoundland with transitional protection against major reductions in its equalization entitlements, which would otherwise happen when its revenue increases because of economic development (for instance, economic growth resulting from the Hibernia, Terra Nova and other projects). The Accord, which was reached in February 1985, provides transitional protection for twelve years. The protection is triggered once cumulative production reaches 15 million barrels of oil (or the equivalent in natural gas). The protection was triggered in 1999-2000. As in the preceding case, Newfoundland can opt for protection under the Accord or the protection provided by the “generic solution.”

#### **The “generic solution”**

A particular problem arises when a province occupies a large share of a tax base, or even the entire base (as is the case for some natural resources). The tax rate of the province in question is the average Canadian rate. The province could accordingly reduce it, knowing that equalization would rise equivalently. In addition, if the province is not in the standard, the tax-back on the additional revenue is 100%, regardless of the rate it applies to this tax base.

The so-called “generic solution” in effect since 1993, mitigates this problem. Under this provision, when a province occupies over 70% of a tax source, the revenue subject to equalization is reduced by 30% for all the provinces. The net effect is that, for each dollar of revenue a province earns from a concentrated tax base, its equalization entitlements fall by only 70 cents. The generic solution is applicable to revenue and taxes produced by the offshore activities of Newfoundland and Nova Scotia, two separate tax bases, and applied before 1999 to potash in Saskatchewan and asbestos in Québec.

### 2.3.2 Rate tax-back

The rate tax-back creates an incentive for a province to “overtax” the tax sources for which the province shows a deficiency in relation to the standard, and to “undertax” sources where it exceeds the standard.

#### Theoretical effect

When a province raises taxes on a base for which it shows a deficiency, there are two effects:

- ◆ Its own-source revenue increases.
- ◆ Its equalization entitlements also rise, since the average Canadian tax rate rises and the tax base declines in particular, because of the effects of mobility or tax evasion following the tax increase.

Lastly, equalization may affect a province’s overall fiscal policy by encouraging it to choose tax rates different from those it would have selected in the absence of equalization.

This rate effect should, in theory, increase the tax effort of provinces whose fiscal capacity is less than that of the five provinces in the standard for most of the major tax bases. And indeed, tax rates are, overall, higher in recipient provinces than in more affluent provinces, but it would be dubious to claim that this difference is due solely to equalization.

**TABLE 18**

**COMPARISON OF FISCAL EFFORT AMONG THE PROVINCES**  
(Canada = 100)

	Québec	Ontario	Recipient provinces	Non-recipient provinces
Fiscal effort index	114.7	100.0	111.1	94.9

Notes: Fiscal year 2001-2002 (2<sup>nd</sup> estimate).

Sources: Commission on Fiscal Imbalance; Department of Finance Canada.

#### Some perspective

In reality, differences in fiscal effort from one province to another must be seen in perspective.

- ◆ Public preferences in a province regarding public spending and the size of government have a direct impact on the overall tax burden.
- ◆ Even after the payment of federal transfers to the less affluent provinces, the more affluent provinces still have more capacity to reduce their

citizens' tax burden. The current context of tax competition, especially with the United States, encourages them to cut their taxes.

- ♦ With mobile tax bases, the cause and effect relationship may be the inverse of what rate tax-back would suggest: a lower fiscal capacity may result from excessively high taxes.
- ♦ Lastly, even after equalization, the recipient provinces remain relatively fiscally poor. People's expectations in these provinces regarding public services are high. Probably, this relative "poverty" in terms of fiscal capacity, rather than rate tax-back, leads to higher tax rates.

### **The Commission's conclusions regarding tax-back**

The Commission draws two conclusions from its analysis of tax-back.

- ♦ Currently, no definite conclusion is possible regarding the scope of the impact of tax-back on governments' choices. Accordingly, it would be wise to carry out further analysis to prove the existence of the effect before implementing reforms to the equalization program to deal with it – with the risk of distortions to the program as a result.
- ♦ Bilateral agreements, such as those with Newfoundland and Nova Scotia, as well as the generic solution, are not a promising solution to the problem of tax-back, are not necessary. In addition, these agreements are not equitable to the other provinces, for which the formula applies in full.

Lastly, these agreements, which mitigate the decline in equalization payments arising from increased economic activity, are designed to resolve an economic development problem, which is not the equalization program's objective. The objective of equalization is to enable the provinces wishing to offer a level of public services comparable to that of the other provinces, to do so by imposing a comparable tax burden.

### **3. THE FISCAL ARRANGEMENTS FORMULATION PROCESS**

For the CHST as for equalization, and in general for all the fiscal arrangements between the federal government and the provinces, the process governing to their formulation raises a number of questions.

The Commission paid particular attention to two of these questions with a direct and immediate link to the current fiscal imbalance to the detriment of the provinces.

- ◆ First, does the public have enough information to assess the major issues relating to the fiscal balance of the federation, the division of tax fields and federal transfer programs to the provinces?
- ◆ Second, can the institutions and mechanisms that currently accompany and structure the formulation of fiscal arrangements between the federal government and the provinces be considered appropriate to deal with the issues at stake?

#### **3.1 Public information**

The CHST and equalization are programs administered by the federal government. Accordingly, responsibility for informing the public on the operation of the programs, as well as the issues raised by their administration, lies with the federal government.

The Commission notes that, in many regards, the public does not have sufficient information on the administration of these programs.

- ◆ First, little in the way of documentation is available to the public to provide information on the operation of the CHST and equalization. The Commission undertook a systematic review of the documents the federal government has published in this regard and came to the conclusion that they are few in number and provide only very general information. Currently, there is no detailed description of the methodology of the calculation of the tax bases for equalization, the characteristics of the two programs and the issues they raise.

This lack of documentation is astonishing considering that the programs concerned represented, in 2001-2002, payments of \$28 billion, accounting for over 20% of federal spending.

- ◆ Second, the federal Minister of Finance has no problem providing interested persons with various detailed tables showing the calculation of payments under equalization and the CHST. These tables, however, are provided without any documentation explaining their logic and allowing an analysis of their components.

### 3.2 Institutions and mechanisms

Within the Canadian federation, the study of questions on the fiscal relations between the two orders of government lies essentially with the federal and provincial Ministers of Finance. The first thing to note is that there is no organization or committee specifically charged with analyzing the issue of the fiscal balance between governments.<sup>78</sup> However, a number of committees of public officials have gradually been set up to carry out this joint analysis.

#### The existing structure

Currently, four committees discuss fiscal relations between the orders of government on a regular basis.

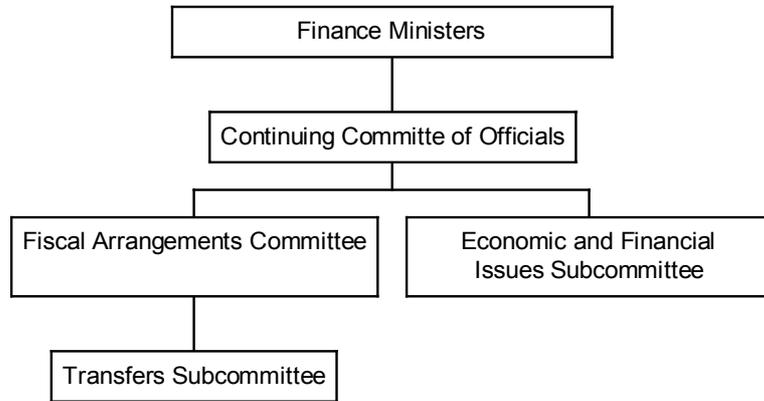
- ◆ The Continuing Committee of Officials, consisting of federal and provincial deputy ministers, coordinates all the work and ensures liaison with ministers.
- ◆ The Fiscal Arrangements Committee consists of the federal and provincial assistant deputy ministers more directly responsible for transfer programs.
- ◆ The Transfers Subcommittee consists of officials responsible for examining technical issues relating to transfer programs, particularly when they are periodically renewed.<sup>79</sup>
- ◆ Lastly, the Economic and Financial Issues Subcommittee, is charged more generally with studying issues relating to the state of the economy and the public finances of the two orders of government.

<sup>78</sup> Whereas, in Germany, "the constitution [s. 106-4] stipulates a redetermination of the quota according to which turnover tax [VAT] is shared if the ratio between the confederation's and states' earnings and expenditure follow a significantly different course" (*Texts Submitted for the International Symposium on Fiscal Imbalance, op. cit.*, note 8, p. 56). The objective of maintaining fiscal balance in the Germany Federation is thus at the heart of its federal institutions.

<sup>79</sup> The equalization program is reviewed every five years. Its Act and Regulations are in effect until March 31, 2004. As for the CHST, the legislation stipulates the amounts until 2005-2006 even though the federal government has undertaken to review the program in 2003-2004 when it will set the amounts to be granted in 2006-2007 and 2007-2008.

**DIAGRAM 3**

**FISCAL INTERGOVERNMENTAL RELATIONS COMMITTEE STRUCTURE**



**An opaque process**

The first problem with this analysis and discussion structure is that it is opaque. The work of the various committees is confidential and it is impossible, in practice, to gain access to the documents they exchange. This opacity prevents, for instance, experts on the issue from studying the content of the various ongoing debates.<sup>80</sup>

The current lack of transparency aggravates the problem of public information previously raised. It also has two other consequences:

- ◆ Outside experts do not have the opportunity to contribute their point of view to the debate, despite the substantial impact of the issues discussed.
- ◆ The opaque nature of the process creates a dynamic that favours the status quo rather than change. The issues discussed only rarely give rise to public discussion, and the committees accordingly face little pressure in this regard.

<sup>80</sup> This is quite different from the situation in Australia where the *Commonwealth Grants Commission (CGC)*, created in 1933, “monitor[s] and coordinate[s] the distribution of equalization grants paid to the states. [...] Before the agency hands down a decision, it collects information from the parties concerned by means of consultations and public hearings. The agency’s decisions are not legally binding but the federal government usually implements the CGC’s recommendations. The CGC’s reports are submitted to the federal government and made available to the state governments.” See *Intergovernmental Fiscal Arrangements: Germany, Australia, Belgium, Spain, United States, Switzerland*, op. cit, note 8, p. 22.

### **A process gradually pushed to the sidelines**

The second problem stems from the fact that this review process is gradually being pushed to the sidelines, even though it has some merits. This examination and analysis process has been in place for a few decades. It has many advantages. Essentially, and as the representatives of the provinces have regularly pointed out, it provides a discussion mechanisms even if, in the final analysis, the federal government retains full discretion as to the final decisions.

Since the mid-1990s, it seems clear that, little by little the mechanisms used to discuss fiscal relations between the two orders of government have been pushed to the sidelines. The major decisions taken by the federal government and concerning transfer programs most often are not discussed beforehand by the committees set up for that very purpose. There are many examples in this regard.

- ◆ The provinces were not consulted before the CHST was created.
- ◆ The CHST allocation formula, announced in 1997 by the federal government in its 1996 budget, had not been submitted to the provinces. Some limited consultations had been held previously on the allocation problem.
- ◆ The announced reinvestments in the CHST and the additional changes to the allocation formula, announced in 1998-1999 were indeed discussed with the provinces – but only in the political arena, and at the highest level.<sup>81</sup> The committees of officials were never asked to study them.
- ◆ Similarly, the increases in CHST funding announced by the federal government in September 2000 were discussed by the Prime Ministers but were not analysed by the committees of officials.

Accordingly, the Commission concludes that the analysis of issues relating to fiscal balance between the two orders of government has gradually changed forum, and thus its nature. The technical aspects and the very content of the programs are unilaterally defined by the federal administration, and negotiations are sporadically held at meetings of Prime Ministers, when required by the political situation.

This situation differs from that in other industrialized countries with a federal system. Political practice and institutional mechanisms in these countries stipulate that the major partners in the federation play an active, even formal, role in the political negotiations and technical discussions on the definition of intergovernmental fiscal arrangements.

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<sup>81</sup> Discussions on the changes to the CHST were held directly by the Prime Ministers of Canada and the provinces, at the same time as the debate on the Social Union Framework Agreement. Following these discussions, the federal Minister of Finance announced in the 1999 Budget an \$8.0 billion increase in the CHST over five years to which must be added a \$3.5 billion in a Trust Fund.

In Germany, all such decisions require the approval of the *Bundesrat*, the second chamber of the federal Parliament where members of the *Länder* governments sit. The cantons wield considerable power within the political institutions of the Switzerland. In Belgium, federated entities (the Communities and Regions) are funded through a voting procedure that makes it essential to achieve a broad political consensus (in each chamber of the federal Parliament, two-thirds approval of the members of the chamber and a simple majority within the French-speaking and Dutch-speaking linguistic groups). In Australia, legislation stipulates that the parameters of the goods and services tax (GST), whose proceeds are returned in full to the states and territories, cannot be changed without their consent.

### **The second cause of fiscal imbalance**

The problems noted by the Commission regarding the fiscal arrangements formulation process thus contribute, along with those concerning the CHST and equalization, to explaining the existing fiscal imbalance.

On the whole, intergovernmental transfers are inadequate in many regards, and this inadequacy is the second cause of the fiscal imbalance that currently exists to the detriment of the provinces, after the disparity between spending and access to revenue sources.

## **THE “FEDERAL SPENDING POWER” AND ITS IMPLICATIONS**

As we saw with respect to the CHST, the inadequacy of intergovernmental transfers stems, first and foremost, from their conditional nature. Indeed, conditional transfers are one example of the “federal spending power,” which the federal government invokes in order to spend in fields that fall under provincial jurisdiction.

There are other forms of the “federal spending power” that also interfere in provincial fields of jurisdiction and curtail the provinces’ budgetary and decision-making autonomy. All of these examples of the “federal spending power” have one thing in common, i.e. they can only develop insofar as the division of taxation fields puts the federal government at an advantage, thus ensuring that its revenues largely exceed its expenditures in respect of its fields of jurisdiction.

### **A problem closely tied to fiscal imbalance**

The problem of the “federal spending power” is closely tied to fiscal imbalance, and its use is underpinned by the surplus funds that the federal government controls. At the same time, various examples of the “federal spending power” are, in themselves, causes of fiscal imbalance, since they are all transfers or expenditures that limit the provinces’ decision-making and budgetary autonomy in their fields of jurisdiction.

The Commission deemed it essential to analyse and consider the “federal spending power” in conjunction with its deliberations on fiscal imbalance.

- ◆ First, the Commission examined various forms of “federal spending power,” starting with the existence of conditional transfers, the factor that most directly affects fiscal imbalance. As we will see, this reflection explains the impact of the “federal spending power” from the standpoint of respect for the provinces’ fields of jurisdiction and ultimately raises the question of the division of taxation fields.
- ◆ Second, the Commission felt it was essential to review Québec’s traditional stance regarding the “federal spending power” invoked by the federal government. Québec’s responses to the “federal spending power” reflects the logic of fiscal balance and the means by which the existing fiscal imbalance could be reduced. It is essential to take them into account throughout the analysis of financial relations between the two orders of government.

## 1. VARIOUS FORMS OF “FEDERAL SPENDING POWER”

### Conditional transfers to the provinces

The CHST, whose conditional nature and operation we analysed in the preceding chapter, vividly illustrates the “federal spending power.” We have already mentioned the strategic control that the federal government exercises by means of this transfer program<sup>82</sup> in a field under provincial jurisdiction. We also pointed out that the CHST replaced other forms of conditional transfers, in respect of which federal government control extended to the verification of each expenditure.<sup>83</sup> The federal government has also implemented other conditional transfers that are less significant financially.<sup>84</sup>

### Other forms of the “federal spending power”

There are other forms of the “federal spending power” that are linked, at least indirectly, to financial arrangements between governments.

- ◆ The first example is federal transfers to individuals, i.e. transfers that the federal government effects to individuals in fields of jurisdiction that the Constitution attributes to the provinces. This is true of federal transfers to families. In 1945, the “federal spending power” was invoked to justify the implementation of such transfers. Over the years, these transfers have become substantial both in financial terms and from the standpoint of social policy. In the case of unemployment insurance and old age pensions, which were initially examples of the “federal spending power,” the fields in question now fall under federal jurisdiction, although an amendment to the Constitution was necessary.<sup>85</sup>
- ◆ Direct expenditures are another form of the “federal spending power,” i.e. program spending that does not consist in transfers and that the federal government effects in fields under provincial jurisdiction.

This type of federal government intervention is not new, although it has become significant of late. Two recent examples of direct expenditures of this nature are the Canada Health Information System in 1997 and 1998, and the introduction in 1998 of the millennium scholarships. The latter

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<sup>82</sup> See above, Chapter 3, p. 69.

<sup>83</sup> See above, Chapter 3, p. 68. For additional information, see *Fiscal Imbalance in Canada – Historical Background*, *op. cit.*, note 6.

<sup>84</sup> Conditional transfers pertain to manpower management, housing, student loans, and the integration of immigrants. Several of these transfers have been subject to bilateral agreements between the federal and Québec governments. It should be noted that, since the early 1960s, the Québec government has agreed on several occasions to conditional transfers, since it did not wish to penalize Quebecers whose taxes fund such transfers. However, Québec has always emphasized that its adherence to such programs was merely a “*last resort until a satisfactory solution is found to this problem*” (Jean Lesage, March 1964, in *SECRETARIAT DES AFFAIRES INTERGOUVERNEMENTALES CANADIENNES, Positions du Québec dans les domaines constitutionnel et intergouvernemental, de 1936 à mars 2001*, p. 134. Our translation).

<sup>85</sup> In the case of unemployment insurance, now called employment insurance, and old age pensions, these fields originally came under provincial jurisdiction. Constitutional amendments were adopted to bring the transfers into line with the division of powers stipulated in the Constitution. In 1937, the Judicial Committee of the Privy Council, which, at the time, acted as the court of last resort, declared unconstitutional a federal statute intended to establish a Canada-wide unemployment insurance program. In the case of old age pensions, the constitutional amendment allows the federal government to intervene in this field but gives precedence to provincial legislatures.

alone represents a \$2.5 billion investment by the federal government in the education sector, which is under provincial jurisdiction.

In February 2002, the federal government announced another set of direct expenditures, the “Canada’s Innovation Strategy,” carried out by invoking its “federal spending power.” This strategy sets out a “*number of national objectives*” pertaining to “*children and young people, post-secondary education, adult workers and immigration.*”<sup>86</sup> In particular, it calls for new scholarship programs and new spending on post-secondary education.

- ◆ Tax expenditures are the most recent form of “federal spending power” when they affect the fields of jurisdiction attributed by the Constitution to the provinces.<sup>87</sup>

This is true, for example, of tax expenditures in the education and family sectors.<sup>88</sup> The Canada Education Savings Grant alone now stands at \$1.2 billion,<sup>89</sup> and the cost has quadrupled since the measure was implemented in 1998. The measure will ultimately be the federal government’s costliest intervention among new federal government education expenditures.

All of these tax expenditures are likely to alter the behaviour of taxpayers in the fields covered, which is equivalent to intervening in these fields.

In order to illustrate the importance of this phenomenon, it is worthwhile noticing that, all in all, according to a survey conducted by the Secrétariat aux affaires intergouvernementales canadiennes, the cost of federal initiatives in fields under provincial jurisdiction announced in the 1997 to 2000 federal budgets exceeded \$15 billion for the provinces overall.

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<sup>86</sup> See [www.strategieinnovation.gc.ca](http://www.strategieinnovation.gc.ca).

<sup>87</sup> Tax expenditures, which are also found in the provinces’ budgets, can take various forms, e.g. tax expenditures include all income not subject to tax, deductions used to calculate income, tax credits, tax deferrals and tax exemptions. Generally speaking, these are exceptions to what may be regarded as the basic taxation system (see MINISTÈRE DES FINANCES DU QUÉBEC, *Tax Expenditures – 2001 Edition (2002-2003 Budget)*, p. 3).

<sup>88</sup> This includes, in particular, the tax credit for tuition fees, the education credit, the transfer of credits for education and tuition fees, the deferral of education credits, the credit for interest on student loans, the registered education savings plan, the Canada Education Savings Grant, the partial exemption on scholarship income, withdrawals from RRSPs for educational purposes, credits for natural caregivers, the deduction for child care expenses, and the credit for health care attendant expenses.

<sup>89</sup> The federal government deems this expenditure to be a budgetary expenditure, although it is linked to the education savings plan, which is of a fiscal nature. Donnelly, Welch and Young in their study of the RESP consider the Canada Education Savings Grant to be a tax expenditure (“Registered education savings plans: A tax incentive response to higher education access,” in *Canadian Tax Journal*, 1999).

**TABLE 19**

**FEDERAL INITIATIVES IN PROVINCIAL FIELDS OF JURISDICTION**  
(millions of dollars)

Federal initiatives	Cost
<b>Health and social services</b>	
Medical Equipment Fund	1 000
Health Transition Fund	800
Information Technologies in Public Health	500
Other (Improving access to health information, Canadian Institutes of Health Research, Health Transition Fund, Community Action Program for Children, Canada Prenatal Nutrition Program, diabetes, Canada's health information system, nursing research fund (NURSE))	979
	<b>3 279</b>
<b>Education and research and development</b>	
Canada Millennium Scholarship Foundation	2 500
Canada Foundation for Innovation (CFI)	1 900
Canada Research Chairs Program	900
Other (Connect Canadians to knowledge information, Genome Canada, Networks of Centres of Excellence, dissemination of knowledge, Forest Research Institutes and earth sciences, National Literacy Secretariat)	694
	<b>5 994</b>
<b>Family policy</b>	
Canada Child Tax Benefit	2 850
Extension under unemployment insurance of parental leave	900
	<b>3 750</b>
<b>Income security</b>	
Supporting Communities Partnership Initiative and assistance for the homeless	753
	<b>753</b>
<b>Miscellaneous</b>	
(Environmental Technologies and Practices, Youth Employment Strategy, regional economic development, Climate Change Action Fund (CCAF), regulation of biotechnology, Canadian Tourism Commission, Canadian cultural content on the Internet, strengthening communities and the volunteer sector, Community Access Program, rural development)	2 041
	<b>2 041</b>
<b>Total</b>	<b>15 817</b>

Source: Secrétariat des affaires intergouvernementales canadiennes; Department of Finance Canada, 1997 to 2000 Budget.

It should be noted that there are no hermetic dividing lines between each of these forms of intervention and conditional transfers to the provinces such as the CHST. When one instrument becomes less effective, it is partially or wholly replaced by another form of "federal spending power."

- ◆ In the realm of higher education, for example, at different times the federal government has resorted, often concurrently, to various kinds of transfers and expenditures.
- ◆ In recent years, direct and tax expenditures have increased at the very time that the federal government has been cutting back its conditional transfers to the provinces.

### **Singular logic, significant impact**

The “federal spending power” displays a singular logic in that the federal government intervenes every time in a field falling under provincial jurisdiction without having to adopt a constitutional amendment. The use of the “federal spending power” affects virtually all fields of provincial jurisdiction, mainly social services, health care, and postsecondary education, which are provinces’ crucial areas of intervention affecting certain basic choices for citizens.

Given the amounts in question, federal intervention through the “federal spending power” has a considerable impact on provincial policy in the provinces’ fields of jurisdiction. For example, the Québec government has had to adjust its family policy to take into account new federal policy and it must constantly contend with the proliferation of direct federal spending in the education and health care sectors. In the past, shared-cost programs may also have had a leverage effect, which encouraged the provinces to invest more or less rapidly in certain sectors. This impact had a destabilizing effect when the federal government withdrew from several programs or, more broadly, when it reduced social transfers overall.

This impact is likely to recur in new sectors of federal government intervention, for example, in health care and education, where direct, one-off, visible expenditures are preferred to system-wide expenditures, which are largely the provinces’ responsibility.

In a broader perspective, federal initiatives distort the provinces’ budgetary choices by favouring certain sectors or approaches to the detriment of other options. The “federal spending power” issue is directly linked to fiscal imbalance: it is the means by which the federal government limits the provinces’ decision-making and budgetary autonomy in their fields of jurisdiction.

### **The “federal spending power” and the division of taxation fields**

Federal government initiatives in conjunction with the “federal spending power” in the provinces’ fields of jurisdiction have another common trait. They are, ultimately, only possible because of the resources available to the federal government, which exceed those that the federal government needs to assume its own fields of jurisdiction.

As we can see, the “federal spending power” is directly linked to the division of taxation fields between the two orders of government. A tax disparity in favour of the federal government can only aid and abet intervention in the provinces’ fields of jurisdiction since the federal government can mobilize substantial resources and allocate them at its discretion in fields that it deems strategically or politically worthwhile.

## 2. QUÉBEC AND THE “FEDERAL SPENDING POWER”

In light of the “federal spending power,” which places the provinces in a sensitive position, Québec has displayed considerable consistency by adopting a series of stances that all Québec governments have advocated for half a century. Indeed, Québec’s response to the “federal spending power” reflects the logic of fiscal balance between the two orders of government in a federation such as the Canadian federation. It centres, first and foremost, on respect for the Canadian Constitution and has led to a number of precise proposals that directly call into question financial relations between the two orders of government.

### **2.1 An instrument of the federal government whose constitutionality has not been established**

The Québec government has always maintained that the “federal spending power” invoked by the federal government calls into question the division of powers established by the Constitution and that, for this reason, it is contrary to the very spirit of federalism.

The Commission conducted its own analysis of the constitutionality of the “federal spending power” especially to have at its disposal an evaluation of the constitutional nature of conditional transfers. Supporting Document 2 in this report indicates the highlights of the analysis undertaken. The analysis calls for a number of observations.

- ◆ First, it should be noted that neither the *Constitution Act, 1867* nor subsequent amendments to the Act mention the “federal spending power” in fields falling under provincial jurisdiction, nor has it been recognized by jurisprudence. A “federal spending power” which imposes conditions equivalent to the exercising of a normative power in the provinces’ fields of jurisdiction, is not explicitly covered by the Constitution.
- ◆ The absence of any reference to the “federal spending power” in the Canadian Constitution is not an oversight: in most of the federations that resort to this power, it is explicitly enshrined in the constitution. This is true of the Australian federation, whose Constitution was adopted in 1900 by the British Parliament. It is noteworthy that, in this case, the same Parliament, at the same time, incorporated from the outset the notion of “federal spending power” into the constitutional provisions of another federation while it avoided doing so with respect to Canada. The absence of this provision in the Canadian Constitution is no accident.
- ◆ Moreover, the Commission has noted that Québec, while it has always challenged the constitutionality of the “federal spending power,” has however been reluctant to bring the matter before the courts. The same is true of the federal government, which, although it regularly invokes “federal spending power,” has never put its case before the courts.

The Commission believes it is obvious that “federal spending power” is a means of intervention used by the federal government whose constitutionality has not been established.<sup>90</sup>

## 2.2 Proposals defended by Québec

This situation, and the issues at stake, explain Québec’s position concerning possible ratification of the “federal spending power.” The only way the federal government can have recognized in its favour the “federal spending power” in fields falling under provincial jurisdiction is to adopt a formal constitutional amendment, as it did when unemployment insurance and old-age benefits were introduced.

### Québec Prime ministers and the “federal spending power”<sup>91</sup>

For half a century, various Québec Prime ministers have adopted a single stance in respect of the “federal spending power,” defining a position that never waived on this issue.

*Of what use would the right to build schools and hospitals be to the provinces were it necessary to approach another authority to obtain the necessary funds? Their sovereignty in the realm of education and hospitalization would be meaningless (Maurice Duplessis, October 1955).*

*[...] it is very clear that Ottawa must not tax for provincial purposes and, if at a given moment in the near or distant future, the federal government reaches agreement on the matter, there will be no conflict in the taxation field (Paul Sauvé, September 1959)*

*The constitutional problem raised by joint programs is serious. In practice, the existence of these plans reduces the provinces’ initiative in fields of jurisdiction that the Constitution attributes to them and even distorts the order of priorities that the provinces would like to establish in their own expenditures. Moreover, most of the time, they are intended to cover the cost of initiatives that should normally fall under provincial jurisdiction (Jean Lesage, March 1964)*

*Québec continues to believe that, ideally, federal spending power in fields falling exclusively under provincial jurisdiction should simply not exist and that the federal government should simply relinquish it. However, Québec would be willing to accept the federal proposals provided that the compensation formula for non-participating provinces is enhanced so that the provinces are not really affected by their constitutional right to opt out (Robert Bourassa, September 1970)*

*For several years, Ottawa has steadily reduced its financial transfers to the provinces. It is using the leeway thus obtained not to reduce the size of its deficit but to intervene in provincial fields of jurisdiction by means of its spending power. It has become a priority to limit this power, which is the key component of the federal offensive (René Lévesque, August 1984).*

*If one thing is essential in Québec, it is indeed respect for Québec’s exclusive fields of jurisdiction and, in particular, the realms of health care, income security, education and family policy. For 30 years, the federal government has sought to interfere in Québec’s fields of jurisdiction. It does so, essentially, through spending power that Québec has never recognized in order to protect its exclusive fields of jurisdiction (Lucien Bouchard, June 1998).*

In light of this policy stance, the Québec government has sought, in recent decades, to better define the scope of the “federal spending power” and limit its impact. Québec has constantly defended two complementary positions in this respect. It has demanded control over “federal spending power” accompanied by the right to opt out with compensation, while seeking the

<sup>90</sup> For more details, see *The “Federal Spending Power”, op. cit.*, note 6.

<sup>91</sup> *SECRETARIAT AUX AFFAIRES INTERGOUVERNEMENTALES CANADIENNES, Position historique du Québec sur le pouvoir fédéral de dépenser, 1944-1998*, Québec, Gouvernement du Québec, July 1998; *SECRETARIAT AUX AFFAIRES INTERGOUVERNEMENTALES CANADIENNES, Positions du Québec dans les domaines constitutionnel et intergouvernemental, de 1936 à mars 2001*, Québec, Gouvernement du Québec, 2001. Our translation.

redefinition of the effective division of taxation fields in order to tackle the very root of the problem.

**Control over “federal spending power” accompanied by the right to opt out with compensation**

The notion of controlling the “federal spending power” has been widely discussed in Québec and Canada since the early 1960s. The idea is a simple one: the “federal spending power” would be constitutionalized, but subject to a number of constraints aimed at preserving Québec’s autonomy and respect for the division of powers. At the same time, a province that did not wish to adhere to a program financed by the federal government could exercise the right of withdrawal, with full financial compensation. Québec authorities deem the two proposals to be indissociable.

The *Meech Lake Accord* of 1987 and the *Charlottetown Accord* of 1992, which foundered, included such provisions. In August 1998, the provincial governments agreed in Saskatoon on a new proposal to control the “federal spending power,” including the right of opt out with full financial compensation. However, the agreement rapidly collapsed and the *Social Union Framework Agreement* of February 1999, which Québec refused to sign, does not really control the “federal spending power.” Furthermore, it makes no provision for withdrawal with compensation. This agreement, which was normally to be reviewed and renewed in February 2002, is of a solely administrative nature. It does not have the authority of a constitutional agreement but its contents and Québec’s decision to dissociate itself from the agreement indicate Québec’s difficulty in convincing the other provincial governments of the logic of a right to opt out with full financial compensation.

**A new division of taxation fields**

Québec’s other response to the “federal spending power” focuses on the source of this power and directly touches upon the problem of fiscal imbalance. From the outset of Confederation, the Québec government has associated recourse to “federal spending power” with fiscal imbalance. The reason is simple: if the actual apportionment of financial resources reflected the division of powers, the question of “federal spending power” would be less acute. For this reason, Québec has constantly demanded a new division of tax resources while vigorously advocating control over the “federal spending power.”

At the beginning of this report, we referred to the deliberations of the Tremblay Commission, which, in its investigation of constitutional problems, emphasized the effective division of financial resources and called at the conclusion of its deliberations for exclusive control by the provinces over personal income tax. We will return later on to the question of the division of taxation fields and of a reallocation of tax room as a remedy to fiscal imbalance. The Commission simply wishes to stress that the analysis of the “federal spending power” leads naturally to the question of division of taxation fields.

### **Fiscal imbalance and the functioning of the federation**

The distribution of resources within the federation and coherence between this division and the division of powers are at the very heart of the functioning of the federation.

- ◆ Fiscal imbalance is partly reflected by federal spending in fields under provincial jurisdiction, with all of the attendant malfunctions.
- ◆ This fiscal imbalance also fosters federal intervention since it gives one order of government the financial means to interfere in the other order of government's fields of jurisdiction.

The “federal spending power” thus reveals fiscal imbalance, explaining in part the problems engendered and resting on its existence.



# **PART THREE**

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## **THE CONSEQUENCES OF FISCAL IMBALANCE AND SOLUTIONS**



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The fiscal imbalance that currently exists in favour of the federal government has major consequences affecting the daily lives of people and the management of provincial government functions. The missions concerned are among the most important that governments have to carry out for their population.

These consequences justify major changes to the fiscal relations between the two orders of government.

The third and last part of the Commission' s report consists of two chapters, focusing on the effects of fiscal imbalance and the corrective measures to be taken.

- ♦ In Chapter 5, the Commission describes the consequences of fiscal imbalance.
- ♦ Chapter 6 gives the solutions the Commission proposes to correct fiscal imbalance. These solutions in fact constitute the recommendations the Commission puts forward as a result of its work.



## **THE CONSEQUENCES OF FISCAL IMBALANCE**

Fiscal imbalance, because of its scope, has a significant impact on provincial government operations and accordingly the delivery of public services. Furthermore, the practical result of the encroachment on the provinces' decision-making and budgetary autonomy is that the choices of provinces' citizens are not taken into account precisely where they should be.

The consequences of fiscal imbalance appear at both the levels of individuals and in the definition and formulation of government policy.

These consequences have been raised in the preceding chapters. The Commission summarizes them here, dividing the effects that have been identified into three broad observations, which will be dealt with in order:

- ◆ First, social needs are ill-addressed because of the lack of resources available to the provinces to deal with them.
- ◆ Second, the delivery of services by governments is not as efficient as it could be because of a variety of dysfunctions in intergovernmental fiscal relations.
- ◆ Third, the provinces' decision-making and budgetary autonomy is compromised, whereas this autonomy is one of the foundations of federalism because it gives people in the provinces the assurance that their choices will be respected, even if they differ from those of the rest of the federation.

### **1. CITIZENS' NEEDS ARE ILL-ADDRESSED**

As we have pointed out beginning with the analysis of the fields of jurisdiction allocated to the federal government and the provinces under the Constitution, the provinces are charged with providing priority services or services considered as such by the public. In particular, the three key missions of health, education and income security have been allocated to them, so that the budget difficulties resulting from fiscal imbalance affect people in fields of intervention they consider the most important.

Because of these budget difficulties, needs are not addressed as they should be. The provinces' difficult budget situation has prompted them to make cuts in services and rationalize certain public demands, since the budgets allocated to the major government missions have not kept pace with demand.

In particular, unaddressed needs that are difficult to quantify exist in the health and education fields.

Fiscal imbalance and the budget problems it causes for the provinces spread to all government services. The significant pressure exerted on the health field has reduced the provinces' capacity to respond to other government priorities. In Québec's case, this situation was emphasized by the Commission d'étude sur les services de santé et les services sociaux (Clair Commission) in December 2000:

*Thus, unless higher economic growth results in an unexpected level of tax revenues sustained over time, the most likely scenario for the trend in health and social services expenditures, given the current dynamics, is that year after year it will swamp all other government priorities. This is an untenable situation for the government and, indeed, a critical problem for the overall operation of the state.<sup>92</sup>*

### The message received from the public hearings

*"For some years now, [...] we have suffered extremely drastic cuts in federal government transfers to the provinces. [...] The result has been a Draconian reduction in access to health care and services."*

*"The current level [of federal transfers] does not allow Québec to achieve its general health objectives."*

**Fédération des infirmières et infirmiers du Québec**  
[Our translation]

*"The cuts to federal transfers have reduced the capacity of Québec's health system to absorb the growth in demand for care and the increase in costs, thus limiting access and even threatening quality of care."*

**Association des hôpitaux du Québec**  
[Our translation]

During its public hearings, the Commission heard many accounts that confirm the impact of the fiscal imbalance and the resulting lack of resources for Québec, as far as addressing of needs is concerned.

- ◆ In the health sector, the conclusion is straightforward: this is the spending item exerting the heaviest pressure on the Québec government, the one where the demands are greatest, and probably the one with the highest proportion of unaddressed needs.
- ◆ In the education sector, the Commission was made aware of similar difficulties. Speakers pointed out that because of fiscal imbalance and its budgetary consequences, Québec was forced to choose between the health of its people and their education.
- ◆ As has just been mentioned, the impact of fiscal imbalance on health and education has repercussions on other government programs. The Commission was thus made aware of problems people face in such varied fields as regional development, anti-poverty initiatives, support for older persons and groups of young people.
- ◆ Even in fields where the constitutional jurisdiction of the two orders of government is shared, people experience the consequences of fiscal imbalance. The Commission was informed, from the people concerned, of the situation in the farm sector, where the lack of resources from the federal government has placed additional pressure on the provinces.

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<sup>92</sup> COMMISSION D'ÉTUDE SUR LES SERVICES DE SANTÉ ET LES SERVICES SOCIAUX, *Report of the Commission d'étude sur les services de santé et les services sociaux*, December 2000, p. 142.

### An opinion shared by the entire population

*“The Fédération is particularly worried by the tremendous increase in current and future costs of health services and social services, and their impact on education funding.”*

**Fédération des commissions scolaires du Québec**  
[Our translation]

*“[...] fiscal imbalance [...] is becoming a fiscal choke hold, Ottawa [taking advantage of the provinces’ lack of budget resources] to intervene in their fields of jurisdiction or to set conditions.”*

**Bloc Québécois**  
[Our translation]

*“[...] there has been a decline in the Canada social transfer to the provinces, and drastic cuts in our universities in Québec. As a result, faculty has thinned considerably [...] and buildings have deteriorated excessively, equipment has not been replaced, in short, our universities have passed through a dark period.”*

**Fédération étudiante universitaire du Québec**  
[Our translation]

*“The government with a budget surplus, the federal government, is the one that seems to have the greatest difficulty understanding its role in the farm sector.”*

**Union des producteurs agricoles**  
[Our translation]

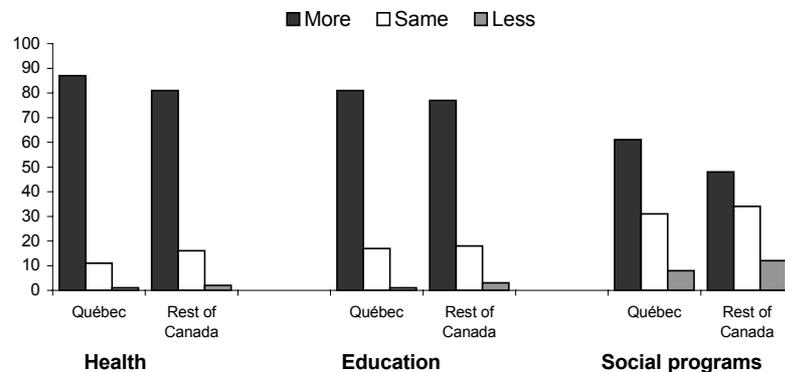
The observation concerning the addressing of needs is shared by the population as a whole, in Québec as well as in all of Canada. The survey conducted on the initiative of the Commission provides very clear results in this regard.

- ◆ In answer to the question as to whether governments should spend more in various sectors, 81% of Canadians answered yes for health, 77% for education and 48% for social programs.
- ◆ In Québec, public awareness of the necessity to further address needs is even greater: according to the survey, 87% of Quebecers support more government spending on health, 81% on education and 61% on social programs.

### CHART 37

#### OPINION OF QUEBECERS AND CANADIANS ON THE LEVEL OF GOVERNMENT SPENDING BY SECTOR

Question asked: *“In your opinion, should governments spend more, less or about the same as now on the following sectors?”* (responses in per cent)



Source: Commission on Fiscal Imbalance.

## 2. LESS EFFICIENT DELIVERY OF GOVERNMENT SERVICES

The consequences of fiscal imbalance are measured not just in terms of unaddressed or poorly addressed needs. The various dysfunctions in fiscal relations between governments mean that the delivery of public services is less efficient than it could be.

The definition, administration and delivery of social programs and public services suffer directly from the problems previously identified, particularly the operating terms and conditions of transfer programs.

*“Eliminating arbitrariness from the transfers process would prevent the federal government from acting unilaterally and by surprise as was the case with the overhaul of the Canada Health and Social Transfer. A stable system that is understood by all players would enable better long-term allocation of resources.”*

**Association des économistes québécois**  
[Our translation]

*“[...] in many countries, intergovernmental transfer system is not formula based and the central government decide on the amount of transfer on a discretionary basis. Therefore, intergovernmental transfer system in many countries is not transparent and subject to political manipulation, which lead to uncertainties on the part of subnational governments. Such uncertainties discourage fiscal planning and effective budgeting.”*

**Robert D. Ebel**<sup>93</sup>

*“These funds are time-limited, four years in most cases, with no guarantee of continuity. We’ll be developing things with these funds with no guarantee that at the end of four years, we’ll be able to continue funding them.”*

**Association des CLSC et CHSLD du Québec**  
[Our translation]

*“We have a system in which a tax dollar leaving Québec taxpayer’s pockets goes to the federal government, which then takes it and returns it in its transfers, filters it through programs, conditions in some cases, so that it finally ends up in programs administered by provinces throughout Canada, which in turn convert it into services. [...] That is a very serious weakness in the administration of public funds.”*

**Québec Liberal Party**  
[Our translation]

- ◆ The first difficulty stems from the uncertainty surrounding the size of the amounts transferred. Mention has already been made of the arbitrary way the federal government uses its discretion in the matter. This uncertainty has a cost: provinces cannot plan their initiatives with confidence regarding the resources they can count on from the federal government. Under such circumstances, they can hardly innovate.

Funding received under transfer programs is not a reliable source of revenue for the provinces. The experience of the unilateral cuts to the CHST, or the periodic and unexpected adjustments to equalization payments require that the provinces be prudent in this regard.

Robert D. Ebel from the World Bank, one of the experts invited last fall by the Commission to examine fiscal imbalance from an international perspective, confirmed the direct effect of inefficient intergovernmental transfers on governmental and budgetary planning.

- ◆ Some transfer payment procedures introduce a dynamic that distorts the prioritization of needs. The case of the CHST trust accounts is a particularly good illustration in this regard: the resources paid are non-recurring and the mechanics of the trust accounts place the provinces under political pressure that may prevent them from administering these resources as efficiently as possible. The provinces are encouraged to spend the funds they have received as quickly as possible, rather than carry out long-term planning for the funds transferred by the federal government.
- ◆ Fiscal imbalance can be seen not just in cuts to resources transferred from the federal government. It also consists in federal intervention in provincial fields of jurisdiction, when the “federal spending power” is invoked. In this case, loss of efficiency stems from the duplication caused by such federal intervention in provincial fields of jurisdiction. At the public hearings, many speakers pointed out to the Commission the practical consequences of this duplication and these unwanted interventions.

— The coexistence of two orders of government in the same field of intervention is a source of additional costs. Duplication gives rise to problems of coordination, the federal government’s priorities often affecting the province’s priorities in the same field.

— Furthermore, the simultaneous presence of two orders of government in the same field of intervention raises the problem of accountability. It can be very hard to identify the order of government that is truly responsible for a given decision, which has repercussions on the very operation of the democratic system and the clarity of public sanction on which it is based.

<sup>93</sup> *Texts Submitted for the International Symposium on Fiscal Imbalance, op. cit., note 8, p. 148.*

In a federation, accountability always raises a specific problem, because of the presence of two orders of government. However, such accountability will be all the more imprecise as the allocation of jurisdictions is confused, which is the case when the federal government intervenes in provincial fields of jurisdiction.

During his presentation to the Commission, the Leader of the Québec Liberal Party emphasized the direct link between *“the accountability of governments [that must be] raised [and the access of these] governments [to] tax revenue that effectively corresponds to their responsibilities [if] we want governments that make the best decisions possible in the public interest.”*<sup>94</sup>

#### Accountability, responsible government and transparency

Accountability is a basic concept, intimately linked to the notions of responsible government and transparency. The concept of accountability applies to situations that can vary, but in every case, it refers to the possibility of identifying the responsibilities of a player, an institution or a government. In other words, governments are said to be accountable when citizens know whom to hold responsible for a given policy, or when they know whom to blame and whom to credit for a particular public policy.<sup>95</sup>

For the citizens of a federation, it is generally more difficult than for those of a unitary country to determine which order of government is responsible for a specific policy or sector.<sup>96</sup> However, the difficulty is increased when the division of powers is not respected. This is what happens when there is fiscal imbalance. For instance, in the administration of health care, a field of particular public concern, Canadians find it very difficult to clearly identify the roles and responsibilities of each order of government. They seem to overestimate the financial contribution of the federal government and, more generally, do not seem to know exactly who is responsible for what.<sup>97</sup>

### 3. THE PROVINCES’ DECISION-MAKING AND BUDGETARY AUTONOMY IS THREATENED

At an even more basic level, fiscal imbalance raises the whole question of respect for the provinces’ decision-making and budgetary autonomy.

Here again, many speakers pointed out to the Commission the practical implications of the federal government’s intervention in provincial fields of jurisdiction, as far as provincial priorities and their implementation are concerned.

<sup>94</sup> “Government accountability must also be increased. Governments must raise tax revenue that effectively corresponds to their responsibilities. For me, this is a very important issue if we want governments to make the best decisions possible in the public interest.” Jean Charest, presentation to the Commission on Fiscal Imbalance, Montréal, November 21, 2001. Our translation.

<sup>95</sup> THOMAS, Paul G., “La nature changeante de l’imputabilité,” in B. Guy et Donald J. Savoie (dir.), *Réformer le secteur public: où en sommes-nous?*, 1998.

<sup>96</sup> SMILEY, Donald V., *The Federal Condition in Canada*, 1987, pp. 19 and 60.

<sup>97</sup> CUTLER, Fred, *Federalism and Accountability: Can Voters Cope with Federalism?*, paper presented at the annual congress of the Canadian Political Science Association, May 2001.

"A concrete example is the Canada Foundation for Innovation. [...] One of the problems is that this federal government intervention changes a university's research and teaching priorities."

**Fédération québécoise des professeurs et professeurs d'université**  
[Our translation]

"The Canada Foundation for Innovation reserves the right to reclassify the Québec government's priorities, but funds only 40% of these infrastructures. [...] Accordingly, for us, this has a direct influence on students' education, because the university often provides funds for those projects."

**Fédération étudiante universitaire du Québec**  
[Our translation]

"The imposition of federal conditions raises the issue of the legitimacy of federal intervention in the definition of programs under provincial responsibility. [...] The strict interpretation of the five principles of the Canada Health Act and the requirement to comply with them to obtain funding hamper the development of new initiatives."

**Parti libéral du Québec**  
[Our translation]

## The Canada Foundation for Innovation

A typical example is the Canada Foundation for Innovation. The purpose of this foundation, in particular, is to make grants to universities. In doing so, it interferes with decisions in this sector made as part of provincial policies. The federal government may succeed in having universities' research and teaching priorities change, even if these institutions are under the direct authority of the provinces and carry out their activities in a provincial field of jurisdiction.

Many speakers from the education community emphasized to the Commission their unease regarding the Canada Foundation for Innovation. In the health field, similar comments were made concerning the funds set up by the federal government, in particular to fund the acquisition of medical apparatus and support the use of information technology in the health field.

## The Canada Health Act

In the health sector, the *Canada Health Act* is another example of federal intervention in the definition of provincial policy. In this case, the means used is the linkage established between the principles defined in this legislation and payment of transfers under the CHST.

Mention has already been made of the situation created by the linkage between the CHST and the *Canada Health Act*. The standards defined by the federal government impose conditions on the payment of transfers from the same government, transfers that fund a portion of provincial spending in a field fully within provincial jurisdiction. Québec has frequently pointed out that while it agrees with the underlying principles of the *Canada Health Act*, it cannot accept that the federal government impose constraints in a field of jurisdiction allocated to Québec under the Constitution.

In its brief to the Commission, the Parti Québécois underscored the consequences of fiscal imbalance on the determination of health priorities. In particular, the brief notes that "*by instituting a system of financial penalties for dissidence, the federal government can set priorities for the provinces [...] it can definitely encroach on provincial fields of jurisdiction.*"<sup>98</sup>

In its interim report, released in February 2002, the Commission on the Future of Health Care in Canada chaired by Roy Romanow stressed the discretion the federal government has assumed in this field, stating that "*the federal government has exclusive responsibility for interpreting the Canada Health Act,*" in a context in which its principles "*are not fully defined or described in the legislation,*" leaving "*significant flexibility in how to interpret the meaning of the principles.*"<sup>99</sup>

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<sup>98</sup> Brief tabled with the Commission by the Parti Québécois, p. 13. Our Translation.

<sup>99</sup> COMMISSION ON THE FUTURE OF HEALTH CARE IN CANADA, *Interim Report*, February 2002, pp. 14 and 15.

### The federal point of view

The Commission points out that the very creation of the Romanow Commission is an illustration of the federal government's intervention in a provincial field of jurisdiction, all the more enlightening on federal intentions since three provinces – Québec, Alberta and Saskatchewan<sup>100</sup> – have in recent months formed commissions to deliberate and consult precisely on the future of health care under their administration.

For some provinces, the *Canada Health Act* has become a major irritant. Provincial governments perceive the constraint it represents on their choices increasingly negatively, while at the same time the federal government has reduced transfers in the health sector. From the federal government's standpoint, the *Canada Health Act* corresponds to the idea that Canadians share certain common values and that the federal government is responsible for ensuring compliance. Federal authorities thus postulate an identity, values and preferences common to all citizens of Canada, without reference to the fact that Canada is a federation precisely because it encompasses societies with distinct identities, specific values and different preferences.

### The implication for the citizens of Québec

This federal view has a tangible implication for the provinces' citizens. It effectively limits these citizens' ability to make choices different from those of other provinces.

Québec, especially, which has specific needs and collective preferences related to its unique position in North America, is obviously highly sensitive to this ability to make its own choices in such basic fields as health, education and social assistance. Over the years, Québec has built an original, coherent social policy model. In this regard, federal interventions often cause problems because they fail to pay sufficient attention to this model and this coherence.<sup>101</sup>

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<sup>100</sup> Québec: COMMISSION D'ÉTUDE SUR LES SERVICES DE SANTÉ ET LES SERVICES SOCIAUX, *Emerging Solutions*, December 2000. Alberta: PREMIER'S ADVISORY COUNCIL ON HEALTH, *A Framework for Reform*, December 2001. Saskatchewan: COMMISSION ON MEDICARE, *Caring for Medicare, Sustaining a Quality System*, April 2001.

<sup>101</sup> See VAILLANCOURT, Yves, "Le modèle québécois de politiques sociales et ses interfaces avec l'union sociale canadienne," 2002.

### Priorities of the citizens

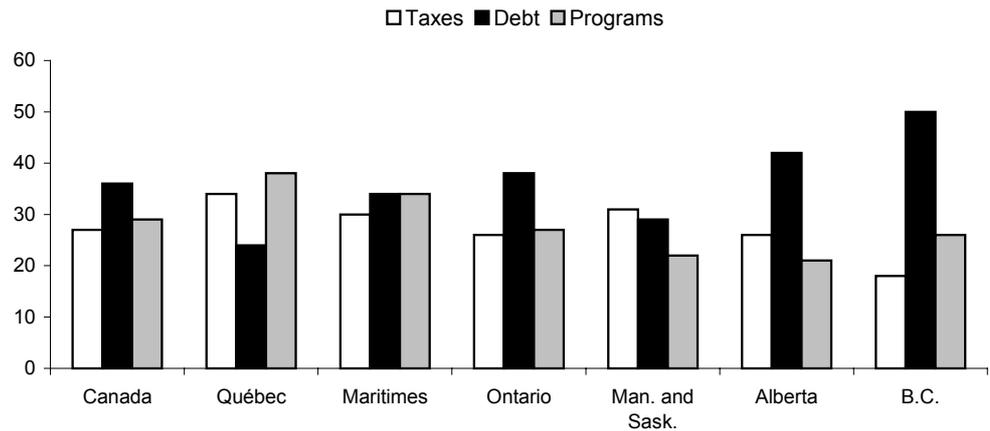
The survey carried out at the Commission’s initiative shows once again that Quebecers are particularly sensitive to certain social choices and the diversity of options expressed by the provinces.

Quebecers and Canadians were asked about their priorities as to how any future budget surplus should be applied. Québec proved to be the only province in Canada where most respondents want the surplus to be applied first to improve social programs. In Ontario, Alberta and British Columbia, respondents indicated that their first priority is debt repayment, while in the Prairies, tax reduction was the primary concern.

### CHART 38

#### OPINION OF QUEBECERS AND CANADIANS ON THE UTILIZATIONS OF GOVERNMENT SURPLUSES

Question asked: “In your opinion, how should government surpluses be used? Should the main priority be lowering taxes, reducing the debt or improving social programs?” (responses in per cent)



Source: Commission on Fiscal Imbalance.

### Solutions commensurate with the problems raised

We can see that fiscal imbalance and the reduction in the provinces’ decision-making and budgetary autonomy that it implies reduce the capacity of the provinces’ citizens to make their own choices, in fields defined by the Constitution – although this is the very basis of federalism.

Fiscal imbalance thus constitutes a dysfunction of the federal system. It has major consequences, for people and for the two orders of government. The solutions that must be brought are commensurate with the problems raised.

## **RECOMMENDATIONS**

The Commission's work has confirmed the existence and scope of a structural fiscal imbalance to the detriment of the provinces. The Commission has identified its causes, and we have just pointed out its main consequences, which are quite significant.

In response to this dysfunction in Canadian federalism, the Commission has formulated solutions that, in its view, should correct the current situation. These solutions are the recommendations the Commission puts forward as a result of its work.

To put an end to fiscal imbalance, major transformations are needed in intergovernmental fiscal relations within Canada. The transformations identified by the Commission provide a blueprint of what would be a Canadian federation that respects more closely the principles of federalism, in the short and medium term.

The Commission recommends these transformations in order to meet two general concerns:

- ♦ Fiscal balance needs to be restored within the federation, which implies that the provinces must have additional financial resources, that the terms and conditions under which resources are currently divided must be changed, that the operation of the equalization program must be improved and that the “federal spending power” must be countered.
- ♦ Ways must also be developed to respond to any future cause of imbalance in fiscal relations between the two orders of government, since these relations are by their very essence, dynamic and evolving.

The Commission presents its recommendations on the basis of these two concerns.

## **1. RESTORE FISCAL BALANCE WITHIN THE FEDERATION**

The Commission is convinced of the imperative need to restore fiscal balance within the federation if the federal principle with all its financial implications is to be satisfied. This restoration requires a new division of Canada's financial resources, implying four types of changes to the current situation:

- ◆ The provinces must have additional financial resources to address the needs within their fields of jurisdiction.
- ◆ The terms and conditions governing the existing division of resources must be changed, by eliminating the CHST and freeing new tax room for the provinces.
- ◆ The equalization program must be improved.
- ◆ The "federal spending power" must be countered.

### **1.1 Additional financial resources for the provinces**

It is clear that if fiscal balance is to be restored within the Canadian federation, the financial resources on which the provinces can count must first be adjusted. The Commission has taken care to specify the size of such an adjustment, in Québec's case. To that end, it took into account both Québec's financial situation, by estimating the financial needs that must be satisfied, and the federal government's capacity to keep its budget balanced following such an adjustment.

The results of this analysis are given below.

#### **Québec's financial needs**

In its study, the Conference Board evaluated Québec's short-term structural deficit at about \$2 billion. However, over the next 20 years, it showed that this deficit will reach an average of \$3 billion annually.

**TABLE 20**

**BUDGET BALANCES OF THE FEDERAL AND QUÉBEC GOVERNMENTS**  
(billions of dollars)

	Year			Five-year average			Annual average
	2002-2003	2003-2004	2004-2005	2005-2010	2011-2015	2016-2020	
Budget balance of the Québec government	-1.8	-2.2	-2.6	-2.5	-3.3	-4.2	-3.2
Budget balance of the federal government	0.2	2.1	2.3	11.6	30.8	67.8	30.9

Source: Conference Board of Canada.

The Commission is of the view that Québec should have annual additional financial resources of at least **\$2 billion in the short term and \$3 billion in the medium term** to correct the current fiscal imbalance between the two orders of government.

This is a large amount, but it corresponds to the impact, in Québec, of the cuts the federal government has made in its transfers to the provinces. As we have seen earlier, when the scope of the federal disengagement is compared to the growth in needs, Québec's shortfall for 2001-2002 alone amounts to \$2.2 billion.<sup>102</sup>

### The federal government's financial capacity

For Canada as a whole, the need for resources that the Commission has quantified implies that the provinces should receive an adjustment to their financial resources of at least \$8 billion in the short term. This is greater than the federal surpluses, as estimated by the Conference Board for the next five years. However, beginning in 2007-2008, again according to the Conference Board, the federal government's surplus will be sufficiently large to fund such an adjustment: its surplus is projected to reach \$11.8 billion in 2007-2008.

The Commission wants to make the following comments on the issue of the federal capacity to fund the recommended adjustment:

- ♦ First, in its study, the Conference Board was not able to allow for the federal government's latest announcement concerning the budget situation for 2001-2002. On February 12, 2002, the federal government announced that the accumulated surplus as at December 31, 2001, stood at \$13.4 billion. The Conference Board estimate, putting the 2001-2002 surplus at \$5.6 billion, is therefore conservative – as are the surplus figures for the following years.

<sup>102</sup> See above, Chapter 3, p. 81.

- ◆ Second, recent experience shows that each year, the federal government's true leeway is substantially greater than the surplus announced, and that has been the case for almost six years now. According to its 2001 Budget, the federal government's accumulated surplus for the period 1997-1998 to 2003-2004 would amount to \$41.8 billion. In 2004, the actual federal leeway will have reached \$238 billion, including \$46 billion for 2001-2002 alone. Rather than using this leeway to restore fiscal balance within the federation, the federal government has allocated it to new spending, frequently within provincial fields of jurisdiction, tax cuts, and debt repayment.

**TABLE 21**

**ANNOUNCED SURPLUSES AND LEEWAY BEFORE MEASURE OF THE  
FEDERAL GOVERNMENT SINCE THE 1997 BUDGET**  
(billions of dollars)

	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Total
Announced surplus (including contingency reserves)	3.5	2.9	12.3	17.1	1.5	2.0	2.5	41.8
▪ New spending	4.0	7.5	10.8	12.8	18.7	19.6	20.2	93.6
▪ Tax cuts	0.2	2.2	6.2	14.1	25.4	25.3	29.5	102.9
<b>True leeway</b>	<b>7.7</b>	<b>12.6</b>	<b>29.3</b>	<b>44.0</b>	<b>45.6</b>	<b>46.9</b>	<b>52.2</b>	<b>238.3</b>

Source: 2001 Budget, Department of Finance Canada, p. 184.

## 1.2 Elimination of the CHST and a new division of tax room

The Commission's second recommendation concerns how the provinces' financial resources should be adjusted. The Commission holds that this adjustment requires a profound transformation of transfer programs. More specifically, the Commission is convinced that the CHST must be eliminated and replaced with tax room freed for the provinces.

### Eliminate the CHST

Increasing the CHST's transfers is the first option for adjusting their financial resources that was identified by the provinces. In August 2001, the provincial Prime ministers and Ministers of Finance were unanimous in adopting a proposal that reads as follows:

*Premiers invited the Prime Minister to join with them in following through on his commitment to achieve adequate and sustainable fiscal arrangements over the immediate to medium term, including: [...] Restoration of federal health funding through the CHST to at least 18% and introduction of an appropriate escalator [...].<sup>103</sup>*

<sup>103</sup> Sustainable Health Care for Canadians, Press release Annual Premiers' Conference, Victoria (British Columbia), August 1 to 3, 2001.

Québec was part of the consensus because the proposal explicitly mentioned, in the fiscal arrangements to be reached with the federal government, “*work on other CHST measures, including tax-point transfers as one possible alternative to the current CHST cash transfer.*”<sup>104</sup>

The Commission does not consider an increase of the CHST’s transfers to be a satisfactory solution. While it would provide the provinces with additional financial resources, the other dysfunctions mentioned in this report would remain unresolved.

- ◆ There would be no long-term guarantee concerning the maintenance of federal funding. Cuts such as those the federal government has made since the beginning of the 1980s would still be possible.
- ◆ The conditions attached to the CHST would still be in place and their impact would be even greater because of the increase of the CHST’s transfers.
- ◆ There is no logic to allowing the federal government to collect taxes only to return them to the provinces without taking their respective needs into account, to enable them to fund spending in their fields of jurisdiction. It would be much simpler and more rational to give the provinces the possibility of directly collecting these same taxes from taxpayers, of defining taxes on the basis of the needs they must address, and of being accountable to their constituents regarding how these funds are used

The Commission maintains that in order to restore fiscal balance, the **CHST must first be eliminated.**

### **The true solution: a new division of tax room**

The alternative to increasing the CHST’s transfers is that a new tax room be freed for the provinces. According to this approach, the provinces would no longer receive federal cash transfers under the CHST, and in return, the federal government would vacate a portion of the tax room it currently occupies for their use.

The overall tax burden should not be affected by this operation. Only the distribution of taxes between the two orders of government would change.

Freeing tax room for the provinces would correct the fiscal imbalance by dealing with all the causes of the phenomenon.

- ◆ A new tax room for the provinces means secure and predictable funding. As has been emphasized in the report, the arbitrariness of federal decisions concerning the amounts allocated under the CHST is

<sup>104</sup> *Sustainable Health Care for Canadians*, Press release Annual Premiers’ Conference, Victoria (British Columbia), August 1 to 3, 2001.

unquestionably one of the chief causes of fiscal imbalance. By occupying additional tax room, Québec and the other provinces would directly collect from taxpayers the revenue needed to fund health, education and income security programs, and would no longer be vulnerable to cuts in their funding without warning.

- ◆ A new division of tax room means greater accountability. It would mean that the order of government that is responsible for delivering services would also be the one responsible for collecting all the revenue needed to fund such delivery. Accordingly, taxpayers would be fully able to assess the decisions of their governments, in particular regarding the level and quality of services, as well as the weight of the tax burden.
- ◆ A new tax room for the provinces would be obviously unconditional, unlike the current CHST. Withdrawal from a tax room occupied until now by the federal government would therefore limit its intervention in provincial fields of jurisdiction accordingly.

The Commission recommends that the CHST be replaced by a **new division of tax room**, because of the **secure and predictable** nature of the resulting source of funding to which the provinces would have access, *its unconditional nature and the greater accountability that would result.*

#### **A new division of tax room: two options**

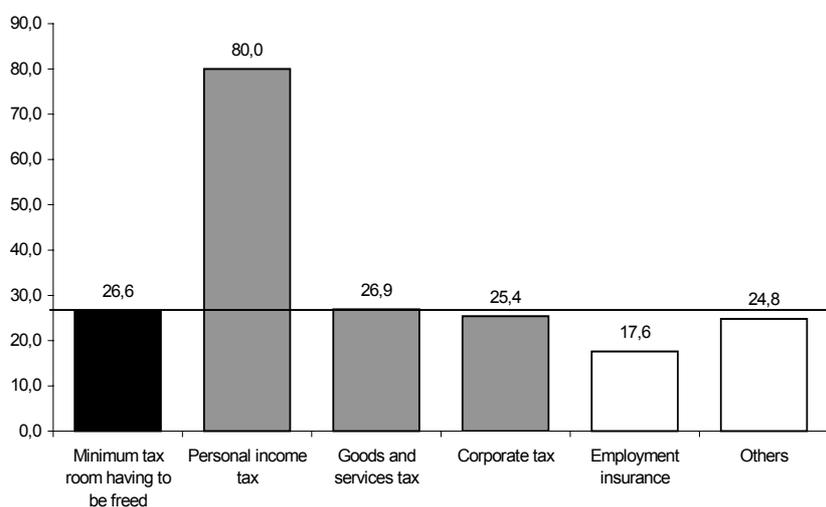
The Commission used two criteria to study the possible options for a new division of tax room.

- ◆ The first criterion is the size of the tax field in which such a new division could be effected for the benefit of the provinces. The tax field concerned must be sufficiently large so that the new tax room freed for the provinces corresponds to the amount of needs to be addressed, as previously quantified.

In 2002-2003, CHST cash transfers will total \$18.6 billion, and the size of the financial adjustment to be made in favour of the provinces has been estimated at, at least, \$8 billion. The only tax fields that produce revenue of this magnitude are personal income tax, the GST and corporate income tax.

**CHART 39**

**MINIMAL TAX ROOM TO BE FREED AND REVENUES OF THE  
FEDERAL GOVERNMENT, 2002-2003**  
(billions of dollars)



Source: Department of Finance Canada, 2001 Budget.

- ♦ The second criterion is revenue stability. This is very important in view of the nature of the needs that are funded by the revenue, and the requirement that the provinces be able to plan their actions for this purpose over the medium and long term. As was pointed out in Chapter 2, corporate income tax is highly variable, and accordingly is poorly suited to fund health and education, which require access to stable and predictable resources.

For this reason, the Commission has limited its analysis of the possible options to divide in a new manner the personal income tax and the GST fields.

The Commission believes two scenarios may be drawn on this basis:

- ♦ Replacement of the CHST by provincial occupation of the entire federal GST field, which represents resources of \$27 billion.<sup>105</sup>
- ♦ Replacement of the CHST by relinquishing a portion, i.e. \$26 billion, of the federal personal income tax field.

For each of these two scenarios, the Commission has studied the financial impact of the new fiscal division on Québec's public finances, the advantages and disadvantages of the two options and the consequences of this new division on federal public finances.

<sup>105</sup> As will be seen below the relinquished personal income tax room is less than that of the GST because of the impact on equalization.

### 1.2.1 The financial impact for Québec

The financial impact of each of the two scenarios for Québec was calculated using data from the Conference Board study. The amount of the CHST used in the calculation includes the “special Québec abatement” because according to the federal government’s way of calculating, this abatement is part of the payment under the existing transfer program.<sup>106</sup>

It was assumed that no change is made to the current equalization program. As will be seen, this program automatically affects the results, since each of the two scenarios implies a change in the average tax rates of the provinces, and accordingly to the equalization payments to the less-affluent provinces.

According to the Commission’s estimate, the two scenarios for a new division of the tax room would have the following financial impact:

- ◆ For the first scenario, concerning personal income tax, and including the automatic impact on equalization payments, replacement of the CHST by the occupation of new tax room would mean that Québec would control 58% of this income tax, compared with 41% currently.
  - The combined impact of this new division of tax room and equalization payments would increase Québec’s financial resources by \$1.8 billion in 2002-2003, \$2.7 billion annually during the period 2005-2010 and by \$4.9 billion a year during the period 2016-2020.
  - The impact of equalization payments would be far from negligible: for 2002-2003, for instance, the payments resulting from the automatic impact of the new division of tax room on equalization would reach \$1.2 billion, or roughly one fifth of the tax room that would be gained by Québec.
  - Overall, and including the savings Québec may achieve on debt service because of repayments it would be able to make, the budget would be balanced for the next three fiscal years and would be in a surplus position beginning in 2005-2006. The surplus would average \$7.4 billion during the period 2016-2020.<sup>107</sup>

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<sup>106</sup> See *Appendix 7*.

<sup>107</sup> The Commission itself carried out these simulations for purposes of illustration. Accordingly, the Conference Board bears no responsibility for them, but the Commission used the same assumptions as the Conference Board did.

**TABLE 22**

**IMPACT ON QUÉBEC OF THE ELIMINATION OF THE CHST AND ITS REPLACEMENT  
BY A FREED TAX ROOM OF \$26 BILLION UNDER THE PERSONAL INCOME TAX**  
*(billions of dollars)*

	Year			Five-year average		
	2002-2003	2003-2004	2004-2005	2005-2010	2011-2015	2016-2020
<b>Budget balance (according to the Conference Board)</b>	-1.8	-2.2	-2.6	-2.5	-3.3	-4.2
<b>Scenario:</b>						
▪ Elimination of CHST	-4.7	-5.1	-4.8	-5.4	-6.2	-7.2
▪ Transfer of personal income tax	5.3	5.5	5.8	6.6	8.1	9.9
▪ Automatic impact on equalization	1.2	1.2	1.3	1.5	1.8	2.2
<b>Sub-total</b>	<b>1.8</b>	<b>1.6</b>	<b>2.3</b>	<b>2.7</b>	<b>3.7</b>	<b>4.9</b>
▪ Estimated impact on debt service	0.0	0.1	0.3	1.0	3.0	6.7
<b>Total impact of scenario</b>	<b>1.8</b>	<b>1.7</b>	<b>2.6</b>	<b>3.7</b>	<b>6.7</b>	<b>11.6</b>
<b>Budget balance after scenario</b>	<b>0.0</b>	<b>-0.5</b>	<b>0.0</b>	<b>1.2</b>	<b>3.4</b>	<b>7.4</b>

Note: The elimination of the CHST includes the impact of the elimination of the special Québec abatement. As will be seen further on, the increase in personal income tax in Québec will be less than in other provinces because of the existence of this abatement.

Source: Commission on Fiscal Imbalance, based on the study by the Conference Board of Canada.

- ♦ Turning to scenario two, concerning the replacement of the CHST with the transfer of the entire GST field to the provinces, the Commission's analyses lead to the following results:
  - The federal government would have to relinquish the entire GST field to the provinces to achieve the financial objectives set by the Commission.
  - The combined impact of this new division of tax room and the equalization payments that automatically result would increase Québec's financial resources by \$1.6 billion in 2002-2003, \$1.4 billion in 2003-2004 and \$1.9 billion in 2004-2005. For the period 2005-2010, the increase in Québec's financial resources would amount to \$2.1 billion annually. It would reach \$3.3 billion annually during the period 2016-2020.
  - Unlike the first scenario, the impact on equalization payments would be relatively minor. For 2002-2003, payments resulting from the automatic impact of the new division of the tax room on equalization would be \$0.2 billion, or 3% of the total tax field transfer to Québec.
  - Overall, and including – just as with the preceding scenario – the savings Québec may achieve on debt service because of repayments, Québec's budget would remain in a deficit position for the next three fiscal years. It would be in a small surplus position during the period 2005-2010, and the surplus would reach \$4.1 billion a year during the period 2016-2020.

**TABLE 23**

**IMPACT ON QUÉBEC OF THE ELIMINATION OF THE CHST AND ITS REPLACEMENT  
BY THE TRANSFER OF THE GST FIELD TO THE PROVINCES**  
(billions of dollars)

	Year			Five-year average		
	2002-2003	2003-2004	2004-2005	2005-2010	2011-2015	2016-2020
<b>Budget balance (according to the Conference Board)</b>	-1.8	-2.2	-2.6	-2.5	-3.3	-4.2
<b>Scenario:</b>						
▪ Elimination of CHST	-4.7	-5.1	-4.8	-5.4	-6.2	-7.2
▪ Transfer of the GST	6.1	6.3	6.5	7.2	8.5	10.1
▪ Automatic impact on equalization	0.2	0.2	0.2	0.3	0.3	0.4
<b>Sub-total</b>	<b>1.6</b>	<b>1.4</b>	<b>1.9</b>	<b>2.1</b>	<b>2.6</b>	<b>3.3</b>
▪ Estimated impact on debt service	0.0	0.1	0.2	0.8	2.3	5.0
<b>Total impact of scenario</b>	<b>1.6</b>	<b>1.5</b>	<b>2.1</b>	<b>2.9</b>	<b>4.9</b>	<b>8.3</b>
<b>Budget balance after scenario</b>	<b>-0.2</b>	<b>-0.7</b>	<b>-0.5</b>	<b>0.4</b>	<b>1.6</b>	<b>4.1</b>

Note: The elimination of the CHST includes the impact of the elimination of the special Québec abatement.

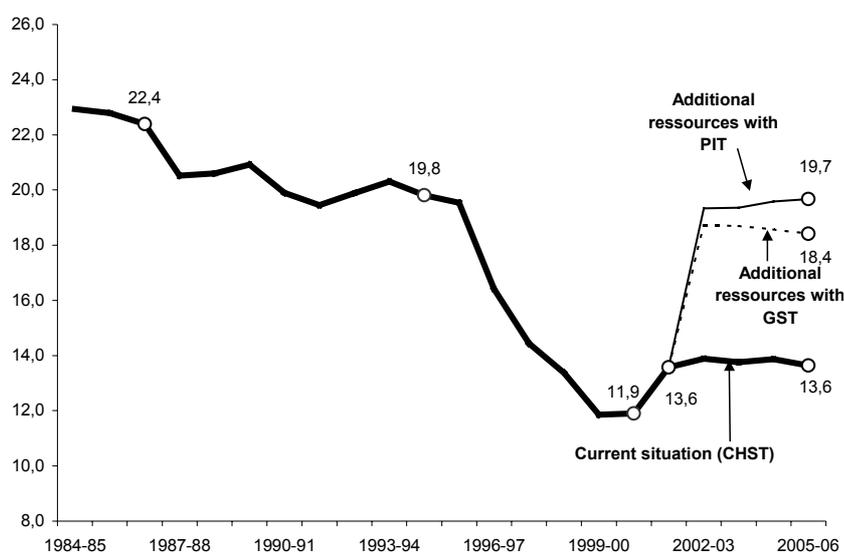
Source: Commission on Fiscal Imbalance, based on the study by the Conference Board of Canada.

A comparison of the two scenarios leads to the following observations:

- ♦ In both cases, Québec returns to a balanced budget in the near term. Depending on whether the first or the second scenario is used, the budget remains balanced or is in a slight deficit position for the next three fiscal years. In the medium term, Québec would post a budget surplus in both cases, though Québec's gains would be greater in the case of a new division of the personal income tax field than if it occupied the GST field.
- ♦ Under both scenarios, Québec would gain additional financial resources of \$2 billion in the near term, restoring funding previously provided by the CHST: the tax room Québec would obtain represents 18.4 to 19.7% of funding for health, post-secondary education and income security, whereas the CHST provided 19.8% of this funding in 1994-1995, subsequently falling to 11.9% in 2000-2001.
- ♦ However, the second scenario has two very important consequences in terms of public finances, that account for its interest and which we will return to subsequently: the new division would encompass the entire tax room currently occupied by the federal government, and the financial gains obtained would depend only very marginally on equalization.

**CHART 40**

**CURRENT CHST AND ADDITIONAL FINANCIAL RESOURCES QUÉBEC WOULD  
GAIN AS A PROPORTION OF ITS SPENDING ON HEALTH,  
EDUCATION AND SOCIAL SERVICES, 1984-1985 TO 2005-2006  
(as a percentage)**



Notes: CHST including special Quebec abatement and excluding federal trust accounts.

Sources: Commission on Fiscal Imbalance; ministère des Finances du Québec, *2002-2003 Budget*; Conference Board of Canada.

### 1.2.2 Advantages and disadvantages of each scenario

Under both scenarios, the overall financial objective is achieved, namely a rebalancing of the division of financial resources between Québec and the federal government. The Commission carried out a deeper analysis of the impact of each scenario to identify certain advantages and disadvantages in relation to a number of important criteria. The criteria studied by the Commission are as follows:

- ◆ revenue growth potential;
- ◆ utility as a social development tool;
- ◆ risk of reoccupation of the tax room by the federal government;
- ◆ reliance on equalization;
- ◆ administrative feasibility of the new division of tax room;
- ◆ tax competition;
- ◆ the specific impact on the “special Québec abatement.”

### **Revenue growth potential**

Concerning revenue growth potential, personal income tax is the source of revenue with the greatest potential increase in yield when the economy is growing. This point has already been explained.<sup>108</sup> This feature would enable the provinces to respond more easily to the heavy pressure being exerted on their spending, especially health. However, the income tax base varies fairly significantly with business cycles.

The potential increase in the yield of the GST is lower. However, growth in revenue from this tax corresponds fairly closely to economic growth. In addition, the yield of this tax base is less sensitive to business cycles and accordingly is more stable than the yield of the income tax base – an advantage for funding public spending.

### **Utility as a social development tool**

Québec has always used personal income tax as an important social development tool, in view of its progressive structure and the possibility to use the tax system to define targeted actions. Accordingly, from the outset, this criterion favours personal income tax, but two qualifications must be made:

- ◆ First, the sales tax can also be used for social development purposes, for instance in the form of tax credits or differentiated rates depending on the nature of the goods and services taxed.
- ◆ Second, it must be pointed out that redistribution among individuals also occurs through social programs, not just through the tax system. Accordingly, a government can also act effectively on income redistribution through its spending.

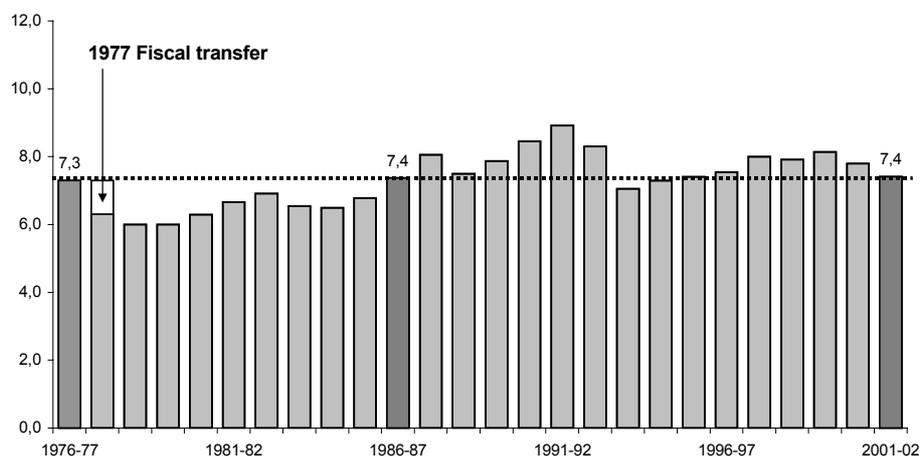
### **Risk of reoccupation of the tax room by the federal government**

As we have already seen, because of the financial objectives that have been adopted, replacement of the CHST by a new division of the tax room would require that the federal government completely relinquish the GST field. In practice, it would accordingly be difficult for the federal government to reoccupy this field in the future. It is even possible that, under the new division, the federal government would give an undertaking not to reoccupy this field, as it did for lotteries and gambling.

This would not be the case with a new division of the personal income tax room. The federal government would still occupy 42% of this tax after the new division. The experience of the transfer of tax points to the provinces in 1977 shows that the federal government quickly reoccupied the tax room it had previously yielded. As a percentage of GDP, federal income tax is greater now than it was in 1977.

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<sup>108</sup> See above, Chapter 2, p. 56.

**CHART 41****FEDERAL PERSONAL INCOME TAX, 1976-1977 TO 2001-2002**  
(as a percentage of GDP)

Source: Commission on Fiscal Imbalance.

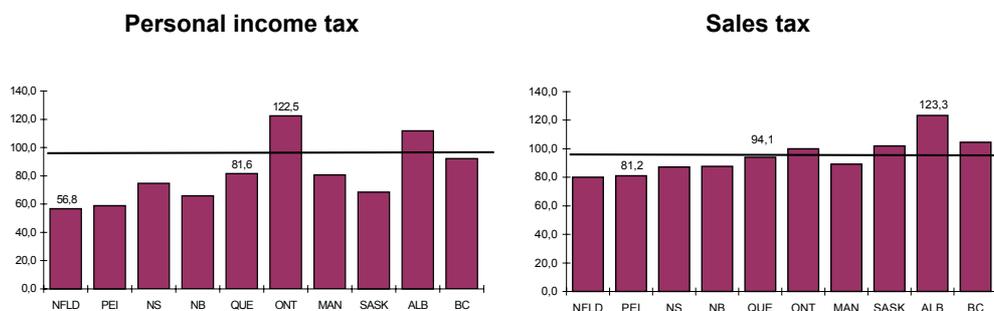
**Reliance on equalization**

It has already been noted that the scenario involving a new division of the personal income tax field would have an automatic impact on equalization greater than would be the case if the federal government were to relinquish the GST field. This phenomenon stems from the fiscal disparities among the provinces regarding the personal income tax base, whereas the disparities are much smaller for the sales tax.

- ◆ Québec's fiscal capacity is close to 20% below the Canadian average for the personal income tax base. The difference is only 6% for the sales tax.
- ◆ This means that in the case of a new division of the tax room, the gains would be more equally distributed if the new division involves the sales tax rather than personal income tax.

**CHART 42**

**DISPARITIES IN FISCAL CAPACITY AMONG THE PROVINCES, 2001-2002**  
(Canada = 100)



Note: 2001-2002 fiscal year (2<sup>nd</sup> estimation).

Source: Department of Finance Canada.

- ◆ This shows that a new division of the personal income tax room would involve more equalization revenue than the complete evacuation of the GST, for the less affluent provinces. We have seen that overall, for 2002-2003, the additional revenue from equalization would amount to \$0.2 billion in the case of the GST and \$1.2 billion if the new tax division concerns personal income tax.

In proportion to the additional financial resources Québec would obtain following this new tax division, this means that in the scenario concerning personal income tax, almost 70% of the additional revenue would be derived from equalization, compared with 13% if the federal government relinquishes the GST.

**TABLE 24**

**BREAKDOWN OF ADDITIONAL QUÉBEC REVENUES STEMMING FROM THE NEW DIVISION OF TAXATION FIELDS, 2002-2003**  
(in millions of dollars and as a percentage)

	Sales tax (GST)		Personal income tax	
	Amount	Breakdown	Amount	Breakdown
Value of the transfer	6 059		5 259	
CHST abolished	- 4 705		- 4 705	
Tax room	1 354	87%	554	32%
Attendant equalization	199	13%	1 202	68%
Total	1 553	100%	1 756	100%

Source: Commission on Fiscal Imbalance.

This is a key issue to be considered in the choice of taxation field to be reassigned. As we saw earlier, several facets of the operation of the equalization program are problematic. Above all, despite its unconditional nature, the very amount of total equalization payments is in fact largely defined in a discretionary manner by the federal government.

The scenario calling for a new division of the personal income tax field means that in practice most of the additional revenues transferred to Québec would not be derived from own-source revenues but from a transfer program that poses a number of problems.

### **The administrative feasibility of the new division of tax room**

The new division of the personal income tax field in favour of the provinces does not pose any particular administrative problems. Changes of this kind have already been made on several occasions. As the Commission emphasized earlier, this type of modification demands, first and foremost, close coordination between the governments concerned, since it assumes a simultaneous adjustment of federal and provincial tax rates.

As for the sales tax, the transfer from the federal government to the provinces of the GST would engender greater, although superable, administrative difficulties.

- ◆ The incorporation of the GST into the sales tax system that the provinces administer could be achieved fairly easily in Québec and the Atlantic Provinces since the provincial and federal sales taxes are already harmonized and collection is made in part by only one order of government, i.e. the ministère du Revenu du Québec in Québec and the Canada Customs and Revenue Agency in the Atlantic Provinces.
- ◆ Some of the provinces that have not harmonized their sales tax with the GST could be encouraged to do so, since they would collect all of the revenues generated within the province by the two sales taxes. In any event, whether or not their tax is harmonized with the GST, it will be up to each province to decide on the occupation of the newly relinquished tax room and terms and conditions of collection. This would also apply to Alberta, which does not collect any provincial sales tax.

### **Tax competition**

As we noted earlier, tax competition at least partly explains the tax reductions initiated by the federal and provincial governments in recent years.<sup>109</sup> Such tax competition does not affect in the same manner the personal income tax and sales tax fields.

- ◆ Tax competition is usually very strong in the case of personal income tax and corporate tax, given the high mobility of capital and the relative mobility of workers, who can thus react to different fiscal pressures.

<sup>109</sup> See above, Chapter 2, p. 58.

- ◆ This situation is much less important in the sales tax field. Tax competition is likely to affect trade in frontier zones although such competition will, overall, be more limited. The experience of the United States or the European Union, where there are different types of sales tax, is revealing in this respect.

Taking into account this criterion means that, when the equalization program does not entirely level out the disparities in fiscal capacity between the provinces, which is now the case, the sales tax field has the advantage of being less subject to pressure from the fiscal policy of other jurisdictions than the personal income tax field.

### **Specific impact on the “special Québec abatement”**

Both of the scenarios that the Commission examined imply the complete replacement of the CHST by a transfer of tax room, whether of personal income tax or the sales tax, since the federal government deems the CHST to include the special Québec abatement. In both instances, this means eliminating the “special abatement.”

- ◆ In the case of the first scenario, calling for a new division of the personal income tax field, the abolition of the “special abatement” would be imperceptible since it would be more than offset by the new division arrangement.

Under this scenario, federal personal income tax would be reduced by an amount equivalent to the difference between the “special abatement” and the taxation field occupied by Québec. In exchange, Québec personal income tax would increase by the same amount.

- ◆ Under the scenario concerning GST, modifications would occur simultaneously in two different taxation fields.
  - In the personal income tax field, the federal government would recover the amount of the “special Québec abatement” by increasing the taxes collected in Québec. The Québec government would offset the elimination of the abatement by reducing personal income tax by the same amount.
  - In the sales tax field, the new Québec sales tax would be equivalent to the former GST and QST. The Québec government would offset the reduction in personal income tax with a portion of the additional revenues collected through the transfer of the GST.

In both instances, the elimination of the «special Québec abatement» would have the advantage of making more realistic the method of collecting personal income tax. The «special Québec abatement» gives the impression that the occupation by the federal government of the personal income tax field is less extensive than it really is. It is a question of pushing the federal

government's logic to the limit since the federal government actually treats the «special Québec abatement» as a form of payment of the CHST.

### Two valid approaches

In the wake of its analysis, the Commission prefers the occupation by the provinces of the GST field, without permanently ruling out a new division of the personal income tax field.

- ◆ The occupation by the provinces of the GST field would have two major advantages, i.e. it would enable the provinces to increase by a bigger proportion their own-source revenues in relation to the personal income tax scenario, since its automatic impact on equalization would be limited. Moreover, the risk that the federal government would subsequently reoccupy the taxation field would be limited, since the federal government would completely relinquish the GST. From the standpoint of tax competition, the sales tax base is subject to less pressure than is true of personal income tax.
- ◆ The main advantage of a new division of the personal income tax field lies in the potential growth of the attendant revenues. Such a reallocation, which reflects Québec's traditional demands, must not be rejected for this reason, although the Commission relativizes about the importance of this advantage compared with the difficulties stemming from greater dependence on the equalization program.

The Commission expresses its preference for an **occupation of the GST field by the provinces**. In light of the financial objective adopted, the federal government would entirely relinquish the GST in favour of the provinces, which would effectively bolster the provinces' decision-making and budgetary autonomy while ensuring better funding of expenditures in their fields of jurisdiction.

However, the Commission does not wish to reject the scenario calling for a **new division of the personal income tax field**. This scenario, which reflects Québec's traditional stance, would have the advantage of giving the provinces broader access to a source of revenue with high growth potential.

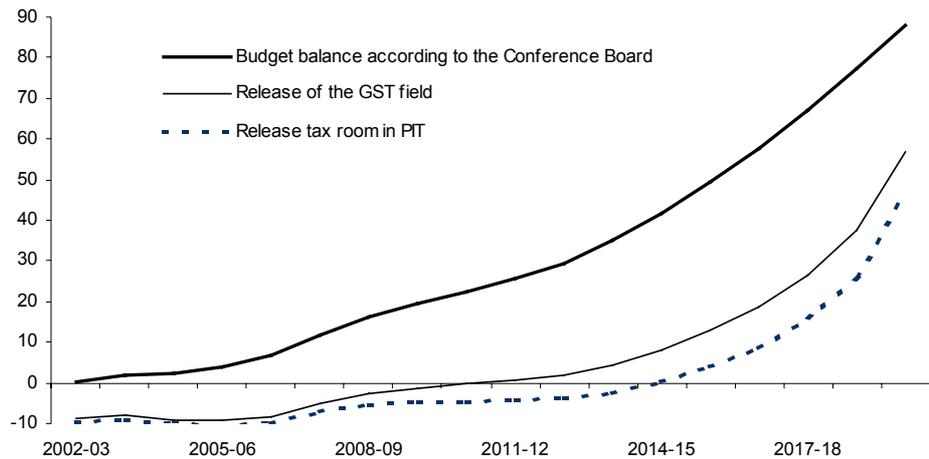
### 1.2.3 Impact on the federal government

The Commission has specifically analysed the impact of each scenario on the federal government's public finances. In each case, bearing in mind the Conference Board's findings, the new division of tax room would produce a federal budget deficit in the short term, although budget surpluses would reappear in the medium and long term.

As we noted earlier, the Conference Board projections probably underestimate the federal government's future surpluses.<sup>110</sup> The new division of tax field could be achieved gradually to avoid federal budget deficits.<sup>111</sup>

**CHART 43**

**BUDGET BALANCE OF THE FEDERAL GOVERNMENT: IMPACT OF THE TWO SCENARIOS EXAMINED, 2002-2003 TO 2019-2020**  
(billions of dollars)



Sources: Commission on Fiscal Imbalance; Conference Board of Canada.

The Commission is of the opinion that the new division of tax room that it is recommending in favour of the provinces **must not lead to federal government budget deficits**.

Moreover, the Commission believes that this demand is compatible with the transfer recommended if the transfer is made **gradually** and if account is taken of the **actual size** of federal budget surpluses.

However, it is essential that **priority** be given to allocating future surpluses to the new division of tax room in favour of the provinces.

<sup>110</sup> For instance, if federal surpluses are larger than forecast by the Conference Board in the short term, the federal government could be in a position to relinquish the requested tax room without running a deficit. See *Fiscal Prospects for Federal and Québec Governments*, *op. cit.*, note 4.

<sup>111</sup> The new division of tax room could be implemented by means of a gradual adjustment in personal income tax rates under the first scenario. Under the second scenario, the gradual shift from the federal to the provincial governments of the GST is also easy to imagine: for example, the provinces could collect all GST revenues and remit to the federal government a decreasing portion of such revenues over a stipulated period.

**I. THE COMMISSION'S RECOMMENDATIONS CONCERNING THE RESTORATION OF FISCAL BALANCE IN THE FEDERATION: ADDITIONAL RESOURCES ACCORDING TO NEW PROVISIONS**

- (a) *The provinces must benefit from additional financial resources. In Québec's case, such resources are estimated at an annual \$2 billion in the short term and \$3 billion in the medium term, and at least \$8 billion for the provinces overall.*
- (b) *The Commission recommends the elimination of the CHST and its replacement by a new division of tax room, because of the assured and predictable nature of the source of funds to which the provinces would have access, its unconditional nature and the greater accountability that would result.*
- (c) *The Commission expresses its preference for an occupation of the GST field by the provinces. In light of the financial objective adopted, the federal government should entirely relinquish the GST in favour of the provinces.*
- (d) *However, the Commission does not wish to reject the scenario calling for a new division of the personal income tax field.*
- (e) *In both instances, the new division of tax room would focus on the equivalent of between \$26 billion and \$27 billion for Canada as a whole, i.e. the amount of the existing CHST, to which would be added the additional financial resources freed for the provinces.*
- (f) *The Commission believes that the new division of taxation must not lead to federal government deficits, which is possible if the new division is implemented gradually and account is taken of actual federal government surpluses. Priority should be given to allocating future surpluses to the new division of tax room demanded in favour of the provinces.*

### **1.3 Enhancement of the equalization program**

The Commission is of the opinion that two types of reforms must be undertaken in respect of the equalization program.

- ◆ First, the program's technical procedures must be enhanced in order to achieve a fiscal framework that accurately reflects the provinces' position and reduce the variability of payments stemming from these procedures.
- ◆ Second, the very definition of the program must be modified so that it better satisfies the objectives in respect of which it was established. These changes concern a return to the ten-province standard and the elimination of ceiling and floor provisions.

### 1.3.1 *Technical procedures governing the equalization program*

#### **Respect the representative taxation system**

The Commission has emphasized the arbitrary nature of several criteria used to delineate the tax bases that are considered for the purpose of defining the representative taxation system.

- ◆ Especially significant shortcomings were pinpointed with regard to the measurement of the property tax base and revenues generated by the sale of goods and services.
- ◆ These shortcomings mean a large shortfall for certain provinces.

The Commission requests **total compliance** with the representative tax system approach, which is the very basis for the measurement of the provinces' fiscal capacity.

At the next renewal of the equalization program, fiscal capacity for the property tax base must be measured on the basis of property assessment rolls. Similarly, the full amount of revenue from the sale of goods and services must be subject to equalization.

#### **Unexpected revisions**

The Commission has emphasized the problems stemming from the marked variability in equalization payments. Such problems are unacceptable when they result from payment procedures or "unexpected revisions" of data.

The Commission recommends that any new method or data be submitted to the provinces and subjected to satisfactory study before being applied.

No change in methodology or data should be implemented during the five-year period following a renewal of the equalization program.

### 1.3.2 *The equalization program's ability to satisfy its objectives*

#### **The replacement of the five-province standard with the ten-province standard**

The five-province standard that now applies to the equalization program does not completely eliminate discrepancies in fiscal capacity between the provinces, although this is the program's very objective.

- ♦ The only standard that would make it possible to attain this objective would be the standard defined in light of the wealthiest province, which is now Alberta. The application of this standard would obviously be too costly to the federal treasury. The application of such a standard would increase the cost of the program by more than \$100 billion per year.
- ♦ The Commission deems the application of the ten-province standard to be a reasonable compromise. The replacement of the five-province standard by the ten-province standard would draw the equalization program closer to the objectives in respect of which it was established. At the same time, the program's financial impact would be acceptable to the federal government, at least in the medium term. According to the Commission's assessment, the application of the ten-province standard would increase the equalization revenues of the receiving provinces by \$2.9 billion in 2002-2003, including \$1.5 billion for Québec.
- ♦ The application of the ten-province standard would have another advantage in that it would reduce the possible impact of the tax-back effect inherent in an equalization program for the receiving provinces not now included in the five-province standard.

The application of the ten-province standard would mark a return to an earlier situation, since the federal government applied this standard until 1982.

Given the potential cost of a shift to the ten-province standard, the Commission suggests the gradual implementation of this standard, according to a timetable to be agreed, and to avoid a federal budget deficit. Until the measure achieves its full effect, the federal government should clearly inform the public of what remains to be done in this regard by indicating the percentage of equalization paid in relation to the amount that would result from the measure's full application.

The Commission is of the opinion that equalization payments must be defined using a standard that reflects the average fiscal capacity of all of the provinces, i.e. the **ten-province standard**, which would replace the existing five-province standard.

The shift to the ten-province standard should be effected **gradually** to allow for the impact of this change on federal public finances and prevent it from leading them into deficit. However, the federal government should clearly consider the ten-province standard **as the objective to attain** by indicating the percentage of equalization paid in relation to the amount that would result from its full application.

### The elimination of ceiling and floor provisions

The existing ceiling provision is another component in the definition of equalization payments that diverts the current program from its objectives. This provision, when it is applied, consists in limiting growth in equalization entitlement to growth in GDP. It can thus widen the gap in fiscal capacity between receiving provinces and the less-privileged ones.

The floor provision is inequitable since it results in the different treatment of two provinces with the same fiscal capacity.

The Commission recommends the **elimination** of the “ceiling” and “floor” provisions so that the equalization program can satisfy its objective more adequately and to improve its equity.

## II. THE COMMISSION’S RECOMMENDATIONS CONCERNING THE RESTORATION OF FISCAL BALANCE IN THE FEDERATION: THE ENHANCEMENT OF THE EQUALIZATION PROGRAM

- (a) *The Commission is of the opinion that equalization payments must be defined using a standard that reflects the average fiscal capacity of all of the provinces, i.e. the ten-province standard, which would replace the existing five-province standard. The shift to the ten-province standard should be effected gradually to allow for the impact of this change on federal public finances and prevent it from leading them into deficit. However, the federal government should clearly consider the ten-province standard as the objective to attain by indicating the percentage of equalization paid in relation to the amount that would result from its full application.*
- (b) *The Commission recommends the elimination of the “ceiling” and “floor” provisions so that the equalization program can satisfy its objective more adequately and to improve its equity.*
- (c) *The Commission requests total compliance with the representative tax system approach, which is the very basis for the measurement of the provinces’ fiscal capacity. At the next renewal of the equalization program, fiscal capacity for the property tax base must be measured on the basis of property assessment rolls. Similarly, the full amount of revenue from the sale of goods and services must be subject to equalization.*
- (d) *The Commission recommends that any new method or data be submitted to the provinces and subjected to satisfactory study before being applied. No change in methodology or data should be implemented during the five-year period following a renewal of the equalization program.*

## 1.4 Counteract the “federal spending power”

The “federal spending power” interferes with provinces’ jurisdictions and curtails their decision-making and budgetary autonomy. It has developed all the more rapidly since the federal government has benefited from a division of taxation fields that puts it at an advantage and generates revenues that largely exceed its expenditures in respect of its fields of jurisdiction.

The reallocation of financial resources in favour of the provinces that the Commission recommends and the new division of resources that it implies would at least partially nip in the bud federal initiatives launched under the aegis of “federal spending power” in provincial fields of jurisdiction.

However, there is no indication that this adjustment in the division of financial resources between the two orders of government would suffice to protect the provinces from any subsequent stray impulses in this respect. The Commission is of the opinion that, in order to counteract the “federal spending power,” Québec’s traditional proposals are more germane than ever.

### III. FISCAL BALANCE IN THE FEDERATION: COUNTERACT “FEDERAL SPENDING POWER”

- (a) *The Commission wishes to emphasize that the new division of financial resources that it recommends would limit future federal government initiatives under the aegis of “federal spending power” by reducing the financial leeway available for this purpose.*
- (b) *The Commission also recommends that:*
- *Québec vigorously reiterate its traditional stance concerning the absence of a constitutional basis for the “federal spending power” since this “power” does not respect the division of powers stipulated in the Constitution;*
  - *Québec maintain its demand to exercise an unconditional right to opt out with full financial compensation in respect of any program implemented by the federal government in a field falling under provincial jurisdiction.*

## 2. RESPOND TO ALL NEW CAUSES OF IMBALANCE

Throughout this report, the Commission has emphasized from the beginning of this report that fiscal imbalance prejudice in the functioning of a federation. For this reason, procedures must be implemented to respond rapidly to new causes of imbalance.

The Commission believes that we must simultaneously:

- ♦ engage in an ongoing, reliable assessment of the conditions surrounding financial relations between the two orders of government;
- ♦ initiate a genuine process of exchanges and discussion between the two orders of government on all facets of intergovernmental financial relations.

## **2.1 Systematic, transparent monitoring of the fiscal imbalance dynamic**

### **Understanding the issues**

The Commission has stressed how difficult it is for the public to fully understand the issues surrounding fiscal balance in the Canadian federation.

- ♦ We note an almost total absence of information on the functioning of and issues surrounding intergovernmental financial arrangements.
- ♦ Moreover, federal-provincial analyses of fiscal balance in the federation and transfer programs are noteworthy for their opacity.

The Commission recommends that the federal government significantly enhance the **information available to the public** concerning fiscal balance in the federation and intergovernmental fiscal arrangements.

The Commission is of the opinion that, given the issues at stake, the federal-provincial analysis of fiscal balance and transfer programs should be **revitalized** and made much more **transparent**.

- ♦ Any change to the fiscal arrangements must be studied by existing committees before being applied;
- ♦ Each year, the federal and provincial Ministers of Finance should release a joint report to the public on the issues discussed.

### **Systematic monitoring**

Systematic monitoring of various facets of fiscal imbalance must be carried out and Québec can take certain initiatives in this respect.

- ♦ The Standing Committee on Public Finance of the National Assembly should analyse each year the state of fiscal imbalance between Québec and the federal government.
- ♦ To this end, the Minister of Finance should submit a report to the Standing Committee in order to take stock of the question. When

preparing the report, the Minister could seek the advice of a Committee of experts assembled for this purpose.

- ♦ The Minister's report would examine, in particular, the state of fiscal balance in the federation and the key factors pertaining to federal transfers, including evidence of "federal spending power."

This public, annual process would allow for periodic, ongoing discussion of various facets of fiscal imbalance. It would permit open debate on the question and possibly lead to a consensus in the National Assembly concerning the initiatives to be taken. It would engender analyses and initiatives that would enable Québec and the provinces to better position themselves in the federal-provincial debate.

The Commission believes that the National Assembly should engage in **systematic monitoring** of various facets of fiscal imbalance through discussion by a parliamentary committee of a report submitted annually by the Minister of Finance and including the advice of a Committee of experts.

In particular, the report would examine the state of fiscal balance in the federation and issues such as evidence of "federal spending power."

## ***2.2 Broaden exchanges and discussion with the other provinces***

Fiscal imbalance concerns all of the Canadian provinces. Québec's current efforts to halt fiscal imbalance are all the more likely to succeed insofar as the other provinces support them. The Québec government has traditionally played an active role in questions concerning federal-provincial relations and intergovernmental fiscal arrangements.

The provinces' efforts must ultimately lead the federal government to accept the establishment of an ongoing and effective process of exchanges and discussion between the two orders of government.

The Commission recommends that the Québec government pursue its efforts to ultimately establish with the other provinces a **common strategy** aimed at halting the existing fiscal imbalance and implementing a genuine, permanent and effective process of exchanges and discussion between the two orders of government on intergovernmental fiscal relations.

**IV. THE COMMISSION'S RECOMMENDATIONS TO DEAL WITH ANY NEW SOURCE OF IMBALANCE**

- (a) *The Commission believes that the National Assembly should engage in systematic monitoring of various facets of fiscal imbalance through discussion by a parliamentary committee of a report submitted annually by the Minister of Finance and including the advice of a Committee of experts.*
- (b) *The Commission recommends that the Québec government pursue its efforts to ultimately establish with the other provinces a genuine, permanent and effective process of exchanges and discussion between the two orders of government on intergovernmental fiscal relations.*

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## CONCLUSION

Three essential factors underpin the conditions for fiscal balance in a federation on which the Commission has based its analysis.

- ◆ Own-source revenues must be attributed to each government in such a way that the resulting division of taxation fields allows each government to obtain sufficient funding to be accountable to taxpayers for decisions that it has made in its fields of jurisdiction.
- ◆ The total revenues to which each government has access must enable it to fully cover the cost of assuming responsibility for its fields of jurisdiction.
- ◆ The attendant conditions in respect of federal government transfers to the provinces or the procedures by which such transfers are defined must not curtail the provinces' decision-making and budgetary autonomy in their fields of jurisdiction.

The Commission is convinced the recommendations it has formulated would correct the fiscal imbalance that is currently a feature of intergovernmental fiscal relations within the Canadian federation.

The restoration of fiscal balance will directly benefit individuals since they will receive from the provinces an adequate level of services in sectors they consider a priority. Moreover, it will fully enable them to make the choices to which they are entitled in the fields stipulated by the Constitution as under provincial jurisdiction.

The ability to make choices in clearly identified fields is at the very heart of the federal system. It is a cornerstone of federalism, to which Quebecers are especially sensitive. The restoration of fiscal balance in Canada through a new division of financial resources must respect and guarantee it.



# **APPENDIX**

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**ORDER-IN-COUNCIL CONSTITUTING THE  
COMMISSION ON FISCAL IMBALANCE**

*Order-in-council n° 533-2001 of May 9, 2001*

CONCERNING the constitution  
of the Commission on Fiscal Imbalance

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WHEREAS in his speech delivered at the opening of the 2nd session of the 36th Legislature of the National Assembly, March 22, 2001, the Premier announced that a commission would be constituted consisting of experts and representatives of the community, to report on the fiscal imbalance that prevails between the federal government and the Québec government and how to correct it;

WHEREAS to do so, it is desirable to constitute a travelling commission of inquiry to study these issues;

WHEREAS under section 1 of the Act respecting public inquiry commissions, the government may constitute a commission of inquiry in particular when it is appropriate to conduct an inquiry into any matter relating to good government or the management of any part of public affairs;

IT IS ORDERED, consequently, on the recommendation of the Minister of State for the Economy and Finance and Minister of Finance:

THAT in accordance with section 1 of the Act respecting public inquiry commissions (R.S.Q., c. C-37) a commission of inquiry be constituted and designated as the Commission on Fiscal Imbalance;

THAT Mr. Yves Séguin, President, Groupe Marine inc., be appointed commissioner and chair of the Commission on Fiscal Imbalance;

THAT the following persons be appointed commissioners and members of the commission:

- Anne-Marie d'Amours, President, Capimont Technologies inc.;
- Renaud Lachance, associate, professor and director of the Bachelor of Business Administration program at the École des Hautes études commerciales (HEC);
- Andrée Lajoie, foundation professor, Centre de recherche en droit public (CRDP), Faculté de droit, Université de Montréal;
- Nicolas Marceau, associate professor, Département des sciences économiques, Université du Québec à Montréal (UQAM);
- Alain Noël, associate professor, Département de science politique, Université de Montréal;
- Stéphane Saintonge, tax lawyer, Legault, Joly, Thiffault;

THAT the mandate of the Commission be as follows:

- a) identify and analyse the basic causes of the fiscal imbalance between the federal government and Québec;
- b) solicit and receive opinions and suggestions from experts and stakeholders in Québec and elsewhere regarding:
  - the actual consequences of this imbalance;
  - the practical solutions to put forward to correct this imbalance;

THAT the Commission be authorized to constitute an advisory committee if need be to advise it in carrying out its mandate;

THAT the Commission be authorized to sit in various regions of Québec;

THAT the Commission submit a report of its conclusions and recommendations to the government no later than November 30, 2001;

THAT Mr. Mario Albert, General Director, Budgetary Revenue Analysis and Forecasting at the ministère des Finances, be appointed secretary to the Commission and, as such, be given responsibility for the general administration of the Commission;

THAT the chair and members of the Commission receive fees of \$1 100 and \$1 000 per day worked for a minimum of eight hours of work per day;

CONCERNING an amendment to order-in-council n° 533-2001 of May 9,  
2001

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WHEREAS, by order-in-council n° 533-2001 of May 9, 2001, the government constituted a commission of inquiry designated as the Commission on Fiscal Imbalance;

WHEREAS, under the seventh paragraph of the operative part of this order-in-council, the commission must submit a report of its conclusions and recommendations to the government no later than November 30, 2001;

WHEREAS the deadline for submitting the report must be extended and there is reason to extend the date by which the commission must submit its conclusions and recommendations to February 28, 2002;

IT IS ORDERED, consequently, on the recommendation of the Minister of Finance:

THAT order-in-council n° 533-2001 of May 9, 2001 be amended by replacing, in the seventh paragraph of the operative part, the date "November 30, 2001" with the date "February 28, 2002."

CONCERNING an amendment to order-in-council n° 533-2001 of May 9, 2001

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WHEREAS, by order-in-council n° 533-2001 of May 9, 2001, the government constituted a commission of inquiry designated as the Commission on Fiscal Imbalance;

WHEREAS, under the seventh paragraph of the operative part of this order-in-council, the commission must submit a report of its conclusions and recommendations to the government no later than November 30, 2001;

WHEREAS, by order-in-council n° 1363-2001 of November 14, 2001, the deadline for submitting this report was extended and deferred until February 28, 2002;

WHEREAS this deadline must again be extended and deferred until March 31, 2002;

IT IS ORDERED, consequently, on the recommendation of the Minister of Finance:

THAT order-in-council n° 533-2001 of May 9, 2001, amended by order-in-council n° 1363-2001 of November 14, 2001, be amended by replacing, in the seventh paragraph of the operative part, the date "February 28, 2002" with the date "March 31, 2002."

## **PRESENTATION OF THE MEMBERS OF THE COMMISSION**

### ***Yves Séguin, President***

Mr. Yves Séguin holds a degree in law and a master's degree in business law, with a concentration in taxation, from the University of Ottawa. He is also a member of the Barreau du Québec.

Mr. Séguin is currently president of Groupe Marine inc. Since 1999, he has held various positions with the Bank of Montreal, including that of vice president for business development with the firm Jones Heward Investment Management. He was also executive vice president and assistant to the president, Québec and vice president and chief operating officer with BMO Harris Private Bank. He also sits on a number of boards of directors.

From 1993 to 1998, he held the position of delegate for Canadian affairs with the Compagnie générale des eaux (Groupe Vivendi). From 1991 to 1993, he practised law with a number of law firms. He was elected to the National Assembly in 1985 in Montmorency riding, and was appointed Minister of Revenue in 1987 and Minister of Labour in 1988, positions he held until 1991.

### ***Anne-Marie D'Amours***

Ms. Anne-Marie d'Amours holds a master's degree in business administration (M.B.A.) from the École des Hautes Études Commerciales and a degree in law from the Université de Montréal. She is also a member of the Barreau du Québec.

Ms. d'Amours has been president of Capimont Technologies inc. since 1999. She worked for the Fonds de solidarité FTQ for nine years, holding successively the positions of legal counsel, director of legal affairs, vice president for legal affairs and assistant secretary. She has also worked for the firm Marchand, Jasmin et Melançon as an expert in business law. She is a member of the board of directors of Roctest.

### ***Renaud Lachance***

Mr. Renaud Lachance holds a master's degree in economics from the London School of Economics and a master's degree in taxation from the Université de Sherbrooke. He has also studied business administration at the École des Hautes Études Commerciales in Montréal.

Mr. Lachance is currently an associate professor at the HEC specializing in taxation economic policy programs at the graduate level, and in taxation at the undergraduate level. He has participated in many research activities in the field of taxation policy, in the course of which he has frequently lectured at symposiums and other public events. He has directed the HEC's bachelor's program in business administration since June 2000.

His relations with the economic and taxation communities have led him to take part in many committees examining these issues. Among others, he was a member of the Public Policy Committee of the Association des économistes québécois, an economics adviser to business people at the socio-economic summit conference, and a guest expert of the Commission on Taxation and the Financing of Public Services. Lastly, he was governor of the Canadian Tax Foundation and economic adviser to the president of the Ordre des comptables agréés du Québec.

### ***Andrée Lajoie***

Ms. Andrée Lajoie holds a master's degree in political science from Oxford University and a law degree from the Université de Montréal. She is also a member of the Barreau du Québec.

Ms. Lajoie is foundation professor at the Centre de recherche en droit public of the Faculté de droit of the Université de Montréal, which she directed from 1976 to 1980. Her career there is focused on research on constitutional law and - more particularly in the field of interest to the Commission on Fiscal Imbalance - on the federal government's "spending power," in particular in health and higher education.

More recently, her research has covered the theory of law, which she teaches in a doctoral seminar at her faculty. She has been a guest professor at many universities, both in Europe and Canada, and has published a number of articles and works with Canadian and European publishers, some of the most recent being: *Théories et émergence du droit: pluralisme, surdétermination et effectivité* (Thémis/Bruylant, 1998); *Jugements de valeurs* (PUF, 1997), and *Le statut juridique des peuples autochtones au Québec et le pluralisme* (Blais, 1996). She heads the collection *Le droit* published jointly with Liber/Blais.

### ***Nicolas Marceau***

Mr. Nicolas Marceau holds a doctorate in economics from Queen's University in Kingston, Ontario and a master's degree in economics from the Université de Montréal.

Mr. Marceau is currently associate professor with the Département des sciences économiques of the Université du Québec à Montréal, where he has taught since 1996. He was also assistant professor in the Département d'économie of Université Laval from 1992 to 1996.

Mr. Marceau is the author and co-author of a number of publications. He has lectured and participated in seminars at many institutions of higher learning, including: Concordia University, University of Toronto, University of Victoria, the École des Hautes Études Commerciales, Queen's University, Simon Fraser University, the Université de Montréal, the Université de Sherbrooke and the University of Ottawa. His research has led him elsewhere in Canada, to Belgium and France.

### ***Alain Noël***

Mr. Alain Noël holds a doctorate in international studies from the University of Denver and a bachelor's and a master's degree in political science from the Université de Montréal.

Mr. Noël is associate professor in the department of political science of the Université de Montréal and director of the Centre de recherche sur les transformations économiques et sociales (CRITÈRES), also at the Université de Montréal. He is also an associate researcher with the Institute for Research on Public Policy, and a member of the Advisory Council of the Institute of Intergovernmental Relations at Queen's University, Kingston, Ontario.

Mr. Noël has authored many studies on social policy and federalism, in Québec and in Canada, and from a comparative perspective. These works have been published in various journals, including the *American Political Science Review*, *International Organization*, the *Revue française des affaires sociales*, and the *Canadian Journal of Political Science*.

In recent years, Mr. Noël has been director of advanced studies at the department of political science of the Université de Montréal, assistant director of *Canadian Public Policy journal*, and guest professor in Canadian studies and social work at the University of California, Berkeley. He has also served as an expert for the Secrétariat aux affaires intergouvernementales canadiennes and for the ministère de l'Emploi et de la Solidarité sociale of the Québec government.

***Stéphane Saintonge***

Mr. Stéphane Saintonge holds a master's degree in taxation from the Université de Sherbrooke, a bachelor's degree in law from the Université de Montréal and is a graduate of the École du Barreau du Québec and the Institut québécois de planification financière. He is a member of the Barreau du Québec since 1985.

In 1993, Mr. Saintonge joined the firm of Legault-Joly-Tiffault as associate attorney. Since 1987, he has been a lecturer at the Association de planification fiscale et financière (APFF) and with the training program of the Barreau du Québec.

Mr. Saintonge is a member of the APFF and the Canadian Tax Foundation. He was a member of the board of directors of the Institut québécois de planification fiscale et financière from 1992 to 1996, a director of the Société générale de financement du Québec from 1996 to 2000 and a director of the Centre de recherche industriel du Québec from 1997 to 2000. He has lectured on many occasions, among others, for the APFF and the Canadian Institute.

## **CONTRIBUTORS TO THE WORK OF THE COMMISSION**

The realization in such a short time of a project of this scope required the collaboration of a competent, totally dedicated team.

In my capacity as Secretary of the Commission on Fiscal Imbalance, I would like to acknowledge the important contribution made by everyone who has supported the Commission's deliberations over the past 10 months.

### Analysis

**Laurent Martin**, Ph.D., coordinated the organization of the International Symposium on Fiscal Imbalance that the Commission planned to hold on September 13 and 14, 2001. He supervised the drafting of a preparatory report and the preparation of the speakers' presentations. He also contributed to various facets of the Commission's analysis, especially in respect of the equalization program.

**David Bard** and **David Boisclair** collaborated extensively on the preparation of the International Symposium on Fiscal Imbalance, in particular with regard to the drafting of the preparatory report. **David Boisclair** also helped to analyse the briefs submitted to the Commission and contributed to the examination of the structure of and pressure on the revenues and expenditures of the two orders of government.

**Daniel Prud'homme** skilfully coordinated the analysis of the division of taxation fields between the two orders of government in Québec. **Katy Tremblay**, who supervised the writing of the document, **Julie Gingras**, **Luc Biron**, **Claude Dallaire**, **Lévi Pagé** and **Gilbert Fontaine** assisted him in this task. **Daniel Prud'homme**, in collaboration with **Charles Duclos** and **Mireille Diambomba**, also supervised the Conference Board of Canada's deliberations on behalf of the Commission.

**Jocelyn Savoie** and **Suzie St-Cerny** collaborated on the analysis of the historic context of fiscal imbalance. **St-Cerny** also contributed to the analysis of the briefs submitted to the Commission. **Jocelyn Savoie** also participated in the analysis of federal transfer programs to the provinces. He played a leading role in the preparation of the final report and the supporting documents and the revision of the English versions of the documents.

**Luc Godbout** coordinated the analysis of the briefs submitted to the Commission. In addition, he contributed to the analysis of various consequences of fiscal imbalance and questions pertaining to “federal spending power.”

**Marcelin Joanis** collaborated on the analysis of the briefs submitted to the Commission. He also contributed to the analysis of pressure on the expenditures of both orders of government, “federal spending power” and the detailed review of approaches aimed at remedying fiscal imbalance.

**Valérie Caverivière** and **Katy Tremblay** collaborated on the analysis of the equalization program. In particular, they estimated the impact on equalization of the various scenarios examined.

**Karine Dumont** contributed to various facets of the Commission’s analyses, especially questions related to the CHST. She carried out the impact analyses of the scenarios that the Commission examined.

**François Vaillancourt**, Ph.D., a full professor in the Département de sciences économiques at the Université de Montréal, acted as a consultant to the Commission, which benefited from his extensive expertise in the realms of public finance and federal-provincial financial relations.

#### Public hearings and logistical and administrative support

**Lise Hamelin** very professionally assumed most of the Commission’s administrative tasks. In particular, she coordinated logistical support with respect to the Commission, the International Symposium and public hearings.

**France Légaré** oversaw with remarkable efficiency the production of various documents. She also provided constant support with regard to the Commission’s communications, the organization of the International Symposium and public hearings.

#### Communications

**Dominique Lebel** efficiently, competently assumed responsibility for the Commission’s communications. He was supported in this capacity by staff from the Direction des communications in the ministère des Finances, in particular, the Director, **Hélène Sarazin**. I also wish to acknowledge the important contribution made by **Paule Laquerre** and **Hélène Gilbert**.

#### Senior writer

**Jean-Pierre Pellegrin**, a veteran of several commissions established recently by the Québec government, served as the Commission’s senior writer. The Commission has benefited from his vast experience, incomparable ability to synthesize and considerable skill in formulating on paper the inevitable compromises that any commission engenders.

Work coordination and supervision

**Patrick Déry** served as Assistant Secretary to the Commission. Last June, he replaced **Daniel Bienvenue**, who took up a new position with the Conseil exécutif. **Patrick Déry** made a key contribution to the Commission's analysis and planning activities. His skill and dedication played a large part in the smooth operation of the Commission's work.

Support services

I would like to acknowledge the patience, efficiency, skill and availability of **Joanne Cadorette** and **Isabelle Richard**, who formatted various documents produced by the Commission, assisted by **Élyse Pelletier**, **Joan Flowers**, **Chantal Lagacé**, **Lyne Verret** and **Chantal Villeneuve**.

Administrative duties, Montréal office

The Commission completed part of its deliberations in its office in Montréal. It was able to rely on the efficiency of **Manon Bolduc**, who assumed responsibility for overall administrative duties in the office, assisted by **Monique Larivière**, to whom I would also like to express my thanks.

Mario Albert  
Secretary of the Commission on Fiscal Imbalance

Québec, February 28<sup>th</sup>, 2002



## **LIST OF EXPERTS CONSULTED BY THE COMMISSION**

For specific expertise on some of the issues considered, the Commission met with a series of outside experts. An alphabetical list of the experts the Commission consulted is given below. Other individuals who were consulted preferred to remain anonymous.

The experts the Commission met with added greatly to its deliberations, through their specialization and expertise, on the basic causes, actual consequences and practical solutions to apply to the fiscal imbalance.

### *Meetings at the Commission's offices*

- ◆ Bev Dahlby, professor at the Department of Economics, University of Alberta
- ◆ Richard Nadeau, professor at the Department of Political Science, University of Montréal
- ◆ Annette Ryan, senior analyst, Ministry of Finance of Prince Edward Island
- ◆ Michael Smart, professor at the Department of Economics, University of Toronto
- ◆ François Vaillancourt, professor at the Department of Economics, University of Montréal
- ◆ Bruce A. Wallin, professor at the Department of Political Science, Northeastern University, Boston

### *Meetings in Québec City following the cancellation of the Symposium*

- ◆ David J. Collins, professor of economics, Macquarie University, Sydney
- ◆ Bernard Dafflon, professor of public finance, University of Freiburg
- ◆ William F. Fox, professor at the Department of Economics, University of Tennessee
- ◆ Magali Verdonck, researcher at Catholic University of Louvain
- ◆ Sonja Wälti, guest researcher and assistant professor, Georgetown University, Washington

***Meetings outside Québec***

- ◆ Otto Beierl, Assistant Deputy Minister, Intergovernmental Financial Policy, Ministry of Finance of the Free State of Bavaria
- ◆ David Cameron, professor of political science, University of Toronto
- ◆ Stephen Clarkson, professor of political science, University of Toronto
- ◆ Philip Dewan, principal secretary, office of the Liberal Party of Ontario
- ◆ Howard Hampton, Leader of the New Democratic Party (NDP) of Ontario
- ◆ Kenneth McRoberts, professor of political science, Glendon College of University of York.
- ◆ Michael Hinterdobler, Ministry of Finance, Free State of Bavaria
- ◆ Richard Simeon, professor of political science, University of Toronto
- ◆ Reinhold Sterzer, Ministry of Finance, Free State of Bavaria
- ◆ Thomas Wilson, professor of economics, University of Toronto

## LIST OF BRIEFS AND SCHEDULE OF PUBLIC HEARINGS

The public consultation began with a call for briefs. Following the invitation issued last June, the Commission received 45 briefs from the same number of groups, organizations and individuals.

Subsequently, six days of public hearings were held in Montréal and Québec City, between November 21 and December 4, 2001. The Commission heard from 42 speakers.

Because of the depth and relevance of the public consultation, the briefs and testimony added greatly to the Commission's deliberations on the basic causes, actual consequences and practical solutions to apply.

Below is the alphabetical list of groups, organizations and individuals that submitted a brief to the Commission as part of the public consultation and the dates when the briefs were presented at the hearings. The briefs submitted in the course of the public hearings are all available on the Commission's website.<sup>112</sup>

<i>Groups, organizations and individuals</i>	<i>Public hearings</i>
Action démocratique du Québec	Québec City November 27, 2001
Canadian Alliance	Montréal December 4, 2001
Association des CLD du Saguenay-Lac-Saint-Jean	Québec City November 27, 2001
Association des CLSC et des CHSLD du Québec	Montréal November 22, 2001
Association des économistes québécois	Montréal November 21, 2001
Association des hôpitaux du Québec	Montréal November 22, 2001
Binette, André	Not submitted
Bloc Québécois	Québec City November 27, 2001
Centrale des syndicats du Québec	Québec City November 27, 2001
Chaire d'étude socio-économique de l'UQAM	Montréal December 3, 2001
Chambre de commerce du Québec	Montréal December 3, 2001
Collectif pour une loi sur l'élimination de la pauvreté	Québec City November 28, 2001

<sup>112</sup> [www.desequilibrefiscal.gouv.qc.ca](http://www.desequilibrefiscal.gouv.qc.ca)

<b>Groups, organizations and individuals</b>	<b>Public hearings</b>	
Commission scolaire de Montréal	Montréal	December 4, 2001
Confederation of National Trade Unions	Montréal	December 3, 2001
Conférence des recteurs et des principaux des universités du Québec	Montréal	November 22, 2001
Conseil central des syndicats nationaux du Saguenay–Lac-Saint-Jean	Québec City	November 27, 2001
Conseil du patronat du Québec	Montréal	November 21, 2001
Consensus Enr.	Montréal	November 22, 2001
Debel, Marcel	Montréal	December 3, 2001
Ducharme, Daniel	Montréal	November 21, 2001
Canadian Federation of Independent Business	Montréal	December 3, 2001
Fédération de l'âge d'or du Québec	Montréal	November 21, 2001
Fédération des commissions scolaires du Québec	Québec City	November 28, 2001
Fédération des infirmières et infirmiers du Québec	Montréal	December 3, 2001
Fédération des médecins spécialistes du Québec	Montréal	December 4, 2001
Fédération des travailleurs et travailleuses du Québec	Montréal	December 4, 2001
Fédération étudiante collégiale du Québec	Montréal	December 4, 2001
Fédération étudiante universitaire du Québec	Montréal	November 21, 2001
Force Jeunesse	Montréal	December 4, 2001
Fédération québécoise des professeures et professeurs d'université	Montréal	November 21, 2001
Girard-Bujold, Jocelyne	Not submitted	
Maltais, Nickol	Québec City	November 28, 2001
Manufacturiers et Exportateurs du Québec	Montréal	November 22, 2001
Moussally, Sergieh F. and Fortin, Michel	Québec City	November 27, 2001
Mouvement national des Québécoises et Québécois	Montréal	December 4, 2001
Ordre des CGA du Québec	Montréal	December 3, 2001
Québec Liberal Party	Montréal	November 21, 2001
Parti Québécois	Québec City	November 28, 2001
Pelletier, Réjean	Québec City	November 27, 2001
Pepin, Jean-Guy	Québec City	November 28, 2001
Syndicat de la fonction publique du Québec	Québec City	November 28, 2001
Table des aînées et aînés de Lanaudière	Montréal	November 22, 2001
Union des municipalités du Québec	Montréal	November 22, 2001
Union des producteurs agricoles	Québec City	November 28, 2001
Ville de Laval	Not submitted	

## SURVEY FINDINGS AND METHODOLOGY

### Findings

The Commission asked Professor Richard Nadeau of the department of political science at the Université de Montréal to survey Quebecers' and Canadians' perceptions of the issues raised by debate on fiscal imbalance. The data analysed are drawn from questionnaires used in surveys conducted by Léger Marketing in January 2002.

The findings for respondents outside Québec are drawn from a Canada-wide survey conducted between January 8 and 13 among a representative sampling of adult Canadians. Some 1519 interviews were completed. Table 1 below indicates the regional breakdown of the interviews. The findings in respect of Québec respondents are drawn from the Québec sub-sample of the Canada-wide survey (370 respondents) and two surveys conducted among adult Quebecers in January 2002.

**TABLE A1**
**INFORMATION ON THE SURVEY AND SAMPLES**

	Canada-wide survey	Québec surveys	
		First survey	Second survey
<b>Territory</b>	January 8-13, 2002	January 8-14, 2002	January 31 <sup>st</sup> to February 4 <sup>th</sup> , 2002
<b>Sample size</b>	1 519	1 003	1006
<b>Margin of error</b>	2.6%	3.20%	3.20%
<b>Number of interviews</b>			
• Québec	370		
• ROC	1 149		
• Maritimes	120		
• Ontario	574		
• Manitoba and Saskatchewan	110		
• Alberta	145		
• British Columbia	200		

## QUESTION 1

### SUPPORT FOR INCREASED SPENDING IN CERTAIN FIELDS (as a percentage)

**Question:** « In your opinion, should governments spend more, less or about the same as now on the following sectors?»

	Canada	Québec	Rest of Canada
Health	82	87	81
Education	79	81	77
Defence and security	54	26	60
Social programs	52	61	48
International aid	25	25	24

Sources and sample sizes: Canada-wide survey (January 8-13 2002) in respect of data for Canada as a whole and the rest of Canada; Canada-wide surveys and Québec survey (January 10-14 2002) for Québec. Sample sizes: Canada (1 519), Québec (1 373) and rest of Canada (1 149).

## QUESTION 2

### PREFERENCES CONCERNING THE USE OF SURPLUSES (as a percentage)

**Question:** « In your opinion, how should government surpluses be used? Should the main priority be lowering taxes, reducing the debt or improving social programs?»

	Canada	Québec	Rest of Canada
Lowering taxes	27	34	25
Reducing the debt	36	24	39
Improving social programs	29	37	26

Sources and sample sizes: see Question 1.

**QUESTION 3****PREFERENCES CONCERNING THE DIVISION OF POWERS**  
(as a percentage)

**Question:** « In your opinion, which government should have the primary responsibility in the following areas?»

	Canada	Québec	Rest of Canada
<b>Education</b>			
Provincial government	63	76	58
Federal government	24	14	28
Both governments	10	9	11
<b>Social programs</b>			
Provincial government	56	63	54
Federal government	27	22	29
Both governments	13	12	13
<b>Health</b>			
Provincial government	45	62	40
Federal government	38	23	43
Both governments	14	13	13
<b>Economic development</b>			
Provincial government	42	45	42
Federal government	38	35	38
Both governments	15	17	14
<b>International relations</b>			
Provincial government	8	15	6
Federal government	85	74	86
Both governments	4	9	3
<b>Defence</b>			
Provincial government	6	10	5
Federal government	88	82	89
Both governments	3	6	2

Sources and sample sizes: See Question 1.

**QUESTION 3B**

**QUEBECERS PREFERENCES CONCERNING THE DIVISION OF POWERS**  
(as a percentage)

**Question:** « In your opinion, which government should have the primary responsibility in the following areas? »

	<b>All</b>	<b>French-speakers</b>
<b>Education</b>		
Provincial government	76	79
Federal government	11	9
Both governments	10	9
<b>Family policies</b>		
Provincial government	67	70
Federal government	17	15
Both governments	10	10
<b>Social programs</b>		
Provincial government	64	66
Federal government	18	16
Both governments	15	15
<b>Culture and communications</b>		
Provincial government	60	61
Federal government	23	22
Both governments	14	14
<b>Health</b>		
Provincial government	59	64
Federal government	23	18
Both governments	16	16
<b>Economic development</b>		
Provincial government	50	52
Federal government	25	23
Both governments	23	23
<b>Employment insurance</b>		
Provincial government	46	50
Federal government	41	38
Both governments	10	9

Source: Québec survey (January 31<sup>st</sup> to February 4<sup>th</sup>). Sample size: 1 006.

**QUESTION 3B**

**QUEBECERS' PREFERENCES CONCERNING THE DIVISION  
OF POWERS (CONTINUED)**  
(as a percentage)

**Question:** « In your opinion, which government should have the primary responsibility in the following areas?»

	<b>All</b>	<b>French-speakers</b>
<b>Old age pensions</b>		
Provincial government	36	39
Federal government	47	45
Both governments	13	12
<b>International relations</b>		
Provincial government	16	18
Federal government	69	67
Both governments	12	13
<b>Defence</b>		
Provincial government	14	16
Federal government	77	76
Both governments	6	6

Source: Québec survey (January 31<sup>st</sup> to February 4<sup>th</sup> 2002). Sample size: 1 006.

**QUESTION 4**

**PERCEPTION OF THE EXISTENCE OF FISCAL IMBALANCE IN CANADA**  
(as a percentage)

**Question:** « Do you think, yes or no, that the finances of the Canadian Government are currently out of kilter, that is to say, do you think that the Federal Government has too much revenue for the responsibilities it has while the provincial governments lack revenues to fulfil their responsibilities ? »

<b>Answer</b>	<b>Canada</b>	<b>Québec</b>	<b>Rest of Canada</b>
Yes	66	71	64
No	21	21	20
Don't know	13	8	15

Sources and sample size: see Question 1.

## QUESTION 5

### SUPPORT FOR A LARGER SHARE OF TAX REVENUES FOR THE PROVINCES (as a percentage)

**Question:** « Overall, do you think, yes or no, that revenue from taxes would be better distributed in Canada if the share of the revenue going directly to provinces were increased? »

Answer	Canada	Québec	Rest of Canada
Yes	73	74	72
No	18	18	17
Don't know	9	8	10

Sources and sample sizes: see Question 1.

## QUESTION 6

### SUPPORT FOR A LARGER SHARE OF REVENUES FOR THE PROVINCES TO INCREASE THEIR SPENDING ON HEALTH, EDUCATION AND FAMILY POLICY (as a percentage)

**Question:** « Would you totally agree, somewhat agree, somewhat disagree or totally disagree with the idea of transferring part of the taxes paid by citizens of your province to the Federal Government back to the Government of your province in order to increase spending in the following areas? »

	Canada	Québec	Rest of Canada
<b>Health</b>			
Totally agree	46	59	42
Somewhat agree	31	29	31
Somewhat disagree	9	5	9
Totally disagree	10	6	11
<b>Education</b>			
Totally agree	46	54	43
Somewhat agree	30	33	30
Somewhat disagree	9	5	10
Totally disagree	10	6	11
<b>Family support</b>			
Totally agree	36	51	32
Somewhat agree	34	34	34
Somewhat disagree	12	6	13
Totally disagree	11	6	13

Sources and sample sizes: see Question 1.

**QUESTION 7**

**PERCEPTION OF THE SHARE OF TAX REVENUES ATTRIBUTED  
TO THE FEDERAL GOVERNMENT**  
(average share as a percentage)

**Question:** « A part of the taxes paid by the citizens of your province goes to the Government of your province and the other part goes to the Federal Government. In your opinion, what is the proportion of taxes paid by citizens of your province that goes to the Federal Government? »

Answer	Canada	Québec	Rest of Canada
Federal share	46	42	48
Don't know	35	29	38

Sources and sample sizes: see Question 1.

**QUESTION 8**

**DESIRED BREAKDOWN OF TAX REVENUES BETWEEN THE PROVINCIAL  
AND FEDERAL GOVERNMENTS**  
(average share as a percentage)

**Question:** « How would you like your taxes to be distributed between the Government of your province and the Federal Government? Please use a percentage for each for a total of 100%. »

Answer	Canada	Québec	Rest of Canada
Federal share	42	38	42
Provincial share	57	62	56
Don't know	8	7	8

Sources and sample sizes: see Question 1.

## **Methodology**

### *Methodology of the Québec-wide OMNIBUS*

This survey, conducted by Léger Marketing, was realised by means of telephone interviews among a random sampling of 2009 Quebecers 18 years of age and over who spoke French or English.

The survey was carried out in two phases, the first one involving 1003 respondents and the second one, 1006 respondents. The interviews were conducted between January 10<sup>th</sup> and 14<sup>th</sup> in the first instance, and between January 31<sup>st</sup> and February 4<sup>th</sup>, 2002, in the second instance, from our call centre in Montréal. We made up to 10 calls when no response was obtained. The response rates were 60.9% and 63.8%, respectively.

In light of 1996 Census figures, the findings were weighted by region and language spoken in the home in order to make the sample representative of the overall adult population of Québec.

The maximum margin of error for each survey is 3.2%, meaning 19 times out of 20.

### *Methodology of the Canada-wide OMNIBUS*

This survey, conducted by Léger Marketing, was realised by means of telephone interviews among a random sampling of 1519 Canadians 18 years of age and over who spoke French or English.

The interviews were conducted between January 8 and 13, 2002 from our call centre in Montréal. We made up to 10 calls when no response was obtained.

In light of Statistics Canada data, the findings were weighted by region, sex and language spoken in the home in order to make the sample representative of the overall adult population of Canada.

The maximum margin of error for the 1519 respondents surveyed is more or less 2.6%, meaning 19 times out of 20.

## **CALCULATION OF THE CHST**

The federal and Québec governments do not account in the same manner for transfers effected under the Canada Health and Social Transfer.

- ♦ The federal government determines the overall amount of the CHST and adds to it the transfers of tax points handed over in 1976-1977, to ascertain the “total entitlement” and apportion the funds among the provinces and territories according to their share of population. The federal government then deducts from the amount allocated to the Québec government a portion of the value of the “Québec special abatement.”<sup>113</sup> Consequently, the federal government deems the special abatement to simply be a way of paying a portion of a transfer, the overall amount of which is determined according to the program’s rules (the amount is explicitly integrated into expenditures).
- ♦ The Québec government only accounts for as being chargeable to the CHST the funds actually received from the federal government, once the special abatement has been deducted. The revenues that Québec obtains through the occupation of taxation fields following the implementation of the special abatement are included in own-sources revenues and are thus part of the revenues collected in the form of personal income tax.

### **The transfers in question**

Under the CHST, the federal government distributed \$17.3 billion among the provinces in 2001-2002, of which Québec received \$4.4 billion (including the Québec special abatement).

During the same fiscal year, Québec considers that it received \$2.9 billion under the CHST, the amount of the cheque actually sent by the federal government, including the amounts pertaining to the trusts set up by the federal government (discussed in detail in Chapter 3).

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<sup>113</sup> Québec alone took advantage of the transfer of taxation field proposed to the provinces in 1964. The special Québec abatement is now equivalent to 16.5% of basic federal tax: 13.5% is subtracted from Québec’s share of cash transfers and Québec repays the federal government 3% in the wake of the abolition in 1974 of the youth allowance program (see *Fiscal Imbalance in Canada – Historical Background*, *op. cit.*, note 6, pp. 39 and 40).

## Method of calculating the CHST

Payments made to a province under the CHST are calculated in two stages.

### First stage: total entitlement

- The total entitlement is established for Canada as a whole and corresponds to financial transfers, defined according to the program's rules, to which the federal government adds what it estimates to be the value of the tax points transferred in 1976-1977 to the provinces. The total entitlement is then divided among the provinces proportionally to their share of the population of Canada.

### Second stage: cash transfers

- To establish the amount of cash transfers granted to each province, it is necessary to subtract from the total entitlement the value estimated by the federal government of the tax points attributed to the province. In the case of Québec, it is also necessary to subtract the value of the Québec special abatement.

## TABLE A2

### A SAMPLE CALCULATION OF THE CHST CASH TRANSFER TO QUÉBEC, 2001-2002 (millions of dollars – accrual basis)

Canada		
1.	Financial transfers in Canada (Part V of the <i>Federal-Provincial Fiscal Arrangements Act</i> )	17 300
2.	Value of tax points in Canada	16 265
3.	<b>Canada's total entitlement (1 + 2)</b>	<b>33 565</b>
Québec		
4.	Québec's demographic weight	23.9 %
5.	Québec's total entitlement (3 X 4)	8 007
6.	Less: value of the tax points according to the federal government	
	♦ 14.9% of BFT	- 3 331
	♦ 1% of CTI	- 314
7.	CHST payable to Québec	4 362
8.	Less: special Québec abatement (13.5% of BFT)	- 2 467
9.	<b>CHST cash payment to Québec</b>	<b>1 895</b>

Notes: Cash transfer excluding the amounts in federal trusts. Value of the tax points including attendant equalization. BFT: basic federal tax (individuals). CTI: corporate taxable income.

Source: Department of Finance Canada.

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