

*Autonomous Actors and Cooperative Federalism:  
There is no vertical fiscal imbalance in the Canadian federation*

A Presentation to the Subcommittee on Fiscal Imbalance  
of the  
Standing Committee on Finance  
of the  
House of Commons

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*Summary.*

There is no problem of vertical fiscal imbalance; the question is wrongly-posed.

The equalization program is not achieving exactly what Section 36 of the Constitution says it should, but it has been increased in scale and some further renewal and adjustment is underway. Challenging problems of horizontal imbalance—unequal fiscal capacity across provinces—are being addressed through growth in this fundamental feature of our system of fiscal federalism.

There is an ongoing shift in the balance of expenditures as between provincial and federal governments, and provinces certainly face major pressures in their health, education and social services programs. But there is no case for these expenditures in any one province to be financed to a greater extent than they are now by taxpayers resident in other provinces. Provincial governments that have cut taxes can also raise them.

Decentralization within the federation has been substantial, and there seems no point in pressing for further general reduction in the relative scope of the federal government; the argument for further transfers of tax points is a non-starter.

The long-term solution to the current transitory imbalances is greater inter-jurisdictional cooperation to achieve more effective subsidiarity, greater harmonization to achieve policy coherence in cross-scale responsibilities, more responsive adaptation to changing circumstances and emerging challenges, and greater awareness among citizens of the degree of joint effort and mutual accommodation already built into our system. We should recognize and respect a fundamentally strong and successful federation when we see it.

### *Introduction*

Let me describe my background a bit, so you will understand better why I have no simple solutions to offer in response to the question posed to me in your letter of invitation.

I completed Bachelor's and Master's degrees at UBC in mathematics and economics, and then went off to MIT for a

PhD in economics. I returned to Canada after a spell teaching at Harvard, and was Professor of Political Economy at the University of Toronto when I was invited to go to Ottawa to teach senior public servants how to make good decisions. That was my first exposure to the idea that the classroom had some real limitations so far as lessons for life are concerned. I served as Deputy Secretary to the Treasury Board in Ottawa for a few years, then had an opportunity to work with an international team at OECD, and by then felt that I had lost the faith to such an extent that I couldn't really go back to teaching graduate economic theory. I came here to Victoria as Director of the School of Public Administration for six years, then had the opportunity to serve a seven-year term as President of the Institute for Research on Public Policy, after which I returned here as Winspear Professor of Public Policy, and now Emeritus Professor.

Perhaps the most significant experience during all that time was the opportunity to serve as Director of Research for two Parliamentary Task Forces—the 1983 Frith Task Force on Pensions, and the 1981 Breau Task Force on Fiscal Federalism.

Following the latter I was also invited to write the section on Intergovernmental Finance for The Canadian Encyclopedia.

In light of all this experience I was given a little plaque by my daughters, which reads “Am I confused? Yes, but I believe I am now confused on a higher plane and about more important things.”

The point is that when it comes to simple and sweeping solutions promoted with great confidence, I have learned to be much less certain than most of the people you will probably hear.

*particularly those based on long-term projections using complicated models;*

### *Your question*

With respect, I have to argue that your mandate is badly skewed and mis-specified. ~~You~~<sup>It</sup> pose the question, “What long-term solutions can be found to the fiscal imbalance between the two levels of government?”. The premise implicit in that question—that there *is* some problem of structural fiscal imbalance—is invalid. This formulation of your mandate violates the first rule of policy analysis, which is to get the question right—to be sure that the question is well posed and is

not framed in a way that in itself rules out relevant options and important lines of analysis.

If we start from the question whether there exists a vertical fiscal imbalance in Canada at this time, I would have to say definitely not. A vertical fiscal imbalance must be a structural feature, not simply a transitory outcome of discretionary decisions made with respect to tax and spending choices.

I will come back to that argument later, but I'd also like to mention two other respects in which it seems to me the mandate established for your sub-committee is perhaps a bit unfortunately phrased. It is important to remember, as the Breaux Report said, the federal structure of Canada involves two orders of government, each autonomous and independent, ~~neither subordinate to the other.~~ "The distinguishing feature of a federal system of government is that it provides for a division of governmental powers between two orders of government, the existence of which is guaranteed by a written constitution specifying the powers of each. It is in this sense that each order of government may be said to be autonomous. In a federal system, each order of government has a life of its own: neither is subordinate to the other." [Breaux, P. 29]

Revenue is not “shared” between the provinces and the federal government, though powers of taxation might be reallocated. It is misleading to talk as if decisions were taken to “share” revenues as between two levels, a senior and a junior, of government.

Questions of fiscal balance thus relate to the consequences of discretionary decisions independently taken by autonomous governments independently accountable to their own electorates.

### *Context*

Concerns and controversies over fiscal imbalances, both vertical and horizontal, have waxed and waned over many decades. It was a real issue in the Great Depression of the 1930s, and led to the fundamental reforms proposed by the Rowell-Sirois Commission. A number of measures to address the inadequacy of provincial resources, and inequalities in fiscal capacity, were undertaken subsequently. By the time of the Parliamentary Task Force on Fiscal Federalism in 1981, the concern was quite the opposite: a dramatic fiscal imbalance was alleged, in which the federal government was running deep

structural deficits while the provinces were enjoying substantial fiscal transfers. Now we are back again to long-term projections of federal surpluses accompanied by provincial deficits.

So we must recognize that the balance has shifted substantially with shifting times. Only twenty-five years ago, the conclusion that there is no fiscal imbalance was directed against the claims and entreaties of the federal government. The Breau Task Force refused to recognize a mandate that would have required it to accept the constraints of a federal budget that proclaimed a need to reduce transfers to provincial governments in order to deal with the prospect of future federal deficits.

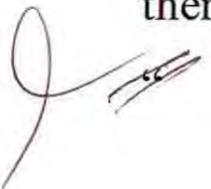
*“The Task Force concludes that there does not exist a long-term, structural mismatch between the revenue capacities and expenditure responsibilities of the federal government. It cannot be claimed that the capacity of the federal government to raise revenues has reached a structural (as opposed to a political or discretionary) ceiling. [Breau p. 33]*

*It seems to me you three might well come to the symmetrical conclusion. What is vertical fiscal imbalance?*

Vertical fiscal imbalance must arise from structural issues, not current events.

“The fact that the federal share of total government revenues has been declining over time, and that the federal government has been registering substantial deficits in recent years, has prompted some to argue that there is a ‘fiscal imbalance’ between the two orders of government.”

“On closer examination, however, it appears that the concept of fiscal imbalance is not so simple. ... The mere fact that one order of government is experiencing a succession of deficits does not imply that there is a fiscal imbalance... Only if the fiscal posture of a government has deteriorated for reasons beyond its control is a fiscal imbalance said to exist. That is, there must be some structural cause to explain the situation.”



“Thus the Task Force considers that the concept of fiscal imbalance requires a careful distinction between a structural problem in the design of the arrangements of Confederation, and a problem of budgetary imbalance reflecting political judgments on revenue and expenditure priorities.”

~~“The Task Force concludes that there does not exist a long-term, structural mismatch between the revenue capacities and expenditure responsibilities of the federal government. It cannot be claimed that the capacity of the federal government to raise revenues has reached a structural (as opposed to a political or discretionary) ceiling. [Breau p. 33]~~

The basic arguments against the claim for vertical fiscal imbalance seem very simple: every province has access to all the significant tax bases, and exclusive access to a couple of rapidly growing sources—natural resource rents and gaming revenues. The choice whether or not to exercise authority to levy those taxes is in the hands of each provincial government, and the decision to reduce tax rates must be seen to have consequences for the levels of expenditure that can be supported. Every province has the right to be different, and every province can choose the combination of expenditures and taxation that it considers its electorate will support.

You have no doubt been here long enough—it doesn't take long—to hear the speeches about the BC budget situation.

Minister after minister is commenting that the BC government now has the resources to spend on things they were unable to do the last four years. You know much better than I do that governments will spend what they consider themselves able to spend, in response to the perceived desires or demands of their electorate. And in this case the move from a deficit caused by tax cuts to a surplus available to spend is almost entirely accounted for by the increase in federal transfers.

With adequate resources, the federal government will no doubt also respond to the demands of its electorate—voiced by many Members of Parliament, not all on the government side—for an increase in expenditures on military security, human security, environmental security, as it has recently done in response to demands for more on health and education.

The point is that the concerns about the balance of expenditures do not rest on the structure of the federation, <sup>or its present allocation of tax powers</sup> they rest on differences of opinion about priorities in spending—differences as between public spending and private, as between provincial spending and federal, as between programs within either order of government. These are legitimate public debates, but they have nothing to do with fiscal imbalance.

The basic principles of fiscal federalism include the principle that each government should be accountable to its own electorate, that it should justify expenditures on particular programs through its ability to raise the necessary revenues from its own electors.

Of course, the resources available to a province are not confined to own-source revenues; there are substantial transfers from the federal government through equalization payments. But the equalization program, though it puts substantial and growing resources in the hands of provincial governments without any conditions on the uses to which the resources can be put, is intended to address the challenge of horizontal fiscal imbalance—differences in fiscal capacity across provinces. And direct transfer payments by the federal government can be seen as distorting or restricting the discretion of provincial governments, either by offering 50 cent dollars<sup>?</sup> through cost-sharing programs or by insisting on specific conditions on the purposes to which grant funds can be put. Any such transfers demand that the federal Parliamentary be accountable for them, so a requirement for scrutiny, monitoring and reporting is

inevitable. So increases in direct grants as a long-term solution to provincial revenue needs are not desirable.

[It is interesting that this concern was already clearly addressed by the Rowell-Sirois Commission in very practical terms, <sup>in the</sup> ~~excerpt~~ <sup>excerpt quoted on pp 21-25 of the</sup> ~~Bureau Report.~~

The problem of downloading of expenditure responsibilities, or unfunded mandates, or transfer of function without revenue, is of course a serious problem that needs to be addressed, where it exists. But it is not really a question of vertical fiscal imbalance. And in some ways the problem is much more severe at the provincial-municipal level than as a matter of federal-provincial intergovernmental transfers.

In respect of that issue, a recent CTF study says  
“...Over the past decade...Most provincial governments have decentralized major expenditure responsibilities to their municipalities without providing them with additional funding tools. Indeed, they have reduced their grants to municipalities and forced them to rely increasingly on own-source revenues”  
(P41, Kitchen, CTF #107, 2002)

*Accountability in the face of fiscal transfers*

“Overall, [the Task Force Report leaves] an impression of a system of fiscal relations that is fundamentally sound, but in need of some adaptation to new circumstances...” [Breau, 1981, p. xi]

“One can understand our federal system only as the outcome of earlier struggles to reconcile these desires for a community that is national in scope with concerns for regional autonomy in the delivery of programs serving different cultural groups and meeting diverse needs.”

“The traditional posture on the question of accountability, one set out forcefully by the Rowell-Sirois Commission and repeated in the principles set out in 1966 by the Minister of Finance of the day is that each order of government should be directly responsible for raising the resources necessary to finance its own expenditures...But we have already observed that this principle obviously conflicts with other principles. Principles of equalization and equity or universal access to national programs all call for federal support of expenditures

falling within provincial jurisdiction in order to realize national goals..."...]

u For this reason, the principle of direct fiscal responsibility for program expenditures must be supplemented by some form of indirect accountability for intergovernmental transfers. This is a generic problem where federal parliamentarians are asked to authorize the transfer of federal revenues to provincial governments for use in financing expenditures in programs deemed to be of national interest or concern. As federal parliamentarians we see no escape from an obligation to ensure that national objectives are achieved through these programs funded in part by federal taxpayers. That is, we see no escape from a responsibility to monitor conditions with respect to programs in which a significant national interest is at stake, and to report to the public, through Parliament, on the satisfaction of those conditions." [Breau, p. 5]

<Already the Rowell-Sirois Commission articulated some of the problems with carrying this argument too far.>