

Fiscal Federalism: An Unlikely Bridge between the West and Quebec

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Abstract

Is there common ground in intergovernmental fiscal relations? This question is tackled by examining the ongoing federal-provincial debate about the most appropriate way to allocate resources among governments and the related issue of vertical and horizontal fiscal imbalance. It turns out that the provinces have found common ground with respect to vertical imbalance and the need to limit Ottawa's spending power. The Equalization program, however, illuminates significant differences not only between Quebec and the western provinces but also among the four western provinces themselves. Fiscal federalism raises too many divisive issues for anyone to hope that these differences can all be settled in the foreseeable future.

Introduction

Fiscal issues are much of the stuff of Canadian intergovernmental relations. In a workshop dedicated to exploring the scope for a renewed partnership between Quebec and the West, it was therefore essential to consider the fiscal dimensions to that question. This article does just that. It examines whether and under what conditions the Government of Quebec and the governments of the four western provinces might be able to find *common ground* in intergovernmental fiscal relations. This question is tackled principally by examining the ongoing federal-provincial debate about the most appropriate way of allocating revenues among governments and the related issues of vertical and horizontal fiscal imbalance. This approach is supplemented by touching briefly on the related issue of the federal spending power.

This article is organized as follows. Section I discusses the concepts of horizontal fiscal imbalance and vertical fiscal imbalance. Section II provides examples of circumstances in which provinces have found common ground in recent years, including Quebec and the west. The main example is the case where all provinces successfully came together to demand more money from the federal government. A second deals with situations where provinces were able to unite in demanding limits on the use of the federal spending power. Section III provides examples of

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where common ground has not been found. These relate mainly to differences associated with the federal government's Equalization Program. Section IV is forward-looking. It argues that fiscal federalism is not likely to be a strong basis for partnership between the western provinces and Quebec for the foreseeable future. This is because the biggest issues that are likely to be on the fiscal federalism agenda for the next few years are inherently divisive. Section V provides a brief conclusion.

The Politics of Defining Horizontal and Vertical Imbalance

Questions of revenue allocation among governments are conventionally understood to have both vertical and horizontal dimensions. The horizontal dimension is discussed first.

The idea of horizontal fiscal imbalance relates to differences in fiscal capacity and fiscal need among constituent units in a polity, provinces and territories in the Canadian case. The greater the disparities in fiscal capacity and fiscal need among constituent units the larger the horizontal fiscal imbalance and vice-versa.

In Canada, the idea of horizontal fiscal imbalance is relatively uncontroversial as a concept and since 1957 the Government of Canada has operated an Equalization Program with the aim of reducing these imbalances. The legislative details of the program are included in the *Federal-Provincial Fiscal Arrangements Act*. They authorize the federal government to make cash transfers to provinces with below average fiscal capacity to help Ottawa meet its constitutional obligation of ensuring that all provinces "have sufficient revenues to provide reasonably comparable levels of services at reasonably comparable levels of taxation rates" (*Constitution Act, 1982*, Section 36.2). Differences in fiscal need (that is, disparities in the cost of providing reasonably comparable services) are ignored in the program and the 2006 report of the federal Expert Panel on Equalization and Territorial Formula Financing recommended that these differences should remain outside the program. The panel adduced several reasons for its conclusion including: complexity in measuring differences in need, intrusiveness into provincial jurisdiction, and the absence of evidence that introducing need would affect allocations in a material way (Expert Panel, 86-88). The federal government has accepted this view. In essence, then, at any point in time, the federal government's Equalization scheme provides a Canadian definition of and a means for reducing horizontal fiscal imbalances.¹

Since its inception in 1957, except for one brief period, Equalization has operated as a principles-based formula-driven program. The program has commanded significant public support which the 2006 report of the federal Expert Panel linked to its "basic commitment to fairness and equity" (Expert Panel, 18). The Council of the Federation's Advisory Panel on Fiscal Imbalance similarly wrote, "Canada's Equalization program reflects the Canadian values of sharing and mutual support" (Advisory Panel on Fiscal Imbalance, 77).

Although the idea of equalization has enjoyed widespread support, the formula for translating that support into a politically viable legislative scheme has nonetheless been subject to continuous debate. To accommodate and facilitate that debate, the 1957 federal legislation that created the Equalization Program also provided that the program would be reviewed every five years. The result has been an ongoing dialogue among federal and provincial governments regarding the legislative details of Equalization. And since these details determine which provinces receive federal funds and the amounts that they receive, the debate has invariably

been contested with federal and provincial ministers and officials arguing for and against alternative ways of measuring fiscal capacity and the fiscal standard to which less affluent provinces should be raised (to the level of the province with the highest capacity, to a 10-province average, to an average that excludes the hydrocarbon capacity of Alberta and so forth). In such debates, individual provinces typically and understandably have taken positions that reflect their economic and financial interests as well as historical and political claims (Advisory Panel on Fiscal Imbalance, 32). Sometimes groups of provinces share a common view, for example, when Equalization-receiving provinces urge Ottawa to adjust program parameters in a way that will increase the total amount of money in the program and non-recipient provinces take the opposite position. From a federal Department of Finance viewpoint, these issues are also of importance if only because they determine the quantum of money to be spent on Equalization. In any case, over the years federal and provincial officials have debated myriad technical issues that have served as stalking horses for the amount and allocation of large sums of money.

The concept of vertical fiscal imbalance is less widely accepted. Yet it has long been “normal” for provinces to spend more money than they have raised through their own tax efforts and to press the federal government to transfer cash to them to make up the difference (Ruggeri, 83-126). A crucial part of the 1867 constitutional settlement was the Government of Canada’s commitment under section 118 of the original Constitution to pay grants and subsidies to provincial governments (Canada, *Constitution Act, 1867*). Following protracted negotiations between the provinces and the Dominion government, the Constitution was amended in 1907 to increase these amounts (Canada, *Constitution Act, 1907*). During the Second World War, the provinces agreed to “rent” the revenues from three of their principal tax bases, including personal and corporate income tax, to the federal government. These bilateral federal-provincial agreements were intended to terminate one year after the end of hostilities. But the federal government had ambitious plans for post-war reconstruction and was reluctant to give up its privileged revenue position. The outcome was a series of federal-provincial negotiations that extended the tax rental agreements on an asymmetric basis until the 1960s, after which they gradually morphed into the asymmetric federal-provincial tax collection agreements we have today. These contemporary agreements effectively allow provinces to levy their own income taxes at whatever rates they see fit with the federal government collecting those revenues on behalf of provinces subject to certain conditions. Not all provincial governments, however, participate. Quebec collects its own personal and corporate income tax. Alberta and Ontario collect their own corporate income tax. Thus, provinces “recovered” their taxing authority more than 40 years ago regardless of whether they chose to collect their revenues on their own or to rely on the federal authorities for that purpose. Nonetheless, during the decades since then, provincial governments have continued to look to the federal government to make up for what they perceived to be revenue shortfalls. Their position in this regard has been linked to the vast expansion of their spending commitments. These commitments were undertaken in key cases, like health and social services, with fiscal encouragement from Ottawa, initially in the form of matching grants.

Since the mid-1990s, provincial governments have referred to these shortfalls as a “vertical fiscal imbalance” (hereafter VFI). What provinces meant by this term was something along the following lines. The federal government was raising more money than it needed for its own programs resulting in Ottawa running large budgetary surpluses. At the same time provinces, except Alberta, were having trouble balancing their books. For reasons of economic

competitiveness, provinces could not increase their tax rates. Provinces were also experiencing stronger spending pressures than the federal government mainly because of the rapid rate of growth in health care expenditure and health was a priority for the public. These factors together constituted an imbalance and the way to correct it was for Ottawa to turn over its excess federal revenues to the provinces either in the form of cash or tax room (Annual Premiers' Conference, 2000, Noël, 2005).

But during the Chrétien and Martin governments, Ottawa consistently argued that the concept of VFI was meaningless, pointing out that provinces have constitutional access to all major revenue sources. Provinces therefore were free to deal with their deficits by either raising taxes or cutting expenditures (Dion, 153-174). It made no sense to acknowledge the idea of a VFI.

The view taken below is different. While technically the federal argument has considerable merit, the idea of VFI is a political concept not a technical one and cannot be ignored despite the position that the federal Liberals took while in power in the 1990s and 2000s. Assuming VFI is a political idea, how then can we know when it exists? The answer is "with difficulty." It is normal for federal governments to collect more revenue than they spend on their own programs and to transfer their *excess* revenue to provinces. This happens in all federations (Watts, 51-55). This normal *excess* is what is often referred to as a vertical fiscal *gap* (Boadway, 51-82). Thus, the presence of federal budgetary surpluses and provincial budgetary deficits before intergovernmental transfers does not necessarily imply "imbalance." But when the provinces are still very short of required finances after receiving these normal federal transfers and the federal government is enjoying large surpluses and using these surpluses through its spending power to impose its will on the provinces on matters that are within exclusive provincial competence under the Constitution, it is arguable that there is something that might reasonably be called a VFI. The Canadian situation in the late 1990s and at the beginning of the 2000s fits this definition. Ottawa was spending a high proportion of its incremental expenditures on items within exclusive provincial jurisdiction, either without provincial concurrence or more usually with limited provincial enthusiasm owing to new conditions associated with the transfers (Lazar, St-Hilaire, 137-188, Advisory Panel on Fiscal Imbalance, 55-56).

The Conservatives ran for office in 2006 pointing to the need for a "permanent" fix to the issue of fiscal imbalance without defining what they meant by such an imbalance. Subsequently Minister of Finance Flaherty asserted: "Budget 2007 restores fiscal balance with provinces, territories and municipalities by providing long-term, equitable and predictable funding for shared priorities." Whether the provinces accept his declaration that fiscal balance has been restored remains to be seen. What is certain, however, is that he did not rest his case on a technical definition of fiscal balance. He simply stated:

There's been a lot of talk about fiscal balance, Mr. Speaker. But what is it really about? It's about better roads and renewed public transit. Better health care. Better-equipped universities. Cleaner oceans, rivers, lakes and air. Training, to help Canadians get the skills they need. It's about building a better future for our country. And that means getting adequate funding to provincial and territorial governments. We get that. The provinces get that. Canadians get that. Almost everybody gets it. So we're taking action. Through this budget, we are delivering an historic plan worth over \$39 billion in additional funding to restore fiscal balance in Canada." (Federal Budget Speech, 2007.)

In other words, Flaherty declared “enough is enough” in much the same way provinces might say “enough can never be enough.”

With these elusive ideas and definitions of horizontal and vertical fiscal imbalance as background, we move next to consider the areas of fiscal federalism where there has been interprovincial collaboration in recent years and subsequently areas where conflict has been prominent.

Interprovincial Collaboration

Following the 1995 federal budget, the fiscal position of the Government of Canada improved rapidly. In part this was because the federal government had cut spending dramatically in the 1995 budget. But more important was a buoyant economy that helped to generate very large increases in federal revenues while the rate of interest on public debt was falling. By 1997-98 Ottawa was running budgetary surpluses and debt had begun falling.

A big part of the federal expenditure reductions were the transfer cuts associated with the introduction of the Canada Health and Social Transfer (CHST) announced in the 1995 federal budget. The provinces objected, making the point that Ottawa was slashing cash transfers to the provinces proportionately more than it was cutting its own programs. Provinces then began a campaign to persuade the federal government to restore their transfers to pre-CHST levels. Initially, they argued their position in terms of VFI but this abstract concept apparently had little traction with the public. When, however, the provinces began to translate their political argument into claims that the federal government was shortchanging them on health care funding (Ottawa had once paid 50 percent of their health costs but had allowed its share to dwindle to 11 percent) the political dynamics began to change (Annual Premiers’ Conference, 2003; Provincial and Territorial Ministers of Health, 2000: 29). In 2002 provincial premiers created what they euphemistically called the Premiers’ Council on Health Awareness as the vehicle for continuing to wage a coordinated public relations campaign that pitted them collectively against Ottawa (Provincial-Territorial Premiers’ Meeting, 2002). What is relevant here is that all provinces including Quebec and the western provinces were shoulder-to-shoulder on this issue. This was not surprising since all provinces stood to gain financially if the campaign was successful. The provincial pressures on the federal government led to an increase in the CHST in the 1999 federal budget, specifically intended for health care, and the federal-provincial-territorial (FPT) health accords of 2000, 2003, and 2004 (Canada, Department of Finance, September 25, 2007). The cumulative result was that the federal government’s cash share of provincial health care costs rose to around 22-23 percent by the mid-2000s. (If the value of the tax points that the federal government transferred to the provinces in 1977 is included in the calculation, the federal share was around 35 percent.)

By the early 2000s, the provinces’ objective case for a large VFI began to weaken. This was mainly because the federal government had *de facto* acknowledged the justice of the provincial case. It had increased transfer payments to them and had also begun new direct transfers to provincial clients. Initially, the most significant of these developments was the 2000 federal-provincial-territorial (FPT) First Ministers’ Communiqués on Health and on Early Childhood Development in which the Government of Canada undertook to increase its cash transfers to provinces and territories (PTs) by \$23 billion over a five-year period (First Ministers’ Meeting,

2000, http://www.scics.gc.ca/cinfo00/800038004_e.html, http://www.scics.gc.ca/cinfo00/80003806_e.html). The federal government had also reached an important understanding with the provinces and territories on a National Child Benefit program and Labour Market Development agreements had been negotiated. These arrangements either directly or indirectly took further pressure off of provincial spending. New federal government spending commitments for postsecondary education may have irritated provinces because they were bypassed (for example, the Canada Foundation for Innovation and the Canada Millennium Scholarship Program) but to varying degrees this federal spending also indirectly helped the provincial financial position. In short, the provincial case for VFI weakened because the provinces were succeeding in making their case. To be sure, the provincial authorities did not stop arguing that they were being ill treated. And with Canada's health care system still the number one priority of the public, the 2003 and then the 2004 FPT health accords included further large federal government cash transfers to provinces for health care. The 2003 agreement also announced that the "H" or health component of the CHST was to be split from the "S" or social component, creating a new Canada Health Transfer (and a new Canada Social Transfer) in order to provide a more transparent indication of the extent of federal financial support for provincial health care. The 2004 agreement also included a six percent annual growth escalator in the Canada Health Transfer (CHT) for a period of 10 years to provide predictability of federal funding to the provinces and territories (PTs).

After the 2004 FPT health accord, the provinces began to focus on alleged shortfalls in the other large vertical transfer, the Canada Social Transfer (CST), which is the federal government's transfer to the provinces for social programs and postsecondary education. To varying degrees provinces also supported municipal appeals to Ottawa for more money for cities and other communities, including for infrastructure. These pressures delivered some results when the federal government committed additional sums for early learning and child care and subsequently announced the introduction of a CST escalator of three percent annually to come into effect 2009-10. The federal government also agreed to provide a share of the federal gas tax revenues for infrastructure projects at the community level and created a fund to support public transit.

By the mid-2000s, however, the political steam had gone out of the claim of VFI because it had achieved much of what it had demanded. Provinces were continuing to struggle with their public finances but they had considerably more federal money for their health care systems and Ottawa had directly and indirectly helped financially in several other areas.

This cryptic and partial recent history of federal-provincial fiscal relations shows that provincial governments can unite successfully on issues of fiscal federalism when their objective is to obtain more money from the federal authorities. This is not surprising. After all, this is a game in which all provincial treasuries are fiscal winners.

Yet it is also worth noting that in the case of the four western provinces and Quebec, this coming together required them to set aside issues that might have divided them. These included differences in economic circumstances, party label and traditional policy stance towards Ottawa's use of the federal spending power. The differences in economic circumstances are reflected in the fact that since the 1990s Alberta has not been recipient of Equalization payments, Manitoba and Quebec have been consistent recipients, and British Columbia and Saskatchewan recipients in some years but not in others. As for party label, since 1995 the

governments of the five provinces have included Liberal, Progressive Conservative, New Democratic and Parti Québécois administrations.

The issue of policy stance toward the federal spending power is raised because when the federal government increased its major transfers to the provinces in 2000, 2003 and 2004, it also added conditions to those transfers that had not previously been part of the CHST and historically there have been differences among the five provinces on the issue of conditionality. Thus, over many years Quebec governments of different political stripes have challenged the legitimacy of the federal spending power. When Ottawa created new transfer programs in areas of exclusive provincial jurisdiction, Quebec sometimes opted out and negotiated for full financial compensation. Quebec officials also resisted accepting conditions on any transfers Quebec received. In the case of Alberta, its policies aimed at *clarifying roles and responsibilities* of federal and provincial governments were in effect calls for Ottawa to make less use of the spending power and better respect provincial jurisdiction. On the other hand, the governments of Saskatchewan and Manitoba often argued for a strong federal government that could lead the federation in the creation of Canada-wide programs and redistribute resources to the less affluent provinces. They were generally willing to accept federal conditions more readily than either Quebec or Alberta. With regard to British Columbia, its stand on these issues was sometimes strongly supportive of the federal spending power and at other times less inviting. These provincial differences might have affected the results of the VFI debate because it was being played out through a negotiation for specific-purpose cash transfers that entailed conditionality or the appearance of conditionality. This incremental conditionality was particularly hard for Quebec governments to accept regardless of which political party was in power.

The result was that in several of the federal-provincial agreements noted above the Government of Quebec did sign on but only after negotiating specific clauses or side-deals perceived to protect Quebec's autonomy. In other cases, the Quebec authorities practiced what Alain Noël has called "federalism with a footnote" (Noël 2005). It declined formally to accept some of the federal-provincial agreements announcing its position through footnotes to the first ministers' news releases.

A striking example of the first case was the 2004 FPT health accord. Quebec accepted this document but only after Ottawa agreed and other provinces accepted that this federal-provincial agreement had room for *Asymmetrical Federalism that Respects Quebec's Jurisdiction*, as the joint federal-Quebec side-deal was headed. In its opening paragraph, this document again reflects Quebec's determination to ensure that its traditional constitutional position is not undermined by a non-constitutional arrangement. It states:

Recognizing the Government of Quebec's desire to exercise its own responsibilities with

respect to planning, organizing and managing health services within its territory, and

noting that its commitment with regard to the underlying principles of its public health

system – universality, portability, comprehensiveness, accessibility and public

administration – coincides with that of all governments in Canada, and resting on

asymmetrical federalism, that is, flexible federalism that notably allows for the existence of specific agreements and arrangements adapted to Quebec's specificity, the

Prime Minister of Canada and the Premier of Quebec have agreed that Quebec's support

for the joint communiqué following the federal-provincial-territorial first ministers'

meeting is to be interpreted and implemented as follows. (Canada and Quebec, 2007)

The document then went on to describe Quebec's intentions relative to the commitments provinces had undertaken in the first ministers' agreement.

The second case is shown in the first ministers' agreement on early childhood development in September 2000. Among the provinces only Quebec did not accept this FPT agreement. But the Government of Quebec made clear that it expected the federal authorities to transfer Quebec's share of the funds for that initiative to Quebec City. The relevant footnote to the news release from first ministers stated:

While sharing the same concerns on early childhood development, Québec does not adhere to the present federal-provincial-territorial document because sections of it infringe on its constitutional jurisdiction on social matters. Québec intends to preserve its sole responsibility for developing, planning, managing and delivering early childhood development programs. Consequently, Québec expects to receive its share of any additional federal funding for early childhood development programs without new conditions (First Ministers' Meeting, 2000a).

The point of providing these detailed examples of Quebec's strategy is that the governments of the other nine provinces, including western provinces, understood the realities of Quebec politics and the apparent political necessity of any Quebec government to be seen to be protecting its historical jurisdiction. In this sense, the other provinces demonstrated flexibility and good will in their relations with Quebec.

In short, in the post-1995 history of fiscal federalism, the main area where the governments of the western provinces and Quebec, indeed all provinces, have found common ground is in vertical fiscal relations. All provinces determined that it was in their interest to rectify what they saw as the injustice of Ottawa's cuts in cash transfers associated with the introduction of the CHST. Every dollar the federal government gave up would be a gain for them collectively and that dollar would be shared among provinces on an equal per capita basis. This is the kind of condition – one where all provinces win – that makes partnership easy. Indeed, it turned out to be the kind of condition that facilitated accommodation among provinces on an important related issue: Quebec's insistence on respect for its traditional autonomist position.

The above discussion of interprovincial accommodation on conditionality provides a useful segue into a second and related example of interprovincial cooperation, namely, the federal spending power as a separate file in its own right (and not as an issue linked to specific fiscal negotiations as above). Although provincial positions have often differed on the legitimacy of the spending power, twice since the early 1990s provincial governments have signed on to consensus positions to limit its use. In one case Quebec was a part of the consensus and once it was not. The first time was with the signing of the 1992 Charlottetown Accord, which the Government of Quebec endorsed. Section 25 of that agreement set out a framework that was to guide the use of the federal spending power in all areas of exclusive provincial jurisdiction. Picking up on wording very similar to the language of the Meech Lake Accord, that section also provided “that the Government of Canada must provide reasonable compensation to the government of a province that chooses not to participate in a new Canada-wide shared-cost program that is established by the federal government in an area of exclusive provincial jurisdiction, if that province carries on a program or initiative that is compatible with the national objectives.” The Charlottetown Accord was not, however, adopted.

Partly due to pressures from provinces, similar provisions were again included in the 1999 Social Union Framework Agreement (SUFA). The latter agreement is a political document, not legally binding on its signatories (First Ministers’ Meeting, 1999). The Parti Québécois government did not sign SUFA and the opposition Quebec Liberal Party supported the government’s decision not to. When the Quebec Liberals were subsequently elected to office, they continued to stay outside the SUFA. Quebec chose not to sign in part because it interpreted the 1999 agreement as weaker in its opting out provisions than the Meech and Charlottetown Accords (see, for example, Special Committee of the Quebec Liberal Party, 47-50).

The spending power case thus illustrates that Quebec and western provinces can find common ground on the desirability of limiting the use of the federal spending power. It also illustrates that sustaining such consensus can be difficult.

Interprovincial Conflict

In this section we consider the condition that is more likely to provide conflict than common ground among provinces, namely, the allocation of revenue among provinces.

During the late 1990s and the early 2000s, federal-provincial fiscal negotiations were focused mainly on VFI and the related health care issue. But even then the issue of horizontal fiscal imbalance was dividing provinces. On the one hand, wealthier provinces complained that the per capita federal cash transfers they were receiving under what was then the CHST were lower than the per capita cash amounts Ottawa was paying to the Equalization-receiving provinces. In other words, they objected to the idea that there was an equalization component in a transfer was not intended to serve equalization purposes. On the other hand, the Equalization-receiving provinces were demanding improvements in the Equalization Program.

The issue of equal per capita cash amounts has been a divisive issue since the 1982 amendments to the Established Programs Financing legislation, which initiated the unequal cash transfers for health and postsecondary education, and the 1990 federal budget, which imposed a ceiling on transfers to non-Equalization receiving provinces under the Canada Assistance Plan. These inequalities were carried forward with the implementation of the CHST in 1995. Under

political pressure from the wealthier provinces, Parliament finally enacted legislation that provided equal per capita cash payments to all provinces for the CST beginning in fiscal year 2007-08. But moving to equal per capita cash for the CHT, which is more than double the size of the CST, was deferred until 2014-15, when the current legislation is due for renewal. The amount of the health cash transfer has been particularly problematic for the Government of Ontario as its relative economic position within the federation has deteriorated in recent years. Indeed, Ontario has been waging an aggressive political campaign on this issue with a special web site devoted to this and related concerns (Ontario, 2008). The governments of the four western provinces and Quebec have generally not supported Ontario's initiative, however, although the reasons for their opposition in some cases and indifference in others have varied.

It is the Equalization Program controversies, however, that are our main focus here. The Annual Premiers' Conferences during the late 1990s gave these matters relatively low priority. But by 2000 the Annual Premiers' Conference had become more forceful on the latter point stating:

The Equalization Program is constitutionally mandated to address the horizontal imbalance in Canada. Premiers called on the federal government to strengthen its commitment to the Equalization Program so that the Program meets its constitutionally mandated objectives. They noted that the ceiling on payments through the Equalization Program may be triggered by re-estimates later this year. Premiers reiterated that the federal government strengthen the Equalization Program including the immediate removal of the ceiling on Equalization payments, in concert with the restoration of the CHST and adoption of an appropriate escalator (Annual Premiers' Conference, 2000).

The case for removing the ceiling was subsequently presented to the House of Commons Standing Committee on Finance by the chair of the Provincial and Territorial Ministers of Finance (Manitoba, 2001).

In September 2003 provincial and territorial finance ministers released a document entitled *Strengthening the Equalization Program*. Among other things, it called for a change in the then 5-province standard against which the fiscal capacity of provinces was compared to a 10-province standard and a few other technical changes. Although these proposals would have increased Equalization payments, it is noteworthy that they had the support of the governments of Alberta and Ontario – the two provinces that were consistently not recipients of Equalization. But that is only part of the Equalization story.

World oil prices rose sharply in 2002 and then took a dramatic leap upward in 2006. One result was a huge increase in the horizontal fiscal imbalance between Alberta and other provinces. However, this increased imbalance did not initially influence Equalization entitlements in an equally large way. This was because Alberta was not part of the 5-province national standard against which entitlements were to be measured and, of course, a very high proportion of Canada's oil and gas reserves are in that province. But a consensus had emerged before the 2007 federal budget in favour of a return to a 10-province standard, for reasons of fairness, and this brought into sharp focus the issue of how a reformed Equalization Program should treat natural resource revenues. (Expert Panel, 44-45, Advisory Panel 84-87).

For many years there had been controversy regarding the extent to which natural resource revenues should be included in the Equalization formula (Expert Panel, 106). Thus, between 1957 and 1982, the rate of inclusion had at different times been 0, 33, 50, and 100 percent of natural resource revenues. The 1982 Equalization amendments returned the program to 100 percent inclusion but also introduced the 5-province standard to remove Alberta from the measurement of fiscal capacity and thus prevent a large rise in Equalization payments. With the new consensus for a 10-province standard and thus potentially for Alberta's natural resource revenues to be included, large differences emerged among provinces concerning the extent to which natural revenues should in fact be equalized. This issue has been discussed in detail elsewhere including the reports of both the federally appointed Expert Panel on Equalization and Territorial Financing (105-114) and the Advisory Panel on Fiscal Imbalance appointed by provincial and territorial governments (77-90). Suffice it here to make two simple points. The first is that decisions about the natural resource inclusion rate entail big money. Moving from a 5-province standard with 100 percent resource inclusion (which does not include Alberta's oil revenues because Alberta is not part of the 5-province standard) to 10-province standard with the 100 per cent inclusion rate was calculated by the Advisory Panel on Fiscal Imbalance to hypothetically add \$5.7 billion to the program in 2005-06.

Second, the impact of the natural resource inclusion rate on individual provinces varies sharply due to their large differences in resource endowment. That is, for any single formula there will be provincial winners and provincial losers. For example, again based on the Advisory Council's analysis, in 2005-06, Saskatchewan would have received \$152 million with the 10-province 100 percent inclusion formula. With a 10-province zero inclusion formula, despite the fact that the Equalization pool of money would be smaller, its entitlement would have been \$950 million higher in that year. British Columbia would have gained roughly \$450 million under the same circumstances. For Manitoba, the differential impact was a little under \$500 million but in its case it would have received the larger amount with 100 percent inclusion, the opposite of Saskatchewan and British Columbia. As for Quebec, the difference was \$3 billion with 100 percent inclusion (Advisory Council 80-84).

In the event, the 2007 federal budget adopted the Expert Panel report recommendation to include/exclude 50 percent of natural resource revenues in determining each province's fiscal capacity and the standard.

The main point here is that with such large impacts depending on the choice of formula, all provinces pursued their self-interest. Thus, for example, the governments of Manitoba and Quebec wanted all natural resource revenues included in the formula. Although they have large hydroelectric and other natural resources (such as base metals and iron ore), unlike Alberta they do not have hydrocarbon reserves and the rents related to them. The larger the proportion of resource income included, the more money there would be to be shared and the larger the proportion that would accrue to them.

Not surprisingly, the Government of Saskatchewan was the most aggressive. Saskatchewan is a resource rich province and it was strongly opposed to seeing its Equalization payments decline as it developed its natural resources. What was especially galling to Saskatchewan officials was that the Martin Liberals agreed not to offset the Equalization entitlements of Newfoundland and Labrador and of Nova Scotia against their offshore hydrocarbon revenues in special arrangements signed in 2005. Some saw these 2005 arrangements as merely extending the

previous time-limited revenue sharing arrangements that had been in place between Canada and Nova Scotia since 1982 and between Canada and Newfoundland and Labrador since 1985. These earlier agreements had provided for these provinces to receive payments from Ottawa to partially offset any reductions in Equalization payments due to increased revenues from the offshore. But others considered that Ottawa's 2004 deals with the two Atlantic provinces were more far-reaching than the 1980s arrangements and ran more strongly counter to the principles-based approach to the Equalization Program than had been in force for almost 50 years (Expert Panel on Equalization and Territorial Financing, 21-22). Adding insult to injury, although Mr. Harper had promised repeatedly during the 2006 federal general election campaign not to include any natural resource revenues in a reformed Equalization Program, once in office the Conservative government retreated from this undertaking and decided to honour this much criticized offshore revenue legacy it had inherited from the Liberals. And it did so without affording comparable advantages to Saskatchewan in respect of its onshore revenues. Understandably, therefore, the Government of Saskatchewan saw these offshore arrangements as discriminatory. And while the New Democratic Party was in power it relentlessly pursued a policy of trying to secure a commitment from Ottawa that would afford it the same advantages as these two Atlantic provinces. The 50 percent inclusion rate compromise in the 2007 federal budget did not do much to assuage it, as the NDP reckoned the new arrangements were hurting its finances to the tune of \$800 million annually. The Government of Saskatchewan did not, however, secure support from other western provinces or from Quebec. One measure of Saskatchewan's frustration with this situation was that in October 2007 the government of that province filed a reference with the Saskatchewan Court of Appeal concerning the constitutionality of the Equalization formula set out in the 2007 federal budget (Calvert, 2007).²

With regard to the natural resource issue, British Columbia has been relatively quiet in its public diplomacy but, like Saskatchewan, it too is generally thought to prefer to have all natural resource revenues excluded.

With the highest fiscal capacity among provinces, Alberta is not a recipient of Equalization. And it has argued strenuously against any inclusion of natural resource revenues. At times, when he was in office, Premier Klein was fuzzy in his explanation of his position, leaving the impression that he thought the Government of Alberta was funding the program directly (CTV, 2006). However, Alberta authorities may have also judged that if the cost of Equalization were to rise sharply, this would necessitate either higher taxes on federal taxpayers in Alberta or reduced federal transfers to Alberta from the CHT and CST. Both possibilities would be inimical to Alberta's interests.

The main point here is that natural resources are distributed unequally across the federation. Accordingly, provincial treasuries are affected differentially depending on whether and to what extent natural resources revenues are equalized in the Equalization Program and inevitably individual provincial governments press the federal government to shape the program in a way that reflects their fiscal self-interest. The treatment of natural resources by Equalization is thus not an area of common ground between Quebec and the West. Indeed, there is no common ground among the western provinces on this issue.

While the divisions among PTs on natural resource revenues have clearly been the most troublesome item on the recent FPT Equalization agenda, it has not been the only divisive one.

For example, in recent years the interests of Quebec and British Columbia have clashed on the way Equalization should treat revenues from real estate. The 2007 federal budget settled this difference in a manner that favoured Quebec, leaving British Columbia quietly disgruntled.

Fiscal Federalism Today

Let's jump to the situation in early 2008, when this article was being completed. The question here, it is worth repeating, is whether intergovernmental fiscal relations provide a basis for Quebec and the western provinces to work together constructively in pursuit of their interests and for the better governance of Canada. The answer that arises from the above analysis is that "it depends." It depends on the fiscal federalism agenda going forward. Are the big issues that are on the agenda today and that are likely to emerge before, say, the end of this decade ones where these five provinces share common fiscal interests? Or are the big issues inherently divisive?

It has already been seen that in the realm of fiscal federalism the easiest way to construct an alliance among provinces is to focus on policy positions from which they all stand to benefit financially. This kind of situation arises when they can find some plausible basis for taking a collective run at the federal treasury. This was the case from the time of the 1995 federal budget until the 2007 budget. Following the 1995 budget, the provinces had a cogent case that the federal reductions in transfer payments to them were unfair and putting their health care systems at risk. They fought this issue politically and gradually won the debate with the federal authorities increasing transfer payments in 1999, 2000, 2003 and 2004. In particular, the 2004 First Ministers' Accord on Health Care provided a long-term federal financial commitment to PTs for health care with a new CHT. The Conservative Party bought into the 2004 FPT health accord in its 2006 election platform and signed on to it after it formed the government that year (Conservative Party of Canada, 2006, 43). These federal financial undertakings for health care run until 2013-14. In its 2007 budget, the Conservative government also set out a long-term fiscal strategy for the CST, the second largest vertical transfer. This too included commitments until 2013-14 with an escalator of three percent annually to kick in 2009-10. In other words, at least as seen from Ottawa, with its long-term fiscal commitments for the two large vertical fiscal transfers, there is no need to re-open these programs until the end of the commitment period.

Ottawa's stance that it has restored fiscal balance will not prevent provinces from continuing to argue in favour of additional vertical transfers. Indeed, they will do so and on some files, such as infrastructure and labour market training, their priorities will match those of the federal government's and they will succeed. From an overall fiscal viewpoint, however, these sector-specific transfers are small potatoes compared to the \$35 billion (in 2007-08) in the two major cash transfers to provinces (CHT and CST). Having long term plans for both the CHT and CST, the federal government will not want to reopen these programs except perhaps at the margin. It will prefer to move on to other matters such as tax cuts.

If VFI is not likely to be a big agenda item, what is? Well, for one thing, there is leftover business stemming from the 2007 amended Equalization Program and the related offshore accords. In its 2007 budget, the federal Conservatives tried to accommodate the governments of Newfoundland and Labrador and Nova Scotia by offering these two provinces the choice of either receiving Equalization payments based on the rules that were in force up until 2007 with their offshore revenues sheltered as per the two special arrangements, or receiving Equalization

based on the new and more generous rules but without shielding their offshore revenues. The governments of the two Atlantic provinces cried foul arguing that they should be entitled to payments based on the 2007 rules without any impairment to their special arrangements for offshore revenues. The result was a dispute that pitted the federal government against the governments of these two provinces. In October 2007, it appeared that the federal government had found a compromise that was satisfactory to the Government of Nova Scotia but not to the Government of Newfoundland and Labrador. (The stakes were greater for Newfoundland and Labrador.) In the meantime, the Government of Saskatchewan was nursing a grievance that set it apart from other provinces. Finding a political solution to the divided views and interests of the provinces on this issue is thus likely to remain an agenda item but not one that will unify the west and Quebec.

Perhaps the biggest risk to the Equalization Program over the next few years has to do with the world price for oil. Should it remain high, this would add to the adverse effects on the trade-sensitive sectors of the Ontario and Quebec economies that were experienced beginning initially in 2002 and then more strongly in 2006, with continued negative consequences for their fiscal capacities. Conversely, Alberta and Newfoundland and Labrador would benefit from a further rise in oil prices, probably reviving the acrimonious debate about the treatment of natural resources in the Equalization Program. As in the last few years, this would be divisive among the five provinces that are our focus.

A second and related issue that could easily move to the top of the agenda is the energy-environment file. It is already clear, for example, that hydrocarbon rich Alberta and to a much lesser extent Saskatchewan have a different set of interests and policy preferences than do hydroelectric rich Quebec, Manitoba and British Columbia. The latter three provinces produce energy that is much friendlier from a greenhouse gas perspective than the first two, especially Alberta. It is not difficult, in this regard, to imagine the federal government adjusting its system of fiscal incentives, including Equalization, in a way that would again divide the provinces.

What about the prospects for common ground among provinces on the issue of the federal spending power? The October 2007 Speech from the Throne stated:

Our Government believes that the constitutional jurisdiction of each order of government should be respected. To this end, guided by our federalism of openness, our Government will introduce legislation to place formal limits on the use of the federal spending power for new shared-cost programs in areas of exclusive provincial jurisdiction. This legislation will allow provinces and territories to opt out with reasonable compensation if they offer compatible programs. (Canada, Speech From Throne, 2007)

If the federal government adheres to this plan, it will be committing to positions that the provinces collectively endorsed in both the Meech Lake and Charlottetown Accords. Such statutory provisions might be welcomed by the Government of Quebec both for their substantive content and symbolism. To the extent that the governments of the four western provinces publicly support this federal legislation, this common ground could well improve relations between the West and Quebec. At the same time, it is possible that individual provinces, including Quebec, will quibble with one detail or other of the federal legislation and such quibbles could be divisive.

In sum, looking ahead, internal dynamics seem unlikely to create an ongoing alliance between the western provinces and Quebec in the fiscal federalism world although the spending power file could conceivably be an exception to this generalization. As for external influences, like oil prices and pressures for new international approaches to greenhouse gas emissions, they are more likely to strain relations among these provinces than to ameliorate them.

Conclusion

This workshop considered a variety of ways and mechanisms through which the western provinces and Quebec might be able to find common ground in the management of the federation. This article has probed that issue through the lens of fiscal federalism. Its conclusions in this regard are straightforward. First, the West is not a monolith. There are important differences in resource endowments among western provinces that will continue to divide them on matters of intergovernmental fiscal relations. Second, to unify the four western provinces and Quebec on fiscal matters without the other PTs being part of such an alliance is unlikely. The fiscal item that is most likely to bring the first five together – endeavouring to persuade the federal government to transfer more fiscal resources to them – will normally also interest the other PTs as well. In any case, and this is a third conclusion, the VFI dossier is not a likely candidate to move high on the FPT fiscal agenda for some years to come. Fourth, what is high on the fiscal federalism agenda, at least in early 2008, is the federal government's plans for Parliament to enact legislation that would impose limits on the federal spending power and create a statutory right for provinces to opt out of shared cost programs with compensation under certain conditions, as was proposed in both the Meech Lake and Charlottetown Accords. This spending power proposal does not require PT approval to be implemented legally. Nonetheless, to the extent that PTs lend political support to this initiative, this should be positive for the climate surrounding intergovernmental relations. As with the issue of vertical fiscal relations, this file might potentially be of interest to all PTs, not just Quebec and the western provinces.

But finally, and perhaps most significantly, a continued debate about the Equalization Program, including its relationship to the offshore accords and its treatment of natural resources, is likely to remain a divisive influence on the fiscal federalism environment for the next few years. The increasingly important and related energy-environment nexus could be even more divisive. This suggests that if common ground is to be found between the western provinces and Quebec, it is best to look outside the realm of fiscal federalism.

Endnotes

¹ I follow the convention of capitalizing the word "equalization" when referring to the federal Equalization Program but not capitalizing it when referring to the idea or concept of equalization.

² These comments on the position of the Government of Saskatchewan applied until the defeat of the NDP government by the Saskatchewan Party in November 2007. As this paper was finalized in early 2008 it appeared that the newly elected government would approach this issue in a less confrontational way than its predecessor.

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