Fiscal Imbalance: Problems and Issues

Discussion Paper for public consultation
FISCAL IMBALANCE:
PROBLEMS AND ISSUES

DISCUSSION PAPER FOR PUBLIC
CONSULTATION
A WORD FROM THE CHAIR OF THE COMMISSION

Fiscal imbalance between the federal government and the provinces has been the subject of much discussion for several years now. It raises fundamental questions about government revenue and spending, and, beyond a strictly public finance context, about the very role of the federal government and the provinces within Canada.

The Québec government created the Commission on Fiscal Imbalance precisely for the purpose of reflecting on these questions. The mandate is a demanding one: by the end of the fall, the Commission must submit to the government an in-depth analysis of the situation, its causes and the possible corrective measures.

The Commission must show imagination and innovation in elaborating these measures. The mandate conferred by the government calls for nothing less, since the Commission must make practical recommendations and find sustainable solutions.

This mandate must be carried out with the utmost transparency, the Commission having been set up to facilitate public discussion and foster constructive dialogue. The Commission is taking the first step to that end by publishing this discussion paper and two accompanying background papers: all interested persons and organizations are invited to participate in the public hearings to be held this fall.

A symposium bringing together experts and practitioners for the purpose of examining the fiscal situation of a number of countries will also be organized in the fall, thereby enriching the reflection process.

Thus, on behalf of all the commissioners, I invite each and every Quebecker to take part in the shared reflection process getting under way.

YVES SÉGUIN
Chair, Commission on Fiscal Imbalance
The Commission on Fiscal Imbalance was set up on May 9, 2001 by the Québec government.

It is mandated to:

- identify and analyse the underlying causes of fiscal imbalance between the federal government and Québec;

- solicit and gather the opinions and suggestions of experts and stakeholders from Québec and elsewhere, regarding the practical consequences of this imbalance and the concrete solutions to be put forward to redress it.

**MEMBERS OF THE COMMISSION**

The Commission on Fiscal Imbalance is composed of the following seven commissioners:

- **Yves Séguin**, chair of the Commission  
  (president, Groupe Marine inc.)

- **Anne-Marie d’Amours**  
  (president, Capimont Technologies inc.)

- **Renaud Lachance**  
  (professor and director of the undergraduate business administration program, École des Hautes études commerciales – HEC)

- **Andrée Lajoie**  
  (full professor, Centre de recherche en droit public – CRDP, faculty of law, Université de Montréal)

- **Nicolas Marceau**  
  (full professor, department of economics, Université du Québec à Montréal – UQAM)

- **Alain Noël**  
  (full professor, department of political science, Université de Montréal)

- **Stéphane Saintonge**  
  (tax lawyer – Legault, Joly, Thiffault)

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The government has given the Commission until November 30, 2001 to table a report containing its observations and recommendations. The report will then be submitted to the Deputy Prime Minister and Minister of State for the Economy and Finance.

**APPROACH**

To carry out its mandate, the Commission will rely on public hearings, collaboration with outside resources and in-depth studies conducted on its initiative.

- **Public hearings** will be held in October 2001. The hearings will enable the Commission to discuss the briefs submitted by interested persons and organizations.

- Two **background papers** have been prepared by the Commission. These documents, which deal with federal transfer programs and the effective sharing of taxation fields, analyze the specific situation of Québec in this regard. They are being made public and available to participants immediately to help them prepare their briefs and to provide a basis for upcoming discussions. Other documents will also be published between now and when the public hearings are held.

- The Commission will invite a number of experts to participate in an **international symposium** at which the main issues pertaining to fiscal imbalance, as well as intergovernmental financial arrangements, will be discussed. The symposium, to be held in Québec City on **September 13 and 14, 2001**, will provide insight into foreign experiences in this area, thereby enriching the reflection process.

- The Commission has a **Website**, which citizens can use to communicate their thoughts and suggestions. Interested persons can consult, in particular, the documents published by the Commission, conference papers and an up-to-date list of bibliographic references and electronic links. The briefs presented to the Commission will also be available on the site, as of the day on which they are discussed at the public hearings.

The Commission’s Website can be accessed at the following address:

[www.desequilibrefiscal.gouv.qc.ca](http://www.desequilibrefiscal.gouv.qc.ca)
PUBLIC HEARINGS

The Commission invites interested persons and organizations to submit briefs presenting information, analyses and recommendations relating to the questions that it has been mandated to study.

- Participants who intend to submit a brief must so advise the secretariat of the Commission in writing no later than **August 10, 2001**.

- The briefs must be sent to the Commission on or before **September 21, 2001**.

- Persons and organizations having submitted briefs will have the opportunity to present and discuss their analyses and proposals at the public hearings, or later on, alternative scenarios for discussion having been provided for, should the number of briefs submitted prevent the Commission from hearing all of the participants during the public hearings.

Briefs may be sent to the secretariat of the Commission, at the following address:

Commission on Fiscal Imbalance  
630, boulevard René-Lévesque Ouest  
5e étage  
Montréal (Québec)  
H3B 1S6

Briefs must be in letter format and include a synopsis of no more than three pages.

All documents transmitted to the Commission in conjunction with the hearings will be considered public.
FISCAL IMBALANCE

The Commission was created to analyse a phenomenon—that of fiscal imbalance—which raises a number of questions in Canada and has found a very strong echo in the public opinion.

The term “fiscal imbalance” is used to describe the situation which Québec and other provinces experience with regard to public finances: given the current occupation of taxation fields, they do not have enough revenue to finance their program responsibilities whereas, conversely, the federal government has at its disposal more revenue than it needs to finance its own areas of jurisdiction.

A number of observations can be made further to a preliminary examination of the situation:

- First, the Constitution grants the provinces jurisdiction in the areas of health, education and social services. The programs in these areas—health programs in particular—are the most costly government programs. Moreover, health spending increases very rapidly. On the other hand, the federal parliament has jurisdiction in areas where the programs are currently less costly and spending increases at a slower rate.

- Second, despite the different scale and nature of their spending, the federal government and the provinces split the total accessible revenue pretty much evenly between them. In addition, the federal government has a preponderant share of personal income tax revenue—the revenue with the highest growth potential.

- Third, the federal government makes transfers to the provinces, in particular to contribute to the funding of social programs. However, since the mid-1980s, there has been an almost steady decline in the relative percentage of provincial funding needs covered by federal transfer payments. Québec and the other provinces have unanimously denounced the unilateral and discretionary nature of the decline. Although very recently reversed, the trend toward the reduction in the relative weight of federal transfers will likely resume as early as 2002-2003.
Fourth, the federal government uses its spending power to bolster its presence in, and control over, the areas of provincial jurisdiction, despite the opposition of Québec and other provinces.

As a result, in part, of these circumstances, the current and foreseeable budgetary context is characterized by large surpluses in Ottawa, whereas Québec and most of the other provinces have less leeway.

These five observations, which are constants in the discussion on fiscal imbalance, will be gone into at some length here.
The Constitution grants the provinces jurisdiction in the areas of health, education and social services

The Constitution grants the provinces jurisdiction in three major areas, namely, health, education and social services. These three areas alone accounted for a little over three-quarters of total program spending by the provincial governments in 2000-2001. More importantly, spending in these three areas exceeded total program spending by the federal government.

The provinces spent $122 billion on health, education and social services in 2000-2001, whereas total program spending by the federal government—including transfer payments—for the same fiscal period was $120 billion, that is, $40 billion less than total program spending by the provinces.

By comparison, seniors’ benefits, employment insurance, national defence and Indian affairs were once again the four most funding-intensive programs assumed directly by the federal government in 2000-2001. Together, these four programs represented $50 billion in spending.

![Chart 1](image-url)

Source: 2001 federal budget; 2002 provincial budgets; Commission on Fiscal Imbalance.
Thus, health programs alone account for two-fifths of provincial program spending. Moreover, spending in this area increases very rapidly, climbing 47.9% between 1990-1991 and 2000-2001 despite rigorous, often tough, management. This progression shows the strong pressure exerted on the provinces in conjunction with the most important program under their jurisdiction.
Equivalent revenue and a preponderant share of the federal
government in personal income tax

To finance the areas over which they have jurisdiction, the two levels of
government rely first and foremost on their own-source revenue. On the
whole, this revenue is shared pretty much equally by the federal government
and the provinces, whereas the scale and nature of the responsibilities differ.
In 2000-2001, the own-source revenue of the federal government was
$179 billion, while that of the provinces was $164 billion. The federal
government thus received 52%, or a little over half, of the own-source
revenue collected by the two levels of government, while the provinces
received 48%.

1 Data adjusted for the special Québec abatement. The background paper Effective Occupation of Taxation Fields in Québec deals with the special Québec abatement and its impact on the effective occupation of the personal income tax field.

Source: 2001 federal budget; 2002 provincial budgets; Commission on Fiscal Imbalance.
Fiscal imbalance: problems and issues

Chart 2 also illustrates another phenomenon—that of the share of personal income tax in the own-source revenue of both levels of government, and particularly that of the federal government. In 2000-2001, personal income tax accounted for 30% of the provinces’ own-source revenue and for 47% of the federal government’s.

Personal income tax is the fastest-growing tax revenue. This is due to the progressive nature of the income tax system: a 1%-increase in the personal income tax base results in an estimated 1.2% rise in income tax revenue.

Under the provisions of the Constitution, the personal income tax field is open to both levels of government. The federal government occupies a preponderant share of this taxation field. The federal government receives 63% of the amount collected across Canada in this taxation field, compared with 37% for the provinces. The same observation can be made with regard to Québec specifically, since the federal government occupies 58% of this taxation field in Québec, and the Québec government, 42%.

CHART 3


Provinces

37%

Federal government

63%

1 Data adjusted for the special Québec abatement. The background paper Effective Occupation of Taxation Fields in Québec deals with the special Québec abatement and its impact on the effective occupation of the personal income tax field.

Source: 2001 federal budget; 2002 provincial budgets; Commission on Fiscal Imbalance.
Relative decline in federal transfers

The federal government makes transfer payments to the provinces, notably to contribute to the funding of social programs.

Since the mid-1980s, there has been an almost steady decline in the relative percentage of provincial funding needs covered by federal transfer payments. For Canada as a whole, the portion of health, education and social services spending financed by the Canada Health and Social Transfer (CHST) dropped from 23% in 1985 to 11% in 1998-1999. In particular, the provinces underscored the unilateral and discretionary nature of the reductions decided on by the federal government.

As a result of the reinvestments announced by the federal government, the relative percentage of provincial funding needs covered by federal transfer payments should rise to just over 14% in 2002-2003. However, the trend toward the reduction in the relative weight of transfer payments will likely resume after that period.

CHART 4

CHANGE IN THE CHST\(^{(1)}\) CASH COMPARED WITH PROVINCIAL SPENDING ON HEALTH, EDUCATION AND SOCIAL SERVICES – 1982-2005
(as a percentage)

1 The CHST replaced the Established Programs Financing (EPF) agreement and the Canada Assistance Plan (CAP) in 1996-1997.
Source: Commission on Fiscal Imbalance.
Federal transfers also include amounts accorded as equalization payments. Even when this other category of transfer payments is taken into account, the relative weight of federal financing is nonetheless in decline.

In just under 20 years, between 1983-1984 and 2000-2001, the share of total federal transfers in provincial revenue fell from 24.6% to 15.0%.

Source: Commission on Fiscal Imbalance.
Federal presence in areas of provincial jurisdiction

The federal government’s heightened presence in, and control over, areas of provincial jurisdiction is another point that is regularly brought up. Areas of jurisdiction are split between the federal government and the provinces in accordance with the provisions of the Constitution. For a number of years, the federal government has been using its spending power to bolster its presence in, and control over, areas of provincial jurisdiction—notably, health and education—despite opposition from most of the provinces.

This intervention takes various forms:

- The federal government sets up its own programs in areas of provincial jurisdiction.
- The federal government imposes certain conditions on the payment of its contribution to the funding of programs administered by the provinces.

A quick look reveals that the federal government has spent an estimated $10 billion over the last five years to set up programs in areas of provincial jurisdiction. The millennium scholarships fund alone resulted in a $2.5-billion injection in education.

The Canada Health Act is the best-known example of the other approach taken by the federal government to intervene in areas of provincial jurisdiction. Under this approach, the federal government ties its financing of a particular provincial area of authority – health – to a number of conditions subject to so-called national objectives.

The federal presence in areas of provincial jurisdiction causes numerous problems, such as the following:

- It interferes in the determination of priorities, which the provinces have the authority to establish.
- It results in costly overlapping for the public.
- The impact of the fiscal imbalance to which it is linked can be worsened when the federal government withdraws part of its support after having imposed ways of doing things on the provinces that are not in keeping with their financial means.
Large surpluses in Ottawa, less leeway for the provinces

These circumstances are in part responsible for the current budgetary situation of the federal government and the provinces, which is characterized by the accumulation of large surpluses in Ottawa, while the provinces dispose of less leeway.

Analysis of the budgetary data for the 1997-2002 period, the most recent data available, shows the scale of the federal government’s surpluses. The federal budget balance, which stood at $3.5 billion in 1997-1998, rose to $12.3 billion in 1999-2000 and climbed to $15.0 billion in 2000-2001. Another surplus is forecast for 2001-2002, and should reach $7.3 billion.

On the other hand, the budget surplus of provinces that have one is much more modest. Excluding Alberta, whose oil and gas revenues distort the outlook, the provinces’ budget balance showed a deficit of $6.7 billion in 1997-1998 and of $3.3 billion in 1998-1999. The balance has since shown a surplus: $0.1 billion in 1999-2000, $4.9 billion in 2000-2001 and $1.1 billion in 2001-2002.

Source: Federal and provincial budgets; Commission on Fiscal Imbalance.
GUIDELINES

To facilitate the public hearings, the Commission proposes certain guidelines, based on its mandate, for the upcoming discussions.

The Commission’s mandate and the constitutional framework

The first step in the analysis of the current fiscal imbalance is to look at the sharing of jurisdictions and powers between the federal government and the provinces, as well as at access to certain revenue.

Such sharing constitutes the very foundation of any federation. In Canada, this sharing is determined by the provisions set forth in the Constitution. Certain functional aspects, like spending power, will be discussed by the Commission. The Commission nevertheless situates its reflection within the current constitutional framework.

Fiscal imbalance and public finances

Certain financial and fiscal phenomena interfere with fiscal imbalance and can affect its scale and impact.

Thus, the quality of federal and provincial management of public finances could exacerbate or, on the contrary, attenuate, the effects of the current fiscal imbalance. The economic situation in itself has a major impact on the governments’ public finances.

In analysing the current and foreseeable fiscal imbalance, it is therefore necessary to properly distinguish between the phenomenon itself and the consequences of other economic or financial circumstances.

Budget priorities of the governments

The Commission wishes to point out that it is not mandated to examine the governments’ budget priorities. It was created to analyse the ability of both levels of government to achieve correspondence between their revenue and their responsibilities, not to examine the budget priorities they define in conjunction with their respective jurisdictions.
CONCLUSION

Although the phenomenon of fiscal imbalance has been much debated in the past few years, it is not a new issue. The Commission therefore intends to anchor its analysis in history, persuaded as it is that the history of the Canadian confederation will shed valuable light on the reflection process it is embarking on.

From a broader standpoint, the Commission’s objective is to answer the three questions underpinning its mandate:

- What are the underlying causes of fiscal imbalance between the federal government and Québec?
- What are the practical consequences of this imbalance?
- What concrete solutions can be put forward to redress the imbalance?

The public consultation launched by the Commission will help it to carry out its work, thereby enabling it to find answers to a situation that has major consequences for Quebecers.
HOW TO CONTACT US

The secretariat of the Commission on Fiscal Imbalance is located at the address below:

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All of the documents published by the Commission are available on its Website, at the following address:

www.desequilibrefiscal.gouv.qc.ca