FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

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FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

ISSUE DEFINITION

Federal-provincial fiscal arrangements are an important factor in the economic and social life of Canadians because they set the limits on the actions open to each level of government in this country. The essential concern of these arrangements is the attainment of fiscal balance between and among the levels of government in the Canadian federal state. Two types of fiscal balance are sought: 1) horizontal fiscal balance which refers to the ability of provinces to carry out the same constitutional functions, and 2) vertical fiscal balance which refers to the ability of each level of government to carry out its assigned tasks under the Constitution. While these represent the central issues in past federal-provincial fiscal discussions, other matters have also received considerable attention. These include: the division of responsibilities between levels of governments, the need for coordinated economic policy among all levels of government and the effective provision and financing of public services.

BACKGROUND AND ANALYSIS

The fiscal concerns of the two levels of government in Canada are covered by several agreements, the most important being the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, hereafter known as the Fiscal Arrangements Act.\(^{(1)}\) While the paper will analyse the various items in this Act, it will focus primarily on the three major components of the legislation: 1) Equalization Payments, 2) Tax Collection Agreements and 3) Established Programs Financing.

\(^{(1)}\) The Fiscal Arrangements Act covers about three-quarters of all federal-provincial transfers. Other important fiscal arrangements include the Canada Assistance Plan and the various regional development agreements.
A. The Historical Context

Almost from the beginning of Confederation the federal government and the provinces have been involved in discussions over fiscal relations. The early forms of federal assistance and provincial tax systems broke down during the Depression when they were overwhelmed by the rising financial burdens of the provinces. The Royal Commission on Dominion- Provincial Relations, (Rowell/Sirois), which studied the problem, recommended in 1940 that the federal government should assume the debt of all provinces and responsibility for unemployment relief. Furthermore the Commission advocated the establishment of a system of federal payments to help less fortunate provinces raise their standard of services to the national average. It also recommended that the provinces relinquish their claims in the areas of personal and corporate income taxes and succession duties. The recommendations of the Commission were not accepted, though virtually all the concepts embodied in the recommendations eventually found their way into the present system of federal-provincial agreement.

The modern period of federal-provincial fiscal relations began during the Second World War when the provinces agreed to withdraw temporarily from the income and succession tax fields in return for sufficient cash payments from the federal government. The positive experience associated with the wartime “Tax Rental Agreements” led most provinces and the federal government to agree on new arrangements in 1947. Since then the agreements have been revised every five years to reflect changing economic and social conditions.

B. The 1982-87 Arrangements

The most recent round of fiscal negotiations began in the fall of 1980 when the federal government announced it would seek significant savings in the transfers to the provinces. During the negotiations the federal government declared that it hoped to realize a $1.5 billion saving in social affairs transfers to the provinces over the 1982-83 and 1983-84 fiscal year. It did not immediately reveal how such savings were to be realized but instead established a Parliamentary Task Force to examine the programs authorised by the Fiscal Arrangements Act.\(^1\) In his November 1981 budget, the Finance Minister proposed nine changes to the fiscal

arrangements. The provinces strongly objected to three of these proposals: the change in the standard for equalization, the termination of the 1972 revenue guarantee, and the finalization of the financial arrangements for the Established Programs Financing a year before the program standards were set. In ensuing discussions the two levels of government could not reach agreement and so the federal government decided to act unilaterally by introducing Bill C-97 to amend key sections of the Fiscal Arrangements Act. This bill became law on April 7, 1982.

1. Equalization Payments

The Bill extended the equalization system to March 21, 1987, increased the list of revenue sources from 29 to 33 items, included for equalization the full value of provincial oil and gas revenues (since 1977 only one half of such revenues had been included) and changed the equalization standard from the national average per capita tax yield to a representative average of the tax yield realized by the provinces of Ontario, Quebec, Manitoba, Saskatchewan and British Columbia.

The impact of adding items to the list of revenue sources to be equalized generally is to raise the level of federal equalization payments. However the new equalization standard will more than offset this increase since the new standard does not include Alberta and because three of the representative provinces have low oil and gas revenues.

The new legislation also provides for a minimum and maximum equalization payment as well as a transitional payment to assist some provinces adapt to the changes in the equalization formula. To protect the federal government against uncontrolled increases, the total equalization payments for 1982-83 were allowed to rise at a rate of increase no greater than that shown by the gross national product over the calendar year 1982. Individual provincial entitlements are reduced accordingly.

2. The Tax Collection Agreements

There were no major changes in the Tax Collection Agreements in the 1982-87 Arrangements. However it should be remembered that in January 1981 Alberta withdrew from the agreement in respect of corporation income tax, and therefore joins Ontario and Quebec as a province which collects its own taxes in this area. Quebec remains the only province to collect its own personal income tax.
One change that is of some significance to the provinces involves the 1977 arrangement for protection of provincial income tax revenue against reductions in the federal tax base during the first year of any change. This revenue guarantee has been extended to March 31, 1987.

3. Established Programs Financing

The Bill amended the Fiscal Arrangements Act to allow a simpler formula for calculating federal payments under the Established Programs Financing. Previously the calculations involved a contribution equal to 50% of the 1975-76 federal per capita contributions, plus $7.63 (the cash equivalent of one point of individual income tax provided for under the 1972 revenue guarantee), multiplied by the province's population and escalated according to a three-year moving average gross national product per capita. Beginning in 1982-83 the total EPF entitlements are equal to the national average per capita total federal contribution in 1975-76 multiplied by provincial population and escalated as before.

The actual cash payment is reduced by the cash equivalent of 13.5 percentage points of personal income tax, one percentage point of corporate income tax that the federal government has rebated to the provinces and the associated equalization payment.

4. Other changes

Bill C-97 eliminated the expiry date on the stabilization program thereby making the program a permanent feature. The reciprocal taxation agreements were extended to cover licences for off-road vehicles and interest otherwise payable by the federal government and to enable the federal government to collect taxes or fees on behalf of the provinces in its role as a vendor of goods and services. Under the Act any overpayment of equalization entitlement is recoverable by the federal government. However the Act was amended to allow the federal government to forgive rather than collect such amounts from the provinces.

C. Financial Impact

The federal government intended to realize a savings on social affairs transfers to the provinces in this round of discussions on the fiscal arrangements. The introduction of the new equalization standard and the termination of the 1972 revenue guarantee ensure that federal
payments to the provinces in the 1982-87 period will be lower than what the provinces would have received. In fact the federal government succeeded in implementing cuts in certain programs (see Table I) for the first time in a decade. In fiscal 1982-83, under the Established Programs the federal government realized a $424 million reduction of transfers to the provinces while under the Equalization Program it cut back transfers by $41 million dollars. From the point of view of the provinces the cutbacks are greater because they expected the value of the federal transfers to increase under the old agreements. In spite of these cutbacks, total federal cash transfers continued to increase and are expected to exceed $18.5 billion in fiscal 1984-85. Tax transfers are expected to add a further $7.3 billion for a total federal tax and cash transfer to the provinces of $25.8 billion in fiscal 1984-85.
<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Equalization Payments</th>
<th>Hospital Insurance</th>
<th>Medicare</th>
<th>Post-Secondary Education</th>
</tr>
</thead>
<tbody>
<tr>
<td>72-73</td>
<td>1176</td>
<td>1019</td>
<td>629</td>
<td>481</td>
</tr>
<tr>
<td>73-74</td>
<td>1500</td>
<td>1073</td>
<td>676</td>
<td>485</td>
</tr>
<tr>
<td>74-75</td>
<td>1795</td>
<td>1360</td>
<td>760</td>
<td>503</td>
</tr>
<tr>
<td>75-76</td>
<td>1956</td>
<td>1754</td>
<td>793</td>
<td>535</td>
</tr>
<tr>
<td>76-77</td>
<td>2169</td>
<td>2007</td>
<td>1001</td>
<td>648</td>
</tr>
<tr>
<td>77-78</td>
<td>2521</td>
<td>1754</td>
<td>596 (a)</td>
<td>1095</td>
</tr>
<tr>
<td>78-79</td>
<td>2632</td>
<td>2252</td>
<td>715</td>
<td>1365</td>
</tr>
<tr>
<td>79-80</td>
<td>3309</td>
<td>2462</td>
<td>814</td>
<td>1515</td>
</tr>
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<td>2474</td>
<td>857</td>
<td>1600</td>
</tr>
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<td>4484</td>
<td>2655</td>
<td>907</td>
<td>1628</td>
</tr>
<tr>
<td>82-83</td>
<td>5126</td>
<td>2406</td>
<td>828</td>
<td>1532</td>
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<tr>
<td>83-84</td>
<td>5085</td>
<td>2895</td>
<td>997</td>
<td>1842</td>
</tr>
</tbody>
</table>

(a) Beginning in fiscal 1977-78 transfers for Extended Health Care Services were listed separately from Medicare. They are roughly equal in magnitude to the Medicare transfers.

Source: Public Accounts of Canada (1947-48 to 1982-83), Main Estimates (1983-84 and 1984-85) and Department of Finance data.
D. The Canada Health Act, 1984

The criteria and conditions of payment for the cash portions of the federal contributions made to the provinces for insured health services and extended care services are set out in the Canada Health Act. This Act replaces the Hospital Insurance and Diagnostic Services Act and the Medical Act. It came into force on April 1, 1984.

The most important changes in the criteria and conditions attached to federal contributions concern extra-billing by doctors and user charges, and general non-compliance with the Act on the part of the provinces. Under the Act if any provincial plan fails to satisfy any of the program criteria or if a province fails to comply with the conditions of payments there may be a unilateral reduction in the cash portion of the federal contribution. Where a province fails to comply with the conditions regarding extra-billing and user charges, the cash portion of the federal contribution is withheld in an equal amount. As of the end of 1984, a total of $57.2 million has been withheld from provinces not conforming to the provisions of the Act. In the first three years after proclamation these funds will be held in the Public Accounts of Canada and will be paid to those provinces which eliminate the practice of extra-billing and user charges. The amounts of funds withheld from the provinces are shown in Table II. Currently it is estimated that annual penalties could reach $114.5 million.
### TABLE II

Federal Health Contributions Withheld from the Provinces as of November 30, 1984

dollars

<table>
<thead>
<tr>
<th>Province</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newfoundland</td>
<td>- nil -</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>- nil -</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>- nil -</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>1,710,000</td>
</tr>
<tr>
<td>Quebec</td>
<td>4,385,000</td>
</tr>
<tr>
<td>Ontario</td>
<td>22,320,000</td>
</tr>
<tr>
<td>Manitoba</td>
<td>450,000</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>765,000</td>
</tr>
<tr>
<td>Alberta</td>
<td>5,520,000</td>
</tr>
<tr>
<td>British Columbia</td>
<td>12,665,000</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>47,715,000</strong></td>
</tr>
</tbody>
</table>

**Source:** Health and Welfare Canada.
CHRONOLOGY

1937 – Royal Commission on Dominion-Provincial Relations (Rowell-Sirois Commission) appointed in August; their report recommended a system of “National Adjustment Grants” which, while not established, are acknowledged as forerunners of contemporary equalization grants.

1941 – The Wartime Tax Agreement arranged for the withdrawal of the provinces from certain taxation fields for the duration of the war.

1947 – Dominion-Provincial Tax Rental Agreements Act passed by Parliament and all provinces except Quebec and Ontario; rental of tax fields extended for 5 years; Newfoundland passed similar legislation in 1949.

1952 – Tax Rental Agreements Act passed by the federal government and all provinces except Quebec.

1954 – Quebec introduced a personal income tax.

1957 – Parliament passed Hospital Insurance and Diagnostic Services Act; by January 1961 all provinces had hospital insurance in effect. Equalization payments now explicitly part of governing Federal-Provincial Tax-Sharing Arrangements Act.

1958 – Atlantic Provinces Adjustments Grants made part of fiscal arrangements.


1964 – Tax Structure Committee formed to study fiscal arrangements.

1965 – Established Programs (Interim Arrangements) Act was passed. Although only Quebec took advantage of it, this Act allowed provinces to opt out of the major shared-cost programs with the agreement that they would carry on similar programs and would report periodically to the federal government.

1966 – Medical Care Act passed by Parliament; all provinces were included by January 1971.

1967 – Federal-Provincial Fiscal Arrangements Act took effect; with this round the annual per capita grants to universities, established in 1952, were made part of the fiscal arrangements package.

1975 – A ceiling was placed on per capita growth in the federal contribution to major shared-cost programs; the calculation of equalization was amended to minimize the impact of rising oil prices.
1977 – The Federal-Provincial Fiscal Arrangements and Established Programs Financing Act brought the major joint programs - medicare, hospital insurance and post-secondary education - together as part of the fiscal arrangements.

Nov. 1978 – Finance Minister Chrétien announced changes in the equalization formula: without the adjustment, it was projects that Ontario would become a recipient within a year.

1981 – Parliamentary Task Force set up to examine the programs under the Fiscal Arrangements Act. Its report was submitted in August.

1982 – Bill C-97, an Act to amend the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977 was introduced and adopted. It amended the lists of revenue sources (increased to 33 types), implemented the representative average standard in the equalization formula, and set minimum and maximum equalization payments.

SELECTED REFERENCES


(9) Statistics Canada, Provincial Government Finance, catalogue 68-205, Supply and Services Canada, Ottawa, (various years).