Reforming Canada's Intergovernmental Fiscal Relations in a Post-Pandemic World

Draft Proposal– November 2020

SUMMARY:

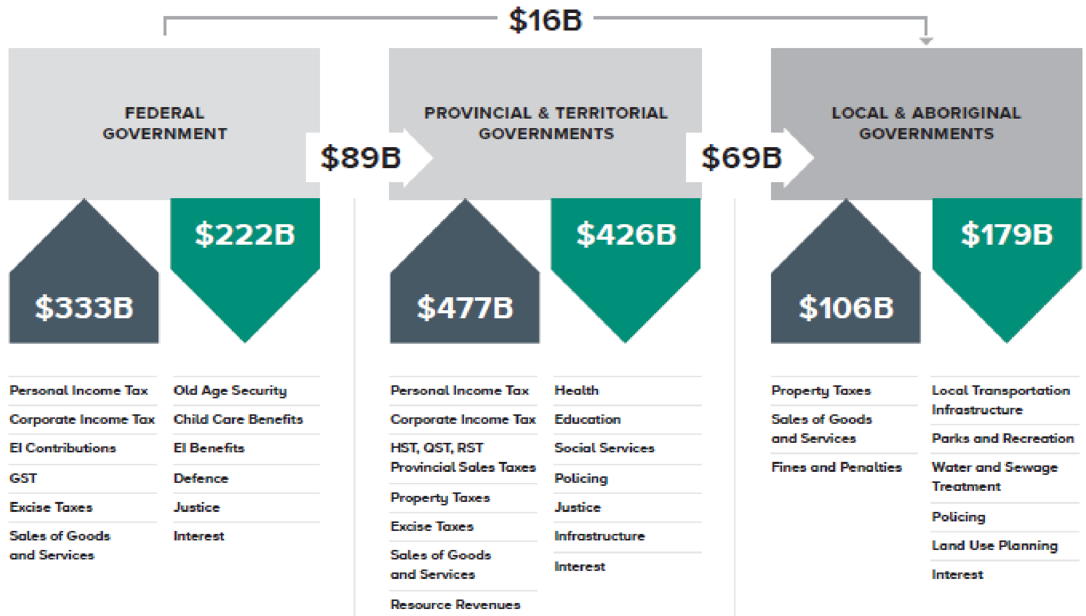
Canada is one of the most decentralized federations in the world, with the federal government playing a key role in raising tax revenues and providing income security programs, while the provinces and municipalities are responsible for delivering the big ticket items — health, education, social services, and infrastructure. To fund these expenditures, the provinces use their substantial tax powers to raise more tax revenues than any other subnational governments in the world. They also receive substantial transfers of funds from the federal government who share the same tax space for the most part. Municipalities rely on property taxes, user fees and grants from the federal and provincial government to provide basic services such as water and sewage and parks and recreation.

The COVID-19 emergency spending measures and the sharp declines in tax revenues and user fees are having an unprecedented fiscal impact on all governments as deficits soar. The long-term implications are difficult to assess but could be significant if the economic recovery is slow and governments finance interest payments on higher debt levels. These events have highlighted the need for a re-examination of the structural foundations of Canada's intergovernmental fiscal relations.

Intergovernmental fiscal relations are complex and multidimensional. They range from formal arrangements for transfers among the orders of government to the interactions from uncoordinated taxation and spending decisions by each government. These are the topics of almost every meeting of the Prime Ministers and Premiers, Cabinet Ministers and Mayors and Councilors.

To address the ongoing issues that have now been exacerbated by the COVID-19 crises, we propose establishing a pan-Canadian commission that would recommend reforms to intergovernmental fiscal relations in Canada. The Intergovernmental Fiscal Relations Commission would be modelled on the Ecofiscal Commission that brought together experts and an advisory board of policy practitioners to identify and communicate solutions to critical issues. The Intergovernmental Fiscal Relations Commission would emphasize workable solutions that could create an intergovernmental consensus as well as communicate those solutions to the public.

CANADIAN GOVERNMENTS | 2018 FISCAL FLOWS



CHALLENGES:

Fiscal relations challenges have been a long-standing concern of provincial leaders and at times federal governments. It is a complex and controversial subject that contributes to strained federal-provincial relations. Perceptions of fairness and concerns about sustainability of critical health and social programming are at issue. One on-going concern is that federal transfers are determined by the federal government independently of the provinces, despite their impact on provinces who deliver services within their jurisdiction.

The second challenge is that the current mix of expenditure responsibilities, tax powers, and intergovernmental grants is unsustainable. Prior to the COVID-19 crisis, provincial governments are running deficits and increasing debt levels over the longer-term (Parliamentary Budget Officer). As we have seen with the current COVID-19 crisis, the federal government is in a much stronger fiscal position compared to provinces-territories and municipalities to deal with the costs of this response.

The third challenge is that Canada's fiscal relations ignore the increasingly important role of municipalities. While municipalities are the jurisdiction of provinces under the Constitution, the growth of city states means the role of municipalities cannot be ignored any further. There is an urgent need to re-assess federal, provincial and municipal expenditure responsibilities, tax powers, and intergovernmental transfers in Canada to address the looming fiscal imbalances.

Two imbalances are driving these concerns:

- Horizontal imbalances – The horizontal fiscal imbalances arise because of differences in regional economic conditions. This gives rise to differences in the fiscal capacities of the provinces. The Equalization Program is the main formal program for dealing with differences in provincial fiscal capacities, but this program has been criticized for distorting the fiscal decisions of the recipient provinces. The Fiscal Stabilization Program has been criticized for failing to provide adequate support provincial governments that have suffered major revenue reductions due to adverse economic shocks.

- Vertical imbalances – In the division of powers under the constitution, the provinces, territories, and municipalities have responsibility for the delivery of the country's major expenditure programs — health, education and social services, and provision of most of Canada's public infrastructure. The financial pressures on the provinces and territories are increasing with rapidly rising expenditures on health care, in particular. And public demand for new programs, such as Pharmacare and greater support for mental illness and addiction will exacerbate the problem. At the same time, municipal governments face fiscal challenges in funding infrastructure projects.

PRINCIPLES:

The Intergovernmental Fiscal Relations Commission is committed to the following principles to help guide the work of the Commission in providing evidence-based research, analysis, and advice in strengthening and modernizing Canada's intergovernmental fiscal relations.

1. <u>Reform intergovernmental fiscal relations within Canada's constitutional framework</u>. Reforming tax powers, expenditure responsibilities and intergovernmental transfers can be done within the existing constitutional framework, which has proven to be remarkably flexible in accommodating the evolution of the federation. We are not recommending changes to the Canadian Constitution but recognize the need to involve municipalities in future fiscal discussions.

2. <u>Retain Canada's fiscally decentralized federation.</u> Canada's decentralized federation has served the country well by fostering greater innovation to reflect regional differences while providing the benefits of a centralized federal government and pan-Canadian coordination of efforts. Provinces and municipalities should have substantial tax revenues and expenditure responsibilities to deliver critical public services.

3. <u>Promote fiscal transparency and accountability</u>. Clear and transparent connections between revenue and spending can enhance accountability and hold each order of

government responsible for outcomes. Disentangling overlapping tax and expenditure powers will improve transparency and accountability.

4. Create an efficient, sustainable and fair fiscal federation. Increasing the efficiency and effectiveness of the federation improves productivity and fosters greater economic growth and prosperity. Growth supports the financing of public services and policies to address income disparities and promote social cohesion. An efficient and fair federation requires a sustainable approach to addressing vertical and horizontal fiscal imbalances.

POLICY AREAS:

The Intergovernmental Fiscal Relations Commission will address three interrelated policy areas. The first concerns reforms to Canada's Federal Provincial Fiscal Arrangements that address the rapidly increasing demands for public services.[1] The changes to the transfer programs can be divided into those requiring immediate, medium and long-term attention. The immediate issue is the reform of the Fiscal Stabilization Program. The medium-term issue is the reform of the Equalization Program. The long-term issue is the reform of the Health and Social Transfers.

The second concerns the coordination public services and income support programs expenditures among the three orders of government. While the Constitution defines the responsibilities and powers of the federal and provincial governments, there are significant interdependences and overlaps in many areas including income security programs, the environment, justice and infrastructure. A re-examination of the roles played by each order of government, within the provisions of the Constitution, is in order to enhance harmonization and eliminate gaps.

The third concerns the financing of municipal governments and their role in the provision of basic public services and infrastructure. These roles are evolving and vary across regions and by population. The large cities in Canada are confronted with new challenges in providing a wider range of services and core infrastructure, while smaller communities, especially in rural areas, are challenged by declining and aging populations. These issues affect communities across the country and have direct impacts on every Canadian's quality of life.

---

[1] The last major federal review was in 2006, the Expert Panel on Equalization and Territorial Formula Financing (O'Brien Report). Provinces have produced their own analyses: Quebec – Seguin Report 2002, Ontario Mowat Centre 2018 A Fair Fiscal Deal: Towards a more principled allocation of federal transfers, 1998 BC Budget, Council of the Federation 2006, 2020 Alberta Budget, among others.

PROJECT OUTINE

Project Goal: The Intergovernmental Fiscal Relations Commission will inform policymakers of all political stripes, at all levels of government, all across the country of the principles and reforms to the federation's fiscal architecture. Its secondary purpose will be to inform the public on the complex topics that go to the heart of both fairness and purpose of Confederation.

Approach: To address the ongoing concerns, an Intergovernmental Fiscal Relations Commission is proposed. An independent team of academic experts and policy practitioners from a variety of disciplines across the country will recommend practical reforms to the system of intergovernmental fiscal relations in Canada. Like a Royal Commission, it would take a coordinated deep dive into complex questions; unlike a Royal Commission it would be independent of government appointments or political priorities.

The Commission would be modelled on the Ecofiscal Commission, which was successful in both providing sensible solutions and raising public awareness on difficult problems.

The Commission structure is a key strength. It includes:

1) Commissioners: independent academic experts and experienced practitioners in government finance and federalism from across the country.
2) Advisory board: respected leaders across the political spectrum representing both federal and provincial perspectives. The Advisory Board provides critical insight, guidance, and perspectives on designing practical and effective policies for Canada's unique context.
3) Staff: research, editing, communications and meeting support provided by hosting institutions, the Canada West Foundation and the Institute for Research on Public Policy.

The Commission would publish research papers, policy briefs and op-eds on proposed changes to intergovernmental fiscal relations.

Scope: The Commission would make recommendations for the reform of fiscal relations among the federal, provincial and municipal governments given the provisions of the Canadian Constitution. Fiscal relations between the First Nations governments and the other orders of government in Canada are beyond the scope of the Commission. A separate commission should be established to report on these important issues

Timing: The Commission would have three years to complete its mandate. The first priority would be preparing a landscape paper on the Canadian Fiscal System, the impact of COVID-19 on fiscal resources and the pressures for reform. The next priority would be a paper assessing options for the reform of the Fiscal Stabilization Program. Next on the agenda would be the reform of the Equalization Program and the Territorial Formula Financing program, which are to be renewed in 2024. Proposals for the reform of the health and social transfers, infrastructure grants municipal transfers, changes in tax fields and expenditure responsibilities would then round-out the Commission's mandate.

STEERING COMMITTEE MEMBERSHIP

Daniel Béland
Professor and Director
McGill Institute for the Study of Canada

Charles Breton
Executive Director
Centre of Excellence on the Canadian Federation
Institute for Research on Public Policy

Colleen Collins
Vice-President
Canada West Foundation

Bev Dahlby
Executive Fellow
Canada West Foundation
Retired Research Director
School of Public Policy
University of Calgary

Steve Orsini
Distinguished Fellow
Munk School of Global Affairs and Public Policy
University of Toronto

Enid Slack
Director of the Institute on Municipal Finance and Governance
Munk School of Global Affairs and Public Policy
University of Toronto

Trevor Tombe
Associate Professor
Department of Economics
University of Calgary

APPENDIX: HOW DID THE ECOFISCAL COMMISSION OPERATE?

The Commissioners met face to face twice a year for two-day meetings where the topics and outlines for future reports were discussed and agreed upon. Working drafts of reports, prepared by the research staff, were circulated in advance of the meetings. These reports underwent a process of "creative destruction" during the meeting which resulted in substantive changes in tone and substance. The revised drafts, based on the collective input of the Commissioners, were subsequently circulated and discussed by the Commissioners in a conference call. Based on these comments, a final version was prepared by the research team.

The Commission's reports were consensus documents. Reaching agreement was not always easy, but a great deal of trust developed over the five years and there were no "minority reports."

In total, the Commission produced 10 major reports and six shorter reports, which internally were known as Snappers. A great deal of effort went into the communications strategy, with op-eds, social media, videos, webinars, media interviews and a conference.