Tax Point Transfers in Canada

An Historical Review and Key Considerations for the Future

FFPN Fiscal Federalism Policy Network

June 2023

Bev Dahlby, Trevor Tombe & Steve Orsini

About the Fiscal Federalism Policy Network (FFPN)

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 will take a coordinated deep dive into complex questions; unlike a Royal Commission it would be independent of government appointments or political priorities. The Network will publish research papers, policy briefs and op-eds and make recommendations for the reform of fiscal relations among the federal, provincial and municipal governments within the framework of the existing Canadian Constitution.

The Fiscal Federalism Policy Network

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

Charles Breton
Executive Director, Centre of Excellence on the Canadian Federation, IRPP

Colleen Collins
Vice-President, Canada West Foundation

Bev Dahlby
Senior Fellow, Canada West Foundation, Research Fellow School of Public Policy, University of Calgary

Herb Emery
Vaughan Chair
University of New Brunswick

Marcelin Joanis
Professor, Department of Mathematics and Industrial Engineering, Polytechnique Montreal

Margaret Melhorn
Former Deputy Finance Minister, Government of the Northwest Territories

Haizhen Mou
Professor, Johnson Shoyama Graduate School of Public Policy, University of Saskatchewan

Steve Orsini
Adjunct Professor, Public Policy and Administration, Carleton University and Sr Fellow, C.D. Howe Institute

Nathalie Des Rosiers
Principal Massey College, Former Dean, Faculty of Law-Common Law at the University of Ottawa

Enid Slack
Director, Institute on Municipal Finance and Governance, University of Toronto

Michael Smart
Professor, Department of Economics, University of Toronto

Tracy Snoddon
Associate Professor, Lazaridis School of Business, Wilfrid Laurier University

Trevor Tombe
Professor, Department of Economics, University of Calgary

Table of Contents

Introduction

The pressures on provincial government finances have been building for some time, given the current mix of expenditure responsibilities, tax powers, and intergovernmental grants. Studies by the Parliamentary Budget Officer (2020, 2021 and 2022) and Tombe (2020b) indicate that the ten provinces and territories, as a whole, will have increasing debt levels over next 30 years and beyond, which was only exacerbated by the Covid-19 pandemic. Although the federal government has incurred a large deficit in response to the Covid-19 crisis, and provinces have seen some improvement in the short term due to higher energy prices and nominal revenue growth, the federal government is still in a much stronger fiscal position structurally than the provinces, territories, and municipalities. Further pressures on intergovernmental finances are bound to occur following the federal government's commitment to enhancing programs in areas of provincial jurisdiction, such as pharmacare, childcare, dental care, and eldercare. In the past, implementing national standards in areas of provincial jurisdiction has required increases in federal transfers to the provinces. Usually these have been cash transfers, but the federal government has also used tax point transfers in the past to enable provinces to finance the increased cost of federally mandated programs. At their peak in the late 1990s, tax point transfers accounted for nearly 40% of all federal fiscal transfers to provinces (Tombe 2018). Recently, there has been renewed interest in a tax point transfer to help resolve the fiscal challenges of the provincial governments, including among political leaders, commentators (Ibbitson 2020), and policy analysts (Nicholson 2023).

Should tax point transfers, rather than increases in cash grants to the provinces, be used to enable the federal government to introduce a national pharmacare program, enhance childcare and eldercare programs, and improve the long-term fiscal position of the provinces?

To understand the implications of a tax point transfer, this report begins with a brief history of tax point transfers and how provincial governments' responded to the tax point transfers that occurred in the 1970s. It then discusses some of the issues that would arise with a future tax transfer given the current main sources of federal and provincial tax revenues.

Tax Point Transfers

A Brief History

Tax point transfers are traditionally understood as shifting tax room between governments. Canada has a long history of such transfers. Historically, the original terms of Confederation called for individual colonies to shift the entire room to tax imports to the federal government. And during the second world war, personal and corporate income taxes, along with estate taxes, were also fully shifted to the federal level. But after the war, a long and sometimes difficult process of the federal government returning some of this tax room back to the provinces, began. Following several rounds of negotiation spanning many decades, the federal government would lower their tax rates while provinces would simultaneously increase theirs. Starting in 1947 with five percent of the federal personal income tax and five percentage points of the corporate tax rate shifted, this gradually increased to reach 28 percent points of personal income taxes and ten percentage points of the corporate tax rate by 1971.[1]

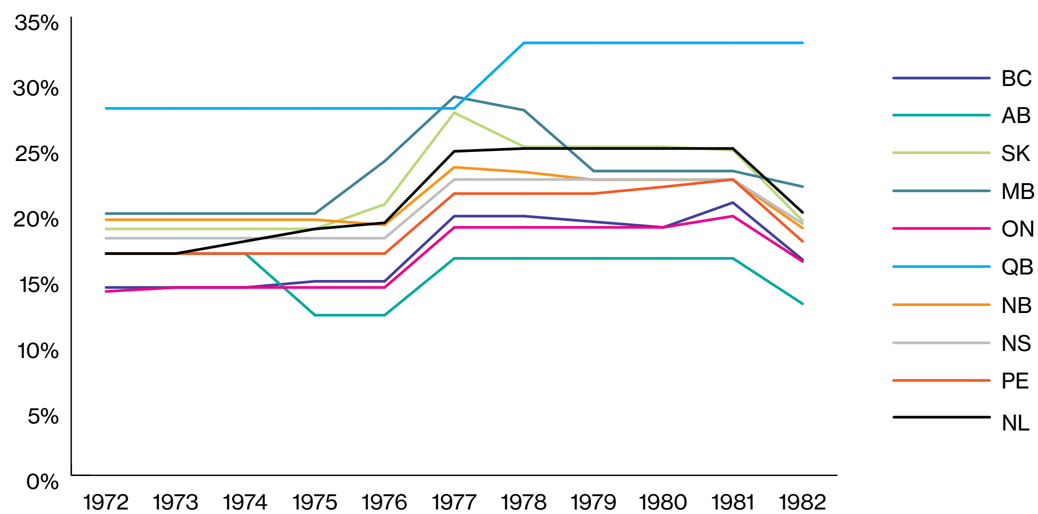
The last major tax point transfer occurred in 1977, when the federal government introduced the Established Programs Financing (EPF) transfer, which supported provincial health and education spending. Under the EPF, the provinces received an equal per capita transfer, composed of cash and the value of federal personal and corporate income tax rate reductions. The federal government considered its tax rate reductions as a transfer, equivalent to a cash transfer, because the province could increase their revenues by increasing their tax rates on these bases without increasing the overall tax burden. As the value of tax points differed across provinces, federal cash transfers to provinces were subsequently adjusted in order to equalize the value of the tax point and cash transfers. The tax point transfers determined the value of the cash transfers to provinces up until 2007 when the federal government moved to equal per capita cash transfers for the Canadian Social Transfer. In 2014 the Canadian Health Transfer became an equal per capita cash transfer. The tax point transfers are still used to evaluate entitlements to the federal Fiscal Stabilization Program.

---

1 There were also historical tax point transfers on inheritances taxes, but as these do not exist today so we abstract from them here.

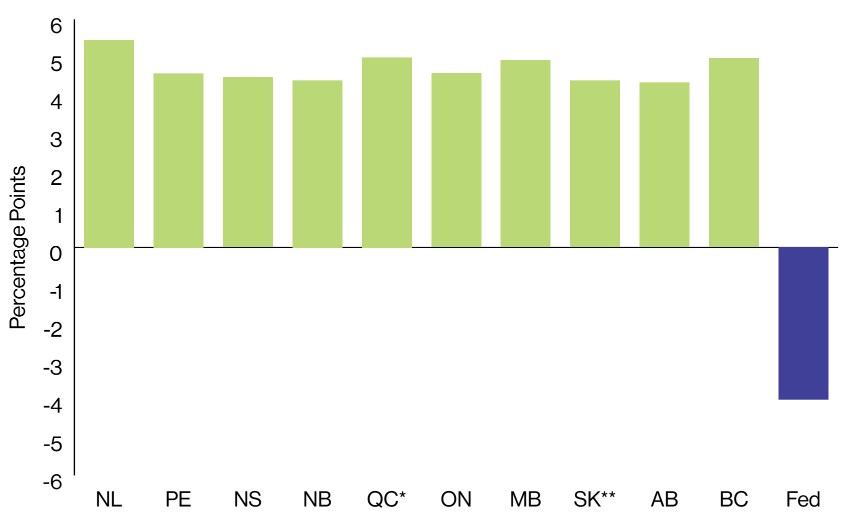
Below we document the changes in the provincial personal and corporate income tax rates in response to the tax point transfers. As Figure 1 indicates, most provinces increased their top personal income tax rates in 1977 in response to the reduction in federal personal income tax rates. The exceptions were Quebec and Saskatchewan, which increased their personal income tax rates in 1978. Figure 2 shows that in response to the 4.0 percentage point reduction in the top federal marginal tax rate, the provinces increased their top marginal personal income tax rates between 4.34 percentage points in Alberta and 5.46 percentage points in Newfoundland and Labrador. This resulted in increases to the combined federal and provincial top marginal tax rates in all provinces, ranging from 0.34 percentage points in Alberta to 1.46 percentage points in Newfoundland and Labrador, following the tax point transfer.

Figure 1: Provincial Top Marginal Personal Income Tax Rates (1972 to 1982)



Source: Authors' calculations from Finances of the Nation, Statutory Tax Rates

Figure 2: Changes in the Top Personal Marginal Income Tax Rates Following the 1977 Tax Point Transfer



* The tax rate change for Québec is between 1977 and 1978.

** The tax rate change for Saskatchewan is between 1976 and 1978.

For the other provinces and the federal government, the change is between 1976 and 1977.

Source: Authors' calculations from Finances of the Nation, Statutory Tax Rates

Provincial responses to the corporate income tax point transfer varied more significantly in terms of the timing and magnitude of the changes, as shown by the tax rates changes highlighted in Table 1. In 1976, the federal government reduced its general corporate income tax rate from 38.2 percent to 36.0 percent. Newfoundland and Labrador increased its tax rate by one percentage point in 1976, while Nova Scotia, Manitoba, and British Columbia increased their rates by two percentage points in 1976. New Brunswick and Saskatchewan increased their tax rates by two percentage points in 1977. Both Ontario and Quebec did not increase their rates until 1979 and 1980 respectively, and thus, it is not clear whether the federal tax rate reduction influenced the corporate tax adjustments in these provinces. Finally, Alberta and Prince Edward Island did not increase their general corporate income tax rates until 1987, likely in response to deteriorating fiscal positions, rather than the federal government corporate tax point transfer of 1977.

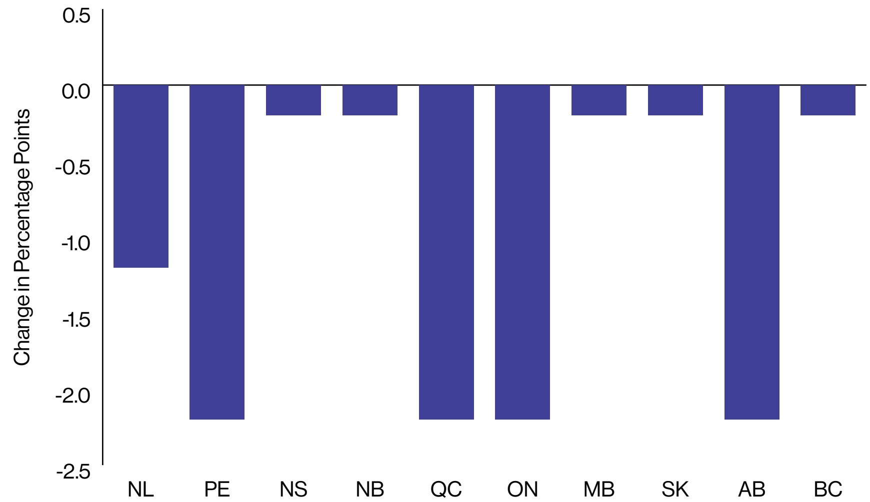
Table 1: Federal and Provincial General Corporate Income Tax Rates 1972 to 1982

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Fed
1972	13	10	10	10	12	12	13	12	11	13	36.5
1973	13	10	10	10	12	12	13	12	11	13	39.0
1974	13	10	10	10	12	12	13	12	11	13	40.6
1975	13	10	10	10	12	12	13	12	11	13	38.2
1976	14	10	12	10	12	12	15	12	11	15	36.0
1977	14	10	12	12	12	12	15	14	11	15	36.0
1978	14	10	12	12	12	13	15	13	11	15	36.0
1979	14	10	12	12	12	14	15	14	11	15	36.0
1980	15	10	13	12	13	14	15	14	11	15	37.8
1981	15	10	13	14	13	14	15	14	11	16	37.8
1982	16	10	15	14	8	14	15	14	11	16	37.8

Notes: Significant provincial tax rate changes following the 1976 federal corporate income tax rate reduction are highlighted in green.
Source: Authors' calculations from Finances of the Nation, Statutory Tax Rates

Given the varied responses and non-responses by the provinces, there were significant differences in the reductions in the combined federal and provincial corporate income tax rates between 1975 and 1977 as shown in Figure 3.

Figure 3: Changes in the Combined Federal and Provincial General Corporate Income Tax Rates Between 1975 and 1977



Source: Authors' calculations from Finances of the Nation, Statutory Tax Rates

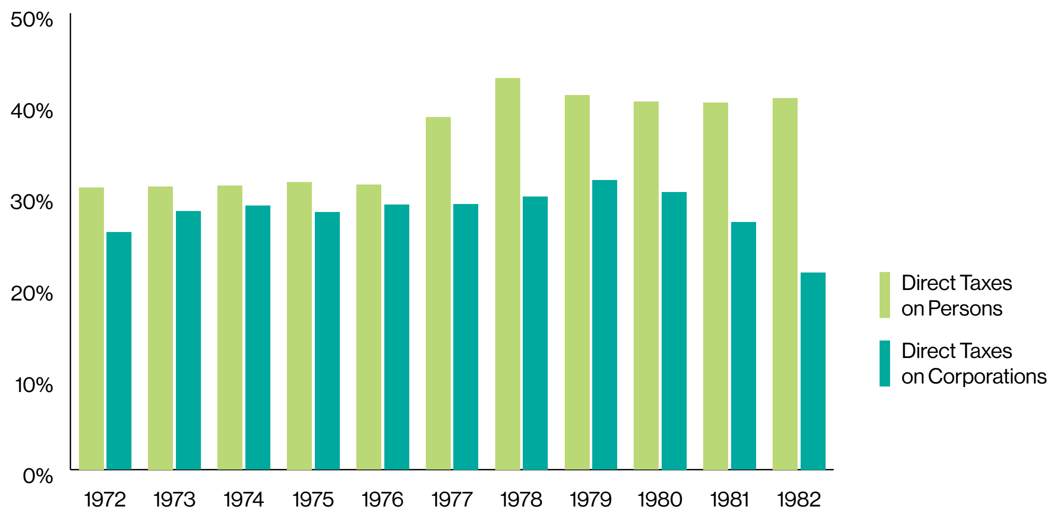
The objective of the tax point transfers was to allow the provinces to collect more personal and corporate income tax revenues without increasing the overall tax burden. As we have seen, in practice the overall personal income tax rate increased, at least in the top tax brackets, while the combined corporate tax rate declined. The different responses to the federal personal and corporate income tax rate reductions may be a reflection of the greater degree of corporate tax rate competition among the provinces because the corporate income tax base is more mobile and hence more sensitive to provincial tax rate differentials than the personal income tax base.

The objective of the tax point transfers was to allow the provinces to collect more personal and corporate income tax revenues without increasing the overall tax burden.

The overall impact of the tax point transfers on the federal and provincial shares of personal and corporate income tax revenues is shown in Figure 4. The provincial governments' share of the personal income tax revenues was fairly constant and averaged 31.1 percent between 1972 and 1976. Their share then jumped to 38.6 percent in 1977 and 42.9 percent in 1978 by which time Quebec and Saskatchewan had increased their top personal income tax rates. Subsequently, the provinces' share of the personal income tax revenues has remained close to 40 percent. Therefore, the tax point transfer had a major impact on the structure of total tax revenues in Canada, with the provinces becoming major players in the personal income tax field.

In contrast, the impact of the corporate income tax point transfer was smaller. The provincial governments' share of corporate tax revenues only increased by 0.8 percentage points between 1975 between 1977 and only increased from 28.2 percent in 1975 to 31.7 percent in 1979, when Ontario finally increased its corporate tax rate. Note also that the provincial share of corporate income tax revenues declined to 21.7 percent in 1982 when Quebec cut its rate by 5 percentage points.[2] Thus, in aggregate, the provinces' share of corporate income tax revenues was lower in 1982 than in 1975, although this reduction was largely due to Quebec's policy of cutting its corporate income tax rate and raising other business taxes. However, since 2000, the provincial governments' share of corporate tax revenues has increased and approaches 40 percent of the total, because the federal government reduced its general statutory rate from 29.12 percent in 2000 to 15 percent in 2012, while the weighted average provincial rate declined by only 3 percentage points over that period.

Figure 4: Provincial Government Shares of Tax Revenues (1972 to 1982)



Source: National Accounts Data, Fiscal Reference Tables 1996, Table 31 and 33

[2] Quebec's reduction in its corporate tax rate was accompanied by increases in its payroll and capital taxes which were deductible under the federal corporate income tax.

Issues to Consider in Evaluating a Future Tax Point Transfer

In this section, we consider some of the issues that would arise if the federal government were to consider transferring additional tax room to the provinces.

Are Tax Point Transfers Actually Transfers?

A tax point transfer is fundamentally different from a cash transfer. The former shifts which order of government raises revenue directly from a particular tax base, which can also rise or fall based on overall economic conditions and the tax rates imposed by that government. The latter is a payment made out of expropriations of Parliament that are determined by federal government policy. The tax point transfers that occurred in the postwar period allowed the provinces to re-enter the income tax fields that they had ceded to the federal government to help finance the World War II effort. For personal and corporate taxation, each order of government has full constitutional authority to increase or decrease their tax rates in many areas, including personal and corporate income and sales taxes. However, as we have seen, the provinces are not obliged to match any unilateral federal government tax cuts with their own equivalent tax increases. Recently, for example, the federal government independently lowered their GST rate from 7 percent to 5 percent. With the increased tax room, some provinces subsequently increased their sales tax rates to take-up this room while other provinces did not, and in two cases, the rate cut provided additional impetus for British Colombia and Ontario to later harmonized their sales tax with the federal GST. From these perspectives, a tax point transfer is not really a transfer of revenue but the ability to shift the responsibility for taxation from one level of government to another. Nonetheless, because of the way the 1970s federal tax rate reductions were described at the time and the way they were used to determine the provincial governments' cash transfers, it is reasonable to continue to refer to the potential for a coordinated change in federal and provincial tax rates as a tax transfer.

It is also important to note that a tax point transfer is not a once-and-for-all transfer of financial resources to the provinces because the federal government could subsequently increase its tax rates to "take back" the tax room that it has ceded to the provinces. A federal tax rate increase will reduce provincial personal income tax revenues because tax avoidance and evasion will increase in response to an increase in the combined federal and provincial income tax rate eroding the personal income tax base. In the public finance literature, this interaction between federal and provincial tax policies is known as a negative vertical tax externality.[3]

Which Federal Taxes Could be Transferred?

There are several tax bases that could be transferred, though each choice has pros and cons. Consider first an administrative issue with transferring personal income tax room. The personal income tax is the largest source of revenue for both the federal and provincial governments, with provinces collecting around 40 percent of the total. A personal income tax point transfer by the federal government to the provinces would move the system closer to a 50-50 split of the personal income tax. But shifting personal income tax room is more difficult today than historically. Prior to 2000, provinces, except Quebec, levied their taxes upon federal basic income taxes owing. That is, taxpayers were not subject to provincial income taxes per se, but were instead subject to federal income taxes that provinces levied an additional tax upon. This tax-on-tax approach was eliminated after 2001, which, importantly, provided provinces with flexibility to choose their own tax brackets. Lowering federal income tax rates and increasing provincial tax rates would today no longer be revenue neutral across taxpayers because basic personal amounts vary widely. This is not an insurmountable challenge, however, as the federal government could provide a universal tax credit on basic federal amounts owing and provinces could re-introduce a tax-on-tax of the same amount. However, this would add complexity and opacity to the personal income tax system that recent reforms have sought to eliminate.

A personal income tax transfer could also have important implications for future income tax policy and tax collections. The federal government has had a dominant role in defining the income tax base and a major influence on the tax rate structure, especially before 2000, when provincial income taxes, except in Quebec, were levied as a percentage of federal tax payable. That dominant position and leadership role would be challenged if the provincial governments imposed close to half (50%) of the personal income tax burden on Canadians. Furthermore, the Canada Revenue Agency (CRA) collects the provincial personal income in all provinces, except Quebec, at no direct cost to the provinces. With an equal split in the tax revenues, would the federal government be willing to continue to pay for the provincial tax collection?[4] Would the provinces not want a greater say in the management of the CRA? For these reasons, some fundamental changes in personal income tax policy and federal-provincial tax collection agreements might follow from a tax point transfer to the provinces.

---

3 For clarity, when both orders of government levy taxes on the same tax base, a tax rate increase by either order of government creates behavioural responses on the part of individuals and firms that tend to shrink that tax base. The other order of government will therefore see revenues decrease. In general, revenues of one order of government are inversely related to changes in tax rates by the other order of government.

4 Historically, the federal government earned income from the timing of payments – when income is collected and when payments are made to provinces. A change in tax share would reopen a long-standing debate between the federal government and provinces with federal tax collection agreements.

These issues would be even more pronounced in the corporate tax field. If the federal government reduced its general corporate income tax rate, provincial governments could increase their share of the corporate income tax revenues beyond the 40 percent that they currently collect. However, international tax competition is creating greater pressure to cut rates further and interprovincial tax competition might restrain provinces from fully offsetting a decline in federal rates. Some would view that as positive by increasing Canada's international tax competitiveness, but it would not, at least directly, put extra revenues in provincial coffers.

Sales and excise taxes are also major sources of revenue, but the provincial and territorial governments already collect two-thirds of the total taxes on goods and services in Canada.[5] Nonetheless, one option would be a reduction in the federal GST rate that would allow the four Atlantic provinces and Ontario to increase their Harmonized Sales Taxes (HSTs), Quebec to increase its Quebec Sales Tax (QST), and Manitoba, Saskatchewan, and British Columbia to increase their Retail Sales Taxes (RSTs). Since there are relatively minor differences between the federal GST base and Ontario's HST base and Quebec's QST base, the tax shift would have relatively minor impacts on taxes levied on most goods and services in those provinces. However, the RST bases in BC, Saskatchewan and Manitoba are substantially different from the federal GST base, especially with regard to whether services are taxable. An increase in the RST rates in these provinces would tend to increase the disparity between taxes on most goods and services in those provinces.

Finally, how would Alberta respond to a cut in the federal GST rate? An attractive option for the Alberta government would be to finally adopt an HST, possibly at the same rate as the decline in the federal GST rate, so that it could obtain the additional revenues without changing the sales burden on Albertans. This could be a first step towards using HST revenues to help stabilize Alberta's revenues.

Richard Bird has argued that Canada has been successful in levying value added taxes at the provincial level, whereas other countries have struggled to collect them at the subnational level, because the federal government's collection of both the GST and HST revenues has enabled it effectively impose provincial taxes on interprovincial sales of goods and services. Implicit in his views is that if the federal government eliminated the GST and turned the entire sales tax area to the provinces, the provincial sales tax collections on interprovincial sales might break down. Thus, the scope for a GST tax point transfer is relatively limited because the current federal rate is only five percent.

Both the federal and provincial governments levy excise taxes on liquor, tobacco, and gasoline and motive fuels. In 2018-19, the federal government collected $1.8 billion from excise taxes on alcoholic beverages, whereas the provinces collected $6.6 billion through the profits of their alcohol control agencies.[6] In 2018, the federal government collected $3.3 billion from tobacco taxes and $5.7 billion from motive fuels, while the provincial governments collected just over $5 billion from tobacco taxes and $10.4 billion from motive fuels taxes.[7] There seems to be no compelling policy rationale for federal excise taxes on alcohol, tobacco or motive fuels, given that all of the provinces tax impose effective rates

[5] Based on data for 2019 in Statistics Canada Government Finance Statistics (Table 10-10-0015-01)

[6] Statistics Canada Table: 10-10-0012-01

[7] OECD Revenue Statistics

that are much higher than the federal rate.[8] Federal withdrawal from the excise taxes on alcohol, tobacco, and motive fuels would have generated around $10.8 billion in "tax room" for the provincial governments. Whether this would be enough, assuming that the provinces boost their excise tax rates by the equivalent of the federal rates, to address the provinces' fiscal gaps will be a matter for future analysis once the funding required to cover the recently announced federal initiatives in areas of provincial responsibility is known.

The Impact on Provincial Revenues from a Tax Point Transfer

Shifting tax room would have varying impacts on the revenues of the provinces because the value of the tax point for PIT, CIT and GST are higher in Alberta, BC and Ontario than the other provinces. Ontario, for example, has nearly 39% of the population but is home to 45% of the taxable corporate income, 42% of the personal income tax base (as measured by the basic federal tax paid), and 40% of the sales tax base. This province therefore enjoys above-average per capita values for each of the three main taxation instruments. Prince Edward Island, meanwhile, is home to 0.4% of the population, but only 0.2%, 0.3%, and 0.4% of the corporate income tax, personal income tax, and sales tax bases, respectively. We report the full distribution of these tax bases and population across all provinces and territories in Table 2.

Table 2: Distribution of Canada's Population and Major Tax Bases (2021-22)

		Share of Total Tax Base (%)		
Province or Territory	**Population** (%)	**Corporate Income Taxes**	**Personal Income Taxes**	**Consumption Taxes (GST)**
NL	1.36	1.25	1.15	1.25
PE	0.43	0.19	0.31	0.36
NS	2.59	1.23	2.01	2.33
NB	2.07	1.05	1.43	1.78
QC	22.51	20.19	19.40	19.65
ON	38.75	44.62	41.94	40.10
MB	3.64	1.95	2.71	3.11
SK	3.09	2.49	2.60	2.74
AB	11.62	13.05	13.25	12.45
BC	13.60	13.80	14.89	15.94
YT	0.10	0.04	0.08	0.11
NT	0.12	0.08	0.13	0.12
NU	0.11	0.06	0.11	0.06

Source: Authors' calculations from the federal equalization worksheets for fiscal year 2021-22. For the GST, we use federal revenue per point collected in calendar year 2021 as reported in Statistics Canada data table 36-10-0450-01.

[8] The federal carbon levy on gasoline and diesel fuel is a separate matter. The federal backstop is not applied in provinces that apply an equivalent or higher carbon price and could be considered a tax transfer.

Differences in the distribution of tax bases across regions has important implications for the value of tax point transfers. To illustrate, if the federal government were to increase cash transfers by $1 billion on an equal per capita basis – through say the Canada Health Transfer or the Canada Social Transfer – then each province would receive $26.18 per person. However, if the equivalent amount of dollars ($1 billion) were transferred through a tax point transfer, the implications for provincial revenues would be very different. If income tax room was transferred, say through a 0.5 percent abatement on the basic federal personal income tax (which would be worth about $1 billion), and if each province increased its tax rates to take up this tax room, then Alberta would see provincial revenues increase by nearly $30 per person while New Brunswick would see revenues increase by only $18. Across all regions, the highest value of this tax point transfer (Alberta) is worth over 65% more per person than it is in the province or territory with the lowest value (NB). An even more extreme difference exists with corporate income taxes. A $1 billion transfer shifted in this way would be worth just $9 per capita in Yukon, but over $30 per capita in Ontario. Even sales taxes, which has a lower degree of variation across regions has meaningful differences in per capita values. We display the results for all regions for each of the three major tax bases in Table 3.

Table 3: Distribution of $1 Billion in New Federal Cash and Tax Point Transfers

	Dollars per Capita (2022)			
Province or Territory	**Canada Health Transfer**	**Corporate Income Taxes**	**Personal Income Taxes**	**Consumption Taxes (GST)**
NL	26.18	24.02	22.03	23.99
PE	26.18	11.64	18.68	22.07
NS	26.18	12.39	20.35	23.53
NB	26.18	13.32	18.07	22.56
QC	26.18	23.49	22.57	22.85
ON	26.18	30.15	28.34	27.09
MB	26.18	14.04	19.48	22.32
SK	26.18	21.10	21.96	23.18
AB	26.18	29.39	29.83	28.04
BC	26.18	26.56	28.67	30.69
YT	26.18	8.83	19.42	28.68
NT	26.18	17.58	29.46	25.82
NU	26.18	14.97	25.13	14.95

Source: Authors' calculations using the tax base shares reported in Table 2.

Differences in the relative value of tax points across different regions of Canada raises important horizontal imbalance considerations. There are options to mitigate these concerns however. Historically, Canada has used two policy levers to equalize the uneven value of tax points: unequal cash transfer supplements and the federal equalization program. The latter program is a stand-alone program that aims to shrink differences in the ability of provincial governments to raise public funds. It operates through a formula that estimates the revenue provincial governments could mechanically raise at national average tax rates.[9] Provinces with below-average amounts are topped-up to the national average. There are subtle complexities and constraints with the current equalization program that we will explore in the next section which mean that it would not fully equalize the value of tax points. Accordingly, unequal cash transfers have been used in the past, as in the 1977 tax point transfers.

For example, if $1 billion were transferred to provinces through a 0.1 point reduction in the federal GST rate and all provinces increased theirs provincial sales taxes by an equal amount (including Alberta and the territories introducing their own increments to the GST[10]) then, as shown in Table 3, the highest amount would go to British Columbia at $30.69 per capita.[11] The value in Prince Edward Island would be $22.07 per capita. A supplementary cash top-up to PEI of $8.62 would then be required to equalize the value of the tax point transfer to the British Columbia per capita level. Overall, equalizing the tax points in this way would add about $171 million to the cost of a $1 billion GST tax point transfer to provinces. The size of cash supplements would be even larger for personal and corporate income tax point transfers.

To illustrate how tax points were equalized in the past, we show in Figure 5 the 2003-04 per capita Canada Health Transfer (CHT) and Canada Social Transfers (CST), Associated Equalization and the value of the tax points across all provinces.[12] We display the values per capita in 2003-04 across all provinces in Figure 5. The values of the tax points are in green, with Ontario and Alberta seeing the largest values per person and PEI and Newfoundland and Labrador seeing the lowest. The equalizing effect of the equalization program of the tax point transfers is illustrated in red and then the CHT and CST in blue. All three components add to an equal roughly $1,200 per person although each sub-component is unequal in offsetting ways.

One of the unintended consequences to this system of equalizing tax points was the potential distortion to provincial fiscal policies. Since the per capita cash grants were dependent on a province's income tax base, it reduced a province's incentive to increase their tax bases through adopting growth-enhancing policies, such as investing in productivity-enhancing public infrastructure or by adopting growth-enhancing tax policies. Similar disincentive effects have been identified with the fiscal equalization program, and the mechanism for equalizing tax points contributed to these adverse fiscal incentive effects.[13] In the next section, we indicate the limited role that the current equalization program would play in equalizing the per capita revenue impacts of a tax point transfer.

---

9 The mechanical effect of taxes is distinct from the actual revenue that would result from a province adopting average tax rates. Since taxes affect behaviour, and therefore the size of the provincial tax base.

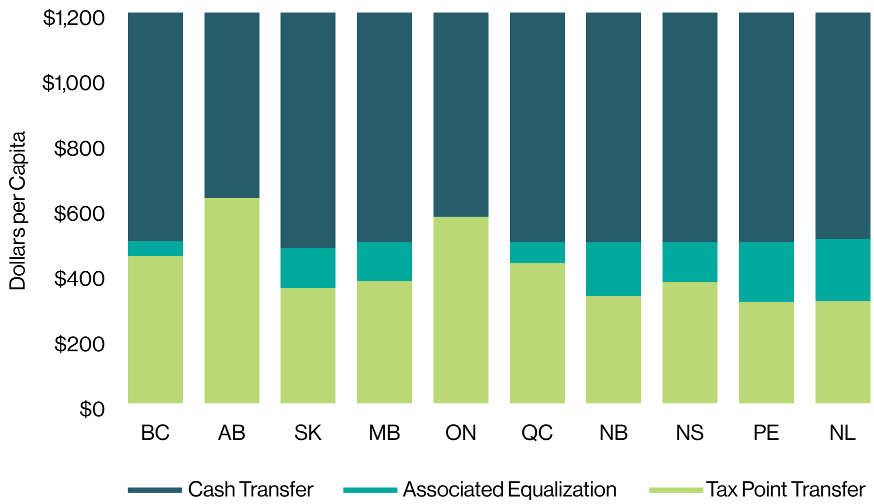
10 This is known as a Harmonized Sales Tax.

11 Note that these estimates reflect the value of a transfer of GST points to provinces. Provincial government may opt not to structure their sales taxes in a harmonized way, which would create differences in the value of sales tax points. In British Columbia, for example, the provincial sales tax yields only 80% of the revenue per point as the federal GST does within the province.

12 Starting in Budget 2007 the Canada Social Transfer was converted to an equal per capita transfer.

13 See Smart (1998), Cyrenne and Pandey (2015) and Ferede (2017) on the adverse fiscal incentive effects of the equalization program.

Figure 5: **Canada Health and Social Transfers per Capita (2003-04)**



Source: Trevor Tombe, "Final and Unalterable – But Up for Negotiation: Federal-Provincial Transfers in Canada," Canadian Tax Journal (2018) 66:4, 871-917

Tax Point Transfers and Equalization

The federal equalization program provides cash transfers to the less prosperous provinces so that they can provide reasonably comparable levels to public services to their residents at reasonably comparable levels of taxation. The origins of the fiscal equalization program in Canada in 1957 may be viewed entirely as a mechanism to facilitate the post-war decentralization of income taxes and to not penalize provinces (Quebec in particular) who did not agree to allow the federal government to maintain its sole position within those fields. However, the federal equalization program has evolved, and today it would not provide any material equalization of tax point transfers.

A simple representation of the equalization formula is based on the difference between population shares and the distribution of tax bases across provinces. Specifically, each province is entitled to a payment approximated by $E_i = \Sigma^J_{j=1}(p_i - f^j_i)\ R^j$ where the summation is over the various revenue categories included in the formula. A tax point transfer of GST points will therefore affect basic equalization entitlements by the difference between population shares and the consumption tax base shares. We report these in the first two columns of Table 4. All equalization receiving provinces have population shares that are larger than their respective consumption tax base shares and would therefore receive additional equalization payments but for one complication: the cap on aggregate payments. Quebec, for example, has 22.6% of the population for the 2021/22 fiscal year and 19.71% of the GST base. This implies a $1 billion GST tax point transfer would increase basic equalization entitlements to Quebec by 2.89% of $1 billion, or $29 million. A full 1 percentage point GST transfer would increase basic entitlements to Quebec by roughly $266 million. Across all recipient provinces, a one-point GST transfer would increase total equalization payments by approximately $373 million. This, however, is not the end of the equalization calculation.

Table 4: Simulated Effect of a GST Tax Point Transfer on Equalization (2021/22)

	Share of Total (%)		Dollars per Capita		
Province	**Population**	**Cons. Tax Base (GST)**	**Unequalized Value**	**Change in Equalization**	**Total Value**
NL	1.37	1.25	222.37		222.37
PE	0.43	0.36	204.55	+6.49	211.04
NS	2.60	2.33	218.07	+2.82	220.89
NB	2.07	1.79	209.07	+1.06	210.13
QC	22.58	19.71	211.80	-1.38	210.42
ON	38.88	40.22	251.08		251.08
MB	3.65	3.12	206.88	+5.12	212.00
SK	3.10	2.75	214.83		214.83
AB	11.66	12.49	256.89		256.89
BC	13.65	15.99	284.43		284.43

Source: Authors' calculations using population shares relevant for the 2021/22 fiscal year and the consumption tax base shares from the latest available data. This differs from the shares reported in Table 2 since the territories are not included. The change in equalization under the full formula is based on the Finances of the Nation Equalization Simulator.

Starting in 2009 following the Global Financial Crisis, Canada's equalization system features a fixed amount on the total payments made to all recipient provinces. In 2023/24, this amount was $23.96 billion, so regardless of the underlying formula no more than this amount may be paid out and no less. The difference between the pre-determined amount and the underlying formula is clawed-back or distributed based on equal per capita amounts among recipient provinces. That is, of the $373 million in additional payments outlined above, an equal amount will be subtracted from the equalization adjustment payments. In effect, total equalization payments are wholly unaffected by tax point transfers of any kind. The net effect of both the increased basic equalization and the reduced adjustment payments will vary across provinces according to their population. That is, since Quebec is 72% of the population of recipient provinces it will absorb 72% of the reduced adjustment payments. The effect of smaller adjustment payments may or may not exceed the increase in basic pre-adjustment entitlements. This would depend on the relative per capita fiscal capacity of a province. Overall, some provinces would see increased payments (PEI and Quebec) while some provinces would see decreased payments (Nova Scotia, New Brunswick, and Manitoba). As illustrated in the last column of Table 4, we find that a tax point transfer in the form of a one point of the GST will still result in unequal benefits across provinces with equalization playing no material role in shrinking these differences. Reforms to the current equalization program are warranted, but it is not clear that the equalization program should be amended just to equalize the revenue impacts of a future one-off tax point transfer.

Future Growth and Volatility of Tax Point Transfers

As the goal of both cash and tax point transfers is to provide provinces with the fiscal capacity necessary to deliver public services, the growth and volatility of such transfers in future years matters. Historically, provinces either favored or opposed tax point transfers over cash based on their expectations of future growth in the underlying tax bases compared to future growth of cash transfers. This remains a relevant consideration today.

In terms of future growth, tax point transfers will increase provincial fiscal capacity over time according to the future growth of the underlying tax base. Some provinces are expected to experience larger future growth than others. Tombe (2020b), for example, projects that in the coming decades, the growth of Alberta's nominal GDP (which, in aggregate follows the approximates growth in many tax bases) will be more than double the growth for Newfoundland and Labrador. The future value of tax points to some provinces are therefore more valuable than for others. Compare this to current cash transfer arrangements such as the Canada Health Transfer (CHT). Under the current arrangements, this program grows according to national, rather than provincial, nominal GDP. In addition, the growth rate has a floor of 3 percent so in years where economic growth is lower (such as 2020), CHT will still grow at this minimum 3 percent rate.

The volatility of tax point transfers versus cash is a related consideration. Provincial revenues raised through levies on their own tax bases tend to rise and fall with overall economic conditions. Cash transfer arrangements today, however, have different growth profiles. The CHT not only has a minimum growth rate of 3 percent, but also grows in line with a three-year moving average of Canada's economy (more precisely, nominal GDP growth). And the Canada Social Transfer (CST) has no volatility at all since it grows at a fixed 3% annually regardless of economic circumstances. This quantitatively matters. Since 1990, a cash transfer structured along the same lines as the CHT has a standard deviation in growth rates of 1.25% – that is, the typical year experiences 1.25 percentage points higher or lower growth than the overall average growth. The standard deviation of nominal GDP over this period, for comparison, is 2.6% – or more than twice as large.

To be sure, this does not imply cash transfers are less risky necessarily. Federal policy decisions can result in unexpected, and potentially large, changes in cash transfer amounts. Following federal Budget 1995, for example, provinces experienced a sudden and material reduction in the size of their cash transfers. Tax point transfer volatility may also be buffered through programs such as the federal Fiscal Stabilization Program (FSP). But, as with the equalization program, FSP would require substantial reform for it to play an effective role in smoothing provincial revenue volatility.[14]

14 For more, see Dahlby (2019) or Tombe (2020a).

Conclusions

In the introduction to this paper, we posed the question – Should a tax point transfer, rather than increases in cash transfers, be used to reduce the vertical fiscal imbalances between the federal and provincial governments? Our review of the issues indicates that, as with most policy choices, there are pros and cons to adopting a tax point transfer. These are summarized in Table 5.

Should a tax point transfer, rather than increases in cash transfers, be used to reduce the vertical fiscal imbalances between the federal and provincial governments?

A tax point transfer would better align provincial responsibilities for providing public services with the responsibility to raise taxes to pay of them. This would increase accountability and transparency, especially regarding health care spending. However, there would be significant differences across provinces in the additional revenues raised from a tax point transfer. As in the past, there would be political pressures to equalize the value of a tax point transfer through complex adjustments to cash transfer grants. Such adjustments to cash grants that compensate for differences in tax bases have the potential to distort provincial fiscal policies by reducing provinces' incentives to adopt growth-enhancing policies.

From a provincial perspective, a tax point transfer would increase their fiscal autonomy and make their revenues less susceptible to abrupt changes in federal policies. However, a province's tax revenues vary with fluctuation in economic conditions in the province and at least in recent years, the CHT and CST have grown at steady and predictable rates, based on the 3 percent minimum floor.

Transferring personal income tax room to the provinces would provide them with a stable revenue source that grows with personal incomes. However, because the provinces have different personal income tax rates and brackets, complex adjustments to federal-personal income taxes would be required to create equivalent provincial tax room. In addition, further decentralization of the personal income tax field could reduce the federal role in harmonizing tax policy and collections.

There are a number of principled arguments for tax point transfer, but there are also some practical difficulties with a tax point transfer compared to the current practice of reducing the fiscal imbalance between the federal and provincial governments through equal per capita cash transfers.

A corporate income tax point transfer would allow the provinces to increase own source revenues and give them increased control over a tax base that can be used to promote business investment. However, transferring corporate income tax room could further distort the allocation of capital across the provinces if they adopt widely varying tax rates. Conversely, provinces might fail to take up the corporate tax room vacated by the federal government because of tax competition and a corporate income tax point transfer might generate little additional revenues for the provinces.

Transferring GST tax points or reducing federal excise taxes could reduce the overlap of federal and provincial tax fields, potentially reducing administration costs and unintended fiscal interactions between federal and provincial tax policies. However, there is a danger that complete elimination of the federal GST could reduce sales tax base harmonization and increase the administrative and compliance burden from collecting taxes on interprovincial sales.

To conclude, there are a number of principled arguments for tax point transfer, but there are also some practical difficulties with a tax point transfer compared to the current practice of reducing the fiscal imbalance between the federal and provincial governments through equal per capita cash transfers.

Table 5: Advantages and Disadvantages of a Tax Point Transfer

ADVANTAGES	DISADVANTAGES
Helps align provincial spending responsibilities with the responsibility to raise tax revenues, promoting greater accountability and transparency.	Requires complex adjustments to cash grants if the value of tax point transfers are equalized, with the potential to distort provincial fiscal policies.
A tax point transfer would increase provincial fiscal autonomy and make their revenues less susceptible to abrupt changes in federal policies.	Provincial tax revenues vary with fluctuation in economic conditions in the province. In recent years, the CHT and CST have grown at steady and predictable rates
A personal income tax point transfer would provide provinces with a buoyant revenue source that grows with the personal incomes	Complex adjustments to federal taxes would be required to create equivalent provincial tax room. Potential reduction in federal role in harmonizing tax policy and collections could occur
A corporate income tax point transfer would allow the provinces to increase own-source revenues and a means to promote business investment.	Could increase tax competition among provinces and generate little additional tax revenues if provinces fail to increase corporate tax room vacated by the federal government.
GST or excise tax point transfers could reduce or eliminate the overlap of federal and provincial tax fields, potentially reducing administration costs and unintended fiscal interactions between federal and provincial tax policies.	Could reduce tax harmonization and collection with reduced federal presence in these tax fields.

References

Cyrenne, Philippe and Manish Pandey. 2015. "Fiscal equalization, government expenditures and endogenous growth." *International Tax and Public Finance* 22: 311–329.

Dahlby, Bev. 2019. "Reforming the Federal Fiscal Stabilization Program." *The School of Public Policy Publications* 12:18, June 2019.

Ferede, Ergete. 2017. "The Incentive Effects of Equalization Grants on Tax Policy: Evidence from Canadian Provinces." *Public Finance Review* 45: 723-747.

Ibbitson, John. 2020. "Ottawa should surrender GST to the provinces and be done with transfers" *The Globe and Mail*, November 13, 2020. Available at: https://www.theglobeandmail.com/politics/article-ottawa-should-surrender-gst-to-the-provinces-and-be-done-with/.

Nicholson, Peter. 2023. "Repairing Health Care in Canada: Time to Take the First Step." *Policy Brief*, Johnson Shoyama Graduate School of Public Policy. Available at https://www.schoolofpublicpolicy.sk.ca/research/publications/policy-brief/repairing-health-care-in-canada.php.

Parliamentary Budget Officer. 2022. *Fiscal Sustainability Report.* (Ottawa: Office of the Parliamentary Budget Officer).

Smart, Michael. 1998. "Taxation and deadweight loss in a system of intergovernmental transfers." *Canadian Journal of Economics* 31: 189–206.

Tombe, Trevor. 2018. "Final and Unalterable – But Up for Negotiation: Federal-Provincial Tranfers in Canada." *Canadian Tax Journal* 66:4, 871-917.

Tombe, Trevor. 2020a. "An (Overdue) Review of Canada's Fiscal Stabilization Program." IRPP Insight 31. Montreal: Institute for Research on Public Policy.

Tombe, Trevor. 2020b. "Provincial Debt Sustainability in Canada: Demographics, Federal Transfers, and COVID-19." *Canadian Tax Journal* 68 (4): 1083-1122.

Fiscal Federalism Policy Network

June 2023

The Fiscal Federalism Policy Network (FFPN)

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 will take a coordinated deep dive into complex questions; unlike a Royal Commission it would be independent of government appointments or political priorities. The Network will publish research papers, policy briefs and op-eds and make recommendations for the reform of fiscal relations among the federal, provincial and municipal governments within the framework of the existing Canadian Constitution.

FFPN Fiscal Federalism Policy Network