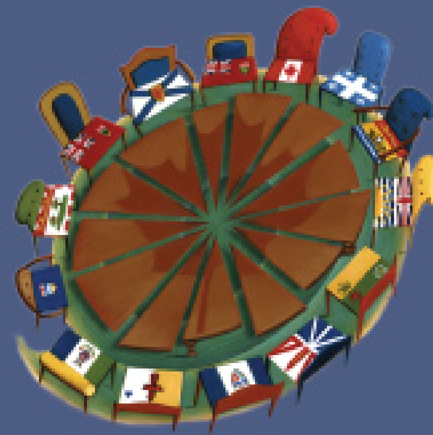
REFORMING THE FRAMEWORK FOR INTERGOVERNMENTAL FISCAL RELATIONS



Harvey Lazar

Since the late 1970, fiscal relations in Canada have been driven first and foremost by Ottawa's decisions and handled on a program-by-program basis. Though pragmatic and flexible, this approach, writes Harvey Lazar, "fails to provide a sense of direction to the federation and makes it hard for provinces and territories to anticipate federal behaviour and plan for their fiscal future." In this article, he argues for a revised intergovernmental framework to achieve greater fairness and predictability. To that end, he discusses three necessary changes and proposes ways to achieve them: limit Ottawa's freedom to act on its own by adopting some form of "protected agreement," increase Ottawa's share of the fiscal risk currently shouldered by provinces by returning to a form of cost-sharing on a 75-25 basis, and establish a better balance between the provinces' longer-term program commitments and Ottawa's shorter-term commitments by removing time limits on federal transfers.

Depuis la fin des années 1970, les relations fiscales intergouvernementales sont principalemnt déterminées par les décisions d'Ottawa et gérées un programme à la fois. Bien qu'elle soit à la fois pragmatique et flexible, cette approche « empêche l'application d'une orientation claire pour la fédération, écrit Harvey Lazar, et permet difficilement aux provinces et territoires d'anticiper les orientations d'Ottawa et de planifier leurs budgets ». Pour plus d'équité et de prévisibilité, l'auteur préconise donc de revoir le cadre intergouvernemental. Pour ce faire, il propose trois modifications : restreindre la liberté d'Ottawa d'agir unilatéralement en adoptant une forme d'« accord protégé » ; accroître la part du risque budgétaire encouru par Ottawa en revenant à un partage des coûts de 75-25 ; améliorer l'équilibre entre les engagements provinciaux à long terme en matière de programmes et les engagements financiers à court terme d'Ottawa en supprimant les limites de temps attachés aux transferts fédéraux.

One plank that distinguished Conservative and Liberal Party platforms during the 2006 federal election campaign was Conservative support for the idea that there is a fiscal imbalance in Canada that is disadvantaging provinces and territories. The 2006 federal budget subsequently set out five principles that are to guide the government's approach to the resolution of this issue: accountability through clarity of roles and responsibilities; fiscal responsibility and budget transparency; predictable, long-term fiscal arrangements; a competitive and efficient economic union; and effective collaborative management of the federation.

How the government will implement these principles is still unknown. A range of possible policy solutions have been proposed: a further *explicit* transfer of federal tax room to provinces/territories; an *implicit* tax transfer by Ottawa simply cutting federal taxes and leaving room for provinces and territories to raise theirs if they so choose; increasing federal cash transfers to the provinces and territories; enhanced reliance on revenue sharing; and uploading some provincial/territorial expenditure responsibilities to Ottawa. Although choosing among these policy instruments is fundamental to managing the federation in the short run, no specific fiscal action by the federal government on its own is likely to satisfy provincial and territorial financial demands for very long. The current incentive structure of intergovernmental relations is such that, whatever the initial intergovernmental fiscal "settlement," the provinces and territories will inevitably and logically demand more.

The purpose of this article is therefore to broaden the scope of public debate by proposing reforms to the governance arrangements through which these intergovernmental fiscal solutions are reached. It is thus intended as one input into the "rich dialogue" on fiscal arrangements called for in the 2006 federal budget. More specifically, I argue that the federal government and Parliament and the provincial/territorial governments must focus much more on the *ground rules* under which such fiscal decisions are made. New institutions and mechanisms for the governance of federal/provincial/territorial (FPT) fiscal relations are required with a view to creating decision rules and processes that are fairer and more transparent and, ultimately, achieving outcomes that are more stable.

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Since the 1977 structural reforms, intergovernmental fiscal relations in Canada have consisted mainly of Ottawa cutting or increasing its planned level of transfers to the provinces and territories according to its own assessment of public finances at both the federal and provincial/territorial levels. Except for the 1995 federal budget, the intergovernmental fiscal file has been handled on a program-by-program basis. Each adjustment, down or up, has been a case unto itself and not necessarily consistent in principle with those that have come before or after.

This approach has had its advantages, especially for Ottawa. It is flexible. It is pragmatic. It allows intergovernmental business to be conducted without undue reference to the kind of symbolism that can be politically divisive for the federation. This approach also has shortcomings. It provides no overall sense of direction to the federation. It also makes it hard for provinces and territories to anticipate federal behaviour and plan for their fiscal future.

My argument here, therefore, is that a better mix of principle and pragmatism could be achieved if this case-by-case approach was, in the future, placed within an updated and politically salient decision-making framework — one that is more consistent with the constitutional division of legislative responsibilities. The present framework, to the extent that it exists, is provided by the Constitution and the 1999 FPT Social Union Framework Agreement (SUFA), with the latter widely thought to have had modest impacts, at best, on intergovernmental behaviour.

Let's begin with two Conservative election platform commitments. First, on the matter of fiscal imbalance the party declared that a "Conservative government will work with the provinces in order to achieve a long-term agreement which would address the issue of fiscal imbalance in a permanent fashion." No specific dollar amount, however, was promised and the 2006 federal budget was similarly silent on numbers. Second, the Conservatives committed to "expanding the economic and social union in Canada," and they set out a few details on such matters as the "patient wait-time guarantee," child care, student support and seniors. These commitments were reaffirmed in the 2006 federal budget, suggesting that federal and provincial governments may continue to work in partnership with one another in key areas of economic and social policy under Mr. Harper's watch.

So where might the government begin? My suggestion is that Ottawa start by creating more certainty in respect of the roughly $40 billion in cash transfers that it now provides to provinces and territories. This is for two reasons. First, any increases in fiscal resources that Ottawa now decides to provide to the provinces/territories will be relatively small in relation to current cash transfers. Second, history has shown that during tough fiscal times, as in the 1980s and the first half of the 1990s, the federal government will reduce its planned level of intergovernmental transfers to provinces, thus complicating provincial finances and affecting their programs adversely.

To create this greater certainty, new intergovernmental ground rules for federal cash transfers are needed. At present, about 90 percent of the federal government's cash transfers to the provinces and territories are found in four major federal programs (Equalization, Territorial Formula Financing, the Canada Health Transfer and the Canada Social Transfer). Although there is a long tradition of the federal government consulting intensively with provinces and territories before making changes to major transfers, it is a legal fact of life that Parliament alone decides on the level of federal fiscal commitments to the provinces and territories. The Supreme Court has confirmed this position.

While this state of affairs is consistent with the Westminster style of government, it rests less easily with the concept of Canada as a federation with federal, provincial and territorial governments working at times in partnership with one another based on mutual respect as called for by SUFA. It is also somewhat at odds with the five principles in the federal budget, particularly the commitment to "predictable, long-term fiscal arrangements" and "effective collaborative management of the federation."

Once again, the Conservative election platform provides a starting point for the proposed ground rules. Along the lines provided for by SUFA (section 5), the platform promises to "ensure that any new shared-cost programs in areas of provincial/territorial responsibility have the consent of the majority of provinces to proceed, and that provinces should be given the right to opt out of the federal program with compensation, so long as the province offers a similar program with similar accountability structures." While this could indeed be one of the ground rules (I prefer a more substantial hurdle than a simple majority), the more difficult and important challenge is how to ensure that the federal financial commitment in existing or new jointly financed programs is maintained once an intergovernmental deal has been struck.

It can, of course, be argued that most federal and provincial programs have no guarantee of long-term funding from their own finance ministries and that the above concerns therefore have little merit. My response is that provincial health, education and social services ministers have at least some recourse when their finance ministers make resource allocation decisions they disapprove of, in that they can take their protests to their premiers. They lack this option, however, when the federal finance minister makes his decisions, and this lack of recourse needs to be offset somehow.

Under SUFA, Ottawa is committed to consulting "with provincial and territorial governments at least one year prior to renewal [sic] or significant funding changes in existing social transfers to provinces/territories, unless otherwise agreed, and [to building] due notice provisions into any new social transfers to provincial/territorial governments." This is a political commitment — not legally enforceable. Thus, SUFA provides only the lightest of federal commitments to provinces/territories on funding predictability. In my view, this is symptomatic of a fundamental power imbalance between federal and provincial governments in jointly financed programs.

To better understand this power differential, let's consider some of the characteristics of the federal/provincial/territorial fiscal partnerships in the key areas of social services, post-secondary education and health care services. First, the provincial/territorial governments are generally expected to provide ongoing benefits or services to their residents for the *indefinite* future. They therefore need to plan and fund their services on a long-term basis. (Planning, building and making operational a new hospital or university from scratch, for example, can easily take 10 years.) Second, the provincial/territorial order of government is responsible for coping in the event of unexpectedly high expenditures in these program areas (think of health care or the effects of the recession of the early 1990s on Ontario's social assistance costs). Fiscally, it is the more vulnerable order of government.

Now consider some of Ottawa's responsibilities. First, the typical FPT agreement of recent years generally commits the federal government to five years of funding with the 10-year agreement for health care an important exception. As just noted, the provincial/territorial program obligations are much longer in duration. Second, Ottawa's commitments are specified in fixed dollar terms rather than as a share of provincial/territorial outlays. Ottawa is thus not automatically committed to additional spending if provincial/territorial costs were to increase unexpectedly. Moreover, in the last several years, the federal government has made its financial transfers to the provinces and territories increasingly conditional. In short, in recent years the federal government has been sitting at the FPT *fiscal* table as if it were a bondholder, assuming minimal financial risks in the joint FPT enterprise but behaving increasingly at the FPT *policy* table like an equity holder, demanding a growing say on policy content.

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To achieve greater fairness in FPT fiscal relations, three linked changes in the structure of the relationship are desirable:

1) There should be more stringent limits on the freedom of the federal government to reduce its fiscal commitments to the provinces and territories without some measure of provincial/territorial and public engagement.
2) The risks of an uncertain fiscal future should be more equitably shared between federal and provincial/territorial governments in jointly financed programs.
3) There should be a better balance between the long-term programmatic commitments of the provinces and territories, often at the behest of Ottawa, and the shorter-term fiscal commitments of the federal government.

The most challenging of the above proposals is the first. The difficulty here is that even if the federal government decides, at a point in time, to limit its freedom to reduce its negotiated level of fiscal commitments as set out in FPT agreements, there is no legal barrier to that government subsequently changing its mind. Indeed, such a reversal in fiscal commitments may even be a priority for a new government after a federal election.

During the 1992 Charlottetown talks, primarily as a result of the federally legislated ceiling on the Canada Assistance Plan, the idea emerged that the Constitution should be amended to create a new generic provision under which the federal government and one or more provinces or territories could enter into an agreement that would be protected from legislative action breaching that agreement by either order of government acting on its own. A protected agreement would only come into force, however, after Parliament and the legislatures of the signatory provinces and territories had passed a law that approved the agreement and included an express declaration that the generic provision applied in respect of that agreement. In effect, an intergovernmental agreement could be protected against one-sided change by one or another of the signatories for up to five years and also be renewable. This proposed provision fell by the wayside when the Charlottetown referendum failed.

There is no political will to resurrect this type of constitutional amendment at the moment, but even if it existed, Ottawa might understandably refuse to give its assent to the constitutional protection of some FPT agreements for fear of losing its fiscal flexibility. Were that the case, provinces and territories might then have reason to think twice about accepting federal largesse and related program commitments. Thus, the behaviour of both orders of government might change significantly, resulting in fewer intergovernmental agreements based on the federal spending power.

While no such constitutional amendment is in the offing, there are ways of implementing a partial proxy for one. Here is one idea. For existing major FPT fiscal agreements (like that on health care, and important new ones), in addition to respecting current funding conditions under SUFA, the federal government could introduce generic legislation that would commit Parliament to not reducing its legislated fiscal commitments to provinces and territories without first following a transparent process that would provide both the provinces/territories and the public ample opportunity to comment on the proposed reduction via a parliamentary committee process. Of course, a new federal government could renege by introducing amending legislation that would do away with this generic commitment. But the political optics of doing so would be difficult and thus reduce the possibility of arbitrary fiscal action by the federal government. Moreover, it would take time for the federal government to pass such an amendment and this would provide an opportunity for public opinion to be mobilized in the event that Ottawa's action was seen as unfair or unreasonable.

What might Ottawa get in return? It could require the provincial and territorial legislatures to enact legislation that would commit them to implement the negotiated program content (like the principles of the *Canada Health Act*) and to not amend such commitments without a process similar to the one outlined above for the federal government. Politically, it would not be simple for a signatory government to back out of commitments unilaterally with such reciprocal legislation in place.

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The second proposed change has to do with finding a way to obtain a more equitable sharing of the risk of an uncertain cost future. One simple way of doing this is to return to the cost-sharing arrangements that prevailed from the 1950s to the late 1970s under which the federal government paid half of the eligible expenses of the provinces in major shared-cost programs. These arrangements were intended to encourage provinces to build new operating capacity in the key areas of hospital and diagnostic services, physicians' services, post-secondary education, and social assistance and services. Cost sharing of major programs was subsequently phased out for three main reasons. First, it had succeeded in its purpose and was no longer necessary. Second, the availability of 50-cent dollars created a disincentive for provinces to manage their expenditures tightly. The 50-cent dollars tended also to distort the resource allocation process within provincial governments. In the event, three major cost-sharing programs, for hospital insurance, medical care and post-secondary education, were replaced by a single block grant in 1977, and cost sharing for social assistance was integrated into that block grant after the 1995 federal budget.

Returning to cost-sharing arrangements today would undoubtedly help to achieve a more equitable sharing of the risk of uncertain future costs. However, a 50-50 arrangement in the health care and social spheres would be unfair to the federal government in light of past transfers of tax room to provinces to help pay for these programs.

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A 75-25 cost-sharing arrangement would be more suitable, for example, in health care. It would also create a stronger incentive for provinces to manage expenditures tightly than was the case when they were only paying half. Any distortion of the provincial resource allocation process would be similarly reduced. To further reduce incentive concerns, implicit cost sharing could be substituted for explicit cost sharing, with the federal sharing arrangements linked to national trends rather than the actual expenses of any individual province or territory. For instance, if health care costs were expected to escalate for another five years at a rate equal to gross domestic product plus 1 percent, then the federal transfers could be linked to the GDP-plus-1 formula. Alternatively, the formula itself could be a rolling average of actual expenditures by provinces/territories over, say, a four-year period. In both alternatives, no one province or territory would receive much additional money from Ottawa by increasing its expenditures since the formula would be linked to national trends, not those in the specific province/territory. Such an approach avoids some of the adverse effects of explicit cost sharing while creating a fairer distribution of risk among orders of government.

As for the Canada Social Transfer, determining an appropriate implicit cost-sharing ratio for it is inappropriate until Ottawa and the provinces decide if there are to be new program conditions attached to this transfer. At present, it is unclear what provincial/territorial costs are being shared.

The third proposed change is to achieve a better balance between the long-term programmatic commitments of the provinces and territories, often at the behest of Ottawa, and the shorter-term fiscal commitments of the federal government. The easiest way to do this is to put no time limit on federal fiscal commitments. If the second proposed change is implemented, then the federal government's planned cash transfers to the provinces will be based on a fixed dollar amount in a base year that would subsequently escalate annually at a rate set out by a formula that would itself adjust with changing conditions. The effect would be to create a long-term fiscal commitment by the federal government that would match the provincial/territorial programmatic commitment. This long-term commitment should, however, be subject to periodic intergovernmental review, as is the case now for Equalization.

There are substantive objections to each of these proposals and I have little doubt that these will be marshalled forcefully by those who prefer the all-too-often unilateral approach to intergovernmental fiscal relations that characterized the Chrétien and Martin administrations. During these years, the federal government initially cut transfers sharply and subsequently "reinvested," both indirectly via the provinces and directly, with provinces and territories only able to influence federal behaviour in many files at the margin.

The point of my argument is not that the federal government has been the "bad guy" and the provinces paragons of virtue. The Chrétien and Martin governments were "right" in criticizing the provinces for cutting taxes even while they were claiming revenue shortages. Indeed, there is a very long history of provinces choosing not to exercise their taxing powers and looking instead to Ottawa for fiscal resources. It is also true, as the previous Liberal governments asserted, that the Constitution provides provinces with broad taxing authority, that Ottawa has more debt to pay down than provinces, and that provinces/municipalities already have more "own-source" revenue than the federal government. The arguments presented above, therefore, are not intended to lay blame for past actions, but rather to modify the conduct of intergovernmental behaviour going forward. If my proposals here were adopted, there might well be fewer intergovernmental agreements but stronger federal and provincial/territorial commitments to those that were negotiated. Such an outcome would be consistent with the federal government's principle of enhanced "accountability through clarity of roles and responsibilities." It would also make the federation stronger.

This brings us to the other ground rules of intergovernmental relations. Most of the headings for these rules can be found in the existing SUFA: "public accountability and transparency," "joint planning and collaboration," "reciprocal notice and consultation," decision rules on "new Canada-wide initiatives supported by transfers to provinces and territories," "direct federal spending" and "dispute avoidance and resolution." On all of these items, SUFA is a good starting point but the Harper government will want to put its own imprimatur on them based on the five principles set out in its budget paper. In that case, I would expect a larger role for federal and provincial/territorial legislatures in scrutinizing the intergovernmental process, making it both more transparent and more accountable. More generally, I would anticipate a more province-friendly approach without weakening Ottawa unduly. Very importantly, to give this framework more political impact than the existing SUFA now has, federal and provincial/territorial legislatures should pass legislation requiring governments to work within that renegotiated framework. Such a framework is consistent with the governance proposals of both the provincial/territorial and federal advisory panels that reported earlier this year, especially those related to transparency.

Although the 2006 Conservative Party platform called for a "permanent" solution to the issue of vertical fiscal imbalance, it is unrealistic to expect all governments to agree on some division of the fiscal pie for all time or even a decade. The political incentive structure that influences the behaviour of governments simply precludes this possibility. What is practicable, however, is the creation of rules of engagement between the different orders of government that are fair and transparent. This in itself would much improve the prospects of more stable intergovernmental fiscal arrangements.

I acknowledge that intergovernmental relations are currently more focused on individual policy files than on the broader governance issues raised here. The Harper government has already acted on the child care file. The future of Equalization is the next big issue, with Ottawa intending to come forward with its proposals this autumn. The federal government also promised in its 2006 budget paper to bring forward "key proposals" for a "new approach to long-term funding support for post-secondary education and training" and a "new framework for long-term funding support for infrastructure" this autumn. The patient wait-time guarantee will almost certainly require ongoing discussion.

But, in addition to the file-by-file approach, Ottawa has also signalled interest in framework or governance issues. Specifically, the 2006 federal budget undertook that the "Minister of Intergovernmental Affairs will seek perspectives on the Government's broad approach to the fiscal imbalance issue, including the merits of limiting the federal spending power in specific areas, and on ways to build a new, open relationship among governments." This article offers one such perspective. The proposals here are also consistent with the Harper government's commitments to "predictable, long-term fiscal arrangements" and "effective collaborative management of the federation," as well as the accountability commitment cited above.

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The overriding question that this article raises, therefore, is whether the traditional ad hoc, file-by-file approach should be allowed to dominate the intergovernmental diplomacy leading up to the 2007 federal budget or whether the issues of governance ought also to be afforded substantial room on the federal-provincial agenda. As we head into the fall of 2006, most of the FPT momentum appears linked to the file-by-file approach. Although the federation would benefit in the medium term and beyond from a fairer structural framework for fiscal decision-making, history suggests that the provinces are likely to be more interested in achieving short-term fiscal gains than in focusing on governance issues. Unless Stephen Harper and his colleagues make a special effort to raise the profile of governance issues, reforming the intergovernmental decision-making framework will almost certainly be left behind in the coming months. In that event, the 2007 federal budget will probably lead to new legislation on two of the three largest federal fiscal transfer programs, Equalization and the Canada Social Transfer (or its replacement), and any subsequent action on the governance issue will have substantially diminished relevance for the power imbalance among orders of government.

One solution is to blend the case-by-case and structural approaches — introducing some of the structural dimensions via the individual case files and then generalizing them over time through a new decision-making framework agreement that secures legislative approval from all orders of government. If this view does not prevail, then we are probably back to "business as usual" in intergovernmental fiscal relations. Whether business as usual is the right approach depends on whether the reader sees the conduct of intergovernmental fiscal relations over the last quarter-century as healthy or dysfunctional. The underlying assumption here is that the dysfunctional label is closer to the truth and that structural change is needed to secure a fairer, more transparent and more stable fiscal equilibrium in the federation.

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