Standing up for Canadians
Restoring Fiscal Balance in Canada

Submission to the Federal Department of Finance from the Canadian Union of Public Employees

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CUPE
On the front line

The federal government has made a commitment to take action to put in place predictable, long-term and equitable arrangements to restore Canada's fiscal balance.

To meet this and other commitments, it is crucial to understand the nature of the fiscal balance and how the federal government can best take a leadership role to strengthen the Canadian economy and improve our quality of life.

What is the nature of the fiscal imbalance?

The recent discussion about fiscal balance in Canada has largely focused on the issue of a "vertical fiscal imbalance" between the federal government and the provinces. But in constitutional terms, there is no significant fiscal imbalance between the federal government and the provinces in Canada. Provinces have almost identical powers of taxation as the federal government. They also have the right to collect natural resource royalties and revenues from property taxes, gambling and alcohol, which far exceed the customs tariffs and import duties under exclusive federal domain. In fact, according to the federal government's Privy Council Office, Canada is one of if not the most decentralized federations in the world thanks to the strong taxation powers of the provinces.[1]

Provinces certainly suffered from the deep cuts to federal transfers implemented in the mid 1990s. They also have direct responsibility for the cost of public services, such as health and education, which have increased at a faster pace than the cost of federal services. But federal cuts in transfers have been matched or exceeded by tax cuts enacted by the provinces themselves and by further downloading by provinces to local governments. The cost of provincial tax cuts implemented since 1995 amounted to over $30 billion in 2005-6 alone, according to federal government calculations.[2]

While there is little evidence of a vertical fiscal imbalance affecting provinces, our municipal governments, with their very limited sources of revenue, are another story.

When faced with cuts to federal transfers, a number of provinces and Ontario in particular, directly and indirectly downloaded billions in costs to municipalities. As the size and role of cities has grown, local governments have also faced increased cost pressures for infrastructure, community and immigrant settlement, environmental and protective services. During the past decade transfers from federal and provincial governments dropped from 26% of local government revenues down to 17% – equivalent to an annual revenue loss of $5 billion.

This has forced local governments to rely increasingly on the only sources of revenue that they have power over: property taxes and user fees. In turn, this has led to a relatively greater tax burden on lower and middle income Canadians because property taxes are much more regressive than income taxes.[3] This growing dependence on an inelastic source of revenue is also at the root of a yawning infrastructure deficit in Canada.

The absence of a vertical fiscal imbalance between the federal government and provinces masks a large and growing "horizontal fiscal imbalance" between the provinces. Disparities in resource wealth between provinces have led to large differences in fiscal capacity between provinces. This has aggravated fiscal inequities, as provinces, led by Alberta and Ontario, have felt compelled to engage in competitive tax cuts.

These horizontal fiscal imbalances will be further worsened if the federal government increased its unconditional transfers or vacated tax room, as some corporate lobby groups have proposed.[4] Provinces wanting to take up the tax room would find it difficult if other richer provinces did not. The end result would be further cuts to services and even greater inequalities and disparities between people and regions in Canada.

The evidence shows:

- There is no overall vertical fiscal imbalance between the federal government and provinces, either in constitutional or practical terms.
- A significant vertical fiscal imbalance between the federal and provincial levels of government and municipalities, which has in turn led to a growing infrastructure deficit and has worsened economic and social inequalities.
- A growing horizontal fiscal imbalance between provinces that would be exacerbated if the federal government used the charade of a vertical fiscal imbalance to vacate tax room or to increase its unconditional transfers.

As the report by the federal Privy Council Office itself concluded, "the (vertical) fiscal imbalance (between the federal government and the provinces) is a myth" and "the invasion of provincial jurisdiction (by the federal government) is a myth."[5]

Instead of proceeding with additional tax cuts, or vacating tax room in favour of the provinces, the federal government should direct further resources to improving the equalization program, improve its own level of social investment and increase conditional transfers to provinces.

The Finance Minister has – through this consultation and the Restoring Fiscal Balance in Canada Budget Paper – highlighted concern in four areas:

- Transparency in federal fiscal planning
- Predictable, long-term fiscal arrangements
- "Blurred accountability" due to reduced clarity in roles and responsibilities
- A competitive and efficient Canadian economy

This submission addresses each of these sets of concerns and then concludes with a summary of priorities for action.

<u>Need for Greater Transparency and Accountability in the Entire Budget Process</u>

The federal Finance department systematically underestimated its revenues and surplus projection for a decade from the mid-1990s to just last year. The Canadian Centre for Policy Alternatives, through its annual Alternative Federal

Budget, has had a much better fiscal forecasting record than all the banks and private forecasting agencies relied upon by the department of finance for its economic and fiscal forecasts. Despite, this evidence, Finance continues to exclude this organization's expertise from its budget planning process.

Biased forecasts for political purposes don't serve the public or parliamentarians well, who are entitled to reliable information about the government's finances in order to effectively engage in democratic discussions about budget priorities.

The proposal to establish an independent Parliamentary Budget Office is a positive step. This office should be properly funded with a broad mandate, provide fiscal forecasts beyond just two years, and be empowered to analyze and report on the impact of a range of budget and tax proposals.

In particular, the office could undertake much greater independent analysis and scrutiny of a major area of federal spending where accountability is often sorely lacking: tax expenditures.

Successive governments have introduced a plethora of costly and often ineffective tax expenditures. These measures appear to be rarely analyzed for their effectiveness in reaching their objectives or their cost effectiveness in comparison with other means of meeting their stated objectives.

The Scientific Research and Development Tax Credit is a rare example of a tax boondoggle that was changed as a result of public controversy. Its successor has had little impact on increasing Canada's level of R&D, yet it has become enshrined in our tax system. Examples of costly, inequitable and often ineffective tax expenditures abound: the stock option tax deduction, reduced rates for capital gains, education savings tax breaks.

Except when used for redistributive purposes or for other very broad-based economic objectives, tax measures are generally much less effective and less accountable than direct program spending and more difficult to control the overall cost.

Unfortunately, the current government has elected to introduce a host of new tax measures of dubious effectiveness. In many cases, direct public spending would be more effective at reaching these objectives than tax measures, such as through education transfers, federal support for R&D, and direct support for public transit or community sports facilities. In other instances, such as preferential treatment of executive stock option, elimination of the tax expenditures by itself would probably be positive.

The last federal budget introduced tax measures that will grow in cost considerably over the next few years and occupy virtually all the federal government's future fiscal flexibility. CUPE strongly recommends that additional federal surpluses should be directed to social investments rather than further expensive, ineffective and less accountable tax cuts.

But greater transparency in fiscal forecasting and analysis is only a small part of increasing transparency, accountability and democracy in the overall budget process.

Canada's budget process, based on the Westminster model, is highly secretive, exclusive and undemocratic. Few people, even inside government, understand how the annual budget process really works, let alone have any influence over it. Most of our elected representatives are left out in the cold and dark until the budget is finalized and tabled in Parliament. In contrast, most other democracies have a much more transparent and participatory budget process, allowing for open discussion, real debate and substantive amendments in their democratic chambers.

The budget process should also involve meaningful and responsive consultation with stakeholders and the public instead of the generally superficial consultation process currently engaged in.

Long-term fiscal arrangements and planning

Provincial governments have become understandably wary of the reliability of the federal government as a fiscal partner in many areas.

Unilateral cuts imposed by the federal government to provincial transfers in the mid-1990s resulted in a decade of declining public services, deterioration of health care, tuition fee increases, and growing infrastructure deficits.

The recent cancellation of federal funding for child care after only one year provided provinces with another reminder of the dangers of relying on federal funding to initiate new programs without an agreement with long-term funding. Municipalities are also very concerned about guaranteeing long-term or permanent funding beyond the five years promised with the gas tax transfer.

Major transfers for equalization and in some social areas have become increasingly complex, opaque, ad hoc and untethered from their founding principles.

The federal government's fiscal infidelity is no doubt also related to the lack of credit and accountability that unconditional transfers provide the federal government. Federal political leaders would be no doubt be less likely to unilaterally cut spending on programs for which it derives political credit – and faces accountability with voters.

This points to the need for predictable and long-term federal funding to be tied to conditional transfers backed up with legislative conditions and enforceable accountability mechanisms where the federal government is seen by the public as a full partner. These should involve separate transparent and accountable transfer with governing legislation and annual escalators for post-secondary education and child care, just as there is for health care.

Need for Strong Leadership and Accountability from the Federal Government

The government has stated that one of the four major sets of concerns at the heart of the debate on fiscal balance is "blurred accountability due to reduced clarity in roles and responsibilities" between federal and provincial levels of government.

The Budget 2006 paper on *Restoring Fiscal Balance in Canada* claims that this concern has developed because of insufficient focus on areas of core federal responsibility and the use of federal spending power in areas of provincial responsibility. The examples used of areas of federal neglect and intrusion are highly selective, misleading, and politically manipulative.

Security and defence are cited as areas of neglect, but the budget of the department of National Defence has increased by almost 80% during the past decade. No mention is made of Employment Insurance – security for unemployed Canadians and a core area of federal responsibility – yet the total value of regular Employment Insurance benefits paid by the federal government is 15% lower than ten years ago, thanks in large part to benefit and eligibility reductions.

This consultation material suggests that accountability would be improved if the federal government reduced its spending – and the conditions it applies to transfers to the provinces – in areas such as child care, early childhood education, and housing and homelessness. But it is likely that exactly the opposite would result. Federal withdrawal from social spending and areas of provincial responsibility would lead to less accountability, not more.

It seems clear that the Conservative government is trying to use the fiscal balance issue as an excuse to cut social spending, increase spending on its selective areas of interest, and implement further regressive tax cuts.

Effective governance requires multiple levels of accountability. Our Westminster-based model of government already has very weak accountability to its citizens, which is why we have developed systems with multiple layers of accountability.[6]

A major public research project to probe Canadians' attitudes on the fiscal balance found they want the federal government to work with provincial governments and citizens to address the fiscal balance issue by articulating and implementing a national vision with common standards and providing conditional transfers.[7] Canadians have also always demonstrated strong support for federal leadership and oversight for health care funding through the *Canada Health Act.*

Canada already has one of the most decentralized federations in the world. National governments in virtually all other countries in the world have much stronger general spending powers than our federal government does. Canada's federation has been able to evolve and modernize because political leaders have capitalized on the flexibility in our Constitution by having the federal take a leadership role in many areas in cooperation with the provinces – and often changing our constitution to do so.

If the federal government had not taken this leadership role in the past, Canadians would not have national Employment Insurance, Medicare, or Old Age Security and Pension programs. These are three of the four cornerstones of individual economic security in Canada. The other cornerstone of individual income security – social assistance for individuals – remains a provincial matter and is widely acknowledged to have crumbled into poverty as result of federal cuts in transfers to the provinces, an absence of national standards, and provincial neglect.[8] Income security for families with children has only been maintained because of the federal government took a leadership role by introducing the national child benefit in cooperation with the provinces in 1998.

To strengthen and modernize our country *and* our economic union, the federal government needs to take more of a leadership role and increase federal spending and accountability in areas that affect the wellbeing of ordinary Canadians. The Social Union Framework Agreement sets out a comprehensive agreed-upon process and accountability mechanisms that would strengthen Canada's social and economic union. This framework should allow flexibility in program delivery between provinces and particularly with Quebec, while reinforcing accountability for public spending.

The type of simplistic 1867 Constitutional fundamentalism that is being advocated by business lobby groups and the current government is a thinly veiled and regressive attempt to reduce the power of the federal government and reduce or eliminate federal spending – and the social security of Canadians – in a wide range of areas.

<u>Competitive and Efficient Economic and Social Union</u>

The focus of the government's proposals for creating a competitive and efficient economic is on reducing or eliminating taxes and reducing or eliminating impediments to competition and business. There is precious little about building and enhancing our society and capacities. This narrow view of the economy appears to see government, regulations, and social programs as a hindrance to business and therefore to competitiveness.

But other more competitive and higher productivity countries in the world have a different perspective. Countries such as Finland and other Scandinavian countries have achieved their rank as the most competitive and productive in the world with strong social and environmental standards and by making extensive investments in people and social and physical infrastructure. These (combined with relatively high tax rates) have steering production towards higher income and higher value-added activities.

As stated in last year's World Competitiveness Report:

"There is no evidence that relatively high tax rates are preventing these countries from competing effectively in world markets, or from delivering to their respective populations some of the highest standards of living in the world."[9]

In the same way that our economic union would benefit from a common securities regulation and better harmonization of taxes our economic and social union would benefit from national programs and standards in social areas.

According to the international KPMG management consulting firm, Canada already has the most competitive cost structure for businesses

We now need increased investments in our social and physical infrastructure, including education, to develop a competitive and efficient economy and high quality of life for all Canadians. The private sector will certainly not invest sufficiently in these areas. History has shown that provinces will not invest adequately to truly build our and modernize nation. The federal government must.

Priorities for Action

The federal government would demonstrate national leadership by investing in the following priority areas.

Renew the Equalization Program

The equalization program is designed to meet the constitutional promise of "making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation".

The equalization program is an important source of revenue for a number of provinces and plays a major role in helping provinces to provide reasonably comparable services – and reducing inequality across Canada. But changes and special deals related to the program have eroded its principles, made it highly complicated and less effective at meeting its objectives.

The program should be renewed and improved by:

- Returning to an objective and principle-based formula
- Basing fiscal capacity on a 10 province standard
- Including at least 50% and preferably 100% of resource revenues in the formula
- Smoothing payment calculations over three years to increase predictability

There is broad agreement on these core areas: expert panels appointed by the federal government and provinces, through the Council of Federation, have come to similar recommendations. Affordability can be addressed by including less than 100% of resource revenues in the formula or by modestly scaling back the overall standard.

Commit to Long-term Funding Support for Public Infrastructure

The relative decline of investment in public infrastructure over the past three decades has been well documented and, more acutely, is apparent through deteriorating conditions on our roads, transit systems, public utilities and communities. The economic, social and environmental benefits of investments in quality public infrastructure have also been well documented.

Much of the responsibility for the erosion of support is due to a decline in direct federal commitments and cuts in federal transfers to provinces and municipalities, which have led to a national infrastructure deficit estimated at close to $60 billion.

The progressive transfer of half of the federal government's gas tax revenues to municipalities is a positive step, but even when it is fully phased in, it will only provide $2 billion a year. This is less than half the $5 billion shortfall in transfers that municipalities have experienced over the past decade. It is just enough to keep the infrastructure deficit from growing, but not enough to meaningfully reduce it.

CUPE urges the federal government to commit to long-term funding to eliminate the municipal infrastructure deficit and reduce the growing reliance on regressive property taxes. In particular, we support calls by the Federation of Canadian Municipalities for access by municipalities to a share of federal and provincial income tax revenues. This transfer would grow over time in line with overall income tax revenues and would also provide a better match than property taxes for many of the growing responsibilities of cities. We are opposed to giving municipalities the power to set their own tax rates since this would lead to economically inefficient tax competition and avoidance behaviour between cities.

The federal gas tax transfer should be made permanent and other transfer arrangements should be enshrined for ten years to allow sufficient time for planning.

Additional funding for municipalities should be directed to priority areas such as public transit, water, sewer and environmental infrastructure, affordable housing community and social services. Public funding should only go to support publicly-owned and operated facilities. Even advocates have acknowledged that public-private partnerships (P3s) and privatized public services cost more.

They are also inherently less flexible in the services provided and vastly less accountable to the public than publicly owned and operated services.

We also urge the federal government to use its status as a preferential borrower to lever substantial renewed investments in Canada's hospital, health and educational infrastructure.[10] The federal government can borrow at a rate up to 100 basis points below provincial and local governments, health and educational authorities and by more than 200 basis points lower than public-private partnerships. On a $1 billion investment, a 100 basis point difference in borrowing costs amounts to $10 million a year – and $300 million over 30 years. It makes no sense for the federal government not to take a leadership role by helping other levels of governments finance their infrastructure projects. Public accounting rules now require governments to adopt accrual and consolidated accounting procedures, which enable the federal government to amortize these costs over the life of the assets, just as private companies do.

The $1 billion committed to a *Post-Secondary Education Infrastructure Trust* over two years in Budget 2006 was a positive step, but this will only meet a small amount of the shortfall in funding for deferred maintenance in universities and colleges. Much more needs to be provided in long-term sustainable funding to meet current and future needs.

Revitalization of Federal Role in Education and Training

Cuts in federal support for post-secondary education over the past two decades have resulted in massive tuition fees increases, led to debt loads averaging over $20,000 for university students and excluded many from further education. The burden of the higher cost of tuition and increased student loans and debt is considerably higher for students from lower income families; consequently their enrolment is much lower than that for higher income families. The federal government has increasingly relied on tax incentives, including RESPs and CESGs that have largely benefited higher income families and accommodate further tuition fee increases.

Tuition rates have risen again this year by an average of 3.2%. The average cost per year of tuition is now $4,347. Meanwhile universities are receiving smaller proportions of the operating budgets from governments. Universities need to be properly funded and tuition must be decreased. The answer is not individual tax incentives or income contingent loans.

Income contingent repayment (ICR) student loan schemes are funding models for post-secondary education that are based on the belief that the individual is the sole beneficiary of education and therefore should bear the full cost. Under ICR, borrowers would repay their loans as a percentage of their incomes upon completion of study. Graduates with lower levels of income would repay their loans over a longer period of time, resulting in higher costs for the education due to the interest. This impact on lower income earners has a disparate impact on women and other disadvantaged groups. We need to see education as an investment and benefit to all Canadians and stop putting the burden increasingly on individuals.

To make post-secondary education affordable for all, the federal government should extend the $750 million per year committed in Bill C-48 to future years and further increase transfers to provinces for post-secondary education, conditional on provinces using the funds to increase access and reduce tuition.

Transfers for PSE should be provided in a separate *Post-Secondary Education Fund* governed by legislation that would ensure tangible outcomes and accountability for federal funding. Federal funding should be restricted to public non-profit educational institutions; private colleges may provide graduates with job matching services, but appear to provide no additional material benefits to their graduates beyond high school education.[11]

A significant number of Canadians continue to have low level literacy skills. Much of the economic benefits from education come from improvements in literacy. Investments in literacy generate both high economic returns, and also promote greater fairness and social equity, sorely needed after a decade of increasing inequalities.

Canada has a poor record for skills training, with employers spending much less than the OECD average in this area. Those with already higher levels of education benefit proportionally more from the training dollars that are spent, with little left for those who need it most – lower income workers with less formal education.[12]

CUPE supports the expanded funding for the *Labour Market Partnership Agreements* with the provinces that was announced a year ago. These agreements are a good example of national support ensuring the provision of appropriate literacy and essential skills training, workplace skills, apprenticeship programs, and labour market support for immigrants across the country with needs and delivery determined at a local level.

Quality early childhood education has been demonstrated to provide high levels of social and economic benefits to children, parents, women, governments, and society in general. CUPE strongly encourages the federal government to increase federal transfers to provinces to support the expansion of affordable non-profit child care programs. Federal funding for these transfers should be on a predictable and long-term funding track, based on principles and accountability mechanisms enshrined in federal legislation.

Stronger Federal Leadership Needed on Social Investments and Health Care

A stronger federal presence and leadership is sorely needed in the area of social support and investments. The federal government made considerable progress in improving the welfare of children with the establishment of the national child benefit in cooperation with provinces and territories.

But income support for adults is poorly inadequate. Benefits for single adults are, on average, about a third of the poverty line. The real value of benefits are far below what they were a decade ago.[13] Cuts to Employment Insurance benefits have increased dependence on provincial social assistance programs. The tattered state of this part of Canada's social safety net – and our poorest citizens who depend on it – during a time of relative plenty is an instructive example of what happens when there is a lack of federal leadership.

The federal government needs to show bold leadership by redesigning Canada's system of adult benefits in cooperation with the provinces. Progressive reform to improve and integrate EI with basic income support, employment preparation services, and better conditions and incentives for low-income workers would put the fourth cornerstone of Canada's economic security system on a firm footing.[14] Comprehensive national reform with an increase in minimum wages would reduce significantly poverty, promote greater labour force participation by reducing the punitively high marginal tax rates faced by the working poor, and help build a stronger and more inclusive and competitive economic union.

The 2004 health accord provided predictable and long-term funding required to repair Canada's health care system for ten years. However, the accord was lacked meaningful accountability measures. The limited provisions of the Canada Health Act have helped to protect Canada's medicare system from the exploitation of patients and government funding that occurs through the privatized health care system in the United States, but stronger accountability measures and enforcement are needed.

The federal government could take a major step forward to reduce financial pressures on provinces and employers by introducing a national prescription drug program. This would also enhance the competitiveness of Canadian businesses, provide a more level playing field for different employers and different regions. A national program supported by a national formulary and effective regulation would control spiralling drug costs and be cost-effective.

Endnotes

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