UPDATE ON FEDERAL TRANSFERS

Finances
Québec

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2011-2012 Budget

Update on Federal Transfers

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Update on Federal Transfers

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Section A

Fiscal Federalism in Canada: For Fact-Based Discussions

INTRODUCTION

The major federal transfers to the provinces, namely the Canada Health Transfer (CHT), the Canada Social Transfer (CST) and equalization, will expire March 31, 2014. Work has already begun on the renewal of these transfers. Public debate is also underway, especially regarding equalization.

Equalization has been central to fiscal federalism in Canada for more than 50 years and its principle is entrenched in the country's Constitution. The program is funded by the taxes collected by the federal government throughout Canada.

While the equalization program has long been described as the glue that holds the Canadian federation together, these days it gives rise to mixed feelings. The fact that in 2008-2009 Newfoundland became a non-recipient province and that the following year, Ontario joined the recipient provinces, sparked many reactions.

Some have maintained that this situation proves that the equalization formula is not working and that it is absurd that Ontarians "pay equalization to themselves". Others maintain that equalization is weighing on the economies of so-called "productive" provinces and rewarding so-called "unproductive" provinces. According to them, the equalization program needs to be thoroughly reformed, or even terminated.

These criticisms are based more on opinion than on fact. For an informed debate to take place as part of the discussions on the renewal of the major federal transfers, it is important to understand the significant economic phenomena currently at work in Canada.

This section explains the role of equalization in Canada, describes the economic factors underlying recent developments in the program, depicts the financial flows within the federation and describes how the redistribution effected by federal transfers to the provinces has evolved over the last 30 years.

1. EQUALIZATION AND THE FUNDING OF PUBLIC SERVICES

1.1 The objective of equalization in Canada

The objective of Canada's equalization program is to reduce disparities in fiscal capacity among the provinces, disparities that result from economic factors.

Accordingly, for the purposes of equalization, "fiscal capacity" is defined as the revenues a province could obtain if it applied, to its tax bases, the average tax rates in effect in the ten Canadian provinces. This fiscal potential differs from the "revenue actually collected" by that province, which result from the tax rates it imposes.

For example, Alberta does not collect a sales tax. However, for the purposes of equalization, Alberta has a non-zero fiscal capacity in respect of consumption taxes since if it decided to apply the average tax rate of the ten provinces, it would obtain substantial revenue.

This difference between a province's fiscal capacity and the revenue it actually collects is fundamental for a correct understanding of the links between equalization and the funding of public services offered by the provinces.

A hypothetical example can provide a simple explanation of how the equalization formula in Canada works:

— Suppose a province has a fiscal capacity of $5 000 per capita, while the average fiscal capacity of the ten provinces is $7 500 per capita. That means that the province in question would obtain 33% less revenue than the Canadian average if it decided to apply, to its own tax bases, the average tax rates in effect in the ten provinces.

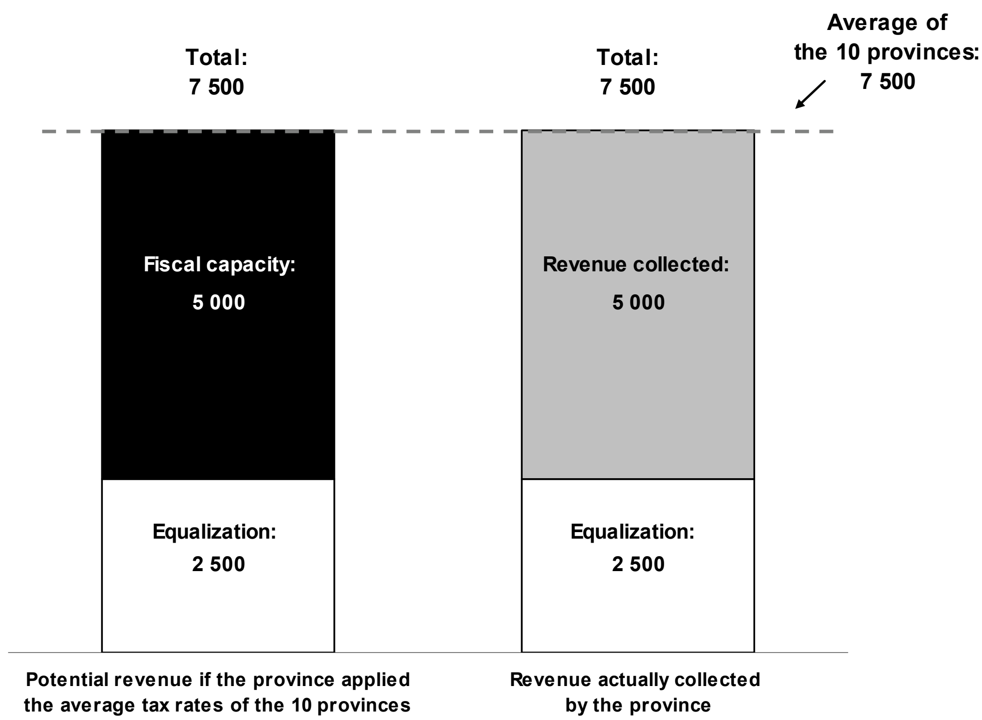
— Suppose also that equalization perfectly offsets this gap with the average of the ten provinces. The province would then receive equalization payments of $2 500 per capita, which would give it a fiscal capacity equal to the Canadian average.

— Lastly, suppose the province decides to actually impose the average tax rates of the ten provinces. The revenue it would actually collect would be the same as the fiscal capacity attributed to it by the equalization formula, i.e. $5 000 per capita.

The following chart illustrates the hypothetical example that has just been described. The left part shows the fiscal capacity of the province as measured by the equalization formula. The right part shows the revenue actually collected by the province.

CHART A.1

Fiscal capacity and revenue collected by a hypothetical province that receives equalization and applies the average tax rates of the 10 provinces
(dollars per capita)



This province can therefore, with equalization, offer a level of public services comparable to the Canadian average without having to impose tax rates higher than the Canadian average. That is precisely the objective of the equalization program as found in subsection 36(2) of the Constitution Act, 1982:

> Parliament and the government of Canada are committed to the principle 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.

This also explains why Canada's equalization program is interested in the fiscal capacity of the provinces and not their spending.[1] In the Canadian federation, the provinces are not required to implement similar tax systems and public services. Canada is a decentralized federation in which the provinces assume important responsibilities and, to do so, have major taxation powers.

However, should a province decide to apply the average tax rates in effect in the ten provinces, it should, after equalization, have revenue comparable to the average of the ten Canadian provinces for the program to achieve the objective entrenched in the Constitution.

1.2 Funding of public services

Some have criticized the fact that some of the provinces that receive equalization provide a higher level of public services than others that do not receive it. They conclude that equalization is too generous.

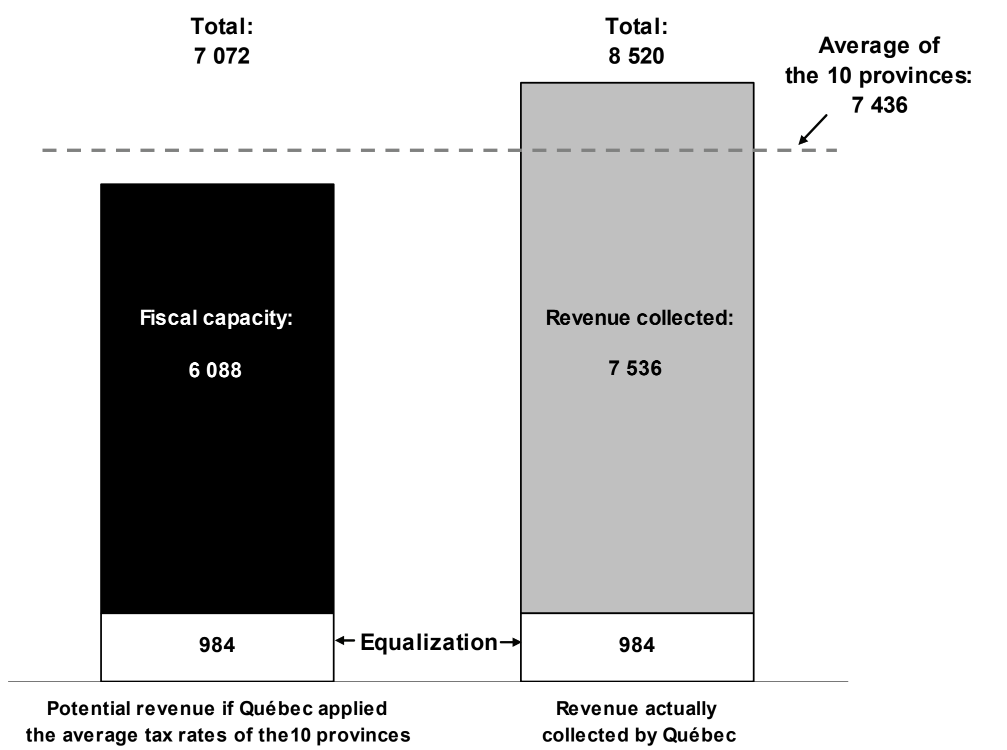
This conclusion generally stems from a misunderstanding of the role played by equalization, as well as confusion between the concepts of fiscal capacity and revenue actually collected described above. Let us take three examples: Québec, Alberta and Ontario.

The following chart illustrates Québec's fiscal capacity and the revenue it collected according to the data used by the federal government to set the amounts of equalization that will be paid in 2011-2012.

1 This question has frequently been the focus of discussion and work over time and it has never been considered desirable to include provinces' spending in the equalization formula. For example, the Expert Panel on equalization set up by the federal government wrote, on page 88 of its report released in 2006: "On balance, the Panel considers that the case for incorporating expenditure need into Equalization has not been made. There is no conclusive evidence that it would have a material effect on the size and allocation of Equalization payments. […] Recognizing expenditure need may be easier and less controversial to do with specific transfer programs such as the Canada Health Transfer or the Canada Social Transfer."

CHART A.2

Fiscal capacity of and revenue collected by Québec for 2011-2012
(dollars per capita)



Source of data: Department of Finance Canada.

This chart sheds light on a number of important points:

- First, contrary to the hypothetical example given earlier, the existing equalization program does not provide the provinces with a fiscal capacity equal to the Canadian average, in particular because of the exclusion from the equalization calculations of half the revenue derived from natural resources and the federal government's implementation in 2008 of capping mechanisms that limit the program's ability to fully play its role.[2]

- Accordingly, Québec has a fiscal capacity of $6 088 per capita before equalization and $7 072 per capita after equalization, while the average of the ten provinces is $7 436 per capita. To offer a level of services comparable to the other provinces, Québec must consequently impose a tax burden that is $364 per capita higher than the Canadian average.

2 See Section G of the 2009-2010 Budget Plan for more information on these issues.

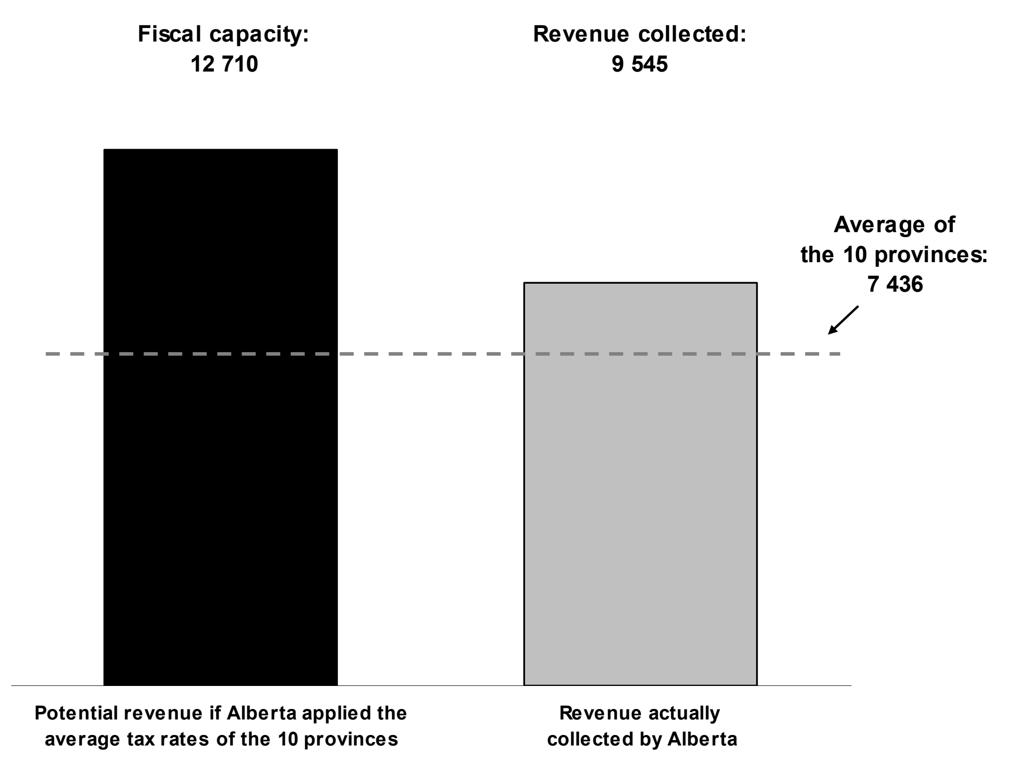
— Moreover, Québec has chosen to offer more public services than the Canadian average. This is reflected in an additional tax burden of $1 084 per capita for revenue actually collected amounting to $7 536 per capita (6 088 + 364 + 1 084).

Consequently, it is false to state that Québec uses equalization to fund more generous public services than the Canadian average. They are funded by higher taxes.

Furthermore, the following chart illustrates Alberta's fiscal capacity and the revenue it collected in 2011-2012, again according to the latest equalization calculations by federal government.

CHART A.3

Fiscal capacity of and revenue collected by Alberta for 2011-2012
(dollars per capita)



Source of data: Department of Finance Canada.

This chart shows that:

- If Alberta decided to apply the average tax rates observed in the ten Canadian provinces, it would obtain revenue of $12 710 per capita, 71% higher than the Canadian average of $7 436 per capita. Alberta's substantial wealth stems in particular from its natural resources, as will be seen later.
- However, Alberta has decided not to use all of this fiscal capacity surplus, by imposing lower tax rates than the Canadian average. Despite that, the province collects revenue of $9 545 per capita, i.e. $2 109 per capita higher than the average of the ten provinces.
- In fact, the revenue Alberta receives is 12% higher than Québec's ($8 520 per capita), despite much lower tax rates.

Consequently, it is false to state that Alberta does not have the capacity to offer the same services as Québec. It has made different choices, which is perfectly consistent with the framework of Canadian federalism, in which the provinces are free to carry out their responsibilities as they see fit.

Could Québec maintain its programs if it adopted Alberta's tax system?

Québec's tax system generates more revenue than those of the other provinces. For example, had Québec applied Alberta's personal income tax system in 2010, it would have collected $5.2 billion less.

Accordingly, Alberta's personal income tax system would not allow Québec to collect enough revenue to fund, for instance, a generous daycare program or a prescription drug insurance plan.

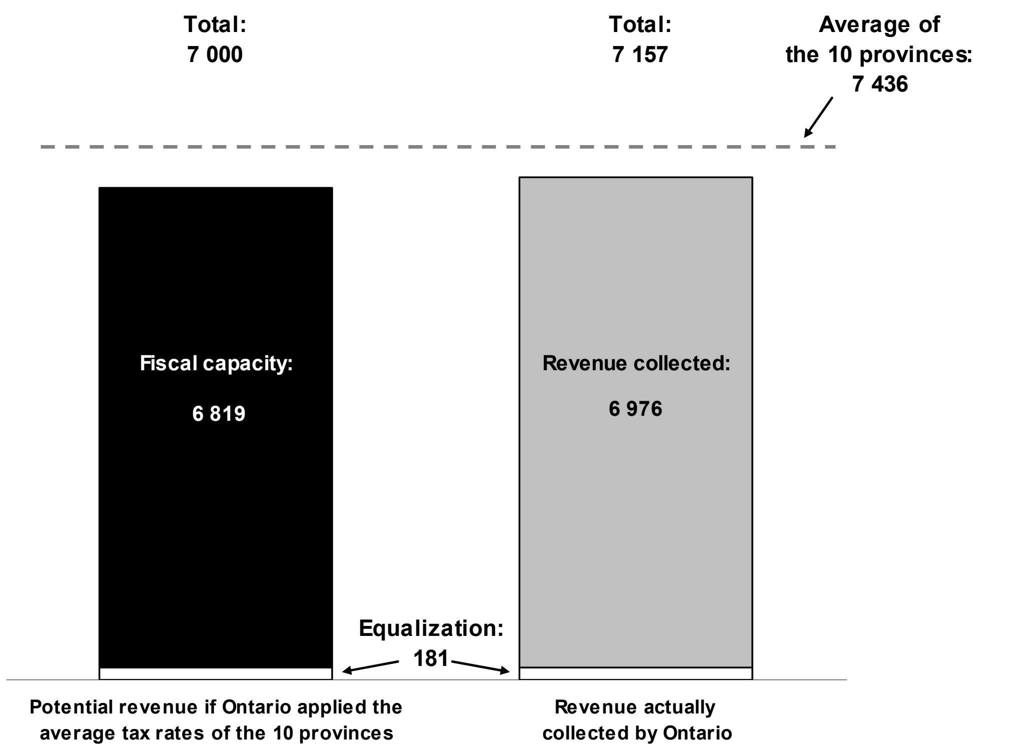
The same is true of Québec's sales tax, which generated revenue of $11.7 billion in 2010-2011. Alberta has chosen not to have a sales tax.

Accordingly, were Québec to adopt Alberta's tax system, it would not be able to maintain the public services it currently offers.

Lastly, the following chart illustrates the fiscal capacity and revenue collected by Ontario in 2011-2012.

CHART A.4

Fiscal capacity of and revenue collected by Ontario for 2011-2012
(dollars per capita)



Source of data: Department of Finance Canada.

This chart shows that:

- After equalization, Ontario, like Québec, has a fiscal capacity below the Canadian average. There remains a gap of $436 per capita.
- However, unlike Québec, Ontario has decided not to completely fill this gap compared to the Canadian average with higher taxes. Accordingly, there remains a gap of $279 per capita.

Consequently, Ontario currently does not have enough revenue to offer a level of services comparable to the Canadian average, because of shortcomings in the existing equalization program and Ontario's choice to keep taxes at a level that is insufficient to bridge the gap.

2. RECENT DEVELOPMENTS IN EQUALIZATION IN CANADA

Two major economic phenomena help explain recent developments in equalization in Canada, and more particularly Ontario's entry into the group of recipient provinces. The provinces have little control over these phenomena:

— the geographical distribution of natural resources, which gives rise to a substantial gap in fiscal capacity among the provinces;

— the appreciation of the Canadian dollar and its impact on the international exports of some provinces.

2.1 Fiscal capacity relating to natural resources

To better understand the sources of economic and fiscal disparities among the provinces, it is worthwhile analyzing the fiscal capacity of the provinces derived from natural resources separately from that arising from all other revenue sources. This analysis shows to what point ownership (or not) of considerable natural resources, on a per capita basis, plays a major role in what makes a province eligible (or not) to receive equalization.

Provincial revenues derived from renewable and non-renewable natural resources amount to $22 billion for Canada as a whole, according to the data the federal government has used to set the amounts of equalization that will be paid in 2011-2012.[3] It can be seen that:

— the four provinces that do not receive equalization account for 82.0% of revenue drawn from natural resources but represent only 28.6% of Canada's population;

— the six other provinces, representing 71.4% of the population, receive 18.0% of revenues derived from natural resources. Note that, within this group, Québec is by far the province that obtains the most revenue from natural resources.

TABLE A.1

Provincial population and revenues derived from natural resources,[1] 2011-2012

	Population		Revenues from natural resources	
	(inhabitants)	(% share)	($ millions)	(% share)
Provinces that do not receive equalization				
Alberta	3 605 006	10.8	9 343	42.5
British Columbia	4 396 712	13.2	3 223	14.6
Saskatchewan	1 016 644	3.1	2 861	13.0
Newfoundland	506 789	1.5	2 613	11.9
Subtotal	**9 525 151**	**28.6**	**18 040**	**82.0**
Provinces that receive equalization				
Québec	7 765 973	23.3	2 981	13.5
Nova Scotia	937 361	2.8	388	1.8
Ontario	12 947 556	38.9	298	1.4
Manitoba	1 207 858	3.6	191	0.9
New Brunswick	747 728	2.2	104	0.5
Prince Edward Island	139 875	0.4	0	0.0
Subtotal	**23 746 351**	**71.4**	**3 962**	**18.0**
TOTAL OF THE TEN PROVINCES	**33 271 502**	**100.0**	**22 002**	**100.0**

Note: Totals may not add due to rounding.
1 Includes revenue from offshore agreements.
Source of data: Department of Finance Canada.

3 Because of the smoothing mechanism used to limit annual variations in equalization payments, the data used to establish the 2011-2012 amounts in fact cover the period of economic activity running from 2007-2008 to 2009-2010.

These revenues include the $358 million paid by the federal government to Newfoundland and Nova Scotia under the agreements on offshore resources these provinces entered into in the mid-1980s and in 2005. These agreements are designed so that Newfoundland and Nova Scotia are compensated 100% for the decline in equalization payments resulting from the development of their offshore natural resources.

Agreements on offshore resources

In the mid-1980s and in 2005, Newfoundland and Nova Scotia reached agreements on offshore resources (oil and natural gas) with the federal government. The amount they receive completely protects them against reductions in their equalization payments resulting from the revenues these provinces derive from their offshore resources. The payments under these agreements are paid outside the equalization envelope.

Payments to Newfoundland and Nova Scotia under agreements on offshore resources
(millions of dollars)

	From 1993-1994 to 2010-2011	2011-2012	Total
Newfoundland	4 252	325	4 576
Nova Scotia	901	34	934
TOTAL	**5 153**	**358**	**5 511**

Note: Totals may not add due to rounding.
Source of data: Department of Finance Canada.

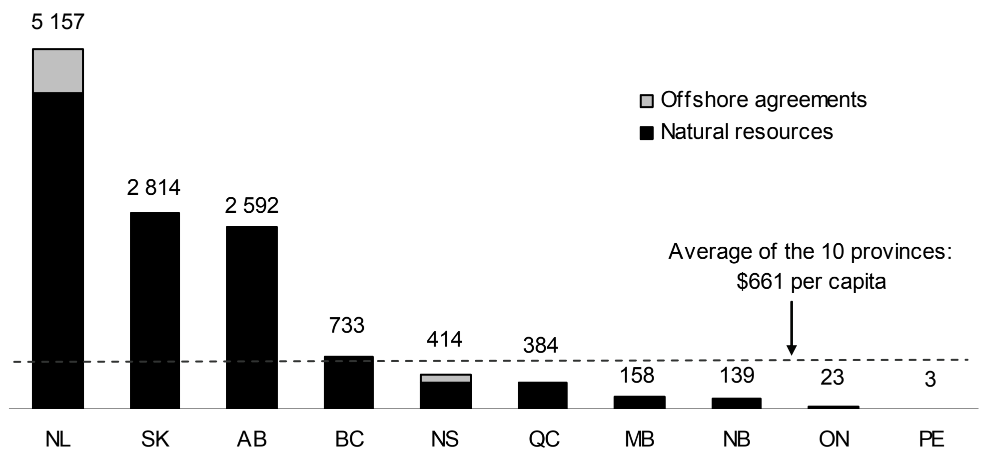
The 1985 agreement with Newfoundland expires in 2010-2011. Under the 2005 agreement, a transition payment of $325 million will be made in 2011-2012. This agreement will not be extended if Newfoundland does not receive equalization as at March 1, 2012, as is currently expected.

The 1986 agreement with Nova Scotia expired in the mid-2000s. Nova Scotia currently receives payments under the 2005 agreement. This agreement will be extended until 2020 unless Nova Scotia's per capita net debt is less than that of at least four other provinces on March 31, 2012.

The concentration of revenue derived from natural resources within certain provinces is a significant cause of fiscal disparities, as can be seen in the following chart. While the average fiscal capacity of the provinces for this revenue source amounts to $661 per capita in 2011-2012, it varies from $3 per capita in Prince Edward Island to $5 157 per capita in Newfoundland. Accordingly, the most affluent province has a fiscal capacity more than 1 700 times that of the least affluent province.

CHART A.5

Fiscal capacity of the provinces arising from revenue derived from natural resources, 2011-2012
(dollars per capita)



Source of data: Department of Finance Canada.

The chart also shows that Ontario's fiscal capacity in respect of natural resources is only $23 per capita, i.e. 17 times lower than that of Québec ($384 per capita) and 113 times lower than Alberta's ($2 592 per capita).

However, it is important to note that the current equalization formula does not include all the revenues the provinces derive from natural resources. Indeed, only 50% of such revenue is included in the formula, while the revenue arising from the offshore resources agreements of Newfoundland and Nova Scotia is completely excluded.

Consequently, the average fiscal capacity of the provinces that is actually taken into account by the equalization formula is not $661 per capita, as shown in the preceding chart, but $325 per capita.

In the equalization formula, Ontario's fiscal capacity is $12 per capita, i.e. $313 less than the average of the ten provinces on account of natural resources. This gap means that for the purposes of equalization, Ontario obtains $4.1 billion less from its natural resources than if its fiscal capacity were equal to the average of the ten provinces.

How much revenue would Québec need to earn from its natural resources in order not to receive equalization?

The presence of significant natural resources in a province with a small population is a key factor for equalization matters.

For instance, Québec will receive $7.6 billion in equalization in 2011-2012. For Québec to no longer receive equalization, it would have to earn some $14 billion more in revenue from its natural resources than the $3 billion it currently obtains for a total of $17 billion, which represents an increase of roughly 460%. It should be noted that Alberta, which has the third-largest proven oil reserves in the world, earned revenue from its natural resources of some $12 billion per year, on average, over the last five years.

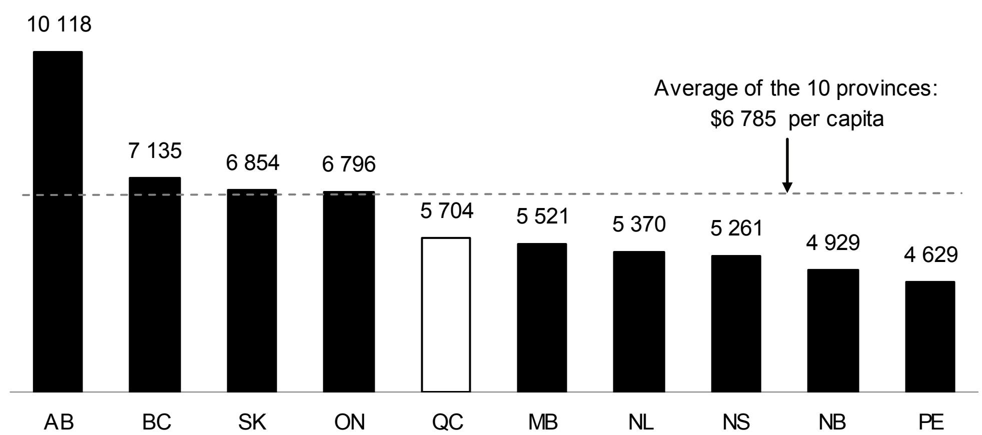
Moreover, Newfoundland earns revenue of $2.1 billion annually from offshore oil development, which is less than the revenue Québec earns from its natural resources. However, Newfoundland's population is 15 times smaller than Québec's. Accordingly, on a per capita basis, the $2.1 billion that Newfoundlanders receive would represent revenue of some $32 billion per year for Quebecers.

The following chart shows the fiscal capacity of the provinces for all other revenue sources. It shows that Prince Edward Island ($4 629 per capita) has the country's lowest fiscal capacity for these revenue sources, while Alberta ($10 118 per capita) has the highest fiscal capacity, i.e. more than double Prince Edward Island's. Despite this substantial gap, the disparities among the provinces are not as great for these revenue sources as for natural resources.

Québec ($5 704 per capita) is the province with the highest fiscal capacity among the provinces that are below the average of the ten provinces ($6 785 per capita).

CHART A.6

Fiscal capacity of the provinces in relation to revenue sources other than natural resources, 2011-2012
(dollars per capita)



Source of data: Department of Finance Canada.

The latter chart also shows that Ontario ($6 796 per capita) is $11 richer per capita than the average of the ten provinces in relation to revenue sources other than natural resources. This means that if Ontario applied the average tax rates of the ten provinces to its tax bases, it would obtain $134 million more than the average of the ten provinces.

Accordingly, Ontario is now an equalization recipient province because its traditional fiscal capacity surplus regarding the other revenue sources no longer offsets its fiscal capacity deficit in relation to natural resources.

These other revenue sources are grouped in four categories within the equalization formula, namely personal income tax, corporate income tax, consumption taxes and property taxes.

The following table shows the change, from 2003-2004 to 2009-2010, of Ontario's share of these four revenue sources, as well as the change in Ontario's share of the population during the same period. This is the period of economic activity underlying the amounts of equalization paid between 2007-2008 and 2011-2012 by the federal government, because of the smoothing mechanism used to limit annual variations in equalization payments.

The table shows that Ontario's share has declined significantly over the period for each of the four revenue sources, especially corporate income tax. Only for personal income tax has Ontario's fiscal capacity remained, despite the decline, significantly higher than its demographic share in the ten provinces.

TABLE A.2

Change in Ontario's population and fiscal capacity

(Ontario's share of the ten provinces, per cent)

	Population	Personal income tax	Corporate income tax	Consumption taxes	Property taxes
2003-2004	38.8	45.4	44.7	39.3	43.6
2004-2005	38.9	44.6	42.8	39.0	42.6
2005-2006	39.0	43.7	38.9	38.4	42.3
2006-2007	39.0	42.4	39.9	38.1	42.0
2007-2008	39.0	41.8	39.5	37.4	40.8
2008-2009	38.9	40.9	32.8	36.9	40.0
2009-2010	38.9	41.2	30.8	37.3	39.0

Source of data: Department of Finance Canada.

The explanation for these economic phenomena is to be found mainly in the province's international exports, as we shall see in the following subsection.

Is Ontario the 2nd largest recipient of equalization?

The equalization program is calculated on a per capita payments basis. In 2011-2012, Ontario is the province whose payments per capita are the lowest of the six recipient provinces. Ontario will receive the second-largest amount of equalization, in 2011-2012, i.e. $2.4 billion, because it has a population of 13 million people. After Ontario, Québec is the province that receives the least equalization on a per capita basis.

Equalization and population of the recipient provinces, 2011-2012

	A	B	A x B
	$ per capita	Population	$ million
Ontario	181	12 947 556	2 350
Québec	984	7 765 973	7 639
Nova Scotia	1 254	937 361	1 176
Manitoba	1 388	1 207 858	1 677
New Brunswick	1 990	747 728	1 488
Prince Edward Island	2 358	139 875	330
TOTAL	**617**	**23 746 351**	**14 659**

Note: Totals may not add due to rounding.
Source of data: Department of Finance Canada.

2.2 The dollar and international exports

Canada's international exports accounted for 28.7% of its GDP in 2009. This share varies from 20.0% in Nova Scotia to 39.4% in New Brunswick. It should be noted that in 2000, exports accounted for 45.6% of Canada's GDP.

TABLE A.3

International exports of goods and services of the provinces, 2009

	$ million	% of GDP
New Brunswick	10 835	39.4
Newfoundland	9 670	38.7
Saskatchewan	21 196	37.5
Alberta	79 135	32.0
Ontario	174 161	30.1
Manitoba	14 068	27.6
Québec	79 837	26.3
Prince Edward Island	1 136	23.9
British Columbia	39 576	20.7
Nova Scotia	6 873	20.0
TOTAL	**436 487**	**28.7**

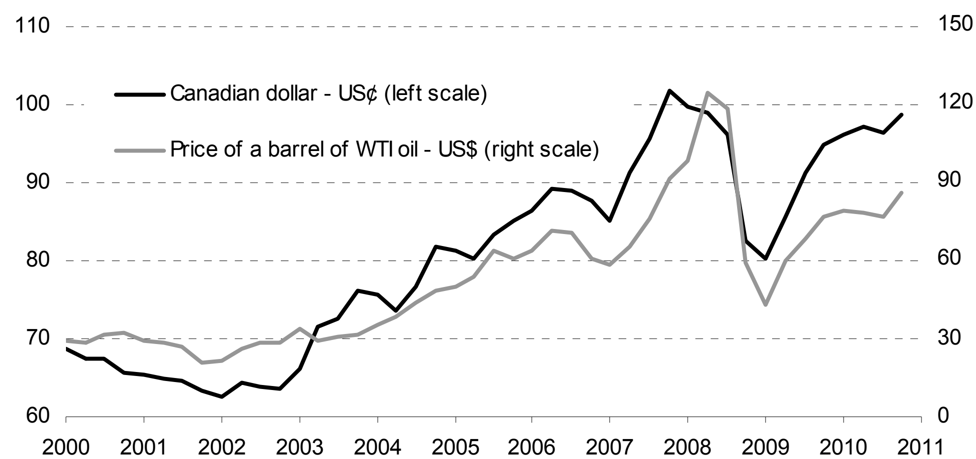
Source of data: Statistics Canada.

Moreover, during the last decade, the Canadian dollar has risen substantially compared with its American counterpart, moving from US$0.64 on average in 2002 to US$1.01 on average in February 2011, an increase of close to 60%. In other words, all other things being equal, a Canadian product imported by an American costs him 60% more today than it did 10 years ago.

There is a documented link between the change in the Canadian dollar and the world oil price,[4] as the following chart also shows.

CHART A.7

Exchange rate and price of a barrel of oil



Sources of data: Statistics Canada and Bloomberg.

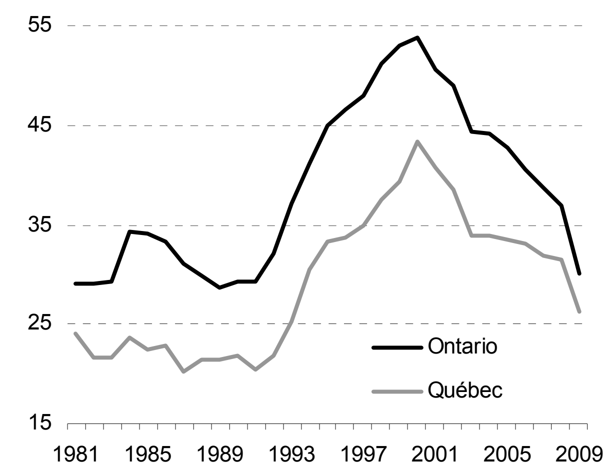
While a higher world barrel price of oil favours provinces that have that resource, the appreciation in the Canadian dollar that accompanies this rise in the oil price makes Canadian international exports less competitive. This impact on international exports varies significantly from province to province.

4 For example: "[...] soaring commodity prices are the primary catalyst for the rise in the Canadian dollar that has hurt export-oriented manufacturers." Economic analysis by TD Bank, April 2008.

For example, the following charts show change in the international exports of goods and services of Ontario, Québec and Alberta since 1981. It can be seen that these three provinces have benefited greatly from the opening of international markets since the early 1990s, in particular following the entry into force of the Free Trade Agreement (FTA) between Canada and the United States, on January 1, 1989, and the North American Free Trade Agreement (NAFTA) between Canada, the United States and Mexico, January 1, 1994.

GRAPHIQUE A.8

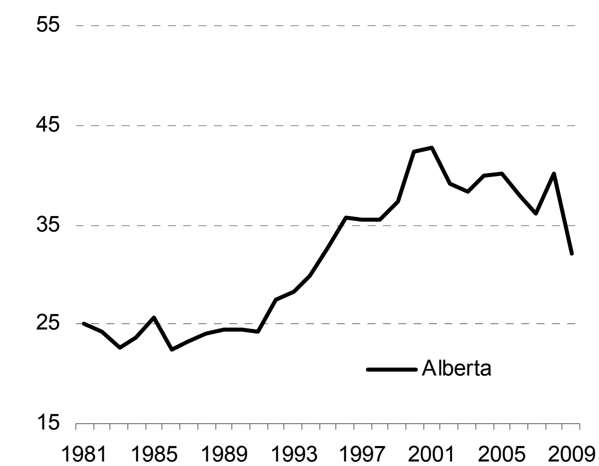
International exports of goods and services
(as a percentage of GDP)



Source of data : Statistics Canada.

GRAPHIQUE A.9

International exports of goods ans services
(as a percentage of GDP)



Source of data : Statistics Canada.

The charts also show that:

— Ontario's international exports have plunged from a peak of 53.9% of GDP in 2000 to 30.1% in 2009. This is essentially the period covered by the table on page A.19, which explains that Ontario became an equalization recipient province because of a substantial decline in its fiscal capacity in relation to revenue sources other than natural resources.

— Québec's international exports have also declined during the same period, dropping from 43.3% of GDP to 26.3%.

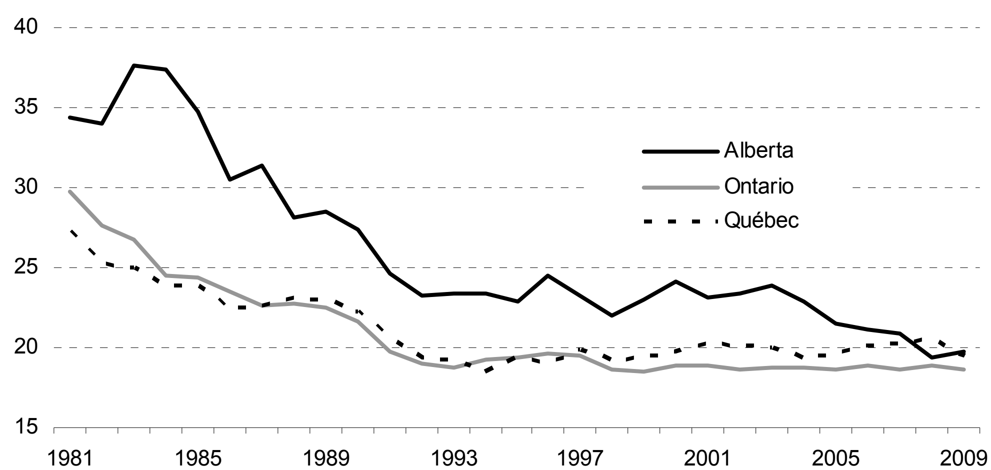
— Moreover, while Alberta's international exports have also suffered from the global economic and financial crisis since the fall of 2008, they have been less affected than those of Québec and Ontario by the dollar's rapid appreciation during the last decade. They have held at close to 40% of Alberta's GDP, on average, for the last 10 years.

— Note that, unlike Québec and Ontario, oil and natural gas account for a very high percentage of Alberta's international exports, representing more than 50% of its exports for the last 20 years.

It is interesting to note that, at the same time, the interprovincial exports of these three provinces – exports that are not affected by changes in the exchange rate – remained much more stable, holding at roughly 20% of their respective GDP over the last 20 years.

CHART A.10

Interprovincial exports of goods and services
(as a percentage of GDP)



Source of data: Statistics Canada.

To summarize, the substantial drop in Ontario's international exports as a proportion of its economy over the last 10 years, which coincides with the significant appreciation of the Canadian dollar, itself related to the rise in the world oil price, explains why this province's traditional "wealth" in respect of other revenue sources no longer offsets its relative "poverty" with regard to natural resources.

3. FINANCIAL FLOWS WITHIN THE FEDERATION

Some say that the taxpayers of certain provinces send “too much money” to other provinces as part of the redistribution carried out by the federal government.

This question deserves serious analysis, in particular by taking into account the substantial financial flows that arise from the trade in goods and services among Canada’s provinces.

3.1 The federal budget balance by province

Criticisms of interprovincial redistribution within the federation are generally based on the federal budget balance by province, taken from Statistics Canada’s provincial economic accounts (PEA).

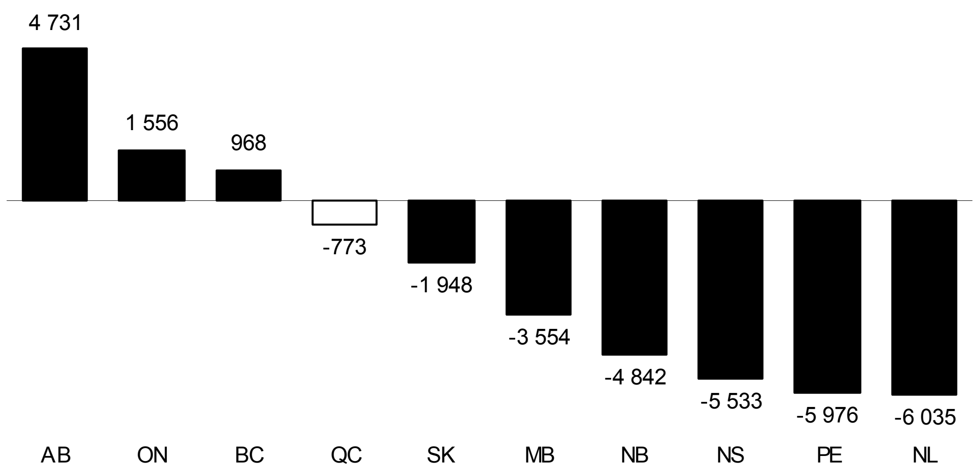
A federal deficit in one province means that the federal government collected less revenue there than what it spent, and vice versa. All federal spending is included in this calculation, whether transfers to the provinces, transfers to persons or direct spending by the federal government (public servants, military bases, etc.).

When these figures are put in proper perspective, it turns out that Québec is not the major beneficiary of federal redistribution in Canada.

Indeed, over the most recent five years available (2004 to 2008), the federal deficit in Québec averaged $773 per capita. This is the smallest amount among the seven provinces where the federal government posted a deficit. The largest federal deficit was $6 035 per capita in Newfoundland.

CHART A.11

Budget balance of the federal government by province, annual average from 2004 to 2008
(dollars per capita)

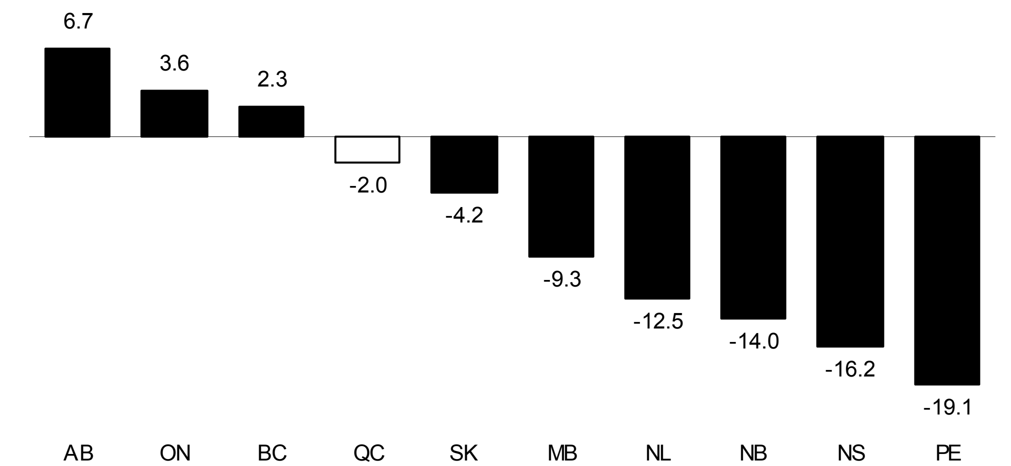


Note: These data, published in November 2010, date from 2008 and do not reflect the fact that, since then, the federal government is once again running a budget deficit and has implemented economic recovery measures that have benefited the provinces.
Source of data: Statistics Canada.

Moreover, the federal deficit amounted to 2.0% of Québec's GDP, on average, from 2004 to 2008. Once again, this is the lowest level among the seven provinces where the federal government posted a deficit. The largest federal deficit amounted to 19.1% of Prince Edward Island's GDP.

CHART A.12

Budget balance of the federal government by province, annual average from 2004 to 2008
(as a percentage of GDP)



Note: These data, published in 2010, date from 2008 and do not reflect the fact that, since then, the federal government is once again running a budget deficit and has implemented economic recovery measures that have benefited the provinces.
Source of data: Statistics Canada.

However, caution is needed when using the PEA to assess inter-provincial redistribution in Canada. On this issue, Statistics Canada noted in the edition of the *Canadian Economic Observer* published in February 2007:

> Performing a cost-benefit analysis of Confederation simply using the federal government revenue and expenditure estimates of the PEA is erroneous. The fiscal arrangements in our confederation are far more subtle [...] While the federal government may, for example, transfer money to the Atlantic Provinces under the equalization program, that money might then be used to purchase medical equipment manufactured in Ontario (pages 3.2 and 3.3).

Accordingly, to assess the interregional financial flows within the federal more accurately, it is also important to study trade in goods and services among the provinces.

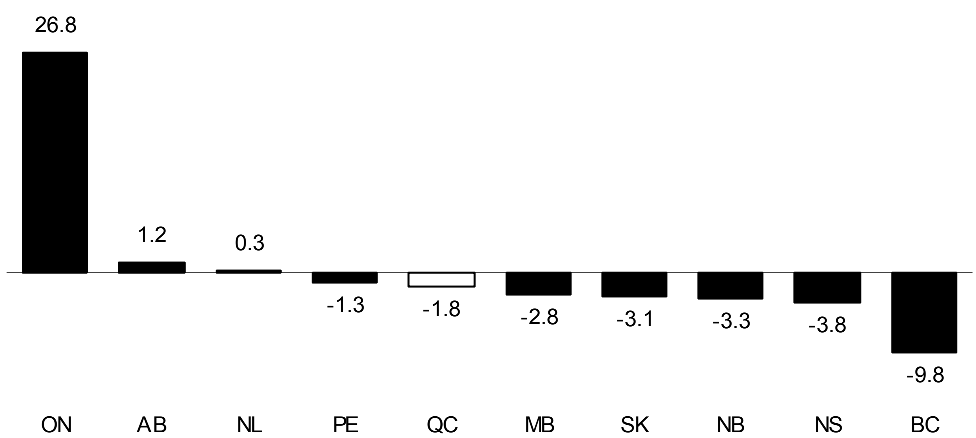
3.2 Interprovincial trade in Canada

Statistics Canada's PEA provide data on interprovincial trade in goods and services. A province's trade balance corresponds to the difference between what it exports to other provinces and what it imports from them. A positive trade balance means that exports exceed imports.

Over the last five years available (2005 to 2009), three provinces have posted a positive trade balance on average in respect of trade in goods and services. Ontario ($26.8 billion) is by far the province with the largest trade surplus, followed by Alberta ($1.2 billion) and Newfoundland ($0.3 billion).

CHART A.13

Interprovincial trade balance in goods and services, annual average from 2005 to 2009
(billions of dollars)

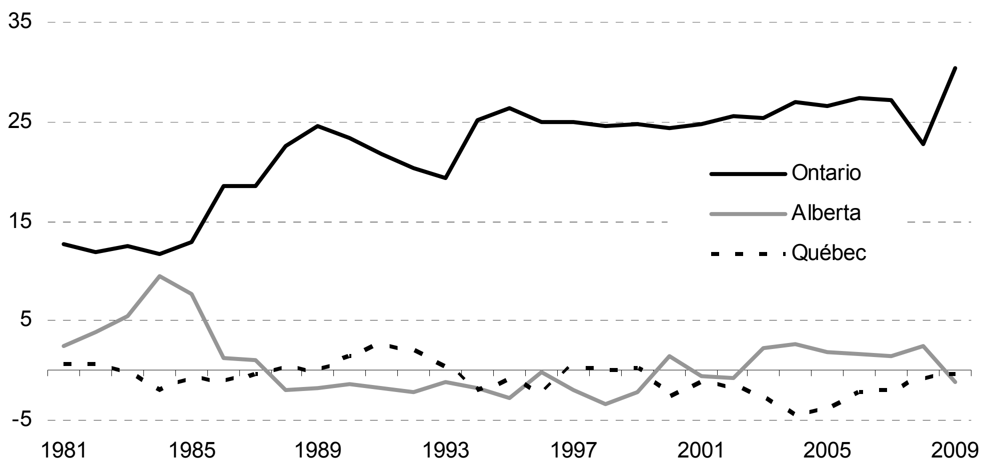


Source of data: Statistics Canada.

Indeed, the following chart shows that Ontario has posted a positive trade balance of roughly $25 billion per year over the last 20 years. Over the same period, the trade balances of Québec and Alberta have fluctuated around zero.

CHART A.14

Interprovincial trade balance in goods and services
(billions of dollars)



Source of data: Statistics Canada.

Over the entire period (1981-2009), Ontario's cumulative trade balance is roughly $643 billion. It is roughly $19 billion for Alberta and roughly – $22 billion for Québec.

The substantial financial flows arising from interprovincial trade in Canada help put the amounts redistributed by the federal government in perspective. This point needs to be considered in assessing fiscal federalism in Canada.

4. REDISTRIBUTION AND FEDERAL TRANSFERS

Some maintain that federal transfers – especially equalization – have grown substantially in recent years. They conclude from this that the current degree of redistribution among the provinces through federal transfers is greater than previously.

However, the facts indicate that on the contrary, redistribution through federal transfers has declined significantly over the last 30 years.

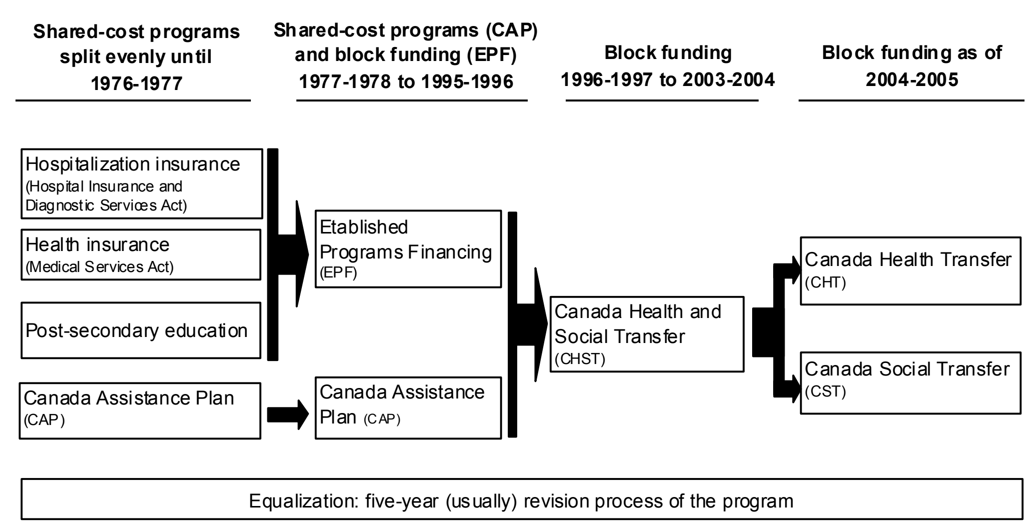
4.1 Changes in redistribution over the last 30 years

Until the mid-1970s, the provinces' eligible spending on health, social services and post-secondary education was split evenly between the federal government and the provinces. Accordingly, a province whose proportion of health or social assistance costs exceeded its demographic weight could receive a greater share of federal transfers.

Subsequently, the federal government gradually introduced "block funding" transfers, i.e. transfers independent of the amount of a province's spending, and allocated on the basis of its population. The degree of redistribution through transfers to the provinces has therefore declined over time, since payment of transfers for health, post-secondary education and social assistance no longer takes into account the provinces' needs in these fields.

TABLE A.4

Changes in the main federal transfers

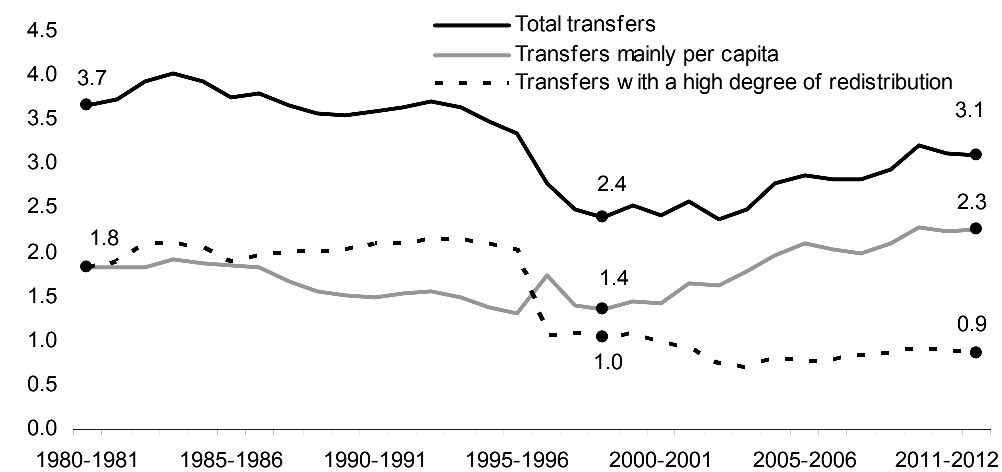


To illustrate this phenomenon, it is interesting to study the changes in the major federal transfers to the provinces as a proportion of the Canadian economy over the last 30 years. The following facts emerge:

- The total of the major federal transfers stood at 3.7% of GDP in 1980-1981. It fell to 2.4% in 1998-1999 and then recovered to 3.1% in 2011-2012.
- However, until 1996, the share of the major federal transfers "with a high degree of redistribution" was greater than the share of the other transfers that are allocated mainly "per capita".[5]
- Now, however, the share of transfers with a high degree of redistribution is clearly less than that of transfers allocated mainly per capita.

CHART A.15

Major federal transfers to the provinces, 1980-1981 to 2011-2012
(as a percentage of GDP)



Note: Transfers with a high degree of redistribution are those for which the share of the provinces is very different from their share of the population (CAP and equalization). Transfers allocated mainly per capita are the following: EPF education, EPF health, CHST, CHT and CST.
Sources of data: Department of Finance Canada and Ministère des Finances du Québec.

5 Transfers with a high degree of redistribution are those for which the share of the provinces is very different from their share of the population (CAP and equalization). Transfers allocated mainly per capita are the following: EPF education, EPF health, CHST, CHT and CST.

4.2 Impact of the 2008 changes to equalization

Some have indicated that in recent years, the cost of the equalization program has risen significantly and that the federal government should take action to limit its growth.

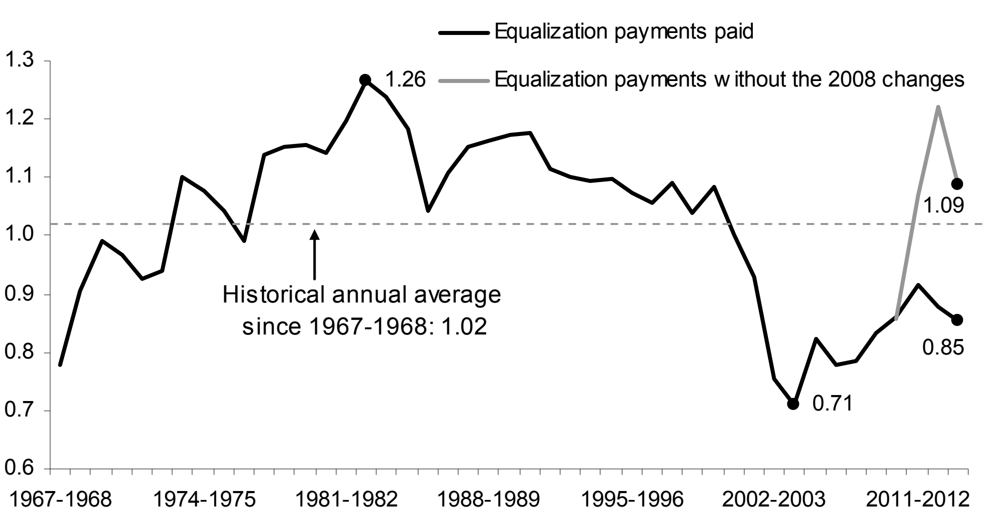
It is important to note that historically, the federal government previously has allocated much more to the equalization program than it currently does. In addition, the increase since 2007 must be viewed in the context of the marked decline in the cost of the equalization program early in the 2000s.

In 2011-2012, the cost of the equalization program represented 0.85% of Canada's GDP, significantly less than the historical annual average of 1.02% observed since 1967-1968. If the cost of the equalization program corresponded to the historical average, it would be $2.9 billion greater in 2011-2012.

In addition, had the federal government not imposed caps on the equalization program in 2008, the amounts that would have been paid to the provinces would have been similar, in proportion of GDP, to those paid from 1970 to 2000.

CHART A.16

Equalization as a proportion of Canada's GDP
(per cent)



Sources of data: Department of Finance Canada, Statistics Canada and Ministère des Finances du Québec.

CONCLUSION

This section has provided an update on the major economic phenomena currently at work in Canada and which it will be important to take into consideration in the discussions leading to the renewal of the major federal transfers in 2014.

It is important that these discussions be based on facts, otherwise the changes that will be made to federal transfer programs could exacerbate the challenges facing the provinces.

In the course of these discussions, the Québec government will work to ensure that federal transfers are adequate, predictable and fair for all the partners of the federation.

Section B

Compensating Québec for Sales Tax Harmonization

INTRODUCTION

In recent years, the Québec government has publicly exposed a number of files and issues relating to federal transfers. For example:

— Section D of the *2007-2008 Budget Plan*[1] set out the substantial changes made to federal transfers since 2003 and the remaining issues regarding the major transfers to the provinces, federal infrastructure programs and the “federal spending power”.

— Section G of the *2009-2010 Budget Plan* set out the unilateral changes the federal government made to the equalization formula in November 2008. These changes were made barely 18 months after the implementation of a significant reform recommended by an independent expert panel. That section also called for better governance of Canadian fiscal federalism.

— Section E of the *2010-2011 Budget Plan* restated certain facts regarding equalization and redistribution in Canada. It also set out a number of priority files to be settled for Québec to be treated fairly compared with the other provinces.

Québec has continued to argue for these positions in discussions with the federal government and the other provinces.

While Section A of this document further examines recent developments in Canadian fiscal federalism, this section provides an update on an issue of particular importance for Québec: obtaining fair compensation from the federal government for sales tax harmonization.

1 Tabled in National Assembly in May 2007.

1. THREE FUNDAMENTAL ISSUES

Discussions with the current federal government on compensating Québec for sales tax harmonization have gone on for almost two years. During these discussions, Québec has been very open, as the following subsection will show.

However, Québec has been very clear on three fundamental issues:

- The fiscal sovereignty of the two governments must be preserved. In particular, the Québec sales tax (QST) will continue to apply by virtue of an Act of the National Assembly and the goods and services tax (GST) will continue to apply by virtue of an Act of the House of Commons.
- Québec will continue to administer the GST and the QST.
- Québec must be allowed to maintain the tax integrity measures it has introduced.

Recently, the federal government publicly confirmed its agreement with Québec's continued administration of the two taxes. Accordingly, this question is settled.

The following subsection explains why the other two issues are important for Québec.

2. HARMONIZATION OF SALES TAXES: THE FACTS

2.1 Fair treatment for Québec

On July 1, 1992, Québec was the first province to harmonize its sales tax with the GST. However, of the six provinces that have harmonized their sales tax, Québec remains the only one not to have received any financial compensation from the federal government.

TABLEAU B.1

Compensation paid by the federal governement for sales tax harmonization

Provinces	Year of announcement	Amount ($ millions)	Amount ($ per capita)
Newfoundland	1996	348	605
Nova Scotia	1996	249	265
New Brunswick	1996	364	479
Ontario	2009	4 300	329
British Columbia	2009	1 599	359
TOTAL		**6 860**	

Sources : Departement of Finance, Ministère des Finances du Québec and Statistics Canada.

The $2.2 billion in compensation claimed by Québec is based on the calculation that justified payment of $4.3 billion to Ontario and $1.6 billion to British Columbia in 2009, i.e. the value of 1.5 points of GST in the province. This amount represents $276 per capita for Québec.

2.2 The QST contributes to the federal government's economic objectives

In recent years, the federal government has raised the issue of provincial retail sales taxes many times in its budgets. For instance, the following quotation is taken from page 262 of the federal budget plan tabled January 27, 2009:

> Provincial retail sales taxes are outdated and inefficient. They impose a significant tax burden on new business investment and increase the day-to-day operating costs of Canadian businesses [...] Ultimately, this makes our businesses less competitive, reduces employment and lowers the standard of living for Canadians.

The same document also states, on page 166:

> [...] if the five provinces (British Columbia, Saskatchewan, Manitoba, Ontario and Prince Edward Island) that still have retail sales taxes were to modernize their systems by implementing a value-added tax structure harmonized with the GST, businesses operating in those provinces would become much more competitive.

Québec is not one of the non-harmonized provinces targeted by recent federal budgets, including the January 2009 budget. In so doing, the federal government has confirmed that the QST contributes to its economic objectives.

2.3 Taxes substantially harmonized from the outset

The expression “harmonization” in itself requires the existence of two separate tax systems whose parameters, once harmonized, are comparable.

From the start, the federal government considered that the GST and the QST were sufficiently harmonized to entrust Québec with administration of the GST. The agreement in principle to that effect, signed August 30, 1990 by Finance Ministers Michael Wilson and Gérard D. Levesque, stated that:

> [...] Québec’s administration of the GST within its territory along with the provincial tax would avoid duplication, reduce administration costs, facilitate compliance for agents and be beneficial for the economy. [TRANSLATION]

It was also recognized, in the April 26, 1991 agreement relating to Québec’s administration of the GST, that the National Assembly of Québec had passed legislative provisions that would make the QST tax base substantially comparable with that of the GST. In addition, this agreement stipulated joint mechanisms designed “to keep the tax bases substantially comparable” [TRANSLATION] over time.

2.4 Differences that represent less than 1% of the tax base

The entry into force of the harmonized sales tax (HST) in Ontario and British Columbia on July 1, 2010, had significant effects on taxpayers in those provinces. However, an agreement between the federal government and Québec in this regard would have no impact on Québec consumers. For example:

- Services that were not taxed previously, such as hairdressing services, taxi rides, dry-cleaning and house-calls by a plumber or electrician are now subject to the HST in Ontario and British Columbia. This is already the case in Québec.

- The purchase of a new home is now subject to the HST in Ontario and British Columbia. This is already the case in Québec.

- Businesses in Ontario and British Columbia are now entitled to a rebate of sales tax paid on their inputs. This is already the case in Québec.

- The restrictions on this rebate imposed on large businesses in Ontario and British Columbia are modeled on those in force in Québec.

Moreover, Québec has been open in the negotiations that have been ongoing for almost two years. As will be seen below, Québec would be prepared to make technical changes to the QST, in particular on matters relating to large businesses and financial services, to bolster the QST's already substantial harmonization with the GST. When these commitments are taken into account, the remaining distinctions concerning exemptions and rebates between the QST and the GST represent less than 1% of the estimated GST base for Québec.

TABLE B.2

Value of goods and services whose tax treatment differs under the QST and the GST systems, 2010
(millions of dollars and as a percentage of the estimated GST base for Québec)

	$ million	%
Zero-rating of books	605	0.5
Zero-rating of diapers for infants and nursing supplies	112	0.1
Reimbursement regarding automatic door openers for handicapped persons	m	m
Reimbursement regarding the temporary supply of a pleasure boat for storage purposes	m	m
TOTAL	**717**	**0.6**

m: minor.
Source: Ministère des Finances du Québec.

Under the HST, the federal government allows the participating provinces to offer exemptions and rebates[2] such that the provincial component of the HST is not perfectly harmonized with the federal component (for instance: Ontario, like Québec, does not tax books).

However, these tax differences must not exceed a limit of 5% of the province's estimated GST base. The above table shows that this criterion is satisfied *de facto* in Québec. Québec has also indicated to the federal government that it would undertake, in an agreement, to comply with the 5% limit on tax differences agreed with the provinces participating in the HST.

[2] Called "point-of-sale rebates" in the HST system.

2.5 An accurate and efficient system

Under the HST, it is impossible for the participating provinces to be certain that the amounts received on account of the provincial component of the HST correspond exactly to the amounts collected on that account on their territory. The fact is that the HST is shared with the provinces on the basis of a complex mathematical formula.[3]

However, the system in place in Québec is based on taxable transactions carried out within its territory, such that each government receives exactly the amounts collected on account of its respective tax.

In addition, Revenu Québec and the Canada Revenue Agency have done studies showing that Québec's administration of the two sales taxes is efficient and less onerous.[4] The 3 200 Revenu Québec employees assigned to sales tax administration do excellent work. Indeed, the Canada Revenue Agency has congratulated Revenu Québec.[5]

The system in place in Québec for 20 years provides genuine "one-stop service" for almost 650 000 mandataries, thus enabling them to comply with their tax obligations easily and at low cost.

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3 See *Ontario's Tax Plan for Jobs and Growth: Cutting Personal and Corporate Taxes and Harmonizing Sales Taxes (Addendum)* http://www.fin.gov.on.ca/en/publications/2009/fbbb.pdf; pages 25 to 60. This is the section of the final Canada-Ontario agreement on harmonization of sales taxes that describes the HST revenue allocation formula.

4 On this matter, it recently came to light that the costs of implementing the HST in Ontario and British Columbia were $58.7 million more than forecast this year. An increase of $112.6 million is also forecast next year. According to a senior official with the Canada Revenue Agency, this increase stems from the decision to transfer provincial officials to the federal agency to help with the administration of the new tax.

5 For example, the commissioner of the Canada Revenue Agency wrote to the Deputy Minister of Finance of Québec as follows on May 22, 2007: "I am writing to express my gratitude and congratulations concerning the successful implementation [...] of the new goods and services tax processing system [...] this success is to a large extent due to the close working relations both organizations have established." [TRANSLATION]

2.6 A “win-win” approach

The tax integrity measures Québec has put in place over the years have benefited not just the Québec government but the federal government as well.

For instance, over the last five years, these measures have resulted in additional GST assessments averaging $480 million per year. The amount of such additional assessments is three times as much as the amount the federal government pays Québec annually to fund its share of the costs of administering the GST and the QST by Québec.

These measures also generate additional QST assessments of some $752 million per year for Québec. That is in addition to the recovery of roughly $342 million per year in tax debts of all sorts, made from the QST input rebates claimed by businesses, thanks to the debt offset mechanism administered by Revenu Québec.

TABLE B.3

Additional assessments of GST and QST and amounts recovered by Québec under the debt offset mechanism in relation to the QST
(millions of dollars)

	2005-2006	2006-2007	2007-2008	2008-2009	2009-2010	Annual average
Benefits for the federal government:						
– Additional GST assessments	426	524	492	470	486	**480**
Benefits for the Québec government:						
– Additional QST assessments	553	653	814	830	911	**752**
– Debt offset	259	326	375	384	368	**342**

Source: Revenu Québec.

Québec would risk losing the additional revenue stemming from these measures if it were to give up its fiscal sovereignty regarding sales taxes, by participating in the HST. Similarly, Québec’s ability to intensify its efforts to counter tax evasion and ensure that everyone pays their fair share of taxes would be significantly reduced.

For example, the RESTO project that Québec has just set up is expected to enable it to recover tax revenue of some $300 million per year. However, this project, which will also generate financial benefits for the federal government, would not have been possible had Québec agreed to participate in the HST.

2.7 Tax integrity measures to be maintained

In light of the above, it is in the interests of both governments that Québec continue to introduce tax integrity measures that ensure that everyone pays their fair share of taxes.

Yet, some of these measures introduce differences between the GST and the QST. However, these measures do not constitute differences in fiscal policy between the GST and the QST, but rather differences in methods of implementing this policy.

For example, to curb a significant tax fraud situation giving rise to substantial QST losses, measures have been taken in the QST system regarding sales of motor vehicles that do not exist in the GST system.

Similarly, to counter tax evasion related to the illegal tobacco trade, the QST is no longer applied on the sale of this product and has been replaced by a corresponding rise in the tobacco tax.

If, at the federal government's request, Québec were no longer able to introduce tax integrity measures to eliminate any differences between the GST and the QST, Québec would lose significant revenue.

That is why, in the course of the negotiations with the federal government, Québec has maintained that it would be important to be able to maintain these tax integrity measures.

3. QUICKLY REACH AN AGREEMENT IN PRINCIPLE

The process the federal government used in 2009 to reach agreement with Ontario and British Columbia was as follows:

- First, Ontario reached a 6-page agreement in principle with the federal government on March 10, 2009, followed by a final agreement of 79 pages on November 9, 2009.
- For its part, British Columbia entered into an 7-page agreement in principle on July 23, 2009, followed by a final agreement of 51 pages on November 30, 2009.

The agreements in principle contained the guidelines. The final agreements contained the technical details. This process was useful and productive for those two provinces; it should be equally so for Québec.

Since the other approaches attempted until then had left the issue unresolved, Québec sent the federal government, on February 22, 2011, a new draft agreement in principle on harmonization of the QST with the GST.

The 6-page draft agreement in principle is similar to the agreements in principle the federal government signed with Ontario and British Columbia in 2009, apart from the necessary adjustments arising from the three fundamental issues mentioned at the beginning of this section.

This draft agreement in principle stipulates in particular that:

- The QST base, which is already substantially harmonized with the GST base, would become even more so. In fact, it would be just as harmonized as the provincial component of the HST in participating provinces.
  - In particular, the GST would be withdrawn from the QST base, restrictions concerning input tax refunds would be gradually eliminated over eight years (as with Ontario and British Columbia) and Québec would agree to the principle of complete harmonization for financial services.

- Québec's flexibility regarding fiscal policy would be the same as the participating provinces.
  - In particular, Québec would agree to comply with the 5% limit on tax differences (exemptions and tax rebates).
- Québec would undertake to maintain harmonization of the two taxes over time, failing which the financial compensation received from the federal government would have to be repaid. There are similar undertakings in the agreements reached with Ontario and British Columbia.

Essentially, the only differences with the HST in the participating provinces would be the following:

- The QST and GST would continue to be imposed under statutes adopted by the National Assembly and the House of Commons respectively.
- Québec would continue to administer the two taxes and assume its share of the costs of such administration, while the participating provinces do not pay for the administration of their sales tax by the federal government.
- The tax integrity measures implemented by Québec would be maintained.

Québec is of the view that this proposal amply justifies payment of fair compensation of $2.2 billion.

CONCLUSION

Twenty years ago, Québec decided to join the federal government in reforming sales taxes in Canada to make businesses more competitive, foster job creation and raise the standard of living of Quebecers and Canadians.

Québec has set a good example. And yet, it is currently receiving the same treatment from the federal government as those provinces that, 20 years later, have still done nothing to harmonize their sales tax with the GST. This situation is unfair and must be rectified.

The agreement in principle submitted to the federal government to that end by Québec last February 22 could lead to a rapid resolution of this file.