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Mr. Yvan Loubier

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● (1625)

[Translation]

The Chair (Mr. Yvan Loubier (Saint-Hyacinthe—Bagot, BQ)):
Good afternoon, ladies and gentlemen.

[English]

Thank you very much for your presence, and excuse us for the vote and the late start of the committee.

Welcome, Mr. Watts and Mr. Boadway. You will have 15 minutes to introduce the issue of fiscal imbalance, and after that we will have a question period from the members of all parties in Parliament.

Prof. Robin Boadway (Professor of Economic Theory, Fellow, Institute of Intergovernmental Relations, Queen's University, As an Individual): Thank you very much for inviting me.

The issue of fiscal imbalance is a very sensitive, indeed, a loaded issue, and I want to steer a little clear of talking about whether or not there was a fiscal imbalance and getting into the arcane discussion of that sort of issue. I don't think it's fruitful for my purpose.

What I'm going to take for granted is this. Given the expenditure responsibilities that provinces and the federal government currently have, given the tax room allocation between the two levels of government, given the level of transfers that are currently being made from the federal government to the provinces, the current situation would not be sustainable into the future. Something will have to be done. What I want to address is really the principles that should underlie what should be done about this, going into the future.

I hope this doesn't sound too much like a lecture at a university, but I've just been doing that this week. Forgive me for this.

I will give you a bit of background to start with. The Canadian federation, as Professor Watts will attest shortly, is very highly decentralized by international standards, in the sense that it has a smaller vertical gap than most other federations. This has been a consequence of a gradual process of decentralization over the last 40 or 50 years, with some sharp periods of unannounced change, leading to unpredictability and most recently to what's perceived as being an imbalance of the federation. I would stress that the imbalance is as much horizontal as it is vertical.

There's also recently been what I think is an unfortunate tendency to implement discretionary changes and to strike special deals that favour some provinces at the expense of others. As I said, given the current fiscal structure, sooner or later some measures must be taken to address the fact that provincial expenditure responsibilities are

growing more rapidly than the resources available to them. I think we need to put into place a structure that is predictable, that's formula-driven, and that respects the joint responsibilities of both the federal government and the provinces, within their respective jurisdictions.

I find it useful to inform the principles to begin by looking at what the relevant responsibilities are that we should take into account when we're talking about vertical transfers. Naturally the first place to look is the Constitution, but I think just looking at the constitutional division of powers doesn't resolve the issue of vertical imbalance, because that division of powers is really functional and it's not goal-oriented and it's compatible with a very large number of degrees of vertical gap.

Furthermore, the policy instruments that are in the hands of the provincial government, I would argue, have impacts on national objectives and national goals, for which the federal government has some responsibility. I'm sure I don't have to refer you to this, but I think what's particularly important is to look at section 36 of the Constitution, which sets out explicitly the shared responsibilities that the federal and provincial governments have in areas of social policy.

Subsection 36.(2) is the one most people are familiar with, which provides a commitment of the federal government to making equalization payments and to satisfying certain objectives.

Subsection 36.(1) is equally important because it makes the federal government and the provinces jointly responsible for some very important social objectives: equality of opportunity, regional development, providing essential public services of reasonable quality to all Canadians.

I take section 36 to be a very serious obligation that ought to inform our debate.

I think it's also the case that, from an economic and social point of view, there are some objectives of a national dimension that are influenced heavily by provincial policies. There are two of them. One is the responsibility for redistributive equity or fairness among Canadians, in its various dimensions, which was reaffirmed and recognized by both the federal government and the provinces in the social union framework agreement. The second is the national objectives of efficiency in the internal economic union, which was recognized and affirmed by the federal government and the provinces in the agreement on internal trade.

So I take it as a starting point that the federal government has a legitimate interest in policies of national fairness among citizens and also in policies that affect the efficiency of the internal economic union. The question is how can the federal government pursue these legitimate objectives, given that many of the policy instruments influencing these objectives are in the exclusive legislative responsibility of the provinces? I'm thinking of major social programs like health, education, and welfare, but I'm also thinking of tax policies that provinces can undertake that influence national equity and national efficiency.

In principle, there are a number of ways in which the federal government can influence the achievement of these national goals. Some of these are pursued quite actively in other jurisdictions: mandates, for example, are common in federations; and constitutional enforcement of obligations and powers of disallowance are used in other federations. None of these, I think, are starters in Canada as ways for the federal government to achieve the objectives set out in section 36.

Three possibilities exist within the feasible set. One is the spending power, which was recognized in the social union framework agreement as being a legitimate way for the federal government to bring its influence to bear. Another is moral suasion, which I think is underestimated, but has been used, I would argue, as a way of the federal government influencing the way in which provinces implement their programs. And there are federal-provincial agreements, which have had very little success, for a variety of reasons: they're not workable and they require too much detail to be put into effect. I think the agreement on internal trade is a good example of the futility of relying on federal-provincial agreements for achieving national objectives.

Personally, I think the spending power is the only instrument consistent with the federal government achieving its objectives and obligations set out in section 36, although I recognize this is a controversial statement to make. But in any case, whether it's the spending power, the use of moral suasion, or the use of federal-provincial agreements, I think there is some role of federal transfers to the provinces implied in any of those three manners of achieving federal objectives.

So the question is, what does this imply about rebalancing the federation and the way in which we go forward in terms of provinces meeting their expenditure obligations, given the existing division of tax room and the existing set of transfers? In other words, what combination of changes in federal-provincial transfers and tax room reallocation should be undertaken to address the existing or prospective imbalance in financing and expenditures by the provinces?

I think there are legitimate arguments that can be made on either side, either for turning over more tax room to the provinces, on the one hand, or increasing transfers from the federal government to the provinces, on the other hand.

Arguments for reducing the spending-taxing gap might include provincial sovereignty, or that provinces ought to be perfectly sovereign in areas in which they have exclusive legislative authority; the view that equity is really more a provincial matter than a national matter, that provinces are better suited to dealing with redistribution

within their jurisdictions than is the federal government; the issue of accountability, or the argument that provinces spending money from the federal government may not be as judicious or accountable as they would have been if they had had to raise their own revenues; the beneficial effects of fiscal competition among governments, meaning the more decentralized the federation is, the more competition there is among provinces, the more innovation is likely to occur and the better service delivery is likely to be. There is also the argument of avoiding federal unilateralism by reducing reliance on transfers from federal government to the provinces, which also reduces the possibility of being greeted with the kinds of unexpected changes that occurred in the budgets of the early 1990s, when the provinces were taken quite by surprise. Then, of course, is the issue of dealing with the aspirations of Quebec, which has strongly favoured their receiving more tax room.

On the other hand, there are counter-arguments for maintaining a sizeable asymmetry between revenue-raising responsibilities and expenditures at the provincial level.

• (1630)

One of the ones I think is very important is the idea that any turning over of tax room to the provinces is likely going to lead to serious problems of disharmonization of the tax system—especially of the income tax system—disharmonization that is going to compromise redistribution within the tax transfer system and also compromise efficiency in the internal economic union.

By the same token, maintaining a sizeable asymmetry, i.e., having the federal government retain a sizeable share of the tax room on the income tax, allows it to achieve legitimate national redistributive objectives more effectively.

An important aspect of the vertical gap is the sustainability of equalization. The more tax room is turned over to the provinces, the more horizontal imbalance occurs, the more difficult it is for the federal government to achieve its obligations for equalization under subsection 36(2), and in fact the more politically unsustainable will equalization become.

Finally, I think there is a lot of historical argument for a more centralized collection of revenue, which relies on the idea of the federal government being better able to absorb shocks to different regions than the regions are themselves.

What does this tell us about prescriptions? As I said, a choice must eventually be made, sooner or later, about the balance between maintaining or increasing federal-provincial transfers and vacating and turning over further tax room for the provinces. I think that's unavoidable.

The choice we make really depends upon judgments—political judgments that I'm not very good at, but also judgments about how important we view the role of the federal government to be in achieving national objectives; how important we view the national objectives themselves to be; how important we think it is that people who live in different provinces in Canada ought to be treated relatively comparably by the fisc, federal and provincial; how important we think it is that people have equal access to essential services such as health care, education, post-secondary education, and social services, no matter which province they live in.

My preference is influenced by a number of observations, the most important of which is that I think it's fair to say governments largely are institutions for redistribution, whether we like it or not, and that the federal government undertakes a lot of policy initiatives that reflect national equity objectives—things such as the federal income tax system, the employment insurance system, the pension system. These are all systems that recognize that the federal government has a legitimate role in pursuing redistribution objectives nationwide.

I think a considerable consensus exists among the citizens of the nation for a national dimension of redistributive equity, and there is evidence that this support exists as well for national standards in some social programs.

And as I say, section 36, the social union framework agreement, and the agreement on internal trade all support the federal role in achieving national, social, and economic objectives.

I would add a final thing, and that is that turning over tax room to the provinces closes off options for the future. In my view, it is hard to reverse. Once you turn over tax room to the provinces, you've done it, and the federation is harder to move in the other direction if all of a sudden you decide that the federal government should undertake an initiative of national importance.

To me—and I don't expect to get a lot of agreement on this issue—this has the following implications for the way we deal with the vertical imbalance. I think first of all that the vertical imbalance should be addressed primarily by higher transfers rather than by transferring more tax room to the provinces. One or the other of those things has to be done, or some combination.

I furthermore think that transfers should not be contingent on the federal surplus. They should be predictable and should be set in a way that doesn't put the provinces at risk.

The transfer system should be revised, in my opinion. I think the equalization system should be moved to a 10-province standard, with all revenues included 100%. If the federal government wants to give any preferential treatment of any revenue source to any province—for example for oil, just to take an example out of the air—it should be calculated below the line. It shouldn't affect the equalization entitlements that go to other provinces that don't happen to have oil.

• (1635)

I think the social transfer system should be disaggregated into three distinct parts—health, social, and post-secondary education; that the transfers in each component should be sufficient to enable the federal government to fulfill its commitments with credibility, although not with intrusiveness, for I'm not arguing that spending power should be used with intrusiveness; that social transfers should escalate in accordance with some index of aggregate provincial spending requirements; and that the allocation of social transfers among provinces should reflect a need for transfers.

I would argue further that the federal government should desist from introducing direct spending programs in areas of provincial jurisdiction and use transfers to the provinces instead. I think there's been far too much program introduction at the federal government

level in areas like post-secondary education, where it makes transfers directly to individuals rather than going through the provinces.

I think the federal share of the income tax room should be heavily guarded so that we'd maintain a harmonized personal income tax system.

I think the disparity in resource revenues is the most serious one facing the federation. The federal government could reform the corporate tax system if it wanted to get a bigger share of the resource rents to reduce the affordability problem they have over equalizing resource revenues. And I think the process of managing federal-provincial fiscal relations should be addressed to enhance more cooperation in long-term thinking in the fiscal arrangements.

Thank you.

• (1640)

[Translation]

The Chair: Thank you very much, Mr. Boadway.

Professor Watts, *vous avez 15 minutes.*

[English]

Professor Ronald Watts (Principal Emeritus, Professor Emeritus of Political Studies and Fellow of the Institute of Intergovernmental Relations, Queen's University, As an Individual): Thank you very much, Mr. Chairman, for this opportunity to present some views on the subject.

I think you will find that the way I'm going to approach this is different from probably most of the presentations you will have received, which deal with it as if it were a specifically Canadian problem. I'm going to approach the issue from a comparative longer-run perspective, rather than from the immediate current balance of political interests perspective.

My comments are based on a recent working paper that I prepared for the Institute of Intergovernmental Relations at Queen's. Copies of that, entitled *Autonomy or Dependence: Intergovernmental Relations in Eleven Countries*, have been distributed to you, I think, by the clerk. It surveys the issue particularly of imbalances, vertical and horizontal, in Canada, the United States, Germany, Australia, Switzerland, Spain, Brazil, India, South Africa—nine federations—and two decentralized unitary systems: Sweden and Japan.

The section that is especially relevant to the issue of imbalances, both vertical and horizontal, is on pages 17 to 28 in the document distributed, particularly the tables at the end. There are six tables at the end, which are attached to that report. Here in my oral presentation I'm simply going to touch on the highlights. If you want much more detail, you can see it in the working paper itself. Obviously I can't cover all of that in 15 minutes.

First I'll say a few words about the concept of imbalance.

The conventional view these days of the current Canadian picture—and it appears in the letter sent by the chairman to prospective witnesses—is that there is an apparent serious vertical imbalance, with provincial deficits and federal surpluses, and thus an imbalance in relation to the constitutional responsibilities and expenditure responsibilities of the governments in Canada. This perception is heightened by the current federal government's focus on additional expenditure and policy of its own in such areas as cities, child care, health—all areas of exclusive provincial jurisdiction under the Constitution.

But I want to suggest that the concept of fiscal imbalance is a slippery one that has an element of subjectivity to it. That is, the surpluses and deficits of each government in any federal system relate to the willingness of each government to adjust its expenditures or its tax levels to balance expenditure and revenues. The appropriate levels of expenditure and revenue are not objective. They are the product of political will and political decisions about what each level of government should do.

Comparative studies of financial relations in federations generally—and you will see that from the working paper I have distributed—identify a virtually universal existence of imbalances between revenues and expenditures of each government within the different levels of government. So this is not something that is uniquely Canadian. While matching the revenues and expenditure of each government may be an ideal objective, in practice this is difficult to achieve for a number of reasons.

First of all, over time the proceeds from different taxes change, and over time the expenditure costs of different functions change, so it's very difficult to achieve some permanent balance of the tax revenues and expenditure responsibilities.

Secondly, the criteria for the most effective allocation of taxing powers do not match those for the most effective allocation of expenditure responsibilities. In virtually all federations, because of these differences, taxing powers are more concentrated and centralized within the federal government than expenditure responsibilities, which may be more effectively and efficiently administered at the provincial level.

Thirdly, there's a need for sufficient central revenues for redistribution, for the redistributive equalization transfers to deal with horizontal fiscal disparities and imbalance.

●(1645)

The result is that virtually all federations are marked by the need for transfers and for adjustments of these from time to time, either by the transfer of responsibilities or more often by transfer of funds through transfer of taxing powers, or through changing the shares of central tax revenues that are distributed to constituent units, or by changing unconditional and conditional grants.

I want to now turn briefly to the actual comparisons among federations, which are set out in much more detail in the working paper, particularly pages 17 to 28, but also in the tables at the end that I referred to, and look at them in terms of what their implications might be for the discussion of these issues in Canada.

In all federations, as I've already suggested, there is a vertical gap between revenues and expenditure levels in the provinces and states.

I would here suggest you look at table 2, page 53, the last column. It identifies the vertical gap in different federations between the revenues, own-source revenues, and expenditures of the constituent units—provinces, states, or whatever other label they may have. It's worth noting that the percentage of combined federal and provincial revenue and of combined federal and provincial expenditure is substantially larger in Canada than in all the other federations except Switzerland. In other words, the first point to note is that Canada is already more decentralized than any other federation in terms of revenues and expenditures except for Switzerland.

The next point to note is that the gap—that's the third column in that table—between provincial and state revenue and expenditure is significantly less in Canada at the present time than in Australia, the United States, Germany, Spain, South Africa, or India. It is comparable to Switzerland and Brazil and slightly less than Sweden, incidentally, which is not a federation but a decentralized unitary system.

Consequently, if you look at the first column of table 4, page 55, the dependency in Canada of provinces on transfers is less than in other federations. Furthermore, if you look at the second column, the degree of dependence on conditional transfers, which limit the autonomy of the constituent units, is significantly less than in Australia, the United States, Switzerland, Spain, and India. It is more comparable to Germany, South Africa, and Brazil. These conditional transfers indicate the degree of control by the federal government over how provinces spend the transfers to them from the federal government.

What are the implications of this for the issues you're addressing for Canada? First of all, vertical imbalance is not unique to Canada. It occurs in every federation. Every federation has had to deal with this issue. There are different ways of correcting these imbalances that have been used in other federations. I've already referred to them briefly. One is the transfer of tax jurisdiction, which ensures at least accountability for the revenue spent on provincial expenditures or shares of central revenues—a popular procedure in Australia, Germany, and India, for instance—where the central government levies the tax but a certain percentage or share of this, either by constitutional specification or by agreement, is shared with the provinces or constituent units, but the level of tax is determined by the federal government. Another approach is unconditional transfers where the amount of the transfer depends upon allocations by the federal government, but how it is spent is left to the provinces. The fourth is conditional transfers where the central government itself influences heavily how the provinces or constituent units spend the transfers.

● (1650)

But the essential point that I want to emphasize is the existence of such imbalances in all federations and also the necessity found in all federations for adjustments from time to time of these imbalances. Here I draw your attention to table 6 on page 57, in which I present a survey of the processes of adjustment in different federations for these vertical imbalances. It's worth looking at those to see the processes that have been followed in other federations for adjusting these imbalances.

Let me go on, then, to horizontal imbalances. A second form of fiscal imbalance in all federations is horizontal imbalance; that is, imbalances among the constituent units themselves because of differences in their revenue capacity and their expenditure needs by comparison with each other.

It's significant to note here that except for the United States, which is an outlier here, virtually all contemporary federations employ some systematic form of equalization transfer. Canada is not unique in that respect at all. In fact, the working paper, pages 26 to 28, and table 5 on page 56 deal with these and the characteristics of the different forms that these transfers have taken in different federations or decentralized politics.

A comparative point to note, especially in relation to Canada, is that some federations like Canada have based their equalization effort mainly upon adjusting for differences in revenue capacity of the provinces, states, or constituent units, while others—notable examples are Australia and India—also take different expenditure needs of the constituent units into account in calculating the appropriate equalization adjustments.

Another point to note is that most have recognized the need to adjust equalization transfers periodically for changed circumstances by establishing standing or periodic advisory or expert commissions. Key examples here are Australia, India, and South Africa, which have relied upon expert commissions to decide what the allocation of horizontal transfers should be or to devise the formulae that should be applied for this purpose.

The point to note is that in all of them—and here I would draw attention to pages 31 and 33 of my working paper—there have been major recent reforms in the arrangements for equalization to adjust to developing and changing circumstances.

Another point to note is that the criteria and the relative weights and use of formulae for distribution have varied widely from federation to federation to suit the particular circumstances.

Finally, I would note that the extent of the equalization effort has varied from federation to federation. I point here to pages 27 to 28 of the working paper. Actually, Australia and Germany have put much greater emphasis on the equity objective, and hence upon equalization, than have Canada or Switzerland—that is, equity has been emphasized there much more strongly.

Significantly, by comparison Canada and Switzerland, which have nevertheless put a considerable effort into equalization, have because of their diverse and multicultural societies tempered the emphasis on equity by an emphasis also upon concerns for maintaining the

autonomy and diversity of constituent units so that they are not totally dependent upon equalization transfers.

● (1655)

While I've tried to survey some of the highlights that are embodied in the much longer working paper that I've made available to you, I'd simply like to conclude by suggesting first and foremost that I hope you will see that, in trying to address the issue of imbalances, there is value in examining the experience and solutions of other federations that have experienced problems and issues similar to those we have in Canada. I would conclude with the plea that the subcommittee look beyond immediate, temporary, political concerns to the broader issue of how to deal with both the vertical and horizontal imbalances that mark all federations including ours, and that you look for longer-run solutions designed to respond to inevitably changing circumstances over time.

The issue of fiscal imbalance in federations, vertical or horizontal, is not something that can ever be solved once and for all, for all time. It is something that has to be constantly adjusted to changing circumstances. It's always going to be there, and it's going to require constant adjustment. As you address the issues facing Canada, this is an important consideration to bear in mind.

Thank you very much, Mr. Chairman.

[Translation]

The Chair: Thank you very much, Professor Watts,

[English]

for your very interesting presentation.

[Translation]

We'll begin the question and answer session with Ms. Ambrose.

You have five minutes, Ms. Ambrose.

[English]

Ms. Rona Ambrose (Edmonton—Spruce Grove, CPC): Thank you.

I have a question for Mr. Boadway. You seem to be a strong proponent of the use of federal transfers to end the vertical fiscal imbalance. One of the issues I have with that—and I think some of the provinces would agree with me—is that the federal government often uses federal transfers as a way to push its own political agenda on the provinces. By focusing on transfer payments as the solution, I would suggest that we're solving only half the problem. On one side, there is the funding concern. On the other side, though, the provinces have to deal with the duplication that comes with this kind of interference.

The other argument is that federal transfers result in a lack of accountability and transparency. How would increasing federal transfer payments address this problem? I was looking at another paper you wrote called "Should the Canadian Federation be Rebalanced?" In one part you say, "The federal government should desist from introducing direct spending programs in areas of provincial jurisdiction and use transfers to provinces instead." I'm not suggesting that there's a contradiction there, but I'm wondering if you believe that transfers will offer more accountability and transparency than direct spending programs. I think the federal government would argue otherwise.

Prof. Robin Boadway: Let me start with the latter issue first.

My objection to the federal government's engaging in direct-spending programs to citizens is partly based on efficiency arguments. It's not easy to run a program out of Ottawa that's going to affect people in all of the provinces, particularly in the area of post-secondary education with which I'm familiar.

Programs that are run by the federal government in post-secondary education are not efficient, and they run into duplication problems, accountability problems, and so on.

What the federal government is well able to do, in respect of direct spending programs to citizens, is make transfers. This they do through the tax system or refundable tax credits. They make transfers to elderly people or to people who are not employed.

Programs that provide services to citizens are much better delivered at the decentralized level. It's better for the provinces in that they can better coordinate what they're doing than the federal government can. The federal government, in my opinion, made a big mistake by getting into direct-spending programs, as it did in post secondary education.

The first question you asked is a key issue. If you're going to make the case in favour of the federal government's increasing its transfers rather than reducing its tax room, you have to worry about the fact that the federal government is imposing its will on the provinces. You have to worry that the federal government has a political agenda that it wants to impose on the provinces.

I wouldn't say that the federal government should use its spending power in an intrusive way, but I don't see how the federal government can fulfill its obligations under section 36 without having available to it a spending power. It can use this in a way that is not intrusive. I view the way in which federal government transfers money for health care as being not a bad model. The Canada Health Act has worked very well, even though some provinces don't like the details of it. The federal government may in some instance have been too intrusive in getting into things like double-billing, user fees, and perhaps even resisting the use of private facilities. But on balance, the Canada Health Act has been a remarkably good—

● (1700)

Ms. Rona Ambrose: Are you referring to the CHST?

Prof. Robin Boadway: Yes, and its predecessors. The same criteria that are in the Canada Health Act have been there since the 1960s, when health insurance was first introduced. That's been a pretty good model.

I would also say that the minimal conditions imposed on welfare transfers have been a good thing. Precluding provinces from engaging in mobility restrictions has been a good thing. I don't think it's fair to say that the use of federal spending power, in recent years anyway, has been all that intrusive, as long as we can put a system in place that guarantees the federal government will allow the provinces to innovate and to design programs that are in the best interests of their citizens.

At the same time, we worry about national objectives that ought to be satisfied: national objectives of equality of opportunity; national objectives associated with making sure that citizens have access to essential public services, of which, I would suggest, health care is certainly one. I think these are important national objectives.

The other side about transfers, and as important from my point of view, is the horizontal imbalance. The CHST or the CHT/CST system is a more effective equalization device than the equalization program itself. The federal government is collecting money nationwide and then giving it out on an equal per capita basis to all provinces. It's the perfect equalization system. If we start disbanding the Canada health transfer and the Canada social transfer, as some would suggest, then we're really doing away with and making more difficult the achievement of subsection 36(2) of the Constitution, as well as taking away a policy instrument that I think has an influence on the way provinces behave.

The fact that the federal government supported welfare and post-secondary education to as large an extent as they did in the sixties and seventies had some salutary effect on the way provinces designed their plans. It's no surprise that provinces didn't start discriminating against out-of-province students until the federal contribution to post-secondary education became minimal. At least that's the inference I've made.

Sorry for the long answer.

Ms. Rona Ambrose: Thank you.

The Chair: Mr. Bell, you have five minutes.

● (1705)

Mr. Don Bell (North Vancouver, Lib.): Thank you.

Just to pick up on that part, Mr. Boadway, the issue of municipal infrastructure is an area the federal government is moving into through infrastructure programs, more particularly, the green municipal funds through the FCM. I don't know your thoughts and whether that represents the national objectives we're talking about. The reason for that, as I've understood it as a former municipal politician, is because quite often the environmental implications cross geographic and political boundaries of provinces.

The other is the more recent infrastructure addition, which is the gas tax and its allocation. Although it's not a directly dedicated tax, as was originally requested by the municipalities, the inference is that consumption of fossil fuels contributing to global warming is a national problem, and that starting out with an allocation equivalent to a cents-per-litre allocation makes some sense. I was just wondering if you'd looked at that model.

Prof. Robin Boadway: I certainly would agree that the municipalities need more money for infrastructure and that all the objectives you outline are valid and important objectives.

The question is, what's the role of the federal government in dealing with the municipalities? Here again I'll take a viewpoint that probably is not shared widely. I think the initiative of the federal government making direct transfers to the municipalities is not a good one. And I think part of the reason why the federal government is doing all these end runs around the provinces is precisely because of the resistance of the provinces to the use of the spending power.

Politics aside, as a matter of economics, it would be much more efficient for the federal government to make earmarked transfers to the provinces for the municipalities, rather than directly to the municipalities themselves, because I think the provinces are much better placed to be able to allocate funds to municipalities within their own jurisdictions. I also think that although the municipalities need more money, the idea of earmarking gasoline taxes to municipalities is a precedent we should think very carefully about. The whole idea of earmarking taxes to particular issues is not one that we've used, with the exception of contributions to social programs.

So I'm not in favour of the federal government making direct transfers to municipalities, but I certainly would be in favour of the federal government making transfers to provinces for municipalities. Indeed, part of the reason why municipalities are having such difficulty is that when the federal government cut back transfers to the provinces in the 1990s, the provinces in turn turned around and cut back transfers to the municipalities. We're faced in Canada now with municipal tax rates that are as high as anywhere in the OECD countries, especially municipal business-tax rates.

Taking a larger whole-picture view of this issue of municipal financing leads me to not support the federal government getting into the area of direct transfers to municipalities.

Mr. Don Bell: Okay.

I would put the same question to Professor Watts if he has an answer or if he has any comment he'd like to add on that aspect.

Prof. Ronald Watts: Yes. Most of it will be along similar lines.

In most federations, taking the comparative approach I've been taking, local government is seen as a responsibility of the constituent units. In other words, the funding to assist local governments is usually routed via the provinces, states—whatever unit you call them. But that's not universally so. In fact, it's interesting to note that in some federations—a particular example is Germany, India is another case, and South Africa is another case—local governments are recognized as a third tier within the federal system. And indeed the constitutional allocation of tax proceeds or transfers specifically includes those directed to local governments. In other words, the federal system is not looked at as a two-tier system but as a three-tier system.

It's in the minority of federations where that occurs, but it does occur in some of those. We belong to the category in which, if you look at the Constitution Act, it's quite clear that local government is the responsibility of the provinces. So until that's changed, federal assistance to localities is really bypassing the constitutional structure

of responsibilities as set out in section 92 in terms of local governments.

But I did want to say that the treatment of local government as a third distinct constitutional sphere does exist in some federations.

• (1710)

Mr. Don Bell: I might add that that is supported by the Federation of Canadian Municipalities and most municipalities across Canada.

Prof. Ronald Watts: Right. And one might note that this was a change made in some of these federations. In the case of India, for example, they did not begin that way, but they had a formal constitutional amendment.

Mr. Don Bell: Is that part of a change towards city-states?

The Chair: Thank you very much, Mr. Bell. I'm sorry, your time has expired.

[Translation]

I found your study to be most interesting, Professor Watts. Before I turn the floor over to my colleague, I'd like to ask you if based on your analyses and experience with politics in the world, you believe some countries choose to use a certain type of mechanism, like Canada did in 1964 when it gave all provinces the choice of opting out, with compensation, of arrangements respecting education. I'm thinking here about the loans and scholarships program, post-secondary education funding and so forth. At the time, Quebec was the only province to take the federal government up on its offer. However, instead of receiving monetary compensation, the province was compensated in the form of a transfer of tax points.

To your knowledge, have other federations that you have looked into often opted to use this type of mechanism?

[English]

Prof. Ronald Watts: It's an interesting question, because that's an area in which Canada has been a pioneer. In other words, few other federations have followed that path, and when comparative studies are made, Canada is usually looked to as the innovator in this particular respect. I use that to suggest not that it's a bad thing, but that it is a precedent we, as a federation, have set among other federations. There are therefore not many examples.

On the other hand, there has been an increasing tendency within federations to recognize the importance of asymmetry among constituent units. Indeed, there's a whole literature on this. It's not extensively developed in that particular working paper, but one notes that in a number of federations—Spain is a particular example, Belgium is another example—in order to recognize different circumstances, it has been recognized that legislative and executive powers—even financial arrangements—may need to differ for different constituent units. This has led to the recognition that differential arrangements may be necessary—and, indeed, they have been implemented. As I say, Spain is one classic example, and Belgium, India, and Malaysia represent other examples in that respect, but we are the pioneers.

[Translation]

The Chair: So then, we should thank Mr. Pearson and Mr. Lesage for taking this innovative approach in 1964.

You have five minutes, Mr. Boire.

Mr. Alain Boire (Beauharnois—Salaberry, BQ): My question is for Professor Watts.

In your study, you say you approached the issue from a global perspective. You also illustrated the existence of a gap between revenue and expenditure levels and argued that it was difficult to strike a permanent balance between the two. As well, you talked about an unconditional transfers by the federal government to the provinces in order to put money back in the provinces' pockets so that they can meet their needs. As matters now stand, we know about the federal surplus, about centralized revenues and about provincial deficits. The provinces are in need of money for education, health and other areas.

In your opinion, what kind of adjustments can we make to the existing fiscal imbalance, whether horizontal or vertical, in order to meet the current needs of the provinces?

• (1715)

[English]

Prof. Ronald Watts: Let me go back to the first part of what you had to say, and then try to come to your final point.

One needs to recognize why these imbalances occur in addressing how they should be resolved. I think one of the points to emphasize is that the imbalances have occurred in all federations because the criteria for most effectively allocating revenue-raising responsibilities—taxation powers—and the criteria for most efficiently undertaking expenditure responsibilities differ. I added, in my introductory comments, that also the values of taxes and the costs of expenditures change over time. A good example is the galloping increase in health costs, if you look back over the recent decades. For these reasons, the imbalances occur everywhere.

The question, then, is how to adjust them. One can't just assume the status quo is the best basis—that is, that it's simply a matter of reallocating resources to meet the status quo of expenditures. The expenditures may not be most effectively allocated at the present time, so one has to look at whether expenditures are being efficiently allocated at the present time, as well as whether the tax ones are. Following that, if there is still an imbalance—as there is likely to be—there are four possible means of resolving these.

One is by transferring taxing powers. Another is by allocating shares of central tax proceeds. We have not done it much in Canada, but quite a number of federations do it quite extensively. Germany and India are two classic examples. More recently, Australia had a similar imbalance problem, perhaps even more acute than ours, in terms of state—they call them states, not provinces—revenues and related expenditures. They established a new federal tax, the GST, but agreed that all the revenue from the GST should go to the states. That was an Australian effort to solve this problem. What's more, they then decided the Commonwealth Grants Commission—"Commonwealth" because of the Commonwealth of Australia—should decide what proportions of that tax should go to each state. The Commonwealth Grants Commission assesses the revenue capacity and the expenditure needs of each state and arrives at what they call the relativities of the proportion of the GST that should go to each state.

So you have there a process involving not only the share of a particular federal tax, in this case all of it going to the states, but also the use of an independent commission to decide how it should be allocated. It may have been easier to do because it was a new tax, but all the proceeds are going to the states. We have tended to deal with these issues in Canada more by intergovernmental negotiation and dispute than by using an intergovernmental commission, an expert commission, to deal with these.

If you want to look at how commissions have been used to make such adjustments, I would suggest you look at India, where they have five-yearly—quinquennial—commissions. They recommend, but the federal government has virtually always accepted their recommendations. I might add that these quinquennial finance commissions are mandated by the constitution; they are constitutionally established commissions that recommend, every five years, what transfers and what level of transfer should be made by the federal government out of their own revenues—either as portions, proceeds, from federal taxes, or as unconditional transfers—and also how the horizontal imbalances should be adjusted by differential transfers.

• (1720)

In Australia it's a standing commission that works on a three-year rolling average in making its recommendations on how the GST should be distributed among the states. In South Africa you have the Financial and Fiscal Commission that recommends to the federal government how transfers should be allocated among the provinces—they call them provinces—in terms of the level, to meet both vertical and horizontal imbalances.

I think there is an advantage in depoliticizing the issue by having, either as an advisory or even as the deciding body, an expert commission that can study the differences in revenue capacity of the constituent units and the relationship of their revenue capacity to the federal revenue capacity and can also look at expenditure needs, which is something we have not embodied in our own equalization arrangements.

Does that give you a response to the closing part of your question?

[Translation]

The Chair: Thank you, Mr. Boire.

Ms. Wasylycia-Leis, for five minutes.

[English]

Ms. Judy Wasylycia-Leis (Winnipeg North, NDP): Thank you, Mr. Chairperson.

Thank you to both Mr. Boadway and Professor Watts for your very helpful presentations.

It may be, Professor Watts, that we will have to look to an expert panel and try to move it out of the political realm to find some way out of a quagmire. I think we're embroiled now in a struggle in Canada the likes of which I have never seen, which I think is very worrisome. I see very little leadership and very little will to deal with a growing crisis in the federation.

I guess what I'd like to focus on for both of you, starting with Robin Boadway, is the question of what's at the heart of the issue we're dealing with. It seems to me we have to deal with this from the point of view of a sovereign nation, a united country. Because unless we start from that point of view, we're going to go down the slippery slope to making concessions—as I'm hearing about more and more from different provinces—to concede fiscal capacity, give tax points, and move away from any kind of national program. The Conservatives have advocated this, and the Bloc to some extent. And I fear that unless we can get back on the track of some sense of national program, which means cash transfers to provinces and territories with some kinds of conditions attached, we simply concede the ground and move towards 13 separate projects across this country.

I guess I'd like your comments, both of you, in terms of how we actually combat this move to concede the ground on cash transfers and move to some of these other solutions that are being offered. How do we advocate a strong central nation with the flexibility that Quebec wants, with special arrangements to capture the uniqueness of Quebec? That's one question.

The other question is on the crisis I see on equalization. When you read the news today in terms of what's happening in Ontario, there's the feeling that the federal government is going to once more go off and do a side deal, making it more and more impossible to get back to the formula that all provinces actually agreed to in 2003, the ten-province solution with all revenues included. It's something the federal government refused to do, and now we're on this path of craziness. I don't see any hope; I don't see any way out of it.

I guess I'm posing political problems to you. I'd like your advice. I'd like your suggestions and help on both matters.

Prof. Robin Boadway: That's very well put. I agree with what you're saying.

We've gotten where we are because of a large number of things that have happened over a long period of time. A lot of what's happened has happened by stealth. We've taken decisions about the fiscal arrangements on a year-to-year basis through the budgetary process that, in my opinion, haven't been made with a long-term perspective in my mind, which would be one benefit of having the kind of commission that Professor Watts is talking about. So there's that. I think we've got ourselves into a position by stealth over a period of time.

We've also had some episodes that I think were very unhelpful in terms of the distrust they created between the federal government and the provinces. With due respect to a liberal colleague here, I think the epitome of this was the budget of 1995, when the federal government made, I think unannounced, very large cuts to transfers to the provinces, disproportionately addressed its own budget deficits by cuts in cash transfers to the provinces, advertised it in a way that was misleading, took the provinces completely by surprise, and largely created the situation we're in today.

Again with all due respect to our Liberal friend here, I think the other problem is that in the most recent budget there were a number of measures with respect to equalization that imposed discretionary changes on the equalization system, which introduced a precedent that I think was very unhealthy. The idea of introducing special

measures to help special provinces for particular ad hoc reasons set another bad precedent.

I think the most recent deal that was struck with Newfoundland and Nova Scotia, whatever you may think of its benefits, was what really set the cat among the pigeons. I think it's what should have upset Ontario and all of the other provinces who don't happen to be blessed with oil and gas within their jurisdictions, including Manitoba, Prince Edward Island, New Brunswick, and so on. There were other special deals in the budget that benefited Saskatchewan in particular and also that benefited British Columbia. So there were all these little discretionary things, which I think put the process into disrepute.

The Senate, in a very comprehensive study of equalization a few years ago, also recommended going to the ten-province standard. I think it's very timely to revisit these things now, because we have a panel of experts. What you're saying suggests that the concept of imbalance you should be looking at is not just vertical but also horizontal.

I mean, I'm agreeing with what you're saying, and I think we have to get the process back to one where there's predictability, where it's driven by a formula, where decisions are taken with a long-term perspective in mind, and where we worry about the irreversibility of decisions that are taken for short-run expediency, such as, in my opinion, turning over more tax room to the provinces.

• (1725)

[Translation]

The Chair: Professor Watts.

[English]

Prof. Ronald Watts: If I can add my two cents on that, as it were, looking again from the comparative point of view, I would say that experience elsewhere suggests that trying to deal with these issues by ad hockery, whether you call them side deals or what have you, is a very slippery slope downwards. The best illustration of this, probably, are the financial arrangements in Brazil, which have resulted in all sorts of intergovernmental tax wars and very damaging economic effects. So if there's one element in the thrust I was trying to make in comparative terms, it is to say this issue needs to be approached systematically, not by ad hoc temporary political expediency. And that's whatever government—I'm not taking any party position on this. I'm just pointing to the danger of ad hockery.

One of the reasons why there is a need for some continued substantial federal taxing power, even when there's a demand for greater provincial or state expenditure needs, is the existence of horizontal imbalances, because if you don't have a federal tax resource to use to balance the differential capacities and needs of the constituent units, you don't have the power to correct the horizontal imbalances.

There is one way of doing that without central taxing powers, but it's not a very popular one. It exists only in two countries that I know of. The most significant is Germany, where the major equalization payments are not from the federal government to the states, but from the wealthy states to the poorer states. You can imagine what sorts of howls you're going to hear from Alberta and from Ontario.

In the German case it's embodied in the constitution, where there's a formula whereby the wealthier states must give up and transfer some of their revenues to the poorer states. The Germans have been going through an agonizing process recently in terms of trying to change that system. The actual system at the moment is that about two-thirds—don't hold me to the precise figure—of the equalization transfers are from state to state and about one-third from the federal government. It's actually a distribution of the VAT, about one-third from the federal government to the needy states.

That's one way of doing it without having too much taxing power concentrated in the federal government, but it's not a popular scheme and it has run into all sorts of disputes and controversies. So there is a need for some substantial locus of federal taxing power that can be used to redress the balance for those provinces that, like Quebec or the Atlantic provinces, just to take examples, currently receive equalization transfers.

• (1730)

[Translation]

The Chair: Thank you, Ms. Wasylycia-Leis.

We have time for another three-minute round.

[English]

Madame Ambrose, you're on for three minutes, and I am waiting for your cheque from Alberta.

Ms. Rona Ambrose: Oh, yeah.

I have another question for Mr. Boadway, a very specific question. This is also from the paper I was reading that you did, *Should the Canadian Federation Be Rebalanced?* It's on the issue of equalization and some of your recommendations.

You talk about equalization being rationalized along the lines suggested by the provincial and territorial finance ministers, where at one point a consensus was reached about the ten-province standard. My understanding lately, or in the last while, is that there isn't a consensus any more along the ten-province standard, particularly with regard to two of the provinces. So I've been doing some reading on this.

You say we should move to a ten-province standard, which will bring oil and gas revenues into the equalization scheme. I thought that the oil and gas revenues were already part of the present equalization formula. Is that correct?

Prof. Robin Boadway: Yes. As you know, the current system is a five-province standard, and the fact that Alberta is not part of the five-province standard effectively means that their oil and gas revenues don't go into the standard against which equalization is calculated.

So this was what I meant. I think one of the reasons why the consensus has broken down, by the way, among the ten provinces, is because of the fact that the federal government in its most recent announcement effectively capped—"capped" may be not the right word—set the limit of equalization with discretion.

Ms. Rona Ambrose: Right.

Prof. Robin Boadway: So once you do that you immediately turn the equalization system into a zero sum game. So it's not surprising that—

Ms. Rona Ambrose: There's not as much flexibility any more.

Prof. Robin Boadway: Right. So it's not surprising that they're not going to agree on things like oil and gas, or property taxes, for example.

Ms. Rona Ambrose: I have another specific question for you. You suggest that natural resource revenues of all sorts would have to be treated on a preferential basis because of the adverse incentive effects associated with equalizing resource revenues. Then you make the suggestion that this could be improved by reforming the corporate tax system so that it is more effective as a rent-collecting device. Can you explain to me what that means, and what the adverse incentive effects are?

Prof. Robin Boadway: The issue of equalizing resource revenues is a very difficult issue, and for a number of reasons. One of the main reasons is that provinces have control, to some extent, over the rate at which their natural resources are exploited.

Take Voisey's Bay, for example, where there were all these big nickel deposits. The Government of Newfoundland and Labrador effectively had a decision to make as to when to move ahead with the exploitation of those resources. In doing their calculation, they figured out that every increment of resource royalties they got was going to cost them, roughly speaking, the same increment in equalization. So there was a financial disincentive for them to exploit that natural resource. This is an argument that's often used by provinces and commentators as to why we might want to think of treating natural resources a little bit differently, just because of this incentive effect.

On corporate taxing, that's an important point. There was a document produced by the Department of Finance recently in connection with changing the way in which resource allowances were paid to mining firms. They documented the proportion of public revenues from natural resources that went to the federal government, as opposed to the provinces. They found that the federal government got something like 25% of oil and gas revenues and the provinces got 75%, and the same for mining. This occurs because of the federal corporate income tax.

My argument is that those proportions are not fixed in stone, that in fact the corporate tax system, as it exists now, favours strongly the natural resource industries. If you look at the Mintz report, which documents this stuff to some extent, they argue quite convincingly that the existing tax system treats preferentially the resource industries—which makes very little sense. My only argument is that if we eliminated the preferential treatment of resource industries, the federal government would get a lot more revenue from natural resources. Then we couldn't abide so strongly by the argument that they can't afford to equalize natural resource revenues if they're getting a bigger share of it themselves.

That's really where I was coming from on that argument.

• (1735)

[Translation]

The Chair: Thank you, Ms. Ambrose.

[English]

Monsieur Bell, for two minutes.

Mr. Don Bell: Thank you.

To get back to the philosophical question, I guess, that underlies some of this, the situation where provinces cut taxes, some provinces are claiming fiscal imbalance, and yet these are provinces that have taken pride in cutting their taxes and in then asking another level of government of elected people to in fact carry the can for the taxes. They're saying, "You take the heat. You raise the federal taxes. But give it to us and let us spend it the way we want." So there's no accountability.

Do you have any comment on that? Is that, in effect, an inconsistency?

Prof. Robin Boadway: No, it's a fair point, and I think it goes to the fact that there's no simple solution, that there are pros and cons. Let me just make a comment or two on that point, which I think is a legitimate point.

One of the things that's really important in the system of fiscal arrangements and transfers from the federal government to the provinces is that the federal government transfers don't respond to particular policies that the provinces undertake. The transfer from the federal government to the provinces should be made on a basis other than provincial behaviour.

This is embodied in the Canada health and social transfer system. It's embedded to as large an extent as possible in the equalization system. And I think therefore I would tend to discount, on those grounds, trying to do something that takes account of the fact that certain provinces are behaving in certain ways.

That was why we got rid of the Canada Assistance Plan system in the first place, because the Canada Assistance Plan responded to the way in which provinces were setting their welfare systems, so that was regarded as being an adverse incentive, and we did away with it.

Now we have a system where whatever transfer we make to the provinces is not supposed to be directly influenced by an individual province's behaviour, and I think that's really as much as I need to say about that.

The other issue about accountability, though, is also a tough issue, and my response to that is a bit the same. If you give money to a province and the money that you give to the province is unconditional and it's not contingent on any behaviour of the province—I'm going to give you several billion dollars, and no matter what you do with it, it's yours—I don't see why accountability falls down in the way in which the province decides to use that money.

There may be some conditions you attach that constrain them in terms of having to design their medical care programs in such and such a way, but I've never really been convinced that accountability is compromised because you have a budget that consists partly of a fixed amount of money that comes from somewhere else.

On those grounds, you could say the most accountable government in Canada is the Alberta government, because they have a pot of money that's coming to them just out of the ground. So

I don't find the accountability argument against federal transfers to be a particularly compelling one, provided the transfers are not conditioned on the way that provinces behave. One way that accountability does become an issue goes back to an earlier question, and that is that accountability is a little lost if the province is perceived as introducing programs that are simply abiding by the priorities of the federal government.

So that's really where accountability gets lots, because a citizen doesn't know who to blame for health care if they perceive that it's the federal government that's causing the problem.

● (1740)

[Translation]

The Chair: Thank you, Mr. Bell.

Mr. Boire, for three minutes.

Mr. Alain Boire: My question is for Professor Watts.

I'd like to delve further into a subject broached by my colleague Ms. Wasylycia-Leis, to get a clearer picture of your understanding of the agreement between the federal government and Newfoundland and Nova Scotia. Is it your opinion that this arrangement also serves to exacerbate the fiscal imbalance, given that the aim of equalization is to achieve equality among the provinces? I'm curious as to whether, in your view, this arrangement ultimately serves to widen the gap, in terms of fiscal imbalance?

[English]

Prof. Ronald Watts: I'm not really an expert on the details of those arrangements.

My concern throughout has been more that once you get into ad hoc judgments there's no end to the special pleading that different governments will bring forth, and so on. And it seems to me that those agreements have raised the issue of special pleading by other provinces, arguing that they are now disadvantaged by those arrangements.

When you ask if it leads to fiscal imbalance, I'm not quite sure what you're implying there in terms of how you measure imbalance. It seems to me that to some extent, insofar as it involves greater funds to provincial governments, it presumably reduces fiscal imbalance. I don't think the issue is just a matter of the degree of imbalance. I think there's also the horizontal imbalance issue—that is, how are the balances among the different provinces affected by such resolutions?

[Translation]

The Chair: I have a related question for you, Professor Watts. The arrangement with Newfoundland and Nova Scotia will mean an influx of approximately \$2.8 billion into provincial coffers over the next ten years, with the first payment of \$2 billion scheduled to be made immediately.

On a per capita basis, this arrangement is worth approximately \$3,600 or \$3,800. Nearly three weeks or one month ago, we were in Toronto. Mr. Sorbara, the Ontario Finance Minister, was critical of the arrangement, arguing that it would give Newfoundland and Nova Scotia a greater fiscal capacity than the per capita fiscal capacity of Ontario.

The conclusion reached was that this arrangement undermined the aims of equalization and increased the horizontal imbalance between the provinces. Do you agree with that statement?

[English]

Prof. Ronald Watts: Yes, that's what I was trying to say before, but I perhaps didn't make it clear. In one sense, it reduces the vertical imbalance, because it gives more funds to provinces to spend, but the form in which it is given seems to have had a destabilizing effect. That is my concern about what I call ad hocery.

It's not that it isn't desirable to assist the problems of Newfoundland or Nova Scotia, but rather that it's got to be looked at systematically in terms of what it means for all provinces, rather than simply dealing one by one with the particular circumstances of each province.

So I think you're stating in a different way what I was trying to say.

The Chair: Thank you very much.

[Translation]

You have three minute, Ms. Wasylycia-Leis.

[English]

Ms. Judy Wasylycia-Leis: Related to that, does Ontario have a legitimate case in terms of its shortfall of \$23 billion, and how should that be handled right now? Given the fact that bad deals were struck with Newfoundland and Nova Scotia, how do you handle this situation before we get to the point where we have to sit down again and figure out a new program with a new formula, perhaps with the advice of expert advisers? How do we handle it now so that we can avoid everything coming undone to the point where there is nothing left to fix?

• (1745)

Prof. Robin Boadway: It's a very difficult issue. I think that Ontario does have a case—so does every other province, as a matter of fact. I would say that an even stronger case comes from New Brunswick and Prince Edward Island and Manitoba, who don't have any resources and who may lose because of the way this has been negotiated and is maybe going to affect the fixed amount for equalization.

I think Ontario does have a good case. The fact of the matter is that this agreement is going to put Newfoundland and Labrador into a "have" status, yet they are not going to be recognized as such, but retain all of their equalization payments.

The question of where we go from here is not entirely clear, and I guess their panel of experts is going to have to really grapple with that one. If this is a done deal and can't be undone, which presumably is the case, I think at the very least it shouldn't be allowed to compromise the amount of entitlements that other provinces should get out of a fair dealing of the equalization system per se.

I personally think that if we want to put in place a good equalization system that treats all provinces fairly, we should have it as comprehensive as possible; we should include 100% of everything, including resources; we should calculate the equalization entitlements; and then if we want to give some special treatment for

resources on the basis of incentives or anything else, that treatment should be below the line. While I don't think they should do that in the first place, it should at least not affect the amount of equalization entitlements accruing to the other provinces who aren't so lucky to have this resource windfall on their doorsteps.

Prof. Ronald Watts: I basically agree with Professor Boadway, and this is why I plead for dealing with these issues systematically rather than on an ad hoc basis.

Ms. Judy Wasylycia-Leis: If there were—

[Translation]

The Chair: You have only a few seconds left, Ms. Wasylycia-Leis.

[English]

Ms. Judy Wasylycia-Leis: Let me try. I'd like to go back to something Robin Boadway said in terms of the source of the problem for all of this being partly the Liberal budget of 1995.

I won't say, with all due respect to my Liberal colleague—I think he knows and we all know—some of the problems that have happened as a result of that. I think the fiscal imbalance really started then, when you had the federal government arbitrarily cut health and education in the transfers to the tune of \$6.2 billion, scrap the Canada Assistance Plan, and then start playing with EI.

In all of those areas where there was significant increase in demand, the federal government had off-loaded a heck of a lot of responsibility onto provinces. More and more people were turning up on social welfare rolls, for which provinces have total responsibility. None of the savings of the EI fund went to help provinces. The \$45 billion or \$46 billion is still sitting there. On top of that, the federal government comes along and starts throwing in these boutique projects that can only be accessed if the provinces match the funds. It's just a mess, a catch-22.

That was more a statement than anything. Do you have any comments to add to that, anything to say?

[Translation]

The Chair: You've gone over your allotted time. Perhaps Mr. Boadway has something to add.

[English]

Prof. Robin Boadway: I think we've already addressed the issues, but I agree.

[Translation]

The Chair: Committee members assembled here would probably be interested in hearing once more one of your answers that really got me to thinking. You stated that we should be negotiating arrangements on natural resources, but that these should not result in a reduction in equalization payments to other provinces. How is that possible given that, first of all, the federal government has concluded an arrangement with Newfoundland and Nova Scotia pursuant to which equalization payments will not be affected, even if dividends on off-shore oil resources are paid, in particular to the Newfoundland government? Secondly equalization has been capped at \$10 billion, an amount that, if memory serves me well, corresponds to payments in 2001-2002 and that is indexed at a rate of 3.5 per cent.

Therefore, if two provinces, namely Newfoundland and Labrador and Nova Scotia, are given this kind of advantage, that means they will in fact receive a larger amount in real terms, in the form of equalization than they would have in fact received without an agreement. It also means that the other receiving provinces will get a smaller amount, in real terms, than what they would normally have been entitled to, since payments are capped at \$10 billion and indexed at a rate of 3.5 per cent.

How then can we conceivably have a system without any form of communication, where payments, although indexed to inflation, are capped?

• (1750)

[English]

Prof. Robin Boadway: My understanding is that the flow-back of funds to Nova Scotia and Newfoundland and Labrador with respect to these offshore agreements should not come, will not come, from the \$10.9 billion that has been put into the equalization pot. That's my understanding.

However, the other issue is whether the existence of those agreements will or should affect the way in which the \$10.9 billion is

allocated among all of the have-not provinces. If the government were abiding by the letter of the promise, then the formula shouldn't disadvantage Newfoundland and Labrador and Nova Scotia when it comes to calculating their entitlement. I guess that would be the answer. But whichever way you cut it, they certainly have been given a favourable deal relative to provinces that aren't so lucky as to have those resources.

[Translation]

The Chair: All that remains is for me to thank you, Mr. Boadway and Professor Watts, for your excellent presentations. Your submissions were impeccable. On behalf of all my colleagues, thank you for contributing to this important debate. You've enlightened us on the various approaches taken elsewhere in the world in this field.

Again, we apologize for the 75-minute delay that was due to circumstances beyond our control.

Thank you very much and we look forward to meeting you again some day.

The meeting is adjourned.

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