

No. 62/3 Canadian Federal-Provincial Fiscal Arrangements

(Prepared in the Federal-Provincial Relations
Division, Department of Finance)

The elements of federal-provincial fiscal arrangements in Canada are logically broken into the following components: tax rental, or tax collection agreements; equalization payments to the provinces by the federal government; and other subsidies to the provinces.

The tax rental agreements have been the main feature of federal-provincial fiscal arrangements since 1941. Under the Canadian constitution the federal government does not have exclusive jurisdiction in the fields of direct taxation. The provinces also have independent tax powers in these fields. Thus Canada has eleven taxing jurisdictions, one federal and ten provincial, in the fields of corporation income, personal income, estate, and other direct taxes. This situation, except that Newfoundland was not yet a Canadian province, faced the federal government in 1941 when it was trying to mobilize Canada's resources for World War II. It was then imperative that taxing powers in the major tax fields of personal and corporation income rest in one authority for the efficient planning of Canada's financial policies for the duration of the War. In order to induce the provincial governments themselves not to use, or permit their municipalities to use, personal and corporation income taxes, the federal government offered attractive payments in compensation, which the provinces accepted. The agreement made in 1941 lasted to 1947. But, after the war, the experience of the advantages of having one tax collecting agency encouraged the continuation of these agreements with modifications.

Actually the term tax rental agreement is a misnomer when applied to agreements preceding the 1957/62 agreement because the compensation paid did not reflect the value of the tax fields relinquished by the provinces but was an arbitrary formula unrelated to the tax revenue collected by the federal government in each province. This was changed in the 1957 agreement, which is the one in effect up to March 31, 1962. This agreement provides for payments to each province, which payments are a certain percentage of the agreed taxes collected from that province - that is, 13% of the yield of the personal income tax, 9% of corporation taxable income (i.e. 9% of the 18% rate of tax on taxable corporate income up to \$35,000 and 9% of the 47% rate of taxable corporate income in excess of \$35,000), and 50% of the yield of federal estate taxes.

The allocation of taxes collected is simplified by regulation. For personal income tax collections, the province in which the taxpayer is resident on the last day of the year is deemed to be the province of residence for the whole year. For corporation income tax, the allocation cannot be so simple and still be equitable, because many companies operate in more than one province. The regulation for the allocation of corporate income provides that the taxable income of corporations having permanent establishments

in more than one province will be allocated 50% on the sales made from the permanent establishments, and 50% on the wages and salaries in those permanent establishments.

Although the tax-rental agreements produced the desirable result of a single tax system for personal and corporate income tax, they had a drawback that became increasingly apparent as each new agreement was negotiated. The size of the rental paid to the provinces was the subject of negotiation, and of course, as each period passed, the provinces pressed for larger and larger amounts, especially since they did not have to accept the political responsibility for increased federal taxes or reduced federal expenditure programmes to meet the amounts demanded. This being the case, the federal government announced that it was not going to retain the tax-rental system after the expiration of the present agreement. What it proposed instead was to reduce successively in each of the next five years; reduce the federal corporate income tax by 9% of corporate income and continue to share 50% of the estate tax; and having thus reduced federal taxes by the amounts it proposed to share with the provinces, let them levy their own taxes, at whatever rates they decided were required. However, in order to encourage the retention of the benefits of a single tax system, and a single tax collector, the federal government offered to collect the provincial taxes free of charge, if the federal income tax statutes were adopted unchanged except for the rates, which could be varied from province to province. In order to receive a 50% share of the federal inheritance tax, the provinces have to agree to refrain from levying their own estate or succession taxes.

The second element in Canadian federal-provincial fiscal arrangements is the equalization grant. This grant is a partial recognition that some provinces have less fiscal capacity than others, and so need to have their revenues bolstered by an additional payment from the federal treasury. The national average per capita of certain taxes and revenues, chosen because of their importance in provincial budgets and their disparity among the provinces, is used as the standard. The provincial per capita yields of the same taxes at the same rates of tax and the same category of revenue are compared with the national average per capita, and the deficiency per capita, if any, multiplied by the population of the province determines the grant. Thus the provinces with the greatest deficiencies will receive the largest per capita grants. The taxes used for calculating the grants, the standard taxes as they are known, are the personal income tax collections at the rates of federal withdrawal of 16%, 17%, 18%, 19%, 20% in the five successive years of the 1962-67 agreement; the federal corporation income tax at the rate of 9%; and 50% of the collection of the federal estate tax. In addition to the standard taxes, 50% of natural resource revenues are included, mainly because of their great variability among provinces, from 0.2% to 50% of provincial budgets in 1958/59. The revenues from natural resources taken account of in the calculation include both annual payments of the nature of royalties and rentals and the like and lump sum payments such as leases for oil and timber rights. Both types of revenues are considered to be payments for the alienation of resources, and that is part of the reason no distinction is made between them. Because the natural resource revenues include both annual and lump sum payments and, in addition, because of different rates and tax base definitions in the different provinces, only one-half of natural resource revenues are considered in the calculation of the equalization grants.

Once again one has to be careful of this terminology. Equalization grants really only equalize the selected provincial revenues per capita up to the level selected. For the 1962-67 agreement, the national average per capita of the selected revenues will

be the equalization level. In the period of the expiring agreement, natural resource revenues were not admitted to the calculation, and the per capita average of the two provinces with the highest per capita yields of standard taxes (personal income tax, corporate income tax, and estate taxes) was the level to which the selected provincial tax yields were equalized. Any level could be adopted, and any taxes included in the formula. The important feature is the measuring of the per capita deficiency in each political area, and the payment of a grant based on this deficiency. In the Canadian federal-provincial fiscal arrangements, no explicit provision is made for the reduction of other federal grants to those provinces having fiscal capacity greater than the selected level.

In addition to the equalization grants described briefly above, the federal government pays special subsidies to the Canadian Atlantic Provinces of Newfoundland, Nova Scotia, New Brunswick and Prince Edward Island in recognition of their lower level of economic development and prosperity when compared with the rest of Canada. Having a lower level of economic activity means that the burden of providing essential public services at a necessary and acceptable level rests more heavily on the citizens of these provinces than those of the rest of Canada. If it were not for additional subsidies some essential services probably would have to be curtailed. In order to help avoid this, the Atlantic Provinces Adjustment Grants were instituted in the 1958/59 fiscal year. They are a device which, when coupled with equalization grants, funnels a greater per capita share of any given amount of federal transfer payments to the relatively poorer provinces.

The Atlantic Provinces Adjustment Grants originally were based on a formula that attempted to measure the fiscal need of individual provinces relative to the average level of personal prosperity in Canada. In this formula the ratio that the total revenues from provincial and dependent lower levels of governments (municipal governments), for all of Canada bear to Canadian personal income was calculated and applied to the amount by which each province's per capita personal income falls short of 85% of Canadian per capita personal income, and the result multiplied by the province's population. That is: Province's Grant = $\frac{\text{total revenue from Provincial \& local sources}}{\text{national personal income}}$

$$x \left[\frac{(.85 \times \text{national per capita personal income}) - \text{province's per capita personal income}}{\text{per capita personal income}} \right] \times \text{population of the province}$$

This scheme relates grants to an estimate of average fiscal capacity for the nation as measured by a percentage of per capita personal income.

A few observations should be made in regard to this formula. First, personal income per capita is not the only measure of taxable capacity. In some instances personal income per family head, or per person of working age, or per worker could well be used instead. The calculation that was originally made was based on the income deficiency per person of working age (15-69 years). Second, the level of national income per person used (in this case 85%) may, of course, be any proportion depending on the objective in mind in using the formula. The 85% level was adopted to ensure the personal income deficiency from the national average was pronounced and not likely to be soon overcome. Third, if it is the desire, as it is in Canada, to use these grants to assist provinces having a chronic fiscal and economic disability, averages of revenues and personal incomes for several years can be used. Five year averages for these quantities are used in Canada. This has the advantage of giving the areas with persistent inequalities the greatest aid by minimizing temporary fluctuations.

