

Fiscal Imbalance in Canada

Historical Background

Report

Supporting Document 1

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INTRODUCTION

Fiscal imbalance between the federal government and the provinces has been the subject of intense discussions for several years. The expression “fiscal imbalance” is used to describe a situation in which, in light of effective occupation of tax fields, Québec and the other provinces have insufficient revenues to exercise their fields of jurisdiction while, to the contrary, the federal government has revenues in excess of what is necessary to fund its fields of jurisdiction.¹ Such imbalance raises basic questions in respect of public finances and the very role of the federal and provincial governments.

This document examines the key events that have marked relations between Ottawa and the provinces since 1867. In so doing, it highlights the historic foundations of the fiscal imbalance prevailing in Canada.

¹ Commission on Fiscal Imbalance, *Fiscal Imbalance: Problems and Issues*, page 4.

THE BRITISH NORTH AMERICA ACT

The *British North America Act* (BNA) – or *Constitution Act, 1867*² – was assented to on March 29, 1867 by the British Parliament and enacted the following July 1. It defined the federative union of United Canada, comprising Upper Canada and Lower Canada and the provinces of New Brunswick and Nova Scotia.

Origins of the British North America Act

The main reason for the unification of United Canada and the provinces of New Brunswick and Nova Scotia was their need for common defence against, in particular, the independence and territorial expansion movements in the United States threatening their borders, their desire for independence from the British, and their desire to broaden trade between the four provinces.³

However, these factors were not new and do not on their own explain why the union was achieved in 1867. Two events fostered interest in a federal union, i.e. the political crisis in United Canada and the willingness of the Atlantic Provinces⁴ to discuss among themselves a proposed union. In particular, they planned to meet in 1864 in Charlottetown to examine this possibility.

By 1864, United Canada had become virtually ungovernable. As the Royal Commission of Inquiry on Constitutional Problems noted,⁵ political instability in United Canada was rampant:

*One government followed the other and all of them failed. Every possible combination between the parties was tried and they, too, failed. Every political expedient was tried, without success. Then, to cap it all, racial and religious passions were aroused and threatened the peace between the two sections of the Province. Political and religious leaders were anxious and pessimistic about the future.*⁶

² *Constitution Act, 1867*, 30 & 31 Vict. R.-U., c. 3.

³ ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, *Report of the Royal Commission of Inquiry on Constitutional Problems*, Vol. I, pages 10 and 11.

⁴ While Prince Edward Island took part in the talks, it did not join Confederation until 1873.

⁵ Better known as the Tremblay Commission.

⁶ ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, *op. cit.*, Vol. 1, page 11. Our translation.

As the *Histoire générale du Canada* notes:

[...] between 1861 and 1864, United Canada had two elections and four governments. On June 14, 1864, the fourth government was overturned and the politicians assembled in Québec City could see no solution to the political crisis. [...] The solution proposed to overcome the stalemate was the development of a confederation project that would unite the provinces of British North America, including the Province of Canada.⁷

As for the solutions suggested:

The movement in favour of a confederation gained strong momentum in 1864. At the end of the summer a conference to discuss the union of the Maritime Provinces was hastily convened in Charlottetown. [...] When apprised of the conference, politicians from the Province of Canada asked to be allowed to attend it, with a view to proposing a broader project, the union of all of the colonies [provinces]. [...] The union sketched out in Charlottetown took shape at the conference held in Québec City one month later.⁸

The choice of a federative model

It was clear at that time that a full legislative union, i.e. the establishment of a single entity and a single government, was unthinkable. First, differences in language, religion and origin combined with divergent economic interests and the isolation of certain provinces tended to promote a federative union. Moreover, the attempt made in United Canada to unite Upper Canada and Lower Canada under a single government failed, revealing the weaknesses of this method of organization. Lower Canada and the Atlantic Provinces strongly opposed it.

The adoption by the provinces of the agreement

The British Colonial Secretary quickly adopted the proposal formulated at the Charlottetown meeting in 1864. However, the elections held in the Atlantic Provinces delayed their support for the project. The new governments in Newfoundland, New Brunswick and Prince Edward Island rejected the agreement while Nova Scotia, which had not consulted the electorate on the matter, postponed its decision.

In 1866, New Brunswick elected a government favourable to the union. Shortly thereafter, Nova Scotia and New Brunswick obtained from their legislatures a resolution in favour of the proposed union. The British Parliament assented to the BNAA on March 29, 1867 and enacted it on July 1 of the same year.

⁷ Peter WAITE, "Un défi continental, 1840-1900" in *Histoire générale du Canada*, page 380. Our translation.

⁸ *Id.*, p. 385. Our translation.

The division of powers under the federal union

Aside from the type of union adopted, the BNAA specifies the division of fields of jurisdiction and sources of revenue between the provincial and federal governments.

Division of powers

As emphasized by the *Report of the Royal Commission of Inquiry on Constitutional Problems* and a study produced by the Royal Commission on the Economic Union and Development Prospects for Canada,⁹ the division of powers stipulated in the BNAA was strongly influenced by the presence of Catholic French-Canadians, who made up a separate linguistic and religious group in the country.

[because of] *the presence of the French-Canadians [...]: **certain powers may be exercised in a general way without harming the national interests of this group, while others may not;** consequently, the former may be entrusted to a federal government and **the latter must be reserved for the provinces.***¹⁰

[...] *section 93 confers on the provincial governments the exclusive power to legislate in respect of education [...]. Invested with these powers, the provincial governments and, above all, Québec, can prevent the national majority from trampling on community customs in respect of language, religion, education, civil law and the public good. Responsibility for social policy – **the public good** and the municipalities that assume responsibility for it, provided that this sector is not turned over to the churches and charities – **is attributed to the provincial governments.** This suggests that **the preservation and development of infranational communities and identities are deemed to be important and primarily fall under the jurisdiction of the provincial governments.***¹¹

Thus, the division of powers stipulated in the BNAA (see Tables 1A, 1B and 1C) is strongly imbued with the following principles:¹²

- matters that do not divide the two linguistic and religious groups that make up the population and in respect of which the two groups have a common interest are attributed to the federal government;
- matters in the social and cultural fields and everything affecting the private lives of citizens and social institutions are attributed to the provinces.

⁹ Better known as the Macdonald Commission.

¹⁰ ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, OP. CIT., SEE NOTE 3, Vol. I, page 37. Our emphasis. Our translation.

¹¹ Richard SIMEON and Ian ROBINSON, *L'État, la société et l'évolution du fédéralisme canadien*, page 27. Our translation. Our emphasis.

¹² ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, OP. CIT., SEE NOTE 3, Vol. I, pages 37 and 39.

Consequently, the *Constitution Act, 1867* and subsequent interpretations of it defined the jurisdictions of the two orders of government, confining shared fields to immigration, agriculture and pensions.

TABLE 1A

**DIVISION OF POWERS STIPULATED BY THE *CONSTITUTION ACT, 1867* AND
SUBSEQUENT AMENDMENTS**

Exclusive powers of the federal government (section 91)

- | | |
|--|---|
| <ul style="list-style-type: none"> • Make Laws for the Peace, Order, and good Government of Canada. • The Public Debt and Property. • The Regulation of Trade and Commerce. • Unemployment insurance. • The raising of Money by any Mode or System of Taxation. • The borrowing of Money on the Public Credit. • Postal Service. • The Census and Statistics. • Militia, Military and Naval Service, and Defence. • The fixing of and providing for the Salaries and Allowances of Civil and other Officers of the Government of Canada. • Beacons, Buoys, Lighthouses, and Sable Island. • Navigation and Shipping. • Quarantine and the Establishment and Maintenance of Marine Hospitals. • Sea Coast and Inland Fisheries. • Ferries between a Province and any British or Foreign Country or between Two Provinces. • Currency and Coinage. | <ul style="list-style-type: none"> • Banking, Incorporation of Banks, and the Issue of Paper Money. • Savings Banks. • Weights and Measures. • Bills of Exchange and Promissory Notes. • Interest. • Legal Tender. • Bankruptcy and Insolvency. • Patents of Invention and Discovery. • Copyrights. • Indians, and Lands reserved for the Indians. • Naturalization and Aliens. • Marriage and Divorce. • The Criminal Law, except the Constitution of Courts of Criminal Jurisdiction, but including the Procedure in Criminal Matters. • The Establishment, Maintenance, and Management of Penitentiaries. • Such Classes of Subjects as are expressly excepted in the Enumeration of the Classes of Subjects by this Act assigned exclusively to the Legislatures of the Provinces. |
|--|---|

Exclusive powers of provincial legislatures (section 92)

- | | |
|---|---|
| <ul style="list-style-type: none"> • Direct taxation within the Province in order to the raising of a Revenue for Provincial Purposes. • The borrowing of Money on the sole Credit of the Province. • The Establishment and Tenure of Provincial Offices and the Appointment and Payment of Provincial Officers. • The Management and Sale of the Public Lands belonging to the Province and of the Timber and Wood thereon. • The Establishment, Maintenance, and Management of Public and Reformatory Prisons in and for the Province. | <ul style="list-style-type: none"> • Local Works and Undertakings other than such as are of the following Classes: <ul style="list-style-type: none"> a) Lines of Steam or other Ships, Railways, Canals, and other Works and Undertakings connecting the Province with any other or others of the Provinces, or extending beyond the Limits of the Province; b) Lines of Steam Ships between the Province and any British or Foreign Country; c) Such Works as, although wholly situate within the Province, are before or after the Execution declared by the Parliament of Canada to be for the general Advantage of Canada or for the Advantage of Two or more of the Provinces. |
|---|---|

Source: *Constitution Act, 1867* and subsequent amendments, sections 91, 92, 92A, 93, 93A, 94, 94A, 95, 96, 100 and 101.

TABLE 1B

**DIVISION OF POWERS STIPULATED BY THE *CONSTITUTION ACT, 1867* AND
SUBSEQUENT AMENDMENTS (CONTINUED)**

Exclusive powers of provincial legislatures (section 92) (continued)

- | | |
|--|---|
| <ul style="list-style-type: none"> • The Establishment, Maintenance, and Management of Hospitals, Asylums, Charities, and Eleemosynary Institutions in and for the Province, other than Marine Hospitals. • Municipal Institutions in the Province. • The Imposition of Punishment by Fine, Penalty, or Imprisonment for enforcing any Law of the Province made in relation to any Matter coming within any of the Classes of Subjects enumerated in this Section. • Shop, Saloon, Tavern, Auctioneer, and other Licences in order to the raising of a Revenue for Provincial, Local, or Municipal Purposes. | <ul style="list-style-type: none"> • The Incorporation of Companies with Provincial Objects. • The Solemnization of Marriage in the Province. • Property and Civil Rights in the Province. • The Administration of Justice in the Province, including the Constitution, Maintenance, and Organization of Provincial Courts, both of Civil and of Criminal Jurisdiction, and including Procedure in Civil Matters in those Courts. • Generally all Matters of a merely local or private Nature in the Province. |
|--|---|

Exclusive powers of provincial legislatures (section 92A)

- In each province, the legislature may exclusively make laws in relation to
 - a) exploration for non-renewable natural resources in the province;
 - b) development, conservation and management of non-renewable resources natural resources and forestry resources in the province, including laws in relation to the rate of primary production therefrom; and
 - c) development, conservation and management of sites and facilities in the province for the generation and production of electrical energy.
- In each province, the legislature may make laws in relation to the raising of money by any mode or system of taxation in respect of
 - a) non-renewable natural resources and forestry resources in the province and the primary production therefrom, and;
 - b) sites and facilities in the province for the generation of electrical energy and the production therefrom.
- In each province, the legislature may make laws in relation to the export from the province to another part of Canada of the primary production from non-renewable natural resources and forestry resources in the province and the production from facilities in the province for the generation of electrical energy, but such laws may not authorize or provide for discrimination in prices or in supplies exported to another part of Canada.
- Nothing in preceding subsection derogates from the authority of Parliament to enact laws in relation to the matters referred to in that subsection and, where such a law of Parliament and a law of a province conflict, the law of Parliament prevails to the extent of the conflict.
- The expression "primary production" has the meaning assigned by the Sixth Schedule. Existing powers or rights.
- Nothing in preceding subsections (1) to (5) derogates from any powers or rights that a legislature or government of a province had immediately before the coming into force of this section.

Source: *Constitution Act, 1867* and subsequent amendments, sections 91, 92, 92A, 93, 93A, 94, 94A, 95, 96, 100 and 101.

TABLE 1C

**DIVISION OF POWERS STIPULATED BY THE *CONSTITUTION ACT, 1867* AND
SUBSEQUENT AMENDMENTS (CONTINUED)**

Exclusive powers of provincial legislatures (sections 93 and 93A)

- In and for each Province the Legislature may exclusively make Laws in relation to Education, subject and according to the following Provisions (section 93):
 - a) Nothing in any such Law shall prejudicially affect any Right or Privilege with respect to Denominational Schools which any Class of Persons have by Law in the Province at the Union;
 - b) All the Powers, Privileges and Duties at the Union by Law conferred and imposed in Upper Canada on the Separate Schools and School Trustees of the Queen's Roman Catholic Subjects shall be and the same are hereby extended to the Dissident Schools of the Queen's Protestant and Roman Catholic Subjects in Quebec;
 - c) Where in any Province a System of Separate or Dissident Schools exists by Law at the Union or is thereafter established by the Legislature of the Province, an Appeal shall lie to the Governor General in Council from any Act or Decision of any Provincial Authority affecting any Right or Privilege of the Protestant or Roman Catholic Minority of the Queen's Subjects in relation to Education;
 - d) In case any such Provincial Law as from Time to Time seems to the Governor General in Council requisite for the Execution of the Provisions of this Section is not made, or in case any Decision of the Governor General in Council on any Appeal under this Section is not duly executed by the proper Provincial Authority in that Behalf, then and in every such Case, and as far as the Circumstances of each Case require, the Parliament of Canada may make remedial Laws for the due Execution of the Provisions of this Section and of any Decision of the Governor General in Council under this Section.
- Paragraphs (a) to (b) of section 93 do not apply to Quebec (section 93A).

Exclusive powers of the federal government (section 94)

- Notwithstanding anything in this Act, the Parliament of Canada may make Provision for the Uniformity of all or any of the Laws relative to Property and Civil Rights in Ontario, Nova Scotia, and New Brunswick, and of the Procedure of all or any of the Courts in those Three Provinces, and from and after the passing of any Act in that Behalf the Power of the Parliament of Canada to make Laws in relation to any Matter comprised in any such Act shall, notwithstanding anything in this Act, be unrestricted; but any Act of the Parliament of Canada making Provision for such Uniformity shall not have effect in any Province unless and until it is adopted and enacted as Law by the Legislature thereof.

Shared jurisdiction of the two orders of government (section 94A)

- The Parliament of Canada may make laws in relation to old age pensions and supplementary benefits, including survivors' and disability benefits irrespective of age, but no such law shall affect the operation of any law present or future of a provincial legislature in relation to any such matter.

Shared jurisdiction of the two orders of government (section 95)

- In each Province the Legislature may make Laws in relation to Agriculture in the Province, and to Immigration into the Province; and it is hereby declared that the Parliament of Canada may from Time to Time make Laws in relation to Agriculture in all or any of the Provinces, and to Immigration into all or any of the Provinces; and any Law of the Legislature of a Province relative to Agriculture or to Immigration shall have effect in and for the Province as long and as far only as it is not repugnant to any Act of the Parliament of Canada.

Source: *Constitution Act, 1867* and subsequent amendments, sections 91, 92, 92A, 93, 93A, 94, 94A, 95, 96, 100 and 101.

TABLE 1D**DIVISION OF POWERS STIPULATED BY THE CONSTITUTION ACT, 1867 AND SUBSEQUENT AMENDMENTS (CONTINUED)****Exclusive powers of the federal government (section 96, 100 and 101)**

- The Governor General shall appoint the Judges of the Superior, District, and County Courts in each Province, except those of the Courts of Probate in Nova Scotia and New Brunswick (section 96).
- The Salaries, Allowances, and Pensions of the Judges of the Superior, District, and County Courts (except the Courts of Probate in Nova Scotia and New Brunswick), and of the Admiralty Courts in Cases where the Judges thereof are for the Time being paid by Salary, shall be fixed and provided by the Parliament of Canada (section 100).
- The Parliament of Canada may, notwithstanding anything in this Act, from Time to Time provide for the Constitution, Maintenance, and Organization of a General Court of Appeal for Canada, and for the Establishment of any additional Courts for the better Administration of the Laws of Canada (section 101).

Source: *Constitution Act, 1867* and subsequent amendments, sections 91, 92, 92A, 93, 93A, 94, 94A, 95, 96, 100 and 101.

Division of fields of taxation

The division of the fields of taxation stipulated in the *Constitution Act, 1867* was intended to ensure that the federal and provincial governments obtained the funds necessary to fulfill their respective obligations, as defined in the division of powers.

Since the federal government had to assume a heavier financial burden in 1867, in particular with respect to the development of maritime and land transportation infrastructure, its potential for levying taxes was much greater than that granted the provinces. Such development required heavier funding than social services. Prior to the BNAA, it accounted for over 40% of the provincial budgets (including debt service), while education and social welfare accounted for only 14%.

Consequently, the BNAA empowered the federal government to levy taxes by any means while it only attributed to the provinces fields of direct taxation, i.e. licences and permits, claims on public lands, the sale of goods and services, and the levying of property taxes and, subsequently, income tax.

[Pursuant to the Constitution Act, 1867 and the Constitution Act, 1982, the federal government] *is empowered to raise funds by any method of taxation. Moreover, the customs duties and excise taxes collected by the provinces at the time of the Union were expressly attributed to the federal government. [...] The federal government's taxing power covers both direct and indirect taxation and is only limited by section 125 of the Constitution Act, 1867, which prohibits the taxation of land and property belonging to the provinces, and by [...] the Canadian Charter of Rights and Freedoms.*

[...] The provinces are empowered to levy direct taxes within their territory with a view to generating revenues to cover provincial objects.

[...] *The provincial legislatures are also empowered to legislate in respect of the issuing of licences and permits in order to cover provincial, local or municipal objects.*¹³

It is no accident that federal government was empowered to levy customs duties and excise taxes, a situation that reflected the conditions prevailing at the time. In 1867, before the BNAA, they accounted for nearly 80% of the provinces' overall financial resources. Since the federal government's financial needs were substantial, especially in respect of the development of transportation infrastructure, it was allowed to tap this source of revenue without competition from the provinces.

The division of fields of taxation also appears to have been strongly influenced by the determination of the provinces and the federal government to foster interprovincial trade since entrusting to Ottawa responsibility for customs duties and excise tax meant limiting potential obstacles to such trade.

Definition of direct taxing power

The definition of direct taxation prevailing in Canadian constitutional law, a definition that was integrated into the *Constitution Act, 1867* and confirmed by the Privy Council just a few years later,¹⁴ is attributable to the reputed 19th century economist John Stuart Mill:

*A direct tax is one which is demanded from the very person who is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another.*¹⁵

While economists do not deem this definition to have the same peremptory character as it had in Mill's time¹⁶ (they no longer make such a restrictive distinction), Canadian jurisprudence unanimously confirms this interpretation.¹⁷ Every time that the constitutionality of a method of taxation has been challenged before the courts, the courts have sought mainly to clarify this definition, not to call it into question.

However, the courts have somewhat qualified the definition.¹⁸ They maintain that the distinction between a direct tax and an indirect tax cannot be judged according to the facts but must focus on the likelihood that a tax may be

¹³ Guy LORD, Jacques SASSEVILLE and Diane BRUNEAU, *Les principes de l'imposition au Canada*, pages 9-12. Our translation.

¹⁴ *Bank of Toronto v. Lamb* (1887) 12 C.A. 575 (C.P.).

¹⁵ John Stuart MILL, *Principles of Political Economy*, Book V, Chapter 3.

¹⁶ Peter W. HOGG, *Constitutional Law of Canada*, Toronto, Carswell 1997, 30 (2) a.

¹⁷ Only one dissenting opinion was recorded on this interpretation, that of Justice Laforest, concerning the reasons, in *Ontario Home Builders Assn' vs York Region Board of Education* – [1996] 2 R.C.S. 929 – in which the majority nonetheless maintained this interpretation.

¹⁸ *Bank of Toronto v. Lamb*, *op. cit.*; *Québec (Procureur général) v. Villeneuve*, (1996) R.J.Q. 2199 (C.A.); *Renvoi relatif à la taxe de vente du Québec*, [1994] 2 R.C.S. 715.

surrendered to a third party and, more specifically, the common perception of this likelihood.

In light of this definition, the courts have declared that income tax and estate tax, property tax and sales tax qualify as direct taxes. They have qualified as indirect taxes excise tax, customs duties and *ad valorem* wholesale tax.

Effect on the financial self-sufficiency of the provinces

By granting to the federal government exclusive jurisdiction over customs duties, the *Constitution Act, 1867* instituted a division of fields of taxation that was unfavourable to New Brunswick and Nova Scotia, since it implied that the provinces must relinquish this important form of taxation at the time and rely on little used sources, especially property tax.

These provinces had limited recourse to property taxes since their municipal networks were hardly developed, contrary to those in Ontario and Québec. Prior to the adoption of the BNAA, property taxes accounted for less than 10% of their revenues, while the revenues surrendered to the federal government accounted for nearly three-quarters of their revenues, compared with only just over half in respect of Québec and Ontario (see Table 2).

TABLE 2

REVENUES OF THE PROVINCES PRIOR TO THE *BRITISH NORTH AMERICA ACT* (as a percentage of the total)

Revenues	Québec and Ontario	Nova Scotia	New Brunswick
Surrendered to the federal government			
Customs duties	45	75	72
Excise taxes	11	—	—
Total	56	75	72
Preserved by the provinces			
Property taxes	23	7	9
Licences and permits	5	2	3
Claims on public lands	5	8	7
Other revenue	11	8	9
Total	44	25	28
Total	100	100	100

Source: Data drawn from ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, *Report of the Royal Commission of Inquiry on Constitutional Problems*, Vol. I.

The levying of a tax on personal income was rather unpopular and hard to effect in a geographically dispersed, pre-industrial society. The excerpt below is from a speech addressed to the lieutenant-governor, which reflects the thinking that prevailed between 1867 and 1919:

*[...] Our progress, hampered by the paltriness of our revenues, is neither as free nor as rapid as it should be. It is pointless for us to resort to a direct tax, which is an inadequate means to which past experience and public thinking are peremptorily opposed.*¹⁹

Under the circumstances, direct taxes could not adequately play the role that the BNAA intended, i.e. to guarantee that the provinces obtain sufficient revenues to properly assume their fields of jurisdiction. It was obvious that the provinces could not balance their budgets under the BNAA and required additional sources of revenue.

To remedy the problem, financial transfer programs intended for the provinces were integrated into the BNAA before it was enacted. According to the Royal Commission of Inquiry on Constitutional Problems:

*[This initiative] is a breach of the federative principle, which demands that each order of government be autonomous and responsible in the financial field as it is in the other legislative fields. [...] we can rightly qualify the initiative as an expedient and a compromise necessary at the time [and which made possible the BNAA].*²⁰

Four statutory subsidy programs were established and integrated into the BNAA:

- Transfers in respect of debt: since the provinces' debt is consolidated at the federal order, the provinces whose per capita debt falls below the national average receive 5% of the difference²¹, while the provinces that are heavily indebted in relation to the national average pay 5% of the difference²²;
- Per capita transfers to mitigate regional disparities in wealth²³;
- A lump sum to support the public administration²⁴;
- Exclusive transfers to take into account the specific financial problems of New Brunswick²⁵ (in 1867) and Nova Scotia (starting in 1869).²⁶

¹⁹ Speech given by MNA Lucien Cannon in the Legislative Assembly on November 12, 1913. Our translation.

²⁰ ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, OP. CIT., SEE NOTE 3, Vol. I, page 29. Our translation.

²¹ *Constitution Act, 1867*, see note 2, section 116.

²² *Constitution Act, 1867*, see note 2, section 112, 114 et 115.

²³ *Constitution Act, 1867*, see note 2, section 118, repealed by the *Loi sur la Révision du droit statutaire* de 1950, 14 George VI, R.-U., c. 6.

²⁴ Id.

²⁵ *Constitution Act, 1867*, see note 2, art. 119.

²⁶ Act related to Nova-Scotia, S.C. 1869, c. 2



THE FEDERATION'S FIRST STEPS (1867-1940)

The *Constitution Act, 1867* establishes fairly precisely the fields of jurisdiction attributed to each order of government. However, from the outset of the federation and until the late 19th century, the federal government attempted to impose its legislative authority over the provinces. Although the *Constitution Act, 1867* clearly established the legal existence of the provinces, their political autonomy emerged only 30 years later.

Moreover, the provinces did not achieve financial self-sufficiency in 1867. The early 20th century was decisive in this respect as the initial attempts by the provinces to achieve greater financial self-sufficiency led to mitigated success at the time of the Great Depression.

Political autonomy of the provinces

Power of disallowance

An important step in the provinces' quest to gain recognition as full-fledged political entities was the federal government's decision to relinquish – following intense pressure from the provinces – recourse to the power of disallowance stipulated in the *Constitution Act, 1867*, whereby the Governor General may rescind legislation adopted by a provincial legislature.²⁷ The federal government's repeated recourse to the power in the late 19th century sparked numerous conflicts stemming from the determination of one order of government's legislative precedence over the other.²⁸

²⁷ Sections 55, 56, 57 and 90 *Constitution Act, 1867* (op. cit., see note 2) confer this power on the Governor General.

²⁸ Research conducted by H. BRUN and G. TREMBLAY (*Droit constitutionnel*, pages 432-437) reveals that this power has been used 112 times since 1867 but that it has not been invoked in respect of Québec legislation since 1910 nor in respect of provincial legislation since 1943.

Constant disagreement between the federal government and the provinces concerning the true scope of this power²⁹ combined with several decisions handed down by the Privy Council in favour of the provinces to the detriment of the federal government gradually convinced Ottawa to use the power cautiously and thereafter sparingly. Brun and Tremblay³⁰ emphasize that on July 21, 1975, then Prime Minister Pierre E. Trudeau expressly indicated in a letter his refusal to invoke this power in respect of the *Charter of the French language*³¹, since it is “an exception to the principle whereby the federal and provincial parliaments are autonomous in their respective fields of legislative jurisdiction and assume full responsibility for the measures that they ratify.”³²

Declaratory power

The power of disallowance is not the only tool to which the federal government resorts to take precedence over the provinces in various fields. Declaratory power, stipulated in section 92.10 c) of the *Constitution Act, 1867*, allows the Parliament of Canada to broaden in a discretionary manner its fields of jurisdiction.

AN OBSOLETE POWER

The power of disallowance is mentioned in sections 55, 56, 57 and 90 of the *Constitution Act, 1867*. It empowers the Governor General to disallow provincial legislation that it deems to go against the federation's interests, and to remove its force of law.

The provinces have repeatedly contested this power. In 1937, 13 years had elapsed since the last instance of disallowance when Alberta unsuccessfully invoked its obsolescence before the Supreme Court,³³ which refused to recognize the non-use of the power under the Constitution. The Court has since changed its mind in light of Ottawa's persistence not only in not invoking the power but also in refusing expressly to do so.

Indeed, a majority of Supreme Court justices noted in 1981 the power's complete obsolescence³⁴ and unanimously reconfirmed this fact in 1998 in the *Reference re Secession of Quebec* in an unequivocal obiter:

Our political and constitutional practice has adhered to an underlying principle of federalism, and has interpreted the written provisions of the Constitution in this light. For example, although the federal power of disallowance was included in the Constitution Act, 1867, the underlying principle of federalism triumphed early. Many constitutional scholars contend that the federal power of disallowance has been abandoned [...] e.g., P. W. Hogg.^{35, 36}

²⁹ In its report (*op. cit.*, note 3, Vol. I, page 38), the Royal Commission of Inquiry on Constitutional Problems stated that: “[...] in order to ensure, they thought, the unity of legislation, the constituents granted the [federal government] two powers, which subsequently **proved to be a source of endless political conflict**, i.e. the power to raise money by any method or system of taxation, and the power to disallow provincial legislation.” Our translation. Our emphasis.

³⁰ H. Brun and G. Tremblay (*op. cit.*, page 435).

³¹ *Loi sur la langue officielle*, L.Q. 1977, c. 5 - aujourd'hui L.R.Q., c. C-11.

³² Our translation.

³³ *Re The Power of the Governor General in Council to Disallow Provincial Legislation and the Power of Reservation of a Lieutenant-Governor of a Province*, [1938] S.C.R. 71.

³⁴ *Renvoi relatif à la modification de la Constitution du Canada*, [1981] 1 R.C.S. 753.

³⁵ Peter W. HOGG (*op. cit.*, page 120).

³⁶ *Renvoi relatif à la sécession du Québec*, [1998] 2 R.C.S. 217.

As a study devoted to the scope of this power notes:

What is referred to in Canadian constitutional law as the declaratory power is the ability of the federal parliament to amend as it sees fit to the detriment of the provincial legislatures and without their consent the sphere of its legislative jurisdiction in respect of measures that it claims generally benefit Canada or two or more provinces.³⁷

Between 1867 and 1961, the federal government resorted nearly 470 times to this power, including 118 times in respect of Québec.³⁸ Ottawa declared that the construction of dams, canals, railways, grain elevators, ice booms, natural gas pipelines and numerous other structures were of benefit to Canada and thus fell under federal government jurisdiction. This power was even exercised to extend federal jurisdiction over certain business operations that can hardly be qualified as “structures” and which could hardly be deemed of general benefit to Canada, such as Québec City, Montréal and Ottawa tramways, the establishment of local bus networks, the construction of hotels, restaurants and theatres, not to mention Montmorency Falls in the Québec City area and the Parc des Plaines d’Abraham in Québec City.

Financial self-sufficiency of the provinces

Statutory subsidies

In the early 20th century, the provinces were far from having achieved financial self-sufficiency since they still relied on federal statutory subsidies to balance their budgets. However, the share of transfers in their revenues declined steadily prior to 1900 as the amounts in question were not indexed (see Chart 1). Moreover, the statutory subsidies were insufficient to offset the shortfall in the provinces’ own-source revenues and adequately satisfy their financial needs.

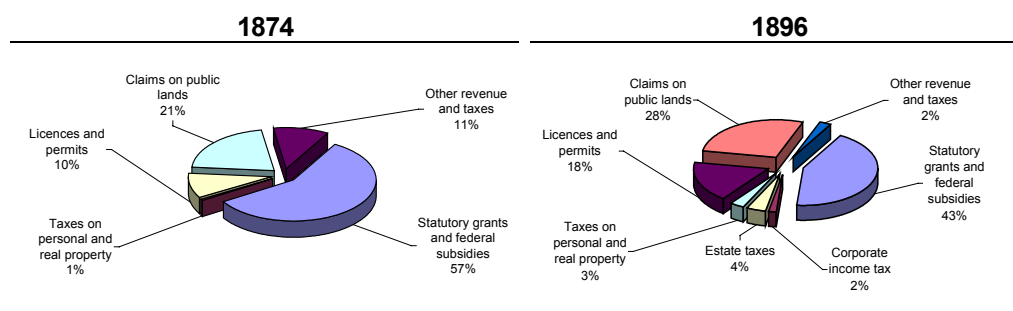
Two solutions, by and large, were open to the provinces, i.e. increase their own-source revenues or demand more federal financial transfers. The diversity of revenues collected by the provinces (Chart 1) and the extent of such revenues rose markedly between 1874 and 1896, although the increase was insufficient to satisfy their needs. The provinces therefore asked the federal government for additional financial support through transfer programs.

³⁷ Andrée LAJOIE, *Le pouvoir déclaratoire du Parlement : augmentation discrétionnaire de la compétence fédérale au Canada*, page 21. Our translation.

³⁸ *Id.*, p. 54.

CHART 1

BREAKDOWN OF PROVINCIAL REVENUES – 1874 AND 1896 (as a percentage of the total)



Source: David B. PERRY, *Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change*.

Subsequent to the implementation of the BNAA, the provinces demanded an increase in federal transfers, their main complaint being that the transfer payments had not changed. They supported their demand by arguing, in particular, that the division of taxation fields stipulated in the BNAA was inadequate: the federal government had exclusive jurisdiction over the most profitable taxation fields, i.e. customs duties and excise taxes, although it was the provinces' needs that were growing the fastest.

This pressure led to the signing of an agreement in 1907 that called for an increase in statutory subsidies and an amendment to section 118 of the *Constitution Act, 1867* that set the annual amounts paid to the provinces. Procedures governing the transfer programs were also included in the Act.

The polemic surrounding statutory subsidies gradually abated in the wake of this agreement. Several factors contributed to marginalizing the importance of these payments in the provinces' finances after 1907 and, consequently, the intensity of the provinces' demands in this respect. Aside from the increase in the provinces' own-source revenues, mention should be made of the introduction of conditional federal subsidies, which gradually replaced statutory subsidies, and the outbreak of World War I, which shifted priority to the federal government's budgetary problems.

Direct taxes

Until the outbreak of World War I, the provinces alone levied direct taxes but scarcely resorted to them. Direct taxes accounted for less than 10% of their revenues at the end of the 19th century. On the eve of World War I, all of the provinces were levying a tax on corporate income but only British Columbia and Prince Edward Island were collecting personal income tax. In response to war-time needs, the federal government started taxing company profits in 1916 and, invoking a national emergency, taxing personal income in 1917.

Conditional subsidies

In 1912, the federal government implemented the first conditional subsidies, payment of which was subject to the attainment of specific objectives and compliance with certain conditions, including the granting of a right of review and federal control over the use of the subsidies.

The first subsidy program targeted the development of agricultural education in the provinces and covered the agriculture sector, a field of jurisdiction shared by the federal and provincial governments, but also education, which falls exclusively under provincial jurisdiction pursuant to the *Constitution Act, 1867*.

Just after the program was initiated, the federal government set up the Royal Commission on Industrial Training and Technical Education to study the kind of assistance that should be accorded to industrial and technical education. In its report submitted in 1913, the commission put forward a twofold argument to justify federal intrusion into a field that the *Constitution Act, 1867* ascribes solely to the provinces: industrial and technical education is of national importance and the provinces do not have the financial resources necessary to develop it, an argument that will be frequently invoked in subsequent years.

In the years that followed, a number of conditional subsidy programs were introduced. The Old age pension program was implemented in 1927 although, contrary to what is now the case, the program was not a direct federal service offered to Canadians. At the time, the federal government simply undertook to repay the provinces half of the expenses they would incur if they decided to set up an old age security plan. It was only after 1951, the year in which a constitutional amendment was adopted allowing the federal government to enact a valid statute on old age security that Ottawa launched the old age security system. Table 3 indicates the first federal conditional subsidy programs.

TABLE 3

MAIN CONDITIONAL SUBSIDY PROGRAMS – 1912-1930

Year	Program	Jurisdiction	
		Federal	Provincial
1912	Development of agricultural education in the provinces	Agriculture	Agriculture and Education
1918	Coordination of placement bureau	—	Local affairs
1919	Technical education in Canada	—	Education
1919	Construction and improvement of major roads	—	Local affairs
1919	Grants to help combat venereal diseases	Quarantine	Health
1927	Old age pensions	Pensions (starting in 1951)	Pensions and Local affairs (income security)
1930	Subsidies and loans to support assistance for the unemployed	Unemployment insurance (starting in 1940)	Local affairs (income security)

Source: A. Milton MOORE, J. Harvey PERRY and Donald I. BEACH, *Le financement de la fédération canadienne, le premier siècle*.

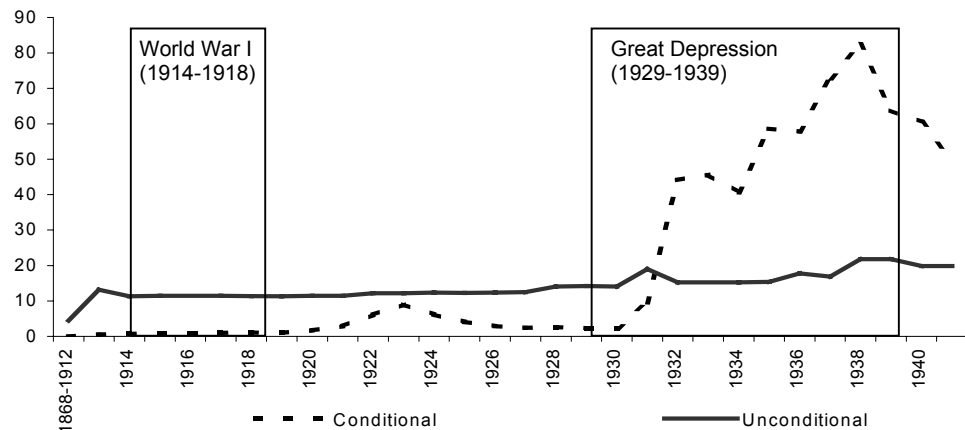
During the 1920s, the pace of implementation of the programs was slow, primarily because:

- the federal government had limited financial resources since it had to assume the burden of debt contracted during World War I;
- federal programs were not always adapted to the needs of the provinces and were somewhat inflexible, since they were designed in a Canada-wide perspective;
- the provinces were afraid that they alone would have to fund the programs in the event of federal government withdrawal;
- the provinces were not equally interested in the programs.

Chart 2 indicates the conditional and unconditional subsidies paid by Ottawa to the provinces from the beginning of the federation until World War II. Conditional payments rose significantly at the beginning of the Great Depression because of the subsidy and loan program to support assistance for the unemployed, which accounted for nearly 60% of federal transfers to the provinces between 1930 and 1939.

CHART 2

FEDERAL TRANSFER PAYMENTS TO THE PROVINCES – 1912-1941 (in millions of current dollars)



Source: Data drawn from A. Milton MOORE, J. Harvey PERRY and Donald I. BEACH, *Le financement de la fédération canadienne, le premier siècle*.

The Great Depression

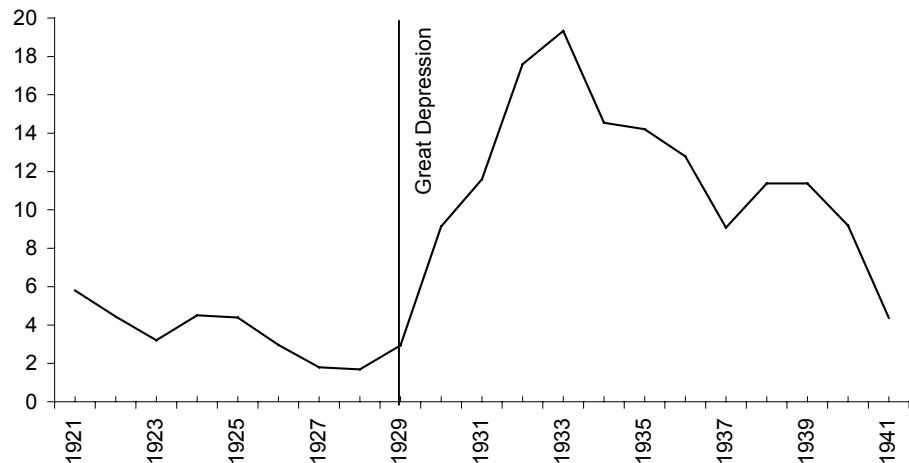
In 1929, the stock market crash heralded the end of the period of post-war prosperity and the beginning of a worldwide economic crisis. In Canada, the crisis was especially severe, above all because of the country's reliance on exports. The first signs of an upturn appeared in 1932-1933, although it was only in 1937 that the worldwide economy returned to its 1929 level of activity. Canada's economy did so only in 1940.

To illustrate the magnitude of the economic crisis, it is sufficient to note that between 1928 and 1933, annual per capita personal income plummeted 48% and the unemployment rate was close to 20% in 1933 (Chart 3). At a time when many households depended on only one wage and income security programs were virtually non-existent, that high an unemployment rate meant that many families had no income with which to feed and house itself.

At the beginning of the Great Depression, governments attempted to restore prosperity through traditional economic policy, especially by means of higher customs duties in order to protect the domestic market. This course of action failed and was quickly abandoned.

CHART 3

UNEMPLOYMENT RATE IN CANADA – 1921-1941
(as a percentage)



Source: Statistics Canada data.

The provinces were unprepared to effectively handle the crisis. First, existing measures to directly assist the unemployed and individuals in distress were inappropriate and were mainly the responsibility of local institutions and charities, such as the municipalities and churches, whose resources were limited and insufficient to satisfy the needs of the unemployed, the sick and the underprivileged. For example, the consolidated deficits of Canada's municipalities stood at \$62 million in 1930, equivalent to 15% of expenditures, although the municipalities had always previously balanced their budgets.

The intensity of the crisis significantly affected the provinces' financial self-sufficiency. Between 1930 and 1933, the provinces' own-source revenues decreased by 17%, while expenditures skyrocketed by 40% between 1928 and 1933. Similarly, the federal government's revenues plummeted by 40% between 1928 and 1936, while its expenditures, before transfers, remained fairly stable.³⁹

The collapse of tax revenues was partly offset in the case of the federal government starting in 1936. As for the provinces, they relied on federal financial support to weather the crisis. In light of the federal subsidies and loans granted to the provinces to support assistance for the unemployed (from 1930 until 1941), federal transfers accounted for nearly one-third of provincial revenues, during the Great Depression.

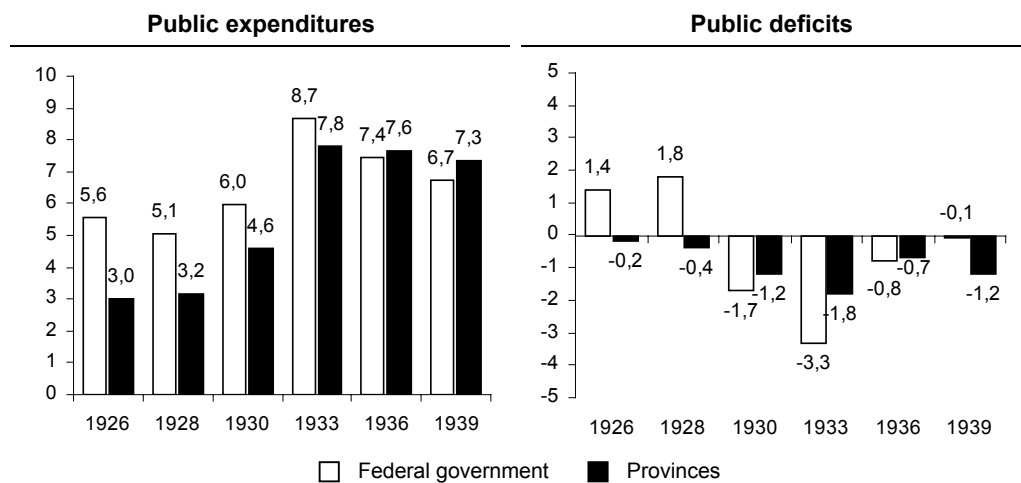
Aside from this assistance, the federal government intervened in order to support a number of industries badly affected by the crisis, such as

³⁹ Data drawn from ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, *op. cit.*, see note 3, Vol. IV, pages 116-117.

agriculture (wheat crops), the coal industry, and railway transportation. The severity and persistence of the crisis encouraged Ottawa to rethink social and economic policy and it became more interventionist and abandoned fiscal balance (see Chart 4). This period witnessed the debut of Keynesian economics.⁴⁰

CHART 4

PUBLIC EXPENDITURES AND DEFICITS – 1926-1939 (as a percentage of GNP)



Sources: Statistics Canada data; ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, *Report of the Royal Commission of Inquiry on Constitutional Problems*, Vol. IV.

Shortly before the 1935 federal election, Prime Minister R. B. Bennett proposed to voters the New Deal, an ambitious economic revival program, a Canadian version of its American counterpart.

The proposed program,⁴¹ which affected several statutes, comprised four sections: the establishment of an unemployment insurance program, the adoption of standards governing the minimum wage and maximum working time, the adoption of new trade rules, and the establishment of a board to set wheat prices. Bennett had scarcely unveiled the program (whose constitutionality appeared uncertain), prior to the 1935 election, when he abandoned it.⁴²

⁴⁰ Keynesianism, derived from the name of its principal designer, John Maynard Keynes, is a current of economic thought dating from 1936 that advocates State intervention to mitigate cyclical economic change. It flourished in the wake of the Great Depression.

⁴¹ *The Weekly Rest in Industrial Undertakings Act* (S.C. 1935, c.14); *Farmers' Creditors Arrangement Act Amendment Act* (S.C. 1935, c.20); *The Employment and Social Insurance Act* (S.C. 1935, c.38); *The Minimum Wages Act* (S.C. 1935, c.44); *Criminal Code* (S.C. 1935, c.56); *Dominion Trade and Industry Commission Act* (S.C. 1935, c.59); *The Limitation of Hours of Work Act* (S.C. 1935, c.63); *The Natural Products Marketing Act* and *The Natural Products Marketing Amendment Act* (S.C. 1935, c.64).

⁴² Neil BRADFORD, *Commissioning Ideas: Canadian National Policy Innovation in Comparative Perspective*, pages 26-27.

The Rowell-Sirois Commission

On August 14, 1937, the federal government set up the Royal Commission on Dominion-Provincial Relations, better known as the Rowell-Sirois Commission.

Its mandate, which covered three fields of investigation (see sidebar) consisted in analysing the breakdown of constitutional powers and the financial agreements in force in the federation.⁴³

Since the 1920s, the courts had granted the provinces considerable jurisdiction in the social field. However, as the Great Depression revealed, the provinces were lacking the resources they needed to effectively assume their responsibilities. The Commission sought to strike a new constitutional balance so that the division of wealth and fields of jurisdiction between the orders of government would be fair and geared to efficient administration.

THE ROWELL-SIROIS COMMISSION

Composition of the Commission

- Established on August 14, 1937.
- Chairman (1937-1938): Newton W. Rowell, Chief Justice of Ontario (withdrew in 1938 because of health problems).
- Chairman (1938-1940): Joseph Sirois, a notary and professor of constitutional law at Université Laval.
- Four commissioners: Thibaudeau Rinfret, Justice of the Supreme Court of Canada, withdrew before the hearings in 1938 because of health problems (Québec); Henry Forbes Angus, MA, BCL, professor of political economy at the University of British Columbia; John W. Dafoe, LL.D, City of Winnipeg; and Robert Alexander MacKay, PhD, professor of political science, Dalhousie University.

Three fields of investigation

- The economic system.
- Constitutional issues.
- Public accounts.

Hearings

- Public hearings were held across Canada from November 29, 1937 to August 8, 1938.
- Final hearings were held in Ottawa from November 24 to December 1, 1938.
- 10 000 pages of testimony were submitted and 427 items put on file.

Report

- Submitted on May 3, 1940.
- Three volumes: *Deliberations and Research*, *Data and Statistics*, and *Recommendations*.

After a year of public hearings, the Commission recommended, in particular:

- that the provinces relinquish jurisdiction over assistance for the unemployed and the old age security program while maintaining their jurisdiction over other social programs;
- consolidating provincial debt and transferring it to the federal government;
- granting the federal government the exclusive right to levy direct taxes (which accounted for 30% of provincial revenues in 1937) to enable it to assume its new fields of jurisdiction;

⁴³ ROYAL COMMISSION ON DOMINION-PROVINCIAL RELATIONS, *Report of the Royal Commission on Dominion-Provincial Relations*, Vol. I, pages 9-10.

- the establishment of an equalization program to enable the provinces to stabilize their finances since fiscal disparities between the provinces were the source of some of their financial difficulties.

Aside from these recommendations, the Commission mentioned in its report its opposition to shared jurisdiction by the two orders of government in a given field of jurisdiction and, consequently, severely criticized conditional subsidy programs.

The commission's recommendations received a mixed response from the provinces. The 1941 First Ministers' Conference, during which the federal government planned to discuss the Rowell-Sirois Commission's recommendations, was a failure.

In 1940, shortly before the First ministers' conference, the provinces accepted an amendment to section 91 of the *Constitution Act, 1867* that conferred on the federal government the power to adopt legislation governing unemployment insurance. Moreover, Ottawa drew inspiration from the report and introduced equalization in 1957, the Old Age Security System in 1951 and a Canada-wide pension plan in 1965 – the latter did not apply to Québec, which had launched its own program the same year following intense negotiations between the two orders of government.⁴⁴

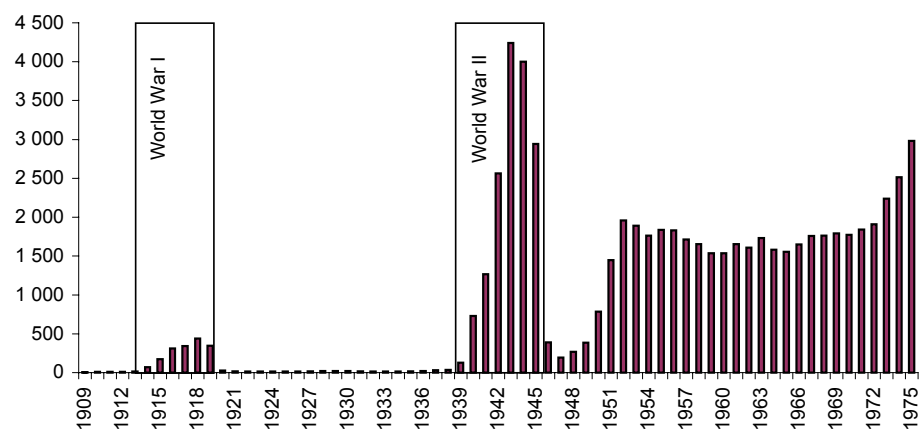
⁴⁴ Claude MORIN, *Le pouvoir québécois... en négociation*, pages 20-21.

THE EMERGENCE OF THE WELFARE STATE (1941-1970)

The Second World War brought about significant changes to the balance of relations between the federal government and the provinces. For the first time since 1914, the federal government found itself in the position of having to ask, since the war effort required more resources than it could assemble. Accordingly, the federal government convened the provinces to a meeting to review the division of tax fields set out in the *Constitution Act, 1867*. The resulting adjustment was to have a profound influence on the Canadian federation and the development of the Welfare State since the provinces emerged fiscally weaker.

CHART 5

FEDERAL GOVERNMENT MILITARY SPENDING – 1909-1975 (Millions of current dollars)



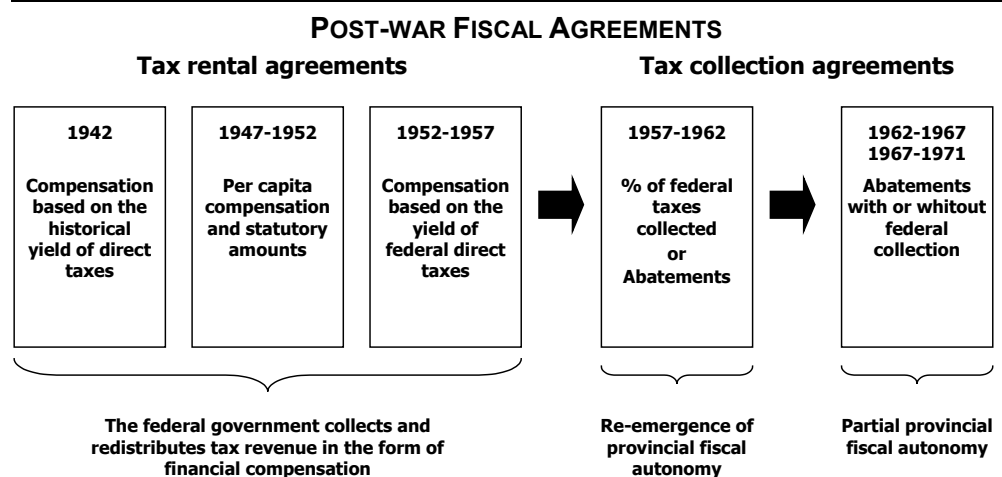
Source: Statistics Canada data.

The division of tax fields

Between 1942 and the end of the 1960s, the federal government and the provinces reached six agreements defining the division of tax fields between the two orders of government. These are the tax rental agreements⁴⁵ of 1942, 1947-1952 and 1952-1957 and the tax collection agreements of 1957-1962, 1962-1967 and 1967-1971.

⁴⁵ The agreements are identified by the fiscal years to which they refer, excepted for the 1942 agreement.

DIAGRAM 1



Source: Commission on Fiscal Imbalance.

Tax rental agreements

The 1942 agreement

In 1941, the federal government asked the provinces to cede the personal and corporate income tax fields. In return, the federal government proposed measures to compensate provinces that refrained from using these tax fields during the war.

TABLE 4

COMPENSATION STIPULATED IN THE 1942 AGREEMENT

Annual payments equal to:

The net amount of provincial debt service of the fiscal year ended nearest December 31, 1940 less recovered inheritance taxes (chosen by Saskatchewan, the Atlantic provinces and Alberta).

or

The revenue collected by each province and their municipalities from personal and corporate income tax during taxation year 1941 (chosen by Ontario, Québec, Manitoba and British Columbia).

Plus:

A guarantee that the revenue from provincial taxes on gasoline and alcohol would be maintained at their 1941 level (two rationed products during the war).

Sources: *Fiscal agreement between the Dominion and the provinces* (S.C. 1942-43, c. 13); A. Milton MOORE, J. Harvey PERRY et Donald I. BEACH. *Le financement de la fédération canadienne, le premier siècle*.

In so doing, the federal government, faced with large budget overruns, hoped to increase its tax revenue sufficiently to support its war effort. Its offer was presented as a temporary measure and was accepted as such by the provinces:

[...] the Dominion will have to raise personal and corporate income tax rates as high as is reasonable at this time [...] However, since these

*increases, together with existing rates of provincial taxes, would result in too heavy a burden, we propose to ask the provinces, as a provisional measure to apply solely during the war, to forego the use of these two tax sources. [...] I want to insist that we have no intention of trying to permanently deprive the provinces of these tax sources.*⁴⁶

Further to this agreement, the federal government passed the *Fiscal agreement between the Dominion and the provinces Act*⁴⁷ in 1942 which formalized the temporary transfer of these two major fields of direct taxation. Section 2 of the act confirmed the temporary nature of this loan of tax fields, though it did not specify for how long:

*The Minister of Finance may [...] reach an agreement with the government of any province of Canada to stipulate, in accordance with and subject to the terms and conditions expressed therein, that the province and its municipalities shall cease to levy personal and corporate income taxes, defined in the said agreement, [...] for the length of the war and thereafter, for a certain adjustment period, and to provide for the payment of an indemnity by the Dominion to the province.*⁴⁸

The provinces passed similar laws authorizing them to conclude an agreement with the federal government. Québec went somewhat further, including in the preamble of the *Agreement between the Governments of the Dominion and of the Province of Quebec*, a mention stressing that the province shall not be deemed to have surrendered any of its powers over tax fields:

*Whereas the Province shall not, by agreeing, as hereinafter provided, to desist from imposing certain taxes during the term of this agreement, be deemed to have surrendered, abandoned or given over to the Dominion any of the powers, rights, privileges or authority vested in the Province under the provisions of the British North American Act, 1867, or any subsequent Act of the Parliament of the United Kingdom or to have impaired any of such powers, rights, privileges or authority [...].*⁴⁹

Thereby, Quebec underlined in the agreement, in section 23(1), the federal commitment that the agreement would expire at the end of the war:

*This agreement shall continue in force until and terminate on the last day of the fiscal year of the Province ending nearest to the thirty-first day of December in the first calendar year which begins after the date of the cessation of the hostilities, complete or substantial, between the Dominion of Canada and Germany, Italy and Japan [...].*⁵⁰

⁴⁶ Annual statement of the Minister of Finance, J.L. Ilsley, on the occasion of the federal budget, April 29, 1941. Our translation. Our emphasis.

⁴⁷ *Fiscal agreement between the Dominion and the provinces Act*, S.C. 1942-43, c. 13.

⁴⁸ *Ibid.* Our translation. Our emphasis.

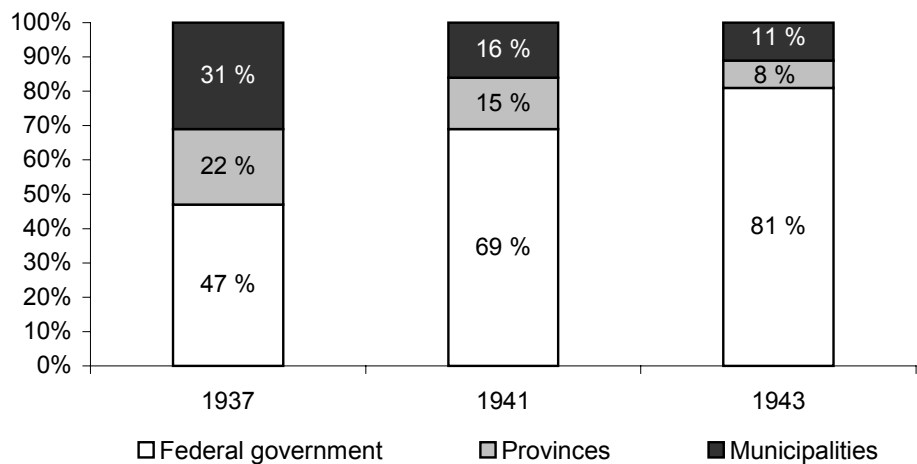
⁴⁹ *Agreement between the Governments of the Dominion and of the Province of Quebec*, S.Q. 1942, c. 27. Our emphasis.

⁵⁰ *Ibid.*

In accordance with this agreement, the federal government occupied virtually all fields of direct taxation during the war, with the provinces' share of all tax revenue falling from 15% before the agreement to 8% after. In this way, the Second World War had a particular effect on the division of tax fields. What the federal government was unable to obtain following the tabling of the Rowell-Sirois Commission's recommendations in 1940, the provinces granted to it in 1942: the fields of direct taxation were transferred to the federal government.

CHART 6

DISTRIBUTION OF TAX FIELDS – 1937, 1941 AND 1943
(as a percentage of total)



Source: Commission on Fiscal Imbalance.

Subsequent tax rental agreements

At the 1945 Reconstruction Conference, at which federal and provincial first ministers participated, the federal government proposed to renew the 1942 Tax Rental Agreement to facilitate the conversion from a wartime economy to a peacetime economy.

Faced with objections from Ontario and Québec, which demanded that their tax fields be transferred back to them so they could institute their own taxes with full flexibility, the federal government backed away from direct confrontation. In its 1947 budget, it gave the provinces to understand that it was prepared to reach tax agreements with those that wanted. This approach enabled it to reach a new tax rental agreement (1947-1952)⁵¹ with all the provinces except Ontario and Québec. This agreement was renewed in 1952 (1952-1957 agreement)⁵² with Québec the only province to refuse to ratify it.

⁵¹ *Loi sur les conventions entre le Dominion et les provinces en matière de location de domaines fiscaux*, S.C. 1947, c.58.

⁵² *Loi sur les conventions de location des domaines fiscaux*, S.C. 1952, c.49.

These agreements implicitly introduced the notion of a capped tax space shared by the provinces and the federal government. In this system, the federal government set the levels of tax that could be collected. It determined the shares of personal income tax and inheritance tax devolved to the provinces. These shares are designated by the term “abatement”. It also set the provincial tax rate on corporate profits.

Under the 1947-1952 agreement, the abatement allowed to the non-signatory provinces, i.e. Québec and Ontario, was five personal income tax points (of which neither Québec nor Ontario availed themselves) and 50 points for inheritance taxes. The corporate tax rate was set at 5%.

The Tremblay Commission

With the 1952-1957 agreement, the federal government succeeded for the third time in giving an air of permanence to something that from the outset was intended to be temporary, namely federal occupation of all fields of direct taxation. Determined to resolve the impasse in which this situation had plunged the provinces, Québec set up the Royal Commission of Inquiry on Constitutional Issues, better known as the Tremblay Commission, in 1953.

The commission was instructed to study four issues:⁵³

- distribution of taxes between the federal government, the provinces, the municipalities and school boards;
- constitutional, legislative and tax problems;
- the repercussions and consequences of these encroachments on the legislative and administrative regimes in Québec;

THE TREMBLAY COMMISSION

Composition of the Commission

- Chairman: Thomas Tremblay, Chief Justice of the Court of Sessions.
- Five commissioners: Esdras Minville, director of the École des Hautes Études Commerciales and dean of the Faculty of Social, Economic and Political Science, University of Montréal; Honoré Parent, c.r., lawyer, former head of municipal services with the City of Montréal and former President of the Montréal Chamber of Commerce; Father Richard Arès, s.j., Deputy Director of the Institut Social Populaire and editor of *Relations*; John P. Rowat, notary, chairman of the protestant committee of the Conseil de l'Instruction publique and chairman of the Protestant School Board of the Montréal region; Paul-Henri Guimont, bond dealer, secretary of the Faculty of Social Science of Laval University.

Field of investigation

- Research on problems of constitutional and tax law.
- Analysis of the operations and needs of provincial government departments, municipalities, school boards and social institutions.
- Public inquiry.

Hearings

- November 3, 1953 to June 23, 1954. 97 public hearings in 58 days.
- 253 briefs and 39 resolutions from municipal and county corporations tabled, some behind closed doors.

Report

- In four volumes: *Needs and Recommendations* (two volumes), *Facts*, *Principles* and *Documentation*.
- Tabled February 16, 1956 after three extensions (March 1, 1954, March 1, 1955 and October 16, 1955).

⁵³ ROYAL COMMISSION OF INQUIRY ON CONSTITUTIONAL PROBLEMS, *op. cit.*, see note 3, Vol. I, page XI.

- federal encroachment in the field of direct taxation.

In its report, tabled in 1956, the Commission noted that Québec lagged in many sectors of public administration. It argued that economic and social measures requiring huge investments were needed to correct this situation.

To do so, the Commission recommended that the provinces and the federal government agree on a new division of tax fields that reflected the current needs of the population and the public administration, and the spirit of federalism and of the constitution.

In 1954, backed by the consensus that emerged from the Commission's public hearings, at which many associations supported the idea of a provincial personal income tax, Québec decided to introduce such a tax. It amounted to 10% of federal income tax.⁵⁴ The government of Maurice Duplessis, with its slogan of "Rendez-nous notre butin!" (Give us back our loot!), tried to obtain exclusive rights to this tax field by asking Ottawa for a full exemption for its taxpayers. Although the federal government refused initially, Québec did obtain an increase in the federal abatement from 5 to 10 points in 1955.

THE RECOMMENDATIONS OF THE TREMBLAY COMMISSION

- Agreement among governments on the percentage of gross national product to be considered an upper limit on income tax.
- Following agreement, division of tax fields allowing each order to obtain the resources it needs to freely exercise its authority.
- Tax-sharing rule:
 - Federal government: exclusive right to indirect taxes, as stipulated in the constitution (taxes on entertainment and shows, on gasoline, on transfers of securities, etc.);
 - Provinces: exclusive rights to direct taxes (income tax, etc.) since they have jurisdiction in the cultural and social fields.
- Jurisdiction over social security to reside in the provinces since they would then have sufficient financial resources.
- Fiscal equalization between provinces according to criteria they define.

Tax collection agreements

1957-1962 agreement

Beginning in the mid-1950s, the tax rental agreements proved inadequate to satisfy provincial needs. At the 1955 Conference of First Ministers, the discussions focused essentially on funding for social security, health, education, roads and other public services considered to lie within provincial jurisdiction.

Following this conference, the federal government proposed a new agreement to the provinces that differed from the earlier ones since it enabled those provinces that wished to collect their own direct taxes, to do so up to

⁵⁴ The income tax introduced by Québec was progressive, with the rate depending on income. The lowest rate was 2.3% and the highest, 12%.

the abatement allowed, while guaranteeing that their financial situation would remain stable by introducing equalization.⁵⁵

TABLE 5

MAJOR COMPONENTS OF THE 1957-1961 AGREEMENT

- 1) **Taxes:** Depending on the choice they make, the provinces receive the following shares of the corresponding direct federal taxes or an equivalent abatement (tax points):
 - 10% of federal personal income tax (PIT);
 - 9% of federal corporate income tax (CIT);
 - 50% of federal inheritance taxes.

The options proposed to the provinces are:

a) Impose and collect their own taxes up to the allowed abatements Québec (PIT and CIT) Ontario (CIT only)	or	b) Rent their tax fields to Ottawa (choice made by all the other provinces)
--	----	--
- 2) **Equalization:** unconditional payments to each province equal to the amounts needed to bring the *per capita* proceeds of rental payments (or of the allowed abatement) to the level of the average *per capita* yield of the two provinces with the highest direct tax yield.

Sources: *Loi sur les arrangements entre le Canada et les provinces relativement au partage d'impôts* (S.C. 1956, c.29); A. Milton MOORE, J. Harvey PERRY and Donald I. BEACH. *Le financement de la fédération canadienne, le premier siècle*.

All provinces accepted equalization. The provinces, with the exception of Québec and Ontario, opted for compensation based on the value of the abatements proposed for personal income tax and corporate income tax. Ontario and Québec retained their corporate income tax and opted for the allowed abatement. In addition, only Québec availed itself of the abatement for personal income tax.

Equalization was introduced following the recommendations of the Rowell-Sirois Commission that insisted on the need for a national system of unconditional grants that would allow the provinces to provide comparable services at comparable levels of taxation.⁵⁶

In 1957, the purpose of equalization was to equalize the yield of the three direct provincial taxes⁵⁷ relative to those of the two wealthiest provinces, namely Ontario and Alberta.⁵⁸ The program provided unconditional cash transfers. This differed from most federal transfers at the time that were tied to shared-cost programs and whose payment was conditional.⁵⁹

⁵⁵ *Loi sur les arrangements entre le Canada et les provinces relativement au partage d'impôts*, S.C. 1956, c.29.

⁵⁶ This principle was entrenched in the *Constitution Act, 1982*.

⁵⁷ Direct taxes are personal income tax, corporate income tax and inheritance tax. The tax universe covered by equalization was gradually broadened, and currently covers 33 different tax bases.

⁵⁸ The federal government has since changed this standard twice, using a national standard from 1967 to 1981 and a five-province standard since 1982.

⁵⁹ *Federal Transfer Programs to the Provinces*, published by the Commission on Fiscal Imbalance (June 2001), contains abundant relevant information on this issue.

The 1962-1967 and 1967-1971 agreements

The 1962-1967 and 1967-1971 agreements provided for a significant increase in the abatements to the provinces for personal income⁶⁰ and inheritance taxes. Though they did not call into question the system of abatements in effect since 1947, these two agreements did allow the provinces greater access to direct taxation fields.

TABLE 6
ABATEMENTS ALLOWED TO THE PROVINCES – 1947-1971

Year	PIT (% of federal PIT)	CIT (tax rate)	Inheritance tax (% of federal tax)	Comments
1947-1954	5	5 (7)	50	1947-1952 and 1952-1957 tax rental agreements. The rate of the non-signatory provinces was 7% of CIT and 5% for the signatory provinces.
1955-1956	5 (10)	5 (7)	50	Abatement of 10 CIT points allowed to Québec following the "Rendez-nous notre butin!"
1957	10	9	50	Standardization of PIT and two-point increase in CIT (1957-1962 agreement)
1958-1959	13	9	50	Three-point increase in PIT (1957-1962 agreement)
1960-1961	13	9 (10)	50	One-point increase in CIT for provinces that opted not to receive university grants
1962	16	9 (10)	50	Three-point increase in PIT (1962-1967 agreement)
1963	17	9 (10)	50	One-point increase in PIT (1962-1967 agreement)
1964	18	9 (10)	75	One-point increase in PIT and 25-point increase in inheritance tax (1962-1967 agreement)
1965	21	9 (10)	75	Three-point increase in PIT (1962-1967 agreement)
1966	24	9 (10)	75	Three-point increase in PIT (1962-1967 agreement)
1967-1971	28	10	75	Five-point increase in PIT, including four for post-secondary education (1967-1971 agreement)

Notes: PIT – personal income tax. CIT – corporate income tax.

Source: Commission on Fiscal Imbalance.

With the 1962-1967 agreement, the federal government offered the provinces that decided to collect their own personal income tax to collect it on their behalf free of charge if their tax base was identical to the federal one. The same treatment was offered to provinces for corporate income tax. This offer was maintained until 1971 when the provinces and the federal government abandoned the principle of a shared and capped tax space (see chapter 4). Until 2000, the personal income tax of signatory provinces corresponded to a fraction of the federal tax, with a few exceptions to this general rule, such as the possibility of including certain tax credits.⁶¹

⁶⁰ *Loi sur les arrangements entre le Canada et les provinces relativement au partage d'impôts* (S.C. 1960-61, c.58) and *Loi sur les arrangements entre le Canada et les provinces relativement au partage d'impôts* (S.C. 1966-67, c.89).

⁶¹ The changes made to this agreement in 2001 will introduce a less harmonized regime in which the signatory provinces will be free to set their personal income tax as they see fit if they maintain the same definition of taxable income as the federal government. The introduction in the near future of a personal income tax at a flat rate of 10% in Alberta is an example of what the provinces can now do. The Canada Customs and Revenue Agency will collect the taxes and bill the provinces based on the degree of harmonization of their tax.

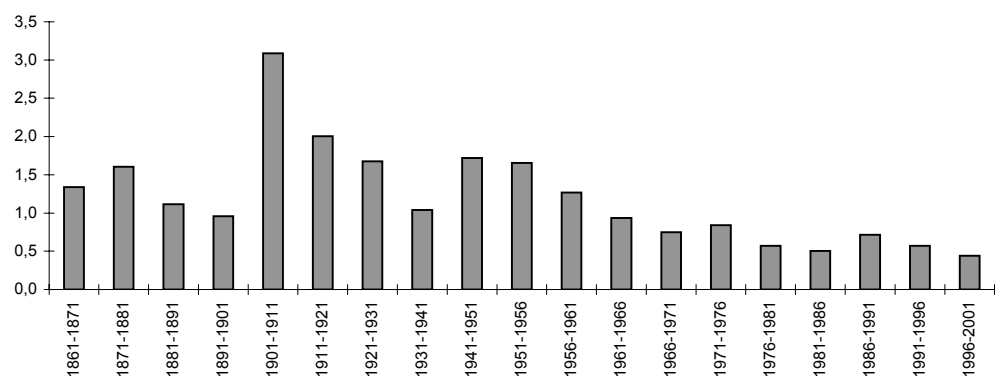
Growth of the Welfare State

The post-war era was one of prosperity for Canada. During this period, foreign trade experienced unprecedented growth and, in 1947, the General Agreement on Tariffs and Trade (GATT) was ratified. Québec and the other provinces experienced a massive influx of American capital that promoted rapid development of primary and secondary industries.

Beginning in the 1950s, the provinces' financial needs grew outstandingly fast, once again making funding of public services a critical issue in relations between the provinces and the federal government. Many socio-economic factors combined to alter the pressure on government finances. In particular, a fast-growing population (Chart 7) that was becoming increasingly urbanized.

CHART 7

AVERAGE ANNUAL POPULATION GROWTH – 1861-1871 TO 1996-2001
(as a percentage)



Note: The data for 1996-2001 are projections.

Source: Statistics Canada data.

This demographic explosion was in marked contrast to the long period of declining birth rate that preceded it, a decline that was accentuated by the Great Depression. A good deal of lost ground was made up, with the annual number of births setting records that would stand for a decade.

The wave of births has a profound effect on the population, in Québec as well as Canada. In addition, the development of an industrial society helped create new needs, in particular a demand for more qualified manpower. Taken together with Québec's economic and social modernization and its accelerated urbanization (Chart 8), these factors placed increasing pressure on public spending, particularly education, hospital, transportation and water infrastructures⁶².

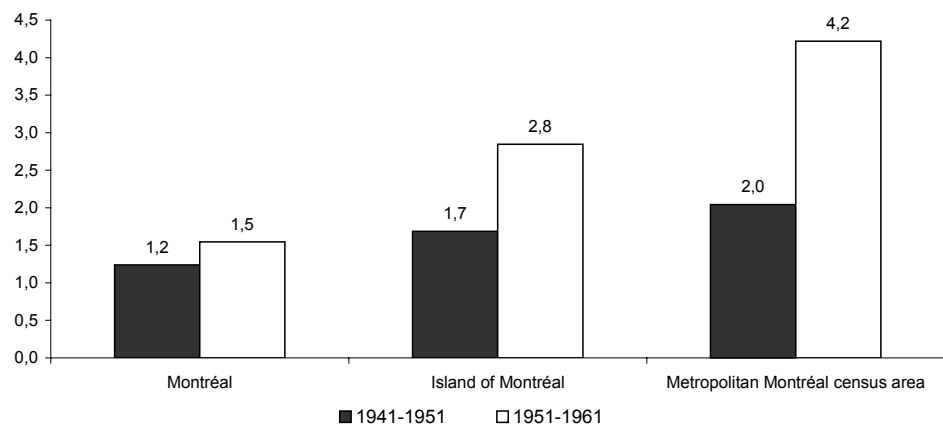
⁶² Paul-André LINTEAU, René DUROCHER, Jean-Claude ROBERT and François RICARD, *Histoire du Québec contemporain : Le Québec depuis 1930*, pages 277-292.

For instance, Desmond Morton noted, for Canada, as follows:

[Development of the] suburbs combined with the baby-boom complicated [problems relating to] the expansion of school enrolment. [...] Schools were improvised [...]. From 1945 to 1961, staff levels at primary and secondary schools rose by over 200% [...]. From 1945 to 1960, the paved road system expanded from 39 600 to 110 000 kilometres.⁶³

CHART 8

AVERAGE ANNUAL GROWTH RATE OF THE CITY OF MONTRÉAL AND ITS SUBURBS – 1941-1951 AND 1951-1961
(as a percentage)



Source: Data taken from Paul-André LINTEAU, René DUROCHER, Jean-Claude ROBERT and François RICARD, *Histoire du Québec contemporain : Le Québec depuis 1930*.

Provincial initiatives

In this context, the Welfare State underwent remarkable growth. The provinces were responsible for laying most of its foundations. For instance, Saskatchewan reorganized its Ministry of Welfare in 1944 to promote the role of social workers and place significant emphasis on social planning. It also created many Crown corporations to plan and manage the development of its natural resources, a major issue at the time. Similarly, it introduced an automobile insurance plan and a hospital insurance plan in 1947-1948, ten years ahead of the federal government, whose hospital insurance plan was not introduced until 1958.⁶⁴ Saskatchewan was followed by three provinces in 1950, namely British Columbia, Alberta and Newfoundland. Saskatchewan again took the lead by introducing the first health insurance program in Canada in 1962. British Columbia followed suit in 1964 and the federal government proposed a national program in 1966.⁶⁵

⁶³ Desmond MORTON, *Crise d'abondance, 1945-1988* in *Histoire générale du Canada*, pages 580-582. Our translation.

⁶⁴ Yves VAILLANCOURT, *L'évolution des politiques sociales au Québec 1940-1960*, pages 120-122.

⁶⁵ J. Harvey PERRY, *A Fiscal History of Canada*, pages 613-614.

The federal government also drew on Alberta and Ontario initiatives regarding income security when it set up the Canada Assistance Plan (CAP)⁶⁶ in 1965. Québec is also among the dynamic provinces, being the only province to implement a provincial pension program for retired persons and applying a social program development model that gives a primary role to the provinces.⁶⁷

Shared-cost programs

The federal government's involvement in the development of the Welfare State is attributable to many factors.⁶⁸ To begin with, it should be mentioned that the federal government wanted to create a state in which Canadians, wherever they live, have access to similar services.

The federal government was helped by the political context. It emerged victorious from the last war and the repeated difficulties of the provinces to handle the crisis during the Great Depression left their mark on the memory of Canadians. In addition, the federal order's hold on tax fields gave it a degree of leeway unavailable to the provinces.

Lastly, some provinces, in particular because of the unequal distribution of fiscal capacity in the country, welcomed the federal initiatives because they would receive sustained support for the development of their social programs.

Shared-cost programs were developed in two successive phases. The first, from 1941 to 1950, consisted of limited shared-cost programs, such as the vocational training coordination program and twelve specific programs in the health sector. These programs were similar to the conditional grants developed during the 1920s. They are specific and targeted (see Table 7).

The second phase (between 1950 and 1968) was more ambitious. The pillars of the Welfare State as we know them today made their appearance, namely hospital insurance, the post-secondary education program and the first income security programs, subsequently merged in 1965 to form the CAP (see Table 7).

These programs generally operated the same way: the federal government undertook to cover a portion of the costs incurred by the provinces, usually 50%, provided these expenditures are recognized as eligible under criteria determined in advance by the federal government (Table 7 shows these programs and their general funding terms and conditions).

⁶⁶ Leslie A. PAL, *Canadian Social Welfare Policy: Federal and Provincial Dimensions*, pages 1-7; Leslie BELLA, *The provincial Role in the Canadian Welfare State: the Influence of Provincial Social Policy Initiatives on the Design of the Canadian Assistance Plan*, pages 439-452.

⁶⁷ Yves VAILLANCOURT, *op. cit.*

⁶⁸ David B. PERRY, *Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change*, chapters 13, 14 and 15.

TABLE 7**MAJOR FEDERAL CONDITIONAL TRANSFER AND SHARED-COST PROGRAMS – 1940-1968**

Year	Program	Jurisdiction		Terms and conditions
		Federal	Provincial	
1st phase	1939 Vocational training for young people	—	Education	C
	1942 Vocational training	—		A
	1948-50 Assistance for the blind	—	Local matters	Discretionary
	1948 National health program	Quarantine	Health	A
	1948-50 Tuberculosis control			C, D
	1948-50 Venereal disease control			C, D, E
	1948-50 Mental health care			C, D, E
	1948-50 Assistance for handicapped children	—	Education	C, D, E
	1948-50 Technical and vocational training	—		C, D, E
	1948-50 Health research assistance	—		Discretionary
	1950 Support for hospital construction	—		Tripartite
	1950 Cancer control	—	Health	C, D
	1950 Support for public health	—		C, D
	1950 Support for health studies	Quarantine		C, D
2nd phase	1950 TransCanada Highway subsidy	Work linking one province to another	Local matters	A
	1951 University grants	—	Education	C, D
	1954 Program for the handicapped	—	Local matters	A
	1955 Program for welfare recipients and employable persons	—		C
	1958 Hospital insurance	—	Health	B, F, G
	1960 Vocational training	—	Education	B
	1962 Agriculture development	Agriculture	Agriculture	A
	1963 Municipal development and loan plan	—	Municipalities	A
	1965 Rural development (agriculture, mines and fisheries)	Agriculture and Fisheries	Agriculture and Natural resources	B
	1965 Canada Assistance Plan (CAP)	—	Local matters	A
	1967 Post-secondary education (replacing university grants)	—	Education	A
	1968 Medical insurance	—	Health	A, F

Notes: A (50/50), B (75/25), C (100/0), D (*per capita*), E (lump-sum), F (national average cost) and G (provincial average cost). Funding shares are expressed as follows: federal/provincial. The CAP is the result of the merger of income security programs for those 65-69, the blind, the handicapped and welfare recipients.

Sources: A. Milton MOORE, J. Harvey PERRY and Donald I. BEACH, *Le financement de la fédération canadienne, le premier siècle*; François Vaillancourt, *Les transferts fédéraux-provinciaux au Canada, 1947-1998: évolution et évaluation*.

While the provinces enthusiastically welcomed some of these programs, they rejected others outright. For instance, Québec declined the TransCanada Highway subsidy in 1950 and the University grants in 1951. However, regardless of provincial decisions before 1964, federal taxes continued to be collected within their territory and they received no compensation when they withdrew from a shared-cost program, the exception being the University grants as of 1960.

Direct federal public services

Along with shared-cost programs, the federal government launched two major direct public service programs in 1940 in fields of jurisdiction initially reserved for the provinces. These programs partially replaced conditional federal funding programs to the provinces.

The first is the unemployment insurance program set up in 1940 and for which an amendment to the *Constitution Act, 1867* was adopted.⁶⁹ It replaced the program providing grants and loans to support relief for the unemployed introduced in 1930. This initiative was a direct consequence of the recommendations made by the Rowell-Sirois Commission.

The second is the Canada Pension Plan⁷⁰ launched in 1965. Between 1927 and 1951, the federal government was satisfied with a shared-cost program introduced under the *Old Age Pensions Act*⁷¹ and renamed the Old Age Security System in 1952 after a constitutional amendment was passed⁷² authorizing its presence in this field of provincial jurisdiction.

At the 1964 first ministers' conference, the federal government informed the provinces that it intended to implement a universal old age pension plan. At the same conference, Québec confirmed that it intended to implement its own pension plan:

*It is reported that Québec also presented a preliminary outline of its proposed provincial pension plan and that it confirmed it would not participate in the Canada pension plan.*⁷³

There was a lot at stake for Québec because it sought to both preserve the exercise of its jurisdiction in this area and implement a large investment fund under its exclusive control,⁷⁴ i.e. a major economic lever.

⁶⁹ *Constitution Act, 1840*, 3-4 Georges VI, U.K., c. 36.

⁷⁰ *Canada Pension Plan Act*, S.C. 1964-65, c.51.

⁷¹ *Old Age Pensions Act*, S.C. 1926-27, c.35.

⁷² *Constitution Act, 1964*, 12-13 Elizabeth II, U.K., c. 73. Originally enacted by the *British North America Act, 1951*, 14-15 George VI, U.K., c. 32.

⁷³ A. Milton MOORE, J. Harvey PERRY and Donald I. BEACH, *Le financement de la fédération canadienne, le premier siècle*, page 95. Our translation.

⁷⁴ Claude MORIN, *op. cit.*

The plan proposed by Québec was seen as more generous and many provinces suggested that the federal government draw on it.⁷⁵ Québec and Ottawa created the two independent pension plans, namely the Québec Pension Plan and the Canada Pension Plan, during the same year. Provincial taxpayers thus had access to two pension programs, namely the federal old age security program and the federal (applicable in nine provinces) and Québec (applicable in Québec only) pension plans.

Right of withdrawal with full financial compensation

Under the government of Maurice Duplessis, the main objective of Québec's economic policy was to support private enterprise. Initiatives in the social sphere, namely the development of a welfare state, were not a priority and Québec's public service remained small. It was not until the 1960s, with the Quiet Revolution, that Québec entered this new era with the election of the Liberal government of Jean Lesage.

Though a succession of political, institutional and social reforms, the Quiet Revolution helped Québec narrow the gap with the rest of Canada. Québec took control of education and health, and proceeded to quickly develop its public service.

THE POSITION OF PROVINCIAL PREMIERS ON SHARED-COST PROGRAMS

The Premier of Québec, Jean Lesage 1960-1966

This touches on a set of sectors that clearly fall within provincial jurisdiction: social assistance, working conditions, health, education, etc. There's no need for a lengthy legal demonstration [...]

For the sake of efficiency and for constitutional reasons, the Québec government is the only government that can and must, within its territory, design such a policy and implement it [...]

Once again, we demand as minimum fiscal powers: 25% of personal income tax, 25% of corporate income tax and 100% of inheritance taxes.⁷⁶

The Premier of Québec, Daniel Johnson 1966-1968

We also consider that the federal spending power must be limited to federal fields [...]. All of the revenue of a government should be available for use without any condition [...]. Québec demands a net increase in its resources that will enable it to carry out its constitutional responsibilities. Québec demands 100% of the three major direct taxes [...].⁷⁷

Premier of Alberta, Ernest C. Manning 1943-1968

The reasons and benefits of these programs are obvious, but I maintain they suffer from four serious weaknesses [...]. First, [...] [they] necessarily shift the initiative for administrative decisions from provincial legislative assemblies to the Parliament of Canada. [...] the provinces thus cease to be legislators that can decide, at their level, whether or not such a form of social service is what their population wants or needs, but instead are reduced to the sole prerogative of agreeing or refusing to participate in a program put forward by the federal state, under a shared-cost plan.

[...] in our view, shared-cost programs produce a degree of uniformity that is undesirable.⁷⁸

⁷⁵ Press release, February 2, 1964. *Federal-Provincial Conference, Québec City, March 31 to April 1, 1964*, page 31.

⁷⁶ Brief submitted by Québec, Conference on poverty, December 7 to 10, 1965. Our translation.

⁷⁷ Brief submitted by Québec on the constitutional question. Intergovernmental Conference, 1968. Our translation.

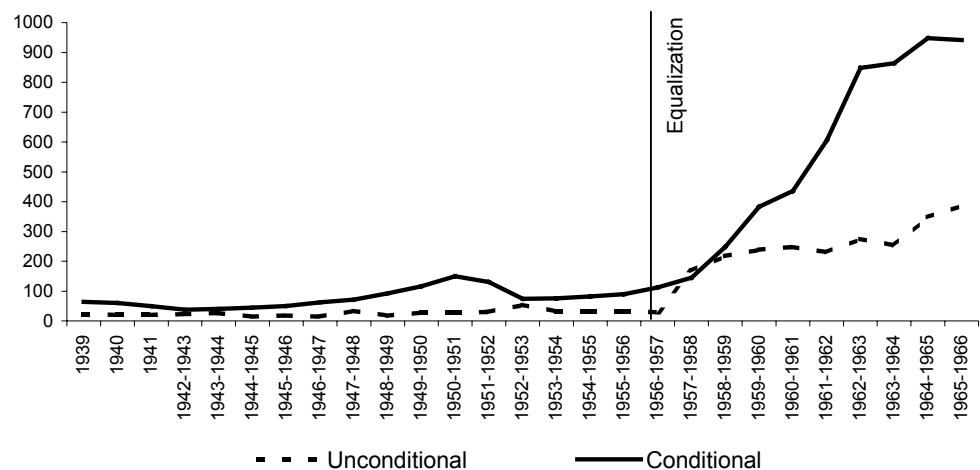
⁷⁸ *Compte-rendu des délibérations de la Conférence fédérale-provinciale de 1960, Ottawa, 25, 26 et 27 juillet 1960*, pages 102-103.

Nonetheless, Québec continued to disassociate itself from the federal government position during this period, not so much on the need for a welfare state, which was now accepted, but what the federal government's role should be in this regard.

Conditional funding and shared-cost programs were frequently criticized since they were seen as a threat to the financial autonomy of the provinces (see sidebar, page 40). In 1962-1963, conditional funding stood at over three times the amount of unconditional payments (see Chart 9), in spite of the implementation of the equalization system.

CHART 9

FEDERAL TRANSFER PAYMENTS TO THE PROVINCES – 1935-1965
(millions of current dollars)



Sources: Data taken from A. Milton MOORE, J. Harvey PERRY and Donald I. BEACH. *Le financement de la fédération canadienne, le premier siècle*; David B. PERRY, *Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change*.

Some provinces, with Québec in the forefront, tried to secure an increase in unconditional funding and in tax points ceded. Throughout the 1960s, Québec challenged the federal government on these questions and protested against controls and Canada-wide standards. Its chief grievances were that the federal government paid no heed to provincial priorities and that the day-to-day management of shared-cost programs was overly complex because of the distinctions between eligible and ineligible expenditures.

In 1964, faced with Québec's insistent demand for more access to the personal income tax field to fund its needs, rather than federal transfers, the federal government proposed to the provinces that it would withdraw from certain permanent shared-cost programs⁷⁹ with full financial compensation. Although the offer was made to all provinces, Québec was the main target

⁷⁹ Also known as "established programs".

and was the only province to accept it. The offer took practical shape with the adoption of the *Established Programs Act*⁸⁰ in 1965-1966.

The proposed compensation consisted of additional tax points, not included in the 1962-1967 Tax Collection Agreement. These points form the special Québec abatement. Québec and the federal government agreed on a five-year period to determine the tax equivalence between the tax points ceded and the transfers eliminated.⁸¹ Table 8 summarizes the history of the tax points that make up the special Québec abatement.

TABLE 8

HISTORY OF THE SPECIAL QUÉBEC ABATEMENT – 1964-2001
(as a percentage of federal personal income tax)

Year	Points	Aggregate	Comments
Period for establishing equivalence	1964	3	Youth allowance
	1965-1966	+ 14	Hospital insurance
		+ 2	Old age assistance, allowances for the blind and the disabled
		+ 2	Unemployment assistance benefits relating to social welfare for unemployable persons
		+ 1	Vocational and technical training
		+ 1	Public health funding
	1967-1971	- 1	Elimination of the Public health funding program.
1971-1976		24	Adjustment of basic federal tax on which the abatement is calculated and adjustment of the abatement. 1974: Start of Québec's annual refund of the three points obtained for the youth allowance following its inclusion in the family allowance program
1976-1977	- 9.143		A portion of EPF (health and education) is now provided to all provinces in the form of tax points
	Re-basing of BFT	14.857	Adjustment of basic federal tax on which the abatement is calculated and adjustment of the abatement.
1977-2001	Re-basing of BFT	16.5	Adjustment of basic federal tax on which the abatement is calculated and adjustment of the abatement.

Note: EPF – Established Programs Financing; BFT – basic federal tax.

Source: Commission on Fiscal Imbalance.

⁸⁰ *Established Programs (Interim Arrangements) Act*, S.C. 1964-65, c.54.

⁸¹ Claude MORIN, *op. cit.*, pages 33-39.

THE REDEFINITION OF THE WELFARE STATE (1971-1995)

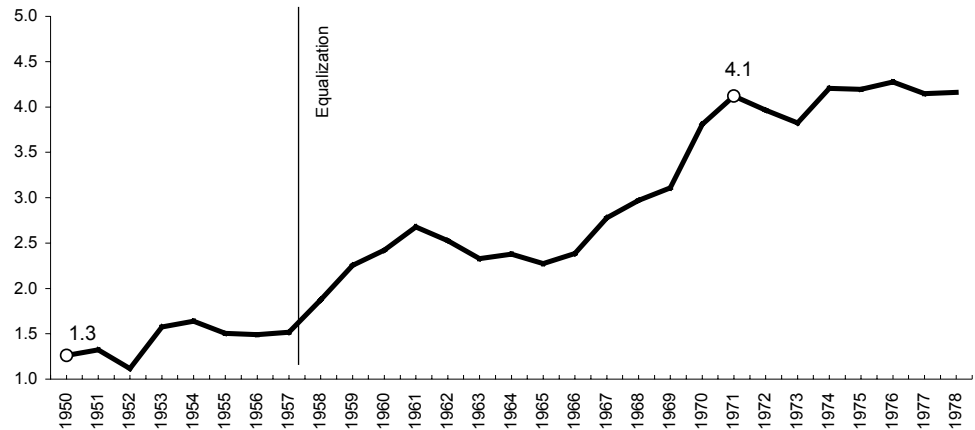
The early 1970s marked the end of a period of expansion that began in the early 1950s. In the wake of the 1973 and 1979 oil shocks, the economy was struck by stagflation, i.e. persistent inflation combined with economic stagnation. Initially, Canada was not hit as hard as other countries by the oil shocks since it is an oil-producing country and adopted in 1973 an energy policy aimed at sheltering it from international price shifts.⁸² In Québec, major projects such as the James Bay hydroelectric complex and construction of the Olympic facilities helped to stimulate the economy. However, Canada did not ultimately escape the effect of the oil shocks and experienced a deep recession from 1980 until 1982.

The period was nonetheless a prosperous one for the Welfare State, during which the provinces and the federal government pursued the development of social programs and contemplated the establishment of new services, a process initiated with the abandonment of the shared, capped taxation system implemented in 1947. During the 1980s, the development of the Welfare State entered a hiatus at a time when governments began to redefine it. In Canada, this process took place against a backdrop of dwindling federal transfers to the provinces.

The golden age of the Welfare State

In the early 1970s, federal transfer programs accounted for 4.1% of GDP, three times the figure in 1950. This striking increase was directly linked to the expansion of the social programs developed during the 1960s. The scope of the Welfare State was such that, bearing in mind the actual division of taxation fields between the two orders of government, it would be difficult for the provinces to single-handedly assume the cost of these programs without calling them into question.

⁸² Essentially, the policy adopted consisted in setting the price of Canadian oil destined for the domestic market below the price on the international market and financially compensating Canadian producers for the losses sustained. Between 1974 and 1985, over \$25 billion was paid under the programs in the form of compensatory payments.

CHART 10**CHANGE IN FINANCIAL TRANSFERS TO THE PROVINCES – 1950-1979**
(as a percentage of GDP)

Sources: Statistics Canada data; A. Milton MOORE, J. Harvey PERRY and Donald I. BEACH, *Le financement de la fédération canadienne, le premier siècle*; David B. PERRY, *Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change*.

Exploitation of liberalized tax room

In conjunction with the 1971 tax reform,⁸³ the federal government ended the formal division of direct taxation fields between the two orders of government that had prevailed since the adoption of the 1947-1952 Tax Rental Agreement (abatement system). Each order of government was, from then on, free to define its taxation policy in order to satisfy its needs without regard for the other order of government's measures. Federal finance minister Mitchell Sharp had announced this intention on September 14, 1966:

It would certainly be preferable for the provinces to fund higher expenditures by increasing taxes, which, they maintain, should be increased, just as the federal government is expected to fund its higher expenditures.

[...] We must abandon this idea that is becoming a tradition [...] that a certain level of sharing of income tax and succession duties is the optimum level that determines that rightful share of each level [order] of government.⁸⁴

⁸³ The 1971 reform of federal personal income tax modified the tax base by integrating various revenues, including unemployment insurance income and capital gains. However, the revision of the tax rates reduced the basic federal tax on which the tax of all of the Canadian provinces except Québec was calculated. To compensate them for this drop, the federal government proposed guaranteeing the other provinces between 1972 and 1977 a level of revenue equivalent to what they collected prior to the reform.

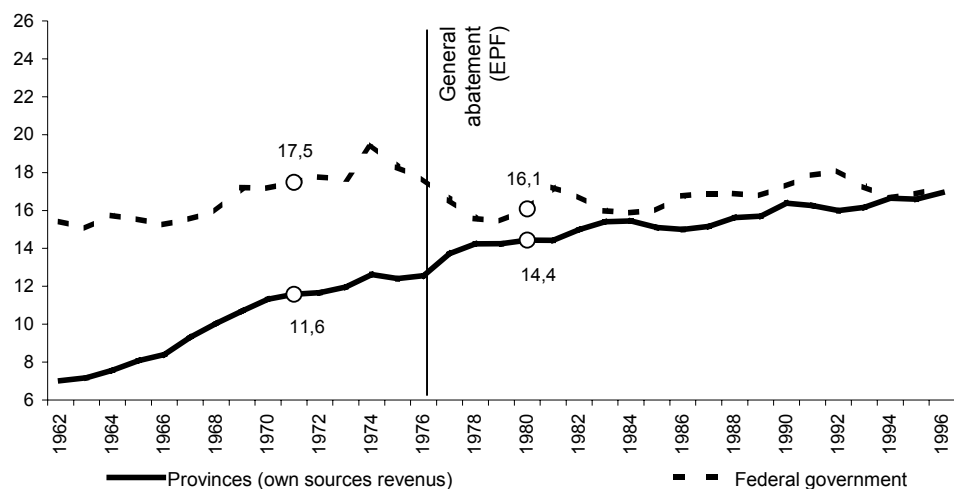
⁸⁴ Statement by federal finance minister Mitchell W. Sharp, *Comité fédéral-provincial du régime fiscal*, 14 et 15 septembre 1966, pages 25-27.

However, the exercising of this freedom continued to be limited by collection and recovery agreements binding the provinces to the federal government (1962-1967 Tax Collection Agreement). Such agreements did not concern Québec, which collected its own direct taxes, nor Ontario and Alberta in respect of their corporate income tax.

Under the circumstances, the provinces' revenues increased markedly between 1971 and 1980. The proportion of their own-source revenues in relation to GDP rose 25% during this period, from 11.6% to 14.4%. Federal revenues as a proportion of GDP declined slightly, from 17.5% to 16.1%, an 8% drop, during the same period. This decrease was attributable, in particular, to the transfer in 1976 to all the provinces⁸⁵ of a 9.143 tax point abatement in conjunction with the introduction of established programs financing (EPF)⁸⁶ and the adoption of an aggressive economic stimulation policy⁸⁷ just before 1980, comprising reductions in personal income tax and numerous tax credits for businesses.

CHART 11

PROVINCES' OWN-SOURCES REVENUES AND FEDERAL REVENUES – 1962-1996
(as a percentage of GDP)



Source: Data drawn from Statistics Canada and provincial economic accounts.

However, the liberalization of tax room had certain limitations since the two orders of government ultimately taxed the same taxpayers. The fiscal capacity of various taxes was limited by what the taxpayer could reasonably bear.

⁸⁵ Québec gained nothing since the abatement was offered to offset programs from which it had withdrawn between 1964 and 1971 and in respect of which it had obtained its special abatement.

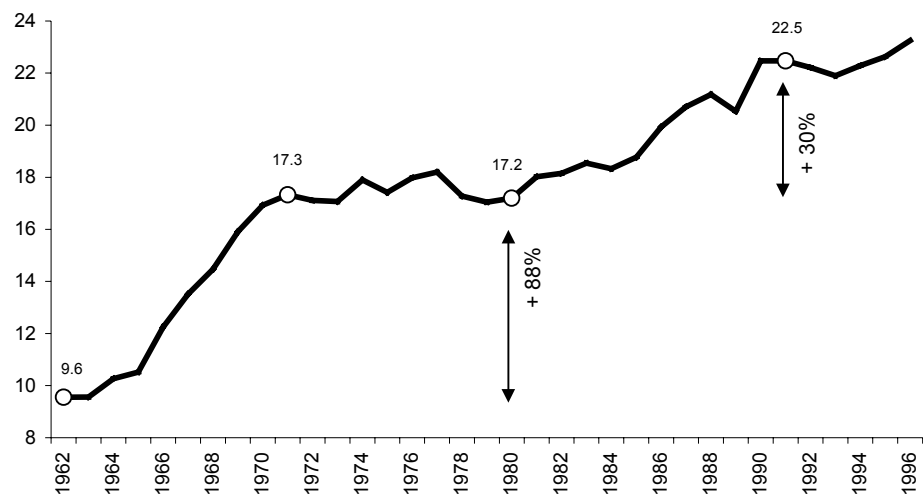
⁸⁶ *Loi sur les accords fiscaux entre le gouvernement fédéral et les provinces et sur le financement des programmes établis*, S.C. 1976-77, c. 10.

⁸⁷ J. Harvey PERRY, *A Fiscal History of Canada*, pages 85-86.

While this limitation did not represent a major constraint during the 1950s and 1960s, despite striking growth in personal income tax between 1962 and 1971, it could not be overlooked on the eve of the 1991 recession. The proportion of federal and provincial personal income tax in taxpayers' income reach an unprecedented level. After achieving relative stability during the 1960s, the proportion increased from 17.2% on average in Canada in 1981 to 22.5% in 1991, a 30% increase in 10 years.

CHART 12

CHANGE IN THE PROPORTION OF PERSONAL INCOME MONOPOLIZED BY FEDERAL AND PROVINCIAL INCOME TAX (INCLUDING SOCIAL CONTRIBUTIONS) – 1962-1995
(as a percentage of personal income)



Note: Social contributions include, in particular, contributions to unemployment insurance and the Québec Pension Plan or the Canada Pension Plan, as the case may be.

Source: Data drawn from statistics Canada and provincial economic accounts.

Development of the Welfare State

The expansion of the provinces' fiscal capacity and growth in the revenues of both orders of government during the 1970s encouraged new initiatives in the realm of social programs.

First, the federal government significantly enhanced the unemployment insurance program⁸⁸ in 1971, then repeatedly revised it. The most recent important reform took place in 1996.⁸⁹

⁸⁸ *Unemployment Insurance Act*, S.C. 1970-71-72, c. 48.

⁸⁹ *Employment Insurance Act*, S.C. 1996, c. 23.

Federal family policy, initiated in 1945 with the family allowance program,⁹⁰ also expanded starting in 1973. It underwent numerous changes, e.g. youth allowances⁹¹ were integrated into the family allowance program in 1973⁹² and a tax credit for dependent children was introduced in 1978.⁹³ These initiatives quickly eclipsed the federal government's failed attempt in 1971-1972 to broaden the family allowance program to make it a family income security program. This policy again shifted in 1997 when the family allowance program was converted into a tax credit (Canada Child Tax Benefit) and maternity leave was offered to Canadians and paid for through unemployment insurance contributions.⁹⁴

The provinces pursued the initiatives launched since the early 1960s. Québec implemented its health insurance program⁹⁵ in 1970, which defined covered hospital services. Moreover, the provinces developed a number of income security programs. In 1972, British Columbia introduced the first income supplement for the elderly. Between 1974 and 1979, Manitoba implemented on an experimental basis an annual guaranteed income program.⁹⁶ Most benefits granted under income support programs were indexed during the 1970s to offset inflation.

In the early 1980s, the provinces redefined financial support for education. In Québec and the Atlantic Provinces, the provincial governments shouldered most of the costs, while in the other provinces, this responsibility was delegated to the municipalities.⁹⁷ Mention should also be made of the Parental Wage Assistance (PWA) program⁹⁸ introduced by Québec in 1987-1988, one of the first programs aimed at encouraging the long-term unemployed with dependent children to reintegrate the labour market.

The period was also marked by the repatriation in 1982 of the Constitution, which Québec has not signed, and, above all, by the adoption of the *Canadian Charter of Rights*.

⁹⁰ *Family Allowances Act* (S.C. 1944-45, c. 40).

⁹¹ Québec obtained an abatement of 3 federal tax points on personal income in 1964 to compensate its withdrawal from the program. Instead of relinquishing this abatement, Québec decided in 1973 to reimburse it each year to the federal government.

⁹² *Family Allowances Act and Youth Allowance Act Amendment Act*, S.C., 1973-74, c. 34

⁹³ *Income Tax Act establishing a tax credit for children and Family Allowances Act of 1973 Amendment Act*, S.C., 1978-79, c. 5

⁹⁴ Quebec doubts the constitutionality of this program.

⁹⁵ *Health Insurance Act*, L.Q. 1970, c. 37.

⁹⁶ Leslie A. PAL, *op. cit.*, pages 1-7.

⁹⁷ J. Harvey PERRY, *op. cit.*, pages 802-805.

⁹⁸ The Parental Wage Assistance (PWA) program is a financial assistance program for low-income families with at least one dependent child.

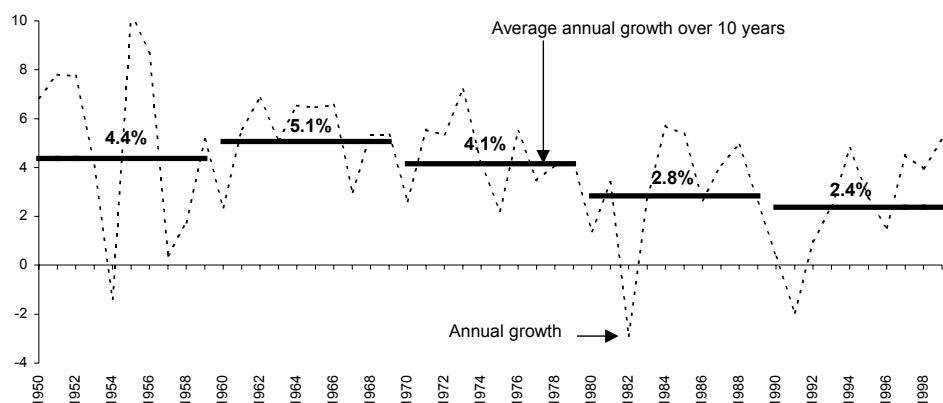
Withdrawal of federal financing

The Welfare State was implemented at a time of sustained growth in government revenues. Few restraints were placed on it from the standpoint of the form of the programs offered or the budgets required, e.g. no ceiling was placed on eligible expenses. While the services provided by these programs were clearly defined in federal legislation, the structure of shared-cost programs did not initially cap eligible expenses.⁹⁹ This particularity encouraged the wealthier provinces to develop increasingly generous programs.

When the socio-economic context changed in the early 1970s, especially with the advent of high inflation, the spending required to maintain the programs skyrocketed. Between 1973 and 1976, federal transfers to the provinces increased by 30% annually, as against only 12% annually between 1966 and 1973. Economic growth was no longer the same. The average annual growth rate of real GDP over 10 years declined after the 1960s, falling from 5.1% between 1960 and 1969 to 4.1% between 1970 and 1979, then to 2.4% between 1990 and 1999.

CHART 13

ANNUAL GROWTH IN REAL GDP – 1950-1999
(annual rate and average annual rate over 10 years)



Source: Statistics Canada data.

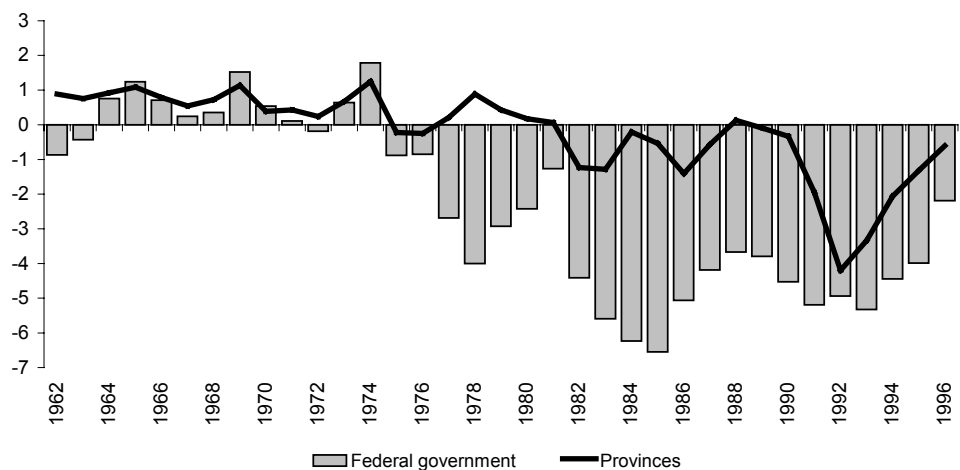
These factors, combined with the federal government's aggressive economic stimulation package centred on tax reductions and the Canadian energy policy mentioned earlier, placed the federal government in a precarious financial position. Starting in 1975, the federal debt increased markedly. Several years later, Ottawa undertook a lengthy process of putting its public

⁹⁹ The Canada Assistance Plan (CAP) was one of the first shared-cost programs subject to a ceiling, only during the 1990s.

finances in order, largely at the expense of the provinces,¹⁰⁰ thus contributing to the provinces' indebtedness starting in 1982. The maintenance of the Welfare State in its most generous form proved almost impossible starting in the mid-1990s.

CHART 14

FEDERAL AND PROVINCIAL BUDGET BALANCES – 1962-1996
(as a percentage of GDP)



Sources: Data drawn from Statistics Canada and provincial economic accounts.

A gradual withdrawal

Between 1976 and 1995, the economic setting, the heavy indebtedness of the two orders of government and substantial growth in spending on social programs encouraged the federal government to undertake a major overhaul of its conditional and unconditional transfer programs aimed at the provinces.

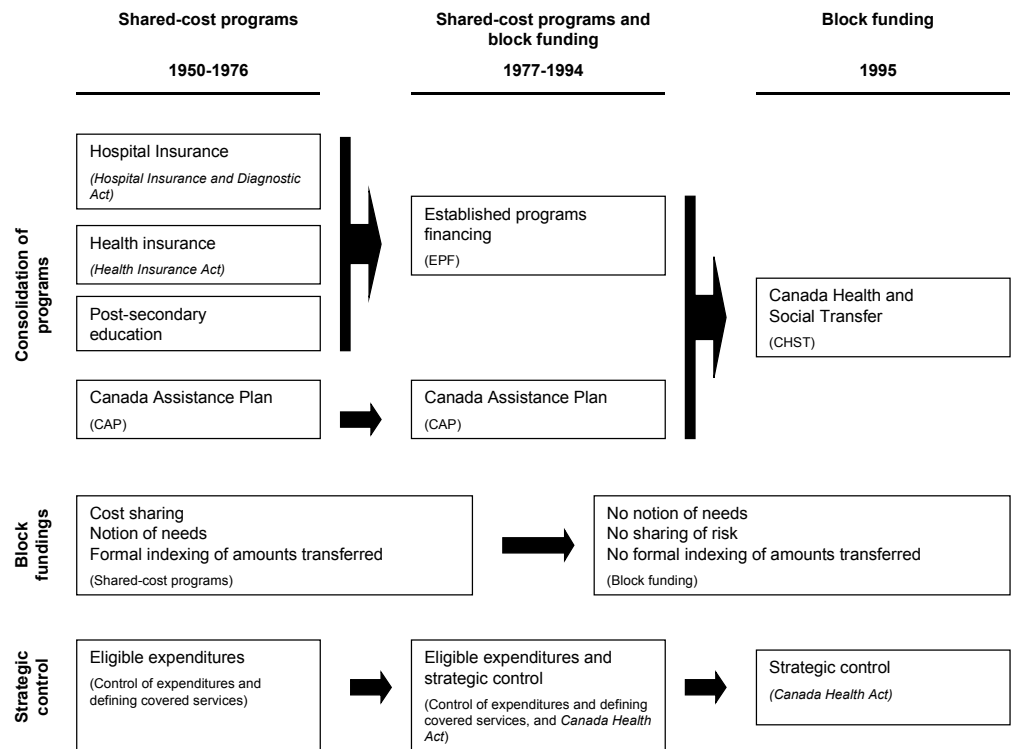
- the consolidation of transfer programs;
- the gradual shift to block funding;
- the reduction in the amounts transferred to the provinces;
- the development of strategic control over the use of the funds transferred.

¹⁰⁰ Between 1994-1995 and 1997-1998, a period significantly affected by the determination of governments to put their finances in order, federal financial transfers to the provinces decreased by 22% while federal programs spending decreased by only 4,5% at the same time. So, even if transfers to the provinces represented only 22% of total federal programs spending, they contributed to 58% of the overall spendings reductions. Source: provincial economic accounts.

The following sections examine the four phases in detail. Diagram 2 summarizes the process of consolidating federal conditional transfer programs.

DIAGRAM 2

PROCESS OF CONSOLIDATING FEDERAL CONDITIONAL TRANSFER PROGRAMS – 1950-1995



Notes: *Health Insurance Act* (S.C. 1966-67, c. 64); *Hospital Insurance and Diagnostic Act* (S.C. 1957, c. 28); *Canada Assistance Plan* (S.C. 1966-67 c. 45); *Loi sur les accords fiscaux entre le gouvernement fédéral et les provinces et sur le financement des programmes établis* (S.C. 1976-77, c. 10); *Federal-Provincial Fiscal Arrangements* (S.C. 1995, c. 17); *Canada Health Act* (S.C. 1984, c. 6).

Source: Commission on Fiscal Imbalance.

The consolidation of transfer programs

The consolidation of transfer programs was the first concrete evidence of the federal government's determination to withdraw from social program funding. Such consolidation encouraged the standardization of methods of establishing the amounts transferred to the provinces, i.e. the shift to block funding, since the successive revisions of the programs offered Ottawa the opportunity to more readily introduce modifications to the method of establishing and making transfer payments.

In 1965, the federal government consolidated under the Canada Assistance Plan (CAP)¹⁰¹ income security programs intended for Canadians in the 65-69 age group, the blind, the disabled and welfare recipients. In 1977, it consolidated hospital insurance, post-secondary education and health insurance under established programs financing (EPF).¹⁰² In 1996, it completed the consolidation of major social programs by merging CAP and the EPF under the Canada Health and Social Transfer (CHST).¹⁰³

Block funding

With a view to better controlling its spending, in 1973 the federal government proposed to the provinces a new method of funding health services, i.e. block funding.

Under the proposal, the amounts transferred would be established on a per capita basis and would no longer increase in light of growth in the provinces' spending but instead in relation to GDP. The proposal implied the abandonment, at least in part, of consideration of the provinces' needs in determining the amounts to be transferred. Similarly, it ended the sharing of risks stemming from the delivery of a public service, especially growth in costs. It also reduced federal control since the notion of eligible expenditures was eliminated, but did not put an end to it.

While the provinces had been seeking greater flexibility in the management of their social programs, they rejected Ottawa's offer. However, in 1977, the *Loi sur les accords fiscaux entre le gouvernement fédéral et les provinces et sur le financement des programmes établis*¹⁰⁴ confirmed the federal government's determination to adopt the principle of block funding. The legislation also stipulated that Québec's special abatement would from then on be deducted from financial transfers (see box on page 50).

The adoption of block funding, while it gave the provinces greater leeway in the use of federal funds, undermined their financial position since, as we noted earlier, growth in health and education needs outstripped growth in GDP and, therefore, the funding base proposed.

The federal government's decision in 1996 to implement the CHST marked the end of the shared financing of major Canadian social programs since none of the programs would be funded according to the provinces' spending in this respect – CAP was the last of this kind.

¹⁰¹ *Canada Assistance Plan*, S.C. 1966-67 c. 45.

¹⁰² *Loi sur les accords fiscaux entre le gouvernement fédéral et les provinces et sur le financement des programmes établis*, S.C. 1976-77, c. 10.

¹⁰³ *Budget Implementation Act*, 1995, S.C. 1995, c. 17.

¹⁰⁴ *Loi sur les accords fiscaux entre le gouvernement fédéral et les provinces et sur le financement des programmes établis*, S.C. 1976-77, c. 10.

THE SPECIAL ABATEMENT FOR QUÉBEC AND ESTABLISHED PROGRAMS FINANCING

Prior to the introduction of established programs financing (EPF), the special abatement gave Québec greater financial autonomy in respect of the financing of its social programs.

Starting in 1971, which marked the end of the period stipulated to establish the equivalence between the tax points transferred and the transfer payments abolished, the value of tax points was no longer tied to the budget allocations earmarked for the federal programs from which Québec had withdrawn. Instead, the value was tied to the tax base in respect of personal income tax. There was one exception: in the event a program was abolished, Québec would have to reimburse the tax points transferred, which was true of the youth allowance in 1974.

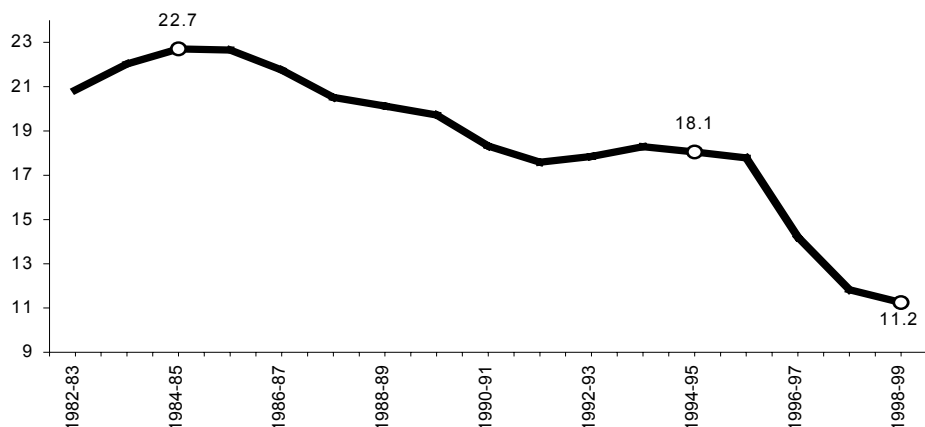
By consolidating the funding of various social programs under the EPF and deducting the abatement of the total amounts granted to Québec, the federal government once again linked the new special abatement to the funding methods stipulated in respect of these programs. From then on, every time the value of the abatement increased, the financial transfer decreased.

Reduction of the amounts transferred to the provinces

Since the mid-1980s, an almost constant decline has been noted in the relative share of federal transfers in the provinces' financing. For Canada as a whole, the proportion of health, education and social services spending funded in cash by the CHST declined from 22.7% in 1983-1984 to 11.2% in 1998-1999 (see Chart 15).

CHART 15

CHANGE IN THE CHST IN CASH IN RELATION TO PROVINCIAL SPENDING ON HEALTH, EDUCATION AND SOCIAL SERVICES – 1982-1983 TO 1998-1999
(as a percentage)



Notes: The Canada Health and Social Transfer (CHST) replaced the established programs financing (EPF) and the Canada Assistance Plan (CAP) in 1996-1997.

Source: Commission on Fiscal Imbalance.

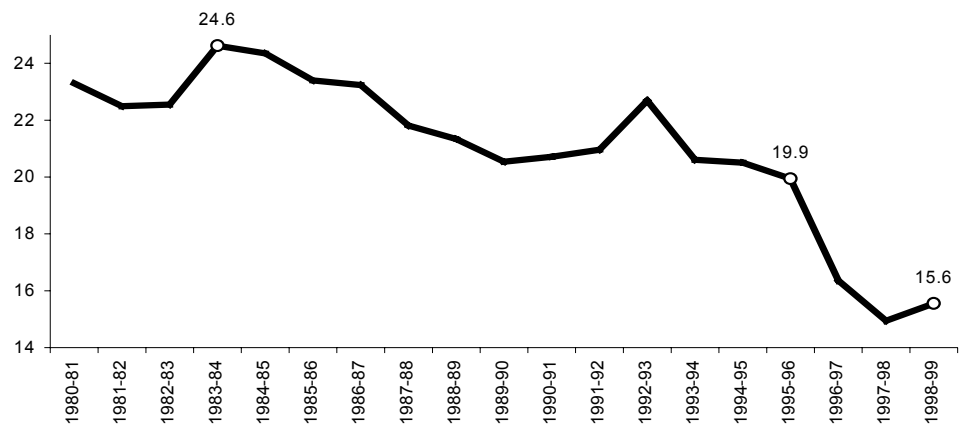
These decreases are attributable to a series of measures aimed at reducing federal financial responsibility toward the provinces, i.e. successive reductions in the amounts of transfers to the provinces, reduced indexing of payments, and so on.¹⁰⁵ The provinces have emphasized, in particular, the unilateral, arbitrary nature of the reductions adopted by the federal government.

The equalization program was also subject to restrictions starting in 1982, the main ones being the adoption of a standard including only five provinces and the implementation of a ceiling on the amounts that are divided among the provinces.¹⁰⁶

Our earlier observation does not change when equalization payments are included. In 15 years, i.e. between 1983-1984 and 1998-1999, the share of federal transfers in the provinces' revenues fell from 24.6% to 15.6% (see Chart 16).

CHART 16

CHANGE IN FEDERAL GOVERNMENT TRANSFERS AS A PROPORTION OF THE TOTAL REVENUES OF THE PROVINCES AND TERRITORIES – 1980-1981 TO 1998-1999
(as a percentage of the total)



Source: Commission on Fiscal Imbalance.

Aside from these measures, it should also be noted that the modifications to the CHST after its introduction significantly affected Québec. The changes centred on a revision of the method of dividing funds among the provinces, i.e. the breakdown based on needs was replaced by a breakdown based on the provinces' demographic weight, which came fully into effect in 2001-2002. Since Québec benefited from a portion of transfers under CAP that exceeded its demographic weight prior to the adjustments as it has a bigger proportion

¹⁰⁵ For additional information on current federal transfer programs, see COMMISSION ON FISCAL IMBALANCE, *Federal Transfer Programs to the Provinces*.

¹⁰⁶ *Ibid.*

of social aid beneficiaries than the other provinces in relation to its demographic weight, it was one of the big losers in the wake of the revision.

TABLE 9

CHANGE IN QUÉBEC'S SHARE OF THE CHST IN CASH – 1994-1995 TO 2001-2002
(as a percentage of the total)

	Years	Health	Postsecondary education	Income security (CAP)	Total	Share of population
CAP and LPP	1994-1995	24.9	24.9	34.1	27.4	24.9
	1995-1996	24.7	24.7	34.1	27.3	24.7
CHST	1996-1997	—	—	—	27.2	24.5
	1997-1998	—	—	—	26.8	24.4
	1998-1999	—	—	—	24.8	24.2
	1999-2000	—	—	—	24.6	24.1
	2000-2001	—	—	—	24.7	24.0
	2001-2002	—	—	—	23.9	23.9

Notes: The breakdown of total entitlement to the Canada Health and Social Transfer (CHST) on an equal per capita basis does not lead to equal per capita financial transfers between the provinces, which stems from consideration by the federal government in the CHST breakdown formula of the tax room relinquished to the provinces in 1977 (abatement). Since the value of this tax room is higher in the wealthier provinces and equalization does not completely balance out the provinces' fiscal capacities, financial transfers are lower than in the less privileged provinces. For additional information on existing federal transfer programs, see COMMISSION ON FISCAL IMBALANCE, *Federal Transfer Programs to the Provinces*, page 11.

Source: Commission on Fiscal Imbalance.

Strategic control over the use of the funds transferred

When the first shared-cost programs were established, to ensure that the funds transferred were actually spent in the stipulated sectors, the federal government relied close definition of covered services and on detailed (invoice-by-invoice) audits of the expenditures effected. This process, which can be effective in respect of the management of very specific programs such as the Handicapped Program in 1954, has proven over the years to be complex and unwieldy. Against a backdrop of expanding programs, clienteles affected and services delivered to the public, programs such as CAP quickly generated an impressive array of administrative documents to be processed and led to the allocation of significant financial and human resources, not for the delivery of services but to handle the documents.

By breaking the direct link between the amounts transferred and the expenditures effected by the provinces, block funding led to considerable gains in efficiency within the bureaucracy. However, by removing this link, it made any direct control over such spending inopportune. During the 1980s,

the federal government modified its approach to control over the use of the funds transferred to the provinces and opted for strategic control in this respect.

The adoption in 1984 of the *Canada Health Act*¹⁰⁷ is the most striking example in this regard. The Act adopted certain principles found in earlier hospital insurance legislation,¹⁰⁸ i.e. accessibility, universality, comprehensiveness, transferability and public administration of health care. Moreover, by confirming that non-compliance would lead to financial penalties, the legislation compensates for the absence of direct federal control over the use of funds transferred. Similarly, the federal government's decision to link the payment of federal funds earmarked for social aid to the obligation not to demand a minimum period of residence in a province or in Canada as a condition of eligibility for social aid is playing a similar role.

¹⁰⁷ *Canada Health Act*, S.C. 1984, c. 6.

¹⁰⁸ *Hospital Insurance and Diagnostic Act*, S.C. 1957, c. 28.

FISCAL IMBALANCE FRONT AND CENTRE

In the wake of the increases in transfers to the provinces for health and social programs announced in the fall of 2000, the debate over fiscal imbalance re-emerged as an issue in relations between the two orders of government. The debate was resumed in a particular context, the signature of the framework agreement on the Social Union in 1999 – without Quebec – and the implementation of new federal initiatives in provincial fields of jurisdiction.

Federal reinvestment

After almost two decades of negative growth, the federal government decided, in the fall of 2000, to raise its cash transfers to the provinces. Since there is no formal indexing mechanism built into the CHST, only a formula for distributing amounts among the provinces, the federal government amended its legislation¹⁰⁹ to confirm its decision. The legislation stipulates that the amounts to be paid to the provinces under the CHST will rise from \$12.5 billion in 1999-2000 to \$21 billion in 2005-2006.

Beginning in 1999-2000, the federal government raised this increase by using trust accounts. It was thus able to provide the provinces with \$7 billion in non-recurring transfers over five years.¹¹⁰

The federal reinvestment is certainly significant, but pales in comparison to the cutbacks imposed on the provinces. It offsets only a quarter of the federal financial withdrawal under the CHST initiated before 1985-1986. And, while it increases the relative share of federal transfers in provincial health, education and social services, funding to just over 14% in 2002-2003, it fails to reverse the downward trend in the relative weight of CHST transfers.

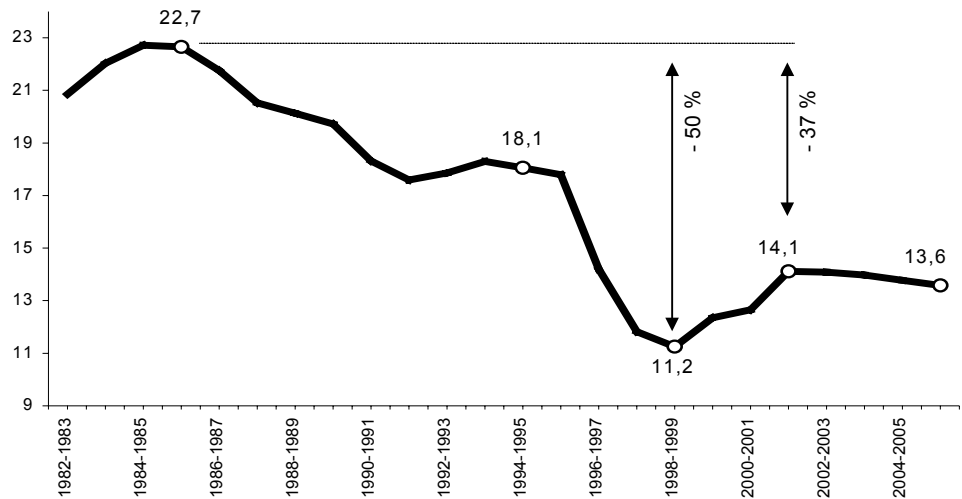
The provinces condemned the non-recurring nature of the trust accounts because it places them in a difficult situation regarding their own financial obligations. The dissatisfaction soon became public and new negotiations were initiated to increase the level of federal funding, placing the debate over fiscal imbalance front and centre.

¹⁰⁹ Part V of the *Federal-Provincial Fiscal Arrangements Act*, R.S.C. 1985, c. F-8.

¹¹⁰ According to the federal timetable, the amounts entered in the trust accounts total \$2 billion in 1999-2000, \$2 billion in 2000-2001, \$1 billion in 2001-2002, \$500 million in 2002-2003 and \$500 million in 2003-2004. The federal government also set up a trust account of \$1 billion under the health agreement from which funds could be drawn in 2000-2001 and in 2001-2002.

CHART 17

CHST CASH TRANSFER (INCLUDING TRUST ACCOUNTS) COMPARED TO PROVINCIAL SPENDING ON HEALTH, EDUCATION AND SOCIAL SERVICES – 1982-1983 TO 2005-2006 (as a percentage of total)



Notes: Data for 2001-2002 to 2005-2006 are projections based on the amendments made by the federal government to Part V of the *Federal-Provincial Fiscal Arrangements Act* (R.C.S. 1985, c. F-8). The trust account amounts are shown with reference to the year in which they are included in the federal calculations. The amount of \$1 billion forecast for the last trust account is not shown in the chart because the federal government does not include it in the Canada Health and Social Transfer (CHST). The CHST replaced Established Programs Financing (EPF) and the Canada Assistance Plan (CAP) in 1996-1997.

Source: Commission on Fiscal Imbalance.

The Social Union

On February 4, 1999, the federal government and the provinces, excluding Québec, agreed on a framework to improve the social union for Canadians, namely the framework agreement on the Social Union.¹¹¹ This is an administrative document that is valid for three years, not a constitutional agreement.

This agreement is different from previous ones because its wording (see sidebar) gives direct federal interventions in fields of provincial jurisdiction a legitimacy they did not have before. As Claude Ryan pointed out:

The right of withdrawal recognized [...] by the provinces on January 28 was formulated so as to be exercised not only regarding federal programs involving transfers to the provinces but also regarding federal programs involving transfers to individuals and organizations.

This interpretation is no longer allowed following the February 4 agreement. Under this agreement, the federal government is committed to giving the provinces and territories three months' advance notice before launching new Canada-wide initiatives funded by direct transfers to persons and to organizations for health, post-secondary education and social assistance and services. In such cases, the federal government also undertakes to "offer to consult".¹¹²

FRAMEWORK AGREEMENT ON THE UNION SOCIALE

The agreement was signed on February 4, 1999 by all the provinces, except Québec, and defines four general principles:

Encourage the mobility of people

- New social policy initiatives must create no new barriers to the mobility of people;
- The provinces must eliminate, within three years, any residency-based policies or practices that constrain access to public services.

Public accountability and transparency

- The parties agree to measure the results of social programs, have Canadians participate in developing social priorities and adopt fair and transparent practices.

Work in partnership

- Joint planning and cooperation with other governments in Canada, including the federal government, to define social programs;
- Reciprocal advance notice and consultation before implementing changes or new programs;
- Equitable treatment of all provinces for any new Canada-wide social initiatives.

The federal spending power

- Recognition of the role played by social transfers to the provinces, stemming from the exercise of the federal spending power;
- Greater predictability of federal transfers through consultation with provincial and territorial government at least one year prior to renewal of or changes to federal transfer program;
- Federal commitment to work with the provinces and seek the consent of a majority of them for any new Canada-wide initiatives in fields of provincial jurisdiction;
- At least three months' notice before implementing a direct federal spending program.

¹¹¹ A Framework to Improve the Social Union for Canadians. Canadian Intergovernmental Conference Secretariat, Government of Canada.

¹¹² Claude RYAN, "L'Union sociale annonce une domination fédérale accrue", *Le Devoir*, June 12, 1999. Our translation. Our emphasis.

And a little further on:

*But the benevolence ends there. **Apart from these weak commitments, the federal government will consider itself authorized under the agreement to multiply initiatives as it sees fit, like the millennium scholarships, tax benefits for specific categories of people, funding to organizations operating in what are clearly provincial fields of jurisdiction.** By means of tax credits and so-called tax benefits, in particular, the federal government will be authorized, if it so wishes, to occupy an increasing portion of the social policy field.*¹¹³

Yet, in the past, the provinces had been prepared to recognize this spending power – Quebec excepted – in return for measures to limit it and set guidelines for its use. Québec's position on this matter has always been clear: the right of withdrawal with full financial compensation must be granted to provinces that refuse to participate in a federal program.

Québec's rejection of the agreement

In the discussions preceding the signature of the agreement, and unlike the other provinces that seemed to define the re-balancing of the federation as a form of cooperation with the federal government, in sectors where it has encroached by exercising its spending power, Québec considers that it must maintain full control over its jurisdictions. Repeating the arguments made many times before by Jean Lesage, Daniel Johnson, Robert Bourassa and René Lévesque (see box page 61), Lucien Bouchard stated:

*The government has neither the intention, nor the mandate to abandon any part of Québec's constitutional jurisdictions, whether the operation under consideration is constitutional or administrative in nature. [...] Québec cannot agree to a re-balancing whose general features and specific measures lead to the relinquishing of Québec's basic demands and their gradual erosion [...].*¹¹⁴

*An intergovernmental mechanism to formulate national standards applicable to social programs would directly threaten Québec's existing prerogatives and responsibilities regarding the definition and management of its social policies, exercised under its exclusive jurisdiction in this field. Such a mechanism, in fact [...] would also result in recognition of federal responsibilities in defining social policies that are not recognized in the Constitution. It would legitimate long-standing federal pretensions on this issue, by clearly circumventing the Constitution.*¹¹⁵

¹¹³ Claude RYAN, *op. cit.* Our translation. Our emphasis.

¹¹⁴ *Le rééquilibrage des rôles et des responsabilités d'Ottawa et des provinces : une autre avenue de centralisation.* Press release issued by Québec at the end of the annual Conference of Provincial Premiers held in Jasper, Alberta, August 23, 1996, page 2. Our translation.

¹¹⁵ *Union sociale canadienne : La position du Québec.* Document tabled by Québec at the First Ministers' Conference, St. Andrews, August 6, 7 and 8, 1997, pages 1-2. Our translation.

QUÉBEC'S POSITION: A FIRM POSITION DATING FROM THE SIXTIES

The position taken by Québec at the conference on the social union differs little from its position over the last 40 years. The first examples of this position are often associated with the stands taken by Premier Maurice Duplessis, in particular his policy of "Rendez-nous notre butin !" (give us back our loot). It is also interesting to note, as mentioned above, that this same position led to the provinces obtaining a right to withdraw from federal shared-cost programs with full financial compensation in 1964. Note that both Jean Lesage and Daniel Johnson advocated, for the sake of efficiency and for constitutional reasons, that the Québec government must have total predominance in designing social policies and implementing them within its territory, with sufficient tax resources to adequately carry out these responsibilities (see sidebar page 38).

Robert Bourassa restated this position in 1970. His government pointed out that:

*The government's major priorities [...] are as follows: 1) the issue of the financing of the federation to achieve a division of tax resources more consistent with the constitutional responsibilities of the federal and provincial governments [...]*¹¹⁶

*Nobody would deny that policies regarding health and social services fall within the primary jurisdiction of the provinces. Yet, in reality, the federal government, through its rigid financial programs, has never ceased to set priorities and determine resources [...]*¹¹⁷

His government repeated this position when it made limitation of the federal spending power one of its five conditions for Québec's endorsement of the Canadian Constitution:

*I feel it is increasingly necessary to subject the federal spending power to the approval of the provinces. That would help substantially to improve the operation of the federal system.*¹¹⁸

Similarly, René Lévesque's government took a position, both before and after the 1980 referendum, seeking to limit the exercise of the federal spending power to fields of federal jurisdiction, whether exclusive or concurrent, and grant financial compensation to provinces that do not recognize the legitimacy of federal incursions in their fields of jurisdiction:

*Québec believes that the federal spending power should be limited to the areas listed as being under exclusive or concurrent federal jurisdiction.*¹¹⁹

*We are witness to a determination to centralize powers in Ottawa, without precedent in modern-day Canada. [...] On this issue, the interest of Québec and that of the other provinces intersect to some degree: because the sovereign exercise by all the provinces of the authorities they have traditionally exercised under the 1867 BNA Act and the decisions of the courts is clearly threatened. Ottawa, making particular use of its unlimited spending power, has undertaken to change to its advantage the division of powers within Canadian federalism, but is attacking the very nature of this system. [...] This federal offensive is especially obvious when it affects powers reserved exclusively to the provinces in three sectors central to their jurisdictions: health, municipal affairs and education.*¹²⁰

¹¹⁶ Inaugural Speech. Journal des débats de l'Assemblée nationale, March 15, 1973, page 1. Our translation.

¹¹⁷ Statement by Robert Bourassa. *Constitutional Conference, Ottawa, September 14-15, 1970*, page 10. Our translation.

¹¹⁸ Speech by Gil Rémillard, Minister for Canadian Intergovernmental Affairs, at the symposium *Une collaboration renouvelée du Québec et de ses partenaires à la Confédération*, Mont-Gabriel, May 9, 1986. Our translation.

¹¹⁹ *Dossier sur les discussions constitutionnelles 1978-1979*. Secrétariat des Affaires intergouvernementales du Québec, 1978-1979, page 6. Our translation.

¹²⁰ Statement by René Lévesque on the current situation and priorities for the future. Annual First Ministers Conference, Charlottetown, 1984, page 2. Our translation.

When the official text of the agreement is published, it is unanimously rejected in Québec:

*« Neither Lucien Bouchard, nor the Parti Liberal du Québec would have accepted the terms of the agreement on the Social Union », stated the leader of the opposition, Jean Charest. « I would not have signed it [the agreement] as it was » revealed M. Charest, « some things should have been added, respect to jurisdiction clarified ».*¹²¹

Accountability

Drawing on the general principles of the framework agreement on the Social Union, the federal government has invited the provinces in recent years to agree to the principle of Canada-wide accountability regarding the delivery of health and social services in which the federal government would assume a dominant role.

To date, this strategy has met with little success since it involves redefining relations between the two orders of government, something in which the provinces have shown little interest. While they acknowledge the importance of accountability, the provinces are not considering yielding their prerogatives in this area to the federal government.

In this regard, it is worthwhile quoting from the text of the press release issued by the first ministers after the federal-provincial conference of September 11th, 2000. In the foreword, the first ministers note:

Nothing in this document shall be construed to derogate from the respective governments' jurisdictions. The Vision, Principles, Action Plan for Health System Renewal, Clear Accountability, and Working Together shall be interpreted in full respect of each government's jurisdiction.¹²²

Further on in the document, they state:

Respecting each other's responsibilities, all governments believe in the importance of being accountable to Canadians for the health programs and services which they deliver. [...] The purpose of performance measurement is for all governments to be accountable to their public, not to each other.¹²³

¹²¹ Denis LESSARD « Charest n'aurait pas signé », *La Presse*, February 5, 1999.

¹²² *Communiqué on health for the First Ministers' meeting*. Ottawa, September 11, 2000, page 1. Our emphasis.

¹²³ *Id*, page 3. Our emphasis.

Federal program spending

Prior to 1996, the creation of federal direct spending programs in fields of provincial jurisdiction was extremely rare, often heralding constitutional amendments to legally sanction the federal intervention. Such was the case with unemployment insurance in 1940 and old age security in 1951.

In recent years, the federal government has increased its presence in fields of provincial jurisdiction, health and education in particular, by using its spending power to create its own social programs. This strategy is not unanimously supported by the provinces, with many being strongly opposed.

Four factors play an important role in the emergence and confirmation of this trend:

- the difficulties inherent in negotiating agreements with the provinces;
- the federal determination to standardize public programs;
- the abundant financial resources of the federal order;
- the legitimacy the federal government has gained from the framework agreement on the Social Union since 1999.

Table 10 shows some of these programs. In some cases, their financial impact is appreciable. For instance, to implement the Canada Millennium Scholarship Foundation, the federal government injected \$2.5 billion in the education field.

TABLE 10

MAJOR FEDERAL PROGRAMS AFFECTING FIELDS OF PROVINCIAL JURISDICTION – 1997-1999

Year	Program	Jurisdiction	
		Federal	Provincial
1997	Health Transition Fund	—	Health
1997	Canada Foundation for Innovation	—	Health and Education
1997	Canada Health Information System	Quarantine	Health
1997	Canada Millennium Scholarship Foundation	—	Education
1999	Canadian Institutes of Health Research	Quarantine	Health

Source: Commission on Fiscal Imbalance.

This inventory does not include tax measures the federal government has developed that, although tied to fiscal policy, also have a social purpose. For instance, the Canada Child Tax Benefit is similar to an income support program, except that the taxpayer obtains his payments through his tax filing rather than from a federal service outlet.

CONCLUSION

This historical review shows that the division of powers and tax fields that prevails today is the result of singular events, such as the Great Depression and the two world wars, and major trends fostered by successive governments of the country and the provinces.

Since 1867, the determination of the provinces to obtain sufficient financial resources to exercise their powers, as set out in the *Constitution Act, 1867* and the *Constitution Act, 1982*, marked the history of the Canadian federation. The many proposals to address this concern have not always had the success hoped for even though the provinces, other than Québec, have generally reached an accommodation.

Over the last 50 years, above all, Québec has taken a firm and clear position on how the two orders of government should divide powers and tax resources. Essentially, this position is based on three points:

- firm determination to have its jurisdictions respected in full;
- determination to restrict the federal spending power to fields of federal jurisdiction and seek a right of withdrawal for the provinces from federal programs;
- clear preference for a revision of the division of tax fields rather than an increase in cash transfers.

As Jean Lesage emphasized in 1963, the autonomy of the provinces is the most important matter for Québec :

We absolutely cannot, even for apparently secondary issues, remain passive in the face of federal initiatives we consider harmful to the exercise of powers that have been conferred on the provinces.

[...] we believe that genuine respect of the legitimate autonomy of the provinces, and everything that flows therefrom, supposes that they have the indispensable resources to effectively occupy the fields within their jurisdiction. In Canada, this essential condition for the success of a provincial initiative that has become necessary because of the dimension of the tasks to be effected, remains unsatisfied. However, federalism, as we understand it, requires that it be satisfied.¹²⁴

¹²⁴ *Federal-Provincial Conference, Ottawa, November 26, 27, 28 and 29, 1963, pages 41-42. Our translation. Our emphasis.*

GLOSSARY

Abatement

(in the context of the fiscal agreements reached between 1941 and 1971)

Portion of a tax that one order of government cedes to another order of government. The expression “income tax concession” is also used.

Abatement

(in the context of a fiscal agreement reached between governments)

Coordinated tax reduction by one order of government and tax increase by another order of government leaving the overall tax burden unchanged. The expression “tax point” is used to designate the size of this tax field transfer.

E.g.: 1 point = 1% of federal tax

BNA Act

British North America Act.

Conditional transfer

Cash transfer between orders of government that includes conditions on how the amounts transferred can be used.

E.g.: CHST, shared-cost programs

Declaratory power

Stipulated in section 92.10 c) of the *Constitution Act, 1867*, it authorizes the Parliament of Canada to unilaterally change, to the detriment of provincial legislatures and without their consent, the sphere of its legislative authority in relation to works it declares to be for the general advantage of Canada or of two or more provinces.

Direct taxation

In constitutional law, a tax is said to be direct when it is required of the person who, according to the intent of the legislator, must pay it. E.g.: income tax, inheritance tax, property tax, sales tax.

Effective occupation

Refers to the notion of control of a tax field rather than its exploitation. For example, while Québec proportionally collects as much personal income tax as the federal government, the latter exercises greater effective control over this tax since it can deduct the special Québec abatement from the transfers it pays Québec.

Equalization Program	The Equalization Program became effective in 1957-1958. It was designed to give provincial governments sufficient revenue to enable them to provide public services at reasonably comparable levels of quality and taxation. Federal payments under the program are unconditional. ¹²⁵ These principles were entrenched in the <i>Constitution Act, 1982</i> .
Established Programs Financing (EPF)	In effect from 1977-1978 to 1995-1996, it was the federal contribution to financing provincial health and post-secondary education spending. The amounts paid under EPF were allocated among the provinces on the basis of their share of the population. ¹²⁶
Great Depression	This expression refers to the prolonged economic crisis that gripped most industrialized countries from 1929 to 1939.
Indirect taxation	In constitutional law, a tax is said to be indirect when it is required of a person who, according to the intent of the legislator, must then obtain compensation at another's expense. E.g.: excise tax, customs duties, <i>ad valorem</i> wholesale taxes.
Keynesianism	Named for its chief architect, John Maynard Keynes, it is an economic school of thought dating from 1936 that calls for government intervention to smooth economic cycles. It was very influential in the wake of the Great Depression.
Own-source revenue	Refers to revenue a government collects from its own sources. Transfers do not constitute own-source revenue.
Right of disallowance	Written into the <i>Constitution Act, 1867</i> , it authorizes the Governor General to cancel a statute duly voted by a provincial legislature that it deems to go against the federation's interest.
S.C. and R.S.C.	Statutes of Canada and Revised Statutes of Canada.
S.Q. and R.S.Q.	Statutes of Québec and Revised Statutes of Québec.

¹²⁵ For additional information on current federal transfer programs, see COMMISSION ON FISCAL IMBALANCE, *Federal Transfer Programs to the Provinces*.

¹²⁶ *Ibid.*

Shared-cost program (in the Canadian context)	Method of funding public services whereby the federal government assumes part of the costs of provincial programs.
The Canada Assistance Plan (CAP)	In effect from 1965-1966 to 1995-1996, it was the federal contribution to funding provincial income security programs. Essentially, the federal government paid the provinces 50% of their eligible expenditures. ¹²⁷
The Canada Health and Social Transfer (CHST)	Since 1996-1997, the chief federal contribution to funding provincial health, post-secondary education, social assistance and social services programs, including early childhood development. This is a block-funding program, meaning that there is no allocation of funds among the various spending sectors it contributes to. ¹²⁸
Unconditional transfer	Cash transfer between orders of government that sets no conditions on how the amounts transferred can be used. E.g.: Equalization, statutory grants

¹²⁷ For additional information on current federal transfer programs, see COMMISSION ON FISCAL IMBALANCE, *Federal Transfer Programs to the Provinces*.

¹²⁸ *Ibid.*

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