

INSTITUTE OF INTERGOVERNMENTAL RELATIONS

The Future of Fiscal Federalism

The Future of Fiscal Federalism

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110 715 104 11772.2

Canadian Cataloguing in Publication Data

Main entry under title:

The Future of fiscal federalism

Proceedings of a conference held at Queen's University, Nov. 4-5, 1993.

Includes bibliographical references.

ISBN 0-88911-657-1

1. Fiscal policy – Canada – Congresses. 2. Federal-provincial fiscal relations – Canada – Congresses.* 3. Canada – Social policy – Congresses. I. Banting, Keith G., 1947- . II. Brown, Douglas Mitchell, 1954- . III. Courchene, Thomas J., 1940- . IV. Queen's University (Kingston, Ont.). School of Policy Studies.

HJ793.F87 1994 336.71 C94-931012-3

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Acknowledgements

From its inception, this book has been a collaborative enterprise to which a large number of people and institutions have contributed. Its origins lie in a conference on "The Future of Fiscal Federalism" held at Queen's University in November 1993, which attracted academics and policymakers from across the country. The conference was jointly sponsored by the School of Policy Studies, the Institute of Intergovernmental Relations, and the John Deutsch Institute for the Study of Economic Policy. A conference of this size represents a significant financial commitment, and the organizers would like to acknowledge the support received from the Social Sciences and Humanities Research Council, the Department of Finance of the Government of Canada, and the Ministry of Intergovernmental Affairs of the Government of Ontario.

The success of the conference also depended heavily on the organizational skills of Sharon Alton, Jane Hodgins, Art Stewart, and Sharon Sullivan. The preparation of the book itself once again reflects the professionalism of the publication unit in the School of Policy Studies. The editors wish to thank Valerie Jarus and Darrel Reid for the production of camera-ready copy, Marilyn Banting for copy editing, and Gary Leroux for graphic design.

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PART ONE

INTRODUCTION

CHAPTER ONE

The Future of Fiscal Federalism: An Overview

*Keith G. Banting,
Douglas M. Brown and
Thomas J. Courchene*

INTRODUCTION

Canadians are rapidly approaching a critical juncture in the evolution of their social programs and the system of fiscal federalism that underpins them. Powerful economic and social forces have thrust the reform of social programs to the top of the public agenda. The fiscal crisis facing Canadian governments at all levels, the globalization of economic activity and rapid technological change are generating pressure for a restructuring of core social programs. At the same time, the current system of federal-provincial fiscal arrangements is under intense strain. Warning signs are flashing on all sides: the impending disappearance of the cash payments to provinces under Established Program Financing (EPF) raises questions about the federal role in postsecondary education and health care; the cap on the rate of growth of transfers to the three richest provinces under the Canada Assistance Plan (CAP) has sparked intense anger, especially in Ontario; the ceiling on equalization grants worries those committed to interregional sharing; and the repeated resort to unilateral federal action has eroded the institutions and practices of intergovernmental collaboration. In the view of many commentators, the existing patterns of fiscal federalism are no longer sustainable.

So interdependent are social programs and the fiscal arrangements between federal and provincial governments that it is impossible to reform one without reconsidering the other. Changes in major social programs inevitably trigger

adjustments in fiscal relations; and seemingly technical changes in the various formulae embedded in fiscal agreements can have major implications for the long-term development of the Canadian welfare state. What makes the contemporary context so compelling is that both our social programs and fiscal arrangements are under debate at the same time.

Given the centrality of these programs to the well-being of Canadians, it is critical that reforms be accompanied by a wide public debate about their future. This book is premised on the assumption that a close look at the structure of social and fiscal programs in Canada can contribute to such a debate. The chapters and commentaries included here range over a wide area, from the implications of the principles of public finance for the design of fiscal arrangements to the impact of globalization and political change on social policy, from the complexities of Canadian social programs to a comparative perspective on fiscal arrangements in federal states around the world, from the history of Canadian programs to projections about their future. Throughout these wide-ranging perspectives run a set of critical questions. How well suited are our existing social and fiscal programs for the emerging economic and political order? Does "social Canada" need radical change or incremental evolution? What are the appropriate roles of federal and provincial governments in preparing "social Canada" for the late twentieth and early twenty-first centuries? Are our political institutions and processes capable of responding effectively to the challenge?

The purpose of this introduction is to provide a survey of the perspectives explored in the chapters that follow, and to summarize the common threads that run through the book as a whole.

FISCAL FEDERALISM: OVERVIEWS

Part two of the book is devoted to a series of broad overviews of fiscal federalism in Canada. In the first chapter, Robin Boadway and Frank Flatters evaluate the system of fiscal federalism in light of core principles of public finance. In the second chapter, Thomas Courchene reverses the approach by beginning with the structure of social programs appropriate to the new global economic order and then tracing their implications for our fiscal arrangements. Richard Simeon rounds out this part by examining the politics of fiscal federalism, and asking whether we have the institutional and political capacities to fashion creative solutions to our social and fiscal dilemmas.

Economic Principles. Boadway and Flatters address the issue of whether the current system of federal-provincial fiscal arrangements, which took shape at

a time when the federation was much more centralized than it is now, meets the economic needs of the federal system we have today. The basic building blocks for their evaluation are five principles of public finance: (a) fiscal efficiency, (b) fiscal equity, (c) the preservation of the integrity of economic union, (d) tax harmonization and (e) the accommodation of spillovers of benefits or costs across provincial boundaries. These principles allow the authors to develop an internally consistent view of Canadian fiscal federalism and how it ought to evolve. For example, the principle of fiscal efficiency leads them to favour provincial design and delivery not only of health, education, and welfare (for which the provinces already have primary responsibility) but also of training and unemployment insurance (which are now either jointly or federally provided). The rationale for the latter has to do with the potential for enhanced integration with provincial welfare and education systems. To the extent that this degree of decentralization leads to differential net fiscal benefits (NFBs) across provinces, which could trigger migration from low-NFB to high-NFB provinces, the solution on fiscal efficiency grounds should be an enhanced equalization program.

While fiscal efficiency can provide support for equalization, it is the principle of fiscal equity or horizontal balance that provide Boadway and Flatters with the real leverage to argue for full equalization of NFBs across provinces. In turn, this objective would call for a "net" scheme rather than the current "gross" scheme in order that the fiscal capacities of the rich provinces were reduced to ensure equality of provincial NFBs. A recurrent theme throughout their chapter is that the more decentralized the federation becomes, the more need there is for effective pursuit of fiscal equity goals by the federal government.

Because of the importance they assign to Ottawa's role in pursuing fiscal equity or redistribution, Boadway and Flatters argue for an enhanced role for the federal government in direct taxation and a devolution of indirect taxation to the provinces. To maintain tax harmonization, the authors would fall back on the use of the federal spending power. Indeed, the federal spending power would also play a critical role in preserving and promoting the economic union, which is a greater challenge in a more decentralized federation, and in providing mechanisms that ensure equitable access to all social programs in the face of spillovers.

Boadway and Flatters give tolerably good marks to the way that the existing system has coped with change, but they also recognize that aspects of the system might be, in the words of their title, in "crisis." One recommendation they offer is to roll CAP and EPF into an expanded equalization program, operated on a net basis — net in the sense that the rich provinces would receive less than under

the current CAP and EPF, with the reductions being used to finance equalization transfers to the have-not provinces so as to move the system towards full equalization of provincial NFBs.

In summary, this is an intriguing commingling of centralization and decentralization, with fiscal equity concerns driving the former and efficiency concerns driving the latter.

In his commentary, Fred Gorbet focuses on issues that in his view are underplayed in the chapter by Boadway and Flatters. Foremost among these are the fiscal pressures faced by all governments. He notes that it was not until the second Conservative mandate that transfers to the provinces were frozen or capped. At that point, Ottawa no longer felt politically able to increase taxes to maintain transfers to the provinces when these transfers (cash and especially cash plus tax transfers) were growing at rates beyond all other federal spending. This was doubly the case since the federal perspective was that the provinces were doing a less-than-adequate job of controlling their program spending. Gorbet's main point here is that while equity and efficiency as developed by Boadway and Flatters may imply that the role of federal-provincial fiscal arrangements should increase in relative importance as budgetary responsibilities are transferred to the provinces, it is not clear that concerns about *accountability* point in the same direction. His tentative conclusion in the first part of his commentary is that the issues of affordability, accountability and flexibility will influence future negotiations as much as equity and efficiency concerns.

In contemplating the pattern of change in the future, Gorbet begins from several presumptions: on the transfer side, equalization remains a robust program but neither EPF nor CAP is stable; on the tax side, there is uncertainty about the future of the GST and growing pressure from certain provinces to gain control over the rate and bracket structures under the shared personal income tax. In this context, Gorbet foresees two broad "families of options." The first would involve the continuation of the tax agreements much as today (with perhaps some harmonization of federal and provincial sales taxes), and the evolution of EPF and CAP towards a merged block fund. The second, more radical approach would see the federal government repeal the GST and make up the difference through major cuts to EPF and CAP and increases in income taxes. Transferring the GST to the provinces, as Boadway and Flatters suggest, would roughly match in dollar value the existing levels of cash transfers under EPF and CAP. However, it is uncertain why Ottawa would opt for this when the cash component of EPF is heading towards zero and GST revenues are likely to grow. This is not a challenge in terms of principle, but in terms of practice.

Fiscal and Global Challenges. Tom Courchene also casts social policy and fiscal federalism within a broad framework. However, unlike Boadway and Flatters who approach the issues through a series of principles, he addresses the social envelope in terms of a set of forces that, in his view, will overwhelm the status quo. He begins by arguing that the old social policy paradigm is unsustainable in its own right for a number of reasons: the set of perverse incentives for individuals; the emergence of transfer dependency across the provincial economies; and the increasing intergenerational tug-of-war that has left a wholly inappropriate burden on younger generations. Beyond this, however, there is an entirely new set of forces — globalization and the information/knowledge revolution — that call for a complete reworking of social Canada. Courchene argues that a restructured social envelope has to address a series of challenges: mounting an east-west transfer system over a north-south trading system; recognizing that social policy has a critical role to play in ensuring the successful transition from a resource-based society to a human capital-based society; and accepting that the diverse nature of the several Canadian economies may make federal-provincial asymmetry unavoidable.

Courchene does not view the fiscal crisis as fully exogenous to social policy reform since part of the reason for the debt and deficit mushrooming was and is the unwillingness of government to jettison the social paradigm inherited from the postwar generation. While he has harsh words for some aspects of deficit offloading such as the cap on CAP, he nonetheless views the various freezes, caps and ceilings as an essential catalyst to social policy reform and restructuring. Central to his conception of a new social order is that reform must begin from the bottom up — the time has come to design programs and policies from the vantage point of individual Canadians. Only then should we focus on which level of government should deliver them and how they should be financed. In other words, the federal transfer system should be “derivative” not “determining.”

In his comments, Lars Osberg takes issue with several aspects of the Courchene chapter. In particular, he challenges Courchene's use of “transfer dependency.” While this term has been in vogue for some time, Osberg argues that it represents a stereotype that is no longer borne out by recent research. Indeed, recent Unemployment Insurance (UI) data for “regular benefits” reveal that Toronto and Montreal have higher UI “dependency” than does Halifax. Osberg is more positive about Courchene's recommendation of a negative income tax for children as one way to address the welfare trap, and he offers some suggestions as to how it might be implemented. Finally, he argues that the returns to restructuring social policy, and particularly to engaging in a substantial training effort, may be low unless there is a demand for trained labour. Thus,

one of his priorities is to integrate both the macroeconomic and social dimensions so that they are pulling in the same direction.

Claude Forget is more comfortable with, if not transfer dependency, then at least Courchene's concept that the perverse incentives in the transfer system have generated a "policy induced equilibrium." However, in his comments, he emphasizes the political barriers to change. From his perspective as the head of the Commission of Inquiry on Unemployment Insurance, he believes that in a period of heightened regionalism underscored by recent federal election results, there seems to be no reason why dysfunctional incentives embedded in the transfer system will be amenable to reform. Forget also notes that the unpredictability of federal transfers has always existed, even though the concern about unpredictability is currently heightened. He does not think that the provinces are sufficiently angry to accept lower transfers for more predictability. Moreover, Forget questions whether federal offloading can be linked to the ongoing provincial restructuring: this may have occurred in its own right. His comments conclude with an observation that one reason why Ottawa may engage in reform of welfare, UI, training, and education is that these areas, individually and collectively, are among the most generously funded in terms of international comparisons. Perhaps an option is to generate savings here and convert them to strengthen the federal commitment and predictability with respect to Medicare, which is seen more and more as a defining characteristic of Canada.

Political Challenges. Richard Simeon then provides a more explicitly political overview of the future of fiscal federalism in Canada. Beginning with the proposition that there is a consensus that existing social policies and fiscal arrangements are unsustainable, Simeon questions whether the conditions for a creative or successful resolution exist. He concludes that the political system lacks the institutional capacity to address and manage the challenge.

In developing this conclusion, Simeon offers a series of five institutional or constitutional "trumps" that are likely to frustrate a coordinated, collective effort to address the social and fiscal challenge.

- Constitutional and related issues of national unity tend to trump substantive, functional policy issues;
- Regional distribution of costs and benefits trump other debates on redistribution;
- Fiscal and financial issues trump debate on social policy;
- Intricacies of intergovernmental negotiation trump citizen understanding and politics; and

- Governmental self-interest in seeking to avoid and transfer blame trumps the willingness to share it.

Simeon then elaborates on each of these "trumps," drawing from our past experience, current realities, and future prospects. Compounding all of this is the fiscal burden. Our experience with political federalism has largely been in the context of an expansion of government activities. Now we are embarked on a "federalism of hard times," in which downsizing, restructuring and the avoidance of blame elevate further the power of the respective "trumps."

Is there a way out? One model that Simeon considers, but later rejects, is a version of Breton's competitive federalism, according to which governments act unilaterally in response to economic and social problems. In this model, Ottawa can transfer deficits to the provinces and the provinces react with a wide variety of program changes, restraint measures and increased taxing and borrowing. However, this approach generates serious problems of social cohesion, as would a reliance on disentanglement and a return to a "watertight compartments" approach to federalism. In the final analysis, Simeon opts for a consultative, coordinated approach that recognizes the interdependence and shared nature of the issues, and would involve revitalizing the intergovernmental process and rebuilding the functional linkages between economic and social policy. But overall, Simeon remains more hopeful than optimistic.

In his comments, André Blais endorses many of Simeon's views, but comes away decidedly more optimistic. He sees considerable virtue in competitive federalism and the politics of crisis, which can and frequently do lead to major policy innovations. Indeed, Blais believes that there is a growing consensus among Canadians that the fiscal overhang requires spending cuts. Implicit in his comments is the suggestion that Ottawa can mobilize citizen support for cuts in transfers to provinces provided it also cuts spending in other areas. More generally, Blais offers the suggestion that the time may well be ripe for completely new systems based on principles that appeal to all Canadians.

FISCAL FEDERALISM: THE POLICY SECTORS

Part three directs closer attention to the individual social programs and their relationship with fiscal federalism. Carolyn Tuohy assesses the sources of change in health care, Judith Maxwell addresses the related challenges of postsecondary education and training, and François Vaillancourt deals with the complexities of our income security programs. Arching over these benefits provided directly to individuals is a set of transfers from Ottawa to the provinces: equalization, EPF, and CAP. Ken Norrie's contribution focuses on these

federal-provincial transfers, and the appropriate balance between them and direct federal benefits to individuals. Moreover, his chapter sparks a lively debate with his two commentators, and is therefore an appropriate launching point for this section.

Federal-Provincial Transfers. The thrust of Norrie's contribution is that the pre-1977 "balance" or compromise between individual equity and provincial equity is in the process of unravelling. Norrie's solution is for Ottawa to play a greater role in the pursuit of individual equity. This strategy has merits in its own right, but Norrie believes that it will also foster political support for the maintenance of a generous equalization program and therefore of inter-provincial equity as well. This sparks a fascinating debate with David Milne, whose commentary adopts the opposite view.

Norrie develops his conclusion on the basis of a historical and philosophical review of the evolution of federal-provincial arrangements. Before 1977, the equalization program focused on equalizing provincial revenues and therefore achieving regional equity, while the shared-cost programs were designed to provide minimum levels of essential services to all Canadians in the name of individual equity. In Norrie's view, the "curious hybrid of measures" adopted in the 1977 EPF arrangements marked an important watershed. The tax-transfer component of the new EPF arrangements could be seen as enhancing accountability; but the cash-transfer component, unconditional as it was, lacked any rationale, especially after the 1982 arrangements made it the residual element. Since then, a long series of shifts have eroded both the integrity of the fiscal arrangements and the ability of the federal government to sustain a generous system of intergovernmental transfers.

In searching for solutions, Norrie first considers completing "what we apparently set out to do in 1977 with EPF," namely making EPF and CAP truly unconditional by converting them into further tax-point transfers and embarking on an enhanced equalization program. However, he rejects this devolutionist approach because, among other things, he does not believe that either Ottawa or Canadians generally would long support such large transfers on a purely unconditional basis, that is, without guarantees that programs supporting individual equity would be maintained. Hence, Norrie is driven in the direction of a larger role for Ottawa in providing individual equity directly. Medicare, where interprovincial spillovers are less, would be devolved to the provinces with enhanced tax room, but funding for postsecondary education and CAP would take the form of federal vouchers, and some version of a refundable tax credit for low-income Canadians. With such anchors securing individual equity,

Norrie believes that Ottawa would also have the political support to pursue interregional equity through a generous equalization program.

Norrie's strategy is reflected by two commentators, although for different reasons. David Milne objects primarily because of his assessment of the political implications. At the "mega-constitutional" level, Milne argues that the federal unilateralism implicit in the approach would be ill-timed given the forthcoming Quebec election and a possible referendum on sovereignty. At the program level, he feels that converting the federal contribution to Medicare into an unconditional tax-transfer is a non-starter because Canadians want to preserve a federal role in defending national goals in health care. More generally, Milne does not agree with Norrie's concern that Ottawa has lost visibility in terms of programs such as social assistance. In general, the "complex interdependence" of the current system is unlikely to give way to strategies for direct federal delivery and disentanglement. According to Milne, the inevitable messiness is best handled by improved institutions for intergovernmental coordination and decision making: "our success or failure in developing and perfecting these intergovernmental institutions and procedures will be a vital part of the story of Canada's unfolding fiscal crisis."

Hobson also rejects Norrie's approach, but on different grounds. He is concerned that reducing the role of intergovernmental transfers in the name of disentanglement and direct federal delivery would increase fiscal disparities between rich and poor provinces. He makes this argument for each component of Norrie's strategy: devolution of full financial responsibility for health care to the provinces, along with the transfer of associated tax room, would erode interprovincial equity; the withdrawal of the federal government from CAP and the introduction of a new federal income-security program would still leave provinces responsible for a residual program of social assistance, with poorer provinces facing greater needs and fewer resources with which to respond; and a shift from the postsecondary component of EPF to educational vouchers would have similar effects. In general, Hobson recommends retaining the existing framework of federal-provincial transfer programs, but making a number of changes to enhance interprovincial equity. The debate between Norrie and his commentators, Milne and Hobson, thus effectively highlights two very distinctive approaches to the future of fiscal federalism in Canada.

Health Care. Health care holds a special place in Canadian political culture, and intense debate swirls around the importance of the federal role in preserving the essential principles of Medicare. The chapter by Carolyn Tuohy investigates these issues by asking a broader question: will the 1990s be "an epoch of fundamental structural change in health care," or will we see a continuation of

normal political struggles over incremental change in the distribution of resources within existing programs and institutions.

Tuohy argues that structural change in the health-care system almost always results from "exogenous factors" rather than from powerful interests within the health delivery system itself. However, when episodes of major change are triggered by the broader political system, the resulting policy shifts are heavily influenced by the climate of policy ideas about health-care delivery. Using this basic model, Tuohy provides an insightful analysis of the development of Medicare, and the basic accommodations that were established between the government and private insurers, between the federal and provincial governments, and between the state and the medical profession.

In contemplating the future, Tuohy admits that there are pressures for structural change, and especially for a reduction in the federal role. She suggests that the Reform Party and the Bloc Québécois could play a role in decentralizing social policy "analogous to the role played by the NDP in centralizing it in the 1960s." These political dynamics could be reinforced by the fiscal crisis of the federal government, a general wish for disentanglement, and a desire on the part of provinces to protect themselves from unilateral federal decisions in the future. A decision by the federal government to withdraw from Medicare would create wider opportunities for structural change at the provincial level, and provincial experiments with market forces within a publicly-provided system could generate greater diversity in the types of coverage that Canadians enjoy.

However, Tuohy is sceptical that the future will unfold in this direction. She doubts that the federal government will abandon the Medicare field. More importantly perhaps, she does not believe that a federal withdrawal would, in fact, undermine the current principles that shape health care. Deep public support for the existing model, and the power of organized interests in the delivery system would constrain reform impulses. In fact, Tuohy anticipates a pattern of incremental change, with the greatest activity coming not in the form of user fees but in the de-insuring of some procedures, stronger clinical guidelines, and a growing role for local health authorities in the hospital sector. In the long term, such incremental shifts can become significant. De-insuring services, for example, would expand the scope for private insurance, and over time augment the role of private insurers in Canadian health politics. Nevertheless, for the foreseeable future, Tuohy does not see the politics of fiscal federalism triggering deep structural changes in Canadian health policy.

In his comments, Greg Stoddart presents a less sanguine view of the future, one characterized by "turbulence" and "an atmosphere of exasperation, if not desperation." However, fiscal federalism is implicated in only some of the stresses that he anticipates. For example, he foresees provincial efforts to

introduce fees purely to raise revenue, since the demand for health care is very inelastic. Clearly, such efforts would place great pressure on the *Canada Health Act*. Elsewhere, however, fiscal federalism seems less relevant. For example, Stoddart expresses frustration that clinical practice has not evolved in response to research findings about the range of medical procedures that are ineffective or inappropriate. But he calls on health science centres and the self-regulating colleges rather than the federal government to show leadership in moving the system towards "the effectiveness and efficiency frontiers." He also emphasizes the need for new institutions to develop a wider social consensus on which services are medically necessary, but anticipates change at the local level. Difficult decisions about which services will be provided to which groups may well be "dumped to the district or regional level through the creation of new decision-making bodies."

Stoddart is clearly not comfortable by a withering of the federal role. The public, he argues, "wants to preserve a sense (maybe even an illusion) of national unity or identity" through a federal role in health care; and he sees an important role for Ottawa in health promotion through preventive and developmental programs. Nevertheless, he does not seem to be particularly optimistic that the world will unfold in his preferred direction.

Education and Training. "More carrots, please" is Judith Maxwell's plea for education and training. Canada's economic future depends on its becoming a knowledge-based society, in which all citizens participate in a learning culture. However, a learning culture also requires continuous innovation, adjustment, and creativity on the part of educational institutions such as universities and colleges, a dynamic that needs to accelerate despite the decline in financial support from governments. Hence Maxwell's emphasis on stronger incentives to innovation in funding arrangements for educational and training programs.

In this context, Maxwell sees a clear role for the federal government as an agent of innovation. The basic problem, she insists, is that "the federal government has been writing cheques without specifying or monitoring the desired outcomes." Under her dietary regime of more carrots, the federal government would begin to use the leverage implicit in its funding. In the case of post-secondary education, she recommends that the federal government formally relinquish any political credit for the tax points transferred to the provinces, but then transform the remaining cash payments into a more strategic set of transfers: operating grants paid directly to universities, sponsored research grants, reformed systems of student support, and a University and College Innovation Program to reward institutions committed to change. In the case of training programs, the federal government should help to pay for the cost of

developing nationwide training standards, and offer to transfer federal activities in training to provinces that have a complete set of standards in place. However, the federal government should also cut funding for training programs in any provinces that are not making clear progress in developing and implementing such common standards.

Given the history of federal-provincial tensions over such strategies, Maxwell recommends abandoning constitutional symmetry and establishing separate arrangements with different provinces. She accepts that Quebec would opt out of the direct payments to universities, and that other provinces might follow suit. If that happens, however, she urges the federal government to insist on a strong innovation program that ensures that federal resources actually promote excellence. In the case of training, asymmetry in the delivery of programs is acceptable as long as common training standards act "as the force that binds the country together and maintains the viability of the economic union."

In his comments, Stefan Dupré supports this combination of assertiveness and asymmetry through his own proposal for "procurement federalism." He argues that Ottawa's capacity to purchase services should be used to reward quality in education and training systems. In the postsecondary education sector, he recommends using the cash portion of EPF to finance the full indirect costs of research that the federal government contracts for in universities. In the case of training programs, he hopes that business and labour representatives on agencies such as the Canada Labour Force Development Board (CLFDB) and the Ontario Training and Adjustment Board (OTAB) will insist that public education institutions face competition from private training schools. Procurement federalism is a potentially powerful instrument of federal assertiveness. For example, the proposal to shift EPF dollars, which currently go to provincial governments, into direct research payments to universities would certainly enhance Ottawa's role in this sector. In the case of training, however, Dupré softens this assertiveness by endorsing Maxwell's call for asymmetric federalism, including the transfer of the federal role in procurement and placement played by Canada Employment Centres to the province of Quebec.

Income Security. The income security sector combines major reform issues and complex intergovernmental relations, which are highlighted in the chapter by François Vaillancourt. The current agenda focuses primarily on income security for the employable population, which is delivered through a complex array of programs by the federal and provincial governments. Seen as a comprehensive system, these programs are bedeviled by differing benefit levels and design features that can inhibit training, mobility, and the transition from welfare to work. Vaillancourt is convinced that program integration and reform requires

greater consolidation of authority over unemployment insurance, workers compensation, and social assistance. "One government should be responsible," he argues. Given the distinctiveness of the labour markets in Quebec and the rest of the country, he also suggests an asymmetric response, with Quebec taking responsibility for the programs in that province but a federal agency serving the rest of Canada. Failing that, he suggests general decentralization to the provinces. One major advantage of such a shift, he argues, would be that provinces would have a stronger incentive to ensure that their minimum wages and labour legislation promote higher levels of employment. If decentralization is impossible, Vaillancourt would actually prefer direct federal delivery of income support to individuals, in this case through the abolition of CAP and the transfer of the resources to the Unemployment Insurance program to provide extended benefits for the unemployed.

Finally, Vaillancourt raises a much more radical approach in which existing income transfers would be replaced with a system of Individual Economic Security Accounts. These accounts would represent forced savings by individuals both for old age and for periods of unemployment. Governments, presumably at any level, would be able to contribute directly to an individual's accounts in order to fulfil their redistributive goals and avoid shortfalls. According to Vaillancourt, one of the advantages of such an approach would be to avoid the maze of intergovernmental complexity that characterizes the current system.

In her comments, Susan Phillips takes issue with many of Vaillancourt's recommendations, including his preference for individual savings accounts as opposed to social security. In the domain of fiscal federalism, she is particularly critical of proposals to devolve CAP and perhaps Unemployment Insurance to the provinces at a time when the Canadian economy is undergoing deep restructuring. In her words, "adjustment is predominantly a national issue, and labour markets are becoming more national, not more local." Devolution risks foreclosing the opportunity to focus on the larger forces reshaping the Canadian economy. Concern for gender equity reinforces Phillips opposition to the devolution of CAP. Arguing that a national child-care program is essential to a comprehensive system of family income support, she fears that "if we devolve CAP to the provinces now, it is unlikely that there will ever be a national child-care strategy." Phillips is also sceptical of proposals that would separate support for children from social assistance, with the federal government using CAP dollars to expand child benefits paid directly to families, and the provinces focusing on the welfare needs of adults. Such proposals, she argues, ignore the "social ecology" of family life; the best way to help poor children is "to improve the income, training, and employment prospects of their parents."

Phillips also raises a general issue about the approach to interregional transfers in the Canadian system. Noting that poverty is increasingly an urban phenomenon, concentrated in major metropolitan regions such as Toronto, Montreal, and Vancouver, she argues that the problems of cities need far greater attention. Because our system of fiscal federalism is designed to respond to provinces, not cities, a reconceptualization of the principle of interregional sharing and associated programs is essential. Given the location of the major metropolitan centres, such a shift in emphasis would have radical implications for the system of transfers developed in the last half-century.

A COMPARATIVE PERSPECTIVE

The next section of the book examines Canada's fiscal federalism from a comparative perspective. Richard Bird's chapter surveys the experience of seven developed countries (Austria, Germany, Belgium, Switzerland, Australia, the United States, and Canada) and two developing countries (India and Brazil). His analysis shows that all federal systems face a similar set of issues in designing their fiscal arrangements: the need to redress the "vertical imbalance" between the revenue-generating capacity of the central government and the expenditure responsibilities of the constituent governments; the need for equalization to correct the "horizontal imbalance" of fiscal capacity and expenditure need generated by economic disparity across the units in a federation; and the need for tax coordination among the central and constituent governments. Bird's survey demonstrates that while there is indeed a menu of choice in the experiences of other federations, choosing solutions from abroad needs to be done carefully with due concern for the overall context of the political system. Formulae for fiscal transfers, for example, will be "always and inevitably political," and attention to the rules and process for political decision making in other federal systems is more productive than examining the actual results achieved.

These conclusions are reinforced in Ronald Watts' commentary on Bird's analysis. Watts finds that comparative analysis is undervalued in Canada, arguing that it can be useful in terms of seeing not only what might work better at home, but what would not. The political context of other federal systems is also crucial to effective comparisons in Watts' view. For example, solutions designed to work in a congressional system of separated powers as in the United States or with a distribution of powers that is largely concurrent as in Australia may not work in the Canadian case of a parliamentary federation with a more exclusive division of powers.

Taken together the two contributions raise some important issues about the substance and process of fiscal federalism in Canada. Bird argues strongly that those who would restructure revenues and expenditures to more closely match the two may be on a fool's errand, that all federal systems have a degree of "vertical imbalance" and that in parliamentary federations accountability for expenditures through the legislature means that the fiscal gap need not entail fiscal irresponsibility. On the equalization side, Bird reminds us that regional sharing in federations is more a matter of political values than of economic necessity, and that the important thing is a credible process rather than any specific formula. Bird's chapter hints at, but does not explore in depth, the significance of an asymmetrical approach to tax coordination and harmonization. Canada already presents one of the world's leading examples of such an approach in the differing arrangements for Quebec in tax collection and revenue sharing. How far can such a trend go? The evidence would appear to be that federal systems tolerate considerable asymmetry.

On the process side, Bird and Watts both indicate that there are effective models abroad for improving the intergovernmental machinery to reach political accommodation on fiscal federalism. If, as Watts notes, fiscal relations in Canada are due for a "big bang," are our intergovernmental institutions capable of delivering? The chapter by Simeon and the commentary by Milne cast doubt on the ability of the system to deliver radical results in Canada. Elsewhere coordination is achieved effectively through formal institutions such as Germany's Bundesrat. Given the defeat of the Charlottetown Accord, constitutional amendments to improve coordination on fiscal matters in Canada are not feasible. However, other devices, such as Australia's Commonwealth Grants Commission or India's Finance Commissions might be more readily adapted to Canadian use without constitutional amendment. In any case, Bird, as would Watts, encourages Canadians to continue to examine the underlying political dynamics in other federal systems to understand the preconditions for successful political processes here.

BIG BANG OR QUIET TINKERING

The final section of the book addresses explicitly an issue that emerges earlier in less explicit ways. Is our system of fiscal federalism now so irretrievably flawed that only comprehensive and radical reform will equip Canada for the years ahead? Or, is the basic structure of federal-provincial fiscal agreements essentially sound, and in need of only incremental adjustments to changing circumstances? Are we in for a "Big Bang" or merely "quiet tinkering"? Four commentators address these questions in different ways.

Peter Leslie is convinced that the system indeed needs reform, and thus is not content to characterize the coming process as "quiet tinkering." He prefers the metaphor of "big bang" or — perhaps better — of a "controlled nuclear reaction." Pursuing this latter metaphor, Leslie surveys three risks that must be controlled. The first is the obvious risk to those Canadians directly dependent on the benefits of social programs. To reduce the harm to the beneficiaries, reform must be slow but steady, he argues, and should proceed on the basis of clearly articulated objectives both in terms of the policy goals and fiscal targets. The second risk is deadlock. To avoid this danger, in his view, it is essential to put as many issues as possible on the negotiating table in order to allow maximum room for trade-offs. This has the side risk, of course, of courting agenda overload. The third risk is a familiar one: that of pursuing reform that is neither decentralist enough for Quebec or symmetrical enough for the rest of Canada. Leslie argues for contingency plans to head off the extreme demands on both sides. In particular, he argues for a pre-emptive strike by the federal government to call the bluff of some Quebecers by proposing as one option dramatic asymmetry, whereby Quebec would be responsible for social security but would not receive equalization. Faced with a choice between this option and a more modest asymmetry, Leslie is confident Quebecers will choose the latter, or at least make a more informed choice.

Robert Normand is less sanguine on the prospects for major reform, for a number of reasons. First, in his view it is almost impossible to reform social programs in a period of high unemployment when the recipients feel most vulnerable. Second, he does not interpret the results of the 25 October 1993 federal election as giving a mandate to the Liberals to make major changes that the Conservatives had promised. Third, the fiscal crisis itself allows little room for tinkering; and fourth, the regionalization of the parties in Parliament reduces the ability to reach accommodation. Finally, Normand sees Canada caught in a vicious circle: the federal system is in a mess because we cannot fix anything; and we cannot fix anything because the system is in a mess. In summary, he foresees the usual federal-provincial tug-of-war producing little by way of change. His own prediction is that change will come in the form of federal and provincial legislation to limit budgetary deficits along the lines of the Gramm-Rudman Bill adopted by the U.S. Congress. He also proposes a constitutional amendment to make the process of public borrowing more transparent and more difficult.

Katherine Swinton dwells more extensively on process issues in any reform attempt. Unless public interest groups have a role in the process, she is convinced that governments run the risk of massive failure, as in the case of the Charlottetown Accord. In light of that example, she does not give much chance

to any reform package that would seek to amend the constitution formally any time soon. In addition, the traditional flexibility and adaptiveness of the constitution which enabled much of the welfare state to be constructed in the first place may now also be constrained by the fiscal limits to the federal spending power, although Swinton does not completely count out reform which hinges on its use. An even more constraining aspect may be the politics of rights — in particular the heightened tendency of interest groups to seek redress through the courts to force the hand of reluctant governments. While litigants have no guarantee of success, Swinton foresees an increase in litigation to force provincial governments to adhere to federal conditions such as those in the *Canada Health Act*, and to extend entitlements through Charter cases and recourse to international covenants. In any case, Swinton warns that a reform process confined to “executive federalism” will not produce public support, and calls for a more open process, and broad public education and debate of the issues.

Finally, John Richards argues for a specific approach to reform. He insists that if the welfare state is to survive, public sector decisionmakers must have the discretion to redesign and restructure programs, including how they are delivered within the public sector. In his view, one of the key obstacles to this flexibility is public sector unions. He goes on to argue for balanced aggregate federal-provincial finances, within a four-year time frame. This can be achieved only by substantially reducing the numbers of persons on the public sector payroll, or the levels of compensation, or both. Moreover, the greatest need for cutbacks is at the provincial and municipal levels, and the federal government should play its role in triggering this process by accelerating the reduction in cash transfers to the provinces.

IN SUMMARY

A number of threads run clearly through the chapters and commentaries in this book, often reflecting the wider public debate over the future of Canada's social and fiscal programs. First, there is widespread agreement here that the status quo is no longer viable. The prescriptions for reform vary widely, but few of our contributors believe that the existing set of programs can meet the needs of Canadians for the rest of this century, let alone the early years of the next.

Not surprisingly, this broad consensus begins to dissolve, however, when attention shifts to prescriptions for change. In the first place, there is debate about the scope and speed of change. On one side are those who see the need for reform or whose analysis points strongly to major change, and who take the view that we must simply “do it.” On the other side are those who may share some sense of the urgency but are more pessimistic about the ability of the

system to produce change. The debate between Norrie and Milne is an obvious example, but the dichotomy runs through the book more generally. Boadway and Flatters, Courchene, Maxwell, Vaillancourt, Leslie, and Richards also call for determined change, while Simeon, Tuohy, Forget, Normand, and Swinton tend to emphasize the constraints. It is hardly coincidental that in this book it is economists who tend to be optimistic about change, and political scientists and former practitioners who are most sensitive to the constraints. However, this tension undoubtedly reflects a current dilemma of Canadian politics. For many, the need to restructure the role of government and its institutions and programs is clear, but the vested interests in the status quo and the dysfunctional aspects of current institutions and processes get in the way of solutions.

There are also differences in the direction of change charted by our contributors. It is notable, however, that there is substantial support for an active role on the part of the federal government. For some contributors, such as Boadway and Flatters, Milne, Hobson, Stoddart, and Phillips, this activism takes the traditional form of national standards in shared-cost programs. However, there is also considerable interest in direct federal delivery to individual citizens of benefits now funded through federal-provincial programs. Norrie suggests this approach for postsecondary education and income security, although not for health care; Maxwell and Dupré agree for postsecondary education and training; Courchene concurs for child benefits and perhaps postsecondary education; and even Vaillancourt recommends shifting resources from CAP, a shared-cost program, to Unemployment Insurance, an exclusively federal program, if his first choice of decentralization proves impossible. In contrast with this enthusiasm for different forms of federal activism, only Vaillancourt envisages a broad decentralization. This balance undoubtedly reflects the selection of contributors to the book. Nevertheless, it is a reminder that, despite the seemingly overwhelming constraints on the federal government, there are still strong expectations that Ottawa has an active role to play in responding to the economic and social problems that we face.

Another striking thread running through many of the contributions to this book is the acceptance of asymmetry in federal-provincial relationships. For Courchene, asymmetry is the appropriate response to diversity in the pattern of economic and social problems that the regions of Canada confront; but for others, such as Vaillancourt, asymmetry is primarily a response to the distinctiveness of Quebec. Interestingly, several advocates of direct federal delivery, such as Maxwell and Dupré, accept asymmetry as a concomitant of federal activism, although the precise modalities are not worked out here. Their approach undoubtedly reflects the tensions implicit in the wider political economy of Canadian life.

The agenda for the reform of fiscal federalism is clearly a daunting one. As several commentators noted, in an earlier era the issues involved would have been managed — amicably or otherwise — after some months of closed-door intergovernmental negotiation. This agenda, however, coming as it does after the failure of Meech and Charlottetown, and after the scarring effects of the debates over free trade, will not be confined to the backrooms of executive federalism. Too much is at stake for Canadians and for governments alike. The current debate represents a significant opportunity for a new, more open style of politics to respond to issues that touch the core of social Canada. This book is dedicated to the proposition that debate about these issues and opportunities is critical to that process.

PART TWO

OVERVIEWS

CHAPTER TWO

Fiscal Federalism: Is the System in Crisis?

Robin Boadway and Frank Flatters

INTRODUCTION

Canada has one of the most highly developed systems of federal-provincial fiscal arrangements in the world. The essential form of these arrangements has remained unchanged now for several decades. In the meantime, the substantive structure of the federation has undergone major changes, especially in recent years. Put simply, ours has become one of the more decentralized federations. The issue to be addressed in this chapter is whether the current system of federal-provincial fiscal arrangements, which took shape at a time when the federation was much more centralized than it is now, meets the needs of the federal system that we have today. To the extent that this is not the case, we wish to ask how the arrangements might be revised or overhauled.¹

The term "fiscal arrangements" covers a wide variety of possible dealings between the two levels of government. Our concern will be mainly with two general types of federal-provincial interactions — transfers and tax-sharing arrangements. We do not deal with other forms of economic relations, such as direct regulation of provincial activities by the federal government (which, unlike many other federations, has not been a feature of the Canadian system), or methods of coordinating federal and provincial activities in areas of shared jurisdiction (such as agriculture and immigration), except to the extent that they have implications for financial transfers. This does not preclude investigating possibilities for shared or cooperative decision making over the forms of financial transfers or tax sharing; indeed, in some cases that is almost a necessary outcome.

The chapter proceeds as follows. We begin the next section by outlining our views of the economic role of federal-provincial fiscal relations in a relatively decentralized federation. This will form the basis against which the existing and alternative arrangements will be judged. Next, we recall some of the ways in which the Canadian federation and the fiscal arrangements have evolved over the postwar period. Of particular importance will be three areas in which significant changes have occurred — the relative responsibilities of the two levels of government, the constitution and its interpretations, and federal policy initiatives which have had an impact on federal-provincial fiscal relations. Then we outline some of the main problems with the existing arrangements, as seen by ourselves and by other observers. Finally, we consider options for addressing these problems, some of which have been advocated in the recent literature or in public debate. We stress throughout that the system must be viewed in its entirety since the various components jointly contribute to the objectives of the system as a whole.

Our intent is to present the alternatives in a more or less objective way, although undoubtedly our own biases will creep in. The hope is that the chapter will put some of the key issues into context and serve as a useful background for the more detailed topics to follow in the book.

THE ECONOMIC ROLE OF FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

The role of federal-provincial fiscal relations depends jointly on the responsibilities that governments at each level are expected to assume, and on how these duties should be divided between levels of government. On neither of these questions is there likely to be strong consensus in Canada. Broadly speaking, those who see a large role for government in addressing the inefficiencies and inequities of the market are likely to expect a great deal from the federal government and to see the system of fiscal relations as an important policy instrument.² On the other hand, those who prefer less rather than more intervention by government (say, because they take a cynical view of the efficacy of the public sector, or because they put a low value on equity objectives) are more likely to be content with a highly decentralized federation and a relatively small role for federal-provincial fiscal arrangements. In outlining the economic role of federal-provincial fiscal arrangements in a decentralized federal economy, we leave these as open questions.

The economic case for government intervention is based on equity and efficiency considerations and the failure of the market to attain these goals. We need not review the familiar arguments for and against government interven-

tion. What is relevant here are the particular efficiency and equity issues that arise in a federal economy, and the roles of the federal and provincial governments in addressing them.

Efficiency Issues in a Federal Economy

An efficiently operating economy is one in which the "gains from trade" are exploited to the fullest. A federal system of government gives rise to a number of additional sources of inefficiency which differ from the standard, textbook types of market failure that occur in a unitary state. There are three in particular that are most relevant for our purposes.

Efficiency of the Internal Common Market. To ensure that resources are allocated efficiently across the federation, it is necessary that goods, services, labour, and capital be able to move freely across internal boundaries, and that the market signals which guide these movements not be distorted. In a decentralized federation, there is considerable scope for provincial taxes, expenditures, and regulations to have distortionary effects on the interprovincial allocation of resources.³ These distortions can be the incidental effects of provincial policies directed at some other goals, or they might result from policies that are deliberately designed to affect the interprovincial allocation of resources. In the first category, differential tax policies and service provision will almost inevitably distort the allocation of resources, especially those that are mobile like capital and some types of labour. In the second category, provinces may attempt to use tax and expenditure policies to attract factors of production to their jurisdiction.⁴ Such "beggar-thy-neighbour" policies can give rise to inefficiencies in the internal common market even if all provinces engage in them to the same extent. The maintenance of an efficient internal common market is an important policy objective of the federal government.

Decentralization of Service Delivery. A key issue in any federal economy concerns the degree of decentralization of the provision of goods and services in the public sector. Many economists take the view that decentralization is a valued objective in itself, and ought to be the rule except for specific cases in which there is a sound argument for centralized delivery of a specific public service. This view is based on the notion that decentralization leads to more responsiveness to local preferences and needs, greater political accountability, more efficient administration, induced efficiency through interjurisdictional competition, and greater program innovation. Central provision is called for only in the case of "national" public goods and significant scale economies.

Thus, public goods that serve a local or regional need are best decentralized to the provinces or their municipalities.

A significant proportion of the goods and services that governments provide take the form of *quasi-private* goods and services, that is, goods and services that are private in nature but which are provided through the public sector, typically free of charge. Examples include education, health services, and welfare services. Public provision of these types of goods and services is typically justified on grounds of equity or social insurance, since there is no apparent market failure reason why the private sector could not provide them at least as efficiently.⁵ There would seem to be, at best, a very weak case for providing quasi-private public services at the federal level; most economists would argue for decentralized provision. The efficiency argument for federal involvement would have to rest on the existence of significant spillover benefits from provincial activities in these areas. Such spillovers of benefits from the expenditures in one province to the residents of others, if uncorrected, could lead to inefficiencies of provision as well as inefficiencies in the allocation of resources across the federation. Transportation and medical services in one province will benefit travellers from others. Welfare and educational services may benefit persons who are only temporarily in a province. Recognition of this may induce provinces to impose residency requirements which restrict the mobility of labour across provinces, or to tailor their programs to preclude residents of other provinces from migrating to take advantage of them. Thus, there may be national efficiency consequences arising from the decentralized provision of public goods and services which the federal government has an interest in addressing, even though it is not responsible for their provision.

More important for our subsequent discussion is the fact that these quasi-private services fulfil an important equity role in the economy; indeed, they constitute perhaps the main instruments of redistribution available to governments. The discussion of the appropriate federal role in their provision, therefore, might hinge, not primarily on efficiency arguments, but rather on questions of the assignment of responsibility for equity goals. Is vertical equity a matter of national or local concern? Is the reference group for equity considerations the residents of a province or of the entire country?

Fiscal Inefficiency. A final source of inefficiency in a federation that has received considerable attention in the literature derives from the notion of fiscal inefficiency.⁶ The idea is that as expenditure and tax responsibilities are decentralized, jurisdictions end up with different abilities to provide public goods and services to their residents.⁷ This is because they have different tax capacities, and because they have different needs for public expenditures. The

consequence is that provinces are able to provide different *net fiscal benefits* (NFBs) to their residents. The literature has tended to focus on two main sources of NFB differentials (see Boadway and Flatters 1982a). First, differences in source-based tax capacities, such as natural resource endowments, allow different provinces the ability to finance a given level of services at different tax rates. The second source of NFB differentials, which is perhaps less transparent, is that provinces that provide more or less equal per capita service benefits, but finance them with taxes on their residents that are roughly proportional to incomes, provide NFBs that differ across provinces in proportion to residence-based tax capacities. The upshot is that a person of a given income will receive systematically higher NFBs in provinces with higher source-based and residence-based tax capacities.

Differences in NFBs will give an incentive for persons to migrate from low NFB provinces to high NFB provinces; to the extent that they respond, this will result in an inefficient allocation of resources. This provides an efficiency argument for the federal government to take action to eliminate these NFB differentials, a role that will be important in our later discussion. Available evidence suggests that this source of inefficiency may not be empirically very significant. Therefore, the efficiency case for federal government action to reduce or eliminate interprovincial NFBs might not be too compelling.⁸ However, as we shall see, the efficiency argument for eliminating NFB differentials can be supplemented by an equity argument.

Equity Issues in a Federal Economy

Much of what governments do addresses primarily redistributive concerns, whether for purely ethical reasons or for more cynical motivations related to political expediency. Therefore, one's view about the role of government in the economy, the degree of decentralization of public sector decision making, and the structure of fiscal arrangements will depend heavily upon one's sense of the importance of redistributive equity as an objective of government policy and one's opinion about how closely government behaviour conforms to benevolence as opposed to expediency. Unfortunately, persons will come to different conclusions about both the properties of society's "social welfare function" and what actually motivates government behaviour.

Two main equity issues arise in federal economies. The first concerns the notional assignment of responsibility for equity; the second concerns the special problem of fiscal inequity which, like fiscal inefficiency, arises whenever budgetary functions are decentralized.

Responsibility for Redistributive Equity. The case for the federal government's assuming a major role in redistribution has a long history in the literature (see Musgrave 1959) and is based largely on normative considerations. The main argument is simply that everyone in the nation ought to "count" equally in the social welfare function; this is taken to be a fundamental implication of citizenship. The relevant social welfare function is considered to be a national one. A second argument is that, because of interregional mobility of factors of production, too little redistribution will be carried out at subnational levels. This is simply an application of the spillovers argument referred to above.

On the other hand, those who argue that responsibility for redistribution ought to be at least partially decentralized do so on two main grounds. The first is that there may be regional preferences for redistribution, or differences in local aversion to inequality, and provinces ought to be allowed to reflect such differences. Lower level governments are felt to be "closer to the people" and hence better placed to meet the particular needs of the poor in their jurisdiction. An extreme version of this argument is that the appropriate "sharing group" or the scope of the social welfare function encompasses only the residents of a province. This is more likely to be the case when provinces are characterized by strong and unique cultural identities. In such circumstances, there might also be far less interprovincial mobility of at least some factors of production, which will also make it easier for provinces to achieve redistributive objectives on their own. The second argument for decentralization of redistributive activities is based on the notion that governments engage in too much redistribution to suit the observer, possibly because much of it is motivated by non-normative concerns. To the extent that resources are interregionally mobile, decentralization will restrain the amount of redistribution undertaken because of competition among jurisdictions and because of economic limitations in the ability to redistribute at lower levels of government.⁹

Of course, this argument is partly an empty one since it is not possible to assign responsibility exclusively to one jurisdiction or another. Virtually everything governments do has redistributive consequences, and that cannot be avoided. Nonetheless, the degree of decentralization of redistribution can be influenced by the extent of decentralization of other functions. In particular, if it is felt that the federal government should play an important role in redistribution, then it should be given access to the policy instruments that are most effective at achieving these goals. This certainly includes direct taxes and their analog on the expenditure side, transfers to individuals. However, as we have mentioned, much redistribution takes place through the provision of quasi-private goods and services, and these are rightly assigned to the provincial level of government on efficiency grounds. To the extent that the federal government

has an interest in redistributive equity, therefore, it can only exercise that influence indirectly through its spending power.

Fiscal Equity. The argument for fiscal equity parallels that of fiscal efficiency encountered earlier.¹⁰ In a decentralized federation, provinces will be able to provide different levels of NFBs to their residents. This implies that horizontal equity is violated — otherwise identical persons will be treated differently by the public sector according to the province in which they reside. This is a particular feature of a federation; it will not arise in a unitary state. As with fiscal inefficiency, a federal government which has an interest in national equity will wish to take remedial action to undo these NFB differentials. How that is done is of major consequence to the design of fiscal arrangements. The extent of remedial action that will be required of the federal government to deal with fiscal inequities of this sort will depend on both the degree of variability of fiscal capacities across provinces, and the extent to which fiscal responsibilities are actually decentralized to provincial governments. A federation in which provinces are very homogeneous in their fiscal capacities, or in which provinces have very few fiscal responsibilities is one in which problems of fiscal equity will be of very little significance.

Given these particular issues of efficiency and equity which arise in a federal economy, and which become more important the more decentralized the federation is, what do they imply for the structure of fiscal arrangements? We discuss in sequence the role of intergovernmental transfers and the harmonization of the tax system.

The Role of Federal-Provincial Transfers

The need for intergovernmental transfers arises because of both the various inefficiencies and inequities that arise in a decentralized federation, and the possible imbalances in expenditure responsibilities and revenue raising capabilities. The literature has stressed the following arguments for transfers.

Vertical Fiscal Gap. In virtually every federal economy, the highest level of government collects more revenue than it needs for its own purposes and transfers some to the next level.¹¹ There are two reasons for this. First, the arguments for decentralizing expenditure responsibilities are much more compelling than for decentralizing taxation. The decentralization of taxation gives rise to inefficiencies in the internal economic union and reduces the ability of the federal government to pursue its equity goals.¹² Second, and perhaps more important, a vertical fiscal imbalance is a prerequisite for the federal government to be able to implement a system of grants to achieve the goals of

efficiency and equity in the federal economy. The optimal amount of vertical fiscal imbalance depends on two counteracting forces. On the one hand, a greater imbalance facilitates the role of the federal government in achieving national objectives and enhances the ability to decentralize expenditures to the provinces. On the other hand, the greater the fiscal gap, the less will be the reliance of the provinces on their own sources of revenue, and hence the less may be their degree of political accountability.

Fiscal Efficiency and Fiscal Equity. A key role of federal-provincial transfers is to eliminate, or at least reduce, the NFB differentials which generate fiscal inequities and inefficiencies across provinces; and this role is more important the more decentralized is the federation. This is an interesting instance in economic policy analysis in which efficiency and equity arguments coincide. The importance of these arguments in the Canadian case is substantiated by section 36 of the *Constitution Act, 1982*, which sets out the broad obligation of the federal government to provide equalization so that provinces can offer comparable levels of public services at similar levels of taxation.

The usual prescription is for a set of unconditional transfers that equalize differences in tax capacity across provinces, but which are unrelated to individual provincial behaviour per se, such as tax effort or actual service provision (see Economic Council of Canada 1982). One way to think of the ideal equalization scheme is as one that essentially replicates the financial setting of a unitary state, while at the same time allowing for the benefits of decentralized decision making. In principle, one might also want to take need differences into account.¹³ However, it is not at all clear how this could be done properly; nor is it clear that it would make enough difference to be worthwhile. An exception to this might be differences in the need to make transfers (i.e., negative taxes) to low-income persons (Breau Committee 1981). NFB differences arising from this source could be significant across provinces, and could be taken account of by the system of equalizing transfers.

It might be argued that the elimination of NFB differentials could be accomplished by a system of transfers to persons that differed according to province of residence. In principle, there is an equivalence between federal-provincial equalizing transfers and transfers to individuals. However, there is one substantive difference between them: for the provincial public sectors to be equally well off financially, some would have to impose higher taxes on their residents. On the one hand, this has the advantage of imposing more fiscal discipline and accountability on provincial governments. However, on the other, it has the disadvantage of decentralizing the tax system and inducing inefficiencies and inequities on that account.

Interprovincial Spillovers. This is a traditional argument for federal-provincial shared-cost programs. If a province's expenditures give rise to benefits to residents of other provinces, the absence of an incentive to take account of the spillover benefits may be expected to give rise to too low a level of provision. The analog is with externalities in private markets. The remedy is for the federal government to provide the correct incentive by an appropriate matching grant. While this argument is logically correct, it is not clear that it justifies the 50-50 matching grants that have been used in the past. While there are undoubtedly spillover benefits from the provision of welfare expenditures and health insurance programs by each of the provinces, it is unlikely that they are anywhere near the order of magnitude that the matching formula would suggest. The high matching rate may have a better justification as a means of taking differential needs into account across provinces by basing them on actual expenditures. Unfortunately, the adverse incentive effects of doing this are quite high.

Expenditure Harmonization: National Standards. One of the most important reasons for federal-provincial transfers, and one that has been less recognized in the literature, has to do with the fact that in a decentralized federation, the federal government may retain a legitimate interest in the overall design of some provincial expenditure programs for reasons of national efficiency or equity. Again, the more decentralized the federation, the more important this role of transfers might be. This can be accomplished by the exercise of the spending power. The economic justification for using the spending power is that there are national objectives that can be attained by encouraging provinces to incorporate particular federally-defined standards into some of the expenditure programs under their jurisdiction, standards that they would not necessarily have an incentive to meet on their own initiative (but that collectively they might agree with).

There are two main sorts of national objectives for which the spending power might be used. The first concerns the efficiency of the internal economic union. Thus, use of this power to ensure portability or accessibility provisions in provincial programs contributes to the free movement of labour across provinces. The second concerns the federal interest in national equity objectives. Given that a good deal of redistribution is delivered through the provision of public sector goods and services, and that a good deal of this is delivered by the provinces, the spending power is the only instrument by which the federal government may attempt to have national equity standards incorporated into these programs. The use of the spending power to require that certain provincial public services are comprehensive and available to all persons are examples of this. Interprovincial competition could well compromise national standards of

equity. The emphasis one puts on the use of the spending power for this purpose will depend upon one's view of the federal role in redistribution.

The exercise of the spending power will require conditional grants, although not matching ones. Given that the conditions may be quite general, the grants could be block grants. It is naturally a matter of judgement as to how extensively the spending power should be used and what sorts of political or constitutional limitations should be placed on its use.¹⁴ The ability to use the spending power in a sense increases the case for decentralizing the provision of public goods and services, since it allows the benefits of decentralization to be achieved without unduly compromising national efficiency and equity. By the same token, the more decentralized the federation, the more important does the spending power become.

In summary, in a decentralized federation, such as that of Canada, federal-provincial transfers play an important role. They allow expenditures to be more decentralized than revenue raising. They allow the federal government to correct the inefficiencies and inequities that result from the fact that decentralization would otherwise lead to differing levels of NFBs across provinces. And, they allow the federal government to exercise some influence over the way in which the provinces design their programs so that national interests are taken into account. Thus, federal-provincial transfers allow decentralization to be done in a way that achieves its benefits without compromising national efficiency and equity goals.

Tax Harmonization and Coordination

Just as the decentralization of expenditures gives rise to inefficiencies and inequities in the federation, so does the decentralization of revenue-raising responsibilities. Therefore, the assignment of tax sources, the division of tax room, and the design of mechanisms for harmonizing taxes should be done so as to allow the benefits of revenue decentralization to be achieved with minimal violation of national efficiency and equity norms.

The principal reason for revenue decentralization is to give the provinces some fiscal responsibility for financing their own expenditures. There are a number of other subsidiary roles that are sometimes alluded to. It allows the provinces to exercise some influence over redistribution and over the tax mix used to satisfy local preferences. It allows them also to use benefit taxation where that may be appropriate (for example, in financing roads out of gasoline taxes or financing health care out of tobacco and alcohol taxes). It may also allow for some coordination between the tax system and certain forms of provincial redistributive expenditures, such as the welfare system.

The main objectives of tax harmonization are threefold. The first is the achievement of efficiency in the internal common market. Differential tax policies across provinces can lead to distortions in the interregional allocation of resources, to wasteful tax competition among provinces, and to excessive use of private sector resources (especially accounting, and financial and management resources), to comply with different tax regimes, and to avoid taxes in high tax jurisdictions. The second objective is national equity, although this is likely to be more contentious. Tax competition can reduce the redistributive content of the tax system, and this may be viewed by some as a disadvantage. As well, different redistributive policies across provinces may detract from national equity goals. This returns us to the question of the appropriate sharing group for the design of redistributive policies. The third main argument for tax harmonization is ease of administration. A harmonized tax system can reduce collection and compliance costs as well as reducing avoidance and evasion.

The goals of tax harmonization can be achieved in a variety of manners. The way in which tax sources are assigned to the two levels of government is important. The general consensus in the economics literature is that the best system is one in which taxes applying on more mobile tax bases (especially capital income) and taxes better able to serve redistributive goals are more centralized.¹⁵ This is generally taken to suggest that taxes on corporations should be highly centralized, followed by taxes on income, and then by general sales taxes, excise taxes, and finally taxes on property.¹⁶ Resource taxation is an interesting case, and one which is relevant for Canada. Since resources are geographically fixed, the efficiency argument for centralizing them is very weak. On the other hand, given the unequal distribution of resources across the federation, decentralization of resource taxes is also likely to lead to significant fiscal inefficiencies and inequities, and to have implications for equalization.

Tax harmonization can be achieved either by assigning to the federal government those bases for which decentralization is very costly, or else, in cases where bases are decentralized or co-occupied, by explicit agreement among governments.¹⁷ In general, however, harmonization is more likely to be achieved for a given tax base the greater is the share of tax room that is occupied by the federal government. In Canada, all major tax bases other than resource and property taxes tend to be co-occupied.¹⁸ Given the extent to which revenue raising is decentralized to the provinces, the federal government cannot be dominant in all of these tax bases. A decision must be made as to which one(s) to dominate. The above arguments would suggest that it is more important to be dominant in the direct than in the indirect tax fields.

With co-occupied tax bases, agreements to harmonize can take a variety of forms. They can be agreements on the base alone (including the allocation of

the base among provinces), or on the base and various dimensions of the rate structure. The agreements may or may not include provision for a single tax collecting authority or for collaboration in the auditing function. From the point of view of administrative simplicity, the advantages of a harmonized collection system are many. However, a harmonized collection system need go no further than a single base in most cases.¹⁹ Whether base harmonization is sufficient from an economic point of view is another matter. In the case of a mobile tax base, some uniformity of rates is important to avoid distortions in the common market. If the tax serves a national equity objective, a common rate structure would also be important. The objective of fiscal responsibility for the provinces probably requires in itself little more than the ability of the provinces to select a level of taxes rather than a rate structure.

Symmetric arguments can be applied to the system of transfers to individuals and firms. To an economist, these are equivalent to negative direct taxes so similar arguments about their assignment and the advantages of harmonizing them can be made. Given the mobility of capital, harmonization of subsidies to firms is important. In the case of individuals, mobility is probably less an issue than that of whether to retain control of equity at the federal level.

Finally, it is important to recognize that there is an interrelationship between the division of tax room and the structure of federal-provincial transfers. In a system in which major tax bases are co-occupied, reassigning tax room to the provinces is always a substitute for making explicit transfers to them. It has the advantage of inducing more fiscal accountability at the provincial level. But, it has the disadvantages of increasing NFB differentials, of opening the way for inefficiencies in the internal common market, of reducing the ability of the federal government to achieve national equity objectives through taxation, and to use the spending power for efficiency and equity ends, and of making tax harmonization more difficult to attain.

SOME FEATURES OF THE EVOLUTION OF THE FISCAL ARRANGEMENTS

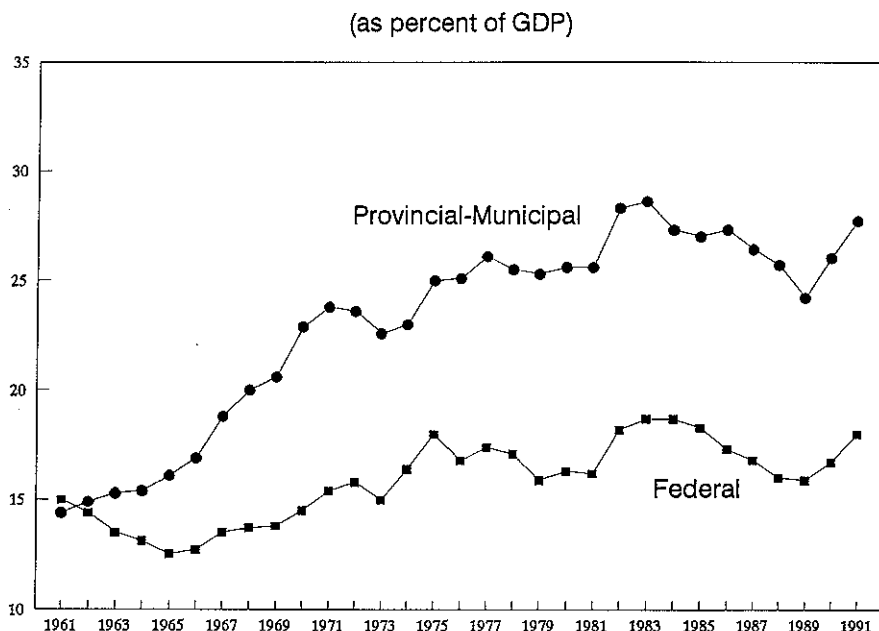
The evolution of the Canadian federation and the place of the fiscal arrangements in it has been widely discussed. Useful historical overviews may be found in the recent papers by Leslie (1993) and Norrie (1993), which focus on the fiscal arrangements as a whole. Courchene's (1984) review of the equalization system and its prospects has become a classic in the field. Our purpose here is the more limited one of highlighting some of the salient changes that have occurred in the practice of fiscal federalism in Canada in the past few decades. We group the changes into three main areas — changes in fiscal responsibilities

by federal and provincial governments, constitutional changes, and federal government policy changes (Boadway 1992). The ultimate objective is to shed light on how the system of fiscal arrangements, the parts of which were essentially put in place in the 1950s, 1960s and 1970s, stand up to the demands that the principles of fiscal federalism put on them, given the substantial changes in environment that have taken place in the meantime.

Fiscal Decentralization

The prominent characterizing feature of the evolution of the Canadian federation in the postwar period is the gradual but persistent decentralization of fiscal responsibilities from the federal government to the provinces (and their municipalities). Figure 1 depicts program expenditures by the federal government and

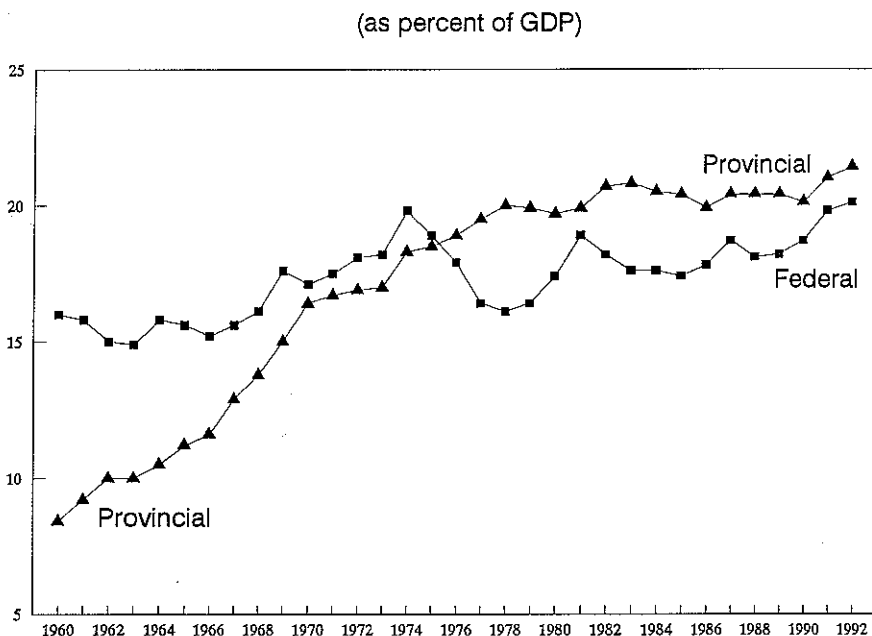
FIGURE 1: Government Expenditures (Non-Debt)



Source: Authors' compilation from Canadian Tax Foundation (various years), *The National Finances*, Toronto: Canadian Tax Foundation.

by the provincial/municipal governments as a percentage of GDP over the period 1961-91. While for the federal government, these barely rose from about 15 percent to about 17 percent over the period, provincial and municipal expenditures were rising from about 14 percent of GDP to over 25 percent. Furthermore, virtually all the rise in federal government expenditures could be attributed to increased transfer payments of various sorts; goods and services expenditures as a percent of GDP actually fell. All categories of provincial and municipal expenditures rose as a percent of GDP. Changes on the revenue side have been equally dramatic. Figure 2 shows federal and provincial own-source revenues as a percentage of GDP over the same period. Federal revenues over the period rose from about 16 percent to about 19 percent of GDP, while provincial revenues went from less than 10 percent of GDP to over 20 percent.

FIGURE 2: Government Revenues



Source: Authors' compilation from Canadian Tax Foundation (various years), *The National Finances*, Toronto: Canadian Tax Foundation.

Table 1 gives a more direct comparison between the federal government and the provinces for various categories of expenditures and taxes. (Note that these tables do not include municipal expenditures or revenues.) Total federal program spending fell from being twice as large as that of the provinces at the beginning of the 1960s to being the same size at the start of the 1990s. If federal transfers to the provinces are excluded from federal expenditures, the ratio of federal to provincial expenditures falls from about 1.7 in 1961 to just over 0.8 in 1990. The change in the ratio for goods and services expenditures is more dramatic, falling from about 2.5 to only 0.7 over the period. The decline in federal dominance on the revenue side is even more pronounced. The federal government collected almost 2.5 times as much as the provinces from own sources in 1961, but only 1.13 as much in 1990. It raised almost ten times as much direct tax revenue as the provinces in 1961, but only about 1.7 times as much in 1990. Similarly, it collected six times as much indirect tax revenue as the provinces in 1961, but only 1.6 times as much in 1990.

While the provinces' fiscal responsibilities have grown relative to those of the federal government, they have also had to become more financially self-sufficient. Table 2 shows that every province now obtains a smaller proportion of its total revenues from federal transfers than it did two decades ago. However, the decline varies across provinces, as does the extent of reliance on transfers. Thus, at one extreme, Newfoundland's share of revenues obtained from transfers fell from 62 percent in 1970-71 to 44 percent in 1992-93, and that of Prince Edward Island from 62 percent in 1970-71 to 41 percent in 1992-93. At the other end, Ontario's share of revenues from transfers fell from 17 percent in 1970-71 to 16 percent in 1992-93, and British Columbia's from 18 percent to 11 percent. The share in two provinces, Manitoba and Saskatchewan, hardly fell at all. Nonetheless, the differential reliance on federal transfers remains high. This reflects an important characteristic of the Canadian federation — the extent to which it is equalizing across provinces. Indeed, despite the decentralization of fiscal responsibilities to the provinces, and the fact that this might be expected to induce considerable fiscal inequalities among them, the equalization system has succeeded so far in reducing disparities in the fiscal capacities of the provinces to a remarkable degree. Table 3 depicts provincial per capita fiscal capacities before and after equalization for the year 1987-88. How long this equalizing thrust can be maintained in light of current fiscal and political contingencies is an open question.

TABLE 1: Ratio of Federal to Provincial Levels of Activity

	<i>Spending Including Transfers (1)</i>	<i>Spending Excluding Transfers (2)</i>	<i>Goods and Services (3)</i>	<i>Revenue Excluding Transfers (4)</i>	<i>Revenue Including Transfers (5)</i>	<i>Direct Taxes (6)</i>	<i>Indirect Taxes (7)</i>
1961	2.03	1.69	2.48	2.46	1.41	9.51	6.17
1962	1.88	1.59	2.53	2.01	1.25	4.39	4.73
1963	1.75	1.49	2.16	1.95	1.26	4.42	4.56
1964	1.66	1.39	2.07	1.95	1.27	4.37	4.07
1965	1.51	1.27	1.89	1.77	1.19	3.24	4.15
1966	1.43	1.19	1.74	1.65	1.10	2.86	3.61
1967	1.32	1.05	1.52	1.58	0.97	2.66	2.99
1968	1.25	1.01	1.40	1.49	0.94	2.70	2.71
1969	1.22	0.97	1.37	1.50	0.95	2.81	2.44
1970	1.13	0.86	1.09	1.39	0.80	2.51	2.33
1971	1.12	0.83	1.05	1.43	0.78	2.56	2.36
1972	1.15	0.89	1.01	1.43	0.83	2.45	2.27
1973	1.14	0.87	0.99	1.39	0.84	2.31	2.02
1974	1.19	0.91	0.95	1.42	0.85	2.21	1.73
1975	1.19	0.92	0.87	1.36	0.77	2.17	1.76
1976	1.12	0.85	0.89	1.26	0.70	2.05	1.62
1977	1.09	0.85	0.89	1.09	0.62	1.67	1.66
1978	1.12	0.87	0.86	1.03	0.59	1.51	1.95
1979	1.05	0.80	0.79	1.06	0.61	1.70	1.57
1980	1.06	0.84	0.74	1.12	0.67	1.73	1.63
1981	1.08	0.86	0.75	1.21	0.75	1.65	1.59
1982	1.10	0.89	0.76	1.10	0.67	1.62	1.37
1983	1.08	0.86	0.71	1.09	0.62	1.66	1.32
1984	1.15	0.93	0.75	1.10	0.64	1.73	1.34
1985	1.15	0.94	0.78	1.08	0.64	1.68	1.39
1986	1.08	0.88	0.74	1.13	0.69	1.72	1.53
1987	1.08	0.88	0.70	1.15	0.71	1.73	1.58
1988	1.08	0.88	0.69	1.11	0.69	1.61	1.52
1989	1.06	0.87	0.72	1.11	0.70	1.63	1.52
1990	1.01	0.83	0.65	1.13	0.76	1.68	1.59
1991	1.00	0.83	0.70	1.15	0.74	1.44	N/A
<i>Five-year averages</i>							
1961-64	1.83	1.54	2.31	2.09	1.30	5.67	4.88
1965-69	1.35	1.10	1.58	1.60	1.03	2.85	3.18
1970-74	1.15	0.87	1.02	1.41	0.82	2.41	2.14
1975-79	1.11	0.86	0.86	1.16	0.66	1.82	1.71
1980-84	1.09	0.87	0.74	1.12	0.67	1.68	1.45
1985-91	1.10	0.89	0.73	1.12	0.70	1.67	1.52

Notes: Column 1 – Federal spending including transfers to the provinces/provincial spending.
 Column 2 – Federal spending excluding transfers to the provinces/provincial spending.
 Column 4 – Federal revenue/provincial revenue excluding transfers.
 Column 5 – Federal revenue less transfers/provincial revenue including transfers.
 Column 6 – Ratio of personal plus corporate income-tax collections.
 Column 7 – Ratio of sales plus excise-tax collections.

Source: Authors' compilation from Canadian Tax Foundation (various years), *The National Finances*, Toronto: Canadian Tax Foundation.

TABLE 2: Proportion of Total Revenues Obtained by Grants

	<i>Nfld.</i>	<i>P.E.I.</i>	<i>N.S.</i>	<i>N.B.</i>	<i>Que.</i>	<i>Ont.</i>	<i>Man.</i>	<i>Sask.</i>	<i>Alta.</i>	<i>B.C.</i>
1970-71	62.2	61.5	47.1	47.3	29.1	17.2	31.7	28.2	23.5	17.6
1971-72	57.2	49.7	46.5	46.3	34.7	20.4	30.5	37.2	22.2	18.8
1972-73	52.3	50.1	42.1	43.4	22.0	19.3	32.3	37.2	20.3	15.7
1973-74	53.9	56.5	47.8	47.8	22.4	18.5	29.8	41.3	16.9	16.2
1974-75	52.0	54.3	45.1	45.7	22.1	17.1	32.7	27.8	17.1	17.3
1975-76	49.4	54.8	47.7	47.5	22.7	21.2	36.5	23.8	13.5	18.5
1976-77	47.9	56.6	46.1	46.5	22.1	22.7	34.0	20.5	13.2	17.9
1977-78	47.2	54.8	46.7	47.6	23.4	17.7	35.3	18.4	9.6	17.1
1978-79	47.8	54.5	47.0	46.3	22.9	17.2	33.9	18.3	9.2	15.7
1979-80	48.1	55.0	46.3	48.2	23.5	17.4	37.1	18.2	8.4	15.8
1980-81	46.8	51.5	45.5	43.5	21.8	17.6	36.4	15.7	7.9	15.2
1981-82	50.5	53.0	49.5	45.5	26.2	18.2	38.4	19.8	11.5	16.2
1982-83	47.2	50.1	42.6	44.4	20.5	15.0	31.1	15.1	6.5	13.9
1983-84	46.6	46.9	42.9	44.1	23.5	17.1	32.6	17.6	9.1	19.3
1984-85	46.7	48.3	39.7	43.4	22.0	16.1	30.4	14.9	10.7	19.3
1985-86	46.5	46.3	38.6	43.6	21.3	16.2	29.1	17.5	9.9	17.2
1986-87	46.9	46.3	38.7	42.8	20.5	14.7	28.1	15.9	14.8	17.1
1987-88	46.2	45.5	38.4	41.3	18.3	14.2	25.0	20.9	14.7	18.3
1988-89	46.7	44.7	21.8	40.9	19.8	12.9	25.9	23.4	16.6	15.3
1989-90	48.6	46.5	38.8	41.0	20.4	11.9	27.7	23.8	15.0	13.6
1990-91	45.6	43.7	36.6	39.8	18.9	11.1	27.9	23.2	14.9	12.3
1991-92	44.5	42.5	36.9	36.6	18.1	11.2	28.5	23.6	11.9	12.5
1992-93	44.2	41.3	37.3	36.4	19.6	15.7	30.0	25.4	14.5	10.8

Source: Authors' compilation from Canadian Tax Foundation (various years), *The National Finances*, Toronto: Canadian Tax Foundation.

TABLE 3: Provincial Per Capita Revenues Before and After Equalization as a Percentage of the National Average for Own-source Revenues, 1987-88

	<i>Nfld.</i>	<i>P.E.I.</i>	<i>N.S.</i>	<i>N.B.</i>	<i>Que.</i>	<i>Ont.</i>	<i>Man.</i>	<i>Sask.</i>	<i>Alta.</i>	<i>B.C.</i>
Before	60	64	76	71	85	108	80	90	146	104
After	98	98	98	98	98	108	98	98	146	104

Source: Boadway and Hobson (1993, Table 4.7).

Constitutional Changes

The Canadian constitution has proven to be extremely flexible and accommodating; for example, it has not precluded the vast decentralization that has occurred over the postwar period. Nonetheless, the constitution remains a legal constraint of sorts, and some of its provisions confer commitments on governments which, even if they are not binding in the legal sense, still have considerable political and moral authority over policymakers.

Some key amendments to the constitution have affected federal-provincial fiscal relationships, beginning with the unemployment insurance amendment of 1940 and the old age pension amendment of 1951, which enabled the federal government to enact two of their largest expenditure programs. The most significant changes occurred with the constitutional amendments contained in the *Constitution Act, 1982*. It contained several provisions with potentially important implications for federal-provincial fiscal relations, of which three are particularly relevant. They are the institution of the *Charter of Rights and Freedoms* (Part I, sections 1-29), the spelling out of federal responsibilities in the areas of equalization and regional disparities (Part III, section 36), and the devolution to the provinces of authority and taxing power over non-renewable resources (section 92A).

The *Charter of Rights and Freedoms* contains at least two sections that may be relevant for fiscal federalism — the mobility rights provision (section 6) and the equality rights provision (section 15). The former provides for the freedom to move among provinces and to pursue a livelihood in any province. In other words, it guarantees the unrestricted movement of labour (subject to the qualification that it may be violated if regional unemployment rates are above the national average), part of what is required for maintaining an effective economic union. The equality rights section guarantees equality before the law without discrimination. The implication of each of these for economic policy has yet to be determined by the courts, but they are potentially important. For example, the equality provision may help define national equity standards, and the mobility provision may restrict provinces in applying discriminatory labour policies.

The non-renewable resource section gave to the provinces the power to regulate and to tax in any manner natural resources within provincial boundaries. In a sense, it simply recognized what had come to be the practice at the time. It is relevant for us because it is undoubtedly one aspect of the federation which is immutable, that is, the provincial ownership and control of resources and the revenues therefrom. One can certainly make strong economic arguments for centralization of ownership and control of resources, and many

federations are organized in this way. However, it is not an option open to Canada.

Section 36 ("Equalization and Regional Disparities") contains two parts. In effect, these provisions have two sorts of possible effects on federal responsibilities and obligations. The first part explicitly recognizes the pursuit of equity as a national objective, though one that is shared with the provinces. This is important since, as already mentioned, much of what all governments do has a significant equity dimension. It might be thought of as a justification for federal involvement in provincial programs through the spending power. The second part imposes an obligation of a specific sort on the federal government to pursue equalization objectives. The wording of the provision, if taken literally, would have serious implications not only for the formal equalization scheme itself, but for other major federal-provincial transfers as well.

An important component of federal-provincial fiscal arrangements has been the use of conditional grants by the federal government. Despite the fact that the *BNA Act* gives the provinces "exclusive" legislative responsibility in the areas of health, education, and welfare, the federal government has from time to time used conditional grants to provide an incentive for the provinces to implement programs satisfying specific federal criteria. The constitutionality of such measures has been an issue in the past. However, the federal government has usually been successful in arguing their case, and it seems to be generally agreed now that the use of the spending power by the federal government as a method for providing financial incentives to the provinces is legally acceptable, as long as the federal government does not directly engage in program provision (see Hogg 1985).

The 1982 constitutional revisions could be taken to support and even strengthen this use of the spending power. As mentioned, section 36(1) explicitly recognizes the shared federal-provincial responsibility for equity. As mentioned, it can be argued that public sector provision in the areas of health, education, and welfare have redistributive equity as their ultimate economic rationale. The federal government can now argue that they have an interest in the equitable provision of these services, and since they are precluded from providing them directly, the spending power is the only instrument available for discharging their equity responsibilities. A similar argument might be made with regard to section 36(2). It could be said that the equalization responsibility is fulfilled jointly by the formal equalization scheme, along with the other major transfer schemes discussed below (EPF and CAP). Each of these has an equalizing component, and they complement each other.

The proposed constitutional amendments of the ill-fated Charlottetown Accord of 1992 contained various provisions which would have elucidated and

given political direction to federal-provincial fiscal arrangements for the future. There was to be a non-justiciable provision to be added to the constitution which would have described the nature of a commitment in principle of both levels of government to preserving and maintaining "Canada's social and economic union." The social union would include the provision of comprehensive and accessible health care, high quality education and adequate social services and benefits. Section 36 would be amended to include a commitment to ensure that comparable economic infrastructures would be available in all regions. The wording of section 36(2) would be strengthened to commit the federal government to make equalization payments, not just to the principle of equalization. And, a new subsection 36(3) would have been added to commit both levels of government to reducing regional economic disparities. The upshot of these changes to section 36 would apparently have been to strengthen the commitment to fiscal equity and the pursuit of economic opportunity. At the same time, the use of the spending power was to be guided by principles that included a contribution to the pursuit of national objectives, a reduction in overlap and duplication, respecting of provincial priorities and ensuring of equality of treatment of the provinces, while recognizing their different needs and circumstances. As with the Meech Lake Accord, provinces could opt out of national shared-cost programs, provided they carried on a program that met with national objectives. Though the Charlottetown Accord was defeated in the national referendum, its content revealed a significant commitment to the role of the federal government in pursuing national objectives, as well as the need to maintain fiscal equity in an increasingly decentralized federation.

Federal Policy Initiatives

It seems clear that the existing constitution is not a significant constraint on the degree of centralization of economic power. The federal government could exercise potentially significant amounts of financial control through its vast taxing and spending power. And, except for the commitments in section 36 of the *Constitution Act, 1982*, they can also choose to decentralize fiscal responsibilities to the provinces. Thus, federal and provincial financial responsibilities are to a large extent a matter of actual policy decisions. A number of recent policy initiatives have had, or will have, a bearing on the fiscal role of the provinces relative to the federal government and on the fiscal relations between them. In many cases, the effect on federal-provincial fiscal relations is an incidental effect of policies taken with other objectives in mind. Part of our purpose is to point out that the consequences for fiscal federalism are often of a lasting and virtually irreversible nature and, as such, we now have to live with

them and adjust our fiscal arrangements accordingly. Each of a number of policy measures is considered separately.

Deficit Reduction Measures. A high priority of the federal government has been the reduction of the budget deficit. In the last several budgets, it has put a substantial part of the burden on reducing expenditures rather than increasing taxes. At the same time, it has taken the position that the part of the budget consisting of transfers to individuals should be protected. That leaves only transfers to governments and business, and expenditures on goods and services as instruments for deficit reduction. Of these, the bulk of the burden was put on transfers to the provinces, including limits on both EPF transfers for all provinces and CAP transfers for the three "have" provinces.

Whatever its merits from a fiscal management point of view, the use of transfers to the provinces for deficit reduction purposes has longer term effects on the structure of federal-provincial fiscal relations.²⁰ One is that the reduction in federal-provincial transfers and the resultant increase in provincial tax requirements shifts the balance in taxing power from the federal to the provincial governments. Furthermore, this shift may be largely irreversible. The ability of the federal government to take a lead in maintaining a system of harmonized direct taxes across the two levels of government depends upon the share of the tax room it occupies. As the provinces occupy a larger and larger share of the income tax room, the pressures for fragmenting the system increase.

Another effect is that the reduction in federal-provincial transfers reduces the ability of the federal government to achieve national objectives through the use of the spending power. As long as the EPF grant is financed by a combination of tax point transfers and cash transfers, as in the current system, reductions in the cash transfer component will ultimately leave the federal government with little spending power clout.

Introduction of the Goods and Services Tax. The GST was introduced for reasons that had little to do with federal-provincial fiscal relations. But it too may have a lasting incidental impact. Most economists would agree that, as an indirect tax system, the GST is basically well-conceived. However, from a federal-provincial fiscal relations perspective, it has some drawbacks. The main one is that, if the evidence from other countries is anything to go by, it is likely that the direct-indirect tax mix of the federal government will gradually change in favour of the indirect. This implies a reduction in federal share of occupancy of the income tax fields. This will compound the strains put on the system of income tax harmonization and further reduce the ability of the federal government to achieve its national equity goals.

It is true that the federal government could buy harmonization with the provinces in the indirect tax field using the GST. However, such harmonization will be far from perfect. A fully harmonized GST involving the federal government and the provinces would be hard to achieve. It is simply too difficult to operate a multi-stage tax in a multijurisdictional system of government. The problem is that the system of crediting becomes difficult to administer when intermediate sales go through more than one jurisdiction. Perhaps the best that can be done is to have the provinces retain a single-stage system, with that stage being harmonized as closely as possible with the GST, as has been done with Quebec. The main disadvantages of single-stage taxes documented by the federal government (bias in favour of foreign goods, and taxation of business inputs) would continue to apply at the provincial level.

The real problem is that, given the degree of decentralization of the fiscal system in Canada, it is simply not possible for the federal government to dominate both the direct and the indirect tax fields. A choice must be made. We would argue that the case for harmonization and a strong federal presence favour federal government concentration in the direct tax field. From this point of view, the introduction of the GST could be seen as a retrograde measure. This was recognized by the Carter Commission some 25 years ago whose advice was that the federal government turn over the indirect tax fields to the provinces and concentrate on income taxation. This would accord with the traditional textbook assignment of tax bases in a federation (McLure 1983). The indirect taxes presumably would not be harmonized among the provinces, and a multi-stage tax would not be used. These disadvantages are outweighed by having a more harmonized income tax system.

The Operation of the Tax Collection Agreements. The basic form of the Tax Collection Agreements has been in place since 1962. The only major change occurred in 1972, when the federal government began allowing the provinces to introduce tax credits to be administered by the federal government. To be admissible, these credits were supposed to satisfy three criteria. They had to be administratively feasible, must not erode the essential harmony and uniformity of the tax system, and must not jeopardize the functioning of the internal common market. When the Tax Collection Agreements were first entered into, the federal government was dominant in the income tax fields. As the provinces have become more important users of income tax, the system has come under increasing strain. The signs of the strain are several. One province (Alberta) has withdrawn from the corporate Tax Collection Agreements. Others have studied the option seriously (Ontario in the case of the personal income tax, and British Columbia for the corporate tax), and have so far declined to take action despite

dissatisfaction with their inability to pursue independent tax policies. The use of tax credits has increased rapidly at both the personal and corporate levels. Some of these credits seem clearly to affect the allocation of capital across provinces, such as venture capital and stock savings programs and various tax credits under the corporate income tax. The principle of a common base has even been eroded, as Alberta, Manitoba, and Saskatchewan received permission to introduce flat taxes on bases different than federal taxable income (i.e., net income).

The tension seems to have arisen because of unilateral federal control over both the base and rate structure of the income taxes. This leaves open to the provinces only the ability to choose the level of rates and the use of credits for provincial policy purposes. As the provinces become more important in the income tax fields, these tensions are bound to increase. Studies in Ontario and British Columbia have recommended that provinces be given a greater role in any changes that involve the base and rate structure, and discussion papers of the federal government and the provinces have proposed changing the form of the Tax Collection Agreements to allow provinces more discretion over their rate structures (see Boadway, Cromb and Kitchen 1989; Clarkson Gordon 1988; Canada 1991). All have recognized that the Tax Collection Agreements have served the federation well. Indeed, the Canadian system has been cited as a model for tax harmonization in the European Economic Community.

Structural Changes in EPF and Equalization. The structures of both the EPF and equalization systems have undergone some significant changes that have influenced their effectiveness. In the case of the EPF, the major structural change resulted from the *Canada Health Act*, 1984. This Act reaffirmed the requirement that had existed since the mid-1960s that to be eligible for the full amount of the federal transfer in support of health expenditures, a province had to maintain a publicly-administered health insurance system which was comprehensive, accessible, universal, and portable. However, it also introduced penalties for provinces whose health-care systems engaged in extra-billing and user charges. The imposition of these additional conditions has been a matter of some controversy. Those who oppose them argue that the provision of health services is clearly a provincial responsibility, and that the full decentralization of health care is likely to lead to more efficient provision through interprovincial competitive pressures. Those who argue in favour of the use of the spending power in the health-care area do so on the grounds that health care is fundamentally an instrument for the pursuit of equity, and the use of the spending power is the only means by which the federal government can achieve national standards of equity in health care. Clearly the matter goes beyond purely

economic considerations and involves value judgements about equity versus efficiency. It is not surprising that economists disagree on the matter. It does seem quite clear, however, that from a constitutional point of view, the use of the spending power in this way is legitimate.²¹

The periodic budgetary reductions in EPF cash transfers will make it more difficult for the federal government to maintain effective national standards in health care. Since the inception of EPF in 1977, there have been a number of instances in which the size of the transfers has been reduced, and these have all been felt on the cash transfer side. In 1982, there was a reduction of the equivalent of two personal tax points which had originally been used to compensate for the so-called revenue guarantee in the 1972 tax reform. This may or may not have been justifiable in terms of the revenue guarantee itself, but one result was a reduction in the size of the cash transfer. In 1984 and 1985, the notional postsecondary education component was restricted to increases of 5 and 6 percent respectively as part of the anti-inflation policy of the time. (This component is notional only since there are no restrictions on its use.) In 1986, the growth of EPF transfers was reduced from the rate of growth of GNP to that rate less two percentage points. Then, in the budgets of 1990 and 1991, the per capita amount of EPF transfers was frozen and extended three years beyond.²² Once the freeze is over, the growth of EPF per capita transfers will be restricted to the rate of growth of GNP less 3 percent. The consequence of these reductions is that the cash component of EPF is becoming less and less important relative to the tax transfer component, and will disappear altogether in the near future (though that day has been postponed by the recession). It could be argued that, once the federal government eliminates cash transfers and requires the provinces to increase their tax room, it will be difficult to reverse the process. While the federal government has stated that it will find other ways to penalize provinces who fail to meet the full criteria set out in the *Canada Health Act*, it is not at all clear how this can be done. The other major grant schemes (equalization and CAP) are negotiated separately with their own objectives in mind. And, equalization applies only to some provinces.

The equalization system itself has undergone some fundamental revisions. Prior to 1982, the system used the so-called national-average standard for determining equalization payments to the have-not provinces. That is, the entitlement was calculated to bring the tax capacity of the have-not provinces up to that of the national average. Oil and gas revenues were not fully equalized. However, as the Economic Council of Canada (1982) argued, given the provincial property rights over natural resources, this was not an unreasonable situation. In 1982, the formula was changed in several significant ways to reduce the financial commitment of the federal government and to ensure that Ontario

did not become a have-not province. The national-average standard was changed to a five-province standard (Ontario, Quebec, Manitoba, Saskatchewan, and British Columbia). Oil and gas revenues were included fully in the formula; but, since Alberta was not part of the standard, they were, in effect, largely unequalized. Also, in 1987, the rate of growth of the total equalization transfer was capped at the cumulative rate of growth of GNP.

International Developments. Changes in the international climate facing the Canadian economy may influence the development of fiscal relations within the federation. In particular, they may increase the constraints faced by policy-makers. For example, the growing internationalization of capital markets constrains the ability of governments, both federal and provincial, to impose taxes on capital income. With highly open capital markets, rates of return on capital are largely predetermined internationally. This implies that the ability to extract taxes from capital income is severely limited. In an economy such as Canada's, the taxation of corporate income is to a considerable extent dictated by foreign tax crediting arrangements in creditor countries, especially the United States.²³ One of the main roles of the corporate tax has become to facilitate a tax transfer from foreign treasuries to Canada by exploiting the ability of foreign corporations to obtain credits for taxes paid in Canada. This implies that our corporate tax structure is constrained to be similar to that in the United States.

At the same time, because of the allocation formula used to allocate corporate income tax revenues among provinces, there is an incentive for provinces to engage in tax competition. Under the tax crediting system which operates internationally, there is little gain to provinces from trying to attract capital from abroad via corporate tax incentives for the reason mentioned above; they will simply reduce the size of the transfer from foreign treasuries without affecting the incentive to invest. However, with the allocation formula used for provincial tax collections, provinces can succeed in attracting capital from neighbouring provinces by offering more attractive tax treatment. The total amount of provincial taxes that domestic firms are liable for depends upon in which provinces their profits are earned. If a province lowers its tax rate (or provides an investment incentive), this will provide an incentive for domestic firms to relocate their activities there, but it should not affect foreign firms because of the crediting arrangement. This means that there is an incentive for provinces to engage in interprovincial beggar-thy-neighbour policies, even though such an incentive does not exist at the federal level. This observation has implications for the ideal assignment of taxes and income tax harmonization.

Future Policies. It is difficult to predict what policy initiatives will occur in the future. However, speculation is not entirely idle. One possibility is in the area of social policy. It seems clear that a major rationalization here is on the policy agenda, and will incorporate a number of programs such as welfare, unemployment insurance, and training. Since these policies overlap federal and provincial jurisdictions, their implications for federal-provincial fiscal relations cannot be ignored. Another possible area concerns public sector infrastructure investment which has surfaced during the 1993 election campaign as a possible policy direction. Such a program almost necessarily involves the use of the federal spending power which, to be effective, requires federal transfers to the provinces (and municipalities). There may well be other major policy initiatives, such as environmental or energy policy measures, which will affect federal-provincial fiscal arrangements. Since all of these things involve federal funding to some extent, the additional strain imposed on existing fiscal arrangements in an era in which decentralization has already evolved a long way will be considerable. It is not clear that the system of federal-provincial fiscal arrangements that has evolved over the period can be sustained without major rethinking. In that sense, the answer posed in the title to this paper would be affirmative.

PROBLEMS WITH THE EXISTING FISCAL ARRANGEMENTS

The basic structure of the existing fiscal arrangements has been in place for 25 years, and some of the key components go back to the early postwar period. Yet, as we have seen, the nature of the federation has changed significantly in the meantime. In particular, it has become much more decentralized. The question becomes, in light of all these changes that have occurred, do the fiscal arrangements now serve the purposes for which they are intended?

The theory of fiscal federalism suggests that the role of federal-provincial fiscal arrangements should increase in importance as more budgetary responsibilities are transferred to the provinces.²⁴ In a sense, the sensible and unobtrusive use of various components of the fiscal arrangements allows the full benefits of the decentralization of public service provision to be achieved without compromising the efficiency and equity of the internal common market. In particular, judicious use of the fiscal arrangements serves to offset the inefficiencies and inequities that inevitably arise as a result of the decentralization of functions, to facilitate coordination among governments on both the expenditure and tax sides of their budgets, to allow for differing degrees of decentralization of taxes and expenditures, and to enable the federal government to retain some means by which it can achieve national efficiency and

equity goals in areas otherwise within provincial responsibility. Although we have stressed that the fiscal arrangements must be seen as a whole, in this section we look at each of the major components individually with a view to pointing out how their structures might have become dated given the evolution of the Canadian federation.

Equalization

The main purpose of the equalization system has been to address the fiscal inefficiencies and inequities that arise in a decentralized federation, that is, to meet the principles enunciated in section 36(2) of the *Constitution Act, 1982*. The task becomes greater the more decentralized is the federation. At the same time, the political basis for equalization may diminish with decentralization, as many commentators have pointed out (see, e.g., Courchene 1991). This is almost certainly the case as decentralization has been accompanied by the freeing of trade and the transfer of deficits to the provinces, in some cases selectively to the better-off provinces. Others are better able to comment on the political economy of equalization. The perspective we adopt here is that of the economist to whom the principle stated in section 36(2) is grounded in the traditional fiscal efficiency and equity arguments of the theory of fiscal federalism, arguments that have become part of the standard analytical baggage of the discipline (see Atkinson and Stiglitz 1980; Wildasin 1986).

We have already described how fiscal equity and efficiency in a federation are jointly achieved by a system of federal-provincial transfers which fully eliminate differentials in NFBs across provinces.²⁵ In principle, this is not easy to achieve in any precise manner since NFB differentials can arise in a variety of different ways, depending on the nature of functions undertaken by government, and also on the extent to which provincial government budgets are redistributive. However, given the stylized facts of the Canadian federation, and some reasonable assumptions about the way in which the provinces behave, a good case can be made for assigning to the equalization system the principal task of equalizing *tax capacities* across provinces.²⁶ The equalization system can be judged primarily on these grounds, while recognizing that other components of the system may also contribute to the overall equalization objective, including the need to take account of other sources of NFB differentials.

Judged from the perspective of the objective of equalizing tax capacities, the difficulties with the equalization system as it has evolved have been well documented, and we need do little more than recount them here (see Courchene 1984; Bird 1990):

- Since the system is a "gross" scheme rather than a "net" one, the have-not provinces are equalized up, but the have provinces are not equalized down. Furthermore, since the federal government finances the scheme, and since it does not have access to some of the revenue sources which cause significant differentials in tax capacity, the degree of implicit equalization operating through the financing of the system through general revenues is limited.
- The use of a representative five-province standard (RFPS) rather than a representative national-average standard (RNAS) makes it impossible to ensure that NFB differentials are properly eliminated. In principle, this could go either way since both the best-off and the least well-off provinces are missing from the standard.
- One of the most important sources of tax capacity differentials, resource revenues, is very inadequately treated by the equalization system on several grounds. For one, since Alberta is left out of the five-province standard, a substantial part of the oil and gas revenues go unequalized. Given that this constitutes one of the most unequally distributed tax bases, this is a significant shortcoming. By the same token, resource revenues accruing to the have-not provinces are effectively fully equalized; indeed, given that the equalization system is based largely on a system of production tax revenues (rather than rents), equalization systematically discriminates against high-cost producers leading to a situation in which more than 100 percent equalization is imposed on the have-not provinces' oil and gas revenues. Of course, it can be argued using notions of provincial property rights (what the Economic Council referred to as "narrow-based horizontal equity") that only partial equalization of resource revenues is called for; even that would be more than the present system allows for. At the same time, there are some other sources of resource revenue which also go fully or partially unequalized; examples include hydro-electric rents as well as forestry rents, both of which are dissipated in forms other than equalizable tax revenues.
- The federal government's lack of direct access to some of the resource revenue bases which generate NFB differentials has led it to pursue alternative policies to spread the benefits of the resources around the federation, some of which have been clearly sub-optimal. Examples include the National Energy Policy as well as bilateral revenue-sharing agreements.
- In each five-year fiscal arrangements period since 1982-83, there has been a ceiling on the growth of equalization payments. Thus, for the 1987-88 to 1991-92 period, total equalization payments were not allowed to exceed those of 1987-88 augmented by the rate of growth of GNP over the same period. This ceiling, which is essentially arbitrary, especially in light of federal

policies to rapidly decentralize a number of important social programs in recent years, became binding in 1988-89, reducing still further the ability of the scheme to achieve full equalization of tax capacities.

- It has also been argued that, by focusing entirely on tax base equalization, other important sources of NFB differentials have been neglected. An often mentioned example of this is the failure to take account of "negative" tax liabilities (i.e., transfers) in the equalization program. We shall return to this when we discuss other components of the system.

These shortcomings in the equalization system imply that it is imperfect when judged against the ideal of full equalization of tax capacities. Despite this, the system does not perform all that badly. Calculations have shown that the RFPS standard has in recent years led to the equalization of the have-not provinces to close to 98 percent of what would be achieved by the RNAS. Whether this would remain to be the case in future years when the ceiling bites more and more, and when (if) resource revenues increase remains to be seen. Of course, the equalization up of the have-not provinces is only one side of the picture. Since the equalization system does not apply to the have provinces, they remain above the national standard. Interestingly enough, in the late 1980s, while Alberta's tax capacity was over 45 percent above the national average, those of the other two have provinces, British Columbia and Ontario, were each above the national average by less than 10 percent (see Boadway and Hobson 1993, Table 4.7, p. 124).

It is worth stressing that our discussion has been premised on the notion that both the economic objectives of the equalization system and the constitutional "commitment" found in section 36(2) can largely be addressed by a system that fully equalizes the tax capacities of the provinces. This policy prescription rests on a set of assumptions about the way in which provincial governments exercise their taxing and expenditure responsibilities that not all observers will agree upon. However, the prescription does have the advantage that it is well-founded in theory. It does put the onus on detractors to be as precise in defending alternatives, including lesser forms of equalization.

Two final points might be made about the equalization system. First, it should be clear that in a system of equalization in which tax capacity is the focus of redistribution across provinces, the degree of decentralization of revenue-raising capacity is an important determinant of the extent of required equalization. To take the extreme case, if taxation remained centralized while expenditures were being decentralized, so that all provincial expenditures were financed from federal-provincial transfers, the transfer system would need only to be a system of equal per capita grants.²⁷ It is only as taxes are decentralized

that differential tax capacities become important. Recognition of this makes clear the complementary relationship that should exist between the EPF and equalization systems. Although it was conceived on political grounds, it is fortuitous that EPF was designed to be an equal per capita grant. Now that the relation between EPF and equalization is clear, opportunities for making that relationship more explicit can be exploited in redesigning the system. We return to this theme in the next section.

Second, our presumption has been that federal-provincial transfers are the appropriate vehicle for addressing NFB differentials across provinces. Some observers have suggested that the task could also be achieved by a system of transfers to individuals.²⁸ This would require a set of transfers to individuals which differ according to province of residence. Such a system is presumably feasible to operate, although it is more complicated than making grants to the provinces and possibly induces incentive effects on individuals which are a lot more transparent than with grants to the province. From the point of view of the proponents of the system, it has the advantage that provinces are forced to decide to tax back the grant from their residents thereby inducing more political accountability. By the same token, one of the key features of the literature on the assignment problem is that the case for decentralizing expenditures is greater than that for decentralizing taxes (the fiscal gap argument). A scheme of transfers to individuals would increase the need for provincial tax collection, thereby leading to increased possibilities for inefficiency in the internal common market and making tax harmonization more difficult to achieve. As well, the dual system of federal taxes and transfers to individuals and subsequent provincial tax back of the transfers leads to a double tax distortion which could otherwise be avoided.

Established Programs Financing

When EPF was instituted in 1977, it was conceived as an equal per capita transfer to the provinces, though with some general conditions attached with respect to health-care expenditures. As such, it had the potential to perform a couple of important functions as a component of the fiscal arrangements. We have already mentioned that its per capita structure fortuitously rendered it a useful component of the equalization system. At the same time, it also provided a vehicle with which the federal government could exercise its spending power for the purposes of maintaining efficiency in the internal common market and pursuing national equity goals as eventually outlined in section 36(1) of the *Constitution Act*. In fact, the implementation of the spending power was restricted to setting out the criteria that provincial health insurance plans must

satisfy. However, EPF was a vehicle that, in principle, could have been used more widely for spending power purposes in other areas.

The fact that part of the transfer took the form of a transfer of tax points to the provinces has had a number of consequences, probably unforeseen or at least unconsidered, which have gradually eroded the usefulness of the scheme, both as an adjunct to equalization and as a block grant with general conditions attached. The mere fact that half of the initial transfer took the form of a transfer of tax points meant that there was a more or less gratuitous shift in income tax room from the federal government to the provinces. While this may have been conceived as a way of inducing more political accountability into the system, it is not clear that any real economic objective was served. It has essentially contributed to the gradual shift in income tax room in favour of the provinces, a shift that is hard to reverse and which many would argue has now reached the point where the harmonization of the income tax system is under threat. This is discussed further below.

Perhaps the more important consequence of implementing part of the EPF transfer in the form of tax room arises from the fact that the cash component is calculated as a residual. That is, for each province, the EPF cash transfer is the total EPF entitlement less the value of the tax transfer to the province, suitably equalized. This has two general types of effects. The first one, which is of lesser importance, is that since the value of an equalized income tax point can differ across provinces, so can the cash transfer. More important, since the growth rate of the aggregate cash plus tax point transfer has been directly tied to the growth of GDP, the growth of the cash component will differ from the rate of growth of EPF to the extent that the tax point transfer does. While the growth rate of EPF was set at that of GDP, this was not a great problem, since the growth in value of the tax points was not much different. However, given the various budgetary restrictions that have been placed on EPF subsequently, the growth in tax room has been and will continue to outstrip the EPF entitlement, with the result that the cash component will gradually be eroded. It has been calculated that under the present regime of a freeze in EPF per capita transfers until 1994 followed by a restriction in the growth rate to the growth rate of GDP less 3 percent, the cash component will disappear early next century. In the case of Quebec, cash transfers will disappear before that, owing to the fact that a higher proportion of the EPF transfer takes the form of tax points. That would obviously spell the end of the system.

Given that the tax transfer is water under the bridge, it is not at all clear that it ought still to be considered a federal-provincial transfer at all. For all intents and purposes, the tax transfer has become part of the provinces' tax room, probably irretrievably so. Thus, it is not clear why the magnitude of the notional

tax transfer ought to be a determining factor in calculating the cash owing to the provinces.

Quite apart from its magnitude and the division of the transfer into cash and tax transfer components, the structure of the EPF system itself has led to some controversy. Very few observers would disagree with the principle of EPF being an equal per capita transfer, that is, with the "equalization" component of the transfer. However, the use of the EPF system as a means of imposing federal conditions on provincial health insurance programs has been more controversial. In particular the strictures against user fees and extra-billing have been viewed by some as unilateral federal intrusions into the specifics of program design. This has led to a fear that the federal government could use its spending power to the same effect in other areas in the future. Hence, during the constitutional debate, many persons called for putting varying degrees of constitutional limitation on the federal government's use of the spending power; even the federal government's own proposals did so.

Canada Assistance Plan

CAP is the only major federal-provincial shared-cost program left. It combines conditionality with a 50 percent matching rule. The major question here concerns the justification for the matching rate, given the obvious adverse incentives that it provides to the provinces. In principle, there are a number of justifications that might be given for using a matching formula, though not necessarily at such a high rate. The first is the standard textbook argument concerning spillovers. Given the potential mobility of welfare recipients, the benefits of one province's welfare system spill out into other provinces. The spillover benefits may also include elements of altruism towards the welfare recipients of other provinces. In the absence of some such incentive, provinces would tend not to take these spillover benefits into account. While this might be true in theory, it is highly dubious that the order of magnitude of the problem is such as to call for a 50 percent matching rate. Another related argument is that interprovincial competition on the expenditure side would compete away welfare benefits to the collective disadvantage of all provinces. Again, it is not clear that the appropriate remedy is a matching formula of anywhere near this magnitude.

Another argument views the CAP system as contributing to the equalization objective. If one views welfare payments and services as being essential public services, then it is certainly true that provinces encounter different expenditure obligations in providing these services. Thus, equalization of NFBs requires some equalization on the expenditure side, something that the equalization system does not do. One way to equalize expenditure needs is to base payments

on actual expenditures. While this has a greater ring of plausibility than the spillover or interprovincial competition stories, it is questionable why expenditure-based equalization has to be accomplished through a system of matching grants, with its associated incentive effects, as opposed to a scheme based more on expenditure needs, suitably measured.

Finally, it could be argued that the sharing by the federal government of the costs of welfare services could be justified by recognizing that the levels of expenditures on welfare are partly a consequence of macroeconomic policies which are the responsibility of the federal government. Whether this could be used to justify the 50 percent matching rate is questionable.

Apart from the issue of the use of matching rates, there is also a question as to the appropriateness of the conditions attached to CAP, and the role of the federal government in imposing them. Some have argued that the type of conditions attached to the use of CAP funds, such as the requirement that they be based on the needs of welfare recipients, have induced the provinces to design welfare programs that pay undue attention to incentive effects and to the working poor. Others might argue that, given the generally perceived inadequacy of income support programs and the lack of coherence among the various components, such as welfare, unemployment insurance, and the tax system, the federal government could be much more imaginative in its use of the spending power in this area.

Finally, there has been some concern recently with the federal government deficit-reduction measure to restrict CAP transfers selectively to the better-off provinces. Not only was this done with little overall rationale in mind other than budgetary expediency, it was also viewed by the provinces as violating what they saw as an implicit contract. Again this issue found its way into the constitutional debate, with demands that some restriction be placed not only over future new uses of the spending power, but also on the federal government's ability to back out of existing spending power policies unilaterally.

Tax Harmonization

Tax harmonization is an important and integral part of the fiscal arrangements, though it is not always recognized as such. The extent of harmonization of Canada's tax system has been enviable when compared with other federations with a comparable degree of decentralization of fiscal responsibilities. The harmonization takes place largely through the Tax Collection Agreements, and is largely confined to the income tax system. There is virtually no harmonization of either indirect taxes or of other direct taxes, such as those on resources. This has been viewed by economists as less of a problem since the major benefits from tax harmonization come from tax bases that are more mobile, especially

capital income (see Boadway and Bruce 1992). Thus, though harmonization of the federal GST and the provincial retail sales taxes might be desirable from the point of view of compliance and collection costs, the economic advantages are limited relative to the income tax, especially that applying to corporations.

From this perspective, there is some concern that the system of harmonization is becoming increasingly eroded and in danger of collapsing. For one thing, the deviations from the common base and rate structure are increasing rapidly as provinces enact more and more tax credits and exemptions, and as the federal government begins to allow major deviations like the flat rate tax in the Prairie provinces. Also, as we have mentioned, the combination of increased provincial reliance on own-source revenues as a result of federal deficit-cutting through the transfer system and the likely changes in the federal and provincial government tax mixes as a result of the introduction of the GST are likely to lead the provinces to occupy an even larger proportion of the income tax room. This, in turn, is likely to cause further provincial discontent with the federal role in the Tax Collection Agreements, a discontent that has already surfaced, at least in the western provinces.

OPTIONS FOR THE FUTURE

We began this chapter with the observation that, while the Canadian federation has undergone major structural changes, especially with respect to the degree of decentralization of fiscal responsibilities to the provinces, the basic form of intergovernmental fiscal arrangements has remained remarkably stable. This could be an indication that the fiscal arrangements are incredibly robust and adaptable to changing economic circumstances. But it could also be the case that the system has been pushed beyond the point where further minor adjustments and tinkering can make any useful contribution to our fiscal structure. According to this latter view, major reforms in the system of intergovernmental fiscal arrangements are long overdue.

The range of possible options for the future is obviously very broad. We begin our consideration of these possibilities with a review of some of the proposals that have appeared in recent discussions. This review is not intended necessarily to be complete, representative, or even fair to those who have put them forward. Our primary purpose is only to illustrate the types of options that have been presented.

Review of Options Under Consideration

Equalization. In the view of some, equalization has become an excessive financial burden to the federal government and, in light of the continuing

decentralization of fiscal responsibilities to the provinces, it no longer serves a legitimate national function. Moreover, considerations of equity at a national level are becoming increasingly irrelevant as a guide to policy design. The sorts of proposals that follow from these considerations are several.

One far-reaching proposal is that the goals of fiscal equalization be abandoned by the federal government and that they be assumed, on a voluntary basis, by the provinces.²⁹ Under such an arrangement, the "have" provinces would transfer fiscal resources directly to the "have-not" provinces, according to measures of fiscal capacity and/or need. This proposal would have the additional advantages of turning equalization into a truly net scheme, and of eliminating the costs that arise under the current scheme which only equalizes the poor provinces up, and which requires the federal government to impose additional tax burdens even on the citizens of poor provinces in order to finance equalization.

The fundamental problem with schemes such as these arises from the fact that the amount of equalization that is required on the basis of the equity and efficiency considerations increases with the degree of decentralization of fiscal responsibilities to the provinces. It is unlikely that provincial governments, responsible only to the residents of their own provinces, would agree to voluntary transfers of the sort that are called for under current circumstances. It is only a federal government, which is responsive to a national constituency, that would be able to sustain a commitment to equalization which is anything like the one we have today. Some people might argue that provinces would voluntarily commit themselves to such a scheme on the principle of social insurance — rich provinces who give today might become recipients tomorrow when their fortunes take a turn for the worse. But this assumes that, say, Newfoundland and Manitoba are equally likely to be "have" provinces in the near future. We would argue that provincial governments would be very unlikely to sustain, on a voluntary basis, even equalization programs that are much less generous than the one we have today. We cannot conceive that they would be able to commit themselves to the sort of transfers required under the current degree of decentralization of fiscal responsibilities. This, of course, would be viewed by some — those who do not recognize a constituency for equity at the national level (and maybe the provincial level as well) — as another advantage of the decentralization of responsibility for equalization to provincial governments. More generally, this raises again the fundamental problem with equalization in a highly decentralized federal system. The greater the degree of decentralization, the greater the amount of equalization that is called for; but the smaller might be the sense of national community and hence the ability of a federal government to maintain a consensus in favour of

equalization. While decentralization increases the economic need for equalization, it might diminish the political will to deliver it, as Leslie (1993) has argued.

There have been a number of other suggested changes to equalization which might be better put in the category of "tinkering" rather than making fundamental changes. This is not to say that they would not necessarily have significant financial implications for the provinces. But they do not represent significant changes in the philosophy or the basic system of equalization. For example, there has been considerable discussion at a political/journalistic level of what have been arbitrary decisions about which provinces to include in calculating "national average" indicators of fiscal capacity, or which provinces to exclude on an *a priori* basis from being possible recipients of equalization. And there has been similar discussion of the details of measuring fiscal capacity for particular revenue sources.

In addition, Norrie (1993) and Usher (1993) have made more substantial suggestions for changes in the nature of the equalization formula. Norrie, for instance, has proposed that the formula be changed to one that is based more directly on simple macro-indicators of interprovincial income differences. Usher has also suggested that such a simple macro-indicator (provincial per capita income) be used, not so much to determine the amount of equalization, but rather to set limits on the amount of fiscal equalization undertaken by the federal government. Usher suggests that equalization payments called for under the current equalization formula be made only to provinces whose per capita incomes fall below 90 percent of the national average. Both of these proposals seem to be based on a perception of equalization as a tool for redistributing income among individuals, rather than correcting for real income differences that arise as a by-product of the decentralization of fiscal activities to provincial governments. In other words, although these might appear to be simplifications of the current equalization formula, they actually deny the basic economic rationale that underlies the system of equalization as it has developed in Canada and is described in section 36(2) of the *Constitution Act, 1982*. Furthermore, in the case of Usher's proposal at least, the magnitude of the financial implications for the federal government and for particular provinces are potentially quite large. To proceed with these sorts of proposals without a clearer exposition of their economic rationale, relative to that of the current system whose rationale is widely accepted, would be unwarranted, to say the least. Our own view is that fiscal equalization is a poor instrument for dealing with any issues of interpersonal equity other than those arising from interprovincial NFB differentials.

EPF, CAP and Cost-Sharing. As with equalization, proposals for reform of these shared-cost programs have ranged from those calling for relatively minor adjustments to the existing system to those that would imply very significant changes in their nature. The major structural reforms suggested by some would require considerable recentralization of fiscal responsibilities in the Canadian federation; while those proposed by others would imply significantly greater degrees of decentralization.

The minor amendments usually suggested are in the nature of proposals to eliminate some or all of the arbitrary adjustments and restrictions imposed by the federal government in recent years. These would include removal of the caps on overall growth and on the amounts that particular provinces are deemed to be eligible to receive. Even less radical are suggestions simply to slow down the rate at which the cash component of EPF is being phased out.

Those with a more centralist view of the role of different governments in these major social programs might suggest not only a reassertion of federal expenditure responsibilities, but also a harder line by the federal government in restricting the options available to the provinces with respect to program design and delivery.³⁰ An even more centralist approach is to suggest that the federal government withdraw from EPF and CAP and replace some or all of these transfers to the provinces with direct transfers to individuals, thus completely bypassing the provinces in the affected areas.³¹ By so doing, the federal government would immediately assume a major, if not dominant, role in areas that traditionally (and constitutionally) have been treated as primarily provincial responsibilities in Canada. Leslie (1993) also suggests a major reassertion of federal responsibility with respect to the financing of social programs, although he does not make very specific proposals as to how this should be accomplished.

The opposite, decentralist, approach, would be to hasten the exit of the federal government from the financing and/or control of social programs. Norrie, for instance, suggests that this be done with respect to health expenditures. No clear economic rationale is provided for distinguishing so sharply between education and health with respect to the extent of centralization of fiscal responsibility and program delivery.³² Bird (1990) and Hobson and St.-Hilaire (1993) recommend that CAP contributions be eliminated and replaced by an expenditure-based equalization program.

As discussed earlier, the real issue here is the extent to which one buys arguments about either interprovincial spillovers or the importance of the internal common market as providing an efficiency argument for federal involvement; or about the national level as representing the appropriate sharing community with respect to concerns of vertical equity, and therefore providing

an equity argument for a federal role in these programs, as suggested by section 36(1). A point worth emphasizing, and one stressed in the fiscal federalism literature, is that a judicious use of the spending power allows one to achieve the abundant advantages of decentralization without sacrificing national efficiency and equity objectives. The key is to find that balance between legitimate federal concerns and overintrusive intervention.

Tax Sharing and Harmonization. There has been surprisingly little discussion in the literature on the issues related to the sharing and harmonization of taxes between the federal and provincial governments. The Carter Commission perceptively recommended nearly three decades ago that the federal government abandon the sales tax field to the provinces and concentrate its efforts solely on direct taxation, using equity as its justification. In his summary of a set of studies prepared for the Ontario Economic Council, Hartle (1983) discussed the need for greater provincial influence over tax structure decisions in order for the Tax Collection Agreements to remain palatable for the provinces. At the same time, he pointed out the dangers in terms of administrative and compliance costs, and more importantly, the threat to the internal common market, that would result from a collapse of the Agreements and the adoption of "go-it-alone" policies in the income tax field by the provincial governments. Boadway (1992) and Ip and Mintz (1992) provide an overview of the arguments presented in the section on the evolution of fiscal arrangements, which rank the various tax fields in increasing order of need to centralize and coordinate — from capital and personal income taxation, to general sales taxes and excises, and finally resource and property taxes.

Decentralization versus Recentralization. Underlying much of the discussion on each of the issues dealt with here are often significant differences in views concerning the appropriate degree of decentralization in the Canadian federation. Those with a strongly decentralist view are often willing to see further erosion of equalization at the federal level, and would certainly agree with proposals that would decrease its total cost to the federal government. They would encourage the federal government to loosen its financial involvement with, and any strings it attaches to, provincial expenditures in social policy areas. And they would be willing to continue to decentralize responsibility for revenue raising and the tax structure to the provinces.

As we pointed out earlier, the appropriate design of the system of federal-provincial fiscal arrangements certainly does depend on the degree of decentralization of various fiscal responsibilities in the federation. Our own approach for the purpose of this chapter is to take the degree of decentralization as more

or less given, and not to make major proposals in that regard.³³ Given that, we ask what sorts of adjustments might be called for, on the basis of basic economic principles outlined and discussed in earlier sections, in the current system of fiscal arrangements. In other words, the system of fiscal arrangements is viewed, not as an end in itself, but rather as a tool for accommodating and making workable the more fundamental goals and characteristics of the federal system. From our discussion here and earlier it will be easy enough to infer many of the adjustments that might be required in the event of further changes in the nature of the federation. The remainder of this section outlines what we perceive to be some of the major options for fiscal arrangements that accord with the basic economic principles we have discussed and which will meet the basic needs of the federal system as it now stands.

Minimal Requirements for Fiscal Arrangements

We begin by outlining what we view as the principal "minimal requirements" of a system of fiscal arrangements in the Canadian federal system. These derive from the basic economic principles outlined in earlier sections, and their application to the Canadian system as it is today. There are five requirements that we feel are worth repeating here.

First, in light of the high degree of fiscal decentralization on both the tax and the revenue side, and the size of the interprovincial disparities in fiscal capacities, it is essential, on grounds of economic efficiency and fiscal equity, for the federal government to continue to operate an effective equalization program. To repeat, increased decentralization of fiscal responsibilities makes equalization *more*, not *less* important. This will require not only a continuation of the commitment to equalization, but also a resolve to remedy some of the major flaws in the current system.

Second, there must be effective mechanisms and procedures for dealing with the shared responsibility between the federal and provincial governments for delivering programs aimed at achieving redistributive equity. We take it as given that social programs will continue to be an area of shared responsibility. When the major shared-cost programs were introduced in the 1960s, there was little question that the federal government played the major role in the "negotiations" over program design. But the cost-sharing formulae almost guaranteed that provincial spending would grow until budgetary pressures forced the federal government to take corrective action and begin to off-load financial responsibilities onto the provinces. This necessarily increased the powers of the provinces in these fields. As a result, there is now considerable tension over the relative roles of the two levels of government. What is necessary at this time is to devise some mechanisms for a true sharing of responsibility. The provinces

need room to experiment with alternative modes of program design and service delivery. At the same time, in order to meet national equity needs, and also to prevent decentralized decisions of provincial governments from causing undue harm to the Canadian common market, the federal government must continue to play a national role.

The final three "minimal requirements" are somewhat related to the second one. First, to the extent that provincial, or shared federal-provincial, activities involve significant spillovers of benefits or costs across provincial boundaries, there must be some mechanism for the federal government, or some other institution, to ensure that these effects are taken into account. Second, there must be sufficient capability at the federal level, and/or some other form of institutional arrangement, to protect the integrity of the economic union. And third, there must be continued harmonization of tax systems across the country. This is especially important with respect to taxes on corporate and personal incomes. Each of these considerations becomes more important the greater is the extent of decentralization of fiscal responsibilities to the provinces.

The Scope for Federal Action in Achieving Them

In order to operate an adequate equalization program at the federal level, the federal government must have access to sufficient revenues to finance the payments to the have-not provinces. In light of the considerations outlined in our discussion of tax harmonization, it would be preferable for the federal government to retain maximum revenue-raising powers in the income tax fields. Given the degree of fiscal decentralization that has already occurred, it is probably unrealistic for the federal government to contemplate remaining dominant in all major tax areas. If a choice had to be made about whether (a) to cede further income tax room to the provinces and expand its role in the sales tax area, and (b) the opposite, i.e., maintain its share of income tax room and let the provinces expand their role in sales taxes, the federal government ought to choose the latter. The introduction of the federal GST could be thought of as retrograde from the viewpoint of the fiscal arrangements.

In order to maintain a federal presence for equity and efficiency reasons in the social program area, it is essential for the federal government to retain some spending power. This cannot, however, be absolute. As mentioned above, some mechanisms for joint power sharing need to be developed. The old systems of cost sharing, subject to federal standards, are not necessarily the optimal way of achieving this goal.

Possible Modest Changes

Is it possible to remedy the major problems with the existing system of fiscal arrangements through a number of relatively modest changes? The answer to this question depends in part on the semantic issue of what sorts of changes are considered "modest," and what would make them "major." Some of the existing problems arise from initial flaws in program design. For instance, the equalization program was never designed as a truly net scheme. While this might not have been too great a problem when provincial fiscal responsibilities were much smaller than they are now, the current magnitude of the equalization program makes them more significant. But many of the other problems arise from the (generally unilateral) imposition by the federal government of ad hoc adjustments in light of underlying systemic changes, and from short-term political or economic expediency. The result is that the current system of fiscal arrangements is very difficult to justify on the basis of any underlying economic principles. In that sense, what is clearly required now is a rethinking, and, where necessary, a redesign of the fiscal arrangements in light of the economic goals they are meant to achieve. We would say, therefore, that any changes that are made should certainly be the result of a *major rethinking* of their purposes and their actual effects. Major changes in program design should not be ruled out.

It is useful to begin by pointing out a number of relatively modest changes in programs that could result in considerable improvement in the arrangements as they now stand. The first of these changes would be to remove the arbitrary caps and exclusions that have been placed on levels and/or growth rates of transfers to the provinces, individually or in aggregate. Some of these "modest" changes would, of course, have significant effects on the federal budget. The correct response to these implications is not to shy away from the changes, but rather to search for other, less arbitrary, ways of dealing with these budgetary effects. Another useful change would be for the federal government to cease the practice of including in what is termed the federal contribution to EPF the tax points that have been transferred to the provinces. By transferring the tax points, the federal government unburdened itself of this share of responsibility for EPF programs. Therefore, these revenues are now the responsibility of the provinces and are no longer, in any sense, a "federal contribution." In the absence of spending caps, this change would have no substantive implications. However, as long as the government imposes limits on the growth of federal EPF contributions, this suggested change would slow down the rate of decline of "real" federal contributions — i.e., what the federal government refers to as EPF cash transfers.

Major Reforms

As we have seen from the earlier discussion, a wide variety of major reforms to the current fiscal arrangements could be imagined. In many cases, however, it is our impression that the changes that have been suggested do not make a coherent package in light of the underlying economic goals of these arrangements. And in other cases, they rest on the assumption of the need for a major change in the degree of centralization of fiscal responsibilities in the federation. What we would like to suggest here is simply a few major reforms that could be justified on the basis of the economic principles we have outlined earlier, and are generally consistent with what we perceive to be the current extent of decentralization. In the event of significant changes in the degree of decentralization, there would have to be corresponding changes in the fiscal arrangements. Such adjustments should be determined on the basis of the economic purposes of the arrangements.

Rationalize EPF and CAP Financing, and Turn Equalization into a Net Scheme. The equalization has never been a net scheme. That is, while it provides transfers to have-not provinces, it only "equalizes down" from the rich provinces to the extent that federal taxes to finance these transfers fall relatively more heavily on the residents of rich provinces than on those of poor ones.³⁴ There are a number of ways in which this deficiency could be corrected. One, as has been mentioned earlier, would be to have the equalization program operated solely by the provinces, so that all transfers to the poorer provinces would be financed by provincial taxes levied by the rich provinces. The amount of taxes to be collected in each of the rich provinces, in an ideal scheme, would be determined in exactly the same manner as the transfers to each of the poor provinces. We have already described our reservations about the viability of a provincially operated equalization program. The same effect could be achieved, however, by several types of federally run schemes. The first possibility would be one in which the federal government financed equalization transfers to the have-not provinces by a special levy on the federal income tax in the non-recipient provinces, where the tax rate in each of the latter jurisdictions varied with their fiscal capacities as measured by the equalization formula. In other words, in order to finance equalization payments to the poor provinces, residents of the rich provinces would pay a province-specific surcharge on their federal income tax.

An alternative is one that would not only deal with some of the problems we have alluded to with the current equalization program, but also rationalize the EPF and CAP schemes. First, as suggested earlier, tax points that had been transferred to the provinces no longer would be counted as part of the federal

EPF contribution. Second, the total amount of the federal transfers to the provinces under these two programs would be aggregated into a single transfer program. This aggregate amount would then be adjusted up or down for each province according to the full amount of their equalization entitlement, positive or negative. In effect, CAP and EPF would be rolled into an expanded equalization program which would be operated on a net basis. The have provinces would end up with smaller federal EPF and CAP contributions, with the reductions being used to finance equalization transfers to the have-not provinces. CAP transfers would no longer be determined by a cost-sharing formula, which, as we have already pointed out, cannot be justified on the basis of any compelling economic argument. As discussed by Bird (1990), they could either be allocated on a simple equal per capita basis, or on the basis of some index of expenditure need in the area of welfare payments and services. This arrangement would make it even more important for the federal and provincial governments to work out an arrangement for both levels of government to exercise their legitimate voice in program design and implementation. Presumably the federal government would have to retain some spending power to withhold funds from provinces who do not meet what are determined to be legitimate national needs. Whether, and if so, under what conditions, the federal government would be permitted to exercise this power unilaterally is something that would need to be discussed.

Reassign Tax Room. It could well be argued on the basis of current thinking about tax harmonization that, given the high degree of decentralization of fiscal responsibilities in the Canadian federation, the federal government is playing too large a role in the sales tax field, and too small a role in income taxes. There could be little justification for the scale to be tipped any further in this direction. And, if there were an opportunity to consider a major realignment in the assignment of tax responsibilities, it might be argued that the federal government should get out of the sales tax field, ceding this area to the provinces, and occupy a much greater share of the income tax.

Also important is the share of the overall tax room occupied by the federal government relative to the provinces. To maintain an effective equalization system, as well as to be able to exercise responsibility for national equity and efficiency objectives through the spending power, it is essential that the federal government have access to sufficient financial resources. It is our view that, as a result of the steady erosion over the past several years, the federal government is perilously close to having insufficient tax room to carry out its national responsibilities. Unfortunately, this cannot be remedied by unilateral action alone. It would seem to be necessary for both levels of government to

collaborate in any major realignment of the tax room between the federal government and the provinces.

New Mechanisms for Joint Federal-Provincial Decision Making. There can be little doubt that key reasons for the somewhat ad hoc current state of federal-provincial fiscal arrangements are that the federal government has often acted unilaterally and for reasons of short-term expediency in making program adjustments, and there is no national institution charged with systematic analysis and consideration of alternative arrangements. Furthermore, in areas of shared responsibility, especially in the area of social programs, there also appears to be a similar lack of joint analysis and decision making. If these allegations are true, and if it is felt that these are significant deficiencies in the current system, then alternatives should be explored, along the lines, say, of the Australian Grants Commission, for introducing institutions for joint analysis and decision making in the area of federal-provincial fiscal arrangements. Such a body would meet regularly in order to consider the state of these arrangements, and to prepare proposals to be considered on a regular basis before the expiry of any particular set of fiscal arrangements.

Extending Grants to Training and Unemployment Insurance, and Decentralizing Them. A somewhat more ambitious change would involve not only the fiscal arrangements but also the division of expenditure responsibilities between the federal government and the provinces. One example of such a change which would appear to be consistent with the general principles we have enunciated above would be to turn over to the provinces responsibility for labour training as well as unemployment insurance on the grounds that they are services that can be delivered more efficiently at the provincial level and that this would allow for coordination of these programs with provincial welfare and education schemes. The latter would result in a rationalized scheme and would eliminate the adverse incentives that provinces are said to face in terms of exploiting the federally-funded unemployment insurance system. Parenthetically, this would also eliminate the temptation that the federal government might have to use these programs as instruments to address regional inequalities. However, the federal government would still retain an interest in ensuring that the programs were designed so as to be consistent with maintaining the efficiency of the economic union and with national equity standards. That is, they would wish to maintain some national standards while at the same time reaping the efficiency benefits of decentralized service delivery. This might be done by retaining some tax room and using it to provide block funding to the provinces with general conditions attached, that is, by using the spending power.

CONCLUSIONS

We have by no means covered all the options that might be considered as suitable ways of renewing the fiscal arrangements. However, we hope we have given a flavour of what in our view are the shortcomings of the existing arrangements, and of the desirable features that a renewed set of arrangements should satisfy. Our basic message is that the federation has evolved into a relatively decentralized one, and that must be recognized when thinking about the fiscal arrangements. Decentralization has its virtues in terms of improving the efficiency with which public services are delivered. At the same time, decentralization increases the need for fiscal arrangements to address the various national inefficiencies and inequities that inevitably accompany decentralization. Fiscal realities suggest that one cannot hope for a major reinjection of federal funding to the provinces. Within these constraints, we must look for a set of federal-provincial fiscal arrangements that allow the federation to take full advantage of the benefits of decentralized decision making and service delivery, but do so in a way that does not compromise the efficiency or equity of the internal economic union.

We would be remiss if we did not acknowledge that the system has served us extremely well in the postwar period. The way in which we have accomplished decentralization while maintaining basic norms and mechanisms for achieving national objectives is a model compared with many other federations. Those that have decentralized have often done it with little regard for the inefficiencies and inequities that result. More often, federations have been too reluctant to decentralize. However, our system is not perfect. The equalization system has well-known warts. The spending power has at times been used too intrusively (some would say in the case of the *Canada Health Act*) and at others too reluctantly (education?). The need for renewal of the existing arrangements is a good opportunity to move the system in the direction of perfection.

NOTES

We are grateful to Leah Anderson for the research assistance she provided and to Paul Hobson for discussions on many aspects of this chapter. Valuable comments were also made on an earlier draft by Travis Armour, Roderick Hill, Wade Locke, and Dennis Stang.

1. We concentrate almost exclusively on fiscal relations between the federal and provincial governments, thus excluding the territories and the municipalities from the discussion. Nonetheless, some of the same issues apply to relations involving these other governments, and some of the same remedies apply as well. In addition, we do not consider other emerging forms of government in Canada such as aboriginal self-government.

2. Nationalists in Quebec would be an important exception to this generalization. An important subset of this group sees a significant role for government in the economy, and sees the provincial government, and not the federal government, as performing it. According to this view, the federal government should leave as much tax room as possible for the province to be able to carry out its functions.
3. Of course, federal government policies may also interfere with the efficiency of the internal common market. We do not address this problem since it is not of direct concern for fiscal arrangements.
4. The same policy instruments could also be used to discourage unwanted factors, like unskilled labour, from entering a province.
5. For more detailed discussion of the rationale for public provision of quasi-private services, see Boadway (1992); and Boadway and Bruce (1993).
6. The concept of fiscal efficiency is discussed in detail in Boadway and Flatters (1982*b*). The notion goes back to Buchanan (1952); and Scott (1952).
7. The literature has also stressed the possibility of a fiscal externality in an economy with local public goods; see Flatters, Henderson and Mieszkowski (1974). The argument here focuses more on an economy in which provincial expenditures are on quasi-private goods and services, which seems to be the more relevant case.
8. Representative empirical evidence may be found in Winer and Gauthier (1882); and Day (1992). The implications of the Winer-Gauthier study for the welfare cost of fiscal inefficiency has been analyzed by Watson (1986).
9. Others might argue that decentralization may lead to more redistribution because interest groups are more likely to capture provincial governments than the federal government.
10. It also has lengthy historical antecedents: see particularly Buchanan (1950) and the application to Canada in Graham (1964); and Boadway and Flatters (1982*a*).
11. This is also true at lower layers of the federation, as well as in unitary states with respect to municipalities.
12. There might also be stabilization reasons for the federal government retaining more tax room than is necessary for its own expenditure purposes.
13. By the same token, it might be argued that cost differences might be taken account of in equalizing grants. However, this can lead to inefficiencies in provision, particularly in reduced incentives for economizing on the costs of providing public services at the provincial level.
14. It might be noted in passing that from the point of view of the arguments given here, the simultaneous recognition of the role of the federal government in maintaining the internal economic union and the virtual gutting of the federal spending power which formed part of the federal government's constitutional proposals of 1992 were mutually inconsistent.
15. Those who would down-play the federal redistributive role, or the redistributive role of government more generally, would not be persuaded by the latter consideration. But the importance of mobility of the tax base can be derived from efficiency considerations alone.
16. See Boadway (1992); Dahlby (1992); and Ip and Mintz (1992) for discussions of the assignment of taxing powers.
17. Harmonization may also be achieved to some extent without formal agreement, simply by competition among governments (see Boadway and Bruce 1992).

However, evidence from various federations suggests that the extent of such harmonization is not likely to be great.

18. We are ignoring customs duties since they are not an important revenue-raising device.
19. An exception to this, discussed further below, is that harmonization of a multi-stage tax (VAT) in a federation is difficult even if rates and rate structure do not differ across jurisdictions.
20. A more detailed discussion of the consequences for federal-provincial fiscal relations of the recent budgetary measures may be found in Boadway (1989; 1992).
21. The Canadian Medical Association apparently feels the same. The court action that they had initiated to challenge the constitutionality of the *Canada Health Act* was dropped.
22. CAP transfers to the three have provinces were also unilaterally restricted to increases of 5 percent, a move that was upheld by the Supreme Court of Canada.
23. This is discussed fully in Boadway, Bruce and Mintz (1987). There is a sizable literature on the issue of why creditor nations offer tax credits since it apparently involves a pure loss of revenue to them. The issue is yet to be resolved.
24. This was one of the themes to come out of the economic analysis that accompanied the constitutional reform initiatives of 1992; see the discussion in Boadway, Courchene and Purvis (1991).
25. Again, we find it most useful to think of the role of equalizing transfers as essentially preserving the financial characteristics of a unitary state, while at the same time allowing for the advantages of decentralization.
26. Basically, what the argument presumes is that provincial public services take the form of quasi-private goods and services, that these goods and services are provided on a roughly equal per capita basis, and that residence-based taxes are roughly proportional. This leads to a system in which all tax sources, residence-based and source-based alike, should be fully equalized according to standard principles of efficiency and equity (see Boadway and Flatters 1982a).
27. Some federations come much closer to this form than the Canadian one, though they do not always implement their transfers in an ideal way. Mexico is a good example, as is Indonesia, both of which are much more centralized on the expenditure side as well. Germany is another example, given its relatively centralized tax collection machinery.
28. For example, François Vaillancourt has stressed this to us in conversation.
29. This is one of the suggestions put forward for consideration, and later rejected, by Norrie. The proposal for a provincially-run equalization system has been made most forcefully by Hobson and St.-Hilaire (1993), though their objective is not to gut national equity but to foster it. They would convert the EPF program entirely to tax points but earmark those tax points to be used for equalization purposes among the provinces.
30. This is one of the "straw men" suggested by Norrie (1993). He ultimately rejects this approach as being unrealistic in face of current fiscal realities.
31. Norrie makes this suggestion with respect to postsecondary education and welfare, but not health, which he would leave entirely to the provinces (1993).

32. Another of Norrie's "straw men," which is similar to one of Leslie's as well, is a suggestion that the federal government remove itself from the social policy field entirely, and decentralize the financing of these programs to the provinces by vacating more tax room.
33. Parenthetically, it might be worth mentioning that we see no convincing *economic* argument against an asymmetric arrangement for Quebec, for example, along the lines of the opting-out provisions of the Meech Lake or Charlottetown Accords. Nor do we see an asymmetric division of powers as being an essential obstacle, provided there is adequate account made for the ability of the federal government to foster national efficiency and equity objectives through the spending power.
34. In fact, because the scheme is not a net one, the federal government has in the past sometimes resorted to ad hoc policy changes designed to shift real incomes from the have provinces to the have-nots. Examples include bilateral energy revenue-sharing arrangements (see Boadway, Flatters and LeBlanc 1983) and the National Energy Policy itself (Boadway and Hobson 1993).

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Comment: Is There a Crisis?

Frederick W. Gorbet

Robin Boadway and Frank Flatters provide an excellent canvass of the principles and issues involved in assessing federal-provincial fiscal relations. Indeed the breadth of their chapter has left me searching for ways that I could add value to their discussion. I concluded that I would try to amplify their ideas by providing the perspective of one who has not delved as deeply into the history or theoretical framework for fiscal federalism, but who, on the other hand, got to play a part in a number of significant decisions that are having and will continue to have profound effects. If you like, you can call this the view from ground level rather than 30,000 feet.

Let me divide my comments into three parts: broad factors that have shaped and will continue to shape the context for bargaining over fiscal arrangements; some specific comments on programs; and some thought-starters on directions for change.

THE CONTEXT FOR BARGAINING

First, and most important, the system is under considerable stress today, in my view, not so much because of the decentralization noted in the essay, but rather because of the fiscal pressures all governments are facing. The remarkable growth in provincial spending and taxing emphasized in the chapter makes a review of the adequacy of federal fiscal relations desirable, but it is the fiscal pressures that give the issue urgency.

It is interesting to note that attempts to deal with the federal deficit over the 1984-92 period divide into two rather distinct subperiods with respect to the fiscal transfers. From 1984-88, during the Conservatives' first mandate, transfers to the provinces were barely touched. There was a deliberate attempt, for

a lot of reasons, to try to deal with the problem without cutting transfers. As a result, while all program spending grew by 3.6 percent per year, on average, from 1984-85 to 1989-90, cash transfers to the provinces grew by 4.5 percent per year (and cash and tax transfers grew by 6.5 percent per year).

Even in the first budget of the second mandate, the government opted for very significant tax increases rather than focusing on transfers to provinces. It was only in 1990, when it became clear that the tolerance for tax increases had been reached if not exceeded and that significant further spending cuts would require cuts to transfers, that the first Expenditure Control Program was introduced, freezing EPF transfers and reducing the growth rate of CAP in the non-equalization-receiving provinces.

I recount this brief history for two reasons. First it is important to understand the fiscal consequences of the status quo. The last renewal of the equalization program was for two years only. The program expired on 31 March 1994 and at that date payments will cease to flow if no legislative action is taken. The EPF and CAP restraints are also legislated. If no action is taken, the controls on EPF and CAP transfers expire on 31 March 1995. At that time, EPF returns to a GDP-3 percent formula and CAP snaps back to a 50 percent cost-sharing ratio in Ontario, Alberta, and B.C. The status quo would result in increased federal expenditures for CAP in the "have provinces" of \$2-3 billion in 1995-96, and this would grow as EPF requirements increased in subsequent years. These federal spending pressures provide an impetus to serious bargaining, and they assure that affordability will continue to be as important as equity and efficiency in the future bargaining context. Subsequent to preparation of these remarks, the Equalization Program was renewed for five years. EPF and CAP are being reviewed with legislation expected in the fall of 1994.

Second, it is important to recognize that there is an accountability issue that is central to fiscal federalism and that is not given as much attention as it deserves in the Boadway-Flatters chapter. Put simply, the federal government in 1990 reached the point where it no longer felt politically able to increase taxes to maintain transfers to the provinces. This political reality was reinforced by the federal perspective that the provinces were doing a less than adequate job of controlling their program spending, particularly in comparison to the restraint that had been exercised at the federal level. (For example, from 1984-85 to 1989-90, federal program spending grew by 3.6 percent per year, while provincial program spending grew by 6.7 percent per year. Provincial growth rates ranged from 4.3 percent annually in Alberta, to 9.7 percent annually in Ontario.)

Boadway and Flatters argue that the "theory of fiscal federalism suggests that the role of federal-provincial fiscal arrangements should increase in impor-

tance as more budgetary responsibilities are transferred to the provinces" (p. 50). While equity and efficiency considerations may lead to that conclusion, particularly in a comparative static framework, it is not clear that concerns about accountability support such a view. There are two dimensions of the accountability issue that need to be considered. The first is the practical political issue I just raised. When one government gets credit for spending and another gets chastized for taxing, there is a political disequilibrium that cannot long be sustained. As well, however, there is the economic issue of whether the allocation of resources between private goods and public goods is optimal when the political accountability for spending and taxing decisions becomes separated. The focus on efficiency in the chapter is almost entirely in the context of the efficiency of the common market, rather than efficiency of resource allocation between public and private goods. Is part of our deficit problem because we have more public goods than we are willing to pay for? And is the blurring of the link between spending and taxing part of the reason why?

The final point I want to make about the future bargaining context concerns the issue of flexibility versus certainty. It is important to recall that the fiscal transfers are federal programs, authorized by federal statute. This is true of equalization, notwithstanding section 36 of the constitution, and it is true of CAP, as the Supreme Court confirmed. The same is not true, however, with respect to the federal-provincial Tax Collection Agreements. These are agreements in the true sense of the word; the provinces have the constitutional right to be in the field and it is in their interest to remain in the agreements only so long as the benefits they feel they get outweigh the costs.

The provinces have made it clear that they are looking for greater certainty with regard to future transfers, and they were quite keen to be able to constitutionalize agreements — a proposal that was accepted by the federal government in the Charlottetown Accord. The defeat of the Accord will not diminish their desire for certainty over funding and Prime Minister Chrétien suggested during the campaign that the new government would wish to provide this certainty in whatever new transfer arrangements it introduced.

An important contextual issue will be how to balance the certainty provinces want with the ability to make changes if circumstances change. It will be equally important to recognize that certainty is also valuable with respect to tax harmonization and as transfers take on more of the characteristics of agreements, it will be useful to keep in mind the possibility of developing a more explicit linkage between transfer agreements and tax harmonization agreements.

To recapitulate, affordability, accountability, and the need to balance certainty against flexibility will influence future negotiations as much as efficiency and equity concerns.

COMMENTS ON PROGRAMS

Let me now make a few comments on specific programs, in the context of the Boadway-Flatters observations. With respect to transfers, I agree completely with their analysis with regard to equalization. It has worked remarkably well. It continues to be necessary to the federation we have developed and, while it is under some stress because of the operation of the ceiling, it is much more robust than either EPF or CAP. It should be maintained and strengthened as the foundation of a reformed fiscal arrangements system.

In my view, neither EPF nor CAP is stable in its current structure. As reforms are considered, the issue of conditionality with respect to the programs these transfers fund will have to be addressed head on. Concerns about the erosion of the power to enforce the *Canada Health Act* as the cash portion of EPF disappeared were taken very seriously by the last federal government and I believe that they have been dealt with in a more definitive way than suggested by Boadway and Flatters through amendments to the *Fiscal Arrangements Act* that allow the withholding of funds from any federal transfer to a provincial government (including CAP or equalization) if the conditions of the *Canada Health Act* are breached and if there is inadequate cash flowing under EPF to support the necessary withholding. Having said that, however, I do believe as we move forward we will have to be more imaginative in the ways by which we seek to impose conditionality on provincial discretion for program delivery.

The chapter makes much of the importance of the spending power as a tool for achieving "the abundant advantages of decentralization without sacrificing national efficiency and equity objectives" (p. 62). My sense is that it will be a long time, if ever, before the fiscal situation of the federal government permits the kind of use of the spending power that we have seen in the past. The federal role in establishing and maintaining national standards (loaded as that phrase is), will in future rest less on coercion and more on leadership and consensus building in an effort to develop standards that are truly national, rather than federal — not an easy exercise, and possibly not achievable, but certainly one worth striving for.

With regard to the tax side, I have three brief comments. First, adopting the GST is characterized as "retrograde" inasmuch as it reflected a choice to replace a sales tax with a sales tax, rather than ceding the room from the manufacturer's sales tax to the provinces in return for income tax points that could make up the

\$15-16 billion shortfall. I doubt whether this would have been possible. It certainly would have been an interesting negotiation with Alberta. In any event, the new government is committed to removing the GST so we are likely to have a chance in the near future to see if a trade-off of sales tax room for income tax points is a starter.

My second comment is with respect to income tax and the debate now going on regarding tax on income rather than tax on tax. It would be a serious mistake to underestimate the strength of conviction on the part of the western provinces, and Ontario, that they need and deserve more flexibility than the current agreements permit. There is a point at which they will withdraw and collect their own taxes, as Quebec does, if they cannot get this flexibility within the agreements. From a federal perspective, the ultimate trade-off in managing this issue is not between more or less harmonization within the agreements, but rather between allowing enough flexibility to convince provincial governments that it continues to be in their own interests to remain within the agreement and being so rigid that the agreement self-destructs. The frontiers are being pushed, as Boadway and Flatters note, and they will continue to be pushed in the coming years. This will not be an easy negotiation!

A final point with respect to tax is to note the very real pressure to deal with the deductibility of provincial payroll and capital taxes. This is not noted in the chapter but it continues to be an important federal-provincial harmonization issue that I believe the new government will have to address.

DIRECTIONS FOR CHANGE

I think that federal-provincial fiscal arrangements will dominate the policy agenda for the life of the next government. The system is not yet in crisis, but it is headed that way. It will have to change, and change will have to be major. Modest changes, such as those set out in the chapter, are unlikely to be practical because the resources to finance them are unavailable. The system is going to have to be reformed within a constrained resource envelope that is consistent with restoring fiscal balance. The fiscal positions of all governments ensure that there will be little, if any, generosity in the negotiations and they are likely to be acrimonious and driven by narrow perceptions of self-interest. The existence of two powerful regional parties in Parliament, vying with each other for the role of official opposition, can only exacerbate the difficulty of finding broad national consensus on these issues.

It will be important in these negotiations that all issues — transfers, taxes, program design, and possibly even budget making and debt financing — be on the table together to maximize the room to manoeuvre and the trade-offs that

can be made. The issues that will drive the process will be the imminent expiry of equalization, together with the government's search for new tax options to replace the GST. But lurking in the background, not too far away, will be the expiry of the controls on EPF and CAP in early 1995 and the federal fiscal burden that will entail, and the unfinished business with respect to tax on income and deductibility of capital and payroll taxes.

It is difficult to speculate, but I could see the negotiations developing in a way where there would be two broad families of options on the table. Each one would have as its centrepiece a strengthened equalization system, which I would hope would operate on a net basis. One family of models would see intergovernmental tax arrangements carry on much as today. There would be some degree of harmonization of the federal and provincial sales taxes: ideally the development of a truly national sales tax with one base, one rate, one administration and audit system, and an agreed formula to share the revenues. It is difficult to see how you get there from here, but it is not a bad model for the new government to aim for. In this world, federal non-equalization transfers (EPF and CAP) would continue but I think would evolve towards a merged block fund. Growth of the fund would be determined by affordability considerations; distribution would most likely be on an equal per capita basis and conditions would apply.

There would be a search, hopefully with some success, for mechanisms to provide certainty (at least for a fixed period of time) and cooperation in establishing national standards. This will be tricky without opening up the constitution again, but worth considering carefully because we will probably be in a constitutional round again in any event before this government's mandate expires.

The second broad family of models would be more radical. If there is no provincial willingness to cooperate in retooling the GST, the federal government could decide to deliver on its promise to repeal the GST by vacating the field and making up the revenue loss by some combination of transfer payment cuts and income tax increases. In 1992-93 cash transfers for CAP and EPF totalled about \$16.4 billion, about \$1 billion more than the revenue raised by the GST. Withdrawing from CAP and EPF totally would raise two very serious concerns: how would efficiency and equity standards be developed and enforced; and what would future flows mean for the federal fiscal position, given that EPF cash is slated to decline anyway and GST revenues would grow over time. Both of these concerns would militate against an absolutist application of this kind of scenario, but these concerns might be minimally satisfied by combinations of GST withdrawal, major cuts to EPF and CAP with residual amounts being delivered as an equal-per-capita block fund, and income tax

increases. In this scenario, the government would have to do some hard calculating, hard thinking and hard bargaining. But it is not a scenario that I would rule off the table.

Let me conclude by providing a capsule commentary on where the players are likely to come from:

The equalization-receiving provinces and particularly Quebec will stress horizontal equity and progressivity. In discussions over the past two years, Quebec more than other provinces has recognized the reality of the federal fiscal position. Their thrust has been to import equalization principles into EPF and CAP so that as transfers become more limited they get distributed more and more on the basis of need.

Alberta and B.C. have consistently stressed accountability and visibility as a basis for replacing transfers with greater income tax room. I expect they will continue to do so.

Ontario has been increasingly preoccupied with its share. This is a relatively new development and will have very real and substantial implications for the next round of negotiations. Ontario has also been a leader in the quest for certainty, in direct response to the federal changes to CAP, though this is something that is shared by all provinces.

Ontario's position is likely to be even more complex in light of its large deficit problem, the reality of a provincial election in 1995 at the latest, and the relative strength of the Ontario caucus in the Liberal government.

The federal government's position so far has been driven primarily by affordability and accountability, although there is obviously a continuing concern to protect the ability to enforce standards that will contribute to efficiency and equity. How the new government will determine the trade-offs that have to be made among these considerations is as yet unclear.

CHAPTER THREE

Canada's Social Policy Deficit: Implications for Fiscal Federalism

Thomas J. Courchene

INTRODUCTION

Social Canada may not be in free fall but it is certainly facing tough and uncertain times. Part of this relates to the emerging range of unmet needs on the social policy front but part, also, reflects the fact that the existing set of programs is being pared back. This is troubling many Canadians, particularly those who view the social programs as an integral part of the glue that binds us together as a nation. Intriguingly, some of these challenges to the existing social policy environment relate to the social envelope itself, namely the inability of the system to evolve and to transfer resources *within* the envelope from low-priority areas to high-priority areas (Courchene 1993a). But the bulk of the challenges comes from outside the social envelope.

One strand of this external pressure arises from globalization and the knowledge/information revolution, and the resulting need for the social envelope to make the transition from a resource-based conception to a human-capital-based conception. Another strand relates to the ongoing fiscal crisis. To the extent that the rest of the economy has begun to make this transition away from a resource-based economy, it has done so by running up the government debt-GNP ratio to 100 percent and by exposing Canada to a 40 percent net foreign debt to GNP ratio. These two strands are related in the sense that one can mount a case that much of the debt accumulation is a result of a last-ditch and ultimately futile attempt on the part of governments at all levels to defend the last generation's social-regional policy and spending conception in the face of the emergence of a new socio-economic paradigm (see Courchene 1993a; Lipsey 1993). This harkens back to the statement by Saskatchewan's Roy

Romanow that "we can't afford any sacred cows or we risk losing the herd." Whatever the cause of this fiscal profligacy, the current reality is one where the social envelope is being squeezed.

Yet a dedicated exercise focused only on reducing costs on the social policy front is equally futile because under such a scenario "Canada begins to look more like the United States" (Maxwell 1993). Restructuring, rather than simply paring, has to be the order of the day because in a knowledge era social policy is progressively indistinguishable from economic policy and, hence, integral to regaining our competitive edge. In his recent Benefactors Lecture for the C.D. Howe Institute, Richard Harris (1993) provides a convenient summary of these issues. Harris notes that there has been a fundamental shift in Canada's wealth generation process — away from resource capital and towards physical and especially human capital. He then notes that although we ran up our debts and deficits within a framework in which our "national collateral" was resources, the national collateral that now has to service this indebtedness is increasingly our human capital base. I would add that part of the reason why employment growth will likely be frustratingly slow and that we will be operating below our potential is that, in key areas, this new collateral is sadly lacking.

In brief (and subject to a couple of critical caveats detailed at the end of this introduction), this is the imperative for restructuring social programs and their relationship with the economic order. Or, in the words of the title, this is Canada's social policy deficit. However, restructuring becomes incredibly complicated because of the way in which our federation addresses the division of money and power. In terms of the latter, both levels of government are involved in virtually every aspect of the social envelope. In terms of the former, the existence of both vertical and horizontal fiscal imbalances implies that these imbalances have to be addressed via a system of intergovernmental grants. And these financial transfers have taken on a life of their own, both analytically and politically, frequently quite independently of their "bridging" role.

For a contribution to a book *The Future of Fiscal Federalism*, it has taken me a long time to get around to mentioning the fiscal arrangements. This is by design. Canadian scholars in economics and political science have made significant contributions to the international literature on intergovernmental relations, both financial and political. Nonetheless, the approach I shall adopt is that the time has finally come to abandon this top-down approach to social policy (in both jurisdictional and fiscal terms) in favour of working from the bottom up. Specifically, in full appreciation of the fiscal crisis on the one hand and the emerging social policy needs on the other, the fundamental social policy issue becomes: what constellation of programs and incentives are appropriate from the vantage point of individual Canadians in order that they can become

productive citizens in this new global order? Then, and only then, should we pose the subsidiary questions: Which level of government should deliver these programs or services? and How should they be financed? In other words, the real problem is, in the first instance, to restructure social Canada, not to restructure the fiscal arrangements. Finding a solution to the latter may not address the former. This is a tall order and I am sure in what follows I shall violate these precepts on more than one occasion. Nonetheless, as we approach the millennium, these principles constitute the appropriate starting point: with the erosion of the fiscal surplus from resources, we no longer have the luxury of harbouring a vision of social Canada where most of the fruits are dissipated in a self-serving tug-of-war between governments.

The chapter proceeds as follows. Part two focuses on those aspects of the old paradigm that are no longer sustainable or economically viable: incentive incompatibility, the entrenched degree of provincial economic disparities, and the intergenerational tug-of-war. However badly the existing social policy envelope performs in terms of the old paradigm, it is woefully off-side in terms of the new socio-economic order. Thus, part three highlights selected features of the globalization and knowledge/information era and the challenges posed for social policy. To this point in the analysis, the emphasis is on restructuring, not on the paring down of the social envelope. Part four then turns to the fiscal squeeze on social Canada, where the focus is on the system of federal-provincial transfers and deficit shifting. In part five, I address the relationship between social policy restructuring and the fiscal transfers, and argue that there have been some salutary effects of deficit shifting. Parts four and five then address, in more detail, selected aspects of horizontal and vertical imbalance in the federation. The final section attempts to draw together the various strands of the analysis in terms of the imperatives for our new social order. The emphasis here is that in the first instance pride of place must go to restructuring the social programs and not to reworking the fiscal arrangements. In other words, social policy ought to be about people, not about governments.

Two Neglected Areas

In approaching the restructuring of social and economic policy, I shall be focusing primarily on integrating the social sphere into the economic and political spheres. This neglects the other direction and, in particular, the integration of the economic sphere with social priorities. The most glaring omission here is the conduct of macropolicy. I take it as axiomatic that the best social-policy environment is a high-employment economy. Moreover, the gains from social policy restructuring will be reaped largely within a growing economy. Apart from the inappropriateness of fiscal policy over the 1983-89 boom (on

which I assume there is mainstream consensus), the key issue here is whether the Bank of Canada's single-minded pursuit of zero inflation in the same time frame as the introduction of the Free Trade Agreement (FTA) and the Goods and Services Tax (GST) as well as the global recession has levelled such a blow to social Canada directly (in terms of unemployment) and indirectly (through the ballooning of deficits and debt from both interest rate charges and from the collapsed economy; and through the consequent ratcheting down of intergovernmental grants and cuts across the social envelope), that social policy restructuring is rather futile until the economy is more robust. There is, of course, another side to this issue, namely that with inflation now laid to rest and private sector restructuring largely behind us, Canada is poised to take full advantage not only of the FTA but as well the emerging consumerism in South Asia and Latin America. Recently, this debate has been cast in terms of goals and instruments: with governments targeting on deficit reduction and the Bank focusing on inflation control, who is concerned about employment (see Fortin 1994; Scarth 1994). In other words, what is the appropriate third instrument: the exchange rate or some version of an incomes policy? While these issues are critical to social Canada, they are way beyond the bounds of this chapter. More importantly, however, they do not, in my view, argue for a delay in terms of rethinking and restructuring social policy in part because restructuring is at the very least a medium-term process. Likewise, the evidence that UI beneficiaries would opt for work if work were available (Phipps 1993) does not constitute evidence against welfare or UI "traps," in part because it leaves "work" undefined. (In particular, for at least one single mother in Ontario, welfare was deemed preferable to a \$41,000 government job!) The key point here is that while the demand side is obviously critical, it will receive scant attention in what follows.

The second omission relates to the nature of, or rather the philosophy underpinning, the conception of our industrial structure. Is Anglo-American capitalism capable of producing and utilizing a highly-skilled labour force? Why is it that the English-speaking industrial economies lag so far in apprenticeships and the emphasis on technologists? Why did the leveraged buyouts of the 1980s, replete with their destruction of many "heritage" firms, not spread to Japan and continental Europe? Must we blindly follow the U.S. conception of anti-trust and merger laws? These important issues have not really been addressed in Canada. But they should be, because skills upgrading will work best within a system that attempts to increase productivity through technical change and the utilization of a labour force with a higher skill mix rather than via the commodification of labour, i.e., competing with the "bottom end" of the labour market (Myles 1991, p. 363). While I have attempted to detail some of

these issues elsewhere (Courchene 1992), the area is basically unresearched. Essentially, the notion is that the commercial/industrial side of the economy ought to incorporate, wherever feasible, the social policy goals and aspirations of Canadians. For example, apart from the chartered banks, the one institution in Canada that has taken low-skilled Canadians and turned them into technologists or skilled workers is the military. Might we not consider a training role for the military as we struggle to upgrade our skills and human capital? As noted, this line of analysis will also not be pursued further in what follows.

THE UNSUSTAINABILITY OF THE OLD ORDER

The claim that the existing social envelope is unsustainable is hardly novel. As early as the mid-1970s, analysts were expressing concern about the nature of the incentives within programs such as UI and welfare and their likely impact on labour market re-entry, regional economic adjustment and the inevitable drift towards what has since come to be referred to as "transfer dependency" for individuals, families, regions and entire provinces. However, these concerns fell largely upon deaf ears with the result that, as years and generations passed, the incentives in the system came more and more to influence and eventually to dominate the socio-economic environment. As importantly, whole industries (e.g., large parts of tourism) have arranged themselves to mesh with the incentives in the social envelope. While many of the early examples of the negative spillovers associated with the operations of social Canada were drawn from Atlantic Canada, these phenomena now apply across the country. Witness the recent attempt by Bell Canada to shorten its work week to four days and to have UI, after a waiting period, pick up the tab for the fifth day. Who's next? Will the 1994 version of Ontario's "social contract" replace the "Rae days" with "UI days"? To be sure, the UI authorities have rejected the Bell request, but the fact that Bell would contemplate such a strategy reveals the pervasiveness of the transfer mentality.

Thankfully, expressing concern about these perverse incentives is now no longer limited to economists and policy analysts. As Premier Frank McKenna noted at the 1993 Couchiching Conference:

Welfare was never meant to be a way of life, but it becomes so for thousands of Canadians. And we do them a disservice by allowing it to spread from one unsuspecting generation to the other. Canada is the only country that I know in the world that offers such generous programs that there is absolutely no incentive in return to divert yourself towards education or training. Passive assistance programs grind away at our ability to move our province forward and they are destroying those that they meant to help. Maintaining a culture of cradle-to-grave dependency is no longer viable. (p. 21)

The premier expresses even more concern when it comes to UI:

I think that a lot of Atlantic Canadians would now tell you ... the truth is that the generosity of Canada has in many ways been the principal impediment to our growth. In Atlantic Canada, we've been the victim of your generosity.... Unemployment insurance was reformed so that not only were people out of work able to obtain unemployment to fill in the gaps, but that everybody who could get 10 weeks of work would be able to draw unemployment for the rest of the year.... I inherited the province in 1987 where we had 128 fish plants, every one of them geared to work 10 weeks, because that's all they needed. (pp. 20-21)

What the 10/42 system implies is that working for \$5,000 for ten weeks (or \$500 per week) will generate close to \$12,000 in UI benefits over the rest of the year. Thus, the societal cost of these ten-week jobs is more than twice as much again as the private cost. Recently, in what the *Toronto Star* (1993) referred to as "a kind of Canadian milestone," Statistics Canada reported that in two New Brunswick counties, 100 percent of two-earner households accessed UI at some time during 1992 and also noted that the ratio was well above 90 percent for many other counties in Atlantic Canada. More anecdotally, when I toured Gaspésie in the mid-1980s as part of a regional development project, there was "evidence" of a rash of small (\$1,000 and \$2,000) loans from the caisses populaires supposedly to help "buy" the required ten-week jobs. This is rational, indeed income-maximizing, behaviour on the part of each individual but at the societal level it is part of what has come to be referred to as "transfer dependency" and, as already noted, it is not limited to the have-not provinces. This is poor economic policy, it is poor social policy and it is making all of us poor!

The aggregate data on UI appear to indicate that benefits increase in each recession, but then do not fall back much in succeeding booms. For example, both 1980 and 1989 had annual unemployment rates of 7.5 percent. Yet UI benefits (in constant dollars) were almost 70 percent greater in 1989 (with the average weekly benefit level only 6 percent higher in constant dollars). In other words, what begins as an increase in benefits triggered by an increase in unemployment (i.e., what begins as a *stabilization* initiative) becomes converted into part of the overall *redistribution* system. That the welfare and UI systems serve to trap individuals should not come as a surprise once one recognizes that, from their inception, these programs embodied a passive income-support rather than an active re-entry mentality. As the Economic Council of Canada (1992) pointed out, the perceived role for welfare at its inception was largely one of addressing the concerns of the disabled and other unable-to-work Canadians whereas the role for UI was conceived largely to mop-up any cyclical unemployment. In other words, full employment was the

order of the day and these programs were designed to cater to the permanently unemployable (welfare) or the cyclically unemployed (UI). There was no provision for the possibility of structural unemployment. This mentality probably explains, but does not condone, the existence of essentially confiscatory tax rates in the transition from these programs to employment at the minimum wage. It is intriguing that we Canadians have been willing to levy 100 percent tax rates (and, for welfare, more than 100 percent because one loses associated benefits like free drugs, etc.) in the transition from welfare or UI to work, whereas we would never contemplate levying such confiscatory taxes on the rest of Canadians. And then we express surprise (indeed, often, "blame the victim") when Canadians react to these confiscatory taxes exactly as the rest of us would react! In any event, what happened is that, over time, an increasing number of welfare and UI beneficiaries have come from the able-to-work category (i.e., as a result of "structural" changes in the economy). Except in circumstances such as the 10/42 syndrome, the social programs do not entice Canadians into their web, but once there, the incentives certainly serve to "trap" them into the system.

All of this speaks to two aspects of unsustainability, one related to individuals and one related to regions.¹ The first is the economic and moral bankruptcy of imbuing the social envelope with a set of incentives that makes it very difficult for rational citizens to pursue avenues that will make them better off over time. These incentives were off-side even in the context of a resource-based economy, but they are exacerbated dramatically in a knowledge/information era (see part three below). The second aspect relates to the unsustainability arising from the gradual entrenching of transfer dependency and the declining economic viability of Canada's provincial and regional economies. This aspect merits further attention.

TABLE 1: Provincial Income Disparity Relatives, 1991 (Relative to the National Average)

	Transfer to Persons Wages and Salaries									T+S+G ² Wages and Salaries			
										Absolute		Relative ³	
	Y/P	E/LF	LF/P	Y/E	P/P	PDI/Y	PDI/P	PDI ¹ /P	AHE ¹	Absolute	Relative ³		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Nfld.	.65	.91	.83	.87	.76	1.25	.81	.83	.92	.57	2.21	1.04	1.57
P.E.I.	.64	.92	.96	.72	.76	1.25	.79	.81	.80	.48	1.87	1.17	1.78
N.S.	.78	.98	.92	.87	.83	1.09	.85	.85	.92	.34	1.32	.94	1.43
N.B.	.76	.96	.88	.88	.80	1.10	.83	.84	.87	.39	1.53	.90	1.36
Que.	.91	.98	.97	.96	.94	1.01	.92	.93	.96	.30	1.18	.78	1.09
Ont.	1.09	1.01	1.04	1.04	1.10	1.00	1.09	1.09	1.04	.21	.83	.56	.85
Man.	.86	1.02	.97	.87	.86	1.06	.91	.92	.90	.29	1.15	.83	1.26
Sask.	.80	1.03	.96	.82	.82	1.06	.82	.86	.91	.36	1.41	1.08	1.64
Alta.	1.15	1.02	1.06	1.06	1.01	.88	1.01	1.03	1.01	.20	.81	.62	.94
B.C.	1.05	1.00	1.01	1.03	1.04	1.00	1.04	1.06	1.05	.25	.98	.58	.88
Canada	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	.26	1.00	.66	1.00
High/Low	1.80	1.13	1.28	1.47	1.45	1.42	1.38	1.35	1.31	N/A	2.73		2.09

Notes: • PI and PDI represent Personal Income and Personal Disposable Income respectively.

• The product of columns (2), (3) and (4) may not equal columns (1), because figures have been rounded to two decimal places.

• PDI¹ equals PDI after the allocation of the federal deficit across provinces (by provincial shares of federal taxation).

1. AHE equals average hourly earnings (fixed-weighted), from Table 19 of *Provincial Economic Accounts*.

2. T+S+G/W+S = Transfers plus Subsidies plus Government expenditures on goods and services, as a percent of wages and salaries (W+S).

3. The relatives in column (11) are not identical to those that would derive from column (10), because the calculations in (11) are based on four rather than two decimal places. This observation also applies to columns (12) and (13).

Source: Statistics Canada (1992).

Provincial Disparities

Table 1 presents data relating to provincial-income- disparity "relatives" for 1991. The first four columns are the components of an identity:

$$\frac{Y}{P} \equiv \frac{Y}{E} \cdot \frac{E}{LF} \cdot \frac{LF}{P} \quad (1)$$

where Y/P = gross domestic (provincial) product per capita;

E/LF = the employment rate, where E is employment and LF is the labour force. This equals unity minus the unemployment rate;

LF/P = the labour force as a proportion of total population.
Essentially, this is the product of the participation rate, LF/LFA (where LFA is the labour-force-age population) and the dependency ratio, LFA/P (where the differences between LFA and P relates to those not of labour-force age, i.e., children and elderly).

Y/E = gross provincial product per employed person, E (where Y/E is derived residually).

Newfoundland has a Y/P ratio of only 65 percent of the national average (or only 55 percent of Alberta's Y/P) because its ratios for columns (2) through (4) are also well below the national average. After the operation of the transfer system, however, Newfoundland's relative disparity improves to 83 percent of the national average (column 8). As the last row of the table indicates, the high-low ratio drops from 1.80 for Y/P to less than half (i.e., 1.35) for PDI^1/P . Some details relating to the operations of the transfer system appear in the last four columns of the table. For example, the ratio of transfers and government expenditures as a percent of wages and salaries exceed 100 percent in Newfoundland, P.E.I., and Saskatchewan (column 12) and would include more provinces if the wages and salaries component of G were removed from the denominator in columns (12) and (13).

Were one to go into more analytical detail relating to the methodology underpinning Table 1 (Canadian Labour Market 1990; Courchene 1994), I think that the following observations/implications could be drawn:

- The degree of regional disparity evident in Table 1 is not new. As the CLMPC analysis indicates, these disparities have long been with us. To be sure, there has been some convergence, but the CLMPC chalks this up to the increasing role of government in the postwar period (1990, p. 36). On the other hand, two

provinces (P.E.I. and Newfoundland) now have levels of Personal Income greater than GDP and this was not true in the early 1980s. What else has altered is that Saskatchewan and Manitoba now appear to have entrenched themselves in the "have-not" group, whereas a decade ago Saskatchewan was in the "have" group in the sense of being ineligible for equalization.

- Analytically, it is hard to escape the conclusion that the operations of the interprovincial and interpersonal transfer system have generated a "policy-induced equilibrium" in terms of the provincial characteristics relating to unemployment and output.
- A comparison with the Australian data (Courchene 1993b; 1994) indicates that the disparities across Australian states reveal almost no divergence in unemployment rates (E/LF) and overall participation rates (LF/P). And in terms of income per capita, the Australian high-low ratio is 1.30 compared with 1.80 for Canada. The comparable Australian data is reproduced as an Appendix to this chapter). While much more research needs to be done to draw firm conclusions from a Canadian and Australian comparison, it is instructive to note that, on the one hand, Australia has a commitment to equality and to an equalization system that is at least on par with Canada's but, on the other, it has no equivalent to our unemployment insurance program (see the Appendix) and very little in the way of explicit regional policy. In any event, the Australian data indicate that regional transfer dependency does not automatically follow from the pursuit of a generous social contract which, in turn, lends support to the argument that Canadian provincial/regional disparities reflect a policy-induced equilibrium.
- One can debate whether this pattern of provincial disparities was sustainable within "old Canada," namely within the framework where we were resource rentiers and running an east-west economy behind tariff walls. As I later will argue, this old Canada is gone and the issue of sustainability has come to the fore.
- Complicating all of this is that the industrial heartland is now reeling. To be sure, the collapse of the centre embodies a significant cyclical component, but the forecasts are for a low-employment-growth recovery.

If they have not yet done so, the have-not provinces should view all of this with alarm. The underlying issues here transcend the viability and affordability of the interprovincial/interregional transfer system; with Ottawa's unilateral fiscal hit on Ontario under the Canada Assistance Plan, issues relating to "willingness" and "desirability" of the existing transfer system are not far from the surface.

Intergenerational Economic Cleavages.

Not too long ago our collective wisdom predicted a rosy future for Canada's younger generations. Their cohorts were relatively small so that what awaited them was higher-than-normal wages and employment prospects. The exact opposite is now turning out to be the case and while this too reflects, in part, the cyclical downturn, the expectation is that lower wages and employment prospects will more likely be their fate.

To be sure, this challenge is not unique to Canada (Courchene 1993b). U.S. Senator Daniel Moynihan has noted that this is the first generation of Americans where the elderly are better off than the young. This observation may not carry fully over to Canada, but the trend is certainly in this direction. (See the paper by Vaillancourt in this volume.) This is disturbing because the ongoing underfunding (in terms of skills formation) of our youth is occurring in precisely the time frame when we all recognize that human capital formation and skills development are the key to their and our continued economic prosperity. But this is not the end of the story since the massive debt overhangs imply that we are also saddling the young with a very substantial negative fiscal dowry. In an era where the elderly will be more numerous and more wealthy, this is a recipe for disaster. In a thought-provoking book, *Selfish Generations?*, New Zealander David Thomson (1991) argues that the welfare state in his country has been hijacked by a single cohort — the soon-to-be goldenagers. Likewise, this scenario may not apply fully to Canada, but the message is clear. If, in a knowledge-intensive world, we underinvest in the young and at the same time burden them with paying the bills for our past and current consumption then we should not be surprised if, when their interests vest, they opt to renege on the intergeneration transfers that underpin aspects of our social contract.

To illustrate aspects of the underlying issue, allow me to focus on two specific examples. The first relates to the entitlement nature of our society and it involves my own sector, the universities. Tenured faculty (largely males) in virtually all universities have either instigated or supported a policy of preferential hiring for women and minorities. The result is massive intergenerational discrimination of young (white) males by older tenured males. This is done in an incredibly clever and politically-correct way; young males cannot hope to advance their own interests because this means arguing against restoring gender balance. Moreover, this approach directs attention away from the real issue — tenure. In this Charter era, there is neither rhyme nor reason for tenure. Ten-year (not tenure) contracts, with provisions for renewal, would be far more appropriate. Yet we in the academy are attempting to use the Charter to lobby for extending our entitlements even further through elimination of mandatory

retirement. Thus, while the private sector is restructuring to stay alive, the university sector is intent on preserving and extending sinecures and in the process ensuring that the current generation of university students is deprived of full access to state-of-the-art ideas. Without too much difficulty, this inter-generational entitlement warfare can be extended to the rest of the public sector.

The other example relates to the operations of the Canada Pension Plan (and the QPP as well, but I will focus only on the CPP). A recent study from the Centre of Public Sector Studies of the University of Victoria by Lam, Prince and Cutt (1993) notes that the contribution rates of 1990 could support an annual CPP payment of \$1,464 if one assumed an average life span of 80 years. But the 1990 CPP for a person with average income was \$6,675, for an annual shortfall of \$5,211 per pensioner. The authors calculate the equilibrium contribution rates required to finance the existing pension levels in real terms is in the order of 16 percent. (Note that the equilibrium contribution rate would be reduced to 8 percent if CPP assets were invested at average rates of return obtained by private sector funds rather than turned over to the provinces at federal government bond rates.) Thus, whereas most of my generation will receive our CPP on the basis of a contribution rate in the range of say 3.6 percent to 5 percent, the next generation can look forward to a 16 percent contribution rate for the *same real benefit levels*.² But this is not the end of the story. With the spotty employment record of many of the young generation, it is likely that a goodly number of them will end up qualifying, at retirement, for more like one-half of a full CPP. As I have indicated elsewhere (1994), this will not mean one additional cent for the future pensioner living in Ontario because the entire half-CPP will be taxed away by GIS and Ontario's GAINS. This is a ticking societal time-bomb. It borders on the immoral, let alone on the inequitable. We are depressing the *current* income prospects of the young with these incredible payroll taxes with little to look forward on their part in terms of *future* (retirement) income benefits.

As noted earlier, this is a recipe for reneging on the implicit intergenerational social contract or, alternatively, for a dramatic opening of our borders to young immigrants who will share in the task of providing entitlements to the older generation. More to the point, this is yet another aspect of the unsustainability of the existing social envelope.

This focus on aspects of non-viability of our social policy framework has been cast largely, but not entirely, in the context of "old Canada," i.e., without reference to the sweeping nature of changes in the society and economy arising from globalization and the information/knowledge revolution. In this "new Canada," the challenges to the social-policy status quo are magnified dramatically, as the next section demonstrates.

THE NEW GLOBAL ORDER

With globalization and the knowledge/information revolution, the world is in the throes of one of its epic transformations. The knowledge/information revolution will have impacts on the role of human capital not unlike the impact of the industrial revolution on the role of physical capital. Figures 1 and 2 attempt to distill the range of influences on the social envelope of globalization and the knowledge/information revolution respectively. Lest readers tend to assign undue credence to material embodied in tables, I have subtitled both Figures with a subjective *tour d'horizon*.

The thrust of these Figures is that sustainability and competitiveness in this new global order requires nothing less than a wholesale rethinking not only of the social envelope but of the relationship between the individual and the state. As noted in Figure 2, this ought to spell the end of "geography" as a defining principle in the federal government's approach to political economy. While there is obviously a role for an equalization program (which I interpret to be part of "people prosperity"), the federal government should remove all "equalizing" aspects from other programs.³ That is, we should put all the equalization into one explicit program. To the extent that "place prosperity" is pursued, this should be advanced by provincial governments (as recommended by the Macdonald Royal Commission), subject to some agreed-upon definitions of an internal economic and social union.

In the previous section, the restructuring focus related largely to the fact that aspects of the old order were becoming increasingly unsustainable. The essence of the message in Figures 1 and 2 is quite different — a new vision of social policy is essential in order for Canada to regain its competitive edge as well as to ensure that all Canadians have the opportunity to develop their human capital potential so as to become effective citizens in the new global order. In other words, straightforward paring down of the existing social envelope cannot be the end of the story: a restructured social envelope is of the essence in an era where knowledge and information are at the cutting edge of competitiveness. As Figure 2 suggests, social policy is, in key areas, becoming indistinguishable from economic policy.

A related thrust (which appears in the lower part of Figure 2) is that this new social order may well involve a reshuffling of powers, *de facto* or *de jure*. In particular, since Canada's competitiveness is in the balance, it is only natural that there will be national, if not federal, dimensions to those social programs that relate to competitiveness, regardless of what the constitution may say. Whether this national or federal dimension will be one of leadership

FIGURE 1: Globalization and Social Policy: A Subjective *Tour d'horizon**A: General Implications*

- At its most basic level, globalization is the internationalization of production. Even at this level, it represents a severe challenge to social policy because welfare states in all countries were geared, incentive-wise, to their respective national production machines. What is the optimal nature of the social policy envelope when production is international?
- It is the international private sector that is globalizing, not the international public sector. Thus, economic space is transcending political space. In countervail fashion, some functions of the economic nation state are being passed upward (FTA, NAFTA, Europe 1992, Bank for International Settlements).
- Power is also flowing downward both to citizens (Figure 2) and to international cities since it is largely via the latter that "institutions" are globalizing. The European regional science literature now focuses on the "regional-international" interface and not only the national/international interface, i.e., economic regions are cross-cutting traditional political boundaries.
- Globalization as represented by free trade pacts has other social-policy implications. With freer markets, delivering social policy via cross-subsidization is more difficult. Distributional (i.e. tax-transfer) instruments, not allocative instruments, must now deliver social policy. This is a welcome development.
- Relatedly, with the spread of FTAs, whether in Europe or America, social policy issues are coming under the rubric of competition policy — hence, the increasing use of the term "social dumping."

B: Canadian Relevance

- As trade increasingly flows north-south, Canada will cease to be a single economy, but rather a series of north-south, cross-border economies. What will then bind us east-west is more of a social policy railway than an economic policy railway. The emerging challenge is how to mount an east-west transfer system over an increasing north-south trading system.
- In particular, the political economy of transfers will alter. When the second-round spending effects of equalization and interregional transfers tend to go south, rather than back to the "golden triangle," how will this alter Canadians' (or Ontarians') taste for transfers?
- In an increasing number of areas, a central vision emanating from the centre will no longer be acceptable — the regions will be too economically diverse in that the requirements for a Great Lakes economy like Ontario will differ from those for a Pacific Rim economy like British Columbia. Part of the solution will likely be one or all of greater decentralization, greater asymmetry and greater east-west flexibility (including wage flexibility).

FIGURE 2: The Information/Knowledge Revolution and Social Policy:
A Subjective *Tour d'horizon*

- The informatics revolution is inherently decentralizing in that individuals can now access, transform, transmit and manipulate data and information in ways that governments at all levels are powerless to prevent. This will make old-style governance more difficult for governments of all stripes.
- With knowledge at the cutting edge of competitiveness, aspects of social policy become indistinguishable from economic policy. Regardless of what the constitution may say, it is inconceivable that the federal government will be relegated to the sidelines in terms of social policy if national competitiveness is at stake.
- Drucker's predictions (1986) are holding up well — the manufacturing sector is becoming uncoupled from the resource sector (i.e., GNP is becoming less raw-material intensive) and, within manufacturing, production is becoming uncoupled from employment. The latest version of the latter is the prediction for a low-employment-growth recovery.
- Despite our generous resource endowment, Canada cannot avoid making the transition from a resource-based economy and society to a knowledge-based economy and society. Further success in the resource areas will progressively require the application of knowledge and high-value-added techniques.
- The middle class in this new era will include versions of technologists and information analysts. But we don't do this. We remain a professional society (as do most Anglo-American countries). Hence, the disappearing middle class. Social policy has a critical role to play in this inevitable shift from boards and mortar to mortar boards.
- In tandem with globalization, the knowledge/information revolution is altering much of the old order:
 - interregional transfers will have to tilt from "place prosperity" to "people prosperity." To the extent that place prosperity remains important, it ought to be a provincial not a federal matter.
 - there is emerging the notion of a global "maximum wage" for certain activities. Wages beyond this maximum wage will shift the activity offshore. As Drucker (1993) notes, this is a powerful argument for "contracting out," i.e., to enhance the productivity of these activities.
 - This is turning the original *BNA Act* on its head. Some of the line functions like forestry, fishing, mining, and energy can and probably should be devolved to the provinces (in any event they will continue to be driven by global imperatives) and some of the traditional provincial areas such as education and training will have to take on national, if not federal, dimensions. Since not all provinces will be able or willing to take down these areas, asymmetry will likely increase.
 - We will witness, if we are not already witnessing, an exciting and, to some, a bewildering set of provincial experiments across the full range of the social envelope. Ottawa's role is to provide the framework within which this experimentation can take place and to ensure that there is information with respect to the successes and the failures. In the same way that Saskatchewan's experimentation led to Medicare a quarter of a century ago the ongoing process is, Schumpeterian-like, creating or re-creating key elements of our new social order.

(i.e., standards, portability etc.) or whether it will involve a legislative role will depend on a range of issues dealt with later in this paper.

To this point in the analysis, there has been no explicit mention of "cutting" social programs. Rather, the emphasis has been on restructuring. However, the ongoing reality is one of squeezing the social envelope by means of a series of caps, freezes, and ceilings to the set of federal-provincial transfers. This is the focus of the next section.

FISCAL FEDERALISM

Table 2 presents estimates of the annual and cumulative "losses" arising from federal "offloading" with respect to EPF and CAP over the period 1986-87 to the present and, indeed, to 1994-95. This table was compiled by the Canadian Teachers Federation and I selected it, rather than others, because of its higher values for deficit offloading. The table assumes as the benchmark the regime in place as of 1985-86. The estimated "losses" result from any and all changes to EPF and CAP since then. For EPF, these changes include the shift from GNP growth as the escalator to GNP - 2 percent, then GNP - 3 percent and finally the freeze on EPF (except for population growth) from 1990-91 through to 1994-95. On the CAP side, the critical change was of course capping the growth of CAP transfers at 5 percent for the three have provinces, Ontario, British Columbia, and Alberta.

The cumulative "losses" for EPF are nearly \$27 billion, spread across provinces on roughly an equal-per-capita basis. The CAP "losses" total \$8.5 billion, with Ontario bearing \$6.8 billion, B.C. bearing \$1.5 billion with a quarter-billion loss for Alberta. Were one to add the equalization program to Table 2, this would add another \$3 billion or so to the "losses" for the have-not provinces, largely as a result of the application of the equalization ceiling in 1989-90 (\$1.4 billion) and 1990-91 (\$1.1 billion), based on Department of Finance numbers.

Given that the resulting grand total is somewhere in the range of \$40 billion, what is one to make of these numbers? The first general point is that they are wholly arbitrary in the sense that the benchmark is arbitrary. For example, were one to benchmark the table in the early 1950s (i.e., *before* the devolution of income tax points), the cumulative totals through to 1994-95 would clearly be hugely *positive*.

Another approach to benchmarking would be to include as "losses" only those shortfalls resulting from arbitrary federal actions *within* any given five-year fiscal arrangement period. Implicitly, at least, this appears to be the approach adopted by Boothe and Johnston (1993). The argument here would be

TABLE 2: Downloading Federal Deficits: Estimated Losses (\$ Millions) in Federal Transfers to the Provinces and Territories, 1986-87 to 1994-95^P

Year	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Yuk.	N.W.T.	Canada
1986-87 EPF	\$ 7.1	\$ 1.6	\$ 10.9	\$ 8.9	\$ 81.5	\$ 113.6	\$ 13.3	\$ 12.6	\$ 29.6	\$ 36.0	\$ 0.3	\$ 0.7	\$ 315.9
1986-87 CAP	-	-	-	-	-	-	-	-	-	-	-	-	-
1987-88 EPF	15.0	3.4	23.2	18.9	174.5	245.3	28.6	26.9	62.9	77.4	0.6	1.4	678.2
1987-88 CAP	-	-	-	-	-	-	-	-	-	-	-	-	-
1988-89 EPF	23.9	5.4	37.0	30.0	279.0	396.2	45.5	42.6	100.3	125.2	1.1	2.2	1,088.4
1988-89 CAP	-	-	-	-	-	-	-	-	-	-	-	-	-
1989-90 EPF	33.9	7.7	52.8	42.7	398.1	570.0	64.6	59.8	144.2	181.2	1.5	3.1	1,559.6
1989-90 CAP	-	-	-	-	-	-	-	-	-	-	-	-	-
1990-91 EPF	67.8	15.5	106.9	86.2	811.4	1,172.3	129.8	118.6	297.5	379.2	3.2	6.7	3,195.0
1990-91 CAP	90.0	20.4	142.6	116.1	1,099.0	1,629.0	172.4	156.5	403.4	524.9	4.5	9.5	4,368.1
1991-92 EPF	-	-	-	-	-	389.5	-	-	0.0	36.2	-	-	425.7
1991-92 CAP	-	-	-	-	-	1,166.4	-	-	41.5	142.4	-	-	1,350.3
1992-93 EPF	100.4	22.5	159.7	129.5	1,232.5	1,835.7	192.2	173.9	455.5	597.9	5.2	10.8	4,915.7
1992-93 CAP	-	-	-	-	-	1,714.8	-	-	63.6	306.3	-	-	2,084.7
1993-94 EPF	103.0	23.1	164.0	132.9	1,269.6	1,904.3	196.9	177.4	473.4	622.1	5.4	11.2	5,083.4
1993-94 CAP	-	-	-	-	-	1,700.0	-	-	66.7	506.8	-	-	2,273.5
1994-95 EPF	111.3	25.1	178.4	144.1	1,384.9	2,094.2	214.7	193.2	521.8	684.3	6.0	12.2	5,570.1
1994-95 CAP	-	-	-	-	-	1,785.3	-	-	70.0	532.2	-	-	2,387.5
Total 1986-87 to 1994-95	552.5	124.7	875.6	709.1	6,730.5	9,960.3	1,058.0	961.4	2,488.7	3,228.2	27.8	57.7	26,774.5
EPF	-	-	-	-	-	6,756.1	-	-	241.8	1,523.9	-	-	8,521.8
CAP	-	-	-	-	-	-	-	-	-	-	-	-	-

P Projected

Notes: 1. EPF: Established Programs Financing. The figure includes both health and postsecondary education and is the sum of both cash and tax points. Losses in EPF are calculated using 1985-86 as the base year. Cumulative losses due to restraints prior to 1986-87 are not included.

2. CAP: Canada Assistance Plan. This was capped at 5 percent for Ontario, Alberta, and British Columbia for 1990-91 to 1994-95 inclusively.

3. Totals may not add up due to rounding.

4. Nominal GNP growth was assumed to be as follows: 1993: 5.7 percent and 1994: 6.0 percent.

5. The federal share of total CAP shareable expenses were assumed to be constant from 1992-93 to 1994-95 for Alberta and from 1993-94 and 1994-95 for Ontario and British Columbia.

Sources: Department of Finance, Established Programs Financing, relevant issues. Department of Finance, unpublished information. Statistics Canada, Population Projections 1990-2011 Based on Recent Changes in Fertility Levels and Revised Immigration Targets, December 1991, unpublished information. Various Ministries of Treasury and Economics, unpublished information. Conference Board, *Provincial Outlook*, Winter 1993.

Reproduced from CTF (1993, Table 10).

that the parameters for each five-year set of arrangements are "negotiated" and that offloading should be defined by federal arbitrary changes within the five-year term that depart from these negotiated agreements. It is probably not necessary to add that this interpretation would not sit well with the provinces.

A third way to approach these numbers is to exclude as "losses" those shortfalls that are not the result of arbitrary initiatives. Arguably, this would exclude equalization payments, since the provision for the equalization ceiling was introduced in 1982-83, although it only became binding during the 1987-92 fiscal arrangements period.⁴ While on the subject of equalization, one might note that the reason that the ceiling became binding in the 1989-91 period had more to do with what was happening in Ontario (spiralling revenues as a result of the prolonged boom and some major tax hikes) than what was happening in the have-not provinces.

A fourth general point that one might make in the context of Table 2 is that the provinces could not have expected to have avoided the federal government's deficit concerns. The issue would then become one of whether the treatment of EPF, for example, was more stringent than the federal government applied to those areas of social policy under its own jurisdiction. On this score, Ottawa was reasonably consistent:

- the indexation of family allowances was reduced to inflation minus 3 percent in 1986. Now that family allowances have been folded into the new child tax credit (1993), this tax credit will also be subject to indexation only by the amount of inflation over 3 percent. Note that this is more restrictive than a GNP - 3 percent escalator;
- While Ottawa had to abort its attempt to partially index OAS/GIS in 1989, it introduced a full clawback of OAS for the elderly rich;
- UI maximum benefits were reduced in 1990 from 46-50 weeks to 35-50 weeks and the qualifying period was increased from 10-14 to 10-20 weeks. In 1993, UI maximum benefits were reduced from 60 percent to 57 percent of insurable earnings. By itself, this latter measure is a 5 percent reduction (on a continuing basis) in what UI benefits would otherwise have been.

Given that all the "losses" arising from EPF in Table 2 relate to decreases in the EPF escalator (i.e., a move towards partial indexation), this was not all that different from Ottawa's moves towards partial indexing for some of its own programs. Indeed, while the EPF freeze embodies *zero* indexing, the fact that GNP has not exceeded 3 percent recently implies that the effective impact is not much different than that which would have prevailed under a continuation of a GNP - 3 percent escalator.⁵

Boothe and Johnston (1993) also adopt this framework and define off-loading as decreases (in percentage terms) in transfers to the provinces that exceed decreases in Ottawa's other programs. They introduce a further twist: transfers to the provinces should be defined only to include the cash component, since the tax-point components are in effect provinces' own revenues.⁶ Under this combined approach, Boothe and Johnston still find that there has been considerable offloading, but at a much reduced rate than would be obtained from a Table 2 methodology.

My fifth general comment on Table 2 relates to the Canada Assistance Plan. Not since the National Energy Program has there been a federal initiative as destructive to the integrity of federal-provincial fiscal relations as the cap on CAP. One can visualize what may have triggered this. Ontario was embarking on a substantial enriching of its welfare system and unless Ottawa took some counter initiative it would be dragged along for half the cost in the very time frame that it was pursuing (at least rhetorically) deficit control. Including all three have provinces within the cap provides some "rationale" for the measure,⁷ but it is evident that the real target was Ontario (and the figures in Table 2 bear this out). The dollars involved are very substantial. Indeed, the annual shortfall this year is not far off the province's savings from the imposition of its "social contract."

More importantly, this does not auger well for the future of the fiscal arrangements. Ontario is already on record as warning Ottawa that a failure to restore Ontario to parity with the rest of the provinces could "dissipate" the support for equalization and the interregional transfer system generally (Ontario 1992). This could be a tall order, given that achieving parity for the three have provinces, at least under existing arrangements, will involve over \$2 billion annually in additional transfers (see the CAP total for 1993-94 in Table 2). While some of the Liberals elected in the Toronto area argued during the campaign for a restoration of the old CAP arrangements, it is difficult to envision this as a Liberal priority, given that it would absorb the entire "savings" from the helicopter contract cancellation within three years. More on the CAP dilemma later.

Summarizing to this point, while the data in Table 2 are correct in a technical sense, they probably exaggerate federal offloading in the broader political economy context. On the other hand, the above comments relating to alternative interpretations of the numbers probably go too far in the direction of minimizing the impact. While there is probably no consensus or middle ground here, it must certainly be the case that there has been substantial federal offloading. Moreover, the issue relates not just to the dollars involved but as well to the arbitrary and sudden nature of these federal initiatives. Provincial finance ministers are

left with precious little in the way of lead time to adjust to these negative fiscal shocks. Note also that this deficit shifting and lack of lead time also applies to a broader range of federal fiscal hits than those associated with federal-provincial transfers. For example, Ottawa's decision to clawback OAS payments for the elderly rich represents a significant tax loss to the provinces. This is so because under the old system OAS payments were part of income for tax purposes and the provinces received something like one-third of the total taxes raised against OAS incomes. Under the new system, the clawback goes to Ottawa and, once fully clawed back, OAS ceases to be part of income. Given that future retirees will at the same time be more numerous and more wealthy, this will represent a progressively more significant provincial fiscal hit. One can, of course, point out that since OAS payments come from Ottawa, it does make sense that the clawback should also go to Ottawa and not be shared with the provinces. In a sense, the logic here is impeccable. But the political economy is quite different: these and other sorts of "sweeteners" to the provinces were part and parcel of the system that led to our shared personal income tax system, one that is at the same time both harmonized and decentralized and generally held up as a model system for a decentralized federation.

Generalized offloading (directly through transfer caps and freezes or indirectly by removing sweeteners such as the previous treatment of OAS and family benefits) could well lead to a fraying of the Tax Collection Agreements and a tendency for other provinces (or groups of provinces) to follow Quebec in establishing a separate personal income tax system, or at least to insist on a switch from the current "tax on tax" approach to a "tax on base" approach which would allow rate and bracket freedom for the provinces' share of the joint personal-income-tax system. (This point is also made in the contribution by Gorbet in this volume). Cast in this somewhat broader framework, the issue of generalized offloading is more than a social policy issue for the provinces. It is a fiscal integrity and fiscal autonomy issue.

Pursuing this latest theme, were one discussing federal transfers a few years ago, the key issue would have been one of sorting out the implications that would arise when the cash component of EPF fell to zero. Because Quebec opted to receive an extra 8.5 personal income tax points in lieu of cash transfers for hospital insurance, Quebec's cash was expected to fall to zero sometime in the mid to late 1990s. The severity of the recession (and, in particular, the collapse of personal income) probably means that the zero-cash-transfer eventuality has been pushed into the millennium. Nonetheless, the combination of a shift to a "tax on base" approach coupled with a receipt of an additional 8.5 personal income tax points (i.e., parity with Quebec)⁸ has surfaced as a

desirable option for the provinces, on both fiscal autonomy and predictability grounds.

THE TRANSFER/RESTRUCTURING NEXUS

Now that I have focused in turn on the restructuring imperative and, albeit briefly, on the fiscal-federalism or deficit-shifting developments, it is appropriate to explore the relationship between the two.

To begin, I think that I am on rather safe ground by asserting that fiscal stringency will continue to be the order of the day. Indeed, the projected fiscal deficits for this fiscal year for both Ottawa and Queen's Park are already recognized as being far too optimistic and, since the forecasting error arises largely because of a revenue shortfall, this presumably carries over to the other provinces as well. With a year or so remaining in terms of the EPF freeze, the provincial finances are bound to be under continued and even enhanced pressure. This, then, is the backdrop to the discussion of the relationship between fiscal federalism and social policy restructuring.

Let me now shift to more shaky ground and proclaim, subject to an important caveat to be aired later, my personal support, thus far at least, for the ongoing degree of fiscal stringency embodied in the federal-provincial transfers (although not necessarily for the form it has taken, especially in terms of CAP). My rationale here is related in part to a recent article by Chandler (1993). She notes that the private sector has spent most of the last decade engaged in dramatic restructuring. To a degree, the federal government has also got into the game by restructuring aspects of both the economy (e.g., the FTA and the GST) and its own fiscal house (e.g., personal and corporate tax reform, the GST, expenditure control). Chandler's answer to her implicit question, "Guess who's turn it is now?" is, not surprisingly once one poses such a question, "the provinces." The catalyst for this provincial restructuring is, of course, the fiscal crisis:

The severity of the recession, combined with the restructuring in the private sector and restraints on federal transfers, dealt a heavy blow to provincial governments. Tax revenues fell way shy of expectations, and the cost of providing welfare and other social services soared, with the result that provincial deficits ballooned. The combined provincial deficit rose from \$4.8 billion in 1989/90 to \$24.7 billion in 1992/93. The combined provincial debt has risen in tandem, from \$119 billion in 1989/90 to \$186 billion in 1992/93. (Chandler 1993, p. 3)

In the face of such a fiscal crunch, the obvious, indeed rational, first response by the provinces will be to appeal to Ottawa to ratchet up transfer payments. Were Ottawa to cave in, the result would be to forestall meaningful

restructuring. After all, the provincial public sectors spent the decade of the 1980s believing themselves largely immune from the traumatic dislocations taking place in the private sector. How many IBMs and GMs must be brought to their knees before the provinces begin to question the effectiveness and efficiency of the university sector (particularly Nova Scotia with its dozen or so institutions), or of the university/community college interface (e.g., Ontario, where they exist as two solitudes) or of the transition from school to work (in all provinces)? Restructuring is inevitable and essential, and I view the pressure coming from the federal-provincial transfer system as both message and messenger in this process. This said, however, there is a limit in terms of how far Ottawa can push the provinces. Surely, all governments should now realize that a strategy of fundamental restructuring must dominate an offloading strategy.

This last concern relates to the above-mentioned caveat, namely the possibility that the fiscal overhang at the provincial level will lead primarily to social policy cost-cutting rather than fundamental restructuring. What happened in the private sector in the 1980s may be instructive here. The early 1980s restructuring agenda was essentially aborted because of the combination of (a) the booming U.S. domestic economy reflecting Reagan's "military Keynesianism" (tax cuts and defence expenditures); (b) the fall in the Canadian dollar to the low 70 cent range; and (c) the willingness of the Americans to tolerate massive balance-of-payments deficits. In tandem, these factors restored *temporary* viability to our industrial status quo. However, when the restructuring finally came, it was nothing short of brutal since it involved not only this foregone or aborted restructuring but as well the adjustment to the FTA and to the macro parameters (the GST and the pursuit of zero inflation which sent the dollar up to 89 cents). That it would have been preferable to pace this adjustment more evenly over the decade is, I think, not in doubt, but it is somewhat irrelevant from the vantage point of 1993. Even were one to argue that the fiscal crisis for the provincial sector is roughly analogous to an 89 cent dollar for the private sector, there are at least two differences between the provincial and private sector restructuring processes that generate cause for concern. The first is that there are no markets as such in the provincial public sector and, as economists, we know very little about the "triggers" and processes of major institutional change. I doubt that political scientists know much more, but hopefully they do. Second, and relatedly, because of the jurisdictional overlap in the social envelope, no amount of fiscal squeezing of the provinces can generate meaningful restructuring unless Ottawa is also willing to commit itself to major structural initiatives. To be sure, Ottawa has introduced some welcome changes in family benefits and elderly benefits, but thus far it has been singularly unwilling to make meaningful structural changes to the critical area of UI and

its relationship to welfare, training and labour force re-entry. If this continues to be the framework within which the federal government is exerting fiscal pressure on the provinces, then there is a danger that the result will be social policy erosion rather than social policy restructuring. Indeed, I will go much further here: this is unconscionable behaviour⁹ on the federal government's part because pressuring the provinces on the fiscal front without at the same time recognizing that Ottawa itself holds the key to unlocking the system in a manner consistent with the dictates of a global/information society will inevitably lead to a grinding down of social Canada and an acceptance, willy nilly, of an American vision and version of social policy.

This critical caveat aside, it is instructive to focus on what is in fact occurring at the provincial level. While cost-cutting is now the order of the day, most of these initiatives also embody aspects of "creative destruction" or restructuring across a very wide range of policies. Quebec is, I think, the acknowledged leader here, whether in terms of a holistic approach to health and welfare or in terms of creative approaches (including wage supplementation) to the welfare-work transition. This should not come as a surprise, since this province has, since 1976 and probably since 1960, embodied a vision of a society where fiscal, cultural, financial, and even economic policy has been geared to weaning itself from dependency on Ottawa. Note that in this process, it still makes eminent sense for the province to ensure that it gets (more than?) its fair share of any federal favours and largesse. In its quest for greater control over "social Quebec," I think that the province is helped substantially by having its own income tax system which, because of its additional tax-point transfers, accounts for roughly one-half of income taxes paid by Quebecers. Control over the parameters of an income tax system is a powerful device for coordinating and integrating the social envelope. This is not meant as an argument for extending the Quebec approach to other provinces, especially since Quebec is marching to the beat of a different drummer. But it may be a strong argument for granting the provinces greater flexibility under the existing shared personal income tax (Courchene and Stewart 1991).

Quebec aside, virtually all provinces have embarked on significant initiatives that fall somewhere between cost-cutting and restructuring: Alberta's stripping away of parliamentarians' pensions and its rather draconian across-the-board expenditure cuts and controls; Saskatchewan's closing of 52 hospitals, one of which was never opened; Ontario's "social contract," following upon somewhat similar controls over the civil service in Newfoundland, etc. Some of this is clearing restructuring — for example, implicit in the social contract legislation is that the combination of wages/job security has placed civil servants in a privileged position vis-à-vis the private sector. And Saskatchewan's hospital

closings can hardly fall solely in the cost-cutting category. Were the truth to be told, most should never have been opened. Perhaps this is why Romanow's popularity still remains in the 40 percent range.

However, it is New Brunswick that, thus far at least, has taken the lead in terms of overall restructuring. Among the features of "NB Works," as the program is called, is the shift from passive income support towards what the Europeans would call an "active society" — education, training, etc., that combines UI/welfare/training, Ottawa and New Brunswick, and the public and private sectors. The other major initiative on the horizon is Ontario's "Turning Point," namely the blueprint for a fresh approach towards welfare which foresees both workfare and a shift towards a negative-income-tax approach for children of low-income families.

I revert back to rather safe ground in suggesting that these initiatives represent but the tip of the iceberg in terms of what one can expect in the future. More to the point, however, the system is embracing a mentality that recognizes the inevitability, even desirability, of fundamental restructuring. In this sense, off-loading has been successful and the time has come for governments to abandon their internal tug of war and jointly embark on the restructuring imperative. How might the fiscal arrangements, and particularly the set of federal-provincial transfers, fit into all of this? In order to address this, it is useful to take an analytical view of these transfers.

INTERGOVERNMENTAL TRANSFERS AND HORIZONTAL/VERTICAL IMBALANCE

Given the unconditional nature of EPF, equalization and, for the three have provinces, parts of CAP as well, these transfers are no longer closely related to the financing of the social programs.¹⁰ Rather, they are best viewed as measures designed to mitigate the vertical and horizontal imbalances in the federation. Since these transfers for 1992-93 range from \$994 per capita in Alberta to \$2,276 in P.E.I., one could argue that \$994 represents the per capita transfer directed towards restoring vertical imbalance with the excess for any province representing the contribution towards restoring horizontal imbalance.

The rationale for these vertical transfers is to ameliorate the situation where the provinces' share of overall expenditures exceeds their share of overall revenues. A secondary role for these transfers (though important in the eyes of many Canadians) is to allow the federal government to exert some "national" control over the social envelope, e.g., portability, preservation of the economic union, the *Canada Health Act* requirements. However, there are alternative ways to address this vertical imbalance issue.

At one end of the spectrum would be the elimination of the vertical imbalance by transferring additional tax points to the provinces. Several analysts have proposed that the cash component of EPF (or at least that associated with health) be converted to a tax-point transfer. In the limit, one could conceive of the disappearance of federal-provincial cash transfers, except for the equalization program.

At the opposite end of the spectrum, one can envisage sorting out vertical balance by an enhancement of Ottawa's expenditure responsibilities. This approach, too, has some adherents: elsewhere (1993a) I have argued that Ottawa could replace CAP transfers with a direct negative-income-tax-type transfer to children and could convert the PSE component of EPF to a system of portable PSE vouchers to students.

The middle ground here would be to perpetuate the existing set of transfers, albeit with some changes in the direction of enhancing their predictability both within and between the five-year agreements.

How ought one to choose among these alternatives? My position on this issue is that the time has finally come to rethink and restructure the social programs from the perspective of those who may have to fall back on them, that is from the vantage point of individual Canadians and not from the vantage points of the various governments. What this means is that fiscal federalism issues must become *derivative, not determining*, in terms of the future of the social programs.¹¹ The remainder of the chapter is directed towards elaborating on aspects of this option. Prior to addressing the many issues involved in such an option, I want to devote some time to the issues relating to horizontal imbalance, i.e., to the equalization program.

EQUALIZATION AND THE SOCIAL ENVELOPE

Section 36(2) of the *Constitution Act, 1982* enshrines the principle of equalization. However, Canada's approach has been to embody equalization in a whole range of programs in addition to the formal equalization program. There are significant and highly distorting equalization components in UI, in terms both of qualifying weeks and benefit weeks. The equal per capita nature of EPF transfers embodies significant equalization because, for example, the costs of delivering health care is significantly more expensive in Ontario than in some other provinces. With the cap on CAP transfers to the have provinces, this program has now been effectively "equalized." I support the Ontario position (Ontario 1992) that all the equalizing aspects of federal-provincial or interprovincial transfers should be combined into a *single* equalization program. Beyond this, there should be no special "geography" or "place-

prosperity" aspects to the range of other interregional and intergovernmental transfers.

Turning now to the formal equalization program, there are both equity and efficiency arguments underlying the system. An impressive theoretical literature on these issues now exists, thanks in large measure to Queen's economist Robin Boadway and his colleagues (e.g., Boadway 1992; Boadway and Flatters 1982; Boadway and Hobson 1993). The simplest version of the model begins with the notion that an individual's comprehensive income or benefits is the sum of his/her net private sector income or benefits and net public sector benefits (or NFBs, net fiscal benefits). On efficiency grounds, one would want to ensure that individuals in different provinces who have similar net private sector benefits (or, for simplicity, similar wages) also have similar NFBs. Suppose that this is not the case and, in particular, suppose that residents in a resource-rich province have larger NFBs than residents in other provinces because resource royalties accrue (untaxed by Ottawa) to the province which can then be used to finance the province's expenditures. Given that what matters to individuals is overall or comprehensive income, it would be rational for an individual to migrate to this province at a lower level of net private benefits (a lower wage rate) provided that this was more than compensated by the increase in NFBs. Such migration would be output-diminishing since the individual would be moving to a lower wage (productivity) job. In the literature, this is referred to as rent-seeking or fiscally-induced migration. An equalization program can help equate net fiscal benefits across provinces and, therefore, be efficiency enhancing. Alternatively, under the assumption that provincial ownership of resources is triggering the differential net fiscal benefits, these NFBs could be eliminated if the resource revenues were included (imputed) as income for personal income tax purposes.

There is also a "fiscal equity" rationale for equalization which would require full equalization of NFBs over all provincial revenue sources (broad-based horizontal equity) or full equalization of NFBs over all non-resource-based revenues and only a portion of resource revenues (narrow-based horizontal equity) (Boadway and Hobson 1993, chap. 4). While I support the efficiency rationale for equalization, I have considerable trouble with this "fiscal equity" approach because it seems to impose a unitary-state vision on a federal system. I would rather cast the equity case in terms of either or both a "federal rationale" or a "citizenship (nationhood) rationale."¹² In any event, the constitution now requires us to provide equalization so as to ensure reasonably comparable levels of public services at reasonably comparable rates of taxation. The concerns that I wish to air relate not so much to the theoretical principles as to the manner in which we have applied them in the existing equalization formula. In particular,

the notion that the analytics of equalization means that all provinces' revenues should be brought up to the national average level, let alone the level of the top province as is frequently argued, is not correct once one broaches Canadian reality.

Most of the issues I want to raise relate in one way or another to the "standard" for equalization. When equalization was first introduced in 1957, provincial revenues were brought up to the level in the two wealthiest provinces. In 1962 the standard became the national average level, but in 1964 it reverted back to the top two provinces. With the introduction of the comprehensive program in 1967, the national average again became the standard, up until 1982 when the current "five-province" standard was introduced. Most of these changes had to do with the role and impact of resource rents in the system. If this book had been produced in the mid-1980s, there would have been an argument on behalf of the have-not provinces that the five-province standard was inappropriate because it resulted in a lesser amount of equalization than would arise under a national average standard. This is not a big concern today because the five-province and national-average standards are essentially identical. If they diverge again, this issue will surely come to the fore once more.

A more important issue relating to the standard is that there are recurring pressures for equalization to embody both "needs" and "costs." In principle, this is the correct approach. In practice, however, the manner in which some have-not provinces tend to phrase the argument is, in my view, quite inappropriate. This issue arises most frequently in terms of the Canada Assistance Plan. Specifically, given that, say, Newfoundland has a very high unemployment rate, should not this be factored into its level of transfers (either in equalization or in CAP by, for example, having more than 50 percent cost sharing)? My answer here is probably "yes." Newfoundland's per capita CAP transfers are roughly \$250. This does seem inadequate to accommodate an unemployment rate in the high teens. But the growth of welfare spending in Newfoundland in the 1980s has been the lowest of all the provinces, in large measure because the province has been able to channel much of its potential welfare burden onto the UI program. The *net* inward flow of UI benefits to Newfoundland in 1991 was roughly \$750 million, or about \$1,300 per capita. By all means let us take account of "need" in the equalization formula, but we must then *net away* funds from *all* other transfer programs specifically designed to address aspects of this need.¹³ It is precisely because we tend to focus program by program, without taking an overall perspective, that the overall transfer system has given rise to aspects of transfer dependency in the first place.

A related issue has to do with introducing "costs" into the equalization formula. We know that, in general, the costs of providing most public services

are higher in, say, Ontario than in many other provinces; physician fee schedules are higher; university salaries tend to be higher, particularly for the top echelon of universities; average wage levels for civil servants are higher, etc. Most of this arises because of "capitalization"; the higher incomes in Ontario are capitalized in the value of land, services, etc. Recall that the Americans do not have an equalization program and one of the rationales for its non-existence is that income differences across states are "capitalized," so that there is nothing to equalize, as it were. Hence, one of the leading federal scholars in the U.S., Wallace Oates (1972) is able to claim that equalization programs are a matter of "taste," not of "principle." While I do not accept Oates' view of equalization (and, more importantly, nor does our constitution), it is nonetheless the case that as between P.E.I. and Ontario the impact of capitalization is such that arguments to the effect that equalization must bring P.E.I.'s revenues up to the national average (or the top province, as is favoured in some quarters) in order to provide "reasonably comparable" level of services is not correct. It is a matter of taste, not principle.

Another aspect of the equalization literature is that the appropriate form of equalization ought to be constituted on a "net" rather than a "gross" system, where "net" in this context relates to direct transfers of revenue from have provinces to have-not provinces (as in the German equalization system) and where "gross" refers to the existing system where equalization payments are made from Ottawa's general revenues with no attempt to reduce *actual* revenues accruing to have provinces. Once again, I have no problems with a "net" equalization system and indeed my article with Glen Copplestone (1980) was, I think, the first time that the possibility of an interprovincial revenue-sharing pool for equalization was aired in the Canadian context. What I do have problems with is the notion that the appropriate role of a "net" system is to bring the "rich" provinces down to the level of the "poorest" province (or bring the poorest up to the richest) in terms of access to per capita provincial revenues. This conception of equalization is clearly implicit, if not explicit, in the Boadway *et al* theoretical literature. Setting aside once again whether the concept of horizontal equity underpinning this body of analysis is an appropriate one for a federal nation, the substantive application issue is that this equality of per capita revenues is not called for in practice, as some of the above argumentation was designed to demonstrate.

None of this is intended to downplay the critical role that equalization plays in our system. But it should sound a warning that we might recoil a bit from our national proclivity to equalize here, there, and everywhere. Indeed, we have now reached a point where the existence of equalization payments themselves have been capitalized in land, labour, services, etc. of the have-not provinces.

Not to put too fine a point on this, my view is that we do too much equalization now, not too little.

TOWARDS A NEW SOCIAL ORDER

The socio-economic climate is ripe for meaningful social policy reform since the existing system is grinding down under the combination of the debt/deficit burden and competitive pressures. In a sense, change is no longer the issue. Rather, the issue is a choice between erosion and restructuring. And, to repeat a theme of this chapter, this restructuring must be undertaken from the perspective of citizens, not governments. However, any restructuring agenda must deal with the perennial federal complications on the economic and political fronts. Among the complications, I would include the following:

- Ottawa is likely to achieve fiscal flexibility sooner than the provinces, unless Ottawa expands the transfer system. Along with this flexibility, it is probably the case that Ottawa is poised for some major initiatives in the social policy area. As I argued earlier, now that knowledge is at the core of competitiveness, it is inconceivable that Ottawa will not want to play a leading role in this area. Moreover, an initiative on the apprenticeship front was a key plank in the Liberal's platform. It will not take long for the Liberals to realize that the obvious source of funding for apprenticeship and training is from a major restructuring of the social programs. And as we now know, the former Tories had a blueprint for social policy reform at the ready. Pressures are clearly building in the Ottawa corridors for major restructuring.
- Some provinces are in such dire economic straits that they are probably not far away from inviting Ottawa to take over areas such as welfare. Hence, these provinces would presumably welcome a federal initiative.
- So would most Canadians who, on the issue of restructuring, are well ahead of their political leaders.
- But there are also some provinces who would vigorously resist, and even challenge in the courts any federal intrusion in areas under provincial jurisdiction.
- In some areas like training and apprenticeship, there may be a middle ground: devolution from both Ottawa and the provinces to local boards composed of labour, business, provincial, and federal representatives.
- In other areas, however, asymmetrical solutions will be inevitable. This harkens back to something along the lines of my "concurrency with provincial paramountcy" proposal during the constitution debates (1991). For example,

Ottawa could step in and rationalize the UI/welfare subsystem, but then be willing to let provinces take back the area under some considerations such as respecting the economic and social union. This would be *symmetry in principle* but likely *asymmetry in practice*. I think that the time has come to recognize that asymmetry in practice has always existed and to view some potential further asymmetry in practice as a solution rather than a problem. We cannot expect Ontario to do only what P.E.I. either wants to do or is able to do. Nor can we expect Ottawa to lie dormant unless it obtains the approval of Quebec and Alberta. Some version of concurrency with provincial paramourcy is needed to break through this jurisdictional logjam.

- If we embark on such a restructuring, the likelihood is that the present set of federal-provincial transfers would have to be reworked in a manner consistent with the social policy reform. It is in this sense that I argued earlier that the transfers ought to be viewed as derivative.

Most of the above points relate to process, not to substance. Part of the reason for this is that it is not at all obvious that there even exists an "optimal" social restructuring. Because of this, there is an argument for some degree of flexibility in any new restructuring so that the system can evolve in ways that make sense for the various cross-border economies. Nonetheless, I think that we have to begin to "think the unthinkable" in terms of proposals that are placed before Canadians for debate and discussion. For example, the typical reform proposal for UI is to return it to insurance principles that apply identically across the country. But why not go the further step and ask whether or not both UI and welfare can be replaced by some version of a negative income tax? This would certainly alter what would be appropriate in terms of the fiscal arrangements! Likewise, why not consider ways in which our two subsystems for the elderly (OAS/GIS and CPP/QPP) can be combined into a single program? (See Hamilton and Whalley 1984.)

Perhaps not fully consistent with the above proposals, but certainly also worth placing on the restructuring agenda is the suggestion of converting CAP into some version of a negative income tax for children. This would not be like the existing child tax credit because it would begin to be clawed back at a much lower income level. While my intent here is not to argue for any particular proposal, I do want to direct some attention to this one. There has been much discussion in policy circles to the effect that Ottawa could look after the income-support or social insurance programs for unemployed employables while the provinces would look after the "unable-to-work." However, the line between the two will inevitably be very fuzzy, with the likely result of yet another jurisdictional quagmire. Making Ottawa responsible for the welfare of

children (to go along with its responsibility for goldenagers) cuts through all of this much more cleanly. The provinces would focus on all adults and, within this context, one could contemplate an integration of the existing UI and welfare programs in ways that provide incentives for training and labour-force re-entry. (Note that under some version of opting out or concurrency with provincial paramountcy, this approach need not differ from the approach in the previous paragraph for those provinces that wish to exercise their paramountcy.) One potential advantage to this approach is that because all children would be treated equally, this proposal would restore the "Ontario deficit" that currently besets the Canada Assistance Plan.

The reader will recognize that in arguing for converting CAP to a negative income tax for children I have violated my earlier enunciated principle, namely that the fiscal transfers ought to be derivative, not determining. The correct approach would be to focus on the restructuring imperative related to welfare. If, as I suspect, the result will be that some separate provision has to be put in place for children, *then* the conversion of CAP into an NIT for children becomes a potential instrument.

One can add many more proposals to this agenda — a tax-point transfer for Medicare, a voucher system for PSE, etc. And readers will have their own proposals. My role here is not to opt for a particular form of restructuring, only to present the case for a restructuring imperative. Since most of these proposals represent substantial restructuring, they will need adequate lead times and in some cases the provision for transitions. In turn, this implies that we must engage in this societal debate now, while we may still have a window of opportunity, rather than later when any restructuring in all likelihood will be driven by the international capital markets.

Prior to concluding, I want to devote some attention to where and how pressures for fundamental restructuring may come to the fore. Simeon (this volume) argues that there is a set of "trumps" that are characteristic of our federation: regional politics trumps other dimensions of distribution; fiscal federalism trumps social policy; the intergovernmental dynamics trumps citizen politics, etc. These are the sorts of insights that we have come to expect from Simeon. However, while they certainly applied to the old order, we are now in a new paradigm — fiscally, socio-economically, and in terms of the citizen-state relationship. The game has changed; to mix the metaphor, kings, queens, and even pawns can now check-mate any trump.

To sustain such an argument, I need to identify some restructuring dynamics that can finesse the powerful cards that federalism in all its forms (constitutional, regional, intergovernmental) has always held. Let me suggest three.

The first has already been alluded to, namely that in this globalization/knowledge/fiscally-constrained era, Ottawa will recognize that social envelope restructuring holds the key to regaining our competitive edge. Short of a dramatic economic recovery, this option easily dominates (initially at the conceptual level and then on the political level) the alternatives of embracing the U.S. social envelope or turning the task (via inaction) to the gnomes of Zurich. Therefore, expect a new dynamic from Ottawa.

The second way in which federalism or jurisdictional deadlocks can be finessed is through provincial initiatives.¹⁴ Typically, one associates this with the demands from Quebec or perhaps Ontario now that it is likely to play a more assertive role in the wake of the CAP fiasco. This is clearly possible. But it does not address Simeon's "regional politics trumps other dimensions of distribution." Consider, therefore, the following avenue. Implicit, even explicit, in Premier McKenna's Couchiching address was the fact that the days of the status quo on the New Brunswick social envelope front are numbered. Transfers of the existing magnitude will not be sustainable economically or politically. NB Works was the initial response. The obvious next step is a joint Maritime or perhaps Atlantic initiative which would involve a total reorganization of the social envelope and which could involve regional control of the existing level of net transfers under UI, to be phased out gradually over, say, a ten-year period to the non-place-prosperity level of UI prevailing elsewhere. The rationale for this would be two-fold: to devise a more rational approach to the UI/welfare/training subsector and to forestall some pre-emptive strike by Ottawa on UI. Would Ottawa refuse such a package? Negotiate perhaps, but refuse, no. Therefore, with somewhat less likelihood, expect a new dynamic from the provinces.

The third dynamic is at the same time more speculative and less likely, namely that citizens in one or more of the provinces will find their services reduced to a level where they will ask Ottawa to step in on their behalf. The extreme case here would be one where the capital markets require a federal guarantee on the province's bond offering, i.e., the province runs into the proverbial "debt wall." Since it is inconceivable that Ottawa would provide such a guarantee, we will be in for major institutional change and restructuring. But pressures will build up well before this bankruptcy point. Federal transfers can maintain revenues per capita, but they cannot prevent a run-up in expenditures or an outflow of people, both of which will complicate the servicing of the existing debt levels. One hopes that one is wrong here, but this harkens back to the earlier comment that some provinces are probably willing right now to transfer areas like welfare to the federal government.

To be sure, given that unsustainability of the old paradigm and the unmet challenges of the new socio-economic order represent the underlying thrusts of much of the above analysis, it may well be the case that this perspective leads me to place too much emphasis on the restructuring imperative and too little on the entrenched constitutional-political-intergovernmental-regional dynamics that have been the hallmark of Canadian federation. Or, in economists' jargon, this vantage point may lead me in the direction of falling back on "heroic" assumptions. But I adhere to the proposition that heroes are not so much born as cornered. Canada is cornered!

IMPLICATIONS FOR FISCAL FEDERALISM

Prior to concluding, it is appropriate to redirect attention to the theme of this book, namely the implications for the future of fiscal federalism. In the world sketched out above, federal-provincial transfers would be derivative, not determining. Currently they play more of a determining role. In effect, they drive much of social Canada. We tend not to speak of a welfare problem but rather about a CAP problem. Likewise the challenges relating to health tend to be framed in terms of an issue of EPF or the *Canada Health Act*. These were the instruments that were critical to delivering the social infrastructure and policies associated with the old paradigm. Redesigning these federal-provincial transfers is not the same as restructuring social Canada.

This does not in any way downplay the critical importance of the federal-provincial financial interface in any restructured system. But it may be a quite different interface. For example, both structure and magnitude of federal-provincial transfers would presumably be very different under a scenario where UI and welfare were replaced by some version of a negative income tax or a guaranteed annual income. This more fundamental rethinking of social Canada will become more difficult if, in the first instance, reform initiatives are focused on the fiscal arrangements. The thrust of this chapter has been that the time has come in terms of fiscal, economic, and social considerations to engage in this more fundamental restructuring. And the way to do this is to begin by asking ourselves what constellation of policies makes sense from the perspective of individual Canadians and their families, not what makes sense for governments.

In all of this, however, there is one aspect of the existing set of fiscal relations that must survive in one form or another, namely the preservation and enhancement of the economic and social union. Currently, the spending power plays a critical role in this process. Preserving the integrity of the personal income tax system (e.g., the prohibition of beggar-my-neighbour tax provisions) is accomplished largely through the exercise of the federal spending power. So are the

provisions relating to portability and the lack of residency requirements on the social union front. Were the ideal social policy restructuring to involve further asymmetry or further decentralization, the case for an effective social and economic union would presumably become all the stronger. To be sure, the exercise of the spending power is not the only way to deliver a social and economic union: I have long adhered to the principle that for programs to be national they need not be central. But until other effective provisions are put in place to guarantee the internal socio-economic market, Ottawa should not abandon the leverage associated with the exercise of the spending power.

CONCLUSION

In an era where fiscal deficits are dominating the economic landscape, one can, as the title suggests, speak meaningfully of a social policy "deficit." Intriguingly, the two sorts of deficits are related since, as noted earlier, the failure to undertake social policy reform in the 1980s contributed to the running up of fiscal deficits. Now the shoe is on the other foot; fiscal deficits are wreaking havoc with the social programs. However, simple cost-cutting on the social policy front merely widens the social policy deficit or deficiency in the important sense that a restructured social policy envelope is crucial to our longer-term prosperity. In the broader context, the message here is that social policy restructuring is the order of the day and that the fiscal arrangements must be reworked to accommodate the new social policy order. Indeed, this restructuring will likely have significant implications for other aspects of fiscal federalism which have not been touched upon in this chapter, such as the assignment of tax powers. For example, the jurisdiction that is ultimately in charge of overseeing the transition from welfare/UI to work should probably have considerable control of, or flexibility within the personal income tax since this is an obvious integration and reconciliation vehicle for the subsystem.

Nonetheless, whatever the imperatives for the medium term, I suspect that in the immediate future it is inevitable that "tinkering" of some sort will be the order of the day when it comes to the fiscal arrangements, in part because some decisions have to be made within a matter of months. We will be very poorly served by our political class if they view this tinkering as anything other than a temporary and stop-gap measure on the road to addressing the real challenge — restructuring social and economic policy to render it consistent with globalization and the knowledge/information revolution. To be a Canadian in the new millennium must mean that all citizens have full opportunities to develop and enhance their human capital. Thankfully, there is no trade-off here — this is good economic policy and good social policy. But getting there will be tough

because the required decision making will likewise be tough. Unlike private sector restructuring, there is precious little that individual Canadians can do, acting in their own spheres, to bring about this new social order. Thus, my advice to like-minded Canadians is to maintain pressure on our political class and perhaps even to adopt the admittedly irreverent slogan that appears daily on the masthead of the *Whitehorse Star* — *Illegitimus non carborundum*.

Appendix

State Income Disparities in Australia

Table A.1 presents data on regional disparity relative for the Australian states in the same time frame (1991) and on more or less the same basis as Table 1 (in the text) for Canada. The first four columns of Table A.1 are fully comparable with the corresponding columns of Table 1. Columns (5) and (6) of Table A.1 are closely, if not fully, comparable with columns (6) and (7) of Table 1. HDI stands for Household Disposable Income and is the Australian counterpart, at least as far as I can ascertain, to our Personal Disposable Income. The last column of Table A.1 is AWE (average weekly earnings) which is a proxy for the Table 1 entry AHE (average hourly earnings).

The message in the text is that state regional disparities in Australia embody much less disparity than in Canada. This is obvious. What is not so obvious is why this is the case. The text argues that part of this is probably attributable to the fact that there is little in the way of specific regional policy on the part of the Australian government. Indeed, there is no UI program, as such, in Australia. What they call "unemployment benefits" (administered centrally) are really what we would call welfare.

Since this comparison between Australia and Canada is somewhat peripheral to the main message of the paper, I shall leave it to the reader to make the relevant comparisons. However, I would add three observations. First, it appears that Australia has avoided the regional transfer dependency that is evident in Canada, even though Australia holds equity and equality in at least as high a regard as do Canadians. Second, Australia appears to be suffering from "national" transfer dependency in the sense that what was once the highest income per capita economy has now fallen to the high teens or low twenties in terms of income per capita rankings among developed nations. Canada has managed to retain its overall income per capita ranking. Finally, the comparison of Table 1 and Table A.1 requires much more research before one can draw meaningful conclusions. Somewhat more in the way of comparative analysis appears in Courchene (1993b), but these tables represent a puzzle that clearly requires more research.

TABLE A.1: Regional Disparity Relatives (Australia 1991)

	(1) Y/P	(2) Y/E	(3) E/LF	(4) LF/P	(5) HDI/Y	(6) HDI/P	(7) A.W.E.
New South Wales	1.035	1.047	1.008	0.981	1.035	1.018	1.022
Victoria	1.053	1.051	0.991	1.010	.0984	1.043	1.008
Queensland	0.888	0.891	0.989	1.008	1.001	0.891	0.931
South Australia	0.883	0.889	0.990	0.974	1.048	0.926	0.952
Western Australia	1.037	1.020	0.981	1.036	0.858	0.889	1.005
Tasmania	0.810	0.850	0.982	0.970	1.061	0.859	0.968
Australia	1.000	1.000	1.000	1.000	1.000	1.000	1.000
High/Low ¹	1.300	1.240	1.030	1.070	1.240	1.210	1.100

Notes: ¹For the six states.

Sources: ABS, *The Labour Force, Australia* (July 1991), 6203.0; *Australian National Accounts, 1990-91, State Accounts*, 5220.0; *Estimated Resident Population by Sex and Age, States and Territories of Australia* (June 1990 and Preliminary June 1991), 3201.1; *Distribution and Composition of Employees, Earnings and Hours, Australia* (May 1991), 6306.0.

NOTES

This chapter draws heavily on my forthcoming C.D. Howe monograph on social policy. I would like to thank Paul Boothe for valuable comments on an earlier draft.

1. Note that at this juncture, the issue relates to *structure, not to dollars*. Indeed, it might be best to view all of this under the assumption that the dollars dedicated to the social envelope remain fixed. Later, I shall drop this assumption.
2. Recently, an alternative approach to the CPP has been floated in the policy arena, namely increasing the retirement age to 70. This will serve to keep contribution rates down, but it will discriminate against younger Canadians since this age increase will have a substantial lead time associated with it.
3. There will still be regional redistribution in many of the social programs. For example, a UI program with identical qualifying weeks and with benefit weeks based on these qualifying weeks would still generate greater benefits in high-unemployment areas. This is appropriate. The reference in the text is intended to remove any specific regional provisions built into programs such as UI. Note also, that there will always need to be "emergency" measures, such as the grain subsidy and the "cod moratorium." What is disturbing here, however, is the lack of sunset or phase-out provisions to ensure that such stop-gap measures do not end up as yet another feature of our "permanent" redistributive system.
4. The equalization ceiling is "rebased" in the first year of each five-year period (i.e., equalization is set equal to formula entitlements for this first year). Thus, the ceiling can only be binding for the remaining four years of each five-year agreement. For these four years, equalization in aggregate cannot exceed the cumulative rate of growth of nominal GNP from the base (initial) year. If it is in excess, the reduction in equalization entitlements is an equal per capita decrease for all recipient provinces.
5. This is not quite correct because the definition of GNP for EPF purposes is a three-year moving average ending with the current year. Thus, even though GNP fell below 3 percent almost immediately after the freeze was in effect, the three-year GNP average would have exceeded 3 percent at least for the first year of the freeze. However, all of this ignores the symbolic impact of a freeze.
6. Note that the contributions by Boadway and Flatters and especially that by Dupré (both in this volume) also take issue with including tax points as part of the EPF transfers. It is true, of course, that these tax points are now part of the provinces' own revenues. However, one has to separate the value of these tax points in the hands of the provinces from the notional role that they play in the EPF program. At the very least, a fuller analysis would have to focus on the 1977 arrangements themselves and on the critical 1982 arrangements which introduced an overall ceiling to EPF and converted the cash component into a residual transfer (see Courchene 1984).
7. One way of interpreting the cap on CAP is that it "equalized" the CAP transfers — it tilted payments away from the "have" provinces, while leaving the system untouched for the have-not provinces. Some provinces, Quebec in particular, had argued that the growth rate of overall federal-provincial transfers was larger for the have than for the have-not provinces in recent years. Ottawa may have been responding to these concerns. However, given that per capita CAP transfers for

1992-93 to Quebec were \$335 compared with, say, \$233 for Newfoundland and only \$183 for Saskatchewan, it is difficult to see where or why Quebec had much to complain about.

8. Actually, these 8.5 PIT points relate only to EPF. Quebec also receives another 5 PIT points under CAP and yet another 3 for various other programs for an overall transfer of 16.5 PIT tax points. Thus, full parity with Quebec probably means 16.5 tax points, not only the 8.5 associated with EPF.
9. One might argue that Ottawa's behaviour is unconscionable in another sense — it was its inability to put its own fiscal house in order during the 1980s boom that has precipitated the existing fiscal havoc. As argued in the introduction, a major part of this fiscal profligacy represented a futile effort to adhere to an outdated and outmoded social policy paradigm.
10. EPF transfers are unconditional in that they can be spent as the provinces please. However, provincial spending on health (from whatever revenue source) must satisfy the requirements of the *Canada Health Act*.
11. Thankfully, I am not alone in arguing for this refocus — see Boothe and Reid (1993).
12. The "federal" rationale for equalization payments relates to the proposition that equalization is the cornerstone of a meaningful federal system. For any constitutional assignment of powers to be meaningful, provinces must have the financial capacity to fulfil these responsibilities. The "citizenship" rationale has to do with the notion that Canadians, wherever they live, ought to have access to certain basic economic and social rights — rights that ought to attend Canadian citizenship, as it were. Since some of these rights fall under provincial jurisdiction, it is imperative that provinces have funds adequate to provide them. While there are aspects of equity associated with both these rationales, they are distinct from the horizontal equity notion underlying the NFB conception. Indeed, under either the federal or nationhood rationales, the first-best solution is an equalization program, whereas under an NFB formulation the first-best solution really is a set of differentiated transfers to individuals. One arrives at a set of equalization payments only as a second-best solution. It is in this sense that I argue that the concept of "fiscal equity" as reflected in the NFB conception is essentially alien to a federal system. For more detail, see Courchene (1984, chap. 3).
13. Or more correctly, net away all funds that flow in because of specific "place-prosperity" features of other programs.
14. The ideas in this paragraph and the following one are the result of a conversation with Fred Gorbet about our respective conference papers. Needless to say, Gorbet may not be in agreement with the way I have distilled some of these ideas.

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Comment: The Nature of Dependency

Lars Osberg

There are a great many insights and observations in Tom Courchene's chapter — some I agree with heartily and some I disagree with. Since a commentary should be somewhat shorter than the original paper, I will select one aspect of the chapter I dislike and one aspect that I like, and make a general, overall comment.

The aspect that I dislike is the use of the term "dependency." This term is used repeatedly and has been used and re-used in the broader public discussion until it has become a cliché. However, the phenomenon which the term seeks to describe is rather vague and all-embracing, and the evidence that is cited is often entirely anecdotal. In fact, the term "dependency" has two quite distinct meanings and the debate on "dependency" has become sloppy and misleading because people often shift back and forth between these two meanings, without realizing the transition.

The term "dependency" is sometimes used in the accounting sense of "being reliant on," as indicated by the fact that a relatively high percentage of total income comes from a particular income source. In the accounting sense, senior citizens are highly "dependent" on unearned income in transfer payments and pensions, while the Alberta government is heavily "dependent" on transfer payments from oil companies. Dependency, in this sense, is an *ex post* accounting relationship which describes income flows. Since this conference has already heard numerous comparisons between Atlantic Canada and the rest of the country, and since unemployment insurance has often been mentioned, I could not resist the temptation of preparing Table 1. In order to maintain comparability, Table 1 compares urban areas only and it is notable that in the

TABLE 1: 1992 Unemployment and Unemployment Insurance Dependency

	Halifax	Toronto	Montreal
<i>Unemployment Rate (%)</i>			
Age 15-24	15.4	19.1	18.0
Age 25-44	8.9	11.0	12.6
Age 45+	7.7	8.1	11.4
Total	9.9	11.5	13.1
<i>Labour Force (000's)</i>			
Total	166.8	2,005.2	1,585.6
<i>Population >15 Years of Age</i>	246,200.0	2,890,900.0	2,469,900.0
<i>UI Claimants</i>			
Number	11,594.0	161,472.0	136,356.0
% of Labour Force	7.0	8.1	8.6
% of Population	4.7	5.6	5.5

Note: Regular benefit claimants only.

Source: Author's compilation

accounting sense, Halifax had in 1992 a *lower* rate of "dependency" on unemployment insurance than either Toronto or Montreal.

However, the term "dependency" is also often used in a behavioural sense to evoke images of addiction, false reliance on transfers and bad behaviour induced by the presence of transfer mechanisms. Observed outcomes are in this context, interpreted as voluntary choices and evidence on *ex post* accounting flows is used to justify the presumption of behavioural impacts from the presence of transfer payments. The Courchene chapter, like much of the literature in this area, shifts back and forth between the accounting and the behavioural interpretation of dependency, often without any apparent realization of the transition.

It is often hard to penetrate this dialogue with empirical evidence since "dependency" in the behavioural sense is vaguely specified, and it is an easy slide from stereotypes and anecdotes to macro data on accounting flows between provinces and broad generalizations about the psychological attitudes of entire regions of the country. Courchene's chapter, for example, discusses a hypothetical example of a worker who is employed for ten weeks and on unemployment insurance for 42 weeks. This sentence is followed by the statement that in two New Brunswick counties 100 percent of two-earner

households accessed UI at some point during 1992 and the ratio was above 90 percent in "many" other counties. The paragraph concludes with the statement "this is transfer dependency." Although the insinuation is clear, no attempt is made to ascertain whether the average duration of unemployment insurance receipt was two weeks or 20. There is no attempt to examine whether similar concentrations of unemployment insurance receipt could be found elsewhere (e.g., in east end Montreal) and there is no consideration of whether individuals "chose" in any sense to become unemployed.

For the record, however, ten-week workers are a very small proportion of total employment. Christofides and McKenna (1992) report that nationally, ten-week jobs were 2.19 percent of all jobs in 1988. Green and Riddell (1993, Table 6) report that in high-unemployment local labour markets the number of 10-13 week jobs were 2.44 percent of total jobs. Since some fraction of these jobs were followed by a return to school or a short duration spell of unemployment, the stereotypical "10/42 worker" is necessarily a smaller percentage of total employment. The continued reappearance of this stereotype in the public debate indicates the important fact that anecdotes have a far greater political and social impact than their numerical importance would warrant.

It is observably the case that people and governments in Atlantic Canada, and in depressed regions of the country generally, receive transfer payments. However, before those accounting flows are transmuted into a broad, overall behavioural assertion of "dependency," the mechanisms of presumed behavioural change should be specified. *Which* program is affecting *what* behaviour? *Who* is doing *what* differently? *How much* does behaviour actually change in response to program changes?

As it stands, the "dependency" argument is often used in a vague, overall macro sense, but is it individuals, firms or governments that are supposed to be behaving differently? The recent literature on unemployment insurance is far more uncertain about the behavioural impacts of UI than the literature of the early 1970s (see Osberg 1993). Is it being suggested that equalization payments to provincial governments are altering the wage elasticity of labour supply of individuals? Are firms supposed to be less profit-maximizing because provincial governments have additional revenue? Why is it that additional revenue in equalization payments to Saskatchewan induces "dependency" while additional revenue in oil royalties to Alberta does not? Economists have long argued that decisions are influenced by prices at the margin, and federal transfer payments such as equalization and EPF are unconditional — how is it that these transfer payments are supposed to influence provincial government priorities?

On the other hand, if one prefers broader generalizations, should Canadians be using the evidence of Table 1 to support a whole new series of anecdotes

about lazy residents of Toronto and Montreal, living a life of leisure on unemployment insurance? I think not, because Table 1 really indicates the disproportionate impact of the 1990-93 recession on Toronto and the longer term structural problems of the Montreal economy. As Sharpe (1994) has shown, two-thirds of the job loss of the 1990-93 recession was concentrated in metropolitan Toronto. (On the other hand, Montreal has had higher unemployment than Halifax since the late 1970s.) The serious point to make is that the demand side of labour markets is crucial to our understanding and interpretation of accounting data on unemployment insurance flows.

A second point to emphasize is the sharp divergence between urban and rural labour markets in many parts of Canada. Atlantic Canada's rural problems are not unique. Although fishing villages in Atlantic Canada have been dramatically affected by the collapse of the east coast fishing industry, the broad employment trends in farming, forestry, and mining are similar across Canada. And although the problems of Algoma Steel may be relatively new, while those of Sydney Steel are long-standing, they are very similar. The greater relative importance of the rural, resource-based economy in Atlantic Canada heavily influences interprovincial statistical comparisons, but the fundamental structural problem is rural-urban, not interprovincial, in nature.

One thing that I agree with strongly in the Courchene chapter is the emphasis on knowledge and information as being the cutting edge of international competitiveness and his statement that a well-educated labour force is essential for future prosperity. Intergovernmental transfer payments are crucial to maintaining accessibility of education. In discussing educational attainment, it is essential to distinguish carefully between stocks and flows. As Table 2 indicates, there has been a dramatic change in recent years in the Grade 12 retention rate in Nova Scotia. However, the educational characteristics of the labour force stock are still dominated by the older cohorts of workers who entered the labour force during a period when educational attainment was much lower. In the mid-1960s two-thirds of Grade 7 students in Nova Scotia dropped out before Grade 12 — these people are now in their mid-40s and will continue to be in the labour force for about the next 20 years. As Table 3 indicates, the educational attainment of Atlantic Canadians differs dramatically by age cohort, and older cohorts have a relatively low attendance rate at university, compared to the national average. However, since Courchene's chapter points out the necessity for reformed social policy to emphasis the development and enhancement of human capital potential, it is worth recognizing that the recent dramatic increase in educational attainment in Atlantic Canada has produced a rate of university attendance among 20-24 year olds that is *higher* than the national average.¹

TABLE 2: Nova Scotia Department of Education Provincial Retention Rates*

Grade 12		Grade 7		Retention Rate (%)
Year	Enrolment	Year	Enrolment	
1992	12,881	1987	13,678	94
1991	12,165	1986	13,981	87
1990	11,578	1985	14,099	82
1989	11,662	1984	14,450	81
1988	11,834	1983	14,927	79
1987	11,408	1982	14,576	78
1986	10,972	1981	14,999	73
1985	10,777	1980	15,372	70
1984	11,376	1979	15,794	72
1983	11,691	1978	16,826	69
1982	11,637	1977	18,360	63
1981	10,910	1976	18,832	58
1980	10,742	1975	19,003	57
1975	9,817	1970	18,417	53
1970	8,860	1965	17,111	52
1965	5,315	1960	16,146	33

*Retention rates may be over-estimated as there is no record of the number of students returning to grade 12 after dropping out for a period of time. During downturns in the economy, more students are likely to return to school.

Source: Author's compilation.

TABLE 3: Percentage of Population Years 15 and Older Who Have Attended University

Age Group	Nfld.	N.S.	N.B.	P.E.I.	National
(percent)					
All>15	16.4	20.9	17.9	20.7	20.8
15-19	10.0	9.1	10.2	12.3	5.5
20-24	31.9	34.7	33.0	35.7	29.9
25-34	20.5	27.1	22.1	24.9	26.3
35-44	19.4	26.8	21.8	27.4	27.9
45-54	14.4	19.1	16.7	18.8	21.7
55-64	7.5	13.1	10.8	13.4	13.3
65+	4.9	10.1	8.0	9.7	9.8

Source: Census of Canada, 1991. Cat. No. 93-328 pp. 24-29.

It is clear that the governments of Atlantic Canada have delivered substantially more educational services to their population in recent years. Clearly, intergovernmental transfer payments are a crucially important part of the revenues of the provincial governments in Atlantic Canada, from which educational expenditures are financed. Although it is hard to know for certain the counterfactual case — what quantity and quality of educational services provinces would have been able to deliver in the absence of federal transfer payments — my suspicion is that money matters. The educational system has managed to deliver a relatively high level of accessibility and quality, even in some of the poorest rural areas of Atlantic Canada. I do not see how this would have been possible in the absence of intergovernmental transfer payments and I think that such investment in education is highly desirable, on both equity and efficiency grounds. In all our talk of fundamental reforms to intergovernmental transfer payments we should, therefore, remember that there really is a baby in this bathwater.

As to transfer payments to individuals, one of the proposals in the Courchene chapter that I do like is his suggestion for a negative income tax for children. The chapter does not provide many details and one has to recognize that such a program will be inserted into an economy, and a society, undergoing very rapid change. The high rate of divorce and remarriage (as well as more informal mergers and dissolutions of households) means that the membership of family units changes continually. Increasingly sophisticated managerial strategies for the “just in time” hiring of labour and an increased casualization of the low wage labour force means that *individual* income flows have also become highly variable. As a result, a negative income tax scheme which requires people to qualify *ex-ante*, *before* they receive benefits would face very high administrative costs, because individual children will be continually moving into and out of eligibility. Since it is essential for income to arrive *in time* to pay for the groceries, a negative income tax scheme, to be useful, must have fairly frequent payments. There are, therefore, substantial administrative advantages to delivering the guarantee level of a negative income tax for children as a demogrant and taxing back any excess payments through an existing mechanism such as the income tax system. An effective negative income tax for children would, therefore, be very similar to the recently abolished family allowance system, although presumably considerably larger in value.

My most general comment on the Courchene chapter is that although I found it relatively easy to agree with the need to “restructure” social policy in some general sense, I found very few details. I agree that changes must always be made in social policy because social problems are always changing. I agree that it is increasingly necessary to recognize the linkages between economic and

social policy. However, I am left wondering what exactly is meant by "restructuring."

Furthermore, I would argue that one cannot realistically consider restructuring social policy without paying some attention to the macroeconomic context. In many ways, redesigning unemployment insurance and social assistance in the middle of a recession is like redesigning bathing suits in January. Although little harm is done by conceptual redesign (indeed one must plan ahead if new bathing suits are to be delivered in July) people will resist wearing new bathing suits right away — and their resistance is entirely reasonable, if, in fact, the lake is frozen.

If continued high unemployment means that jobs are not, in fact, available there is little point in reforming social policy to "increase incentives" to accept (non-existent) jobs. Without a demand for trained labour, there are few payoffs to increasing the supply of training. A balanced reform of social policy must recognize the crucial importance of the demand side of labour markets, and the role of macroeconomic policy in influencing aggregate demand.

NOTE

1. Although, during the school year, Nova Scotia attracts a substantial inflow of out-of-province students, the census data on which Table 3 is based measures population as of 1 June, and records residence as "place of normal residence."

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Comment: The Constraints on Change

Claude E. Forget

Tom Courchene's central point seems to be the following. Canada along with many other countries but perhaps more acutely than some, is confronted with a new economic and social paradigm: globalization, the knowledge-based economy and all that. Much of our current economic and particularly social policies is embedded in a system of federal-provincial fiscal transfers. Can those fiscal transfers, and hence relevant economic and social policies, be restructured to fit the new paradigm? That is the central issue raised by Courchene.

The first part of his presentation is devoted to these social policies and fiscal transfers said to be non-viable or non-sustainable. A powerful set of misguided incentives is described through its impact on individuals, regions, and the balance between the young and the old. From my own perspective, it is hard to disagree with the characterization by Courchene of those impacts as a "policy induced equilibrium in terms of the provincial characteristics relating to unemployment and output." The additional point is made that bad as they have been, those impacts look even worse from the vantage point of the emerging economic and social paradigm. However, their characterization as non-sustainable is unfortunate as it suggests some sort of natural equilibrium process whereby the adverse effects of the existing incentives on the economy and those, in turn, on the public finances would naturally lead to a reform of fiscal transfers.

At the time of my work on unemployment insurance, I used to think that the dysfunctional incentives inherent in that program were corrupting our political process. With the benefit of hindsight, I would now reverse the order of causality: our political system itself reaches a position of equilibrium by

generating such dysfunctional incentives. In a period of heightened regionalism underscored by the recent federal election results, there seems no reason to believe that dysfunctional incentives embedded in net fiscal transfers to a number of regions can be successfully challenged.

In his second section, Courchene describes how some \$40 billion cumulatively have been cut back from fiscal transfers since 1986-87. Whether or not this is in line with Ottawa's cutbacks in its own programs is, in my opinion, a rather moot point. Those federal savings account for much less than half of the total increase in provincial debts over the period.

At this point, Courchene indulges in a digression that has little to do with his main point. He is concerned that federal unilateral actions with regard to fiscal transfers have destroyed the mutual trust between provincial and federal governments a phenomenon much in evidence for instance in regard to the CAP payments to Ontario subjected by Ottawa to a unilateral ceiling. However, it has long been known that the relationship between giver and recipient is not an equal relationship and that transfer payments from Ottawa to the provinces are not based on a contractual relationship, the commonly used expression "federal-provincial agreements" being just a public relations face saver for the provinces. Provinces never complained about the unpredictability of federal moves when grants were on the increase, the question is: Are they sufficiently miffed with that unpredictability now that grants are decreasing that they would be prepared to forego some transfers in favour of greater certainty? My guess is that it is not very likely. Also bear in mind that it is not a question that is up to Ottawa to settle or even agree to with the provinces, as the constitution itself would have to be amended to provide for binding intergovernmental agreements.

Be that as it may, the real question is not whether or not provincial governments are happy with their relationship with Ottawa, but whether the scaling back of federal payments to provinces is leading to a mere erosion or to a restructuring of social policies. Courchene presents some examples of provincial initiatives at restructuring public policies in Quebec, Saskatchewan, Ontario, and New Brunswick. However, he does not make clear whether Ottawa is necessary to the process. It is not even clear whether provincial experiments in restructuring are triggered by federal offloading. Given the nature of the examples quoted, the answer is: probably not.

The next and last section of Courchene's chapter is devoted to exploring ways in which what he calls horizontal transfers could be limited. That they should be is something that he supports and which is hardly in any doubt. The increasing number of recipients and the decreasing surplus from which those transfers are financed make that inevitable. What is important to know is rather

whether the dysfunctional incentives inherent in the "welfare-UI-training-education" nexus are at the top of the list of items that will be modified if and when horizontal transfers are scaled down. Here Courchene does not take us very far, but we can collect a number of throw away sentences that provide a glimpse of his thinking on this issue.

- Ottawa is unwilling to act on the UI front taken in isolation;
- Ottawa desires to be active on the nexus described above but taken as a whole;
- Ottawa's initiatives in that regard can be expected to be welcomed by some provinces;
- However, in other provinces and notably Quebec, this will be vehemently rejected hence the likelihood of an asymmetrical outcome.

Interesting as it is to speculate about these various propositions, no evidence is produced to support any of them, and therefore it is legitimate to doubt whether indeed the financial need to reduce transfers will lead as a matter of priority to a restructuring of the incentive systems present in the welfare to education nexus.

I would add that perhaps the strongest incentive for Ottawa to act and articulate strong initiatives (including wholesale delegation to the provinces) relating to that nexus just could be the realization that all those programs, that is to say welfare, UI, training, and education, singly and collectively are among the most generously funded in Canada as compared to almost all OECD countries. The issue for Canadians here is not to spend more but to spend more smartly. Indeed, savings can be made by Ottawa out of these programs that could be far more politically rewarding if reinvested, assuming tax reduction is not on the agenda, in strengthening federal commitment and funding predictability with regard to our national health system seen more and more as a defining characteristic of Canada.

CHAPTER FOUR

The Political Context for Renegotiating Fiscal Federalism

Richard Simeon

INTRODUCTION

The chapters in this book have underscored the magnitude and intractability of the current issues in fiscal federalism. There is a consensus among commentators, and perhaps even among governments, that the existing arrangements are unsustainable. In this chapter, I will address the political and institutional context within which fiscal arrangements and the associated issues of managing public debts and deficits and the future of social policy are to be debated and discussed. To what extent do we have the political will and the institutional capacity to decide these issues effectively? "Effectiveness," of course, has different meanings for different authors: for some the central priority is restraining debts and deficits, for others it is preserving the social safety net and for yet others it is integrating social, educational, and other policy areas with policies for growth and competitiveness. I will take effectiveness to mean achieving some degree of coordination between the different levels of government, making tough decisions to manage the deficit and ensuring that the costs of that are fairly distributed, and establishing a policy framework in which we can build the linkages between fiscal arrangements and social policy and other policies aimed at economic restructuring, such as workforce training. This is the basic policy challenge for the country, to which all governments must contribute. Effectiveness in the federalism context also means the ability to minimize interregional and intergovernmental conflict and to maximize the responsiveness of the intergovernmental process to citizen concerns.

My central argument is that we are faced with some profound dilemmas. On the one hand, the problems of debt, deficits and the future of social policy face

the public sector collectively, as a whole. The national deficit is a function of both federal and provincial taxing and spending. Governments are interdependent, so that initiatives taken at one level have immediate consequences for the other. The programs available to citizens, and the tax burdens to pay for them, are a combined product of what all the governments do. This suggests that any re-thinking or restructuring of public finances or the welfare state which is to meet the needs of citizens requires a coordinated effort with all the governments working together.

But on the other hand many factors stand in the way of such collective effort. If the policy imperative calls for a coordinated approach, seeing the public sector as a whole, the political imperatives render that extraordinarily difficult to achieve.

This may be too pessimistic a conclusion. There is indeed a general consensus that something must be done, and the fiscal crisis no doubt concentrates the minds of those involved. Governments at both levels now appear to be making concerted efforts to curb spending and "rationalize" expenditures. The initial exchanges between the provinces and the new federal government have been characterized by relative harmony and goodwill, along with a sense that "we are all in it together." The Liberal Party's "Plan for Canada" promises close coordination and cooperation with the provinces (Liberal Party of Canada 1993) — as, indeed, all new governments do. Nevertheless, it is hard to believe that the conditions for a creative or successful resolution exist. The system lacks the institutional capacity to address and manage the challenge.

That difficulty can be summed up in a number of propositions which I will explore in this chapter.

First, in federal-provincial relations, the constitution and related issues of national unity tend to trump or dominate debate on substantive, functional policy issues.

Second, questions about the regional distribution of costs and benefits tend to trump debate in terms of alternative aspects of distribution.

Third, fiscal and financial issues tend to trump debate on social policy.

Fourth, the intricacies of intergovernmental negotiation tend to trump citizen understanding and participation and blur accountability.

And finally governmental self-interest in seeking to avoid and transfer blame usually trumps willingness to share it. This is especially true in the current context when the task is clearly to make very difficult decisions with strong distributional implications, both regionally and intergovernmentally.

We are only just becoming familiar with the federalism of restraint, the federalism of hard times. It is likely to be very different from the competition and conflict associated with the federalism of growth, which characterized the

period between the 1960s and 1980s. Then the governmental competition was over the expansion of government activities and the competition for credit. Today it is about downsizing, restructuring and the avoidance of blame.

Let us explore each of these dilemmas.

PRIMACY OF THE CONSTITUTION

First, ever since the 1960s, the high politics of the constitution, and the associated debates about the character and structure of the Canadian political community, have dominated federal-provincial relations. We have practised what one might call "constitutional federalism." Specific policy issues have been subordinated to the more symbolic politics of identity, and the federalism of community has dominated functional approaches to federalism. None of the major rounds of constitutional debate since 1970 have focused primarily on designing institutions to render the division of powers more coherent. Where division of powers issues have been debated — as in the debate over the spending power, or the proposals of the Allaire Report (for the best summary, see Russell 1993) — the discussion has focused more on the implications for community, than on the functional policy consequences. The constitutional amendments of 1982 barely touched on the division of powers — except for a clarification of provincial jurisdiction over resources. The Meech Lake Accord referred only to the federal spending power and constitutionalizing agreements concerning immigration. The Charlottetown Accord dealt with a longer list of division of powers issues, but that discussion too was not approached with a view to exploring the most appropriate sharing of responsibilities from a policy perspective. We may now be paying a high price for this.

For a blessed brief period following the defeat of the Charlottetown Accord, it appeared that through exhaustion if nothing else, we had removed the symbolic, community, constitutional issues from the table. We could turn our attention from the crowded constitutional agenda to the shared policy problems, and from constitutional "fixes" to the informal mechanisms of adaptation in fiscal arrangements and intergovernmental cooperation. But clearly this was a temporary respite. The election of 25 October 1993 and its aftermath, seem certain to pull us back to the constitution and to the debate about the future of the federation.

The election result can be seen as the dropping of the second shoe after the Charlottetown referendum of October 1992. It signalled the continuing rejection by many citizens of politics as usual. The counter-elites who master-minded the attack on Charlottetown have now achieved massive representation in the House of Commons. The differences between Quebec and the rest of

Canada which were papered over by the referendum result have now achieved renewed salience. Thus Quebec, which voted NO in the referendum largely because it gave Quebec too little recognition of its distinct status, has struck back by electing enough Bloc Québécois MPs to form the Official Opposition. Many "rest of Canadians," notably but not only in the west, who apparently voted against the Accord largely because it gave too much to Quebec and too little to them have struck back by electing an almost equal number of Reform Party MPs.

Throughout the last 30 years, despite the obvious differences in emphasis between Liberals and Conservatives, two broad alternatives for accommodating French-English differences have been put forward — renewed federalism on the decentralist model and national bilingualism, combined with multiculturalism. The new Liberal government clearly falls squarely within this framework. Nevertheless, the strength of the Bloc Québécois and the Reform Party reveals the fragility and lack of consensus on both these models. Significant proportions of Canadians outside Quebec reject both constitutional recognition of Quebec as a distinct society, and official bilingualism (Stark 1992; Adams and Lennox 1990). In Quebec, majority opinion ranges from a federalism that recognizes its distinct status, through various forms of sovereignty (Stark 1992; Dion 1992) Indeed, it would appear that each successive round of constitutional negotiations has peeled back the onion to reveal the underlying differences about the nature of the Canadian political community more sharply. The divisions have become more polarized.

The election result has ratcheted up the stakes one more notch, as each side of the debate now has a major regionally based political party to speak for it; and as two of the three parties which shared the earlier consensus (the Conservatives and the NDP) have been decimated. Moreover, of course, the election result has placed this debate at the heart of national politics, in Parliament. Reform is in Parliament in part to challenge both the commitment to official bilingualism and recognition of Quebec as a distinct society, emphasizing instead provincial and individual equality. And the Bloc is in Parliament to show that federalism cannot be renewed and cannot meet Quebecers' aspirations. As we saw in the election campaign, there was a kind of dynamic interaction between them. More support for the Bloc in Quebec reinforced Reform's pledge to stand up to Quebec; more support for Reform showed Quebecers how little they could expect from renewed federalism.

What are the implications of these developments? In some ways, it could be argued, the effects may be positive. Legitimate and widespread opinions once suppressed, muted or papered over have been democratically expressed and brought out into the open. So there may be a new kind of honesty to the process.

Moreover, the debates will no longer go on mainly in the elitist confines of federal-provincial negotiations, or the Cabinet and caucus room; instead they will take place in public parliamentary sessions, for all to see. If the result is failure, so be it, and let the chips fall where they may.

There is a lot to be said for this view. But it illustrates an old dilemma: processes that meet the democratic criterion of openness may fail on the criterion of the ability to manage or resolve conflict and to find compromise. If it is positive to get the disagreements out on the table, the problem remains of how to put the pieces back together.

It is hard to predict how the new Parliament will play out, or what the consequences of the federal election will be for the next Quebec election, to be held by the fall of 1994. It may be that all parties will tacitly agree to put the constitutional issues aside. It may be that participation in Parliament will bring both the Bloc and Reform into the traditional politics of accommodation. It may be that having made their point in electing the Bloc, Quebec voters will opt for federalist Quebec Liberals in the provincial election. Or that if they elect the PQ, they will reject sovereignty in a subsequent provincial referendum.

But none of this is certain or even likely. Bloc and Reform are more likely to continue to play off against each other. The very fact that the Liberal government holds a majority, rather than minority, may strengthen this tendency, since both Bloc and Reform can indulge these regionalist impulses without fear of actually bringing the government down. The Liberal government will be caught in the middle: any concessions to Quebec to undermine the Bloc will fuel Reform sentiment; refusal to do so will fuel the Bloc. Every government decision will be intensely scrutinized for its distributional consequences, as we have seen already with concessions on agriculture within the GATT, and with the decision to terminate the previous government's helicopter program.

It is also possible that the presence of the Bloc as the Official Opposition will add fuel to the growing recent tendency in the rest of Canada to say: "Let Quebec go."

However it develops, the effect of the election is that in one form or another, the constitutional or national unity issue is or soon will be back on the table. The dangers are that fiscal possibilities will be assessed and interpreted in terms less of their ability to meet the substantive policy problems than in terms of their likely implications for the coming Quebec election and the future of national unity; and that the energies and attention of policymakers will be diverted to the constitution. Once again, the constitution is likely to trump functional federalism.

REGIONAL POLITICS TRUMPS OTHER DIMENSIONS
OF DISTRIBUTION

A number of years ago, Edwin R. Black pointed out that in Canada, issues of distribution which in other advanced countries might be played out in terms of class or economic sectors, in Canada are played out in terms of distribution across provinces and regions (Black 1975). Again, the results of the election will reinforce this tendency because of the prominence of the two regionalist parties, and because of the relative weakness of the Liberals in some regions — though this regional imbalance is far less marked than in most of the Trudeau years. All federal proposals will be scrutinized and attacked on the basis of regional balance sheet calculations of relative gains and losses. The politics of regional jealousy is likely to be exacerbated by the nature of the choices that have to be made. Assuming those choices will inevitably involve reductions rather than increases in transfer payments and regional development spending, then what we will see is not that some are gaining relative to others, or even that some are gaining while others are losing, but rather that *all* will be losing. Every province and region will have grievances against the centre. Following the election of the Parti Québécois in 1976, there was a flurry of “balance sheet federalism,” in which various governments purported to demonstrate how they lost and others gained in the distribution of federal revenues and spending (Leslie and Simeon 1977). In 1993, the Ontario government began what may be a new round of such efforts with the publication of a similar set of studies demonstrating unfair treatment of Ontario (Ontario Ministry of Intergovernmental Affairs 1993). Again, this does not augur well for a rational or coherent addressing of the problems, or for the ability to build consensus around fiscal arrangements and social policy.

This may have especially important implications for the long-term future of equalization. What is likely to be most threatened in the politics of the zero-sum is the commitment to sharing and redistribution, or what Peter Leslie calls the “sharing community” (Leslie 1993, pp. 3-9). There may be much less willingness to see this as an essential part of the Confederation bargain, especially in a province like Ontario, which is increasingly preoccupied with its own problems, increasingly linked economically to the United States rather than to other Canadian provinces, and increasingly has a population whose experience of Canada is not rooted in the traditional Canadian emphasis on region and language.

FISCAL FEDERALISM TRUMPS SOCIAL POLICY

Fiscal federalism is simultaneously concerned with two sets of issues. On the one hand, it is concerned with revenue sharing and intergovernmental transfers, which in turn then are linked to the economic issues of macroeconomic policy, debts, deficits, and the like. But on the other hand it is about social policy: about the amount and quality of the health care Canadians receive, about our social welfare systems, and about postsecondary education. Each perspective tends to raise a different set of conceptual issues; each engages a different set of interest groups; each has a different policy network associated with it; and each engages different sets of government officials — finance and treasury on one side, ministries of health, education, and welfare on the other. Hence a debate in one policy network about the future of fiscal federalism is likely to be very different from a debate about the welfare state which might take place in another network.

Since in Canada, federal-provincial cooperation in social policy has been expressed in terms of financial instruments — EPF, Equalization, CAP — the treasury and economics network has tended to dominate. The social policy network has played a subordinate role, especially in a period of restraint. We see this in the design of such programs as EPF. This transmuting of social policy into fiscal arrangements has frustrated full debate about national social policy, and effectively excludes from the discussion groups and agencies in the social policy network.

This tendency for the fiscal horse to drag the social policy wagon is undoubtedly exacerbated by the current fiscal crisis. The danger is that the finance and treasury agencies which are likely to drive the renegotiation process will do unnecessary damage to our social policy framework, and fail to explore creative reform of the social policy system.

Clearly, in the current context, when we need both to deal with debts and deficits and to re-think our social policy system, we must bring these two networks together. We cannot discuss fiscal policy without thinking about social policy — and vice versa. This is difficult enough to do *within* a level of government; it is even harder to do when we must simultaneously bridge across levels of government. Thus we have to ask whether there is a mismatch between the institutional machinery and the way in which the issues are structured.

THE INTERGOVERNMENTAL DYNAMIC TRUMPS CITIZEN POLITICS

The dominance of the intergovernmental forum, and the transmuting of social into fiscal policy creates enormous frustrations for citizens in understanding, and therefore contributing to the process. There are the familiar problems identified by Smiley (1979) and others: the secrecy of the intergovernmental process, the arcane and esoteric language of fiscal and intergovernmental issues replete with their formulae and assumptions. As a Quebec journalist wrote in 1966, "The holy spirit seems to have a marked horror for those mortal men who occupy themselves with fiscal arrangements" (In Simeon 1972, p. 66). Where, as in our federal system, governments spend money which they have not taken responsibility for raising; and spend money over whose use they have no control, accountability is attenuated.

Perhaps more fundamentally, the dominance of fiscal and intergovernmental perspectives draws a dark veil between cause and consequence in public policy. It is not easy for citizens to perceive the link between a development in the fiscal arena and the real world policy implications. To take a hypothetical example, if a potential client visits a rehabilitation centre in Toronto and finds the doors locked, how is he or she to link that to a federal "cap on CAP" a few years earlier. The complexities and intricacies of intergovernmental relations are at war with the transparency necessary for effective policy debate at the level of the public.

More generally, the ability of intergovernmental processes to work out effective arrangements in the current context is seriously undermined by the delegitimation of executive federalism that occurred during the constitutional process. There remains little citizen confidence in these mechanisms. Citizens have traditionally been even more excluded from fiscal federalism debates than they have from the constitution. Yet, especially in this round, the results will have consequences at least as great for many of the groups that mobilized around the constitution as the constitution itself had. Continued exclusion will further contribute to the delegitimation of the intergovernmental system. This too undermines the institutional capacity of the system to make the very hard decisions that now face it. Indeed, another consequence of our preoccupation with the constitution in recent years — and of the very personal way in which Prime Minister Mulroney approached it — is an undermining and deterioration of the intergovernmental machinery, and of the functionally-oriented trust relationships among officials which make it work effectively (Dupré 1985). To rehabilitate intergovernmental relations is a daunting task, given the disrepute

into which this process has fallen. Thus what we might call the democratic deficit and the performance deficit reinforce each other.

GOVERNMENTAL SELF-INTEREST TRUMPS COLLECTIVE APPROACHES

Finally, to return to my starting point, while it is obviously true, and recognized by all the governments that they are all in this together, and that the issues of debts and deficits are a collective problem which neither level can solve alone, the fact of the matter is that each government is primarily concerned with its own bottom line. Each seeks to minimize its losses and maximize its gains. There are few incentives or rewards for doing anything else. So each seeks to maximize its revenues, while transferring as many costs as possible to other levels. The result is a kind of cascading of the fiscal burden, from Ottawa to provinces, and from provinces to municipalities and other transfer agencies and ultimately to the citizen. Again, this is not propitious for a coherent or cooperative resolution of the issues.

CONCLUSION

Thus to repeat the central point: the current politics of federalism and of intergovernmental relations reduces our capacity to deal with the financial crisis and to re-think our social policy. My suggestion is the same as that recently advanced by David Cameron: that federalism, in the context of restraint, may have an "obstructive capacity" (1993, p. 9) — getting in the way of resolution of crucial issues. It may be a system that works well in good times, but is less well-equipped to deal with the bad times. This analysis may be too pessimistic. There do seem to be a number of areas where there are mutual incentives to agree — for example, in more integration of the federal and provincial sales taxes, or in some common approach to borrowing. The "Liberal Plan for Canada" does pledge a commitment to intergovernmental cooperation, and "working together" with the provinces in many areas (1993). Yet there is no escaping the zero-sum character of what happens to federal transfers.

Given the need for coordination and integration of the fiscal system and associated social policies, what alternatives are available? One model has been proposed by Albert Breton (1985). His "competitive federalism" would achieve coordination by having each government look to its own powers and taking its own decisions, reacting and adjusting to the actions of other governments and to its own economic and political environment as it sees fit. Ottawa has considerable flexibility in this regard. The major elements of fiscal federalism

— CAP, equalization and EPF — represent the exercise of the federal spending power. There is no legal barrier to unilateral federal reduction of these transfers. The Canada Assistance Plan is the most vulnerable, because the federal transfer is entirely in the form of cash. That is also true for equalization, though it may receive at least some symbolic protection through section 36 of the *Constitution Act, 1982*. EPF consists of a combination of cash and tax transfers, but here federal leverage is limited because of the declining proportion of cash. Similarly, it is also conceivable that Ottawa could bring substantial pressure to bear on provincial policy choices through altering the conditions attached to the transfers, as was done with the *Canada Health Act, 1984*.

Faced with budget crises, provinces also have considerable freedom to act alone, whether through expenditure cuts, increased taxation, borrowing or policy change. Existing program conditions place relatively few constraints on provincial experimentation in this area.

This process has, of course been proceeding. While the provinces were largely protected from federal restraint measures between 1984 and 1988, the first term of the Mulroney government, since 1988 a wide range of limits and caps have been applied to federal transfers. For their part, provinces have responded to these developments, and to changes in their revenue and expenditure situations with a wide variety of program changes, restraint measures and increased taxing and borrowing.

There is little doubt that the federal measures have been a strong stimulus to more aggressive provincial restraint measures. Perhaps then, the Breton model is the correct approach.

However, it has high costs, not only for the governments involved, but also for citizens. Unilateral federal limits on transfers have obviously contributed to the ballooning of provincial deficits and the accompanying debt, which the smaller, economically weaker, provinces have much more difficulty financing. Unlike the federal debt, most provincial debt is held abroad (Mendelson 1994). We risk repeating the situation of the 1930s, in which some provinces teetered on the brink of bankruptcy. Similarly, leaving the governments on their own risks unrestricted competition for revenues and the break down of the tax collection agreements which have provided considerable harmony in the taxation system. Thus, there are dangers in unrestricted fiscal free-for-all. More generally, unilateral, competitive federalism fails to deal with the linkages between federal and provincial policies. For example, it is now conventional wisdom that unemployment insurance (federal) must be more tightly integrated with education (provincial) and welfare (shared). Similarly job creation is now tightly linked to education. No government alone possesses the instruments and powers to attack any of the issues on the current policy agenda. And efforts to

do so may play havoc with coherence of programs at the other level. Thus, unvarnished competitive federalism, despite its attractions, is not a desirable model.

A second model which has achieved much attention is to seek savings, transparency, and a closer link between programs and costs by a program of rationalization of federal and provincial responsibilities through disentanglement. While there may be much potential here, the record offers little optimism for the achievement of major change. Governments have advocated "disentanglement" since the 1970s. The clarifications of the division of powers in the Charlottetown Accord ostensibly were designed to entrench provincial paramountcy in a number of fields, but instead ended up setting out a bewildering array of new intergovernmental agreements. Similarly, the Charlottetown provisions on the economic union and trade and commerce increased rather than decreased overlap and interdependence. These results illustrated that most policy areas do indeed have both federal and provincial dimensions, and that both orders of government are loathe to give up their policy levers or to concede leadership to the other. There is indeed, much room for rationalization through informal transfers of responsibility. But there will be no return to an earlier model of the federalism of watertight compartments.

Indeed, the emphasis on federal-provincial agreements underlines the need for the third model: a return to functionally-based collaboration. Given the existing roles of government and the present financial arrangements, it seems to me we must try to convince governments to adopt a cooperative approach, and to recognize the interdependence and shared character of the problems they are facing, however difficult that is.

The critiques of such an approach are well-known (Breton 1985). There is the danger, on the one hand, that governments may constitute an "elite cartel," cobbling together agreements that meet their own institutional needs, but which pay little heed to broader citizen concerns. This is the criticism of the Meech Lake process. There is, on the other hand, the risk of deadlock, paralysis and inability to agree. These risks increase the more the intergovernmental arena is seen as the formal decisionmaker; effective action by any government is then held hostage to intergovernmental agreement.

We need, therefore to seek a middle ground, between the uncoordinated independent action of governments which seek to relieve their own budgetary crisis by dumping the problem onto others and the requirement of joint decision making in order to get anything done. The Royal Commission on the Economic Union and Development Prospects for Canada distinguished four levels of federal-provincial interaction — autonomous, independent action by each government; consultative processes to exchange information and provide

opportunities for persuasion, pressure and influence; coordination, in which governments would seek agreements on broad policy objectives, implementing them independently; and joint decision making in which formal, binding commitments are made (Royal Commission 1985, p. 261). As I have argued, neither the first nor the last is acceptable in light of current challenges. The emphasis must be placed on the consultation and coordination parts of the spectrum.

Even that is no panacea and will be difficult to achieve. In order to do so, it is first necessary for governments to recognize that this is a set of collective, shared problems, and that unilateral solutions are likely to cause more problems than they solve. We urgently need to reorient our thinking about federalism from the constitutional/community axis to a more functional, policy-oriented perspective. One might hope that the gravity of the issues and the pressure of public opinion will bring this about. We then need to develop mechanisms, both within governments and between governments, which recognize the interaction of fiscal federalism and social policy, and social policy and economic policy, rather than keeping them separate. This suggests that participation at the intergovernmental table should not be limited to finance and treasury ministers and officials. We also need to recognize the need for more transparency in these relationships, so that citizens can see and understand the linkage between fiscal arrangements and social policy. And we need to provide greater opportunity for citizen groups to inject their views into the intergovernmental process. Proposals to open up the budget process might help here. Another model is the 1981 parliamentary enquiry — the Breau Task Force — (Canada 1981) which provided the first public forum for extensive interest group commentary on fiscal federalism. However, it was flawed by its being a federal government vehicle designed largely to make the case against the provinces in fiscal matters. A better model might be some form of enquiry which was jointly sponsored by the 11 governments. Following the Supreme Court decision on CAP, we also need to develop some rules for the conduct of the "dis-spending power." As the Liberal program states, there is a need to ensure at least some predictability and stability for each level of government as it plans its own responses to the new challenges (1993, p. 21). We need to ensure that provinces are not vulnerable to arbitrary or capricious cuts, while at the same time accepting that ultimately, these are federal spending powers for which Ottawa must be responsible to Parliament. Perhaps one model might be binding five-year agreements. Changes within those periods could be made only with some level of intergovernmental consensus. Finally, I think to revitalize the intergovernmental process, rebuilding the functional linkages in economic and social policy which have fallen into disrepair in the past few years of constitutional high politics.

In the longer run, we also need to consider some broader changes, including a re-thinking of federal and provincial roles and responsibilities in these linked areas of public finance, social policy, and economic policy. In the short run, however, as governments grapple with the enormous problems of dividing up the pain of deficit reduction and policy restructuring, the prospect is for more rather than less conflict. No simple set of institutional fixes gets us around the tensions associated with the politics of restraint and cut-backs. And we are left with the dilemma that just as our continuing constitutional, regional, and linguistic conflicts have got in the way of a coherent approach to the practical issues, so failure to deal with them effectively will exacerbate those same fundamental conflicts about the very future of Canada.

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Comment: The Politics of Fiscal Federalism

André Blais

Richard Simeon makes the following arguments:

1. Canadian fiscal federalism is facing tough problems.
2. Solving these problems requires the political will and the institutional capacity to achieve some degree of coordination between the different levels of government.
3. The structure of the political debate in Canada, the focus being on constitutional issues and questions of regional distribution, does not facilitate the achievement of such coordination.
4. The present political context just seems to aggravate these difficulties.

Let me briefly react to these points. I will elaborate somewhat more on the last.

TOUGH CHOICES

I would certainly not dispute the fact that governments face tough choices. The federal deficit is a very serious problem. The federal government will have to cut spending even more in the coming years, and transfers to the provinces will have to be reconsidered.

INSTITUTIONAL CAPACITY AND COORDINATION

I am a little more skeptical here of Simeon's emphasis on coordination. First, while I would agree that it is preferable to have *some* degree of coordination, I also see many virtues in competition among governments. We obviously need

a mixture of competition and coordination. Second, I am not convinced that institutional capacity is the crucial factor. Major policy innovations tend to occur in times of crisis, and as we are presently in a crisis situation, politicians might be forced to bring about substantial changes to the way Canadian fiscal federalism works. More on this below.

THE CONSTITUTIONAL AGENDA

There is no doubt that much of fiscal federalism, and federal politics more generally, has been driven by the constitutional (and regional) agenda. But this has not prevented the Conservatives from adopting some bold and innovative policies, most especially the Free Trade Agreement (FTA) and the Goods and Services Tax (GST), despite the fact that both these policies had very substantial constitutional and regional implications. The point here is that I am not convinced that fiscal federalism has performed that poorly in the past. In fact if we were to compare Canada with the United States, perhaps we would conclude that Canadian fiscal federalism is a small success, and that part of the success should be imputed to our obsession with the constitution.

THE NEW POLITICAL CONTEXT

Simeon believes that it will be extremely difficult to renew fiscal federalism, because constitutional and regional preoccupations will remain at the forefront. In fact, things will get even worse, as the presence of the Bloc and Reform will ensure that "all federal proposals will be scrutinized and attacked on the basis of regional balance sheet calculations of relative gains and losses."

There is much truth in these assertions. But this is not the whole story. It is also a fact that the Bloc and Reform cannot afford to be catering solely to regional interests. Certainly Lucien Bouchard and Preston Manning also want to be perceived as *responsible* politicians who are able to overcome narrow regional perspectives.

There is another new dimension of the political context whose consequences are, in my view, insufficiently explored by Simeon. That is the fact that Canadians have been sensitized to the seriousness of the deficit. On the one hand, Canadians have told parties that jobs are more important than the deficit. However, in making up their minds on this priority issue, the great majority of Canadians have come to recognize that the deficit is also more serious than they thought. There is now a near consensus that there is a fiscal crisis, that something has to be done about it, and that something is spending cuts.

I would argue that this crisis situation gives the Liberals some room for manoeuvre. Canadians will, I think, understand that the federal government might have to reduce transfers to the provinces to the same extent it cuts its spending in other areas.

It is also in times of crisis that existing ways of functioning get questioned and that new approaches get considered. Gorbet has indicated in his comments that the status quo is not the reversion point, since the existing system of transfers will expire. This seems to be a ripe moment to establish a completely new system, and to build that new system on broad principles that appeal to all Canadians. These principles would have to compete with regional sensitivities; but I believe that, in times of crisis, Canadians would support a system of fiscal transfers with a clear political and philosophical rationale.

PART THREE

POLICY SECTORS

CHAPTER FIVE

Social Policy and Equalization: New Ways to Meet an Old Objective

Kenneth Norrie

INTRODUCTION

The brochure that sets out the program for this conference states that, "We are approaching a critical juncture in the evolution of fiscal federalism." Few would disagree with this view as it applies to fiscal transfers under the Established Programs Financing (EPF) arrangements for health care and postsecondary education, and those under the Canada Assistance Plan (CAP) for social assistance. Jurisdictional disputes and issues of program design have never been far from the surface in these cases, and recent constitutional initiatives and federal budgetary measures have brought these debates to the fore.

These same observers would almost certainly agree, however, that the comment does not apply with equal force to the third pillar of Canadian fiscal federalism, the equalization program. The principle of unconditional transfers to have-not provinces, based on indices of relative fiscal capacity and funded out of federal government general revenue, seems firmly ensconced. Criticisms of this program, such as they are, generally focus on the suitability of the five-province standard, the ceiling on entitlements, and a number of minor design flaws.

Indeed, some authors see equalization as the key to reform of the other programs (see Richards 1992; Cousineau 1992; Boadway and Hobson 1993; Hobson and St-Hilaire 1993; Hobson 1993). Briefly, the argument runs as follows. A convincing case can be made, on efficiency grounds, for full and final devolution of responsibility for social programs to provincial governments. There is a fair element of interregional redistribution implicit in EPF and CAP transfers, however, which would be lost if these programs were simply

ended. This trade-off between efficiency and interregional equity could be avoided, the argument goes, if the equalization program were modified and expanded to offset these effects.

I shall argue in what follows that this proposal, while logically appealing, rests on two untested propositions. First, it is not clear that devolution will increase the efficiency of social program delivery. Second, the federal government may be more constrained in its ability to expand the equalization program than is realized. I suggest instead a set of arrangements that constitute a new way to meet a long-standing federal government policy objective: a parallel commitment to individual and regional equity.

FISCAL FEDERALISM TAKES SHAPE

The federal and provincial governments began immediately after World War II to put together the complicated series of intergovernmental fiscal arrangements that would come to define postwar Canadian federalism. The major components of this system are familiar: the cost-sharing arrangements in health, post-secondary education, and social assistance, together with an equalization program. Since the degree of substitutability between shared-cost programs and equalization is at issue, it is important to understand the origin and subsequent evolution of this set of measures (see Norrie 1993; Leslie 1993).

Shared-Cost Programs

The first example of shared-cost programs in the postwar period was the National Health Grants of 1948, wherein Ottawa provided matching grants to the provinces for a variety of health-care services. Nine years later, the *Hospital Insurance and Diagnostic Services Act* was passed, and by 1961 all provinces had plans covered by the legislation. Under this Act, Ottawa agreed to pay to each province annually an amount equal to 25 percent of the average per capita cost of hospital services in Canada plus 25 percent of the per capita cost of hospital services in that province, this sum multiplied by the province's population.

Medical insurance was next. The federal government responded to pressures for a national insurance scheme by introducing the *Medical Care Act* in 1966. By 1971 all provinces were part of the scheme, and by 1972 both territories were covered as well. The Act specified that each province was to be in charge of designing, implementing, and administering its own medical insurance plan. As long as the plan met four general conditions — comprehensive in terms of medical coverage, universal in its coverage, publicly administered, and fully transferable among provinces — it would be eligible for federal funding

amounting to 50 percent of the national per capita cost of medical insurance, this figure multiplied by the province's population.

The first major initiative in postsecondary education came in 1951 when Ottawa instituted a series of cash grants to universities. This assistance was altered significantly as part of the 1967 fiscal arrangements legislation. Direct cash grants to universities ended, and the funds went instead to provincial governments. The federal contribution to each province was set at 50 percent of the operating costs of its postsecondary educational institutions. A portion of this transfer came via an abatement of personal and corporate income tax. The residual amount was in the form of a cash transfer.

Ottawa was involved in a number of cost-sharing ventures with the provinces in the social assistance field prior to 1966. In that year, these programs were consolidated under the Canada Assistance Plan (CAP). Under the plan, the federal government undertook to pay 50 percent of each province's expenditure in meeting the basic requirements of recipients of aid. The only conditions were that the programs be directed to families and individuals in need, and that there not be unreasonable residency requirements.

In modern textbook terms (Boadway and Hobson 1993), one can offer two rationales for these federal government transfers. First, to the extent that provincial government expenditures on health, postsecondary education, and social assistance programs spill over into other jurisdictions, federal transfers improve efficiency by providing a subsidy for the benefits received by non-residents. Second, to the extent that government expenditures on social policy are intended to be redistributive, federal cost-sharing grants contribute to national equity by ensuring some minimum standard of uniformity among individual Canadians.

It is difficult to gauge how relevant the spillover argument may have been at this time, but the federal government grants certainly had important inter-regional equity implications. Interestingly, however, these effects differ notably among programs. The formulae used to determine the transfers for hospital and medical insurance meant that the programs were implicitly equalizing as long as low-cost jurisdictions were also relatively poor ones. The arrangements for the other two programs were less implicitly equalizing. The 50-50 cost-sharing of postsecondary education expenditures meant that the more a province spent in this area per capita, the higher was its per capita federal grant.¹ The per capita value of the federal transfer for social assistance could vary significantly as well. The redistributive effect could, in principle, go either way. For given benefit rates, provinces with high social assistance requirements would receive extra federal funding. This feature would favour the less-advantaged

jurisdictions. To the extent that benefit rates were more generous in richer provinces, however, the redistribution would be reversed.

Equalization

The federal government's concern for interregional equity went beyond transfer programs for health, postsecondary education, and social assistance. Significantly, however, this commitment took quite a different form. When the system of tax-sharing replaced that of tax-rentals in 1957, Ottawa introduced a formal equalization scheme intended to even out the resulting fiscal disparities among provinces. Provinces whose fiscal capacity fell below a certain standard were entitled to receive equalization payments.² The transfer in each case was equal to the per capita amount needed to bring the province up to the standard, this sum multiplied by the province's population. The payments, then as now, were made out of federal general revenues, and were intended to be purely unconditional transfers.

The terms of the equalization program were adjusted several times in the ensuing years. Natural resource revenues were introduced into the tax base in 1962, and in 1967 the standard became the average national per capita yield from each of 16 separate tax sources. Each province's fiscal capacity was now compared, tax by tax, against this standard. If the per capita yield on the first tax category was higher, a negative entitlement on that tax category resulted. If the per capita yield from that source was below the national average, a positive entitlement resulted. If the sum of the entitlements over the 16 tax categories was positive, the province received an equalization payment equal to this shortfall multiplied by its population. If the sum was negative, the province's entitlement was set at zero.

Remarks

Like the shared-cost programs, equalization acted to redistribute income inter-regionally, but, significantly, the rationale for doing so was quite distinct. Federal grants to provincially-designed and administered social programs were intended to provide a measure of equality among individual Canadians. Thus it made sense to base the federal transfers on provincial government expenditures in these areas, and to attach broad conditions to them. Equalization payments, on the other hand, were meant to offset disparities among provincial governments, with no concern as to how these funds were used. Thus it made sense to base the transfers on provincial government revenues, and to make them entirely unconditional.

The force of this distinction is underscored by considering that, if inter-regional redistribution were the main policy objective at this time, Ottawa could simply have offered a larger share of equalized tax revenue to the provinces, and not bothered with grants tied to specific provincial government expenditures. Put differently, while the shared-cost programs were generally equalizing in nature, their primary purpose was to provide minimum levels of essential services to individual Canadians. The Rowell-Sirois Commission explained the unconditional nature of equalization payments, which it called national adjustment grants, with the now-famous phrase "A province ... may, for example, starve its roads and improve its education, or starve its education and improve its roads" (Royal Commission 1940, p. 84). Perhaps out of concern that provinces might actually starve education, shared-cost programs in key social services for individual Canadians were developed in tandem with equalization.

THE 1977 EPF ARRANGEMENTS

The equalization program gained immediate acceptance, but the cost-sharing arrangements met with some resistance from the outset. The federal-provincial discussion and negotiation that ensued brought about, in 1977, an important change in Canadian fiscal federalism. These arrangements were widely applauded at the time, but in retrospect they appear as a curious hybrid of measures, responsible for the quandary that we find ourselves in today.

Forces for Change

The first concern with the shared-cost programs was political in nature. Some provinces, Quebec in particular, objected to the federal government playing an active role in areas that they saw as falling under exclusive provincial jurisdiction. To meet this objection, Ottawa introduced a technique known as "opting out." Under it, a province could decline to participate in a federal government program, and instead receive additional tax points to finance a program of their own creation. The practice was formalized in 1965 under the *Established Programs Financing (Interim Arrangements) Act*. All provincial governments were given the opportunity to take tax points instead of cash grants in a number of social policy areas. Quebec opted for the tax points in all cases, but no other province expressed any interest in the option.

The second concern was fiscal. The federal government soon learned what it meant to make open-ended spending commitments to programs over which it had little direct control. In response, it began to implement a series of ad hoc adjustments. The 1972 *Fiscal Arrangements Act* placed a ceiling on the annual increase in grants for postsecondary education, and in 1975 officials announced

a ceiling on health-care expenditures. These actions are the first examples of what was to become an important irritant in later years, namely a unilateral change in federal government spending commitments for shared-cost programs.

The third concern was with the efficiency of program delivery. Some observers argued that minimum national standards for social policy were inappropriate because preferences with respect to social policies varied by region. By putting conditions on its grants, Ottawa was imposing an inappropriate mix of social programs on Canadians, and was discouraging the experimentation and innovation that would improve the efficiency of these programs over time. Provincial governments were more aware of local preferences, or at least more likely to uncover them through experimentation. Thus, it was argued, they should be free to tailor social policies to what they perceived were the best interests of their own residents.

Other observers pointed to the potential for resources being mis-allocated due to the fact that, with cost-sharing, provincial governments could provide \$1 worth of social programs for less than \$1 of their own-tax revenue. In the cases of social assistance and postsecondary education, for example, provinces were effectively spending 50 cent dollars. This feature was less true for the health and hospitalization grants, since the size of the federal transfer to any province depended on more than just the amount of spending on these programs in that province. Simple economic theory suggested that, faced with distorted relative prices of this magnitude, provincial governments were likely overspending on social policy, and underspending in other areas.

The EPF Arrangements

The Federal-Provincial Fiscal Arrangements and Established Programs Financing Act was unveiled in 1977 as a response to these concerns. Ottawa maintained its commitment to health and postsecondary education, but altered the manner in which it supported them. Henceforth, its contribution to these two very different programs, with their distinct shared-cost funding histories, was to be made in the form of a block grant. The grant was to be paid in two parts. The first portion consisted of an annual cash payment to each province, equal to 50 percent of the average per capita federal contribution to health and postsecondary education in 1975-76, this figure multiplied by that province's population. The base grant was to be escalated each year by the rise in per capita GDP averaged over the preceding three years. The other part of the federal contribution involved a transfer of personal and corporate income tax points to the provinces. Practically, this provision meant that Ottawa reduced its tax rates by these amounts, leaving room for the provinces to increase theirs.

The cash transfer portion of the new arrangements retained the equalization feature that was implicit in the earlier cost-sharing arrangements for hospital and medical insurance. The tax point portion of the transfer did not have this same property, however, given the differences in provincial fiscal capacities. This effect was offset to some extent by making the transferred tax points subject to equalization. Thus, poorer provinces received the value of their tax points plus an additional cash transfer, referred to as associated equalization. Some inequality remained, however, since the tax points transferred to the richer provinces were not equalized downwards to the national standard.

The Canada Assistance Plan was not altered at this time, although there was some discussion about treating it in a parallel fashion to health and post-secondary education. For whatever reason, it remained a straight cost-sharing formula. The federal government remained committed to cover 50 percent of the social assistance costs each provincial government incurred, subject to some general conditions. The grant to each province under this program thus continued to depend on the case load and the generosity of the provincial scheme.

Remarks

In retrospect, the mix of cash and tax transfers adopted in the 1977 EPF arrangements was a curious hybrid of measures. As noted above, there is a clear, if controversial, rationale for the conditional grants that were in place until 1977. National social programs can be justified to the extent that they offset important interprovincial spillovers from social policy expenditures. More importantly, by bringing about minimum national standards in these program areas, they reflect a commitment to national equity.

There is also a clear, if equally controversial, rationale for the tax transfers that were part of the 1977 arrangements. Tax transfers are consistent with the view that efficiency is better served if provinces are free to design and administer social programs as they see fit. The argument is a simple one of accountability. With tax transfers, the government that spends is also the government that taxes. The opportunity cost of each \$1 spent on social programs is clear to voters, who can therefore be expected to choose more wisely the amount of government spending they wish to see.

There is no obvious rationale, however, for the cash portion of the federal contribution. As lump sum transfers, they could no longer be used to ensure a minimum national standard of social services. To the extent that the cash transfers were used in that manner anyway, as in the case of the *Canada Health Act* some years later, there was little point in altering the form of the grant in the first place. If they were not intended to be so used, it is legitimate to ask

why the entire contribution did not take the form of an equalized tax point transfer, to enhance political accountability.

It might be argued that cash transfers were retained to provide a degree of interregional equity that tax point transfers could not, even when equalized. But if equalization was the dominant motive, why choose to transfer tax points at all, and why leave the Canada Assistance Plan with a different, and less obviously redistributive, funding formula? Why not rely entirely on purely unconditional cash transfers for all programs? Once tax transfers are introduced, it is fair to ask why there must be a greater degree of equity among provinces with respect to social policy than there is for other expenditures. If the equalization formula is adequate for all other provincial government responsibilities, why is it deficient in these specific instances? If the answer is that these expenditures are somehow more fundamental, we are back to the case for minimum national standards, and hence shared-cost programs.³

This curious choice of a mixture of grants and tax transfers in the 1977 EPF arrangements explains the nature of much of the debate on fiscal transfers since. Both those who saw the arrangements as preserving a role for the federal government in social policy formation, and those who saw them as removing Ottawa from this field completely, were disappointed by the subsequent experience with this hybrid arrangement.

FISCAL FEDERALISM TODAY

The 1977 arrangements were no sooner in place when the federal government began adjusting the terms and extent of its commitments. The cumulative effect of these adjustments has been to bring the arrangements for EPF and CAP to the point where it is legitimate to refer to them, as the program brochure does, as "under immense strain." The equalization program faced its own set of pressures, and the formula was adjusted accordingly. The issues surrounding the future of this program are quite different, however.

The EPF Arrangements

The EPF arrangements were altered in 1982 to take the form that is still in effect today. Each province is entitled to receive an annual transfer equal to the product of a uniform basic entitlement⁴ and its population. The entitlement is paid in two parts. Federal authorities first calculate the value to each province of the tax points transferred to it in 1977, plus associated equalization where relevant. This amount is then recorded as EPF tax transfers. The second part of the transfer is a cash payment. It is equal to the difference between the province's total entitlement and the estimated value of the tax transfer plus any

associated equalization. Cash payments are a residual amount in effect.⁵ They have no independent base as they did between 1977 and 1982.

The intent in 1982 was to escalate the basic entitlement each year by the average of the change in GDP over the last three years. As the federal government budget situation worsened, however, this provision was altered. Payments deemed to be owing to postsecondary education (an hypothetical figure given the nature of the grant) were limited to 6 percent growth in 1983-84 and 5 percent growth in 1984-85. In 1986, Ottawa lowered the escalator on the basic entitlement to two points below the growth rate of GDP (GDP less 2) for 1986-87 and subsequent years. In the 1989 budget, the escalator was reduced by another percentage point, effective for 1990-91. In the 1990 budget, the basic EPF entitlement was frozen for two years at the 1989-90 per capita figure. The next year the freeze was extended to 1994-95.

This freezing of the basic entitlement has an important implication for the future of the programs covered. With the per capita entitlement frozen, the only growth in federal contributions to established programs comes from population growth. The value of the tax points transferred in 1977 continues to grow, however, meaning the residual cash portion is declining. Eventually, if the freeze is extended long enough, the cash contribution will fall to zero. This situation will occur first in Quebec because it has more tax points to begin with, the result of an earlier opting-out arrangement. Cash transfers will be effectively zero for Quebec before the end of this decade, and for the other provinces soon thereafter.

The Canada Assistance Plan

The Canada Assistance Plan escaped federal budget austerity scrutiny until 1990. In that year, Ottawa announced a ceiling of 5 percent growth on the total amount it would transfer under CAP in the next two fiscal years to those provinces not receiving equalization — B.C., Alberta, and Ontario. This limit was extended to 1994-95 in the 1991 budget. British Columbia challenged the initial action, and the B.C. Court of Appeals ruled in its favour in June 1990. This decision was overturned by the Supreme Court of Canada in August 1991, clearing the way for the federal government to impose its spending ceilings.

This ceiling has no effect as long as social assistance expenditures in each of the three have provinces rise by 5 percent or less each year. The federal contribution remains at 50 percent of total provincial outlays. If provincial expenditures rise by more than 5 percent annually, however, whether due to a rising case load or a more generous benefit structure, the federal share falls. The result is that the marginal dollars spent on social assistance are purely

provincial ones. The federal government cannot influence these expenditures in any way, for better or worse, since it has no fiscal levers left.

The other implication of the ceiling is that the further Ottawa's share of CAP expenditures falls below 50 percent, the less likely it is that the cost-sharing arrangement will ever be reinstated. The reason is that the snap-back required to bring Ontario back into the program will be too large for the federal authorities to manage. This temporary budget measure will almost certainly become a permanent feature.

Equalization

The equalization program came under considerable pressure during the 1970s as a result of the energy crisis (Courchene 1984). The huge increases in resource revenues in the western provinces, Alberta in particular, increased equalization entitlements substantially. After a series of ad hoc adjustments, in 1982 the base for calculating equalization entitlements was changed from a national average to a five-province standard. Alberta was omitted from the base to remove the energy revenue distortion, and the Atlantic provinces were removed as an offset. There were further adjustments to the number of taxes represented, and to the revenue guarantees.

A cap was placed on the program at this time whereby total federal payments for equalization could not rise above the 1982-83 figure by more than the increase in GDP. This ceiling became binding late in the decade, and the equalization formula in effect became irrelevant. The recipient provinces complained of an equalization shortfall, equal to the amount they would have received under the formal program less the amount they would receive as a result of the cap. Total payments were "re-based" in late 1991 in response, which solved the problem for the time being.

EPF AND CAP: IS FURTHER DEVOLUTION THE ANSWER?

If EPF and CAP are under "immense strain," what is to be done? As noted in the introduction to this chapter, one prominent view is that we should finish what we apparently set out to do in 1977 with EPF: make the fiscal transfers truly unconditional, and extend equalization as needed to maintain interregional equity. The validity of this view depends crucially on the strength of two key assumptions: devolution is efficiency-enhancing, and the federal government's ability to provide equalization funds is essentially unconstrained.

What Would Further Devolution Involve?

Health and postsecondary education are the most obvious candidates for further devolution. The minimum solution in these cases is to do absolutely nothing. The federal government presence is rapidly winding down at any rate, and soon there will be little or no cash transfers left. At this point, the programs will be purely provincially funded since Ottawa clearly cannot take back the tax points transferred in 1977. With no federal government leverage remaining, the provinces will be able to administer these programs as they wish.

Most proponents of this view, however, envision that, upon withdrawing, Ottawa will also turn over to the provinces all the fiscal resources it currently devotes to social policies. One way to do this is to make the cash transfers purely unconditional; that is, to drop any pretence that they are destined for particular uses by the provinces, or that they can be used to influence provincial policies. Cash grants would still go to zero over time, but at least the provinces could use them to ease the transition.

Generally, however, the devolution scenario envisions the federal government transferring to the provinces enough personal and corporate income tax points to replace the current cash transfers. This adjustment would take place in two steps. First, the nine provinces would receive the points that Quebec already has by virtue of earlier opting-out arrangements. Then, all ten would receive whatever tax room was left to reduce the cash entitlement to zero. In the interests of maintaining equity among provinces, these tax transfers would be equalized as was done for the tax points that were transferred in 1977.

Even with associated equalization, however, this action would increase the degree of fiscal disparity among provinces since the formula does not equalize the rich provinces downward. Hobson and St-Hilaire (1993) would avoid this outcome by having the federal government cede the value of the EPF cash transfers in the form of a tax abatement rather than actual tax transfers to individual provinces. Thus Ottawa would declare that a certain portion of its revenue base was reserved for established programs. The revenue it collected from this base would be distributed to the provinces much as EPF cash is currently. The advantage over the present arrangement, presumably, is that Ottawa would lose its ability to vary the size of the cash transfers for budgetary reasons.

Federal withdrawal from the Canada Assistance Plan could be accomplished with an EPF-type procedure. First, a figure would be chosen to represent the national average per capita federal government contribution to CAP programs. The next step would be to calculate the number of tax points needed to generate this sum, and reduce the federal rate accordingly to make the room available to

the provinces. This tax transfer would be equalized, as in 1977. Since the per capita value of the cash transfer for CAP varies by province, it may be necessary to consider special transitional arrangements for provinces whose per capita revenue will fall under the new arrangement.

Devolution of CAP through tax transfers is subject to the same comment that applies to the idea of converting EPF cash to tax transfers. The end result may not be as fully equalizing as the current arrangement. Boadway and Hobson (1993) and Hobson and St-Hilaire (1993) suggest a way around this objection. Social assistance liabilities should be viewed as negative tax liabilities, with transfers to provinces rolled into the equalization formula. A province with an above-average social assistance liability and a below-average revenue capacity would receive equalization payments on both counts. A province with an above-average social assistance liability and an above-average revenue capacity, however, would not receive transfers until the former amount began to exceed the latter amount.

A decade or more of work on social policy makes clear that it is impossible to talk about reforms to CAP without mentioning unemployment insurance. If this connection is acknowledged, and if CAP is to be completely devolved to the provinces, it is logical to presume that the recommendation of the devolutionists is that unemployment insurance would be as well.⁶ Provinces would be free to structure their program as they wished, to set contribution and benefit rates, and to integrate unemployment insurance and social assistance.

How would unemployment insurance be funded in this event? Presumably, in keeping with the efficiency perspective that informs the devolution argument more generally, each plan would be self-financing, with the provincial government (or governments if the smaller provinces decided to coordinate actions) alone responsible for any differences between claims and employer-employee contributions. In the interests of not restricting interprovincial labour mobility, there would be some provision for migrants being able to draw the benefits for which they were entitled while seeking work in another province.

The present unemployment insurance scheme acts to redistribute income among regions (Reid and Snoddon 1992; Leslie 1993), so any move to devolve responsibility for it would have to take this effect into account. Presumably, contribution rates and benefits would be adjusted in each region until the plans became actuarially sound. Boadway and Hobson (1993) argue that any such devolution would have to be accompanied by associated equalization payments to equalize the abilities of provincial governments to contribute to the plans.

Is Devolution Efficiency-Enhancing?

The traditional argument as to why devolution is thought to be efficiency-enhancing presumes that social policy preferences vary sufficiently by province or region, and that regional governments are more likely to be aware of these differences, and will therefore tailor policies accordingly. National standards, however general, are inefficient because they impose the same mix of policies on all Canadians, regardless of preference. A variant of this argument says that even if preferences do not vary in this manner, there are dynamic efficiency gains from freeing provinces to experiment with respect to new ways to deliver social policies. National standards are inefficient in this view because they discourage this process of innovation.

This argument is most compelling in the case of health insurance. However important Ottawa's involvement was in getting hospital care and medical insurance schemes established initially, these programs are now established in the true sense of the term. On a more positive note, health care is also the example that best fits the public choice model of competitive federalism. The challenge of containing costs may be best met by encouraging the experimentation and innovation that come with decentralized control. The one important national standard from an economic point of view, that of portability, can be fairly easily achieved through interprovincial coordination.

In other areas, the efficiency argument is less convincing. It is at least arguable that spillover effects and externalities are important in these cases. Provincial governments have little incentive to plan their social policies with the residents of other jurisdictions in mind. Postsecondary education is often cited as an example of an activity particularly prone to this consideration. Educated workers are more mobile interprovincially, so are likely to receive their training in one province and spend their working lives in others. Social assistance is another example. Unemployed workers frequently move among provinces in search of jobs, or back to their home province when laid off.

One might argue that the costs of spillovers of these types normally are not large enough to offset the efficiency gains from further decentralization. Alternatively, to the extent they are important, they can be countered by a zero-sum system of interjurisdictional transfers. But consider what this latter recommendation means in practice. Provinces such as Alberta would make payments each year to those such as Newfoundland, as compensation for the educational expenses embodied in interprovincial migrants. B.C. would bill Alberta each year for part of the cost of social assistance for its out-migrants that end up on B.C. welfare rolls. The difficulty of making this type of calculation, not to mention enforcing the actual payment, is obvious, as the recent exchange

between Premiers Harcourt and Klein over bus tickets to Vancouver for Alberta welfare recipients well illustrates. Thus if spillovers are a problem in fact (and on this point we badly need better information), there is certainly cause for concern.

There is also a logical problem with the argument for devolution with full equalization. The rationale for transferring tax points to the provinces rather than cash is the simple public finance principle of accountability. Governments will be better policymakers if they are forced to raise taxes commensurate with their program expenditures. Any political benefit they derive from introducing a new program will have to be set against the political price that comes with higher taxes. This discipline is missing if governments are spending funds that another government has raised. If this principle is sufficient to justify tax transfers, however, it is fair to ask why it does not apply with equal force to equalization payments, especially as these transfers will grow significantly under the devolution scenario.

Will the Equalization Transfers be Forthcoming?

Efficiency considerations aside, the devolutionist proposals presume that equalization and equalization-type transfers can be extended as required to meet equity objectives. Is this faith justified?

If the interpretation of the historical development of Canadian social policy given above is at all credible, it is wrong to think that the federal government's commitment to equalization is invariant to the associated set of social and economic union policies. Voters may well support transfers aimed at providing basic social services to individual Canadians, yet balk at transferring the same amount of money unconditionally to provincial treasuries.

It is legitimate to question, therefore, whether the political consensus for a national equalization scheme can hold in the face of further devolution. Unconditional cash transfers would increase under the devolution scenario, and they would be more visible with the presence of the Bloc and the Reform Party in the House of Commons. It is entirely possible that a point would be reached where the federal government loses political legitimacy with the voters. Ottawa taxes individual Canadians, bearing the political costs as it should. It then transfers the revenue on an unconditional basis to other governments, who get the political credit for the services provided. It is easy to see why provincial governments like this system. It is more difficult to see why any federal politician would countenance it for long.

Political will aside, there is another reason to question whether the federal government should be left with responsibility for equalization under the devolution scenario. Provinces are certain to seek more control over personal income

taxes in order to integrate postsecondary education and training, unemployment insurance, and social assistance programs. This change would force the federal government to rely relatively more on sales taxes and other such revenue sources. Since these taxes tend to be more regressive, the equity basis of a national equalization scheme becomes suspect.

These considerations suggest that one implication of the devolution of social policy may well be the sacrifice of some of the interregional income redistribution that is contained in the current transfer programs. This outcome could be avoided, however, if responsibility for equalization could be shifted to the provinces. Ottawa would wind down the equalization program. In its place, richer provinces would make direct fiscal transfers to poorer ones. There is some recent theoretical work (Dahlby and Wilson forthcoming; Burbidge and Myers 1992; Snoddon 1993) on interprovincial equalization schemes, and there are a number of proposals as to how such a system might operate in practice (Helliwell and Scott 1981). The first step in all of them is to decide upon a representative provincial fiscal base, much as is done now. Provinces with a fiscal capacity above this figure would contribute some portion of their surplus to an equalization fund. Those with capacities below this level would draw from the fund. Net payments would be zero.

This type of scheme is consistent with the public choice principles that are advanced to support devolution of social policy in the first place. Residents of the richer provinces would get to decide each election how much they are willing to contribute annually in the way of unconditional transfers to other provincial governments. If it is important to have questions of intraprovincial redistribution settled within each province, as the proponents of devolution insist, surely it is equally important to have interprovincial sharing handled in the same manner.

A PREFERRED APPROACH

If one accepts that the time for cost-sharing ventures in social policy is past, and if one is reluctant to accept a greater degree of interregional inequality, and if one is sceptical that an interprovincial equalization scheme would ever see the light of day, what option is left?

One solution is to retain a federal presence in social policy, but alter its form. Fiscal transfers should go directly from the federal government to individual Canadians. This is hardly a novel idea. In its most general form, cash transfers to individuals have been the staple recommendation for decades of economists working in the social policy field. The idea received considerable airing in Canada in the 1980s, in accounts that went beyond general arguments in support

of the idea to quite detailed recommendations as to how to proceed with particular schemes (Royal Commission 1985; Commission of Enquiry 1986; Courchene 1987). The perception at the time was that Canada was not ready for radical reform of this type. Maybe now it is an idea whose time has come.

Direct grants to individuals have three important advantages over transfers to provinces. First, they remove the efficiency problems that come with the separation of taxation and expenditure responsibilities. Provincial governments would not be financing programs with revenue they have not collected, which public choice theory suggests should lead to a more efficient set of policies. Second, the federal government would not have a major problem of political legitimacy, since it would be providing visible benefits to Canadians with the taxes it levies. With its legitimacy enhanced, the national equalization program is more secure. Third, direct grants to individuals can be the first step in a move towards a more efficient and effective system of social support measures.

How would this reform of the transfer system proceed? The first two steps are purely bookkeeping ones. First, the federal government should acknowledge that it no longer controls the tax points it transferred to the provinces in 1977 as part of the EPF arrangements. This step reduces the reported federal contribution considerably, but these are fictional transfers in any case. Second, it should formally separate the EPF cash transfers into the two basic components of insured health services and postsecondary education. They are distinct programs, with very different objectives, and they should be treated as such. For want of any more logical division, the proportions can be the ones used to allocate cash and tax transfers between the programs currently.

We acknowledged above that there is little compelling case for a continuing federal government role in health-care administration. Thus the next step is to compensate the provinces for the fact that henceforth they will be solely responsible for this activity. The federal cash transfer for insured health services for 1992-93 is estimated to be \$6.2 billion (Canadian Tax Foundation 1992, 16:18). This sum would be turned over to the provinces, in exchange for which the provinces take over sole authority for health-care services. The transfer would be by means of extra tax points rather than cash transfers, for reasons spelled out above.

The case for a continued federal presence in postsecondary education rests on two assumptions: there are important spillover effects in this area due to interprovincial mobility, and provinces are not likely to act to offset them through a system of transfers. The form of federal assistance must be altered, however. The current transfers would be redirected from provincial governments directly to students. This objective can be achieved by means of educational vouchers, or as additional tax credits for tuition and other expenses.

Students would be free to use this assistance at the (accredited) institution of their choice. The provinces would cut back their contributions to universities and other institutions by an equivalent amount, and allow tuition fees to rise.

This approach has several advantages over the present one. The more direct link between supply and demand for education should encourage a more flexible and responsive educational system. Further, spending and taxing responsibilities would be more properly aligned. Provincial governments would no longer be spending revenue raised by Ottawa. Conversely, the link between the federal government's taxation and spending in this area would be more obvious, thereby enhancing its political legitimacy.

The Canada Assistance Plan can be transformed in a similar manner. The basic idea would be to convert the present cost-sharing arrangement with the provinces into a system of direct grants (or refundable tax credits) to individuals. Ideally, this change would be part of a more encompassing reform that would replace the current hodge podge of income support and supplementation programs with a basic guaranteed annual income scheme. Part of the attraction of this innovation is that it would allow some badly needed parallel reform of the unemployment insurance system. The scheme itself could revert to basic insurance principles, while the income support component would be shifted to the guaranteed annual income.

There are several variants of such schemes in the recent Canadian literature. The Macdonald Commission recommended first that the unemployment insurance scheme operate more like an actual insurance program. This goal would be accomplished by reducing the benefit rate, raising the entrance requirements, tightening the link between the maximum benefit period and the minimum employment period, and removing regional differences. The Commission argued as well for a transitional adjustment assistance plan designed to allow Canadian workers to adjust to changing opportunities in the labour market. Finally, it advocated a guaranteed annual income scheme to be known as the Universal Income Security Program (UISP).

The Forget Commission focused mainly on reforms to the unemployment insurance system, but its recommendations were premised on there being in place a comprehensive program of income support and supplementation. Courchene also makes his recommendations for reform of UI in the broader context of changes in job creation and adjustment enhancement, and changes to what he calls the family benefits package. He favours an incremental approach to reform, largely because of the monumental federal-provincial bargaining and consultation that would precede it. But, as noted above, we no longer have this luxury of time.

The proposals by the Macdonald Commission, the Forget Commission and Courchene differ in detail, but they all bring the same advantages. They are less costly to administer than current schemes, they are less demeaning for recipients, and they remove the worst of the perverse work incentives. Provinces could supplement the basic income support with schemes of their own design and funding, so the proposals do not run afoul of jurisdictional concerns. An important ancillary benefit is that these changes make it possible to undertake some badly needed reform of the UI system. Equally important from the perspective of this paper, a system of direct grants to families and individuals brings with it enhanced accountability by provincial governments, and renewed political legitimacy to the federal government.

The mention of increased visibility for the federal government returns to a theme that has run throughout this chapter. Ongoing support by Canadians for purely unconditional interregional income redistribution, such as that achieved through the current equalization program, requires that the federal government have a legitimate and independent role in the federation. Without some enhancement of Ottawa's political role, there is every chance that the federation will alter in ways that even the most ardent proponents of devolution will come to regret.

CONCLUSION

This paper has argued that the future for social policy reform in Canada lies in devising new ways to meet an old objective. The old objective is the balance between a commitment to individual equity and to regional equity that characterized the system of intergovernmental fiscal relations that developed after World War II. This balance was tilted seriously in 1977, and it will be lost entirely if the federal government continues to withdraw from social policy formation. The new ways to meet the old objective are federal government transfers for postsecondary education, training, and social assistance that go directly to individual Canadians. There are direct benefits to such a scheme, and there is one important associated benefit, the maintenance of a national equalization program.

NOTES

1. This feature was offset somewhat by introducing a supplementary provision whereby any province could, if it wished, receive a flat grant of \$15 per capita, accelerated annually by the rate of growth of postsecondary education expenditures.

2. Defined in 1957 to be the average per capita yields from personal and corporate income taxes and succession duties in the two richest provinces.
3. Cash transfers might be justified if one could show that there was a vertical fiscal gap evident at this time. This argument is difficult to make for Canada at any time in the post-World War II period, however, and is particularly difficult to make in this decade.
4. Defined as the national average federal contribution to established programs in 1976.
5. As Hobson and St-Hilaire note this change in the funding arrangements for EPF made the federal contributions fully equalizing (1993).
6. Thus Boadway and Hobson write, "It would make more sense if both unemployment insurance and welfare were delivered at one level of government, and the provincial level would be the appropriate one." (1993, p. 153)

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Comment: Political Constraints on Fiscal Federalism

David Milne

This collection boasts a wonderful blend of economists, public finance specialists and political scientists gathered together to tackle important questions about the future of Canada's fiscal arrangements. In this case, I am joined by two economists — one presenter and one commentator — who are attempting to speculate on the future of Canada's equalization program, especially in the light of the changes that may arise in other intergovernmental fiscal arrangements. As a political scientist, I know that my principal job will be to test the political dimensions of these ideas and proposals, but I must admit to feeling some initial reticence about what political science may actually have to offer to this discussion.

On re-reading Richard Bird's recent piece on future fiscal arrangements, I was, however, again reminded about how central political science is to this whole question. The reasons are quite simple:

Federal-provincial fiscal arrangements are much more than an economic issue. How financial and administrative responsibilities are allocated between governments is a central political question. The answer to this question reflects a country's style, its concerns, and its goals. (1990, p. 109.)

A federation is inherently a political creation with primarily political objectives, and its fiscal arrangements must be viewed within this political framework. (1990, p. 129.)

And just as fiscal arrangements in the past were the product of larger political, social, and economic forces, so future fiscal arrangements will be "set outside the narrow parameters of public finance." Ultimately, Bird argues the arrangements may come down two critical factors: "who determines the [future] rules of the game and how are these rules changed: all else follows" (1990, p. 129.)

Now if we are to bear in mind this wise advice, and apply it to the paper at hand, what should we say? Of course, there still remains a major question mark on the future of Quebec in Canada, a matter that Bird thought central to any filling in of answers on future fiscal arrangements. The recent election of the Bloc Québécois as Official Opposition in Parliament has only served to increase uncertainty on that score. Nor has the question of addressing the forces of regionalism found resolution either with the Charlottetown Accord or the future fate and agenda of Preston Manning and his Reform Party. But at least some things are clearer from the 1993 federal election about the strength and alignment of political forces and how they are likely to be brought to bear on the fiscal proposals in Kenneth Norrie's chapter. In short, what will those who set the future fiscal rules have to say and what changes will they permit?

With the uncertainty surrounding the current political landscape and the high political stakes in yet another renewal of the old battle of Quebec separatism-Canadian unity, it would seem likely that federal leaders who set the fiscal rules would wish to approach the question of sharing money cautiously, postponing any decisive action at least until after the unfolding of an election or referendum in Quebec. In any event, such an interval would provide Ottawa with an opportunity to launch consultative vehicles and generally encourage public discussion of the question of reworking fiscal arrangements, including social programs and unemployment insurance, without exposing the advocates of federalism to risk in what will be the second major debate by Quebecers over their political future in less than a generation. Certainly, we cannot reasonably expect a stable set of financial arrangements until this mega-constitutional question is again faced. Moreover, given the strength of devolutionist thinking in Quebec, the west, and elsewhere, it seems scarcely reasonable to see this as a time for a vigorous reassertion of the federal spending power in provincial areas of jurisdiction.

If this is so, I think the government of Canada would be most unlikely to adopt Norrie's proposals for changing Established Programs Financing. Adopting a student voucher system instead of transfers to provinces for postsecondary education, for example, would virtually guarantee a vicious showdown with Quebec and many other provinces on one of the most sensitive of provincial jurisdictions — and this at precisely the point when the federal Liberals are engaged in fending off a two-front war in Parliament with Quebec sovereignty and western regionalism. It would also almost certainly constitute a serious blow to the Chrétien government's efforts to present a new Liberal face to Canadians, since adoption of former Prime Minister Trudeau's old pet student voucher scheme to circumvent provinces would reinforce the claim that Chrétien is indeed "yesterday's man." Moreover, it is not at all clear that

precipitate action on this front would be much welcomed by the client groups caught in the middle of the intergovernmental crossfire, namely the post-secondary educational institutions themselves. In any event, while it is certainly true that innovation and diversification is needed in Canada's postsecondary educational system, we may be entitled to wonder whether an effective and enduring solution can really be purchased by the application of this simple market expedient.

Political pitfalls of an even more serious kind await a federal government that would seek to follow Norrie in jettison any federal role in defending national equity goals in health care, leaving the field entirely to the provinces. While I am hardly a booster for the politics of the *Canada Health Act* as practised by Trudeau,¹ it is obvious that Canadians at large do regard the maintenance of these goals within our public Medicare system as — to steal a tarnished phrase — a "sacred trust." Certainly public concern goes much further than the mere issue of portability, to comprehensiveness and accessibility of health care. For that reason, no government in Ottawa whatever its partisan stripe could politically countenance any such withdrawal, even if personally inclined to do so. Rather the federal challenge will be to find ways of providing sufficient flexibility and incentive within the terms of the *Canada Health Act* to permit provinces to achieve needed economies and innovation. In short, the challenge will be to find a way to marry the advantages of a genuine decentralization of program design and delivery within a system of general national equity goals.

It is worth underlining too that any proposed federal transfer of tax room to the provinces for health care (in the order of \$6.2 billion in 1992) will merely increase the provinces' stake in the direct tax field, and potentially raise risks to harmonization of the tax system and to the economic union.² Moreover, this decentralization of taxing would also seem to put additional pressure upon the equalization program just when the strains on Canada's notion of the "sharing community" may be at their most severe.

The preference for transfers to persons rather than to governments continues in Norrie's suggestions respecting the Canada Assistance Plan. Here, too, direct grants to individuals, perhaps in the form of a guaranteed annual income, are proposed as a means of securing federal visibility, currently lost in the existing CAP fiscal arrangements. While it is true that the federal government has frequently complained of its lack of visibility in these and other social policy expenditures, this case has often been much exaggerated. The fact is that, despite the arcane nature of the intergovernmental fiscal arrangements, neither the Canadian public nor the social policy community and interest groups have failed to recognize the important federal role in social policy; indeed, outside

Quebec, people have consistently looked to the federal government for leadership in this area, even when the jurisdiction is provincial and when federal financial contributions towards the maintenance of social programs are declining.

But apart from Ottawa not needing (nor wanting) enhanced visibility for expensive social costs during a period of restraint, the proposal is unlikely to proceed for at least two additional reasons. The first is that the impediments of federalism are likely to be as effective a conservative force against dramatic policy innovation as they have been in the past.³ The second is that Ottawa would have to worry about its ability to manage and fund a guaranteed annual income scheme over the long haul. After all, if it is unable to afford its part of the existing *cost-shared* arrangements for social assistance under CAP, what confidence can one have in Ottawa's capacity to assume the function on its own through a guaranteed annual income scheme?

Kenneth Norrie's chapter shows a commendable resistance to the messiness and apparent disorder of Canadian federalism and a desire to tame and discipline it with the application of relatively straightforward rules or doctrines. It is, of course, always tempting to see the problems in our current fiscal arrangements resolved forthrightly by the assignment of a clear division of responsibility based on a public choice model of federalism, but the stubborn reality of shared jurisdiction and interdependence resists such appealing solutions. Disentanglement strategies are not easy to execute nor to maintain.

In my view, complex interdependence over budgetary and fiscal relations among governments in Canada is likely to continue. In short, fiscal federalism will resist neat compartmentalization. It is for that reason that I am inclined to accept scholars such as Robin Boadway and Frank Flatters in their arguments in this collection for better institutions for intergovernmental coordination and decision making. That was also the thinking behind the ill-fated Council of the Federation proposal in the September 1991 federal proposals. One way or another, our success or failure in developing and perfecting these intergovernmental institutions and procedures will be a vital part of the story over Canada's unfolding fiscal crisis.

Now, oddly enough, Norrie's chapter has relatively little explicitly to say about the future of equalization. Neither the problem of the ceiling on the equalization program, nor the widening disparities in fiscal capacity among provinces, nor the question of a net scheme get treated. And while his proposed changes to Established Programs Financing arrangements would substantially negate the *implicit* elements of equalization in these current arrangements, his proposals do not address this erosion of equalization nor estimate its consequences. Certainly, there is no reason to suppose that a system of transfers

to individuals would itself actually compensate for or even address this notion of equity in the federation.

The ideological rationale underlying Norrie's preference for "transfers to persons" may also deserve more careful scrutiny. He wishes his proposals to be seen as an attempt to "rebalance" fiscal arrangements following the confusions and disorder flowing from the 1977 changes to Established Programs Financing. In effect, his proposals for transfers to individuals would allegedly preserve an "old objective of a balance between a commitment to individual equity and to regional equity." To make this claim, equalization is cast wholly into the "regional equity" category; shared-cost social programs, since they are conditional upon provincial expenditures for certain purposes, are placed in the box of "individual equity" because "their primary purpose was to provide minimum levels of essential services to individual Canadians." But this distinction does not hold up. Not only is Norrie forced to acknowledge a substantial redistributive and equalizing role in these arrangements (hence, they cannot be programs exclusively devoted to individual equity), but federal conditionality permitted considerable variation in levels of public service in these programs. Since federal payments were linked to provincial expenditure decisions, it could hardly have been otherwise.

Moreover, the problems of maintaining this distinction are just as problematic with the equalization program. First, it is worth pointing out that equalization speaks to a notion of *provincial* equity, not regional equity. It aims to give each province the requisite financial means to meet its constitutional responsibilities. Moreover, equalization, although unconditional, has always aimed at equalizing the provision of basic public services for individual Canadians. That is self-evident in our constitution in the language of section 36 on equalization and regional disparities where the commitment is to "promoting equal opportunities for the well-being of Canadians" and "providing essential public services of reasonable quality to all Canadians." Equalization payments are specifically aimed at ensuring that "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." Individual equity for all Canadians is inextricably linked with that of provincial equity. It would seem artificial to attempt to separate them.

It is time to remind ourselves once again that fiscal arrangements after all arise as products of politics; they are not constructed on clear and distinct rules of logic, equity, or economic theory. For that reason, I hesitate to accept the claim that Norrie's proposals merely retrieve a logic allegedly lost in the fateful changes to the established programs financing arrangements in 1977. In my view, the proposals signal rather a preference to depart from the intricate

workings of cooperative federalism and to move towards federal unilateralism and selective disentanglement. While Ottawa unilaterally retreats from any role in health care, it proceeds with bold new programs over the heads of the provinces in postsecondary education and income security. Decentralization in one direction, centralization in two others. In the end, however, it remains unclear how these decisive steps would help resolve the complicated and unavoidably *shared* patterns of intergovernmental interdependence for these and related policy areas — or, for that matter, why and how they are thought necessary to shore up federal legitimacy and equalization itself.

While there are undoubtedly many changes coming in Canada's social programs that will require a restructuring of fiscal arrangements, the complexity and interdependence of the whole system of arrangements does not really permit fast unilateral solutions. Neither a course of simple devolution nor centralism will do. Instead, a decent respect for the genuine complexity of the fiscal system is called for. Nor are the answers to the problems of Canada's debt and economy easy or obvious. Under these circumstances, even if Canada were not facing an ongoing national unity crisis, it would be reasonable to expect federal politicians to take time to experiment with many new ideas and arrangements rather than boldly charting a wholly new system for the future. For policy rationalists in a hurry, this sounds maddeningly conservative. But perhaps that is why, for the most part, "big bang" is reserved for physics.

NOTES

1. See my critique of this feature of Trudeau's federalism (Milne 1986, pp. 181-184).
2. See Boadway and Flatters, in this volume, for expressions of concern on this score.
3. See Banting for a classic statement of the conservative influence of federalism upon Canadian social policy (1987).

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Comment: New Versus Old Instruments

Paul A.R. Hobson

One of the numerous contributions of Kenneth Norrie's chapter is that it draws attention to the importance of discussing the various elements of federal-provincial fiscal arrangements as a package, as does the chapter by Boadway and Flatters (this volume). The central message appears to be that a wholesale devolution of social policy to the provinces would so seriously undermine the legitimacy of the federal government as to put in jeopardy the essential feature of Canada as a sharing community. Rather, it is argued, the federal role in delivery of social policy needs to be recast, placing a greater emphasis on transfers paid directly to persons.

Correctly, the chapter identifies the principle of equalization as the foundation on which Canada's "national" social programs rest. Equalization as presently structured, however, cannot be relied on alone to achieve the goal of fiscal equity. The chapter by Boadway and Flatters has discussed this thoroughly. To reiterate, what this would require in the extreme is the full equalization of provincial fiscal capacities (more or less, depending on adjustments for need and/or cost differences). The fiscal equalization program, however, raises fiscal capacities in the have-not provinces to a level somewhat below the corresponding national average. Even after equalization, there remains a significant degree of fiscal disparity between the have and have-not provinces. Thus, the devolution of responsibility for financing social programs to the provinces along with an accompanying transfer of tax room would simply exacerbate the problem.¹ It would also place upward pressure on levels of equalization payments, possibly further straining the level of political commitment to maintaining a system designed around unconditional cash transfers to recipient provinces.

In these comments, I want to make three main points, all of which promote federal-provincial fiscal disentanglement but are consistent with the goal of promoting fiscal equity, and none of which involve any increased equalization commitment on behalf of the federal government:

- EPF cash contributions to the provinces should be replaced with a tax abatement to the provinces (i.e., Norrie's proposal that there should be a simple transfer of tax room in place of the "health-care component" of the EPF transfer should be rejected).² EPF cash would henceforth grow in step with the income tax base. Associated revenues would be distributed across provinces so as to preserve the equal per capita nature of EPF inclusive of the value of the existing EPF tax points.
- CAP (or its successor after income security reform) should be replaced with a block funding scheme, distributed across provinces so as to fully equalize (standardized) per capita social assistance liabilities.
- The federal government should not replace the "postsecondary education component" of EPF and contributions to social assistance payments under CAP (or its successor after income security reform) with direct transfers to individuals. (i.e., Norrie's proposals along these lines should be rejected.)³

EPF AND THE POSTWAR DEVOLUTION OF INCOME TAX ROOM TO THE PROVINCES

It is useful to think about the evolution of federal-provincial cost-sharing arrangements in the social policy field as transfers in lieu of the return to the provinces of income tax room ceded under the Wartime Tax Rental Agreements. Over the immediate postwar period, the system of tax rentals evolved into a system of tax abatements accompanied by explicit equalization payments. When it was first introduced in 1957, the standard for equalization was per capita revenues in the two richest provinces. As a result, income tax abatements made to the provinces at that time were, in effect, equal per capita revenue transfers.

The process of actually returning income tax room to the provinces began with the 1962 *Federal-Provincial Fiscal Arrangements Act*. In part, this was designed to promote a greater degree of accountability at the provincial level as the provinces clamoured for increased access to income tax revenues to meet rapidly rising expenditures on social programs in the areas of health, education, and welfare. The 1962 arrangements also included a proposal to adopt a national average standard for equalization. This was to be accompanied by the inclusion of 50 percent of natural resource revenues among the revenue bases eligible for

equalization. While revenue neutral at the time, this posed a problem as to how to effect any further devolution of income tax room without widening fiscal disparities between the have and have-not provinces.

By retaining its dominance in the income tax field, the federal government had been able to achieve a variety of social policy goals through the use of the spending power. In practice, cost-sharing arrangements in the areas of hospital insurance, health care and postsecondary education were tied to national average per capita expenditures and amounted to specific purpose, equal per capita transfers.⁴ The genius of EPF, introduced in 1977, was that it permitted the replacement of these earlier cost-sharing arrangements with a further devolution of income tax room to the provinces that was, in effect, fully equalized. This was accomplished by augmenting the (equalized) value of the EPF tax points with a cash component. This further devolution of tax room in 1977 had the effect of placing the other provinces on a more equal footing with Quebec, which had secured additional tax room for itself under earlier opting-out provisions. In addition, it should be recalled that a portion of the earlier postsecondary education transfer had been in the form of a tax transfer.

When viewed in the context of the postwar devolution of income tax room to the provinces, then, there is no implication that somehow "there must be a greater degree of equity among provinces with respect to social policy than there is for other expenditures." (Norrie this volume, p. 162). Rather, the equal per capita nature of EPF was consistent with the objective of not further widening the degree of fiscal disparity across provinces, i.e., promoting the goal of fiscal equity. Fiscal equalization alone (as presently structured) cannot accomplish the goal of fiscal equity; equal per capita transfers such as those under EPF complement the fiscal equalization program in levelling fiscal capacities between the have and have-not provinces.

WHAT TO DO ABOUT EPF?

The problem with EPF was that the per capita total transfer was designed to grow in line with per capita GDP, a growth rate that was less than the rate of growth of the personal income tax base. In addition, various federal budget measures, including the five-year freeze on per capita entitlements beginning in 1990-91, further reduced that rate of growth. Thus, whatever the effective transfer of tax room was in 1977, the associated number of tax points has been severely eroded since then. This has been a significant cause of the widening fiscal imbalance between the federal government and the provinces.

This erosion in the effective number of EPF tax points could be halted by a simple but clear division of federal income tax revenues. The federal

government would cede a negotiated fraction of its income tax revenues to the provinces in the form of a tax abatement. The value of this tax abatement would grow in line with the income tax base, in step with the value of the existing EPF tax points. The tax abatement would then be distributed across provinces on a residual basis, much like the existing EPF cash component, thus preserving the equal per capita — cash plus tax — feature of EPF (Hobson and St-Hilaire 1993).

The issue is, therefore, really one of disentangling the EPF cash component from the federal government's budgetary decisions. It is a question of how to halt the further erosion of the tax points effectively transferred in 1977, tax room to which the provinces might legitimately lay claim. This cannot be accomplished through a direct transfer of additional tax points to the provinces without sacrificing fiscal equity.⁵ It can, however, be done by instead following the proposed tax abatement procedure. In effect, the procedure ensures a fully equalized transfer, with all provinces implicitly equalized to the national average.

RECASTING CAP

The determination of provincial fiscal capacities for equalization purposes fails to take into account "negative" tax liabilities in the form of transfers to persons, such as those made under provincial welfare programs. To some extent CAP provides an offset for this since provinces are, in principle, reimbursed for 50 percent of social welfare expenditures. Thus, in principle, those provinces with relatively high social welfare liabilities — per capita social welfare expenditures — receive proportionately more by way of transfer. In practice, however, provinces differ in terms of "need" (the number of welfare recipients per capita) and "generosity" (expenditures per recipient) in respect of welfare programs. Moreover, those provinces with below average fiscal capacities have less ability to spend on social welfare yet, typically, they exhibit greater need.

From the perspective of the have provinces, the cap on CAP first imposed in the 1989 budget has limited growth in entitlements to a maximum of 5 percent per annum. This has resulted in federal transfers falling significantly below the 50 percent level around which the program was designed. Indeed, at the margin, welfare expenditures in the have provinces are simply not cost-shared once the growth ceiling has been passed. Provinces are not equal in terms of their eligibility under CAP.

It is difficult to predict the outcome of the federal initiative on income security reform in Canada. One possible scenario is that responsibility for income security — including unemployment insurance — may be devolved

completely to the provinces. At the very least, this would require the transfer of associated payroll and income tax room to the provinces. The provinces would then be in a position to develop more integrated approaches to delivery of income security (e.g., the Newfoundland guaranteed annual income proposal). The problem would be accommodating what would inevitably be a widening gap in fiscal capacities (after equalization) between the have and have-not provinces, one element that would be essential to ensuring reasonably comparable levels of income security across provinces.

An alternative scenario, seemingly preferred by Norrie, would be some form of guaranteed annual income scheme delivered by the federal government, with the provinces, presumably, left with responsibility for making cash transfers to those who are not caught in the income security net. To the extent that this suggests an increased federal presence in the income security field, it seems improbable that it would be adopted without some accommodating transfer of tax room from the provinces to the federal government. Moreover, it suggests either an accompanying transfer of responsibility for welfare services or a separation between responsibility for income assistance (primarily at the federal level) and responsibility for welfare services (at the provincial level). Certainly, a case might be made for maintaining a decentralized delivery system for welfare services.

As long as there remains a role for the provinces in delivery of social welfare, the case can be made that some form of cost-sharing arrangement is justified. Hobson and St-Hilaire propose a block grant scheme that is equalized for differences in need across provinces (1993). Under their scheme, the total federal commitment would be based on a fixed percentage, say 50 percent, of standardized provincial social welfare expenditures across all provinces. Each province's equal per capita entitlement would be adjusted according to a built-in equalization formula, based on the difference between its per capita liability and the corresponding national average. The net effect would be a system of differential cost sharing: those provinces with above average need would receive in excess of 50 percent cost sharing; those with below average need would receive less than 50 percent cost sharing. The associated equalization scheme would operate separately from fiscal equalization; since it simply acts to redistribute a given pool, there would be no additional cost to the federal treasury.

TRANSFERS TO GOVERNMENTS OR INDIVIDUALS?

The main thrust of Norrie's reform proposals is to substitute transfers to individuals for existing transfers to governments (education and welfare) and

for the federal government to withdraw from health care with an accompanying transfer of tax room. The problem with a simple transfer of tax room has already been discussed. As an option, it inevitably carries with it the implication that the degree of fiscal disparity between the have and have-not provinces will be allowed to increase. In principle, a federally administered guaranteed annual income scheme would reduce the pressure on provincial welfare programs and obviate the need for a significant portion of transfers currently made under CAP. There would still be a case, however, for cost-sharing arrangements associated with remaining provincial social welfare expenditures — that is, there would still be a place for transfers to the provinces in respect of social welfare expenditures, although the levels would be much lower than at present and the way in which the monies are distributed across provinces might take a different form.

What of the option of replacing the “postsecondary education portion” of the EPF transfer with a system of educational vouchers? The logic of substituting transfers to individuals for transfers to governments is based in what Boadway describes as “the false dichotomy between place prosperity and people prosperity.” Again, the combined effect of fiscal equalization and EPF is to reduce the degree of fiscal inequity in the system. To follow Norrie’s proposal would therefore increase the degree of fiscal inequity between the have and have-not provinces. In turn, this would result in a greater degree of horizontal inequity across provinces associated with the federal personal tax-transfer system. A uniform federal personal tax-transfer system will only be horizontally equitable if all sources of fiscal inequity through provincial budgets are first eliminated.

As noted in the Boadway and Flatters contribution, fiscal equity (and fiscal efficiency) may be promoted through a federal personal tax-transfer system which discriminates against those provinces with above average fiscal capacities. That is, such a system could, in principle, substitute for a system of equalization payments designed to eliminate differences in net fiscal benefits (NFBs) across provinces. The federal rate structure would vary by province; tax rates would be higher (and subsidies lower) in those provinces with relatively high levels of NFBs. In practice, however, such a system would be complex, difficult to administer, and politically destructive.

Since the fiscal equalization program does not operate as a net scheme, fiscal disparities remain between the have and have-not provinces. The disparity in fiscal capacities is reduced under EPF as an equal per capita transfer since it is a “fully equalized” transfer. Anything that increases the degree of fiscal disparity will increase the degree of horizontal inequity in the system. Replacing the “postsecondary education component” of the EPF transfer will increase the

extent of horizontal inequity associated with the federal personal income tax structure.

CONCLUSION

The interplay among the three major federal-provincial transfer programs is a significant component of the federal commitment to equalization enunciated in section 36(2) of *The Constitution Act, 1982*. While that principle is certainly addressed by the fiscal equalization program, it is also addressed significantly by EPF as structured. Equally, CAP (or its successor following income security reform) partially addresses the problem associated with the asymmetric treatment of personal taxes and personal transfers under the fiscal equalization program, a recognized deficiency of the program. There is an important role, then, for maintaining transfers to governments: fiscal equity in the federation is a necessary condition for there to be overall horizontal equity.

Much of the disenchantment with federal-provincial fiscal relations in Canada at the present time arises from a poorly defined allocation of federal revenues between federal programs and transfers to the provinces under EPF and CAP. It is possible to achieve a greater degree of fiscal disentanglement without sacrificing the principle of fiscal equity (or fiscal efficiency) within the same general framework as the existing system. Indeed, within the same general framework, there can be improvements in program design that will enhance their functioning by equalizing for differences in need as regards the delivery of social programs at the provincial level. Thus I do not accept Norrie's conclusion that the form of the federal presence in funding social programs must be altered. Moreover, to do so along the lines he proposes would increase fiscal inequity in the system as well as introduce an element of horizontal inequity into federal transfers, to the detriment of residents of the have-not provinces in particular.

NOTES

1. Technically, a transfer of tax room occurs when the federal government alters its rate structure such as to open up tax room to be filled by the provinces with no net increase in the burden on taxpayers.
2. A tax abatement involves the transfer to a province of a fixed proportion of income tax revenues collected by the federal government within that province.
3. As Norrie observes, it is difficult to attach much other than symbolic significance to the terms "health-care component" and "postsecondary education component" of EPF.

4. Thus, for example, hospital insurance grants (25 percent national average per capita + 25 percent actual per capita), medical insurance (50 percent national average per capita), and even the university grants (minimum 50 percent national average) were all (more or less) equal per capita revenue transfers and with relatively few strings attached.
5. In principle, this could be avoided by a change in the equalization standard, say to a top-two-province standard. Alternatively, voluntary interprovincial equalization might be relied on. However, neither option would be likely to find much political support.

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Health Policy and Fiscal Federalism

Carolyn Tuohy

In order to understand the evolution of public policy regarding health care in Canada, and to speculate about its future development, it is useful to distinguish three dimensions of policy. A dimension which I will call “distributional” policies relates to the allotment of tangible benefits across various interests in society. A second dimension, which relates to issues of identity, status and belief, is the “symbolic” dimension of policy. The third dimension is “structural” — it relates to the allocation of positions of influence in the making and implementation of policy.¹ These dimensions are not mutually exclusive — a given policy may well have distributional, symbolic, and structural implications. But policies differ in the level of their distributional, symbolic, and structural content.

This chapter focuses primarily on the distributional and structural dimensions of policy, although I will make some reference to symbolic dimensions as well.

The central argument advanced here can be summarized simply. Structural policy change in the health-care arena almost always results from exogenous factors. This is not surprising; it is in the nature of health-care delivery systems to create powerful vested interests who are unlikely to generate internal pressures for structural change. Episodes of structural change in health care, generated as they are by factors external to the arena, arise independently of the evolution of policy ideas about health-care delivery. But the effect of these episodes is likely to be shaped very much by the prevailing climate of policy ideas. To put it another way, the “window of opportunity” for structural change in the health-care arena may be created and opened by factors in the broader political system. But that window will open onto a landscape of policy ideas that is in a constant state of evolution. The particular structural changes that

result will depend in large part upon that landscape. They will also depend upon the way prevailing policy ideas are absorbed and translated within the existing structure. And in the meantime, between episodes of structural change, ongoing distributional policies will be determined by the constellation of actors and institutions that takes shape within the prevailing structure.

The period roughly from 1958 to 1971 was a watershed epoch of structural change in Canadian health care. Since then, with the exception of one or two structural amendments, policies have been largely distributional in nature, and have rested on a fundamental accommodation between health-care providers, notably the medical profession, and the state. The key question for the 1990s is whether policy will continue to be shaped by this profession-state accommodation, or whether we are entering into another era of structural change in health care. If a window of opportunity for structural change does open, it will open onto a landscape of policy ideas very different from the one that established the structure of the current system.

The relatively stable process governing distributional changes within an existing structure is inherently easier to understand and predict than is the episodic intersection of factors that results in major structural change. Because they involve changes in positions of influence and hence of status, moreover, structural policies tend to have a high symbolic content, with the volatility that symbolic politics typically entail. Given the unpredictability and volatility of structural politics, it is much easier to explain past episodes with the benefit of hindsight than it is to speculate about the future. Let me begin with the easier task.

STRUCTURAL CHANGE:

THE ESTABLISHMENT OF CANADIAN MEDICARE

The first attempt at fundamental structural change in the Canadian health-care arena occurred immediately after World War II. In 1945-46, the federal government presented a set of proposals for a cost-shared national health insurance program to the provinces, proposals that had been shaped in part by the observation of contemporary developments in Britain. At the time, there existed a remarkable consensus among medical, hospital and insurance interests favourable to the establishment of a comprehensive health insurance plan in the public sector. Viewing such a plan as "necessary ... and probably inevitable," (Taylor 1978, p. 23) these groups supported it in principle and sought to maximize their influence over its development and implementation. The sense of inevitability arose in no small part from their observation of events in Britain. Had the "window of opportunity" for fundamental change in the health-care

arena been opened at that time, then, the resulting regime would undoubtedly have borne a closer resemblance to the NHS than did the scheme that ultimately resulted two decades later (Taylor 1973, p. 33; Tuohy 1989, pp. 144-145). In particular, it might well have meant much more extensive organizational change. As it was, however, the opening of the window was forestalled by forces beyond the health-care arena. The federal health-care proposals were tied to a broader package of proposals for federal-provincial fiscal arrangements that were unacceptable to the provinces, and the entire package went down to defeat.

The resulting delay gave time for private plans to develop and expand, and for various provincial governments to experiment with different models of governmental health insurance plans. It was not until the late 1950s and early 1960s that another window of opportunity for comprehensive structural change in the health-care arena opened. The opening was facilitated, as it had been forestalled in the 1940s, by the climate of federal-provincial relations. With the dawning of an era of "cooperative federalism," that climate was more favourable to the launching of a national health insurance plan. It was also facilitated by the presence of the New Democratic Party at the federal level both as an electoral threat and, after the 1965 election, as the holder of the balance of power in a minority Liberal government. The time was ripe for a broad re-thinking of social policy at the federal level.

In the health-care arena, the landscape upon which this window of opportunity opened was different than it had been in the 1940s. A substantial proportion of the population had become accustomed to relatively generous and comprehensive coverage under private insurance plans. Furthermore, opinion within the medical profession had come to favour governmental subsidization and supplementation of private plans. Although its view ultimately did not prevail, the medical profession presented a relatively united front, and could establish a policy price for its participation in the program. That price was essentially the maintenance of the existing delivery system, and the governmental underwriting of its costs on relatively generous terms. The buoyant economic conditions of the time, moreover, placed few constraints on such a design. The system was hence launched on an economic and political base favourable to more generous financing and a greater degree of medical influence than had been the case in Britain two decades earlier.

The structure of Canadian Medicare was established in two phases, each following a period of provincial experimentation. In 1958, Parliament passed the *Hospital Insurance and Diagnostic Services Act*, providing federal cost-sharing for eligible provincial plans. In the 1960s, the focus turned to medical services. The adoption of a publicly-funded medical insurance plan by the government of Saskatchewan in 1962 had a profound demonstration effect. It

demonstrated the willingness of the provincial NDP to weather a medical strike to bring the program in, but also provided an example of a program that essentially underwrote the costs of the existing delivery system (notwithstanding some experimentation with community clinics) and led to an immediate rise in physician incomes. In 1964, the report of the Royal Commission on Health Services recommended the establishment of a national medical insurance plan, and by 1966, legislation establishing such a plan, the *Medical Care Act*, was passed. By 1971, all provinces were participating in the national regime. To be eligible for 50 percent federal cost sharing, provincial programs had to meet five general criteria: universal coverage (at least 95 percent of the population), comprehensive coverage of medical and hospital services, provision of coverage on uniform terms and conditions, portability across provinces, and public administration. These criteria were consistent with the "Health Charter for Canadians," that had been set out by the federal Royal Commission on Health Services. Notably, the Health Charter also included commitments to "freedom of choice" for patients in the selection of physicians and *vice versa*, and to "free and self-governing professions." While these latter two principles in the Health Charter were not specifically enshrined in legislation, they were clearly embedded in the system that resulted.

The structural changes wrought by Medicare in the Canadian health policy arena were essentially three: the role of private insurers was drastically reduced; the role of the federal government vis-à-vis the provinces was enhanced; and the role of the state as a whole was expanded.

Restriction of the Domain of Private Insurance. The advent of Medicare effectively foreclosed private insurers from covering the vast majority of medical and hospital services. A distinctive feature of the Canadian system is worth noting in this respect. The proportion of total health-care spending in Canada that flows through the public treasury, at about three-quarters, is close to the OECD average. Canada differs from most OECD nations, however, in the *pattern* of public and private expenditure. In most other nations public and private expenditures are divided on a "tiered" basis — with private alternatives to publicly-funded services within each category of service. In Canada, however, public and private expenditures are segmented. Certain segments — notably medical and hospital services — are almost entirely publicly funded; others, such as dental care, drugs and eyeglasses and other prostheses, are in the private sector. (Various provinces have plans covering drugs or dental care for certain categories within the population, such as children's dental care or drugs for those over 65. In the hospital sector, various amenities, such as private

rooms, can be purchased on a private basis.) Private insurers, then, are effectively confined to certain segments of the system.

Federal-Provincial Relations. The federal government's financial leverage under cost-sharing arrangements gave it a significant steering effect on the system. Initially, by allowing provinces to cover medical and hospital services with "fifty-cent dollars," it favoured the provision of such services as opposed, for example, to home-care services. Furthermore, although the criteria for eligibility for provincial programs were very generally phrased, the requirement that services must be provided on "uniform terms and conditions" presented a potential — and, as it turned out in the 1980s, a real — constraint on the choice of policy instruments by provincial governments.

The federal government retained its financial leverage even as it decreased, over time, its share of health-care expenditures. The Established Programs Financing (EPF) arrangements negotiated in 1977 in the shadow of a threat by the federal government to act unilaterally moved from a shared-cost basis of funding to a block grant system. Federal transfers for health care (and post-secondary education) were thenceforth to have two components. One was in the form of a cash transfer conditional on the provinces continuing to meet the federal conditions of eligibility. This cash transfer was to be calculated on the basis of one-half of the per capita transfer to the province in 1975-76, escalated by the rate of increase in nominal GNP and population (not at the rate of actual health-care costs). The other "half" of the transfer was unconditional, and took the form of "tax points," essentially the revenue generated by a specified number of percentage points of the income tax yield of the federal basic tax in a given province. The actual number of tax points transferred was calculated as the number that would indeed have yielded an amount equivalent to half of the federal transfer in the base year to the two richest provinces, then Ontario and B.C. It was assumed that the growth in the yield from the tax points would outpace the growth of the cash transfer, and that eventually all provinces would be as well off as or better off than they would have been if the federal government had simply converted the entire transfer to a block grant and escalated it according to nominal GNP and population. In the meantime, a transitional payment was provided for, to ensure that no province was worse off than it would have been had that simple conversion occurred.

In the event, the economic downturn of the late 1970s and early 1980s meant that tax points were not as lucrative as had been expected, and "transitional adjustment payments" threatened to become a fixture of the arrangements. In the early 1980s, a change to the transfer formula was made that, while technical and little remarked-upon, marked the beginning of a set of structural

amendments to the federal-provincial relationship in the health-care arena. The change was simply to calculate the *entire transfer* to a given province on the basis of the per capita in the base year, escalated by nominal GNP and population growth. The conditional cash component of this transfer was calculated as the difference between the yield of the tax points and the total provincial entitlement. The conditional component of the transfer, the basis of the federal government's policy leverage, hence became the residual once the tax points had done their work.

The federal government still retained considerable financial leverage in the early years of this arrangement. This was nowhere better demonstrated than with the passage of the *Canada Health Act* in 1984, reiterating the principles of eligibility for federal cost-sharing, and interpreting those principles to ban user fees and extra-billing.

Shortly after the passage of the *Canada Health Act*, however, with the coming to power of the Progressive Conservatives in 1984, the structural change implicit in the EPF formula revisions was accelerated. The Conservatives constrained the escalation of the total EPF transfers to the provinces under EPF — holding them below the rate of increase in nominal GNP from 1986 to 1990, and freezing them from 1990 onward. Since the tax point portion of the transfer continued to grow more or less in line with nominal GNP, the conditional cash transfer portion became correspondingly smaller. Various provincial governments have estimated that over the next decade the conditional portion will disappear entirely, and with it the federal government's policy leverage over Medicare.²

The State vis-à-vis the Medical Profession. Before speculating on the effects of these developments in federal-provincial relations, it is necessary to turn to the implications of the third structural change in the health field wrought by Medicare — the augmentation of the role of the state as a whole vis-à-vis health-care providers, and particularly the medical profession.

Under Medicare, the state became the primary bearer of the costs of hospital and medical services. And as the federal government progressively limited its share of the costs, provincial governments became entirely liable for cost increases above the rate of increase of nominal GNP and population, and finally for cost increases above the rate of population increase alone. For health-care providers, the effect of this type of change was not so much to diminish their influence as it was to change, over time, the channels through which it was exercised. In the case of the medical profession, in particular, the effect was to enhance the role of organized medicine. To understand this effect, it is necessary to understand the fundamental accommodation between the medical profession

and the state that was established in the wake of Medicare, and from which subsequent distributive policies flowed.

The particular nature of that accommodation varies across provinces, for it is at the provincial level that health-care policy has been made, within broad federal guidelines. In some provinces, notably B.C. and Manitoba, the profession-state relationship has been adversarial; in Quebec it has been more "statist;" and in other provinces it has been more collaborative, albeit marked by episodes of conflict. But each of these accommodations has revolved around two pivotal trade-offs for the medical profession: one between the entrepreneurial and the clinical discretion of physicians; the other between their individual and their collective autonomy.

Almost all of the conflict between the medical profession and the state that followed in the wake of the adoption of Medicare concerned the price of medical services. Rather than paying the medical fees that were "usual and customary" in particular localities as did U.S. third-party payers, provincial governments at first agreed to pay physicians on the basis of the fee schedules set by the provincial medical associations, prorated by a given percentage. Soon, however, the schedule of payments was set through negotiations between the government and the medical association in each province. In most cases they negotiated overall increases in the payment schedule, leaving the allocation of these increases across individual items in the fee schedule to be carried out internally by the medical associations themselves. In making these internal allocations, medical associations have typically been more concerned with smoothing income differentials across specialty groups than with measuring the relative costs or benefits of given procedures. In reaching their accommodations with the state, that is, medical associations have had to manage delicate internal accommodations — a point to which I shall shortly return.

Over time, the agenda of these negotiations has broadened to include the establishment of more-or-less firmly fixed caps on total expenditures on physicians' services under the government plans. The rationale for the establishment of these limits was to take account of utilization increases. In fact, however, Lomas and his colleagues concluded after a comprehensive survey of the negotiation process in all ten provinces that the purpose of governments was to establish global limits: arguments about increased "utilization" simply provided a politically feasible way of doing so (Lomas *et al.* 1992, pp. 180-181).

As a result of these negotiations, then, the entrepreneurial discretion of individual physicians has been limited. Prices are established centrally, and the economic pay-off from varying volume and mix may bump up against either individual or global caps. But throughout this process, the *clinical* discretion of individual physicians — the ability of the individual physician to exercise

his or her clinical judgement in individual cases according to professionally-determined standards — has remained virtually untouched. Financial constraints have been global and across-the-board; within those constraints, physicians experience relatively little second-guessing by third parties. Utilization review committees established in several provinces to monitor physicians' practice patterns have focused on only the most aberrant cases, identified by volume of billings.

It can legitimately be argued that the clinical autonomy of physicians is constrained to the extent that the diagnostic and therapeutic options open to them are constrained by limits on available facilities and equipment. It must be remembered, however, that the facilities subject to the greatest constraint in Canada, in contrast especially to the U.S., are those involving certain high-technology procedures;³ and there is considerable debate among clinical epidemiologists as to the range of conditions for which such procedures are in fact indicated. As for other resources such as hospital beds and nursing staff, Canada has fewer hospital beds per capita but more employees per bed than the OECD average. (In the U.S., the bed-population ratio is even lower, while the employee-bed ratio is higher.) In a three-nation survey of physicians, Canadians were not significantly more likely than Americans to complain of a shortage of competent nursing staff (Blendon *et al.* 1993, p. 1015).

The point remains that within gross over-all constraints, the clinical autonomy of the individual physician, and of the profession as a whole, has been maintained. And in the process of making the trade-off of entrepreneurial discretion for clinical autonomy, the role of organized medicine has been substantially increased. This brings us to the second, and indeed more basic trade-off with which physicians are faced under Canadian Medicare. In order to retain some power over the price of their services, individual physicians had to cede their ability to set prices to the central association. This process was not without conflict; and each provincial association has had to manage a complex and delicate internal accommodation.

For a time, there was an option for physicians to escape these constraints to some extent by "extra-billing" their patients — that is, by billing patients over and above what the government plan would pay. Only about 10 percent of physicians exercised this option, and the amount of extra-billing was estimated at only about 1.3 percent of total physician billings under Medicare. In no province did this amount exceed 3 percent. The economic and political significance of extra-billing was increased, however, by the fact that it was "clustered" in certain specialties and localities. Even more important in political terms, extra-billing flew in the face of one of the fundamental principles underlying

Canadian Medicare — the removal of financial barriers to access to medical and hospital care.

In the early 1980s, a federal Liberal government declining in popularity and facing non-Liberal governments in each of the provinces, seized upon the issue of extra-billing as a way of symbolizing its commitment to preserving the universality of the nation's most popular social program — and, by extension, of others. It portrayed non-Liberal governments in the provinces as allowing the principle of universality to be eroded by condoning extra-billing, and passed legislation, the *Canada Health Act*, penalizing those provinces by providing for federal transfer payments to be reduced by an amount equal to the estimated amount of extra-billing in any given province — a dollar-for-dollar penalty.

In one sense at least, the federal strategy back-fired. The federal Conservatives, whom the Liberals had hoped to tar with the same brush as their siblings in power in several provinces, supported the *Canada Health Act* in Parliament. With its passage in 1984, the politics shifted to the provinces, and were shaped by the relationship between the medical profession and the government in each province. In all cases but one, the process of negotiating the ban on extra-billing was relatively non-conflictual, and the medical profession achieved substantial gains. Some of these gains took the form of fee schedule increases. Others, however, were structural, in the form of binding arbitration mechanisms for future fee schedule disputes. Even in Ontario, where the banning of extra-billing occasioned unprecedented conflict between the Ontario Medical Association and the government, culminating in a four-week doctors' strike, the dust settled by 1991 to reveal substantial structural gains for the Ontario Medical Association. A binding arbitration mechanism was agreed to, as was a "Rand formula" arrangement whereby OMA dues would be automatically "checked-off" or deducted from each individual physician's billings to the Ontario Health Insurance Plan. Finally, a Joint Management Committee of OMA and government representatives was established as a planning mechanism. In all, as of the beginning of 1993, some type of formal dispute resolution process was in place in eight provinces, and "Rand"-type dues check-offs were in place in seven.

As the agenda of health policy evolves in Canada, the various accommodations between the medical profession and provincial government that underlie the preservation of clinical autonomy will be tested. So far, these accommodations have proved remarkably resilient. This can be seen by considering the course of development of several major items on the health-care agenda of the 1990s: user fees, de-insurance, clinical guidelines and organizational change.

THE EVOLVING AGENDA

User Fees. The issue of "user fees" for insured services was put to rest for a time with the passage of the *Canada Health Act* and the compliance of all provinces with that federal legislation. The issue of user fees has reemerged, however, as the *Canada Health Act*, which bans such charges, has become increasingly toothless. With the end of federal contributions in some provinces over the next decade, the federal government's ability to enforce the provisions of the *Canada Health Act* will come to an end as well, unless funding is restored or some other enforcement mechanism is introduced.

Without the discipline of the federal legislation, it is possible that some provincial governments will reintroduce user fees. To the extent to which this occurs, it is likely to involve flat charges. (Quebec, for example, has recently announced plans to levy flat charges for certain services — such as visits to hospital emergency rooms for conditions that might be treated at community clinics. The federal government has signalled that these draft regulations will be reviewed to determine their conformity with the *Canada Health Act*.) It is highly unlikely, however, that "extra-billing" by physicians, and hence medical discretion over price, will again be permitted. That battle has been fought, and the treaties made. Any government that sought to reintroduce extra-billing would do so a great political risk, for little political or fiscal gain.

De-insuring. So far, provincial governments appear to be more attracted to the option of de-insuring some services than to the imposition of user fees as a cost control measure. This response is, indeed, more consistent with Canada's "segmented" rather than "tiered" approach to the role of the public and private sectors. The *Canada Health Act* made even more explicit the premises of its predecessor legislation: on its face, it requires provincial health insurance plans to cover fully all "medically required" physician services and a broadly defined set of "necessary" types of hospital services in order to qualify for federal financial contributions. Provincial governments, in complying with the federal legislation, have either *de facto* or *de jure* accepted "medical necessity" as the standard for coverage under their respective plans. The determination of what physician services are "medically required" and which hospital services are "necessary," however, has not been defined in legislation.

In the hospital sector, the operational definition of "necessity" has been negotiated by government and health-care providers. Through a process of prospective global hospital budgeting, provincial governments have, since the 1970s, been negotiating with individual hospitals about how many beds, imaging machines, etc. are "necessary." Differences of opinion in this regard resulted for a time in hospitals breaching their budgets to adopt non-approved programs.

The resulting deficits were tolerated and forgiven for a time by governments, but the limits of that tolerance were reached in the late 1980s.

As opposed to the question of which hospital services are "necessary" and thus must be publicly funded, the question of what physicians' services are "medically required" has until recently not been a matter of negotiation between providers and governments. As noted earlier, fee schedule negotiations between medical associations and provincial governments have generally focused on the overall percentage increase in fees, not the relative value of items and nor the scope of the services covered, which has changed little since a broad base of coverage was set up in each province upon the establishment of Medicare.

There have been, however, recent attempts to delimit the scope of coverage under Medicare. Under the letter and the spirit of both federal and provincial legislation, services can be de-insured only if they are deemed not to be medically necessary. Negotiations to identify potential candidates for de-insuring have been undertaken between the medical profession and government in a number of provinces. To date, there has been very little effect on the comprehensiveness of coverage, but the discussions around these issues are worth briefly considering here for what they can tell us about the shape of future developments.

Most of the services and procedures considered for "de-insuring" have related to cosmetic surgery, mental health and reproduction. The selection of these procedures for consideration has resulted in part from the ideological agendas of governments, and in part from a consideration of income differentials within the medical profession. In Alberta in 1985, as part of the negotiations between the Alberta Medical Association and the provincial government around the banning of extra-billing, it was decided that several services be "de-insured," including family planning counselling, tubal ligations, vasectomies, and mammoplasty. This selection was driven largely by the conservative social policy ideology of the governing Conservative party of the day. From the perspective of the medical profession, however, it focused with few exceptions on fairly lucrative procedures performed by relatively high-earning specialists. Furthermore, the de-insurance of such services freed physicians to bill for them privately at rates of their own choosing. As an internal accommodation within the profession, then, it allowed for some smoothing of differentials in Medicare earnings while allowing a "safety valve" for the specialties affected. This agreement did not survive the public protest that ensued, however, and funding for most of these services was restored. More recently, governmentally-sponsored round table discussions in Alberta proposed a policy option formed of an intersection between user fees and de-insurance that might be called

"partial de-insurance." This option involves the identification of certain "non-essential" medical services to which user fees would apply.

In Ontario, a number of services are also being considered for de-insuring. In this case, the list includes some forms of cosmetic surgery, and *in vitro* fertilization (IVF) procedures. (Ontario is the only province in which IVF is a publicly-insured service.) Again, these are lucrative services and procedures performed by relatively high-earning specialists, and their de-insurance would allow them to be offered in private markets. The list also includes the annual health exam — a service whose efficacy when offered on a routine basis was first brought into question in the Canadian context by a consensus panel reporting to the federal and provincial health ministers in 1979.

The Ontario Medical Association, however, was initially less disposed to enter into this type of accommodation than its Alberta counterpart had been. The initial response in Ontario was essentially procedural. That is, the provincial government and the OMA came to an agreement on the structures through which decisions would be made about the efficacy of various procedures, through health services research; and decisions about insurance coverage would be made on that basis. As part of the wide-ranging 1991 agreement between the Ontario government and the OMA noted above, a Joint Management Committee was formed between the Ontario government and the OMA, and under its aegis an Institute for Clinical Evaluative Sciences was established, based at a Toronto teaching hospital. The process of developing a list of procedures to be de-insured went on for over a year until it became entailed in the government's broad expenditure control agenda in the spring of 1993. The unfolding of that episode casts further light on the evolving nature of the profession-state accommodation, and merits some elaboration here.

As part of a broad expenditure control package in June 1993, the NDP government of Ontario introduced legislation giving it broad powers to de-insure services, and to limit payments under the government health insurance plan on the basis of the utilization profile of the patient, the practitioner or the facility involved.⁴ The OMA reacted strongly and vociferously against these provisions, accusing the government of pre-empting the Joint Management Committee process, and mounting an extensive public relations campaign. The government, for its part, stated that the legislative provisions constituted a "fail-safe" to take effect only if a negotiated agreement with the OMA could not be reached. In the result, the OMA and the government reached agreement on a range of cost-control measures, including a three-year freeze on medical fees and a "hard cap" on total physicians' billings. The JMC process for determining which services were to be de-insured was reinstated, tied to tighter deadlines, given a set dollar volume (\$20 million) by which billings were to be