



**Canada:  
The State  
of the  
Federation  
1999/2000**

**Toward a New  
Mission Statement  
for Canadian  
Fiscal Federalism**

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The Institute is the only organization in Canada whose mandate is solely to promote research and communication on the challenges facing the federal system.

Current research interests include fiscal federalism, the social union, the reform of federal political institutions and the machinery of federal-provincial relations, Canadian federalism and the global economy, and comparative federalism.

The Institute pursues these objectives through research conducted by its own staff and other scholars through its publication program, seminars and conferences.

The Institute links academics and practitioners of federalism in federal and provincial governments and the private sector.

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L'Institut sert de lien entre les universitaires, les fonctionnaires fédéraux et provinciaux et le secteur privé.

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## FOREWORD

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This year's volume is dedicated to the memory of the Institute's first director, Ron Burns, who died last year. Mr. Burns was an outstanding expert and scholar on federal-provincial fiscal relations. Thus, it is fitting that this year's annual *State of the Federation* volume should focus on the state of Canadian fiscal federalism at the beginning of a new century.

One of the questions that initially motivated this volume related to the decentralization trend in our system of fiscal federalism that began in the late 1960s. The issue was whether this trend had run its course by the end of the 1980s and whether the policy changes of the 1990s had more to do with re-balancing than further decentralization. As the volume took shape, however, it became clear that there was a second and perhaps more fundamental issue raised by the various chapters. That is, there was a huge amount of uncertainty about the future of fiscal federalism in Canada at a time when we might have begun to expect a period of stability.

In the first sentence of a volume published in 1994, Keith Banting, Doug Brown and Tom Courchene wrote "Canadians are rapidly approaching a critical juncture in the evolution of their social programs and the system of fiscal federalism that underpins them." Since then, we have witnessed important reforms in the federal-provincial tax-collection agreements, the federal-provincial transfer system, the signing of the Social Union Framework Agreement, and a huge improvement in the fiscal situation of federal and provincial governments. These reforms responded in significant measure to the 1994 warning signals, while the strengthening of public finances has created the possibility of a more stable outlook.

Yet, a theme running through the chapters of this volume is the urgency of further reform. For example, there are well-documented concerns about the state of municipal finance, questions about the future financing of Aboriginal governments, doubts that the Canada Health and Social Transfer constitutes a stable political equilibrium, and proposals that structural decisions about fiscal federalism be decided outside the framework of the federal budgetary cycle.

These concerns are reflected in important parts of the political arena. The major opposition parties in the House of Commons are advocating further decentralization. The larger provincial governments have frequently issued similar demands. Some large municipal governments are also becoming increasingly outspoken about their desire for more fiscal autonomy.

From the federal government, the usual argument is that the federation is adequately decentralized and that what is needed is simply fine-tuning or re-balancing.

What may be lacking in this debate is a reconsideration of the basic purposes of Canadian fiscal federalism. In the early postwar decades, there was an informal mission statement for Canadian fiscal federalism. That statement was a reflection of the postwar consensus that aimed for high employment through counter-cyclical stabilization policy, social security against the contingencies of unemployment, old age and sickness or injury, and a system of last resort for those who were most disadvantaged. The tax-rental and tax-collection agreements and the system of intergovernmental and direct federal transfers were integral to that purpose. By the early 1980s, however, the postwar consensus had eroded. With its loss, fiscal federalism began to respond to the political needs of the moment, but without a new compass to guide it.

When taken together, the chapters in this volume suggest the need for a new mission statement for Canadian fiscal federalism. In a world where borders are becoming less important and intergovernmental collaboration more important, there is a need for the partners in the federation to be able to better trust one another. To secure trust, there is a need for individual governments to minimize the number of surprises they spring on other governments. But in the absence of some shared sense of purpose for Canadian fiscal federalism, this greater predictability in government behaviour may be difficult to achieve. There is therefore a need for a new public debate on these issues and this volume is intended to help animate it.

As in other years, we have included a chronology of major events in the federation. In this issue we have covered 18 months, from July 1998 to December 1999.

The production of this volume was made possible by the contributions of several people. Patti Candido and Mary Kennedy of the Institute of Intergovernmental Relations provided assistance and organizational expertise both in the conference that preceded this volume and in the preparation of the manuscript. Mary Wade and Charles-Henri Warren contributed translation assistance. The conference participants, the discussants and anonymous reviewers furnished the authors with valuable feedback on their work at important junctures in the process. Valerie Jarus, Mark Howes and Marilyn Banting managed the desk-top publishing, design and copy-editing assistance that helped turn a collection of pages into a book.

Finally, I would like to thank the federal Finance Department for its financial support for the 1999 Kingston symposium that was an important stepping stone in the preparation of this volume.

*Harvey Lazar*  
August 2000

## DEDICATION

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It is entirely fitting that this volume of *Canada: The State of the Federation*, focused on current issues of fiscal federalism, should be dedicated to the memory of Ron Burns who passed away in Victoria, BC in June 1999.

Ron was the founding Director of the Institute of Intergovernmental Relations, leading the Institute from its inception in 1965 until his retirement in 1975. His interest in federalism and intergovernmental relations was wide-ranging, but his primary concern and expertise lay in the area of what was then called Dominion-Provincial financial arrangements.

He had unparalleled experience in the intricacies of these matters, as Director of financial negotiations in the federal Department of Finance, and as deputy minister of finance in both Manitoba and British Columbia. He had played a central role in the work of the Continuing Committee of Fiscal and Economic Matters, established in 1956 to provide support for the work of finance ministers. The committee was both an important step in what Don Smiley called "executive federalism," and an ongoing seminar on the shape of a rapidly changing federal system.

This was a period of major change in fiscal federalism — the end of the postwar "tax-rental agreements" and the adoption of "tax-sharing" and tax-collection agreements, establishment of the equalization program, increased tax abatements by which Ottawa provided increased room for provincial taxes, heightened debate over shared-cost programs, and the decision to permit Quebec to "opt-out" of some of these programs.

Underlying these debates were much larger questions about Canadian federalism: the Quiet Revolution in Quebec, and its desire to be *maitres chez nous*; increased provincial shares of revenues and expenditures and a concomitant growth in provincial bureaucratic capacity, self-confidence and assertiveness; and a shared desire to complete the construction of the Canadian welfare state.

As a civil servant, Ron Burns was at the centre of these discussions. He had also come to share the concern of Alec Corry, then Principal of Queen's, that these new developments were occurring in an ad hoc and piecemeal way — "tinkering and patching" as the first proposal for an Institute of Intergovernmental Relations at Queen's University put it. There was a need to stand back and analyze the future of federalism in a broader framework.

The proposal states, "The problems considered a generation ago by the Rowell-Sirois Commission are with us still in more bewildering profusion and complexity; the tensions in our federal system are greater than ever before." The Institute would become a kind of permanent Rowell-Sirois Commission.

Ron's experience and his ability to build networks both across the country and between practitioners and academics made him the ideal person to bring this vision to reality.

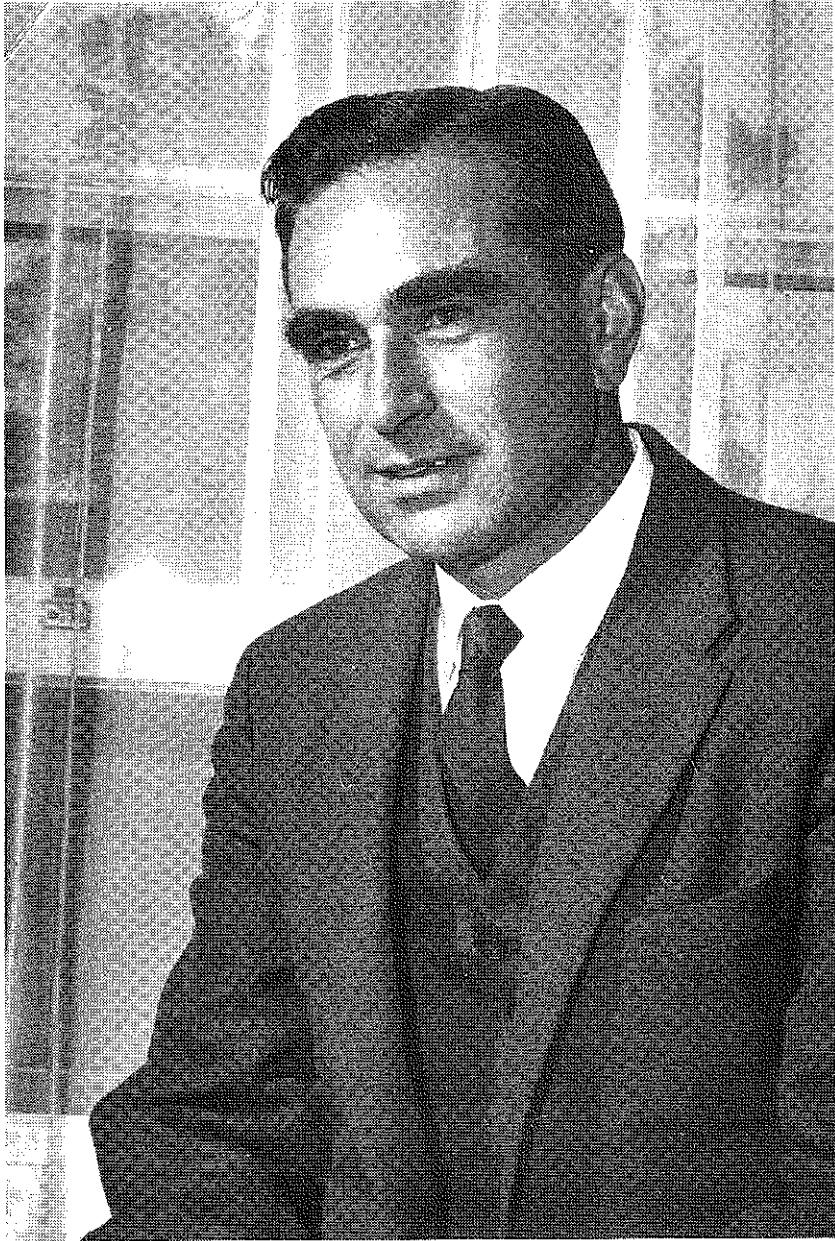
During his term, he set the Institute on the path that in many respects continues to drive its work today: a deep engagement with contemporary policy issues as they are played out in the federal and intergovernmental system; building bridges between the public service and academia; and a high standard of scholarship matched with a commitment to bring this scholarship to bear on public debate.

In his own work, he became increasingly interested in the machinery of intergovernmental relations. The system was shifting from the often paternalistic, Ottawa-led "cooperative federalism" of the postwar period toward a more equal partnership of governments which were at once autonomous and interdependent. His work helps us understand the shift, and in important respects helps lay the groundwork for current discussions of collaborative federalism exemplified in agreements such as the Social Union Framework Agreement of 1999.

That shift preoccupied me in my PhD thesis, later published as *Federal-Provincial Diplomacy*, in 1972. Its footnotes refer no less than nine times to the work of Ron Burns, and I still remember his painstaking and patient attempts to explain the complexities of fiscal federalism to a young graduate student.

The dimensions of fiscal federalism addressed in this volume are in some ways very different from the issues of Ron Burns' time; but in other respects they would be all too familiar to him; and he would be a vigorous participant in the debates.

*Richard Simeon*



*Photo by Newton, Copyright 3 October 1937*

RON M. BURNS (1910-1999)

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I

Ideas,  
Theories and  
Concepts



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## In Search of a New Mission Statement for Canadian Fiscal Federalism

Harvey Lazar

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*Ce chapitre présente un survol du fédéralisme fiscal au Canada au cours des dernières décennies. La première section porte sur les tendances en matière de recettes, de dépenses et de transferts entre les gouvernements fédéral et provinciaux. On y conclut que la centralisation a atteint un sommet dans la deuxième moitié des années 1960. La tendance s'est renversée en faveur des provinces lors des deux décennies suivantes. Au cours des années 1990, il y a des mouvements tant de centralisation que de décentralisation, mais la situation actuelle demeure beaucoup plus décentralisée qu'il y a trente ans.*

*Lors des décennies suivant la Deuxième Guerre mondiale, le fédéralisme fiscal canadien poursuivait un ensemble d'objectifs relativement clairs. Toutefois, cet énoncé de mission a commencé à s'éroder au cours des années 1980. Le comportement des partenaires dans le système, y compris celui du gouvernement fédéral, a depuis varié en fonction des besoins et des circonstances, sans toutefois poursuivre d'objectif global clair. Ces variations font en sorte qu'il est difficile pour les différents niveaux de gouvernement de prévoir le comportement de leurs partenaires. Une compréhension commune des «règles du jeu» est nécessaire pour qu'une forme coopérative de fédéralisme soit mise en place. Sans cette compréhension, il devient trop difficile d'établir et de maintenir les relations de confiance sans lesquelles le fédéralisme coopératif ne saurait qu'être dysfonctionnel. D'où le besoin pour les gouvernements de s'entendre sur un nouvel «énoncé de mission» du fédéralisme fiscal canadien pouvant être mis en oeuvre parallèlement à l'entente-cadre sur l'union sociale de 1999.*

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Canada's system of fiscal federalism is complex and arcane. It is understood well by perhaps a few dozen people in government and an even smaller number in the academy and the think tanks.

The system is made up of several connected strands. They include the constitutional and political provisions for allocating revenues and expenditure responsibilities between orders of government, the intergovernmental transfers

that are used as a way of offsetting imbalances between the revenues and expenditures of the various governments, and arrangements for harmonizing tax systems among governments. Each of these strands entails complexity.

Referring to the system in even this brief way helps to explain why fiscal federalism is a subject that few people know about or would want to know about if afforded the opportunity. Behind these words, however, are issues that do matter to Canadians — issues like fairness and opportunity for individuals, the survival of the distinctive peoples and nations that help to make up Canada, and indeed the very future of Canada as a country. So while the elements of fiscal federalism entail a vocabulary and set of arrangements that are highly specialized, the justification for this volume rests in the fundamental importance of these issues to the well-being of our country, its constituent units, and the citizenry at large.

The various chapters of this volume deal with these issues in detail. They focus on challenges and difficulties in relation to revenue assignment and revenue-sharing, issues of vertical and horizontal imbalance and the system of intergovernmental transfers. They deal not only with the federal-provincial dimensions of these issues but also with recent relevant trends affecting other orders of government, including Aboriginal governments, municipalities, school and hospital boards, and postsecondary institutions.

This introductory chapter draws on this rich analysis. It is in no way, however, a survey or summary of what the other authors have to say. Rather, it is an effort to stand back from the inherent complexity of fiscal federalism and provide a relatively straightforward overview of what is happening and why it is happening, with some assessment of implications.

Three themes underlie this chapter. One has to do with the uncertainty surrounding the direction of fiscal federalism. In the first quarter century after World War II, fiscal federalism was centralized. It subsequently underwent a large decentralization, a process that continued until the 1990s. In the 1990s, there were cross currents, but without a clear direction. Whether there is a further leg of decentralization ahead of us is unclear.

This uncertainty is linked to the second theme. Until the late 1970s or early 1980s, Canadian fiscal federalism had a "mission statement." Its sense of purpose mirrored the wider postwar consensus about the role that the state could play, through programs of redistribution and macroeconomic stabilization, in building a fair and compassionate society and a prosperous and stable economy. In turn, this consensus was predicated on the idea that there was a latent sense of Canadian political nationhood which could be mobilized in pursuit of these noble goals.

The golden age of consensus had eroded badly, however, by the early 1980s. And since then, fiscal federalism has also lacked a strong sense of purpose. It has continued to adapt and adjust in response to changing circumstances and

pressures. But, with the important exception of the ongoing commitment to the concept of equalization, an overarching sense of purpose has been lacking, in many ways reflecting the broader uncertainty about the role of the state itself.

This leads to the third theme. The lack of a clear mission statement makes the behaviour of governments, especially the federal government, hard to predict. If federal and provincial governments were operating in watertight compartments, this might not matter much. But the forces of global and continental integration are increasing interdependence among economies and politics. For functional reasons, therefore, they are making intergovernmental collaboration a growing necessity for an ever-broadening range of issues, not only across international borders but also for governments within Canada.<sup>1</sup> For that collaboration to be effective, however, the various governments have to have some minimum level of trust for one another. The "rules of the game" must entail a measure of predictability about the behaviour of the partners. The absence of a mission statement for contemporary fiscal federalism erodes predictability, and therefore trust.<sup>2</sup>

The chapter begins by noting the criteria that are relevant to assessing fiscal federalism. It is then followed by a discussion of recent trends. Two questions are asked. Where has the system of fiscal federalism been headed in recent years? And where does it appear to be headed in the future? Finally, the trends are analyzed on a basis of our assessment criteria.

## CRITERIA FOR ASSESSING TRENDS IN FISCAL FEDERALISM

As discussed by Robin Boadway in Chapter 2, it is conventional to assess systems of fiscal federalism for their impact on economic efficiency and equity. Assessing trends in fiscal federalism is about more than efficiency and equity, however. In a Canadian context, it is also about building the Canadian state and provincial states. And given the unique position of Quebec among Canadian provinces, it has also been about the building of a special Quebec state within Canada. Thus, it is important to consider the impact of fiscal federalism trends on the relative roles of the different orders of government and whether these trends are privileging some governments more than others. It is also relevant to assess whether these trends are leading to more independence or more interdependence among orders of government and whether the relationship between the orders of government is becoming more or less equal. In short, assessing trends in the fiscal arrangements is important not only for determining equity and efficiency effects but also because of their impact on the nature of the federalism practised in Canada.

Our system of fiscal federalism also influences the way in which our democratic institutions function. It raises considerations like the now familiar

concern about a "democratic deficit" and related issues of political accountability and transparency.

While the pages that follow immediately below are intended to provide an overview of the main trends, ultimately what matters most is what these trends imply for policy goals like equity and efficiency, for the nature of the federation and for democratic values.

## TRENDS IN CANADIAN FISCAL FEDERALISM

Examining trends in fiscal federalism raises a question about the time period that is of interest. We could focus on trends since 1867, the date of Confederation. This would allow for a broad historical sweep. Conversely, the focus of our attention might be confined to the years since the re-election of the Chrétien Liberals in 1997, allowing for a detailed analysis of the various initiatives that federal and provincial governments have launched over the last three years. For this chapter, neither of these extremes seemed appropriate. The world has changed too much since 1867 to make the early years of Confederation relevant to this analysis. And it is too soon to have perspective about the events since 1997. In any case, most of what follows covers two periods: first, the period since the end of World War II; and, second, the decade of the 1990s. Focusing on one of these periods risks the telling of a partial story only. But by considering both, the analysis can provide more context and perspective to the changing face of Canadian fiscal federalism.

### CENTRALIZATION OR DECENTRALIZATION?

Much of the literature in fiscal federalism is about whether the tide is flowing in favour of the federal government or the provinces and the factors that lie behind those trends. Casual reporting of this issue often focuses on the power struggle between orders of government. That there may indeed be struggles between self-serving power structures is no doubt part of what makes this question a subject of interest to political and policy analysts. Buried underneath this issue are, however, questions related to how individuals are affected by the "Canadian state," including in this term the institutions of both the federal and provincial governments. In this regard, perhaps the main issue is whether the "sharing community" within Canada is the country as a whole or its constituent units. To what extent is it the role of the provinces and their residents to assure that opportunities and outcomes are distributed fairly and reasonably and to what extent is this role the responsibility of Ottawa and all Canadians?

The answers to these kinds of questions raise normative considerations about the merits of centralization and decentralization. And on this issue, there are several splits within the country. Two are touched on here. The first is in the political arena itself. Provincial spokesmen, sometimes from wealthier provinces and frequently from Quebec, talk about an arrogant, insensitive, and centralizing federal government. The Canadian Alliance (and the Reform Party before it), the Bloc Québécois, and to a lesser extent the Progressive Conservative Party tend to share that perspective. From the federal government side, there is a view that substantial decentralization has occurred over recent decades and what has been happening more recently is re-balancing or "fine-tuning" within a reasonably balanced federation. The less wealthy provinces sometimes share the federal government view. These governmental positions, on both sides, are often expressed in a context of bargaining for tactical advantage and therefore may not be the most reliable source for perspective on trends in fiscal federalism.

The academic community provides a second split. Here the dividing line appears to be between some but by no means all English-speaking analysts from outside Quebec, on the one hand, and mainly French-speaking Québécois, on the other. The mainly francophone group is often supported by English-speaking analysts who are generally "conservative" on economic and fiscal matters.<sup>3</sup> While political preferences may in fact also influence the views of these two broad groupings, their differences may have more to do with the different lens through which they observe the trends. In general, the Quebec view is filtered through the lens of how a "classical" federal system should operate. With respect to the view expressed often elsewhere in Canada, there may be a tendency to examine events without this kind of filter — to look at the data with less of a pre-disposition toward the classical model.<sup>4</sup>

Both academic perspectives capture important elements of Canada's economic and political reality. Accordingly, they have helped to shape the analysis below. In what follows, trends in the allocation of revenues and expenditures of the two senior orders of government, and the changing size and nature of transfers, are examined. Attention is also paid to the character of the intergovernmental relationship that is associated with distribution of taxing and spending actions of federal and provincial governments and with the intergovernmental transfer system.

World War II was an important watershed in the history of the Canadian federation. The war years saw a massive build-up in government activity dedicated to fighting and defeating the enemy. With defence and security matters the exclusive responsibility of the federal government, this wartime expansion of government inevitably took place at the federal level.

But the wartime expansion of government had implications that went well beyond the actions that were directly necessary for the prosecution of the war itself. For one thing, huge sums of money were needed which led to changes

in the allocation of revenues between the two orders of government. The exigencies of the crisis precluded the kind of decentralization and tax competition that Canada had experienced in the inter-war years. In the event, a tax "rental" agreement was worked out between the federal and provincial governments. Under these arrangements, Ottawa alone would levy and collect personal and corporate income taxes and death duties in return for rent payments to the provinces. From the viewpoint of the way power is distributed within the Canadian federation, the war years were ones of very strong centralization.

Even before the war was over, political leaders and intellectuals in Canada and many other countries had begun to consider what kind of transformation might be necessary in order to make the postwar years safe and prosperous. For the liberal democracies of the Western world, there was enthusiasm for the creation of multilateral institutions to promote peace and security (notably the United Nations) and economic growth (the International Monetary Fund [IMF], the General Agreement on Tariffs and Trade [GATT], and the World Bank). The idea that fiscal and monetary policy could be used counter-cyclically to stabilize the economy and ensure high employment took root. The seeds of the modern welfare state were also planted.

The Cold War dominated the postwar era internationally. Defence spending thus remained a high priority for the country and the federal government, especially with the war in Korea. The IMF and GATT became the vehicles through which the international system of payments and trade were liberalized and it was the federal government that represented Canadian interests in those bodies. With regard to domestic policy, Keynesian counter-cyclical stabilization policy emerged as an accepted and viable role for the federal government. Ottawa also began to implement its vision of a modern welfare state. This had begun with unemployment insurance in 1940 and was followed by family allowances in 1945 and old age security in 1952.<sup>5</sup> With its responsibilities for defence and security, for liberalizing trade and payments, for economic stabilization, for tax harmonization, and for early developments in the postwar welfare state, the federal government remained the dominant actor in the Canadian federation even after the end of the war.

Constitutional responsibility for legislating and regulating in the areas of health care, education and social services were and remain areas of almost exclusive provincial legislative competence under the constitution. The Canadian constitution is also close to unique among federal countries in providing both orders of government with wide taxing authority in all of what are now the major sources of tax revenue (personal and corporate income tax, sales/value-added tax, payroll tax, etc.). Accordingly, it might have fallen to the provincial governments to lead the postwar reconstruction and the welfare state that were among the central achievements of the era. After World War II, however, the federal government was reluctant to give up all of the incremental revenues that it had begun collecting during the war years. Perhaps because

Ottawa had been responsible for fighting the war, it was natural for Canadians to look to the federal government for leadership in constructing the postwar peace. In the event, Ottawa was determined to build a more secure and fairer society than the one that Canadians had experienced in the 1930s. The federal government envisaged a social security system that would protect Canadians against the contingencies of unemployment, old age, and illness. This promised to be costly and was thus an incentive for the federal government to retain its strong revenue position. Ottawa also wanted to be able to implement a high employment policy. This required access to the large economic levers to effect macroeconomic stabilization and taxation was one of the key levers. Tax harmonization was also important to the federal government because it wished also to avoid a return to the system of checkerboard taxation that had been a hallmark of the 1930s, with all of the inefficiencies and inequities it entailed. In the event, Ottawa was able to negotiate agreements with most provincial governments to extend initially the tax-rental agreements. And, over time, the federal government secured provincial acceptance of a set of tax-collection agreements for personal income and corporate income taxes — allowing a harmonized tax system and a single tax-collection agency for signatory provinces. But Quebec declined to enter such an agreement for either personal or corporate income tax, and Ontario decided to collect its corporate income tax separately, as did Alberta at a later date.

Since the provinces had most of the authority for social programs, the federal government recognized that it could not act on its own. It could use its constitutional powers to design unemployment insurance programs and its “spending power” to deliver cheques to individuals.<sup>6</sup> But it lacked the constitutional power to design and deliver most social services. Accordingly, for key components of its vision, Ottawa could only act working with and through the provinces. The result included a series of federal-provincial shared-cost programs that included hospital care, medical services, postsecondary education, social assistance, and social services. The arrangements also included federal equalization transfers to the less wealthy provinces to enable them to provide reasonably comparable levels of services at reasonably comparable levels of taxation. Thus, power remained centred in Ottawa during the early postwar decades.

But during these same decades, events were also sowing the seeds of change in the workings of the Canadian federation, and especially the system of fiscal federalism. For one thing, as the scope and size of the Canadian welfare state grew to encompass more and more of these activities, the role and size of provincial governments began also to expand rapidly. The late 1950s and mid-1960s saw the introduction of public hospital insurance and medical insurance by the provinces under cost-sharing arrangements with the federal government.<sup>7</sup> At the same time, helped by fiscal incentives from Ottawa, provinces undertook a massive expansion of Canada’s postsecondary education

and social service systems. Provincial governments thus came to play a progressively larger role in the lives of Canadians. With these changes, they had a consequential requirement for additional sources of revenue. The result, however, was not a simple expansion of the provincial sector, but rather a provincial expansion in collaboration with the federal government as a cost-sharing partner. Motivated by economic efficiency and equity concerns, on the one hand, and nation-building, on the other, the federal government transferred large sums to the provinces to facilitate the construction of national programs for social purposes and postsecondary education.

The federal government's direct role in social policy also increased during these years. Through negotiation with the provinces, Ottawa secured their support for a constitutional amendment that allowed for the introduction of the Canada Pension Plan. The age of entitlement to benefits under this plan became 65 and entitlement to federal Old Age Security payments was also lowered to age 65 from age 70 at the same time. The coverage of Unemployment Insurance was also vastly broadened and the program made much more generous, especially with the major revisions to the *Unemployment Insurance Act* in 1971.

By the early 1970s, all of the basic building blocks of Canada's current welfare state were in place. The role of both orders of government had grown. But the provincial role had grown more because the largest program components, health care and education, were provincial responsibilities. And even as these provincial responsibilities were growing, there were three parallel developments that led inevitably to a declining program role for the federal government. The first was that the tension surrounding the Cold War had begun to ease. In relative terms, defence expenditures fell year after year. By the 1970s, well before the collapse of the Soviet Union, defence and security had shrunk dramatically as political and spending priorities. Second, counter-cyclical macroeconomic stabilization policy had come to be seen as ineffective. The combination of "stagflation" of the 1970s and the serious recession of the early 1980s led to the emergence of a new macroeconomic orthodoxy — one that placed much less weight on counter-cyclical macroeconomic policy and much more on getting the economic fundamentals right. With this shift in economic management, the case for Ottawa continuing to control a large enough share of the tax system to effect stabilization came to be diminished.<sup>8</sup> The third development was an accumulation of federal government deficits and rising debt-service costs that, over time, reduced its ability to undertake new spending initiatives and hence to shape and influence provincial spending patterns through the use of federal-provincial matching grants or other cost-sharing programs. The federal government even found it difficult to maintain its commitments for existing joint programs.

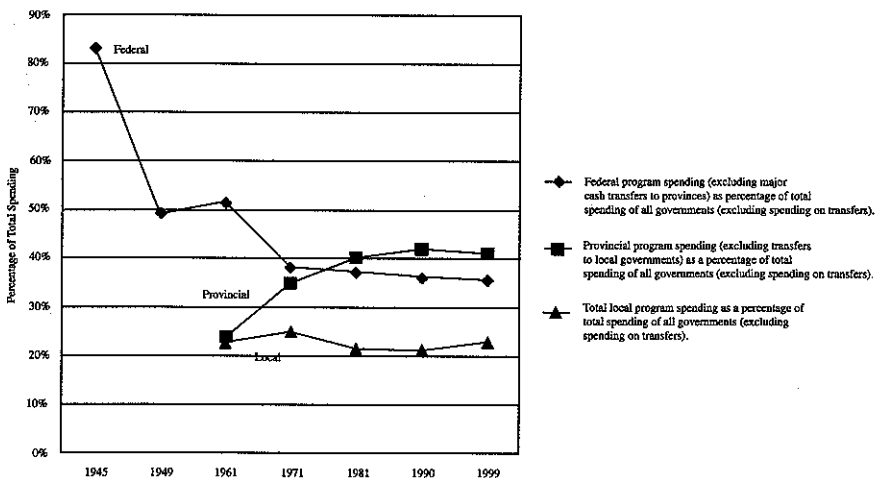
Centralization in the postwar Canadian federation probably may have peaked sometime in the 1970s or possibly the early 1980s, with the *Constitution Act, 1982*.<sup>9</sup> But from the perspective of spending and taxing only, and related policy



initiatives, the peak in federal government power occurred in the second half of the 1960s.<sup>10</sup> In any case, the provincial tide has been rising for some time. Even with this relative shift in power from the federal to the provincial order of government, however, the distribution of effective authority between the two orders of government has remained nicely balanced. While there has been a shift toward the provinces, the federal government has by no means been emasculated as a political actor.

Figure 1 shows the changing relative role of the different orders of government. In 1945, of course, the distribution of spending reflects the federal government's role in financing the war effort. By the 1960s the implementation of the postwar welfare state was well under way. From 1961 to 1999 the overall size of the state was growing sharply (from around 30 to 45 percent of the gross domestic product). The strongest growth, by far, was experienced by provincial governments. In relative terms, provincial program spending almost doubled from 1961 to the early 1990s. At the same time, the federal share of total government program spending dropped by over 30 percent.

**Figure 1: Program Spending of Federal, Provincial and Local Governments as a Percentage of Total Spending of all Governments (Excluding Spending on Intergovernmental Transfers)**



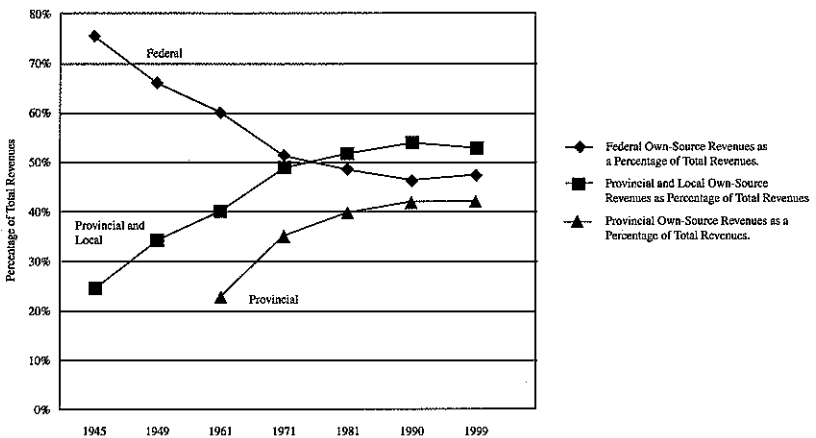
Source: Calculated from Statistics Canada, National Accounts, CANSIM Series and *National Accounts Income and Expenditure 1942-49*.

While Figure 1 provides a broad overview of the size of the two orders of government, the changed nature of program expenditures is equally striking. In 1955, for example, Ottawa spent more on defence than it did on transfers to individuals and other governments for social purposes. By the late 1990s, defence outlays had dropped to barely one-tenth of social spending. Close to 70 percent of federal program spending today is made up of transfers to individuals and provinces for social purposes. From a spending perspective, the contemporary federal state is overwhelmingly a *social* state.

The same trend is found on the provincial side. As already noted, beginning in the late 1950s and more strongly in the 1960s, health care, education, and social services became political priorities for Canadians. All three were labour intensive and hence costly. Provincial program spending thus rose dramatically. It was over 8 percent of the gross domestic product (GDP) in 1960 but was 18 percent in 1990. Despite recent cost cutting, provincial program spending remains at around 16 percent of GDP today.<sup>11</sup> At the new millennium, 75 percent of provincial spending is for social programs. Even more than Ottawa, the provincial state is thus about social programs.

Turning to the allocation of revenues, a similar story emerges. Figure 2 shows that in the early 1960s, Ottawa accounted for three-fifths of "own-source" revenues collected by governments. Provinces collected just under one-quarter of the total. By 1990, the two orders of government were raising equal shares of revenue as a result of rising provincial shares and declining federal shares.

**Figure 2: Federal, Provincial and Local Government Own-Source Revenues as a Percentage of Total Revenues**



Source: Calculated from Statistics Canada, National Accounts, CANSIM Series and *National Accounts Income and Expenditure 1942-49*.

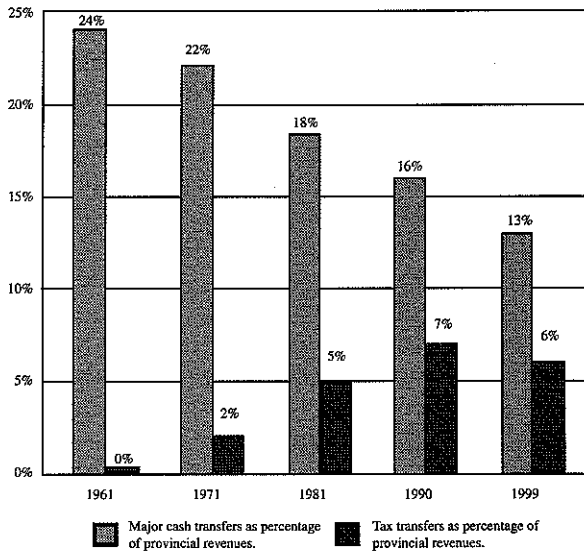
The data in Figures 1 and 2 are mainly a reflection of the expansion of the Canadian welfare state and the decline in military spending, as discussed above. The former are mainly the constitutional responsibility of provincial governments, whereas the latter are the responsibility of Ottawa.

As noted earlier, the growth of the provincial state was financed in part through the huge increase in its own-source provincial revenues. But it also reflected a growth in transfers from the federal government — payments Ottawa could afford to make in good measure because it had retained through negotiation much of the tax room it had occupied during the war. Other chapters of this volume go into the role of transfers in some detail. (See especially Chapters 6 and 7.) It is sufficient here to note that in the early years of the postwar welfare state, federal transfers were a major source of revenue to the provinces and that the transfers were all cash transfers. By the end of the century, however, transfers had become relatively less important as a source of provincial revenues. Moreover, almost one-third of federal transfers were in the form of “tax transfers,” which for statistical purposes at least are recorded by Statistics Canada as “own-source” provincial revenues. The political controversy surrounding the issue of tax transfers is discussed in Chapter 4 of this volume. The main point to note here is that federal cash transfers to the provinces are now a relatively small share of provincial revenues, just over half of what they were in 1961 (although they remain very important in Atlantic Canada). This reflects more the huge growth in provincial “own-source” revenues than it does relative reductions in those federal transfers. Figure 3 shows these trends.

In summary, from the perspective of the broad trends in revenues and expenditures, the role of federal transfers to the provinces, and policy initiatives related to revenues, spending, and transfers, the peak in federal government power was reached during the 1960s. Since then, the provincial role has been increasing in relative importance, whether one is examining spending or revenues or the declining role of federal transfers to the provinces.

Moreover, when one digs deeper, this conclusion is reinforced. For example, the level of conditionality associated with federal transfer payments to the provinces has been lightened significantly over the last three decades. Today, the two largest transfers by far are the Canada Health and Social Transfer (CHST) and Equalization. The latter program has no conditions and the former, a bloc fund intended for provincial health, higher education, and social welfare programs, has only two sets of conditions. The first is that provinces impose no restrictions on eligibility for welfare for residents arriving from other provinces. The second is that provinces meet the five broad principles of the *Canada Health Act* in the design and delivery of their health services.<sup>12</sup> In recent years, all provinces have affirmed their support for the principles of the *Canada Health Act* (CHA) so it is arguable that these conditions themselves are not onerous for the provinces. It is true that some provinces have

**Figure 3: Major Cash and Tax Transfers as a Percentage of Provincial Revenues**



Source: Calculated from Statistics Canada, National Accounts, CANSIM Series and *National Accounts Income and Expenditure 1942-49*.

been strongly critical of the fact that it is the federal government alone that has formal responsibility for interpreting and enforcing the CHA.<sup>13</sup> But in an overall sense, it is clear that the conditionality in the transfer system has dropped significantly relative to the period of extensive cost-sharing during the 1960s and 1970s. During those years, the federal law determined which provincial expenses were eligible for cost-sharing and which were not. This not only necessitated additional record-keeping by the provinces, and some periodic hassles regarding the eligibility of expenses, it meant also that Ottawa might audit provincial books. There is none of this today.

A second example can be found in the area of personal and corporate income taxes. For reasons of economic efficiency, administrative efficiency and to avoid a "tax jungle," almost all provinces agreed to sign tax-sharing and then tax-collection agreements with Ottawa in the years after World War II. One result was a cost-effective personal and corporate income tax-collection system for the provinces. Another was that compliance costs of businesses that operated in more than one province were minimized.

These agreements did entail costs for the provinces, however. In the case of personal income tax, one cost was that the federal government required provinces to "piggyback" their income taxes on top of federal taxes, which narrowed

the freedom of the provinces to design an incentive structure to meet local needs and political preferences. Provinces could raise and lower their tax rates but were not free to adjust the basic structure of the system. This has now changed. Chapter 9 documents the vastly increased autonomy of provincial governments in relation to personal income tax. Under new flexibility afforded by Ottawa, provincial governments are able to continue to secure the economies and efficiencies of a single tax-collection agency while obtaining much more room to design the incentive structure of their systems. This is an important growth of effective provincial power.

Finally, in the context of assessing the relative roles of the two orders of government on fiscal matters, it is very important to note that the federal government has not launched any new Canada-wide initiatives since the 1960s that are remotely similar in scale to the huge joint undertakings of that decade. Perhaps the most significant was the National Child Benefit (NCB) a few years ago. And it was arguably a replacement for earlier programs like Family Allowance and elements of provincial welfare. In sheer magnitude, the NCB is smaller than the big programs of the 1960s. Furthermore, the leadership in bringing it forward was shared between federal and provincial governments, whereas Ottawa drove the agenda of the 1960s.

The next question of interest here is whether the broad trend to decentralization persisted into the last decade. The answer is ambiguous. On the one hand, there was a further modest decentralization in spending. In this instance, both federal and provincial expenditures as a share of total government spending dropped slightly, with the share of municipalities rising. Second, some of the reduction in conditions on federal transfers, noted above, occurred in the 1990s. And much of the new flexibility in effective provincial power in respect of personal income tax has come about in the last year. On top of this, there is perhaps the beginning of a trend toward more fiscal autonomy for First Nations.

But federal and provincial shares of own-source revenues were more or less flat in the 1990s. And it was around ten years ago that Ottawa moved into the area of value-added tax, a revenue base that had, by convention, been largely the domain of the provinces. Moreover, in the last few years the federal government has begun exercising its spending power again in such diverse areas as child benefits, Millennium Scholarships and Canada Research Chairs.<sup>14</sup> There is also a view held by some that the Social Union Framework Agreement (SUFA) is effectively a centralizing document, cloaked in the guise of collaborative federalism.<sup>15</sup> While I read the SUFA differently, the "proof of the pudding will be in the eating," and this more sceptical perspective must be acknowledged.

Thus, the 1990s appear to have been a period of cross-currents rather than clear directions. The movement toward a relatively greater role for the provinces from a fiscal federalism perspective may thus have slowed or stalled

over the last decade. But it has not been reversed. From a fiscal viewpoint, the Canadian federation remains much more decentralized than it was 30 years ago.

## ASSESSING THE TRENDS

In the remainder of this chapter, the focus is on providing some perspective on these trends. Did the trend toward decentralization of the last several decades serve the public interest well? If so, how? If not, why not? Whatever the answer to these questions, what about the last decade? If some decentralization was appropriate, then is the slowing or stalling of decentralization over the last decade inappropriate? In seeking to shine some light on these questions, the assessment criteria introduced at the outset of this chapter, relating to policy, federalism, and democracy, will be our focal points.

## POLICY GOALS

The early postwar decades were ones in which many of the advanced capitalist democracies built their modern welfare states. In Canada, as discussed above, although much of the constitutional power for promoting equity goals rested with the provinces, the federal government heavily influenced the construction of the systems of social security and last resort. Two main constitutional powers enabled Ottawa to play this role. One was the power to levy both direct and indirect taxes and thus to construct a progressive tax system. The second was the "spending power" which enabled the federal government to transfer money to provinces and to persons to achieve desired social goals.<sup>16</sup> The two powers were connected, in the sense that the revenues raised through the federal tax system provided the federal government with the financial wherewithal to exercise its spending power.

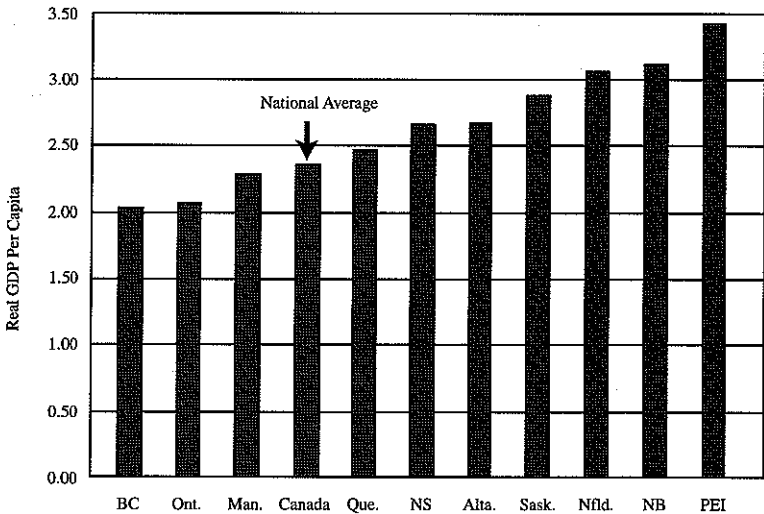
The transfer system, both direct and indirect, was used by Ottawa to promote equity and efficiency. While in the absence of a strong federal government, it is likely that some provinces would have developed the infrastructure of the welfare state on their own, it is unlikely that the result would have served Canada-wide equity or efficiency goals as well as the federal-provincial partnership did. The late 1950s and 1960s saw the establishment of a pan-Canadian system of universal publicly insured systems of hospital and medical services. Postsecondary education was expanded hugely. A last resort safety net ensured that the most disadvantaged would be able to survive with at least a modicum of dignity.<sup>17</sup> In all of these cases, federal-provincial cost-sharing was a key instrument. In addition, as noted earlier, country-wide systems of old age security, child benefits, and unemployment insurance were

also introduced, in these instances through direct spending by Ottawa. This is not to deny the crucial role some provinces played in pioneering some programs, notably Saskatchewan in relation to both hospital insurance and medical care. Rather, it is simply to observe that federal initiative, and imaginative use of Ottawa's constitutional powers, accelerated the advancement of these goals.<sup>18</sup> At the same time, federal government leadership avoided a return to the tax jungles of the interwar years with all of the inefficiencies they entailed.

The importance of equity goals was also given concrete expression in the patriated constitution of 1982. Section 36 of the *Charter of Rights and Freedoms* committed both orders of government to "promoting equal opportunities for the well-being of Canadians"<sup>19</sup> and "furthering economic development to reduce disparity in opportunities." It also committed the Government of Canada to the "principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."<sup>20</sup> A basic instrument of fiscal federalism, the intergovernmental transfer, was thus given constitutional status to do its task.

By several criteria, regional differences in economic conditions were narrowed over the postwar decades, as reflected, for example, in provincial trends in GDP per capita. Part of this may have been attributed to the important role of intergovernmental transfers in the economy of the less wealthy provinces, including not only Equalization but also the transfers for health and especially higher education.<sup>21</sup> In those parts of the country, and most especially Atlantic Canada, transfers from Ottawa have been major components in provincial budgets, helping to promote the goals of reasonably comparable levels of services at reasonable comparable tax rates. One result, in particular, has been to improve education and skill levels relative to other regions of the country. The narrowing of the gap is shown in Figure 4.

The economics literature is, in general, supportive of the idea that decentralization of public services is a good idea for efficiency reasons. Chapter 2 in this volume by Robin Boadway speaks to both the benefits of decentralization, as well as its limitations. Thus, the general trend to decentralize spending, as outlined above, is consistent with this element of theory. However, there is a divide in the literature about whether it is as important to have decentralized revenue collection. For much of the postwar period, to the extent that there was a consensus, it was that there were advantages in centralized revenue collection and therefore some vertical imbalance was appropriate. There were thought to be efficiencies in a relatively centralized and harmonized system of revenue collection. These included administrative efficiencies in collection, efficiencies in compliance and the avoidance of spillovers associated with the differing fiscal capacities of the provinces. In this view, the vertical imbalance could be used by the federal government to support Canada-wide

**Figure 4: Average Annual Growth Rates by Province, 1961-1996**

Source: Serge Coulombe, *Economic Growth and Provincial Disparity: A New View of an Old Problem* (Toronto: C.D. Howe Institute, 1999), Table 1.

equity goals. Chapter 3 by Ken Norrie and Sam Wilson develops this case further.

This relatively rosy picture of the policy impacts of fiscal federalism has become more blurred over the last decade and perhaps even a bit longer. For one thing, from at least some perspectives, it appears that Ottawa has reduced its commitment to equity. In Chapter 6, Paul Hobson and France St. Hilaire describe the replacement of Established Programs Financing and the Canada Assistance Plan (CAP) by the CHST bloc grant as the financial equivalent of terminating federal cost-sharing for provincial welfare (i.e., eliminating CAP). Given the political priority that health has these days, and to a lesser degree postsecondary education, relative to welfare, this characterization should not be dismissed lightly. Reinforcing this argument, Lars Osberg demonstrates in Chapter 8 that many of the gains that Canada was able to achieve in the 1970s and 1980s in dealing with poverty, and the way poverty was distributed across Canada, had eroded badly by the mid-1990s.

Moreover, the economics literature is more divided now than it once was about the merits of a central government collecting more revenue than it requires to finance its own programs and other orders of government collecting less. There is an increased concern that this leads the governments that are the recipients of intergovernmental transfers to spend more than would otherwise be the case. And there is a more general criticism that these transfers obscure



accountability relationships. In this view, the government that spends should also be the government that levies the tax. This view heavily influences the proposals for tax re-assignments in Chapter 10 by Jack Mintz and Richard Bird.

The questioning of the efficiency aspects of federal transfers to the provinces overlaps two much broader concerns about the role that the Canadian state came to play during its postwar expansion. The first was the growth in public sector deficits and debt, including at the federal level. During the expansionary period of fiscal federalism, especially from the mid-1950s to the late 1960s, the fiscal base of the federal government was also growing rapidly. But starting in 1975, federal government spending exceeded federal revenues every year for more than 20 years. As the deficit problem grew, all government programs were subject to more scrutiny and question. This inevitably included the major federal transfers to the provinces, if only because they were among the largest programs in the federal budget.

The second development was the huge growth in economic linkages between Canada and the United States relative to the east-west links within Canada. Courchene has written eloquently about the growing interdependence of each of Canada's regional economies with its neighbours.<sup>22</sup> What is especially significant in this regard is that this process has been consciously accelerated by Canadian government policy, as reflected in the Canada-United States Free Trade Agreement and the North America Free Trade Agreement. The result is that the provincial economies are drawn into increasingly tight relationships with the US regional economies closest to them, from both a cooperative and competitive perspective. The economic self-interest of the wealthier provinces in seeing the federal government redistribute income to the less prosperous regions has thus been diminished.<sup>23</sup>

Under the twin pressures of deficit reduction and competitiveness, as noted above, Canada's system of fiscal federalism has not served Canada-wide equity goals as well in recent years as it did in earlier decades.<sup>24</sup> Public health insurance is under stress. Income-support programs have deteriorated. Tuition fees in postsecondary institutions have risen dramatically. These are all programs that were once heavily supported through federal transfers.

It might be thought that many economists would applaud the shift from cost-shared to bloc-funding and reduced transfers, at least from an efficiency perspective. But as noted above, the very idea of intergovernmental transfers has itself come under challenge by some analysts.<sup>25</sup> And therefore there is probably less consensus today about the efficiency benefits of fiscal federalism than there was when the system was less flexible. This does not deny the value of programs like Equalization in reducing differences in fiscal capacity and thus reducing the probability for economically inefficient migration of households or firms and in reducing horizontal externalities (as when a province with low investments in education can poach from others that invest more).

But in an era where the value of fiscal restraint has risen, the political weight attached to these particular efficiency arguments has weakened.

In summary with respect to policy matters, there is less consensus today than there was 20 or 30 years ago that the tools of fiscal federalism are effectively serving the goals of equity and efficiency. This is partly because the cash amounts being transferred have fallen substantially in relative terms. But it is also because the contextual setting has shifted. The twin concerns of fiscal restraint and provincial competitiveness are leaning against a return to the kind of fiscal federalism practised in the postwar decades.

#### IMPACT ON FEDERALISM

This in turn raises questions about the impact of fiscal federalism on the state of the federation itself. On the favourable side, Canadian fiscal federalism has been an important instrument for giving concrete expression to the idea that there is a social dimension to citizenship: that there are rights that accrue to Canadian citizens no matter where in Canada they may live. This is reflected in the various mechanisms for promoting mobility rights. In recent years, it has been reflected most profoundly in the apparently symbolic stature of Canada-wide medicare as a "right" of citizenship. If federations are polities that seek to bridge shared rule and self-rule, fiscal federalism has been an important tool for building the areas of commonality and for promoting the idea of Canada as a sharing society. The evidence for the success of these programs in building a sense of common purpose is reflected in the apparent determination of the citizenry today to preserve and repair the deterioration in the public health insurance system.

The federal government has played an essential leadership role in this process, providing much of the vision and important amounts of money. Provincial governments have also been vital to what has been achieved. In some cases, they have provided the ideas. And in most cases they are the government "on the ground," the jurisdiction responsible for designing and delivering the benefits and services. Working together, the two orders of government have accomplished much.

This does not mean, however, that these achievements came easily. From the viewpoint of provincial governments, each step along the way has involved serious concerns. In the 1950s and 1960s, the lack of clear rules around the use of the federal spending power in respect of intergovernmental transfers created tension. In subsequent decades, provinces continued to demand that they be fully involved in federal "spending power" decisions before they were taken. They also wanted transfers to be made less conditional and more stable. As discussed above, the transfer system is much less conditional today than it was 25 years ago. The 1999 SUFA agreement also included some new

limits on unilateral federal use of its spending power. It provided as well for advance consultation provisions prior to renewal of or significant changes in social transfers to make federal funding more predictable for the provinces.

An "on again off again" tug of war around revenue-sharing has been a second source of conflict, with the provinces periodically arguing that the sharing of revenues between the federal and provincial governments has unduly favoured the federal government. On this latter point, the federal government has on two occasions ceded substantial tax room to the provinces, although the last time was 1977.<sup>26</sup> This tension remains today. Thus, in a report to premiers in 1998, provincial and territorial ministers of finance asserted that "there is a fiscal imbalance between the federal government and the provinces, even after the federal transfer system is taken into account" and that this imbalance "is likely to widen."

The third tension was related to the tax-collection agreements, the provincial argument being twofold. First, the federal government was not administering the agreements in a flexible enough way to accommodate provincial priorities. Second, provincial revenues were too vulnerable to changes in federal tax law. Whenever, in the case of personal income tax, Ottawa changed either the tax base or the federal tax rate, provincial revenues were automatically affected. Beginning in the 1970s, the federal government began allowing some kinds of provincial credits to be included in provincial personal income tax systems. Over the following quarter century, Ottawa became progressively more flexible, to the point where it agreed over the last few years that provinces would have autonomy, within the framework of the federal-provincial tax-collection agreements, to impose their tax on taxable income rather than on federal tax payable.<sup>27</sup> For their part, provinces that were in the tax-collection agreements undertook to adhere to the federal definition of taxable income. The result was to provide provinces with wide discretion in the design of their systems and somewhat more stability in forecasting revenues.<sup>28</sup> Provinces have since begun acting on this freedom. Whether this new arrangement fully meets provincial needs, however, remains to be seen.

Viewed over a period of decades, the above synopsis suggests that Canadian fiscal federalism does adapt to changing needs and circumstances. At any point in time, however, this kind of historical sweep is likely to be absent. In other words, the federal government's willingness to adjust invariably follows on a period of sustained provincial political pressure.

In the current context, the amount that Ottawa is transferring to the provinces under CHST, and more generally the reliability of Ottawa as a funding partner, are hot spots. For almost three decades, the federal government has been reducing the amounts it has committed to the provinces in support of jointly financed programs (although it bears noting that it has been a consistently reliable payer of Equalization). As one Parliament cannot bind another,

there is no constitutional impropriety in the federal government changing its mind about how much money it transfers to the provinces for joint programs. It is also the case that the federal government requires flexibility to deal with the finances of the country as they shift. But politically, when Ottawa changes the financing of joint programs unilaterally, it undermines the confidence of the provinces in the federal government as a trustworthy partner and this is all the more so when the provincial governments believe that the federal action is lacking in basic fairness. Thus, federal-provincial relations reached a boiling point after Ottawa announced its planned cuts in transfer payments in conjunction with the introduction of the CHST. As is well known, this led to a united negotiating position among all provinces (Quebec included) and the signing of the Social Union Framework Agreement (Quebec excluded), as an effort to secure agreed rules around the uses of the federal spending power and stability in funding.

Two main points are being made here. The first is the simple one that the growth of Canada-wide programs has helped to build civic nationalism in Canada and that the tools of fiscal federalism were prominent in their accomplishment. This achievement has become a defining feature of the Canadian polity. The second is that while intergovernmental cooperation played an important role in the construction of this pan-Canadian nationalism, the process has also entailed periodic political conflict. The 1990s were particularly acrimonious in this regard and one of the legacies of that decade is too much mistrust between the two orders of government.

The above analysis excludes Quebec, which views pan-Canadian nationalism with considerable suspicion to the extent that it offers potential competition to deep-seated Quebec nationalism. Holding to a classical view of federalism, with its watertight compartments, consecutive Quebec governments have argued that the federal spending power makes a mockery of the division of powers embedded in the constitution. This view from Quebec can, of course, be criticized. It is not clear, for example, that the majority of the people of Quebec dislike the idea of a federal government playing some role in social policy, although they want cooperation, not bickering, between Ottawa and Quebec City. The attack on the spending power also suggests that only those parts of the constitution which Quebec governments like, such as the legislative division of powers, have legitimacy. In this regard, a case can be made that the federal spending power is a less centralizing provision than the constitutional powers of disallowance and reservation, both of which were assigned to Ottawa in 1867 although unused for over a half-century.

Furthermore, Ottawa has not been inflexible in its implementation relative to Quebec. The safety valve of opting-out was worked out between Quebec City and Ottawa on more than one occasion. For example, Quebec chose to stay out of the Canada Pension Plan and instead constructed its own earnings-

related pension plan, the Quebec Pension Plan. It opted out of the Canada Student Loan Program and Youth Allowance programs. In 1960 the Quebec government became the first to receive a tax transfer from the federal government in the form of a special tax abatement. More recently, the federal government has relied on the Government of Quebec to collect the Goods and Services Tax (GST) in that province on Ottawa's behalf. So the system has been administered with some flexibility.

For those outside Quebec, the decentralization of the last two to three decades might be thought to be sufficient to relieve Quebec's concern about an arrogant and centralizing federal government. But, perspective is everything. From a Quebec perspective, the postwar expansion of the federal government was inappropriate to the extent that it encroached on the legislative powers assigned to the provinces. In this regard, the legislative powers of the federal government did not require Ottawa to hold on to as much tax room as it did, especially after the Cold War began to ease. Thus, in this view, the federal government remains too large and too intrusive in the affairs of provincial governments, or at least the Quebec government. Whether these "intrusions" have played a significant role in the growth of the secessionist movement in Quebec, or whether it would have developed on its own, is difficult to gauge.<sup>29</sup> To the extent that Quebec nationalism is a natural expression of the collective will of the Quebec people, it may be that Quebec nationalism would have grown regardless of federal use of the spending power. Moreover, in the counterfactual situation, where Ottawa would have hypothetically played a much smaller role in constructing a postwar safety net and thus a much smaller role in the lives of Québécois, this seeming indifference might have also led to feelings of alienation and support for secession. Whatever the answer to this question, the fact is that a strong state apparatus has been constructed in Quebec, one that forcefully and often effectively pursues the goal of protecting and advancing Quebec as a mainly French-speaking nation within Canada and North America.

In sum, looking broadly at the impacts on the federation, Canadian fiscal federalism has been instrumental in building a sense of political nationhood within Canada outside Quebec. The effects on bridge-building between Quebec and the rest of Canada are harder to evaluate. While fiscal federalism may not have played a decisive role in contributing to secessionist pressures from Quebec, as a minimum it has periodically served as a substantial irritant in Quebec-federal relations.

#### IMPACT ON DEMOCRACY

In the early decades of its development, there was little or no serious discussion about the implications of fiscal federalism for democracy. The 1960s

were a decade of joint programming in such areas as hospital insurance, medical care, welfare, taxation, and higher education. Some of the most important political matters facing Canadians were being debated and discussed in the largely confidential confines of the federal-provincial conference and meeting. But it was not until the beginning of the 1970s that Donald Smiley coined the expression "executive federalism," a term that was not only descriptive but also normative.<sup>30</sup> And the concept of the "democratic deficit," developed initially to describe democratic shortcomings in the institutional structures and processes of the European Economic Community, only began to be used extensively in Canada after the secretive processes that resulted in the Meech Lake Constitutional Accord.

Since the collapse of Meech, governments have shown greater sensitivity to the criticism about inadequate transparency and the need to involve citizens more in the federal-provincial process. The differences between the Meech Lake process and the political process around the Charlottetown Accord and then the Calgary Declaration illustrate the growing awareness within governments about the democratic deficit. The 1999 Social Union Framework Agreement provides for a significant role for citizens and stakeholders in the making of social policy. It talks of the value of transparency and of the need for outcome measures through which governments can be held accountable for their actions.<sup>31</sup>

The democratic deficit is admittedly a vague notion. In our Westminster-style of government, power is concentrated in the executive and increasingly in the first ministers and finance ministers. The decision-making process in the Westminster system is also a relatively closed one. The democratic character of the system is based on the fact that those who hold high office have been elected in an open, fair, and genuinely competitive process. If the public is dissatisfied with the government's performance, the government can be removed at the next election. To the extent that this view of democracy is adequate, then it can be argued that the closed nature of the federal-provincial process is no different than the normal processes of Westminster-style government. The ministers representing both orders of government have been duly elected, they carry majority support within their legislatures and they are answerable in those legislatures and ultimately to the public in the next general election.

This latter view of Canadian democracy is too narrow a view for contemporary Canada, however, as the above innovations from both the constitutional and non-constitutional areas suggest.<sup>32</sup> Unfortunately, even with this greater openness to various forms of more deliberative and more direct democracy, the inherent complexity of fiscal federalism makes it difficult for the public to understand the issues that are at stake. And to the extent that the major decisions that affect the basic *structure* of fiscal federalism are taken within the context of the annual federal budgetary process, and the secrecy it entails,

this problem of complexity is compounded. By the same token, if such structural issues were to be removed from the annual federal budgetary process, this would assist the deliberative dimension of democracy. It would leave more room for citizen and stakeholder involvement.<sup>33</sup>

## LOOKING BACK

Looking back, it can be seen that Canada's system of fiscal federalism was highly centralized in the first quarter-century after World War II. Since then, it has undergone a very substantial decentralization. In the 1990s there was evidence of further decentralization but also some cross-currents. The cross-currents make it difficult to know whether the broad decentralizing trend has run its course or whether it still has a distance to cover.

In the postwar years leading up to the early 1980s, the report card for fiscal federalism was a relatively strong one. It advanced important policy objectives. It helped construct Canadian nationalism. There were periodic tensions in the federation but, on the whole, they proved manageable.

Underlying this period of success was a broad measure of consensus about the role of the state in the Canadian economy and society. The postwar objectives of fostering high employment and economic stability, helping to secure people against the contingencies of unemployment, sickness, and old age, and protecting the most vulnerable were the building blocks of those decades.

But by the early 1980s that consensus had begun to erode. The objectives of macroeconomic stabilization and high employment had been undermined by the stagflation of the 1970s. The weak productivity growth of that decade and weak government revenues had begun to raise questions about the affordability and sustainability of the social programs. And in the ongoing debate about the equity-efficiency trade-off, the balance began to shift toward the efficiency side of the equation.

The larger constitutional agenda that dominated the 1980s and early 1990s initially obscured the effect of these changes for the conduct of federal-provincial fiscal relations. With the politics surrounding the *Constitution Act, 1982* and the huge amounts of political energy expended on the failed Meech Lake and Charlottetown Accords, the more substantive issues of fiscal federalism were on the back burner.<sup>34</sup> The main changes in fiscal federalism in the 1980s were federal cuts in planned increases in transfers to the provinces as fiscal deficits began to acquire a larger place in the agenda of the country.<sup>35</sup> For the most part, however, this was a period of relative calm in Canadian fiscal federalism.<sup>36</sup>

Looking back, it seems that the re-fashioning of the Canadian state in the 1980s and 1990s — a re-fashioning that made it much slimmer and more market-oriented — left some unfinished business in its wake. During these years, the

political landscape of the provinces began to tilt heavily to economic conservatism. That this had not yet run its course by the second half of the 1990s was reflected not only in the re-election of Ralph Klein's government in Alberta and Mike Harris' in Ontario, it was also seen in the political gains of the Saskatchewan Party in the 1999 Saskatchewan provincial election, the new fiscal orthodoxy of the Parti Québécois government, and in the election of Progressive Conservative governments in three Atlantic provinces. The fiscal retrenchment of the federal Liberal government elected in 1993, under Paul Martin's stewardship in the federal Finance Department, in some ways paralleled what was happening in the provincial level. Arguably, the smaller and less conditional federal transfers associated with the introduction of the CHST were a part of that overall trend. The signing of the Social Union Framework Agreement, with a new set of restrictions on the federal use of the federal spending power, was arguably similarly consistent in political direction. Even the more recent new federal flexibility around provincial personal income tax could be part of the same story.

Indeed, if the events described above were the full story, it might be possible to suggest that, over the 1990s, and contrary to what was suggested early in this chapter, a new mission statement had been written for Canadian fiscal federalism. That mission statement would have acknowledged a more modest role for fiscal federalism in an era when the state itself was attempting to do less. That statement would have emphasized the need for flexibility on the part of the federal government to accommodate the growing integration of provincial/regional economies with their US neighbours. It would have been a more conservative mission statement than the postwar statement in an era of increased economic conservatism. And it would have been a mission statement that was decentralizing in a world where Quebec nationalism and western Canadian assertiveness were powerful forces and the position of the Ontario government increasingly critical of the federal government. And if one were to look only at the cap on CAP, the CHST, new provincial freedoms under the federal-provincial tax-collection agreement, and the apparently reduced emphasis on equity considerations, it might be concluded that there was indeed such a new mission statement for fiscal federalism. To be sure, this statement would have acknowledged bumps in the road, including the destabilization of provincial finances and programming with the federal transfer cuts. But this arguably could have been portrayed as unfortunate but necessary pain in moving toward a more modest system of fiscal federalism.

The argument here, however, is that no such new mission statement has yet been written. There is in fact no overarching sense of purpose in contemporary fiscal federalism, in part because there is no new consensus on the role of government and no consensus on the nature of the federation. For example, Ottawa did not cut Equalization during the 1990s. It increased Equalization. As for the other major transfers, they were cut dramatically. At the time of the



CHST, the federal government dressed up its spending cuts with “noise” about the reduced conditions that the new transfer would require. This was portrayed as further evidence of flexible federalism. Thus, Finance Minister Martin declared, in his 1995 budget speech: “we believe that the restrictions attached by the federal governments to transfer payments in areas of clear provincial responsibility should be minimized.”<sup>37</sup> The finance minister then talked about the removal of unnecessary strings attached to the Canada Assistance Plan. Yet, only moments later in that same speech, he asserted that there were national goals and principles that had to be preserved and he committed the federal government to maintaining the conditions of the *Canada Health Act*. The finance minister’s speech did not provide a clear rationale for easing conditions around social assistance but not doing so for health. But few informed Canadians would have been confused by these decisions. There was strong public support for Ottawa to remain involved in public health insurance even though this is an area of provincial legislative competence and much less support for Ottawa doing so in the area of welfare. Ottawa’s policy changes were a response to practical political choices. They did not derive from some larger set of principles regarding the nature of the Canadian federation.

In fact, the CHST was mainly about one thing — reducing the federal deficit. Ending cost-sharing for welfare was the price of that change. To be sure, there had been voices around Ottawa for some time, urging that the cost-sharing for provincial welfare should end and be replaced by a bloc grant.<sup>38</sup> But these voices were ignored until the fiscal crunch. In any case, by rolling the EPF and CAP into a single transfer, Ottawa hoped to be able to obscure the impacts of its financial actions on the individual programs.

Federal actions since then, including restoring some of the CHST cuts, either directly or indirectly through funding direct transfers to individuals, indicate that the federal behaviour surrounding CAP and CHST was grounded at least as much in pragmatic deficit considerations as some entirely new set of principles for fiscal federalism. And Ottawa’s apparent determination to play a role in “saving” medicare during the debates of 1999 and 2000 adds to this view. Notwithstanding its modest financial contribution to the provinces for health care, it has been attempting to find a way of exercising leadership.<sup>39</sup> This has been reflected in its political challenge to the privatization initiatives in Alberta. It is seen also in its offer of further transfers to the provinces in exchange for a provincial plan to make medicare more effective and sustainable.

It is not the case that Ottawa has substituted direct transfers for intergovernmental transfers. As discussed in Chapter 4, since CHST, more money has been reinvested in intergovernmental transfers than direct transfers (notwithstanding the Millennium Scholarship Fund, the Canada Child Benefit, the Canada Research Chairs, and other direct initiatives). Nor has efficiency trumped equity as a goal. Rather, what we have is a series of “one off” federal decisions that reflect the details of the individual files and the exigencies of

the moment. "Ad hocery," with the federal government moving back and forth between the postwar consensus and the more conservative mission statement referred to above, is what characterizes the current federal approach to fiscal federalism.<sup>40</sup> Thus, for an extended period after the cap on the CAP, Ottawa continued to transfer far more money to needy provinces on a per capita basis, relative to wealthier provinces, than it had done prior to the cap on CAP. This suggested that the federal government was heavily equity-oriented, an argument that was reinforced by the enrichment of Equalization in 1994, at a time when few federal programs were being enhanced. Now, the federal government is eliminating entirely the per capita differential in favour of the needier provinces as it moves swiftly to end the per capita differences among provinces in the CHST. Thus, outside Equalization, Ottawa has shifted, in roughly one decade, from having a needs-related component in its transfer programs (the Canada Assistance Plan), to a kind of super needs-related component (per capita preferences in CAP in favour of equalization-receiving provinces) to no needs-related component in CAP's replacement (with equal per capita transfers under CHST).

It could be argued that, to some extent, the enriched Canada Child Benefit is a substitute for the needs-related CAP. This would, however, miss the main point here, which is not to criticize any of these individual decisions. Rather, it is to illustrate the thesis that it is difficult to discern any overarching vision for the future of Canadian fiscal federalism from analyzing the recent actions of the federal government.

Nor have provincial governments been entirely consistent in their approach to fiscal federalism. For example, they came together in 1998 in presenting a joint position to the federal government, arguing that there was a vertical imbalance in public finances that needed redressing. They set out three broad options for removing the imbalance: a cash transfer option, an equalized tax point reallocation option and a tax field realignment option. Provinces differed in their preferences among those models.

In the context of proposing a Social Union Framework Agreement, the provincial governments developed a series of positions that included restraints on the exercise of the federal spending power and better stability in federal transfers to the provinces. The provincial negotiating position on SUFA also included proposals that would have enabled a province to opt out of a new Canada-wide initiative and receive full compensation from Ottawa. They pressed as well for a quite formal set of arrangements around dispute avoidance and resolution. In the event, provincial governments accepted weaker controls on the federal spending power, weak federal commitments for revenue stability, and a lesser provision on opting-out than they had proposed. The provisions around dispute avoidance and resolution were also well short of a provincial negotiating position. The incentive for the provincial premiers to go along with the compromise position was the lure of a large additional

federal financial contribution to the CHST. In the event, the final SUFA deal was made in conjunction with enhanced federal transfers to provincial governments. These extra cash transfers thus corresponded to one of the options in the 1998 Finance Ministers' Report to Premiers. While it is always easy for those who are not engaged directly in the business of government to poke holes in what governments decide to do, there are few commentators who will dispute the notion that provincial governments backed away from a large part of their negotiating position in return for additional federal money. This may not have been an unwise decision by provincial governments. But it clearly does speak to the fact that provincial strategies have reflected heavily pragmatic considerations, much like Ottawa's.

## LOOKING AHEAD

Over the last several years, federal and provincial governments have been experimenting with new forms of "collaborative federalism."<sup>41</sup> While collaborative federalism has some things in common with the "cooperative federalism" of earlier decades, it differs in important respects. One difference is that collaborative federalism envisages partnership and equality between orders of governments whereas cooperative federalism involves strong federal government leadership. And as a practical matter over the last few years, collaborative federalism has involved the federal government responding to provincial initiatives as much as provincial governments responding to federal initiatives. Several of the ideas now under federal-provincial negotiations or implementation emerged at least in part from the work programs of the annual Premiers' Conferences. Conditional transfers were a trademark of cooperative federalism. Bloc transfers are a hallmark of collaborative federalism. The era of cooperative federalism was one in which the federal government had substantial fiscal flexibility and could use its spending power to drive the federal-provincial agenda. The period of collaborative federalism began at a time when Ottawa was engaging in fiscal retrenchment. In some sense, the federal government was required to accept a more equal partnership by virtue of its inability to use money as an incentive to shape provincial behaviour.

Thus, a crucial issue for the future of Canadian fiscal federalism is whether the concept of collaborative federalism can survive a period of federal government fiscal prosperity. It was easy for the federal government to accept restraints on its spending power when it had little money to spend. But whether Ottawa is willing to accept the same constraints now that it is back in fiscal surplus is an open question. There are mixed signals from the federal government on this matter. Notwithstanding some real evidence to the contrary, the general picture in the period since SUFA was signed is of a federal government living within the rules of the restraints on its spending power, as

discussed in Chapter 4. There is also evidence that many federal public servants, especially in sectoral departments, are trying hard to make the collaborative federalism of the Social Union Framework Agreement a meaningful reality. This is reflected in such diverse tables as those on disability, labour markets, and children.

But provincial governments remain suspicious of federal *bona fides*. They were clearly disappointed by the absence of large new funds for health care in the 2000 budget. They suspect Ottawa is tempted to make greater use of direct transfers than intergovernmental transfers. And they are alienated by the federal government's unwillingness to agree to a more substantive set of practical arrangements for dispute resolution.

With the Chrétien Liberals in power, the possibility of a further tax transfer to the provinces, or tax realignment, appears remote. In the event of a more conservative party forming the next government, it is conceivable that Ottawa might take a different stance. In that case, it would be reasonable to expect a conscious effort to reduce vertical imbalances and perhaps greater commitments to preserve the stability of existing transfers. It would also be reasonable to anticipate a re-drafted SUFA in which the restraints on the federal spending power become more stringent. This does not mean that such a government, whether made up of the Canadian Alliance, the Progressive Conservatives or some coalition would, or should, simply adopt stated provincial positions. But a significant move in that direction would be consistent with the policy positions the opposition parties have taken.

In the period immediately ahead, several important questions remain unanswered. The first is whether fiscal federalism will be characterized by the paradigm of collaborative federalism, and an equal partnership among orders of government, or whether it will revert to one in which the federal government attempts to play the role of senior government. A second is whether the decision-making processes around fiscal federalism will become more transparent, with structural decisions taken outside the federal budget-making process. A third has to do with the balance between equity and efficiency. And a fourth has to do with whether fiscal federalism can be used constructively to narrow the political gap between Quebec and the rest of Canada.

The answers to the first three of these questions may be intertwined and determined by the readiness of the two orders of government to live by the spirit of the Social Union Framework Agreement. This agreement proclaims "mutual respect between orders of governments and a willingness to work more closely together to meet the needs of Canadians." It provides for "joint planning and collaboration." It has provisions for dispute resolution. So there is already a federal-provincial plan to move in the direction of collaborative federalism. SUFA also includes provisions for enhanced transparency in the federal-provincial decision-making process and for a stronger public account-

ability regime. Since the social spending programs that are SUFA's focus are *also fiscal federalism programs*, the answer to the first two questions will depend in large measure on whether there is the political will among first ministers to breathe life into this agreement. The answer will also hinge on whether *major structural* decisions about the future of fiscal federalism are taken out of the political hot house of the annual federal budget-making process. If they remain there, the dice are loaded against the kind of equal partnership that SUFA contemplates and that, arguably, the current political context demands. Such a change would not require the federal minister of finance to surrender control of the federal fiscal framework to the provinces or other parts of the federal government. It would necessitate, however, that structural decisions relating to jointly financed programs or federal-provincial tax arrangements be worked out in a joint forum, not the federal budgetary process, which Ottawa must necessarily own. Under these conditions, the prospects for a reasonable balance between Canada-wide equity and efficiency goals are also enhanced because, in such a setting, there is a functional mechanism (i.e., SUFA) for promoting equity.

Whether fiscal federalism can help to bridge the Quebec-Rest of Canada divide is a separate issue. Perhaps perversely, the inherent complexity of fiscal federalism may be a bit of an advantage in this regard. This is because the technical nature of fiscal instruments makes them difficult to use for symbolic purposes. This does necessarily favour one side more than the other in the federalist-sovereignist struggle for Quebec. Thus, Ottawa seems to have received little credit from either the Government or people of Quebec for devolving labour market training to that province. And the PQ was unable to gain much support for an attack on Ottawa's decision to make CHST an equal per capita transfer. The issues appear to be too complex. To the extent that there is some truth in this analysis (and its truth will vary from item to item), it suggests that governments as different as those of Jean Chrétien and Lucien Bouchard should be able to do business with one another from time to time without putting at risk their longer term goals. That is, it should be possible for the federal and Quebec governments to work together on "meat and potato" fiscal-federalism issues related to taxation and spending. Whether this kind of collaboration will translate into a narrowing of the political chasm between the two sides is less clear, however. These larger differences between the federalist and sovereignist agendas will probably require changes in the political symbols and perhaps institutions of the country. But fiscal federalism may be a useful complementary instrument in this larger agenda, should there be governments in Ottawa and Quebec City that wish to tackle a political reconciliation agenda.

## THE NEED FOR A NEW MISSION STATEMENT

The current era of global and continental integration is leading to growing functional interdependence among the peoples and governments of the world, whether the subject is financial markets, the environment, fighting organized crime, the migration of peoples or the spread of diseases. This interdependence applies as much to relationships within countries as between them.

In Canada, the functional need to manage this interdependence has arisen within a context where provincial governments were demanding respect for their position within the Canadian constitutional family and some academics were calling for more independence among governments as a way of assuring enhanced public accountability. In turn, these demands have led to changes in the structure of fiscal federalism which have served to strengthen *de facto* provincial independence on fiscal matters. Provinces rely less on federal cash transfers today than they did 30 years ago. The transfers they do receive have fewer conditions attached to them. Provinces are also less tightly tied into the federal income tax structure.

There are thus pressures for both interdependence and independence within the federation. While these two forces may appear to conflict with one another, in practice they need not always do so. On some issues, it may be sensible, even inevitable, that the two orders of government work closely together. On others, there may be little or no cost to governments working independently of one another and clear advantages to doing so. Even sorting these issues out, however, requires some kind of partnership and collaboration among governments.

Federal government documents and representatives have repeatedly declared their support for collaborative federalism. The 1997 Liberal *Red Book* stated: "Our philosophy of federalism is that the best way for the various orders of government to meet the needs of Canadians is to work together."<sup>42</sup> The federal minister of intergovernmental affairs enunciated the same viewpoint two years later stating: "Our federation is evolving toward greater cooperation and consensus-building, while respecting the constitutional jurisdiction of each order of government."<sup>43</sup> As already noted, SUFA, which Ottawa signed, enshrines this principle.

For collaboration to be effective, the behaviour of governments must have a substantial degree of predictability. If one order of government zigzags too much, the second order of government will find that first order too unpredictable and hence difficult to trust as a partner. In this regard, it is particularly important that the federal government be predictable because the intergovernmental impact of Ottawa's actions is much larger than that of individual provincial governments. And the analysis above suggests that the behaviour of governments is still not predictable enough to create and sustain the necessary trust relationships.

In the context of fiscal federalism, this suggests the need for a new mission statement. This is a tall order, but this chapter has already suggested some of the key elements. First, both orders of government should seek to reduce the number and size of the surprises they spring on the other. One way of doing this is to take seriously the joint planning provisions of SUFA. Joint planning should not, and will not, mean joint design and delivery of social programs. But it can and should mean jointly analyzing the challenges of the sectors, exchanging information that is relevant to those challenges, systematically documenting successes and failures and, where possible, setting objectives together. Individual governments would then be responsible for designing and delivering programs to meet those challenges and objectives. Among other things, this leaves lots of scope for asymmetry in the federation.

Second, the federal government should not attempt to deal with the big structural issues of fiscal federalism in the context of its annual budget cycle. If it does so, there is no real chance that provinces will be equal partners in the decision-making process. The big change to the transfer system in the 1970s was the decision to roll three large cost-shared programs (hospital insurance, medical insurance, and postsecondary education) into a single bloc transfer. This was worked out through a long negotiation between the two orders of government that was not dominated by the annual federal budgetary process. Whatever one thinks of the outcome, it was the product of both orders of government working together. This was different than the more or less unilateral processes that led to the cap on CAP and CHST and that have so poisoned intergovernmental relations since their implementation. Without this kind of shift in internal federal budgetary processes, joint planning at the sectoral level will be dysfunctional.

Third, there is a need to imbed the idea of mutual respect between the two orders of government. Not only is this necessary for functional reasons, it is also what the public wants, as evidenced in polling data.

Finally, the mission statement should confirm the importance of both equity and efficiency goals. Each is essential for a balanced public policy. It is important, however, to articulate what these commitments may mean in the year 2000. For example, the postwar federal-provincial tax rental and tax-collection agreements were linked to particular public purposes. These included a big role for federal fiscal policy in macroeconomic stabilization, achieving tax harmonization for purposes of economic efficiency; and Ottawa's perceived need to maintain a strong revenue position to help fund a more equitable post-war society. The first of these purposes is no longer present today. As for the second, it may remain but with growing north-south economic integration, it needs to be spelled out in a way that reflects current circumstances. In this regard, the recently reformed tax-collection agreements may be adequate for this purpose but this remains to be seen. Even the third goal merits re-examination to capture contemporary thinking about the shifting roles of security and opportunity in the Canadian social security system.

These four elements fall far short of a full statement of principles. And they in no way speak to the substance of policy content. If governments committed effectively to them, however, this would help to build the trust relations that are required to fashion a modern system of fiscal federalism which advances policy goals, supports democratic values, and respects the very idea of a federal state.

Notice that the statement does not imply that the current balance between orders of government is appropriate. Rather, what happens to centralization/decentralization will be an outcome of implementing a set of principles and agreed processes and not an end in itself. And sorting out the size of vertical imbalances will be at least in part a result of careful analysis about the efficiency and equity impacts of sustaining current imbalances relative to reducing them. That there is controversy about this issue will be seen in the different chapters in this volume.

Such a new mission statement would be constructed on top of the one element of fiscal federalism that is apparently not controversial, namely, the commitment to equalization. This commitment is not only imbedded in the constitution, the wealthier provinces as well as the federal government also support it politically. Governments of wealthier provinces often question whether an equalization component should be included in programs other than the formal Equalization program, but they are consistent in support of some substantial program to meet the equalization objectives set out in the constitution.

If Ottawa and the provinces are unable to agree on the role and purpose of fiscal federalism for the new century, the price will be large. Friction among governments within the federation will grow. National purpose will be eroded. Equity and efficiency goals will be undermined. The price of inaction could be huge.

The Social Union Framework Agreement provides that the governments involved will undertake a full review of the agreement and its implementation by the end of its third year. We are about halfway there in the middle of the year 2000. This is an important opportunity for beginning the task of renewing not only the governance structures and rules around the safety net but also the closely related system of fiscal federalism. This should be a priority item in the public policy agenda of the next few years.

## NOTES

I would like to thank John McLean, Research Associate at the Institute of Intergovernmental Relations, Queen's University, for his extensive research assistance, especially in compiling the fiscal data.



1. For a fuller statement of this argument, see Harvey Lazar and Tom McIntosh, "How Canadians Connect: State, Economy, Citizenship and Society," *Canada: The State of the Federation, 1998/99: How Canadians Connect* (Kingston: Institute of Intergovernmental Relations, Queen's University, 1999), pp. 25-30.
2. The assertion that a clear mission statement is lacking requires a brief elaboration. First, the missing "mission statement" need not necessarily be a formal mission statement. Second, I am not asserting that governments do not, from time to time, make statements that appear to convey an overarching sense of purpose. At any point in time, there may be, for example, a federal government declaration that has coherence. As for provincial governments, they have in recent years issued some excellent papers on fiscal federalism. My argument is that over the last two decades there have been insufficient consistency and coherence in fiscal federalism to the point where neither order of government can have confidence about the limits within which the other order of government may act.
3. I would include in this group Paul Boothe, Tom Courchene, John Richards, and Bill Robson. Alain Noël has also made the case that there is no automatic link between more centralized approaches to governance and a social democratic perspective, on the one hand, and a more decentralized approach and fiscal/economic conservatism, on the other. See "Is Decentralization Conservative? Federalism and the Contemporary Debate on the Canadian Welfare State," in *Stretching the Federation: The Art of the State in Canada*, ed. Robert Young (Kingston: Institute of Intergovernmental Relations, Queen's University, 1999).
4. I am aware that the last two paragraphs oversimplify the differences among political and academic commentators.
5. Prior to the enactment of the *Old Age Security Act*, there was an income-tested state pension available under the 1927 *Old Age Pensions Act*. This provided for provincial administration of pensions, but with the then Dominion (i.e., federal) government paying one-half.
6. Section 94A of the *Constitution Act* was amended in 1964. The amendment allowed the Parliament of Canada to "make laws in relation to old age pensions and supplementary benefits" but with the qualification that no such federal law "shall affect the operation of any law present or future of a provincial legislature in relation to any such matter."
7. The Government of Saskatchewan introduced publicly insured hospital and medical services before the federal government acted.
8. The case by no means disappeared, however, given the role of tax harmonization in promoting economic and administrative efficiency and equity.
9. There are different dimensions to centralization/decentralization. I state that the peak "perhaps" was reached in 1982 because of the constitutional amendments then. I consciously leave this ambiguity since, from a fiscal federalism perspective, the peak was reached in the mid- to late 1960s.
10. I chose this date since, as noted in the main body of the text, the middle of the 1960s was the period when federal government initiatives led to several major

social programs. They included the federal-provincial agreements to provide public insurance for medical services, to create a single shared-cost program for needs-related provincial programs (the Canada Assistance Plan), to create the Canada and Quebec Pension Plans, and to expand Canada's postsecondary education systems. Once these initiatives were taken, it was inevitable that provincial program costs and revenue needs would grow rapidly.

11. If local governments are included, and under the Canadian constitution they are creatures of the provinces, combined provincial and local program spending increased from around 14 percent of GDP in 1960 to 24-25 percent of GDP by 1990. These figures are from Department of Finance, *Fiscal Reference Tables*, Table 30.
12. If provinces fail to meet the principles, the federal government may penalize the province by reducing its cash transfer. The principles include: universality, accessibility, comprehensiveness, portability, and public administration.
13. Section 6 of the SUFA appears to subject the "interpretation of the Canada Health Act principles" to the collaborative dispute avoidance and resolution provisions of that agreement but there is no public indication to date about how this is to be implemented.
14. Some of these actions were taken only after extensive negotiation with the provinces (as with child benefits). In other cases, negotiation with the provinces has been focused on how to jointly implement the federal initiative (such as scholarships).
15. *The Canadian Social Union Without Quebec: 8 Critical Analyses* (Montreal: Institute for Research on Public Policy, 2000).
16. The federal constitutional powers that were important in constructing the welfare state also included the authority to operate a system of unemployment insurance and the authority to make laws in relation to old age pensions and supplementary benefits (but with provincial powers in this area having paramountcy).
17. James Rice and Michael Prince, *Changing Politics of Canadian Social Policy* (Toronto: University of Toronto Press, 1999), pp. 54-80.
18. One example of what was achieved is illustrated by trends in the distribution of income in Canada relative to other countries. Over the last 20 to 30 years, labour market earnings have become more polarized and more unequal in virtually all advanced capitalist economies, including Canada. In general, the result has been that the distribution of disposable family income (i.e., after-tax, after-transfer family incomes) also became more widely dispersed. However, in Canada, thanks to an effective system of transfers and taxes, the distribution of Canadian family incomes managed to remain remarkably stable. This is one of the central messages in Chapter 8 by Lars Osberg.
19. *The Constitution Act*, sub-sections 36 (1) and 36 (2).
20. *Ibid.*, sub-section 36 (2).
21. Serge Coulombe, *Economic Growth and Provincial Disparity* (Toronto: C.D. Howe Institute, 1999).

22. See Thomas J. Courchene with Colin R. Telmer, *From Heartland to North American Region State: The Social, Fiscal, and Federal Evolution of Ontario* (Toronto: Centre for Public Management, Faculty of Management, University of Toronto, 1998). In *Canada: The State of the Federation 1998/99: How Canadians Connect* (Kingston: Institute of Intergovernmental Relations, 1999) John F. Helliwell provides convincing evidence of the much greater density of economic linkages between the regions of Canada than between the Canadian regions and the United States. See Chapter 4. However, this does not deny that the growth rate in north-south linkages is much faster than the growth rate in east-west ties.
23. This assertion does not preclude the governments of wealthier provinces supporting Equalization payments for reasons other than economic self-interest.
24. The cap on CAP was intended to help protect the most vulnerable provinces during a period of fiscal restraint. The federal government decision to carry forward the legacy of this measure in the form of unequal per capita provincial CHST payments during the first few years of CHST can also be seen as a continuation of that policy. While this is evidence of federal concern to protect the most vulnerable regions, the ending of CAP as a distinctive policy has virtually ensured that the focus of provincial expenditure would shift to programs that do not involve the poorest of Canadians. More generally, the federal reductions in cash transfers, and in planned increases, associated with major transfers for health, education, and welfare over a period of years has weakened the equity goal.
25. See, for example, John Richards, "Reducing the Muddle in the Middle: Three Propositions for Running the Welfare State," in *Canada: The State of the Federation 1997: Non-Constitutional Renewal*, ed. Harvey Lazar (Kingston: Institute of Intergovernmental Relations, Queen's University, 1998).
26. The federal government offered to abate tax points to the provinces in the mid-1960s, in conjunction with the growth of shared-cost programs. Quebec took up the federal offer in 1965. The other provinces took up abatements for personal and corporate income tax in 1967.
27. In effect, this has enabled provinces to retain the efficiency benefits of having a central revenue collection agency while obtaining autonomy to design their own personal income tax systems.
28. When the federal government changes its personal income tax rates, this will no longer automatically impact on provincial income tax revenues. However, if the federal government adjusts the tax base, this will impact provincial revenues unless the province explicitly offsets the federal change by altering its tax rates or other elements of the tax structure that it is now free to shape, like credits.
29. While Quebec nationalists, both federalist and secessionist, often argue that Ottawa's incursions and provocations help to fuel support for an independent Quebec, it is difficult to know whether an entirely different federal strategy would have meant a weaker separatist movement. In this regard, it is noteworthy that the federal Royal Commission on Bilingualism and Biculturalism was appointed in 1963, well before many of the so-called federal provocations. A re-reading of that report, or of Quebec's Tremblay Report (Report of the Royal Commission

- of Inquiry on Constitutional Problems, 1956), makes clear that Quebec nationalism was alive and well in the early postwar years.
30. Smiley uses this term and makes comments on the development of executive federalism in Donald Smiley, *Constitutional Adaptation and Canadian Federalism Since 1945* (Ottawa: Queen's Printer, 1970). For Donald Smiley's criticisms of executive federalism, see Donald Smiley, "An Outsider's Observations of Federal-Provincial Relations among Consenting Adults," in *Confrontation and Collaboration: Intergovernmental Relations in Canada Today*, ed. Richard Simeon (Toronto: The Institute of Public Administration of Canada, 1979), pp. 103-13. For another criticism of cooperative federalism, see Albert Breton, "Supplementary Statement," in *Report of the Royal Commission on the Economic Union and Development Prospects for Canada*, Vol. 3 (Ottawa: Supply and Services Canada, 1985), pp. 486-526.
  31. Mathew Mendelsohn and John McLean, "SUFA's Double Vision: Citizen Engagement and Intergovernmental Collaboration," *Policy Options* (April 2000):43-45.
  32. For a survey of the various models of democracy, see David Held, *Models of Democracy* (Stanford: Stanford University Press, 1987).
  33. This argument does not prevent the federal government from using the federal budget process for introducing the resolutions that would lead to the necessary legislation to enact major changes in fiscal federalism. But the substantive content would have been discussed thoroughly with the provinces and debated publicly and in Parliament before the budget action.
  34. They were on the back burner except in the sense that the Meech and Charlottetown Accords attempted to deal with issues like the federal spending power.
  35. For a crisp chronology of federal cuts to planned transfers, see Thomas J. Courchene, *Redistributing Money and Power: A Guide to the Canada Health and Social Transfer*, Appendix A (Toronto: C.D. Howe Institute, 1995).
  36. It is possible that these federal reductions in planned levels of transfers did not cause a major controversy with the provinces for at least three reasons. The federal transfers were still growing. Second, provinces were aware that fiscal restraint was becoming increasingly necessary. Third, the constitutional file was at the political forefront.
  37. Budget Speech, 27 February 1995, p. 17.
  38. This view essentially held that the federal CAP bureaucracy and the regulations it administered was impeding provincial innovation in welfare programs.
  39. It is, of course, arguable that there is absolutely no link between the CHST and provincial health spending. Federal money flows into the consolidated revenue funds of provinces and then flows out based on provincial priorities. Even the 1999 Health Accord between provincial governments and Ottawa is more about political symbolism than ensuring that federal "health dollars" are spent on health by provinces.

40. One example is that the federal government allowed large per capita discrepancies among provinces in the dollar amounts it was distributing for CAP. This per capita differential was rolled over and absorbed into CHST. The 1999 federal budget announced that CHST entitlements would be equal per capita beginning in 2001/2002. Thus, Ottawa has shifted from a transfer system that was partly needs-related (the CAP years), to one where need was arguably accentuated even more (the cap on CAP years because the least wealthy provinces were spared the CAP cuts) to one where need is not recognized (the equal per capita transfer in CHST that is coming).
41. For a fuller definition and discussion of collaborative federalism, see Harvey Lazar, "The Federal Role in a New Social Union," in *Canada: The State of the Federation 1997: Non-Constitutional Renewal*, ed. Harvey Lazar (Kingston: Institute of Intergovernmental Relations, Queen's University, 1998).
42. Liberal Party of Canada, *Securing our Future Together*, 1997, p 19.
43. Speech by Honourable Stéphane Dion, 22 April 1999.

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## Recent Developments in the Economics of Federalism

Robin Boadway

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*Ce chapitre présente une revue de la littérature internationale récente sur le fédéralisme fiscal et des leçons qu'elle offre au cas canadien. On souligne, en premier lieu, les gains que la formation d'une fédération offre aux États membres, en particulier quant au marché commun interne et à la citoyenneté. De plus, on met en évidence l'attrait puissant qu'exerce la décentralisation des services publics aux juridictions internes pour des raisons d'efficacité. Une telle décentralisation peut, néanmoins, avoir des conséquences négatives en matière d'efficacité et d'équité dans une économie fédérale. Les effets négatifs sur l'efficacité proviennent du fait que la décentralisation crée des disparités fiscales et que la prise de décision de manière décentralisée peut mener à des chevauchements interjuridictionnels. Les effets négatifs sur l'équité proviennent eux aussi des disparités fiscales, mais aussi de l'importance des instruments politiques provinciaux en matière d'équité. Le rôle des ententes fiscales est d'éviter ces problèmes d'efficacité et d'inégalité qui accompagnent la décentralisation des responsabilités fiscales aux provinces, ce qui, par le fait même, facilite la décentralisation. Certaines caractéristiques des ententes fiscales pouvant mener à une fédération plus équitable et plus efficace sont évaluées, notamment la péréquation, l'utilisation conditionnelle du pouvoir de dépenser, l'harmonisation des politiques ainsi que les processus qui permettent d'obtenir une meilleure coopération.*

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### INTRODUCTION

There is a growing interest among economists in issues of fiscal federalism. Much of the impetus comes from institutional changes faced by various governments around the world. Examples include the development of the European Union as an instrument for joint economic decision-making and the implications that has for the European nation-state; the requirement of the transitional economies to establish public sector institutions to replace state firms as providers of public services; and the need for rapidly developing countries to

begin to provide public services that are traditionally provided by subnational governments. As well, the fiscal pressure faced by many governments in an increasingly competitive international environment has sparked a general interest in decentralization as a means of improving the effectiveness of public sector decision-making. Not surprisingly, the key features of the Canadian model have received much attention — our allocation of responsibilities, our evolving fiscal decentralization, and the main elements of our fiscal arrangements (equalization, tax harmonization, and the spending power).

Along with this interest has come an explosion of academic research on fiscal federalism, especially among Europeans, in a field that has traditionally been the preserve of the established federations. Modern instruments of economic analysis have been brought to bear on the issue of how governments do and should interact in multi-government settings. The models used mirror many of the models of economic analysis that have been developed in the postwar period. Simple game-theoretic models have been used to capture the outcomes of independent decision-making by governments in a federation. The principal-agent perspective and issues of commitment and time consistency have focused on the importance of the timing of decisions by various levels of government. The problems posed by public choice considerations and the opportunity for decentralized decision-making to overcome them have been studied. The preoccupation with constraints on economic policies resulting from the fact that policymakers have imperfect information about those whom the policies are intended to affect is of obvious relevance for decentralization: lower levels of government may be better informed about their citizens' wants, needs, and opportunities than are higher levels. The role of governments in shedding the risks faced by individuals by the provision of social insurance is of relevance for federalism insofar as risks might be more completely shared by higher levels of government. More generally, the level of government involved can affect the efficacy of delivering redistributive policies, which account for a substantial proportion of policies that governments undertake.

The literature on fiscal federalism is large and has led to many interesting and suggestive phenomena at the theoretical level which could serve to inform policy analysts. But it also has some shortcomings. Most of the work is theoretical, with very little empirical testing or substantiation. This reflects the natural difficulty of empirically testing models of government behaviour: policy changes are not frequent, they have potentially broad-ranging effects, and formulating the appropriate behavioural model to test is difficult if not impossible. The theoretical models, like many economic models, tend to be highly abstract, chosen so as to highlight particular phenomena of interest to the exclusion of others. There is a general tendency to ignore institutions and the complexities they impose, and also to ignore process. Models of political choice are beginning to be used; indeed, they are very much in fashion at the

moment. But they are often fairly rudimentary: ranging from simple median voting models to rather more sophisticated political competition models to crude Leviathan models of government as predator. Nonetheless, they do capture some overriding influences that economists think to be important.

The purpose of this chapter is to provide an overview of the sorts of things that economists have been exploring in their study of the economics of federalism. The recent literature has not focused much on issues of Canadian concern. Nonetheless, some implications might be drawn. One does, however, come away from the economic literature with the firm feeling that no definitive prescriptions are possible. Anyone who suggests otherwise is probably reading more into the literature than is there. We proceed as follows. The following section provides a brief summary of the main message of the chapter, introducing some key concepts that will be explored in more detail in later sections. The next section provides two perspectives from which the economic consequences of federalism can be judged. One involves considering the gains that can be achieved by previously separate entities joining in a federation, while the other involves the opposite conceptual exercise of evaluating the gains from decentralization beginning from a unitary nation. Different lessons can be learned from adopting these two perspectives. The fourth and fifth sections consider in more detail the efficiency and equity effects of decentralizing fiscal responsibility in a federation, these being the two main criteria used by economists for evaluating any economic policies or institutions. Section six considers the consequences that these efficiency and equity effects have for the design of fiscal arrangements, including the size and structure of federal-provincial transfers and the various elements of policy harmonization. The final section then provides some comments on the implications that economic considerations might have for some of the current issues facing the Canadian federal fiscal system, especially with respect to the ongoing debate over decentralization. These comments are necessarily speculative and represent but one observer's judgement.

## A SUMMARY OF THE MAIN MESSAGE

To put issues into perspective, it is worth briefly summarizing what have been the main preoccupations in the fiscal federalism literature. The analysis focuses largely on two issues. The first is that in an interdependent world in which governments act in the interest of their own residents, decisions taken by one government will inevitably impose spillover effects on residents of other jurisdictions. The second is that in a federation, there are both benefits and costs of decentralizing fiscal responsibilities to lower-level jurisdictions, and there is no unambiguous "optimal" degree of decentralization. Both the fact of fiscal externalities and the desire to achieve the benefits of decentralization have



consequences for the role of the federal government as a coordinating institution. Resolving the role of the federal government turns out to be especially contentious when one recognizes that much of what is at stake revolves around the redistribution function that governments perform.

To be more specific, the main message of the literature is as follows. In nations with regionally diverse economies, there are sound economic arguments for decentralizing fiscal responsibilities to the provinces. This is especially true in the case of providing local public goods and public services that must be delivered to households and firms. At the same time, decentralizing the responsibility for raising revenue is not valuable in its own right, but mainly as a way of facilitating responsible fiscal decision-making at the provincial level. Put differently, the case for decentralizing expenditure responsibilities is much stronger than for decentralizing taxation.

The decentralization of fiscal responsibilities entails various spillover costs, what economists refer to as *fiscal externalities*. These fiscal externalities take three main forms. The first are the fiscal inefficiencies and inequities that arise from the fact that decentralization per se creates different fiscal capacities among provinces to provide public services at comparable tax rates. This implies that the net fiscal benefits (NFBs) that given residents obtain from their jurisdiction — the level of benefits received less the level of taxes paid — differs from what they would receive if they resided elsewhere in the federation. These NFB differentials create both fiscal incentives for firms and households to relocate (*fiscal inefficiency*) and horizontal inequities among those who stay put in the sense that otherwise like people are treated differently solely on the basis of their province of residence (*fiscal inequity*).

The second forms of fiscal externalities are the so-called *horizontal fiscal externalities*. These arise on the one hand from tax and expenditure competition, whereby one province's fiscal decisions serve partly to achieve its objectives at the expense of other provinces. For example, tax incentives serve to attract businesses from neighbouring jurisdictions or a reduction in welfare rates induces the poor to move elsewhere. On the other hand, a province may be able to export part of the burden of its fiscal policies to the residents of another jurisdiction. Horizontal fiscal externalities can on balance be positive or negative; that is, they can provide an incentive for provincial governments to set too high or too low a level of taxes and expenditures. Moreover, by interfering with the allocation of resources across the federation, they can be the source of inefficiencies in the internal economic union.

The third forms of fiscal externalities are *vertical fiscal externalities* whereby provincial governments can export part of their tax and expenditure burdens to the federal government. For example, increases in the rate of a tax will have as one of its effects a reduction in the tax base to which the tax applies. If the federal government occupies the same tax base, it will suffer a loss in

revenues, which ought to be treated as part of the cost of the tax. Again, there will be an incentive for the provinces to adopt fiscal policies that may be non-optimal from a national point of view.

These disadvantages constitute the *limits to decentralization*. Although the limits are elastic, they do provide the rationale for provisions to offset the adverse consequences of decentralization, such as constitutional limitations on provincial policies or the ability of the federal government to enact policies to correct these fiscal externalities. Indeed, the fiscal arrangements, which encompass the financial relations between the federal and provincial governments, can be viewed as devices for facilitating the benefits of decentralization while reducing their costs. Greater decentralization puts more onus on the fiscal arrangements, and, perhaps paradoxically, more responsibility for managing the federation in the hands of the federal government.

The fiscal arrangements can include many components. In addition to the day-to-day financial relations between the federal and provincial governments and policy coordination agreements for various taxes and expenditure programs, there are the underlying constitutional and political constraints that govern the spheres of action of the various jurisdictions. These might include an overriding set of principles outlining some key functions of the various levels of government — a statement of citizen rights, the basic obligations or objectives of governments to pursue equity, the free flow of persons, capital, goods and services among jurisdictions, etc. Next, there might be a judicious division of legislative responsibilities between levels of government, including especially those for the delivery of important public services, transfers, and social insurance programs. Finally, there might be provisions that serve to resolve conflicts between governments or enable the federal government to facilitate the achievement of national objectives when provincial actions have national consequences. First and foremost might be a provision for the use of the spending power, which to an economist can be an effective instrument for achieving the benefits of decentralization without incurring the costs. But in many jurisdictions, more forceful means of federal oversight are contemplated, such as the ability to impose mandates on lower-level jurisdictions and the power to disallow their legislation. There is always the possibility to resolve interjurisdictional disputes and to achieve common national objectives by voluntary agreements among the provinces with or without the connivance of the federal government. But, while good in theory, voluntary agreements have proven to be elusive in practice because of the well-known problems of securing binding agreements among independent governments. The Canadian constitution is somewhat remarkable in the assignment of responsibilities, in its statements of obligations, and in the way it condones the essential elements of sensible fiscal arrangements.

In the end, there is a trade-off between the perceived benefits of decentralization and its costs, and with the extent of activism that the federal government should engage in to ensure that decentralization does not compromise national objectives. Where one comes down on that trade-off depends on a mixture of judgements and values. Most important is one's attitude toward the role and responsibilities of government in pursuing redistributive equity. Most of the arguments for national oversight rest in the end with the federal government's responsibility for redistributive equity. As well, arguments for decentralization depend in part on one's attitude toward the benevolence of government. Some observers see decentralization as a way of taming a rapacious government, intent on aggrandizing itself and its policy interventions at the expense of the private sector. Finally, arguments for decentralization will be informed by one's judgement about the way the economy works: How mobile are individuals and firms between jurisdictions? How elastic are tax bases? How important are externalities? How tight is the equity-efficiency trade-off? The fact is that there is no scientific answer to the question of the optimal degree of decentralization. Strength of conviction about decentralization undoubtedly reflects some underlying conviction about the role of government in the economy and the extent of benevolence that governments exhibit.

## VIEWS OF THE ROLE OF A FEDERATION

Economists view the role of a federation through an economics prism, concentrating largely on the economic consequences of regions participating in a federation, and of the organization of public sector decision-making in a federation. There are two perspectives that one can adopt — the *bottom-up* and the *top-down* — and they emphasize somewhat different aspects of the economic consequences of federalism. The bottom-up approach focuses on the gains that regions obtain by joining a federation and succumbing to some common policy instruments. The latter begins conceptually with a centralized, or unitary, state and asks what is to be gained by decentralization. Lessons for actual federations can be learned from both these approaches.

### THE BOTTOM-UP VIEW: THE GAINS FROM FEDERATING

Participating in a federation entails both breaking down borders and extending common citizenship to all members of the broader nation. This yields a number of potential gains.

*Access to the Internal Economic Union.* To the extent that a border is an economic barrier, the formation of a federation secures freer access to a larger

market for goods, services, labour, and capital. As well, since a federation operates under a common currency, the benefits of monetary union are obtained, especially the reduction in uncertainty facing cross-border traders. This leads to gains from trade of the standard sorts.

Many of the benefits of the enlarged common market can be achieved without forming a federation. For example, countries can participate in free trade agreements (NAFTA) or economic unions (EU), and secure many of the advantages of enlarged markets. But, there are two aspects of federations that are difficult to replicate in economic unions of sovereign states. First, in a federation, all persons are citizens of the nation and enjoy the rights to reside and work where they choose. While economic unions might agree to the free mobility of labour among member states, it is undoubtedly the case that this falls short of the rights of citizenship that exist in a federation. We return to the implications of this below.

Second, federations have a consequential federal government with its own independent legislative authority, while economic unions do not. This implies that a level of government exists which can tend to issues of nationwide interest, without having to rely on the agreement of member states. This might be particularly important in a situation in which regions are joined together in an economic union or common market. The free flow of goods, services, labour, and capital is often thought to impose constraints on regions to engage in independent policies; indeed, this is a common argument with respect to the effects of globalization on policies of nations. Within a federation, this need not be a concern. There is a federal government role which is precisely to facilitate the ability of the regions to achieve their objectives in the face of pressure from neighbouring jurisdictions. Moreover, one of the acknowledged roles of the federal government in many federations is to enhance the efficiency of the internal common market by working against pressures that might exist for provinces to impose barriers of the free flow of products, labour, capital, and firms into and out of their jurisdictions.

*Common Public Goods and Economies of Scale.* Federations are able to provide federation-wide public goods and exploit economies of scale that might exist in the provision of public services or tax-transfer programs. Examples include defence arrangements, systems of justice, banking and monetary arrangements, management of the waterways, and environmental protection. Again, this is something that could potentially be accomplished by common assent by nation-states within an economic union. But it is clear that the unanimous agreement which would be needed to initiate and maintain suitable levels of national contribution to common public goods and to exploit economies of scale is very difficult to come by. A federal government is in a much better position to accomplish such a task.

*Risk-Sharing against Regional Shocks.* A traditional argument for federating, and one that has been prominent in the European literature, is that participation in a federation provides a form of insurance to regions against adverse macroeconomic shocks. Regions can use capital markets to self-insure to some extent. But, the ability to shed the risk of adverse shocks seems quite limited, perhaps because governments are not far-sighted enough to use debt reliably for such purposes.

There are various ways that federations can provide insurance to their regions against adverse shocks. The fact that regions are part of a common market implies that the adjustment to shocks might be smoother than it would be if they were more self-sufficient: workers who lose their jobs can move to neighbouring regions; capital can flow in relatively quickly, etc. Federal government tax-transfer programs implicitly provide insurance to regions. A common income tax system applies, which means that if incomes fall, so do tax liabilities; and, by the same token, transfers rise. Finally, the system of federal-provincial transfers will typically have a component that insures provinces against shortfalls in their revenues. In Canada, the Equalization program (and previously the Canada Assistance Plan) has that effect.

*Citizenship/Equity/Sharing Benefits.* Perhaps the most important, as well as the most controversial, consequence of joining a federation is that a region's citizens assume citizenship in a broader nation. What citizenship entails is a matter of judgement. One view of the economic content of citizenship is that at a minimum it carries with it the right to horizontally equitable treatment, that is, the right to be treated equally with others of like circumstances regardless of the province of residence. This is a right that is virtually taken for granted in unitary states, where the central government agenda dominates. It is somewhat more difficult to accomplish in a federation, but serves as one of the prevalent aims of federalism, one that is enshrined in the Canadian constitution.

The importance of the principle of horizontal equity derives from the fact that much of what governments do is redistributive in nature, as we shall repeatedly stress in what follows. Moreover, in a federation, this also applies to provincial levels of government. Extending the principle of equal treatment of equals to a federal setting is not a trivial undertaking, especially in a decentralized federation. It is not a value that will be shared by all, especially in a federation where provinces have systematically differing levels of per capita income and perhaps different community make-ups. Applying the principle of horizontal equity means that not all participating communities will gain: some will persistently be net contributors and some will be net recipients. Moreover, one of the key lessons from the Canadian experience is that decentralization, to which we turn next, makes it more difficult to satisfy the principle of equal treatment of equals.

## THE TOP-DOWN VIEW: THE GAINS FROM DECENTRALIZING

The bottom-up view is useful for reminding us of what might be expected from being a member of a federation. The most pressing federalism policies of the day, however, come from adopting the top-down perspective. The issue here is what economic responsibilities to decentralize to lower levels of government. It is in the nature of their discipline that economists favour decentralization of economic decision-making. The analogue with the private sector is compelling. It is an article of faith that decentralization of decisions in the private sector to the lowest level of agents (households and firms) is efficiency-enhancing. Incentives are better, lower-level agents are better informed, and property rights are exercised more responsibly. There has been a tendency to transplant similar arguments to the public sector, and the arguments are almost as compelling, at least from an efficiency perspective. A summary of the economic arguments for decentralization follows.<sup>1</sup>

*Catering to Local Preferences and Needs.* The classic argument for decentralization is that different communities have different demands for types and levels of public goods and services.<sup>2</sup> These may simply come from personal preferences of the residents themselves, or they may come from more objective factors such as geographical differences (terrain, population density, etc.), demographic differences (age structure of the population), or relative price/cost differences. The presumption is that central provision will be uniform, so that efficiency could be improved if local communities were allowed to provide their own local public goods and services.

The famous model of Tiebout went one step further and argued that the make-up of communities themselves was endogenous, and that decentralized decision-making would facilitate the formation of optimal mixes of communities.<sup>3</sup> There would be a natural tendency for persons with similar preferences to congregate together, and this would induce local governments acting competitively to provide efficient levels of public goods and services for their residents. While there is a grain of truth in the Tiebout view of federal economies, the literal acceptance of the Tiebout hypothesis has been largely discredited. For one thing, mobility among communities or provinces is nowhere near the magnitude required to generate optimal communities, with the possible exception of intra-city mobility. As well, the Tiebout model was too simplistic and one-dimensional. It turned out to be fairly simply to formulate Tiebout-type models in which either equilibrium did not exist (households would always want to move elsewhere) or if they did, they would be inefficient. Indeed, the existence of zoning laws is evidence that in the context of cities, unfettered mobility of households and firms is not likely to result in acceptable outcomes.

Nonetheless, the main message of the Tiebout model is a powerful one. In the face of heterogeneous communities, decentralized decisionmakers constrained by the need to cater to potentially mobile households and firms will strive to provide the best mix of public goods and services for their residents that they can. Against this must be set three considerations. First, its message is really meant only to apply to public goods and services that serve community residents. Many public programs have benefits that are further flung than that, which implies that spillover effects will occur which will limit the efficiency of decentralized decision-making, an issue we return to below.

Second, catering to local preferences can conflict with the efficiency of the internal economic union. Different communities may have different preferences concerning environmental degradation, product safety, cultural protection, labour standards, and so on. These might lead to policies that interfere with the free flow of products and factors across borders.

Third, profound issues arise with respect to the redistributive dimension of local programs. Different communities may have different preferences for redistribution, not only relative to each other but also relative to the national government. An unavoidable conflict arises as to which level's preferences will prevail. The resolution of this conflict necessarily involves a compromise, perhaps the most important of the many compromises that constitute an interdependent federal system of government. The extent to which federal versus provincial preferences for redistribution prevails depends on how decentralized the federal system is. Roughly speaking, the more decentralization, the more scope there is for federal and provincial redistribution policies to be in conflict. As we shall see, this possibility for conflict over redistribution is a key determinant of the desired extent of decentralization, and is also an important consideration in designing fiscal arrangements for an already decentralized system.

*Information Asymmetries.* There are some spheres of policy-making in which lower-level jurisdictions may be better informed and therefore better able to provide public services effectively. We have already mentioned the advantage they may have in knowing the preferences and needs of local residents to determine the optimal amounts of public goods and services to provide. As prominent in the literature have been the information issues associated with administering public programs and delivering public services. Such programs are typically delivered by agencies on the ground (public, private, or non-profit). These agencies are not subject to the profit motive so have to be monitored by the public sector. This gives rise to standard "agency problems" of management and control.<sup>4</sup>

One such problem, analogous to the *adverse selection* in insurance contexts, is that agencies serving different populations may have systematically different costs of delivery.<sup>5</sup> If the bureaucracy does not know these costs

precisely, it is not clear how much funding is required to run the agency. For example, what are the costs of running a school in a high-income neighbourhood relative to a deprived one? If that is not known, the result is that resources might be wasted. It is argued that lower-level governments may be better able to monitor the true costs of providing such public services.

Another problem is analogous to *moral hazard*.<sup>6</sup> It may be difficult to monitor the effort that providers of public services are putting out, and it may be difficult to ensure that they are targeting the services to the intended population. Programs like unemployment insurance, disability benefits or welfare are intended for particular groups, and may be contingent on those groups satisfying some conditions (searching for work, taking training, etc.). Again, in the absence of careful monitoring, this is likely to lead to significant waste. Lower-level governments may have an advantage at such monitoring.

Finally, decentralization may itself reduce the administrative costs of delivering services by cutting down the number of layers of bureaucracy. This constitutes a further argument for decentralization.

These information-based arguments are relatively powerful ones in a world where administrative costs are an important part of the costs of delivering some programs. They apply with much more force to public services that are delivered to persons or firms than to large-scale transfer programs or to tax collection, for which there may be significant economies of scale. Indeed, many of the arguments for decentralization have that feature. It is therefore not surprising that in many federations the delivery of public services is much more decentralized than the system of taxes and transfers.

To anticipate a line of argument to be taken up later, these arguments for decentralization are based on efficiency considerations. Many of the important public services that provinces provide have an important equity dimension — examples of health, education, and welfare come immediately to mind. The federal government may therefore have an interest in how well and at what level the services are delivered. If decentralization were unaccompanied by other measures, independent-acting provincial governments might well design their programs in ways that do not satisfy national norms of equity. One role of the fiscal arrangements is to address this issue.

*Innovation and Cost-Effectiveness in Public Programs.* Decentralization may lead to improvements in program design and program delivery because of the opportunities and constraints faced by lower-level decisionmakers. Because there are many provinces, perhaps in competition with one another, there are more opportunities for innovations in program design and delivery to occur. And, once improvements do occur, other jurisdictions can imitate them.

The existence of neighbouring jurisdictions can itself have a salutary effect on service delivery. Yardsticks for delivery costs will become available which will serve to discipline a given jurisdiction. And such mobility as there is will



induce lower-level jurisdictions to deliver their services in a cost-effective way. Of course, such competition may have its downside as well, an issue to which we return in the next section.

*Political Economy Arguments.* Public choice economists are prone to use market analogies to judge public sector outcomes. They see political competition induced by decentralization to be a force for greater efficiency.<sup>7</sup> The arguments are not always fully articulated in an economic model and they are sometimes difficult to substantiate, but they have some intuitive plausibility. A common notion of political competition is based on the Tiebout-type presumption that households and firms, especially desirable ones, are mobile across jurisdictions. This constrains competing governments from excessively high tax rates or public service levels. Of course, this argument can cut both ways. Given that it might be the better-off households that are the most mobile, competitively reduced levels of public programs may make it more difficult to achieve redistribution objectives. This is why decentralization is often identified with those who wish to constrain government's ability to redistribute.

An extreme form of this argument is based on the notion that governments are essentially self-serving Leviathans intent on aggrandizing themselves at the public's expense. In the well-known version of Brennan and Buchanan, governments maximize their size.<sup>8</sup> Decentralization can serve to tame the Leviathan by constraining the ability of the government from extracting resources from an unwitting electorate.<sup>9</sup> This argument, too, relies on interjurisdictional mobility as the source of the constraint: firms and households can exercise their exit option.

Political economy arguments also come in other forms. A common argument is that lower-level governments are more "accountable" because they are "closer to the electorate." Political accountability might be enhanced by decentralization because it is possible to identify given public programs with given levels of government, and given tax dollars with given expenditures. But, the accountability argument is not a clear-cut one. There is no compelling evidence that lower levels of government are more accountable to their electorates. In fact, given that the glare of media publicity is typically directed at the central government, one could argue just the opposite. Moreover, one could also argue that the lines of responsibility get blurred rather than clarified as one decentralizes responsibilities.

A final political economy consideration concerns the effect of decentralization on anti-social political behaviour — rent-seeking, influence peddling or outright corruption. It is argued that decentralization reduces the possibilities for such behaviour, perhaps by reducing the size of the rewards for engaging in it.<sup>10</sup>

*Decentralization as an Antidote to Time Inconsistency.* In the economics literature, a major source of inefficient government decision-making arises because of the so-called *time-inconsistency problem*, which typically leads to excessive government taxation and spending. Unlike with many public choice explanations for excessive government, this one applies even if governments are fully benevolent. It arises essentially because of the inability of governments to be able to abide by long-term commitments. If a government announces a policy that has long-run effects, it will presumably want to take account of all the long-run consequences of it, especially the effect it has on the long-run decisions of its residents. However, once time has passed, and firms or households have committed themselves to long-run decisions and cannot undo them, the government will have an incentive to renege on its previously announced policy. For example, taxes on capital will discourage investment and governments would prefer not to implement them at high levels. However, once investment is in place, it is to some extent irreversible. The government has an incentive to levy high tax rates on it. This kind of argument has been used to explain high tax rates on capital and wealth, as well as the tendency of governments to accumulate debt and run down the funds of public pensions, and to bail out declining or inefficient industries. Decentralization and the resultant political competition it induces can serve as an antidote to these tendencies.

## EFFICIENCY EFFECTS OF DECENTRALIZATION

The arguments for decentralization are compelling from the point of view of enhancing the ability of provincial jurisdictions to meet the needs and desires of their constituents as effectively as possible. But decentralization has its adverse consequences. As the literature continually emphasizes, the benefits of decentralization can only be acquired by inducing some *potential* sacrifices in efficiency and equity. Whether those sacrifices are realized depends critically on the complementary measures that accompany decentralization. This section and the next one outline the various consequences that decentralization by itself might have for efficiency and equity in the federal economy, respectively. This will provide the foundations for considering how the fiscal arrangements might be structured to facilitate the achievement of the benefits of decentralization while avoiding adverse effects on efficiency and equity.

There are broadly speaking three main sources of inefficiency: *fiscal inefficiency* arising from the financial consequences of decentralization, *horizontal fiscal externalities* arising from the interaction between provinces, and *vertical fiscal externalities* arising from the interaction between the federal government and the provinces. We consider each in turn.

## FISCAL INEFFICIENCY

In a federation consisting of heterogeneous regions or provinces, fiscal decentralization is likely to lead to fiscal disparities. Different provinces will have different capacities to finance the provision of public services. And different provinces will have different needs to provide public services because of different demographic compositions of the population, different illness rates, and so on. As has been long-recognized, a consequence of this is likely to be that otherwise identical persons residing in two different provinces will receive different *net fiscal benefits* — roughly speaking the value of public services provided to them less the tax price they pay — from their provincial government.<sup>11</sup> A simple example commonly found in the literature supposes that provinces all tax the incomes of their residents at the same proportional tax rate and use the proceeds to provide public services of equal per capita value. In this case, the NFB differential between any two provinces is just the difference in per capita tax revenues, here the tax rate times the difference in average incomes. As Dan Usher has put it, the pool of provincial income is like a common property resource that residents of a province have access to for financing public services.<sup>12</sup> The problem is a unique consequence of decentralization because in a unitary nation the presumption is that all residents of the country have access to the national income pool for tax purposes.

The consequence of NFB differentials is that they provide a fiscal incentive for households and firms to locate in provinces with higher NFBs. Resources may not therefore be allocated according to their most productive uses. The problem can be circumvented if the NFB differences can be neutralized by the fiscal arrangements. As we shall see, this is one of the arguments for equalization grants, though not the most compelling one.

Differences in NFBs can come from various sources. Differences in residents' per capita incomes across provinces are an important one. Differences in source-based tax capacity — that is, business revenues that are taxed at source regardless of ownership, such as resource rents and corporate income — are a source of NFB differentials which can be particularly unequally distributed. On the expenditure side, differences in need are important for determining provincial requirements to finance important public services like education, health, and welfare. Similarly, there will be differences in need for making transfer payments to the less well-off members of society. The relevance of these sources of NFBs depends, of course, on the sorts of responsibilities decentralized to the provinces. Some important types of expenditures that would otherwise lead to differences in need may not be decentralized, such as unemployment insurance. The same might be said for the tax system. In some federations, major sources of resource rents may not be available to the provinces as a source of revenues. Indeed, in some federations there is relatively

little tax decentralization to match expenditures (e.g., Australia, South Africa). In these cases, almost all NFB differentials arise from expenditure needs.

In attributing fiscal inefficiency to decentralization, a number of caveats must be kept in mind.

*Benefit Taxation.* NFB differentials only arise to the extent that persons of a given type do not get benefits commensurate with the taxes they have paid. If all provincial public expenditures were financed by benefit taxation, there would be no NFBs and no fiscal inefficiency from decentralization. But most observers presume that provincial government budgets, like their federal counterparts, are redistributive in nature. That being said, there may be some programs that are financed roughly according to the benefit principle. For example, funded social insurance programs, like workers' compensation might be of that sort. Or, activities financed by user fees or licences, such as fishing, driving an automobile, etc. are close to the benefit principle. No corrective action would be required on account of these.

*Costs versus Needs.* Differences in provincial expenditure requirements to serve persons with different needs are a legitimate source of inefficiency. Differences in the costs of providing public services are not. It may well be inequitable that some persons face higher prices for public services as a result of costs of provision being higher in their province of residence. But if it costs more to provide public services in a region, efficiency in the allocation of resources would require that that not be neutralized.

*Capitalization Effects.* NFB differentials may to some extent be reflected in local property values. If so, their effects on relocation will be offset. Regions with higher NFBs would have correspondingly higher land costs, so there would be no fiscal incentive to move. In effect, for this to happen, all future NFBs must be capitalized into land values implying that their entire benefit went to the landowners sometime in the past. It is unlikely that full capitalization occurs. That would require perfect foresight concerning future government policies, which is hard to imagine. Moreover, it should do no harm to correct for NFB differentials since to the extent that the capitalization hypothesis does apply, the correction will simply be absorbed into further capitalization.

*Empirical Significance.* Quite apart from the capitalization effect possibly rendering NFB differentials ineffective, the empirical significance of fiscally induced relocation may be limited. Migration may simply be very unresponsive to differences in NFBs. Empirical studies have tended to indicate that the effect is limited, though they have usually concentrated on labour migration.<sup>13</sup> It is conceivable that relocation of entrepreneurs, firms, and skilled persons might be more responsive to NFBs than the average worker. As with the capitalization hypothesis, the finding of limited fiscally induced migration turns

out not to be a devastating blow to the case for undoing NFB differentials. As we shall see in the next section, to the extent that efficiency arguments do not apply, equity ones do. It is one of the relatively few instances in economic policy that efficiency and equity arguments are self-reinforcing.

*Equalizing NFBs versus Equalizing Incomes.* It is worth cautioning at this point about a source of considerable confusion in the literature on the relevance of NFB differentials, a confusion that has been perpetrated, especially in the literature on equalization. The argument for equalizing NFB differentials, whether on efficiency or equity grounds, is not based on vertical equity considerations. That is the job of the interpersonal redistribution system. Equalization is intended solely to facilitate the process of decentralization by ensuring that all provincial governments have the capacity to deliver required public services at comparable tax rates. The implication is that the success of equalization should not be judged according to how well it redistributes from the better-off to the less well-off.<sup>14</sup> This is obviously most relevant when equity arguments are at stake, as in the next section.

#### HORIZONTAL FISCAL EXTERNALITIES

A federation is, among other things, an economic union in which markets are not constrained by borders. This means that the actions of provinces will have effects that go beyond their jurisdictions, and will have effects on the residents of neighbouring provinces. Since a provincial government is answerable only to its own constituents, these spillover effects will not be taken into account in provincial decision-making leading to inefficient resource allocations across provinces and inefficient levels of taxes and public services within each jurisdiction. These effects are referred to as horizontal fiscal externalities, the analogy standard market externalities being apparent.

There is an enormous literature on the consequences of horizontal fiscal externalities arising from the main provincial policy instruments and applying in all three major markets: capital, labour, and product.<sup>15</sup> We can summarize only the main themes in the literature.

*Tax Externalities.* Tax externalities arise because tax bases are mobile across borders. Taxes levied in one province can spill over into others in a variety of ways, and this can have positive or negative effects on other provinces. Economists find it useful to summarize the effects of tax externalities using the concept of the *marginal cost of public funds* (MCPF).<sup>16</sup> The MCPF is a measure of the cost to the economy of extracting a marginal dollar of tax revenues. The idea is that an additional dollar of resources transferred by taxation from the private to the public sector has a true cost of more than a dollar. The true cost includes not only the dollar's worth of resources transferred, but also the increment in the deadweight loss due to the tax distortion. The latter arises

because a tax levied on, say, consumption drives a wedge between the consumer and producer prices of consumer goods preventing the economy from operating efficiently. At the margin, additional consumption forgone has a value to consumers in excess of the productive resources saved. Thus, excess value is the marginal deadweight loss associated with a reduction in consumption induced by higher taxes.<sup>17</sup> This marginal deadweight loss can increase dramatically as the tax rate rises. For our purposes, it is useful to write the marginal cost of raising an increment of tax revenues as follows  $MCPF = -\Delta W/\Delta R$ , where  $\Delta W$  is the change in welfare and  $R$  is the change in tax revenues from a given tax rate change.

Positive tax externalities arise from *tax competition* effects. An increase in the tax rate on a tax base that is mobile across provinces causes the province to overestimate the true MCPF. In the above expression for the MCPF, the term  $\Delta R$  (positive for an increase in taxes) is underestimated since part of the tax base flees to other jurisdictions yielding an increase in their revenues. This tends to make the tax rate too low from an efficiency point of view. The tax competition effect is obviously more important the more mobile the tax base in question. Thus, capital and capital income taxes are more prone to tax competition than taxes on labour income, which is far less mobile. The latter includes both payroll taxes and general consumption taxes, both of which are essentially taxes on the supply of labour. Specific excise taxes also have relatively mild tax competition effects. In this case, the mobility of the base involves cross-border shopping. The least mobile tax bases are those whose location is fixed, such as real property or natural resources, although capital used in conjunction with these fixed factors will itself be mobile.

One important type of positive tax externality occurs in the context of specific projects when provinces engage in *strategic tax competition* or *beggar-thy-neighbour policies* to attract businesses. This involves the use of tax incentives or subsidies to individual firms. The trouble with beggar-thy-neighbour policies is that all provinces are likely to treat similar types of firms as being desirable, and therefore are likely to provide competing tax incentives for them. In the end, no one province will succeed in providing a more favourable tax environment, so the allocation of firms across provinces is not likely to be affected much. Instead, the firms receive favourable tax treatment no matter where they reside, which is a self-defeating outcome from the provinces' point of view.

Negative tax externalities arise from *tax exporting*, whereby part of the burden of a tax is borne by non-residents. This can occur when taxes are imposed on incomes generated in a province that accrue to non-residents. Thus, business income taxes, taxes on natural resources and withholding taxes on capital income may partly be exported. As well, taxes levied on products that are purchased by non-residents can be exported. In terms of the formula, the magnitude of  $\Delta W$  and therefore the MCPF are underestimated, so there is an

incentive to set tax rates too high. However, tax exporting can be severely limited by adjustments in relative prices. An attempt to tax non-residents on their capital income earned in a province will be at least partly offset by the capital fleeing. Similarly, an attempt to capture tax revenue from the sale of products to non-residents will be frustrated by a reduction in demand. In a small open economy that is a price-taker on outside markets, tax exporting cannot occur. It may well be that the provinces are in such a position.<sup>18</sup>

The existence of horizontal fiscal externalities is undoubtedly a fact of life, although their magnitude may be disputed. Options for the federation to deal with them are limited. They have implications for the assignment of taxes. It is widely accepted that, on efficiency grounds, taxes on mobile bases should be assigned primarily to the federal government and those on less mobile ones assigned to the provinces. Thus, taxes on capital income, capital, and businesses would be mainly federal, while provinces (and their municipalities) could access taxes on consumption, labour income, natural resources, and real property. Of course, assignment based on efficiency may well conflict with that based on equity or administrative considerations.

Some of the consequences of tax externalities can in principle be addressed by cooperation among the provinces. Tax bases and tax rates could be harmonized by agreement, as could codes of conduct to preclude beggar-thy-neighbour policies. But binding cooperative agreements are difficult to achieve, and are rarely effective in practice. They require not only unanimous agreement, but also a dispute settlement mechanism that binds future legislative decisions, something that seems to be difficult to achieve in a decentralized setting.

Alternatively, fiscal arrangements between the federal government and the provinces could address some effects of tax competition. Tax competition will be less, the smaller the tax room occupied by the provinces. This is an argument for a vertical fiscal gap. The federal government may be instrumental in encouraging the provinces to harmonize their taxes on mobile tax bases, possibly by arrangements akin to the Tax Collection Agreements. Some authors<sup>19</sup> have suggested that the federal government could use matching grants based on provincial tax effort to induce provinces to internalize the tax externalities, though they have not been used. They would involve grants to the provinces which are some proportion of revenues that the provinces themselves raise, with the purpose being to offset the disincentive that provinces have to levy taxes on bases that are mobile (e.g., capital taxes, inheritance taxes, cigarette taxes). Ideally, the proportions would have to vary by type of tax. But, since the sizes of the externalities arising from tax competition are difficult to ascertain, such corrective grants are impractical. The grant formula may, however, contain elements that offset tax externalities. For example, the Canadian Equalization system effectively sanitizes tax competition effects for the have-

not provinces by compensating them for any losses in their tax bases.<sup>20</sup> But, that probably goes too far, for tax-base losses from any source are sanitized, not just those from tax competition. The result is that the MCPF perceived by the have-not provinces could be effectively unity.

*Expenditure Externalities.* The effects of provincial expenditure programs may spill over into other provinces as well. Expenditures on roads may benefit travelers from neighbouring provinces, higher education and health facilities may be used by non-residents, education and training may be provided to workers who change provinces of residence, transfers to low-income persons may attract them from other provinces, and so on. These interjurisdictional spillovers result in the classic argument for matching grants in a federation as a way of inducing provinces to take account of the benefits they impose on other jurisdictions. It is an argument that is undoubtedly overstated, given the relative unimportance of these spillover effects and the fact that they cannot be measured in any case. Matching grants have gone out of fashion.

A more important type of expenditure externality involves the strategic use of beggar-thy-neighbour policies. Provinces may attempt to attract businesses using infrastructure investments or outright subsidies. Procurement and local hiring policies may discriminate against non-residents. Residency restrictions may be put on access to provincial public services such as welfare, education, and health care. Such measures will distort the internal economic union if they are effective. But if all provinces engage in them, they are likely to be self-defeating and ineffective. Preventing them involves the same considerations as in the case of tax incentives. It is hard to see how such measures can be effective without the participation of the federal government.

*Regulation Externalities.* Virtually identical arguments apply in the case where provinces impose regulations that affect non-residents. Regulations can apply on all three major markets. Capital market regulations may restrict the free flow of capital among jurisdictions, for example, by favouring locally owned capital. Similarly, labour market regulation may preclude non-residents from taking employment in a province. Different curricula across provincial educational and training programs may make it difficult to pursue further education in another province. Different environmental or health and safety regulations may impose different costs on businesses across provinces. Regulation to foster local customs, culture, and language will typically favour residents. In all these cases, there is inefficiency induced in the internal economic union by the relevant regulation. While some of the regulations may reflect legitimate social policy objectives, others constitute outright protection. Avoiding it therefore involves not only appropriate forms of cooperative agreement with or without the connivance of the federal government, but also some judgement as to which sorts of discriminatory regulation are justified by social arguments.



## VERTICAL FISCAL EXTERNALITIES

The third source of inefficiency arising from decentralized decision-making in a federation is one that has been prominent in the literature only recently. It involves externalities between upper and lower levels of government. The idea is that budgetary actions taken by, say, the provincial government affects not only its budget but also that of the federal government. Consider changes in a province's tax rate on a base that is co-occupied by the federal government, such as labour income. While this will raise more revenue,<sup>21</sup> it will also cause the tax base to shrink. Since the federal government occupies the same tax base, it will find its revenues shrinking as well. The province neglects to take account of this, implying that the MCPF it perceives is less than the true MCPF. To see this, recall the expression  $MCPF = -\Delta W/\Delta R$ . The province overestimates the full change in revenue  $\Delta R$  from a tax change since it neglects the fall in revenue to the federal government. This same effect applies even if the provinces and the federal government do not occupy precisely the same tax bases. All major tax bases overlap to some extent, so changes in, say, provincial payroll taxes are likely to affect not only federal payroll tax bases, but also federal income and consumption tax bases.

This tendency to underestimate the MCPF because of vertical fiscal externalities has a number of implications. It gives the provinces an incentive to raise too much revenue since it underestimates the cost of doing so. It especially encourages the provinces to levy excessive taxes on bases that bear a high federal tax rate. On the other hand, to the extent that tax bases are mobile among jurisdictions, the vertical fiscal externality offsets the tax competition effect that tends to make provinces overestimate their MCPF. As with the MCPF itself, there is some uncertainty about the magnitude of the vertical fiscal externality, though given the size of federal tax rates in Canada and the fact that the provinces occupy the major tax bases, the expectation is that it can be reasonably large. There is certainly strong evidence that vertical tax interaction effects exist. Besley and Rosen found for the United States that increases in the federal excise tax on both cigarettes and alcohol caused states to increase their excise taxes significantly, indicating *prima facie* evidence of a vertical fiscal interaction.<sup>22</sup> Hayashi and Boadway studied the interaction between the federal and provincial governments in the setting of business income taxes.<sup>23</sup> They also found that changes in the federal tax rate significantly affected provincial rates, but the sign was negative in this case. Of course, unlike with cigarettes and alcohol, capital is highly mobile across provincial borders so that vertical and horizontal externalities both apply. Evidence that vertical interaction effects exist.

In principle, the same kind of vertical externality also applies in the opposite direction: changes in the federal tax rate will cause a loss in revenues to

the provinces because their bases shrink. But there is good reason to believe that this will not induce the federal government to behave inefficiently. It is sensible to suppose that the federal government acts as a first-mover or leader with respect to the provinces' policies.<sup>24</sup> If so, it will anticipate the effects of its tax policies on provincial behaviour in setting its tax rates. (The provinces acting as followers take federal tax rates as given.) The federal government will therefore choose its tax rates to minimize the consequences of vertical fiscal externalities of the provinces. In very simple settings, this can involve the federal government levying only lump-sum taxes and turning over the responsibility for redistribution to the provinces.<sup>25</sup> But more generally, little can be done to avoid vertical fiscal externalities. As long as the federal government is imposing taxes, such externalities will exist. Perhaps sophisticated formulas for grants can be designed that penalize provincial tax effort by enough to offset vertical externalities. But as of now that approach is probably impractical as well as being politically difficult to achieve.

These vertical externalities can in principle also arise on the expenditure side, though less directly.<sup>26</sup> For example, an increase in labour training at the provincial level can increase the income tax base and generate tax revenue for the federal government. This form of externality would provide an incentive for provinces to provide too little of the expenditure relative to the efficient level. As with interjurisdictional spillovers, this could potentially be corrected using matching grants.

The literature has also dwelled on the possibility of the provinces' being first-movers in the policy interaction with the federal government. In this case, a province's policies are conditioned by how it expects the federal government will subsequently react. This, it turns out, leads to some rather unexpected results, results that arise because of the ability of the provinces to exploit the future behaviour of the federal government. One result is an application of the so-called Samaritan's Dilemma.<sup>27</sup> Suppose the federal government operates an equalization system that transfers to provinces according to some measure of their residents' well-being — average income, tax capacity, etc. To the extent that provincial policies can influence such measures at some cost, they will have an incentive not to make themselves better off, anticipating the transfers that the federal government will make to them. The real-world relevance of the Samaritan's Dilemma is obvious. Another result is in a sense the opposite, and is an application of what is known as the Rotten Kid Theorem. If provincial governments enact some expenditure programs that have benefits nationwide, left to their own devices they will tend to provide too low a level of the programs since they are costly to provide. But if the federal government tends to equalize after-tax incomes, provinces will have an incentive to contribute efficiently to such programs because the marginal cost of an increased contribution will, to some extent, be covered by the expected transfer.<sup>28</sup>

## OTHER SOURCES OF INEFFICIENCY IN FEDERATIONS

There are other reasons why resources may be allocated inefficiently in a federation, and these are just coming to be studied by fiscal federalism scholars. The process of regional development might itself be characterized by externalities that render market solutions inefficient. This is something that geographers have long studied, but it has been slow to penetrate fiscal federalism theory, which tends to be based on conventional economic modeling. One argument is that there are economies of agglomeration, which enhance the efficiency of labour and capital markets as they become more concentrated. Information exchange is improved and there is more opportunity for matching skills to jobs the larger are regional labour markets. These agglomeration benefits are unlikely to be taken account of by those persons or firms choosing their locations. The result is that resources may not be allocated efficiently across regions. In fact, there might be multiple possible optima, depending on which locations grow to be large. In practice, history determines which regions will grow and which will not.

Not only will the allocation of resources be inefficient in this context, but also government policies may themselves be detrimental to an efficient agglomeration of regions or urban areas. For example, equalizing grants may serve to perpetuate a dispersed population, resulting in a version of the so-called dependency hypothesis, albeit one that is based on different reasoning than in the fiscal federalism literature. Although this is a possible problem, there is simply not the knowledge available to know how to deal with it.

Related to the agglomeration issue is the burgeoning field of endogenous growth theory, which also has regional implications. Endogenous growth theory posits that the growth of a given economy is determined partly by factors that are both endogenous to the economy in question but external to the decision-makers in the economy. Thus, human capital investment and R&D contribute to productivity growth, but those undertaking them do not appropriate the rewards from these activities, so that too little is undertaken. For example, persons with high skills pass some of the knowledge and techniques associated with the skills on to other workers in the same local labour market. An implication is that the in-migration of highly skilled workers will provide external benefits to existing workers, benefits that are not accounted for when location is decided. The result is that resources could be inefficiently allocated within a federation, and regional growth rates are not as high as they could be.

Again, the literature has not developed to the extent that policy prescriptions can be proposed on the basis of the models. But the possibility of these agglomeration and regional interaction effects being important cautions one not to be too doctrinaire in adopting policies for a federation.

## EQUITY EFFECTS OF DECENTRALIZATION

The more important, or at least controversial, consequences of decentralization are its implications for equity. They are controversial because as we have emphasized, much of what governments do revolves around equity, which itself is a value-laden concept. Fortunately, we do not really have to take a stand on the larger question of how redistributive government policy should be. Much of the literature on fiscal federalism applies whatever judgement is made in that regard. Federations are decentralized largely for efficiency reasons. The literature is more concerned with how a decentralized federation can deliver whatever degree of redistributive equity governments desire. The main conflict is probably between the federal and provincial governments, which may take rather different views about redistribution.

The one substantive judgement that must be made involves the principle of *horizontal equity* — the principle that the fiscal system should treat those in equal circumstances equally. In the context of a federation, horizontal equity would suggest that persons should be treated comparably no matter where they reside. In a decentralized federation where provinces exercise their responsibilities independently, horizontal equity cannot be satisfied as long as different governments want to behave differently. To force them to treat all households of a given kind identically across jurisdictions would involve essentially abrogating their independence and would contradict the principal purpose of a federal system of government. Thus, inevitably horizontal equity must be compromised. We take the view that a reasonable way to compromise horizontal equity is to ensure that all provinces have the resources to implement policies that are horizontally equitable, though they may not choose to do so. This seems a reasonable compromise between the social value of horizontal equity and the spirit of federalism.

The ways in which decentralization impinges upon equity is parallel to the efficiency case.

### FISCAL EQUITY

Fiscal equity is simply the version of horizontal equity outlined above: the potential of all provinces to treat identical persons identically. Accepting horizontal equity in a federation is equivalent to assuming that all persons count equally in the nation's "social welfare function," something that citizenship could be viewed as conferring on all members of society. In what follows, we shall accept fiscal equity as a social objective. Others may well disagree.

Fiscal decentralization leads to fiscal inequity simply because it gives rise to different abilities of provinces to provide public services for their residents at given tax rates. Thus, in the absence of corrective action, NFB differentials

are likely to occur. Just as NFB differentials led to fiscal inefficiency, so they lead to fiscal inequity. But there is one important difference. NFB differentials cause fiscal inefficiency only to the extent that they induce migration. They cause fiscal inequity only to the extent that migration does not occur. If there were costless migration, otherwise equal persons could not end up being unequally well-off; they could migrate so that they are equally well-off in all jurisdictions. Thus, the principles of efficiency and equity are not in conflict, as is usually the case. Instead they are self-reinforcing.

We have already discussed the sources of NFB differentials when considering their consequences for fiscal inefficiency. The same sources apply here. As well, the same remedy for fiscal inequity applies — undo the NFB differentials through a system of equalizing transfers. As discussed in the next section, equalization transfers is a major component of a system of fiscal arrangements that respect the principle of fiscal equity.

One way to view fiscal inequity is through the fictitious device of the unitary state. In a unitary state, governments are presumed to provide common public services to all citizens and to finance them with a common tax schedule. This ensures the equal treatment of equals. If the unitary state then becomes federated and fiscal responsibilities decentralized, fiscal inequity would fail (unless migration were perfect). Provinces with more tax capacity and less need would be able to provide a given level of public services at lower tax rates than those with less tax capacity and more need. If a system of equalization transfers were implemented to offset the NFB differentials, all provinces would have sufficient resources such that they could implement the unitary state outcome if they so choose. Of course, they may choose not to, but in any case we shall say that fiscal equity prevails.

#### HORIZONTAL FISCAL INTERACTION

Just as horizontal interaction gives rise to fiscal externalities (tax and expenditure competition, tax exporting, beggar-thy-neighbour policies), so too it gives rise to adverse consequences for equity. At a general level, mobility of households and firms can cause provinces to compete away some redistribution: less redistribution attracts higher income persons and repels lower income ones.

How important this is in practice is an open question. If mobility is restricted, it may not be quantitatively important. As well, to the extent that equalization compensates for losses in tax base, provinces should not be too concerned with redistribution-induced migration. There is some evidence that provinces respond to competitive incentives in choosing their redistribution policies. In the Canadian case, inheritance taxes were quickly competed away when they were turned over to the provinces. And, provincial welfare programs

responded when the federal government imposed a cap on transfers to the high-income provinces.<sup>29</sup>

#### VERTICAL FISCAL INTERACTION

Vertical fiscal externalities have similar consequences for redistribution as they do for efficiency. Part of the deadweight loss of provinces raising taxes to finance transfers to lower income persons is effectively borne by the federal government. That is, an increase in taxes by a province shrinks both its own tax base and that of the federal government, so the cost of that shrinkage in terms of lost revenues is partly borne by the federal government. As a consequence, there is an incentive on this account for provincial tax rates and the expenditures they finance, including transfers to the poor, to be too high, an incentive first noted by Johnson.<sup>30</sup> This is an interesting innovation in the literature since it casts doubt on the standard argument that decentralization is unambiguously bad for redistribution. But, as in the case of efficiency, vertical and horizontal fiscal externalities have contradictory effects.

It is not at all obvious what the policy implications are. The harmonization of the rate structure in the income tax system, as in the Canadian case, is a way of ensuring that national standards of redistributive equity apply, albeit ones that are chosen by the federal government. But in the absence of that it is not clear how policies could be designed that avoid the effect of fiscal externalities, both horizontal and vertical, on provincial redistribution policies.

#### TOO MUCH OR TOO LITTLE REDISTRIBUTION?

We are apparently left with the finding that it is not clear *a priori* whether decentralization will provide an incentive for too much or too little redistribution. Vertical externalities reduce the perceived costs of redistribution to the provinces; horizontal externalities increase the costs. In principle, either one could dominate. The more mobile people are across jurisdictions, the more important will be the tax competition effects, which tend to inhibit redistribution. Vertical externalities are more important the more elastic the tax bases within the province and the higher the federal tax rates on co-occupied tax bases.

An implication of this analysis is that the case against decentralizing redistribution functions to the province is much weaker than has traditionally been assumed.<sup>31</sup> Provided the provinces have comparable fiscal capacities, there is no strong argument against relying on them to undertake redistribution. Indeed, as we have seen, they may well be relatively more efficient than the federal government at implementing redistribution through the provision of

public services, leaving the federal government to pursue vertical equity through the tax-transfer system.

## THE FISCAL ARRANGEMENTS

The fiscal arrangements, encompassing the fiscal relationship between the federal government and the provinces, are a critical element of a decentralized federation. The preceding sections have stressed the benefits of decentralization, but also the fact that decentralization by itself can cause various inefficiencies and inequities in the internal economic union. The fiscal arrangements can facilitate decentralization by offsetting some of these inefficiencies and inequities, a task that becomes increasingly important the more decentralization there is. The fiscal arrangements include both the system of fiscal transfers between the federal government and the provinces as well as policy coordination or harmonization measures. The existence of federal-provincial transfers presumes a mismatch between revenue-raising and expenditure responsibilities at the two main levels of government, or a *vertical fiscal imbalance* (also called a fiscal gap). We begin with a brief discussion of that before turning to the components of the fiscal arrangements.

### VERTICAL FISCAL IMBALANCE (VFI)

A feature of almost all federations is that the federal level of government raises more revenue than it needs and transfers the excess to the provinces.<sup>32</sup> But the extent of VFI varies widely across countries, being very large in Australia and Germany, but much smaller in Canada and the United States. There is no established theory to serve as a guide to choosing the right level of VFI. Only recently has fiscal federalism even attempted to analyze the optimal degree of VFI.<sup>33</sup> In general terms, there seems to be two main reasons for a VFI.

The first argument for a VFI is that the case for decentralizing expenditures to the provinces is much greater than that for decentralizing taxes. Provinces might be more efficient at delivering public services to individuals and firms. Major public services in areas like health, education, and welfare constitute a substantial component of public sector budgets, and in many federations are highly decentralized. On the other hand, there are strong arguments for not decentralizing taxes to as great an extent. Taxes can readily be administered at the centre, where a common tax system can apply with the benefits of a single collection agency. Distortions in the internal economic union due to a fragmented tax system can be avoided by centralized collection, and a uniform standard of redistribution can be applied. Some of the benefits of a single tax system can be achieved by tax harmonization agreements, but those too

can be more readily maintained if the federal government maintains a dominant share of the tax room. The exact size of the VFI based on these arguments remains a matter of judgement. Too much VFI is argued to reduce the accountability of the provinces since they are not responsible for raising the revenues that they are spending.

The second argument for a VFI is that the federal government needs to make transfers to the provinces in order to fulfil its responsibility for achieving efficiency and equity in the internal economic union. To assess this argument, we turn to the role of federal-provincial transfers in a decentralized federation.

#### FEDERAL-PROVINCIAL TRANSFERS

Federal-provincial transfers exist not only to "close the fiscal gap," but have important objectives in their own right. Three main forms of transfers, each with its own role, can be distinguished — equalization, matching, and conditional. Consider each in turn.

*Equalization.* There is a worldwide interest in equalization, and an enormous literature to draw on, much of it emanating from Canada.<sup>34</sup> But the issues are general and apply in all federations. Equalization transfers exist primarily to offset the NFB differentials that occur in a decentralized federation and cause fiscal inequity and/or fiscal inefficiency. As we have seen, these differentials can arise due to differences in tax capacity at the provincial level as well as differences in the need for public expenditures. The design of an equalization system to deal with these things faces both measurement problems and incentive problems. Measuring tax capacity and need is not straightforward, especially in a heterogeneous federation where provinces adopt different policies. If provincial tax bases are reasonably uniform, the representative tax system approach works well. But as provincial tax bases become more diverse, which is more likely to happen the more decentralized is the federation, the definition of standard tax bases becomes further removed from tax bases actually used. And need is even more difficult to measure, especially for public service. For transfers, the representative tax system approach could in principle be used, with need being incorporated into the standard base for the transfers. As provinces become more diverse, for example, because of greater degrees of decentralization, the representative tax or expenditure approach becomes less accurate, and cruder approximations might be used. These might take the form of simple macro indicators, such as per capita income.

The extent of equalization should in principle be 100 percent, though in practice it rarely is. The payments may only apply to those provinces with below-average NFBs per capita. Or some elements of tax capacity might be less than fully equalized, such as natural resource revenues. This may be



because they are too costly for the federal government to equalize, or because provinces are deemed to have independent property rights to the resources.<sup>35</sup> Some authors have even argued that the federal government need not get involved with equalization at all. The have provinces would voluntarily make equalization payments to the have-nots as a way of internalizing the fiscal inefficiencies from NFB differentials.<sup>36</sup> But this argument, which is an analogue of the famous Coase theorem, really applies only in very special circumstances, including where individuals in each jurisdiction are all identical.

Incentive effects are also an important consideration in designing an equalization system. Ideally, equalization payments should depend on some objective indicator of the ability to provide public services at given tax rates, but it is practically impossible to design suitable indicators which abstract completely from provincial behaviour. In the representative tax-system approach, there may be incentives for provinces to change either their tax rates or their tax bases in order to exploit the equalization system. The former case can arise if one province makes up a significant portion of a given tax base. Much more relevant is the fact that the representative tax approach roughly equalizes on the basis of provincial tax bases. If provinces can influence the size of their tax bases, they will be discouraged from increasing them because of the loss in equalization they will suffer. This can be a potent deterrent to resource development, and another reason for not equalizing resource rents fully. It can also cause provinces to misperceive the MCPF of raising revenues from various sources. Recall that the MCPF exceeds one essentially because tax bases shrink when taxes are increased. If the tax-revenue consequences of the shrink in a tax base are undone by equalization payments, provinces will have an incentive to over-tax. This may help explain why provinces levy sizable taxes on capital income despite the fact that these are presumably mobile tax bases.

Finally, a secondary function of equalization is to serve as a device by which risk-sharing can take place among provinces. If provinces are subject to idiosyncratic shocks, an equalization system that transfers to them when their incomes fall and vice versa will act as an insurance device. This has been the focus of some recent literature, which has also emphasized the incentive problems with this form of insurance.<sup>37</sup>

*Matching Grants.* Matching grants are the traditional device for the federal government to use to correct for interjurisdictional spillovers. They were quite important in the development of social programs in Canada as well as in some shared-cost projects in transportation and agriculture, but have now gone out of fashion. The basic argument for matching grants is quite seductive. If provincial programs cause spillover benefits to other provinces, they will have no incentive to take account of those benefits when deciding levels of public expenditure. The spillover benefits can, however, be internalized by a properly

chosen matching grant formula, where the rate of matching reflects the share of spillover benefits in the total benefits of the project. Similar arguments could apply to the correction of misperceived MCPFs due to tax competition, but matching grants based on revenue sources or tax effort have not been common.<sup>38</sup> Implementation of the optimal matching grant system is problematic, since by definition external benefits are difficult to measure. Most matching grant programs use formulas of the order of one dollar of grant for every dollar of provincial expenditures, which is far in excess of any reasonable estimate of the size of spillovers. Presumably the matching rate was intended to fulfil other purposes. In the case of major social programs, one objective was to bribe the provinces into establishing such programs. The matching formula might also serve as a rough measure of need. Greater provincial expenditures on welfare, for example, reflect greater provincial need. Matching grants could therefore be considered a form of equalization in a system where need was not otherwise included in the formula. Alternatively, the matching grant for welfare could be viewed as compensating for the fact that transfers were not treated symmetrically with taxes in the equalization formula, a point emphasized long ago by the Breau Committee report.<sup>39</sup>

The trouble with matching grants used for these purposes was that they introduced adverse incentive effects into the transfer system. The availability of "50-cent dollars" could potentially cause rational governments, which had already established the shared-cost programs, to expand the size of them significantly. It has been alleged that the increase in welfare rates in various periods in the 1970s and 1980s was partly attributable to the matching grant formula.<sup>40</sup>

*Conditional Grants.* An important reason why matching grants have gone out of fashion is that it has been recognized that many of their alleged objectives could be achieved by conditional bloc (non-matching) grants. By avoiding the matching aspect, adverse incentive effects would be avoided. The size of the grants by jurisdiction could be designed to reflect need as well as whatever spillover benefits there were thought to be.

But conditional grants can have a much broader purpose. They can be the vehicles by which provincial spending programs can be induced to conform to norms of national efficiency and equity. Conditions such as the rights of non-resident citizens to have access to provincial public services, principles of accessibility, need, and comprehensiveness can all be attached to the use of conditional grant funds. Such conditions can be designed so that decentralized decision-making does not result in the violation of efficiency in the internal economic union, or that equity standards are not compromised. The conditions can be made biting by reducing the size of the grant in the event of non-compliance. Conditional grants of this sort should be seen as complements to equalization and not substitutes. Equalization addresses the particular

issues of fiscal inefficiency and fiscal inequity, while conditional grants deal with the other potential violations of national efficiency and equity outlined above.

The use of conditional bloc grants is an exercise of the federal spending power, and its use has been controversial in Canada. The problem is that the federal spending power appears to contradict the independent exercise of provincial legislative authority. It is not at all clear how to avoid this. If the federal government is seen as the custodian of national equity and efficiency, it is hard to imagine a policy instrument other than the spending power that it might use to achieve its objectives. The spending power is widely used in federations around the world, typically much more intrusively than in Canada.<sup>41</sup> Compared to other potential policy instruments such as disallowing provincial legislation or imposing mandates on the provinces, it is relatively non-intrusive.

#### POLICY COORDINATION AND HARMONIZATION

The fiscal arrangements may involve more than financial transfers; they may also involve agreements to harmonize policies. Harmonization serves various purposes: securing efficiency in the internal economic union, implementing common standards of equity, and simplifying the administration of fiscal programs for governments and citizens alike.

The need for harmonization differs by policy area. A high priority is in the area of taxation. The costs of collection and compliance and the transparency of tax laws can be reduced by a tax system that has features of the base in common, and even has a single tax-collecting authority. In addition, if taxpayers are involved with more than one province, some form of coordination is essential to avoid double taxation. The transfer system might also be simplified by harmonization, especially if it too is administered alongside taxes. Harmonization of public services is perhaps less urgent on administrative grounds, since there tends to be relatively little jurisdictional overlap for users. Of course, there may be issues of national efficiency and equity that could be addressed by interprovincial harmonization in the event that the spending power is not used. Finally, harmonization of regulations is also desirable, especially where taxpayers operate in different provinces.

The manner in which harmonization can be accomplished is controversial. Some observers argue that much of it can be achieved by horizontal agreement among the provinces, with or without the participation of the federal government.<sup>42</sup> As we have mentioned, achieving horizontal agreement among governments has proven to be difficult. The need for unanimous agreement makes substantive agreements very hard to negotiate as the threat of veto can be used to obtain one's preferred components. It also restricts the scope of agreements to those in which all provinces stand to gain. Thus, horizontal

agreement over interprovincial equalization, dividing up a given amount of federal transfers, or many policies involving national equity objectives would be infeasible. The participation of the federal government would not seem to make a difference. If agreement could be secured, enforcement would then be an issue. Dispute settlement mechanisms could be constructed, but their ultimate effectiveness would always run up against the sovereignty of parliaments.

These considerations make the use of the federal government as facilitator attractive. The federal government has the power of the purse, which allows it to enforce or induce harmonization in a way that not only respects democratic decision-making but also avoids the use of the courts. In the case of harmonizing spending programs, this involves the use of the spending power. This need not be done in a heavy-handed manner; the conditions attached to its use could be made only as intrusive as necessary for the purpose, and the provinces could be consulted on an ongoing basis. But in the end, the need to report to the national electorate is the real check. To harmonize taxes, provincial participation seems to require a quid pro quo such as a single tax-collecting authority and some provincial input into tax policy issues, as well as enough federal dominance in the tax field so that the federal government can assume a leadership role in defining the broad parameters of the tax. This has implications for the degree of vertical fiscal imbalance and for the tax mixes used by the federal government and the provinces.

## CANADIAN FISCAL FEDERALISM ISSUES

After this long discourse on the principles of fiscal federalism, we conclude with a brief discussion of its implications for the Canadian practice. Given the judgements that must be made along the way about the role of governments, the weight that ought to be given to redistributive equity, the merits of decentralization, and the responsibilities of the federal government, conclusions are bound to be subjective. Moreover, the conclusions we draw are bound to be controversial given that they contradict much of what is being advocated by policy research institutes and the national media, and question the direction in which most recent governments have taken the federation.

### THE CONSTITUTIONAL AND ECONOMIC SETTING

Canadian constitutional prescriptions as well as political and institutional practice are aligned remarkably well with economic arguments. The constitution assigns to the provinces responsibility for delivering important public services in areas of health, education, and welfare, as well as providing them access to all the major broad-based taxes for financing. As a result, a high degree of fiscal decentralization is achieved, significantly greater than comparable

federations (e.g., Australia). At the same time, the constitution recognizes as matters of principle the responsibilities the federal government has for national equity issues. Section 36(1) explicitly recognizes the joint responsibility of the federal government and the provinces for providing essential public services to all Canadians, for fostering equality of opportunity, and for reducing economic disparities. These are various dimensions of redistributive equity, and significantly, ones whose fulfillment involves policy instruments that are the exclusive legislative responsibility of the provinces. Section 36(2) recognizes the federal responsibility for addressing fiscal inequities and inefficiencies by prescribing an equalization system that would eliminate NFB differentials. Perhaps surprisingly, the only main national economic objective left out is that of securing the efficiency of the internal economic union. But that seems to be the one objective that is non-controversial.

The constitution also provides the federal government the policy instruments in the form of broad taxing and spending powers to achieve national equity and efficiency objectives. The spending power enables the federal government to engage in active tax-transfer policies and to maintain a vertical fiscal imbalance necessary to enable it to use the instrument of federal-provincial transfers to full advantage and to facilitate a harmonized tax system. Most important and controversial, it enables the federal government to use conditional grants as a vehicle for fulfilling its joint responsibility with the provinces for redistributive equity (section 36(1)) and for pursuing an efficient internal common market.

#### HOW MUCH DECENTRALIZATION?

Fiscal decentralization has been the operative policy in the 1990s' world of fiscal discipline and government retrenchment. In practice, this has meant a reduction in federal transfers and a corresponding increase in provincial reliance on own-source revenues, since the provinces have already assumed responsibility for major public services in health, education, and welfare. The combination of reduced federal transfers and increased provincial occupancy of the major tax bases has potentially serious effects on the ability of the federal government to fulfil its responsibilities for achieving national equity and efficiency goals.

To appreciate this argument, it must be understood that the spending power is virtually the only policy instrument available for the federal government to pursue the equity responsibilities set out in section 36, and to pursue efficiency in the internal economic union, which almost all observers agree is a useful goal. Moreover, on economic grounds, the spending power is in principle an ideal policy instrument for the task. It is a relatively non-obtrusive way of combining provincial responsibility for delivering major public services with the legitimate interest the federal government has in the equity and

efficiency consequences of decentralized delivery. In other words, it is a powerful policy instrument for the management of the decentralization.

The gradual process of the provinces assuming more responsibility for raising their own revenue undermines the use of the spending power. Although greater reliance by the provinces to rely on own-source revenues might lead to greater accountability, it also results in more resistance to the federal spending power. The ability of the federal government to induce national standards into the provision of important public services is considerably lessened if the federal share of funding is relatively small. Moreover, greater provincial self-sufficiency itself exacerbates NFB differentials across provinces, making it more difficult to achieve fiscal equity and efficiency both economically and politically.

This is not to say that the use of the spending power has been perfect in the past and could not be improved. It is clear that part of the reason for its demise can be attributed to the sometimes insensitive and secretive way that it has been exercised. There could obviously be more openness and more consultation with the provinces in its use, an issue we return to below. The alternatives to the spending power are impalatable. One is simply to abrogate the federal responsibility for national equity and efficiency issues where they involve provincial programs. There are those who would argue that the provinces could be relied on to come to an agreement among themselves, or even jointly with the federal government, to devise their programs in ways that abide by national standards. There is virtually no evidence that meaningful agreements would be forthcoming. National equity objectives would simply not be achieved, which may well suit the agenda of opponents to the spending power. The other alternative of giving the federal government more direct powers to achieve national objectives, such as exercising its disallowance powers, are simply not on. The only practical way for the federal government to achieve national objectives is through the spending power.

Reducing the vertical fiscal gap has a further adverse effect on the efficiency and equity of the economic union. By requiring the provinces to raise more of their own revenues, their occupancy of tax room increases, possibly in ways that threaten the integrity of tax harmonization. The Canadian tax-collection agreements have been a model of tax harmonization for federations elsewhere, and with good reason. They combine the benefits of a common base and single tax-collecting authority with provincial power over their own tax rates. Not surprisingly, as the provinces have come to occupy more and more of the income tax room, they have insisted on more and more discretion in tax policy. This has led to gradual erosion of the integrity of the agreements to the point where their survival is in jeopardy. A full discussion of the consequences of this for tax policy in the federation is beyond the scope of this paper.<sup>43</sup> Suffice it to say that decentralization of revenue-raising responsibility cannot but put strains on tax harmonization.

## PROCESS CONSIDERATIONS

Our argument leads inexorably to the views that decentralization should leave a sufficient vertical fiscal gap to enable the federal government to pursue its legitimate objective of equity and efficiency in the internal economic union, and that the spending power should be nurtured as the only feasible policy instrument available for the federal government to achieve its objectives. This implies that some work must be done to avoid the strains that the past use of the spending power has caused for the federation. The exercise of the spending power in recent decades has been characterized by excessive secrecy, inadequate notice to the provinces of major changes that affect their budgetary plans, a lack of public transparency and consultation, and an apparent absence of a long-term perspective in managing the fiscal arrangements. A good part of the problem may stem from the fact that major changes in the fiscal arrangements typically take place as part of the federal budget process, which is necessarily shrouded in secrecy and which often has short-to-medium-term fiscal objectives in mind.

Other federations have institutions for managing the federation in a much more open and consultative way. Advisory bodies exist with more or less influence on the fiscal arrangements in federations like Australia, India, South Africa, and the United States. Arm's length advisory bodies can adopt a suitably wide perspective, can serve as a vehicle for full consultation with the provinces, and can provide a forum for much more open discussion and debate, leading to a more informed management of the fiscal affairs of the federation. Such a body has performed an extremely valuable function in Australia, and has succeeded in bringing the states into a meaningful dialogue with the federal government over fiscal issues of mutual concern, despite the fact that the fiscal stature of Australian states is much less than Canadian provinces. It is worth considering whether more rationale and far-sighted decision-making can be brought to the Canadian case by such an institution. The institution of the social union agreement is a useful step in that direction, and is discussed elsewhere in this volume. It remains to be seen if it will serve as a useful device for furthering goals of national importance in a way that involves the provinces and the federal government in a true partnership, or whether it will further stultify the federal government's legitimate role in achieving national equity and efficiency objectives.

## NOTES

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1. Further discussion of the consequences of decentralization may be found in Robin Boadway, "The Folly of Decentralizing the Canadian Federation," *Dalhousie Review* 75 (1996):313-49.
2. Wallace E. Oates, *Fiscal Federalism* (New York: Harcourt Brace Jovanovich, 1972).
3. Charles M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64 (1956):416-24.
4. The notion of agency problems is well known to economists, but perhaps less well known to non-economists. It refers to the fact that managers of organizations or programs are unable to manage efficiently because they cannot perfectly observe relevant characteristics of those under their control. These include the costs of delivering programs, the effort or productivity of those in the organization, the need for the service by the target population, and so on.
5. Adverse selection arises when those being insured fall into different risk categories, but the insurer cannot observe to which category a particular person belongs. This prevents insurance being provided on actuarially fair terms to the least risky persons because more risky ones will want to purchase it. This prevents markets from providing insurance efficiently, and may even cause the market to break down.
6. Moral hazard in the insurance context occurs when those being insured can take actions that affect the chances of a claim being filed, or its size. Again, insurance cannot be operated efficiently in this context. An analogous phenomenon occurs when employees' efforts are hidden so that their contributions (rather than the contribution of some extraneous force) to the output of the enterprise cannot be determined.
7. See the discussion and further references in Albert Breton, "Designing More Competitive and Efficient Governments," in *Defining the Role of Government: Economic Perspectives of the State*, ed. Robin Boadway et al. (Kingston: School of Policy Studies, and McGill-Queen's University Press, 1994), pp. 55-98.
8. Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (New York: Cambridge University Press, 1990).
9. An elegant demonstration of this may be found in Jeremy S.S. Edwards and Michael J. Keen, "Tax Competition and Leviathan," *European Economic Review* 40 (1996):113-34.
10. An analysis of this may be found in Motohiro Sato, "Essays in Fiscal Federalism and Decentralization," PhD Thesis, Department of Economics, Queen's University, 1998.
11. The classical reference is James M. Buchanan, "Fiscal Grants and Resource Allocation," *Journal of Political Economy* 60 (1952):208-17, elaborated in James M. Buchanan and Charles J. Goetz, "Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model," *Journal of Public Economics* 1 (1972):25-43. A formalization of the argument for a decentralized federation may be found in Robin Boadway and Frank R. Flatters, "Efficiency and Equalization Payments in a Federal System of Government: A Synthesis and Extension of Recent



- Results," *Canadian Journal of Economics* 15 (1982):613-33, and its consequences for equalization in Boadway and Flatters, *Equalization in a Federal State* (Ottawa: Economic Council of Canada, 1982).
12. Dan Usher, *The Uneasy Case for Equalization Payments* (Vancouver: The Fraser Institute, 1995).
  13. See, for example, Stanley L. Winer and Denis Gauthier, *Internal Migration and Fiscal Structure: An Econometric Study of the Determinants of Interprovincial Migration in Canada* (Ottawa: Economic Council of Canada, 1982); and Kathleen M. Day, "Interprovincial Migration and Local Public Goods," *Canadian Journal of Economics* 25 (1992):123-44. William G. Watson, in "An Estimate of the Welfare Gain from Fiscal Equalization," *Canadian Journal of Economics* 19 (1986):298-308, has argued that the estimated migration levels translate into relatively limited welfare consequences.
  14. This tendency to evaluate equalization in terms of its effect on interpersonal redistribution may be found in Usher, *The Uneasy Case for Equalization Payments* and Paul Boothe and Derek Hermanutz, *Simply Sharing: An Interprovincial Equalization Scheme for Canada* (Toronto: C.D. Howe Institute, 1999).
  15. See the recent surveys in works by Ben Lockwood, "Tax Competition and Tax Co-Ordination under Destination and Origin Principles: A Synthesis," unpublished paper, University of Warwick; and J.D. Wilson, "Theories of Tax Competition," *National Tax Journal* 52 (1999):269-304.
  16. This is the approach taken in the survey of fiscal externalities by Bev Dahlby, "Fiscal Externalities and the Design of Intergovernmental Grants," *International Tax and Public Finance* 3 (1996):397-411.
  17. This is an efficiency approach to the MCPF. Equity considerations can also be incorporated, as discussed in Bev Dahlby, "Progressive Taxation and the Social Marginal Cost of Public Funds," *Journal of Public Economics* 67 (1998):105-22.
  18. Of course, in the short run, when capital has been installed, it will be possible to tax it without the capital fleeing. But such a policy is not sustainable in the long run, because capital owners will not want to install capital equipment if they expect that it will be taxed once in place. This is the problem of time consistency which was referred to earlier.
  19. For example, Dahlby, "Fiscal Externalities."
  20. For an analysis of this, see Michael Smart, "Taxation and Deadweight Loss in a System of Intergovernmental Transfers," *Canadian Journal of Economics* 31 (1998):189-206.
  21. Unless the tax rate is on the wrong side of the Laffer curve, which is a distinct possibility in a federal setting as Michael Keen and Christos Kotsogiannis show in their paper, "Federalism and Tax Competition," unpublished paper, University of Essex, 1995.
  22. Timothy J. Besley and Harvey S. Rosen, "Vertical Externalities in Tax Setting: Evidence from Gasoline and Cigarettes," *Journal of Public Economics* 70 (1998):383-98.

23. Masayoshi Hayashi and Robin Boadway, "An Empirical Analysis of Intergovernmental Tax Interaction: The Case of Business Income Tax in Canada," unpublished paper, Department of Economics, Queen's University, 1999.
24. There is some evidence that the federal government is in fact first-mover with respect to the provinces. Hayashi and Boadway, "An Empirical Analysis of Intergovernmental Tax Interaction," found that to be the case for business income taxes levied by the two governments.
25. See the analyses in Robin Boadway and Michael Keen, "Efficiency and the Optimal Direction of Federal-State Transfers," *International Tax and Public Finance* 3 (1996):137-55; and Robin Boadway, Maurice Marchand and Marianne Vigneault, "The Consequences of Overlapping Tax Bases for Redistribution and Public Spending in a Federation," *Journal of Public Economics* 68 (1998):453-78.
26. See Dahlby, "Fiscal Externalities and the Design of Intergovernmental Grants."
27. The Samaritan's Dilemma refers to a situation in which a potential recipient of assistance from a donor (the "Samaritan") exploits the situation by choosing a course of action that impoverishes himself in (correct) anticipation that the Samaritan will provide remedial support.
28. See the analysis in A.J. Caplan, R.C. Cornes and E.C.D. Silva, "Pure Public Goods and Income Redistribution in a Federation with Decentralized Leadership and Imperfect Mobility," unpublished paper, 1998. Models also exist in which households move first, followed by federal and provincial governments. If the households anticipate the equalizing policies that the governments will implement in the future, the allocation of labour will be inefficient. Mitsui and Sato construct a simple example in which households prefer to live in the largest community, which leads to concentrations of population that are too high, Kyoshi Mitsui and Motohiro Sato, "Ex Ante Free Mobility, Ex Post Immobility, and Time-Consistent Policy in a Federal System," *Journal of Public Economics* (forthcoming).
29. For some recent evidence, see Michael Baker, A. Abigail Payne and Michael Smart, "An Empirical Study of Matching Grants: The 'Cap' on CAP," *Journal of Public Economics* 70 (1999):269-88.
30. See W.R. Johnson, "Income Redistribution in a Federal System," *American Economic Review* 78 (1988):570-73.
31. The classic approach to fiscal federalism in Richard A. Musgrave, *The Theory of Public Finance* (New York: McGraw-Hill, 1959); and later in Oates, *Fiscal Federalism* argued strongly that redistribution should be the responsibility of the federal government.
32. The exceptions are China and Russia where, for historical reasons, tax collection is highly localized and revenues are passed up to the centre.
33. See Boadway and Keen, "Efficiency and the Optimal Direction of Federal-State Transfers."
34. For a summary of the issues in Canada, see Robin Boadway and Paul A.R. Hobson, *Intergovernmental Fiscal Relations in Canada* (Toronto: Canadian Tax

- Foundation, 1993); and Boadway and Hobson eds., *Equalization: Its Contribution to Canada's Economic and Fiscal Progress* (Kingston: John Deutsch Institute for the Study of Economic Policy, Queen's University, 1998). A contrary view may be found in Usher, *The Uneasy Case for Equalization Payments*.
35. The case for partial equalization on these grounds was put by Boadway and Flatters, *Equalization in a Federal State*, and proposed by the Economic Council of Canada, *Financing Confederation: Today and Tomorrow* (Ottawa: Supply and Services Canada, 1982).
  36. G.M. Myers, "Optimality, Free Mobility and Regional Authority in a Federation," *Journal of Public Economics* 43 (1990):107-21.
  37. See especially T. Persson and G. Tabellini, "Federal Fiscal Constitutions: Risk Sharing and Redistribution," *Journal of Political Economy* 104 (1996):979-1009; and "Federal Fiscal Constitutions: Risk Sharing and Moral Hazard," *Econometrica* 64 (1996):623-46; and A. Alesina and R. Perotti, "Economic Risk and Political Risk in Fiscal Unions," *Economic Journal* 108 (1998):989-1008. These authors have also emphasized some of the political economy aspects of decentralization.
  38. See Dahlby, "Fiscal Externalities and the Design of Intergovernmental Grants," for an analysis of the theoretical case for this.
  39. Canada, *Fiscal Federalism in Canada: Report of the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements* (Ottawa: Supply and Services Canada, 1981).
  40. Some recent evidence of this may be found in Baker *et al.*, "An Empirical Study of Matching Grants."
  41. See Ronald Watts, *The Spending Power in Federal Systems: A Comparative Study* (Kingston: Institute of Intergovernmental Relations, Queen's University, 1999) for a wide-ranging survey of the use of the spending power in other federations. There is very little economics literature on the spending power. Economists tend to take its use for granted.
  42. A prominent recent exposition of this view is found in Thomas Courchene, *ACCESS: A Convention on the Canadian Economic and Social Systems*, Working Paper prepared for the Ministry of Intergovernmental Affairs, Government of Ontario.
  43. See Robin Boadway and Harry M. Kitchen, *Canadian Tax Policy* 3d ed. (Toronto: Canadian Tax Foundation, 1999) for further discussion of tax policy issues in a federation.

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## On Re-Balancing Canadian Fiscal Federalism

*Kenneth Norrie and L.S. Wilson*

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*Les ministres provinciaux des finances soutiennent que le fédéralisme canadien est marqué par un déséquilibre fiscal vertical, puisque les provinces ont des besoins financiers plus élevés que leur capacité de prélever des recettes, alors que le gouvernement fédéral se retrouve dans la situation inverse. Cependant, sauf quelques exceptions mineures, les deux niveaux de gouvernements ont accès aux mêmes sources de financement. Il n'est donc plus possible de parler d'une situation traditionnelle de déséquilibre vertical, c'est-à-dire d'une situation où l'un des niveaux de gouvernement a d'importantes responsabilités financières tout en ayant un pouvoir de taxation limité par la Constitution. On se demande, dans ce chapitre, s'il est possible de parler de déséquilibre vertical sans qu'il y ait de limites constitutionnelles au pouvoir de taxation. Selon une première hypothèse, il en coûterait moins cher au gouvernement fédéral qu'aux gouvernements provinciaux et territoriaux de prélever des recettes par la taxation. Selon une autre hypothèse, les provinces et territoires pourraient prélever des recettes de manière aussi efficace que le gouvernement fédéral, mais ne peuvent le faire puisque ce dernier occupe déjà l'espace fiscal. Enfin, il existe des raisons politiques et distributives justifiant les transferts fédéraux aux provinces et aux territoires.*

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### INTRODUCTION

Canadian fiscal federalism is once again under the microscope. Provincial and territorial ministers of finance issued a report last year on the state of Canadian fiscal federalism. The basic premise of this document is that there is a fundamental vertical fiscal imbalance in Canadian federalism in that, "the distribution of revenue sources between orders of government ... is out of line with the distribution of spending responsibilities."<sup>1</sup> Provinces have spending needs greater than their revenue-raising capacities, while the federal government is in the opposite position. This fiscal imbalance has existed throughout the postwar period, in their view, but it became particularly acute in the years of federal fiscal restraint in the 1990s as cash transfers to the provinces were cut significantly more than other federal program spending. Further, it will

get worse in the future since provincial expenditure responsibilities in the areas of health, education, and social assistance in particular are widely expected to grow significantly, outstripping the natural growth in their revenue.

The ministers recognize that the federal government provides fiscal transfers to offset this fiscal imbalance, but they argue that there are three basic objections to such payments. First, the amounts are inadequate. Second, provinces have been subject to sudden and arbitrary changes in the amounts of the transfers, making budgeting difficult. Third, Ottawa has often attached conditions to what should, in principle, be unconditional transfers, thereby distorting provincial spending priorities. This final problem is most acute in the case of health spending, although it extends to social assistance as well.

The report concludes that there is a pressing need for fiscal re-balancing. Expenditure responsibilities for the major areas of health, education, and social assistance are properly assigned to the provinces in their view, so the only recourse is to transfer some revenue capacity to them. The transfer can take any of three forms: increased cash transfers, equalized tax point reallocations or tax field realignment. The report discusses briefly the pros and cons of each option, but makes no recommendations on a preferred option.

The concept of a vertical fiscal gap is familiar in the fiscal federalism literature. All federal systems must assign expenditure responsibilities and tax powers across levels of government. In principle, these assignments are done separately, expenditure function by expenditure function, and revenue source by revenue source. The question in each case is where, on efficiency and equity grounds, the responsibility is best lodged. Not surprisingly, the accepted view is that it is unlikely to be optimal to match revenues and expenditures perfectly. Almost certainly, some governments will find themselves with significant expenditure obligations, yet be formally excluded from exploiting one or more of the major tax sources. Conversely, other orders of government will be able to raise revenue in excess of their assigned expenditure obligations.

If taxes and expenditures do not match perfectly, a vertical fiscal gap exists and intergovernmental fiscal transfers are called for. The jurisdiction with the "surplus" fiscal capacity taxes in excess of its expenditure obligations and makes transfers to those who face formal (e.g., constitutional) constraints on their revenue-raising ability.<sup>2</sup> Most often, the gap is such that transfers flow from national to subnational orders of government. The arguments for assigning tax powers to higher levels of government seem strong while expenditure responsibilities often seem better assigned to lower levels of government.<sup>3</sup> Transfers for fiscal gap reasons are appropriately purely unconditional in design.

The assignment of taxation authority between federal and provincial governments in Canada is unique, however, in that, with minor exceptions, both levels of government have full access to all current major revenue sources. Thus, the traditional reason for expecting a vertical fiscal gap — one order of government with significant expenditure responsibilities but constitutionally

shut out of one or more major tax-revenue sources — does not apply. On the surface at least, it would seem that provinces can spend what they wish on social and other programs as long as they are willing to bear the political and other costs of funding them with their own taxation efforts. They simply have to weigh the perceived benefits of additional expenditures against the perceived costs of financing them. Thus it is tempting to view the finance ministers' position as an attempt to avoid politically unpopular taxes.

The belief in the need for fundamental fiscal re-balancing in the Canadian federation is too deeply ingrained to dismiss this easily, however. It is important to ask whether a vertical fiscal gap is possible *even if* there are no important constitutional constraints on taxation. We shall address that question in the remainder of this chapter. We begin in the next section by setting out very briefly the traditional concept of a vertical fiscal gap. We then move on to consider how vertical fiscal gaps might exist in the absence of constitutional constraints. One possibility is that, whatever the constitutional situation, the economic cost to the federal government of raising revenue through taxation is actually lower than it is for provinces and territories. Thus it is efficient for Ottawa to tax in excess of its expenditure obligations and transfer cash unconditionally to the other orders of government. We examine this argument in the third section.

This first possibility clearly calls for unconditional cash transfers. The finance ministers' document considers cash transfers, as noted above, but it also calls for tax point transfers from the federal government to provinces and territories. Essentially it suggests that Ottawa should reduce its taxation efforts in the main revenue categories so that provinces and territories can take up the room. The argument seems to be that provinces and territories could exploit this tax room as efficiently as the federal government does, but that they are prevented from doing so by Ottawa's prior occupancy. We examine this possibility in the fourth section. Section five looks at two other possibilities and the final section provides some brief concluding comments.

## THE TRADITIONAL CONCEPT OF A VERTICAL FISCAL GAP

We shall not attempt a broad review of the considerations for the optimal assignment of tax and expenditure powers across levels of government. Excellent reviews are available in Boadway and Hobson and Boadway, Roberts and Shah.<sup>4</sup> When all arguments are considered, however, the conventional wisdom places relatively more taxation powers at the national or central order of government and relatively more expenditure responsibilities at the regional or provincial order. This conclusion implies that the fiscal gap, in a system with the optimal allocation of powers, is such that national governments must transfer funds to subnational governments.

Much government expenditure is on private or local public goods such as education, local services such as roads and health care. The standard argument is that there are few spillovers from these types of expenditures to the nation as a whole, and that the regional/provincial level can be more responsive to local needs and preferences. Thus, a large portion of expenditure responsibility should be assigned to that order of government. The efficiency gains from tailoring the services to the preferences of the local populations will outweigh the efficiency losses from having some spillover of benefits into neighbouring jurisdictions. Where the reverse is true, as in defence expenditures, for example, the responsibility is best assigned to the federal government. The presumption, however, is that the former types of expenditure outweigh the latter by a considerable margin in a regionally diverse nation such as Canada.<sup>5</sup>

Taxation, on the other hand, as described in detail in the next section, is perceived as having large spillovers, with the implication that central control is desirable. Many of the main tax bases — labour income, taxes on capital such as corporation and taxes on interest earnings — are quite mobile. This feature invites tax competition among provinces and the inefficient allocation of resources or the tax burden. Factor inputs, for example, may locate inefficiently so as to minimize the tax burden. Tax competition among provinces may result in a level of overall government expenditure that we might view as too small: the “race for the bottom” as it has been called.

This, then, is the standard depiction of a vertical fiscal gap in a federation. For efficiency reasons, the bulk of expenditure responsibilities are assigned constitutionally to provincial, territorial and local governments. Likewise for efficiency reasons, the main taxation power is vested in the central government. Society is best served if the central government is the main taxing authority, transferring some of the revenue unconditionally to subnational governments to cover their expenditure responsibilities.

This standard story presumes that the assignments of taxation and expenditure authority are done formally. In this instance, a vertical fiscal gap exists because subnational governments are excluded from one or more important revenue sources. But this is not the case in Canada, as already mentioned. With a couple of minor exceptions, provincial and territorial governments have access to the same tax bases as the federal government. The standard story does not hold, in other words. The question though is whether provinces and territories are constrained in their access to the main revenue sources *in fact*, if not in principle. We address this question in the next section.

Before doing so, however, it is important to note that there are other reasons to argue that the central government should retain a significant share of the tax base. Management of the macro economy and thus fiscal policy is usually thought best done at the national level,<sup>6</sup> and this task requires the federal government to have sufficient control over taxes to pursue these

policies. The tax system is also a main policy tool for redistribution among persons. Thus, if equity is seen as a policy that should be pursued, nationally this tool must be available to the federal government. These considerations apply whether the federal government spends the revenues itself or transfers the funds to other governments; it is the share of the tax base that is at issue.

There is yet another important reason why the federal government will tax in excess of its own program expenditure needs, one that provincial and territorial governments in Canada embrace, it should be noted. Horizontal equity is important across provinces. The general idea that citizens of equal ability need to be treated equally by government in its entirety implies that citizens should have approximately equal access to government services at similar tax rates wherever they live. This is a basic idea of the equalization system. Equalization would be possible with a "net" system, where "have" provinces transferred funds directly to "have-not" ones.<sup>7</sup> In Canada, however, it is not done this way. Rather the federal government raises the potential revenues of the have-nots up to some level, currently the "five-province average." This commitment requires that the federal government have revenues in excess of its expenditure needs, that is, that there be a fiscal gap in favour of the federal government.

In closing this section, we should note that there is a contrary view of transfer payments in the fiscal federalism literature. Essentially, this group argues against separating taxation and expenditure decisions.<sup>8</sup> Governments at all levels should face some tax responsibility in order to make them accountable to their constituents for efficient management and expenditures. This condition is normally seen as satisfied if governments have to raise their own funds at the margin for any extra expenditures. The Canadian equalization system, for example, is carefully designed so that recipient provinces receive transfers based not on what their actual revenues are but rather on what they would get if they were to apply the average rate of taxation to the average base. This leaves provincial governments free to make their own tax decisions, without any impact on the amount of equalization they receive, and leaves them responsible to their citizens for prudent expenditure and taxation decisions.

While the literature is fairly clear on the optimal assignment of taxes and expenditure powers across levels of government, the Canadian situation only partly conforms to this wisdom. In particular, as discussed above, both levels of government have virtually full access to all major tax bases. In this situation it is less clear why a fiscal gap might exist, and it is this question we turn to now.

## A CASE FOR CASH TRANSFERS

The case for cash transfers rests on the premise that it is socially efficient for the federal government to raise revenues in excess of its program expenditure



needs, and transfer the surplus to provinces and territories. There are at least two reasons why this situation might hold.

#### ELASTICITY PERCEPTIONS

Assume initially that there are no fiscal transfers in the federation. Each order of government sets its own program-spending priorities and finances them by exploiting its own tax-revenue sources. There is a marginal benefit to government program spending, denoted as  $MB_f$  for the federal government and  $MB_p$  for a provincial government. These terms can be thought of as representing the value that residents in a given province place on one more dollar of federal and provincial government program spending respectively.

There is a cost to raising an extra dollar of government revenue, known as the marginal cost of public funds and denoted as  $MCPF_f$  for the federal government and  $MCPF_p$  for a provincial government. Briefly, the marginal cost of public funds can be thought of as a measure of the social cost of the government collecting one more dollar of revenue. It includes the private opportunity cost of the income transferred to the government plus the costs of any distortions in the economy that taxes bring about. An example of such a distortion would be the value of the output foregone if higher income taxes caused workers to work fewer hours. The  $MCPF$  typically will vary among tax bases, although governments acting optimally will equalize the marginal social cost across different sources. If it is less costly to get revenue by taxing base A than by taxing base B then taxes would be lowered on B and raised on A. Thus, we can think of the  $MCPF$  as the social cost of raising one dollar of taxes from the least-cost revenue source open to the government.

Governments acting optimally will expand spending to the point where the marginal benefit from the last dollar of program spending equals the marginal cost of raising that last dollar. Thus in equilibrium,  $MB_f = MCPF_f$  for the federal government and  $MB_p = MCPF_p$  for each provincial government. Assume now that  $MCPF_f < MCPF_p$ ; that is, that for some reason the cost to the federal government of financing the final dollar of program spending is less than it is for the provinces. From a citizen's perspective, the implication is that  $MB_f < MB_p$ . The marginal benefit to taxpayers of the last unit of federal government program spending is less than the marginal benefit of the last unit of program spending by their provincial government.

Here then is the case for fiscal transfers. Residents would clearly be better off if the federal government were to reduce its program spending by one dollar, and transfer the dollar to the provincial government to allow it to increase its program spending by that amount. The loss from lower federal program spending is more than made up for by the gain from higher provincial program spending. Increasing provincial program spending and reducing

federal program spending will narrow the gap between  $MB_f$  and  $MB_p$ . Transfers should continue as long as there is such a gap, however. The optimal level of transfer is that amount sufficient to ensure that  $MCPF_f = MB_f = MCPF_p = MB_p$ . A vertical fiscal gap can be said to exist in this case if the value of cash transfers falls short of this optimal amount.

The key to either result is the assumption that  $MCPF_f < MCPF_p$ ; that is, that the cost to the federal government of raising a dollar of revenue from its existing revenue sources is less than that for the provinces from their existing sources. In the absence of transfers, and assuming all governments push program spending to the point where the marginal benefits equal marginal costs, the federal government will overspend relative to the provincial government. The obvious question then is why this condition might hold.

Provincial perceptions of the social costs of raising extra revenues depend on the elasticity of the bases they tax. Because of the possibility of interprovincial migration of these bases, there can be significant differences between the elasticities of the bases an individual province faces and the elasticities the federal government would face were it to tax across all provinces. This will be true of all bases — labour, capital, and consumption — except land. We might think capital to be particularly mobile.<sup>9</sup> Any individual provincial government is thus very different than either a coalition of all provincial governments, acting in unison, or the federal government, perhaps acting on behalf of the provinces.

To the extent that provincial governments perceive that their tax base is quite elastic because of this possibility of migration to other provinces, they will “under-tax”<sup>10</sup> and “under-spend,” compared to what they would do if they faced the same base elasticities as the federal government. The marginal cost of raising the revenue is higher, due to the potential tax distortions, so they will spend less. In this sense then, even though both federal and provincial governments have full access to the same tax sources, it cannot be said that individual provinces face the same bases as does the federal government. Hence the case for unconditional cash transfers.

One might argue that the provinces could collude to raise taxes, thereby by-passing the need to rely on Ottawa’s compliance. If all agreed to raise their rates in unison the problems of migration of the bases between provinces would be minimized, although, as in response to a federal tax increase, bases may still be induced to migrate internationally. In this sense then, if they are able to reach a collusive agreement, the provinces can be said to face the same tax bases as does the federal government. The marginal cost of raising public funds would be the same, and there would be no case for a transfer of revenue capacity from the federal government.

In principle this collusion might seem straight-forward. There are, however, obvious reasons why it may not work so well. These mainly parallel the

reasons we normally believe other forms of oligopoly will be unstable. First, it may be difficult for the provinces to agree on an optimal overall tax rate. Even in collusion, each will face different bases and have different needs and social preferences so each would prefer to agree on a different, standardized, tax rate. There may, however, be a number of uniform tax rates that would represent an improvement across all provinces even if the one chosen would not necessarily be the optimal one from the point of view of any individual province. In addition, provinces may all be able to improve their positions, not by agreeing on a uniform overall rate, but by being able to agree on a uniform increase from their current rates, which may all differ from each other. Thus, all may currently have different rates and all can improve their welfare by agreeing to a uniform increase, leaving them all continuing to have different rates.

A more difficult problem is the standard problem of any oligopoly — that it pays individual provinces to cheat or break ranks. As with other oligopolies, any individual player can do better by going its own way, assuming others continue to play by the rules of the oligopoly. In this case then, any province would be better off lowering its tax rates if it has the expectation that the other provinces will not follow. A general question is how exactly a province might behave in this situation. Will they expect that their own behaviour will have no impact on what the others do? Will they expect some sort of implicit collusion such that if it raises its rates, the others will follow? Casual empiricism suggests provinces compete to have low tax rates, implying they do not believe others will follow their lead and thus that they do not implicitly collude.

One way of colluding in a “binding” fashion is to get the federal government to levy the taxes on the part of the provinces. In this case, once agreement is reached between the federal government and the provinces, “cheating” could be much more difficult and, depending on the arrangements, less important.

There are various possible ways in which the revenues collected by the federal government could be distributed. One possibility is that the federal government would be the equivalent of a collection agency for the provinces, as indeed it already is for personal income taxes for all but Quebec, transferring to each province all revenues collected from the bases within that province. Here, then, provinces would continue to levy their own taxes, collected through the current arrangements, but in addition the federal government itself could levy taxes with the promise that the revenues from these would be passed on to the provincial governments. These federal government levied taxes would have the feature that individual provinces would not be able to alter the rates that applied to bases within their own jurisdictions. Assuming, however, that the provinces continued to have enough tax revenues under their direct control, they would be able to counteract the agreed-upon overall rates by changing their provincial tax rates, in other words to “cheat” on the collusive arrange-

ment just as if the federal government were not involved. This arrangement, then, would be equivalent to transferring tax points to the provinces.

Alternatives where the federal transfers of taxes collected on behalf of the provinces were less directly related to the base within the particular province would reduce the incentives for individual provinces to break the collusive arrangement. Arrangements to transfer taxes collected as lump sums or fixed per capita amounts would break the link between base size and provincial transfer revenues (or per capita revenues). In the case of per capita transfers, for example, changes in the provincial tax rates will affect the provincial base, and direct provincial revenues, perhaps including equalization payments, but this will not affect their federal government transfers from the agreement. In the previous case, where the amounts of federal transfers that provinces receive are dependent on their bases, changes in provincial tax rates will affect both own revenues and transfers as the impact of tax changes on the base will feed through both sources.

Provinces still have the incentive to alter their rates, and thus change their bases, because of the impact on their own revenues, but if this makes up a smaller portion of their overall revenues this will be less important. In this sense, then, arrangements where federal revenues collected on behalf of the provinces are distributed in some way unrelated to the provincial tax base provide less incentive for the provinces to "cheat on," or counteract, the agreement than would arrangements where transfers depended on the base. These sorts of arrangements are thus likely to be more stable and provinces might prefer them.

This introduces another factor which may make it more difficult for the provinces to agree than would be the case in the simple collusion case as a collusive arrangement to raise taxes does not require the provinces to also decide on the distribution of revenues. At the same time, having the federal government involved does provide an arbiter with some authority. If, as we argue, the provinces need the federal government in order to provide stability in collusion, this gives the federal government at least some power to impose distributional arrangements.

Finally, it is clear that the need to have the federal government involved to impose discipline on collusion, combined with the fact that distribution of tax revenues in ways other than according to base is desirable, means that this argument for federal involvement is inextricably entwined with the arguments around redistribution of revenues across provinces. Some provinces may like a system where the federal government taxes and redistributes on a per capita basis because they stand to be significant gainers, for example, while others may be enthusiastic because it allows provinces to raise revenues without competition over the bases. These two arguments therefore reinforce one another.

## FISCAL EXTERNALITIES

The literature on fiscal externalities in federal systems suggests that provincial fiscal decisions will not be optimal.<sup>11</sup> The type of collusion, whether with or without the federal government's help, discussed in the previous section will correct for some, but not all, of these externalities.

There are externalities from both the taxation and expenditure decisions of both levels of government and these externalities can be both horizontal, in the case of provincial governments, and vertical. Provincial government taxation decisions, through causing migration of the bases, can have impacts on revenues in other provincial jurisdictions. If Newfoundland raises its income tax rate, causing people to migrate to other provinces where they pay taxes, then Newfoundland causes a horizontal fiscal externality. If some of the impact of this Newfoundland tax increase is to reduce hours of work or investment in training or otherwise lower the overall income tax base then this will cause a vertical externality in that federal tax revenues will decrease.

There are parallel externalities in expenditures. Some provincial expenditure will have impacts on residents of other provinces. Flood control expenditures in Alberta, for example, may also benefit residents of Saskatchewan. This is the classic and best-known argument for interprovincial transfers in federal systems. There can also be horizontal expenditure externalities that work through provincial government fiscal variables. An example of this would be where expenditure on education in Alberta raises the productivity of someone who ends up paying higher income taxes in Saskatchewan. Finally, expenditure on education by the Alberta government, by raising workers' productivity will also raise federal tax revenues. This is an example of a vertical fiscal expenditure externality.

All of these types of externalities suggest that provincial (and federal) governments will not make optimal tax and expenditure decisions because they do not take the full implications of their decisions into account. Collusion among provinces so that they raise their taxes in concert, thus facing the same elasticities as would the federal government, will correct for horizontal fiscal externalities but not vertical ones. If the provinces raise their rates together then bases will not migrate between provinces and thus horizontal fiscal externalities will be eliminated. There may still be an impact on the overall size of the base nationally, however, and thus the vertical — between the provinces and the federal government — externalities will remain. In general, in taxation, the two externalities will oppose one another in effect such that we cannot say whether provincial tax rates will be too high or too low for overall economic efficiency. Correction for only the horizontal externalities, then, seems likely to ensure that provincial taxes are too high as only the vertical fiscal externality effects on federal revenues will remain. This, then, will provide a further argument for having the federal government play an important

role in the collusion process. If the federal government taxes and transfers to the provinces then the full fiscal impact, both vertical and horizontal, of the tax can be taken into account and taxation would be closer to optimal in this sense.

#### SUMMARY

In summary, provincial governments realize that the tax bases they face are more elastic than those same bases are when taxed by the federal government because of the possibility of migration between provinces. If provincial governments believe they are acting independently, then they will feel that the social cost of raising revenues is higher than it would be if they could act in concert or get the federal government to act on their collective behalf. Collusion is difficult among provinces for the same reasons that we think other forms of oligopoly are unstable, in particular that it pays any individual "player" to cheat on the collective group. For this reason a system where the federal government plays an important role will be or should be attractive to the provinces.

Involving the federal government means that the allocation of these federal revenues to the provinces is an issue in a way that it would not be if the provinces taxed for themselves, directly. Depending on the method of allocation of revenues, some provinces will have an additional interest in enforcing collusion through the federal government.

There are reasons to believe that taxation decisions will not be made optimally by either level of government because of horizontal and vertical fiscal externalities. Collusion between provinces to act in concert will correct for horizontal externalities. Using the federal government to enforce collusion, on the assumption that provinces would otherwise cheat on the collusive arrangements, will be only partially successful as the provinces could still partially off-set the federal share of taxes collected on their behalf by lowering their own rates. On the other hand, the direct involvement of the federal government in the arrangements may allow for some accommodation for the vertical fiscal externalities existing between the federal and provincial decisions.

#### A CASE FOR TAX POINT TRANSFERS

In the preceding section, the appropriate response to a vertical fiscal gap was unconditional cash transfers. The finance ministers considered this solution, but they also called for tax point transfers. Ottawa would lower its taxation rates on the main revenue sources, allowing provinces and territories to take up the room. Implicit in this position is the assumption that there is no

difference in the marginal cost of public funds facing national and subnational governments. The federal government dominates taxation because of prior occupancy, and not because of any natural efficiency advantage. The obvious question is how prior occupancy can provide such an advantage.

Suppose first that the marginal cost of public funds does not differ significantly between national and subnational jurisdictions. Suppose further that there is some maximum combined federal and provincial tax rate that is acceptable, say, because we believe rates cannot go beyond a certain amount higher than those in the United States. Put differently, suppose the marginal cost of public funds for the combined government sector rises steeply beyond current taxation levels. Suppose, finally, that the marginal benefit of provincial and territorial program spending is greater than that for Ottawa. Provinces and territories must tax more if they are to spend more, and if they are to tax more then Ottawa must tax less.

In principle this is a bilateral bargaining situation where there is a fixed amount that must be divided some way. One might argue that the provinces are at a disadvantage in this bilateral bargaining. First, to force reallocation of this fixed amount, the provinces would have to raise taxes hoping to force the federal government to lower theirs. Which level of government would win out in this confrontation presumably depends on public opinion. Because the federal government already "occupies" this tax room, the provinces will be seen as the ones raising taxes. "Prior occupancy" is thus important.

Second, as noted above, this is only a bilateral bargaining situation if the provinces act in concert. A single province raising its rates will not be able to force the federal government into reducing its tax rates on the base nationally — the province will stand out in public opinion as the government raising taxes to unacceptable levels.

The notion of prior occupancy certainly figures prominently in the general history of federal-provincial fiscal relations in the postwar period.<sup>12</sup> The federal government assumed full control over personal income tax, corporate income tax, and succession duties during World War II, renting these revenue sources from the provinces. This tax rental system continued after the war, albeit on a voluntary basis. Provinces that wished could opt out of the arrangement and levy their own taxes, in which case they received an abatement of a specified percentage of the federal taxes. In effect, Ottawa lowered its taxes on individuals and businesses in the opting-out provinces, giving the provincial government room to levy its own taxes.

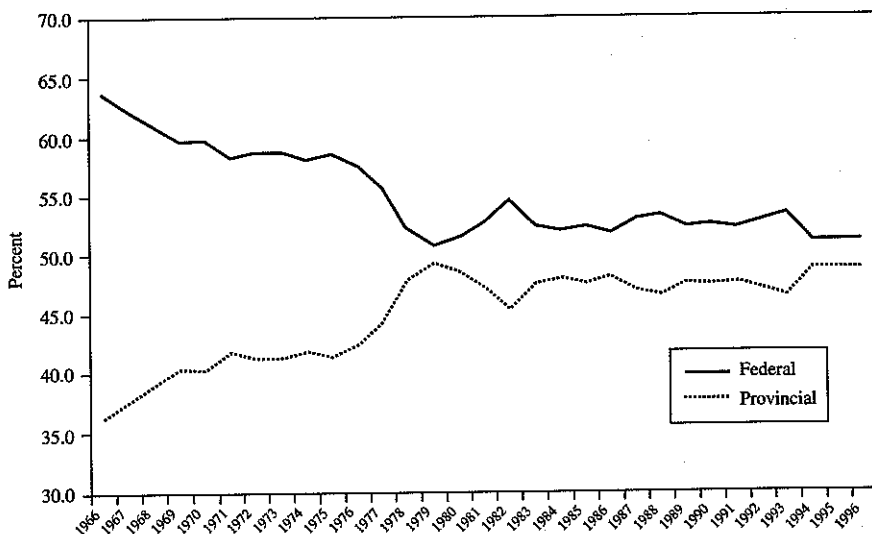
The opting-out option with abatement from federal taxes continued in 1957 when tax-sharing replaced tax rentals. Tax-sharing gave way in 1962 to the tax-collection agreements that underlie the present system. All provinces received a standard abatement of personal and corporate income tax points, and were free to set their own tax rates as a percent of the basic federal tax. The standard abatements rose in a series of adjustments, the last coming in 1977

under the established programs financing arrangements when they reached 44 points for personal income tax and ten points for corporate income tax.

This general transfer of revenue capacity from the federal to the provincial governments is evident in Figure 1. As late as 1966 the federal government accounted for nearly two-thirds of total own-source revenue, while the provinces accounted for one-third. The federal share fell quickly thereafter, when the federal abatements were increasing, reaching just above 50 percent by the late 1970s. It flattens out thereafter, when there were no further changes in abatements. There have been some fluctuations in the shares since then, largely because of variations in provincial government resource revenues, but essentially the trend is constant.

This pattern appears to be consistent with the prior occupancy thesis, wherein provinces can only increase their tax efforts when the federal government reduces its effort. The situation is not that straightforward, however. Provinces responded differently to the freedom in the 1962 tax-collection agreements to set their own rates as a percentage of basic federal tax. Apparently, some provinces had more room than others between the ceiling rates and the room occupied by the prior federal effort. This outcome is not inconsistent with the

**Figure 1: Federal and Provincial Shares of Own-Source Revenue, 1966-1996**



Source: Authors' Compilation.

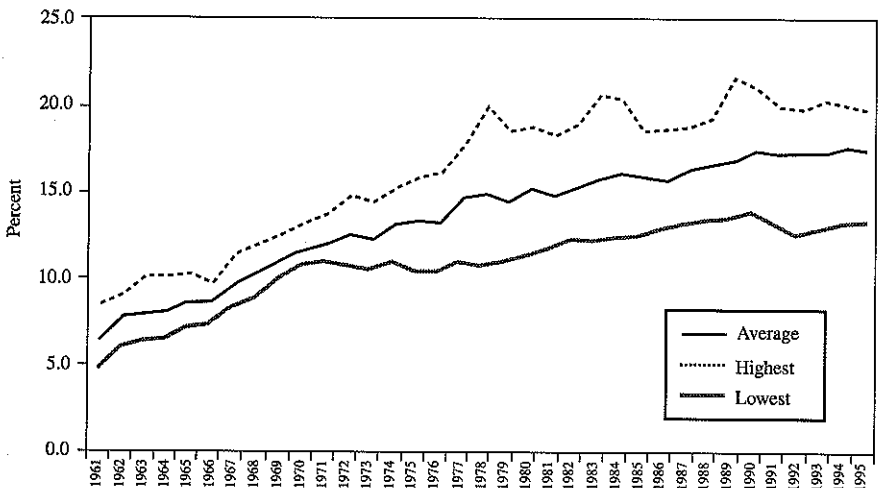


prior occupancy thesis, but it requires that the marginal benefits of public spending or the marginal costs of public funds vary among provinces in a particular fashion.

Certainly, the tax efforts of provincial governments have varied considerably in the postwar period. The solid line in Figure 2 shows the average of own-source revenue as a percent of gross domestic product (GDP) for all provinces for the period 1961-95. The trend is clearly upward, rising from 6.4 percent of GDP at the start of the period to 18.2 percent by the mid-1990s. There is considerable variation among the provinces, however. The bottom line in Figure 2 shows the lowest values for own-source revenue as a percent of GDP, while the top line shows the highest values. Even in 1961 the spread between the lowest (4.9 percent of GDP) and the highest (8.5 percent of GDP) values was 3.6 percentage points. The spread fell slightly to 1970, and then rose more or less continuously to the late 1970s when it reached nearly ten percentage points. It has remained roughly constant since then, albeit with some fluctuations. Removing Alberta, with its swollen energy revenues, from the data narrows the spread in the 1970s and early 1980s only a little.

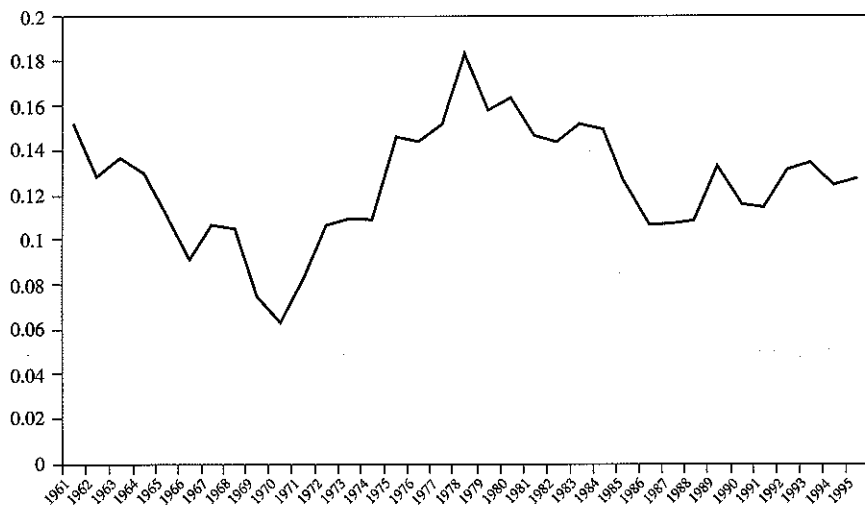
Figure 3 shows the coefficient of variation of own-source revenues as a percentage of GDP for all provinces for the period 1961-95. This value fell markedly in the 1960s, rose again just as dramatically in the 1970s, fell from

**Figure 2: Highest, Lowest, and Average of Own-Source Revenue as a Percent of GDP, All Provinces, 1961-1995**



Source: Authors' Compilation.

**Figure 3: Own-Source Revenue as a Percent of GDP,  
Coefficient of Variation, All Provinces, 1961-1995**



Source: Authors' Compilation.

the late 1970s to the mid-1980s, and has remained virtually constant since. Again, removing Alberta from the data moderates the trends only slightly.

Figures 2 and 3 indicate two facts about provincial taxation efforts. First, despite the equalization program, there is considerable variation at any moment in time among the provinces in the ratios of own-source revenues to GDP. Second, there is considerable change over time in this variation of tax effort among provinces. It is not easy to reconcile these facts with the prior occupancy thesis, which implies that provinces only have the tax room between some upper overall limit on taxation and the first-in share of the federal government.

## OTHER CONSIDERATIONS

Thus far, we have examined situations where the case for fiscal realignment rests on potential real differences between the federal and provincial governments with respect to the cost of raising public funds or on the fact of prior occupancy of the key tax fields. It is always possible, of course, that the real motives lie elsewhere. We look briefly at two such explanations in this section.

## POLITICAL CONSIDERATIONS

One possibility is that the provincial/territorial case for fiscal transfers is purely politically motivated. They may believe that the tax-expenditure decisions of government in total are not well understood by the public, and thus that getting the other level to do the taxing, while they do the spending, will be politically popular. In this case, the social cost of taxation as the provinces perceive it includes a "blame" factor. Thus even though  $MCPF_p$  may not in fact be higher than  $MCPF_t$ , the provinces act as if it were. This argument can explain a call for unconditional fiscal transfers, but presumably not for tax point transfers or tax field realignment.

A variant of this point is that the *changing* of rates is politically costly even if the actual level of rates is not. If governments believe that leaving rates as they are will keep taxes from being an issue, and that taxpayers are only reminded of how unpopular taxes are if rates are changed, in particular raised, then there is some bias to keep rates as they are. In the last few years, when the federal government has been in surplus, then, an overall political cost-minimizing strategy might be for the federal government to pass some of this surplus onto the provinces, as opposed to having the federal government lower, and the provinces raise, taxes. This would require some myopia on the part of voter/taxpayers, but it is possible.

Another possibility is that the marginal political cost of raising funds differs from what we have called the  $MCPF$ . Hettich and Winer suggest that governments do not behave as we have described, equating marginal benefits of expenditure to the marginal cost of public funds, but rather choose taxes and expenditures so as to equate the marginal political cost of funds (MPC) to the marginal political benefits (MPB) of expenditure where these are measured as voting possibilities.<sup>13</sup> The government maximizes its expected vote where the probability of any individual voting for the government depends on functions of expenditure and taxation. The marginal cost of public funds and marginal benefit of expenditure to individuals is quite closely related to these MPC and MPB concepts, but, for example, some beneficiaries may not be voters so these concepts will not be the same. In addition, once a voter is committed to the government, extra benefits, in the form of reduced taxes or increased expenditures, will have no impact on voting behaviour and thus will have no political benefit. The two levels of government may differ in their calculations of the MPC and MPB of extra expenditure, and governments might see this as a reason for transfers.

## DISTRIBUTIONAL CONSIDERATIONS

A further political reason for some provinces to favour fiscal transfers would be the implicit redistribution inherent in the arrangements. Most straight-

forwardly, those provinces in which average income was less than the national average might expect they would be better off with a system in which the federal government taxed and transferred to the provincial governments. This would, of course, depend on the tax and transfer arrangements. Taxes can be expected in our system to be roughly proportional to income. Thus, if transfers were "progressive," say on a per capita basis, the average person in provinces with average incomes less than the national average would benefit. Given that the majority of provinces have average incomes below the national average, any system that gives roughly equal weight to each province, or to each provincial premier in First Ministers' Meetings, might pressure the federal government to tax and transfer.

A more sophisticated argument for federal involvement in financing provincial provision of goods is in articles by both Bos and Wilson.<sup>14</sup> They argue that decisions on the public provision of private goods, which are essentially decisions on redistribution, will depend on the ratio of the median to the mean income in a jurisdiction. There are reasons to believe that this ratio will be lower nationally than in individual provinces<sup>15</sup> — there is more diversity across the nation as a whole than in individual provinces. Thus, the federal government, if it somehow responds to the median federal voter, will be more likely to tax and spend to supply goods to voters than would any provincial government. In this theory, in this case where the federal government must work through the provincial governments, it will be necessary for the federal government to constrain the provincial governments to ensure the transfers are actually made. Thus the concern of the federal government in the recent negotiations that the provinces might use the transfers for tax cuts rather than to increase expenditures on medical care.

## CONCLUSION

Provincial governments in Canada have persistently argued that there is a fiscal gap such that it is easier for the federal government to raise sufficient revenue to meet its needs than for the provinces to meet theirs. This has been used to press for more federal-provincial transfers of either cash or tax points. At the same time, Canada is unique in that the lower level of government, the provinces, have virtually the same access to the tax bases as does the higher level. The question arises, therefore, of whether this fiscal gap really exists and, if so, of the policies that might best be used to correct for it.

While much of the motivation of the provinces for claiming this fiscal gap might be political, there are good reasons to believe that, despite having access to the same tax bases, the provinces are at a disadvantage in using them. In particular, the fact that many, or all, of the tax bases are more mobile interprovincially than internationally makes it more socially costly for the

provinces to raise revenue than for the federal government to do so. Provinces could solve this by cooperating to set rates but this has the usual problems of collusion. One way to enforce collusion is to enter into an arrangement to have the federal government tax and transfer funds to the provinces. This is an argument, as well, in support of the federal government transferring cash rather than tax points.

There are other arguments for leaving the federal government with a large share of the tax base, such that transfers are necessary. If the federal government is to properly pursue a macro-stabilization policy it needs control over a significant portion of revenues. Coordination of tax policies to ensure that factors of production and other goods and services are allocated efficiently can most easily be done if the national government plays an important role in these policies. Third, the goals of personal income distribution and horizontal equity in the country as a whole require a permanent role for the federal government. In particular, equalization of provincial revenue capacities, if this is to be done from federal revenues, requires a federal surplus of revenues over own expenditures. Transferring, however this is done, too much tax room to the provinces endangers the federal government's ability to do this as, not only do federal government revenues fall, but provincial revenues, and thus the amounts needing equalization rise.

There is some evidence that provincial governments have been steadily increasing their share of overall tax revenues. At the same time, their share of overall expenditure responsibilities has also been increasing so this cannot be said to necessarily mean that the fiscal gap has been narrowing. There is also evidence that many provinces have not "hit a wall" in terms of their ability to raise revenues. It seems rather that they are politically restrained in some way. This conclusion follows from the wide range of provincial own-source revenue to GDP ratios observed across the provinces.

## NOTES

1. Provincial/Territorial Ministers of Finance, *Report to Premiers* (Ottawa: Supply and Services Canada, 1998), p. 13.
2. The clearest example of a vertical fiscal gap is the situation brought about by the fiscal arrangements introduced with the *Constitution Act, 1867*. Customs and excise duties were the major source of government revenue at the time. Provinces were prohibited from levying them, so as not to interfere with inter-provincial trade. But provinces still had significant expenditure responsibilities, even though they had no access to the sole significant revenue source. Thus, Ottawa provided statutory subsidies to the original four provinces, and to new ones as they entered the union.
3. This is not necessarily the case, however. One might argue that the fiscal gap ran in the other direction in Canada in the energy-crisis years of the 1970s and

early 1980s when some provincial government coffers were swollen by natural resource royalties denied to the federal government.

4. Robin Boadway and Paul Hobson, *Intergovernmental Fiscal Relations in Canada* (Toronto: Canadian Tax Foundation, 1993); and Robin Boadway, Sandra Roberts and Anwar Shah, *The Reform of Fiscal Systems in Developing and Emerging Market Economies: A Federalism Perspective*, Policy Research Working Paper Series No. 1259 (New York: World Bank).
5. This argument ignores the possibility that the federal government could tailor its policies regionally or, conversely, that provincial and territorial governments could collude to offer national ones. See Albert Breton and Anthony Scott, *The Economic Constitution of Federal States* (Toronto: University of Toronto Press, 1978), for a model where these possibilities are considered by including comparative transactions costs.
6. Ignoring the possibility of provincial governments colluding in this task. See the previous note.
7. See Paul Boothe and D. Hermanutz, *Simply Sharing: An Interprovincial Equalization Scheme for Canada* (Toronto: C.D. Howe Institute, 1999), for a discussion of such a scheme.
8. See Boadway, Roberts and Shah, *The Reform of Fiscal Systems*, p. 20.
9. There are a large number of studies showing the mobility of labour. See Stanley Winer and Denis Gauthier, *Internal Migration and Fiscal Structure* (Ottawa: Economic Council of Canada, 1982); K.E. Mills, M.B. Percy and L.S. Wilson, "The Influence of Fiscal Incentives on Interregional Migration: Canada 1961-78," *The Canadian Journal of Regional Science* 6, 2(1983):207-29; and R. Paul Shaw, "Fiscal versus Traditional Market Variables in Canadian Migration," *Journal of Political Economy* 96, 3 (1984):648-66. See Bev Dahlby, "Distorting Taxation and the Design of Intergovernmental Grants," Edmonton: Department of Economics, University of Alberta, unpublished paper, re: consumption and cross-provincial boundary shopping. There is, of course, elasticity in the bases even nationally — international capital flows, emigration, some cross-border shopping.
10. While provinces are under-taxing compared to what they would wish to do if they could somehow control migration of their bases, they are not necessarily under-taxing compared to an efficient outcome. We will explain below that there are two types of externalities from provincial tax decisions and these may work in opposite directions. Thus, while it is likely that the level of provincial taxes will not be optimal we cannot say whether they will be too high or too low compared with the efficient level.
11. See William R. Johnson, "Income Redistribution in a Federal System," *American Economic Review* 78, 3 (1988):570-73; and Bev Dahlby and L.S. Wilson, "Fiscal Capacity, Tax Effort and Optimal Equalization Grants," *Canadian Journal of Economics* 27 (1994):657-72, and "Tax Assignment and Fiscal Externalities in a Federal State," in *Reforming Fiscal Federalism for Global Competition: A Canada-Australia Comparison*, ed. Paul Boothe (Edmonton: University of Alberta Press), pp. 87-107.

12. For a general history of federal-provincial fiscal relations, see Boadway and Hobson, *Intergovernmental Fiscal Relations in Canada*; or Peter M. Leslie, Kenneth Norrie and Irene K. Ip, *A Partnership in Trouble: Renegotiating Fiscal Federalism* (Toronto: C.D. Howe Institute, 1993).
13. Walter Hettich and Stanley Winer, *Democratic Choice and Taxation: A Theoretical and Empirical Analysis* (Cambridge: Cambridge University Press, 1999), pp. 44-46.
14. Dieter Bos, "A Voting Paradox of Fiscal Federalism," *Journal of Public Economics* 11 (1979):369-82; and L.S. Wilson, "The Socialization of Medical Insurance in Canada," *Canadian Journal of Economics* 18, 2 (1985):355-76.
15. See Wilson, "The Socialization of Medical Insurance in Canada," p. 373.

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## The Social Union Framework Agreement and the Future of Fiscal Federalism

Harvey Lazar

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*Ce chapitre étudie les effets possibles de l'entente-cadre sur l'union sociale de 1999. On y soutient que cette entente pourrait devenir une innovation importante en termes d'élaboration des politiques sociales dans la fédération. Comme les ententes fédérales-provinciales sur les politiques sociales majeures constituent un élément essentiel du fédéralisme fiscal, il est de mise d'étudier les interactions possibles entre l'entente sur l'union sociale et les instruments et processus du fédéralisme fiscal.*

*L'analyse ici présentée conclut que l'ECUS prévoit un rôle continu tant pour les transferts fédéraux aux provinces que pour les transferts fédéraux directs. On y soutient aussi que la simple existence de l'entente sert sans doute à diminuer la probabilité d'un transfert de points d'impôt d'Ottawa aux provinces. L'entente témoigne aussi d'une plus grande préoccupation, de la part d'Ottawa, face aux déséquilibres horizontaux plutôt que verticaux. Les clauses sur la planification concertée jouent cependant le rôle d'un contrepoids. Si elles sont proprement mises en oeuvre, elles pourraient réduire les coûts externes associées à une fédération décentralisée et ainsi ouvrir la porte à une plus grande décentralisation. Nul ne peut toutefois prédire comment ces forces contradictoires s'équilibreront.*

*En ce qui a trait à la pratique du fédéralisme fiscal, il y a une tension entre le rôle central qu'ont traditionnellement joué les ministres des finances provinciaux et fédéraux dans le développement du fédéralisme fiscal et le rôle accru que l'ECUS assigne aux ministres responsables des affaires sociales dans la planification des programmes sociaux. Si les décisions fondamentales en matière de transferts sociaux sont prises dans l'environnement extrêmement politisé de la planification du budget fédéral, il sera difficile de mettre en oeuvre les principes sous-jacents de l'ECUS. Il faudra que les ministres des finances se montrent ouverts à la participation des ministres responsables des affaires sociales pour que l'ECUS fonctionne.*

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Federal and provincial finance ministers and their officials have been the principal architects of Canadian fiscal federalism in the decades since World War II. They are the ones who have shaped the way in which taxation revenues are shared and harmonized. They have also played the lead role in devising the system of intergovernmental transfers that has served to reduce vertical and horizontal fiscal imbalances among provinces. The federal Finance ministry in particular has been especially influential in determining the size of these transfers and the design of the Canada-wide social programs associated with them.

Among other things, this chapter investigates the possible impacts on Canadian fiscal federalism of the 1999 agreement to establish A Framework to Improve the Social Union for Canadians.<sup>1</sup> The SUFA (Social Union Framework Agreement) was negotiated mainly through intergovernmental and social ministries, not finance ministries.<sup>2</sup> It is argued here that the Framework Agreement could turn out to be a major innovation in the workings of the federation, heralding a new era of collaboration, mutual respect among orders of government and a more coherent and systematic approach to social policy-making. It could accordingly mean a different set of dynamics in our system of fiscal federalism. Alternatively, it could be ignored by its signatories and relegated to a footnote in the country's history. The energy and spirit with which government leaders implement the agreement's provisions during its initial three-year term will help to determine which of these directions will be followed.

An analysis of SUFA is important for this volume because of the large overlap and interaction between the Framework Agreement and Canadian fiscal federalism. Fiscal federalism, through its use of the federal spending power, has played a large role in promoting interprovincial equity and in facilitating the creation and maintenance of Canada-wide social programs. SUFA is in part about joint intergovernmental planning of social programs and the uses of and limitations on the federal spending power. Thus, there is an apparently tight link between these two sets of policies.

This chapter is by no means restricted, however, to the effects of SUFA on fiscal federalism. The agreement is also analyzed from a broader perspective, in part because such an assessment has merit in its own right but also because it helps to create a context for the discussion of possible implications for fiscal federalism. The objects of this chapter are thus three-fold. The first is to describe the architecture of SUFA. The focus here is on its broad scope: what it contains and what is excluded. Second, taking account of the analysis in the first section, the accord is then examined for its potential effects on the design and implementation of *social policy*, on the institutions and processes of *democratic government* and on the workings of the *federal principle*. The last section then focuses on what SUFA may mean for the future of fiscal federalism in Canada.

## PART 1: ARCHITECTURE OF THE FRAMEWORK AGREEMENT

Section 1 of the Framework Agreement sets out a series of *principles* which signatory governments agree to abide by in the design, implementation, and evaluation of social policy. In general, the principles are very broad. Among other things, they commit governments to “treat all Canadians with fairness and equity,” “promote equality of opportunity for all Canadians,” “ensure access for all Canadians, wherever they live or move in Canada, to essential social programs and services of reasonably comparable quality,” “promote the full and active participation of all Canadians in Canada’s social and economic life” and “ensure adequate, affordable, stable and sustainable funding for social programs.” Intertwined with these principles is a rather more specific commitment, namely, respect for “the principles of medicare: comprehensiveness, universality, portability, public administration and accessibility.” Appropriately, the principles involve a balancing act. For example, principles that appear to support benefit entitlements, such as “provide appropriate assistance to Canadians in need” and “ensure access for all Canadians ... to essential social programs and services of reasonably comparable quality” are balanced by the principle related to affordability cited above.

There is more than one way of analyzing SUFA. One way is to examine to what extent the remaining six sections (sections 2-7) of the agreement are concerned with *process* and to what extent with *substance*. On this basis, at least at first blush, five of the sections appear to deal mainly or exclusively with process. These include section 3 on “Informing Canadians — Public Accountability and Transparency,” section 4 on “Working in Partnership for Canadians,” section 6 on “Dispute Avoidance and Resolution,” and section 7 on “Review of the Social Union Agreement.” Section 5 on “The Federal Spending Power — Improving Social Programs for Canadians” is also about process. Only section 2 on “Mobility within Canada” is mainly about substance.

But, of course, this distinction between process and substance implies a clear separation of purpose that in some cases may be more apparent than real. The section on the spending power effectively re-affirms the legitimacy of this instrument in the eyes of signatory governments and also sets out some limitations on its use. These spending-power provisions do not, in themselves, constitute changes in the substance of social policy. Arguably, however, they are of substantive significance in the context of how federal and provincial governments wish to manage the federation and will also in due course bear on the future of Canadian social policy. Similarly, over time, the requirement to better inform Canadians about the outcomes of current programs may be expected to help shape their future evolution. It may also be expected that citizens and social activists will point to the principles laid out in section 1 as a basis for demanding improved social policies and programs. Other examples can be provided. So it is indeed possible that SUFA will have an important

substantive impact on social policy. Indeed, some officials who were involved in the negotiation of SUFA believe that, in the eyes of the public, SUFA's ultimate success or failure will be judged by its results in terms of social policies and programs.<sup>3</sup>

In the years immediately preceding the social union agreement, commentators from the research community recognized that one of the fundamental issues that needed resolution in the social union debate was how best to balance three sets of vital public interests: the quality and effectiveness of social policy; protecting and advancing the institutions and processes of democracy; and respect for Canada's federal character.<sup>4</sup> Looking at SUFA through this perspective, it can be seen that the section 1 principles touch mainly on the goals and purposes of social policy. This is evident from re-reading the several principles cited above (relating to equality, medicare, assistance to those in need, affordability, etc). Secondly, that section implicitly acknowledges the risk of a democratic deficit in the social union. And it seeks to attenuate this possibility by committing governments to "work in partnership with individuals, families, communities, voluntary organizations, business and labour, and ensure appropriate opportunities for Canadians to have meaningful input into social policies and programs." All the section 1 commitments to the various policy and democratic principles noted above are to be carried out by governments "within their respective constitutional jurisdictions and powers." In this way only does section 1 allude to Canada's federal character.<sup>5</sup>

As noted above, section 2 is about mobility. It includes some quite precise undertakings by governments to remove existing barriers to mobility and to avoid creating new ones. In part, these are re-statements of old commitments found in either the *Canadian Charter of Rights and Freedoms* (section 6) or chapter 7 of the Agreement on Internal Trade. But the language of the section also extends these commitments, as will be discussed further below. It is the only section of the agreement that focuses on *policy*, as such. In this regard, the accord's architecture is quite different than the Agreement on Internal Trade, which contains substantive policy chapters on such issues as government procurement, energy, transportation, and indeed labour mobility.

Section 3 is concerned heavily with the *democratic* processes, committing governments to ensure "effective mechanisms for Canadians to participate in developing social policies and reviewing outcomes." It also provides for "appropriate mechanisms for citizens to appeal unfair administrative practices and bring complaints about access and service" and requires governments to "report publicly on citizen's appeals and complaints." Perhaps most importantly, it requires each signatory government to "monitor and measure outcomes of its social programs and report regularly to its constituents on the performance of these programs." It thus proposes to make available to the public the kind of information that could enable citizens to engage one another, and their governments, in serious dialogue about policy choices.

The remaining sections are about how federal-provincial relations are to be conducted in relation to social policy. Section 4 commits governments to "undertake joint planning [sic] to share information on social trends, problems and priorities and to work together to identify priorities for collaborative action...[to] collaborate on implementation of joint priorities when this would result in more effective and efficient service to Canadians." It also requires governments to "give one another advance notice prior to implementation of a major change in a social policy or program which will likely substantially affect another government" and to "offer to consult prior to implementing new social policies and programs that are likely to substantially affect other governments or the social union more generally." That section also provides the equivalent of a most-favourite-nation clause to the effect that "for any new Canada-wide initiative, arrangements made with one province/territory will be made available to all provinces/territories in a manner consistent with their diverse circumstances."

The provincial governments were the driving force behind the negotiations that led up to the Framework Agreement for reasons that were straightforward. They had been badly shaken by the large cuts in federal transfers associated with the introduction of the Canada Health and Social Transfer (CHST). They wanted a new set of "rules" that would enable them to plan their programs and financial affairs within a more stable policy and fiscal framework. To achieve this, they negotiated for an agreement that would give them more influence over the federal government's use of its spending power, greater stability in intergovernmental transfers (i.e., rules regarding the federal government's freedom to reduce transfers) and an agreed mechanism for settling disputes.<sup>6</sup> Thus, in section 5, the federal government makes three basic commitments relating to its use of that power. The first is to "consult with provincial and territorial governments at least one year prior to renewal of or significant changes in existing social transfers to provinces/territories ... and build due notice provisions into any new social transfers to provincial/territorial governments." The second is a new decision rule regarding new Canada-wide initiatives supported by financial transfers from Ottawa to provinces/territories. This will be discussed further below. Suffice it here to say that such new initiatives require the support of a majority of provinces, although without any requirement that those six provinces represent some minimum share of the Canadian population.<sup>7</sup> And while there is no formal "opting-out" rule in this area, the detailed provisions offer a *de facto* opting-out provision that makes available to provinces at least as much flexibility as does current practice (as will be discussed further in the next section). The third commitment is that before the federal government introduces new Canada-wide social programs funded through direct transfers to individuals or organizations, "it will, prior to implementation, give at least three months' notice and offer to consult" other governments. Importantly, there is no "opting-out" clause, *de jure* or *de facto*, in relation to direct transfers.

Section 6 is also focused on federal-provincial relations, in this case dispute avoidance and resolution, another area where the provinces pressed for new arrangements. The section suggests that governments may be able to avoid disputes through the information-sharing, joint planning, collaboration, and advance notice and consultation provisions referred to above. It emphasizes joint fact-finding, including the use of third parties to fact-find, mediate or advise on dispute resolution. Although there is no requirement that any government accept the findings of a third party, that is, the sovereignty of all governments remains intact, governments did commit to "report publicly on an annual basis on the nature of the intergovernmental disputes and their resolution." So the affirmation of their sovereignty does not mean that they will be able to avoid public scrutiny of their behaviour. Section 7 provides that governments will jointly review the Framework Agreement after three years and make appropriate adjustments.<sup>8</sup>

In essence then, sections 4-7 are the framework for a "code of conduct" about how the two orders of government are to relate to one another in relation to social policy and the social union. From one perspective, these sections reflect the recognition of the two orders of government that they are necessarily and inevitably becoming more interdependent. But constitutional powers remain as they have been all along. Thus, from a second perspective, they also establish rules about the obligations of governments to one another to the extent that they act independently. In brief, signatory governments have given voluntary undertakings to be more sensitive to other governments as they conduct their business.

In the press coverage prior to and following the 4 February 1999 agreement, much attention was given to the political dynamics that had surrounded the negotiating process. In particular, journalistic coverage focused on the interplay between three factors: first, the fiscal negotiations surrounding the size of the increase in the federal government's CHST payment to the provinces; second, the objective of ensuring that the incremental CHST payments would be used by the provinces for health-care purposes only; and finally, the actual content of SUFA. A common media interpretation of the results was that provincial governments accepted weak controls on the federal spending power in exchange for incremental CHST dollars. This view was stated most colourfully by Gordon Gibson who observed, just before the agreement was signed, that "the premiers look for all the world like a bunch of squeegee kids, circling the prime-ministerial limousine and offering to clean the windshield for another 100 million loonies. They wait for the great man to smile or snarl."<sup>9</sup> Writing afterwards, Andrew Coyne observes that most media commentators saw the agreement as a "great big pile of fudge."<sup>10</sup> From the French-language Quebec media, with few exceptions, there was a sense that the agreement did not go far enough to satisfy Quebec's demands.<sup>11</sup>

While some of these views have some validity, they reflect a very partial analysis of the intergovernmental dynamics. For one thing, the provincial negotiating position became public (through a leak), and thus it was relatively easy to determine the distance between their negotiating position and the final agreement. The federal negotiating position was not as widely known. Thus, the concessions made by the federal government received less coverage. In any case, these kinds of criticisms have focused mainly on alleged deficiencies of SUFA rather than analyzing it for what it is. The next part of the chapter seeks to fill this gap by examining the implications of the agreement for social policy, democracy, and federalism.

## PART 2: IMPACT ON SOCIAL POLICY, DEMOCRACY AND FEDERALISM

### SOCIAL POLICY IMPLICATIONS

What needs to be evaluated here has as much or more to do with process than with social policy substance. Thus, it should not come as a surprise that the direct and immediate effects of the social union accord on *social policy* are modest. They are not, however, inconsequential. Provincial governments endorsed the five principles of the *Canada Health Act*. This suggests the possibility that provincial privatization initiatives have become less likely and that the use of facility fees has been rendered more remote. Provincial governments had indicated support for the five principles in the past but sometimes in conjunction with additional principles that provinces considered significant.<sup>12</sup> On this occasion, the endorsement of provincial signatories was unqualified.

The most substantive policy references in the agreement are section 2. In it, reflecting mainly Ottawa's desire to reinforce and broaden mobility, governments commit that no new barriers to freedom of movement will be created as a result of new social policy initiatives. They promise to "eliminate within three years, any residency-based policies or practices which constrain access to post-secondary education, training, health and social services and social assistance unless they can be demonstrated to be [both] reasonable and consistent with the principles of the social union framework."<sup>13</sup> While this qualification may turn out to be a loophole, it is noteworthy that the onus is on governments to demonstrate that their exceptional practice meets these two conditions. There is also a commitment to ensure that full compliance with the mobility provisions of the Agreement on Internal Trade has been achieved by 1 July 2001 including requirements for mutual recognition of occupational qualifications and the elimination of residency requirements for access to

employment opportunities. Sector ministers are called upon to submit annual reports to the Ministerial Council identifying residency-based barriers and action plans to end them.

The explicit extension of the mobility provisions to postsecondary education is new. Whether it has implications for provinces that wish to charge higher tuition fees to out-of-province postsecondary students than for in-province students is not obvious. A similar question arises in relation to geographic restrictions on the use of provincial loans, scholarships, and fellowships. In both cases, however, SUFA appears to provide a mechanism through which these kinds of questions can be tackled and potentially resolved. Indeed, it is understood that the removal of out-of-province limitations on student loans is now being examined as one possible outcome of current deliberations inside governments.<sup>14</sup>

As for the explicit reference to "training" in the mobility section, it is similar to provisions found in the nine federal-provincial bilateral agreements that Ottawa has signed with provincial governments on the devolution of training to the provinces. What is new here is that, in the event of dispute, there are modestly more elaborate dispute settlement mechanisms in SUFA than in the bilateral agreements.<sup>15</sup>

At first glance, it may appear that the mobility commitments relating to health and social services and social assistance are only a re-hashing of provisions found in the *Canada Health Act* (CHA) and the CHST. Under these provisions, mobility rights are protected by those legislative provisions that enable the federal government to penalize financially any province that violates them. That is, the enforcement mechanism is based exclusively on federal law. In fact, however, there are several differences from what had existed previously. First, many provincial health and social services are beyond the reach of the CHA and CHST. For instance, home care, pharmacare, and some social services are not clearly covered by those federal statutes. And some of those particular service areas are growing rapidly. SUFA now covers them. Second, the mobility provisions will also apply to federal activities. They may have implications, for example, for federal programs that affect Aboriginal people when they move off-reserve. Third, with the new Framework Agreement, enforcement may not be as heavily dependent on the *de jure* federal unilateralism associated with CHST and the CHA. It seems logical that where there are disputes, provinces will seek to ensure that they are resolved through SUFA's dispute settlement arrangements. In this regard, it is especially noteworthy that the section 6 dispute avoidance and resolution provisions declare that the "commitments on mobility, intergovernmental transfers and interpretation of the Canada Health Act principles, and as appropriate, on any new joint initiative" are covered.

Potentially very significant in the accord are the provisions that could, over time, add coherence to social policy. The commitments to "undertake joint planning to share information on social trends, problems and priorities and to work together to identify priorities for collaborative action" (section 4) have the prospect of improving policy in three ways. The first is by providing a mechanism for minimizing the number of situations where federal and provincial policies work at cross-purposes, thwarting, and undercutting one another. Second, they should reduce situations of duplication and waste between orders of government, to the extent that these may exist. Third, if both orders of government acquire the habit of sharing information, reviewing trends, and assessing priorities together, the knowledge brought to bear on policy choices will be broadened and enriched.

These commitments to joint planning and collaboration go well beyond past practice. There has never been ongoing federal-provincial information-sharing or joint planning in the social area, although there have been periodic attempts that have not been sustained. At present, there are joint activities on many issues, including early childhood development, health, skills and learning, disability, homelessness, youth, older workers, and Aboriginal affairs. While this list understates the scope of intergovernmental discussions in the social area, in and of itself the length of the list is not unusual. It is true that there is more federal-provincial momentum on social policy now than there was during much of the 1990s, mainly because the 1990s were dominated by fiscal restraint. But the current range of issues under review by sectoral tables would not appear unusual to anyone associated with social policy tables of the 1960s and 1970s. What sectoral tables have lacked in the past, however, was an ongoing systematic attention to their sectors. Federal and provincial labour market ministers, for example, have not regularly reviewed the labour market outlook for the coming year and set priorities in the light of that outlook. Labour market and social service ministers have not systematically examined the interaction between federal Employment Insurance and provincial Social Assistance. Health ministers have not systematically analyzed epidemiological trends and their implications for health policy. SUFA commits governments to change this and, as a result, joint planning has the potential to improve significantly the quality of social policy. Whether in fact these undertakings by governments are implemented seriously is, of course, the issue.<sup>16</sup> In this regard, a vigilant citizenry has an important role to play.<sup>17</sup>

In summary, the Framework Agreement is not mainly about the content of policy. It does offer, however, some new benefits to Canadians, mainly related to mobility. It also strengthens existing commitments related to mobility and public health care. Much more importantly, there is the prospect that joint planning will generate more coherence, better value for money, and a more



intelligent way to establish priorities. Only time will tell, however, whether SUFA in fact delivers on this potential.

#### IMPLICATIONS FOR DEMOCRACY

In the discussion above, SUFA's heavy emphasis on joint planning and collaboration was noted. And section 5 sets out the federal-provincial decision rules for the use of the federal spending power. Moreover, the preamble to the agreement refers to the fact that it is based on mutual respect between various orders of government and "a willingness to work more closely together to meet the needs of Canadians." So if SUFA is successfully implemented, executive federalism will also be strengthened.<sup>18</sup> And other things being equal, stronger executive federalism could mean more decision-making behind closed doors. When deals are struck, it will be difficult for the public to change them, as the deals will reflect whatever fine balance was struck in the intergovernmental negotiation that led up to them. SUFA thus raises the issue of democratic deficit.

The negotiators of the accord were aware of these dangers. Their effort to address them is reflected in section 3 on "Informing Canadians — Public Accountability and Transparency." Specifically, it commits governments to three kinds of undertakings that might help the workings of the democratic process. The first is a regular flow of information from each government to its constituents reporting on the outcomes of social programs. Over time, it anticipates that different governments will use comparable indicators to measure progress so that this flow of information to the public will enable those who are interested to compare results in their jurisdiction to results in other jurisdictions. Second, the agreement contemplates effective mechanisms for Canadians to participate in developing priorities and reviewing outcomes. Third, there are obligations to individual citizens which would enable them to appeal administrative decisions that they consider unfair and this appeal mechanism is strengthened by requirements that governments make publicly available eligibility criteria and service commitments for social programs. This last commitment should be relatively easy for governments to honour. The same is not true of the first two.

On the surface, the first of these undertakings is precise and straightforward. Implementing some system of monitoring and "output" measurement is indeed a relatively simple exercise given political will. But the agreement mentions measuring "outcomes," not "outputs," and measuring outcomes in a meaningful way is a huge and difficult challenge. It is, for example, one thing to measure the number of medical and surgical procedures a hospital carries out in a year and the cost per unit procedure. It is another thing to determine the health outcomes of those expenditures and to determine whether the health benefits of those outputs exceed the benefits of an equal sum spent on public

health. In short, constructing meaningful outcome measures may be a slow task. In some cases, output measures may have to serve initially as very weak substitutes for outcome measures. From the perspective of improving the democratic process, however, understanding outcomes is basic to being able to understand policy choices. Therefore, this is an area that will require intense effort in the coming years if this accountability technique is to be truly meaningful.

The second undertaking in section 3 — “ensure effective mechanisms for Canadians to participate in developing social priorities and reviewing outcomes” — is both ambiguous and difficult to achieve. The challenge of “citizen engagement” is one that governments everywhere struggle with and, to date, the results everywhere are disappointing. *In part*, this aspect of accountability is linked to the role of legislators and legislatures. Citizens vote for representatives and one way that citizens might be able to influence the decision-making process is by influencing the people who represent them in legislatures. However, the role of Parliament and of provincial legislatures is not discussed in SUFA, leaving one to assume that legislatures, as such, will have at best their usual relatively small role with respect to executive federalism. And unless new mechanisms are invented, the same may be equally true for interest groups and individual citizens who wish to interact directly with ministers and officials who are in decision-making positions. In any case, there is at present no evidence that signatory governments have a blueprint up their sleeves for improving democratic processes in relation to the social union.

One way to better involve legislatures would be for each of the signatory governments to establish a legislative committee on the social union in its jurisdiction. That committee might hold regular hearings reviewing compliance with SUFA undertakings. It could call witnesses on the development of performance indicators and on the relationship between the indicators and outcomes. It could also review government reports on appeal procedures and assess the workings of the dispute-settlement mechanisms. If membership had some continuity, and there was adequate professional staff, legislators might carve out for themselves a recognized if modest role on SUFA, notwithstanding the well-known executive dominance of Westminster-type systems. Even more audaciously, such committees might periodically hold joint meetings with one or more comparable committees from other jurisdictions, perhaps focusing on items that are not jurisdiction-specific, such as performance indicators. Such committees might also serve as mechanisms through which interest groups and individuals were able to have their voices heard on matters of policy and administration.

One proposal that has been talked about for some time is the idea that one or more third parties be selected to review the outcomes of social programs — the idea of an independent social audit. This merits further consideration. One

possibility, of course, is that governments/legislatures will individually appoint an arm's length body to conduct this function, a kind of auditor-general/ombudsman for social programs in their jurisdictions. A related question is whether all governments that are signatories to the agreement should jointly appoint a third party to monitor the overall workings of the social union and, in particular, whether the commitments of governments, one to the other, are being respected. An intergovernmental auditor would be a bold innovation and could potentially serve as an important force for governments to live up to their commitments.

Even if measures along these lines are implemented, more will be needed. It would be useful, for example, to have an independent research organization assessing trends in social outcomes and differences across the country in relation to those outcomes. After all, the processes of the social union must, at the end of the day, be evaluated not only for how they affect Canadian democracy and federalism. They must also be assessed on whether they serve to strengthen the very idea of "social union," which presumably must take account of whether social outcomes are converging or diverging from region to region across Canada.<sup>19</sup> With suitable adjustments, the Caledon Institute and Canadian Policy Research Networks might fill play a role in carrying out this function.

These are among the issues that governments and citizens need to address. They are also the kinds of issues that are easy to ignore. The social union accord has bowed curtly in their direction. Governments and citizens need to do more. Indeed, the more successful the social union turns out to be from an executive federalism perspective, the greater the risks that it will increase the size of the democratic deficit and the greater the need to put real flesh on the bare bones of section 3.

#### IMPLICATIONS FOR FEDERALISM

In the weeks leading up to the signing of SUFA, all ten provinces as well as the two territories<sup>20</sup> presented a common negotiating position to the federal government. The federal government countered. In the end, both sides made some concessions. Although only those who were directly involved in the negotiations know the exact details of the "give and take" that occurred, it appears that the federal government modified its position on such issues as public accountability and dispute settlement while the provincial/territorial side adjusted their position on the extent of their influence over the federal spending power. It was for the last reason, in particular, that the Government of Quebec chose not to sign. In press commentary after these events, Premier Bouchard was quoted as saying that the social union accord was a centralizing document. Ironically, in the Bouchard perspective, he alone (a sovereigntist) had defended the federal system whereas the other premiers had failed to do so.<sup>21</sup>

What in fact does this agreement mean for Canadian federalism? Is it a centralizing document? Is it best viewed through the lens of which order of government "won" and which "lost"?

We begin with Quebec's objections. In an article written a few months before the signing of the social union accord, the Quebec minister responsible for Canadian intergovernmental affairs declared: "For Quebec, only a true opting out clause with full fiscal compensation can concretely assure respect for Quebec's responsibility in relation to social matters."<sup>22</sup> But in the final weeks and days of bargaining leading up to the final deal, as noted above, a formal opting-out provision was lost by the provinces. While the equivalent of an opting-out provision remains in relation to Canada-wide programs funded partly by federal transfers to the provinces, there is no provision for opting out in relation to direct transfers to individuals or organizations. In the event, Quebec chose not to sign the agreement, pointing mainly to the inadequate opting-out provisions.

Turning first to the issue of opting out in relation to new jointly financed Canada-wide initiatives, SUFA provides that such initiatives may be launched by the federal government, exercising its spending power, when it has the support of at least six (that is to say, a majority of) provinces. Once the majority support rule has been satisfied, a province that had initially withheld its support would nonetheless be able to design and deliver its own program and receive federal compensation provided it decides to offer its residents a program that *meets the agreed objectives* of the Canada-wide initiative. In this sense, SUFA is somewhat similar to the opting-out provisions of the Meech Lake and Charlottetown Accords. Under Meech Lake, for example, an opting-out province was to receive reasonable compensation if it carried on a program or initiative that was *compatible with the national objectives*. And in two ways SUFA goes further than Meech Lake and Charlottetown in terms of accommodating provinces. It provides that a "provincial/territorial government which, because of its existing programming, does not require the total transfer to fulfill the agreed objectives would be able to reinvest any funds not required for those objectives in the same or a related priority area" (section 5). Second, the opting-out provision of the Meech Lake and Charlottetown Accords was limited to "shared-cost" programs whereas the SUFA provisions include jointly-financed programs that are not based on cost-sharing.<sup>23</sup> Thus, although the expression "opting out" is not used in SUFA there is *de facto* opting out that is modestly more flexible than what was contemplated in the Meech Lake and Charlottetown Accords. In fact, since six provinces are required to launch such an initiative, some federal officials think of these provisions as a kind of "opting in."<sup>24</sup>

Robson and Schwanen express concern that SUFA "says nothing about the conditions under which provinces might opt out if their own priorities ... are at odds with those of other provinces."<sup>25</sup> If there were a consensus to start a

new Canada-wide program on, say, early childhood development, and one province wanted to give priority to retraining of older displaced workers instead of to early childhood, that province would not qualify for its federal share of funds. If this is what is meant by a province being "at odds" with the priorities of other governments, then this concern is probably quite fair. But previous federal-provincial negotiations to secure intergovernmental agreement on opting out also excluded provision for this kind of large difference in priorities. For example, as noted above, the Meech Lake Accord would have required the Government of Canada to "provide reasonable compensation to the government of a province that chooses not to participate in a national shared cost program ... [only] if the province carries on a program or initiative that is compatible with the national objectives."<sup>26</sup> The Charlottetown Accord provisions were the same. Moreover, the hypothetical example above, based on the wide difference between early childhood programs and older worker retraining, is quite unrealistic. The differences in priorities among provinces are virtually never that wide and all governments will normally be active in both areas. In other words, it is probable that there will be relatively few (if any) situations where the concerns expressed by Robson and Schwanen will have practical consequences. Thus, Claude Ryan's conclusion that, in practice, "this new system will closely resemble what we have known until now" is probably not far off the mark.<sup>27</sup> I would re-state, however, to the extent that SUFA differs, it leans toward accommodating provinces.<sup>28</sup>

It must be acknowledged, however, that there is one "wild card" in this conclusion. Since only six provinces are required for Ottawa to launch a new Canada-wide program, in theory the six could be made up of the six smallest provinces that together contain only 15 percent of the Canadian population. Since all six of those provinces are equalization-receiving provinces, they might have a self-interest in the implicit redistribution in their favour that would flow from a new national program that distributed funds on a needs basis or even an equal per capita basis. For this reason, Robson and Schwanen speculate that this element "may turn out to promote centralization rather than the flexibility that ought to be the hallmark of a federation."<sup>29</sup> This could indeed put the federation under strain. There is an alternative view that may be equally plausible however, namely, that no federal government would risk launching a new Canada-wide initiative against the opposition of the four largest provinces. In this perspective, this relatively easy formal threshold could have the effect of thwarting rather than facilitating new programs. Larger provinces could take the line that Ottawa should act on new Canada-wide initiatives if it so wishes since it is free to do so without their support. They could plausibly deny that their opposition to new programs is an obstacle to Canada-wide action even though in practice their opposition might deprive Ottawa of the political legitimacy it requires to act. In this alternative speculation, the majority-province rule could turn out to be anything but centralizing. In this

regard, it is noteworthy that the majority-rule provision originated with provincial governments, not Ottawa.<sup>30</sup>

As for the issue of opting out in relation to direct transfers, this is what has Quebec most concerned. Under SUFA, there is no explicit or implicit provision for provincial opting out, as Quebec was able to negotiate many years ago in relation to the Canada Student Loan Program. Since that loan program was first put in place, Ottawa has transferred federal money to Quebec City and the provincial government has made loans to Quebec's postsecondary students. Neither the students nor their tax-paying parents have been made aware that a share of the funds comes from Ottawa. The social union accord does not explicitly anticipate a similar opting-out arrangement in relation to a new program. At the same time, SUFA does not prevent a federal government from agreeing to such an opting-out arrangement in relation to some future direct transfer program. In other words, SUFA does not tie Ottawa's hands in this regard. But SUFA certainly does signal that Ottawa will not agree to such arrangements lightly.

The position of the current Parti Québécois Government of Quebec is, at least in principle, broadly similar to that which both federalist and sovereignist governments in Quebec have held for several decades. In essence, it is that while the federal spending may be constitutionally valid, it lacks political legitimacy.<sup>31</sup> By enabling the federal government to spend in areas of the constitution that are within the exclusive legislative competence of the provinces, the spending power undermines the federal character of Canada. It destroys the federal pact that is the bedrock of Canada as a political nation. Opting out enables Quebec to retain exclusive authority within the legislative areas reserved for the provinces.

Underlying the official Quebec position is the classical view of federalism espoused by K.C. Wheare. In that view, the federal principle entails "the method of dividing powers so that the general and regional governments are each, within a sphere, co-ordinate and independent."<sup>32</sup> For Wheare, a federal state is one in which each order of government is sovereign within its own sphere of constitutional competence and neither order of government is unduly dependent on the other.

Few modern federal states function in this classical way. Watts has shown that in most federations there is a wide array of concurrent powers.<sup>33</sup> Also, in all federal states that were the subject of a second study by Watts, there was the equivalent of Canada's federal spending power.<sup>34</sup> Whereas a "classical" federation is characterized by *independence* and an *absence of hierarchy* (co-ordinate) between orders of government,<sup>35</sup> contemporary federations are characterized by *interdependence* with varying degrees of *hierarchy* between orders of government, with the central government often the more powerful.

In this regard, the Canadian federation has less interdependence and less hierarchy than most federations, for at least four reasons. First, there are only

a few concurrent legislative powers in the Canadian constitution (relating to agriculture, immigration, and old age pensions). Second, both orders of government have taxing powers in relation to what are today the main revenue bases of modern states. Third, some of the federal government's general powers (such as the power to disallow and to reserve provincial legislation) have fallen into disuse. Fourth, to the extent that the federal government makes use of its spending power to transfer funds to provincial governments, there is a low level of conditionality attached to those transfers compared to similar transfers in other federations. Owing in particular to the last three of these reasons, there is relatively little hierarchy in the Canadian federal system (compared, say, to the American, Australian or German federations)<sup>36</sup> although there are certainly some areas that have significant hierarchical attributes.<sup>37</sup> And the extensive revenue-raising powers of the provinces make them somewhat independent of Ottawa, at least in respect of government finance.<sup>38</sup>

But there is also considerable interdependence among Canadian governments and it is growing. Apart from the interdependence recognized in SUFA, other recent illustrations include the Agreement on Internal Trade, the Canada-Wide Agreement on Environmental Harmonization, and the National Child Benefit. Older intergovernmental arrangements that have been amended recently include the Canada Pension Plan and bilateral agreements relating to the labour market.<sup>39</sup> Moreover, as domestic policy becomes increasingly subject to international disciplines, including in areas that are wholly or partly within provincial legislative competence, the need for cooperation between the two orders of government can only be expected to grow. The negotiation of the Kyoto climate change agreements is a recent illustration; and the implementation effort associated with that international agreement requires even more extensive federal-provincial collaboration.

The reasons prompting provincial governments to seek a social union accord were discussed above. Having been burned by the large cuts in cash transfers associated with the introduction of the CHST, they pressed for some formal understandings regarding the federal government's use of its spending power, in relation both to Ottawa's freedom to launch new programs and its discretion to reduce spending on existing ones. They also looked for rules to help settle federal-provincial disputes, believing that they would be better served by a regime in which disputes are settled through rules rather than raw power. Provincial reasoning on this latter point is analogous to the position that the federal government often takes in relation to international economic matters. On international trade, for example, Ottawa has long believed it is better served by a regime that is rules-based, like the World Trade Organization, than it would be by a series of bilateral agreements, where Canada's trade interests might be vulnerable to decisions by much more powerful governments, especially that of the United States.

As for the federal government's interests in SUFA, it had a particular desire to strengthen the mobility rights of Canadians and more generally promote the idea that Canadian citizenship carries with it "equal opportunities to participate fully in the social and economic opportunities of the country."<sup>40</sup> The federal government also attached substantial importance to the accountability provisions, perhaps in part because it hoped that, eventually, extensive public reporting would lead to cross-provincial comparisons and support a growing commonality of programs based on best practice.<sup>41</sup> Also, federal initiatives could be undermined by provincial government actions in the absence of good cooperation. Prior to the National Child Benefit, for instance, Ottawa was concerned that any increase in the federal refundable tax credit for relatively low-income families with children would flow to provincial coffers, not poor families with children.<sup>42</sup> The federal government may have also attached some weight to having its spending power recognized in a federal-provincial agreement. The value that Ottawa attached to this, however, is uncertain and possibly not very high given that the constitutional validity of the power had not been challenged and that, as just noted, it enjoyed political legitimacy in most of Canada.<sup>43</sup>

Thus, it is being argued here that whatever the short-term political dynamics that gave rise to SUFA, it is not now most constructively viewed in terms of who "won" and "lost." Provinces can be said to have "lost" to the extent that they had to modify some of their original negotiating position, including on the opting-out clause.<sup>44</sup> But it could also be argued that the provinces "won" to the extent that Ottawa agreed to put into an intergovernmental agreement a set of decision rules that gives the provinces a formal if modest role in the exercise of that power that they had not previously had. It could also be argued that provinces won to the extent that the federal government agreed to dispute-settlement mechanisms. As for the accountability provisions, they represent a nice balance between federal and provincial negotiating positions.

In any case, the Framework Agreement is consistent with the idea of a modern federal system that recognizes both the interdependence and independence of both orders of government. Most provinces and the federal government are comfortable with this concept. In the absence of a wide and explicit opting-out provision, however, it is not consistent with the classical federalism preferred by Quebec governments.

The lack of a Quebec signature on SUFA is also consistent with recent trends in Quebec's approach to federal-provincial relations. Quebec signs intergovernmental agreements when it is convinced that those agreements advance or protect Quebec's autonomy, improves its finances or fit with its broad economic strategy.<sup>45</sup> Otherwise, it declines to do so fearing that what the federal government calls "collaboration" is a poorly disguised attack on Quebec's areas of exclusive sovereignty. The number of cases where Quebec has not



signed recently (although observing in some cases it concurs with the stated objectives of the agreement) has now become quite significant. They include the Canada-Wide Agreement on Environmental Harmonization, the National Child Benefit, and, of course, SUFA. In this regard, it is noteworthy that the leader of the opposition in Quebec has stated that he too would not have signed SUFA as negotiated, although he also declared that he could have negotiated a better deal for Quebec.

There are some commentators who interpret Quebec's unwillingness to sign SUFA as indicating that it will not receive its "share" of federal funds the next time there is a new federal-provincial jointly financed Canada-wide initiative. Andrew Coyne is among the most hard-line, writing: "If Quebec opts out of some future shared-cost program, it should not get one dollar of federal funds."<sup>46</sup> Robson and Schwanen are more cautious on this same point. They observe: "In practical terms, every new initiative under the agreement will present a fresh dilemma: Quebec will either get transfer money without having had to agree to broad terms on engagement vis-à-vis Canadians in other provinces, or the federal government will deny Quebec money that the other provinces are receiving."<sup>47</sup>

In the short run, these views are probably off the mark. In particular, it is most unlikely that Ottawa will pay much attention to Coyne. Rather, it can be expected that the federal government and the other provinces will avoid social initiatives that they know to be inconsistent with Quebec's policy directions. And because there will not be inconsistency between the new initiatives under SUFA and what Quebec is doing, Ottawa will likely transfer the same amount of funds to the Quebec authorities as Quebec would have received had it signed SUFA. This will be rationalized on the grounds that the Quebec government's actions are consistent with the objectives of the new Canada-wide initiative. While this approach may buy some time for Ottawa, it is not a happy resolution of the dilemma noted by Robson and Schwanen. And over time, it may not be sustainable.

In a carefully crafted piece for the journal *Inroads*, Claude Ryan concludes that the only resolution to this problem is to allow Quebec "the right to withdraw unconditionally from all Canada-wide programs within provincial jurisdiction.... accompanied by financial compensation."<sup>48</sup> This solution will not be acceptable to a Chrétien government. But with different governments in Ottawa and Quebec City, some form of explicit opting-out arrangement may sooner or later be required as a way of better managing if not fully resolving the dilemma.<sup>49</sup>

In this regard, it is important to distinguish between substance and symbolism. With regard to intergovernmental transfers, it was suggested above that there are *de facto* opting-out provisions in SUFA that are, if anything, more accommodating to provincial needs and circumstances than what previous Quebec governments had agreed to in the Meech Lake and Charlottetown

Accords. Moreover, the recent trend in the area of federal-provincial transfers is toward lightly conditioned federal bloc transfers, not cost-sharing. To the extent that this trend continues, from a substantive perspective, formal opting-out arrangements in SUFA would not add to Quebec's flexibility, at least as compared to the flexibility it has experienced in the decades since World War II.

But substance is not everything. Symbolism also matters. The fact is that the vision of the federal system found in SUFA does not correspond to the traditional Quebec position. Even if SUFA exceeds what Meech Lake and Charlottetown offered in terms of opting out, which the above analysis demonstrates, it only does so implicitly, whereas those two accords would have done so explicitly.

Similarly, without a SUFA, the issue of direct transfers would not have arisen for Quebec as a matter of principle. New direct transfer programs would have been dealt with on a case-by-case basis, as in the past. It is true that SUFA provides the provinces with a commitment from Ottawa to "give at least three months' notice and offer to consult" before acting. This should make provinces less vulnerable to unanticipated federal initiatives, especially when this provision is read in conjunction with other sections of SUFA, such as those related to joint planning. So, in substance provincial governments are better off in relation to direct transfers. But again the symbolism looks different. From a Quebec perspective, on a case-by-case basis, it was possible to opt out of some previous direct transfer programs whereas SUFA does not deal explicitly with this possibility.

All of this suggests that some modifications on the issue of opting may be needed if SUFA is to be signed by a future Quebec government. Four features of such an opting-out provision might be part of some new middle ground. I use the expression "new middle ground" recognizing that, for the federal government, SUFA entailed some movement on its part in relation to the spending power and, in that sense, for Ottawa, SUFA is the "middle ground." The first is the provision in section 3 of SUFA that each government agrees to "publicly recognize and explain the respective roles and contributions of governments." Thus, in a new direct or jointly funded program, an opting province would publicly acknowledge the federal financial contribution. The second is a requirement that the opting-out province use the funds in one of two ways. The funds would have to be used in a way that is broadly compatible with the purposes of the new program. Alternatively, if the province's existing programming had already enabled it to achieve the Canada-wide program objectives, it would be able to use the funds in the same or a related priority area. This would be less than the unconditional withdrawal called for by Ryan but, as a practical matter, not too far from it. Moreover, if Quebec was truly offended by the purposes of a new national initiative, and had signed SUFA, it could register its objection publicly and forcefully. In a setting where there is

the kind of joint planning that is called for by SUFA, it would be an unwise federal government that would launch a new program that was so far removed from Quebec's objectives (recall we are writing about areas of exclusive provincial jurisdiction) that Quebec would be unable to opt out and reasonably provide its own program under one of the two carve-outs noted above.<sup>50</sup> Third, to reduce the possibility of Ottawa agreeing with six small provinces on Canada-wide priorities, a rule under which seven provinces representing at least half the population would be better as a measure of national consensus. Fourth, and given the above analysis, perhaps most important, the opting-out arrangements would be explicit, for the symbolic reasons noted, and not inferred.

The first three of these features need not, in substance, make a big difference relative to what is now in SUFA. Smaller provinces might dislike the 50 percent of the population rule and so they would have to judge whether the disadvantages of giving up that provision were outweighed by the prospects of a Quebec signature. As for Ottawa, while opting out of direct programs is something that the federal government might prefer not to contemplate, it has in fact agreed to this in the past in specific cases and is likely to do so in the future.

So the big difference comes in the symbolic recognition that opting out would in some cases be possible under SUFA and that it is consistent with the traditions of post-World War II federalism practice in Canada. From a federal government perspective, a broad opting-out "right" might be seen as a strong incentive for Quebec to opt out of many social programs that are Canada-wide, including the kinds of programs that Quebec has not opted out of in the past. But symbolic recognition would not necessarily have to be drafted as an indisputable right. Rather, it could be drafted as a possibility that would be open for discussion and negotiation on a case-by-case basis.<sup>51</sup> While the Quebec government would no doubt prefer opting out as a "right," *explicit* recognition of opting out as a possibility might be enough to bring it to the negotiating table. In any case, this possibility should be considered when SUFA is up for review in the next couple of years.

In the meantime, the *de facto* asymmetry of the federation grows. Given the real differences between Quebec and other provinces, this may be inevitable and even desirable, up to a point. But much of the essence of the Canadian reality is about social sharing. And if Quebec remains outside the Framework Agreement that oversees that sharing process, the long-term consequences for the future of the federation are troubling. This suggests the federal government and other provinces should be willing to pay a price to persuade a future Quebec government to sign the SUFA. Moreover, as argued elsewhere, the federal government may have its hands more than full in the coming decades in managing the interface between Canadian governments and the growth of international governance associated with a world that continues to integrate

across borders.<sup>52</sup> This would also suggest that it play a lighter role in social areas that are within the exclusive legislative competence of the provinces.

### PART 3: IMPLICATIONS FOR FISCAL FEDERALISM

It was observed at the outset of this chapter that the impact of SUFA would depend on the extent to which governments chose to adhere to principles and processes. This leads to the pedestrian conclusion that if governments largely ignore SUFA, then its implications for fiscal federalism will be equally modest. Its impact on the processes and content of fiscal federalism will be not much different than they would have been had there been no agreement.

What if governments slowly but systematically implement their commitments? In that case, one can posit a number of possible implications. These are speculations rather than forecasts.

The first flows from the fact that, in important respects, fiscal federalism is about integrating the benefits of decentralized design and delivery of government services while preserving the benefits of a larger market, both for reasons of economic efficiency and to widen the population base for risk-sharing and redistribution. Unfortunately, as Boadway notes elsewhere in this volume, there is no optimal level of centralization/decentralization.<sup>53</sup> What can be said, however, is that the greater the degree of decentralization, the greater the risk of externalities that flow from decentralized programs (such as government-induced incentives for labour or capital to move in an economically inefficient manner from one province to another). In this regard, the section 4 provisions for joint planning and collaboration and reciprocal notice and consultation can reasonably be interpreted as providing for the kind of ongoing communication among governments that would minimize such externalities. While current arrangements among governments do enable some of these issues to be dealt with reasonably, SUFA has the potential to serve as a much more effective vehicle for systematically managing them.

A second and possibly related impact is that the joint planning provisions and the role envisaged for the Ministerial Council have the potential to lead to a strengthening of "line" social departments at both the federal and provincial levels, in relation to finance ministries. As suggested above and has been argued elsewhere, especially at the federal level,<sup>54</sup> the Finance Department has played the dominant role in shaping joint federal-provincial social programs. While the federal Finance ministry has always been a crucial player in such activities, through much of the 1990s it was the dominant actor on the federal stage. The experience of the 1990s can be contrasted with earlier periods, when line social departments also played a significant role. When the Established Programs Financing (EPF) was being negotiated during the 1970s, for example, finance and health ministries worked jointly on this program and

officials from both federal departments met jointly with provincial counterparts.<sup>55</sup> Furthermore, the EPF decisions were not taken mainly in the political hothouse of the federal budgetary process. Rather, they were seen as structural policy matters, not cyclical budgetary ones, and worked out over a period that was not governed principally by the federal budgetary cycle. When issues are settled in the context of budget preparation, finance ministries inevitably control the terms of the debate and structural factors tend to get less consideration than fiscal considerations. Decision-making around EPF can be contrasted, for example, with the way in which the cap on CAP (Canada Assistance Plan) and the decision to create the CHST were decided. In these latter cases, the federal Finance ministry overwhelmingly controlled the processes of decision-making and the policy content associated with those measures. A second impact of the Framework Agreement may therefore be to help restore a more balanced equilibrium between line social ministries and their Finance colleagues in the development of social policy.

In this regard, it was suggested earlier in this chapter that the use of legislative committees to review progress on implementing SUFA, and the use of third-party social auditors, could be important in ensuring that the vision represented by SUFA is realized. One impact of improving the transparency implied by such steps would be to reinforce the public responsibility of line social ministries and thus to potentially give them relatively more clout in social policy-making.

Third, while SUFA provides some new formal limitations on the unilateral exercise of the federal spending power by Ottawa, it is equally the case that all provinces except Quebec have again confirmed its political legitimacy. Moreover, SUFA itself specifies a process for helping to ensure that it is used appropriately. So if anything, the legitimacy of the spending power may have been strengthened a little. This observation is not inconsistent with the argument above that, over time, the opting-out provision will need to be re-visited.

Fourth, with the federal spending power still available, the actual role of the federal government in paying for social programs is unlikely to change drastically. The spending power is a principal instrument through which the federal government is able to remain active in the social area and social expenses are by far the largest claim on the public purse. Consequently, the federal government's needs for revenues are similarly unlikely to drop drastically (although they are likely to fall modestly relative to provincial revenue needs). As noted in the chapter by Norrie and Wilson in this volume, provincial governments have been calling for a transfer of revenue from federal to provincial coffers on the grounds that there is a growing vertical fiscal imbalance between orders of government. The purpose here is not to comment on that claim but rather to make the simpler point that, with a continued role for the federal spending power, there is unlikely to be any incentive for a major transfer of tax room from federal to provincial governments. Those who worry

about the inefficiencies of a further large decentralization in revenue collection may draw at least some solace from the spending power decisions.<sup>56</sup> This conclusion does not, however, deny that some cash reallocation in favour of the provinces may be in order.

On a related matter, to the extent that SUFA itself can be viewed as an instrument for strengthening what Courchene calls Social Canada,<sup>57</sup> and leads Ottawa to focus on social initiatives, whether through intergovernmental or direct transfers, this will by definition entail the transfer of money from wealthier to less prosperous provinces. In this sense, SUFA can be seen as an instrument for narrowing horizontal fiscal imbalances. This orientation, however, bumps up against claims from the wealthier provinces that Ottawa should focus more on vertical fiscal imbalances and transfer more tax room to the provinces. To the extent that such new initiatives are more about promoting common rights of citizenship than explicitly about reducing disparities in living standards across provinces (and therefore more likely to result in equal per capita transfers than needs-related transfers) this conflict will be muted but not eliminated.<sup>58</sup>

Fifth, it is a nice question as to whether the decision rules surrounding the spending power will create an incentive for Ottawa to prefer direct spending relative to intergovernmental transfers. The section 5 rules surrounding programs financed in part through intergovernmental transfers appear to constrain the federal government more than do the rules in respect of direct transfers. Thus, one possible outcome is that the accord will create a bias toward direct transfers. Such an outcome would be attractive to those who call for a strong federal government and who want to strengthen the direct relationship between Ottawa and the citizenry.

While this incentive appears real, it can also be exaggerated. In my discussions with officials from both orders of government who were involved in SUFA negotiations, they emphasized that the provisions of section 5 should not be read on their own but in connection with the spirit and letter of the whole agreement. The spirit is captured in the preamble that refers to the agreement as one "based upon a mutual respect between orders of government and a willingness to work more closely together to meet the needs of Canadians." And the letter includes a section on "Joint Planning and Collaboration." So the apparently less constraining rules on direct transfers may not be much different in practice than the limits on new "Canada-wide initiatives supported by transfers to provinces." It also bears noting that if the counterfactual to SUFA is the *status quo ante*, then the new rules that require the federal government to give three months advance notice and consult on direct transfers are more constraining than was the situation prior to SUFA. This is simply because there were no rules previously, just federal practices that varied from situation to situation and program to program. Thus, under the new rules, Ottawa would have been compelled to give notice of the Millennium Scholarship Fund. Instead, the decision was announced as a *fait accompli* even though

the federal government was open to negotiation about the modalities of the implementation. Formal notice and consultation under the terms of the Framework Agreement more or less assure provinces that a new federal proposal will attract public attention; and if provincial views are dismissed out of hand, Ottawa will be seen to be making light of the accord. At the same time, it must be acknowledged that "advance consultation" rules do not guarantee provinces a particular outcome.

In the short run, certainly for the life of the Liberal government now in office in Ottawa, direct spending might be preferred to new intergovernmental transfers. The political reasons for this would presumably include the government's belief that some strengthening of its direct link to individual citizens is important. Recent evidence includes the Millennium Scholarship Fund, the federal government's increasing transfers for the National Child Benefit and its proposal to make Employment Insurance benefits for parental leave more accessible. The federal government may also attach some weight to the idea that political accountability for spending is greater when the government that taxes spends directly rather than acting through another level of government. But once again, even under the Chrétien government, this tendency can be exaggerated. The Equalization program was one of the very few in Ottawa that was not cut during the first mandate of the federal Liberals. And Ottawa poured substantial money back into CHST in the 1999 budget. So while the Chrétien government may lean toward direct transfers, recent experience suggests it will not rely exclusively on this approach.

Moreover, provincial governments may lean the other way. They will not want new heavily conditioned transfers from the federal government. But SUFA does not contemplate heavily conditioned transfers. Rather, it contemplates both orders of government agreeing on Canada-wide objectives, the federal government transferring some funds to the provinces to assist them in pursuing the objectives, provinces then designing and delivering their own programs to achieve the objectives and public accountability for the results. So the new transfers will not be unconditional. But the conditions would be general and provinces would have played a large role in shaping them. In many situations, provinces will prefer this kind of intergovernmental transfer to a direct transfer.

Given the apparent leanings of both orders of government, a plausible outcome is that both direct and intergovernmental will be with us for a long time. And the choice of instrument will depend not only on the kinds of broad arguments set out above but also on the specifics of the individual files in question.

Finally, if SUFA is to have a policy impact, and not only an effect on the processes of government, then it will necessarily have to be reviewed periodically from the viewpoint of whether it is facilitating convergence or divergence of social outcomes. While the Framework Agreement does not require this measurement, section 3 does anticipate all governments monitoring and measuring outcomes and reporting regularly to constituents. Almost certainly, this

will over time provide a factual basis for determining whether social outcomes are diverging or converging. Other thing being equal, therefore, this will, as a minimum, create an incentive for governments to pay some attention to the redistribution role of fiscal federalism.

In terms of fiscal federalism, the accord is also significant for what it does not say. In particular, it does not provide provincial governments with guarantees of revenue stability in their transfers from Ottawa.<sup>59</sup> It is true that section 5 does require the Government of Canada to consult with provincial/territorial governments "at least one year prior to renewal or significant changes in existing social transfers to provinces/territories ... and build due notice provisions into any new social transfers to provincial/territorial governments." While this is a positive step, it is worth noting that, in late 1993, federal Finance Minister Martin forewarned his provincial counterparts that he would have to cut intergovernmental transfers — the notice that led ultimately to the CHST. But the provincial governments were genuinely stunned by the size of the reductions announced in the 1995 budget, reductions that did not actually kick in until 1996. And what is disappointing in the Framework Agreement is that it does nothing to prevent another disproportionately large federal cut to provincial transfers at some future date. Although it is understandable that the federal government would want to preserve the right to reduce provincial transfers during periods of fiscal stress, it is arguably inconsistent with the spirit of the accord that there are no rules that govern provincial vulnerability to disproportionately harsh federal cuts.

## CONCLUSIONS

SUFA implies modest changes in the content and conduct of Canadian fiscal federalism. On the content side, SUFA contemplates an ongoing role for both intergovernmental and direct transfers. Both are, of course, fundamental instruments of fiscal federalism. Second, the mere existence of SUFA probably serves as a force against the transfer of tax room from the federal to provincial governments. Third, it also implies perhaps a greater concern for issues of horizontal fiscal imbalance than vertical fiscal imbalance.

Conversely, the joint planning provisions of SUFA create a vehicle for reducing the externalities associated with a decentralized federation, which in turn might imply more scope for further decentralization. How these contradictory forces balance out is, of course, part of what remains unknown.

As for the conduct of fiscal federalism, the analysis above suggested the possibility that line social departments will play a larger role than they have in the past in designing the principal features of new social transfer programs. This is crucial to the future of SUFA. If basic political decisions about large social transfer programs continue to be decided in the political hot house of



the federal budgetary cycle, the principles that underlie SUFA will almost certainly be impossible to sustain. If SUFA is to work, therefore, finance ministries will have to leave adequate room for the social ministries to do their job.

## NOTES

1. The Government of Quebec did not sign the agreement. While the main purposes of this chapter do not include an analysis of Quebec's decision not to sign the Framework Agreement, this issue is touched on below.
2. Each government was represented by the minister appointed by his or her first minister. At the federal level, the minister selected was the Justice minister, presumably appointed because of the personal qualities she brought to the task and not because of her portfolio. Several provinces, including Ontario and Quebec, were represented by their intergovernmental ministers. In the final week of negotiation, the file was shifted to first ministers, who finalized the arrangements. The key point to note here is that finance ministers did not manage this file.
3. Author's interviews with government officials.
4. Margaret Biggs, *Building Blocks for Canada's Social Union*, Working Paper No. F-02 (Ottawa: Canadian Policy Research Networks, 1996); Keith Banting, "The Past Speaks to the Future: Lessons from the Post-War Social Union," in *Canada: The State of the Federation 1997: Non-Constitutional Renewal*, ed. Harvey Lazar (Kingston: Institute of Intergovernmental Relations, Queen's University, 1998); Harvey Lazar, "The Federal Role in a New Social Union: Ottawa at a Crossroads," in *Canada: The State of the Federation, 1997*, ed. Lazar; Harvey Lazar, "The Social Union: Taking the Time to Do it Right," *Policy Options* (November 1998).
5. The Framework Agreement is a political and administrative agreement. Whether its commitments are on process or substance, there is no change in the constitutional powers of either federal or provincial governments. Similarly, nothing in the agreement "abrogates or derogates from any Aboriginal treaty or other rights of Aboriginal peoples including self-government" (section 1).
6. Lazar, "Taking the Time to Do it Right," pp. 43-46.
7. It is noteworthy that the agreement refers to the agreement of a "majority of provincial governments," not "majority of signatory provincial governments." In effect, the agreement of six provinces is apparently required, not five of the nine signatory provinces.
8. The section also provides that the public must have "significant opportunities" for input.
9. *The Globe and Mail*, 19 January 1999, p. A21.
10. *The National Post*, 8 February 1999.
11. See, for example, *Le Devoir*, 13 February 1999, article by Andr Burelle; *Le Soleil*, 16 March 1999, article by Michel David. See also Alain Noël, "Canada, love it or don't leave it," *Policy Options* (forthcoming).

12. For example, the January 1997 report of the Conference of Provincial/Territorial Ministers of Health, *A Renewed Vision for Canada's Health System*. This explicitly endorses the five principles but does so in a context that raises many other matters.
13. Note: The author has added the word in parentheses.
14. Based on author's interviews.
15. At the time this was written (December 1999), the federal government and the Ontario government had still not signed a bilateral agreement.
16. If joint planning becomes effective, this will create an additional significant mechanism for discussing financial relations between the two orders of government. In turn, this could have an impact on the relative roles of finance ministries and line social ministries in the making of social policy and in the workings of fiscal federalism. This is discussed further in part 4.
17. The argument in this paragraph speaks to the issue of information-sharing and -planning. I recognize that in some sectors there are at times frequent meetings of ministers or their officials. Frequent meetings are often, however, the result of the need to deal with a crisis. A good recent example is the federal-provincial health ministers dealing with the tainted blood crisis through 1997 and 1998.
18. SUFA also calls for "clarification of roles and responsibilities" and thus it contemplates governments acting independently of one another where there is no particular public interest in or need for collaboration. To this extent, SUFA contemplates competition among governments as well as collaboration.
19. See the chapter in this volume by Lars Osberg.
20. During the negotiation period, Nunavut had not yet been officially established.
21. For a complete statement of Quebec's position just prior to the SUFA signing, see "Declaration by Prime Minister of Quebec, 27 January 1999, at <[www.premier.gouv.qc.ca/discours/a990127.htm](http://www.premier.gouv.qc.ca/discours/a990127.htm)>
22. Joseph Facal, "Pourquoi le Québec a Adhéré au Consensus des Provinces sur L'Union Social," *Policy Options* (November 1998):12-13. (Author's translation.)
23. While it might be argued that there is nothing to be "opted out from" in the case of bloc transfers, there can in principle be conditions attached to the bloc transfer (as with CHST).
24. Author's interviews.
25. William B.P. Robson and Daniel Schwanen, "The Social Union Agreement: Too Flawed to Last," C.D. Howe Institute Backgrounder, 8 February 1999, p. 3.
26. Section 106A. (1), the 1987 Constitutional Accord. The word in brackets is my addition to the authoritative text.
27. Claude Ryan, "Quebec and the Social Union," *Inroads* 8(1999):34. I assume that Ryan was alluding to what had been promised at Meech and Charlottetown. In fact, Quebec did not opt out of the major shared-cost programs of earlier years like the *Hospital Insurance and Diagnostic Services Act*, the *Medical Care Act* and the Canada Assistance Plan. The most important "opting out," using this

- term in a loose sense, was Quebec's decision not to have Québécois participate in the Canada Pension Plan and instead set up the Quebec Pension Plan. This was a direct transfer program, not a jointly funded one.
28. David Cameron has taken a very similar view to the one expressed here. See "The Social-Union Agreement: A Backward Step for Quebec," unpublished paper, 8 February 1999. Claude Ryan has taken the opposite view in "Quebec and the Social Union," pp. 35-36. Ryan ignores the points noted in this chapter. He instead focuses on three alleged deficiencies of SUFA relative to Meech Lake. The first is that other provisions of the Meech Lake Accord, "most notably a constitutional provision explicitly recognizing the distinct character of Quebec society," would have gone a long way toward meeting the demands of Quebec. The second is that SUFA is an administrative agreement that initially at least lasts for only three years, whereas Meech Lake would have meant constitutional entrenchment. While these are accurate statements by Ryan, it is unclear to me why they would have afforded Quebec more freedom to opt out than does SUFA. Ryan sees a connection that is not, on the face of it, obvious. On Ryan's third point, it is simply unclear why Ryan believes that the Meech Lake words are more open to "supple interpretation" than the words of SUFA, especially when SUFA contemplates provinces that have satisfied a Canada-wide objective using federal transfers for other purposes in a "related priority area."
  29. Robson and Schwanen, "The Social Union Agreement: Too Flawed to Last," p. 3.
  30. Author's interview with provincial official. The explanation for this provincial position is that when the interprovincial consensus was being forged, an equality of provinces perspective helped secure the support of some smaller provinces.
  31. See, for example, the "Declaration by Premier Lucien Bouchard," 27 January 1999, which may be found at <http://www.premier.gouv.qc.ca/discours/a990127.htm>
  32. K.C. Wheare, *Federal Government*, 4<sup>th</sup> ed. (London: Oxford University Press, 1963), p. 10. Note that the term "co-ordinate," as used by Wheare, is in some sense the opposite of "subordinate." It implies equality among orders of government.
  33. Ronald Watts, *Comparing Federal Systems in the 1990s* (Kingston: Institute of Intergovernmental Relations, Queen's University, 1996).
  34. Ronald Watts, *The Spending Power in Federal States: A Comparative Study* (Kingston: Institute of Intergovernmental Relations, 1999).
  35. K.C. Wheare, *Federal Government*, p. 10.
  36. The Swiss situation is different not only because it is a confederation with residual powers resting with the cantons but because of its extensive use of plebiscites to amend the constitution.
  37. The *de jure* federal responsibility for interpreting and enforcing the provisions of the *Canada Health Act* is one example.
  38. This statement is obviously highly qualified in respect of those provinces most dependent on federal equalization payments, that is, the four Atlantic provinces.

39. For a more detailed discussion of these items, see Harvey Lazar, "The Federal Role in a New Social Union: Ottawa at a Crossroads," in *Canada: The State of the Federation 1997*, ed. Lazar.
40. See, for example, the speech by the federal minister of intergovernmental affairs, "Social Union: Canadians Helping Canadians," 10 December 1998, at <http://www.pco-bcp.gc.ca/ala/ro/doc/spchdec1098.htm>. The quotation is from federal Justice Minister Anne McLellan, "Modernizing Canada's Social Union: A New Partnership Among Governments and Citizens," *Policy Options* (November 1998):6.
41. Ottawa may have also thought that extensive reporting would put pressure on governments to spend money in a more cost-effective fashion, a view that could have carried considerable weight given that governments were still feeling the effects of heavy expenditure reductions. Since more social programs are designed and delivered by the provinces than by the federal government, the burden of these provisions falls more heavily on provinces than on Ottawa.
42. This might have happened to the extent that provinces reduced their social assistance rates for children, dollar for dollar with the increase in the federal benefit.
43. For a contrary view, see Noël, "Canada, love it or leave it."
44. For a commentary on the provincial negotiating position, see Lazar, "The Canadian Social Union: Taking the Time to Get it Right."
45. Examples include the Agreement on Internal Trade, the bilateral federal-Quebec labour market agreement, the February 1999 Health Accord and the March 1999 Employment Assistance for Persons with Disabilities cost-sharing agreement.
46. *The National Post*, 15 February 1999.
47. Robson and Schwanen, "The Social Union Agreement: Too Flawed to Last," p. 5.
48. Ryan, "Quebec and the Social Union," p. 40.
49. For the views of the Quebec Liberal Party see article by Jean J. Charest, Leader of the Quebec Liberal Party, in *Le Soleil*, 15 February 1999.
50. Had SUFA been in effect several years ago, with Quebec a signatory, I would speculate that the federal government would have found it politically impracticable to launch the Millennium Scholarship Program as a unilateral federal initiative.
51. Such a proposal could borrow heavily from the existing language of SUFA. For example, it could provide that "in respect of any new intergovernmental transfer to promote an agreed Canada-wide objective, a province may seek to opt out with financial compensation if the new initiative interferes with its freedom to select the program mix and design that meets the objective." In substance, this would represent little or no change from what SUFA now effectively says. And it should result in relatively few cases of opting out if the overall SUFA provisions are respected as there would be little from which to opt out. For direct transfers, the SUFA might provide that "in relation to direct transfers, a province may seek financial compensation to replace the federal transfer where that province can show that its effort to reach objectives similar to the program

objectives are being unduly thwarted or made inefficient by the federal program." In practice, this is likely to be what happens under SUFA in any case. If Ottawa launches a new direct program, the Government of Quebec will press for the funds saying that it knows better how to spend those funds wisely in Quebec than does the federal government. In some cases, the federal government may agree and in others it may not.

52. Harvey Lazar and Tom McIntosh, eds., *Canada: The State of the Federation 1998/99: How Canadians Connect* (Kingston: Institute of Intergovernmental Relations, Queen's University, 1999).
53. See Boadway, "Recent Developments in the Economics of Federalism," in this volume.
54. See Edward Greenspon and Anthony Wilson-Smith, *Double Vision: The Inside Story of the Liberals in Power* (Toronto: Doubleday Canada, 1996); and Donald Savoie, *Governing from the Centre: The Concentration of Power in Canadian Politics* (Toronto: University of Toronto Press, 1999).
55. The author participated directly in these processes as a federal Finance official.
56. See chapter 2 in this volume.
57. Thomas J. Courchene, *Social Canada in the Millennium: Reform Imperatives and Restructuring Principles* (Toronto: C.D. Howe Institute, 1994).
58. It is recognized that programs that provide for common social entitlements for all citizens may not result in equal per capita distribution across provinces where there are objective differences among provinces. A province with a larger share of seniors than the national average will, for example, attract a larger than average per capita amount of old age payments than do other provinces on average. The general point, however, is that needs-related programs will normally lead to more interprovincial redistribution than those that are not explicitly needs-related.
59. Harvey Lazar, "Taking the Time to Do it Right."



## II

# The Federal- Provincial Transfer System

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## Changes to Federal Transfers to Provinces and Territories in 1999

*Edith Boucher and Arndt Vermaeten*

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*Le gouvernement fédéral fournit une assistance financière directe aux provinces et territoires via trois principaux programmes: le Transfert canadien en matière de santé et de services sociaux (TCSPS), la péréquation et la formule de financement des territoires (FFT). Le TCSPS procure une aide financière dans les domaines de la santé, de l'éducation post-secondaire et de l'assistance sociale. Grâce au programme de péréquation, les provinces moins prospères reçoivent une assistance financière qui leur permet d'offrir des services comparables à ceux offerts dans les autres provinces tout en imposant des taux d'imposition comparables. Finalement, la FFT définit les termes du support financier aux trois territoires. En 1999, ces trois programmes ont subi des modifications importantes. Ce chapitre décrit ces programmes de même que les changements qui leur ont été apportés. Les mesures annoncées dans le budget 2000 ne sont pas discutées parce que le chapitre a été complété avant le dépôt du budget.*

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The federal government, pursuant to its national responsibilities for equality of opportunity among all Canadians, transfers funds to other orders of government primarily through three major programs — the Canada Health and Social Transfer (CHST), Equalization, and Territorial Formula Financing (TFF). Including the value of tax transfers, the CHST support for health, postsecondary education, and social services and social assistance amounts to approximately \$29 billion. The federal government also transfers over \$9.5 billion a year to lower-income provinces under Equalization, which enables them to provide public services that are reasonably comparable to those provided in other provinces. Transfers to the three territorial governments amount to approximately \$1.4 billion per year. In 1999, significant changes were made to all three of these programs.<sup>1</sup> This chapter describes the programs and outlines the recent changes. It does not discuss measures introduced in the 2000 budget because the budget was tabled after the completion of the chapter.

## CANADA HEALTH AND SOCIAL TRANSFER: THE CHST

## ORIGINS OF THE CHST

The federal government has had a long history of partnership with the provinces in health, higher education, and social services. Over the years though, the nature and structure of the federal-provincial relationship has undergone substantial change. During the 1980s, federal support for provinces was provided under two programs: the Canada Assistance Plan (CAP), a cost-shared program that helped fund provincial social assistance and social service programs, and Established Programs Financing (EPF), a block-fund transfer providing assistance to provinces for health care and postsecondary education. By the early 1990s, financial pressures led both the federal and provincial governments to re-examine the design and funding of social programs.

In its 1994 budget, the federal government laid out its objectives for reviewing, with provincial governments, Canada's social security system and reforming the system of transfers that supported it. It moved to establish fiscal parameters and a predictable funding environment for reform to ensure that the system was financially sustainable and "more effective and responsive to the needs of people."<sup>2</sup> In line with the deficit reduction exercise, the 1994 budget indicated that social security transfers would "be no higher after reform in 1996-97 than 1993-94 levels."<sup>3</sup> The budget also made clear that "if social security reform fails to achieve these savings by 1996-97, alternative measures to take effect in 1996-97 will be implemented to ensure the savings are realized."<sup>4</sup>

The 1995 budget announced the creation of the CHST "to create a system that is both better suited to contemporary needs and financially sustainable."<sup>5</sup> The CHST was a block-fund transfer replacing two existing programs — EPF and CAP. It came into effect in fiscal year 1996-97 and marked a further step in the evolution from specified-purpose transfers to a single transfer conditional on very broad principles. The new transfer was also smaller than EPF and CAP and thereby contributed to federal expenditure restraint.

Although provinces are "able to spend these transferred resources on priorities of their own choosing,"<sup>6</sup> the transfer was not totally unconditional. Provisions were included "to invite all provincial governments to work together on developing, through mutual consent, a set of shared principles and objectives that could underlie the new transfer."<sup>7</sup> Provinces must comply with the principles of medicare as set out in the *Canada Health Act* and they must not impose residency requirements for social assistance programs.

Established as a block fund, the CHST gave provinces<sup>8</sup> greater flexibility to design and administer social programs and to allocate funds among social programs according to their priorities. The CHST reduced rigidities associated



with cost-sharing under the Canada Assistance Plan by extending the flexibility that already existed under Established Programs Financing to allocate funds between health and postsecondary education as deemed appropriate by the provinces and territories to social assistance programs. There are neither specific limitations on how provinces may choose to spend CHST funds or notional allocations among the three sectors that the CHST supports.

The funding formula for the CHST follows the model of EPF. Provincial entitlements are calculated on a per capita basis and include both a cash and a tax component. This structure reflects decisions by federal and provincial governments that led to the creation of EPF in 1977. At that time, the provinces and the federal government agreed to redesign the delivery of federal support by making the entitlements equal per capita and by converting part of the federal support from cash transfers to tax transfers. The tax transfer was put into effect when the federal government reduced its personal income tax rates by 13.5 percent and its corporate rate by 1 percent and provinces simultaneously raised their tax rates by corresponding amounts. The federal government then provided cash support to top up each provincial government to its total entitlement.

The determination of EPF entitlements as the sum of the value of tax points and cash served to ensure that all provinces would have the same overall federal support, per capita, to provide health care and postsecondary education regardless of differences in provincial income and growth rates. Provinces with higher personal income or with persistently faster growth rates would also have higher revenues or faster growing revenues from the transferred tax points. Basing the transfer on entitlements meant that richer provinces would receive more of their support from the tax points than from cash transfers. As the value of tax points relative to other provinces increased, the cash transfer decreased. Thus, the value of these tax points had an important impact on the interprovincial distribution of the cash component of the transfer.

Initially, the CHST had essentially the same basic design as EPF. Total CHST entitlements were established, and then the value of the transferred tax points were subtracted from this number to determine the total size of the federal cash payment. The entitlement was fixed, and the cash payment varied inversely with the value of tax points.

In the 1995 budget, the level of CHST entitlements was set at \$26.9 billion for 1996-97, about \$2.8 billion less than the combined EPF and CAP in 1995-96. Of this, the value of the tax points was estimated at the time to be about \$12 billion. Entitlements for 1997-98 were originally set at \$25.1 billion (of which tax points were expected to be about \$13 billion).<sup>9</sup> The 1996 budget set out a new five-year funding arrangement for the CHST, maintaining the national entitlement level for 1998-99 and 1999-2000 at \$25.1 billion.<sup>10</sup> After that, growth in entitlements was to equal the rate of growth of gross domestic

product (GDP) less 2 percent for 2000-01, GDP less 1.5 percent for 2001-02, and GDP less 1 percent for 2002-03.

As entitlements were set to decline initially and then to grow at a rate below GDP, the tax component of CHST, which should grow more or less in line with GDP, was expected to become a larger share of total entitlements and the cash component was expected to decline. This situation had already occurred under EPF due to the restrictions on the growth of EPF entitlements implemented in the early 1990s. In the 1990 budget, EPF entitlements were frozen on a per capita basis for two years — 1990-91 and 1991-92.<sup>11</sup> The 1991 budget extended the freeze for three more years through 1994-95 and announced that EPF entitlements would grow at a rate corresponding to the growth in GNP minus 3 percent after 1994-95.<sup>12</sup> Between 1992-93 and 1995-96, tax points generally grew at a faster rate than total entitlements. As a result, the EPF cash transfer went down from \$11.0 to \$10.6 billion over this period.

In the 1996 budget, the government established an \$11-billion cash floor to “ensure that cash remains a large component of the CHST.”<sup>13</sup> The total cash contribution to CAP and EPF was \$18.5 billion in 1995-96 — the last year these two programs were in operation. It was expected to drop to \$15 billion in 1996-97, to \$12.5 billion in 1997-98, to \$11.8 billion in 1998-99, and to close to the \$11-billion floor in 1999-2000. The cash component was then expected to begin growing again as the GDP-based formula allowed entitlements to rise.

By 1997-98, the federal government’s fiscal position had improved substantially. At the same time, strong economic growth increased the value of the provinces’ tax points faster than expected and reduced the federal cash contribution below the levels previously forecast. In 1998, the government passed legislation increasing the CHST cash floor by \$1.5 billion to \$12.5 billion beginning retroactively in 1997-98. The floor was operative immediately. Federal cash contributions were thus no longer determined residually as the difference between entitlements and tax transfers. From this point, federal cash contributions were determined by the floor, and total entitlements varied with the value of tax points.

#### CHANGES INTRODUCED IN THE 1999 FEDERAL BUDGET

By 1998, the years of federal and provincial expenditure restraint had created a much healthier fiscal climate in Canada.<sup>14</sup> However, the restraint had engendered growing concern by Canadians about the adequacy of resources for the health-care system. The 1999 federal budget sought to respond to these concerns and specifically to provincial requests for additional federal funds through the CHST to deliver basic health care.

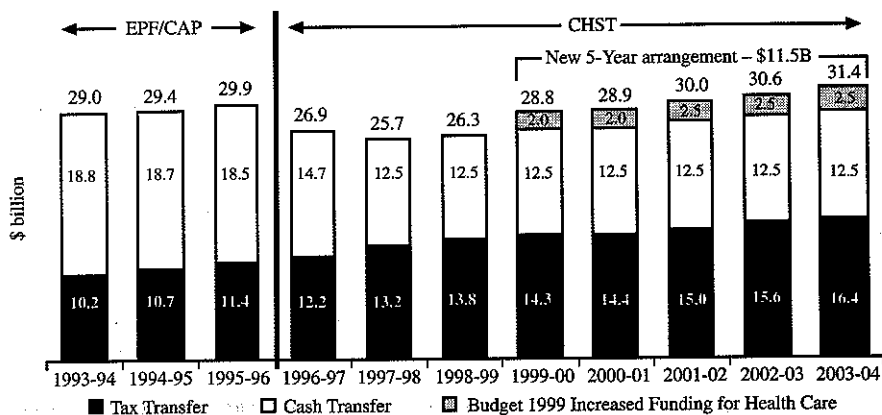
The federal government announced in the budget that it would increase CHST cash funding by \$11.5 billion over the five years from 1999-2000

through 2003-04. Support effectively increased the floor by \$2 billion to \$14.5 billion in 1999-2000 and 2000-01, and by \$2.5 billion to \$15 billion in each of the following three years. Including the value of tax points, the level of CHST entitlements was expected to reach \$30 billion by 2001-02, which would just exceed the level of EPF/CAP entitlements in 1995-96. Figure 1 shows cash, tax points and total entitlements both under EPF/CAP and under CHST from 1993-94 through 2003-04.<sup>15</sup>

Prior to the 1999 budget, at a first ministers' meeting in February, all provincial premiers and territorial leaders undertook to spend any incremental CHST funds on health services in accordance with health priorities within their respective jurisdictions. This commitment was confirmed in an exchange of letters with the prime minister. Of the \$11.5-billion incremental CHST cash, \$3.5 billion was paid into a third-party trust and made immediately available to provinces to draw upon according to their priorities over the three years from 1999-2000 to 2001-02. The use of a trust fund allowed the federal government to record the expenditure in fiscal year 1998-99 when its fiscal position was in surplus, while giving provinces flexibility to draw funds when they needed them.

The 1999 budget laid out a notional draw-down schedule under which provinces were shown to draw down the trust by \$2 billion in 1999-2000, \$1 billion in 2000-01, and \$500 million in 2001-02 consistent with the figures shown in Figure 1. However, under the terms of the trust, provinces could draw their share of the funds more quickly or slowly. The remaining \$8 billion of the \$11.5-billion increment was provided by increasing the legislated cash from

Figure 1: CHST: 1993-94 to 2003-04



\$12.5 billion in 1999-2000 to \$13.5 billion in 2000-01, to \$14.5 billion in 2001-02 and to \$15 billion in 2002-03 and 2003-04.

#### CHST ALLOCATION

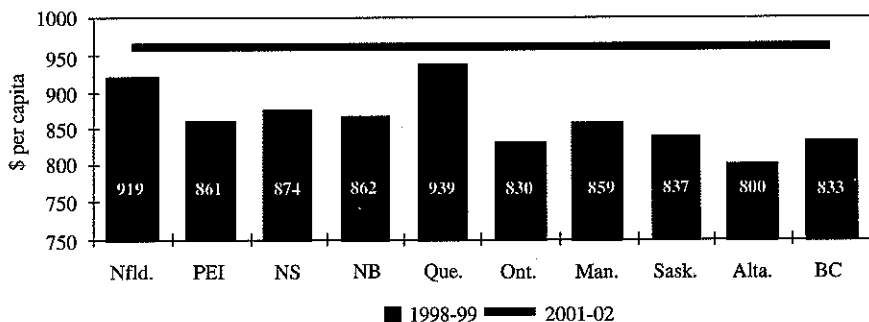
EPF entitlements for each province were calculated on an equal per capita basis while CAP was a cost-shared program under which the federal government paid 50 percent of eligible provincial social assistance and social services costs.

Prior to 1990-91, CAP covered 50 percent of eligible costs for all provinces. In 1990-91, the federal government limited the annual growth in CAP payments to 5 percent for higher-income provinces not eligible for equalization — Ontario, Alberta, and British Columbia.<sup>16</sup> The so-called “cap on CAP” was part of a broader expenditure restraint plan. The seven equalization-receiving provinces continued to benefit from the open-ended, cost-sharing arrangements.

Although this was originally intended to be a two-year temporary measure, CAP payments to the three affected provinces continued to be subject to the “cap on CAP” until 1994-95.<sup>17</sup> In 1995-96, CAP payments were frozen at 1994-95 levels for all provinces.<sup>18</sup> As a result of the “cap on CAP” and the freeze, the share of federal CAP transfers to the three higher income provinces fell substantially relative to the transfers to other provinces and this differential treatment of provinces became a growing source of strain on federal-provincial relations.

When the CHST came into effect in 1996-97, provinces received the same share of CHST as their previous combined share of EPF and CAP transfers.<sup>19</sup> As a result, the uneven per capita allocation caused by the “cap on CAP” was carried over into the CHST. (In 1998-99, for example, per capita CHST entitlements ranged from \$800 in Alberta<sup>20</sup> to \$939 in Quebec.) After consultations with the provinces, the federal government announced in its 1996 budget that these per capita disparities would be reduced by 10 percent a year, over five years from 1998-99 to 2002-03.<sup>21</sup> This would reduce the disparities by half at the end of the five-year track. Figure 2 shows the per capita distribution of CHST entitlements in 1998-99.

Increasing the resources for CHST in the 1999 budget provided an opportunity to address the allocation issue while still ensuring that all provinces benefited from the increase. Rather than eliminating half the disparities by 2002-03, the 1999 budget ensured that all disparities would be eliminated one year earlier by 2001-02.<sup>22</sup> This measure meant that provinces with below-average entitlements in 1998-99, such as Alberta, Saskatchewan, British Columbia, and Ontario, would receive larger incremental amounts over the period while their entitlements were catching up with the average. As Figure 2 shows, by 2001-02 all provinces will receive identical CHST entitlements

**Figure 2: Provincial CHST Entitlements**

estimated at \$960 per capita. After 2001-02, all per capita entitlements will grow by identical amounts.<sup>23</sup>

Although entitlements will become equal per capita by 2001-02, the differential value of tax points among provinces means that the federal cash contribution, per capita, will continue to vary as it did under EPF. Provinces with higher income will generate more of their entitlement from their tax points while the equalization-receiving provinces will need more federal cash, per capita, to bring their entitlements to the national average.

Some observers have argued that since tax points now belong to provinces, only the cash component of federal transfers to provinces is actually relevant. However, the CHST calculations incorporate the value of tax points transferred to provinces at the inception of EPF to ensure that each province receives the same value of resources through the program for the provision of health care, postsecondary education, and social assistance. If the CHST cash component were allocated on an equal per capita basis, the total per capita entitlements would be higher for provinces with higher income than for those with lower income because of the higher value of tax points in higher income provinces.

#### PROVINCIAL REACTION

The measures announced in the 1999 budget provided a significant increase in federal funding for health care. However, all provinces continued to argue for further increases in funding. Provinces have also argued for a transfer of federal tax room to meet their spending needs. Some provinces, particularly those receiving above-average CHST entitlements, were critical of the federal government's decision to eliminate the disparities in per capita entitlements.

Provinces' concerns are reflected in the consensus reached at the Annual Premiers' Conference held in August 1999 and in a common position paper released by provincial premiers in December 1999.<sup>24</sup> Provinces are calling for the restoration of the CHST cash component to its 1994-95 level of \$18.7 billion by 2000-01 and then the implementation of an escalator to the CHST cash portion. Provinces are also asking for the elimination of the ceiling of the Equalization program. "This would parallel, to a degree, recent federal action to reverse constraints affecting more affluent provinces under the CHST, namely the removal of the "cap" on Canada Assistance Plan payments."<sup>25</sup> In a letter to the prime minister dated 3 February 2000, premiers and territorial leaders reiterated their consensus and promised to use any additional funding provided through the CHST for health care and social programs according to their respective priorities.<sup>26</sup>

## EQUALIZATION

Equalization is the second largest transfer to provinces. Because all parts of the country are not equally prosperous, provincial governments, even if they exercise comparable tax effort, cannot all generate the same revenues with which to finance public services. The purpose of the Equalization program is to provide transfers to less prosperous provinces to enable them to provide public services reasonably comparable to those provided by more prosperous provinces at comparable rates of taxation. Equalization is unique among transfers to the provinces in that its purpose is entrenched in the Canadian constitution.<sup>27</sup>

Currently, seven provinces qualify for equalization payments: Newfoundland, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba, and Saskatchewan. All provinces except Ontario have qualified at some time in the past, and Saskatchewan has occasionally not qualified. Equalization payments are unconditional, and receiving provinces are therefore free to spend these payments according to their own priorities.

Since the inception of the program in 1957, and with the exception of a two-year renewal in 1992, Equalization legislation has been renewed on a five-year cycle.

### DESCRIPTION OF RENEWAL PROCESS

Prior to the expiry of Equalization legislation, and before the introduction of new legislation for the next five-year term, the program is subjected to an extensive "renewal process," in close consultation with all provinces, during which modifications to the program are considered. While both federal and provincial officials continually monitor the program's operation, the renewal

process involves a focused and comprehensive review to identify possible technical changes and improvements to the program's design and structure.

The renewal process that preceded the enactment in March 1999 of Equalization legislation for the current five-year period took place over a period of more than two years and involved numerous meetings of federal and provincial officials. Issues were discussed at several meetings of federal and provincial finance ministers. The technical review of the Equalization program is done largely by officials at meetings of the Equalization Subcommittee and special working groups.

#### HOW EQUALIZATION WORKS

Equalization payments are calculated according to a formula set out in federal legislation (and accompanying regulations). Comparisons are made of the relative capacities of provinces to raise revenues from taxes and from other (non-tax) revenue sources. This is done each year by estimating the potential per capita revenues that each province could derive from a representative tax system (RTS). The results are then compared to a standard consisting of the estimated average per capita RTS revenues of Ontario, British Columbia, Quebec, Saskatchewan, and Manitoba.<sup>28</sup> Provinces with revenue-raising capacities below this standard receive Equalization transfers to bring them up to the standard.

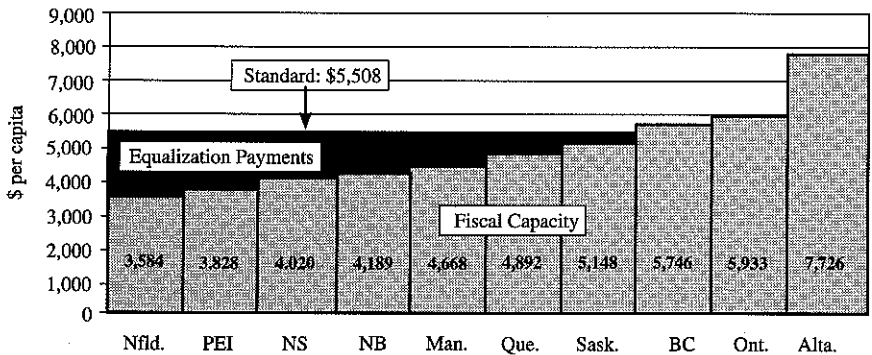
The revenue-raising capacity of provinces is calculated separately for more than 30 revenue sources available to provincial and local governments. In order to objectively compare the capacity of provinces to raise revenues from each source, this capacity has to be estimated in a standardized way for all provinces. Note that what is of interest is not what revenues provinces *do* (in fact) raise, but what revenues provinces *could* (potentially) raise from a typical tax system. Both the actual tax rates and actual tax bases upon which provinces levy taxes vary significantly from one province to another. But for the purpose of calculating Equalization entitlements, standardized tax bases are defined, and what is measured is what each province could raise in revenues if it applied the national-average tax rate on these standardized tax bases.

Uniform or standardized tax bases are the key element of the RTS. A standardized tax base for a revenue source is a measure of what is typically taxed by provinces in deriving revenues from that source. The standardized base for corporate income taxes, for example, is the amount of profit earned by corporations in a province; for alcohol revenues, it is the number of litres of alcoholic beverages sold in a province; and for tobacco taxes, it is the number of cigarettes sold in a province. The base may either be an average of the actual statutory bases on which provinces levy the tax or some proxy that can be expected to have a distribution among provinces similar to that of the true base. Standardized bases are meant to incorporate the common elements of the tax systems of provinces.

A province's fiscal capacity with respect to a revenue source is calculated by multiplying the standardized base for the province by the national-average tax rate. The national-average tax rate for a revenue source is the sum of the (actual) revenues collected by all ten provinces from the revenue source divided by the total standardized tax base of the ten provinces for the source.

In determining Equalization entitlements, the total per capita revenue-raising capacity of each province is calculated by summing its per capita fiscal capacities for all revenue sources. If a province's estimated total per capita revenue-raising capacity is higher than the standard, it is ineligible for Equalization. If a province's total per capita revenue-raising capacity is lower than the standard, it receives transfers equal to its per capita shortfall multiplied by its population. Total Equalization payments for 1999-2000 are currently estimated to be \$9.5 billion.<sup>29</sup>

**Figure 3: The Equalization Formula, 1999-2000**



Source: October 1999 Equalization estimate for 1999-2000.

#### OVERVIEW OF CHANGES

The changes made to the Equalization program for the 1999-00 to 2003-04 fiscal arrangements period are significant but not fundamental. The basic mechanics of the system remain the same, and the five-province standard first adopted in 1982 remains in place. The ceiling and floor provisions of the program were modified, and a substantial number of revenue sources and bases were redefined. Several administrative changes were also introduced.



## CHANGES TO PROGRAM PARAMETERS

*Ceiling.* Ceiling provisions set an upper limit on the growth rate of Equalization entitlements and are meant to protect the federal government from rapid and unaffordable increases in payments. As mentioned earlier, provinces have requested the elimination of the Equalization ceiling in addition to additional CHST funding in their recent provincial consensus.

The previous ceiling (prior to the 1999 changes and beginning in 1994-95) limited the growth rate of total entitlements to the growth rate of gross national product (GNP) from a 1992 base year.<sup>30</sup> This ceiling did not apply during the five-year period from 1994-95 to 1998-99. For 1998-99, the ceiling was approximately \$10.4 billion, about \$800 million higher than entitlements for that year.<sup>31</sup>

In response to concerns expressed by the Auditor General, the initial level of the ceiling for the new fiscal arrangements period was set at a fixed dollar amount rather than at the level of entitlements for a base year. Setting the initial ceiling at the level of entitlements for a base year created uncertainties because the ultimate level of entitlements for the base year is not known until 30 months after the end of that year when the final entitlement calculations are made. This means that the level of the ceiling is unknown during an initial portion of the fiscal arrangements period.<sup>32</sup>

The new ceiling was set at \$10 billion for fiscal year 1999-2000. For the four fiscal years after 1999-2000, the ceiling increases from \$10 billion in proportion to cumulative GDP growth. If total entitlements in any fiscal year exceed the ceiling for that year, entitlements are scaled back for all receiving provinces on an equal per capita basis until total entitlements are reduced to the ceiling level.

*Floor.* Floor provisions limit year-over-year reductions in Equalization entitlements for individual provinces. They are meant to protect provinces from large annual declines in entitlements.

The old floor provisions (for 1994-95 to 1998-99) were more generous for some provinces than others. Year-over-year reductions in entitlements were limited to 15 percent of total entitlements for provinces with own-source revenue-raising capacity above 75 percent of the national average, to 10 percent for provinces with revenue-raising capacity of 70-75 percent of the average, and to 5 percent for provinces with revenue-raising capacity below 70 percent of the average. These floor provisions came into effect for Saskatchewan in 1994-95 and in 1996-97, but did not affect entitlements for any other province or any other year during the 1994-95 to 1998-99 period.

The new floor provisions for 1999-2000 to 2003-04 provide the same protection for all provinces, regardless of their fiscal capacity. Per capita declines in entitlements are limited to a maximum of 1.6 percent of the per capita five-province standard (or about \$90).<sup>33</sup>

## ADMINISTRATIVE CHANGES

*Thirty-Month Closing.* Previously, equalization calculations were finalized (or closed) 24 months after the end of the fiscal year to which they pertain.<sup>34</sup> CHST calculations, on the other hand, were left open for 30 months after the end of a fiscal year. As a result, population data used to calculate Equalization and CHST entitlements differed between the two programs. To make the programs consistent, the closing of equalization calculations has been extended to 30 months after the end of the fiscal year.

*Transition from Old to New Revenue Source and Base Definitions.* The new tax base and revenue-source definitions will be phased in over a five-year transition period. The main reason for this phase-in is to ensure that undue weight is not placed on new data sources early in the new fiscal arrangements period. Some of the data sources referred to in the new base definitions have only recently been developed, or are still under development, as part of Statistics Canada's Project to Improve Provincial Economic Statistics (PIPES). The reliability and accuracy of these sources will not be fully understood until later on in the fiscal arrangements period.

The phase-in is also meant to prevent abrupt impacts on the distribution of entitlements from the change in definitions.

## CHANGES TO TAX BASE AND REVENUE-SOURCE DEFINITIONS

The new revenue-source and base definitions are expected to result in an increase in entitlements of about \$50 million for 1999-2000, rising to an estimated \$200 to \$300 million by 2003-04 when the definitions are fully phased in. The most significant changes are as follows:

*Sales Tax.* The sales tax base was redefined to take into account both the value-added sales tax systems of Quebec, New Brunswick, Nova Scotia, and Newfoundland, and the traditional sales tax systems used in other provinces.<sup>35</sup>

The old base did not do this adequately. It included or excluded various categories of expenditures (such as expenditures at retail outlets, expenditures on capital equipment, expenditures on residential construction materials) on the basis of whether or not those items were typically taxed by provinces. Whether an item was "typically" taxed was determined by a majority rule. Expenditures were included in the base if they were taxed under the sales tax systems of provinces representing a majority of the population. Thus, for example, expenditures on school supplies were fully included in the base, even though consumption of school supplies was exempt from tax in some provinces.

With this majority rule, the old equalization base for sales taxes closely resembled Ontario's statutory sales tax base. This base used to be reasonably representative of the statutory bases of other provinces because provincial

sales tax systems were similar to Ontario's. But with the adoption of value-added tax systems by some provinces, the old base no longer adequately reflected the statutory base upon which value-added taxes are levied.

The new sales tax base is an "average" rather than a "majority" base. It includes a weighted average of expenditures on a commodity-by-commodity basis. The weight given to expenditures on any particular commodity is proportional to the extent to which that commodity is taxed, on average, across all provinces. The base thus reflects the average taxing practices of all provinces and takes into account both value-added and traditional sales tax systems.

The new base is highly representative and constitutes a significant improvement over the old base. It makes use of data, including input-output data, that have only recently become available as a result of PIPES.

*Gaming.* With the introduction and rapid rise of video lottery, slot machine, and casino gambling, the gaming field has undergone a significant change over the past several years.<sup>36</sup> Due to this change, the old revenue-source and base definitions used to equalize provincial gaming revenues — definitions which had originally been put in place when provincial gaming revenues consisted mainly of ticket lottery revenues — were no longer adequate.

Provincial gaming revenues consist of the remitted profits of provincially-owned gaming corporations. Under the old definitions, all provincial gaming revenues were equalized as part of one revenue source (called "Lottery Revenues"). This included revenues derived by provinces from ticket lottery operations, as well as revenues derived from video lottery, casino, and other gaming operations. The base for this revenue source though was the gross dollar value of lottery tickets sold in each province.

The old revenue-source and base definitions resulted in a mismatch between revenues subject to Equalization and the base. All gaming revenues — including both revenues derived from traditional ticket lotteries and revenues derived from other games of chance — were equalized on a ticket lottery base, a base that did not in any way reflect differences in fiscal capacity among provinces with respect to non-ticket lottery gaming. The revenue-raising capacity of provinces with low sales of lottery tickets but with a high capacity to raise revenues from video lotteries and casino gaming was thus underestimated, while the revenue-raising capacity of provinces with high sales of lottery tickets but with low revenue-raising capacity for video lotteries and casino gaming was overestimated.<sup>37</sup>

One way of addressing this problem would have been to simply add the dollar value of sales of non-traditional gaming products to the lottery ticket sales included in the old base to create a more inclusive consumption base. This would, however, have been problematic due to the fact that tax effort for non-traditional gaming varies significantly among provinces. Some provinces have extensive casino and video lottery gaming operations while others do not have any. The level of consumption of these types of games in a province

is therefore more a reflection of the availability of the games (and thus the fiscal choices of the province) than of the underlying fiscal capacity. There is, for example, no video lottery consumption in Ontario because the province does not permit this type of gaming. But this does not mean — as a pure consumption base would indicate — that Ontario has zero fiscal capacity in the video lottery field. Measurement of fiscal capacity must be independent of the *actual* tax effort exerted by provinces and should reflect what provinces *could* raise in revenues *if* they exerted the same (national average) level of tax effort.<sup>38</sup>

The solution implemented for the new fiscal arrangements period was to split the old lottery revenue source into two separate revenue sources and to adopt a multi-variable base for each of these sources. One revenue source consists exclusively of the revenues derived by provinces from ticket lotteries, while the other includes revenues derived from all other games of chance.<sup>39</sup> The bases for these two revenue sources each consist of three weighted components: a consumption component, a disposable income component, and a population component. The consumption component is given a high weight in the ticket lottery base (80 percent versus 10 percent for disposable income and 10 percent for population) and a low weight (20 percent versus 40 percent for disposable income and 40 percent for population) in the base for other games of chance. The consumption component of the ticket lottery base consists of the dollar value of sales net of prize payouts for ticket lotteries, and the consumption component of the base for other games of chance consists of the dollar value of sales net of prize payouts for non-ticket lottery games.<sup>40</sup>

The consumption component was given a low weight in the other games of chance base because tax effort for other games of chance (including video lottery gaming, casino gaming, provincially operated electronic bingo, slot machines, etc.) differs significantly from province to province. Disposable income and population (which together have a weighting of 80 percent) were chosen as the main indicators of fiscal capacity for non-traditional gaming because the propensity of individuals to engage in gaming activities is positively, though not proportionally, related to disposable income. Empirical evidence indicates that as disposable income increases, the percentage increase in average gaming expenditures for an income group is approximately one-half of the percentage increase in income. The inclusion of both a disposable income and a population component in the base, and the equal (40 percent) weighting of the two, is designed to reflect this fact. The two components together constitute a proxy measure of gaming fiscal capacity. They function in the base to indicate that a province whose residents have a per capita disposable income that is, for example, 5 percent lower than that of residents of the five standard provinces, has a fiscal capacity that is 2.5 percent lower. This proxy measure is a good indicator of fiscal capacity for non-traditional gaming because it is correlated with fiscal capacity in a reliable way and because it is independent of provinces' tax effort.

In addition to the main disposable income and population components, a small consumption component was also included in the base for other games of chance. It takes into account the possibility that there is some substitution among ticket lotteries and other types of games.<sup>41</sup> Also, a consumption component may contain some additional relevant information on fiscal capacity not captured by the disposable income and population components alone.

The consumption component was given a high weight in the ticket lottery base because tax effort for ticket lotteries is very similar across provinces. Lottery tickets are available in all provinces, and the lottery corporations of all provinces attempt to maximize sales and profits. Sales (consumption) of lottery tickets are therefore a good indicator of the relative fiscal capacities of provinces.

A pure consumption base could have been used for ticket lotteries, but a small proxy element (consisting of disposable income and population components) was also included in the base to address a potential incentive problem. With a pure consumption base, receiving provinces which reduce tax effort for lottery tickets could trigger an increase in their Equalization approximately equal to the reduction in own-source gaming revenues resulting from the reduced tax effort. A pure consumption base might therefore cause equalization-receiving provinces to reduce their tax effort relative to non-receiving provinces. This undermines the consumption base since its usefulness as an indicator of relative fiscal capacity for ticket lotteries in the first place is premised on the fact that all provinces exert equal tax effort. More generally, the Equalization program is not supposed to influence provincial fiscal choices, but a pure consumption base would run the risk of doing so.

*Resource Revenues.* Some of the most interesting discussions during the renewal process concerned the treatment of natural resource revenues.

Provinces generate most of their natural resource revenues through taxes on the value (or in some cases the volume) of resources produced. In most cases, costs of production (i.e., costs of resource extraction) are not deducted from the statutory tax base, even though a resource that costs less to produce represents greater fiscal capacity to a province than one that costs more. This is because producers with lower costs are better able to pay taxes than ones with higher costs. Provincial tax rates on production bases take into account differential production costs, with higher rates levied on resources with lower extraction costs. Some provinces are able to levy significantly higher tax rates on resource production than others because resources in different locations often have very different costs of extraction.

Indeed, it could be argued that the true source of fiscal capacity for natural resources is the net profit (after extraction costs) or, more specifically, the economic rent, generated by those resources. Although the statutory base upon which provinces levy natural resource taxes is production volume or production value with no province *directly* taxing economic rent,<sup>42</sup> both economic

theory (efficient taxation theory) and observation of actual provincial taxing practices indicate that it is really economic rent that is being (*indirectly*) taxed.<sup>43</sup>

These observations suggest that economic rent should be used as the Equalization base for resource revenues. Equalization bases are supposed to reflect the relative fiscal capacities of provinces, and if these fiscal capacities are ultimately determined by economic rent, then economic rent is the correct base for resource revenues.<sup>44</sup>

This conflicts, however, at least to some extent, with the representative tax-system approach (RTS) generally used to select Equalization bases. Under the RTS approach, Equalization bases should reflect the actual taxing practices of provinces — and the actual statutory bases taxed by provinces are not economic rent bases. Furthermore, good economic rent data are not available at the provincial level for most resource types.

Changes to specific natural resource bases were made with these general considerations in mind. All resource bases were significantly improved, with an attempt being made to balance different conceptual viewpoints. In several instances, use is made of new data that have become available from Statistics Canada's PIPES project.

**Mining.** There were previously four mining revenue sources — potash, coal, asbestos, and other minerals. For the new fiscal arrangements period, these four have been combined into a single revenue source. In addition, the old mining bases (of which two were volume of production bases and two were value of production bases) have been replaced by a single pre-tax net profit base.<sup>45</sup>

The new revenue-source and base definitions improve on the old definitions in several ways. First, the new base is an improved indicator of underlying fiscal capacity since the net mining profits, which constitute the new base, approximate economic rent. Second, the new base better reflects the actual taxing practices of provinces. Mining is the one resource sector for which provinces, in fact, directly tax profits rather than volume or value of production.

Finally, the new base eliminates the need to use the "generic" tax-back provision of the Equalization formula. This is an ad hoc provision in the formula meant to deal with an incentive problem which arises when one equalization-receiving province has a very high proportion of the total tax base for a given revenue source<sup>46</sup> — a rare situation that occurs only with natural resource bases. In particular, it has occurred with potash and with asbestos, for which production is highly concentrated in, respectively, Saskatchewan and Quebec. With the new mining base, invocation of the formula's tax-back provision is no longer necessary because the new base is a combined base for all mining — including coal, asbestos, potash, and other minerals — and is thus much more evenly distributed across provinces than were the old

separate bases. There is no exceedingly high concentration of the new base in any one province and therefore no need to use the provision.

**Forestry.** The old forestry revenue source was split into two separate sources — forestry revenue from private lands and forestry revenue from provincial Crown lands — and the old *volume* of production base was replaced with two *value* of production bases.

Value of production is a better indicator of fiscal capacity than volume of production. The volume of forestry production in two provinces may be the same, but the value of that production will differ significantly if, for example, the tree species harvested in one province differ from those harvested in the other. Since higher value production can be taxed at higher tax rates than lower value production, a province with higher value production has more fiscal capacity than one with a lower value production. The old base incorrectly assigned the same fiscal capacity to two provinces with the same volume of production and thus overestimated the fiscal capacity of provinces with lower per unit value of production relative to those with higher per unit value of production.

Separate revenue sources were created for forestry revenues derived from provincial Crown lands and forestry revenues derived from private lands because of differences in fiscal capacity. Production on Crown lands can generally be taxed at higher rates. With the old revenue-source and base definitions, the fiscal capacity of provinces with a high proportion of production on private lands was being systematically overestimated relative to the fiscal capacity of provinces with a low proportion of production on private lands.

Although the new value of production bases represent a significant improvement over the old volume of production base, it can be argued that the new bases are still not ideal because they do not take into account differences in production costs. Unfortunately, good economic rent data by province are currently not available for the forestry sector. However, work toward developing an economic rent base for forestry will continue in the next renewal round.

**Oil.** Two new revenue sources — light/medium third-tier oil revenue and heavy third-tier oil revenue — were added to the existing oil revenue sources, and some of the old revenue sources were redefined. Two new value of production bases which correspond to the new revenue sources were added to the existing value of production bases.

The reason for adding the two new oil revenue sources is that production costs vary significantly for different types of oil deposits and for different vintages of oil pools. In general, recovery costs are higher for more recently discovered oil pools. Oil production from these pools is less profitable and therefore cannot be taxed at the same rate by provincial governments as oil production from older pools.

Oil from the newest pools (in the case of Alberta, pools discovered after 1 October 1992) is called "third-tier" oil. Revenue derived from this oil was previously included among new-oil and heavy-oil revenues. The new classification system will lead to an improvement in the measurement of the provinces' relative fiscal capacities — particularly for Saskatchewan and Alberta. The proportion of third-tier oil in total oil production is higher for Saskatchewan than Alberta, and the old revenue-source definitions, which failed to distinguish the less highly taxed third-tier oil from other types of oil, therefore resulted in Saskatchewan's fiscal capacity being overestimated relative to Alberta.

**Natural Gas.** The domestic and exported natural gas revenue sources have been combined into a single revenue source, and the old volume of production bases have been replaced with a single value of production base.

The two revenue sources were combined because domestic and exported gas are taxed at the same rate by provinces. A value of production base has been adopted in place of the old volume of production base because value of production is a better indicator of fiscal capacity. (See the discussion of the forestry base earlier.)

Because it does not take into account differences in the cost of production, value of production is still not an ideal base. Work toward developing an economic rent base for natural gas revenues will be undertaken during the next renewal round.

**Payroll Taxes.** The payroll tax revenue source was redefined to exclude payroll taxes paid by provincial and local governments. These revenues do not add to the fiscal capacity of the consolidated provincial-local government sector, and their inclusion in revenues subject to Equalization therefore constituted double counting.

The base, which previously consisted of all wages and salaries earned in a province, was modified to exclude wages and salaries paid by provincial and local governments (consistent with the changes to revenues subject to Equalization). To make it more representative of actual provincial taxing practices, the base was also modified to exclude a weighted average of the wages and salaries below the tax exemption cut-offs of the various provincial payroll tax systems.

**Miscellaneous Revenues (User Fees).** The miscellaneous revenue source includes various tax and non-tax revenues which are not included in any of the Equalization program's other revenue sources. A large portion of miscellaneous revenues (approximately 80 percent) consists of user fees. The remainder consists of various minor taxes and non-tax revenues.

All user fees collected by the provincial general government sector, the local government sector, and the school-board sector — as those sectors are



defined by Statistics Canada — were previously equalized. User fees collected by the university and college sector and by the health and social services sector were not equalized.

Henceforth, only 50 percent of the user fees previously equalized will continue to be equalized.<sup>47</sup> At the same time, revenue coverage for the miscellaneous revenue source will be expanded to include certain non-tax revenue (including fines and penalties) collected by local governments and were previously excluded from equalization.

The reason for reducing the percentage of user fees subject to equalization is that these revenues, which are benefit charges, do not create fiscal disparities. In fact, it can be argued that theoretically, user fees should not be equalized at all.<sup>48</sup> However, no longer equalizing user fees would have constituted an abrupt change with substantial impacts on entitlements. Furthermore, the theoretical argument against equalizing user fees assumes that none of the user fees levied by provincial and local governments exceed the costs of the goods or services on which those fees are charged.<sup>49</sup> But this may — as indicated, for example, by a recent Supreme Court decision on provincial probate fees<sup>50</sup> — not be the case. For these reasons, rather than not equalizing user fees at all, it was decided that the percentage of user fees subject to Equalization should be reduced to 50 percent.

*Other.* Changes were made to a number of other revenue-source and base definitions as well. These include:

- *Capital Taxes.* For reasons identical to those discussed in the previous section, the percentage of debt-guarantee fees subject to Equalization was reduced by 50 percent.<sup>51</sup>
- *Property Taxes.* Although participants in the renewal process agreed that the current property tax base is unsatisfactory, only minor changes, consisting of the updating of some parameters, were made.
- *Medical and Hospital Insurance Premiums.* Base parameters were updated and new components were added to the base to reflect changes in provincial premium structures.
- *Gasoline Taxes.* Changes were made in the data sources and methodology used to calculate the gasoline tax base for Ontario.
- *Race Track Taxes.* Wagers are now included in the base on the basis of where (in which province) those wagers are made rather than on where the races on which they are made are run.<sup>52</sup>

#### FUTURE CHALLENGES

*Property Tax.* The treatment of property taxes has always posed a problem for the Equalization system.<sup>53</sup> The current base is not a representative base which

reflects the statutory bases upon which provincial and local governments levy property taxes. This is partly due to the fact that, although they are generally based on some measure of property value, statutory property tax bases differ significantly from province to province.

More importantly, it is questionable whether property value constitutes the correct Equalization base for property taxes, because it is not clear to what extent the capacity of provincial and local governments to raise property taxes is actually a function of property values. It could be argued that property values serve mainly to determine how property taxes are *distributed* among citizens in a jurisdiction rather than to determine the overall capacity of a government to raise revenues from property taxes.

During this most recent renewal process, concerns with the property tax base continued to be raised. The current multi-variable base is too complex and lacks clear theoretical justification. There are also statistical and design problems with specific components of the base and with the way components are combined in the base.

No clear alternative to the current base emerged during the consultation process. The decision was therefore made to keep the existing property tax base (with some updated parameters) for the time being and to continue research to improve this base.

*Representative Tax System versus Macro Approach.* A second research priority is to examine macro-indicator approaches to Equalization.

There are two major approaches to measuring fiscal capacity recognized in the literature.<sup>54</sup> One of these is the representative tax system approach and the other is the macro-indicator approach. The RTS approach measures the per capita revenues that can be raised by a typical tax system. This is done separately for each revenue source. With the macro-indicator approach, fiscal capacity is determined by a single indicator (e.g., GDP) used as an overall measure of fiscal capacity for all revenue sources.

Although the RTS approach has much to recommend and has generally served the Canadian Equalization program well, it also has certain shortcomings. A number of conceptual criticisms of the RTS have been raised in the literature. For example, it fails to take into account interrelationships among the various tax bases, and it does not measure what is ultimately available to be taxed — income.<sup>55</sup> The RTS approach has also frequently been criticized — most recently in the Parliamentary debates and hearings on the 1999 Equalization legislation — for being too complex. Finally, significant controversy arose among participants in the recent Equalization renewal on the measurement of fiscal capacity for some important revenue sources, which raises concern. Differences of opinion on the property tax base, in particular, often appeared to be fundamental. The RTS framework does not provide any clear means of resolving questions of how fiscal capacity should be measured for

certain revenue sources, and this may make difficult any future progress in improving the Equalization program within an RTS framework.

*Interaction with Aboriginal Issues.* Many of the services generally funded by provincial governments (education, health services, social services) are, in the case of First Nations, funded by the federal government. Also, self-government agreements, comprehensive land-claim agreements, and other recent developments (such as the opening of casinos run by First Nations) are increasingly resulting in a sharing of tax room between provincial and Aboriginal governments. Both of these issues have implications for Equalization.

Some initial discussions of the interaction of Equalization with the financing of public services for Aboriginals took place during this last renewal round, but no changes to the Equalization program were immediately implemented. It was, however, decided that detailed research on this topic would be undertaken and given high priority for the next renewal round.

## TERRITORIAL FORMULA FINANCING (TFF)

### CONTEXT

The federal government provides funds to the three northern territorial governments — the Yukon, the Northwest Territories and Nunavut — through a formula-based grant. Territorial Formula Financing was established in 1985-86 and is generally reviewed and renewed every five years. In 1999, besides the regular review, the federal and territorial governments also had to redesign the financial arrangements to accommodate the division of the Northwest Territories to create Nunavut.

The Territorial Formula Financing agreements provide annual unconditional transfers to enable the territorial governments to provide a range of public services comparable to those offered by provincial governments. As the name indicates, the size of the grants to the territories is determined by a formula. This formula provides for annual increments and adjustments to a base level of support depending on such things as population, fiscal developments in the territories and the level of public services provided by provincial governments. TFF payments take into account the high costs of providing public services in the north, due to its vast land mass and scattered population, as well as the less-developed state of the territorial economies.

The financing formula is defined in agreements between the federal finance minister and territorial governments, rather than by legislation as is the case with the other major transfers.

Although territorial governments have the authority to raise their own revenues by taxation and the sale of goods and services, TFF provides between 65 and 90 percent of territorial revenues. As an unconditional transfer, it

provides the territories with autonomy to design and manage their own public services and allows them to be accountable directly to their citizens. The agreements also include financial incentives to promote economic development and to encourage greater territorial self-sufficiency. In 1999-2000, the federal government will transfer about \$1.4 billion: \$550 million to the Northwest Territories, \$540 million to Nunavut, and \$320 million to the Yukon.

#### HOW ARE TFF PAYMENTS CALCULATED?

Like Equalization, Territorial Formula Financing is based on a gap-filling principle. Territorial expenditure needs are measured by the gross expenditure Base, which, subject to a ceiling, is indexed to grow in line with provincial spending to reflect the public services provided by governments in other parts of the country. It is also adjusted for territorial population growth relative to that of Canada as a whole.

Revenue-raising ability is measured by estimating the revenue that a territory would have at its disposal if it exercised a tax effort similar to that in other parts of the country (adjusted to recognize the special circumstances of the north).

Federal transfer payments fill the gap between the calculated expenditure needs and the revenues estimated to be available to territorial governments.

#### NEW FUNDING ARRANGEMENTS

The federal and territorial governments conducted their review and restructuring of the financing arrangements to accommodate Nunavut over the course of 1997 and 1998. New funding arrangements were finalized for all three territories and took effect 1 April 1999. The main changes from the previous agreements were:

- The development of two separate expenditure bases to reflect the division of the Northwest Territories and the creation of Nunavut. This includes the provision of incremental funding of about \$95 million, starting in 1999-2000, to meet the costs of running two governments instead of one while maintaining the current level of services.
- Simplification of the revenue formula in the agreements with the Northwest Territories and Nunavut. Only major revenues are calculated annually while minor revenue sources will be treated as fixed for the duration of the agreement.

In addition, there were administrative changes to the estimate and payment processes to bring them in line with the other transfer programs. There will now be two estimates and adjustments to payments per year instead of one.

Finally, the length of time that a payment remains open for adjustment due to data revisions has been reduced to three years from five (with the exception of population).

## CONCLUSION

The CHST measures introduced in the 1999 budget, and the renewal of Equalization and Territorial Formula Financing, constitute incremental adjustments rather than fundamental changes to the transfer programs. Taken together though, the changes in 1999 were substantial. Over the period from 1999-2000 to 2003-04, the federal government will provide an extra \$11.5 billion for health care through an increase in the CHST cash component. The CHST allocation formula will ensure equal per capita entitlements for all provinces as of 2001-02. The structural changes to the Equalization program improve the measurement of provincial fiscal capacity and the calculation of appropriate levels of support. The new TFF agreements reflect the division of the Northwest Territories and the creation of Nunavut. A total of \$95 million will be provided to recognize the incremental costs of running two governments instead of one and maintain the provision of the current level of services. All three major programs are now on a common predictable five-year renewal cycle and are designed to operate in their current form from 1999-2000 through 2003-04. It will continue to be essential to keep these programs under review as the fiscal circumstances underlying federal-provincial and territorial relations continue to evolve.

## NOTES

The authors work for the federal Department of Finance. The views expressed in this paper are those of the authors and do not necessarily represent official federal government views.

1. CHST and Equalization are both governed by the *Federal-Provincial Fiscal Arrangements Act*. The terms of Territorial Formula Financing are set out in separate agreements with each of the three territories.
2. *Budget Plan*, February 1994, p. 38.
3. *Ibid.*
4. *Ibid.*, p. 39.
5. *Budget Plan*, 27 February 1995, p. 51.
6. *Ibid.*, p. 53.
7. *Ibid.*

8. Territories, as well as provinces, are eligible for CHST. However, for simplicity, the term "provinces" is used to refer to both provinces and territories here unless otherwise indicated.
9. Ibid.
10. *Budget Plan*, 1996, p.57.
11. *The Budget*, 20 February 1990, p. 78.
12. *The Budget*, 26 February 1991, p. 66.
13. *Budget Plan*, 1996, p. 57.
14. *The Budget Plan 1999*, 16 February 1999, p. 83 and *Federal Financial Support for the Provinces and Territories*, published with the 1999 budget.
15. Levels are re-estimated in February and October and posted on the Finance Website, <http://www.fin.gc.ca>, under Publications and Federal Transfers to Provinces and Territories.
16. *The Budget*, 20 February 1990, p. 76.
17. *The Budget*, 26 February 1991, p. 66.
18. *The Budget Plan*, February 1994, p. 39.
19. *Budget Plan*, 27 February 1995, p. 54.
20. Alberta had responded to the cap on CAP by reforming its social assistance programs with the result that by 1996-97, the federal contribution under CAP remained close to 50 percent of eligible spending.
21. *Budget Plan*, 6 March 1996, pp. 58-59.
22. *The Budget Plan 1999*, 16 February 1999, pp. 89-90.
23. Ibid.
24. Fortieth Annual Premiers' Conference, Press Releases, "A Balanced Approach for Better Competitiveness" and "Priority Health Sector Issues," Québec City, 10-11 August 1999. Also, Common Position of Provincial and Territorial Finance Ministers, "Improving the Competitiveness and Standard of Living of Canadians," Ministère des finances du Québec, December 1999.
25. Common Position of Provincial and Territorial Finance Ministers, p. 9.
26. Premiers and Territorial Leaders, "Letter to the Prime Minister of Canada," Meeting of Premiers and Territorial Leaders, Québec City, 3 February 2000.
27. "Parliament and the Government of Canada are committed to the principles of making Equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (subsection 36(2) of the *Constitution Act*).
28. This standard has been in use since 1982-83. It is a population-weighted average of the per capita fiscal capacity of each of the five "middle-rich" provinces.
29. This figure is from the second official entitlements estimate for 1999-2000 made in October 1999 (rounded from \$9,501 million).

30. The base level for the ceiling was set at the amount of Equalization provinces would have received for 1992-93 had entitlements been calculated using the formula introduced in 1994-95. The ceiling for the five fiscal years beginning with 1994-95 was then set at the base level plus a percentage equal to the cumulative percentage growth in GNP from 1992 to the calendar years ending in those fiscal years.
31. The ceiling estimate is based on GNP figures for 1998 from the 1999-Q2 National Accounts. Equalization entitlements for 1998-99 were estimated at \$9,614 million in October 1999.
32. This is true unless the base year that is chosen precedes the first year of the new fiscal arrangements period by at least three years. In that case, entitlements for the base year will have been finalized by the end of the first fiscal year of the new fiscal arrangements period.
33. As in the previous fiscal arrangements period, the ceiling would apply to total Equalization entitlements after any floor adjustments had been made. In the unlikely event that both the ceiling and floor provisions apply in the same year, the floor provision will be less than 1.6 percent of the per capita standard.
34. Except for some calculations which rely on local government data.
35. Alberta has no sales tax.
36. Whereas only a few years ago, virtually all provincial gaming revenues were derived from ticket lotteries, today only about 35 percent are derived from this source.
37. Also, with the old revenue-source and base definitions, an equalization-receiving province could both increase its own-source revenues from gambling by expanding non-ticket lottery gaming and at the same time trigger an increase in the Equalization transfers it received.
38. Note that if there were a high degree of substitution by gaming patrons among different types of gaming, an expanded consumption base might still be appropriate for Equalization purposes, despite the large differences in tax effort among provinces in the non-traditional gaming area. This is so, because for ticket lotteries, tax effort is similar for all provinces. Consequently, if there were a high degree of substitution between ticket lottery gaming and other types of gaming, low consumption of non-traditional gaming products in a province (because of restricted availability) would translate into correspondingly higher consumption of ticket lottery products (which are equally available in all provinces). An expanded consumption base could therefore fully capture the demand for gaming products in a province, regardless of the availability of non-traditional gaming, and would thus adequately reflect provinces' relative fiscal capacities. However, substitution among different gaming types is actually very low. There have been only very small decreases in the rate of growth of lottery ticket sales in provinces that have implemented video and casino gaming relative to provinces that have not implemented video lottery and casino gaming.
39. More precisely, it includes revenues derived from all non-ticket lottery gaming other than race track taxes. Race track taxes continue to be equalized as a separate revenue source, as was the case prior to the renewal.

40. Sales net of prize payouts, rather than gross sales, are used as the consumption measure because the percentage of gross wagers returned to players in the form of prizes varies significantly among different games. This variation occurs both among major gaming types and within major gaming types (e.g., among different ticket lottery games). In a gross wagers base, games with high prize payouts would be given too large a weight and games with low prize payouts would be given too low a weight, so that provinces' relative fiscal capacities would not be measured accurately.
41. As stated earlier (see note 38 above), there is, in fact, only limited substitution between ticket lottery games and other games of chance. But to the extent that there is substitution, higher fiscal capacity in non-traditional gaming that is associated with lower consumption of lottery tickets will, at least partially, be captured by the consumption component.
42. Exceptions are Crown lease sales and mining taxes. Crown lease auctions capture in a fairly direct way the economic rents that resource properties are expected (at the time of the auction) to generate. Most mining taxes are taxes on profits.
43. For example, in the forestry sector, we observe provinces setting higher stumpage fees for species that are more profitable than for species that are less profitable. We observe provinces adjusting tax rates to reflect changes in prices and input costs (both of which affect the amount of economic rent available to be taxed). And in provincial documents, we see references to such concepts as "responsible sharing of profits" with the private sector.
44. The actual statutory bases taxed by provinces (volume or value of production) are inferior indicators of fiscal capacity because those bases cannot be taxed at the same rates by all provinces. Two provinces can have production bases of equal size, but one province may be able to levy a much higher tax rate on its base because there is more underlying economic rent available to be taxed. The relative volume or value of production of a natural resource in two provinces may thus be a misleading indicator of the relative capacities of the governments of those provinces to raise revenues from the resource.
45. Mining profits will be determined using provincial input-output data from Statistics Canada. As a result of PIPES, these data are now of higher quality, and are available on a more timely basis than in the past.
46. The problem arises if such a province raises its rate of tax on such a base. The resulting increase in its own-source revenues is completely (or almost completely) offset by a corresponding decrease in Equalization. In the absence of some alleviating mechanism, the Equalization program thus creates incentives that could inappropriately distort provincial tax policy. The generic tax-back provision stipulates that if a province has 70 percent or more of a total tax base for a revenue source, the revenues subject to Equalization for that source are scaled back by 30 percent. This substantially reduces the decrease in Equalization that would result from an increase in tax rates and thus the effect of Equalization on the province's taxing decisions.



47. Note that like all other redefinitions of revenue sources and bases, this change will be phased in, so that in 1999-2000, 90 percent of user fees will be equalized, in 2000-01, 80 percent will be equalized, and so on.
48. See, for example, Robin Boadway, "The Economics of Equalization: An Overview," in *Equalization: Its Contribution to Canada's Economic and Fiscal Progress*, ed. Robin Boadway and Paul Hobson (Kingston: John Deutsch Institute for the Study of Economic Social Policy, Queen's University, 1998), p. 78.
49. To the extent that user fees exceed the cost of the goods or services provided by government, these user fees are taxes, not benefit charges, and they create fiscal disparities.
50. Eurig Estate (Re) — 22 October 1998.
51. Debt guarantee fees are a type of user fee. Whereas all other user fees are included in the miscellaneous revenue source for Equalization purposes, debt guarantee fees are included in the capital tax revenue source.
52. The new base is an improvement over the old base because race track taxes are levied on the amount *wagered in a province* (regardless of where the races on which wagers are placed are run). The province where a bet is placed can differ from the province in which a race is run for simulcast races. Simulcast racing has become increasingly common over the past several years.
53. Boadway, "Economics of Equalization," p. 77.
54. See Stephen Barro, *State Fiscal Capacity: An Assessment of Measurement Methods* (Washington, DC: SMB Economic Research Inc., prepared for the US Department of Housing and Urban Development, April 1984).
55. See, for example, Richard Bird and Enid Slack, "Equalization: The Representative Tax System Revisited," *Canadian Tax Journal* 38, 4 (1990):913-27; and especially Barro, *State Fiscal Capacity*.

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## The Evolution of Federal-Provincial Fiscal Arrangements: Putting Humpty Together Again

Paul A.R. Hobson  
France St-Hilaire

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*Les années de restrictions budgétaires fédérales se sont traduites par des changements radicaux dans les programmes de transferts aux provinces. D'abord avec le plafond imposé aux dépenses engagées dans le cadre du Régime d'assistance publique du Canada (RAPC), ensuite avec la fusion du RAPC et du financement des programmes établis (FPE) dans le nouveau Transfert canadien en matière de santé et de programmes sociaux (TCSPS) donnant lieu à des coupures massives des transferts en espèces aux provinces, et, plus récemment, avec la restauration partielle et conditionnelle de ce financement uniquement pour les soins de santé, la décennie 1990 aura été une période des plus tendues pour les relations fédérales-provinciales. Tant le principe que la politique de péréquation ont été remis en cause. Le budget fédéral de 1999 signale-t-il un désir de rétablir un certain équilibre?*

*Ce chapitre examine l'évolution, les modalités et la distribution du TCSPS jusqu'au budget de 1999. Les auteurs considèrent le nouveau programme de transfert dans toutes ses dimensions et plus particulièrement en tant qu'un des éléments constitutifs de l'union sociale canadienne.*

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### INTRODUCTION

The signing of the Framework Agreement on the Social Union in February 1999 and the measures related to fiscal transfers announced a few weeks later as part of the federal budget have been interpreted by many as a turning point in the evolution of federal-provincial relations in the area of social policy.<sup>1</sup> However, looking back at the events of the last five years, it can be argued that the real turning point occurred much earlier, in 1994, with the release of the Axworthy Green Paper<sup>2</sup> which set the stage for a major re-engineering of social policy in Canada. While the fiscal crisis of the mid-1990s did provide the real impetus for change, much of the rationale and basic elements

underlying the most significant reforms to the social policy infrastructure in the past six years can be traced back to this document. These changes have had a profound impact on the federal government's role in social policy and have fundamentally altered the federal-provincial fiscal framework upon which the Canadian social union has rested for decades.

Although the Green Paper dealt significantly with issues of social policy delivery at the provincial level, the implications for Canadian fiscal federalism were treated almost as an afterthought. Yet, the principal reform options set out in the paper carried with them the potential for large reductions in transfers to the provinces under Established Program Financing (EPF) and the Canada Assistance Plan (CAP) and paved the way for the introduction of new federal social programs. In the event, it was the Canada Health and Social Transfer (CHST) that was to be the vehicle for implementing massive cuts in cash transfers to the provinces, while at the same time doing away with the last major federal-provincial cost-sharing program.

The social union talks, at the outset, were a province-led initiative in reaction to the years of unprecedented cuts and unilateral changes in federal fiscal transfers and other social programs, much of which followed the release of the Green Paper. The negotiations were aimed at establishing the ground rules of a new intergovernmental partnership in the area of social policy. The provinces were also eager to discuss provisions for adequate funding of social programs and changes to fiscal arrangements within the context of these negotiations. However, the federal government opted to hold parallel talks on these issues. This approach seemed somewhat incongruous, since, from the time when they were first established, federal-provincial fiscal arrangements have had a determining effect on the design, the evolution, and the allocation of resources to social programs. But then again, perhaps not.

One of the conclusions of this chapter is that rather than an instrument of social policy, the CHST, as it has evolved, is little more than a mechanism for distributing federal revenues back to provincial governments. It appears that fiscal federalism is no longer the preferred instrument for maintaining a federal role in the areas of health care, postsecondary education, and social assistance. Recent federal budgets reflect a new policy stance whereby Ottawa wishes to establish a distinct federal presence in these areas by implementing new and highly visible initiatives such as the Millennium Scholarship Fund and the National Child Benefit and by reverting to conditional and earmarked transfers for health care. In our view, this approach is inconsistent with the respective role that each level of government has come to play in these areas of social policy and it creates significant gaps in our social safety net. It also redefines the principle of fiscal equity upon which national social programs had initially been established. In the process, the promotion of equal opportunity for all Canadians has been replaced by a new objective — that of fiscal equality. Using "equal per capita" as the new benchmark

for fiscal arrangements certainly provides greater simplicity and transparency, but it does not necessarily make for good social policy. In sum, the CHST fails on several grounds to epitomize the set of fiscal arrangements required to make the transition to a new social union framework, especially one as loosely defined as the February 1999 agreement.

The chapter begins by providing some historical perspective from which the CHST must be assessed. We review the evolution of the various elements of federal-provincial fiscal arrangements over the postwar period, including the gradual return of tax room to the provinces, the advent of Equalization, the transition to block-funding under EPF in lieu of cost-sharing in health and postsecondary education, and cost-sharing for welfare programs under CAP. In particular, we highlight the equalization elements in these latter programs — pertaining to provinces' fiscal capacities in the case of EPF and to expenditure need in the case of CAP. We then track the CHST from birth through its formative years, both in design and in its role as the vehicle for instituting massive cuts in cash transfers made to the provinces for social programs. This is followed by a critical assessment of the CHST as an instrument of social policy, arguing that changes to fiscal arrangements in the 1990s have fundamentally altered the scale, the function, and the allocation of federal social transfers to the provinces.

Next, we provide our own assessment of the fiscal state of the social union in the shadow of the Green Paper and in light of subsequent actions by the federal government. Finally, we conclude by making the point that the proper design of funding arrangements requires recognition that these are instruments of social policy, not merely mechanisms for distributing federal money. This should not be misconstrued as simply a desire to put Humpty together again. In coming years, pressures to reform and adjust our social programs will continue unabated as a result of changes in need brought about by new realities. The implications for health care of an aging population and rapid medical advances, the changing face of poverty, and unemployment are only some of the challenges that loom on the horizon. Appropriately designed fiscal arrangements are more important than ever.

## SOME BACKGROUND

### THE PRE-1990S SOCIAL CONTRACT

Over the past decade, the system of intergovernmental transfers has come under much criticism for being unnecessarily complex and obscure. More importantly, it has come to be viewed in certain regions of the country as unfair and inequitable, so much so that simplicity and equality have become paramount on the agenda for reform of fiscal federalism,<sup>3</sup> often to the detriment

of other considerations. Our purpose in retracing the evolution of the federal-provincial fiscal arrangements over time is not to reminisce about the good old days or rehash past injustices, but to remind ourselves of the reasons these were put in place, the objectives they served, and to understand how we have arrived at our current situation and what this implies for the future.

The social programs that Canadians have come to regard as part of their fabric and identity were for the most part established after the Second World War. At that time, the federal government, having acquired effective control of the entire income tax field as a result of the Wartime Tax Collection Agreement with the provinces, was able to retain sufficient control to implement its "national agenda" for social welfare. In practical terms, this meant that the provinces had to accept Ottawa's control over the major tax fields even though the constitution also gave them access to these. By establishing a variety of cost-sharing programs in the fields of health, postsecondary education (PSE), and welfare, the federal government was then able to assume a key role in social policy, even though these programs were in areas of provincial jurisdiction.

Thus, over the next three decades, both orders of government set out to promote the growth of social services demanded by the public, to ensure universal access to a given minimum level of services to all Canadians and reduce interprovincial disparities in the levels of public services provided. This period of cooperative federalism was to produce well-established national health care, university, and welfare systems; tax-collection agreements facilitating tax harmonization; the equalization program; and revenue stabilization arrangements.

#### THE DIVISION OF TAX ROOM

Ultimately, the whole history of federal-provincial fiscal arrangements revolves around the division of income tax room between the federal government and the provinces.<sup>4</sup> The process was one of evolution, with the postwar tax rental agreements giving way to the 1957 Tax Sharing Agreements (whereby the provinces received a fixed percentage of income tax revenues collected in their jurisdictions) and finally the 1962 Tax Collection Agreements that underlie the present system. Under the tax-collection agreements, the federal government yielded income tax room to the provinces by lowering its rate schedule and allowing the provinces to increase their rates to fill the gap as they wished, provided they accepted the federal definition of the base and rate structure by applying a single rate to the basic federal tax.

Subsequently, the federal government also began providing further tax room to the provinces in lieu of specific-purpose transfers, a trend that culminated in 1977 with the move to block-funding for programs in the areas of health and PSE through EPF. The federal government's objective at the time was to

sever the cost-sharing link to provincial expenditures and to have the provinces eventually assume entire responsibility for these programs, which by then were considered "established."

#### EQUALIZATION

Coupled with the tax-sharing and tax-collection agreements, the Equalization program was put in place to ensure that provinces with below average fiscal capacities were able to provide comparable levels of public services at comparable levels of taxation. When it was first introduced in 1957, Equalization was designed to raise the fiscal capacities of the "have-not" provinces to a level equivalent to that of the top two provinces. Income tax points transferred to the provinces at that time were therefore "fully equalized." Under the 1962 arrangements, the number of revenue bases eligible for equalization was increased and a new national average standard was adopted. While revenue-neutral at the time, this posed a problem of how to accomplish any further devolution of income tax room without widening fiscal disparities across provinces, since transferred tax points would be equalized only up to the national average.

The inclusion of resource revenues among the bases eligible for equalization proved to be particularly problematic. The energy shocks of the late 1970s and early 1980s created a situation whereby the federal government was being forced to equalize provincial revenues without reference to expenditure needs and with only limited access itself to the one revenue source that was creating the problem. Finally, in 1982, this problem was addressed by adopting a "representative" standard which excluded Alberta and the four Atlantic provinces — the five-province standard still in effect today. The key point, for purposes of this chapter, is that Equalization serves the role of raising per capita revenues in recipient provinces up to the standard (a level slightly below the national average); that is, it reduces, but does not eliminate, fiscal disparities.

#### ESTABLISHED PROGRAMS FINANCING

The introduction of EPF in 1977 permitted a major devolution of income tax room to the provinces in place of direct cost-sharing arrangements for health care and postsecondary education.<sup>5</sup> In its original design, approximately one-half of the total EPF entitlement took the form of a transfer of tax points, equivalent in value to half the amount of federal transfers in the previous year, with the other half provided as an equal per-capita cash transfer. Thereafter, the value of the tax points would have grown in accordance with the tax base; the cash transfer was to grow in accordance with the gross domestic

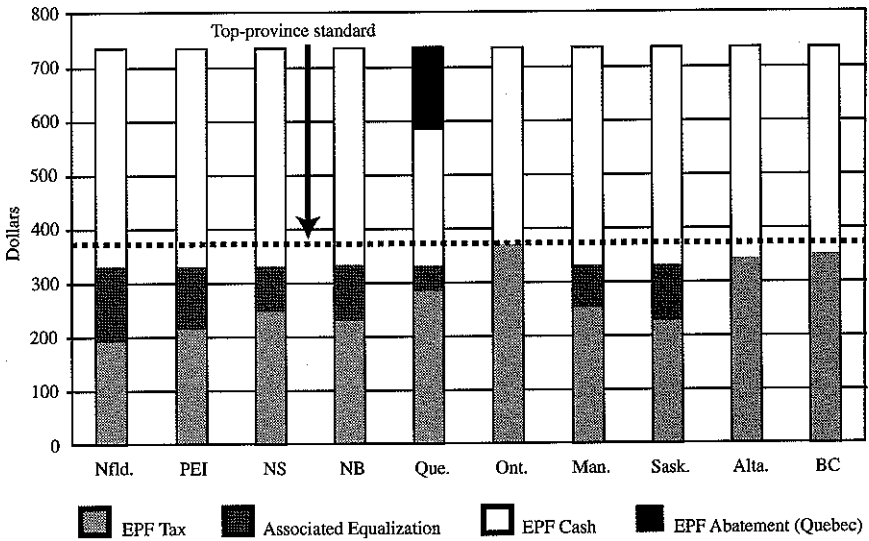
product (GDP). Since the (equalized) value of the tax points differed between the recipient provinces under Equalization and the non-recipient provinces, total EPF grants were not equal per capita; only the cash component was. This remained the case until 1982, when the EPF arrangements were modified so that total entitlements (cash plus the value of the tax points) would be on an equal per capita basis. From that point on, each province's per-capita cash transfer under EPF was to be calculated as the difference between its equal per-capita entitlement and the per capita value of the EPF tax points.

The decision to combine the cash component with the value of the EPF tax points had important implications which still characterize current transfer arrangements under the CHST. Most significantly, the method of calculating the cash transfer by residual, in effect, adds a "super equalization" component to the transfer by raising the per-capita value of EPF tax points in *all* provinces to a top-province standard. This, indeed, was the genius of the 1982 version of EPF — it accomplished a "fully equalized" transfer of tax room to the provinces. In other words, it accomplished a transfer of tax room without opening up wider gaps in fiscal capacities between the "have" and "have-not" provinces.

This process is illustrated in Figure 1. The value of the EPF tax points is calculated on the basis of 13.5 percentage points of federal personal income tax revenues and one percentage point of federal corporate income tax revenues. In addition, EPF tax points are subject to equalization under the Equalization program — this is the "associated equalization" in the figure. Thus, all recipient provinces under Equalization show the same equalized value of tax points per capita. Per-capita cash entitlements are then calculated as a residual.<sup>6</sup> The allocation of EPF cash across provinces can be decomposed into two components. First, EPF cash has the effect of raising the (equalized) value of the tax points to an Ontario standard — the "super equalization" mentioned earlier (as indicated by the dotted line). This applies equally to those provinces that are recipients under the Equalization program and to those, Alberta and British Columbia in this case, that are non-recipients. Second, cash transfers beyond that level are equal per capita across provinces.<sup>7</sup>

Total per-capita entitlement was designed to grow in line with per-capita gross national product (GNP). Subsequent federal budgets, however, restrained this growth formula significantly, culminating in a five-year freeze imposed in 1990-91. The total value of the EPF transfer therefore failed to grow in step with the economy, let alone in step with growth in income tax revenues. Put differently, had the federal government simply ceded tax room to the provinces in 1977 equivalent to the total value of the EPF transfer (twice the number of EPF tax points), the value of the associated tax points would have grown in step with income tax revenues. Thus, there has been an erosion of the effective transfer of tax points made in 1977.

Figure 1: EPF Entitlements Per Capita by Province, 1992-1993



Source: Created from data provided by the Federal-Provincial Fiscal Relations Division, Finance Canada.

The design of EPF also gave rise to certain incongruities that remain as part of the current set of arrangements. For instance, notwithstanding its nature as a block grant for health and PSE (which in effect simply becomes part of provincial general revenues), the federal government continued to separate the total EPF transfer into a notional transfer for health and a notional transfer for PSE based on 1975-76 shares in total transfers (67.9 percent for health and 32.1 percent for PSE). It also adopted the practice of reporting EPF transfers to the provinces as the combined value of the cash transfer and the value of the EPF tax points, as though the tax transfer were a yearly event.<sup>8</sup> In fact the tax transfer occurred once, in 1977, when the federal government lowered its rate schedule to make room for the provinces to increase theirs (i.e., it was the tax points that were transferred). Thereafter, the associated revenues have been collected directly by the provinces while federal tax rates (and provincial rates, for that matter) have evolved quite independently. The point is that even though the structure of EPF has made it necessary to keep track of the value of the tax points in order to calculate the value of cash transfer payments, they do not constitute a transfer — they are simply part of the provinces' own-source revenues.

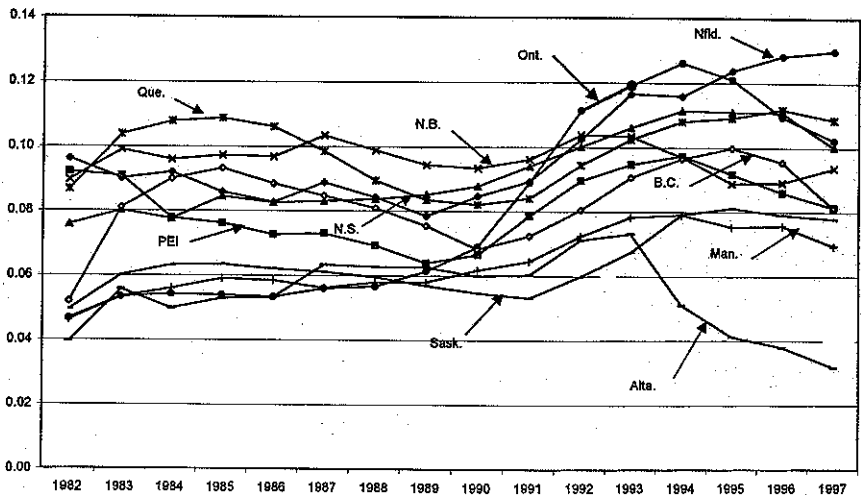


## THE CANADA ASSISTANCE PLAN

The intent of the CAP, established in 1966, was for the two orders of government to share the costs of provision of income support to needy individuals who had exhausted all other avenues available to them — it was the program of last resort for the unemployable. CAP was designed as a matching grant program under which the federal government picked up 50 percent of eligible, provincial social assistance expenditures.

For Ottawa, CAP became increasingly problematic for two reasons: first, wealthier provinces which could afford more generous welfare programs were seen to benefit unduly from this cost-sharing formula and second, CAP did not lend itself to expenditure control measures on the part of the federal government. Moreover, welfare did not remain a program of last resort. Over the latter part of the 1980s and the early 1990s, social assistance became one of the fastest growing areas of provincial spending with obvious repercussions on federal transfers under CAP. Over time the employable unemployed have come to represent a significant share of the welfare caseload (by a margin of

**Figure 2: Welfare Recipients as a Proportion of Population by Province, 1982-1997**



Source: Authors' calculations. Constructed from recipients data found in National Council on Welfare, *Another Look at Welfare Reform* (Ottawa: Minister of Public Works and Government Services Canada, 1997), p. 2, and population data provided by the Federal-Provincial Fiscal Relations Division, Finance Canada.

three to one according to estimates by the National Council of Welfare)<sup>9</sup> both as result of economic restructuring and the cumulative effects of changes implemented by the federal government to the Unemployment Insurance program. Thus, the national social assistance rate has increased from 5.5 percent in the 1970s, to 7 percent in the 1980s, and to 9.5 percent in the 1990s.<sup>10</sup> And while poorer regions continue to have consistently high welfare dependency ratios, all regions have become increasingly susceptible to the welfare impact of economic downturns, even wealthier provinces like Ontario and British Columbia (see Figure 2). Indeed, CAP payments, in addition to providing support to poorer regions, had also come to play important insurance (economic risk-sharing) and stabilization roles in the provinces.<sup>11</sup>

The 1990 federal budget fundamentally changed the nature of these arrangements. In addition to imposing a freeze on EPF entitlements, the budget measures included a 5 percent annual growth ceiling on CAP payments (the cap on CAP) to the three non-recipient provinces under Equalization (Ontario, Alberta, and British Columbia). The ceiling was initially put in place for two years, but it was extended for a further three years in the 1991 federal budget. The timing of this measure, just at the onset of a severe recession that hit Ontario the hardest, generated significant inequities in the transfer system that persist to this day. Cost-sharing of social assistance expenditures in Ontario, for example, fell to roughly 25 percent compared to 50 percent in the Atlantic provinces.

## THE TRANSITION TO BLOCK-FUNDING: IN SEARCH OF A NEW FEDERAL-PROVINCIAL BALANCE

### THE CANADA HEALTH AND SOCIAL TRANSFER

The effect of the cap on CAP was to create a two-tier system whereby seven provinces continued to benefit from cost-sharing arrangements for social assistance while for the three others CAP became more a block-funding arrangement. In its 1995 budget, Ottawa declared that the time had come "to complete the gradual evolution away from cost-sharing to block funding of programs in areas of provincial responsibility."<sup>12</sup> The announcement that EPF and CAP were to be combined and replaced by a single block fund meant the end of the last major federal-provincial matching grant program. The new transfer arrangements were to significantly alter both the scale and the distribution of federal resources across provinces and, in our view, have dramatically changed the federal government's role in the social union.

First introduced as the Canada Social Transfer (CST), the new transfer was presented as advantageous for all parties involved. At the time, it was argued that compared with current arrangements, the new CST would "end the

intrusiveness of cost-sharing under CAP.<sup>13</sup> as well as reduce federal-provincial entanglement and other long-term irritants. As stated in the 1995 budget plan<sup>14</sup>

- Provinces will no longer be subject to rules stipulating which expenditures are eligible for cost-sharing or not.
- Provinces will be free to pursue their own innovative approaches to social security reform.
- Federal expenditures will no longer be driven by provincial decisions on how, and to whom, to provide social assistance and social services.

However, greater flexibility was to come at a price for the provinces, since the introduction of the new CST was to be accompanied by significant cuts in federal transfers over the next few years. Moreover, the new transfer was to retain the tax points/cash transfer characteristics of EPF and therefore some of its "irritants." Details of the new transfer were laid out as follows:

The provinces will receive \$29.7 billion in transfers under the existing programs for 1995-96, about the same as in 1994-95, to allow for a period of stability before change. Under the CST, funding will be reduced from what it would otherwise have been in 1996-97 by \$2.5 billion to \$26.9 billion. It will be further reduced from what it would otherwise have been in 1997-98 by \$4.5 billion to \$25.1 billion. While the reductions in major transfers are significant (4.4 percent), they are less than cuts to other federal government program spending.<sup>15</sup>

This immediately opened up the old debate over the value of the tax points as a transfer. Since the "cuts" by definition were to come from cash, the magnitude of these relative to the CST cash component was, in fact, much greater (on the order of 33 percent). In addition, it was proposed that the CST, in its first year, be allocated across provinces in accordance with 1995-96 provincial shares in total entitlements under EPF and CAP. Thus, the initial allocation formula carried forward the discrimination against the three "have" provinces resulting from the cap on CAP. Further, provinces were to remain subject to the general provisions of the *Canada Health Act* and the absence of residency requirements for welfare. The federal government's determination to maintain its role in health care was also reflected in its decision to quickly rename the new transfer the Canada Health and Social Transfer.

The 1996 budget introduced further measures to deal with three unresolved issues related to the new transfer arrangements: (i) preventing the erosion of the cash transfer; (ii) defining a permanent allocation formula; and (iii) providing revenue predictability for the provinces.

One of the problems with combining cash and tax points into a single block fund under the CHST was the risk that without real growth in entitlements, the cash component (and, therefore, federal leverage) would be subject to erosion over time, much as had previously been the case with EPF. To ensure that

the cash transfers remained a significant component of CHST, it was announced in the 1996 budget that an \$11 billion cash floor would be legislated to provide "an iron-clad guarantee that cash can never fall below \$11 billion throughout the five-year arrangement."<sup>16</sup>

The 1996 budget also dealt with the outstanding issue of a permanent provincial allocation formula for the CHST by providing for a gradual shift toward equal per capita distribution: "Over the five-year arrangement beginning in 1998-99, each province's allocation will be further adjusted to more closely reflect its share of Canada's population. By 2002-03, current disparities in per-capita entitlements among provinces will be reduced by half."<sup>17</sup>

There are two important points to make regarding this allocation policy. First, the so-called disparities in provincial per-capita entitlements stemmed directly from the federal government's decision to roll previous transfer arrangements (EPF and CAP) into one block fund and to adopt the 1995-96 distribution of transfers by province as the benchmark for future allocation. Since previous EPF entitlements were already on an equal per-capita basis, this meant that the "provincial disparities" in per-capita CHST entitlements that did exist were a direct reflection of per-capita differences in 1995-96 CAP payments to the provinces. The disparities were thus both a function of each province's welfare caseload and level of benefits for that particular year and the cumulative effects of the cap on CAP since 1990. The second point is that in the process of moving from the 1995-96 benchmark to a semi-equal per-capita allocation, the CHST would remain a transfer that is neither fish nor fowl since it would be unrelated to expenditure needs, or population shares, or economic circumstances, or fiscal capacities. This formula would prove to be unsustainable and a source of growing acrimony on the part of the three "have" provinces.

The third element emphasized in the 1996 federal budget was that of revenue predictability. In laying out the parameters of a five-year arrangement for the CHST, Ottawa wanted to provide advance notice to the provinces to allow them to prepare for the severe reductions in federal transfers in store for them. As originally planned, there were to be significant cutbacks in total entitlements in 1996-97 and 1997-98, followed by a two-year freeze and then modest growth based on a three-year moving average of the rate of growth of GDP (lagged one year) minus 2 percent in 2000-01, minus 1.5 percent in 2001-02, and minus 1 percent in 2002-03. Total cash entitlements, as projected in the 1996 budget documents, are listed in the following schedule (Table 1).

Thus, for 1996-97 the cut in cash transfers amounted to just under \$3.5 billion; for 1997-98 it was just over \$2.5 billion.

The severity of the cuts was mitigated by the federal government's decision in 1998 to raise the CHST cash floor to \$12.5 billion. Indeed, the 1998 budget marked a turning point for the federal government which, having

**Table 1: Entitlements under EPF/CAP and CHST  
(in millions of dollars), 1996 Estimates**

<i>Year</i>	<i>System</i>	<i>Total Entitlements</i>	<i>Cash Component</i>
1995-96	EPF+CAP	29,735	18,538
1996-97	CHST	26,900	15,047
1997-98		25,100	12,489
1998-99		25,100	11,826
1999-00		25,100	11,129
2000-01		25,702	11,111
2001-02		26,512	11,180
2002-03		27,426	11,303

Note: Cash amounts include the value of the special Quebec tax abatements and reflect 1996 projections on the value of tax points.

Source: CHST Technical Backgrounder, Federal-Provincial Relations Division, Finance Canada, 1996.

reached its zero-deficit objective much sooner than anticipated, also announced future funding for the National Child Benefit and its plans for the Canada Millennium Scholarships.

#### THE HEALTH-CARE BUDGET

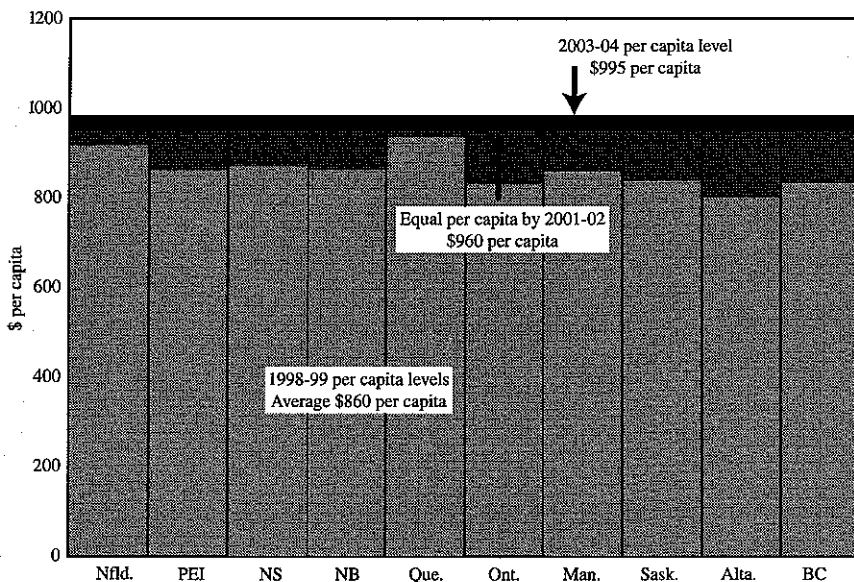
The most significant aspect of the first post-deficit federal budget in 1999 was its primary focus on health care. In the midst of federal-provincial negotiations on the social union and growing public pressure to resolve what was perceived as a crisis in the national health-care system, there had been much pre-budget speculation as to how Ottawa would re-inject funding into health care and ensure it received due credit for it. Grand schemes featuring new national programs for home-care or Pharmacare were among the rumoured possibilities. Only two weeks after the signing of *A Framework to Improve the Social Union for Canadians*, the federal budget announced with great fanfare that the provinces would receive an additional \$11.5 billion in transfer payments over the next five years "specifically for health care."

The 1999 budget provided for an increase in CHST cash of \$2 billion — thus raising the total cash transfer to \$14.5 billion in each of 1999-2000 and 2000-01, and a further increase of \$0.5 billion in 2001-02, thus raising the total cash transfer to \$15 billion in each of 2001-02, 2002-03 and 2003-04.<sup>18</sup> These funds are to be earmarked for health care — a commitment the provinces

have formally agreed to — and are to be divided on an equal per-capita basis across the provinces. The other significant element of the 1999 budget was the announcement that measures initiated in 1996 to reduce per-capita disparities in CHST entitlements by half by 2002-03 would be stepped up significantly in order to completely eliminate such disparities by 2001-02, at which point all provinces and territories will receive equal per-capita entitlements — cash plus the value of the associated tax points. As Figure 3 illustrates, this will be a particularly difficult transition for Quebec and Newfoundland. These two provinces, which currently have the highest ratios of welfare beneficiaries to population in the country, had benefited significantly from the previous cost-sharing arrangements under CAP, especially relative to Ontario — the province most affected by the cap on CAP.

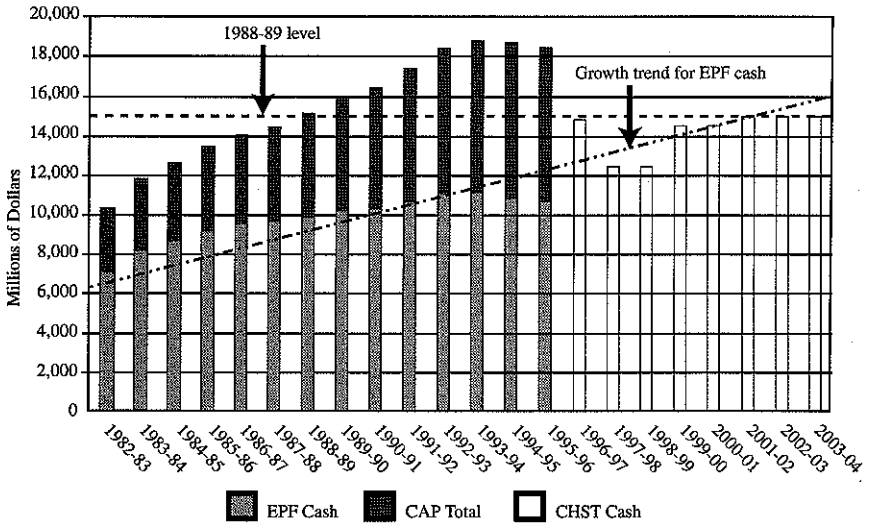
Figure 4 depicts the evolution of cash transfers since 1982 and includes the projected increases announced in the 1999 budget. According to the budget papers, the \$2.5 billion increase in CHST cash from \$12.5 to \$15 billion in 2001 brings “*what is regarded as the health component of the CHST* [our italics] as high as it was before the period of expenditure restraint of the mid-1990s.”<sup>19</sup> While this may be the case (see Table 2 below), it is also true that

**Figure 3: Changes in Provincial CHST Entitlements Per Capita**



Source: Adapted from Department of Finance, *Budget 1999, Federal Financial Support for the Provinces and Territories* (Ottawa: Department of Finance, February 1999), p.16.

**Figure 4: Cash Transfers to the Provinces under EPF, CAP and CHST (millions of dollars), 1982-2004**



Source: Compiled from data provided by the Federal-Provincial Fiscal Relations Division, Finance Canada and figures contained in the 1999 federal budget documents.

the overall federal cash contribution to social programs under the CHST at that point will be no higher than it was in 1988-89, in nominal terms (see Figure 4).

As has traditionally been the case, however, the emphasis in the budget documents is on the growth in entitlements (cash plus tax): "Together with the value of CHST tax transfers ... federal support is expected to grow to \$31.4 billion in 2003-04. A new high for the CHST will be reached by 2001-02 — surpassing where transfers stood prior to the expenditure restraint of the mid-1990s."<sup>20</sup> To that effect, the federal government reiterates its claim to the value of the EPF tax points as a *bona fide* federal transfer to the provinces in support of health and postsecondary education programs:

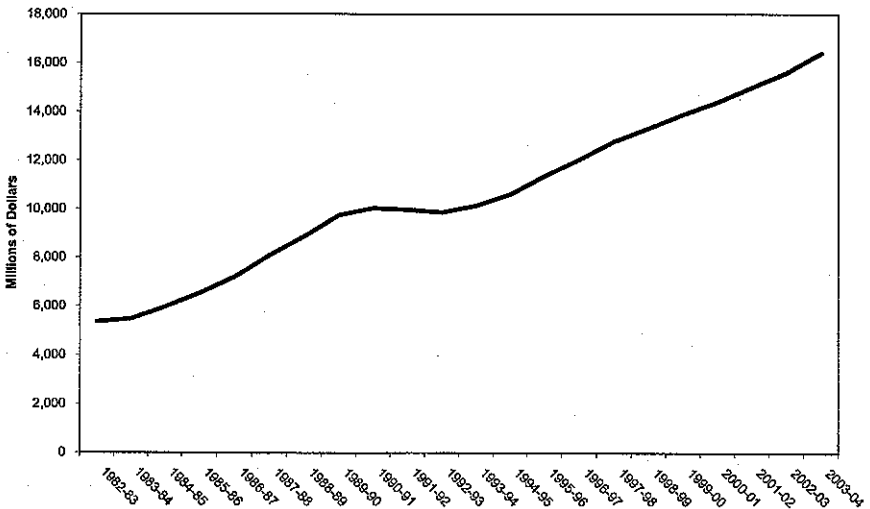
While the mechanism for delivering federal support differs under cash and tax transfers, both have exactly the same impact on federal and provincial finances. They represent foregone [sic] revenue to the federal government and increased revenue to provincial and territorial governments.<sup>21</sup>

Our analysis of the fiscal impact of changes in these funding arrangements over time suggests a very different interpretation. The transfer of tax room

that occurred under EPF in 1977 meant that in the first few years under the new regime the provinces would be funding directly (i.e., through their own revenues) approximately 75 percent of the costs of health care and PSE, as opposed to 50 percent under previous cost-sharing arrangements. The EPF tax points did represent forgone federal revenues, but this was accompanied by a corresponding reduction in federal transfers to the provinces on the expenditure side of the ledger. Moreover, under block-funding not only would the remaining federal cash contribution no longer increase in line with program costs, it would also significantly erode in real terms over time due to federal constraints on growth in entitlements under EPF and substantial cuts under the CHST. As a result, the provinces' share of funding for these programs has continued to increase in subsequent years.

Nor does the federal government's argument about tax and cash transfers having the same impact on provincial finances stand up to scrutiny when viewed over time. As shown in Figure 5, the value of the EPF tax points will have roughly tripled between 1982-83 and 2003-04. The evolution of cash transfers as we have seen (Figure 4) has been quite different,<sup>22</sup> and there are no indications that this is about to change.

**Figure 5: Value of EPF Tax Points (millions of dollars), 1982-2004**

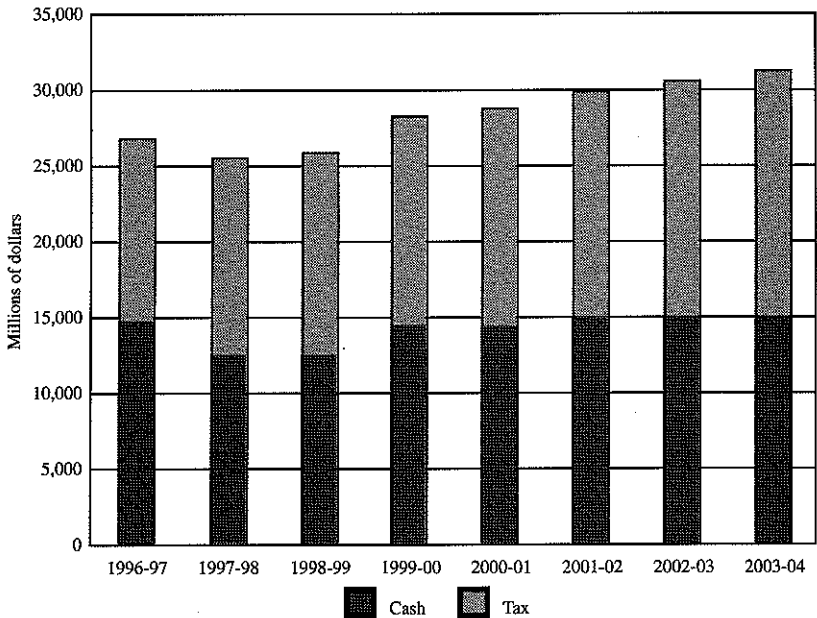


Source: Data provided by the Federal-Provincial Fiscal Relations Division, Finance Canada.



Figure 6 illustrates the growth in the combined value of the CHST cash transfer and the value of the EPF tax points for each year since its inception through 2003-04. The \$2 billion increase in CHST cash in 1999-2000 is followed by a one-year freeze; the \$0.5 billion increase in 2001-02 is followed by a two-year freeze. To the extent that there is growth, as argued in the 1999 budget, it is in the value of the tax points. As was pointed out earlier, for the provinces this does not constitute growth in transfers; rather it represents growth in their own-source revenues.

**Figure 6: CHST Cash and the Value of Tax Points Combined (millions of dollars), 1996-2004**



Source: Data provided by the Federal-Provincial Fiscal Relations Division, Finance Canada.

## AN ASSESSMENT OF THE CHST AS AN INSTRUMENT OF SOCIAL POLICY

The most generous interpretation of the CHST is that it is the vehicle for maintaining a federal presence in funding provincial programs in health care, postsecondary education, and welfare, albeit at much lower levels. A less

generous interpretation is that in the first year of cuts and transition to the CHST (1996-97), the \$3.6 billion reduction in cash transfers (see Table 2) more than eliminated "what had been regarded as" the PSE component of EPF (estimated at \$3.4 billion in 1995-96). As will be discussed further below, this would have been consistent with the directions proposed for PSE in the Axworthy Green Paper. The 1997-98 cuts (a further \$2.4 billion) are then seen as cuts to health and welfare transfers.

From Figure 4 we observe that had EPF cash continued to grow on trend, the level of transfer would have been roughly equivalent to the entire cash transfer under the CHST by the year 2001-02 (see dashed trend line in Figure 4). Viewed from this perspective, it might be argued that the CHST does not embody any federal contribution toward provincial welfare expenditures.

As an alternative scenario, consider the implications for the growth of EPF if, instead of the combined tax point/cash transfer put in place in 1977, there had only been a tax point transfer to the provinces of equivalent value (inclusive of associated equalization). This would have doubled the number of tax points allocated to the provinces and would have generated roughly \$30 billion in EPF revenues by the year 2001-02 (see Figure 5) — the same amount as total (cash plus tax) CHST entitlements projected for that year. Interestingly, a similar point is made in the 1999 budget documents where it is stated that: "[t]oday, as in 1977, approximately half the CHST is in the form of cash, while the other half is in the form of tax transfers."<sup>23</sup> Unfortunately for the federal government's case, this would also suggest that CAP somehow vanished along the way. Viewed this way too, the CHST fails to embody any federal contribution toward provincial welfare expenditures.

The point of this discussion is that while Ottawa still views the role of the CHST as providing "specific support to all provinces and territories for health care, PSE and social assistance and social services [to] help ensure these important programs are adequately funded,"<sup>24</sup> the fact remains that it has withdrawn significantly from the financing of these programs in recent years. The federal government's overall contribution now represents less than 15 percent of provincial expenditures in these areas. Even with the cash infusions announced in the 1999 budget, federal contributions will not rise above 1988-89 levels in nominal terms.

To illustrate the trends in federal funding for each of these three *policy* areas, Table 2 divides federal cash transfers into nominal education, health, and welfare components, respectively. As mentioned previously, this follows the practice by the federal government, since the inception of EPF in 1977, of tracking notional specific-purpose transfers, based on 1975-76 shares of 67.9 percent for health and 32.1 percent for PSE in the case of EPF. For the CHST, this nominal allocation is based on 1995-96 shares of EPF cash (57.6 percent) and CAP (42.4 percent) in the total cash transfer. Accordingly, we infer the PSE share of CHST to be 18.5 percent and the health share 39.1 percent.

Table 2: Notional Federal Cash Transfers for PSE, Health and Social Assistance (millions of dollars), 1982-2004

	Total EPF and CAP	Total EPF	EPF PSE	EPF Health	CAP Social Assistance	Total CHST	CHST PSE	CHST Health	CHST Health Supplement	CHST Social Assistance
1982-83	10,240	7,018	2,253	4,765	3,223					
1983-84	11,738	8,069	2,590	5,479	3,669					
1984-85	12,534	8,574	2,752	5,822	3,960					
1985-86	13,395	9,117	2,927	6,190	4,278					
1986-87	13,973	9,468	3,039	6,429	4,505					
1987-88	14,387	9,531	3,059	6,471	4,857					
1988-89	15,061	9,759	3,133	6,626	5,301					
1989-90	15,837	10,093	3,240	6,853	5,744					
1990-91	16,328	10,120	3,248	6,871	6,208					
1991-92	17,345	10,589	3,399	7,190	6,755					
1992-93	18,326	11,003	3,532	7,471	7,323					
1993-94	18,736	11,024	3,539	7,485	7,712					
1994-95	18,642	10,794	3,465	7,329	7,848					
1995-96	18,391	10,601	3,403	7,198	7,790					
1996-97						14,786	2,736	5,787		6,263
1997-98						12,444	2,302	4,870		5,271
1998-99						12,447	2,303	4,871		5,272
1999-00						14,500	2,313	4,892	2,000	5,295
2000-01						14,500	2,313	4,892	2,000	5,295
2001-02						15,000	2,313	4,892	2,500	5,295
2002-03						15,000	2,313	4,892	2,500	5,295
2003-04						15,000	2,313	4,892	2,500	5,295

Source: Authors' calculations.

Finally, for 1999-00 through 2003-04, the nominal "health transfer" is augmented by the "health supplements" announced in the 1999 budget. As noted in the budget documents, with the addition of the health supplements, transfers for health have been returned to mid-1990s levels. The table also suggests, however, that transfers for PSE and welfare remain well below these levels.

The supplementary funding arrangements for health care under the CHST, announced in the 1999 budget, would seem to signal a shift toward earmarked, conditional health grants. The budget documents emphasize that the increased CHST cash is "designated specifically for health care" and refer to the premiers giving their consent to that effect at the 4 February meeting of the first ministers. It is also stated that the provinces have agreed to renew their commitment to the five principles of medicare and to make information available about the health-care system as part of the Framework Agreement on the social union signed on that date. Earmarking increases in transfer payments for health care certainly flies in the face of the increased flexibility and reduced entanglement attributes originally associated with the move to block-funding under the CHST.

The federal government's insistence that the health-care supplement be allocated to provinces and territories on an equal per-capita basis is revealing as well. Although the provinces had been adamant that new federal funding should be channelled through existing transfer arrangements, the end result is that a whole new set of fiscal arrangements designated for health care has been superimposed on the old block-grant structure. As a result, the latter is now for all intents and purposes little more than a mechanism for distributing federal revenues across provincial governments to address the problem of vertical fiscal imbalance. In terms of maintaining the integrity of the social union, the one advantage this mechanism has over a simple transfer of tax room is the implicit super-equalization element carried over from EPF.

Finally, the linking of new funding for health care in the federal budget to commitments made by the provinces in the context of the Social Union Framework Agreement is also somewhat surprising, given Ottawa's commitment in the same document to "consult with provincial and territorial governments *at least a year prior* [our italics] to renewal or significant funding changes in existing social transfers" The immediate change to a three-year fast track toward equal per-capita CHST entitlements announced in the budget would certainly seem to qualify as a significant funding change, particularly for some provinces (see Figure 3). This move raises questions about the federal government's commitment to funding predictability either through the five-year arrangements announced in previous federal budgets or the new provision to that effect in the Social Union Framework Agreement.

## THE STATE OF THE SOCIAL UNION

Our analysis has shown that changes to fiscal arrangements in the 1990s have fundamentally altered the scale, the function, and the allocation of federal social transfers to the provinces. These changes have occurred in the context of other reforms to social programs, which on the whole have had major consequences for the federal government's role in the social union. Most of these reforms can be traced back to the Axworthy Green Paper which, in hindsight, did set the stage for a major restructuring of social policy in Canada. The proposals with regard to PSE funding and social assistance are particularly relevant, as are the repercussions of the UI reforms that followed the release of this blueprint document.

### POSTSECONDARY EDUCATION

On the topic of PSE funding policy, the Green Paper had acknowledged the precipitous decline in the EPF(PSE) cash transfer and proposed that the remaining cash be diverted from transfers to provinces and replaced by a system of expanded student loans and restructured grants to individuals. It was anticipated that the provinces would respond by passing on transfer cuts to PSE through corresponding reductions in grants to PSE institutions. It was further expected that institutions would adjust to these reductions by increasing tuition fees.

The Canada Millennium Scholarship Fund established in 1998 can be seen as consistent with the earlier proposals found in the Green Paper. The \$2.5 billion endowment, which will be managed by an arm's-length foundation, will award postsecondary education scholarships, based primarily on financial need, over a ten-year period beginning in the year 2000.

The federal government's decision to introduce the Millennium Scholarships in 1998 following years of reductions in PSE transfers to the provinces has placed them in a position where they can either accept this program's underlying premise — that increases in tuition are appropriate, since students should bear a greater portion of the cost of their education — or reduce their own programs of student loans and bursaries by a corresponding amount and use the funds to increase university grants. Moreover, the annual funding to be derived from the \$2.5 billion endowment (\$300 million per year over a ten-year period) is relatively small compared to previous reductions (an estimated \$1.2 billion since 1994) in fiscal transfers designated to PSE. The western premiers have recently called for full restoration of funding for PSE through the CHST.

The Millennium Scholarships were also introduced without prior consultation with the provinces, which again seems contrary to the spirit of the recent social union agreement calling for "advance notice being given *prior* [our

italics] to implementing a major change in a social policy or program which will substantially affect another government"<sup>25</sup> and consultation with the provinces to identify potential duplication.

#### SOCIAL ASSISTANCE

On social assistance funding, the Green Paper emphasized the deficiencies and restrictions associated with CAP, especially the cost-sharing conditions that created a disincentive to innovations in program delivery, as well as the problems arising from the cap on CAP. A number of options were reviewed, including integrating income-support programs under a Guaranteed Annual Income scheme, replacing CAP with either conditional or non-conditional block-funding, and redirecting federal spending under CAP and the Child Tax Benefit<sup>26</sup> toward priority areas such as improving income support for low-income families with children.

The National Child Benefit (NCB), which came into effect in July 1998, is described as a new joint initiative of Canada's federal, provincial, and territorial governments to help children in low-income families, promote attachment to the labour market, and reduce government overlap and duplication. Effective July 1998, the federal government combined two existing programs — the former Child Tax Benefit and the Working Income Supplement — into one benefit, the Canada Child Tax Benefit (CCTB) available to families with incomes of up to \$66,721 and added a new monthly benefit for low-income families (with revenues of less than \$25,921 in the case of a two-child family), called the NCB Supplement.

The federal government had committed \$850 million in new funding for the NCB by July 1998 and announced further increases of \$425 million in July 1999 and an additional \$425 million in July 2000. A key point is that the NCB Supplement is paid regardless of the family's source of income. While low-income working families keep the entire supplement to the CCTB, provinces and territories may reduce social assistance benefits by the same amount as the NCB supplement such that families on social assistance continue to receive at least the same federal and provincial/territorial basic income support as before. As part of the NCB initiative, provinces are to reinvest the social assistance savings in programs and services benefiting children in low-income families. The objective of the program is to remove barriers to moving from social assistance to employment by providing children's benefits outside the social assistance system.

According to *The National Child Benefit Progress Report*<sup>27</sup> released in the spring of 1999, provinces had reinvested about \$225 million from adjustments to social assistance funding during 1998-99 (or an estimated \$303 million per year on a full-year basis). New Brunswick and Newfoundland chose to maintain social assistance payments and invested an additional \$9.9 million, an

amount equivalent to what would otherwise have been available for reinvestment. The report indicates that provinces/territories have opted to provide new or enhanced support for low-income families primarily through additional child benefits and earned income supplements (31 percent of funding) and child/day-care services (39 percent). Some have also invested in early childhood services, children-at-risk services, and supplementary health benefits.

The NCB initiative is commonly cited as a prime example of cooperative federalism adapted to today's needs. The program is based on the concerted action of the two levels of government to address the problems of child poverty and the welfare trap. The overall policy results have been greatly enhanced by having each level of government play its appropriate role: in the case of the federal government that of income redistribution at a national level and for the provinces that of designing and providing programs and services that reflect local needs and priorities. To the extent that it reduces provincial expenditures on social assistance, it could be said that the NCB acts as a substitute for cost-sharing transfers under the former CAP. However, even with projected funding increases, the figures released in the progress report clearly indicate that the NCB by no means replaces previous federal contributions to social assistance programs under CAP.

#### THE WELFARE IMPACT OF UI REFORMS

There is an additional dimension to the move by the federal government to cut the cost-sharing link to provincial social assistance expenditures. As was mentioned earlier, there has been a significant increase in social assistance rates (SAR) in Canada in the past few decades as the long-term unemployed have come to represent the bulk of the caseload. With every recession the national SAR has experienced a dramatic hike and only recovered marginally in subsequent periods of recovery. At present, over 9 percent of the Canadian population is on welfare rolls, compared with 5 percent in the 1970s and 7 percent in the 1980s. With the SAR increasingly a function of economic cycles, the move to block-funding under the CHST has helped insulate the federal government from the fiscal effects of future recessions while making the provinces correspondingly more vulnerable in that regard. This situation has been further exacerbated by the cumulative changes brought to the Unemployment Insurance Program (UI) in the 1990s.

Following the release of the 1994 Green Paper, the federal government implemented a series of UI reforms whose overall effect was to tighten the eligibility requirements and the benefits available under the renamed Employment Insurance Program. The impact of these reforms has been significant. Whereas 75-80 percent of unemployed Canadians were UI beneficiaries in

the 1980s, less than 40 percent qualified by 1997. In a recent study of the determinants of social assistance rates in Canada between 1977 and 1996, Arnau, Crémieux and Fortin estimate that cumulative changes to UI eligibility in the 1990s (including the 1990, 1994, and 1996 amendments) have resulted in more than a 20-percent increase in the population on provincial social assistance.<sup>28</sup> According to the authors' estimates, the resulting SAR increase translates into an additional \$2.5 billion in welfare expenditures for the provinces on an annual basis. While these estimates do not fully take into account the counteracting effects of administrative changes<sup>29</sup> to provincial social assistance programs implemented since the mid-1990s, they do provide a sense of the magnitudes involved. Given federal spending reductions of \$6 billion annually on UI and an estimated additional \$2.5 billion reduction in federal transfers designated to social assistance since 1995-96, the extent of federal fiscal offloading to the provinces has been quite dramatic.

#### THE FUTURE OF FISCAL FEDERALISM

Beyond its immediate budgetary impact, the combination of UI reforms and changes in fiscal transfer arrangements has long-term consequences for the provinces which will not only bear the full cost of increases in their welfare caseload, but will also have to deal on their own with the problems associated with the long-term unemployed. This represents the most significant shift in federal-provincial expenditure responsibilities in decades. Yet this issue failed to be addressed in the context of the Social Union Framework Agreement even though it is at the very heart of the matter. It was also completely ignored in the set of fiscal arrangements laid out for the next five years. As we pointed out earlier, the new federal funding is strictly for health care, otherwise the growth in CHST entitlements stems only from the increase in the value of EPF tax points. As for the move to an allocation formula on an equal per-capita basis, it has been presented as necessary to redress the long-standing inequities created by the cap on CAP for the "have" provinces. In its imminent manifestation as an equal per-capita grant, the CHST does away with the arbitrary nature of a distribution tied to the cap on CAP and differences in welfare "need" as they existed in 1995-96. Yet, by its very nature, an equal per-capita distribution fails to reflect differences in welfare "need" as they exist in 1999-2000 and beyond. One would be hard-pressed to find the rationale for funding social assistance on such a basis.

In a recent paper, Coulombe observes that with a SAR of 3.2 percent in Alberta and 12.8 percent in Newfoundland in 1997 (see Figure 2), the amount of federal subsidy received under the new CHST formula by the social assistance beneficiary in Alberta will be four times that received by the beneficiary



in Newfoundland.<sup>30</sup> The author also questions the merit of funding health care and PSE on an equal per-capita basis without regard to expenditure need when significant regional differences in demographics, urbanization, and other factors are bound to play an increasing role in the costs of provision of these services. He argues that the new funding formula signals the abandonment by the federal government of its primary role in the federation, which is to ensure that provinces are in a position to provide comparable levels of services at comparable levels of taxation and rejects the idea that equalization alone can fulfil that role.

The National Council of Welfare has also been strong in its condemnation of the CHST:

The Canada Health and Social Transfer was the culmination of a series of social policy blunders made by the federal Finance Department in recent years. Subsequent announcements by the federal government have softened its original financial impact, but the transfer is still bad social policy and should be replaced entirely.<sup>31</sup>

In the same report, the Council has advocated a new package of financial arrangements for social programs, specifically: (i) the abolition of the CHST, to be replaced by four new "cash-only" deals in support of medicare, postsecondary education, welfare, and social services; (ii) legislation to prevent "arbitrary and unilateral" changes in these programs; and (iii) guarantees that provincial governments will respect minimum national standards for welfare.

One of the Council's concerns about the CHST as a single block fund had been that "provincial or territorial governments could theoretically use all the federal money for medicare and none for the other three areas." Yet another reason for separating funds advanced by the Council is related to setting appropriate escalators. The fund for medicare, for example, might be escalated according to economic growth or inflation. Welfare, on the other hand, would be better suited to an escalator such as one linked to unemployment by province which would ensure changes in the level of federal support in times of recession.<sup>32</sup>

When the CHST was introduced in 1995, we argued for a decoupling of health and welfare components of the transfer.<sup>33</sup> The issue in health-care funding having become, in our view, one of revenue-sharing between the two levels of government and maintaining a federal presence, we proposed that the federal government cede the remaining value of the EPF cash transfer to the provinces as a tax abatement. Thus, a given percentage of federal income tax revenues (the Canada Health Tax Abatement) would be earmarked for provincial health-care programs and allocated to the provinces in the same fashion as the "cash" component under EPF; the difference being that its value would

grow in step with growth in the value of the income tax base. This would have provided a way to effect fiscal disentanglement, while maintaining a federal role in preventing increases in fiscal disparity across provinces.

With regard to social assistance, the Hobson-St-Hilaire proposal was for a block grant that is equalized for differences in need across provinces. The total federal commitment (the Canada Social Transfer) would be based on a fixed percentage of *standardized* provincial social assistance spending across all provinces with a built-in system of differential cost-sharing whereby those provinces with above (below) average "need" would receive greater (less) than average cost-sharing. The equalization factor would therefore take into account differences in economic circumstances across provinces, including the "have" provinces when their need for social assistance is above the national average.

However, as this chapter has shown, there has been a lot of water under the bridge (all the king's horses and all the king's men) with regard to the fiscal arrangements since 1995. Our reading of the 1999 budget is that the federal government believes that it has brought closure to the whole debate concerning its role in funding social programs nationally. The cuts in transfer payments to the provinces have come to an end; more federal money has been injected directly into health care while reaffirming Ottawa's role in this area; and the transition to equal per-capita funding is almost complete, thus stemming the tide of discontent among the "have" provinces. In many ways, one gets a sense of "case closed" from the perspective of the federal government.

More importantly, the events of the last few years suggest that a "virage"<sup>34</sup> has taken place and that fiscal federalism has *de facto* become more of an instrument of last resort for the federal government in its efforts to maintain a federal presence in the area of social policy. With budgetary surpluses now a reality, the federal government seems little inclined to either restore non-health-related social transfers to the provinces or reduce the tax room it occupies to reflect a diminished federal role in these areas. Rather, it seems more intent on developing new and highly visible federal initiatives in the areas of health, education, and child poverty. The Canadian Innovation Fund, the Millennium Scholarships, and the National Child Benefit initiatives and the measures related to health care and research in the last federal budget all signal a new approach to federalism. While gaining federal visibility is clearly at issue, there may also be benefits if the result is greater transparency and accountability to the public in terms of who is responsible for what programs. However, this new way of doing things will require even more consultation and cooperation between the levels of government to avoid conflict, overlap, and duplication. This is why there will be so much at stake as events unfold and the Framework Agreement on the social union gets put to the test.

## CONCLUSION: FISCAL ARRANGEMENTS FOR A NEW SOCIAL UNION

The federal government's decision not to discuss the issue of adequate funding of core social programs in the context of the social union negotiations — except as a last-minute deal breaker — is unfortunate, as this represented a unique opportunity for both orders of government to consider the fiscal parameters required to lay the groundwork for a new social union framework. Instead, these issues were dealt with in the usual fashion (unilaterally and with little consultation) as part of the annual federal budget process.

The 1999 budget restated the role of the CHST as providing support for health care, postsecondary education, and social assistance and social services to "help ensure these important programs are adequately funded." After nearly a decade of freezes and cutbacks in federal transfers, the announcement of an \$11.5 billion cash infusion for health care through 2003-04 was undoubtedly received with great relief in provincial capitals. In the budget documents much was made of the fact that by 2003-04, "what is regarded as the health component of the CHST [will be] as high as it was before the period of expenditure restraint in the mid-1990s." If this point of view is accepted, then "what is regarded" as the postsecondary education and welfare components of the CHST remain well below what they were prior to the period of expenditure restraint in the mid-1990s. Moreover, it is not clear how an earmarked, conditional health grant fits into the CHST's original scheme as a general-purpose block fund for social programs that was meant to give provinces greater flexibility in program design and delivery and enable them to allocate funds according to their own priorities.

Should we then also expect to see distinct block grants for PSE and welfare in coming years? We have argued that the rationale and the main options for reforming federal funding for PSE and social assistance were clearly outlined in the Axeworthy Green Paper. In PSE, it may well be that the federal government wishes to shift away from fiscal transfers to the provinces to some form of voucher system directed at students and more direct funding for research in general. As for social assistance, new federal funding is being allocated to the NCB with the objective of removing children from the welfare caseload and toward some form of guaranteed annual income for low-income families. The new, earmarked, and conditional health-care supplement has been artificially superimposed on the CHST structure because it was the most straightforward way to inject additional federal funding directly into the system. But at the same time, the federal government is still considering new funding scenarios for home care and community-based services. Finally, what remains of the CHST is unrelated to expenditure need, policy objectives or economic circumstances. Rather than an instrument of social policy, the CHST is little

more than a mechanism for redistributing federal revenues across provincial governments. Thus, it is no longer a question of putting Humpty together again.

It is our view that the 1999 budget does not bring closure to the debate surrounding the CHST. In many ways, the last decade has been one of transition from the old social union framework, which was put in place in the postwar period and founded on a cost-sharing partnership between the levels of government in the areas of health, PSE, and welfare to a new social union framework which involves less fiscal entanglement and potentially more efficiency and transparency. But this is still a work in progress. The transition is not complete and one of the main issues that needs to be addressed is the structural shift that has occurred in federal-provincial expenditure responsibilities for core social programs.

In the early 1990s, a number of studies, including one by the Economic Council of Canada, showed that Canada was facing a situation of increasing fiscal imbalances, with the federal government's revenue growth potential well in excess of its projected spending, mainly due to its dominance of the fastest-growing revenue sources. For their part, the provinces faced the opposite scenario, essentially because of cost pressures related to social programs.<sup>35</sup> Since then, UI reforms and changes in fiscal transfer arrangements have clearly worsened the imbalance. For instance, under current block-funding arrangements, the health-care cost implications of an aging population will be for the provinces to bear. This is where proposals such as ours for a move to a tax abatement, or that by Bird and Mintz in this volume for a transfer of tax room to the provinces, could play an important role in providing the provinces access to a growing source of revenue to ensure adequate funding without increasing fiscal disparities.<sup>36</sup>

This would still leave one important issue unresolved, however, which is the need to address the implications of the end of cost-sharing of social assistance and recent EI reforms. The future cohesiveness and resilience of Canada's social union will hinge on the risk-sharing mechanisms in place in our federal system to absorb the fiscal impact of future recessions and provide adequate support for regions with higher than average poverty and unemployment. And this is where "fair-shares" federalism falls well short of the mark.

## NOTES

1. See, for example, Thomas Courchene, "Fair-Shares Federalism and the 1999 Budget," *Policy Options* (April 1999):39-46.
2. Human Resources Development Canada, "Improving Social Security in Canada: A Discussion Paper," (the Axworthy Green Paper) (Ottawa: Supply and Services Canada, 1994).

3. See, for example, Paul Boothe and Derek Hermanutz, *Simply Sharing: An Inter-provincial Equalization Scheme for Canada*, C.D. Howe Institute Commentary No. 128 (Toronto: C.D. Howe Institute, 1999).
4. The discussion in this and subsequent sections on the evolution of federal-provincial fiscal relations draws heavily on Paul A.R. Hobson and France St-Hilaire, *Reforming Federal-Provincial Fiscal Arrangements: Toward Sustainable Federalism* (Montreal: Institute for Research on Public Policy, 1993).
5. This further devolution of tax room placed all provinces on a roughly equal footing with Quebec, which had secured additional tax room for itself under earlier provisions for opting-out of shared-cost programs. In addition, a portion of the PSE transfer had been in the form of a tax transfer.
6. Quebec's cash transfer is reduced by the value of additional tax points granted to Quebec in lieu of cash transfer — the Quebec EPF abatement as it is labelled in the chart.
7. The Quebec special abatements, gained under earlier opting-out provisions, are treated as cash transfers for purposes of this discussion. It should be noted that these special abatements are not eligible for Equalization.
8. Stephan Dupré referred to this as being at the top of the list of the "Big Lies" of Canadian public finance. See *The Future of Fiscal Federalism* (Kingston: The Institute of Intergovernmental Relations, Queens University, 1995), p. 250.
9. Inferred from National Council of Welfare, *Profiles of Welfare: Myths and Realities* (Ottawa: Minister of Public Works and Government Services Canada, 1998), p. 15.
10. Inferred from National Council of Welfare, *Another Look at Welfare Reform* (Ottawa: Minister of Public Works and Government Services Canada, 1997), p. 2.
11. See Hobson and St-Hilaire, *Reforming Federal-Provincial Fiscal Arrangements*.
13. Department of Finance, *Budget Plan* (Ottawa: Department of Finance, 27 February 1995), p. 52.
13. *Ibid.*, p. 53.
14. *Ibid.*
15. *Ibid.*
16. Department of Finance, *Budget Plan* (Ottawa: Department of Finance, 6 March 1996), p. 57.
17. *Ibid.*, p. 59.
18. In fact, a "CHST Supplement" of \$3.5 billion was made available to the provinces effective 1999-00. This amount was accounted for in 1998-99 by the federal government through the establishment of a trust fund in the name of the provinces. It was "anticipated" that the provinces would draw down their shares "in a gradual and orderly manner" — \$2 billion in 1999-00, \$1 billion in 2000-01, and \$0.5 billion in 2001-02. In addition to these amounts, CHST cash was to be augmented by \$1 billion for the year 2000-01, \$2 billion for the year 2001-02,

and \$2.5 billion for each of 2002-03 and 2003-04, thus raising the notional cash transfer to \$14.5 billion in each of 1999-00 and 2000-01 and to \$15 billion in 2001-02. The actual transfer would be \$15 billion in each of 2002-03 and 2003-04. See Department of Finance, *Budget 1999, Federal Financial Support for the Provinces and Territories* (Ottawa: Department of Finance, February 1999), p.13.

19. Department of Finance, *The Budget Plan 1999* (Ottawa: Department of Finance, 1999), p. 83.
20. Department of Finance, *Budget 1999, Federal Financial Support*, p.13.
21. *Ibid.*, p.11.
22. It could even be argued that reductions in cash transfers to the provinces amount to the same thing as a reassignment of tax points from the provinces to the federal government. A reasonable estimate of the equalized value of one PIT point in 1997-98 is \$900 million. The reduction in cash transfers between 1995-96 and 1997-98 (in excess of \$6 billion) would, therefore, be roughly equivalent to the federal government grabbing PIT points.
23. *Budget 1999, Federal Financial Support*, p.11.
24. *Ibid.*, p. 9
25. *A Framework to Improve the Social Union for Canadians*, an agreement between the Government of Canada and the governments of the provinces and territories, 4 February 1999.
26. The Child Tax Benefit (CTB) was established in 1993 to replace the former family allowance program and the deduction for child dependants under the PIT.
27. National Child Benefit, *The National Child Benefit Progress Report, 1999* (Ottawa: Minister of Public Works and Government Services Canada, 1999).
28. Philippe Arnaud, Pierre-Yves Crémieux and Pierre Fortin, "The Determinants of Social Assistance Rates: Evidence from a Panel of Canadian Provinces, 1977-1996," unpublished paper, April 1998.
29. The model takes into account the effects of changes in provincial benefit rates for social assistance, but not those resulting from increased administrative stringencies which are of some importance in certain provinces (e.g., Alberta, Ontario, and British Columbia).
30. Serge Coulombe, "Le fédéralisme fiscal a-t-il un avenir avec une division par habitant du TCSPPS?" Présentation au XXIV<sup>e</sup> Congrès de l'Association des économistes québécois, Hull, le 14 mai 1999.
31. National Council on Welfare, *Another Look at Welfare Reform*.
32. *Ibid.*
33. Paul A.R. Hobson and France St-Hilaire, "The CHST in Two-Part Harmony," notes for a presentation at the IRPP Roundtable on the CHST, Montreal, 2 December 1995.
34. French term to describe a major change in direction.
35. Economic Council of Canada, *A Joint Venture: The Economics of Constitutional Options, Twenty-Eighth Annual Review* (Ottawa: Economic Council Of Canada,

- 1991), pp. 57-126. See also G.C. Ruggeri, D. Van Wart, G.K. Robertson and R. Howard, "Vertical Fiscal Imbalance and the Reallocation of Tax Fields in Canada," *Canadian Public Policy/Analyse de Politiques* 19, 2 (1993):194-215
36. Richard Bird and Jack Mintz, "Tax Assignment in Canada: A Modest Proposal," in this volume.

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# Federal-Provincial Small Transfer Programs in Canada, 1957-1998: Importance, Composition and Evaluation

*François Vaillancourt*

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*Ce chapitre porte sur les petits transferts fédéraux-provinciaux au Canada. Ceci mérite examen car ces transferts, définis comme tous les transferts sauf le TSC et la péréquation, représentent environ 20% des transferts fédéraux aux provinces. Nous nous penchons tout d'abord sur leur importance au Canada pour la période 1957-1998 et constatons un certain déclin. Nous examinons ensuite quels sont les programmes les plus importants au Canada (1977-1998) et par province (1997-1998). Nous constatons que les transferts dans les domaines du logement et de l'agriculture sont les plus importants au Canada mais que d'autres programmes tels ceux pour la pêche (Terre-Neuve) et les langues officielles (Nouveau-Brunswick) importent à une province en particulier. Nous concluons en évaluant sommairement quelques programmes.*

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## INTRODUCTION

The purpose of this chapter is to examine federal-provincial small transfer programs, that is, those other than Equalization and the Canadian Health and Social Transfer (CHST) (Established Programs Financing [EPF]/Canada Assistance Plan [CAP]) programs.<sup>1</sup> This is of interest as there has been little analysis of these programs in recent years, yet in the aggregate they have amounted to \$3 to 4 billion every year since 1987. Transfer programs in areas other than health, income support, and postsecondary education have long histories in Canada, starting with the 4H Club subsidies in 1900 and the railway grade crossing program in 1909. This chapter, however, is limited to an examination of the 1957-58 to 1997-98 period with the main focus on more recent years as more precise issues are addressed. The choice of the first year



reflects the introduction of both the Equalization and hospital insurance transfer programs in that year. The choice of the last year reflects the availability of data (Public Accounts) at the time of writing.

The chapter is divided into three parts. The first part presents evidence on the absolute and relative importance of small transfers, using both dollar amounts and percentages of various indicators for the 1957-98 period. The second examines the composition of small transfers for Canada as a whole for the 1977-98 period and by province for 1997-98. The third puts forward evaluation criteria and uses them to assess the ten most important programs in 1997-98. The time period covered is reduced as we move from the first to the third part of the chapter, reflecting in part the availability of data for the issues under discussion.

### IMPORTANCE OF SMALL TRANSFER PROGRAMS, 1957-58 TO 1997-98

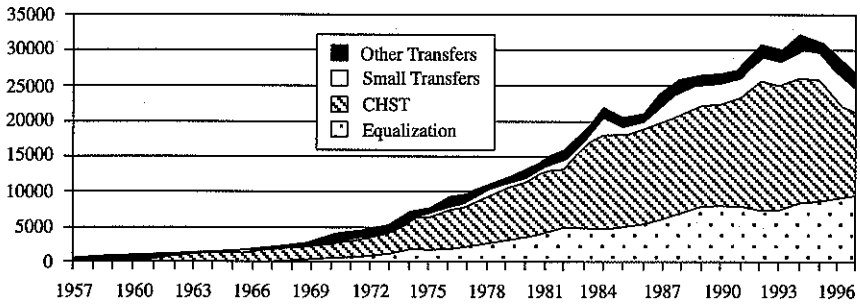
This first part examines the importance of small transfers. We begin by presenting data at the national level in Figures 1 and 2. The main trends over the 1957-98 period are:

1. an increase in total cash transfers in nominal and real dollars until 1994-95, followed by a sharp drop with 1997-98 transfers equal to about 80 percent of the 1994-95 transfers (see Figure 1);<sup>2</sup>
2. a less stable pattern for small transfers which increased until 1966-67, then decreased until 1969-70, increased again in 1970-71, decreased for two years and so on until 1997-98. This irregular behaviour is readily visible in Figure 2. As a result, small transfers have the second highest coefficient of variation of the various types of transfers at 0.97; only CAP transfers are more volatile (1.03) while Equalization (0.9), CHST (0.88), EPF (0.84) and other (0.75) are less volatile. This variability is explained mainly by the introduction and end of various programs rather than by abrupt changes in existing programs; and
3. a reduction over time in the importance of small transfers as measured by the four ratios (Figure 2) although there are signs of a small increase from the mid-1990s onwards. This is not surprising if one examines the three trend regressions estimated using the following equation:  $\text{Transfers} = B_0 + B_1 t$  (all coefficients are significant at the 1 percent level) where  $B_0$  is the constant and  $B_1 t$  the trend (the changes from year to year in the transfer examined). The results are shown in Table 1 below.

One sees that small transfers increase more slowly in nominal dollars over time than equalization or CHST and that the  $R^2$  is smaller indicating more variability around the trend.

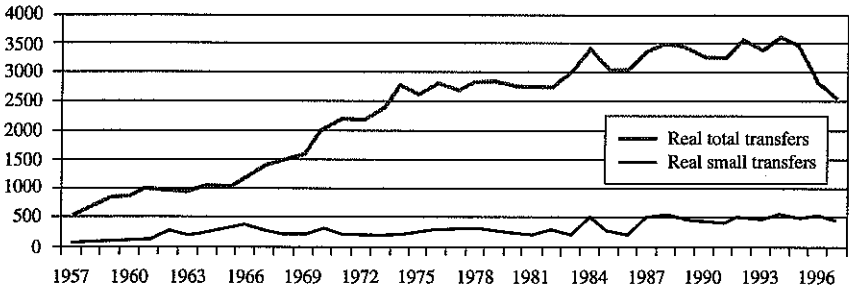
**Figure 1: Federal Transfers to Provinces, Canada, 1975-1998**  
 (\$ 000,000, Nominal and Real)

**1a (Nominal)**



Source: Table A-1, items (1), (4), (5) and (6) in the Appendix.

**1b (Real)**



Source: Table A-1, items (8) and (9) in the Appendix.

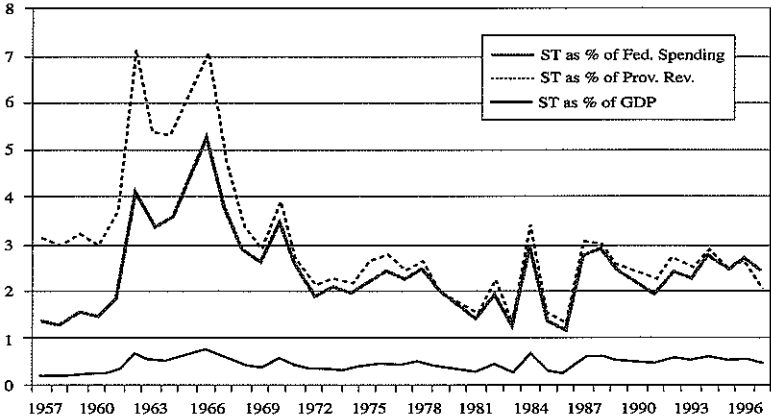
**Table 1: Trends in Transfers in Canada, 1957-1998,**  
**Regression Analysis**

	<i>Constant</i>	<i>Trend</i>	<i>R<sup>2</sup></i>
Equalization	1,964	266	0.93
CHST	3,043	475	0.90
Small transfers	875	115	0.82

Source: Table A-1 and calculations by the author.

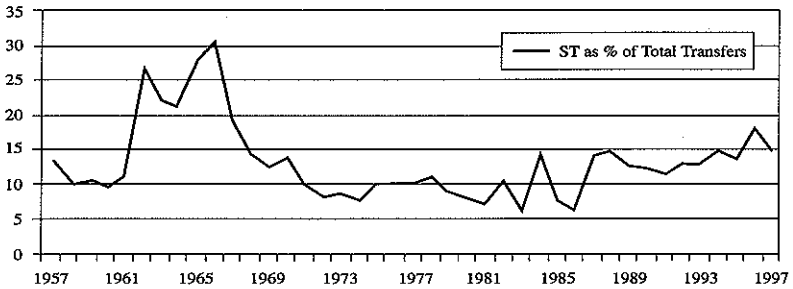
**Figure 2: Importance of Small Transfers (ST), Four Ratios, Canada, 1957-1998**

2a



Source: Table A-1, items (13), (14) and (15) in the Appendix.

2b



Source: Table A-1, item (12) in the Appendix.

Table 2 presents evidence at ten-year intervals on the amount of small transfers by province, on their importance in provincial revenues, which is also illustrated in Figure 3, and on the share of total small transfers received by each province.

These shares are presented for the full 1957-98 period in Figure 4. Figure 3 shows that in general, equalization-receiving provinces derive a greater share of their provincial revenues from small transfers than do Ontario, Alberta, and

Table 2: Small Transfers by Province (Nominal and Percentage) Canadian Provinces, 1957-58 to 1997-98

	1957-1958		1967-1968		1977-1978		1987-1988		1997-1998		
	\$000,000	Prov. % in Total Revenues	\$000,000	Prov. % in Total Revenues	\$000,000	Prov. % in Total Revenues	\$000,000	Prov. % in Total Revenues	\$000,000	Prov. % in Total Revenues*	
Nfld.	3.2	4.51	26.6	6.73	67.1	6.97	213.6	6.45	353.4	9.31	6.57
PEI	1.5	2.12	6.3	1.59	31.7	3.29	45.9	1.39	39.3	1.04	4.57
NS	4.2	5.92	42.9	10.85	48.1	5.00	143.7	4.34	140.3	3.70	3.66
NB	5.5	7.76	31.2	7.89	62.8	6.52	180.3	5.45	129.8	3.42	4.27
Que.	0.4	0.56	132.4	33.49	320.8	33.32	821.0	24.81	808.8	21.30	2.01
Ont.	17.8	25.11	85.8	21.70	133.3	13.85	909.5	27.48	1,081.2	28.48	2.61
Man.	4.5	6.35	18.5	4.68	73.1	7.59	172.7	5.22	264.4	6.96	3.54
Sask.	4.7	6.63	18.4	4.65	72.2	7.50	218.5	6.60	364.3	9.59	11.28
Alta.	7.2	10.16	16.2	4.10	77.9	8.09	289.6	8.75	352.2	9.28	1.98
BC	21.9	30.89	17.1	4.32	75.7	7.86	314.4	9.50	263.1	6.93	1.56
All provinces	71.0	100.00	397.8	100.00	970.2	100.00	3,378.3	100.00	3,899.4	100.00	

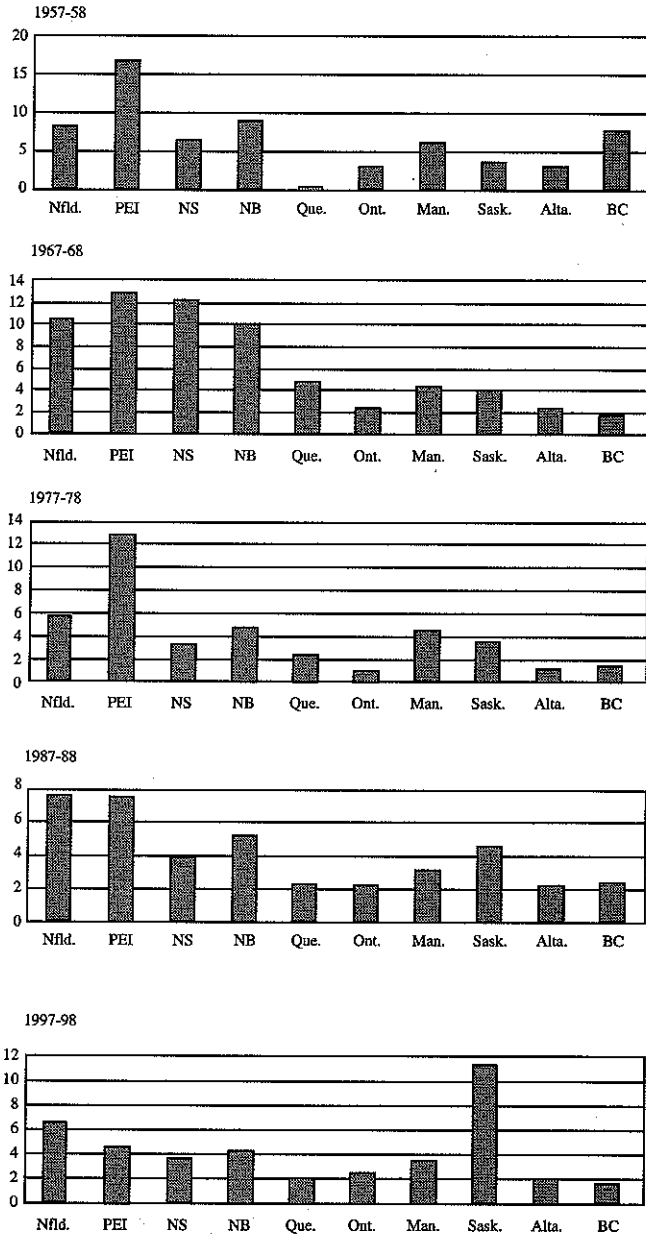
Note: \*1995-96 results.

Sources: 1957-88, Perry (\$) and Cansim (Revenues).

1997-98, Public Accounts.

1997-98, (2), Statistics Canada, 68-207 (1957), Financial Statistics of the Provincial Government.

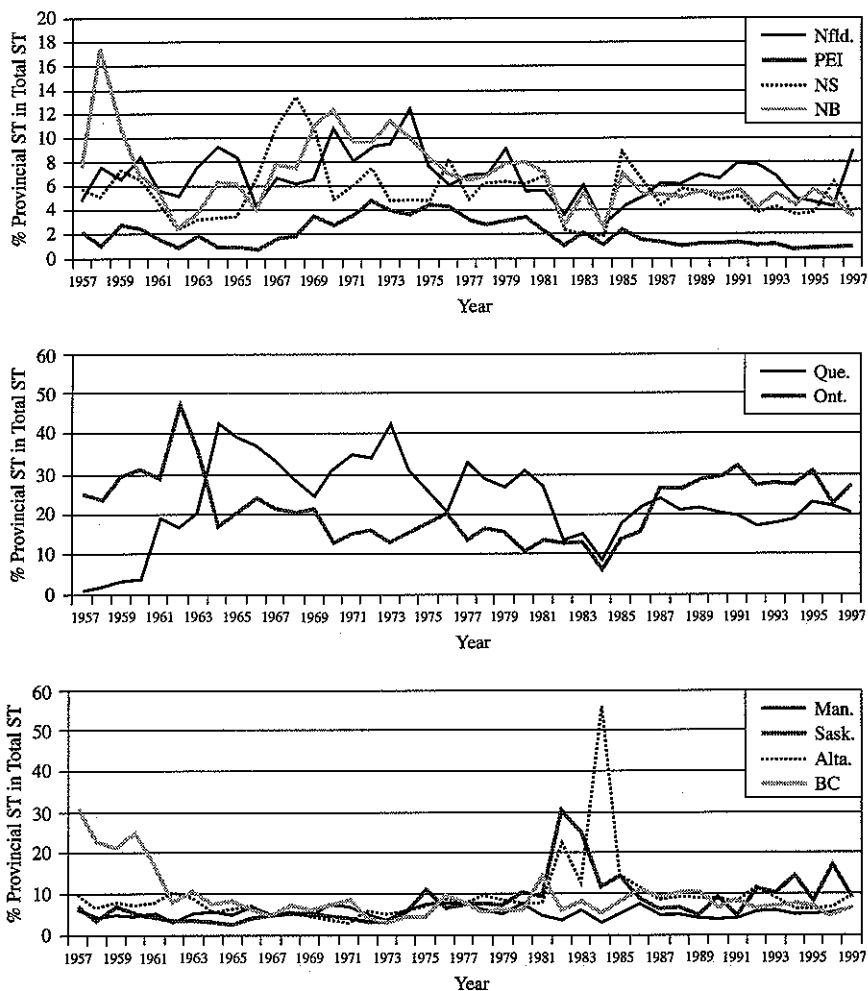
**Figure 3: Share of Small Transfers (%) in Provincial Total Revenues, Canada by Provinces, from 1957-58 to 1997-98**



Source: Table 2.

British Columbia.<sup>3</sup> Figure 4 (and Table A2) shows that since 1990 the four Atlantic provinces each received a share of small transfers greater than their share of Canada's population, that Quebec received somewhat less, Ontario substantially less, Manitoba and particularly Saskatchewan more, and Alberta and, in particular, British Columbia less.

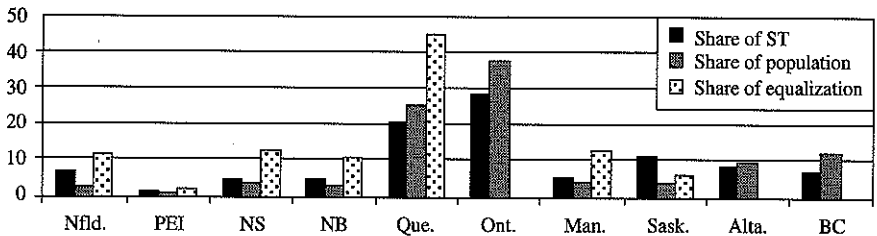
**Figure 4: Provincial Shares of Small Transfers, Canada, from 1957-58 to 1997-98**



Source: Table A-2.

Figure 5 compares each province's share of small transfers for the 1990-97 period with their share of the population (1991-96) and with their share of Equalization payments (1991-96). It shows that the equalization-receiving provinces generally get more small transfers than their share of the population, but that this is not true for Quebec.

**Figure 5: Share of Small Transfers (1990-97), Population (1991-96) and Equalization (1991-96), All Canadian Provinces**



Sources: Table A2 in Appendix; Statistics Canada; Canadian Tax Foundation, *Finances of the Nation* (Toronto: Canadian Tax Foundation, 1995), and *The National Finances* (Toronto: Canadian Tax Foundation, 1991-1994).

#### THE COMPOSITION OF SMALL TRANSFERS, 1977-78 TO 1997-98

In this part we turn to the composition of small transfers for five select years. We limited ourselves to that period since Public Accounts information is available in comparable form for that period and the federal inventory of federal-provincial programs was published (almost annually) for the 1974-95 period, thus covering about the same years. A bird's eye examination of available documents shows a large number of programs (108 in 1987-88), some of which are extremely small, a fair number of which are extremely local in nature. Examples in 1987-88 range from the Canada-Manitoba agreement to correct damage to provincial lands due to beavers from a national park (\$20,000 per year) to restoring St. Trinity Church in Saskatchewan (\$9,000) and including others such as the Forges du Saint Maurice and the downtown Moncton renovation scheme. It is impossible to list them all, let alone describe or evaluate them in the space and time available.

We thus present, in Table 3, the ten most important programs in terms of spending for five years, 1977-78, 1982-83, 1987-88, 1992-93 and 1997-98, and also for all years for programs ongoing in 1997-98. We present the information by programs and not by department, since programs are sometimes moved from one department to another. We attempted to standardize program titles over time as much as possible.

The following is clear from Table 3: First, the most important program over time, Canada Mortgage Housing Corporation (CMHC) transfers, is not in the list for 1977-78. It shows up for the first time in 1982-83. This appears to be explained by a change in funding for the program from 1977-78 to 1982-83. It is now funded through a ministerial account and thus appears as a federal-provincial transfer and no longer as a Crown Corporation expenditure.

Second, if the three programs aimed at the agricultural sector are grouped, they account for 14.8 percent of cumulative spending, which puts them in a solid second place. Only the crop insurance and waterfowl program is mentioned in either 1977-78, 1982-83 or 1987-88; the two other programs are relatively recent in the field, which is formally a field of joint jurisdiction.

Third, the official language and vocational rehabilitation programs, ranked second and sixth overall, are long established programs that are renewed on a regular basis; fourth, the Saskatchewan Uranium Mine transfers is a stealth program that never shows up in the top ten for a given year but comes in eighth overall in the ongoing programs; and fifth, the regional and industrial development program underestimates regional economic spending, which is also found under region-specific agencies (ACOA, Quebec, Western Diversification).

An examination of the results for the five separate years shows that the most important program measured by spending is not the same for each of these years. The top-ranked program in 1977-78 ranks fifth in 1987-88 and drops off the chart in 1997-98. The number one program of 1987-88 is not on the 1977-78 or 1997-98 charts nor is the 1997-98 number two program on the 1977-78 or 1987-88 charts. Crop/revenue insurance for farmers remains in the top five throughout, whereas official languages and transportation programs lose grounds and the vocational rehabilitation program gains grounds. Of course, the national picture may obscure provincial differences. We thus present, in Table 4, for 1997-98, the top five programs by province. We note that CMHC is in the top five programs in all provinces — no other program has such a national presence; the Atlantic provinces use ACOA programs as well as programs specific to their needs such as the Northern Cod Program in Newfoundland and official language programs in New Brunswick. Also, the Prairie provinces make more use of agricultural programs than the other provinces.



**Table 3: Ten Largest Small Transfer Programs, Canada, Overall as of 1997-98, and in 1977-78, 1982-83, 1987-88, 1992-93 and 1997-98 (Nominal and Percentage)**

1977-1978				
<i>Programs</i>	<i>Department</i>	<i>\$ 000</i>	<i>% of Total 955,248</i>	<i>% Cumulative</i>
Economic and Regional Expansion	Economic and Regional Expansion	365,898	38.3	38.3
Official Languages in Education	Secretary of State	222,516	23.3	61.6
Road Improvement	Transport	72,931	7.6	69.2
Crop Insurance	Agriculture	72,812	7.6	76.8
Vocational Rehabilitation of Disabled Persons	Health and Welfare	22,245	2.3	79.1
Legal Aid	Justice	19,611	2.1	81.2
Young Offenders Assistance	Health and Welfare	16,829	1.8	83.0
National Capital Commission	Urban Affairs	9,704	1.0	84.0
Fraser River Flood Control	Environment	5,809	0.6	84.6
Community Development	Indian Affairs and Northern Development	4,500	0.5	85.1
1982-1983				
<i>Programs</i>	<i>Department</i>	<i>\$ 000</i>	<i>% of Total 5,375,924</i>	<i>% Cumulative</i>
Economic and Regional Expansion	Economic and Regional Expansion	189,288	3.52	3.52
Official Languages in Education	Secretary of State	176,285	3.28	6.80
Crop Insurance	Agriculture	142,191	2.64	9.44
Canada Mortgage and Housing Corporation	Public Works and Services	118,101	2.20	11.64
Forestry Management	Environment	65,829	1.22	12.86
Vocational Rehabilitation of Disabled Persons	National Health and Welfare	55,554	1.03	13.89
Young Offenders	National Health and Welfare	41,205	0.77	14.66
Legal Aid	Justice	34,148	0.64	15.30
Road Improvement	Transport	26,188	0.49	15.79
James Bay Agreement	Indian Affairs and Northern Development	20,996	0.39	16.18

... continued

Table 3 (continued)

1987-1988

<i>Programs</i>	<i>Department</i>	<i>\$ 000</i>	<i>% of Total</i> <i>3,378,291</i>	<i>%</i> <i>Cumulative</i>
Canadian Jobs Strategy	Employment and Immigration	1,409,268	41.7	41.7
Canada Mortgage and Housing Corporation	Public Works	561,650	16.6	58.3
Official Languages in Education	Secretary of State	216,458	6.4	64.7
Crop Insurance	Agriculture	181,475	5.4	70.1
Industrial and Regional Development	Economic and Regional Expansion	113,341	3.4	73.5
Vocational Rehabilitation of Disabled Persons	Health and Welfare	92,658	2.7	76.2
Legal Aid	Justice	63,553	1.9	78.1
Additional Forestry Resource Agreement	Agriculture	63,486	1.9	80.0
Road Improvement	Transport	52,834	1.6	81.6
Forestry Resource Development Agreement	Agriculture and Agri-food	35,370	1.0	82.6

1992-1993

<i>Programs</i>	<i>Department</i>	<i>\$ 000</i>	<i>% of Total</i> <i>10,743,962</i>	<i>%</i> <i>Cumulative</i>
Canada Mortgage and Housing Corporation	Public Works	1,146,178	10.67	10.67
Gross Revenue Insurance Plan	Agriculture	679,253	6.32	16.99
Canadian Jobs Strategy	Employment and Immigration	526,041	4.90	21.89
Official Languages in Education	Secretary of State	267,405	2.49	24.38
Vocational Rehabilitation of Disabled Persons	National Health and Welfare	182,015	1.69	26.07
Crop insurance	Agriculture	173,391	1.61	27.68
Young Offenders	Justice	157,992	1.47	29.15
Legal Aid	Justice	89,467	0.83	29.98
Program for Older Worker Adjustment	Labour	75,950	0.71	30.69
Canada/Newfoundland Development Fund	Energy, Mines and Resources	52,467	0.49	31.18

... continued

Table 3 (continued)

1997-1998				
Programs	Department	\$ 000	% of Total 3,899,414	% Cumulative
Canada Mortgage and Housing Corporation	Public Works and Services	1,008,057	25.9	25.9
Terra Nova Offshore Petroleum Board	Environment	235,886	6.1	32.0
Vocational Rehabilitation of Disabled Persons	Human Resources Development	235,599	6.0	38.0
Crop Insurance and Waterfowl	Agriculture and Agri-food	206,073	5.3	43.3
Net Income Stabilization Account	Agriculture and Agri-food	203,177	5.2	48.5
Payments in Connection with the <i>Farm Income Protection Act</i>	Agriculture and Agri-food	192,109	4.9	53.4
Official Language in Education	Canadian Heritage	191,450	4.9	58.3
Young Offenders Assistance	Justice	150,000	3.9	62.2
Emergency Preparedness and Disaster Financial Assistance	National Defence	149,039	3.8	66.0
Canada-Ontario Infrastructure	Industry	119,701	3.1	69.1

*Cumulative, Existing Programs in 1997-1998*

Programs	\$ 000	%		Number of 5 Years in Top 10
		Total	Cumulative	
Canada Mortgage and Housing Corporation	14,017,138	29.6	29.6	4
Official Languages in Education	5,164,412	10.8	40.4	5
Regional and Industrial Development	3,791,740	7.9	48.3	1
Crop Insurance and Waterfowl	3,579,646	7.5	55.8	5
Gross Agricultural Income Assistance	2,474,906	5.1	45.5	1
Vocational Rehabilitation of Disabled Persons	2,448,724	5.1	50.6	5
Young Offenders Assistance	1,819,411	3.8	54.4	2
Saskatchewan Uranium Mines	1,788,214	3.7	58.1	0
Legal Aid	1,296,444	2.7	60.8	2
Net Agricultural Income Stabilization Scheme	1,047,137	2.2	63.0	1
<b>TOTAL</b>	<b>47,736,000</b>			

Note: The total is obtained by subtracting from the Public Accounts total, amounts for CAP, New Horizons (70,907,108) and Job Planning (6,674,329). These amounts are cumulative since the beginning of the relevant program in nominal dollars.

Source: *Public Accounts of Canada*, Volume II, Section entitled "Federal Provincial Shared Cost Programs."

**Table 4: Top Five Transfer Programs by Province, 1997-1998***Newfoundland*

<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total</i> 353.4
Terra Nova Offshore Petroleum Board	Environment	235,886	66.8
Canada Mortgage and Housing Corporation	Public Works	20,816	5.9
Atlantic Canada Opportunities Agency: Coop Agreements - TAGS / ER	Industry	19,072	5.4
Newfoundland Agreement	Indian Affairs and Northern Development	10,907	3.1
Northern Cod Fisheries Retirement	Fisheries and Oceans	10,434	3.0

*Prince Edward Island*

<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total</i> 39.3
Atlantic-Canada Opportunities Agency: Coop Agreements	Industry	13,556	34.5
Canada Mortgage and Housing Corporation	Public Works	7458	19.0
Atlantic Regions Freight Assistance Transition	Transport	4,823	12.3
Payments in Connection with the Farm Income Protection Act: Safety Net Companion Programs	Agriculture and Agri-food	2,606	6.6
Net Income Stabilization Account	Agriculture and Agri-food	2,084	5.3

*Nova Scotia*

<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total</i> 140.3
Canada Mortgage and Housing Corporation	Public Works	45,361	32.3
Atlantic Regions Freight Assistance Transition	Transport	24,352	17.4
Strategic Capital Investment Initiative - Highways and Airports	Transport	19,643	14.0
Atlantic-Canada Opportunities Agency: Co-op Agreements	Industry	13,122	9.4
Vocational Rehabilitation of Disabled Persons	Human Resources Development	7,445	5.3

... continued

Table 4 (continued)

<i>New Brunswick</i>			
<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total 129.8</i>
Atlantic Regions Freight Assistance Transition	Transport	46,000	35.4
Official Language in Education	Canadian Heritage	16,201	12.5
Canada Mortgage and Housing Corporation	Public Works	14,193	10.9
Atlantic-Canada Opportunities Agency: Co-op Agreements	Industry	12,583	9.7
Highway Improvements	Transport	9,060	7.0
<i>Quebec</i>			
<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total 808.8</i>
Canada Mortgage and Housing Corporation	Public Works	180,003	22.3
Payments in Connection with the Farm Income Protection Act: Safety Net Companion Programs	Agriculture and Agri-food	105,824	13.1
Economic Development of Canada for the Regions of Quebec: Contribution to the Province of Quebec under the Canada Infrastructure Works Agreement	Industry	96,651	12.0
Vocational Rehabilitation of Disabled Persons	Human Resources Development	80,133	9.9
Cree-Kativik School Board (James Bay)	Indian Affairs and Northern Development	63,354	7.8
<i>Ontario</i>			
<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total 1,081.2</i>
Canada Mortgage and Housing Corporation	Public Works	417,756	38.6
Canada-Ontario Infrastructure	Industry	119,701	11.1
Social Services	Indian Affairs and Northern Development	97,264	9.0
Official Language in Education	Canadian Heritage	71,449	6.6
Vocational Rehabilitation of Disabled Persons	Human Resources Development	69,326	6.4

... continued

Table 4 (continued)

## Manitoba

<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total 264.4</i>
Joint Emergency Preparedness Program and Disaster Financial Assistance	National Defence	57,299	21.7
Canada Mortgage and Housing Corporation	Public Works	54,470	20.6
Crop Insurance and Waterfowl	Agriculture and Agri-food	45,220	17.1
Net Income Stabilization Account	Agriculture and Agri-food	32,041	12.1
Canada Infrastructure Works (Western Economic Diversification)	Industry	15,431	5.8

## Saskatchewan

<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total 364.3</i>
Canadian Environmental Assessment Agency: Saskatchewan Uranium Mining Development	Environment	82,809	22.7
Net income Stabilization Account	Agriculture and Agri-food	77,490	21.3
Crop Insurance and Waterfowl	Agriculture and Agri-food	62,412	17.1
Canada Mortgage and Housing Corporation	Public Works	50,756	13.9
Canada Agriculture Infrastructure	Agriculture and Agri-food	20,103	5.5

## Alberta

<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total 352.2</i>
Canada Mortgage and Housing Corporation	Public Works	78,912	22.4
Payments in Connection with the Farm Income Protection Act: Safety Net Companion Programs	Agriculture and Agri-food	51,502	14.6
Crop Insurance and Waterfowl	Agriculture and Agri-food	48,115	13.7
Net Income Stabilization Account	Agriculture and Agri-food	39,265	11.2
Western Economic Diversification: Infrastructure Works	Industry	23,477	6.7

... continued

Table 4 (continued)

<i>British Columbia</i>			
<i>Program</i>	<i>Department</i>	<i>Transfers</i>	<i>% of Total 263.1</i>
Canada Mortgage and Housing Corporation	Public Works	96,527	36.7
Western Economic Diversification: Canada Infrastructure Works	Industry	46,903	17.8
Vocational Rehabilitation of Disabled Persons	Human Resources Development	25,253	9.6
Strategic Initiatives	Human Resources Development	17,342	6.6
Young Offenders Assistance	Justice	16,516	6.3

Note: The total amount in millions of dollars reported for each province is from Table 2.

Source: *Public Accounts of Canada*, Volume II – Part II (II) “Federal Provincial Shared Cost Programs” section.

## A SUMMARY EVALUATION

A full evaluation of federal-provincial small transfers requires that criteria be established, each program be described in detail (formula, etc.) and, finally, that program characteristics be assessed with respect to the criteria. Since we do not describe each program in sufficient detail, the evaluation will be a summary one.

### CRITERIA

One can assess federal-provincial transfers using various criteria as follows:

- first, one may want to assess the basis for state intervention in a given area such as the provision of private goods, such as housing or insurance programs. If one concludes that the state should not intervene, then the transfers are inappropriate;
- second, given that one accepts that the state is intervening, one may wish to argue that the distribution of power between the national/central and the subnational government is inappropriate and that it should be changed, doing away with transfers;

- third, accepting the existing division of powers, one may examine the need for transfers and the appropriate transfer mechanisms. We will evaluate the transfers from this third perspective.

Intergovernmental conditional transfer programs are appropriate from an economist's perspective when, for one reason or another, subnational units fail to produce a sufficient amount of publicly provided services or goods. The key reason for this is that there are external benefits to this provision that cannot be captured by the producing jurisdiction due to migration of individuals (postsecondary education) or contaminants (airborne/waterborne pollution) or public nature (on-air educational TV) of the service. A second reason may be that a given service may be seen as a merit good (i.e., a good that some individuals wish to see be consumed by others) by a majority of the national population but not by a majority in each subnational jurisdiction, leading again to underprovision.

#### PROGRAM DESCRIPTION

We now briefly describe the top ten transfer programs.

*Canada Mortgage Housing Corporation.* As of December 1996, there were 385,000 provincially (territorially) administered housing units (59 percent of the total CMHC stock) of which 204,000 (53 percent) are public housing units and 108,000 (28 percent), non-profit units. Major programs in the field of housing were: (i) non-profit housing: where owners of non-profit housing (which could be provincial or municipal housing) authorities received subsidies equal to the difference between admissible costs and rental income. This program was terminated in December 1993. Spending continues according to previous commitments; (ii) rent supplements where either CMHC or a provincial body administers the program, which pays out subsidies to landlords (private, co-ops, non-profit) for specific housing units. This program was also terminated in December 1993 with spending continuing due to previous commitments; and (iii) public housing where CMHC either lent up to 90 percent of the capital cost or paid 75 percent of the investment costs and losses to provincial government. This program was terminated in 1985 with spending continuing for previous commitments.

*Official Languages in Education.* This program helps finance some of the costs associated with minority language education (French outside Quebec, English inside Quebec) and with the teaching of the second official language. This program was introduced in 1970 following the recommendation of the Royal Commission on Bilingualism and Biculturalism. Agreements signed in 1970-71 were renewed in 1974 for five years, and extended annually until 1983 and then followed by a five-year agreement and a new federal-provincial protocol in 1997. Payments are mainly set on a per-pupil basis, but there is some specific project financing.



*Regional and Industrial Development.* These programs are negotiated with provinces and take into account their preferences and economic needs. Financing arrangements vary between 50/50 to 25/75.

*Crop Insurance and Waterfowl, Gross Income Insurance and Net Income Stabilization.* Agricultural income support was modified in 1991 with the *Farm Income Protection Act* which replaced the *Crop Insurance Act* and introduced both gross income insurance and net income stabilization account. This program requires participants to make contributions of up to 3 percent of eligible net sales (maximum \$250,000) which in the 1995 stabilization years were matched (two-thirds federal, one-third provincial) by the participating governments. In Alberta, the federal government provides 100 percent of matching funds because of non-participation by the province.

These three programs all help protect the income of farmers indirectly (through crop insurance) or directly. They are negotiated on a provincial basis and require financing from farmers. Moral hazard and adverse selection issues are addressed in the federal-provincial agreements.

*Vocational Rehabilitation of Disabled Persons.* This program is now called the Employability Assistance for People with Disabilities Program. It provides employment counselling, training, and skills development funding for assistance, aids and devices, wage, and earnings supplements.

*Young Offenders.* This program was introduced in 1984, following changes in the *Delinquent's Act*, that meant that services previously funded under CAP were no longer funded, given that they were not deemed to be welfare services. Provinces faced additional costs due to various requirements such as larger segregated youth facilities.

*Saskatchewan Uranium Mines.* The title is self-explanatory.

*Legal Aid.* The title is self-explanatory.

#### EVALUATION

As Table 5 shows, the two economic reasons indicated earlier appear to play a small role in the justification of the ten largest small transfer programs. Issues such as history (CMHC), national security (Uranium) and overlapping jurisdiction matter more.

Given that these programs exist, a second question one can ask is: Are they well designed? To ensure this, the formulas used to fund the small transfers can be examined or an impact analysis can be carried out, that is, did the program attain the desired result without perverse effects? On the formula design issue, the following points can be made: (i) with respect to CMHC, the issue is irrelevant insofar as current transfers are the result of past decisions,

**Table 5: Criterion Evaluation of Top Ten Programs**

<i>Program</i>	<i>Externalities</i>	<i>Merit Good</i>	<i>Jurisdiction</i>	<i>Other Justification / Comments</i>
Canada Mortgage and Housing Corporation: • non-profit housing, • rent supplements, and • public housing	No	No	?	Post-WWII program self-perpetuating? Redistribution in kind?
Official Languages Education	No	Yes	P	Quebec + Ontario preferences?
Regional/Industrial Development	No	No	P	Reduce migration to occupy territory?
Agricultural	No	No	Joint-constitution	Avoids overlaps/inefficiencies?
Vocational Rehabilitation of Disabled Persons	No	No	P	?
Young Offenders	No	No	FP	?
Saskatchewan Uranium Mines	No	No	F	Strategic mineral?
Legal Aid	No	No	Joint	?

Source: Author's compilation.

that is, there is nothing one can do now to modify the end result; and (ii) the agricultural insurance programs appear to attempt to control for moral hazard and adverse selection. Examining the Canada-Quebec Crop Insurance Agreement, one finds, for example: a requirement that a minimum of 10 percent of producers be insured; very detailed coverage calculation taking into account the type of crop, experience, minimum/maximum yield and so on. Indeed, this level of detail justifies the use of regional/provincial agencies to carry out the program; a funding of 25 percent of insurance premiums and 50 percent of administrative costs by the federal government; a two-page appendix on "Recognition Requirements" that states that "The Canada and Quebec signatures shall be presented with equal prominence (i.e., same content, size, style and weight of type) side by side."

In the Official Language Act in Education Program, financing is based on (i) transfers per full-time equivalent student and (ii) project financing — it is

not 50/50 financing. The Employability Assistance for People with Disabilities Program is a 50/50 cost-sharing program with an annual ceiling (\$168 million in 1997-98); and the Young Offender's Act and legal aid programs are 50/50 cost-sharing programs with an annual maximum. Thus, overall, one sees the use of non-open-ended programs with either 50/50 funding or a per-unit transfer. This is a reasonable design for this type of program.

## CONCLUSION

My purpose was to establish the importance of small transfers, to describe their make-up and to evaluate them. This, in retrospect, was an overly ambitious goal, especially given the absence of an existing literature on the various small transfers. This chapter succeeds in establishing the quantitative magnitudes of small transfers in Canada; it provides only a summary description of their make-up, and does not examine the degree of conditionality; it evaluates them briefly. This is unfortunate since small transfers have accounted for about 15 percent of federal transfers to provinces over the last five years (1993-98), which is somewhat higher than in the first five years examined (1957-62) which was 11 percent and slightly more than the average for the 1957-98 period, which is 13 percent. They are thus a permanent and fairly important component of federal-provincial relations in Canada. They are of particular interest in that the variability in their amounts and composition show them to be a rapid response instrument for the federal government to specific problems.

Given the importance and complexity of small transfers, it is appropriate to conclude by noting the need for more detailed research. This would allow us to examine the appropriateness of existing arrangements and in particular to assess if some programs could be integrated into large transfers (vocational rehabilitation into CHST, for example) and if other programs are still appropriate.

## NOTES

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1. The Territorial Formula Financing grant is not included as it is similar to Equalization.
2. We do not consider tax points ceded to the province to be transferred although this value is used in calculating cash transfer under the EPF/CHST arrangement. Also note here that as indicated in Table A-1, the computation of the various transfers for 1996-97 and 1997-1998 uses a different source than the sole one used for the 1957-96 period. As a result, numbers may not be strictly comparable but trends and order of magnitudes are unaffected.
3. In 1957-58, Quebec was an important exception to this generalization.

## APPENDIX

**Table A-1: Federal-Provincial Cash Transfers, Total and by Type, Nominal and Real per Capita %, Canada 1957-1998, \$000,000 for Items (1) - (9)**

Year	Equal. (1)	EPF (2)	CAP (3)	CHST (4)	Small Transfers (ST) (5)	Other Transfers (6)	Total Nominal (7)	Total Real (8)	ST Real (9)	ST per Capita Nominal \$ (10)	ST per Capita Real \$ (11)	ST as % of Total Transfers (12)	ST as % of Federal Spending (13)	ST as % of Provincial Revenues (14)	ST as % of GDP (15)
1957-58	136.0	34.6	39.7	74.3	71.0	246.7	528.0	528.00	71.00	4.27	4.27	13.45	1.36	3.14	0.21
1958-59	143.4	100.7	73.7	174.4	74.3	323.7	715.8	692.10	73.60	4.35	4.21	10.38	1.27	2.98	0.21
1959-60	183.0	196.8	90.7	287.5	95.7	335.8	902.0	844.18	91.50	5.47	5.12	10.61	1.57	3.24	0.25
1960-61	189.7	237.4	102.6	340	95.3	349.4	974.4	883.62	88.10	5.33	4.83	9.78	1.46	3.01	0.24
1961-62	164.7	332.9	143.3	476.2	129.2	378.9	1,149.0	1,004.51	115.03	7.08	6.19	11.24	1.87	3.69	0.32
1962-63	158.5	387.6	159.2	546.8	301.8	120.4	1,127.5	962.66	126.26	16.24	13.87	26.77	4.17	7.11	0.68
1963-64	156.2	445.6	171.8	617.4	247.5	100.3	1,121.4	930.25	209.10	13.07	10.84	22.07	3.35	5.41	0.52
1964-65	214.9	490.5	181.6	672.1	275.8	137.7	1,300.5	1,049.02	226.50	14.30	11.53	21.21	3.53	5.31	0.53
1965-66	273.4	421.2	147.2	568.4	372.9	118.3	1,333.0	1,029.72	293.40	18.98	14.66	27.97	4.53	6.15	0.65
1966-67	316.4	480.7	181.4	662.1	501.5	148.1	1,628.1	1,165.21	365.60	25.06	17.94	30.80	5.36	7.09	0.78
1967-68	544.8	698.4	363.7	1,062.1	397.8	78.4	2,083.1	1,401.53	271.80	19.52	13.13	19.10	3.76	4.72	0.58
1968-69	586.7	935.2	385.2	1,320.4	337.8	106.6	2,351.5	1,486.23	216.50	16.32	10.31	14.37	2.87	3.39	0.45
1969-70	675.3	1,177.6	414.0	1,591.6	339.2	112.3	2,718.4	1,587.55	200.80	16.15	9.43	12.48	2.61	2.92	0.41
1970-71	927.0	1,593.7	547.2	2,140.9	527.0	124.7	3,719.6	2,049.29	294.20	24.75	13.64	14.17	3.55	3.90	0.59
1971-72	1,052.5	1,970.7	654.1	2,624.8	418.1	156.8	4,252.2	2,201.49	215.00	19.04	9.86	9.83	2.47	2.68	0.43

... continued

Table A-1 (continued)

Year	Equal.	EPF	CAP	CHST	Small Transfers (ST)	Other Transfers	Total Nominal	Total Real	ST Real	ST per Capita Nominal \$	ST per Capita Real \$	ST as % of Total Transfers	ST as % of Federal Spending	ST as % of Provincial Revenues	ST as % of GDP
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
1972-73	1,176.8	2,112.0	674.0	2,786	371.1	165.5	4,499.4	2,168.03	177.40	16.70	8.05	8.25	1.90	2.15	0.34
1973-74	1,517.1	2,239.8	702.3	2,942.1	457.8	280.8	5,197.8	2,335.01	204.40	20.35	9.14	8.81	2.11	2.28	0.36
1974-75	2,287.0	2,609	946.6	3,555.6	547.8	650.3	7,040.7	2,778.22	215.20	24.02	9.48	7.78	1.97	2.16	0.36
1975-76	1,921.6	3,071.3	1,230.7	4,302	757.0	573.4	7,554.0	2,619.68	260.70	32.71	11.34	10.02	2.19	2.61	0.44
1976-77	2,086.6	3,666.7	1,378.8	5,045.5	922.1	1,097.9	9,152.1	2,813.07	281.20	39.32	12.09	10.08	2.45	2.76	0.47
1977-78	2,383.5	3,921.8	1,352.1	5,273.9	970.2	851.5	9,479.1	2,687.28	278.60	40.89	11.59	10.24	2.26	2.43	0.45
1978-79	2,747.2	4,738.7	1,598.1	6,336.8	1,203.2	480.0	10,767.2	2,842.70	321.90	50.21	13.26	11.17	2.51	2.65	0.50
1979-80	3,321.4	5,328.7	1,653.2	6,981.9	1,049.7	463.7	11,816.7	2,846.93	257.00	43.37	10.45	8.88	2.02	2.05	0.38
1980-81	3,590.4	5,385.3	1,973.3	7,558.6	1,009.0	471.1	12,629.1	2,760.25	224.10	41.16	9.00	7.99	1.67	1.75	0.33
1981-82	4,478.2	5,909.9	2,337.5	8,247.4	1,013.5	601.5	14,340.6	2,765.82	198.30	40.83	7.87	7.07	1.42	1.52	0.28
1982-83	5,267.1	4,804.8	2,887.9	7,692.7	1,684.7	1,306.9	15,951.4	2,756.10	283.40	67.07	11.59	10.56	1.98	2.28	0.45
1983-84	5,358.4	7,665.5	3,359	11,024.5	1,114.4	766.2	18,263.5	2,975.97	184.00	43.93	7.16	6.10	1.20	1.37	0.27
1984-85	5,395.2	8,595.1	3,736.6	12,331.7	3,095.4	947.1	21,769.4	3,410.23	491.30	120.88	18.94	14.22	2.98	3.43	0.70
1985-86	5,155.8	8,663.9	3,876.1	12,540	1,543.5	1,137.3	20,376.6	3,070.16	235.80	59.73	9.00	7.57	1.37	1.60	0.32
1986-87	5,767.2	8,853	4,001.4	12,854.4	1,293.4	914.9	20,829.9	3,041.17	192.00	49.55	7.23	6.21	1.14	1.30	0.26
1987-88	6,386.2	8,800.3	4,245.7	13,046	3,378.3	1,086.5	23,897	3,358.00	482.80	127.72	17.95	14.14	2.80	3.09	0.61
1988-89	7,371.7	8,905.6	4,583.6	13,489.2	3,732.3	1,062.8	25,656.0	3,471.53	516.10	139.28	18.85	14.55	2.92	3.06	0.62
1989-90	8,155.1	8,829.2	4,885.3	13,714.5	3,362.6	1,213.3	26,445.5	3,432.04	444.40	123.24	15.99	12.72	2.44	2.58	0.52
1990-91	8,260.6	7,894.5	5,966.9	13,861.4	3,275.2	1,195.2	26,592.4	3,270.84	408.90	118.23	14.54	12.32	2.17	2.37	0.49
1991-92	8,075.1	8,830.6	6,130.3	14,960.9	3,144.9	1,117.3	27,298.2	3,229.77	378.80	112.19	13.27	11.52	1.95	2.27	0.47

1992-93	7,376.9	11,193.7	6,722.1	17,915.8	4,021.8	1,443.8	30,758.3	3,552.78	473.80	141.73	16.37	13.08	2.44	2.73	0.58
1993-94	7,755.9	9,610.3	7,219.2	16,829.5	3,836.6	1,247.4	29,669.4	3,368.38	444.00	133.67	15.18	12.93	2.28	2.50	0.51
1994-95	8,543.4	10,051.8	7,279.4	17,331.2	4,656.1	1,473.5	32,004.2	3,602.63	535.60	160.36	18.09	14.55	2.81	2.89	0.60
1995-96	8,800.6	9,605.8	7,184.5	16,790.3	4,244.7	1,210.8	31,046.4	3,451.45	481.80	144.60	16.08	13.67	2.47	2.51	0.53
1996-97	9,418.0	-	-	12,743	4,562.3	720.0	27,443.3	3,026.84	509.00	153.76	16.96	18.06	2.75	2.65	0.55
1997-98	10,000.0	-	-	10,504.0	3,899.4	681.1	25,084.5	2,619.10	429.40	129.93	14.17	14.63	2.41	2.07	0.46

## Notes:

- (2) EPP: Before 1977-1978, this is the sum of hospital insurance, medical care and postsecondary education transfers.  
 (3) CAP: Before 1965-1966, this is the sum of old age assistance, blind and disabled persons allowance and unemployment assistance.  
 (4) CHST: Before 1996-1997, this is the sum of EPP + CAP.  
 (5) Items vary across years: includes vocational training, natural resources (incl. agriculture), transportation, vocational education, natural resources, labour and employment and immigration, agriculture and primary industries, trade and industry, regional development, transportation and communications, agriculture, resource conservation, resource conservation and industrial development, natural resources (incl. agriculture and industrial development), protection, employment, housing, official languages services.  
 (6) Other Transfers: are total transfers (7) - (1 + 4 + 5) except in 1996-97 and 1997-98. They include items like statutory subsidies, share of utilities taxes, stabilization, etc. It is a balancing item.

Population: from 1957 to 1970: Cansim C892268, from 1971 to 1997: X100000.

Implicit price index, GDP: 1957-1993: Statistics Canada, 11-210; 1994-1997: Statistics Canada, 11-010.

## Sources: Transfers:

1957-58 to 1995-96: "Financing the Federation, 1867 to 1995: Setting the Stage for Change." D.P. Perry; Canadian Tax Paper No. 102, 1997, Appendix Tables.  
 1996-97 and 1997-98: Computed by the Author, *Public Accounts of Canada*. Equalization and CHST figures are from Volume 1, p. 1.16, 1997-1998. Small transfers are the total from Vol. II-II, Section II. Other transfers are [Statistics Subsidies and Territorial Financial Arrangements - Youth Allowance Recovery] from Table 8.1 Finances of the Nation 1996 and 1997 to ensure coherence with the Perry numbers.

## Federal Spending and Provincial Revenues:

1957-58 to 1960-61: Statistics Canada, 13-531, Tables 44 and 45.  
 1961-62 to 1991-92: Statistics Canada, 13-213, Tables 6 and 7.  
 1992-93 to 1996-97: Cansim D 25776 and D 26079.  
 1997-98: Computed by the Author, *Public Accounts of Canada*.

## GDP:

1957-58 to 1960-61: Statistics Canada, 13-531, Table 1.  
 1961-62 to 1996-97: Cansim D 44959  
 1997-98: Statistics Canada, 11-010.

**Table A-2: Provincial Shares of Small Transfers, Canada, 1957-58 to 1997-98**

	<i>Nfld.</i>	<i>PEI</i>	<i>NS</i>	<i>NB</i>	<i>Que.</i>	<i>Ont.</i>	<i>Man.</i>	<i>Sask.</i>	<i>Alta.</i>	<i>BC</i>
1957	4.8	2.1	5.8	7.7	0.6	24.9	6.1	6.6	10.1	30.7
1958	7.5	0.9	5.1	17.4	1.7	23.6	3.9	3.1	6.1	22.3
1959	6.5	2.7	7.3	10.7	3.1	29.4	4.6	6.7	7.8	21
1960	8.4	2.4	6.6	7	3.6	31.2	4.5	5.1	6.9	24.3
1961	5.6	1.5	4.8	5.7	19.1	28.7	4.9	4.1	7.9	17.9
1962	5.1	0.8	2.3	2.3	16.5	48	3	3.2	10.2	8.1
1963	7.7	1.8	3.2	3.9	20.7	35.2	4.8	3.2	8.6	10.5
1964	9.3	0.9	3.3	6.3	42.8	16.9	5.5	2.9	5	6.9
1965	8.4	0.9	3.5	6.1	39.4	20.5	4.7	2.3	5.9	8.2
1966	4.3	0.7	6.7	4	37.1	24.1	6.7	3.9	6.9	5.7
1967	6.7	1.6	10.8	7.8	33.2	21.5	4.7	4.6	4.1	4.3
1968	6.2	1.8	13.5	7.4	28.5	20.5	5.3	4.7	5.1	6.3
1969	6.6	3.5	10.5	11.1	24.5	21.3	4.8	5.4	4.3	5.6
1970	10.8	2.8	4.9	12.3	31.7	13	7.4	4.4	3.4	6.7
1971	8.1	3.6	6	9.7	35	15.4	6.8	4	2.8	8.3
1972	9.3	4.8	7.5	9.7	34.4	16.1	5.1	2.9	5.3	3.7
1973	9.6	4	4.8	11.5	42.9	13	3.1	2.8	5	2.7
1974	12.5	3.7	4.9	10	31	15.8	6	5.4	6	4.1
1975	7.7	4.6	4.8	8.2	25.1	18.3	7.5	11	6.9	4.4
1976	6.1	4.4	8.2	7	20.2	20.4	7.9	6.6	9.2	9.4
1977	6.9	3.3	4.9	6.5	33.1	13.7	7.5	7.4	8	7.8
1978	7	2.9	6.2	6.9	28.7	16.8	6.1	7.7	9.7	5.7
1979	9.2	3.2	6.4	7.8	27	15.7	5	7.4	8.3	6.6
1980	5.7	3.5	6.1	8	31.1	10.9	7.7	10.4	7.8	6.4
1981	5.7	2.2	6.8	7.1	26.9	13.9	4.6	9.5	8.1	12.9
1982	3.7	1.1	2.3	2.7	13.6	13	3.5	30.5	22.6	5.2
1983	6.1	2.1	1.9	5.6	15.2	13.4	6.1	25.3	12.9	8.3
1984	2.8	1.2	1.9	2.6	8.9	6.2	2.9	11.8	55.3	5
1985	4.3	2.5	8.8	7	17.6	14.1	5.1	14.5	14.4	8.2
1986	5.2	1.6	6.5	5.4	21.9	16	7.7	9.1	11.5	10.7
1987	6.3	1.4	4.3	5.3	24.3	26.9	5.1	6.5	8.6	9.3
1988	6.2	1.1	5.8	5.1	21.3	26.7	5.1	6.8	9.5	10.1
1989	7	1.3	5.6	5.7	21.9	28.7	4.2	4.9	8.6	10.2
1990	6.7	1.3	4.8	5.3	20.3	29.5	4	9.4	9.1	7
1991	7.9	1.4	5.1	5.7	19.8	32.5	4.4	4.9	7.2	7.8
1992	7.8	1.2	3.8	4.1	17.4	27.6	5.7	11.6	11.6	6.4
1993	6.9	1.3	4.1	5.4	18	28.1	6.3	10.1	9.4	7.1
1994	5.1	0.8	3.8	4.3	19.1	27.9	5.2	14.6	6.6	7.6
1995	4.8	0.9	3.9	5.7	23.5	31.2	5.3	8.4	6.1	6.8
1996	4.4	1	6.3	4.7	22.4	22.8	5.7	17.4	7.1	5
1997	9.1	1.1	3.6	3.4	20.7	27.7	6.8	9.3	9.9	6.6

Note: % may not add to 100.0 across columns due to rounding.

Sources:

1957-58 to 1995-96: "Financing the Federation, 1867 to 1995: Setting the Stage for Change," D.P. Perry, Canadian Tax Paper No. 102, 1997, Appendix Tables.

1996-97 and 1997-98: Computed by the Author, *Public Accounts of Canada*.

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## Poverty Trends and the Canadian "Social Union"

Lars Osberg

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*Ce chapitre soutient que les effets de la pauvreté doivent être similaires entre les provinces si on veut que le terme «union sociale canadienne» ait un sens pratique. On y compare l'intensité de la pauvreté entre le Canada et les États-Unis, de même qu'entre les provinces canadiennes, au début des années 1970 et entre 1994 et 1996. Même si, au plan statistique, l'intensité de la pauvreté au Canada et aux États-Unis n'était pas différente au début des années 1970, elle était beaucoup moindre au Canada qu'aux États-Unis en 1994. Au début des années 1970, l'intensité de la pauvreté variait considérablement entre les provinces canadiennes, tant avant et après avoir tenu compte des impôts et des transferts. Cependant, en 1994, toutes les provinces canadiennes partageaient une faible intensité de la pauvreté après impôts et transferts. En termes pratiques, on pourrait dire qu'une «union sociale» était présente entre les années 1973 et 1994. Toutefois, depuis 1994, la tendance s'est renversée. De 1994 à 1996, la pauvreté de la population non-âgée a augmenté, particulièrement chez les enfants âgés de moins de six ans en Ontario et en Nouvelle-Écosse. En conclusion ce chapitre, on présente certaines projections sur l'avenir de l'union sociale canadienne.*

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What is the practical meaning of a term like the Canadian "social union"?

How has the social union evolved in Canada in recent decades and how is it likely to evolve in future?

Why might it matter?

### INTRODUCTION

This chapter takes the view that if a "social union" is to have practical meaning, it should find some concrete reflection in the outcomes that people actually experience — in particular, in the poverty outcomes that Canadians experience. This is not to say that other aspects of social policy are unimportant to a



social union: social policy also affects the education, health care, and retirement incomes of non-poor Canadians. The public programs that provide these broader services are important to rich and poor alike, and the degree of commonality that people have in their personal experiences with these programs is important because a social union is presumably concerned with generating a national sense of shared experience and common destiny. Hence, services to the non-poor are clearly important.

However, because mitigating poverty is such a central issue for the welfare state, poverty outcomes are a particularly crucial and practical indicator of a social union. Poverty affects many Canadians directly<sup>1</sup> right now and the probability and depth of potential poverty affect the sense of economic insecurity with which many non-poor Canadians contemplate the future. If Canada is to be a meaningful social union one might therefore think that a basic objective of such a social union would be some commonality,<sup>2</sup> across provinces, of poverty outcomes and poverty mitigation.

The first part of this essay starts by asking how well the Canadian state has done over the period 1971 to 1994 in reducing the intensity of poverty to a common level in different areas of the country. Either by comparison with the United States, or in comparisons of provinces with each other, this period of roughly two decades saw a dramatic change in the effectiveness of Canada's tax/transfer system in reducing poverty intensity. However, the rapidity of the change also implies that such change is potentially vulnerable to equally rapid reversal.

The next section then outlines a few of the ways in which the federal government has withdrawn from anti-poverty policy in the period since 1994, and presents some evidence on recent trends in poverty intensity by demographic group. Although the provincialization of social policy has had relatively little effect on senior citizens, impacts on younger cohorts have been more significant. In particular, the poverty intensity of children under six years of age in Ontario and Nova Scotia has increased in recent years.

The third part is more speculative. It focuses on the possible future evolution of fiscal efforts to reduce poverty in Canada, in a more "provincial" environment where: (i) in the short term, the federal government faces political pressure to reduce further its anti-poverty initiatives from the official opposition and from major provinces; (ii) the federal government has effectively downloaded to the provinces much of the fiscal risk of any future recession; and (iii) there may be a secular trend to diminished saliency of pan-Canadian political sentiment.

## TRENDS IN POVERTY INTENSITY IN CANADIAN PROVINCES

What trends have there been in recent years in poverty in Canada? The most commonly used statistic on poverty is the poverty rate, but since Sen in 1976,

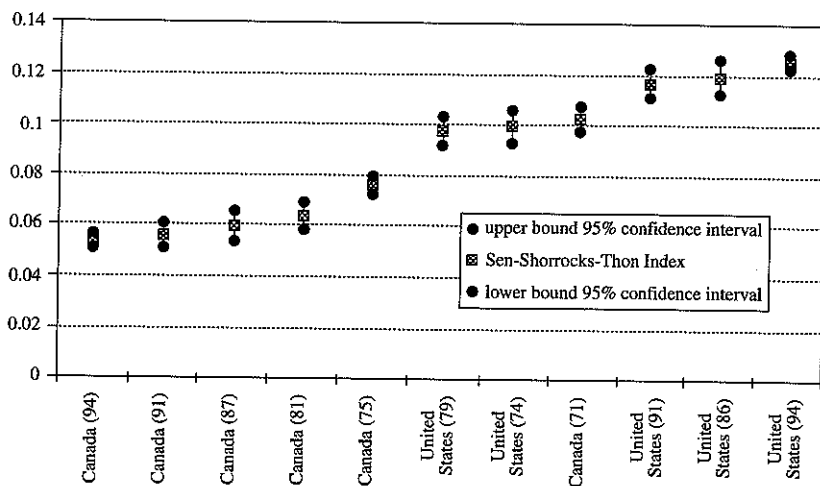
many authors have recognized that the poverty rate, by itself, is a poor index.<sup>3</sup> Simply counting the number of poor, as a percentage of all people, ignores any consideration of the depth of their poverty. As Myles and Picot have noted, some social policies transfer income to groups (such as single parents) whose incomes are well below the poverty line.<sup>4</sup> *Because* their incomes are so far below the poverty line, policy changes that affect these groups may have large impacts on their well-being, but not show up in the poverty rate statistics if few individuals are actually moved over the poverty line.

On the other hand, an index such as the average poverty gap ratio, which looks only at the average percentage shortfall of income below the poverty line, has the defect that it ignores the issue of how many people are poor. This chapter therefore uses the Sen-Shorrocks-Thon (SST) index of poverty intensity, which combines consideration of the poverty rate, average poverty gap ratio and inequality among the poor.<sup>5</sup> This chapter also takes the view that poverty in Canada should be assessed in terms of *Canadian* social norms, and therefore calculates the poverty rate and poverty gap for each individual with reference to a Canada-wide norm of living standards.<sup>6</sup>

What differences between provinces are meaningful? Since this essay will focus on the differences between Canadian provinces in poverty outcomes, it is essential to know when those differences are statistically significant and when they are not. Data on poverty are obtained from surveys of the population, and there is inevitably some statistical uncertainty in forming estimates of the characteristics of a population based on sample data. Osberg and Xu show how bootstrap estimation<sup>7</sup> can be used to establish the confidence intervals surrounding poverty estimates. Hence, this chapter reports both point estimates of poverty intensity and the 95 percent confidence band that surrounds such estimates, since we want to know when the differences between provinces are large enough to be statistically significant.

Overall, how much has the anti-poverty effectiveness of taxes and transfers changed in Canada in recent decades? Quite a lot, as it happens. Over the period 1971 to 1994, Canadian social policy followed a different trajectory than that of the United States.<sup>8</sup> As a result, Canadians have become accustomed to (and perhaps a bit sanctimonious about) the lower level of poverty to be observed in Canada, compared to the US. Figure 1 is based on Luxembourg Income Study data and plots the SST index of poverty intensity for Canada and the US from the 1970s to the 1990s. It is notable that although the 1994 data show a considerably greater intensity of poverty in the US than in Canada, this difference is of relatively recent origin.<sup>9</sup> In the early 1970s, Canada and the US were statistically indistinguishable in poverty intensity (indeed the point estimate of Canadian poverty in 1971 is actually a bit higher than the point estimate of poverty intensity in the US in 1974).

**Figure 1: Canada-United States Comparison  
The SST Index from 1971 to 1994**



**Notes:**

Poverty Line=1/2 Median Equivalent Income—After Taxes and Transfers

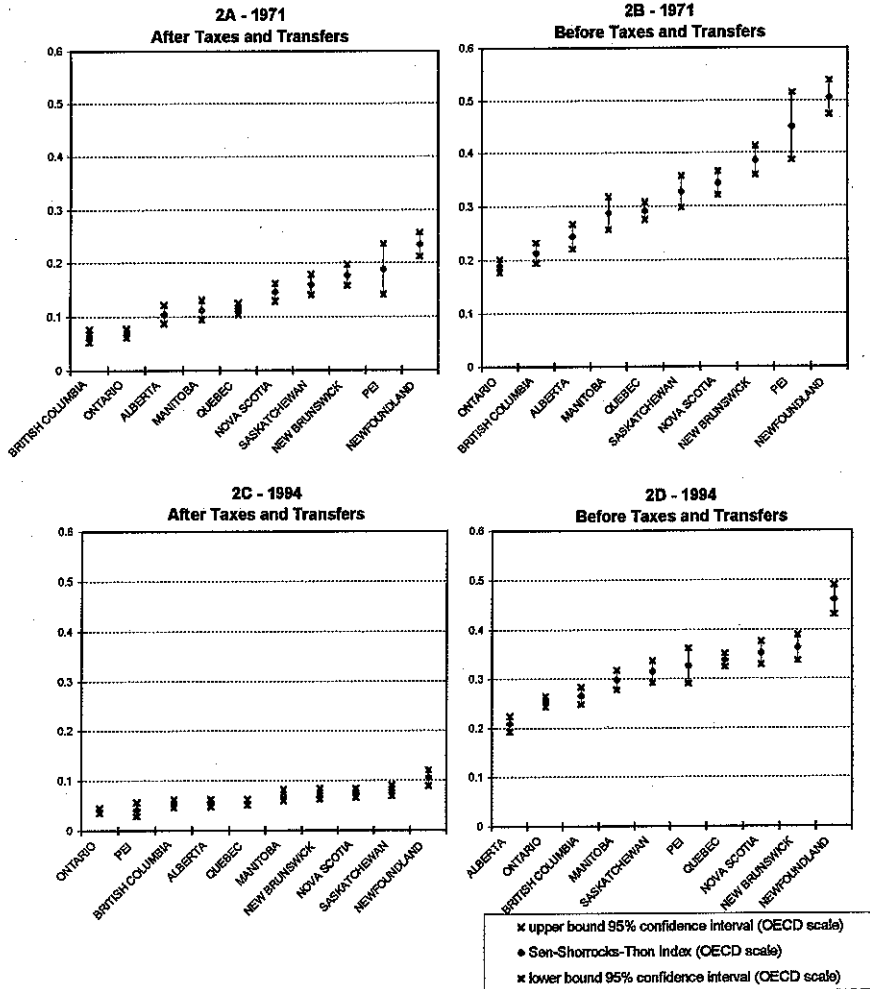
Equivalence Scale=OECD (first adult=1, other adults=0.7, kids=0.5)

[95 percent confidence interval=mean +/- 2 standard deviations] of 200 bootstraps, (income = money income of household after tax/after transfers).

Source: Luxembourg Income Study, Osberg and Xu, "International Comparisons of Poverty Intensity: Index Decomposition and Bootstrap Inference," Working Paper No. 97-03 (Halifax: Department of Economics, Dalhousie University, 1997).

How much similarity has there been across provinces in these trends? Figure 2 also uses the Luxembourg Income Study database, but instead of looking at Canada-wide outcomes in 1971, it compares Canadian provinces. Since this chapter is interested in the impact of social policy on poverty, Figure 2 contrasts the level of poverty intensity "pre-fisc" (before taxes and transfers) and "post-fisc" (after the impact of taxes and the receipt of transfer payments).<sup>10</sup> The wide range of poverty intensity across Canadian provinces in 1971 is notable, and it is particularly striking that Canadian provinces differed a good deal in poverty intensity, both before and after the impact of taxes and transfers. Indeed, in 1971 poverty intensity *before* taxes and transfers in some Canadian provinces (Ontario, British Columbia, Alberta) was

Figure 2: Sen-Shorrocks-Thon Index of Poverty Intensity



Notes:

Poverty Line=1/2 Median Equivalent Income

Equivalence Scale=OECD (first adult=1, other adults=0.7, kids=0.5)

Source: Luxembourg Income Study, author's calculations.

statistically indistinguishable from poverty intensity *after* taxes and transfers in several Atlantic provinces. Evidently, although the net impact of taxes and transfers within all provinces was a reduction in poverty intensity, in 1971 the tax/transfer system left poverty at a relatively high level and did little to equalize the experience of poverty across Canada.

By 1994, a very different picture in post-fisc outcomes had emerged. Panels 2c and 2d of Figure 2 present the SST index of poverty intensity (and its 95 percent confidence interval) for Canadian provinces in that year, pre- and post-taxes and transfers. Over all, the tax and transfer system produced a considerably lower national level of poverty intensity post-fisc in 1994 than in 1971. As well, it is notable that although pre-tax/transfer poverty outcomes continued to diverge substantially across provinces, by 1994 there was much more homogeneity in post-fisc poverty outcomes across Canadian provinces than in 1971. If mitigating poverty and substantial equalization of the life chances of Canadian citizens across provinces are indicators of the success of a social union, the 1994 data offer considerable reason for satisfaction.

#### SOCIAL POLICY CHANGE SINCE 1994

Although the data up to 1994 tell a hopeful story about the successes of the Canadian social union, 1994 was also a year that marked a major transition in social policy regimes in Canada.<sup>11</sup> "Since 1994, Canada has seen: (i) major revisions to the unemployment insurance (UI) system, and its replacement by the employment insurance (EI) system; (ii) replacement of the Canada Assistance Plan (CAP) by the Canada Health and Social Transfer (CHST); (iii) substantial devolution of authority to the provinces of in-kind service delivery such as social housing and training; (iv) major expenditure cuts in transfers to the provinces by the federal government; (v) substantial cuts in social assistance generosity in Ontario (and to a lesser extent in some other provinces).

The federal government has clearly been retreating from social activism and de-emphasizing poverty mitigation as a major goal of policy. As the pendulum swings toward greater provincial autonomy, in general, provinces now also have to rely much more on their own fiscal resources for social transfer expenditures.<sup>12</sup> Social assistance payments are no longer partially borne by the federal government, since cost-sharing under CAP has been replaced by block funding under the CHST, and provinces may differ in both fiscal capacity and inclination to reduce poverty.

In thinking about how poverty outcomes may have diverged across provinces, it is useful to distinguish between the outcomes experienced by different age groups. Improvements in the old age security system (Canada Pension Plan, the Guaranteed Income Supplement, and Old Age Security) occurred in

the late 1960s and early 1970s and their impacts were phased in during the 1970s. The reduction in poverty among senior citizens which that produced has been a major success of Canadian social policy.<sup>13</sup> Because the old age security system is largely federal and has been mostly untouched in recent years there is likely to have been very little change across provinces in the poverty outcomes observed for senior citizens.

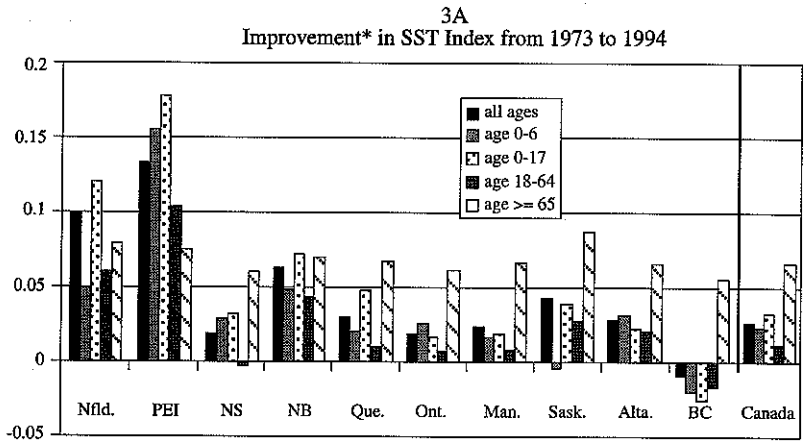
The experience of adults of working age, on the other hand, is more likely to vary across provinces. There have been different trends in local labour market conditions and the details of the UI/EI system have changed substantially. These changes interact in their effects on the working poor (and near poor) of different provinces, who have been differentially exposed to the impacts of changes in local unemployment and UI/EI regulations. Since provincial social assistance regulations for the working-age population have also changed in differing ways, they may also have experienced changes in social assistance benefit levels and accessibility. Since the poverty of children is determined by the poverty of their parents, child poverty outcomes are likely to have changed in different degrees in different provinces — and since the parents of very young children are likely to be the young adults who have been disproportionately affected by the labour market environment of the 1990s,<sup>14</sup> it seems useful to pay particular attention to the poverty of children under six.

Figure 3 examines changes in poverty intensity among people of different ages, in the different provinces of Canada from 1973 to 1994 and from 1994 to 1996. All figures embody the assumptions that: (i) family income is equally shared among all family members,<sup>15</sup> (ii) the OECD equivalence scale adequately captures the economies of scale in family consumption; (iii) the post-tax, post-transfer money income of the economic family measures family economic resources; (iv) the poverty line is drawn at one-half of the median equivalent income of all Canadians.<sup>16</sup> If these assumptions are granted, one can assign an equivalent income to each member of each economic family in the Survey of Consumer Finance,<sup>17</sup> and calculate the poverty intensity, rate of poverty and average poverty gap for four age groups: all persons aged 0 to 6, 0 to 17, 18 to 64, and 65 or over.

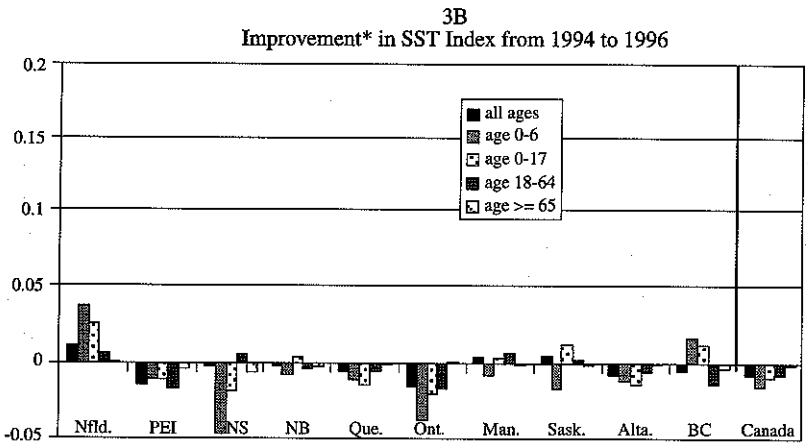
Figure 3A is consistent with the picture already painted in Figure 2: over the 21-year period, 1973-94, with the exception of British Columbia, all demographic groups in all provinces experienced a decline in poverty intensity. Notably, in all provinces other than Prince Edward Island and Newfoundland, the improvement for senior citizens was both greater than that for other demographic groups and much more uniform across provinces, possibly reflecting the greater federal role in old age security.

However, Figure 3B indicates a general trend since 1994 to stable or worsening poverty intensity. Although there has been little change in the poverty intensity of senior citizens, there have been especially large increases in poverty intensity among very young children in Ontario and Nova Scotia. And,

**Figure 3: Improvement in SST Index – All Provinces**



\*Change in SST Index [1973-1994]



\*Change in SST Index [1994-1996]

**Notes:**

Poverty Line=1/2 Median Equivalent Income—After Taxes and Transfers

Equivalence Scale=OECD (first adult=1, other adults=0.7, kids=0.5)

Poverty Line set at 1/2 the median equivalent income of economic families.

Source: Author's calculations from SCF.

although there has undoubtedly been an increase in the level of rhetorical concern with child poverty in recent years, the net effects of the actual policy measures adopted (e.g., the 21 percent cut in October 1995 in social assistance payments in Ontario) have not been consistent with that rhetoric. The increase in the poverty intensity from 1994 to 1996 among children under six in Canada's largest (and richest) province is especially notable.

### LIKELY FUTURE TRENDS

The future trend of poverty outcomes in Canada will undoubtedly be affected by trends in household composition and stability, the ups and downs of aggregate demand in low-wage labour markets, and the impacts of regulatory, market, and technological changes on labour market structure and institutions. However, trends in social transfers are always particularly important for those who cannot rely on an adequate and stable stream of earnings. In thinking about likely future trends in poverty intensity in Canada, there is no escaping the central role of the adequacy of transfer payments.

Unlike some other federations (e.g., Australia), there is in Canada a substantial degree of divergence across provinces in pre-transfer/pre-tax poverty intensity. In the Canadian context, there is, in a sense, more for the federal government to do, if there is to be some commonality across provinces in citizenship rights and poverty outcomes, after taxes and transfers. However, there is no mistaking the direction of the political winds in the immediate future. The official opposition and the governments of the two largest provinces unite in the proposition that the federal government should play a diminished role in the tax/transfer system and in social policy, which is more or less the direction in which federal policy has moved in the last five years anyway. Provincial governments have been observed making rhetorical commitments to something called a "social union" but this appears to be code for restricting federal powers to impose conditions in cost-shared programs or to initiate federal social policy initiatives — the federal-provincial agreement on the social union is notably without any specific constraints on provincial decisions.<sup>18</sup>

Longer term trends can be decomposed into cyclical and secular components. Federal institutions (i.e., the Bank of Canada and the Department of Finance) retain sole control over monetary and fiscal policy in Canada, but the distribution of fiscal risk from business cycle fluctuations has shifted significantly in recent years. During the recessions of the early 1980s and 1990s, the federal government shared in the costs of cyclical downturn through its responsibility for unemployment insurance, and the cost-sharing of social assistance under the Canada Assistance Plan.<sup>19</sup> In those recessions, the vast majority of the unemployed got UI (paid for by the federal government) and



those who ran out of UI could sometimes go on social assistance, for which the federal government paid 50 percent of the cost.

In the late 1990s, the situation is fundamentally different. A minority of the unemployed are eligible for EI and any increase in social assistance costs produced by a downturn in labour demand will be entirely borne by provincial treasuries. The shift to block funding of transfers to the provinces embodied in the CHST means that the federal government's participation in increased social assistance payments in a recession is now zero. Demands on the social assistance system are likely to be more sensitive to future business-cycle downturns because the dramatic decline in eligibility for unemployment insurance payments under EI<sup>20</sup> means that provincial social assistance programs will be called on to carry the burden earlier, and to a far greater degree, than in past recessions.

Furthermore, in addition to "recession proofing" its own fiscal situation at the expense of the provinces, the federal government has backed away from its commitment to the macroeconomic stabilization of output and employment, preferring a commitment to "price stability," with concomitant greater likelihood of output and employment fluctuations.<sup>21</sup> Aggregate cyclical risk has grown, and the provinces now have a greater share of that higher risk.

Provincial revenues from sales tax and income taxes are clearly vulnerable to downturns in the business cycle: with the added wrinkle in Atlantic Canada that Newfoundland, Nova Scotia, and New Brunswick have, by replacing their provincial sales tax with the Harmonized Sales Tax, surrendered control of both the rate and the definition of the tax base of one of their major revenue sources.<sup>22</sup> In some provinces explicit legislation now ties governments to a balanced budget and in all provinces there is heightened political sensitivity to budget deficits. Hence, provincial expenditure cuts are a likely response to any future recession. Of the four main headings of provincial government expenditure (health care, education, debt payments, and social assistance), social assistance is clearly the most vulnerable, since debt-servicing is sacrosanct, and there are broad and powerful coalitions supporting health and education. There is thus reason to believe that the poor are increasingly at risk in any future economic downturn.

During the 1930s, the inability of the provinces to cope with the fiscal burden of the Depression led to serious re-examination of federal-provincial relations, which ushered in an era in which federal macroeconomic policy aimed at minimizing downturns in output and employment, and federal programs shared the burden of cyclical downturns. That policy regime has now been substantially dismantled, but nearly 60 years ago the Rowell-Sirois Commission expressed fairly clearly its rationale:

The quality of education and welfare services is no longer a matter of purely provincial and local concern. In Canada today, freedom of movement and equality of opportunity are more important than ever before, and these depend in part

on the maintenance of at least minimum national standards for education, public health and care of the indigent. The most economically distressed areas are the ones least capable of supporting these services, and yet are also the ones in which the needs are likely to be greatest. Whether the remedy lies in emigration from these areas or in the development of alternative means of livelihood, they must not be allowed to become backwaters of illiteracy and disease. Not only national duty and decency, if Canada is to be a nation at all, but equity and national self-interest demand that the residents of these areas be given average services and equal opportunities — equity because these areas may have been impoverished by the national economic policies which enriched other areas, and which were adopted in the general interest. Those whose interests were sacrificed have some claim that the partnership should work both ways. National self-interest demands it because the existence of areas of inferior educational and public health standards affects the whole population, and creates many grave and dangerous problems. More fortunate areas cannot escape the pressure on their standards and the effect on their people; in this case prevention, in both fiscal and human terms, is much cheaper than the cure.<sup>23</sup>

However, it is not clear that these lessons have been remembered.

In the new millennium, business-cycle fluctuations will interact with longer term secular trends in determining the degree of redistribution in Canada's tax/transfer system. Fundamentally, such redistribution is driven by a political sense of common membership in a national community (as Rowell-Sirois put it: "If Canada is to be a nation at all") and some expectation of the appropriate degree of sharing of aggregate output. The longer term question is whether a sense of national community in Canada can survive the barriers of geography, political decentralization, Quebec nationalism, regional alienation, the louder voices of the global entertainment industry, and the pervasive marketization of social policy. The issue is clearly somewhat circular, since the saliency of common institutions and the objective reality of a common situation underpin political support for pan-Canadian redistribution, and a decline in federal programs and an increase in the objective differences in outcomes between provinces undermines both, thereby accentuating the trend to greater provincialism.

Within the last three decades, two different patterns have been observed in Canada. In 1971, Canada had a similar overall level of poverty intensity as the United States and because pre-transfer poverty levels differed and because different tax and transfer systems were in place in different Canadian provinces, the provinces differed considerably in ultimate post-fisc poverty outcomes. In 1994, Canada had, overall, much less poverty than the United States and much greater commonality than in 1971 in the level of post-tax/transfer poverty intensity — the operation of the tax and transfer system meant that despite differing levels of pre-transfer poverty, Canadians in all provinces had in the end a much more similar chance and depth of poverty. In 1971, one could hardly say that there was a social union, but in 1994 a practical social union was in existence.

## CONCLUSIONS

Which scenario is more likely for the future?

Who cares?

On balance, there would seem to be more likelihood than not that the federal role in social policy will continue to shrink and that poverty outcomes will continue to trend up and to diverge across provinces. The rhetoric of social union may continue, but not the reality — at least for those under 65. The direct impacts will clearly be felt primarily by the poor, who are a minority of society, with very little political influence, and among senior policymakers there may well be a diminished sense that this matters much.<sup>24</sup>

My own opinion is that this is a mistake. The prevalence and depth of poverty is of personal concern not only to those who are poor at any given time, but also to the much larger number who will experience a spell of poverty at some point in their lives, and to the even larger number who are anxious about their probability of poverty. Even those people who are certain that they will be affluent all their lives are affected, since growing poverty affects the general quality of urban life and undermines any residual sense of national community. Having a sense of a larger identity to belong to seems to be important to many people, including the securely affluent, and there are many economic costs to diminished social cohesion.<sup>25</sup> The maintenance of Canada's social union and an effective anti-poverty role matters, in many ways, but it is unclear whether current trends will continue or not.

## NOTES

Revised version of paper presented at the Symposium on Fiscal Federalism, Queen's University, Kingston, Ontario, April 16-17, 1999. I would like to thank Lynn Lethbridge for her excellent work as research assistant and the Social Sciences and Humanities Research Council for its support under Grant No. 410-97-0802. Thanks also to Jim Stanford and two anonymous reviewers for their helpful comments — errors remaining are my responsibility.

1. The Appendix discusses measurement issues. The main body of this chapter uses the common practice, in the international literature, of drawing the poverty line at one-half the median equivalent after-tax/after-transfer income of individual Canadians (where household economies of scale are assumed to be captured by the OECD equivalence scale). This measurement choice implies a significantly lower poverty rate (11.57 percent in 1994) than the use of the Statistics Canada Low Income Cut Off (15.9 percent in 1994). However, the issue this chapter focuses on is *trends* in poverty, which are much the same for all combinations of poverty lines and equivalence scales examined.

2. Note that "commonality" of poverty outcomes could be at either a high or low level of poverty. The issues of *whether* there is a social union, and *what type* of social union that may be, are analytically distinct.
3. Amartya K. Sen, "Poverty: An Ordinal Approach to Measurement," *Econometrica* 44 (1976):219-31. For surveys of the literature, see Aldi J.M. Hagenaaars, "The Definition and Measurement of Poverty," in *Economic Inequality and Poverty: International Perspectives*, ed. Lars Osberg (Armonk, NY: M.E. Sharpe, 1991), pp. 134-56; or B. Zheng, "Aggregate Poverty Measures," *Journal of Economic Surveys* 11, 2 (1997):123-61.
4. John Myles and Garnett Picot, "Social Transfers, Earnings and Low-Income Intensity Among Canadian Children, 1981-96: Highlighting Recent Developments in Low-Income Measurement," unpublished paper (Ottawa: Statistics Canada, 1999).
5. The Sen-Shorrocks-Thon (SST) index of poverty intensity can be calculated as  $I = (\text{rate}) * (\text{gap}) * (1 + G(x))$  where "rate" is the percentage of the population with incomes below the poverty line (sometimes called the head-count ratio), "gap" is the average percentage gap between the incomes of the poor and the poverty line and  $G(x)$  is the Gini index of inequality of the poverty gap among all people. In the main body of this essay, cash incomes are converted to "equivalent income" using the "OECD" equivalence scale ratios for households of different sizes. For further details on the SST index, and its trends over time in Canada, see Lars Osberg and Kuan Xu, "Poverty Intensity: How Well Do Canadian Provinces Compare?" *Canadian Public Policy/Analyse de Politiques* 25, 2 (1999):179-98; or Myles and Picot, "Social Transfers, Earnings and Low-Income Intensity Among Canadian Children, 1981-96." For international comparisons, see Lars Osberg and Kuan Xu, "International Comparisons of Poverty Intensity: Index Decomposition and Bootstrap Inference," Working Paper No. 97-03 (Halifax: Department of Economics, Dalhousie University, 1997). Also, Anthony F. Shorrocks, "Revisiting the Sen Poverty Index," *Econometrica* 63 (1995):1225-30.
6. The alternative point of view is that there is no such thing as "Canadian" society, and poverty norms should therefore be appraised with reference to local/provincial standard-of-living norms. Clearly, if this were the case, there would be no point at all in talking of a Canadian social union.

In this version of the essay, the poverty line norm adopted is one-half the median equivalent income of all Canadian individuals, since this concept of poverty has been widely used in the international literature and can therefore be compared to international data. A disadvantage of this approach is that it does not recognize the differences in the cost of living that accompany residence in urban and rural areas. The Statistics Canada Low Income Cut Off (LICO), which builds in city size and urban/rural cost of living differentials, is unique to Canada and cannot be directly compared internationally. For results using the LICO, or the "LIS" equivalence scale (which are essentially identical), see the full paper at <http://is.dal.ca/~osberg/home.html>.

7. The idea behind bootstrap estimation is that of experimenting (by multiple random resampling of the survey micro data) with the implications of drawing somewhat different samples, from which to calculate the characteristics of the population. See Osberg and Xu, "Poverty Intensity: How Well Do Canadian Provinces Compare?" and "International Comparisons of Poverty Intensity."
8. See David E. Card and Richard B. Freeman (eds.), *Small Differences that Matter: Labour Markets and Income Maintenance in Canada and the United States* (Chicago: University of Chicago Press).
9. As well, it should be emphasized that the United States is a clear outlier in poverty intensity, and it is not really that hard to look good compared to the worst. Compared to other developed countries, Canada in 1994 was at the high end of a continuum, with a similar level of poverty as Spain or the UK, but clearly greater poverty intensity than Belgium, the Netherlands or the Scandinavian countries; for more details, see Osberg and Xu, "International Comparisons of Poverty Intensity."
10. In Figure 2, the poverty line is set at one-half the median of the relevant income concept — before tax and transfer or after tax and transfers.
11. Osberg and Xu compare poverty intensity within Canadian provinces in 1984 and for each year from 1989 to 1996; see Osberg and Xu, "Poverty Intensity: How Well Do Canadian Provinces Compare?"
12. The new national child benefit system does allow provinces to reduce social assistance payments to families in receipt of child benefits if the money is being spent on related programs.
13. Osberg discusses trends from 1971 to 1994 in the poverty and inequality outcomes of different birth cohorts of Canadians, and emphasizes that because many senior citizens depend on the same transfer programs, many have much the same income. This "spike" in the income distribution of senior citizens means that the poverty rate among the over 65 cohort is sensitive to choice of poverty line; see Lars Osberg, "Economic Growth, Income Distribution and Economic Welfare in Canada 1975-1994," *North American Journal of Economics and Finance* 8, 2(1997):153-66.
14. Osberg, Erksoy and Phipps discuss the impacts of the greater risk exposure of the youth cohort in the 1990s, due to higher unemployment and less generous unemployment insurance; see Lars Osberg, Sadettin Erksoy and Shelley Phipps, "How to Value the Poor Prospects of Youth in the Early 1990s?" *Review of Income and Wealth* 44, 1 (1998):43-62.
15. Sharif and Phipps note that the measurement of child poverty levels in Canada is quite sensitive to intra-family sharing assumptions. If, in all provinces, there is the same degree of intra-family inequality, the level of child poverty will change but not the interprovince differences reported above. However, if there are substantial differences across provinces in social norms with respect to the degree of inequality with which family resources are shared, the conclusions of Figure 3 with respect to child well-being may need to be revised; see N. Sharif and

Shelley Phipps, "The Challenge of Child Poverty: Which Policies Might Help?" *Canadian Business Economics* 2, 3(1994):17-20.

16. Note that this methodology implies a lower poverty rate and poverty gap than the use of the Low Income Cut Off, since the LICO is higher than half the median: see Note 1 and Appendix Table A-1. However, the main body of this chapter uses one-half the median equivalent income as the poverty line to keep comparability with the international literature on poverty. See Appendix A of the full version of the paper at <http://is.dal.ca/~osberg/home.html> for calculations embodied using the Statistics Canada LICO as the poverty line and the corresponding equivalence scales.
17. Note that Figure 3 uses the Survey of Consumer Finance micro data directly, since 1994 is the most recent data for Canada available on the LIS. This necessitates a small change in definition from the poverty of households (LIS) to that of economic families (SCF): but there is no significant change in results. As well, 1971 is available in LIS but 1973 is the earliest SCF data available to us under the Data Liberation Initiative.
18. With the possible exception of residency-based policies which impede labour mobility, although the wording ["unless they can be demonstrated to be reasonable and consistent with the principles of the Social Union Framework"] would appear to have lots of room for interpretation.
19. In the 1990s' recession, federal participation in recessionary costs was greatly limited by the "Cap on CAP" which limited annual increases in Canada Assistance Plan transfers to Ontario, British Columbia, and Alberta to 5 percent — despite the fact that the recession hit Ontario hardest.
20. In 1997, the percentage of the unemployed receiving EI benefits was 25 percent. The beneficiary to unemployed ratio was significantly higher (at 42 percent), largely because a significant fraction of EI recipients work while on claim (and declare their earnings) and are therefore not counted as unemployed. The decline in UI/EI recipiency in the 1990s has been dramatic: the beneficiary-unemployed ratio in 1989 was 83 percent. See Human Resource Development Canada (HRDC), *An Analysis of Employment Insurance Coverage in Canada*, Research Paper No. W-98-35E (Ottawa: Applied Research Branch, HRDC, 1998), p. 56, Table 4.1.
21. See Federal Reserve Bank of New York, "Rigid Inflation Targetting Can Lead to Wide Swings in GDP Growth," *Research Update* (New York: Federal Reserve Bank of New York, July 1998).
22. Because federal transfers are either fixed sums per capita (CHST) or formula driven (equalization) and because the federal government retains control of the definition of the income tax base, the only major revenue parameter these governments now control is the provincial percentage rate of the income tax.
23. Canada. Report of the Royal Commission on Dominion-Provincial Relations (Rowell-Sirois), *Royal Commission on Dominion-Provincial Relations*, Book 2, *Recommendations* (Ottawa: Queen's Printer, 1940), p. 128.

24. See Frank L. Graves, Tim Dugas and Patrick Beauchamp, "Identity and National Attachments in Contemporary Canada," in *Canada: The State of the Federation 1998-99: How Canadians Connect*, ed. Harvey Lazar and Tom McIntosh (Kingston: Institute of Intergovernmental Relations, Queen's University, 1999), pp. 307-54.
25. A growing literature has begun to recognize the importance of social cohesion for economic growth; see Stephen Knack and Philip Keefer, "Does Social Capital Have an Economic Payoff?: A Cross-Country Investigation," *Quarterly Journal of Economics* (November 1997):1251-88. For a series of studies on the economic impact of social cohesion in a Canadian context, see Lars Osberg, *The Economic Implications of Social Cohesion* (Toronto: University of Toronto Press, forthcoming).

## **APPENDIX**

### ***Measurement Choices***

The issue of where to draw the poverty line has been much debated over the years.<sup>1</sup> The main body of this chapter uses the common practice, in the international literature, of drawing the poverty line at one-half the median equivalent after-tax/after-transfer income of individual Canadians (where household economies of scale are assumed to be captured by the OECD equivalence scale). By this criterion, 11.57 percent of the population were poor in 1994. In using one-half the median, the poverty criterion of this essay is conceptually similar to what is now called the Low Income Measure (LIM) by Statistics Canada, which sets the 1994 poverty rate at 14.7 percent.<sup>2</sup> The difference arises because the Statistics Canada LIM uses pre-tax, post-transfer income (while we use after-tax, after-transfer income), calculates the median across households (we take the median across individuals), does not exclude people with negative incomes (we do), counts children as those under 16 (OECD uses 18), and uses an equivalence scale with much greater economies of scale in which additional adults count for 0.4 adult equivalents (OECD uses 0.7), and children count as 0.3 (OECD uses 0.5). By the more widely known (in Canada) Low Income Cut Off or LICO criterion, the poverty rate (after tax) was 15.9 percent in 1994 and 17 percent in 1996. See Table A-1 for the dollar values that correspond.

The sensitivity of the poverty rate at a point in time to the exact measure of the poverty line chosen is symptomatic of the ambiguity of definition of poverty for those just at the margin.<sup>3</sup> However, trends over time among the non-elderly, and the conclusions of this chapter, are not sensitive to these measurement choices. Because the dependence of many senior citizens on the same transfer programs implies that many have much the same (low) income, and because that "spike" in the income distribution of senior citizens lies between the LICO and one-half the median in 1994, poverty measurement among the over 65 cohort is more sensitive to measurement choices.<sup>4</sup>

Table A-1 presents the dollar values of the poverty line, in 1994 and 1996, which correspond to the conceptual choice of "Low Income Cut Off" or "one-half the median equivalent individual income" as the poverty line. Although these two conceptual choices generated much the same dollar poverty line for a four-person family in the late 1980s, they have diverged since then. In the period 1990-96, average real family income has fallen since consumer prices have risen faster than family money incomes. Because the LICO has been updated by the increase in consumer prices, while a poverty line drawn at one-half the median increases with family incomes, the LICO is now significantly higher than "one-half the median."



However, a major advantage of using the one-half the median equivalent individual income concept to draw the poverty line is the possibility of making international comparisons. An earlier version of this chapter (available on the web at <http://is.dal.ca/~osberg/home.html>) presented the numbers that correspond to Figures 2 and 3 in the text. The advantage of using the LICO is that it builds in consideration of the cost-of-living differences that go with residence in different urban or rural settings.<sup>5</sup> The disadvantage is that international comparability is lost, since the LICO methodology is unique to Canada.

In the international literature on equivalence scales, reference to the "LIS" scale is increasingly seen. This refers to the hypothesis that the number of equivalent adults in a household should be calculated as the square root of the number of household members. Are the results in the main body of the text sensitive to our use of the "OECD" equivalence scale? Figini notes that "OECD and other two-parameter equivalence scales empirically used show a similarity of results [in measurement of inequality] to one parameter equivalence scales with elasticity around 0.5,"<sup>6</sup> but that leaves open the possibility that in poverty-intensity calculations there may be differences due to equivalence scale choice. The paper posted on the Website presents the results obtained with the LIS equivalence scale, which are essentially identical to those in the main text.

## NOTES

1. For surveys, see Hagenaaars, "The Definition and Measurement of Poverty"; or Anthony B. Atkinson, *Poverty in Europe* (Oxford: Blackwell Publishers, 1998).
2. Statistics Canada, *Low-Income Measures (LIMs) 1996*, Catalogue No. 13-582-XPB (Ottawa: Household Surveys Division, Statistics Canada, 1998), p. 17.
3. See Michael C. Wolfson and J.M. Evans, *Statistics Canada's Income Cut Offs: Methodological Concerns and Possibilities: A Discussion Paper*, Research Paper Series No. 23 (Ottawa: Statistics Canada, 1989); and K. Short, T. Garner, D. Johnson and P. Doyle, *Experimental Poverty Measures: 1990 to 1997*, US Census Bureau, Current Population Reports, Consumer Income No. P60-205 (Washington, DC: Government Printing Office, 1999).
4. See Osberg, "Economic Growth Income Distribution and Economic Welfare in Canada 1975-1994."
5. The difference in housing costs between Metro Toronto and rural Ontario (or rural Nova Scotia) is a clear example of the importance of urban size to cost of living and since provinces differ in the relative importance of urban and rural areas, these have the potential to influence interprovincial comparisons. Note that interprovincial differences in cost of living, controlling for urban size, are much smaller than urban size differentials in cost of living.
6. Paolo Figini, "Inequality Measures, Equivalence Scales and Adjustment for Household Size and Composition," paper presented at the general conference of the International Association for Research in Income and Wealth, Cambridge, 1998, p. 2.

Table A-1: Poverty Lines – After-Tax LICO and one-half the Median Equivalent Income (OECD scale)

1994 # in household	Low Income Cut-Offs						1/2 Median Equivalent Income (OECD scale)		
	Urban			Rural			1 adult	2 adults	3 adults
	> = 500,000	100,000-499,999	30,000-99,999	< 30,000					
1	13,635	11,486	11,309	10,333	8,940	8,332	—	—	
2	16,638	14,014	13,798	12,609	10,908	12,498	14,164	—	
3	21,043	17,726	17,452	15,948	13,797	16,664	18,330	19,997	
4	26,209	22,077	21,736	19,862	17,184	20,830	22,496	24,163	
5	29,294	24,675	24,293	22,199	19,206	24,996	26,662	28,329	
6	32,378	27,273	26,851	24,537	21,229	29,162	30,828	32,495	
7 (or more-LICO)	35,462	29,871	29,408	26,874	23,252	33,328	34,994	36,661	
8	—	—	—	—	—	37,494	39,160	40,827	
1996									
1	14,240	11,996	11,811	10,792	9,337	8,590	—	—	
2	17,376	14,637	14,411	13,169	11,393	12,885	14,603	—	
3	21,977	18,513	18,227	16,656	14,410	17,180	18,898	20,616	
4	27,373	23,058	22,701	20,744	17,947	21,475	23,193	24,911	
5	30,595	25,771	25,372	23,185	20,059	25,770	27,488	29,206	
6	33,816	28,484	28,044	25,627	22,172	30,065	31,783	33,501	
7 (or more-LICO)	37,037	31,198	30,714	28,067	24,285	34,360	36,078	37,796	
8	—	—	—	—	—	38,655	40,737	42,091	

Sources: Statistics Canada – Catalogue 13-592-XPB. Survey of Consumer Finance, author's calculations.



# III

## Federal- Provincial Taxation Issues

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## The Tax on Income and the Growing Decentralization of Canada's Personal Income Tax System

Geoffrey E. Hale

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*Le récent accord fédéral-provincial qui permet aux provinces de prélever l'impôt sur les particuliers comme un «impôt sur le revenu» plutôt qu'un pourcentage de l'impôt fédéral de base provoquera sans doute les plus importants changements qu'a connu le système fiscal canadien au cours des trente dernières années. Ce chapitre analyse les changements proposés aux systèmes fiscaux provinciaux en fonction de la décentralisation des politiques fiscales et économiques canadiennes. Il présente les facteurs qui contribuent aux divergences entre les provinces en matière de politique fiscale de même que la dynamique et le contenu des réformes fiscales ou des réductions d'impôts proposées, à ce jour, dans cinq provinces: l'Alberta, la Saskatchewan, le Manitoba, l'Ontario et Terre-Neuve.*

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The recent federal-provincial agreement to allow provincial governments to redesign their personal income tax systems within specific limits promises to trigger the most significant changes to the Canadian tax system since the signing of the 1962 federal-provincial tax collection agreements and the federal tax reform bill of 1971.

Federal acceptance of the so-called "tax on income" proposal put forward by five provinces in December 1997 promises to accelerate what Dyck and Dahlby have called the continuing "provincialization of the Canadian fiscal system," while preserving a common personal income tax base and a shared tax collection system as central elements of the Canadian economic union.<sup>1</sup> These changes reflect several trends in federal-provincial fiscal and economic relations:

- the growing decentralization of fiscal and economic policies in Canada as provincial governments pursue a range of different economic

strategies in response to growing regional and international competition, and the different agendas arising from very different provincial political cultures;

- the growing use of the tax system as a vehicle for policy innovation in response to changing economic and social conditions;
- the federal government's efforts to accommodate a growing diversity in provincial economic and social arrangements, while attempting to maintain its own leadership role in economic and fiscal policy; and
- growing interprovincial competition, especially at a regional level, for investment, employment, and skilled workers.

This chapter examines the changes that have been proposed to provincial income tax systems in the wake of the revisions announced in 1998 to the federal-provincial tax collection agreements. It addresses these changes in the context of the ongoing decentralization of Canadian fiscal and economic policies, factors contributing to divergent provincial fiscal and tax policies and the dynamics of federal-provincial relations. Finally, it reviews the dynamics and contents of tax reform and/or tax-reduction proposals that have emerged to date in five provinces: Alberta, Saskatchewan, Manitoba, Ontario, and Newfoundland.

## THE TREND TO FISCAL DECENTRALIZATION

The re-emergence of the "tax on income" model, which enables provincial governments to design rate structures for their provincial income tax (PIT) systems independently of the federal PIT structure while maintaining a common definition of income and a unified system for tax administration and collection, reflects a broader trend toward the decentralization — or "provincialization" — of Canadian fiscal policy since the 1970s.<sup>2</sup>

The rapidly growing cost of provincial welfare states, and of related federal transfers to the provinces, has repeatedly forced Ottawa to introduce changes to its fiscal arrangements with the provinces in order to maintain some degree of control over its own fiscal priorities. The introduction of the Established Programs Financing program in 1977 was accompanied by a shift in personal and corporate income tax points intended to make provincial governments, at least those of the wealthier provinces, more fiscally self-sufficient by enabling them to finance a larger portion of their overall spending from their "own-source" revenues.

As a result, aggregate provincial government revenues (including federal transfers) have exceeded those of the federal government for more than 20 years, and provincial revenue sources have continued to grow marginally faster

than those of the federal government.<sup>3</sup> Whether or not greater provincial self-sufficiency — a rather elastic concept subject to different interpretations — has been achieved is open to question. However, the decline of federal transfers as a percentage of provincial revenues (in most provinces) and the increasingly diverse political and economic priorities of provincial governments have contributed to a growing decentralization of fiscal policies. (See Table 1.)

These changes have done little to mitigate tax competition between the federal and provincial governments. As both senior levels of government share most major sources of revenues, the integration of federal and provincial tax systems makes each vulnerable to unilateral policy shifts by the other. Although the gradual broadening of the federal tax base following the partial deindexation of personal income taxes in 1985 allowed the provinces to reap windfall revenues, most provinces moved rapidly to offset the tax cuts introduced as part of the Mulroney government's tax reforms of 1987-88 by raising their own tax rates. In its turn, the federal government responded to the growth of provincial payroll and capital taxes, which cut into its own tax base, by warning the provinces that future increases in these areas would not be deductible from federal taxes. It also imposed the so-called "cap on CAP," which limited the growth of federal support for rapidly growing social assistance programs in Ontario, Alberta, and British Columbia.

**Table 1: Federal Transfers as a Percent of Provincial Revenues**

	1980-81	1989-90	1994-95	1997-98	1998-99
Canada	23.3	20.6	20.5	14.9	15.6
Newfoundland	49.4	48.7	48.3	52.1	49.1
PEI	50.6	44.4	40.9	37.1	52.5
Nova Scotia	47.9	40.5	42.6	39.5	39.3
New Brunswick	43.2	39.7	37.8	37.1	37.5
Quebec	26.6	21.3	20.3	14.3	17.5
Ontario	20.1	13.0	16.5	9.7	8.2
Manitoba	42.4	36.0	36.4	32.8	26.2
Saskatchewan	17.5	29.6	24.8	10.7	16.9
Alberta	8.3	15.1	11.9	6.6	7.9
British Columbia	18.0	15.5	12.6	9.1	10.5

Source: Canada, *Fiscal Reference Tables* (Ottawa: Department of Finance, 1999); Nova Scotia, *Budget Highlights*, 14 October 1999.

These conflicts of the late 1980s and early 1990s, combined with the federal government's huge structural deficit and rapidly growing debt, undercut the federal government's ability to provide effective leadership in fiscal policy, reinforcing the Bank of Canada's already strong bias toward restrictive monetary policies and contributing to the length and severity of the recession of the early 1990s.<sup>4</sup> They help to explain federal Finance officials' caution in accommodating provincial proposals to exercise greater control over their own tax systems and their reluctance to accommodate proposed provincial innovations through the federal-provincial tax collection agreements — both in the early and mid-1990s.<sup>5</sup>

However, there have been two significant exceptions to this pattern. In 1985, federal Finance Minister Michael Wilson allowed his provincial counterpart in Saskatchewan to experiment with the introduction of a flat tax on net income — in effect, a form of provincial minimum tax applied on a relatively broad base. Manitoba and Alberta were allowed to follow suit in 1987. In 1996, Ottawa agreed to facilitate British Columbia's creation of a refundable child tax credit, in what became a prototype for the 1997 federal-provincial agreement leading to the introduction of the National Child Benefit.

Federal fiscal and tax policies during the Chrétien government's first term (1993-97) were characterized by a single-minded focus on the elimination of the federal deficit. The broader trend toward fiscal decentralization, or "provincialization," during this period was reinforced by Ottawa's decision to phase in reductions of its cash transfers to the provinces by almost 25 percent in return for giving the provinces greater flexibility in applying the new Canada Health and Social Transfer (CHST) to their fiscal priorities.

However, since balancing its budget in 1997-98, the federal government has pursued a very different approach to its relations with the provinces, negotiating specific general and bilateral agreements with provinces to link increased transfer payments to the achievement of specific federal objectives. This approach reflects the federal Liberals' clearly expressed desire to increase their political credit for tax and spending measures with Canadians, while maximizing the flexibility of the federal Department of Finance in balancing the political and economic demands of the government's broadly-based political coalition.<sup>6</sup>

While most provinces anticipated or paralleled the fiscal policies of the federal government in reducing their budget deficits and moving toward balanced budgets at different rates after 1993, they adopted very different paths in moving toward these goals.

## DIVERGING PROVINCIAL FISCAL POLICIES

The decentralization of Canadian tax policies since 1997 has resulted from more than just the federal government's declining political leverage over the

larger and wealthier provinces. It also reflects the growing diversity of provincial economies and the lack of synchronization among provincial economic cycles as by-products of Canada's integration into the continental and global economies.<sup>7</sup> These have resulted in very different political responses from province to province based on four major factors:

- the emergence of widely differing strategic visions for provincial economic development — and the role of provincial governments in these “province-building” strategies;
- the countervailing pressures of regional economic competition, both in tax levels and the levels of services provided by governments;
- the effects of different electoral cycles, often involving the tightening of fiscal constraints immediately following an election and a combination of increased spending and actual or promised tax reductions closer to an election; and
- the relative dependence of individual provinces on federal cash transfers, and their differing capacities to insulate themselves from their decline over the long term (see Table 1).

#### DIFFERENT APPROACHES TO ECONOMIC DEVELOPMENT

Province-building is not a new phenomenon in Canada. However, Canada's growing integration into the continental and global economies has contributed to a much stronger external orientation among most provincial economies. Most provinces now export more to other countries than to other parts of Canada. International exports now account for 41 percent of Canada's gross domestic product — ranging from a high of 52 percent in Ontario to a low of 30 percent in British Columbia.<sup>8</sup>

Virtually all provincial governments have sought to diversify their provincial economies, and to develop provincial economic strategies emphasizing regional comparative advantages. Some provinces, particularly New Brunswick, Quebec, and British Columbia, have sought to attract or retain business investment with a variety of incentives that can withstand challenges under World Trade Organization and North American Free Trade Agreement rules. Others, notably Ontario and Alberta, have significantly reduced their business subsidies, and sought to make their provincial tax systems more competitive with those of neighbouring American states and other international competitors.

Several provinces, particularly New Brunswick, British Columbia, Alberta, Prince Edward Island, and more recently, Ontario, have centralized control over property taxes levied to finance primary and secondary education costs. In most cases, this has been intended to balance greater budgetary control over provincial education costs, equity in funding between urban and rural



areas and, in some cases, the perceived need to limit the growth of property tax rates in the name of economic development.<sup>9</sup> Many of these changes were closely linked to budgetary pressures as provincial governments struggled to balance their budgets in the mid-1990s.

Most provinces, regardless of ideological outlook, have taken steps both before and during the 1990s to reduce tax rates for lower income taxpayers, raise the income thresholds at which provincial income taxes are applied, and increase the progressivity of their provincial tax systems. These changes were usually justified on the grounds of fairness — particularly in sharing the burdens of deficit and debt-reduction policies introduced by most provinces during the early and mid-1990s. However, the extent and rapidity of tax reduction have been closely tied to the political outlooks of individual provincial governments and their relative emphasis on promoting private sector wealth creation rather than income redistribution and the extension of public services.

#### DIFFERENT ROADS TO BALANCED BUDGETS

Both federal and provincial governments faced massive deficits at the end of the 1991-92 recession. Provincial deficits totaled \$26.3 billion on a financial management system basis,<sup>10</sup> about 3.8 percent of GDP. Managing deficits and balancing budgets became the central priority of virtually all provincial governments for the next several years — although they approached this challenge in several different ways.<sup>11</sup>

British Columbia, Newfoundland, New Brunswick, and Quebec limited spending growth at different times between 1992-93 and 1996-97, or made modest spending reductions, hoping to take advantage of economic growth to balance their budgets. Manitoba and Alberta made significant spending reductions, while avoiding tax increases. Saskatchewan and Nova Scotia combined significant spending reductions with “deficit-reduction” tax increases. After the 1995 provincial election, Ontario cut both spending and taxes in a bid to stimulate economic growth and reduce the direct role of government in the economy and society. (See Table 2 for provincial spending trends.)

Most provinces also used their deficit-reduction campaigns to restructure their tax systems, both by changing rate structures and the mix of various revenue sources. Most increased the progressivity of their provincial tax systems — adding a variety of surtaxes on middle and/or upper income earners. Five provinces have reduced their basic personal tax rates below 1988 levels (see Table A-1). Top marginal tax rates in all ten provinces, including federal and provincial surtaxes, are higher than they were in 1988, although these increases have been rolled back somewhat in most provinces since 1995 (see Table 3).

**Table 2: Provincial Spending Trends, Real per Capita Spending (FMS, \$1998)**

	1992-93	1996-97	1998-99	1992/93-96/97	1996/97-98/99	1992/93-98/99
	1998 Constant Dollars			%		
<b>Increased spending</b>						
BC	6,407	6,573	7,473	+ 2.6	+13.7	+16.6
Nfld.	6,796	6,549	7,073	- 3.6	+ 8.0	+ 4.1
<b>Modest spending reductions</b>						
NB	6,640	6,539	6,590	- 1.5	+ 0.8	- 0.8
Que.	6,940	6,636	6,784	- 4.4	+ 2.2	- 2.3
Prov. average	6,533	6,043	6,241	- 7.5	+ 3.3	- 4.5
<b>Significant spending cuts</b>						
PEI	6,751	6,222	6,336	- 7.8	+ 1.8	- 6.1
Ont.	5,957	5,417	5,464	- 9.1	+ 0.9	- 8.3
Man.	6,855	6,196	6,191	- 9.6	- 0.1	- 9.7
NS	6,301	5,443	5,816	-13.6	+ 6.8	- 7.7
Sask.	6,937	6,017	6,318	-13.3	+ 5.0	- 8.9
Alta.	7,148	5,730	5,666	-19.8	- 1.1	-20.7

Source: Statistics Canada, "Provincial and Territorial General Government Revenue and Expenditure," *Public Sector Finance, 1995-1996*, Cat. No. 68-212 (Ottawa: Statistics Canada, 1999).

**Table 3: Personal Income Taxes – Top Marginal Tax Rates by Province (in percent)**

	1988	1995	1999
Newfoundland	47.3	51.3	52.9
Prince Edward Island	47.7	50.3	49.5
Nova Scotia	46.3	50.3	49.2
New Brunswick	47.3	51.4	49.7
Quebec	51.1	52.9	52.1
Ontario	46.1	53.2	48.7
Manitoba	47.5	50.4	49.0
Saskatchewan	48.4	51.9	50.8
Alberta	44.9	46.1	45.2
British Columbia	44.8	54.2	52.3

After 1996, most provinces relaxed their controls on spending to some degree and introduced a series of modest tax reductions as a way of "rewarding" taxpayers for the sacrifices resulting from deficit reduction (see Table A-2). Ontario and Alberta were "outliers" in this process. The Harris government chose the path of fiscal stimulus through tax reductions to offset provincial spending cuts — implementing its promised 30 percent reduction in basic personal income tax (PIT) rates between 1996 and 1998. It also announced plans for a further 20 percent cut in PIT rates over four years before its successful re-election campaign of 1999, while continuing to project a balanced budget in 2000-01. The Klein government in Alberta followed the most consistent policy of fiscal constraint, deferring tax cuts and applying 75 percent of its sizeable surpluses — which averaged \$1.8 billion in the four years after balancing its budget in 1994-95 — to debt reduction.<sup>12</sup>

Arguably, the deficit- and tax-reduction strategies adopted by each government have tended to reflect its political philosophy and the political culture of each province rather than external economic pressures. For example, Ontario's high-profile emphasis on tax cuts before balancing its budget reflected as much of an ideological commitment to smaller, more frugal government as to increasing its economic competitiveness. Faced with a low tax regime in neighbouring Alberta, the Romanow government in Saskatchewan emphasized sales-tax reductions rather than lower income taxes after balancing its budget in 1994-95, while allowing overall provincial tax levels to grow relative to those of its neighbours (see Table 4). Quebec's decision to rely more on tax increases than spending reductions to balance its budget suggests that its social democratic political culture has greatly outweighed competitive pressures from Ontario's tax cuts in shaping the province's recent budgetary priorities.

While each government's political philosophy colours its budgetary priorities to some extent, these are also affected by the practical realities of the electoral cycle. Governments of all political stripes have tended to concentrate painful economic news in the early years of their mandates, while relaxing their purse strings (or in some cases, the rigours of proposed budget reductions) as the prospect of an election nears.<sup>13</sup>

Now that the federal and most provincial governments have balanced their budgets, both senior levels of government can look forward to a growing fiscal dividend of sorts. According to a study by the Royal Bank, the federal surplus could rise to about \$26 billion by 2004-05, compared to about \$16 billion at the provincial level.<sup>14</sup> Finance Minister Paul Martin's announcement of a multi-year personal income tax reduction plan, with incremental tax cuts averaging \$3 billion in each of the next five years, is likely to have a significant effect on provincial revenues in the absence of further changes to provincial income tax systems.

However, as both levels of government scramble to maximize their fiscal flexibility, as well as the political credit to be obtained from lower taxes and

**Table 4: Provincial Own-Source Revenues as Share of Gross Provincial Product**

	<i>Own-Source Revenues</i>					
	<i>As Share of Provincial GDP</i>			<i>As Percent of National Average</i>		
	<i>%</i>					
	<i>1992</i>	<i>1996</i>	<i>1998</i>	<i>1992</i>	<i>1996</i>	<i>1998</i>
Newfoundland	20.1	20.3	18.4	120	120	108
Prince Edward Island	19.9	19.4	18.3	119	115	107
Nova Scotia	16.4	16.1	16.2	99	95	95
New Brunswick	18.3	20.1	19.1	110	119	112
Quebec	20.0	20.1	21.2	120	119	124
Ontario	13.7	13.9	14.5	82	82	85
Manitoba	17.5	18.5	18.6	105	110	109
Saskatchewan	18.4	18.4	19.2	110	109	112
Alberta	15.8	14.8	14.8	95	87	87
British Columbia	18.9	21.6	20.0	113	128	117

Source: Statistics Canada, "Provincial and Territorial General Government Revenue and Expenditure," Cat. No. 68-212.

higher spending on public services, the federal government cannot reduce its taxes under the present system without reducing the flexibility of provincial governments to set their own political and fiscal priorities. To avoid this problem, provincial finance ministers have persuaded the federal government to allow them greater flexibility in managing their own tax systems.

This has led to the revival of provincial proposals from the early 1990s to decentralize the personal income tax system, giving the provinces (and territories) greater flexibility to manage their own tax systems by allowing them to set their own rate structures on a common definition of income — the so-called "Tax on Income" system.

#### THE REVIVAL OF THE "TAX ON INCOME" PROPOSAL

Like most ideas for tax reform, current proposals to provide provincial governments greater flexibility in the design of their personal income-tax systems reflect years of discussion and debate among federal and provincial government officials.<sup>15</sup>

The "tax on income" concept, or TonI as it is known among senior tax officials, is intended to allow the nine provincial governments which have participated in the federal-provincial tax collection agreements since 1962 to set their own tax rates and brackets on a common definition of taxable income, while continuing to contract with the federal government for the collection and administration of personal income taxes.

Federal and provincial finance ministers agreed in principle on the proposed change in December 1997, delegating responsibility for the details of the new system to a federal-provincial committee of senior officials, which issued its report in October 1998.<sup>16</sup>

This agreement reflects the broader trend toward the "provincialization" of fiscal policy discussed earlier by allowing provincial governments to design tax-rate structures more responsive to local political and economic conditions while maintaining several features of the present system that are central features of Canada's economic union.

1. a common definition of taxable income, to be defined by the federal government;
2. a core system of tax preferences and expenditures based on the federal definition of income, which provide a common base of entitlements to all Canadians and which help to maintain the coherence of fiscal policies;
3. maintaining the centralized collection of personal income taxes and source deductions, thus avoiding the creation of separate tax-collection bureaucracies in each province and increased administrative and compliance costs to employers and individual taxpayers; and
4. allowing the new Canada Customs and Revenue Agency, successor to Revenue Canada, to administer different provincial tax initiatives:
  - *free of charge* — if they mimic comparable provisions of the federal tax system,
  - *at their incremental cost of administration* — if somewhat different from comparable federal provisions, but still provided for within the tax-collection agreements, and
  - *at full cost recovery* — if outside policy harmonization agreements.<sup>17</sup>

These changes provide for a rationalization of provincial tax structures, which have become increasingly convoluted since the mid-1980s, as most provinces have introduced a series of surtaxes, flat taxes, and low income-tax credits in addition to the basic "tax on tax" levied as a percentage of federal income taxes payable (see Table A-1).

Several provinces, mainly in western Canada, sought to persuade the federal government to accommodate their revenue needs and differing tax policy objectives by allowing them to shift from the existing "tax on tax" system to a

"tax on income" system as early as 1987.<sup>18</sup> During the early 1990s, federal and provincial officials worked together to develop options for resolving technical issues. A joint Discussion Paper relating to these issues was released in 1991.<sup>19</sup> However, growing pressures of other issues, particularly those related to controlling federal and provincial deficits, and the strong opposition of many tax professionals and business groups side-tracked further action on the tax on income for several years.<sup>20</sup>

Provincial tax officials, especially in Alberta and Manitoba, continued to work out the details of a feasible tax on income proposal for much of the mid-1990s, although the proposal languished in the absence of political support.<sup>21</sup> One senior tax-policy observer, noting the effects of unilateral federal actions on federal-provincial relations during the period, commented that "if the provinces were not simply to be subject to the whims of the federal tax base and tax rates, they had to gain somewhat greater control over the provincial tax situation."<sup>22</sup> However, they also recognized the political and economic benefits to their citizens of maintaining a common tax base and a common tax-collection system with the federal government, including:

- a common definition of what constitutes income for tax purposes;
- a common set of deductions that recognizes the importance of certain expenditures such as child care expenses, medical expenses, education costs and retirement planning;
- a common definition of residency, ensuring that taxpayers will be taxed fairly; and
- a common tax administration, allowing provincial residents to file only one tax return and follow a common set of tax rules.<sup>23</sup>

When the tax on income proposal resurfaced in 1997, both political and financial conditions had changed. The federal government, having balanced its budget, could look forward to the prospect of lowering its income taxes, with a corresponding impact on provincial tax revenues. The tax on income proposal would allow the provinces to shield their tax bases against erosion by unilateral reductions in federal tax rates, and prevent them from using federal tax cuts as an excuse to raise their own tax rates as they had following federal tax reforms in 1987-89. If provinces took advantage of the new system to reduce taxes, Ottawa could use this as an excuse not to accommodate provincial demands for increased transfer payments — arguing that most provinces already enjoyed all the potential revenue sources necessary to finance their public services.<sup>24</sup>

Another factor that may have served as a catalyst for federal consent to the decentralization of tax policies was Ontario's implicit threat to withdraw from the federal-provincial tax-collection agreements and to set up a separate