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The Folly of Decentralizing the Canadian Federation*

It appears that it is not only economically sound and ethically desirable, but also possible, to dispense roughly the same fiscal treatment to similarly situated individuals throughout a federal country. (Graham 31)

I. Introduction

Nowadays we hear often that the solution to Canada's ongoing constitutional and economic malaise is to decentralize the federation, the implication being that if only the provinces had more responsibility and the federal government less, our problems would disappear.¹ Yet, what it is about decentralization that would be our salvation is never explicitly stated; at best it is only hinted at. Indeed, it is rarely made clear what decentralization actually means. In this paper, we explore from the perspective of an economist some of the implications that decentralization might have for the functioning of the Canadian federation. As is clear from the title, the view we are driven to by the logic of both economic and constitutional arguments is that, far from being a panacea, further decentralization will have adverse consequences.

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It is worth at the outset clarifying what might be meant by decentralization. It is a multi-faceted concept whose full meaning will only become clear as we proceed. Nonetheless, at the level of broad generality, we should distinguish among various concepts of decentralization. The first is *legislative decentralization*, decentralizing the responsibility for implementing programs of various sorts from Parliament to the provincial legislatures. Given that detailed legislative responsibilities are set out in the Constitution Act, some, though not all, of this requires constitutional amendment. There are some areas where jurisdictional boundaries either overlap or are not defined, and therefore that can readily be re-allocated between levels of government. Examples include transfer payments of various sorts, environmental policies, manpower training, tourism, and agriculture.

A second type of decentralization, and the one that we shall mainly focus on, is *fiscal decentralization*. This involves decentralizing the responsibility to spend and to raise revenues. The extent to which spending and taxing responsibilities are decentralized may differ. It is important to recognize that the degree of legislative decentralization is to some extent independent of the degree of fiscal decentralization. That is, decentralization of certain responsibilities to the provinces need not be accompanied by the corresponding amount of fiscal decentralization. Equivalently, the federal government can choose among varying degrees of fiscal decentralization with little or no change in the allocation of responsibilities between itself and the provinces. Indeed, that is the very essence of fiscal federalism. The division of fiscal responsibilities between levels of government is of crucial importance to the long-run economic functioning of the federation. Yet it is typically determined by annual budgetary decisions that have shorter term objectives as their goal. Deciding on the extent of fiscal decentralization relative to legislative decentralization involves resolving the tension between making legislatures more accountable both fiscally and politically versus maintaining the ability of the federal government to use fiscal levers to attain national objectives. The essence of the line of argument is that this tension has increasingly been resolved in favor of fiscal decentralization to the detriment of legitimate national objectives.

A third form of decentralization is *administrative decentralization*. This refers to the decentralization of the actual delivery of services,

implementation of regulations, making of transfer payments, collection of taxes, and so on. Administrative decentralization can be from one level of government to another, such as when provinces turn over to municipalities the responsibility for delivering social assistance. Or it can be from one bureaucracy to a lower level bureaucracy, with the upper level retaining some overall control. In any economy, some degree of administrative decentralization is necessary in the delivery of public services to persons and firms, and that fact is relevant in contemplating legislative or fiscal decentralization.

In evaluating economic arguments for decentralization, it is good to bear in mind some underlying criteria that we might think public-sector decision making ought to satisfy. Economists typically stress the efficiency and equity arguments for government intervention, albeit attaching differing weights to each. These are well documented in the literature.² The efficiency objective refers to the role of government as a fixer of market failures and a provider of those public goods and services whose need the private sector is unable to meet for one reason or another. The equity role refers to government's redistributive function. It encompasses three distinct dimensions: i) facilitating fairness of outcomes resulting from the market economy, ii) promoting equality of opportunities to participate in the market economy, and, related to both equality of outcomes and of opportunities, iii) providing social insurance to those who get a bad draw in life's lottery. It ought also to be recognized that the achievement of redistributive equity goals involves a myriad of instruments, ranging from the tax-transfer system, to the provision of public services, to various forms of social insurance. A scrutiny of what governments, both federal and provincial, actually do will reveal that addressing redistributive equity in the above senses accounts for the lion's share of public sector economic activity. *Government is largely an institution for redistribution*, a fact that is extremely important in evaluating arguments for decentralization.

The existence of political boundaries and decentralized legislative responsibility gives rise to two further refinements of efficiency and equity in a federation. The first is *efficiency in the internal economic union*, which refers to the unfettered and non-distorted freedom of movement of goods, services, labor and capital across provincial borders. Efficiency in the economic union also includes so-called *fiscal efficiency*,

the absence of incentives to locate in one province rather than another because of differential tax and/or public service levels rather than productive opportunities. The second is the notion of *fiscal equity* within the federation, a notion that John Graham helped to define and whose relevance for Canada he was one of the first economists to appreciate. Fiscal equity is a technical term that refers roughly to the idea that citizens ought to be treated comparably by the public sector regardless of where they reside. It is an extension of what economists call horizontal equity to a federal setting. The principle of fiscal equity implies not only that like persons be treated comparably in all provinces, but also that national norms of vertical equity should apply. These two concepts, efficiency in the economic union and fiscal equity in the economic union, are of critical importance to the issue of decentralization and we shall refer back to them frequently.³

Finally, before finishing with preliminaries, let us recognize that a lack of consensus exists among economists on the desired degree of decentralization, especially fiscal decentralization, in a federation. There are two fundamental differences in views that account for this. One is a difference in *values*, though one would not want to trivialize that difference as reflecting goodness or badness of economists. For whatever reason, some economists put more emphasis on efficiency relative to equity than others do. As a matter of logic, those that emphasize efficiency more tend both to argue for a more limited role for government and a more decentralized federation, the latter on the grounds that in a more decentralized federation governments are less able to engage in redistributive activities because of competition among lower-level jurisdictions for mobile labor and capital.

The other difference is in perception of the benevolence of government. At one extreme, some economists view government as benevolent in the sense of faithfully acting in what it believes to be the best interest of its citizens. At the other extreme, some view government as essentially self-serving or serving the will of a group of bureaucrats, lobbyists, wealth-owners, or whatever. In the middle, others think of government as being basically benign. Which of these is closest to the truth is more an empirical question than an ethical one, but it is an empirical question that is largely non-testable. Where one stands on this issue also colors views about decentralization. To those who have a dim view of government,

decentralization is a good thing essentially because decentralization serves to constrain the exercise of discretionary power by government.

II. The Setting

Let us now prepare to address the issue of decentralization by briefly characterizing some key features of the Canadian federal setting from three perspectives—the institutional setting, the constitutional setting, and the economic policy setting.

The Institutional Setting

The federal fiscal system consists of, first, a division of responsibilities, and, second, a system of fiscal arrangements. Though these will be familiar to most persons, let us summarize some of the stylized features of both.

The Division of Responsibilities

The division of responsibilities can be readily characterized. Consider the federal government first. On the expenditure side, only about one-quarter of its program spending is on goods and services.⁴ In the main, these are non-controversial, including such clearly national responsibilities as defence, foreign affairs and international assistance, management of the currency and criminal justice, as well as government operations. What is more relevant is the other three quarters of federal program spending that is on transfers. These are of three broad sorts—transfers to persons, which are dominated by unemployment insurance (now called Employment Insurance) and payments to the elderly; transfers to business, including payments to the agricultural sector and regional development expenditures; and transfers to the provinces, which we return to below. Two things are noteworthy about the pattern of federal government expenditures. First, they are largely redistributive in nature, given the sizable component of transfers, most of which serve redistributive objectives. Second, most goods and services spending is for national public goods. The federal government is not in the business of providing services to individuals, with the notable exception of those to aboriginal peoples. The federal government also has certain regulatory responsibilities, especially in goods and services markets (agriculture, transportation, com-

munications, fisheries, etc.). On labor and capital markets, federal regulatory powers are limited, exceptions being immigration and regulation of the banking system.

The expenditure pattern of the provinces and their municipalities is quite different than that of the federal government. Over three quarters of their program spending is on goods and services. They deliver most of the important public services to individuals, especially health, education and social services. These are coincidentally areas of rapid expenditure growth in the postwar years. But the neat dichotomy of the federal government as the provider of transfers and national public goods and the provinces as the providers of public services breaks down in one significant way. The provinces have assumed responsibility for welfare payments (social assistance), itself a large transfer program. Close to one fifth of their spending is on this program. Moreover, regulatory functions are somewhat confounded. The provinces have significant regulatory power in labor and capital markets, and share with the federal government the regulation of some areas like agriculture and the environment. These features of the federation—the provincial role in transfers to the poor and in regulation of factor and product markets— have implications for the efficiency and equity of the economic union. So does the responsibility the provinces assume for the management and taxation of resources like oil and gas, mining and forests on provincial lands.

The Fiscal Arrangements

Alongside the division of responsibilities, the set of fiscal arrangements governing the fiscal relations between levels of government is an indispensable part of any federation. The fiscal arrangements in Canada consist of several key components.⁵ One is the system of transfers from the federal to the provincial governments. These take two major, but interdependent, forms. The first is the Equalization program under which the federal government transfers funds unconditionally to the "have-not" provinces to make up for shortfalls in their tax capacity relative to a national norm. As we discuss later, the Equalization program is an essential policy instrument, though not necessarily the only one, for achieving fiscal equity in the economic union. The other transfers are those in support of specific types of provincial expenditures. These can range from shared-cost programs, like the now-defunct Canada Assistance

Plan (CAP) and the proposed day-care plan, to block transfers like those in support of health and postsecondary education under the old Established Programs Financing (EPF) program or the new Canada Health and Social Transfer (CHST). A common feature of these plans is that conditions are set that provincial programs must satisfy for them to be eligible to receive full funding.

A second component of the fiscal arrangements is the system of tax harmonization, in Canada the Tax Collection Agreements that serve to harmonize income taxes. In our federation, both levels of government have virtually full access to all the main tax sources—income taxes, sales and excise taxes, and payroll taxes. Under the Tax Collection Agreements, the federal government collects individual and corporation income taxes for participating provinces in exchange for an agreement to abide by the base and rate structure chosen by the federal government. This system has been highly successful and is held up as a model of income tax harmonization elsewhere in the world. Some such system of tax harmonization is an indispensable element of a federation with decentralized taxing powers that wants to maintain an efficient and equitable internal economic union. As well as being necessary for the sorts of reasons of economic efficiency that economists usually stress, it is also crucial for implementing a coherent system of federal-provincial transfers. For example, the design of the Equalization program based on a representative tax system requires that provinces have reasonably similar tax bases.

The final component of the fiscal arrangements, and arguably the least well-developed in Canada, is the collection of co-operative and consultative arrangements in areas of joint interest and overlapping jurisdiction. Thus, the federal government shares with some provinces various degrees of administrative responsibility for operating the immigration system. It manages with provincial participation the Canada Pension Plan (CPP). It confers on an ongoing and informal basis on various areas of mutual interest, such as agriculture, delivery of services to aboriginals, fisheries, and the environment. There have also been slightly more formal attempts to negotiate agreements among governments, the most notable of which is the recent agreement on eliminating interprovincial barriers to trade.

The upshot of all this is a federation that is fiscally very decentralized relative to other federations around the world, and is rapidly becoming

more so. In Canada, provincial expenditure responsibilities are far more extensive than elsewhere, and taxing powers are correspondingly greater. Moreover, the extent to which provinces are responsible for the regulation of factor and product markets virtually without constraint is quite unusual compared with most other federations. At the same time, the system of fiscal arrangements ensures that despite the decentralization of responsibilities to the provinces, the levels of public services that are offered are surprisingly similar across provinces, and provincial tax structures are relatively highly harmonized.

Some Stylized Facts

A few stylized facts will illustrate the extent to which fiscal decentralization has evolved over the last few decades in Canada. Consider the expenditure side of the budget first. In 1960, federal government program expenditures comprised about 15% of GDP. By 1992, this proportion had peaked at about 18%, before falling to 17% in 1994. As a result of recent deficit reduction policies, it is predicted to fall to a mere 12% before the turn of century. Furthermore, virtually all the rise in federal government expenditures prior to the 1990s could be attributed to increased transfer payments of various sorts. Federal government expenditures on goods and services actually fell from 6.3% of GDP in 1960 to about 4.3% in 1994.

Meanwhile, provincial and municipal government program expenditures rose from about 14% of GDP in 1960 to 24% in 1994, well above the federal level. And, all categories of provincial and municipal expenditures rose as a percent of GDP. Provincial government expenditures on goods and services rose from 2.6% to 9.6% of GDP, while provincial and municipal government expenditures on goods and services rose to 15.8% of GDP, over three times that of the federal government.

As a consequence of these changes, total federal program spending fell from being twice as large as that of the provinces at the beginning of the 1960s to being the same size at the start of the 1990s (and much less than provincial and municipal expenditures combined). If federal transfers to the provinces are excluded from federal expenditures, the ratio of federal to provincial expenditures falls from about 1.7 in 1961 to just over 0.8 by the early 1990s. The change in the ratio for goods and services expenditures is more striking, falling from about 2.5 to only 0.7 over the period.

The decline in federal dominance on the revenue side is even more pronounced. Over the last three decades, federal revenues rose slightly, from about 16% to about 16.8% of GDP, while provincial and municipal revenues went from less than 10% of GDP to over 20%. The federal government collected almost 2.5 times as much as the provinces from its own sources in 1961, but only 1.25 as much in 1994. It raised almost ten times as much direct tax revenue as the provinces in 1961, but only about 1.4 times as much in 1994. Similarly, it collected six times as much indirect tax revenue as the provinces in 1961, but only 1.6 times as much in 1994. Thus, the traditional dominance of the federal government in revenue raising, especially in the direct (income) tax field, is gradually being eroded.

And, while the provinces' taxation and expenditure responsibilities have grown relative to those of the federal government, they have also had to become more financially self-sufficient. Every province now obtains a much smaller proportion of its total revenues from federal transfers than it did two decades ago. However, the decline varies across provinces, as does the extent of reliance on transfers. At one extreme, Newfoundland's share of revenues obtained from transfers fell from 62% in 1970-71 to 43% in 1994-95, and that of Prince Edward Island from 62% in 1970-71 to 37% in 1994-95. At the other end, Ontario's share of revenues from transfers fell from 17% in 1970-71 to 15% in 1994-95, and British Columbia's from 18% to 11%. The share in two provinces, Manitoba and Saskatchewan, hardly fell at all.

Once the effects of the 1995 and 1996 federal budgets work themselves out, these declines in reliance on federal transfers will be much more dramatic. Transfers to the provinces have, in fact, accounted for a disproportionate share of federal deficit reduction. The ultimate consequence will inevitably be not just less provincial reliance on federal transfers, but also a higher share of tax room occupied by the provinces. Moreover, the proportion of federal transfers accounted for by Equalization will rise dramatically, while that of block and conditional transfers will virtually fade away.

Despite the fact that overall self-sufficiency has risen, the differential reliance on transfers across provinces remains pronounced. This reflects an important characteristic of Canadian fiscal federalism—the extent to which it is equalizing across provinces. Indeed, despite the decentraliza-

tion of fiscal responsibilities to the provinces, and the fact that this might be expected to induce considerable fiscal inequalities among them, the equalization system has so far succeeded in reducing disparities in provincial fiscal capacities to a remarkable degree. For example, the tax capacities of the "have-not" provinces rise to 98% of the national average by the system of federal-provincial transfers from as little as 60% before transfers for some of them.⁶ Whether this can continue to be the case as more and more is demanded of the Equalization system is an open question.

These dramatic reallocations in fiscal responsibilities between levels of government have happened without major changes in the assignment of functions. Rather they have occurred gradually over a long period of time because of a combination of rapid increases in the provision of the sorts of public services for which the provinces are responsible (health, education, welfare), and policy changes of the federal government, to which we return shortly. Of particular note is the fact that whereas prior to 1977 the major federal transfers in support of health and post-secondary education grew at the rate of growth of provincial expenditures, after 1977 they grew only at the rate of growth of GNP. And, given the deficit reduction policies of the current government, they are about to decline precipitously.

What ought to be appreciated in contemplating this enormous fiscal decentralization is the crucial role that the fiscal arrangements have played. They have enabled us to adjust to the sizable decentralization of fiscal responsibilities to the provinces in a way that has not yet jeopardized the efficient and equitable functioning of the Canadian economic union or common market. Our federal system until now has epitomized the three key features of an ideal federal system:

Harmonized Taxes. We have a highly harmonized income tax system, one that is used as an example for other federations ranging from industrialized countries to the transition economies of Eastern Europe to developing countries around the world, as well as for looser economic unions such as that of Europe.

Decentralized Public Services. The federation has evolved into one in which most major public services are decentralized to the provinces—with the associated benefits of efficiency and in-

novation of delivery, while at the same time, there is enough conformity in their design to satisfy general notions of efficiency and equity in the economic union. We have one of the most decentralized federations in the world.

Equal Access to Public Services. The level of public services that most Canadians have access to, and the tax burdens they are asked to bear is surprisingly uniform across provinces, despite the extent of decentralization.

In short, despite the gradual decentralization that has occurred, much of it without conscious design, our federal fiscal arrangements have allowed us to obtain the many benefits of decentralized public sector decision making while at the same time retaining the basic foundations of an efficiently operating internal economic union that satisfies certain national standards of equity. That is the essence of a well-functioning system of fiscal federalism. The issue is whether this can be retained under the sorts of further fiscal decentralization that are being proposed by many, including both the federal government and, less surprisingly, many of the provinces.

The Constitutional Setting

While this extensive decentralization has gone on without fundamental changes in the constitutional division of powers, it is nonetheless worth reminding ourselves both of the constraints and the obligations that the constitution sets out. One of the remarkable things about the Canadian constitution is the extent to which its terms coincide with accepted fiscal federalism principles, and in particular how it explicitly recognizes the responsibility the federal government has for national efficiency and national equity objectives. Some of the key features of the constitution are as follows.

The commitment to equalization. Section 36(2) of the *Constitution Act*, 1982 commits the federal government 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." This is precisely what economists refer to as fiscal

equity. While this may not legally bind the federal government, it nonetheless provides strong moral and political support to the sorts of equalizing fiscal programs that have characterized our federation since World War II.⁷

The joint responsibility for equity. Section 36(1) commits the federal and provincial government jointly to "a) promoting equal opportunities for the well-being of Canadians; b) furthering economic development to reduce disparity in opportunities; and c) providing essential public services of reasonable quality to all Canadians." This constitutes part of the vertical equity responsibility of the government, and is shared by both levels.

The exclusive provincial responsibility for health, education and social services. By the *BNA Act*, the provinces enjoy the exclusive right to legislate in the provision of health, education and social services, areas that are crucial for achieving the commitments set out in Section 36(1). I stress the word services, because the Constitution seems to restrict exclusive provincial responsibility to provision of services rather than the making of transfers. This has not been an issue in constitutional law, but from the point of view of social policy, the distinction between public services and transfers is a crucial one. It is important to recognize that in these and other areas of exclusive provincial jurisdiction, provinces are sovereign. Unlike in some federations, the federal government can neither instruct provinces on how to legislate nor can it strike down provincial laws. This limits severely the ability of the federal government to influence provincial legislative behavior.

The spending power. The use of the federal spending power legitimizes the ability of the federal government to make transfers of all sorts, including for equalization, conditional grants, and transfers to individuals and businesses. As such, it is the main instrument by which the federal government can address its responsibilities as outlined in Section 36, including those that must be implemented via provincial legislation, as well as other national equity and efficiency objectives, including interpersonal income redistribution as through the welfare system and the integrity of the internal

economic union. The spending power is an essential feature of the federal system, especially one with highly decentralized legislative responsibilities. I regard it as being an indispensable federal policy instrument. It is the *only* means by which the federal government can carry out the redistributive obligations that are legitimized by Section 36(1), especially those that can only be enacted through programs in exclusively provincial jurisdiction.⁸

Tax authority: The federal government has unrestricted use of the tax system (with the possible exception of the taxation of natural resources). At the same time, while the provinces are supposedly restricted to using "direct" taxation, this has not proven to be an obstacle to them using general sales taxes and excise taxes. As a result, the two governments co-occupy most major tax bases, a feature that is relevant for the federal government's role in both national equity and efficiency.

Pensions and unemployment insurance. By constitutional amendment, the federal government acquired the right to legislate in these areas. In the case of unemployment insurance, they assumed exclusive responsibility. However, in the area of pensions, there was to be joint occupancy, though with provincial paramountcy. The case of unemployment insurance may be particularly constraining since the economics of federalism might suggest that unemployment insurance be decentralized to the provinces.

Social Assistance. Though social assistance, or welfare, has not been constitutionally assigned to the provinces, it has evolved into a *de facto* provincial responsibility. Given that, any constitutional constraints that would otherwise apply to federal intervention presumably need not apply here. There are no sound legal or economic reasons why the federal government should not intervene in the provision of social assistance, either directly or through its spending power.

Internal economic union. While it is commonly agreed that maintaining efficiency in the internal economic union is an important national objective, it is nowhere explicitly stated in the *Constitution Act*, except to a very limited extent in Section 121 which rules out

interprovincial barriers to trade in goods alone and in the Mobility Rights section of the Charter of Rights and Freedoms. Efficiency in the internal economic union could be taken to be one of the natural components of Peace, Order and Good Government that is mentioned in the Preamble to Section 91 as a suitable objective for federal legislation. The desire to foster the internal economic union can lead the federal government to pursue policies that lead to the harmonization of provincial service provision so that provinces do not engage in wasteful and distortionary program competition with one another, or at least so that any negative consequences for the internal economic union from healthy interprovincial competition are offset. Again, the spending power is the only instrument available to the federal government for this purpose.

To my mind, these elements of the constitution both lend moral and political authority to and sanction the sort of fiscal arrangements that some economists, including John Graham, have argued are reasonable. For example, they specify that the provinces are legislatively responsible for designing and delivering most public services (with the notable exception of unemployment insurance). They commit the federal government in principle to fostering fiscal equity in the federation, and they recognize the joint responsibility of the federal government with the provinces for achieving objectives of equity through the delivery of public services. They also sanction the use by the federal government of instruments that would enable it to fulfil its constitutional and economic responsibilities for maintaining an equitable and efficient internal economic union. Of particular importance is the spending power and the unlimited power of taxation. In my view, the use of the spending power is the *sine qua non* of a legislatively decentralized federation. Its effectiveness is in great danger of being dissipated, partly through lack of will by policy makers, partly through lack of appreciation of its role in a federation, and partly through fiscal decentralization. The consequences of the latter will only be recognized when it is too late.

The Economic Policy Setting

Our constitution is a flexible one allowing for varying degrees of fiscal decentralization. In practice, the fiscal features of the federation are

shaped by economic policy. Several policy initiatives of the recent past have had, or will have, important implications for the operation of the federation. Many of them also have had, willy-nilly, significant decentralizing effects which, once implemented, are very difficult to reverse. This irreversibility is a cause for great concern because much of the fiscal decentralization that has gone on has not been a result of conscious decision making. Rather it has been an unintended side effect of policies undertaken with other goals in mind. There has been no one in government minding the fiscal federalism store. Some of the policy initiatives that are of particular relevance for fiscal federalism are as follows.

Deficit Reduction/Expenditure Control Measures. At several times in the past two decades, the federal government has reduced transfers to the provinces for purposes of expenditure control, either as part of anti-inflationary policy or to reduce the deficit. The dramatic cutbacks in federal-provincial transfers announced in the last two budgets are not new in that regard. They are merely a culmination of policies that have been gradually eating away at the system since EPF was introduced in 1977. Whatever its merits from a fiscal management point of view, targeting transfers to the provinces as an expenditure control device has cumulative longer term effects on the structure of federal-provincial fiscal relations.⁹ It irreversibly shifts the balance in taxing power to the provinces, thereby jeopardizing the ability of the federal government to take a lead in maintaining a system of harmonized direct taxes. As the provinces occupy a larger and larger share of the income tax room, the pressures for fragmenting the system increase. And, the reduction in federal transfers reduces the size of the vertical fiscal gap and may ultimately jeopardize the ability of the federal government to achieve national objectives through Equalization and the use of the spending power. Moreover, the devolution of fiscal responsibility to the provinces itself exacerbates fiscal capacity differences thereby putting more and more pressure on the equalization system.

Introduction of the Goods and Services Tax (GST). The GST was introduced for reasons that had little to do with federal-provincial fiscal relations. But it too may have a lasting incidental impact.

Most economists would agree that, as an indirect tax system, the GST is basically well conceived. However, from a federal-provincial fiscal relations perspective, it has some drawbacks. The main one is that, if the evidence from other countries is anything to go by, it is likely that the direct-indirect tax mix of the federal government will gradually change in favor of indirect taxation. This implies a reduction in federal share of occupancy of the income tax fields. This structural shift will compound the strains put on the system of income tax harmonization by fiscal decentralization and further reduce the ability of the federal government to achieve its national efficiency and equity goals. It is true that the federal government could buy harmonization with the provinces in the indirect tax field using the GST. However, such harmonization will be far from perfect. A fully harmonized GST involving the federal government and the provinces would be hard to achieve. As economists well know, it is very difficult to operate a multi-stage tax in a multi-jurisdictional system of government. Moreover, harmonization of sales taxes is much less important in a federation than harmonization of income taxes. For one thing, sales taxes are much less important as a device for redistribution and much less open to tax competition of the "race for the bottom" sort. For another, the sales tax base, by excluding capital income, tends to be less mobile among provinces than the income base that applies to capital income and businesses alike.

The Operation of the Tax Collection Agreements. When the Tax Collection Agreements were first entered into, the federal government was dominant in the income tax fields. As the provinces have become more important users of income tax, the system has come under increasing strain. One province, Alberta, has withdrawn from the corporate Tax Collection Agreements. Others have studied the option seriously, but have so far declined to take action despite dissatisfaction with their inability to pursue independent tax policies. The use of tax credits has increased rapidly at both the personal and corporate levels. Some of these credits seem clearly to affect the allocation of capital across provinces, such as venture capital and stock savings programs and various tax credits under the corporate income tax. The principle of a common base has

even been eroded, as Alberta, Manitoba and Saskatchewan received permission to introduce flat taxes on bases different from federal taxable income (i.e., net income). The tension seems to have arisen because of unilateral federal control over both the base and rate structure of the income taxes. As the provinces become more important in the income tax fields, they naturally want to use the income tax for provincial policy purposes, so these tensions are bound to increase.

Structural Changes with Equalization. The Equalization program has been regarded as a great success story in the eyes of many observers both in Canada and elsewhere. The main issue of concern for the future is how well it can continue to function in an increasingly decentralized federation. Decentralization entails greater differences in fiscal capacities and inevitably puts increasing pressure on the system. Reduced harmonization of provincial taxes makes it more and more difficult to administer a representative tax system of equalization. And, the federal government becomes less and less able to fund the program. From a structural point of view, the one feature of the program that would prevent it from evolving with the federation is the cap on its growth rate. In 1987, the rate of growth of the total equalization transfer was capped at the cumulative rate of growth of GNP. This cap, which is now binding, will become more and more so as time passes.

Conversion of Established Programs Financing (EPF) and Canada Assistance Plan (CAP) to the Canada Health and Services Transfer (CHST). The most recent policy change brought on by the imperative of deficit reduction combined with a convenient taste for fiscal decentralization was the folding in of the federal-provincial shared-cost program for welfare into the block EPF grant to become the CHST. The salient features of the CHST relative to the previous system are the loosening of the conditions on transfers for welfare, the significant reduction in the size of the transfer, and the decision to calculate the cash component of the CHST transfer as a residual after deducting the value of EPF tax points. Apart from perpetuating the silly and self-serving myth that tax points turned over to the provinces in 1977 still represent federal transfers, this

latter essentially would have guaranteed that the CHST transfer and the spending power that it represents will disappear early in the twenty-first century. The 1996 budget promises a floor below which the cash component will not be allowed to fall. Even assuming that commitment will be honored by succeeding governments, the size of the transfer is a mere shadow of itself. It is not clear that it is of sufficient size to provide the economic and political justification for using it effectively to achieve national objectives in all three areas of health, post-secondary education and welfare, let alone in other areas of national interest such as child-care. The federal government simply will not be able to carry out its share of the obligations set out in Section 36(1) of the Constitution Act.

Social Policy Reform. Of particular relevance for the state of fiscal federalism in Canada is the ill-fated desire of the federal government to initiate a general reform of social policies, ranging from unemployment insurance to welfare to education and training.¹⁰ What is remarkable about the first foray into the area in the form of the Axworthy Green Paper was the complete lack of recognition that a substantial proportion of the social policies being considered were in provincial jurisdiction. There was no attempt to try and square the circle and consider the means by which the federal government could actually carry out the needed reforms. The thrust of our argument is that the only instrument the federal government has at its disposal is the spending power, and the sooner that is recognized the better. The fiscal decentralization implicit in the CHST virtually guarantees that federal participation in meaningful social policy reform involving the crucial area of welfare is all but impossible. In these circumstances, it is not surprising that the Axworthy Green Paper was "axed" as being "unworthy" and attention has been restricted to things like unemployment insurance and pensions where awkward jurisdictional battles are less likely to arise.

Concern over the Division of Responsibilities. Finally, there remains some concern over the division of responsibilities, concern which is more pressing given the referendum debate in Quebec and

its aftermath. The concern seems to be, first, that the federal government provides services that could better be designed and delivered at the provincial level, and, second, that there is duplication of effort at the two levels. The most obvious instance of this is in the labor market area, especially unemployment insurance and labor force training. Unfortunately, in the case of unemployment insurance there are constitutional restrictions on the ability of the federal government to decentralize responsibilities. Other areas where there may be some potential for decentralizing service provision is in areas such as mining, fishing, agriculture, tourism, and so on. There may also be room for reallocation of regulatory responsibilities. For example, the regulation of markets for goods and services might be decentralized, while that for capital and perhaps labor could be centralized. However, that is likely to involve issues that go beyond the scope of purely fiscal aspects of federalism.

Issues concerning the division of responsibilities go to the heart of legislative decentralization. Obviously, some clear and detached thinking on the issue of decentralization is needed. Perhaps we should step back and recount the pros and cons of decentralization.

III. The Case for Decentralization

Though the Canadian federation is highly decentralized in terms of legislative responsibilities, much of this decentralization is in accordance with the prescriptions of modern fiscal federalism theory. Indeed, the economic case for a highly decentralized assignment of legislative responsibilities in a federation is a very strong one. However, legislative decentralization carries with it some adverse side effects. The challenge is to structure the federation in such a way as to reap the substantial advantages of legislative decentralization while at the same time having in place safeguards that counter its adverse effects on national efficiency and equity objectives. The appropriate balance of legislative with fiscal decentralization is the key to achieving that goal.

Let us begin by briefly recounting the main arguments in favor of decentralization of decision-making in a federation. Economists always recite the decentralization mantra when it comes to stating the benefits of

private-sector decision-making. Decentralization improves the information to decision-makers, enhances the use of incentives, reduces so-called "agency" problems and inefficiencies of decision-making in large organizations and bureaucracies, reaps the benefits of competition, spurs innovation, and so on. Analogous arguments can be made for decentralized decision-making in the public sector, and they are equally compelling. The arguments have to be adopted to the fact that decisions are being made collectively (or politically) and the objectives of decision-makers are different. We can summarize them as follows:

- a) Lower-level decision-makers are likely to be better informed about and responsive to local needs and preferences, and to be better able to adapt the provision of local services to those needs and preferences. Centrally provided public services are more likely to be uniform across jurisdictions. This argument applies both to the provision of public services and to regulation involving local matters.
- b) Local decision-makers face better incentives to provide public services efficiently. They are closer to those institutions that actually deliver the services and are able better to monitor and control them, or, as economists say, to deal with "agency" problems. Centralized responsibility for the provision of public services would require some administrative decentralization anyway. Central authorities would have to monitor lower level decision makers. Decentralizing legislative responsibility reduces the number of layers of bureaucracy. This, like many of the arguments for legislative decentralization, applies much more strongly to public service provision than to transfers.
- c) Decentralized decision-making is also said to lead to better political accountability. Dividing responsibilities between levels of governments allows closer identification of politicians with particular functions. A noted feature of Canadian politics is the frequency with which candidates from different parties are elected in the same federal, provincial and even municipal constituencies. Decentralization may also lead to better fiscal accountability, at least to the extent that legislative decentralization is accompanied

by revenue-raising decentralization. Citizens can see better how their tax dollars are being spent.

- d) Viewed from a public choice perspective, decentralization can induce more efficient public-sector decision-making for several reasons. The existence of fiscal competition among lower-level jurisdictions itself induces efficiency of local decision-making. The mobility of citizens and capital constrains governments more, and the ability to compare results across jurisdictions, so-called *yardstick competition*, imposes some discipline on them by informing citizens of what is possible. Lobbying may also be less effective at lower levels. The stakes are lower, as are the probabilities of success. Related to this, there may be less resources spent on rent-seeking activities. The rents generated by lower governments are less and are divided among lower-level jurisdictions in smaller bundles.
- e) Lower-level decision-making should induce more innovation in public services and program delivery, partly as a result of the competition induced among jurisdictions. This is a common argument in Canada where major innovations and experimentation in health care have been claimed for provincial decision-making. It might also be an unfair claim, since we have no idea how much innovation would have occurred had the federal government been responsible for health care.

To an economist, many of these arguments are convincing and make a strong *prime facie* case for provincial or local responsibility for delivery of public services. Naturally, they do not all have the same force. For example, we do not find the argument that lower-level jurisdictions are more politically accountable to their citizens to be as self-evident as some persons do. Nonetheless, on balance the case for decentralization of the provision of public services is a strong one. More generally, it might lead us to apply the same litmus test to public-sector decision-making as we apply to the case for interfering with private-sector decision-making. In this context the analogue with the market failure justification for interfering with the private sector is that decentralization should be viewed as being the norm except in circumstances in which it can be

shown to have adverse consequences.¹¹ Let us recount some of the limits of decentralization.

IV. The Limits of Decentralization

There are two general sorts of reasons why decentralization may not always be unambiguously a good thing. One is that in the case of some types of public expenditure, the arguments for decentralization do not have much force. The second is that decentralization can give rise to a variety of negative side-effects. It is important to distinguish between these two cases because they call for different sorts of remedies. In cases where arguments for decentralization do not apply, the natural response is to place responsibility in the hands of the federal government. In the case where there are benefits from decentralization, but there are also adverse side-effects, the trick is to find ways of taking advantage of the benefits of decentralized decision-making while at the same time implementing policies to counter the adverse side-effects. This is where the fiscal arrangements assume importance.

In most instances where the arguments for decentralization do not hold with much force, there is agreement. For example, the list of public goods that are national in dimension is fairly noncontroversial. Most observers would agree that things like defence, foreign affairs, international trade, control of the currency, and criminal justice are sensible areas for exclusive federal jurisdiction. Indeed, there would probably be widespread acceptance that those items actually listed in Section 91 ought to be there.¹²

Somewhat more controversial is the use of transfer payments, something that is within the scope of federal policy instruments by virtue of the spending power. The arguments for the decentralization of transfer payments to the provinces are not nearly as compelling as those for decentralizing public services to persons. Just as the federal government can efficiently administer direct taxes, so they should be able to administer transfers, which are nothing other than negative taxes. Of course, as the transfers become more narrowly targeted, there may be some advantages to administering them at lower levels. But, in principle, there is no strong argument for welfare payments, payments to the elderly, or transfers to businesses being provincial. Unemployment

insurance is more debatable since it involves more than the simple payments of funds to designated recipients.

The more relevant issues from our point of view come from the various negative side-effects of decentralized decision-making in a federation. Some of these apply even to the cases where decentralization arguments are the strongest, such as in the provision of health or education services. The more important negative consequences of decentralization are the following three.

Inter-jurisdictional Spillovers

A well-known negative side-effect of decentralization arises because of the existence of spillovers of the benefits (or costs) of one province's programs on the residents of another. Highways in one province are used by residents and businesses of another; persons educated or trained in one province might migrate to another; and so on. The existence of spillovers from a program does not imply that the responsibility for it should not be decentralized. This is one of those instances where the negative side effects can be addressed by suitable policies, in this case conditional grants. This justification for the use of conditional grants has been a prominent one in the fiscal federalism literature. However, it is unlikely to account for the major shared-cost programs we have seen in Canada in the postwar period.

Inefficiency in the Internal Economic Union

Decentralized decision-making can have various adverse effects on the efficiency of the internal economic union. The mere fact that provinces are taking independent economic decisions can cause distortions in the markets for factors of production, goods and services. This is particularly true for more mobile goods and factors. Provincial taxes (or subsidies) on capital and labor income can distort national markets, as can provincial regulations and procurement policies. Even the structure of provincial public services can distort the internal economic union, such as residency restrictions that apply to the use of the services, or education standards that differ from one province to another. To some extent, inter-jurisdictional competition might restrict differential policies being applied across jurisdictions. However, it also brings with it the possibility that provinces

will behave strategically and engage in "beggar-thy-neighbor" policies to attract capital, labor and businesses to their own jurisdictions. There is plenty of evidence that provinces have engaged in various sorts of beggar-thy-neighbor policies.

Though the federal government has no explicitly stated responsibility for ensuring efficiency in the internal economic union, most observers would agree that it is a responsibility that the federal government ought to assume; it is a natural component of "Peace, Order and Good Government." Again the main instrument available to the federal government is the spending power that enables it to induce some measure of co-ordination among provincial policies. It is, of course, also possible that the provinces themselves could agree to constrain their policies to conform with some national codes of conduct. However, given the necessity to achieve unanimity of agreement, it seems unlikely that efficiency in the internal economic union can be relegated to interprovincial agreement. History seems to confirm that scepticism. Even with the participation of the federal government, progress in dismantling interprovincial barriers to trade through interprovincial agreement has been disappointingly slow. Similarly, the attempt to agree on national regulatory standards for stock markets has come to naught.

Another important dimension of efficiency of the economic union has to do with tax harmonization, something that we have taken for granted in Canada in the postwar period. A reasonably uniform national income tax system is a necessary feature of an efficient internal economic union. We have in place a system of tax harmonization that is the envy of the world, yet it relies on the fact that the federal government is dominant in the income tax fields for its effectiveness. As the provinces have become more and more important in the income tax fields, the integrity of the Tax Collection Agreements have been threatened to the point where they are now very fragile indeed. Further loss of federal income tax room either as a result of fiscal decentralization or as a result of the federal government coming to rely more and more on indirect taxes could prove fatal to the agreements as we know them. It is a convenient feature of fiscal federalism that the extent of expenditure and tax decentralization can be determined largely independently, and that the case for decentralizing revenue-raising is considerably weaker than that for expenditures. In fact, decentralizing revenue-raising may be much more damaging to

the efficiency and equity of the internal economic union than decentralizing expenditures. In other words, a good case can be made for having a vertical fiscal gap. That said, it should be repeated that harmonization is much more important on both equity and efficiency grounds for direct taxes, especially those on capital incomes, than for sales taxes. Direct taxes are the instrument most suitable for achieving vertical equity in the nation. They are also more prone to the distortions of tax competition since their base is more mobile than that of sales taxes. The Carter Commission wisely recognized this three decades ago when it argued that the ideal tax assignment was for income taxes to be a federal responsibility and sales taxes a provincial responsibility.

Inequity in the Internal Economic Union

From our perspective, the most serious consequences of decentralization and the ones that demand most of the fiscal arrangements are those applying to national equity. National equity is also the dimension of fiscal federalism to which John Graham's work greatly contributed. As in standard public finance applications, it is useful to distinguish between horizontal and vertical equity in a federation.

Horizontal equity is simply the principle of equal treatment of equals, which we take to be an implication of citizenship in a nation. When applied to a federation, horizontal equity, or *fiscal equity* as it is called, requires that persons of given income be treated comparably by the fiscal system regardless of their province of residence. In the absence of corrective measures, decentralization leads to a violation of horizontal equity. Better-off provinces are financially better able to provide public services to their citizens than less well-off provinces. As a result, a person of given income will be systematically better off residing in a high-income province than a low-income province for reasons having nothing to do with differences in productivity. In a unitary state, such an issue would not arise because there would be a single government applying a single tax system to provide a given level of public services across the nation. Fiscal equity would prevail. However, in a federation, decentralization itself gives rise to differential treatment of otherwise comparable citizens.

There is a large literature on the consequences of fiscal inequity for the fiscal arrangements. The upshot of that literature is, I think, fairly

clear. Fiscal equity can be achieved by a system of equalizing transfers among provinces whose aim is to equalize the ability of different provinces to provide comparable public services to their citizens at comparable costs. It is remarkable to an economist that the constitutional imperative set out in Section 36(2) of the *Constitution Act* accords closely with fiscal federalism principles. The same principle applies of course within provinces; decentralization of fiscal responsibilities to municipalities leads to fiscal inequities across regions of a province and calls for equalizing grants to municipalities, something that most provinces have in place at least to some degree.¹³

It is worth mentioning that equalizing transfers cannot literally ensure that different provinces treat citizens of a given income level the same. Nor should they be expected to. Different provinces will use their decentralized powers differently. Some will be more redistributive than others. They will all choose to offer a mix of public services that best suits their local needs and preferences. The fiscal arrangements must respect the ability of provinces to exercise their decentralized powers. What the equalization system does is to equalize the *potential* of each province to provide comparable public services at comparable rates of taxation. This is in the spirit of Section 36(2) and of federalism itself.

The other dimension of equity is vertical equity, the role of government in redistributing from the better-off to the less well-off. We have emphasized earlier that redistribution takes various forms ranging from redistribution through the tax-transfer system to in-kind redistribution using public services to social insurance. Many of these policy instruments are in the hands of the provinces, especially those that are critical components of redistributive equity, such as health, education, and social services, as well as welfare payments. If left entirely to decentralized provincial decision making, it seems clear that very different norms of vertical equity would apply across provinces, and that fiscal competition would severely constrain the provinces in their ability to pursue standards of redistribution that citizens would otherwise prefer. Provincial redistributive policies give rise to a special form of beggar-thy-neighbor policy. Acting independently and apparently in the interests of their own citizens, provinces find it irresistibly tempting, in the face of mobility of persons and capital, to compete away redistribution. We have a foretaste of things to come when a province like British Columbia with an NDP government

can impose residency requirements and issue free return bus fares to migrants.

Should the federal government care how the provinces choose to exercise their redistributive functions? A major question in fiscal federalism is which level of government has primary responsibility for redistributive equity. There is no clear-cut answer to this, depending as it does on the sorts of value judgments and views of government mentioned in the Introduction. We tend strongly to the view that the federal government has a strong interest in redistributive equity, despite the fact that many of the instruments for achieving equity are in the hands of the provinces. This is based jointly on the view that the public sector has a role in delivering redistributive equity, that the public sector is reasonably benevolent, that fiscal competition unduly constrains lower level governments from pursuing the role, and that citizenship or belonging to a nation implies that all persons should weigh equally in society's "social welfare function" regardless of where they reside. Fortunately, neither our nor anyone else's judgment has to determine where responsibility for vertical equity lies. The constitution clearly indicates in Section 36(1) that the federal government shares with the provinces responsibility for vertical equity, even in areas of provincial jurisdiction.

Given this commitment, how can the federal government exercise it when so many of the instruments are in the legislative jurisdiction of the provinces? The answer is self-evident. The only way it can do so is by the use of the spending power, in this case by the use of conditional grants, whether shared-cost or block grants with conditions. But in order to exercise this constitutional responsibility, it is necessary for the federal government to retain enough fiscal power to induce the provinces to design their programs in accordance with certain national equity norms and, as important, to have the moral authority to do so. This seems to us to be a matter of logic as well as of sensible policy, but one that is obviously not widely appreciated or accepted.

In recounting the arguments for and against decentralization, we have kept to general arguments. Their application to particular situations requires many more details to be worked out. Two are of particular relevance to Canada and the Atlantic provinces. The benefits of decentralization presumably have their limits. There is some size of government

below which decentralization generates no further benefits. Otherwise, why stop at the provinces? Why not decentralize all the way to municipalities? Dan Usher has in fact seriously argued that in the event of separation, the rest of Canada should reconstitute itself as a unitary state. This is presumably not a widely held position. Closer to home, the issue is whether some or all of the Atlantic provinces are too small for efficient fiscal decision-making. I leave that as an open question.

Perhaps more pressing is the issue of Quebec. Do the arguments for decentralization have more force in Quebec than in other provinces, given the unique cultural and linguistic features of that province and the lower degree of mobility between Quebec and the other provinces? In my view, the answer is no. More particularly, we are not convinced on economic grounds that the redistributive responsibilities of the federal government or its responsibilities for ensuring an efficient internal economic union are any less applicable to Quebec than to the rest of Canada. Or to put it another way, a province cannot opt into the economic union but opt out of the social union.¹⁴ However, that too is a topic for another day and another person.

IV. Assessing the State of the Federation

To summarize the preceding arguments, the case for decentralizing legislative responsibility for the provision of public services to the provinces is a compelling one. But such decentralization and the fiscal decentralization that accompanies it have some negative side-effects from a national perspective. Generally speaking, decentralization can cause provinces to behave in ways that they may perceive to be in the interests of their respective residents, but that can also be detrimental to the efficiency and equity of the internal economic union. Given that the federal government has an interest in national efficiency and equity issues, it must assume some responsibility for ensuring that these objectives are achieved. The only instruments it has to exercise that responsibility are its taxing power and its spending power. Ideally, its use of the taxing and spending power in co-ordination with the provinces through the fiscal arrangements should enable us to obtain the benefits of decentralized decision-making without sacrificing national equity and efficiency objectives. That is the challenge facing any federation, but especially one such as ours that is already very decentralized and is

facing intense fiscal pressures to become more decentralized. The trouble is that succumbing to those fiscal pressures can be, and has been, irresistible to a federal government that focusses on the short term. Unfortunately, fiscal decentralization can be largely irreversible; tax room and expenditure responsibilities turned over to the provinces are difficult to retrieve at a later date.

How does the Canadian federation stack up in light of these arguments for and against decentralization? In terms of the division of legislative responsibilities, the answer has to be very well, significantly better than virtually any other federation in the world. In the main, the provinces are assigned those tasks for which they are best suited—the provision of public services and local public goods, and regulation of local matters. The federal government is responsible for things of a clearly national nature and for redistribution and social insurance delivered through the tax-transfer system. But the assignment is not perfect. There are several areas where, if one were starting with a blank cheque (as economists are prone to do), things might be assigned differently. Our own list would include:

Social assistance. It is anomalous that the redistributive income tax with its refundable credits for low-income persons is largely a federal prerogative, while the major transfer program aimed at low-income persons is a provincial responsibility. As a consequence, the welfare system is very uneven across the country, is administratively cumbersome, and is not well-integrated with the tax-transfer system, with the significant exception of Quebec where the province operates its own income tax. Moreover, the fact that the federal government has not had access to this program for assisting the poor has led it to using other, less suitable, schemes for that purpose, such as unemployment insurance. As mentioned, the assignment of welfare payments to the provinces is not a constitutional requirement, but an historical convention.

Unemployment insurance. By the same token, one could argue that unemployment insurance along with its training and employment services ought to be a provincial responsibility since it is partly in the nature of a public service. Of course, as with health insurance, there are issues of national efficiency and equity involved that will

require federal attention. This seems like one of those areas where the judicious use of the federal spending power could ensure that the advantages of decentralization are achieved without compromising national objectives.

Tax assignment. Both levels of government have comparable tax mixes, and that is clearly problematic. This implies that harmonization is difficult to maintain for either direct or indirect taxes, and that the federal government is constrained in exercising its redistributive responsibilities. It also makes little sense for the provinces to be in the corporate tax area, given the mobility of capital and the temptation to use the corporate tax system for beggar-thy-neighbor purposes. A strong case can be made on both efficiency and equity grounds for the federal government concentrating on income taxes, leaving sales taxes to the provinces.

Business subsidies. By the same token, the use of business subsidies as a policy device by provincial governments is clearly at odds with the economic principles of federalism. They give rise to distortions in the internal economic union and allow provinces to engage in wasteful interprovincial competition.

Provincial regulation. Some areas of provincial regulation also give rise to potentially significant distortions of national markets. Examples include regulation of trades and professions, and regulation of provincial stock markets. This is a difficult problem to deal with since many of the arguments for decentralization apply equally well to regulation as to public service provision. But unlike with public service provision, since there is little spending involved, it is not clear how the federal government could use the spending power to provide incentives to the provinces to abide by national standards. Perhaps this is one area where interprovincial agreement is the only way to achieve national objectives.

Federal regulation in areas of local interest. By the same token, there may be areas where federal regulation intrudes on issues of purely national interest. Examples include telecommunications, culture, language, and environment.

As this list indicates, if we could change the legislative assignment of functions, it is not clear that we would want to make them more decentralized. Rather the reassignment would involve decentralizing some functions and centralizing others. Unfortunately, we do not have the luxury of being able to redesign our federation from scratch; very few federations do. (An unusual exception is the case of South Africa, where many principles from the Canadian case are being adopted.) For all intents and purposes, we are probably stuck with the existing assignment, which, after all, is a reasonable one. What we can do is adopt the most suitable form of fiscal decentralization to make sure that our decentralized federation serve the national interest. That involves designing a sensible set of fiscal arrangements.

What might we reasonably expect from a well-constructed system of fiscal arrangements in a decentralized federation such as ours? We might expect a federation in which, despite the fact that public services are delivered by the provinces, the levels of public services enjoyed by Canadians and the tax burdens they face are comparable across provinces, though not necessarily exactly the same; the direct tax system and the system of transfers are harmonized enough to ensure that the internal economic union is efficient and free from distortion; and national standards of redistributive equity are satisfied in all provinces. These objectives can be met in a decentralized federation when the appropriate system of fiscal arrangements are in place. The system would consist of three main pillars. The first pillar is a comprehensive and effective system of equalizing transfers among provinces to ensure that each has the potential to provide comparable public services at comparable tax rates. These transfers may encompass much more than the Equalization system proper. Historically, all the major transfer programs—Equalization, EPF and CAP—contributed jointly to the equalization objective.¹⁵ The second pillar is an effective system of income tax and transfer harmonization so that distortions in the internal market resulting from provincial tax/transfer policies are avoided, and national standards of redistributive equity are achieved. The third pillar involves the judicious use of the federal spending power in all its dimensions to ensure that programs delivered at all levels of government are consistent with national equity and efficiency objectives. The need for each of these pillars effectively

puts a limit on the extent of fiscal decentralization, a limit that is almost certainly in the process of being breached.

The current policy stance of the federal government involves fairly extensive fiscal decentralization to the provinces and works directly against these objectives. Fiscal decentralization that forces the provinces to become more self-sufficient may have some immediate benefits from the point of view of federal deficit-reduction policy, though we would argue that even from that perspective it has little merit. More to the present point, it also has some adverse consequences for the working of the federation. Three immediate ones come to mind.

One likely outcome of the continuing decentralization of fiscal responsibilities to the provinces is that the Tax Collection Agreements are likely to come under increasing strain. As the provincial share of income tax room has gradually increased, so too has the discontent of the provinces with the existing system. The number of provincial credits, deductions and special measures has increased exponentially in the past few years. Should the Agreements fall apart, which is a distinct possibility, the consequences for the internal economic union could be significant.

Second, as the provinces become more self-sufficient, the pressures for them to engage in beggar-thy-neighbor policies on both the tax and expenditure sides of their budgets will increase. Already we are seeing small signs of that, with provincial tax incentives and tax holidays, restrictions on out-of-province students in professional degree programs, welfare changes in some provinces, and so on. Both the equity and efficiency of the internal economic union will suffer.

And third, as provinces occupy more of the tax room in order to finance greater proportions of their own expenditures, more strain will be placed on the Equalization system. Provinces will become increasingly different in their tax capacities, and the Equalization entitlements of the have-not provinces will grow more rapidly than the rate of growth of GNP. In the presence of growth caps on Equalization payments, the program will increasingly be unable to fulfil its objectives. Moreover, the political will to maintain an effective system of equalization, despite the commitment of Section 36(2), may well dissipate. If so, from an economic perspective, we shall hardly have a country left.

In short, the sort of decentralization of fiscal responsibilities implied by the 1995 and 1996 federal budgets could effectively emasculate the

ability of the federal government to carry out its obligations to foster national efficiency and equity within the Canadian economic union. That is, it would preclude it from satisfying the constitutional commitments to pursue national vertical equity as set out in Sections 36(1) and 36(2) of the Constitution Act, and to achieve an efficiently functioning internal economic union. It would do so by seriously compromising the system of federal-provincial fiscal arrangements, which is an indispensable instrument for reaping the considerable benefits of decentralized decision-making while at the same time preserving an efficiently functioning and equitable economic union. Moreover, it would do so by a process of fiscal decentralization that is largely irreversible and that has not been subject to public scrutiny in any meaningful way.

Part of the problem seems to be one of process. Measures of fiscal decentralization and major changes to the fiscal arrangements tend to be part of the budgetary process of the federal government. That means that they are taken under the veil of budgetary secrecy with very little public input. Moreover, for reasons that we do not fully understand, decision making in Finance Canada, where budgets are drawn up, seems not to give due regard to the implications of budgetary changes for the federal system. Federal-provincial fiscal arrangements seems to be a relatively non-influential constituency within the Department. A primary example of that is the Goods and Services Tax (GST). Virtually no currency was given to the fact that the GST would likely have very deleterious effects on the federation, even though some of us expressed that view. The issue was simply not raised or discussed.

Not only is the public not consulted about major changes to the federation, it seems that the provinces are typically not as well. This may simply be a throwback to the early postwar era when the ethos of the federal government reflected that the provinces were clearly their fiscal inferiors. Finance Canada seems not to have adapted to the fact that that is no longer the case. (Nor has the national media, for that matter.) That problem may be self-correcting as the provinces continue to strengthen their fiscal position vis-à-vis the federal government.

Perhaps, given the long-term nature of the fiscal arrangements, we should be thinking about alternative institutional mechanisms for ensuring that fiscal federalism considerations are given the attention they deserve. One that comes to mind seems to be favored by the federal and provincial

governments as well as by other observers such as Courchene and to some extent the Group of 22. It is to rely on interprovincial negotiation, with or without federal participation, as a means of achieving national objectives. Apart from the fact that the track record of such negotiations has not been exemplary and that nothing in the public-choice literature makes one enthusiastic about the outcome of bargaining with unanimity decision rules, such an approach is essentially an abdication of federal responsibility. National efficiency and equity objectives are federal responsibilities, sanctioned by the constitution as well as by economic reasoning. We have a right to expect leadership from the federal government.

Another more promising addition to the process that comes to mind is the establishment of a "federal-provincial grants commission" along the lines of those found in other federations, such as Australia and India. A grants commission could be a standing body that advises Parliament on various aspects of the fiscal arrangements, such as the formula for transfers, the definition of national standards, and the ongoing evolution of the Tax Collection Agreements. It would be a forum for open deliberation, consultation and research. It could include provincial representation and be used as a vehicle for federal-provincial negotiation. Obviously, such organizations could and should only be advisory in nature in a parliamentary democracy, since Parliament must have the ultimate responsibility for spending decisions. But in view of the prominence given to the principles of fiscal federalism in the constitution, such a body might perform an important role in evaluating the state of the fiscal arrangements from a longer run and arm's length perspective. It would help to give the fiscal arrangements the visibility they deserve given the crucial function they perform in a federation. Currently, major changes in the fiscal arrangements are implemented largely through the budgetary process behind the veil of budget secrecy. By making the process leading up to changes in the legislation governing the fiscal arrangements more open, considerations other than those involving the immediate budget stance could be given more prominence. And such an institution might serve to temper what has been one of the most damaging features of the current process—the tendency of the federal government to undertake major changes, especially those that involve unannounced reductions in transfers to the provinces, without prior notice.

It would also seem to me to be the sort of institution that of which John Graham might approve: one which will enable sound economic principles to be brought to bear to serve the social and moral needs of the nation.

NOTES

1. Much of the pressure for decentralization comes from politicians and the media. Recently, a variety of proposals for rebalancing the federation have been published, most of which suggest some decentralization. A good example is that of the self-anointed Group of 22, which emphasizes the principle of *it subsidiarity* (the assignment of government powers to the lowest level where they can be effectively exercised) and the importance of joint decision making by the federal and provincial levels of government. More provocative proposals for extensive decentralization have been presented by Gibson and Courchene.
2. For a discussion of these in the context of a federal economy, see Boadway, *Constitutional Division*.
3. These notions of fiscal efficiency and fiscal equity and their relevance for fiscal federalism are discussed in more detail in Boadway and Flatters, and Boadway and Hobson.
4. A good summary of federal and provincial fiscal activities may be found in Treff and Cook.
5. See Boadway and Hobson for a full discussion of the fiscal arrangements.
6. See Boadway and Hobson, Table 4.7, 124.
7. Hogg has suggested that the obligation set out in Section 36(2) may be too vague and political to be justiciable. It may simply provide a moral commitment that induces Parliament to maintain an effective Equalization program.
8. Hogg has documented that the spending power has been found to be a legitimate policy instrument of the federal government from a constitutional point of view. Moreover, he argues that the addition of Section 36 in the 1982 constitutional amendments served to reinforce a broad interpretation of the spending power.
9. These concerns have been raised earlier. See, for example, Boadway, "Federal-Provincial."
10. For further discussion of the relevance of fiscal decentralization for social policy, see Boadway, "Fiscal Federalism."
11. This is similar to the notion of subsidiarity, borrowed from the European Union, that has motivated the arguments for decentralization found in the Group of 22 and Courchene.
12. Some observers would go much further than that. For example, Usher argues that in the absence of Quebec, the rest of Canada would be better served by being a unitary

state, that is, by transferring all functions to a federal government and abolishing the provincial level altogether.

13. Accepting horizontal equity as a criterion for policy in a federation clearly involves a value judgment. One observer who does not accept it is Usher. He argues that a more compelling form of equity is that which gives support to the stability of democratic decision-making, and that involves equal treatment of equals by each jurisdiction within its own sphere of influence only. According to this view, the use of equalization transfers to achieve fiscal equity is unnecessary and counterproductive.
14. We are indebted to Peter Leslie for this point, which he made forcefully at a recent round-table discussion on fiscal federalism.
15. The EPF system was a pure form of equalization. It consisted of equal per capita transfers to all provinces financed out of federal government general revenues, so made equal financial capacity available to all provinces regardless of their average income levels. The CAP system was equalizing in a different sense. Its payments were based on expenditure levels on welfare in each province. To the extent that such expenditures reflected need, it was a form of needs-based equalization. Of course, because of its 50-50 matching formula, CAP had the potential for inducing provinces to change their behavior so as to take advantage of the formula. And better-off provinces might have been better able to do so. For this reason, conversion of CAP to a block grant had been advocated by many observers. A full discussion of the equalizing effect of the fiscal arrangements may be found in Boadway and Hobson.

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