Financing Confederation Revisited: The Economic State of the Federation

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Introduction

This festschrift for David Slater coincides with the twentieth Anniversary of two important events in Canadian fiscal federalism: the completion of the Economic Council of Canada's landmark study entitled *Financing Confederation* and the passage by Parliament of what would become the *Constitution Act, 1982*. David was the Chair of the Economic Council at the time, and as such was responsible for what is arguably the most influential and lasting of the Council's projects. By apparent coincidence, the publication of *Financing Confederation* coincided with the coming into force of the *Constitution Act*. While the *Constitution Act* is perhaps better known for repatriation of the constitution and the implementation of the Charter of Rights and Freedoms, it also included a rather far-reaching set of principles governing the relative roles and responsibilities of the federal and provincial governments in delivering social policies. Although these principles are no more than that, their elevation to constitutional status gives them a special standing as ideals against which our federal fiscal arrangements should be judged. Remarkably, *Financing Confederation* provided the economic justification for at least some of these principles, and explored their implications for the design of the fiscal arrangements.

This paper takes a brief retrospective view of the development of the fiscal arrangements in light of the principles enunciated in both these documents. In particular, we consider the consequences of the substantial fiscal decentralization that has occurred in the past 20 years for the achievement of the objectives set out in these principles. We use as our benchmark not only the principles enunciated in *Financing Confederation*, which have stood the test of time, but also the relevant principles of the *Constitution Act*. In particular, we might remind ourselves of the content of Section 36, entitled Equalization and Regional Disparities, which states:

> (1) Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed 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.
>
> (2) Parliament and the Government of Canada are committed 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 section not only commits the federal government to the principle of a strong form of equalization, but also essentially makes the federal government jointly responsible for the delivery of important social policies. Other relevant aspects or interpretations of the constitution for the fiscal arrangements include the assignment of powers, in particular, the exclusive provincial legislative responsibility in the areas of education, health and social services; the spending power, which includes the right to make conditional transfers to the provinces as well as targeted transfers to individuals and institutions; and the surprising absence of the assignment of responsibility for maintaining and promoting efficiency in the internal economic union, which is generally regarded as a prerequisite of a smoothly functioning federation.

Principles and Values

This is an exercise in policy evaluation, and as such, the perspective that we take is unabashedly a normative or prescriptive one. Policy evaluation and advice necessarily involves value judgements. This issue is the extent to which one's policy stances ought to be conditioned by positive considerations, in particular by political feasibility. This is especially important in fiscal federalism, given that many of the conflicts that constrain policy implementation are political in nature. Nonetheless, we take the view, as did the authors of *Financing Confederation*, that economic policy analysis should not be unduly constrained by considerations of political feasibility. To do so would be to eschew that which economists are best prepared to contribute. At the same time, it should be recognized that the design of the fiscal arrangements cannot be based solely on economic considerations. There are obviously other issues involved that non-economists are in a better position to judge, and that may in the end be more telling.

The normative approach involves adopting some normative principles or objectives and investigating their implications for policy. This means we must make clear what one's societal value criteria are. We take as our basic economic objectives the following three: economic efficiency, redistributive equity and horizontal equity or fairness.

Efficiency

The criterion of efficiency is taken for granted by economists. It refers broadly to the exploitation of all gains from trade, both those that can be obtained best through markets and those that require collective action. From the point of view of fiscal federalism, one can identify three relevant ways in which economic efficiency is relevant.

The first involves *efficiency in the internal economic union*. This requires that there be free and non-distorted flows of goods, services, labour and capital across the borders within the federation. This can only be achieved if lower level governments do not engage in actions that, intentionally or otherwise, impede cross-border flows. This is a very difficult principle to fulfill, and almost certainly will be violated to some extent. The essence of federalism is that lower level jurisdictions be able to enact policies within their spheres without restraint. These policies will almost certainly impinge upon cross-border flows. The challenge is to devise a system whereby distortions are the result of legitimate policy objectives, such as social policies or the protection of language and culture, and not the result of protectionism at the expense of other provinces.

The second involves the efficient provision of public goods and services. Some of these will be national in nature and others of a regional or local level. Moreover, some will be public in nature, some will involve infra-structure, and others will take the form of services to individuals or firms. Their efficient provision is a challenge because their allocation is outside the market. The quest for efficient provision of public goods and services is one of the main arguments for the decentralization of expenditures in a federation.

The third efficiency issue in federal systems is one that was emphasized in *Financing Confederation*, and is referred to as fiscal efficiency. The issue arises as a direct consequence of the decentralization of fiscal responsi-bilities. This brings with it differences in the need for public services and the fiscal capacity to finance them across jurisdictions. These differences can imply that otherwise identical persons receive different benefits per tax dollar in different jurisdictions, referred to as net fiscal benefits (NFBs). These NFB differences provide incentives for households and firms to relocate based on fiscal considerations rather than productivity. Such fiscally-induced migration will cause economic activity to be allocated inefficiently across provinces.[1]

Given the importance of NFBs for the design of the fiscal arrangements, it is worth dwelling briefly on their relevance and some caveats for policy purposes. First, it should be noted that NFB differences arise across jurisdictions only to the extent that public services are not financed by benefit taxation. The latter would imply that benefits are reflected in individual taxes so there can be no systematic differences in NFBs across provinces. The evidence is fairly convincing that services provided by provincial and local governments are, in fact, redistributive, in which case regions with higher resources are able to provide services at lower tax rates. Given that, NFB differences will arise from differences in the ability to raise revenues at given tax rates, as well as differences in the need for public services because of demographic differences. Differences in the cost of providing public services are not, however, sources of NFB differential that lead to fiscal inefficiency.

Second, there is an issue with respect to the empirical relevance of migration induced by differences in tax rates or spending programs across jurisdictions, which is mixed. Watson (1986) had argued, based on the empirical estimates of Winer and Gauthier (1982), that the efficiency cost was very low. However, that has been challenged in a recent paper by Wilson (2000) who argues that when one takes a stock rather than a flow perspective

[1] This source of inefficiency in a federation was first identified by Buchanan (1952). Its application in a Canadian context was due to Graham (1964), and formalized in Boadway and Flatters (1982a).

with respect to migration, the efficiency cost of fiscally induced migration is much higher. Others argue that the impact of NFB differentials on migration will be muted to some extent by capitalization into land prices. In short, the empirical evidence is not convincing one way or the other, especially when one considers that only labour migration is studied and not the movement of business activity more generally. However, it turns out that the case for equalizing NFB differentials does not rely solely on fiscally induced migration. A key part of the *Financing Confederation* argument was that fiscal equity arguments also call for equalization.

Finally, it should be noted that most arguments for equalization are based on static modes of analysis. There is growing realization that the development of regions in an economy may be influenced by agglomeration effects and other externalities, and these could have important implications for equalization and other transfers. This is yet unexplored terrain, and it is not at all obvious what the implications for equalization might be. On the one hand, to the extent that equalization causes economic activity to be spread more thinly across the country, the benefits of agglomeration are not being exploited. On the other, equalization might induce regions to develop more quickly precisely by reinforcing local agglomeration effects where they might not otherwise exist.

Redistributive Equity

Redistributive equity encompasses what public finance economists traditionally refer to as vertical equity. However, it has come to be interpreted more widely in recent years. One can think of there being three dimensions of redistributive equity, all of which are objectives of government policy.

The first of these is equality of opportunity, to which Section 36(1) draws attention. This can be thought of as an *ex ante* objective. The aim is for the public sector to offer redress for the different opportunities that households face to participate in the economy. Thus, youth are educated and trained to upgrade their skills and talents. Given that different persons are born with different abilities, equality of opportunity can be interpreted as requiring that society compensate to some extent for differences in abilities. But, of course, there are efficiency costs involved so equality of opportunity is bound to be less than perfect.

This leads to the second dimension of equity, equality of outcomes. This takes the form of *ex post* redistribution, such as through progressive taxation, income-tested or targeted transfers, and in-kind transfers.

The final form of redistribution is social insurance, which as the name implies is insurance offered by the public sector. This encompasses not just insurance in the usual meaning of the word, but also compensation for bad luck that is otherwise uninsurable privately, such as that resulting from bad demographic luck, ill health, unemployment and other misfortunes that are deemed not to be the responsibility of the person. Major social programs like unemployment insurance, disability benefits, workers' compensation, and health care fall into this category.

The relevance of redistributive equity for fiscal federalism should be evident. Virtually everything governments do at all levels have redistributive consequences. Moreover, some of the most important policy instruments used to achieve redistributive equity are in the hands of lower-level governments.

Horizontal Equity

The criterion of horizontal equity is widely accepted as an objective of government policy. However, its logical extension to a federal setting is contentious. Horizontal equity requires that persons who are equally well off in the absence of government ought to remain so after government policy. In other words, persons in comparable circumstances ought to be treated comparably by the government. Of course, there will be conceptual difficulties in determining who are equally well off, especially given differences in preferences and need among households, as well as differences in family size. For our purposes, we need not enter that debate; much income tax policy debate revolves around such issues. We can presume that there is some measure of real income or ability to pay that suitably reflects one's economic well-being.

In a federalism context, horizontal equity takes on special, and somewhat demanding, importance: persons of a given real income ought to be treated comparably no matter where they reside in the federation. This can be viewed as a form of equal treatment or fairness — everyone counts with the same weight in society's social welfare function — and can be interpreted as a natural consequence of citizenship. Two things should be emphasized. The first is that horizontal equity is compatible with any degree of vertical redistribution, and in that sense there is no conflict between the two objectives. Indeed, as noted below, there is no conflict between horizontal equity and efficiency either: in fact, the two are complementary.

Second, in a federation, it will not be literally possible, or desirable, to achieve horizontal equity to the fullest. That would require provinces and municipalities to apply exactly the same tax and expenditure policies, which is obviously inconsistent with the idea of federalism. Instead, horizontal equity must be compromised to a federal setting. One way of doing so, which is compatible with the views of *Financing Confederation*, is to ensure that all provinces have the potential to satisfy horizontal equity. This means that they must have the fiscal capacity to provide comparable levels of public services at comparable levels of tax rates, so they could, if they so choose, satisfy the requirements of horizontal equity. At the same time, they should not be compelled to provide exactly the same public service levels and have the same tax/transfer structures. (Of course, there may be reasons based on efficiency and redistributive equity why some harmonization of policies is desirable.) The objective of horizontal equity in potential terms has come to be referred to as fiscal equity.[2] Like fiscal efficiency, it is achieved by equalizing NFBs across provinces, precisely the prescription found in Section 36(2).

Not all economists will agree with the above objectives. And, even if they do, they will not agree with the prescriptions. There are three main sources of disagreement. The first is that different economists will make different judgements about the relative weight to be given to equity versus efficiency. Moreover, they may not accept the values embodied in the principle of fiscal equity, that is, equal treatment of comparable citizens no matter where they reside. Unfortunately, alternative principles are not readily found in the literature, though presumably they have to do with some notion of differences in property rights depending on where one resides. The second source of disagreement concerns one's views of the benevolence of government. The less benevolent the government is thought to be, the less willing might one be to have the government involved in the economy, including in its redistributive functions. Roughly speaking, those who put low weight on equity and low weight on benevolence tend to prefer government to be smaller and less redistributive. They will also tend to favour decentralization as a brake on both intervention and redistribution. Finally, economists may disagree with the way the markets work, especially the severity of the trade-off between equity and efficiency. This too can lead to different views of the role of government, but differences that are less ideologically charged.

[2]The concept of fiscal equity is due to Buchanan (1950). *Financing Confederation* and Boadway and Flatters (1982b) proposed a restricted version of fiscal equity referred to as narrow-based fiscal equity as an attempt to take account of the presumed property rights of provincial residents in their own jurisdictions.

Whatever one's views of the role of government, the incontrovertible fact is that much of what governments do through their budgets — especially that which is controversial — is redistributive in nature and intent. This is reflected in the most important policy instruments used. These include the progressive tax system, including transfers administered through the tax system; targeted transfers to the needy; social insurance programs (unemployment insurance, workers' compensation, pensions, disability); health-care expenditures; education and training. These comprise a substantial proportion of what governments do, and are of critical importance to the fiscal arrangements, given the shared responsibility between the federal government and the provinces for social policy.

Federalism and Decentralization

The essence of federalism is decentralized decision-making, although this is by no means restricted to federations. The arguments for decentralization of fiscal responsibilities are well known and widely accepted among economists. The big issue is how to manage the consequences of decentralization.

The alleged benefits of decentralization can be briefly summarized. They amount largely to improving the efficiency of delivering public services. Lower jurisdictions can cater to local needs and preferences. They are better informed about these needs and preferences as well as about local cost conditions, which they are better able to control. So-called agency costs arising from the imperfect ability to monitor service deliverers are less, and layers of bureaucracy are reduced. Innovation is enhanced by decentralized provision by independent units of government. And, efficiency and accountability improvements are induced by decentralization and the competitive federalism that accompanies it. These arguments apply especially to the delivery of local public goods, the delivery of services to households and firms, and the delivery of targeted transfers. These include many policy instruments that are of importance from a redistributive point of view.

It is important to note that the benefits of decentralization apply largely to the expenditure side of the budget. There are no particular benefits to decentralizing taxation, except perhaps those based on accountability. Indeed, while many multi-level governments decentralize the provision of public services in the key areas of health, education and welfare, the decentralization of revenue-raising varies widely across countries (and even within them with respect to provincial-local fiscal arrangements). In other words, countries have a wide variety of discretion in the extent of the so-called vertical fiscal imbalance (VFI). The decentralization of revenue-raising responsibility in Canada — and the effective VFI — is probably the greatest in the Organisation for Economic Co-operation and Development (OECD) countries.[3]

This leads us to the potential costs of fiscal decentralization, including the decentralization of both spending and taxing decisions. These can be grouped under the usual headings of efficiency and equity.

Efficiency

Three sorts of efficiency effects of decentralization of fiscal responsibility can be identified. The first are distortions in the internal economic union simply because of uncoordinated or different policies that affect cross-border trade in labour, capital, goods and services. These reflect *fiscal externalities* arising from tax or expenditure competition: policies implemented in one province will affect the well-being of households in other provinces either directly or indirectly through its effect on provincial budgets.[4] Such externalities can be positive, such as when one province provides public services that benefit residents of neighbouring provinces. These fiscal externalities often provide a basis for policy harmonization and/or federal intervention. Negative externalities are more pervasive, and include such things as tax distortions on interprovincial trade, beggar-thy-neighbour policies, residency restrictions for the use of public services, and policies of discrimination or local protection. Some of these reflect legitimate policies of a social, linguistic, cultural, environmental, or labour standards nature and must be simply taken as a cost of federalism. They may also represent legitimate differences in provincial preferences over tax-transfer policies. In fact, as in the international sphere, it is hard to distinguish protection from legitimate social policy, which is why it has been very difficult to implement effective free trade within the internal economic union, or to achieve an understanding of the role of the federal government in fostering efficiency in the internal economic union.

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[3]One must be cautious in interpreting statistics on the VFI. Some countries, like Germany, might appear to have a low VFI because of revenue-sharing agreements that direct a proportion of federal revenues to the states. However, revenue-sharing is really a form of transfer because the states have no individual discretion over their amount or structure.

[4]A taxonomy of fiscal externalities and how they affect the efficiency of resource allocation may be found in Dahlby (1996).

The second source of inefficiency is a relatively newly discovered phenomenon referred to as vertical fiscal externalities.[5] This refers to the fact that provincial level fiscal decisions have effects that spill over onto the federal government, and thereby to residents of other provinces. For example, an income tax increase in one province reduces the tax base and thereby causes federal tax revenues to shrink. This is a cost of revenue-raising that is neglected by the province and leads to an incentive to over-expand. The overall consequences of this are not obvious. Vertical fiscal externalities work in a direction that offsets horizontal tax competition, so it is not obvious that on balance it is a bad thing. Nor is it clear how the fiscal arrangements can overcome them, except perhaps by either limiting the extent of decentralization of revenue-raising responsibilities to the provinces or implementing effective tax harmonization agreements.

The third source of inefficiency is what we have referred to as fiscal inefficiency. Recall from above that decentralization in itself entails that different provinces will have different capacities to provide public services to their citizens because of differences in tax capacity and need. Given that the activities of provincial governments are redistributive in nature (rather than being based on the benefit principle), differences in NFBs will arise that provide a purely fiscal incentive to economic activity to gravitate towards more advantaged provinces. This is a critical efficiency effect for the fiscal arrangements, since it is one that can readily be corrected without compromising the integrity of the federation. A system of unconditional equalizing transfers can effectively undo NFB differences and thus facilitate the very process of decentralization. The more decentralization there is, the greater is the need for fiscal equalization (but also the more difficult it may be to achieve politically).

[5] Canadian economists especially have been involved in their study, including Boadway and Keen (1996); Dahlby (1996); Boadway, Marchand and Vigneault (1998); and Dahlby and Wilson (2000). For a general survey of vertical fiscal externalities and their relevance, see Keen (1998).

Equity

Decentralization can have parallel effects on the extent and structure of redistribution policies implemented by the various levels of government in a federation. Evaluating these effects is much more tenuous than in the case of efficiency since additional value judgements are involved. As in the case of horizontal fiscal externalities, interprovincial competition for business activity and for tax bases can result in a competing down of redistribution policies. Provinces have an incentive to attract higher income persons and firms at the expense of lower income ones or those who are likely to be heavier users of public services. The extent to which this competing down of redistribution (the co-called race to the bottom) occurs in practice is more a matter of anecdotal evidence than substantiated analysis.[6] As well, the influence of vertical fiscal externalities tempers horizontal competition effects. To the extent that the costs of redistribution can be shifted to the federal budget, provinces will be induced to over-redistribute, and this latter effect can dominate if transfer-recipients are relatively immobile.

Whether or not these fiscal externalities induce too much or too little redistribution, different provinces are almost certainly likely to adopt different standards of redistribution with respect to various groups. As we have argued, redistribution policy is multi-faceted, and relies on a variety of policy instruments. It would be surprising if different provinces adopted similar structures. The consequence is that from a national point of view, needy persons of a given type in different provinces may face very different standards of redistribution, potentially violating the notions of equal opportunity, reduction in economic disparity and the availability of public services of reasonable quality set out in Section 36(1).

Whether one should be concerned with differences in standards of redistribution across provinces is a matter of judgement. It could certainly be argued that the essence of federalism is that different provinces should be able to choose their own standards of redistribution. At the same time, this might be tempered by the fact that these differences may simply reflect the consequences of fiscal competition. It might also be argued that citizenship in a nation implies some minimal expectation of reasonably comparable treatment in different jurisdictions, as set out in Section 36(1). This is obviously a debate that is well beyond economics.

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[6]There is, however, some strong evidence that provincial welfare policies respond to incentives introduced by federal shared-cost versus block-funding. See the recent study by Baker, Payne and Smart (1999).

One remaining equity consequence of decentralization is less susceptible to concerns about the nature of federalism and the desire for autonomy by provincial governments in their own spheres of legislative authority. As we have stressed, decentralization inevitably results in differences in fiscal capacity and need across provinces. If these are not addressed citizens in different provinces will receive different levels of service for given tax rates. In addition to providing incentives for inefficient fiscally induced migration, these also result in fiscal inequity. This, along with the complementary principle found in Section 36(2), provides a strong case for full equalization of fiscal capacities across jurisdictions. Equalization is in a sense the quintessential instrument of federalism. It equips the provinces with the ability to provide comparable levels of public services to their citizens at comparable tax rates, without at the same time compelling them to do so. It thus represents a healthy compromise between achieving horizontal equity and fiscal efficiency on the one hand, and maintaining effective decentral-ization on the other.[7]

The Fiscal Arrangements: Can They Deliver?

Standard fiscal federalism theory holds that the fiscal arrangements represent the means by which decentralization can be facilitated, while at the same time the costs of decentralization are contained, the principles of the constitution are fulfilled, and the responsibilities of the federal government in achieving national objectives are accomplished. The greater the amount of decentralization, the more important are the fiscal arrangements, but at the same time the more difficult and challenging their task.

The extent of decentralization in Canada has evolved dramatically over the past four decades, especially since the years of fiscal restraint in the early 1990s. For example, the proportion of public spending (excluding inter-governmental transfers) attributable to the provinces and their municipalities went from 47 per cent in 1961 to 61 per cent in 1999. Over the same period, the provincial share of total revenues went from 40 per cent to 53 per cent, and federal transfers as a share of provincial revenues declined from 22 per cent to 13 per cent. This change has been accompanied by a change in the structure of federal-provincial transfers. Equalization payments doubled in the 1980s from about $3.6 billion to $7.3 billion, while block grants for health,

[7] Another role of equalization is sometimes stressed, and that is its role as a risk-sharing device. It effectively acts as a form of insurance against adverse shocks to provinces' tax bases. This was not stressed in *Financing Confederation*, but is in no way inconsistent with equalization as a device for addressing fiscal efficiency and equity.

education and welfare rose by about 70 per cent from about $8 billion to $13.5 billion. In the 1990s, equalization rose by much less, from $7.3 billion to $8.5 billion, partly reflecting the fiscal retrenchment at the provincial level. At the same time, block transfers for health, education and welfare actually declined from $13.5 billion to $12.5 billion.

As mentioned, provinces in Canada now have much more fiscal autonomy than in virtually any other federation in the world. It can be presumed that this decentralization is virtually irreversible; indeed, it seems to breed further decentralization. The issue is whether the fiscal arrange-ments can cope with this degree of fiscal decentralization. To me this is an open question.

Much depends upon the view one takes of the role of the federal government. The constitution provides some limited guidance here. The legislative powers of the federal government are not controversial. What is controversial is how these powers — especially taxation, regulation and the spending power — are used in areas that overlap with provincial legislative responsibilities. Some guidance is found in section 36, which as we have seen gives the federal government some responsibility for ensuring that equality of opportunity and the provision of basic public services apply across the country. However, this does not clearly specify the role of the federal government in achieving either efficiency in the internal economic union or national equity. And, it is not just a matter of agreeing to these objectives as goals of government. One can vigorously argue for national efficiency and equity as legitimate objectives of government, but at the same time take the position that the federal government is not primarily responsible for achieving them.[8] Our position, which is consistent with that taken by *Financing Confederation*, is that the federal government has a legitimate interest in national efficiency and equity objectives, and that without federal initiative it is unlikely that these objectives can be suitably addressed.

The components of the fiscal arrangements can be summarized as follows.

[8]Indeed, some might argue that they are objectives that could be achieved by collaborative provincial action, with minimal participation by the federal government. The position taken by Courchene (1996) is close to that.

Vertical Fiscal Imbalance

In virtually every multi-level system of government, including federations, higher level governments collect more in revenue than they need for their own program expenditures. This is true with respect to the federal government and the provinces in Canada, as well as with respect to the provinces and their municipalities. Interjurisdictional transfers, of course, balance this VFI. In itself, the existence of a VFI between the federal government and the provinces reduces the incidence of fiscal externalities, contributes to harmon-ization of tax and transfer policies, avoids excessive fiscal imbalance, without at the same time necessarily reducing provincial responsibility in the areas of provincial legislative responsibility. But it does so largely by making the federal government preponderant, allegedly at the expense of provincial autonomy and accountability. Moreover, this preponderance lends itself to the possibility that the transfers used to close the VFI are used in ways that expose the provinces to the uncertainly associated with unannounced changes.

Equalization

Equalization is the *sine qua non* of fiscal decentralization, and is also present in virtually every multi-level system of government. Its purpose in the Canadian federation is twofold. First, from a constitutional point of view, it is meant to fulfill the principles of both parts of Section 36 of the *Constitution Act*. That is, it redresses the differences in fiscal capacity that come about simply from fiscal decentralization (the equalization principle of Section 36(2)), and it facilitates the ability of provinces to achieve the objectives set out in Section 36(1). Second, by redressing fiscal capacity differences, equalization avoids the fiscal inefficiencies and fiscal inequities that would otherwise arise, a position well documented in *Financing Confederation*.

There has been much debate about the relevance of these problems, and a large literature has developed.[9] Some allege that fiscal inefficiency is empirically unimportant. More important, others do not accept the value judgement on which the notion of fiscal inequity is based, essentially a notion of equal treatment of citizens regardless of where they reside. Suffice it to say that it is the principle that underlies Section 36(2), and, it seems to be a natural extension of the notion of citizenship and equal treatment. It is a

[9] See the recent overview in Boadway and Hobson (1998).

principle that does not detract from the responsibilities meant to be enjoyed by the provinces. And, it applies whatever one's views about the redistributive role of government. In short, it is a very powerful principle, and one that is widely accepted.

The Spending Power

The spending power represents the only realistic policy instrument available to the federal government to achieve its presumed responsibilities for efficiency and equity in the economic union, and its joint constitutional responsibility with respect to redistributive equity (Section 36(1)).[10] In much of the economic literature, its use is taken for granted. As with equalization, the spending power is also a widely used instrument in all federations around the world, and usually with less controversy (Watts, 1999). It has been found by the courts to be a constitutionally valid federal policy instrument (Hogg, 1996), and it underlies some of the most important federal social policy initiatives, including refundable tax credits, grants to various institutions including universities, the Canada Health and Social Transfer, shared cost transfers, and even equalization.

Its use is not without difficulty, quite apart from concerns of a political nature. It can be viewed as intrusive and unpredictable, especially if it is used in intrusive and unpredictable ways! While there is nothing inherent in the spending power that requires that it be used unilaterally, unpredictably and without adequate consultation, detractors argue that since the instrument is ultimately a federal legislative power involving budgetary spending, it is prone to such problems. Not surprisingly, there is a constant search for alternatives that might avoid these difficulties. The main alternative is negotiation and joint decision-making, the final element of the fiscal arrangements.

Policy Harmonization

Interjurisdictional agreement over the structure of tax or expenditure policies is an alternative to the spending power, with or without the connivance of the federal government. It is not the only alternative, but others would be even

[10] In principle, the federal government could use its power of disallowance to cajole the provinces into conformity. But that is clearly an unrealistic alternative to the spending power. Other alternatives that involve collective federal-provincial decision-making are discussed below.

less palatable than the spending power. These include the use of federal mandates, the power of disallowance, or resort to the courts. Examples of these occur in other federations around the world, but it seems clear that they would be unacceptable in our decentralized federation (and they were not seriously considered in *Financing Confederation*).

We have had some mixed experience in Canada with policy harmonization. There have been various tax collection agreements that have served to harmonize various taxes between the federal government and several provinces. These include the highly successful income tax collection agreements, which have been widely regarded as model forms of tax harmonization. Harmonization of sales taxes has been much less widespread, but has enjoyed some success with the Quebec Sales tax and the Harmonized Sales Tax in three of the Atlantic provinces. The federal-provincial agreement on child tax credits can be regarded as successful, as can the Canada Pension Plan. On the other hand, the Agreement on Internal Trade (AIT), intended to bring some order to interprovincial trade, is notable for its lack of bite. And, the Social Union Framework Agreement (SUFA) changes the status quo relatively little. It is notable that the main successes among these agreements occur when the federal government uses it spending or taxing power as a carrot or stick.

Canada has been a bit of an innovator in the use of federal-provincial agreements, perhaps being driven by the imperatives of decentralization. The extent of success remains to be seen. There are two grounds for being sceptical about the efficacy of federal-provincial agreements as means of achieving national policy objectives. First, negotiating a successful agree-ment can only be done with unanimous consent. Not only is that difficult to do with ten to fourteen governments involved, by its nature it implies that such agreements cannot involve any redistribution among provinces. That rules out effective agreements involving national equity considerations. Second, to be effective, such agreements must have a means of enforcement — a so-called dispute settlement mechanism — and that must be binding. The most successful agreements have been the tax collection agreements, and that has been because the federal government was effectively able to induce the provinces into participation because of the disparity in tax room that existed when the agreements were negotiated. It is instructive that these agreements are undergoing a considerable transformation as the balance of tax room shifts gradually in favour of the provinces.

Tensions Resolved versus Tensions Created

The past four decades have witnessed a gradual decentralization in fiscal responsibilities to the provinces, a trend that was abruptly accelerated in the early 1990s. Our federation is now the most decentralized federation in the world. The proportion of subnational government revenues that come from own sources is the highest among all federations. The subnational share of total government expenditures is also among the highest. And, provinces in Canada exercise more actual discretion over their own spending than in other federations, where mandates, conditionality and federal oversight are often the norm. Some of this decentralization has been a result of conscious policy. But, most of it has occurred piecemeal as the cumulative result of a series of decisions taken as part of the budgetary process, and in response to fiscal pressures that have had little to do with fiscal federalism. Indeed, it could be held that the process of decentralization itself fed centrifugal tendencies rather than the reverse. In other words, decentralization has done more to create tensions than to resolve them.

There are many signs of strain in virtually all aspects of the federal system. The following list is intended to indicate the strains that now exist in the system.

Equalization. Most seriously, the equalization system and the will to maintain it are in peril, at the same time that fiscal disparities are more likely to rise than to fall. The latter is an inevitable consequence of the gradual decentralization of revenue-raising responsibility to the provinces: for a given pattern of per capita tax bases across provinces, fiscal capacity differences are greater the larger is the amount of revenues raised by the provinces. The equalization system is no longer comprehensive, and is unable to cope with the huge disparities arising from oil and gas revenues. The current system does not even accomplish what *Financing Confederation* referred to as the narrow-based approach to dealing with resource revenues. It suffers from a number of structural defects that are likely to be more serious as the federation becomes more decentralized. For example, equalization is based solely on revenue-raising capacity, whereas disparities in the ability to provide reasonably comparable levels of public services at reasonably comparable levels of taxation can arise because of different demographic compositions of provincial populations. These differences in the need for public services are components of equalization in many other countries (e.g., Australia, South Africa, Japan, Scandinavia). Proposals that are now on the table, such as moving to an apparently simpler macro formula, are unlikely to resolve the underlying problems.

The Spending Power. As the VFI has fallen, the federal government has effectively lost control of the spending power. This means that there is no effective mechanism by which they can exercise their responsibility for pursuing equality of opportunity and for maintaining reasonable standards of quality in public services. There are many who would argue that this is a good thing, but so far there is no effective alternative in place for achieving national equity objectives.

The Economic Union. Nor is there a mechanism for maintaining the integrity of the internal economic union. There are signs that both national equity standards and the efficiency of the economic union are beginning to erode. Examples can be found in provincial tax policies (tax holidays, preferential treatment for provincial residents), education policies (differential fees, local preferences in university admissions, preferential tax treatment of provincial scholars) and welfare policies (waiting periods and rate reductions). International free trade has itself enhanced the incentives for provinces to engage in tax competition, expenditure competition and beggar-thy-neighbour policies with respect to one another.

Tax Harmonization. The income tax system is becoming disharmonized, and provinces seem to be engaged in competitive reductions in income tax progressivity. Attempts at harmonizing the sales tax system have been stalled, and are unlikely to make any headway in the near future.

Cooperative Solutions. Attempts at arriving at cooperative solutions by federal-provincial negotiation have not been very successful. We have discussed above the fact that the most successful negotiated arrangements seem to be in circumstances in which enforcement is implicitly achieved by the federal power of the purse.

It may well be that the decentralized Canadian federation will evolve into one in which provinces behave "cooperatively" with respect to national objectives of efficiency and equity. After all, provinces do not take their decisions in isolation. However, there is little evidence that we are evolving to such a cooperative outcome. Perhaps the time has come for an updated version of *Financing Confederation*. Unfortunately, we now lack the Economic Council of Canada from which the original wisdom emanated. As well, we lack institutions such as the Commonwealth Grants Commission in

Australia or the Financial and Fiscal Commission in South Africa that could do the job. These bodies have the mandate to take a longer run view of the evolution of their respective federations, one that is at arm's length from the year-to-year budgetary problems of the central government. In both cases, the force and logic of their recommendations have been very influential in formulating policy.

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