

## Fiscal Federalism and Social Policy Reform

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Social policy has become the current by-word for redistributive policy. It comprises a wide variety of government programmes and constitutes the bulk of programme expenditures by the public sector. It includes traditional income-based redistribution operated through the tax-transfer system (the progressive tax and various refundable credits). It also includes transfers to individuals based on criteria other than income, especially those made to the poor and the elderly. Yet another important category involves social insurance schemes intended to compensate for various forms of misfortune, such as unemployment, illness, injury, disability and the like. A final, but important, category involves the public provision of goods and services, most of which are essentially private in nature but are provided through the public sector for redistributive reasons. This would include not only social services, but also such big ticket items as education and health care expenditures.

While governments have obviously been involved in these sorts of things for a long time, economists are only now coming to recognize the legitimate role to be played by social insurance and the provision of public services alongside income-based transfers as redistributive instruments. Until recently, the general view was that income transfers were inherently superior to transfers in kind; and, social insurance schemes were justified by standard efficiency based market failure arguments. However, the 'new public economics' is now very much cognizant of the fact that redistributive policy (such as social policy)

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is multi-faceted.<sup>1</sup> This is an important change in perspective, for it suddenly implies that much more of what governments do is now perceived to be redistributive in nature. Indeed, contrary to the classical view of Musgrave (1959) that dominated the literature for so long, it seems quite reasonable to view governments as largely being institutions for achieving collective equity goals rather than as being instruments for correcting market failure.

The fact that redistributive or social policy is seen to consist of many components renders policy making difficult. Every policy depends on other policies, and policy coordination becomes important to the success of the overall package. In a federation, the problem becomes ever more difficult. For one thing, the assignment of responsibility for redistributive policy is not an easy matter, especially since virtually all policies of significance have redistributive consequences. For another, different instruments of redistributive policy may have been assigned to different levels of government. Not only does this cause problems of coordination. It also constrains each level of government in achieving its redistributive goals, and may induce them to undertake non-optimal policies.

These problems are particularly acute in Canada, where the federation is highly decentralized by international standards. Many of the instruments for redistribution are in exclusive areas of provincial legislative responsibility. Yet, the federal government retains major responsibility for redistributive equity. The one possible way out of this dilemma is through the imaginative use of the federal-provincial fiscal arrangements. That is the topic we explore in this paper.

We argue that as the federation becomes more decentralized as a natural and legitimate consequence of improving the delivery of public services, the fiscal arrangements should assume greater and greater importance. They are the only means by which the federal government can insure that national objectives of efficiency and equity are maintained. Instead, precisely the opposite has been allowed to occur. The fiscal arrangements have been allowed to deteriorate both in size and in design to the point where the ability of the federal government to pursue its proper objectives has been dangerously eroded, perhaps irreversibly. We offer some suggestions about how this erosion can be arrested.

### **Roles of the Federal and Provincial Governments in Social Policy**

A key to making progress in social policy is to sort out which level of government is responsible for what. Since virtually everything governments do have

1. For a discussion of the relevant public economic theory supporting this position, see Boadway (1994).

equity dimensions to them, that is not an easy task. Economists have typically argued that the federal government ought to have an overriding interest in redistributive equity on the grounds that citizenship in a country should imply that everyone has the same weight in society's 'social welfare function' regardless of where they reside.<sup>2</sup> Thus, there is a national equity objective that the federal government alone must be the steward of. Beyond that, one must look at the ways in which responsibilities are divided between the two levels of government. The first place to look is the Canadian constitution, the Constitution Act, 1982. The basic responsibilities of the federal and provincial governments are clearly enunciated there. For the purposes of social policy, the most important features of these responsibilities are as follows.

**The Joint Responsibility for Equity.** Section 36(1) clearly states that both levels of government are jointly committed to at least part of the national equity agenda, including providing equal opportunities, reducing disparities and providing essential public services to all Canadians. We interpret this provision, though it may be more a guiding principle than a binding obligation, as providing support to the federal government's interest in the delivery of services that are essential or that serve to equalize opportunities and reduce disparities. This is critical since, as we see below, most of the policy instruments involved are in the exclusive legislative jurisdiction of the provinces.

**The Federal Equalization Commitment.** Complementary to the joint commitment for providing essential public services is the federal commitment to provide equalization payments to ensure that all provinces can provide reasonably comparable public services at reasonably comparable tax rates (Section 36(2)). This can be viewed as a commitment to national 'horizontal' equity; that is, the principle that identical persons should be treated equally by the public sector as a whole regardless of where they reside.

**The Federal Spending Power.** An extremely important federal policy instrument, not mentioned explicitly but generally regarded as being constitutionally sanctioned, is the spending power. A high proportion of the transfers by the federal government not only to other governments, but also to persons and businesses, reflect the exercise of this power. What is particularly relevant is that the spending power enables the federal government to make transfers to the provinces conditional on the way in which the provinces spend, even though the spending is in an area of exclusive provincial jurisdiction. This will be of obvious relevance for our discussion on social policy since the spending power is the only federal policy instrument available for achieving national objectives in areas of exclusive provincial jurisdiction. It also enables the federal government to enact income transfer schemes to individuals for redistributive purposes, provided they do not constitute legislative programmes in areas of provincial jurisdiction.

2. This is discussed in more detail in Boadway (1992).

**Tax Authority.** The federal government has unrestricted use of the tax system (with the possible exception of the taxation of natural resources, a restriction that is of little relevance to social policy). This implies that the federal government is not restricted, in principle, in achieving those equity goals that it can through progressive taxation. However, since the provinces also occupy the direct tax fields, federal redistributive tax objectives could be thwarted to the extent that provinces adopt independent and conflicting income tax systems. This becomes more likely the more income tax room do the provinces occupy relative to the federal government.

**Exclusive Provincial Legislative Authority.** The provinces enjoy exclusive responsibility for programmes in areas such as health, education and welfare services (Section 92, Constitution Act).<sup>3</sup> Indeed, by virtue of provincial responsibility for civil and property rights, the provinces can be taken to be legislatively responsible for almost any public service to be provided to individuals. Thus, to take a current example, day care services are a provincial responsibility, as would be others that might become relevant in the future. Moreover, those that were not covered under the rubric of civil and property rights would be provincial as 'residual powers'. This means that almost all public services whose objective is redistributive equity, and which, therefore, are part of social policy, are the exclusive legislative responsibility of the provinces, despite the joint obligation imposed on the federal government under Section 36(1) of the Constitution Act, 1982. This poses a serious question for the role of the federal government in the implementation of national social policies, a question that is mentioned but not resolved by the recent federal Green Paper.

**Constitutional Amendments in Pensions and Unemployment Insurance.** The notable exceptions to the above are in the areas of pensions and unemployment insurance (UI). By constitutional amendment, the federal government acquired the right to legislate in these areas. In the case of UI, they assumed exclusive responsibility. However, in the area of pensions, there was to be joint occupancy, though with federal paramountcy.

**Internal Common Market.** Though social policy is primarily equity-oriented in objective, issues of national efficiency naturally arise.<sup>4</sup> It is commonly agreed that an important national objective is to maintain the efficiency of the internal common market, or economic union. This is nowhere explicitly stated in the Constitution Act, but it 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. Moreover, the tenets of Section 36 could also be seen as lending support to a federal role in main-

3. Social assistance payments, as opposed to social service provision, is apparently not, however, an exclusive provincial responsibility.  
4. Social policy can, of course, also contribute to efficiency by improving productivity through human capital accumulation and health care.

taining an efficient economic union. The desire to foster the internal common market 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 programme competition with one another, or at least so that any negative consequences for the internal common market from healthy inter-provincial competition are offset. Again, the spending power is the only instrument available to the federal government for this purpose. In principle, it can be used to provide financial incentives to the provinces to take account of national equity and efficiency objective in designing their programmes. The criteria imposed by the Canada Health Act, 1984 are examples of this. Some of them are for equity reasons (for example, accessibility) and some for efficiency (for example, portability of benefits).

We can summarize this discussion of the allocation of responsibilities. The federal government has responsibility for objectives of a national nature, and these presumably imply both national equity and national efficiency objectives. The Canadian constitution explicitly recognizes the federal interest in equity in Section 36. At the same time, the federal government does not have direct access to all the policy instruments necessary to achieve either national equity or national efficiency. Quite reasonably, the responsibility for providing most public services that serve redistributive ends are in the exclusive legislative domain of the provinces. This decentralization of public service provision is in accord with federalism theory. However, it does pose an important dilemma for the federal government. How can it begin to achieve its legitimate social policy objectives when many of the instruments for doing so are in the hands of the provinces? The answer is clear: it can only do so with the use of spending power. Otherwise, a national social policy is out of reach, and one must rely entirely on the provinces to accomplish social policy objectives. And, given the narrow geographical interests that the provincial governments represent, even the most well-meaning behaviour by decentralized provincial decision makers is likely to violate national norms of equity and efficiency.

### Suitability of the Existing Fiscal Arrangements for Addressing Social Policy Issues

The deficiencies of Canada's social policy system have been well-documented, and proposals for reforming it have been frequently made, the federal Green Paper only representing the most recent, and perhaps least sweeping, of these.<sup>5</sup> We need not go over that ground again. However, the tendency in many of

5. Perhaps the most comprehensive review was that of the Macdonald Royal Commission on The Economic Union and development Prospects for the Canadian Economy. See also the recent work by Courchene (1994).



these exercises is to ignore both the real constraints and the real opportunities resulting from the fact of federalism. In this section, we review some of the features of the way in which the fiscal arrangements have evolved in recent years with a view to evaluating their suitability as a system for supporting effective social policy.

The fiscal arrangements include a wide variety of forms of fiscal interaction between the federal government and the provinces.<sup>6</sup> For our purposes, we concentrate on two main components: the major federal-provincial transfers and the system of tax harmonization. The form of both of these are critical in facilitating a coherent national social policy. Until recently, the major transfers include Equalization, Established Programmes Financing (EPF) and the Canada Assistance Plan (CAP). The federal budget of 1995 consolidated the latter two into what is now called the Canada Health and Social Transfer (CHST). The system of tax harmonization involves mainly the Tax Collection Agreements negotiated between the federal government and the participating provinces for the individual and corporation income taxes.

Prior to the 1995 budget, all of these programmes had been in place for a long time, despite some fairly significant changes that have occurred in the fiscal relationship facing the federal government and the provinces in the meantime. Some of the most important changes that have occurred are the following:

**Growth of Provincial Expenditure Responsibilities.** From the previous section, we can see that those expenditure responsibilities that are growing most rapidly (for example, health, education, welfare) are at the provincial level. In fact, the provinces have long since overtaken the federal government in terms of programme expenditures, as well as in terms of expenditures on goods and services.<sup>7</sup> Moreover, the form of federal and provincial expenditures differ considerably. While a high proportion of federal expenditures is on transfers of various sorts, a high proportion of provincial expenditures involves the provision of public services, many of them services related to social policy.

**Provincial Government Self-Reliance.** At the same time as provincial expenditure responsibilities have grown, so has their reliance on own-source revenues.<sup>8</sup> Thus, the fiscal system is becoming more decentralized as time passes. This entails not only reduced reliance on federal transfers, and therefore a reduction in the opportunity for the federal government to influence provincial expenditure programmes, but also an increase in the share of tax room

occupied by the provinces. The latter implies that it may be more difficult to maintain an effective system of income tax harmonization, such as we have come to enjoy. Under the existing system of fiscal arrangements, the trend to provincial self-reliance is bound to increase since most of the transfers grow at a rate significantly less than the rate of growth of provincial expenditures. However, federal policies themselves have served to exacerbate the trend.

**Federal Deficit-Reduction Policies.** The federal government has an obvious debt problem, and it is not surprising that reductions in transfers to the provinces have been used as part of a deficit-reduction strategy. The problem is that this transfer of the deficit to the provinces, whatever its benefit in terms of inducing provinces to become more cost-effective, has longer run consequences from the point of view of federal-provincial fiscal arrangements. The consequent occupation of further tax room by the provinces reduces, in an almost irreversible way, the remaining ability the federal government has to play a part in achieving national equity and efficiency goals.<sup>9</sup> We would argue that as the federation becomes more decentralized, the role of the fiscal arrangements in achieving national economic objectives becomes more, rather than less, important.

**Tax Reform.** The ability of the federal government to achieve national equity and efficiency objectives may have been further compromised by the recent federal tax reforms. As with deficit reduction, these were undertaken seemingly without being unduly troubled by the resulting consequences for fiscal federalism. The particular component of the tax reform that is most troubling from this perspective is the introduction of the GST. Most economists would heartily agree that as indirect taxes go, this is a good tax. The documentation that Finance Canada produced to accompany and justify its implementation were by economic standards well-argued and reflected state-of-the-art thinking in the tax reform area. However, the case for the GST was all predicated on the presumption that the federal government needed, as part of its tax menu, a general sales tax. Once the fiscal arrangements are taken into account, additional considerations arise. The main one is that the more revenue the federal government obtains from the GST, the less it will need from the income tax.

There will necessarily be a shift over time of income tax room in favour of the provinces, and this shift will be larger the more does the federal government come to rely on the GST for its revenues. The upshot will be less federal presence in the income tax, and a lesser chance of maintaining a harmonized system. The fact is that, given the extent of decentralization in Canada's federal system, the federal government can dominate at most one tax base. The implementation of the GST reduces its ability to dominate the income tax and therefore threatens the continued viability of income tax harmonization (which is one

6. For an overview, see Boadway and Hobson (1993).

7. For example, federal programme spending (excluding intergovernmental transfers) is only 80% of provincial programme spending, while federal spending on goods and services is only 70% of that of the provinces. See Boadway and Flatters (1994) for more detail.

8. For example, Nova Scotia and New Brunswick now receive just over one-third of their revenues from transfers, compared with about half in 1970. Similarly, Alberta receives about 14% now compared with 24% in 1970. See Boadway and Flatters (1994).

9. These arguments are developed in Boadway (1989).

of the instrument for achieving national equity and efficiency).

These events have changed the nature of the federation immensely over the past two decades. The major components of the fiscal arrangements themselves are under some strain. This is due to a combination of neglect (most of the programmes have been unchanged structurally since they were introduced), piecemeal changes in response to events and fiscal exigencies. It is worth looking at each component in turn to identify some of the major problems facing them. It will be difficult to imagine a successful social policy reform process in the absence of rationalizing the system of fiscal arrangements, especially given that their purpose is largely to support the achievement of redistributive equity. We begin with a consideration of the pre-budget system since it serves as a useful basis for evaluating the consequences of the CHST. In fact, the introduction of the CHST is no more than a natural culmination of events that have been gradually in the making.

### Equalization

The Equalization scheme is the heart of the system of fiscal arrangements. It is also the programme whose design most closely suits its objective, and is the one that probably commands the most public support. There is a large literature both on the principle of equalization and on the Equalization programme itself.<sup>10</sup> The upshot of that literature is that in a decentralized federation, equalization is necessary to achieve both fiscal efficiency and fiscal equity, and is, therefore, an indispensable tool of the federal government, and a requirement of social policy.

The Equalization system can be viewed as the main instrument by which the federal government satisfies its commitment under Section 36(2) of the Constitution Act. However, it does not do so perfectly; nor is it the only policy instrument that contributes to that objective. The main drawbacks to the current Equalization system are well-known, though they are largely matters of programme design.<sup>11</sup> Because the system is a gross one, it equalizes the have-not provinces up, but does not equalize the have provinces down (at least directly). It is based on a five-province standard rather than a national-average standard. While this may not make much difference on average, it does have some odd effects in certain areas, especially oil and gas revenues; for example, it effectively taxes new oil and gas revenues received by have-not provinces at confiscatory rates. It is also subject to a cap on growth that detracts from its effectiveness.

Perhaps its most serious shortcoming is the fact that it concentrates only

on tax capacity differences and neglects other sources of fiscal capacity difference such as different needs for public services across provinces. This might be thought of as a potentially serious limitation of the programme, given especially the significant differences in demographic make-up among provinces that translate into different needs for things like education and health expenditures. While some countries have attempted to incorporate elements of need into their equalization systems (for example, Australia), ours is based solely on tax capacity. Any equalization that occurs on account of need does so through matching grants, and that is limited mainly to CAP.

It is important to recognize not only what Equalization is intended to do, but also what it is not intended to do. It is a programme for equalizing potential access to public services. It is not meant to be an instrument for income redistribution. The common argument that 'people' prosperity ought to supersede 'place' prosperity in designing government redistributive programmes seems to be partly based on confusion about the intention of equalization. Of necessity, it must be a transfer based on provinces since its purpose is to ensure that in a decentralized federation, different provinces are in fact able to provide comparable public services at comparable tax rates. It is a purpose that is well-grounded in economic theory, as well as being a principle found in the Canadian constitution.

### Established Programmes Financing

On the surface of it, EPF was a simple equal per capita block grant to the provinces to support their expenditure responsibilities in the areas of health and post-secondary education. As such, it was a useful complement to Equalization, since by collecting federal taxes nationwide using the federal tax system and redistributing them on an equal per capita basis across provinces, it was a form of equalization. To that extent, it could be seen as a part of the means by which the federal government satisfied its constitutional equalization commitment. At the same time, although it was a block grant, the payments were made with conditions attached. To be fully eligible to receive them, provinces had to maintain publicly administered health insurance systems that satisfied the criteria set out in the Canada Health Act. This was just an example of the spending power in action as a means of fostering national standards of equity and efficiency.

At the same time, there were some fundamental problems with the EPF system that threatened its very existence. First, the overall rate of growth of EPF transfers was limited to the annual growth rate of GDP and, in fact, it had been temporarily reduced even further in the past two decades in response to various federal government expenditure restraint efforts. This limitation on growth in EPF transfers in itself ensured that provinces financed higher and higher proportions of their own expenditures in health and post-secondary

10. See the summary in Boadway and Hobson (1993).

11. See Boadway and Hobson (1993).

education, since both grew more rapidly than EPF receipts.

The second structural feature was even more consequential, and that was that the EPF transfer, as originally instituted in 1977, was divided between a cash transfer and a tax point transfer component. At the time, the division was such that about half the 'transfer' was in tax points and the other half in cash. Since then, because the value of the tax transfer has grown more rapidly than that of the overall entitlement, the residual cash component has gradually fallen. It was due to disappear entirely early next century.<sup>12</sup> As a result, the lever available to the federal government for enforcing the conditions of the Canada Health Act, or for encouraging provinces to adopt national standards in other areas of expenditure, will have been lost.

The inclusion of the tax-transfer component as part of the EPF transfer was always anomalous, and became more so as time went by. The fact is that once the tax points were turned over to the provinces, they became part of the provinces' own-source revenues, for all intents and purposes. The federal government lost complete control over those funds. Despite that, it continued to report the EPF transfer as including both the tax-transfer and the cash component, a practice that was more than a bit misleading. More than that, it had become mischievous. We have already mentioned the fact that its inclusion was responsible for gradually driving the cash transfer towards zero and effectively removing from the federal government in a virtually irreversible way one of the few instruments that remain open to it for fulfilling its national equity and efficiency objectives in an increasingly decentralized federation. As well, because the tax-transfer was allowed to enter the EPF cash calculation, and because the (equalized) tax-point transfer was worth different amounts to different provinces (because of both the gross nature of the Equalization scheme and the fact that Quebec received more tax points than the rest of the provinces), the amount of cash that was paid to the have provinces (and to Quebec) differed in per capita terms from that paid to the have-not provinces. Finally, the use of tax points, alongside cash transfers in the original EPF transfer, also directly contributed to the decentralization of income tax room to the provinces, a decentralization that could threaten the integrity of income tax harmonization.

The EPF transfer was nominally divided between the health and post-secondary education components, and was reported as such by the federal government. This distinction was basically meaningless. There were no restrictions on the way in which the provinces spent the money they received (and certainly

12. It would have disappeared much sooner for Quebec because more tax points were transferred to it in 1977. What would have happened when Quebec incurs a negative cash entitlement is an open question.

none on the way they used their tax points).<sup>13</sup> Moreover, there were no conditions attached to the use of EPF funds for post-secondary education, such as the portability or accessibility provisions of the Canada Health Act. Despite this, many observers have argued of the need for a national policy on post-secondary education. Given that the latter is clearly in provincial jurisdiction, the only instrument available for implementing such a policy would be the spending power.

### Canada Assistance Plan

The CAP remained the only significant matching grant programme in the Canadian system. Social service operating costs and social assistance were shared 50-50 with the federal government. An exception to this was the arbitrary limit currently imposed on the amount transferred to the three have provinces, the so-called 'cap on CAP'. For them, the transfer was effectively a lump-sum conditional grant as long as the cap was in place. CAP was also an obviously important programme from the point of view of social policy reform and was the subject of one of the thrusts of the federal Green Paper, despite welfare being an accepted provincial responsibility.

The standard justification given for the matching form of the CAP was to internalize for spillovers arising from the fact that welfare recipients may be mobile among provinces. Acting on their own, provinces might be inclined to adopt a strategy of reducing their welfare payments below that of neighbouring provinces in an attempt to reduce the number on the welfare rolls at the expense of other provinces. If all provinces acted in this beggar-thy-neighbour way, the end result would be that welfare levels would be significantly reduced in all provinces with no resulting effect on numbers of recipients by province. Legitimate though this argument may be in qualitative terms, it is unlikely to be able to support full 50-50 cost sharing; that would imply an enormous externality effect.<sup>14</sup>

An alternative argument for cost sharing is a more cogent one. It is that basing CAP on actual costs incurred in provincial welfare systems acted as a form of equalization, effectively incorporating differences in need into the system of fiscal transfers. By this argument, CAP was a complement to the

13. It is interesting to note that when the federal Green Paper presents a number representing federal support for post-secondary education, it includes this notional share of the full EPF transfer, including tax points. In other words, a good part of 'federal' support for post-secondary education is attributed to tax revenues raised by the provinces themselves from their own tax points!

14. Some evidence that the argument has some justification may be found in the substantial cuts in welfare levels recently implemented in Alberta, a province which, because of the cap on CAP, no longer enjoys 50 cent dollars at the margin.

Equalization scheme, and helped contribute to the objectives of Section 36(2) of the Constitution Act. The trouble is that, unlike the Equalization system itself, it did so in a way that imposed potentially strong incentive effects on the provinces. The lure of 50 cent dollars should be an inducement for provinces to overspend. The usual argument for including need factors in equalization systems calls for doing so using indicators of potential need rather than actual expenditures. Examples would include numbers of welfare recipients or demographic indicators.<sup>15</sup>

As a component of a system of fiscal arrangements whose objective was intended to contribute to national equity and efficiency, CAP did not fare particularly well. We have already mentioned the adverse incentives imposed by the matching formula that effectively meant that (apart from the provinces temporarily facing a cap on CAP) provinces were spending 50 cent dollars. There was no sound economic rationale for this. The conditions imposed on the use of CAP funds by the provinces appeared to be minimal. Much is made of the requirement that provincial welfare assistance be based on 'need'. Provinces have argued that this constrained them from integrating their welfare schemes with their income tax systems, though it is not obvious that such a constraint did in fact operate.<sup>16</sup> Existing welfare schemes are notorious for their adverse work incentives, often imposing very punitive implicit tax rates on outside earnings. Moreover, they have equally adverse incentives for savings, since welfare recipients are typically not allowed to accumulate significant amounts of wealth. A consequence is that welfare schemes do little to assist the working poor.

Despite the obvious interest that the federal government has in the way in which provincial welfare systems are designed, and despite the well-documented problems with provincial welfare systems and various national recommendations for some sort of national policy for the poor, the CAP was never used as a vehicle for implementing national standards. This stands in sharp contrast with the case of health care where national standards were quite successfully introduced via the criteria of the Canada Health Act (and its predecessors, which had similar criteria). In fact, as we have emphasized above, virtually the only policy instrument the federal government has for pursuing national equity and efficiency objectives in areas of provincial jurisdiction (like welfare) is the spending power. CAP would have been an ideal transfer for the federal govern-

15. For a recent proposal for incorporating need into the CAP system, see Hobson and St.-Hilaire (1993). They suggested converting CAP to a block grant and distributing the funds across provinces in accordance with an index of need.

16. Quebec is the one province that has pursued this path. Of course, the fact that they operate their own income tax system was of some assistance.

ment to use for these purposes.<sup>17</sup>

One of the interesting consequences of the decision to let the provinces basically go their own way in the welfare fields is the resulting complete lack of coordination between the unemployment insurance (UI) system and provincial welfare systems. This has led to rather perverse behaviour by both levels of government. On the one hand, the provinces obviously have an interest in keeping low income persons on UI rather than welfare, and are alleged to engage in employment practices designed to exploit the short qualification period, especially in the high-unemployment Atlantic region. On the other hand, the federal government is constrained in pursuing redistributive policy by not having access to welfare for the lowest income persons. This may have led them to use UI not only as an insurance device for unexpected lay-offs, but also as a form of income support for low-income persons. This state of affairs is no doubt partly due to a division of powers that makes the provinces responsible for welfare and, by constitutional amendment, the federal government responsible for UI. This apparently precludes the two being operated jointly, as, for example, in many European countries. However, a judicious use of the spending power could have served to coordinate these programmes to a greater extent than is the case.

### The Canada Health and Social Transfer

The budget of 1995 rationalized the system of fiscal arrangements to some extent, though it did not alter their ultimate purpose. There are several elements to the changes proposed in the Budget. The CAP transfer was converted from a matching conditional grant to a block grant, and rolled in with EPF to form the CHST. The initial entitlement across provinces was in the same proportion which existed in the CAP/EPF funding arrangements. Provinces were given full freedom to allocate the funds as they see fit, subject to the maintenance of the general conditions attached to use of funds for health care (the Canada Health Act criteria) and the absence of residency requirements for welfare. There were cutbacks imposed on the CHST base allocations for 1996-7 (\$2.5 billion) and 1997-8 (\$4.5 billion), but presumably thereafter they could grow growth at per capita nominal GNP rate as at present under EPF (although what happens after 1997-8 is not actually stated). Negotiations are to be undertaken with the provinces over principles that should govern the future reallocation of CHST

17. One of the interesting consequences of the constitutional reform debate leading to the Charlottetown Accord was the seemingly broad consensus that existed among Canadians for there to be national standards imposed on various social programmes, at least partly to avoid them being eroded. Of course, the same people seemed to show some distaste for the use of the federal spending power. We would argue that these two attitudes are fundamentally contradictory.



funds. More generally, the federal government will work with provinces to develop a set of shared principles and objectives that could underlie the new transfer. As under EPF, there was to be a continued use of tax points transferred in 1977 as part of CHST transfers, with cash calculated as a residual.

The cornerstone of this change in fiscal arrangements is the conversion of the CAP transfer to a block grant. This allows the provinces freedom to determine spending levels as they see fit, subject only to general conditions that the federal government may choose to impose, which are few. Gone is the adverse incentive imposed by 50-cent dollars, and gone is the need to obtain federal approval for types of expenditures that are suitable for cost sharing. Few long-time observers will find fault with that. On the other hand, the cost-sharing formulation did serve one useful purpose. The allocations under a cost-sharing programme corresponded in a rough way with needs and costs among provinces, and to that extent was a useful complement to Equalization. Moreover, it could be argued that the size of aggregate welfare programs was to some extent determined by the unemployment rate that the federal government helped determine. So, sharing the costs of high unemployment was appropriate.

However, these objectives could actually be met better by a block grant program whose allocations were determined by an indicator of need that did not depend directly upon provincial expenditures, such as the number of welfare cases per capita relative to the national average. This would effectively be like the incorporation of need considerations into federal-provincial equalizing transfers, something that many have argued for in the past. The federal government chose not to go that route, preferring instead to freeze temporarily the allocation among provinces according to the rather perverse distribution that has resulted from the arbitrary cap put on CAP payments to the three have provinces.

The conversion of the CAP shared-cost programme to a block grant is only part of the story. The decision to include the EPF program with the CHST and to allow the resulting transfer to be comprised partly of a tax-point transfer dating back to 1977 virtually assures that the cash component of the CHST will automatically fall to zero sometime early in the 21st century (and earlier for Quebec than for the other provinces). Further more, this is under the rosy assumption that the CHST itself will rise at the rate of growth of GNP per capita as the previous EPF was supposed to do. Either a failure of the CHST to resume this growth path, or future cutbacks in the CHST allocation as a result of continuing budget restraint that is almost certain to come, will simply accelerate the time at which the cash runs out.

### Tax Harmonization and Coordination

The Canadian system of income tax harmonization has been a model looked up to in other federations. It has combined the uniformity of base and rate struc-

ture, a single tax collection authority, and provincial discretion over rate levels. In other words, it has allowed for national standards of equity, simplicity in terms of compliance and collection costs, and fiscal responsibility at the provincial level. It is also this system of harmonization that allows the income tax system to be used as a vehicle for rearranging tax points between the federal government and the provinces, and facilitates the use of equalization based on tax capacity.

However, such a system is only sustainable as long as the federal government retains a dominant share of the tax room. The less tax room the federal government has, the more the provinces wish to impose their own policies through the income tax system, and the less likely is it that the main features of harmonization are retained. As we have mentioned above, there has been a gradual but persistent reallocation of fiscal responsibilities in favour of the provinces. This has resulted in the provinces occupying more and more income tax room relative to the federal government. Moreover, with the institution of the GST and with federal deficit-reduction policy partly taking the form of restricting transfers to the provinces, this trend is being exacerbated.

Not surprisingly, the result has been to erode the system of tax harmonization. The number of provincial tax measures (credits, exemptions, etc.) has increased dramatically as the provinces try to implement their own policy interests through the income tax system. Many of these measures serve to distort the internal common market as well as possibly violating national equity norms. Moreover, some provinces, especially those in western Canada, are now floating the idea of withdrawing from the income tax collection agreements. Pressure for these sentiments is bound to rise if the federation continues to evolve in a fiscally decentralizing way as it has in the past two decades.

Nor has the reduction in income tax harmonization been compensated for by an increase in sales tax harmonization. Only Quebec has undertaken a partial form of harmonization of its retail sales tax with the federal GST. However, even if sales tax harmonization were the norm, it could not compensate for the loss of income tax harmonization. The gains from income tax harmonization in terms of equity and efficiency outweigh considerably those from sales tax harmonization. As we argued earlier, the principles of federalism would suggest that if the federal government can choose only one tax type to dominate, it should choose the income tax rather than the sale tax. The Carter Commission had it correct thirty years ago when it argued that the federal government ought to vacate the sales tax field entirely in favour of the provinces, and concentrate instead on the income tax.

To summarize this section, the fiscal arrangements have been allowed to deteriorate dangerously in Canada, arguably to the point where the federal government is no longer able to pursue its legitimate objectives of national equity and efficiency. The relevance of the fiscal arrangements becomes more and more important the more decentralized is the federation. The Canadian federation has become very decentralized, yet the fiscal arrangements are



virtually unchanged in form since their various components were first introduced. Though they have served us well, they are no longer suitable for supporting the sorts of national social and economic policies that Canadians are now demanding.

We would argue that there are three main components of an effective set of fiscal arrangements in a decentralized federation. They are equalization, the judicious use of the spending power, and income tax harmonization. Equalization is perhaps the least contentious of these, and also the component of the fiscal arrangements least in need of major reform. Advocating the use of the spending power has become a bit unfashionable in Canadian policy circles. In our view, this is a grave mistake. It is effectively the only policy instrument available to the federal government for influencing provinces to design their programmes in ways that do not violate norms of national equity and efficiency. The fact is that many of the most important policy instruments for achieving redistributive equity are in the hands of the provinces; yet, by Section 36(1), the federal government bears some responsibility for ensuring that they are delivered equitably. Finally the value of income tax harmonization as a device for pursuing national equity should be obvious.

In the next section, we consider how the existing fiscal arrangements might be revised with these views in mind.

### **Reform of the Fiscal Arrangements**

While the Canadian federation has undergone major structural changes, especially with respect to the degree of decentralization of fiscal responsibilities to the provinces, the basic form of intergovernmental fiscal arrangements has changed very little until the 1995 budget. In the wake of the latter, the final shape of the fiscal arrangements is still an open question. It is timely to ask what form should the fiscal arrangements take in the light of the Budget and of the new fiscal reality. We begin by reviewing the minimal requirements of an adequate system of fiscal arrangements in the Canadian federal system. There are five such requirements.

First, in light of the high degree of fiscal decentralization on both the tax and the expenditure side, and the size of the interprovincial disparities in fiscal capacities, it is essential, on grounds of economic efficiency and fiscal equity, for the federal government to continue to operate an effective equalization programme. Increased decentralization of fiscal responsibilities makes equalization all the more important. This will require not only a continuation of the commitment to equalization as set out in the constitution, but also a resolve to remedy some of the major flaws in the current system.

Second, there must be effective mechanisms and procedures for dealing with the shared responsibility between the federal and provincial governments

for delivering programmes aimed at achieving redistributive equity. We take it as given that social programs will continue to be an area of shared responsibility. When the major shared-cost programmes were introduced in the 1960s, there was little question that the federal government played the major role in the 'negotiations' over programme design. But the cost-sharing formula almost guaranteed that provincial spending would grow until budgetary pressures forced the federal government to take corrective action and begin to off-load financial responsibilities onto the provinces. This necessarily increased the powers of the provinces in these fields. As a result, there is now considerable tension over the relative roles of the two levels of government. What is necessary, at this time, is to devise some mechanisms for a true sharing of responsibility. The provinces need room to experiment with alternative modes of programme design and service delivery. At the same time, in order to meet national equity needs, and also to prevent decentralized decisions of provincial governments from causing undue harm to the Canadian common market, the federal government must continue to play a national role.

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

The current fiscal arrangements fall well short of these minimal requirements and are, therefore, not well-suited to achieve the sorts of social policy objectives that Canadians appear to want. In the remainder of this section, we outline some of the measures that might be taken to remedy this.

Is it possible to remedy the major problems with the existing system of fiscal arrangements through a number of relatively modest changes? The answer to this question depends in part on the semantic issue of what sorts of changes are considered 'modest', and what would make them 'major'. Some of the existing problems arise from initial flaws in programme design. For instance, the equalization programme was never designed as a truly net scheme. While this might not have been too great a problem when provincial fiscal responsibilities were much smaller than they are now, the current magnitude of the equalization programme makes them more significant. But many of the other problems arise from the (generally unilateral) imposition by the federal government of ad hoc adjustments in light of underlying systemic changes, and from short-term political or economic expediency. The result is that the current system of fiscal arrangements is very difficult to justify on the basis of any

underlying economic principles. In that sense, what is clearly required now is a rethinking, and, where necessary, a redesign of the fiscal arrangements in light of the economic goals they are meant to achieve. We would say, therefore, that any changes that are made should certainly be the result of a major rethinking of their purposes and their actual effects. Major changes in programme design should not be ruled out.

It is useful to begin by pointing out a number of relatively modest changes in programmes that could result in considerable improvement in the arrangements as they now stand. The first of these changes would be to remove the arbitrary caps and exclusions that have been placed on levels and/or growth rates of transfers to the provinces, individually or in aggregate. Some of these 'modest' changes would, of course, have significant effects on the federal budget. The correct response to these implications is not to shy away from the changes, but rather to search for other, less arbitrary, ways of dealing with these budgetary effects. Another useful change would be for the federal government to cease the practice of including, in what is termed the federal contribution to the CHST, the tax points that have been transferred to the provinces. By transferring the tax points, the federal government long ago unburdened itself of this share of responsibility for health and post-secondary education programmes. Therefore, these revenues are now the responsibility of the provinces and are no longer, in any sense, a 'federal contribution'. In the absence of spending caps, this change would have no substantive implications. However, as long as the government imposes limits on the growth of federal CHST contributions, this suggested change would slow down the rate of decline of 'real' federal contributions -- such as what the federal government refers to as CHST cash transfers. What we would like to suggest here are a few major reforms that could be justified on the basis of the economic principles we have outlined earlier, and are generally consistent with what we perceive to be the current extent of decentralization. In the event of significant changes in the degree of decentralization, there would have to be corresponding changes in the fiscal arrangements. Such adjustments should be determined on the basis of the economic purposes of the arrangements.

The Equalization programme has never been a net scheme. That is, while it provides transfers to have-not provinces, it only 'equalizes down' from the rich provinces to the extent that federal taxes to finance these transfers fall relatively more heavily on the residents of rich provinces than on those of poor ones. Operating Equalization on a net basis would seem to be problematic. It would apparently require the have provinces contributing directly to the equalization pool based on their superior tax capacity. Since the federal government has no power to compel them to participate in this way, it seems to be a non-starter.

An alternative way to achieve the same result without requiring the provinces to contribute directly to the scheme would be to amalgamate the two remaining major transfer schemes -- Equalization and CHST -- into a single

scheme and reformulate its terms so as that the unified scheme accomplishes the objectives intended by each of the components. Indeed, only by so amalgamating the transfer schemes can the federal government recover the financial clout to be able to use the fiscal arrangements to achieve goals of national equity and efficiency, and satisfy the obligations set out in Section 36 of the Constitution Act. The key features of such a unified scheme would be as follows.

First, tax points that had been transferred to the provinces as part of the original EPF transfer would no longer would be counted as part of the federal CHST contribution. This would be belated recognition of the fact that these tax points are now part of the own revenues of the provinces and cannot meaningfully be viewed as a federal transfer. Eliminating them from the CHST calculation would stop the erosion of the cash transfer component. The latter could be computed as a straightforward equal per capita cash transfer (although with an appropriate reduction for Quebec, since the federal government has abandoned more tax points there.)

Second, the component of transfers attributable to welfare would no longer be determined by a cost-sharing formula, which, as we have already pointed out, cannot be justified on the basis of any compelling economic argument. They could either be allocated on a simple equal per capita basis, or on the basis of some index of expenditure need in the area of welfare payments and services, as proposed by Hobson and St-Hilaire (1993). The latter would be the preferred option, given that expenditure needs for welfare differ across provinces.

Third, the total amount of the federal transfers to the provinces under Equalization and the CHST would be aggregated into a single transfer programme. It would be designed to accomplish the joint objectives of the two programmes separately, which we take to be national equity (including equalization), as prescribed in Section 36 of the Constitution Act and national efficiency (especially, the maintenance of an efficient internal common market). This aggregate amount would be adjusted up or down for each province according to the full amount of their equalization entitlement, positive or negative. In effect, the CHST would be rolled into an expanded equalization programme which would be operated on a net basis. The have provinces would end up with smaller federal CHST contributions, with the reductions being used to finance equalization transfers to the have-not provinces. In this way, a net equalization scheme could be attained without having the have provinces explicitly contribute to it.<sup>18</sup>

Fourth, the funds transferred under this aggregated scheme would be

18. Presumably, this would remove the temptation of the federal government to achieve the same general objectives in more discretionary, ad hoc ways, such as caps on CAP, National Energy Programmes and the like.

available as vehicles for the use of the spending power by the federal government. We have argued that the spending power is an indispensable federal policy instrument, the only one that can be used to exercise the joint responsibility the federal government has for ensuring equal opportunity and the provision of essential public services. The spending power is, and has been, a controversial policy instrument. Given that, it may be opportune for the federal and provincial governments to work out an arrangement for both levels of government to exercise their legitimate voice in programme design and implementation. Whether, and if so, under what conditions, the federal government would be permitted to exercise the spending power unilaterally is something that would need to be discussed.

We have also argued that the system of tax harmonization is in need of attention. Given the high degree of decentralization of fiscal responsibilities in the Canadian federation, the federal government is playing too large a role in the sales tax field, and too small a role in income taxes. There could be little justification for the scale to be tipped any further in this direction. And, if there were an opportunity to consider a major realignment in the assignment of tax responsibilities, it might be argued that the federal government should get out of the sales tax field, ceding this area to the provinces (as was proposed by the Carter Commission thirty years ago), and occupy a much greater share of the income tax.

Also important is the share of the overall tax room occupied by the federal government relative to the provinces. To maintain an effective equalization system as well as to be able to exercise responsibility for national equity and efficiency objective through the spending power, it is essential that the federal government have access to sufficient financial resources. As a result of the steady erosion over the past several years, the federal government is perilously close to having insufficient tax room to carry out its national responsibilities.<sup>19</sup> Unfortunately, this cannot be remedied by unilateral action alone. It would seem to be necessary for both levels of government to collaborate in any major realignment of the tax room between the federal government and the provinces. We have mentioned that the system of federal-provincial fiscal arrangements has been allowed to deteriorate after years of neglect and ad hoc adjustments. It could be argued that one reason for this is that the federal government has often acted unilaterally and for reasons of short-term expediency in making programme adjustments. Unlike in many federations, there is no national institution charged with systematic analysis and consideration of alternative arrangements. Furthermore, in areas of shared responsibility, especially in the area of social programmes, there also appears to be a similar lack of joint analysis and decision-making. In these circumstances, alternatives should be explored, along

the lines, say, of the Australian Grants Commission, for introducing institutions for joint analysis and decision-making in the area of federal-provincial fiscal arrangements. Such a body would meet regularly in order to consider the state of these arrangements, and to prepare proposals to be considered on a regular basis before the expiry of any particular set of fiscal arrangements.

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

These suggested changes are all driven by a desire to take full advantage of the opportunities that decentralized decision making affords in a federal economy, while at the same time retaining for the federal government the ability to implement policies that ensure that standard of national equity national efficiency are maintained. We have argued that, in practice, this involves not only an effective equalization system, but also that the use of the spending power is indispensable. It is the only instrument available to the federal government for influencing provincial programme delivery so that national standards are maintained. Not only is this necessary to satisfy the standard economic policy objectives of national equity and the maintenance of an efficient internal common market, it is also explicitly prescribed by Section 36 of the Constitution Act. For those who fear that the unfettered access to the spending power might lead the federal government to be too intrusive in areas of exclusive provincial jurisdiction, one might contemplate instituting a national grants commission with an oversight role over the fiscal arrangements. Given our parliamentary system, it could not have true decision making authority. How-

19. For example, as pointed out by Boadway and Hobson (1993), to implement the full net equalization scheme proposed above, the federal government would need additional tax room.



ever, as a forum for non-partisan advice, it might well serve to constrain the federal government from excesses that many observers seem to fear. It should also be noted that there is a tension between the use of federal transfers as means of influencing provincial program design, and the principle of political accountability by provincial governments. There is a danger that too much provincial dependency on federal transfers will lead to too little accountability at the provincial level. This is obviously something that must be taken into account in designing the fiscal arrangements. It does not detract from the argument that some degree of dependency on grants is an inevitable consequence of the combined desire to decentralize service provision with that of maintaining the efficiency and equity of the economic union.

There remains the possibility that any scheme such as that proposed here might founder over the Quebec question. It may simply not be possible politically for the federal government to assume the kind of role being proposed, despite its consistency with the constitution. That need not cause the whole edifice to tumble. It would be quite possible to operate the system on an asymmetric basis, with Quebec effectively opting out from part of the package, as it has opted out from shared cost programmes in the past. This would not be ideal, since it would increase the complexity and detract from national standards of equity and efficiency. On the other hand, it may be the only option.

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