

Reforming Federal-Provincial Fiscal Relations: An Assessment of Some Recent Proposals

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Federal-provincial disentanglement has become part of the vernacular of the 1990s. The merits of this are typically enumerated in terms of the principles of visibility, accountability and simplicity. Under the current arrangements, the visibility of the federal presence in funding social programs is clouded by the perception of an unduly complex transfer system. The federal government takes the blame for collecting the taxes, yet receives little credit for the programs on which they are spent. Since responsibility for delivery of health, education and welfare rests with the provinces, these transfers have become an easy target for federal expenditure restraint. By the same token, it is argued that federal-provincial cost sharing arrangements detract from the fiscal discipline imposed by accountability since expenditure decisions in the social policy field are not financed solely from provinces' own tax bases. Finally, the system of shared tax fields accompanied by federal-provincial transfers is seen as being overly complex. On grounds of simplicity, surely a neater division of tax fields might be accomplished? Viewed in this light, the notion of fiscal disentanglement is indeed seductive.

The point of this paper is that much of the disenchantment with federal-provincial fiscal relations in Canada, at the present time, arises from a poorly defined allocation of federal revenues between federal programs and transfers to the provinces. It is possible to achieve a greater degree of fiscal disentanglement.

Editor's Note: The following three papers were guest edited by Paul Hobson of Acadia University on what is clearly one of the most important issues facing Canadians in the last half of the decade. The problems associated with maintaining good federal-provincial relations while, at the same time, ensuring that income security for Canadians continues is fundamental in our federation. These three papers provide valuable insight into the reforms needed in federal-provincial fiscal relations.

ment, without sacrificing the principles of fiscal efficiency and fiscal equity, within the same general framework as the existing system. Indeed, within the same general framework, there can be improvements in program design that will enhance their functioning by equalizing for differences in need as regards the delivery of social programs at the provincial level.

The paper begins with a statement of some background and principles which will help put the proposals into context as well as providing a benchmark against which to assess alternative proposals. In the following section, an assessment of the existing set of fiscal arrangements is provided, including an assessment of the various alternatives which have been suggested to reform these programs. Finally, a set of preferred reform proposals is presented, together with some concluding remarks.

Some Background and Principles

Canada is an economic union, notwithstanding the many well documented barriers to mobility of both goods and factors. The free mobility of factors within an economic union, however, does not guarantee either efficiency or equity in the market equilibrium. The Canadian federal system is widely recognized as being one of the most decentralized, on both the expenditure and the revenue sides, in the world. The role of fiscal relations, then, is to facilitate the attainment of both efficiency and equity goals within the economic union given the institutional structure of Canadian federalism. The important point to recognize is that the more decentralized is the institutional structure of any federation, the greater will be the potential for inefficiency and inequity within the economic union and hence the more significant will be the potential role for an appropriately structured set of fiscal relations.

This is not to say that decentralized decision making is not a desirable feature in an economic union. Indeed, decentralized decision making can itself be viewed as an important instrument in attaining efficiency goals where individuals' preferences differ. The essence of the Tiebout Hypothesis (see, Tiebout 1956) is that free migration will elicit the information necessary to ensure that governments of independent jurisdictions provide efficient levels of pure public goods.¹ This is a model that emphasizes the importance of differences in preferences and resulting differences across jurisdictions in terms of the relative sizes of the public and private sectors as well, perhaps, as the mix of goods provided by each of these sectors. It is a model that has, at its centre, the notion of competition among jurisdictions for residents based on the sorts of tax-expenditure packages on offer.

1. The argument here is standard and can be found in any public finance text. See, for example, Boadway and Wildasin (1984).

This model of competitive jurisdictions within a federal system can be taken a step further. To the extent that governments conduct independent experiments in the method of delivery and financing of public services, there is an ongoing process of adaptation and information exchange within the public sector -- harnessing the entrepreneurial spirit, as it were, gives rise to more efficient delivery and finance mechanisms in the public sector (see, for example, Courchene 1993).

Public choice theory emphasizes the principle of accountability in relation to efficient decision making -- governments making decisions on expenditure programs should be accountable to the taxpayers who pay for those programs. Accountability is not, however, a necessary condition for efficient public spending in multi-jurisdictional models with household mobility. In particular, full accountability will not exist in the presence of transfers from other jurisdictions either in direct form or indirectly through, for example, an ability to export local tax burdens. Direct transfers from other jurisdictions might include equalization grants tied to fiscal capacities as well as matching grant schemes tied to local expenditures. One source through which taxes may be exported is external ownership of immobile local resources such as land.

A standard argument is that local governments will overspend if pure public goods are financed through residence-based taxes, such as taxes that are incident on local residents (see, for example, Starrett 1980). The explanation here is that local governments have an incentive to indulge in activities which encourage excessive in-migration, such as over provision of public services, since new residents will broaden the local tax base, lowering the "tax price" to existing residents. Boadway (1982) has shown, however, that there is, in fact, no tendency to overspend relative to population size in this case; rather, the problem is that free migration will result in excessive population -- that is, too much migration -- relative to the optimum.

There may be a tendency to over provision if public services are financed through source-based taxes, such as taxes for which incidence is independent of jurisdiction of residence, since some of the cost of provision is borne by non-residents. This is due to the lack of accountability in the presence of an ability to export some portion of the tax burden. Regardless of the underlying scenario, however, recognition by local governments of the potential migration response associated with local expenditure decisions provides a powerful incentive to provide efficient levels of public services, as well as to establish mechanisms which will promote efficient migration flows. With source-based finance, for example, the recognition that migration responses will dissipate any advantage bestowed on local residents provides an incentive to act in the best interests of society as a whole rather than simply in the interest of local residents -- local residents can only be made better off to the extent that everyone is better off regardless of jurisdiction of residence (see, Boadway 1982 and Myers 1990).

Thus, there can be no presumption of bias in local government spending

decisions. Certainly, accountability is not a necessary condition for efficient spending decisions. It is a sufficient condition, however, that local governments take into account migration responses to their expenditure decisions. The problem of efficient migration remains; this is not something local governments have direct control over and the outcome has nothing to do with accountability considerations. Rather, the issue is one of ensuring that local governments have access to appropriate revenue sources and, as well, that appropriate revenue equalization schemes are in place.

Fiscal Efficiency

To move the discussion away from issues of efficient expenditure at the local level, it is useful to restate the basic proposition that decentralized federal systems of government permit the exploitation of the benefits of decentralized decision making, but at the same time give rise to inherent sources of inequity and inefficiency; the role of intergovernmental fiscal relations is to counteract these, inevitably giving rise to fiscal entanglement. Fiscal entanglement is a good thing (an essential feature) in a highly decentralized federal system.

Migration may result in a form of fiscal externality through changes in net fiscal benefits (NFBs) accruing to others. NFBs represent the difference between benefits received and taxes paid by residents of any jurisdiction. Thus, for example, there will be NFBs associated with pure public goods financed from residence-based taxes. Migration will result in a change in NFBs accruing to residents to the extent that it impacts on their taxes but not on the level of services available. This change in NFBs -- the fiscal externality -- will not be taken into account in individuals' migration decisions, potentially giving rise to an inefficient allocation of residents across jurisdictions. This suggests that local head taxes, for example, will not be efficient as a means of financing pure public goods unless an appropriate equalization scheme is implemented -- one that equalizes head taxes across jurisdictions (see, Mieszkowski and Zodrow 1989). Source-based taxes used to finance pure public goods, on the other hand, will be efficient since tax liabilities are independent of jurisdiction of residence -- there is no fiscal externality associated with migration.

The bulk of provincial public expenditures would not be correctly characterized as pure public goods; rather, services such as health care and education would fall into the category of publicly provided private goods. Source-based taxes used to finance such publicly provided private goods will confer NFBs on local residents. In this case, the fiscal externality associated with migration is the reduction in NFBs accruing to existing residents. A pertinent example here is that of publicly provided private goods financed through resource rents

accruing to the provincial public sector.² As such, residents are able to claim their "share" of provincial resource rents. Migrants will fail to take into account the resulting dissipation of rents accruing to existing residents giving rise to a further source of inefficiency in migration.³ One way of resolving this is through an equalization scheme, designed to fully equalize per capita resource rents accruing to provincial treasuries.⁴ Publicly provided private goods financed through residence based taxes, on the other hand, do not give rise to inefficient migration to the extent that such taxes serve the role of user charges -- there are no NFBs conferred on residents.⁵

Finally, provincial welfare programs are largely redistributive income transfers, financed, in the first instance, by provincial taxpayers. Here, spillover benefits will arise when one jurisdiction is relatively generous in its welfare payments, drawing recipients from other jurisdictions. The benefits to residents of other provinces will include the savings on welfare expenditures due to outmigration of some recipients as well as the net increase in welfare payments received by those who in fact migrate. Since there is an incentive to underspend on welfare in order to inhibit immigration, the case can be made for matching grants tied to standardized expenditures (note the distinction here between standardized expenditures and per capita expenditures). What this implies is a need for matching grants to offset the sort of interjurisdictional welfare competition (which bids down levels of welfare payments) or, alternatively, harmonization of welfare payments.

Fiscal Equity

As a federal system of government, there is also a commitment to fiscal equity within the Canadian economic union. Fiscal equity is an extension of the principle of horizontal equity to federal systems of government: individuals in similar economic circumstances should be treated in a like manner by provincial government, regardless of province of residence. If different provinces are able to provide different levels of NFBs to their residents, the principle of fiscal equity will be violated.

2. This case was central to the arguments in Economic Council of Canada (1982).

3. This begs the question as to the distribution of resource rents in resource rich provinces. To the extent that these remain in some form of "heritage fund", there is no immediate problem for resource allocation. Where these are used to finance publicly provided private goods or income transfer programs such as welfare, however, a serious potential problem exists.

4. Taking migration responses into account, there is an incentive for provinces to directly enter into such a revenue sharing scheme, without need of federal intervention. See Myers (1990).

5. Redistributive tax-expenditure regimes will give rise to differential NFBs in the presence of income disparities across jurisdictions, providing a case for equalization of residence-based taxes also. See Boadway and Flatters (1982).

The principle of fiscal equity requires that all such differences in NFBs be eliminated. Consequently, fiscal equity requires an even greater commitment to equalization than does fiscal efficiency. It is worth noting, however, that in the case of publicly provided private goods financed using source-based revenue sources and welfare liabilities, the same degree of equalization is called for on grounds of either fiscal equity or fiscal efficiency.

Shared Tax Fields⁶

In practice, the Canadian tax system has evolved as a highly decentralized system subject to a substantial degree of voluntary harmonization. Harmonization of tax bases has been achieved, for example, in the personal and corporation income tax fields through bilateral tax collection agreements. More recently, there has been a trend to tax collection agreements in the sales tax field. Wide disparities in provincial fiscal capacities have been compensated for through the federally administered equalization program, permitting a substantial degree of harmonization in provincial tax rates.

Personal income taxation in Canada became highly centralized during the tax rental period, established during the Second World War -- a system under which the provinces ceded the right to levy personal income taxes to the federal government in return for defined "tax rentals". The system evolved over the immediate post-war period into a system of tax abatements to the provinces accompanied by explicit equalization payments. In part, this was to accommodate the special arrangements made with Quebec, which had opted out of the tax rental agreements in 1947, and Ontario, which, also having opted out in 1947, had demanded a clear commitment to revenue sharing as its price for opting in (which it did in 1952). The 1957 Federal-Provincial Tax Sharing Arrangements Act effectively extended the same terms to all provinces (in keeping with the principle of "equal treatment") accompanied by the explicit introduction of equalization payments, designed to bring each province's per capita revenue transfer up to a weighted average of that to the top two provinces (the so-called top-two-province standard for equalization). Thus, to all intents and purposes, the tax rentals became equivalent to equal per capita revenue transfers to the provinces.

The process of actually returning income tax room to the provinces began with the 1962 Federal-Provincial Fiscal Arrangements Act. One objective of this, based on the "equal treatment" principle, was to place all provinces on an equal footing. Quebec had secured tax room in lieu of tax abatements with the introduction of its own personal income tax (PIT) in 1954. Both Ontario and Quebec had maintained separate corporation income tax (CIT) systems and had,

6. Some of the material in this section is drawn from Boadway and Hobson (1993).

accordingly, been granted tax room in lieu of abatements. A second objective was to promote accountability at the provincial level. A third was to meet the demands of the provinces for increased access to income tax revenues to meet rapidly rising expenditures on social programs -- health, education and welfare.

When it was first introduced in 1957, the standard for equalization was per capita revenues in the two richest provinces. As a result, income tax abatements made to the provinces at that time were "fully equalized".⁷ The 1962 arrangements, however, included a proposal to adopt a national average standard for equalization. This was to be accompanied by an increase in the number of bases eligible for equalization to include 50 percent of natural resource revenues. While revenue neutral at the time, this posed a problem as to how to effect any further devolution of income tax room without widening fiscal disparities across provinces.

The genius of Established Programs Financing (EPF), introduced in 1977, was that it provided, in effect, a fully equalized transfer of tax room through the operation of the cash component while permitting a further devolution of income tax room to the provinces in place of direct cost-sharing arrangements.⁸ This further devolution of tax room in 1977 again placed the other provinces on (roughly speaking) an equal footing with Quebec, which had secured additional tax room for itself under earlier opting-out provisions. In addition, a portion of the post-secondary education (PSE) transfer to that province had been in the form of a tax transfer.

When viewed in the context of the post-war devolution of income tax room to the provinces, the equal per capita nature of EPF is seen to be consistent with the principle of not increasing the degree of fiscal disparity across provinces, such as, promoting the goal of fiscal equity. In this sense, equal per capita transfers, such as those under EPF, complement the fiscal equalization program in levelling fiscal capacities across provinces.

The problem with EPF was that the per capita total transfer was designed to grow in line with per capita GDP, a growth rate that is less than the rate of growth of PIT revenues. In addition, various federal budget measures, including the five year freeze on per capita entitlements beginning in 1990-91, further reduced that rate of growth. Thus, whatever the effective transfer of tax room was in 1977, the associated number of tax points has been severely eroded.

An Assessment of the Existing Fiscal Arrangements

The motivation for federal-provincial cost sharing in health care and PSE was,

7. Technically, a tax abatement involves the transfer to a province of a fixed proportion of income tax revenues collected by the federal government within that province.

8. This interpretation is developed in Hobson and St-Hilaire (1993).

initially, a desire to stimulate development of public provision in areas of provincial jurisdiction in order to promote redistributive goals. By retaining its dominance in the income tax field, the federal government was able to achieve a variety of social policy goals through the use of the spending power. This use of the federal spending power was in lieu of the direct return of tax room to the provinces ceded under the tax rental agreements. It is worth noting that, in practice, cost-sharing arrangements in the areas of hospital insurance, health care and post-secondary education amounted to specific purpose, equal per capita transfers. Thus, for example, hospital insurance grants (25 percent average per capita + 25 percent actual per capita), medical insurance (50 percent national average per capita), and even the university grants (minimum 50 percent national average) were all (more or less) equal per capita revenue transfers and with relatively few strings attached. Only the Canada Assistance Plan (CAP) was structured to match actual provincial expenditures within designated programs.

One source of continuing contention is that in social programs (as well as other areas) "need" and/or the cost of delivery may vary by province. In the area of social assistance, for example, provinces differ significantly in terms of benefits per recipient (generosity) and recipients per capita (need). Similarly, it has long been the case that the Maritime provinces have above average participation rates in education (students per capita) but spend less than the national average per student.

Equalization

In principle, an ideal equalization scheme would operate as a net scheme -- that is, all provinces' per capita revenues would be equalized to a national average, redistributing revenues from those provinces with above average fiscal capacities to those with below average fiscal capacities. The fiscal equalization program as presently structured, however, accomplishes this only partially by raising fiscal capacities in the have-not provinces to a level somewhat below the corresponding national average, paid for out of general federal revenues. In particular, even after equalization there remain significant disparities in terms of fiscal capacities between the have-not and the have provinces. This arises both as a consequence of the "standard" for equalization being below a national average standard and the growth ceiling on entitlements which limits growth in aggregate entitlements to growth in GDP.

In addition, the determination of provincial fiscal capacities under the present system fails to take into account "negative" tax liabilities in the form of transfers to persons, such as those made under provincial welfare pro-

grams.⁹ If provincial social assistance benefits were delivered entirely through some form of refundable income tax credit, they would be buried within the provincial income tax system and reflected in provincial income tax revenues. Accordingly, differences in negative tax liabilities would be subject to equalization (see, Hobson and St-Hilaire 1993). Negative tax liabilities delivered through cash transfers should, in principle, be similarly subject to equalization.

The Canada Assistance Plan

Transfers to the provinces under CAP may be viewed as a partial offset to this asymmetric treatment of income transfers and income taxes under the fiscal equalization program. However, there remains the problem of provinces' abilities to participate in cost-sharing under CAP. Specifically, equalization only raises per capita revenues in the have-not provinces up to a standard somewhat below the national average, yet welfare case loads ("need") tend to be relatively high in the poorer provinces. Provinces are not equal in their ability to participate in cost-sharing under CAP, both as a result of differences in need and as a result of differences in fiscal capacities.

From the perspective of the have provinces, the cap on CAP first imposed in the 1989 budget has limited growth in entitlements to a maximum of 5 percent per annum. This has resulted in federal transfers falling significantly below the 50 percent level around which the program was designed. Indeed, at the margin, welfare expenditures in the have provinces are simply not cost shared once the growth ceiling has been passed. Provinces are not equal in terms of their eligibility under CAP and this alone suggests that the terms of CAP must eventually change.¹⁰

Income security reform in Canada will inevitably bring this issue to the fore. One possible scenario is that responsibility for income security may be devolved completely to the provinces.¹¹ This would require at the very least the transfer of associated payroll tax room to the provinces. More generally, to the extent that an integrated approach to delivery of income security were adopted, largely through incorporation into the income tax structure (for example, the Newfoundland guaranteed annual income proposal), the significance of direct cash transfers to individuals would be considerably reduced.

9. This point was significant in the Breau Report. See Canada (1981).

10. It seems to be generally agreed that restoring 50 per cent cost-sharing to the have provinces would involve too great a burden on the federal budget to be feasible. See, for example, Norrie (1994).

11. For proposals along these lines see Richards (1993). Boadway and Hobson (1993) also discuss the equalization implication of devolving responsibility for unemployment insurance to the provinces while conceding that there may be some logic to having income security delivered by just one level of government.

This begs the question as to how CAP might be reformed to offset the significant loss in revenues to the provinces that would result -- to counter what would be a serious disincentive for provinces to explore alternative means of delivering income security.

Another possibility would be that the federal government withdraw from cost sharing under CAP accompanied by an offsetting transfer of tax room to the provinces.¹² This might be accomplished by the federal government transferring tax room to the provinces equivalent to the present national average per capita transfer under CAP. The value of the transferred tax points would be equalized in the have not provinces under the terms of the fiscal equalization program. Alternatively, CAP might simply be converted to a block grant set according to current national average per capita transfers and escalated annually according to some growth factor, for example growth in per capita GDP.¹³ Finally, the terms of CAP may be expanded to include social assistance payments made through the income tax system -- in short, an extension of the status quo.

Norrie (1994) has proposed that the present cost-sharing arrangements for CAP should be converted into a system of cash grants paid to individuals directly by the federal government. Alternatively, this might take the form of refundable tax credits, perhaps directed at children in low-income families (as favoured by Courchene 1994). On its own, it is difficult to see what is achieved by this other than substantial duplication in delivery of welfare assistance. Under the present arrangement, while the CAP transfer in respect of social assistance is paid directly to the provinces, the monies transferred are ultimately paid to recipients. However, coupled with a broad reform of income security programs, as Norrie suggests it should be, what this proposal might permit, for example, would be a guaranteed annual income scheme delivered by the federal government, with the provinces left with responsibility for making cash transfers to those who fall through the income security net. To the extent that this suggests an increased federal presence in the income security field, it seems improbable that it would be adopted without some accommodating transfer of tax room from the provinces to the federal government. Moreover, it suggests either an accompanying transfer of responsibility for welfare services or a separation between responsibility for income assistance (at the federal level) and responsibility for welfare services (at the provincial level). Certainly, a case might be made for maintaining a decentralized delivery system for welfare services.

In fact, consistent with basic equalization principles, provincial social assistance liabilities, however extensive and however they may be delivered,

12. Such a proposal may be found in both Norrie (1994) and Richards (1993).

13. See Richards (1993). It is a version of this which seems to have been favoured by the federal government in announcing the Canada Health and Social Transfer in its 1995 budget.

should be incorporated directly into the fiscal equalization program as "negative" tax liabilities.¹⁴ From the perspective of those provinces that are recipients under the fiscal equalization program, such a change may be acceptable, even financially beneficial. From the perspective of the have provinces, however, such a change would likely result in a significant net revenue loss to the extent that positive entitlements under social assistance liabilities would not be sufficient to offset negative entitlements overall for other revenue sources; in effect the CAP transfer would be eliminated for the have provinces.¹⁵

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

Established Programs Financing

EPF has been discussed above in terms of the erosion of effective tax point transfer made in 1977. Since EPF is, in practice, delivered through a combination of cash transfers and the equalized value of the associated EPF tax points, that erosion is ultimately captured in the rapidly declining value of the cash transfer. Many have interpreted this decline as a gradual federal withdrawal from funding programs in health care and post-secondary education. Some provinces have advocated the transfer of further tax room in lieu of EPF cash. As was done in 1977, this might involve transferring sufficient additional tax points to the provinces to replace the average per capita transfer to the two richest provinces. Since income tax capacities vary significantly across prov-

14. See Boadway and Hobson (1993). Hobson and St-Hilaire (1993) provide details on how such a proposal may, in practice, be implemented. They do not, however, recommend implementation of the proposal.

15. Boadway and Flatters (1994) suggest a modification to the transfer system whereby provincial transfers would be based on the sum of entitlements under EPF and CAP and those under fiscal equalization. Thus, provinces with negative overall equalization entitlements -- the have provinces -- would have their EPF and CAP entitlements reduced accordingly. This would have the effect of converting the equalization system to a net scheme.

inces, even with equalization, the per capita yield would be significantly below that for, say, Ontario in all of the have-not provinces. Supplementary equalization payments may, therefore, be required.

As an alternative, and one that would not result in an increase in fiscal disparity across provinces, Hobson and St-Hilaire (1993) have proposed instead having the federal government cede the value of the cash transfer to the provinces as a tax abatement rather than as a transfer of tax room. Thus, a given percentage of federal income tax revenues would be earmarked for EPF. The per capita value of the abatement plus the aggregate equalized per capita value of the existing EPF tax points would then determine total per capita entitlement. Each province's per capita transfer from the value of the abatement would then be determined on a residual basis as the difference between total per capita entitlement and the per capita equalized value of the EPF tax points. Thus the "cash" component of EPF would continue to operate much as it does at present; the difference would be that its value (along with the value of the EPF tax points) would grow in step with growth in the value of the income tax base. In this way, a complete fiscal disentanglement between the two orders of government would be achieved in respect of the established programs without sacrificing the goal of fiscal equity across provinces. In effect, the procedure ensures a fully equalized transfer, with all provinces implicitly equalized to the national average.

Both Norrie (1994) and Courchene (1994), on the other hand, argue that EPF cash should be split, however arbitrarily, into a health care component and a post-secondary education component. With regard to health care, it is Norrie's position that there is no "compelling case for a continuing federal government role in health care administration" (Norrie 1994: 25). Thus he advocates a complete federal withdrawal in respect of health care funding with an associated transfer of tax room. Courchene argues for a transfer of 8.5 equalized tax points, in lieu of present federal cash transfers in respect of health care. Both are prepared to accept the increased fiscal disparity across provinces that would inevitably be associated with such a move. With regard to post-secondary education, Norrie argues that interprovincial spillovers might be used as a justification for moving to a system of federally administered education vouchers. Courchene is also in favour of implementing a voucher system for PSE in lieu of existing transfers to provinces. Thus the post-secondary education component of the EPF cash transfer would be converted from a cash transfer made to provincial governments to a system of income transfers paid directly to individuals.¹⁶

These proposals would inevitably result in a significant increase in the degree of fiscal disparity across provinces by eliminating what is at present equivalent to an equal per capita transfer of income tax revenues to the prov-

inces. This would be particularly so as a result of the transfer of tax room in lieu of the health care component of EPF cash.

It is important, however, to put proposals such as these into their proper context: Both authors are concerned that further devolution to the provinces will so strain the equalization program as to place in jeopardy the political legitimacy of the federal government. This being so, a greater degree of fiscal disparity across provinces becomes almost inevitable; the federal government's ability to pursue the goal of fiscal equity would be lost. What is being advocated, therefore, is that a federal presence be maintained in funding social programs -- at least in post-secondary education and social assistance -- but in a very different form, such as, via transfers made directly to individuals. There remains, however, the problem of fiscal disparity. Under their proposals this will inevitably be increased. In contrast, the point of the Hobson and St-Hilaire proposals is that it is possible to effect a further devolution without either increasing the degree of fiscal disparity or increasing the federal government's liability for making equalization payments (and hence its political legitimacy).

Boadway and Flatters (1994) propose strengthening EPF cash through a return of income tax room from the provinces, including the EPF tax points, in exchange for a federal withdrawal from the sales tax field. A significantly enriched EPF cash component would then, coupled with provincial CAP entitlements, be used to effect a net equalization scheme -- provincial fiscal capacities would be fully equalized to the national average. Under their scheme, a province's EPF cash entitlement (calculated as at present) would be added to its CAP entitlement (calculated as at present) and its overall equalization entitlement (calculated according to a national average standard). For those provinces with negative overall equalization entitlements, then, their EPF and CAP transfers would be reduced accordingly. The savings from such reductions would be sufficient to pay for positive equalization transfers made to the have-not provinces. Through the overall transfer system, then, equalization would indeed operate as a net scheme. This would be accomplished, of course, at the direct expense of the have provinces. At the same time, since equalization would no longer be a drain on the federal treasury, there may be a possibility of transferring tax room to the provinces in lieu of the federal revenues which would otherwise have been required to fund equalization.

Ruggeri, Howard, Robertson and Van Wart (1993) adopt a very different position. They argue for a realignment of tax fields, but instead propose that the federal government should cede income tax room to the provinces in exchange for control of the sales tax base. In addition, EPF and CAP would be eliminated. The problem of increasing fiscal disparity among the provinces would be addressed through a voluntary interprovincial pooling of income tax revenues. Their objective is to restore vertical fiscal balance in the federation; they argue that only through greater provincial access to the income tax base will provincial revenues (in aggregate) grow in step with expenditure responsibilities in the social policy field. However, while the interprovincial revenue

16. Such a system was proposed in Human Resources Development Canada (1994).

pooling proposal is of interest, it is difficult to envisage it being sustainable in practice. Rather, the sort of indirect revenue pooling proposal of Hobson and St-Hilaire would suggest a more stable approach.¹⁷

The Canada Health and Social Transfer

The 1995 federal budget announced the creation of a new super-block grant to the provinces in respect of programs in health care, post-secondary education and welfare -- now termed the Canada Health and Social Transfer (CHST). In effect, this grant rolls together EPF and CAP into a single block grant and, at the same time, scales back the total federal cash transfer by roughly one-third over a two year period commencing 1996-97.

The magnitude of the overall reductions in total transfers will inevitably place additional strains on provincial resources. To the extent that the cuts cannot be absorbed through associated cuts in program spending in the provinces, differences in fiscal capacities across provinces will give rise to wide variations in resulting provincial tax increases. This is especially so in view of the growth ceiling on equalization entitlements. Alternatively, the degree of harmonization in social programs across provinces may be expected to diminish. In any event, the existing proposal for a CHST makes little sense in light of the discussion above.

What has yet to be determined is the formula for distributing the CHST among provinces post-1996-97 (in its initial year of implementation it is to be distributed in accordance with 1995-96 shares) and that for escalating it over time. The latter issue is significant, since the inclusion of the existing EPF tax points in calculating CHST entitlements means that the cash component will continue the precipitous decline previously associated with EPF. In the next section, a proposal is made that would both determine the growth of entitlements for a triad of block grants as well as the distribution of each across the designated program areas.

Block Grants Equalized for Differences in Need

Consider a block grant that is based on national average per capita expenditures in a particular program area -- for example, in health care, post-secondary education or welfare. Such a grant bears no direct relation to actual per capita

expenditures by province. This is a positive feature in that it places a limit on the ability of provinces to manipulate their grant entitlement; accordingly, it constrains growth in federal spending. It is a negative feature in that it fails to account for differences in need across provinces, instead giving the advantage to those with below average need. It seems appropriate, then, that the grant be equalized for differences in need; that is, that it reflects standardized expenditures.

The equalization component would transfer grant revenues from those provinces with below average need to those with above average need. Thus, if the basic per capita grant is x percent of national average per capita expenditure, the result of full equalization for differences in need would be that all provinces shoulder a liability equal to $(1-x)$ percent of national average per capita expenditures times population. Accordingly, the transfer exceeds x percent of standardized expenditures in those provinces with above average need, and is less than x percent of standardized expenditures in those provinces with below average need. To be more precise, let

$$\begin{aligned} S_i &= \text{transfer to province } i \\ E_i &= \text{standardized program expenditure in province } i \\ N_i &= \text{population in province } i \\ E_c &= \text{aggregate (national) standardized program expenditure} \\ N_c &= \text{national population} \end{aligned}$$

Then,

$$S_i = x(E_c/N_c)N_i + (E_i/N_i - E_c/N_c)N_i.$$

Next, let

$$\begin{aligned} e_i &= E_i/N_i \text{ standardized per capita expenditure in province } i \\ e_c &= E_c/N_c \text{ national average per capita expenditure} \end{aligned}$$

Then the above expression can be rewritten as:

$$S_i = [(e_i/e_c) - (1-x)]e_c N_i$$

Provincial shares in the total transfer will then be greater than, equal to, less than in proportion to population shares as (e_i/e_c) is greater than, equal to, less than unity -- that is, dependent on relative need.

What is significant about this proposal is that it would place all provinces on an equal footing with regard to funding social programs. In the case of welfare, for example, the current arrangement whereby provinces receive a grant equal to 50 percent of actual expenditures leaves those provinces with relatively high need at a fiscal disadvantage; they must raise a greater amount per capita from own sources. Similarly, a province with a relatively high

17. There are also questions about the federal government's ability to pursue vertical equity goals were it to lose access to the income tax base as well as potential tax harmonization problems in a highly decentralized system. Norrie also discusses the possibility of direct interprovincial revenue pooling but is less than sanguine about its sustainability.

participation rate in post-secondary education or health care nonetheless receives the same grant per capita under EPF, leaving a greater per capita amount to be made up entirely from own sources.

Initially, each block could be determined by the existing level of transfers in each program area, perhaps scaled back further according to current federal budgetary targets. This would determine initial x values by program area, making explicit the federal share in funding. Future growth of each block fund might be negotiated between the federal government and the provinces, perhaps in accordance with growth in the value of the effective tax points presently associated with EPF and CAP. (Under the proposed CHST, the implied size of the total grant pool is the bottom-line budget targets for transfers to the provinces.) Alternatively, cost-sharing in welfare might be tied to growth in standardized provincial welfare expenditures, reflecting the somewhat cyclical nature of such expenditures. In that case, the federal share (x) in standardized expenditures would remain constant. Tying the growth of the block fund to growth in the value of associated tax points, on the other hand, would most likely result in a declining federal share (x) in aggregate standardized expenditures.

Actual cash entitlements paid to each province would require that existing EPF tax points be apportioned between health care and PSE and their value be deducted from total entitlements by province (similar provisions would apply for Quebec's special EPF and CAP abatements). One advantage of tying the growth rate of the block grants for PSE and health care to that of the associated tax points is that the cash component of transfers would grow in step with the value of the tax transfer, thereby preserving the "federal presence" in funding those programs.

Conclusions

Fiscal entanglement is wholly justifiable if it enhances the efficient functioning of Canada as an economic union. Moreover, as a federal system, there is a commitment to fiscal equity as a policy goal, not to mention the constitutional recognition of this goal. The institutional structure of Canadian federalism has evolved in a manner that is compatible with the goals of fiscal equity (and efficiency).

The principal justification for government provision of services such as health care and education lies in the attainment of redistributive goals.¹⁸ Indeed, on efficiency grounds it is difficult to see how direct government

provision of such services would be justifiable.¹⁹ The model of competitive federalism, however, places the emphasis on the red herring of efficient expenditure at the provincial level (efficient resource allocation within individual jurisdictions) rather than equity. In fact, the basic Tiebout framework from which this model is derived provides no strong basis for concern over bias in local expenditures resulting from problems of accountability. Rather, the Tiebout framework has correctly identified the real problem as one of promoting efficient resource allocation across jurisdictions in a decentralized system, while still acquiring the benefits of decentralized expenditure decisions, particularly in the social policy field. In addition, issues of fiscal equity cannot be forgotten within a highly decentralized federal system.

Fiscal disentanglement has become one of the by-lines of the 1990s. Yet, in a highly decentralized federal system, in terms both of expenditure responsibilities and tax authority, fiscal entanglement is inevitable if general efficiency and equity goals are to be attained. In Canada, what appears to be lacking is a clearer mechanism for determining the allocation of federal revenues between federally administered programs and transfers to the provinces.²⁰ In its absence, there has been a groundswell of support for disentanglement which threatens both fiscal efficiency and fiscal equity as national policy goals.

In its present form, the equalization program alone cannot prevent a widening degree of fiscal disparity between the have and the have-not provinces in the face of further transfers of tax room to the provinces. EPF, as an equal per capita transfer, replicated a fully equalized transfer of tax room to the provinces. The problem is that transfers under EPF have not grown in step with federal revenues since its inception in 1977; the effective number of tax points transferred in 1977 has been steadily eroded, both as a result of program design and as a result of a series of adjustments to the escalator on annual per capita entitlements. CAP is an imperfect substitute for a system that would equalize "negative" tax liabilities symmetrically with tax revenues. Yet, both EPF and CAP have provided a means of effectively transferring revenues to the provinces in a way that is consistent with the principle of equalizing fiscal capacities; that is, they ought to be viewed as transfers in lieu of the return of income tax room ceded to the federal government by the provinces some fifty years ago.

Both EPF and CAP can be sustained as individual block grants rather than the crude amalgamation of the two transfers proposed under the CHST. In the

18. See Guesnerie and Roberts (1987) and Boadway and Marchand, forthcoming, for a theoretical discussion on this topic.

19. Richards (1993) would appear to differ on this point, arguing that public provision must be more efficient than the market, otherwise "...by now, the major G-7 countries would be doing so, and change in social policy would be in the direction of eliminating state control." Such casual empiricism is not supported by any theoretical model of which I am aware.

20. In Germany, for example, while both income and sales taxation authority rests solely with the federal government, the portion of revenues earmarked for the states is a matter of periodic renegotiation with constitutional protection.

case of EPF, this would simply extend the existing system as a combination of cash and tax transfers. Simply put, what is required is that the block fund be escalated in accordance with growth in federal income tax revenues rather than the ad hoc arrangements which have been in place since its inception. For CAP, this would involve converting the existing cost-matching system to one tied to average per capita entitlements. EPF could then be distributed among provinces under a formula that (a) separates out health care and education expenditures and (b) equalizes for differences in need within each of the program areas. Similarly, CAP funds could be distributed in accordance with differences in need. In addition, it would be necessary to extend programs covered under CAP to include income support measures delivered through the tax system.

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