

AN EVALUATION OF ECONOMIC MANAGEMENT AT THE PROVINCIAL LEVEL: THE CASE OF ONTARIO

D. A. L. Auld
The School of Natural Resources
Sir Sandford Fleming College
Lindsay, Ontario
K9V 5E6

In 1969, the Province of Ontario became the first provincial jurisdiction to recognize publicly the need for counter-cyclical fiscal policy at the regional (provincial) level. It did so as a result of its own analysis of the federal government's budget policy which, at least to Ontario, demonstrated that the actions of the senior level of government in Canada were detrimental to the well-being of the Province of Ontario. For the next decade, Ontario followed a policy of deliberately changing one or more fiscal instruments in an attempt to accelerate or retard the rate of economic growth, thus "controlling" inflation and unemployment. Given the position taken by the Royal Commission on the Economic Union and Development Prospects for Canada [25] and in light of recent studies of regional fiscal policy [11;12;30;2;21], the Ontario "experiment" merits close scrutiny. This paper attempts to do just that. The following section provides a short history of counter-cyclical fiscal policy as developed and enacted in Ontario during the period 1969-1979. The effectiveness of fiscal measures is then evaluated. This is followed by a discussion of the future of provincial fiscal policy in Canada in light of Ontario's experience and with reference to the Royal Commission's findings on this subject.

A History of Provincial Fiscal Policy

In 1969, the Treasurer of Ontario announced that the province was about to embark on an anti-inflationary fiscal policy:

I have directed my efforts towards achieving a balanced budget or a small surplus. . . . If we and other governments chose to be over-expansionary in our fiscal policies at this time, then the provincial economy would be quickly pushed up against the limits of productive capacity. . . . [18:14].

Within a year, however, the province changed direction in response to the unexpected deflationary effects of the federal government's fiscal policies of 1969-70. The 1970 Provincial Budget Paper concluded that ". . . in times of increased federal restraint, fiscal drag in Ontario increases faster than in other regions" [17:12]. The province estimated that the impact of Ottawa's restraint program was equivalent to a loss of 6.25 percent of provincial personal income in 1969 and closer to 7.0 percent in 1970.

Federal decisions on macroeconomic stabilization affected the Ontario economy disproportionately, as evidenced by such policies as lower spending of public funds in Ontario and the proposal to reduce consumer credit, thus creating a slowdown in Ontario's manufacturing sector. All in all, the province concluded that ". . . these policies constitute a broad, unitary state application of economic policy rather than a co-ordinated intergovernmental package to increase output and lessen price increases" [17:14].

In addition to an examination of specific fiscal measures, the Ontario Budget Paper attempted to measure the overall impact of the federal government in Ontario. The figures for 1968-69 and 1969-70 were as follows:

Table 1
FEDERALLY GENERATED DEFICIT OR SURPLUS IN
CANADA AND ONTARIO
(\$ million)

| | Ontario | Canada |
|---------|---------|--------|
| 1968-69 | 1,400 | (67) |
| 1969-70 | 1,850 | 600 |

Source: MacNaughton [16].

Thus the federal government, in moving from a deficit to surplus position equal to more than \$600 million, induced a swing of \$450 million in Ontario. In short, it was alleged that the Province of Ontario had to shoulder the burden of Ottawa's fiscal policy. The 1970 budget expressed the provincial government's concern about broadly based fiscal and monetary restraint:

It is far from certain that the continued application of broadly restrictive monetary and fiscal policies will be effective. . . . The question suggests the need for a basic re-examination of the ways in which government policy can be used more flexibly and selectively. . . . [17].

With that in mind, the parameters of the budget were altered to try to achieve a smaller surplus by using some of the 1969-70 surplus to increase expenditure in 1970-71.

The new treasurer, the Hon. D'Arcy McKeough, wasted no time in attacking federal fiscal policy in his maiden budget speech of 1971. The large "fiscal drag" imposed upon Ontario as a result of federal fiscal policy forced Ontario to change its budget direction during 1970-71:

. . . we decided it was appropriate to increase expenditure by advancing the implementation of certain high priority programs . . . to combat unemployment directly [19:11].

The result was a deficit of \$115 million instead of a surplus of \$11 million.

For 1971-72, the treasurer proposed to steer the budget to an all-time record deficit of \$415 million: ". . . to meet our economic objectives, it is necessary that our expansionary policy be continued and increased" [19:11].

The Ontario government's philosophy with respect to expansionary fiscal policy was clearly enunciated; expansion should come from the private sector through tax cuts, not expenditure increases. According to the treasurer:

. . . expenditure increases can also work to impede recovery . . . [by] pre-empting economic resources that can be used more productively in the private sector. . . . For these reasons, the Government has decided to pursue the alternative route . . . by tax reductions [19:11].

The budget of 1971 employed the concept of the Full Employment Budget Surplus to demonstrate that the federal government's fiscal policy was restricting economic expansion in Ontario.¹ Aside from clearly demonstrating the federal government's impact on the Ontario economy, this "new" budget concept provided the rationale for provincial fiscal policy in 1971-72.

The persistence and growth of this tax drag on Ontario are serious obstacles to the resumption of normal growth and attainment of full employment . . . the Ontario budget . . . is designed as an offset to the federal government's excessive tax drag . . . [19:53].

The restrictive impact of Ottawa's budget policy on Ontario was alleged by the Province to be the result of Ottawa's preoccupation

¹This concept is explained in detail below.

with redistributing wealth to regions of Canada which excluded Ontario.

Notwithstanding the treasurer's statement above, expenditure increases did occur, along with a tax credit for the purchase of new equipment and machinery during the coming year. For the first time, a province had chosen to alter its "share" of a tax to stimulate aggregate demand. It would not be the last for Ontario.

Shortly after the presentation of the 1971 budget, the Province of Ontario tabled at the November 1971 meeting of the Ministers of Finance a document entitled *The Reconstruction of Economic and Fiscal Policy in Canada*. Although it was introduced as a "statement" from the treasurer, Hon. D'Arcy McKeough, the forty-six pages were more than a statement. The first thirteen pages are of most interest for purposes of this review; subtitled "Economic Policy Co-ordination", they consist of a severe criticism of federal stabilization policy and past attempts at fiscal policy co-ordination among governments. As far as Ontario was concerned, fiscal policy had been "... handed down to the provinces rather than developed in a harmonized manner ..." [19:5].

Repeating the theme of the 1971 budget, the statement made it clear that Ontario had to develop its own counter-cyclical fiscal policy to offset the deflationary impact of federal policy. Although it is not documented analytically, the statement suggests that even though the federal government reversed its position and engaged in expansionary measures in June and October of 1971, Ontario's fiscal actions were of a greater magnitude than those of the federal government.

In a section on seasonal unemployment, the Province makes the point that in order to reduce winter unemployment, the provincial governments were "invited" to borrow money from Ottawa to finance winter works programs. Although it may seem quite appropriate for the federal government to transfer resources for the program to the provinces and permit them to work out the arrangements with local governments, it seems highly *inappropriate* to transfer the debt associated with these programs to the provinces. Ontario was clearly justified in raising objections to this rather unorthodox procedure and suggesting that there be some agreement "... on a fair division of financial responsibility for the programs which reflects the major role of the federal government in both long and short term economic planning" [19:9].

The document concluded with a request for more co-ordination, a clarification as to what role the federal government envisaged for the provinces in matters of stabilization policy, and an improved economic intelligence system. The overriding theme was clear; if co-operation

and co-ordination did not occur, Ontario was prepared to formulate its own fiscal policy program to achieve its own goals.

By the time of the 1972 budget [20 (1972)], the economic recession was well entrenched and the province decided, again, to incur a budget deficit: "The substantial but manageable deficit which I am proposing will stimulate economic recovery" [20:5]. Spending between the 1971 and 1972 budget had been accelerated somewhat and the planned deficit for 1971-72 of \$367 million became an actual deficit of \$389 million. This was, according to the treasurer, completely justified as a "... response to the continued deterioration in the employment situation" [20:65].²

By 1973, the Ontario economy was operating close to full employment, but this was not the case for other regions of Canada, where high unemployment persisted. Thus the stance of the Ontario government was a budget that would be in balance *if there was full employment*. In other words, fiscal policy was designed to ensure that the Full Employment Budget Surplus was zero. Since, however, there was less than "full employment" (the unemployment rate was 4.1 percent), such a fiscal stance meant an actual budget deficit of \$193 million. While the treasurer wanted to be more expansionary, the increase in total debt was obviously a constraint [29].

Although Ontario had, for the past three years, argued that there was an important role for the provinces to play in fiscal policy, the cost of "going alone" was impossible to sustain. "There is no way that Ontario can continue to carry an undue share of deficit financing" [29:5]. It is ironic that just at the point where the liquidity aspects of fiscal policy were seriously impinging on the financial capacity of the province, the federal government was "formally" recognizing the role of fiscal policy at the provincial level. The context of this recognition was not what the provinces wanted to hear.

But such a division of power also means that provincial governments—and those of the largest provinces in particular—must be prepared to carry an appropriate share of the responsibility in policies for stability and growth in the national economy. This naturally means that substantial provincial deficits, as well as federal deficits, may well be appropriate when there is a need to accelerate growth in the economy [28].

The appended paper associated with the 1973 provincial budget speech was appropriately titled "Federal-Provincial Fiscal Policy and Deficit Sharing". It encompassed a detailed analysis of federal fiscal policy from 1966 to 1973, including the use of the Full Employment

²The planned deficit for 1972-73 was based on expected expenditure increases, not tax reductions, which had been used in the past.

Budget Surplus. Application of this concept to the proposed 1973 federal budget led the budget paper to conclude that although the federal government intended the budget to be a stimulus to the economy, it would likely have a small contradictory net fiscal impact. The Full Employment Budget Surplus, when applied to preceeding years, suggested that the actual impact of the federal budget was somewhat removed from the intended impact. Ontario's fiscal impact, however, had been far greater, measured either in terms of net fiscal impact as a percent of GNP or of GPP, or in terms of an employment target.³

But, the province noted, this activity cannot be sustained. "The province has only a 'spurt' capacity for conducting stabilization policy and lacks the resources to carry large scale deficits on a prolonged basis" [29:A-18].

One final feature of this budget was the more direct integration of the budgetary and non-budgetary deficit. When non-budgetary items such as the guaranteed new debt of Ontario Hydro were included in the overall fiscal picture, the total cash requirement worried the Province. The combination of increases in both areas was placing a strain on the financial capacity of the Province.

Inflation was the number one problem in 1974, according to the treasurer [29:1]. The provincial government's fiscal policy in this environment was to both restrain inflation and expand supply. More important, however, was a budget plan that would substantially alter the redistribution of income in the province, and the "anti-inflation" tax increases were in part designed to provide the necessary funds for old age income security, retail sales tax exemptions, and the financing of a relatively expensive property tax credit.

The restraining measures incorporated new taxation of the gains made from real estate transactions in land and the purchase of land by non-Canadians. There were highly selective measures directed at crushing the rising levels of inflationary expectations that were believed to be prevalent in the housing and related markets. The fiscal measure used to stimulate supply was a minor one—an income tax credit of 5 percent for small businesses. It did, however, once again demonstrate the use of a fiscal instrument at the regional level to encourage a provincial objective.

The most surprising feature of the 1974 budget was the lack of any discussion on fiscal policy—either federal or provincial. After five years of consistent attacks on federal policies and very detailed measures of the fiscal impact of the public sector, there is a considerable

³The Treasury's estimate of this impact was derived by calculating $(NFI)/(U_a - U_t)$ where NFI is the dollar value of discretionary policies to the contribution of the deficit from expenditure increases or tax reductions, U_a is actual unemployment for the same period, and U_t is target unemployment.

vacuum in this regard. The total deficit (both budgetary and non-budgetary) is estimated to be \$708 million for 1974-75 compared to \$721 million in 1973-74. The budgetary deficit was increased by \$204 million, while the non-budgetary deficit was decreased by \$217 million. These data, however, provided little scope to compare the net fiscal impact of 1974 with other years and in relation to the state of the Ontario economy.

The Hon. D'Arcy McKeough returned as treasurer in 1975, and more detailed fiscal analysis was provided in the budget. The outlook in early 1975 was a complex one: high rates of wage and price inflation and a weakening economy, although there had been virtually no change in the unemployment rate from 1973 (4.0 percent) to 1974 (4.1 percent). The economy of Ontario ". . . needs only temporary stimulation to ensure its recovery to a higher level of performance by the end of 1975" [20:3 (1975)]. To bring about that stimulus, there would be a temporary sales tax reduction of 2 percent for the period April to December, 1975. It would also provide, according to the treasurer, cost reductions to business, a clear recognition that such a move may also have some short-run anti-inflation effect.

The economy would also be stimulated through a temporary housing subsidy to first-time buyers equal to \$1,500 over three years. With the land speculation tax firmly in place, there was obviously little worry that such a move would rekindle the housing price explosion of 1972-74.

Although there was not the intense criticism of federal policy, as had been the case in the past, the 1975 budget paper justified provincial action because of the weak federal response to a softening economy. The reason for Ontario's policy was expressed as follows:

The temporary duration of the tax cuts and the consumption promoting measures . . . are aimed to spark a rapid response on the part of consumers . . . and to combat inflationary forces . . . [20:A-9 (1975)].

The Ontario government clearly saw the inflation problem as one of cost-push in nature.

In July of 1975, the provincial government introduced an interim budget measure to stimulate Ontario's economy: a rebate of the sales tax on automobiles purchased between July 7 and December 31. Once again the sales tax was used to promote a highly flexible short-term fiscal policy that could be directed not only regionally but on a sectoral basis as well.⁴

The 1976 budget viewed inflation as a problem, and the Throne Speech hinted at a monetarist view of the cause of inflation. In the fight against inflation, "One of those remedies must be to reduce

⁴A detailed analysis of this tax reduction can be found in Gusen [14].

government expenditure rather than borrow more money . . ." [20:1 (1976)]. The treasurer concluded that the Ontario economy did not require any government stimulation at the time and that efforts in 1976 would be directed to lowering the growth rate of spending and the relative size of the public sector. There was little analysis of future fiscal policy in the framework of previous McKeough budgets, but it was clear that again the deficits were coming home to roost and that this fact combined with the shift in priorities to the private sector meant one thing: expenditure constraint.

The fiscal policy analysis in the budget was *ex post* in nature. The Province's analysis showed that:

- (1) in response to the tax rebate on new cars, new car sales in Ontario were up 13.8 percent in 1975 (-0.4 percent in the rest of Canada);
- (2) in response to the sales tax reduction, total retail trade was up 14.4 percent in Ontario (12.2 percent in the rest of Canada); and
- (3) the housing grant helped to bring about a 74 percent increase in housing starts in late 1975.

The cost of these measures was \$590 million, but well worth it, according to the provincial government.

The 1977 budget again ignored the earlier approach to analyzing the fiscal impact through the Full Employment Budget Surplus and instead concentrated on the actual budget balance and size of the public sector. The reason for this omission is not apparent from the budget itself but can be found in a budget paper of the Speech [20:A-3-A-25 (1977)]. After a detailed analysis of the employment/unemployment situation in Ontario and a review of the debate on what constitutes full employment, the budget concludes:

“. . . the 3 to 4 percent full employment norms . . . are not appropriate to . . . the 1970s. . . . [Changes to the Unemployment Insurance Act and increased levels of labour force participation] suggest that Ontario's high employment norm be redefined to 5.3 percent . . . macro stabilization policies aimed at stimulating demand will only impact on unemployment levels above this norm" [20:19(1977)].

A reinterpretation of full employment would affect previous calculations of the "swing" in fiscal impact and make current estimates of the Full Employment Budget Surplus more complicated. It would be a year before the "new estimates" would be available.

Attention in 1977 focused on balancing the budget and reducing public spending. The reversal of the 1965-1975 period would be painful but necessary. "We have badly tilted our economic and fiscal policies towards social over-management . . ." [20:3 (1977)]. There was no further expenditure flexibility on a broad scale.

In the historical framework of the province's budget speech, 1977 was notable in its acceptance that Ottawa's fiscal policy was sufficient and substantially directed toward Ontario. Tax reductions and new levels of premiums and tax credits would add roughly \$400 million to Ontario incomes. The Province, however, did feel there were some special areas of concern in the Ontario economy and proposed a \$75 million expansion in capital spending, a program to stimulate jobs for youth, retail sales tax exemptions in the tourist/entertainment sector, and a deferred tax for small business. The net effect of all these and other changes would be a budgetary deficit of \$992 million, almost \$300 million below 1976-77.

The final budget in this historical review of Ontario fiscal policies is that of 1978 [20 (1978)]. The basic theme of the budget in terms of fiscal policy is selectivity. Based upon a Ministry Staff Paper [23], the treasurer concludes that ". . . one reluctantly comes to the conclusion that the taxpayers of Ontario would see only marginal returns to the Provincial Treasury when government stimulates the economy through general measures" [20:4 (1978)]. Combined with Ontario's desire to hold the line on public spending and work toward a budget balance, there was obviously little room for fiscal manipulation.

The fiscal aspects of the budget involved a balancing act: giving a little here but taking from somewhere else to make up the lost revenue. The fiscal measures were highly selective. First, there were extensions to the youth job creation programs that were started in 1977. Second, changes were made in the taxation of mining profits, to stimulate exploration and development. Third, there would be a suspension of the retail sales tax on accommodation in the hospitality sector, as a means of encouraging tourist trade. The total cost of these selective incentives would be almost \$50 million, a very moderate stimulus.

The 1978 budget speech includes a detailed paper on the Province's borrowing and capital formation. The Province's view of the future was that there would be a diminishing need for public capital and, hence, internally generated funds would be available to reduce the debt and channel monies into the private sector. The balanced budget objective, however, did not imply that the Province was abandoning a "Keynesian" type of fiscal policy. The treasurer was prepared to accept a deficit, ". . . the financing of temporary fiscal actions during periods of economic slowdown . . ." [20:A-3 (1978)]. The Province was obviously prepared to employ deficits as a counter-cyclical policy but only within the limits of its overall (budgetary and non-budgetary) cash requirements.

Evaluating the Effectiveness of Provincial Fiscal Policy

Evidence from aggregate studies and macroeconomic models suggests that provincial budget results tend to move in a counter-cyclical manner; as the economy accelerates, budget deficits become smaller or surpluses increase, and when the rate of growth falls short of a full employment growth rate, the reverse effects occur for provincial budgets [11;12;24]. This evidence tells us very little about the effectiveness of the deliberate changes in policy to stimulate or dampen the rate of growth in the economy. To do so it is necessary to use the approach referred to earlier, the Full Employment Budget Surplus (FEBS). While this approach has been used in fiscal policy analysis for the past thirty years, it may be useful to review it briefly.

The FEBS in a given year is the budget result that would occur if the economy were operating at its potential and the actual fiscal parameters (tax rates, benefit rates, and expenditure on goods and services) were fixed. Suppose that the FEBS in one period was \$+200 million. If in the next period the FEBS was again \$+200 million, we can conclude that no discretionary fiscal policy was undertaken in this period or that action on the tax side was offset by action on the expenditure side. Had the FEBS *declined* to \$+100 million, this decline would be a clear indication that stimulating policies were applied. The difference in the *actual* budget result between one period and the next would indicate not only discretionary policy effects (if there were any), but also the effect of changes in actual GPP on the budget result.

The example given in Table 2 may help to explain this approach. Consider Case I. When actual gross provincial product (GPP^A) declines, the actual budget result (R^A) moves from a surplus (+50) to a deficit (-75) as tax revenues fall and transfer payments rise. None of this is due to any discretionary action, since the full employment budget surplus (FEBS) remains unchanged at 100. If, in the face of mounting unemployment, the provincial government reduced taxes, forgoing some of its revenue, the scenario might be as shown in Case II. In this example, there is a greater decline in the actual budget result and a decline in the FEBS, a clear indication of discretionary policy, the effect of which is included with the induced budget response in the change in the actual budget result. Attempts to maintain the \$50 million surplus by higher taxes or lower spending in the face of a recession would only deepen the recession and possibly contribute to a higher deficit in the short run.

Table 2
EXPLANATION OF DEVIATION OF FULL EMPLOYMENT BUDGET SURPLUS

| Time Period | GPP ^A | GPP ^F | R ^A | FEBS |
|-------------|------------------|------------------|----------------|------|
| Case I | | | | |
| 1 | 100 | 110 | +50 | +100 |
| 2 | 90 | 110 | -75 | +100 |
| Case II | | | | |
| 1 | 100 | 110 | +50 | +100 |
| 2 | 90 | 110 | -100 | +70 |

Having briefly reviewed the concept of the FEBS, we turn to its application to Ontario in the 1969-78 period. Table 3 shows actual and full-employment budget results for 1969-78. The actual deficit, D, in any year when there was a change in discretionary policy would have been different in the absence of any policy change. For example, an actual deficit of \$500 million would have been smaller if a tax reduction had not been implemented in that same year. Thus, the existence of discretionary policy, if it is counter-cyclical, dampens the rise in the deficit or fall in the surplus. To obtain a measure of the budget result's automatic response to the cycle, we must account for the "feedback" effects of discretionary policy as indicated by the change in the FEBS.

Table 3
ACTUAL BUDGET RESULTS AND FEBS IN ONTARIO
(NATIONAL ACCOUNTS BASIS) AND OUTPUT GAP, 1970-78

| Year | FEBS* | | Change | | Actual Budget Result | | Output Gap | |
|------|-------|------------|----------------------|--------|----------------------|--------|------------|------|
| | FEBS* | Change | Actual Budget Result | Change | Output Gap | Change | Output Gap | |
| | | \$ million | | | | | % change | |
| 1969 | +272 | | +216 | | +216 | | +2.5 | |
| 1970 | +117 | -155 | + 52 | | + 52 | -164 | +1.2 | -1.3 |
| 1971 | -229 | -342 | -346 | | -380 | -362 | -432 | -0.5 |
| 1972 | -311 | -408 | - 82 | - 66 | -386 | - 24 | +0.9 | +0.4 |
| 1973 | | -411 | | - 3 | -282 | +104 | +2.9 | +2.0 |
| 1974 | | -359 | | + 52 | -219 | +163 | +1.8 | -1.1 |
| 1975 | | -1,301 | | -942 | -1,464 | -1,145 | -3.5 | -5.3 |
| 1976 | | -1,241 | | + 87 | -1,392 | + 72 | -1.9 | +1.6 |
| 1977 | | -886 | | +328 | -1,279 | +311 | -3.8 | -1.9 |
| 1978 | | -1,084 | | -198 | -1,602 | -323 | -4.1 | -0.3 |

*The 1969-72 and 1971-78 FEBS estimates were arrived at in different ways, causing a split in the series.

The change in the FEBS is the net, unweighted injection of aggregate demand into the provincial economy.⁵ If this is multiplied by the disposable income multiplier, we have a rough measure of the effect of the change in discretionary policy on GPP. If this, in turn, is multiplied by the marginal response of provincial revenue to a change in GPP, we have an estimate of the feedback on the budget deficit or surplus. Therefore, the hypothetical deficit in the *absence* of policy (D^H) is:

$$D^H = - (\Delta \text{FEBS}) (\Theta) \frac{\Delta T}{\Delta \text{GPP}} + D$$

where Θ is the multiplier, T represents tax revenue, and D is the actual deficit.⁶

Actual and hypothetical deficits since 1970 are shown in Figure 1 (the "split" in the series at 1978 is due to the lack of consistent data for the entire period on a calendar year basis). The pattern of hypothetical and actual deficits shows clearly that the Ontario budget is very responsive to changes in economic conditions, such as the recessions of 1975 and 1981-83. In short, deficits are to a large degree created by the general economic environment.

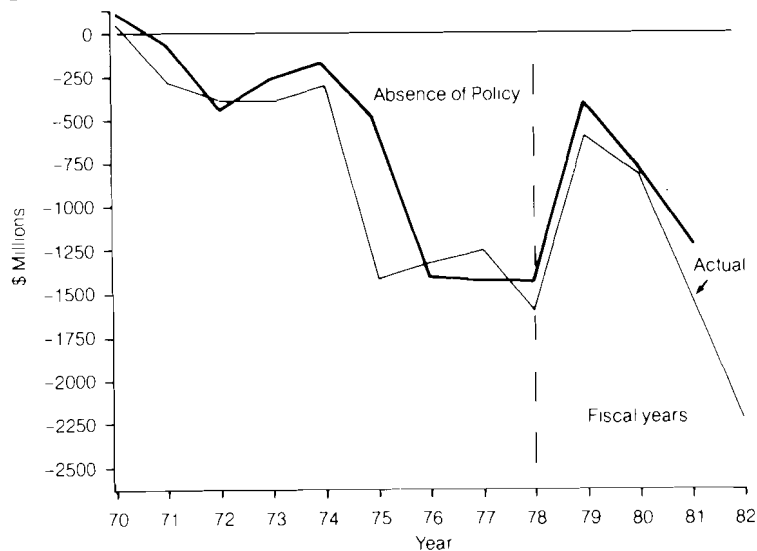


Figure 1

ACTUAL DEFICIT AND DEFICIT IN THE ABSENCE OF DISCRETIONARY POLICY

⁵"Unweighted" refers to the absence of a coefficient on any tax and expenditure variables that would represent the "first round" impact of change in that variable on aggregate demand.

⁶The value of the multiplier here is 1.3, which has been used by the Ontario Economic Council in earlier forecasts.

The second question to be answered is: If changes in the deficit were deliberately engineered for counter-cyclical reasons, have these changes been at least qualitatively successful? To answer this question, the change in the FEBS is compared with the change in the official output gap for the period 1970-78. Efficient counter-cyclical fiscal policy suggests that as the economy moves *away* from full employment, discretionary policies would be expansionary, as indicated by a negative change in the FEBS or a negative change in the policy-induced result. The reverse would be expected as a gap narrowed. Observations based on these data should show a trend if fiscal discretionary action has been stabilizing.

Figure 2 plots actual observations of the change in FEBS or policy-induced deficit and change in the GNP gap for the 1969-70 to 1978-79 period. There appears to be one major instance, in 1977, when discretionary policy was not counter-cyclical. The increase in the FEBS in 1977, when the economy moved farther away from potential GNP, was probably largely due to public pressure on the government to reduce its deficit, which had been expanded in 1974-76 in response to the widening gap between actual and full-employment GPP.

The Future of Provincial Fiscal Policy

In its discussion of federalism and stabilization policy, the Royal Commission on the Economic Union and Development Prospects for Canada had this to say:

By the 1970s, several developments had strained federal-provincial collaboration in economic and social management. The economic difficulties of those years called into question the effectiveness of post-second world war techniques of economic management. The widespread consensus among citizens and governments about the policies began to erode. Much of this growing dissension expressed itself through rival economic policies . . . [25:Vol. 3:145].

Whether these rival economic policies were beneficial or detrimental to Canada's economic growth and stability is not discussed by the Commissioners. They conclude, however, that the federal government is primarily responsible for stabilization policy but concede that:

The very scale of Provincial taxing and spending, along with the interdependence of federal and provincial fiscal systems means that they must be involved in stabilization policy. [25:Vol. 3:149].

The major recommendations in this regard are an echo from the past: more meetings among Ministers of Finance, better co-ordination and timing of budgets at the federal and provincial level, and tax base

harmonization. One of the recommendations of the Task Force on Canadian Unity was as follows:

The annual conference of finance ministers should be used more actively to ensure the co-ordination of economic stabilization policies by providing a common assessment of the economy and a better knowledge of the total revenues, expenditures and borrowings of the Canadian public sector as a whole [7:124].

Similar suggestions came from the Economic Council of Canada [9].

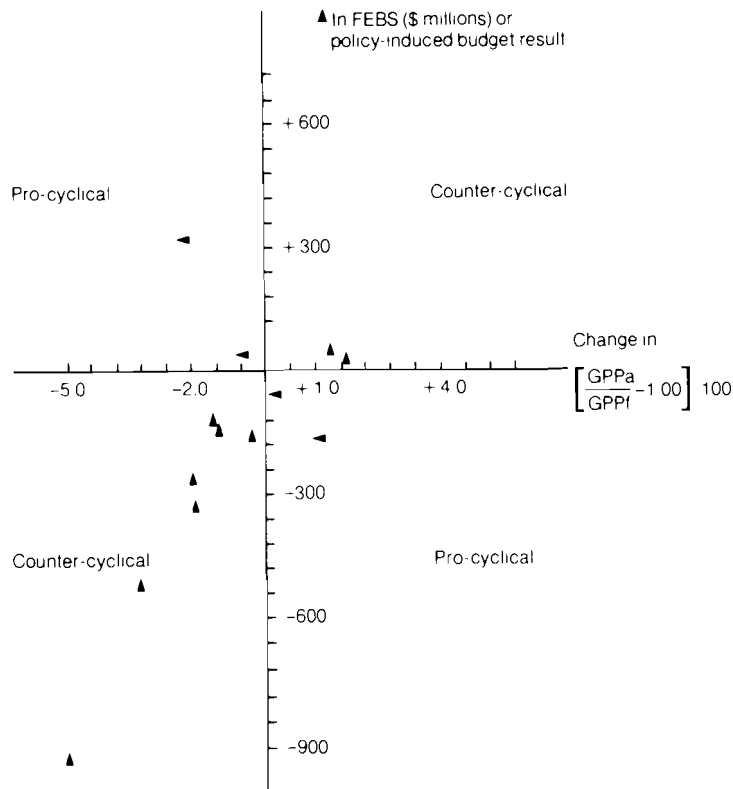


Figure 2

MEASURING THE IMPACT OF DISCRETIONARY POLICY

What these recommendations amount to is a statement that Ottawa and the provinces should consult one another regarding fiscal policies, a position advanced by Ontario in the 1970s. They do not come to grips with the question: Should provinces or regions follow independent stabilization policies similar to those implemented by Ontario in the 1969-1979 period? Of major importance is the answer

to the following question: Does independent fiscal action on the part of a province or group of provinces improve economic stability? In a study for the Ontario Economic Council, Boadway and Treddenick concluded that in the case of Ontario, "... the brunt of the effect of Ontario tax changes is on Ontario industries" [5:120]. In the same year, Kubursi argued that provincial policies can be developed to have considerable impact on unemployment when it is regionally concentrated within a province [16].

In more recent work, Fortin concluded that:

... the oft-expressed theoretical fear that import leakages would drain off a significant share of the expansionist multiplier of an isolated provincial measure compared to a federal or co-operative measure is without serious empirical basis [11:33].

As to the potential destabilizing effects of provincial policies, the same author concludes that provincial budgetary policy has, in recent years:

... reinforced rather than weakened the cyclical stability inherent in the economy and has facilitated the federal government's task of discretionary stabilization policy [12:22].

This conclusion is supported by Selody and Lynch [26], whose research indicated that indirect provincial fiscal policies were stabilizing over the post-war business cycle in Canada.

The experience of the 1970s and recent research suggests that there are no inherent destabilizing effects of provincial fiscal policy; in fact, the opposite appears to be the case. That does not imply that each province or region should embark on major counter-cyclical fiscal policies; there are serious limitations to what provincial governments can do and indirect consequences which cannot be ignored. First, there is no way a province can sustain a continuously rising debt-to-income ratio, as the federal government can, if it cannot generate significant surpluses in periods of high economic growth. Unlike the federal government, the provinces do not have access to the central bank to finance debt. Second, while import leakages in the aggregate may not be a problem, that does not mean that there is no significant import leakage for a given fiscal initiative in a given region or province. Third, heavy borrowing by a province, especially in the foreign money markets, has the potential to cause difficulties with exchange rate management [30]. While the above constraints do not eliminate the use of fiscal stabilization policy at the sub-federal level, they clearly limit the scope and depth of such policies.

Conclusion

During the 1970s, the Province of Ontario followed a deliberate policy of attempting to stabilize the level of unemployment in the province through selective tax and expenditure policies. On balance, these policies were more stabilizing than destabilizing. Recent evidence, on an aggregate basis, suggests that provincial budgetary policies in Canada have contributed to economic stability. Furthermore, there is no evidence to suggest that import leakages between regions in Canada are sufficiently high to exclude the use of deliberate fiscal actions at the sub-federal level. Provincial or regional fiscal policy is, however, constrained by several important factors. In conclusion, it would appear that provincial fiscal policy is likely to be most effective to offset short run, sectoral, or regionally specific instabilities.

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