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Communiqué

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Restore balance to Canada's intergovernmental transfer system, says economist

Canada's system of intergovernmental transfers has lost the balance between individual and regional equity that made it the envy of many federal states, says University of Alberta economics professor Paul Boothe in the C.D. Howe Institute's annual Benefactors Lecture, delivered in Calgary today.

Boothe, an Adjunct Scholar of the C.D. Howe Institute, addresses the practical problem of reforming the current Canadian transfer system. He criticizes some recent proposals for taking a "start-from-scratch" approach to reforming transfers that ignore the federal nature of the country and fail to recognize the political environment in which transfers are embedded. The need for provinces to have adequate revenues to discharge their constitutional responsibilities must underlie any redesign of transfers, Boothe argues. Moreover, he says, a reformed system must treat individual Canadians equitably and enhance rather than hinder the efficient operation of the economy.

Boothe outlines a number of "hard problems" that need to be addressed in any package of reforms:

- The current system of transfers treats Canadians very differently depending on where they live, with the result that income is transferred from poorer Canadians in richer regions to richer Canadians in poorer regions.
- The current system hinders economic efficiency. For example, Canadians in some regions have little incentive to move to seek better employment opportunities. Further, the equalization program often confiscates extra revenue that an equalization-receiving province generates when it encourages economic growth in a particular activity.
- Inequities and the complexity of intergovernmental transfers have diminished the political viability of the current system. "Much is made of the sharing nature of the Canadian federation," Boothe notes, "but how can individual Canadians evaluate their contribution to promoting equity in other provinces when they do not even know how much they contribute or how it is redistributed?"

Ottawa's approach is increasingly to replace intergovernmental transfers to provinces with direct transfers to individuals — as demonstrated by the new Millennium Scholarship Fund and by the Child Tax Benefit. "The federal move to direct transfers to persons does have some positive elements," Boothe says, but it means a "return of federal-provincial overlap and duplication" that governments have been working to reduce over the past decade.

In his search for a solution, Boothe assesses other reform proposals that policymakers are now examining. One such scheme proposes a new transfer system that mimics outcomes from a unitary state. Boothe argues that such an approach would create huge winners (Ontario and Quebec) and losers (Alberta and British Columbia) and is "antithetical to federalism."

Moreover, this approach fails to deal with concerns about equity and efficiency in the current system, and promises to make transfers even less politically viable. An alternative reform proposal suggests that all federal redistribution among provinces be confined to the equalization program — in other words, programs outside equalization should treat Canadians the same no matter where they live. Boothe is more favorably disposed to this proposal, but questions whether it goes far enough, as it would not solve the efficiency concerns and would further complicate the system.

Boothe prefers a more radical reform — creating an interprovincial revenue-sharing pool that would replace the most important of the current transfers and that would use a single indicator, rather than the 33 tax bases in the current system, to determine who gets what. This proposal, which takes the current level of redistribution as its starting point, would transfer sufficient tax revenue to the provinces to allow them fulfil their current spending responsibilities. The revenue-sharing pool would be used to transfer money from richer to poorer provinces and the federal government would take on a new role as the program's guarantor. Boothe argues that his proposal not only addresses the equity problems of the current program, but also makes progress on the efficiency front. Its greater transparency and simplicity, Boothe says, would make the system more politically viable.

Boothe concludes that "Canadians face a national choice. Forces of change are at work in our federation, and we can choose to ignore them or to manage them for our collective benefit." If we act now, he says, "we can renew Canadian fiscal federalism, and find a new balance for our federation to prepare it for the challenges of the next century."

The Benefactors Lecture, which is presented annually in the fall, was sponsored this year by Koch Oil Co. Ltd. Past lecturers include economists John McCallum, Richard Harris, Thomas J. Courchene, Richard G. Lipsey, and D.G. McFetridge, and political scientist Richard Simeon.

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Il faut rétablir l'équilibre du système des transferts intergouvernementaux du Canada, affirme un économiste

Le système des transferts intergouvernementaux du Canada est dépourvu de l'équilibre entre l'équité individuelle et régionale qui en faisait l'envie de nombreux États fédéraux, a affirmé un professeur d'économie de l'Université de l'Alberta, Paul Boothe, dans le cadre de la conférence annuelle des bienfaiteurs de l'Institut C.D. Howe, qui a été donnée aujourd'hui à Calgary.

M. Boothe, qui est attaché de recherche auprès de l'Institut C.D. Howe, a cerné le problème pratique que pose la réforme du système actuel des transferts canadiens. Il critique certaines propositions récentes pour leur méthode voulant « commencer à pied-d'œuvre » la réforme des transferts, qui ignore totalement la nature fédérale du pays et qui refuse de tenir compte du milieu politique d'où sont issus ces transferts. Selon M. Boothe, c'est le besoin des provinces de disposer de recettes suffisantes pour s'acquitter de leurs responsabilités constitutionnelles qui doit gouverner tout remaniement des transferts. De plus, affirme-t-il, un système remanié doit traiter les Canadiens équitablement et contribuer au fonctionnement efficient de l'économie, plutôt que de l'entraver.

M. Boothe cite plusieurs « problèmes sérieux » qui doivent être résolus dans le cadre d'un assortiment de réformes :

- Le système actuel des transferts traite les Canadiens de manière bien différente selon l'emplacement où ils vivent, ce qui entraîne un transfert des revenus des Canadiens démunis dans les régions nanties vers les Canadiens nantis des régions démunies.
- Le système actuel entrave l'efficience économique. Ainsi, dans certaines régions les Canadiens ont peu de motivation à aller s'établir ailleurs pour obtenir de meilleurs débouchés d'emploi. De plus, le programme de péréquation confisque souvent les recettes supplémentaires que produit une province bénéficiant de la péréquation lorsque cette dernière favorise la croissance économique d'une activité en particulier.
- Les iniquités et la complexité des transferts intergouvernementaux ont affaibli la viabilité politique du système tel qu'il existe maintenant. « On fait grand cas de la nature partageuse de la fédération canadienne, souligne M. Boothe, mais comment chaque Canadien

peut-il évaluer sa contribution à l'équité dans d'autres provinces lorsqu'il ne sait même pas combien il contribue ou comment sa contribution est redistribuée ? »

La méthode employée par Ottawa consiste à remplacer de plus en plus les transferts intergouvernementaux aux provinces par des transferts directs aux particuliers, comme en témoignent le nouveau Fonds des bourses du millénaire et la prestation fiscale pour enfants. « La décision fédérale d'accorder des transferts directs aux particuliers comporte certains éléments positifs », indique M. Boothe, mais elle marque un « retour au chevauchement fédéral-provincial et au double emploi » que les gouvernements s'efforcent d'éliminer depuis dix ans.

À la recherche d'une solution, M. Boothe passe en revue d'autres propositions de réforme qui sont présentement à l'étude par les artisans de la politique. L'une d'entre elles propose un nouveau système de transferts qui imite les résultats d'un État unitaire. Selon lui, une telle méthode créerait de gros gagnants (l'Ontario et le Québec) et de gros perdants (l'Alberta et la Colombie-Britannique) et serait « contraire au fédéralisme ».

De surcroît, cette méthode ne résout pas les problèmes d'équité et d'efficience que pose le système actuel, et promet de rendre les transferts encore moins viables du point de vue politique. Une autre proposition de réforme suggère que l'on limite au programme de péréquation toute redistribution fédérale entre les provinces — autrement dit, les programmes extérieurs à la péréquation doivent traiter les Canadiens sur un pied d'égalité, où qu'ils se trouvent. M. Boothe est plus favorable à cette proposition, mais se demande si elle va assez loin, car elle ne résoudrait pas les problèmes d'efficience et compliquerait davantage le système.

M. Boothe penche pour une réforme plus radicale, soit de créer un fonds commun interprovincial de partage des recettes qui remplacerait les transferts les plus importants et qui aurait recours à un seul indicateur, plutôt que les 33 assiettes fiscales du système actuel qui servent à établir qui obtient quoi. Cette proposition, qui prend comme point de départ le niveau actuel de redistribution, transférerait suffisamment de recettes fiscales aux provinces pour leur permettre de s'acquitter de leurs responsabilités actuelles de dépenses. Le fonds commun de partage des recettes servirait à transférer les sommes des provinces nanties aux provinces démunies, tandis que le gouvernement fédéral assumerait le nouveau rôle de garant du programme. M. Boothe soutient que sa proposition traite non seulement les problèmes d'équité du programme actuel, mais marque également une amélioration du point de vue de l'efficience. En raison de sa transparence et de sa simplicité accrues, le système serait selon lui plus viable sur le plan politique.

M. Boothe conclut en affirmant que « les Canadiens sont placés devant un choix national. Les forces du changement sont à l'œuvre dans notre fédération, et nous pouvons choisir soit de les ignorer, soit de les gérer pour le bien collectif ». Si nous agissons dès maintenant, ajoute-t-il, « nous pouvons renouveler le fédéralisme fiscal du Canada, et donner un nouvel équilibre à notre fédération qui la préparera aux défis que pose le siècle prochain. »

La conférence des bienfaiteurs, qui a lieu annuellement à l'automne, était parrainée cette année par Koch Oil Co. Ltd. Parmi les conférenciers des années précédentes, figuraient notamment les économistes John McCallum, Richard Harris, Thomas J. Courchene, Richard G. Lipsey et D.G. McFetridge, et le politicologue Richard Simeon.

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L'Institut C.D. Howe est un organisme indépendant, non-partisan et à but non lucratif, qui joue un rôle prépondérant au Canada en matière de recherche sur la politique économique. Ses membres, individuels et sociétaires, proviennent du milieu des affaires, syndical, agricole, universitaire et professionnel.

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C.D. Howe Institute
Benefactors Lecture, 1998

Finding a Balance:
Renewing Canadian Fiscal Federalism

by

Paul Boothe

Professor of Economics,
University of Alberta

Calgary, October 30, 1998

Sponsored by
Koch Oil Co. Ltd.

Foreword

Fiscal transfers from rich subnational governments to poorer ones are an essential ingredient of a well-functioning federation. In Canada, transfers through equalization and other programs have no doubt helped to make this federation one of the most successful in the world.

But how much is enough and how much is too much? Is Canada's transfer system fair? As the federal and provincial governments get ready next year to review equalization, the main transfer program, it seemed appropriate to focus the 1998 Benefactors Lecture on those crucial fiscal ties. Given his long study of the issue, the C.D. Howe Institute invited Paul Boothe, Professor of Economics at the University of Alberta and an Adjunct Scholar of the Institute, to undertake a review of Canada's system of intergovernmental transfers and to suggest a way to find, as he puts it, "the balance point where our federal system works best."

In presenting the Benefactors Lecture this year, Professor Boothe joins a distinguished group of previous lecturers: John McCallum, Richard Harris, Richard Simeon, Thomas Courchene, Richard Lipsey, and D.G. McFetridge.

The Institute's aim in presenting the Benefactors Lecture series is to raise the level of public debate on issues of national interest by presenting diverse points of view. By so doing, the Institute hopes that it will give Canadians much to think about, including the information they need to exercise their responsibilities as citizens.

I wish to thank our benefactor for this year's lecture, Koch Oil Co. Ltd., and in particular Randolph C. Aldridge, President, Koch Canada Ltd., whose support also enabled us to make copies of the lecture available free of charge.

The text of the lecture was copy edited by Lenore d'Anjou and prepared for publication by Wendy Longsworth and Barry A. Norris. As with all C.D. Howe Institute publications, the opinions expressed here are those of the author, and do not necessarily represent the views of the Institute's members or Board of Directors.

Thomas E. Kierans
President and Chief Executive Officer
C.D. Howe Institute

Canada's system of fiscal transfers is the envy of many developing countries. Almost every month, it seems, another foreign delegation visits Canadian universities to learn about fiscal federalism in this country. And well others should want to learn more about us. In the main, the Canadian economy is efficient and prosperous. Our federation works effectively and enables a generous amount of interregional sharing.

As has often been the case in the past, however, the Canadian federation currently has some hard problems to solve. As the *Globe and Mail* put it in an editorial last year:

> The transfer system at the heart of fiscal federalism is broken….Our transfer system has to balance two kinds of fairness: fairness between individual Canadians, and fairness between rich and poor regions. For a variety of historical and political reasons, the delicate balance between the two has been lost, with the principle of interregional equalization progressively crowding out fairness to individuals. (August 18, 1997, A18.)

This essay is about finding the balance point where our federal system works best.

After the Great Depression, the Canadian federation went through a long process of centralization that culminated in the 1960s. Since then, however, the trend has reversed. Boadway (forthcoming) discusses the process of decentralization of the Canadian federation that has been under way over the past three decades. Federal program spending was almost 70 percent larger than provincial program spending in the early 1960s; by 1994, it was more than 10 percent smaller.

Changes in the character of the federation are to be expected. Federations are living organisms, continually evolving in response to both internal and external pressures.[1] As Wheare puts it:

Many of my colleagues gave generously of their time in providing comments and discussing issues as this work has evolved. I wish to thank, without implicating, Richard Bird, Ken Boessenkool, Tom Courchene, Bev Dahlby, Dagmar Dyck, Derek Hermanutz, Paul Hobson, Tom Kierans, Mel McMillan, Ken Norrie, Finn Poschmann, John Richards, Bill Robson, Sam Wilson, and John Wright. Ron Cheung and Christine Stelmack provided superb research assistance, and Lenore d'Anjou's editing improved my exposition substantially. Of course, all remaining errors of omission, faults of logic, and unintended slights belong solely to me.

1 For my own views regarding the evolutionary properties of the Canadian federation, see Boothe (1995).

> There is and can be no final solution to the allocation of financial resources in a federal system, there can only be adjustments and reallocations in the light of changing conditions. What a federal government needs, therefore, is machinery adequate to make these adjustments. (1963, quoted in Courchene 1984, 81.)

The fact that fiscal changes are continuous does not mean, however, that we should simply accept them uncritically. As custodians of the federation, we should manage its evolution to ensure that it serves our needs in the face of new circumstances at home and abroad.

Nineteen ninety-nine will be the time for the quinquennial review of equalization, one of Canada's most important transfer programs. The need for substantive reform is pressing. The provinces are increasingly divided. More important, lacking a coherent plan for dealing with provincial concerns, the federal government is drifting toward its 1960s' strategy of expanding spending in areas of provincial jurisdiction, thus setting the stage for another war of attrition between Ottawa and the provinces.

Whether academic economists will make a useful contribution to the debate on transfer reform is unclear. Bird (1994) argues that economists tend to approach issues of federal finance from a normative perspective: that is, deducing from first principles which fiscal system would be ideal, assuming that governments are solely concerned with maximizing the economic well-being of a representative citizen. Although this approach is ideal for professors designing federal systems from scratch, it provides little help in understanding why particular fiscal institutions currently exist or what forces shape changes in such institutions.

In this essay, I hope to avoid this from-scratch approach and instead deal with the practical problem of reforming the current Canadian transfer system. To do this, I must make a number of value judgments; I try to make them explicit so that readers can see clearly how they affect the analysis.

The heart of my analysis is the evaluation of two proposals representative of the main competing visions for transfer reform. I contrast these proposals with a new, radical approach to reform, one that is designed specifically to restore the balance that has been lost in Canada's transfer system.

The structure of the essay is as follows. In the first section, I provide a primer on transfers, setting out the rationales for federated states and for intergovernmental transfers within them and describing the history of such transfers in Canada. I also explain the current form of the largest parts of its transfer system: the equalization program, the Canada Health and Social Transfer (CHST), and the regionally sensitive component of an important transfer to individuals, the employment insurance (EI) program.

The next section deals with problems in the current system and how they developed. The focus is on inequity, economic inefficiency, political viability, and the effects of changes in international competition.

In the third section, I outline a set of criteria for evaluating reform proposals and proceed to explain and evaluate the recent ones of Hobson (forthcoming) and Boessenkool (1998), and in the next section I describe a more radical approach. Designed explicitly to deal with the problems outlined earlier, it is based on my own work with Derek Hermanutz (forthcoming). Adopting it would reduce the scale of transfers in Canada by more than two-thirds, enhance transparency and accountability, and substantially improve the incentives faced by governments.

In the concluding section, I survey the road ahead, discussing whether conditions are right for substantive reform at this time. Given the political and economic forces currently at work, my view is that fundamental reform is possible. The debate we begin now will lay the groundwork for future progress in finding the balance that has made Canada one of the world's most enduring and successful federations.

A Primer on Transfers

The purpose of this section is to provide some background on transfers to help readers understand both the problems of and the proposed reforms to Canada's transfer system. I begin by discussing what Wheare (1963) calls the prerequisites to federations: what causes some groups of communities to choose to form federations rather than unitary states. Next, I give rationales for transfers. The section concludes with a brief history of Canadian intergovernmental transfers and descriptions of the current form and size of the largest programs.

Why a Federation?

To understand intergovernmental transfers, one must consider why federations exist at all. Wheare (1963) argues that three prerequisites must be satisfied before federation is possible.

The first prerequisite is the will to federate on the part of the partners: the communities[2] concerned must want to be under common government for some purposes. Many reasons are plausible. For example, communities may federate in the interests of common defense and to remain independent of foreign powers. This was clearly one of the motives of the Canadian colonies, given the expansionist sentiment of the United States in the mid-1800s. In addition, potential economic advantages may lead communities to federate. These advantages may arise from pooling resources to lessen the expense of providing public services or from reducing costly trade barriers between communities.

The second prerequisite for federating is that communities must wish to retain independent regional governments for some purposes. (If they did not, logic would dictate their forming a unitary state.) Wheare (1963) argues that all modern federations are made up of former separate colonies or of states with a history of independence. Communities may have differing economic, geographical, cultural, or political interests. Probably all of these disparate interests were factors when the Canadian federation was formed in 1867, and many of them are clearly still relevant today. For example, the economic interests of British Columbia and Alberta, with their resource-intensive economies, sometimes differ substantially from the interests of Ontario and Quebec, where manufacturing plays a more important role. Cultural differences in 1867 were mostly linguistic. Today, although language is still important in some parts of Canada, in others it has been overtaken by regional and ethnic differences. Political interests in Canada are today as diverse and important as they were in 1867 and continue to shape the way the federation evolves.

The third prerequisite is having the capacity to actually operate a federal state. Relative similarity of social and political institutions makes federation more feasible; in Canada, for example, all the colonies had a constitutional monarchy. Size is also important. Federation is more diffi-

2 I use the word *communities*, but *regions*, *states*, *nations*, or *colonies* might also apply.

cult if the new nation is dominated by one or two relatively large entities. In Canada, the size of Ontario and Quebec relative to the other provinces has certainly played an important role in the way the federation has evolved. Finally, the federated communities must have the resources to finance the activities of two levels of government. In Canada, the relatively small size of some provinces probably means that economies of scale are lost in particular areas. If we were forming a federation anew in 1999, we might consider these communities too small to be provinces, but our history is such that all existing provinces are accepted as full partners in the federation.

One can also ask why federations stay united over long periods. To some extent, the reason is probably that the grounds that led the communities to federate in the first place are enduring. Also, part of the reason that federations stay united is inherent in the normal development of the federal state itself. As trade grows between communities, their economic links with one another grow relative to links with outside groups; Canadian provinces, for example, trade much more with each other than with, say, US states at comparable distances (see Helliwell 1996; McCallum 1995).[3] Migration in response to changing economic conditions leads to a growing number of families with members living in a number of regions, which, in turn, improves understanding and appreciation of regional differences. A well-functioning system of intergovernmental relations leads over time to national growth along with accommodation of regional differences.

Rationales for Transfers

Intergovernmental fiscal transfers are common in federations. Four reasons for transfers between the federal government and the communities (provinces) are obvious and not mutually exclusive.

The Federal Rationale

Courchene (1984; 1998) argues that, for a federal system to be effective, each level of government must have the revenue it requires to carry out

3 Hartt (1992) makes the point that legal comity (the willingness to accept and enforce the decisions of the courts of other provinces) is an important factor in the facilitation of interprovincial trade and commerce.

its constitutional responsibilities. To ensure that this is the case when tax revenues and spending do not exactly match — that is, in the presence of *vertical fiscal imbalance*, where one level of government, typically the central government, collects more revenue than it spends and the other collects less than it spends — transfers are needed.[4] Interestingly, this rationale for intergovernmental transfers was given in Canada more than half a century ago by the Rowell-Sirois Commission (Canada 1939) in its inquiry into the nation's fiscal circumstances.

This rationale implies that transfers should be unconditional — that is, they should have no strings attached — because provinces should be free to discharge their constitutional responsibilities without hindrance.

The Citizenship Rationale

Citizens of a federation have the right to certain publicly provided social and economic services regardless of where they live (again following Courchene 1984; 1998). Provincial governments provide some of these services. To ensure that residents have access to these services, provinces must have adequate resources to provide them. Hence the need for transfers in the presence of vertical fiscal imbalance.

In contrast to the federal rationale, this rationale implies that transfers be conditional. Indeed, a key condition of some Canadian transfers (for health care, for example) is that the services they fund be portable from province to province. Recently, this portability has been threatened, with Quebec charging higher fees to out-of-province university students[5] and British Columbia threatening to put residency requirements on social assistance payments.

The Economic Efficiency Rationale

Transfers can alleviate efficiency problems in a federation related to the mobility of workers and the detrimental effects that the policies of one province can have on another.

4 Alternatively, taxing or spending responsibilities can be reallocated. Canada has employed this option in the past.

5 It is worth noting, however, that while these tuition fees are higher than those paid by Quebec students, they are not higher than the average fees in other provinces.

The first basic notion is that when citizens choose where in the federation to live, they compare regions not just on the basis of the private incomes and costs they offer but also on the basis of *net fiscal benefits* (the difference between the value of public services received and taxes paid). The usual form of the argument is that, if a region has large net fiscal benefits because of a substantial endowment of natural resources or locational or other advantages, people may be induced to move there to capture those benefits, rather than to take advantage of better job opportunities. Thus, the distribution of labor in the federation is distorted and the national economy runs less efficiently.

A second efficiency rationale for transfers comes from spillovers (*externalities*, as economists call them), which may arise if a province does not take account of the effects of its policies on other provinces. Suppose air pollution generated in one province reduces the air quality of its neighbors, and the offending province does not invest sufficiently to mitigate the problem.[6] Conditional grants from the federal government (representing the residents of all provinces) may induce the offending province to invest enough to relieve not only its own pollution problem but the problems caused for its neighbors.

The Equity Rationale

The equity rationale is closely related to the citizenship rationale already discussed. The focus is, however, directly on comparisons of individuals, rather than on governments' ability to offer comparable basic services. Clearly, the federal government has a role to play here, since it is difficult for provinces to ensure equity outside their own boundaries. But at this point, matters become complicated.

Students of federalism generally distinguish between two notions of equity. *Narrow-based equity* means that governments, in their own actions, treat individuals in similar economic circumstances equivalently. The implications are that the federal government should give the same services and transfers and levy the same taxes on similarly situated individuals regardless of where they live and that provinces should do like-

6 The offending province might, for example, build a large smokestack to send pollution beyond its borders rather than invest in more expensive pollution-reduction technology.

wise within their own boundaries. Provinces need not, however, have identical taxes, services, or transfers.

Broad-based equity is much more sweeping and, some argue (for example, Courchene 1998), antithetical to federalism. The implication is that similarly situated individuals should be treated equivalently by all governments taken together. Thus, if provinces do not have identical taxes, services, and transfers, then a job of the federal government is to undo these differences; for example, if one province decides to lower taxes, the federal government should transfer income from taxpayers in that jurisdiction to those with higher taxes. This view motivates analysts such as Hobson (forthcoming) when they call for expansion of the Canadian equalization scheme.[7]

Regardless of which view of equity one takes, intergovernmental transfers are at best an indirect way of dealing with inequity among individuals. The problem arises because all provinces do not spend their revenue (including transfers) in the same way. For a federal government, it is much more efficient to make transfers to individuals directly, and, indeed, Canada has many instances of such direct-to-individuals transfers, such as EI and seniors' pensions.

A Brief History of Transfers in Canada

In Canada's original constitution, the *Constitution Act, 1867*, the Fathers of Confederation gave the federal government unrestricted taxation powers, while confining provinces to direct taxes and revenues from the public domain. Their motivation was to prevent provinces from using customs duties (indirect taxes) to erect trade barriers within the federation.

This allocation of tax fields caused an immediate fiscal problem, however. Most provincial revenue before Confederation had come from customs and excise duties, so provinces were now deprived of their most important revenue source. To deal with this fiscal imbalance, the Fathers of Confederation established a system of transfers, providing each province with a statutory grant of $0.80 per person (up to a maximum population of 400,000). As well, special grants were made to Nova

7 If broad-based equity is the goal, it is hard to understand why its proponents do not simply advocate that Canada become a unitary state.

Scotia and New Brunswick in recognition of the fact that they trailed Ontario and Quebec in economic development.

Over time, provisions for intergovernmental transfers were often amended in response to provincial demands or new provinces' joining Confederation. Nevertheless, transfers from Ottawa fell as a proportion of provincial revenues between the 1860s and the onset of the Great Depression, while provincial spending responsibilities grew dramatically.

During the Depression, Canadian governments at all levels raised taxes substantially in order to combat growing deficits. The result of this tax grab by all parties was that Canada's tax system became very fragmented and complicated — a tax jungle.[8] Meanwhile, transfers from the federal government to the provinces soared, rising from 10 to 45 percent of provincial revenues.

In 1939, the federal inquiry into Canada's fiscal circumstances, the Rowell-Sirois Commission (Canada 1939), recommended that unemployment relief and pensions become federal responsibilities and that the federal government collect all personal and corporate income taxes and assume all provincial debt. Thus, the commission's report gained a reputation as a plan for centralizing the Canadian federation. But the commission also recommended that a system of "national adjustment grants" be instituted for poorer provinces and that general transfers be made to ensure that provinces had enough revenue to fulfill their constitutional responsibilities without undue taxation. Few of the Rowell-Sirois Commission's recommendations were adopted immediately, but it is interesting to note how many of them have become received wisdom in Canada over the years, even to the enshrinement of the principle of equalization in the *Constitution Act, 1982*.

To help finance the nation's effort during World War II, the federal government "rented" the income tax field from the provinces in return for fixed transfer payments, with the understanding that it would be returned after the war. In 1947, however, the federal government wanted to continue with the rental of personal income taxes (PITs), but Ontario and Quebec resisted. The former did join the tax-rental agreement in 1952, after it was modified, but Quebec remained outside, setting up its own PIT system in 1954.

8 For example, at one point, the city of Edmonton levied an income tax.

Formal equalization payments began in 1957 with the fiscal arrangements, a program that had both an equalization and a stabilization component. The equalization standard was based on revenues from three tax bases in the two richest provinces (Ontario and British Columbia). In addition, in 1958, the federal government introduced conditional (50 percent) grants for hospital insurance — a precursor to what would become the CHST.

In 1962, direct taxation was returned to the provinces, but the federal government agreed to collect their PITs free of charge if they accepted the federal definition of income. Equalization entitlements under this round of agreements were based on a national average, rather than a two-province average, and natural resource revenue was included as a tax base. This latter measure had the effect of transforming Alberta into a contributing province.

In 1967, the equalization program kept a national standard but with 16 bases, and took on a form that is close to today's. By this time, the federal government had transferred 28 PIT points and 10 corporate income tax (CIT) points to the provinces. It now offered additional tax points in lieu of transfers for other programs, but only Quebec took up the offer.

Subsequent revisions of the program increased the number of eligible tax bases. In 1974, the federal government abandoned full equalization of energy revenues. In 1977, it instituted what was called Established Programs Financing (EPF), a system that converted cost-shared grants for health care and postsecondary education into block (unconditional) cash transfers of about half their former size. At the same time, an equivalent amount of PIT and CIT points was transferred to the provinces.[9] The cash transfer, which was an equal amount per capita, was to grow with the economy.

Rising energy prices continued to cause problems for equalization, so that by the late 1970s even Ontario had qualified as a receiving prov-

9 This is the "tax-point transfer" that enters the calculation of the CHST even today. One of the more confusing features of the Canadian transfer system is that every year the federal government claims to be transferring taxes to the provinces that they have been collecting on their own for more than 30 years. Of course, this transfer is not recorded in the public accounts of the federal government or any province. One can only wonder whether some day Ottawa will drop this claim in the interests of having a productive discussion about the CHST.

ince. The federal government responded by introducing a special provision that had the effect of making that province ineligible for equalization. In addition, Ottawa launched the National Energy Program (NEP) in 1980 as a means of gaining access to this rapidly expanding provincial revenue source.

In hindsight, one can see the critical role transfers played in the federal government's decision to go to war with Alberta over energy. Rising energy revenues in that province were causing equalization entitlements to rise, and without access to that revenue source (revenues from the public domain being constitutionally assigned to the provinces), Ottawa had to finance these increased entitlements from general revenues. The lion's share of those revenues came from Ontario taxpayers, who were already reeling from the direct impact of rising gasoline and heating costs. Thus, the growing wealth of Alberta was forcing the federal government to expand equalization beyond what it could afford without new revenue. The result was not only the NEP but also, in 1982, changes to the equalization program; they included moving to a five-province standard (FPS) — excluding Alberta and the four Atlantic provinces — and constraining the growth of payments to match the growth of gross national product.

Also in 1982, the federal government linked the EPF cash component with the tax points. This measure had two important consequences. First, it meant that the overall federal cash transfer would grow at a rate less than that of the economy. Second, it was the end of equal-per-capita cash transfers because, under the new scheme, the three contributing provinces received less cash than the seven recipients.

To round out this momentous year, the federal government and all the provinces except Quebec agreed to enshrine the principle of equalization in the Constitution as part of the process of its repatriation.

Through the late 1980s and early 1990s, the federal government struggled to control its deficit. In 1990, as part of this effort, it capped the growth of Canada Assistance Plan (CAP) payments, the shared-cost program targeted at social assistance, but only for British Columbia, Alberta, and Ontario. The provinces lost their resulting Supreme Court challenge to this measure. In this and other measures, federal deficit-cutting measures fell disproportionately on transfers and especially on those to the contributing provinces.

In 1995, the new Liberal government introduced the CHST, reducing the total transfer from $18.5 billion to $11 billion over four years and locking in the differential treatment of British Columbia and Ontario under CAP.[10] During the 1997 election campaign, with mounting criticism of cuts to transfers supporting health and education, the federal government promised that cash transfers for the CHST would not fall below $12.5 billion in total.

Canadian Intergovernmental Transfers

Intergovernmental transfers are a key part of the machinery of Canada's federal system. I begin by describing the two largest intergovernmental transfers, equalization and the CHST, and then I turn to the regionally sensitive portion of EI, even though it is a transfer to individuals, not to provinces.

Equalization

Federations can experience two kinds of fiscal imbalances: *vertical*, as already defined, and *horizontal*, which occurs when at least one regional government has a higher proportion of collected revenue to spending than other regional governments have. Both kinds of imbalances occur in Canada, although equalization is a program that helps to ameliorate horizontal imbalances.

The equalization program guarantees that all provinces have access to per capita revenues equal to the potential average of British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec.[11] This representative FPS includes 33 different tax bases. If a receiving province set all its tax rates equal to *national*-average rates, its tax revenue plus equalization payments would be equal to the potential average-per-capita revenues of the five provinces.

The system is nothing if not complicated. To see how it works, suppose there is only one tax: the PIT. Define a province's *fiscal capacity* as its

10 Having just completed its welfare reform, Alberta was not touched by the cap on CAP.

11 *Potential* means what the average per capita revenues would be if the five provinces all levied taxes at national-average rates.

tax base multiplied by the national-average tax rate. Provinces with fiscal capacity below the five-province average receive equalization payments; provinces with fiscal capacity greater than or equal to the FPS do not.

A example may make this point concrete. Say personal income rises in Ontario, leading to an increase in tax revenue (everything else is unchanged). Equalization payments to other provinces rise since Ontario's larger base causes the FPS to rise. However, if the rise in personal income occurred in Alberta or Nova Scotia (again, everything else is unchanged), equalization payments to other provinces remain unchanged because those two provinces are not included in the FPS. If tax *rates* (rather than the size of the PIT base) rise anywhere in Canada, all equalization payments are affected because it is the *national*-average tax rate, rather than the five-province average, that is used to calculate fiscal capacity.

Of course, there are 33 tax bases, not one. A province's fiscal capacity may be above or below the five-province average for any of these bases. If the sum of the deviations from average over all 33 bases is positive, the province receives no equalization. If the sum is negative, the province receives equalization equal to that amount. Because contributing provinces are not leveled down — that is, they do not make payments when their fiscal capacity is above the five-province average — while receiving provinces are leveled up, Canada's equalization program is called a *gross* scheme, rather than a *net* one. (As I discuss later, this feature of the program leads to some rather odd effects.)

Notice my time-saving terminology. Equalization grants are financed by residents of *all* provinces through the federal taxes they pay. I refer to provinces that get equalization payments as *receiving provinces* and to those that do not as *contributing provinces*, even though it is provincial residents, rather than governments, who contribute under the current scheme.[12]

Notice too that, in receiving provinces, some of the equalization received is actually being paid by their own residents. In other words, money flows from a Newfoundlander's pocket to Paul Martin's pocket to Brian Tobin's pocket and, one hopes, back to the Newfoundlander's pocket (with a little being lost to administration at each step along the way). If everything works correctly, the Newfoundlander will have a bit

12 This terminology fits well with the net interprovincial scheme I introduce later in the essay.

more in his or her pocket than when the process started — or at least more government services than he or she could otherwise afford. In contributing provinces, however, the transfer never returns: money flows from the British Columbian's pocket to Paul Martin's pocket to Brian Tobin's pocket to the Newfoundlander's pocket. This is why Newfoundlanders should end up with a bit more in their pockets than when it all started.

In addition, the rules governing equalization include a floor and a ceiling limiting the overall size of the program, which can affect both the size and the distribution of payments. Once the equalization program is negotiated (about every five years), it cannot grow at a rate faster than the growth of nominal gross domestic product (GDP). If it does, the ceiling is invoked, and payments are scaled back. (Over the past ten years, the ceiling has sometimes been a binding constraint and thus made the program grow more slowly than it otherwise would.)

The floor provisions benefit the receiving provinces when their entitlements are falling, which is often when their economies are performing well. If a province's fiscal capacity is less than 70 percent of the national average, actual equalization payments cannot fall by more than 5 percent in one year. If a province's fiscal capacity is between 70 and 75 percent of the national average, payments cannot fall by more than 10 percent in one year, and if its fiscal capacity is more than 75 percent of the national average, payments cannot fall by more than 15 percent in one year. Thus, the floor provision has the impact of smoothing out the reductions in equalization entitlements that come as a provincial economy improves relative to the national one. This constraint has been binding recently for Saskatchewan and might actually prevent its joining the ranks of the contributing provinces for fiscal year 1996/97.

The CHST

If the equalization program seems complicated, the CHST is even more so. Indeed, Courchene calls it "one of the least transparent transfer programs ever" (1998, 44).

To understand this program, one needs a bit of background. The CHST was born in the rush of the 1995 federal budget preparations (see Greenspon and Wilson-Smith 1996) and bears the stamp of the time and care spent designing it. It rolled the CAP (a shared-cost transfer for funding social assistance) and EPF (an unconditional transfer ostensibly to fund health and postsecondary education expenditures) into a single bundle and reduced the federal contribution to these programs from $18.5 billion to the current level of $12.5 billion.

The program has two important features. First, like one of its predecessors, EPF, the CHST contains a kind of equalization since Ottawa's calculations take into account the differences in the value of tax points across provinces (although these differences are already equalized in the formal equalization program). Second, the program perpetuates one of the most infamous of federal moves in the area of transfers: the 1990 decision to limit the growth of CAP payments for the contributing provinces but not the receiving provinces — converting this program to another, *ad hoc* form of equalization. Because the initial CHST entitlements were based on the entitlements for EPF and CAP, the *ad hoc* equalization inherent in these programs was locked into the CHST.

This equalization outside the formal equalization program has led to what Courchene calls *super-equalization* and triggered the profound unhappiness within the federation that is now manifest in contributing provinces and that is spilling over into issues such as fisheries policy in British Columbia and tax collection in Ontario.

Provincial shares of the total transfer were originally calculated by a bizarre method that defined total entitlements as the sum of a specific number of PIT points (collected by the provinces) and cash to reach an overall fixed amount. With the total fixed and the value of tax points depending on the economy, the cash transfer — the thing that really mattered — was determined as a residual. To bring the story up to date, the federal government, stung by criticism of its cuts to transfers aimed at health and postsecondary education, pledged in its most recent election campaign that total CHST cash transfers would never be allowed to fall below $12.5 billion. Now, with the value of tax points determined by the economy and the value of the cash transfer set at $12.5 billion, the old calculation of entitlements is used solely to determine the distribution of the CHST *among* the provinces.

Needless to say, few Canadians, even politicians, understand the workings of the CHST. To test my assertion, ask your lunch partner how the CHST, the country's largest transfer program, is allocated to the provinces. If he or she cannot answer (and probably fewer than one Canadian in a thousand can), ask your elected federal and provincial representatives. You will quickly find that no one except a few civil servants understands how a sum of $12.5 billion is distributed.

Regional Differences in EI

Although EI is a transfer from the federal government to individuals, the amount that is transferred depends, in part, on where each recipient lives. So here I include that regionally sensitive portion of the EI program.[13]

People in some parts of Canada may be surprised to learn that, if an Albertan works for 17 weeks and then loses his or her job, he or she will receive no EI benefits, while a person facing the exactly the same circumstances in New Brunswick could receive benefits for up to 21 weeks. The only difference is the province of residence.

The argument supporting this inequitable treatment of some Canadians is that it is harder to find a job in Saint John than in Edmonton. This lack of equity may seem unfair to the unemployed Edmontonian, and I am sure it is. But even more important for my purposes is that it has the unfortunate effect of encouraging unemployed people to stay in Saint John, where there may be fewer jobs, instead of moving where jobs are more plentiful. Overall, the Canadian economy works less efficiently than it might because regionally sensitive EI discourages workers from moving to find jobs. (For a review of the empirical evidence, see Day and Winer 1994.)[14]

The Size of Transfers in Canada

The amounts involved in transfers within Canada are huge, and the variations among provinces great. Table 1 presents the per capita amounts transferred to the provinces in equalization payments and the CHST in

13 Why include this transfer and not others that are regionally sensitive? The practical reasons are that it is the largest such transfer and that it is the most offensive to the principle of fiscal equity (the equivalent treatment of similarly situated individuals).

14 It is important to recognize that eliminating the regionally sensitive portion of EI would not mean that per capita EI payments would be the same in New Brunswick and Alberta. Rather, the implication is only that unemployed workers with the same characteristics would receive the same benefits regardless of where they lived.

Table 1: *Gross Federal Transfers per Capita, fiscal year 1996/97*

	Equalization	CHST	EI[a]	Total
		(dollars)		
Newfoundland	1,767	609	643	3,019
Prince Edward Island	1,441	524	513	2,479
Nova Scotia	1,276	544	230	2,050
New Brunswick	1,293	530	427	2,250
Quebec	558	615	196	1,369
Ontario	—	436	87	523
Manitoba	961	528	93	1,582
Saskatchewan	221	486	71	778
Alberta	—	416	69	485
British Columbia	—	466	123	589
Provincial average	296	497	142	935

[a] Regionally sensitive portion of employment insurance payments, as described in Boessenkool 1998.

Source: Boothe and Hermanutz forthcoming.

fiscal year 1996 / 97, and estimates the transfer associated with regional differences in EI.

Equalization transfers ranged from a high of almost $1,800 per person for Newfoundland to a low of about $220 per person in Saskatchewan. Even though Quebec received the largest amount in total (more than $4 billion), its transfer, when divided by population, was second lowest, at about $560. (Of course, British Columbia, Alberta, and Ontario received no equalization payments.)

CHST per capita amounts varied across provinces, with Quebec receiving almost $200 per person more than Alberta. All three contributing provinces were well below the average, while all the receiving provinces except Saskatchewan were well above. This pattern shows the hidden equalization embodied in the CHST.

The third column of Table 1 provides estimates of the regionally sensitive portion of EI received in each province. I took these estimates from Boessenkool (1998), who based them on data published by Human Resources Development Canada, the federal department responsible for EI. The gap across provinces is very large, ranging from $643 per person in Newfoundland to $69 per person in Alberta.

Table 2: *Net Federal Transfers per Capita, fiscal year 1996/97*

	Equalization	CHST	EI[a]	Total
		(dollars)		
Newfoundland	1,558	259	543	2,360
Prince Edward Island	1,187	102	392	1,680
Nova Scotia	991	67	93	1,151
New Brunswick	1,044	110	307	1,460
Quebec	300	181	72	553
Ontario	–335	–126	–74	–536
Manitoba	704	96	–31	770
Saskatchewan	–17	87	–43	27
Alberta	–308	–101	–79	–489
British Columbia	–299	–36	–21	–356

[a] Regionally sensitive portion of employment insurance payments, as described in Boessenkool 1998.

Source: Boothe and Hermanutz forthcoming.

Table 2 demonstrates what happens when the gross transfers of Table 1 are turned into net transfers by taking the transfers that each provincial government actually received from Ottawa and subtracting the proportion of the total transfer that taxpayers in that province contributed to the federal government through taxation. Note that the net transfers were uniformly smaller than the gross ones, reflecting the contributions each province made to its own transfers. In the case of the contributing provinces, the transfers became negative because these provinces put in more than they received (of course, by definition they received no equalization payments). All four western provinces (including Manitoba and Saskatchewan, which received equalization payments) plus Ontario were net contributors to the regional component of EI, while the Atlantic provinces and Quebec were net recipients.

Table 3 presents changes in transfers over time. (I chose fiscal year 1994/95 as my starting point because it was the first year of the current federal government's mandate.)

Notice that the aggregate equalization transfer remained stable over the three-year period. A sharp drop in the payments to Saskatchewan reflected the marked improvement in that province's economy. Turning to the CHST, observe that the program was cut by about $6 billion, or 30 percent, over three years, with Ontario and Alberta experiencing the largest reductions.

Considering equalization and the CHST together, one can see that the size of the cuts has varied dramatically by province. For the Atlantic provinces and Quebec, overall cuts were less than 20 percent over three years. For the contributing provinces, cuts were 30 to 37 percent.

Current Problems with Transfers

In this section, I consider four of the general problems in the Canadian transfer system that require reform: inequity, inefficiency, declining political viability, and the impact of international competition. I conclude with a brief discussion of some of the underlying causes of these problems.

Inequity

The first problem is the interpersonal inequity created by the current system of intergovernmental transfers. Ironically, although intergovernmental transfers are designed, at least in part, to improve the distribution of revenues among provincial governments, they may have the effect of worsening the distribution of income among persons. As Oates notes:

> The obvious problems is that [intergovernmental transfers] represent transfers from one group of people to another, whereas a just distribution of income is normally defined over individuals. If, for example, the central government attempts to redistribute income from rich to poor by transferring funds to the governments of poorer jurisdictions, it is bound to find itself engaging in some perverse transfers. (1977, 14.)

Since this problem has been known as a theoretical possibility for some time and since all intergovernmental transfer systems (including the three schemes discussed later in this essay) are more or less vulnerable to it, why should anyone be concerned? The answer is that it is a matter of degree. The magnitude of these perverse transfers will vary from scheme to scheme. At what point does the inequity become too great to tolerate? Ultimately, the issue comes down to a question of societal values.

The current size of the problem for Canada is estimated empirically in a recent paper by Poschmann (1998). His work, which uses 1997 data,

Table 3: ***Equalization and CHST Levels and Their Percentage Change, fiscal years 1994/95 and 1997/98***

	Equalization			CHST[a]			Equalization + CHST[a]		
	1994/95	1997/98	Change	1994/95	1997/98	Change	1994/95	1997/98	Change
					Total Amount				
	($ millions)		*(%)*	*($ millions)*		*(%)*	*($ millions)*		*(%)*
Newfoundland	958	966	1	425	281	–34	1,383	1,247	–10
Prince Edward Island	192	199	4	89	60	–32	281	259	–8
Nova Scotia	1,065	1,201	13	634	429	–32	1,699	1,629	–4
New Brunswick	928	996	7	500	334	–33	1,428	1,330	–7
Quebec	3,966	4,059	2	5,550	3,866	–30	9,516	7,925	–17
Ontario	—	—	—	6,337	4,030	–36	6,337	4,030	–36
Manitoba	1,085	1,098	1	744	500	–33	1,829	1,597	–13
Saskatchewan	413	82	–80	630	446	–29	1,044	529	–49
Alberta	—	—	—	1,492	934	–37	,492	934	–37
British Columbia	—	—	—	2,235	1,566	–30	2,235	1,566	–30
All provinces	8,607	8,600	—	18,636	12,445	–33	27,243	21,045	–23

	Per Capita Amount								
	(dollars)		*(%)*	*(dollars)*		*(%)*	*(dollars)*		*(%)*
Newfoundland	1,651	1,721	4	732	666	–9	2,383	2,222	–7
Prince Edward Island	1,429	1,450	1	662	586	–11	2,091	1,888	–10
Nova Scotia	1,139	1,268	11	678	604	–11	1,817	1,720	–5
New Brunswick	1,24	1,307	7	660	585	–11	1,885	1,746	–7
Quebec	543	546	0	760	694	–9	1,303	1,065	–18
Ontario	—	—	—	578	471	–18	578	352	–39
Manitoba	961	960	0	659	583	–11	1,620	1,397	–14
Saskatchewan	408	81	–80	623	583	–6	1,032	517	–50
Alberta	—	—	—	548	439	–20	548	328	–40
British Columbia	—	—	—	607	533	–12	607	398	–34
All provinces	294	284	–3	638	412	–35	932	696	–25

[a] Because the CHST did not exist in 1994/95, it is compared here with its predecessors, the Canada Assistance Plan and Established Programs Financing, taken together.

Source: Alberta Treasury, special tabulations.

looks at the three transfers in Table 1. For equalization, he makes two simple assumptions. The first is that the equalization program is financed from federal general revenue. Thus, all individuals of a given income class pay for equalization in the same share as they contribute to overall federal revenue. The second assumption is that the receiving provinces use equalization grants (which are unconditional) to reduce taxes from otherwise higher levels. In other words, provincial spending patterns are unchanged; in the absence of transfers, receiving provinces would simply levy higher taxes.

Poschmann also looks at EI and the CHST. Because EI transfers go to individuals and more data are available, he is able to follow them directly without the two simplifying assumptions. For the CHST, he assumes Canadians pay for it in the same proportion as they they contribute to overall federal revenue, but attempts to trace through the incidence of spending on health and postsecondary education. His results show that Ottawa transfers income from lower-income people in contributing provinces to higher-income people in receiving provinces. This occurs primarily because taxes are generally progressive, falling more heavily on the rich than the poor. If transfers permit lower taxes and services are provided more or less evenly across income groups, rich people in recipient provinces benefit most from transfers.

The perverse redistributions of income are immediately apparent when one looks at Poschmann's estimates of the net effect of transfers on families divided by income class and province (see Table 4). For example, take families with $30,000 to $40,000 in total income in 1997. In Alberta, this family was a net contributor of 9 percent of its income; a similar family living in Prince Edward Island was a net recipient of an amount equal to almost 20 percent of its income. The same family in Ontario contributed nearly 3 percent of its income, while its counterpart in Newfoundland received an amount equal to 28 percent of its income.

The story does not end here. In addition to redistributing income among similar families in different provinces, the federal government also redistributes from families with lower incomes in some provinces to families with higher incomes in other provinces. For example, a Saskatchewan family with income between $30,000 and $40,000 in 1997 contributed an amount equal to 1.5 percent of income, while a family in Newfoundland with income of more than $100,000 received a transfer to

Table 4: ***Federal Net Balance as a Percentage of Family Income, 1997***

	Census Family Total Income									
	≤ 20,000	$20,001–30,000	$30,001–40,000	$40,001–50,000	$50,001–60,000	$60,001–75,000	$75,001–100,000	≥ $100,001	All	Per Family Average
	(percent, post-tax and post-transfer)									
(dollars)										
Newfoundland	70.8	48.5	28.0	15.7	8.4	1.1	0.1	1.2	25.4	6,690
Prince Edward Island	61.2	36.8	19.8	7.1	–2.3	–8.9	–13.0	–12.8	10.2	$2,976
Nova Scotia	52.8	28.6	10.8	–1.1	–6.5	–10.4	–13.6	–18.0	6.6	1,807
New Brunswick	54.4	29.6	11.6	–1.9	–6.8	–11.3	–16.0	–14.8	6.2	1,738
Quebec	48.4	23.0	3.2	–7.6	–13.5	–17.7	–21.8	–27.0	–2.2	–652
Ontario	36.2	18.8	–2.8	–12.3	–21.2	–24.9	–29.7	–36.9	–16.1	–5,742
Manitoba	43.8	22.4	2.1	–8.0	–12.1	–16.3	–20.8	–25.4	–4.9	–1,551
Saskatchewan	44.9	16.0	–1.5	–14.1	–18.2	–22.1	–25.6	–34.8	–9.0	–2,659
Alberta	28.8	11.3	–9.0	–18.1	–21.9	–27.3	–31.4	–35.8	–17.6	–6,007
British Columbia	44.1	8.4	–5.2	–16.4	–21.4	–23.5	–29.9	–35.6	–15.9	–5,156
All Canada	42.8	19.1	–0.5	–10.9	–17.9	–21.9	–27.0	–33.7	–10.7	–3,480
	(average dollars per family)									
Per family average	5,191	3,959	–133	–3,469	–6,731	–9,828	–15,243	–32,849	–3,480	

Notes: Net balance is federal direct and indirect transfers less federal taxes. Transfer amounts used in the calculations are for fiscal year 1996/97.

Source: Poschmann 1998, table 11.

the tune of 1.2 percent of its income. It is worth asking whether redistributions of this direction and magnitude are acceptable to Canadians as the price of maintaining the current transfer system.

Inefficiency

Economic inefficiency is a general heading for several problems created by Canada's current transfer system. They include inhibiting the efficient movement of labor and distorting provincial decisions about taxation.

Inhibitions to Mobility

Ironically, one of the earliest theoretical rationales for intergovernmental transfers was that they could improve economic efficiency by curbing wasteful migration by offsetting regional differences in net fiscal benefits. This result, which has dominated academic thinking about this issue since it was introduced, is based on the early work of Buchanan (1950), Scott (1950), and Boadway and Flatters (1982).

Several important assumptions must be satisfied for the theory to be a useful description of reality. As Courchene (1998) notes, the rationale implicitly assumes:

- Increases in revenue are not capitalized into higher wages and rents. If increases in provincial government revenue are capitalized, net fiscal benefits will not differ by nearly as much as is typically assumed and in the limit might disappear.
- Provincial governments actually use transfers to eliminate differential net fiscal benefits for similarly situated individuals. This is akin to assuming that the patterns of spending and taxes is the same in every province.
- Migration is costless. If migration has costs (presumably related to distance), net fiscal benefits will trigger migration only if they are larger than those costs.

The theoretical and Canadian policy literature on fiscally induced migration has largely ignored the role of capitalization of potential net fiscal benefits, even though economic theory suggests that differing endowments of natural resources or locational advantages will be capitalized into wages and rents. As Courchene (1998) notes, the lack of a US system of fiscal transfers comparable to Canada's is related to Americans' view that potential differences in benefits across states (stemming largely from differing endowments) are largely capitalized into local land values and costs of living. Thus, potential net fiscal benefits are dissipated directly through higher rents and housing prices and indirectly through the higher salaries that must be paid to public servants.

Another strand of literature, based on Courchene's pioneering work (1970; 1978), shows that, rather than promoting efficiency, transfers may actually discourage efficiency-enhancing migration, leaving receiving provinces trapped in a cycle of dependence. Following Courchene came a large number of studies that reinforced his conclusions (including Winer and Gauthier 1982; Mills, Percy, and Wilson 1983; and Shaw 1985; 1986).

Reviewing this work, Day and Winer (1994) come to two main conclusions. First, there is strong evidence that regional differences in EI benefits hinder migration, inducing people to stay in regions with relatively high unemployment rather than moving to regions with relatively low unemployment.[15] Second, although the level and mix of provincial government spending and taxation seem to affect migration, there is no clear evidence that intergovernmental grants or the size of natural resource revenues (another potential source of net fiscal benefits) have a direct effect. Thus, the balance of evidence is that transfers, including regional differences in EI, have not enhanced economic efficiency in Canada and, indeed, may have hindered it.

Interestingly, the size of the potential benefit from discouraging fiscally induced migration may never have been large. Here, academic researchers may have been guilty of debating theoretical niceties without looking at the practical import of their work. Watson (1986) uses the estimates of Winer and Gauthier (1982) to calculate the benefit of the growth in equalization over the 1971–77 period. He finds an overall welfare gain

15 Of course, regional differences in EI are not the only barriers to migration. For example, language may be an important factor in migration to and from Quebec.

of $1.4 million, while the total cost of the program was $720.0 million. Even if one calculates the cost as only the expense of raising that total — say, 10 percent or $72.0 million — the program had a ratio of costs to benefits of 54:1.[16] Thus, Watson concludes, the underlying rationale for equalization must be equity, not efficiency.

New work by Coulombe and Day (1997) has substantially improved our understanding of these issues. They compare income per capita, output per capita, and output per worker for Canadian provinces and 12 US border states, looking for convergence of growth rates, which would reduce the dispersion of these resources. They find that, over a long period (1929–95), both states and provinces reduced dispersion of income per capita. However, the states converged much faster than the provinces and had lower dispersion in 1945 than Canada did in 1990. In the latter year, the dispersion of per capita output was twice as large in the provinces as in the states.

Turning to output per worker, Coulombe and Day find that dispersion of this measure in the provinces has been roughly equal with dispersion in the states since the mid-1980s. So it seems that our problem is not productivity of workers, but rather that Canadians tend to remain in low-productivity provinces even if they cannot work, while Americans tend to live in low-productivity states only if they are employed.

Why does this difference come about? An obvious place to look is in Canada's more generous transfer system, whereby governments can provide comparable services with comparable taxes even in low-productivity regions. Regional differences in EI transfers to persons compound the effect. Thus, the gap between output per worker and output per capita is opened up.

Coulombe (1997) argues that Canada has reached a steady state of convergence among provinces, meaning economic forces cannot be expected to further reduce regional disparities in output per capita. He estimates that, if unemployment rates were lower and participation rates higher in low-productivity provinces, disparities in per capita output and the need for interregional transfers could be cut in half. It seems that

16 Further, this calculation ignores the deadweight loss associated with raising the required revenue (see Dahlby 1994).

receiving provinces are still trapped in the cycle of dependence that Courchene wrote about almost 30 years ago.[17]

Perverse Incentives

Another efficiency problem with the current transfer system (especially the equalization program) is that it sometimes creates bizarre incentives that distort provincial decisions relating to taxes and spending. Boothe and Snoddon (1994) examine this issue in detail and find that contributing and recipient provinces pursuing deficit-reduction strategies face quite different incentives. Equalization causes receiving provinces to favor tax increases, while contributing provinces are better served by expenditure reductions.

The equalization program also affects a province's choice of which tax to change. Receiving provinces benefit most by raising tax rates for bases in which they have the greatest deficiency — ones for which they collect little revenue relative to the national average — because increases in these taxes will least reduce their equalization entitlements. On the other hand, contributing provinces benefit most by raising taxes on bases in which receiving provinces are least deficient, since these tax increases will cause the largest declines in equalization grants to receiving provinces. Incentives for privatization are positive for contributing provinces and mixed for receiving provinces.

All of the equalization-related incentives discussed by Boothe and Snoddon (1994) are economically small. However, if one desirable characteristic of the tax system is that it not distort economic decisions, any such incentives for government behavior are unwelcome.

Smart (1998) highlights a different potential inefficiency. He argues that features of the current equalization program, such as the FPS, give receiving provinces an incentive to overuse some distorting taxes. Be-

17 This phenomenon is well recognized in Atlantic Canada. Writing recently, Don Cayo, long-time Atlantic Canada journalist, says:

> When federal money began piling up in Atlantic treasuries and private pockets, our natural growth, at the time twice the Canadian average, slowed to a crawl and stayed there. Wages for some jobs shot artificially high. Regionally enriched unemployment insurance kept some people home when the pay packet for other jobs was smaller than they'd come to expect. (1997, A17.)

cause transfers partly offset the loss of tax revenue as tax bases shrink, the equalization system has the effect of subsidizing provinces that set tax rates at higher-than-optimal levels.

Another problem comes from what is known in equalization circles as *taxback*. If a receiving province encourages growth in a particular activity, any extra revenue that activity generates may be lost through reductions in the province's equalization payments. As Courchene (1998, 20) puts it, the program "confiscates" the additional revenue through dollar-for-dollar reductions in equalization. It is not hard to see how this feature of the program discourages receiving provinces from promoting certain kinds of new activity. Indeed, the federal government has had to negotiate special agreements[18] with both Nova Scotia and Newfoundland regarding the development of offshore energy reserves for exactly this reason.[19]

Declining Political Viability

Over the past decade, tensions over fiscal transfers have been rising in both contributing and receiving provinces. As part of federal deficit-reduction efforts, Ottawa cut its transfers to the provinces — by substantially more than it reduced spending on its own programs. A critical point occurred in 1990 when Ottawa capped CAP payments for the three contributing provinces but not the rest.[20] The three provinces were vociferous in denouncing this federal move and challenged its legality in the Supreme Court (which ruled, however, that the federal government could not be bound by the intergovernmental agreements of previous parliaments).

18 As well as inject massive direct support for projects such as Hibernia.

19 Currently, an *ad hoc* method is used to deal with the taxback problem. If a province has more than 70 percent of a tax base, revenues from this base are equalized at 70 rather than 100 percent, effectively reducing the taxback rate to 70 percent.

20 I have heard at least two explanations for the federal move. The first is that it was simply a blunder. Federal officials never anticipated the explosion of welfare payments when the 1991 recession hit Ontario; at that point, however, it was politically too late to turn back. The second is that Ottawa was paying back Ontario for running such an expansionary policy when the Bank of Canada was moving to zero inflation. The impact on the federal government was that the Bank had to keep interest rates high, raising debt-service costs and making it impossible for Ottawa to reduce its deficit.

The burden of federal deficit reduction placed on transfers to provinces intensified when the Liberals came to power in 1993. Between fiscal years 1994/95 and 1998/99, the CHST was cut by 35 percent — from $19.3 to $12.5 billion. Total federal program spending excluding the CHST was cut by only 7 percent. The growth of equalization payments was also limited, but relatively speaking, the program emerged from federal deficit reduction largely unscathed, falling by only 1 percent over this period (Provincial and Territorial Finance Ministers 1998).

The contributing provinces reacted to this inequitable treatment in a number of ways. One was to support moves to further decentralize the federation. Courchene (1996) advocates substantial reallocation of spending responsibilities to the provinces, and Boothe and Hermanutz (1997) examine the attending reallocation of tax fields. In part, these changes were proposed to protect the provinces from further unilateral transfer reductions by the federal government.

Another reaction has been Ontario's recent move to explore withdrawing from the tax collection agreement for the PIT and setting up a provincial tax collection system similar to Quebec's. Finally, contributing provinces have argued strongly against the allocation formula embedded in the CHST that includes an important equalization component outside the formal equalization program.

Ontario politicians complain vigorously about the inequitable treatment they perceive their province receives. In one speech, Minister of Intergovernmental Affairs Dianne Cunningham (1997) said:

> Some people claim that Ontario is selfish to demand equitable treatment in the federal funding transferred to provinces for national programs. They say it's a departure from Ontario's tradition of sharing its wealth. That is not the case....Our point is that federal programs outside equalization should treat all provinces equitably.

The province's 1997 budget echoed the theme:

> Whether it is people in Ontario who need training, who are unemployed and need EI benefits, or who need health care, the federal government provides less support to individuals in Ontario than to people in other parts of Canada. (Ontario 1997, 34.)

Ontario Premier Mike Harris turned up the rhetoric this year, claiming that his province is being "cheated out of billions of dollars by the federal government through discrimination on a variety of programs and payments" (*Globe and Mail* [Toronto], March 25, 1998).[21]

Federal transfer cuts have also generated some sharp divisions among provinces. Recent joint provincial statements on fiscal matters have failed to get the support of Quebec and also of Newfoundland and Nova Scotia. John Savage (1996), when premier of Nova Scotia, aimed a particularly virulent attack at Courchene's ACCESS proposal (1996), claiming that "the richer members of our Canadian family are out of touch with their poorer relations" and that "Alberta and Ontario don't fully appreciate the implications of what Courchene is suggesting." Savage went on to argue that equalization should be a part of all federal transfers, not just the formal equalization program.

Overall, it seems that provinces are both unhappy and divided over the current state of Canada's intergovernmental transfer system.

Transparency and Accountability

Loss of support among provincial governments is not the only threat to the political viability of the current transfer system. It is also out of step with the revolution in government that is occurring from the local to the national level throughout industrialized countries. Governments are trying to define their goals more clearly and measure the results of their actions, all in an effort to give citizens more value for their tax dollars.

Canada's transfer system, which is becoming more and more complicated, stands in stark contrast to this trend. As already noted, it is beyond the capacity of most people to understand. Most Canadians would probably be deeply offended to discover that the CHST, the program that is supposed to help fund health care and postsecondary education, delivers widely varying amounts across the country. For example, in fiscal year 1997/98, it provided $694 and $666 per person in Quebec and Newfoundland, respectively, but only $471 and $439 per person in Alberta and Ontario (look back at Table 3). Differences in fiscal capacity are already equalized through the formal equalization program, and it is hard to argue that Canadians in some provinces are more worthy of health care or social assistance than those living elsewhere.

21 These remarks evoke memories of the "fair-share federalism" of Mike Harris's predecessor, Bob Rae.

Some commentators (for example, Leslie 1993; Milne forthcoming) would argue that this lack of transparency is actually a good thing because it helps to protect transfers to recipient provinces from political backlash in times of fiscal restraint. However, it is hard to square these views with basic principles of democracy. In addition, no public finance theory says that when cuts to government spending are required, redistributive transfers should be exempt.

A closely related issue is accountability. Choices about the size of government are fundamentally political and should be made by voters taking account of both the benefits and costs of government programs. In evaluating the costs and benefits of those programs, voters hold elected officials accountable. Citizens in Nova Scotia cannot, however, evaluate the true value of a program if part of its cost will be paid by people in Alberta. Thus, government programs are too “cheap” in receiving provinces and too “expensive” in contributing provinces.

This lack of accountability extends to programs that are purely redistributive. Much is made of the sharing nature of the Canadian federation. But how can British Columbians evaluate their contribution to promoting equity in other provinces when they do not even know how much they contribute or how it is distributed?

International Competition

Until now, I have mostly looked at internal forces for reform of the transfer system. But forces external to the Canadian economy are also at work. For several years, Courchene has been arguing that, as Canada becomes more integrated in the North American economy as a result of the Canada-US and North American Free Trade Agreements, the principal directions for provinces’ trade have become north-south (see, for example, Courchene 1995).

In the past, when trade was primarily east-west and Ontario was the center of Canadian manufacturing, that province could rationalize its role as the largest net contributor to the transfer system because the second-round benefits of transfers would return to it through trade with provinces in the outlying regions. Now, however, as trade becomes north-south, these second-round benefits leak out. Thus, it is not surprising that Ontario's support for the current transfer system, of which it is still the mainstay, is now on the wane.

One effect of the new direction for trade is that all provinces compete with their US neighbors (which differ considerably from west to east) while trying to maintain a unified and coherent social system across Canada. Vancouver's closest competitor is Seattle, while Calgary competes with Houston and Halifax with Boston. Thus, each may need to structure its economy and public sector to face a very different competitor. Courchene (1995) argues that only through decentralization and flexibility will Canada be able to both remain internationally competitive and maintain the generous social system Canadians prefer.

Technological change is also having an effect on the dynamics of the Canadian federation. As knowledge goods become more important and communications technology expands, distance grows less important, and locational advantages and agglomeration economies change. North American firms are now having back office work done overnight in Ireland or India because distance is irrelevant when all information is stored and sent digitally.

These technological changes present new opportunities for formerly outlying regions. Moncton, New Brunswick, for example, has been able to capitalize on its bilingual workforce by providing call-center services to any firm that needs to offer 1-800 service to both Quebec and other parts of Canada and the United States. The New Brunswick government's most important input to attracting new firms in this field was not a tax break, but rather the provision of a modern, digital telephone system. This new kind of activity, whereby Moncton may be "trading" knowledge with South Carolina rather than cars with Ontario, has profound implications for provincial fiscal regimes and, in turn, for the transfer system.

The Politics of Transfers

Having given readers an understanding of what the transfer system's current problems are and when they occurred, I now turn to considering their underlying causes. To do this, I call on public-choice theory, the area of economics that views politicians and bureaucracies as maximizing entities with political interests that are more complex than simply maximizing the welfare of some representative citizen. I begin with a relatively simply question: Why did the federal government put the burden of deficit reduction disproportionately on transfers that fund health care and postsecondary education spending? And I go on to consider another puzzle: What is preventing governments from fixing the system's inefficiencies and perverse incentives?

Why target transfers when reducing the federal deficit? On the face of it, disproportionately cutting transfers for health care, postsecondary education, and social assistance seems like very bad politics. After all, polling reveals that the health care system consistently tops Canadian voters' list of concerns. Concerns regarding access and the cost of postsecondary education are not far behind.

Indeed, if the federal government spent these funds directly on health care and postsecondary education programs, that simple political calculus would probably be correct. Public-choice theory predicts, however, that, when faced with necessary but unpopular measures, governments will look for the implementation strategy that is least costly in terms of maintaining their electoral coalition. If the public is uncertain or confused about who is responsible for cuts to spending — the federal government or the provincial governments that actually deliver the services — cuts to transfers that support health care and postsecondary education programs may be less costly than cuts to Ottawa's own programs.

The underlying problem is the lack of transparency and accountability. The federal government is counting on voters to associate cuts to health care and education spending with provincial governments. If voters had instead been confronted by the choice of cuts to health care and education versus cuts to other federal programs (say, foreign affairs), the political decision might well have been different. Thus, the lack of transparency and accountability in Canada's current transfer system leads to inefficient political outcomes.

The instability of transfers may also be better understood from a public-choice perspective. Although frequent change is bad for the provinces' fiscal planning, it may be advantageous to the federal government. The unpredictability of transfers provides Ottawa with flexibility to deal with emerging political issues as needed to maintain its electoral coalition. Thus, the federal government may not have much interest in measures to enhance the stability of the transfer system when such measures would reduce its own flexibility and when the beneficiaries of such measures would be provincial governments.

Why not fix perverse incentives and inefficiencies? The public-choice perspective also provides some help in understanding why inefficiencies and perverse incentives have been allowed to persist for so long. Take regional differences in EI benefits as an example. From a pure economic standpoint, it would clearly be better to eliminate this feature of the EI program and allow the normal incentives for migration to operate. Indeed, it is likely that, if those incentives were functioning, both migrants and those who remained (mostly employed people) would be better off. But no departed migrant votes for the politician back home, so local MPs may lack enthusiasm for such changes.

Some provincial politicians are also likely to oppose changes to transfers that might encourage economically efficient migration. Legislators in the province of origin are as likely as MPs to view migration as a potential loss of votes, while those in the destination area cannot be sure migrants will even come to their particular province, let alone join their supporters. Thus, the political costs of such changes are concentrated and immediate, while political benefits are diffuse and delayed.

In the longer term, the global economic forces discussed earlier may begin to outweigh the short-term political incentives some provinces face. As trade becomes increasingly north-south, the competition that individual provinces face is likely to change significantly. In turn, they may find it necessary to change the structure of their public sectors. Courchene and Telmer (1998) make this case convincingly for Ontario. Provinces' need to gain more flexibility at the expense of the federal government may open up opportunities for fruitful interprovincial bargaining and the formation of provincial coalitions.

Ottawa's New Approach

Now that Ottawa has accomplished its deficit-elimination goal, it appears to be embarking on a new strategy in its dealings with the provinces — at least one that we have not seen since the era of Pierre Trudeau.

As it gains more fiscal room to maneuver, Ottawa is shifting resources from transfers to provinces to direct transfers to persons. The federal government seems set on this approach, despite the fact that all provinces have asked that any new federal money for health care and social programs go to the existing fiscal arrangements (the CHST or equalization), not to new federal programs in areas of provincial jurisdiction. Two examples of this shift are the child tax benefit (CTB) and the Millennium Scholarship Fund. The attraction of this approach for the federal government is obvious. Direct delivery of these programs allows it to target benefits to the groups of voters it is trying to influence and to earn full political credit.

Are these measures bad for federalism? The answer is probably mixed. Clearly, they intrude into areas of provincial jurisdiction and thus may lead to overlap, duplication, and confusion — exactly the things both levels of government claimed to be trying to eliminate in the early part of the 1990s. (To be fair, the CTB was developed jointly with provinces, and a cooperative effort may preclude some fears about overlap and duplication. The announcement of the scholarship fund came, however, without provincial input.)

In addition, these measures may have some unintended political consequences. For example, the combination of cuts to the CHST and increased federal grants to students through the Millennium Scholarship Fund will force provinces to raise tuition fees. In dealing with public discontent over the rising cost of postsecondary education, provinces can convincingly point to the federal government as the culprit. Indeed, the provinces have recently had some success in implicating Ottawa in the reductions in the growth of health care spending, and this success seems to have stymied unilateral federal initiatives in that field to date.

The federal move to direct transfers to persons does have some positive elements. Most important, transparency and accountability may be enhanced. If voters think money spent on the CTB or the scholarship fund is being wasted, the accountability of federal politicians is clear. In a broader context, however, this benefit becomes less certain. If voters wish to evaluate the use of tax dollars in health care or social assistance for children more broadly, the return of federal-provincial overlap and duplication makes it harder to determine which politicians should collect the associated darts or laurels.

Current Proposals for Reform

Now that I have described Canada's intergovernmental transfers and explained the problems with the current system, the time has come to consider some possible reforms. In this section, I discuss two current proposals that represent competing mainstream views on the direction reform should take. Before outlining and evaluating these proposals, however, I spend some time discussing a set of principles that can guide the evaluation.

Criteria for Evaluating Reforms

Clark (forthcoming) and Courchene (1998) consider principles that should underpin an intergovernmental transfer system. In this section, I draw on their work, without necessarily choosing a set of criteria to evaluate reform proposals that either might wholly agree with.

Promote Equity

Outside of equalization, the federal government should promote equity by striving to design programs that treat individuals in similar circumstances in an equivalent way. In evaluating the overall impact of its actions, the federal government should take account of the fact that intergovernmental transfers may result in perverse interpersonal redistributions of income.

Promote Efficiency

The system of fiscal transfers should promote economic efficiency by creating appropriate incentives for government and individual behavior. Social scientists call this goal *incentive compatibility*.

Consider, for example, the taxback problem that occurs when a province controls a large portion of a given tax base and receives equalization. Under the current scheme, increases in tax bases are matched almost one for one by decreases in transfers. Thus, as described in the previous section, potential revenues are confiscated by the transfer scheme. The result is that the province has little incentive to encourage economic activity related to that tax base.[22] The incentives for government behavior created by a redesigned transfer scheme need to be examined carefully.

Incentives for individuals are also important. Disincentives to move, such as those created by regionally sensitive EI payments, hinder economic adjustment and growth (in addition to being inequitable). The transfer system should not create disincentives to normal economic adjustment by individuals.

Enhance Political Viability

The political viability of any transfer scheme has a number of dimensions. First and foremost, it should be consistent with the *Constitution Act, 1982*, both because the Constitution expresses the Canadian consensus on the desirability of interprovincial sharing and because of the well-known difficulty in enacting substantive constitutional change in Canada.[23]

In addition, political viability suggests that any reform proposal must recognize the political bargain embodied in the current level and distribution of transfers in Canada. Thus, this criterion deals in part with the question of the optimal amount of redistribution across governments in the federation. Hobson (forthcoming), for example, argues that the optimal amount of redistribution in Canada would mimic the conditions found in a unitary state — that is, all provinces would have exactly the same level of per capita revenues. With Courchene (1998), I reject this unitary-state approach to the optimal level of redistribution in favor of one that reflects the federal nature of Canada and is aligned with the Constitution.

Following Bird (1986), I assume that the current level and distribution of transfers is the outcome of a political bargain among provinces and the federal government. The implication of this principle for a re-

22 Ironically, the federal government uses a set of regional economic development programs to encourage the very activity they discourage through this feature of the equalization program.

23 Some may argue that the Constitution requires that transfers be made directly by the federal government. This question is probably one for lawyers and constitutional scholars to debate. My working assumption is that the Constitution commits all governments to the principle of equalization, but that actual transfers could come from either the federal government or the provinces themselves.

designed system of transfers is that it should start at a point that is deficit neutral for all governments. In a practical sense, using this criterion makes an important contribution to the political feasibility of the system since it means there would be no fiscal winners or losers. In brief, the main source of gains from a redesigned system should come from the improved incentives that it embodies.

A third dimension of political viability is that a reformed transfer scheme should reflect the trend in government toward greater transparency. The rationale for and mechanisms used to collect and spend public funds should be as understandable as possible to taxpayers. The current equalization scheme, based as it is on 33 tax bases for five provinces, is inaccessible to all but a very small group of experts. Insofar as it is possible, a redesigned transfer system should be simple enough for most taxpayers to understand and therefore to judge in an informed way.

Closely related to transparency is the notion of accountability. To the extent possible, governments that spend public funds should be responsible for raising them through taxation so that taxpayers can form a clear idea of the tax-price of public services and hold the appropriate government accountable for their spending of public funds. In the current system, although in differing degrees, taxpayers in every province pay taxes to the federal government, which collects the money and returns it to provincial governments to provide local public services. A redesigned system of fiscal transfers should seek to make the link between taxes and public spending as direct as possible.

Enhance Sustainability

Transfers are an important revenue source for most provinces. Therefore, it is important that entitlements be relatively stable and predictable so they can contribute to good fiscal planning by provincial governments. A redesigned transfer system should smooth changes in transfers and allow them to be reasonably predictable in the medium term (say, two to four years).

Related to stability and predictability is affordability. In the past, concerns about affordability have forced frequent changes in transfer programs, and frequent changes should be avoided if possible. Thus, a redesigned transfer system should embody internal control mechanisms to ensure that entitlements and the revenues that finance them are not allowed to diverge for long periods, thereby imperiling the political viability of the program.

Hobson's Unitary-State Approach

In a recent paper, Acadia University's Paul Hobson (forthcoming) proposes substantial alterations to Canada's intergovernmental transfer scheme. This study provides a good example of one of the mainstream views of the direction that transfer reform should take. I begin by describing the proposal, and then I evaluate and test it against the criteria outlined above.

Description

Hobson's reform proposal is motivated by two concerns. First, the existence of net fiscal benefits in contributing provinces may be hindering the efficient allocation of economic activity in Canada. Second, the current scheme falls far short of redistributing income to the extent required to satisfy broad-based horizontal equity. (As discussed above, this notion of equity requires that the federal government ensure that all citizens of similar means in Canada be treated equally by all governments taken together, even if it means undoing the actions of democratically elected provincial governments.)

Hobson uses the existing framework for equalization, but he proposes to modify the current scheme substantially by moving to a national-average standard, rather than the current five-province standard; including all revenue sources (including natural resources) in the calculation;[24] moving to a net scheme, rather than the current gross scheme so that provinces are equalized down and up to the national average; and fully equalizing to the new standard to obtain the result that all provinces have access to exactly the same per capita revenues.

When Hobson applies his proposed scheme to actual data, two important results emerge. First, the amount of equalization his scheme implies is substantially greater than the current level. For example, in 1994/95, Hobson's scheme would have sent $9.5 billion to the receiving provinces; the net flow under the current program was $5.6 billion.

24 Hobson makes no mention of the current special deals between Ottawa and Nova Scotia and Newfoundland regarding revenue from offshore resources.

Second, the distribution of equalization contributions would change substantially. Figure 1 summarizes the net flows that would have occurred if Hobson's proposal had been in place in 1994/95. Notice that Ontario's would have been considerably less than they actually were — $1.5 billion, rather than $3.6 billion — while Alberta's would have gone to $5.7 billion from $0.9 billion.[25]

Evaluation

Earlier, I discussed the efficiency case for intergovernmental transfers and found it weak both from a theoretical and empirical standpoint. Indeed, the empirical evidence seems to suggest that, rather than needing to use fiscal transfers to eliminate incentives for too much migration, Canada actually impedes efficiency-enhancing labor mobility through the transfers embodied in the regionally sensitive portion of EI.

In fairness, Hobson and other supporters of the mainstream view (such as Boadway) no longer see efficiency as the most important rationale for equalization. Rather, its primary role, they believe, is to promote broad-based horizontal equity. However, this notion of equity needs to be considered carefully.

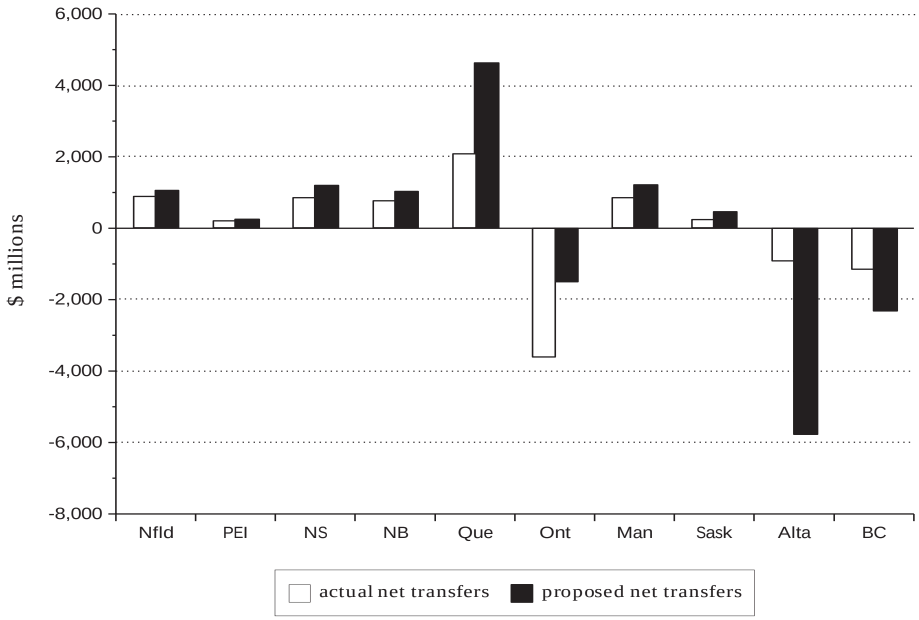
The degree of redistribution in a society is a fundamental political choice. Although Canadians probably want more redistribution through the state than do, say, Americans, it is not clear that they want everyone to have exactly the same income. If they did, such an income distribution could easily be accomplished through the tax system, abstracting from the incentive effect on work effort. How different is such a view from Hobson's proposal that all provincial governments should have access to exactly the same revenue?

Consider the impact Hobson's proposal would have on the perverse interpersonal transfers discussed earlier in the context of the Poschmann (1998) study. It seems clear that Hobson's scheme would exacerbate perverse transfers among individuals simply because it would dramatically increase the scale of intergovernmental redistribution.

In justifying his approach, Hobson argues that his proposal would replicate the outcomes of the unitary state, while allowing the full bene-

25 To put this amount in perspective, Alberta's total natural resource revenue in 1994/95 was about $3.4 billion.

Figure 1: ***Hobson's Proposal — Impact on Net Transfers, fiscal year 1994/95***



Source: Hobson forthcoming.

fits of local (provincial) decisionmaking. However, this characterization is not quite accurate. Hobson's scheme would encourage local decision-making but only on the expenditure side of the government's ledger. If, for example, Albertans decided to continue to forgo a provincial sales tax, they would be treated and taxed by the federal government as if they did levy such a tax at the national average rate. Thus, provincial tax rates are not a matter for local choice under the Hobson approach.

The problem here relates to the broad-based notion of horizontal equity underpinning Hobson's proposal. Defining equity in this way requires the federal government to undo the fiscal actions of any province that differ from the national-average policy. Surely this approach would be antithetical to federalism.

To round out my discussion of the Hobson proposal, it is useful to test it against the four criteria outlined at the beginning of this section. Would it:

- *Promote equity?* No. Although Hobson would argue the answer should be yes, I believe that his notion of broad-based horizontal equity is the wrong one for a federation. In addition, the massive increase in the overall size of the program would likely increase the size of perverse interpersonal transfers discussed by Poschmann (1998). Finally, the scheme includes no attempt to deal with the inequity embodied in the regionally sensitive portion of EI.

- *Promote efficiency?* No. Hobson's proposal would not change the perverse incentives that may distort governments' taxation and economic development decisions. The disincentives to individual mobility would also remain.
- *Enhance political viability?* No. Although Hobson's proposal respects the Constitution, it does not respect the current political bargain in that it would make winners out of the receiving provinces and Ontario and losers out of Alberta and British Columbia. The impacts on transparency and accountability would be mixed. Transparency would be enhanced because the net scheme would show clearly where the money went, but taxpayers would still be unlikely to comprehend the calculation of equalization itself. Accountability would be diminished because receiving provinces would be spending even more money they did not raise themselves.
- *Enhance sustainability?* No. The proposal's impact would be the same as the current scheme's on the predictability of equalization amounts. Further, the affordability of the scheme is questionable. Alberta would be unlikely to collect energy revenues if the result would be to have to give them all away (and more) in equalization. And since Alberta's energy revenues make up most of the national-average standard in that tax field, there would be no constitutional way for the federal government to get those revenues if Alberta decided to leave its oil and gas in the ground.

In sum, Hobson's proposal fares poorly even compared with the status quo.

Boessenkool's Overarching Approach

I next turn to a second reform proposal based on an alternative, narrower conception of horizontal equity. It comes from Ken Boessenkool (1998) of the C.D. Howe Institute.

Description

The essence of the Boessenkool proposal is to modify the current equalization program to become an overarching system based on a national-average standard. Using a narrow notion of horizontal equity, he seeks to have the federal government treat all provinces similarly, except in equalization. He proposes accomplishing this by treating most other transfers to provinces — specifically including the CHST, federal-provincial shared-cost programs in areas of provincial or joint jurisdiction, and the training and regional differences in EI payments — as provincial revenues to be equalized. His scheme is “overarching” in that all federal transfers would be included in calculating equalization. Thus, if a receiving province gets more than the national average per capita in, say, CHST grants, that extra amount would be netted against its equalization entitlement.

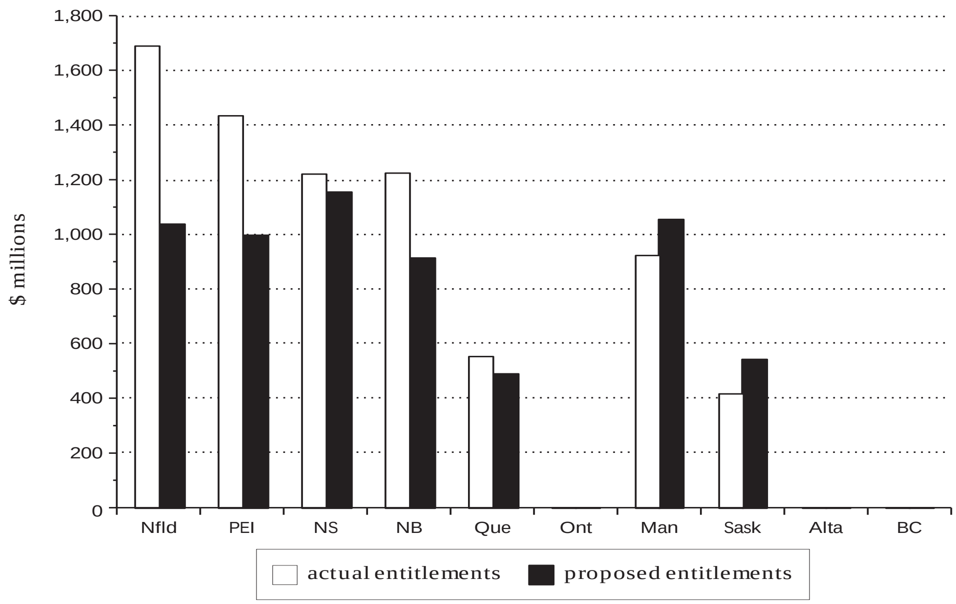
Boessenkool uses fiscal year 1996 / 97 data to illustrate the impact of his proposal. Moving from a five-province standard to a national-average standard in that year would have raised equalization entitlements for all the receiving provinces, but adding in the deviations from national averages for the programs outside equalization (except regional differences in EI) would, in most cases, have reduced the amounts. The net effect of these offsetting measures is that overall equalization would have fallen, but by only $178 million from its actual level of more than $8 billion. If regional differences in EI had also been included, the overall reduction would have been $924 million. Figure 2 presents the full fiscal impacts of Boessenkool’s proposal.

Transition

Unlike Hobson, Boessenkool devotes considerable attention to the issue of implementing his proposed reform of the transfer system. In the interests of a workable transition, he argues that including regional differences in EI in the calculation should be postponed until the effects of recent reforms to that program had a chance to work though the system.

In addition, he recommends that the inclusion of the other programs be phased in over a long period — say, ten years. With such a transition, the resulting impacts on equalization entitlements would be well within normal fluctuations. Finally, he argues that, as entitlements rise

Figure 2: ***Boessenkool's Proposal — Net Impact on Equalization Entitlements, fiscal year 1996/97***



Source: Boessenkool 1998.

because of the current strength of the Ontario and Alberta economies, it might well be that no receiving provinces would face an absolute reduction in its transfers.

Evaluation

Judged against Boessenkool's goal of moving toward narrow-based horizontal equity in the transfer system, his proposal is a success. Indeed, if the regional differences in EI were included in his scheme, it would probably make some progress in reducing the level of perverse redistribution on the interpersonal level. In addition, by considering the problems of implementation and transition, he has gone a long way in making his proposal useful at the practical policy level.

As I argued earlier, however, a lack of narrow-based horizontal equity is only one of a number of problems with Canada's current transfer system. Thus, it is legitimate to ask whether Boessenkool's proposal goes far enough. It does not satisfy efficiency concerns. Provinces still have an incentive to manipulate their tax regimes in order to maximize their equalization entitlement. More important, the confiscatory nature of the current system would continue, distorting provinces' incentives to encourage certain types of economic activity. On the positive side, however, any special deals provinces might negotiate with the federal government to ease the taxback of additional revenues would presumably be included in the overarching scheme, and thus their original purpose would be defeated.

To test the Boessenkool proposal against my four criteria, I ask would it:

- *Promote equity?* Yes. Narrow-based horizontal equity would be restored. If regionally sensitive EI were included in the equalization calculation, the scale of perverse interpersonal transfers would be reduced.
- *Promote efficiency?* Mixed. Incentives for provinces to seek bilateral deals with the federal government would be eliminated, since any benefits would presumably be counted in the equalization calculation. But the provinces' incentives to distort their tax systems to affect equalization would remain; so would individuals' perverse incentives as long as regionally sensitive EI payments continued to be made.
- *Enhance political viability?* Mixed. The scheme respects the Constitution. As for the current political bargain, although the proposal would create winners and losers, the transition plan is designed to mitigate negative impacts on some provinces. Transparency would be somewhat enhanced because all redistribution would be captured in a single program. In some ways, however, the program would be even more complicated that the current one, and thus taxpayers would be unlikely to comprehend it. Accountability would remain a problem because receiving provinces would still be spending a great deal of money they did not raise themselves.
- *Enhance sustainability?* Mixed. The scheme's predictability would be the same as the current one's. Overall entitlements would be lower in the long run, but their calculation would still be based on a gross scheme, an approach that has been unaffordable to the federal government in the past and therefore has led to a number of *ad hoc* changes to equalization.

In sum, Boessenkool's proposal does a good job of dealing with one of the major problems of the current transfer system and may well represent as much as realistically can be accomplished in this round of negotiations. I believe, however, that a new, more radical approach to transfer reform is needed.

A Radical Proposal for Reform

In evaluating Hobson's proposal, I rejected its underlying goal of trying to use transfers to mimic the outcomes found in a unitary state and argued that it addresses few of the problems inherent in the current transfer system. Boessenkool's proposal, while certainly a step in the right direction, is mostly aimed at the equity problem and leaves unresolved some important questions related to efficiency, as well as some other concerns about to the current system.[26] Here I lay out a third, more radical scheme, developed jointly with Derek Hermanutz, which is designed explicitly to deal with the problems highlighted in this essay (Boothe and Hermanutz forthcoming).

Description

Our proposal departs from the current scheme in four important ways:

1. It is purely interprovincial. Provinces would make transfers directly among themselves. A tax-point transfer would eliminate vertical fiscal imbalance and therefore the federal role as the distributor of cash transfers.
2. It is a net scheme, rather than a gross one, so that the revenues collected to fund the program would be directly related to the fiscal capacity of the provinces.
3. It is overarching or comprehensive, so that transfers outside of the formal equalization program would be considered.

26 A proposal by Courchene (1994) also dealt with a number of the problems with the current transfer scheme outlined earlier. He proposed dealing with equity problems by eliminating the regionally sensitive portion of EI payments, converting the CAP to a low-income tax credit, and converting the postsecondary education portion of EPF into portable student vouchers and the health care portion into tax points to be shifted to the provinces. This proposal was overtaken by events with the introduction of the CHST and thus is not included in my discussion of current options.

4. It is based on a simple macro formula rather than a multibase representative tax system.

To develop our scheme, we began by calculating net federal transfers to provinces, using the methodology from Franke and Hermanutz (1997) and considering three transfers: equalization, the CHST, and the regional differences in EI.[27] To obtain the net figures for equalization and the CHST, we took the proportional contribution to federal revenues made by the taxpayers of each province and subtracted those amounts from the transfers themselves. For EI, we used the estimates of Boessenkool (1998).

Table 5 presents the results of this calculation for fiscal year 1996 / 97.[28] Net transfers for all provinces sum to zero by construction.[29] The total amount of the gross transfer is $27.9 billion, of which only $8.8 billion (32 percent) is actually redistributed *between* provinces; the rest of the transfer simply returns to the province where the revenue originated.

To convert the current scheme to a net interprovincial one, we transferred $27.7 billion in PIT points from the federal government to the provinces (just as tax points were shifted from the federal government to the provinces in 1967 and 1977). Likewise, we assumed the elimination of all federal transfers related to equalization, the CHST, and the regional differences in EI. The result of this reallocation of tax points was to completely eliminate vertical fiscal imbalance and leave deficits unchanged for the federal government and the provinces as a group.

Although the transfer of tax points would not affect the sum of provincial deficits, the deficits of individual provinces would change because the distribution of income tax would differ from the distribution of federal transfers. To deal with the resulting horizontal fiscal imbalance, we propose having each province contribute or withdraw exactly the revenues required to leave its deficit (or surplus) unchanged by the transfer. Thus, there would be no winners or losers among the federal or provincial governments as a result of setting up the new scheme.

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27 Unlike Boessenkool, we do not include the other shared-cost programs.

28 This table provides the same information as Table 2 expressed in levels, rather than in per capita terms.

29 Notice that two of the receiving provinces, Manitoba and Saskatchewan, are actually net contributors to the regionally sensitive portion of EI.

Table 5: *Net Federal Transfers, fiscal year 1996/97*

	Equalization	CHST	EI[a]	Total
		($ millions)		
Newfoundland	888	148	309	1,345
Prince Edward Island	162	14	53	229
Nova Scotia	932	63	88	1,082
New Brunswick	794	84	233	1,111
Quebec	2,217	1,338	530	4,085
Ontario	–3,772	–1,423	–835	–6,030
Manitoba	800	110	–35	875
Saskatchewan	–17	88	–44	27
Alberta	–857	–282	–220	–1,359
British Columbia	–1,148	–139	–80	–1,367
All-province total[b]	*0*	*0*	*0*	*0*
Total redistribution[b,c]	5,793	1,844	1,214	8,800
Program size[c]	8,834	14,820	4,248	27,901
		(percent)		
Redistribution ratio[c]	65.6	12.4	28.6	31.5

[a] Regionally sensitive portion of employment insurance payments, as described in Boessenkool 1998.

[b] Because of rounding, some actual totals are not quite those shown.

[c] Total redistribution is the net amount shifted between provinces; program size is the overall amount involved. For example, of the equalization amounts shown here, $8,834 million is the size of the program, and $5,793 million of it is redistributed; the remainder ($8,834 million –$5,793 million = $3,041) is sent back to the provinces in which it was collected. The redistribution ratio is total redistribution as a percentage of program size.

Source: Boothe and Hermanutz forthcoming.

Figures 3 and 4 present the results of applying this scheme to fiscal year 1996/97 data. As one would expect, the pattern of contributors and recipients would be the same as in the current system. In absolute terms, population size is the determining factor, with Quebec dominating the recipients, at $2.3 billion, and Ontario the contributors, at $5.3 billion. The largest per capita contributor in 1996/97 would have been Alberta, at $528, and the largest per capita recipient would have been Newfoundland, at $2,647.

Of course, this is not the end of the story, since we allocated transfers for one year only so as to leave deficits unchanged. What remained was to develop a formula that would allocate contributions and withdrawals from the interprovincial equalization pool in the future.

In the interests of transparency and accountability, we opted for an equalization scheme based on a simple macro formula. After examining a number of macroeconomic variables and comparing them to the distribution of the net transfers presented in Figures 3 and 4, we chose adjusted personal income (API)[30] as our macroeconomic indicator of fiscal capacity. This variable adjusts personal income by subtracting federal direct taxes, the goods and services tax, provincial-local transfers to persons, and changes in farm inventories.

The theoretical reasons for the desirability of this indicator are simple. It does not include federal taxes, which, by definition, are not available for provinces to tax. And not including provincial-local transfers would prevent provinces from manipulating their macro indicator.[31]

An important characteristic of the API is that it does not explicitly include natural resource revenue, a feature that would certainly be attractive to Alberta and Saskatchewan (and probably to Newfoundland as its revenues from Hibernia come on stream). Two arguments support omitting such revenue from the formula's macroeconomic indicator of fiscal capacity. First, the nonrenewable nature of a natural resource means its exploitation should be treated as the sale of a capital asset; thus, the full amount of resource revenue should not be treated as current income to provinces. Second, the benefits of owning natural resources enter the formula indirectly through the effect on the personal income of individuals.

We also prefer the API on empirical grounds. Of the three macro variables we considered,[32] provincial deviations of API from its national average was the variable most closely correlated with the current distribution of transfers and thus the best choice for a formula that seeks to recognize the current political bargain over transfers.

Our optimal formula for transfers is straightforward:[33] Each province contributes or withdraws 32 percent of the difference between its per capita API and the national-average value. We found that such a for-

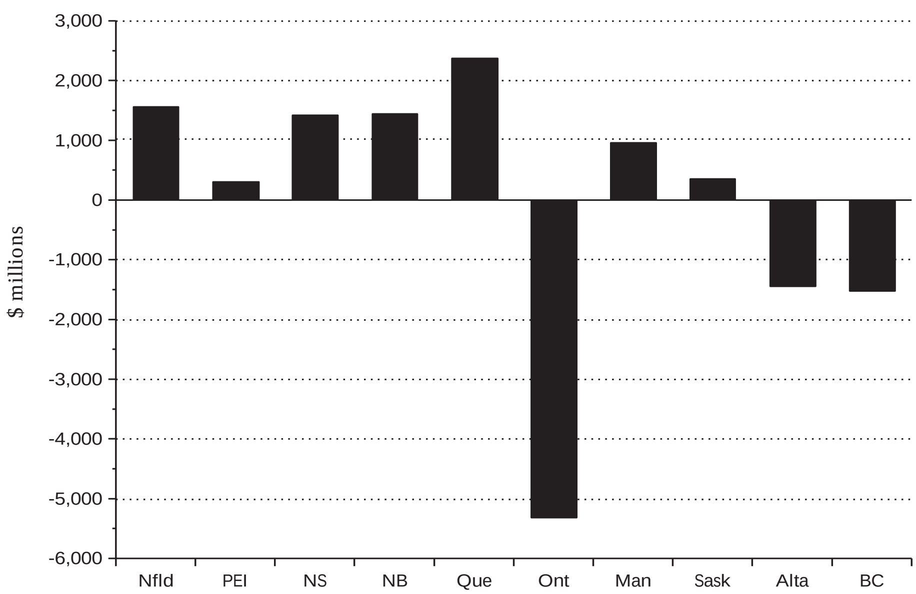
30 Smoothed by a five-year moving average to enhance stability.

31 Inventory changes are subtracted as part of the API calculation because this accounting measure may not actually be realized as income in a given period.

32 The other two were smoothed GDP and unadjusted personal income.

33 We chose it using a simple regression of net transfers on provinces' deviation from national average API.

Figure 3: ***Net Provincial Transfers, fiscal year 1996/97***
(after eliminating vertical fiscal imbalance)



Note: Calculated assuming a transfer to the provinces of PIT points worth $27.9 billion (the 1996/97 amount of equalization, the CHST, and regionally sensitive EI) and corresponding expenditure responsibilities. See the text for further information.

Source: Boothe and Hermanutz forthcoming.

mula accounted for 96 percent of the actual variation in net transfers, the largest amount of the three macro variables considered.

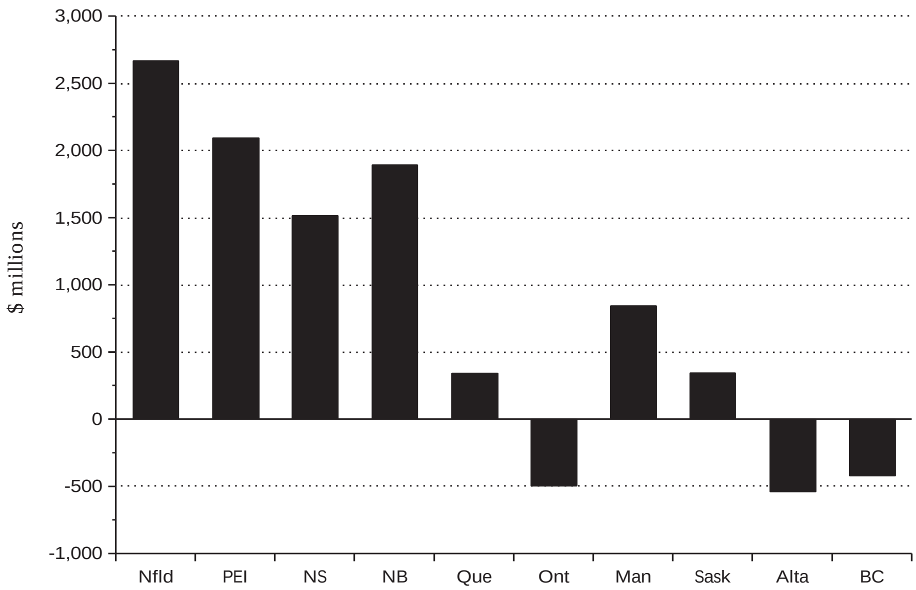
Figure 5 presents a comparison of actual transfers in fiscal year 1996/97 and those that would have resulted from our formula. Notice that the pattern of contributions and withdrawals matches fairly closely overall. But some differences are apparent, especially for the smaller contributors and recipients.

Transition and Governance

Key to making our scheme a practical proposal for reform are the issues of transition from the current system to one governed by a macro formula and of governance of the new interprovincial equalization program. In this subsection, therefore, I examine a number of specific issues related to transition and governance.

In considering the transition to this new scheme, one must recognize that the main benefits expected would not come from any financial

Figure 4: ***Per Capita Net Provincial Transfers, fiscal year 1996/97***
(after eliminating vertical fiscal imbalance)



Note: Calculated assuming a transfer to the provinces of PIT points worth $27.9 billion (the 1996/97 amount of equalization, the CHST, and regionally sensitive EI) and corresponding expenditure responsibilities. See the text for further information.

Source: Boothe and Hermanutz forthcoming.

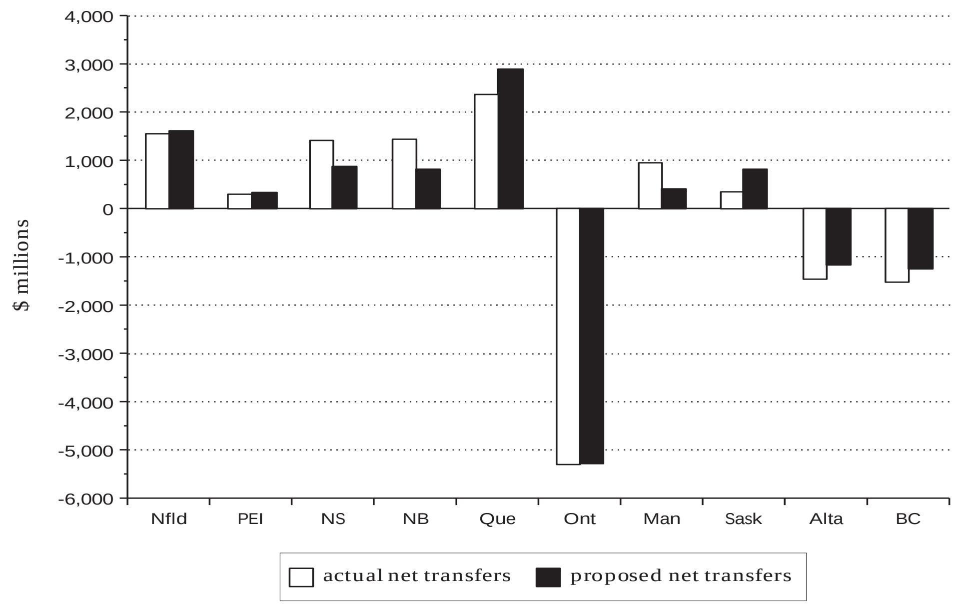
savings — indeed, our proposal is not designed to produce any in aggregate. Rather, the benefits would derive from improved accountability and transparency and from improved incentives for governments and individuals.

With this caveat in mind, suppose the transition to the new scheme would take place over 20 years. That is, the new formula would be implemented immediately, and differences between the amounts predicted by the new formula and today's actual allocation would be removed in 20 equal parts over time.[34] In this way, the main benefits from the scheme would accrue from the outset, but the net financial impacts on individual provinces would be small.[35]

34 With this approach, there would be no need to keep running the old scheme into the future.

35 It could be argued that the new scheme would create winners and losers in subsequent years, but in reality it is impossible to predict what the old scheme would have produced in the future, just as it is impossible to be certain what the new formula would produce.

Figure 5: ***Boothe-Hermanutz Proposal — Impact on Net Transfers, fiscal year 1996/97***



Source: Boothe and Hermanutz forthcoming.

A key requirement for successful implementation would be giving receiving provinces the assurance they need to move from the current system, where federal MPs from receiving provinces have a direct say in the evolution of the program, to one governed by a simple, transparent formula. Here, the federal government's role would be crucial. We believe Ottawa would have to change its role from paymaster of equalization to that of guarantor of equalization. In addition, it could collect the data required for the calculation of equalization and determine payments. Finally, it could also act as banker for the program, managing the equalization pool and overseeing the payments.

One way the new federal role might work is as follows. Assume Ottawa would continue to collect PIT on behalf of all provinces except Quebec. On implementation of the new scheme, Ottawa would transfer the requisite tax points to provinces on the condition that this revenue would remain with each province only as long as it participated in the interprovincial scheme. If any province withdrew, the federal government would immediately resume collecting the tax there on its own behalf and contribute the proceeds to the pool, thus eliminating any advantage from unilateral withdrawal.

Future changes to the scheme would be possible, but only with the agreement of seven provinces representing 50 percent of the population. Thus, the current contributing provinces could not change the scheme without the agreement of some of the recipients. Again, to minimize disruption, agreed-on changes would require three years' notice unless agreement was unanimous.

Evaluation

It is useful to see how our proposal deals with two of the broad concerns about the current scheme: equity and efficiency. Like Boessenkool, we are successful in restoring narrow-based horizontal equity to the transfer system. With vertical fiscal imbalance eliminated completely, the only reason for intergovernmental transfers would be to deal with horizontal fiscal imbalance and all such transfers would be made through the interprovincial equalization pool. Indeed, because our proposal is a net scheme, rather than a gross one, it would deal with equity concerns more effectively than would Boessenkool's proposal.

Further, our scheme would likely reduce the amount of perverse interpersonal transfers that characterize the current scheme. One reason is that, with vertical fiscal imbalance eliminated, the scale of transfers would be substantially reduced — from more than $27 billion to less than $9 billion for our example fiscal year, 1996/97. In addition, including regional differences in EI in the single transfer would eliminate a particularly important source of perversity.

On the efficiency front, our proposal deals with a number of the problems of the current system. The macro formula would eliminate the provinces' incentives to manipulate their tax bases and reduce the size of the taxback problem that bedevils the current arrangements. The elimination of regional differences in EI would improve incentives for individuals to migrate in response to changing economic opportunities. The simplicity of the proposed system would make it much more transparent. Also, with provinces raising as much of their own revenue as possible, accountability would be enhanced.

The fact that the program is deficit neutral by construction would ensure that there were no big winners or losers at the outset. The proposed long transition period means that adjustment to the new scheme would be gradual and relatively painless for provinces.

Some analysts will, however, question what they view as the proposal's significant diminution of the federal role in transfers, especially as transfers would no longer be available to enforce so-called national standards in areas such as health care. This concern is important and deserves careful attention.

First, while the federal government would no longer be making direct transfers to the provinces for equalization and the CHST, it would have a new and important role as guarantor and administrator of the interprovincial equalization pool. That role should provide receiving provinces with the assurance they need to support such a change.

Second, as Boothe and Johnston (1993) show, financial penalties by themselves have never been enough to enforce the standards embodied in the *Canada Health Act*. The financial penalties are simply too small; in fact, it is the *political* cost of violating that act that has led governments to respect its constraints. These political constraints would be undiminished by our proposal.

In reality, the national standards of the *Canada Health Act* are mostly about health care financing,[36] rather than health care or, more fundamentally, health. Boothe (1998) and others argue that the federal government needs to take a new leadership role in building national consensus around the goals for Canada's health system. The provinces' recent paper on social policy renewal (Ministerial Council on Social Policy Reform and Renewal 1995) calls for this kind of involvement from the federal government, and our proposal is consistent with the federal government's assuming such a leadership role. Clearly, the outcome of the current federal-provincial framework negotiations on social policy would have a significant bearing on the particulars of our proposal.

To complete the discussion of our proposal, it is useful to test it against the four criteria outlined at the beginning of the previous main section. Would the scheme:

- *Promote equity?* Yes. It would restore narrow-based equity. Moreover, the reduction in the scale of overall transfers and the elimination of regionally sensitive EI should contribute to reducing the degree of perverse interpersonal transfers.

36 An important exception is the portability provisions, but these have never been a matter of contention.

- *Promote efficiency?* Yes. It would eliminate incentives to manipulate tax bases to maximize equalization. With taxback problems reduced, incentives to distort decisions regarding economic development would be reduced. The elimination of regional differences in EI would improve incentives for individuals to move in the face of differences in economic activity.[37]
- *Enhance political viability?* Yes. Neither the transfer of tax points to eliminate vertical fiscal imbalance nor the interprovincial equalization concept would require constitutional change. The current political bargain would be recognized since, by construction, the scheme would be fiscally neutral for all provinces and the federal government at the outset. Transparency would be enhanced because taxpayers would have a much clearer idea of how much money is involved and where it goes. The actual calculation of contributions and withdrawals from the pool would be simple compared to the current system. Accountability would be enhanced because provinces would themselves raise more of the money they spend.
- *Enhance sustainability?* Yes. Increased stability would enhance fiscal planning. Given the governance structure of the scheme, no party could make unilateral changes, as Ottawa has done in the past. Having a formula based on a five-year average of API would mean that four-fifths of the information needed to calculate contributions would be known in advance. And the fact that the scheme is a net scheme would make it more affordable than the current one; provinces with rising economic fortunes would pay directly for increased equalization to their neighbors. If further convergence between provincial incomes occurred, equalization would decline as it should.

The Road Ahead

Although the proposal made in the last section would deal with most of the concerns with the current scheme, it is unquestionably radical for a system that has historically evolved gradually. Is such a sharp change

37 As my colleague, Bev Dahlby, has cautioned me, some further work is warranted here to examine the new incentives that would be created for the contributing provinces.

possible for Canada? Is the time right for reform? In other words, are the political and economic forces sufficiently aligned to make substantive reform possible? It is to that question I now turn.

The Alignment of Political and Economic Forces

Like all good managers, successful politicians deal with problems in priority order. Priority is established by political calculus. In other words, the political need for change must be pressing to get politicians' attention. Thus, reforms of any kind are mostly likely to occur when they form at least part of a solution to a political problem.

What kind of political problems might motivate action on transfer reform? Although probably not the most important motivation, the first is simply the need to deal with the upcoming review of equalization as mandated by federal legislation. Moreover, although this review will certainly not force the issue, it will provide the opportunity for transfer reform to move up on the national political agenda.

The key political problem for the provinces is how to counteract a federal strategy of using its new, post-deficit fiscal room to make direct transfers to individuals in areas of provincial jurisdiction, rather than to restore transfers to provinces. Clearly, the federal government is preparing an offensive to reverse the trend of the last three decades. Ottawa's latest invasion of provincial jurisdiction is understandable, given the political value of being seen to be doing good in the social policy field and the lack of credit that has resulted from transfers in the past. However, few, if any, provinces look forward to a return to the subordinate status of the 1960s or the creation of new overlap, duplication, and confusion among voters and taxpayers.

According to Coulombe (1997), the process of regional convergence has at least stalled, if not stopped. Without reform, receiving provinces can look forward to another generation of weaker economies and scarce opportunities for their young people. Given Frank McKenna's political success as premier in his drive to make New Brunswick more competitive, other Atlantic Canadian politicians may find it politically attractive to advocate radical reform in the long-term interest of their province.

Another factor that suggests that substantive reform may be possible is the improvement in all the provinces' fiscal positions over the

1990s. Only British Columbia, Ontario, and Quebec remain substantially in deficit, and even those provinces are moving relatively quickly to restore fiscal balance. Provinces are in better fiscal shape than they have been for many years, a fact that bodes well for their ability to manage the transition to a new transfer system.

On the federal side, the government is currently adrift and lacks any clear vision of how the federation should evolve or a coherent plan for dealing with the provinces. Seemingly by default, Ottawa is implementing conflicting strategies of trying to cooperate with provinces to demonstrate to Quebecers that federalism works and at the same time using newfound fiscal room to expand its presence in areas of provincial jurisdiction. Our proposal would fit well with the ongoing national unity file. The reforms that I advocate should be attractive to Quebecers, given that province's longstanding concern over its jurisdiction. Further, finding agreement on substantive transfer reform would provide the clearest proof possible of the vitality of the Canadian federation.

Beyond its positive spillovers on national unity, transfer reform may have another attraction to Ottawa. Reform of the type I propose would free up the federal government to assume a new role, one more consistent with the way industrialized democracies are evolving in response to globalization and advances in information technology. Instead of simply contributing to the financing of social programs, Ottawa would be free to define a leadership role as consensus builder and monitor of national goals for social programs. Provincial premiers have opened the door to the federal government, but it remains to be seen whether Ottawa has the vision and courage to transform itself.

The Status Quo Option

What is the likely outcome of doing nothing — the result if politicians find problems other than transfer reform more pressing? It is unlikely that disaster will strike if we fail to substantively reform transfers in the next couple of years. The Canadian federation has weathered much more threatening storms and survived intact. We must always expect some tension between the federal and provincial governments, given their overlapping jurisdictions. Transfer reform is certainly no panacea, and we will have to continue to work collectively in order to make our federation run well.

It is clear, however, that divisions are growing both between the federal government and some provinces and between provinces themselves. The longer these divisions are allowed to grow, the more difficult it will be to repair them. In a sense, ignoring these problems means failing to maintain the machinery of federalism. As any good mechanic will tell you, the longer you wait the more costly the eventual repairs will be.

Finally, the provinces will not willingly accept the undoing of the decentralization that has occurred over the past three decades. If that is the ultimate federal goal, Canadians are in for a long war of attrition. The forces of global competition and the growth of north-south trade, both underlying causes of decentralization, show no signs of abating. Thus, the need to adapt our federation and its transfer system to these realities is unlikely to disappear, despite the fervent wishes of some for a return to the good old days of dominant central government.

Getting Change Started

Radical is not an adjective usually applied to anything Canadian, and yet I have used that word in this essay to describe the kind of reforms I propose. Therefore, it is obvious to ask, could we get to where we want to go in steps? My answer is, in principle, yes but in practice, uncertain.

Our proposed reform has four distinct parts:

1. Combine equalization, the CHST, and regional differences in EI to arrive at total transfers.
2. Transfer the required PIT tax points to eliminate vertical fiscal imbalance.
3. Create a net interprovincial equalization pool that leaves all provinces deficit neutral at the outset.
4. Use a macro formula to calculate contributions and withdrawals from the pool in the future.

A number of partial reform programs would be possible. For example, the federal government could move to an overarching definition of equalization including the current equalization program, the CHST, and regional differences in EI (part 1) and to a macro formula for calculating equalization (part 4). This is essentially the Boessenkool scheme with the addition of a macro formula.[38] It would improve both the efficiency and equity of the transfers relative to the current system, but it would not deliver all the benefits of the full proposal.

What would be the benefits of such a partial package? The contributing provinces would benefit from increased transparency coming from the overarching nature of the scheme. Presumably they could argue that future major programs with regional biases should be included as part of equalization entitlements *à la* Boessenkool. Receiving provinces would benefit if the new formula for equalization reduced the problem of taxback that distorts economic development decisions. In addition, awarding regional differences in EI benefits to provinces rather than individuals would give receiving provinces more flexibility to deal with unemployment in ways that are less harmful to labor mobility and the work ethic.

Finally, the federal government might also benefit if the macro formula was designed in a way to make equalization payments more affordable. However, this outcome would depend on the particular form of the formula. Also, because the program would operate as a gross scheme, rather than a net one, sudden rises in particular revenues in particular regions might still cause problems for equalization.

If this partial reform were accomplished, would we ever take the next step and move to a net interprovincial scheme? Here, I am unsure. The benefits from eliminating vertical fiscal imbalance and moving to a net interprovincial scheme — improved transparency and accountability and a reduction of perverse interpersonal transfers — would accrue mostly to citizens, rather than to governments. It is not clear whether the political benefits of such reforms on their own would be sufficient to convince any political leader, provincial or federal, to become their champion. Thus, successful partial reform might well make full reform impossible. Of course, what I have outlined is just one of many possible partial reform programs; others might not be susceptible to the same problem.

When all is said and done, whether reform is politically possible depends on citizens. Canadians face a national choice. Forces of change are at work in our federation, and we can choose to ignore them or to man-

38 Of course, given that parts 2 and 3 would not be implemented, the macro formula would be completely different from the one we used.

age them for our collective benefit. If we choose to ignore the forces of change, Canada's future may well be less than it could be. If we choose to act now, we can renew the Canadian federation, finding a new balance for our federation to prepare it for the challenges of the next century.

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