

Moreover, the balkanization of fiscal relations implicit in the Meech Lake Accord will continue unabated. The Western Canadian provinces are talking about collecting their own taxes and funding directly programs presently cost-shared with the federal government. Accompanying this dispute over fiscal relations will be efforts by the remaining provinces to duplicate any success Québec achieves in negotiating separate agreements with the federal government.

The fight among the provinces and the federal government over how to distribute shares of a declining economic pie is going to obscure entirely the debate regarding a more efficient set of political and economic relationships suitable for promoting long-term growth.

To conclude, I was not surprised that the failure to ratify Meech Lake had so little effect on the Western Canadian economy. Yet I am not that sanguine about the future. I believe there are legitimate issues regarding aspects of current federal-provincial fiscal relationships that should be

discussed and open for debate. Unfortunately, I think the debate which will emerge will be driven by short-term considerations motivated by current fiscal problems and efforts by all provinces to keep pace with Québec's attempts to obtain separate agreements with the federal government.

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## CONSTITUTIONAL REFORM: DOES ECONOMIC EFFICIENCY FIT IN?

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The quick and simple answer is that economic efficiency does fit in with constitutional reform, but that it fits in with lots of other things. Political, social, and cultural matters may all have a more important bearing on the nature of constitutional reform than do economic matters. And where "economics" comes on to the scene, the concern may be more with equity than with efficiency.

What is necessary in federal fiscal relations to achieve economic efficiency? The requirement is that provincial tax and spending activities do not cause factors of production, labour, and capital to move from one province where they are more productive to another where they are less productive. This requires, except for cases where there is a clear desire to affect location decisions, either

- a) equal tax bills with equal expenditure benefits for individuals in similar circumstances regardless of where they live, or it requires,
- b) tax differentials matched by differences in expenditure benefits — i.e., equal fiscal residuals (net fiscal benefits).

Achieving this requires either tax and expenditure harmonization across the country which is equivalent to

complete centralization of power, or it requires a system of equalization payments, which allow for provincial policy differences, but equal fiscal residuals.

In the limited space I have, I want to look at Canada with respect to these efficiency criteria, and to look briefly at what the failure of the Meech Lake Accord may mean with respect to the question of "efficiency".

### 1. TAX HARMONIZATION

Tax harmonization in its most extreme form refers to the fact that a taxable entity, person or corporation, will face the same tax regardless of provincial location. Harmonization exists in another form if taxes are lower, but this is offset by the fact that some services are privately purchased rather than provided by the public sector. You don't pay as much, but you don't get as much.

Provincial taxes vary substantially in Canada. Nevertheless, Canada has a relatively high degree of harmonization compared to some federations — the United States and Switzerland. It has a low level of harmonization compared to Germany and Australia, and diversity is much greater than in unitary states such as the United Kingdom.

**TABLE 1**  
**INDICES OF TAX EFFORT (a), AND PROVINCIAL-LOCAL FISCAL CAPACITY FOR ALL**  
**OWN-RESOURCE REVENUE (b), PLUS THE FEDERAL EQUALIZATION TRANSFER (c),**  
**PLUS ALL FEDERAL TRANSFERS (d)**

	<u>Tax Effort</u> <u>Index (1988)</u>		<u>Fiscal Capacity Indices</u> <u>(1988/89)</u>	
PROVINCE	(a)	(b)	(c)	(d)
Newfoundland	102	61.8	92.8	95.1
Prince Edward Island	95	65.0	92.8	95.0
Nova Scotia	92	76.6	92.8	94.4
New Brunswick	95	72.2	92.8	96.2
Quebec	120	86.8	92.8	93.5
Ontario	98	108.7	101.9	100.3
Manitoba	113	81.7	92.8	94.7
Saskatchewan	103	90.2	92.8	95.3
Alberta	77	137.0	128.4	125.9
British Columbia	95	104.5	98.0	99.9

Source: Tax effort indices have been calculated by David Perry of the Canadian Tax Foundation, based on data provided by the Department of Finance in April 1989. Fiscal Capacity Indices are from "Historical Summary of Provincial Indices of Fiscal Capacity, 1972-73 to 1988-89" (Ottawa: Department of Finance, March 31, 1989), mimeo.

The *British North America Act* (now the *Constitution Act, 1867*) specified revenue sources available to the federal and provincial governments. Constitutional reform could, by limiting provincial authority in the area of taxation, contribute to harmonization. This won't happen, nor do I think it would add to economic efficiency. In an economic union such as Canada, provinces have no control over monetary policy or customs duties and international trade. They retain some control over their tax system. This may permit taxes to reflect differences in economic and social structures (family size), different views of appropriate taxes (no sales taxes in Alberta), differences in preferences concerning the size of the public sector (Manitoba vs. British Columbia, or Ontario vs. Québec). Recognizing differing tastes may contribute to, rather than detract from, efficiency.

In sum, more tax harmony may not add to efficiency in Canada. Surely there is a case for harmonization of CIT and PIT bases, and we have this. With the GST at the door, potential benefits exist for harmonization of sales tax bases across provinces. But it is not clear that the costs of existing diversity outweigh the benefits. As Richard Bird (1990) has said, "it will always be more difficult, more costly, and more apparently wasteful to do things in a federal than in a unitary state." This does not mean that greater harmonization is

more "efficient" for Canada. A high level of tax harmonization may be great for Germany, a low level for Switzerland, and an in-between level for Canada. One result of the Meech failure may be more diversity as Québec strikes out on its own. But this need not detract from efficiency.

## 2. WHAT ABOUT EQUALIZATION?

Equalization was enshrined in the 1982 *Constitution* to ensure that "reasonably comparable levels of services" could be provided at "reasonably comparable levels of taxation". Equalization payments have been important in reducing fiscal residuals (or the extent to which the benefits received minus taxes paid vary according to where you live), and thus in reducing inefficient movements of labour and capital within Canada. (In 1988/89, equalization payments were about \$7 billion.) Equalization helps ensure that labour or capital receive a reasonable level of public service in a province at a reasonable cost, rather than cause it to move to another province where it may be less productive, but would get more in public expenditure benefits for the same tax, or the same for less tax.

Table 1 reflects the extent to which equalization enabled

a certain level of expenditure to be achieved at an "average" tax level in 1988/89. Alberta, we see, could still spend 38 percent more per capita, with average tax rates, than many of the other provinces even after equalization, although prior to equalization it would have been able to spend more than double that in Newfoundland and PEI at identical tax rates. In other words, fiscal residuals remain large. Equalization has an important contribution to make to efficiency by reducing fiscal residuals, and it is doing so. *Substantial additional equalization payments would be required if we were to eliminate all fiscal residuals.* On efficiency grounds, there is room for an expended role for equalization payments.

*"It is debatable, but I think that the Meech Lake Accord would have contributed to economic efficiency."*

### 3. EXPENDITURE POWERS

Equalization payments are *unconditional* transfers. Provinces can spend the funds as they wish, or they can use the revenue to lower provincial taxes. Efficiency in a federal system requires these unconditional grants. It also requires *conditional* grants. In other words, the federal government gives money to provinces if they do certain things.

Such were the grants under the Established Program Financing system for post-secondary education, hospitals, health care, and welfare prior to 1977, and so Canada Assistance Plan welfare payments have remained after 1977. (\$16 billion in grants were provided in 1988/89.) When dealing with mobile people, part of the benefits of education, health and welfare expenditures are realized outside of the province. Hence, if spending is determined solely by the benefits to the spending province, too little is spent. By reducing the cost to the province, matching grants from the federal government ensure that a higher level of expenditure occurs, one that recognizes the benefits that "spillover" as people move about.

Spillovers must be recognized if economic efficiency is to be achieved. Federal government matching grants in the areas of health, education, and welfare, are a means to do this. Yet these are areas of exclusive provincial jurisdiction, areas in which Québec, in particular, has fought to limit activity by the national government, often with the support of other provinces. It may be worth reflecting on the extent to which spillovers are less important for Québec because of less mobility in and out of that province. However, where spillovers are important, constitutional reform which guarantees the federal government spending power for

shared cost programs in these areas may contribute to efficiency.

### 4. OBSERVATIONS ON THE MEECH LAKE ACCORD AND ECONOMIC EFFICIENCY

Much of the controversy surrounding Meech Lake had to do with the possible increase or decrease in centralization of power within the Canadian federal system. I agree with those who felt that the Meech Accord would have little effect on the centralization or decentralization of economic power in Canadian federalism. Its failure may have greater effects, but other factors are likely to be more important. First, the federal deficit severely limits the ability of the federal government to take initiatives. This inevitably causes provincial governments to assert their authority. Examples include Premier McKenna's promotion of a Maritime economic union, Alberta's challenge to the GST, Québec's moves toward sovereignty, Saskatchewan's pursuit of the Rafferty - Alameda dam, and the general distancing of Conservative premiers from Ottawa and its policies.

Second, forces of global competition, and the integration of markets, with the United States, Mexico, and others will influence both federal and provincial initiatives. As parts of Canada become more closely linked with external markets, conditions in these markets will influence Canadian fiscal systems. Québec's link with New York, and British Columbia's with California or Japan may require differing regional responses.

But greater or lesser centralization may have little effect on efficiency, so determining Meech's effect on centralization does not tell us its effect on economic efficiency. More relevant, I think, is the question of whether Meech Lake would have increased the flexibility of federal arrangements in Canada in a way that would have better allowed government responses to reflect regional and local preferences, and to adjust for spillovers. Does its failure have either a positive or negative effect on economic efficiency? It is debatable, *but I think that the Meech Lake Accord would have contributed to economic efficiency for four reasons.*

*First, Meech enshrined in the constitution federal government spending power in areas previously considered the exclusive preserve of the provinces, areas with large spillovers. Meech may have reduced Québec's continual pressure to see the federal government draw back from these areas. One area close to home is that of post-secondary education. Prior to 1977, federal contributions to financing higher education were based on actual expenditures with 50-50 sharing of the cost with the provinces. In the view of the provinces, this permitted the federal government to be too directive and*

manipulative in an area of provincial responsibility. Whereas 50-50 sharing may not be the right figure, some sharing, in recognizing spillovers in areas such as health and higher education, would rightly encourage more spending in these areas. The Meech Accord would have contributed to the legitimacy of federal initiatives and participation in shared cost programs. This could increase economic efficiency.

*Second, Meech Lake would likely have increased the diversity that could be accommodated within "national" programs.* The Meech Accord gave the provinces the constitutional right to opt out of national programs and receive "reasonable compensation". I subscribe to the idea (Courchene, 1988) that this would result in the Federal government designing national programs with sufficient flexibility in them to minimize opting out. Such flexibility would make national programs more responsive to regional and cultural differences. Increased consultation and collaboration would likely occur in the development of new programs. As noted earlier, federal systems are costly, but again it can be efficient if the diversity is responding to real differences in tastes and preferences. The NEP, success of the Reform Party, the separatist forces in Québec, the failure of Meech, all reflect the need to recognize different values and tastes within the Canadian federation.

*Third, the Meech Lake Accord, by contributing to a sense of "unity in diversity" or a greater sense of "shared nationhood" (Bird, 1990) may have further strengthened a commitment to equalization as a concept.* Although equalization is in the constitution, sizable fiscal residuals remain and contribute to economic inefficiencies. Meech, if successful, may have contributed to a stronger equalization concept and hence to greater economic efficiency.

*Fourth, Meech may have moved us closer to Senate reform.* (Although the recent Senate activities may have moved us much faster in this direction than Meech ever could have.) How does this relate to economic efficiency? The existing strong form of parliamentary government may not adequately ensure sensitivity to the differing tastes, values, and cultures across Canada. The result may be policies which do not sufficiently reflect these differences. Constitutional reform that enables the federal government to more adequately reflect the diversity of the country, that permits a more collaborative model of legislative change rather than the parliamentary confrontational model, should help government policy to be more responsive to the people of diverse regions.

In sum, the constitution at most can facilitate the process of adjustment to other major economic forces. In particular, the Meech Accord may have contributed to enhanced efficiency

1. by more clearly establishing the role of the federal government in shared cost programs where sizable spillovers exist,
2. by ensuring the right of provinces to opt out when values, culture, and tastes dictate,
3. by further strengthening commitments to equalization,
4. by increasing the likelihood of Senate reform.

To the extent that these differences, and there is uncertainty surrounding each and every one of them, could have enhanced economic efficiency, the failure of Meech and any similar reforms makes the country less productive.

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