



**REFORMING SOCIAL POLICY:
CAN THE FEDERAL GOVERNMENT DELIVER?**

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I. Introduction

The topic of this talk is one that is of considerable interest to the community of Canadians — the reform of social policy and the role of the federal government in that process. Interest in it is reflected in a recent survey reported in the *Globe and Mail* that showed that the average Canadian feels quite strongly that governments have an important and indispensable role to play in the achievement of social justice. However, they also think that governments are not delivering. There is obviously much scope for reform. The issue to be addressed is how the federal government can and should participate in that process, especially in light of current fiscal realities.

Let me start by stating what aspects of social policy I do not intend to address. The talk is not about the appropriate design of social programs. That is, it is not about how unemployment insurance should be reformed, whether it should be two-tiered, whether it should have a training component, and so on. It is not about how the welfare system should be changed to address the problem of child poverty or of the working poor. It is not about whether public pen-

sions should be targeted to those in need, or whether they should be funded according to actuarial principles. Nor is it about whether the state should have a role in the delivery and financing of child care. It is also not about whether principles of pricing and privatization should be applied to health care, or whether students should bear a greater burden of the financing of post-secondary education. More generally, it is not about the relative role of cash transfers versus tax preferences versus the in-kind provision of goods and services as components of social policy. Finally, it is not about the implications of the current fiscal (debt) crisis for the funding of social programs, though all of these are important and relevant issues.

Rather, it is about the nature of decision-making over social policy issues in a federation such as Canada's, one which is highly decentralized by international standards. As the title suggests, it asks 'Can the Federal Government Deliver?' rather than 'What Can the Federal Government Deliver?' or 'What Should the Federal Government Deliver?' It is about the way that the responsibility for achieving social policy objectives is divided between (and shared by) the federal and provincial levels of government, and how this might be reflected in the policy instruments available to these governments. Obviously, this is not unrelated to the above questions about the design of social policy. Indeed, one of the themes of my talk is that the social policy reform can be greatly constrained by a failure of the federal system to condone policy instruments commensurate with responsibilities at the two levels of government.

Briefly speaking, my main thesis can be summarized in the following line of reasoning:

- (1) We take it as a major premise that the federal government has a legitimate role to play in pursuing national standards of redistributive equity or social justice, as well as national efficiency objectives where:
 - (a) national equity includes horizontal and vertical equity applied on a national basis, which implies citizens are treated equivalently independent of province of residence; and equality of opportunity;
 - (b) national efficiency includes preservation and enhancement of the

efficient operation of the internal economic union, or common market; The issue is what implications for social policy reform follow from that major premise.

(2) Social policies (a) are integral components of national equity policies and (b) can have implications for national efficiency; social policies include a wide array of policies and comprise much of what governments do.

(3) Some social policy instruments are federal (especially unemployment insurance, largely pensions), some are jointly occupied (taxes and transfers), while others are 'exclusive' provincial responsibilities (health, education and welfare);

(4) While there are very good economic reasons for decentralizing the delivery and financing of social programs, such decentralization can lead to violations of national efficiency and equity norms:

(a) lack of coordination among policy instruments and among provinces can lead to inefficiencies in the national economy (the internal common market);

(b) beggar-thy-neighbour policies of provinces can lead to adverse redistribution consequences (the 'race to the bottom');

(c) fiscal decentralization leads to fiscal (horizontal) inequities among provinces, and to inconsistent standards of vertical equity;

For these and other reasons, the system of fiscal arrangements between the federal government and the provinces is an integral part of the social policy arsenal of the federal government; indeed, it is the major source of federal influence.

(5) Given the extent and nature of fiscal decentralization that has taken place, and the fact that critically important instruments of redistributive policy are the responsibility of the province, the ability of the federal government to achieve its national efficiency and equity objectives are on the verge of becoming seriously compromised. This has occurred gradually over the past three decades as a result of policies undertaken with little regard for the longer-term consequences for fiscal federalism;

(6) The fiscal foundations of the federation are now very fragile; federal policies in the next few years can undo in an irreversible way benefits of the fiscal system that we have largely taken for granted,

so much so that we are on the verge of having to answer 'no' to the question posed in the title. The issue then is:

- (a) Should we worry about it; that is, do you accept the major premise of my argument?
- (b) If so, what, if anything, could we do about it?

I will suggest that, while the provinces have primary responsibility for the design and delivery of social programs, the federal government can be viewed as having a legitimate role to play in coordinating social policy, establishing minimum national standards and financing social policy, a role both based on sound economic policy reasoning and sanctioned in the Constitution. I will argue that the federal-provincial fiscal arrangements in the broadest sense form the basis for the federal role in social policy. The gradual decentralization of fiscal responsibilities in Canada over the past quarter century has reached the point where the ability of the federal government to fulfill any role it might have in the social policy area, or even to achieve the minimal reforms set out in the recent Axworthy Green Paper, is in jeopardy. We must now decide, perhaps as soon as the next few budgets, whether we want to retain that role. My fear is that this issue has not been given proper airing. This is an attempt to contribute to that debate.

Before proceeding, I should make a couple more disclaimers. The topic I am addressing is large in scope, although it is also one that has not been widely debated in public. Since I am an economist, and one whose work tends to be somewhat more formal than that found in policy debates, my focus will be on economic issues, especially on evaluating the use of the fiscal arrangements as instruments of desirable economic policy. I shall be less concerned with matters of political feasibility, of political process, or of legality. Moreover, I shall have little to say about the relevance of the Quebec situation for the topic, though that is obviously an issue of some timeliness and importance. It may well be that the sorts of remedies that might constitute good economic policy as I understand it may well be compatible only with some sort of asymmetric arrangement with Quebec.

II. What is Social Policy?

Let me begin with defining what I take the term ‘social policy’ to mean. Social policy is a synonym for redistributive policies, that is, policies whose objective is to address social justice or equity in all its dimensions. It involves both fostering greater equalities of opportunities as well as greater equalities of well-being among Canadians. It comprises a wide variety of government programs and constitutes the bulk of program expenditures by the public sector, both federal and provincial. Its components include:

- (1) Traditional income-based redistribution operated through the tax-transfer system (the progressive tax and various refundable credits);
- (2) Transfers to individuals delivered outside the income tax system, especially those made to the poor and the elderly;
- (3) Social insurance schemes intended to compensate for various forms of misfortune that for various reasons are not insurable privately, such as unemployment, illness, injury, disability and the like;
- (4) The public provision of goods and services, most of which are essentially private in nature but are provided through the public sector for redistributive reasons (so-called in-kind transfers, such as education, health care, public housing, day care, etc.).

Social policy in this broad sense might also be taken to include inter-governmental redistributive transfers, such as equalization, of which we shall have more to say.

While governments have obviously been involved in these sorts of things for a long time, economists are only now coming to recognize the legitimate role to be played by social insurance and the provision of public services alongside income-based transfers as redistributive instruments. Until recently, the general view was that income transfers were inherently superior to transfers in kind; and, social insurance schemes were justified by standard efficiency-based market failure arguments. However, the ‘new public economics’ is now very much cognizant of the fact that redistributive (i.e. social) policy is multi-faceted. This is an important change in perspective, for it suddenly implies *that much of what governments do is redistributive in nature*. Moreover, much more redistribution is accom-

plished through the expenditure side than through the tax side of the budget. Contrary to the classical view of market failure that dominated the literature for so long, it seems quite reasonable to view governments as largely being institutions for achieving collective equity goals rather than as being instruments for correcting market failure.

Moreover, we need not necessarily bemoan the fact that relatively little redistribution seems to get done through the progressive tax-transfer system. Nor ought we to expect more redistribution to be done in that way. The fact is that far more redistribution gets done through the provision of public services and social insurance, and that is probably the way that it should be.

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

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

The argument is that as the federation becomes more decentralized as a natural and legitimate consequence of rationalizing the

delivery of public services, the fiscal arrangements should assume greater and greater importance. They are the only means by which the federal government can insure that national objectives of efficiency and equity are maintained. Instead, precisely the opposite has been allowed to occur. The fiscal arrangements have been allowed to deteriorate both in size and in design to the point where the ability of the federal government to pursue its proper objectives has been dangerously eroded, perhaps irreversibly. We consider some consequences of that erosion.

III. Roles of the Federal and Provincial Government in Social Policy

A key to making progress in social policy is to sort out which level of government is responsible for what. Since virtually everything governments do has redistributive dimensions to it, that is not an easy task. Economists who study these things, and they constitute a relatively small number, have typically argued that in a federation, the federal government ought to have an overriding interest in redistributive equity on the grounds that citizenship in a country should imply that everyone has the same weight in society's 'social welfare ordering' regardless of where they reside. If one accepts that view, the implication is that there is a national equity objective of which the federal government must be steward.

This objective would have a vertical equity dimension as well as a horizontal equity dimension to it. The vertical equity dimension would involve norms of redistribution from the better-off to the less well-off, where relative well-being depends upon not only ability to pay, but also other indices of well-being such as health status or disability. Vertical equity also includes the notion of equality of opportunity. Horizontal equity involves seeing that otherwise-equal citizens should be treated equally by the public sector broadly defined, regardless of where they reside.

At the same time, there are very strong and widely accepted economic reasons for decentralizing to the provincial level the responsibility for the design and delivery of public services that serve

individual citizens. The reasons include:

- (1) Cost effectiveness and the reduction of a layer of bureaucracy;
- (2) Ability to cater to local differences in need, cost and preferences;
- (3) Incentives to innovate in service provision;
- (4) Beneficial effects of inter-provincial competition;
- (5) Reduction in monitoring and agency costs involved in delivering services at the local level.

Given the decentralization in fiscal responsibilities that this entails, there is naturally scope for provinces to engage in their own redistributive policies within their own borders. Purely provincial programs can lead to a patchwork of programs that violate national standards of equity and also induce distortions in the national economy. For example, provinces might impose residency requirements (like countries do) on the access to public services; they might compete with one another to attract high-income residents and discourage low-income residents; and they might have widely differing capacities to provide public services. Given that the provision of public services represents one of the major ways in which objectives of social policy are achieved, the federal government obviously has a great interest in the design of these programs, and in ensuring that they contribute to national equity objectives and do not violate efficiency in the internal economic union.

Obviously there is scope for tension between the two levels of government, this being greater the more do the two levels conflict in terms of the desired degrees, and forms of redistribution, and the more decentralized is the federation from a fiscal point of view. Part of the role of the fiscal arrangements is to facilitate the harmonious co-existence of decentralized decision-making while at the same time allowing the federal government to pursue its national efficiency and equity objectives.

In the post-war period, as the welfare state has developed and reached maturity, the federal fiscal system in Canada has come to conform broadly with this notion of the ideal division of responsibilities. The provinces are largely responsible for the delivery of public services as well as for their financing, especially at the margin where it is more important. The federal government, through the fiscal ar-

rangements, has been able to maintain a satisfactory degree of national horizontal equity through its system of federal-provincial transfers (Equalization, EPF and CAP). It has been able to implement a reasonably uniform amount of progressivity in the tax-transfer system through its control of the income tax base and rate structure, and its participation in the field of transfers to persons. And, there has been a reasonable amount of harmonization among provinces in the provision of public services like health and welfare, owing to the system of federal-provincial transfers, and the use of the spending power to encourage provinces to maintain certain minimal national standards. In short, the system has evolved to one in which the responsibility for delivery of many major public services is decentralized, while at the same time the system of fiscal arrangements is used imaginatively to offset those inefficiencies and inequities that are a natural consequence of decentralization. Nonetheless, the system is not perfect, and some cracks are not only beginning to show but are becoming wider. I return to this shortly.

In looking at the ability and responsibility of the federal government to pursue national equity and efficiency goals, and in particular to ensure that social policies conform to these norms to an acceptable extent, it is worth looking briefly to what the Canadian constitution has to offer. Surprisingly few colleagues in my discipline, even those who dabble in fiscal federalism, are informed about this. The basic responsibilities of the federal and provincial governments are clearly enunciated in the *Constitution Act* as revised in 1982. For the purposes of social policy, the most important features of these responsibilities are as follows.

(1) *Provincial Responsibility for Health and Education Programs:* The provinces are given “exclusive” legislative responsibility for programs in areas such as health and education (Section 92), and arguably for welfare services as well. Indeed, by virtue of provincial responsibility for civil and property rights, the provinces can be taken to be legislatively responsible for almost any public service to be provided to individuals. Thus, to take a current example, day-care services might be considered a provincial responsibility, as would

be others that might become relevant in the future. This means that almost all public services whose objective is redistributive equity, and which therefore are part of social policy, are the exclusive legislative responsibility of the provinces. This poses a serious question for the role of the federal government in the implementation of national social policies, a question that is mentioned but not resolved by the recent federal Green Paper.

(2) *The Joint Responsibility for Equity:* The constitutional amendments of 1982 are best known for repatriating the constitution and implementing a Charter of Rights albeit without the approval of the Quebec legislature. For our purposes, the package also contains some important provisions. Section 36(1), clearly states that both levels of government are jointly committed to at least part of the national equity agenda, including providing equal opportunities, reducing disparities and providing essential public services to all Canadians. We interpret this provision, though it may be more a guiding principle than a binding obligation, as providing support to the federal government's interest in the delivery of public services that are essential or that serve to equalize opportunities and reduce disparities. While on the surface, this might seem to be an obligation that is in direct contradiction to provincial exclusive legislative responsibility, in fact the two provisions can be reconciled by the use of the fiscal arrangements, of which one facet is the following.

(3) *The Federal Spending Power:* An extremely important federal policy instrument not mentioned explicitly but generally regarded as being constitutionally sanctioned is the so-called spending power. A high proportion of federal government expenditures consist of transfers not only to other governments, but also to persons and businesses, and reflect the exercise of this power. What is particularly relevant is that the spending power enables the federal government to make transfers to the provinces conditional on the way in which the provinces spend the moneys, even though the spending is in an area of exclusive provincial jurisdiction. This will be of obvious relevance for our discussion on social policy since the spending power

is the only federal policy instrument available for achieving the objectives set out in Section 36(1). The spending power is what reconciles the joint federal-provincial responsibility for achieving equity through the provision of public services with exclusive provincial responsibility.

(4) *The Federal Equalization Commitment:* Complementary to the joint commitment for providing essential public services and equal opportunities is the commitment imposed upon the federal government in Section 36(2) to make equalization payments to ensure that all provinces can provide reasonably comparable public services at reasonable comparable tax rates. This can be viewed as a commitment to national ‘horizontal’ equity, that is, the principle that identical persons should be treated equally by the public sector as a whole regardless of where they reside. The provisions of Section 36 may not be justiciable; that is, the federal government cannot be forced by the courts to act on them. Nonetheless, they can be interpreted as not only committing the federal government to the principle of pursuing national equity objectives, but also providing a powerful sanction to the federal government to do so through such methods as the spending power.

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

(6) *Pensions and Unemployment Insurance:* The notable exceptions to the above are in the areas of pensions and unemployment insurance (UI). By constitutional amendment, the federal government

acquired the right to legislate in these areas. In the case of UI, they assumed exclusive responsibility. However, in the area of pensions, there was to be joint occupancy, though with provincial paramountcy.

(7) *Internal Common Market.* Though social policy is obviously equity-oriented in objective, issues of national efficiency naturally arise. Economists especially put particular emphasis on fostering efficiency in the internal common market, which includes ensuring the free and undistorted flow of labour, capital, goods and services within the national economy. While it is commonly agreed that this is an important national objective, it is nowhere explicitly stated in the *Constitution Act*, except to a very limited extent in Section 121 which rules out inter-provincial barriers to trade in goods alone. It could be taken to be one of the natural components of Peace, Order and Good Government that is mentioned in the Preamble to Section 91 as a suitable objective for federal legislation. The desire to foster the internal common market can lead the federal government to pursue policies that lead to the harmonization of provincial service provision so that provinces do not engage in wasteful and distortionary program competition with one another, or at least so that any negative consequences for the internal common market from healthy inter-provincial competition are offset. Again, the spending power is the only instrument available to the federal government for this purpose. In principle, it can be used to provide financial incentives to the provinces to take account of national equity and efficiency objective in designing their programs. The criteria imposed by the *Canada Health Act*, 1984 are examples of this. Some of them are for equity reasons (e.g., accessibility), and some for efficiency (e.g., portability of benefits).

We can summarize this discussion of the allocation of responsibilities. The federal government has responsibility for objectives of a national nature, and these presumably imply both national equity and national efficiency objectives. The Canadian constitution explicitly recognizes the federal interest in equity in Section 36. At the same time, the federal government does not have direct access to

all the policy instruments necessary to achieve either national equity or national efficiency. Quite reasonably, the responsibility for providing most public services that serve redistributive ends are the exclusive responsibility of the provinces. This decentralization of public service provision is in accord with federalism theory. However, it does pose an important dilemma for the federal government. How can it begin to achieve its legitimate social policy objectives when many of the instruments for doing so are in the hands of the provinces? The answer is clear: it can only do so with the use of the spending power. Otherwise, a national social policy is out of reach, and one must rely entirely on the provinces to accomplish social policy objectives. And, given the geographical interests that the provincial governments represent, even the most well-meaning behaviour by decentralized provincial decision-makers is likely to violate national norms of equity and efficiency. Thus, what becomes critical in evaluating the fiscal arrangements as instruments for social policy is ensuring that the scope of the spending power is sufficient for achieving national objectives. It is almost as simple as that.

One interesting case in which the provinces participate in social policy without enjoying exclusive constitutional jurisdiction is in the area of social assistance (welfare payments as opposed to services). The provinces are the sole occupants of welfare programs, albeit with a significant financial contribution by the federal government. This is not a constitutional requirement, but a matter of practice, though not necessarily one that economics would advocate. The federal government through its spending power could as well implement national welfare assistance programs; indeed, it could be said to do so in part through the unemployment insurance system. It is useful to remember this as we investigate options for the future below.

IV. Suitability of the Existing Federal Fiscal System for Addressing Social Policy Issues

In this section, we review some of the features of the way in which the fiscal arrangements have evolved in recent years with a view to

evaluating their suitability as a system for supporting effective social policy.

The deficiencies of Canada's social policy system have been well-documented, and proposals for reforming it have been frequently made, the federal Green Paper only representing the most recent, and perhaps least sweeping, of these. Perhaps the most comprehensive review was that of the Macdonald Royal Commission on The Economic Union and Development Prospects for the Canadian Economy some ten years ago. We need not go over that ground again. For our purposes, it is worth observing the tendency in many of these exercises to ignore both the real constraints and the real opportunities resulting from the fact of federalism. For example, the Green Paper dealt essentially with three of the many areas of social policies — unemployment insurance, post-secondary education and welfare. In each case, among the reforms addressed were those that by the Constitution or by accepted convention probably required provincial enactment. This is clearest in the case of welfare reforms, especially those dealing with the provision of services to the poor rather than cash transfers. It is also true for post-secondary education; a meaningful system of income-contingent loans or of other mechanisms for inducing choice in publicly-supported education, such as vouchers, realistically requires legislation at the provincial level. Even UI reforms may require the concurrence of provincial legislators to the extent that it involves the use of training facilities. Yet there was no indication how the federal government would induce provinces to engage in the proposed reforms.

One such vehicle is the system of 'fiscal arrangements.' The fiscal arrangements include a wide variety of forms of fiscal interaction between the federal government and the provinces. For our purposes, we concentrate on two main components: the major federal-provincial transfers and the system of tax harmonization. The form of both of these are critical in facilitating a coherent national social policy. The major transfers include Equalization, Established Programs Financing (EPF) and the Canada Assistance Plan (CAP). The system of tax harmonization currently involves mainly the Tax Collection Agreements negotiated between the federal government and

the participating provinces for the individual and corporation income taxes. Its scope could potentially be widened to, say, sales taxes.

All of these programs have been in place for a long time, despite some fairly significant and largely irreversible changes that have occurred in the fiscal relationship facing the federal government and the provinces. Most of these changes have been gradual, most have occurred without any conscious effort to manage or influence them, and most are virtually irreversible. Some of the most important changes that have occurred are the following.

Growth of Provincial Expenditure Responsibilities. Those expenditure responsibilities that are growing most rapidly (e.g., health, education, welfare) are at the provincial level. In fact, the provinces have long since overtaken the federal government in terms of program expenditures, as well as in terms of expenditures on goods and services. For example, federal program spending (excluding inter-governmental transfers) is now only 4/5 of provincial program spending; in the early 1960s, it was over 1-1/2 times larger. Even more striking, federal spending on goods and services was 2-1/2 times that of the provinces in 1961; today it is only 70% of the provinces'. Moreover, the form of federal and provincial expenditures differ considerably. While a high proportion of federal expenditures is on transfers of various sorts (over 2/3 of program expenditures), provincial expenditures involve a higher proportion on the provision of goods and services, many of them public services related to social policy (about 2/3 of provincial and municipal program expenditures are on goods and services).

Provincial Government Self-Reliance. At the same time as provincial expenditure responsibilities have grown, so too has their reliance on own-source revenues; that is, the vertical fiscal gap has shrunk. For example, Nova Scotia and New Brunswick now receive just over 1/3 of their revenues from transfers, compared with about 1/2 in 1970. Similarly, Alberta receives about 14% now compared with 24% in 1970. And, British Columbia receives 11% now, the lowest in Canada, compared with about 18% in 1970. Thus, the fis-

cal system is becoming more decentralized as time passes. This entails not only reduced reliance on federal transfers, and therefore a reduction in the opportunity for the federal government to influence provincial expenditure programs, but also an increase in the share of tax room occupied by the provinces. The latter implies that it may be more difficult to maintain the effective system of income tax harmonization that we enjoy. Under the existing system of fiscal arrangements, the trend to provincial self-reliance is bound to increase since most of the transfers grow at a rate significantly less than the rate of growth of provincial expenditures. However, federal policies themselves has served to exacerbate the trend.

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

Tax Reform. The ability of the federal government to achieve national equity and efficiency objectives may have been further compromised by recent federal tax reforms. As with deficit reduction, these were undertaken seemingly without being unduly troubled by the resulting consequences for fiscal federalism. The particular component of the tax reform that is most troubling from this perspective is the introduction of the GST. Most economists would heartily agree that as indirect taxes go, this is a good tax. The documentation that Finance Canada produced to accompany and justify its implementation were by economic standards well-argued and reflected state-of-

the-art thinking in the tax reform area. However, the case for the GST was predicated on the presumption that the federal government needed as part of its tax menu a general sales tax. Once the fiscal arrangements are taken into account, additional considerations arise. The main one is that the more revenue the federal government obtains from the GST, the less it will need from the income tax. There will necessarily be a shift over time of income tax room in favour of the provinces, and this shift will be larger the more the federal government comes to rely on the GST for its revenues. The upshot will be less federal presence in the income tax, and a lesser chance of maintaining a harmonized system. The fact is that, given the extent of decentralization in Canada's federal system, the federal government can dominate at most one tax base. With the implementation of the GST, it likely reduces its ability to dominate the income tax and therefore threatens the continued viability of income tax harmonization (which is one of the instrument for achieving national equity and efficiency).

Inter-Governmental Co-ordination Problems. Fiscal decentralization has many beneficial effects. However, it is a two-edged sword. Policies taken by different levels of government can be in conflict; and, inter-jurisdictional competition can have distortionary effects on economic activity. Moreover, the assignment of responsibilities itself can induce conflicting behaviour. Examples of these sorts of problems abound. At the federal level, the single most distorting policy from an economic point of view is undoubtedly UI. The problem seems to be that the federal government uses it not just as a social insurance system, but also as one of income support. A cogent reason for this is that, since welfare is a provincial responsibility, UI is the next-best instrument that the federal government has available to it to pursue social assistance-type policies. For their part, the provinces systematically undertake policies partly designed to exploit the federal UI system, such as by funding short-term work or training schemes for persons who might otherwise draw welfare cheques. Inter-provincial competition has been alleged to have had beggar-thy-neighbour components to it in the welfare field, in bidding for

industry, and in access to post-secondary institutions by out-of-province students, examples that are all close to home here in B.C.

These various events have changed the nature of the federation immensely over the past two decades. There is evidence that this gradual decentralization is being increasingly accompanied by strains within the federation. Policies being undertaken by different levels of government are more and more coming into conflict (e.g., the federal unemployment insurance system with provincial welfare programs, and the tendency for provinces to exploit the former). Provinces are engaging in forms of inter-provincial competition that have beggar-thy-neighbour aspects to them — bidding for industry, tinkering with welfare programs, restricting access to post-secondary education programs to out-of-province students, etc. The income tax system is becoming increasingly fragmented as provinces implement ever-increasing numbers of exemptions, special incentives, and special tax bases. And, concern escalates over the federal government tendency to act unilaterally and without notice to the provinces in areas of transfers to the provinces as well as tax reforms that affect provincial budgets. In short, the federation is becoming more balkanized as it becomes more decentralized, and it is happening with scant regard being given to the longer-term consequences for the federation, especially the increasing inability of the federal government to use the spending power to encourage national standards.

The major components of the fiscal arrangements themselves are under some strain. This is due to a combination of neglect (most of the programs have been unchanged structurally since they were introduced), piecemeal changes in response to events, and fiscal exigencies. It is worth looking briefly at each component in turn to identify some of the major problems facing them. It will be difficult to imagine a successful social policy reform process in the absence of rationalizing the system of fiscal arrangements, especially given that their purpose is largely to support the achievement of redistributive equity.

1. *Equalization*

The Equalization scheme is the heart of the system of fiscal arrangements. It is also the program whose design most closely suits its objective, and is the one that probably commands the most public support. The purpose of Equalization is to fulfill the commitment enunciated in Section 36(2) of the *Constitution Act*, which is to enable provinces to be able to provide reasonably comparable public services at reasonably comparable tax rates. In a decentralized federation, equalization is necessary to achieve both fiscal efficiency and equity, and is thus an indispensable tool of the federal government. It enables provinces to have the tax capacity to be able to finance some minimal level of social programs, and thus contributes immensely to a national social policy.

Though Equalization largely succeeds in its objective, it does not do so perfectly; nor is it the only policy instrument that contributes to that objective. The main drawbacks to the current Equalization system are well-known, though they are largely matters of program design. Because the system is a net one, it equalizes the have-not provinces up, but does not equalize the have provinces down (at least directly). It is based on a five-province standard rather than a national-average standard. While this may not make much difference on average, it does have some odd effects in certain areas, especially oil and gas revenues; for example, it effectively taxes new oil and gas revenues received by have-not provinces at confiscatory rates. It is also subject to a cap on growth that detracts from its effectiveness. These have been relatively minor defects. In fact, the existing system succeeds in equalizing the tax capacities of the have-not provinces up to over 95% of the national average.

Perhaps a more serious shortcoming is the fact that it concentrates only on tax capacity differences and neglects other sources of fiscal capacity difference such as different needs for public services across provinces. This might be thought of as a potentially serious limitation of the program, given especially the significant differences in demographic make-up among provinces that translate into different needs for things like education and health expendi-

tures. Any equalization that occurs on account of need does so through matching grants, and that is limited mainly to CAP.

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

2. *Established Programs Financing (EPF)*

On the surface of it, EPF is a simple equal per capita block grant to the provinces to support their expenditure responsibilities in the areas of health and post-secondary education. As such, it is a useful complement to Equalization, since by collecting federal taxes nationwide using the federal tax system and redistributing them on an equal per capita basis across provinces, it is a form of equalization. To that extent, it can be seen as a part of the means by which the federal government satisfies its constitutional equalization commitment. At the same time, although it is a block grant, the payments are made with conditions attached. To be fully eligible to receive them, provinces must maintain publicly administered health insurance systems that satisfy the criteria set out in the *Canada Health Act*, most of which are carried over from the earlier medicare legislation of the mid-1960s. These include comprehensiveness of services, universality of coverage, accessibility and portability. Provinces that fail to adhere to these minimum national standards may be penalized by the federal government by having their grants reduced; to date, no such penalties have been imposed. As well, there are penalties for provinces that engage in extra billing and charge user fees.

I would not wish to defend the particular form of these conditions. However, to my mind, these sorts of general conditions are precisely the kinds of exercise of the spending power that are consistent with the notion of a federation that is decentralized in terms of service delivery and yet has incentives in place to induce provinces to deliver services in a way that is compatible with national standards of equity and efficiency. Each of the general conditions could be rationalized in these terms. Yet they leave the provinces plenty of scope for innovations uniqueness in service provision. In my mind, it is a model use of the spending power that one might contemplate applying in other areas, such as education, welfare, day care, and training. Indeed, one might even argue that federation would be extremely well-served if UI were decentralized to the provinces, but partly financed by block grants with general conditions attached.

At the same time, there are some fundamental problems with the EPF system that threaten its very existence. The problems with the EPF system arise from the two main features in its structure. First, the overall rate of growth of EPF transfers is limited to the annual growth rate of GDP, and in fact it has been temporarily reduced even further in the past two decades in response to various federal government expenditure restraint efforts. This limitation on growth in EPF transfers in itself ensures that provinces must finance higher and higher proportions of their own expenditures in health and post-secondary education, since both grow more rapidly than EPF receipts.

The second structural feature is even more consequential, and that is that the EPF transfer as originally instituted in 1977 was divided between a cash transfer and a tax-point transfer component. At the time, the division was such that about half the 'transfer' was in tax points and the other half in cash. Since then, because the value of the tax transfer has grown more rapidly than that of the overall entitlement, the residual cash component has gradually fallen. It is due to disappear entirely early next century. (Indeed, it will disappear much sooner for Quebec because more tax points were transferred to it in 1977. What happens when Quebec incurs a negative cash entitlement is an open question.) As a result, the lever available to the

federal government for enforcing the conditions of the *Canada Health Act*, or for encouraging provinces to adopt national standards in other areas of expenditure will have been lost. For example, minimum national standards in the area of post-secondary education, such as prohibitions on residency requirements or on out-of-province fee differentials, will be difficult to implement.

The inclusion of the tax-transfer component as part of the EPF transfer has always been anomalous, and becomes more so as time goes by. The fact is that once the tax points were turned over to the provinces, they became part of the provinces' own-source revenues for all intents and purposes. The federal government lost complete control over those funds. Despite that, it continues to report the EPF transfer as including both the tax-transfer and the cash component, a practice that is more than a bit misleading. More than that, it has become mischievous. Because the tax-transfer is allowed to enter the EPF cash calculation, and because the (equalized) tax-point transfer is worth different amounts to different provinces (because of both the gross nature of the Equalization scheme and the fact that Quebec received more tax points than the rest of the provinces), the amount of cash that is paid to the have provinces (and to Quebec) differs in per capita terms from that paid to the have-not provinces. Moreover, the use of tax points alongside cash transfers in the original EPF transfer also directly contributed to the decentralization of income tax room to the provinces, a decentralization that could threaten the integrity of income tax harmonization.

3. *Canada Assistance Plan (CAP)*

The CAP remains the only significant matching grant program in the Canadian system. Provincial social service operating costs and social assistance are shared 50-50 by the federal government. An exception to this is the arbitrary limit currently imposed on the amount transferred to the three have provinces (including B.C.), the so-called 'cap on CAP.' For them, the transfer is effectively a lump-sum conditional grant as long as the cap is binding. CAP is also an obviously important program from the point of view of social policy reform

and was the subject of one of the thrusts of the federal Green Paper, despite welfare being a provincially exercised legislative power.

There are two relevant aspects of CAP. One is the 50% matching rate, which has been widely criticized in economic policy circles. A standard justification given for the matching form of the CAP is to internalize for spillovers arising from the fact that welfare recipients may be mobile among provinces. Legitimate though this argument may be in qualitative terms, it is unlikely to be able to support full 50-50 cost sharing; that would imply an enormous externality effect.

An alternative argument for cost sharing is a more cogent one. It is that basing CAP on actual costs incurred in provincial welfare systems acts as a complement to equalization, effectively incorporating differences in need into the system of fiscal transfers. Thus, it has allowed provinces to be able to provide more comparable levels of welfare systems despite the great differences in relative numbers of recipients. The trouble is that, unlike the Equalization system itself, it does so in a way that imposes potentially strong incentive effects on the provinces. The lure of 50 cent dollars are a clear inducement for provinces to overspend. The usual argument for including need factors in equalization systems calls for doing so using indicators of potential need rather than actual expenditures. Examples would include numbers of welfare recipients or demographic indicators.

The second aspect of CAP are the conditions imposed on the provinces for the receipt of funds. Though these are minimal, they have served to introduce some national standards into provincial welfare schemes, such as the absence of residency requirements, the stipulation that the only eligibility requirement be need and the requirement that the basic needs of recipients be adequately met. Provinces have argued that these conditions have constrained them from pursuing certain strategies in their welfare programs, such as opening it to the working poor, integrating it with the income tax system or requiring work from recipients. To the extent that this is true, it is more a statement about the specific types of conditions that were imposed in 1966 rather than the principle of imposing conditions to maintain national standards *per se*.

These two aspects of conditionality in CAP, the cost-sharing component and the imposition of minimal standards, are logically quite separate. It has long been argued that the sharing component ought to be dispensed with and the conditionality retained (and perhaps rationalized). This could be accomplished by transforming CAP into a block grant along the lines of EPF, while retaining criteria for the full receipt of funding. The distribution of funds across provinces need not be equal per capita; they could incorporate some element of need. The point is that some element of conditionality would seem to be the only way in which the federal government accomplish national objectives in the welfare area, given the responsibility the provinces have for legislating there.

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

4. *Tax Harmonization and Coordination*

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

However, such a system is probably only sustainable as long as the federal government retains a significant share of the tax room. The less tax room does the federal government have, the more do the

provinces wish to impose their own policies through the income tax system, and the less likely is it that the main features of harmonization are retained. As we have mentioned above, there has been a gradual but persistent reallocation of fiscal responsibilities in favour of the provinces. This has resulted in the provinces occupying more and more income tax room relative to the federal government. Whereas less than 10% of income taxes were collected by the provinces in 1961, they now collect well over 40%. Moreover, with the institution of the GST and with federal deficit-reduction policy partly taking the form of restricting transfers to the provinces, this trend is being exacerbated.

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

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

To summarize this section, the fiscal arrangements, which represent an essential federal instrument for the pursuit of social policy objectives, have been allowed to deteriorate dangerously in Canada, arguably to the point where the federal government is no longer able to pursue its legitimate objectives of national equity and efficiency. The relevance of the fiscal arrangements becomes more and more important the more decentralized is the federation. The Canadian federation has become very decentralized, yet the fiscal arrangements are virtually unchanged in form since their various components were first introduced. Though they have served us well, they are no longer suitable for supporting the sorts of national social and economic policies that Canadians seem now to be demanding.

V. Options for Policy and Practice

The upshot of our discussion is that, given the responsibility of the federal government for equalization and the shared responsibility with the provinces for the provision of adequate public services and ensuring equality of opportunity, given the federal responsibility for maintaining efficiency in the internal economic union, and given that the provinces have exclusive legislative responsibility for the provision of many key public services, the fiscal arrangements represent one of the few policy instruments available to the federal government for pursuing national efficiency and equity objectives. Of the three major roles the fiscal arrangements perform — equalization, the use of the spending power to encourage national standards and tax harmonization — only equalization remains on solid footing. As a consequence, the ability of the federal government to assume its responsibility for social policy broadly defined is now in jeopardy. Given the pressing constraints imposed by the large stock of accumulated debt at the federal level, what options are available?

At least in the short run, options are limited by the fiscal problems of the federal government. There are essentially two options. Which of the two you prefer is largely a matter of individual values. More specifically, it depends upon whether you accept the major premise outlined earlier — that the federal government has a legiti-

mate role to play, as stated in the constitution, in pursuing national standards of redistributive equity or social justice. If you do not subscribe to this premise, your preferred option will be to let events take their course. If you do subscribe to the major premise, you will prefer that policies be undertaken to both rationalize the existing system and forestall it decline. Let us consider the options in turn.

OPTION A: Let Events Take Their course

In this case, the federal government would oversee the gradual or accelerated demise of the system of transfers to the provinces. In doing so, the consequences of federal fiscal actions for the fiscal arrangements and fiscal federalism more generally are simply not an issue. Letting events take their course could entail, among other things, keeping the cap on Equalization; continuing to let tax points count towards EPF transfers thereby letting the cash component run down to zero; turning CAP into a block grant and reduce its rate of growth; amalgamating EPF and CAP into a single block grant and letting it run down by allowing it to be eroded by tax points; removing or watering down conditions in EPF and CAP; accelerating the running down of the cash transfer by cutting the size of federal transfers under EPF and CAP as part of the deficit reduction process; removing the post-secondary education component from EPF cash transfers, and converting them to a student loan program. As a result of these measure, the federal government will come to occupy less and less of the income tax room.

The consequences of this for the federation and for the ability of the federal government to implement social policy would be as follows: the federation will become more fiscally decentralized, with the provinces even becoming more self-reliant and fiscally accountable. The federal government will become less able to fulfill the principle of joint responsibility for those aspects of redistributive equity as outlined in Section 36(1) of the *Constitution Act*, or more generally to participate in broad social policy reforms. The use of the spending power would be suspended, perhaps irreversibly, thus placating Quebec and perhaps other provinces as well. Provincial public ser-

vice provision would become more balkanized, thereby further rendering the principles of Section 36(1) more difficult to achieve. The system of income tax harmonization would be placed in further jeopardy with adverse consequences for the internal common market and for vertical equity within the federation, while provinces are better able to implement tax policies to meet provincial objectives. And, the system of Equalization would be more difficult to maintain since fiscal decentralization leads to greater divergences in provincial fiscal capacities. Of course, from a fiscal management point of view, federal deficit reduction would be made easier by the ability to use cuts in transfers to the provinces freely. At the same time, there is less pressure to rationalize the main federal social programs — unemployment insurance and pensions. But, more generally, there would be a virtual end to the system of fiscal federalism as we know it.

OPTION B: Forestalling Further Decline

This option would involve the federal government taking action to prevent the vertical fiscal gap from reducing further, maintaining its ability to use the spending power, and keeping its share of income room intact. Whatever ability still exists to pursue national social policy objectives would be preserved, essentially buying time for a more considered reform of the system of fiscal arrangements.

Policies that would be compatible with this objective would include: removing tax points as a component of EPF and allowing the cash component to rise with GDP over time; maintaining general conditions on the use of EPF funds, though not necessarily those currently in place (e.g., penalties for extra billing and/or user fees); converting CAP into a block grant program, maintaining (or improving) national criteria as conditions for full funding, and allocating the funds by province using need considerations (whether or not it is amalgamated with EPF is of relatively little concern, except to the extent that it increases the strength of the spending power); avoiding the reduction of transfers to the provinces as part of a federal deficit reduction strategy; retaining the federal government's share of income tax room; and rationalizing social policies delivered by the

federal government.

The consequences of this for the ability of the federal government to deliver social policy would be to retain the, perhaps limited, ability of the federal government to achieve the principles enunciated in Section 36 of the *Constitution Act* through Equalization and the use of the spending power. As well, the erosion of the ability of the federal government to maintain the system of income tax harmonization would be arrested. At the same time, the ability of the federal government to cut the deficit by relying on expenditure cuts would be made more difficult, and it would have more incentive to rationalize its own social programs. Most important, this holding action would buy time for the federal government to sort out its own fiscal problems before attention is turned to a more fundamental rationalization of the federation in light of what the system is intended to accomplish.

Which of these paths we chose depends upon our vision of what we want the Canadian federation to look like in the twenty-first century. That is a matter of judgment. It would, however, be a great shame if we let the choice be made by default, which is the course we have adopted so far.