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12

Contemporary and Historical Economic Dimensions of Canadian Confederation

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Centre for Research on Federal Financial Relations
The Australian National University

CONTEMPORARY AND HISTORICAL ECONOMIC DIMENSIONS OF CANADIAN CONFEDERATION

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CONTEMPORARY AND HISTORICAL ECONOMIC DIMENSIONS
OF CANADIAN CONFEDERATION

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PREFACE

The Centre is grateful to Professor Auld for preparing this paper at a time when constitutional relationships and federalism in Canada are the subject of considerable controversy and concern.

Professor Auld is Professor of Economics at the University of Guelph. After completing degrees at the University of Western Ontario, the University of Toronto and the Australian National University, Professor Auld has held academic appointments at Guelph, the University of British Columbia, the University of Toronto, the University of York (England) and Duke University (North Carolina).

R.L. Mathews
Director

March 1979

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January 1979 Douglas A.L. Auld

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March 1979 R.L. Mathews
Director

I INTRODUCTION

Canada, initially a Confederation of four colonies of the British Empire, did not evolve as a consequence of careful marginal calculations pertaining to the costs and benefits of political union. Confederation was, in part, a matter of expediency and, along with that, a romantic dream of men with unbounded vision. Unfortunately, this vision was coupled with extreme naiveté in other respects. It was a union of suspicion, of economic exploitation and of personal ambitions producing an almost paranoic sense of nationalism.

In the beginning, the assignment of economic responsibilities under the *British North America Act* 1867, in terms of expenditure functions and the right to collect tax revenue, was simple and clear. The Provinces were granted exclusive control over certain specific areas of expenditure which, in 1867, were not extremely important; for example, roads and public education. Ottawa's sphere of activity was unbounded: in fact, anything that would contribute to 'peace, order and good government' was allowable. To finance their expenditures, the Provinces were permitted to levy direct taxes, almost unheard of at the time, in exchange for their main source of revenue in pre-Confederation days, the import duty. Ottawa could draw its revenue from any tax base.

The ink had barely dried on the British North America Act when the Provinces complained about the inequity of the fiscal arrangements embodied in Confederation. As the country expanded to include the Western Provinces, the diversity of Canada expanded even more, setting the stage for new interjurisdictional conflicts.

In a sense, the story of Canada is a tale of conflict between 'province building' and 'nation building' and the ongoing resolution of that conflict.[1] That fact should not be surprising considering the social, cultural and economic complexity of the country. Of course, this conflict has more than just economic ingredients but at the heart of many social and cultural arguments there has been a strong element of economics.

The exhaustive story of the conflicts within Canadian Confederation would require several volumes, a task that cannot be

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[1] The political nature of this conflict has recently been highlighted in a paper by Richard Simeon, "Intergovernmental Relations", *Issues in Intergovernmental Relations*, Ontario Economic Council, Toronto, 1978.

accomplished here. The objectives in this essay are much more limited: to highlight the economic dimensions of this conflict in terms of the instruments for province and nation building, especially in terms of the regional economic diversity of Canada, and to discuss instances where the solution to a problem became a problem in itself.

The next section of the essay outlines, in the form of a very brief summary, several 'standard' approaches to the economic analysis of federal countries. This discussion will be the benchmark to which later topics are referred. Section III outlines the economic dimensions of regionalism in Canada, dimensions which have, more than anything else, shaped the conflict between Ottawa and the Provinces. In Section IV, recent developments in the area of intergovernmental grants are outlined. The purpose of this section is to highlight the extent of what Mathews calls 'vertical and horizontal' fiscal imbalance.[2] These are the issues upon which much of the past and present conflict has centred. The fifth section looks at what economic instruments are available for nation building and how the use of these instruments has led to interjurisdictional conflict. Section VI briefly sketches the debate over the 'balance sheet' approach to Confederation and focuses on the implications of that debate. The final section of the essay is rather speculative in that the comments are directed toward the future of Canadian Confederation.

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2 Mathews, R., "Federal Balance and Economic Stability", Presidential Address to ANZAAS, Melbourne, 1977, published in *Economic Record*, August 1978.

II THE POLITICAL ECONOMY OF FEDERALISM: BASIC ISSUES

Why do individuals in some geographical areas collectively opt for a federal country rather than a unitary state? There are many reasons. One determinant of federation is defence, where small independent nations believe that a single collective defence effort is a greater deterrent to foreign invasion than a situation where each jurisdiction has its own military force. Looking to the south, the size and power of the United States and apprehensions concerning U.S. territorial interests were crucial factors in the decision to create Canada.

Alternatively, economic reasons may be prominent factors, in that each individual state can reap advantages of a common currency, foreign policy and a single transportation network that would not exist if each part maintained single-country status. Commerce and transportation advantages are some of the arguments advanced by those who advocated Canadian Confederation in the 1860s.

Unlike the situation where one country with a single level of government is established by a union of several states, the desire for a federation reflects a wish for the retention of *some* local autonomy. A major problem in all federations is the possibility that the degree of local autonomy desired may change over time, such that the original structure of the federation no longer serves its constituent parts.

From an economic viewpoint, one approach to federalism is to consider the demand for public goods by individuals within a geographical area. Suppose that within the population of a geographical area there is a general consensus in favour of a specific level of a particular public good or service. Then a national (central) government is the logical political jurisdiction to provide this good. In the case of Canada, defence is an obvious candidate for central government control. However, within this population there may be one group or collection of persons who desires an additional public good and a further group desiring still another public good. Alternatively, one group may wish to spend a greater share of the public budget on one service than does another subset of the total population. Even a cursory glance at the data on public budgets in Canada confirms the existence of this diversity of preferences.[3] Education, which at the time of Canadian

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3 As an example, the Province of Alberta spends roughly 10 percentage points more of its budget on education than does the Province of Saskatchewan.

Confederation was largely restricted to primary grades, was a service that the Provinces wished to control because of the diversity among Provinces in their views about how education should be delivered and to whom it should be delivered.

In theory, then, each group demanding a particular good could form a 'government' to supply that good. Within these two groups there may be additional sub-groups demanding additional or differentiated public goods. Other 'governments' could then be formed to satisfy these needs and so on. If people were highly mobile, they could reside in the region where the bundle of public goods (and the accompanying tax burden) best met their preferences.[4] Preferences would be revealed by voting for the candidates or parties expressing their wishes.

From a practical viewpoint, however, it is apparent that such a proliferation of governments would not be achieved without losses in efficiency and the creation of interjurisdictional conflict. This, of course, is precisely what occurs in countries where there are several levels of government and provides an argument for those who call for a stronger central government. The result of greater centralization may be improvements in general administrative efficiency and better co-ordination but it cannot be denied that certain interests will be ignored or receive only limited attention, resulting in a distribution of public goods that is not in keeping with the preferences of specific regions or groups of citizens. For decades, Canadian Provinces have argued that Ottawa has interfered with the preferences of people for various reasons by 'imposing' programs that do not have strong support in every region.

Suppose, for example, that municipalities are consolidated into regions; that is, municipal governments administer only a very limited range of public goods and services and there exists a larger 'super' regional government which oversees six or seven municipalities. In such a scheme, certain needs or desires of particular municipalities may be ignored or only accorded superficial attention because of the relatively small weight any one unit has in a system of regional government. On the other hand, the absence of regional government may result in no attention being paid to the collective interests of several municipalities. Some success may be achieved through intermunicipal committees but these are imperfect substitutes for political jurisdictions.

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4 This idea was explored initially by C. Tiebout, "A Pure Theory of Local Government Expenditure", *Journal of Political Economy*, October 1956.

The implication up to this point has been that the benefits of a public good desired by a collection of individuals are available only to those in that specific group. In actual fact, it is likely that the benefits (or even the disbenefits or costs) of a public activity may 'spill over' to persons in other political jurisdictions. For example, the municipal waste disposal system of one jurisdiction may involve dumping untreated waste into a river which is at the border of another jurisdiction. There is no incentive for the first municipality to reduce its pollution. Alternatively, if the waste does affect part of one jurisdiction, resources will be used to abate the pollution only up to the point where the marginal cost of doing so equals the marginal benefit to that one community. The geographical spillover effect is ignored.

Traffic facilities in one city may be used by others outside the city when travelling from one area of the Province to another. The heavy traffic may call for improved facilities but the city may be very reluctant to provide facilities for non-residents who are not taxpayers. Such a situation calls for either joint action by all those jurisdictions whose citizens use the facilities or outside intervention in the form of special grants from a higher level of government to the jurisdiction which assumes the excess burden. This provides the rationale for Federal government involvement in Provincial and local government highway building. The use of a conditional grant permits considerable control to be exercised by the central government.

If the jurisdictions involved are independent nation states, resolution of this problem requires an international agreement between the two states. In a federal country, the problem may be easier to resolve by relying on the central government to take corrective measures. This, of course, assumes that the central government has some jurisdiction in the conflict area. This will be necessary once the number of jurisdictions is large and there are other objectives to be achieved. An environmental spillover problem could conceivably be resolved through negotiation between the two parties affected. However, when the number of parties becomes large, solution to such problems through this process is difficult, if not impossible. The recent (1969) creation of the Federal Department of Environment in Canada is an example of the Federal government's perception of need in this area.

Federalism and Basic Public Finance Objectives

An alternative approach to federalism is to examine the primary objectives of the public sector in a setting of a highly centralized versus a highly decentralized political framework.[5] It is generally recognized that there are three primary objectives of the public sector: the provision of public goods, the redistribution of wealth in accordance with society's norms and stability of prices with full employment.

First consider the objective of price stability and full employment. The public sector may legislate changes in budget components in order to alter the level of aggregate demand when and where such is required to control inflation or unemployment. To perform its function satisfactorily, it should have access to the money supply and capital markets to finance a deficit if required and to co-ordinate budgetary changes with monetary policies. How would regional political jurisdictions perform in the stabilization role?

First of all, if they are 'open' economies in the sense that a considerable amount of expenditure is destined for the purchase of goods and services outside the community, an 'expansionary' fiscal policy carried out in one region will increase aggregate demand in the region but will also bring about increases in demand in other communities and Provinces. Second, debt financing will, in the absence of access to the money supply, require the sale of bonds which are likely to be purchased not only by residents of the region where expansion is desired but also elsewhere in society. The regional community will be burdened with considerable external debt requiring, in later years, the transfer of resources outside the community.

Thus stabilization policy would appear to be a candidate for a central government where there will be a minimization of leakages, internalization of debt and access to the money supply. Canadian Provinces are not all small and there has emerged recently a conflict between Ottawa and some Provinces over the performance of the national stabilization policy.[6] The Federal government, it is alleged, has not considered the particular needs of specific regions when executing its fiscal policies. Ottawa, however, has

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5 See for example, Oates, W., "The Theory of Public Finance in a Federal System", *The Canadian Journal of Economics*, February 1968.

6 1971 Ontario Budget, "New Directions in Economic Policy Management", *Budget Paper A*, Toronto. It has also been alleged that the Federal government's pre-occupation with national objectives has damaged the economy of Quebec. See P. Fréchette, "L'economie de la Confédération: un point de vue québecois", *Canadian Public Policy*, Autumn 1977.

dramatically increased its fiscal expansionary policies directed at specific regions in recent years.[7] As a result of the controversy some Provinces, notably Ontario, have undertaken to conduct their own counter-cyclical budget policy on the ground that Ottawa's policies have conflicted with the goals of the Province.

The distribution branch of the public sector is charged with changing the market-determined distribution of income according to the preferences of the society. A more egalitarian distribution would call for taxing the rich more than the poor or subsidizing the poor directly. Suppose there exists an economy of many regional jurisdictions and as many 'public sectors'. Each community may have its own idea of what redistribution of income it desires and attempt to achieve this through an appropriate tax-subsidy scheme. One problem with regionally-determined income distribution is that, if public goods are equally available to all, low-income people may move to a high tax-expenditure area if the latter's tax is based on income or wealth. If, however, the amount available for redistribution is roughly equal across regions, the method of redistribution can then be decided on a regional basis which may more correctly reflect a consensus than will a national policy.[8]

Which level of government should provide specific public goods and services? In a sense, this has been considered in connection with the issue of how the demands for certain public goods may be considered in terms of the geographical or collective extent of the benefits. Of equal importance, however, is whether or not the structure of a particular federation implies minimum levels of public services across the country. If this is the situation then, regardless of the geographical dispersion of the administration, the central government will be the overall architect. Until very recently, Ottawa has held the view that a large array of services should be provided at a similar level of quality across Canada. If the area of public service provision is not clearly defined in the Constitution, all the ingredients for intergovernmental conflict exist. From the discussion below, it will be seen that the stage for this kind of conflict was established in Canada in the 19th century when the British North America Act was enacted and Canada was accorded Dominion status.

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[7] See pages 28 to 30 below for a discussion of regional expansion policies.

[8] In Canada, the political philosophies of governments at the Provincial level range from socialism to conservatism. Precise regulation as to the *methods* of income distribution inevitably lead to conflict in such a situation.

A final argument for decentralization, and a powerful one in this age of the expanding public sector, is the more direct link between expenditures and tax prices (or costs). The proposed introduction of a new local service can be better evaluated if the cost can be expressed in terms of additional taxes in that community. At any time, it is extremely difficult for individuals to evaluate the benefits of public goods. This difficulty is accentuated if the cost of these goods is remote from local residents.

Federalism and Redistribution

The discussion so far has been centred on the three basic objectives of the public sector: economic stability, the provision of public goods and the interpersonal redistribution of income and wealth. In addition to these objectives, a collection of jurisdictions in a federal system may be concerned about redistribution *among member governments* and pursue policies to achieve such an objective.

The fact that one or more regions has a smaller tax base, for example because of the distribution of fertile land or other natural resources, may concern all regions of a country. Instead of redistribution to those who live in less wealthy areas, the preference may be to redistribute to governments in the less wealthy areas. Redistribution of this kind was never intended when the British North America Act was drafted, but it soon became evident that to keep the country together such intergovernmental redistribution was necessary. It is of such importance that a separate section of this essay is devoted to the subject.

Redistribution of this nature can be achieved through three types of transfers. First, there may be a transfer of funds from rich to poor areas by means of unconditional central government grants to the governments of the poorer Provinces. These grants may be based upon the particular need of the recipient areas or their capacity to generate their own public revenues. The main criticism of such a scheme is that recipient governments may simply reduce their own taxes. There is nothing wrong with this if their tax effort (the ratio of tax collections to the revenue base) is excessively high. If it is not, then there is a reallocation of the private-public goods mix. One may argue that this may be the desired state for a region and that it can therefore hardly be considered an inappropriate policy. It may occur even if interpersonal redistribution replaces intergovernmental redistribution.

An alternative approach is to ensure that there is a minimum level of essential services in each Province without any one Province having to impose a tax burden that is excessive. This seems a reasonable objective, but implementation requires that there be agreement on just what the essential services are and what is the minimum requirement. It also begs the question as to what is an excessive tax burden. Provided these problems can be solved, implementation of this scheme calls for specific purpose or conditional grants to certain Provinces from the central government.

A third redistributive approach is to have the central government apply the principle of horizontal equity to all citizens in all Provinces, regardless of tax and expenditure packages in each. Different families or individuals will experience different tax burdens and expenditure benefits, resulting in different 'fiscal residues' - the net result of the tax and expenditure package. According to the proponents of this scheme, equity is achieved from a fiscal point of view only when the fiscal residues are equal for *similarly situated individuals*. In effect, this concept requires that any individual, regardless of where he chooses to live in the federal country, should be subject to the same overall fiscal treatment. If there are differences in fiscal capacity among Provinces, then persons in a low fiscal capacity area will have to bear greater Provincial tax burdens for a given level of public goods than similarly placed persons in rich Provinces. The problem is resolved by having the central government impose a tax transfer scheme to ensure that the net benefits of comparable persons are equal. The scheme may be conceptually attractive but in reality its operation would be rather difficult.

Summary

A political scientist has defined a federation as:

> ' ... a microcosm of the international world: it has its own internal balance of power, its alliances and its axes, none the less real for being informal, its diplomacy and its diplomats.'[9]

The political scientist is concerned with power and the development of legislation while the economist usually concentrates more on resource allocation, the distribution of income and economic stabilization. The two approaches are not mutually exclusive. Power has to do with the level of economic control that is available, while knowledge of legislative arrangements is necessary before theories of intergovernmental co-operation can be put into practice.

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9 Lower, A.R., "Theories of Canadian Federalism", *Evaluating Canadian Federalism*, Duke University Press, Durham, 1958.

Just as political scientists have found good reasons for federalism as a compromise between the extremes of centralization and pure local autonomy, so has the economist. Differences do, of course, emerge in the sense that the economist is concerned not with what underlies certain arrangements so much as how they can be used to achieve economic and social goals. What neither the economist nor political scientist can tell us at this time is the precise structure that a federal system should have in order to achieve the goals of the whole society, both as one group and as a collection of smaller groups.

The central government of any federation requires certain taxation rights and expenditure powers to achieve its basic goals. If one region does not like the arrangements, it may be able to opt out and will try to do so if it feels that its own aims and objectives are being thwarted by its membership of the federation. The degree of central government interference and hence of potential conflict with regional goals will depend upon the geographical dispersion of the member jurisdictions and the extent of the public sector's involvement in the economy. The conflict is obvious. The larger the sphere of centralism, the greater the opportunity to internalize spillovers, achieve economies of scale and redistribute wealth in a broad sense. Extensive centralism means a reduction in local autonomy and less scope for the achievement of local aspirations. Furthermore, the more rigid the constitution governing the spheres of activity for each level of government, the more intensified the conflicts become. A classic economic problem of this kind is the one involving constitutional rights and the energy crisis, a phenomenon that is testing the bonds of Confederation in Canada.

Canada is not characterized by any single economic theory of federalism. Instead, there are elements of a variety of theories, some of which have evolved over the decades as economic circumstances have changed while others still have their roots in the original British North America Act of 1867. More than anything else, the economic dimensions of Canada are measured by the vast regional disparities that exist throughout the country. The extent of these disparities and their origin must be understood in order to appreciate the conflict in the Confederation.

III REGIONAL DISPARITIES AND NATIONAL POLICY

> 'Differences in both the levels of economic and social well-being and in economic opportunity among the various regions and provinces of Canada are large, and have persisted with only a modest change for over 40 years. This persistence has been remarkable: neither strong economic growth nor the strains and turbulence of depression and war have had lasting effects on the basic pattern of regional disparities. There is little reason to suppose that the historical mix of market forces and public policy is likely to lead in good time to a significant reduction in these disparities.'[10]

An understanding of Canadian Confederation requires knowledge of the regional aspects of the Canadian economy. There is ample evidence to suggest that much of the political economy practised in Canada has a strong regional economic bias! For the reader who is not familiar with the geographical aspects of Canada's economy, it is important to sense the regional diversity of Canada. This section provides a brief outline of the extent of the economic and demographic diversity and the impact of policy on the regions of Canada.

One could fill pages with economic and population statistics that describe the regional diversity of Canada and still be criticized for leaving something out. In the discussion which follows, a great deal of information is omitted and only a few basic statistics are presented as necessary for the analysis of the political economy of Canadian federalism. The data in Table 1 are intended to give the reader sufficient information to appreciate the analysis which follows.

Canada is generally perceived to be composed of five regions: the Province of British Columbia; the three Prairie Provinces (Alberta, Saskatchewan, and Manitoba); the Province of Ontario; the Province of Quebec; and the Atlantic Provinces (Nova Scotia, Prince Edward Island, New Brunswick and Newfoundland). One may quarrel with this division but, because it has a long-standing tradition both in terms of how Canadians view Canada and in terms of economic policy, it is a reasonable disaggregation. The reason for quarrelling with a regional delineation of this kind is that *within* regions there are substantial differences in terms of

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10 Economic Council of Canada, *Fifth Annual Review*, Ottawa, 1968, p. 141.

Table 1

MEASURES OF REGIONAL DISPARITIES IN CANADA

Economic/Demographic Characteristics	British Columbia		Prairie Provinces		Ontario		Quebec		Atlantic Provinces	
	1960	1974	1960	1974	1960	1974	1960	1974	1960	1974
Per Capita Personal Income ($)	1,909	5,608	1,593	4,990	1,951	5,713	1,443	4,634	1,064	3,646
Value of Retail Trade as Percentage of Total Canada (%)	10	12	19	17	39	37	24	27	8	8
Total Private Gross Investment ($m)	895	4,511	1,907	6,472	2,856	11,816	2,007	7,398	597	2,685
Labour Force as Percentage of Total Canada (%)	8.9	10.8	17.4	16.2	37.1	38.3	28.1	26.6	8.6	8.0
Unemployment Rate (%)	8.5	6.2	4.2	3.5	5.4	4.4	9.1	6.6	10.7	8.5
Index of Per Capita Earned Income (Canada = 1.00)	1.14	1.09	.83	.84	1.23	1.17	.91	.92	.57	.64
Manufacturing Output as Percentage of Total Canada (%)	8.2	9.0	8.4	8.2	49.5	52.5	30.0	26.1	3.9	4.0
Population as Percentage of Total Canada (%)	9.0	10.7	17.4	16.2	34.2	36.1	28.8	27.3	10.4	9.5

Source: Statistics Canada, *National Income and Expenditure Accounts* (annual); Department of Finance, *Economic Review* (annual).

wealth and incomes, population and resources. This is especially true in the case of Alberta, where the explosive increase of oil prices has pushed the per capita income in that Province considerably above that of Manitoba and Saskatchewan. Agriculture is important, but oil wealth dominates everything else at the present time. More will be said in this connection later, when the impact of the oil crisis on Federal-Provincial fiscal relations is discussed.

The data presented in Table 1 are limited but they do point to one important conclusion: the very different levels of per capita income and output across Canada and the variation in the unemployment rate across the country. It must be borne in mind that the per capita income figures *include* Federal transfer payments. A more meaningful measure of the regional differences is per capita earned income by region. In terms of the type of economic activity in the regions, every region has some manufacturing, agriculture and other natural resource employment activity. There are, however, predominant characteristics in each region. Ontario, for example, with 38 per cent of the labour force produces more than half the country's manufactured output while the Prairies, with 16 per cent of the labour force, produce only 8 per cent of manufactured output. On the other hand, a very high percentage of total agricultural output is produced by the western Provinces.

Differences among regions with respect to the predominant economic activity or the mix of activities does, of course, explain the variability in economic activity, total income and unemployment. It may even help to explain long-run differences in per capita income. It is less than satisfactory as an explanation for the chronic or secular differences in levels of unemployment across Canada, as shown in the Table 2 and Figure 1. It is the persistence of high unemployment rates in the Atlantic Provinces and Quebec that has resulted in the increased attention by Ottawa to regional expansionary policies.

Table 2

REGIONAL UNEMPLOYMENT RATES IN CANADA

	1954	1964	1976	1954-76 Average
Canada	4.6	4.7	7.1	5.2
British Columbia	5.2	5.3	8.6	6.3
Prairie Provinces	2.5	3.1	4.1	3.6
Ontario	3.8	3.2	6.2	4.2
Quebec	5.9	6.4	8.7	6.8
Atlantic Provinces	6.6	7.8	11.0	8.2
Standard Deviation of Regional Rates	1.65	2.10	2.86	1.98

Source: Statistics Canada, *The Labour Force*.

These data suggest that, over time, there has not been a movement of people from the chronically high to the low unemployment regions. Otherwise, there should have been some reduction in the dispersion of unemployment rates from the average. There has been migration, but most of it appears to have involved the young, higher educated and perhaps more enterprising individuals of the high unemployment areas. This type of migration is not likely to lead to a narrowing of unemployment rates or a reduction in income differentials.

Although the fortunes (and misfortunes) of the regions of Canada are in part due to changes in technology, resource needs and industrial patterns, national policies affecting the flow of trade within and beyond Canada have had a considerable bearing on regional activity.

Canadian tariff policy in the past did much to shape the economic base of the regions of Canada by determining, to a large extent, interregional and international trade. A complete evaluation of the emergence of tariff policy is beyond the scope of this paper.[11] Fundamentally, the tariff was designed to ensure that Canadian manufactured goods would find a market in Canada in the face of increased competition from Britain and the U.S.A. This meant that all regions of Canada paid more for manufactured goods than would otherwise have been the case, including the agriculturally rich Prairie Provinces. To pacify the objections to high-priced farm machinery, very low freight rates for shipments of grain out of the west were legislated. However, they were not matched by low return rates. Compromises were the order of the day but the small cosmetic alterations to satisfy one group or another did little to alter the basic structure. Consequently, manufacturing developed in Ontario and south-western Quebec while the tariff established the need for an east-west transportation system.

In addition to making the Prairies pay more for their manufactured goods, the tariff restricted the development of an export industry in British Columbia. Canada's protective tariff policy pre-dates the 20th century and, although tariffs have declined in the period after World War II, much of the present industrial structure was determined by the earlier policy. Interprovincial conflict over tariff policy and transportation rates high-lighted much of the policy debates up to the 1930s, to the extent that at times there were serious threats of secession by one

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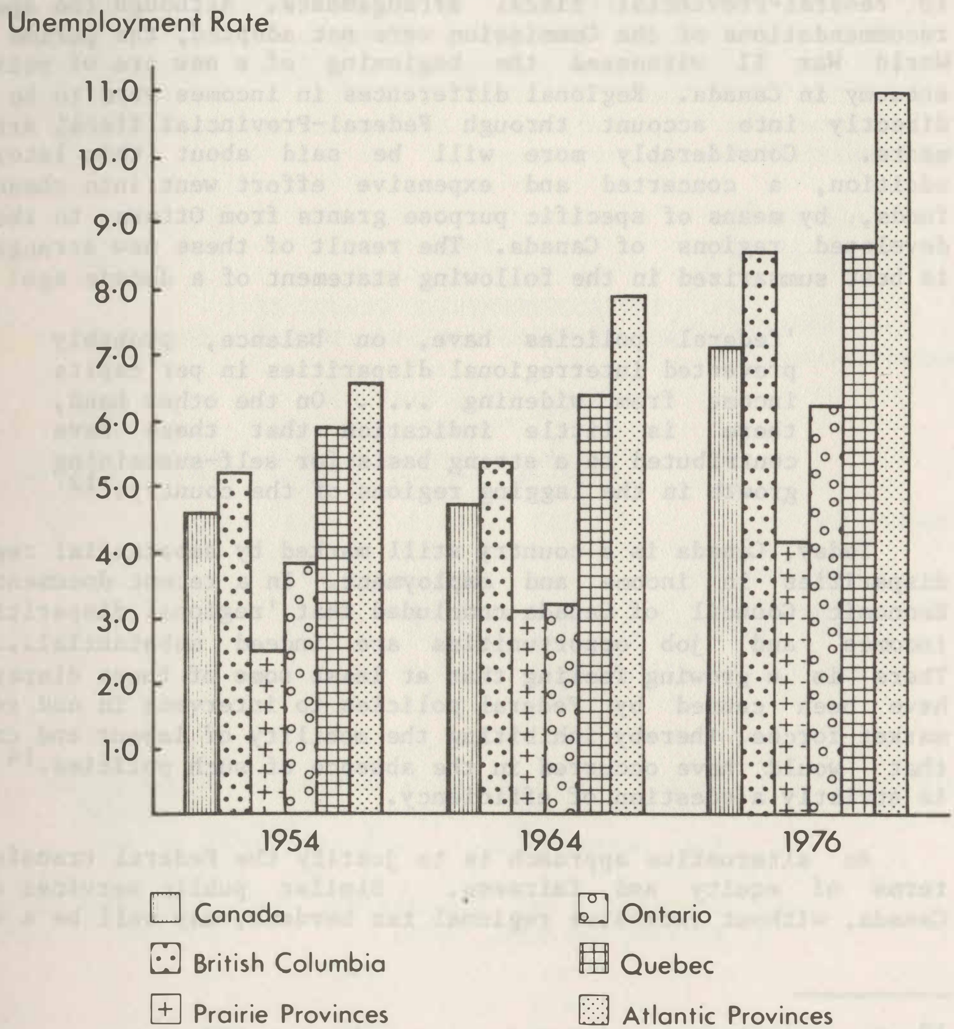
11 For a detailed discussion of the development of tariff policy in a federal-provincial context, see W.A. Mackintosh, *The Economic Background of Dominion-Provincial Relations*, Appendix III, Rowell-Sirois Report, Ottawa, 1939.

Figure 1

REGIONAL UNEMPLOYMENT RATES IN CANADA
1954–1976



Source: Statistics Canada, The Labour Force.

region or another. The conflict took on a different dimension in the period after World War II. Furthermore, the development of particular natural resources introduced a new element of regional economic development into Canada.

All regions of Canada suffered during the 1930-39 Depression, but the problem in some areas was more severe than others. The regional impact of the Depression led to the establishment of the Rowell-Sirois Commission, which in 1940 recommended sweeping changes in Federal-Provincial fiscal arrangements. Although the specific recommendations of the Commission were not adopted, the period after World War II witnessed the beginning of a new era of political economy in Canada. Regional differences in incomes were to be taken directly into account through Federal-Provincial fiscal arrangements. Considerably more will be said about this later. In addition, a concerted and expensive effort went into channeling funds, by means of specific purpose grants from Ottawa, to the less developed regions of Canada. The result of these new arrangements is best summarized in the following statement of a decade ago:

> 'federal policies have, on balance, probably prevented interregional disparities in per capita income from widening ... . On the other hand, there is little indication that these have contributed to a strong basis for self-sustaining growth in the lagging regions of the country.'[12]

Today, Canada is a country still marked by substantial regional disparities in income and employment. In a recent document, the Economic Council of Canada concluded that 'regional disparities in incomes and job opportunities are indeed substantial....'.[13] There is a growing feeling that at least some of these disparities have been caused by Federal policies to intervene in and replace market forces, thereby inhibiting the mobility of labour and capital that would have occurred in the absence of such policies.[14] That is strictly a question of efficiency.

An alternative approach is to justify the Federal transfers in terms of equity and fairness. Similar public services across Canada, without excessive regional tax burdens, may well be a viable

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12 Economic Council of Canada, *op. cit.*, p. 177.

13 Economic Council of Canada, *Living Together: A Study of Regional Disparities*, Ottawa, 1977.

14 Courchene, T., *The Transfer System and Regional Disparities*, University of Western Ontario (mimeo), 1978.

nation-building objective even at the cost of some efficiency. If so, such an objective calls for intergovernmental transfers of both a conditional and unconditional nature. Equal opportunity of employment for those living in a given region involves regional economic stimulus. Although designed with good intentions, the complicated and expensive array of federal transfer payments has been a source of conflict for more than three decades.

IV FEDERAL-PROVINCIAL TRANSFERS AND THE CONFLICT BETWEEN NATION AND PROVINCE BUILDING

Equalizing Tax Capacity

Perhaps no other federal country in the world has been characterized in the past decade by such large transfers of funds between levels of government. Although this discussion is confined to Federal-Provincial aspects of Canadian federalism, it should be noted that local governments depend to a large extent on Provincial Treasuries for their finances. Table 3 and Figure 2 clearly illustrate the rapid expansion in Provincial-local grants compared to Federal-Provincial transfers.

Table 3

INTERGOVERNMENTAL GRANTS AS A
PERCENTAGE OF GROSS NATIONAL/DOMESTIC PRODUCT

Per cent

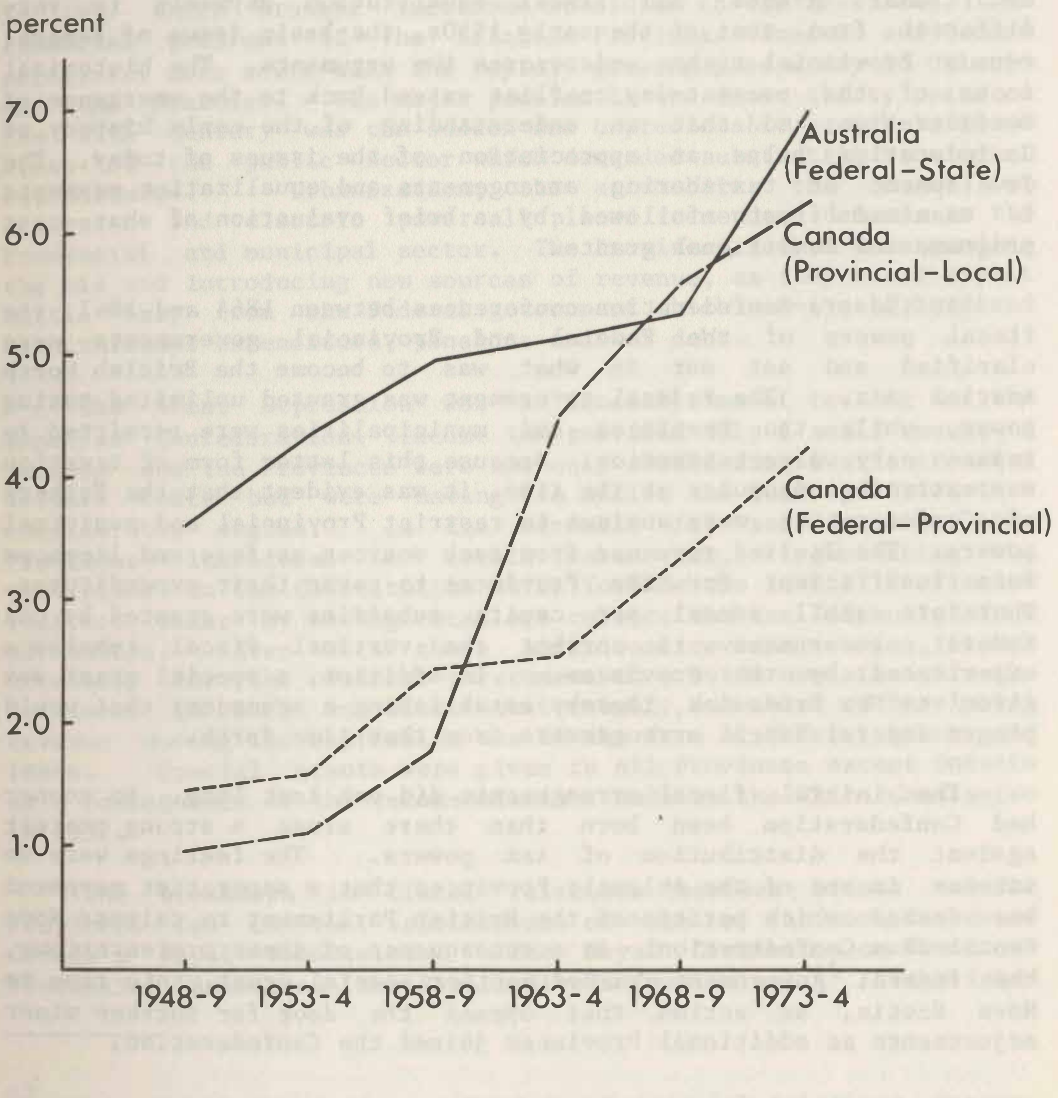
	1948-9	1953-4	1958-9	1963-4	1968-9	1973-4
Australia(1)	3.6	4.3	4.8	5.1	5.3	6.9
Canada(2)						
(Federal-Provincial)	1.4	1.6	2.4	2.5	3.3	4.2
(Provincial-local)	0.9	1.1	1.7	4.5	5.6	6.2

Sources: (1) Centre for Research on Federal Financial Relations, *Responsibility Sharing in a Federal System*, R.L. Mathews (ed.), Canberra, 1975, p. 44.

(2) Canadian Tax Foundation, *The National Finances, 1977-8*, Toronto, 1978.

Figure 2

INTERGOVERNMENTAL GRANTS AS A PERCENTAGE OF GROSS NATIONAL EXPENDITURE



Since the early 1950s, the Federal government and the Provinces have assembled every five years to work out an arrangement with respect to the allocation of equalization payments and other grants from Ottawa to the Provinces. Government representation at these meetings is at the highest level: the Prime Minister, Premiers and Ministers of Finance. In addition, intergovernmental meetings of other ministers are held from time to time to agree on the operation of a myriad of share-cost programs. It is at these meetings that the conflicts between the Federal government and the Provinces often emerge.

Although the conflict that exists today over tax sharing, conditional grants and fiscal equalization payments is very different from that of the early 1950s, the basic issue of Federal versus Provincial rights underscores the arguments. The historical roots of the present-day conflict extend back to the emergence of Confederation, so that an understanding of the early history of Confederation helps an appreciation of the issues of today. The development of tax-sharing arrangements and equalization payments is examined first, followed by a brief evaluation of share-cost programs and conditional grants.

At the pre-Confederation conferences between 1864 and 1867, the fiscal powers of the Federal and Provincial governments were clarified and set out in what was to become the British North America Act. The Federal government was granted unlimited taxing power, while the Provinces and municipalities were permitted to impose only direct taxation. Because this latter form of taxation was extremely unpopular at the time, it was evident that the Fathers of Confederation were anxious to restrict Provincial and municipal powers. The limited revenues from such sources as fees and licences were insufficient for the Provinces to cover their expenditures. Therefore small annual per capita subsidies were granted by the Federal government to correct the vertical fiscal imbalance experienced by the Provinces. In addition, a special grant was given to New Brunswick, thereby establishing a precedent that would plague federal fiscal arrangements from that time forth.

The initial fiscal arrangements did not last long. No sooner had Confederation been born than there arose a strong protest against the distribution of tax powers. The feelings were so intense in one of the Atlantic Provinces that a separatist movement was formed which petitioned the British Parliament to release Nova Scotia from Confederation. As a consequence of these protestations, the Federal government awarded another special grant, this time to Nova Scotia, an action that opened the door for further minor adjustments as additional Provinces joined the Confederation.

Adjustments to the original financial arrangements were insufficient to balance Provincial budgets, and during the last two decades of the 19th century the Provinces sought new sources of revenue. British Columbia and Prince Edward Island introduced income taxes, Ontario a succession duty and Quebec taxes on business enterprises. The revenues from these sources were not substantial, but the door to direct taxation by the Provinces was opened and provided the basis for much conflict between the Federal and Provincial governments in the future.

With the return to more prosperous times, a new so-called 'final rearrangement' of federal financial matters was undertaken in 1907 which brought increased subsidies to the Provinces. The financial problems of the Atlantic Provinces remained and became relatively more acute with the rapidly growing prosperity in Ontario and the Prairies. The major problem in the first thirty years of the 20th century was the sudden and unpredictable growth in those areas of the public sector which demanded substantial Provincial expenditures. Urbanization, the automobile, the demand for education and electric power all placed tremendous demands on the Provincial and municipal sector. The Provinces looked to expanding the old and introducing new sources of revenue, as they could expect little help from the Federal government which was itself burdened with railways expenditure, pensions and war debt.

The Great Depression was a crucial time of testing for the Canadian Confederation. Income tax provided only a small amount of revenue and the Provinces were not only shouldering ever-increasing welfare costs but were having to assist the municipalities to a considerable degree. In the scramble for more revenue, some Provinces introduced a retail sales tax, circumventing the provisions in the Constitution which forbade the levy of Provincial indirect taxes by having retailers collect the tax 'directly' from purchasers. Even with these additional revenue sources, it was necessary for the Federal government to provide assistance to the Provinces to such an extent that roughly one-third of Provincial revenue during the Depression was in the form of Federal grants and loans. Special grants were given to all Provinces except Ontario as a consequence of the recommendations made by the White Commission in 1932.

The breakdown in fiscal relations between Ottawa and the Provinces led to the appointment of one of the more famous of Canada's Royal Commissions: The Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission).[15] Established

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15 *The Royal Commission on Dominion-Provincial Relations*, Ottawa, 1939.

in 1937, the Commission was directed to examine the whole structure of fiscal federalism in Canada and to recommend a tax-expenditure structure that would allow the responsibilities of the Federal and Provincial governments to be executed in a rational and efficient manner.

The major recommendations of the Commission, in its Report published in 1940, are summarized below:

1. The Federal government should absorb existing Provincial debt.

2. Personal and corporate income taxes should become the exclusive right of the Federal government.

3. Unemployment relief should be a Federal matter.

4. General social welfare programs should be the responsibility of the Provinces, with no joint occupancy and no share-cost programs or conditional grants.

5. The Federal government should make annual national adjustment grants to the Provinces in lieu of the per capita subsidies paid since 1867. The grants would ensure that each Province had sufficient funds to supply an average level of public services. In effect, the Commission was suggesting an equalization scheme, albeit without a very rigorous formula.

The philosophy behind the new grant proposal was that each Province, if it so desired, should be able to provide government services to its population equivalent to some average standard without having to impose taxation beyond an average level of severity. This required a definition of the average standard of service and of a tax rate that was not excessive.

The Commission's recommendations were presented to a Federal-Provincial conference in 1941, but little action was taken because of the pressing problem of financing World War II. In short, the Commission's proposals were shelved and further negotiations between Ottawa and the Provinces had to wait until the end of the war.

Under the Wartime Tax Agreements inaugurated during the second year of World War II, complete control of the personal and corporate income taxes, as well as of inheritance taxes, was assigned to the Federal government. The Provinces were compensated for 'renting' these tax fields to Ottawa through a variety of grants and subsidies that also included certain 'floors' below which revenues would not be allowed to fall. The agreement was to be re-examined at the end of World War II, since the Federal government, at least in 1941, had no desire to maintain exclusive control over these three tax areas indefinitely.

The attempt by the Federal and Provincial governments to secure a mutually satisfactory fiscal arrangement following World War II could well be the subject of an entire book. Before a compromise was reached in 1947, there were a number of proposals and counter-proposals, none of which were acceptable to all nine governments. The Federal government's post-war position in 1945 was clearly centralist, as indicated by: (a) its proposal to enter Provincial social welfare areas through share-cost programs and (b) its desire to remain in all income tax fields. In return for surrendering the direct taxes to Ottawa, the Provinces would be given per capita grants, adjusted by the annual rate of growth in Canada's gross national product (GNP). There was no proposal for the adoption of the Rowell-Sirois Commission's idea of national adjustment grants from Ottawa, but Ontario's proposal did make this point. In addition, Ontario wished to return to the pre-World War II situation and to levy income taxes. Since Ottawa did not share this view-point, a new Federal proposal was made including: (a) higher per capita payments; and (b) a Provincial inheritance tax. This was not accepted by the Provinces and the stalemate continued.

The Federal budget of 1946 presented two options to the Provinces: rental of the income tax fields or the collection of income taxes by Ottawa for any Province up to an amount composed of (i) 5 per cent of the corporation income tax, (ii) 5 per cent of the personal income tax and (iii) 50 per cent of the amount the Federal government collected in succession duties. At first this scheme seemed likely to succeed, but it also collapsed when it became known that Ottawa had made a special concession to British Columbia.

An alternative scheme was introduced in 1947 which provided several options for the Provinces, one of which again involved a share of the income taxes collected in each Province. All but Ontario and Quebec entered into an agreement with Ottawa under one of the options. The abstaining Provinces imposed their own corporate and inheritance taxes. Quebec also imposed its own personal income tax, while Ontario enacted its own personal income tax law but did not put it into effect. By now, all governments had come to realize that, within the context of Canadian fiscal federalism, there would be no 'final' settlement, and consequently agreements or arrangements were limited to five years.

A conference was convened in 1950 to discuss, among other things, the tax-sharing or tax rental arrangements for the 1952-57 period. At the outset, the Prime Minister (Mr. St. Laurent) made it clear that because of the Korean War and the question of national defence, the Federal government would remain in the direct tax field. The Federal government proposed a new tax arrangement for the Provinces to consider and also made suggestions for Federal-Provincial co-operation in the area of old age pensions. The new tax arrangement proposed was similar to the 1947-52 agreement, although some changes were made in the method of calculating the tax rental payments. Basically, the Provinces wanted increased revenues, but the Federal government remained firm except to agree that payments be made by reference to population and GNP growth in the previous year, not the average of the three previous years. This substantially increased the payments for 1952 and 1953.

Negotiations for the 1957-62 fiscal arrangements began early with a meeting in April 1955. Dissatisfaction with the 1952-57 arrangements was based on a number of factors, such as Quebec's independent action in levying a personal income tax, the high cost of financing Provincial expenditures and the need to assist less wealthy Provinces. The proposals put forward by the Prime Minister in late 1955 made provision for the following:

(a) unconditional payments which would bring the tax yield in each Province up to the yield of the two wealthiest Provinces when a standard tax rate was imposed;

(b) payment of the foregoing equalization grants regardless of whether or not a Province rented its income taxes;

(c) stabilization payments or guaranteed minimum payments to Provinces regardless of general economic conditions.

The precise agreement in 1956 provided for the Provinces to share the three standard taxes as follows: personal income tax, 10 per cent of the Federal tax; corporation profits tax, 9 per cent of corporate profits; succession duties, 50 per cent of the Federal tax. These were on the basis of existing 1956 Federal tax rates and hence would not be affected by Federal decisions to alter tax rates or structures. Tax sharing thus became the only arrangement for solving conflict in the direct tax field. Ontario and Quebec did not enter the tax rental scheme and instead collected their own taxes. The equalization payment was formally calculated as follows:

X_A, X_B, ... = revenue for Province A, B ... from the application of the 'standard' tax rental scheme to that Province.

N_A, N_B, ... = number of persons in Province A, B ...

If Provinces B and D were the wealthiest as defined by the per capita standard taxes (X_B/N_B and X_D/N_D), then the per capita grant to Province A was equal to $[(X_B + X_D)/(N_B + N_D)] - [X_A/N_A]$.

No sooner had the agreement been adopted than a new Federal government was elected and announced its intention to modify the

1957-62 arrangements. Following a series of meetings and consultations, the Federal government agreed to raise the Provincial share of personal income tax from 10 to 13 per cent of the Federal tax and to pay additional lump sum annual grants to the Atlantic Provinces (which raised Prince Edward Island's revenue by 28 per cent and Nova Scotia's by 12 per cent).

Each period or era of Federal-Provincial fiscal relations seems to have become more and more complex, and 1962-67 was no exception. Discussions were not confined to a single meeting prior to the expiration of the five-year period, and the establishment of a Federal-Provincial Continuing Committee was testimony to the dynamic nature of Canadian fiscal federalism. In July 1960, a conference was held at which the various Provincial Premiers expressed their feelings about the financial arrangements. The growth, in terms of subject areas and total expenditure, of share-cost and conditional grant programs was especially criticized. Premier Lesage of Quebec, a newcomer to these meetings, wanted Ottawa to withdraw these programs and compensate the Provinces with more independent tax flexibility. It was becoming apparent that the aspirations of at least one Province did not parallel the objectives of the Federal government. Nation building and province building did not coincide. The stage had thus been set for what would later become a massive 'opting out' formula for Provinces desiring no Federal involvement in a number of areas.

In February 1961, Ottawa proposed to reduce taxes in the income tax fields and to allow the Provinces to impose their own taxes which, if the Provinces desired, the Federal government would collect at no charge. The reduction in personal income taxes levied by Ottawa would allow the Provincial share of this tax to reach 20 per cent of the total by 1966. Thus, if a Province decided to impose a rate of 20 per cent based on the Federal rate schedules, the effect in terms of the existing 1957-62 agreement would be a 20 per cent abatement of Federal tax in the Province. Federal corporate taxes would be reduced by nine percentage points to allow Provincial tax room in this area as well. The Provinces could tax more or less than the amounts given up by Ottawa.

The major change in the equalization formula was to include a portion of Provincial revenue from natural resources in the standard tax base. This was to overcome an inequity whereby resource-rich provinces were eligible to receive equalization payments, although a major source of their revenue was from oil royalties, licences, etc. and not the standard income taxes. The averaging procedure was also to be adjusted to use the national average of all ten Provinces and not the two wealthiest Provinces as the benchmark for making grants.

As in 1958, the Federal election of 1963 upset the 1962-67 fiscal arrangements. The basic changes were as follows:

1. Equalization payments were to be based on the two wealthiest Provinces, not the national average.

2. The Federal government was to increase its abatement of estate tax to 75 per cent.

3. There was to be increased abatement of Federal personal income tax to 24 per cent by 1966 instead of 20 per cent.

4. Provinces were to be given the choice of 'opting out' of share-cost and conditional grant programs, receiving additional personal income tax abatements for doing so. The provisions for doing so were outlined in the famous Bill C-142 which was passed in April 1965. Quebec took full opportunity of this option, receiving an additional abatement of 23 per cent of personal income tax.

5. A Federal-Provincial Tax Structure Committee was appointed to study the whole range of Federal-Provincial financial problems.

One of the major changes in the 1967-72 financial arrangements between Ottawa and the Provinces was the expansion of the base for calculating equalization payments. Until 1966, the base included the three standard taxes plus the revenues from natural resource levies and royalites. The 1967-72 arrangements expanded this to 16 revenue sources in an attempt to arrive at a more reasonable concept of tax capacity. In addition, the Provinces were granted four additional percentage points as far as personal income tax abatement was concerned and one more point on the corporate tax.

The 1972-77 arrangements negotiated in 1971 contained no significant changes as far as equalization payments were concerned. Conflict was, nevertheless, evident. Alberta and Ontario combined to seek the right to opt out of certain share-cost programs in the same way that Quebec had been given the right to exchange share-cost programs for additional tax points. The Federal government refused. The personal income tax abatement was, however, raised from 28 to 30.5 per cent. The equalization formula was unchanged although three additional taxes were added to the tax base.

The emergence of the oil crisis in 1973 and the resulting escalation in energy prices had a profound impact on equalization payments because royalties from energy sources were one of the 20 revenue sources in the equalization formula. Although there is no intention to examine the technical details of this arrangement, the impact of the oil crisis can perhaps be better appreciated if the reader knows something of the method used to calculate these payments.[16] For each of the different revenue sources, the grant

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16 See Breton, A., "The Federal-Provincial Dimensions of the 1973-4 Energy Crisis", *The Political Economy of Federalism*, W. Oates (ed.), D.C. Heath, Lexington, 1978.

to a Province is calculated as follows:

$$G_j^i = T^i \left[\frac{N_j}{N} - \frac{B_j^i}{B^i}\right]$$

where G_j^i is the grant to the jth Province with respect to the ith revenue source; N_j is Province j's population; B_j^i is the value of the ith revenue base in Province j; N is the total population of the Provinces and B^i the total value of the ith revenue base. T^i is the total revenue from the revenue source B^i. Basically, a Province receives a grant if its share of a revenue base is less than its share of population. If its share of the revenue base is equal to or exceeds its share of the population, the grant is zero.

The escalation in oil prices resulted in Alberta receiving an enormous increase in royalties. The impact on total equalization payments with respect to this revenue source would have forced Ottawa to increase its payments substantially to all other Provinces, including Ontario. Therefore it was decided that, for the 1974-77 period, equalization with respect to energy royalties would be discounted by 66 per cent.

The formula governing resource revenue equalization was a major concern in drafting the 1977-82 fiscal arrangements. Most Provinces wanted as large a transfer from Ottawa as possible, a view which was not shared by Ottawa. The agreed compromise was to divide resources into renewable and non-renewable. Revenue from the latter was to be equalized at a 50 per cent discount, while in the case of renewable resources full equalization was to take place. But equalization payments in respect of all resource revenues were not to exceed one-third of total equalization payments. Although unanimity is virtually impossible among all eleven governments with respect to the quinquennial agreements, the short duration of any change is usually a key factor in promoting a general consensus. Each Province is aware that it can regularly voice any complaint and seek a redress of any inequity that a change in the arrangements might impose.

Conditional Grants and Share-Cost Programs

The third major element in the fiscal arrangements between the Federal government and the Provinces is the joint responsibility for certain expenditure areas. Conditional grants emerged after World War I and soon became a regular item on the agenda of Federal-Provincial conferences.

Conditional grant payments rose sharply in 1932, when the devastating impact of the Depression forced the Federal government to supply funds to the Provinces for welfare relief. These payments, along with pensions for the elderly and blind, continued to increase. In 1938 they accounted for three-quarters of the total Federal payments to the Provinces, which then exceeded $100 million. The advent of World War II brought about a full utilization of the work force and relief payments fell substantially.

On 6 August 1945, the Conference on Reconstruction was convened. Here, in the famous 'Green Book' proposals the Federal government proposed a substantial realignment of Federal-Provincial finances, including two major share-cost programs. One was an old age pension scheme, the other a health insurance plan. The proposals, which were in sharp contrast to the Rowell-Sirois recommendation for functional separation of expenditures, were not acceptable to the Provinces and a new fiscal arrangement was initiated in the 1946 Federal budget with the social welfare share-cost programs omitted.

Despite some opposition from the Provinces, there slowly emerged a wide variety of conditional grants and share-cost programs in the immediate post-war years. By 1948, there were nine programs in the area of health, and during the 1950s programs for highway construction, welfare grants and hospital insurance were inaugurated. More programs were added to the list in the 1960s, so that by 1970 there were ten major areas of public expenditure involving conditional and share-cost programs in Canada. The absolute growth in these programs and their relative importance for total Provincial spending are illustrated in Table 4.

By 1970, it was obvious that the escalating cost of share-cost programs was becoming a burden on the Federal Treasury. Thus negotiations with the Provinces were directed toward a new arrangement that would limit costs. It was proposed to index the payments to the rate of growth of gross national expenditure (GNE). Other suggestions involved the cancellation of certain share-cost agreements in exchange for more Provincial room in the income tax areas. Although it is impossible to describe the conflicts between Ottawa and the Provinces (and among Provinces) in detail, the general nature of the debate is captured in the comments below.

The Federal government was justifiably concerned about the cost of these programs, because it had roughly to match dollar for dollar on the basic and most expensive programs: hospital insurance, medicare and post secondary education. In addition, however, it was concerned that the per capita level of spending on these programs varied across Canada and took the view that the less wealthy Provinces could not afford to participate fully in these programs. This was a rather weak argument because (a) costs differed across the country and (b) the fiscal equalization payments or unconditional grants gave the Provinces a capacity to spend equal to the national average.

Table 4

FEDERAL CONDITIONAL GRANTS - SELECTED YEARS 1946-1975

Year	Amount	As a Percentage of Provincial Revenue	As a Percentage of Federal Expenditure
	$m	%	%
1946	49.5	6.9	1.7
1950	115.7††	9.4	4.9
1954	77.3	4.6	1.7
1958	145.2	5.5	2.3
1962	594.9	13.4	7.9
1966	1,117.7	15.1	11.5
1968	1,455.4	14.1	11.8
1975	4,197.9	14.0	11.8
1976	4,919.5	14.4	12.7

†† Special relief for Winnipeg Floods and Rimouski Fire, Quebec.

Source: Carter, G., *Canadian Conditional Grants since World War II*, Canadian Tax Foundation, 1971; and Canadian Tax Foundation, *National Finances*, 1977-8.

The Provinces have always welcomed Federal money but they have argued that share-cost programs have several drawbacks, notably the direction of public funds into share-cost areas which may not be of highest priority for a Province. This occurs because not all public spending in, say, health care is part of the share-cost program. There is excessive bureaucracy associated with joint-administered programs and delays in settling accounts. The problem of uncertainty is also of concern. Since financial agreements are restricted to five years (which is beneficial in some senses), Ottawa can decide periodically to discontinue support of a particular program. If a Province commits itself to a new program to take advantage of financial assistance through a share-cost arrangement, it may take two or three years before the program is operating in an efficient and desirable manner. To have the program cancelled shortly after its inception is not an encouraging prospect and it inhibits long-range planning.

There is, in addition to these specific arguments, the broader question of income redistribution as it pertains to conditional grants. The Canada Assistance Plan, which is more or less the broad umbrella under which the welfare programs of Ottawa are gathered, has a strong element of cost sharing. Thus, not only the magnitude but the nature of much redistribution is governed by this Plan. This is very much in keeping with the orthodox theory that, in a federal state, redistribution is the job of the central government.

In a federation like Canada, however, this may not be the most appropriate position to take. Provincial governments are not comparable to local councils and, indeed, not politically comparable to U.S. State governments. The political spectrum in Canada at the Provincial level is very wide, ranging from socialism to conservatism. To attempt to impose a single welfare system on a complex political structure such as that of the Canadian Provinces is openly to invite conflict. Even if Canadians were in general agreement about how much they wished to redistribute, there would surely be differences as to the means of redistribution.

Proposals and counter-proposals circulated between the Provinces and the Federal government between 1970 and 1975. Basically, Ottawa wanted control over the types of programs and limits on the cost, while the Provinces wanted more flexibility in the use of Federal funds and guarantees (especially for less wealthy Provinces) that the long-term level of transfers would not fall below a certain minimum.

A compromise was finally achieved late in 1976, whereby: (a) the Provinces were to be given more access to the personal income tax field; (b) Ottawa's cash payments with respect to the whole health area were to be tied to the growth in gross national product; and (c) there was to be a legislated commitment to a 'national standard' with respect to these share-cost programs (now called established programs).

There are no clear winners or losers once a new five-year fiscal arrangements act is passed, unless weights are attached to each of the objectives of the central and Provincial governments. Clearly this is not possible. The 1977-82 arrangements were almost six years in the making and no one would be bold enough to suggest that they will remain intact for 1982-87. Political and social circumstances change and, in conjunction with rapidly changing economic circumstances, Confederation must be flexible enough to accommodate these changes.

The Federal conditional grant has been one of the more powerful instruments for nation building. Ottawa's access to all sources of taxation gave it the power to gather more revenue than it needed, then direct it to the Provinces with or without conditions. Provincial reluctance to levy direct taxes became less of a constraint and, in conjunction with the introduction of indirect taxes, the Provinces found that they could use their fiscal power to achieve their own economic objectives. In spite of the increased fiscal power of the Provinces, we shall see in the next section that the Federal government still possesses fiscal instruments that give it considerable power.

V ECONOMIC INSTRUMENTS FOR NATION AND PROVINCE BUILDING

It should be evident, even to a non-Canadian reader, that Canadian federalism has never been a solid, stable constitutional arrangement. With the exception of the two World Wars of the 20th century, nation building and province building have been locked in a struggle and economic issues have played a major role in this struggle.

Ottawa is naturally the centre of nation building. What economic instruments have been available to the Federal government and how has their use changed in recent years? How has the nation-building objective interfered with province building? What economic instruments of province building are available? How powerful are these instruments? Do they conflict with nation building? Is there any common ground between the two objectives? These are some of the questions to be discussed (but not necessarily answered) in this section. There are political and judicial instruments that have been exercised to achieve national and Provincial goals, but a discussion of these is beyond the scope of this essay.

The major economic instruments which can be exercised exclusively by the Federal government are the tariff, the money supply and foreign exchange reserve management. In the earlier discussion concerning the regional dimensions of Canadian federalism, the tariff emerged as a focus for conflict in Confederation. It is a powerful tool, having the leverage to make or break industrial and resource sectors and thus exert a substantial impact on various regions of the country. From the point of view of national policies, the tariff can be used to achieve such broadly defined goals as maximum employment, minimum costs or highest level of national income. Given an economic structure for the country, there is an optimal tariff to achieve any one of these national goals.

National objectives of this kind are free of any normative, distributional concerns. If maximum employment is the long-run objective for the country and a tariff is set in accordance with this goal, any short-run costs to particular regions or industries must be accepted as part of the means to achieve the particular end. This is precisely why national tariff policies have, for decades, inflamed some Provincial governments; there is no single tariff policy that will maximize both national goals and Provincial objectives.

The issue was recently stated succinctly in the following manner:

> ' ... the Atlantic and western provinces feel strongly that they have paid continuously for the industrialization of Central Canada ... it [free trade] would lessen the discrimination against Atlantic and Western Canada that is perceived in the protection afforded central Canadian industries ... '17

Monetary policy, which can influence the level of aggregate demand in the economy, is the responsibility of the Bank of Canada, an exclusive Federal agency. Basically, the Bank is charged with ensuring that monetary policy is conducted to achieve price stability, full employment and balance in Canada's international balance of payments. The achievement of the first two is sought through the appropriate regulation of aggregate demand, which at first glance does not appear to interfere with Provincial goals. Beneath the surface, however, is the critical problem of timing and regional imbalance.

A 7 per cent national unemployment rate may very well call for monetary expansion. This 7 per cent rate may, however, reflect a 4 per cent figure in Alberta, 5.5 per cent in Ontario and 11 per cent in the Atlantic Provinces. Since monetary policies such as open market operations do not discriminate regionally, there is a proportionately greater impact in those regions where it is required least.

Manipulation of the foreign exchange reserves to achieve a long-run balance of payments may be a worthy national goal, but from the viewpoint of province building it may be very unsatisfactory. For example, allowing the Canadian dollar to appreciate as a means of offsetting a surplus in the balance of payments will probably cause some reduction in exports and consequently unemployment in export-oriented regions of the country.

The other set of economic instruments that can be used to achieve broad national goals can best be described in the composite term: fiscal policy. The Federal government influences economic activity with virtually every form of tax and changes in rates and exemptions provide considerable flexibility for achieving a variety of policy targets. Expenditures can be used in a similar manner. Unlike monetary policy, fiscal policy can, at least on the

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17 Economic Council of Canada, *Looking Forward: A New Trade Strategy for Canada*, Ottawa, 1975.

expenditure side, discriminate regionally, thus providing more economic expansion in high employment regions than in low ones. However, broad tax changes receive the same criticism as monetary policy and exchange rate policy for their insensitivity to regional disparities.

Provincial governments are not able to exercise monetary or tariff policies unilaterally, but they do have considerable fiscal flexibility which can be directed toward regional economic goals. In recent years, several Provinces have adopted the position that the 'blunt' edge of Federal fiscal policy is not entirely appropriate for their economy. If fine tuning is to be done, it is better to do it at the Provincial level.[18] Although it is rather difficult for a Province or region directly to offset national tariff or exchange rate policies, demand management policies (fiscal or monetary) can be countered or reinforced at the Provincial or regional level. One writer has in fact argued that national fiscal policies have been directed at maximizing the economic growth of Canada and that Provinces such as Quebec have suffered. This argument has been challenged by reference to the massive regional redistribution schemes carried out by the Federal government.[19] It is here that fiscal policy has been used in a very selective manner. Through the Federal Department of Regional Economic Expansion (DREE), Ottawa has pumped hundreds of millions of dollars into the less wealthy areas of Canada (in addition to equalization payments). The DREE grants are made to the private sector to encourage the development of new industry in depressed regions. They are also directed to public capital formation (such as roads and sewage disposal facilities) so as to enhance the efficiency of private production. These policies and subsequent expenditures have met with only modest success, according to several studies.[20]

It is certainly true that the Federal government has used its exclusive and not so exclusive economic instruments to achieve national goals. Furthermore, it is true that these objectives have interfered with Provincial aspirations and have given rise to inter-jurisdictional conflicts. However, one would have to reject the idea that Canada has been developed at the Federal level by policies

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18 For a discusion of this issue and additional references see Auld, D.A.L., "Toward a Theory of Fiscal Decentralization", in *Canada at the Crossroads*, Fraser Institute, Vancouver, 1978.

19 Shoyama, T.K., "Comment", *Canadian Public Policy*, Autumn, 1977.

20 Woodward, R., "The Effectiveness of DREE's New Location Subsidies", *Canadian Public Policy*, Spring, 1975.

that are limited only to nation building. Although it was noted earlier that geographical-oriented redistribution schemes have not closed the income gap between economic regions in Canada, attempts have been made to do just that through the channelling of funds into the less wealthy areas of the country. Table 5 gives some indication of the magnitude of these transfers and their geographical distribution. Over the six-year period 1970-75,

Table 5

DEPARTMENT OF REGIONAL ECONOMIC EXPANSION GRANTS 1970-75

	Atlantic Provinces	Quebec	Ontario	Prairie Provinces	British Columbia	Total
All grants ($m)	714	523	97	190	33	1,559
Percentage of total (%)	46	34	6	12	2	100
Annual grants as proportion of Provincial income (%)	2.08	.04	.00	.00	.00	1.10

more than $1.2 billion has been directed to Quebec and the Atlantic Provinces from the Federal Treasury. In addition to the massive expenditure to encourage private development in these regions, large sums in the form of equalization payments have been made to the poorer Provinces. If anything these payments, and others like them, have *retarded* national economic growth because the funds for these transfers have been drawn from the high productivity, high income and faster growing regions of the country.[21]

Nation building is a term that is more easily digested than province building and yet it is obvious that province building is an important fact of politics in many parts of Canada. Quebec is, of course, the most outstanding example of province building. Here the objective is simple: to maintain a unique Francophone culture

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21 This argument was advanced sometime ago by Scott, A.D., "A Note on Grants in Federal Countries", *Economica*, November 1950.

in North America. In other parts of the country, province building may take a similar but less pronounced course, or it may involve protection for particular industries or simply the maximization of per capita income in the Province. Provinces may wish to design their own social security systems in terms of both the extent to which they wish to redistribute income and the persons to whom the redistribution should be directed. There is some evidence that this may have taken place in the Province of Ontario.[22]

Can Provinces achieve their own cultural, social and economic goals? What instruments, both legislative and economic do they possess? At this juncture, we will consider only economic tools. Canadian Provinces probably possess greater tax leverage than any other non-federal jurisdictions in the federations of the world. Personal income, corporate income and sales taxation vary among Provinces in accordance with the wishes of the electorate in each Province. In the tax field, there are certain constraints or limitations on the extent of the differences among Provinces, both in terms of tax collection (the Federal government is willing to collect the tax on behalf of the Province in the case of income taxation) and the effect that large tax differentials have on the mobility of capital and labour.

Provinces do have the fiscal power to try and influence aggregate demand in their own areas and such power has been used. There are some doubts about the effectiveness of such policies, but there are situations in which they are likely to meet with modest success. More will be said about this particular problem later. Provinces can encourage industrial location through tax holidays and other geographic-specific financial incentives. They have the power to establish marketing boards and thus regulate the output and price of products. Since local governments are the responsibility of the Provinces, there is also considerable scope for Provincial governments to influence the direction, size and structure of urban centres.

Province building, as the above examples show, is possible. The major constraints on Provincial activity stem from their lack of control over the money supply, their inability to influence directly foreign trade, and the constitutional provisions which regulate interprovincial activity. Without these exclusive powers and the ability to carry out national fiscal policy, Canada would not even qualify as a free trade area.

On the surface, it would appear that the Provinces' most powerful economic instrument for province building is the

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22 Gillespie, I., "An Examination of Tax Burden Changes in Ontario", *Canadian Tax Journal*, Vol. XIX, No. 4, 1971.

constitutionally delineated ownership of national resources. Section 109 of the British North America Act makes this fact clear. However, the Constitution gives the Federal government the power to regulate and control the transportation of resources both within and without Canada. This regulation encompasses both quantity and price jurisdiction.

Thus a Province can decide which resources to develop and how fast to deplete the resources, subject to a Federal constraint. Although Federal-Provincial conflict has existed for a considerable period of time, it was forcefully and dramatically consolidated with the emergence of the energy crisis in 1973. Suddenly there were rich and poor Provinces on a scale hitherto unknown. Nation building began to be directed toward a reasonable redistribution of energy wealth; province building was directed toward the long-term assurance of Provincial wealth.

The Federal government's position was that, in the past, Canada shared its wealth through various intergovernmental schemes and such sharing should continue. The Prime Minister's statement in 1974 is particularly clear:

> 'Would it be reasonable for a province to receive continuing revenues which would give it the capacity to spend, in proportion to its population, three or four times as much as other provinces?'[23]

The broad tax power of the Federal government was therefore used to place an export tax on Western Canadian oil, the proceeds being used to subsidize the oil imports of Eastern Canada so that the price of oil was roughly constant across Canada. WesternCanada vehemently opposed this approach, contending that it would stifle Provincial aspirations, development and growth. Fossil fuels were very much limited in supply and the wealth derived from them would be required to construct an industrial infrastructure that would have a longer time horizon.

Nation building and province building were thus locked in a bitter struggle over the sharing of the wealth created by the energy crisis. The conflict over resources had always existed, but since 1973 the dimensions have expanded considerably.

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23 Trudeau, P.E., *Statement at Federal-Provincial Conference*, January 1974.

VI CONFEDERATION: A FINANCIAL BALANCE SHEET?

At this critical juncture in the evolution of Canadian history, the conflicts of the past have been either resurrected or underscored by the debate on the future of Confederation. Not surprisingly, the question is being asked: is Confederation worth the price? There are those who despise debating Confederation in economic terms, but to ignore this element of fiscal federalism is to reject reality and hide in a tower of ignorance. Conversely, those who would decide the fate of Canada in terms of an economic balance sheet are grossly underestimating the passion of many Canadians.

Nevertheless, there is some reasonable middle ground to be explored, if only to put into perspective the balance sheet conflict between some Provinces and the Federal government. Interregional transfers, equalization payments and employment subsidies to particular areas of Canada have already been discussed. However, the 'balance sheet battle' goes beyond those programs because it involves the geographical redistributive effect of the *entire* Federal budget. For any given region the question then is how much does Ottawa take out in the form of taxes and levies and how much does it put back.

One reason for the emerging conflict over this issue is the wide discrepancy between Quebec's calculation and Ottawa's calculation of the net impact of Federal government activity on the Province of Quebec. The results differ because of the method used to make the calculation, the underlying assumptions and the definition of just what is a Federal budgetary transaction.

It is the intensity of the present conflict that has given rise to such studies not only by Quebec but also by Ontario, Alberta and the Atlantic Provinces. Other Provinces have obviously done their calculations as well. In addition, independent studies of a balance sheet approach to Confederation are now beginning to emerge. It is not the intent here to review in detail all the studies that have been made of this financial book-keeping of Confederation. However, some discussion of this issue is necessary in order to understand all the dimensions of the present conflict. First of all, does it really matter what the redistribution impact of the non-transfer portion of the Federal budget really is? From an economic policy viewpoint it does, because there are two possibly conflicting objectives of such expenditures. When taxes are drawn from the private sector, the demand for private goods and the employment to produce them declines. Expenditure of these tax proceeds is used to supply public goods and provide new employment for those industries or services that produce public goods. In addition, governments would obviously like to provide these goods and services in an efficient and least-cost manner. If $500 million in taxes are drawn from region A and public employment in region A is valued at $300 million, there is a reduction in the total labour value of demand in region A. In region B, tax proceeds might be $800 million while public employment is valued at $1,000 million; this obviously creates additional labour demand in region B. With perfect labour mobility at zero cost, this interregional redistribution does not matter and will be *beneficial* to both regions A and B *if* allocation of the $1,300 million for public goods provision minimizes costs.

But labour is not freely mobile and there arises the possibility of considerable resentment on the part of the regional government in A towards the central government.

This example highlights the two different approaches to the financial balance of a federation. If one examines the value of the goods and cash transfers received by a region from the central government, and compares that with taxes paid to the central government, that is a *net benefits* approach. The other approach is the *cash flow* method of financial accounting. In this instance, one compares the central government's purchase of factors of production in a region (plus any transfers to the region) with taxes paid to the central government. The results can be startlingly different.

In terms of employment creation, the cash flow approach is the critical one. Even here we find conflicting estimates, due to the method of allocating indirect taxes or the treatment of Crown corporations in terms of their losses, profits or assets. The message is quite clear: the gaps in the data and the sets of reasonable assumptions about the distribution of benefits and costs are so broad that any numbers purporting to demonstrate the precise cost of federalism must be scrutinized carefully. The overall direction of the net impact of federalism is likely to be considerably more appropriate than any specific numbers:

> 'in the Canadian federation, regional disparities are precisely one of the major sources of tension and conflict. In a country like Canada the main objective of one level of government - the federal government - is the promotion of equality of opportunities for all. The existence and persistence of interregional inequalities of all kinds and, in particular, income and unemployment disparities, becomes unacceptable to the citizens of the low-income regions, whatever the cause of these differences.'[24]

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24 Lacroix, R., 'The Regions and Unemployment', *Conference on the Future of Canadian Confederation*, Toronto, October, 1977.

If the Federal budget, without intergovernmental transfers being considered, does lead to a redistribution in terms of job creation, it is important to know at least the direction of this redistribution. Regional disparities are clearly a cause for conflict in Confederation and, if the passive impact of the Federal budget contributes to disparities, then specific transfers may be doing little more than making up the balance. A plus or minus on a balance sheet should not be the decisive factor in deciding the future of Confederation. However, it should give policy makers a better understanding of the sources of conflict and avenues to explore to reduce political tensions.

VII CONCLUSION

Canadian Confederation is today at the crossroads and the directions for the future are not, at the moment, well marked. It is not an overstatement to say that the great uncertainty surrounding the outcome of the Quebec referendum on separation is crucial to the future of Canada and to a realignment of fiscal powers and responsibilities. It would nevertheless be incorrect to assign to the Quebec situation all blame for the present apprehension regarding the future of Canadian federalism. The general economic climate, regional disparities in energy resources and use, and major political changes in Provincial governments have also been contributing factors. Although oversimplified, there exists a feeling at the regional Provincial level that Federal-Provincial relations must change to guarantee more regional input into Federal decision making and less Federal involvement in areas deemed to be almost exclusively the purview of Provincial governments.

Both the Federal government and the official Opposition Party have recently responded to this challenge by publishing proposals for redrafting the Canadian Constitution. The proposals differ in several respects but, as far as broad fiscal matters are concerned, they do attempt to incorporate regional representation into several Federal agencies such as the Canadian Transportation Commission and the Wheat Board. Whether or not such changes will be accepted by Provincial governments will depend largely on how the broad principles in these documents are translated into detailed programs. However, it is likely that each Province will ask 'how does the change affect this Province?' and base its response on benefit-cost calculations at the margin. Consensus is unlikely in this context, because in the past the Federal government has been able to exert leverage through reallocations of an ever-increasing economic pie in such a way that all may gain. This is no longer possible and it will require considerable political skill and patience to design a new fiscal structure in which not all the participants can achieve a majority of their objectives.

Failure to reach an accord on a new fiscal structure will signal a return to the preoccupation by politicians with details concerning amendments to the present structure and institutions. The existing framework must be significantly altered if the potential of all parts of Canada is to be realized.

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