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Squeezing Gaps Shut:

Responsible Reforms to Federal-Provincial Fiscal Relations

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In this issue...
Continuing battles between Ottawa and the provinces over spending responsibility and taxing authority highlight Canada's need to rebalance the finances of the federation. One route to reform: tax relief from Ottawa, in the form of lower personal taxes and a lower GST. For their part, the provinces would have room to tax smarter — and would be more accountable for their spending.

The Study in Brief

Under the fiscal pressure of rapidly growing health and social program costs, most provincial governments in recent years have pushed for increased financial support from Canada's federal government. The common provincial complaint — gaps or imbalances between Ottawa's large revenues and the provinces' large spending needs.

The gap is real, in that Canadians pay to the federal government sufficient taxes to finance more than $40 billion dollars in annual cash transfers to provincial governments. This gap in revenue, or overlap in spending, generates and sustains confusion over who is responsible for funding and delivering needed public services. The overlap makes it difficult for citizens to identify which government is responsible when social program delivery falls short of voters' expectations — expectations fuelled by voters' natural tendency to link the taxes they pay to the services they see delivered.

Political stress on the federation would be reduced, and political accountability for public service delivery increased, if Canadians paid more of their taxes to the level of government that spends them on delivering the services voters want and need.

How to better balance taxing and spending? This study evaluates several options and concludes that the best choice involves federal personal tax relief and a lower Goods and Services Tax (GST) rate, creating room for provinces to raise the taxes of their choosing, by as much or as little as their voters desire, to suit regional preferences and spending needs. Given the high marginal effective tax rates on investment in Canada, the authors argue that reform at the provincial level should entail a shift to consumption-based, value-added taxes (VATs), and away from retail sales taxes.

Specifically, the study sets out a scenario in which Ottawa would lower personal income tax rates by three percentage points, and reduce the GST to 5 percent, for $24 billion dollars in annual federal tax relief. Ottawa would simultaneously reduce cash transfers to the provinces. Provinces should seize the opportunity to opportunistically reform their tax bases. The reform aspect is important: reducing the federal GST only to charge higher retail sales taxes in the provinces that have them would be economically foolhardy. However, a lower federal GST could be the tonic that prompts provincial holdouts to adopt their own GST-compatible VATs.

Ottawa would retain its role in addressing horizontal equity concerns by providing core social-program financing to provinces, with the equalization program continuing to ensure a common level of provincial capacity to finance such programs.

Under this approach, regional tastes gain more influence over how, and how much, provinces tax and spend. And with the overall tax mix becoming economically smarter, Canadians' capacity to build their incomes and wealth would fare all the better.

The Author of This Issue

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Amid wrenching changes to Canada's federal-provincial fiscal arrangements, public debate continues over two thorny issues. The first is the federal government's proper role in reconciling differences in provinces' revenue and spending capacities; the second is the influence that the federal government's spending power gives to Ottawa when it comes to steering policy — and resources — in areas of provincial responsibility.

The recent proliferation of provincial commissions, special parliamentary committees, and calls for a Royal Commission on the finances of the federation suggests that the case for reform is settled — the question is what sort. This *Commentary* recommends closing the much-debated fiscal gaps, or imbalances, through changes to federal and provincial tax and transfer arrangements that would see provinces adopt more responsibility for raising the revenue that underpins spending programs within their jurisdictions. This involves Ottawa taxing less, alongside reduced provincial cash transfers, and the provinces perhaps taxing more, continuing the process of tax and spending realignment that governments have, since WWII, occasionally found necessary to keep the federation working. The purpose of this paper is to recap the reasons why,[1] and explain the arithmetic of how the process works.

The political tension over these issues is at times extreme. Provincial leaders have used the opportunity to extract federal commitments to substantial new spending plans, with support in particular for healthcare financing. Federal politicians have seized the opportunity to extend influence over provincial policy, while satisfying voters' demands to see more of their federal tax payments sent back to their neighbourhoods. They have done so in the form of rapidly expanding cash grants to provinces, nominally labeled as healthcare financing.

One recent watershed event was triggered by the anger of Nova Scotia and Newfoundland and Labrador over the prospect of federal equalization transfers being reduced on a formulaic basis as provincial resource revenue increased. Such an outcome, of course, would have been exactly as prescribed by the equalization program's longstanding legislation. The federal government's response was to suspend the direct link between provincial fiscal capacity and provincial entitlements to equalization grants, leaving the provincial fiscal equalization program in existential limbo.[2] What is the equalization program intended to do and how? Ottawa has appointed an "Expert Panel on Equalization and Territorial Formula Financing," to propose answers, and that panel is scheduled to report its findings in the spring of 2006.

Meanwhile, high energy prices have been generating unexpectedly large revenue flows for Alberta's government — and unexpectedly high costs for many households and businesses — prompting envious eyes to turn toward Alberta.

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1 Drawing heavily on a series of working papers discussed at C.D. Howe Institute Policy Conference "Federal-Provincial Fiscal Reform," Toronto: June 23, 2005.

2 In fall 2004, the federal government agreed to fixed floors and fixed growth rates for equalization entitlements, effectively severing future grant entitlements from their historical links to the richness of each province's tax potential.

Fresh discussions about how best to share Alberta's energy[3] wealth prompted an unenthusiastic Ralph Klein, the province's premier, to tell the rest of the country to "keep its hands off Alberta's oil" (*The Globe and Mail* 2005).

As debate over Quebec secession reheats, attention to fiscal federalism, and fiscal balance-sheet politics, naturally grows. Yet the heat is perhaps strongest in Ontario, where residents are increasingly aware of the province's strained fiscal relationship with Ottawa. Since the province has above-average income per capita, its taxpayers finance more than their national per-capita share of federal spending. Moreover, Ottawa has shifted from spending far more than it collected over the 25 years leading up to 1995, to collecting far more than is needed to fulfill federal constitutional responsibilities. In the process, the apparent net loss to Ontario taxpayers has grown to substantial figures. The Ontario government now speaks of a "$23 billion dollar funding gap" between the province and the federal government, and has called for a commission to examine Canada's fiscal architecture, determine the source of the leak, and plug it.

The recently large federal surplus has made the dollar outflow more visible in the richer provinces, because of the gross mismatch between federal taxes paid and services and transfers received, as shown in Panel A of Table 1. On a federal balanced-budget basis, where a federal deficit represents future taxes on provincial residents and a federal surplus represents prepaid taxes (Panel B), the figure in Ontario is not as large as headlines have indicated. However, the flow has been persistently large over time, and in Alberta and Ontario has often been in the neighbourhood of $2,000 per head (Panel C).

From the point of view of "have" provinces, federal transfers do not much help matters. British Columbia, for example, receives significant federal cash transfers (see Panel D of Table 1), but when those receipts are netted against the share of federal taxes provincial residents pay in support of those transfers, the balance turns negative (Panel E). On an inflation-adjusted, per capita basis, the pattern is remarkable stable over time (Panel F).

With the improvement in federal fiscal fortunes in the past decade, the pressure has grown on Ottawa to respond with numerous, one-off solutions. These have included blanket increases in federal transfers to all provincial governments and ad hoc side-deals with individual provinces. Along the way, this approach has highlighted some of the political difficulties created by a system with overlapping and unclear responsibilities for social program spending and for imposing taxes to fund those programs. The resulting policy adventurism is not merely inequitable; the mismatch in governments' revenue raising and spending also imposes efficiency costs on the Canadian economy, depressing the standard of living that Canadians might otherwise enjoy.

A view to a resolution

Three generic resolutions to these problems would seek to put Canada's federal-provincial fiscal arrangements on a more politically sustainable foundation. The

3 For example, Courchene (2005) suggests that Alberta "voluntarily" share some of its windfall through a revenue-sharing mechanism. Hirsch (2005) recommends a resource pool among the Western provinces.

Table 1: *Fiscal Background to Fiscal Gaps*

	NFLD.	P.E.I.	NS	NB	PQ	ONT.	MAN.	SASK.	ALTA.	B.C.
A: Federal Net Lending (Federal Revenue Less Expenditure, by Province)										
					Millions of current dollars					
1981	(1,565)	(392)	(3,082)	(2,231)	(7,010)	2,635	(1,139)	(145)	4,639	311
1986	(3,143)	(610)	(4,034)	(2,562)	(8,973)	3,691	(2,543)	(3,180)	(489)	(2,950)
1991	(3,362)	(745)	(4,536)	(3,226)	(12,031)	893	(3,524)	(3,378)	(484)	(1,242)
1996	(3,132)	(588)	(4,545)	(2,920)	(8,631)	8,565	(3,292)	(2,933)	2,820	2,328
2001	(2,694)	(753)	(4,113)	(2,866)	(2,727)	26,361	(2,798)	(2,060)	8,199	2,993
2002	(2,586)	(699)	(4,173)	(2,840)	(2,798)	22,057	(3,006)	(1,764)	7,978	1,781
B: Federal Balanced Budget-Adjusted Net Lending (Revenue Less Expenditure, Adjusted for Federal Surplus/Deficit)										
					Millions of current dollars					
1981	(1,450)	(367)	(2,832)	(2,015)	(4,936)	6,494	(801)	272	6,161	1,456
1986	(2,802)	(518)	(3,302)	(1,992)	(2,737)	16,526	(1,515)	(2,306)	2,621	44
1991	(2,847)	(616)	(3,545)	(2,477)	(4,084)	16,877	(2,275)	(2,309)	3,251	3,409
1996	(2,923)	525	(4,135)	(2,590)	(5,044)	15,700	(2,753)	(2,447)	4,637	4,637
2001	(2,956)	803	(4,450)	(3,120)	(5,633)	20,086	(3,216)	(2,429)	6,511	1,288
2002	(2,692)	731	(4,385)	(2,999)	(4,651)	18,139	(3,268)	(1,993)	6,903	707
C: Per Capita Balanced Budget-Adjusted Net Lending (Revenue Less Expenditure, Adjusted for Federal Surplus/Deficit)										
					Constant (2004) dollars per capita					
1981	(4,816)	(5,652)	(6,327)	(5,451)	(1,440)	1,408	(1,477)	532	5,130	985
1986	(7,405)	(6,157)	(5,655)	(4,183)	(621)	2,666	(2,112)	(3,411)	1,641	23
1991	(6,159)	(5,942)	(4,861)	(4,166)	(725)	2,031	(2,572)	(2,888)	1,573	1,268
1996	(6,065)	(4,481)	(5,161)	(4,002)	(809)	1,646	(2,821)	(2,791)	1,941	1,391
2001	(5,887)	(6,309)	(5,137)	(4,476)	(819)	1,816	(3,006)	(2,613)	2,292	340
2002	(5,523)	(5,682)	(4,994)	(4,259)	(665)	1,596	(3,011)	(2,131)	2,359	183
Average 1981-2002	(6,399)	(5,935)	(5,376)	(4,408)	(904)	1,972	(2,409)	(2,211)	2,512	690

Table 1 continued

Table 1: *Fiscal Background to Fiscal Gaps (cont'd)*

	NFLD.	P.E.I.	NS	NB	PQ	ONT.	MAN.	SASK.	ALTA.	B.C.	TOTAL
D: Total Major Federal Cash Transfers to Provinces (Including Equalization)											
					Millions of dollars						
1991	1,270	277	1,506	1,349	8,354	5,409	1,594	1,096	1,526	1,951	25,348
1996	1,347	281	1,761	1,370	9,788	6,215	1,788	896	1,485	2,235	28,438
2001	1,408	344	1,916	1,669	9,559	5,135	1,937	738	1,323	2,373	27,659
2006	1,354	409	2,239	2,066	12,039	10,913	2,725	1,095	2,679	4,633	42,250
E: Provincial Net Benefit From Major Federal Cash Transfers (Receipts Less Provincial Share of Federal Tax Revenue)											
					Millions of dollars						
1991	985	207	893	879	2,921	(5,328)	798	373	(1,555)	(1,067)	0
1996	1,027	202	1,073	843	3,693	(5,831)	895	84	(1,972)	(1,151)	0
2001	1,097	268	1,247	1,156	3,631	(6,581)	1,068	(51)	(2,039)	920	0
2006	878	292	1,217	1,282	2,983	(6,984)	1,398	(111)	(2,457)	398	0
F: Per Capita Net Benefits From Major Federal Cash Transfers (Receipts Less Provincial Share of Federal Tax Revenue)											
					Constant (2004) dollars per capita						
1991	2,202	2,032	1,266	1,545	545	(689)	932	476	(792)	(426)	0
1996	2,099	1,766	1,350	1,309	592	(618)	931	98	(847)	(362)	0
2001	2,225	2,108	1,431	1,651	529	(604)	998	(55)	(728)	(244)	0
2006	1,636	2,021	1,247	1,639	378	(536)	1,140	(107)	(728)	(90)	0
Average 1981-2006	1,993	1,904	1,213	1,480	549	(635)	864	164	(776)	(318)	0

Source: Authors' calculations.

options are: first, increasing federal transfers to the provinces, perhaps with the transfers governed by a revised architecture; second, increasing provincial taxes; or third, decreasing federal taxes alongside increases in provincial taxes, whether or not coordinated or negotiated.

The first approach, advocated by Boadway (2004), for example, recommends a relatively centralized solution that would guard federal tax room and expand federal transfers, though in a more principled fashion than recent policies. This approach is grounded in the beliefs that national considerations are more important than provincial ones, and that governments are less self-serving than analysts sometime assume. Boadway suggests tackling the accountability and sustainability problems, such as may arise under centralized arrangements, through the creation of an arm's-length body that would advise on federal-provincial issues.[4]

The federal Department of Finance contemplates the second approach. It argues that the appropriate policy action — if action is needed at all — is for provinces to unilaterally increase their own-source revenues through higher provincial tax rates.[5] After all, goes this quite reasonable line of thought, both federal and provincial governments have unfettered access to the major sources of tax revenue — personal, corporate and sales taxes. In addition, the provinces have access to potentially lucrative natural resource royalties. Nothing in policy, nor politics, need block provinces, whose voters seek more publicly financed services, from taxing their residents to finance the services they desire.

The Seguin Commission (Government of Quebec 2002), and a recent C.D. Howe Institute Working Paper series (Dahlby, McKenzie, Poschmann, Smart 2005), among others, describe a third approach: tax realignment and reform. Tax realignment involves lowering federal taxes, while permitting or encouraging provinces to raise the taxes of their choosing to better match own-source revenues with spending responsibilities.[6] Under such an arrangement, the overall tax revenue collected in the federation would be more or less unchanged. However, all governments would have an opportunity to use the realignment process to implement reforms that made the total tax mix less damaging to the economy. What is most important, however, is that with provinces more responsible for collecting their own revenue to finance their spending, they would be in a better position to match the wants and needs of their voters with their abilities to fund them. Proponents of this view argue that spending is, thus, more accountable to voters (Oates 2005) and fiscal policy ultimately more sustainable. In fact, McKenzie (2005) believes such changes, in the face of continuing political strain, are a matter of inevitability.

The three competing approaches may seek to address the problem over the medium term, but "there can be no final solution … only adjustments and

4 Australia, for example, uses a quasi-independent Commonwealth Grants Commission to oversee federal-state fiscal arrangements.

5 Finance disputes the premise of a fiscal imbalance in the Canadian federation (see, for instance, Dion 2005, or Finance Canada 2004).

6 Formal transfers of "tax room" occurred most recently in 1967 and 1977; the latter move still figures in the calculation of the federal transfers that are nominally intended to support health and social services.

reallocations in light of changing conditions" (Wheare 1963). Furthermore, as Boadway (2004) notes, any analyst's preferred approach is influenced by the weight given to subjective factors — such as provincial autonomy versus a "nationhood" view of public services, and prior views about the ability of governments to act in benevolent ways. Hence, reasonable people can disagree on the correct policy option. This is not to say that all options are created equal; rather, that any proposed solution will be controversial to some and that with policy improvements there come drawbacks. In other words, the usual policy tradeoffs arise.

In the face of uncertainty about the weight to attach to divergent viewpoints, the way to proceed is to identify the pressing problems that hinder Ottawa and the provinces in achieving their policy goals. The major failings of current arrangements do not lie in an insufficiently national flavour for policies, or in insufficient total tax revenues being collected across the Canadian federation. Rather, the issues identified in a wealth of prior research include: poor government accountability for raising and disbursing tax revenue; federal and provincial tax designs; and tax levels that hold back Canada's growth potential (Mintz et al. 2005).

Given improved accountability and better tax design as central targets, the proposed solution must first address these problems. This *Commentary*, therefore, focuses on the implications of the tax realignment approach for reasons to be discussed in the next section. Our rationale for this approach is followed by a discussion of our proposal and its fiscal impacts.

This paper's primary conclusion is that Ottawa should initiate tax realignment and reform that would see increased revenue raising and spending responsibility seated with the provinces. In the process, the line of accountability would tighten between the governments that provide services and the regional voters who pay for them. We would see provinces collecting more revenue, yet doing a smarter job of it.

Ottawa should lower personal income tax rates as well as the Goods and Services Tax (GST) rate, and simultaneously reduce cash transfers to the provinces. Provinces should seize the opportunity to adjust their tax designs and rates as they see fit, opportunistically reforming tax bases. In particular, they should implement provincial value-added taxes set at rates that meet their revenue needs — and, in the process, become more fiscally self-sufficient. The net result will be an improved provincial capacity to finance the social programs their voters choose, given the understanding that they will be the primary financiers of those programs.

Ottawa would retain its role in addressing horizontal equity concerns by providing core social-program financing to provinces, with the equalization program continuing to ensure a common level of provincial capacity to finance such programs. Under this approach, regional tastes for taxing and spending gain more influence over how, and how much, provinces tax and spend. And with the overall tax mix becoming economically smarter, Canadians' capacity to build their incomes and wealth fares all the better.

Accountability First, Efficiency Second

The accountability imperative makes tax realignment the best approach to improving federal-provincial fiscal relations. Realignment offers the opportunity for reforms that simultaneously improve the economic functioning of Canada's tax system.

Why the accountability imperative argues against growing transfers

Accountability — the extent to which politicians and governments are held responsible for public policies and their results — is crucial to any well-functioning democracy. Accountability suffers when the policies that citizens must judge are jointly administered, or have overlapping financing. Voters cannot disentangle who is responsible for what — the so-called transparency problem. In fact, where jurisdictional overlap is high, incentives are weak for politicians to efficiently allocate and account for spending.

This is the central concern with some aspects of federal-provincial transfers. Incentives are weakened for one level of government when they spend money that is raised by another. In Canada, this description currently applies to numerous areas of public service provision — such as healthcare, education and, recently, municipal infrastructure — where federal transfers to other governments have shown hefty, if sporadic, growth in response to the political pressures of the day (Smart 2005).

Money's fungibility is one issue. Voters may say they are happy to pay higher federal taxes, provided the taxes fund provincial delivery of desired social services. Yet, the federal government cannot demonstrate that those tax revenues, in fact, fund those services (rather than some other federal activity), nor can it ensure that provinces allocate such money in the ways envisioned by federal taxpayers. This much is a matter of simple observation, insofar as dollars do not come and go with labels indicating their actual use in service provision.

The reason fungibility is a substantive policy problem is that proper accountability for a program can rest only with an agency that has the capacity to deliver the required service, the information needed to do so effectively and the ability to ensure that the desired service is in fact delivered. In the case of healthcare, none of the three criteria applies to the federal government and, so long as provinces rely to a significant degree on federal financing for health programs, the provincial level fails on at least one of the criteria (capacity). This failure of accountability is directly caused by the financing overlap, or the gap between revenues and responsibilities at the provincial level.

But if this lack of accountability is such an issue, why is it that rising transfers to provinces (and municipalities) are a feature of the recent political landscape? The starting point of the answer is Ottawa's fiscal turnaround. Since 1996/97, the federal government has moved to an annual surplus position, helped in part by a decision to restrain transfers to provinces. In response, provinces have actively and persistently lobbied for increased federal funding for social programs, because lobbying is less politically costly than increasing provincial taxes or reducing provincial spending.

The political lobbying strategy that provinces have pursued contains a built-in defence should it fail to produce improved public services. In that case, the premiers may say, healthcare delivery (for example) is unsatisfactory because it is under-funded due to federal government restraint of transfers. The apparent success of this defence short-circuits the normal lines of accountability. After all, it is tempting to argue that voters do, or should, hold provinces accountable for the quality of service delivery, irrespective of its source of finance. However, opinion polls in recent years have repeatedly shown popular support for federal taxes and spending in support of health and education, even though the quality of local service in these areas is not easily linked to the level of grants Ottawa delivers to the provinces. The federal government has next to no ability for example, to ensure that a transfer from Ottawa to Victoria improves the availability of diagnostic services in Kelowna. Because it cannot ensure that the desired local service is, in fact, delivered, the federal government becomes vulnerable to the claim that unsatisfactory delivery is the result of its insufficient funding to the province.

So why does the federal government acquiesce? The reason is not merely that Ottawa has the money and provinces do not. Rather, it is that the federal government can seek political credit for supplying incremental social program funding in response to popular regional, sectoral and demographic demands. In fact, successive election campaigns have prominently featured federal support for healthcare, the issue that almost entirely dominated the 2004 federal election.

Regional politics' intense influence over budget policy makes it extremely difficult for the federal government to commit to a fixed and immutable schedule for cash transfers. The dynamics of provincial lobbying and federal acquiescence are demonstrated in the case of the Canadian Health and Social Transfer (CHST),[7] where the dollars allocated were increased in every federal budget since the initial cuts of 1995 (Smart 2005). As Smart concludes, the federal government is unable to credibly commit to a fixed transfers schedule.

The lack of commitment's potential harm is highlighted by Boadway and Tremblay (2005), who describe optimal arrangements where low federal taxes and transfers complement relatively high provincial taxes. However, if the federal government is unable to credibly commit to the level of transfers, provinces have an incentive to compete for them. This adverse competition could show itself by way of provinces running larger and more visible deficits than their neighbours, in order to demonstrate a funding crisis and thereby increase the likelihood of getting their transfer share increased. The end result is that, relative to the social optimum, provincial taxes are too low and federal taxes and transfers are too high.

Along the way, the ability of the equalization program to properly respond to evolving economic conditions has become limited by political fixes to perceived failings. For example, Ottawa's fall 2004 federal-provincial policy initiative set the value of the equalization program's total pot at a specific base level ($10.9 billion) that will increase at a given rate (3.5 percent) each year.[8]

7 In 2004, the federal government split the CHST into separate CHT and CST components.

8 There is a glaring conceptual flaw in the steady-growth rule. The constitutional principle guiding equalization is that of equalizing provincial fiscal capacities; this means that when provincial ...

While future allocations are unspecified, on an interim basis the provincial shares will follow rolling averages of past shares and past fiscal capacities. In the past, a province's transition from below- to above-average fiscal capacity, or vice versa, would result in a corresponding change in the province's entitlement. This mechanism is to be muted in its functioning by the rolling average rule, stabilizing payments at the expense of making them less responsive to provinces' fiscal capacities.

Lastly, but not to be overlooked, analysts have argued that large-scale transfer schemes create regional dependency (Courchene 1978 being an early example, citing a host of economic ills that accompany dependency; Martin 2001 picks up the theme). The situation is most acute for the Atlantic Provinces, where federal transfers offer the cash equivalent of roughly 70 percent of provincial spending on social services (Figure 1). Hard choices about spending are less-likely outcomes when voters face little of the direct or indirect cost of making them.

The dependency argument is a variation on the theme that transfer design insulates provincial governments from the negative impacts of poor policy choices. This extends to debt policy. Martell and Smith (2004, p. 79) conclude that among US states, "debt issuance is positively related to both matching and non-matching grants," because the federal transfers loosen the budget constraint faced by states. Transfer income is much like any other source of revenue, and can be used to finance greater debt. This result appears to hold in Canada as well, where per-capita debt among the equalization-receiving provinces has averaged about double the level of other provinces over the past 15 years. The poorer provinces' average debt burden is 36 percent of GDP, while the weighted average among non-equalization-receiving provinces is 14 percent of GDP (Mintz and Poschmann 2004). Evidently, transfer policy significantly loosens the restraint on provincial borrowing that fiscally prudent decision making would usually impose.[9]

These accountability-related issues argue against increasing transfers as a remedy for federal revenue surpluses and perceived provincial revenue deficiencies. Among the two remaining policy alternatives, the choice between simply raising provincial taxes versus raising provincial taxes while simultaneously reducing federal taxes, suggests other questions for consideration, as follow.

Higher provincial taxes and economic performance

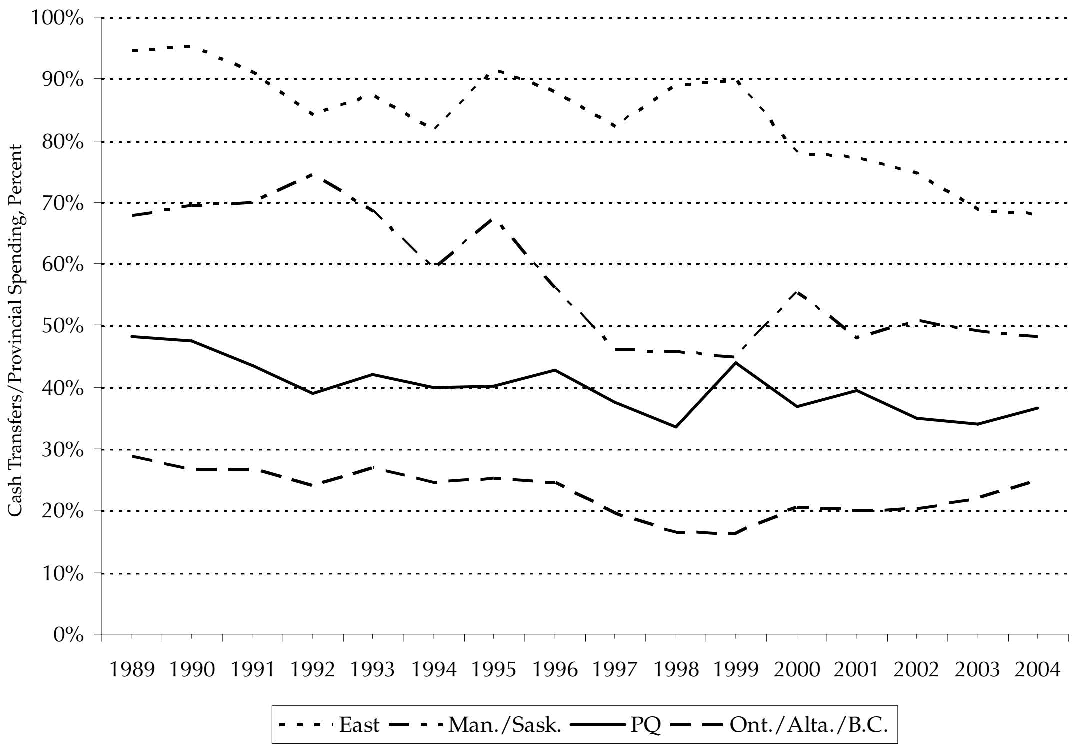
The level of taxes and how they are collected are key issues for governments as they compete to attract and retain individuals and businesses in a competitive global economy. This context makes the findings of Mintz et al. (2005) all the more

footnote 8 cont'd

incomes converge, as they have in recent years, overall entitlements should go down, not up. The growth rule potentially stands the equalization goal on its head.

9 This is why Mintz and Poschmann (2004) recommended a major adjustment to equalization's method of calculating provincial fiscal capacity, whereby debt accumulation would represent a source of fiscal capacity, and asset accumulation (or debt reduction) would constitute a lessening of fiscal capacity. For example, a province that chose to use windfall tax revenue to reduce debt, rather than fund new services, would be rewarded for doing so.

Figure 1: *Federal Cash Transfers to the Provinces in Relation to Provincial Social Spending, 1989 – 2004.*



Source: Statistics Canada, Financial Management Statistics.

noteworthy for Canadian governments: Canada has the second-highest marginal effective tax rate on investment out of the 36 OECD and leading developing countries. Among sub-jurisdictions, Ontario reports one of the very highest effective tax rates on capital investment. This is a worrisome feature for a province with a manufacturing base that depends on continuing investment in plant and equipment and the productive innovation that underpins growing wages and living standards.

The high-tax result pertains, despite the fact that the total amount of taxes collected relative to the size of Canada's economy is near the OECD average. This highlights the fact that tax structure, not simply the overall tax take, is crucial to defining the incremental burden of taxation. Design features that increase the effective tax rates on investment, as distinct from the statutory tax rate on income, include the following: first, retail sales taxes that apply to business inputs (unlike value-added taxes — VATs — such as the GST) and thereby raise the cost of doing business; second, federal and provincial capital taxes, including large corporation capital taxes and capital taxes on financial services providers; third, a taxable income definition that requires first-in versus last-in inventory accounting; and fourth, federal capital cost allowances that lag risk- and inflation-adjusted economic depreciation rates on physical capital.

Perhaps not surprisingly, there is also evidence that more efficient taxes — taxes that rely less on such distortionary tax bases as income and capital taxes, and rely more on consumption — increase a nation's economic growth potential (Kneller, Bleaney and Gemmell, 1999). Indeed, Lindert (2004) and Mintz et al. (2005) describe how many countries have recently adjusted their tax systems to enhance growth. In particular, Scandinavian countries, known to have strong safety nets, as well as the transition economies in Eastern Europe, have deemphasized capital and investment taxation in favour of consumption taxes and carefully structured personal income taxes.

These issues speak to the risk of tax rates and tax design hindering investment and growth. For the most part, these features are amenable to welfare-enhancing repairs, which do not necessarily reduce the government tax take but do involve taxing smarter. This implies tax reform, rather than a unilateral increase in provincial taxes within the status quo environment. Higher provincial taxes, without federal offsets and associated structural tax changes, would increase the overall tax burden in Canada and increase the incremental burden on personal and business activity to more harmful levels than already exist.

That said, provinces are free to make welfare enhancing tax-design choices on their own, absent any federal impetus or coordination. Numerous analysts, of course, have recommended that the provinces do so, especially those provinces that are persistently reliant on retail sales taxes and capital taxes on business. Nonetheless, the prospect of federal rate reductions and reform, accommodation or encouragement, may make such choices more politically palatable than otherwise.

Given the three generic options for repairing Canada's structural fiscal gap, and the seemingly compelling reasons for rejecting the first two, heavy expectations land on the last: tax realignment and reform that would see provinces collecting more revenue, yet doing a smarter job of it.

The Tax Realignment Proposal

Better economic performance is achievable when the level of government that has the lowest cost of raising additional tax revenue collects the additional tax, as described in Dahlby (2005). In other words, when deciding which level of government should raise taxes to fund needed spending programs, the answer depends on which level of government would inflict the least economic damage if it did so. This notion of economic damage, in turn, depends on the responsiveness of the tax base to the marginal tax rate. The more elastic, or responsive, the tax base is to the tax rate — because economic activity shifts in space or time to avoid the tax, or does not occur at all — the higher the economic cost to the jurisdiction that imposes the tax. Hence, the cost of raising additional revenue (the marginal cost of public funds) associated with a particular tax is high if incremental taxation depresses economic activity more than would alternative sources of revenue.

Therefore, an important consideration in the design of any tax realignment is that provincial tax bases are generally more mobile than federal tax bases. The primary reason for this, of course, is that economic activity moves more easily among provinces than between countries.

Among the provincial tax bases, some are more mobile than others. And of the major tax bases — personal income tax, corporate income tax and sales tax —

corporate taxes are the most mobile. The reason: multi-jurisdictional taxfilers can adjust financial activity in response to differences in tax treatments across provinces. For example, they change the physical location where revenue is recognized and where costs, such as interest payments, are claimed as deductions. Indeed, companies that can readily shift financial activity across jurisdictions are the most sensitive to regional differences in tax rates (Mintz and Smart 2004). As an example, according to two analyses discussed in Saskatchewan (2005), a 1 percent increase in the provincial statutory corporate tax rate shrinks the corporate tax base by about 1.2 percent.

As Bird and McKenzie (2001) argued, firms that use the provincial taxable income allocation formula are also sensitive to provincial tax rates. For such firms, booking sales and employment in a high-tax province raises income tax payable on income booked in that province, as well as in all provinces.[10] Moreover, plant location seems to depend crucially on the marginal effective tax rate on business investment: Beaulieu et al. (2004) shows that business taxes' impact on marginal production costs is a statistically significant determinant of manufacturing establishments' location decisions.

The potential harm from high provincial business taxes is all the greater in the international context, given the ready mobility of capital. Given the high mobility of corporate income, it is difficult to recommend that provinces should raise corporate taxes, even in concert with federal corporate rate reductions.[11] Indeed, this is consistent with Canada's fiscal history, during which provinces have shown strikingly little interest in taking up corporate tax room (Perry 1989).

One common concern about decentralized tax-rate setting is the risk of more intense tax competition, potentially leading to under-provision of public goods. However, Hale (2005) argues that fears of this race-to-the-bottom are unfounded. Despite recent tax collection agreements that afforded provinces greater tax-rate setting autonomy, Hale notes no tendency for neighbouring provinces to adopt more similar rates.[12]

There are principled reasons for unconcern on this point: regional differences in tax levels should reflect regional differences in public spending needs and voters' wants. To the extent they do so, and voters sort themselves among regions according to their tastes, there is less pressure on rates. Moreover, tax reforms are not necessarily aimed at pushing overall tax levels downward, but at taxing in less economically damaging ways. Changes that decrease taxes on business investment, for example, make a jurisdiction more hospitable to voters and their businesses, but do not necessarily imply less revenue for governments.

10 The general income allocation methodology requires firms to book taxable income in the provinces in which they operate according to a formula based on provincial employment by the firm and sales in each province.

11 Nonetheless, the federal government should pursue long-term plans to lower corporation income tax rates, for the growth-oriented reasons laid out in Mintz et al. (2005) and in prior papers.

12 It seems likely that the presence of differing rates indicates that voters sort themselves across provinces in ways that suit their own preferences for tax and spending levels and mixes, as suggested by Tiebout (1956).

Improved provincial consumption taxes

The above reasoning argues for realigning toward reliance on a less mobile tax base such as an indirect or consumption-based tax. Increased taxation on personal consumption would encourage saving and investment, and in turn encourage economic growth.

The sticking point, however, is that five provinces — British Columbia, Saskatchewan, Manitoba, Ontario and Prince Edward Island — levy retail sales taxes (RSTs) rather than VATs, such as the GST. Since they apply to many business inputs, RSTs increase production costs, raising the price of Canadian goods in the domestic market and abroad, with concomitant harm to export prospects. In particular, goods and services whose production involves significant business inputs generated in-province end up bearing a far higher sales tax burden than do imports.

The costs of RSTs are surprisingly large. Both Mintz et al. (2005) and Canada (2005) show that RSTs are big drivers of provincial and state effective tax rates on business investment, with clear implications for investment and growth patterns. In fact, about half of all provincial retail sales tax revenue is derived from the sale of business inputs (Patry and Lemay forthcoming). This poses an immediate impediment to business investment and growth, with subsequent impacts on productivity and wage growth prospects.

The economic costs of retail sales taxes are high for other reasons. Retail taxes tend to apply to a narrower base than do VATs, in the sense that that fewer goods and services are taxable under typical RSTs than under the federal GST. This narrower base requires higher rates to raise equivalent tax revenue, which is economically harmful. In addition, RSTs distort relative prices because they apply only to some goods and services as opposed to others. Furthermore, provincial RSTs increase the complexity of the tax system. They are not coordinated with the federal GST, with respect to administration or compliance mechanisms, raising business' compliance costs.

For all these reasons, reducing the federal GST only to charge higher RST rates would be economically foolhardy. However, a lower federal GST could be the tonic that prompts provincial holdouts to adopt their own GST-compatible VATs.[13]

The prospect of eliminating provincial retail sales taxes represents an opportunity for improving economic efficiency in tax design (Dahlby 2005). The advantages of such an approach are numerous. Broadening the tax base would reduce economic distortions in consumption and production. Reducing the tax bearing on business inputs would lower the marginal effective tax rate on capital investment by up to one-quarter, further reducing the economic cost of taxation (Chen and Mintz 2003). The dynamic improvement to social welfare could entail permanent efficiency gains worth about $6 billion to $10 billion annually (Dahlby 2005), based on conservative assumptions about the economic costs of the different taxes. Coordinated federal and provincial consumption tax bases and administrative apparatuses could offer further savings in compliance costs.

13 As we discuss later, the tonic would be ginned-up by a functioning equalization program, making the proposal easier to swallow.

It is not necessary for rates or bases to be entirely coordinated, while nonetheless reaping most of the economic gains associated with tax reform. What we recommend, and illustrate below, is a scenario where: the federal GST drops by 2 percentage points; the RST provinces adopt similar VATs; and all provinces (save Alberta[14]) raise their consumption tax rates by amounts sufficient to take up the revenue room vacated by the federal government. We use slightly tentative phrasing because provinces may and should consider bases that are better designed than is the GST base, which is a levied on a less-than-comprehensive tax base (excluding numerous grocery items, for instance). The GST's treatment of financial services and groceries is decidedly imperfect, and were these handled better, then provinces could fulfill their revenue needs with less distorting tax designs.

The simplest route, administratively speaking, would be for other provinces to adopt the Harmonized Sales Tax model used in Newfoundland and Labrador, Nova Scotia, and New Brunswick, whereby Ottawa and the provinces would share the stream of revenue generated by the combined tax rates and collected by the Canada Revenue Agency. However, this revenue-sharing model would make accountability for overall rate setting unclear, and that would run counter to the accountability imperative we described above.

It is therefore difficult for us to recommend that provinces precisely emulate the federal GST treatments simply because it would be administratively convenient for provinces to do so. While the administrative and compliance costs for businesses facing variations on the GST would be higher than if they faced a fully harmonized federal-provincial consumption tax base, costs would be lower than they are now with both a GST and RST. The issue that provinces must decide is whether the transition costs plus continuing administrative costs would more or less offset the economic gains on offer from adopting a better VAT system.

Repositioning the personal income tax

The federal government's largest revenue source is the personal income tax. For this reason alone, a realignment proposal for tax and spending capacity at the federal and provincial levels must contemplate the personal income tax. Given the federal government's excessive revenue collection, and the role of personal income tax in it, the change we discuss is a federal rate cut for every bracket on the rate schedule. Provinces that perceive a need for more revenue in support of their spending programs would increase their personal taxes by as much as they saw fit. In practice, their residents may prefer to leave the tax room untouched, or to see increases in other taxes whose effects are less economically damaging than income taxes. Thus, the realignment of tax and spending responsibility offers an opportunity for reform that provinces would seize as desired.

Major shifts have happened before, such as in 1976 when Ottawa ceded 9.1 percentage points of personal tax to the provinces. Demographic and social change in the years since means the cost of meeting provincial, versus federal, spending

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14 On the assumption that political opposition to a provincial sales tax in Alberta — wise or not — is so strong that the provincial government would let the potential revenue stream go untapped.

responsibilities has risen sharply relative to provincial revenues suggesting that significant shifts should be on the table again. Indeed, on numerous occasions in the past, the federal and provincial governments have agreed to sweeping change in who taxes what, and at what rate, with the changes being offset by decreases or increases in federal cash payments to provinces (see Box 1 for highlights).

We emphatically do not propose such a choreographed shift, for the choreography would serve to obscure the provinces' responsibility for raising and spending revenues in accord with voter preferences. Instead, we see federal rate relief as the first step to provinces' making clear, independent choices.

Two generic scenarios deserve discussion, each transpiring in a situation where the federal government cuts personal tax rates across the board, while tying these cuts to dollar-equivalent reductions in cash transfers to provinces. Provincial governments would then decide how to respond. In the past, the governing assumption of the tax-transfer agreements was that provinces would formally seize any rate room made available by the federal government. If they did not, revenue would decrease, because until 2000 all provinces except Quebec calculated personal tax liability as a percentage of federal income tax payable. In today's tax-on-taxable income world, where provinces set their own bracket and rate schedules, the choice is not so obvious.

In the present case, provinces with strong income statements and balance sheets will contemplate other options. One possibility is that provinces raise income tax rates by precisely enough to match the revenue forgone by the federal government; the other is that they raise marginal tax rates by the same amount that Ottawa lowers them.[15] In the latter case, provinces that have more heavily graduated tax schedules than Ottawa's, like Ontario, wind up collecting more in personal tax revenue than Ottawa gives up. In Alberta, where the provincial personal rate schedule is less geared-to-income, an equivalent percent-of-income rate increase would deliver less money to the province.[16]

Making the numbers work

First, we recap the proposals and assumptions; then we illustrate the static fiscal impacts for the federal and provincial governments of enacting the tax realignment proposal.

As noted above, political, competitive, and strategic considerations rule out significant unilateral increases in provincial taxes. As such, the first mover is the federal government. The starting place is a reduction in the federal GST rate from

15 Ontario's *Taxpayer Protection Act* poses a small political hurdle that did not exist in past rounds. The *Act* specifies that a government seeking a provincial tax increase requires either a referendum or written statement by the party in an election campaign two weeks prior to an election. The *Act* can easily be sidestepped by a majority parliament; that fact, and the possibility that it could pose an independent political obstacle to reforms that would be financially beneficial to Ontario voters, raise questions about the usefulness of such acts, either in practical or political terms.

16 Provinces should observe that there is a strong economic argument for letting overall income tax rates fall, while raising consumption taxes, rather than taking up personal tax room made available in Ottawa. The may find, however, that this would not be a politically attractive option, so we do not seriously pursue it here.

Box 1: *Previous Tax Realignments in the Canadian Federation*

1941-1946, **Wartime Tax Agreement:** The provinces refrained from levying individual and corporate taxes during the period 1941 to 1946. The federal government took up the vacated tax room and instead increased transfers to the provinces. The value of the transfers depended on the provinces' choices, with the available options being either the relevant taxes (less inheritance taxes) collected in 1940, or the net interest charges on provincial debt.

1947-1957, **Tax rental agreements:** The provinces[a] continued to "rent their tax room" to the federal government, which offered three options for compensation: a flat annual payment; or unconditional per capita grants of $15 (based on 1942 provincial populations); or unconditional per capita grants of $12.75 plus half of the annual revenue due under the Wartime Tax Agreement for 1947.

1957-1962, **Tax sharing agreements:** The federal government continued to collect the main taxes on behalf of the provinces. The provinces were offered 10 percent (later 13 percent), 9 percent and 50 percent of federal personal income tax, corporate income tax and estate tax, respectively. From 1960 onward, the federal government held out a standing offer of tax room in lieu of cash transfers, an offer mostly pursued by Quebec, whose political leadership was most defensive of provincial spending authority.

1962-1967, **Tax sharing agreements:** Federal personal income tax rates were lowered by 16 percent in 1962, and by an additional one percent each year until 1966. Ottawa decreased federal corporate tax rates by 9 percent in 1962, with the federal government instead collecting matching amounts on behalf of the provinces.

1976: **Tax point transfer:** An additional 9.1 percentage points of personal income tax room was transferred from the federal government to the provinces, representing a share of block transfers, tied grants and direct social spending previously underwritten by Ottawa.

Note: [a]Ontario did not join initially, but did so in 1952. Quebec opted out.

Sources: Perry (1989) and Perry (1997).

7 percent to 5 percent, and a dollar-equivalent cut in federal cash transfers to the provinces.

Next, provinces wishing to do so take up to 2 percentage points of value-added tax room. Provinces that are currently levying a RST adopt a value-added tax compatible with the GST (i.e. with new provincial consumption tax bases more or less equivalent to the existing GST base). Provinces might, however, take up the extra tax room by choosing broader VAT bases and lower rates, because it would economically smarter to do so. This would not affect the amount of revenue collected for the purposes of our static fiscal arithmetic. If all provinces except Alberta adopted the GST base, the average revenue-equivalent provincial VAT would be under 10 percent.

For personal income taxes, there would be a 3 percentage point reduction in each federal rate, bringing the rates down to 13, 19, 23 and 26 percent of taxable income.[17] Distinct from the sales tax case, we assume that provinces including Alberta step into the vacated room either with revenue-equivalent rate increases

17 Or 12, 18, 22 and 26 percent if current federal proposals survive as legislation.

or with equivalent statutory rate increases. The former would leave provincial fiscal balances more or less unchanged, while the latter would produce a revenue gain for Ontario (at the expense of its residents) and a revenue shortfall in Alberta, which of course might be politically tolerable in that province.

As with the consumption tax shift, the federal tax cut on personal income is matched by dollar-equivalent cuts in federal cash transfers to provinces. Which transfers should Ottawa cut? Our answer is the CHT/CST, given that the proximate source of angst over rapidly growing cash transfers and the implications for government accountability is the ad hoc escalation in these health and social transfers.

The other major cash transfer is the fiscal equalization program, which for the moment, and pending the spring 2006 recommendations of the Expert Panel, is an untied block grant program. Equalization is not much distinguishable from the CST and CHT except to the extent that its allocations are much more generous for poorer provinces. Yet suppose section 36(2) of Canada's *Constitution Act* is to be taken as at least loosely binding. It states that the federal government is committed to making equalization payments that ensure provinces have sufficient revenues to provide reasonably comparable public services at reasonable comparable tax rates. This implies a commitment to equalization grants that have a continued, strong linkage to future fiscal capacity.

As things stand, given the fixed floor and fixed growth rates currently attached to the equalization program, if recipient provinces fare well and other provinces do not, we may soon find Ottawa transferring income from have-not provinces to the haves (Courchene 2005). This would be politically unsustainable, and certainly not in the spirit of Canada's Constitution (section 36(2)). So in the exercise here, we assume the equalization grants are keyed to representative tax rates as with the status quo before 2005.[18] No doubt the future program will function differently from the past, but it seems safe to take past provincial entitlements, and their link to fiscal capacity, as roughly indicative of what will happen in future.

Hence, we assume that the equalization program functions roughly as it has in the past, and illustrate cuts in CST/CHT cash that match the federal tax room ceded. We show two scenarios — one with equal percentage cuts to provincial allotments, the other with cash payments trimmed to leave provinces with equal per capita amounts, as with federal-provincial transfer arrangements of decades past. In both cases, the cuts amount to 80 percent of CST/CHT cash.

What do the numbers reveal? Table 2 shows the transfer exercise, structured to be roughly fiscally neutral for all governments. In other words, federal tax cuts would match federal cash transfer cuts; the latter, in turn, to be offset, from the provinces' point of view, by higher provincial taxes. The calculation begins with a microsimulation of personal income tax rate changes and their hypothetical

18 This is not to suggest that the representative tax system equalization model is optimal; the program contains growth limiting flaws as discussed above and in Smart (1998). Pending serious discussion of reform options such as outlined in Mintz and Poschmann (2004), which would offer provinces strong incentives for better fiscal performance, we take the recent equalization program as indicative of the future.

Table 2: *The Fiscal Impacts of Tax Realignment and Reform Proposal, in 2005 – 06*

		NFLD.	P.E.I.	NS	NB	PQ	ONT.	MAN.	SASK.	ALTA.	B.C.	All
	Federal revenue impacts						*Millions of dollars*					
1	Three percentage points of federal persnal income tax (PIT) (Note a)	(162)	(45)	(346)	(247)	(3,122)	(6,294)	(430)	(392)	(1,858)	(1,741)	(14,636)
2	Two percentage points of GST	(131)	(33)	(238)	(189)	(1,960)	(3,515)	(287)	(279)	(1,201)	(1,179)	(9,013)
3a	Equal percentage cuts in CST/CHT cash payments	399	107	725	581	5,860	8,814	910	821	2,161	3,272	23,649
4a	Interim federal balance (3a-1-2)	105	29	141	145	778	(995)	192	149	(898)	353	0
3b	Cuts in CST/CHT cash payments with equal per capita remainders	403	108	732	586	5,917	8,728	918	839	2,113	3,304	23,649
4b	Interim federal balance (3b-1-2)	109	30	148	151	835	(1,081)	201	168	(946)	385	0
	Scenario I											
5a	Provinces take up equivalent dollars of personal income tax (Note b)	162	45	346	247	3,122	6,294	430	392	1,858	1,741	14,636
6a	Equalization associated with PIT changes	80	22	98	106	477		123	121	0	165	1,193
7a	Provinces take up equivalent dollars of GST (Note c)	131	33	238	189	1,960	3,515	287	279	0	1,179	7,812
8a	Equalization associated with GST changes	43	20	81	74	489	0	153	0	0	0	859
9a	Net provincial government gain (5a+6a+7a+8a-3b)	14	12	31	28	131	1,081	75	(47)	(255)	(219)	851
10a	Net federal government impact (4b-6a-8a)	(14)	(12)	(31)	(28)	(131)	(1,081)	(75)	47	(946)	219	(2,052)
	Scenario II											
5b	Provinces take up personal income tax rate room (Note b)	17	49	373	249	3,227	8,131	439	369	1,509	1,688	16,210
6b	Equalization associated with PIT changes	64	18	63	80	157	0	79	85	0	0	546
7b	Provinces take up equivalent dollars of GST (Note c)	131	33	238	189	1,960	3,515	287	279	0	1,179	7,812
8b	Equalization associated with GST changes	43	20	81	74	489	0	153	0	0	0	859
9b	Net provincial government gain (5b+6b+7b-3b)	10	12	23	5	(84)	2,918	39	(106)	(603)	(437)	1,777
10b	Net federal government impact	3	(8)	4	(3)	189	(1,081)	(30)	83	(946)	385	(1,404)

Notes: a Estimated as a 3 percent cut in each federal rate, given the existing 2005 tax schedule.
b Provinces adjust provincial income tax rates upward by amounts sufficient to offset dollar amounts of federal rate reductions.
c Alberta does not take up GST room, by assumption.

Sources: Author calculations, data provided by Department of Finance, and Statistics Canada's Social Policy Simulation Database and Model.

impact on federal and provincial revenues, and the same for GST revenues.[19] The sum is matched by pro rata decreases in CHST cash transfers (lines 3a and 3b), providing an interim federal balance on a province by province basis (lines 4a and 4b).

The first scenario assumes that provinces raise personal taxes precisely enough to recover the cash equivalent of the federal personal tax cut (line 5a). The second scenario assumes that they step in with equivalent marginal rate increases (line 5b), which generate more revenue for the Ontario government and less in Alberta. The next step is to estimate the impact on provincial equalization entitlements, given changes to the provinces' tax bases and rates. The process is straightforward: we converted the revenue shocks to per capita values, which establish a new standard for provincial fiscal capacity. The hypothetical increase in equalization is the per capita gap between provincial (income tax and sales) tax bases, multiplied by population, and the results appear in lines 6 and 7.

In Scenario II, although the national average tax rate becomes higher, the rate grows more slowly in Alberta. As a result, most provinces end up slightly closer to the national standard and this reduces the overall changes' impact on equalization entitlements. Scenario I seems the more likely, given that provinces may choose not to let the federal changes cause unplanned bumps in net provincial revenue.

The crucial issue for the health of provincial budgets is the net bottom line, and it should be reassuring to see numbers that are relatively small (lines 9a and 9b). The largest dollar gain is in Ontario, with a net improvement of about $1 billion, although even that is small in per capita terms ($86). Alberta shows a net loss, but that is primarily the result of our assumption that the province does not reverse a century of history and implement a provincial sales tax — which means the gains from the federal GST cut go directly to Albertan consumers rather than their government.

The federal government comes out behind by about $2 billion in Scenario I. This result obtains mainly from the assumption that equalization functions as it has in the past (irrespective of whether it should). The difference between provincial net gains and federal losses (lines 9a and 10a, or 9b versus 10b) is accounted for by net gains to individuals, in particular the just-mentioned Albertans. This hypothetical increase in equalization entitlements, while obviously a cost to the federal government, is small relative to revenue, small relative to previously planned tax reductions, and small relative to currently planned increases in CHT/CST cash transfers. It is thus a small federal price to pay in exchange for provinces accepting more political and financial responsibility for delivering social services of the quantity and quality their citizens expect.

The residual per capita payment that we assume persists under CHT/CST is not large, at $144 dollars per head in 2005/06. However, in combination with the transfer of tax room and its equalization backstop, it is clear that the federal government would continue to play its nationhood role in ensuring reasonably comparable provincial financing for social services.

19 Some estimates were prepared using Statistics Canada's Social Policy Simulation Database and Model, Release 10.2. Responsibility for the results and their interpretation lies with the authors.

Smart (2005) argues that eliminating federal CHT/CST cash funding is the uniquely stable political outcome. However, the existence of the Canada Health Act and its political symbolism likely render such an arrangement unlikely in the foreseeable future. So our recommendation moves to reduce, rather than completely eliminate, federal transfers in this domain. If, for instance, the federal government were to continue in its currently scheduled transfer increases, as under 2004's health accords, that per capita payment would double, and risks reintroducing the same degree of harm to accountability over where, and how, that money is spent. This potential risk we see as an acceptable tradeoff, given that the Canada Health Act's portability guarantee receives extraordinarily broad political support. This guarantee can be defended even with a low federal per capita cash contribution; it seems unlikely that legal mandate would be durable with zero federal financial leverage.

The biggest political gain from the large change we propose is in accountability, as taxes collected in-province, after the tax realignment, would play a significantly greater role in financing in-province social services. This is a welfare-enhancing change, as provincial residents are better able to match their wants and needs with their willingness to pay taxes in support of them (Tiebout 1956). The transfer of tax and spending room reduces the quantity of dollars that cycle through Ottawa, and that significantly reduces money's leakage across provincial borders, and therefore, the fiscal gap between federal revenue and spending in Ontario and elsewhere.

The other gains, as discussed above and in Dahlby (2005) and by other authors, are the potentially large dynamic benefits derived from taxing smarter. The main source is the growth-stimulating shift from provincial RSTs to VATs, which would involve a welfare gain, or a permanent improvement in Canadians incomes, of $6 billion to $10 billion. This implies substantial improvements to social welfare, and we regard this as the economic sweetener to a reform program that begins with improved accountability.

Conclusions

In recent years, the federal government has responded to political trauma in Canada's fiscal arrangements with ad hoc increases in cash transfers to provinces, in support of provincial social program delivery. The cash transfers have provided provincial governments with more resources, but the side-effect of the cash treatment has been continued stress over the federal role in determining how, and what, services should be delivered by the provinces, particularly in Alberta and Quebec. In addition, the growing transfers have awakened political leaders in Ontario and Alberta to the fiscal arithmetic of sending more tax revenue to Ottawa to finance those transfers. The result in these provinces is a smaller provincial share of the total revenue pie.

Given the increased pressures on Canada's federal-provincial fiscal relations, this *Commentary* looks for options for change. Of the available options, economic logic best supports a tax realignment and reform program — because this will improve public sector accountability, offer a fresh opportunity to reposition tax bases in a way that is less harmful to Canada's economic growth, and finally, offer some political durability.[20]

Significant policy reforms tend to generate tradeoffs that should not be ignored. Our approach gives provinces more control over their finances, so they will suffer less budgeting uncertainty regarding often-variable federal transfers. An increased role for provincial own-source financing of their social programs would reduce the overlap and conflict, or the imbalance of power, between the provinces and Ottawa in setting public spending priorities and financing them.

But with greater provincial autonomy comes the potential for increased horizontal inequality, because the benefits of greater economic growth — which tax reform offers — are not always shared equally across regions. Decentralization raises the risk of uncomfortable disparities among provinces in their abilities to finance comparable social services.

This concern highlights the importance of maintaining a healthy role for the equalization system, and we trust its functioning will be improved by the forthcoming recommendations of the Expert Panel. The imbalances among provincial financing capacities can be substantially redressed with a well-designed equalization program, and the more decentralized is provincial financing, the more important is fiscal equalization in meeting the federal goals listed in Canada's Constitution. A predictable, responsive equalization program can help smooth provinces' transition toward shrewder tax policy.

Perhaps the most difficult outstanding question in this policy debate is whether the political will exists, or can be found, to implement these clearly favourable changes to federal-provincial fiscal arrangements. In calling for fundamental reforms almost a decade ago, Boothe (1998) wrote, "it remains to be seen whether Ottawa has the vision and courage to transform itself." The question stands.

20 For further discussion on this point see McKenzie (2005), who surveys the recent political economy literature that emphasizes the importance of political accountability and finds that decentralizing tax authority is likely the most stable political equilibrium.

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