

# **Vertical Imbalance in the Canadian Federation**

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This version, July 2, 2010

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This is a version of a paper that previously appeared in *How Ottawa Spends, 2008-2009*, the annual review of the federal public sector edited at the School of Public Policy at Carleton University. Allan Maslove and Susan Phillips provided helpful comments, and Haizhen Mou provided research assistance. This paper benefitted from a panel discussion on fiscal federalism with Paul Boothe and Nicolas Marceau at Carleton University.

## 1. Introduction

Vertical fiscal imbalance between the provinces and the federal government, usually referred to as VFI, is an issue that resembles the proverbial phoenix. It arises again and again out of the ashes of federal-provincial competition in Canada to reassert itself as a major concern in national debates. After playing a significant role in the deliberations by the historic Rowell-Sirois Royal Commission on Dominion-Provincial Relations (1940), although not under this name, VFI was reborn four decades later as the main focus of influential studies by the Economic Council of Canada (1982). In the past few years the phoenix has arisen again in full force in current debates on intergovernmental relations. The pending renewal of intergovernmental grant agreements with the provinces in 2014 further adds to the continuing importance of the issue.

Canada is not China of course. But the balance between central and provincial governments in has long been of concern in any assessment of the state of public finances in China. Hopefully there is something to be learned by students of public finance in other countries by being exposed to the VFI issue as it plays out in a highly decentralized federal country like Canada, where the issues has been debated and studied intensively.

The re-emergence of VFI over the past several years as a central issue in Canadian public finance relates both to recent Canadian fiscal history and to current international and domestic economic conditions. After 1992, the federal government, faced with a recession and with the historically unprecedented peacetime buildup of public debt over the previous decade, made major cuts in fiscal transfers to the provinces as part of its broadly based policy of debt reduction (see Ferris and Winer 2007 on the history of this retrenchment). As indicated in Figure 1 (from the Ferris-Winer spreadsheet), the cuts in grants were both dramatic and rapid. In the early 1960's, federal grants had accounted for around 3 per cent of GDP. By 1992 they had risen to approximately 4 per cent, only to be reduced in rapid succession to the lower level of the 1960's.

[Figure 1 here]

The comparison with grants to the states by the U.S. federal government, also shown in the figure, reinforces the view that something dramatic happened in Canada after the 1992 recession: By the measures shown, Canada and the U.S. federation show a very similar degree of decentralization after that date, whereas in 1960, federal grants in Canada had exceeded those in the U.S. by as much as 2 percentage points of GDP. In the light of this recent history, provincial complaints that the federal government is not paying its proper share of the cost of important social services are hardly surprising.

A further reason for the current turmoil comes from a quite different direction. The rapid rise in international oil prices has led to fiscal pressures on the federal government because of the resulting obligations under the current Equalization program.<sup>1</sup> While this program is usually discussed in relation to horizontal equity rather than with regard to VFI, it has become linked to vertical imbalance because of the nature of the formula used in determining Equalization payments, a topic that will receive more attention in a later section of this paper. In addition,

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<sup>1</sup> We follow the convention of capitalizing the term equalization when it refers to the relevant federal program in Canada.

problems have become complicated further by the special treatment of resource revenues in the Atlantic Accord which was introduced by the previous Liberal government, and which partly sheltered resource revenues in the Atlantic provinces from the recapture aspect of the Equalization formula.

The renewed interest in vertical imbalance is reflected in several recent governmental publications, including the reports by the Advisory Panel on Fiscal Imbalance of the Council of the Federation (2006), the Commission on Fiscal Imbalance (2002) of the government of Quebec (the Seguin Report), and the Expert Panel on Equalization (2006) set up by the Department of Finance (the O'Brien Report). In addition, the topic has led to a renewed debate among academic researchers, with contributions by prominent economists from different parts of the country and has been the subject of a chapter in a recent edition of *How Ottawa Spends*.<sup>2</sup>

A full and logical discussion of VFI requires a formal framework in which the terms “balance” and “imbalance” can be clearly defined. Many of the writings on the concept lack an adequate framework to accomplish this. Moreover, as we shall see, the fiscal aspects of imbalance are only one dimension of the problem. While our discussion will allude to a broader context, we shall nevertheless continue to make use of the adjective 'fiscal' in referring to possible imbalances so as to keep the discussion in accord with the long history of the debate.

To come to grips with the essential nature of VFI, we need a framework that allows us to characterize the equilibrium allocation of taxing powers and public expenditures among levels of government in a federation. In addition, any model of vertical imbalance must consider the allocation of resources between the public and private sectors, an issue almost always omitted from the debates. Finally, we must devote attention to the questions of how the assignment of taxing powers and other fiscal (and nonfiscal) policy instruments occurs in a federation and to how it evolves over time.

In an earlier paper (1986), we proposed a simple framework to describe static equilibrium for fiscal balance and proposed a standard for judging under what circumstances VFI will occur. In this paper, we extend this framework in an informal manner to include the static mis-assignment and dynamic re-assignment of fiscal instruments among levels of government, noting that such re-assignment is a continuing fact of life in all federations.

## **2. A Simple Framework**

The literature on VFI exhibits a lack of consensus on general underlying principles. This is reflected in widely differing assessments of how to characterize the concept. One view, often expressed in budget documents, is that persistent deficits at the federal level or at the provincial level of government indicate the existence of an imbalance in the structure of the federation. A test for distinguishing whether such deficits reflect a true imbalance in federal structure or whether they are caused by other influences on public budgets (such as the desire to avoid hard fiscal choices) is not provided.

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<sup>2</sup> See Teliszewsky and Stoney (2007). See also Paquet (2007) in addition to the contributions cited in the text .

A more useful definition of imbalance refers to a mismatch between revenue sources and expenditure responsibilities. (See the reviews of literature in Bird 2003, Lazar et al 2004 and Sharma 2006). Boadway and Tremblay (2006), working in this tradition, define VFI as a situation where the federal government does not provide the proper level of grants to bridge the *vertical gap* between revenue sources and expenditure responsibilities at the provincial and federal levels, a gap that arises because of the greater revenue-raising ability of the federal government. VFI occurs when this gap is too large or too small relative to what would be efficient from a national point of view, as a result of co-ordination problems among the provinces and constraints on the federal government's ability to transfer resources between provinces. Their analysis includes the important assumption that the assignment of fiscal instruments is given.<sup>3</sup>

While Boadway and Tremblay keep the assignment of instruments fixed, it is less clear in the literature as a whole whether the imbalance identified is caused by an inappropriate use of given instruments, whether the assignment of instruments is itself faulty, or whether both possibilities play a role. Presumably, the Seguin Report is arguing that both aspects are involved when it states (p. 25) that one of the prime causes of VFI is the inappropriate use of federal spending power.

One should note that the federal assignment as well as the mix and extent of use of each fiscal instrument employed at each level of government are determined in the course of electoral competition. This fact has led some observers to suggest that VFI is essentially political in nature (McKenzie 2005, Smart 2005), a view with which we have considerable sympathy.

## **2.1 Key assumptions**

We begin the presentation of our framework by listing several critical assumptions and by explaining how they depart from those commonly found in the existing literature.

1. There are three goods that must be part of any framework: federal goods (F), non-federal or provincial goods (NF) and private goods (P). Inclusion of private goods, which are usually omitted in the discussion, is essential in order to discuss the assignment of instruments and to assess the implications of VFI for the private sector and hence for economic well-being. Allocation of resources among all three types of goods is determined simultaneously (Hettich and Winer, 1986).

2. There is a market for policy instruments among levels of government with "rights", analogous to property rights, established by the constitution and defined and redefined by judicial interpretation. Although such a market is discussed by Breton and Scott (1979) and Breton (1996), most analysts do not consider its existence or operation. We follow Breton and Scott in

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<sup>3</sup> Dahlby and Wilson (1994) also take the assignment of instruments as fixed and define VFI as a situation where the marginal cost of funds is not equalized across jurisdictions. In their view, this situation may be created by differences in the ability of taxpayers to migrate from local as opposed to national jurisdictions and by federal grants that are not properly structured to compensate for this.

assuming that the constitution helps to establish property rights in policy instruments, while electoral competition tends to force governments to trade instruments in order to exploit economies of scale, so that such instruments are efficiently allocated among them.

3. Competition among provinces is effective and drives “price” to “marginal cost” in the production and provision of provincial goods. To the extent that taxes are perceived by voters as payments for desired goods and services, provinces are not at a disadvantage in raising revenues. In other words, mobility among provinces does not lead to “a race to the bottom” as has sometimes been argued. This key assumption is in accord with recent theoretical results in the literature (Breton 1996, Mueller 1998, Wildasin 2006, Dhillon et al. 2007) and finds informal empirical confirmation for Canada in a recent volume on this issue edited by Harrison (2005) <sup>4</sup>.

4. The assignment of policy instruments continually evolves in response to shocks. Although most observers treat the assignment as fixed, historical analysis of Canadian and Australian intergovernmental relations shows that judicial reinterpretation, together with the operation of the market for policy instruments, leads to regular adjustment and redefinition of the constitutional assignment (Maslove and Winer 1996, Winer 2000). Similar responses have also been observed for the United States where the phenomenon has been referred to as 'authority migration' (Rodden 2004).

5. To simplify the exposition in the paper, we add two further assumptions that are preliminary in nature and that will be relaxed in later sections of the paper.

*There are no federal grants to provinces except those required to deal with interprovincial externalities.* (Federal grants required to deal with interprovincial externalities are treated as part of F goods.) While we shall drop this assumption when focusing more specifically on the role of grants, it is initially useful in showing that VFI is not a problem arising from the grant system itself, or from the vertical gap between taxes collected by the federal government and spending by the provinces.

*Governments do not engage in redistribution between regions.* This removes, in the initial discussion, problems raised by Equalization and by conditional grants that are based in part on population, while being unrelated to income. The restriction will be relaxed when we consider how vertical and horizontal balance, two issues that are usually treated as separate in the literature, are intertwined in the Canadian context.

In summary, our framework depends on the following critical assumptions:

- There are three goods: F, NF and P.
- There is a well functioning market for policy instruments among levels of government.
- Competition among provinces drives “price” to “marginal cost” for provincial goods.
- The assignment of responsibilities among governments evolves over time.

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<sup>4</sup> Parry (2003) has made an interesting attempt to calculate the welfare cost of interregional tax competition in the United States, and finds it to be quite small. To the best of our knowledge, no such calculations have been made in Canada.

These four assumptions are joined by the two additional ones mentioned above that are imposed initially, but that will be relaxed later. The set of assumptions provides the basis for a consistent and logical analysis of VFI and for a new and different understanding of the concept.

## ***2.2 What is vertical balance in this framework?***

In view of the preceding discussion, we may define a *balanced* situation from an economic perspective as one that involves an efficient allocation of resources (i) among levels of government and (ii) between the public and the private sectors. This must hold for any given assignment of policy instruments among levels of government. In the longer run, vertical balance must also include an efficient assignment of policy instruments among federal and provincial governments.

This means that the fundamental perspective in defining a balanced situation refers to economic efficiency from a national standpoint. However, in contrast to most discussions of VFI, we specifically include in the application of this definition the overall public-private balance and the federal assignment of policy instruments.

Competition among provinces that is effective enough to drive them to deliver desired public services at least cost for any given assignment of policy instruments is a prerequisite for the emergence of such an allocation. In addition, we must have conditions sufficient for an efficient allocation between F and P goods. This will occur if federal electoral competition is strong enough, so that winning political parties are forced to offer policy programs that allow no room for believable alternatives that will lead to further improvements in economic efficiency for voters.

## ***2.3 Basic types of imbalance***

Given this framework, we can identify three types of imbalances. In our approach, these imbalances are essentially political in origin:

**Type 1 (Static VFI).** This type arises in the following circumstances. Although intergovernmental competition is strong at the provincial level, inappropriate or insufficient electoral competition at the national level, and/or impediments to the international mobility of labor, prevent achievement of an efficient trade-off between private (P) and federal public (F) goods. In other words, the problem has to do with the different constraints on federal and provincial decision making. *It is important to note that the private sector is part of the definition of static VFI – this is perhaps the single most important message of this paper.*

Inappropriate political competition at the national level may be caused by the common pool problem, which tends to assert itself more forcefully at the federal than at the provincial level, where migration serves as an additional check.<sup>5</sup> Since legislators can draw on a nation-wide

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<sup>5</sup> On the common pool problem in a federation see, for example, Inman and Rubinfeld (1997), Baqir (2002) and Migué (2006). Inman and Rubinfeld, Migué and others have suggested that decentralization in a federation may in

pool of taxable resources for financing decisions, while being responsible primarily to their more narrowly defined constituency to obtain votes, they may overspend on programs targeted to their constituents; and they may support each other by forming implicit or semi-formal coalitions to achieve such a result.<sup>6</sup>

A second factor affecting efficiency at the federal level is represented by international mobility of capital and labor resources. While it is very difficult for modern governments to impede the mobility of capital across international boundaries, they can and do limit the mobility of labor to some extent, although the possibility of outsourcing of blue- as well as of white-collar jobs limits the effectiveness of such attempts by serving as a partial substitute for the actual physical movement of labor. The lack of mobility for individuals makes the common pool problem worse at the national level and may permit political rents to persist.

VFI of type 1, first suggested by Wagner (1971) and formalized by Hettich and Winer (1986), implies an imbalance among the relative size of F, NF and P, since the standard is defined in a general equilibrium setting. In particular, the federal sector is too large, while the private sector is too small. Note that such VFI exists even though by assumption the provincial sector is at an efficient level – there is no implication that the provinces should get more funds from the federal government as a remedy! While the provinces may be politically hungry for more funds (as they always tend to be), they are not “underfed” in relation to an efficient standard of reference. Furthermore, given the preliminary assumptions mentioned earlier, grants are *not* involved as a contributing factor and do not cause or affect such VFI.

**Type 2 (VFI in the longer run due to mis-assignment).** VFI may also arise if the market for intergovernmental instruments does not function efficiently. Imbalances of this kind may persist in static equilibrium as long as political processes fail to force the federal and provincial governments to reach efficient solutions in apportioning fiscal and service responsibilities and policy instruments.

**Type 3 (Dynamic VFI).** VFI of this nature represents the dynamic counterpart to type 2. The ideal assignment of instruments and service responsibilities among levels of government evolves in response to significant changes of an economic, demographic or political nature. History demonstrates that the actual assignment, even though it may appear as constitutionally fixed, will also change, but it may not do so quickly or completely enough over time. In this case, maladjustment is related to a dynamic equilibrium, rather than to a static one and VFI becomes a dynamic concept. In practice, dynamic maladjustment may be more important than static VFI.

External shocks continually occur, but there is some rigidity in existing political institutions governing decentralization of service responsibilities and fiscal resources. In federal states such as Canada, these are constitutional restrictions. The important point is that adjustment does eventually occur, but that it may take time.

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fact be a way of bounding the size of the common pool problem by limiting the scope of spending at the national level where the problem is likely to be most intense.

<sup>6</sup> From an analytical perspective, this common pool problem in politics has a lot in common with the analysis of overfishing. The matter is more complicated here, however, because we are dealing with citizens who vote.

## **2.4 *The role of federal grants to the provinces***

The greater elasticity of tax bases with regard to tax rates for the provinces than for the federal government is likely to lead to a situation where the federal government raises taxes on behalf of the federation to an extent beyond what is required for its own purposes. This phenomenon is driven by political competition at all levels to provide services to the electorate at least cost, with different orders of government exchanging functions in order to capitalize on efficiency gains (See Breton and Scott 1978).<sup>7</sup>

While VFI may occur in the absence of federal grants, their presence may add to the size of VFI. Federal grants to the provinces may be too large because of the common pool problem identified earlier, a problem that also applies to federal -provincial bargaining. Provinces, as political units, may act like citizens who want someone else to pay for benefits obtained. Elected representatives in Parliament will be complicit to some extent in this quest to shift tax burdens elsewhere. If there is an excess of federal grants over the efficient level, it may also increase the NF sector and/or alter the structure of NF goods, thereby adding another dimension to static imbalance.

The analysis of the role of grants bears on complaints by the provinces concerning the exercise of federal spending power. The Seguin Report appears to argue that almost any use of such power other than Equalization in areas of provincial responsibility creates an imbalance. This view is consistent with our analysis to the extent that federal grants are too large relative to the efficient level defined in the absence of the common pool problem.<sup>8</sup> One should note, however, that there are also other issues concerning the autonomy or sovereignty of Quebec involved in the Seguin Report's analysis that go beyond a concern with VFI, and which lie beyond the scope of the paper.

## **3. Measurement and Historical Record**

Measurement of the vertical imbalance arising because of the common pool problem or imperfect mobility at the national level has not been accomplished so far. Although it does not seem more difficult to measure such VFI than to deal with many other measurement problems that have been overcome successfully, we know of no relevant estimates for the Canadian federation as a whole, or of any studies quantifying the consequences of VFI for the economic well-being of citizens. This is a fruitful area for research.

In any event, the analysis suggests that one cannot take pronouncements at the provincial level at face value. As pointed out earlier, the provinces may be hungry for more resources, but they are not necessarily “underfed”. In the framework we have outlined, complaints from the private sector about high taxes may be just as indicative of a possible imbalance in the federation as those by provincial officials.

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<sup>7</sup> Costs are defined in this context to include the welfare loss from taxation.

<sup>8</sup> The possibility that elected members of Parliament may be complicit in exploiting the common pool problem to arrange for federal grants to their own constituents at the expense of the average taxpayer in the federation tempers the force of any such criticism.

While the magnitude of static VFI has not yet been estimated, it is possible to consider informally how mis-assignment and its dynamic counterpart have been kept in check over the decades by what appears to be efficient re-assignments of policy instruments. Such an analysis imparts a positive view of the robustness of the Canadian federal system. In what follows we briefly consider three episodes in federal fiscal history dealing with (i) the allocation of the power of indirect taxation in the federation, (ii) the responsibility for and provision of unemployment insurance, and (iii) the Diefenbaker tax point transfer.

(i) *The allocation of sales taxation*: It is likely that provincial tax structure was inefficient before the courts effectively turned the *indirect* sales tax into a *direct* tax in a series of legal judgments during the 1930's and 1940's. The British North America Act of 1867 had granted to the provinces only the power of direct taxation. Thus it was difficult for them to take advantage of the growth of sales tax bases. Provincial sales taxes became constitutionally viable only when through a series of judicial interpretations retail merchants came to be viewed as agents levying taxes on behalf of the provinces on those supposed to bear the tax burden, thus satisfying the prevailing definition of a direct tax. (See Laforest 1981, and for the history of the adoption of provincial sales taxes in the federation, Winer 2000).

In this example, the courts created a more efficient distribution of taxing powers in the federation after being faced repeatedly with the problems caused by a glaring mis-assignment of such powers. The reassignment left the provinces with a more efficient tax structure. It probably also led to an increase in the NF to F ratio and to an overall increase in the size of the public sector.

(ii) *Unemployment insurance*: Prior to a constitutional amendment in 1940 that made unemployment insurance a federal responsibility, the courts in the mid 1930's invented a provincial responsibility for such insurance. UI was not, and could not, be anticipated in the division of powers embodied in the BNA Act, and some such decision was required (Usher 2003, 394). But the initial judicial assignment was surely inefficient, since it was likely to result in a level of insurance that was too small due to the difficulties of arranging interprovincial cooperation to provide portability and to deal with moral hazard issues.

Before the constitutional amendment assigning UI (now called Employment Insurance) to the federal government, VFI of the second type identified above evidently existed, and the assignment of policy instruments was not efficient.

(iii) *The Diefenbaker tax point transfer*: After the 1958 election in which John Diefenbaker assumed the office of Prime Minister with one of the largest majorities in Canadian history, his government increased abatement of tax points to the provinces from 10% to 13%.<sup>9</sup> This represented a substantial and rapidly implemented increase (Hettich and Winer 1986).

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<sup>9</sup> As shown by Figure 1, grants to the provinces also began to increase quickly relative to GDP in the late 1950's.

The re-assignment of income taxation represented a response by the federal system that kept the extent of dynamic imbalance in check. Key questions about this response that are prompted by our framework include the following: What were the shocks that lead to this reassignment? Was it the demands for provincially provided education, health and social welfare that were growing quickly in response to the baby boom? Was it new demands for autonomy in Quebec which could not be satisfied by asymmetric treatment of one province? How did the process unfold? And, finally, was the response of the federal system appropriate with regard to speed and structure?

#### 4. VFI in the Future

Before turning to the link between vertical and horizontal balance, it is interesting to speculate on how the federal assignment will develop in the future in response to significant changes in society. By so doing, it may be possible to predict where VFI and the consequent re-assignments may emerge in coming decades. Important developments that warrant attention include aging of the population, global warming, and the longer-run consequences of the Charter of Rights.

Care of the elderly may be increasingly provided for by higher provincial spending, by provincial and federal preferential tax treatment, or some combinations of these.<sup>10</sup> In view of the high costs of institutionalizing a growing proportion of elderly citizens, one may expect to see targeted reductions in private tax burdens so that individual families can deal with aging parents themselves to a much greater extent than in the past. If these reductions are entirely born by the federal government, there will be a decrease in the relative size of the federal public sector. Tax reductions to support home-care and similar programs may, of course, also be implemented at the provincial level, making it unclear what may happen to the NF to F ratio. In any event, it is reasonable to suggest that aging will lead to an increase in the relative size of the private sector. The extent of VFI that may emerge will depend on how quickly the necessary adjustments occur.

Global warming is an externality par excellence where policy responsibility is best assigned to the federal government. A national carbon tax to deal with the matter, whether introduced by itself, or together with a trading and cap system of pollution permits, could provide substantial new resources to the federal government, some of which could be used to subsidize environmental innovation. Given the absence of any serious current policy to deal with carbon emissions and given the nature of the problem, one can argue that there is now a vertical imbalance, with the necessary adjustments requiring an increase in the ratio of F to NF sectors.

Finally, if U.S. experience with the Bill of Rights is any guide, it is likely that the Charter of Rights will exert a centralizing force in the coming decades in many areas where the public sector intersects with the private lives of Canadians. It will be a centralizing influence because the Charter places the federal government in an advantageous position to deliver public benefits in a non-discriminatory manner. The Charter may also lead to an increase in the relative size of the private sector because it gives more latitude to private action in areas, such as the provision

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<sup>10</sup> On aging and federalism see, for example, Foot (1984) and Seitz and Kempkes (2007).

of health services, where government action has been paramount.<sup>11</sup> Whether prolonged periods of imbalance in federal structure will occur as a consequence of these influences will depend on the responses of the public sectors at both the provincial and federal level.<sup>12</sup>

## 5. Allowing for Interregional Redistribution and Natural Resource Rents

To complete the analysis, we now drop the assumption that there is no coercive interregional redistribution. The analysis then leads to the conclusion that vertical and horizontal balance or imbalance are linked in the Canadian federation largely because of the existing constitutional assignment of policy instruments. As noted earlier, the literature on VFI has generally treated issues of vertical balance between federal and provincial public sectors as distinct from those dealing with horizontal balance among the provinces.<sup>13</sup>

Even if intergovernmental and political competition accomplish what they are supposed to do, the desire to redistribute interregionally will inevitably shift resources upwards. This re-assignment, one that we observe in most federal countries, limits the welfare costs of raising the taxes necessary to fund redistribution through the fiscal system, while bypassing the difficulties of arranging voluntary interprovincial arrangements.<sup>14</sup> It also leads to redistributive grants to lower levels of government. In Canada, it has led both to formal Equalization payments and to equalization implicit in conditional grants, paid partly on the basis of the recipient provinces' population rather than on their per capita income. (While not formally labeled as such until 1957, redistributive grants have been in existence since Confederation.)

The current structure of the Canadian Equalization system is in all likelihood a source of VFI because of the particular nature of the present federal assignment. A central problem arises from section 36(1) of the Constitution Act of 1982 that requires Equalization, combined with section 192 that forbids the federal government from taxing provincial resource revenues flowing through the provincial public sector rather than into private hands (the Crown cannot tax the Crown; see Usher, 2007). Oil revenues entering the provincial treasury directly do not constitute federally taxable income. Similarly, implicit subsidies to citizens of Ontario and Quebec through the under-pricing of hydro power cannot be taxed by the federal government.<sup>15</sup>

In view of the current Equalization formula, this constitutional setup leads to a situation where a substantial increase in oil prices, which benefits oil-producing provinces, forces the federal

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<sup>11</sup> The Chaoulli decision of the Supreme Court (2005), opening the door to private insurance in Quebec for medically necessary services, may represent a case in point, though the decision was made on the basis of the Quebec charter of rights so that its impact on the country as a whole is not (yet) clear.

<sup>12</sup> We are aware that introducing Charter issues into the discussion raises questions of equity in addition to those concerning efficiency.

<sup>13</sup> In contrast, these issues are effectively linked in normative discussions of intergovernmental competition, where it is often argued that the onus is on the federal government to redistribute interregionally in order to offset the adverse economic consequences of horizontal competition among the provinces.

<sup>14</sup> One may also note here that in a recent contribution bearing on our key assumption that intergovernmental competition does what it is supposed to, Breton and Frascini (2007) argue that equalization enhances such competition by maintaining the financial viability of the smaller provinces in the face of globalization.

<sup>15</sup> It would be interesting to measure the size of these implicit subsidies.

government to raise national tax rates (including, but not limited to, tax rates in the oil-rich provinces) in order to finance Equalization payments to the relatively poorer provinces.<sup>16</sup> As a result, citizens in provinces that have no oil, such as Ontario, must pay higher taxes as well as higher oil prices. In this case, VFI results in a private sector P that is too small because federal tax rates are too high, compared to a situation where all income sources are treated symmetrically and efficiently for the purpose of taxation, and where what one province gains, another directly loses. In addition, fairness in interregional distribution is put in question.

The imbalance and inefficiency of excessive federal tax rates created by the impact of oil prices since the OPEC oil embargo of 1973 have been reduced by a series of ad-hoc adjustments in the Equalization formula.<sup>17</sup> The federal government's responsibility for Equalization entitlements has been scaled back through changes of the formula. After 1973, the ten-province standard was reduced to a five-province standard that excluded oil-producing provinces. One can also see the National Energy Program and the oil export tax of the Trudeau era as a partial response and partial solution of the problem. While the federal budget of 2006 reintroduced the ten-province standard, only one-half of all resource revenues has been made subject to the revised formula. The latter feature keeps federal tax rates down, and limits the risk to the federal government of having to raise taxes in order to pay for Equalization if oil prices should increase further.

Usher (2007) has recently proposed a different and more consistent solution, one that may or may not be feasible given the current constitution. He advocates the use of a 'macro' formula defining Equalization payments on the basis of provincial per-capita GDP, rather than on the current basis of the yield (relative to a national average) of a basket of provincial revenue sources. This would bring all resource revenues and implicit subsidies into the Equalization accounting framework. In addition, his proposed scheme involves Equalization 'down-as-well-as-up', in contrast to the current system which equalizes 'up-but-not-down', so that what the recipient provinces gain is financed at the expense of the oil-rich provinces.

Courchene (2006) has proposed another, related solution where oil-producing provinces in a series of strategic moves contribute a substantial portion of their oil revenues voluntarily to a fund jointly administered by the provinces. Income in this fund would be passed back to the provinces in proportion to their populations, resulting in a transfer from the oil-rich provinces to those without oil without the intermediation of the federal fiscal system.

Exactly how either of these proposals could be implemented under the current constitution and in the current political situation is not clear, and is a matter for further debate. What is important in the present discussion is that these proposals both illustrate how the issues of vertical and horizontal balance are linked, and that the current assignment of fiscal instruments is not working well.

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<sup>16</sup> The current Equalization formula is, in Usher's (2007) useful terminology, one that equalizes 'up-but-not-down', so that equalization is financed by the federal government using taxation levied on all Canadians in the same way in all provinces in order to reduce tax rates in recipient provinces to a national average. This is in contrast to what he refers to as Equalization 'down-as-well-as-up'; in that sort of scheme, what one province gains, another loses, so that an overall increase in federal taxation is not required when oil prices increase.

<sup>17</sup> For a recent discussion of the history of Equalization and its relationship to natural resources, see Courchene 2006.

## 6. Conclusions

We complete the paper by summarizing key points of the analysis and by offering some comments on the implications of some recent policy developments:

1. A set of general principles is required in order to discuss VFI. An analysis of government deficits does not result in an appropriate framework unless it can distinguish between structural deficits due to the federal assignment of policy instruments and deficits caused by the many other possible reasons for budget imbalances.
2. VFI can be analyzed both as a static and as a dynamic problem. In a dynamic framework, it is fruitful to place the emphasis on the inappropriate assignment or use of policy instruments among levels of government in long run equilibrium and in the transition from one equilibrium to the next. One should note that the concept of VFI does not inherently depend on intergovernmental grants and that VFI may exist in the absence of such grants.
3. Provincial arguments about imbalance are often invalid, while private sector complaints about the burden of taxation may point to the existence of an actual imbalance in a federation.
4. The need for reassignment of policy instruments is continuous, and VFI is a normal state of affairs. If one takes a negative view of this fact, one may perceive it as a chronic problem. On the other hand, if one looks at how VFI has been kept in check in the past, one is led to a more positive view of the robustness and responsiveness of the Canadian federal system.
5. We have no empirical assessments of the magnitude of VFI, or of its implications for economic well-being, especially when it relates to mis- or re-assignment of policy instruments. It may be possible to identify and measure the welfare consequences of mis-assignment in particular cases by creating an appropriate comparison of relevant benefits and costs.
6. It is interesting to predict how the federal assignment and VFI will evolve in the future, but it is difficult to do so successfully in practice. We may expect that big changes affecting society, such as the aging of the population, global warming and the introduction of the Charter of Rights will lead to VFI in the coming decades and require commensurate adjustments in federal structure.
7. VFI includes what is often treated as a separate problem, namely horizontal balance. Because of the mis-assignment of instruments under the current constitution, the federal government must pay Equalization without having adequate access to all resource revenues and implicit subsidies, a situation that has only partially been dealt with by excluding half of oil revenues from the Equalization formula. Thus it is most likely that we currently experience VFI in Canada related to the pursuit of horizontal balance.

The federal government has claimed (in its Budget of March 19, 2007) that it eliminated VFI by adjusting the Equalization formula and by transferring funds to the provinces while also

adjusting the basis for the Canada Social Transfer grants to a per-capita basis. Our analysis suggests to the contrary that Equalization continues to be a source of interprovincial inequities, and that it remains a reason for the existence of VFI. We expect the matter to reassert itself in the negotiations that will proceed the next renewal of the Fiscal Arrangements Act in 2014. The problems in this regard call for bolder steps than those so far adopted. As concerns intergovernmental transfers to the provinces, such payments do not remove the underlying basic issues connected to the relative size of the private and public sectors. Nor will they deal with structural changes occurring over time, such as the aging of the population or global warming, that may require substantial changes in the way policy instruments at different levels are used.

Concerning the public-private aspect of imbalance, a more helpful policy would be to cut federal taxes, thus allowing the provinces to raise additional funds directly from their own revenue bases (thereby reducing the size of the private sector) if they think these tax increases will be supported by their electorates. Recent federal cuts in the GST and in income taxes may thus represent a more effective response and may have resulted in a reduction of VFI. Ultimately, it is electoral competition that must drive the federal system to an efficient allocation of resources among federal, provincial and private sectors. In the absence of work on the measurement of vertical imbalance, it is difficult to determine whether such competition has served its role in a sufficiently effective way and whether recent policy changes have made a significant and substantial contribution to the resolution of the problems associated with imbalance in the structure of the fiscal system.

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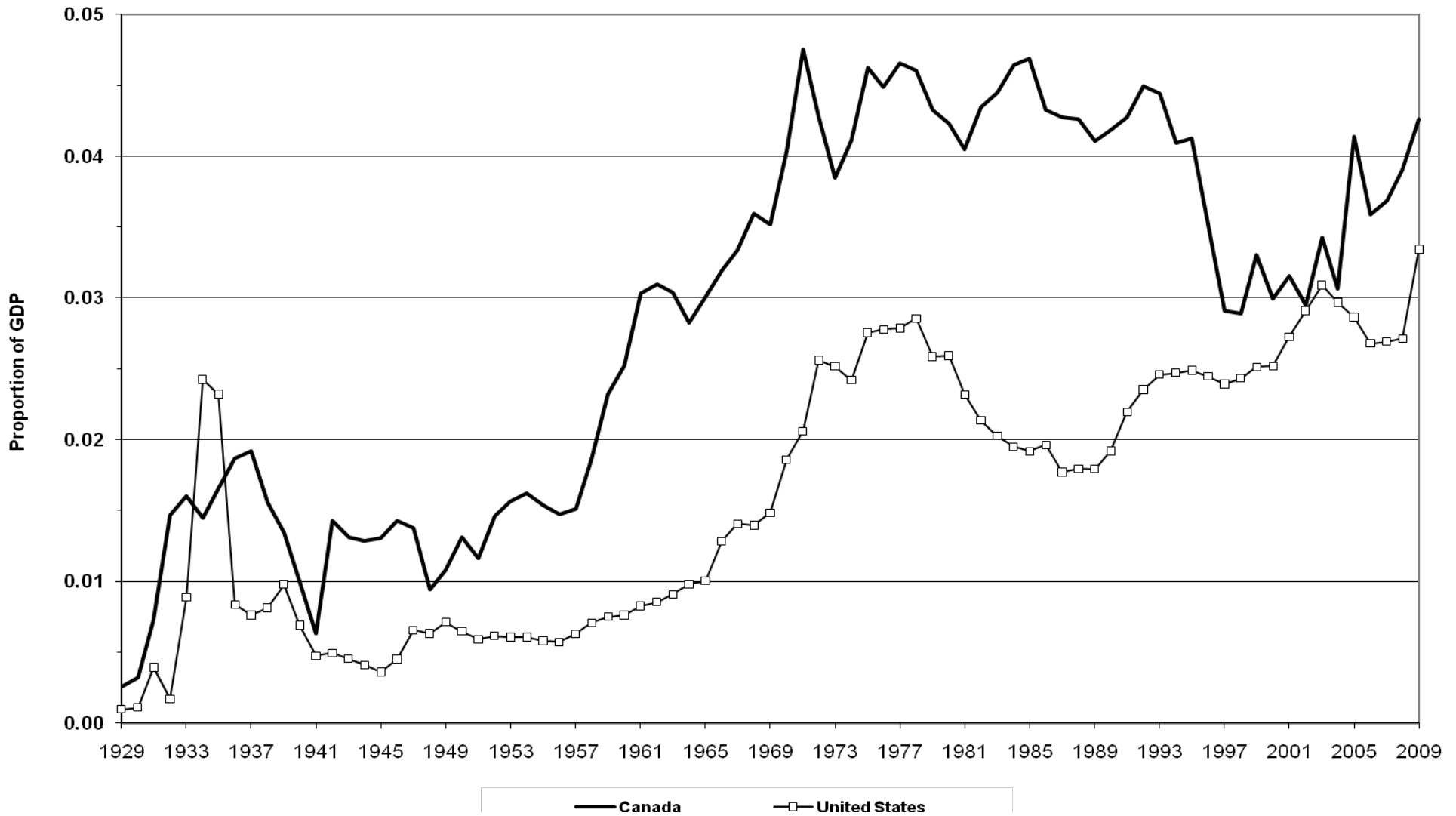
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### Federal Grants to Lower Levels of Government as a Proportion of GDP 1929 - 2009



**Source:** Spread sheet accompanying Ferris and Winer (2007). At [www.carleton.ca/~winers](http://www.carleton.ca/~winers) or at [www.carleton.ca/~sferris](http://www.carleton.ca/~sferris). Abatements of tax points are not included.