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REGIONAL ADJUSTMENT, THE TRANSFER SYSTEM
AND CANADIAN FEDERALISM

by

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and Canadian Federalism

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PART ONE: A CRITIQUE OF THE STATUS QUO*

I. INTRODUCTION AND OVERVIEW

The purpose of this paper is to explore the nexus between regional disparities and the transfer system. More specifically, the thrust of the analysis is that the level of, and incentives embodied in, the current system of transfers both between governments and from governments to persons is not at all conducive to eliminating regional economic differentials in this country. Indeed, I shall argue that the current pattern of transfers is serving to rigidify and perhaps even exacerbate provincial and regional disparities. In short, the status quo is unacceptable and it is time to rethink and restructure the economic interface between Canadians and their respective levels of government and, as well, between the various levels of government.

The persistence, although not necessarily the existence, of regional disparities is essentially a reflection of the fact that something has gone awry with the process of economic adjustment within Canada. Hence, the paper begins with a brief analysis of the various avenues of regional and economic adjustment. To highlight the role of interregional transfers, emphasis is directed principally, although not exclusively, toward the process of macroeconomic adjustment. Within this context, it is argued that the presence of the large and growing network of transfers lessens both the necessity for, and the desire on the part of, the "have-not" regions to make the adjustments required to remain economically viable. As a consequence, their relative economic position has deteriorated vis-à-vis the "have" regions to the point

* It is a pleasure to acknowledge the many comments and suggestions I received on earlier versions of this paper. In particular, I would like to thank Richard Bird, Carl Beigie, Neil Swan, Robin Richardson, Grant Reuber, Peter Howitt, Geoffrey Carliner, Michael Parkin and the members of the money workshop at Western. I hasten to add that not all the comments were favourable to the variety of views addressed in the paper, so that responsibility for these views rests entirely with me. A somewhat similar version of this paper is forthcoming in a publication by the Fraser Institute.

where several of the provinces are in danger of being reduced to the level of "dependencies" of the federal government. This conclusion is buttressed by presenting some recent data that indicate a marked increase in the role of government in the economic affairs of several provinces.

However, it is not only the level of overall transfers that is impeding the process of regional economic adjustment. The incentives embodied in the current transfer system are such that many provinces are encouraged to enact legislation which is almost certainly detrimental to their economic viability. Several examples will be proffered, including the fact that the pattern of minimum wages across the provinces bears little or no relationship to the pattern of average earnings. Moreover, legislation deleterious to ameliorating regional disparities is not the prerogative of provincial governments: Ottawa has its own complement of misguided policies. Examples of these will also be presented.

To this point much of the analysis that will follow will be "backward-looking", as it were,--focussing on the traditional concept of regional disparities within Canada. However, it is critical that some attention be directed to the very important regional changes that are currently on-going. With the quadrupling of the price of energy, the revenues of several of the western provinces, and in particular Alberta, have mushroomed and with this development there has been and will continue to be a very perceptible shift westward in the centre of economic gravity within Canada. For the first time in our history the economic pro-eminence of Ontario is being challenged and this will pose an entirely new set of regional tensions for Canadians. This theme will also be explored in some detail in the paper.

It is always easier to be critical than constructive. Nonetheless, the final section of the paper does attempt, by means of several "propositions", to devise a few ground rules that ought to apply in restructuring the transfer

system with a view toward enhancing the economic viability of the regional or provincial economies. Underlying these propositions is the presumption on my part that Canada is currently at a crossroad in its economic and political history where some decentralization of economic power from Ottawa to the provinces is inevitable and indeed considerable decentralization has in fact recently occurred. Accordingly, the proposals are designed toward enhancing both individual and provincial economic opportunities within our federation. Obviously there will be a trade-off between the two goals and the analysis makes some attempt to recognize and reconcile this conflict. The paper concludes on a positive note by referring to the recent renegotiation of the shared-cost programs as an example of precisely the sort of incentive restructuring that is needed if we are ever to achieve meaningful economic viability at a regional level.

II. MICROECONOMIC AVENUES OF ECONOMIC ADJUSTMENT

A. Wage and Price Flexibility

The simplest form of economic adjustment is wage and price flexibility. The existence of such flexibility will tend to contribute simultaneously to efficient resource allocation and to the attainment of full employment. Increases in demands for particular goods, generated say by changing consumer tastes, will be reflected in increases in the relative prices of these goods. In order to satisfy these increased demands, resources must be transferred from existing production. This will be accomplished by increasing payments for factors producing these goods in high demand which in turn will bid the necessary capital and labour away from other sectors. In addition to ensuring the relative prices and wages across industries or sectors reflect the patterns of final demands of consumers, flexibility of wages and prices will also tend to ensure that

absolute price and wage levels are consistent with full employment of resources. If there were to exist an excess supply of labour at the going wage structure, wages would fall in response to employees bidding down the asking wages until the supply of and demand for labour coincide. A similar situation would occur in the market for commodities--an excess supply of commodities will result in firms lowering their prices in order to equilibrate supply and demand.

Conditions of perfect wage and price flexibility are found principally in rarified air of textbook economics. Nevertheless, the greater are the imperfections in wage and price adjustment, the more difficult it will be to achieve an optimal allocation of resources. Some of these imperfections are bound to characterize the real world: information and knowledge are not free goods and as a result it is more difficult to achieve price and wage flexibility. Others, however, are man-made: monopolistic elements (such as corporations with substantial market power, professional associations with control over fee-setting and admission standards, and labour unions) will serve to impede the degree to which wage and price flexibility is operative.

B. Factor Mobility

Interregional flows of labour and capital provide another avenue of economic adjustment and one that is geared more directly to eliminating inter-regional differences in the return to factors of production. Suppose that real wages are higher in region A than they are in region B. Put somewhat differently, suppose that the productivity of labour in region A is higher than it is in region B. Labour will tend to move out of region B toward region A to take advantage of the higher wages, and capital will flow in the opposite direction to take advantage of the differential in wages. The net result will be a tendency for factor rewards to be equalized, or, equivalently, for regional economic disparities to be diminished.

It is important to note that the various avenues of adjustment are interrelated. For example, the degree of factor mobility will not be independent of the degree of wage and price flexibility. To see this, suppose that there are substantial impediments to wage flexibility in the "have-not" regions in the form, say, of high and effective minimum wages. As a result, there will be considerable unemployment in the poor region and the rewards to out-migration will be high, especially for the unemployed. On the other hand, the presence of high minimum wages will deter capital inflows. In other words, in a world where the "poor" region is characterized by substantial downward wage rigidity, the ensuing factor mobility will probably be dominated more by labour out-migration than would otherwise be the case. If, however, the poor region has significant downward wage flexibility, factor mobility will come to be dominated more by inflows of capital. In any event, it can be shown that the optimal adjustment process involves a combination of both out-migration of labour and inflows of capital. These are, of course, theoretical observations and abstract from real world considerations (such as the impact of the unemployment insurance program) which will loom large in later sections of this paper.

III. MACROECONOMIC ADJUSTMENT AT THE REGIONAL LEVEL

A. The Gold-Standard Adjustment Mechanism

With some degree of misrepresentation, one can classify both wage flexibility and factor mobility as micro adjustment mechanisms. There are, however, adjustment mechanisms that would be classified as "macro" processes. Perhaps the most well known of these is the classical "gold standard adjustment mechanism". Nearly every introductory textbook in economics devotes a section to outlining the features of this process of adjustment. It is convenient to focus in some detail on the workings of this mechanism because, as will be argued below, it is a particularly attractive framework for viewing

the macroeconomic implications of interregional adjustment.

Assume that gold is the only circulating means of payment both within and between countries. Equivalently, one can assume that there exists paper money but the quantities of this paper money are, within each country, tied rigidly to gold stocks. There is no need that each country's ratio of domestic paper money to gold be identical, only that it bear a rigid and unvarying relationship. Two other critical assumptions are also assumed to hold: a) wages and prices are flexible both in an upward and downward direction, and b) the quantity theory holds--fluctuations in price and wage levels are proportional to money supply changes. In combination, these ingredients ensure that in the long run i) all countries' balance of payments will be in equilibrium ii) full employment will obtain in each country and, in addition, iii) prices, net of transport costs, will also be equal across countries. To detail the mechanism as well as to give evidence of widespread acceptance, it is convenient to quote from one of the leading introductory economics texts:

"Whenever one country imports too much and begins to lose gold, its loss of gold reduces its price and cost level, thereby decreasing its imports of foreign goods that have become relatively expensive, and increasing exports of its home produced goods that have become relatively cheap.

The other country, which had been having a so-called "favorable balance of trade" in which it was sending more goods abroad than it was importing and merely receiving barren gold in exchange, now has (via the quantity theory) its price and cost levels of goods raised. This is a further reason for its expensive exports to go down in physical amount and for its citizens to import more of the now-cheap goods of the first country."¹

¹P. A. Samuelson and A. D. Scott, Economics, 3rd Canadian Edition (Toronto: McGraw Hill, 1971), pp. 775-76.

In this way, then, balance-of-payments equilibrium will be established and prices, net of transport costs, will be equalized across countries.

The gold-standard adjustment mechanism will proceed unimpeded only as long as countries abide by the "rules of the game". What this means is that if a country loses gold, it must allow its money supply, and therefore, its nominal income to fall in proportion to the loss of gold. If its central bank engages in offsetting behaviour, i.e., increasing the domestic money supply by the amount of the money outflow, it is "sterilizing" the gold outflow and, therefore, not following the "rules of the game". To sterilize a gold outflow only perpetuates the disequilibrium and ensures that even more gold will flow out. Put differently, attempts at sterilization of the outflows amount to a severing of the automatic adjustment mechanism.

As noted above, this adjustment process applies to a range of economic environments much broader than that where gold is the circulating means of payment. For example, the Bretton Woods fixed-exchange-rate system does not differ much from the gold standard as far as the operation of this adjustment mechanism is concerned. Moreover, it can encompass international flows of capital as well as international flows of commodities. Modern-day economists might be inclined to refer to this process as a wealth adjustment mechanism. Countries facing an overall balance-of-payments deficit can be viewed as owing more to foreigners than foreigners owe to them. As such, they are required to draw upon their savings to service this balance-of-payments deficit. In other words, a payments deficit represents a decrease in domestic wealth, just as any individual must draw upon his savings (decrease his wealth) if his current payments outrun his current receipts. With a decreased level of wealth, spending (including imports) will diminish and the balance of payments will eventually be brought into equilibrium. However, to the extent

that the government sterilizes or offsets these payments imbalances by creating domestic credit, the "total" wealth of the country can be maintained-- the decrease in private wealth on the part of the citizenry is replaced by an increase in wealth created by the government in the form of money balances. Paying for a deficit by this process of creating offsetting money balances is likely to generate much more serious payments problems over the longer term because the underlying disequilibrium has not been removed.

B. Application to Interregional Adjustment

Consider the following scenario. Canada is assumed to comprise the "world". In this world, we have either five "countries" (the five regions) of ten "countries" (the ten provinces), depending on the perspective one wishes to adopt. The countries are linked together by a system of fixed exchange rates. Indeed, since all "countries" utilize the same currency (namely, the Canadian dollar), the exchange rates between them are not only fixed, but equal unity--one Nova Scotia dollar exchanges for one Saskatchewan dollar. In short, we have here one of the essential ingredients for the operation of the gold standard or its equivalent, "the Canadian dollar standard".

Now let us carry this scenario one stage further by assuming that one of the countries (let us call it the "Maritimes"), incurs a balance-of-payments deficit on current account with the rest of the world, i.e., with the rest of Canada.² There must be some compensating dollar inflows to the Maritimes to offset this current account imbalance. Maritimers, or their governments, can finance this imbalance by selling financial or real assets to the rest of the world. To some extent both of these come into play.

²This is not really an assumption but rather a statement of fact. See Columns 5 and 6 of Table 1 below.

Maritime governments, corporations and individuals are likely increasing their liabilities to the rest of Canada either in the form of increasing government debt, corporate bond floatations or money transfers via the chartered banking system on the one hand or by increasing the degree of foreign ownership of Maritime property on the other. Alternatively, Maritimers can draw down their savings. However, these sources of dollar inflows are not likely to be sufficient to offset the magnitudes of the current-account deficits displayed in Table 1--from 23% to 48% of provincial output for the Atlantic provinces.

This leaves but one major source of dollar inflows--the federal government's system of transfer payments. It is rather difficult to escape the conclusion that the transfer system plays a major role in sterilizing dollar outflows and, hence, in inhibiting the operation of the gold standard adjustment mechanism. Essentially, the federal government in its tax-transfer or sterilizing role is taking the place of a central bank for the Maritimes. However, whereas a national central bank in a fixed-exchange-rate regime can sterilize only to the extent that it has a supply of international reserves, there appears to be no theoretical limit to the ability of the Government of Canada to "replenish" the spending power in one of its regions or provinces. The net result of this activity is that the Maritimes have latched on to the fabled "widow's cruse" that enables them to escape the rigors of the gold standard adjustment mechanism. It is important to note that the effect of these transfers is not limited to the deficit area. Since they are essentially interregional in nature, they inhibit the adjustment process in both the deficit and surplus regions, thus tending to ensure that the current account imbalances will continue.

It is instructive to trace out the impact of these transfers in terms of the modern conception of this process as involving a wealth adjustment. An overall balance of payments deficit implies that citizens are drawing down

their savings and wealth. Without federal transfers, the reduction in wealth would call forth a reduction in consumption (including imports) in order to restore payments balance. The presence of transfers allows regions or provinces to maintain their consumption levels at levels that are higher than otherwise would be the case. Indeed, for one of the Atlantic provinces, consumption is greater than increase or output. Nonetheless, private wealth is reduced and it is replaced by "federal government wealth". The annual flow of transfer payments can be viewed as the yearly returns to an annuity that the Maritimes holds against Ottawa. Put differently, the capitalized value of the annuity is part of the "wealth" of the region and it allows their consumption levels to be greater than would be the case in the absence of these transfers. This example focussed on the Atlantic region, but obviously the analysis is more general.

C. The Interaction Between Wage Flexibility, Factor Mobility and the Transfer System

Once again it is important to stress the interdependencies among the various factors in jamming up the regional adjustment mechanism. In this context it is important to note that regional wages are not very sensitive to local demand conditions. This wage inflexibility can be traced in part to "the wage policy of governments and large national corporations, and the labour union demands for wage parity."³ The former arises to a large degree because the federal government has a single wage policy throughout the country. Post office employees receive the same wage rates and pension benefits in rural Newfoundland as they do in urban Ontario, i.e., quite independent of the going wage for labour

³Robert Lacroix, "The Regions and Unemployment: The Canadian Problem," paper prepared for "Options" (the University of Toronto Conference on the Future of the Canadian Federation), October 14-15, 1977 (forthcoming in the Conference Volume), p. 5.

in the local area. Wage patterning in the provincial civil services, either with respect to the wages of federal employees in the region or in relation to rates of remuneration in neighbouring provincial governments, also exists and this adds to the regional rigidity of wage structures. Under these circumstances both the public and private sectors alike are rather easy prey for unions pressing for wage parity and the elimination of interprovincial wage differences.

Another important factor contributing to wage rigidities is the existence of minimum wage legislation and in particular the fact that, as often as not, the poorer provinces have minimum wages in excess of those in the richer provinces. For example, a year or two ago, only Newfoundland had a minimum wage lower than that in Ontario. I will have more to say on the role of high minimum wages in low-income provinces later in the paper. For the present, it is sufficient to recognize their existence.

The net result is that regional wages are far more rigid in response to shortfalls in demand than would otherwise be the case. Consequently, unemployment rates are correspondingly higher and an incentive for outmigration is generated:

"If wages are not in line with regional conditions, the employment situation in high-unemployment regions cannot improve, and may even deteriorate. In these circumstances, the choice confronting many workers in the low-income regions will not be between low income and out-migration, but between unemployment and out-migration. In other words, because of the rigidity of relative wages among regions, only worker mobility can contribute to a reduction in unemployment rates when economic policies are designed for country-wide application."⁴

But in the real world there is nowhere near the degree of outmigration that wage inflexibility would imply because the transfer system impedes this process. From the individual's standpoint the existence of unemployment insurance

⁴ Ibid., pp. 5-6.

payments reduces the income returns to mobility. With U.I. the gain from migration for the unemployed is not the income level one would receive in the new area but rather this level minus the level of unemployment benefits. Hence the presence of U.I. inhibits mobility. From the province's standpoint the revenues lost from the increased unemployment are compensated in part by an increased flow of equalization payments. In short these mechanisms feed upon each other. If wages are inflexible downward, a shortfall in demand will generate more unemployment than would otherwise be the case which in turn will ensure that more federal funds will be forthcoming. And with greater federal inflows there is then less need for a particular province or region to be concerned about the adequacy of wage adjustment and factor mobility. This is a vicious circle and it is imperative that it be broken.

Prior to proceeding with the analysis it is important to note that considerable interprovincial migration has taken place. And most of the net flows have been in the direction expected from an analysis of interregional disequilibrium. Interestingly enough, however, the traditional situation where the Atlantic region was a net loser of people has undergone considerable change recently, especially for the 1971-76 period where the data indicate that it is now a net-recipient region. The reasons for this are not completely clear. In part, it may be a reflection of the fact that job creation programs such as DREE are having an impact in the have-not regions or, more recently, that the increasing rates of unemployment in Canada's industrial heartland make immigration to Ontario less profitable. My own hunch, however, is that one of the factors that cannot be overlooked is the new unemployment insurance program, enacted in 1971. Not only have benefit rates been increased substantially and the number of weeks needed for qualification reduced considerably, but as well the claimants in high-unemployment regions are authorized to

receive benefits for a longer period of time--up to 18 weeks longer for workers who have logged in the minimum number of qualifying weeks. Moreover, to qualify for U.I. a worker needs few working weeks in high unemployment areas than, say, in Alberta. This affects migration in two ways: a) the new provisions reduce the returns to mobility from high-unemployment regions and b) there is an incentive for "back-migration", i.e., workers losing jobs in the industrial heartland have an incentive to return to a high unemployment area to file for benefits in order to take advantage of the regional aspects of the new legislation.⁵

By way of summarizing some of these points it is convenient to note that in a recent empirical study focussing on the time period 1952-67, both total federal transfers to a region and unemployment insurance transfers by themselves acquired significant negative coefficients as explanatory variables for interprovincial migration.⁶ Not surprisingly, per dollar of transfers the UIC benefits tend to inhibit interprovincial migration more than total government transfers. Given that the UIC transfers have increased substantially as a result of the 1971 revision, it seems probable that they are an important contributing factor to the recent changes in interprovincial flows of migrants.

⁵ To be eligible for the extended regional benefits, a UIC claimant need not have worked in a high-unemployment region as long as he files his claim in such a region.

⁶ More specifically, in the context of a multiple regression analysis in which the determinants of provincial outmigration rates were related to variables such as age, origin income, destination income, levels of education, distance moved, etc., an increase in the level of unemployment insurance transfers led to a decrease in the rate of outmigration. This was also true for a more inclusive transfer variable, namely the flow of total federal transfers to a region. By itself, an increase in unemployment in a particular region led to an increase in outmigration. This corresponds to the analysis in the text which implies that the natural tendency for outmigration to follow in the wake of increasing unemployment is offset by the existence of unemployment insurance benefits. See Thomas J. Courchene, "Interprovincial Migration and Economic Adjustment," Canadian Journal of Economics, vol. III, No. 4 (November 1970), especially equation 7, Table VI and the accompanying text.

IV. THE INCENTIVES EMBODIED IN THE TRANSFER SYSTEM

In addition to the problem created by the mere existence of sizeable interregional transfers there is a related and perhaps more serious problem in that the incentive structure implicit in the transfers is such that it has evoked policy responses from governments that have likely aggravated an already bad situation. The purpose of this section is to focus on several examples at both the federal and provincial level, beginning with the former.

A. U.I. as an Aid to Fishermen

In the preceding analysis I have already focussed on some aspects of the impact of unemployment insurance. The special regional provisions of this program (longer benefit periods and shorter qualifying periods for the high-unemployment areas) have served to inhibit the migration of the unemployed to the areas of high economic activity of the country. In addition, it is now fairly well established that as a result of the new U.I. provisions enacted in 1971 the overall unemployment rate in Canada has increased considerably.⁷ There is, however, another aspect of the program that is probably detrimental to regional development, especially in the Atlantic region, and this relates to the federal decision, taken in the late 1950's, to allow self-employed fishermen to become eligible for U.I. benefits in the off-season. In my opinion this was, and is, misguided policy. Consider the impact on Newfoundland. Not only has this decision served to increase the measured rate of unemployment in Newfoundland but, as well, it has hampered the rationalization of the fishing industry. The program has helped maintain the one-man, one-boat (i.e., labour-intensive) approach to fishing when this industry is everywhere becoming more

⁷ See H. G. Grubel and M. A. Walker (editors), Unemployment Insurance: Global Evidence of its Effects on Unemployment (Vancouver; The Fraser Institute), 1978.

capital intensive. In short, there are today more fishermen and their operations are smaller in scale than the economics of the industry would dictate. Suppose Ottawa had at the same time extended this privilege to self-employed farmers in Saskatchewan (and it appears that farmers were no less deserving to receive this windfall than were fishermen). There is no doubt that this would have significantly altered the economic geography of Saskatchewan. Rather than consistently having the lowest unemployment rate in the country, due in large measure to the fact that Saskatchewan residents are the most responsive migration-wise to changes in economic activity, the province would currently have a much higher unemployment rate. Furthermore, Saskatchewan would now have a considerably larger population, the farms would be smaller and less efficient and, most likely, the incentive environment of this prairie province would be altered in such a manner as to render its economic fabric much less viable.

The power of inappropriate macro policy to influence economic and social attitudes and behaviour is such that Saskatchewan has a lot to be thankful for in that farmers were not treated in the same fashion as fishermen. Newfoundland is not so lucky. Perhaps it is the case that the fishing industry merits special separate treatment. This being the case, it should not have been difficult to design an intelligent subsidy scheme that embodies both an incentive to work and a rationalization of the industry. Unemployment insurance does neither and moreover it has left the fishing industry in a state where it is not presently equipped to take advantage of the new 200 mile limit, and, not surprisingly, it is seeking further federal subsidies.

B. Minimum Wage Legislation

Many provinces are in the process of enacting minimum wages that on the surface appear to be much higher than warranted by economic conditions within their respective jurisdictions. The most obvious example is the minimum wage in Quebec, which is now well over \$3.00 per hour and is currently the highest minimum wage on the continent let alone in Canada. But Quebec is not the only outlier. In Living Together, the Economic Council of Canada's study of regional disparities, the Council notes that "the minimum wages in three provinces that have always had higher-than-average unemployment rates-- New Brunswick, Nova Scotia, and Quebec--were actually above those in Ontario and Alberta, traditionally low-unemployment provinces."⁸

Why does this situation exist? In part, it results from the fact that the unemployment insurance program is on the one hand so generous in terms of its benefits and, on the other hand, so riddled with disincentives toward work. People collecting U.I.C. benefits will likely not be enticed to accept a job unless it dominates by a considerable margin their unemployment benefits because after a certain point their U.I.C. benefits are reduced dollar-for-dollar by each dollar of earned income. Under a more work-incentive-oriented program such as a negative income tax this situation would not prevail: people would always benefit, income-wise, from working and the various provinces would find themselves under pressure to hold down minimum wages in order that their citizens might better their lot by seeking employment.

There is, however, another reason why provinces with relatively low levels of economic activity can have high minimum wages and that is that they do not bear the full economic costs of such a decision. The existence of federal

⁸Economic Council of Canada, Living Together: A Study of Regional Disparities (Ottawa: Ministry of Supply and Service), 1977, p. 228.

transfers such as equalization payments and unemployment insurance benefits and the 50% federal contribution to welfare means that Ottawa bears a very significant proportion of the unemployment costs arising from the high minimum wage. In other words, there exist incentives for the provinces to raise their minimum wages to levels higher than would otherwise be the case under a more rationalized system of transfers.

Once again it is useful to focus on the manner in which the various parts of the transfer system interact. For example, partly because of Quebec's policies with respect to minimum wages, its unemployment rate is abnormally high. And because it has such a high unemployment rate it has increased leverage in lobbying (successfully) for a combination of tariffs and quotas to support its textile and clothing industries. More generally, Canada is reaching the stage where the amounts of money spent to counteract regional disparities and the policies deployed to prop up sagging industries are endangering our international competitiveness. If this occurs all provinces will suffer. The answer is not that Quebec, to continue with the textile example, should be cut off immediately from further support. This would be to take too narrow a view of the problem. It is true that Quebec has far too much of its industry concentrated in this and other non-competitive sectors. Yet it is not entirely Quebec's fault. In part it is a result of the fact that the federal transfer system never provided sufficient incentives for Quebec to make the needed transition into more competitive areas. This too is part of the legacy of Canada's regional policies and obviously it applies to more provinces than Quebec.

The Economic Council of Canada has also expressed a view that minimum wages in several provinces are out of line. As a way around this situation the Council made a specific suggestion:

"We recommend that, as part of a strategy of full employment, the ministers of labour in high-unemployment provinces gradually move to a situation where their minimum wages are not higher than in any provinces where unemployment is lower than the national average."⁹

While I am in full agreement with the economic analysis underlying this recommendation, I do not think that it addresses the reality of the situation. The setting of minimum wages is a prerogative of the provinces. The way to get the provinces to enact more realistic minimum wages is not to pressure them by recommendations. Rather it is to set in place an appropriate set of incentives such that they bear the full economic consequences of their own actions. If, in the face of such incentives, they still wish to maintain very high minimum wages, then that is their own privilege. However, they will have to live with the results--a drain on their provincial treasury or an increase in outmigration, or most likely some of both.

C. The Nova Scotia Job Corps

In the spring of 1977 the Government of Nova Scotia embarked on a program entitled the "Nova Scotia Job Corps," the thrust of which was to hire 1,000 employees for a 12-week period. The length of the program was, in all likelihood, not accidental--under the unemployment insurance legislation (as it applied in mid-1977), if workers logged in 12 weeks of employment they were eligible for unemployment insurance benefits for the remaining 40 weeks of the year, providing they resided in a high-unemployment area. Nova Scotia qualifies as such an area. Despite the fact that this program was run during the summer months, the newspaper advertisement announcing the program made it abundantly clear that non-students were not only eligible but encouraged to apply. The only condition laid down was that the potential workers be unemployed. From a strictly "business" standpoint, this is probably a very lucrative investment. Nova Scotia pays these

9

Ibid., p. 228.

employees the minimum wage for 12 weeks and then Ottawa takes over payment, for the remaining 40 weeks, at 2/3 the minimum wage. The return to Nova Scotia is not only the income taxes it collects on the unemployment insurance payments but as well other taxes on the full range of the recipients' expenditures. In addition the "multiplier" effects of the federal inflow will increase economic activity in the province and lead to further tax inflows. Finally, if the employees were previously on welfare, the net cost to the province is diminished even further.

That this program was geared to milk the unemployment insurance program is, I think, quite obvious. A lead editorial in The Chronicle-Herald recognized it as such:

"The three month period through which jobs will be promoted under the program is not long but it covers the time period between school terms and meets the needs of students. At the same time it is sufficiently long to enable a family head to build up an entitlement for unemployment insurance benefits."¹⁰

Once again, this is the sort of policy that the incentives embodied in the current transfer system encourage. Some of the provinces find themselves in such dire straits that they are literally forced into resorting to such measures. Moreover, this practice is probably more widespread than is generally believed. I think it is now the case that some universities are tailoring their contracts for non-tenured faculty so that university teachers can get access to U.I. payments during the four-month summer recess. The individual professor may or may not bring home a larger total income as a result of this practice, but it is the case that the university is benefitting, dollar wise, at the expense of the Canadian taxpayer. From the standpoint of the individual institution or province this makes a good deal of financial sense, but it certainly does not

¹⁰

"Job Corps," The Chronicle-Herald, (Halifax), May 6, 1977, p. 6.

contribute to the economic viability of the country as a whole.

V. HAVE-NOT PROVINCES AS "WARDS OF THE STATE"

The thrust of the above analysis suggests that the economies of the have-not provinces may well have deteriorated relatively over time, deteriorated in the sense that they are put in a position where to an increasing extent they rely on federal transfers for their well being. Put more bluntly, the result of the combined policies with respect to Canada's various regions is such that to a substantial degree Canada has turned several provincial economies into what financial analyst Don McGillivray has referred to as "government dependencies",¹¹ Table 1 provides some evidence on this point. The first column of the table contains data relating to the gross domestic product of the ten provinces for 1974. Column 2 contains data relating to the total government spending in these various provinces. This total is the sum of federal, provincial, and local government spending on goods and services as well as the sum of transfer payments from all levels of government to persons. Excluded are the inter-governmental transfers, both federal-provincial and provincial-local. Column 3 presents the ratio of total government spending to gross domestic product for the respective provinces. These ratios range from 105% for Prince Edward Island to 27% for Alberta. More generally, the Atlantic Provinces all have ratios of government spending to gross domestic product above 60 percent. Quebec holds an intermediate position with just over 40 percent, while the remaining provinces are below the 40 percent mark.

The last column of the table reproduces the column 3 proportions for 1970. Quebec records an increase of 7 percentage points over the 1970-74 period. For each of the Atlantic Provinces the increases are substantially greater--15

¹¹ Don McGillivray, "Provincial Accounts: What They Really Show," Financial Times of Canada (June 13, 1977), p. 6.

The Role of Government in the Provincial Economies

	Gross Domestic Product \$ million (1) (1974)	Total Government Spending \$ million (2) (1974)	Government Spending as a % of GDP (3) (1974)	Government Spending as a % of GDP (4) (1970)	Net Imports (-) or Exports (+) as a % of GDP (5) (1969)	Net Imports (-) or Exports (+) as a % of DGP (6) (1973)
Newfoundland	1,831.6	1,305.0	71	52	-31	-47
Prince Edward Island	302.2	321.0	105	68	-39	-48
Nova Scotia	3,460.0	2,424.0	70	58	-31	-32
New Brunswick	2,649.6	1,630.0	66	51	-27	-23
Quebec	34,927.4	14,754.0	42	35	+7	-1
Ontario	59,576.0	20,167.0	34	33	+7	+7
Manitoba	6,115.1	2,347.0	38	39	-9	-3
Saskatchewan	6,093.8	2,090.0	34	43	-10	+14
Alberta	15,055.6	4,049.0	27	33	-5	+7
British Columbia, Yukon and Northwest Territories	17,151.5	5,977.0	35	32	-3	+1
Canada	147,162.8	55,064.0	37.4	35.9	N/A	N/A

Source: These data are adopted from Provincial Economic Accounts (Ottawa: Statistics Canada), 1977. The figures in column 1 are from Table 1. Column 2 equals row 73 (Table 3) minus row 66 (Table 3) plus rows 6 and 15 of Table 2. Column 3 is the ratio of the first two columns. Column 4 reproduces the column 3 figures for 1970. Essentially they equal row 73 (Table 3) minus row 66 (Table 3) plus rows 6 and 15 of Table 2. Columns 5 and 6 utilize data for 1969 and 1973. Data for 1974 were available but the impact of the oil price increases leads to rather large increases in the net exports of Alberta and net imports of New Brunswick for example. It was deemed preferable to utilize data that do not reflect this energy price rise. The first three columns are reproduced from McGillivray, *op.cit.*

percentage points for New Brunswick, 12 for Nova Scotia, 19 for Newfoundland and a whopping 37 for Prince Edward Island.¹²

These data are not only very revealing but, in the blinding light of hindsight are, as well, not very surprising. Decades of interrupting the natural adjustment processes at the interregional and interprovincial levels within the country are bound to result in a situation where one or more provinces become what, for lack of a better term, one might call "wards of the state". More generally, these data in my opinion provide a ringing indictment of the economic incentives embodied both explicitly and implicitly in the constellation of policies that come under the umbrella of the "transfer system".

VI. GAP-CLOSING VS. ADJUSTMENT ACCOMMODATION

It is appropriate to do a bit of recapitulating at this juncture. From an analytical standpoint, the problem is that Canada's policies towards its regions have progressively assumed the nature of "gap-closing" operations, when in fact an "adjustment accommodating" mentality is, and would have been, far more appropriate. As a result of these gap-closing policies the poorer regions of the country have been saddled with too many people relative to their economic potential and the current thrust of policy is such that there exist incentives for even more people to move into these high-unemployment areas.¹³ It is my

¹²There is some evidence that the figure of 105% for P.E.I. is a trifle high, due to an error in calculating output for this province. However, there is nothing inconsistent in having this ratio exceed 100%. Indeed, two Atlantic provinces also have ratios of consumption to net provincial income in excess of 100% whereas the ratio in Alberta is just above 50%. On the "income" side of the national accounts this occurs because of the dominant role of transfers and on the "output" or "expenditure" side of the accounts this high consumption ratio is offset by a high negative current account balance (see columns 5 and 6 of Table 1).

¹³e.g., as noted above, U.I.C. benefits continue for an additional 18 weeks in high-unemployment areas and the minimum number of weeks of employment required to become eligible for Canada's generous unemployment insurance benefits is considerably lower in these areas.

belief that future policy in this area should place far more emphasis on the interplay of market forces than has hitherto been the case. The next section elaborates on this theme.

A. Conflicting Objectives: National Output vs Provincial Industrialization

There is a danger in belabouring, as I have done, the harmful side-effects of various policies in the federal-provincial arena because, by implication, it would seem to suggest that there exists an "ideal" transfer system that has none of these "spillovers". Unfortunately, such is not the case. Any system of transfers whether between Ottawa and the provinces or between governments and individuals is bound to have some spillover effects. As a general principle, if the rationale for a transfer is to affect the distribution of income, then it should be geared as much as possible to influencing distribution directly. Attempting to solve a distribution problem by tampering with the allocation mechanism is inappropriate. Not only will resources be misallocated in the process but there is no guarantee that any such transfer would have the desired influence on the distribution of income. Likewise, if the objective of a particular transfer is to re-allocate resources, then the appropriate policy is one that alters factor prices in the appropriate direction. This can be refined further. If the purpose of resource reallocation is to increase employment in a particular region, then the most efficient policy is a labour subsidy and not, for example, a subsidy to capital. The latter may bring new industry to a region but will not increase employment, per dollar of transfer, as much as would be the case under a labour subsidy because incentives will exist for firms to substitute capital for labour since the former is subsidized whereas the latter is not.

Even if these principles are followed, spillovers cannot be avoided. For example, a negative income tax system is a more efficient policy measure than the current welfare-cum-unemployment-insurance-system to ensure that all Canadians have access to some minimum level of income. This is so because a negative income tax system would embody much less serious disincentives toward work than Canada's current policies in this area. In other words, attacking the income distribution problem via a negative income tax system would result in fewer negative spillovers to the allocation process. Nonetheless, some spillovers will still exist. Compared to no program for providing some minimum income levels for all Canadians, a negative income tax system embodies an incentive towards leisure and a corresponding disincentive toward work.

The issue, therefore, is not to design a system that would eliminate all spillovers or externalities. Rather it is to ensure that the externalities, which must of necessity exist, be minimized.

Equally important is the fact that by their very objectives some transfers are going to have some offsetting and negative implications. Perhaps the most familiar of these relates to the trade-off between maximizing national output and ensuring that regional income disparities are diminished. Programs such as DREE are designed explicitly to interfere with resource allocation in order to encourage firms to locate in certain areas rather than in others. In the short run at least, the very necessity of having to subsidize firms to alter their production locations means that national output has been sacrificed at the expense of ameliorating regional disparities. In its report on regional disparities the Economic Council of Canada did not shy away from addressing this issue:

"Policies designed to move firms or industries to places where they would not normally locate or designed to prevent them from going where they would normally locate, can be costly if they result in the loss of comparative advantages or scale economies. Two small steel plants in two provinces may be less efficient than one big plant in one province...

Of course, the relocation of a firm or industry in a disadvantaged region has beneficial results if it creates jobs for persons who would otherwise be unemployed....It seems to us, however, that federal or provincial policies designed to promote industrialization in regions where it does not normally occur will sometimes have negative repercussions on national output. These measures may well promote regional equity by reducing income disparities, standardizing rates of unemployment, but they will sometimes carry a cost and this conflict between national efficiency and regional equity should be explicitly recognized."¹⁴

In this situation, even the most efficient transfer system or subsidy system will be viewed as detrimental by those who do not accept the objective of the policy.

Most, but perhaps not all, of the analysis of the problems inherent in the various federal and provincial programs outlined above relate to the fact that I deem the manner in which the transfers are effected to be inefficient and inadequate and not to the fact that I am opposed to the underlying policy objectives.

B. Provinces as "Welfare Bums"

A second implication that may arise from the litany of disincentives emanating from the current structure of federal-provincial payments, and one that I certainly want to disavow, is that the provinces, especially the have-not provinces, are gleefully engaged in a process of maximizing their federal transfers. These payments, whether directly to the provinces or to their citizens, are certainly not "free goods" from the provinces' standpoint.

¹⁴Living Together, op. cit., p. 18.

The cost to them of the inadequacy of the present framework has been, as emphasized above, to convert some of their economics into "government dependencies", relying to an increasing degree for their economic well being on the existence of federal transfers. It would be absurd to argue that the provinces deliberately chose this option. No Atlantic premier could view the Table 1 data without the utmost concern. Likewise it would be inappropriate to assert that it was a conscious policy decision on Ottawa's part to generate the current status quo with respect to the economic viability of various provinces.

I perceive that there is a growing recognition among the provinces that the current framework must be jettisoned. Recently, for example, the Government of Quebec questioned the value to the province of the increasing inflow of federal funds. These flows served to lull the province into a false sense of security by masking the economic adjustments Quebec had to make in order to remain economically viable. By so postponing corrective action, the ultimate economic adjustment was made more difficult. In the interim Quebec has been saddled with an industrial structure riddled with inefficiency and dependent for its survival on such things as import quotas on textiles, etc.

Rather than continue with present policy trends, it seems preferable to recognize that the overall system of transfers needs to be revamped and Canadians should be willing to pay the short-term costs of restructuring the entire incentive system to ensure a more viable economic structure for the future. Prior to turning attention toward some elements that might be incorporated in a restructured transfer system, it is important to note that Canada is now entering an era where regional disparities or at least regional tensions are going to heighten considerably: the centre of economic gravity is rapidly moving west. I now turn to some implications of the rise in economic dominance of the West.

VII. ENERGY AND THE "NEW" REGIONAL DISPARITIES

As a result of energy royalties and related incomes the energy producing provinces (essentially the west) will receive about \$5 billion in revenues for fiscal year 1978-79. This will rise as Canada moves closer to adopting the world energy price. At current world prices, Alberta's royalties would probably be in the \$3 to \$4 billion neighbourhood. And this does not include the potential natural gas exports arising from recent massive gas discoveries. What this means is that this province could abolish all other sources of provincial revenue and still end up with substantially more revenue per capita than, say, Ontario. Contributing to the economic rise of Alberta is the fact that this province is depositing a substantial portion of energy royalties in its Heritage Fund which is designed to further development in Alberta. In a few years the value of this fund will exceed \$10 billion, making it one of the largest pools of investment money in Canada. What will Alberta do with these monies? Will they be used to pull industry into the province from elsewhere in Canada? Even if the Heritage Fund does allocate its spending according to market rates of return, the option is still open to this province to become a relative tax haven in order to entice industry. Indeed this process has already begun: Alberta has no sales tax and its rates of income taxation are well below those of other provinces.

It is, of course, too narrow a view to zero in only on Alberta. Saskatchewan is now anticipating similar propensity in the near future from its uranium fields.

In short, we are about to witness substantial changes in the Canadian economy as a result of energy. How will Canadian policy react to this challenge? Ottawa can continue with a "gap-closing" mentality and attempt to offset the regional impact of this development by transferring large sums of money to the remainder of the country, but in the longer run this will only make the eventual

adjustment all the more severe. Canadians simply have to realize that, as a result of the change in the world price of energy, there must be a permanent transfer of income away from consumers and toward the energy-producing regions. If the required resources, both capital and labour, are not transferred to the new growth areas via internal adjustment (which means an increase in wages in the West relative to the Centre and the East), then they will be brought in via the foreign sector and the resulting increase in the exchange rates will generate the required differential in returns to economic activity between the energy-producing provinces and the rest of the country. Indeed, the question of the appropriate level of the exchange rate is going to loom even more important in the future--strong international demand for Canada's resources and the resulting tendency for the exchange rate to appreciate will put our secondary manufacturing sector under substantial competitive pressure.

A. Ontario as a Have-Not Province

As a result of the renegotiation of the financial arrangements between Ottawa and the provinces last year, one-half of energy royalties are eligible for equalization rather than the previous one-third.¹⁵ In the current fiscal year approximately \$1 billion will be paid to the have-not provinces because of energy royalties. It is usually not recognized that this \$1 billion must come out of Ottawa's general revenues and not from the coffers of the royalty-receiving provinces. In turn, this implies that roughly 40% of the \$1 billion

¹⁵The equalization formula equalizes revenues over some 30-odd categories. Equalization entitlements for a province for each category are calculated as a product of a) total provincial revenue for the category (but only one-half of the total for energy) and b) the difference between the province's population share and its share of the total tax base. These entitlements are summed over all categories and this sum, if positive, is the equalization payment. If the sum is negative (i.e., the province is "rich"), equalization payments are set equal to zero. That this is a very generous formula can be seen from the fact that Quebec (with 27% of the population and a zero proportion of the energy tax base) is eligible to receive 27% of one-half of all energy royalties accruing to the energy producing provinces. It is common practice to refer to the provinces which receive equalization payments as "have-not" provinces.

will come from Ontario residents and about 10% from residents of Alberta--these percentages being a rough approximation of Ontario's and Alberta's share of federal general revenue. In other words the province of Alberta does not turn over any of its royalties either to Ottawa or to the poorer provinces.¹⁶ This raises an interesting issue: what is the rationale for Ottawa (i.e., the Canadian taxpayers) to be equalizing a revenue source that is under provincial control?

Adding to the interest in this issue is the fact that Ontario is itself now a "have-not" province. The energy royalties accruing to the west are so large that Ontario has joined the ranks of provinces whose equalization entitlements are positive. However, the formula is designed so that Ontario is not allowed to receive any actual payments. Nonetheless, for good measure, Ottawa has recently proposed to amend the equalization formula (at the Federal-Provincial Meeting of Finance Ministers in early November, 1978) by removing a major energy category (sale of crown leases) from the revenues eligible for equalization. And as oil prices rise or as Saskatchewan's uranium comes on stream one can expect further amendments of the formula in order to keep Ontario out of the have-not classification. Ontario's role in the equalization system is, in effect, to pay the bulk of the cost (for fiscal year 1977-78 total equalization payments amounted to \$2.5 billion, of which about \$1 billion came from Ontario residents) but to be denied the privilege (stigma?) of being on the recipient end.

¹⁶ There is an important exception. The receipts of the energy export tax go to Ottawa and not to the producing provinces. In turn Ottawa uses these funds to subsidize energy imports in the eastern part of the country. In this sense, Alberta can be viewed as turning over a significant portion of its royalties to Ottawa. When the Canadian price reaches the world price level this transfer will disappear because the export tax will be zero.

The purpose of this digression into the workings of equalization is not to lobby on behalf of Ontario. Rather it is to emphasize two implications that derive from the analysis. First of all, it should be clear that the equalization formula is now rather arbitrary. The identical treatment of all revenue categories under the old formula has now been jettisoned. Hence the time has come to rethink the role of equalization both within the context of federal-provincial financial relations and within the context of regional policy. The second implication is probably more important. With the recognition that Ontario is in effect a have-not province the political nature of our federalism will be altered markedly. On a rather trivial level, the typical economic conference on regional policy will now include an Ontario position, whereas heretofore the regional points of view were restricted to the West, Quebec and the Atlantic. More seriously, the rising economic star of the west will force Ontario into a position where it will become far more aggressive in defense of its own interests. In turn, this will mean that the traditional discussion of regional disparities will to an increasingly degree become part of a broader debate which will encompass the division of powers between Ottawa and the provinces. Indeed, this larger debate has already begun.

B. Regional Disparities and the Division of Powers

The interaction between the "old" and the "new" regional disparities on the one hand and the future of Canadian federalism on the other was cast in bold relief at the historic First Ministers' meeting on the economy last February. Judith Maxwell of the C.D. Howe Research Institute made this point extremely well in a recent address:

"It strikes me that the political philosophy of the First Ministers at their economic summit in February [1978] reflected two distinct views divided along regional lines. The premiers of Ontario and most of the western provinces spoke frequently of government restraint, calling for greater support for private sector activity, and generally invoking a conservative approach to economic policy (the

exception was Saskatchewan). In contrast, the leaders from Quebec and the Atlantic provinces realize that they have precious little private sector activity to encourage and that many of the enterprises that do exist are facing highly unfavourable competitive conditions. These provincial leaders therefore tended to speak about protection, subsidies, and the need for financial and economic assistance. That kind of division of views does not strike me as a sound base for developing national policies to suit all the regions."¹⁷

The differing economic experience of the regions also influences their perception of the changes required for the federalism of the future. The 'have' provinces would welcome a transfer of powers away from Ottawa. For a somewhat different set of reasons so would Quebec. Basically, however, the Atlantic region is fearful of a devolution of greater economic power and responsibility to the provinces because it is currently so dependent upon Ottawa. To remain viable under a highly decentralized federalism, the Maritime provinces may want to consider the possibility of forming a single province--an idea they once flirted with but which was rendered less necessary by the creation of the Department of Regional Economic Expansion and the general mushrooming of the federal transfer system.

Thus far, I have argued that the current transfer system has led to a situation where regional disparities within Canada have become entrenched and, perhaps, even exacerbated. In turn, the existence and persistence of these regional disparities are now playing a very critical role in deliberations relating to the division of economic and political power between Ottawa and the provinces. Therefore, the problem of restructuring the transfer system in order to lend greater emphasis to the interplay of market forces and to the restoration of incentive and initiative is intimately intertwined with the outcome of the federal-provincial power struggle. The design of a transfer

¹⁷ Judith Maxwell, "Regional Disparities: The Economic Challenge for Confederation," HRI Observations (Montreal: C.D. Howe Research Institute), No. 17, April 1978, p. 5.

system consistent with a more decentralized federalism differs considerably from that which would be consistent with a concentration of power at the federal level. The purpose of Part Two of this paper is to present, in an admittedly subjective manner, some propositions for a revised transfer system under the assumption that the future of our federalism will involve a devolution of power from the centre.

VIII. CONCLUSION

By way of summary, the thrust of the critique of the current transfer system can be expressed as follows:

- The incentives embodied in the transfer system are not conducive to ameliorating regional disparities. On the contrary, provinces are encouraged to enact legislation that is not in their long-run economic interest, nor in the interest of their citizens. In turn, these decisions can force Ottawa's hand in the type of legislation it enacts.

- As a result, the interregional transfers of funds are larger than they would otherwise need to be. In turn, this has led to a situation where several provinces have become extremely dependent upon these transfers for their economic survival (i.e., they have become "government dependencies", as Table 1 indicates). A necessary goal for future policy must be to reduce this dependency.

- This large but inefficient flow of funds geared toward eliminating regional disparities is progressively endangering Canada's overall competitiveness in international markets.

• From an analytic standpoint, our transfer system has been more oriented towards "gap-closing" and, therefore, impeding rather than facilitating some of the adjustment that must occur within the nation.

• Frustrated with the persistence of these disparities, Ottawa is building regional differences into an increasing number of its policies. The recent budget presented ample evidence of this continuing trend towards introducing distortions in the market in an effort to combat disparities.

• The rising dominance of the west has magnified substantially the regional tensions in Canada. Progressively regional disparities and the transfer system are becoming interwoven with the struggle over the distribution of power between Ottawa and the provinces. This is, I think, a welcome result because it should force the authorities to adopt a more consistent framework for overall economic policy, including policy directed towards regions. Too often the existing division of powers resulted in situations where the provinces could offset the intentions of overall policy or, alternatively, could enact legislation which would force Ottawa to pay for a considerable portion of the economic costs resulting from the legislation.

• Finally, there is no "ideal" structure for the transfer system. Any program will of necessity involve some unwanted externalities. The problem, therefore, is essentially one of attempting to minimize these externalities. In my view, this implies a movement toward increased reliance on market forces.

PART TWO: RESTRUCTURING THE TRANSFER SYSTEM

I. The Relationship Between the Transfer System and the Distribution of Powers

The "transfer system" is an all-inclusive term for payments between levels of government (e.g., equalization payments), between governments and individuals (e.g., welfare payments and U.I. benefits) and between governments and business (e.g., DREE grants). As was indicated above, it is increasingly the case that in order to develop a consistent framework for the transfer system it is essential to decide upon the division of powers between the provinces and the federal government. However, the relationship is not unidirectional: the form of intergovernmental transfers will also determine the degree of centralization or decentralization in our federalism. The purpose of this section is to detail the relationship between federal provincial transfers and the distribution of powers.

It is commonplace to refer to the BNA Act, and the courts' interpretation of the BNA Act down through the years, as the basis for deciding upon the relative power or responsibility of the provinces versus the federal government. Section 91 is quite specific when it comes to the areas of responsibility that fall entirely within the federal jurisdiction. Section 92, amplified by judicial interpretation, likewise spells out certain areas of provincial responsibility. Education belongs to the provinces under Section 93, and so on. Yet this de jure distribution of powers may be somewhat misleading when it comes to sorting out the de facto distribution of powers. This is so, in the Canadian context at any rate, because among other things it neglects the distribution of government revenues, or more correctly, the distribution of revenue-raising capacities of Ottawa and the provinces. The rapid growth in the importance of expenditures categories falling under

provincial jurisdiction has not been accompanied by an equivalently rapid increase in the provinces' access to tax revenues. Hence, the provinces have come to rely increasingly on transfers of funds from Ottawa.

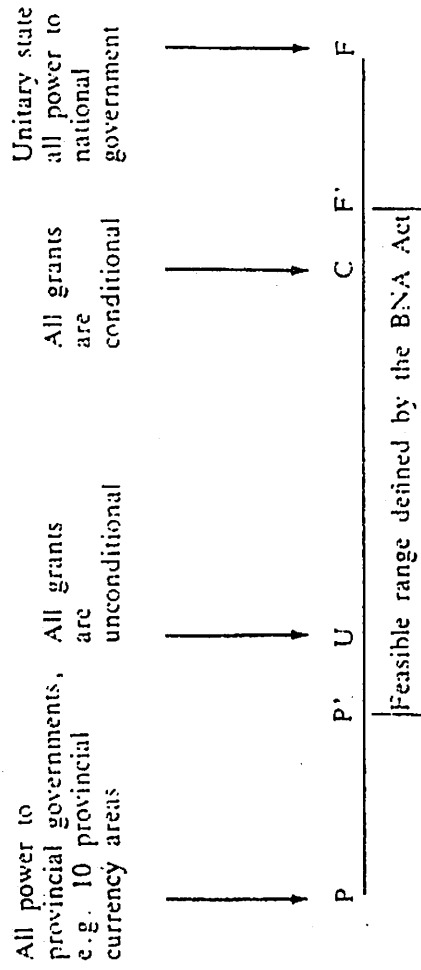
It is rather axiomatic, therefore, that if sufficient funds are not forthcoming from Ottawa, the effective power vested in the provinces is correspondingly diminished. In the extreme, this non-coincidence of spending and revenue-raising authorities could lead, by mutual agreement, to a transfer of expenditure functions to Ottawa. With some degree of misrepresentation, this is what occurred in 1940 (for Unemployment Insurance) and 1951 (for Old Age Pensions), despite the fact that in the present environment such transfers of spending authority from the provinces to Ottawa would not likely be entertained.

However, it is not only the magnitude of the federal transfer that is important: The manner in which this transfer is effected is also critical to establishing, de facto, the distribution of powers. No-strings-attached transfers, normally referred to as "unconditional" transfers or grants, contribute to the exercise of provincial autonomy. "Conditional" grants or transfers, whether of the form of matching grants from Ottawa or of payments depending upon the provinces abiding by the various conditions laid down by Ottawa, serve to erode provincial autonomy relating to spending functions that are, constitutionally, under provincial jurisdiction.

To amplify somewhat on this point, consider Figure 1 which is a stylized representation of the federal-provincial power spectrum. Point F depicts a position where all power rests with the national government, i.e., F represents a unitary state. At the other extreme, represented by point P, all power rests with the provincial governments. This latter extreme is consistent with the

Figure 1

Federal-Provincial Transfers and the
Distribution of Power



adoption of "separate currency areas" for the provinces, which would give them control over both fiscal and monetary policy.

Both these extremes are ruled out by the usual definition of a federal state. Nonetheless, it is possible to characterize various federations (again with some degree of misrepresentation) according to the relative positions they would occupy along this power spectrum. Switzerland, for example, would be to the left of Canada. In other words, the Swiss Cantons have more power with respect to their national government than do the Canadian provinces. Correspondingly, the U.S.A. would be to the right of Canada--the Canadian provinces enjoy more autonomy than the U.S. states.

Our interest, however, is not to focus on the relative positions of various federations in this power spectrum. Rather it is to gain insight regarding the workings of the Canadian federation. Toward this end, let P'F' depict the feasible range defined by the BNA Act.¹⁸ What determines where on the P'F' segment the division of responsibility will settle? To a major degree it depends, naturally, on the distribution of powers in the BNA Act. Responsibility for monetary policy, for example, rests with the central government. But de facto responsibility need not coincide with de jure responsibility. It would be quite possible for the central bank to regionalize monetary policy (e.g., by supporting the bonds of some or all of the provincial governments, which in turn would imply that these provincial governments could in effect conduct open market operations) and,

¹⁸P'F' is intended to reflect the "aggregate" of government activities. It would also be possible to focus on specific activities, but presumably the P'F' segment would vary both in terms of length and position depending on the activity in question.

therefore, shift some of the responsibility for monetary policy to the provinces, i.e., move away from F' and toward P'. However, since the rate of inflation depends on the rate of monetary expansion, it is rather inconceivable to contemplate a decentralizing of the authority over monetary policy.

Of more interest for present purposes is the extent to which federal-provincial financial flows interact with the power spectrum. Because Ottawa collects a proportion of total taxes larger than its expenditure proportion, a need arises for some sort of revenue sharing between the federal government and the provinces. As noted above such transfers to the provinces are generally classified into two groups--conditional and unconditional transfers. The latter increases provincial revenues without any implications as to how the money should be spent while the former impinges on provincial autonomy in one way or another. The most succinct discussion of these two types of transfers still remains that by Jacques Parizeau:

Unconditional transfers can take all kinds of shapes or forms. They can, for instance, be the result of a change in the shares that each level of government raises in a given tax field, when it has been accepted by both sides that the tax field will be shared and that the total tax burden in that field is set at a certain level. Or, they can result in the complete evacuation by the federal government of a given tax field. Or again, they can be produced by the creation of a new tax field, accepted by both authorities as being allocated permanently to the provinces. Or, they can be straight financial annual transfers from the federal budget to the provincial treasuries. And, of course, there can be a combination of all these formulas.

A conditional transfer implies that the federal authorities agree to pay for all or part of a provincial program, as long as that program, its norms, and possibly its administration, have received federal approval or are subject to federal controls.

Conditional transfers not only maintain federal control but they can also be used to expand it. Insofar as they take the shape of shared-cost programs, in other words, while the federal contribution is only a fraction of the total cost, the provincial contribution constitutes so much that cannot be allocated by provincial authorities to autonomous adventures. If the federal government opens shared-cost programs in existing fields of public expenditures, it can thus "freeze" gradually an increasing share of provincial budgets. At the limit, provincial authorities become more or less administrative agencies of federally initiated or federally financed programs, irrespective of how the legal documents distribute formal powers between the two levels of government.

It should be pointed out that each of these two formulas is compatible with the present Canadian constitution. While one formula strengthens provincial autonomy and the second maintains federal control, both can be fitted to the same legal document.¹⁹

In terms of Figure 1, extensive reliance on unconditional transfers would imply a position like U where the provinces are able to exercise considerable autonomy. Point C represents the other extreme: by means of conditional grants, Ottawa is able to wield considerable influence even in areas that are in theory at least, assigned to the provinces. As Parizeau emphasizes, an extensive recourse to conditional grants not only reduces provincial autonomy on the expenditure areas directly affected, but on the non-affected areas as well. Consider the 50% shared-cost programs that came up for review in the recent negotiations (post-secondary education, hospital insurance and medicare expenditures). In order to provide one dollar of these services to their citizens, the provinces had to spend only 50¢. Yet to the extent that this encourages them to overspend on these expenditure functions, it allows them fewer resources to devote to other spending areas.

¹⁹ Jacques Parizeau, "Federal Provincial Economic Coordination" in Canadian Economic Problems and Policies (edited by L. H. Officer and L. B. Smith), Toronto: McGraw-Hill, 1970, pp. 82-83. The last two paragraphs have been reversed.

Thus far, it might appear that the only role for conditional grants is to allow the central government to gain a greater say in programs that are in the provinces' jurisdiction. This would be misleading. Among the various rationalizations for conditional grants is that the "federal government has a duty to ensure that all Canadian enjoy certain common minimal standards of certain social services."²⁰ Presumably the shared-cost programs for health, higher education and welfare derived part of their rationale from this principle. A more convincing argument for conditional grants from an economic standpoint is that some programs involve spillovers-- provinces do not capture all the benefits from expenditures on certain activities because some of them spill over into other provinces. As a result, a province is likely to underspend on this activity. Conditional grants help to rectify this situation--the federal government compensates the provinces for the spill-out. However, it is hard to argue that this would require uniform matching grants for all provinces. In any event, there is a body of economic literature that would lend support to conditional grants.

The point of all this is to emphasize that the nature of inter-governmental grants does have a major impact on the de facto distribution of powers between Ottawa and the provinces. Furthermore, a major change in the funding arrangements is tantamount to a change in the constitution itself, as far as altering the effective autonomy of the various levels of government. It should be noted, however, that just as the financing arrangements can

²⁰ Geoffrey Young, "Federal Provincial Grants and Equalization," in Issues and Alternatives-1977: Intergovernmental Relations (Toronto: Ontario Economic Council, 1977), p. 40. Young goes on to question the validity of some of the assumptions underlying this proposition.

influence the effective power distribution, so too is it the case that the formal delineation of powers set out in the constitution is likely to affect the form of interprovincial grants. Thus it is not surprising to find that transfers from Ottawa to the provinces tend to be of the unconditional variety relative to similar transfers between Washington and the states because the Canadian provinces have more autonomy than the U.S. states. The best example of this is with respect to equalization payments. In Canada, it has long been the case that equalization has been applied to provincial revenues and these payments have been unconditional. Until recently, the bulk of equalization payments in the U.S. has been expenditure-related. Individual states would receive a varying proportion of the program costs depending on their "need". In other words, equalization payments in the U.S. took the form of a variable "matching" grant, i.e., equalization payments were "conditional" in nature.

This has been a considerable detour, but it will have served its purpose if it pressed home the necessary relationship between the size and form of intergovernmental transfers on the one hand and the distribution of powers on the other. Moreover, in what follows I will assume that what awaits our federalism is a movement towards devolving more power to the provinces. The renegotiations of the established programs completed in the spring of 1977 resulted in converting the shared-cost programs for medicare, hospital insurance, and post-secondary education into unconditional grants. In effect this transferred greater autonomy to the provinces (more on this later). More recently, Ottawa has proposed to convert part of the shared-cost program for welfare into an equal-per-capita unconditional grant. Added to this is the expressed desire on the part of several provinces for an increased economic

voice in their own affairs. Accordingly, the operational assumption is that decentralization rather than centralization will be the way of the future.

The format for the remainder of this paper will be characterized by a series of rather general propositions relating to restructuring the incentive system. These will be geared to enhancing provincial economic rights but as well they will attempt to ensure that the economic opportunities of individual Canadians will also be enhanced. I hasten to add that a different set of propositions would be appropriate for a more centralized federalism. The analysis begins with safeguarding the economic rights of individuals.

II. GUARANTEEING INDIVIDUAL ECONOMIC RIGHTS

Proposition 1:

No Canadian individual or family should receive an income below some generally accepted poverty level.

To achieve this objective in an efficient manner requires a complete rethinking and restructuring of the current legislation with respect to both welfare and other income-maintenance programs. What is needed is a negative income tax system which at the same time ensures that individuals and families do not fall, income-wise, below certain minimal standards and that the incentives in the scheme will be pro-work rather than anti-work. Perhaps the most important aspect in the design of a negative income tax system is to recognize that, consistent with putting greater power in the hands of the provinces, it probably should not be run entirely by Ottawa. At the present time, welfare payments vary not only across provinces but as well vary within provinces depending on whether or not the recipients reside

in rural or urban centres. Not only do these differentials make economic sense but as well they are essential from a provincial planning point of view: they discriminate among individuals according to the economic situation in which they find themselves and at the same time allow scope for the provinces to alter these rural-urban differentials in a manner which is consistent with their overall development plans. Naturally, nothing would prevent an individual province from equalizing these negative income tax benefits irrespective of the location of the recipients. But this should be the result of a conscious decision on the part of the province, and not superimposed by Ottawa.

If Ottawa funded and administered the entire program there is no way, politically (or constitutionally for that matter), that it could get away with differentiating among recipients on the basis of either province of residence or rural-urban location. Furthermore, the uniform support level of a federal plan undoubtedly would be determined by the needs of the richest communities. Thus a uniform negative income tax program run by Ottawa would result in substantial "back migration" both toward have-not regions (where the support level would ensure that the recipient would be in a relatively higher income class than a similar recipient in, say, metro Toronto) and, within each province, toward the rural sectors. This would not likely accord with provincial economic development plans and would serve to erode further provincial responsibility in an area which is, constitutionally, under provincial jurisdiction.

The appropriate federal role in such a scheme would be to provide a minimum support level applicable throughout the country. Perhaps this

level would be adequate for, say, rural Canadians. The provinces would then be able to supplement this level as they saw fit--perhaps by introducing urban-rural differentials or differences reflecting family size.²¹ This approach would provide enough flexibility to accommodate one and all provincial development plans.

This negative-income-tax proposition is not intended to be a program tacked onto the existing set of income-support and income-maintenance programs. Quite the opposite. It is intended to replace and rationalize the wide spectrum of current programs. For example, existing programs such as family allowances, the old age pensions and income supplements could be integrated into a new comprehensive negative income tax scheme.

Unemployment insurance poses a more difficult problem as far as integration with a negative income tax. One alternative might be to put unemployment insurance on a family rather than an individual basis. This would eliminate one problem associated with the present system whereby a secondary family earner can be collecting UIC benefits while the principal breadwinner is earning a very high income. With a comprehensive negative income tax scheme in place, the rationale for a separate unemployment insurance program would diminish substantially. One impressive recent

²¹ For a concrete two-tiered (i.e., the federal government providing the basic level and the provincial governments providing supplementary benefits) proposal along these lines, see Thomas J. Courchene, "The Poverty Reports, Negative Income Taxation, and the Constitution: An Analysis and a Compromise Proposal," Canadian Public Administration, 1973, pp. 349-369. More recently the Ontario Economic Council has recommended a somewhat similar system. See Issues and Alternatives, 1976: Social Security (Toronto, Ontario Economic Council), part VI.

study of the welfare system recommended that unemployment insurance has no place in a comprehensive negative income tax scheme.²²

The source of funds for the provincial share of the proposed two-tiered negative income tax scheme would come from an unconditional grant from Ottawa either in the form of, say, equal per capita cash transfers that would escalate over time or a transfer of equalized tax points. Ottawa's current contributions to the provinces under the 50% cost sharing system for welfare might provide the basis for determining the base year contributions for the unconditional grant. The essential point is that the present 50% sharing procedure must go. Unconditional grants have the advantage that they will make provincial decisions with respect to benefit levels similar to any other provincial spending priority: provinces will weigh expenditure on income-support programs on their own merits because Ottawa will no longer stand ready to match this spending on a dollar-to-dollar basis. Further implications of this proposal will become more evident in the context of Proposition 5 below.

Proposition 2:

Movement of people, factors and goods across provincial boundaries should be as unrestricted as is possible.

This is really an argument for a common market within Canada. There are currently many impediments to the free flow of both goods and factors

²²See Income Security, Chapter 9, Volume 5, of the Report of the Commission of Inquiry on Health and Social Welfare, (commonly referred to as the Castonguay Report, after one of its commissioners), Government of Quebec, 1971, paragraph 807. This report recommended that unemployment insurance should be self-financing (i.e., a private sector activity) with government providing only a coordinating and administering role.

within Canada--e.g., provincial purchasing policies and provincial licensing and regulatory activities. There is a danger in moving to a more decentralized federation that even more balkanization will occur. Elimination of these barriers must be part and parcel of any decentralization of economic power in order to prevent individual Canadians from becoming economic prisoners by actions of their own province or by other provinces. Too often the discussion or debate over the division of power between the various levels of government tends to overlook the rights of individual Canadians. It is only natural that some provinces want increased power and authority. But hand in hand with any transfer of power must go a corresponding transfer of responsibility. It is important to note that if one were to design a transfer system under the assumption of an increase in federal power the recommendation of a common market would also be one of the preconditions since the status quo with respect these impediments is unacceptable.

I turn now to some aspects of provincial economic rights. Once again the analysis will be very aggregative and will highlight only certain aspects of what is a more difficult and controversial area.

III. GUARANTEEING PROVINCIAL ECONOMIC RIGHTS

Proposition 3:

The provinces must be allowed greater scope for tailoring their institutional and economic fabric to suit their own development needs.

Basically, this implies that the provinces should not be forced into Ottawa's perception of what is appropriate economic policy. In turn this means that Ottawa must hold back on the exercise of its spending authority.

The best example to illustrate this proposition is the experience of the shared-cost programs. This will be dealt with in some detail in the conclusion of the paper.

More generally, if decentralization proceeds rather far afield, then there are probably several federal activities that could devolve to the provinces or to the private sector. What is important in any transfer of function to the provinces, however, is that the corresponding financing accompanying the transfer of responsibility be unconditional rather than conditional. If the past is any guide, conditional grants are merely a screen for maintenance of centrally-run programs and an erosion of provincial autonomy as well as an invitation to overspend since the expenditure responsibility does not coincide fully with the funding responsibility.

Proposition 4:

So-called "National Standards", enforced by Ottawa, are not likely to work to the economic advantage of the provinces and in any case will serve to erode provincial autonomy.

Undoubtedly there are and will continue to be many cases when the federal government must legislate for the benefit of all Canadians. But it is easy to carry this too far. A case in point is the oft-referred-to concept of a "national industrial strategy". Constitutionally, the provinces have ownership rights over resources within their jurisdiction and presumably how they are allocated. The presence of such a national industrial strategy may simply constitute a way in which Ottawa can infringe on provincial jurisdiction. Two examples are worth emphasizing.

Pollution

Should Canada have a uniform overall policy toward pollution? The answer, I think, must be "no". In certain areas, such as setting the maximum limits to which a body of air or water can be subjected to pollution, there is a compelling rationale for national standards. However, the degree to which a particular plant should be allowed to pollute should not be so controlled. The environment has a natural ability to cleanse itself and it should be classified and recognized as one of the inputs into the regional production functions. Allowing another factory with given polluting capacity in an already polluted area is very different from having this plant locate in a relatively "clean" environment where its overall impact may not subject the environment to much, if any, damage. Too often, calls for national standards with respect to things like pollution are, in effect, what the late Harry Johnson used to refer to as "Ontario First" policies--the industrialized areas of this country, having ravaged parts of their environment, now want to ensure that no other region can have lower (but not necessarily environmentally inappropriate!) pollution standards in order to attract industry.

Ideally, each province will put in place a set of appropriate effluent charges or taxes such that pollution can be kept well within the acceptable levels. And as noted above, Ottawa should have the right to specify the maximum pollution levels. But many provinces have a long way to go before their environment is at the same stage of deterioration as that of some of the other provinces. National standards reward those who polluted first and correspondingly punish provinces whose environments are quite capable of absorbing and even cleansing substantial amounts of pollution.

Foreign Ownership

Much the same point applies to the issue of foreign ownership. Federal laws regulating the degree of foreign ownership severely restrict many provinces in their ability to attract industry and develop their own economies. Canadians are by nature fairly risk averse and until recently it appeared that only the "central corridor" was attractive to Canadian investors. To have national regulations with respect to foreign ownership will likely serve to maintain the "have provinces" favoured economic position within our federalism. In short, the likelihood is that "national" strategies or standards will not be interregionally neutral.

Proposition 5:

The overall incentive system should be such that the provinces are made to bear the full costs of their actions in the economic sphere.

Earlier in the paper, several examples were presented where provinces were enacting legislation in full knowledge that a portion of the costs of the legislation, perhaps a large portion, would be borne by Ottawa and/or the rest of Canada. While individual provinces may still wish to enact such legislation, it is essential that they bear the brunt of the resulting cost. Consider, for example, the employment creation programs in the have-not regions. Ottawa has embarked on a policy that attempts to create jobs in depressed regions. However, if provinces know that Ottawa has a firm commitment to such a program, it may be in their own interest to follow a policy of either increasing unemployment (via high minimum wages) or inhibiting outmigration in order to force even further Ottawa's hand in the job creation role in the province. Every effort must be taken to ensure that individual provinces cannot hold the country for "ransom", so to speak. This is much easier said

than done, but it is critical that the provinces come to realize that they must be held responsible for their own decisions.

An interesting further example relates to the system of equalization payments. Under the old program, the corporate tax base excluded provincial crown corporations and provincially-run enterprises. Hence, if Saskatchewan nationalized (or provincialized!) the potash industry this would decrease its corporate tax base and Saskatchewan would then be eligible for a substantial increase in equalization payments with respect to corporate income taxes. Under the new legislation (which took effect April 1, 1977) this loophole has been closed. For purposes of calculating the corporate income tax base in each province, the new legislation combines the tax base in the private sector and the government enterprise sector. This is but one example of the sort of legislation that is needed in order to ensure provincial economic decisions will not be influenced by incentives emanating from the overall transfer system.

A third example relates to the pattern of provincial minimum wages. Proposition 1 above argued for a two-tiered negative income tax scheme, with the funds for the provincial portion coming from a system of unconditional grants from Ottawa. Therefore, these funds will be available to the provinces to spend as they wish. Presumably a large proportion of the unconditional grant will be directed toward topping up Ottawa's uniform minimum support level. In any event, it is the case that each dollar the provinces devote to the negative income tax system means that there is one less dollar that can be allocated to another provincial program. Under this arrangement it is very unlikely that "have-not" provinces will end up with high minimum wages.

If they so choose, one of two events will occur. Firstly, unemployed families will tend to migrate in order to obtain employment because, relative to the present system, the incentives will be pro-work. In other words, the provinces, by setting a high minimum wage, will be encouraging outmigration. Secondly, if the unemployed families remain, they will be in receipt of the full amount of provincial support for the second tier of the negative income tax system. This will generate a considerable drain on the provincial treasury. In all likelihood, therefore, the provincial pattern of minimum wages will be closely correlated with the provincial pattern of average earnings. But if provinces persist in setting excessively high minimum wages, it is they who will bear the brunt of the cost--in terms of depopulation or a drain on their treasuries.

Proposition 6:

Provinces must accept the fact that part and parcel of gaining more economic independence is assuming more responsibility for economic matters.

With devolution of power from Ottawa to the provinces, it is only natural to expect that the provinces accept a corresponding increase in their responsibilities. This applies to the richer provinces as well as to the poorer ones. Alberta provides an interesting example. Currently this province is rather unhappy, to say the least, about the fact that Ottawa is calling most of the shots when it comes to such things as the pricing and export policies with respect to oil and natural gas, i.e., Ottawa is "managing" a resource that belongs, constitutionally, to the province. On the other hand, it is important to note that it is Ottawa and not Alberta that is responsible

for paying the equalization arising out of provincial energy royalties.²⁴ Had Ottawa allowed the price of domestic energy to rise to world price levels in 1974 without altering the equalization formula, federal income tax rates would have had to rise by roughly 25% to cover the cost of the increased equalization. Clearly Ottawa, on the part of all Canadians, will want to exact some quid quo pro from the provinces in return for transferring increased economic power to them.

On a more general level, if greater autonomy is granted the provinces it ought to be more and more the case that individual Canadians must look to their respective provinces for the solutions to a wider range of problems. Decentralization is bound to be inefficient and counterproductive if citizens (and provinces) continue to look to Ottawa as the perennial provider of last resort.

This completes the admittedly superficial overview of some aspects of a restructured transfer system under a more decentralized federalism. As was noted at the outset, the choice of focussing on a decentralized rather than a centralized federalism was motivated by the direction in which the current debate over the division of power seems to be proceeding. From one vantage point, this may have been a useful exercise. The provinces, or some of them at any rate, have been arguing for greater autonomy in economic matters. Yet little has surfaced in the way of the added responsibility that they are willing to undertake in return for this increased power. It seems to me that in order to make their demands more credible they must begin to articulate the corresponding responsibilities that they are willing to shoulder. And these "costs" can be substantial indeed, as I have argued above. For

²⁴Footnote 16 is relevant here.

Ottawa to simply turn over increased power and authority to the provinces while at the same time to carry on the current complement of responsibilities with respect to regional policy and the transfer system will only serve to magnify greatly the inefficiencies that were highlighted in Part One.

Nonetheless, some degree of decentralization is a viable option. The paper concludes with a recent example of a major move in this direction which, on balance, should prove to be efficient.

IV. RESTRUCTURING THE INCENTIVE SYSTEM: AN EXAMPLE

(The New Arrangements For the Established Programs)

Apart from a few specific proposals, the propositions relating to the restructuring of the incentive system provide more of a conceptual framework than a blueprint for action. However, I would like to end the paper on a more concrete and positive note by focusing on a recent specific policy initiative that falls well within the mainstream of the spirit of the above propositions. This initiative is the set of new arrangements for the so-called "established programs"--post-secondary education, medicare, and hospital insurance. Under the previous arrangements Ottawa contributed 50% of the overall cost of these programs. While it is generally agreed that this arrangement contributed substantially to the quality of post-secondary education and health care, it is also the case that these programs were beginning to run into substantial difficulty. For one thing the costs were escalating at an unacceptable rate, especially for health care. Ottawa became uncomfortable because the open-ended feature of the shared-cost format implied that its contributions were determined by decisions taken in the 10 provincial capitals. From the provincial vantage point, the situation was becoming equally uncomfortable. Basically the provinces were spending 50 cent dollars which represented a substantial erosion of any incentive to economize on these programs. Equally important, the structure of these programs was counterproductive as far as contributing to efficiency. Rationalization of medicare in terms of the creation of a wide range of services that could be provided at less cost by paramedics rather than doctors was effectively blocked because, for the most part, federal support would not be forthcoming for services performed other than by doctors.

The provinces also resented certain other features related to the cost-sharing aspect of these programs. Poorer provinces claimed that it was

difficult to generate their own funds in order to take advantage of federal aid. Furthermore, all provinces at one time or another expressed the view that the conditional nature of Ottawa's contributions distorted provincial preferences as between services covered by the program and the provision of other government services. The other side of the coin is that conditional grants enabled the federal government to exert some influence over programs that were, constitutionally, under provincial jurisdiction.

Under the new arrangements the cost-sharing format is gone. In its place is a complex set of arrangements that, over the short term at least, boil down to equal per capita unconditional grants. While the provinces may be unhappy with the amount of this unconditional grant (and certainly with Ottawa's attempt earlier this month to curtail the funding even further), the program is a marked improvement as far as incentives are concerned. Provinces will be pressed into searching for measures to deliver health care more efficiently--they can no longer count on Ottawa to cover 50% of any expenditure overrun. As part of this drive toward efficiency, I would expect that several provinces will move in the direction of eliminating the current zero cost for visiting a physician. This need not take the form of deterrent fees: there have already been several proposals for dealing with this via the tax system. Out of the experimentation of the various provinces it is reasonable to expect that some important initiatives and proposals will result that will indeed lead to more efficient delivery systems for health care. The unconditional nature of the grant also means that provinces will now view expenditures on post-secondary education and health services in terms of their own merits: they are no longer subsidized relative to other expenditures.

Some problems will of course arise as a result of the new set of arrangements. Nonetheless, in terms of restructuring incentives and encouraging efficiency it represents an important milestone in federal-provincial financing. Furthermore it provides a timely reminder that new arrangements are also required for most of the remainder of the transfer system.