C.D. Howe Institute

Working Paper

www.cdhowe.org September 2005

Reflections on the Political Economy of Fiscal Federalism in Canada

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Prepared for the C.D. Howe Institute Policy Conference "Federal-Provincial Fiscal Reform," Toronto: June 23, 2005

Inside...
Growing federal transfers set the stage for perpetual fiscal imbalances and continuing political instability. A politically and economically sustainable alternative is to increase provincial own source revenue.

The Study in Brief

The traditional view of the political economy of fiscal federalism focuses on vertical and horizontal externalities and limits to local redistribution in a federation. That line of research sees a case for very strong federal government role in provincial finances.

The new political economy literature focuses on political institutions and considers the incentives faced by political actors at both the federal and provincial level. The new view stresses the importance of fiscal accountability.

Close attention to fiscal accountability in setting policy weakens the case for growing federal-provincial transfers. Accordingly, vertical fiscal imbalance in Canada (real or perceived) should be reduced through more tax room for the provinces. How far we should go in this regard is an open question, and it is important to emphasize that relying a little more heavily on provincial taxes, rather than transfers, implies a rebalancing rather than an elimination of all fiscal imbalances. Moreover, the character of the Canadian federation, with wealth concentrated in two or three provinces coupled with the sovereignty aspirations of Quebec, suggests that decentralizing tax authority to the provinces may generate a more stable political equilibrium.

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Canadians seem to be permanently preoccupied with the balance of the federation, or fiscal federalism, as some economists refer to it. Though fiscal federalism has many dimensions, at its core is the division of revenue and expenditure responsibilities between the federal and provincial governments (and municipalities). Central to this definition is the share of tax room for various revenue sources occupied by the federal and provincial governments, and the size and structure of federal transfers to the provinces, in particular the big three transfer programs: Equalization, the Canada Health Transfer (CHT), and the Canada Social Transfer (CST).

While one wonders about the extent of the angst over fiscal federalism on the part of "ordinary" Canadians, particularly given the current political climate in the country and in light of the fact that it is extremely unlikely that any ordinary Canadian actually understands the complex and perhaps unfathomable nature of fiscal federalism in Canada, there is little doubt that the fiscal balance of the federation is a front-of-mind issue for federal and provincial politicians and bureaucrats. The microbiology of fiscal federalism in Canada is under the microscope…again.

Consider a sampling of events that have taken place over just the last couple of months:

- An Expert Panel on Equalization traverses the country seeking input on reforms to the equalization program.
- The federal government and the Atlantic provinces strike a "special deal" on the inclusion of resource royalties (or not) in the Equalization program after Newfoundland Premier Danny Williams removed Canadian flags from the provincial government buildings in the now infamous "flag flap."
- After a "marathon" nine-hour session in May, Paul Martin and Ontario Premier Dalton McGuinty strike another special deal, this time to transfer $5.75 billion to Ontario over five years in response to Mr. McGuinty's claim that Ontario pays "more than its fair share" into the federation.
- Subsequent to this, Mr. McGuinty calls for a major review of the federal tax and transfers system, which he feels is disadvantageous to Ontario.
- Professor Tom Courchene of Queen's University calls for a rethinking of the role of resource revenue in the equalization formula and a sharing of Alberta's oil and gas revenues with the rest of the country in light of high oil and gas prices (Courchene 2005).
- Raising the spectre of another National Energy Program, a concerned Alberta fires back, pointing out that on a per capita basis Albertans contribute more to

the federation than any other province, with the per capita net fiscal transfer (the excess of revenues collected by Ottawa in a province over expenditures made in the province) $742 higher in Alberta than Ontario (this is a 2002 figure; see Kneebone [2005]).

Interesting times indeed.

Concerns over the fiscal balance of the federation are perhaps to be expected in a country where the provinces have more fiscal autonomy than any other subnational government in the world. However, these recent events, as well as several others over the past couple of years — the Seguin Commission in Quebec in 2002, which called for a substantial transfer of tax points from the federal government to the provinces; the report issued in 1998 by provincial and territorial finance ministers that indicated that "the distribution of revenue sources between orders of government...is out of line with the distribution of spending responsibilities " (Ottawa, Supply and Services 1998, p. 13); ongoing squabbling between provincial and federal governments regarding the financing of health care, to name but a few — call into question the extent to which the current arrangements constitute a stable economic and political equilibrium.

The purpose of this note is to reflect on the state of fiscal federalism in Canada through a political economy lens. The analytical economics research on fiscal federalism has been overwhelmingly normative, and theoretical, and has paid little attention to political and institutional details. This is changing, and indeed the political economy of fiscal federalism is quite the fashion nowadays. Although the models are relatively simple, with political and bureaucratic institutions represented in very rudimentary ways, they are becoming more sophisticated and, in my view, provide some new insights into fiscal federalism Canadian style.

A somewhat lengthy summary of the arguments that will be presented below goes something like this. Traditional normative models of fiscal federalism identify various costs and benefits of decentralization. The goal of federalism is to simultaneously achieve the benefits of centralization — including, among other things, free trade, interregional risk sharing, common currency, scale economies in the provision and production of public goods, internalizing externalities, not to mention protection from common enemies — and the benefits of decentralizing to small, relatively homogenous local government units — primarily the ability to cater to local needs, circumstances and preferences. At the risk of drastically oversimplifying volumes of complex research in this area, I think that it is fair to say that most of the benefits of federalism are associated with the decentralization of spending while most of the costs are associated with the decentralization of revenues. In other words, the traditional arguments tend to be stronger for decentralizing spending than for decentralizing taxes. The solution to this problem within a federation is to incur a vertical fiscal gap, whereby the federal government raises more revenue than it needs for its own programs and transfers the surplus funds to provincial governments to spend on local programs and initiatives.

Nice and simple? Federalism allows us to enjoy the benefits of both centralization and decentralization, while a vertical fiscal gap allows us to enjoy the benefits of decentralized spending while avoiding the costs of decentralized taxation. While this basic idea is compelling — and indeed I think that that there is a great deal to it — there are at least two difficulties with it from a practical point of view. The first is that even in the context of the traditional normative models there is no consensus on what the optimal fiscal gap is, and therefore no consensus on the optimal balance between federal transfers and provincial own source revenues. The normative public finance literature offers little in the way of solid prescriptive advice in this regard. As Robin Boadway puts it, "Anyone who suggests otherwise is probably reading more into the literature than is there," (Boadway 2003).

The second problem is that the political and institutional context in which decisions over spending responsibilities, tax room, etc., take place is a dark and murky thing. While it is trite to point out that the political and institutional structure in which decisions are made matters, that doesn't make it any less important. Moreover, bargaining, negotiation, threats about removing flags or withdrawing from federal programs, and so on are all part of the federal-provincial dynamic in Canada, whether or not they take place in a formal institutional context. They matter too. The traditional normative research on fiscal federalism ignores much of this.

And so there are a wide range of opinions — and given our current state of knowledge they are nothing more than opinions — regarding the appropriate balance within the Canadian federation, about how to go about rebalancing the current system, and indeed about whether it is out of balance at all. Returning again to Boadway, on this, "reasonable people can reasonably disagree."

And there is no shortage of disagreement. Accepting for the sake of argument that the current state of public finances in Canada is out of balance given projected federal and provincial revenues and expenditures under the current transfer and tax arrangements — and even this is open to argument — there are two basic ways of addressing this imbalance. One is to increase federal transfers to the provinces, the other is to enhance provincial own source revenue-raising capacity by having the federal government provide "tax room" to the provinces.

As examples of two disparate opinions on how to address the imbalance, consider the views of three highly respected economists and experts on fiscal federalism. Robin Boadway in his 2003 "Memo to Paul Martin": "The imbalance that exists between the federal government and the provinces should be addressed by an increase in transfers from the federal government to the provinces...[and] the federal share of the tax room should be jealously guarded and even enhanced." Jack Mintz and Michael Smart in a 2002 op-ed in the *National Post*, commenting on the Seguin Commission's call for more tax room for the provinces: "One of the more sensible proposals made in Quebec is to transfer 'tax points' to the provinces, in exchange for elimination of federal cash payments under the Canada Health and Social Transfer (CHST). The idea is a simple one: Ottawa would reduce its tax rates by the full amount of the current CHST, and the provinces would increase theirs in an offsetting way...This idea has the potential to strengthen Canada's fiscal union and improve political accountability for all governments. And it may be the best way to tackle our current crisis over health care." So yes, reasonable people can reasonably disagree.

In what follows I will very briefly review some of the traditional normative arguments concerning fiscal federalism. I will then juxtapose those arguments on some more recent insights from the political economy literature. This research emphasizes the role of political accountability in policy decisions, and it emphasizes that different fiscal systems have different incentive effects for policymakers in different institutional environments. It typically adopts a game theoretic framework, and focuses on bargaining and negotiation between different levels of governments. It emphasizes that the institutional environment and structure of federal fiscal arrangements affect the incentives facing political decision makers, and that federations will not function effectively (nor efficiently) unless incentives are properly structured.

My bottom line, finally, and it is just another opinion from an arguably reasonable person, is that the new political economy literature — and I stress here that the models are as abstract, as rudimentary, and as theoretical as the traditional literature, and that drawing policy implications from this research is slippery at best — provides two types of insights in a Canadian context. The first is a normative insight that tips the balance, in my mind, in favour of some amount of fiscal rebalancing via the transfer of tax points to the provinces rather than an expansion of transfers. The second is a positive insight, which predicts that the institutional and political environment in Canada is such that this rebalancing may be inevitable in any event, for good or ill.

I should stress that this note is not intended to be an exhaustive survey or synthesis of the vast literature on fiscal federalism. It is very much a thought piece, reflecting my own interpretation of selected research in this area and its implications for fiscal federalism in Canada.

Reflections on the Traditional Normative Approach

Boadway (2003) makes an important distinction that I think is quite useful — the distinction between a vertical fiscal gap (VFG) and a vertical fiscal imbalance (VFI).

- VFG: taking the expenditure responsibilities of each level of government as given, how should the revenue raising activities be split? How much should the federal government raise and how much should the provinces raise? The VFG is therefore the "optimal" or "desired" gap between provincial spending responsibilities and their revenue-raising activities.

- VFI: the federal system is in balance when the actual difference between provincial spending and own source revenues is equal to the VFG. If this is not the case, a VFI exists, in which either federal transfers or provincial own source revenues are not adequate to finance provincial expenditures.

As discussed in the introduction, there is a good deal of disagreement among reasonable people regarding the appropriate VFG. While I don't mean to suggest that it is not a matter of some debate, I think it is fair to say that there is less disagreement on whether or not a VFI currently exists in Canada. In my view the evidence suggests that a VFI does exist and that it will not go away in the foreseeable future if not attended to. I offer as support Figure 1, which illustrates Conference Board of Canada projections of budgetary balances for the federal and (aggregate) provincial governments given current transfer and tax arrangements.

Given that Canadian provinces have virtually unfettered revenue-raising capabilities, why should there be a vertical fiscal imbalance at all? Can't provinces just cut their spending and/or increase their own taxes to eliminate an imbalance? I will have more to say about this question below, but at this point I refer again to Boadway (2003), who argues that:

- The extent to which provinces rely on own source vs. federal transfer revenues is endogenously determined;

- It is an equilibrium outcome of a game where the federal government has first-mover advantage in setting tax and transfer rates; and

- These decisions are made largely, though not completely, independently.

For these reasons, Boadway argues that a VFI is a possible equilibrium outcome.

Norrie and Wilson (2000) — another couple of reasonable people — have a slightly different take. They suggest that there may be some combined federal-provincial tax rate that is somehow acceptable, perhaps, for example, because rates cannot be much higher than the combined rate in the U.S. Suppose also that the marginal benefit of local government expenditures is higher than federal government expenditures. Thus, to spend more, provinces must tax more, and to tax more, the federal government must tax less. They go on to suggest that this gives rise to a bilateral bargaining game over how to divide up a fixed pie (assuming that provinces act in concert, which is a bit of a stretch) whereby the federal government is at an advantage because of prior occupancy — because the federal government already occupies the tax room, the provinces are handcuffed because they will be perceived as being the villain for raising taxes.

I think both views have some merit, and that provincial governments are indeed constrained in their ability to close the VFI by increasing their own taxes without some sort of tax room provided by the federal government.

As mentioned above there are two basic ways that the federal government can deal with the VFI. One is to increase transfers. The other is to enhance the own source revenue-raising capabilities of the provinces by providing tax room or tax points — lowering federal tax rates (presumably on the personal income tax, though this is not a foregone conclusion) and allowing the provinces to fill the gap.

Economists have considered the pros and cons of the alternative approaches to addressing the VFI largely from a normative perspective. Normative arguments for closing the VFI via the increase in federal grants (or arguments for raising or maintaining the VFG) include:

- Tax harmonization across provinces is maintained.

- Tax exporting would be limited.

- Horizontal tax competition is bad — the perceived marginal cost of public funds (MCF — the social cost of raising one more dollar in revenue) facing the provinces is high because provinces ignore the positive externality associated with a rise in taxes in their own jurisdiction, suggesting that provinces will set their taxes too low.

- Vertical tax competition is bad — because of tax base overlap, the perceived MCF on the part of provinces is too low and provincial taxes are too high. Dahlby (1996) shows how matching federal grants can be used to undo this effect and equalize the MCF across governments. On a related note, matching grants for provincial expenditures in areas where there are positive spillovers to other provinces, as in postsecondary education, are efficiency enhancing.

- The ability to achieve national equity and redistributive goals is enhanced.

- National equalization is facilitated — the CHT and CST are both equalizing in the sense that they provide equal per capita transfers financed via taxation. More provincial tax room would increase provincial disparities that would have to be made up by the equalization system, and this when the federal taxing room and therefore revenue-raising ability is lower. The CHT and CST and their predecessor, the CHST, were mildly redistributive in an absolute sense, with the total value of the transfers (tax points plus tax transfers) higher in low-income provinces than in high-income provinces.

- Insurance is provided against regional shocks.

- Harmonized programs enhance efficiency.

- Even though provinces may differ in their preferences for income redistribution, the mobility of households and businesses may make provincial distributional policies self-defeating as the rich move out and the poor move in.

Normative arguments for closing the VFI via the provision of tax room (or arguments for lowering the VFG) include:

- Provincial autonomy and heterogeneous provincial preferences. There is a concern that federal government transfer programs are not pure block grants and that the federal government uses grant conditions to impose themselves on provincial spending areas. The CHT, for example, requires adherence to the *Canada Health Act*. The normative issues here involve the possibility of different provincial preferences for some programs and the stifling of experimentation in areas such as health care and social services. A related issue involves different preferences for equity and redistribution among provinces — national standards imposed uniformly across the country allow neither for this nor for different circumstances and local conditions. Shah (1996) provides evidence that the expenditure needs of the provinces vary because of differences in demographic, environmental, and economic factors. To the extent that these differences are largely exogenous to provincial policy decisions, this argues for federal cash transfers that are responsive to local needs and conditions. Yet this is rarely the case. Giving the provinces more tax room allows them to better deal with local conditions.

- Budgetary uncertainty results because of arbitrary federal cuts. Witness the offloading of federal deficit reduction onto the provinces in the 1990s.

- Horizontal tax competition is good, for two reasons: 1) it constrains Leviathan (big government), and without it provincial tax rates would be inefficiently high, and 2) it works against the tendency for taxes to be too high because of the vertical fiscal externality and the equalization system.

• Fiscal accountability is enhanced — more on this below.

Reflections on the Political Economy of Fiscal Federalism

The bulk of traditional normative models make rather blunt assumptions about the motives of politicians and public officials, assuming politicians are either malevolent rent-seekers (as in Leviathan models) or benevolent dictators (as in Welfarist models).

Aside from disagreements as to the size and importance of vertical and horizontal fiscal externalities — essentially a disagreement about elasticities — in many ways different views about the size of the VFG and about the desirability of addressing the gap via tax points or cash transfers boil down to which view of government one thinks is more appropriate — the Leviathan view or the Welfarist view.

The new political economy view takes what might be considered a middle road. It presumes simply that politicians are primarily interested in maintaining and enhancing their political careers. This straddles both Leviathan and Welfarist models and both economics and political science.

Rather than viewing politicians as either revenue or social welfare maximizing automatons, and focusing on the size of fiscal externalities and the relative elasticities of tax bases, these models treat government decisions as bargains struck among self-interested politicians attempting to form winning coalitions. For example, Besley and Coates (2003) and Lockwood (2002) argue that the case for decentralization depends critically upon the nature of legislative bargaining over distribution; see also Inman and Rubinfeld (1996, 1997) and Persson and Tabellini (1996).

Soft budget constraints play a particularly important role in much of this research. When an entity such as a provincial government faces a soft budget constraint, it means that it can implicitly or explicitly pass on its liabilities to other entities, such as the federal government. Much of the research focuses on bailouts in debt crises, though I will argue below that the idea goes beyond debt crises. It argues that when the central government plays a significant role in financing provincial governments (via cash transfers, for example), it is difficult to credibly commit to not bail the provinces out in the event of a debt crisis (see the edited volume by Rodden, Eskeland, and Litvack [2003], and in particular the chapter by Bird and Tassonyi on Canada). This creates poor incentives for fiscal discipline on the part of provincial governments. In particular, it provides incentives for provincial governments to overspend, undertax, overborrow, and under provide services in the hope that local public expenditures will ultimately be subsidized by taxpayers in other jurisdictions. Instead of implementing politically painful expenditure cuts or tax increases, provincial politicians might choose not to adjust fiscal policy if they believe that ultimately they will be bailed out by the federal government. This sort of dynamic fiscal irresponsibility is one possible manifestation of the fiscal accountability argument in favour of tax decentralization referred to above.

It is important to emphasize that a debt-servicing crisis is not the only type of crisis that provinces can argue for a bailout from. An obvious Canadian example is health-care funding, where the provinces have been crying for more federal money for years on the basis of a health-care crisis.

Not only the federal fiscal structure but also the structure of political institutions affects the likelihood of these types of moral-hazard problems. In many federal countries the structure of the central government includes representation of the subnational constituent units. Depending on the details of such representation, and on other aspects of a country's political institutions, this can give rise to logrolling by which a central government would opt to provide bailouts to certain states, even though the policy is inefficient for the federation as a whole.

Canada is one of the few federal countries that does not have formal representation of provinces in federal institutions. However, this does not mean that these sorts of political considerations do not play a role in federal bailouts, implicit or explicit. In Canada, bailouts may manifest themselves in more subtle ways, through the design of general federal-provincial transfer programs and other government programs that favour some provinces/regions/constituencies over others, and through special deals struck between the federal government and individual provinces that are not applied more generally.

The recent special deals struck between the federal government and the Atlantic provinces and Ontario are examples of the latter. Notably, the equalization deal on resource revenues with the Atlantic provinces did not include Saskatchewan, although it too is (periodically) a have-not province where resource revenues are increasingly important. The $5.75-billion deal with Ontario was struck in response to Premier McGuinty's cry that Ontario was paying more than its fair share into the federation. No such deal has been struck, or even discussed, with Alberta, where the per capita fiscal transfer was higher than in Ontario. Could it be that that swing voters in Atlantic Canada and Ontario are more important to the current federal government's electoral success than voters in Saskatchewan and Alberta, where there is little likelihood of an increase in Liberal Party fortunes? Is it possible that politics and not economics or concerns over efficiency and equity determined the outcome of these deals?

A historical anecdote on the politics of soft budget constraints suggests that this is not a new problem. Perhaps ironically, the only default of provincial government debt in Canadian history was by the Government of Alberta. As documented by Boothe (1995), the federal government refused to bail the province out, and it defaulted on its international debt in 1936. This state of affairs continued until the federal government finally intervened to pay off Alberta's international debt in 1945, more to cleanse the country's international credit rating than the province's. Boothe points to the federal government's decision to offer financial relief to Saskatchewan, which was in a similar fiscal malaise in the 1930s, as suggestive of the view that perhaps political considerations played a role in the bailout decision.

Some non-anecdotal evidence that electoral politics determines the interregional allocation of federal-provincial transfers in Canada is provided by Milligan and Smart (2003). They examine the allocation of two federal government transfer programs: the Atlantic Canada's Opportunities Agency and the Economic Development Agency of Canada for Quebec Regions. These programs provide transfers to local governments, businesses and NGOs to finance capital projects. The authors find that transfers from these programs are significantly higher in electoral districts that are close races and in the districts of senior government members (but not in government-held ridings in general). The transfers under these programs are discretionary, and not formula driven, suggesting that political considerations are more likely to play a role here than in formula-driven programs such as Equalization, the CHT, and the CST. However, the formulas themselves are the result of political decisions, and the application of the conditions of the programs is a matter of political discretion.

This discussion of accountability and soft provincial budget constraints suggests, importantly in my view, that as long as a significant amount of provincial revenues are derived from federal transfers (and importantly more so in some provinces than others), the political incentives faced by provincial politicians will generate a perpetual state of vertical fiscal imbalance. Hence attempts to close the fiscal gap by increasing federal transfers will inevitably set the stage for another imbalance in the future. Perhaps the only way of addressing the imbalance in the long run, in a politically and economically sustainable fashion, is to increase provincial own source revenue via the provision of more tax room. Only when provincial governments are more accountable to their own citizens will the moral-hazard problems associated with soft budget constraints be eliminated. Recalling again the quote from Mintz' and Smart's *National Post* article: "This idea has the potential to strengthen Canada's fiscal union and improve political accountability for all governments."

Another line of research that considers the incentives faced by provincial politicians in the face of a vertical fiscal gap filled by federal transfers has its origins in some seminal articles written more than thirty years ago. Atkinson and Stern (1974), following Diamond and Mirrlees (1971), show that the marginal cost of taxation can be reduced if public expenditures that are financed by taxes help to expand the tax base. Thus, if taxes are spent on growth-enhancing, tax-base-enhancing expenditures, the optimal tax rate is higher than in a situation where there is no feedback effect.

While this research does not deal explicitly with federal-provincial transfers, it does have important implications for fiscal federalism and the size of the vertical fiscal gap. For example, to the extent that they rely on transfers from the federal government to finance their expenditures, provincial governments do not take proper account of the base-enhancing impact of their expenditures and may underspend in those areas. An obvious example is expenditures on education, a provincial responsibility. A recent paper by Careaga and Weingast (2002) makes a similar point. The authors present a simple model in which governments that raise their own revenues have incentives to provide market-enhancing public goods, such as education, whereas governments that rely on grants from the central government are more likely to use resources on patronage and rent seeking.

There are differing views on the merits of decentralized taxation from other perspectives. Boix (2003) argues that decentralized taxation is necessary to hold countries together in the face of uneven interregional income distribution. The basic idea here is that decentralized taxation ensures rich regions that their wealth will not be expropriated by poor regions. In a Canadian context this raises the perennial question of how long Ontario and Alberta will be willing to pay for programs in other provinces, particularly in light of the accountability issues raised above. Under this view, federal transfers financed by taxing wealthy provinces can be pushed only so far before the wealthy provinces rebel. In light of the rhetoric coming out of Ontario, is it possible that we have reached this point in Canada?

A contrary view points out that agglomeration effects and differences in natural resource endowments can lead to pronounced income differences between regions. This can lead to a situation where the median jurisdiction is poorer than the mean jurisdiction. Since decentralized taxation allows only the wealthy provinces to provide public goods (infrastructure investment, education), the poorer provinces fall further and further behind. In this scenario, poor provinces push for tax centralization to capture the wealth generated by the wealthier provinces. Median voter logic then suggests that it is difficult to maintain decentralized taxation in the face of concentrated wealth.

There are limits to this argument, however, which are particularly relevant for Canada. One is that if wealthy provinces with preferences for decentralized taxation are outnumbered, they may be able to make credible secession threats to harness the redistributive aspirations of the less-wealthy provinces. Given the complexity of interprovincial and federal-provincial relations in Canada, while explicit secession threats may not be credible in some cases, there are other things that the wealthier provinces can do to withdraw from the federation that may be more credible.

Another issue relates to the importance of Quebec in defining fiscal federalism in Canada. Although by most accounting Quebec is a fiscal winner from the current arrangements, Quebec desires fiscal, and in particular tax, decentralization for other reasons — sovereignty. This provides the wealthier provinces of Ontario and Alberta with an ally in the call for tax decentralization. Consequently, decentralized taxation, via a transfer of tax points to the provinces, may well be a stable political equilibrium in the Canadian context. Indeed, it may be necessary to keep the country together.

Concluding Reflections

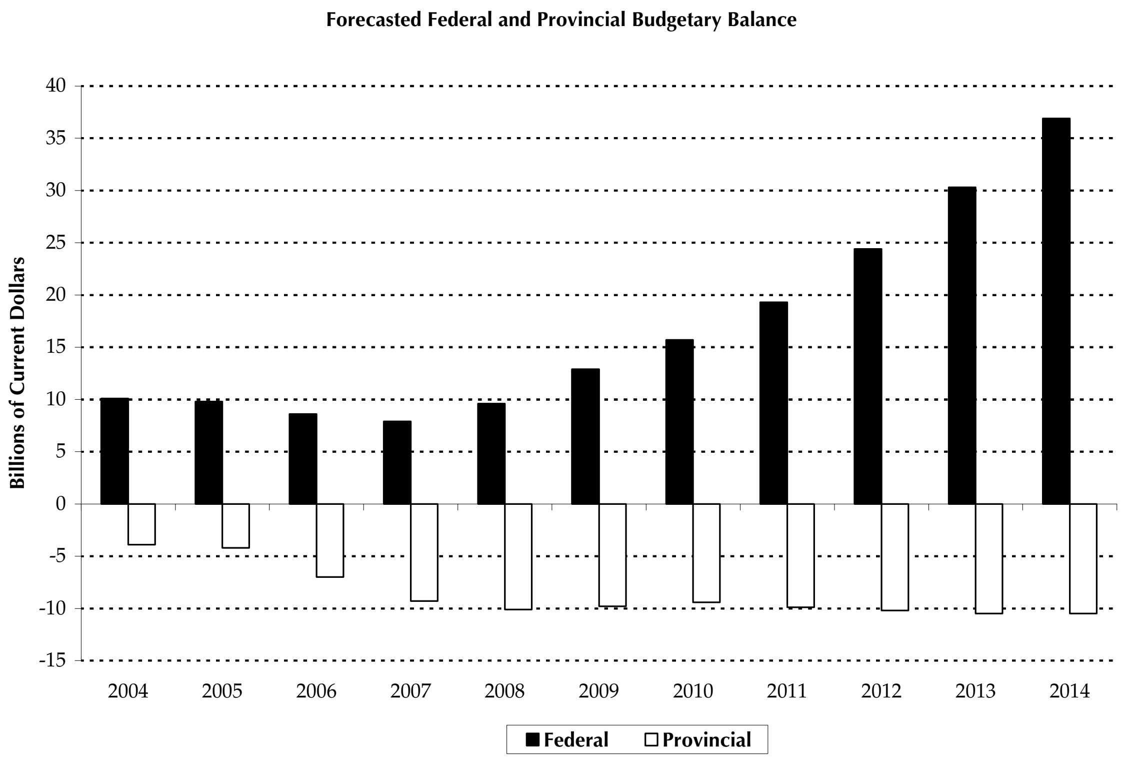
I have considered some of the new (and not so new) political economy literature as it relates to fiscal federalism in Canada. The traditional normative fiscal federalism research focuses on vertical and horizontal externalities and limits to local redistribution in a federation. This research has caused many to call for the maintenance, if not a strengthening, of the federal government's role in provincial finances.

The new political economy literature focuses on political institutions and considers the incentives faced by political actors at both the federal and provincial level. It stresses the importance of fiscal accountability.

My reading of this literature is that it weakens the case for federal-provincial transfers, suggesting that any vertical fiscal imbalance in Canada, real or perceived, should be closed via the provision of tax room to the provinces. How far we should go in this regard is an open question, and it is important to emphasize that I am not advocating the elimination of the VFG altogether — merely a rebalancing that relies a little more heavily on enhanced tax room than on transfers.

Moreover, the somewhat unique character of the Canadian federation, with wealth concentrated in two or three provinces coupled with the sovereignty aspirations of Quebec, suggests that decentralizing tax authority to the provinces may constitute a stable political equilibrium.

Figure 1



Source: Conference Board of Canada (2004) Table 2b and 3a.

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