A Joint Venture

The Economics of Constitutional Options

Twenty-Eighth Annual Review

Economic Council of Canada

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This report reflects the views of the Members of the Economic Council of Canada; however, a comment on Chapter 2 by Pierre Paquette and Marcel Pepin appears at the end of the document.

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Foreword

The choices that we Canadians must make about the political structure of Canada over the next few years will have economic repercussions. The goal of the Economic Council, in this Annual Review, is to arm Canadians with information that will enable them to understand better the key economic issues in the constitutional debate, and to help them to make more-informed choices about this *joint venture* that is Canada.

The original concept envisaged for the review was to examine the trends in east/west linkages within Canada in the light of rapid changes in the global economy. As political events unfolded in 1990, however, the research design was adapted to take into account the emerging debate about political change in Canada. In particular, we had to develop a capacity to analyse the economic repercussions of various political options as well as the east/west linkages.

Our objective has been to go beyond the "balance sheet" approach that characterized the economic debate leading up to the 1980 referendum in Quebec. Simply adding up federal spending and revenues in each province in order to come up with the benefit or cost of participating in the federation is limited and, in many respects, misleading. Therefore, we chose to use more-complex tools that would enable us to make more-comprehensive calculations. First, we developed a model to project the future profile of federal and provincial revenues and expenditures that could take into account variations in the division of tax and spending responsibilities. We also used a general-equilibrium model to analyse the regional repercussions of changes in fiscal arrangements under various political structures.

In presenting the results of our research, we have been careful to place those quantitative results in the appropriate context, since there remain complex questions that can only be answered qualitatively. For example, economists cannot measure to what extent a change in political structure will act as a spur to economic growth by releasing new energy that has been dormant in a society. Such dynamic gains exist, we know. But we cannot assess their scope or the conditions that unleash them. Nor can we measure the consequences if the change involves acrimony. As a result, any comprehensive assessment of a new political structure will include unresolved questions.

Our results are put forward here in all humility, for three reasons. First, economics is not the whole story in this debate. It is only one aspect of the whole issue that Canadians must weigh as they assess possible changes to the federation. As we point out in Chapter 4, Canadians must make a fundamental choice about how they define the responsibilities for sharing between citizens. The broad vision of sharing calls for a common standard of public service and tax burdens for all Canadians; the "communities" vision of sharing allows for quite different treatment of individuals living in different provinces. Second, as just noted, many of the most important questions can only be answered in qualitative terms. And third, although we have done what we could with the tools available, we know the results are not perfect. With better data and more time, better answers could probably be provided.

The review was completed and sent to Council members for signature just before the federal proposals on constitutional reform were released. To avoid any delay in publication, we chose not to modify the text to evaluate these proposals. Our assessment will be published separately. Readers will find, however, that the review can serve two purposes in the debate on the federal proposals. It provides a great deal of analytical background on the economic union, which is one of the cornerstones of the proposals. It also sets out a range of alternative mechanisms that can be used to meet the objective, which we share, of better coordination of federal and provincial actions on economic policy.

The Council's research team, directed by Jean-Pierre Voyer on the economic union, with assistance from Ross Preston and the members of the Performance and Outlook group, has completed an ambitious research agenda within a short period. The other key figures in this process were the Council members listed on the preceding pages. They represent the diverse regions and interests in Canada, and thus they encompass almost every point of view on the issue of the future of the federation. Each Council member brings his or her own vision of the Canadian economic union. Each, in turn, reserves the right to draw his or her own conclusions – to measure the costs and benefits against a yardstick that is highly personal. Their signatures bear witness to the objectivity of the research.

Judith Maxwell
Chairman

A Joint Venture

READER'S NOTE

The reader should note that various conventional symbols similar to those used by Statistics Canada have been used in the tables:

. .	figures not available
. . .	figures not appropriate or not applicable
– –	amount too small to be expressed
–	nil or zero
x	data omitted for reasons of confidentiality

Details may not add up to totals because of rounding.

1 Introduction

Canada is one of the richest countries in the world, with a quality of life that is the envy of citizens of many other nations. Yet this country is going through troubled times that could lead to its fragmentation if Canadians are not vigilant. The failure of the Meech Lake Accord was met with disenchantment and anger in Quebec, and it has also revealed profound discontent, elsewhere in the country, with the current operation of the political and economic system.

As a result, Canadians are now engaged in an introspective search for values and directions on which to build their future. Government and academic circles, and people in general are participants in a lively debate on the political changes required to respond to the aspirations and claims of citizens from various groups or regions.

As a body of economic advisors, we tend to view these developments through an economic lens; we are particularly concerned with the impact that a new political structure will have on the prosperity of Canadians in all regions. Economics, of course, does not embrace all the ramifications of the political dilemma, but it remains a central preoccupation for the large majority of Canadians. In this review, we hope to contribute to the debate by helping to clarify some of the economic stakes at issue.

The Evolution of a Joint Venture

The upcoming decisions concerning the political and institutional structure of the Canadian federation will set the framework for several generations into the future. In preparing for those decisions, it would be unwise to ignore the achievements of past generations.

Canada has accumulated wealth over the past 125 years by combining its natural resources and the creativity and generosity of its people. Chart 1-1 shows the trend in real income per capita since 1870. The early decades were perilous – fraught with global recessions, dependence on a few staple exports, and a limited capacity to generate the capital needed to build the railways and other essential infrastructure. Prosperity seemed to be established after 1900 but was soon interrupted by war, inflation, and then depression. The essential fabric of a modern Canada was woven after 1945 – infrastructure (schools, hospitals, airports, roads), industrial diversification, and the public services and personal support system that constitute the Canadian safety net.

Since the first census was taken in 1871, the population has increased more than sixfold, and income per capita has risen twelvefold. Public and private investment in railways, canals, schools, mines, factories, houses, hospitals, and so on contributes to today's well-being. Over the past 50 years, social insurance, publicly provided health and education services, and interregional sharing have formed a comprehensive safety net. All this has been achieved as a joint venture of the Canadian people. Together, they have created a great deal of wealth, as well as a system for sharing it.

Political stability – and adaptability – have contributed to this economic success. Federal institutions have evolved over time in response to shifting economic, demographic, and political forces. The provinces were powerful at the beginning, but the federal role grew in response to the crises of the Depression and World War II. After the war, the creation of many new international institutions to foster cooperation among nations gave rise to a new role for the federal government. Domestically, the federal authorities believed that the mission of the central government was to make Canada a better, fairer society.

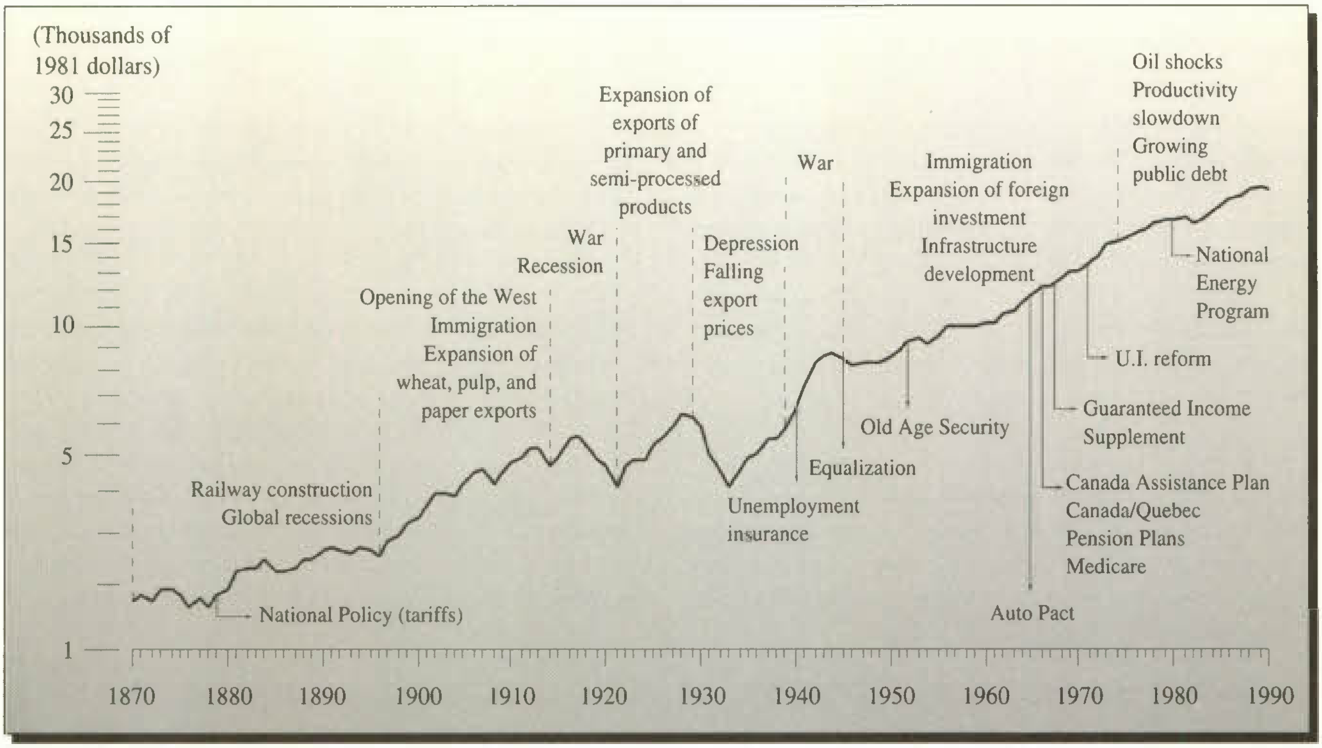
Thus began a gradual process of modernization and harmonization. Governments negotiated agreements to implement the key elements of a welfare state. In some cases, Quebec opted for a formula that differed from that adopted by the other provinces. These agreements altered the division of powers several times over the period. But this was done through executive federalism, not through the kind of public rethinking that is now under way.

As the social responsibilities of the provinces grew, Canadian governments became preoccupied with regional issues: the regional economies are diverse – specialized in different commodities, serving different markets, with quite uneven wealth and tax bases. Thus political commitments were made to achieve "equity" among the regions and to narrow regional disparities.

In contrast to the 1860s, when the former British colonies were most concerned about military security and access

Chart 1-1

Real Income per Capita, Canada, 1870-1990



SOURCE M. C. Urquhart, "Canadian economic growth, 1870-1980," Discussion Paper No. 734, Institute for Economic Research, Queen's University, 1988, and estimates by the Economic Council, based on data from Statistics Canada.

to markets, Canadians today are more concerned with their entitlements as citizens and their capacity for self-expression within the political system. But economic security is still a priority: Canadians place a high value on owning their own home and on access to universal health-care services.

Fallout from the Failure of the Meech Lake Accord

The failure to ratify the Meech Lake Accord by the predetermined deadline (23 June 1990) marked a turning point in Canadian history. The 1987 Constitutional Accord between Quebec, the federal government, and the nine other provinces, which laid out the terms under which Quebec could agree to adhere to the 1982 Constitution Act,[1] did not obtain the necessary approval of all ten provincial legislatures.

This failure was perceived in Quebec as a rebuff to its commitment to Canada and as a rejection of its distinctive character. It was interpreted as a signal that any steps to promote Quebec's language and culture would be opposed by the rest of Canada.

The Quebec government responded by creating a special advisory body – the Commission on the Political and Constitutional Future of Quebec, also known as the Bélanger-Campeau Commission. Following the commission's recommendations in March 1991,[2] the National Assembly passed an act (Bill 150) establishing the process by which the political and constitutional future of Quebec would be decided. Part I of the act calls for a referendum on Quebec sovereignty to be held before 26 October 1992; should the result be favourable, Quebec would become a sovereign state exactly one year to the day after the date of the referendum. Part II calls for the creation of a special parliamentary commission by the National Assembly to assess all proposals that the federal government might make for new constitutional arrangements and to recommend responses to the National Assembly.

The Quebec Liberal Party also set up a committee to study the constitutional situation. The committee's report, named after its chairman, Jean Allaire, was adopted by the party in March 1991 and had a substantial impact on setting the tone of the current debate.[3] It called on Quebec to take over exclusive authority in several areas and proposed to eliminate federal spending and residual powers. The report recognized the need for a stronger economic union, cooperative mechanisms, substantial reform of common political institutions, and a new formula for amending the constitution. One overriding objective set by the Allaire report was a substantial reduction in the size of the federal government and the elimination of "costly and sterile overlapping jurisdiction, leading to inefficiency and irresponsibility."[4] These comments struck a responsive chord not only in Quebec but in western Canada as well.

Reacting to the failure of the Meech Lake Accord, a number of provinces and private groups launched study groups or task forces to examine constitutional issues more closely.[5] The federal government itself created two commissions: the Beaudoin-Edwards Commission, which provided advice on the formula for amending the constitution;[6] and the Citizens' Forum, which reported on the concerns of 400,000 Canadians about the future of their country.[7]

In some respects, the current focus on the constitutional question resembles the period leading up to the Quebec referendum in the late 1970s. Yet the analogy should not be drawn too closely. Today's political and economic context is fundamentally different. Quebecers are more confident about their capacity to "go it alone." And so far, at least, the emotional confrontation that took place between federalist and sovereignist forces in Quebec during the 1980 referendum has not recurred; in fact, there seems to be broad consensus on many aspects of the question.

More important, Quebec is not alone in calling for change. The native peoples have communicated clearly their anger at having been alienated from the riches of the country for so long. They have made it clear that the next constitutional round will not be limited to Quebec's concerns.

Westerners, too, have expressed sentiments of frustration and isolation from the centre of power. They are questioning the foundations of Canadian political institutions and proposing major changes to eliminate overlapping jurisdictions[8] and to reform representative government in Canada in order to take better account of regional interests.

Pressures on the Joint Venture

These political forces are not the only threat to the Canadian joint venture. In fact, there are a host of economic, fiscal, and political factors at play.

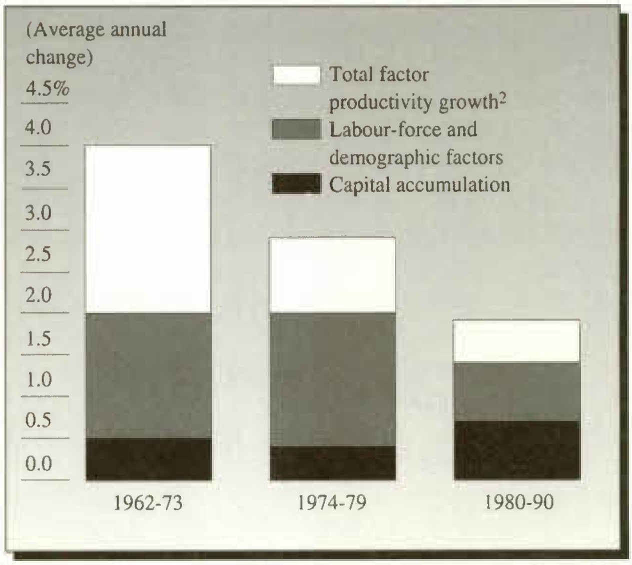
The *economic* pressures are the least visible but perhaps the most corrosive. First, there is the growing interdependence of industrial economies on a worldwide scale, which leaves Canadians, much like the citizens of other countries, with less control over their lives. Governments must conform to international conventions and must deal with transnational corporations with a global perspective. Most domestic corporations are exposed to more volatile markets and more competition from new sources. Individuals find that their lives are turned upside down by distant competitors and faraway trade wars (as in agriculture). They are starting to question whether the existing political institutions have any influence at all in preserving their economic security.

A second source of pressures, more specific to Canada, is the secular decline in the prices of natural resources on world markets. Resources have generated much of our wealth in the past, but given the current trends in demand and supply, the value of the resource base is diminishing.

Canada is also experiencing the cumulative effect of a slowdown in productivity growth that began in 1973. This slowdown has been more pervasive and longer-lasting here than in other industrial countries. Chart 1-2 shows how sagging productivity growth has affected the growth of real incomes. Real incomes have continued to rise, but the real

Chart 1-2

Sources of Growth in Real Income per Capita,[1] Canada, 1962-90



1 Measured as growth in real GDP per person.

2 Total factor productivity is the efficiency with which all factors are used in the production process.

SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

earnings of a typical worker have not. The gains in income have occurred mainly because more family members work and because transfers from government accounted for a greater share of personal income in the 1980s than in the 1960s and the 1970s.

Fiscal issues constitute a more direct challenge to the current political structure and to federal institutions. First and foremost are the problems arising from the federal deficit. After decades of building up the public sector and responding to Canadians' sense of entitlement to new forms of social security, the federal government has seen its deficits grow and its debt build up to the breaking point. Entitlements have been eroded, spending has been cut, national institutions have been privatized or have shrunk, and taxes have been raised. Canadians are paying more in taxes and getting less service for that money because one third of the taxes go into debt servicing. This undermines the traditional leadership role of the federal government.

Added pressure comes from the recent period of provincial ascendancy. The provinces have jurisdiction in most of the areas where costs are rising quickly (such as health) and in those areas where citizens want to see reform and revitalization (such as education). The share of provincial/local governments and hospitals in total public-sector spending on these programs is now 61 per cent.

Finally, as the federal government reduces its transfers to the provinces, the latter demand more control over the tax structure and over the setting of standards for key programs (health care, for example). If Ottawa pays less of the freight, they argue, it should have less of the political power.

On the *political* front, the disillusion, anger, and frustration coming from Quebec, the aboriginal people, and the Western provinces form only one side of the picture. More profoundly entrenched and more difficult to address are the disappointed expectations of a generation of Canadians who find that they are working harder, paying more taxes, and still not making the gains in living standards that they had expected to achieve. These sentiments are linked to the fiscal crisis, the dependency on transfers, the fact that earnings from work are distributed less equally than they were in the 1960s, and the shift of income from younger to older families.[9]

The Task Ahead

The pressure from Quebec creates a deadline for change that has concentrated the minds of many Canadians. The anger of the native populations and the disappointment of the broad middle class has led to a boiling-over of frustration with politicians and political institutions. It has also heightened regional tensions, with Quebecers and westerners each convinced that they are getting a raw deal from the federal government.

Thus we have no choice but to deal with both economic and political pressures on the system at the same time. We cannot begin to tinker with political institutions unless the changes respond well to the economic and fiscal pressures that have helped to destabilize the status quo.

In a way, this can be seen as a great opportunity. In our last Annual Review, we identified two transitions that Canada must make during the 1990s in order to safeguard the living standards to which Canadians are accustomed. On the domestic front, we argued that Canadians need to rethink their priorities and their economic decision-making apparatus in order to improve their ability to fight inflation while avoiding severe recessions that can impose substantial and lingering social and private costs. Internationally, we stressed the urgent need for Canada to adapt to global realities. The constitutional crisis has, in some respects, complicated and hampered the goal of accomplishing these crucial transitions. Yet this situation may also present an unprecedented opportunity in that, by encouraging Canadians to take a long, hard look at the strengths and weaknesses of their political and economic system, the national-unity debate may end up precipitating the kind of change needed to make these transitions. It may even lead to some real improvements in the democratic process.

The Council does not pretend to have the answer to today's political and economic challenges. What we wish to do in this Annual Review is to set out the economic background to the debate by describing the economic linkages among regions and to set out as clearly as possible the unavoidable trade-offs involved in some of the paths that Canadians may elect to follow.

In Chapter 2, we look at the economic challenges that Canadians must face in the 1990s – the task of getting ready for world competition and getting their own fiscal and monetary house in order. We set out targets for the medium term.

In Chapter 3, we pose the following questions: What should citizens expect from an economic union? Are Canadians making the best of what they have? How much do provinces trade with each other? Do corporations do business in more than one province? Do people move from one part of the country to another? What can be done to improve the way the union works?

In Chapter 4, we ask: How has Canada organized the system for sharing between citizens and between regions? What are the pressures for change? What are the linkages among governments? How do the fiscal arrangements shape up? How could they be changed?

In Chapter 5, we examine several constitutional options now under discussion and provide a general assessment of their economic impact on Canadians from all regions.

In Chapter 6, we summarize our findings and set out the fundamental question that Canadians will have to ask themselves if they are to forge the foundations of a future joint venture.

2 The Medium-Run Economic Context

Today's political and social tensions derive in part from economic difficulties. The economy has been struggling under a heavy burden of federal debt and has been weakened by an inefficient industrial base. As a result, Canadians have found it increasingly difficult to earn their way in the world, particularly over the past 15 years or so. The repair process is now under way, but a successful ending is not yet guaranteed.

In this chapter, we focus on the two fundamental shifts that Canada must make – the need to gear up for international competition, and the need to adapt to a very basic change that is occurring in the federal government's approach to monetary and fiscal policies. Our examination of trends in productivity, costs, and trade policy addresses the first of these concerns. It is followed by a review of the current performance of fiscal policy, inflation, and unemployment. The chapter concludes with our assessment of the medium-term outlook and our performance targets for the mid-1990s.

Canada's Competitiveness and Trade Challenges

In the past, Canada's abundant raw materials have given it a competitive advantage on world markets. That legacy must now be transformed into a capacity to capture the new opportunities emerging in international markets, so as to ensure that Canadian living standards will continue to rise. More and more competitors are now entering international markets with widely different and very competitive cost structures. Canada's success in this environment will depend upon its ability to manage its costs and to strengthen productivity growth. In the short run, meeting the test of the market will depend on trends in prices, wages, and the exchange rate; over the longer run, however, productivity growth and innovation will play a fundamental role.

International trade is still vital to continued prosperity in this country; at the same time, international trading relationships are shifting dramatically. The Canada-U.S. Free-Trade Agreement (FTA), the continuing economic integration of the European Community, the prospect of increased trade with eastern Europe and the Soviet Union, the emerging markets on the Asia Pacific Rim, and the more recent prospect of freer trade with Mexico – all offer both a rich menu of new trade and investment opportunities for Canadian business, and an incentive to consolidate past strengths.

Canada's Export Specialization

While the bulk of Canada's exports has traditionally consisted of resource-based products – pulp and paper, lumber, metals, wheat, and energy – the share of these staples in the volume of exports declined from 62 to 51 per cent during the 1980s; at the same time, the share of motor vehicles and parts rose from 20 to 25 per cent over the decade (Table 2-1). There was also a noticeable shift in the pattern

Table 2-1
Composition of Canadian Exports,[1] 1980 and 1990

	1980	1990
	(Per cent)	
Resource-based exports		
Food	11.4	9.3
Lumber and sawmill products	6.3	4.8
Pulp and paper	12.8	8.7
Energy materials[2]	9.7	10.3
Other metals and minerals	16.3	12.9
Chemicals and fertilizers	5.1	5.1
Subtotal	61.7	51.0
Other exports		
Motor vehicles and parts	19.7	25.2
Other manufactured goods[3]	18.5	23.8
Subtotal	38.3	49.0
Total	100.0	100.0

1 Based on data in 1986 constant dollars.
2 Includes crude petroleum, natural gas, and other energy products.
3 Includes aircraft and parts, other transportation equipment, agricultural and industrial machinery, communications and electrical equipment, and other consumer and industrial goods. The largest increase in export volume was observed in communications and electrical equipment.

SOURCE Estimates by the Economic Council, based on data from the *Bank of Canada Review*, March 1991.

of export growth to the "other manufactured goods" category, which includes a range of capital- and technology-intensive products, such as aircraft and parts, communications and electrical equipment, and other industrial goods. The biggest volume increase was in communications and electrical equipment, but falling prices tend to obscure the remarkable success of this sector. All in all, these facts point to an important shift in the structure of trade.

Other evidence of a gradual shift in exports to technology-oriented products has been uncovered in the Council's current research project on competitiveness and trade performance, but Canada's progress is much slower than that of other industrialized countries. A forthcoming Council Statement will pursue this issue in some depth.

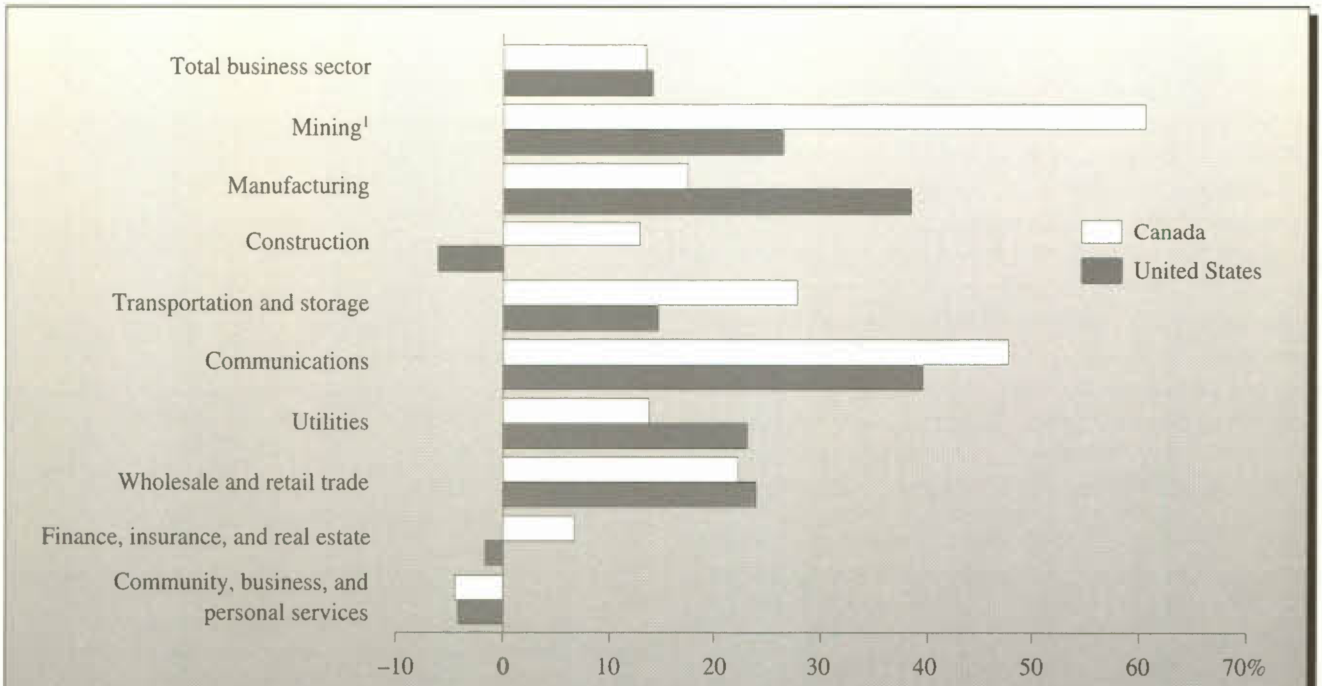
The Productivity Gap

In a number of service and resource sectors, Canadian productivity is growing at rates that are on a par with, or exceed, those of the United States (Chart 2-1). Since many of these industries are suppliers of important inputs to the manufacturing and resource sectors, strong productivity growth here has the potential to boost Canada's competitiveness in the manufacturing sector, helping to both extend and consolidate past gains. However, it is within manufacturing – the sector that accounts for the bulk of world trade – that Canada's productivity growth has been disappointing. Not only has the gap vis-à-vis the United States widened since 1980, but West Germany, France, and Italy all leapt ahead of Canada during the 1980s (Chart 2-2). Japanese manufacturing has dramatically improved its relative standing since 1951 and will soon catch up to the productivity levels recorded by Canada and others. These broad averages suggest that Canadian manufacturers did not modernize quickly enough during the 1980s. This impression is reinforced when cost factors are taken into account.

Unit labour costs, expressed in a common currency, provide a good proxy for international cost competitiveness. Between 1980 and 1986, a steady depreciation of the Canadian dollar (lower left panel of Chart 2-3) significantly improved the cost competitiveness of Canadian manufacturing firms vis-à-vis their U.S. counterparts, even though their productivity grew more slowly (upper left panel) and hourly compensation in Canada rose at a faster rate (upper right). Since then, however, the relative cost position of Canadian

Chart 2-1

Change in Output per Person/Hour, by Industry, Canada and United States, 1980-88

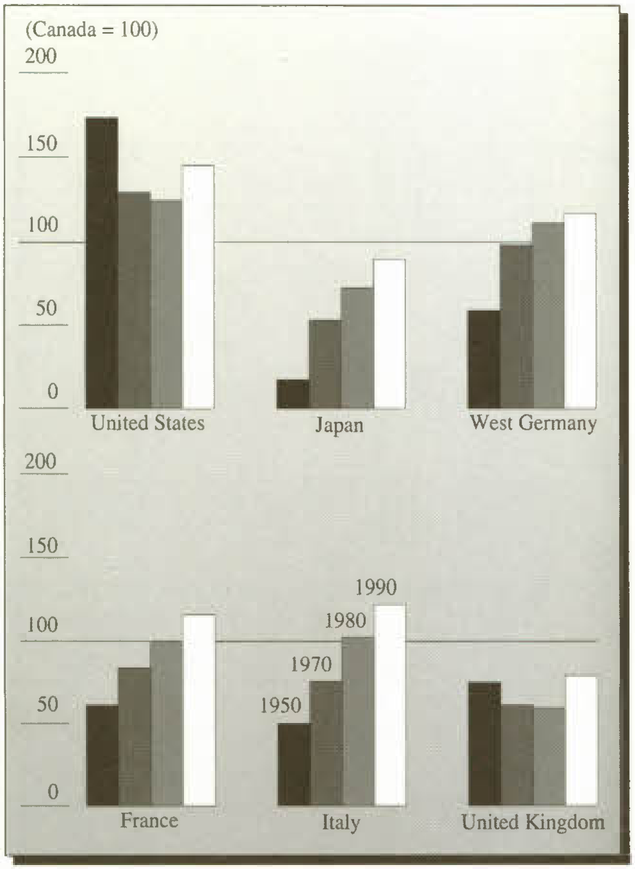


1 The estimates for Canada are based on real value-added per employee; for the United States, on real GDP per employee.

SOURCE Estimates by the Economic Council, based on data from Statistics Canada and from the U.S. Bureau of Labor Statistics.

Chart 2-2

Labour Productivity in Manufacturing,[1] Six Industrialized Countries, 1950, 1970, 1980, and 1990



1 Based on data measured in output per hour.

SOURCE Estimates by the Economic Council, based on data from Statistics Canada and from the U.S. Bureau of Labor Statistics.

firms has deteriorated, not only because those two negative factors continued to play a role, but also because of the appreciation of the Canadian dollar. Indeed, average unit labour costs in Canadian manufacturing deteriorated by an alarming 39 per cent vis-à-vis the U.S. average over the 1980s. Since the Canada/U.S. exchange rate in 1990 was roughly the same as in 1980, this can be attributed to inferior performance at the plant level with respect to both productivity and nominal wage costs.[1] The industrial detail in Chart 2-4 shows that this deterioration of Canadian unit labour costs was pervasive, affecting nearly every industry in the manufacturing sector.

It is interesting to note that the appreciation of the U.S. dollar in the early 1980s led to a painful period of rationalization that accelerated U.S. productivity growth during the second half of the decade; this, in turn, led to a surge in exports of high-value-added goods in the late 1980s. By comparison, the Canadian depreciation during the early 1980s produced little incentive to rationalize production facilities. However, the appreciation of the Canadian dollar since 1987 and the implementation of the trade agreement with the United States in 1989 have created both the need and the incentive for Canadian manufacturers to modernize and specialize.

At first, the trends were encouraging. Investment in new machinery and equipment soared in 1988 and 1989 – a sign that firms were gearing up to be more competitive. But before the modernization process could bear fruit, the recession hit in 1990. Indeed, the accumulated deterioration in firms' performances over the 1980s made many of them vulnerable to bankruptcy during the recession; as a result, many plants were closed and many others were rigorously reorganized. Some even moved part or all of their production to lower-cost locations. Those which did survive should be well-placed to capitalize on growth in demand during the recovery. But the challenge is by no means over. Canadian hourly compensation is still high, and productivity performance is low, relative to the United States. Thus Canada still has to deal with cost and productivity issues at the level of the firm, at the same time that it must contemplate the arrival of strong competitors on the world scene, including Mexico.

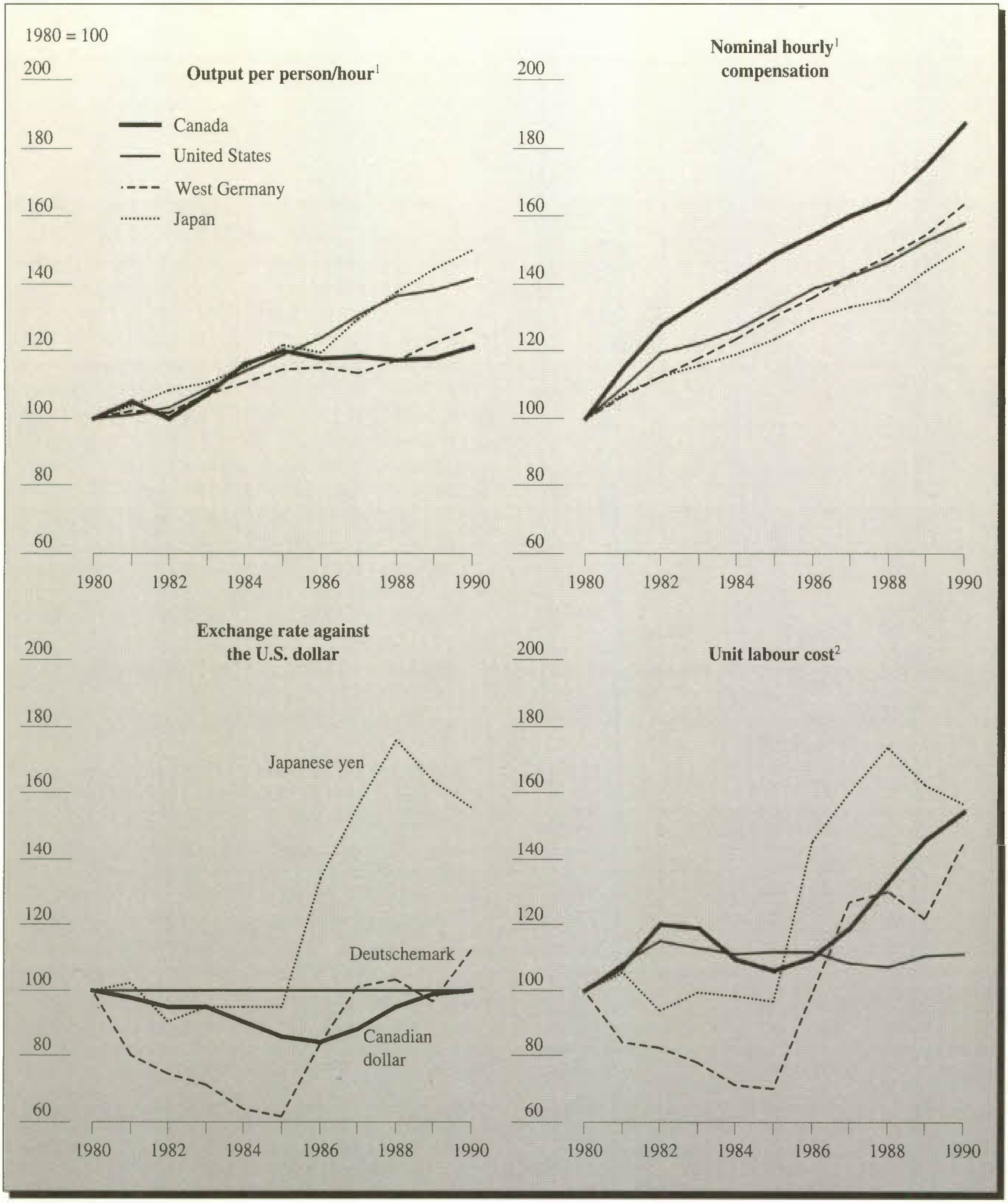
Canada-Mexico-U.S. Trade Flows

The Mexican economy has been undergoing major structural reforms and is becoming more open to international competition. A number of public enterprises (including those involved in steel and copper production, air travel, telephone service, and commercial banking) are now in the process of being sold to private investors. Going even further, Mexico has *unilaterally* reduced its tariff and nontariff barriers (Chart 2-5). The average tariff rate declined from 23.5 per cent in 1985 to 12.5 per cent in 1989, and the maximum tariff rate has been lowered from 100 per cent to 20 per cent. Nontariff barriers have been reduced substantially as well, and in many instances import licenses have been eliminated. Now Mexico is aggressively seeking to assure its access to the U.S. and Canadian markets through a free-trade agreement. The hope is to have the agreement in place before the next presidential election in the United States, scheduled for 1992.

Mexico views the trade agreement with the United States and Canada as the cornerstone of a strategy aimed at duplicating the success story of Taiwan and South Korea. In this

Chart 2-3

Measures of Competitiveness in Manufacturing, Four Industrialized Countries, 1980-90



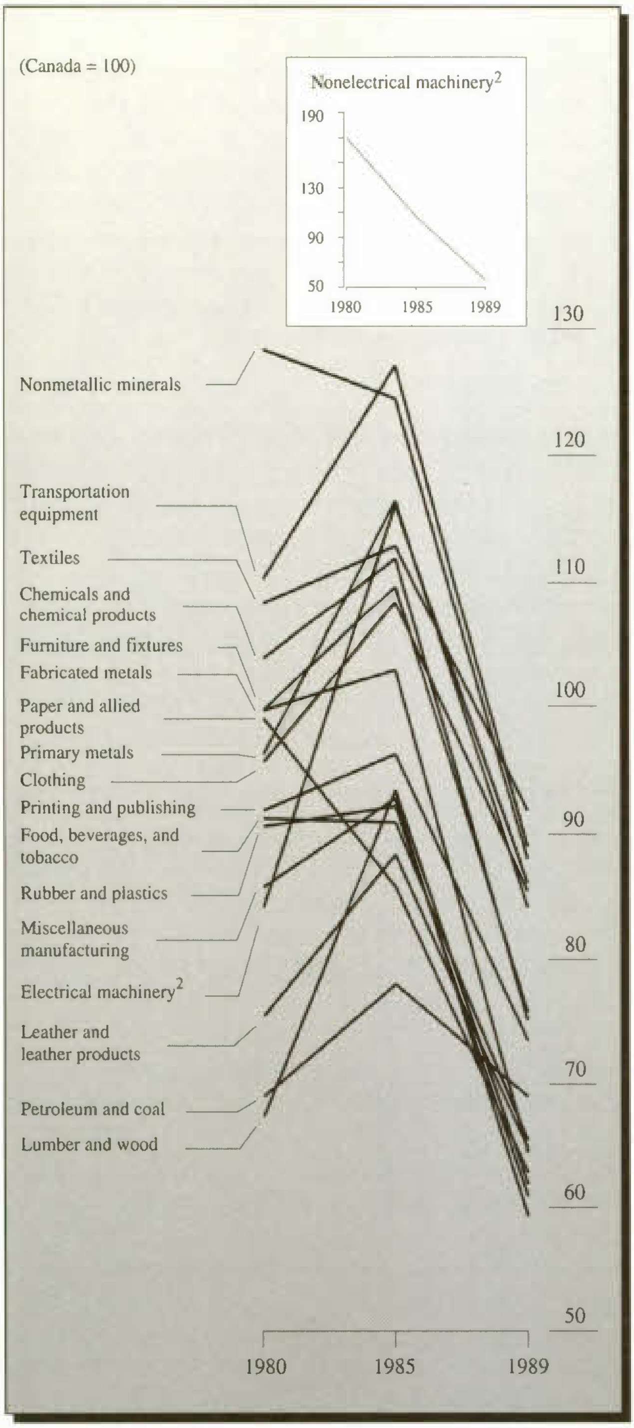
1 Based on data expressed in national currencies.

2 Based on data expressed in U.S. dollars.

SOURCE Estimates by the Economic Council, based on data from Statistics Canada and from the U.S. Bureau of Labor Statistics.

Chart 2-4

Relative Unit Labour Costs in Manufacturing, United States/Canada, 1980-89[1]



1 Based on market exchange rates.

2 In the U.S. data, computers are included in the nonelectrical machinery category while in the Canadian data, they are included in electrical machinery.

SOURCE Estimates by the Economic Council, based on unpublished data from the U.S. Department of Labor and from the Organisation for Economic Co-operation and Development.

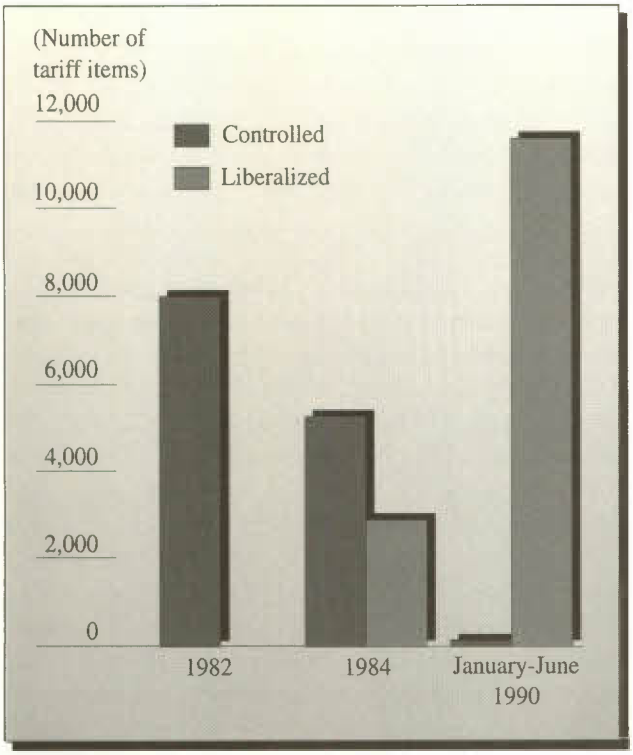
respect, the Mexican government regards access to the U.S. market as absolutely crucial. Canada's participation and interest in the substance of this agreement is just as crucial, because the accord, whether bilateral or trilateral, will shape the competitive architecture of the North American market for decades to come. If Mexico is successful in launching itself on such a path, its economy has the potential to become much larger than that of Canada, and Mexico could well replace this country as the largest single trading partner of the United States. Clearly, the stakes are high for Canada.

What Mexico has in mind is a North American free-trade area that will remove trade and investment barriers, and protect rights to intellectual property. Common to Canada and Mexico is one simple fact: the United States is their largest trading partner, as it receives 75 per cent of Canada's exports and 65 per cent of Mexico's. Table 2-2 provides a detailed breakdown of trade flows for seven broad commodity groups between the three North American countries. It shows that the two smaller partners have substantial trade with the United States but very little with each other: Mexico ranks seventeenth among Canada's trading partners. Where trade does exist, it is concentrated in machinery and transportation equipment, and agricultural products.

The strongest potential growth for Mexican exports exists in areas where light-assembly production technology and low wages give Mexico an advantage as a supplier. The question is whether Canada and Mexico will be competing head on for the same customers or whether the vast U.S. market gives the two smaller economies scope to specialize (either by region or by product line). In either case, they will encounter other producers (from Asia) striving to increase their share of those same markets.

One worry is that a U.S. deal with Mexico or a North American free-trade agreement could result in Canadian imports into the United States being displaced by lower-cost Mexican products. Should this occur, some of the expected gains from the Canada-U.S. Free-Trade Agreement would not be realized by Canada. The amount of trade diversion that might take place depends upon the degree of similarity and substitutability between Canadian and Mexican exports. The impact would be significant if the overlap of Canadian with Mexican exports in the U.S. market is found to be substantial. Table 2-3 shows that Mexico's export mix has become more similar to Canada's over the past two decades: the overlap index rose from 16 per cent in 1971 to 34 per cent in 1987. Thus if a North American free-trade agreement is reached, Canada would face relatively more competitive pressures from Mexico in the U.S. market and in its own market. This would have the

Chart 2-5
Liberalization of Import Controls, Mexico, 1982 to June 1990



SOURCE Based on data from the Mexican ministry of commerce and industrial development.

greatest impact on labour-intensive industries that use relatively more unskilled labour, including textiles, apparel, rubber and plastic products, leather and leather products, and miscellaneous manufactured products. Greater competition from Mexico in those industries will reinforce the already strong competition from the newly industrialized countries (NICs) of Asia and from Third World nations. The secret of survival for Canadian firms in these industries will be to shift to high-value-added products – products that require extra creativity or talent that is unique to Canada.

The Uruguay Round

In fact, Canada is now seeking, through the mechanism of the Uruguay Round – the current round of multilateral negotiations conducted under the auspices of the GATT – to improve its access to rapidly growing trading networks located in Latin America, as well as the Pacific Rim and other Asian countries. Canada has offered to reduce its tariffs by about one third and has proposed global free trade in forest products, fisheries, chemicals, and high-technology products, such as telecommunications and data-processing equipment.

There is still the possibility that the Uruguay Round will fail to produce a useful agreement. Disagreement on agricultural subsidies brought the talks to a standstill in December. As a result, parallel discussions on other issues (including trade in services, market access, and intellectual property) also came to a halt. Since then, little progress has been made, even though the leaders of the seven largest industrial countries have expressed a desire to see a successful conclusion to this round. They agreed in July that a positive outcome would favour an expansion of trade flows and weaken protectionist sentiment.

The issues to be resolved in the Uruguay Round are much broader in scope, and therefore more difficult to solve, than those of previous rounds. Accordingly, the payoff from success could be even greater than in the past. Solving the thorny problem of agricultural subsidies and bringing trade in services under a separate agreement would set a new standard for international trading relationships in the 1990s, for example. But the risk of failure is also high. Countries would come under intense pressure to seek other, more protectionist means to sustain gains in living standards. A failure of the negotiations would certainly feed into U.S. protectionist sentiments and thus provoke more-aggressive use of U.S. trade laws in bilateral disputes. It would also increase the pressure to proceed with more-limited agreements, such as those envisaged in the Canada-U.S.-Mexico free-trade talks and the recently proposed ASEAN group discussions. This would reinforce the current trend towards the development of three large regional blocks in Europe, Asia, and North America.

In summary, a major shift in world trading relations and industrial structure is taking place. Massive restructuring is under way in Mexico and the United States, and this process is now poised to move into a second phase. These changes are pressing heavily on Canada's ability to compete not only in its own backyard but also in that of its neighbours. In Canada, some of these changes will be more painful because they have been delayed for so long. Recovering from the current recession and coping with these longer-term trade and industrial shifts at the same time will not be an easy task.

Current Performance and the Policy Setting

A shift is also occurring at the domestic policy level, with the focus on deficit and debt reduction and a stronger

Table 2-2
Trade between Canada, the United States, and Mexico,[1] by Commodity Group, 1987

	Canada to Mexico		Mexico to Canada		Canada to United States		United States to Canada		United States to Mexico		Mexico to United States	
	(Value)	(Per cent)	(Value)	(Per cent)	(Value)	(Per cent)	(Value)	(Per cent)	(Value)	(Per cent)	(Value)	(Per cent)
Mineral fuels, lubricants, and related products	1.3	0.3	108.8	12.3	8,614.0	11.6	1,448.0	2.8	698.5	4.5	4,059.8	19.8
Agricultural products	203.2	48.6	87.3	9.9	12,696.1	17.0	3,902.8	7.5	1,609.6	10.4	2,393.1	11.7
Resource-intensive manufactured products	64.3	15.4	32.6	3.7	10,671.5	14.3	3,798.8	7.3	1,227.5	7.9	1,798.3	8.8
Labour-intensive manufactured products	4.2	1.0	32.8	3.7	1,501.8	2.0	1,515.9	2.9	899.4	5.8	845.5	4.1
Chemicals and related products	6.7	1.6	11.1	1.3	3,209.0	4.3	3,246.4	6.3	1,424.8	9.2	416.0	2.0
Machinery and transportation equipment	132.5	31.7	567.9	64.4	34,783.1	46.6	33,773.5	65.3	7,737.5	50.1	8,716.3	42.5
Miscellaneous manufactured equipment	5.6	1.3	42.0	4.8	3,096.8	4.2	4,040.7	7.8	1,855.3	12.0	2,294.5	11.2
Total	417.8	100.0	882.4	100.0	74,572.2	100.0	51,726.2	100.0	15,452.6	100.0	20,523.5	100.0

1 Values are in millions of U.S. dollars.
SOURCE Based on data from Statistics Canada.

Table 2-3
Index of Similarity[1] of Exports, Canada, Mexico, and United States, 1971 and 1987

	Importing countries					
	Canada		Mexico		United States	
	1971	1987	1971	1987	1971	1987
	(Per cent)					
Exporting countries:						
Canada/Mexico	–	–	–	–	16	34
United States/Mexico	12	13	–	–	–	–
United States/Canada	–	–	21	21	–	–

1 To measure the export similarity index [$S(ab,c)$] for Canada and Mexico, the following formula is used:

$$S(ab, c) = \{\sum_i Minimum\,[X_i\,(ac), X_i\,(bc)]\} * 100,$$

where:

a and b = exporting countries;
c = importing country;
$X_i\,(ac)$ = the share of commodity i in country a's exports to country c;
$X_i\,(bc)$ = the share of commodity i in country b's exports to country c.
If the commodity distributions of a and b's exports are totally similar, the similarity index is equal to 100. If a and b's exports are totally dissimilar, the index is equal to zero.

SOURCE Based on data from Statistics Canada, and on J. M. Finger and M. E. Kreinin, "A measure of 'export similarity' and its possible uses," *The Economic Journal* (December 1979):905-12.

commitment to stable prices. Over the short run, this new policy regime has had repercussions for growth and unemployment. For example, the recession is forcing people to adjust and make sacrifices. The strength of the recovery now under way will also be influenced in part by the way Canadians respond to the new policy regime.

Governments' Financial Crisis

The size of Canada's public sector is close to the average for all OECD countries. In 1989, total outlays by governments in Canada were still lower than in most European and Nordic countries, but higher than in the United States.[2]

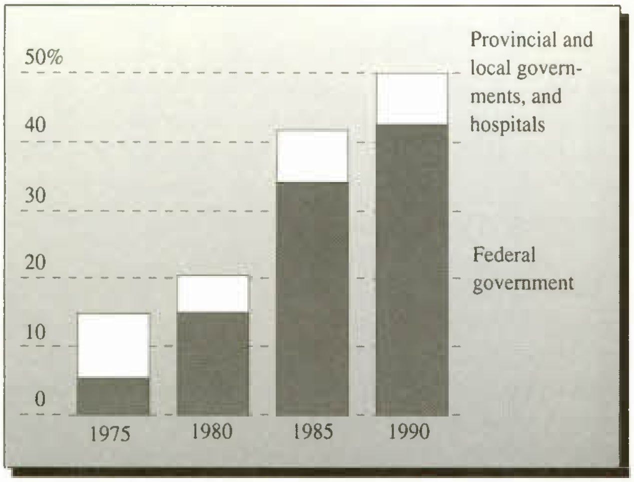
Indeed, the public sector in Canada has grown markedly in size over the past 30 years. Government expenditures as a whole rose from about 30 per cent of GDP in the early 1960s to 48 per cent in 1983; they have since dropped back slightly – to 45 per cent in 1990. For the most part, this increase reflects the desire of Canadians to deliver health-care and other services through the public sector and to maintain a comprehensive set of social programs. However, it also reflects the growing burden of interest on the public debt generated by persistent federal deficits since the mid-1970s. Chart 2-6 shows that the stock of federal debt continued to increase between 1985 and 1990, despite persistent efforts to cut spending and increase revenues. Taxpayers are exasperated by the sharp increase in tax burdens – including the highly visible goods and services tax (GST) introduced in January 1991 – at the same time that many individuals are dismayed by the cutbacks in programs that affect their daily lives.

Despite a rapid expansion of their expenditures, the provinces managed to keep their deficit and net debt in better order until the early 1980s. Since then, there has been a slight net increase in accumulated debt; and there are signs, in the latest provincial budgets (particularly that of Ontario), that the level of indebtedness is beginning to rise more quickly.

Belt-tightening in Ottawa has led to substantial cuts in federal cash transfers to the provinces. Chart 2-7 shows that

Chart 2-6

Net Debt,[1] Canada, by Level of Government, 1975-90



1 As a proportion of GDP.
SOURCE Estimates by the Economic Council, based on national accounts data from Statistics Canada.

they have been declining progressively – from about 29 per cent of total provincial revenues in the early 1960s to 19 per cent in 1989.

Budgetary cutbacks designed to reduce the deficit and the federal debt have a direct impact on federal/provincial relations and hence on the national unity debate. As Premier McKenna of New Brunswick recently stated:

> I say unequivocally that a major part of our current constitutional dilemma stems from our fiscal situation.
>
> The natural tensions which exist in Canada have been horrifically exacerbated by the constant grinding down of our fiscal capacity. Cut-backs in the West bring cries of alienation, cut-backs in the East bring cries of poverty, and cut-backs in central Canada further undermine the national dream. Our constitutional and fiscal situations are inextricably intertwined.[3]

The dilemma is that correcting the fiscal imbalance is essential to the future health of the economy, but it also generates social and political friction, and erodes the capacity of governments to deal with urgent shorter-term issues like recessions.

Recent Economic Policy and Performance

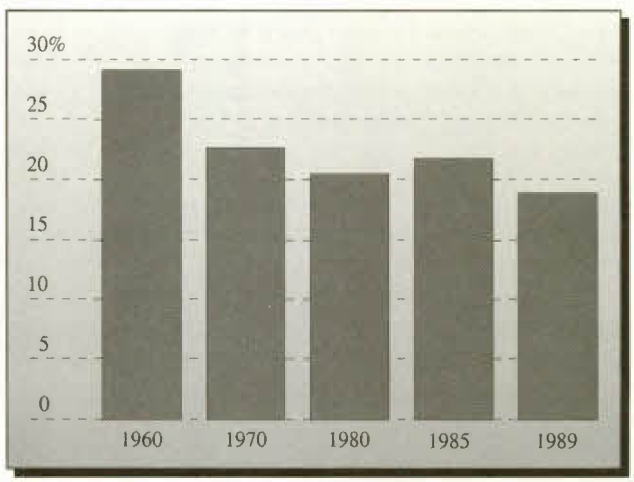
Since the middle of the 1980s, the aim of trade, fiscal, and monetary policies has been to increase the productive capacity of the Canadian economy, to reduce the indebtedness of the federal government, to tame inflation, and to increase flexibility in market decisions – in short, to make Canadian firms more competitive. The free-trade agreement with the United States, Phases I and II of tax reform, and the program of fiscal restraint were the operational elements of trade and fiscal policy, while the pursuit of price stability was the guiding principle of monetary policy.[4]

Inflationary pressures first began to surface in early 1988. Several factors contributed to this. The unemployment rate for Canada settled in a range between 7 and 8 per cent – the range where inflation typically begins to accelerate. These boom conditions prevailed throughout 1988, and it was at this point that interest rates began their upward trek. Federal fiscal policy did little to curb demand at the time. Indeed, taxes were lowered in mid-1988 as part of the tax-reform initiative. At the same time, the Ontario government pursued a program of fiscal stimulus, even though high demand in Ontario was the prime source of inflationary pressures in the country.

By the end of 1988, credit conditions had tightened considerably – the three-month Treasury Bill rate rose by nearly 4 percentage points during the year. The immediate effects showed up not in slower rates of inflation but in mounting debt-servicing costs, especially at the federal level, thus resulting in a larger deficit. In addition, the expectations of business and labour about the future course of wages and prices seemed inconsistent with those of the central bank.

Chart 2-7

Federal Cash Transfers to the Provinces,[1] Canada, 1960-89 (Selected Years)



1 As a proportion of provincial revenues.
SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

As labour markets tightened in 1989, the size of both private- and public-sector wage settlements added to concerns about the trend away from stable prices. Monetary policy became more restrictive in late 1989 and early 1990, adding another 2 percentage points to interest rates. In April 1990, a recession began. It was to last for 12 months.

As interest rates soared in 1988, the value of the Canadian dollar appreciated relative to the U.S. dollar, rising from about 76 cents to about 86 cents. The appreciation had a number of repercussions. First, it made imports from the United States much more competitive in Canada. The cheaper imports helped to reduce inflationary pressures, but of course this effect will eventually be reversed once the dollar returns to a level that is more in line with relative purchasing power in the two countries – in the 80-cent range.

Second, the high-flying dollar made it more difficult for Canadian exporters to maintain market share, particularly in the U.S. market. This put tremendous pressures on manufacturing and resource-based firms to overcome the severe cost disadvantage described earlier in this chapter. There was no question that restructuring was essential, but there are both positive and negative forms of restructuring. Decisions to modernize Canadian facilities obviously help future productivity growth and put firms in a position to increase market share (and employment) once sales begin to rebound. But decisions to move production to a lower-cost location have the opposite effect, permanently reducing the market share of Canadian firms and eliminating the scope for job creation. No one knows, at this point, how many of the negative decisions have been made and whether the gains in productivity and market share from the positive side will be large enough to offset the losses from the negative side. The difficulty for policymakers is that the temporary overvaluation of the Canadian dollar may have provoked decisions with long-lasting effects on market share and on employment in Canada.

While Canadian firms were struggling with this stressful situation, demand conditions in the U.S. market also began to slacken in 1990 (for details, see Appendix A). This was followed by a deceleration in growth of the major economies of Asia and Europe. German reunification, with its impact on German financial markets, and the Gulf War both had the effect of keeping international credit tight and confidence at low levels. As a result, the United States slipped into recession late in the fall of 1990, whereas Canada had already entered recession in the spring of that year. In both Canada and the United States, there is now evidence that a recovery began in the spring of 1991.

Although activity was rising by mid-1991, the economy was still registering signs of distress, with unemployment reaching 10.6 per cent and consumer price inflation more than 6 per cent. The volume of total output was down 1 per cent from a year earlier; for manufacturing, the decline was 7.2 per cent. In sum, it proved much more difficult than anticipated to eliminate the upsurge in inflationary expectations that occurred as demand pushed against capacity. These difficulties, plus the weakening in world economic growth and the industrial shake-out mentioned earlier, caused four consecutive quarters of recession in Canada.

The federal budget of February 1991 took steps to break the logjam of inflation expectations, tight credit, and deficits that has recently blocked the smooth adjustment of the economy. In order to encourage the downward trend in the core rate of inflation, the Governor of the Bank of Canada and the Minister of Finance jointly set targets for inflation for the period 1992-95 – 3 per cent by the end of 1992 and 2 per cent by the end of 1995. These measures should serve as an anchor for future private-sector wage and price decisions. On the fiscal side, the 1991 federal budget also extends to the mid-1990s the expenditure control program originally set out in the 1989 federal budget, with the objective of bringing federal borrowing down to zero by 1993-94. Thus for the first time in some years, there is now clear evidence of close coordination between federal fiscal and monetary policies.

Provincial Fiscal Policy

It is clear that economic conditions in the late 1980s called for fiscal restraint. Not only was the federal government already running large deficits, but the economy in general – and that of Ontario in particular – were operating at levels of capacity utilization that could not be sustained without causing inflationary pressure. Because neither the Ontario government nor the federal authorities stepped in to curb this pressure, interest rates shot up. Thus, as the Council noted in its 27th Annual Review, there was a serious lack of coordination between monetary policy, on the one hand, and federal and provincial budget policies, on the other. Some of these contradictions continued in 1990 and 1991, as both levels of government raised indirect taxes (and many regulated prices) in order to increase revenues, thus adding a visible layer of tax burden to the consumer price index at a time when inflation was a major policy concern.

The federal fiscal strategy contained in the February 1991 budget was clearly designed to shoulder some of the burden of the fight against inflation in order to create an appropriate environment for the relaxation of monetary policy. Most of the provinces chose to cooperate in this strategy. Ontario would have had a large deficit under any circumstances because the recession was concentrated in that province. But it chose to add $800 million or more of discretionary stimulus.[5] Table 2-4 shows that the first-year impact of Ontario's 1991 budget clearly differs from that of the other nine provinces. There was little sign of restraint in the areas of public-sector compensation or program spending. (Total spending is expected to increase by 13.4 per cent in 1991-92; and the Ontario deficit is expected to remain as high as $8.4 billion in fiscal year 1993-94 – two years after the anticipated end of the recession.) The net effect of the Ontario budget was to undo about one fourth of the contribution towards restraint made by the other provinces. This, added to the prospect of a high Ontario deficit in the next two fiscal years, will probably moderate the support that monetary policy gives to the recovery.

If Ontario is excluded from the analysis, the combined fiscal restraint of the nine provinces amounts to $3.5 billion. Combining the spending and revenue measures across all provinces, it appears that aggregate fiscal restraint will amount to about $2.7 billion in 1991-92. If these measures had not been introduced, the expected aggregate provincial deficit would have been in a range near $18 billion rather than near $15 billion.

But the provinces did not avoid adding to measured inflation. The combined impact of provincial changes to indirect taxes should add about 0.3 percentage points to the annual rate of inflation in 1991, over and above the impact of the GST, and another 0.3 points in 1992. Thus, once more, the underlying rate of inflation in the economy will be partially obscured by indirect-tax effects. This, too, could prolong the period needed to convince Canadians that the new inflation targets are feasible.

Table 2-4
Budget Measures, by Province, 1991-92

	Change in budget balance from 1990-91[1]	Impact of new measures[2]	Spending restraint: Wage restraint	Spending restraint: Cuts in programs	Indirect tax increases[3]
	(Millions of dollars)				
Newfoundland	82	146(s)	Yes	Yes	Yes
Prince Edward Island	9	16(r)	No	No	Yes
Nova Scotia	–45	208(s)	Yes	No	No
New Brunswick	17	225(s)	Yes	No	Yes
Quebec	–685	941(r)	Yes[4]	No	Yes
Ontario	–6,681	–800(s)	No	No	Yes
Manitoba	–41	276(s)	Yes	No	Yes
Saskatchewan	93	475(s)	Yes	Yes	Yes
Alberta	1,119	983(s)	Yes	Yes	Yes
British Columbia	–410	247(r)	No	No	Yes
All provinces	–6,542	2,717			
All provinces, excluding Ontario	139	3,517			

1 Expected change in consolidated budget balance from fiscal 1990-91 to fiscal 1991-92.
2 s = mainly spending measures; r = mainly revenue measures. Amounts for Ontario, Saskatchewan, and British Columbia are estimates. In the case of Ontario, the estimate is probably low, since it was not possible to determine how much discretionary new spending will go into grants to education and health as opposed to wage settlements. In all three areas, rates of increase were notably higher than in the other provinces.
3 Apart from increases in "sin" taxes, Quebec and Saskatchewan will harmonize their provincial sales taxes with the federal goods and services tax, resulting in a broadening of the revenue base from indirect taxes.
4 A wage agreement reached between the Government of Quebec and its employees provides for a six-month wage freeze, to begin January 1992. However, that agreement was reached before the presentation of the 1991-92 budget, and no estimate for its impact on the 1991-92 budget balance is provided in Quebec's budget documents.
SOURCE Based on budget documents of the provinces.

Progress on Reducing Inflation

History shows that periods of recession help ratchet down wage and price expectations. Given the current amount of slack in the economy, there is good reason to believe that the inflation target of 3 per cent by late 1992 (set out in the February 1991 federal budget) is attainable. In fact, we anticipate a marked deceleration in the rate of price inflation over the next year. The major uncertainty is the growth in nominal wages. The Bank of Canada is unlikely to move to more accommodating monetary conditions unless the increase in nominal wages is consistent with the announced targets and with the underlying growth in labour productivity.

Twice during the 1980s, the fear of accelerating inflation led to restraint on the part of the central bank. Yet, noninflationary growth has been an elusive goal for Canada. The first episode of restraint in the early 1980s produced a substantial fall in the inflation rate from 12 per cent to about 4 per cent (upper left panel of Chart 2-8). During the long expansion that followed the 1981-82 recession, little progress was made in lowering the rate further. And after a period of depressed wages in the mid-1980s, growth in average hourly earnings climbed to 6 per cent in 1990. To be compatible with the Bank of Canada's inflation target (2 per cent) and the underlying trend in productivity (1.5 per cent), hourly-wage increases will have to fall to about 3.5 per cent by 1995.

Much of the tension in this transition revolves around the question of who should bear the burden of adjustment. Must workers lower their standard of living or forgo increases in it? If so, who are the winners from the exercise? Chart 2-8 (upper right panel) shows the widening gap between the actual costs of production and the consumer price index. The gap between these two measures reflects, among other things, the increasing pressure of indirect taxation mentioned above, shifts in the terms of trade, and subsidies. Rising indirect taxes have created an extra layer of costs between what producers receive for their output and what consumers pay in the marketplace.[6] Thus there are actually three parties at the bargaining table – employers, employees, and the tax collector.

The middle left panel shows this distortion in another way. Since the early 1980s, the gap has been widening between the real consumer wage (the wage rate relative to what consumers pay for products) and the real producer wage (the wage rate relative to what producers receive for their products). This divergence between consumer and producer price trends creates more pressure at the bargaining table. Producers see little room to raise wages, while workers see a decline or little increase in the real purchasing power of their earnings.

The slow growth in real wages has not been caused by a growing share of profits. In fact, the share of profits in the value of national income[7] (middle right panel) has been following a declining trend since the early 1960s; during cyclical downturns, it usually drops below its trend value. The rapid deterioration in the profit share during this recession is comparable to what occurred in 1981-82. As the recovery proceeds, however, producers will attempt to restore their profit margins to a more normal position. Workers will struggle to protect real wages, and the federal and provincial governments will probably continue to use indirect taxation as the route to deficit reduction. The result of this battle for shares of the national-income pie will determine who bears the cost of the transition to stable prices and how long it takes to achieve that goal.

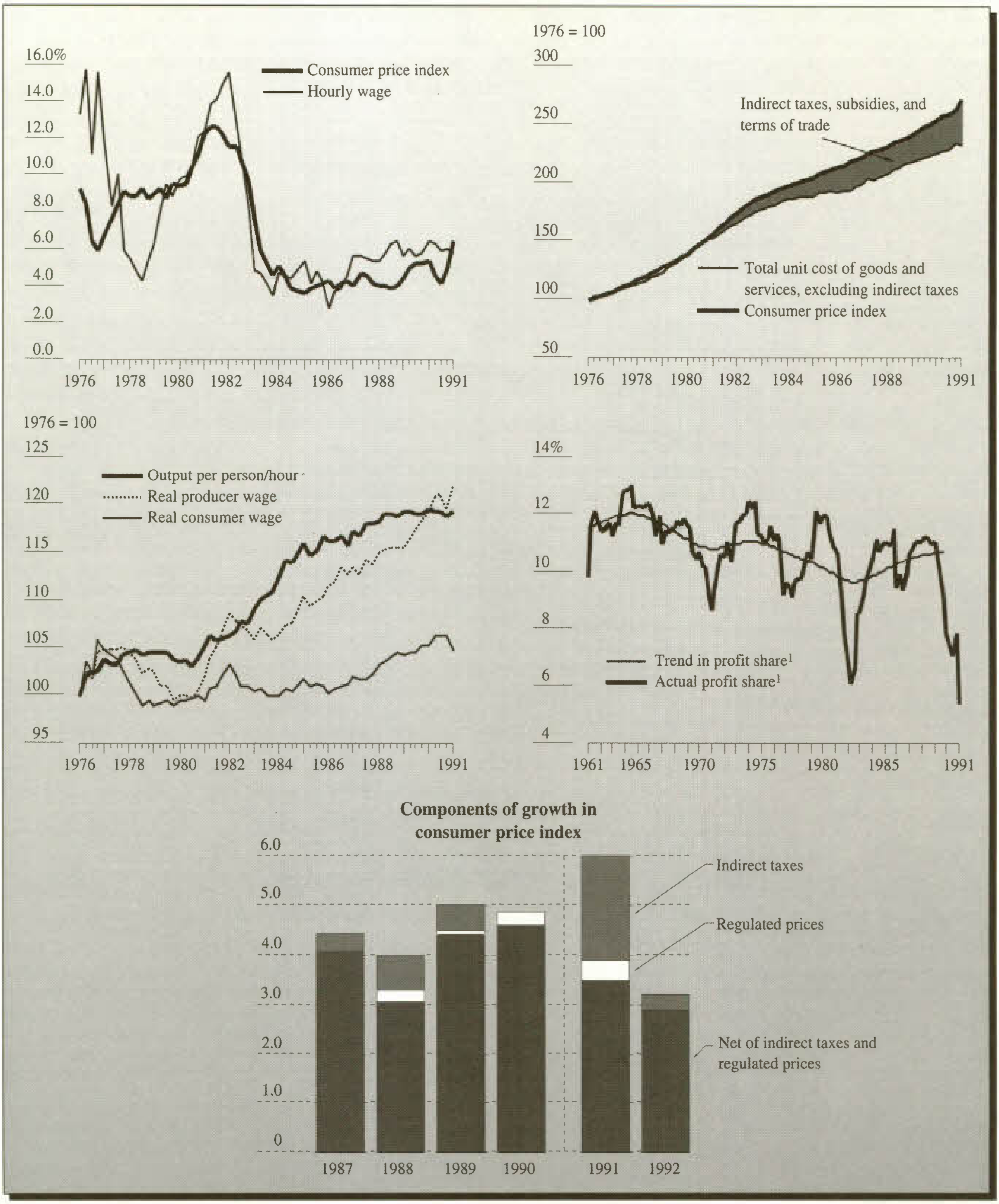
Although indirect taxes were not the root cause of this round of inflation, they are prolonging the process of disinflation. Indirect taxes and regulated-price increases contributed roughly 0.5 percentage points per year to the inflation rate from 1987 to 1990 (bottom panel). Decisions built into 1991 federal and provincial budgets will add more than 2 percentage points (when the GST is combined with provincial indirect-tax measures) in 1991 and 0.3 percentage points in 1992. If indirect taxes and regulated prices continue to add to the inflation rate over the next few years, they will create pressures in the bargaining process that will tend to prolong the transition to price stability.

The Unemployment Damage

On the surface, the current upswing in unemployment seems almost indistinguishable from that of 1981-82. The unemployment rate rose by 3.3 percentage points during the first 12 months of both recessions. But this comparison hides a great deal:

– In 1981-82, the initial burden of unemployment was distributed more evenly between Quebec, Ontario, and British Columbia (Chart 2-9). In the current situation, Ontario is experiencing the brunt of the rise in unemployment. For the key age group (persons aged 25 to 44), the unemployment rate in Ontario has risen by 4.9 percentage points since late 1988, whereas in the rest of Canada it has increased by only 2.6 points. In previous Annual Reviews, we described how the restructuring of resource industries in the West led to a sharp increase in long-term unemployment (especially for people over 45 years of age) in British Columbia and Alberta during the 1980s, and thus to a prolonged period of high unemployment rates. There is now concern that

Chart 2-8
Change in Factors that Influence Wages and Prices, Canada, 1961-92



1 As a proportion of GDP, excluding indirect taxes and subsidies.
SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

Ontario will experience the same problem of persistent unemployment.

– In the current downturn, the severe slump in manufacturing has coincided with a drop in construction and some slippage in services, whereas in the early 1980s, both construction and services were a source of new jobs.

– Finally, the latest recession has hit the prime-age workers – those aged between 25 and 44. In the 1970s and early 1980s, half the unemployed were under 24 years of age (Chart 2-10). In 1991, however, half the unemployed are in the 25-to-44 age group. Demographic trends are partly responsible, but two other possibilities may also have played a part: the unemployed young may have grown up to become unemployed adults; or the depth of this recession may have touched a whole new group of workers who were in relatively secure jobs until now.

The question that now arises is: To what extent will the restructuring being forced on the manufacturing sector (described earlier in this chapter) lead to permanent job losses? When and how these workers can re-establish themselves with new employers is a major concern.

In the past year, the Council has completed new research that underscores the high cost of using tight money as the sole instrument to fight inflation. The resulting temporary increase in unemployment may actually affect the re-employability of Canadian workers. This is crucial for younger workers, who in the 1980s faced less favourable labour-market conditions than their predecessors in the 1970s.

One way to test the hypothesis that the young generations of unemployed simply graduate to adult unemployment is to track the generations over time. Chart 2-11 follows two generations through two recessions. The 1971 generation of 15- to 24-year-old men experienced 17 per cent unemployment in 1971 (more than twice the rate for prime-age workers). But these workers got their start in a decade of relatively fast employment growth; by 1981, their unemployment rate had dropped by more than half – to 6.9 per cent. In the recession of 1991, this group is worse off, with a 9.3-per-cent unemployment rate, but its rate is nonetheless below the national average. Contrast this with the 1981 generation, which entered the labour market in the early 1980s and lived through a high-unemployment decade. Ten years later, their situation was only slightly

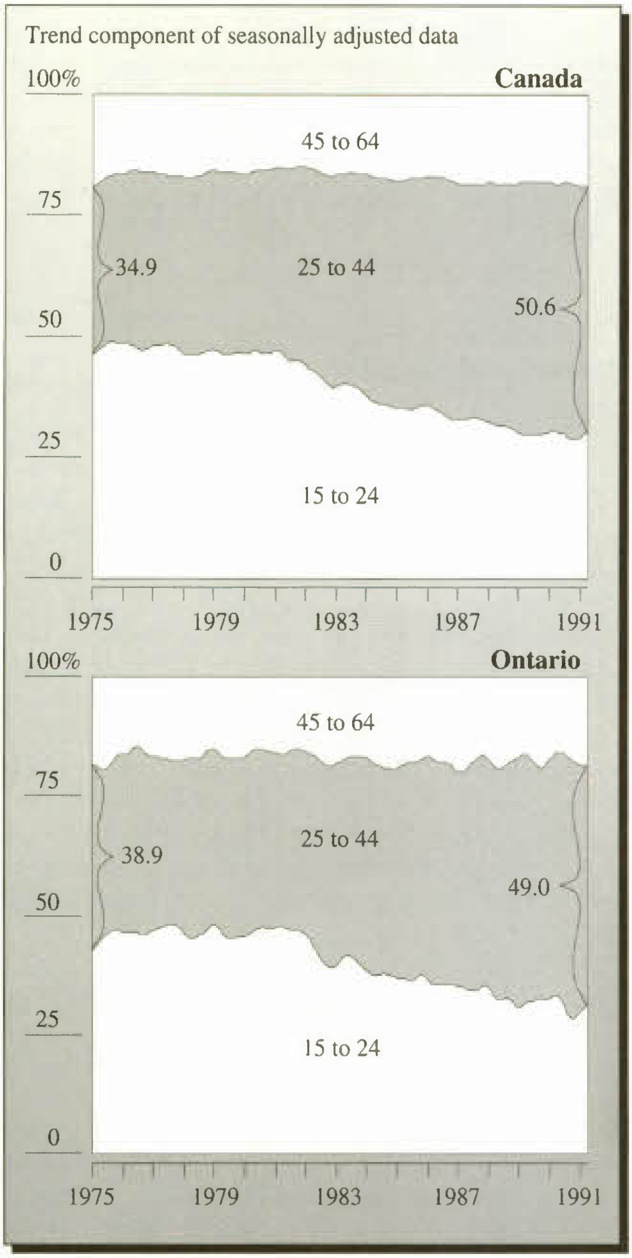
Chart 2-9

Regional Distribution of the Increase in the Number of the Unemployed, Selected Periods, March 1981-March 1991

SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

Chart 2-10

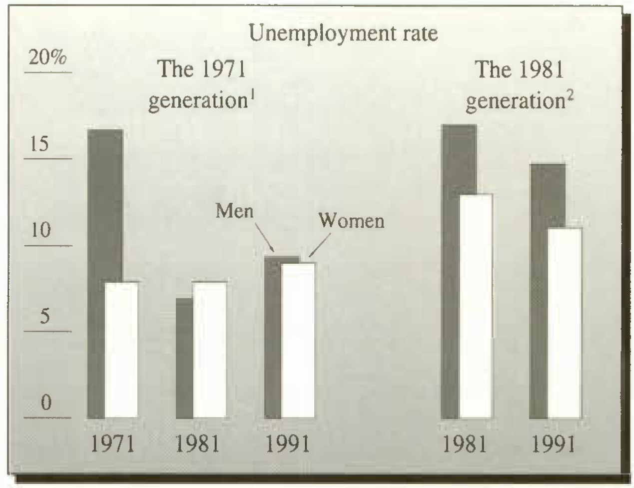
Age Distribution of the Unemployed, Canada and Ontario, 1975-91



SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

Chart 2-11

Unemployment Rate of Two Generations of Young Labour-Force Participants, Canada, 1971, 1981, and 1991



1 Aged 15-24 in 1971, 25-34 in 1981, and 35-44 in 1991.
2 Aged 15-24 in 1981 and 25-34 in 1991.
SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

improved from their start-up years. Their unemployment rate in 1981 was 17 per cent; in 1991, it was 14.8 per cent.

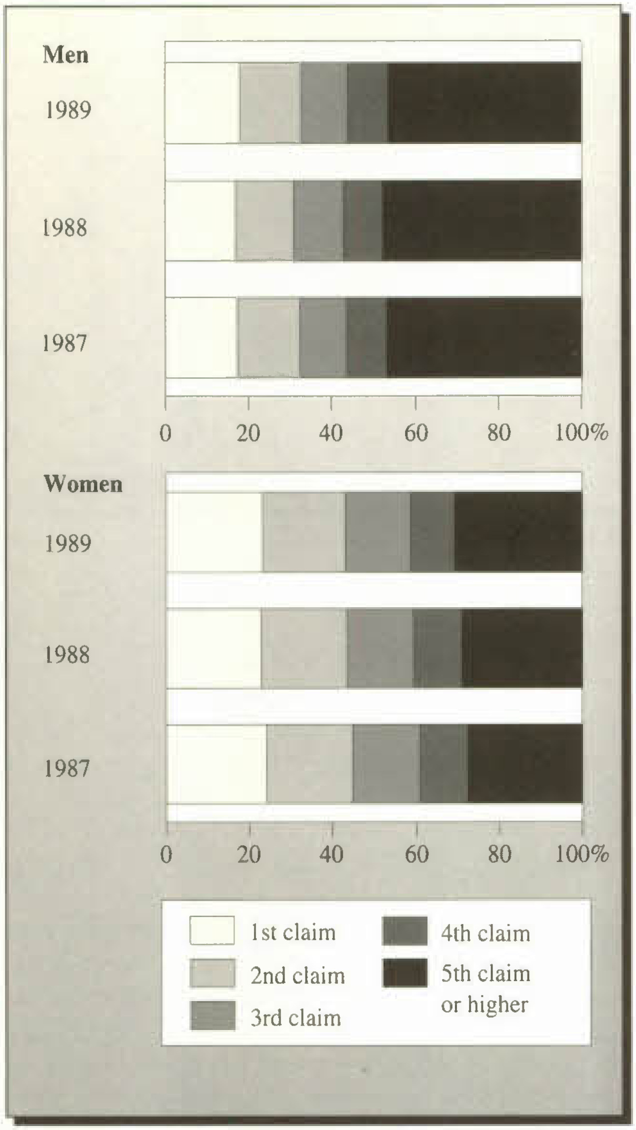
The pattern for women was somewhat different. Women aged between 15 and 24 in 1971 had an unemployment rate of 7.9 per cent – much lower than the rate for men. Their unemployment rate remained unchanged between 1971 and 1981 but drifted upward during the 1991 recession. On the other hand, the unemployment rate of the generation of women aged between 15 and 24 in 1981 was much higher than that of their 1971 counterparts; and it declined at about the same slow pace as that for men between 1981 and 1991.

Another set of data concerns those who claimed unemployment insurance between 1971 and 1989. Of this group, 50 per cent of the men who submitted UI claims in 1989 were doing so for the fifth time (or more) in the intervening 18 years (Chart 2-12). A similar pattern emerges for women, but their dependency on UI benefits was much weaker, as only 30 per cent of the claims submitted by women in 1989 were for the fifth time or more over the 18-year period. On average, UI recipients who return to work experience another period of joblessness once every three to four years; their second UI benefit claim period tends to be slightly more than three weeks longer than the first. This suggests that there is a group of people who are caught in regular cycles of unemployment that may gradually become lengthier and more frequent, thus forming a trap from which it is difficult to escape.

Thus there is some evidence that the problem of unemployment is cumulative in the sense that many young workers who get trapped in a cycle of short-term, seasonal, insecure jobs and unemployment insurance dependency are unable to break away from it when they become adults. This

Chart 2-12

Distribution of Repeat Claims for Unemployment Insurance, Canada, 1987-89[1]



1 The years are those during which the effective UI benefit period begins.

SOURCE Based on Miles Corak, "A longitudinal analysis of participation in the Canadian unemployment insurance program," a background paper prepared for the Economic Council, 1991.

is a profound social problem. Our concern here is that recessions may aggravate the problem: if unemployment is concentrated in abrupt cyclical downturns, more workers may get caught in that cycle.

This does not mean that restructuring should be avoided or that the commitment to price stability should be abandoned. But it does mean that Canada should be working with determination to develop alternative ways of fighting inflation and supporting workers whose jobs are at risk. In the past, the implicit policy strategy has been to alternate policy goals – fighting inflation for a period of time and then fighting the ensuing unemployment for a further period of time. The Council believes that it is important to keep both of these goals front and centre if Canada is to ensure sustainable growth in the longer run. To achieve this, monetary policy must be supplemented by two other policy instruments – coordination of fiscal policy, and cooperation with business and labour leaders. We return to this subject later on.

The Medium-Term Outlook and Targets

The projected performance of the economy over the decade to the year 2000 is set out in the base case in Table 2-5 and Chart 2-13. Even after more than a full year and a half of recovery (to the end of 1992), a substantial gap between potential and actual output will remain – perhaps as much as 4 or 5 percentage points. During the recovery, growth in labour productivity and the labour force will hover near 2 per cent. A potential growth rate of slightly less than 3.5 per cent, combined with a current output gap of 4 to 5 per cent, means that actual growth rates may exceed the potential growth rate by as much as 1 percentage point each year for a number of years, without putting undue pressure on prices or wages. This means that during the expansion phase of the cycle, the economy can grow in a range above 4 per cent and Canada can still expect a continued decline in inflation rates.

However, this outcome depends upon a number of domestic and international factors. Among them will be: relative political stability in the Middle East and the Soviet Union, forestalling another jump in oil prices and instability in financial markets; U.S. success in achieving a low-inflation, high-growth economic performance; widespread acceptance by both the public and private sectors of Canada's inflation targets; a continued reduction of the borrowing requirements of the federal and provincial governments; and a movement towards the resolution of constitutional issues.

Risks and Uncertainties

The focus of policy in the base case includes the budget setting of February 1991 and the inflation targets set out at that time by the Minister of Finance and the Bank of Canada. The alternative scenarios presented below explore the factors that could knock the economy off the course set

Table 2-5
Selected Indicators, Base Case, 1986-2000

	Actual, 1990	Projection					Average		
		1991	1992	1993	1994	1995	1986-90	1991-95	1996-2000
					(Per cent)				
Change in:									
Real GDP	0.5	−1.1	4.2	5.1	4.5	4.3	3.0	3.4	3.8
Consumer price index	4.8	6.0	3.2	2.8	2.4	2.0	4.5	3.3	1.6
Labour force	1.3	0.8	1.2	2.0	2.1	2.7	1.8	1.8	2.0
Employment	0.7	−1.5	1.5	2.8	3.1	3.2	2.3	1.8	2.3
Productivity (output per person/hour)	0.3	2.0	2.3	3.0	1.1	1.9	0.7	2.1	2.3
Real wage rate	1.2	−2.2	−1.0	0.1	1.7	1.0	−0.4	−0.1	2.0
Nominal wage	6.0	3.7	2.2	2.9	4.1	3.1	4.1	3.2	3.7
Level of:									
Unemployment rate	8.1	10.3	10.1	9.4	8.5	8.0	8.4	9.2	7.0
Participation rate[1]	67.0	66.5	66.5	66.8	67.2	68.0	66.5	67.0	69.6
90-day Treasury Bill rate	12.8	9.1	8.7	7.9	6.9	5.3	10.3	7.6	5.8
Exchange rate of the dollar (U.S. cents)	85.7	87.0	84.6	82.5	82.6	84.0	79.8	84.1	91.3
Level, as a proportion of GDP:									
Real investment	21.2	19.6	20.2	20.8	21.3	21.9	21.4	20.8	23.2
Government balance									
Federal	−3.8	−3.7	−2.8	−2.0	−1.2	−0.4	−3.8	−2.0	0.2
Provincial and local	−0.3	−1.4	−0.8	−0.5	−0.4	−0.2	−0.4	−0.7	–
Balance of payments									
Current account	−3.3	−2.9	−2.5	−1.6	−1.5	−1.1	−2.6	−1.9	−0.6
Merchandise	1.6	1.8	1.6	1.9	1.7	1.5	1.7	1.7	1.0
Nonmerchandise[2]	−1.3	−1.4	−1.2	−1.0	−0.9	−0.7	−1.1	−1.1	−0.5

1 The labour force as a proportion of the population aged 15 and over.
2 Excludes net income services.
SOURCE Estimates by the Economic Council, July 1991.

out in the base case. In particular, we examine the consequences of:

– a monetary policy that is much more expansionary than in the base case (go/stop);

– a pattern of inflation expectations that is much higher than in the base case (stop/stop); and

– a fiscal policy that exceeds the expenditure path set out in the February 1991 budget.

The details are set out in Table 2-6 and in Chart 2-14.

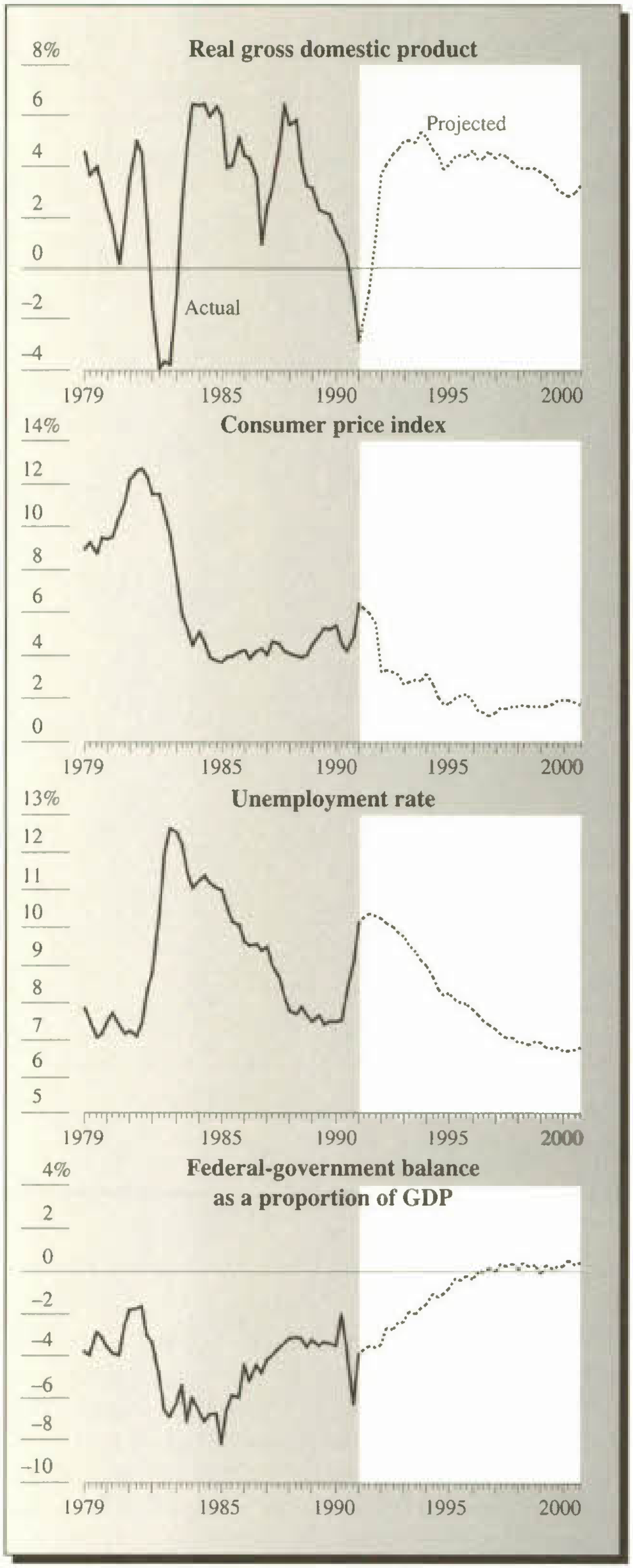
A Policy of Go/Stop

The monetary authorities have been repeatedly criticized for not quickly bringing short-term interest rates down to levels comparable with those prevailing in the United States, once it was clear that Canada had entered a recession period. Here, we explore a policy aimed at quickly bringing short-term interest rates down so that the Canadian dollar drops to about 80 cents (U.S.) over the short term.

In the short run, an easing of monetary conditions would almost certainly engineer a faster recovery in spending,

Chart 2-13

Actual Trend of Selected Economic Indicators, Canada, 1979-90; and Base-Case Projections, 1991-2000



SOURCE Data from Statistics Canada and estimates by the Economic Council.

production, and employment (Table 2-6, "go/stop"). The budgetary balance and the trade balance would also improve. But there would be a rapid acceleration of inflation after 1993, as output reached and exceeded productive capacity. In fact, a rapid energizing of the economy with this sort of monetary expansion carries with it an implicit abandonment, by the monetary authorities, of their commitment to inflation control. Once inflation was rolling again, the desire to revert to the original commitment would no doubt provoke another round of monetary restraint – hence the expression go/stop – leading to a slump in 1997. During the "go" phase, real growth would average 4.1 per cent, compared with 3.4 per cent in the base case. But during the "stop" period, growth would fall well short of the base-case figure – 1.4 vs. 3.8 per cent (Chart 2-15).

With inflation picking up so early during the expansionary phase, lenders (both domestic and foreign) would require a premium to protect their real return, and yields on all maturities would increase. Pressures on interest rates would eventually hinder the central bank's ability to maintain narrow spreads between Canadian and U.S. interest rates. In such a go/stop environment, the bank's credibility would clearly be damaged, thus making it even more difficult to contain inflation in the next cycle of restraint. Viewed from a long-term perspective, the costs of controlling inflation would increase, because policy would not provide an anchor for wage and price expectations. In the past, this uncertainty about inflation, interest rates, and exchange rates has led to stagflation.

A Policy of Stop/Stop

Another risk is that the authorities may misjudge the response of the private sector to the inflation targets announced in February. The political will and commitment may be there, but the loss of output and employment may be greater than anticipated if price and wage decisions in the public and private sectors do not respond to the message of the targets.

As a result, monetary conditions would have to remain tight for a longer period of time; alternatively, following that first unsuccessful attempt to meet the inflation targets, a second round of credit tightening would occur during the expansionary phase of the business cycle. Under these circumstances, it is not the monetary authorities or the government who lose sight of the targets, but it is Canadians who fail to adopt the benchmarks set by the Minister of Finance and the Bank of Canada. In this scenario, the next expansion is interrupted abruptly by another sharp recession in 1994 (middle panel of Chart 2-15, "stop/stop"). In

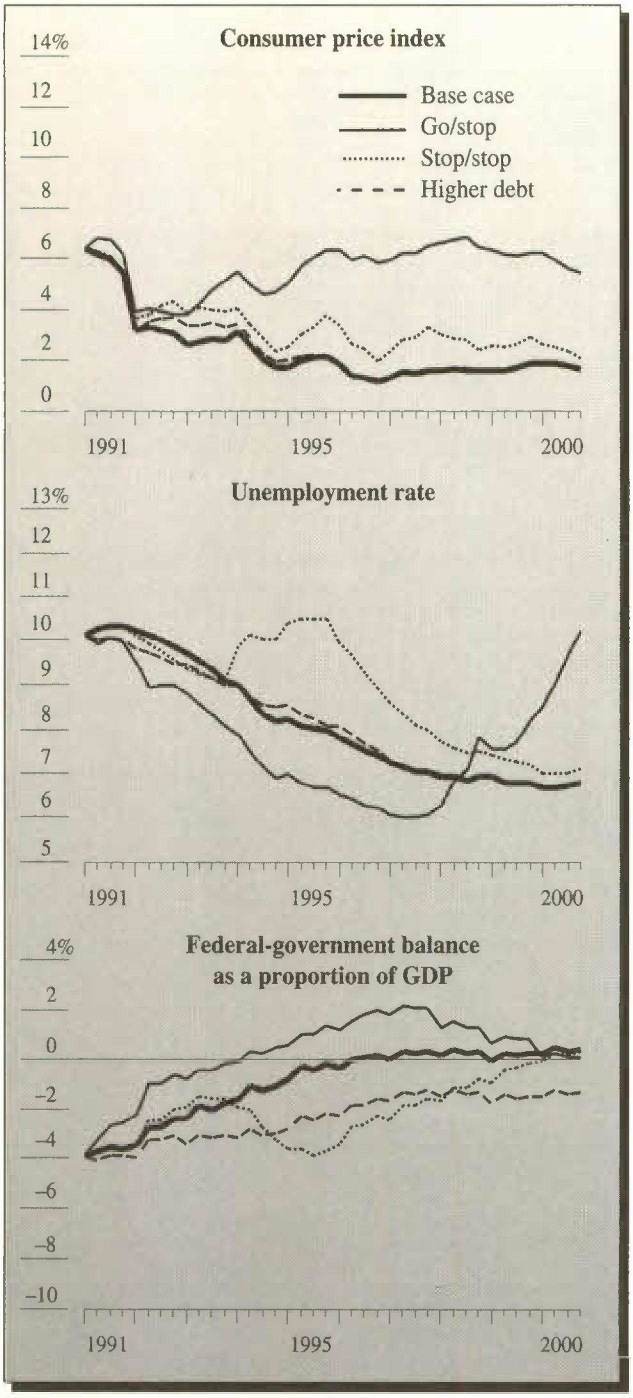
Table 2-6
Selected Indicators, Base Case and Alternatives to the Base Case, Canada, 1986-2000

	Actual, 1990	Projection 1991	1992	1993	1994	1995	Average 1986-90	1991-95	1996-2000
	(Per cent)								
Growth in:									
Real GDP									
Base case	0.5	–1.1	4.2	5.1	4.5	4.3	3.0	3.4	3.8
Go/stop	0.5	–	5.5	5.7	5.0	4.3	3.0	4.1	1.4
Stop/stop	0.5	–1.1	4.8	5.1	0.7	0.9	3.0	2.1	4.9
Higher debt	0.5	–0.6	4.8	4.4	3.7	3.8	3.0	3.2	4.0
Consumer price index									
Base case	4.8	6.0	3.2	2.8	2.4	2.0	4.5	3.3	1.6
Go/stop	4.8	6.5	3.9	4.5	5.0	5.8	4.5	5.1	6.2
Stop/stop	4.8	6.1	4.0	4.0	3.2	3.2	4.5	4.1	2.7
Higher debt	4.8	6.0	3.5	3.4	2.6	2.1	4.5	3.5	1.6
Level of:									
Unemployment rate									
Base case	8.1	10.3	10.1	9.4	8.5	8.0	8.4	9.2	7.0
Go/stop	8.1	10.0	9.1	8.4	7.4	6.8	8.4	8.3	7.3
Stop/stop	8.1	10.3	9.8	9.2	10.0	10.5	8.4	10.0	7.9
Higher debt	8.1	10.1	9.7	9.2	8.7	8.3	8.4	9.2	7.1
90-day Treasury Bill rate									
Base case	12.8	9.1	8.7	7.9	6.9	5.3	10.3	7.6	5.8
Go/stop	12.8	7.6	6.2	7.7	7.9	7.8	10.3	7.4	12.0
Stop/stop	12.8	9.1	8.7	8.3	10.7	12.1	10.3	9.8	8.1
Higher debt	12.8	9.1	9.6	9.8	9.3	7.8	10.3	9.1	7.4
Level, as a proportion of GDP:									
Federal balance									
Base case	–3.8	–3.7	–2.8	–2.0	–1.2	–0.4	–3.8	–2.0	0.2
Go/stop	–3.8	–3.1	–1.2	–0.5	0.2	1.0	–3.8	–0.7	1.2
Stop/stop	–3.8	–3.7	–2.6	–1.7	–2.5	–3.7	–3.8	–2.8	–1.3
Higher debt	–3.8	–3.9	–3.4	–3.2	–3.0	–2.4	–3.8	–3.2	–1.5
Federal debt									
Base case	44.5	47.8	48.2	47.5	46.4	44.9	42.3	46.9	38.9
Go/stop	44.5	47.0	45.4	42.3	39.0	35.0	42.3	41.7	24.2
Stop/stop	44.5	47.8	47.5	45.9	46.4	48.1	42.3	47.1	44.5
Higher debt	44.5	47.7	48.1	48.3	48.8	49.0	42.3	48.4	46.8
Current-account balance									
Base case	–3.3	–2.9	–2.5	–1.6	–1.5	–1.1	–2.6	–1.9	–0.6
Go/stop	–3.3	–3.0	–2.4	–0.5	–0.2	–0.3	–2.6	–1.2	–0.2
Stop/stop	–3.3	–2.9	–2.5	–1.7	–1.6	–1.3	–2.6	–2.0	–1.3
Higher debt	–3.3	–2.9	–2.7	–2.1	–2.1	–1.9	–2.6	–2.3	–1.3

SOURCE Estimates by the Economic Council, July 1991.

Chart 2-14

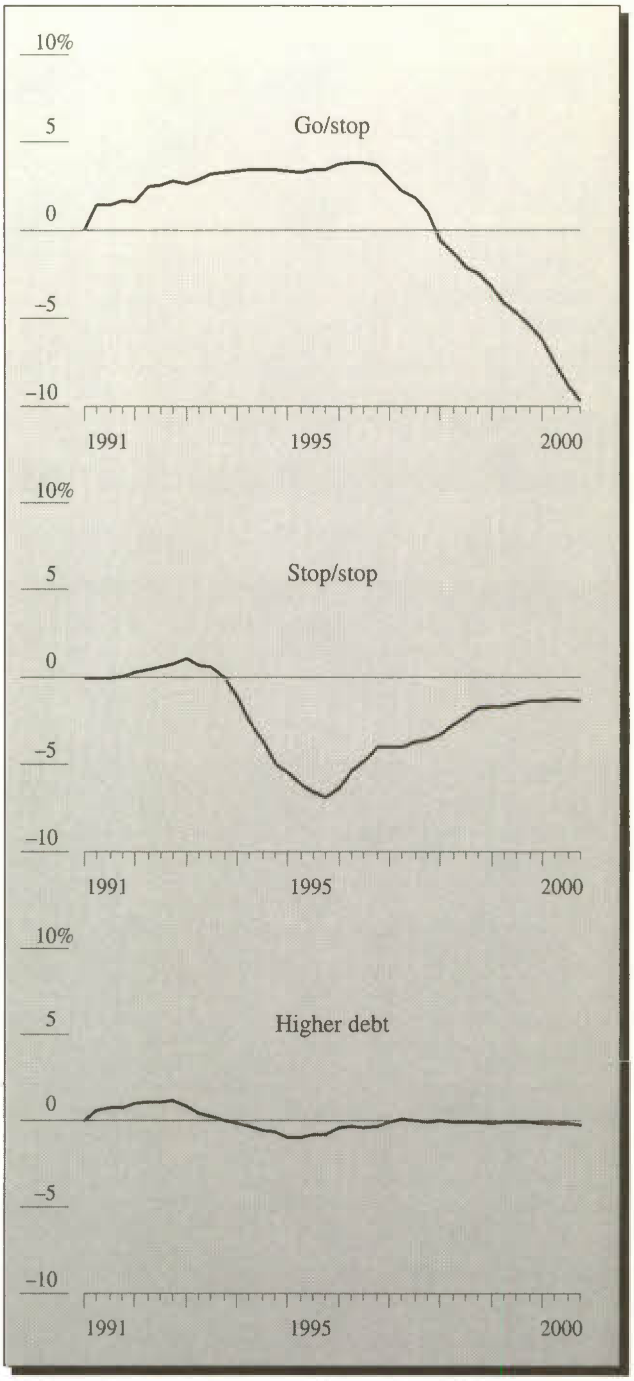
Projected Impact of the Base Case and Three Alternative Scenarios on Selected Economic Indicators, Canada, 1991-2000



SOURCE Estimates by the Economic Council.

Chart 2-15

Real Gross Domestic Product,[1] Three Scenarios, Canada, 1991-2000



1 Measured as a percentage-point difference from the base-case projection.

SOURCE Estimates by the Economic Council.

this simulation, until the expectations of all the players (both public and private) are brought down, demand remains below potential, and unemployment averages 10 per cent for the period 1991-95. Another recession followed by a period of slow growth is required before inflation expectations begin to match the government's targets.

Faltering Expenditure Restraint

The base case reflects the view that the government follows through on its plans for expenditure restraint – that is, the wage cap, the expenditure control program, and budget freezes – which brings its borrowing to zero by fiscal 1993-94. If spending were to drift above the set limits, it would no doubt lead to larger deficits. With this failure to contain expenditures, it is doubtful that the government could muster a convincing argument for higher taxes, particularly during a period of high unemployment and weak demand. Given the objectives of monetary policy, the extra spending could only be financed by borrowing.

To test the impact of a faster increase in public debt, a case was examined in which public spending (on goods, services, and transfers) grows by 2 to 3 percentage points more than the base-case projection during the period 1991-94 (Chart 2-15 and Table 2-6, "higher debt"). The spending is entirely financed by borrowing. Under these circumstances, the stronger aggregate demand feeds through into higher rates of inflation, which in turn cause the monetary authorities to tighten credit. Tighter monetary conditions soon offset the impact of higher public spending on aggregate demand, eventually bringing it below the base-case figure. In these circumstances, both higher real interest rates and the appreciation of the real exchange rate work against the positive impact of public spending on aggregate demand. Higher real interest rates depress investment spending, while the higher real exchange rate encourages imports to replace domestic production. The only lasting impact of such a policy would be a higher stock of domestic and foreign debt in relation to GDP.

If such a fiscal shock were large enough, the productive potential of the economy could be permanently affected by way of a smaller capital stock. Furthermore, in the long run, higher tax rates would be needed to service or pay back the public debt. That, in itself, would have adverse implications for future labour supply and investment, threatening the rate of growth of potential output, labour productivity, and real after-tax income. Mounting debt-servicing activity would also tend to reduce the real incomes of Canadians.

The sort of expenditure policy tested here is ineffective because it is offset by monetary policy to ensure that the targets set for inflation are met. Once again, the economy is knocked off course because of an inconsistency in objectives. Fiscal policy is at odds with the stance of monetary policy during the early years of recovery.

In summary, these simulations all carry the same basic message. As long as the private sector, governments, and the central bank have divergent expectations with respect to inflation and deficits, the economy will malfunction. The central bank will act to tighten credit when it sees that its targets go unrealized, and labour will step up its wage demands when it sees that its expectations are unfulfilled. Incongruent expectations can only add to repeated periods of recession in output and employment. If Canada adopts the route of more volatility in output growth, it will also be accepting slower growth, on average, over the longer term.

Medium-Term Targets

The major policy development of the past year has been a clear statement of joint inflation targets by the Minister of Finance and the Governor of the Bank of Canada. The targets promise an explicit coordination of monetary and fiscal policies – something that has been missing in recent years. They provide firm anchors for the private sector and for provincial finance ministers. They also create a clear accountability framework for current and future federal governments. We wish to make two comments on the inflation targets; one deals with process; the other, with the long-range target beyond 1995.

Two Caveats

Given the pervasive impact of the targets on provinces and on the private sector, we think it would be desirable to have provincial ministers, along with business and labour leaders, participate in the implementation of the targets and the identification of priorities among other policy objectives. Canada does not yet have the consensual process in place to facilitate this kind of policy discussion. Nevertheless, there has been, as noted earlier, a significant degree of coordination between the federal and provincial governments in the recent round of budgets – with the exception of Ontario, where the new government had little sympathy for the objectives implicit in the federal targets. In the longer run, Canada will be able to manage its fiscal and monetary policies well only if it can create better mechanisms for drawing the provinces into a partnership in the management of the Canadian economic union – a subject to which we will return in Chapter 3.

Private-sector leaders should also become more involved in debating policy objectives, as the Council recommended in its 27th Annual Review. In the past year, we have seen some encouraging signs of progress in this direction. There is now considerably more contact between business and labour leaders actively seeking to broaden the dialogue and to develop joint problem-solving mechanisms. Sectoral agreements on training and adjustment have been strengthened and are being extended into new sectors. The federal Labour Force Development Board is now starting up, and some jurisdictions – including New Brunswick, British Columbia, Saskatchewan, Nova Scotia, and Yukon – have now signed agreements to establish parallel organizations. These initiatives are still fragile, and much work remains to be done. But progress is being made. Over the longer term, the participants could also become active players in setting mutually agreed targets for achieving high employment and price stability. This would make Canada much less dependent on the blunt instrument of monetary policy in times of rising inflation expectations.

The second comment on the inflation targets concerns what should happen after 1995. The statement by the Bank of Canada in February implied a target of less than 2 per cent, to be specified at a later date. Public discussion has referred to a long-range target of zero.[8] We believe that more research and more experience with low rates of inflation are needed before policymakers can specify those longer range targets.

Economists generally agree that low and stable rates of inflation are highly beneficial: they create a climate of stability and certainty for investors, savers, and consumers. At this stage, however, economists do not know enough about the benefits of forcing the rate below 2 per cent or about the costs of doing so. This is not just an academic issue, since the monetary-policy choices made in 1993 and later will have a bearing on the trend after 1995.

There are two analytical questions to be resolved. (The technical background is spelled out in Appendix B.) The first is money illusion. Would workers be able to adapt to a world of zero inflation and 1- to 1.5-per-cent wage increases? If they cannot, then zero would be an exceedingly costly target to achieve, since policy would have to be harshly restrictive for a long time. The second question is whether the risk of permanent damage to the economy increases if the currency remains overvalued or if output remains depressed for the extended period of time needed to bring inflation down to zero.

Answers to both of these questions should become clearer as the process of disinflation unfolds over the next few years. Until the answers are clearer, however, policymakers will not be in a position to determine what the post-1995 targets should be.

Table 2-7
Performance Targets and Projections, Canada, 1992-95

	28th Annual Review[1] targets, 1992-95	Base case,[2] 1992-95
	(Per cent)	
Growth in:		
Real GDP	4 to 5	4.5
Level of:		
Unemployment rate	7 to 8 by 1995	8.1*
Inflation rate	2 to 3 by 1995	2.0*
Level, as a proportion of GDP:		
Federal balance	Small surplus by 1995	–0.4*
Net capital inflows	–2 or less by 1995	–1.1*
Social programs	Maintain objectives and substance of social programs; improve efficiency; and, where possible, fill the most urgent gaps	
Regional development	Balanced growth, employment opportunities, and social infrastructure	

*Projection for 1995.

1 The target growth rate of 4 to 5 per cent is composed of potential growth of 3 to 4 per cent and additional growth of between 1 and 2 per cent, which by mid-decade would close the gap opened by the recession. Subsequent to 1995, a growth path of between 4 and 5 per cent per annum would be unsustainable. During this subsequent period, growth in line with the potential growth rate for the Canadian economy – between 3 and 4 per cent – would be more appropriate.

2 The key financial assumptions in the base case are as follows (averages for 1991-95): short-term real interest rates, 4.8 per cent; the Canada/U.S. spread on short-term interest rates, 1.04 percentage points; and the average value of the Canadian dollar, 83.4 cents (U.S.).

SOURCE Economic Council, July 1991.

The Council's Targets

With those caveats in mind, the Council's targets for the period 1991-95 are set out in Table 2-7. The targets are substantially revised from those set out in the 26th Annual Review, mainly because the recession has knocked the economy so far off course over the past two years. Indeed, none of the targets set out in the 26th Annual Review for 1992 and 1993 are within reach, except for the inflation rate.

Our estimate of potential growth has not been altered from the estimates set out two years ago – it is just over 3 per cent (and could be higher, depending on the growth in trend productivity). But with so much unused productive capacity, it is possible to operate at much stronger rates of economic growth in the early stages of the recovery. This means that output can grow by 4 to 5 per cent per year during the period 1992-95. On this growth track, employment can expand by more than 2 per cent per year over the recovery period, without jeopardizing the inflation targets of 3 per cent at the end of 1992 and 2 per cent by 1995. Thus we do not believe that the inflation targets need to inhibit a solid recovery in employment and output. However, the slack in the economy is such, at this stage, that this will mean some shortfall in meeting other targets. The unemployment rate still would not quite reach the target range of 7 to 8 per cent by 1995; and the federal deficit, while shrinking fast, would not achieve the small surplus that we think is desirable. The only comfort is that both are heading in the right direction.

In the longer run, the Council would like to see a more ambitious target for reducing unemployment in a world where high employment and price stability are seen as mutually compatible goals and where monetary policy is supported and supplemented by broad support from fiscal policy and from the private sector. That, as explained in the 27th Annual Review, will require new kinds of institutions for coordination and cooperation. While we see progress in this direction, we recognize that such institutions cannot be created without first establishing a foundation of trust between the social partners.

Conclusions

There are two essential ingredients for a restoration of rising living standards in Canada. One is a major restructuring of industry to shift production to products and services that include more value-added – more of the creativity of Canadians. We will have more to say on this in a forthcoming Statement on competitiveness and trade.

The other is a transition to an economic policy regime characterized by decelerating inflation, faster job creation, and a correction of the federal deficit. Progress is being made on this front, although at the time of writing the pain of the adjustment was more evident than the successful conclusion. Nonetheless, we are optimistic that the inflation targets can be reached, even as the economic recovery gains the momentum that will eventually reduce the deficit and lower the unemployment rate to more desirable levels.

The economy could, of course, be knocked off course again. One risk is that inconsistent expectations by key players in the economy – the federal government, the provinces, business, and labour – might make output, employment, and inflation more volatile and, at the same time, reduce overall growth and job creation. A second risk is that the overvalued currency provoked by a combination of tight money and slack fiscal policy during the period 1988-90 may have led to investment decisions that will have long-lasting effects on Canada's capacity to compete for market share.

It will take both political determination and careful coordination to strike the right balance between federal and provincial fiscal restraint, on the one hand, and the accommodating monetary stance needed to steer the course mapped out in the February targets for economic policies. Many painful wounds were opened by the economic stresses of the past few years, and any diversion from that course – towards fiscal ease or monetary restraint – would prolong the period of stress. It is essential to proceed at a pace that will not jeopardize the prospect of a better performance on the inflation front during the recovery. But that still leaves scope, in our view, for relatively robust rates of economic growth over the next several years. That recovery should bring with it an increase in living standards, higher employment, and a rapid decline in the federal deficit.

All three are essential to the credibility of the economic union – the subject of the next chapter.

3 The State of the Economic Union

> If change is to contribute to a more efficient and competitive country, we must be prepared to tear down the barriers that currently impede the movement of people, goods and services across the provinces of Canada.
>
> Prime Minister Brian Mulroney[1]

> There is no question of reconsidering the integrity and completeness of the Canadian economic market. In fact the Quebec Liberal Party is proposing the creation of a true common market, a market that moves closer toward integration than the current agreement between Quebec and the rest of Canada.
>
> Quebec Liberal Party[2]

There seems to be a broad consensus in Canada – encompassing all provinces and all political parties – that the internal common market and economic union should be preserved and even reinforced. At the same time, there are strong economic and political forces that could erode the level of integration that now exists – the desire for greater power and responsibilities expressed by Quebec and other provinces, for example, and the rapidly growing presence of provincial governments in spending and revenue-raising activities. For the second time in less than 15 years, challenges to the current political structure raise important questions with respect to the merits and state of the economic union. What are the real benefits of the internal market for the people of Canada? Are all potential benefits being adequately captured? If not, how can they best be appropriated? Those are the issues that we address in this chapter by examining the economic linkages that exist between the provinces at the moment and by taking a critical look at several strategic features of the union.[3]

The Benefits of Economic Integration

Regions or countries pursue economic integration with others in order to capture benefits that they could not achieve on their own. In the process, they have to give up some autonomy. There are several distinct levels of economic integration (see box), each involving a greater or lesser surrender of autonomy on the part of the parties concerned. In moving from a customs union to a common market, for example, members lose some of their ability to promote domestic production or local employment by granting preferential tax treatment to local investors or by discriminating against workers from other regions. In moving from a common market to an economic and monetary union, additional constraints are imposed on the autonomy of regional units: regional priorities may have to be compromised to achieve countrywide gains in living standards.

Steps towards Economic Integration

Free-Trade Zone

Participants in a free-trade zone eliminate all forms of duties and quotas on trade in goods and services among themselves, although they reserve the right to apply restrictive measures in their trade with non-members.

Customs Union

Very similar to a free-trade zone, except that the members agree to impose identical duties (i.e., a common customs policy) on imports from non-participants.

Common Market

A customs union that also embraces the free mobility (i.e., unimpeded movement) of factors of production – labour and capital – across the borders of the participating countries or regions.

Economic Union

A common market that also involves some degree of harmonization of economic policy, with a central authority usually being instituted to administer common policies.

Monetary Union

An economic union, with the added element of a common currency.

Unitary State

An entity in which the participants are fully integrated under a unique political authority, which exercises full jurisdiction over all economic policies.

As a federal state where the central government and the provinces share responsibilities in some areas but keep exclusive jurisdiction in others, Canada falls short of the complete political integration that characterizes the unitary state. At the same time, it is much more than an economic union, since the responsibilities of the central government include the direct provision of a variety of services to the public. Paradoxically, Canada remains an imperfect example of economic union, because there is a lack of coordination in certain policy areas (such as budget policy). It also falls short of being a perfect common market because of the various interprovincial barriers that impede the free flow of goods, services, people, and capital.

The inverse relationship between economic integration and political autonomy is sometimes painfully evident in a federal state like Canada. The existence of two major levels of government, each with considerable powers of its own, leads to the emergence of divergent interests and policies, even though all parties involved recognize the merits of the common market and the economic union. The Task Force on Canadian Unity (the Pepin-Robarts Commission) of the late 1970s highlighted the issue this way:

> Taking both benefits and costs into account, equilibrium is reached in practice when the advantages in favour of a higher level of integration are counter-balanced by the social and political costs which each region is prepared to tolerate. In the case of Canada the limits to integration are imposed by those Canadian realities which we have previously described as the principles of dualism and regionalism.[4]

Canada chose to create a federal structure in 1867 in order to respect the diversity of the colonies and at the same time, enjoy the advantages of a common market and economic union. That diversity still exists today. Westerners and Maritimers see the world in very different ways. They face different risks and enjoy different opportunities; they have different social priorities. Ontarians, for their part, have more contact with the other provinces, but they too see the Canadian economic reality from a unique perspective. In Quebec, the majority speaks a different language and enjoys a different culture; these have shaped a strong commitment to collective goals and a determination to defend collective rights that reflect the experience of being a minority group.

Clearly, the objective today, as in the past, should not be to push economic union to the point where Canada becomes a unitary state. The real test should be whether enough gains from integration accrue to each participant to compensate for the loss of regional autonomy that integration entails. Ideally, we would like to measure the dividend created by integration by comparing the well-being of Canadians today with what they would have achieved in the absence of Confederation. That is clearly an impossible task. Instead, we shall try to assess the degree to which Canada is now exploiting the potential gains from integration – i.e., the gains from market integration, greater bargaining power in international affairs, the sharing of overheads, and the pooling of risks.

Market Integration

The benefits from market integration arise from the common market. The creation of a common market eliminates barriers that prevent companies from being as efficient as they could be; and it establishes a competitive environment that will encourage them to exploit new opportunities. Firms specialize and achieve productivity gains that would not otherwise be possible, thus increasing the living standards of citizens.

The Canadian common market is now well established. It is not without imperfections, however: barriers to trade remain, and regulation and taxation systems are not fully harmonized. At the same time, trade barriers against the rest of the world have declined considerably in recent decades, and international competition has attained unprecedented levels. As a result, some Canadian firms can achieve many of the gains from specialization and economies of scale through better access to foreign markets. The dynamic gains flowing from a more competitive business environment can also be captured outside the Canadian common market. Nevertheless, for many industries the internal market still provides the home base from which they compete with foreign producers.

In addition, the economic advantages associated with the free flow of labour within Canada continue to provide a raison d'être for the common market. The right to work anywhere in the country broadens the job opportunities of Canadians and thus increases their income potential. It also contributes to a more efficient allocation of resources and is an important mechanism of adjustment to economic shocks. In addition, the free flow of investment in the common market can play a valuable role in accelerating the transmission of new technologies and innovations.

Increased Bargaining Power

Because Canada speaks with one voice in international forums – the GATT, the International Monetary Fund, the United Nations, and so on – or in trade disputes under the Canada-U.S. Free-Trade Agreement, it clearly has more influence than would the provinces individually. Very small countries are vulnerable in the international arena, and even large ones have found that their clout has diminished and that they can only act in concert with their allies or neighbours.

Sharing of Costs

Substantial gains accrue when governments agree to co-operate, coordinate, harmonize, or share within an economic union in order to provide lower-cost services to their citizens. Among the areas where costs and overheads can be shared are common services, defence, weather forecasting, satellite communications, airports, and national standards for health care and other basic services. In general, Canada has achieved these gains through federal initiative rather than through interprovincial cooperation. An extensive system of common services and shared costs has been established, largely financed by the federal government.

Now, however, Canada faces new challenges. The slower rate of economic growth since the mid-1970s has slowed the increase in government revenues, and many services have had to be financed by debt. As a result, there is less federal money available to finance the areas where growth is occurring – mainly in provincial jurisdictions. Even if there were no constitutional debate at this time, the fiscal squeeze would make it necessary to analyse and redefine the federal role in the economy, as well as the system for sharing costs in Canada.

Pooling and Sharing of Risks

For individuals, the pooling and sharing of the risks generated by economic upheaval is accomplished through insurance programs to support the elderly, the unemployed, farmers, depositors, and so on. Sharing risks among regions is effected through interregional transfers from high-income to low-income regions. Those are vital elements of the Canadian economic union that may become more important in the future, as the growing interdependence of countries within the world economy and the speed of technological change may well expose Canadians to greater risk – to a greater number of job changes over the course of a lifetime, for example.

The complex web of insurance and stabilization programs in Canada reflects a strong preoccupation with equity, though in many cases, the programs are also justified on efficiency grounds. As the federal government's fiscal situation deteriorates and as the role of the provinces in the economy expands, however, new stabilization and insurance mechanisms may be needed. Moreover, there is a growing recognition that the country's future economic viability will, as one author recently put it, require "grappling with Canada's internal transfer dependency which is sapping the innovation and viability of an increasing number of provinces."[5]

This statement of the four sources of potential gain from integration is phrased in strict economic terms. However, it is important to note that in social and political terms, these gains – the scope for personal mobility and for income growth, the access to common services, for example – constitute key elements of citizenship for many Canadians.

In the 1860s, it was the fear of an invasion by the United States and the need to build an internal market that motivated the creators of the Canadian confederation. But over time, priorities have shifted. Canadians now take for granted the common market and their participation in the club of most powerful nations. They probably place more emphasis now on risk-sharing and common services as the essence of their citizenship, though both are being challenged by international developments and by the fragile fiscal situation of the federal government.

While it is impossible to quantify the gains provided by the union today, we know some of the factors that will have an impact on the importance of these benefits. Two are particularly significant. First, the more the Canadian economic union falls short of the ideal model – the greater the barriers to the mobility of goods, labour, and capital, and the less effective is policy harmonization, for example – the less important will be the potential advantages of the union. Second, the potential gains of the common market cannot be realized if there is no trade among the members of the union because they are too distant from one another or because their industrial structures are not complementary. The stronger are the interregional trading and commercial links, the stronger is the evidence that the common market has economic benefits for Canadians.

Economic Linkages in Canada

Trade

Recent analyses of interprovincial trade flows have led to the view that globalization and the expansion of north/south trade flows following the introduction of the Canada-U.S. Free-Trade Agreement are eroding east/west trade linkages within Canada, as provincial trade gets diverted towards outside markets. Our research confirms that the international ties are growing, but it does not show that the east/west linkages have been weakened.

Our analysis of interprovincial trade linkages is based on the provincial input/output tables.[6] The tables embrace the production and trade of all goods and services, and provide an integrated framework for examining provincial links with markets outside the province.[7]

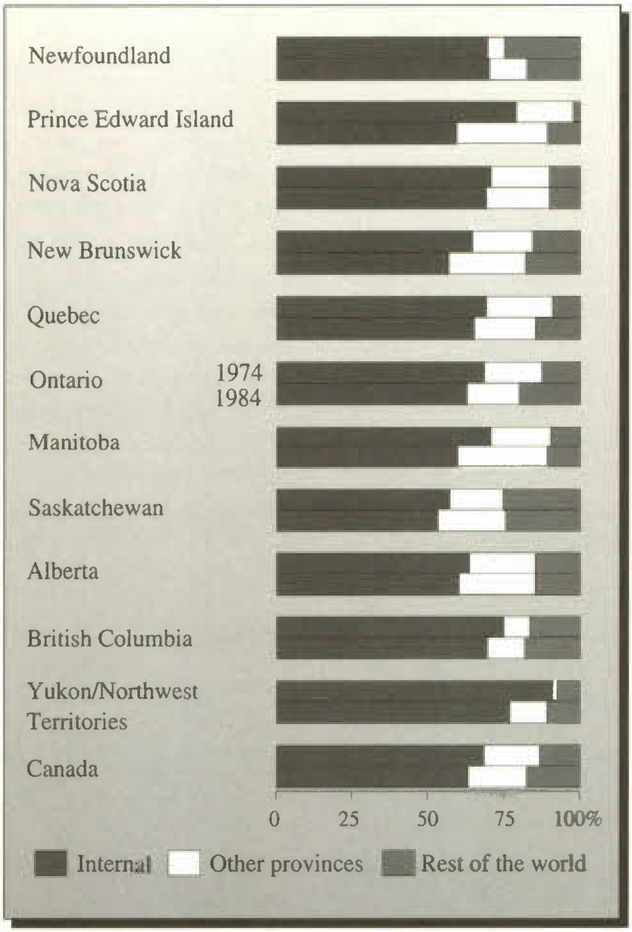
Interprovincial Trade Patterns

Chart 3-1 depicts the distribution of provincial gross output[8] of all goods and services to three destinations: the local market (for example, what Newfoundland firms sell in Newfoundland), markets in the rest of Canada, and foreign markets. The local market is by far the most important destination of local output in all provinces: in 1984, for example, nearly two thirds of provincial gross output was sold in local markets.[9] The chart also shows that, for Canada as a whole, interprovincial trade in goods and services was still more important that year, as a proportion of gross output, than international trade – 19.3 per cent vs. 17.5 per cent. We estimate that interprovincial trade alone may have accounted for about 2 million direct jobs in 1990.[10]

Also noteworthy is the fact that the increase in the relative importance of international trade since 1974 has reduced the role of the local market – not interprovincial trade. Indeed, interprovincial trade in goods in Canada (18 per cent of GDP) seems high, compared with trade within the European Community (13 per cent), particularly when one takes into consideration the greater barrier of geographic distance in this country, as well as Canada's smaller population and greater dependence on resources.[11] Interprovincial trade in goods in Canada is also much greater than trade within the European Free Trade area (4 per cent).

Chart 3-1

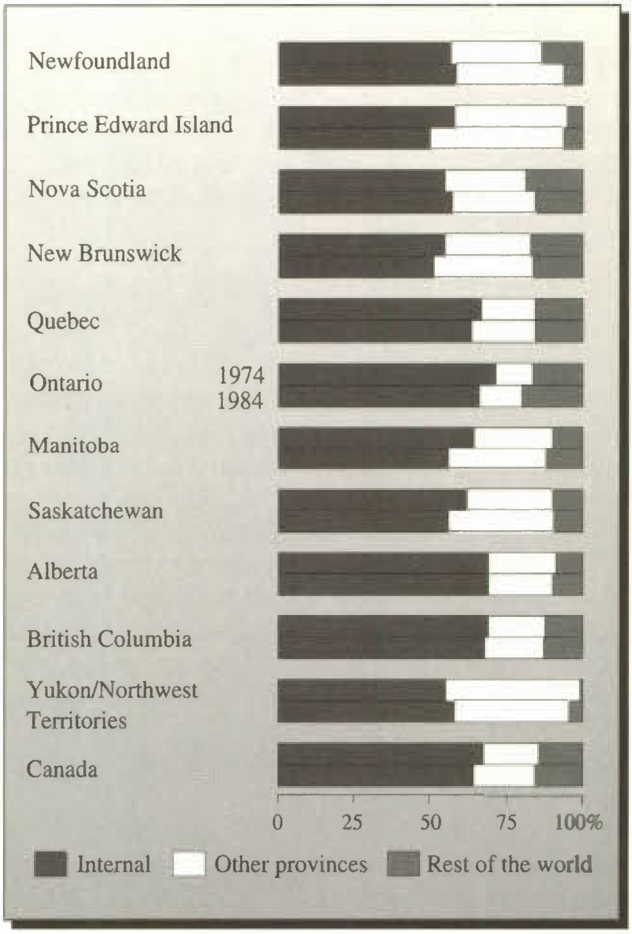
Destination of Provincial Output, Canada, 1974 and 1984



Source Estimates by the Economic Council, based on data from Statistics Canada.

Chart 3-2

Sources of Supply of Goods and Services, Canada, by Province, 1974 and 1984



Source Estimates by the Economic Council, based on data from Statistics Canada.

The patterns of trade flows for Canada as a whole conceal important differences between the provinces, as Chart 3-1 also shows. While the ratio of international trade to gross output rose substantially for Ontario, Quebec, and Prince Edward Island between 1974 and 1984, the increase was much more modest for New Brunswick, Manitoba, and British Columbia; the ratio remained unchanged for Nova Scotia and Alberta, and decreased for Newfoundland and Saskatchewan. The share of output destined for markets in the rest of Canada decreased for Ontario and Quebec, but increased in all other provinces, often quite substantially.

We also looked at the degree of interdependence between the provinces from the perspective of the sources of supply of the goods and services consumed in each province (Chart 3-2). The distribution of supply was similar to that of exports. All provinces except Ontario relied more on interprovincial trade than on international trade for their imports. Ontario's greater reliance on foreign imports reflects its substantial intra-industry trade with the United States, particularly in the automobile sector.[12] On average, the importance of the local market as a source of supply declined between 1974 and 1984, while that of imports from other countries and especially from the other provinces increased. Thus the links between the provinces and their suppliers in the rest of Canada became stronger during that period.

The detailed pattern of trade between the provinces is described in Table 3-1. The linkages seem to be strongly influenced by geography and by the vestiges of the old National Policy of the 19th century, which was based on a vision of regional specialization.

Ontario and Quebec have very strong ties with one another. These two provinces sell more to each other than to any other part of Canada. In 1984, Quebec exported products valued at $18 billion (11.7 per cent of its gross provincial output) to Ontario, while Ontario's exports to Quebec reached $21 billion (7.5 per cent of Ontario's output). Thus their bilateral trade amounted to nearly $40 billion. While this interdependence has been declining since 1974, Quebec still generates more revenue from sales to Ontario markets than to any other destination, both within Canada and in the rest of the world. Next to Ontario, Quebec's most important markets within Canada are Alberta and British Columbia, where 1.9 and 1.5 per cent, respectively, of its gross output are sold.

All of the other provinces and the territories have significant trade ties with Ontario and Quebec, but trade links both within and between these other regions are rather weak. This is particularly true for trade between provinces in the Atlantic region. While trade links among the western provinces are stronger than those among the Atlantic provinces, they are still much weaker than the ties between Ontario and Quebec.

Also noteworthy is the fact that trade links between the Atlantic region and the West are almost insignificant. The Atlantic region exports very little of its output to the provinces west of Ontario; conversely, the western provinces depend very little on markets east of Quebec. Distance as well as similarities in the composition of exports explain these weak links.

Have these trends changed much since 1984? While no internally consistent data such as those used in Table 3-1 are available, Quebec, Ontario, and the western provinces maintain their own statistics on trade. These data suggest that all of these provinces, except Saskatchewan, have experienced increases in the importance of foreign markets as a destination for goods exports. Also interesting is the fact that Quebec seems to have recorded a significant increase in exports of manufactures to the rest of Canada, primarily Ontario.

International Aspects

The pattern of trade linkages between the provinces and their foreign markets is dominated by geography. All provinces sell more of their total exports to the United States than to any other foreign destination, the proportion ranging from a high of 88 per cent for Ontario to a low of 41 per cent for Saskatchewan (calculated from Table 3-1). In general, the western provinces tend to export relatively more to Asia and Oceania than to European markets, while the latter are relatively more important to the Atlantic provinces than Asian markets. But the importance of comparative advantage in shaping trade patterns is also evident. For example, British Columbia exports large quantities of forest products to Europe, and Newfoundland exports fish products to Asia.

Geography also seems to be a determining factor in the pattern of trade between the provinces and their markets in the United States. Exports from the Atlantic provinces to that country are concentrated in the regions along the eastern seaboard (Figure 3-1).[13] The Eastern North Central region absorbs the largest share of Ontario's exports; in the case of Quebec exports, it is the Northeast. Given the concentration of the U.S. automotive industry in Michigan, it comes as no surprise that the Eastern North Central region receives more than half of Ontario's merchandise exports to the United States, as well as one quarter of Quebec's. British Columbia's exports to the United States are

Table 3-1
Distribution of Gross Provincial Output by Destination, Canada, 1984[1]

	Origin of output											
	Newfound-land	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Yukon and Northwest Territories	Canada[2]
	(Per cent)											
Destination of output:												
Foreign markets[3]	17.9	10.9	10.2	18.5	14.6	20.2	11.1	24.8	14.7	18.1	10.9	17.5
United States only[4]	11.0	6.9	7.0	12.0	10.9	17.7	6.7	10.2	10.7	8.0	0.8	13.1
All other provinces[5]	12.2	30.1	20.7	24.8	20.2	17.4	29.5	22.2	25.4	12.4	12.0	19.3
Newfoundland	**69.9**	1.7	2.7	1.6	--	--	--	--	--	--	--	...
Prince Edward Island	--	**59.0**	1.1	1.4	--	--	--	--	--	--	--	...
Nova Scotia	1.9	4.4	**69.1**	4.9	1.1	--	--	--	--	--	--	...
New Brunswick	--	2.9	3.7	**56.8**	1.2	--	--	--	--	--	--	...
Quebec	4.1	9.4	5.9	9.8	**65.2**	7.5	3.8	5.4	4.5	1.5	1.0	...
Ontario	5.2	11.1	5.7	5.9	11.7	**62.4**	13.7	6.9	10.4	3.5	1.2	...
Manitoba	--	--	--	--	--	1.3	**59.5**	4.0	1.5	--	--	...
Saskatchewan	--	--	--	--	--	1.1	4.1	**53.0**	3.1	--	--	...
Alberta	--	--	--	--	1.9	3.1	4.6	4.4	**60.0**	5.1	1.8	...
British Columbia	--	--	--	--	1.5	2.1	2.1	1.1	4.9	**69.5**	7.7	...
Yukon and Northwest Territories	--	--	--	--	--	--	--	--	--	--	**77.0**	...
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	...

1 Bold figures indicate the proportion of output that is sold locally. The average for Canada is 63.2 per cent.
2 Weighted averages.
3 Including the United States.
4 Estimates based on the U.S. share of total merchandise exports, by province, from the international trade data file. It is assumed that the U.S. share of provincial service exports to the rest of the world is identical to its share of provincial merchandise exports to the rest of the world.
5 Includes shares under 1 per cent, which do not appear in the table.
SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

primarily destined for the western regions of the country. However, the effect of geography is less evident in the case of exports from the Prairie provinces. The same general patterns are evident in the sources of imports from the United States (not shown in the figure).

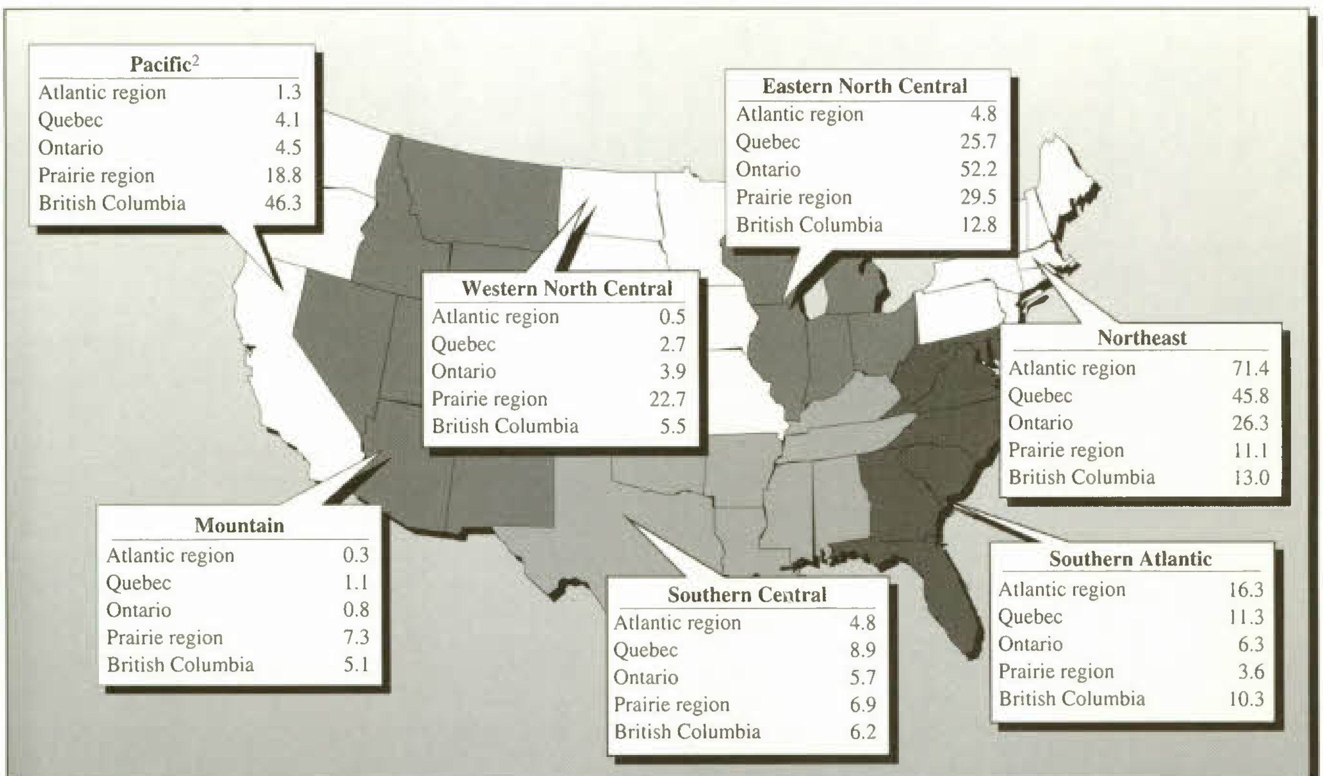
Composition

In 1984, service exports accounted for 43 per cent of total interprovincial trade, whereas they represented only 13 per cent of Canada's sales abroad. For most provinces, four or more of the top nine categories of exports to the other provinces are services (Table 3-2). Generally, transportation and storage services comprise the largest share of interprovincial exports, in some instances accounting for more than one quarter of the total.[14] Financial services also rank very high.

Another striking feature of interprovincial trade is its high concentration in goods that have traditionally received tariff protection. Many of the tariffs originated with the National Policy (introduced in 1879), which envisioned an economic union in which the provinces with abundant natural resources would specialize in those products, while the central provinces, with their fledgling industrial base, would become the industrial heartland of the country. Tariffs on a wide selection of goods were used to protect domestic producers of manufactured goods in central Canada against the growing competition from south of the border.

In a free-trade environment, one would expect that if a province enjoys a comparative advantage in the production and export of a given group of commodities, then the commodity composition of exports to the rest of the world and to the rest of Canada should also reflect that advantage. While comparative advantage is evident in the composition of merchandise exports from Newfoundland, Prince Edward Island, and the Prairie provinces, it is much less apparent in the exports of the other provinces. In Ontario and Quebec, international exports are dominated by intra-industry sales to the United States (mainly autos and parts). While both provinces have developed some high-technology industries

Figure 3-1
Regional Distribution of Provincial Exports to the United States, Canada, 1988-89[1]



1 Averages in percentages; shares for any individual province or region may not add to 100, as there is a category of exports comprising goods for which the region of destination could not be determined.
2 Includes Alaska and Hawaii.
SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

Table 3-2
Interprovincial Exports: Shares of Major Commodity or Service Category, Canada, by Province, 1984[1]

	(Per cent)
Newfoundland	
Transportation and storage	**37.8**
Metallic ores and concentrates	13.4
Other utilities	**10.2**
Other finance, insurance, and real estate	**8.4**
Food products	4.8
Paper and paper products	4.1
Wholesale trade	**3.7**
Communication services	**3.2**
Personal and other miscellaneous services	**2.8**
Prince Edward Island	
Transportation and storage	**43.0**
Food products	15.3
Other agricultural products	13.1
Other finance, insurance, and real estate	**7.3**
Wholesale trade	**5.6**
Personal and other miscellaneous services	**3.1**
Business services	**2.8**
Chemicals and chemical products	2.8
Grains	1.3
Nova Scotia	
Transportation and storage	**24.9**
Petroleum and coal products	19.2
Other finance, insurance, and real estate	**7.9**
Food products	7.7
Wholesale trade	**6.1**
Rubber and leather products	5.3
Autos, trucks, and other transportation equipment	4.1
Business services	**2.8**
Paper and paper products	2.8
New Brunswick	
Transportation and storage	**28.2**
Food products	12.2
Petroleum and coal products	10.0
Autos, trucks, and other transportation equipment	9.3
Other finance, insurance, and real estate	**6.8**
Wholesale trade	**6.0**
Paper and paper products	4.6
Metallic ores and concentrates	2.7
Personal and other miscellaneous services	**2.5**
Quebec	
Other finance, insurance, and real estate	**13.3**
Transportation and storage	**12.4**
Wholesale trade	**7.4**
Food products	7.3
Knitted products and clothing	6.7
Chemicals and chemical products	5.9
Paper and paper products	4.5
Primary metal products	4.1
Personal and other miscellaneous services	**3.9**
Ontario	
Transportation and storage	**13.3**
Wholesale trade	**10.7**
Other finance, insurance, and real estate	**8.4**
Food products	7.8
Chemicals and chemical products	6.7
Business services	**5.5**
Personal and other miscellaneous services	**5.0**
Electrical and communication products	5.0
Primary metal products	4.0
Manitoba	
Transportation and storage	**22.5**
Wholesale trade	**10.9**
Other finance, insurance, and real estate	**10.1**
Food products	8.8
Grains	5.3
Other agricultural products	4.2
Business services	**3.7**
Knitted products and clothing	3.5
Personal and other miscellaneous services	**3.2**
Saskatchewan	
Transportation and storage	**23.0**
Mineral fuels	14.9
Other finance, insurance, and real estate	**10.6**
Other agricultural products	8.4
Food products	7.1
Wholesale trade	**4.7**
Grains	4.3
Business services	**3.4**
Services incidental to mining	**3.0**
Alberta	
Mineral fuels	45.6
Transportation and storage	**12.2**
Petroleum and coal products	7.9
Food products	6.0
Other finance, insurance, and real estate	**4.9**
Business services	**4.7**
Chemicals and chemical products	3.5
Wholesale trade	**3.3**
Services incidental to mining	**1.8**
British Columbia	
Transportation and storage	**31.2**
Other finance, insurance, and real estate	**15.5**
Lumber, sawmill and other wood products	7.1
Wholesale trade	**6.7**
Business services	**6.1**
Food products	4.4
Personal and other miscellaneous services	**4.2**
Paper and other paper products	3.3
Other agricultural products	2.6
Yukon and Northwest Territories	
Transportation and storage	**57.4**
Metallic ores and concentrates	25.5
Mineral fuels	3.7
Business services	**3.8**
Other finance, insurance, and real estate	**2.6**
Travel, advertising, and promotion	**2.4**
Retail trade	**1.0**
Communication services	**1.0**
Primary metal products	0.7

1 The bold typeface denotes services. Final-demand expenditures on goods and services are valued at producers' prices. The retail and wholesale margins have been identified as the services exports of the retail and wholesale trade sectors. The transportation margins have been incorporated in the transportation and storage category.

SOURCE Based on data from Statistics Canada.

in such areas as electrical and communications equipment, and machinery and other transportation equipment, they export significant quantities of mineral products, forestry products, and primary metals products. At the same time, a large portion of Quebec and Ontario exports to the rest of Canada is made up of labour-intensive goods, such as rubber and leather products, knitting and clothing, and textile products. These products still accounted for more than 21 per cent of Quebec's interprovincial merchandise trade in 1984 but represented about 3 per cent of its goods exports to foreign markets.

The same pattern emerges for Manitoba, New Brunswick, and Nova Scotia, where international exports include a high proportion of primary and semi-processed products, while exports to the rest of Canada display a higher share of manufactures.

In sum, our analysis of trade flows shows that the export orientation of many of the provinces has shifted noticeably towards foreign markets. But this move has not, at least so far, resulted in a decline in the flow of trade between provinces.

The two major surprises emerging from the analysis are: 1) the importance of services in interprovincial trade; and 2) the weak trade linkages within the Atlantic and western regions. Indeed, each Atlantic province has stronger links with central Canada than with the other provinces in its own region. In addition, the trade linkages between the Atlantic region and the West are weak, probably because they are far apart and they produce similar commodities.

Nonetheless, the dominant message that emerges is that markets in the rest of Canada are very important to all provinces and will likely remain so for some time to come, even as international trade continues to grow.

Corporate Links

Another important aspect of interprovincial linkages consists of corporate branch operations and parent/subsidiary linkages. They can be either substitutes for, or complements to, interprovincial trade. In some cases, branch plants or subsidiaries may be established in other provinces in order to supply the local market. Such corporate links substitute for trade. In other cases, branch operations or subsidiaries may be established in other provinces to facilitate sales and thereby complement interprovincial trade.

When a corporation owns controlling interests in another firm, it can make strategic decisions for the latter. This has both positive and negative aspects. On the positive side, intercorporate linkages can provide access to technologies and to best-practice management techniques that lead to greater economic efficiency and hence to higher incomes. On the negative side, there is some concern that when economic decisions are made outside the province, this may have a negative impact on the local economy, inasmuch as R&D investment and promotions to management positions will tend to favour the province where the controlling corporation has its head office.

Our data on the location of corporate control and our estimates of interprovincial linkages are based on an analysis of the revenues earned in each province by 646,000 corporations that filed income tax returns in 1987. Statistics Canada's Intercorporate Ownership File (ICO) was used to identify the corporation, trust, or individual controlling each firm that was part of an enterprise that year. Head-office location was used as a proxy for the location where strategic decisions are made. This is the first time that such information has been compiled for Canada (see Appendix C for technical details).

Table 3-3 shows the number and proportion of corporations controlled in each province and outside Canada, as well as the values of their assets and revenues.[15] Not surprisingly, Ontario dominates with respect to all three indicators, while Quebec occupies the second place. Ontario's relatively high share of assets reflects the concentration of financial institutions in that province. Although foreign-controlled firms accounted for only 1 per cent of all corporations in Canada, they held 18 per cent of corporate assets and earned 26 per cent of corporate revenues.[16]

As Chart 3-3 shows, the revenue shares earned by locally controlled firms (excluding the "other" category) ranged from less than 50 per cent in Alberta and Manitoba to a high of 69 per cent in Quebec. Thus, while Quebec had the highest degree of local control of its corporate activity, as measured by revenues, about 30 per cent of corporate activity was accounted for by firms under outside control.

The share of corporate revenue controlled in other provinces (excluding "other") ranged from 10 per cent in Ontario to 29 per cent in Manitoba. These percentages are indicators of the interprovincial linkages that exist through intercorporate ownership and branch operations. On average, 14 per cent of revenues were earned by corporations controlled in other provinces. This percentage is about half the proportion of revenues earned by foreign-controlled firms (26 per cent). Canadian-controlled firms under out-of-province control generally earned more revenue than foreign-controlled firms in the smaller provinces, while the reverse was true for the larger provinces. The revenue share of foreign-controlled firms ranged from a low of 10 per cent in Prince Edward Island to a high of 31 per cent in Ontario.

Table 3-3
Distribution of Corporate Control in Canada, by Location, 1987

	Number of firms		Assets		Revenues	
	(Thousands)	(Per cent)	(Billions of $)	(Per cent)	(Billions of $)	(Per cent)
Location of control:						
Foreign countries[1]	8.0	1.2	390.9	18.2	287.8	25.7
United States only	4.3	0.7	216.6	10.1	196.3	17.5
Canada	638.2	98.8	1,754.1	81.8	833.8	74.3
Newfoundland	7.1	1.1	7.4	0.3	6.6	0.6
Prince Edward Island	2.5	0.4	2.5	0.1	2.3	0.2
Nova Scotia	14.1	2.2	29.2	1.4	15.8	1.4
New Brunswick	12.2	1.9	15.2	0.7	13.6	1.2
Quebec	154.8	24.0	460.1	21.5	226.3	20.2
Ontario	219.9	34.0	864.8	40.3	353.3	31.5
Manitoba	22.1	3.4	31.7	1.5	23.6	2.1
Saskatchewan	22.8	3.5	28.9	1.3	20.9	1.9
Alberta	86.0	13.3	140.6	6.6	70.4	6.3
British Columbia	94.8	14.7	109.9	5.1	76.8	6.8
Other[2]	1.8	0.3	2.2	0.1	2.1	0.2
Federal[3]	0.1	--	61.7	2.9	22.1	2.0
Total	646.2	100.0	2,144.9	100.0	1,121.6	100.0

1 Including the United States.
2 Includes corporations controlled in the Yukon and Northwest Territories, and corporations for which a provincial location of control could not be determined.
3 Federal crown corporations and subsidiaries.
SOURCE Special tabulations by Statistics Canada for the Economic Council.

Table 3-4 provides greater detail on the linkages between individual provinces. Ontario-controlled corporations accounted for the largest share of revenues earned in each province, ranging from 8 per cent in Quebec to 16 per cent in New Brunswick. Corporations controlled in Quebec also accounted for a significant share of the revenues earned in other provinces – about 4 per cent in Alberta and British Columbia, and almost 7 per cent in Saskatchewan. Corporations controlled in provinces other than Quebec and Ontario generally do not contribute significantly to corporate activity in other provinces.[17] Nova Scotian firms have links in the Atlantic region, and Albertan firms have links to Saskatchewan and British Columbia, but links between the Atlantic region and the West are insignificant.[18]

In summary, distance again appears to be a critical factor in determining the pattern of interprovincial linkages; this is surprising, in that we would not expect distance to have such a great impact on investment. Corporate links between the Atlantic provinces and the West are generally very weak. The most significant links were not within regions but between Ontario – and, to a lesser extent, Quebec – and each of the other provinces.

Quebec has the greatest domestic control over its corporate activities: locally controlled firms account for more than two thirds of corporate revenues. In most of the other provinces, that proportion runs closer to 60 per cent, which means that 40 per cent of corporate revenue is attributable to firms with nonlocal decision makers. The four largest provinces and Nova Scotia are more exposed to decisions from abroad than to those made in other provinces. Indeed, the proportion of total provincial corporate revenues generated by nonlocal, Canadian-controlled corporations is smaller, on average, than that generated by foreign-controlled firms.

Labour Mobility

One cherished feature of the Canadian economic union is the right of residents to move freely within Canada and

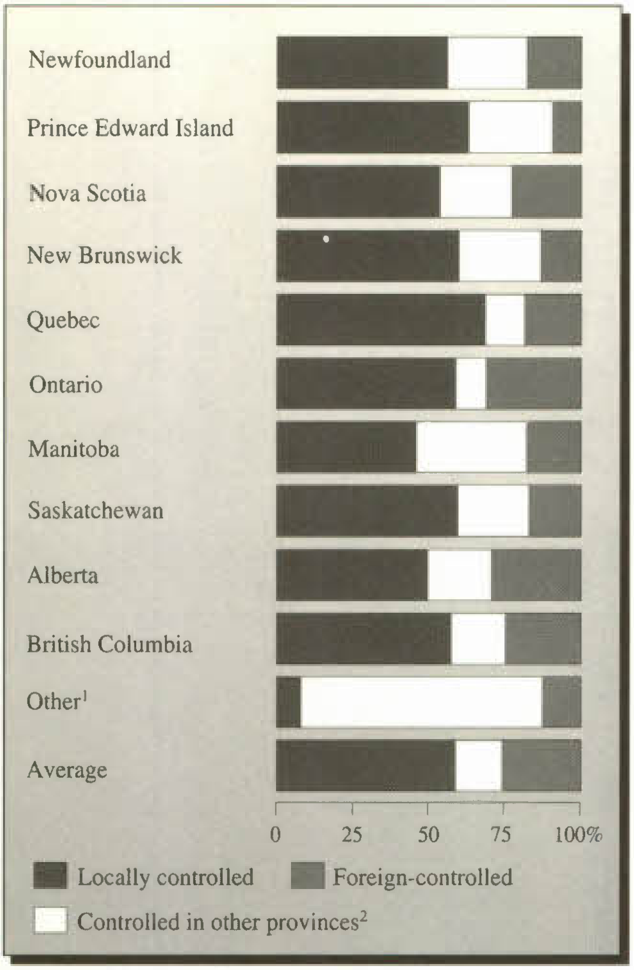
Table 3-4
Provincial Allocation of Corporate Revenues, by Location of Corporate Control, Canada, 1987[1]

	Provincial revenue allocation										
	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Other[2]
						(Per cent)					
Location of control:											
United States	12.6	4.8	15.9	9.4	10.6	22.4	12.9	12.5	22.3	13.8	7.8
Other foreign countries	5.2	4.6	6.9	4.0	7.9	8.8	5.1	4.6	7.0	10.9	4.8
Newfoundland	**56.1**	--	--	--	--	--	--	--	--	--	x
Prince Edward Island	--	**62.9**	--	--	--	--	--	--	--	--	--
Nova Scotia	4.3	7.6	**53.5**	3.0	--	--	--	--	--	--	--
New Brunswick	--	4.4	2.4	**59.9**	--	--	--	--	--	--	--
Quebec	6.2	--	4.7	5.3	**68.6**	6.3	6.2	6.6	4.3	3.5	23.6
Ontario	12.6	12.9	13.0	16.0	8.0	**58.8**	14.7	9.5	11.2	10.3	45.7
Manitoba	--	--	--	--	--	--	**45.9**	2.3	--	--	--
Saskatchewan	--	--	--	--	--	--	--	**59.3**	--	--	--
Alberta	--	--	--	--	--	--	--	2.9	**49.5**	2.0	6.1
British Columbia	--	--	--	--	--	--	--	--	2.2	**57.3**	--
Other[2]	--	--	--	--	--	--	--	--	--	--	8.1
Federal[3]	--	--	--	--	3.5	--	9.8	--	--	--	x
Total[4]	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1 Bold figures indicate the proportion of corporate revenues earned by locally controlled firms.
2 Includes corporations controlled in the Yukon and Northwest Territories, and corporations for which a provincial location of control could not be determined.
3 Federal crown corporations and subsidiaries.
4 Detailed figures may not add to 100.0 because shares under 2 per cent are omitted.
SOURCE Special tabulations by Statistics Canada for the Economic Council.

Chart 3-3

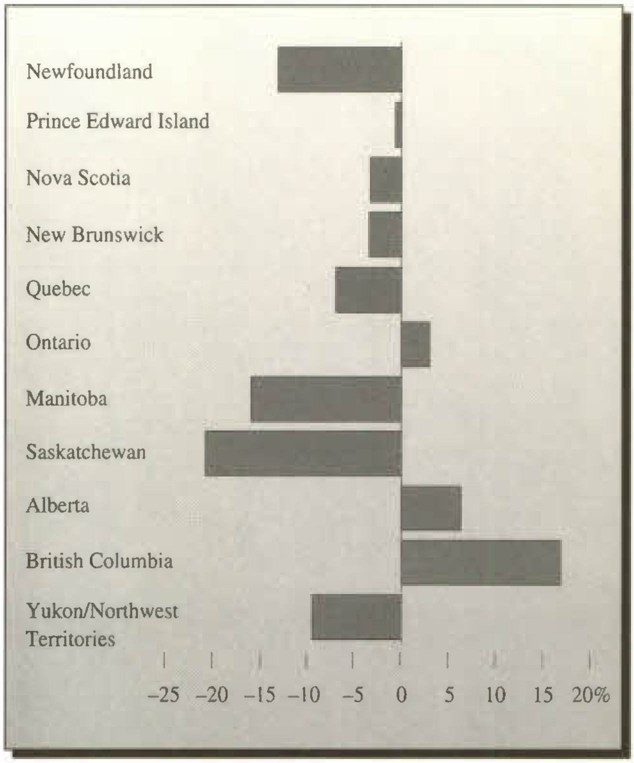
Corporate Revenues Earned by Firms Controlled Locally and Non Locally, Canada, by Province, 1987



1 Includes Yukon, the Northwest Territories, and corporations for which the province of control could not be determined.
2 Includes revenues earned by federal crown corporations, which amounted to less than 2 percentage points in all provinces except Quebec (3.5 points) and Manitoba (9.8 points).
SOURCE Estimates by the Economic Council, based on special calculations by Statistics Canada.

Chart 3-4

Net Interprovincial Migration,[1] Canada, 1961-91[2]



1 As a proportion of 1991 population.
2 The period covered extends from 1 June 1961 to 31 May 1991.
SOURCE Based on data from Statistics Canada.

to work in any province. When workers move to jobs in which they will be more productive, both individual and national incomes rise. Labour mobility can also help to speed up the adjustment to economic shocks that affect one region more than another.[19]

Migration Flows

Relative to people in other countries, Canadians are quite mobile: during the 1980s, an average of 320,000 people changed provinces each year. Indeed, Canadian mobility is comparable with that of the United States,[20] which is considered to be among the highest within the Organisation for Economic Co-operation and Development (OECD); mobility in both countries is significantly higher than in the European Community.

These flows are large enough to make a significant contribution to labour-market adjustment needs in Canada. The number of labour-force participants who changed provinces in 1986 represented around 8 per cent of the total number of job changes that year.[21] As shown in Chart 3-4, the net redistribution of population resulting from interprovincial migration has had a significant impact on provincial population levels. For example, even though migration from Quebec is limited by the language barrier – about 60 per cent of Quebecers are unilingual francophones, and there are few French-language jobs available outside of Quebec – the net outflow from Quebec over the past three decades has totaled almost half a million people – about 7 per cent of the province's current population. Francophones generally account for 20 per cent or less of Quebec's net outflows. While net outflows have occurred every year since 1962, they were particularly large at the time of the FLQ (Front de libération du Québec) crisis in 1969-70 and after the election of the Parti Québécois in 1976.[22] After 1984, the outflows diminished, reflecting the stronger recovery in Quebec.

Net migration flows can have a very significant impact over a short period when economic incentives are strong. During the economic boom in Alberta (1976-81), for example, net inflows into the province totaled almost 200,000 – an amount equivalent to over 8 per cent of Alberta's 1981 population. But following the oil-boom collapse in the early 1980s, there was a large exodus of people, resulting in a net outflow of more than 120,000 between 1982 and 1989.

Ontario's net flows have generally been positive, except during the 1970s, when the western economies were booming. When Ontario experienced strong economic growth after 1982, it received more than 200,000 net migrants.

Net migration flows have generally been negative for Manitoba and Saskatchewan. However, both provinces experienced net inflows following the 1981-82 recession, as many previous outmigrants returned home. Saskatchewan also had net inflows during the mid-1970s – a period of strong grain prices and rapid growth.

British Columbia has attracted large net inflows of migrants in most years since 1961. Noneconomic factors (such as the climate) may have contributed to this in-migration over time, but economic incentives have also been important; in the early 1980s, for example, when soft resource prices hurt British Columbia's economy, net migration inflows were either very small or negative.

Yukon and the Northwest Territories have generally experienced net outflows, except during the late 1960s and early 1970s, when exploration and drilling activities, mining activity, and highway construction attracted an influx of people.

The Atlantic provinces have generally experienced net outmigration. However, there was a reversal from negative to positive figures in three of the four provinces over the 1970s (Chart 3-5), after changes were made to the Unemployment Insurance program in 1971.[23] These changes increased unemployment benefits in all regions of Canada, but more so in those with high unemployment. The generosity of the UI program was reduced somewhat in 1979, but benefit levels and eligibility criteria remained more liberal than they were prior to the 1971 amendments. Net migration flows appear to have responded to the changes but have not been restored to their pre-1971 pattern.

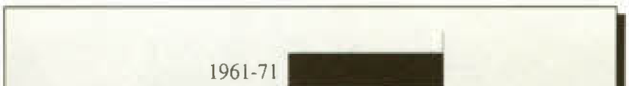
Overall, the pattern of provincial flows reveals that migration results in a significant amount of net labour-force redistribution, with labour supply shifting to regions with expanding employment and higher wages. This suggests that labour mobility in Canada probably makes a positive contribution to economic efficiency and provides workers with opportunities that would not otherwise be available in their home province. It would take further research, however, to ascertain whether the new jobs pay better wages than the ones that are being left behind.[24]

Integration of Provincial Labour Markets

Outmigration rates are much lower in Ontario and Quebec than in the other provinces (Chart 3-6). Ontario's low rate could be explained by the diversity, strength, and size of its economy. In Quebec, while those same factors may also play a certain role, language is the dominant explanation for the low rate of mobility. The five-year outmigration rate for the province as a whole in 1986 (that is, the number of people who lived in Quebec in 1981 but had moved out by

Chart 3-5

Net Interprovincial Migration, Atlantic Provinces, 1961-91[1]



1 The period covered extends from 1 June 1961 to 31 May 1991.
SOURCE Based on data from Statistics Canada.

1986, expressed as a proportion of Quebec's 1986 population) was 2.0 per cent: for Quebecers who declared French as their mother tongue, the rate was only 0.8 per cent, but for those who declared English as their mother tongue, it was almost 10 per cent.

The pattern of interprovincial migration flows shows that distance is again a critical factor in explaining linkages between provinces.[25] Ontario is the clearing house for the national labour market (Chart 3-7). All jurisdictions, with the exception of Saskatchewan, Yukon, and the Northwest Territories, have strong links with Ontario. In western Canada, provincial labour markets are highly integrated with one another. This is particularly evident in Saskatchewan, as about 80 per cent of its outmigrants go to the other western provinces. The corresponding figure for the Yukon and Northwest Territories is 70 per cent.

The Atlantic provinces have relatively weak links with one another, although people from Prince Edward Island do move within the region. Each of the other Atlantic provinces has closer ties with Ontario than with the other provinces in the region.

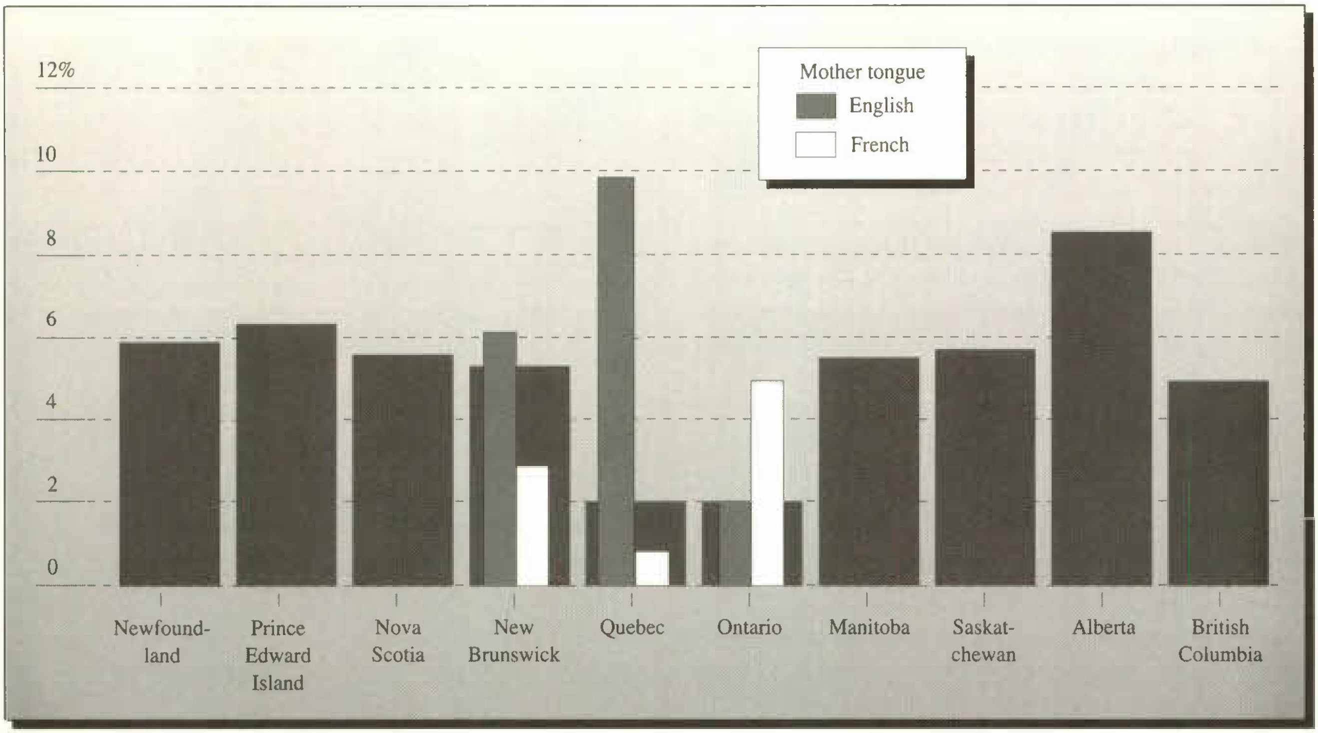
Quebec has weak links with all provinces except Ontario and, to a much lesser extent, New Brunswick. The greater integration of the New Brunswick and Quebec labour markets reflects the relatively high percentage of the population that speaks French in New Brunswick.[26]

In summary, Canada has a high rate of internal migration, and this movement results in a significant amount of labour reallocation. There is enough migration to make a significant contribution to labour-market adjustment needs; there is also evidence that migration flows are responsive to economic conditions and, as a result, probably contribute to a more efficient allocation of labour.

However, the pattern of outmigration suggests that the geographical integration of the Canadian labour market is limited by both distance and language. Although distance seems to be the major contributing factor, in the case of Quebec language is of paramount importance. The links between the provinces to the east and to the west of Ontario are quite weak, particularly in the direction of west to east. Ontario has fairly strong links with almost all of the other provinces.

Chart 3-6

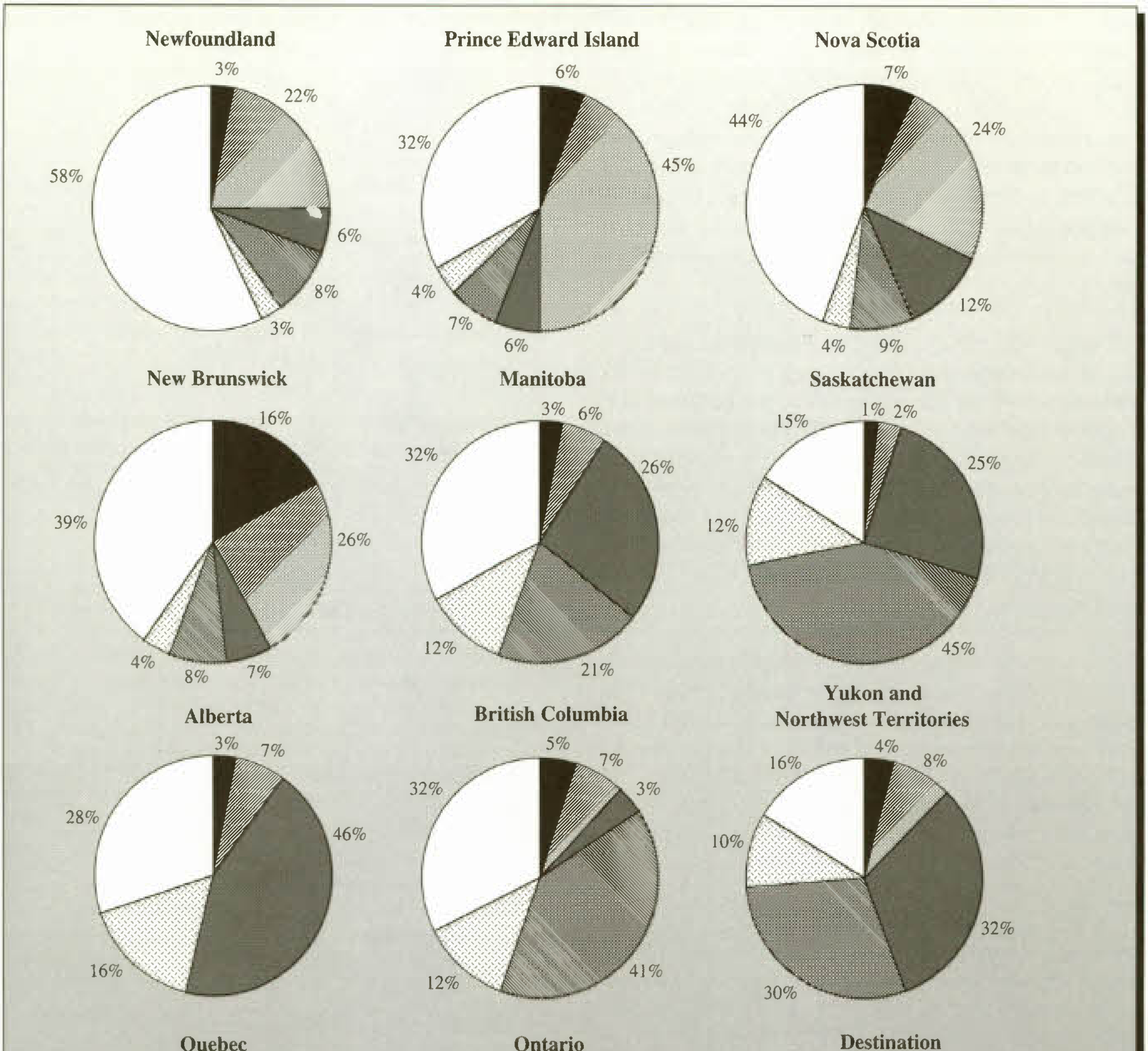
Outmigration between 1981 and 1986,[1] Canada, by Province



1 As a proportion of the population in 1986; excludes multiple moves. The period covered extends from 1 June 1981 to 31 May 1986.

SOURCE Based on data from the 1986 census.

Chart 3-7
Destination of Outmigrants, Canada, by Province, 1986-91[1]



1 The period covered extends from 1 June 1986 to 31 May 1991.
SOURCE Based on data from Statistics Canada.

The State of the Common Market

Interprovincial linkages in Canada are important today, and they are likely to remain so for some time to come, despite the pressures of growing international interdependence. The trade linkages are especially strong, but they are asymmetrical. The strongest ties are those between Ontario and Quebec, and then those which link the rest of the country to those two provinces. Within the Atlantic region and, to a certain extent, the western provinces, trade ties are surprisingly weak. Thus current trade flows offer no logical support to any plans to restructure Canada around regional "blocks."

There remain vestiges of the hinterland/heartland model underlying the National Policy adopted over a century ago. Resource-based provinces ship primary materials to central Canada and overseas, while Ontario and Quebec ship manufactures to the hinterland provinces, many of them made by protected industries that are not competitive internationally. It is important to note, however, that other provinces ship manufactures to the Canadian market as well and that services are an important element in all interprovincial trade.

The corporate linkages are not as strong as the trade linkages, perhaps because foreign firms are active participants in the industries that feature national and multinational activities. Note, however, that corporate linkages can act as a substitute for, or a complement to, trade. Again, the ties run from Ontario and Quebec to the other provinces, with limited integration in the East and in the West, and weak links between them.

Despite the barriers of distance and language, noted above, it is clear that the internal Canadian market is important to all provinces and accounts for a sizeable amount of their income and their employment. Thus any changes in the political structure must be carefully judged, in order to avoid disrupting this trade and the livelihood of many Canadians.

Capturing the Benefits of the Union

Apart from the natural barriers of distance and language, there are other, more artificial obstacles to the integration of the Canadian market. These artificial barriers encompass a broad array of government activities. They include the effects of discriminatory tax, spending, or regulatory policies on the flows of trade, capital, or labour. Other obstacles exist because of the failure of governments to coordinate their actions in key policy areas such as the tax structure or fiscal policy. For illustrative purposes, we deal here with three particular cases where the economic union has faltered – internal trade barriers, tax harmonization, and budget policy coordination. All three are matters of central concern for economic policy in the 1990s.

Internal Trade Barriers

The first of these examples concerns the free mobility of goods, services, labour, and capital. It is hard to define exactly what measures constitute trade barriers, since practically all government policies have an impact on the allocation of resources and therefore represent potential distortions to the common market (see box). Some of these policies implicitly discriminate on the basis of origin. Others do not, but they distort flows nonetheless. For example, provincial standards for the licensing of professionals are aimed at guaranteeing competence, yet differences in these standards among provinces can reduce the mobility of professionals.

Internal Barriers to Trade

Barriers to the Free Flow of Goods and Services

Government procurement policies
Agricultural marketing boards and support programs
Provincial policies on beer and wine
Technical norms and product standards
Transportation regulations and subsidies (e.g., Western Grain Transportation Act)
Resource policies (e.g., processing and exploration incentives)
Government subsidies (e.g., export subsidies, and tax concessions)

Barriers to the Free Flow of Labour

Occupational licensing and certification
Preferential hiring practices
Non-portability of private pension plans
Regionally differentiated unemployment insurance benefits

Barriers to the Free Flow of Capital

Tax preferences for in-province investment
Controls on land purchases
Restrictions on the portfolios of investment funds and financial institutions
Enterprise zones
Industrial incentives and subsidies

It is interesting to note that while the provincial governments are usually the focus of debate on impediments to internal trade and factor mobility, some policies of the federal government also interfere with the common market, such as regional and industrial development policies, regionally differentiated UI benefits, and transportation subsidies.

There is general agreement that internal barriers to trade reduce national economic efficiency. Some also believe that a larger home market would enable more Canadian companies to achieve the size and competitive edge needed to compete successfully in world markets.

Recognizing the potential danger of market fragmentation caused by trade barriers, the federal and provincial ministers of economic development established a task force to study the issue in 1985. This led the first ministers to agree to a moratorium on new barriers in 1986 and to establish, in late 1987, the intergovernmental Committee of Ministers on Internal Trade, which was asked to take immediate steps to eliminate such barriers to interprovincial trade as government procurement, liquor-board marketing practices, transportation regulations, professional mobility, and standards for products or construction.

Progress to date has been slow and uncertain. The moratorium on new barriers, for example, seems to have been ineffective, even though all provincial governments have explicitly stated that they support a concerted effort to reduce or remove obstacles to interprovincial trade. Various forms of protectionism for local industry and local jobs are often hidden behind the legitimate goal of regional development.[27]

Nevertheless, a series of agreements have recently been signed or are in the process of being finalized. A detailed description falls outside the scope of this report, but four examples will provide an idea of recent developments.

Government Procurement Practices

Provincial policies concerning government procurement involve such items as local-presence requirements, tendering practices, control over subcontracts, and zone pricing. All of these tend to favour local sourcing of goods and services.

All provinces except Quebec and Nova Scotia have signed an agreement that would open up tendering for contracts of $25,000 or more for the procurement of goods, as well as establish a formal, impartial, and timely dispute-settlement mechanism for goods-procurement contracts. Negotiations to extend the principle of open tendering to the procurement of services are planned.

Provincial Liquor Policies

Discrimination against out-of-province producers of beer and wine has been a source of controversy and inefficiency for a long time. Partly as a result of international pressures, several draft interprovincial agreements on beer and wine have been prepared. With respect to wine, a draft agreement currently under discussion would result in Canadian wine products being treated as favourably as imports in every province. Less progress has been made on reaching an agreement to eliminate specific interprovincial barriers, as profound differences remain between the respective positions of Ontario, Quebec, and British Columbia.

With respect to beer, an agreement has been accepted by six provinces and the two territories, providing for the elimination of some discriminatory practices and setting a time limit for the establishment of a timetable for removing the remaining barriers.

Marketing Boards

Marketing boards with supply-management powers exert substantial regulatory control over interprovincial trade in milk, chicken, eggs, and turkey by means of import, licensing, and quantitative restrictions, and various other regulations. In the case of fluid milk, which is subject to separate provincial supply-management schemes, interprovincial trade is effectively banned.

At their annual meeting on 4 July 1991, the ministers of agriculture agreed to a series of initiatives, including a set of guidelines for a "second generation" of supply-management systems that would be more responsive to market conditions; they also agreed on a dispute-settlement mechanism to assist in the removal of technical barriers to trade.

Regional Initiatives

In the meantime, other initiatives have been launched in the West, where a major effort to eliminate interprovincial barriers occurred in the 1980s. In the Atlantic region, the governments of New Brunswick, Nova Scotia, and Prince Edward Island are committed to eliminating barriers and actively promoting cooperation in the provision of some services. The government of Newfoundland has been invited to join in this effort.

Studies conducted in the 1980s suggest that, viewed on a national scale, existing barriers at the time were small.[28] Since then, there seems to have been some modest progress in reducing the barriers noted earlier.[29] While the current costs of interprovincial barriers may not give rise to serious problems at the moment, lack of vigilance in this domain could turn out to be very costly. The Council, therefore, strongly supports government efforts in this direction. We would also caution Canadians that changes in the political structure should not lead to the creation of new trade barriers.

Strains on Tax Harmonization

The second case study in fragmentation of the economic union concerns the harmonization of tax systems between governments. The objective of harmonization is to ensure that the tax systems of the three levels of government are organized in such a way as to limit the costs of collection and compliance, and to ensure that taxpayers are subject to roughly the same rules, no matter where they live, so that a free flow of capital and labour can be maintained across the economic union. This ensures fairness, administrative efficiency (by minimizing tax-collection costs), and economic efficiency (by removing the bias of tax discrimination affecting investment and location decisions).

Internationally, the Canadian federation is viewed as a model for harmonizing taxes. In recent years, however, there have been worrying signs of fragmentation with respect to both income and sales taxes.

All provinces except Quebec participate in the personal-income-tax agreements, under which they follow the federal tax base and rate structure but may choose their own tax rates (as a percentage of the federal tax payable). The federal government also administers corporate taxes for all provinces except Quebec, Ontario, and Alberta; those three provinces nevertheless maintain tax bases very similar to that of the federal government.

While a high degree of harmonization has been achieved through the tax-collection agreements, a number of innovations introduced in recent years could be viewed as disharmonizing. Provinces have been permitted to introduce tax credits, and the practice has become extensive in both personal and corporate income taxation, as the box shows.[30] Tax credits alter the effective-tax rate structure. Moreover, even though the tax agreements require that provincial tax credits be nondiscriminatory, these credits are sometimes aimed at encouraging investment in particular types of activities; thus it would be difficult to argue that they do not have at least some influence on the allocation of capital. Even personal-income-tax credits can contribute to the fragmentation of the capital market by encouraging investment in local firms.[31] Other disharmonizing measures include the implementation of flat taxes for personal income taxation by some western provinces, tax reductions for low-income taxpayers, surtaxes on personal and corporate income, and corporate-income-tax "holidays" for new corporations in some provinces. Table 3-5 provides an overview of the major provincial differences with respect to personal and corporate income taxes.

Although the many signs of "disharmonization" may be increasingly worrisome for the operation of the economic union, the situation has not reached crisis proportions. There are relatively few examples of policies that discriminate against non-residents or that single out certain industries for discriminatory treatment (such as differentiated tax rates). Moreover, the situation in terms of tax harmonization in this country is better, in relative terms, than in some of Canada's major trading partners – the United States, in particular – and it compares quite favourably with that of other federal states.

Of serious concern, however, is the possible breakdown of the tax-collection agreements. All of the recent disharmonizing measures in the area of personal and corporate income taxes reflect a growing use by provinces of the tax system as an active instrument of policy to reflect their own economic and social priorities and their specific circumstances. In recent years, the western provinces have argued that they need even greater flexibility and have raised the possibility of leaving the tax-collection agreements in order to establish completely independent personal-income-tax systems, with separate tax administrations, thus emulating Quebec. What would be the consequences of such a step for the economic union? Should we expect a return to the tax jungle that prevailed during the 1930s?

The impact might not be that dramatic. Even in the absence of concrete measures to formally harmonize tax regimes, a certain degree of "natural" harmonization would result from the forces of tax competition. In the current environment of modern communications and transportation, the mobility of capital and people is such that it is difficult for a jurisdiction to tax without precipitating the departure of people or capital if they can find a more advantageous tax treatment in another jurisdiction. The more mobile the tax base across jurisdictions, the more naturally would

Growth of Provincial Credits and Surtaxes Administered under the Tax-Collection Agreements (TCA)

1972 Ontario property tax credit
Manitoba property tax credit

1973 Ontario sales tax credit
Alberta renter assistance tax credit

1974 Manitoba cost-of-living tax credit
Saskatchewan royalty tax rebate
Alberta royalty tax rebate
Alberta royalty tax credit
British Columbia royalty tax rebate

1975 Ontario tax reduction
Ontario political contributions tax credit
Saskatchewan tax reduction
Alberta tax reduction
British Columbia renters tax credit

1976 New Brunswick negative reduction
Saskatchewan royalty tax rebate

1977 Manitoba tax reduction
British Columbia tax reduction

1978 Saskatchewan surtax
Alberta political contributions tax credit

1979 Saskatchewan mortgage interest tax credit
Saskatchewan capital gains refund (not in TCA)
British Columbia political contributions tax credit
British Columbia dividend tax credit (not in TCA)

1980 Prince Edward Island negative surtax
New Brunswick political contributions tax credit
Ontario pension tax credit eliminated
Manitoba political contributions tax credit
Manitoba royalty tax rebate
Manitoba surtax

1981 Nova Scotia political contributions tax credit
British Columbia surtax
British Columbia renter credit repealed

1982 Yukon political contributions tax credit

1983 Nova Scotia research and development tax credit
British Columbia housing and development bond tax credit
Yukon manufacturing and processing tax credit

1984 New Brunswick zero rate for small businesses (1984 only)
Manitoba manufacturing and investments tax credit
Saskatchewan manufacturing and processing reduction
Saskatchewan venture capital tax credit
Saskatchewan livestock tax credit
British Columbia health care maintenance surtax

1985 Prince Edward Island political contributions tax credit
Saskatchewan temporary flat tax
British Columbia venture capital tax credit
British Columbia small business employment tax credit
British Columbia special enterprise zone tax holiday

1986 Nova Scotia tax reductions eliminated
Nova Scotia two-year tax holiday for new small businesses
New Brunswick small business tax credit
Ontario surtax
Saskatchewan stock savings plan tax credit
Saskatchewan livestock facilities tax credit
Saskatchewan labour-sponsored venture capital tax credit
Saskatchewan two-year tax holiday for new small business corporations
Alberta stock savings plan tax credit
British Columbia tax reduction eliminated

1987 Newfoundland three-year tax holiday for new small businesses
Nova Scotia stock savings plan tax credit
Manitoba temporary flat tax on net income
Alberta temporary flat tax on taxable income
Alberta temporary high income surtax
Alberta renter assistance tax credit eliminated
British Columbia employment equity capital tax credit
British Columbia surtax eliminated
British Columbia health care maintenance surtax eliminated
Northwest Territories political contributions tax credit

1988 Newfoundland stock savings plan tax credit
Newfoundland venture capital tax credit
Ontario home ownership savings plan tax credit
Prince Edward Island surtax
Saskatchewan manufacturing and processing reduction eliminated
Saskatchewan two-year holiday for new small business corporations extended

1989 British Columbia logging tax credit

1990 Nova Scotia home ownership savings plan tax credit
New Brunswick stock savings plan tax credit
Manitoba small business tax credit

SOURCE Based on Canadian Tax Foundation, *The National Finances* (Toronto: the Foundation, 1991), and data from Finance Canada.

Table 3-5
Selected Provincial Tax Rates, Canada, 1990

	Personal income tax					Corporate income tax		
	Basic provincial tax[1]	High-income surtax[2]	Low-income reduction	Flat-rate tax[3]	Average effective tax rate[4]	General tax	Small business tax	Retail sales tax
	(Per cent)							
Newfoundland	62.0	...	...	...	62.0	17.0	0-10.0	12.0
Prince Edward Island	57.0	10.0	...	...	57.3	15.0	10.0	10.0
Nova Scotia	59.5	10.0	...	...	59.8	16.0	0-10.0	10.0
New Brunswick	60.0	...	...	...	60.0	16.0	5.0-9.0	11.0
Quebec[5]	...	...	...	...	76.9	6.33-14.9	0-3.45	9.0
Ontario	53.0	10.0	yes	...	53.6	14.5-15.5	0-10.0	8.0
Manitoba	52.0	2.0	yes	2.0	63.6	17.0	10.0	7.0
Saskatchewan	50.0	12.0	yes	2.0	64.1	15.0	0-10.0	7.0
Alberta	46.5	8.0	yes	0.5	49.5	15.0	0-6.0	...
British Columbia	51.5	...	...	...	51.5	14.0	9.0	6.0

1 As a percentage of the basic federal tax.
2 Where applicable, the surtax rate is applied to basic provincial tax except in Manitoba, where it is applied to net income.
3 The rate is applied to net income.
4 Total provincial personal-income-tax revenues after reductions, surtaxes, and flat-rate taxes, divided by the basic federal tax of provincial taxpayers.
5 Quebec is not a party to the tax agreements, and its personal-income-tax rates are not set as a percentage of the basic federal tax.
SOURCE Based on Canadian Tax Foundation, *The National Finances* (Toronto: the Foundation, 1991), and on data from Finance Canada.

harmonization take place.[32] For example, there should be less need to harmonize provincial corporate taxes for large firms, as market forces will tend to steer them towards a common base and rate over time. A greater level of differentiation between provinces can be tolerated with respect to corporate taxes for small businesses and personal income taxes because of geographical distances and language barriers, but there, too, significant differences in tax burdens could result in inefficient movements of people and capital.

Natural harmonization is not costless, however. By definition, tax competition involves frequent changes in tax rules and imposes significant costs on individuals and businesses in terms of the uncertainty surrounding provincial tax codes. And without central harmonization, there would still be a need for extensive consultations and bilateral agreements to avoid double taxation and tax evasion, and to determine the provincial allocation of income for corporations that operate in several locations.

Extreme competition may also make it impossible for provinces with a low capacity for raising revenues to finance the level of expenditures or redistribution policies needed to respond to local needs. Indeed, tax competition undoubtedly creates pressures for lower tax collections and thus for smaller governments, over the longer term. Provinces seeking more flexibility to implement their own economic and social priorities may find themselves working under market conditions that are more restrictive than the administrative framework they chose to break away from.[33]

Thus there are substantial benefits in preserving certain features of a common tax-collection scheme, even though tax competition should insure some degree of natural harmonization. In June 1991, the federal Minister of Finance released a discussion paper on the personal-income-tax collection agreements in an attempt to obtain reactions from the public about whether it is possible to combine the new flexibility requested by the provinces with the benefits of harmonization present in the current system. Arrangements whereby the provinces would be allowed to establish their own tax rates, credits, and brackets while preserving the administrative benefits of the current agreements will be explored during these discussions. The Council believes it should be possible to accommodate the provincial requests for more flexibility within the national-income tax system without running the risk that major inefficiencies will develop, as long as the following conditions are met: 1) a relatively comprehensive equalization system must be preserved; 2) similar tax-base definitions must exist in all provinces; and 3) there must be uniform attribution rules for allocating personal income earned outside the province of residence.

Provincial differences in the area of indirect taxes are also important. Both the bases and rates of retail sales taxes vary considerably across provinces. Only two provinces – Quebec and Saskatchewan – have agreed so far to harmonize their provincial retail sales taxes with the federal goods and services tax (GST).[34] The other provinces have delayed or rejected harmonization because they wish to maintain full control over the definition of the tax base and, in part at least, because they do not wish to be associated with an unpopular new tax. This creates serious inefficiencies in tax collection and considerable frustration for shopkeepers and other businesses.

The lack of harmonization of indirect taxes should be resolved eventually, as more provinces are likely to be attracted by the increased revenue flows associated with the GST over time. The most important aspect of harmonization is not consistency of rates so much as consistency of tax bases and administrative procedures, so as to avoid locational advantages developing through double taxation or missed taxation. Thus the effort to seek federal/provincial collection agreements such as those which have already been signed should be pursued; and existing bilateral agreements should be transformed into multilateral agreements.

Coordination of Budget Policies

The third case of fragmentation is budget policy. This has become an important issue in recent years, as federal dominance in public-sector spending has diminished and as Canada's margin for manoeuvre in economic policy has narrowed.

This Council argued in its 27th Annual Review that Canada could no longer afford contradictions in the setting of budget policies. We pointed out then that a successful economic union between the regions requires that national economic policy goals be shared by all parties involved and that monetary and fiscal policies be consistent. Two examples will demonstrate the scope of the problem.

The first is the decision by the government of Ontario, in its budgets over the period 1985-90, to increase expenditures at an average annual rate of 10 per cent, even as the Ontario economy was stretched to capacity and signs of inflationary pressures were evident.[35] This choice contradicted the explicit efforts of the Bank of Canada to avoid an acceleration in inflation and those of the federal government to control the deficit. Perverse effects showed up in three ways. First, the Bank of Canada had to slow down growth in the money supply even further in order to restrain total spending in the economy. This caused interest rates to rise. Second, there may also have been negative effects on the credibility of monetary policy in the minds of consumers. And third, Ontario's spending increases in areas of shared costs – such as welfare payments – caused direct increases in federal spending at a time when the federal government was trying to reduce its deficit.

A second example of the lack of consistency has been the tendency (documented in Chapter 2) for provinces and local governments to choose the route of higher indirect taxes, fees, and charges to businesses in order to deal with their own budget squeeze, provoked by rising costs and reductions in federal transfers. Since inflation expectations are, to a certain extent, based on recent increases in the consumer price index (which include the effects of new taxes), these tax increases result in new inflation pressures and make the process of disinflation more costly than it would otherwise be.

These two examples make it clear that better coordination of federal and provincial budget choices is essential. But coordination does not require uniformity. The level of activity in each province or region relative to its potential fluctuates in response to the strength of the markets for local production. (For example, Saskatchewan and Alberta both experienced negative growth in 1986, a year when other provincial economies were expanding.) The industrial structures of the regions are so diverse that a single uniform budget policy would not have the same stabilizing effect on all provinces; for example, restrictive monetary policy might not be appropriate for a Prairie province that is trying to recover from a serious drought or from a drop in worldwide grain prices. Because regionally differentiated monetary policy is ruled out by the mobility of capital, there seems to be a strong argument for regionally differentiated fiscal policy.[36]

A regionally differentiated fiscal policy can take two quite different forms.[37] The first involves actions by the federal government that are directed at the cyclically stronger and/or weaker areas of the country. The second involves fiscal actions by the provincial governments to offset cyclical pressures in their own regions.

The first option – federal stabilization – is, to a certain extent, a built-in feature of the current system. If incomes are weak in Saskatchewan, less federal tax will be collected there, and there will be more federal spending on farm subsidies, unemployment insurance, and shared-cost programs (e.g., welfare). But automatic stabilizers like these cannot always deal directly with the circumstances at hand, and some discretionary budgetary changes may therefore be necessary. Examples of such discretionary changes in Canada are: changes in sales tax rates, investment tax credits, job-creation programs, major capital spending projects, housing assistance, new forms of subsidies, and so on.

However, the federal government's ability to fine-tune its policies so as to isolate one province from the impact of its overall fiscal position is quite limited. In recent years, fiscal realities have constrained the capacity of the federal government to take new initiatives.

A look at federal budget deficits since 1977 (Chart 3-8) suggests that fiscal policy has been contributing positively to aggregate demand over the period, despite the fact that the economy showed signs of overheating both at the beginning and at the end of the 1980s. Thus federal fiscal policy was not even used to stabilize activity at the aggregate level.

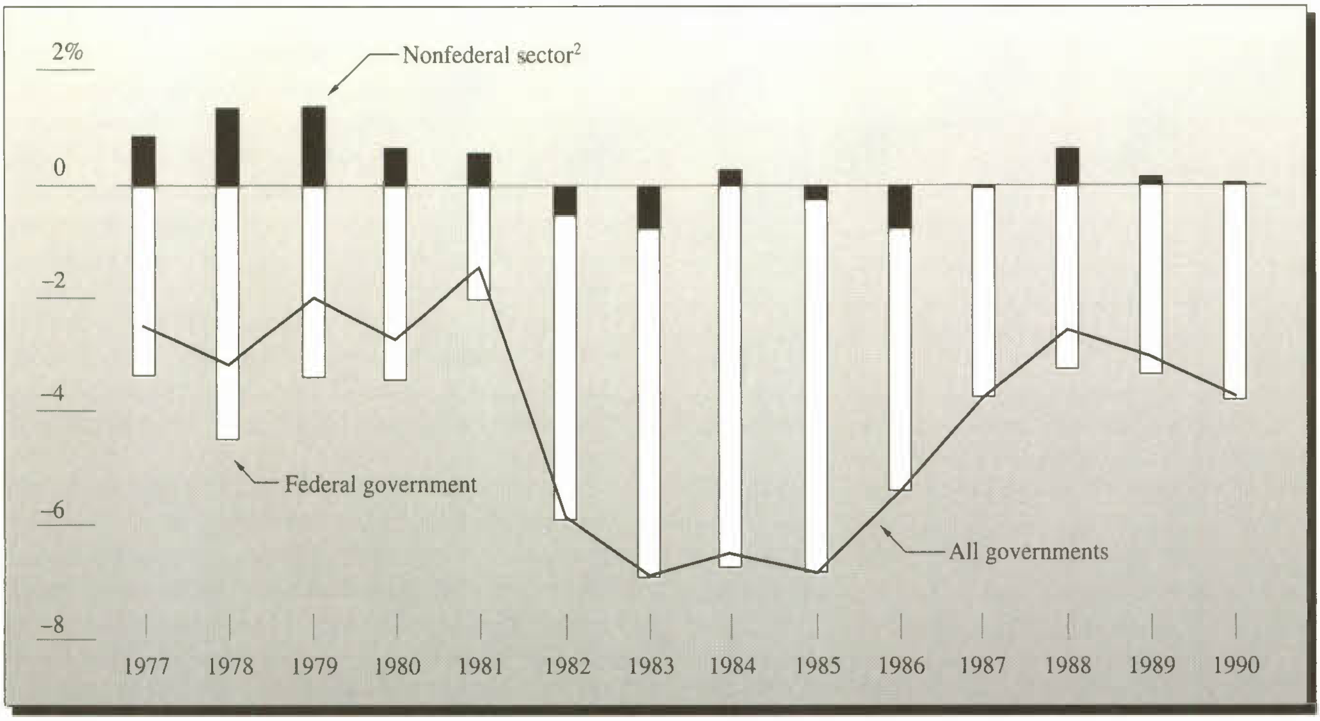
Deficit figures for jurisdictions other than the federal government (i.e., provincial and local governments, plus the Canada and Quebec pension plans) show that the nonfederal sector has generally been operating a countercyclical policy since 1977 – that is, it has generally run budget surpluses during periods when the economy was strong, and deficits when growth was weak or negative. However, the overall contribution has been relatively small, compared with that of the federal government.

The second option is to rely on the provinces to carry out their own regionally differentiated fiscal policy. A case can be made in favour of flexibility in that respect: for members of a monetary union, the absence of direct control over monetary policy (and over the exchange rate) would give weight to the argument that a flexible budgetary policy is needed at the regional level. But the inconsistencies between federal and provincial objectives with respect to fiscal policy, discussed above, suggest that the role of the provinces must change in the future.

Until the 1980s, the federal government had the spending power needed to dominate fiscal policy in Canada.

Chart 3-8

Public-Sector Budget Balances,[1] Canada, 1977-90



1 As a proportion of GDP, on a national accounts basis, calendar years.

2 Provincial and local governments and hospitals, Canada and Quebec pension plans.

SOURCE Statistics Canada, *National Income and Expenditure Accounts*, Cat. 13-001.

When the provinces enacted policy that contradicted national priorities, this could usually be compensated for by federal actions. Canadians seemed ready to accept these contradictions in fiscal policy as one of the costs of diversity. Today, both economic and political forces shape a new role for the provincial governments in the management and stabilization of the economy – especially for the large provinces whose actions spill over to the others. With increased powers and visibility come increased responsibilities, however. If the regions are called upon to play a larger role and if Canadians are to ensure that the gains from the economic union are properly captured, the need for coordination between regional fiscal policies and federal fiscal and monetary policies will be even stronger.

The State of the Economic Union

Figure 3-2 provides a rough accounting of the state of the union at the beginning of the 1990s. Key elements of the common market and the economic union are presented separately. As discussed earlier, there are some problem areas in the Canadian common market, but it remains reasonably strong. Goods, services, and factors of production can move quite freely within the country; to the extent that we can make comparisons with other countries, the amount of internal movement appears to be significant. Furthermore, as was also discussed earlier, governments are making some progress towards dismantling some of the remaining barriers to the mobility of capital and labour.

With respect to the factors that determine the state of the economic union, however, the situation is more problematic. Canada scores high with respect to national systems that are meant to insure individuals against economic upheaval and to equalize incomes amongst provinces, but there remain major problems to be resolved in the way the federal and provincial governments coordinate their activities and policies in order to maximize the gains from the economic union. In particular, there are important gaps in the way that monetary and fiscal policies are coordinated, but also in the implementation of framework policies in telecommunications, science policy, and financial regulation.

The member states of the European Community (EC) are also going through a new phase of integration of their economies. Since the late 1950s, these countries have been developing a common market and have created opportunities for the movement of goods, services, and capital within the community. In 1979, some of the member countries also adopted a system of fixed exchange rates (the European Monetary System), which demands close coordination of monetary policies. Then in 1987, the EC launched a major new initiative to complete the integration of the internal market. This involved almost 300 measures (in such areas as financial regulation, government procurement, taxation, weights and measures, and so on) aimed at eliminating the remaining barriers to create a single market by the end of 1992. Most of these measures have now been adopted by national legislatures; to some extent, they bring the European Community beyond a common market to the threshold of an economic union.

In the process of completing the internal market, the EC has developed some unique instruments for integrating markets – such as the "Directives," which impose obligations on member states but allow each to implement these requirements through national laws – while respecting their political sovereignty. In some areas, such as financial regulation, for example, the community works on the basis of mutual recognition. Mutual goals are agreed to by member states, and then each respects the judgment of the others on how to ensure that those goals are realized. Another important facilitator of internal market completion is the adoption of qualified majority voting in most areas of decision making to avoid the paralysis that occurred in the past when unanimity was required.

As yet, however, the member states have made only limited efforts at pooling risks and providing common services. There is one very large program resulting in important interregional transfers – the Common Agricultural Policy – but, beyond this, there is limited community spending on social programs, structural adjustment, or regional development.[38]

As they approach the threshold of economic union and as more and more powers are being transferred to the central authority, the EC members are realizing that there is a natural evolution towards more political integration. In the view of many, this is needed to enable the central authority to be more effective in developing and implementing present and future common policies by means of community action in two related fields – foreign policy and European security. In addition, the members have now begun a complex set of negotiations on a common currency, the coordination of fiscal policy, and other areas of economic and social policy. New institutions are being discussed – such as the creation of an independent central bank for Europe (the "Eurofed") – which would reduce the freedom of action of member states.

Thus the EC members are struggling with the familiar tensions between integration and diversity that plague the design of the Canadian federation. The difference is that the European Community is not a federation of states but

Figure 3-2
State of the Union, Canada and Europe

	Canada			Europe		
	Market integration exists[1]	Integration in progress or planned	Problems to be resolved	Market integration exists[1]	Integration in progress or planned	Problems to be resolved
Common Market						
Goods						
Common tariff	X			X		
Interprovincial transport	X				X	
Product standards and labelling requirements	X				X	
Government procurement policy		X			X	
Sale and distribution of alcohol		X		X		
Supply management			X			X
Services						
Standards for insurance	X				X	
Capital						
Banking and credit	X				X	
Stock market coordination	X				X	
Labour						
Freedom of entry and exit	X			X		
Licensing of professionals			X		X	
Access to social insurance	X			X		
Portable state pension	X			X		
Portable private pensions		X			X	
Health care	X			X		
Education and training		X		X		
Unemployment insurance	X			X		
Economic Union						
Common monetary policy	X				X	
Coordination of fiscal policy			X		X	
Regional stabilization						
Equalization and unemployment insurance	X				X	
Economic development	X				X	
Fiscal harmonization						
Personal income tax	X					X
Corporate income tax	X				X	
Sales tax		X			X	
Framework policies						
Competition	X			X		X
Bankruptcy	X				X	
Intellectual property	X				X	
Telecommunications			X		X	
Financial regulation	X		X		X	
Science policy			X		X	

1 "Market integration exists" indicates the presence of either a common policy or harmonized policies that are consistent with the operation of a common market and economic union.

essentially a joint central management, primarily operating, at present, as a common market while planning the transition to an economic and monetary union. Canada is on the other side of the threshold. It has an economic and monetary union, and is looking for ways to make it work better. In the Council's view, the key challenge for Canada in the coming years is to commit more energy to finding new mechanisms to coordinate policies among the provinces, and between them and the federal government – to give more coherence to the way in which they manage the Canadian economy. Further progress on reducing internal trade barriers would be desirable, but the most significant benefits to residents, in terms of higher living standards, will come from intergovernmental cooperation. This would be a priority under the existing political structure, but it will become even more important if a decision is made to decentralize the federation or if Quebec opts for greater independence.

Securing the Economic Union

Market integration in Canada is extensive, but there will always be practical difficulties in securing the Canadian economic union. Some provinces – Newfoundland and British Columbia, for example – are quite autonomous in their commercial linkages with the other provinces. Others, like Quebec and Ontario, have much closer ties to the rest of the country. In a sense, Canada has no typical province or region. Each has a unique resource base. The nature of that resource base, the physical location of the province, and the history and distinct characteristics of its population dictate its relationships with the rest of Canada. This diversity obviously creates major challenges in forming an economic union.

The concern about preserving or improving the Canadian economic union is not new. It goes back to the 1930s and to the Rowell-Sirois Commission,[39] which recognized the threat of local protectionism. A new wave of interest in the integrity of the economic union emerged during the constitutional discussions of 1979 and 1980 and through the work of the Macdonald Commission in the mid-1980s. During that period, many proposals were put forward for the reinforcement of the union. The most frequently recommended means of achieving this objective has been the entrenchment of guarantees in the Constitution. For example, in a 1980 discussion paper, the federal government recommended entrenching mobility rights in the Constitution, strengthening Section 121 of the Constitution to cover services, as well as prohibiting nontariff barriers and expanding the federal government's trade and commerce power (Section 91) in order to enable it to override provincially imposed barriers.[40] Only the entrenchment of the mobility rights found its way into the Constitution Act of 1982.

In the mid-1980s, the Macdonald Commission also recommended constitutional protection of the economic union through changes to Section 121, but it argued that specific rules and practices be detailed in a negotiated "code of economic conduct," which would then be enforced through public and governmental pressures. A third approach that has been proposed is the creation of an apolitical administrative authority to foster the development of and to protect the common market. This model is inspired by the EC model, where the European Commission, an administrative body, proposes ways and means to strengthen the common market and ensures compliance with community law.

Support for legislative or constitutional enforcement is usually based on the perceived need to provide the federal government with the powers necessary to bring the provinces into line. A better approach for a federation should be to get a strong commitment from the provinces to pursue the objective of the abolition of trade barriers. This is more likely to be accomplished through the current system of federal/provincial negotiations where the federal government has adopted the role of facilitator. As the Macdonald Commission wrote, "balancing the economic union against other goals is an essentially political process that should take place in a political forum."[41]

Nonetheless, new institutional arrangements will be needed to create a forum where the political trade-offs can be made. There are a number of areas where improvements could be made, and we wish to highlight those where innovations would be useful.

First, the current mandate of the Committee of Ministers on Internal Trade to take steps to reduce and remove barriers to interprovincial trade should be reinforced. At a minimum, regular reports of the committee to the First Ministers' Conference should be institutionalized.

Second, the efficacy of intergovernmental meetings is often diminished by the requirement of unanimity.[42] In that respect, lessons could be learned from the Single European Act, which provided for the replacement of unanimity by qualified majority voting on most issues. This is an idea that deserves careful thought by political and constitutional experts.

Third, and perhaps most important, new procedures for coordinating federal and provincial policies are needed, as Canadians from all regions face greater competition from the outside world. In our view, the resolution of this problem will have even greater benefits than the removal of internal trade barriers.

In the particular case of fiscal and taxation policies, governments should alter the existing practices for pre-budget consultation and abandon the tradition of budget secrecy, so that all governments may participate in setting economic targets and policies.

Opening up the budget process means that the federal government would make public its fiscal plan and economic forecast several months before the actual tabling of the budget. This would enable the Minister of Finance to conduct consultations with the provinces and with the private sector, with a blueprint in hand. The provincial governments would be invited to present their own budget plans and thus launch their own form of pre-budget consultations. The ministers of finance could then schedule their annual meeting in order to debate and resolve the contradictions before the official tabling of the federal and provincial budgets.

Ideally, there should be an organization with an analytical capacity designated to review the inconsistencies between federal and provincial policies and bring them to public attention. This could be a parliamentary committee (as proposed by the Macdonald Commission), an independent commission (such as the Loans Commission used in Australia to coordinate government borrowing), or a committee of the reformed Senate. A parallel in the U.S. system would be the Congressional Budget Office.

Two basic principles would be promoted here: greater participation by the provinces in decision making regarding national policies, and more transparency in the decision-making process.

The provinces and various experts could point to inconsistencies in federal fiscal and monetary policies, while federal, provincial, and other experts could point to inconsistencies and spillover effects in provincial fiscal policies. In addition, the consultation process would focus on targets and spillovers – not just on the wish lists of special interest groups.[43]

In summary, securing the economic union will require more commitment and less adversarial rhetoric by all governments, as well as innovations in institutional arrangements that will enable policymakers to make coherent decisions focused on the effective management of the Canadian economic union.

4 Fiscal Federalism in Canada

Canada has a long track record of sharing. Its social safety net is designed to protect citizens from hardship; its intergovernmental transfer system, to create a common standard of public services across the country. However, the debate on the country's future has revealed some cracks in the consensus over how to share, particularly with respect to sharing among citizens of different regions.

The economic and social institutions of a community can reflect two different motivations for sharing. The first is self-interest – the desire to maintain the social safety net as a form of "social insurance" in order to protect oneself and one's family in time of need. The second is a commitment to equity – the desire to take account of the interests and welfare of others when making economic or social decisions.

The tradition of sharing in Canada is illustrated in Figure 4-1, which details a wide range of different activities undertaken by federal and provincial governments in Canada. The principal programs listed in the figure (notably unemployment insurance, medicare, social assistance, the elderly and child benefits programs, education and training, and equalization) represent 55 per cent of all government expenditures in Canada (or about 26 per cent of GDP).[1]

Two Visions of Federalism

The current political debate on the allocation of powers between the federal government and the provinces reflects two very different perceptions of their appropriate roles in promoting equity – two stylized visions of federalism in Canada. The "broad" vision calls for very similar, if not uniform, policies of sharing throughout the country, while the "communities" vision places greater emphasis on the identification of Canadians with their regional communities.

The broad vision requires a relatively robust federal government that can actively promote both *horizontal* equity (which requires equal treatment of similarly placed individuals) and *vertical* equity (which generally involves the redistribution of income from those who are better off to those who are worse off). The broad vision therefore focuses on similarities between citizens across the country and sometimes asserts uniformity of government taxation and services as a basic right of citizenship. It does not pay much attention to differences in regional preferences for the pursuit of equity.[2]

Taken to the extreme, this view would virtually rule out the provinces' setting their own social policies and would essentially leave them with minor responsibilities with respect to the delivery of national programs. In its less extreme versions, the broad vision allows for differences among the provinces with respect to a wide range of government activities while still providing a rationale for national standards for many provincial- and local-government activities in the areas of spending, regulation, and taxation.

Though there is much talk about decentralization these days, there is also little doubt that many Canadians have a significant attachment to certain national programs (such as medicare, old-age security benefits, and family allowances) that are the products of this broad vision. The Citizens' Forum on National Issues (the Spicer Commission) found that the commitment of many Canadians – particularly outside Quebec – to a broad vision of federalism is still quite strong.

The second stylized vision of federalism – the "communities" vision – finds its expression in the desire of many, particularly in Quebec but also in other parts of the country, for greater provincial autonomy. It allows for greater diversity in the way that individuals in similar situations are treated across the country. It is also supported by those who would prefer a smaller role for governments overall and who see decentralization as a means to achieve that goal.[3]

In its most extreme forms, the communities vision would give the provinces exclusive jurisdiction over a wide range of policy areas with a significant redistributive component (e.g., health, education, labour-market, and other social policies), leaving no room for federal intervention of any kind in those areas. The only redistributive role that might be assigned to the federal government under this vision is the promotion of sharing among the provinces. In other words, the federal government could still make equalization transfers

Figure 4-1
Sharing as a Primary Goal or Secondary Impact of Various Government Programs in Canada

	Social insurance	Interpersonal sharing	Interregional sharing
Program:			
Unemployment insurance	S	S	S
Medicare			
Provincial programs	S	S	. . .
Federal transfers	S	S	I
Social assistance	S	S	I
Primary and secondary education	. . .	S	. . .
Postsecondary education			
Provincial programs	. . .	S	. . .
Federal transfers	. . .	S	I
Training programs	. . .	S	I
Old Age Security, Guaranteed Income Supplement	S	S	I
Canada Pension Plan/Quebec Pension Plan	S	S	I
Family allowances, child tax credits, and child-care deductions	. . .	S	I
Equalization payments	. . .	I	S
Regional development programs	. . .	I	S
Social housing programs	I	S	I

"S"= sharing is the primary objective of the program.
"I" = sharing is an incidental result of the program.

to the less well-off provinces in order to give them the *capacity* to adopt the same spending and tax policies as their richer counterparts, but it could not play any role in ensuring equality of *results*.[4]

Less extreme versions of this vision do not rule out the possibility of federal involvement in the financing or provision of services to the public, as long as the provinces have the ultimate control over how that money is spent. This vision would, in particular, favour extensive use of the "opting-out-with-compensation" approach to enable the provinces to supersede federal initiatives when they believed it was in the best interests of the provincial community to do so. In this case, however, competition between the two levels of government – when both seek to play a leadership role in initiating government services – might actually lead to increased government spending.

The clash between these two visions of federalism in Canada has been evident since Confederation, when the British North America (BNA) Act first struck a tentative compromise between them.[5] That compromise has evolved over the years and is evident even in the current constitution.[6] Defenders of the broad vision frequently complain about the lack of uniformity of government interventions and stress the need for enforceable national standards in a number of areas. Proponents of the communities vision bemoan the costs and inappropriateness of uniformity in many existing national standards and programs. They argue that regional preferences will remain unmet and that this will lead to wasteful overlap and duplication of government activities.

There are, however, areas of common ground. Champions of both visions usually agree on the need for clear political accountability for the actions of governments and for flexibility in meeting the needs of people, groups, and even whole regions with different needs. They also agree on the need to minimize inefficiency in the undertaking of government activities and to minimize the adverse impacts of economic instability (such as recessions) on the lives of Canadians.

The public debate today is going on at two levels. In the broad political sense, it is focused on important symbols – arguments over the "legal equality" of provinces and over recognition of "distinct societies," for example. There will likely be significantly more common ground when (and if) the debate turns towards case-by-case consideration of areas where uniform or harmonized policies are necessary and where they are not.

At the more technical level of intergovernmental relations, the debate is centred on revisions to the major programs of federal transfers to the provinces. The carefully constructed compromises of the 1970s that led to this transfer mechanism have begun to unravel, following a series of unilateral decisions made by the federal government during the 1980s to restrict the growth of equalization payments and of federal funding for health, education, and welfare. This has dramatically altered the dynamics of federal/provincial fiscal relations, opening up new pressures for decentralization and reinforcing the communities vision of federalism.

Just as the Spicer Commission provided evidence of support for the broad vision of federalism, the reports of the Bélanger-Campeau Commission and the Allaire Committee of the Quebec Liberal Party, as well as several other studies prepared in western Canada,[7] clearly demonstrate the vitality of the communities vision in Canada. It is clear that some sort of reconciliation between these two views is essential if the gains from integration described in Chapter 3 are to be retained or strengthened. Fortunately, federalism can be a very flexible form of government that offers large and regionally diverse countries such as Canada a wide latitude for creative compromises. In this chapter, we identify some of the key economic dimensions of such compromises, focusing first on the role of fiscal equalization and national standards in a federation and then more directly on the thorny issue of the allocation of powers. First, however, we look at past and future trends in the pattern of growth in the federal and provincial levels of government.

Changing Fiscal Relationships

In spite of the apparent intent of the Fathers of Confederation, the formal division of powers between the federal and provincial levels of government in Canada – first set out in the BNA Act and confirmed in the Constitution Act, 1982 – has never been watertight. While most legislative powers are clearly restricted to one level of government (for example, health, education, and social welfare are under exclusive provincial jurisdiction), many of them are expressed in very general terms, with the result that actual jurisdiction over many matters has been shared between the two levels of government. The constitution also grants to both levels a kind of residual power whereby the provinces retain authority to legislate in matters of "purely local" interest and all responsibilities left unspecified fall automatically to the federal government. At the same time, the constitution imposes no constraints on the power of either federal or provincial governments to spend on activities (including the provision of government services) that they consider important to Canadians.

As a result, the original balance of powers has evolved considerably over time – sometimes by formal agreement, often on an *ad hoc* basis – in response to a wide range of pressures and circumstances: the two world wars, the Great Depression, the pressures for greater provincial autonomy, the evolution of public preferences with respect to economic and social equity, and the general financial situation of the federal and provincial governments at particular points in time.

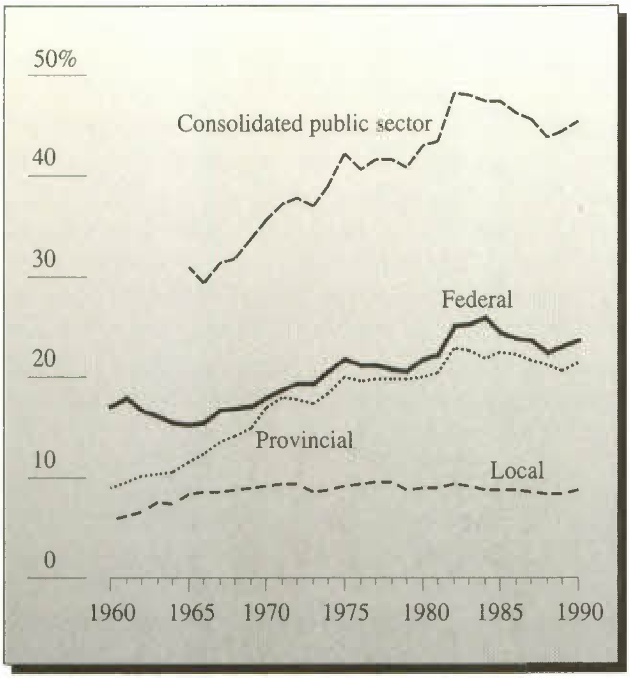
Past trends

At present, there is a widespread sense that the federal government's role is declining, largely as a result of the severity of its budgetary crisis of recent years. Chart 4-1 shows that this decline in its relative importance has been in evidence since at least the early 1960s. While consolidated government expenditures rose from 31 per cent of GDP in 1965 to 46 per cent in the late 1980s, the provinces accounted for a much larger proportion of that growth than the federal government.

The growth of provincial spending was primarily the result of new or expanded programs in the areas of health care, education, and social services. In many cases, the increase was precipitated by the federal government, which offered the cost-sharing "carrot." The significance of the growth of provincial spending in these areas is made clearer in Chart 4-2, which excludes transfers to other levels of government and debt service from total expenditures and shows the trend in overall program spending. This is the type of government spending that is most "visible" to the public. The chart shows that the provinces are now responsible for almost as large a share of such expenditures as the federal government.

Chart 4-1

Public-Sector Expenditures,[1] by Level of Government, Canada, 1960-90

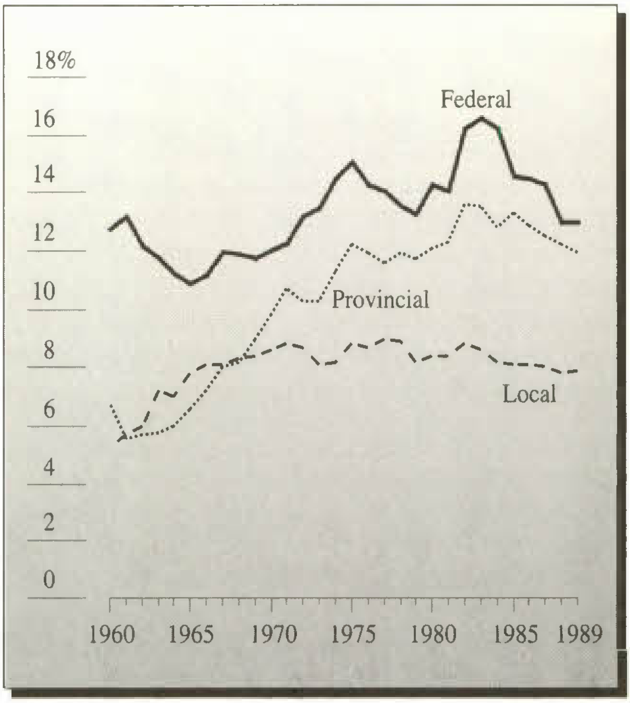


1 As a proportion of GDP. Consolidated data are available from 1965 only; they exclude transfers to lower levels of government, whereas federal and provincial expenditures include them.

SOURCE Estimates by the Economic Council, based on data from Finance Canada and Statistics Canada.

Chart 4-2

Program Expenditures,[1] by Level of Government, Canada, 1960-89



1 As a proportion of GDP. Debt service and transfers to lower levels of government are excluded.

SOURCE Estimates by the Economic Council, based on data from Finance Canada and Statistics Canada.

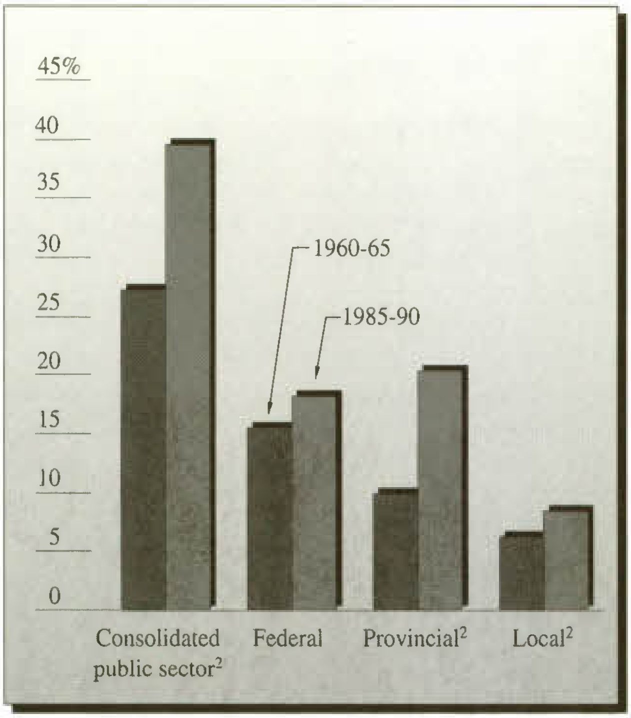
A similar pattern emerges in Chart 4-3 with respect to government revenues. Consolidated government revenues climbed from 27 per cent of GDP in 1965 to 40 per cent during the period 1985-90, with the increase being almost entirely attributable to the provinces. Their revenues more than doubled as a proportion of GDP. Chart 4-4 shows the dramatic increase in provincial reliance on personal income taxes as a source of revenues. This reflects both the transfer of a significant number of tax points from Ottawa to the provinces in the 1970s and the increases in provincial tax rates required to meet their growing spending requirements. As we saw in Chapter 3, this growing reliance on personal income taxes has led the provinces to press for more influence in establishing the rules of the game and for greater flexibility to tailor their tax regimes to their own priorities. It poses a direct challenge to the existing federal/provincial tax-collection agreements.[8]

It should also be noted that federal transfers to the provinces still provide a significant proportion of provincial revenues. From the 1940s to the early 1970s, the federal government enjoyed large surpluses, which were used to finance the sharing of the costs of providing public services on an interregional basis. In recent years, however, the growth in federal cash transfers has been curtailed as part of the effort to control the federal deficit. As a result, federal cash transfers – which accounted for about 29 per cent of all provincial revenues in the early 1960s – now represent only about 19 per cent (Chart 4-5). This trend will likely intensify in coming years, particularly because of the strong impact of federal budgetary restraint on Established Programs Financing (EPF) – the program that provides financial support to provincial health-care and postsecondary-education programs. EPF currently accounts for more than one third of all federal budgetary transfers to provincial and local governments.

Though at first glance EPF does not appear to have been hit harder than other federal expenditures by budget cutbacks since 1984,[9] it is important to note that total EPF transfers include both a cash component, which is the true budgetary expenditure of the federal government, and what is known as a "tax-point" component – the value of tax points ceded by the federal government to the provinces in 1977.[10] Because the limits on the growth of EPF transfers apply to the total of "cash-plus-tax" transfers (and not just

Chart 4-3

Public-Sector Revenues,[1] by Level of Government, Canada, 1960-65 and 1985-90



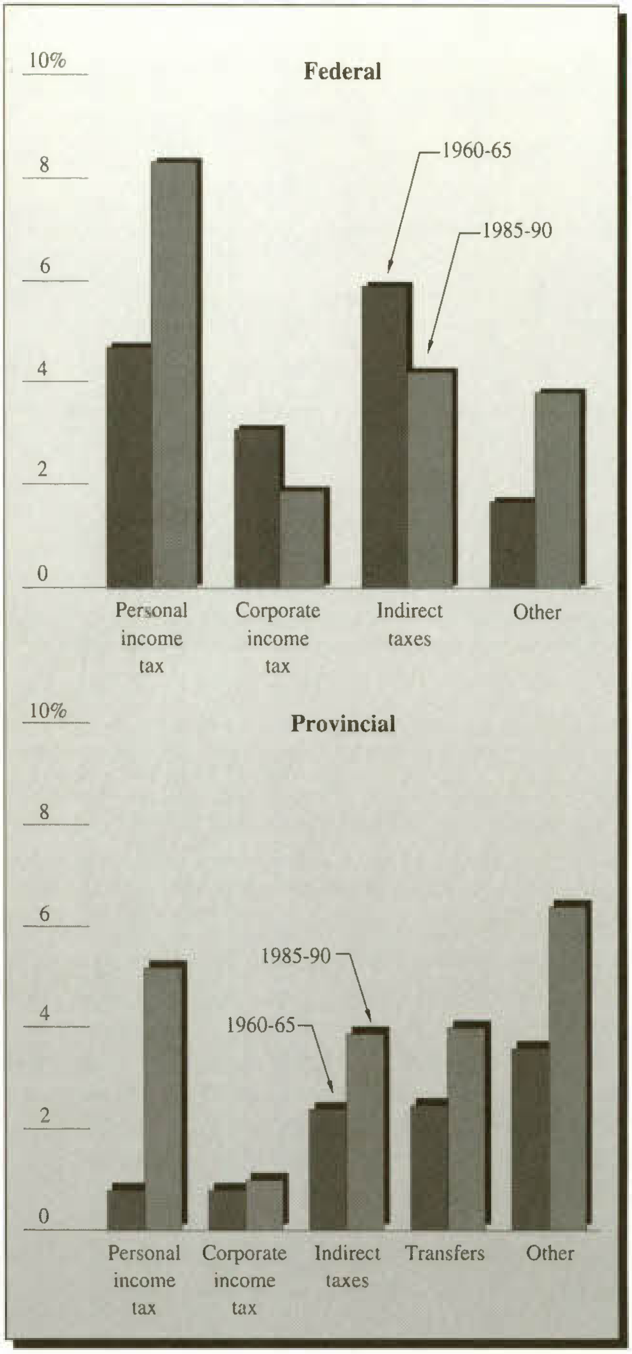
1 As a proportion of GDP.
2 Consolidated data are available for 1965 only; they exclude transfers from higher levels of government, while provincial and local revenues include them.
SOURCE Estimates by the Economic Council, based on data from Finance Canada and Statistics Canada.

to their budgetary cash component), natural growth in the value of the tax points crowds out the cash component. As a result, the cash component is expected to disappear for all provinces within a decade.[11]

Chart 4-6 shows how the cash component of EPF has begun to decline in recent years. As these transfers disappear, two important developments may occur. First, the federal government may lose its capacity to influence decisions regarding the establishment of national standards for health care and postsecondary education.[12] Second, the disappearance of the transfers may implicitly result in a reduction in the federal government's role in promoting interregional sharing.[13]

Chart 4-4

Composition of Federal- and Provincial-Government Revenues,[1] Canada, 1960-65 and 1985-90



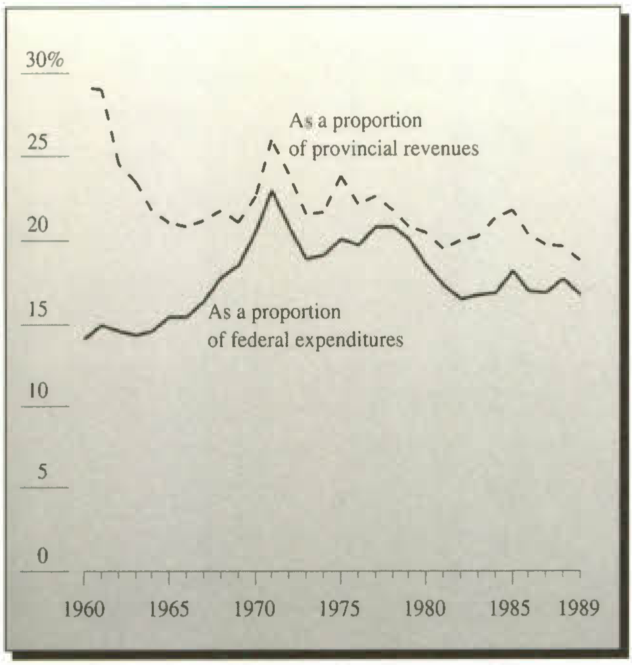
1 As a proportion of GDP.
SOURCE Estimates by the Economic Council, based on data from Finance Canada and Statistics Canada.

Future trends

Does this mean that the federal government's capacity to influence provincial priorities through its spending power and to transfer revenues across regions is permanently impaired? To try to answer this question, we have developed a model to project federal and provincial revenues and expenditures. The model covers 26 separate expenditure

Chart 4-5

Relative Importance of Federal Cash Transfers, Canada, 1960-89



SOURCE Estimates by the Economic Council, based on data from Finance Canada and Statistics Canada.

items and four distinct revenue sources, at both the federal and provincial/local levels, to the year 2015. The detailed assumptions are presented in Appendix D.

The projections below should be viewed as an attempt to identify plausible outcomes regarding expenditures and levels of taxation at both levels of government, given current policy commitments and given reasonable assumptions about the economic environment, about public preferences for government expenditures, and about the level of taxation or deficits needed to finance them. On the economic side, for example, the projections are based on the base-case medium-term outlook (to the year 2000) presented in Chapter 2. Beyond 2000, they simply assume that the economy will grow at its long-run potential rate of growth.[14]

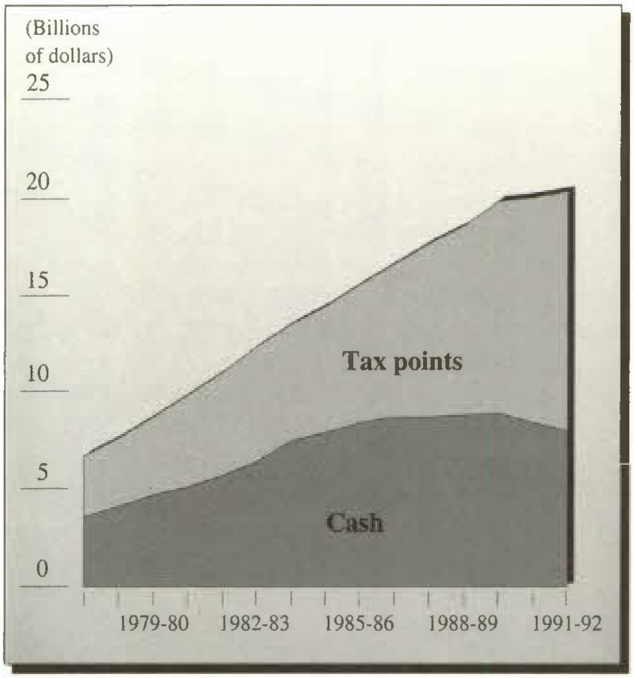
On the political and social side, we have taken into account the changes in the age structure of the population and allowed for likely new spending priorities (such as the settlement of aboriginal land claims). In most cases, provision has also been made for increases in the real value of programs over time, though in some cases (e.g., family allowances and old-age security benefits), spending is adjusted for inflation only, while in others (notably defence and spending on veterans) actual declines in real spending are assumed. In general, the projection is meant to reflect the long-term consequences of the existing policy framework, including the effects of federal expenditure restraint until 1995-96 and the disappearance of EPF transfers by early in the next decade. (The effects of variations in constitutional arrangements are dealt with in Chapter 5.)

Another important aspect of any projection of future trends in expenditures and revenues is the assumption regarding the deficit/debt situation of the federal and provincial governments. In the case of the provinces, we generally assume that the ratios of provincial and local debt to provincial GDP will be maintained at their 1991-92 levels from 1992-93 onward.[15] In other words, it is assumed that any new provincial spending will be matched by additional revenues so as to maintain a constant debt/GDP ratio. As shown in Chart 4-7 these assumptions are reasonably consistent with the pattern of provincial debt over the last few decades, which has been far more stable, as a percentage of GDP, than the federal debt.

In the case of the federal government, there are three alternative scenarios regarding the evolution of the debt/GDP

Chart 4-6

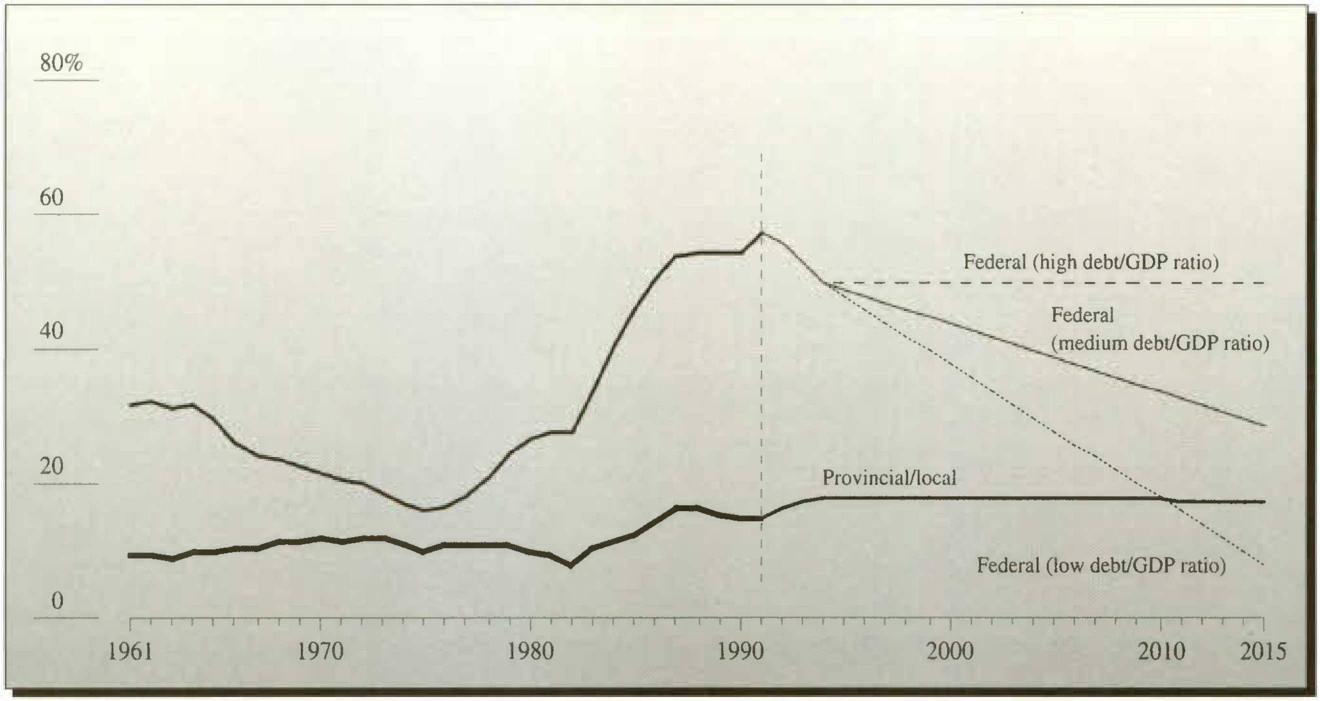
Federal Cash and Tax-Point Transfers under Established Programs Financing, Canada, 1977-78 to 1991-92



SOURCE Estimates by the Economic Council, based on data from Finance Canada.

Chart 4-7

Federal and Provincial/Local Debt,[1] Canada, 1961-91 (Historical Data) and 1991-2015 (Projections)



1 As a proportion of GDP.
SOURCE Estimates by the Economic Council, based on data from Finance Canada and Statistics Canada.

ratio. In the "high-ratio" scenario, the federal government adopts the same debt strategy (starting in 1994-95) as is assumed for the provinces – namely maintaining its debt/GDP ratio at the level prevailing in 1993-94. In the "middle-ratio" scenario, the federal government adopts a more restrictive fiscal stance, starting in 1994-95, that has the effect of reducing the debt/GDP ratio to approximately 30 per cent – the level that generally prevailed at the beginning of the 1980s – by fiscal year 2014-15. In the "low-ratio" scenario, the federal fiscal stance is even more restrictive and would lead to a drop in the debt/GDP ratio to approximately 10 per cent (which would be a postwar low).

Chart 4-8 shows a steady upward trend in provincial tax rates (expressed as own-source revenues, as a percentage of GDP) to meet the expenditure requirements and debt targets just described. The overall increase over the next 25 years is roughly 2 per cent of GDP, which is significantly less than the increase in provincial own-source revenues over any comparable period since 1960. This projected increase results primarily from the continuing pressures that are exerted on health-care costs by the rapid rise in the average cost of providing health care to persons of any given age and by the aging of the population as a whole.

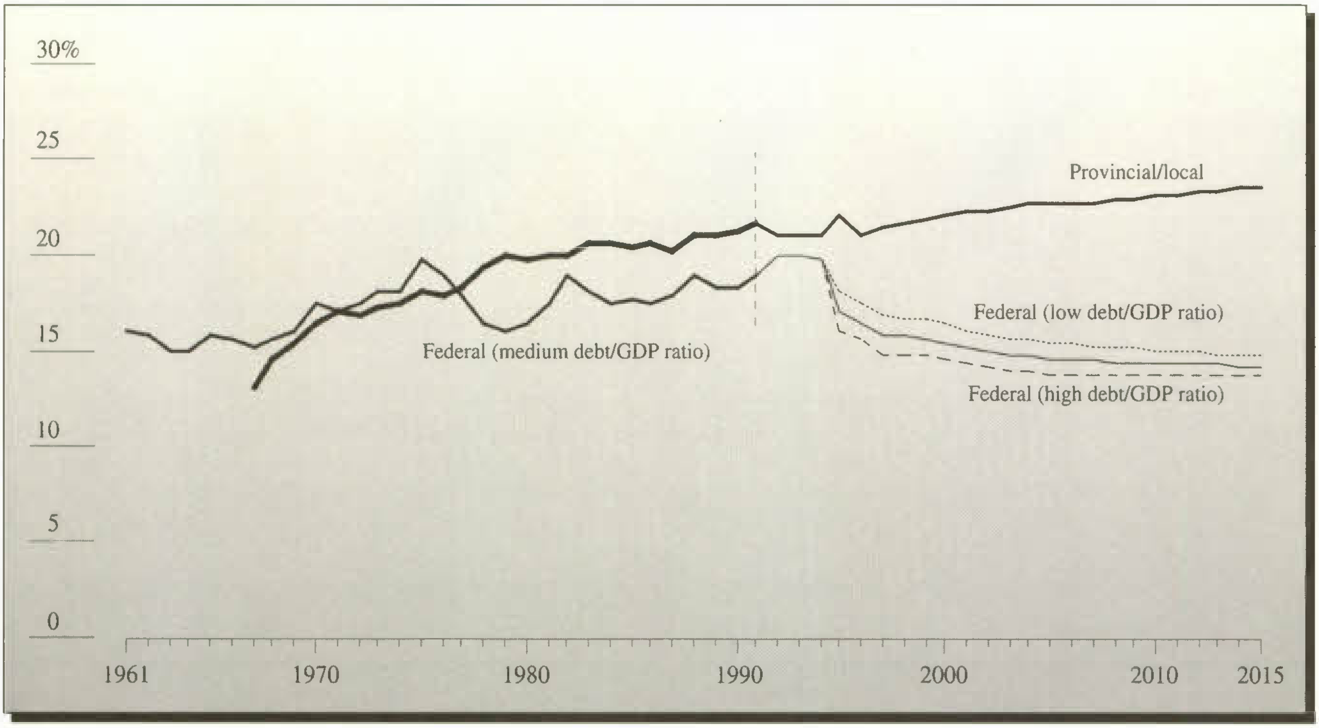
A very different picture emerges from Chart 4-8 in the case of the federal government. The projection is dominated by the drop, beginning in 1994-95, in the federal revenues needed to meet expenditure requirements and debt targets over the simulation period. The decline occurs for a number of reasons. For the most part, it is caused by the cumulative effect of the federal expenditure restraint and tax increases in recent years.[16] But it is also reinforced by the trends in the economy that are implicit in the base-case projections for the 1990s – especially with respect to stronger productivity growth and falling interest rates.

In short, current federal taxes seem to be higher than what would be required to meet both the government's projected expenditure requirements and relatively ambitious targets for reducing the level of its debt over the long term. This means that by the mid-1990s, the federal government may begin to enjoy some budgetary breathing space[17] – assuming, of course, that the relatively favourable economic conditions postulated in the medium-term outlook actually come about.[18]

This may open up some intriguing options for the federal government after the mid-1990s. Not only may the

Chart 4-8

Revenues Required by Federal and Provincial/Local Governments to Meet Their Expenditure Commitments and Assumed Debt Targets,[1] 1961-91 (Historical Data) and 1991-2015 (Projections)



1 As a proportion of GDP. Consolidated provincial/local data are not available before 1967.
SOURCE Estimates by the Economic Council, based on data from Finance Canada and Statistics Canada.

government be able to achieve a considerable reduction in the stock of debt, but it may also be in a position to either lower taxes – thus freeing up resources for the private sector – or launch new spending initiatives. Furthermore, while our projection model cannot capture the secondary effects of such changes on the economy in general, it is quite possible that these developments might themselves create a "virtuous circle" by promoting faster economic growth that could, in turn, make it easier for the government to reduce its debt, lower taxes, and so on.

Given the many assumptions that underlie these projections and given the fact that it will take time before we can be sure that the federal debt situation is truly under control, it is certainly too early for the federal government to start planning how to make use of the fiscal breathing space that it is trying to create for itself. What is clear, however, is that decisions about the future allocation of powers in Canada should not presume that the federal government will be permanently handicapped by the fiscal crisis of the 1980s. In other words, Canadians should make the choice between a federation that is relatively centralized and one that is decentralized on its own merits, rather than simply assume that the outcome has already been decided for them.

The Confederation Debate: Some Key Issues

If there is an area where a longer-term view is required, it is in the design of constitutions. This is especially true in Canada, where consensus on constitutional change is difficult to achieve at the best of times. Although the current opportunity for change arises primarily out of a political crisis, the health of the Canadian economic union is nevertheless a crucial consideration: few Canadians would take a favourable view of constitutional solutions that made their politics simpler while reducing their prospects for future prosperity. In the remainder of this chapter, we assess the economic aspects of three key issues surrounding any constitutional reform: fiscal equalization; national standards; and the allocation of responsibilities and powers among the various levels of government.

Fiscal Equalization

Any federal state where the component regions have significant expenditure responsibilities must deal with the problem of uneven fiscal capacities – that is, the uneven ability of regions to raise revenues. Table 4-1 shows that the ability of Canada's provinces to raise revenues with the same tax effort in 1991-92 ranges from a low of 63 per cent of the national average in Newfoundland to a high of nearly 135 per cent in Alberta. While these gaps have varied somewhat over time, they reflect fundamental structural differences in the economies of the different provinces – particularly their industrial and demographic composition (for example, the relative importance of industries employing well-paid labour) and their endowments of natural resources.[19]

In most federations, the problem of uneven fiscal capacities is addressed through various equalization mechanisms. Some federations, including Canada, have explicit equalization programs that make unconditional transfers to the poorer provinces in order to bring their fiscal capacities closer to the national average. In 1991-92, Canada's equalization program accounted for nearly $8.5 billion of federal expenditures, or approximately 1.2 per cent of GDP.[20]

As was noted in Figure 4-1, however, other federal programs can also achieve a kind of "implicit" equalization, such as the federal/provincial transfers tied to provincial activities in the areas of health, education, and welfare, as well as the federal government's direct transfers to Canadians and other spending activities. Because these measures are financed through a uniform federal tax effort across the country, they reduce the need for provinces with different fiscal capacities to raise revenues themselves. In this way, they provide all Canadians with at least the possibility – and in some cases the reality – of equivalent public services financed through equivalent tax burdens.

In Canada, the idea of equalization payments dates from the 1940 report of the Rowell-Sirois Commission, which had been created to study the financial difficulties faced by many provinces in the 1930s. It was not until the signing of the Federal-Provincial Fiscal Arrangements of 1957, however, that a formal equalization program was established. The program was gradually extended and altered over the decades, and the principle of making equalization payments was itself enshrined in the Constitution Act of 1982.

The box on p. 66 outlines how the current equalization program works and the extent to which it actually succeeds in equalizing the gaps in fiscal capacity among provinces. As the diagram illustrates, the equalization program is not designed to achieve "complete" equalization of provincial fiscal capacities. The payments are only designed to bring the fiscal capacity of the disadvantaged provinces up to the average of five "representative" provinces[21] – a level that is now about 99 per cent of the national average – and the formula does not provide for "downward" levelling of the fiscal capacity of provinces that lie above this threshold.[22]

The current formula also has some other shortcomings, including the restrictions on the growth of equalization payments (item 7 in the box) and the absence of a mechanism to take into account gaps not only in the capacity to raise revenues but also in the basic demand for services (or the

Table 4-1
Provincial Fiscal Capacities,[1] Canada, Selected Fiscal Years, 1974-75 to 1991-92

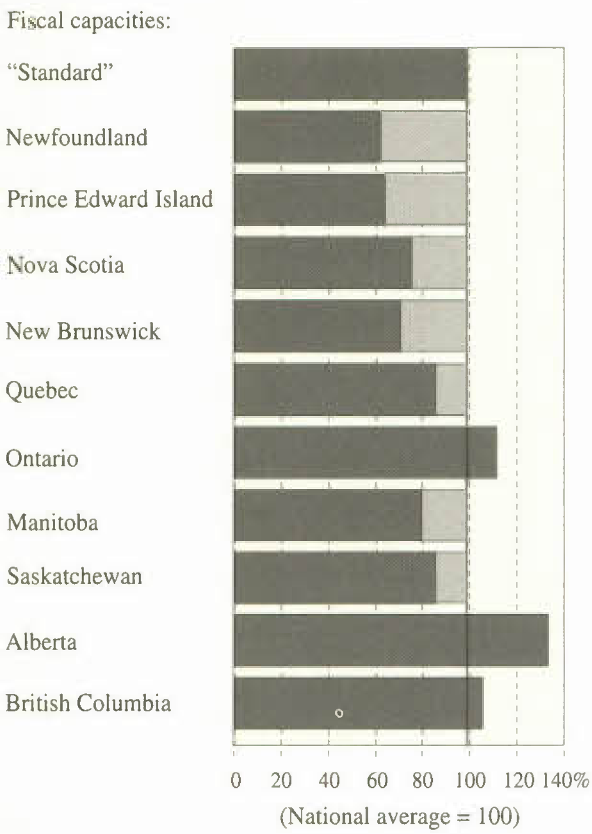
	1974-75	1979-80	1984-85	1989-90*	1990-91*	1991-92*
			(Canada = 100)			
Newfoundland	62.5	57.6	58.6	62.7	62.4	63.1
Prince Edward Island	58.6	55.3	60.2	64.4	63.8	64.6
Nova Scotia	67.2	64.0	72.0	74.9	75.0	75.6
New Brunswick	68.9	67.2	66.5	71.1	70.4	71.2
Quebec	81.1	77.1	78.6	86.0	85.6	86.1
Ontario	102.3	91.3	97.3	111.2	110.9	109.5
Manitoba	85.1	75.7	79.6	79.1	79.3	80.0
Saskatchewan	104.1	105.6	109.3	83.8	85.8	87.3
Alberta	182.3	231.3	207.0	130.5	133.0	134.5
British Columbia	116.2	120.1	100.7	106.5	105.2	104.9

*Estimates.

1 Measured as an index for each province before taking equalization payments into account.

Source Based on data from Finance Canada.

How the Equalization Formula Works



1 A representative tax base is first defined for each of 37 sources of revenue covered by the formula.

2 Average national tax rates are then calculated for each source.

3 Using the average national rates, per-capita revenues from all revenue sources are calculated for each province. The dark portion of the bars in the diagram at left represents the total per-capita revenues from all sources in each province as a proportion of the national average in 1990-91.

4 Average per-capita revenues are then calculated for the five "representative" provinces, taken together (Quebec, Ontario, Manitoba, Saskatchewan, and British Columbia). This "standard" is the minimum revenue-raising capacity that is, in principle, guaranteed to all provinces under the program. As shown in the diagram, the 1990-91 standard was equal to about 99 per cent of the average fiscal capacity of all provinces.

5 The difference between the figures calculated under 3 and 4 represents the per-capita equalization entitlement of a province and is represented by the shaded portion of the bars in the diagram.

6 Provinces with fiscal capacities in excess of the standard do not participate directly in the equalization program, though general revenues raised by the federal government in those provinces do provide most of the financing for the payments.

7 Provinces with fiscal capacities below the standard would normally receive equalization payments equal to their per-capita entitlement, multiplied by their population. However, provisions in the law introduced in 1987 to limit the rate of growth of equalization payments have had the effect of reducing them below the level needed to bring the receiving provinces up to the standard shown in the diagram.

delivery costs of such services) for which provincial governments are responsible.[23]

Equity and Efficiency Considerations

The debate on the need to reform Canada's equalization system is likely to focus on two key issues. First, how necessary is the federal government's equalization role (including both its formal equalization program and its other financing/spending activities) to the maintenance of the economic union? Second, even if equalization is not crucial to the future of the economic union, can it still be justified as a conduit for Canadians' willingness to share? In other words, the debate is likely to focus on issues of economic efficiency and equity. And as the Economic Council of Canada, we are convinced that mechanisms to narrow the fiscal gaps between the provinces are justified on the grounds of both economic efficiency and equity.[24]

The equity argument is fairly straightforward. The equalization of provincial fiscal capacities ensures that, on average, people in the same circumstances – but living in different provinces – have the opportunity to receive similar public services under similar tax burdens. Note, however, that the equity objectives served by the formal equalization programs do not generally extend to ensuring that individuals in similar situations across the country actually receive exactly the same public services. Other mechanisms are required to meet these objectives, and we shall discuss some of them later on.

On efficiency grounds, equalization helps to maintain the integrity of the economic union, since disparities in fiscal capacity can lead to labour mobility that is inefficient for both the province of destination and the province of origin. Differences in fiscal capacity lead to systematic gaps between the "net fiscal benefits" (i.e., the benefits provided by government programs, net of taxes) enjoyed by residents of different provinces. Because the residents of a province with low fiscal capacity must, on average, face higher tax rates than the residents of a high-fiscal-capacity province to obtain similar services, there will be a tendency to migrate from poor to rich provinces.

Any migration arising from differences in fiscal capacity creates inequality between the marginal productivities of labour in the provinces concerned and gives rise to a productivity loss for the economy as a whole.[25] In addition, labour mobility of this kind also tends to perpetuate and even accentuate interprovincial gaps, since the disadvantaged province typically loses its most productive taxpayers (e.g., its more highly educated young adults).

Given the high degree of labour mobility in Canada, the inefficiencies that would arise in the *complete* absence of equalization should be significant for most provinces. As noted in Chapter 3, however, the language barrier in Quebec keeps its labour mobility low and undoubtedly makes Quebecers less sensitive than other Canadians to differences in net fiscal benefits. This means that the efficiency argument for equalization payments to that province would be much weaker.

Options for Reform

There is little doubt about the need for some form of equalization in a federation whose regions are as economically diverse as they are in Canada. However, the extent of such equalization will largely be a function of the country's commitment to sharing across regions. Whatever decision Canadians reach in this regard, there are, as we noted earlier, many ways of achieving the desired degree of equalization.

In a highly centralized federation, equalization is achieved implicitly by virtue of the more important direct-spending role enjoyed by the federal government.[26] In such cases, there may be relatively little need for a formal equalization program. In less extreme cases, however, the greater the spending responsibilities of the provinces and the greater the interprovincial disparities in fiscal capacity, the greater is the need for either conditional federal/provincial transfers tied to provincial spending or a formal program of equalization payments with no conditions attached.

In the case of conditional federal/provincial transfers, there is greater uniformity of results across the country, since the federal government generally imposes national standards as a condition of the transfers. However, if there are significant interregional differences in public preferences for particular government programs and services, conditional transfers may also lead to a greater entanglement of federal and provincial jurisdictions, and impose more uniformity than is necessary or desirable. In the case of unconditional equalization payments, the provinces enjoy more latitude to set priorities reflecting local preferences, and there is less risk of entanglement. At the same time, there may turn out to be less equality of results for citizens in similar situations but residing in different provinces.

In a decentralized federation, equalization might still take the form of unconditional payments from the federal government. Indeed, reinforcement of the federal role in making equalization payments might well be needed to offset the loss of other federal programs that have an equalizing effect.[27]

Alternatively, in an even more decentralized federation, the provinces could themselves take over the responsibility for the design and financing of equalization payments. Such arrangements could take many forms, and precedents exist in other federations. In Australia, for example, the states are closely involved in the development of their equalization formula, though they do not themselves finance equalization payments. In Germany, on the other hand, the well-off *Länder* contributes to a fund that makes equalization payments. One advantage that this approach would have in the Canadian context is that it would make the extent of the transfers clear to both contributing and receiving provinces. But the rights and obligations of the provinces would have to be binding. Otherwise, the contributing provinces could unilaterally decide to cut back on their commitments to interregional sharing.[28]

Another approach (also used in Germany) is tax sharing, under which tax revenues belonging to the provinces might be collected on a national basis, then used to shore up the fiscal capacities of the disadvantaged provinces.[29] This option might be particularly appropriate if there were to be a significant transfer of tax room from the federal government to the provinces as part of the decentralization of spending responsibilities.

As noted earlier, a high degree of equalization – in some form or another – is a necessary but not always sufficient condition to ensure that the treatment of similarly placed persons is the same in all parts of the country. The extent to which equivalent treatment is to be a reality rather than a theoretical possibility is more a function of a federation's commitment to national standards.

National Standards

The decisions to constrain the growth of federal transfers in support of health, postsecondary education, and social assistance in recent years have raised a tough political question: If the federal government is contributing less money, why should it be able to set national standards for provincial programs in these areas? For some, such standards are the essence of the Canadian polity. For others, they are the most visible evidence of federal meddling in the provincial domain.

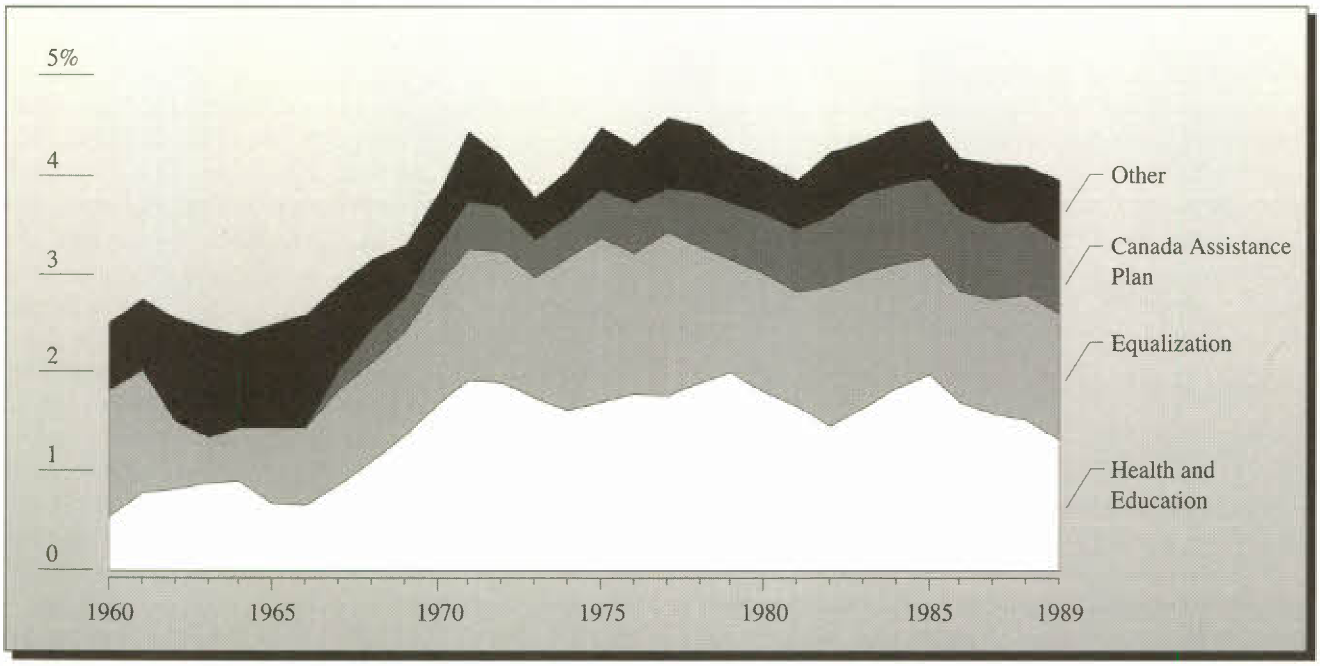
Total federal transfers in support of such programs – which fall under the EPF arrangements and the Canada Assistance Plan (CAP) – have long been a major component of federal/provincial fiscal arrangements for providing common services to Canadians (Chart 4-9). As stated earlier, they also represent a key component of "implicit" equalization in Canada. In addition, they help to stabilize provincial revenues.[30] These transfers will amount to nearly $14 billion (or 2 per cent of GDP) in 1991-92.[31]

It is their role in setting national standards that is the most controversial, however, and the different transfers play that role in quite different ways. In the case of transfers for social assistance under CAP, the costs of eligible provincial expenditures are shared equally, and "national standards" result from elaborate rules defining the types of expenses that are covered. The provinces are free to adjust the level of covered benefits, however, and the generosity of social assistance benefits does in fact vary considerably across provinces. As long as the benefits meet the standards for coverage, the federal government is required to pay its half.[32]

Although similar arrangements had long existed in the case of health transfers as well, these were changed in 1977, in part because they were thought to be discouraging the

Chart 4-9

Federal Cash Transfers[1] to Other Levels of Government, Canada, 1960-89



1 As a proportion of GDP.

SOURCE Estimates by the Economic Council, based on data from Finance Canada and Statistics Canada.

provinces from adopting more-efficient ways of delivering health care. The EPF arrangements in place since then provide for per-capita transfers that are intended to support both health care and postsecondary education but are not tied to the actual level of provincial expenditures in either area. However, this has opened up EPF to the opposite criticism – that the provinces are now able to divert these funds to other purposes and that several of them may already have done so, particularly in the case of postsecondary education, where no nationally agreed standards of any kind exist.[33] In the case of health care, however, the provinces must meet certain requirements (universality, portability, etc.) in order to receive their full cash portion of EPF transfers.

In all three cases, there is a problem of accountability. The federal government is spending $14 billion a year to finance programs delivered by the provinces. The federal transfers are essentially invisible to the public, so that the government derives little political benefit from them, even though it is blamed for the high tax burden needed to finance the transfers. At the same time, the provinces are frustrated by limits on their freedom to depart from national standards. What, then, are the arguments in favour of national standards?

Equity and Efficiency Considerations

The idea of national standards extends far beyond the issue of federal transfers under EPF and CAP. National standards can be found or contemplated, for example, in the areas of regulatory policy (protection of the environment, legislation dealing with pension-benefit standards, regulation of financial institutions, and so on) and taxation (tax harmonization), as well as in the area of government spending programs. One equity argument that can be made for national standards in many of these areas is that they maintain a common set of rules and benefits that are the basic entitlements of citizenship, much like the principle of equal treatment before the law or the right to take up residence anywhere in the country.

In the case of government spending programs that involve a significant element of income redistribution (health care, family allowances, old-age security benefits, and so on), equity arguments can also be used to justify uniform benefits for disadvantaged Canadians, regardless of where they live. It must be recognized, however, that conflicts may exist between the "broad" and "communities" visions of what constitutes an equitable redistribution of income and that it may be difficult to reconcile national standards with differing regional preferences in the area of income redistribution.

Furthermore, there are at least some situations where national standards may themselves create inequities – particularly when the implementation of standards involves significant additional provincial spending and significant gaps remain in the revenue-raising capacity of provinces, even after equalization is taken into account. For example, if national standards requiring the provinces to increase their spending on education or preventing them from implementing measures to contain the growth in health-care spending were implemented, the poorer provinces would have to impose a heavier tax burden than would have been the case in the absence of the national standards. Alternatively, they would have to curtail their activities in other areas that might better reflect the preferences of their residents.

The principal efficiency argument for national standards is that certain standards are essential to preserve or promote the economic union. In the case of rules to prevent discrimination against the residents of other provinces in such areas as mobility, trade, and investment, national standards ensure that choices in these areas are not distorted by nonmarket factors. In the case of certain regulatory policies – for example, weights and measures, or pension-benefit standards – national standards also work in favour of efficiency in trade and in labour mobility.

In the case of most government spending programs, however, the main efficiency argument for national standards is based on the need to avoid triggering excessive migration that could result if different provinces were to offer their respective residents significantly different patterns of net fiscal benefits (such as different packages of taxes, regulatory policies, and government services). In such a situation, individuals in one province might find the pattern of net fiscal benefits offered by another province more to their liking and might decide to move as a result.

This mobility would permit a better matching of government programs and taxation to the preferences of residents in each province. But it could also cause inefficiencies in the sense that individuals would be basing their mobility decisions on factors other than market signals.

Options for Reform

Many alternative mechanisms can be used in a federation to try to achieve national standards. In a centralized federation, many national standards can be implemented and maintained through the actions of the federal government alone. For example, in those areas where it has exclusive legislative jurisdiction (e.g., banking), it can prescribe uniform laws and regulations. Through its spending power, it can also establish uniform standards for certain government services by providing them directly to the public (e.g., family allowances and old-age security benefits) and by providing financial incentives to the provinces to tailor their programs to such standards (e.g., health care).

The use of the federal spending power to establish national standards in new areas has largely been discontinued in recent years because of the federal budgetary crisis. Moreover, in the case of some existing national standards, notably in the area of health care, the ability of the federal government to set standards through its transfers to the provinces is diminishing along with the transfers themselves. As our earlier projections showed, however, the federal government's financial situation may improve by the end of the decade to such an extent that it may once again be able to play a role in setting standards in this way.

The Canadian tradition of federal/provincial arrangements in such cases has been for the federal government to set the standards after consultations or negotiations with the provinces. There has been much criticism, however, of the one-sided nature of these negotiations. This is particularly true in the case of the federal ability to change the terms of the transfers to the provinces unilaterally. One alternative would be to make such arrangements more like "contracts" that would be binding on all parties for a fixed or indeterminate period and that could be enforced through the courts. Another would be to adopt the European approach, under which the federal government, subject to a requirement for provincial approval, could set out fairly general national objectives while giving the provinces a great deal of flexibility in deciding how to meet those objectives.[34]

In a decentralized federation, national standards could also be implemented by the provinces themselves. The provinces might, for example, establish national standards through interprovincial agreements similar to the recent accord on government procurement practices. While this approach could serve as a substitute for federal involvement in setting standards, it would be important to make such agreements both binding and enforceable. This might require that the agreements be administered through joint agencies and be enforceable through the courts or through quasi-judicial bodies.[35] Even then, the European experience with directives indicates that there could be significant scope for confusion and for uneven application of standards.[36] Also, it might be difficult to launch new national standards through what is essentially a "committee" approach, even if there existed a fairly general public consensus in favour of them.

Another possibility for implementing national standards in either a centralized or decentralized federation would be to entrench them in the constitution – that is, to explicitly recognize them as rights of citizenship. While this is, in many ways, the most direct approach, it has the serious disadvantage of inflexibility. It is exceedingly difficult to amend the Canadian constitution, and it is highly probable that citizens and governments would want to change many standards over time. Furthermore, the entrenchment of national standards as constitutional "rights" would likely reduce the scope for compromise and create a more adversarial climate surrounding matters of public policy because of the constant need to appeal to the courts to rule on the precise meaning of such rights.

Regardless of the mechanism used to implement national standards, it is important to keep in mind the possible impact that the introduction of such standards may have on the financial situation of provincial governments with weak fiscal capacities. There is not much point, on either equity or efficiency grounds, in imposing standards – particularly in a federation where spending and taxation are significantly decentralized – unless there exists sufficient equalization to enable all provinces to meet them. This underlines the close relationship between the decisions regarding the need for equalization and national standards. It also leads directly to the fundamental question of how the responsibilities and powers of government are to be allocated between federal and provincial governments.

The Allocation of Powers

It is sometimes tempting to view the struggle for powers between federal and provincial governments as nothing more than a turf war between political elites for the political allegiance of Canadians. However, the allocation of powers has real consequences for the state of the economic union and for social cohesion over the longer term.

Governments seek to play three distinct but interrelated roles in the economy:

– they promote the efficient use of resources by fostering an environment that favours efficient economic activity and by providing certain types of goods and services directly to the public when the private sector is unable to do so;

– they redistribute income or provide goods and services to individuals and households in a way that conforms with what the public generally considers to be fair or just; and

– they foster greater stability in the economy in terms of employment, price levels, and living standards.

The choice of Canadians among different allocations of powers – that is, between "centralization" and "decentralization" – will be based primarily on political and social preferences that may well change over time. From an economic point of view, we need to know how to ensure that the tasks of government mentioned above can be performed under different political structures and how the shifting preferences of the population can be accommodated. In the pages that follow, we pose these questions and explore two closely related issues – the merits of competition among governments and the entanglement of jurisdictions.

Political and Economic Dimensions

When it comes to interregional and interpersonal redistribution, political and social preferences play the key role in determining the respective roles of the provinces and the federal government. That choice, in turn, is a major factor in determining the allocation of government responsibilities in a wide range of areas, since almost everything that governments do – raising taxes; making transfers to individuals, businesses, or other governments; or even issuing various types of regulations – in some way involves the redistribution of income, privileges, or other benefits from one group to another.

Accordingly, those who espouse the broad view of federalism will conclude that the federal government should have a significant role in ensuring that the progressivity of the personal-income-tax system is roughly the same throughout the country and that individual Canadians enjoy similar access to transfer programs and social-insurance schemes. Holders of the communities view will instead give the provincial governments the power to redistribute income through both the tax system and government programs according to local preferences.

When it comes to the other two roles of government – stabilization, and the promotion of an efficient, well-functioning economy – economic considerations take on more importance. In Chapter 3, for example, we showed that the free flow of goods, services, and investment across both internal and external borders, and the unhindered mobility of labour within the country are essential to generate the maximum possible level of income for Canadians. The equalization of interprovincial gaps in fiscal capacity is also an important element in the efficient allocation of resources, as seen earlier in this chapter.

In a highly centralized federation, this can all be achieved through a strong federal role in regulating trade, investment, and labour markets, and in setting national standards for public services, taxation, and so on. But in a more decentralized federation – such as Canada, even today – other mechanisms are required to facilitate the integration of the internal market across many jurisdictions. Some of these mechanisms were described in the preceding section.

The common thread through all of these options is that if preserving or reinforcing the economic union remains the goal of all Canadian governments, decentralization may not increase the scope for independent action by provinces. It may simply alter the roles of the players in securing the basic requirements of economic integration. The provinces gain more influence on the determination of those requirements and standards, but they also acquire more responsibility for enforcing and respecting them.

In the area of taxation, the boundaries of what should be done federally and provincially are determined by two basic principles. First, one should use local taxation to finance local expenditures, and national taxation to finance national expenditures. In that way, the governments who do the taxing can be held accountable for the spending that results. Second, taxes should, in many cases, be harmonized and collected by as few agencies as possible for reasons of efficiency in both compliance (i.e., to reduce costs to the taxpayer and avoid double taxation) and collection (i.e., to reduce administrative costs and prevent tax evasion).

One could argue that these principles require that personal and corporate income be collected nationally (or at least in a coordinated fashion) – which is what Canada currently does – and that the federal government collect no more than is necessary to finance its own expenditures. These expenditures might include certain transfers to individuals (assuming that the federal government were to play a role in redistributing income) but would not include transfers to the provinces other than equalization.

On the spending side, the basic principle is that programs that have predominantly local or regional benefits (garbage collection and highways, for example) should be provided by local or provincial governments, while programs that have predominantly national benefits (national defence and equalization, for example) should be provided by the federal government. There are a number of qualifications to this principle, however.

First, there may be spillover effects from providing certain government services locally or regionally. This means that residents of one province may benefit from the services provided by another province to which they did not contribute (e.g., when employers in one province hire workers who received their education and training in another). In such cases, the intervention of the federal government might be warranted in order to provide the proper financial incentives for the provinces to produce the right amount of goods or services. Second, there may be economies of scale, in the production of certain public goods and services, that will make it more efficient to produce them at the federal level than at the provincial or local level. Third, in some cases the decentralized provision of government services may lead to greater innovation by creating multiple provincial "laboratories" to seek alternative ways of meeting the needs of the public at least cost.

From the brief discussion above, it is clear that the economic principles guiding the division of powers between governments help to define the boundaries of an appropriate allocation, but they do not provide a definitive formula for choosing the "right" one. In truth, they leave a great deal of scope for Canadians to make choices based on the extent to which they are willing to accommodate diversity and on their confidence in the ability of more-decentralized constitutional arrangements to preserve the benefits of the economic union.

Competition and Entanglement

One unresolved issue in the preceding discussion is whether citizens can benefit from competition between governments – be it between the provinces or between them and the federal government. Interprovincial competition is often seen to have harmful effects on the health of the economic union. In particular, competition involving policies that are discriminatory towards non-residents – for example, by deliberately protecting local producers or creating special incentives to attract investment or skilled labour from other provinces – can be costly in terms of lost efficiency. On the positive side, however, competition may lead to better public services – better education, for example, because a province identifies education as a key to its economic prosperity or because its education services are better attuned to the preferences of its population.

Competition between the provinces can also have the effect of shrinking the size of provincial governments, though opinions obviously vary on whether this is desirable or not. For example, if interprovincial competition involved reducing tax rates in order to attract investors or high-income individuals, then some tax bases might be seriously eroded or might even disappear altogether (as succession duties and estate taxes did in the 1970s). Over the long run, a smaller revenue base limits the size of government.

Competition between the federal government and the provinces raises a quite different set of concerns, commonly referred to as the "entanglement" of jurisdictions. In general terms, entanglements occur whenever the actions of one government on a particular policy matter interact with those of another government. In many respects, entanglements are an inevitable outcome of the decision to adopt a federal structure. By design, a federation accommodates diversity among regions and localities while providing for a federal presence that can serve as a common frame of reference for all its citizens. Inevitably, however, many policy areas (the environment, transportation, communications, and immigration, for example) are of interest to both federal and provincial jurisdictions. That makes it difficult to separate out the "provincial/local" from the "federal" sphere of influence.

The principal objection to the entanglement of jurisdictions is that it may involve significant costs for Canadians as taxpayers, as clients of government services, and as subjects of government regulation. For example, where federal and provincial regulations in related areas deviate from each other – or, worse, conflict with each other – the private sector faces higher compliance costs.

In cases of duplication of government services, two different agencies may be trying to do the same job. This may not only lead to waste of tax dollars but also to ineffective or incoherent policies, especially if the agencies fail to cooperate or even get in each other's way, if they engage in turf wars, or if they attempt to transfer the burden of serving a particular clientele to one another.[37] Furthermore, there can be a loss of accountability if governments at one level are able to avoid responsibility for shortcomings in their policies by claiming that the "other" level is responsible for them. Finally, there may be costs associated with governments "bidding up" their services to the public as they compete for the allegiance of the public.

At the same time, one could also argue that there can be benefits to federal/provincial competition. In the case of spending programs and regulation, for example, competition makes it more likely that unmet policy needs will be addressed. For many government services, clients may benefit from the existence of competing programs because they have a better chance of finding programs corresponding to their particular needs. In the case of regulatory policies (consumer protection, for example), a body of uniform national regulations may be best for dealing with questions that have significant national implications (e.g., product standards); in other cases (e.g., "cooling-off" periods following purchases made through telephone solicitations), local public preferences and needs may best be served by provincial regulations.

The problem for the analyst is that the costs and benefits of competition cannot easily be identified. Many of the measurable costs can only be identified by asking the clients of government programs whether or not they have been incurred. So far, the few studies done in this area have tried to answer that question either by asking public servants themselves whether they felt there was wasteful duplication[38] or simply by classifying federal and provincial programs according to their general policy area and target clienteles.[39]

Typically, such studies are able to identify considerable overlapping of responsibilities between the two levels of government but cannot identify the true extent of wasteful duplication of services or assess the costs associated with the alleged ineffectiveness or incoherence of policies. (See the box for a glossary of some of the relevant distinctions between entanglements that are wasteful and those that may not be.) As a result, we are left with anecdotal examples that infuriate the clients or taxpayers who are aware of them, but with no overall assessment of the extent of the problem.

Options for Reform

Assuming that overlap and duplication do constitute a serious concern, however, in what way could the allocation of powers be changed in order to overcome the problem? Obviously, the problem would disappear if Canadians were

Glossary: The Entanglement of Government Activities

Redundancy occurs when a government initiative addresses a need that is entirely satisfied by another program and does not further any additional policy objective.

Duplication occurs when a government initiative gives rise to parallel structures for program administration, delivery, etc. The extent to which such duplication constitutes a true redundancy depends on what economies of scale might be realized in the administration of the initiative and on whether there might be a better matching of services to the needs of the target client group as a result of the wider range of options offered.

Overlap generally refers to simultaneous spending-program initiatives directed at the same client group by more than one level of government. The effects of such initiatives may be cumulative (one serving to reinforce the other), complementary (because the initiatives target different client groups or address different needs of the same client group), or superfluous (i.e., leading to redundancy).

Direct overlap occurs when two or more levels of government carry out similar initiatives in the same "policy area" by setting up parallel administrative and delivery structures. Where such direct overlap has cumulative or complementary effects, redundancy in the strict sense does not necessarily exist, even though there may be problems of coordination – if not outright incoherence – in the actual operation of the overlapping programs. Direct overlaps may also be superfluous when the target client group can benefit simultaneously from two different programs, one of which does not contribute to policy objectives. Such cases are very rare, however, because steps are usually taken to ensure that (for example) two governments do not knowingly fund the same undertaking.

Indirect overlap occurs when one level of government helps another – typically, by providing funding, as under the Established Programs Financing (EPF) and the Canada Assistance Plan (CAP) – to implement programs for which the first takes no direct responsibility. This type of overlap does not involve duplication *per se*, although it may lead to a diffusion of accountability.

Double regulation occurs when an activity is subject to binding regulatory restrictions imposed by more than one level of government. Generally speaking, the costs resulting from inconsistency or contradictions between particular regulations imposed by different levels of government are much higher than those associated with overlaps in government services. In addition, the existence of two noncontradictory but nonetheless distinct sets of regulations may, in itself, lead to higher compliance costs (for example, when additional legal staff must be hired to research and interpret the relevant regulations).

Entanglement occurs when the same "policy area" is affected by programs or regulations emanating from more than one level of government. This concept thus subsumes overlaps and double regulation, but is broader than both. For example, changes to unemployment insurance eligibility introduced by the federal government can have indirect impacts on provincial welfare expenditures.

to adopt one or the other extremes of either centralization or decentralization, since there would then be few, if any, opportunities for competition between different levels of government. Between the two extremes, one solution might be to entrench a truly watertight division of powers in the constitution that would prevent the recurrence of overlapping and duplication. Even assuming that this could be done – How could the interprovincial and international aspects of, say, transportation or the environment be separated out from their local or regional aspects? – it would risk giving absolute priority to clarity at the expense of flexibility. Any allocation of powers that suits the technology, economic environment, and political choices of today would probably need to evolve with the times. It would be costly, to say the least, to go through periodic debates about how the constitution should be changed to reallocate powers between the federal government and the provinces.

The other possibility would be to continue the practice of allowing the two levels of government to exercise more or less concurrent powers in the same policy areas but to make clear which one would have "paramountcy" in some (or all) cases. This would mean that the government with paramountcy would be able to override laws and regulations of the other level and substitute its own. In cases where the federal government exercised its spending power in an area of provincial paramountcy, each province could opt out of those federal expenditures and receive unconditional compensation.[40]

This option offers the advantage of allowing either level of government to enter a policy area in order to meet unmet needs, while enabling the one with paramountcy (or with the right to opt out) to avoid costly, inconsistent, or contradictory regulations or spending programs. Another possible advantage is that this approach would permit asymmetric arrangements in cases where certain provinces had particular reasons to prefer provincial regulation or spending programs to federal ones.[41] As shown in the box, such asymmetries are already quite common in Canada. The 1867 Constitution provided for asymmetries for property and civil rights, and for education. Since then, special administrative arrangements have been made in a number of different policy areas. Some of them reflect the special needs and preferences of certain provinces (e.g., Quebec's different approach to investing contributions to the Quebec Pension Plan), while others are the result of the ability of the larger provinces to capture economies of scale in the production of certain public services (as Ontario and Quebec have in the area of provincial policing, for example).

The choice of who gets paramountcy over what would depend in principle on whether Canadians felt more comfortable with centralizing or decentralizing arrangements. In practice, however, the balance between the two types of arrangement would likely evolve over time, as the political process would tend to ensure that a government with paramountcy in a particular area could not easily replace a popular policy adopted by another government with a less popular policy.

Conclusions

The principal decision in any revision of the roles and responsibilities of federal and provincial governments in Canada is the choice about the vision of sharing. Do Canadians regard the federal government as the primary arbiter of equity in the country? Or do they identify with a particular region or community, and do they therefore look to the provincial government as the relevant arbiter? In the first case, the federal government has a direct role to play in redistributing income from rich to poor, as well as from "have" to "have-not" provinces. In the second case, its role may be much more limited, while the provinces take on more responsibility for setting and maintaining basic standards in programs with an important redistributive element.

Our analysis suggests that the federal budgetary crisis has influenced the public's perception of the federal government's ability to play its redistributive role. The government's decision to alter its commitments to the existing fiscal arrangements with the provinces unleashed pressures for decentralization, because the main source of legitimacy for its involvement in areas of formal provincial jurisdiction was the fact that it paid some of the bills. Thus the fiscal crisis has undermined the federal role as guardian of some key values of Canadian citizenship. Our analysis also shows, however, that it would be a mistake to assume that extensive decentralization – and a dominant provincial role in the areas of income redistribution and program standards – is inevitable simply because the federal government is currently disabled by its budgetary crisis. It is quite possible, though by no means certain, that the crisis will subside by the mid-1990s.

There are risks in assigning the tasks of redistributing income and setting standards to the provinces – risks that the provinces' commitment to interregional sharing will erode over time, as the richer provinces lose their taste for transfers to others; and risks that the provinces will be unable to forge the kind of coordinating mechanisms that is essential to the economic union. Yet there are also risks in too dominant a role for the federal government – risks of inflexibility and of too little attention being paid to the particular needs and aspirations of different provinces. None of these risks are insurmountable, but all of them need to be taken seriously.

Asymmetric Arrangements in Canada: Selected Examples

Policy Area	Asymmetries
Property and civil rights	Quebec's property and civil law is based on civil code; elsewhere, it is based on common law;
	Quebec has its own charter of rights in addition to the Canadian Charter of Rights; other provinces have the Canadian Charter only;
Education	Quebec: constitutional protection for denominational schools;
Language	New Brunswick: only fully bilingual province (language of proceedings of provincial courts, language of legislature and laws, and right to obtain government services in either official language);
	Quebec: French is the official language; the proceedings of provincial courts and of the legislature are bilingual; the Anglophone minority enjoys significant privileges in practice;
	Manitoba: officially bilingual regarding language of proceedings of provincial courts and language of legislature and laws; some services available in both official languages;
	Ontario: some services available in both official languages;
Contributory pension plans	Quebec has its own Quebec Pension Plan; other provinces use the Canada Pension Plan;
Immigration	Quebec is the only province that participates in the process for selecting immigrants and for their settlement in the province; the other provinces leave this task to the federal government;
EPF and CAP	Quebec receives more of its health and postsecondary education (EPF) and social assistance (CAP) transfers from the federal government in the form of tax point transfers than do other provinces;
Family allowances	Quebec supplements the federal program and has a modified benefit structure that varies with the number of children in a household;
Indirect taxes	Quebec and Saskatchewan are committed to harmonizing their sales taxes with the federal GST; other provinces continue to have widely differing sales tax systems;
Corporate income tax	Ontario, Quebec, and Alberta do not participate in the tax-collection agreements;
Personal income tax	Quebec does not participate in the tax-collection agreements;
Financial institutions	Ontario, Quebec, British Columbia, and Alberta supervise their own provincially incorporated institutions; other provinces delegate supervision to federal regulators; Quebec has its own deposit insurance scheme for provincially incorporated institutions;
Policing	Ontario and Quebec run their own provincial police forces.

SOURCE Based on David Milne, "Equality or asymmetry: Why choose?," a paper prepared for the Business Council on National Issues, Toronto, 1991.

By looking at other federations and at multinational institutions like the European Community, we have identified a number of possible alternatives for enhancing federal/provincial and interprovincial coordination that could be adapted for use in a more decentralized Canada. But we also discovered that these mechanisms are themselves subject to inevitable tensions between integration and diversity. In general, they give the provinces or states more formal powers and more responsibility, but they do not give them significantly more independence of action within the economic union.

Thus while there is scope for much innovation in rethinking the current division of powers, one must also be cautious about long-term effects. Implicit in any change are a new set of political incentives and a new balance of power. Past experience shows that it is difficult to anticipate just how these changes affect the dynamic political relationships both among governments and between governments and the public that they serve.

The most important implication of this uncertainty is that any new set of institutional arrangements must be flexible enough to adapt to the needs of a society undergoing rapid change. Canadian society is aging, it is experiencing a dramatic shift in technologies and industrial structure, and it is slowly learning how to live in a world without borders. Whatever the changes in powers and responsibilities turn out to be, it is essential to build in the capacity to adapt to this new environment as it develops.

5 Economic Aspects of Reconfederation

In Chapters 3 and 4, we showed that there are many ways to balance the desire for diversity and the need for integration in the Canadian economy. Here, we analyse several scenarios for a new division of powers and responsibilities between the provinces and the federal government. Some of these scenarios involve a renewal of the federation, while others adopt a new form of confederation altogether. Rather than try to assess all of the options proposed by the numerous commissions and task forces that have debated the constitutional issue in recent months and years, we have selected a limited number of stylized options that capture the range of possibilities: 1) the status quo; 2) a moderate decentralization of federal responsibilities and functions; 3) an extensive decentralization; 4) a confederation of regions; and 5) Quebec sovereignty in association with the rest of Canada. This research was completed before the release of the federal government's proposal for constitutional reform; as a consequence, none of the options analysed here reproduces the details of those proposals. Also excluded from our analysis is a scenario of acrimonious breakdown of the country. The tools available to economists to study the impact of change in political structure are simply not suited to an analysis of the unpredictable effects that can result from such a scenario.

The discussion is restricted to the more visible and tangible benefits and costs that could accompany these changes in political structure, with special attention being paid to their different impacts on the regions of Canada. Many important questions are left out – probably including those which are driving the debate, such as the preservation of a Canadian identity, the protection of culture and language, minority rights, self-government and the settlements of land claims for the natives, adequate regional representation in federal institutions, and so on. It is important, as well, to note that we cannot quantify the way in which changes in political structure might affect the size and growth of the Canadian economy as a whole. That involves a dynamic process that cannot be measured. Despite these limitations, however, our analysis does provide essential information for the decisions that will redefine the relationships between citizens in the different provinces.

We begin with a brief description of each option, highlighting some of the trade-offs between economic and equity considerations that each would require. We then discuss some of the transition issues involved in moving from the current federal arrangements to a new constitutional model. We close with a general assessment of the economic impact of each option on the residents of the different regions of the country.

Constitutional Options

The Status Quo

The status quo is an example of the "broad" vision of sharing described in Chapter 4, with the federal government having a major role in redistribution policies and in promoting similar programs and services throughout the country (see box). However, it does not correspond to an extreme version of the broad vision, as the provinces do have the power to alter the distribution of income, as well as the design and delivery of social welfare, education, and health-care services.

Numerous asymmetries in the division of duties have evolved over time – in some cases by virtue of constitutional provisions, but in most instances through a variety of programs, policies, regulations, and special administrative arrangements. This asymmetry is particularly evident in the case of Quebec, but it exists as well for other large and well-to-do provinces like Ontario and Alberta, as described in Chapter 4.

Status Quo

- Federal responsibility for the economic union
- Shared responsibility for income redistribution
- Federal responsibility for national standards, after consultation with the provinces
- Federal equalization
- Numerous administrative asymmetries between provinces

For various reasons, however, it may be impossible to maintain the status quo: not only are political considerations (which fall outside the scope of our mandate) likely to make change necessary, but several practical reasons may also lead to the same outcome. First, the progressive reduction of cash transfers for education, health care, and social assistance (under both EPF and CAP) has jeopardized the leadership role of the federal government in the promotion of equity principles and national standards. Given the government's current financial difficulties, these objectives will have to be realized, at least for a while, through means other than federal spending. In deciding upon those means, important choices will have to be made with respect to how much more autonomy the provincial governments should have in setting standards. Similar choices will have to be made in the context of the current discussion on the future of the personal income tax-collection agreements, as some provinces are challenging the status quo and arguing for more flexibility in levying their own tax. (The status quo is clearly in a state of flux, but for the purposes of this chapter, it involves the retention of the fiscal and taxing powers that existed in recent years.)

Decentralized Federalism

The second option involves the devolution of federal powers and responsibilities to the provinces. This option is an amalgamation of several key proposals: the Livre beige of 1980 and the Allaire report, both products of special constitutional committees of the Quebec Liberal party; and the brief presented by the Quebec Chamber of Commerce to the Bélanger-Campeau Commission. One of the main goals of this option is to eliminate overlaps and duplication (see box).

Details of the reallocation of responsibilities with respect to programs and policies are shown in Figure 5-1. Two variants of the decentralized-federalism option are presented. Under "moderate" decentralization, federal specific-purpose transfers to the provinces, as well as federal direct spending in the areas of health, education, and social welfare, would be eliminated. Under "extensive" decentralization, federal transfers to individuals (UI benefits, old-age security benefits, family allowances, and so on) and to businesses would also become a provincial responsibility. In both cases, equalization payments to the "have-not" provinces would continue to be made according to the current formula. However, the federal government's spending power would be eliminated under the extensive option. Indeed, federal legislative and spending responsibilities would be limited to a few areas of exclusive jurisdiction (such as monetary policy, defence, international relations, customs, and tariffs) and to a few areas of shared responsibility (e.g., justice, financial institutions, immigration, telecommunications, transportation, the environment, and so on). All other policy areas would fall under the exclusive jurisdiction of the provinces.

The impact of this reorganization on federal and provincial budgets is shown in the charts that follow. The estimates assume that the resulting reduction in federal spending would be matched by a corresponding across-the-board reduction in federal taxes.[1] Chart 5-1 shows that the implementation of the moderate option in 1994-95 would shift expenditures, valued at 2 percentage points of GDP, from the federal to the provincial/local sector, if the level of services to the population remained unchanged. Under extensive decentralization, the shift to the provinces would exceed 8 percentage points, and the size of the federal public sector in the economy would shrink to approximately one third of the size of the provincial/local sector. Indeed, the federal government's total spending would be less than Ontario's.[2]

The impacts on the provinces are very uneven. This is better illustrated by looking at the total provincial and federal revenues that would be necessary in 1994-95 to keep the level of services unchanged from the status quo in each

Decentralized Federalism

- Preservation of the economic and monetary union
- Extensive redistribution of powers to eliminate overlaps
- Elimination of the federal spending power
- Elimination of federal specific-purpose transfers and direct federal spending in the areas of health, education, and social assistance
- Federal transfers to individuals and to business:
  - no change under "moderate decentralization" option
  - provincial responsibility under "extensive decentralization" option
- Maintenance of the equalization system
- Pressures towards tax disharmonization
- Regional representation on economic institutions

Figure 5-1
Allocation of Responsibilities under Various Constitutional Options

	Status quo	Decentralized federalism: Moderate	Decentralized federalism: Extensive	Confederation of regions	Sovereignty-association
Intergovernmental transfers					
Health	P/F	P	P	P	P (Quebec) – P/F (others)
Social assistance	P/F	P	P	P	P (Quebec) – P/F (others)
Postsecondary education and manpower training[1]	P/F	P	P	P	P (Quebec) – P/F (others)
Equalization	F	F	F	None	None (Quebec) – F (others)
Income-redistribution programs					
Unemployment insurance (including training benefits)	F	F	P	P	P (Quebec) – F (others)
Old-Age Security Pensions	F	F	P	P	P (Quebec) – F (others)
Contributory pension plans	P (Quebec) F (others)	P (Quebec) F (others)	P	P	P (Quebec) – F (others)
Child benefits programs[2]	P/F	P/F	P	P	P (Quebec) – P/F (others)
Student/trainee aid	P/F	P/F	P	P	P (Quebec) – P/F (others)
Social housing	P/F	P/F	P	P	P (Quebec) – P/F (others)
Framework policies					
External trade[3]	F	F	F	F	F (jointly with Quebec)
Sectoral policies[4]	P/F	P/F	P	P	P (Quebec) – P/F (others)
Environment	P/F	P/F	P/F	P/F	P/F
Transportation	P/F	P/F	P/F	P/F	P/F
Financial institutions	P/F	P/F	P/F	P	P (Quebec) – P/F (others)
Communications[5]	F	F	P/F	P/F	P/F
Monetary, taxation, and macroeconomic policy					
Currency and monetary policy	F	F	F	F	F
Economic stabilization (fiscal)	P/F	P/F	P/F	P	P (Quebec) – P/F (others)
Taxation and revenues	P/F	P/F	P/F	P/F (limited)	P (Quebec) – P/F (others)
Management of current federal debt	F	F	F	F	P (Quebec) – F (others)
Customs and tariffs	F	F	F	F	F (jointly with Quebec)
Other areas of jurisdiction					
Culture (including recreation and sport)	P/F	P/F	P/F	P/F	P (Quebec) – P/F (others)
Defence and international relations	F	F	F	F	P (Quebec) – F (others)
Native affairs	F	F	F	P	P (Quebec) – F (others)
Policing, courts, and administration of justice	P/F	P/F	P/F	P/F	P (Quebec) – P/F (others)

"P" = provincial; "F" = federal.

1 Manpower training primarily consists of the purchase of training courses from educational institutions on behalf of trainees and subsidies to businesses for apprenticeship programs. The category excludes income support measures for trainees (including UI training benefits), which are included under the Unemployment Insurance and Student/trainee aid categories.

2 Includes family allowances, child tax credits, and child care.

3 In addition to international trade, this category encompasses responsibility for promoting and preserving the "economic union" (particularly trade in goods and services; capital and labour mobility; marine, air, and rail transportation; and pipelines). In the asymmetrical scenarios, Canada/Quebec harmonization may be envisaged.

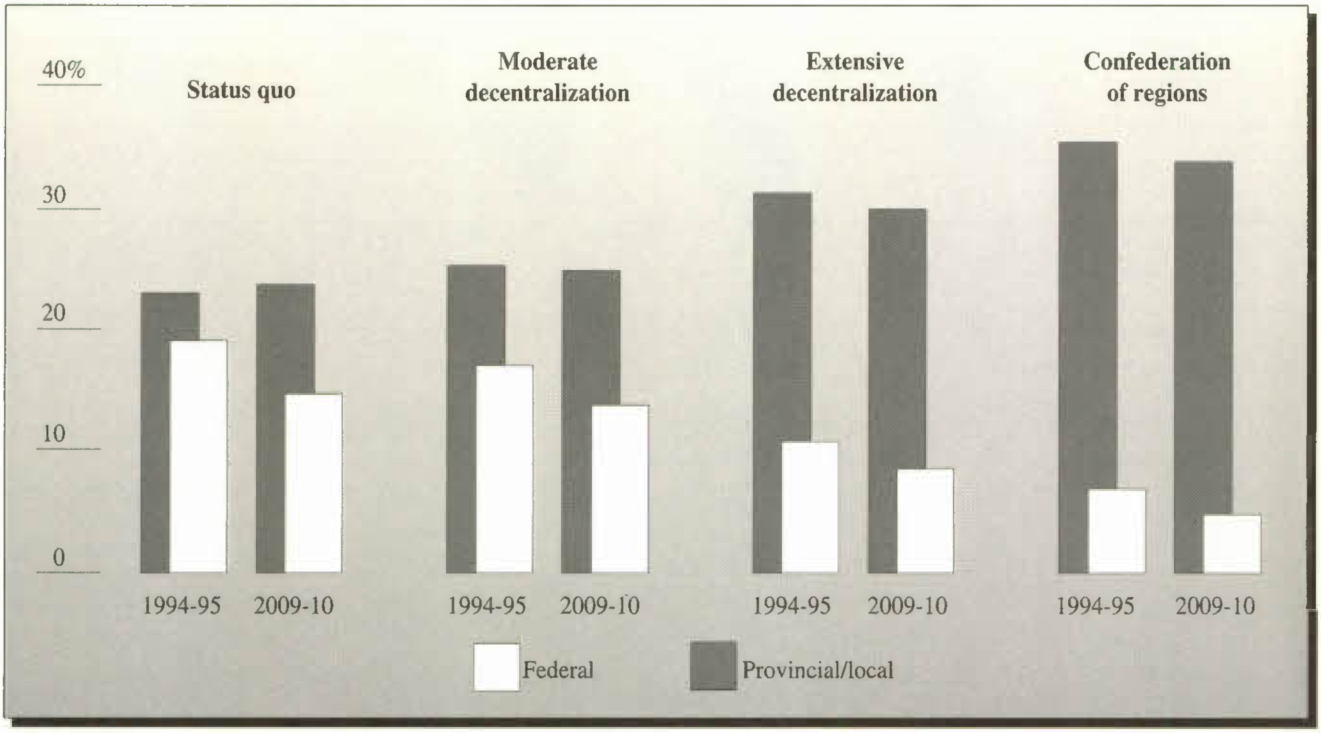
4 Includes, among others, regional development, natural resources, agriculture, municipal affairs, housing (other than social housing), and research and development.

5 Includes, among others, telephones, telecommunications, and technical (i.e., noncultural) aspects of radio and television broadcasting.

SOURCE Economic Council.

Chart 5-1

Projected Federal and Provincial/Local Government Spending[1] under Four Constitutional Options, Canada, 1994-95 and 2009-10



1 As a proportion of GDP. Federal expenditures include transfers to the other levels of government; these transfers are subtracted from provincial/local expenditures. The decline in total government size through time is caused by the gradual decline of debt-servicing charges.

SOURCE David Péloquin, Haider Saiyed, and Marcel Bédard, "Expenditure simulation model," a background paper prepared for the Economic Council, 1991.

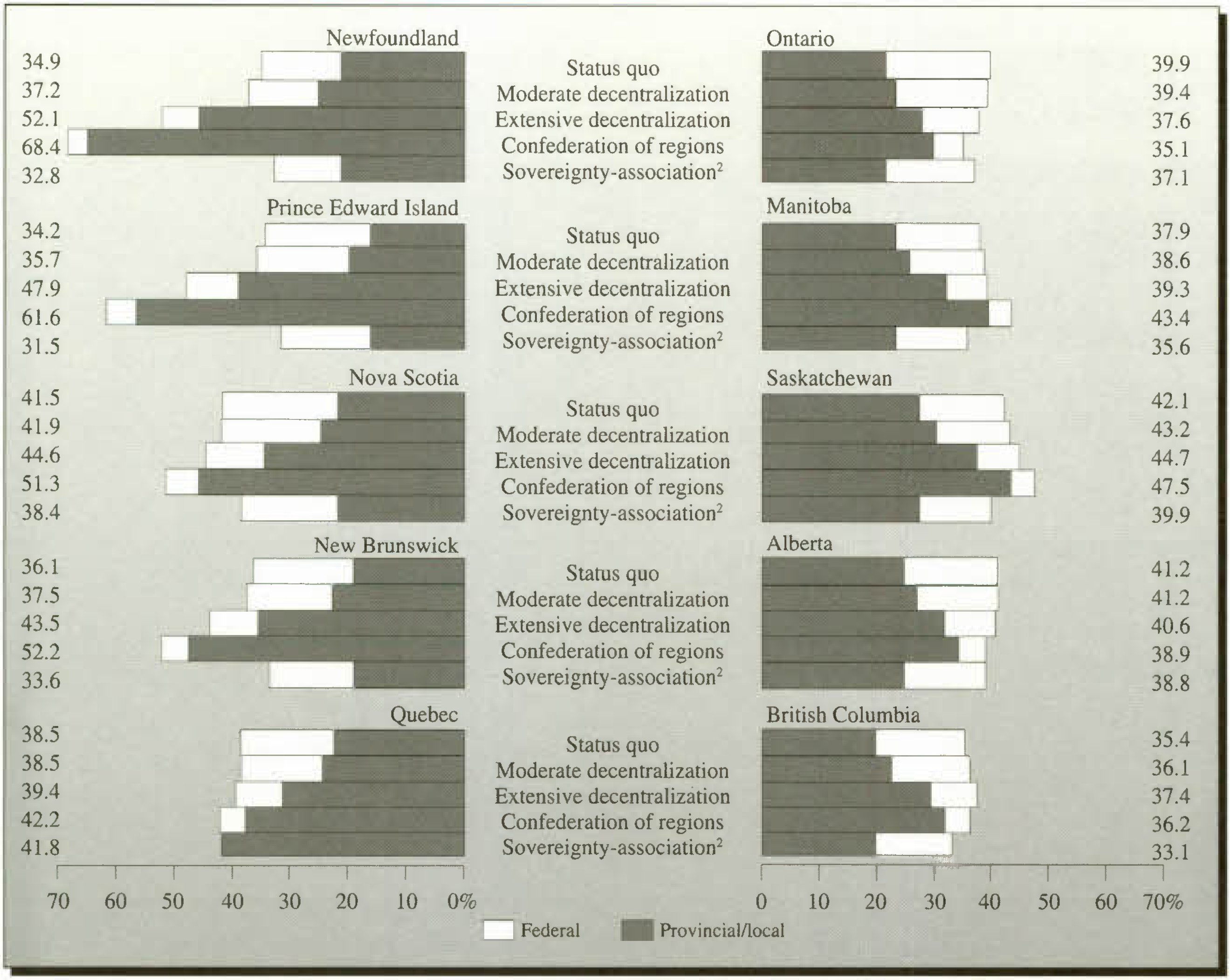
province (Chart 5-2). It can be seen that, under the status quo, the overall government revenues collected in each province would range from a low of 34 per cent of provincial GDP in Prince Edward Island to a high of 42 per cent in Saskatchewan. Under the decentralization options, the total revenues required to maintain the same level of government services in the less well-off provinces would rise significantly (by over 17 per cent of provincial GDP in Newfoundland under the extensive-decentralization option), while in Ontario and Alberta, they would decline slightly. Changes in revenue requirements on this scale would undoubtedly require the have-not provinces to make painful decisions with respect to the trade-off between higher taxes and reduced government services. The greatest problems would occur in the Atlantic provinces.

Changes in the overall tax burden borne by the residents of each province from one option to the next reflect the influence of two factors. First, they reflect provincial differences in the demand or need for programs that are currently funded by the federal government. For example, residents of a province with a larger proportion of older people than average would have to pay more taxes if the province were to assume responsibility for the old-age security program. Second, the changes in tax burden reflect differences in provincial contributions to federal revenues. As the federal government disengaged itself from various programs and activities, federal taxes would decline across the board. But provincial taxes would rise as the provinces took on new responsibilities. The total increase in provincial revenues needed should be matched exactly by the reduction in federal taxes, but this is not true for individual provinces. A have-not province will generally need to increase its own tax revenues by a greater amount than the reduction in the federal taxes previously collected in that province. The opposite would be true for provinces with higher fiscal capacities.[3]

Chart 5-3 provides a better sense of the current extent of redistribution taking place between the provinces through three particular categories of federal programs and transfers: equalization; health, education, and social welfare; and transfers to individuals.[4] The chart shows the differences between federal spending in each province and the federal

Chart 5-2

Projected Government Revenues[1] Required to Maintain the Same Levels of Government Expenditures under Various Constitutional Options, Canada, by Province, 1994-95



1 As a proportion of GDP.

2 Outside Quebec, the revenue requirements under the sovereignty-association option decline, relative to the status quo, because of the decline in federal revenue requirements associated with the elimination of net federal transfers to Quebec.

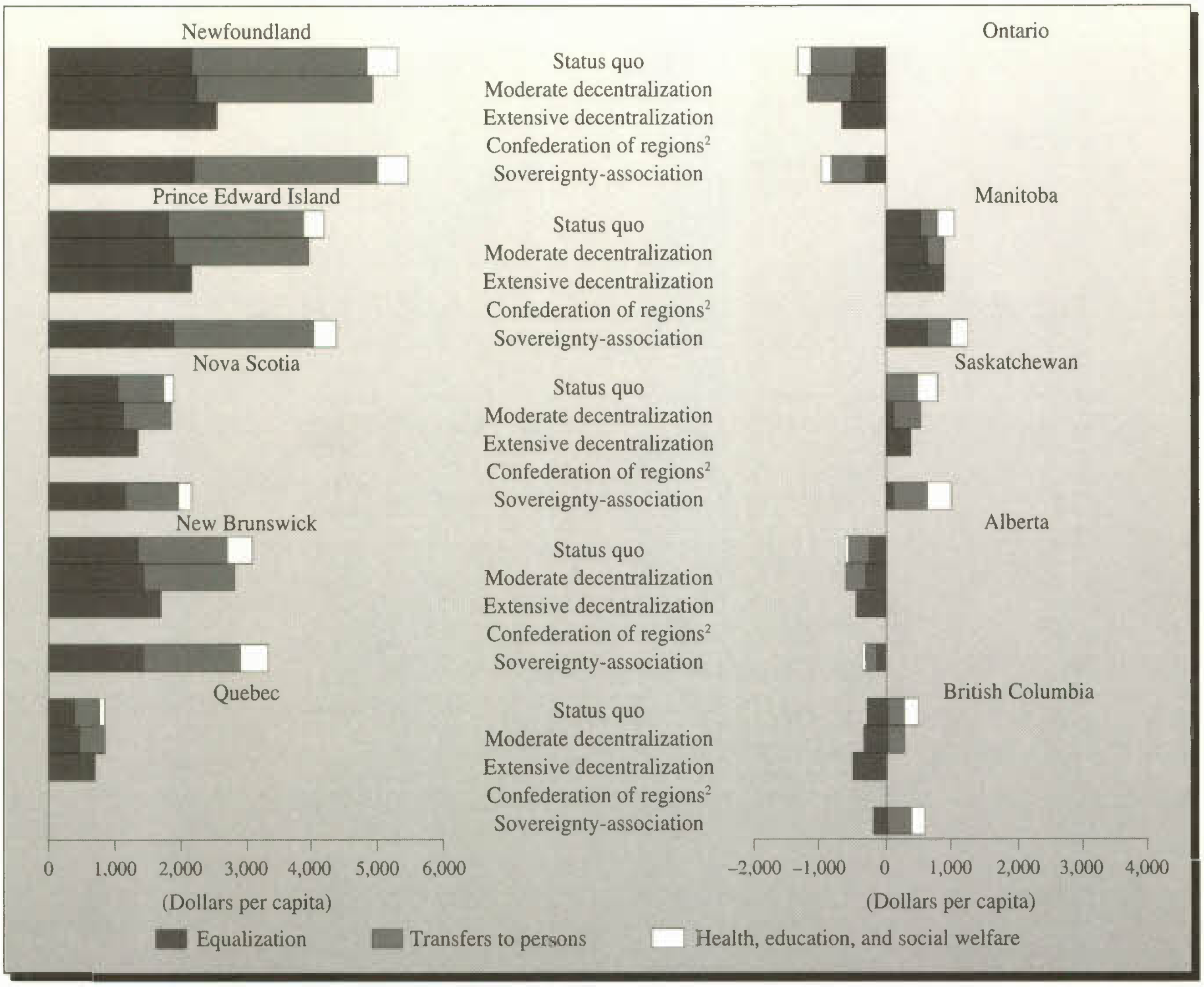
SOURCE Péloquin, Saiyed, and Bédard, "Expenditure simulation model."

revenues that must be raised in each in order to finance each of those three categories in fiscal year 1994-95 under the various constitutional options. Net transfers would not change by much under moderate decentralization, but they would under extensive decentralization, particularly for the Atlantic provinces.[5]

Thus the more extensive the decentralization and the wider the differences in the revenue-generating capacity of the provinces, the greater the risk of serious pressures on the economic union: either the tax rates will diverge from one province to another or disparities in the level of government services will emerge. As discussed in Chapter 4, the loss of effective equalization that would follow from the decline in interprovincial transfers implicit under the decentralization scenarios could be avoided by enriching equalization payments to the have-not provinces. This could be done by altering the existing formula – in particular, by incorporating interprovincial differences in the "need" for particular programs (such as unemployment insurance[6]) – or by developing new schemes involving direct interprovincial transfers.

Chart 5-3

Implicit Interprovincial Net Transfers per Capita under Selected Federal Expenditure Items[1] and under Five Constitutional Options, 1994-95



1 Implicit interprovincial net transfers under a particular expenditure item are calculated as the difference between federal expenditures in a province and the contribution of that province to the federal revenues that are needed to finance those expenditures.

2 There are no net transfers for the programs considered here, as there are no federal expenditures for such programs under this option.

SOURCE Péloquin, Saiyed, and Bédard, "Expenditure simulation model."

There are other repercussions on the economic union as well. Because of its shrinking role with respect to both taxes and transfers under extensive decentralization, the federal government would no longer be in a position to dominate the design of the income tax structure or to redistribute income between the rich and the poor. Nor would it have the fiscal clout to perform its traditional stabilization role with respect to prices, output, and employment. Thus tax and budget policies that play a crucial role in the management of the economy would require new institutions for interprovincial coordination, along the lines suggested in Chapter 3.

In summary, while the advocates of decentralization generally emphasize the need to preserve the economic union, the extensive option contains some powerful forces moving in the opposite direction. To offset those forces, it would probably be necessary to act on two fronts: first, in order to sustain the principle of equal opportunities across regions, the equalization system would have to be enriched so as to reduce interregional disparities in fiscal capacity and in the need for government services. And second, a whole new set of federal/provincial or interprovincial institutions would have to be created to establish and enforce basic standards for the economic union. Many of the proposals for decentralization mention the need for a greater contribution by the provinces to institutions such as the Bank of Canada. But maintaining the economic union will require much more sweeping changes to political and economic institutions, so that the provinces may coordinate their activities on regulation, tax policy, fiscal policy, and so on, while preventing the creation of barriers to the movement of goods, services, people, and capital.

Finally, a comment about "asymmetric" federalism – a type of decentralized federalism under which Quebec and possibly others would seek new arrangements with the federal government that differed from those of other provinces. Quebec could favour one type of decentralization – say, the "extensive" option – while other provinces might prefer the status quo or moderate decentralization. Various possibilities can be considered here, since a federal system can provide for a wide range of asymmetric arrangements, as long as appropriate coordinating mechanisms are put into place.

One should not, however, underestimate the political issues that can complicate the implementation of asymmetric arrangements. So far, Canada has shown that opting-out formulas and special administrative arrangements can be implemented without too much difficulty. But the issue of voting rights in central institutions could become a problem when a province formally seeks a special status or when the asymmetries are so numerous or so lopsided that they become politically unacceptable to some of the participants. These issues fall outside the scope of our work, however.

A Confederation of Regions

The third stylized option considered here is the formation of a new Canada made up of regions working in a functional partnership, similar to the current European Community model. Member regions would become politically sovereign and would then delegate a limited number of powers to a central, apolitical authority.[7] This delegation of powers would include the allocation of responsibility for defence, external affairs, international and interregional trade, environment, transportation, and a few others (see box, as well as Figure 5-1).

One of the major features of this option is the elimination of the equalization system.[8] Note, as well, that some regions (the Atlantic provinces, for example) would have to create a new regional structure to take on some of the responsibilities transferred from Ottawa.

There could be several interesting aspects to this option from the strict point of view of efficiency. First, disputes between levels of governments should be reduced considerably. Every participating region would become the sole keeper of the political, social, and cultural values of its communities, which should reduce tensions over the assignment of responsibilities and ensure a better match between the activities of governments and regional preferences with respect to public goods and social services. The Canadian common market might be better secured under this arrangement than under other options. Because the central authority would exercise a particular responsibility only in those areas specifically agreed upon by the member regions, it should have an unparalleled capacity of enforcement. Regional activities that affect the operation of the common market would therefore be more constrained than they are under the current system. Finally, any problem of overlap and duplication that may exist currently would be eliminated, given the degree of decentralization of responsibilities involved.

Chart 5-1 provides an idea of the impact of the confederation-of-regions option on the relative sizes of the provinces and the central authority. Of all the scenarios considered here, this is the option that would imply the smallest role for the federal government, largely because of the devolution of various administrative and other responsibilities to the provinces and of the elimination of equalization payments. Aggregate provincial government expenditures would be five times as large as those of the federal government in 1994-95. With the contraction of the federal government, the provinces would become the dominant force

A Confederation of Regions

- Common market and monetary union among several regional blocks
- Exclusive regional jurisdiction in all but a few areas
- Elimination of federal specific-purpose transfers and direct federal spending in the areas of health, education, and social assistance
- No federal transfers to individuals or businesses
- Elimination of the federal spending power
- Elimination of the equalization system
- Independent tax collection by each region and by the superstructure
- Regional representation in economic institutions

in fiscal policy; close coordination among them with respect to objectives and methods would be essential.

While reduced duplication and a closer match of government programs to taxpayers' preferences might result in efficiency gains, these gains could be offset totally as a result of large interprovincial differences in government services and taxes. In the absence of any equalization mechanism, decentralization of taxing and spending responsibilities would result in important differences in taxes and services across the provinces. This would almost certainly lead to inefficiencies in the allocation of investment and in labour mobility across the country.[9]

It should be clear that this option is also weak on the equity front. By denying the central authority any role in income distribution, the confederation-of-regions option does not even meet the expectations of the communities vision of the federation, which would support at least some form of interregional distribution through the equalization system.

Sovereignty-Association

The fourth model is based on Quebec sovereignty in association with the rest of Canada, as proposed by the Parti Québécois.[10] It shares many features of the confederation-of-regions option discussed above. In particular, the proposed terms of association are not political, but strictly economic. They involve the preservation of the common market and a monetary union (see box). Quebec would have exclusive responsibility for all areas except monetary policy and customs, where responsibility would be shared.[11]

As a sovereign nation, Quebec would participate in international accords, such as the GATT and the free-trade agreement with the United States. It would collect all taxes within its boundaries, both direct and indirect, and would receive no intergovernmental transfers or transfers to individuals or businesses from the federal government. Finally, Quebec would service its portion of the federal debt and receive its share of federal assets.

The impact of this model on the respective sizes of the parties involved is detailed in Chart 5-4. If Quebec were to maintain the level of expenditures on public goods and government services that was formerly provided by the federal government, Quebec spending in 1994-95 would rise to 47 per cent of its output, up from 24 per cent under the status quo. The federal government would see its size as a proportion of the smaller GDP (of nine provinces) decline marginally.

Sovereignty-Association between Quebec and Canada

- Common market and monetary union between Quebec and Canada
- Quebec with exclusive responsibility for all areas except monetary policy and customs and tariffs (shared)
- Quebec, as a sovereign nation, participates in international accords (e.g., FTA, GATT)
- Quebec collects all taxes within its boundaries
- No federal transfers to Quebec
- Quebec no longer participates in the equalization system
- Quebec assumes its portion of the federal debt and receives its share of federal assets
- Quebec has a say in Bank of Canada decisions

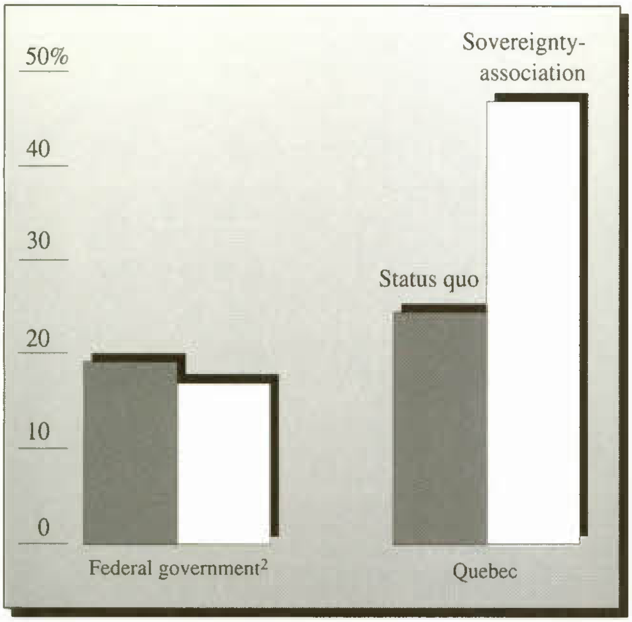
As mentioned earlier, the decentralization of virtually any regulatory, tax, and expenditure responsibilities is bound to put some pressure on the economic union. A scenario of asymmetric arrangements as extreme as the sovereignty-association option would involve the negotiation of new terms of economic association between Quebec and the rest of Canada that would no doubt include strong guarantees with respect to actions or policies that could affect the mobility of goods, services, labour, and capital between the two jurisdictions. These contractual provisions would limit Quebec's economic sovereignty in certain areas, possibly to an even greater extent than is currently the case under the status quo.[12]

On the equity front, the sovereignty-association option allows the two conflicting views of sharing to coexist. In fact, if the residents of Quebec decided that the federal government should play no role in redistributive policies within their territory, while those of the other regions preferred a strong role for the federal government in this area, then the proposed association could be optimal for all parties involved.

However, the elimination of formal or *de facto* equalization between Quebec and the rest of Canada might encourage some people and investors to leave Quebec. Chart 5-2 shows that with the elimination of all implicit interprovincial transfers to Quebec,[13] the total tax burden on its residents

Chart 5-4

Projected Spending[1] under the Status Quo and the Sovereignty-Association Option, Federal and Quebec Governments, 1994-95



1 As a proportion of GDP.
2 Spending is measured as a proportion of output for 10 provinces under the status quo option and for the nine remaining provinces under sovereignty-association.
SOURCE Péloquin, Saiyed, and Bédard, "Expenditure simulation model."

would rise by approximately 3.3 per cent of its GDP, while the total tax burden in the other provinces would decline slightly. This would undermine Quebec's capacity to offer services similar to those in the rest of Canada at comparable tax rates.

Such a radical shift in the political structure would have an impact on international economic relations as well. Some experts have questioned whether it would be possible for Quebec to negotiate a parallel free-trade agreement with the United States or whether the terms of such an agreement could be as advantageous to Quebec as are those of the existing agreement between Canada and the United States. One author has pointed out that even in the best scenario, Quebec would lose some manoeuvrability, as the current agreement contains few constraints on the freedom of the provincial governments.[14] At the same time, much uncertainty would prevail about the future of the current agreement if Canada were to lose the Quebec market after a declaration of independence. Similar questions have been raised with respect to the feasibility of Quebec's participation in monetary policy and the negotiation of a common Canada/Quebec commercial policy. All of these questions warrant very serious consideration, but they go beyond the scope of this Review.

Transition Issues

When the citizens of a country undertake to transform its political structure, they do so in the expectation that they will be better off under the new arrangement. However, any significant change imposes transition costs as people reorganize their affairs to adapt to the new structure. Some of these costs are strictly private – the relocation of corporate offices in response to shifts in political responsibilities and decision centres, for example. But some important costs have a bearing on the well-being of all citizens. We examine two types of transition costs here.

The first has to do with the reaction of financial markets to the change in political structure and with the higher risk premiums on Canadian assets that may result. The second is associated with the sharing of responsibilities for the public debt that would be necessary under sovereignty-association and, perhaps also, under the confederation-of-regions option.

Risk Premiums

Financial markets will react to any real or perceived increase in the uncertainty associated with political change by incorporating a greater risk premium on funds borrowed by governments and businesses. And higher risk premiums have a negative impact on the economy. As they raise real interest rates, they cause an increase in the marginal cost of borrowing and investment. This reduces capital spending and thus the level of productivity. Our estimates indicate that a permanent rise of 100 basis points in real interest rates would result in a permanent loss of approximately 1.5 per cent in GDP over the long run. In addition, higher risk premiums mean a higher cost of servicing the public and foreign debts, leaving less of the future national income available for consumption. Thus a small but permanent increase in risk premiums could have a significant cumulative impact on living standards over a generation. In order to understand better the negative reaction of financial markets to risk, it is useful to distinguish between three categories of risk – political risk, default risk, and currency risk.

Political Risk

Uncertainty about the potential impact of political change on taxes, investment income, capital flows, and macroeconomic policies will cause investors to demand a political-risk premium on Canadian assets. Such premiums vary with the degree of uncertainty. The increase in premiums could happen during the actual transition phase from one structure to another, but it could also occur before and after the transition, if expectations about the direction of the change are very negative or if the outcome of the political change is perceived by investors to be less stable than the status quo.

In general, this kind of risk premium is temporary. For example, following the election of the Parti Québécois in 1976 the spread between Quebec and Ontario bonds increased by 60 basis points in Canada and 100 points in the United States. The additional spread was at its highest for the nine months following the election, but it declined gradually to reach zero after a period of two years.[15]

So far, it seems that the current episode of constitutional debate has had little impact on the value of Canadian assets; the risk premiums on Canadian or provincial bonds, if any, have been small.

Table 5-1
Interest-Rate Spreads, Credit Ratings, and Gross Public Debt,[1] Selected Member States of the European Community, 1989-90

	Interest-rate spread, 1989[2]	Credit rating, 1989	Debt/GDP ratio, 1990
	(Basis points)		(Per cent)
United Kingdom	–33	AAA	40
Italy	–33	AA+	101
France	–20	AAA	35
Belgium	–19	AA+	126
Ireland	–3	A+	105
Portugal	6	A	76
Greece	80	BBB	92

1 As a proportion of GDP.
2 Eurodollar floating-rate note market: discount margin versus six-month LIBOR, mid-market, at 31 October 1989 (December 1990 for Greece).

SOURCE G. Bishop, D. Damrau, and M. Miller, *1992 and Beyond. Market Discipline CAN Work in the EC Monetary Union* (London: Salomon Brothers, November 1989).

Default Risk

Once the new political structure is in place, the markets will reassess the creditworthiness of each of the governments that emerge. These market ratings are influenced by the level of debt as a proportion of GDP, the outlook for the economy, the tax burden, and the existence of a bail-out option (through an implicit or explicit guarantee by a senior level of government). This kind of default-risk premium tends to be long-lasting.

Recent credit ratings given by Standard & Poor's to the Canadian provinces range from AA+ for Ontario (recently downgraded from AAA+) to A– for Newfoundland. Correspondingly, the borrowing-cost differences between those two provinces has averaged a little less than 50 basis points over recent years. This variation in the rate spread is rather modest, probably because of the implicit federal guarantee.

In comparison, the variation in European interest-rate spreads is greater. The high correlation between the spreads and credit ratings on the Eurodollar market (Table 5-1) provides interesting evidence of the importance of default-risk premiums. At the same time, there is little correlation between the credit ratings (or default risk) and debt burdens of the countries considered, as the table shows. Belgium, for example, has a better interest-rate spread than Portugal or Greece, although its debt/GDP ratio is much higher.

Currency Risk

A third category of risk reflects uncertainty about future exchange-rate variations. This may induce foreigners to demand a higher interest rate to compensate for the higher risk on assets denominated in Canadian dollars.

Once a change in political structure has occurred, capital markets will reassess the possibility that unexpected shifts in the value of the Canadian dollar might occur. For example, increased uncertainty could arise with respect to the future stance of monetary policy, the future course of inflation, or the breaking-up of the monetary union into more than one currency area. There is considerable evidence that currency premiums are important and volatile. How large they really are is difficult to determine, however.

In general, risk premiums can have an important bearing on a country's future capacity for growth. Some of the premium is temporary, and abrupt increases can be avoided by eschewing unnecessary friction and uncertainty. Other aspects of the premium are based on a hard-nosed assessment of the economic viability and stability of the new political structure.

Public Debt

While the decentralized-federalism options do not involve any substantial changes in current debt-management arrangements, the other scenarios do imply some changes. The sovereignty-association scenario assumes that a division of the federal public debt and assets between Quebec and the rest of Canada would take place. Such an exercise might also be required in the confederation-of-regions scenario, unless the regions delegate responsibility for managing the public debt to the central authority.[16]

The division of the national debt could be a contentious issue because it is a zero-sum game. What one party might gain by obtaining a reduced share, the others would lose through increased shares. Moreover, any negotiation over the sharing of the debt would be more difficult if it were carried out in a climate of conflict. It would be much harder to achieve an agreement if Quebec were to choose political independence and the rest of Canada were to object to an economic association than it would be under the sovereignty-association or confederation-of-regions scenarios.

International law provides no firm guidance on the distribution of assets and liabilities in such a situation. The parties involved would have to negotiate the principles to be followed. Whatever the approach, it would require that all assets and liabilities be appraised to determine their current market value. This would undoubtedly be one of the largest valuation exercises ever to take place.

The 1990 Public Accounts indicate that total federal liabilities as of 31 March amounted to $399 billion. The federal government has $41 billion in financial assets, but no recent estimate of the value of physical assets is available.[17] It would be necessary to take into account the assets and liabilities of the Bank of Canada as well.

The criteria that can be used to determine the sharing of assets and liabilities include: 1) population (allocating each Canadian an equal share); 2) measures of the ability to pay, such as gross domestic product or the federal revenue collected in each province[18]; or 3) measures of the debt incurred on behalf of each province by the federal government over time.

Table 5-2 shows how the public debt would be divided according to those different criteria. Quebec's share could vary between 21 and 31 per cent, depending on the criterion used. Note also the wide variation in the shares attributable to the other provinces – that of the Atlantic region ranges between 3.5 and 47 per cent, for example.

Table 5-2
Possible Criteria for Dividing the Federal Debt, by Region, 1989

	Atlantic provinces	Quebec	Ontario	Manitoba and Saskatchewan	Alberta	British Columbia	All provinces, excluding Quebec	Total
	(Per cent)							
Population	8.8	25.5	36.5	8.0	9.2	11.6	74.5	100.0
Gross domestic product	6.0	23.3	41.9	6.6	10.2	11.7	76.7	100.0
Revenue	6.0	21.6	46.6	5.4	9.1	10.7	78.4	100.0
Revenue, adjusted[1]	6.8	21.0	44.5	6.3	9.9	11.4	79.0	100.0
Revenue, adjusted[2]	6.7	22.2	43.5	6.2	9.7	11.2	77.8	100.0
Revenue, adjusted[3]	3.5	22.8	49.4	4.8	10.2	11.9	77.2	100.0
Federal net lending[4]	47.2	30.9	–7.5	19.9	–13.4	2.2	69.1	100.0

1 Total federal revenue, with indirect taxes distributed as consumer expenditures instead of production.
2 As in 1, but with federal revenue in Quebec increased by $1,931.5 million to reflect Quebec's 16.5-per-cent abatement.
3 As in 2, but net of federal transfers to the provinces.
4 Federal net lending is cumulated from 1961 to 1989. Federal net lending is the Provincial Economic Accounts equivalent of the federal deficit. Cumulating it over time shows the proportion of the cumulative federal deficit that can be attributed to each region. This can be viewed as a measure of the debt incurred on each region's behalf by the federal government. Even then, this indicator is far from being an accurate reflection of the benefits that each region derives from federal spending in any province. There is generally no simple correspondence between dollars spent by governments and benefits derived from such expenditures. Federal expenditures undertaken in one province may generate benefits for residents of other provinces. A proper use of this indicator would also require that the historical period be extended back to the year the provinces actually entered Confederation.

SOURCE Patrick Grady, "National debt and new constitutional arrangements," Economic Council of Canada Working Paper (forthcoming).

According to a formula developed by the Bélanger-Campeau Commission, Quebec would have to assume 17.5 per cent of the federal government's financial and pension liabilities[19] – substantially less than any of the shares shown in Table 5-2. Since a 5-per-cent increase in the debt/GDP ratio of the federal government would result, this proposal is unlikely to be viewed as equitable by the rest of Canada.

The ability of a region to assume the additional debt load resulting from the division of the federal debt and assets would depend on the extent of its current indebtedness. Table 5-3 shows the provincial/local public-debt levels and interest charges in 1989 as a proportion of provincial GDP. Quebec would not be in a good position to bear its share of the debt: it is more heavily indebted than the other regions, and its public-debt charges are also higher than average. In addition, any distribution of the federal debt burden among the regions would make it more difficult to service the total public debt because regional revenues are less stable than federal revenues. Interregional risk-pooling makes the federal government a more dependable source of revenue, and that explains why it has a triple-A credit rating.

In the end, whatever approach is chosen to allocate the debt, there are several ways to minimize the transition costs. First, maintaining a common currency through a monetary union would avoid introducing any element of exchange risk into the financing of the debt. Second, it would be important to avoid redeeming existing debt and replacing it with new debt by negotiating a phasing-in of the debt transfers.[20] Third, this transfer of debt could be phased in over a period long enough to allow the development of new markets, so that the new securities could be issued without paying a premium over market interest rates. Fourth, it could prove advantageous to leave the responsibility for the management of the debt to the federal government or to create a special agency to that effect. Finally, financial markets would be strongly influenced by the climate in which the division of the debt would be negotiated. Thus there is a strong connection between risk premiums on interest rates and the division of the debt. Markets thrive on stability; any possibility that a political change will lead to instability will therefore result in a negative reaction. The costs of any political change, no matter how radical, can be significantly reduced if that change takes place in an orderly way, with the participants exhibiting fiscal and financial responsibility, as well as mutual respect.

Table 5-3
Debt-Service Ratio,[1] Federal and Provincial/Local Governments, Canada, 1989

	Public debt	Public-debt charges
	(Per cent)	
Provincial/local governments		
Atlantic provinces	30.5	4.6
Quebec	30.7	3.7
Ontario	11.3	1.8
Manitoba and Saskatchewan	19.1	4.1
Alberta	–5.1	2.4
British Columbia	3.6	1.7
All provinces, excluding Quebec	10.1	2.3
Federal government	54.5	6.0

1 As a proportion of GDP.
SOURCE Estimates by the Economic Council, based on data from Statistics Canada.

The Economic Impact of Reconfederation

The political and institutional changes being considered in the options described above are intended to respond to the political preferences being expressed by a number of Canadians. Before any decision is made, Canadians must consider whether these changes would have consequences on their economic well-being. The short answer, of course, is that they would have major consequences. But it is difficult to make quantitative comparisons of those economic consequences, because some of the impacts are measurable while others are not.

A number of studies have attempted to net out the sums of federal expenditures and revenues for each province in order to estimate the possible impact of new arrangements. That, however, is only a small part of the picture. A broader perspective must be taken to examine the impacts of the changes from a number of different angles. In particular, the risks must be identified, and the regional effects must be considered in a long-term perspective.

We have examined five types of costs and benefits: the impact of a change in political structure on the operation of the economic union; the dynamic gains from increased regional autonomy and social coherence; the long-term economic impact caused by the reorganization of taxes, transfers, and spending responsibilities in line with the new division of powers; the possible efficiency gains to be achieved in the provision of government services; and the transition costs that arise as institutions and markets adapt to the new structure. The results are presented in stylized form in Figure 5-2 and explained in greater detail below.

All options have been assessed relative to the status quo. The exercise does not lead to a bottom-line figure on the costs or benefits of each option under consideration, but it does contain some useful lessons.

Strength of the Economic Union

The top line of the figure shows the expected impact of each option on the quality of the economic union. As pointed out above, the more radical the political changes and the more extensive the decentralization, the greater the pressures on the economic union. If the decentralization of responsibilities results in large disparities in services and taxes, some of the efficiency gains provided by market integration will be lost. In addition, the reallocation of certain responsibilities to the provinces may entail efficiency losses from the economies of scale forgone in the delivery of public goods and government services. This loss could be significant for small provinces but is likely to be quite marginal for large provinces or regions. The benefits from pooling the risk of economic instability among the regions

Figure 5-2
Economic Impact of Constitutional Options

	Decentralized federation			
	Moderate	Extensive	Confederation of regions	Sovereignty-association
Economic union	•	?	–	–
Dynamic gains	•	?	+	+ (Quebec)
Long-term impact of a new division of powers[1]				
Atlantic provinces	–	– –	– – –	•
Quebec	•	+	–	–
Ontario	+	+	++	•
Manitoba and Saskatchewan	–	– –	– – –	•
Alberta	•	–	+	•
British Columbia and territories	–	–	+	•
Increased government efficiency	•	+	+	+ (Quebec)
Transition costs				
Political risk	•	•	–	–
Default risk	•	•	–	–
Currency risk	•	–	–	–
Debt-sharing and others	•	•	–	–
Treaties and others	•	•	–	–

NOTE ? Uncertain
\+ Benefit
– Cost
• Insignificant

1 Reflects the impact of a reorganization of responsibilities in the areas of taxation, transfers, and government spending.

could also be lost in the absence of a central authority with substantial fiscal clout.

The benefits of the union could be preserved, however, if coordination mechanisms were set in place to preserve the common market and ensure the effective operation of the union. It is because of that possibility that a question mark appears in the figure under extensive decentralization. Most of the proposals favouring a more decentralized federation also display a strong preoccupation with the effective management of the Canadian economic union. Thus we cannot presume that the union would be better protected under the status quo than under any of the options of decentralized federalism. The outcome depends on the political will and commitment of the participating governments to maintain and reinforce the union under a new political structure. We will discuss this aspect in greater detail in the concluding chapter.

However, there is the presumption that the confederation-of-regions and sovereignty-association options will have a negative impact on the integrity of the union. The absence of an equalization system under the confederation-of-regions option makes it virtually impossible to avoid disparities in services and taxes, resulting in a misallocation of resources within the union. Under the sovereignty-association option, the absence of equalization between Quebec and the rest of Canada could also lead to some inefficiencies, albeit to a lesser extent. We have no estimates, however, of the magnitude of the likely efficiency losses.

Dynamic Gains

A clearer constitutional situation would probably eliminate the uncertainty that has been weighing down on the business climate everywhere in Canada, but in the long run some lasting dynamic gains in business activity may also result from greater provincial autonomy if it is achieved in the context of an economic and monetary union. In particular, the greater autonomy of regional governments under the confederation-of-regions option – or that of the province of Quebec under the sovereignty-association option – could, if properly designed, produce a better business and political climate within those communities. These are reported as potential positive effects on the second line of Figure 5-2. Dynamic gains might also occur in the cases of extensive decentralization, but they are less certain and are likely to be less significant.

The catalyst for such dynamic gains could take a number of forms. For example, the Council argued in its 27th Review that a new social contract, implicit or explicit, between the various partners in the communities could raise growth rates and reduce inflation and the risk of unemployment. A social contract of this nature is more likely to materialize when a strong sense of community exists, and when cultural and historical ties are strongly developed. Although it is difficult to generalize in these matters, dynamic gains occurring in this context are likely to be positive and should therefore be taken into account in any assessment of the sovereignty-association scenario.

One can only speculate about the size of these potential dynamic gains in a closely knit community like Quebec. If the choice of sovereignty-association is based on a large consensus within Quebec society, the dynamic gains are likely to be important. However, if the option were achieved with a very small majority, those gains are likely to be negligible.

Long-Run Impact of a New Division of Powers

The third type of cost/benefit analysis presented in the table has to do with the change in regional fortunes provoked by a reorganization of tax, transfer, and spending responsibilities under a new division of powers. The reallocation of responsibilities envisaged in each political option will set off a chain reaction in the economy. Changes in taxes and transfers will affect disposable income differently from one region to another. This, in turn, will change the mix of goods and services consumed, produced, and traded; the prices of these goods and services; and the costs of labour, capital, and materials used in their fabrication. These price and cost changes will, in turn, induce more changes in the economy through changes in disposable income and patterns of consumption, and so on. To capture all of the effects of a particular policy change, economists use "general-equilibrium" models that attempt to reflect behavioural relationships within the economy. We have used such a model to simulate the economic impact of the changes in taxes and government expenditures underlying the constitutional options described earlier.

Figure 5-2 presents an assessment of the long-run and *permanent* economic impacts on the residents of each region of these economic policy changes in terms of general direction and approximate relative size. We chose to express the model results in this way to underline the limits of any model in predicting the real economic impact of such changes. A detailed description of the results of the model is presented in Appendix E. Note that these results do not take into consideration the path of adjustment or the transition costs that may be incurred in going from one situation to another.

The first column in Figure 5-2 shows the impact of the moderate-decentralization scenario. Residents of the Atlantic region and British Columbia and the territories would see their standard of living decline significantly (around 2 per cent) if this scenario were to be implemented, while those of Ontario would experience a slight increase (in the order of 1 per cent). The impact on a particular region reflects a number of effects. The most important is a decline in income, occurring in regions that are net recipients of the federal transfers (see Chart 5-3). The Atlantic region and British Columbia and the territories would give up more in federal transfers for health, education, and social welfare (under EPF and CAP) than they would gain from reduced federal taxes. Provincial incomes would therefore be reduced, which is the principal cause of negative impact. Second, changes in the tax structure and in the income distribution induced by the new policy regime would imply altered patterns of demand for goods and services, as well as related price changes – more specifically, changes in the terms of trade (i.e., the relationship between the prices that a province receives for the goods and services it produces and sells to another province, and the prices of the goods and services that it imports from that province). A decline in a region's terms of trade reflects a deterioration in its purchasing power; it receives fewer import goods in exchange for any given level of exports. In the moderate-decentralization option, only Manitoba and Saskatchewan enjoy an improvement in terms of trade; the other provinces experience small declines or no change.

In the second option – extensive decentralization – which assumes that the provinces also take over responsibility for transfers to individuals (Old Age Security, family allowances, and so on) and to business, the size of the impacts increases dramatically. The negative effects for the Atlantic provinces, Saskatchewan, and Manitoba increase substantially to a range between 4 and 8 per cent of their respective regional incomes (GNPs). Manitoba and Saskatchewan see their fortunes deteriorating substantially because of the removal of agricultural subsidies (which have been exceptionally high in recent years). This also explains why Alberta loses, compared with the previous option. For British Columbia and the territories, the costs of this option are not changed much from those in the moderate option. Both Quebec and Ontario residents would gain from the extensive option.

The long-run economic impact of moving from the status quo to the confederation-of-regions option is illustrated in the third column of Figure 5-2. Under this option, regions that used to receive equalization payments would see their situation deteriorate, while there would be an improvement for Ontario, Alberta, and British Columbia because their federal tax burden would decline. The impact on the Atlantic provinces and the Prairie region would be devastating: the cost in the Atlantic region would approximate 23 to 27 per cent of the regional income and fall in the area of 15 per cent for Manitoba and Saskatchewan.

The impacts of sovereignty-association are captured in the fourth column. In this case, Quebec and its residents would receive no federal transfers, no equalization payments, and federal spending on public goods and services in Quebec would be practically eliminated. In turn, Quebec residents would pay no more federal taxes. The cost to Quebec would amount to between 1.5 and 3.5 per cent of its provincial income. Other provinces would lose or win, depending on their current contribution to the equalization payments to Quebec and on the extent of their trade with that province. But in all cases, the changes in economic well-being are close to zero.

Government Efficiency Gains

One source of potential gains from decentralization that is not captured in the model's results is the reduction in waste and duplication that could follow from the elimination of overlapping areas of jurisdiction. We have no evidence as to the real extent of savings that could result from the disentanglement of provincial and federal jurisdictions. Those potential efficiency gains are reported in Figure 5-2 as positive signs for all options except moderate decentralization, where any such gain would be quite marginal. It is impossible to measure the size of these gains with any degree of accuracy, but they are likely to be very small compared with the costs and benefits just described above.

Transition Costs

The bottom of Figure 5-2 lists a series of transition costs that would have to be faced under the various constitutional scenarios of reconfederation. Transition costs can be very high. Their size is mainly a function of the level of social and political harmony prevailing in a period of constitutional change. But even in the best climate possible, some transitional costs will be incurred, as people and corporations adjust to the new political realities and as financial markets react to the increase in uncertainty and then reassess the long-term risks associated with the new structure.

On the basis of the typology of financial risks exposed earlier, one can expect that *political*-risk premiums would be incurred whenever structural changes are substantial. The costs involved would increase with the duration of the transition period and with the level of acrimony that might occur between the parties. Also, the premiums would be larger in the case of the sovereignty-association and confederation-of-regions options, as the changes would likely involve the transformation of important political institutions.

Default-risk premiums would also be part of any scenario involving a reallocation of the public debt. The mere fact that debt reallocation would remove the federal government as a possible guarantor in case of default would give rise to a premium. The smaller the region, the higher the premium would likely be.

With respect to *currency*-risk premiums, one can expect nervousness on financial markets if discussion about a possible provincial or regional representation on the board of directors of the Bank of Canada triggers some questions about the influence of the provinces or regions on the conduct of monetary policy. This is likely to become an issue under all options, except perhaps the moderate-decentralization scenario. However, the currency-risk premiums would be much smaller under any option that preserves a common currency, as this would go a long way towards reassuring lenders about the security of their assets.

The Canadian economy is certainly robust enough to absorb the pressures of a temporary increase in the risk premiums embodied in interest rates. But any increase in default risk that would lead to a permanent downgrading of the credit rating of all or some of the regions would undoubtedly impose a high cost on future generations.

The negotiation of debt arrangements would be difficult and could involve substantial administrative costs. Other transition costs would be incurred as well under those scenarios which involve important changes in institutions. For example, in the case of sovereignty-association, some international treaties would need to be renegotiated; since both Quebec and the rest of Canada would be smaller, they would likely have to make concessions to their respective partners. These costs could be small if negotiations and relations between the Canadian parties remained harmonious.

In the extreme case of a fragmentation of the economic and monetary union resulting from one or more provinces or regions seeking independence in an acrimonious political climate, the cost of renegotiation could be substantial. The increase in risk premiums discussed above would be large. In addition, there could be difficulties associated with the flight of people and capital if political instability reached a level that citizens found unacceptable. These costs would affect *all* Canadians – and thus they highlight the importance of maintaining a climate of reason in the debate on constitutional change.

Conclusion

The analysis in this chapter shows that Canada is indeed a joint venture where the partners must constantly be aware of each other's aspirations and needs. Any alteration to the fiscal and trade linkages outlined in Chapters 3 and 4 has a bearing on the economic well-being of all provinces. In the short to medium term, the transition costs – the risk premiums imposed by financial markets – are significant. Even in the long run, the more radical options may entail a serious penalty in terms of higher real interest rates. And also in the long run, the well-being of individual citizens is affected – in some cases positively; in other cases, negatively. But we cannot be certain about any of the possible outcomes described here: it is arguable whether even the gains of the winners in any option are large enough to offset other costs that cannot be quantified.

The analysis shows that some options are more viable than others. To be economically viable, the status quo needs some important adjustments to deal with the inconsistency between the reduction in cash transfers from the federal government and the promotion of national standards. It also needs a new decision-making apparatus that can foster the coordination of federal and provincial actions, especially in the areas of taxes and fiscal policy. But it is questionable whether the "status quo" is politically acceptable to many Canadians.

The confederation-of-regions solution would place some provinces in a situation of such deprivation that it must be excluded from the range of viable possibilities. It would take a major crisis to make it worth investigating further – and even then, its merits and drawbacks would have to be compared with those of other alternatives, such as the eventual annexation of some regions to the United States.

From an economic point of view, Canadians therefore seem to be left with three possibilities among the stylized options reviewed in this chapter – moderate or extensive decentralization, or sovereignty-association. In the real world, of course, there may be scope for blending these options into yet another variation of federalism, including different forms of asymmetric federalism that would go beyond the degree of asymmetry that prevails currently.

The main concern in the case of extensive decentralization would be the negative effect that it would have on the provinces with lower fiscal capacities. They are likely to object strongly to any decentralization unless arrangements are made to reinforce the equalization system. A second concern would be the need to create effective institutions to coordinate and harmonize government decisions.

In the case of asymmetric federalism and sovereignty-association, Quebec would bear most of the direct cost of changes to the tax and transfer systems. Those Quebecers who expect large dynamic gains from more autonomy would also expect that citizens would be economically better off in the long term. However, for asymmetric-federalism options to be sustainable for both Quebec and the other provinces, the question of political representation in central institutions might have to be addressed. This is the major unknown in any asymmetric option: how to build accountable institutions where voting rights are allocated in ways that meet the aspirations and requirements of all the players. With respect to sovereignty-association as proposed by the Parti Québécois, there would be no problem of political representation, but a similar issue would be raised with respect to representation on administrative bodies such as the Bank of Canada and others that would deal with areas of joint concern.

Finally, it is important to note that all the provinces share the same economic system. This means that they would all share in the transition costs and in the cost of any failure to build the necessary coordinating institutions. Both the transition costs and the risks of uncoordinated actions increase as the political change becomes more radical. At the same time, these costs and risks can be minimized – but not eliminated – if the participants are successful in avoiding an escalation in political tension.

6 A Joint Venture

Canadians stand on the brink of a crucial moment in the history of their country – a moment where they will make decisive choices about their future. In coming consultations, referendums, and elections they will be asked to choose among different visions of Canada – to determine their future relations with fellow citizens in other linguistic and cultural communities and in other regions of Canada.

How can one hope to come to grips with the complexity of the issues involved and, in the end, make the right choice? The Council does not claim to know what all the features of a renewed Canada should be. Our aim, in this Review, has been to clarify the stakes involved, from an economic perspective. As Chapter 5 showed, no economic analysis can be comprehensive or definitive; but we know that the economic costs of political change can be significant.

However, we think that Canadians may find their way out of the economic maze by focusing their attention on two issues. The first is the need to create wealth. Any new political structure should promise better prospects for sustainable growth in standards of living. Right now, governments, business, labour, and other economic agents lack the political will to address this challenge as a joint venture; they are still wrestling for bigger portions of a pie that is not growing nearly as fast as it used to. The second issue has to do with choosing how the risk of economic hardship and the proceeds from economic growth will be shared in the Canadian joint venture.

Creating Wealth

It is clear that the current constitutional crisis is accentuated by a host of fiscal and economic pressures. Underlying the current tensions is the fact that many Canadians have been unable to preserve their standard of living in recent years and that governments can no longer conceal this with debt-financed transfers to those individuals and businesses most affected. This, in turn, is giving rise to serious questions about the role and leadership of governments in the economy.

In this Review and in its recent Statements, the Council has emphasized that increases in the standard of living come first and foremost from improvements in productivity and from innovation that leads to the diversification of output into higher-value-added products. Those will be key elements in the future success of Canadian products on world markets, and thus the source of good jobs for Canadian workers.

Also needed is a policy framework that can provide the proper context for productivity growth and innovation and that can facilitate the necessary modernization of the industrial base. For the Council, the proper framework requires policies directed at reducing the indebtedness of governments, creating employment, and controlling inflation. These are essential objectives to ensure sustainable growth in the future. However, the economic strategy used to attain these objectives is also important. We have argued in the past that the current approach is flawed because it relies too much on the blunt instrument of tight money to fight inflation. This leads, more often than not, to bouts of high unemployment. The objectives of high employment and price stability should be given joint priority, and that can be more readily achieved if the provinces and business and labour leaders participate in the identification of economic priorities and the selection of the proper targets. Unfortunately, this approach is out of reach in the short run. Hence the heavy toll of the recessions of 1981-82 and 1990-91, and the long delay in the process of disinflation, now finally under way.

In Chapter 2, we observed that the main threats to the current recovery are the inconsistent expectations about the future path of inflation and an unfortunate policy mix of fiscal ease and tight money that leads to an overvalued currency. The best way to support the recovery over the next few years is to contain cost pressures in the private sector and, at all levels of government, to refrain from introducing inflationary taxes or regulatory decisions and from excessive growth in total spending. The right combination of federal and provincial fiscal restraint and monetary accommodation over the next few years will facilitate a rebound in employment, a decline in the federal deficit, and a better inflation performance. Progress on all three fronts would add immeasurably to public confidence in Canadian institutions.

Once the expansion is well under way, the breathing space should be used to establish appropriate longer-range targets for price stability and to agree on the respective roles of governments and the private sector in striking a balanced set of economic goals. The experience of the past two years should not be allowed to repeat itself: we cannot afford to discover once again, a decade from now, that the only way to deal with inflationary pressures is to endure another devastating blow to employment and potential permanent damage to the economy.

A third and final element of wealth creation is an efficient economic union. Chapter 3 makes it clear that the provinces cannot ignore the internal Canadian market: they are bound together by trade and commercial ties. Indeed, for each province, the rest of Canada still constitutes a strategic trading partner. On average, 19 per cent of provincial output, and hence provincial income, is generated by sales to other provinces. Moreover, interprovincial migration may account for as much as 8 per cent of job changes in the Canadian labour market in a given year. In short, whatever the political structure, the federal government and the provinces are obliged to accept responsibility for governing a shared economic system. This demands a genuine commitment by all provinces to remove barriers to interprovincial trade. But even more important, in our view, is the need to coordinate federal and provincial decisions on economic policy.

In Chapters 2 and 4, we showed that the federal government no longer has the economic clout to operate on its own, independently of the provinces. Indeed, the larger provinces now have enough clout to seriously disrupt the success of national policy choices. At the same time, the slowdown in productivity growth leaves Canada less room to make mistakes. Hence new decision-making systems are needed to make Ottawa and the provinces jointly accountable for the efficient operation of the union, and to ensure that they pursue compatible economic objectives.

The example given in Chapter 3 is budget coordination. The federal government and the provinces should abandon the tradition of budget secrecy. Instead, they should publish their fiscal plans and economic forecasts for public review, so that the ministers of finance and the public can debate the contradictions before formal budgets are tabled. This exposure to public critiques and frank discussion among ministers should lead to better coordination of budgetary policy and tax policy, and of the many other social and economic policies that are often addressed in budgets nowadays. The process could be strengthened if an organization with an analytical capacity were designated to assess the consolidated impact of federal and provincial fiscal plans and thus expose any inconsistencies to the public.

There will always be differences in provincial circumstances that will call for different policies and differences of views among governments with respect to the best policy choices. But in a joint venture where the participants actively work together, there are better chances of finding compromises and common ground than if everyone acts in isolation. When governments undermine each other's actions through conflicting policies, they make hard choices even harder; they foster cynicism instead of support from the public; and they also shrink the size of the pie to be shared among Canadians.

Terms of the Joint Venture

The other important issue that Canadians must address is whether they wish to maintain similar policies across the country for the redistribution of income and for sharing the risks of economic adjustment. Should the common standards of services and taxation across the country remain a fundamental aspect of Canadian citizenship?

In view of the speed of technological change and of the pressures of international competition, Canadians everywhere will want to preserve a solid system of safety net and insurance schemes to guard against economic upheaval. In order to make this a reality, future constitutional arrangements will have to preserve a strong element of interregional sharing. We have shown in Chapter 5 that the elimination of equalization would make it impossible for the have-not provinces to deliver basic social insurance to their citizens at tax rates that compare with those in other provinces.

But even if there is agreement among Canadians on the need for the preservation of a safety net and some form of equalization, the fundamental dilemma remains. Which vision of sharing should be favoured? The broad vision, which rests on the conviction that Canadians in similar situations should have access to similar public services with roughly similar tax burdens regardless of where they live in Canada? Or the communities vision, which insists that regional variations in basic standards of support for individuals (income support for families with children and the elderly, public pensions, unemployment insurance benefits, and so on) and in public services such as health care and education are appropriate, desirable, and acceptable?

More bluntly, should elderly people in Cape Breton, the Beauce region, and the Okanagan Valley have access to roughly the same social security and health services? Should we strive for education and training opportunities that are similar all across the country? Or should each province be responsible for setting standards of support and then developing its own programs?

Addressing this issue is a fundamental step in determining, first, the division of responsibilities between the federal government and the provinces; and, second, the need for national standards in public services.

At the moment, the tide is running in the direction of decentralizing, for both political and fiscal reasons. However, the fiscal constraints may well diminish over time. As the analysis in Chapter 4 pointed out, Canadians should not assume that the federal government will be permanently handicapped by its current fiscal crisis. Our projections show that if the government maintains its current fiscal plan, it should have room to repay its debt and to consider tax cuts or spending increases after the mid-1990s. Thus the question of the size and role of the federal government should be decided on its own merits.

In our view, Canada can flourish as an economic and monetary union under either the broad or the communities vision of sharing, as long as all governments are prepared to commit to the effective management of the economic union. To make this commitment, they must create a set of decision-making systems that correspond to their vision of sharing. The further the country moves in the direction of decentralization and the communities view of sharing, the greater the risk of losing the gains from the economic union. At each step of the discussion in Chapter 4, we mentioned alternative mechanisms to preserve the union. Some of the possibilities are set out in Figure 6-1. Each has its advantages and disadvantages in ensuring the mobility of people, goods, services, and capital; in establishing the common standards for public services such as health care; and in coordinating federal and provincial economic policies.

In a centralized system, for example, binding rules of the game – rules that are enforceable before the courts – can be spelled out in federal laws or even in the constitution. In other cases, nonbinding mechanisms can be put into place through conditional federal funding of provincial services or through federal/provincial agreements. The rules of the game can also be made binding in a decentralized system, but, in this case, they come from interprovincial contracts or treaties, or possibly from independent adjudicating bodies designated by federal and provincial governments to manage specific aspects of the economic union.

Figure 6-1

Alternative Mechanisms for Preserving the Economic Union[1]

Binding ↓ Nonbinding	Centralization →	Decentralization
Binding	– Uniform federal laws and regulation – Direct federal spending – Constitutional entrenchment	– Interprovincial contracts or treaties enforceable by the courts – Independent adjudicating bodies with regional representation – Constitutional entrenchment – European Community directives
Nonbinding	– Conditional funding – Direct spending (with opting-out provisions) – Regular federal/provincial conferences	– Codes of conduct – Interprovincial agreements – Regular federal/provincial conferences

1 By preserving the economic union, we mean preserving the capacity 1) to enforce the four fundamental freedoms (mobility of goods, services, capital, and labour) of market integration; 2) to promote national standards for public services; and 3) to ensure the coordination of economic policies.

Alternatively, a decentralized system can rely on good will, using codes of conduct and less formal interprovincial agreements to ensure that goods, services, people, and capital can move across provincial borders without interruption.

Whether the system is centralized or decentralized, the binding approaches tend to reduce provincial autonomy, and they are more difficult to negotiate. But, of course, they offer greater stability and better guarantees for citizens. The nonbinding approaches, on the other hand, are easier to negotiate in the first place, but they offer no guarantee against bad faith or against a change in priorities by the participating governments.

The upshot is that provincial autonomy is not determined by the degree of decentralization, so much as it is by the decision-making rules that govern intergovernmental agreements. There is a distinct trade-off between the stability and certainty of binding systems and the flexibility of those that are not binding. An efficient economic union will need some guarantees, as well as the flexibility to adapt over time. This leads us to two conclusions: first, in cases where guarantees are required, it is better to use binding agreements or laws than constitutional entrenchment, because constitutions are too difficult to amend and they leave too much room for interpretation by the courts; second, whether agreements are binding or not, there are many areas where it would be better to adopt a qualified majority voting rule. Even the European Community has found, for example, that the requirement of unanimous consent leads to paralysis and has replaced it with qualified majority voting in all but a few areas.

In the Chapter 3 discussion on preserving the economic union and on the possibilities of improving the status quo version of federalism, we indicated a strong preference for nonbinding mechanisms that rely on the political process as the main engine for setting common standards and objectives for the economic union. However, we recognize that if Canada were to take the path of extensive decentralization (or sovereignty-association), more-binding mechanisms might become necessary in order to ensure the efficiency of the economic union.

The dilemma then is not whether it is possible to achieve a more decentralized federation; it is to reach a decision on one vision of sharing. Can a compromise between the two be reached? In the models that we have analysed, a devolution of powers along the lines of the extensive-decentralization option would correspond to the communities vision of the federation, but it would be unacceptable to the proponents of the broad vision. A more moderate form of decentralization could be attempted as a middle ground, but it would require compromises from both groups. For the proponents of the communities vision, it falls short of delegating exclusive responsibilities in such strategic areas as regional development, training, culture, and unemployment insurance. For the proponents of the broad vision, it would be acceptable only if an alternative route is found to enforce national standards in health care, education, and social security.

If, in the end, Canadians are unable to agree on a single unifying vision of sharing, they need not abandon the joint venture. The traditional Canadian values of tolerance and mutual respect have already produced an array of creative compromises and special arrangements to accommodate the diversity of the provinces. Some of these arrangements reflect the realities of geography, language, and special economic circumstances described in Chapter 3. Others simply reflect political preferences. Thus the federation may offer the latitude for more asymmetric arrangements that permit the co-existence of two visions of sharing in one political structure. However, that choice would raise a host of political questions that are beyond our expertise.

We can conclude, nonetheless, that all Canadians could agree that they wish to see a political structure that will be more successful in creating wealth – a joint venture that fosters productivity and innovation, that can mobilize the coordination of fiscal and monetary policies, and that can preserve and reinforce the economic union.

In summary, a successful economic union is needed to increase the size of the pie. With that as a common starting point, we hope that the current constitutional debate can be transformed into an opportunity to renew the terms of reference for a joint venture dedicated to improving the well-being of Canadians. The terms of reference will also have to specify how the pie is to be shared and how federal and provincial governments will work together. Canadians have demonstrated that it is possible to build a successful economic union around diversity as long as all the players are truly committed to the joint venture.

Comment by Pierre A. Paquette and Marcel Pepin

Our comments concern Chapter 2 of the Review, which deals with the medium-run economic outlook.

First of all, we believe the Council is too optimistic about the end of the recession and the certainty of recovery. On the basis of information available at the time of publication, the recovery still looks very fragile, even doubtful. Second, we think the Council gives too much emphasis to the possibility that the recovery might take place too quickly. The Council refers to this possibility in warning against inflationary pressures and speaking approvingly of the Bank of Canada's restrictive monetary policy and the deflationary budgets adopted by the federal government and most provinces.

In our opinion, these policies have had a dramatic impact on the Canadian economy, resulting in an unemployment rate that remains in the double-digit range. That is why we cannot endorse the Council's approval of restrictive fiscal policies designed to "fight inflationary pressures"; in our view, these measures are likely to prolong the recession and maintain unemployment at high levels. In addition, this assessment by the Council ignores the fact (acnowledged elsewhere in the text) that current levels of inflation are not market-based, but instead result primarily from increases in taxes and regulated prices, and especially from the introduction of the GST.

Along with other Council members, we deplore the lack of coordination between federal and provincial monetary and fiscal policies. We do not believe, however, that this lack of coordination gives the Council grounds for singling out the government of Ontario for criticism because of its refusal to follow the other provinces and impose restrictions on public-sector wages and public spending. In our opinion, economic developments over the past year confirm what the Council suggested in its 27th Review – namely, that Canada and the provinces should make it a priority to create jobs and control inflation through means other than fiscal and monetary tightness. The 27th Review stressed the importance of cooperation among all socio-economic agents, but it seems obvious to us that some government actions are in direct conflict with such an approach.

This is particularly true of the steps taken by the federal government and some provinces to maintain wage increases below the inflation rate, on the pretext that this will help the fight against inflation. Such measures do not attack the real sources of inflation in 1991, and they fail to take into account the fact that wage increases over the last decade have consistently trailed behind price increases. Like similar measures adopted in the past 20 years – Bill C-73 in the 1970s and the "6 and 5" program in the early 1980s – the current wage restrictions will simply shift a disproportionate share of the burden of fighting inflation to Canadian workers.

Appendices

A Economic Conditions in the United States

Conditions at the Peak of the Business Cycle

The U.S. economy entered a recession during the last quarter of 1990, following the second longest expansion in five decades. Output growth started to slow down during the spring of 1989 in response to tighter credit conditions. Over the previous year, the Federal Reserve Board acted to reduce inflationary pressure by curbing excess demand in both product and labour markets. The resulting slowdown in growth led the Federal Reserve to ease credit conditions in late 1989 in an attempt to permit gradual relief of inflationary pressures, accompanied by moderate output growth – a soft landing.

The Federal Reserve eased monetary conditions again in 1990 in response to the adoption by Congress of a multiyear federal deficit reduction plan and to an unusual tightening of credit by commercial banks, as financial-market regulators reacted to the Savings and Loan crisis by asking for stricter standards of creditworthiness.

Three other factors contributed to the downturn – the rapid growth in consumer and business debt ratios, the persistence of high commercial-property vacancy rates, and the confidence factor associated with the Persian Gulf crisis.

Despite falling capacity utilization rates and widespread conditions of excess supply, the core rate of inflation (as measured by the year-over-year rate of increase in the CPI, excluding food and fuel) reached 5.5 per cent during the first quarter of 1991 – the highest rate since the third quarter of 1982. However, the core rate of inflation decelerated to 5.1 per cent during the second quarter, and continuing moderation in the growth of wages and of nonfood, nonenergy producer prices point to a continued easing of underlying inflationary pressures.

The federal budget deficit (measured on a unified basis) posted a large deterioration in fiscal year 1990 (climbing by nearly $70 billion to $220 billion), caused by the impact of automatic stabilizers and by the Savings and Loan bailout. The economic slowdown also eroded the fiscal position of state and local governments, reducing their overall budget surplus to about $39 billion, the lowest level since fiscal year 1982.

On the other hand, the economic slowdown in the United States helped to reduce the U.S. current-account deficit by $14 billion in 1990.

The U.S. Base Case

The medium-term projections for the U.S. economy rest on the assumption that the current direction of monetary and fiscal policies will reduce internal and external imbalances while maintaining sustained growth and stable inflation.

The base case assumes that the U.S. recovery began during the second quarter of 1991. Lower interest rates, lower oil prices, and reduced uncertainty have all made their contribution to the recovery. However, as the 1990-91 downturn was one of the shallowest on record, the rebound from this downturn will also be shallow. Also explaining the moderate strength of the recovery is the fact that the potential growth rate of the U.S. economy is not nearly as high as in previous decades, because of much slower growth of the labour force and of labour productivity (Table A-1). In addition, the lingering problems of high vacancy rates in commercial property, including apartments, will dampen the rebound in these interest-sensitive sectors.

The desynchronization of international monetary policy (looser monetary conditions in the United States and tighter monetary conditions in Germany and Japan) should produce faster growth in the United States than in the other G-7 economies, but this is not expected to have much of an impact on U.S. imports (world exports), as the real exchange rate of the U.S. dollar will continue to depreciate in 1991 and 1992. This will limit the increase in the U.S. demand for foreign products.

Inflation Targets

In the medium term, the base case assumes that the Federal Reserve Board will seek to avoid a re-acceleration of inflation. However, the emphasis will be on a low, stable rate of inflation as opposed to price stability (zero inflation). We expect monetary conditions will allow output growth to be in excess of potential during the period 1992-94,

Table A-1
Base Case: Selected Indicators for the United States, 1986-2000

	Actual,	Projection					Average		
	1990	1991	1992	1993	1994	1995	1986-90	1991-95	1996-2000
External environment									
					(U.S. dollars/barrel)				
Price of crude petroleum	22.35	19.80	21.06	22.19	23.69	25.21	17.50	22.39	29.74
					(Per cent)				
Growth in:									
Producer price index[1]	16.2	9.3	9.1	8.1	7.8	8.0	12.3	8.4	8.4
Real GNP[2]	2.5	1.1	2.4	3.3	3.6	3.9	3.4	2.8	3.5
United States									
Growth in:									
Real GNP	1.0	–0.1	3.3	3.8	3.6	2.8	2.8	2.7	2.3
GNP deflator	4.1	3.5	3.5	3.3	3.5	3.8	3.5	3.5	3.8
Nominal GNP	5.1	3.4	6.9	7.3	7.2	6.8	6.4	6.3	6.2
Consumer price index	5.4	4.4	3.8	4.5	4.3	4.2	4.0	4.2	3.8
Civilian labour force	0.8	0.9	1.6	1.6	1.4	1.4	1.6	1.4	1.3
Labour productivity	–0.9	1.0	2.2	2.0	2.3	1.8	0.8	1.9	1.5
Level of:									
Unemployment rate	5.5	6.7	6.6	5.9	5.1	4.8	5.9	5.8	4.6
Participation rate	66.4	66.4	66.8	67.2	67.5	67.8	65.9	67.1	68.5
Federal funds rate	8.1	6.0	5.8	6.1	6.8	7.3	7.7	6.4	7.4
As a proportion of GNP:									
Federal deficit	–3.0	–2.8	–2.3	–1.4	–0.7	–0.5	–3.4	–1.5	–
Current-account balance	–1.8	–0.1	–0.7	–0.5	–0.3	–0.2	–2.7	–0.4	–0.3
					(Dollars)				
Minimum wage	3.69	4.14	4.25	4.50	4.68	4.87	3.42	4.49	5.48
					(Per cent)				
Growth in:									
Federal wages	4.8	7.9	6.5	4.0	4.0	4.0	4.4	5.3	4.0
State and local wages	4.5	4.3	3.4	3.5	4.0	4.4	5.0	3.9	3.9
Level of tax rates:									
Personal income tax	11.8	12.0	12.1	12.0	11.9	11.8	11.6	11.9	11.4
Statutory corporate income tax	34.0	34.0	34.0	34.0	34.0	34.0	37.6	34.0	34.0
Growth in real federal expenditure on goods and services:									
Defence	0.9	0.2	–6.2	–3.5	–2.5	–3.6	1.8	–3.1	–0.9
Nondefence	8.0	–	–1.6	–1.5	1.2	2.5	–0.3	0.1	2.0
Total	2.6	0.2	–5.1	–3.0	–1.6	–2.0	1.1	–2.3	–
					(Per cent)				
U.S. dollar index	190.2	202.7	211.9	212.0	213.1	215.5	163.5	211.1	233.8

1 Trade-weighted index of producer price indices (excluding food and energy) of U.S. trading partners.
2 Trade-weighted index of real GNP of U.S. trading partners.
SOURCE Estimates by the Economic Council, based on projections from the WEFA Group.

resulting in a gradual elimination of unused capacity. Thereafter, output should grow at its potential rate, with the inflation rate settling between 3.5 and 4 per cent.

At the same time, real interest rates will remain relatively high by long-run historical standards – but not nearly as high as has been the case recently. Pressure in financial markets from a sustained increase in worldwide investment activities – including the modernization of plant and equipment in eastern Europe, the needs of German reunification, the ongoing needs of the Soviet Union, reconstruction in the Persian Gulf, and the ever-present needs of developing countries – will be offset only in part by an increased North American capacity to generate domestic savings.

Savings Capacity

The management of aggregate demand by the Federal Reserve Board will be facilitated by a restrictive fiscal policy aimed at reducing gradually the budget deficit and increasing domestic savings capacity. A balanced budget will be attained during the second half of the decade. This will allow a steady decline in the federal debt outstanding as a share of GNP from a peak of 67 per cent in 1993 to about 52 per cent in the year 2000. It is assumed that the Administration will take advantage of the easing of East-West relations and cut defence spending in real terms over most of the next 10 years. Restraint will also extend to real purchases of nondefence goods and services.

One benefit expected from an improved fiscal position is an increase in national savings relative to GNP. This will benefit credit markets. Although the personal savings rate will remain low and the current account will remain in deficit, increasing financial requirements for domestic investment purposes will rely less and less on foreign savings. Finally, the reduced level of government dissaving and the related increase in national savings – as well as the reduction in U.S. real interest rates, in comparison to foreign rates – will produce downward pressure on the U.S. real trade-weighted exchange rate. With renewed growth in foreign economies, this is expected to bring the current account balance to a much more favourable position.

B Long-Run Inflation Targets

The purpose of inflation targets is to anchor expectations and thus influence wage and price decisions. The Council argued in its 27th Annual Review that setting credible targets would help Canadians to sort out the confusing signals – distorted on the high side by a reform of indirect taxes and on the low side by an overvalued currency – from the trend in inflation. Targets are also useful when the authorities are in the process of implementing a structural shift in the policy regime.

The targets for inflation set out jointly by the Minister of Finance and the Governor of the Bank of Canada in February 1991 are: 3 per cent by the end of 1992, 2.5 per cent by the middle of 1994, 2 per cent by the end of 1995, and price stability beyond 1995. (An allowance was made for fluctuations of 1 percentage point in either direction.) A working definition of price stability is still to be determined, but it is expected to be in the range between zero and 2 per cent of measured inflation. The purpose of this appendix is to comment on some of the problems involved in specifying an appropriate long-run inflation target.

The relation between unemployment and inflation in the short and long run (the so-called Phillips curve)[1] is a fundamental ingredient in setting the target. In the base case, we have assumed a conventional Phillips curve – one that is devoid of problems arising from hysteresis[2] and is not subject to money illusion[3] – with a sacrifice ratio[4] of about four. But the cost of reducing inflation (the sacrifice ratio) could be much higher if the Phillips curve is subject to hysteresis or is predicated on the fact that workers are unwilling to accept moderation in nominal wage demands that would be required to lower inflation close to zero.

One simple way to illustrate how one can consider the costs and benefits simultaneously is to proceed with an explicit welfare function defined on current and future unemployment and inflation rates as suggested by Pierre Fortin.[5] Using Fortin's methodology, Table B-1 shows how large the benefits of lowering inflation for a year by 1 percentage point must be (expressed as a share of real GDP) in order to compensate for the loss of output that will be required to achieve this reduction in inflation. For example, the benefits of reducing inflation by 1 percentage point must be greater than 0.08 per cent of GDP in the initial year for such a policy to be worth implementing. If hysteresis is present, the benefits of lowering inflation by 1 percentage point must be at least 4 per cent of the base-year GDP to make the disinflation exercise worthwhile. Thus the size of the required benefits varies, depending on the assumed structure of the Phillips curve. As a result, the *major* risk facing policymakers is *uncertainty* related to both the size of the benefits and the true structure of the economy, as characterized by the Phillips curve.

Except for another paper by Fortin,[6] little evidence exists to support hysteresis[7] at the macro level for Canada. But research using micro datasets – some of which have been reported in the section on "The Unemployment Damage" in Chapter 2 – reveals a significant relationship between the length of unemployment spells and number of spells, when a variety of other factors that may have a direct influence on the length of spells are taken into account.

Thus there is the possibility that further work might confirm the presence of hysteresis (not to be confused with structural adjustments) in Canadian labour markets.[8] More work is required to help settle the question. Similarly, formal statistical tests of money illusion (or nominal wage rigidity) at low levels of inflation have not yet yielded positive results. Nevertheless, because Canada has not experienced such a low inflation regime for any significant period of time, we cannot exclude the possibility that nominal wage rigidity exists at low levels of inflation. There are other possibilities that are not as yet fully tested (or testable for Canada) that would cause wages to be less responsive to the output gap when inflation is low than when inflation is high.[9]

As to the benefits of reducing inflation, there exists two estimates for Canada. That of Peter Howitt is based on efficiency considerations and, in the current context, is equal to 1.8 per cent of GDP.[10] This estimate implies a benefit equal to 125 per cent of the base-year GDP (in present value terms) if the reduction is permanent. The estimate by Jarrett and Selody[11] suggests a present-value estimate of 1,600 per cent. Howitt considers his figure to be conservative, while the Jarrett and Selody estimate is considered high. As shown by this range of estimates, there are enormous theoretical and empirical difficulties in assessing such benefits. In addition, as in the case of the costs of disinflation, there is

Table B-1
Benefit[1] Required to Reduce Inflation by 1 Percentage Point for One Year[2]

	Benefits required, assuming a discount factor of:	
	1 per cent	2 per cent
Assumptions with respect to the Phillips curve:		
Natural-rate hypothesis[3]	0.04	0.08
Hysteresis[4]	4.00	4.00
Wage rigidity[5]	2.02	2.04
Wage rigidity and hysteresis[6]	84.0	44.0

1 As a proportion of GDP.

2 Following Fortin, assume the following representation of the Phillips curve:

$$\dot{p} = a \times \dot{p}_{-1} - b \times [(1-h) \times u + h \times (u - u_{-1})] + c$$

where $\dot{p}$ and $\dot{p}_{-1}$ are the current and previous years' inflation rates; u and u_{-1} are the current and previous years' unemployment rates; and a, b, h, and c are "parameters." Assume a welfare-loss function for inflation and unemployment that is equal to the present value of annual current and future losses, of the form:

$$k_{\dot{p}} \times \dot{p} + k_u \times u$$

where $k_{\dot{p}}$ and k_u are the marginal costs of inflation and unemployment as a proportion of GDP.

It can be shown that for a marginal increase in u (increasing unemployment by 1 percentage point) to ensure an increase in welfare, we must have:

$$k_{\dot{p}} > k_u \times (d+1-a) / b \times (d+1-h)$$

where d is the net discount factor (the real interest rate minus the rate of growth in real GDP). The table reports the required marginal benefit $-k_{\dot{p}}$ for various values of d, a, and h, assuming $b = 0.5$ (the slope of the short-term Phillips curve), $k_u = 2$ (Okun's coefficient, the percentage-point increase in the unemployment rate for one year, consistent with a 2-per-cent reduction in GDP).

In the base case, we assume $a = 1$ and $h = 0$, so that $k_{\dot{p}} > 2 \times 0.02/0.5 \times (0.02 + 1) = 0.08$. This is compatible with a sacrifice ratio of 4 for the base case, that is:

$$k_{\dot{p}} > 2 \times 0.02 / 0.5 \times 0.02 = 4.$$

3 No hysteresis and no wage rigidity ($a = 1$ and $h = 0$).

4 Hysteresis but no wage rigidity ($a = 1$ and $h = 1$).

5 Wage rigidity at low levels of inflation ($a = 0.8$ and $h = 0$).

6 Hysteresis and some wage rigidity at low levels of inflation ($a = 0.8$ and $h = 1$).

SOURCE Economic Council, July 1991; and Pierre Fortin, "Credit crunches and wage dynamics: a revision of the Canadian Phillips curve, 1957-1987," a paper presented at the third annual conference of the Canadian Macro Study Group, Queen's University, Kingston, Ont., November 1989.

the question as to whether these benefits change as the rate of inflation changes.

Based on Howitt's estimate, there is a case for proceeding with disinflation under the assumptions of the base case, because the benefits are equal to 23 times the costs, using a discount factor of 2 per cent (i.e., 1.8/.08). On the other hand, if hysteresis is present, disinflating will reduce welfare because the costs would be more than twice the benefit.

Under limited and uncertain knowledge, a better way to proceed is in *probabilistic* terms. For instance, if one believes that the probability for hysteresis is low but significant (say 25 per cent) and the Howitt estimate has a 50-per-cent chance of turning out to be 1.8 per cent and a similar chance of turning out to be zero, then the expected cost of disinflation still exceeds the expected benefit – the required benefit is 1.06, while the expected benefit is only 1.8/2, or 0.9. Under these circumstances, a risk-averse policymaker would choose not to disinflate. If the subjective probability of hysteresis is 50 per cent, then the expected costs exceed the benefits suggested by Howitt, even if the benefits are certain.

Given these risks, it appears that more research is needed before policymakers can choose a target for the period beyond 1995.

C Corporate Linkages

To examine the interprovincial linkages that occur via the corporate sector, we have attempted to measure the out-of-province activities of corporations that have offices, plants, or subsidiaries in more than one province. Our analysis is based on Statistics Canada data pertaining to 646,174 corporations that filed income tax returns in 1987.

Income tax regulations require corporations to allocate their positive taxable income among the provinces where they have permanent establishments. This enabled us to proxy the activity of each corporation in each province by using an estimate of the revenues it earned in each province. Statistics Canada generated these estimates by applying the provincial distribution of each corporation's taxable income to its revenues. If a corporation did not have positive taxable income in 1987, Statistics Canada used the provincial allocation of its taxable income in the first year in which the company had positive taxable income, in the following order: 1986, 1988, or 1985. Using this methodology, 88 per cent of corporate revenues could be allocated by province.

The revenues of each corporation for which allocations could not be made were assigned to the province where the corporation's head office was located. Government crown corporations are in general nontaxable and thus most of them had all of their revenues assigned to the province where their head office was located. Of the 12 per cent of revenues that could not be allocated provincially, a proportion of 5 percentage points was accounted for by small firms (i.e., with less than $10 million in revenues) unlikely to have multi-province operations.

Intercorporate ownership linkages (i.e., parent/subsidiary links) were established by using Statistics Canada's Intercorporate Ownership File (ICO) to identify the corporation, trust, or individual that controlled each of the 50,593 corporations covered by the ICO in 1987. With respect to the 595,581 corporations not covered by the ICO, it was assumed that they were single-enterprise corporations (i.e., neither a parent nor a subsidiary). These firms were small in size and accounted for only 26.5 per cent of total corporate revenues.

The concept of control used by the ICO is based on the potential to make the strategic decisions of a corporation. In most cases, control is the result of owning more than 50 per cent of the voting shares of a corporation; however, control is sometimes assigned on the basis of minority control and interlocking directorships. Even with less than 50 per cent of voting shares, effective control can result from owning the largest block of voting shares. The ICO assigns effective control to the owner of a block of equity that has at least 33 per cent of the voting rights and that exceeds the sum of the next two largest blocks. In addition, the ICO assigns control to a holding company if the majority of board members of the held company are also members of the board of the holding company. Using these criteria, the ICO assigns a country location of control for corporations, but does not assign a provincial location of control for Canadian-controlled corporations.

To assign provincial locations of control, we used head-office location as a proxy for the location where strategic decisions potentially are made. For corporations that were part of a multi-unit enterprise (i.e., a group of corporations under common control), we used the head office of the ultimate parent. In cases where the Council believed that head-office functions were being carried out in a location different than that specified in a corporation's charter, the location of control was reassigned to the assumed location of head-office functions. For enterprises controlled by an entity other than a corporation – by a trust, for example – control was assigned to the province where the majority of the enterprise's assets were legally held (these enterprises accounted for 33 per cent of revenues). All location-of-control assignments made on the basis of assets were reviewed by the Council as well as by experts at the department of Consumer and Corporate Affairs and at Statistics Canada, to identify cases where the methodology may have resulted in an inappropriate location assignment. The Council alone was responsible for all final decisions regarding reassignment of location of control (reassigned enterprises accounted for 2.9 per cent of revenues).

Our assignment of provincial location of control must be interpreted with care. It is the shareholders of corporations who have the ultimate power to make important decisions concerning the corporations whose shares they own. Using the head-office location as a proxy for the location of control is probably not very controversial in the case of privately held corporations, since the residence of the shareholders and the head office are most likely to be in the same province. However, our proxy is probably less widely accepted in the case of public companies whose shareholders can live anywhere in the world. The issue is whether or not the decisions of firms reflect the priorities of the boards of directors (i.e., the head office) or those of the shareholders. We cannot aspire to resolve this question here, but it should be kept in mind when interpreting our results.

D Detailed Assumptions Underlying the Simulation of Government Revenues and Expenditures

Revenue and Expenditure Categories	Assumptions
HEALTH CARE PROGRAMS	
Health care	Growth of unit costs 1 percentage point faster than the rate of growth of gross domestic product (GDP) per capita.
EDUCATION AND LABOUR MARKET PROGRAMS	
Primary and Secondary Education	Growth of unit costs in line with rate of growth of GDP per capita.
Postsecondary Education	Growth of unit costs in line with rate of growth of GDP per capita.
Manpower Training (Other than Training Benefits under the Unemployment Insurance System)	Growth of unit costs in line with rate of growth of GDP per capita.
Unemployment Insurance (UI)	Gradual increase in UI training benefits, reaching the current statutory maximum 15 per cent of total UI benefits by 1994-95 in all provinces. For other UI benefits, growth of unit costs in line with rate of growth of GDP per capita and with increases or decreases in proportion to changes in the level of unemployment. Premium rates to be changed to ensure that premiums exactly equal benefits for all years between 1992-93 and the end of the simulation.
ELDERLY BENEFITS PROGRAMS	
Old Age Security	Growth of unit costs in line with the consumer price index (CPI).
Guaranteed Income Supplement	Growth of unit costs in line with the CPI *plus* an adjustment factor (–1 per cent per year) to reflect the maturing of the retirement savings system.
Spouse's Allowance	Growth of unit costs in line with the CPI *plus* an adjustment factor (–2 per cent per year) to reflect the maturing of the retirement savings system.

CHILD BENEFITS PROGRAMS

Family Allowances	Growth of unit costs in line with the "partial de-indexation" formula of CPI minus 3 per cent during the entire simulation period.
Child Tax Credits	Growth of unit costs in line with the "partial de-indexation" formula of CPI minus 3 per cent during the period to 1996-97 and full re-indexation to the CPI thereafter.
Child Care	Overall growth of expenditures implicitly in line with rate of growth of GDP.

SOCIAL WELFARE PROGRAMS

Social Assistance	Growth of unit costs in line with rate of growth of GDP per capita.
Other Social Welfare Services	Overall growth of expenditures in line with the ratio of growth of GDP.

REGIONAL DEVELOPMENT, NATURAL RESOURCES, CULTURE, TRANSPORTATION, COMMUNICATIONS, AND THE ENVIRONMENT

Regional Development, Natural Resources, and Culture	Overall growth of expenditures in line with rate of growth of GDP.
Transportation and Communications	Overall growth of expenditures in line with rate of growth of GDP *plus* overall incremental expenditures of over $600 million annually for 10 years starting in 1994-95, in line with projected renewal of transportation infrastructure.
Environment	Overall growth of expenditures in line with rate of growth of GDP *plus* overall incremental expenditures of over $300 million annually for 10 years starting in 1994-95, in line with projected renewal of environmental infrastructure (principally water and sewage-treatment facilities).

CATEGORIES OF EXCLUSIVE FEDERAL JURISDICTION

Equalization and Other General-Purpose Transfers	No change in current equalization formula, but current restrictions on overall rate of growth of equalization payments (limiting them to the rate of growth of GDP) lifted after 1994-95, resulting in a one-time increase of approximately 8 per cent.

Native Affairs	Settlement of aboriginal land claims: $10 billion spread over 10 years from 1994-95 to 2003-04; other expenditures: overall growth in line with rate of GDP growth plus three quarters of 1 per cent over the entire simulation period.
National Defence	Overall growth of expenditures in line with rate of growth of GDP, but 15-per-cent decrease in base level of expenditures to reflect the "peace dividend" phased in over the period 1994-95 to 2003-04.
Veterans' Benefits	Overall growth of expenditures at the rate of GDP growth minus 4 per cent over the entire period of the simulation.
Official Development Assistance	Maintain current restrictions on growth of ODA (maximum 3-per-cent growth per year) until 1996-97; maintenance of expenditures at the then-prevailing ratio to GDP thereafter.

OTHER EXPENDITURE CATEGORIES

Housing	At the provincial and local level, overall growth of expenditures at the rate of GDP growth. At the federal level, growth in line with the rate of GDP growth plus an adjustment factor (2 per cent per year) reflecting projected new social housing commitments.
Justice and Law Enforcement	Overall growth of expenditures in line with rate of growth of GDP.
Debt Service	Endogenous.
Other Expenditures	Overall growth in line with rate of growth of GDP.

REVENUES AND DEBT

UI Premiums	Increases in line with GDP growth and announced premium rate changes to 1992-93; changes to ensure that premiums equal benefits in all years thereafter.
Taxation of Interest on Government Debt	Endogenous (function of average interest rate and of total liabilities).
General Revenues (Excluding UI Premiums, Taxation of Interest on Government Debt and Seigniorage)	Growth of revenues during recovery and period of partial de-indexation as projected under the macroeconomic base-case scenario until 1994-95; growth in line with GDP thereafter; other changes as required to meet stipulated debt/GDP profiles (see below).

Ratio of Debt to GDP

For provinces other than Ontario, tax rates are adjusted to maintain the debt/GDP ratio at its 1991-92 level throughout the simulation period.

For Ontario, debt increases in line with the forecast in the last provincial budget until 1993-94; tax rates are adjusted to maintain the debt/GDP ratio at its 1993-94 level thereafter.

For the federal government, debt/GDP ratio is endogenous until 1993-94; three different scenarios for subsequent years:

- "High-ratio scenario": tax rates are adjusted to ensure that the debt/GDP ratio remains at its 1993-94 level until the end of the simulation period;

- "Middle scenario": tax rates are adjusted to ensure decline in debt/GDP ratio to under 30 per cent by the end of the simulation period;

- "Low-ratio scenario": tax rates are adjusted to ensure decline in debt/GDP ratio to under 10 per cent by the end of the simulation period.

E General-Equilibrium Estimates of the Long-Run Welfare Impact of Various Constitutional Options

Economists generally agree that in order to analyse the long-run impact of a given policy change, a model that can capture its major effects on resource allocation, economic efficiency, productivity, and economies of scale in production is needed. Of the tools available to economists, general-equilibrium models are best able to capture these effects.[1] This appendix describes the regional general-equilibrium model (RGEM) used by the Council to analyse the welfare implications of the constitutional options presented in Chapter 5, as well as the results deriving from that analysis.

It is important to note that no model, no matter how sophisticated, can capture with certainty the impact of such changes. Because of the inability of models to take account of a host of intangibles, reality can turn out to be very different from their predictions.

The Model

The Council's model is based on one originally developed for the Macdonald Commission by John Whalley, of the University of Western Ontario. The equilibrium dataset has been updated to reflect the most recent data on taxes, transfers and the technology of production.[2]

The model provides a relatively detailed description of economic activity within Canada and of Canada's relations with the rest of the world. Six Canadian regions are identified: the Atlantic provinces, Quebec, Ontario, the Prairie provinces, Alberta, and British Columbia and the territories. These regions trade with each other and the rest of the world (ROW). For the purposes of the model, each region and the ROW produce six commodities: an agricultural good, a heavy manufactured good, a light manufactured good, a resource good, services, and public administration. These goods and services are assumed to be qualitatively different from one region to another, so that each region both imports from and exports to each of the six other regions. In addition to the six regions and the ROW, the federal government has its own demand for each of the commodities produced in each region.

In addition to consumption and production, RGEM contains a comprehensive description of the federal and provincial taxation systems, as well as government transfers to individuals and between levels of government. The model also contains mechanisms by which changes in these fiscal arrangements can impact on the mix of goods and services produced, demanded, and consumed in each region of the country as well as in the rest of the world. By describing in some detail the fiscal arrangements that would exist under each of the alternative constitutional options described in Chapter 5, the model makes it possible to examine the resulting changes in the pattern of international and interregional production and trade, the impact on economic efficiency, and most important, the impact on the economic well-being of individuals living in each of the regions.[3]

Modelling Confederation

Figure 5-1 outlines the reallocation of programs and transfer responsibilities that would occur under each of the constitutional options. Such policy changes in taxes and transfers and patterns of government expenditure will cause changes in prices, the amount of goods demanded and supplied, and the quantity of labour and capital used in the production of goods. Each one of these changes will invoke secondary changes which will in turn provoke tertiary changes which will cause further changes *ad infinitum*. The major strength of general equilibrium analysis is its ability to capture all of these reactions and adjustments. RGEM provides a detailed picture of the long-run impact of policy changes "once all adjustment has taken place."This strength is also the model's principal weakness as it provides only a static "before" and "after" comparison of the economy. The model is unable to describe the timing and path of adjustments, it only tells us what the world will look like once these adjustments have taken place.

Model results take the form of changes in welfare, expressed as a proportion of regional GNP, for each of the six Canadian regions.[4] The interpretation of the results is straightforward. A 5-per-cent increase in welfare for the Atlantic region would imply that individuals living in that region benefit from the policy change by an amount equal to 5 per cent of regional GNP. This is a permanent gain: at all points in time following the policy change, the residents of the region would be 5 per cent better off than they would be had the change not taken place. This would be true in the year the change occurred, as well as in each subsequent year.[5]

The impact on a particular region reflects a number of effects. Foremost among these is the redistributive effect implied by the reorganization of taxes and transfers. A region will receive a net benefit if the *reduction* in federal taxes associated with a constitutional option *exceeds* the lost transfers (either to the governments of the region or to its residents). By the same token, a region will experience a net loss if the sum of transfers lost exceeds the reduction in federal taxes.

The redistributive effect on a particular region can be distorted or even submerged by spillover effects from adjoining regions and by terms-of-trade effects. Changes in the tax structure and the income distribution implied by the new policy regime alter the pattern of interregional demand. Regions that export to regions adversely affected by a policy change will face reduced demand for their products. These changes will, in turn, be reflected in changes in the terms of trade between regions. In the context of regional economies, terms of trade can have a significant impact on regional welfare. A 1-per-cent reduction in the terms of trade of a region can translate into as much as a 0.6-per-cent decrease in its purchasing power.[6]

Sensitivity of the Analysis to the Assumptions

In addition to the nature of the policy change modelled, the magnitude of the welfare changes will depend on a number of assumptions. In particular, results will depend on how sensitive producers and consumers are to changes in price and income. For the most part, economists have extensively estimated these sensitivities – called "elasticities" – and have reached agreement about their approximate values. Some elasticities, however, have not been estimated because of a lack of data. As a result, there is no consensus as to their actual values.

In order to ensure that our results are not influenced by our assumptions about the value of these unknown elasticities, we have run over 30 simulations, assuming different values for interregional price elasticities of demand and supply, interregional labour mobility, returns to scale, and tax structures. A range of possible values has been applied to each of these key assumptions to see how the results generated by the model would be affected. Table E-1 presents the range of elasticity values simulated in this way, as well as the values of some important but less controversial sensitivities that were held constant.[7]

Table E-1
Elasticity Values Used in Model Simulations

	Elasticities
Demand side	
Elasticity of substitution between:	
Energy and nonenergy goods	0.5
Nonenergy goods and regional public services	1.0
Imported and domestically produced goods	1.3
Alternative sources of Canadian goods, for ROW	3.0
Imported and domestic oil	3.0
Goods produced within a region and those produced in other Canadian regions, for Canada	1.3 to 2.6
Extra-regional goods produced in different Canadian regions, for Canada	3.0 to 6.0
Supply side	
Elasticity of substitution between:	
Capital and labour	0.5
Labour and resources	0.8
Regional elasticity of labour supply (mobility)	0.05 to 0.25
	(Per cent)
Manufacturing return to scale	0 to 10

Simulation Results

Table E-2 reports the range of model results observed as elasticities are varied.[8] The low estimate – the first column in the table – is the smallest regional change in welfare observed when the constitutional options are subjected to different assumptions as to elasticities. The high estimate represents the greatest change in regional welfare deriving from the same experiment.[9]

Moderate Decentralization

In the "moderate decentralization" option, the federal government is assumed to cease to play a role in health care, postsecondary education, and social welfare. Federal taxes are lowered across the board by an amount equal to the reduction in federal expenditures. Regional (or provincial)

Table E-2
Long-Term Welfare Impact of Alternative Confederation Scenarios

	Change in welfare[1]	
	Low estimate	High estimate
Moderate decentralization		
Atlantic region	–1.9	–2.0
Quebec	0.0	0.6
Ontario	1.1	1.3
Manitoba and Saskatchewan	–0.2	–1.0
Alberta	0.4	–0.3
British Columbia and territories	–2.5	–2.4
Extensive decentralization		
Atlantic region	–4.0	–4.4
Quebec	1.1	1.3
Ontario	2.8	3.8
Manitoba and Saskatchewan	–7.1	–8.0
Alberta	–1.3	–1.7
British Columbia and territories	–2.8	–3.0
Confederation of regions		
Atlantic region	–22.6	–27.2
Quebec	–2.3	–3.5
Ontario	7.9	9.3
Manitoba and Saskatchewan	–14.2	–15.5
Alberta	0.6	1.3
British Columbia and territories	1.1	1.3
Sovereignty-association		
Atlantic region	0.4	0.2
Quebec	–1.4	–3.5
Ontario	–0.1	0.4
Manitoba and Saskatchewan	–0.1	–0.1
Alberta	–0.2	0.4
British Columbia and territories	–0.1	–0.3

1 As a proportion of regional GNP.

SOURCE Andrew Burns, "Regional welfare impacts of alternative confederation scenarios: some preliminary results," a background paper prepared for the Economic Council, 1991.

taxes are raised by an amount equal to the reduction in federal spending on transfers and on goods and services within the region. In other words, it is assumed that the provinces/regions attempt to maintain the same level of services as previously provided by the federal government. As discussed in Chapter 5, this may imply a significant increase in net tax rates for the "have-not" provinces.

British Columbia and the territories, as well as the Atlantic provinces, experience small but significant losses under this scenario (around 2 per cent of provincial GNP, respectively). These losses mainly reflect a gap between the economic cost to these provinces of lost federal transfers and spending, and the benefits that they would now receive from reduced federal taxes. In other words, the results reveal that under the status quo, these provinces contribute less to the funding of the national system of health care, education, and social welfare than they receive from it. The reverse is true for Ontario, which records a small gain under this scenario. Manitoba and Saskatchewan would show up with a larger loss were it not for a terms-of-trade gain, which partly offsets their initial loss.

Although the magnitude of the results varies with the assumptions used, the extent of that variation is limited. Welfare changes, in terms of both direction and magnitude, are not significantly affected by different assumptions about labour mobility, returns to scale, and interregional supply and demand substitutability.

Extensive Decentralization

The "extensive decentralization" option envisions the federal government ceding to the provinces responsibilities for a number of transfer programs and expenditures, such as regional economic development, crop insurance, unemployment insurance, pensions, housing, and child welfare. As with the "moderate-decentralization" option, it assumes the continued operation of the system of equalization.

Under this scenario, the impact on the welfare of residents of all provinces is significantly greater than that of the moderate-decentralization option. The Atlantic region and the Prairie provinces experience the largest welfare changes. The agricultural provinces – Manitoba and Saskatchewan – are the big losers, however. The main reason for the change in their fortunes is the loss of federal transfers associated with agricultural subsidies. To the extent that the subsidies are a temporary response to worldwide agricultural protectionism, then the welfare loss here would also be temporary.[10] Alberta also suffers as a result of the loss of agricultural subsidies, but to a much lesser extent. In this option, Quebec realizes a welfare gain, largely because it benefits from the federal tax savings incurred with the elimination of the agricultural policies.

The difference between high and low estimates is somewhat greater in this scenario. This reflects the greater sensitivity of the extensive-decentralization option to our assumptions with respect to increasing returns to scale in manufacturing and interregional substitutability in demand and supply.

Confederation of Regions

The "confederation of regions" scenario envisions the disappearance of the federal government as we know it. It views the federal government purely as a superstructure providing limited services to largely independent regional governments. This scenario incorporates all of the features of the two previous scenarios, and it includes the elimination of equalization payments and the replacement of federal programs dealing with the native peoples, with culture, and with amateur sport by regional programs.

Under this scenario, the clear beneficiary is Ontario, with Alberta and British Columbia and the territories also benefiting but to a much lesser extent. The Atlantic region and the Prairie provinces emerge significantly impoverished. The loss of equalization payments clearly plays a major role in explaining the welfare losses in those two regions as well as in Quebec. The abandonment of the program serves to explain some of the benefits derived by Ontario and Alberta, as well as the improvement in the situation of British Columbia and the territories relative to the extensive-decentralization option. Were it not for the loss of federal agricultural subsidies, Alberta's gains would be somewhat larger.

Sovereignty-Association

The "sovereignty-association" scenario envisions a situation where Quebec is given control over all the programs previously provided by the federal government and where federal expenditures on public goods and services in the provinces are reduced to zero. Federal taxes levied in Quebec are completely eliminated, and the province no longer takes part in the equalization program. The federal government's role in the rest of Canada remains unchanged from the status quo.

Quebec suffers a significant loss in this scenario – up to 3.5 per cent of its GNP. The impact on the other provinces is mixed and small. It reflects two main influences: the redistribution of the federal savings resulting from the federal withdrawal in Quebec, and the spillover and terms-of-trade effects that follow from this redistribution. The terms of trade are particularly important in the case of Atlantic Canada (positive) and Quebec (negative).[11]

Notes

Chapter 1

1 From a strictly legal point of view, the Constitution Act, 1982 has always applied to Quebec; however, the fact that it has never been signed by the Quebec government deprives the legislation of political legitimacy.

2 Commission on the Political and Constitutional Future of Quebec, *The Political and Constitutional Future of Québec*, Michel Bélanger and Jean Campeau, co-chairmen (Québec: the Commission, March 1991).

3 Quebec Liberal Party, *A Québec Free to Choose: Report of the Constitutional Committee*, Jean Allaire, chairman (Québec: the Party, 1991). The report was adopted by the party, with two important amendments concerning the proposal to abolish the Senate and the application of the Charter of Rights.

4 Quebec Liberal Party, *A Québec Free to Choose*, p. 4.

5 Among private efforts are the papers commissioned and published by the Business Council on National Issues, as well as such tasks forces as The Group of 22 and the Northumberland Group. Provincial commissions include the Select Committee on Ontario in Confederation, the New Brunswick Commission on Canadian Federalism, the Manitoba Constitutional Task Force, and the Constitutional Reform Task Force of Alberta.

6 Special Joint Committee of the Senate and the House of Commons, *The Process for Amending the Constitution of Canada*, Gérald Beaudoin and Jim Edwards, joint chairmen (Ottawa: Queen's Printer, 20 June 1991).

7 *Citizens' Forum on Canada's Future: Report to the People and Government of Canada*, Keith Spicer, chairman (Ottawa: Supply and Services Canada, 27 June 1991).

8 See "Economic and fiscal developments and federal-provincial fiscal relations in Canada," report of the western finance ministers, submitted to the Western Premiers' Conference, Lloydminster, Saskatchewan, July 1990; and a speech made at the Empire Club, Toronto, by New Brunswick Premier Frank McKenna, on 21 February 1991.

9 The real income of families with heads over the age of 65 rose by about 36 per cent between 1977 and 1989, while it fell by 9 per cent for young families (under the age of 25). The average increase for all families over that period was about 12 per cent. The gains by the elderly reflected improvements in income-support programs (such as the Guaranteed Income Supplement) and in the retirement-income system, rather than in earnings from work.

Chapter 2

1 Real wages barely changed in Canada between 1986 and 1990, while they actually declined in the United States. In addition, a gap in nominal wages opened up between the two countries mainly because consumer prices rose more quickly in Canada.

2 See Organisation for Economic Co-operation and Development, *Economic Outlook* (July 1991). To the extent that the accumulated debt will have to be paid off, Canada's relative position within the OECD with respect to taxation is likely to deteriorate in the years to come.

3 Extract from a speech made at the Empire Club, Toronto, on 21 February 1991.

4 John W. Crow, "The Bank of Canada and its objectives," *Bank of Canada Review* (April 1987).

5 This estimate reflects discretionary increases of $1.5 billion for spending and $700 million for revenues, for a net discretionary stimulus of $800 million.

6 Among the factors that influence the gap between market prices and factor cost are: indirect taxes, subsidies, and the terms of trade. Product mix changes can also influence this gap.

7 National income is defined as the gross domestic product less indirect taxes and subsidies.

8 See, among others, *Zero Inflation: The Goal of Price Stability*, ed. Richard G. Lipsey, Policy study no. 8 (Toronto: C. D. Howe Institute, 1990).

Chapter 3

1 Extract from an address by Prime Minister Brian Mulroney, given at Buckingham, Quebec, on 16 December 1990.

2 Quebec Liberal Party, *A Québec Free to Choose*, p. 36.

3 There are other aspects of interdependence – telecommunications and information networks, transportation infrastructure, financial flows, and so on – that will not be analysed in this review.

4 Task Force on Canadian Unity, *A Future Together: Observations and Recommendations*, Jean-Luc Pepin and John P. Robarts, co-chairmen (Ottawa: Supply and Services Canada, January 1979), p. 70.

5 Thomas J. Courchene, *In Praise of Renewed Federalism* (Toronto: C. D. Howe Institute, 1991), p. 2.

6 The input/output tables are a detailed set of accounts that articulate the flows of goods, services, and primary inputs among the many sectors of an economy. They show how much of a particular commodity is produced and where it is consumed (as an input in the production of another good or service, or as a final demand product) and also whether it is consumed within the province or outside it. Statistics Canada publishes a set of input/output tables for each province and for Canada as a whole. The provincial tables are fully integrated and balanced with the national tables. Because the input/output tables describe economic relations in a highly disaggregated form, they facilitate the analysis of issues pertaining to economic interdependence more readily than do more aggregative models. Data are available for three years: 1974, 1979, and 1984.

7 Many recent studies that have examined the evolution of interprovincial trade flows over time have used data on manufacturing shipments. That approach suffers from important limitations, however, inasmuch as the activities of the primary sector and the service sector are excluded from the analysis. This is a serious omission, since exports of manufactured goods accounted for only 43 per cent of interprovincial exports in 1984, on average. Another shortcoming of the manufacturing data pertains to the survey methodology underlying the collection process. The survey requires firms to identify the first destination of shipments. In many cases, the first destination may not coincide with the point of final consumption. For example, a shipment from a plant to a wholesaler within the same province, which is actually destined for export outside of the province, would be tabulated as a shipment to the local market.

In contrast to the manufacturing-shipments statistics, the input/output data embrace the production and trade of all goods and services, thus providing a more comprehensive view of overall provincial trade patterns. Also, some effort has been made to adjust the trade statistics to coincide with the final destination of exports.

8 Gross output is a measure of all goods and services produced, including those which are used as inputs for final products, as well as the final products themselves. Therefore, a province's gross output is greater than its gross domestic product (GDP) because there is double counting of output in the former while the latter measures value-added only. For Canada as a whole, gross output exceeds GDP by roughly 75 per cent.

9 Goods and services used as intermediate inputs in the production of products bound for markets outside the province are deemed to be consumed locally. As a result, the share of gross output allocated to the local market by the input/output tables overstates the importance of the local market to provincial economies, because the demand for the intermediate inputs used in exports depends on the nonlocal rather than the local market. Similarly, the importance of nonlocal markets is understated by the shares of gross output that they receive.

10 This estimate was derived using 1990 provincial employment data, by major sector, from the Labour Force Survey, as well as the distribution of interprovincial exports by sector, from the 1984 input/output tables.

11 Exports among Canada's provinces and among the European countries are not valued in the same way; the difference results in a lower value for interprovincial exports than would obtain if both data sets were consistent. This difference reinforces the conclusion that trade linkages between the provinces are greater than among the member states of the European Community.

12 The automobile sector accounts for almost 50 per cent of Ontario's exports to the United States and almost 35 per cent of its imports from that country.

13 Note that the distribution of exports reflects their first destination in the United States. Exports sold to a wholesaler in one region may be destined for final consumption in other regions, but the data do not reflect this.

14 Transportation and storage services include, for example, the transportation of passengers and freight by air, railway, road, and water; pipeline transportation; highway and bridge maintenance; grain elevators; and other storage and warehousing.

15 Revenues earned by subsidiaries located outside Canada are excluded.

16 Foreign ownership is quite high in Canada relative to that found in many other countries. In 1986, foreign-owned firms accounted for 10 per cent of sales in the United States, 1 per cent in Japan, 18 per cent in West Germany, and 20 per cent in the United Kingdom; the corresponding figure for Canada in 1987 was 26 per cent. The international data are from Edward Graham and Paul Krugman, *Foreign Direct Investment in the United States* (Washington, D.C.: Institute for International Economics, 1989).

17 This is largely a reflection of the smaller size of the provinces and their corporate sectors, but it also reflects the fact that in most provinces, locally controlled corporations earn a smaller proportion of their revenues out of province than do corporations controlled in Ontario and Quebec (the exceptions are Manitoba, Prince Edward Island, and "other").

18 We also looked at corporate links between provinces from another perspective – the provincial sources of revenues of the corporations controlled in each of the provinces (e.g., the proportion of revenues of Alberta-controlled corporations earned in each of the provinces). When viewed from this

perspective, the links among provinces within the Atlantic region and within the West are more evident. Still, most provinces had stronger ties with Ontario than with other provinces in their own region. Corporations controlled in the western provinces earned almost no income in the Atlantic provinces; corporations controlled in the Atlantic provinces earned a considerably larger share of their income in the West, although in all cases but one, that share was still less than 2 per cent of revenues.

19 There may also be negative economic consequences arising from migration. For example, a massive influx of in-migrants can strain the existing infrastructure in a province; similarly, massive outmigration can leave the infrastructure underutilized. Perhaps more importantly, mobility is higher among the more educated and the young. Disadvantaged provinces lose a disproportionate share of their most productive workers – a fact that tends to weaken the effect that migration has on regional disparities. Some economists go so far as to argue that migration is destabilizing and exacerbates regional disparities; however, this view is not widely accepted.

20 Mobility rates for all moves involving a change of residence are almost identical in the two countries. Mobility rates for interstate moves in the United States exceed the rates for interprovincial moves in Canada, however; this is not unexpected, since the average U.S. state is much smaller than the average Canadian province. All things being equal, the smaller the size of the geographic unit used to calculate mobility rates, the shorter the distance required to cross a boundary and, consequently, for a given number of moves, the higher the calculated inter-unit mobility rate.

21 From the Labour Market Activity Survey, we know that 2.3 million workers changed jobs (involving a change of employers) in 1986. There were 227,000 working-age interprovincial migrants that same year, resulting in an estimated 181,000 labour-force migrants (based on the labour-force participation rate of interprovincial migrants of 80 per cent from the 1986 census). This amount is equivalent to 8 per cent of the total number of job changes in 1986. Not all migrants who were labour-force participants would have changed jobs during the year – some would have been unemployed and a few might not have changed jobs – so that the proportion of job changes that involved interprovincial migration would have been less than 8 per cent.

22 The rise in net outflows was primarily caused by an increase in gross outflows. While migration to Alberta increased, the attraction of the oil boom was not a major factor in the latter increase (Alberta received only 13 per cent of the increase).

23 In the case of Newfoundland, net migration flows were positive (net inflows) for a few years, following the changes in the UI system.

24 Evidence on the effect of migration on wages has been limited by a paucity of suitable microdata. Existing studies have generally found only very small positive effects on income during the first years following a move; see, for example, E. Kenneth Grant and John Vanderkamp, "The effects of migration on income: a micro study with Canadian data, 1965-71," *Canadian Journal of Economics* 13 (1980):381-406.

25 Econometric studies on the determinants of migration always find distance to be the most important factor.

26 The proportion of the population that could conduct a conversation in French was 41 per cent in New Brunswick vs. an average of 9.5 per cent in the rest of Canada, excluding Quebec, according to the 1986 census.

27 In that respect, it is interesting to note the ambivalence in the statement of the first ministers when they announced their desire to address the problem in November 1987:

> . . . desiring to undertake collective action with the intent of reducing or eliminating barriers to trade between provinces in the context of national regional development principles and recognizing the development needs of all regions within Canada.

28 A study published by the Ontario Economic Council suggested that losses from interprovincial barriers were quite modest for the economy as a whole; see John Whalley, "Induced distortions of interprovincial activity: an overview of issues," in *Federalism and the Canadian Economic Union*, eds. M. J. Trebilcock, J.R.S. Prichard, T. J. Courchene, and J. Whalley (Toronto: University of Toronto Press, 1983), pp. 161-200.

Empirical work done for the Macdonald Commission in the mid-1980s suggested that the net efficiency cost of internal barriers was substantially less than 1 per cent of GDP. However, that estimate has been criticized for not addressing the longer-term salutary effects that the removal of barriers could spawn, such as reinforced competition in the sectors dominated by public procurement, industrial rationalization, and greater scope for exploiting industry-wide economies of scale in the wake of increased demand.

In a March 1989 survey of entrepreneurs, 30 per cent of the respondents stated that interprovincial trade barriers were major; 55 per cent said they were minor; see "Small business briefs," *Financial Post* (16 March 1990):11.

29 The Canadian Manufacturers' Association (CMA) has estimated that the removal of interprovincial trade barriers could result in savings to consumers and taxpayers of some $6 billion, which is close to the Macdonald Commission's estimate ($6 billion is approximately 1 per cent of GDP). Most of the estimated savings come from an estimated 5-per-cent reduction in the price of goods and services purchased by governments and government enterprises that would result from the abolition of preferential procurement policies. The market of public procurement is estimated at about $100 billion. The CMA's analysis does not, however, take into account the fact that a substantial portion of the current public-procurement market is already fully open to competition. See Canadian Manufacturers' Association, "Canada 1993: a plan for the creation of a single economic market in Canada," Toronto, April 1991.

30 The box does not include the deharmonizing measures of the federal government itself. Although rare, there are a few examples of federal tax discrimination regarding corporations in certain provinces. For example, the federal government gives favourable treatment to corporations operating in the Atlantic provinces by granting them an additional tax credit of 15 per cent that is no longer available in other provinces, as it was phased out over a three-year period, beginning in 1987.

31 Examples include stock-savings-plan tax credits – available to the residents of a province who invest in the shares of certain corporations operating in the province – and venture-capital tax credits, which are available to individuals who invest in venture-capital corporations (which, in turn, invest in small businesses in the province).

32 There have already been examples in Canada in the past of fierce interprovincial tax competition that has even led to the complete elimination of certain revenue sources. In the wake of the 1972 tax-collection agreements, the federal government ceased to levy its own succession duties and left this field of taxation exclusively to the provinces. Within a few years, however, several provinces also abandoned the area of succession duties in an attempt to attract wealthy persons residing in other provinces. In the end, succession duties disappeared from all the provinces because of that competition.

33 In a federal structure, this may signal a more important role for the federal government. If Canadians wanted to pursue redistribution policies and if tax competition were driving provincial revenues downward, the federal government would be left with essentially two options: 1) to take more responsibilities for redistribution objectives by raising its tax and spending presence in the economy; or 2) to supplement the current equalization system in order to re-create a level playing field among the provinces by raising the revenues of those with a lower fiscal capacity. Both options would require a strong presence of the federal government in the tax system in order to raise the appropriate revenues.

34 Among the signs of harmonization in progress, one might cite the fact that two signatory provinces have agreed to acknowledge federal responsibility for ensuring the uniform application of the federal GST in all provinces (including the exclusive authority to issue interpretations and regulations, the administration of a national data base, and a list of corporations and other individuals registered to receive tax credits).

35 The growth in expenditures was partly the result of the large influx of interprovincial migrants into Ontario (114,000), but per-capita spending still increased at an average annual rate of 8.3 per cent.

36 For an expanded discussion, see "Monetary policy: a Canadian perspective," a speech by the Governor of the Bank of Canada, *Bank of Canada Review* (November 1990).

37 For a thorough discussion of the advantages and disadvantages of regionally differentiated fiscal policies, see Yves Rabeau, "Regional stabilization in Canada," in *Fiscal and Monetary Policy*, ed. John Sargent, Royal Commission on the Economic Union and Development Prospects for Canada, Research studies, volume 21 (Ottawa: Supply and Services Canada, 1986), pp. 151-97.

38 Total EC expenditures, which amounted to 1 per cent of the community's GDP in 1989, were allocated as follows: agriculture and fishing, 65 per cent; regional policy, 11 per cent; social policy, 7 per cent; research, energy, industry, environment, and transport, 4 per cent; foreign aid, 3 per cent; miscellaneous, 4 per cent; administration, 5 per cent; see Commission of the European Communities, *A Community of Twelve: Key Figures* (Luxembourg: the Commission, March 1989), p. 29.

Total expenditures are projected to grow to 1.3 per cent of the community's GDP by 1992. The regional and social funds' resources, which amounted to about 0.2 per cent of GDP in 1989, are to double by 1993.

39 *Report of the Royal Commission on Dominion-Provincial Relations*, Newton Wesley Rowell, chairman (1937-38) and Joseph Sirois, chairman (1938-40) (Ottawa: King's Printer, 1940).

40 Hon. Jean Chrétien, *Securing the Canadian Economic Union in the Constitution* (Ottawa: Supply and Services Canada, 1980).

41 Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], *Report* (Ottawa: Supply and Services Canada, 1985), volume 3, p. 139.

42 Recent agreements on procurement policy and on wine and beer have been delayed because of this requirement.

43 Criticisms of the existing process of budget secrecy are not new. The Macdonald Commission argued in favour of less-comprehensive budget secrecy. The concern of the commission centred on the need to open up both the budget-making process and the legislative procedures to more meaningful public involvement. The commission pointed out that the current process of consultation is often disappointing for both sides. Those who make representations cannot know in advance how their submissions will relate to the budget options that the government has under consideration. For the minister and his officials, budget secrecy limits the frankness of the government response and the thoroughness of the subsequent discussion.

Budget secrecy is a largely outdated concept. Most of the information contained in budgets today could be released well in advance without causing problems of privileged information or protective market reactions. Whenever a particular measure is expected to create real problems, it could remain secret until the official tabling of the budget.

Chapter 4

1 The extent to which these forms of sharing translate into net transfers between regions has been the subject of studies based on a "balance sheet" approach; see, in particular, Robert L. Mansell and Ronald G. Schlenker, "An analysis of the regional distribution of federal fiscal balances: updated data," University of Calgary, Calgary, 1990; and Isabella D. Horry and Michael A. Walker, *Government Spending Facts* (Vancouver, B.C.: Fraser Institute, 1991). These studies have shown that the activities of the federal government have resulted in significant net transfers from the wealthier provinces (in particular Alberta, British Columbia, and Ontario) to "have-not" regions.

2 The will to share – and the kinds of government intervention that are deemed proper and equitable – can be defined in terms of many different reference groups: one's own family, the extended circle of one's friends and acquaintances, one's local community, one's province, the entire country, even the world community. As a result, clashes may occur between different communities over whether particular policies should be geared to a "national" or a "local" view of the equity objectives to be pursued.

3 In particular, they view decentralization as a means of fostering greater interprovincial competition for mobile capital and skilled labour that would have the effect of reducing the overall size of government (and the level of overall taxation).

4 If fierce interprovincial tax and expenditure competition actually were to result from significant decentralization, a role for the federal government in providing equalization – to enable provinces to compete with each other on an equal footing – might actually be required on efficiency as well as equity grounds.

5 A good illustration of the compromise is the fact that sections 91 and 92 of the BNA Act set out not one but two sets of clauses outlining powers over policy areas not otherwise enumerated in the Act. The Act provided for provincial paramountcy over all matters not otherwise enumerated that were of a purely local nature and, at the same time, accorded the federal government residual powers over matters that were not "local" in nature, as well as certain other general powers to act in areas of "national" interest.

6 For example, section 36 of the Constitution Act, 1982 uses highly qualified language in describing its provisions regarding the equal fiscal treatment of Canadians. It does not actually require equal treatment in terms of services and levels of taxation but simply asserts that the federal and provincial governments are "committed" to providing public services of "reasonable" quality and to the "principle" of an equalization mechanism that would ensure that provinces have sufficient revenues to provide "reasonably" comparable levels of such services at "reasonably" comparable levels of taxation.

7 See, for example, Roger Smith, "Constitutional reform and the structure of government: fiscal residuals in the West – a reason for getting together," Western Centre for Economic Research, University of Alberta, Edmonton, June 1991; and the papers read at the conference on "Alberta and the economics of constitutional change," held under the auspices of the University of Alberta's Western Centre for Economic Research, Edmonton, September 1991.

8 The provinces' increased importance in the income tax field may grow further, following the recent introduction of the federal goods and services tax, particularly if that change were to signal a move towards further devolution of income tax responsibilities to the provinces in exchange for a greater role for the federal government in the indirect tax field; see Robin W. Boadway, "Federal-provincial fiscal relations in the wake of deficit reduction," in *Canada: The State of the Federation, 1989*, eds. Ronald L. Watts and Douglas M. Brown (Kingston, Ont.: Institute of Intergovernmental Relations, 1989), pp. 107-35.

9 For example, according to the February 1991 budget (pp. 60 and 62), total EPF transfers grew by 6 per cent per year between fiscal year 1984-85 and fiscal year 1990-91; this was actually *faster* than program spending, which grew by only 3.7 per cent annually over the same period.

10 The decision in 1977 to grant a portion of federal transfers in the form of tax-points posed a problem, since – even after equalization payments are taken into account – the same percentage of a tax base does not generate the same per-capita revenue in all provinces because of differences in their capacity to raise revenues. To fill in the gaps between provinces that would have resulted from a transfer of tax points alone, it was decided to provide a fairly substantial proportion of transfers (54 per cent in 1977) in the form of cash transfers.

Only cash transfers are shown in Chart 4-5 because tax-point transfers are not considered to be budgetary expenditures of the federal government. Even so, the growth of tax-point transfers exerts a significant influence on the growth of cash transfers, since the latter are calculated as the difference between the tax-point component and transfers as a whole.

11 The cash portion of EPF transfers to Quebec is expected to disappear completely by fiscal year 1997-98 or thereabouts, largely because Quebec opted in the 1960s to take a larger proportion of its health- and education-related transfers in the form of "tax points" than did other provinces. The corresponding dates for the other provinces are towards the beginning of the next decade.

12 This reality was implicitly recognized in the last federal budget, which indicated that the federal government would be considering reforms to the major federal/provincial transfer programs.

13 EPF transfers result in implicit interprovincial transfers because of the difference between the way the transfers are distributed (i.e., on an equal per-capita basis for all provinces) and the way they are financed (i.e., out of general revenues,

to which residents of the better-off provinces contribute more on a per-capita basis than those of the poorer provinces).

14 The long-run potential rate of growth ranges from a high of 3 per cent in 2002 down to a low of 2.3 per cent in 2015; it is calculated as the sum of the rate of projected labour-force growth of between 0.8 and 1.1 per cent per annum and the assumed growth of labour productivity of 1.5 per cent per year.

15 The only exception is Ontario, where it is assumed that the significant rise in provincial debt levels forecast by the last provincial budget do occur. It is, however, assumed that, beginning in 1994-95, the debt/GDP ratio stabilizes at its 1993-94 level.

16 If no debt/GDP targets were to be adopted and if the current trends of federal taxation and expenditures were to be maintained, our projections show that the federal government would begin to enjoy large surpluses by the end of the decade and that the debt/GDP ratio would begin to decline even faster than the targets shown in Chart 4-7. In fact, the surpluses would succeed in completely eliminating the existing federal debt by approximately the year 2005.

17 Thus the size of the projected drop in federal revenues in 1994-95 can best be interpreted as an estimate of the breathing space that the federal government may have in order to lower taxes or increase expenditures. The magnitude of the breathing space obviously depends on the strength of the commitment to reducing the level of the existing federal debt.

As shown in Chart 4-8, by 1994-95 the budgetary breathing space varies from 1.7 per cent of GDP in the low-debt case to 3.7 per cent in the high-debt case. Putting these numbers into perspective, current (1990-91) federal expenditures on unemployment insurance amount to 2.6 per cent; those on old-age security total 2.6 per cent; and those in health care total 1.1 per cent.

18 For example, one important underlying assumption concerns the interest rate that will prevail over the projection period. While the declining interest rates assumed under the base-case medium-term outlook in Chapter 2 are not the sole factor causing the drop in tax rates, they do contribute to it. To verify the sensitivity of the model results to interest-rate assumptions, we ran additional projections assuming that existing interest rate levels are maintained. Those simulations yielded a federal tax effort that was slightly higher than in the base case – approximately 0.75 per cent of GDP in the early years of the simulation period and almost 1 per cent of GDP higher towards the end of the period.

In addition, neither the base-case medium-term outlook nor the subsequent projection beyond the year 2000 make any provision for further recessions. In any period as long as the projection period that we are considering, it is likely that there will be at least two or three recessions, each of which would increase the federal deficit and slowdown (or temporarily reverse) the trend towards lower debt ratios. To test the sensitivity of the results to recessions and to other factors (such as a possible slowdown in productivity growth) that would result in slower average growth over the projection period, we ran an additional projection that assumed a rate of real GDP growth that was 0.5 percentage points lower than the rate assumed in the base case for all fiscal years from 1992-93 to 2014-15. This also translated into marginally higher federal revenue requirements – from about 0.4 per cent of GDP per year in the early years to 0.55 per cent by the end of the simulation period.

19 The constitution grants the provinces ownership of the natural resources located on their territory. Consequently, the economic rents derived from these resources enable the provinces with significant natural resources to finance some of their activities and to reduce their financing requirements from other sources (in particular personal and corporate incomes tax, property taxes, and indirect taxes).

20 Canada has long been the federation that devotes the most resources to equalizing provincial fiscal capacities. By contrast, the United States has no formal equalization mechanism at all. Formal equalization payments in Germany (for the western German *Länder* [states] only) were only about 0.3 per cent of GDP in 1990, though this does not include the full equalizing effects of the German approach to "tax sharing," which are more difficult to measure. The same problem afflicts any estimation of effective equalization in Australia and Switzerland, both of which place an even greater reliance on tax sharing as an implicit equalization measure. Although the federations that we have studied vary greatly in terms of their reliance on implicit equalization, it is unlikely that taking these differences into account would alter the general conclusion regarding the relative size of Canada's equalization efforts.

21 Both Alberta (the province with the largest fiscal capacity) and the four Atlantic provinces (those with the lowest fiscal capacities) are excluded from the group of "representative" provinces.

22 The provinces with fiscal capacities in excess of the standard do not participate directly in the equalization program, though general revenues raised by the federal government in those provinces do provide the greater part of the financing for the payments. The mechanism whereby the federal government equalizes "up" is the one most often used by federations that have instituted formal equalization mechanisms. One exception is Germany, where the equalization formula requires the well-off *Länder* (states) to finance directly, but in part only, equalization payments to the have-not *Länder*.

23 Certain federations (notably, Australia) have established a complex equalization formula that also takes these gaps (as well as differences in fiscal capacity) into account. This type of mechanism can be justified on the grounds of symmetry: government spending on the population can be construed as "negative" taxation and should therefore enter into the calculation of the equalization formula, as other taxes are.

24 In reaching this conclusion, we follow in the footsteps of the Economic Council's 1982 report on *Financing Confederation*,

which sets out in greater detail many of the arguments that follow (see in particular Chapter 3 of that report).

25 For a complete demonstration of this argument, see Robin W. Boadway and Frank Flatters, *Equalization in a Federal State: An Economic Analysis*, Economic Council of Canada (Ottawa: Supply and Services, 1982).

26 To the extent that a significant number of spending functions are directly performed by the federal government, the fiscal relationships in a federation begin to resemble those of a unitary state where there is no need for any formal equalization at all, since the financing of those government activities does not suffer from uneven access to tax revenues.

27 While recommending a substantial decentralization of spending powers, the report of the Allaire Committee did recommend the retention of a kind of equalization program. Under those proposals, however, the goals of the program would be significantly altered. Instead of being geared to equalizing the fiscal treatment of Canadians in different parts of the country, the program would take on more of the attributes of a fund for promoting regional economic development.

28 Although it might be seen as impractical to entrench a detailed equalization formula in a constitution, it might be possible for such arrangements to be set out in legally enforceable interprovincial "treaties" and/or to be made the responsibility of independent bodies. Such formal bodies exist in a number of federations, including Australia and India.

29 Unlike the current tax-collection agreements in Canada, tax-sharing equalization would not allocate collected revenues on a "source" basis, reflecting the yield of the tax from the participating jurisdictions, but on some other basis. In Germany, both the "equal per-capita distribution" and "fiscal-capacity-enhancing" approaches are used to distribute revenues derived from the value-added tax (VAT), the second most important source of taxation in the country. Three quarters of total VAT revenues going to the *Länder* are distributed according to the first rule, while the remaining quarter is distributed according to the second.

30 Under the current EPF mechanism (whereby cash transfers fill the gap between the value of transferred tax points and the overall amount of transfers), cash transfers play a stabilizing role, since they serve to fill this gap whenever it widens as a result of declining yields on the transferred tax points during a recession. This mechanism also operates for Quebec in the case of CAP, since Quebec has always received a large portion of its federal transfers for social assistance in the form of tax points. In both cases, however, the mechanism does involve lags in identifying the extent of the decline in the value of tax-point transfers and making the corresponding adjustments to the cash component. As such, it cannot be said that the transfer mechanism serves as a fully automatic stabilizer.

31 This figure can be broken down as follows: EPF (health), \$6.1 billion; EPF (postsecondary education), \$1.9 billion; and CAP, \$5.7 billion.

32 Note, however, that the federal budget of 1990 did modify the fifty-fifty rule somewhat in order to limit the growth of CAP transfers to high-income provinces. Much of the growth in federal transfers under CAP in recent years had come from moves to increase the generosity of social assistance benefits in the wealthier provinces (Ontario, in particular).

33 The breakdown of EPF transfers into health care and education components has always been more notional than real. Essentially, the breakdown used today is still based on the same ratio of health to education transfers as existed in 1976 under pre-EPF arrangements. In other words, it does not take into account the fact that health-care expenditures have since then increased substantially, relative to education, at the national level and that the ratio of health to education transfers would have evolved in the same way if the pre-EPF arrangements had been retained. In addition, the breakdown is presumed to be the same in all provinces, despite the existence (even in 1976) of significant differences between them in terms of the relative sizes of these two expenditure items. Accordingly, some have concluded that the official breakdown under EPF is meaningless and that allegations of funds diversion are unfounded.

34 Under the European Community's Treaty of Rome, "directives" are prepared by the EC Commission (the Community's "civil service") and, once approved by a qualified majority of member states, require all member states to take whatever measures are needed to meet the objectives stated in the directive but leave to the member states the decisions on the form of such measures. In the Canadian context, requiring provincial approval of the standards proposed by the federal government might take several forms, including a requirement for approval by a First Ministers' conference, by the provincial legislatures themselves or – as is the case in Germany – a role for a reformed Senate that would directly represent provincial interests.

35 The possible mechanisms that could be envisaged range from "codes of conduct" (which primarily rely upon retaliation as the enforcement mechanism) all the way to full-fledged interprovincial treaties akin to the European Community's Treaty of Rome and its provisions for a specialized Court of Justice whose jurisdiction might be limited to questions relating to the economic union. Alternative adjudicating bodies could also be envisaged (such as either standing or *ad hoc* "committees of experts"). Consistency of administration could be ensured through the creation of various sorts of permanent administrative and policymaking bodies that exist more or less independently of the parties to the agreement or treaty establishing the standard. These could be modelled on bodies such as the Australian Grants Council, which is largely responsible for developing and refining that country's equalization formula, and, of course, the Commission of the European Communities, though one could also envisage transferring responsibility in certain areas to fully independent nongovernmental organizations.

36 For example, the European Community "directives" requiring member states to implement legislative measures meeting

community objectives give them flexibility with regard to the means for achieving these objectives, but this has resulted in uneven results in many cases. Although the European Court of Justice constitutes (in principle) a significant check on the ability of recalcitrant member states to deviate from community objectives, this has not prevented some of them from dragging their feet in adopting the legislative mechanisms required to give effect to many directives.

37 For example, it is frequently charged that federal and provincial agencies have largely failed to integrate primary and secondary education (an exclusively provincial area of jurisdiction) with vocational training (a policy matter where the federal government is responsible for significant expenditures). The most frequently cited example of the transferring of burdens is when provinces sponsor temporary job-creation programs with a view to transferring the responsibility for providing financial assistance to the recipients of provincial social assistance programs onto the federal unemployment insurance program.

38 This was the approach taken by a recent Australian study, "Commonwealth/state overlap of functions and regulations: an overview of responses from state and commonwealth government departments and agencies," a paper prepared by the Office of the Economic Planning Advisory Council, Canberra, 1990.

39 Germain Julien, Marcel Proulx, and A. Tremblay, "Les chevauchements des programmes fédéraux et québécois," École nationale d'administration publique, Québec, 1978; and G. Julien and M. Proulx, "Analyse des conséquences du chevauchement des programmes fédéraux et québécois," ÉNAP, Québec, 1978.

40 Provincial paramountcy requires both that a province opting out of a federal spending program be eligible to receive compensation and that the compensation be unconditional. In the absence of compensation, a province would essentially be forced to go along with the federal program, since it would be politically impossible for a provincial government to refuse the federal program while leaving its residents subject to the higher federal taxes that would be needed to finance the program in other provinces. Furthermore, such compensation would need to be unconditional since a province could hardly be said to wield paramountcy if it were forced to adhere to conditions that required it to implement much the same sort of program as the federal government.

For a more detailed discussion of the "paramountcy" option, see Thomas J. Courchene, "The community of the Canadas," a submission to the Commission sur l'avenir politique et constitutionnel du Québec, School of Policy Studies, Queen's University, Kingston, Ont., November 1990; and David Milne, "Equality or asymmetry: Why choose?" a paper prepared for the Business Council on National Issues, symposium on Canada's constitutional options, Toronto, 1991.

41 It could be argued that this is the principal advantage of this option over the "watertight" approach. Under the former, the need to entrench the precise allocation of powers in the constitution may make it politically impossible to accommodate asymmetries since this would involve explicit recognition of the constitutional inequality of provinces.

Chapter 5

1 It was assumed that the federal government and the provinces would maintain the same debt/GDP ratios as in the "middle-ratio" scenario presented in Chapter 4. The estimates do not take into account any saving that might result from a reduction of overlaps and duplication, following the reorganization of responsibilities.

2 Moving towards the year 2010, the differences in the relative importance of the federal and provincial/municipal governments are accentuated as the decline in debt-servicing charges further reduces the relative size of the federal government.

3 While the retention of the current equalization formula attenuates this result somewhat, it does not do so completely, since, as noted in Chapter 4, it reduces – but does not eliminate – differences between provinces with respect to their ability to generate revenues from a given tax effort. In addition, it does not take into account the differences between provinces with respect to their "need" for particular government services and programs.

4 The category "health, education, and social welfare" includes all federal spending in these areas but is dominated by transfers under EPF and CAP. The category "transfers to persons" includes unemployment insurance benefits, the federal elderly benefits programs (OAS, GIS, and spouses' allowance) as well as family allowances and child tax credits. Together, these expenditures (along with equalization payments) account for the majority of all implicit interprovincial transfers.

The magnitude of transfers under the three expenditure categories is roughly in keeping with the pattern of provincial fiscal capacities (see Table 4-1). The comparison is not exact, however, because the federal government does not enjoy access to exactly the same revenue sources as the provinces. As a result, Alberta – which has access to significant natural-resource revenues (royalties, etc.) that cannot be levied by the federal government – contributes relatively less to federal revenues than does Ontario. This largely explains why the net transfers from Ontario are somewhat higher than those from Alberta.

The pattern of transfers shown in Chart 5-3 is also broadly similar to that resulting from similar sorts of exercises done by others in recent years (see, for example, Horry and Walker, *Government Spending Facts*). The one significant exception is the study by Mansell and Schlenker, which examined cumulative net transfers over a longer time period and specifically considered the interregional impacts of a much wider range of government activities. In particular, Mansell and Schlenker's estimates of the value of interprovincial transfers arising out of the two-price policy on petroleum during the era of the National Energy Program had the effect of significantly increasing the level of net transfers from Alberta to other provinces.

5 Note that Chart 5-3 shows an increase in equalization transfers under the moderate- and extensive-decentralization options. This results from the retention of the equalization formula prevailing under the status quo. Since the provinces must increase their revenues overall in order to finance their increased spending responsibilities, equalization payments to the provinces with a low fiscal capacity must also be raised in order to raise those capacities to the representative standard described in Chapter 4.

6 Implicit transfers under unemployment insurance are among the more important interprovincial transfers. Per-capita take-up (a measure of "need") under the other federal expenditure items shown in Chart 5-3 tends to vary only slightly from province to province as a result of differences in such factors as demographic composition. In such cases, differences in revenue-generating capacity are the principal source of interprovincial transfers. In the case of unemployment insurance, however, per-capita take-up varies very significantly among the provinces, and the provision of benefits by the federal government generates significant transfers as a result.

7 This would be done according to the principle of "subsidiarity" – that is, the central authority would be delegated only those powers which it could handle better than individual member states.

8 The loss of equalization payments is a particularly important feature of this option: equalization payments are projected to total 1.3 per cent of national GDP (or nearly $11.5 billion) by 1994-95 under current arrangements; the loss of these transfers under the confederation-of-regions option would be felt most heavily among the have-not provinces, where they currently represent a significantly larger proportion of provincial GDP.

9 These efficiency losses might be lower for Quebec because the language barrier makes Quebecers less sensitive to disparities in tax burdens and government services.

10 Parti Québécois, *La Souveraineté, Pourquoi? Comment?* (Montréal: the Party, 1990).

11 Monetary policy would be a shared responsibility in the sense that the Parti Québécois proposal refers to an input from Quebec as a "minority stockholder" in the decision-making process of the Bank of Canada.

12 This point has been fully developed in Courchene, *In Praise of Renewed Federalism.*

13 The eliminated interprovincial transfers include those shown in Chart 5-3, as well as implicit transfers associated with other federal expenditures, such as transfers to businesses under regional and resource development, manpower training and housing, and national defence and debt service. We have arbitrarily assumed that Quebec would take on 22 per cent of the existing federal debt at the start of the 1994-95 fiscal year. The issue of how to divide federal debt and assets under the sovereignty-association scenario is discussed in greater detail below.

14 Courchene, *In Praise of Renewed Federalism*, p. 32.

15 See A. Thibeault and L. Wynant, "Investor reaction to the political environment in Québec," *Canadian Public Policy* (Spring 1979):236-47. Similar movements occurred after the failure of the Meech Lake Accord. The observed yields on U.S.-dollar-denominated bonds seem to support the view that the failure of the agreement temporarily increased the risk premium on Quebec bonds by about 25 basis points. But an overview of private-sector comments on the Meech Lake Accord shows how wide the spectrum of opinions could be on assessing the risk of current constitutional developments. For example, on 9 April 1990, the Deutsche Bank Group recommended a decrease in Canadian bond holdings from 10 to 5 per cent of the global portfolio. On 23 February 1990, Merrill Lynch of New York wrote that in the long run, a sovereign Quebec of some kind is inevitable but its bond ratings will suffer little if at all as a result.

16 The figures shown in Charts 5-2 and 5-3 assume the central management of the debt under the confederation-of-regions option.

17 The Task Force on Program Review estimated that the value of federal real property holdings, which is the most important component of physical assets, was between $40 and $60 billion in 1984. See Task Force on Program Review, *An Introduction to the Process of Program Review* (Ottawa: Minister of Supply and Services Canada, May 1986), p. 29.

18 One could argue that past debt was incurred on the assumption that all regions would continue to provide the same revenues to the federal government. To complicate matters, there are several different ways of looking at revenue, and various adjustments can be made to reflect better the real contribution of provinces to the funding of federal activities. Some of these adjustments are described in Table 5-2.

19 The Bélanger-Campeau Commission assumed that Quebec's share of federal liabilities should be the same as its share of federal assets. Its conclusion that the share would be 17.5 per cent was the result of separate estimates of a Quebec share with respect to three different categories of assets: financial assets (including debt and equity investments in crown corporations), nonfinancial assets (primarily real property), and the total of accumulated federal deficits incurred to fund noncapital spending. The calculation of these shares is likely to be controversial, however.

First, the calculation of Quebec's share of financial assets was based on the assumption that Quebec would be able to make a selection of only those assets which it wished to retain. The calculation was also based on the historical book value of investments, some of which may differ significantly from a realistic assessment of their current value – particularly in the case of investments in certain crown corporations.

In the absence of hard data on the value of federal real-estate holdings in Quebec, the commission also based its calculation of Quebec's share of federal real property holdings on the arbitrary assumption that this proportion would be the same as Quebec's share of federal transfers to local governments in lieu of taxes.

Finally, the commission assumed that Quebec's share of the accumulated federal deficit would be equal to the share of federal revenues derived from Quebec.

20 This is primarily a consideration that applies to long-term debt, which represents the smaller portion of total federal indebtedness. Instead of requiring Quebec to issue new debt to enable the federal government to redeem its outstanding long-term bond issues, Quebec might instead simply guarantee repayment of its share of such debt and enter into arrangements whereby it would agree to reimburse the federal government for its share of debt-servicing costs. Ultimately, as issues of long-term federal debt matured, Quebec could issue its own debt in order to reimburse the federal government.

Appendix B

1 For details on the Phillips curve, see Robert Campbell, *The Full-Employment Objective in Canada, 1945-85: Historical, Conceptual, and Comparative Perspectives*, Economic Council of Canada (Ottawa: Supply and Services Canada, 1991).

2 The most comprehensive work dealing with hysteresis in economics is *Unemployment, Hysteresis and the Natural Rate Hypothesis*, ed. Rod Cross (New York: Basil Blackwell, 1988), which contains the papers presented at a conference that took place at the University of Saint Andrews in Scotland in July 1986.

Chapter 3 of this compendium contains a paper on the history of hysteresis by Cross and Andrew Allen. They use a number of examples from the physical sciences to illustrate the meaning of hysteresis. They make reference to the famous visual representation of the effect of hysteresis in ferromagnetic fields. Within this context, the hysteresis loop describes how the electro-magnetic characteristics of ferrometals change during a complete cycle of magnetization and demagnetization. In fact, field characteristics never return to their original state, once a magnetizing force has been applied and removed. The implication is that the equilibrium properties of the metal have changed in some fundamental way.

This idea has been carried over to economics. Most models in economics assume unique equilibria. Hysteresis admits to the possibility of multiple equilibria. The importance of hysteresis can be traced to its policy implications, given the existence of numerous equilibriums.

For example, an exchange-rate misalignment or a recession, no matter what the cause, could permanently affect the equilibrium value of the real exchange rate or the natural rate of unemployment (the point where involuntary unemployment is zero or labour markets clear at the going wage). Simple models from the literature on industrial organization (dealing with exit and entry) can produce hysteresis effects in the trade balance if sunk costs are present, as can labour-market models that contain thresholds tied to the choice between labour and leisure.

Under hysteresis, given a temporary misalignment of the exchange rate, the equilibrium current-account position can change permanently when the exchange rate returns to the value prior to misalignment. In labour markets, traditional policy anchors (such as the natural rate of unemployment under hysteresis) are themselves dependent upon the means of implementing policy goals, such as opening the output gap to control inflation.

This viewpoint has important implications for demand-management policy. If hysteresis is a factor, then permanent damage could result (a permanently higher unemployment rate or a permanently worse current account position) from a policy that forces the economy away from equilibrium as a means to achieve a particular goal. This is very different from a paradigm, which counts on the independence of policy from any effect on equilibrium.

Concepts related to hysteresis (such as persistence) are much less of an obstacle to policy formulation. For example, the slow return to equilibrium – as characterized by the long tail on the Canadian unemployment rate or by changes in the composition of the duration and incidence component of national and provincial unemployment rates – as reported in the 27th Annual Review does not point in the direction of permanent damage but only to a long-lasting effect that diminishes over time.

3 In the current context, money illusion (or nominal wage rigidity) becomes a factor only when going from a low to an even lower rate of inflation or to price stability. The existence of nominal wage inflexibility puts a floor on how low one can drive inflation rates by opening up the gap between actual and potential performance. Nominal wage rigidity, at low rates of inflation, would increase the sacrifice ratio.

4 The sacrifice ratio characterizes the degree of flexibility in labour markets during the disinflation process. It indicates the cumulative loss in GDP required to lower the inflation rate by 1 percentage point. For example, P. Howitt (1990), using data from the 1981-82 recession and recovery, obtains a sacrifice ratio of 4.7 per cent of initial-year GDP for Canada. That is, to reduce inflation by 1 per cent permanently, the forgone output would be equal to 4.7 per cent of initial-year GDP.

5 Pierre Fortin, "Credit crunches and wage dynamics: a revision of the Canadian Phillips curve, 1957-1987," a paper presented at the Third Annual Conference of the Canadian Macro Study Group, Queen's University, November 1989.

6 Pierre Fortin, "The Phillips curve, macroeconomic policy and the welfare of Canadians," Innis Lecture, Meetings of the

Canadian Economics Association, Queen's University, June 1991.

7 Hysteresis is what really matters for policy purposes. Strong persistence does not affect the cost/benefit analysis significantly. For example, with a coefficient for h of 0.9 as opposed to 1, the required benefit, assuming a 2-per-cent rate of discount, is 0.67. This compares with 4 with hysteresis ($h = 1$) and 0.08 with no hysteresis ($h = 0$).

8 It is important to distinguish between hysteresis and structural adjustment. A combination of a shock in relative prices and a generous UI program might lead to a continuous rise in unemployment through time. If this happens at the same time that monetary policy tightens and if one does not *properly* control for such structural factors in the analysis, any conclusion might point incorrectly to hysteresis as the culprit.

9 W. Scarth, "Fighting inflation: are the costs of getting to zero too high?" in *Taking Aim: The Debate on Zero Inflation*, ed. Robert York (Toronto: C. D. Howe Institute, 1990), pp. 81-103.

10 Peter Howitt, "Zero inflation as a long-term target for monetary policy," *Zero Inflation: The Goal of Price Stability*, ed. R. G. Lipsey (Toronto: C. D. Howe Institute, 1990), pp. 67-108.

11 P. J. Jarrett and J. G. Selody, "The productivity-inflation nexus in Canada, 1963-1979," *Review of Economics and Statistics* 64, no. 3 (August 1982):361-7.

Appendix E

1 Shoven and Whalley provide a good review of general-equilibrium models, their properties, and the kinds of analyses for which they are best suited. See J. B. Shoven and J. Whalley, "Applied General Equilibrium Models of Taxation and International Trade," *Journal of Economic Literature* 22 (September 1984):1007-51.

2 The technology of production in the equilibrium dataset is essentially that described by the 1984 provincial input-output tables. Technology is not static, however, and the mix of capital, labour, and intermediate inputs will adjust under simulation in response to change in the relative prices of these commodities. For a more complete discussion, see John Whalley and Irene Trela, *Regional Aspects of Confederation*, Royal Commission on the Economic Union and Development Prospects for Canada, Research studies, volume 68 (Toronto: University of Toronto Press, 1986).

For a complete description of how these data were incorporated with the provincial economic accounts to produce the equilibrium data base, see France St-Hilaire, "Provincial benchmark data set 1984: sources and methods documentation," a technical paper prepared for the Department of Finance, July 1990.

The updating of the tax and transfer dataset was undertaken in the following manner: from the provincial economic accounts, effective rates of taxation and transfer were calculated for both 1984 and 1988 for each of the major tax and transfer categories in the model – indirect taxes, direct taxes, income taxes, taxes on factors, subsidies, transfers to individuals, transfers to governments, and equalization payments. In order to make the tax and transfer data in the 1984 dataset reflect the tax *structure* observed in 1988, all tax rates and transfer levels in the model were multiplied by the ratio of the appropriate 1988 and 1984 effective rates. The model was then simulated, and the new equilibrium solution was the base used in comparing scenarios. In this way, the changes in the relative importance of different categories of tax or transfers are reflected in the updated dataset, although the intra-category distribution of taxes continues to reflect the structure observed in 1984.

3 Detailed descriptions of the model and its properties have been published in various places; the most accessible of these is Whalley and Trela's contribution to the 1984 Royal Commission on the Economic Union. Although minor changes have been incorporated into the model in order to make it more suitable for the particular task at hand, its structure and nature remain unaltered.

4 The values are Hicksian equivalent variations, expressed as a percentage of pre-shock regional GNP. A Hicksian equivalent variation is the amount of money that would make individuals in each region indifferent to the implementation of the policy under consideration. It is a money measure of the amount by which the policy would make them better off or worse off.

5 Because the general-equilibrium model is timeless, the welfare gain or loss is permanent. For a world with growth and time, a static welfare gain/loss implies that in every subsequent period, people would be 5 per cent better off than they would otherwise have been, regardless of any growth that might have occurred in the system.

6 One indicator of openness is one half the value of (exports plus imports)/regional GNP. Using this measure, the degree of openness of the Atlantic region is 60 per cent; the corresponding figures for Quebec, Ontario, Manitoba and Saskatchewan together, Alberta, and British Columbia and the territories are 55 per cent, 58 per cent, 56 per cent, 55 per cent, and 48 per cent.

7 Not all possible elasticity combinations were simulated because of some technical limitations of the model.

8 A more detailed description of the simulations and of the model's sensitivity to particular assumptions can be found in Andrew Burns, "Regional welfare impacts of alternative confederation scenarios: some preliminary results," a background paper prepared for the Economic Council, 1991.

9 For each scenario, the high (low) estimate was taken from the simulation whose assumed elasticities produced the smallest (largest) sum of absolute regional welfare changes.

10 Unlike other transfers and expenditures, these subsidies are a specific response to a temporary situation external to Canada – worldwide protectionism in agriculture. To the extent that the subsidies do offset protectionism, a return of world prices would eliminate the welfare loss associated with the subsidies.

11 In this scenario, the net saving to the federal government produced by the excess of federal transfer and program spending in Quebec over the taxes collected in that province is redistributed among the remaining regions in the form of increased intergovernmental transfers.

List of Tables, Charts, and Figures

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Project Contributors

Research

Jean-Pierre Voyer, Director

David Péloquin
Kei Moray
James Nightingale
Marcel Bédard

Economic Outlook

Ross Preston, Director

Richard Roy, Deputy Director
Andrew Burns
Haider Saiyed
Gilles Bérubé
Marg Willis
Pat Nevin

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Economic Council of Canada
Conseil économique du Canada

P.O. Box 527
Ottawa, Ontario
K1P 5V6

C.P. 527
Ottawa (Ontario)
K1P 5V6