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**EFFICIENCY AND GOVERNMENT: COMPETING HYPOTHESES OF  
CENTRALIZATION AND DECENTRALIZATION**

*Stuart Landon and C.E. Smith*

*Department of Economics, University of Alberta*



**Efficiency and Government:  
Competing Hypotheses of Centralization and Decentralization\***

**Stuart Landon and C.E. Smith**

**University of Alberta  
Edmonton, Alberta  
Canada T6G 2H4**

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## I. Introduction

This paper examines the economic costs and benefits of several competing hypotheses for a restructured Canadian federalism. As background to this comparison, it is first necessary to review the literature on fiscal federalism as it relates to the degree of centralization in a federal system. Section II summarizes the relative costs and benefits of centralized and decentralized federal systems with respect to the standard roles of government: public goods provision, the regulation of externalities, redistribution, and stabilization. In Section III, the impact of more and less centralized federal systems on the efficient operation of government is discussed. Section IV uses the results of Sections II and III to examine several alternatives for a restructured Canadian federalism.

The principal conclusion of the paper is that there exist potentially large costs to further decentralization of the Canadian federal system. In fact, the existing level of decentralization may impose significant economic costs which could be countered by increased policy harmonization. While it is desirable to include all ten provinces in this harmonization program, the paper considers reasons for treating Quebec asymmetrically and suggests how this could be done.

## II. The Roles of Government

### *Public Goods Provision*

One of the key responsibilities of governments is the provision of public goods (where these goods may be of varying degrees of publicness). The determination of the appropriate level of government to provide these goods depends on several factors. If tastes differ significantly between regions, but are homogeneous within regions, regional governments may be better able to choose the quantity and type of public goods that correspond to individual preferences than can the central government.<sup>1</sup> If these regions correspond to provincial boundaries, the provinces would be the optimal level at which to determine the provision of public goods. However, if tastes

differ more across groups within provinces than across provinces (between income groups or between rural and urban residents, for example), provincial provision of public goods may not be preferred to national provision.<sup>2</sup>

If regional endowments differ significantly, the level and type of public goods provided in one region may be more extensive than those provided in other regions. This difference in public goods provision may encourage the migration of factors (labour and capital) from the less to the more well endowed region. This migration may cause factor productivity to differ across regions and lead to the inefficient allocation of factors. Migration of individuals from one region to another due to differences in public goods provision may also lead to the imposition of residency requirements for public goods consumption.<sup>3</sup> Restrictions of this type can alter the mobility decisions of individuals and lead to the inefficient allocation of resources. If public goods are uniformly provided by a national government, regional endowment disparities would not lead to corresponding disparities in the provision of public goods and, as a result, would not distort migration decisions.

Public goods may also have spillover effects that benefit the residents of other regions due to their portability. For example, health care, post-secondary education, and job retraining are all goods that represent investments in human capital which do not dissipate once an individual leaves the region in which the investment took place.<sup>4</sup> One region may also be able to free ride on the research and regulatory investment of another jurisdiction. This could involve, for example, copying product safety guidelines or financial firm and pollution regulations.<sup>5</sup> Since these spillover effects may not be taken into account by regional providers, public goods will be under provided relative to that level which would be optimal from a national perspective.<sup>6</sup>

The public provision or non-provision of goods can also have a negative effect on other regions. The James Bay Hydro project, for example, may affect water quality in James Bay and impose costs on the residents of

Ontario and the Northwest Territories. Quebec's decision to not invest in sewage treatment facilities has led to the continued dumping of raw sewage into the Ottawa River at the expense of Ontario residents. Since regional governments do not generally take the costs borne by non-residents into account when deciding on the quantity of public services to provide, they may under-provide or over-provide these goods from a national perspective.<sup>7</sup>

### *Externalities and Regulation*

One role of government is the use of taxation and/or regulation to internalize the externalities associated with the production of private goods. When regulating the production of an externality in its region, a regional government typically considers only the costs borne by its residents. If the externality is more widespread than the geographical jurisdiction of the government, its total effect will not be internalized and national welfare will not be maximized.<sup>8</sup> The total impact of the externality will be taken into account only if the regulating jurisdiction includes the entire region over which the externality has an effect.

As with the provision of public goods in general, considerable fixed costs may be associated with administering regulations and undertaking research into the regulation of externalities (for example, product testing, assessing environmental dangers, etc.). If every province is responsible for regulating the impact of various activities on the environment, taxpayers will have to collectively finance the fixed costs associated with eleven sets of regulators. In addition, firms will have to bear the costs associated with satisfying several sets of provincial regulations if they have plants located in different provinces. These extra costs may discourage firms from operating in more than one province and lead to the suboptimal location of production. Finally, provincially-based regulations often lead to certification requirements for professionals which reduce labour mobility between regions.

• Against these costs of regional regulation, all of which justify



regulation at a higher jurisdictional level, must be weighed the major benefit from regional regulation which is its ability to conform to potentially distinct regional preferences for regulation.

### *Redistribution*

If the quantity of redistribution is determined at the regional level, access to redistribution, and/or the taxes required to finance redistributive programs, may vary across regions due to regional differences in tastes for redistribution as well as because of different regional endowments. These inter-regional differences in programs and taxes may cause labour and capital to choose their location on other than efficiency grounds. In addition, jurisdictions may strategically choose lower levels of redistribution than their preferences for redistribution would otherwise imply in order to discourage in-migration of the poor. A uniform program of redistribution financed at the national level would prevent one region from free-riding on another as well as prevent redistribution programs from causing the inefficient inter-regional allocation of labour and capital.

One of the key normative principles underlying most redistributive systems is the "equal treatment of equals." That is, individuals who are identical in every way except for their region of residence should not be treated differently by the redistribution system. Equalization payments lead to the redistribution of revenues to provincial governments, but do not necessarily lead to the equal treatment of individuals across the country. For example, welfare programs, though jointly financed by the federal and provincial governments (but administered by the latter) differ widely in their generosity across provinces.<sup>9</sup> In addition, health services and education, both of which are in part redistributive, also differ significantly in quality across provinces.<sup>10</sup>

### *Stabilization Policy*

Stabilization policy is generally viewed as the responsibility of the



central government.<sup>11</sup> One reason for this is that a central government is better able to carry debt than a regional government. As long as disturbances across regions are not perfectly correlated, the national government experiences smaller variations in its revenues and expenditures, and so pays a lower risk premium than do individual regions. The central government also pays a smaller risk premium than the regions because it can borrow from the central bank.<sup>12</sup> For both these reasons, it has greater flexibility in its response to cycles.<sup>13</sup>

Regional governments are also less effective stabilizers because expansion in one region leads to the leakage of demand into the regions it trades with. In general, the smaller is the expanding region, the smaller is the impact of an expansion on output within its borders. While there is some disagreement in the literature about the size of provincial government spending multipliers in Canada, it is generally agreed that they are smaller than federal multipliers.<sup>14</sup>

Even though regional stabilization policy may have an impact on other regions, regional governments do not generally take this effect into account when determining their policy stance. As a result, the stabilization policies of different regions may be offsetting or too extreme.<sup>15</sup> The greater the effort of provinces to stabilize output and employment, the greater this problem is likely to be. Therefore, decentralization of taxing and spending powers to the provinces is likely to increase regional stabilization policy conflicts.<sup>16</sup>

### III. Efficiency in the Implementation of Government Policy

This section discusses the efficient operation of government and its relationship to the degree of decentralization. The issues covered include competition between governments, intergovernmental transfers, duplication of services, and the monitoring of government activity.

### *Competition Between Governments*

Brennan and Buchanan (1980) argue that a monolithic national government will set its tax rate to maximize tax revenues. The allocation of taxing and spending power to the local level, by initiating competition between local governments for mobile taxpayers, causes tax rates to be kept low.<sup>17</sup> While justifying a decentralized federal structure, this analysis of tax behaviour does not assign much weight to the ability of voters to replace a high tax government through the electoral process. A competitive political system, however, may be a relatively low cost substitute for a federation designed primarily to produce competition between local governments.

Horizontal competition between regional governments in a federation may lead to more efficient production of public services for two reasons in addition to that cited above. First, different regional governments may experiment with different forms of public good provision. This innovation may eventually lead to more efficient methods for the provision of public goods which could then be copied by other regions. Second, the ability to observe the performance of different regional governments may lead to the more efficient production of public goods as voters compare the performance of their government to that of other regional governments (Breton (1990)).<sup>18</sup>

Competition between regional governments may have a negative impact on national welfare if it leads regions to use taxing, spending or regulatory rules to induce firms or labour to locate within their borders on other than efficiency grounds.<sup>19</sup> This type of competition may lead to sub-optimal levels of taxation, public goods provision and regulation from a national perspective.<sup>20</sup> Furthermore, barriers to trade among regions may arise from competition for investment and jobs. This may distort the location of plants and workers and lead to the inefficient production of goods.<sup>21</sup>

Divergent tastes for government services and tax competition may yield inter-regional tax differences. Differential taxation of mobile factors may lead to the sub-optimal location of these factors and may also raise the

administrative costs of firms operating in more than one region. In Canada, the federal government promotes tax harmonization by collecting personal and corporate income taxes for all provinces that agree to use the federal income tax base. This policy has been fairly effective at harmonizing taxes (only Quebec collects its own personal income tax and only Ontario, Quebec and Alberta collect their own corporate income tax), but has been eroded recently by the inclusion of special provincial tax provisions on the federal tax form. In addition, the four western provinces have been seriously considering setting up their own tax collection system. Despite the relative harmonization of the tax base, Canada is still characterized by significant inter-provincial differences in provincial sales tax rates, gasoline taxes, corporate and individual income tax rates, royalty taxes, and subsidies to firms, all of which may distort the location of factors. These differences are likely to become more significant if more taxing and spending power is given to the provinces.<sup>22</sup>

#### *Intergovernmental Transfers*

Some of the costs associated with a decentralized federal structure could be counteracted, at least in part, by conditional or unconditional transfers from the central to the regional governments. Conditional grants can counteract spillover effects since these imply that the regions are using incorrect relative prices when determining their optimal policies. Inefficient resource allocation caused by unequal regional endowments, and the inequality between government programs these imply, could be countered by unconditional grants that equalize the fiscal capacities of the regions.

The correct level of conditional grants may be difficult to determine because spillover effects are potentially large in number and difficult to measure. In addition, neither of these two types of grants can eliminate many of the costs of decentralization noted above such as free-riding, the fixed costs of regional administration, tax competition, differential tax systems, or the strategic choice of public goods provision and

redistribution.<sup>23</sup>

Intergovernmental grants are also associated with two sources of potential inefficiency, the extent of which is likely to be smaller the greater the proportion of services provided by the central government. The first source of inefficiency is the "flypaper effect". This is the empirical observation that intergovernmental grants increase spending on public goods by more than would an equivalent transfer to private individuals and, as a result, cause too many public goods to be provided.<sup>24</sup>

The second source of inefficiency arises because the use of intergovernmental grants may blur the tax-price of public goods and lead to an inefficient quantity of these goods being chosen. As Bird (1986, p.223) notes "One rationale for matching revenues and expenditures is that governments responsible for financing their own expenditure are more likely to spend carefully and efficiently. This aim would seem to require, however, that local taxes should be independently levied. It cannot easily be satisfied by tax-sharing arrangements in which (as in Canada) political responsibility for taxes is blurred, however clear the legal responsibility may be." Matching taxes and revenues, as opposed to the use of intergovernmental transfers, might also lead to better accountability.<sup>25</sup>

#### *Government Duplication*

Horizontal and vertical duplication of government services raises the total cost of providing a given level of public goods. In addition, when different levels of government have overlapping jurisdictions, a lack of coordination and communication, as well as possibly conflicting goals, may lead to the suboptimal provision of services. Finally, if only one level of government is responsible for supplying a particular service it is easier for voters to attribute responsibility for results, thus clarifying the tax-price of government services. By making governments more accountable, this is likely to increase the efficiency of the public sector.<sup>26</sup>

The fixed costs associated with administering public goods programs



imply that provision of these goods by a higher level of government is more cost effective. This follows because it can spread its fixed costs over a larger number of potential consumers.<sup>27</sup>

### *Efficiency in the Choice of Government*

The form of federal system chosen should encourage government accountability and the efficient choice of government which both, in turn, rely on effective monitoring by voters, the opposition, the media and other non-government organizations. The more complicated are vertical government interactions due to overlapping jurisdictions and intergovernmental transfers, the more costly is monitoring likely to be. Because there are fixed costs associated with monitoring a government, monitoring a single government, even if it is the national government, is likely to be less costly than monitoring eleven different governments. In addition, the fixed and variable costs of providing a given level of monitoring are likely to be similar for individual regional governments and the national government. As a result, the cost per voter of monitoring the federal government is likely to be much less than that for monitoring a provincial government.

The social benefit of monitoring at the national level is likely to be greater than provincial monitoring since national government policies affect more people than do the policies of individual provincial governments. Furthermore, the private benefit of monitoring at the national level is likely to be larger since larger national media audiences produce larger advertising revenues. The relative costs and benefits of monitoring at the national and regional levels imply that there is likely to be more monitoring of the national government than of individual provincial governments. This implies that the provision of government services at the national level may be preferred because it can be more effectively monitored.

#### IV. Competing Hypotheses of Centralization and Decentralization

In this section, the results of the two preceding sections are used to compare competing forms of fiscal arrangements. The alternatives considered are the devolution of most taxing and spending power to the provinces, and the transfer of these same powers to the central government. Variations on these two themes and some suggestions for reform of the current system are also considered.<sup>28</sup>

##### *Increased Provincial Powers*

Since the failure of the Meech Lake Accord, the view that Canadian federalism should be restructured to give more power to the provinces has been widely promoted. One extreme version of this view would see the transfer of all taxing and spending authority to the provinces except for those powers associated with the provision and financing of truly national public goods (national defense, external affairs, a central bank and the repayment of the existing national debt). This form of decentralization would have three principal benefits. First, duplication of services by the provincial and federal governments would end. This would reduce administrative costs as well as avoid the pursuit of conflicting policies by different levels of government. In addition, the devolution of taxing and spending power would clarify the tax-price of public services.

The second important benefit of decentralization of power to the provinces is that, being smaller political units than the federal government, they may be better able to institute policies that conform more closely to local preferences.<sup>29</sup> This is likely to be important if the residents of a particular province differ significantly from the majority of the national population, as is the case for the francophone population of Quebec. Finally, government orchestrated stabilization policies could potentially be more sensitive to provincial level shocks than might a stabilization scheme directed from the national level.<sup>30</sup>

Following from the discussion in Sections II and III above,

decentralization might entail a number of significant costs. The desire to encourage "job creation" by attracting new firms or stimulating the output of existing firms is likely to lead to tax, subsidy and regulatory competition as well as the imposition of barriers to trade between provinces. Spillover effects associated with public goods will not be internalized and externalities will be under-regulated. Taxpayers in each province would have to bear the fixed costs of a complete provincial bureaucracy.<sup>31</sup> Different tax systems, regulations and accreditation requirements will raise costs to firms operating in more than one province and inhibit the mobility of capital and labour. Heterogeneous provincial endowments (particularly due to resource rents) are likely to yield different levels of public goods provision. This may lead to the inefficient allocation of capital and labour as well as reduce equity. Interprovincial mobility may decline since access to provincially-funded services, such as post-secondary education and health, may be restricted to taxpayers who have lived for some time in a province. Revenue shocks are likely to lead to larger swings in the level of services provided and provinces may pursue uncoordinated and potentially contradictory stabilization policies.<sup>32</sup> Finally, provinces may strategically choose their redistributive programs and there may be less effective monitoring of government actions.

It may be possible for the provinces to reduce the costs of a decentralized federal system through some form of cooperation.<sup>33</sup> For example, provinces could agree to jointly reduce barriers to trade and mobility, harmonize taxes, and institute equalization grants. To the extent that such interprovincial agreements restrict provincial actions, the ability of a decentralized system to conform to local preferences is decreased. As well, there may be additional costs associated with implementing and monitoring these agreements at the provincial level and it may be difficult to prevent some provinces from free-riding. It is also not certain that such agreements could be reached between all the provinces due to their population and resource heterogeneity. Furthermore, to some extent agreements of this type



simply proxy a more centralized form of government in a potentially more bureaucratic fashion.

#### *A More Centralized State*

The most extreme version of a centralized state would allocate all taxing and spending power to the central government. This form of government would eliminate the problems associated with a decentralized federal system. In addition, it would reduce program duplication, clarify the tax-price of public goods, and reduce the costs of monitoring.

The principal cost of a more centralized system of government is that public services and taxes may not conform to the preferences of residents in different regions. This cost is particularly important if tastes differ significantly across regions. It is, therefore, likely to be highest for the francophone residents of Quebec who, for linguistic reasons, may feel that the central government cannot reflect their preferences adequately. This problem is considered in the next sub-section.<sup>34</sup>

To move toward a more centralized system of this type, the federal government would have to oppose any expansion of provincial jurisdiction. It would, in particular, have to oppose increased provincial government control of the Supreme Court (as was recommended in the Meech Lake Accord) or the Senate since both these institutions could be used by the provinces to restrict federal actions. In addition, to the extent that such powers could be used to promote inter-provincial policy harmonization, the federal government would want to increase or obtain sole jurisdiction over property and civil rights;<sup>35</sup> the regulation of trade and commerce, financial markets, labour practices and the environment; health, education and welfare; as well as corporate and personal income taxes.

#### *Suggestions for Reform of the Existing Federal System*

The analysis above indicates that there can be large costs associated with further decentralization and that there may be some benefit to enhancing

the economic powers of the central government. However, the provinces are unlikely to accept constitutional changes that increase federal power. Therefore, none of the policy suggestions considered below require changes to the existing Constitution of Canada.<sup>36</sup>

The federal government could reduce the costs associated with the present decentralized system by exploiting many of its existing powers.<sup>37</sup> First, it could seek agreements with the provinces to bring about increased tax, subsidy and regulatory harmonization, thus limiting interprovincial competition and distortions.<sup>38</sup> For example, the federal government could strongly press for the establishment of national bodies (under joint federal-provincial control) to regulate the environment, all financial institutions, business practices and labour standards. As well, the federal government should continue to encourage provinces to take advantage of its offer to collect personal and corporate income and sales taxes as long as they use the federal tax base.<sup>39</sup>

Second, the federal government could use cash grants to encourage coordination, interprovincial portability and accessibility of programs, as is currently (but soon to be phased out) done for health care and post-secondary education.<sup>40</sup> Without these cash grants, it is not in the interest of all provinces to maintain access and portability.<sup>41</sup>

Third, since the uniform provision of social services across the country would promote the efficient allocation of resources, the federal government could make greater use of benefits that go directly to individuals (rather than to the provinces). For example, the funds currently transferred to the provinces through the Canada Assistance Plan (which is a 50 percent shared-cost program) and, perhaps also, the equalization program (which is a block grant) could be used to make direct transfers to individuals through the income tax system. In addition to promoting equity in welfare programs, this would help clarify the tax-price of provincially-provided goods.

Finally, the federal government could make greater use of the powers granted to it in the constitution to pressure provincial governments to

follow policies that promote economic efficiency. Such policies would include limiting interprovincial barriers to trade, promoting tax, subsidy and regulatory harmonization and promoting the free movement of factors.<sup>42</sup>

The pursuit of the policies mentioned above may conflict with the aspirations of Quebec for greater economic and political control. Given the current political climate, suggestions for a restructured Canadian federalism must recognize this fact. One method of promoting increased economic harmonization across Canada, while at the same time accommodating Quebec, would be for the federal government to transfer certain taxing, spending and regulatory responsibilities to Quebec while concurrently pursuing policies of increased harmonization in the rest of Canada. The remainder of this sub-section briefly examines how this might be accomplished.

At present, the government of Quebec has (and uses) extensive powers to tax, spend and regulate. The federal government could increase these powers by transferring some of its responsibility for spending and regulating to the Quebec government. By causing greater government decentralization, this change would not be costless. While most of the costs following from greater decentralization would probably be borne by Quebec residents, some would be shared by the rest of Canada (due to spillover effects, tax competition, reduced factor mobility and barriers to trade.) However, the increase in costs to the rest of Canada may not be excessively large since Quebec already exercises extensive power in many areas and, more importantly, existing taxation and administrative differences as well as language barriers already restrict factor mobility.

The greater costs associated with granting more authority to Quebec imply that the federal government should withdraw from the minimum number of areas necessary to fulfill the requirements of Quebec for greater independence. The areas it should be most willing to give up responsibility for are those for which the tastes of Quebec residents differ most significantly from those of residents of the rest of Canada. As well, it should concentrate on those areas for which the costs borne by residents

outside of Quebec are the smallest (for example, education, culture, communications, agriculture, Canada Mortgage and Housing Corporation operations in Quebec, and the responsibilities of the Secretary of State).

Those areas over which the federal government should resist giving up control are those that impose the greatest costs. For example, a transfer of federal funds currently used for "economic development" and "industrial expansion" to Quebec is likely to increase inter-provincial subsidy wars. Giving Quebec responsibility for the fisheries may cause common property problems as well as inhibit federal involvement in environmental regulation which may adversely affect other provinces. Transferring responsibility for the unemployment insurance system in Quebec to the Quebec government might give rise to large costs, in terms of reduced labour mobility, unless portability and uniformity of benefits is maintained.

The federal government should resist attempts by Quebec to alter the portability, uniformity and accessibility of programs which are currently partly funded by the federal government (health and post-secondary education) since changes to these programs may distort labour mobility. This can be best done by funding these programs with federal cash-grants to the provinces.

If the federal government reduces its spending responsibilities in Quebec, its taxation of Quebec residents should fall correspondingly. The government of Quebec could then tax and spend as much as it would like in the areas it chooses. By cutting the taxes of Quebec residents instead of transferring the equivalent tax revenues to the Quebec government, the tax-price of federal and provincial government services would be made clearer to voters in Quebec. This should improve the efficiency of public good choice as well as government accountability.

The transfer of spending powers to Quebec does not imply that these powers should also be transferred to the other nine provinces. This follows because the costs (in terms of reduced factor mobility, etc.,) are likely to be smaller and the benefits greater (due to linguistic differences) in Quebec



than in the other provinces.

## V. Conclusion

The analysis above suggests several broad conclusions. Decentralization of taxing, spending and regulatory power brings with it potentially large economic costs. While a more decentralized federal system might allow government policy to conform more closely to regional tastes, it is unclear to what extent the provinces, as primarily artificial geographic entities, are composed of individuals with significantly more homogeneous tastes than the nation as a whole.

For linguistic, historical and cultural reasons, Quebec would probably benefit the most from decentralization. In fact, increased decentralization of power to Quebec would probably not yield that many more costs than already are implied by Quebec's separate tax system, legal system and language barriers. However, similar decentralization of power to the other provinces might significantly increase inter-provincial barriers to trade and factor mobility, as well as magnify tax and spending distortions, while providing little compensating benefit. This suggests that further decentralization should be resisted and greater harmonization of tax, regulatory and social programs across Canada encouraged. This could be accomplished through increased cooperation between the provinces and the federal government as well as through the implementation of federal policies to encourage policy harmonization.

## Notes

1. According to Tiebout (1956), a federation consisting of a large number of local authorities, each providing different bundles of public goods, would yield the optimal provision of public goods through the process of individuals moving to the locality which provides their preferred bundle. This result relies on a number of restrictive assumptions: there must be a large number of different communities; no mobility costs; perfect information; individuals' incomes must be independent of their location; and inter-regional free-riding must be impossible. (For brief summaries of Tiebout's hypothesis see Boadway and Wildasin (1984) or Stiglitz (1986).)
2. The recent Saskatchewan election boundaries case before the Supreme Court suggests that preferences may differ more between rural and urban areas within a province than between rural or urban areas in different provinces.
3. The type of publicly provided goods for which this is most likely to be important are health care and post-secondary education. Both of these are consumed disproportionately by the old and young. They tend to be mobile and may not have paid taxes in the region providing the service. Residency requirements are common in Switzerland and the United States.
4. The benefits of a public good could also be exported from a region in the form of goods produced in that region. For example, an efficient road network may lower the cost of production in a particular region and part of this benefit may accrue to consumers and stockholders in other regions.
5. In Canada, various provinces have copied the rulings and regulations of the Ontario Securities Commission.
6. Note, however, that if all ten provinces determine their level of regulation independently, and there are fixed costs of regulating, there will be over-expenditure on regulation, but still under-provision of regulation.
7. The usual Coasean solution to the externality problem may be inappropriate in this case due to disagreement over the appropriate allocation of property rights, the transactions costs associated with bargaining over each externality, and the ability of labour and capital to relocate.
8. An example is the pulp and paper development along the Athabasca River in Alberta which may have a negative impact on the residents of the Northwest Territories.
9. For example, the welfare rates for a single parent with one child varied from \$8816 in New Brunswick to \$12,539 in Ontario in 1989, according to the National Council on Welfare, as quoted in the Globe and Mail (8 May 1991, p. A4).
10. One of the few social welfare programs over which the federal government has exclusive jurisdiction is the unemployment insurance (UI) system. The present UI system provides more extensive benefits to individuals living in high unemployment regions and, as a result, inhibits labour mobility. However, this bias in the UI system also counteracts, to some extent, inter-provincial inequality in provincially administered redistribution programs. National harmonization of these programs would facilitate the reform of the UI system to eliminate its mobility disincentives.

11. See Oates (1972, pp. 4-6, 21-30) and Musgrave (1959, pp. 181-2).
12. Auld (1982, p. 308) notes that the cost of deficit financing has been a major deterrent to provincial counter-cyclical policy.
13. This also implies that greater centralization in the provision of public goods prevents shocks from causing as large swings in the level of services provided than would regional provision.
14. Fortin (1982) finds that the multipliers for Ontario, Quebec and B.C. are over 75 percent of the federal multiplier. Wilson (1977, pp. 127-135) finds that for these three largest provinces, demand leakages are sufficiently small that fiscal policy is not "totally futile" as it would be in the smaller provinces.
15. This was also recognized in the Carter Commission report (1966, p.102).
16. The Western premiers recently called on Ottawa to surrender more taxing power to the provinces so that they could "stimulate their economies in their own ways." (The Globe and Mail, 14 May 1991, p. A4). Decentralization of taxing and spending power may also cause the federal government to rely more heavily on monetary policy as its stabilization policy instrument than is optimal. According to Knott (1977, p.75), dissatisfaction with the lack of coordination between federal and local fiscal policy goals led the federal government in Germany to put greater emphasis on monetary policy.
17. This argument contrasts with the traditional public finance approach in which it is optimal to allocate taxing power to higher levels of government because they can minimize tax avoidance and inter-regional tax induced distortions. See Breton (1989).
18. To a certain extent, both these benefits also apply to national governments since they typically exist within an international setting in which comparisons can be made with other national governments.
19. For example, Alberta's decision to allow only firms producing toxic waste within its borders to use its toxic waste disposal facility may cause firms to locate in Alberta even though it may not be the most efficient location.
20. As Manitoba Premier Gary Filmon recently noted, "The provinces have entered into bidding wars to attract business. . . . It has distorted the market." (The Globe and Mail, 13 May 1991, p. A3).
21. Existing barriers to inter-provincial trade, of which the recent Throne Speech indicated there are approximately 500, include "purchasing policies that favour local suppliers over lower-cost suppliers from other provinces, regulations that make it easier for producers to sell products in other countries than in other provinces, preferential provincial hiring policies and occupational standards that restrict people from other provinces." (The Globe and Mail, 14 May 1991, p. A6.).
22. Strauss (1990) sees fiscal balkanization in the U.S. as extremely costly for U.S. firms and damaging to their competitive position, particularly in light of the movement toward European integration.
23. On conditional and unconditional grants see Break (1980).
24. For an early review of the flypaper effect see Gramlich (1977).



Theoretical justifications for this result appeal to misinformed voters (likely to be more significant the more complicated is the tax system) or a powerful bureaucracy. An additional reason for the flypaper effect may be that regional governments are hesitant to reduce taxes in response to increases in unconditional grants if they think these grants may be cut in the future.

25. Note that revenue sharing also subverts tax competition of the Brennan-Buchanan type since each jurisdiction does not have the responsibility for raising its own revenues. Thus, while decentralization may lead to competition between regions, transfers for redistributive purposes may undermine this competition.
26. One indication of the potential level of duplication is the number of similar departments that exist at both the federal and provincial levels of government. These include departments that deal with health, welfare, transportation, the environment, energy, labour, mining, agriculture and communications.
27. This is the case even if the goods are purely private, but publicly provided and is, therefore, different from the usual argument that it is optimal to increase the size of the tax-paying cohort consuming a pure public good in order to reduce the per person cost.
28. One option we are not explicitly considering would consist of a national government, a second level of government for each of Quebec and the rest of Canada, and then provincial governments in the rest of Canada. This would add one more layer of government in the rest of Canada, with all its associated costs, and is likely to yield few benefits.
29. As mentioned above, this would not be the case if the residents of each province are no more homogeneous than residents of the nation as a whole.
30. The unemployment insurance scheme, although administered and funded nationally, is an automatic stabilizer that responds to local shocks.
31. This cost may be particularly large for taxpayers in the smaller provinces.
32. Unless the central bank was completely independent of provincial influence, there would be potential for policy conflicts among the provinces in setting monetary policy.
33. This might take a form similar to that currently in place in the European Economic Community.
34. A modification to this highly centralized system of government which may reduce the costs associated with heterogeneous tastes for public services is the allocation to municipal authorities of increased power to spend and tax in order to provide purely local public services. This allocation of powers might also satisfy the urban-rural preference gap better than would the transfer of power to the provinces.
35. In the past, provincial jurisdiction in this area has been used to restrict federal jurisdiction in the regulation of trade and commerce.
36. Even with no changes to the Constitution, there is potential for more inter-provincial policy disharmony than has been previously observed since most provinces have not utilized all the powers granted to them in the Constitution.

37. These attempts should be directed at all the provinces, including Quebec to the extent that this is politically feasible.
38. In the European Economic Community, tax, subsidy and regulatory harmonization have been a high priority and it is a much more diverse federation than Canada.
39. The federal government could increase the provinces' willingness to participate in its tax collection system by avoiding large and unpredictable changes in the personal and corporate income tax bases.
40. Another advantage of federal government grants to the provinces is that they provide a stable revenue source over the cycle. As noted above, intergovernmental grants are associated with several potential sources of inefficiency. However, given existing constitutional constraints, they are the best method available to maintain national programs.
41. Greater use of restrictions on out-of-province users of post-secondary education and health care is to be expected if federal grants are ended. In the United States access to state-funded colleges and universities usually depends on whether a student comes from within the state.
42. An alternative method of reducing the costs associated with a decentralized state is to introduce into the constitution a provision to preserve the free mobility of goods and factors. (See Boadway, Purvis and Wen (1991)).

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