

Federal Fiscal Systems in Theory and History

Robin Neill

Economics, Carleton University and University of Prince Edward Island

Whatever theory proposes, historically, fiscal federalism has not always been efficient. At the very least, fiscal federalism has not been efficient as efficiency has been defined and elaborated by those who have made a special study of the matter: Knut Wicksell (1896), Erik Lindahl (1919), Brennan and Buchanan (1980), Albert Breton (1978, 1996), and Dahlby and Wilson (1996).

The Ideal Allocation of Tax and Expenditure Functions

Ideally, specific tax and expenditure functions in a federation are assigned to, or appropriated by, different constituent governments (central, local, or sub local) on the basis of least cost for most return, (Breton and Scott, 1978). If there are different values in different jurisdictions, different amounts per capita will be spent on particular goods and services. Depending on economies of scale and effects external to particular jurisdictions, the production of some goods and services will occur only in some jurisdictions, and they will be supplied to others in return for some payment in the form of a fee, a grant, or a tax expenditure. Similarly, if there are economies of scale in the collection of taxes the collection function will be carried on in one jurisdiction and the revenues will be granted back to others. Further, each government will exclusively exploit that tax base with respect to which it can most readily equate the costs and benefits of its overall operations, because joint exploitation of tax bases (tax overlap) gives rise to the usual sort of common pool efficiency problems (Dahlby and Wilson, 1996), and, with disconnected taxation and expenditure (fiscal imbalance) those who benefit do not bear the associated costs.

On the surface there would seem to be an internal contradiction in this ideal assignment of tax and expenditure functions. To accommodate externalities and economies of scale the benefits of expenditure, on the one hand, and the costs of taxation, on the other, must reside in different governments. In the presence of this fiscal imbalance (one government taxing and another government spending the revenue), an immediate and tellingly simultaneous sense of benefits and costs is absent from either government. Indeed, in the case of conditional grants, in the context of which governments spend "fifty cent dollars", it would seem that the receiving government is driven to mismatch costs and benefits. It has been asserted, however, that this is not, or, at least, need not be the case. In a democracy, it is alleged, competition between centres of governmental power drives taxes and expenditures to efficient levels (Breton, 1996). Indeed, it is the spirit of Breton's allegation that fiscal imbalance and tax overlap are a consequence of such efficiency generating competition. Further, if taken into account at the constitution making stage of government, any legal obstruction to efficiency can be guarded against and competitive minimization of the inefficiencies associated with fiscal

imbalance and tax overlap can be effected (Brennan and Buchanan, 1980, pp. 168-186).

There are, then, conjectures about how prudence in the making of constitutions and competition between centres of political power might lead to an efficient allocation of taxes and expenditures, despite fiscal imbalance and joint exploitation of tax bases. But, is there any evidence that federal systems historically have exhibited the conjectured efficiency generating processes?

The Condition of Efficiency in Fiscal Systems

In his classic treatment of the problem of fiscal efficiency, Knut Wicksell (1896) proposed that a nice matching of costs and benefits would be possible only when new combinations of taxes and expenditures were voted on simultaneously under a unanimity rule; and when the share of costs, that is the tax imposed on each individual voting, was specified (Wicksell, 1896, pp. 89-91). Erik Lindahl expanded on these conditions by adding that each item in total expenditures would have to be specified, along with the associated tax for each individual, and that all citizens would have to be in an equal position to defend their economic interests (Lindahl, 1919, pp. 173-174).

There are two points to be noted in this Wicksell-Lindahl proposition. First, it is a statement of conditions that would have to hold if efficiency were to be achieved. Second, the possibility of inefficiency due to political coercion is admitted.

There are both differences and similarities between the Wicksell-Lindahl proposal and subsequent conjectures of Albert Breton, and Brennan and Buchanan. Breton asserts that historical tax and expenditure mechanisms, quite different from those proposed by Wicksell and Lindahl, may, in fact, have achieved the hoped for efficiency effects of Wicksell-Lindahl unanimity and simultaneity rules (Breton, 1996, p. 89). Because there is after-the-fact inter group acquiescence, according to Breton, *virtual* unanimity and simultaneity is achieved by what is called "in-period choice". Brennan and Buchanan, believing with Lindahl that there has been considerable political coercion, and, therefore inefficiency, in historical outcomes, offer suggestions about how constitutional constraints, that is "constitutional choice" as opposed to in-period choice, either has minimized or can minimize the difference between actual outcomes and efficient outcomes (Lindahl, 1919, p. 174-175; Brennan and Buchanan, 1980, pp. 17-26, 37, 203).

The central concept in these propositions is an efficient connection between taxes and government expenditures, what Breton has called the "Wicksellian connection": an equation of marginal costs and marginal benefits in the public sector. For Breton, by assumption, it is historically achieved or, at least, reasonably approximated. For Brennan and Buchanan it would be achieved only under ideal conditions that have not been historically realized, at least, not in full, though it could be approximated given the appropriate constitutional arrangements. Both of these propositions have associated analytical models of how the world would work if by constitutional arrangement the connection were to be made, or how it putatively works in fact to make the connection (Wicksell, 1896, pp. 87-96; Lindahl, 1919, pp. 169-173; Breton,

1996, pp. 66-69, 87-90; Brennan and Buchanan, 1980, pp. 39-47, 49-54.). Neither of them has been supported by anything approaching systematic historical or statistical evidence.

The Dark side of Wicksell and Lindahl

Wicksell and Lindahl stated conditions that would, in their view, ensure an efficient connection between taxes and expenditures: Breton's Wicksellian connection. Both also stated conditions under which that connection would be out of the question. These we may refer to as Wicksellian hiatuses. The asserted bases of these hiatuses were four. First, when a new and good expenditure is envisioned by a few, and the mass of the voters will not see its value until it has become a part of the fiscal system, the rule of unanimity and simultaneity cannot hold (Wicksell, 1996, p. 88). Second, when tax revenues increase for exogenous reasons, that is, reasons other than the passage of specific legislation, the rule of unanimity and simultaneity is in abeyance until the exogenous increase has been dealt with by specific legislation (Wicksell, 1996, p. 91). Third, when expenditures increase for exogenous reasons, for example to meet past obligations, the rule of unanimity and simultaneity cannot be kept (Wicksell, 1996, p. 93; Lindahl, 1919, p. 174). Fourth, when expenditures entail an either-or choice, and no trade off is possible between interested parties, the rule of unanimity and simultaneity cannot be kept (Lindahl, 1919, p. 174). In the presence of these conditions there is a Wicksellian hiatus, and, according to both Wicksell and Lindahl, some coercion is present. The result is inefficiency.

Neither Wicksell nor Lindahl intended to give an exhaustive and detailed list of the bases for the Wicksellian hiatus, and there is no need to generate such a list. In an historical investigation of the appearance of such bases, the existence of any one of them, that is the existence of any historical circumstance that is an obex to efficiency, is moot until it actually appears. Strictly speaking, of course, the Wicksellian hiatus is the absence of an efficient connection between taxes and expenditures. In answering an historical question concerning the matter, however, it will be convenient to metonymously label circumstances giving rise to a Wicksellian hiatus, a Wicksellian hiatus.

The question is, then, to what extent has inefficiency been associated with Wicksellian hiatuses in the fiscal system of some specific historical federation? Specifically, to what extent have tax overlap and fiscal imbalance been introduced into some historical federal fiscal system, without having their consequences with respect to efficiency removed by either an in-period or a constitutional choice? The occurrence of fiscal imbalance and tax overlap is not the essence of this question. For Breton, they occur, but they occur as a rational instrument of efficiency. Rather, the question is, to what extent are they non rational Wicksellian hiatuses? Alternatively, to what extent has rationality eliminated these non rational elements from the fiscal system? There are very serious difficulties in answering this question with respect to Bretonian in-period choice, because the assumption of efficiency, that is, that what exists is accepted and therefore is efficient, is historically invincible. Still, it may be possible to show that over time tax overlap and fiscal imbalance have diminished, thereby providing some evidence that something like a dragged out, non equilibrium, Bretonian in-period, inefficiency removing choice is at work. The case with respect to the Brennan-Buchanan constitutional mechanism is different.

Constitutional choice is a matter of explicit historical act. Its presence, or absence, is a matter of factual record.

The fiscal system of the Canadian confederacy is a suitable case to examine in attempting an answer to this question. Its history is short and well documented. The constitution of Canada was not fixed in the beginning, and has taken form slowly over time. It is as yet not formally accepted by a province containing about a quarter of the population, and may be said to be still in the making. The presence of both any historical "constitutional choice" and "in-period choice", that is, the presence and success of the efficiency producing mechanisms postulated by Brennan and Buchanan, and by Albert Breton, respectively (insofar as the latter might be construed into an historico-operationally viable form) can be observed along with any inefficiency generating tax overlap or fiscal imbalance that metonymously might be labelled a Wicksellian hiatus.

Fiscal Federalism in Canada: 1867-1914

The fiscal history of Canada, as presented here, begins with the British North America Act of 1867 and ends with the 1998 Supreme Court reference concerning the secession of Quebec from Canada. It begins with the original assignment of jurisdictions, taxes, and transfers, and ends with the so-called Health Budget of 1999. This history has been well told (Bird, 1970, Dawson, 1947, pp. 116-136, 587-647; Perry, 1955, 1989, 1990; Moore, Perry, and Beach, 1967; Leslie, Norrie and Ip, 1993.), and needs only to be contextualized into considerations of the Wicksellian connection and hiatus, that is, considerations of inefficiency.

In the British North America Act the federal government was assigned all modes of raising revenue (Sec. 91, #3.). The provincial governments were specifically given direct taxation of persons within their own jurisdictions (Sec. 92, #2.). Customs and excise taxes were given solely to the federal government (Secs. 121-123.). The reason for the allocation of taxing powers was not given in the Act itself. A reason has been supplied by constitutional historians, but it falls short of the mark. In their view, the government assigned a responsibility was also assigned suitable tax powers to carry it out. The federal government was given responsibility for defence, and for regulation and development of the economy. Accordingly, it was exclusively given the tariff, the primary source of revenue at the time, and all other taxes. The provinces, having responsibility for the administration of local matters, such as health, education, welfare, and the administration of justice with respect to civil law, so it was conjectured, were given lesser revenues to be derived from direct taxation of persons (Dawson, 1954, pp. 116-117.). Accordingly, in this view, A Brennan-Buchanan type, efficiency generating, constitutional choice had been made.

The problem with this conjecture is evident in the failure of the assignment of revenues to even approximate the needs of the provinces. In the first years, over half of provincial revenues came in the form of transfers from the federal government. Massive fiscal imbalance obtained. Some alternative conjecture is needed, and its bases are not far to seek. There are two of them. First, health, education, welfare, and civil rights were matters that touched closely on the distinct cultures of the old colonies of Upper and Lower Canada. That is to say, it was not because these

were light local matters that they were left in the hands of the provinces. Politically, they were very heavy matters that had destroyed the Union of 1841. Second, in the beginning Canada was a unitary state. The Lieutenant Governors were appointed by the federal government, and were thought to be responsible to it. Provincial legislation was subject to federal disallowance, and was, in the first years disallowed, even in matters of civil rights. That is to say, the lion's share of revenues went to the Dominion (not federal or confederate) government because Canada was a unitary state, not a federal state. Substantially, the central government was responsible for all fiscal matters.

Expenditures with respect to health, education, welfare, and civil rights were given to the provinces for political reasons. This might be rationalized, following the reasoning of Breton, on the grounds that values, the purposes of expenditures, would be different in different provinces. But that rationalization would not cover all aspects of the situation. The original dispensation was untenable in at least three different ways.. First, it was internally inconsistent. Revenues did not match responsibilities. Second, the different values in provincial jurisdictions, having destroyed the old union of Upper and Lower Canada, continued to generate political pressures that, through the decisions of the Judicial Committee of the Privy Council in Britain, turned the nation into a true federation. The provinces were ascribed sovereign power in specified jurisdictions. Third, the fiscal burden of providing health, education and welfare services grew to overreach the burden of nation building. The tasks of the provinces became heavier than the tasks of what became a federal and, eventually a confederate, government. In short, the recurrence of Wicksellian hiatuses required continual in-period, Bretonian adjustments, and for these there is little historical evidence, though there is some.

These inefficiency generating aspects of the original dispensation could have been met by adjustments in taxing powers; and to some extent for some time they were. The provinces came to rely less on transfers from the Dominion government, and more on their own sources of revenue. The portion of provincial revenues coming in the form of federal transfers grew absolutely, but declined to a third of provincial revenues by 1900, a quarter, by 1910, and a tenth, by 1930. Over the same period all the provinces adopted succession duties, corporation taxes, and gasoline taxes. Five adopted personal income taxes, and British Columbia adopted a corporate income tax. Ontario, British Columbia, and Quebec were able to generate significant revenues by selling off mining and forestry resources.

On the surface, then, there would seem to be something like a Bretonian adjustment taking place. From 1867 until 1914, both Dominion and provincial expenditures rose, absolutely, and as a portion of Gross National Product (Bird, 1970, pp. 13-15.). After the turn of the century, provincial expenditures rose more rapidly than Dominion expenditures, but the provinces seemed to be managing more revenues to cope. In fact, however, they were not coping, because levels of debt and demands for provincial services were growing much more quickly than provincial revenues, to the point that a constitutional crises on the matter was in the making.

In all of this there was nothing that could be called an efficiency generating constitutional choice with respect to the fiscal system. There was no popular vote on the British North America Act, and so no evidence of anything like unanimity. In violation of two of Brennan

and Buchanan's criteria for a fiscally efficient federation (Brennan and Buchanan, 1980, pp. 179-181.), the number of provinces were few and their sizes varied widely. History made these decisions, not economic reasoning. Further, some provinces entered confederation under protest. In the case of Nova Scotia a decision of the Imperial government prevailed over the result of a popular vote. British Columbia came in on the promise of a transcontinental railway, threatened withdrawal when that promise was not kept, and remained unsatisfied with Confederation even when it finally was. Prince Edward Island came in because it could not carry the debt associated with an overbuilt railway system, and on the promise of the financial means to settle its "land question". One might say that there was an efficient exchange involved, but continued demands and protests by the province thereafter indicate, at least, a degree of dissatisfaction. It is not an efficient exchange when a bankrupt submits to receivers. The general level of coercion was evident in the demands of the provinces at the Interprovincial Conference of 1887, demands that were turned down by the Imperial government. After 1890, protests from the Prairie Provinces over the tariff, concessions to the Canadian Pacific Railway, and Dominion control of provincial resources, certainly did not indicate anything like unanimity on the fiscal system. The economic consequences of constitution making at the time of Confederation were fiscal inefficiencies.

It is not that there was no constitution making after Confederation. Constitutionally significant decisions by the Judicial Committee of the Privy Council (the supreme court) granted the provinces sovereignty over matters in Section 92 of the British North America Act, confirming Canada as true federation, if not a confederation. The grant took place, however, without changes in the original dispensation of powers to tax and spend. Further, under persistent political pressure, per capita financial grants to the provinces were increased absolutely, but never in such a way that one could ascribe to the result a Wicksellian connection. The process was characterized by "an air of grotesque unreality, untrammelled by logic and the ordinary restrictions and meanings of words" (Dawson, 1947, pp. 120). The result was a consequence of history, not reason. "[C]ircumstances over which the provinces had virtually no control operated to increase, and greatly increase, the quantity and intensity of provincial activity" (Dawson, 1947, pp. 121). Evidence of a Wicksellian hiatus is thick on the ground.

In this first period of fiscal federalism in Canada there are only weak grounds on which to assert a Wicksellian connection; and there are no grounds on which to assert that there was rational constitution period choice of the sort conjectured by Brennan and Buchanan. No constitutional restraints were placed on the taxing power of the Dominion government in the beginning, and none was generated as the Dominion evolved into a federation. The monopoly granted the federal government over the tariff remained in force. Despite complaints from Western Canada and the Maritime Provinces, there was no competition in that major source of revenue, and certainly no unanimity on the rates levied. The fiscal imbalance entailed in the grants to the provincial governments might have been rationalized on the grounds that the nation was a unitary state, when that was the case. Once the provinces were ascribed sovereignty in a specified domain, the fiscal imbalance needed another economic rationalization. There was none. The arrangement was an accident of political expedience, not a trade-off based on economies of scale and externalities. Neither was it explicitly rationalized by the idea that jurisdictions with different values should have control of spending related to their different values, though, likely,

implicit considerations of that sort played a part.

In general, however, this first period did not witness the worst of Canada's tax inefficiencies. The provinces did come to rely less on federal grants, at least as a portion of their budgets. Inefficiencies deriving from common exploitation of the pool of taxable exchanges were minimal. For the most part, those who taxed bore the political and economic cost of the damage to the tax base. There was some tax competition. Ontario municipalities, for example, undertook what they called "bonusing" to attract industry (Neill, 1978, p. 284), and there is no reason to think that there was no "bonusing" in other provinces. Such activity is consonant with in-period generation of efficiency (Brennan and Buchanan, p. 183). There may also have been competitive reduction of revenues extracted from the resource sector of provincial economies (Neill, 1978, p. 285; Robin, 1972), but that certainly could have been at the expense of an efficient rate of exploitation of both non-renewable and renewable resources.

The point is not that there was nothing in the evolution of Canada's fiscal system that resembled Breton's conjectured Wicksellian connection, or that there was nothing resembling Brennan and Buchanan's constitution phase limitation on the power to tax. Rather, the point is that Breton's conjectured process, insofar as it operated at all, operated "slowly, painfully, and probably not completely" (D.G. Hartle, 1968, p. 7.); and that Brennan and Buchanan's constitution phase limitation, insofar as it was present at all, was weakened by a process of constitution making that was a semi-conscious, sporadic response to immediate exigency. In all likelihood the Bretonian adjustment toward efficiency was continually swamped by new changes to which adjustment had to be made; and any constitutional restraint on the Leviathan-like propensities of governments to exploit tax monopolies was largely accidental. The point is that history repeatedly generated a Wicksellian hiatus that frustrated any efficiency generating processes.

From the First World War to the Rowell-Sirois Report

The First World War put an end to the trend to own-source taxation for own expenditures. As a residual of the dispensation of 1867 the federal government retained the right to all forms of taxation, and it retained the powers of a unitary state in times of national emergency. The demands of the First World War brought these powers and responsibilities into full play. A grave but temporary expedience obviated any rational, dispensation of fiscal powers and responsibilities. In particular, in 1917, the federal government levied a personal income tax, a field, until then, left to the provinces. In 1920, in an additional effort to pay for war debts, the federal government adopted a sales tax. Both of these taxes survived the elimination of the war debt, despite a general lowering of taxes in the late 1920s. During the war Canada approached the characteristics of a command economy. There can be no question about the element of coercion involved. After the war, the debt had to be paid. It was a very clear case of a Wicksellian hiatus resulting in higher federal taxation, new forms of federal taxation, and an increase in tax overlap as the federal government invaded the provinces income tax base.

By the 1920s it was legally established that the provinces were sovereign in the matters listed in Section 92 of the British North America Act. It was also evident that these matters were matters of relatively increasing importance. Apart from the attendant consequence that the

federal government had most of the revenues and the provincial governments had most of the responsibilities, there was an entailed implicit assertion that the efficiency criteria to be taken into account were not those of the nation as a whole, but those of its constituent parts. This rationale for reassignment of tax and expenditure functions was recognized, but reassignment was both constitutionally and politically impossible (Kemp, 1931; Bladen, 1935; Rogers, 1935). There was no Brennan and Buchanan type constitutional phase adjustment toward efficiency. Some ten years later a similar constitutional adjustment was called for, this time in favour of centralization, rather than decentralization, but that call also elicited no response.

The problems of the 1920s and 1930s were to be found in the allocation of both responsibilities and revenues. Health, education, and welfare services were the areas in which the demand for expenditures was greatest. The tasks of economic development that had belonged to the federal government in the late nineteenth century had been largely completed. New departures in economic development, depending largely on resource exploitation, which by then had come under provincial jurisdiction, naturally fell to provincial responsibility. This new, non-rational, historically determined allocation of responsibilities called for a new dispensation with respect to revenues. The provinces should have had the lion's share, but, among other things, temporary expedients during the First World War had ensured that that would not be the case. The initial dispensation of 1867, generated without reference to fiscal efficiency, married history to breed further fiscal inefficiencies, and, formally, the initial dispensation could not be changed, though some changes in the fiscal system did take place.

The nature and purposes of federal transfers changed after 1911. They came to include grants for agricultural instruction, vocational education, highway construction, employment offices, venereal disease prevention, and old age pensions. Special grants-in-aid, to the Maritime provinces in 1926, the Duncan Commission Grants, virtually doubled the Maritimes' original statutory grants. It was a sign of things to come. Tax assignments could not be adjusted, in part due to constitutional rigidities, but also because of the widely differing sizes and economic conditions of the provinces. Some provinces were simply incapable of bearing the costs that had been put upon them. Once again the hand of History restrained reason in the matter of policy. With the advent of the Depression this aspect of the fiscal problem was accentuated. By 1935, "relief" grants raised intergovernmental transfers to 46 percent of provincial budgets and 20 percent of the federal budget. As the federal government took on responsibilities not envisioned in its initial dispensation, a clear Wicksellian hiatus, the potential for inefficiency as a result of fiscal imbalance grew.

Increasing potential for inefficiency from fiscal imbalance was soon accompanied by increasing potential for inefficiency from tax overlap. In the 1930s, Quebec, Ontario, Manitoba and Saskatchewan joined other provinces and the federal government in levying personal income taxes. All the provinces had adopted gasoline taxes in the 1920s, which was a tentative intrusion on the federal sales tax base. In 1936 and 1937, Alberta and Saskatchewan intruded directly on the federal sales tax, though, in general, the provincial sales tax awaited a 1943 enabling decision by the Privy Council (Perry, 1955, 377). The potential for inefficiency from tax overlap rose as all government taxes rose from 13.2 percent of GDP, in 1926, to 18.1 percent in 1936.

There were inconsistencies that could not be overcome. Some regions suffered more than others from the effects of the depression. It seemed right that the federal government should transfer funds from the less affected provinces to maintain the economic viability of the more affected. This was not a matter of efficiency, but of redistribution on the basis of an implicit compact theory of confederation (Bladen, 1935, p. 27). Such a theory was not constitutionally established at the time, but it has been since. (Supreme Court of Canada, 1998). At the same time, the areas of service that were most in need of expenditures (health, education, and welfare) were those that entailed different values in the different provinces, and ideally should have been left to the provincial governments. And that was not all. Regions suffering most in the depression of the 1930s claimed that their difficulties were a consequence of federal government policy in the preceding period of expansion, and they demanded post facto compensation for past wrongs not related to current inefficiencies in the allocation of resources (McQueen, 1935.). The Wicksellian Hiatus intruded from a number of directions into the fiscal system.

By the end of the Depression, in the late 1930s, the fiscal constitution of the nation had become so patently obsolescent that a royal commission was set up to look into the matter. It was an occasion for Brennan and Buchanan style constitutional phase adjustment towards efficiency. The [Rowell-Sirois] Royal Commission on Dominion-Provincial Relations was "(a) to examine the constitutional allocation of revenue sources and governmental burdens to the Dominion and provincial governments ... ; (b) to investigate the character and amount of taxes collected from the people of Canada ... and to determine whether taxation as at present allocated and imposed [was] as equitable and as efficient as can be devised." (Royal Commission on Dominion-Provincial Relations, Report, Book I, p. 10).

Needless to say, history did not allow a simple approach to these classic questions. The Keynesian Revolution and the advent of the welfare state compounded the task by imposing additional items on the agenda. Governments were to undertake counter cyclical compensatory fiscal and monetary policies to maintain full employment and stable prices, and grants to provinces were to be made on the basis of a newly asserted need to maintain national standards in social welfare services. Prior to the 1930s, grants were influenced by the patronage, bribes, implicit welfare considerations, and compensations that were required to keep the federation from disintegrating (Dawson, 1947, pp. 116-136; Ward, 1962; Dupre, 1965), but they were constitutionally justified by the provisions of the British North America Act, not by the emerging values of the twentieth century welfare state.

The Commission recommended that responsibility for unemployment be taken from the provinces and given to the Dominion, for the simple reason that some of the provinces could not bear the burden. This was accomplished by an amendment to the British North America Act. To match this responsibility, to ensure that taxation could fulfil its redistributive function in a federation of economically unequal units (Perry, 1955, pp. 312-315), and to give a competent government some control over the general level of economic activity, the federal government was to be given sole right to personal and corporate income taxes. Most social services were to be left to the provinces, however, for two reasons. First, there were wide differences in social philosophy and economic conditions among the provinces. Second, local, detailed and highly personal administration was required.(Moore and Perry, 1966, pp. 12-13.). To meet their

obligations without sufficient fiscal capacity, the weaker provinces were to receive a National Adjustment Grant, an unconditional transfer, that was to enable them to provide government services at the average Canadian standard. Given the historical circumstances, rationalization of the income tax entailed fiscal imbalance. Efficiency here entailed inefficiency there.

The Commission was a Brennan and Buchanan type constitutional phase exercise, but it included Breton in-period type considerations. The different values of different jurisdictions and something like economies of scale were elements in the argument. The provinces were to be formally allowed joint exploitation of the sales taxes, but the income tax was to be a federal tax. Joint exploitation of the sales tax could hardly have promoted efficiency, but reserving the income tax to one government would have. However contaminated by the legacy of history, reason was to be given a say, and something like a Wicksellian connection was to be achieved. When it came to implementation the provinces that were not to receive adjustment grants refused co-operation. Immediately upon their refusal, Canada entered the Second World War. The nation again reverted to being a virtual unitary state, and the federal government took the major share of all taxes. Formally, however, the provinces retained the right to income taxes, and the way had been cleared for them to adopt sales taxes. Few, if any of the proposed adjustments would have reduced fiscal imbalance or tax overlap, in any case, but it did not matter, because none were made. When special wartime fiscal arrangements were dismantled the National Adjustment Grants were temporarily forgotten, joint exploitation of tax bases continued its relentless increase, and the federal government added to fiscal imbalance by intruding still further into provincial responsibilities in health, education, and welfare.

Late Twentieth Century Reforms

In 1950, 24 percent of provincial revenues originated in federal transfers. These transfers were 9 percent of federal revenues. By 1970, when yet another major reform of the fiscal system was being implemented, 32 percent of provincial revenues originated in federal transfers, and these transfers were 21 percent of federal revenues. All government expenditures rose from 22.2 percent of Gross National Product, in 1950, to 29.7 percent, in 1960, and 36.4 percent in 1970. The potential for damage from fiscal imbalance and joint exploitation of tax bases continued to increase.

In general, the structure of wartime arrangements continued until 1956. The provinces received a payment from the federal government in the form of a tax rental (10 percent, 9 percent, and 50 percent of the personal income tax, the corporation tax, and succession duties, respectively) in return for which the federal government collected all personal and corporate income taxes and succession duties. At that time the tax rental was by far the largest of contemporary unconditional grants, the total of which grew from \$338.7 million to \$395.4 million, between 1952 and 1956. Conditional grants grew from \$70.9 million to \$111.0 million, over the same years.

Ontario and Quebec did not enter the post-war rental agreement of 1947, but collected some of their own taxes, for which their citizens received an abatement of their federal tax. Quebec levied its own corporation tax from 1947, and introduced its own personal income tax in 1954.

The unconditional tax rental, where it continued, was supplemented with unconditional "equalization" and "stabilization" grants, which, like the formerly proposed National Adjustment Grant, were to permit the maintenance of national standards in government services. Conditional grants, largely in the fields of health, education and welfare, increased steadily from \$144.8 million, in 1957-58, to \$606.5 million, in 1962. The consequence of these adjustments, of course was an increase in both fiscal imbalance and tax overlap, and in increase in the level of taxation and expenditure that increased the dead weight of the inefficiency entailed.

Only Quebec argued for a Wicksellian restructuring of the fiscal system. In 1955, and again in 1957, Premier Duplessis decried fiscal imbalance and centralization of power on economic grounds. Quebec had responsibilities that only it could fulfill in line with local values, and it could only do this efficiently if it had associated independent powers to tax (Perry, Moore and Beach, 1967, 121-125). There was, then, some awareness that Breton type, in-period adjustments were needed. And, indeed, the [Carter] Royal Commission on Taxation (1962-1967) was set up to look into the matter on the grounds that "... most of the main taxes had been imposed under conditions of grave emergency, with no time for planning or study. The wording of the income tax statute had been borrowed from the United States, and as it had to be interpreted in the light of British jurisprudence, the results were frequently chaotic" (Perry, 1989, 280). Evidently, the intrusions of history, the Wicksellian Hiatus, continued to weigh heavily in the shaping of the Canadian fiscal system.

Apart from fine tuning the economy (The Monetarist Revolution had yet to take hold.), the Commission's principle concerns were to tax as "comprehensively" and as "fairly" as possible, raising taxes to the maximum short of damage to saving and investment, or, indeed, massive evasion (Perry, 1989, 285-292). Everything was to be taxed. A federal-provincial overlapping sales tax was recommended. In short, achieving the Wicksellian Connection was no part of the reform. The Brennan and Buchanan charge that "traditional public finance" assumed a benevolent government and focussed only on how its activities could be financed was exemplified in the attitude taken by those responsible for the Commission's Report. The chosen limit to taxation, that is the proposal to tax everything to the point of positive damage to the economy or massive evasion, suggests the establishment of a "leviathan" that would charge what the traffic would bear. Nothing in the Report suggests the nice Wicksellian adjustments assumed in Breton's romantic rationalization of federal fiscal systems.

Between 1956 and 1966, unconditional grants remained at about \$400 million. Conditional grants to the provinces, mostly in the areas of health, education and welfare, had grown to over a billion. Tax abatements grew from about \$300 million to over a billion in the same period. Despite this impressive growth in fiscal imbalance and tax overlap, administrative order and "comprehensive" coverage were the avowed goals of piecemeal reform over the succeeding years, and, despite opposition leading to compromises and half measures, there was some progress in these matters by 1981 (Perry, 1989, 307). The general sales tax, recommended by the Carter Commission as a substitute for the Manufacturers Sales Tax, was not implemented until 1991. Fiscal imbalance and joint exploitation of tax bases were given no consideration. By 1976, federal transfers to the provinces had fallen to 32 percent of provincial budgets, but

they remained 23 percent of the federal budget; the decline in the percentage of provincial budgets coming from simple transfers was negated by increased abatements associated with provincial taxation. Fiscal imbalance was replaced with tax overlap. Between 1960 and 1980, combined provincial and federal expenditures rose from 29.7 percent to 41.3 percent of Gross National Product, increasing potential for damage from Wicksellian Hiatuses, while reform of the fiscal system moved in another direction. Neither Brennan and Buchanan nor Albert Breton could have found any empirical evidence to support their conjectures and rationalizations in the Canadian case.

Reform did not stop with the 1970s, during which the Carter Commission Report and a series of White Papers based on it were released. In 1981 tax expenditures were reduced on the grounds of "fairness", indicating that a Wicksellian Hiatus had generated unwarranted tax exemptions. By then, however, the O.P.E.C. oil price shock had given yet another expedient twist to the fiscal system, adding yet another Wicksellian Hiatus to the tortured fiscal history of the confederacy.. Reform in the late 1980s focussed on fine tuning tax expenditures on business development projects, and on substituting the General Sales Tax for the Manufacturer's Sales Tax. Whatever efficiency may have been achieved by these moves was swamped by efforts to meet an emerging problem of increasing deficits and debts as the new GST was accompanied by surtaxes loaded on the Personal Income tax. Through the late 1980s and into the 1990s no attention was paid to the Wicksellian connection, or the want thereof. These years of deficit and debt fighting did see a reduction in the rate of growth of transfers to the provinces. Beginning in 1976 the transfers were restructured into Canada Assistance Plan payments and Established Programs Financing payments. In the mid 1990s these, in turn, were collapsed into the Canada Health and Social Transfer. In both instances the restructuring was motivated by a desired to slow the growth of federal expenditures (Leslie, Norrie, and Ip, 1993). By 1998, transfers had fallen to 14 percent of provincial revenues and 15 percent of federal revenues. Once again, however, the decline in fiscal imbalance was countered by an increase in tax overlap as the federal government campaigned for a federal-provincial Harmonized (General) Sales Tax, thereby, at the same time, reducing room for the competition that both Breton and Brennan and Buchanan thought conducive to fiscal efficiency.

The decline in the portion of federal and provincial budgets accounted for by federal provincial transfers may have done something to reduce fiscal imbalance growing out of historical Wicksellian hiatuses, but other factors were working to increase the associated inefficiencies. From 1947 through 1997, total government expenditures grew from 24 percent to 48 percent of national output, and, of course, they grew absolutely, from \$3.2 billion to \$389 billion. Over the same period provincial and local expenditures grew from 68 percent to 123 percent of federal expenditures. Whenever transfers fell as a portion of provincial budgets, provincial taxes rose. By 1997, provincial personal income tax rates had risen to between 45 percent and 69 percent of the federal tax. Quebec collected its own personal income tax, but the level of its tax fell into the range of the other provinces. In fact, the 1997 levels of provincial personal income tax were the result of minor tax reductions in a number of provinces, indicating the extent to which the 10 percent rate that prevailed until 1957 had been abandoned up to that point. Over the long run, given the rise in provincial and local expenditures, tax overlap had to rise. The rise in the absolute and relative size of governments, the continuing high level of fiscal imbalance, and the

increase in tax overlap increased the potential for damage from fiscal inefficiencies.

Conclusion

The question was, to what extent are inefficiencies associated with a Wicksellian hiatus to be found in the historical development of some specific federal fiscal system? In the Canadian case the very substance of the fiscal system has been shaped by history, rather than reason. Various forms of Wicksellian hiatus have either generated or deflected attention away from inefficiency generating fiscal imbalance and tax overlap. Far from being the product of reasonable compromise on the way to an efficient system, as Albert Breton has suggested, fiscal imbalance and tax overlap have been the result of happenstance, expediency, historically entrenched political blockages, and sheer inadvertence. However one might wish for the constitution making provisions conjectured by Brennan and Buchanan, or the rational adjustments towards Wicksellian connections imagined by Albert Breton, in the Canadian case, if they are there at all, they have been swamped by the effects of Wicksellian hiatuses.

References

- Bird, R.M., 1970, The Growth of Government Spending, Canadian Tax foundation, Toronto.
- Bladen, V.W., 1935, "Problems of the Canadian Federation", Canadian Journal of Economics and Political Science, vol. 1, pp. 26-40.
- Bladen, V.W. 1935(b), "The Economics of Federalism", Canadian Journal of Economics and Political Science, vol. 1, pp. 348-351.
- Breton, A and Scott, A., 1978, The Economic Constitution of Federal States: University of Toronto Press, Toronto.
- Breton, A, 1996, Competitive Governments: an Economic Theory of Politics and Public Finance, Cambridge University Press, Cambridge Mass.
- Brennan, G and Buchanan, J.M., 1980, The Power to Tax, Cambridge University Press, London.

- Canada, 1941, Report, Royal Commission on Dominion-Provincial Relations, Queen's Printer, Ottawa.
- Canada, 1998, Supreme Court, Reference by the Governor in Council concerning certain questions relating to the secession of Quebec from Canada, Ottawa. [<http://www.uni.ca/reference.html>]
- Dahlby, B and Wilson, L.S.1996, "Tax Assignment and Fiscal Externalities in a Federal State", in P. Boothe (ed.), Reforming Fiscal Federalism for Global Competition, University of Alberta Press, Edmonton.
- Dawson, R. McG., 1954, The Government of Canada, University of Toronto Press, Toronto.
- DeBrou, D. and B. Waiser 1992, Documenting Canada, Fifth House Publishers, Saskatoon.
- Dupre, J.S., 1965, "Tax Powers vs. Spending Responsibilities" in University League for Social Reform, The Prospect for Change, McGraw-Hill, Toronto, pp. 83-101.
- Hartle, D.G., 1968, "The Impact of New Tax Policies on National Unity", Institute for the Quantitative Analysis of Social and Economic Policy, Toronto, Policy Paper, Number 1.
- Kemp, H.R., 1931, "Is a Revision of Taxing Powers Necessary?", Proceedings of the Canadian Political Science Association, vol. 3, pp. 205-230.
- Leslie, P.M , Norrie, K, and Ip, I.K., 1993, A Partnership in Trouble, C.D. Howe Institute, Toronto.
- Lindahl, E., 1919, "Just Taxation - a Positive Solution", in R.A. Musgrave and A.T. Peacock, Classics in the Theory of Public Finance, Macmillan, New York, 1967, pp. 168-176.
- Neill, R., 1978, "The Politics and Economics of Development in Ontario", Ontario History, vol. 70, pp. 281-290.
- Perry, H.J. 1955, Taxes, Tariffs, and Subsidies, University of Toronto Press, Toronto.
- Perry, H.J., A.M. Moore, and D.J. Beach 1967 The Financing of Canadian Federation, Canadian Tax Foundation, Toronto.
- Perry, H.J.1989, A Fiscal History of Canada - the Postwar Years, Canadian Tax Foundation, Toronto.
- Perry, H.J. 1990, Taxation in Canada, Fifth Edition, Canadian Tax Foundation, Toronto.

- Robin, M., 1972, The Rush for Spoils, McClelland, Toronto.
- Rogers, N.M. 1935, "The Political Principle of Federalism", Canadian Journal of Economics and Political Science, vol. 1, pp. 337-377.
- Ward, N., 1962, The Public Purse, University of Toronto Press, Toronto.
- Weldon, J.C. 1966, "Public Goods (and Federalism)", Canadian Journal of Economics and Political Science, vol. 32, pp. 230-238.
- Wicksell, K., 1896, "A New Principle of Just Taxation", in R.A. Musgrave and A.T. Peacock, Classics in the Theory of Public Finance, Macmillan, New York, 1967, pp. 72-118.