TOO MANY COOKS:
National Purpose and Equalization

ROBIN NEILL

July 2006

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CONTENTS

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EXECUTIVE SUMMARY

In a recent government report on equalization, the economic question, "What is the efficient way to achieve the sought-for equity?" was not even raised, let alone answered. If it had been raised, the answer would have been that equalization would be achieved most efficiently by a system of provincially differentiated taxes.

The equity goal is to ensure Canadian citizens receive reasonably equal government services at reasonably equal levels of taxation. To accommodate local differences in social values and in the circumstances of delivery, it has been seen best to have the provinces deliver the services, while equity is served by having differences in costs equalized by federal transfers. Both equity and efficiency seem to be achieved.

In fact, however, a number of collateral efficient and inefficient consequences are entailed in the system. On the one hand, for example, transfers inhibit an economically warranted out-migration from less prosperous provinces. On the other hand, again for example, transfers support training and education that facilitates out-migration to more prosperous provinces.

The current equalization system has a long list of such side-effects, which this paper exhaustively reviews for purposes of choosing a system of equalization on the basis of efficiency. Many of the side-effects counteract one another. In some cases, they would be the same under either a system of taxes or a system of transfers, thus providing no grounds for choosing between the two systems. However, one inefficient side-effect in the system of transfers is not balanced out: the entailed fiscal imbalance.

A fiscal imbalance obtains when one government taxes and another government spends the revenue from the tax. In this circumstance, the costs of the tax are not measured against the benefits from spending the revenue. The economic goal of getting the most for the least is not achieved. If, alternatively, equalization was carried out through a system of provincially differentiated taxes — with the federal government reducing its taxes to make room for provincial taxes — the fiscal imbalance would be eliminated. Governments would match the benefits of spending against the costs of taxing or they would face irate voters. There would be accountability and efficiency even as the goal of equity was achieved.

INTRODUCTION

The recent report commissioned by the Canadian government, *Achieving a National Purpose: Putting Equalization Back on Track* (http://www.eqtff-pfft.ca/english/EQTreasury/index,asp), has typified the product of a committee of disparate opinions. The list of those consulted includes a large number of blue ribbon economists. Some are internationally recognized experts in the tax and transfer mechanisms entailed in equalization. It is well known, of course, that where there are two economists there are two opinions. But the problem of the report goes beyond this, because an equally long list of “government representatives” and “others” was also consulted. The result is what one would expect: a bland mix of high-sounding words and a recommendation that tinkers with the current system without either fundamental analysis or fundamental change. Naturally, the report recommends a greater infusion of money.

With at least 40 economists among those consulted, the report should have featured what economists focus on: efficiency, getting the greatest benefit for the least cost, getting value for money. The economists’ concern must have been lost in the concerns of the government representatives and the others, because economic efficiency is not emphasized, if raised at all, in the report.

There certainly are relevant considerations besides ensuring that taxpayers get value for their money. In a country as diverse and difficult to govern as Canada, non-economic considerations have to come into play. But the economic concern also has a place. The economic question should have been raised. Had it been raised, and had it been given priority the recommendations of the report would have been very different.

The economic question is, *What is the efficient way to achieve the equity goal of equalization?* How can the goal best be achieved at the lowest possible cost? The answer is, by using a system of provincially differentiated taxes rather than a system of provincially differentiated transfers.

This proposal is theoretical. There are no numbers, charts, or graphs to prove its merit. However, the history of the Canadian federal fiscal system supports it, as does the perception that our tax payments get lost in government bureaucracies and political machinations. The result is that government revenues do not reappear in activities that compensate for the loss due to taxation.

EQUALIZATION: NATURE AND PURPOSES

In 1939, the Royal Commission on Dominion-Provincial Relations recommended that responsibility for unemployment be taken from the provinces and given to the federal government. The reason was simple: some provinces could not bear the burden. To match this responsibility, to ensure that taxes could be equitably distributed, and to give government some control over the general level of economic activity, the Commission recommended that the federal government be awarded sole right to personal and corporate income taxes. Provision of most social services, however, was to be left to the provinces, 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.

To provide these comprehensive administrative services at something approaching a national standard, provinces with insufficient fiscal capacity were to receive a National Adjustment Grant. And so it was that a proposed rationalization of the income tax system led to a vision of a complex federal fiscal system in which both efficiency and equity were achieved (see Perry 1955, 312–15; and Perry and Moore 1966, 12–13). Many of the recommendations of the Commission were rejected by the provinces, but the National Adjustment Grant survived under the name of "equalization". The concept was subsequently enshrined in the Constitution.

Today, equalization amounts to the following: provinces with lower-than-average fiscal capacities receive equalization transfers from the federal government, while those with higher-than-average fiscal capacities do not. The amounts transferred are shared out depending on the degree of shortfall in fiscal capacity. A province's fiscal capacity is determined by examining actual or potential revenues from 33 different sources. This is what a province could collect if it imposed the average provincial tax on each of these sources (for example, income, sales). The average provincial rate is derived from weighted average rates of taxation in the five "middle" provinces: British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec. The Atlantic provinces and Alberta, having the greatest and least fiscal capacity, are left out of the calculation.

Equalization Justified

Equalization has been justified on grounds of both equity and efficiency. The equity argument is that citizens of a nation have a right to reasonably comparable government services at reasonably comparable levels of taxation. According to the efficiency argument, because different provinces want different services in different mixes, and because government services are best delivered locally where immediate contact with clients is possible and physical circumstances of delivery can be taken into account, government services are best delivered by provincial governments. With these justifications, equalization reasonably can take the form of unconditional, provincially differentiated transfers from the federal government. And it does.

On the surface, then, equity and efficiency are both served by equalization transfers. There is, however, much that lies below the surface. There are inefficiencies, for example, that offset those resulting from local delivery, and there are other efficiencies that re-enforce the efficiency of local delivery. Taking such facts[1] into account, the question arises, Would it be more efficient if equalization were carried out by provincially differentiated federal taxation rather than by provincially differentiated federal transfers?

1 The suggestion that equalization could be achieved by differentiated taxation was made first by J.M. Buchanan (1950, 1952). The Constitution calls for “payments”. It also calls for a “steam” connection between Prince Edward Island and the mainland. Because a bridge was considered more efficient than obsolescent steamship transportation, a bridge was deemed to satisfy the constitutional requirement. On the same grounds, differentiated federal taxation may be taken to satisfy the constitutional requirement for differentiated payments.

There can be no constitutional objection to differential taxation, as opposed to differential transfers. The federal government, in transferring “tax points"”differentially to Quebec and Ontario, has been engaged in provincially differentiated taxation for decades.

EQUALIZATION INEFFICIENCIES

Equalization by way of transfers entails a fiscal imbalance, which occurs when one government taxes and another government spends the revenue generated by the tax. This must be distinguished from a fiscal gap, which occurs when a government draws from the citizens of some jurisdiction more than it returns in expenditures.[2] A fiscal gap may occur as a result of a fiscal imbalance, but the two are not the same thing. The inefficiency of a fiscal imbalance follows from the principle that a tax is efficient if the cost of the tax in the private sector is matched by some corresponding benefit generated by expenditures in the public sector. When there is a fiscal imbalance, the government estimating the benefit from the expenditure is not the government estimating the cost of levying the tax. This is true whether the costs and benefits are a matter of substance in the economy or of electoral gain or loss for the governments involved. Given the different points of view, the costs and benefits calculated are not likely to be in balance. Indeed, it would be a matter of pure chance, or more probably of miscalculation, if they were.[3]

Equalization by way of transfers from the federal government to the provinces entails yet another kind of inefficiency. The basis of the transfer is a lamentable deficiency in fiscal capacity in some provinces. So, insofar as the transfer of revenue damages the fiscal capacity of the receiving province, the transfer can be labeled inefficient, because it adds to the unfortunate situation that it was intended to ameliorate. There are circumstances in which this would be the case.

It is theoretically possible for a province to gain revenue by taxing a source so heavily that the source is damaged. It loses revenue because the damaged source has a lower yield, but it gains revenue because in consequence it receives a larger inflow of equalization payments.[4] When the compensating equalization revenue is greater than the lost revenue, a province will gain revenue by damaging the

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2 Complaints from the Ontario government about a fiscal gap in the early years of the twenty-first century were related to a fiscal imbalance, but a fiscal gap evokes considerations of equity and efficiency quite different from those entailed in a fiscal imbalance. This distinctions has not been maintained in all of the literature on the subject. (See Courchene 2005a,b.)

3 This form of inefficiency has not been featured in recent discussions of the benefits and costs of equalization, but it has been noted in the literature on fiscal systems since early in the twentieth century. (See Wicksell [1896] 1967; Lindahl 1967.)

4 The argument is essentially that of supply-side economists. If Prince Edward Island, for example, were to put a special tax on the production of beverage cans, ostensibly to prevent litter, it would drive the industry off the Island, reduce employment, and lower provincial output. With its total industry so reduced, despite the higher tax rate on one industry, its total tax take would also be reduced. This reduced fiscal capacity, however, would be the occasion of a larger equalization grant. This form of inefficiency was first exposed by Courchene and Beavis (1973). More recently, it has been brought forward by Dahlby and Wilson (1991). See also Crowley and McIver (2004, 7–10).

source and, in fact, may be tempted to target any such source for damaging taxation. Further, if the provincial government perceives that announcement of a larger transfer will have a more positive electoral result than an announcement that a tax base has not been impaired, it will be sorely tempted to choose the larger transfer.

It is a corollary of this that a provincial government could see a gain in refusing to develop a tax base — that is, by deliberately not taking steps to improve the province's fiscal capacity.[5] By choosing a greater inflow of equalization payments rather than a lesser flow of net revenue gains generated by development expenditures, the government of a province might see itself better off. Alternatively, it could exchange possible fiscal capacity gains from private sector development for electorally favourable spinoffs, such as subsidized jobs in low-employment constituencies or unprofitable natural gas distribution in small centres. In such cases, as in the case of tax manipulation, the unfortunate disparity in fiscal capacity that equalization is meant to ameliorate is increased or perpetuated by the equalization transfer itself.

What is perhaps the most notorious inefficiency attributed to the Canadian equalization scheme is the effect it has on internal migration of resources, particularly of labour.[6] It is the economically lagging regions of the nation, where resources are less productive, that receive equalization transfers. To the extent that the transfers equalize government services, pressure on resources to move to regions where they would be more productive is reduced, and a natural process of adjustment that would bring about convergence in the level of productivity and fiscal capacity in different regions is frustrated. Again, the argument is that the relatively deficient fiscal capacities that equalization payments are intended to ameliorate are made worse or perpetuated by the equalization payments themselves.

The process by which this last alleged inefficiency comes about is a matter of special consideration. It is asserted that provinces with low fiscal capacity are provinces with an excess of labour, high unemployment, and low wages. In the normal working of a market system, a low return to labour is the result of a relative shortage of capital. The capital/labour ratio is low and, accordingly, the return to capital is relatively high. The normal result would be an inward flow of capital and an outward flow of labour. The increasingly productive change in the capital/labour ratio would bring productivity into line with that in other provinces.[7] There would be a convergence in the productivity of economic activity and in the fiscal capacities of all provinces. What is alleged, then, is that equalization payments so disturb the working of normal market adjustments, inhibiting the out-migration

5 This form of inefficiency has recently been brought to the public's attention with respect to the development of oil and gas reserves off the east coast of Canada. (See Martin 2001; Boessenkool 2002; Crowley and McIver 2004, 7–10.)

6 The allegation, in this specific form, was first put forward by Scott (1950). Scott's allegations were countered by J.M. Buchanan. An excellent summary of the debate that followed can be found in Graham (1963, 153-94). The debate took place in the early 1950s.

7 The simplest form of this argument states that abundant, inexpensive workers will induce business to locate in a region and better-paying jobs elsewhere will induce workers to leave the region — the sort of thing that is happening across the Mexico-United States border.

of labour, distorting provincial policies, and generating interferences in the investment of private capital, that the efficiencies entailed in convergence do not occur.

There are yet other inefficiencies of a different sort attributed to equalization transfers. It is alleged that failures of the public sector generate economically inefficient policies. These failures are due to the intrusion of electoral motives into economic policy, the ability of special interests to influence policy outcomes, and the deficiencies of motivation in, and the inefficiency of, government bureaucracies.[8] All of these seriously impair the economic efficiency with which fiscal systems operate.[9] This, it is argued, is particularly true of equalization transfers, because two governments are involved. Elaborations of this argument conclude that, as a result of government failure, equalization payments have been unpredictable, voters have not been able to hold governments accountable for their actions, and, indeed, reasonable equalization has not occurred. Further, it is contended that the process by which equalization transfers are calculated is so inscrutable as to render the scheme inappropriate in a democracy (see Boothe 2002).

8 The most blatant cases are typified by the upgrading of roads in economically futureless ridings with large voting populations, while ridings with economic potential but small voting populations are ignored. Subsidizing losing industries in ridings with large populations is another case. The subsidy keeps the population in place, and the voting population's being in place, the subsidy continues to be paid.

9 This argument has been brought forward more recently in something like a recantation by J.M. Buchanan (2002); see also Grubel (2002).

EQUALIZATION EFFICIENCIES

There are efficiencies attributed to equalization transfers that to some extent offset the conjectured inefficiencies. Foremost among these is having different provincial preferences for and conditions of delivery of government services addressed at the provincial level. As with inefficiencies, however, we must dig below the surface.

The allegation that equalization payments would inhibit an efficient reallocation of resources across the nation has not gone unchallenged.[10] It has been asserted that the transfers would, in fact, facilitate an efficient allocation of resources by preparing the population in a fiscally weak province to relocate to a province in which its productivity would be greater. For example, expenditures on education would prepare the population of a low-employment province for employment in more prosperous provinces.

Yet, in the case of education, a provincially delivered government service, there are other inefficiencies seeming to justify equalization payments that have not received attention in the current debate. There is an unintended consequence when one province pays to educate a population and the human capital thereby built up emigrates to generate income in another province. Why would a province make an investment from which some other province would get the benefit? Still, taking the nation as a whole, the investment would be profitable. It would seem that, without some contribution to the investing province from the receiving province, the level of investment from the point of view of the national allocation of resources would be too low.

There is an alternative conjecture: that those paying for the education of the young in a fiscally weaker, investing province do so willingly, taking satisfaction in the greater opportunities opened for their children outside the province in which the investment takes place. Rather than a contribution of one province to another, the investment in human capital that facilitates out-migration is thus construed to be made for local benefits. It is seen as an efficient intergenerational transfer within the investing province. This additional conjecture seems to strengthen the argument from efficiency for equalization, because the transfers facilitate both meeting local preferences at a national standard and effecting an efficient out-migration of population.

The specific contention that equalization payments prevent convergence of productivity levels and so of fiscal capacities also has been challenged. The nub of the contention, as already noted, is that efficient capital/labour ratios would not be achieved in the presence of the transfers. The counter

10 The assertions of A.D. Scott in this matter and their contradiction by J.M. Buchanan have been summarized in the précis written by Graham (1963). During the debate, Buchanan made a number of assertions; the attempt here is to present only the main thrust of his argument.

contention is that the presumption of higher returns to capital in relatively depressed regions is untenable.[11] The problem of lower productivity stems, it is asserted, from a relatively high ratio of both capital and labour to natural resources. Because natural resources do not migrate from province to province, natural market forces do not necessarily produce convergence of fiscal capacities. They may, in fact, produce relatively if not absolutely declining regions: “ghost towns”, “pockets of poverty”, and the like. The contention is that natural market forces, particularly in a technologically advancing economy, generate losers as well as winners.

This argument can be generalized in the following way. With technological advance and economic growth rendering the resources of some regions obsolescent and exhausted, the advance of the national economy necessarily entails relative decline in some regions. Not only, then, is there a case in equity for compensating those who, without commensurate benefit to themselves, have borne the cost of general improvement, but one must expect that, without compensation, the losers, acting efficiently from their own point of view, will use the political system to obstruct the advance of the whole.

Another argument asserting efficiency from equalization transfers is rooted in the theory that open access resources are overused.[12] The theory was first worked out under the heading of “the tragedy of the commons”, and the nub of the argument can best be grasped by considering that example. In feudal systems, cattle grazed on commonly owned fields. Anyone in a village could put a cow on the commons, but no one had an interest in investing in the upkeep of the commons. Any investment they might make would generate a return from which others could not be excluded. The result was congestion, deterioration of the land and its grass, and small, scrawny, sickly cattle — clearly an inefficient use of the resource.

Now, government services, being paid for out of tax revenues, are provided free of charge to individual users. They are a kind of commons. So, the existence of superior government services in one province will induce migration to the point that the services are overused. A transfer of funds that eliminates the disparity in the level of government services between provinces will eliminate this particular inefficient allocation of resources.

Further, in the Canadian case, differences in the level of government services can usually be accounted for by greater fiscal capacity due to greater availability of publicly owned (commonly owned) natural resources. Accordingly, migration from provinces of weak fiscal capacity to provinces of strong fiscal capacity entails the congestion of a commonly owned resource, or, in this case, the depletion of a resource at too fast a rate. An equalization transfer that would ensure reasonably equal levels of government services at reasonably equal levels of taxation in all provinces would help to eliminate this inefficiency.

11 This contention is elaborated in detail with reference to Nova Scotia by Graham (1963, 141–59).

12 These contentions have been made most recently by Boadway and Flatters (1982); Hobson (2002); and Buchanan (2002). They have been illustrated, if not constructed, by contrived model building. It is beyond the patience of the present exercise to reconstruct these “arguments of tedious intent”. Nonetheless, their conclusions appear to have some validity. They deserve attention, but here only what seems to be the nub of the arguments is presented.

EQUALIZATION SYSTEMS: A CHOICE

There are reasons for not looking to quantitative evidence to justify a choice between differentiated transfers and differentiated taxation as systems to achieve the equity goal of equalization. Very little quantitative evidence has been brought forward in the debate over the matter, largely, one suspects, because quantitative evidence is very difficult to come by.[13] Further, for example, numerical evidence that tax rates are greater in provinces receiving payments is not definite proof of anything. It certainly does not negate the conjecture that provinces detrimentally manipulate their tax structures to increase equalization payments, but it does not prove it, because there are other explanations ready to hand. It can be explained by the inefficiencies entailed in the fiscal imbalance itself.

For example, the fact of higher rates of taxation in low-fiscal-capacity provinces may be a consequence of the availability of equalization transfers that induce larger expenditures of so-called fifty cent dollars and higher rates of taxation to make this possible. That is to say, spending governments, aided by transfers from the rest of the nation, experience an own-tax cost per unit of government services less than the benefit derived, and so they are willing to tax more than they otherwise would to achieve that benefit. Clearly, then, numerical evidence of greater tax effort in receiving provinces is not proof of the alleged type of manipulation of tax structures and, in general, quantitative evidence is not as useful as might be thought.

In addition, much that is in contention about the efficiency or inefficiency of equalization transfers is rooted in subjective benefits with respect to the level and mix of services in particular provinces. These things are not subject to numerical measurement, first, because subjective benefits are simply

13 There are ample data supporting the existence of fiscal imbalance in the Canadian federal fiscal system. Very few data, if any, measuring the inefficiencies entailed in the fiscal imbalance have been brought forward. Of course, fiscal imbalance in Canada is associated with programs other than equalization. The Canadian Health and Social Transfer — by whatever name — involves federal taxation and provincial spending, and, according to Courchene (2005a,b), it is “equalized”. Insofar as it is equalized, it falls under the critique of differentiated equalization transfers offered here.

In recent public discourse, fiscal imbalance has been defined in a number of ways, and surely, debaters can define a term however they want. For example, it has been taken to indicate that the federal government takes more from the citizens of a province than it expends in the province, or that federal spending is intruding into provincial jurisdictions, or indeed that the federal government is balancing its budget at the cost of increases in provincial taxation and debt. The definition used here is none of these, but is that put forward by the C.D. Howe Institute, the Fraser Institute, the Saskatchewan Institute for Public Policy, and the Minister of Finance for Quebec. It is the technical definition of fiscal imbalance used in standard public sector economics. (See Canada 2005.)

not measurable and, second, because of government failures, there can be no certitude that a government's choices reflect the underlying preferences of its citizens.

With respect to the contention that use of government services or natural resources would be excessive if migration were not impeded by equalization transfers, one can point to quantitative evidence that doctor shortages and emergency room line-ups exist in provinces with both stronger and weaker fiscal capacities. Further, given historical experience in the matter of technological advance and the value of particular resources, who can say at what rate some non-renewable resource should be used up? There was a general fear that the industrial world was running out of coal in the very years in which the refining of mineral oil, the electric dynamo, and the internal combustion engine appeared on the scene.

In sum, we are not yet in a position to make a choice between a tax-based and a transfer-based equalization system on the strength of quantitative data.

The argument for choosing between provincially differentiated federal taxation and provincially differentiated federal transfers will proceed by eliminating alleged efficiencies and inefficiencies from consideration until an irreducible set is left. For example, efficiencies and inefficiencies can be eliminated from consideration if they are deemed to be the same under both a tax and a transfer system of equalization. They also can be eliminated from consideration if in either system particular inefficiencies offset one another.

The inefficiencies associated with the fiscal imbalance entailed in provincially differentiated federal transfers would be eliminated with the adoption of provincially differentiated federal taxation. The fiscal imbalance would be removed. If provincial preferences in reasonably equal government services can be met with transfers of money, they could still be met if a province raised its taxes to fill a gap left by the withdrawal of federal taxation. While the tax burden on the population would remain unchanged, a gain in efficiency would arise from the province's being able to match the costs of the tax with the benefits from expenditures. Indeed, assuming that the electorate held the government responsible for its fiscal behaviour, it would be forced to do so. Of course, the same can be said of the federal side, because it would no longer be generating revenue for a provincial government to spend, at least not on the grounds of equalization.

A clarification is necessary here. Equalization is based on the relative weakness of a province's fiscal capacity. This seems to imply that the province would have to raise the rate of its taxation more than the federal government would lower its rate of taxation and that, in the end, equal government services would be available only at higher rates in fiscally weak provinces. In fact, this would not be the case because it is precisely a province's fiscal weakness that is to be taken into account when the federal government applies different tax rates in different provinces. The federal taxes would be so lowered that there would be roughly equal levels of government services at roughly equal levels of taxation in all provinces.

The inefficiencies entailed in forestalling economic development to maintain equalization transfers or of reducing fiscal capacity to gain transfers would remain if differentiated taxation was adopted. A less federally taxed province could improve or maintain its fiscal capacity only at the cost raising or maintaining the rate at which its citizens pay federal taxes. So, on this count, there is nothing to choose between differentiated transfers and differentiated taxation. Still, it could be argued that provincial governments, being less sensitive to changes in the rate of federal taxation than to changes in direct inflows of revenue, would be less likely to undertake damaging behaviour to achieve a reduction in federal taxes paid by its citizens. If that is the case, differentiated taxation is more efficiency generating than differentiated transfers.

There are some contentions about the effects of equalization that are simply in doubt and so should not be taken into account. This would seem to be the case when conjectures contradict one another. That equalization encourages or discourages the migration of resources is a matter of unresolved dispute. In any case, an argument could be made that, whatever the effects with respect to migration of resources, the effects would be the same under differentiated taxation as under differentiated transfers.

The contention that equalization transfers compensate those who do not benefit from but have contributed to the general advance of the economy is of a different order. The position seems to favour differentiated transfers over differentiated taxation because, with differentiated taxation, the have-not province taxes up to fill the gap left by a reduction in federal taxation. There is no compensating gain when all that is achieved is the same level of services at the same cost in taxation. But there is something amiss here. If the transfer was in compensation for costs borne for the sake of the general advance of the economy, the transfer would have to be such as to provide revenue over and above what is necessary to provide reasonably equal government services at reasonably equal rates of taxation. The transfer would have a purpose different from that intended in the equalization provision of the Canadian fiscal system. Accordingly, such compensation ought not to be considered in an assessment of alternative equalization systems.

The same can be said of provinces' being compensated for investment in education from which other provinces benefit. The compensation internalizes an external benefit. This is reasonable, but it is not the purpose of equalization. It should not be considered in choosing a system of equalization.

Inefficiencies associated with economic failures in the public sector do offer grounds for choosing differentiated taxation over differentiated transfers. With the former, only one level of government handles money, and the responsibility for taxation is moved to the government that spends. The lines of accountability are clear, the opportunity for holding politicians responsible for their fiscal behaviour is increased, and the benefits of expenditures are more likely to be greater than the costs to the economy of taxes.

With respect to the contention that equalizing the level and tax cost of government services would prevent overuse of government services, it is clear that there is nothing to be gained by choosing one system over the other. The inhibition to migration that allegedly causes inefficient overuse of any resource would be the same with both differentiated transfers and differentiated taxation. In any case, overuse of a government or commonly owned resource is a consequence of an inappropriate property rights structure. It should be remedied by a reorganization of property rights, not by equalization of government services.

Finally, and perhaps this does not need to be said, the process by which differentiated tax levels would be calculated might be beyond the mental resources of the average taxpayer, but it could not be more arcane than the present method by which differentiated transfers are calculated. Quite likely, there is nothing to choose between the two methods on this count.

CONCLUSION

The contentions outlined in this paper are only conjectures. But then that is what is presented in all of the policy assertions dealing with equalization transfers in Canada. Most of these conjectures provide no basis for choosing one system over the other. One of them, however, stands out as offering a great, unmatched advantage: that of a system of differentiated taxation. It is the contention of this paper that there would be a large reduction in inefficiency attendant upon eliminating fiscal imbalance — that is, by having the responsibility of taxing rest with the spending agent.

The recommendations of the federal government's commissioned report on equalization are not without merit. There are advantages as well as disadvantages in having a ten-province average in assessing fiscal capacity. There are advantages as well as disadvantages in having resource revenues included in fiscal capacity. These advantages and disadvantages fall differentially across the provinces, however, and so these marginal adjustments to the system have to be fought out in the arena of distribution, rather than of efficiency. They are primarily political concerns. They could be embodied in a tax-based system as well as in a transfer system. Further, though the report has recommendations in these matters, they are not principled and clearly are a matter of ad hoc compromise. For example, there are arguments for and against including natural resources in the equalization formula, but without reconciling these arguments, the report simply splits the difference and calls for 50 percent inclusion. Indeed, at every point, the report rejects a principled, reasoned approach in favour of political consensus. Economic costs and benefits are simply ignored in its recommendations.

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