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12 Subnational Budgetary and Stabilization Policies in Canada and Australia

Thomas J. Courchene

12.1 Introduction

At first blush, Canada and Australia appear to be very similar nations. Both are former British colonies and are members of the Commonwealth. Both are parliamentary federations and constitutional monarchies, although Australia may be close to becoming a republic. The land masses of the two countries qualify them among the largest nations on earth. They are both small, open economies endowed with ample natural resources. Both nations have significant aboriginal or First Nations populations, both have vast parts of their territory that are sparsely populated, and on and on. And at the broad policy level, Canada's system of equalization payments was patterned, conceptually, after the philosophy underpinning Australia's Commonwealth Grants Commission. And Australia has followed Canada in relying on "executive federalism" as a key policy and coordination institution, even to the point where COAG (the Council of Australian Governments) is currently operating much more effectively than Canada's FMCs (First Ministers' Conferences).

To be sure, there are some important differences. Australia does not have a United States on its border with the resulting dominant impact on trade, cultural identity, and policy independence. Moreover, Australia has no equivalent to Quebec—a province that is linguistically, culturally, and legally (civil law rather than common law) distinct. At the institutional level, Canadian scholars

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have duly noted the differences in our upper chambers and, on more than one occasion, we have unsuccessfully attempted to convert our appointed Senate into the Australian “triple E” version—elected, equal, and effective. Even recognizing these important differences, Canadians and Australians (let alone others) tend, nonetheless, to assume that the similarities far outweigh the differences, with the result that relevant literature is replete with Canadian-Australian comparisons, the most recent of which is Boothe 1996.

From this vantage point, therefore, one might assume that the rationale for comparing subnational budgetary and stabilization policies in Canada and Australia is to assess important or intriguing differences in what otherwise is an essentially similar approach to the conduct of provincial/state fiscal policies.

Reality, however, is quite another matter: one can make a convincing case that the taxation, spending, and borrowing autonomy of the Canadian provinces and of the Australian states represent the polar extremes in modern, mature federations. The wide-ranging powers and fiscal autonomy of the Canadian provinces place them at least on par with the Swiss cantons. Contrast this with the Australian states, which have no effective access to broad-based taxation (sales and/or income taxes) and, therefore, suffer from an incredible vertical fiscal imbalance—Commonwealth transfers exceed the states’ own-source revenues. And, of course, the operations of the Australian Loan Council have traditionally limited the states’ borrowing *autonomy*, although it may have increased the states’ borrowing *ability* since they did so with the imprimatur of Canberra.¹ Given all of this, it should then come as no surprise that Australia has in place an institutional framework designed to ensure that the states’ budgets are harmonized and/or coordinated with the Commonwealth’s overall philosophy and objectives. Likewise, it should not come as a surprise that on far too many occasions the fiscal policy initiatives of the Canadian provinces have created significant negative spillovers for the Canadian macro strategy.

Cognizant of these divergent subnational fiscal environments, the analysis begins by detailing the different constitutional/institutional frameworks for Canadian provinces and Australian states (sec. 12.2). Beyond the tabular approach to constitutional differences, attention is directed to the allocation of taxing powers, to the extent of vertical fiscal imbalance, to the degree of conditionality of fiscal transfers, to an assessment of the two countries’ equalization programs, and, finally, to regional disparities. With this as backdrop, and in line with the budgetary-institutions theme of the volume, section 12.3 highlights the operations of the extensive degree of Commonwealth-state fiscal coordination, while section 12.4 contrasts this with the lack of federal-provincial fiscal coordination in the Canadian federation.

The analysis then shifts to the 1990s fiscal history at the national level (sec-

1. For purposes of this paper, “Canberra” and the “Commonwealth government” are used interchangeably to refer to the central government in Australia while “Ottawa” and the “federal government” will be the Canadian counterparts.

tion 12.5 for Canada and section 12.6 for Australia), replete with the manner in which national fiscal policy interplays with provincial and state fiscal policy. The final substantive section presents and assesses Standard and Poor's credit ratings for Australian states and Canadian provinces. An integrative conclusion completes the paper.

Because of the polar nature of these two fiscal systems, this comparative case study may provide useful insights with respect to some of the analytical issues that feature prominently in other papers in the volume. In particular, the decentralized budgetary and borrowing flexibility of the Canadian provinces probably has some implications for the EU in the era of monetary union. Likewise the impressive recent deficit turnaround in Canada may shed light on issues such as the role of a strong finance minister, the role of deficit targets, and the importance of transparency—issues that occupy center stage in the analyses of other papers in this volume. And with its Charter of Budget Honesty, Australia has carried transparency to new heights. Where relevant, these relationships between budgetary institutions and fiscal performance will be highlighted.

12.2 The Constitutional/Institutional Frameworks Relating to Subnational Budgetary Autonomy

The theme of this section is that a comparative analysis of the subnational fiscal/budgetary policies and processes of the Canadian provinces and Australian states can only be understood in the context of the differing constitutional/institutional frameworks in the two countries. Toward this end, table 12.1 provides selected salient features of the comparative constitutional backdrop. We begin the more detailed analysis by directing attention to the allocation of taxing powers.

12.2.1 The Allocation of Taxing Powers

In the 1930s, both the Australian states and Canadian provinces had, de facto, significant and similar taxing powers. For example, the Canadian provinces (including municipalities) accounted for nearly 70 percent of total own-source revenues in the federation. In Australia, the states accounted for 46 percent of total taxation, including 60 percent of income tax revenues (Walsh 1996, 125). In the 1940s, both countries dramatically centralized their taxation systems as part of the war effort. To this point, therefore, their experiences were roughly similar.

In the postwar period, however, the Canadian provinces regained their former taxation powers, whereas, in Australia, the Commonwealth effectively precluded any resurgence in state taxation. As noted in table 12.1, there were two key events that led to the maintenance of the Commonwealth's monopoly of broad-based taxation. One was the High Court's peculiar decision to interpret a state-levied general retail sales tax as a customs duty, thereby prohibiting

Table 12.1 Fiscal Federalism in Canada and Australia: The Constitutional/Institutional Framework

Area	Australia	Canada
A. General provisions		
1. Powers	Formal listing of Commonwealth powers. Most of these are concurrent, but with Commonwealth paramountcy. Residual powers to states.	Federal and provincial governments have own listing of powers, section 91 for Ottawa and section 92 for the provinces. Residual power to federal government.
2. Internal economic union (and judicial interpretation)	Commonwealth trade and commerce power given expansive reading by the High Court (similar to scope of U.S. interstate commerce power). Substantially enhances Commonwealth powers.	Federal trade and commerce power given much less expansive reading by the Supreme Court. Provincial head of power ("property and civil rights") serves as de facto residual clause. Canada is much more decentralized than is Australia.
B. Taxation		
1. Direct taxes	Commonwealth and states can both levy direct taxation.	Both federal and provincial governments can levy direct taxation.
Income taxes	However, Commonwealth has effectively monopolized personal and corporate income taxes: States will lose Commonwealth grants if they reenter income taxation. No state has yet done so.	Provinces collect roughly 40 percent of personal income taxation. Nine provinces piggyback off federal income tax, while Quebec has its own separate PIT. Three provinces have separate corporate income tax (Quebec, Ontario, Alberta) while the rest piggyback on Ottawa's corporate tax.
2. Indirect taxation	Except for customs duties, are concurrent powers. But High Court prohibited state sales taxes on grounds that they were the customs duty. Australia has no general sales tax.	Provinces cannot levy indirect taxes. But provincial sales taxes (following British interpretation) were viewed as a direct tax. All provinces except Alberta now levy sales taxes. Federal government levies value-added tax (GST). Hence, joint occupancy with limited harmonization (only Quebec, New Brunswick, Newfoundland, and Nova Scotia have harmonized their PST with federal GST).

Table 12.1 (continued)

Area	Australia	Canada
3. Natural resources	Concurrent, with Commonwealth paramountcy	Provincial jurisdiction, except for resources on Canada (nonprovince) lands. When Saskatchewan and Alberta joined the federation in 1905, Ottawa maintained the subsurface property rights. It transferred these subsurface rights to these provinces around 1930. The result is that these two provinces own the subsurface rights on virtually all the (energy rich) lands within their borders.
C. Intergovernmental grants	Section 96 states that the Commonwealth may grant financial assistance to any state on such terms or conditions as parliament thinks fit. As noted above, the Commonwealth has used this power to prevent states from levying income taxes. This provision provides the authority for the Commonwealth's specific-purpose grants and for the general revenue grants falling under the Commonwealth Grants Commission.	Generalized federal spending power provides mechanism for Ottawa to make grants to the provinces (but probably not in a way that serves to regulate activities in the provincial domain). The principle of equalization (but no precise formula) has been enshrined since 1982. Recently, the federal government has agreed to curtail the exercise of its spending power in areas of exclusive provincial jurisdiction—now requires broad provincial support and opting out with compensation for those provinces not on side.

state action (since customs duties were the prerogative of the Commonwealth). More recently, the High Court has also struck down state excises on gasoline and tobacco. The other, and more important, decision was the Commonwealth's threat under s.96 (panel C, table 12.1) to withdraw financial transfers from any state that reentered the income tax field. Given the critical role that these Commonwealth-state transfers play in state revenues (elaborated in the following section), it is perhaps not surprising that no state has seriously considered reentering the income tax field.

The result of all of this appears in tables 12.2 and 12.3 for Australia and Canada respectively. Focusing initially on the Australian data, a few features merit highlighting. First, very few tax bases are shared. Of the first ten entries

Table 12.2 Access to Revenue Sources: Australia, 1992–93

	Total (\$ billions)	Percentage Distribution		
		Commonwealth	States/ Territories	Local
A. Taxes, fees, and fines				
1. Income taxes (personal and corporate)	63.2	100.00	0.00	0.00
2. Property taxes				
Financial transactions	4.9	0.00	100.00	0.00
Other	6.7	0.00	30.9	69.1
3. Sales taxes				
General sales tax	9.3	100.00	0.00	0.00
Excises	10.8	95.5	4.5	0.00
Gambling and insurance	3.5	0.00	100.00	0.00
International trade	3.3	100.00	0.00	0.00
4. Payroll taxes				
General	5.8	0.00	100.00	0.00
Selective	1.4	100.00	0.00	0.00
5. Taxes on use of goods and performance of activities	6.5	3.6	96.4	0.00
6. Fees and fines	2.4	39.0	46.9	14.1
Total taxes, fees, and fines	117.7	75.3	20.5	4.2
B. Operating surplus of public trading enterprises (PTEs)				
Total revenues	11.5	34.6	62.9	2.5
Total revenues	129.2	71.7	24.2	4.1

Source: Australian Bureau of Statistics 1995, section 24.

in table 12.2 (up to and including row A5) eight are allocated 100 percent to either the Commonwealth or the state/local level, with the remaining two having at least a 95 percent share allocated to one or the other level of (95.5 percent of excises accrue to the Commonwealth, while 96.4 percent of taxes on goods accrue to the state/local level). Of the 12 Canadian tax categories (table 12.3), only 3 fall in this 95 percent plus range—all property taxes are local, the international component of sales taxes (customs) is federal, and virtually all natural resource revenues are provincial.² The second general point is that

2. While this observation obviously depends on the manner in which tax sources are classified, the thrust of the argument would hold under alternative classifications as well. In terms of the classification utilized in tables 12.2 and 12.3, some elaboration is probably in order. In table 12.2, the states' general payroll taxes accrue to the consolidated revenue fund and are part of the states' general revenues; i.e., they are not social insurance levies. Indeed, in the OECD definition of social insurance levies, Australia has none. It has no unemployment insurance program. Workers' compensation is compulsory for firms, but this is run largely through third-party (private) insurance. And there is no Australian equivalent to the Canada/Quebec Pension Plan, the compulsory public pension system. Entry B of table 12.2 (public trading enterprises) is probably quite similar to entry 9 in table 12.3—for example, they would both include the provincial/state monopolies for the various utilities. The "financial transactions" entry under the property tax heading in table 12.2 is generally referred to as "stamp duties"—taxes on securities transactions. And so on.

Table 12.3 Access to Revenue Sources: Canada, 1992

	Total (\$ billions)	Percentage Distribution	
		Federal	Provincial
1. Income taxes			
Personal	103.7	62.8	37.2 ^a
Corporate	14.0	65.0	35.0 ^a
2. Property taxes	27.8	0.00	100.00 ^b
3. Consumption taxes			
General sales	35.6	47.9 ^c	52.1 ^d
Fuel	8.0	37.0	63.0 ^a
Alcohol and tobacco	6.8	57.5	42.5 ^a
International (customs)	4.0	100.00	0.00
4. Social insurance levies	24.7	62.6 ^e	37.4 ^e
5. Sales of goods and services	13.4	23.0	77.0
6. Licences and permits	4.2	6.6	93.4
7. Natural resource revenues	4.6	1.0	99.0 ^a
8. Miscellaneous taxes	11.0	56.0	44.0
9. Return on investments and other revenue	23.5	26.6	73.4 ^a
Total revenues	277.5	46.7	53.3

Source: Canadian Tax Foundation 1994, table 4.3.

^aEntirely or largely provincial.

^bLargely local.

^cPrimarily the GST, a value-added tax.

^dPrimarily general retail sales taxes at the provincial level.

^eFederal component is largely unemployment insurance premiums, and provincial component is premiums for workers' compensation. The public pension premiums (CPP/QPP) are not included.

not only are the states left with a narrow set of own-source revenues, but even these are under increasing competitive pressure. Payroll taxes (which are probably the closest thing the states have to a broad-based tax) are increasingly viewed as problematic in an era of high unemployment, and they are under further pressure because the Commonwealth has recently begun encroaching on this base with pension contributions. As a result of the recent (1995) Competition Principles Agreement, which opens the state's public-sector business enterprises to interstate competition, it will be more difficult for the states to maintain their large revenues arising from the operating surplus of Public Trading Enterprises (row B of table 12.2). And because of the inherent mobility of financial transactions, the various taxes on financial transactions (stamp duties) are also coming under pressure—in the mid-1990s Queensland cut its stamp duties on marketable securities by 50 percent in order to attract securities business from New South Wales. Given the inherent mobility of this tax base, other states had no choice but to follow Queensland's lead.

Table 12.3 presents comparable tax allocation data for the Canadian federation. Ottawa maintains just under two-thirds of the personal and corporate in-

come taxation and about half of the general sales taxation (the federal share is the GST, a value-added tax, and the provincial share relates to the point-of-sale retail sales taxes). While most of the remaining detail is left to the reader, the natural resource revenues entry (row 7) is critical for the ensuing analysis. It is not just that nearly 100 percent of the revenues from this source accrue to the provinces. It is also that, for two provinces, Saskatchewan and Alberta, the subsurface rights (e.g., for oil and gas) rest with the province, not with the owners of the land (see row B3 of table 12.1).

The final row of each table presents aggregate revenues and their distribution between the national and subnational governments. In Australia, the Commonwealth's share is 71.2 percent, while the federal share in Canada is less than 50 percent (46.7 percent). What is also very evident is that, subject to some adjustment for exchange rates,³ the level of overall taxation in Australia is much lower than in Canada. In a recent paper comparing taxation in Canada and Australia, Dahlby and Wilson (1996) argue that one of the reasons for this likely has to do with the fact that so many tax sources are shared in Canada. The analogy here is that of a common-property resource. Hence, sharing a common tax base will lead to "overtaxation" in the same way that the "tragedy of the commons" leads to "overgrazing." For example, on at least two occasions over the last decade Ottawa reduced personal income taxes in order to bring Canadian personal income tax rates more in line with those in the United States. On both occasions, some provinces (e.g., Ontario) responded by raising their own tax rates, thereby "taking up" the vacated tax room. This is a fiscal federalism example of the common-pool or 1/N problem that plays center stage in many papers in this volume.

For our purposes, however, the key message that emerges from tables 12.2 and 12.3 is that the Canadian provinces have much more in the way of meaningful tax autonomy and flexibility than have the Australian states, including access to broad-based tax sources such as sales and personal/corporate income taxation. As Walsh (1996, 115) has noted, "Australia has by far the highest degree of vertical fiscal imbalance among the major federations in the industrialized world. It is even high by the standards of most unitary countries."

12.2.2 Vertical Fiscal Imbalances

Tables 12.4 and 12.5 present data on vertical fiscal imbalances, *inter alia*, for the two federations. While the fiscal years differ, the qualitative implications derived from putting the Canadian data on a comparable fiscal year would

3. The Canadian dollar depreciated relative to the Australian dollar over the recent period. In terms of the number of Canadian cents per Australian dollar, the average of monthly exchange rates was 91.1 cents in 1990, 89.2 cents in 1991, 88.7 cents in 1992, 87.6 cents in 1993, 100 cents in 1994, 101.7 cents in 1995, and 107 cents in 1996. The PPP values are quite different because the Canadian dollar is considerably undervalued. On a PPP basis for 1996, the Australian rate is 135 Australian cents per U.S. dollar, and the Canadian rate is 122 cents per U.S. dollar, with roughly similar values for 1994 (134 and 125 respectively [OECD data]).

Table 12.4 Horizontal Equalization in Action: Australia, 1993–94

	Own Revenues (standardized)		Commonwealth Grants (\$ per capita)		Grants Plus Revenues (1+3+4)		Grants as a % of Own Revenues ((3+4)÷1)
	\$ per capita (1)	% of National Average ^a (2)	General (3)	Specific Purpose (4)	\$ per capita (5)	% of National Average (6)	(7)
New South Wales	1,774	105.0	686	910	3,370	96.9	90.0
Victoria	1,618	95.8	699	914	3,231	92.9	99.7
Queensland	1,658	98.2	902	924	3,484	100.1	110.1
Western Australia	1,907	113.0	945	969	3,821	109.8	100.4
South Australia	1,502	88.9	1,113	1,033	3,648	104.9	142.9
Tasmania	1,269	75.2	1,326	1,033	3,628	104.3	185.9
Northern Territory	1,788	105.8	5,001	1,546	8,335	239.6	366.2
Australian Capital Territory	1,641	97.2	1,154	763	3,558	102.3	116.8
Australian standard	1,689	100.0	847	943	3,479	100.0	106.0

Sources: Commonwealth Grants Commission 1995, table VI-10 (columns 1–2); table 3, Budget Paper no. 3, pursuant to the 1993–94 Australian budget (columns 3–4).

^aThese percentages represent the difference in revenue-raising capacity across the states, since tax effort is held constant.

Table 12.5 Horizontal Equalization in Action: Canada, 1991–92

	Own Revenues (standardized) ^a		Own Revenues Plus Equalization ^b		Own Revenues Plus Equalization, CAP, and EPF		Net Transfers					
	\$ Per Capita (1)	% of National Average (2)	\$ Per Capita (3)	% of National Average (4)	\$ Per Capita (5)	% of National Average (6)	\$ Millions ^c (7)	Financing Share (\$ millions) (8)	Net (\$ millions) ^d (9)	Net (\$ per capita) (10)	Net (as a % of own revenues) ^e (11)	Grants as a % of Own Revenues ^f (12)
Newfoundland	2,991	67	4,440	93.5	5,077	94	1,196	315	881	1,536	0.51	70
Prince Edward Island	3,019	67	4,440	93.5	5,089	94	271	82	189	1,446	0.48	69
Nova Scotia	3,506	78	4,440	93.5	5,118	95	1,452	754	698	775	0.22	46
New Brunswick	3,171	71	4,440	93.5	5,116	95	1,426	519	907	1,249	0.39	62
Quebec	3,958	88	4,440	93.5	5,186	96	8,377	5,393	2,984	436	0.11	31
Ontario	4,761	106	4,761	100	5,352	99	5,863	10,878	-5,015	-506	-0.11	12
Manitoba	3,681	82	4,440	93.5	5,080	94	1,526	764	762	697	0.19	38
Saskatchewan	3,970	89	4,440	93.5	5,017	94	1,011	653	388	390	0.10	26
Alberta	5,937	133	5,917	125	6,565	122	1,586	2,395	-809	-321	-0.07	11
British Columbia	4,840	108	4,840	102	5,487	102	2,081	3,067	-986	-306	-0.07	13
All provinces	4,478	100	4,751	100	5,397	100	24,819	24,819	-1			21
High/low		1.99		1.34		1.31						

Source: Reproduced from Courchene 1994, table 17; author's calculations.

^aRevenues from representative tax bases at national average tax rates—that is, fiscal capacity.

^b\$4,440 is the five-province standard.

^cEqualization plus CAP plus the cash components of EPF (plus the tax abatements for Quebec).

^dThe shares of federal taxes by province appear in Courchene 1994, chapter 2, note 3.

^eColumn 10 ÷ column 1.

^f(Column 5 - column 1) ÷ column 1.

not differ. The first point to note is that standardized own revenues (i.e., at comparable tax rates and standardized tax bases) are considerably more variable across the Canadian provinces. From table 12.5, standardized own revenues for Alberta are twice that of Newfoundland and Prince Edward Island (i.e., the high/low ratio is 1.99, from the last row), whereas Western Australia's own revenues are only 1.5 times that of Tasmania. Second, on average, own revenues for the Canadian provinces are well in excess of those for the Australian states (\$4,478 from the second to last entry in column 1 of table 12.5 vs. \$1,689 from the "Australian Standard" row of column 1 in table 12.4). This follows directly from the earlier data on the allocation of tax sources: there is simply no scope for the Australian states to raise anywhere near the own-source revenues of the Canadian provinces. While Commonwealth-state transfers as a percentage of own-source revenues are, as elaborated below, much higher than federal-provincial transfers, it is still the case that, after transfers, the provinces' revenues significantly exceed those of the Australian states (\$5,397 vs. \$3,479, from the last entries of column 5 in both tables). Much of this relates to the allocation of expenditure functions—for example, welfare is a provincial matter in Canada but a Commonwealth responsibility in Australia. Some also reflects the fact that, as a percentage of GDP, Australian taxes overall are much lower than Canadian taxes.

One measure of the degree of vertical fiscal imbalance appears in column 6 of table 12.4 for Australia and in the last column of table 12.5 for Canada. At the all-province level, federal-provincial transfers represent 21 percent of standardized own revenues in Canada, while Commonwealth-state grants actually exceed average own revenues—grants are 106 percent of standardized own revenues. The most fiscally autonomous state in Australia (New South Wales, with a grants-to-own-source-revenues percentage of 90 percent) is far more grant-dependent than any Canadian province. The Canadian ratios range from a high of 70 percent for Newfoundland to 11 percent, 12 percent, and 13 percent for Alberta, Ontario, and British Columbia, the three "have" (or non-equalization-receiving) provinces. Indeed, in the fiscal year 1996/97, Alberta's budget *surplus* was well in excess of *all* transfers from Ottawa, so that this province's own revenues *exceeded* its total expenditure. And Alberta has by far the lowest tax effort of all the provinces. Thus, Alberta is fully autonomous fiscally!

12.2.3 Conditional versus Unconditional Grants

Given the centralist and egalitarian features of the Australian federation, it should follow that the Commonwealth grants to the states should be tilted in the direction of conditional or specific-purpose payments (SPPs). From columns 3 and 4 of table 12.4, this is precisely the case—specific-purpose transfers exceed general-purpose transfers (\$943 per capita vs. \$847 per capita). What is not shown in table 12.4 is that SPPs have been increasing relative to unconditional grants. The situation in Canada is precisely the reverse. With the

recent move to “block funding” of federal transfers relating to health, postsecondary education, and welfare in the form of the CHST (Canada Health and Social Transfer), there remain *no* specific-purpose transfers in the Canadian federation. To be sure, *all* provincial monies spent on health must abide by five principles (universality, accessibility, comprehensiveness, portability, and public administration). However, these principles relate more to the requirements of an “internal social union” than to conditions on the transfers themselves.

Australia may well be unique among modern federations in terms of having its intergovernmental grants gradually shift from general purpose to specific purpose or from an unconditional to a conditional basis. Indeed, even the general-purpose grants that fall under the rubric of the Commonwealth Grants Commission (CGC) are not as unconditional as they might appear. This is because one of the determinants of the CGC grants is “expenditure disabilities.” If there is a greater expenditure “need” in a given state, it will receive a larger share of the grant for that specific expenditure purpose. What appears to be occurring is that special interests are increasingly aware of this and are pressuring the states to spend these monies more *in accordance with the associated expenditure needs*. And if the special interests fail in this endeavor to bring the states in line, they can then lobby Canberra to remove this category from general-purpose grants and to convert it to a specific-purpose grant. This is part of the dynamic in favor of tied grants in Australia, and without access to broad-based taxation the states are rather helpless to combat this dynamic. In this sense, the core problem relates to the enormous degree of vertical fiscal imbalance. Hence Australian policy analysts desirous of enhancing state autonomy are, not surprisingly, focusing on creative approaches to significantly enhancing the states’ taxation powers and, therefore, fiscal autonomy (e.g., Walsh 1996). In line with the earlier analysis, these efforts will probably not succeed unless the Commonwealth alters its centralist/egalitarian philosophy. Now that we have broached the operations of the CGC, it is appropriate to focus on this celebrated institution in more detail and to compare it with Canada’s equalization program. To anticipate the analysis, nowhere is Australian egalitarianism more evident than in its approach to these CGC “equalization payments.”

12.2.4 Equalization

By way of an introductory set of comments on revenue equalization in Canada and Australia, the first point to note is that the CGC approach (which relates to General Revenue Grants, not specific-purpose payments although, as noted later, some of the SPP’s are indirectly taken into account in the CGC calculations) combines both vertical and horizontal balance considerations, whereas the Canadian equalization program is concerned only with horizontal balance (i.e., only seven of the ten provinces qualify for equalization). Second, the CGC model equalizes for both “revenue means” and “expenditure needs,” whereas the Canadian model is limited to ensuring that all provinces have ac-

cess to some “standard level” of per capita revenues (currently a “five-province standard,” where the five provinces in the standard are Ontario, British Columbia, Saskatchewan, Manitoba, and Quebec). Third, Canadian provinces with per capita revenues in excess of this five-province standard level of per capita revenues *keep* their excess revenue. In other words, rich provinces are not “leveled down.” Because the CGC model integrates both vertical and horizontal transfers, there are no “tall poppies”—Australian states are fully leveled, both up and down. Finally, the CGC model only determines the states’ “shares” or the “relativities” with respect to the overall general-revenue grant. The Commonwealth government determines the amount to be distributed. This differs from the Canadian equalization formula, which simultaneously determines the distribution and the magnitude of the payments, except when ceilings and/or floors apply, as they have on occasion over the past decade.

The CGC Model

The Commonwealth Grants Commission model is a computational nightmare in the sense that it equalizes across 19 categories on the revenue side and 40 on the expenditure side. Having spent months wrestling with the mechanics and mathematics of the CGC model, I have come to the conclusion that whatever the merits of the CGC (and there are many—its independence, its accessibility, its competence) one of them is not its expositional ability. Thankfully, there is a much more intuitive approach to the CGC model, one employed in the article *Horizontal Fiscal Equalization*, the Report of the Heads of Treasuries Working Party to the 1994 Premiers’ Conference (1994). Essentially the grants to each state can be expressed as

- an equal per capita share of the total revenue grant;
- *plus* revenue needs $[R_s/P_s (1 - p_i)]$, where revenue-rich states ($p_i > 1.0$) will be leveled down from the standardized per capita revenue (R_s/P_s), and vice versa;
- *plus* expenditure needs $[E_s/P_s(\gamma_i - 1)]$, where “needy” states ($\gamma_i > 1.0$) will receive a larger share of the standardized expenditures (E_s/P_s), and vice versa;
- *minus* the excess of those Specific Purpose Payments that are included in the analysis (and not all of them are) in relation to the amounts that the CGC model would call for.⁴

This approach is applied in table 12.6 for 1993/94. Column 1 contains the equal per capita value of the grant, which is \$980 (i.e., the \$17,400 million figure in column 7 divided by total population). Column 2 corrects for revenue

4. Some but not all SPPs are integrated into the CGC model. If the amount of these SPPs across states is in excess of what would result if these SPPs were allocated on the basis of the CGC’s approach to *expenditure need*, then the excess (deficiency) is subtracted (added) in order to determine the CGC grant for the state in question.

Table 12.6 The Anatomy of CGC Grants, 1993–94

	Equal Per Capita Share of General Revenue (\$ per capita)	Revenue Needs ^a (\$ per capita)	Expenditure Needs ^b (\$ per capita)	Adjustment for Receipt of Other Commonwealth Payments ^c (\$ per capita)	General Revenue Grant Requirement (sum of columns 1–4) (\$ per capita)	Per capita relativities (column 5 ÷ column 1) ^d	Interstate Redistribution			
							CGC Grants (\$ millions)	Source of Funds (\$ millions)	Difference (column 7 – column 8) (\$ millions)	Difference (\$ per capita)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
New South Wales	980	–91	–66	13	836	0.853	5,046	6,197	–1,151	–191
Victoria	980	23	–203	17	818	0.834	3,658	4,905	–1,247	–279
Queensland	980	35	46	9	1,070	1.092	3,367	2,502	865	274
Western Australia	980	–95	247	–39	1,094	1.116	1,842	1,730	112	66
South Australia	980	203	40	–28	1,196	1.219	1,752	1,229	523	357
Tasmania	980	335	177	–44	1,449	1.478	686	335	351	755
Northern Territory	980	–4	4,064	–356	4,685	4.778	795	165	630	3,696
Australian Capital Territory	980	141	–296	21	847	0.864	255	337	–82	–273
Average (columns 1–5) or total (columns 7–8)	980	0	0	0	980	1.000	17,400	17,400	0	0

Sources: Report of the Heads of Treasuries 1994, table 2.1 for first six columns. Distribution in column 8 is taken from table 2 of Brosio 1994. Author's calculations for the remainder.

^aNegative revenue needs mean above-average revenue-raising capacity, and vice versa.

^bNegative expenditure needs means below average expenditure requirements, and vice versa.

^cNegative adjustment means above-average receipt of relevant payments.

^dThese relativities differ slightly from the Premiers' Conference relativities due to a minor technical adjustment.

^eThis column allocates the grants according to the distribution by state of the source of Commonwealth revenues.

needs, that is, New South Wales loses \$91 per capita because it is revenue rich, and so on. Column 3 corrects for expenditure needs. Victoria and the Australian Capital Territory are the big losers here since, they are in effect, deemed less “needy” than the remaining states. Column 4 adjusts for those SPPs that are included in the CGC model. The per capita entitlements appear in column 5 and the resulting relativities in column 6. Note that the *net* adjustment in each of columns 2, 3, and 4 is zero, so that the overall \$980 per capita value of the average grant is maintained.

As noted in the introduction to this section, the Australian approach to general revenue assistance embodies both horizontal and vertical equalization. Column 5 of table 12.6 provides a way of disentangling, conceptually, these two components. The per capita payment for Victoria is the lowest among the states, at \$818 per capita. One could call this the *vertical equalization* component of the general revenue grants, that is, the component that all states receive. Any amounts above this \$818 represent, in effect, *horizontal equalization*, namely payments necessary to bring every state to the Victorian level, as it were, that is, to enable other states to provide the average standard of state-type services, assuming they do so at the average level of operational efficiency and that they make the average effort to raise revenues from their own sources (CGC 1995, 51).

The Analytics of the Canadian Equalization Formula

The five-province standard (FPS) Canadian equalization formula can be expressed as follows:

$$(1) \quad \frac{E_{ij}}{P_i} = t_{cj} \left(\frac{B_{Rj}}{P_R} - \frac{B_{ij}}{P_i} \right)$$

for all j (revenue sources) and all i (provinces), where E_{ij} = equalization to province i from revenue source j ; P_i = population of province i ; E_{ij}/P_i = per capita equalization to province i from revenue source j ; t_{cj} = the national average (all-province) tax rate, defined as total revenues from revenue source j (that is, TR_j) divided by the total base for source (that is, B_{cj}), where subscript c refers to Canada or, more correctly, the all-province total; B_{Rj}/P_R = the per capita base for source j in the five-province standard (FPS). The five provinces comprising the standard are Ontario, Quebec, British Columbia, Manitoba, and Saskatchewan. Subscript R refers to the representative five provinces.

For each of the 33 revenue sources that enter the formula, a common base is established and a national average tax rate is calculated. Note that even if a province does not tax a given revenue source, it will still be assigned a tax base. For example, Alberta has no sales tax, but it obviously does have a sales tax *base*, namely the value of retail sales in the province. Thus, the focus of the formula is on equalizing fiscal capacity, not actual revenues.

As equation (1) indicates, if a province has a per capita tax base that is less

than the average per capita base of the five provinces that make up the standard, that is, if the term in parentheses in equation (1) is positive, the province in question will have a positive entitlement for this revenue source and vice versa. Entitlements are summed for each province over all revenue sources, and the resulting total, if positive, represents the province's equalization entitlement. If the sum is negative, the entitlement is set to zero. That is, rich provinces' revenues are *not* brought down to the five-province standard (FPS). Indeed, there is no transfer of monies between provinces—equalization payments are made from the federal government's consolidated revenue fund. The seven equalization-receiving provinces are typically referred to as the “have-not provinces,” with the remaining three (Alberta, Ontario, and British Columbia) enjoying the title of the “have provinces.” Finally, equalization payments are *unconditional*—they can be spent as the receiving provinces wish.

Equalization in Action: A Comparison

Equalizing Impact. From column 2 of table 12.5, per capita differences in the Canadian provinces standardized own-source revenues range from Newfoundland's 67 percent of the all-province average to Alberta's 133 percent. As noted beneath the table, the five-province standard for 1991–92 was \$4,440 per capita. The operations of the equalization formula mean that all provinces with less than this per capita revenue level will be brought up to \$4,440. The post-equalization revenues appear in columns 3 and 4. The high/low ratio falls from 1.99 pre-equalization (column 2) to 1.34 postequalization (column 4) and further to 1.31 once the vertical transfers (for health, postsecondary education, and welfare) are added in. Indeed, were one to remove energy-rich Alberta from the comparison, the “relatives” would range from 94 percent of the all-province average to 102 percent. Intriguingly, the differences in these per capita revenue levels (again excluding Alberta) are not much different from those for Australian states, posttransfer, as recorded in column 6 of table 12.4, especially if one excludes the Northern Territory.⁵ However, the differences in per capita revenues for Australian states are *deliberate* and are *designed to create effective equality in providing services*.

One final note in this context. The Canadian data in table 12.5 relate to standardized revenues, not actual revenues. Estimates of *actual* per capita revenues across provinces for fiscal year 1996–97 reveal that six provinces have per capita revenues *in excess* of those of Alberta. In other words, Alberta has taken out its superior fiscal capacity in terms of a low tax effort (i.e., the lowest personal income taxes, no provincial sales tax, etc.).

5. Note that the Australian data include the Northern Territories, whereas the Canadian territories (Yukon and the Northwest Territories) are not included in table 12.5, in part because, unlike the Northern Territory, their fiscal transfers do not fall under the rubric of the general equalization formula. Were one to include them in the analysis they, like the Northern Territory, would be “upside” outliers because their transfers also incorporate a “needs” component.

Net Interstate Distribution. The last four columns of table 12.6 focus on the net interstate redistribution as a result of the operations of the CGC. The dollar values of the CGC grants by state appear in column 7. The resulting total (\$17.4 billion) is then reallocated across states in accordance with the source of Commonwealth revenues. Thus, Victoria receives \$3.658 billion in CGC grants, but its citizens' share of financing the overall grant would be \$4.905 billion; that is, it contributes \$1.247 billion net (or \$279 per capita) to the financing of the general-purpose revenues. This amounts to over one-third of its actual CGC grant.

Columns 7 through 11 of table 12.5 repeat this exercise for Canadian transfers. From column 7, Ontario receives \$5.8 billion in transfers, but its citizens' share of Ottawa's consolidated revenue to pay for the transfers is \$10.8 billion, for a net contribution of \$5.015 billion or nearly 90 percent of its own transfer. But this is not the identical exercise as in table 12.5, because Ontario also gets to keep its tax revenues in excess of the five-province average level. Nonetheless, these data help clarify the actual degree of interprovincial redistribution. For example, overall grants to Quebec equal 31 percent of its own revenues (column 11). But when one takes into account who pays for these transfers, the *net* transfer to Quebec as a percentage of its own revenues is 11 percent (column 10). Even on this net basis, transfers remain high for some provinces—51 percent of own revenues for Newfoundland and 48 percent for Prince Edward Island.

Stabilizing Features of Equalization: Canada. Under the Canadian equalization system, a have-not province is guaranteed the average per capita revenue of the five provinces that make up the equalization standard. Thus, if the tax bases collapse in a have-not province that is not included in the five-province standard because, say, of an asymmetric negative shock, its revenue level will be *unaffected*. This is 100 percent stabilization, as it were. This result is symmetric, in the sense that equalization will “confiscate” any revenues arising from an increase in these provinces' tax bases. That this is the case is obvious from equation (1) above, because the fall in B_{ij}/P_i does not affect B_{Rj}/P_R for those provinces that are *outside* the five-province standard.⁶ For have-not provinces that are part of the standard, the offset is not complete because any fall in that province's tax base will also reduce the five-province standard. Assume that Quebec has a 30 percent weight in the five-province standard. If Quebec's tax bases were to fall by 10 percent, the five-province standard would fall by 3 percent and Quebec's total revenues would accordingly fall by 3 percent (as would the equalization for *all other have-not provinces*).

On the other hand, the three “have” provinces receive no insulation on either

6. For a detailed discussion of the analytics of the Canadian equalization formula, readers can consult Boadway and Hobson 1993 or Courchene and Wildasin 1984.

the up or down side. If Alberta suffers a 10 percent fall in its tax bases, then its revenues fall by 10 percent and vice versa. The same applies for Ontario and British Columbia, with one important proviso—their tax bases enter the five-province standard. With its 50 percent weight in the FPS, a 10 percent increase in Ontario's tax bases implies a 5 percent increase in the level of the five-province standard for *all* have-not provinces. In the last half of the 1980s, the Ontario economic boom meant a rapidly rising FPS, so much so that the ceiling provisions of the equalization program came into play. And the dramatic collapse in Ontario's revenues in the 1990s recession served to lower the five-province standard, so that the "floor" provisions of the equalization formula came into play.

Therefore, in terms of stabilization properties, Canada's equalization program has, at one extreme, zero stabilization for the three "rich" provinces, and, at the other, full (100 percent) stabilization for the four have-not provinces outside the FPS, with the remaining three provinces occupying the middle ground.

Two final comments are in order. First, have-not provinces can gain, revenue-wise, from an increase in their tax *rates*. But this is not a realistic alternative in the current environment where all the pressures are in the direction of tax cuts, not tax increases, and this applies with even more force in have-not provinces, which tend to already have higher-than-average tax rates.

The second point is that the equalization schemes are, on balance, probably more *redistributive* than *stabilizing*. Because Ontario has a 50 percent weight in the five-province standard, the equalization payments received by Nova Scotia depend as much, if not more, on what happens in Ontario as in Nova Scotia. For example, Nova Scotia's GDP need not be deviating from a trend line (i.e., no stabilization problem, *per se*) yet its equalization could still increase if Ontario's tax revenues are revving upward and vice versa. That many of the so-called stabilization programs in federal nations embody substantial redistribution is a key theme in Goodhart and Smith 1993.

Both these final two comments also apply to the CGC model, to which I now turn.

Stabilizing Features of Equalization: Australia. The CGC model has potential stabilizing features since the total amount to be equalized is set annually by the Commonwealth. On a timely basis, this could be increased in a recession and vice versa. But this would apply to *all* states in accordance with the existing "relativities": on an immediate basis, it cannot be targeted to a state with a negative economic shock because the CGC approach employs a five-year average, lagged three years.

More generally, the Australian states are severely revenue constrained: they cannot pocket the proceeds of an economic boom (except for the initial three years before their newfound fortune becomes reflected in the revised relativities). To see this, consider the following example, drawn from the early 1990s.

Western Australia received a \$750 million Commonwealth transfer relating to offshore energy initiatives. Apart from the initial three years, this will enter WA's relativities and WA may not even retain its population share of this revenue. This will depend on the relevant revenue and expenditure relativities. And if the Commonwealth holds overall revenue transfers constant, WA will experience a sharp fall in its transfers, offset by increases in all other states. Whether this results in a confiscatory drop in transfers will, as noted, depend on WA's relativities. Were this revenue windfall to occur in Alberta, the province would pocket *all of it*. Since Alberta is not part of the FPS, there would be no impact on equalization in other provinces. Were British Columbia the recipient province, it also would pocket all of this windfall, but since the FPS would rise as a result (since British Columbia is part of the FPS), all other provinces would stand to have their equalization increased somewhat, financed from Ottawa's consolidated revenues.

At this juncture, it is important to raise an important issue. Whatever philosophy is behind these equalization programs, they have a common defect—there is precious little *revenue incentive* for Australian states and Canadian “have-not” provinces to implement policies that ensure state/provincial growth. As already noted, a revenue increase resulting from growing tax bases for poor provinces outside the FPS in Canada is fully confiscated by the Canadian equalization formula. And this confiscation is presumably high as well for *all* Australian states. While there are admittedly other rationales for states and provinces to embark on growth-producing policies, the incentives in the equalization formula are, nonetheless, perverse.

12.2.5 Regional Disparities

Two final issues merit attention in preparing the ground for a focus on subnational budgetary policies and institutions. Since they are drawn from the existing literature, the analysis will be brief.

The first is that per capita regional income (GDP) disparities are much higher across Canadian provinces than across Australian states (Courchene 1993a, 1996a). With Victoria on the high end (for 1991) and Tasmania on the low end, the high/low ratio for the Australian state is 1.30, or 130 percent. For the Canadian provinces, the corresponding 1991 high/low ratio is 1.79, or 179 percent (with Alberta on the high end and Newfoundland and Prince Edward Island essentially tied for the low end). Were one to replace Alberta with Ontario, the high/low ratio would still be above 170 percent. The ratio of employment to the labor force (i.e., unity minus the unemployment rate) reveals an even greater disparity—a high/low ratio for the Australian states of 1.03 compared with 1.13 for the Canadian provinces, or four times as disparate for Canada. These results should come as no surprise. With wage grids roughly identical across states, with automatic stabilizers (e.g., welfare) located at the center, and with full fiscal leveling, there is nowhere near the scope in Australia for an Alberta resource boom or an Ontario manufacturing surge to ratchet up

these provinces' revenues and for them to become capitalized in wages and rents.

However, were one to focus on personal income per capita (as distinct from GDP per capita) the variation in the degree of regional disparity is substantially reduced—1.21 for the Australian high/low ratio across states and 1.30 across the Canadian provinces. What this means is that Canada has a (relatively) more generous set of federal transfers to individuals, particularly to individuals in the poorer provinces. Much of this relates to the operations of the Canadian unemployment insurance program—eligibility criteria are tilted toward poorer regions, as are the duration of benefits. (Australia does not even have an unemployment insurance program.) Indeed, Canada's interpersonal transfers are such that, for Newfoundland and Prince Edward Island, personal income actually *exceeds* provincial GDP in 1991. For no Australian state is this even close to being the case.

This leads to an important observation. Just as the Canadian provinces have more effective powers than the Australian states, so too does Ottawa have more maneuverability than Canberra. Except for the Commonwealth's free reign on designing transfers to the states (section 96), the Commonwealth is prohibited from discriminating in favor of particular states in its other policies. There is no similar provision in the Canadian Constitution, and Ottawa is notorious for building regional preferences into programs other than equalization. Indeed, at one point in the recent past, investment incentives in *national* income taxation were tilted in favor of have-not provinces. One result of the proliferation of federal policies (replete with perverse incentives) designed to combat Canadian regional disparities is that these disparities have become long-standing and entrenched. Elsewhere (1993b and 1994) I have referred to this as "transfer dependency" or a "policy-induced equilibrium." At the analytical level, one could probably make the case that these Canadian initiatives at the regional level are rather inevitable. While the Canadian federation is not structured to deliver an Australian type of egalitarianism, the Canadian Constitution does commit governments to "promote equal opportunities for the well-being of all Canadians" (s.36(1)(a) of the Constitution Act, 1982). Since equal opportunity is deemed not to arise out of the interplay of market forces (as evidenced by the degree of provincial per capita disparities in GDP), it falls on the federal government to become an active regional player in programs beyond the formal equalization program. Indeed, Ottawa is finding itself more and more driven to regionally redistributive roles. On the other hand, Canberra is able (and, actually, constitutionally bound) to play a regionally neutral role in delivering national programs. This poses no particular challenge to the Australian egalitarianism, since the concerns relating to individual and state equity/equality are accommodated within the confines of the operations of fiscal federalism and the centralized nature of the federation.

With this admittedly lengthy constitutional/institutional/empirical backdrop, we now direct attention to the frameworks within which the Australia states and Canadian provinces conduct their fiscal/budgetary policies. To anticipate

the ensuing analysis, it should come as no surprise that the Australia case is a model of coordination and harmonization, while the Canadian case is neither and, in some aspects, actually borders on the dysfunctional.

12.3 Commonwealth-State Fiscal Coordination in Australia

12.3.1 The Original Commonwealth Loan Council (CLC)

In 1927, the Commonwealth and the governments of the six states entered into a Financial Agreement to coordinate and centralize their borrowings. This agreement took effect in 1929. The thrust of the agreement was as follows (Saunders 1990, 38–39):

The Commonwealth would finally use its long-neglected power in Section 105 of the Constitution to take over all state debts. The Commonwealth would contribute the amount it had previously paid in per capita grants toward the interest due on the debts for a period of fifty-eight years, which was assumed to be sufficient to amortize them. For the future, a Loan Council, representative of all governments, would be established to make decisions about the terms and levels of borrowings. Most decisions would be by majority, with the Commonwealth having two votes and a casting vote and the states one vote each. With a few exceptions all borrowings would be carried out by the Commonwealth. The states would be liable to the Commonwealth for interest on the loans and the Commonwealth would be liable to the bondholders.

The Loan Council has had a very checkered history, important details of which appear in Saunders 1990. Of interest for present purposes are a few main points. First, the role of the respective governments within the Loan Council was a function of the financial resources available to them. This altered dramatically in 1942 when the Commonwealth assumed sole responsibility for income taxation. As Saunders (1990, 42) notes, “one important result was virtually to eliminate Commonwealth reliance on Loan Council decisions for borrowing for its own purposes.” Relatedly, the Commonwealth’s power in the Loan Council became preeminent, since the states were wholly dependent on revenue transfers from the Commonwealth.

There was a more serious problem however. There were a set of exemptions in the 1929 legislation that allowed the states to utilize semigovernment or local government “authorities” to effectively borrow for them, with some of the resulting funds appearing in their consolidated revenues. This “end run” on the Loan Council eventually reached dramatic proportions. For example, in 1989–90, “states or their authorities are expected to borrow \$3.7 billion on their own behalf, in both domestic and overseas markets. A significant portion of these funds will find their way into state consolidated revenue” (Saunders 1990, 40). Thus, the 1929 version of the Loan Council was essentially in shambles by the 1990s. However, the basic principles underlying the council were still alive and well and were embodied in the reconstituted Loan Council.

12.3.2 The Reconstituted Loan Council

As of 1993, the Loan Council was reconstituted. It now operates largely under voluntarily agreed arrangements rather than the legislated provisions of the earlier Financial Agreement. The council is a Commonwealth-State Ministerial Council comprising the Commonwealth treasurer (as chair) and the premier or treasurer of each state, with the Commonwealth Treasury providing the Loan Council Secretariat. The goals of the new council as reflected in Commonwealth Loan Council 1993 are intended to

- facilitate financial market scrutiny of public-sector finances via better reporting and so make jurisdictions more accountable to the markets
- enhance the role of the Loan Council as a forum for coordinating public-sector borrowings in light of the discussion of fiscal strategies
- promote greater understanding of budgetary processes
- provide the basis for states and territories assuming greater freedom and responsibility in determining their financing requirements consistent with their fiscal and debt position and overall macroeconomic constraints

The macro coordination role is a carryover from the old Loan Council. What is new is that the states will now borrow in their own right rather than via the Commonwealth or through their various borrowing authorities. But this borrowing will be filtered through the Loan Council process in a way that facilitates transparency, public accountability, and enhanced financial market monitoring. What is not as yet clear is whether the financial markets will view the states as “independent” market participants or whether they will assume that the Commonwealth, via the Loan Council process, is implicitly or explicitly guaranteeing the state debt. (More on this in section 12.7 below.)

It is too soon to tell whether this new procedure will work, particularly since the arrangements are voluntary. In the first couple of years or so, all has worked well because the Loan Council has accepted the LCA nominations submitted by the states and because, as will be evident in section 12.6, the Commonwealth's deficit bore the brunt of the 1990s recession.

I now turn to a brief discussion of the context within which the Loan Council and, more generally, Australian fiscal federalism operates.

12.3.3 The Anatomy of Australian Financial Federalism

Figure 12.1 presents my interpretation of the anatomy of Australian financial federalism. The budget cycle begins with the National Fiscal Outlook. This is an overarching document to the entire process of Australian intergovernmental financial relations. It presents projections, on a comparable and consistent basis, for all governments' fiscal outlooks for the medium term (i.e., the current year and the following three years) under both a high- and low-growth scenario. The underlying assumption in these forecasts is that the fiscal parameters

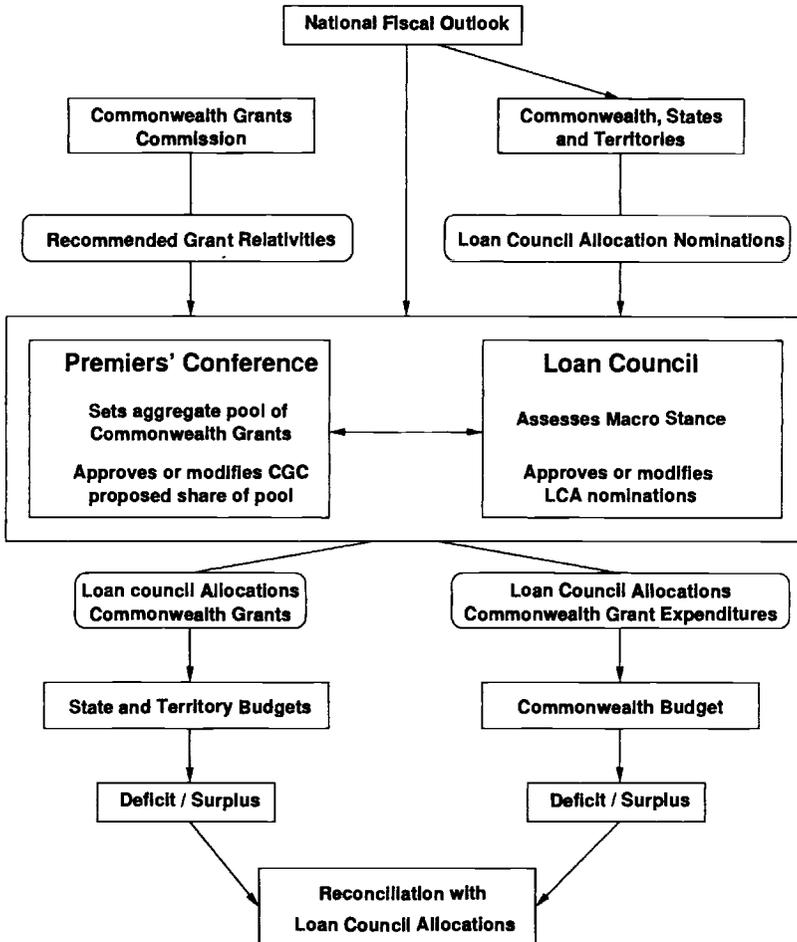


Fig. 12.1 The anatomy of Australian financial federalism

remain unchanged over the projection period, including the *real* value of revenue assistance from the Commonwealth to the states and territories. Initially, these forecasts were provided in advance only to state and territorial governments and were made public only at the time of deliberations of the Loan Council and the Premiers' Conference. In 1995, however, these projections were made public in advance of the Premiers' Conference. As an important aside, this official public document providing an assessment of all governments' fiscal stances on a consistent basis does not exist in Canada, although some private-sector agents (e.g., the economics department of the Toronto Dominion Bank) have partially filled the gap.

The National Fiscal Outlook (NFO) feeds into the Commonwealth, state,

and territorial Loan Council Nominations (LCAs in figure 12.1). In tandem, the NFO and the LCAs provide the public and the financial markets with a prebudget overview of the various fiscal positions, which, in turn, enhances the transparency and accountability of the overall budgetary process.

Roughly coincident with the preparation of the National Fiscal Outlook is the publication of the Commonwealth Grants Commission “relativities,” that is, the state/territorial shares of Commonwealth grants. These grant relativities and the LCAs then feed into the daylong meeting of the Loan Council and the Premiers’ Conference. The role of these meetings is at least threefold: (i) to ratify or otherwise reconsider the LCAs; (ii) likewise to ratify or otherwise adjust the “relativities” recommended by the Commonwealth Grants Commission; and (iii) to decide on the *total* amount of the Commonwealth-state general-revenue grants, which will then be allocated in line with the shares or relativities. These decisions are also released immediately to the public and the financial markets.

Given the grant-dependent nature of the Australian states, as outlined earlier, the effective coincidence (i.e., on the same day) of the decisions relating to loan allocations and Commonwealth transfers means that the Commonwealth government is clearly in the driver’s seat. For example, one could conceive of generous Loan Council allocations along with a curtailment of overall Commonwealth transfers; that is, the Commonwealth could force the states to borrow. There is precious little that the Australian states could do, at least in the short term, in response to such a tactic.

This comment aside, the next stage in the process, in terms of figure 12.1, is the preparation of budgets. Because data on deficit projections and Loan Council allocations are already public, the incentives facing the various governments are clearly to do “better” than this in terms of their bottom line.

This focus on transparency, on accountability, and on linking overall government deficits to the underlying macro strategy stands in stark contrast to the *laissez-faire* approach in Canada. Even though the reconstituted Loan Council arrangements are voluntary, the revenue dependence of the states on the Commonwealth is such that it is highly unlikely that the errant Ontario fiscal scenario (elaborated later) could ever be replicated in Australia. More generally, Australia has in place a fiscal, or at least a borrowing, coordination process that appears to ensure that the aggregate fiscal stances are rendered consistent with the overall macro strategy. None of this should come as a surprise, given the centralist/egalitarian nature of the Australian federation.

12.4 Federal-Provincial Fiscal Coordination in Canada

In a word, there is no coordination! Moreover, any monitoring of provincial finances is done by the capital markets (bond-rating agencies), not by Ottawa. As Kneebone (1994) argues, these capital market constraints were effective (at least in the 1980s) in terms of keeping the lid on provincial borrowing, but they did not really constrain the federal government.

However, one can report some recent progress in related areas. Canada now has a version of a budget cycle. The federal budget comes down in late February or early March of each year. This fixed date does serve as a harmonization element of sorts in the sense that most provinces will know what Ottawa is doing when they present their own budgets. In particular, provinces are obviously interested in any changes in federal-provincial transfers, which, except for equalization, typically appear in federal budgets. In addition, federal and provincial finance ministers and/or deputies do apparently share basic budgeting information in closed-door meetings prior to the beginning of the budget cycle. An important initial step in terms of providing greater transparency, information, and even potential coordination would be to make these projections public à la Australia's National Fiscal Outlook.

Beyond these measures, however, Canada has nothing to compare to the Australian institutional process. Phrased differently, the provinces can tax and spend as they wish and they can borrow as long as they can find markets for their bonds.

However, the real subnational fiscal story in Canada is the potential conflict between provincial and federal policies. I shall focus here only on the province of Ontario and deal with three periods within the last decade or so where its policies ran fully counter to Ottawa's fiscal/macro thrust. Then, I shall focus on errant behavior by the federal government.

12.4.1 Fiscal Conflict: Ontario versus Ottawa

To illustrate the problems that can arise in a highly decentralized federation with effective fiscal autonomy at both levels of government, it is convenient to focus on three recent episodes where the policies of the province of Ontario (which has roughly 40 percent of Canada's GDP) either offset or dramatically complicated Ottawa's macro agenda.

The first occurred in the mid-1980s when the federal government followed the Americans in reducing personal and corporate income tax rates. Ontario responded by "taking up" the vacated federal tax room. That is, it increased its provincial income taxes by the same amount. Overall, taxpayers in Ontario were left in a "neutral" position—total personal income taxes remained constant, but more now went to Ontario and less to Ottawa. I should note in passing that Ontario was not the only province to adopt this strategy. The effect was to negate what the federal government was intent on achieving—a reduction in personal income taxation to bring Canada's tax rates more in line with those in the United States, especially since this was the run-up period to the Canada–United States Free Trade Agreement. Moreover, the tax break was intended primarily for the footloose manufacturing sector (i.e., for Ontario) in order to alleviate the high marginal tax rates on upper-echelon management. But all for naught. Essentially, this is the common-property-resource issue in yet another guise since both Ottawa and the provinces share the income tax bases.

The second episode occurred in the latter half of the 1980s. Ontario was in the throes of a very substantial economic boom. Real GDP growth rates for

the province averaged over 5 percent annually for the 1984–89 period. But Ontario was also launched on a veritable spending spree. As a result, inflation pressures were beginning to emerge in the province. Partly to counter this and partly because of a philosophical conversion, the Bank of Canada launched its price stability strategy in early 1988. Yet Ontario's spending increases kept marching along at midteens growth rates. Given that Ontario accounts for roughly 40 percent of Canada's GDP, this severely complicated the price-stability strategy. Interest rates and exchange rates soared—for example, the Canada-U.S. exchange rate appreciated from the low 70 cent range in 1986 to nearly 90 U.S. cents per Canadian dollar in 1991. These rates were much higher than would have been required had Ontario's fiscal policy been coordinated with the overall macro strategy. In the event, rough justice prevailed, as it were, since Ontario was the principal loser in early 1990s recession. Nonetheless, the lack of policy coordination generated substantial economic costs to *all* Canadians.

The third episode follows from the second. Thanks to the spending and taxing spree of the 1980s, Ontario entered 1990 with one of the highest tax rates in the country and with a legitimate claim to be the premier social spender at the provincial level. Both of these features were wholly out of character for the province of Ontario—traditionally a low-tax and moderate-spending province. In any event, the 1990s recession pulled the rug out from under Ontario's revenue base. Ontario's newly elected New Democratic Party (Canada's version of a socialist party) responded by attempting to spend its way out of the recession. The result was a \$10 billion budget deficit for Ontario for the fiscal year 1990–91, compared to budget balance in 1988, for example. And not once in the five-year mandate of the New Democrats did Ontario's deficit fall beneath \$10 billion. From a net public debt level of just over \$40 billion in fiscal 1990–91, Ontario's debt mushroomed to \$99 billion in fiscal 1995–96—an increase of nearly 150 percent. During this same period, the federal government was launched on a determined deficit-reduction course, which was obviously and seriously compromised by Ontario's deficit spending. Although Canada's inflation rate was running below that in the United States, our nominal interest rates and, therefore, our real interest rates were well above comparable U.S. rates. We only achieved the interest-rate “crossover” (i.e., Canadian nominal rates for short- and medium-term maturities *below* U.S. nominal rates) once the new Conservative government in Ontario (elected in 1995) committed the province to budget balance by the end of the century.

Several implications arising from Ontario's debt run-up merit highlighting. The first relates to severity of the early 1990s recession for Ontario. The revenue collapse was such that it would have been impossible to keep the province out of the red. The New Democrats may have thrown fiscal caution to the winds, but achieving budget balance, at least in the first year or two of the recession, would have required draconian measures. The second is related. Because Ontario is a “have” province (and remained a have province throughout

the recession), it has no equalization “safety net” underpinning its revenue base. Third, Ontario entered this period in rather enviable fiscal shape. Its budget was balanced in 1988–89 (table 12.7), and its debt-to-GDP ratio was less than 15 percent. (Only British Columbia had a lower debt/GDP ratio in this era.) Indeed, as late as 1990 Ontario had a (Standard and Poor’s) AAA rating. Therefore, Ontario had ready access to capital markets, at least initially. However, it did not take long for the capital markets to react. Standard and Poor’s dropped Ontario’s rating to AA+ in 1991, to AA in 1992, and then to AA– in 1993, where it still remains. Nonetheless, the province was able to float roughly \$60 billion in new bonds over a five-year period—undoubtedly a record for a subnational government, anywhere, anytime.

The fourth point situates Ontario’s behavior in the EU context. As I have argued elsewhere (1993b), the challenge to coordinated macro policy in either Canada or the EU is not likely to come from the smaller provinces or countries. In part, this is precisely because they are small and, hence, likely to have minimum impact on the overall stabilization strategy: errant behavior by Portugal or Newfoundland will have little effect on EU or Canadian inflation targets. In part, also, the capital markets will tend to keep these countries or provinces in check. On both counts, this is less likely to apply to the powerful nations or provinces. For example, in the second of the above two episodes, Ontario was well within any sort of Maastricht-type guidelines. In terms of the 1990s, however, Ontario’s deficit-to-GDP ratio did exceed 3 percent from 1991–92 onward (3.9 percent in 1991–92, 4.4 percent in 1992–93, 3.9 percent in 1993–94, 3.3 percent in 1994–95, dropping finally to 2.8 percent in 1995–96), while the debt/GDP ratio increased from 14.2 percent in 1989–90 to 31.3 percent in 1995–96. The point I am making here is that large countries in the EU that are “intramarginal” in terms of the Maastricht guidelines are far more likely to wreak havoc with overall macro and inflation guidelines than are some of the smaller and likely capital-markets-constrained countries who are likely to be bumping against the Maastricht guidelines in any event.

The key message in the Canadian case is that the federation is in dire need of some coordinating, perhaps even harmonizing, mechanisms that would address the deleterious spillovers arising from fiscal and budgetary decentralization. Note that this is not meant to downplay the potential for stabilization policies at the provincial level, especially for the three have provinces. In particular, there is an important provincial role in terms of “tempering” their economic booms.

12.4.2 Fiscal Conflict: Ottawa versus the Provinces

While Canada’s taxation system is very decentralized, it is at the same time quite harmonized. The decentralized personal income tax allows the provinces (except for Quebec, which has its own personal income tax) to levy a single tax rate against federal taxes payable. For example, a 50 percent provincial tax rate would imply that the province in question would receive one-third of over-

Table 12.7 Canadian Federal and Provincial Governments: Surpluses and Deficits (as of July 21, 1997)

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	Projections	
									1997-98	1998-99
Surpluses/Deficits (\$ millions)										
Total federal and provincial	-33,253	-42,060	-57,005	-65,941	-62,205	-53,368	-40,544	-23,116	-18,768	-10,622
Federal	-28,930	-32,000	-34,357	-41,021	-42,012	-37,462	-28,617	-15,000	-10,000	-5,000
Total provincial	-4,323	-10,060	-22,648	-24,920	-20,193	-15,906	-11,927	-8,116	-8,768	-5,622
Newfoundland	-175	-347	-276	-261	-205	-127	9	-29	-20	-10
Prince Edward Island	-8	-20	-50	-82	-71	-2	4	-7	-17	1
Nova Scotia	-266	-257	-406	-617	-547	-235	-201	5	4	4
New Brunswick	-24	-182	-348	-259	-250	-69	51	74	26	23
Quebec	-1,760	-2,967	-4,301	-5,014	-4,921	-5,821	-3,950	-3,245	-2,200	-1,200
Ontario	90	-3,029	-10,930	-12,428	-11,202	-10,129	-8,800	-7,470	-6,580	-4,800
Manitoba	-142	-292	-334	-566	-431	-196	157	56	27	30
Saskatchewan	-378	-360	-842	-592	-272	128	18	369	24	79
Alberta	-2,116	-1,832	-2,629	-3,415	-1,384	958	1,132	2,527	154	252
British Columbia	456	-774	-2,532	-1,686	-910	-414	-347	-395	-185	0

	Surplus/Deficit-to-GDP Ratios (% of GDP)									
Total federal and provincial	-5.1	-6.3	-8.4	-9.6	-8.7	-7.1	-5.2	-2.9	-2.2	-1.2
Federal	-4.4	-4.8	-5.1	-5.9	-5.9	-5.0	-3.7	-1.9	-1.2	-0.6
Total provincial	-0.7	-1.5	-3.3	-3.6	-2.8	-2.1	-1.5	-1.0	-1.0	-0.6
Newfoundland	-2.1	-3.9	-3.0	-2.8	-2.2	-1.3	0.1	-0.3	-0.2	-0.1
Prince Edward Island	-0.4	-1.0	-2.4	-3.8	-3.1	-0.1	0.2	-0.3	-0.6	0.0
Nova Scotia	-1.7	-1.5	-2.3	-3.5	-3.0	-1.3	-1.1	0.0	0.0	0.0
New Brunswick	-0.2	-1.4	-2.6	-1.9	-1.7	-0.4	0.3	0.5	0.2	0.1
Quebec	-1.2	-1.9	-2.8	-3.2	-3.0	-3.5	-2.3	-1.9	-1.2	-0.6
Ontario	0.0	-1.1	-3.9	-4.4	-3.9	-3.4	-2.8	-2.3	-1.9	-1.3
Manitoba	-0.6	-1.3	-1.5	-2.4	-1.8	-0.8	0.6	0.2	0.1	0.1
Saskatchewan	-1.9	-1.7	-4.1	-2.9	-1.3	0.6	0.1	1.4	0.1	0.3
Alberta	-3.2	-2.6	-3.7	-4.7	-1.8	1.2	1.3	2.8	0.2	0.2
British Columbia	0.6	-1.0	-3.1	-1.9	-1.0	-0.4	-0.3	-0.4	-0.2	0.0

Sources: Federal and provincial budgets and governments, Statistics Canada, and TD Economics, Toronto Dominion Bank.

Note: Federal government deficits for 1996–97 to 1998–99 are estimated by TD Economics. Nominal GDP forecast by TD Economics as of July 1997. Provincial surplus/deficit data are government estimates. Fiscal years begin on April 1 and end on March 31. Data may not be comparable across years. The consolidated surplus/deficit estimates generally include operating and capital items, and equal consolidated revenues less consolidated expenditures. Some provinces include a portion of sinking-fund earnings when reporting their consolidated balances. Ontario's deficit for 1993–94 to 1998–99 is presented on a PSAAB basis, and is not strictly comparable to data for prior years. B.C.'s Consolidated Revenue Fund excludes most capital spending. Manitoba's 1997–98 operating revenue includes \$100 million from the Fiscal Stabilization Fund. Saskatchewan's 1996–97 consolidated revenue includes a special CIC dividend of \$364.7 million.

all personal income tax revenues. The overall tax is harmonized because the federal government determines all the relevant parameters (definitions of income, definitions of tax credits, overall progressivity, etc.) and because the tax compliance for the provincial portion of the tax is minimal (the provincial tax component occupies only a line or two in the overall tax form). While the harmonization of the personal income tax remains, Ottawa introduced a 7 percent European-style VAT (the goods and services tax, GST) beginning in 1991. This replaced the former manufacturers' sales tax. The rationale for the switch is not in question. The GST, like any VAT, is export-import neutral and, therefore, ideally designed for the enhanced U.S. and North American integration under the FTA and NAFTA. Unfortunately, this tax was introduced in the face of almost universal opposition from the provinces. Initially, only Quebec agreed to harmonize its PST (provincial sales tax) with the GST base (and was rewarded with the power to collect both the GST and its harmonized PST). For the nine other provinces (actually eight, since Alberta does not levy a PST), the tax bases of the GST and the PST are very different. In particular, the PSTs generally exclude services. This has introduced a very substantial compliance cost on businesses and, generally, has led to a sales tax "jungle," as it were. As of April 1, 1997, Ottawa offered a \$1 billion dollar bribe to three Atlantic provinces (Nova Scotia, New Brunswick, and Newfoundland) to adopt a "blended" (GST plus PST) sales tax at a combined rate of 15 percent. This billion-dollar subsidy has not been well received by the other provinces (who were not offered the subsidy), and the sales tax disharmony still prevails in these other provinces. Whatever the problems and challenges of Commonwealth-state fiscal relations in Australia, this degree of lack of harmonization could never occur.

The other, and more far-reaching, federal-provincial dysfunction is that the Canadian federal government has achieved its quite remarkable deficit-turnaround by "off-loading" or "deficit shifting" much of its problem to the provinces. This issue will be addressed in the context of Canada's recent fiscal history, to which I now turn.

12.5 Recent Fiscal History: Canada

Canada came out of the severe 1990s recession in absolutely dreadful fiscal shape.⁷ In fiscal year 1992–93, the federal deficit was \$41.0 billion (5.9 percent of GDP) and the combined (federal and provincial) deficit was \$65.9 billion (9.6 percent of GDP), as revealed in table 12.7. Federal net public debt was \$466 billion (68 percent of GDP) and the combined federal and provincial debt was \$660 billion, or 95.7 percent of GDP. Beyond this, our current account deficit was running at 4 percent of GDP. Spilling this amount of red ink was tantamount to an open invitation to what we Canadians call the "kids in red

7. For a longer sweep of Canada's macro history, see Courchene 1997.

suspenders” (the international capital markets) to exert some external pressure on our fiscal profligacy. And they did, not only by downgrading Canada’s foreign currency debt (which as a percentage of GDP was well above any other G7 nation) but also by providing an external discipline that in turn provided the needed catalyst for bringing Canadians to their fiscal senses. The fiscal story from 1993, and especially 1995, to the present is one of a quite remarkable turnaround: in 1998 Ottawa is forecast (by Finance Canada) to be the only G7 nation to run a financial requirements surplus. What follows is a brief survey of the key elements of this turnaround.

12.5.1 Inflation, Interest Rates, and Exchange Rates

In 1988 the Bank of Canada adopted a price stability strategy. The immediate result of this was that interest rates spiraled upward, the Canadian dollar appreciated from the low 70 cent range to nearly 90 U.S. cents in 1991, and Canadian competitiveness vis-à-vis the United States (as measured by comparative unit labor costs expressed in a common currency) deteriorated sharply, all of which exacerbated the early 1990s recession.

Nonetheless, the price stability policy did achieve its intended results by early 1992, when Canadian inflation rates dipped below U.S. inflation rates, where they have stayed ever since. And the exchange rate fell back to the low 70 cent range. The problem, however, was that until early 1996, Canadian short-term nominal rates remained above, often well above, comparable U.S. rates with the result that Canadian *real* interest rates were well in excess (often by 4 percent) of U.S. real rates. It was not until early 1996 that Canadian treasury bill rates dipped below comparable U.S. T-bill rates, and it was not until early 1997 that Canadian interest rates were below comparable U.S. rates up to a maturity of 10 years. This “interest-rate crossover” is a historic development and clearly a feather in the Bank of Canada’s cap.⁸ While not downplaying the role that the Bank of Canada’s credibility played in this interest-rate crossover, it is nonetheless the case that the Bank probably needed the commitment to deficit reduction and the budget credibility of the finance minister. Moreover, it probably also needed the newly elected (1995) Conservative government of Ontario to ride herd on the province’s five-year average of \$10 billion-plus annual deficits.

At the time of writing, interest rates are at 30- or 40-year lows, inflation remains roughly at the midpoint of the 1–3 percent target range and lower than U.S. inflation, the Canadian economy is probably as competitive vis-à-vis the

8. Elsewhere (1997), I expressed some pessimism in terms of Canada’s (and the bank’s) ability to generate this interest-rate crossover. Obviously, I was wrong. However, the larger point relates to the wisdom of pursuing a lower inflation rate than the Americans, when 80 percent of exports are destined for U.S. markets. Canada cannot tolerate the massive exchange rate swings of the last decade (70 U.S. cents per Canadian dollar in 1986, roughly 90 cents in 1991, and back to the low 70 cent range recently). What may guarantee more exchange-rate fixity is that the U.S. Federal Reserve is also targeting on a low inflation rate. While others (e.g., Fortin 1996) are also concerned about Bank of Canada policy, we are clearly in the minority of the Canadian economics profession.

Americans as it has ever been, the merchandise trade surplus is running at nearly 5 percent of GDP, and the current account is balanced. Fiscal policy is an integral part of this impressive turnaround.

12.5.2 The Fiscal Story

The Chrétien Liberals were elected in 1993 on a platform that included, à la Maastricht, bringing the federal deficit down to 3 percent of GDP. However, Finance Minister Paul Martin, pressured by domestic and international financial markets and the Canadian economics policy community, buoyed by substantial citizen support, and chastened with the reality that debt-servicing costs were running at 33 percent of revenues (in fiscal year 1993–94), utilized this Maastricht window to pursue a much more thorough exercise in fiscal restraint. The key fiscal blueprint was the 1995 federal budget. This budget trimmed the federal civil service by 45,000 persons (25 percent), generated major cuts to program spending (especially federal-provincial transfers), led to the passing down of many areas to the provinces (mining, forestry, tourism, training, etc.), and extricated the federal government from a wide range of areas (privatization, contracting out, desubsidization, etc.).

Almost as important as the budget content was the budgetary *process* adopted by Finance Minister Paul Martin. Apart from opening up the process, these initiatives included

- Setting rolling targets for only two years in the future, but ensuring that these targets would be met. For example, the deficit target for 1995–96 was set for \$32.7 billion and that for 1996–97 for \$24.3 billion (3 percent of GDP). Actual deficits came in much under target—under \$30 billion for 1995–96 and an estimated \$15 billion for 1996–97 (table 12.7). The new targets are \$17 billion (2 percent of GDP) for 1997–98 and \$9 billion (1 percent of GDP for 1998–99). These targets will be met “come hell or high water,” to quote from the 1997 budget, and virtually all analysts would agree. Indeed, the 1996–97 deficit is already under the 1997–98 target.
- To ensure that the targets are met, the finance minister has adopted deliberately “prudent” estimates for forecasts of variables like GDP growth and interest rates. For example, the average of private-sector forecasts of nominal GDP growth for 1998 is 4.7 percent. The budget forecasts assume a 4.1 percent growth rate. And the average private-sector forecast for ten-year government bonds is 6.6 percent, whereas the budget forecast uses 7.1 percent.
- In addition, Finance Minister Martin’s deficit targets also include a contingency reserve (\$3.0 billion for 1997–98), which cannot be spent elsewhere. For 1997–98, the impact of this contingency reserve is such that the deficit target will be met “even if interest rates were 100 basis points higher, and growth one-half percentage point lower, relative to the *prudent* assumptions” (Finance Canada 1997, 47).

The result of all of this is that the finance minister and his budgets have acquired a degree of credibility hitherto unknown in Canadian fiscal circles.

Prior to focusing on a few performance indicators, it is critical for purposes of the present paper to note that much of the successful federal expenditure restraint came at the expense of the provinces: Ottawa took a page out of the Australian hymn book and engaged in significant “deficit-shifting” or offloading to the provinces. The equalization system was untouched, but the cash transfers for health, postsecondary education, and welfare (now rolled into the block-funded CHST) were reduced from \$18 billion in 1995–96 to (a projected) \$11 billion at the turn of the century. This represents, roughly, a 40 percent cut in CHST cash transfers to the provinces.

For their part, the provinces found themselves with little room to maneuver. The bond rating agencies were poised to lower credit ratings further if the provinces attempted to accommodate this dramatic cash transfer reduction in terms of deficit increases. Since provincial tax rates were already very high, this avenue was effectively closed off. Moreover, the citizen concern over deficits that led to the general acceptance of federal fiscal constraint also applied at the provincial level. Accordingly, these federal cash transfer cuts to the provinces were transformed into roughly equivalent expenditure reductions at the provincial level.

Ontario is especially interesting in this context. The new market-oriented Progressive Conservative government of Ontario (elected in mid-1995) launched the province on both a tax-cutting and deficit-reducing strategy. Ontario’s personal income tax rates have been reduced by 30 percent and the budget is to be balanced by the millennium. Ontario also adopted the federal budgeting strategy—very conservative income/revenue growth estimates for its forecasts and a large contingency reserve. As a result, Ontario’s deficit has also come in “under forecast,” as it were, so that Ontario’s budgetary policy is also acquiring considerable credibility. Intriguingly, this approach carried over to the other fiscally errant province—Quebec. Faced with an Ontario tax cut, the separatist Parti-Québécois government in Quebec also had to begin the process of sharp expenditure reduction rather than tax increases. Moving on the tax side would have led to a (further) exodus of Quebec businesses to Ontario or elsewhere.

The result of all of this was that all Canadian governments are currently moving quickly toward budget balance. As already noted, Ottawa’s deficit for 1996–97 will probably come in at less than 2 percent of GDP, down from 6.5 percent earlier in the decade. Table 12.7 presents the evolution of federal and provincial deficits from fiscal year 1989–90 through to (forecasts for) 1998–99. Several features of the table merit highlight:

- Both levels of government recorded very substantial increases in their deficits as a result of the 1990s recession—provincial deficits increased from

\$4.3 billion in 1989–90 to \$24.9 billion at the peak of the fiscal damage (1992–93), while the federal government's deficit increased from \$28.9 billion to \$41.0 billion over this same period (and actually increased further in 1993–94).

- Unlike the Australian case (detailed later) where the 1990s recession primarily affected the Commonwealth deficit, the Canadian provinces have shared roughly equally in the Canadian deficit increases. This is because the provinces share the cyclically sensitive revenues with the federal government and also share in the automatic stabilizers on the expenditure side (welfare is provincial, employment insurance is federal, and both mushroomed in the recession).
- The aggregate deficit-to-GDP ratio nearly touched 10 percent in 1992–93—indeed, five *provinces* had deficit/GDP ratios in excess of the Maastricht guideline of 3 percent!
- The real “problem” provinces in 1992–93 were Alberta, Ontario, and Quebec. Alberta has made a remarkable turnaround (thanks to an increase in revenues from oil and gas production); in 1996–97 it ran a surplus of 2.5 percent of GDP.
- More generally, the post-1992–93 fiscal story is one of dramatic improvement. The 1996–97 data, when finalized, are projected to yield an aggregate (federal plus provincial) deficit just under the 3 percent Maastricht guideline, with further improvement in sight.
- In 1996–97, five of the ten provinces are in surplus, and the forecast is for seven to be in surplus in 1998–99. Ontario and Quebec remain the errant fiscal provinces, but both are on track for budget balance by the millennium.
- Although not detailed in table 12.7, the result of this deficit-cutting exercise was very dramatic in government program spending as a percentage of GDP. From the 1992–93 level of roughly 37 percent of GDP (20 percent provincial and 17 percent federal), program expenditures will fall to less than 30 percent in 1997–98 (under 16 percent for the provinces and roughly 13 percent for Ottawa). Reductions of this magnitude in EU nations would qualify virtually all of them for EMU entry!

However, the fiscal news is not all good. Were one to reproduce table 12.7 for debts and debt ratios, the results would reveal a rise in the debt/GDP ratio from 74.7 percent in 1989–90 to 105.9 percent in 1996–97. While this latter percentage is down slightly from the peak of 106.3 percent in 1995–96, the reality is that Canada has not yet come to grips with its massive debt overhang. Not to put too fine a point on all of this, Canadian governments now need to develop debt-reduction targets along the lines of the earlier deficit-reduction targets. More to the point, the Canadian fiscal position is clearly vulnerable to either an economic downturn or a rise in interest rates, or both.

12.5.3 Summary

Since much of this volume focuses on the relationship between fiscal institutions and budgetary performance, it seems appropriate to attempt to recast the Canadian experience in the context of some of the conference themes. The commitment to the 3 percent Maastricht-type deficit target in the 1993 electoral platform of the victorious Liberals was no doubt an important catalyst to deficit reduction. But it was not much more than this because it was cast as a five-year goal and only applied to the federal government: the provinces were also running deficits in the range of 3 percent of GDP in 1993. Moreover, Finance Minister Paul Martin's first budget (1994) was not only very unimpressive on the deficit front but held out the promise for major social policy reform that, arguably, could have led to increased rather than decreased expenditures. Beyond this, it became evident that the Canadian public was well ahead of the finance minister in terms of its willingness to accept deficit reduction.

What this disappointing 1994 federal budget triggered was a dual set of processes—one internal to the government and one that was capital-markets driven—that led to the watershed 1995 budget. The former took the form of an intense struggle within cabinet between the finance minister and the social policy minister. This is superbly documented in *Double Vision* (Greenspon and Wilson-Smith 1996). The result was a near-complete victory by the department of finance—social policy reform became subordinated to fiscal priorities, and, as important, restoring fiscal integrity would be achieved principally by expenditure paring. On the external and capital-markets front, the major think tanks in the country came down forcefully on the side not only of deficit reduction, but deficit elimination over a short time frame. Virtually all mainstream economists and bank/financial economists came down on this side. This domestic pressure was reenforced by capital-market developments. One key aspect here was the peso crisis in the fall of 1994 and the suggestion, in the U.S. financial papers, that Canada could well be next. The other was a most unusual move by Moody's—a month or two before the 1995 budget, Moody's placed Canada under a "credit watch."

In tandem, these developments stiffened the finance minister's resolve and led to the watershed 1995 budget, including the budgetary innovations in the area of targets, prudence, and transparency that eventually led to budget credibility. So confident was the finance minister that the 1995 budget would assuage capital markets that he invited the chief economists of domestic and foreign financial institutions to a special budget "lock-up." One measure of the newfound transparency and credibility of successive Canadian budgets is that this lock-up tends no longer to attract chief economists but, rather, their designates. Indeed, now that these budgetary processes have become standard fare, it will be very difficult for the federal government to pull back from them, so much so that pressures are now mounting to shift the focus from deficit reduc-

tion to debt/GDP targeting. This view of the Canadian experience lends support to the thrust of many of the papers in this volume.

There is, however, another way to view the evolution of Canadian fiscal history. In my own work (1997), I have argued that one of the principal reasons for the run-up of deficits and debts over the last two decades had to do with some unpleasant fiscal arithmetic, as it were. Up until the first energy crisis in 1973–74, real growth rates exceeded real interest rates, often by a significant amount. In turn, this meant that, *ceteris paribus*, the debt/GDP ratio would fall. From the mid-1970s on, real interest rates increased relative to real growth rates and, in Canada's case, eventually exceeded real growth rates by 4 percent. Under the old regime, one could run primary deficits (i.e., excluding debt servicing) and still have a falling debt/GDP ratio. No longer. Running primary *surpluses* may not lead to a falling debt/GDP ratio in an environment when real interest rates exceed the real growth rate. The argument would be that governments and fiscal institutions were very slow to recognize this profound change in underlying parameters and, in the process, saddled themselves with debt levels that began to be self-reinforcing.

In a recent paper, Ronald McKinnon (1997) takes a different slant on this historical evolution. For McKinnon, the major turning point was the end of Bretton Woods and the *de facto* "softening" of budget constraints under the resulting flexible rate regime. Hence, he views EMU as an attempt by member countries to reimpose "hard" budget constraints on themselves, via "monetary separation" (severing the link between national central banks and national budget authorities) and the no-bail-out clause of the EMU. This approach focuses on an *external* imposition of hard budget constraints that would apply to all varieties of electoral systems and fiscal institutions, whereas most of the papers in this volume focus on *internal* innovations that would serve to "harden" budget constraints. In the Canadian case, one could mount a case that aspects of the McKinnon analysis appear to ring true. The federal government recognized that the Bank of Canada could not be deterred from its price stability strategy. Despite the fact that Canadian inflation rates were lower than U.S. rates, if nominal and, therefore, real interest rates were to fall, this required some determined action on the deficit front. Note that this assertion embodies two assumptions, both of which were widely accepted in Canada at the time: (i) that the existing high nominal rates embodied an inflation premium that related to the possibility that the deficit could eventually be monetized and (ii) that over the short term the Bank of Canada would hold firm to its price-stability stance. In essence, this is the definition of a hard budget constraint since the fiscal authorities became boxed in—lowering interest rates required deficit paring. Likewise, the deficit shifting to the provinces was also passed onward in terms of expenditure cuts at the provincial level since the provinces also faced hard budget constraints, largely enforced by the capital markets.

How much relevance the Canadian and McKinnon perspectives have for other countries, and the EMU in particular, is best left for others to assess.

12.6 Recent Fiscal History: Australia

Like Canada, Australia was savaged by the 1990s recession. From a 1989 manufacturing employment index of 102.7 (1990 = 100), the index was still languishing at 92.9 in 1995. Comparable Canadian data are 107.5 in 1989 and 93.4 in 1995 (International Monetary Fund 1997, line 67ey). In terms of the overall labor market, Fortin (1996, 762) comments as follows: "Relative to the 1989 unemployment level, Canada accumulated 15.7 point-years of excess unemployment over 1990–95. According to OECD standardized unemployment statistics, this is significantly more than Japan (2.3 point-years), the United States (6.3) and the European Union (10.7). Our bad unemployment result has been matched only by Australia (16.3 point-years)." Hence, it should come as no surprise that Australia also registered substantial deficits during this period.

However, where Australia differed markedly from Canada is that it entered the recession with an aggregate net debt/GDP ratio in 1990 that was not much above 10 percent (panel A of figure 12.2), compared with the Canadian counterpart of nearly 80 percent. By 1995, Australia's ratio of aggregate net debt to GDP exceeded 25 percent, with almost all of this increase accounted for by the Commonwealth government. This is clear from panel B of figure 12.3: the Commonwealth budget balance deficit went from a surplus of almost 2 percent of GDP, prerecession, to a deficit of over 4 percent in 1992–93, whereas overall state deficits increased only slightly (lower panel). This was primarily the result of the operations of automatic stabilizers. In particular, in the face of the dramatic and sustained fall in employment (alluded to earlier) the Commonwealth spending category "social security and welfare" soared from \$25.5 billion in 1988–89 to nearly \$50 billion in 1994–95. This was one half of the problem: the other half was the revenue collapse. The behavior of outlays and revenues appear in figure 12.4. Note that this allocation of the burden for accommodating a recession is quite different from that which applied in Canada. As noted earlier, on the expenditure (outlay) front, automatic stabilizers are shared (unemployment insurance at the federal level and welfare at the provincial level) as are the cyclically sensitive taxes (income taxes and sales taxes). Hence, the 1990s recession in Canada resulted in substantial increases in both federal and provincial deficits. Not so in Australia, since on both the outlay and revenue side, the cyclically sensitive programs rest with the Commonwealth.

However, the seemingly benign behavior of state and territory deficits (fig. 12.3) and outlays and expenditures (fig. 12.4) masks a great deal of variation at the state level. All of the states in panel B of figure 12.2 record substantial debt increases, while low-spending Queensland (panel C) increased its net assets as a percent of GDP from 1 percent in 1988 to roughly 11 percent by 1996.

As is evident from these figures, Australia is now putting its fiscal house in order, at least on the deficit side—the projections for the Commonwealth are

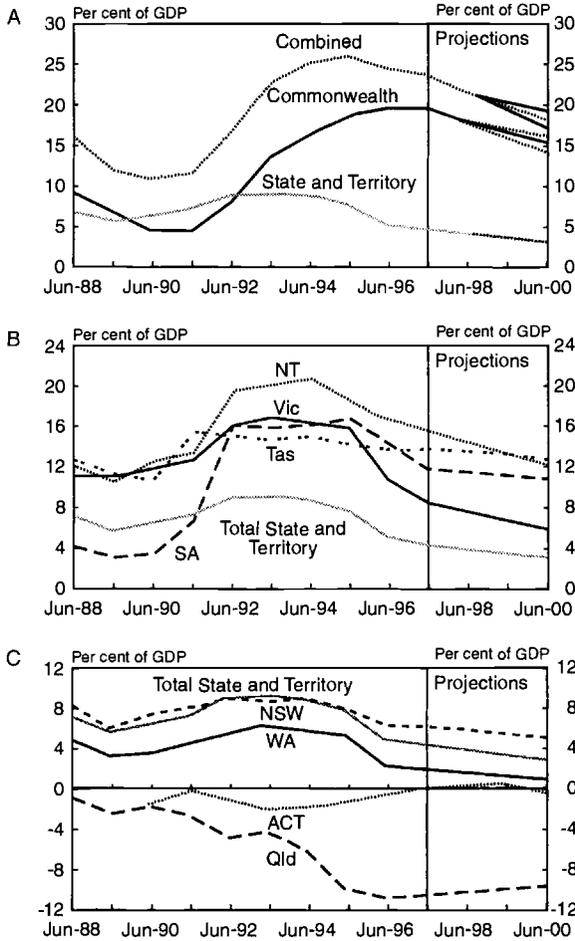


Fig. 12.2 Net debt in Australia: A, General government; B, C, State governments

Source: Working Party of Commonwealth 1997.

Note: In panel A, bands indicate the impact of GDP growth varying by half of one percentage point each side of the central case. “Combined” is the combination of the Commonwealth and the state and territory sector. In panels B and C, the total state and territory sector is expressed as a percentage of GDP.

for a budget surplus before the millennium. This arises largely from an “unwinding” of the operations of the automatic stabilizers in light of the recent strength in Australia’s real growth rate.

The projected decline in state revenues from now to the turn of the century (panel C of figure 12.4) has a different explanation. As a result of the 1995 Competition Principles Agreement (elaborated below), CGC grants have been indexed for inflation through to 1998–99. But this means that they will fall as

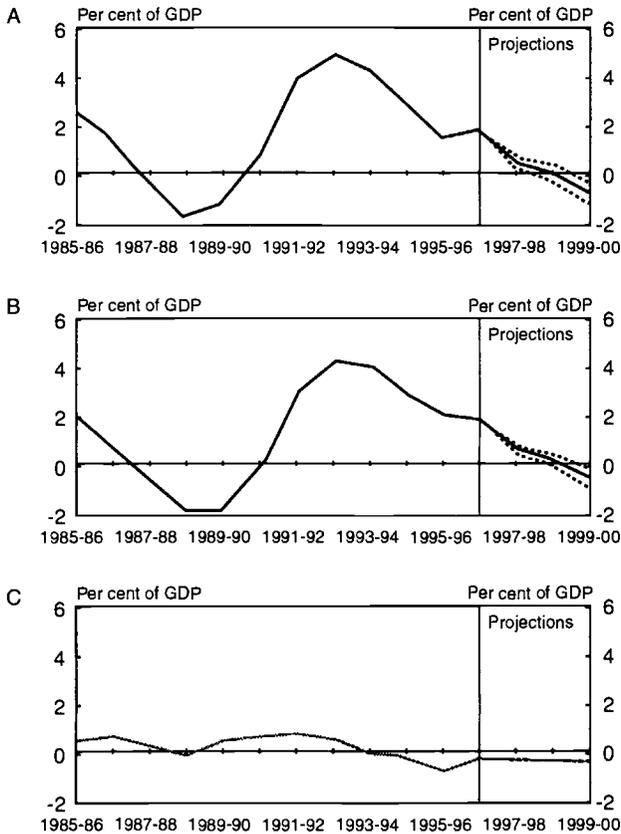


Fig. 12.3 General government underlying deficit: A, Combined Commonwealth and state and territory sector; B, Commonwealth; C, State and territory sector
Source: Working Party of Commonwealth 1997.

a percentage of GDP since the latter is growing in real terms. Beyond this, the Commonwealth will extract a 2 percent “efficiency dividend” from specific-purpose payments made to the states. For both reasons, aggregate state revenues are forecast to fall as a percentage of GDP.

In contrast to the earlier Canadian scenario, the Australian states are relatively sheltered from the impacts of a major recession. This, too, is consistent with the centralization/egalitarian thrust of Australia fiscal federalism.

12.6.1 Budgetary Process Initiatives

The Commonwealth budgetary process incorporates a feature that may well be unique to Australia. In comparing forecasts with actual outcomes the budget classifies (and publishes!) the deviations in terms of two components—parameter changes (e.g., errors in forecasting GNP) and discretionary changes. In

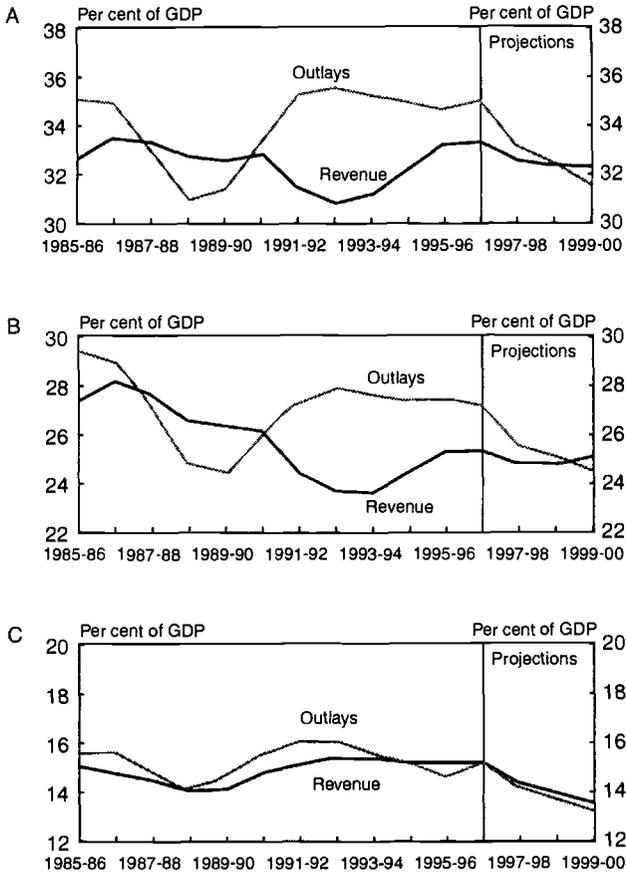


Fig. 12.4 Outlays and revenues: A, General government; B, Commonwealth; C, State and territory sector

Source: Working Party of Commonwealth 1997.

theory, this should make for much better analysis of budgetary policy, since discretionary decisions are now fully transparent. Utilizing this data set, Dixon (1993) conducts an illuminating analysis of discretionary Commonwealth policy over the period 1983–84 to 1992–93. This is a degree of transparency that has no counterpart in Canada.

The major institutional change in the Australian federation over this period occurred in 1995. This was the so-called microeconomic reforms, embodied in the Competition Principles Agreement signed by the heads of government (COAG). This agreement introduces structural reform (enhanced competition, including cross-border competition) for state monopolies and state enterprises (e.g., gas, electricity, water, rail, urban transit [including taxis], ports, self-

regulating professional organizations, agricultural marketing boards, and so on). Beyond this, the agreement seeks competitive neutrality between the public and private sector and provides price oversight of utilities and other corporations with significant monopoly power. This is truly landmark reform/legislation that will serve to dramatically free up the internal common market or the internal economic union. More to the point, such legislation is well beyond the fondest dreams of even the most ardent centralists in Canada!

Intriguingly, the states are the principal losers (financially) from the reform because their erstwhile fees, profits, royalties, and so on from these public trading enterprises will decrease as a result of enhanced (and cross-border) competition. In return, the states were promised an additional \$600 million in CGC grants (in three tranches of \$200 million each) provided that they implemented the reforms. Moreover, the CGC grants in totality are also indexed for inflation until fiscal year 1998–99. Relatedly, and quite significantly, COAG agreed on a mechanism for voting amendments to the Competition Code. The Commonwealth will have two votes and a casting vote, with each of the other parties having a single vote. As the COAG communiqué notes: “This will provide meaningful State and Territorial participation in changes to the competitive conduct rules while maintaining a consistent national scheme” (COAG 1995, 2).

Not only does this provision further erode the states’ revenue-raising powers, it also *increases* the already high degree of vertical fiscal imbalance in the Australian federation. Perhaps Richard Bird (1986, 242) was right when he noted “had Australia not been established initially as a federal country, it seems rather unlikely that it would be one today.” And no less an authority on federalism than W. H. Riker (1964, 113) proclaimed that “the divisions in Australian culture seem to be economic and religious with hardly any geographical basis. . . . One wonders why they bother with federalism in Australia.” In any event, and as alluded to in the introduction, Australia appears fully embarked on a version of *intrastate* federalism—centralizing powers at the Commonwealth (or national level) but giving the states a greater say in policy promulgation. What is not readily apparent is whether this amounts to a *real* say for the states, given the enormous leverage of the Commonwealth arising from the degree of vertical fiscal imbalance.

The final budgetary process initiative draws upon a similar New Zealand initiative. Frustrated by the fact that during the 1996 election campaign, the then-serving Labor Government declared that the 1996–97 budget deficit would be \$590 million with a surplus of \$2.7 billion in 1997–98, when the postelection reality revealed deficits of \$7.6 billion and \$7.3 billion for 1996–97 and 1997–98, respectively, Liberal treasurer Peter Costello introduced a Charter of Budget Honesty. The purpose of the charter is to provide comprehensive fiscal information *prior to elections*. Among the provisions are (Costello 1996, 4)

- An independent pre-election report prepared by the secretaries to the Treasury and the Department of Finance that will provide updated fiscal and economic projections;
- Arrangements for more equal access to Treasury and Finance costings of election commitments by the Government and the Opposition to allow the electorate to be better informed of the financial implications of election commitments.

The latter provision is voluntary: the request for costing must come from the leaders of the parties. However, one can be certain that if one party submits to such a costing, the other will certainly be pressured to do so as well. In the above analysis, I noted that the existence of the National Fiscal Outlook substantially enhanced fiscal transparency and accountability. In part, the Charter of Budget Honesty can be viewed as a further step in this direction. If this process meets with any success, it will only be a matter of time, and probably not much time, before it is replicated at the state level.

12.7 States and Provinces: S&P Credit Ratings

To conclude the analysis of subnational budgetary policies in Australia and Canada, table 12.8 presents the analysis by Dafoe, Shepherd, and Thiemann (1996) of comparative state and province credit ratings, fortuitously published in the November 1996 issue of Standard and Poor's *Canadian Focus*. (This is a variant of the analysis of Poterba and Rueben, chap. 8 in this volume.) Prior to focusing on the ratings themselves, it is instructive to focus on the data relating to per capita GDPs for the states and provinces. The Canadian data serve as the numeraire for the comparison. The Australian data in column 3 are presented in Canadian dollars using the then-existing exchange rates—102.2 Canadian cents per Australian dollar. Column 4 presents the Australian data in terms of purchasing power parity—135 Australian cents per U.S. dollar and 122 Canadian cents per U.S. dollar (OECD data)—and, obviously, reflects the fact that the Canadian dollar rate is dramatically undervalued vis-à-vis the Australian dollar. In terms of the “operating balance” column, the outliers are clearly Queensland on the up side (an operating balance equal to 18 percent of revenues) and Ontario and Quebec on the downside (operating “deficits” of 12.5 percent and 9.4 percent respectively). As documented earlier, both Ontario and Quebec have begun to significantly turn around their deficit burdens. However, the real story in the table has to do with indebtedness, and here the evidence is clear—the provinces are much more indebted than are the Australian states. Setting aside British Columbia (with a debt to total revenues ratio less than that of Tasmania and Victoria), all the other provinces have debt/revenue ratios well in excess of the Australian states. Intriguingly, S&P does not focus on net debt as a percent of *own-source revenues*. Because of the degree of vertical fiscal imbalance, this would essentially double the ratios for

Table 12.8 S&P Subnational Credit Ratings: Canada and Australia

	Senior Rating ^a	Outlook	Nominal GDP Per Capita (C\$) 1995–1996 ^c	Nominal GDP Per Capita (purchasing power parity) ^b	Real GDP Growth (%) ^b	Operating Balance as a % of Operating Revenues	Total Balance as a % of Total Revenues	Net State/ Provincial Debt as a % of Total Budget Revenues, 1996 ^c	Public-sector Pension Plan Unfunded Liabilities as a % of Total Revenues, 1996 ^c
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Australian states									
Australian Capital Territory	AAA	Stable	33,240	29,392	4.0	4.0	1.3	14	43
New South Wales	AAA	Stable	27,029	23,900	9.8	9.8	(0.0)	56	38
Queensland	AAA	Stable	24,500	21,664	18.3	18.3	8.6	22	0
Victoria	AA+	Stable	29,187	25,809	8.4	8.4	12.1	90	41
Western Australia	AA+	Positive	30,504	26,973	8.2	8.2	4.6	55	6.3
South Australia	AA	Stable	24,449	21,619	5.5	5.5	3.5	84	40
Tasmania	AA–	Stable	22,389	19,797	7.3	7.3	0.6	115	44
Canadian provinces									
British Columbia	AA+	Stable	27,057		2.6	2.7	(7.1)	87	17
Alberta	AA	Stable	31,092		3.0	6.4	0.9	125	52
New Brunswick	AA–	Stable	20,833		2.2	6.0	(0.4)	104	35
Ontario	AA–	Stable	28,385		3.1	(12.5)	(20)	207	16
Manitoba	A+	Stable	23,140		2.5	5.6	(0.1)	118	37
Quebec	A+	Stable	23,783		2.1	(9.4)	(16)	165	10
Nova Scotia	A–	Stable	20,000		1.1	2.4	(3.0)	175	17
Saskatchewan	A–	Stable	23,899		2.6	2.6	(0.7)	166	66
Newfoundland	BBB+	Stable	17,318		(0.6)	3.4	(0.5)	137	78

Source: Dafoe, Shepherd, and Thiemann 1996, 19.

Note: GDP = gross domestic product.

^aLocal currency ratings.

^bThree-year average, 1994–96 (1996 estimated).

^cEstimated.

the states in the second to last column of the table, with much smaller increases for the Canadian provinces. Hence, it is clear that from S&P's perspective, the national/subnational transfers are essentially viewed as own-source revenues. As noted later, I find this to be a peculiar assumption.

Now to the ratings. For Australia, they vary from AAA for the ACT, Queensland, and New South Wales to a low of AA- for Tasmania. The provincial ratings are much lower—from British Columbia with AA+ to Newfoundland with close to a junk bond rating, BBB+. These ratings may make eminent sense in terms of the debt/revenue ratios in the second to last column of the table. But they make much less sense if the focus were on the ratio of debt to own-source revenue. In my view, therefore, there are important other factors that S&P is (implicitly) factoring in. One is the fact that Ottawa is much more heavily indebted than is Canberra. Indeed, while Canberra has an AAA rating across the board, Ottawa has an AAA rating for its domestic debt, but only an AA+ rating for its foreign debt. All credit-rating agencies impose the notion of a "sovereign ceiling"; that is, Alberta could not acquire an AAA rating across the board if Ottawa only has an AA+ rating on its foreign debt. Beyond this issue, I find these ratings to be very peculiar. As noted in the above analysis, not only has Alberta been running a surplus for several years (and, therefore, paying down its debt) but, in addition, its own-source revenues exceed its expenditures and it has by far the lowest tax effort of all the provinces. Yet its credit rating exceeds only that of Tasmania and is lower than five of the Australian states. Since the publication of these ratings, S&P has upgraded Alberta's "outlook" (column 2) to "positive." But this does not address the core of the issue. Specifically, despite the recent alteration in the Loan Council arrangements (which are intended to have the states borrow on their own hook, as it were), it seems that S&P is *implicitly* assuming that Canberra is ultimately responsible for the states' debts. Given the nature of the Commonwealth-state fiscal interaction (as reflected in figure 12.1 above), this may well be an appropriate assumption, but it is an assumption nonetheless. How else can one explain the fact that S&P rates Ontario AA-, tied with Tasmania and lower than any other Australian state? With Commonwealth grants equal to 185 percent of its own revenues, Tasmania's debt to own-source revenue ratio would be in the order of 330 percent, while that of Ontario would be somewhere in the 230 percent range. Surely the implicit imprimatur of Canberra comes into play here. Thankfully, some Australians also believe that these state credit ratings are inflated. Walsh (1996, 119) remarks that

notwithstanding the potential for Australia's federal fiscal arrangements to encourage and sustain inefficient state decision making, the size of the Commonwealth's share in funding the states' budgets almost certainly results in the states, collectively and individually, receiving "ratings" from the international agencies consistently higher than their less "dependent" counterparts in other federations. That is, the role of the ratings agencies in disciplining state decision making, increased in significance though it may have become,

is moderated by an “understanding” (or presumption) that the capacity of the Australian states to meet their future obligations is implicitly underwritten by the Commonwealth.

Even with this important caveat, the fact of the matter is that with an overall debt/GDP ratio exceeding 100 percent, all levels of government in Canada are perilously overindebted. This is true in absolute terms, and it is even more evident in relative terms, given that Australia’s overall indebtedness is between one-fifth and one-fourth of Canada’s indebtedness.

12.8 Conclusion

The preceding analysis of subnational fiscal/budgetary policies and institutions in Canada and Australia has been a comparison of polar extremes. What is very apparent is that the fiscal institutions buttress the salient features of the respective national polities. In Australia, the Commonwealth-state fiscal relationships are fully consistent with the centralist/egalitarian nature of the federation, while the decentralized nature of the Canadian federation is surely enhanced by features such as the degree of subnational tax autonomy and the move toward unconditionality for all federal-provincial transfers. What is not so apparent is whether these fiscal institutions play a determining role in terms of defining their respective polities or whether they are largely a reflection of (i.e., endogenous to) deep-seated societal values. One could probably mount a case to the effect that Canada’s decentralization has, historically, been associated with the demands of the province of Quebec, although in more recent years decentralization has probably been fiscally triggered. This issue is more complicated in Australia: for example, was the key High Court decision to label a state sales tax as equivalent to an excise tax and, therefore, preclude the states from entering this field, a reflection of juridical principles or was it more a reflection of the justices’ view of what was appropriate for Australian society? Note that this is not intended to be a slight against the judiciary. Now that Canada–United States free trade is a reality, the Canadian Supreme Court will presumably give a more expansive reading to the internal free trade provisions of the Canadian constitution. Beyond these few observations, however, the role of this conclusion is to look to the future.

For the next few years, at least, Canada is locked into more decentralization. Some of this is being driven by the very real threat of a successful independence referendum in Quebec (likely to be held in 1999). However, globalization is also taking its toll on the federation. Only tiny Prince Edward Island now exports more to the rest of Canada than to the rest of the world. Ontario’s exports to the United States are running at 2.5 times the value of its exports to its sister provinces and are growing nearly a magnitude faster. Hence, Canada is no longer an east-west economy but more and more a series of cross-border (north-south) economies. This increases the pressures for devolution and

asymmetry. Hence, the challenge to the Canadian federation is how to accommodate the increasing policy interdependencies among and between Ottawa and the provinces. One recent intriguing initiative is that the provinces have become more active in generating “pan-Canadian” public goods (Courchene 1996a).

Highly centralized Australia is also being whiplashed by the forces of globalization. At one level, the polarization of market incomes following in the wake of global integration will wreak havoc with Australian egalitarianism, if it has not already done so. At another level, Australia is experiencing challenges similar to those in Canada. Western Australia is progressively integrating internationally rather than nationally. WA’s net imports from the rest of Australia have remained fairly constant at \$4 billion over the 1985–86 to 1992–93 period, whereas its net export surplus internationally has increased to \$11 billion in 1992–93 from \$4 billion in 1987–87 (Courchene 1996b). Queensland also has a substantial export surplus with the rest of the world offset by a similar import surplus with the rest of Australia. For the largest states—Victoria and New South Wales—the situation is reversed: they have large external import surpluses and large export surpluses with the rest of Australia. Hence the pressures for increased decentralization, at least on the part of several states, are potentially very strong and very pervasive.

Earlier I indirectly suggested (drawing from Richard Bird) that had Australia not been constituted as a federation it would not now be one. And there is some sympathy in influential Australian circles to do away with the states (Macphee 1994). However, the thrust of the previous paragraph is that there are also powerful countervailing forces pointing in a decentralizing direction. When in opposition, the now-ruling Liberal Party adopted a strong (for Australia!) states’ rights perspective. And in the run-up to the Australian Constitutional Centenary, which is replicating the various constitutional conferences one hundred years ago, one of the propositions that was passed was what might be termed the principle of “fiscal coincidence,” namely that the jurisdiction responsible for spending should also be responsible for raising the equivalent revenues. Later constitutional conferences will address the issue of vertical fiscal imbalance in more detail. In any event, the real challenge facing Canberra as Australia approaches the millennium is whether or not it can maintain its centralist-egalitarian thrust. Intriguingly, Canberra’s current approach appears to be that of bringing the states more fully and more formally into national decision-making processes rather than decentralizing powers, *per se*.

In summary, my personal view is that *internal pressures* (i.e., policy interdependencies and externalities) will drive the Canadian federation toward more harmonization and coordination of national/subnational policies, even if this coordination is “national” rather than “federal” (Ottawa imposed), while *external pressures* will eventually drive Australia toward a greater decentralization of powers and taxation authority to the states.

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