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The Constitution and the Social Contract

I. INTRODUCTION

Canada is in crisis. Sometime between now and the fall of 1992 we must come up with a set of proposals that can convince Quebec to remain in the federation, and that can at the same time meet the aspirations of others who expect to see their vision of Canada reflected in and supported by the constitution. This is not just another round of negotiations focussing on specific sections of the constitution or on one province. The entire document is under scrutiny, as part of an even larger enquiry into "being Canadian". Thus while there is some need to move quickly on constitutional reform, it is also important to take the time required to understand what we want from constitutional reform, and to get it right so that we are not doing it all over again in a few years.

Fundamentally, constitutions are language for the long term. A constitution attempts to articulate a general vision of the rights and responsibilities of citizens and governments, and to enunciate a particular set of legal mechanisms that can give expression to that vision. It provides a statement of general principles, but it is part of something larger yet. We think of a constitution as the legal framework of a grander "social contract" among the members (present and future) of the society. Within the framework laid out in the constitution, politicians will propose the legislation, bureaucrats will administer the regulations, and jurists will adjudicate the interpretations that collectively define the social contract.

Good constitutions cannot guarantee good policy decisions, but bad constitutions can make good policy exceedingly difficult or even impossible. It is essential then that any reform must produce a constitution that at least makes possible, and hopefully facilitates, achieving the kind of social contract that Canadians desire. As the Meech Lake debacle demonstrated, constitutional reform will not be possible unless Canadians see that their visions for the social contract are at least possible under what is being proposed. A successful constitution must allow and encourage a society to live out its social contract.

The details of any social contract are continually changing. In part, this happens because values and expectations of individuals alter. One need look no further than the shift in male and female social roles in the last 25 years to illustrate how changing values alter the social contract. In part, the social contract changes because the external environment does. The ability to deliver on aspects of the social contract can be profoundly affected, for example, by fluctuations in world prices or by new technologies. Hence, in order to arrive at a constitution that will last, one must write a constitution that is poetic enough to inspire loyalty, specific enough to resolve the details of governance, yet flexible enough to cope with the changes we know will come.

Our argument for what we feel is the proper direction for constitutional reform can be summarized as follows. By 1980, a fairly well-defined social contract had evolved in Canada, involving expectations and understandings between governments and citizens, and among governments, with respect to economic rights and responsibilities. The broad outlines of this social contract were enshrined in the Constitution Act, 1982. But they were enshrined incompletely and imperfectly, with the result that in important ways the constitution has continued to frustrate rather than to facilitate important economic and social policy innovations. Our direction for reform thus lies in identifying

those constitutional reforms and other changes needed to allow us to "make good" on the social contract.

It will become clear from the discussion that we feel the federal government has an important role to play in implementing the terms of the social contract. Consequently, we spend much of our time elaborating these responsibilities. This focus might make our prescription for a renewed federation seem unduly centralist. This would be a misinterpretation. We support the notion that the design and delivery of a good number of public services is most efficiently achieved by the provinces, including not only many that are now decentralized (e.g., health, education and welfare), but some others that currently are not (e.g., unemployment insurance). The current federal system, which is quite decentralized relative to others, has performed reasonably well.

At the same time, there are some important issues of national interest for which the federal government must have overriding responsibility, and for which it must possess the constitutional right or obligation as well as the instruments to fulfill. Those overriding issues fall under two heads — matters of efficiency of the national economy and matters of national equity. The constitution as it stands is largely correct with respect to these issues. We propose only minor extensions in federal authority balanced, as we have noted, by some shifts in jurisdiction downwards. Our real motive in focussing on these principles as extensively as we do is defensive. We wish to caution against too ready acceptance of the wholesale decentralist proposals currently in play in the constitutional debate (Courchene, 1991d; Allaire Report, 1991). By giving up federal authority over national economic efficiency and national equity, these proposals threaten the core of the enviable social contract Canadians have built up so painstakingly over the last century and a quarter.

The paper proceeds as follows. Section II sets out our view of the historical evolution of the Canadian social contract. Sections III and IV discuss the efficiency and equity dimensions of the social contract, and their implications for constitutional reform. Section V considers the special status of Quebec. Section VI is a conclusion.

II. THE EVOLUTION OF THE COMMUNITY OF CANADIANS, 1867-1982

The roots of the present social contract trace back to 1867 and even beyond. With the British mercantile system already largely dismantled and the Reciprocity Treaty with the United States coming to an end, elites in British North America looked to integration of the colonies for economic salvation. Union had several apparent attractions. It would expand the market available to manufacturers and other producers. It would give the colonies enhanced bargaining power when dealing with their major trading partners. Most importantly perhaps, it would increase their borrowing power on international capital markets. With that access they could construct the transcontinental railways needed to open up the western plains to agricultural settlement. Confederation in short was first and foremost an economic act.

Integration and western expansion required an institutional structure to manage it, which in the circumstances meant a central authority charged with these responsibilities. Hence the British North America (BNA) Act of that year, and the division of powers contained therein. The BNA Act created a national government, to

be responsible generally for defence and national economic development. The preamble to section 91 empowers Ottawa to make laws for the "peace, order and good government of Canada" in all matters not specifically assigned to the provinces. Of particular interest for economic development, are the clauses in that section dealing with the regulation of trade and commerce, the raising of money by any mode or system of taxation, the postal service, defence, navigation and shipping, currency and coinage, weights and measures, banking, and the criminal code. Section 121 states that all articles of the "growth, produce, or manufacture of any of the provinces shall ... be admitted free into each of the other provinces".

Integration could not come at the expense of local diversity though. Thus provinces retained exclusive authority for, in the words of section 92.16, "Generally all Matters of a merely local or private Nature". Jurisdiction over property and civil rights is set out explicitly, an apparent move to give the provinces control over "culture". They were also to manage local economic development through powers over direct taxation within the province, the management and sale of public lands, hospitals, municipalities, local works and undertakings and property and civil rights. Section 93 adds education to the list of provincial responsibilities, and agriculture and immigration are included as concurrent powers in section 95.

The fiscal arrangements set out in the BNA Act deserve special mention. The federal government took control of customs and excise duties, which made up about 85% of total government revenue at that time. The resulting vertical fiscal gap was covered by Ottawa's agreeing to make annual per capita grants to the provinces, to provide a cash subsidy in support of government and legislatures, and to assume all provincial debts. New Brunswick received a special ten-year grant in recognition of its unique financial needs, and the same provision was extended to Nova Scotia in 1869. These arrangements signal an early commitment to broad fiscal equality across provinces, and a recognition that responsibility for achieving it rested with the federal government.

Three features of the Confederation pact indicate the course of future developments. First, Canada was created as an economic union. The colonies integrated their economies to enhance opportunities for trade among themselves, and to make westward expansion possible. The federal government was the instrument of this objective, created with the powers needed to oversee national economic development. Second, there was little sense of national citizenship in the debates leading up to Confederation, and no recognition of it in the BNA Act. John A. Macdonald may have hoped to see provincial governments "wither away", but the sentiment was not widespread. Attachments and political loyalties were largely to provinces. Third, there was a broad commitment to provincial fiscal equity, through the mechanism of transfers from the centre.

After a disappointing start, the economic union developed largely as intended. The railways were built, the west was settled, manufacturing industries developed, and a national banking and financial sector emerged. The central government played the lead role in these national development schemes, as intended. It subsidized some railway projects and built others itself. It purchased western lands, surveyed them, advertised for immigrants to fill them, and even taught them the appropriate agricultural

techniques. Much of the industrial development was due to the National Policy tariffs, instituted by Macdonald after 1879 and retained by Laurier after 1896.

The provinces were active in promoting and managing their own economic and social development, again as intended. They controlled the new industrial staples of hydroelectric power, pulp and paper, metals and petroleum directly, and intervened continuously to direct the pace and direction of their development. Most of the responsibility for dealing with the consequences of structural change in the economy fell to the provinces as well. As towns and cities grew, provinces had to provide the infrastructure. With the appearance of the automobile, they had to construct a network of roads and highways. With industrialization and urbanization came increased demands for public support for health, education and welfare. Families, churches and volunteer agencies simply could not cope with the fall out from economic change and dislocation as they had in the previous century.

This era of classical federalism, with its characteristic "watertight compartments" division of responsibilities, came to an end in 1929. The world economy was thrown into the worst depression on record, and Canada was among those nations most seriously affected. Critics questioned the logic of capitalist economies in general, and federalist ones in particular. Divided authority was seen by some as a handicap to effective economic management. The new Keynesian theories of demand management seemed to require a strong central government with dominant control over spending and taxation. The decentralized fiscal system that had emerged to 1929 not only precluded this concerted effort, but the "tax jungle" it represented also impeded the operation of the internal economic union. The new views on social security, such as that set out in the Marsh Report, added to these pressures. Coming up with a comprehensive package of income security and support measures was too large and complex a task for the smaller provincial governments.

Canadians were only beginning to sort through the constitutional difficulties these challenges posed when World War II broke out. War represented a different set of management challenges. The immediate need was to put the economy on a war-time footing. The federal government assumed this planning role, with little opposition from the provinces. It took effective control over all major taxes, accounted for most of the public sector spending and borrowing, and regulated industries large and small. The record was not perfect, as it could not be, but by most accounts Canada managed the economic side of its war effort successfully.

The demonstration of the need for central government involvement in the 1930s, coupled with the demonstration of competence in the war years, encouraged Ottawa to propose a major shift in economic functions as part of its reconstruction plans. It would continue to rent the three major tax sources. The revenue net of payments to the provinces would be used in part to finance national programs in health, education and welfare. These social policy initiatives would build upon those already in place with respect to pensions, unemployment insurance and family allowances.

The larger provinces rejected these federal proposals. Ontario and British Columbia had large enough tax bases that they were not dependent on transfers. Quebec opposed in principle any extension of federal authority into what it regarded as areas of exclusive provincial jurisdiction. Generally, the larger and wealthier provinces

wanted to retain control over social policy to fit it to their perceived needs, and they wanted to use tax and other policies to structure their own economic development.

The idea of national social programs did not end with the failure of the Reconstruction conferences, however. It remained only to find a way to deliver them that respected the division of powers set out in 1867 yet capitalized on the perceived advantages of introducing them on a national basis through central government involvement. The solution came in the form of shared-cost programs. A series of ventures in health and hospitalization services led eventually to the Medical Care Act of 1966. Similar programs were introduced in post-secondary education, vocational training and income security. The details varied, but essentially all provided for approximately equal per capita federal grants towards provincial expenditures, provided the programs met specified conditions. The conditions were generally designed to make the schemes national in scope and character. Provinces could opt out of national programs in exchange for additional (equalized) tax points, but only Quebec chose to do so.

The federal government maintained its custodial role over the economic union in this period as well. Trade policies expanded markets for Canadian products. Immigration and investment initiatives assisted in attracting the labour, capital and technology needed to produce them. Banking, transportation and other framework policies were modernized to reflect the realities of the postwar economy. There was federal aid for infrastructure development, and tax concessions and subsidies for fledgling (and sometimes not so fledgling) enterprises. The succession of arrangements from tax rental to tax sharing to tax collection provided a degree of fiscal harmony in the Canadian economic union that was unique among federations.

The commitment to equity of Canadians, as residents of provinces, established at the time of Confederation, continued and expanded. Up to 1957 grants to provinces were on an equal per capita basis, and were thus implicitly fully equalized. Tax rental replaced tax sharing in 1957. Now each provincial government received a transfer equal to the share of revenue Ottawa actually derived from levying taxes on individuals and businesses in that province. To offset the fiscal disparities inherent is this system, the federal government introduced the first formal equalization scheme. Provinces deemed to have a fiscal capacity below some critical level received unconditional transfers to bring them up to this national standard.

The introduction of cost-sharing programs in health, education and welfare simultaneously with adoption of a formal equalization scheme is a notable development in the evolution of Canadian federalism. It illustrates the emergence of a new feature of the social contract. There was now a distinction between rights and entitlements Canadians enjoyed as residents of provinces, and those they enjoyed as individual Canadians independently of where they happened to reside. The quality and quantity of the former might vary from province to province; indeed they should vary to be true to the diversity inherent in the federation. Equity required only that each province be in a position to provide comparable services without recourse to undue levels of taxation. Equalization payments financed out of federal general revenues provided that guarantee.

The entitlements enjoyed as a right of national citizenship had different standards, however. The fact that health, education and welfare received special funding

suggests that variation in their quantity or quality by province was, by this time in our history, deemed unacceptable. Canadians, as Canadians, should have approximately equal access to these basic social services, as a national entitlement. The federal government could have contributed towards these programs through unconditional grants to provinces, perhaps through the equalization scheme to ensure equal capacity among provinces. It did not do so, however. It chose instead to fund its share separately, through conditional grants, to get the programs in place and to ensure that they were available on a comparable basis to individuals. This reflects a commitment to individual equity on the basis of national citizenship.

The focus on individual equity recognized, at least implicitly, the need to accommodate Quebec as a distinct society. Opting out with compensation provided the device. Quebecers received generally the same economic and social services, on essentially the same terms, as did other Canadians. But provincial control allowed them to adapt the programs to support their linguistic and cultural distinctiveness.

With one important exception, the social contract as it had evolved to the early 1980s received formal expression in the Constitution Act, 1982. Much writing on this period treat this event as a break with the past. The new federalism set in motion in 1980 would "conduct federal-provincial relations on a fundamentally different set of premises from those which had operated over the last twenty years" (Simeon and Robinson, 1990, p. 289). This interpretation puts too much stress on personalities and style, however, and ignores the obvious continuity between what was done in 1982 and the century or more of history that preceded it. 1982 was much more a culmination of past trends than the beginning of a new one.

The economic union figured prominently in constitutional reform discussions leading up to the 1982 Act. There was considerable concern by 1980 that the internal economic union was not producing as large an economic surplus as it might. Critics could point to long lists of barriers to the internal flow of goods, services, capital and labour. Some were imposed by provinces through attempts to stimulate local development, while others were implemented or at least tolerated by the federal government. There was also concern over the amount of overlap and duplication among governments, and a belief that federal and provincial fiscal policies were often off-setting.

A federal government document (Chretien, 1980) linked fragmentation of the economic union directly to deficiencies in the constitutional framework. Dubbed the "Pink Paper", the publication proposed three key reforms. Mobility rights should be entrenched in the constitution, section 121 should be strengthened and expanded to cover services as well as goods and nontariff barriers, and the federal trade and commerce power contained in section 91.2 should be strengthened and expanded to allow the federal government to override provincially imposed barriers. Interestingly, federal actions were to be largely exempt from these restrictions, for reasons that few outside observers found compelling.

In the end, the economic union featured only marginally in the 1982 Act. Section 6 of the Charter of Rights and Freedoms sets out mobility rights of Canadians. Section 6.1 covers international movements, while 6.2 states that:

> Every citizen of Canada and every person who has the status of a permanent resident of Canada has the right
> a) to move to and take up residence in any province; and
> b) to pursue the gaining of a livelihood in any province.

Section 6.3 allows for a reasonable residency requirement as a qualification for publicly provided services, while 6.4 permits affirmative action programs for economically or socially disadvantaged individuals, but only in regions with relatively high unemployment rates.

Commitments to equity appear explicitly in the Constitution Act. Economic rights are found in section 36 under the heading "Equalization and Regional Disparities". Section 36.2 contains a formal commitment to the principle of equalization and to federal responsibility for it:

> Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

Equalization, long an informal political commitment by successive Parliaments, now became a formal constitutional obligation.

Recognition of the concept of national citizenship, and of rights attached to it, are found throughout the Act. Indeed, the very idea of a Charter of Rights and Freedoms is a national concept. As John Whyte has written, relations between citizen and state under the Charter become "systematized, centralized, uniform, constant, unilateral, and direct", as opposed to "diverse, filtered, diluted, subject to mediation and complicated" (Whyte, 1984, p. 28).

Section 36.1 of the Charter deals specifically with individual economic equity:

> Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any one of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to
> (a) promoting equal opportunities for the well-being of Canadians;
> (b) furthering economic development to reduce disparity in opportunities; and
> (c) providing essential public services of reasonable quality to all Canadians.

This clause sets out most clearly the newest element of the Canadian social contract, the commitment to individual economic equity.

The Constitution Act, 1982 had a major flaw, of course; Quebec did not sign it. Indeed, it was widely condemned in that province. The concern stemmed from the fact that Quebec has always thought of itself as a distinct society within Canada. Quebec worried that the Charter would be used to override provincial language policies.

It was concerned as well that it had lost some powers to fashion its economic and social development in its own image. Its presumed veto had disappeared over significant parts of the constitution. Further, there was no guarantee of opting out of national programs with fiscal compensation, a practice used by the province since the 1960s as we have seen.

The Meech Lake Accord was an attempt to alter the Constitution Act, 1982 to deal with these concerns, to complete the entrenchment of the social contract so to speak. Quebec was officially recognized as a distinct society. Its veto power was enhanced by extending the number of areas where unanimity was required for constitutional change. Another feature gave any province the right to opt out, with compensation, of any new national shared-cost program as long as it was replaced by one consistent with national objectives. Two other provisions dealt with the Supreme court and immigration.

The rest is history. The Accord did not pass, for a variety of reasons from objection to its substance to the manner in which it was presented for ratification. The reaction in Quebec and elsewhere to the collapse set in train the events that bring us to the present. We have until October 1992 to come up with a constitutional proposal that will satisfy Quebec, and at the same time meet the expectations of all others interested in constitutional renewal.

The Constitution Act, 1982 spelled out important parts of the social contract that had developed over the preceding century and more. But it did so incompletely and imperfectly. The key to constitutional reform, we argue, must be to "make good" on this social contract. We must look to changes in the division of power and responsibility and other fundamental reforms that will allow us collectively to improve economic performance, to retain the commitment to the principle of equalization, to refine and advance the commitment to individual equity, and somehow to do all this in a way that corrects for Quebec being excluded in 1982. We have set out in the following sections what making good on the social contract seems to entail.

III. MAKING GOOD ON THE SOCIAL CONTRACT: ECONOMIC PERFORMANCE

It is useful to distinguish two basic ways to improve economic performance, although they are closely related. The first opportunity stems from evidence that the internal economic union does not function as effectively as it might. Canada's regions are not exploiting fully the gains obtainable from economic connections among themselves. The second relates to concerns that Canada's traditional economic strengths are slipping, and that we need to take measures to be more competitive if we are to benefit fully from economic connections with our global trading partners. In both instances, a case can be made that the constitution as it stands "gets in the way" of what needs to be done.

The Internal Economic Union

There are two basic issues with respect to the operation of the internal economic union. First, are there unexploited gains from more effective integration of the regional

economies? Second, if there are, what is the best way to organize institutionally to appropriate these gains? We argue in what follows that unexploited gains from integration do exist, that the national government has an important role in bringing them about, and that some constitutional adjustment is required to allow them to do so.

The Gains From Integration: An economic union is valued because of the real output gains it can provide. Successfully integrated economies produce in total a volume of goods and services greater than the sum of what each member could do individually. The difference between the real output of the union and that of the members separately is usefully thought of as the surplus from economic association. The larger this surplus, assuming it is shared "fairly", the more valuable is the economic union.

There are several sources of surplus. One is the gains from scale and specialization that flow from reducing or removing barriers to the internal flows of goods, services, capital and labour. This is not an unambiguous gain though, for a couple of reasons. First, a common market may cause members of the country to purchase from domestic suppliers at the expense of cheaper foreign sources. Many have argued that this "trade diversion" was a feature of Canadian economic development historically. However, as external trade barriers have been reduced, especially recently with the Free Trade Agreement, the cost of trade diversion has been reduced. Second, as long as some domestic distortions remain within the economic union, the theory of second best teaches us that removing some distortions while others remain is not necessarily optimal. This argument is slightly harder to evaluate in the Canadian case. Still, economic logic would suggest that maintenance of the internal common market is generally a desirable objective in an otherwise distorted economy if one is not certain as to which way the second best effect works. Welfare costs of distortions increase roughly with the square of the size of the distortion. Thus, if deviations are as likely to be in a detrimental as in a beneficial direction, expected social welfare will be higher in the no-distortions case.

The case for lowering internal barriers is strengthened when dynamic efficiency gains are taken into account. The "chill winds" of competition force local firms to reduce costs, improve quality and market their products more aggressively. National markets are also an important conduit for the transfer of technology (Harris and Purvis, 1991a). New ideas and products are imported into larger centres, and then diffused throughout the country via the networks of companies, governments, professional groups and other associations built up over the years. Technology would eventually get transferred to smaller centres without an economic union, but integration speeds up the process.

The bulk of evidence suggests that the Canadian economic union is not exploiting these gains fully. A recent report (Canadian Manufacturers' Association, 1991) referred to more than 500 provisions restricting the internal flow of goods, services, capital and labour. The list is well known: procurement policies that favour local firms, restrictions on the sale of out-of-province beer and wine, trucking regulations that make interprovincial movement difficult or impossible, marketing boards that prohibit the flow of agricultural products, certification requirements that restrict labour mobility, and restrictions on savings and investment practices. It is notable that most of these result from regulatory practices of governments, federal,

provincial and municipal. Distortions can also occur through budgetary policies such as differential or discriminatory tax rates.

Work done in the 1980s (Trebilcock *et al.*, 1983; Whalley and Trela, 1986) suggested that the costs of these barriers were quite small, typically less than 1% of GDP. These estimates generally come from partial equilibrium, constant cost models though, and ignore the gains from firm and industry restructuring that were an important part of revisionist thinking on the impacts of international trade liberalization (Harris and Cox, 1984). As well, they take no account of the impact of integration on the rate of technology diffusion and other economic processes noted above. Finally, the data underlying the calculations are notoriously incomplete and unreliable. We cannot be certain of course, but it seems probable that the true social costs of the barriers (or, conversely, the true social gains from removing them) are larger than these early estimates suggested.

There are other sources of surplus from integration, and corresponding evidence that they are not fully exploited either. Members of an economic union are better off to the extent that together they can negotiate more effectively with their major trading partners than each could separately. Larger economies typically have more bargaining power than smaller ones, all else being equal. As well, the diversity in a larger unit increases the prospect of reaching an agreement. Central Canada got a better free trade arrangement with the United States because western energy could be included as part of the package, for example.

Canada has participated actively in international trade negotiations in the postwar period, but these efforts have been hampered by problems of divided jurisdiction. The federal government has authority to conduct international negotiations and to sign treaties. The treaties are not enforceable upon signing, however; generally they require enabling legislation. If they cover matters falling under provincial jurisdiction, as international trade treaties increasingly do, the enabling legislation must come from the provinces. This constraint was overcome in the Canada-U.S. free trade negotiations by careful consultations among governments, but it remains as a potential obstacle to further dealings.

Another source of surplus derives from the ability of an economic union to insure its members against cyclical instability. The potential for such insurance arises from the fact that regional business cycles are likely to differ. A shift in the terms of trade in favour of primary products, for example, will stimulate resource-based economies and dampen manufacturing-based ones that use raw materials as inputs. Left alone, markets will react to this disturbance by altering the volume and composition of trade flows, and by inducing capital and labour to relocate from lower to higher remuneration areas. If the shift in relative prices is transitory, this adjustment may be socially inefficient; the process will be repeated in reverse once the terms of trade shift back.

Economic unions can avoid some of these social costs by making temporary transfers from expanding to contracting regions. Agricultural insurance programs can shield what may be a structurally viable sector against wide swings in income due to weather or international trade shocks, for example. Unemployment insurance can keep temporarily unemployed workers in areas where their training and skills will soon be required. Stabilization payments to provincial governments triggered by cyclical

downturns in revenues obviate more drastic fiscal measures. If effective, much costly and unnecessary economic dislocation can be avoided.

Economic unions can provide insurance of a different form in the event of longer run structural decline. If the terms of the trade shift noted above are permanent, for example, the adjustments in goods and factor markets are entirely appropriate. Trade patterns *should* adapt, and capital and labour *should* relocate. If some regions are expanding at the same time as others are declining, and if capital and labour are free to move, the adjustment process is greatly facilitated. Without these possibilities, workers would remain in uneconomic pursuits longer or they would be unemployed, at great personal and social cost. Alternatively, the government of the region would have to attempt to diversify the local economy, again at potentially great economic cost. By providing another option, mobility supports greater regional specialization and exchange.

Again the evidence is that the Canadian economic union does not exploit the potential gains from these insurance features as effectively as it might. The equalization program provides a cushion of sorts for provincial governments that receive transfers (7 provinces presently), but it does nothing for provinces that do not qualify. The formal revenue stabilization program operates with such a long lag as to be effectively irrelevant to cyclical stabilization. Some type of true stabilization scheme would be especially welcome in the resource dependent western economies, given their great relative cyclical instability (Chambers and Percy, 1991). There is a political bonus to innovation here as well, as the west has long felt, fairly or not, that it derives relatively little else from the operation of the Canadian economic union.

Where programs do exist, they often work less to insure against cyclical fluctuations than to impede longer run structural change. Most sector specific subsidies fall into this category, as do the bulk of regional development grants. The most obvious example though is that of labour market regulation/income security/social assistance. There is considerable evidence that the package of policies put in place since 1945 has acted to distort Canadian labour markets. Restoring Unemployment Insurance (UI) to a pure insurance scheme, and dealing with other income security and maintenance needs separately, would improve the operation of the internal economic union notably (Macdonald Commission, 1985; Forget, 1986).

The problems in this area are not entirely, and perhaps not even mainly, constitutional in origin. But in some important respects the constitution does "get in the way" of better policy. Jurisdiction is unclear and overlapping. Unemployment insurance is a federal program, while labour market regulation and social assistance regulations are set at the provincial level (cost-shared by the federal government). Social assistance regulations are strongly affected by the UI system, however, both because some people exhaust their UI benefits and because others can never qualify. Since society is continually changing, the appropriate dividing line between social assistance and social insurance is always changing too (to different degrees in different local labour markets). For example, the growth, over the 1980s, of "non-standard" employment relationships has produced an increasing fraction of "self-employed" workers, who are not eligible for unemployment insurance and must turn immediately to social assistance if work is unavailable.

Turning to ways to keep people from needing transfer programs, the confusion between federal and provincial jurisdictions is almost complete. Provincial governments set employment standards, labour law and minimum wage, yet Employment and Immigration Canada is responsible for Canada Employment Centres and most industrial retraining. Both levels of governments are heavily involved in employment and industrial subsidy programs. Clearly, this division of jurisdiction leads to inefficiencies within the common market.

Organizing to Appropriate the Gains From Integration: The message on the economic union is clear. There are unexploited gains from integration of the regional economies. They stem from the presence of barriers to the internal flow of products and factors, overlapping authority over international treaties, and incomplete and inappropriate arrangements for providing insurance against cyclical and structural change. To some extent these shortcomings derive from policy flaws, and have little to do with the constitution. One might wish for better policy in these instances, but pursuing constitutional change is not the way to get it. There are instances though, as we shall argue in this section, where improving the operation of the internal economic union requires some constitutional rebalancing.

One option with respect to internal barriers is to assign the role of custodian of the economic union to the provinces, acting individually and in concert where necessary. The argument to do so runs as follows. Economic competition forces provinces, as small open economies, to harmonize much of their activity. They cannot have tax or regulatory policies seriously out of step with international levels without suffering the consequences, for example. Where they do have some policy control, and where harmonization and coordination would be beneficial, they will reach agreements among themselves in their own self-interest. Conversely, they will not harmonize where it is not needed, or where diversity is important for local reasons.

Provinces clearly must play an important role in bringing down barriers to internal trade, for these and other reasons, but they cannot be the paramount authority. They face economic competition now, and they are free to harmonize whatever policies they wish, and yet as noted we still have more than 500 barriers in place. Attempts to bring down some of them through intergovernmental negotiations have proven frustrating. An agreement to give out-of-province bidders equal access to government contracts over $25,000 still lacks two signatories. A companion agreement aimed at breaking down interprovincial beer sales is still pending after several years of effort.

It is important then to make whatever progress possible on inducing governments to remove barriers through discussion and agreement. But more is needed. The mobility provisions contained in section 6 of the Charter need to be clarified or possibly even extended to prohibit restrictions on professional and other types of labour. The other necessary measure is to strengthen the constitutional authority of the central government with respect to the internal economic union. This might take the form of a new constitutional head, to signify the importance to be attached to the reform. At a minimum, existing powers need to be strengthened and expanded. Section 121, covering internal barriers, applies only to tariffs on "All Articles of the Growth, Produce, or Manufacture" of the provinces. It needs to be extended to services and to cover nontariff barriers. Finally, section 91.2, the trade and commerce power, could be

strengthened to allow the federal government to be more active in prohibiting internal barriers. A fully comprehensive approach to strengthening the economic union would be to spell out an obligation guaranteeing the free and unimpeded flow of goods, services, labour and capital that binds all governments.

The treaty-making power needs to be clarified as well. The federal government must be able to conduct international negotiations and sign treaties knowing that it can deliver on them. There must, of course, be extensive consultation with the provinces throughout the negotiation process.

Interregional insurance provisions could be introduced under current constitutional arrangements. No fundamental change is needed. Some constitutional rebalancing is needed with respect to responsibility for income maintenance, security- and labour-market regulation, however. Social assistance, unemployment insurance, labour-market regulation and employment subsidies are a highly interrelated package of policy measures, which should have some internal coherence. This coherence would be more likely if provinces had clear responsibility for the entire package. Provinces are "closer to the action" in local labour markets, and have a better chance of understanding the needs of their local communities. If they had clear responsibility for the entire package, we would likely observe a process of experimentation, as each provincial government attempted to deal with the specific realities of its local labour markets.

The federal government still has a role to play in this area, however. Since booms in one region may coexist with others, it makes sense to preserve a federal role in equalizing transfers between provinces to finance the uneven fluctuations of social security payments. Second, mobility within Canada is a personal right of Canadians, and is also important for economic efficiency reasons as noted above. The federal government thus should ensure (as it now does in the Canada Assistance Plan) that eligibility for benefits is portable across provinces. Finally, if social security is seen as a basic right of all Canadians, as we shall argue in more detail in the next section, the federal government should ensure some minimum level of standards.

These federal goals can be accomplished by the use of transfers. The imaginative use of block grants with some conditions attached could facilitate the attainment of national standards, ensure that all provinces have the resources to meet the basic needs of these programs, and at the same time allow for enough decentralization of program design and delivery to guarantee efficiency and innovation. In other words, something like the Established Programs Financing (EPF) and equalization model could be applied to the financing of decentralized provision of unemployment insurance and other labour market programs, welfare, health, and perhaps even education.

The combination of decentralization of services to the provinces along with the use of federal grants to ensure that provinces have the resources to provide comparable service levels as well as to induce some minimum of national standards has a further efficiency consequence. To finance the transfers to the provinces, the federal government will have to raise more tax revenue, perhaps considerably more, than it needs for its own purposes. That is, there will be a fiscal gap, or vertical fiscal imbalance. Most federations, including the existing Canadian one, have considerable vertical imbalance. There is, in fact, an efficiency advantage of having tax collections somewhat more centralized than expenditures, apart from the advantages that come

from the system of transfers itself. The more tax room the federal government occupies relative to the provinces, the more chance there is of having a harmonized system of taxes. Harmonized taxes can reduce collection and compliance costs considerably, as well as reducing the efficiency costs of differential and perhaps discriminatory taxation.

Harmonization can take many forms and be of different degrees ranging from a common base to a common rate structure as well, with or without a single collection authority. The literature suggests that harmonization is relatively more important in the income tax fields than for indirect taxes, and the federal government may well want to concentrate their tax-raising there. However, that is probably more a matter of legislative policy than constitutional design, although the policy itself may well be influenced by objectives stipulated in the constitution, such as enforcement of the economic union or federal government equity obligations (discussed below).

Globalization and Competitiveness

There are two basic questions to pose with respect to remaining competitive in global markets. Are there measures Canada might adopt to ensure that we are as successful economically in the next century as we have been in this one? If so, what is the best way to organize institutionally to implement the changes that are required? We argue that there are policy innovations that can improve our chances of success, that the national government must play an important part in developing and managing them, and that in some important respects the present constitution stands in the way of these reforms.

The Competitiveness Challenge: Notwithstanding the hype it receives today, competitiveness is not a new challenge, to Canada or to any other nation. Producing cheaper and better quality products has been the key to economic success since peasants first began to trade their surplus agricultural production for the cloths and other wares of the towns. The only things that do change over time are the determinants of competitiveness and the environment within which the competition takes place.

The evidence on Canada's international competitiveness is unclear. Certainly we continue to have one of the highest standards of living in the world. The question is whether this enviable position is in jeopardy. Much current thinking suggests it is. We rank relatively highly on some measures of competitiveness, but near the bottom of the advanced industrial countries on others (Rugman and D'Cruz, 1991). Our worst relative performances come in the categories of industrial efficiency, financial dynamism, international orientation (presence in other markets through exports and foreign investment as well as openness to imports), and future orientation (efforts to adapt to an increasingly technological world). For what the measure is worth, our overall competitiveness relative to the industrial nations slipped in 1990, and it is worse yet if newly industrialized countries are considered.

The determinants of international competitiveness are certainly changing; recipes for economic success that worked before will not any longer. Resource extraction and processing activities serve less and less as a base for national economic development, however important they may continue to be for particular regional economies. Increasingly, economic prosperity lies in manufacturing and service industries, and in

particular in activities where comparative advantage derives from superior knowledge and specialized skills. Nations such as Canada that have depended on resource endowments for their prosperity will have to adjust to this new reality to maintain their relative living standards. To complicate the task, they must fashion the shift in the face of stiff international competition, and in an environment where technology is rapidly eroding economic boundaries.

The keys to success in knowledge-intensive industries lie in what Harris and Purvis (1991b) term the "people factor" and the "national environment factor". The former term covers the skills and innovative ability of the population. To succeed, nations require entrepreneurs, creative managers and skilled and adaptable work forces. The latter term refers to the host of laws, customs, institutions and policies that underlie production, exchange and adjustment in a mixed enterprise economy. The institutional framework must be able to garner and channel domestic and foreign savings, and it must encourage innovation, experimentation, risk-taking and adjustment to change.

There is considerable disagreement yet on how these basic determinants of competitiveness translate into specific policy prescriptions. One position, the least interventionist one, would restrict government assistance to establishing the preconditions for a market-led response. This means introducing policies to improve Canada's basic competitive position relative to other nations. The people factor can be enhanced by immigration policies that favour skills and entrepreneurship, by assisting in the education and training (and re-education and re-training) of workers and managers, and by guaranteeing mobility both occupationally and geographically.

Governments control the national environment factor now; the challenge is to adapt it to the new realities. Framework policies such as those regulating intellectual property, competition, bankruptcy and labour relations must reward innovation and risk-taking, and promote rather than retard adjustment and flexibility. Crucial physical infrastructure must be provided. Foreign investment must be encouraged. Research and development activities must be encouraged, and ways found to acquire and disseminate other technology.

The alternative position on promoting competitiveness is that in a world with very rapid changes in fundamental technologies and in international economic relations, there may very well be a more prominent role for the public sector. Governments can finance research and development endeavours that are beyond the capacity of individual firms. They can coordinate investment decisions so as to exploit more fully the potential for interindustry and interfirm linkages. They can facilitate the establishment of joint standards and the exchange of information. Since the debate on how much government intervention is needed to encourage competitiveness is not closed — indeed it is possible that different routes to competitiveness may be appropriate at different times — it would seem unwise to introduce measures, constitutional or otherwise, that effectively precluded the adoption of either model.

Organizing to be Competitive: If the connection between competitiveness and policy prescription is unclear as yet, so too must be that from competitiveness to constitutional reform. The main requirement must be to make certain that the constitution does not get in the way of policy response. In Canada today, it probably does in a few respects.

Provinces have an important role to play in promoting competitiveness, but in some areas at least primary policy responsibility must lie with the national government. The basic rationale lies in the very nature of the task. Pursuing competitiveness means committing to excellence, to flexibility, to adaptation and to change. Scarce resources have to be directed to sectors and to regions where the chance of success in terms of being internationally competitive is greatest, and they have to be encouraged to relocate as conditions change. The effort, in short, must be as blind as possible to considerations of "place prosperity".

Provincial governments cannot by definition be blind to considerations of territory. They will support local industries, and will vie with other jurisdictions to attract new activities. They may also under-spend in areas with significant spillover effects such as post-secondary education, training and basic research and development. Regions of net outmigration will balk at training labour since most will leave upon graduation. Regions of net inmigration may feel free to under-invest since they can reasonably expect to receive infusions of human capital. Provinces will also only sponsor research and development activity that comes with assurances of spin-offs of local production activity.

The national government faces fewer such constraints, however. It has responsibility for the nation as a whole, rather than for any part of it. It can focus on economic performance from a national perspective. Although regional interests are often reflected in decisions made by the federal government, at least these regional interests have to compete with alternative regional and national objectives. The federal government has a larger range of possible "best locations" to choose from when considering support for activities that can compete internationally. It can internalize more of the externalities, such as supporting post-secondary education or training in one jurisdiction without having to worry about whether the recipients might migrate to another province.

The federal government already controls many of the important economic levers for promoting competitiveness. Two areas where some change is appropriate are in education and training and in the regulation of financial markets. Basic control over education and training can remain with the provinces. But Ottawa must be free to direct resources to universities, colleges, and other institutions as necessary to assist in skills development. It is also important to have a more integrated and harmonized set of financial markets than exists currently in Canada, which means giving the federal government more authority in areas now under the control of the provinces.

Conclusion

The implicit presumption of a constitution that guarantees the free mobility of goods, services and people is that the social contract is a compact among individuals as well, and not just between communities. If market relationships are a prime determinant of where production takes place, it is only realistic to recognize that economic activity will continue to migrate away from some of the places where it is now conducted. Some communities, from outport Newfoundland to rural Saskatchewan, will wither and die in a market economy. Those who have a purely place-based vision of Canada as a "Community of Communities" will find this trend unacceptable. The constitution would

have to enable governments to restrain market forces, since it is hard to see how a true community of communities could constitutionally forbid actions to prevent the demise of some of its members.

Ours, however, is a vision of "people prosperity" rather than "place prosperity". This focus makes it easier to accept the inevitability of economic decline in some regions, and the need for structural adjustment. We recognize, however, that people continue to support inefficient ways of maintaining place prosperity because they fear the loss of the small share they have. Fear of the consequences of change is a large part of the reason why people cling to declining industries and dying towns, and thereby provide the political constituency for interventions that slow the adaptation of the economy to market forces.

Fear of change is a realistic attitude if the consequences have a high likelihood of being personally disastrous: if there are few jobs elsewhere for individuals to go to, for example, and if there are few guarantees of social support available. If a new constitution is to deprive these people of their ability to vote to affect the economic events, it must offer some guarantees in return. Reforms that make it more difficult for governments to intervene to counter market forces will be unacceptable to those who fear the demise of their communities and industries unless they simultaneously provide some assurances regarding the range of possible outcomes of this market process. Hence it is essential that constitutional guarantees for open and effective markets be paired with strong assurances that social policy will provide equality of opportunity and the maintenance of individual social and economic rights. This link brings us to the second aspect of making good on the social contract.

IV. MAKING GOOD ON THE SOCIAL CONTRACT: CITIZENSHIP AND EQUITY

We argued earlier in the paper that the social contract implicit in the Canadian federation contains a commitment to equity, a commitment whose observance was formalized in the Constitution Act, 1982, particularly section 36. It is not clear how binding that obligation is, however. In particular, it is not clear that the principles enunciated in section 36 are, in fact, judiciable. Any new constitutional pact must, we submit, recognize the equity component of the social contract in the same way it deals with the efficiency aspect; it must be a fundamental obligation of governments. Thus making good on the social contract means elevating the principles found in section 36 to the status of obligations.

Section 36 contains two parts, one dealing with interpersonal equity and the other dealing with interprovincial equity (i.e., equalization). In a federal state, both types of equity are important and interrelated. We discuss each in turn.

Individual Equity

Ultimately, the principle of equity applies to individuals since society's welfare in the end depends upon the welfare of individuals in the society. The concept of equity and all its difficulties are well-known to economists, and we need not go into too much

detail here. Nonetheless, a summary of some of the aspects of equity as an objective of policy is useful for the purposes of considering its role in constitutional design. Equity is concerned with the weight to be placed on the well-being of different members of society. It is an important and unavoidable component of policy evaluation.

There are two difficulties with implementing equity as a policy objective, and these have implications for the way in which the principle of equity can be written into a constitution. The first is that equity cannot be an unconditional standard of policy since there will sometimes be a conflict between equity objectives and efficiency ones. In these cases, a judgement must be made by policymakers as to the extent to which distortions of behaviour can be tolerated in pursuing equity. For this reason, it may be difficult to impose absolute equity obligations in the constitution.

The second difficulty with settling on equity as an objective is more important. The concept itself involves value judgements. Making choices involves, among other things, judging when two persons are equally well off, comparing the welfare of persons of different means, and weighting individual welfare against non-economic objectives such as freedom and justice. Obviously, reasonable persons can disagree on these objectives. A social consensus must somehow be arrived at, all the while recognizing that this consensus can vary as time goes by. For this reason as well, it would be folly to put explicit and detailed equity objectives into the constitution.

However, there are certain principles of equity that we think to be reasonable, to be part of any civilized country, and to be part of the social contract that has evolved in Canada. The most fundamental of these is that every citizen should "count" regardless of where he or she happens to reside. In technical economic terms, this is sometimes referred to as the principle of anonymity or horizontal equity. Persons who are otherwise identical should be afforded similar treatment no matter where they reside in the federation. We take this principle to be part of what it means to be a citizen of a nation. National citizenship means that there are rights and obligations that Canadians have as individuals no matter where they reside. As far as possible, these should not vary in their guarantee or delivery. This principle of equal treatment regardless of residence implies that the federal government necessarily has an interest in equity; that is, equity is fundamentally national in dimension.

This principle of horizontal equity across the federation is compatible with a wide range of judgements about vertical equity, or tolerances of inequality. It only says that people of given means be equally as well off no matter where they reside. Vertical equity is also an important objective, but it is one that admits of considerable variation in opinion. However, once again we argue that there are certain basic requirements that a constitution should impose in order to be consistent with a reasonable social contract. We regard these as minimum requirements for vertical equity. They are basic economic and social rights of individuals, and as such they must be accorded the same status as fundamental freedoms which the Charter of Rights and Freedoms now preserves in other dimensions.

The first basic economic and social right we wish to see firmly entrenched in the constitution is a guarantee of equality of opportunity for, or access to, economic advancement. This provision is captured to some extent now in the wording of section 36.1, and is also related to some parts of the Charter. Our concern is to move it from the status of vague commitment to an obligation with real meaning.

The promotion of equal opportunity and access has several dimensions. One is an ability to exploit one's given abilities to the fullest without barriers such as discrimination. Another is the ability of individuals to take up residence and employment where they wish, and to invest their savings as they see fit. We have already noted the importance of mobility of labour and capital as two desirable features of an efficient economic union. Here it is defended as a fundamental right of citizenship. Thus, it has both an efficiency and an equity dimension.

The mobility provision should be viewed as more than something applying only to individual behaviour and initiative. It also implies that there be no barriers set up by the public sector which detract from the benefits of mobility, or distort the decision. Thus, equal opportunity could be taken to include portability of public services, and even a minimum required level of basic services. Section 36.1, in fact, stipulates this provision without being specific about the types of services provided. By making the promotion of equal opportunity a joint responsibility, the federal government can undertake measures to promote individual equity that might otherwise be deemed unconstitutional.

The promotion of equal opportunities has stronger implications than simply the removal of barriers. It also implies that persons be given an opportunity to develop their potential. It means, for example, that they have access to basic education and training, to health services, and to social insurance systems that provide protection against unforeseen and unavoidable contingencies. It is important to emphasize that the promotion of equality of individual opportunity is entirely consistent with — indeed a prerequisite for — the efficient operation of the Canadian economic union. The free mobility of an educated, healthy work force is desirable for *both* efficiency and equity reasons. There is a great deal to be said for making it a binding obligation involving the federal government.

The second basic economic and social right the constitution should recognize is the guarantee of access to a minimum standard of living for those unable to advance economically on their own. This is a necessary companion to a commitment to pursuing national economic competitiveness, even if greater equality of opportunity makes the starting line more even. Some people are born handicapped, or become disabled, and are unable to advance economically. These people are still members of the community, and still have rights. This principle underlies the United Nation's Universal Declaration of Human Rights: "Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other loss of livelihood in circumstances beyond his control" (Article 25).

One reason to enshrine the principle of access to a minimum standard of living in the constitution is to provide some recourse for individuals who now "slip through the cracks" of the welfare state because they do not fit exactly into the categories of current legislation. Another, however, is to recognize the limits of defining a division of powers in functional terms. Even though it makes sense to have most public services delivered by the provinces, many of these services have an equity dimension to them. The federal government therefore has some interest in the standards of some of these programs since, as we argue here, it too has important equity responsibilities. Making

equity an overriding responsibility of both governments ensures that the constitution has the flexibility to allow for the implementation of national standards in social services where they are warranted.

In fact, it could be argued that most of what governments do in Canada is done with equity primarily in mind. Contemplating the federal and provincial budgets will make that clear. Two-thirds of program spending of the federal government consists of transfers of one kind or another. Transfers to individuals (unemployment insurance, pensions, family allowances, etc.) are naturally distributive in nature. Transfers to business are largely concentrated in agriculture and regional development, both of which can be interpreted as redistributive or social insurance schemes. Transfers to government are, as discussed further below, either explicitly or implicitly redistributive. Only the one-third of the budget devoted to goods and services are oriented towards mainly efficiency objectives.

Provincial government spending is heavily weighted in favour of health, education and welfare services. In each of these cases, economic analysis would suggest that equity is the prime reason for government involvement. Market failure is not the reason for the extensive public sector involvement in the provision of these services; they could have been provided through private markets as well. Public finance theorists have begun to recognize that these expenditure instruments complement the tax-transfer system as a means of pursuing redistributive objectives. In fact, it could be argued that expenditures are at least as important as the tax-transfer system as redistributive devices. Since the provinces are so fully involved in delivering these services, and rightly so for reasons of effective delivery, it is not possible to imagine assigning the role of equity exclusively to one level of government or the other.

The fact that the provinces have an important role in delivering services that have an equity component to them has important implications for the way in which the federal government can pursue its equity objectives. Though the provinces maintain legislative responsibilities in the areas of health, education and welfare, the federal government will have an interest in the standards of service delivered either for reasons of maintaining efficiency in the common market or for guaranteeing standards of national equity. From a practical point of view, they may only be able to induce equity through these programs by use of the spending power. Indeed, good economic arguments could be used to support the spending power for these reasons. Putting the obligation to pursue equity in the constitution and making the federal government bear some responsibility for it should suffice as a justification for the spending power while at the same time preserving the legislative rights of the provinces. It will also allow the flexibility that the provinces, especially Quebec, may well desire without, at the same time, sacrificing national standards.

Some flexibility is essential therefore, but too much flexibility may make it too easy to renege opportunistically on specific aspects of the social contract. Society as a whole has an interest in ensuring that the social contract does not start to unravel. Thus while the rights of access to a minimum income must be general, they must also have some teeth. How matters of important principle such as this can be written as binding obligations is something we as economists can offer little guidance on, it being more a matter of constitutional law. To repeat though, we think it necessary to do so.

However the drafting is done, it is important to make clear as well that responsibility for equity remains within the federal government's purview. In this way it cannot be precluded from undertaking policy measures that have equity as their objective, but which may involve things within the legislative responsibility of the provinces. In our view, the federal government is the logical and final guardian of these rights of national citizenship. They, along with the national efficiency objectives involved in maintaining the internal common market and promoting good economic management discussed above, should be overriding principles rather than ones that are subservient to an explicit division of powers.

If social and economic rights are embedded in a new constitution, there will be costs: an increased propensity to litigation in social policy issues, some degree of judicial uncertainty, and a tendency for social policy to evolve as the result of a series of case-by-case decisions rather than as the result of an overall design. However, if social and economic rights are not embedded constitutionally, the risk of myopic reneging on the social contract will continue to exist. In a more decentralized federation there will be little to prevent discrepancies in benefits across provinces from widening. If no credible assurance is provided that the citizenship rights of *all* Canadians will be protected in a federation where administrative powers over social policy are substantially devolved to the province, the whole process of constitutional reform may founder on the rock of public distrust.

The ability to deliver on the spending power presumably entails that the federal government have more access to tax revenues than they have need for in terms of financing their own expenditures. In fact, there are a couple of other reasons why some degree of "vertical fiscal imbalance" might be desirable in a decentralized federation. One is that, though there are good reasons for decentralizing extensive expenditure responsibilities to the provinces, there are equally good reasons for retaining sufficient tax room at the federal level. For one thing, it is important that the federal government have enough tax room in the direct tax fields to induce a harmonized income tax system. This will serve to improve the efficiency of the internal common market and to reduce the compliance and collection costs. In the case of the corporate income tax, and that part of the personal tax that applies to capital income, a harmonized system will help to avoid inefficient tax competition and provincial beggar-thy-neighbour tax incentives that fragment the common market. As well, the federal government needs sufficient tax room in the direct tax field to be able to achieve national equity goals, especially vertical equity. The only instrument available for achieving that, given that the provinces are responsible for health, education and welfare, is the direct tax-transfer system. This is yet another reason for the federal government maintaining dominance in the direct tax fields. In fact, this supports the tax-assignment arguments in favour of concentrating direct taxes as much as possible at the centre, and leaving indirect taxes to the provinces.

One final argument for an asymmetry between the tax-raising and expenditure responsibilities of the federal government concerns the need for a system of equalizing federal-provincial transfers, to which we now turn.

Equalization

The commitment to equalization is certainly the least contentious notion in this paper and, along with the principle of the internal common market, is probably the least contentious in the entire constitution debate. As discussed, the principle of equalization has been a fundamental principle of Canadian federalism since Confederation, and is a well-accepted part of the social contract. It has been enshrined in the constitution as section 36.2 of the Constitution Act, 1982. It also seems to have been accepted as an element of federal responsibility by the Allaire Report. And, more to the point, it is a principle that commands widespread support as an economic requirement in a federal state. Virtually all federations have some form of equalization as part of their fiscal arrangements, if only implicitly. It is a necessary complement to both an efficient and an equitable federal economy.

The argument for equalization is a compelling one. Canada is necessarily and appropriately a federal state. Many government services are most effectively administered at the provincial (or municipal) level of government. Local governments are better positioned to recognize and respond to local preferences and to tailor policies to them. As well, this promotes innovation and experimentation in policy design and implementation, and improves accountability. Thus, even if preferences do not vary significantly among regions, but there is some uncertainty about how to deliver government services, there is an efficiency case for decentralizing authority for the delivery of some services.

At the same time, if provinces are to have some spending authority, it seems appropriate to decentralize some revenue-raising authority at the same time. Doing so promotes fiscal responsibility and accountability. As well, there may be purely local preferences for the choice of financing instrument, for, say, equity reasons. However, to the extent that both taxing and expenditure responsibilities are decentralized to the provinces, provinces will differ in the ability to provide local services. To use the terminology from the fiscal federalism literature, different provinces will be able to provide different net fiscal benefits to their citizens. This will be the case because of differences in tax capacity of the provinces, differences in income distributions within provinces, differences in the need for public services and differences in the cost of public services. To paraphrase section 36.2, different provinces will be able to provide different levels of public services at different rates of taxation. Such differences are purely a consequence of the decentralization of fiscal responsibilities; in a unitary state, they would not exist. It is this difference that accounts for the difference in net fiscal benefits.

It is well-known from the fiscal federalism literature that the existence of differences in net fiscal benefits is undesirable for two reasons. The first is that they can lead to an inefficient allocation of resources, both labour and capital, within the federation. These factors will respond, in part, to net fiscal benefit differentials in choosing their residence or location rather than solely to differences in productivity. Second, they cause a violation of the principle of horizontal equity, referred to in the literature as "fiscal inequity". The source of the problem is that otherwise identical persons are treated differently by the fiscal system.

This problem of fiscal inefficiency and fiscal inequity resulting from decentralized financial responsibilities has been studied extensively in the literature. The results have been well-documented by the Economic Council in its study entitled *Financing Confederation* published in 1982. In this study, the case was made for eliminating net fiscal benefit differentials using a system of equalizing interprovincial transfers. The purpose of these transfers was to provide the provinces with comparable abilities to provide public services at comparable tax rates. At the same time, the benefits of decentralization would be preserved. That is, although provinces would have the potential to provide comparable public services, they would not be obliged to. In a sense, the purpose of equalization transfers can be seen as providing the different provinces with the ability to replicate the services of a unitary state, while at the same time preserving the decentralization benefits of federalism.

The details of ideal equalization schemes need not concern us. It is really the principle that is important, enough so as to be included as a constitutional principle. These rationales clearly underlie the development of the equalization program in Canada, and the decision to include it as a constitutional obligation in 1982. Section 36.2 captures one sense of citizenship in Canada, and one type of obligation that accompanies it. The national government is committed to equity for individual Canadians, but for Canadians as residents of provinces. The commitment as stated recognizes that some government services will, and rightly should, vary in quantity and content across provinces. The equity obligation stops at the point of making it possible for provincial governments to deliver roughly equal values of bundles of these services. That is why the payments are unconditional, and why they go to governments rather than individual citizens.

In our view, history, current practice and economic reasoning all support including in the constitution a principle very much like that found in section 36.2, and including it in a way that effectively makes it a fundamental object of policy. As with the case of individual equity, it is not necessary, or wise, to make it more than a principle. That is, the details of a scheme need not be spelled out. Indeed, we would not identify the equalization objective solely with the formal Equalization scheme, and vice versa. In fact, the major federal-provincial transfers all contribute to equalization in the broader sense, and complement one another in doing so. The Equalization scheme itself as currently constituted cannot be regarded as fulfilling the letter of section 36.2. For example, while it equalizes the have-not provinces up, it does not equalize the have provinces down. Also, it does not take account of need or cost differences in the provision of services, nor does it equalize negative tax liabilities (i.e., transfers) symmetrically with positive ones. Both the EPF scheme and the CAP transfer, which together with Equalization make up by far the bulk of federal-provincial transfers, help make up for these shortcomings. The EPF scheme taken together with its financing is effectively like a scheme that equalizes the haves down and the have-nots up. The CAP scheme takes some account of differences across provinces in negative tax liabilities (welfare payments) as well as implicitly using need as a criterion. That is not to say that these schemes are perfect equalization devices; only that equalization can be achieved by a variety of instruments simultaneously. The constitution should not restrict policy options by being too specific.

V. MAKING GOOD ON THE SOCIAL CONTRACT: THE DISTINCT IDENTITY OF QUEBEC

One of the tragedies of the Meech Lake debacle is that, since the Meech Lake Accord contained a "distinct society" clause, opposition to the Accord has often been interpreted, especially within Quebec, as an attempt to deny Quebec's distinct identity. Yet many of those who opposed the Accord did so because of the implications of the Meech Lake package for the rest of the country — *not* because they opposed the idea of Quebec's distinctiveness. The evolving social contract of Canada has in fact recognized Quebec's distinctiveness for many years, as demonstrated in the maintenance of separate systems of income taxation, the separation of the Quebec Pension Plan and the Canada Pension Plan, the delegation of powers to select immigrants, and now Quebec's collection of the Goods and Services Tax (GST).

In the evolution of Quebec's distinct status, two points stand out. First, although many of the powers that Quebec has assumed (e.g., over pensions or provincial income taxes) are in principle available to all provinces, only Quebec has chosen to assume them — by voluntary consensus a distinct status has already emerged for Quebec. Second, one can note that within this special status, the Canadian genius for compromise has found reasonable solutions to practical problems of detail — e.g., pension eligibility is portable between the Canada Pension Plan (CPP) and the Quebec Pension Plan (QPP), the federal government continues to collect GST from corporations who want English correspondence, etc.

There are good, practical reasons for some degree of "special status" for Quebec. The mobility of labour into and out of Quebec is much lower than that between the other provinces. (In 1986-87, 0.4% of Quebec residents aged 16-69 moved interprovincially [the fraction is even lower for francophones]. By contrast, 2.1% of Newfoundlanders and 2.6% of Albertans migrated.) Historically, Quebec had a unique social problem — the economic domination of a francophone majority by an anglophone business class — which required, and requires, a unique set of laws, and substantial social change, to resolve. And Quebec faces a unique demographic future, in its combination of a declining birth rate and a tendency for immigrants to assimilate to the anglophone community.

In addition, Quebec must always be on guard to defend its unique culture. English is not only the language of most of the rest of the continent, it has also acquired a unique global role. To maintain and to enhance a francophone culture in North America has required, and will require, a unique set of laws and institutions. Whether Quebec wants to try to continue to maintain and enhance its distinct status within Canada is a choice for Quebec alone to make. But in trying to make good on the social contract, the Rest of Canada should make it clear that Quebec has had, and would continue to have, a distinct status within Canada.

In part, our proposals attempt to meet the concerns of Quebec in a symmetric fashion. If all provinces have control over the manpower policy jurisdictions that directly influence the local labour market (i.e., UI, re-training, labour law, employment subsidies), a good part of Quebec's demands for autonomous control of local development would be satisfied. The requirements of portability, minimum standards and equalization offer a combination of benefits to Quebec citizens, and constraints on

Quebec governments, which Quebec would have to weigh — much would depend on how specific "minimum national standards" are.

In part, we would propose that Quebec's unique situation be recognized by a degree of asymmetry in the federation. However, "asymmetric federalism" is a concept that is a bit like an airplane with wings of different lengths. Unless the asymmetries are limited in extent, and clearly justifiable, the thing will not fly. We all recognize that Quebec has a legitimate interest in ensuring the survival of a distinct culture on the North America continent. For decades, Quebec has resisted vigorously any federal intrusion into the provision of education, precisely because education is so central to a common culture and common citizenship. Since the special need to ensure the survival of French culture within North America is widely recognized within Canada, one could offer to Quebec, *and to Quebec alone*, the right to opt out (with full financial compensation) of the federal funding of, say, child welfare and education programs. Limiting the right to opt out to Quebec would recognize that Quebec is not quite "a province like the others" without opening the door to a wholesale disintegration of Canada's national identity. It would represent a degree of "asymmetric federalism" that is limited in extent, and justifiable in purpose. Conceivably, it just might fly.

VI. CONCLUDING REMARKS

Our discussion in this paper has been very general. We have argued that, from an economics point of view, the constitution of a nation embodies the principles of a social contract that should both guide and commit future governments. Of necessity, these principles must be broad and general in nature. The actual implementation of the social contract depends upon the circumstances of the day facing each government. The components of the social contract we have focussed on are those that we believe to be consistent with, and implicit in, the evolution of Canada since Confederation. They would essentially facilitate and promote the use of the market economy as the main mechanism for allocating the economy's resources, while at the same time protecting the basic rights of citizens, providing for the most effective delivery of public services, and committing governments to some minimum standards of equity applicable to all citizens no matter where they reside.

We have suggested that this implies two overriding economic objectives in the constitution that essentially provide obligations to the federal government. The first is a requirement to guarantee the efficient operation of the internal common market, which means primarily ensuring the free and undistorted movement of goods, services and factors of production within the economy. Such a principle does not exist in the current constitutional arrangements, although there are sections that address it in part. We believe the principle is important enough to be given primacy as a constitutional obligation. Necessarily, the federal government must bear ultimate responsibility for ensuring that this principle is satisfied.

The second is the commitment of governments to the promotion of equality of opportunity and equity among citizens no matter where they reside in the country. Such a commitment includes the provision of basic public services. In a federation that decentralizes considerable responsibilities to provinces, territories, municipalities and

first nations, this principle also implies a commitment to equalization among such jurisdictions. The Constitution Act, 1982, included a section (36) that states these principles. We believe that a new constitution should include a similar set of equity principles in a way that ensures that they have some real teeth, that is, impose real obligations on governments to enhance equality of opportunity and to maintain the social and economic rights of all Canadian citizens. Again, the federal government must play a paramount role in furthering these principles, although all levels of government would jointly bear a responsibility for equality of opportunities and the provision of basic public services.

Given these two principles, a division of powers could then be devised. Although we have not been very specific on this, the general outlines should be clear from our discussion. Essentially, the federation could be highly decentralized in one sense; that is, the design and delivery of many, if not most, services to citizens could be the responsibility of the provinces, as well as the territories, municipalities and first nations. This includes those in the areas of health, education and welfare, which are now basically provincial, as well as labour market services such as unemployment insurance and manpower training.

The federal government would remain responsible for items of national interest, such as defence, foreign affairs, treaties, money and currency, and the like, most of which seem to be non-controversial in any case. However, the federal government, because of both its responsibility for the common market and its equity responsibility, retains an interest in ensuring that there is some national standard of basic public services provided, and that the design of the programs does not interfere with the efficient operation of the common market. This means that the use of the spending power for these purposes is unavoidable. Indeed, we would argue that the ability to use the spending power in whatever way is necessary to achieve these objectives must be made explicit in the constitution.

The significant decentralization of the responsibility for public services to the provinces requires that some revenue raising be decentralized as well. However, we do not believe that the decentralization of tax responsibilities should be as extensive as that of expenditures. There are several advantages to the federal government retaining more revenue-raising responsibilities than the provinces and the territories. One is that there is a need for a system of federal-provincial transfers that must be financed out of federal revenues. Second, there are efficiency advantages to some centralization of revenue-raising responsibilities. This will facilitate tax harmonization and the reduction in opportunities for tax competition and differential provincial taxation. This may be relatively more important for direct rather than indirect taxes. Third, if the federal government is to have a redistributive role, and we have argued that it should, it will need to have access to significant direct tax room for that purpose. However, the assignment of tax bases, and tax room applying on those bases, is not a matter for constitutional prescription. Rather it should be a matter of policy, albeit constrained by overriding constitutional obligations. The requirement for maintenance of the common market and the equity obligations of the federal government should result in an allocation of revenue-raising responsibilities suitable to the task.

More generally, the constitution cannot be too specific about the roles of the respective governments in the economy. There is a great advantage to be had from

retaining a degree of flexibility, as history has demonstrated. That is why we have put such strong emphasis on getting general principles and obligations up front, with the same degree of force as the Charter of Rights and Freedoms.

The one outstanding issue remains Quebec's response. We believe that our prescription is decentralized enough and flexible enough to accommodate their legitimate concerns. If more is needed, some ingenuity could be used to design suitable asymmetric opting-out arrangements on specific items, such as the use of the federal spending power. At the same time, we feel that some commitment to the social contract is required for Quebec to continue to remain a partner in the country. In our view, that includes both a commitment to the internal common market and all that entails, as well as a commitment to the sorts of citizenship rights that would be included in a strengthened version of section 36 of the Constitution Act, 1982.

Finally, it might be worth spelling out more explicitly what this all implies for actual constitutional reform. We restrict ourselves here to the economic aspects of the reform, leaving institutional, political and legal aspects to others. Our proposals are tempered by a recognition that the existing system has served Canada well since Confederation. It has proven to be flexible enough to adapt to change in the economic roles of government, and that is its virtue. At the same time, the existing tensions for further decentralization of powers in some constituencies combined with a fear of erosion of the special national responsibilities of the federal government in others makes the task of constitutional reform a delicate task of balancing. In our view, both the decentralizing objectives of some and the maintenance of a federal role in protecting and enhancing national objectives can be achieved by renewing the existing federation in a way that is not too disruptive. In fact, minimal changes from the status quo would be required.

The key feature of our proposals would be the elevation to matters of judiciable principle of two things. The first is section 36 of the Constitution Act, 1982, presumably without the caveat that this has no effect on the existing powers of the federal government and the provinces. Clearly this embodies a notion of equity in the constitution, and makes it a responsibility of the federal government and the provinces. We see it at least partly as enabling the federal government to make interventions in the national interest in areas that in its absence would be matters of provincial jurisdiction. Ours is a highly decentralized federation, and we would be willing to make it even more so on the expenditure side, with the constitutional protection of the national interest and rights of citizenship as embodied in section 36. We would be no more explicit than that about the national interest. Nor would we be more explicit about how the federal government might exercise its national equity responsibility, whether it be by the spending power to provinces, by payments to individuals or organizations, or by other means such as regulation. That is a matter of legislative policy.

The second key feature would be the elevation to a constitutional obligation of the maintenance of the internal common market, by which we mean the maintenance of the free and undisturbed flow of goods, services, capital and labour within the federation. This would also be an obligation binding on both governments, but presumably, the federal government could adhere to it as another national objective, along with the equity one mentioned above. As mentioned there are already elements in the existing constitution in sections 91.2 and 121 as well as the mobility section of

the Charter of Rights and Freedoms. We would simply wish to make them comprehensive of all the sorts of transactions within the Canadian common market, and elevate them to binding and judiciable status. Again, it is not necessary or desirable to make things more explicit than that.

These two elements may be seen as centralizing components of renewing the federation. Given that they are in place, we would be in favour of decentralizing to the provinces certain expenditure items, such as the responsibility for unemployment insurance. This should serve the interest of efficiency in the delivery of services. However, given the above two provisions, the federal and provincial governments would be responsible for ensuring that the delivery of unemployment insurance would not compromise either the internal common market or the principle of national equity. Thus, standards of portability of comprehensiveness may well be required. How this is done in practice must be a matter of legislative responsibility. Other areas of responsibility could well be placed (or kept) in the hands of the provinces, such as manpower training and other labour-market policies, as well as child care. At the same time, the principles of internal common market and national equity would not preclude the federal government from encouraging national standards in these areas, or in others with important national advantages such as post-secondary education, research and development or capital-market regulation.

The constitution would be no more specific than it is now about the allocation of taxing power. However, the maintenance of the internal common market and the promotion of national equity standards, including the need for equalizing transfers to the provinces, would undoubtedly influence the amount of tax room that the federal government occupied in different tax fields. In our view, the federal government would presumably be better placed to maintain a strong position in the two income-tax fields (individual and corporation), and would have less need for indirect tax room.

In our view, the above changes would strengthen the federation in a way that seems to accord with the evolution of the social contract in the past, and at the same time allow enough flexibility for change as time goes by, and for decentralizing expenditure responsibilities to the provinces without compromising national objectives. It would also provide a framework within which we can consider selective decentralization of additional responsibilities to Quebec (economic or otherwise), i.e., an asymmetric federation. As mentioned, we would have no objections to allowing such arrangements, with compensation, provided the two overriding principles of national equity as embodied in the wording of section 36 and the principle of the internal common market were respected.