THE AFTERMATH OF MEECH LAKE: IMPLICATIONS FOR THE WESTERN CANADIAN ECONOMY

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INTRODUCTION

Economic life as we know it in Western Canada did not end with the demise of the Meech Lake Accord. Interest rates remained too high and, perversely, the value of the Canadian dollar actually rose following the failure to ratify Meech Lake, much to the chagrin of doomsayers who had predicted it would plummet as the international investment community lost confidence in the Canadian economy. Nor did Meech have much effect on the forecasting ability of federal and provincial governments; deficits at all levels of government continue to be higher than anticipated and this problem will be further exacerbated as the North American economy heads into recession.

From the perspective of Western Canada and the nation, the collapse of Meech Lake was an economic non-event. The purpose of my brief discussion is to suggest why that was so and to predict what we might expect in the short term as we digest the political response to our constitutional impasse. In the short term, I believe that federal-provincial relations, especially those relating to tax and transfer programs, will be characterized by even more extreme rhetoric and ill-feeling than has been evident in the past. The economic ties which bind federal and provincial governments (and link individual Canadians regardless of location) are going to be strained, possibly to the breaking point, as all levels of government cope with deficits which are not sustainable at current levels. This short-term fiscal crunch will certainly colour discussions regarding the nature of economic ties which should underpin our constitutional linkages.

What the longer term holds is difficult to predict, especially in light of the ever increasing number of provincial constitutional committees and federal initiatives all seeking public input. We can, however, be reasonably confident of two outcomes. The first is that at some point the Canadian public will tire of endless discussion and seek action on constitutional issues even if proposed initiatives are ill-advised. Second, an even greater degree of decentralization and a reduced role for a federal government in tax-transfer programs will emerge regardless of whatever is the constitutional configuration that ultimately arises from the Meech debacle. The logic of the Meech Lake Accord itself and the economic context in which constitutional discussions will take place all point in this direction.

Let me hasten to add before going on to discuss the implications for the West of the rejection of the Meech Lake Accord that my brief is narrow. It is simply to address some of the *economic implications* of this constitutional impasse for the West. By necessity of time and space it cannot focus on likely reforms nor can it integrate the interface between economic and political change as much as I would like.

WHY WAS THERE SO LITTLE ECONOMIC IMPACT TO THE FAILURE OF MEECH?

The overall indifference of financial markets to the Meech debacle clearly brought home the message that, at least in the short to medium term, the Canadian constitutional crisis was perceived to have relatively few spill-overs to the economic arena. This reaction of financial markets to the aftermath of Meech Lake is instructive and highlights three key points that are important in assessing the implications of the Meech Lake failure for the Western Canadian economy. The first is that, regardless of the outcome of the Meech Lake failure, it is likely that the economic consequences will occur only incrementally. That is, if Québec or some other region of the country opts for sovereignty-association it will not come about overnight. Negotiations regarding the economic and political links will be time consuming and provide plenty of lead time for firms and investors to adjust to whatever new political configuration arises. Perhaps, more importantly, the political realignments which emerge will be constrained by economic reality. This latter issue brings me to the second point.

Canada, and certainly Western Canada, are relatively small players in international markets. In large part prices for our exports and imports are set in world markets where Canadian industries are small in relation to the volume of world trade. Living standards in all regions of Canada depend on our ability to compete in international markets. All regions of Canada rely extensively on access to foreign capital to help finance both private and government borrowing. I am an economic pragmatist and believe that the discipline of the market, especially the potential big stick wielded by bond rating agencies who evaluate both private and federal and provincial government debt offerings, will serve to minimize the economic consequences of constitutional redesign. Poorly designed constitutional reform which inhibits our international economic competitiveness would result in an immediate downgrading of credit ratings and increase the cost of borrowing. The fact that financial markets reacted so little to the failure of Meech suggests that, at least currently, financial analysts perceive that all players in the game are aware that this constraint limits the potential adverse economic spill-overs of constitutional reform. Our economic ties to the rest of the world will continue regardless of the outcome of the constitutional debate in Canada.

Third, the extent of integration of Canadian regions with the international economy in terms of exports, imports and capital has reduced the relative importance of the rest-of-Canadian market to the economic well-being of any one region. The alternative to strong east-west economic links is strong rest of world links. The Free Trade Agreement (FTA) is an example of this process but it should be noted that it was simply a logical continuation of a process of trade liberalization that had long been under way. At the time of the FTA over 75 percent of Canada-U.S. trade was already duty free. Moreover, trade links of Western Canada, especially those of British Columbia and Alberta, with the Pacific Rim countries are expanding significantly. Thus, the potential disruption to regional economies of Canada as a result of any significant constitutional realignment could be quite modest.

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HOW DOES THE CANADIAN ECONOMIC UNION CONTRIBUTE TO LIVING STANDARDS IN WESTERN CANADA?

This question can be answered by assessing the implications for economic well-being of the West as a result of being a member of an economic union with a relatively decentralized federal structure – Confederation. Maxwell and Pestieau (1980:13-20) provide a thorough discussion of the possible economic gains which arise from an economic union such as Confederation. They suggest four basic gains from the integration of markets for labour, capital and commodities and the harmonization of policy instruments which underpin economic unions. The first and most important of these are the gains from greater economic specialization and the capture of economies of scale which accompany the elimination of regional barriers to flows of people, capital and commodities. The second source of economic gain is the pooling of risks at the national level to ameliorate the consequences of regional instability. This pooling includes interregional insurance and transfer programs, labour and capital migration across regions in response to varying economic opportunities, and macroeconomic stabilization policies aimed at specific regions. The ability to pool risks nationally is a useful feature of an economic union. It permits regions to specialize in those areas of production in which they are most efficient while at the same time insulating themselves from the major cost of specialization – greater variability of income and employment.

The sharing of overhead expenditures on joint projects such as defence, and large-scale transportation projects with economic spill-overs across regions is the third source of economic gain in the Maxwell-Pestieau framework. This attribute lies at the heart of allocating economic responsibilities among political jurisdictions. The allocation of economic responsibilities to a particular level of government should be consistent with the spatial distribution of benefits and costs from that economic function. The final source of economic benefit is the possible market power possessed by an economic union but not by an individual region. The use of this market power to increase export prices or to reduce import prices would enhance the economic benefits of trade to members of an economic union by reducing the amount of exports required to pay for a given amount of imports.

When seen in this perspective, Confederation does seem to offer the potential for increasing the real incomes of provinces and their residents because of the benefits derived from regional integration. The real issue, however, is whether benefits of similar or even greater magnitude are available to the participating regions through alternate trade arrangements. If each of the provinces were to pursue a policy of autarky in the absence of Confederation, the economic union would yield very large economic gains. Yet if the alternative to Confederation is free trade by each of the provinces with all trading partners it is likely that the gains from the economic union would be modest. All of the gains arising from greater regional specialization and the capture of scale economies are available from multilateral free-trade.

As was noted earlier, the post-war period for Canada and the world has been characterized by significant trade liberalization. This trend and its most recent manifestation, the Free Trade Agreement, thus suggests many of the gains in trade from the economic union are available through trade with the rest of the world. However, this perspective must be placed in context. It is highly likely that in 1867 Confederation did produce a positive economic gain especially through the incentives for specialization and scale. The two largest external markets open to the British North American colonies had become increasingly difficult to gain access to. The United Kingdom's move to free trade and the elimination of colonial preferences meant that Canada's distance and high costs hindered access to this traditional market. In the case of the U.S., lingering disputes from the Civil War manifested themselves both in high tariff barriers and overt hostility. Yet, in the current environment, multilateral trade initiatives through the General Agreement on Tariffs and Trade (GATT) and bilateral initiatives such as the FTA provide alternative means of capturing the gains from trade for a region such as Western Canada.

What of the gains from risk pooling? Here, the evidence suggests that the Western Canadian economies remain remarkably volatile. A recent study by Mansell and Percy (1990) found that economic instability in Western Canada, but especially in the case of Alberta, was far above national levels. Furthermore the evidence suggested that an array of federal policy initiatives, again mainly in the case of Alberta, exacerbated the underlying instability arising from specialization in volatile resource markets. A forthcoming study by Chambers and Percy (1991) finds that macroeconomic policies, especially exchange rate strategies, have tended to exacerbate swings in economic activity brought about by movements in natural resource prices.

On one level the existence of stabilization programs at the sectoral level funded by large federal expenditures — agriculture and, those which are general in nature, unemployment insurance — do ameliorate some of the shocks arising from reliance on volatile natural resource markets. In this regard they certainly do improve economic well-being in Western Canada.

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On the other hand, there is evidence that the weight of federal policies has not always contributed to higher levels of economic well-being in the West. John Whalley and Irene Trela (1986) in a study undertaken for the Royal Commission on the Economic Union and Development Prospects for Canada found that on the basis of data for 1981, Confederation did not lead to positive net gains. They note that "..if anything, rather than accounting for a surplus to be distributed between regions, Confederation seems to account for a deficit, and this seems to be due in large part to the distorting policies pursued by the federal government" (Whalley and Trela: 199). Government policies have changed since 1981, especially those related to the energy sector. However, the one estimate that does exist regarding the effect of Confederation on national income clearly indicates that it has lowered rather than increased income on average with the resource-rich and higher-income provinces bearing a disproportionate share of the costs. These results thus indicate constitutional reform accompanied by a better designed set of federal policies could increase incomes in Western Canada.

WHITHER FEDERAL-PROVINCIAL FISCAL RELATIONS?

The next two years or more in federal-provincial fiscal relations promise to be among the worst in recent memory. The federal government is committed to reducing the deficit to $28.5 billion in the fiscal year 1990-91 and in the subsequent three year period reducing it to $14 billion. Deficit reduction and prudent fiscal management are the apparent planks of the Tory government's efforts to improve their popularity. The fiscal plan designed to achieve these goals included a ceiling on Canada Assistance Plan payments to "have" provinces — B.C., Alberta, and Ontario — and further reduced the extent of various shared cost programs. While there were legal challenges to the federal government's arbitrary revisions to signed agreements between itself and the provinces, the point was moot. Negotiations for a new five year agreement on funding these welfare, medical, and post-secondary programs are now under way as the current agreement expires in 1991. Since these statutory programs represent a major expenditure commitment by the federal government there is every incentive for them to reduce their contribution. Moreover, since these expenditures are to provinces there is not the political visibility associated with them that the federal government obtains from direct transfers to individuals.

Unfortunately, the coming North American recession will make economic hash out of the optimistic budget scenarios provided in the February 20, 1990 budget of Michael Wilson. The recession will lead to a decline in tax revenues and an increase in expenditures as automatic economic stabilizers such as unemployment insurance come into play in response to rising unemployment. Thus the imperative to pare expenditures is going to increase, and this does not even include the costs to Canada of the Persian Gulf crisis and our participation there.

Many provinces are facing exactly the same constraints of the necessity for deficit reduction in an economic environment where all the pressures are leading to increased deficits. The provinces face an added constraint. They, unlike the federal government, cannot finance their debt through increasing the money supply. Provinces must enter the money markets and subject themselves to the scrutiny of bond rating agencies. Several provinces face downgrading of their current high ratings unless deficits are brought under control. Thus they have neither the fiscal capacity nor the inclination to absorb a larger component of shared-cost programs.

Moreover, the balkanization of fiscal relations implicit in the Meech Lake Accord will continue unabated. The Western Canadian provinces are talking about collecting their own taxes and funding directly programs presently cost-shared with the federal government. Accompanying this dispute over fiscal relations will be efforts by the remaining provinces to duplicate any success Québec achieves in negotiating separate agreements with the federal government.

The fight among the provinces and the federal government over how to distribute shares of a declining economic pie is going to obscure entirely the debate regarding a more efficient set of political and economic relationships suitable for promoting long-term growth.

To conclude, I was not surprised that the failure to ratify Meech Lake had so little effect on the Western Canadian economy. Yet I am not that sanguine about the future. I believe there are legitimate issues regarding aspects of current federal-provincial fiscal relationships that should be discussed and open for debate. Unfortunately, I think the debate which will emerge will be driven by short-term considerations motivated by current fiscal problems and efforts by all provinces to keep pace with Québec's attempts to obtain separate agreements with the federal government.

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CONSTITUTIONAL REFORM: DOES ECONOMIC EFFICIENCY FIT IN?

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The quick and simple answer is that economic efficiency does fit in with constitutional reform, but that it fits in with lots of other things. Political, social, and cultural matters may all have a more important bearing on the nature of constitutional reform than do economic matters. And where "economics" comes on to the scene, the concern may be more with equity than with efficiency.

What is necessary in federal fiscal relations to achieve economic efficiency? The requirement is that provincial tax and spending activities do not cause factors of production, labour, and capital to move from one province where they are more productive to another where they are less productive. This requires, except for cases where there is a clear desire to affect location decisions, either

a) equal tax bills with equal expenditure benefits for individuals in similar circumstances regardless of where they live, or it requires,

b) tax differentials matched by differences in expenditure benefits – i.e., equal fiscal residuals (net fiscal benefits).

Achieving this requires either tax and expenditure harmonization across the country which is equivalent to complete centralization of power, or it requires a system of equalization payments, which allow for provincial policy differences, but equal fiscal residuals.

In the limited space I have, I want to look at Canada with respect to these efficiency criteria, and to look briefly at what the failure of the Meech Lake Accord may mean with respect to the question of "efficiency".

1. TAX HARMONIZATION

Tax harmonization in its most extreme form refers to the fact that a taxable entity, person or corporation, will face the same tax regardless of provincial location. Harmonization exists in another form if taxes are lower, but this is offset by the fact that some services are privately purchased rather than provided by the public sector. You don't pay as much, but you don't get as much.

Provincial taxes vary substantially in Canada. Nevertheless, Canada has a relatively high degree of harmonization compared to some federations – the United States and Switzerland. It has a low level of harmonization compared to Germany and Australia, and diversity is much greater than in unitary states such as the United Kingdom.