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Should Alberta and Saskatchewan Unite?

Examining Proposals for Closer Co-Operation — From Maintaining the Status Quo to Political Union

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In this issue...

From equal beginnings, the economies of Alberta and Saskatchewan have evolved much differently. Alberta now has three times the population and 4.5 times the GDP of Saskatchewan. Would closer policy coordination close this gap and be beneficial to the people of Alberta and Saskatchewan? Or are the political preferences of their populations too diverse to allow greater co-operation?

The Study in Brief

In 1905, Wilfrid Laurier's government established the provinces of Saskatchewan and Alberta with a border running north to south and drawn to create two provinces approximately equal in size, population and economy. Over time, the political boundary has defined two increasingly unequal economies, with Alberta now having three times the population and 4.5 times the Gross Domestic Product (GDP) of Saskatchewan. While the size and structure of the two economies differ, the provinces are economically integrated. This has prompted some measure of cooperation to harmonize regulations, jointly promote tourism and coordinate education curriculums. However, persistent differences in economic performance have prompted questions about whether a closer union might not be beneficial and enable those living in Saskatchewan to enjoy greater prosperity.

In this *Commentary* we investigate the possible benefits of a range of choices from greater policy coordination between the two to a political merger of Alberta and Saskatchewan into a single unified province. In discussing the benefits of various forms of greater policy coordination, we rely on the assumption that the policies adopted by the governments of the provinces of Alberta and Saskatchewan reflect the preferences of voters. A review of policy choices made in the two provinces reveals significant differences in preference. In our view, the fact that the fiscal regimes and industrial policies of the two provinces have remained different over many decades, even during recent periods of fiscal stress when the economic forces for harmonization have been most strong, suggests that these distinctions in preferences are firmly held. Overcoming these preferences will form the critical challenge facing those advocating greater policy coordination over key areas of provincial public policy.

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In 1905, Wilfrid Laurier's government established Saskatchewan and Alberta with a border running from north to south and drawn to create two provinces approximately equal in area, population and economy. Over time, the political boundary defined two increasingly unequal economies, with Alberta now having three times the population and 4.5 times the Gross Domestic Product (GDP) of Saskatchewan. While both provinces began as predominantly agricultural economies, Alberta's is now dominated by the production and processing of oil and gas. Saskatchewan produces potash and some oil and gas; however, it remains dependent on agriculture. Reflecting this contrast, in 1996, 80 per cent of Alberta's population lived in urban areas compared to 63 per cent of Saskatchewan's. While the size and structure of the economies differ, the two provinces are economically integrated. For example, from 1972 to 1999, 700,000 Saskatchewan residents migrated to other provinces and close to half that number chose Alberta as a destination (Roach and Berdahl, 2001).

The challenges for policymakers created by the border were recognized even before it was established. Before 1905, the North-West Territories included that area that became the provinces of Alberta and Saskatchewan. In 1901, Territorial Premier Frederick Haultain lobbied for the creation of a single province, arguing that the establishment of two provinces would "simply double the government, double the legislature, and double every expense as it would be necessary to double all the institutions which we need at the present time…." (Owram 1979, 185) and would create the potential for conflicting policies and regulations. In 1946, the Planning Board for the Province of Saskatchewan said that "there is a legitimate question as to the efficacy of developing an area restricted by accidental political boundaries, such as a province, when necessity demands planning within a wider economic unit…." (Richards and Pratt 1979, 132). More recently, the Canada West Foundation (CWF) has been a leading proponent of strengthening the political voice and the economic prosperity of the western provinces as a region by identifying issues of common interest, areas for inter-provincial cooperation and coordination, and beginning the discussion of the development of supra-province regional institutions to make this possible. Wayne Eyre and his organization, Home Rule for the West, have gone so far as to suggest that the four provincial western legislatures should be combined to form a single western Parliament.[1]

Would the populations of Alberta and Saskatchewan benefit from greater policy coordination, or a form of union? Robert Roach (2003) of the CWF outlines the theoretical case for greater regional cooperation among the four western provinces, though he limits his proposal to one favouring increased cooperation among the legislatures rather than unification. Roach identifies several advantages to regional cooperation. Among the gains are: political strength through numbers within the federal system; economic efficiency gains from the free mobility of labour and capital across borders; improved international competitiveness; increased market size for provincially based producers and reduced costs; better quality of public programs, and better management of policy issues that spill over

1 Wayne Eyre, "End Alienation: Let the West Rule Itself", *Calgary Herald*, Tuesday, Feb. 18, 2003, page A15. See the Web Site for Home Rule at www.westernhomerule.ca

provincial boundaries. While Roach offers no explanation for not discussing a possible merger of the western provinces, Wayne Eyre states the case for unification in strong terms. Eyre favours the dissolution of the western provinces and their reconstitution as a single entity with one parliament. He proposes the Scottish Parliament as a model that could be followed. While Eyre's view is extreme, his construct for government in the West represents the limit of the cooperative model.

Fox and Roach (2003) produced a lengthy inventory of more than 150 examples of inter-provincial cooperation in the West. In agriculture, there are sustained efforts to share information, to harmonize regulations and inspections and to allow for freer movements of agricultural produce across provincial borders. In culture and tourism there are joint promotion efforts for the sector. For education (kindergarten-to-grade12), there are efforts to coordinate on policy and curriculum across the provinces. In advanced education, Saskatchewan established agreements under which students from that province have access to programs in Alberta and Manitoba in return for Saskatchewan covering the costs of expanding those programs to accommodate them. Overall, the CWF study produces a long list of areas of inter-provincial cooperation, illustrating that the provinces have been able to coordinate on policies and programs when the mutual benefits of doing so are clear.

One movement favors dissolution of the western provinces and their reconstitution as a single entity with one parliament.

Fox and Roach (2003, 3) note that inter-provincial cooperation has amounted to co-ordination among the four provinces rather than the erosion of provincial power or unification: "Working together as provinces rather than seeking to create a single Prairie or western province remains the basic principle of inter-provincial cooperation in the region and shows no signs of being replaced by a single vision."

What is lacking in these studies is an assessment of how far inter-provincial cooperation might go. Since 1990, an average of two-thirds of provincial program spending in Alberta and Saskatchewan has been in the areas of health care, education and social services. Similarly, since 1990, an average of two-fifths of provincial tax revenues, excluding natural resource revenues, came from personal and corporate income taxes. The potential for cooperation in the setting of personal and corporate income tax rates and in the establishment of common standards for spending in health, education and social services are not discussed. This indicates that despite the number of cooperative initiatives identified by the CWF studies, they represent lesser orders-of-magnitude changes. Our *Commentary* builds on these efforts by addressing the larger issue of whether the citizens of Alberta and Saskatchewan would gain from a merger, or at least from closer coordination of economic and social policies that are fundamental to their economic welfare. In the process, we examine many of the economic gains as discussed in Roach (2003) in terms of the key areas of provincial spending and revenue.

We also examine an important issue that neither the CWF nor Eyre address — the role of heterogeneous preferences in policy initiatives. Alesina, Angeloni and Etro (2001) say that the desirability of co-ordination amounts to assessing the trade-off between the benefits of co-ordination against the loss of independent policymaking. In the context of Alberta and Saskatchewan, the existence of provincial boundaries enables provincial populations to set policy according to constituents' preferences. A desire for greater income distribution may also mean that a province's population is willing to tolerate some foregone scale economies of administration or other costs associated with distortionary tax policies used to support redistributive programs. While an economic analysis can identify and potentially quantify the trade-offs associated with greater policy coordination, it is ultimately up to voters whether they want to make the trade-offs.

One Was Bigger Than Two

By 1897, Canada's population was expanding through the territories west of the Province of Manitoba. Immigration policy, which was the jurisdiction of the federal government, contributed to this population growth, while the responsibility for providing "local works and improvements" was the responsibility of the territorial government. Predictably, a growing population created financial problems for the territorial government that, along with a larger population, led the territories to pursue provincial status (Lingard 1946, Nicholson 1954). There were proposals for the creation of one, two, three, and even four provinces considered by the Dominion Government. The federal government rejected the creation of one province because it would have been too big to maintain political balances within Confederation and to efficiently administer. In addition, the government found that one province would be problematic because of the diversity of interests within the territories. Proposals for two provinces, however, reflected the natural geographic boundaries that existed on the western plains and delineated lines of economic activities. While the expected costly duplication of administrative and legislative machinery was well recognized, many residents of the territories said that their interests were best represented in smaller but more homogeneous political entities. Thus, from the outset, the establishment of the new provinces reflected two competing principles: efficiency in administration versus the separation of diverse interests. In 1905, Wilfrid Laurier's boundary decision was somewhat remarkable in that in choosing to create two "equal-sized" provinces he seemed to give little weight to administrative efficiency or to delineating the boundaries of economic interests.

At the time of the border decision, the new provinces of Alberta and Saskatchewan were remarkably similar in population and geographic area. The Department of the Interior at the time reported that Alberta possessed 80,000 square miles suitable for grain growing, and 114,000 square miles for ranching, while the corresponding figures for Saskatchewan were 86,000 and 107,000 square miles (Lingard, page 205). While natural resource endowments would prove to be markedly different across the two provinces — the border decision put most of the conventional crude oil and tar sands on the Alberta side and all potash on the Saskatchewan side — this was not known in 1905 and indeed would not be known until a string of discoveries of large oil pools, beginning with the 1947 Leduc strike, confirmed that Alberta held by far the largest share of the oil and gas wealth. Gibbins (2001) stresses that the two provinces began in very similar fashion and were "divided more by a political line on the map than anything else."

In the 1930s, when Alberta embraced right-wing populism with its Social Credit government, and Saskatchewan embraced left-wing populism with the rise of the CCF, the Social Credit policies of William Aberhart and Ernest Manning were not radically different from the policies proposed by Tommy Douglas's CCF. The exception was Saskatchewan's brief experimentation with import substitution and public entrepreneurship in the CCF's first term 1944-to-1948.[2] In the years following 1948, the CCF harmonized its natural-resource royalty regimes with those of Alberta and renounced its interest in nationalizing resources and industries. Afterwards, the big differences in public policies between the two provinces would be Saskatchewan's sales tax, introduced by the Liberals in the 1930s, and the public health insurance that Saskatchewan introduced in 1962. With the rise of oil prices following the formation of OPEC, and during Peter Lougheed's tenure as premier of Alberta, the provinces radically diverged in terms of private incomes and levels of government spending and revenue. These changes manifested themselves in the expansion of spending by the Alberta government in areas of health care, education, social services, investment in infrastructure and a decision to increase the province's share of resource rents as a way to pay for these services.

Throughout the histories of Saskatchewan and Alberta, the governments in power have sought to diversify the provincial economies. Neither province had much success in this regard before the 1970s as the fates of the two economies followed the price cycles of the natural resources each produced for export. In the 1970s, in response to rising resource prices, both provinces pursued strategies of public entrepreneurship in resource sectors that differed only in the degree of public participation. Peter Lougheed's public entrepreneurship in the oil patch promoted the development of forward processing with the petrochemical industry and it served to promote domestic ownership and control in the oil and gas sector in Alberta. For example, the Alberta Energy Company was created in 1973 as a joint public-private venture with 50 percent of the shares held by the provincial government. Where Lougheed's Alberta was content to participate in a booming industry, Saskatchewan in the 1970s turned towards the creation of government owned and operated corporations. In 1973, the Government of Saskatchewan created the Saskatchewan Oil and Gas Corporation (SaskOil) in response to the decisions of the major oil companies to concentrate prairie petroleum refining in Alberta and to phase out their Saskatchewan and Manitoba refineries (Richards and Pratt 1979). In 1975, Allan Blakeney's NDP government created the Potash Corporation of Saskatchewan during a period of instability in the potash industry.[3]

In the past, residents of the two provinces tended to view the border only as a political line on a map, to the extent that it enabled the voters of Alberta and Saskatchewan to support different public policies; many observers no longer consider it to be so benign. Hirsch and Roach (1999) suggest what many believe: Saskatchewan's provincially owned commercial ventures and social programs led to slower growth for the province, less wealth and a smaller economy than Alberta's. While Saskatchewan residents have benefited from the ability to set their

2 Kenneth David Falconer (1978) Tommy Douglas, 1930-1944: A Case Study of Leadership and Social Structure (MA Thesis, Canadian Plains Studies, University of Regina). Richards and Pratt (1979).

3 In 1976, ex-premier Ross Thatcher and several former ministers and deputy ministers in Saskatchewan were named as co-conspirators in a U.S. anti-trust case against potash producers.

own policies, critics argue, that power may have come at a high price in terms of standard of living. The impact on economic growth of Saskatchewan's industrial policies and higher taxes is difficult to assess because it is also possible that the different growth paths of the two provinces reflect differences in resource endowments. One way of appreciating the impact of resource endowments is to use Manitoba, which enjoys the benefits of few non-renewable resources, but is a similarly small province, as a counterfactual for the experience of Saskatchewan. During the potash boom of the 1960s, Saskatchewan's per capita income converged with that of Alberta's. Then, when the rise in potash prices slackened and oil prices rose rapidly in the aftermath of the formation of OPEC, per capita income in Saskatchewan again fell below Alberta and returned to levels similar to that in Manitoba. It is notable that at no time did Manitoba per capita income exhibit convergence with that in Alberta. What this suggests is that it is difficult to separate the role of public policies from resource prices in determining growth and standards of living using a macro approach. For this reason we take a more micro approach in comparing public policies in Alberta and Saskatchewan.

The Economic Consequences of a Public Policy Union

In this section we consider the benefits and costs of different types of fiscal arrangements that might be considered by Alberta and Saskatchewan. All involve ways of adjusting the jurisdictional boundaries between the two provinces. An effective, if not literal, adjustment to the jurisdictional boundary is possible if the two governments choose to increase policy cooperation in certain areas of provincial jurisdiction. More ambitiously, a policy union in which the two provinces agree to a common tax regime, a common design to spending programs and a common regulatory regime is possible. A still bolder step is to literally erase the boundary and create a political union in which the two provinces unite into one, with a single provincial government. Such a union would enable a closer and more complete policy union than is otherwise possible.

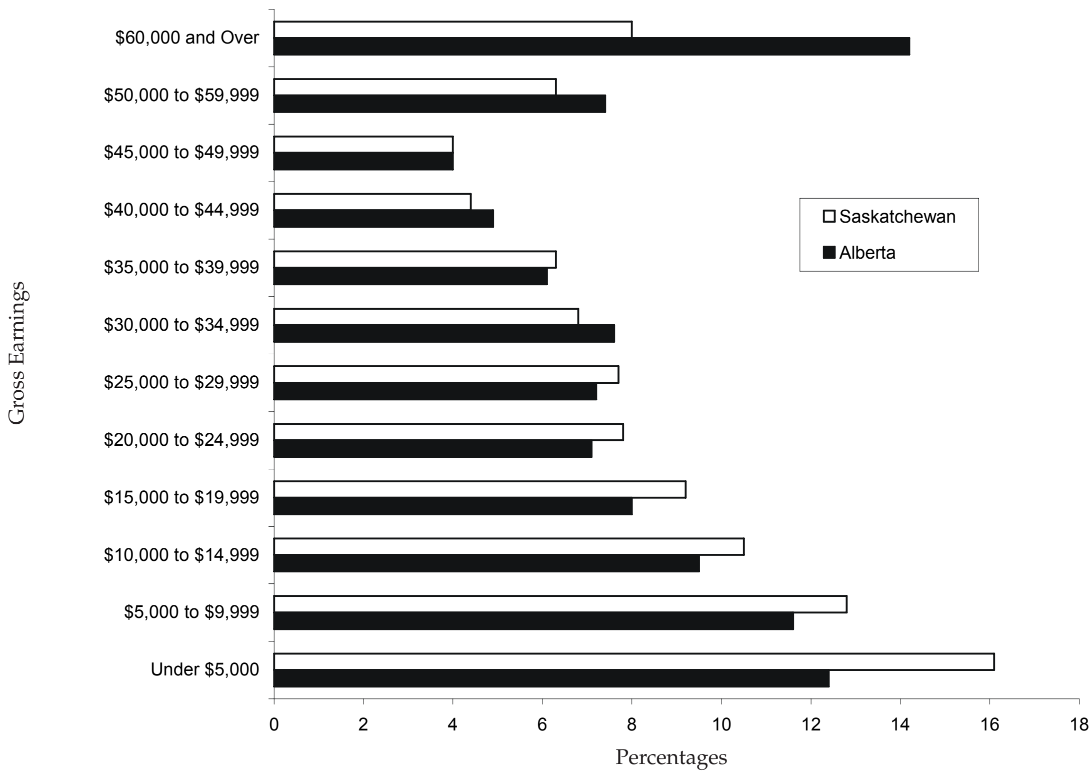
When contemplating a move toward any type of union, be it greater government cooperation, a policy union or a political union, voters in each region must weigh the costs and benefits of union.[4] A closer policy union is obviously costly when the preferences of citizens in the two jurisdictions are significantly different. We begin then, with an investigation of this issue.

Differences in Preferences

If voters in the two regions are homogeneous in their preferences for taxes and publicly provided goods and services, the gains from a policy union are strong because the benefits of retaining more localized government are small. Bolton and

4 See Wellisch (2000) for a thorough discussion of the costs and benefits of government centralization. Risk sharing against regional shocks is a potentially important benefit of union not discussed here. This benefit is small if the candidates for union have highly synchronized business cycles. Kneebone and McKenzie (1997) show real per capita provincial GDP in Alberta to be far more closely synchronized with that in Saskatchewan than any other province.

Figure 1: *Distribution of Earnings, 2001*



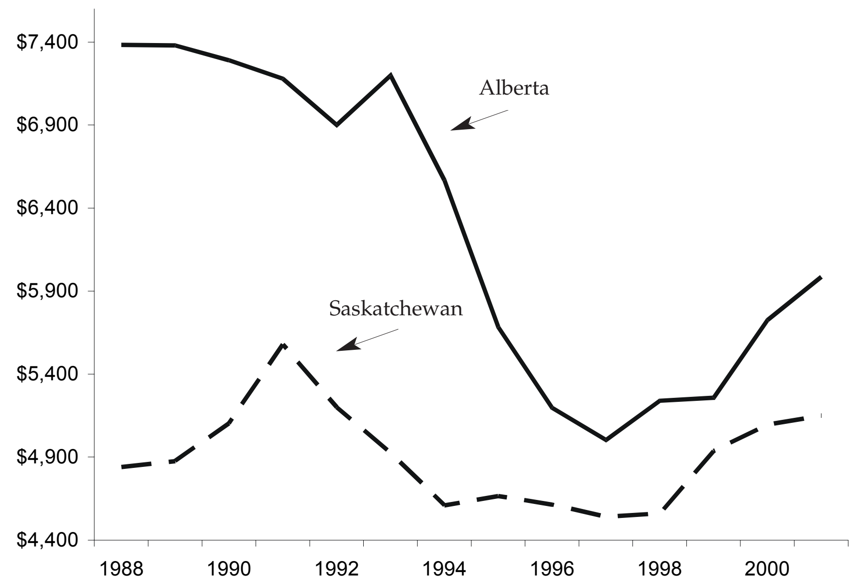
Roland (1997) emphasize differences in income distribution as being a key determinant as to whether citizens in the two regions have different preferences for tax rates and levels of publicly provided goods and services. Differences in income distribution imply different preferences for redistribution policies, in particular. Where these differences are large, conflict may arise over the design of tax systems and the generosity of income-redistribution programs. Differences in demographics may also result in different preferences for publicly provided goods. For example, an older population may demand a more generous health-care system.

Figure 1 shows some potentially important differences in the income distributions for Alberta and Saskatchewan in 2001. The respective income distributions differ significantly at both the upper and lower ends of incomes. In 2001, average earnings were $32,853 in Alberta and $26,607 in Saskatchewan. Median family earnings were $25,819 in Alberta and $20,914 in Saskatchewan.[5] The fraction of the total population aged 65 years and older is larger for Saskatchewan than for Alberta and is projected to remain so.[6]

5 Data on distribution of earnings are from Cansim II Table 2020101. "Earnings" refers to wages and salaries plus self-employment income, all measured before tax. It excludes investment and retirement income.

6 Demographic projections assuming medium rates of natural increase and immigration suggest the current 4.4 percentage-point gap in the percentage of the population aged 65 years and over will shrink to 2.2 percentage points over the next 25 years.

Figure 2: *Real Per Capita Program Expenditures (millions of 2001 dollars)*



Source: Public Accounts of the Governments of Alberta and Saskatchewan, various years. Population data are from CANSIM series D9 and D10. Nominal values are deflated using provincial all-items CPI.

Differences in age and income distribution can find expression in two areas of provincial fiscal policy in particular: income-tax policy and the design of welfare programs. Identifying differences in voter preferences in the form of tax and expenditure choices can sometimes be difficult, however, if these choices are made under different constraints. Thus, Alberta taxpayers, as a result of large natural resource revenues, are typically able to support generous spending levels while enjoying low taxes. Taxpayers in Saskatchewan enjoy the benefits of smaller amounts of natural resource revenues and must make tax and expenditure choices subject to a tighter budget constraint.

Recently, economic and political events have conspired to put taxpayers in the two provinces on a somewhat more even footing. In May 1993, in his first budget as Alberta premier, Ralph Klein introduced a plan to reduce program spending by 20 percent by the end of fiscal year 1997. To that end, over the next four years, the government of Alberta required that decisions about spending be subject to a much tighter budget constraint than had been previously the case. Similarly, in 1991, a fiscal crisis in Saskatchewan required difficult choices to be made to rein in deficits and pay down debt. The early 1990s, then, saw both provinces in a position of facing a very tight budget constraint. Figure 2 shows the effect of these tighter constraints on real per capita program spending in the two provinces. It is especially useful to compare provincial differences with respect to these policy choices during periods of fiscal stress because it is then that tradeoffs must be made and principles put to the test.

The provincial governments of Alberta and Saskatchewan each impose taxes on the incomes of corporations and small businesses. Table 1 presents data on the key

Table 1: *Taxes on Business*

	1993	1995	2000	2001	2002	2003
				%		
Corporate Income Tax, Small Business Rate						
Alberta	6.0	6.0	6.0	5.0	4.5	4.0
Saskatchewan	8.5	8.0	8.0	8.0	6.0	6.0
Corporate Income Tax, General Rate						
Alberta	15.5	15.5	15.5	13.5	13.0	12.5
Saskatchewan	17.0	17.0	17.0	17.0	17.0	17.0
Capital Tax, Financial Institutions						
Alberta	2.0	2.0	1.0	0.0	0.0	0.0
Saskatchewan	3.3	3.3	3.3	3.3	3.3	3.3
Capital Tax, General						
Alberta	0.0	0.0	0.0	0.0	0.0	0.0
Saskatchewan	0.6	0.6	0.6	0.6	0.6	0.6

Source: Budgets of the Governments of Alberta and Saskatchewan, various years.

characteristics of business taxes imposed by the two provinces since 1993. Only those years in which a change in a tax rate was announced are reported.

Both provinces have reduced the rate charged on small businesses. However, Alberta has also reduced the general rate and eliminated the capital tax on financial institutions; Saskatchewan has not followed suit. Saskatchewan maintained a general capital tax at a rate of 0.6 percent throughout this period, while Alberta has imposed no such tax. A capital tax is paid on corporate assets, while a corporate income tax is paid on the company's profit. As a consequence, even a relatively low capital-tax rate can generate a good deal of income. In fiscal 2003, for example, the corporate capital tax raised $340 million in revenue for the Government of Saskatchewan, while the corporate income tax raised just $118 million.

Corporations in Saskatchewan thus face a substantially higher relative tax burden than might be suggested by a simple comparison of statutory corporate income tax rates.[7] Financial constraints undoubtedly play an important role in explaining why Saskatchewan has been unable to match Alberta's cuts to tax rates on financial institutions and its cuts to the general rate on corporate income. It is noteworthy that Saskatchewan has still been able to match, and indeed surpass, Alberta's cuts to the small-business rate on corporate income. The pressure of tax competition on Saskatchewan will continue because Alberta announced in its 2003 budget that it will further reduce its general corporate income tax rate to 11.5 percent from 12.5 percent and the small business rate to 3 percent from 4 percent in 2004. In its 2003 budget, Saskatchewan announced plans to keep pace by reducing its small business rate to 5.5 percent from 6 percent in 2004 and to 5

7 A summary measure of the relative competitiveness of provincial tax systems is the so-called marginal effective tax rate, or METR. The METR on capital takes into account all relevant taxes and tax base definitions that affect the rate of tax paid by a corporation. Chen and Mintz (2003) report METR values on capital for Canadian provinces and report that in 2003, considering both federal and provincial taxes, the METR was 26 percent in Alberta and 36.7 percent in Saskatchewan. In 2003, the METR in Saskatchewan was the highest in Canada.

Table 2: *Personal Income Taxes*

	1993	1998	1999	2001	2002	2003
Tax on Tax Regime (percent of federal tax rate)						
Alberta	45.5	44.0	44.0			
Saskatchewan	50.0	50.0	48.0			
Tax on Base Regime						
Low rate — Alberta				10.0	10.0	10.0
Low rate — Saskatchewan				11.5	11.25	11.0
High rate — Alberta				10.0	10.0	10.0
High rate — Saskatchewan				16.0	15.5	15.0
Income exemption — Alberta				$12,000	$13,339	$13,525
Income exemption — Saskatchewan				$8,000	$8,000	$8,000

Source: Budgets of the Governments of Alberta and Saskatchewan, various years.

percent in 2005, though it made no announcements indicating reductions in the general rate or the capital tax rate.

Following extensive federal-provincial negotiations, provincial governments have been able to replace the tax-on-tax approach of provincial personal income taxation with a tax-on-base approach. This change enables provinces to define their own tax brackets and basic exemption levels. Thus, provinces now have far greater scope to design a personal income tax system that more closely reflects the preferences of the electorate in that province. Table 2 presents the key characteristics of the personal income tax regimes in the two provinces, both before and after the switch to the tax-on-base system. We provide data for those years when tax rates changed.

Alberta had been able to afford a personal-income tax regime with lower rates throughout this period. In 1998, while still under the tax-on-tax system, Alberta reduced its personal income tax rate and Saskatchewan followed, in the next year, with a larger reduction. After moving to the new tax-on-base system, Alberta adopted a constant marginal tax rate of 10 percent. Saskatchewan chose to establish three tax brackets (a reduction from the five that existed under the tax-on-tax system) and maintained a regime characterized by a rising marginal tax rate.[8] The marginal rate on the lowest income bracket remains higher in Saskatchewan than in Alberta, though since 2001 Saskatchewan has been gradually closing the gap. It is notable that the marginal rate on high income (in excess of $100,000), which is arguably the tax rate paid by more mobile taxpayers, is being reduced in Saskatchewan more quickly than the marginal rate on low income. Finally, the income-exemption level is lower in Saskatchewan than in Alberta though, while the level in Alberta is indexed for inflation, there is no indexation in Saskatchewan.

Hale (2000) emphasizes that recent changes to provincial income tax policies "have been closely tied to the political outlooks of individual provincial

8 Boothe (2002) suggests that this choice of tax rates and brackets was such that for the majority of Saskatchewan taxpayers, the differences in personal taxes owed was roughly equivalent to the difference in the cost of living in major centres in the two provinces. As of January 1, 2003, Saskatchewan's personal income tax has a basic exemption of $8,000 and applies a tax rate of 11 percent on the taxable income up to $35,000, a tax rate of 13 percent on taxable income between $35,000 and $100,000 and a tax rate of 15 percent on taxable income above $100,000.

Table 3: *Welfare Benefits in Alberta and Saskatchewan*

	Saskatchewan						Alberta					
	Single Employable	Person with Disability	Single Parent one child	Couple, two children	Welfare Recipients	Unemploy -ment Rate	Single Employable	Person with Disability	Single parent one child	Couple two children	Welfare Recipients	Uemploy -ment Rate
	($)	($)	($)	($)	(thousands)	(%)	($)	($)	($)	($)	(thousands)	(%)
1993	5,760	8,280	10,381	14,744	68.2	8.2	5,413	6,582	9,876	15,391	196.0	9.6
1994	5,762	8,283	10,384	14,805	81.0	6.8	4,730	6,570	9,195	14,476	138.5	8.7
1995	5,760	8,280	10,381	14,803	82.2	6.6	4,728	6,587	9,191	14,621	113.2	7.8
1996	5,761	8,522	10,384	14,807	80.6	6.6	4,729	6,590	9,194	14,626	105.6	6.9
1997	5,272	7,737	10,382	13,941	79.7	5.9	4,756	6,616	9,268	14,692	89.8	5.8
1998	5,289	7,812	9,289	13,540	72.5	5.7	4,825	6,686	9,186	14,469	77.0	5.6
1999	5,540	8,160	9,484	13,753	66.5	6.1	4,824	6,858	9,080	13,985	71.9	5.7
2000	5,647	8,254	9,450	13,457	63.8	5.2	4,822	7,377	8,964	13,866	64.8	5.0
2001	5,770	8,421	9,398	13,327	60.9	5.8	4,822	7,377	8,738	13,420	58.0	4.6
2002	5,808	8,436	9,687	13,076	56.1	5.7	4,824	7,380	8,565	13,073	53.8	5.3

Source: Dollar figures are annual payments measured in nominal dollars. Real values are reported in Welfare Incomes 2002, National Council of Welfare (www.ncwcribes.net). We thank Joanne Roulston of the NCW for providing us with the nominal values. The number of welfare recipients is an estimate of the number of people on welfare as of March 31st. Source: Human Resources Development Canada, Strategic Policy Branch, Social Policy Directorate. Provincial unemployment rates are for the calendar year (CANSIM V691983 and V692006).

governments and their relative emphasis on promoting private sector wealth creation, rather than income redistribution and the extension of public services." This was especially true of the NDP government of Saskatchewan, which despite a preference for raising revenues via a progressive income tax system, also faced a system in Alberta that offered sharply lower marginal rates and appeared to be attracting upper income taxpayers to Alberta. A compromise was struck under which Saskatchewan maintained a system of rising marginal tax rates, though the top rate applies only to taxable income over $100,000. A significant broadening of the sales tax base in 2000 covered the resulting loss in income-tax revenue. As a result, Saskatchewan's policy choices with respect to personal income and sales taxation reflect the net influences of tax competition with Alberta and the preferences of Saskatchewan voter-taxpayers.[9]

Another area of provincial fiscal policy that might be sensitive to the distribution of income is welfare policy. Table 3 shows total income paid to welfare recipients in the two provinces in 1993 and in 2002. The monetary values are measured in nominal dollars.

Between 1993 and 2002, Alberta and Saskatchewan chose to reduce welfare benefits. The similarity of the changes in the two provinces over this period is

9 Rushton (2000) similarly stresses that many of the changes to the personal income tax had been debated in Saskatchewan for over a decade before this, and he says it would be a mistake to conclude the changes were driven solely by tax competition.

greater than the differences. In both provinces, the nominal dollar reduction in benefits was large, particularly for single, employable recipients in Saskatchewan in 1997, and in Alberta in 1994.

Despite the broad similarities of the changes in welfare payments, in Alberta the reduction in the number of recipients has been much larger. We would expect the state of the labour market to play an important role in determining the number of welfare recipients. Between 1993 and 1997, the unemployment rate in Alberta fell rapidly, and the number of people receiving welfare declined to 89,800 from 196,000. In Saskatchewan, the unemployment rate fell less quickly than in Alberta, though it still declined by an impressive 2.3 percentage points. Still, the number of welfare recipients increased to 79,700 in 1997 from 68,200 in 1993. Since 1997, unemployment rates in the two provinces have been quite similar and fairly steady, and the number of welfare recipients has fallen steadily in both provinces, though somewhat more so in Alberta. In 1993, roughly 7 percent of the population in each province was receiving welfare. By 2002, only 2 percent of the population in Alberta was receiving welfare, compared to 6 percent in Saskatchewan.
The similarity in the changes to welfare benefits, and the observed relationship between the state of the labour market and the number of welfare recipients, points to differences in the administration of welfare programs as the explanation for the dramatic fall in the number of recipients in Alberta, compared with Saskatchewan. The impact of administrative changes on the relative number of welfare recipients in the two provinces was compounded by the fact that changes made by one province were often made in the opposite direction by the other. For example, in 1992, Saskatchewan set the time that a single parent would be ruled unemployable to six years following the birth of a child, while in 1993, Alberta shortened this period from two years to just six months. Similarly, while Alberta more strictly enforced rules regarding common law relationships, Saskatchewan eased the enforcement of these rules. In general, while Alberta was shifting resources into enforcement and allowing caseworkers more discretion and more investigative powers, Saskatchewan was doing the opposite (National Council on Welfare, (1997)).

Taxes and transfers in Saskatchewan tend to be designed to reduce income inequality much more than is the case in Alberta.

Finnie (2001) reported on relative levels of income inequality across provinces and the relative contributions of earned income, taxes and transfers on such inequality. He reports that as of 1994, the design of taxes and transfers were such as to equalize disposable incomes much more in Saskatchewan than in Alberta. While the tax and transfer system acted to reduce income inequality in Alberta, it did so less than in any other province and much less so than in Saskatchewan. While Finnie's analysis stops in 1994 and does not provide information on the effects on income redistribution from more recent policy changes, it would seem unlikely that the changes in personal taxes and social assistance programs that we have described since that time have changed his conclusion.

In both these areas — tax policy and the design of welfare programs — it can be argued that the differences in choices for taxation and publicly provided goods and services reflect differences in voter preferences as predicted by differences in age and income distributions. Saskatchewan has a significantly lower median income and an income distribution that is much less heavily skewed towards higher incomes than Alberta. Consistent with that, Saskatchewan has maintained a more generous welfare system than Alberta and, while Alberta chose a flat 10-percent marginal income tax rate Saskatchewan retained an income tax system with rising marginal tax rates. It is interesting to consider that while differences in statutory tax rates seem to reflect voter preferences in the two provinces, by trying to satisfy these preferences governments may be producing changes to the tax system that either do little to achieve that result or do the opposite to what voters hope. This may be so because the economic incidence of tax changes is often quite different in their impact on income distribution than suggested by their statutory incidence. For example, while relative changes in personal tax rates since 1994 indicate an increase in after-tax income inequality in Alberta, compared with Saskatchewan, the economic incidence of the changes may have had a different influence. This is possible because to the extent that maintaining relatively high tax rates on more mobile skilled workers causes them to migrate to low-tax jurisdictions, the earned incomes for those skilled workers who remain in the high-tax jurisdiction rise until after-tax incomes are equalized. In this way, efforts at income redistribution via provincial tax policy may be undone by the free mobility of labour.

Feldstein and Wrobel (1998) present evidence of just this effect, using data from U.S. states, and they speculate that state politicians still introduce redistributive measures because they know they are politically popular. This popularity is due to a fiscal illusion that causes voters to fail to appreciate that pre-tax earnings adjust to tax changes, rendering efforts at income redistribution ineffective. In a similar way, the gap in after-tax incomes may have shrunk since 1994 due to the different policies in the two provinces regarding business taxes. In a small, open economy, cuts to business taxes benefit consumers by enabling companies to reduce prices, and help workers as the companies invest in increases in labour productivity and pay higher wages. Shareholders, who typically enjoy higher incomes, gain less from business tax cuts because in an open economy international markets fix rates of return. Alberta's efforts to cut business taxes, and Saskatchewan's inability or unwillingness to match those cuts, may therefore have reduced inequality in earned income in Alberta compared with Saskatchewan since 1994. If, as Feldstein and Wrobel speculate, in politics it is statutory incidence that matters, it is not surprising that while in Alberta business taxes keep falling across the board, in Saskatchewan cuts to those levies have been smaller and more selective in favour of small business. The economic incidence of Saskatchewan's business-tax policies may, however, have been in the opposite direction than that favoured by the province's voters.

If preferences for tax design and income redistribution differ across provinces, a closer policy union can be justified only by reference to efficiency gains that are large enough to offset the benefits of policy independence. The efficiency gains from a policy union between two provinces would result from citizens being able to enjoy benefits from economies of scale. Those advantages would result from the internalization of provincial fiscal externalities and benefits due to freer access to a larger market for goods, services, labour and capital. Companies operating in both jurisdictions can also potentially benefit from harmonization of regulations. To the extent that provincial fiscal policies differ, union can also enable a more efficient allocation of mobile resources by internalizing fiscal externalities.

Internalizing Externalities

Provincial taxation is problematic when the subject of the tax can move out of the jurisdiction to avoid it. Thus relatively high-income individuals may flee high-tax areas in favour of low-tax jurisdictions. Capital may similarly respond to differences in tax treatment across jurisdictions. The relatively high-tax region thus generates a fiscal externality (an outflow of high-income individuals and capital) enjoyed by the relatively low-tax jurisdiction. Unable to internalize that external benefit, the relatively high-tax jurisdiction taxes mobile factors at too low a rate. With inefficiently low tax rates, the jurisdiction might also provide an inefficiently low level of publicly provided goods and services. This problem arises because the two taxing jurisdictions are too small; mobile factors can escape the tax by fleeing the jurisdiction.[10]

A similar problem exists with respect to provincial expenditure policies. When public expenditures benefit those outside the jurisdiction of the government making the expenditure, that government will fail to take those benefits into account when reaching spending decisions and will consequently spend less than what is optimal from the point of view of those in all jurisdictions. As is true with respect to taxation, the source of this problem is that the spending jurisdictions are too small. The existence of such public expenditure externalities may be particularly significant in Canada because of the extensive list of provincial spending responsibilities and the free mobility of people across provincial boundaries. The large in-migration of people into Alberta and the large out-migration from Saskatchewan suggests Alberta has been a net beneficiary of spending by other provinces and Saskatchewan has been a net supplier of those benefits to other provinces. A specific example of a fiscal externality on the spending side is the financing of post-secondary education in Alberta and Saskatchewan. Through inter-provincial migration, Alberta has been a net beneficiary of post-secondary education financing from all provinces, but particularly Saskatchewan. Provincial government transfers per student rose to $14,663 in 2000/2001 from $12,308 in 1992/1993 in Saskatchewan, while falling in the same period to $10,531 from $13,374 in Alberta.[11] It is interesting to note that Alberta is potentially the largest beneficiary of Saskatchewan's commitment to post-secondary education through inter-provincial migration. Indeed, Alberta may find it cost effective to import talent, rather than training its own to meet labour-market needs.

The solution usually proposed to solve the fiscal externality problem is a cooperative policy by which the two regions agree to impose the same tax rates on mobile factors and to coordinate spending programs. In this way, the two regions are essentially made larger with respect to policy settings and are forced to internalize fiscal externalities. For example, imposing a common standard on post-secondary financing in the two provinces would eliminate Alberta's ability to free-

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10 Externalities also arise due to tax exportation, when the tax authority is able to collect tax revenue from outside its jurisdiction. In that case, the problem is that the tax jurisdiction is in some sense too large.

11 CAUT Almanac of Post-Secondary Education in Canada, 2002, Tables 6.2 and 6.3.

ride off Saskatchewan's post-secondary education system. While specific cases such as this can be identified, how generally applicable is this solution to the fiscal externality problem in the specific case of Alberta and Saskatchewan?

On the revenue side, the fiscal externality problem exists only if the tax base is in fact mobile among jurisdictions and is sensitive to tax differences. Consider, first of all, the tax base for business taxes. Of the 800 largest (by revenue) corporations in Canada in 2002, 205 have their headquarters in one of the four western provinces, with 76 in British Columbia, 90 in Alberta, 15 in Saskatchewan and 24 in Manitoba.[12] Alberta's large corporations are dominated by the oil and gas sectors with energy (28), utilities (10) and oil-field service (10) accounting for over half of the province's large corporations.[13] Among Saskatchewan's five largest corporations, two are potash/fertilizer producers, one of which was a Crown corporation until the late 1980s. The largest corporation in Saskatchewan is Federated Cooperatives Ltd., and the third largest is the Saskatchewan Wheat Pool. Saskatchewan also lacks large subsidiaries, with no entries in the Top 100 subsidiaries in the National Post FP500 ranking. Alberta, on the other hand, has eight entries, while British Columbia has five, and Manitoba, four. Thus, one interpretation of Saskatchewan not following Alberta's reductions on tax rates for large corporations is that Saskatchewan perceives that it has little to gain by cutting corporate tax rates on large corporations because the ones it has are not mobile. On the other hand, of course, the province would lose little revenue from cutting these tax rates while gaining the benefit of possibly attracting companies from elsewhere. It is difficult to assess the importance of the tax rate as a factor in discouraging large corporations from choosing to locate in Saskatchewan because that issue would have to be disentangled from the effects of Saskatchewan's small local markets, its distance from external markets and other factors due to location. In any case, the mobility of large corporations may not be the most important consideration when it comes to Saskatchewan setting its large corporation tax rates. By choosing not to cut taxes to large corporations, Saskatchewan may be foregoing not only the opportunity of attracting large corporations, it may also be foregoing the opportunity of keeping small companies that expand. Thus, the impact of business-tax competition on the economy of Saskatchewan may prove more important over time than in the short-run.[14] Again, this is a difficult proposition to prove empirically.

Saskatchewan lacks large subsidiaries, with no entries in the Top 100 subsidiaries in the National Post FP500 ranking.

Day and Winer (2001) use data constructed from personal income tax files for the years 1974-to-1996 to investigate the sensitivity of the inter-provincial

12 Source: "FP500: The Rankings", *National Post Business*, June 2003. The 100 largest corporations had revenues of $2.76 billion-to-$37 billion in 2002; the 101st-to-200th largest had revenues between $1.2 billion and $2.76 billion and the 201st-to-800th ranked corporations had revenues between $0.269 billion and $1.2 billion.

13 In B.C., forestry (12) and services (9) are the dominant industries for head offices. In Manitoba, farming (6) is the largest single sector.

14 While Saskatchewan has not kept up with Alberta's cuts to taxes on large corporations, it has been much more vigorous in keeping up with Alberta's cuts to taxes on small businesses. This indicates that Saskatchewan is concentrating its limited financial resources on retaining what it perceives to be relatively more mobile businesses or, as we suggested earlier, that it is simply introducing tax cuts in an area that is politically popular.

migration of people to differences in the personal income-tax base, to differences in tax rates and to differences in publicly provided goods and services. They report that the major determinants of inter-provincial migration are differentials in non-policy related factors. Differentials in earnings, employment prospects and moving costs proved to be the key determinants of inter-provincial migration, with moving costs being the most important of these. The impact of public policies on the volume of inter-provincial migration was found to be small, both absolutely and relative to the non-policy related factors. What's more, the amount of policy-induced migration that they found was due mainly to the design of the federal Employment Insurance program, as opposed to differences in provincially provided levels of social assistance, health care, education and personal income taxes. The elimination of all inter-provincial differences in both federal and provincial policy variables is predicted to affect the volume of inter-provincial migration by less than half of one percent.[15]

This is, however, another difficult issue to assess and to measure empirically. One problem is the lack of significant inter-provincial variation in provincial income taxes under the old tax-on-tax regime in use during the period studied by Day and Winer. Since the switch to the tax-on-base regime, there is now much more variation in provincial income tax systems and this may in future enable researchers to measure with greater precision the sensitivity of migration to tax differences. It is also likely the case that the responsiveness to tax levels differs by class of taxpayer. Boadway (2000), for example, suggests that entrepreneurs, companies and skilled persons might be more responsive to fiscal externalities than the average worker studied by Day and Winer. Boadway also recognizes, however, that even if fiscal externalities exist, these differences might get capitalized in land prices and rental costs. If capitalization occurs there would be no incentive for mobile factors to move. Beyond capitalization in land values, differences in tax regimes and tax levels can be offset by labour and other input costs. Still, lower land and labour costs in Saskatchewan attract different industries than lower taxes attract to Alberta. Only to the extent that higher-growth industries are more attracted by a favourable tax regime than lower land and labour costs would there be long-run growth implications for Saskatchewan from eliminating fiscal externalities in the form of tax-rate differences

There are a number of other reasons to expect that the efficiency gain from eliminating fiscal externalities could be small. Boadway (2000) notes that while the federal government has enjoyed some success inducing harmonization between the federal and provincial levels of government, it has been able to do so only by offering a quid pro quo: a single tax collection agency combined with some provincial input into tax policy. This suggests that an agreement between provinces to harmonize policies may require similar tradeoffs and a consequent dilution of the efficiency gains from harmonization. A similar argument can be made with respect to differences in the provision of publicly provided goods and services. Nor should the administrative costs of negotiating such harmonization agreements be

15 These results are consistent with a CWF survey that emphasized the importance of job opportunities as the key reason for migration. See Loleen Berdahl (2003) *Looking West 2003: A Survey of Western Canadians* (Calgary: Canada West Foundation).

discounted. Mintz and Poschmann (1999) describe the many technical difficulties that would be inherent in any attempt to harmonize provincial tax-on-base systems in a way that minimizes net fiscal benefit differentials. As well, Canada's system of equalization grants is another reason why the efficiency gain from eliminating fiscal externalities might be small. Equalization grants decrease the size of fiscal externalities that arise due to tax base mobility. That is because some of the lost tax revenue and some of the lost expenditures come back to the province in the form of equalization payments. For example, Saskatchewan exports university graduates, but receives cash transfers through the equalization program.[16]

On balance, it seems difficult to make an argument that efficiency gains from eliminating fiscal externalities are either large or present in all provincial revenue and spending categories. Certainly, there is little hard evidence to justify a blanket statement advocating policy coordination over all tax categories and all spending programs. Our conclusion is that while there are specific cases in which clear efficiency gains can be identified, the search for them has to be conducted on a case-by-case basis. As this search is conducted, it is also essential to keep in mind the influence of competition in taxes and publicly provided goods and services. Such competition forces provincial governments to minimize tax rates subject to citizens' demands for publicly provided goods and services. If labour and capital are more sensitive to provincial policy variables than Day and Winer suggest, then tax competition may already have produced a set of tax rates and levels of publicly provided goods and services that are optimal in the sense that they reflect strongly held differences in preferences between voters in the two provinces. Thus, efforts to erase all differences in tax rates and levels of public spending might be missing the point.

Economies of Scale

As we noted, Fox and Roach (2003) produce a lengthy inventory of over 150 examples of inter-provincial cooperation in the West. These are designed primarily to take advantage of economies of scale in publicly provided goods and services. As a result, there are joint efforts in promoting culture and tourism programs and in advanced education. Saskatchewan has established agreements enabling students from the province to get access to programs in Alberta and Manitoba in return for Saskatchewan covering the costs of expanding the programs to accommodate them. Overall, the CWF study shows a long list of areas of inter-provincial cooperation that suggests that the provinces have been able to coordinate on policies and programs when the mutual benefits of doing so are clear.

The potential for a policy union between Alberta and Saskatchewan to realize economies of scale in the provision of publicly provided goods and services is constrained by the fact that there is limited jurisdictional overlap for users of most government services. Local offices, for example, provide welfare services. It is also

16 This is why the brain drain across provinces is not as big a problem as Canada's brain drain to the U.S., where the income of the emigrants is lost to Canada as the sending country.

worth noting that the current fashion for shifting government services to more local levels of government — regional health authorities, for example — suggests at least very small economies of scale relative to the benefits obtained from tailoring programs to local preferences.[17,18] Bird and Slack (1993) and Bish (2001) report that studies found little evidence of substantial economies of scale even at the local level of government. Bish (2001) further notes that the production characteristics of publicly provided goods and services differ considerably by category so that it is difficult for any one organization to be an efficient producer of all. Thus, he concludes that the most cost-efficient form of local government is a polycentric system of small- and medium-sized organizations that also cooperate in providing those services that offer true economies of scale. While his comments are specifically directed toward local government organization, his conclusion echoes comments we offered previously with respect to the provision of goods and services that are the responsibility of provincial governments: While there are undoubtedly specific cases in which clear efficiency gains can be identified, there is little reason to believe that economies of scale are sufficient to justify a wholesale provincial policy union.

As always, even if such evidence of scale economies can be found they might be very difficult to obtain when preferences for different levels of provision or design are strong. This is emphasized by Boadway (2000), for example, who notes that achieving harmonization agreements among governments has proven quite difficult because of the need for unanimous agreement and because of different preferences for service levels. If two provinces have strongly opposed preferences, there seems little likelihood of harmonization. Citing research indicating that the preferences of citizens are better represented in more local governments, Bish (2001, page 18) concludes that “there is no reason to sacrifice the benefits of greater citizen participation and representation that are a feature of small governments only to create a larger government that costs more and provides services that are less likely to meet local preferences.”

At the extreme end of the spectrum of options for policy coordination — a complete political union — the citizens of what is now Saskatchewan would find the political landscape greatly changed. Currently, in Alberta, members of the Legislative Assembly represent on average 35,035 people, while in Saskatchewan the average MLA represents 16,878 people. In a merged province, assuming ridings averaging 35,000 people, the citizens of what is now Saskatchewan would be represented by 28 MLAs in a legislature with 111 members. A political union would

17 In 1916, the four western provinces tried to realize economies of scale in the provision of care for mentally and physically handicapped children. Each province was to provide care for all of the children in the western provinces who suffered from a particular mental or physical handicap (Boothe and Edwards eds., 2003). Similarly, in 1924, the three Prairie provinces co-operated to form a central sales agency, the Canadian Co-operative Wheat Producers Limited. The central selling agency was disbanded in 1930.

18 Both Alberta and Saskatchewan have established local provision of health services in the form of regional health districts. In both provinces, each health district is governed by a board of appointed and elected members who have the responsibility of planning, managing and delivering health services in their region.

thus have important implications for politics and the ability of citizens in what is now Saskatchewan to have their preferences satisfied.[19]

Inter-provincial Trade Barriers

From the perspective of the private sector, the economic benefits of a larger political union are less if companies in smaller political units can more easily trade with each other. This insight has been used in the literature on the impact of globalization on political boundaries (see for example, Alesina and Spolaore (1997) to suggest that increased economic integration will be associated with the break-up of nations and with an increase in regionalization within countries. Indeed, Courchene and Telmer (1998) say that increased economic integration with the United States has changed Ontario from the heartland of Canada to a North American region-state. Evidence suggests that at the present time, there are not significantly large distortions resulting from inter-provincial trade barriers to warrant a union. The empirical evidence indicates that the barriers that do exist do not have a large influence on inter-provincial trade. In addition, the federal government and the 10 provinces have developed an Agreement on Inter-Provincial Trade that is intended to remove those barriers that may still exist (Beaulieu, Higginson and Gaisford, 2002). From this perspective, if the Agreement is enforceable, then there should not be much more to gain from a policy union or merger of Alberta and Saskatchewan. In any event, Fox and Roach (2003) demonstrate that the western provinces are already cooperating in lowering inter-provincial trade barriers, indicating that there will not be large efficiency gains to be realized for long.

The Fiscal and Political Impact of Union

What would be the impact on provincial budgets of a comprehensive policy union? If we assume that the preferences of Albertans for tax design and program spending dominate those of the citizens of Saskatchewan, then a negotiated policy union would have implications for government spending and taxation in what is now Saskatchewan. To get some feel for this, we imposed upon Saskatchewan's provincial budget for fiscal year 2000 the requirement that in each revenue category, the province collected taxes on the same per capita basis as in Alberta. Similarly, we adjusted spending to be the same per capita amounts as in Alberta.[20]

This exercise shows that total program spending and total revenue collected in Saskatchewan would change noticeably. In particular, the mix of spending and

19 Of course, against this cost the citizens of what is now Saskatchewan would need to compare the benefit of sharing in the savings from financing just one combined legislature. But at a cost of $18 per person in fiscal year 2003, we doubt they will find the savings resulting from not having to finance the running of the Saskatchewan Legislature to be a significant inducement.

20 This is admittedly only a rough guide to what would happen to taxes and spending in Saskatchewan if it adopted Alberta's tax and spending policies. Demographic differences and the differences in income levels and income distribution we stressed earlier would affect these values, as well. Budget data are from CANSIM matrices 8484 and 8485.

revenue would change. For example, spending on social assistance would fall by $50 million (13 percent) and spending on all social services would fall by $198 million (18 percent).[21] On the other hand, spending on transportation and communications would increase by $108 million (42 percent). Spending on health, however, would decline by only 6 percent ($116 million).[22] On the revenue side, if Saskatchewan collected taxes on the same per capita basis as Alberta, the full amount of provincial general sales-tax revenue that Saskatchewan collected in 2000 ($666 million) would be lost when Alberta's zero tax rate was applied. The province would also lose the $281 million it collects in capital taxes. Still, the province would have gained $235 million in health-insurance premiums. The net effect of these and other changes to revenues and expenditures is that the $775 million surplus Saskatchewan enjoyed in 2000 by applying its own tax regime and spending according to its own programs would have turned into a significantly smaller $297 million surplus. Put differently, each citizen of Saskatchewan would have enjoyed the equivalent of a $485 tax cut.

A political, as opposed to a policy union, would raise an additional issue with respect to the budget of the new political entity. The new, larger provincial unit would be a province.[23, 24] In this case, the citizens of what is currently Saskatchewan would give up equalization payments – an amount equal to $393 per person in fiscal year 2000. They would, however, presumably gain a share of Alberta's natural resource revenue. Citizens of Saskatchewan would thus be trading one transfer for another. Interestingly, in 2000, the transfers were very nearly offsetting. As an independent province, each citizen of Saskatchewan received $958 in natural-resource revenue, as well as $393 in equalization payments, for a total of $1,351. In a merger with Alberta, each citizen in what is now Saskatchewan would receive $1,470 in natural-resource revenue and zero equalization for a net gain of just $119. Citizens of what is now Alberta would each lose $179. This is the difference between the $1,649 per capita of natural resource

21 Conveniently, the population of Saskatchewan in 2000 was just short of one million. Given the resulting ease with which they are calculated, we leave to the reader the derivation of per capita figures.

22 We point out 6 percent because Saskatchewan has an older population than Alberta. The fact that spending on health on the same per capita basis as Alberta results in a cut in health spending may not be surprising.

23 Another important difference in the two provincial budgets is the fact that since 1994, the province of Alberta has taken control of education financing and spending. As a result, provincial government spending on elementary and secondary education is much higher than in Saskatchewan, where the province has left that spending in the control of local authorities. Alberta finances that additional spending from the property tax, so this revenue source is also much higher than in Saskatchewan's budget. The two amounts are almost offsetting in their impacts on the budget balance.

24 In calculating the effect on Saskatchewan's budget surplus of adopting Alberta's tax and spending preferences, no adjustment was made to the amount of natural resource revenues collected in Saskatchewan or to transfers received from the federal government. To do so would have made Saskatchewan appear to have Alberta's resource base and would have removed equalization payments from the hypothetical budget. Similarly, return on investment and debt charges were also not adjusted because that would have caused the hypothetical budget to reflect Alberta's lower debt position and the interest income generated from Alberta's Heritage Fund.

revenue each Albertan received in 2000 and the $1,470 that would be distributed in the unified province.

Conclusion

In 1905, Wilfrid Laurier's government established the provinces of Saskatchewan and Alberta with a border running north-to-south and drawn to create two provinces approximately equal in area, population and economy. Over time, the effect of the political boundary has delineated two increasingly unequal economies. In this paper we have investigated the possible benefits of a range of changes from greater policy coordination between the two to a political merger of Alberta and Saskatchewan into a single unified province.

In discussing the benefits of greater policy coordination, we have relied on an assumption that the policies adopted by the governments of the provinces of Alberta and Saskatchewan reflect the preferences of voters. These preferences were put to the test in the 1990s as both governments faced a much tighter budget constraint than had previously been the case. Despite facing a serious financial crisis in the early 1990s and very tight finances after that, the government of Saskatchewan chose to maintain a significantly more generous system for the allocation of welfare benefits than Alberta; it also opted to maintain a personal tax system with a rising marginal tax rate, even while Alberta was adopting an income-tax system with a lower constant marginal tax rate and more generous income exemptions. We have argued that these choices are consistent with the relative shapes of income distributions in the two provinces. Choices with respect to business taxes similarly indicate different preferences and different priorities. The government of Saskatchewan has chosen, in the face of numerous cuts to business taxes in Alberta, not to cut to the same extent, or in the same manner. In particular, it has chosen not to follow Alberta in cutting taxes to large corporations, but has been more aggressive in matching tax cuts to small businesses. This choice may reflect the fact that Saskatchewan has relatively few large corporations it might fear losing due to tax competition. It may also mirror a perception that while cutting taxes to big companies is politically unpalatable, reducing taxes for small business is less so.

The decision not to match Alberta's business tax cuts may also be an indication that governments in Saskatchewan have less faith than those in Alberta in the power of tax incentives to attract large companies from outside the province, or to retain small businesses that become large. This interpretation suggests a more ingrained difference in the political and economic philosophies of the governments and voters of the two provinces, one reflected in long-term political differences. Except for relatively brief experiences with a Liberal government from 1964-to-1971 and a Progressive Conservative government from 1982-to-1991, governments in Saskatchewan have been led by the New Democratic Party and its CCF predecessor since 1944, while governments in Alberta have been Social Credit- or Progressive Conservative-led since 1935.

This constancy in favouring political parties leaning to one side of the political spectrum — to the left in Saskatchewan and to the right in Alberta — has had long-run implications not only for tax policy and spending priorities, but also for industrial policy. These differences have not been absolute but of degree. When presented with a natural-resource boom in the 1970s, both provinces pursued strategies of public entrepreneurship in natural-resource sectors that differed only in the degree of public participation. Governments in Alberta preferred joint public-private ventures, while those in Saskatchewan preferred direct ownership. The goal of these policies was the same — to foster growth of locally controlled firms in a key industry — but they again reflected different preferences and a different perception of the free market. By the design of its industrial policy and by the choices made with respect to tax rates and the design of social assistance programs, Alberta has since the 1930s exhibited a greater belief and trust that the free market will prove to be the engine of wealth creation.

By its choices over these same parameters and over the same period of time, Saskatchewan has exhibited less faith in the market, or possibly a greater preference of income redistribution over wealth creation. In any case, our survey of tax and spending choices made during the recent period of fiscal stress, a period during which political and economic principles were put to the test, suggest this has always been a conscious choice.

A tendency to favour political parties leaning to opposite sides of the spectrum has long-run implications for the two provinces.

We have remarked on the fact that a problem that arises for governments seeking to satisfy the preferences of voters is that those preferences tend to be based on the statutory incidence of tax regimes. Thus, cuts to business taxes are typically attacked as a sop to owners of capital, even though the economic incidence of such tax cuts may be such as to favour wage earners and do relatively little for capital owners. Similarly, there is evidence that efforts at income redistribution using the personal income tax are undone at the provincial level due to the mobility of skilled workers. Thus, while differences in statutory tax rates may reflect differences in voter preferences in the two provinces, by responding to these preferences governments may be producing changes to the tax system that either do little to satisfy those desires or do the opposite to what voters expect. While possibly the most difficult proposition to prove empirically, it is interesting to speculate that by obeying the wishes of voters, provincial governments in Saskatchewan may have introduced a fiscal regime and an industrial policy that has over the long run proved to be simultaneously harmful to economic growth and to the goal of income redistribution favoured by the voters.

It is important to emphasize that preferences for public policies might differ in the two provinces. The government of Saskatchewan could choose to harmonize to Alberta's policies if the voters of that province expressed that preference. Significant differences in public policies toward tax design and income redistribution make it less than obvious that policy union involving those provincial fiscal policies would be deemed attractive by citizens in Alberta and Saskatchewan. Assuming one could be negotiated, a merger would force citizens in one or both provinces to surrender public policies that more closely reflect their preferences in favour of policies that reflect the preferences of a different majority. Against this loss of policy sovereignty, voters will have to consider the benefits of harmonization, if not a merger, in the form of savings due to greater economies of scale, internalization of provincial fiscal externalities and the elimination of trade barriers.

Fox and Roach (2003) show that adjustment to jurisdictional boundaries in narrow areas have occurred where the preferences are not likely to differ significantly across provinces and where benefits of coordination are clear to both sides. Our focus in this paper has been on the potential benefits of coordination with respect to the big ticket areas, such as tax policy, as well as spending on health, education and social services. The case for greater coordination is more difficult here because these are more politically sensitive areas in which preferences are more strongly felt and expressed. In our view the fact that the fiscal regimes and the industrial policies of the two provinces have remained different over many decades, even during the recent period of fiscal stress when the economic forces for harmonization have been strong, suggests that these differences in preference are firmly held. Overcoming those differences will form the critical challenge facing those advocating a merger, or some degree of greater policy coordination over key areas of provincial public policy.

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