Contracting for Tax Room: The Law and Political Economy of Tax-Point Transfers

Rory Gillis*

PRÉCIS
Les transferts de points d'impôt peuvent être un outil fondamental pour modifier la répartition de la marge fiscale entre les gouvernements, mais le fédéralisme fiscal canadien a abandonné leur utilisation. Cet article fait valoir que l'utilisation peu fréquente des transferts de points d'impôt peut s'expliquer, en partie, par les obstacles à l'exécution des contrats intergouvernementaux. Le problème est double : 1) les transferts de points d'impôt consistent généralement en des opérations non séquentielles à long terme qui permettent aux gouvernements de s'acquitter de leurs obligations à des moments très différents; et 2) les mécanismes courants pour assurer le rendement dans les opérations non séquentielles à long terme ne sont pas accessibles ou ont peu de poids dans les accords de transfert de points d'impôt. Cette situation fait en sorte que ces obstacles contractuels peuvent décourager les gouvernements d'utiliser les transferts de points d'impôt pour obtenir une répartition optimale de la marge fiscale.

ABSTRACT
Tax-point transfers are potentially a foundational tool for changing the allocation of tax room between governments, but they have fallen into disuse in Canadian fiscal federalism. This article argues that the infrequent use of tax-point transfers can be explained, in part, by impediments to the enforcement of intergovernmental contracts. The problem is twofold: (1) tax-point transfers typically consist of long-term non-sequential transactions, in which governments perform their obligations at substantially different points in time; and (2) the common mechanisms for assuring performance in long-term non-sequential transactions are either unavailable or of only modest force in tax-point transfer agreements. The primary implication is that these contractual impediments may discourage governments from using tax-point transfers to achieve an optimal allocation of tax room.

KEYWORDS: FISCAL FEDERALISM ■ TRANSFERS ■ TAX POINTS ■ TAX ROOM ■ FEDERAL-PROVINCIAL

* Doctoral (SJD) candidate at the University of Toronto Faculty of Law (e-mail: rory.gillis@mail.utoronto.ca). I would like to thank Michael Trebilcock, Benjamin Alarie, Michael Smart, Walter Melnik, Joanna Langille, Greg Bowley, Haim Abraham, Eden Sarid, John Enman-Beech, and Nadia Lambek for their helpful comments, as well as participants at the University of Toronto Faculty of Law workshop and the 2018 annual conferences of the National Tax Association and the Law & Society Association.
INTRODUCTION

In recent years, heated political debates have occurred in Canada and the United States over the allocation of revenue between federal and subnational governments. In 2016, the Canadian federal government reduced the annual growth rate for the cash transfers that it provides to the provinces for health care. The provinces vociferously protested, and eventually walked out of the meetings that sought to negotiate a new accord. (The impasse was resolved in early 2017.) In 2017, the

---

US federal government imposed a cap on the federal tax deduction available for state and local taxes (SALT), which effectively reduced the tax room available to the states.2 High-tax states announced plans to sue the federal government over the legislation.3

Amid the widespread controversy over the use of cash transfers and tax deductions in Canada and the United States, there has been little discussion of an alternative method for redistributing fiscal resources between governments—the use of tax-point transfers. A tax-point transfer occurs when one level of government lowers its tax rate on a tax base so that the other level of government can raise its tax rate by an equivalent amount. A tax-point transfer enables the transferee government to levy more tax points—the individual percentage points that make up tax room4—without increasing the combined federal-provincial tax rate.

Tax-point transfers were once common in Canadian fiscal federalism and were applied along various tax bases, including income tax. In 1942, the provinces transferred income tax points to the federal government in exchange for cash transfers. In 1972 and 1976, the federal government transferred income tax points to the provinces in lieu of pre-existing cash transfers and a series of credits and deductions for provincial taxes. But no income-tax-point transfers have occurred between the federal and provincial governments since 1976, and tax-point transfers have largely disappeared from federal-provincial negotiations.

This article has two objectives. First, it explains the primary function of tax-point transfers—they provide a coordinated means for changing, as circumstances warrant, the allocation of tax room between governments—and then it surveys the reasons why governments may wish to periodically change the allocation of tax room. Second, the article examines why tax-point transfers have fallen into disuse. Its central claim is that impediments to the enforcement of intergovernmental contracts provide a partial explanation. The problem is twofold: (1) tax-point transfers typically consist of long-term non-sequential transactions,5 in which governments

---


4 The term “tax point” can also refer to individual percentage points of tax receipts. See, for instance, the discussion of the 1976 tax-point transfer at note 45 and following below. In this article, I use “tax point” to refer to individual percentage points of tax room except when referring to the 1976 transfer.

5 I borrow this term from Trebilcock and Leng, who use it describe contracts where the two parties perform their obligations at substantially different points in time; see Michael Trebilcock and Jim Leng, “The Role of Formal Contract Law and Enforcement in Economic Development” (2006) 92:7 Virginia Law Review 1517-21.
perform their obligations at substantially different points in time; and (2) the common mechanisms for assuring performance in long-term non-sequential transactions are either unavailable or of only modest force in tax-point transfer agreements. These contractual impediments may discourage governments from using tax-point transfers to change the allocation of tax room, even when a change is in the public interest.

This article has four main sections:

1. In the first section, I define tax-point transfers, examine the prerequisites to their use, and briefly review two historical income-tax-point transfers.

2. In the second section, I examine tax-point transfers from the provinces to the federal government, which I refer to as “upward” tax-point transfers. First, I set out the primary reason why provinces may wish to increase the tax room allocated to the federal government: by transferring tax points to the federal government in exchange for subsequent cash transfers, provinces can reduce interprovincial tax-base shifting and increase the revenue of all governments. I then argue that upward tax-point transfers are rare, at least in part, because the most common tools for assuring contractual performance—judicial enforcement, the threat of termination or revocation, reputational sanctions, self-help, and the use of collateral—are of limited utility in tax-point transfer agreements. In the absence of effective enforcement mechanisms that ensure that the federal government will make good on the promised cash transfers, the provinces are unlikely to voluntarily surrender tax room.

3. In the third section, I examine tax-point transfers from the federal to provincial governments, which I refer to as “downward” tax-point transfers. First, I set out the primary reason why the federal government may wish to increase the tax room allocated to the provinces: downward tax-point transfers can resolve a number of incentive problems that arise in fiscal federalism. I then argue that the same contractual problems that afflict upward tax-point transfers render downward tax-point transfers unattractive from the federal perspective. In particular, in the absence of enforceable agreements, the federal government is likely to prefer alternative revenue-allocation mechanisms, such as cash transfers and deductions, which can be more effectively used to influence provincial spending decisions and advance federal interests.

4. Finally, in the fourth section, I consider the implications of the foregoing analysis for fiscal federalism and for law. For fiscal federalism, the contractual barriers to tax-point transfers mean that the allocation of tax room between governments may be suboptimal. For law, tax-point transfers shed new light on a legal doctrine—parliamentary sovereignty—that limits the capacity of governments to enter into enforceable intergovernmental agreements. While this doctrine seeks to maximize policy flexibility, it may actually limit the policy options available to governments.
WHAT IS A TAX-POINT TRANSFER?

Definition
A tax-point transfer has two elements. First, the transferor government lowers its tax rate on a tax base. Second, the transferee government raises its tax rate on the same base by an equivalent amount. These tax-rate changes are coordinated, so that the tax cut by the transferor government occurs in anticipation of the tax increase by the transferee government. A downward tax-point transfer (from the federal government to a province), for example, consists of a federal tax cut followed by a provincial tax increase. Conversely, an upward tax-point transfer (from a province to the federal government) consists of a provincial tax cut followed by a federal tax increase. Under either scenario, the transfer enables the transferee to increase its tax rate without increasing the combined federal-provincial tax rate.

A simple example illustrates the operation and effect of a tax-point transfer. Imagine a country with a national (“federal”) government and a single subnational (“provincial”) government, both of which occupy the same territory. Both governments impose a flat tax on income. The federal rate is 15 percent and the provincial rate is 5 percent, so that the combined federal-provincial rate is 20 percent. In this scenario, the federal government’s share of total income tax revenue is 75 percent and the provincial government’s share is 25 percent.

If the federal government transfers 5 tax points to the province, the federal tax rate falls to 10 percent and the provincial rate rises to 10 percent. The transfer has no effect on the combined federal-provincial tax rate, which remains at 20 percent, but changes the allocation of revenue between the two governments. The federal government’s share of income tax revenue decreases from 75 percent to 50 percent, while the province’s share increases from 25 percent to 50 percent. These results are shown in table 1.

For the provincial government, the value in the tax-point transfer comes from the tax room vacated by the federal government. In the absence of the transfer, the province could unilaterally increase its tax rate to 10 percent. The problem is that a unilateral tax increase would increase the combined tax rate to 25 percent. For two reasons, the province will almost certainly prefer that its tax increase be preceded by a 5-percentage-point federal tax cut. First, the size of the tax base—the total income available to be taxed—will typically be larger at a combined tax rate of 20 percent than at a combined rate of 25 percent, since taxpayers are more likely to engage in tax avoidance and evasion as tax rates rise. The result is that the province’s revenue will normally be higher if its 5-percentage-point tax hike is matched

6 This federal structure is admittedly unrealistic but simplifies the example.
by a 5-percentage-point federal tax cut. This revenue effect is commonly known as a vertical tax externality. Second, a tax-point transfer provides the province with at least partial political cover for its tax increase. If the province acts unilaterally, its tax increase will lower voters’ after-tax income, potentially reducing the provincial government’s popularity. In contrast, a provincial tax increase that is part of a tax-point transfer has no effect on voters’ after-tax income, and therefore is less likely to provoke a negative reaction.

While the mechanics of tax-point transfers are relatively simple, there are four nuances that are worth observing.

First, the term “tax-point transfer,” though well established in Canada, is arguably a misnomer. The term suggests that the transferor government gives the transferee government tax points that would not otherwise be available to that government. In actuality, the transferee could raise its tax rates even without a transfer. The real object of exchange in a tax-point transfer is not tax points, but a promise of forbearance: in return for the transfer, the transferor promises to lower its tax rate, at least for a period of time. In this way, tax-point transfers are a mechanism for managing the vertical tax externalities that result when two levels of government occupy the same tax base. One implication is that precisely specifying the terms of the forbearance—the duration and scope of the tax cut by the transferor—is important to the implementation of the transfer. The most significant upward tax-point transfers in Canadian history—the tax rental agreements commencing in 1942 (discussed in a later section of this article)—had five-year terms, during which the provinces promised not to levy income taxes. Downward tax-point transfers (from the federal government to the provinces), however, have typically not had time limits, and thus have given rise to debates over whether the transfers remained in place in the decades following their implementation.

---


9 See infra notes 128-131 and the accompanying text.
Second, the design of tax-point transfers can be varied to achieve different effects on the allocation of tax room and revenue. There are three possibilities. In the standard form set out in the simple example above, the tax-point transfer is used to change both the allocation of tax room and the allocation of revenue: the transferee government ends up with a larger share of the levied tax points, so that its share of total government revenue from the tax increases. Alternatively, the terms of the transfer may require the transferee government to fully compensate the transferor for its revenue loss, in which case the tax-point transfer changes the allocation of tax room but not the allocation of revenue. Least commonly, tax-point transfers can be designed so that they change neither the allocation of tax room nor the allocation of revenue. For instance, in 1972 the federal government replaced deductions and credits for provincial income taxes with a downward tax-point transfer. The transfer changed the mechanism for coordinating federal and provincial tax rates, but had no effect on tax or revenue shares. In subsequent sections of this article, I set out a number of reasons why governments may choose one of these objectives over the others.

Third, tax-point transfers typically consist of exchanges that impose obligations—either implicit or explicit—on both the transferor and the transferee governments. At a minimum, a tax-point transfer requires that the transferee raise its tax rate to match the tax cut by the transferor government. If the transferee fails to raise its tax rates, the attempted transfer results in a cut to the combined federal-provincial tax rate rather than a reallocation of tax room. More significantly, a tax-point transfer frequently requires the transferee government to provide the transferor with consideration—something of value—in exchange for the transfer. Consideration is important because a tax-point transfer will typically decrease the transferor’s revenue. Unless the transferor is perfectly benevolent, it will seek to receive something of value in exchange for its revenue loss. In Canadian experience, two types of consideration are most common: the transferor may receive monetary compensation or,
in the absence of compensation, may be promised (or expect) some form of control over how the transferee spends its new revenue.

Fourth and finally, uncoordinated changes to federal and provincial tax rates may mimic the effect of a tax-point transfer. For example, between 2007 and 2008, the federal government cut the federal goods and services tax (GST) from 7 percent to 5 percent, describing the reduction as a “permanent tax cut” to promote “long-term growth.”11 Within two years, the Quebec and Nova Scotia governments increased their provincial sales taxes by 2 percentage points, so that the combined federal-provincial rate in those provinces was the same as it was before the federal tax decrease.12 In effect, this combination of tax-rate changes resembled an unintended (from the federal perspective) downward tax-point transfer. This article focuses on coordinated tax-point transfers, since they can be used as an intentional tool of tax policy, but uncoordinated changes may have similar effects.13

Prerequisites to Tax-Point Transfers

Constitutional Requirement

The only constitutional constraint on tax-point transfers in Canada is that both levels of government must have concurrent constitutional jurisdiction to impose the tax that is the subject of the transfer.14 For instance, the federal government cannot transfer tax points on imports and exports to the provinces, since the provinces lack constitutional jurisdiction to impose import and export taxes.15 As a practical matter,

---


13 One result is that it can occasionally be challenging to definitively identify tax-point transfers, since it may be unclear whether tax-rate changes were coordinated.

14 Under the Constitution Act, 1867 (UK), 30 & 31 Vict., c. 3, the federal government has jurisdiction over “The raising of Money by any Mode or System of Taxation” (section 91.3), and the provinces have concurrent jurisdiction over “Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes” (section 92.2). For a review of the allocation of taxing powers, see Benjamin Alarie and Richard M. Bird, “Tax Aspects of Canadian Fiscal Federalism” (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1689311).

15 Constitution Act, 1867, supra note 14, sections 91.3 and 122. The Supreme Court of Canada has held that the federal and provincial governments may not transfer constitutional
this constraint is relatively insignificant. The constitution limits the provinces to “direct” taxes, but courts have adopted an expansive approach in interpreting the meaning of “direct.”16 The federal and provincial governments possess concurrent jurisdiction over the major tax bases, including income,17 consumption,18 and property taxes,19 and certain forms of estate taxes.20 Tax-point transfers can occur along any of these tax bases.

Significantly, there is no constitutional prohibition in Canada that limits the capacity of the federal government to vary its tax rates from province to province. The absence of a constitutional requirement that federal tax rates be equal in all provinces enables what I will refer to as “asymmetric” tax-point transfers. The federal government is free to transfer tax points to some but not all provinces, if it so chooses, so that federal tax rates will be lower in some provinces than others.21 Similarly, the federal government is free to accept tax-point transfers from some but not all provinces, so that federal tax rates will be higher in some provinces than others. The absence of a prohibition in Canada contrasts with the uniformity clause in the US constitution, which requires that the rates of indirect federal taxes—excise, import, and export—be uniform in each state.22 While the US Supreme Court has created exceptions to the uniformity clause,23 this constitutional requirement

jurisdiction to one another; therefore, the provinces cannot impose import and export taxes even if they have the federal government's consent to do so: Attorney General of Nova Scotia v. Attorney General of Canada, [1951] SCR 31.

16 G.V. La Forest, The Allocation of Taxing Power Under the Canadian Constitution, 2d ed. (Toronto: Canadian Tax Foundation, 1981), at 202: “[T]he power of the provinces to levy direct taxation has been so broadly construed as in substance to permit them, in fact if not in form, to levy taxes from any source.” See also Alarie and Bird, supra note 14, at 13.

17 See, for example, Bank of Toronto v. Lambe (1887), 12 App. Cas. 572 (PC); and Abbott v. Saint John (City), [1908] 40 SCR 597, at 604.

18 The provinces may impose sales taxes if the statutory obligation to pay the tax is placed on the consumer rather than the retailer. See, for example, Atlantic Smoke Shops Limited v. Coulon, [1943] 2 All ER 393 (JCPC), at paragraphs 12-13; and Reference Re Quebec Sales Tax, [1994] 2 SCR 715, at paragraphs 12 and 20.

19 Although the federal government has never levied property taxes, property taxes fall within its jurisdiction over “The raising of Money by any Mode or System of Taxation” (section 91.3 of the Constitution Act, 1867, supra note 14). See also La Forest, supra note 16, at 196.

20 Eurig Estate (Re), [1998] 2 SCR 565; and Burland v. The King, [1922] 1 AC 215 (JCPC), at paragraph 25.

21 An example is the Quebec abatement. See infra note 27.

22 US Constitution, article I, section 8, clause 1: “The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.”

23 In United States v. Ptasynski, 462 US 74 (1983), at 84-85, the US Supreme Court held that the uniformity clause does not prohibit the federal government from varying its tax rates from state to state to combat “geographically isolated problems,” but that it does prohibit rate variation
nevertheless imposes a constraint on tax-point transfers in the United States that does not exist in Canada.24

Substantial Tax-Base Harmonization

Tax-point transfers are more feasible when the federal and provincial tax bases are substantially harmonized. For instance, if the federal GST includes all services, but a provincial sales tax excludes services, a downward transfer of sales tax points to that province would result in a reduction in the combined tax rate applicable to services. Contrary to the numerical example set out in table 1 above, the tax-point transfer would decrease combined tax rates and decrease combined government revenue, rather than merely reallocate tax room and revenue between governments.

In Canada, the major tax bases are relatively harmonized. In exchange for free federal tax collection and administration of most aspects of provincial income taxes,25 nine provinces have substantially harmonized their personal income tax bases, seven have substantially harmonized their corporate income tax bases, and five have harmonized their sales tax bases. In the United States, where tax bases are less harmonized, tax-point transfers would be more complex.

Examples of Tax-Point Transfers

Historically, there have been a number of federal-provincial tax-point transfers,26 including transfers along the personal and corporate income,27 gasoline,28 and estate

---

24 For instance, if the US government were to transfer alcohol excise tax points to Massachusetts but not to other states, the constitutionality of the transfer would turn on whether the federal government intended to provide Massachusetts with an advantage over other states. See Ptasynski, supra note 23. No such judicial scrutiny would apply to an equivalent tax-point transfer in Canada.

25 For a description of the tax collection agreements in personal and corporate income taxation, see Munir A. Sheikh and Michel Carreau, “A Federal Perspective on the Role and Operation of the Tax Collection Agreements” (1999) 47:4 Canadian Tax Journal 845-60. Provinces are responsible for the cost of administering certain added-cost provincial tax credits.

26 Confederation itself can arguably be viewed as effecting an upward tax-point transfer. The provinces relinquished their authority to levy the most lucrative tax of the time—customs duties—in exchange for annual subsidies (in addition to other consideration, such as the assumption of provincial debt). See Canada, Report of the Royal Commission on Dominion-Provincial Relations, vol. 1 (Ottawa: King’s Printer, 1940), at 40-45.

27 In addition to the two transfers of personal income tax points reviewed below, the federal government also transferred personal income tax points to the provinces in 1972. For a (Notes 27 and 28 are continued on the next page.)
the law and political economy of tax-point transfers

This section briefly reviews the two most significant income-tax-point transfers between the federal and provincial governments: the 1942 upward tax-point transfer, effected by the tax rental agreements; and the 1976 downward tax-point transfer, which is the most recent income-tax-point transfer. The purpose of the review is twofold. First, these historical examples illustrate the mechanics of tax-point transfers and their effect on the allocation of tax revenue and tax room. Second, the examples provide context for the argument on contractual enforcement that is advanced in the remainder of this article. In particular, they show how tax-point transfers consist of exchanges in which non-simultaneous obligations are explicitly or implicitly agreed to by, or imposed on, both levels of government. The existence of these obligations raises the need for mechanisms that provide assurance that governments will fulfill their obligations.

1942 Upward Tax-Point Transfer (Tax Rental Agreements)

At the beginning of the Second World War, the federal government occupied the majority of personal and corporate income tax room but shared the personal income tax base with the provinces and some municipalities, and the corporate income tax base with the provinces. In 1941, the federal government proposed that the

discussion, see supra note 10. The federal government also engaged in a number of asymmetric downward tax-point transfers with Quebec in the 1950s and 1960s. Under these transfers, Quebec received tax points in lieu of cash transfers. The extant portion of these tax-point transfers is commonly known as the Quebec abatement. For a history, see David B. Perry, Financing the Canadian Federation, 1867-1995: Setting the Stage for Change, Canadian Tax Paper no. 102 (Toronto: Canadian Tax Foundation, 1997), at 207-24. The constitutional amendments permitting federal employment insurance and public pension plans also arguably enabled upward payroll tax transfers from the provinces to the federal government; see the Constitution Act, 1867, supra note 14, sections 91.2A and 94A.

In 1947, the federal government repealed its gasoline tax, so that the provinces could occupy the tax room. The federal government also withdrew its sales tax on residential electricity and gas consumption. See A. Milton Moore, J. Harvey Perry, and Donald I. Beach, The Financing of Canadian Federation: The First Hundred Years, Canadian Tax Paper no. 43 (Toronto: Canadian Tax Foundation, 1966), at 18-19.


The federal share of corporate income tax receipts was 87 percent, with the provinces collecting the remaining 13 percent. The federal share of personal income tax receipts was 75 percent, the provincial share 20 percent, and the municipal share 5 percent. See Richard M. Bird, “Section H: Government Finance,” Statistics Canada, at tables H52-74, H75-91, H92-112, and H113-123 (www150.statcan.gc.ca/n1/pub/11-516-x/sectionh/4057752-eng.htm).
provinces and municipalities abandon their personal and corporate income taxes for the duration of the war. The federal government's stated purpose was to increase federal revenues to finance the war effort.

Since the proposal would substantially decrease provincial revenues, the federal government used two means—a carrot and a stick—to induce provincial consent to the upward transfer of income tax points. First, as a carrot, it offered two compensation formulas to the provinces. Each province could choose to receive annual cash transfers equal to the greater of

1. the revenues that the province and its municipalities had collected from personal and corporate income taxes in 1940, and
2. the net cost of servicing the province’s debt in 1940 minus any succession duties (inheritance taxes) that the province had collected in 1940.

Second, as a stick, the federal government announced that it would substantially raise its personal and corporate income tax rates in each province, regardless of whether the province abandoned its own taxes, and that only those provinces that abandoned their taxes would receive compensation.

In combination, the carrot and stick presented the wealthier, low-debt provinces with a Hobson’s choice. For instance, if Ontario chose to accept the first federal offer—compensation based on 1940 tax revenues—the province would miss out on the increase in income tax revenues that was likely to result from the growing wartime economy. If it accepted the second offer—debt servicing—its revenues

---

32 Canada, House of Commons, Debates, April 29, 1941, at 2345 (J.L. Ilsley). The proposal also required the provinces to relinquish certain other provincial taxes on corporations.

33 Ibid. Finance Minister J.L. Ilsley also justified the proposal as a means of reducing the unfairness that resulted from variation in the combined federal-provincial tax rate from province to province. Given the wartime context, however, increasing federal revenues appears to have been the primary motive.

34 Moore et al., supra note 28, at 18-19.

35 Ilsley pledged to increase the minimum federal marginal personal income tax rate from 6 percent to 15 percent, the maximum marginal rate from 81 percent to 92 percent, and the minimum corporate tax rate from 30 percent to 40 percent. Canada, House of Commons, Debates, April 29, 1941, at 2345-55 (J.L. Ilsley). See also ibid., at 2713: “After the most careful consideration of all the questions involved the government had reached the conclusion that the rates of personal and corporation income taxes should be raised by the dominion to the maximum levels which would be reasonable at this time, if the provinces were not in those fields.” For a history of tax policy during this period, see Colin Campbell, “J.L. Ilsley and the Transformation of the Canadian Tax System” (2013) 61:3 Canadian Tax Journal 633-70, at 656-57.

36 Ilsley made a weak attempt to dispel provincial concerns that the federal proposal would cost them revenue: “It is true that if incomes continue to rise the provinces might receive even larger revenues from these two sources in the future than they did in the year 1940, but this would depend . . . in part upon the level and nature of dominion taxation and upon many other questions which cannot be foreseen or assessed at this time.” Canada, House of Commons, Debates, April 29, 1941, at 2346.
would decrease below 1940 levels. If it rejected both offers, its tax revenues would certainly shrink below their 1940 levels, since the federal rate increases would cause avoidance responses that would decrease the size of the shared tax base. Moreover, if other provinces accepted the federal government’s proposal but Ontario did not, Ontario’s combined federal-provincial tax rate would be substantially higher than the rate in other provinces, and this would encourage tax-base migration to the participating provinces. Ontario and the other provinces had little choice but to accept the federal offer. The five wealthier provinces chose reimbursement for their lost tax revenue. The remaining four provinces, which had smaller per capita income tax bases, chose to receive compensation to service their debt.

The result was a de facto contractual arrangement in which the provinces surrendered tax room in exchange for ongoing, annual cash transfers from the federal government. From a revenue perspective, the deal was a poor one for the provinces. With a booming wartime economy, Canada’s total corporate and personal income tax revenues more than doubled between 1941 and 1943. Since the wealthier provinces were compensated on the basis of their 1940 revenues, they did not share in this revenue growth. The provinces renegotiated the terms of the transfer in 1947, 1952, and 1957 to improve the compensation formula. These agreements, collectively known as the tax rental agreements, remained in place until 1962.

1976 Downward Tax-Point Transfer

In 1976, the federal government transferred 13.5 points of personal income tax and 1 point of corporate income tax to the provinces, in lieu of a portion of the annual

37 For literature on vertical externalities, see supra note 7.
39 The ongoing war effort, which was financed by the federal government, also made it difficult for provinces to refuse the federal offer. As Moore et al. observed, supra note 28, at 17, “[i]n the prevailing atmosphere of war tension it was almost incumbent on the provinces to accept the federal offer.”
40 See ibid. The 10th province, Newfoundland (now Newfoundland and Labrador), did not join Canada until 1949.
41 The federal government enacted these agreements in the Dominion-Provincial Taxation Agreement Act, 1942, RSC 1942, c. 13.
42 Dominion Bureau of Statistics, The Canada Year Book 1945 (Ottawa: King’s Printer, 1945), at 905.
43 See Bird, supra note 31.
44 The provinces were not unanimous in accepting the new terms. Quebec and Ontario opted out of the 1947 agreements and began to impose their own corporate income taxes. In 1952, Ontario opted back into the tax rental agreements. By 1954, Quebec was imposing its own personal income tax in addition to its corporate income tax. See Moore et al., supra note 28, at 28-51.
cash transfers that the federal government had provided to the provinces for hospital insurance, medicare, and post-secondary education.\textsuperscript{45} The tax-point transfer resulted in a reduction in federal marginal rates in each income bracket and an increase in provincial tax rates.\textsuperscript{46} It also changed the allocation of income tax revenue between the two levels of government: the federal share of personal income tax receipts decreased from 65.8 percent to 58.8 percent, while the provincial share increased from 34.1 percent to 41.1 percent.\textsuperscript{47}

The 1976 tax-point transfer was expressly intended to finance provincial expenditures on hospital insurance, medicare, and post-secondary education. To offset the revenue loss that accompanied the transfer, the federal government reduced the cash transfers made to the provinces for these purposes. Since the tax points were worth less to provinces with smaller per capita tax bases, the federal government also equalized the revenue impacts of the transfer on each province.\textsuperscript{48} In effect, provinces with lower per capita tax revenues had their cash transfers reduced by a lesser amount than provinces with higher per capita tax revenues.

Like the tax rental agreements, the 1976 tax-point transfer imposed implicit obligations on both levels of government. The federal government was required to (1) reduce federal tax rates and (2) reduce cash transfers. The provinces, in turn, were expected to subsequently (1) increase provincial tax rates by the amount of the federal tax cuts; (2) spend the resulting revenue on hospital insurance, medicare, and post-secondary education; and arguably, as discussed further below, (3) give public credit to the federal government for the value of the tax-point transfer, in much the same way as provinces are expected to credit the federal government for cash contributions.

The 1976 transfer also shared another similarity with the tax rental agreements: the transferee governments were generally more supportive of the transfer than was

\textsuperscript{45} Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, SC 1976-77, c. 10. Since, at the time, provincial income taxes were levied as a percentage of federal income tax receipts, the term “tax points” referred to percentage points of federal income tax receipts rather than percentage points of taxpayer income. The tax-point transfer also replaced a pre-existing federal deduction of 4.357 points of provincial personal income tax and 1.0 points of provincial corporate income tax, which had been granted to the provinces in 1967 to help fund post-secondary education. Strick, supra note 10, at 162. For detailed descriptions of the transfers, see Perry, supra note 27, at 237-54; Robin W. Boadway, \textit{Intergovernmental Transfers in Canada}, Financing Canadian Federation no. 2 (Toronto: Canadian Tax Foundation, 1980), at 23-24; and George E. Carter, “Financing Health and Post-Secondary Education: A New and Complex Fiscal Arrangement” (1977) 25:5 \textit{Canadian Tax Journal} 534-50.

\textsuperscript{46} For instance, immediately prior to the transfer, a Nova Scotian taxpayer earning $30,000 per year faced a marginal federal tax rate of 39 percent and a flat provincial tax rate equal to 38.5 percent of the federal tax owing. Following the transfer, the federal rate decreased to 36 percent and the provincial rate increased to 52.5 percent of federal tax owing. See Milligan, supra note 10.

\textsuperscript{47} Bird, supra note 31.

\textsuperscript{48} Strick, supra note 10, at 162. For an explanation of the mechanics of this process, see Canada, Department of Finance, “Associated Equalization” (www.fin.gc.ca/fedprov/aseq-eng.asp).
the transferor. The push for the downward tax-point transfer was led by Ontario, Quebec, and Alberta. The federal government initially proposed that it retain the tax points and fund its contribution entirely through cash grants, but it eventually acquiesced to the tax-point transfer in the face of continued provincial demands for tax room in lieu of cash grants.

**UPWARD TAX-POINT TRANSFERS**

Why might governments engage in upward tax-point transfers? The primary benefit of increasing the federal government’s share of tax room is that tax points will usually generate more revenue when levied by the federal government than by provincial governments. Provinces can exploit this federal tax advantage by transferring tax points to the federal government in exchange for cash transfers. A properly designed combination of tax-point and cash transfers enables both levels of government to split the surplus revenue generated by federal taxation, so that both have higher revenues than they would if the tax points were levied by the provincial governments.

The revenue case for upward tax-point transfers raises a puzzle: Why are these transfers rare? In Canada, there has been only one significant upward tax-point transfer, and it occurred in 1942. As discussed above, the transfer was proposed in an extraordinary wartime political climate, and the provinces agreed to it only after being pressured by the federal government. Contrary to the predictions of some theoretical economists (discussed below), provinces have not been inclined to exploit the federal tax advantage.

The central argument of this section is that impediments to contractual enforcement are a partial explanation for the lack of upward transfers. When a province transfers tax points to the federal government, the federal government must undertake to provide annual cash transfers to the province. Yet the province lacks an effective means of enforcing the terms of the bargain. The common methods of contract enforcement—judicial enforcement, the threat of termination or revocation, reputational sanctions, self-help, and the use of collateral—are either unavailable or of only modest force in the context of tax-point transfer agreements. A province that transfers tax points to the federal government must do so on faith that the federal government will keep its part of the bargain.

This section

- sets out the primary benefit of upward tax-point transfers;
- briefly reviews the historical record to demonstrate the provinces’ hostility to upward transfers;

---

49 Perry, supra note 27, at 239. Smaller provinces were more ambivalent about a downward tax-point transfer, partly because tax points are worth less to provinces with smaller per capita tax bases.

50 Perry, supra note 27, at 238-39.
argues that contractual impediments to upward tax-point transfers can at least partly explain that hostility;
identifies the conditions under which upward transfers are likely to occur, even in the absence of contractual enforcement; and
considers alternative explanations for the lack of upward tax-point transfers.

**Primary Benefit**

There are three reasons why tax points will typically generate more revenue when levied by the federal government rather than the provinces: one economic, one constitutional, and one administrative.

**The Economic Advantage**

The economic advantage of federal taxation is that federal tax bases are usually less mobile than provincial tax bases.\(^{51}\) With respect to the taxation of personal income, for example, taxpayers wishing to avoid paying a high rate of provincial income tax can move to a lower-tax province or channel their income through trusts that are resident in lower-tax provinces.\(^{52}\) In contrast, taxpayers wishing to avoid a federal income tax have to take the much more difficult step of relocating themselves or their income to another country, an option that will normally present a number of immigration, economic, and regulatory obstacles. The same problems of mobility for provincial tax bases arise in corporate taxation, where corporations can relocate their operations to lower-tax provinces; in sales taxation, where consumers can cross provincial boundaries to take advantage of lower taxes on their purchases; and, historically, in estate taxation, where taxpayers could relocate themselves or their wealth to provinces with low or no inheritance taxes.\(^{53}\) The effect of tax-base mobility can be significant. Recent research finds that an increase of 1 percentage point in a province’s top marginal personal income tax rate causes the top 1 percent of income earners to shift, on average, 0.97 percentage points of income to other provinces.\(^{54}\) For corporate income tax, an increase of 1 percentage point in a province’s rates is estimated to cause, on average, at least 2.6 percentage points of corporate income to shift to other provinces.\(^{55}\) This interprovincial migration

---

54 Milligan and Smart, supra note 52.
of people, capital, and corporations can depress provincial tax revenues\textsuperscript{56} and, in the extreme, encourage a race to the bottom in the setting of provincial tax rates.\textsuperscript{57}

Provinces can mitigate the problem of interprovincial tax competition by transferring tax points to the federal government. Through tax-point transfers, the provinces essentially bind their—and their competitors’—hands: a province that is tempted to lower its tax rates to attract tax base from other provinces has less scope to do so if most provincial tax points have been transferred to the federal government.\textsuperscript{58}

The greater efficiency of federal taxation has served as the basis for normative and positive theories that subnational governments should, and will, transfer taxing powers to the federal government. As a normative matter, a large body of foundational economic literature on fiscal federalism, often known as “first-generation fiscal federalism,” calls for federal governments to occupy most or all tax room along highly elastic tax bases, such as income tax, in order to maximize combined government revenues.\textsuperscript{59} As a positive matter, there are two seminal predictions. First, Brennan and Buchanan, in their “Leviathan” theory of taxation, predict that subnational governments will delegate taxing powers to the federal government to prevent horizontal tax competition that reduces tax revenues.\textsuperscript{60} Contrary to most of the normative literature, Brennan and Buchanan view this arrangement negatively: by delegating taxing powers to the federal government, the subnational governments effectively form “cartels” to shield themselves from competition.\textsuperscript{61} Second, Scott and Breton also predict that subnational governments will transfer taxing

\begin{itemize}

\item \textsuperscript{57} See supra note 53.

\item \textsuperscript{58} The revenue case for upward tax-point transfers has limits. As Milligan and Smart show, supra note 52, the revenue-maximizing tax rate will vary between provinces on the basis of each province’s income distribution. If the federal government levies the same tax rate in each province, variation in the combined federal-provincial rate can occur only if the provinces retain some tax points. Therefore, from the perspective of maximizing total public revenue, it is undesirable for provinces to relinquish all tax points to the federal government.


\item \textsuperscript{60} Geoffrey Brennan and James M. Buchanan, \textit{The Power To Tax: Analytical Foundations of a Fiscal Constitution} (Cambridge, UK: Cambridge University Press, 1980), at 182.

\item \textsuperscript{61} Ibid.
\end{itemize}
powers to the federal government in exchange for cash transfers, but view the exchange positively.\textsuperscript{62} The exchange allows the provinces to take advantage of the gains from trade that result from the lower elasticity of federal tax bases.

These positive and normative theories do not expressly address tax-point transfers. They instead predict, or call for, a transfer of taxing powers from subnational to federal governments without specifying the mechanism to be used. In practice, however, an upward tax-point transfer is the only coordinated mechanism for effecting such a transfer, short of a constitutional amendment.

\textbf{The Constitutional Advantage}

The second advantage of federal taxation relates to the federal government’s exclusive constitutional jurisdiction over indirect taxation. The Canadian provinces are limited to “direct” taxation, which Canadian courts, following John Stuart Mill, have defined as a tax “which is demanded from the very persons who, it is intended or desired, should pay it.”\textsuperscript{63} The drafters of the Constitution Act, 1867 limited the provinces to direct taxation in order to constrain provincial taxing power.\textsuperscript{64} Since direct taxes are more visible than indirect taxes, it was expected that it would be difficult for provinces to obtain political support for high levels of direct taxes. Modern research in behavioural public finance confirms that taxpayers underestimate the magnitude of indirect taxes;\textsuperscript{65} as a result, indirect taxation is more politically attractive than direct taxation.

Upward tax-point transfers allow provinces to replace politically salient direct taxes with less salient indirect federal taxes. Since there is less political opposition to indirect taxes, the federal government can potentially raise indirect tax rates to higher levels than the provinces can raise equivalent direct tax rates. Through cash transfers, the provinces can then share in the surplus revenue.

\textbf{The Administrative Advantage}

The third advantage of federal taxation is that federal tax administration and collection is often more efficient than provincial tax administration and collection owing


\textsuperscript{63} \textit{Bank of Toronto v. Lambe}, supra note 17, at 575.

\textsuperscript{64} See, for example, Province of Canada, \textit{Parliamentary Debates on the Subject of the Confederation of the British North American Provinces}, 8th Parl., 3d sess., 1865, at 69 (Galt), 377 (Langevin), and 388 (Langevin); P.B. Waite, ed., \textit{The Confederation Debates in the Province of Canada, 1865}, 2d ed. (Montreal: McGill-Queen’s University Press, 2006), at 42 (Galt); and the Constitution Act, 1867, supra note 14, section 92.2.

to economies of scale. Through tax-point transfers, the provinces can take advantage of these economies of scale to reduce costs. Significantly, however, tax-point transfers are not the only means of exploiting economies of scale. The Canadian government currently collects personal income taxes for nine provinces and corporate income taxes for seven provinces, even though the provinces independently set their own income tax rates. In consideration for federal tax administration and collection, the participating provinces have harmonized their personal and corporate income tax bases with the federal government’s, but have not engaged in upward transfers.

**The Historical Puzzle**

The historical record in Canada does not support the predictions made by the positive theorists discussed above (Brennan and Buchanan, and Scott and Breton). The only significant tax-point transfer from the provinces to the federal government occurred in 1942. Since that time, the provincial share of the three major taxes—personal income, corporate income, and general sales taxes—has steadily increased. The provincial share of corporate income, personal income, and general sales taxes is now at or near its highest point since the 1930s. Figures 1, 2, and 3 set out the respective shares of each of these tax bases for the relevant levels of government.

Rather than offering to transfer tax points, the provinces have generally demanded more tax room from the federal government. Boadway has observed that between 1945 and 1980,

> [m]uch of the conflict in federal-provincial fiscal agreements after the Second World War . . . [arose] out of a desire by the provinces to be given more tax room by the federal government in . . . [the personal and corporate income tax] fields.

---


67 Sheikh and Carreau, supra note 25, at 846-47.


FIGURE 2  Corporate Income Tax Shares—Federal and Provincial Governments, 1933-2016
The conflict has continued since 1980. In 2001, for example, the Quebec government established the Séguin commission to study an alleged “fiscal imbalance” between the federal and provincial governments. The commission recommended that the federal government vacate the sales tax field and reduce income taxes to leave more tax room for the provinces. The federal government, however, rejected the recommendation.

The question is, given the apparent benefits of upward transfers, why have the provinces not engaged in revenue-increasing upward tax-point transfers?

**Contractual Impediments to Upward Tax-Point Transfers**

The central contractual problem with upward tax-point transfers is that provincial and federal obligations are not performed simultaneously. A tax-point transfer made in exchange for cash transfers has three steps:

---

70 Québec, Commission sur le déséquilibre fiscal, *Pour un nouveau partage des moyens financiers au Canada : Rapport* (Québec: Commission sur le déséquilibre fiscal, 2002) (herein referred to as “the Séguin commission”).

71 Ibid., at xii.

1. The provinces lower their tax rates.
2. The federal government raises its tax rate by an equivalent amount.
3. The federal government transfers cash to the provinces in year 1, year 2, and so on, unless and until the governments agree to vary the terms of the tax-point transfer.

While steps 1 and 2 can be performed simultaneously, step 3 imposes a perpetual obligation on the federal government. The risk for the provinces is that the federal government may at some future time cease or reduce cash transfers, or impose unacceptable conditions on those transfers, contrary to the terms of the agreement.

This section first identifies the two ways in which a federal government may breach a tax-point transfer agreement, and then argues that provinces lack an effective mechanism for ensuring that the federal government fulfills its promises. Since provinces have limited tools for ensuring federal compliance, they may resist voluntarily transferring tax points.

**Potential Federal Breaches of Tax-Point Transfer Agreements**

The federal government can breach a tax-point transfer by (1) ceasing or reducing cash transfers to the provinces, or (2) imposing conditions on the cash transfers that reduce their value to the provinces.

The federal incentive to cease or reduce cash transfers will exist whenever it is more advantageous to spend the cash on areas of federal jurisdiction. In a well-functioning federal system, this political incentive will arise whenever voters prefer a federal expenditure to an alternative provincial expenditure that is funded through cash transfers. More problematically, the federal incentive to cease or reduce cash transfers may exist even when social welfare is decreased by such cuts. Federal budgetary decisions are arguably subject to an externality problem. When the federal government reduces cash transfers to the provinces in order to increase expenditures on matters of federal jurisdiction, it obtains the full political benefit of the increased spending, but likely bears only a portion of the political cost of the cuts to provincial services.73 The risk to provinces entering into tax-point transfer agreements is that this externality problem will lead the federal government to conclude that expenditures on federal jurisdiction are more politically advantageous than cash transfers to the provinces.74

---

73 For example, if the federal government reduces its cash transfers to the provinces in order to increase spending on the postal service, a federal responsibility, voters will likely credit the federal government for the improvement in postal service performance and the increase in employment in the postal service. If the provinces subsequently cut health-care spending as a result of the cuts in federal cash transfers, the federal government will likely bear only a portion of voters’ ire. Since the provincial governments have constitutional responsibility for health care, and must implement the cuts, it is likely that they too will feel the political repercussions of the reduction in federal cash transfers.

74 For example, in the 1990s, the Canadian government substantially reduced cash transfers to the provinces in order to eliminate a federal budget deficit. The cuts to cash transfers led to large
The federal government may also breach a tax-point transfer agreement by imposing conditions on cash transfers that restrict how provinces can spend the funds. Just as a $100 gift card that can only be used in one store may be worth less to the recipient than $100 in cash, a cash grant with restrictions will sometimes be worth less to a province than an unrestricted cash grant. Federal conditions on cash transfers may be normatively justifiable, as in the case, for example, of conditions that aim to internalize positive spillovers resulting from provincial expenditures; but they may also be imposed when the federal government has different spending priorities than the provinces, or when it wants the provinces to acknowledge or credit the federal government for its contribution. Provinces that transfer tax points to the federal government make themselves vulnerable to federal attempts to influence provincial policy or to extract some of the political credit for provincial expenditures.

**Enforcement Mechanisms**

There are five mechanisms that are commonly used to assure performance in contracts: (1) judicial enforcement, (2) termination, (3) reputational sanctions, (4) self-help, and (5) collateral. These mechanisms are either unavailable or of reduced effectiveness in securing compliance with tax-point transfer agreements. The result is a de facto time inconsistency problem: provinces may resist upward transfers, even when upward transfers are their preferred policy, because of the federal government’s inability to credibly commit to future cash transfers.

**Judicial Enforcement**

The obstacle to judicial enforcement of tax-point transfer agreements is that, under the doctrine of parliamentary sovereignty, governments can unilaterally repudiate their contractual obligations without penalty. The leading Canadian case is the

---

75 For example, the Canada Health Act, which governs cash transfers for health care, requires that the provinces “give recognition” to the federal contribution “in any public documents, or in any advertising or promotional material, relating to insured health services and extended health care services in the province.” Canada Health Act, RSC 1985, c. C-6, section 13(b).


1991 decision of the Supreme Court of Canada in Reference Re Canada Assistance Plan (B.C.).

The issue before the court was whether the federal government could unilaterally amend federal legislation to reduce the annual cash transfers provided to British Columbia for social welfare programs. The BC government alleged that the federal cuts breached an earlier agreement between the two governments (the Canada Assistance Plan) under which the federal government had promised to fund 50 percent of the province’s social welfare costs. The Supreme Court rejected the BC government’s claim. At its narrowest, the decision held that the federal cuts did not breach the agreement between the two governments because the terms of the agreement left room for unilateral federal amendments to the funding formula. More broadly, however, the Supreme Court held that intergovernmental contracts cannot limit parliamentary sovereignty over spending. Sopinka J, writing for the court, noted:

It is conceded that the [federal] government could not bind Parliament from exercising its powers to legislate amendments to the Plan. To assert the contrary would be to negate the sovereignty of Parliament. . . . A restraint on the executive in the introduction of legislation is a fetter on the sovereignty of Parliament itself.

Sopinka J also quoted approvingly from the decision of the Supreme Court of South Australia in a similar case:

Ministers of State cannot . . . by means of contractual obligations entered into on behalf of the State fetter their own freedom, or the freedom of their successors or the freedom of other members of parliament, to propose, consider and, if they think fit, vote for laws, even laws which are inconsistent with the contractual obligations.

The key implication of Canada Assistance Plan is that the federal government can unilaterally repudiate, through legislation and without penalty, any contractual obligation to provide cash transfers that are promised in exchange for an upward

79 Ibid., at 567.
80 Ibid., at 548 and 560.
81 Ibid., at 560 (quoting from West Lakes Ltd. v. South Australia (1980), 25 SARS 389, at 390). For related academic commentary, see Nigel Bankes, “Co-operative Federalism: Third Parties and Intergovernmental Agreements and Arrangements in Canada and Australia” (1991) 29:4 Alberta Law Review 792-838, at 804 (https://doi.org/10.29173/alr1533): “In the absence of constitutional effect being given to the agreement we must accept the conclusion, in the absence of Charter attack, that a . . . [government] may legislate in derogation of its contractual undertakings.” See also Didier Culat, “Coveting Thy Neighbour’s Beer: Intergovernmental Agreements Dispute Settlement and Interprovincial Trade Barriers” (1992) 33:2 Cahiers de Droit 617-38, at 620 (https://doi.org/10.7202/043149ar): “At best, it can be submitted that the legal nature of an intergovernmental agreement is akin to that of a ‘gentleman’s agreement.’”
Tax-point transfer agreements therefore differ from conventional non-governmental contracts in that judicial enforcement is generally not available as a remedy in the event of a breach (by either party).

**Termination**

An aggrieved party can typically respond to a breach of contract by terminating or threatening to terminate the contract. Through termination, the aggrieved party denies the breaching party the future benefits of the contract. For example, if a vendor of potatoes fails to pay the farmer who supplies him, the farmer can refuse to supply the vendor with the remaining potatoes that are due to be delivered under the contract. The vendor then loses out on future sales.

In the case of a tax-point transfer, however, an aggrieved province cannot deny the federal government the benefits of the transfer without incurring political and revenue costs. For example, consider a province that transfers 5 personal income tax points to the federal government, so that the transfer reduces the provincial income tax rate from 15 percent to 10 percent and increases the federal rate from 5 percent to 10 percent. If the province later terminates the agreement because the federal government has failed to provide the promised cash transfers, the province cannot restore taxes to their previous rates. The province can raise its own rate to its pre-transfer level of 15 percent, but it cannot force the federal government to lower the federal rate to 5 percent. In the absence of federal cooperation, the provincial rate increase raises the combined federal-provincial tax rate. This poses two problems for the province. First, the province will have to justify to voters why it has raised the combined tax rate, and will likely pay a political price for its decision. Second, provincial revenues will be lower than they were prior to the tax-point transfer. As discussed earlier (in relation to the example illustrated in table 1), a 15 percent provincial income tax will raise less revenue when the combined income tax rate is

---

82 It is an open question whether a court would enforce a tax-point transfer agreement if the federal government repudiated the required cash transfers through executive action (or inaction) rather than legislation. Parliamentary sovereignty protects the right of legislatures to legislate in derogation of contractual obligations, but in the absence of legislation, a contract is typically binding on a government. See, for example, *South Australia v. Commonwealth* (1962), 108 CLR 130, at 155, where Windeyer J held that an intergovernmental agreement may be enforceable if the two governments intended to “subject their agreement to the adjudication of the courts.” Similarly, in 2018, the BC Court of Appeal held that the Reciprocal Taxation Agreement and Comprehensive Integrated Tax Coordination Agreement between the BC and Canadian governments were enforceable on a third party because the agreements “bear the hallmarks of agreements that were intended to create legally binding obligations.” See *British Columbia Investment Management Corporation v. Canada (Attorney General)*, 2018 BCCA 47, at 142; leave to appeal to the Supreme Court of Canada granted October 11, 2018. Neither of these decisions, however, limits the capacity of governments to implement legislation repudiating their contractual obligations.

83 American Law Institute and the National Conference of Commissioners on Uniform State Laws, *The Uniform Commercial Code* (Philadelphia and Chicago: ALI and NCCUSL, 2012), sections 2-703(a) and (f) and 2-705.
25 percent than when the combined rate is 20 percent. Table 2 shows the effect of unilateral revocation of the agreement.

The Supreme Court of Canada’s decision in Canada Assistance Plan impedes any contractual solution to this problem. For instance, a tax-point transfer agreement could include a termination clause that requires the federal government to lower its tax rates to pre-transfer levels in the event of a breach. Any such provision, however, would be legally unenforceable, since the provincial and federal governments cannot bind themselves to future increases or decreases in their tax rates without diminishing parliamentary sovereignty.

These challenges in revoking a tax-point transfer do not mean that provinces would passively accept a federal breach. The provinces might respond by raising their tax rates and attempting to persuade voters that the federal government was to blame. The problem for the provinces, however, is that this course of action has uncertain consequences. Some voters might accept the provincial story, but others may blame the provincial government or both governments. The central difficulty is that once an upward tax-point transfer has induced a federal tax increase, there is no politically cost-free way of undoing the transfer without federal cooperation.

**Reputational Sanctions**

There are arguably reputational incentives for the federal government to comply with tax-point transfer agreements. Federal and provincial governments are repeat players in intergovernmental fiscal negotiations. When the federal government breaches a tax-point transfer agreement, it runs the risk that provinces will refuse to participate in such agreements in the future. Since the federal government benefits from tax-point transfers—by sharing in the resulting surplus revenue—it has a financial interest in keeping its promises.

Reputational sanctions can be an effective means of ensuring contractual performance. There are two problems, however, that reduce their usefulness to provinces contemplating upward transfers.

First, the threat of withholding future upward transfers creates leverage only when there is a reasonable probability of future upward transfers. The federal government

---


85 Both levels of government have engaged in ongoing negotiations over fiscal arrangements since Confederation. See the Report of the Royal Commission on Dominion-Provincial Relations, supra note 26.

86 See generally the sources cited in note 84, supra, for a more detailed discussion.
has a fiscal incentive to breach a tax-point transfer agreement whenever the benefits of doing so exceed the value of the remaining tax points that are likely to be transferred. If only a small number of tax points remain in provincial hands, or if future transfers are unlikely in the short to medium term, the federal government may conclude that reneging on its agreement to provide cash transfers is in its best interest, notwithstanding any repercussions.

The second problem is that the identity of political decision makers in provincial and federal governments changes frequently. The federal political party in power at the time of fiscal negotiations may sincerely promise to provide perpetual cash transfers to the provinces, but that promise will be of uncertain value when a different party wins the next federal election. This problem is exacerbated by the perpetual nature of the cash transfers that must be promised in exchange for tax-point transfers. A province may conclude that all major federal political parties would make good on federal commitments for the foreseeable future. But the province cannot realistically predict the attitudes of political parties decades from now. By refraining from entering into tax-point transfers, the provinces retain control over their tax points.

**Self-Help—Political Protests**

Provinces may respond to a federal breach by publicly criticizing the federal government and urging voters to support a different federal political party. Provinces may also withhold cooperation in other matters that are important to the federal government. For example, provincial police forces could refuse to address federal priorities in criminal-law enforcement, or provincial governments could refuse to implement carbon taxes, despite federal urging. To the extent that the provinces can create electoral consequences for the federal government, their actions may discourage the government from reneging on its promises.

---

**TABLE 2  Tax-Point Transfer<sup>a</sup>—Effect of Termination of Transfer Agreement**

<table>
<thead>
<tr>
<th></th>
<th>Federal tax rate</th>
<th>Provincial tax rate</th>
<th>Combined rate</th>
<th>Federal tax share</th>
<th>Provincial tax share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-transfer</td>
<td>10</td>
<td>10</td>
<td>20</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Post-transfer</td>
<td>15</td>
<td>5</td>
<td>25</td>
<td>75</td>
<td>25</td>
</tr>
<tr>
<td>Unilateral revocation</td>
<td>15</td>
<td>10</td>
<td>25</td>
<td>60</td>
<td>40</td>
</tr>
</tbody>
</table>

<sup>a</sup> Assumes a transfer of 5 income tax points from the federal government to the provincial government.

---

These forms of political protest can be effective. The problem for the provinces, however, is that it is difficult to predict whether a protest will succeed or not. Provinces that enter into tax-point transfers in the confidence that they can use political tools to force federal compliance essentially roll the dice: they make an uncertain bet that they will have the political power, in an unknown future political environment, to pressure the federal government into fulfilling its promises.

This article has already identified three instances in which provincial protests failed to cause changes in federal tax and transfer policy. First, in 2016, the provinces vociferously objected to the federal government’s cuts to the annual increase in the Canada health transfer, but eventually all of them relented and agreed to the new terms. Second, after the Séguin commission issued its report in 2002, the federal government rejected Quebec’s request for additional tax room and engaged in a long-running public relations campaign to defend itself. Third, in 1991, British Columbia was ultimately unable to persuade the federal government to reverse its decision to reduce cash transfers under the Canada Assistance Plan.

Collateral

A final common device employed to assure the performance of a contract is the use of collateral. Theoretically, the federal government could post a large sum of money in trust or escrow to secure future cash transfers; then, in the event of the government’s default, the provinces could access the collateral. Collateral would provide some assurance that the federal government will make good on its promise or, at a minimum, that the provinces will receive some compensation in the event of a breach.

There are two problems with the use of collateral in the context of tax-point transfer agreements. The first is that the sum of money that would need to be placed in trust or escrow is potentially massive. If, for instance, the provinces transferred a substantial number of personal income tax points to the federal government, the net present value of the future tax receipts would likely be in the hundreds of billions of dollars. The federal government is unlikely to have sufficient cash on hand to secure the transaction. The second problem is that the trust or escrow account would need to be administered by a third party that was beyond the legislative reach of the two governments; otherwise, one government could unilaterally change the terms of the

---

88 See ibid., at 1265-74.
89 See supra note 1.
91 See generally The Uniform Commercial Code, supra note 83, section 9.
trust or escrow account through legislation. It is difficult to conceive of such a third party within Canada. The simplest solution would be to use a third party outside Canada as the administrator, but it is unlikely that Canadian governments would be willing to deposit huge sums of money with foreign administrators who were beyond the reach of Canadian law.

**Favourable Conditions for Upward Transfers**

The contractual impediments described above do not mean that upward tax-point transfers will never occur again in Canadian fiscal federalism. There are two conditions that are favourable to upward transfers, even in the absence of effective contractual enforcement. First, when trust and goodwill between the two levels of government are high, provinces may be willing to transfer tax points without a contractual guarantee. High levels of trust and goodwill serve as a substitute for the traditional mechanisms of contract enforcement. Second, and paradoxically, upward transfers are also more likely in the presence of coercion. As indicated by the 1942 tax rental agreements, the provinces may be pressured or compelled to surrender tax room to the federal government. Coercion renders provincial concerns over contractual enforcement less significant, since the provinces may have little choice but to proceed with the transfer.

In the absence of these conditions, there are two design features that might also make upward tax-point transfers more palatable to the provinces. First, provinces can mitigate the consequences of a breach by transferring only a small number of tax points or by transferring tax points along less lucrative tax bases. When the amount of potential revenue at stake is smaller, the upward transfer carries less revenue risk to the provinces. Second, and more promisingly, an upward transfer could be structured so that provinces transfer tax points along one base in exchange for tax points along another base. For example, the provinces might agree to transfer corporate income tax points to the federal government in exchange for consumption tax (GST) points. This form of exchange—an upward tax-point transfer for a downward tax-point transfer—makes it more politically costly for the federal government to breach the terms of the transfer. If, for instance, the federal government were to breach the terms of the transfer by subsequently raising its consumption tax rate, it would have to justify to voters why it had raised the combined federal-provincial consumption tax rate. This arrangement is markedly different from a conventional upward transfer, where the federal government can repudiate an obligation to provide cash transfers without raising combined tax rates.

While these conditions and design features mean that upward transfers are possible, they do not obviate the need for enforcement mechanisms. The conditions identified above—high levels of trust or, alternatively, high levels of coercion—are difficult to achieve. The design features also have limits. Reducing the size of tax-point transfers constrains the capacity of the transfers to be used as tools for reallocating tax room. In addition, exchanging tax points for tax points raises a substantial coordination problem: an upward transfer must be paired with a downward transfer along another tax base. While such a transfer is possible, it may be
difficult to find an appropriate downward transfer, especially when the upward transfer is large.

**Other Factors**

Contractual constraints are not the only impediment to upward tax-point transfers. There are at least three other reasons why provinces may resist relinquishing tax points to the federal government, even when contractual enforcement is guaranteed. The contractual argument advanced in this article complements these explanations, and can help to fill a number of gaps.

First, provinces may resist upward transfers because they wish to retain provincial control over tax policy. When provinces relinquish all or most tax points to the federal government, they reduce their influence over tax-base definition. They also potentially limit their capacity to raise tax rates if future circumstances warrant. As a normative matter, there are two seminal justifications for retaining a substantial provincial role in taxation. Under Oates’s decentralization theorem, subnational regions have different preferences for tax and spending policy that can best be met through decentralization.92 Under Tiebout’s model of local government, individuals choose to reside in the jurisdiction that offers their preferred combination of tax and spending measures, thereby solving the preference revelation problem that plagues the financing of public goods.93 Both Oates’s and Tiebout’s models require variation in subnational tax policy.

The attraction of tax-policy autonomy likely contributes to provincial resistance. There are two limitations, however, in the explanatory power of this theory. First, all provinces other than Quebec have been willing to cede substantial control over the definition of key tax bases through the tax collection agreements. Second, provinces could retain their flexibility to raise tax rates in the future by imposing time limits on any upward tax-point transfers, as was done in the 1942 tax rental agreements. These two factors suggest that the provincial desire for autonomy cannot fully explain the lack of time-limited upward transfers. The contractual impediment argument set out above offers an alternative explanation.

Second, some provinces, especially Quebec, have resisted upward transfers for more symbolic reasons. The nationalist movement in Quebec has linked control over tax policy to sovereignty.94 Famously, at the 1955 Federal-Provincial Conference, Quebec Premier Maurice Duplessis cited the axiom “The right to tax is the

---

92 Oates, supra note 59, at 10-11 and 35.


right to govern,” and warned that a province’s agreement to yield tax room to the federal government in exchange for cash transfers “would amount to replacing the reins enabling one to drive with shackles that paralyze and enslave.” Unsurprisingly, Quebec withdrew from the tax rental agreements in 1947. Quebec nationalism has likely also made it easier for other provinces to oppose upward transfers by “provid[ing] an umbrella under which other [provinces] could subsequently shelter.”

The relationship between nationalism and tax sovereignty is complex and multi-faceted, but it intersects in part with the contractual impediment argument advanced in this article. In the absence of enforceable contracts, an upward tax-point transfer places provinces in a position of dependency on the federal government, where they may find themselves “paralyzed” or “enslaved.” In the presence of enforceable contracts, however, an upward tax-point transfer establishes a de facto agency relationship between the two governments: the federal government acts as the province’s agent in maximizing tax revenue. Just as enforceable contracts can enhance the autonomy of individuals by providing them with options that would not otherwise exist, they can also enhance the autonomy of governments.

Third, resistance to upward transfers may result from an interprovincial collective action problem. High-tax provinces may be willing to transfer tax points to the federal government, but low-tax provinces that gain from tax-base shifting, such as Alberta, may not. Absent the participation of the low-tax provinces, the upward transfer will be of less value to the high-tax provinces: tax base will still migrate to the provinces with the lower combined federal-provincial rate. The extent of this collective action problem will depend, in part, on the willingness and capacity of some provinces to offer substantially lower tax rates than others. If some provinces have significant natural resource wealth, or a disproportionate number of high-income taxpayers, they will be able to fund government services at lower average tax rates, which will in turn attract tax base from other provinces.

95 Quoted in Moore et al., supra note 28, appendix B, at 121.
96 Ibid., at 123, where Duplessis also elaborated the concept of “maîtres chez nous,” stating that upward transfers “would amount to giving the key of one’s house to another.”
97 Alarie and Bird, supra note 14, at 28.
99 See, for example, Robin Boadway, “Natural Resource Shocks and the Federal System: Boon and Curse?” in selected proceedings from the 2006 Fiscal Federalism and the Future of Canada conference, Queen’s University, Institute of Intergovernmental Relations, September 28-29, 2006, at 8 (www.queensu.ca/iigr/sites/webpublish.queensu.ca.iigrwww/files/files/WorkingPapers/fiscalImb/boadway.pdf); Musgrave, supra note 59, at 18; Oates, supra note 59, at 132; and Boadway and Shah, supra note 51, at 158 and 162. The interprovincial collective action problem will also be influenced by the number of subnational governments. For instance, agreement among the 50 American states is less likely than agreement among the 10 Canadian provinces.
Collective action problems of this type undoubtedly contribute to the problem of coordinating federal and provincial tax rates. The advantage of the contractual impediment argument, however, is that it can fill two gaps in the collective action explanation:

1. The collective action theory suggests that there should be examples in Canadian history of upward tax-point transfers that were thwarted by a small number of holdout provinces. In fact, while wealthy provinces have generally been more supportive of downward transfers than poorer provinces, there has been little demand from any of the provinces for upward transfers. The lack of interest in upward transfers is evidently not limited to the small number of provinces that gain from tax competition.

2. The prospect of one or more provinces refusing to participate in an upward tax-point transfer does not fully negate the revenue gains of upward transfers, so long as regional groups of provinces are willing to participate. The reason is that tax rates in neighbouring jurisdictions likely have a greater impact on the elasticity of a province’s tax base than the tax rates of distant jurisdictions. For instance, it is easier for taxpayers to avoid income or sales taxes by relocating their residence or purchases to a neighbouring province rather than a distant province. Additionally, taxpayers may be more likely to learn of tax-saving opportunities available in neighbouring provinces rather than distant provinces, owing to the role that geography plays in knowledge diffusion. The significance of geography means that regional groups of provinces may have a fiscal incentive to engage in upward transfers, even if some Canadian provinces refuse to participate. The contractual impediment argument explains why these asymmetric upward transfers have not emerged: even if a regional group desires an upward transfer, it will refrain from doing so if it cannot be sure that the federal government will fulfill its part of the bargain.

100 See supra note 49.
101 See the discussion above under the heading “The Historical Puzzle.”
102 To the extent that provincial attitudes toward upward transfers are fractured, the contractual impediment argument also provides an explanation. If some, but not all, provinces distrust the federal government, it will be harder to obtain the necessary coalition of provinces to implement the upward transfer.
DOWNWARD TAX-POINT TRANSFERS

The case for downward tax-point transfers is more complex than the case for upward transfers. The primary benefit of downward transfers is that they create a more transparent relationship between tax rates and government revenues than do other mechanisms for transferring revenue, such as cash transfers, and deductions or credits for provincial taxes. By improving transparency, tax-point transfers make it easier for voters to assign political responsibility for taxing and spending decisions, and thus can remedy a number of incentive problems that afflict fiscal federalism.

This section proposes that the same contractual problems that arise with upward tax-point transfers make downward tax-point transfers unattractive to the federal government, even when downward transfers are welfare enhancing. In the absence of judicial enforcement, the federal government lacks an effective mechanism for controlling how provinces spend the revenue resulting from a tax-point transfer. In contrast, when the federal government transfers cash or offers credits or deductions to the provinces, it has more effective self-help mechanisms for ensuring that provinces comply with federal conditions.

Primary Benefit

Alternative Revenue-Allocation Mechanisms

Downward tax-point transfers can be placed within a family of mechanisms for transferring revenue from federal to provincial governments. Federal governments wishing to transfer revenue to provinces have a choice between transferring cash or tax room. Cash transfers provide revenue directly to provincial governments. Tax-room mechanisms enable provincial governments to increase their revenue by increasing their tax rates.

Tax-room mechanisms commonly include three alternatives: federal credits for provincial taxes paid; federal deductions for provincial taxes paid; and downward tax-point transfers. Under a credit, federal taxes owing are reduced by provincial taxes paid. Under a deduction, provincial taxes paid are deductible from the federal tax base. Under a downward tax-point transfer, federal nominal tax rates decrease and provincial nominal rates increase. Each of these options effectively opens up tax room for provincial governments.105

Cash and tax-room mechanisms can be used to achieve the same allocation of revenue between governments. To illustrate the effects of each option, assume (as in the example at table 1 above) a country with a national (federal) government and a

105 The Canadian government has used all of these alternatives at various times. Between 1941 and 1962, under a variant of revenue sharing, federal transfers were partly tied to federal tax receipts in each province. Between 1962 and 1972, the federal government offered capped credits for provincial personal income taxes and capped deductions for provincial corporate income taxes. In 1972, most credits and deductions were replaced by tax-point transfers to the provinces, and in 1976, tax-point transfers replaced certain cash transfers. For a history of these changes, see Perry, supra note 27.
provincial government, both of which occupy the same territory. The total personal income tax base is $100. The federal government has historically levied a 30 percent flat tax, which results in $30 in annual federal revenue. The province does not levy a personal income tax and thus has no income tax revenue. Both governments wish to transfer $15 in revenue from the federal government to the province without raising the combined personal income tax rate above 30 percent.

The governments have four options, which are set out in table 3. Each option transfers $15 in revenue to the province, but uses a different combination of federal and provincial tax rates to effect the transfer. At one extreme—cash transfers—the federal rate is 30 percent and the provincial rate is 0 percent. At the other extreme—tax-point transfers—the federal rate and the provincial rate are equal at 15 percent.

As noted above, downward tax-point transfers create a more transparent relationship between nominal tax rates and government revenues than that achieved by the other allocation mechanisms. Following the above tax-point transfer, the ratio of federal tax rates (15 percent) to provincial tax rates (15 percent) is 1:1 (“the tax-rate ratio”), which accurately reflects the ratio of federal revenue ($15) to provincial revenue ($15) (“the revenue ratio”). In contrast, under a deduction, the ratio of federal to provincial tax rates is 1.17:1, which incorrectly suggests that net federal revenue is 17 percent greater than provincial revenue. The disparity is more pronounced under a credit, where the ratio of tax rates suggests that federal revenues are double provincial revenues, and most pronounced under a cash transfer, where the tax-rate ratio (infinity) suggests that provincial revenues are zero, even though revenues are equally divided between the federal and provincial governments. Table 4 sets out the effects of the four options.

This transparency advantage can be illustrated by placing the four revenue allocation mechanisms on a spectrum, as illustrated below. Transparency is greatest with tax-point transfers on the far right, since the tax rate and revenue ratios are 1:1. Moving to the left along the spectrum, the tax-rate ratio diverges from the revenue ratio. This divergence is greatest for cash transfers at the far left, where the tax-rate ratio is infinity.

<table>
<thead>
<tr>
<th>Least transparent (cash mechanisms)</th>
<th>Most transparent (tax-room mechanisms)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash transfers</td>
<td>Credits</td>
</tr>
<tr>
<td></td>
<td>Deductions</td>
</tr>
<tr>
<td></td>
<td>Tax-point transfers</td>
</tr>
</tbody>
</table>

The greater transparency of tax-point transfers has two related benefits. First, it reduces information costs for voters. A voter can determine the allocation of revenue between governments simply by looking at tax rates.\(^{106}\) Of course, with

\(^{106}\) This process is more complicated when progressive rate schedules are used. With progressive rates, a voter can use marginal rates to determine what share of his or her last dollar earned goes to each government, but not what share of his or her total tax payable goes to each government.
enough time, willpower, and skill, voters could untangle the relationship between tax rates and net revenues in even the most complicated systems of cash transfers, deductions, and credits. The advantage of tax-point transfers, however, is that the effort required to determine revenue allocation is greatly reduced.

Second, by reducing information costs, tax-point transfers better align the political costs of taxation with the political benefits of spending. In a federal system where the federal government uses tax-point transfers in lieu of cash transfers, credits, and deductions, each level of government is responsible for levying the taxes needed to fund its expenditures. In contrast, under a system of cash transfers, the federal government arguably bears the political cost of levying taxes while the

---

TABLE 3 Comparison of Options for Revenue Allocation to Provinces

<table>
<thead>
<tr>
<th></th>
<th>Federal tax rate</th>
<th>Provincial tax rate</th>
<th>Combined federal-provincial tax rate</th>
<th>Net federal revenue</th>
<th>Net provincial revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash transfer ($15)</td>
<td>30.0</td>
<td>0</td>
<td>30</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Credit</td>
<td>30.0</td>
<td>15</td>
<td>30</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Deduction</td>
<td>17.6</td>
<td>15</td>
<td>30</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Tax-point transfer</td>
<td>15.0</td>
<td>15</td>
<td>30</td>
<td>15</td>
<td>15</td>
</tr>
</tbody>
</table>

TABLE 4 Tax Rate and Revenue Ratios Under Revenue-Allocation Options

<table>
<thead>
<tr>
<th></th>
<th>Federal tax rate</th>
<th>Provincial tax rate</th>
<th>Net federal revenue</th>
<th>Net provincial revenue</th>
<th>Tax-rate ratio</th>
<th>Revenue ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash transfer</td>
<td>30.0</td>
<td>0</td>
<td>15</td>
<td>15</td>
<td>∞</td>
<td>1:1</td>
</tr>
<tr>
<td>Credit</td>
<td>30.0</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>2:1</td>
<td>1:1</td>
</tr>
<tr>
<td>Deduction</td>
<td>17.6</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>1.17:1</td>
<td>1:1</td>
</tr>
<tr>
<td>Tax-point transfer</td>
<td>15.0</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>1:1</td>
<td>1:1</td>
</tr>
</tbody>
</table>

---


108 Unless voters hold the provincial government responsible for federal taxes because the resulting federal revenues are transferred to the provincial government. As argued above, however, voters face significant information costs in disentangling the relationship between federal tax rates and provincial expenditures.
provinces enjoy some or all of the political benefits of spending the resulting revenue. Credits and deductions similarly detach the political benefits of spending from the political costs of taxation, albeit by a lesser amount. Under a credit, the province levies the necessary taxes to fund its expenditures, but the federal government absorbs some of the political cost by retaining a high nominal tax rate that misleadingly suggests that the federal tax share is higher than it actually is. Under a deduction, the federal government also bears a portion of the political cost by retaining a misleadingly high nominal rate, although less dramatically than under a credit system.

**Incentive Effects**

By aligning the political costs of taxation with the political benefits of spending, downward transfers potentially resolve three incentive problems that commonly arise in fiscal federalism.109

First, tax-point transfers can mitigate what is known as the “soft budget constraint” problem.110 Under a system of cash transfers, provinces have an incentive to run budget deficits rather than raise their own tax rates to fund expenditures.111 As Smart has observed, “provinces have little incentive today to set their own fiscal houses in order, since spending restraint must weaken the case for future increases in federal [cash] transfers.”112 Downward tax-point transfers also raise concerns that provinces may run deficits in the hope of justifying further tax-point transfers.113 The difference, however, is that tax-point transfers require the provinces to assume at least some political responsibility for levying the taxes necessary to fund their expenditures. The possibility of future tax-point transfers is therefore less likely to induce fiscal irresponsibility.

---


111 See Smart and Mintz, supra note 107; and Smart and Bird, ibid.

112 Smart, supra note 107, at 8.

113 The same problem applies to credits and deductions, albeit to a lesser extent. If the federal government offers credits or deductions to a province, the province has an incentive to run budget deficits so that the federal government will increase the size of the credit or deduction. Receiving credits or deductions is more attractive to a province than raising its own tax rates since the credit or deduction obscures the extent of provincial taxation.
Second, downward transfers resolve the vertical externality problem discussed earlier in this article. When the federal government bears the political cost of taxing, but the provinces enjoy the political benefits of spending the resulting revenue, the federal government has an incentive to reduce cash transfers in favour of expenditures on areas of federal jurisdiction, where it receives all of the political benefits resulting from the expenditures. The result is that areas of provincial jurisdiction may be underfunded. In contrast, under a system of tax-point transfers, the federal government passes on the political cost of taxation to the provinces. Tax-point transfers should therefore be more palatable to the federal government and reduce the risk that provincial areas of jurisdiction will be chronically underfunded.

Third, tax-point transfers can arguably lead to more productive provincial spending. Cash transfers can change marginal tax prices, which can in turn distort provincial spending decisions. When a province bears only a portion of the cost of an expenditure, it has an incentive to proceed if the benefits exceed its portion of the cost. The problem is that the benefits may exceed the province’s share of the expenditure but not the combined cost to both governments. Cash transfers raise the concern that provinces will engage in expenditures that they never would have made if they had been required to fund the entire bill. Tax-point transfers remedy this problem.

Qualifications

There are two important qualifications to the case for downward tax-point transfers.

First, downward transfers can exacerbate interprovincial inequality. The per capita value of a tax point will vary with the size of provincial tax bases. For instance, Alberta’s per capita fiscal capacity is approximately double Prince Edward Island’s. If the federal government transferred equal tax points to all provinces, high-tax-base provinces (such as Alberta) would be made substantially better off than low-tax-base provinces (such as Prince Edward Island). The simplest remedy to this problem is to adjust federal cash transfers to equalize the revenue effects of the tax-point transfer, as the federal government did in 1976. By providing additional cash transfers to low-tax-base provinces (or reducing cash transfers to high-tax-base provinces), the federal government can undo the inequality created by the tax-point transfer.


116 Alternatively, the federal government could engage in asymmetric transfers. If the per capita value of a tax point transferred to a high-tax-base province is 50 percent greater than the
Second, the case for downward transfers is limited by the case for upward transfers. A discussion of the theory of the optimal division of tax room between governments is beyond the scope of this article. The distinct normative justifications for upward and downward tax-point transfers, however, can be combined to provide broad guidelines for the choice between these two forms of transfers. The choice presents a tradeoff. Upward transfers increase total government revenue but exacerbate incentive problems. Downward transfers likely decrease revenue but mitigate incentive problems. From a social welfare perspective, governments should engage in upward tax-point transfers when the welfare gains from increased revenue are greater than the welfare losses from increased incentive problems. Governments should engage in downward tax-point transfers when the welfare gains from reducing the incentive problems are greater than the welfare losses from decreased revenue.

Contractual Impediments to Downward Tax-Point Transfers

Why have downward tax-point transfers fallen into disuse? At least part of the explanation is that the same contractual impediments that afflict upward tax-point transfers discourage the federal government from offering downward transfers. When the federal government transfers tax points to the provinces, it lacks an easy mechanism for enforcing the transfer's terms. Under the doctrine of parliamentary sovereignty, the federal government cannot use the courts to ensure that provinces spend the resulting revenue in accordance with federal preferences, notwithstanding any promises that the provinces may have made at the time the agreement was negotiated. The federal government also cannot easily revoke the transfer: it can raise its tax rates to pre-transfer levels if it is dissatisfied with provincial compliance, but it cannot compel the provinces to lower their tax rates to pre-transfer levels.

In the absence of corresponding provincial tax cuts, the federal government will have to explain to voters why it has increased the combined federal-provincial tax rate.

---

per capita value of a tax point transferred to a low-tax-base province, the federal government could equalize the value of the transfers by transferring 50 percent more tax points to the low-tax-base province. The problem with this approach is that the downward transfer of all federal income tax points to a low-tax-base province may not equal the value of a much smaller tax-point transfer to a high-tax-base province. There may be no possible asymmetric transfer to the poorer province that can fully equalize the value of the transfers.

117 For a revenue-maximization theory of the optimal division of tax room, see Milligan and Smart, supra note 52, at 22-25. For a consideration of the optimal division of particular tax bases, see Robin W. Boadway and Harry M. Kitchen, “Personal Income Tax Reform in a Broader Context” (1999) 47:3 Canadian Tax Journal 566-602, at 581-83.

118 Subject to the disadvantages of downward tax-point transfers discussed below. To the extent that the disadvantages cannot be resolved by design features of the transfers, they should be taken into account in determining whether to proceed with a downward transfer.

119 This is the same problem that provinces confront with upward tax-point transfers. See the discussion above under the heading “Judicial Enforcement.”
These contractual problems weaken the normative, or social welfare, case for downward tax-point transfers, and diminish the potential political benefits to a self-interested federal government. On both counts, cash transfers, and, to a lesser extent, credits and deductions, have a number of advantages. This section first considers the normative implications and then considers the implications for the federal government's political interests.

**Normative Implications**

The impediments to contractual enforcement raise two problems. First, it is difficult to use tax-point transfers to internalize horizontal and vertical spillovers. Horizontal spillovers occur when a provincial good or service confers benefits on neighbouring provinces. Provinces will generally underinvest in these goods and services, since they reap only a portion of the resulting benefits. Vertical spillovers occur when the expenditures made by one level of government generate tax revenue for another level of government. To the extent that provincial expenditures are motivated by the expected tax revenue generated by an expenditure, provincial governments will underinvest in goods and services. To correct this problem of underinvestment, the federal government should subsidize any spillover-creating provincial expenditures.

The problem with using tax-point transfers to internalize horizontal and vertical spillovers is that (as discussed above) it is difficult to enforce the conditions of a downward transfer. For instance, if the federal government transfers tax points to a province on the condition that the resulting revenues are used to fund health care, it has only limited enforcement options if the province chooses to spend the revenues on paying down the provincial debt. In contrast, with cash transfers, it is easier to encourage (if not enforce) compliance. If a province fails to use a cash transfer as promised, the federal government can refuse to make a cash transfer in the following year. The annual nature of cash transfers makes them easy to discontinue or reduce, and thus provides the federal government with more control over how the funds are spent.

---


121 See Bev Dahlby, “Fiscal Externalities and the Design of Intergovernmental Grants” (1996) 3:3 *International Tax and Public Finance* 397-412. A productive expenditure will generate economic growth that increases the major tax bases, such as consumption and income. Since both levels of government share these tax bases, the government that funds the expenditure does not capture the entire revenue gain.

122 In the absence of enforcement of the transfer’s terms, the transfer will have an income effect but not the desired substitution effect.

123 For example, when the federal government imposed penalties on British Columbia between 2002 and 2018 for breaching the Canada Health Act, it chose to reduce its cash transfers to the
Second, the impediments to contractual enforcement can result in horizontal tax competition that reduces total public revenues. The risk with any downward tax-point transfer is that some provinces might use the transfer to lower their combined federal-provincial tax rate. These provinces would immediately gain a competitive tax advantage, in that their combined tax rates would be lower than those in other provinces. The simplest solution to this problem is contractual: the federal government could require that provinces promise to occupy the vacated federal tax room for at least a minimum period of time. The challenge, however, is that the federal government lacks a legal mechanism for enforcing this obligation. If a province accepted a downward tax-point transfer but then substantially cut the provincial tax rate two years later, the federal government could not turn to the courts to compel the province to raise its tax rate.

In the absence of judicial enforcement, the federal government has two enforcement mechanisms to address horizontal tax competition, although both have limitations:

1. The government can guard against horizontal competition through the use of asymmetric tax-point transfers. If a province refuses to accept a tax-point transfer, the federal government can simply restore the federal tax rate in the holdout province to its original level, causing the holdout province to lose its tax advantage. The challenge with this approach is political. For instance, if a province were to initially accept a tax-point transfer by raising its tax rate, but then later decrease that rate, the federal government would have to respond by raising the federal tax rate to its pre-transfer level. This move may be difficult to justify to voters, especially if the provincial tax cut occurs many years after the initial tax-point transfer. Voters may not accept, or care, that the combined tax increase is related to the previous tax-point transfer. Asymmetric transfers place the federal government in the unenviable position of having to cancel provincial tax cuts.

province rather than scale back a portion of the 1976 tax-point transfer: Michael Mui, “B.C. Fined for Medical Extra-Billing 16 Years in a Row,” The Star Vancouver, April 12, 2018 (www.thestar.com/vancouver/2018/04/12/bc-fined-for-medical-extra-billing-16-years-in-a-row.html); and Pamela Fayerman, “Penalties Reduce Federal Transfer Payments to B.C. by $500,000,” Vancouver Sun, February 19, 2015 (www.vancouversun.com/health/penalties+reduce+federal+transfer+payments/10824574/story.html). More generally, the federal government could encourage compliance by withholding or reducing cash transfers to provinces that breach the terms of a tax-point transfer. The problem with this approach is that it is then the cash transfer, rather than the tax-point transfer, that operates as the conditional grant. As the federal government replaces cash transfers with tax-point transfers, its ability to use cash transfers to enforce adherence to the terms of a tax-point transfer decreases.

If the federal government credibly signals in advance that it will undo its tax cut in any holdout province, it may never have to engage in an asymmetric transfer. The threat may be enough to discourage provinces from holding out.
The federal government can exert pressure on the provinces to accept the tax-point transfer by reducing the amount of cash transfers by the value of the transferred tax points. The reduction in cash transfers presents provinces with a difficult choice: raise tax rates or cut public spending by the amount of the reduced cash transfer. The federal government used this mechanism in 1976. Reductions in cash transfers are a potentially effective mechanism, but they have two limitations:

a. Growth in other provincial revenue sources, such as natural resource revenues, may enable some provinces to reject the tax-point transfer without cutting public spending. The tax advantage gained by the non-participating provinces will attract tax base that at least partly offsets the decrease in federal cash transfers.

b. It may be politically difficult for the federal government to justify to the public that it reduced cash transfers to a province because the province had failed to increase its tax rates. Historically, the federal government has had difficulty justifying asymmetric cash transfers as part of tax-point transfers. For example, following the 1976 tax-point transfer, the federal government provided unequal per capita cash transfers to the provinces, but the inequality came under sustained attack from the wealthier provinces in the 2000s. The federal government agreed to restore equal per capita funding beginning in 2014.125

In contrast to tax-point transfers, cash transfers, credits, and deductions do not create a risk of horizontal tax competition. With cash transfers, the tax room available to provincial governments remains unchanged. With credits and deductions, a provincial tax cut does not change the combined federal-provincial tax rate: the effective federal rate automatically increases to fill the vacated provincial tax room.

**Political Implications**

In addition to the normative implications, there are two reasons why the contractual impediments may discourage the federal government, as a self-interested political actor, from engaging in downward tax-point transfers.

First, tax-point transfers reduce the federal government’s capacity to obtain a portion of the political credit for provincial expenditures. When the federal government provides cash transfers to the provinces, it regularly requires that the provinces take steps to recognize the federal contribution.126 The renewal of cash

---


126 See supra note 75, referring to the requirement in the Canada Health Act.
transfers is also frequently accompanied by press conferences and advertisements that publicize the federal government’s contribution. Tax-point transfers are harder to use for political benefit. For example, in the 40 years following the 1976 tax-point transfer, the federal government claimed that the revenue resulting from the transfer was a federal contribution to the provinces. The provinces, however, frequently disputed the claim; now that the tax points were levied by the provinces, the resulting revenue was, in their view, own-source provincial revenue. A number of prominent experts agreed: the revenues generated from the transfers had gradually lost their federal character over time. Since tax-point transfers are harder to revoke than cash transfers, credits, and deductions, the federal government had little leverage in the dispute. In 2007, it agreed to remove the 1976 tax-point transfers from the formula used to determine cash transfers under the Canada health transfer, beginning in 2014.

Second, tax-point transfers make it difficult for the federal government to change its mind. When the federal government offers cash transfers to the provinces, it can reduce or cease the cash transfers if it later decides that it would rather spend the revenue on areas of federal jurisdiction. Similarly, the federal government can repeal or reduce a deduction or credit without raising nominal tax rates. In contrast, 

127 See, for example, the 2017 renewal of the Canada health transfer, which allowed the federal government to announce new funding commitments to mental health care: Health Canada, “Federal, Provincial and Territorial Health Ministers Agree on Collaborative Approach To Improve Access to Mental Health and Addiction Services, Home and Community Care,” News Release, August 21, 2017 (www.canada.ca/en/health-canada/news/2017/08/federal_provincialandterritorialhealthministersagreecollaborat.html). Since tax-point transfers do not require renewal, there is less opportunity for public funding announcements.


129 Prominently, a 2000 report prepared by the provincial ministers of health proclaimed that the “provinces/territories do not consider it legitimate to count the tax point value as part of [federal transfers] each year . . . since it is revenue collected from provincial/territorial tax effort.” See Provincial and Territorial Ministers of Health, supra note 74, at 11-12. See also David B. Perry, “Health and Social Transfers” (2000) 8:5 Canadian Tax Highlights 34-35, at 35.

130 See Robin Boadway, “Policy Forum: The Annual Tax Expenditure Accounts—A Critique” (2007) 55:1 Canadian Tax Journal 106-29, at 119 (“[F]or all intents and purposes, the transfers are now part of provincial tax revenues”); Carter, supra note 45, at 547 (warning that the “association the tax transfer now has with a specific area of provincial expenditure” might “vanish”); George E. Carter, “Established Programs Financing: A Critical Review of the Record” (1988) 36:5 Canadian Tax Journal 1225-43, at 1230 (“[O]nly the cash transfer had retained a federal identity”); and Perry, supra note 27, at 275 (“In practical terms, the provinces had the better of the argument: the tax points were now in their hands, and they were not likely to give them back”).

131 See Gauthier, supra note 125, at 6; and Wingrove, ibid.

132 This political advantage may explain why the US government capped the SALT deduction rather than raise nominal tax rates in high-tax states. See supra notes 2 and 3.
once tax points have been transferred, the federal government may be unable to reclaim them if its preferences (or circumstances) change. The problem is that the federal government cannot easily impose time limits on tax-point transfers. It may insist that the provinces return tax points after a limited period—say, five years—but there is a real risk that a downward transfer will result in the permanent, or at a minimum long-term, surrender of tax room.133

CONCLUSION

Tax-point transfers are potentially a foundational tool of fiscal federalism. They provide a coordinated means for changing the allocation of tax room between governments. Upward transfers can be used to increase the revenue of both federal and provincial governments. Downward transfers can be used to mitigate the incentive problems that result from intergovernmental cash transfers.

This article’s central claim is that problems with contractual enforcement render tax-point transfers less attractive to the transferor government than alternative funding mechanisms. The article provides a partial explanation for why provinces have failed to voluntarily engage in upward tax-point transfers despite the potential revenue gains: a province that transfers tax points surrenders control over the resulting revenue. The article also provides an explanation for the absence of downward tax-point transfers over the last 40 years. When the federal government transfers tax points rather than cash, it weakens its control over the resulting revenue, and also jeopardizes its efforts to claim a share of the political credit for provincial spending.

The problem of contract enforcement has implications for fiscal federalism and for law. For fiscal federalism, the contractual impediments to tax-point transfers mean that some welfare-enhancing changes in tax-room allocation may not occur. In the absence of contract enforcement, tax-point transfers require high degrees of intergovernmental trust; high degrees of coercion, as in the case of the 1942 tax rental agreements; or significant benevolence on the part of the transferor government. When trust, coercion, or benevolence are low, tax-point transfers in lucrative tax bases are difficult to achieve.

For law, the problems with contract enforcement cast new light on the doctrine of parliamentary sovereignty. An animating purpose of the doctrine is to preserve the flexibility of legislatures to change legislation as circumstances warrant.134 This article observes that, at least in the context of tax-point transfers, the doctrine actually limits the policy options available to governments. Just as enforceable contracts expand the options open to individuals, they can expand the options open to governments.

133 Carter, supra note 45, at 547; and Carter, supra note 69, at 1529.
