
Introduction and Overview

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Le chapitre préliminaire fournit un bref aperçu des principaux thèmes du tome 2006-2007 de Canada : état de la fédération. Ce tome, intitulé « Transitions : fédéralisme fiscal et politique dans une ère de changements », cherche à analyser plusieurs nouveaux développements dans les politiques intergouvernementales du Canada et à faire des liens entre eux : l'introduction d'un principe de « fédéralisme ouvert » par le gouvernement Harper; la reconnaissance du Québec à titre de « nation » distincte; la restructuration du programme de péréquation dans le budget 2007 et ses répercussions sur le fédéralisme fiscal, pour ne nommer que ceux-là. L'introduction divise le livre en six parties, puis offre un bref résumé de la contribution de chaque auteur au sujet qui l'occupe. Enfin, elle fait valoir que compte tenu des changements drastiques apportés à la fédération sur plusieurs fronts, l'idée de « transition » jouera vraisemblablement, dans les années à venir, un rôle déterminant dans les relations intergouvernementales.

INTRODUCTION

Not surprisingly, the election of Stephen Harper's minority Conservative government in January 2006 represented a dramatic break with many of the policies and commitments of the Chrétien-Martin Liberals. Kelowna is out. So is Kyoto. And Paul Martin's series of bilateral deals with the provinces (day care, cities, infrastructures) have been replaced by Harper's "open federalism," replete with a commitment to limit the exercise of the federal spending power in areas of exclusive provincial jurisdiction. At another level, the Harper government adopted some of the achievements and inherited some of the problems that characterized the Liberal regime. With respect to the former, for example, Finance Minister James Flaherty now champions Ottawa's fiscal and budgetary

proress in ways very similar to those of his Liberal predecessors. And any listing of inherited problems would certainly have to include the fiscal tug-of-war with Nova Scotia and, more particularly, Newfoundland and Labrador over the restructuring of equalization – most notably the treatment of resource revenues – in the wake of Paul Martin’s 2004 “fixed framework.”

Hence, it is fair to say that Canada is in a transition period on policy grounds (since in several areas we are in the process of moving toward new equilibria) as well as on political grounds (since the Conservatives are in a minority position). Accordingly, *Transitions: Fiscal and Political Federalism in an Era of Change* (“*Transitions*”), seems an apt title for a volume devoted to an analysis of the continuing evolution of Canada’s intergovernmental policies and challenges.

This volume has its origins in the Institute’s annual conference (September 2006). However, the march of events quickly overcame selected components of the conference and revealed that other key aspects were missing. For example, while the reports of the Expert Panel on Equalization and Territorial Formula Financing (the “Expert Panel”) and the Advisory Panel on Fiscal Imbalance (the “Advisory Panel”) were available at the time of the conference, the new equalization program (actually programs) introduced in the 2007 federal budgets necessitated additional papers and fresh perspectives. In consequence, roughly half of the papers in this volume represent contributions that were either commissioned or accepted post-conference. It is a pleasure to express our gratitude to all our authors and to acknowledge that their continued interest in the Institute’s activities is our most precious asset.

Transitions is organized as follows. Part II (*The Politics and Economics of Fiscal Federalism: Setting the Stage*) consists of three background papers. The first is a historical and policy overview of fiscal federalism by Brock University’s Garth Stevenson. The other two background papers deal with the reports of the two equalization panels. In his paper, Al O’Brien, Chair of the Expert Panel, summarizes the principal findings of the federal report (*Achieving a National Purpose: Putting Equalization Back on Track*), while those of the Advisory Panel’s report (*Reconciling the Irreconcilable: Addressing Canada’s Fiscal Imbalance*) are provided by the inclusion of its concluding chapter.

Part III (*Equalization: Policy Perspectives*) presents two policy evaluations of the new equalization system (in the larger context provided by the reports of the two panels and the 2007 federal budget). The first of these is by University of Saskatchewan’s Janice MacKinnon and the second by University of Alberta’s Paul Boothe. In Part IV (*Equalization: Analytical Perspectives*), papers by Robin Boadway (Queen’s University), Jean-François Tremblay (University of Ottawa) and Joe Ruggeri (University of New Brunswick) provide in-depth analyses of the related issues of fiscal balance and equalization.

Part V (*Equalization: The Offshore Accords*) rounds out the assessment of the new equalization system with two papers on the implications for offshore

energy, the first by Memorial’s James Feehan on Newfoundland and Labrador, and the second, on the impact on the Maritime provinces, by Acadia’s Paul Hobson and Memorial’s Wade Locke.

The focus of Part VI (*Cities, Local Government, and Federalism*) is on municipal governments, most particularly on cities, with papers by Anwar Shah of the World Bank, Anne Golden of the Conference Board of Canada, and Thomas Courchene of Queens. Part VII (*Federalism and the Spending Power*), the final section of the volume, addresses aspects of the federal spending power. The initial paper is by Marc-Antoine Adam, Government of Quebec, who analyzes the potential of s.94 of the Constitution to be revitalized in the spending-power context. This is followed by Gordon DiGiacomo’s analysis of the interaction between benefits provided pursuant to Employment Insurance and the exercise of the federal spending power. The volume then concludes with a very different perspective – Networked Federalism – provided by University of Toronto’s Janice Gross Stein.

The remainder of the introduction is devoted to a more detailed overview and summary of the included papers.

THE POLITICS AND ECONOMICS OF FISCAL FEDERALISM: SETTING THE STAGE

FISCAL FEDERALISM AND THE BURDEN OF HISTORY (GARTH STEVENSON)

Garth Stevenson’s historical overview is a most appropriate backdrop to this year’s *State of the Federation*. In part, this is because the paper traces the many threads of Canada’s policy and political transitions in federal-provincial fiscal relations from our origins as “an economy based on natural resources, and a society in which social services were mainly provided by the Catholic Church in Quebec and by private charities elsewhere” through to the present time. If there is a constant in Stevenson’s story, it is “the continuity of provincial discontent with our intergovernmental fiscal arrangements.”

Stevenson provides a broad, historical overview of intergovernmental developments from Confederation through to the creation of the CHST. His analysis then becomes more detailed as he focuses on the more recent debates of fiscal federalism: issues of fiscal balance, the spending power, Paul Martin’s offshore accords, the three fiscal federalism reports (Expert Panel, Advisory Panel, the report of Canadian Centre for Policy Alternatives), the Harper election and open federalism, Flaherty’s 2007 budget, including the new equalization formula, and, of course, the continuing provincial discontent that currently embraces most of the provinces.

As with several of the other authors in this volume, Stevenson concludes with his own proposals for reforming Canada’s fiscal relations. Specifically,

he would i) transfer the corporate income tax to Ottawa; ii) transfer the GST to the provinces; and iii) phase out the CST (for CAP, and PSE), which, with respect to areas of provincial responsibility, would leave Ottawa involved only in the health areas (via the CHT). Among the virtues of these reforms would be increasing own-source provincial revenues, limiting the role of the federal spending power in areas of provincial jurisdiction, and reworking the tax assignment in ways that are consistent with the principle of subsidiarity (moving taxes on mobile and volatile taxes up the jurisdictional ladder and vice versa).

THE EXPERT PANEL REPORT (AL O'BRIEN)

In the aftermath of Ottawa's 2004 "fixed framework" approach to equalization (i.e., \$10.9 billion for 2005–06, to be escalated thereafter by 3.5 percent annually for a decade) and the later 14 February 2005 agreement (*The 2005 Nova Scotia and Newfoundland and Labrador Additional Fiscal Equalization Offset Payments Act*), the federal government created the Expert Panel on Equalization and Territorial Formula Financing, chaired by former Alberta deputy provincial treasurer, Al O'Brien.¹ In the same time frame, the Council of the Federation established an independent Advisory Panel on Fiscal Imbalance with a mandate to examine the vertical and horizontal fiscal imbalances among Canada's federal, provincial and territorial governments. This Advisory Panel was co-chaired by Robert Gagné and Janice Stein.² We focus on each in turn, beginning with the federally-commissioned report.³

Al O'Brien outlines the Expert Panel's mandate and recommendations for both the equalization program and for territorial formula financing (TFF). The major recommendations of the Expert Panel include abandoning Paul Martin's 2004 fixed framework in favour of the Expert Panel's "principles-based" approach; opting for a ten-province standard with 50 percent inclusion of resource revenues and 100 percent inclusion of all other revenues; reducing the number of tax bases from 33 by consolidating the smaller bases into five larger, well-established RTS bases; and imposing a confiscatory fiscal-capacity cap to ensure that no equalization-receiving province ends up with an all-in fiscal capacity (defined to include 100 percent of *all* revenues plus equalization) that is higher than that of the lowest non-receiving province.

¹The other Expert Panel members were Fred Gorbet, Robert Lacroix, Elizabeth Parr-Johnston and Mike Percy.

²The other Advisory Panel members were Peter Meekison, Senator Lowell Murray and John Todd.

³We were remiss in not including any paper dealing from a territorial perspective with the issue of territorial financing. The omission of a paper dealing specifically with the unique situation of Saskatchewan is also regretted.

The three annexes to the O'Brien paper relate, in turn, to the recommendations for equalization, to the recommendations for TFF, and to the manner in which the Expert Panel's reductions of tax bases from 33 to 5 was accomplished.

Interestingly, and unlike the experience associated with many similar panels, essentially all of the Expert Panel's recommendations were adopted by the Minister of Finance in his 2007 budget.

THE ADVISORY PANEL REPORT (*RECONCILING THE IRRECONCILABLE: CONCLUSION*)

The Advisory Panel's mandate was broader than that of the Expert Panel: not only was it mandated to examine the vertical and horizontal imbalances "among Canada's federal, provincial, and territorial governments and to make recommendations as to how any fiscal imbalances should be addressed," it was also directed to examine "the current health and social transfer system, the Equalization program, Territorial Formula Financing, and other major federal transfers to provinces and territories and to review a full range of mechanisms aimed at redressing fiscal imbalances between governments" (*Reconciling the Irreconcilable*, 7).

With respect to equalization, the Advisory Panel recommends a ten-province standard, with 100 percent of all revenues entering the formula. This would generate a level of equalization that is well in excess of the status quo, as well as in excess of the equalization arising from the Expert Panel's formula. The Advisory Panel notes that if affordability then becomes an issue, negotiations between the two orders of government should take place and the equalization standard should be lowered in per-capita terms (as negotiated), so that the payments do become affordable. Regarding vertical fiscal balance, the Advisory Panel believes that there is an imbalance in favour of Ottawa. Accordingly, it recommends that the combined per capita CHT/CST be increased from \$807 to \$960 (which increase would notionally be assigned to the CST). The Advisory Panel supports the federal government's commitments to escalate the CHT at 6 percent per year, and recommends that the CST should be escalated at 4.5 percent per year. On the issue of governance, the Advisory Panel proposes that the two levels of government establish a First Ministers' Fiscal Council (FMFC) to deal on an ongoing and quinquennial basis with intergovernmental fiscal arrangements. In addition, this FMFC would establish a new body, the Canadian Institute for Fiscal Information (CIFI), to serve as an "impartial third party with the role and stature to gather information, undertake analyses, prepare reports, and offer recommendations to all governments on the operation of the system as a whole" (*Reconciling the Irreconcilable*, 96).

With these reports as background, we now turn to the assessments of the new equalization program as detailed in the 2007 federal budget (as noted,

largely the O'Brien model). By way of concluding this section, we note that the policy perspectives on the equalization program (by Paul Boothe and by Janice MacKinnon) are broadly supportive of the Expert Panel approach, whereas the analytical perspectives (by Robin Boadway and Jean-François Tremblay), at least with respect to the treatment of resource revenues, are more comfortable with the approach taken by the Advisory Panel.

EQUALIZATION: POLICY PERSPECTIVES

EQUALIZATION: TAX PROBLEMS AND THE 2007 FEDERAL BUDGET (JANICE MACKINNON)

Janice MacKinnon commends the 2007 federal budget for restoring predictability and stability to federal-provincial relations by "establishing a long-term framework for equalization and other transfers based on rules and principles." In terms of equalization, uppermost in MacKinnon's mind is the budget's return to a principles-based approach in the wake of the damage done by Paul Martin's offshore side deals and by his untying the amount of equalization from a formula-determined level. At a more general level, she welcomes the end to the practice of having an equalizing component in other transfers (i.e., "backdoor equalization"). The reference here is in support of the move to put federal cash transfers on an equal per-capita basis by province, although those for health care will only be made equal-per-capita after 2013–14, i.e., after the current health agreement expires. Her hope is that in the future all federal programs "will be funded on a per capita basis unless there is some compelling policy reason to do so otherwise."

MacKinnon's contribution is also refreshing in that she offers some candid comments with respect to most provinces. For Quebec: "it is easier for Quebec to remain a 'have-not' province receiving sizeable equalization payments, than to make the difficult decisions to tackle its own problems with its economic structures and social programming." For her home province: "If Saskatchewan had been willing to compromise and recognize the need for some form of cap, it could probably have negotiated a less restrictive cap." And while equalization is supported throughout the country, we need to be realistic in terms of what it can achieve: "The goal is not to ensure that Canadians in Alberta and Prince Edward Island enjoy the same level of services, and there need to be strict limits on the extent to which resources are redistributed across provinces."

Her conclusion follows directly from this analysis: "Although equalization was broken, mainly by the 2005 side deals with Newfoundland and Nova Scotia, the 2007 budget 'fixed' the main problem by establishing a more realistic approach to what equalization can achieve and what it can NOT achieve, and should not even try to tackle" [capitalization in original].

NATURAL RESOURCE REVENUES AND FISCAL FEDERALISM: AN ALBERTA PERSPECTIVE (PAUL BOOTHE)

By way of an introductory comment, the editors note that Paul Boothe's paper was presented at the IIGR conference and then finalized during his University of Alberta interregnum from senior positions in the federal civil service. In his paper, he first emphasizes the very special place that resources (especially energy) occupy in the psyche, politics and economics of Alberta and Albertans, and then reflects on the treatment of resource revenues in the O'Brien report and in the new equalization formula. With respect to the first of these, the single defining event was the introduction of the National Energy Program (NEP). As he observes, "Albertans, led by Premier Peter Lougheed, regarded the NEP as tantamount to a declaration of war by Ottawa on Alberta." By way of another editorial aside, this perspective is especially important at a time when the energy/environment nexus has the potential for igniting a 21st century version of the NEP, as Peter Lougheed has recently speculated.

Boothe then turns his attention to dispelling a few energy-related myths. For example, it simply is not true that, because Alberta's energy is provincially owned, Ottawa and the other provinces derive no benefit from their development. And, seemingly for balance, "it is simply incorrect to argue that the federal government is unfairly capturing Alberta's natural resource-revenues to finance its activities in other parts of the country." Evidence is presented on both counts.

The remainder of his paper deals with the energy-equalization relationship. Boothe is, by and large, in favour of the compromise for the treatment of resources found in the O'Brien report. And he accepts the manner in which the 2007 budget has embraced the O'Brien report, including the additional option of an alternative formula with zero resource-revenue inclusion but continuing with the requirement of the fiscal-capacity cap. However, he does note that although Alberta and Ontario have been largely supportive of these reforms, Saskatchewan, Newfoundland and, to a lesser extent, Nova Scotia, have vigorously condemned them. Hence the durability of the 2007 arrangements may ultimately rest on the judgement of voters.

EQUALIZATION: ANALYTICAL PERSPECTIVES

NATURAL RESOURCE SHOCKS AND THE FEDERAL SYSTEM: BOON AND CURSE? (ROBIN BOADWAY)

Issues related to energy rents/revenues have created challenges for Canada's equalization program since its inception some fifty years ago (1957). In his contribution to this volume, Robin Boadway distinguishes between the implications arising from an energy boom, per se, and those arising because of the

nature of Canada's federation. Hence, he focuses in turn on energy booms in a unitary state, then in a centralized federation and, finally, in a decentralized federation where resource ownership is provincial. In terms of a unitary state, he notes:

It is not at all clear that the location of valuable deposits of natural resource wealth should itself dictate the location of nodes for the development and growth of diversified activity. On the contrary, natural resources are often located in remote areas that have no other natural advantages for economic development.

Boadway goes on to note that this may be exacerbated in a decentralized federation because "of the potential that resource revenues give the provinces to engage single-mindedly in proactive province-building policies, possibly to the detriment of the development of the nation as a whole." This theme, that the "boon of a positive shock in resource wealth can be a curse at the same time," is reflected in the subtitle of the paper.

Boadway then examines the implications of his analysis for Canada's approach to fiscal federalism and equalization. In terms of equalization, his preference is for the Advisory Panel's approach over the Expert Panel's approach, largely because he believes that horizontal equity requires that 100 percent of *all* revenues should enter the formula. Should this, as it almost certainly would, generate an issue of affordability, Boadway suggests that the appropriate remedy would be to adjust the standard rather than the proportion of resource revenues to be equalized. This alternative would entail equal per capita changes in entitlements for all provinces, thereby maintaining horizontal balance among have-not provinces; in contrast, reducing the proportion of resource-revenues equalized damages relatively the resource-poor provinces. The alternative of "equalizing down," as Australia does, is simply not available politically to Canada at this time.

In terms of vertical fiscal balance, he favours revenue sharing (again as exemplified by Australia and its GST) rather than having the provinces acquire additional tax points. Indeed, he is very concerned that the vertical fiscal gap be sufficiently large for Ottawa to be able to adequately exercise the federal spending power. In Boadway's view, this combination of a large fiscal gap (in Ottawa's favour) and the exercise of the federal spending power is a most-important instrumentality: "It is the only one that is available to the federal government to fulfill its constitutional responsibilities under both parts of section 36 as well as to fulfill its legitimate policy interest in achieving national efficiency and equity."

Clearly, Boadway's recommendations would constitute a markedly centralist departure from the status quo, both for equalization and, more generally, of the conceptual underpinnings of fiscal federalism.

FISCAL BALANCE AND REVENUE-SHARING (JEAN-FRANÇOIS TREMBLAY)

Jean-François Tremblay's contribution continues the centralization thrust of the Boadway paper, in part because both papers draw from the authors' joint article, *A Theory of Fiscal Imbalance* (2006). Specifically:

The main purpose of this paper is to argue that the best way to reallocate a greater share of public funds to provincial governments and maintain vertical fiscal balance in the federation in the long-run is neither to increase federal transfers in their current form, nor to reallocate additional tax room to the provinces, whether that occurs through a coordinated tax-point transfer or through uncoordinated tax decentralization. Instead, the federal and provincial governments should adopt revenue-sharing arrangements under which both levels of government would share the revenues from particular tax bases according to specific rules.

Toward this end, Tremblay presents a series of equity, efficiency and economic-union rationales for a greater centralization of taxes and, therefore, for a larger fiscal imbalance. His choice of taxes for revenue sharing are sales taxes (via a federally run and uniform national GST) and corporation taxes (again via a federally run and uniform national corporate tax). The provincial shares of both these taxes would be allocated on an equal per capita basis. Among the benefits claimed would be a lesser need for equalization, a more harmonized taxation system, and an elimination of "destructive competition in provincial tax policies."

Tremblay concludes by noting that if the optimal fiscal gap is not the same throughout the federation – e.g., if it is smaller for Quebec – then he would (reluctantly) embrace some version of asymmetrical fiscal arrangements for Quebec.

EQUALIZATION REFORM IN CANADA: PRINCIPLES AND COMPROMISES (JOE RUGGERI)

Joe Ruggeri presents and evaluates a fresh approach to Canada's system of equalization and transfer payments. However, en route to this new proposal, he also provides a brief overview of the origins and history of the equalization program and of the variety of ways in which that program has attempted to come to grips with the challenges arising from resource revenues. This accomplished, Ruggeri undertakes a comparison of the Advisory Panel and Expert Panel reports, with emphasis on how resource revenues are treated in each. The basic issue here is that Ottawa cannot directly access revenues from provincial natural resources. Hence, the equalization program needs to provide answers to two questions: first, should resource revenues contribute to a

province's measured fiscal capacity? And second, should the constitutional constraint on the federal government's capacity to raise revenues from natural resources be considered in determining the federal financial commitment to the program? Ruggeri notes that the Advisory Panel's answer is "yes" to the first question, since it recommends 100 percent inclusion of resource revenues in the formula. The answer from the Expert Panel (and that actually adopted) is "yes, but, ..." with the "but" being that only 50 percent of resource revenues will be counted in fiscal capacity. In terms of the second question, both reports recommend "affordability caps" if necessary (i.e., scaling overall equalization down to "acceptable levels"), with the Expert Panel also recommending a fiscal cap to prevent a "have-not province" from being transformed by equalization into an effective "have province."

Ruggeri's proposal is that the answer to the first question should be 100 percent inclusion of all resource revenue, while the answer to the second should be that Ottawa ought not be responsible for financing equalization payments that would be attributable to provincial resource revenues. Given these answers, his preferred approach is as follows. First, calculate the fiscal capacity and the equalization arising from the application of a national-average standard (NAS) with 100 percent inclusion of all revenues. Second, calculate the equalization arising from applying the NAS to provincial revenues with 0 percent inclusion of resource revenues. Third, subtract these two, with the difference being the amount of equalization arising from resource revenues. Fourth, calculate the average per capita value of this difference for the receiving provinces and, fifth, subtract this amount (\$170 per capita in his example) from the equalization entitlements obtained in step number one. The end result is that the provincial fiscal capacities are determined by NAS and 100 percent inclusion, whereas the level of payments would exclude the equalization otherwise attributable to provincial resource revenues. In simpler terms, *the allocation of provincial shares* of equalization would include resource revenues, but *the amount to be allocated* would not. Ruggeri compares the results obtained from this intriguing compromise with those yielded by the two reports, as well as by the federal formula contained in the 2007 federal budget.

EQUALIZATION: THE OFFSHORE ACCORDS

In 1984 the Supreme Court of Canada ruled that offshore oil belonged to Canada, not to Newfoundland and Labrador (and, by extension, not to Nova Scotia). However, in 1985 for Newfoundland and Labrador (via the "Atlantic Accord") and 1986 for Nova Scotia (via the "Offshore Accord"), Ottawa permitted these provincial governments to tax offshore oil and gas as if they were located on their land.

Among other provisions, these accords provide "offset" payments to mitigate the clawback of resource revenues in the form of reduced equalization entitlements, thereby ensuring that the effect of equalization on such revenues is not confiscatory. One might note in passing that the definition of offshore energy revenues adopted in these Accords includes ancillary revenues, such as corporate income taxes. The net result, therefore, is a federal treatment of the "Accord" provinces decidedly more generous than that accorded Saskatchewan which *does* own the oil and gas in the province, but where the effects of equalization have, on occasion, been confiscatory.

During the 2004 federal election, Prime Minister Paul Martin promised Newfoundland and Labrador Premier Danny Williams that, in Williams's words, provision would be made for a full federal offset of all offshore energy clawbacks under the equalization program. After much grandstanding, the result was the 2005 Offshore Revenues Agreement (ORA), which applied to both Newfoundland and Labrador and Nova Scotia.

It is the implications for the Atlantic region of this 2005 agreement that is the focus of Part V of *Transitions*, most particularly the manner in which the O'Brien Report and the 2007 federal budget interacted with the ORA. Of the two papers included, that by James Feehan assesses the implications for Newfoundland and Labrador, while that by Paul Hobson and Wade Locke addresses the significance for the Maritimes.

EQUALIZATION 2007: NATURAL RESOURCES, THE CAP AND THE OFFSET PAYMENTS AGREEMENTS (JAMES FEEHAN)

The Feehan paper begins with a most useful summary of events leading up to and including the new equalization formula contained in the 2007 federal budget. This new formula included i) a 50 percent inclusion rate of resource revenues in the formula; ii) offset payments that would transfer equalization clawbacks back to Newfoundland and Labrador; and iii) a confiscatory cap on overall revenues (defined for this purpose to include 100 percent of energy revenues) such that an equalization-receiving province could not have an all-in per capita fiscal capacity greater than that of the lowest non-equalization-receiving province. It is this "cap" that is now at the centre of Canada-Newfoundland and Labrador relations.

As Feehan notes, however, there are two additional options open to Newfoundland and Labrador. Option two allows for the full exclusion of all natural resource revenues from the equalization formula, but with the confiscatory cap still in place. The third option (available only to Nova Scotia and Newfoundland and Labrador) is the Martin 2004 formula (the so-called "fixed envelope" system), which allows overall equalization to grow at the annual rate of 3.5 percent and under which there would be 100 percent inclusion of resource revenues but no fiscal cap. Under this latter option, Newfoundland and Labrador's equalization would be the difference between its per capita

fiscal capacity (as defined above) and the ten-province value. One advantage of this model is that the offset payment under the 2005 Accord would not reduce Newfoundland and Labrador's equalization; in consequence, the province could at the same time be an equalization-receiving province *and* have an all-in fiscal capacity in excess of that of the lowest non-recipient province. While options one and two are available on a continuing basis for all provinces, should Newfoundland and Labrador opt for option three, it then locks itself into this option for the duration (although Ottawa seems to be relenting a bit here).

Feehan presents an excellent (albeit unavoidably complex) assessment of these options and then focuses on the confiscatory cap and, in particular, why it is 100 percent. His view is that the cap is too severe and needs rethinking. Over the history of equalization, Feehan notes that there have been several occasions when the operative cap related to resource revenues was 50 percent; there is precedent for a less-than-confiscatory cap. His concluding comment focuses on achieving a balance:

Critics should understand that arguing against a clawback mechanism is untenable when all natural resource revenue, or any other major revenue source, is excluded from equalization. On the other side, the federal government should, firstly, recognize the limitations imposed by the offset agreements, and, secondly, re-assess the clawback rate on provinces' natural resource revenues.

The bottom line here is that there is both room and rationale for compromise, especially since Feehan's view is that a bit of compromise may lead to a situation where all provinces could agree on a single equalization formula rather than the multiple formulas that currently exist.

CHANGES TO CANADA'S MAJOR FEDERAL-PROVINCIAL TRANSFER PROGRAMS: IMPLICATIONS FOR THE MARITIME PROVINCES (PAUL HOBSON AND WADE LOCKE)

The Hobson and Locke approach to assessing the impact of Budget 2007 on the fiscal capacities of the Maritime provinces is to undertake an empirical simulation of the various fiscal-federalism models on offer. Among the many conclusions and implications that derive from these simulations, three (at least) are of more than passing interest.

The first is that although all three Maritime provinces are better off initially under the Budget 2007 formula, over time and cumulatively the 2004 fixed framework dominates. Then the natural question is the following: Why are Nova Scotia and Newfoundland and Labrador allowed to access the 2004 fixed framework, but not New Brunswick and PEI (and, by extension, all other provinces)? This question did not arise in the context of the budget debate largely, one must surmise, because the Hobson and Locke calculations were not available at that time.

A second noteworthy result relates to the conversion of the CST and, eventually, the CHT, to an equal per capita basis. To this point, the per capita cash transfer to each province was a residual, namely the difference between the equal-per-capita entitlement and the value of the tax-point transfer to the province. This was "full" equalization in that the cash-plus-tax-transfer per capita revenues for all provinces are brought up to that of the top province (Alberta). Under the conversion to equal-per-capita cash transfers, the resulting relative redistribution will be from lower-than-average income provinces toward higher-than-average income provinces. In terms of the Hobson-Locke paper, this means that all three Maritime provinces lose again, this time relatively and absolutely to the above-average-income provinces.

A final (for present purposes) noteworthy conclusion relates to the range of issues addressed by Feehan. Specifically, Hobson and Locke emphasize that the presence of the confiscatory cap generates a *two-step process for equalization*. In order to determine whether a province qualifies for equalization, the total fiscal capacity of a province (100 percent inclusion of all revenues) must be below that of the lowest non-equalization receiving province. If a province thus qualifies, then its equalization payment will be determined via the new equalization program (50 percent resource inclusion). This is a departure from traditional one-step procedures when the formula determines both eligibility and payments.

The editors note that an intriguing complication to the new equalization program may be about to enter centre stage, namely, the possibility that Ontario slips into have-not territory in terms of the new formula, i.e., the 50 percent resource-revenue-inclusion formula. Ontario is already a have-not province in terms of 100 percent inclusion of all revenues. This would mean that the lowest non-receiving province would become British Columbia, with potential windfalls to Saskatchewan, Nova Scotia and Newfoundland and Labrador and a considerable increase in the cost of the program to the federal government.

CITIES, LOCAL GOVERNMENT AND FEDERALISM

One of the important initiatives of the short-lived Paul Martin government was to elevate the role of cities in the federation. This included the commissioning in 2004 of the External Advisory Committee on Cities and Communities (EACCC) chaired by former British Columbia premier and Vancouver mayor Mike Harcourt. As events transpired, the EACCC reported on Prime Minister Harper's watch and the report disappeared without much of a trace. Nonetheless, the analytical and policy literature seems to point in the direction of the continuing ascendancy of cities. The fact that Canadian cities, especially our global city-regions, are poorly positioned politically and fiscally

in the international rankings of cities seems to establish a presumptive case that we have not heard the end of this issue. In consequence, Part VI offers, in anticipatory fashion, three perspectives by Anwar Shah, Anne Golden, and Thomas Courchene on the role of cities and local government in century 21.

RETHINKING FISCAL FEDERALISM IN CANADA: A LOCAL GOVERNMENT PERSPECTIVE (ANWAR SHAH)

The World Bank's Anwar Shah was invited to the IIGR's fiscal-federalism conference to offer an international perspective on recent Canadian developments in fiscal and political federalism. In addressing this mandate, Shah divides his comments into two distinct parts. The first is a commentary on recent developments in the Canadian federation, and the second relates to his concern that Canada's approach to local governance lags behind creative approaches adopted elsewhere.

Concerning recent developments, Shah offers a series of wide-ranging comments and recommendations, including complimenting Canada on returning to a principled approach to equalization; proposing that Canada move in the New Zealand direction of performance-based budgeting; suggesting that the federal government adhere more closely to the provisions of the Social Union Framework Agreement; and offering kudos to Ottawa for refocusing its activities to areas of exclusive federal jurisdiction. All of these are couched in the context of hoping that Canada will remain an example of best practice for decentralized federations.

Shah's principal message, however, is that Canada's approaches to local government and governance require "urgent attention." In an era where city and municipal governments generally are increasingly important, Canada's cities not only lack constitutional status but, by international standards, they play a relatively smaller role, both politically and fiscally. For example, local governments in Canada account for 12 percent of overall government expenditures and 6 percent of GDP, compared to 28 percent and 11 percent respectively for US local governments and 28 percent and 13 percent for their OECD counterparts. The clear implication is that we need to place greater reliance on this level of government.

The remainder of his paper then focuses on alternative analytical perspectives to local governance, such as traditional fiscal federalism (where local government is subordinate in a multi-tiered system); new public management (where public managers create value by mobilizing and facilitating a network of providers beyond local government); and new institutional economics (where citizens as principals create various orders of government as agents to serve their interests), etc. In the last section of his paper, Shah makes a case for a citizen-centred local governance, where government is responsive to citizens' preferences, is prudent and efficient with citizens' monies, and is accountable

to citizens. Conveniently, he provides a rather all-encompassing tabular comparison between the traditional approach to local government and a citizen-centred approach.

CITIES: A NATIONAL PRIORITY (ANNE GOLDEN)

Anne Golden's thesis is that "in today's globally competitive and connected world, our major cities' distinctive needs require national attention – and action – so they can realize their potential as drivers of sustainable prosperity." Indeed, "big cities need more resources, more autonomy and more influence on senior government decision-making." This is true both in absolute terms and in relation to other (smaller) cities since the challenges facing major cities are "an order of magnitude" greater than those facing other municipalities. Golden also asserts that this is true also of the costs the major cities face: immigration settlement issues; magnets for low-income residents; social housing; public health; police and fire services; infrastructure costs for mass transit and suburbia; and recreational and cultural facilities that only big cities can sustain.

Golden also refers to the conclusions of the earlier Conference Board of Canada's "hub city" study (Brender and Lefebvre 2006). The findings indicate that economic growth in each of these hub cities (Vancouver, Edmonton, Calgary, Saskatoon and Regina, Winnipeg, Toronto, Montreal, and Halifax) has generated an "even faster" rate of economic growth in the other communities within their respective provinces or regions. In other words, and intriguingly, investing in hub cities leads to intra-provincial economic convergence.

On the question of whether Ottawa should defer from focusing on cities because the Constitution effectively make cities the creatures of provinces, Golden answers as follows:

It would be paradoxical to expect Ottawa to restrict itself to indirect ways of helping cities out of deference to constitutional roles prescribed in 1867, an era when conditions were entirely different. All intelligent human arrangements must evolve in response to changing conditions. No observer of Canadian and global trends would today design a constitution that forbade federal government involvement in the engines of national prosperity. It is, after all, a two way street: flourishing cities help Ottawa achieve its overall economic and social objectives.

Golden's concern is that, rather than this being recognized, many of the current transfer programs (EI, the federal gas tax transfer) have built-in biases (either inadvertent or deliberate) against major cities and their residents. Her conclusion is that "the federal government should re-examine all of the programs that transfer funds to cities – directly and indirectly – to ensure that these programs meet the priority strategic requirements of major cities.

GLOBAL FUTURES FOR CANADA'S GLOBAL CITY REGIONS
(THOMAS J. COURCHENE)

In an argument similar to that presented by Golden, Thomas Courchene notes that it is in global city-regions (GCRs) that one finds the dense concentrations of human capital and human-capital-intensive activities so vital in the information age. Because of this, GCRs are becoming the coordinating and integrating networks in their regional economies as well as the national nodes in the international networks that drive growth, trade and innovation. Unfortunately, Canada's GCRs are, in an international comparative context, fiscally weak and jurisdictionally constitutionless. For example, our cities rely primarily on property taxes and provincial transfers rather than being able to access broad-based taxation like the personal income tax which the Nordic and several continental European cities are able to tap. In consequence, Canadian GCRs tend to spend much less than continental European GCRs. Even American cities have far greater revenue autonomy, a point he demonstrates by comparing the access to taxation by Edmonton and Calgary on the one hand and by Seattle and Denver on the other.

Even when Ottawa decides to transfer funding to cities, the GCR's fiscal dilemma is sometimes compounded because Ottawa still tends to view the big cities as places to distribute from. For example, the allocation of the federal gas tax to municipalities is viewed by Courchene as a form of equalization program, one that redistributes from big cities to smaller ones. What the GCRs want and need is access to broad-based taxation on a derivation basis, i.e., allocated on the basis of the revenues derived from the various cities in the first place. One example of this, and a convenient bridge to the jurisdictional section that follows, is the "double devolution" proposed by the External Advisory Committee on Cities and Communities, namely, shifting responsibilities and resources from the federal government to the provincial governments, and then from the provincial governments to the local level.

On the jurisdictional front, the reality that our collective future will almost surely depend on how our GCRs will fare vis-à-vis US GCRs means, according to Courchene, that Canada's major cities need to be integrated more formally and more fully into the processes of fiscal and political federalism. While Prime Minister Martin took some steps in this direction, the very definition of open federalism as encompassing respect for the existing division of powers means that the way forward under Prime Minister Harper is less clear. What is possible is that the provinces could accord their major cities a more formal role in the Council of the Federation and in the formulation of provincial positions in the context of federal-provincial relations.

Although most of Courchene's essay is cast in terms of the GCRs, he concludes by noting that there are ways, drawn from the work of the Canada West Foundation, by which smaller cities might be able to opt into structures/processes initially designed for the GCRs.

FEDERALISM AND THE SPENDING POWER

The combination of Prime Minister Stephen Harper's commitment to open federalism and the House of Commons declaration that the Québécois constitute a nation within a United Canada has served to direct attention to the constitutional division of powers on the one hand and the exercise of the federal spending power on the other. This is so because inherent in the manner in which the Prime Minister defined open federalism is a respect for the constitutional division of powers. And, in turn, respect for the division of powers necessarily requires that some constraints be placed on the exercise of the federal power in areas of exclusive provincial jurisdiction. Since this combination of principles characterizes both the 2007 *Speech from the Throne* and Finance Minister Flaherty's budgets, it is clearly an appropriate introduction to the three papers that constitute the final section of *Transitions*.

The first of the three, by Marc-Antoine Adam, falls four-square within these parameters, since it addresses ways to circumscribe the exercise of the federal spending power within a constitutional framework. Then Gordon DiGiacomo focuses on the evolution of the UI/EI program in terms of the manner in which the federal government chose to respond to situations where the courts gave it the right to manoeuvre in areas that Quebec believed to be in provincial jurisdiction. Finally, and in sharp contrast to the Adam position, Janice Gross Stein argues that the world is evolving in ways that require more, not less, overlap and shared policy space: hence her preference for what she refers to as networked federalism, which is arguably at the opposite end of the spectrum from the vision of watertight compartments implied by a strict adherence to the principles of open federalism.

SECTION 94 AND THE DIVISION OF POWERS (MARC-ANTOINE ADAM)⁴

The overarching issue for Marc-Antoine Adam is that key aspects of the practice of Canadian federalism should be, but are not, grounded in the Constitution. Of particular concern is that the federal government and others have on occasion declared that the exercise of the federal spending power is in no way limited by the distribution of powers. From the vantage point of many, this is hardly compatible with the federal principle, and it is certainly anathema to the province of Quebec.

By way of addressing these concerns, he proposes that we ought to consider s.94 of the Constitution as an instrument or regulator for the exercise of

⁴ Marc-Antoine Adam spent the 2006–07 academic year at the IIGR as a visiting scholar in residence, on leave from the Government of Quebec. This paper was written during this academic sabbatical.

the federal spending power. Essentially, s.94 is a provision that allows the non-Quebec provinces (or the common-law provinces) to transfer upward to Ottawa selected powers relating to property and civil rights in concurring provinces (s.92(13)). As one of the editors has noted elsewhere (Courchene 2006, 49), the provinces' proposal in 2004 for the non-Quebec provinces to transfer responsibility for pharmacare to Ottawa (with Quebec opting out with compensation) is effectively a non-constitutional example of the upward transfer potentially available constitutionally through s.94. As Adam goes on to note, there is also a flip side to s.94, namely, that it allows Ottawa to initiate legislation in areas of property and civil rights as long as the provinces agree to this (with the right of those provinces that do not pass the equivalent or template federal legislation in their own legislatures to opt out).

Several important issues remain, and they occupy the second half of the Adam paper. Principal among these is that most observers view s.94 as a dead letter. Can it be resurrected in this way? And if so, can s.94 be construed as allowing provinces that opt out to receive federal compensation? Is s.94 reversible? All of these issues require further research.

Nonetheless, the role for s.94 as a potential regulator for the exercise of the federal spending power is promising in at least four respects: i) it is already enshrined in the Constitution; ii) it requires provincial consent for any federal intervention in areas of property and civil rights; iii) it can be triggered by either the provinces or by Ottawa; and iv) should the common-law provinces wish to transfer aspects of property and civil rights to Ottawa (e.g., pharmacare), this would not, by the very definition of s.94, be subject to a Quebec veto.

THE GOVERNMENT OF CANADA'S CONTRADICTORY APPROACH TO FEDERAL-PROVINCIAL RELATIONS (GORDON DIGIACOMO)

The thrust of the DiGiacomo paper is that, in its dealing with the provinces, the federal government does not always take advantage of the legislative authority that it has (or that the courts have given it) and that, on occasion, it has devolved power to provinces when there was no legally compelling reason to do so. He notes that in the labour-force training and environmental areas, Ottawa's approach has sometimes been first to assert its authority over an area, then to surrender jurisdiction, and finally, in its negotiations with the provinces, to give up far more than it needs to. The focus of his analysis is to assess whether this pattern of behaviour was true for the UI/EI program as it relates to maternity and parental benefits.

By way of background, DiGiacomo surveys some of the relevant literature relating to how Ottawa approaches the division of powers, drawing from some of the more general assessments of how it approaches policy generally. Textual references are to Stephen Clarkson (Ottawa has alternated between trying to enforce its authority and devolving its own powers), to Carolyn Tuohy

(institutionalized ambivalence across a wide range of policy choices) and, relatedly, to the F. Rocher and M. Smith papers that offer four visions that can be viewed as elaborating on Tuohy's institutionalized ambivalence (equality of the provinces with Ottawa, the nationalizing vision, asymmetrical federalism, and a rights-based constitutional vision). These approaches are appropriate in their own right in a volume devoted to transitions in federal-provincial political, institutional/constitutional and fiscal relations.

In terms of how all of this might apply in terms of illness, maternity (and later, parental) benefits under UI/EI, DiGiacomo notes that the 1971 UI Act states that if a provincial government established its own program for maternity or sickness benefits, the federal program would cease for these provinces and UI premiums would be pared down appropriately. This was included in the legislation in spite of the fact that the legal opinions were consistent with the proposal that loss of earnings due to sickness and maternity should be covered by insurance rather than welfare. DiGiacomo cites this as an example of the federal government asserting its jurisdiction over an area and then ceding it to the provinces even though it was not necessary to do so. But Ottawa and Quebec could not agree on the details of any such devolution, so that the status quo prevailed.

In March of 2002, Quebec asked the Court of Appeal of Quebec to determine the constitutionality of those sections of the *Employment Insurance Act* authorizing payment of maternity and parental benefits. The Quebec Appeal Court ruled in early 2004 that pregnancy and parental benefits are not at all part of unemployment insurance as conceived in 1940, (where 1940 was the date of the UI amendment transferring jurisdiction to Ottawa). Ottawa appealed virtually immediately, but a few months later it reached an agreement in principle with Quebec for devolving maternity and parental benefits, and for reducing the EI premium rates for Quebecers by an amount equivalent to the portion associated with these areas. The agreement was to hold no matter what the outcome of the Supreme Court decision. In 2005, the Supreme Court rejected the Quebec government's contention that the federal government had exceeded its jurisdiction by providing a social program through the *Employment Insurance Act*. DiGiacomo asserts, therefore, that in spite of the reality that it likely had jurisdiction over these areas, Ottawa chose to give the province the option of taking over maternity and parental benefits if it wanted to. In terms of the earlier-mentioned competing visions, DiGiacomo views this as a victory for the equality-of-the-provinces-with-Ottawa vision over the nationalizing vision. And it represents an example of one way in which Ottawa has limited the exercise of its spending power as this relates to the division of powers.

NETWORKED FEDERALISM (JANICE GROSS STEIN)

Janice Stein approaches the analysis of decision making in a decentralized federation very differently. As she sees it:

[The] federal project in Canada is not to disentangle overlapping jurisdictions. It is to acknowledge complexity and [to] pull on the best from the private, voluntary, and public sectors to create shared policy space across levels of government for new ideas, feedback, and correction. Our challenge of the next twenty-five years is not to simplify and order ... but to build a grid that allows all these governments to manage complexity and avoid the gridlock that can be so crippling. The model of networks, embedded in a grid, is ... a more useful metaphor than that of parallel lines of government neatly separated from one another.

I call this networked federalism, located in a grid where movement is along many of the axes, not through a central hub. Others call it the “whole of government” or multi-level governance.

Stein then adds:

Although networks have existed for centuries, the revolution in information and communications technology enabled them to proliferate and grow. They are only now becoming socially important because of their comparative advantage in handling the large volumes of information that flow around the world at unprecedented speed.

Among the many implications arising from a networking approach to federalism would be that Canada’s cities would be brought more fully into federal decision making. As noted earlier, cities, especially global city regions, are key nodes in the international networks that drive growth, trade and innovation in the global economy; allowing them to be players in fiscal and political federalism would be an obvious next step.

Stein goes on to point out that policy making is already becoming less hierarchical. Phrased differently, public policy is already network-like, so in this sense networked federalism can be viewed as evolutionary, not revolutionary. Moreover, networked federalism does not require constitutional change. However, it does preclude unilateralism. But the most serious obstacle to networked federalism is the deeply embedded political culture of rights and entitlements of both orders of government and their emphasis on control. She then asserts that our challenge is not another round of constitutional design, but a shift in culture to accommodate networked politics.

Stein concludes with several bold assertions, the final one of which reads as follows:

Federal institutions, like all other government institutions, must better reflect the societies they govern. Jurisdictional arguments and silo arrangements reflect the past. They slow access by government to new information and new ideas, and lag in policy responsiveness. Problem solving “networked federalism” is just one approach to bring laggard governments up to speed with their societies.

CONCLUSION

In conclusion, transitions seemed an appropriate theme for this issue of *Canada: The State of the Federation 2006–07*. The profound changes introduced by the 2007 budget to the system of equalization, the Harper government’s commitment to “open federalism,” respect for the division of powers, and the proclamation that the “Québécois form a nation within a united Canada,” have all contributed to significant change and a sense of transitoriness in intergovernmental relations in Canada. The ongoing information revolution – which has privileged cities in general, and “global city-regions” in particular, as the new, dynamic drivers of growth, innovation and trade – is a further source of destabilization. Our authors have addressed these change factors, putting them in historical perspective and analyzing their implications for Canadians. We are indebted to them. The way forward, however, remains uncertain.

The repercussions attributable to the recent, unprecedented increases in resource prices are perhaps the major source of this uncertainty. The interaction between these price changes and the new equalization formula, with its inclusion of one-half of resource revenues, is giving an entirely new meaning to the “have and have-not” province distinction: namely, those that have substantial resource revenues (particularly oil and gas revenues) and those that do not. Compensating for the growing gap between the fiscal capacities of those two classes of provinces will impose severe stresses upon the equalization program and the federation, most particularly in the event that Ontario falls – for a second time – into the “have-not” category. As one of the authors of this introduction has speculated (Courchene 2008), the resulting increase in the cost of equalization to the federal treasury could well cause the new “O’Brien formula” to fail to achieve the longevity of its five-province-standard predecessor.

Still further uncertainty, should any be required, is likely to be provided by the emergence of environmental federalism and the intergovernmental stresses likely to be associated with divergent strategies for combating global warming, together with the role that these may play in the next federal election. “Transitions” are thus likely to play a prominent role in future editions of *Canada: The State of the Federation*.

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