Institute of Intergovernmental Relations

Fiscal Federalism and the Future of Canada
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Fiscal Federalism and the Burden of History

Garth Stevenson*

Foreword
In September of 2006, Queen's Institute of Intergovernmental Relations hosted *Fiscal Federalism and the Future of Canada*, a conference organized by the then IIGR Director Sean Conway, Peter Leslie and Christian Leuprecht. Given that several of the conference presentations dealt with the future of equalization and given that the 2007 federal budget will outline the Harper government's preferred future for equalization, the Institute felt it appropriate to publish these contributions in working paper format prior to the federal budget.

Appropriately this working paper series begins with brief summaries of the two commissioned reports on equalization and territorial formula financing – one from the Council of the Federation's Advisory Panel on Fiscal Imbalance and the other from the federal Expert Panel on Equalization and Territorial Formula Financing. These will be followed by analyses by other conference participants whose contributions will relate to these two proposals as well as to the larger fiscal federalism issues now in play. The views expressed in these working papers are those of the authors, not those of the Institute of Intergovernmental Relations.

As the only organization in Canada whose mandate is solely to promote research and communication on the challenges facing the federal system, we are pleased to introduce these working papers into the public debate on equalization and fiscal imbalance

Thomas J. Courchene
Acting Director
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* Department of Political Science Brock Unviersity.

Can anything be done to end the intergovernmental disputes over fiscal federalism? Thousands of Canadians have probably asked themselves this question since Sir John A. Macdonald's government offered "better terms" to a discontented Nova Scotia in January 1869, an initiative which provoked perhaps predictable complaints (and demands for compensation) in the legislative assembly of Ontario.[1] Although the fiscal structure of the Canadian state has actually changed beyond recognition over nearly a century and a half, the continuity of provincial discontent with our intergovernmental fiscal arrangements, and of the rhetoric with which it is expressed, is certainly impressive. Only the weather has been as durable a source of Canadian unhappiness, and even that may decline in importance with global warming.

The controversy over "fiscal imbalance" which has persisted for much of the first decade of the twenty-first century, and the seemingly associated, although actually distinct, problem of how to redesign the system of equalization payments, would probably not surprise Sir John, if he could look down upon our present discontents. The sheer size of the numbers involved, even when adjusted for inflation, might disturb his thrifty Scottish soul, and the growing irrelevance of the constitutional distinction between "direct" and "indirect" forms of taxation might be somewhat unexpected. Fundamentally, though, the politics of fiscal federalism and intergovernmental relations are pretty much the same as they were when the herds of buffalo roamed across the unfenced prairies between the Red River and the Rockies and when rafts of pine timber still floated past the Parliament Buildings on their way to the busy seaport of Quebec.

The problem of fiscal federalism is two-fold, although the distinction between its parts is not always obvious. In the first place, both the federal and provincial (to which some might add the municipal) levels of government should have access to enough revenue to carry out their responsibilities effectively and without financial strain. This happy situation, if and when achieved, is referred to as one of vertical balance. In the second place, the disparity in the resources available to different governments at the same level should not be so great that it exposes some Canadians to hardship depending on where they live, and ideally not so great that it influences their decision about where to live. This happy, and even more elusive, situation is referred to as one of horizontal balance.

Ideally, both kinds of balance should be achieved with a minimum of intergovernmental transfers, since accountability and responsibility are greater when decisions about spending money are made by the same government that has to raise it. Accountability would also benefit, one suspects, from making the system simpler and easier to understand than it is at present. Additionally, each level of government should have access to suitable kinds of revenue, meaning mainly taxation, which are neither inefficient nor inequitable, and which have little or no impact outside the borders of the territory for which that government is responsible.

While it is easy to state these various requirements, it is far more difficult to achieve them, particularly since they are not always compatible with one another. If all the provinces or states in a federation were equally prosperous, and thus had equal capacities to raise revenue from their own resources in proportion to the size of their populations, the problem of horizontal imbalance would, by definition, not exist. If in addition the economies of the provinces or states were similar enough to one another that the various possible sources of revenue and their relative importance did not vary significantly from one province to another, the achievement of vertical balance with minimal recourse to intergovernmental transfers would be a fairly simple exercise. It would merely be necessary to match sources of revenue and their potential to yield revenue with an estimate of the resources needed to carry out the constitutional responsibilities of each level. On the basis of this calculation (admittedly rough since yields depend on rates of taxation and responsibilities can be interpreted in ways that involve varying degrees of expense) one could then decide which tax sources should be provincial, which federal, and which divided between the two levels of government.

The economic disparities that lead to horizontal imbalance between provinces, which are more pronounced in Canada than in some other federations, obviously complicate the search for an ideal system. A specific kind of taxation, or taxation in general, will yield far more revenue per capita in a rich province than in a poor one, while the financial resources needed to carry out provincial responsibilities in an adequate manner will be pretty much the same for both. Therefore to achieve a semblance of horizontal, as well as vertical, balance it will be necessary to relax the rule that intergovernmental grants should be kept to a minimum. If we make this concession, however, it should be fairly easy to estimate a level of grants to the poor province that would bring its per capita revenue up to the level of its more fortunate neighbour. In fact Canada's system of equalization, which has existed for half a century and been constitutionally entrenched for the latter half of that period, is supposedly intended to do so, more or less.

Given these general principles, why is it so difficult to achieve a distribution of revenues, whether from taxes, grants, or a combination of both, that is satisfactory to all the provincial governments? A cynic might say that provincial politicians have nothing to gain, and much to lose, by appearing to be satisfied. Even aside from the old aphorism that the squeaky wheel gets the grease, it is far easier and more convenient to attribute the deficiencies of one's highways, hospitals, universities or schools to the distant federal government, which is generally inhibited by constitutional propriety and self-respect from responding to the verbal abuse that is thrown in its direction, than it is to repair the deficiencies. Blaming other provincial governments is more hazardous, since they are more likely to take offence, and since their co-operation may be required subsequently in the endless battle to win concessions from "Ottawa". However, even that may be more convenient than admitting that the source of the province's problems might lie within its own borders, or even within the walls of its legislature. Thus it is unlikely that provincial grumbling over fiscal federalism would ever cease, even if the system were to approach perfection.

This having been said, it does not follow that efforts to improve the system are pointless. Accountability, simplicity, efficiency, equity, and fairness as between the various governments of our federation are goals worth pursuing, whether or not those who would benefit from progress towards these goals appear to be grateful. But to understand the current state of fiscal federalism and the direction in which it should go, one must understand where it came from. This paper will begin with a sketch of the origins and development of the institution which we call fiscal federalism, will consider recent proposals for reform, and will conclude by suggesting how the system might be improved. The paper will deliberately avoid the question of whether municipal government should be recognized as a third order of government with guaranteed access to certain kinds of revenue, not because the question is unimportant, but because it should be the subject of another paper.

HOW WE GOT HERE

In his book *Politics in Time,* Paul Pierson reminds us that ongoing policies are a type of institutions, that institutions are the product of long processes of change, and that their current situation is the result of many incremental changes over time. At any given time institutions or policies rarely correspond closely, in their characteristics or their effects, with the intentions of their founders, even if the founders had any long-term objectives to begin with, which is not always the case. Pierson also suggests that the timing and sequence, or ordering, of various developments, changes, and decisions affects the outcome, or the shape and consequences of the institution or policy at any point in time. In addition he suggests that the choices made over time may lead in the direction of additional choices at a later date, and may close off (or at least make unlikely) choices and options that might otherwise have been pursued. He refers to this tendency as path dependence. [2]

The incremental development of Canadian federalism provides a good example to support all of these observations. The constitution of 1867 was designed for an economy based on agriculture and natural resources, and a society in which social services were mainly provided by the Catholic Church in Quebec and by private charities elsewhere. It included complex provisions related to public finance, of which the following were the most important: In sections 91 and 92 the provinces were restricted to "direct" taxation, which was not expected to be of major importance, giving Parliament the exclusive right to impose "indirect" taxes, of which the customs tariff was then the most important. Section 109 gave the provinces ownership of natural resources, above and below ground, and access to any revenues from that source. (Unlike the United States, Canada would follow the English common law principle that mineral resources, even under privately-owned land, belong to the Crown, i.e. the province.) Section 111 transferred existing provincial debts to the central government. Section 118 provided for modest federal subsidies to the provinces. There were also a number of financial provisions referring uniquely to a specific province, setting a pattern that would be followed as new provinces were added to the original four.

The most significant developments between 1867 and the end of the twentieth century, significant in the sense that they make a lasting contribution to path dependence, may be listed as follows:

1869: "Better terms" for Nova Scotia establish the precedent that additional grants to any province may be made at the discretion of Parliament.

1887: The Judicial Committee of the Privy Council authorizes a provincial corporation tax in *Bank of Toronto v. Lambe.*[3]

1907: After consultation with the provinces, the constitution is amended to replace Section 118 with a new allocation of statutory subsidies. British Columbia is dissatisfied with the outcome, but the precedent that the provinces will be consulted before any significant amendment to the constitution is established.

1917: Federal income tax is imposed for the first time. It is widely assumed to be a temporary expedient to pay for the war, which the British Empire and its allies appear to be losing.

1927: The Maritime provinces begin to receive special subsidies on a regular basis, allegedly to compensate for the damage done to them by federal economic policies.

1930: The three western provinces carved out of the Hudson Bay Company's territories (which had been annexed by Canada in 1869) are given control over their lands and resources, placing them in the same position as the other provinces.

1937-9: The Rowell-Sirois Royal Commission recommends that the provinces cease imposing income, corporation and estate taxes. In return the federal government will (again) take over all their debts, will pay "Adjustment Grants" to the less affluent provinces, and will assume various additional responsibilities. The recommendations are not implemented.

1942: For the duration of the war (and in practice somewhat longer) the provinces "rent" their power to impose income, corporation and estate taxes, in return for additional subsidies. At the same time the federal government introduces the practice of deducting personal income tax at the source of income.

1943: The Judicial Committee of the Privy Council authorizes a provincial sales tax, which is rather dubiously alleged to be "direct", in *Atlantic Smoke Shops v. Conlon.*[4] Eventually every province except Alberta will have a retail sales tax.

1954: Quebec imposes a personal income tax and the federal government agrees that the amounts paid can be credited against the liability to pay federal tax. This effectively ends the tax rental system.

1957: Equalization payments, similar to the adjustment grants recommended by Rowell-Sirois, begin, but they will be allocated by the federal government according to a formula fixed by Parliament and not by an Australian-style independent commission as Rowell-Sirois had recommended. Initially they are paid to all provinces except Ontario.

1957: The federal government begins to subsidize provincial programs of universal hospital insurance, the beginning of what will eventually be the largest single item of public expenditure in Canada.

1959: Quebec, which has prevented its universities from accepting the federal grants paid to universities in the other provinces, agrees to pay comparable grants itself, in return for which the federal tax on corporation income in Quebec is reduced, with a corresponding increase in the provincial tax.

1962: The tax rental system is formally interred, with the provinces now free to impose any level of income and corporation tax, but the federal government will continue to collect those taxes on behalf of any province that wishes it to do so. More significantly, the federal government promises to reduce its income tax incrementally over the next five years, allowing the provinces to occupy an increasing share of the field. This reinforces the principle, which arguably dates from 1954, that the level of federal taxation is negotiable at the behest of the provinces.

1965: Federal legislation allows any province to "opt out" of health insurance and an assortment of other shared cost programs, meaning that federal grants to the province will be terminated and replaced by reductions in federal direct taxation within that province, provided the province agrees to continue a comparable program. As anticipated, Quebec "opts out" of all the programs but no other province takes advantage of the legislation.

1967: The federal government begins to pay grants to the provinces for post-secondary education, rather than making grants directly to the colleges and universities.

1977: The federal grants in aid of health insurance and post-secondary education are replaced by a singularly complex arrangement known as Established Programs Financing (EPF) which consists of tax abatements and cash grants in roughly equal proportions. Federal income and corporation taxes are reduced so that the provinces can increase their own taxes by a like amount, but since this opportunity will provide greater benefits for some provinces than for others, the abatements are sweetened with "associated equalization" for those that require it. At the same time Quebec retains its existing abatements as a result of the arrangements made in 1959 and 1965. In addition the provinces receive annual cash grants such that the combined per capita yield of the tax abatement and the grant will be approximately the same for each province. To achieve this, the poorer provinces which benefit less from the abatement receive larger per capita cash payments than the richer provinces.

1982: Federal responsibility to make equalization payments "to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" is entrenched in the constitution. At the same time, another provision allows provincial indirect taxes on natural resources.

1991: In *Reference re. Canada Assistance Plan,* the Supreme Court of Canada rules that the federal government can unilaterally reduce or otherwise alter its payments to a provincial government (in this case for the Canada Assistance Plan) without seeking or receiving the consent of the provincial government.[5]

1991: The federal government introduces a Goods and Services Tax (GST) to replace the archaic indirect tax on manufactured goods and urges the provinces to harmonize their retail sales taxes with the GST. Only Quebec agrees to do so, and also to collect the GST within Quebec on behalf of the federal government.

1996: Five years later a new government reaches agreement with Newfoundland, Nova Scotia and New Brunswick whereby those provinces will abolish their retail sales taxes in return for sharing the proceeds of the GST, which is fixed at a level of 15 per cent in those three provinces, compared to 7 per cent in the other provinces. In return they are promised a subsidy of $961 million over four years.

1996: EPF, or more precisely the cash portion of it, is replaced with a single block grant known as the Canada Health and Social Transfer (CHST) The federal government continues to claim that the tax abatements made almost two decades earlier should be counted as part of its contribution to health care and post-secondary education, a claim disputed by the provinces and by almost everyone else. Eight years later CHST will be replaced with two block grants, the Canada Health Transfer (CHT) and the Canada Social Transfer (CST)

This is an admittedly selective list, and some might say that the list should be considerably longer. In particular, there have been several major changes in the formula for calculating equalization payments since 1957, with the formula used to calculate the revenue base becoming increasingly complex and comprehensive. The standard against which provincial revenues are assessed has been variously based on the two richest provinces (1957-62 and 1964-7), the average of all provinces (1962-4 and 1967-82), or the average of the five provinces closest to the overall average (1982 to 2007, although not strictly adhered to after 2004).

Likewise there have been numerous changes in the system whereby the major direct taxes (on incomes and corporations) are shared between the two levels of government. Up to and including 1977 the changes mainly took the form of reducing federal taxes so that the provinces could occupy a larger share of the revenue source in question. After 1977 this practice was abandoned, largely because of a series of fiscal deficits at the federal level which lasted until almost the turn of the century. Instead, the provinces have been allowed increasing flexibility in imposing their taxes, in an effort to prevent them from collecting the taxes on their own behalf, so that the relationship between provincial and federal taxes has become increasingly tenuous, and the paperwork imposed on the taxpayer increasingly onerous. Why the federal government wishes to continue collecting taxes for the provinces is not entirely clear, but it has largely succeeded in its objective. Only Quebec collects its own personal income tax (as it has done without interruption since 1954) and only Quebec, Ontario and (since 1981) Alberta collect their own corporation taxes. However, at the end of the twentieth century the provinces stopped calculating their provincial income tax as a percentage of the federal tax, forcing their long-suffering taxpayers to do all the mathematical calculations twice. The federal government continued to collect the taxes for them nonetheless.

These incremental changes in policy have taken place, of course, against a massive backdrop of social and economic change, including a nearly ten-fold increase in the population, the shift from an economy largely of self-employed farmers and fishers to an industrial, and now increasingly post-industrial, economy of wage and salary earners, the development of the welfare state, and in recent years a rapidly aging population. In the process of all these changes the major items of state expenditure have shifted dramatically since the Second World War from infrastructure and defence to health care, education, welfare and pensions. Interest on the substantial public debt, of course, also accounts for a large share of state expenditures at both levels.

A few conclusions can be drawn from the history summarized above. First, the system has evolved through a series of incremental changes, most of them at the behest of the federal government although some of them in response to complaints by one or more provinces. Second, there has hardly ever, in 1867 or later, been any serious effort to treat all the provinces alike or according to a fixed set of principles and standards. Third, the changes have made the system increasingly complex and difficult to understand, which has reduced accountability and had a detrimental effect on the quality of public debate about fiscal federalism. Fourth, since the changes have been made in response to short-term problems or concerns, it is impossible to identify any consistent purpose or direction behind the evolution of fiscal federalism or indeed any consistent set of outcomes, apart from making the system more complex and increasing the elements of asymmetry among the provinces. Fifth, most of the changes have resolved one problem but at the expense of creating one or more new problems.

The untidy and seemingly directionless evolution of Canadian fiscal federalism tends to confirm Pierson's generalizations about the slow and incremental way in which institutions evolve, as well as their failure to conform to any long-term goals and expected outcomes that might have existed at the beginning. The conclusions of the preceding paragraph also give credence to the concept of path dependence. Path dependence occurs because the costs of changing an existing pattern of behaviour appear to be greater than the costs of staying the same, even when staying the same has obvious disadvantages. It is particularly characteristic of fields, such as federal-provincial relations, in which change requires co-ordinating the behaviour of several distinct actors.

All of the characteristics of Canadian fiscal federalism outlined above–incrementalism, asymmetry, excessive complexity, short-term orientation, and the tendency of one "solution" to create a new problem–became evident at a very early stage in its development. To some extent they were inherent in the fiscal provisions of the British North America Act, and they were decisively and perhaps irreversibly reinforced by the "better terms" given to Nova Scotia when the ink was scarcely dry on the original document. One of the early students of Canadian fiscal federalism, James Maxwell, asserted long ago that the “better terms” of 1869 “made a breach in the constitution not yet repaired.”[6] While Maxwell had a valid point, the constitution itself encouraged such a breach with its very complex fiscal arrangements and its plethora of provisions applying to particular provinces.

Two other major instances of path dependence arose from decisions made in the middle decades of the twentieth century. First, the wartime tax rental agreements, taking effect in 1942, created a lasting bias in favour of integrating or “harmonizing” the federal and provincial systems of direct taxation, a bias that was reinforced by the then-fashionable Keynesian approach to macro-economic policy. Of course the simplest way to set the stage for Keynesian policies would have been for the provinces to vacate the major fields of direct taxation, as recommended by the Rowell-Sirois Commission. This was politically and perhaps constitutionally impossible, and Keynesianism was eventually discarded anyway, but the ghost of the idea has lingered on in the notion that the federal government should collect taxes for the provinces (or vice-versa as in the case of Quebec and the GST) even if no discernible purpose is served thereby. The fact that American federalism gets along perfectly well without such a practice is rarely if ever acknowledged.

Second, the postwar development of shared cost programs, (in defiance of the Rowell-Sirois Commission, which had disapproved of them on grounds that they lacked efficiency and accountability) entangled a whole host of new issues with the already complex politics of fiscal federalism. These programs were particularly resented in Quebec, where they seemed to threaten that province’s original understanding of Confederation. In 1957 no less an authority than Pierre Elliott Trudeau, then a free-lance intellectual, pointed out that federal spending in areas of provincial jurisdiction raised the question of whether the federal government should more appropriately give up some taxing room to the provinces.[7] However, subsequent governments (including to some extent his own) found the temptation to spend in these areas hard to resist, particularly since these types of expenditures seemed to interest and attract Canadian voters more than the equally important subjects enumerated in Section 91 of the constitution.

If vows of abstinence were rarely observed for long, federal remorse more typically took the form of special arrangements for Quebec, or else efforts to withdraw (more or less) from existing programs and hand them over to the provinces. Rapidly escalating and unpredictable costs provided another motive to proceed in the latter direction. Efforts to do so were constrained, however, by the continuing belief in the Department of Finance that the federal government must collect a sufficiently large amount of taxation to pursue Keynesian fiscal policy, even though such policy was no longer being (if it ever had been) seriously pursued. The result of these conflicting pressures and motives reached the *reductio ad absurdum* of EPF, which, complex as it was, had perforce to be superimposed over the “opting out” arrangements made a dozen years earlier for Quebec. How many persons, if any, actually understood EPF is a question that it would perhaps not be tactful to ask. A few years after it came into force Donald V. Smiley, the most influential Canadian federalism scholar of his generation, introduced his last book with the following confession: “In particular, I have nothing to say about fiscal federalism–a subject which I once tried to comprehend but which, I am now convinced, is so complicated that one should either cultivate it as a full-time specialty or leave it alone entirely.”[8] Despite its dysfunctional absurdity, the ghost of EPF has lingered on through several subsequent shifts in fiscal arrangements. The fact that the federal government almost three decades later was still counting the all but forgotten “tax points” given up in 1977 as part of its “contribution” to the costs of health care is a classic instance of path dependence.

THE “FISCAL IMBALANCE” DEBATE

Between 1984 and 1996 two federal governments, and two ministers of finance, systematically pursued the goal of reducing the federal deficit, which had risen to a dangerous level by the end of the Trudeau years.[9] Immediate success was not possible, but a combination of tax reform (mainly the introduction of the GST in 1991), reductions in program spending (most dramatically in the Martin budget of 1995), and a revival of the North American economy that coincided with the election of President Bill Clinton in 1993 eventually brought the series of deficits to an end. By 1997 the federal deficit had disappeared, and over the next few years federal budgetary surpluses were unexpectedly large. This achievement, inevitably, was viewed as being partly at the expense of the provinces, since funds that had been channelled through them accounted for a large share of the reductions in program spending. Nonetheless, the provinces also benefited from the improvement in the North American economy, so that by 1996-97 only three provinces still had significant deficits, one of which was Prince Edward Island with its 0.4 per cent of Canada's population.[10] Unfortunately the two other exceptions were Quebec and Ontario, which together account for about five-eighths of the population.

Quebec's sovereignist government, disappointed in its objective of winning independence for Quebec and approaching the end of the eight years that seems to be the normal life span of Quebec governments, sensed a politically potent issue in these facts, and the issue of "fiscal imbalance" was born. More precisely, the Quebec government appointed a Commission on Fiscal Imbalance on May 9, 2001, including four distinguished academics among its seven members. To give it a bipartisan flavour a former Quebec Liberal minister, Yves Séguin, was appointed as chairman. The choice of the commission's name seemed to suggest that its conclusions had been determined in advance, an impression reinforced by the contents of a discussion paper entitled "Fiscal Imbalance: Problems and Issues" which it released when its investigations had scarcely begun. However, in an effort to demonstrate that the issue was neither inspired by partisan politics nor unique to Quebec, the commission consulted a respected conservative research organization, the Conference Board of Canada, which endorsed the view that a "fiscal imbalance" existed. The Séguin commission also sponsored a survey of public opinion across Canada on the question. Finally, the commission held public hearings, although only in Quebec.

In the Canada-wide survey of public opinion, 66 per cent of those polled (and 71 per cent of respondents in Quebec) agreed with the proposition that "the federal government has too much revenue for the responsibilities that it has while the provincial governments lack revenues to fulfill their responsibilities."[11] This was not particularly surprising for two reasons. First, there is a tendency in polls to respond positively to any proposition that sounds fairly plausible, especially if the respondent is not well-informed about it. Second, health care, the most expensive provincial responsibility, was at this time the main preoccupation of Canadian voters, while some of the most important and expensive federal responsibilities, such as national defence, external aid, immigration, employment insurance, and programs for indigenous peoples, touch the average voter less directly and have, to put it politely, less popular appeal. In fact it is probably surprising that the percentage expressing agreement with the statement was not higher.

The commission completed its investigations more promptly than is usual for such bodies, and the Séguin report appeared in the spring of 2002. The report claimed that "Fiscal imbalance has been one of the major issues of the Canadian federation since the mid-1990s", or in other words since the major cuts to fiscal transfers in the federal budget of 1995. It cited a study by the Conference Board which predicted that in the absence of major fiscal reform Quebec would continue to have deficits every year for the next two decades, while federal surpluses would escalate each year to reach the astonishing level of nearly $90 billion by 2019-20. This bizarre prediction was based on the assumption that federal spending would increase by only 2.1 per cent per year, while provincial spending was projected to increase at a more credible rate of 3.6 per cent. (The annual increase in revenues was projected to be almost the same at both levels: 3.2 per cent for the federal government and 3.1 per cent for the provinces.) The very low anticipated rate of increase in federal spending was entirely attributed to a rapid decline in the cost of servicing the federal public debt, a trend based on the dubious assumption that the federal government would use all of its surpluses to reduce the size of the debt. In fact the report predicted, very questionably, that the federal debt would virtually disappear within two decades, even though the federal level of government has never been free of debt since it assumed the then-existing debts of the provinces in 1867.

The Séguin report blamed the present and future fiscal imbalance on three factors:

imbalance between spending responsibilities and sources of revenue, inadequate intergovernmental transfers, and the federal tendency to use its "spending power" in areas of provincial jurisdiction. The last of these factors would seem to be more a consequence than a cause of the federal government's greater affluence, but the commission argued that it was a cause because it distorted provincial priorities, had a destabilizing effect by making provincial budgets vulnerable to federal decisions, and tended to take the form of highly visible short-term projects rather than ongoing contributions to routine expenditures. None of this was entirely new since very similar complaints had been frequently made by the provincial governments, with Ontario taking the lead as often as Quebec, since at least as far back as the 1950s. (The Séguin commission itself noted examples of such complaints over the preceding few years, but did not pursue the history of the issue further back than 1997) .

In its extended analysis of the three factors, the report predictably devoted considerable attention to health care, an almost obsessive preoccupation of Canadians at that time, as a large and rapidly growing burden on provincial finances. (It predicted that education spending, on the other hand, would grow much more slowly, as would spending on most of the major federal responsibilities.) The report claimed that the Canada Health and Social Transfer (CHST) by which the federal government shares the costs of both health and post-secondary education, was inadequate in size, subject to arbitrary and unpredictable changes, and (more questionably) that it "penalizes the less affluent provinces". (Soon afterwards, Ontario would not only deny the last of these assertions but would claim exactly the opposite) Equalization, the other major federal transfer to the provinces, was also criticized in practice, although strongly supported in principle. The main complaints in this regard were that it was based on a five-province standard (excluding resource-rich Alberta from the calculation), that it was subject to a ceiling, and that the tax bases used to calculate equalization were poorly defined and incomplete. Thus it was alleged that Quebec received a much smaller equalization payment than it should receive.

The Séguin commission made a number of recommendations that would, if implemented, significantly alter the Canadian system of fiscal federalism. It proposed that the CHST be abolished and replaced by a new division of tax room between the two levels of government. This might take the traditional form of giving the provinces a larger share of the income tax, but the commission expressed a preference for a federal relinquishment of the GST in favour of the provinces. It also recommended reforming equalization by basing it on a ten-province standard, eliminating the ceiling and floor on equalization payments, and improving the calculation of tax bases, particularly by measuring capacity to raise property taxes on the basis of assessed value. Finally, it recommended that Quebec continue its interminable campaign against the legitimacy of the federal spending power and that it continue to demand an unconditional right to opt out of shared cost programs, receiving financial compensation in return.[12]

In response to the Séguin report Stéphane Dion, who was then the federal minister of intergovernmental affairs, denied that there was a vertical fiscal imbalance at all. Dion questioned the methodology of the Conference Board's calculations on which Séguin had relied. Quite rightly, he doubted the usefulness of any effort to calculate financial data two decades in advance of the facts. He pointed out that recent federal surpluses had been small in relation to the deficits of the not so distant past and also in relation to the size of the federal debt, that all governments faced financial pressures, and that the provinces had the constitutional authority to increase their tax revenues if necessary. Also, the fact that some of them had reduced taxes indicated that they were not really suffering.[13]

In the following year the Quebec Liberals returned to office, continuing the Quebec tradition whereby no governing party since the Quiet Revolution has won more than two general elections in succession. Yves Séguin became minister of finance, a position he held until 2005. In March 2004 the National Assembly unanimously adopted a motion calling on the federal government to recognize the existence of the fiscal imbalance and to take measures to counteract its effects.[14]

In September 2004, however, Prime Minister

Paul Martin, largely defused the "fiscal imbalance" issue, at least in its original form, by unveiling what was billed as "A 10-year plan to strengthen health care", reversing the cuts to federal health care spending which he had imposed as minister of finance almost a decade earlier and promising increased funding for health care in future.[15] As part of this package the CHST was divided into a Canada Health Transfer and a Canada Social Transfer, with the former scheduled to increase significantly in size over the next decade. This initiative deprived vertical fiscal imbalance of much of its importance as a political issue, at least outside of Quebec and to some extent even there. Yves Séguin was dropped from the Quebec cabinet in a shuffle a few months later. However the Council of the Federation, a permanent interprovincial body recently established at the initiative of Quebec's Liberal Premier Jean Charest, appointed an Advisory Panel on Fiscal Imbalance to investigate the issue in 2005.

A NEW GOVERNMENT AND A SERIES OF REPORTS

The issue of fiscal imbalance was given a new lease on life by the federal Conservative leader, Stephen Harper, who promised during the election campaign of 2005-06 to do something about it if his party was elected to office. This promise received some of the credit for the Conservative victory, and particularly for the unexpected election of ten Conservative members of Parliament from Quebec.

Yet, after he became Prime Minister, Harper and his minister of finance, Jim Flaherty, began to soft-pedal the issue, despite the fact that Flaherty had held the same office in the provincial government of Ontario a few years earlier. A lengthy document released with Flaherty's first budget in 2006, which promised to maintain the increases in health care funding promised earlier by the Liberals, convincingly refuted most of the arguments in the Séguin report.[16] It asserted that Quebec's deficit was expected to disappear in the current fiscal year, that the fiscal balances of the federal and provincial levels of government had followed very similar trends since 1995-96, that federal transfers for health care were growing faster than provincial spending on health care, and that federal revenues had declined more rapidly than provincial revenues in relation to GDP since the 1990s, largely because of federal tax reductions. It also pointed out, as Stéphane Dion had done earlier, that the provinces had access to virtually every significant source of revenue and that their share of total state revenues exceeded that of the subnational governments in any other federation. Simultaneously with the release of this document a long-overdue increase in military spending, partly in response to the war in Afghanistan, made allegations that the federal government had more revenue than it needed increasingly difficult to sustain.

At the same time, the budget implemented a Conservative election promise by reducing the GST from seven to six per cent, with a further reduction promised later. If the government was daring the provinces to raise their sales taxes by a comparable amount, and thus help to redress the alleged vertical fiscal imbalance, there were (predictably) no takers. Was this merely a lack of courage, or a tacit admission that the vertical fiscal imbalance was a myth?

The issue of horizontal fiscal imbalance, meaning fiscal disparities among the provinces themselves, proved to have both a broader appeal and a longer shelf life, although, almost by definition, it is an issue on which consensus among the provincial governments is virtually impossible. This issue had not been entirely ignored by the Séguin report, but that report was primarily concerned with vertical fiscal imbalance, possibly in the hope that concentrating on the latter issue would facilitate a broad coalition among the provincial governments to put pressure on "Ottawa". However, the financial circumstances of the various provinces are so different from one another that a concerted campaign on any fiscal issue, however defined, makes little sense. Alberta can hardly make a serious claim to be in need, and does not do so. For the eight provinces that depend, to varying degrees, on equalization payments, a campaign around the issue of equalization is probably more likely to bear fruit than one on the more nebulous issue of vertical fiscal imbalance.

Thomas J. Courchesne, one of Canada's leading economists, has suggested that Quebec shifted its attention from vertical to horizontal balance because it calculated that, as the principal recipient of equalization, it would get about half of any additional equalization forthcoming from the federal government, but only about a quarter of any additional funds made available by surrendering tax room to the provinces.[17] But there were other reasons as well why the issue of horizontal imbalance began to occupy the centre of the stage, almost before the ink was dry on the Séguin report. First, Ontario in 2003 elected a Liberal provincial government headed by Dalton McGuinty. The new premier charged that Ontario as a rich province was being unfairly discriminated against in the allocation of federal funds, particularly the block grants for health and post-secondary education. His government began a campaign for "fairness", complete with its own website. McGuinty also complained on more than one occasion that Ontario and Alberta taxpayers contributed most of the revenue that supported the equalization program, and that Ontario taxpayers could not afford to make the program any more generous.[18] While more subtle than Premier Mitch Hepburn's complaint in the 1930s that Ontario was "the milch cow of the Dominion", the message was essentially the same.

Second, in 2004 the federal Liberal government announced controversial changes in the equalization program, described as "A New Framework for Equalization", almost simultaneously with the more popular increases in health care funding.[19] Although the Liberals implied that the new approach would make equalization more generous, the reality was that a cap was placed on the amount of equalization to be paid each year, with a fixed rate of increase in subsequent years. This was similar to the arrangement for health and social transfers, but totally unprecedented for equalization. The press release promised that the allocation of this fixed amount among the provinces would eventually be determined by the recommendations of a "panel of experts", rather than by the formula that had been in use for more than twenty years. Pending the receipt of those recommendations, it would be on a per capita basis, which seemed to make little sense if the purpose of the program was to counteract horizontal fiscal imbalance.

Finally, Prime Minister Martin, about a year before leaving office, made an ill-advised agreement known as the Atlantic Accord with the premiers of Newfoundland and Labrador and Nova Scotia. This provided that any revenues received by those provinces from offshore oil and gas would have no effect on the size of their substantial equalization payments. (Saskatchewan and British Columbia, which would have benefited from a similar arrangement for their non-renewable resources, received nothing in return.) Newfoundland and Labrador would also receive a payment of $2 billion to retire a portion of its debt.[20] This politically-motivated agreement, which seemed like a return to the era of "better terms" before formal equalization was established, bequeathed a political hot potato to Stephen Harper, who had further muddied the waters himself by an ill-advised promise that non renewable natural resource revenue bases would be excluded from the calculation of the equalization formula.[21]

2006 saw the publication of three major reports on fiscal federalism, one of which was devoted entirely to equalization while the two others devoted considerable attention to it. A fourth report, on the economic prospects and financial needs of Canadian cities, appeared early in 2007. The first off the mark, in March 2006, was the report of the Advisory Panel on Fiscal Imbalance, which bore the rather unfortunate title *Reconciling the Irreconcilable.*[22] Co-chaired by Robert Gagné, an economist nominated by the Premier of Quebec, and Janice Gross Stein, a political scientist nominated by the Premier of Ontario, the five-member panel also included a Conservative senator from Nova Scotia, a former Deputy Minister of Intergovernmental Affairs from Alberta, and a former Minister of Finance from the Northwest Territories. Like the Séguin commission, it argued that vertical fiscal imbalance was a genuine problem, although its forecasts regarding federal surpluses were considerably more conservative than Séguin's. However, it did not recommend any transfer of tax room to the provinces. Instead it proposed changes to the CHT and CST which would abandon the fiction that the tax abatements of 1977 were part of the federal contribution, increase the size of the cash grants, give the same per capita cash grant to each province, and thus remove the unequal treatment of rich provinces of which Premier McGuinty had complained.

As regards equalization, the panel suggested a more generous formula which would be based on a ten-province rather than the five-province standard established in 1982 and would include all revenue from natural resources in the calculation. This would end the special arrangements Martin had made with Newfoundland and Labrador and Nova Scotia, as well as the fixed yearly amount imposed by the "New Framework". Overall the total amount of equalization paid would increase by more than 50 per cent, with Quebec benefiting the most from the change. The Advisory Panel also proposed more generous financial treatment for the northern territories and the establishment of a permanent First Ministers' Fiscal Council for consultation and liaison among the governments.

The second report, only two months later, was that of the "Expert Panel on Equalization and Territorial Financing" appointed by the Liberal government a year earlier and headed by Al O'Brien, a former Deputy Treasurer in the government of Alberta.[23] The panelists also included Fred Gorbet, a former Deputy Minister of Finance in the federal government. As its name suggested, this panel had narrower terms of reference than the Advisory Panel on Fiscal Imbalance. It too recommended returning to the ten-province standard for equalization. However, it suggested that only 50 per cent of non-renewable natural resource revenue should be included in the formula rather than 100 per cent, an option that would make the equalization program significantly less expensive for the federal government. Responding to a suggestion in the Séguin report, the panel also recommended basing the calculation of the residential property tax base on market value assessment, a procedure that would reduce equalization payments to British Columbia but increase them to every other recipient province.

Two more months elapsed before the appearance of the third report, commissioned by a moderately left of centre think tank, the Canadian Centre for Policy Alternatives, and written by an economic consultant named Hugh Mackenzie.[24] Rather gloomily entitled *The Art of the Impossible,* this report attracted less attention than the other two but added some fairly new ideas to the debate on fiscal federalism. It suggested that, as in Australia, equalization payments should be based on a calculation of provincial needs as well as provincial capacity to raise revenue. It was lukewarm at best towards the inclusion of non-renewable natural resource revenues in the equalization formula, although not totally rejecting the idea. It also drew attention to the financial needs of municipal and local government, a topic that raises constitutional sensitivities on the part of provincial governments and was thus largely ignored by the other reports. Finally, it suggested that provinces should be discouraged from competing with one another to reduce taxes.

Finally, to complete the series of reports, the Conference Board weighed in early in the new year with a document entitled *Mission Possible: Successful Canadian Cities.*[25] This report argued that the large cities were the sources of most of Canada's wealth and economic growth (a claim that might be disputed in some parts of Alberta) and that they needed more taxing powers, and more access to the revenues collected by higher levels of government, in order to carry out their responsibilities. It was favourably received in Toronto, where Mayor David Miller had been repeating the same argument for some time. (Toronto has since launched a campaign, complete with a website and signs on TTC vehicles, to have one percentage point of the GST transferred to the city.) Whether by coincidence or not, the federal government announced exactly a month later that it would make a massive financial contribution to improving transportation infrastructure in the GTA, including a long-discussed extension of the TTC subway.

Meanwhile the provincial governments continued to express very divergent views about fiscal federalism. The premiers of all ten provinces met to discuss equalization in Montreal in April 2006 and in Toronto in February 2007. In June 2006 Flaherty met with his provincial counterparts at Niagara on the Lake to discuss the same subject in the light of the O'Brien report, which had just been released. The meetings accomplished nothing other than to indicate that there was no prospect of consensus among the provinces. Ontario, traditionally the richest province but now a distant second behind affluent Alberta, continued its campaign for "fairness" in the allocation of funding for social programs, and shocked most of the other provinces by opposing any increase in equalization payments.[26] Premier

McGuinty expressed dissatisfaction with the report of the Advisory Panel on Fiscal Imbalance, which he had helped to establish, and continued to claim that Ontario's contributions to federal revenues exceeded by $23 billion, or almost $2000 per capita, the benefits it received from federal spending.

Newfoundland and Labrador, which has surrendered the unenviable distinction of being the poorest province to Prince Edward Island without losing any of its customary truculence, was mainly concerned to ensure that its offshore oil and gas revenues would continue to have no impact on its equalization payments, as promised by former Prime Minister Paul Martin. Premier Danny Williams, who at one point in 2004 had ordered the Canadian flag removed from provincial government buildings as a symbolic protest against the federal Liberals, denounced the O'Brien report, whose recommendations would have resulted in a net loss to his province. Although bearing a Conservative label himself, he warned that the federal Conservatives would lose all three of their Newfoundland and Labrador ridings if they cancelled the Atlantic Accord.[27]

Saskatchewan, a significant producer of oil, argued that non-renewable resource revenues should not be taken into account in calculating equalization. Alberta, which has no direct interest in the equalization formula since no conceivable formula could make it a recipient of equalization, took the same position.(This has been a time-honoured, albeit irrelevant, theme in the discourse of Alberta governments, and has apparently convinced most Albertans that their provincial government, rather than the federal one, bears the costs of equalization.) In March 2007 Alberta's new Minister of Finance, Lyle Oberg, unexpectedly announced that the province no longer had any objection to the equalization formula suggested in the O'Brien report, which he predicted would be adopted in any event. However, Premier Ed Stelmach overruled his minister a few days later and declared that Alberta's position had not changed.[28]

Premier Jean Charest of Quebec, who for various reasons was well-disposed towards the new federal government, was generally restrained in his comments. In fact the "fiscal imbalance" issue was largely and surprisingly ignored by all three parties in the Quebec election campaign of March 2007. However, the Bloc Québécois members of Parliament had threatened in September 2006 to bring down the minority federal government after the presentation of the budget if federal payments to the provinces were not increased by $12 billion per annum, including $3.9 billion for Quebec.[29] André. Boisclair, the leader of the Parti Québécois, briefly mentioned the same figure of $3.9 billion in his televised debate with the other party leaders on March 13, 2007. Federalists could presumably take comfort from the fact that it was a more modest request than Dalton McGuinty's $23 billion.

The Harper government's second budget, presented on March 19, 2007, was awaited with eager anticipation, particularly since the provincial election in Quebec was to occur a week later. As anticipated, "Restoring Fiscal Balance for a Stronger Federation" was a major theme of the budget.[30] More specifically, it adopted selected recommendations from the Séguin and Gagné/Stein reports, while the O'Brien report had the greatest influence on the proposals for equalization. From Séguin was taken the idea that the property-tax base for the calculation of equalization entitlements would be based on market value. As proposed by the Gagné/Stein report, there was a promise of equal per capita cash payments for the CST and the CHT, although the latter would not take effect for seven years (after the expiration of the Martin government's ten-year plan for health care financing) and was thus a promise of dubious value, especially coming from a minority government. The CST would also be formally divided into three component parts, ostensibly earmarked for welfare, post-secondary education, and child care. As suggested by O'Brien, equalization would be based on a ten-province standard, for the first time since 1982, but with only half of non-renewable resource revenues entering into the calculation. There were also improvements in the financing formula for the northern territories, as recommended by both Gagné/Stein and O'Brien. The changes in equalization would remove British Columbia from the list of recipient provinces starting in 2007-08. Equalization payments to Newfoundland and Labrador and Nova Scotia would decline, while payments would increase substantially: from $5.539 billion to $7.160

billion in the case of Quebec and from a negligible $13 million to $226 million for Saskatchewan. Manitoba, New Brunswick and Prince Edward Island would receive small increases. For the first time in history, Quebec would receive more than half of all the money distributed in equalization payments.

Two other features of the budget that might make Canadian federalism more rational and more intelligible should be mentioned. First, the government promised not to launch any new shared cost programs in areas of provincial jurisdiction without the consent of a majority of the provinces, a promise that had been made, sincerely or otherwise, by the Liberal government in the Social Union Framework Agreement of 1999. Second, the provinces and territories that had not already assumed full responsibility for labour training programs (British Columbia, Newfoundland and Labrador, Nova Scotia, Prince Edward Island and Yukon) would be required to do so, receiving appropriate fiscal compensation in return.

However, nothing is ever simple in Canadian fiscal federalism and this budget was no exception to the rule. Although the budget promised "comparable treatment for all Canadians", there were a host of special provisions for particular provinces. The provinces were promised that the shift to per capital grants for the CHT and CST would not reduce grants to any of them. Newfoundland and Labrador and Nova Scotia were promised that they could continue to operate under the previous equalization system for the duration of their offshore accords, which would continue in force, but that they could opt into the new equalization regime permanently at any time they chose to do so. Furthermore, all provinces were promised "the greater of the Equalization entitlements under the formula based on a 50-per-cent exclusion rate and the amounts they would receive under the same formula based on full exclusion of all natural resource revenues", a provision of particular interest to Saskatchewan. This enabled the Prime Minister to state, in a letter to the premier of Saskatchewan, that "Our Equalization plan fully meets our commitments on the exclusion of natural resource revenues." (In fact every premier and territorial government leader received a similar letter highlighting the provisions of the budget that would particularly benefit his province or territory, although in the case of Alberta about all that could be said in that regard was a reminder that Al O'Brien had once been the Deputy Treasurer of that province.)[31] The ghost of "better terms" still haunts the corridors of Ottawa.

Both Premier McGuinty and Premier Charest proclaimed themselves reasonably satisfied with the budget, and Gilles Duceppe of the Bloc Québécois indicated that he would not force an election after all, since Quebec had received, according to his calculation, about 80 per cent of what it asked for.[32] Although an editorial in *Le Devoir* grumbled that the budget was "too little too late" to resolve the fiscal imbalance, its staff cartoonist, Michel Garneau, produced a drawing of a perspiring Jean Charest being carried across the finish line on the back of Stephen Harper and exclaiming "I've found my second wind!"[33] Saskatchewan and Newfoundland and Labrador expressed disappointment that non-renewable resource revenues would continue to be included in the equalization formula.

A MODEST PROPOSAL

In fairness, the provisions for fiscal federalism in the 2007 budget somewhat improved the chaotic situation bequeathed to "Canada's New Government", as it calls itself, by its Liberal predecessors. (They could hardly have made it much worse.) The ten-province standard for equalization, the change in the method of calculating the property tax base, and the equal per capita grants for the CST and CHT are all major steps in the direction of fairness, although the absurdly long delay in the date proposed for implementing the change to the CHT, as well as the feeble excuse for the delay, make that promise of no more than symbolic importance. If it is ever actually implemented, the change to per capita grants will presumably mark the final interment of the pretence that the tax abatement of 1977 should still be counted as part of the federal contribution to health care. O'Brien's fifty per cent solution to the problem of whether or not to count resource revenues in the equalization formula, while hard to defend on any logical grounds, is a pragmatically reasonable compromise on an issue where consensus was clearly impossible. The division of the CST into three parts, although not really binding the provinces actually to spend the money as designated, will give taxpayers some idea of what they are paying for.

Incremental changes in fiscal federalism, often accompanied by long delays and special side deals, will likely remain the normal Canadian practice for the foreseeable future. Nonetheless, it may be worthwhile to conclude by sketching a more radical set of reforms which might increase transparency and accountability and would have other benefits as well.

First, the corporation income tax should be levied exclusively by the federal government. Given the reality of corporate power in the market economy it is questionable whether this tax is really "direct" in any sense that John Stuart Mill would have recognized. Transferring it entirely to the federal level would eliminate the need for the abstruse calculations which are used to allocate the income of corporations that do business in more than one province among the provincial governments. It would also eliminate the arrangement whereby the federal government presently collects the tax on behalf of seven provinces. In addition, it would simplify equalization by removing the corporation tax base from the formula. Most important, it would end the competition among the provinces to attract investment by lowering their corporation tax rates, a problem identified in the Mackenzie report. This change would cost the provinces about $19 billion a year.

In return, the GST should be completely transferred to the provinces, which could then integrate it with their provincial sales taxes, as Newfoundland and Labrador, New Brunswick and Nova Scotia have already done. The provinces could share the proceeds with their municipalities if they so wished. Alberta, which has never had a provincial sales tax, might choose to transfer the GST entirely to its municipalities. Canada's cities could thus benefit from this tax without raising constitutional concerns about federal intrusion in a field of provincial jurisdiction. This change would cost the federal government about $32 billion a year, so that the combination of the two changes in taxation would mean a net loss to the federal government of about $13 billion.

To make up at least part of this loss, the CST should be phased out. This would remove the federal government and its spending power from three fields of provincial jurisdiction, while preserving the federal role in financing health care which most Canadians, for better or for worse, seem to consider essential. The CST will cost the federal government about $9.5 billion in 2007-08, and is projected to rise to more than $12 billion in 2013-14 as a result of an annual increase of three per cent per capita that is promised in the budget. The reduction of federal spending by this amount would not quite cover the net loss to the federal government of the two suggested changes in taxation, but there would probably be some reduction in the cost of equalization by removing corporation tax from the formula, even though the GST would be added to the formula.

ENDNOTES

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