VARIATIONS ON THE FEDERALISM THEME

Thomas J. Courchene

Intergovernmental fiscal arrangements have played a pivotal role in creating Canada's welfare state, and the current debate about fiscal federalism may well end up playing a similar role in dealing with the challenges arising out of the knowledge-information revolution. Indeed, says Tom Courchene, the federal government "faces the Pearson dilemma anew , since one of the ongoing challenges for Canadian political and fiscal federalism is to reconcile the reality that these key policy areas are at the same time in the national interest and largely or wholly within provincial jurisdiction." Against this backdrop, Courchene traces a decade of federal-provincial fiscal and jurisdictional developments, from "hourglass" federalism to *"deux nations"* federalism and "market-preserving" federalism.

Les accords fiscaux intergouvernementaux ont joué un rôle décisif dans la création de l'État-providence canadien, et le débat actuel sur le fédéralisme fiscal pourrait bien jouer un rôle analogue quant aux défis soulevés par la révolution du savoir et de l'information. En effet, soutient Tom Courchene, le gouvernement fédéral « se retrouve face au même dilemme que Pearson à son époque, puisque l'un des défis du fédéralisme politique et fiscal actuel est de concilier le fait que ces deux domaines relèvent simultanément de l'intérêt national et de la compétence entière ou principale des provinces ». C'est sous cet angle que l'auteur retrace une décennie de développements en matière de fiscalité et de compétence, depuis le fédéralisme « de sablier » à celui des « deux nations » en passant par le fédéralisme de « marché ».

Canadian political and fiscal federalism is in full evolutionary flight. In the view of many, the proximate cause of these recent swings in the theory and practice of federalism is the existence of fiscal imbalances, both vertical (federal-provincial) and horizontal (interprovincial). There is, of course, much truth to this since the presence of a fiscal imbalance in Ottawa's favour will almost certainly bring the federal spending power into play which, in turn, will almost certainly shift the underlying approach to federalism even further away from the classical self-rule, shared-rule model. More generally, changes in the magnitude of, and in the incentives embodied within, federal-provincial fiscal transfers are tantamount to de facto changes in the division of powers themselves, with unconditional transfers enhancing provincial autonomy and conditional transfers enhancing the federal government's influence in areas of provincial jurisdiction.

However, fiscal imbalances can also be viewed not so much as a determining force in their own right but rather as an instrument in the service of more fundamental and pervasive forces that are driving both fiscal and political adjustments. For example, intergovernmental fiscal arrangements may become the appropriate vehicle for accommodating the requisite adjustments arising from the role of the knowledge/information revolution in privileging citizens and cities as the new and dynamic drivers of the emerging global order.

Accordingly, both fiscal imbalances as well as the interplay of more fundamental economic and societal forces will figure prominently in the ensuing analysis of the recent and ongoing rapid-fire series of pendular shifts in Canadian federalism. These shifts will include both of Paul Martin's approaches to spending-power federalism — hourglass federalism and then his contractual or bilateral federalism — followed by Stephen Harper's "open federalism," which now seems to be giving way to what has been labelled "market-preserving federalism." Intriguingly, while fiscal imbalances and particularly vertical fiscal imbalance (VFI) have played a key role in all of these variations on the federalism theme, VFI seems now to be rapidly vanishing from policy centre stage.

Prior to examining these recent swings in the theory and practice of Canadian federalism, three preliminary comments are in order. The first one is definitional. Specifically, the terms "fiscal federalism" and "intergovernmental fiscal relations" encompass the entire range of financial interactions between the two levels of government — tax and expenditure assignments, tax transfers, cash transfers, opting-out provisions, the tax collection agreements that promote the fiscal union and so on. Within this general framework, a "vertical fiscal gap" (in Ottawa's favour) exists when the federal or central government collects more in revenues than it needs for its own constitutional purposes. Almost every federation has such a vertical fiscal gap because the increasing mobility of tax bases means that the appropriate jurisdictional level for collecting taxes is rising in the governmental hierarchy, whereas the decreasing cost of information and coordination means that the appropriate jurisdictional level for spending is now moving "closer to the people." This fiscal gap can be redressed by transferring to the provinces additional tax points of existing shared taxes, new tax bases or more cash transfers. Alternatively, the gap could be closed by transferring spending functions upward to Ottawa. If after these adjustments there still exists a fiscal advantage in Ottawa's favour, then it can fairly be said that there does exist a "vertical fiscal imbalance" in the federation.

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To be sure, there is a body of opinion (embraced by the Martin Liberals, for example) that holds that there cannot in principle be a fiscal imbalance since the provinces have access to essentially the same range of revenue sources as does Ottawa. I disagree with this view for three reasons. First, because there are overall international competitive limits to income tax rates, and by virtue of being there first, Ottawa collects about two-thirds of the income taxes so that the provinces cannot meaningfully access this tax base further unless Ottawa reduces its rates; second, because Ottawa occupies the export-import-neutral GST, which is the preferable consumption tax; and third, because the fiscal imbalance also relates to the expenditure needs of Ottawa and the provinces, with the latter responsible for most of the open-ended, citizen-driven and electorally sensitive expenditure programs. Moreover, with Ottawa recently allocating much of its continuing string of surpluses to federal debt reduction and to spending in provincial jurisdiction, the provinces had every right to proclaim the existence of a fiscal imbalance.

The second introductory comment is celebratory as well as instructive in terms of what follows. It refers to the pivotal role of intergovernmental fiscal arrangements in the creation of Canada's modern welfare state. The federalism challenge in that era (largely the Pearson era) was three-fold. First, because the key components of the social envelope were under provincial jurisdiction and because the provinces were, by and large, not yet ready to commit themselves to wholesale increases in their respective social envelopes (Saskatchewan and medicare being the proverbial exception that proves the rule), Ottawa's initial task was to entice the provinces to ramp up their social programs. This it did by introducing four generous shared-cost programs (for physicians' services, hospital services, post-secondary education [PSE] and welfare), each embodying a version of 50-50 cost sharing. Second, in order to link these various provincial social systems into a national grid, Ottawa attached conditions to these transfers — ensuring interprovincial mobility of health coverage, elimination of residency requirements for welfare, an early version of the Canada Health Act principles and so on.

However, there was a third imperative that came to light, namely ensuring that all provinces would have roughly the same ability to generate *their own side* of the 50-50 sharing. This led to the conversion of the Equalization Program in 1967 into its most comprehensive variant — 100 percent of all revenues equalized to the national-average standard.

Over the decade-long period when these conditional grants held sway (from 1967 to the Established Programs Financing or EPF arrangements in 1977), federal cash transfers for the four social programs increased eightfold (from $645 million to $5.1 billion), while other fiscal transfers to the provinces (essentially Equalization) increased nearly ninefold (from $371 million to $3.3 billion). The watershed 1977 fiscal arrangements converted many of these conditional shared-cost cash transfers into relatively unconditional cash and tax transfers, which in turn served to enhance political and fiscal decentralization while maintaining social Canada intact. Effectively, therefore, Canada and Canadians drew upon creative fiscal instruments and arrangements to generate our welfare state in the form of *national* public goods and services that were designed and delivered within *provincial* jurisdiction.

For the third and closely related background comment, fast-forward to the most recent decade and to the emergence of the information era, whose most relevant feature for present purposes is the privileging of knowledge and human capital as the wellspring for competitiveness and wealth creation, for enhancing living standards and for achieving an acceptable societal income distribution. But much of what falls under the knowledge/ human-capital umbrella, such as early childhood development, K-12, PSE and cities (since they are the depositories of dense concentrations of human capital, R&D and high-value-added services that drive growth, trade and innovation), also falls largely or wholly under provincial jurisdiction. This is the Pearson dilemma anew, since one of the ongoing challenges for Canadian political and fiscal federalism is to reconcile the reality that these key policy areas are at the same time in the national interest (i.e., are "national" public goods) and largely or wholly within provincial jurisdiction.

This provides a most convenient segue to the first of the recent swings of the federalism pendulum, the Chrétien-Martin approach to federalism. As part of his "come hell or high water" commitment to put Ottawa's fiscal house in order, Finance Minister Paul Martin in his 1995 budget unloaded on the provinces what might be termed an exercise of the "federal savings power," namely, the dramatic, arbitrary and wholly unprecedented cuts to federal-provincial cash transfers. (By way of an intriguing aside, one of the reasons why Finance Minister Michael Wilson's late-1980s attempt to tame the federal deficit fell short was that Mulroney forbade such cuts to provincial transfers while the Meech Lake Accord was still in play.) My interpretation of the post-1995-budget march of events is that in the same time frame as the cash-strapped provinces were forced to redirect funds from here, there and everywhere to feed the voracious appetite of medicare, Ottawa was buying into the information-era philosophy that policies related to knowledge, citizens and cities were in the national interest and, therefore, ought to be high on the federal agenda. This led to what I refer to as "hourglass federalism," namely, Ottawa's placing its resulting surpluses in the service of the federal spending power to deal with these cash-starved, national-interest, provincial jurisdiction policy areas — Millennium Scholarships, research chairs, early childhood development, GST exemptions and gas-tax sharing for cities and even a federal ministry for cities ("communities"), and so on. Indeed, not only did cities, health care and child care constitute three of the four policy priorities in Prime Minister Martin's 2004 Throne Speech, but Martin ran his two federal election campaigns largely on provincial issues. The result of this federal end run around the provinces by the privileging of cities and citizens progressively left the provinces as the squeezed middle of the division-of-powers hourglass, as it were.

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Hourglass federalism served to trigger two further developments that were quite remarkable in their own right. The more speculative of the two was that Quebec, presumably for all the same "national" interest reasons that influenced Ottawa, recognized that meaningful information-era sovereignty in terms of how a society lives, works and plays lies in those powers that in Canada largely fall under provincial jurisdiction. Hence, the short-term operational priority of the Charest Liberals moved away from demanding more powers from Ottawa (i.e., away from the Quebec Liberal Party's 1991 Allaire Report, which requested the devolution of 22 additional powers) and toward demanding more revenues in order to more effectively exercise its existing powers. This is the backdrop that led Charest to join with the other provinces to convert the Annual Premiers' Conference into the Council of the Federation (COF), whose first priority was, not surprisingly, to seek to redress the vertical fiscal imbalance in the federation.

The second development was at the same time arguably more significant and less appreciated. Following the 2004 election, the Council of the Federation proposed, as part of a comprehensive approach to redress the vertical fiscal imbalance, that Ottawa take over the jurisdictional responsibility for pharmacare. Significantly, however, in the accompanying press release, the provinces added: "[I]t is understood that Quebec will maintain its own program and will receive a comparable compensation for the program put in place by the federal government." This is a remarkable concession, one that builds on the letter and spirit of the 1998 Calgary Declaration. Although Ottawa summarily turned down the provinces' offer at the fall 2004 First Ministers' Conference on Health (why would Ottawa buy into a citizen-driven, open-ended spending program — this is what the provinces are for!), the resulting health care agreement incorporated a signed Ottawa-Quebec addendum entitled *Asymmetric Federalism That Respects Quebec's Jurisdiction* that formally recognized Quebec's specificity. In effect, these two signed documents have delivered de facto to Quebec what this province was denied de jure in the failed Meech Lake process. Elsewhere, I have referred to this as section 94 federalism, since the intent of section 94 of the original *British North America Act* was to allow provinces other than Quebec (henceforth ROC, the rest of Canada) to transfer to Ottawa matters related to "property and civil rights," thereby enabling them to opt into a more uniform approach to selected social programs. Symbolically, I would not associate this with the traditional "opting out" by Quebec. Rather, in the case of pharmacare it was ROC "opting in" to a "national" pharmacare program run by Ottawa. And in the case of the 2004 Health Accord, it was a combined Ottawa-ROC proposal for a more integrated and uniform framework. In my view, this is one of those creative, though unheralded, initiatives that may well rebound to play a pivotal role in Canada's federal future. For those interested in labels, *"deux nations* federalism" may be apt.

With the Quebec issue thus finessed, the Martin Liberals went about devoting much of their remaining time in office to a seemingly unrestrained exercise of the federal spending power in terms of one-off (time-limited) bilateral deals across a bewildering array of policy areas, a process referred to above as *bilateral* or *contractual* federalism. *The Economist* likened this to Paul Martin operating a "fiscal cafeteria" for the provinces. This period merits further attention. Were the provinces so cash-strapped that they signed any and every federal deal available, or were we witnessing ROC expressing a desire to work much more closely with Ottawa to create national programs? In any event, the federalism pendulum had now swung so far in the direction of implementing variations on the theme of spending-power federalism on the one hand, and of Ottawa essentially abandoning whole swaths of federal competences on the other, that some return toward the middle was rather inevitable, even if the Liberals were to be re-elected.

While there were plenty of issues that separated the Conservatives from the Liberals in the 2006 election (Liberal wheeling and dealing with the provinces, accountability and Gomery, daycare and individual choice, GST versus personal income tax cuts, etc.), the battle was ultimately decided in Quebec, where Stephen Harper's promise of "une Charte du fédéralisme d'ouverture" garnered enough seats in the context of a Liberal collapse to give the Harper Conservatives a minority government.

"Open federalism," as reflected in Harper's now-famous Quebec City speech last December 19, represented much more than a swing back to the middle in that it was a sharp move in the direction of classical federalism. Open federalism embraced a recognition and a respect for the constitutional division of powers; a recognition that there exists a fiscal imbalance in the federation, which has led to huge federal surpluses while the provinces face rapid increases in their social expenditures; a commitment to redress this vertical fiscal imbalance; a related commitment to rein in the federal spending power and to finally bring a halt to the "domineering and paternalistic federalism of the Chrétien-Martin Liberals"; and a commitment to work with the COF to improve the management and workings of the Canadian federation.

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At the specific policy level, the differences between the Liberal and Conservative daycare approaches are especially instructive. Harper cancelled the Liberal approach, which essentially used the federal spending power to finance provincial provision of daycare spaces. The Conservatives' approach is to transfer money to individuals in order to allow them to decide whether to access publicly or privately supplied daycare. Were one to carry this comparison over to the medicare file, Martin would be associated with Romanow, and Harper with Kirby. All in all, a full pendulum swing toward a more classical approach to federalism and a message that presumably was music to the ears of the provinces. Or so it seemed.

However, almost immediately upon taking office, Harper's open federalism vision began a fascinating metamorphosis, especially in relation to the VFI. One reason for this is related to the behaviour of the provinces themselves. Specifically, the dramatically increased horizontal fiscal imbalances (HFI) arising from skyrocketing energy prices served to convert the 2004 consensus over VFI into a zero-sum, fiscal free-for-all over HFI. Intriguingly, Quebec played a lead role here, and rationally so since it would only receive its population share (about 24 cents) of every new VFI dollar, whereas its share (at the margin) of a new Equalization dollar is 48 cents, and could jump to nearly 70 cents when Saskatchewan, British Columbia and Newfoundland and Labrador join the ranks of the "have" provinces. This preference for HFI over VFI would be even greater if the Equalization Program were to revert back to a comprehensive 10-province or national-average standard (NAS, including full equalization of resource revenues) because billions of new Equalization dollars could be up for grabs. This same logic applied to the other have-not and fossil-energy-poor provinces — New Brunswick, Manitoba and Prince Edward Island. Saskatchewan also publicly campaigned for NAS but with *zero* resource revenue inclusion, since this would provide it with equalization at roughly the same level as Manitoba, while it would still be able to pocket its billion-dollar-plus energy revenues. Newfoundland and Nova Scotia presumably favoured NAS with 100 percent resource inclusion because they believed that their privileged special deal with Ottawa would return any clawbacks on their own resource revenue while they could retain the equalization derived from other provinces' resource wealth.

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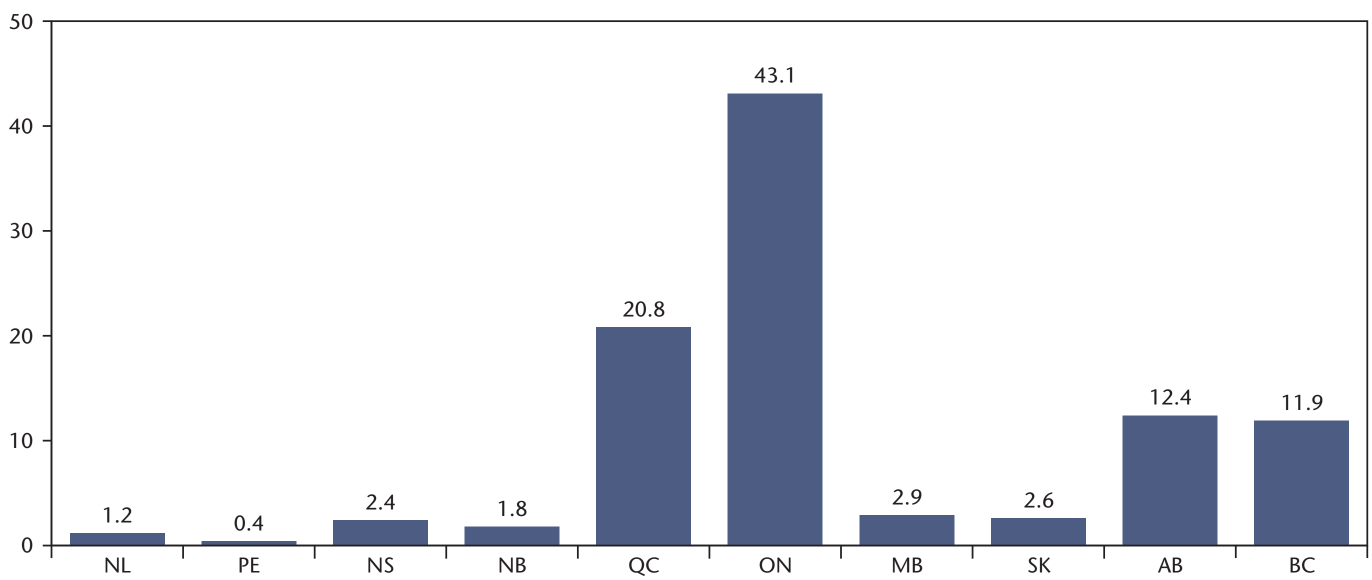
Seriously complicating all of this was the evolution of Ontario's position beyond its initial concern about its $23-billion fiscal shortfall with Ottawa. Part of this is related to the inequity associated with the funding of Equalization. The case for increased equalization is obviously related to the increased energy revenues. But because Ottawa has no direct access to these provincial energy revenues, the additional funding would have to come from Ottawa's traditional revenue sources, over 40 percent of which come from Ontario residents (see figure 1). Ontario deemed this to be inequitable and unacceptable since it would be footing most of the bill for the equalization increases caused by the soaring revenues of the energy-rich provinces. A second and related concern (drawing from my

FIGURE 1. PERCENTAGE OF FEDERAL REVENUES COLLECTED IN EACH PROVINCE, 2003



Source : Statistics Canada: Provincial Economic Accounts earlier work and expanded and given traction by Brian Crowley of the Atlantic Institute for Market Studies) was that the equalization principle in the Constitution is about ability to provide comparable public services and not about provincial per capita revenues per se. The fact that wages, rents, etc., in Ontario are higher than they are in Equalization-receiving provinces means that Ontario needs a higher level of per capita revenues to provide these comparable public services.

The typical counter to this is that other regions have greater "needs." However, this is far from clear. The recent Toronto Task Force (*Modernizing Income Security for Working-Age Adults*, or MISWAA) points out that only 22 percent of Toronto's unemployed qualify for EI benefits, compared with cities like Sherbrooke, Saint John, Quebec, St. John's and Saguenay, where the proportion is double. Therefore, the operation of the regional preferences within EI means that cities like Toronto have to rely proportionally more on provincial welfare rather than on federal EI. Note that this is not an argument against equalization, but more a concern that the present formula is over-equalizing.

Perhaps this is not surprising. Equalization was introduced in 1957 when trade flowed east-west, with Ontario as the principal north-south conduit, and when the economy was operating behind high tariff walls. None of this persists today. While it is the trait of a civil federation to maintain a generous east-west equalization system, it is also the case that these transfers should not imperil our north-south competitiveness. In any event, the message here is that Ontario remains firmly entrenched in the VFI camp.

A second reason why open federalism, and in particular redressing VFI, now holds less promise than originally thought relates to the back-tracking of the Harper Conservatives in their 2006 budget background document *Restoring Fiscal Balance in Canada.* Apart from the fact that "imbalance" has now become "balance," this background document has a distinct "the bureaucracy strikes back" tone. The rhetoric is clearly reminiscent of the Chrétien-Martin era in that it almost questions the very possibility of there being a fiscal imbalance, given the range of provincial revenue sources. Indeed, the federal finance minister recently stated that if the provinces believe that they suffer from a fiscal shortfall, all they need to do is increase their tax rates. Before one declares VFI to be a dead letter only months after its key role in the election, one must note that the background document does commit Ottawa to work with the provinces to develop a financial support package for PSE and to ensure that infrastructure funding is viable on a longer-term basis.

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But what is really novel and wholly unexpected about this budget backgrounder is that it exacts a significant quid quo pro to be delivered by the provinces — securing the economic union, deepening the fiscal arrangements, converting the remaining provincial sales taxes (PSTs) into GSTs and creating a national securities commission. Arguably, this would convert open federalism into a version of what the federalism literature calls "market-preserving federalism," the characteristics of which are: (a) the prohibition of fiscal or monetary bailouts (which ensures that the provinces will face "hard" budget constraints); (b) a commitment to a thoroughgoing internal economic and fiscal union at the provincial level; and (c) "unrestricted public choice," or the freedom for the provinces to spend and tax as they wish within their own jurisdiction. This combination will ensure that provincial policies will be welfare enhancing, in the traditional economic definition of this term.

Now there is no question that competitive gains would flow from this quid quo pro. For example, one reason why Ontario has the highest corporate tax rates in Canada is that its PST ends up taxing intermediate capital inputs: this would not occur under a GST format. Moreover, there are certainly costs arising from the fragmentation of the interprovincial economic union. However, the provinces will (or should) be very leery of this initiative since they will recall how the introduction of the Canadian economic union (CEU) issue in the 1980-82 constitutional negotiations and later in the Charlottetown Accord significantly eroded their powers. Under those variants of the CEU, Quebec subsidies to industry would be summarily declared ultra vires whereas similar initiatives by Ottawa would be exempt on principle because they are by definition in the national interest.

Beyond this, the Conservatives have fixated on the necessity of having a national securities regulator. To be sure, there could be gains here, but it is also important to note that, apart from the fact that Quebec would not go along with such a proposal, Canada has arguably the most efficient capital markets of any country anywhere near its size. Moreover, a single regulator would stifle creative regulatory competition such as the recent experimentation in British Columbia. A preferred approach would be an EU-type passport system with mutual recognition across provincial securities commissions.

If a full-blown CEU does become part of the quid quo pro, then the provinces (and certainly Canada's largest cities) should ensure that federal policies such as the preferential regional benefits under EI also become subject to the CEU. There exists no policy more offside vis-à-vis the skills and human capital dictates of the information era than EI is, nor is there any policy that would be more distorting of such a union. My message to the provinces is that if Ottawa does not buy into the CEU, neither should they, since one province's creative policy asymmetry can easily be viewed by Ottawa as yet another impediment to a full-blown CEU. Phrased differently, one can imagine a CEU scenario where Ottawa recognizes and fully respects provincial jurisdiction but where the provinces would nonetheless end up with much less room to manoeuvre than they currently have. Pendular swings in federalism may not be what they appear.

A further way that the VFI issue has been undermined was actually well telegraphed in Harper's election platform and speeches, namely his intent to direct Ottawa's spending to the national and international areas under federal jurisdiction that the Liberals had been ignoring. These include the rapid-fire series of expenditures on and commitments to Canada's military and its role in the world. Since these and other commitments in Ottawa's jurisdiction are nearing the value where they will exceed future discretionary federal surpluses, it is more difficult, politically and constitutionally, to argue that there exists a fiscal imbalance. Just as the provinces' case with respect to fiscal imbalance was enhanced because Ottawa was spending its discretionary funds in areas of provincial jurisdiction, so too the perception of a fiscal imbalance tends to evaporate if Ottawa's spending in its own spheres of competence is outpacing its revenue capacity. A final related comment is that if the Harper government finds itself cash-challenged but still wants to deliver on its promises to Quebec, then it will presumably opt for putting money into HFI (Equalization), where there is more Quebec bang for the federal buck than is the case if equivalent monies are allocated to VFI, as noted earlier.

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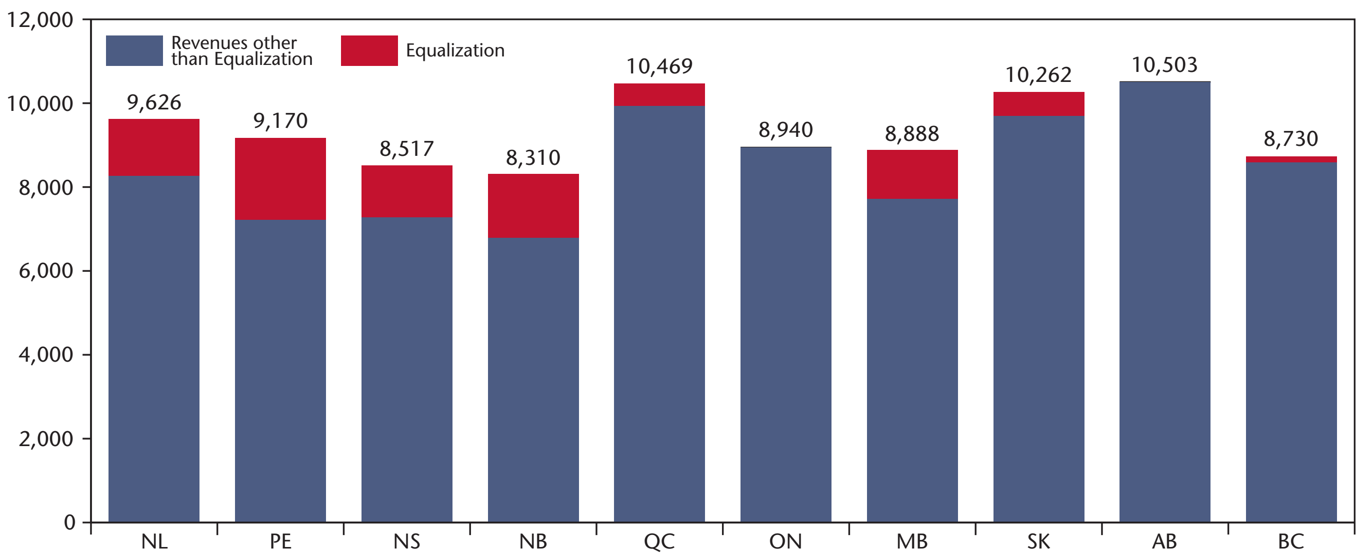
What, then, of Harper's open federalism and his commitment to redress the vertical fiscal imbalance? Have we Canadians been witness to a spectacular electoral-politics-driven rise in the political and fiscal fortunes of the provinces, only to be followed almost immediately by an equally

FIGURE 2. PROVINCIAL AND LOCAL GOVERNMENT PROGRAM EXPENDITURES PER CAPITA BY SOURCES OF FINANCE, 2004-05 (DOLLARS)



Source : Finance Canada, Statistics Canada: Financial Management System dramatic *realpolitik* decline in terms of their political and fiscal powers? And in which direction is the pendulum now swinging? Prior to registering a few final thoughts on these issues, it is important to recognize that these pendulum swings have allowed all of us to view aspects of our federation in a fresh and often exciting light. The following are my selection of ideas that merit further attention in terms of Canada's federal evolution.

What, then, of Harper's open federalism and his commitment to redress the vertical fiscal imbalance? Have we Canadians been witness to a spectacular electoral-politics-driven rise in the political and fiscal fortunes of the provinces, only to be followed almost immediately by an equally dramatic *realpolitik* decline in terms of their political and fiscal powers? And in which direction is the pendulum now swinging?

Focusing first on tax transfers as a way of reducing VFI (assuming that this may still be on the agenda), there is a consensus forming for enticing the remaining provinces to convert their PSTs to GSTs, which should then be followed by transferring GST tax points from Ottawa to the provinces (or simply by Ottawa decreasing its GST rate, noting that Harper has already promised a further 1-percent drop). Not only will this approach enhance competitiveness, as noted earlier, but since consumption is distributed across provinces more equally than income, GST transfers will trigger less equalization than, say, equivalent income tax transfers. Moreover, variations in GST rates across provinces are much less problematic than are differences in marginal income tax rates.

Cities pose a special challenge for Canadian federalism because they are the dynamic drivers in the new economy on the one hand, and because Canadian cities are among the weakest, fiscally, of any modern nation, let alone federation, on the other. Moreover, the principle of subsidiarity operating in tandem with the reduction in the information costs of decentralized coordination and implementation means that even more activities in federal and provincial jurisdiction will be devolved to cities. Ensuring that this leads to enhanced citizen participation and accountability requires a commensurate increase in their fiscal autonomy. Since Canadian cities are, constitutionally, the creatures of the provinces, this can be viewed as a provincial problem. However, and very refreshingly, the budget background paper notes that the "Government of Canada is proposing to discuss ideas on how to further clarify federal and provincial roles and responsibilities." I interpret this to mean that there is some jurisdictional room to manoeuvre in terms of ensuring that cities become more integrated into the operations of Canadian political and fiscal federalism.

On the taxation side, the cities, and especially the global city regions, need access to broad-based taxes (e.g., income tax points) allocated on a "derivation basis" (on the basis of the revenues actually raised within their boundaries). If all that Ottawa can offer politically is equal-per-capita shares for all cities (which would effectively be yet another equalization program, this one transferring funds from large to small cities), then Ottawa should use its influence and perhaps its money to entice the provinces themselves to provide their cities with access to broad-based taxation on a derivation basis, since they would face fewer constraints than Ottawa in so doing.

On the expenditure/transfer front, the Toronto Task Force report on income security for working-age adults has recommended the following:

> *A new refundable tax benefit should be created consisting of a basic tax credit for all low-income working adults and a working income supplement for low-income wage earners. Most Task Force members believe that this new benefit should be federally financed and administered.*

One rationale for a federal role here is that we are witnessing much more economic dislocation both within regions and across regions as Canadians are adjusting to domestic and international forces that are driving occupational and geographical mobility. My preference on the financing front, not the task force's preference to be sure, would be to phase in the above recommendation alongside a phasing out of short-term and regional preferences embedded in the EI program. This would be an exceptional accomplishment were it ever to come to fruition, since it would involve introducing a program designed to reward work and effort, replacing a program designed to reward non-work! I assume that it would be fully understood that this would treat similarly situated Canadians similarly no matter where they might reside; i.e., Ottawa would be required to respect the CEU. Encouragingly, the budget background document has recognized this challenge by proposing to work with the provinces "to reduce the welfare wall through development of a Working Income Tax Benefit," a concept that is essentially identical to the working income benefit of the Toronto Task Force.

On the equalization or horizontal imbalance front, we are in danger of losing our way. Virtually all the equalization proposals struggle with how best to bring the lowest-fiscal-capacity provinces up toward the Ontario level, neglecting the emerging reality that the four fossil-fuel-rich provinces (Alberta, Saskatchewan, Newfoundland and British Columbia) will at current energy prices be progressively and sharply diverging from the rest of the pack. Essentially we are over-equalizing at the bottom end and under-equalizing at the top. My proposal would borrow from Australia and other federations by incorporating *all* of the federal-provincial cash transfers in the pursuit of interprovincial balance.

On the equalization or horizontal imbalance front, we are in danger of losing our way. Virtually all the equalization proposals struggle with how best to bring the lowest-fiscal-capacity provinces up toward the Ontario level, neglecting the emerging reality that the four fossil-fuel-rich provinces (Alberta, Saskatchewan, Newfoundland and British Columbia) will at current energy prices be progressively and sharply diverging from the rest of the pack. Essentially we are over-equalizing at the bottom end and under-equalizing at the top.

The first of the proposed two tiers would be some version of the existing Equalization Program and would bring the five provinces with a fiscal capacity below Ontario's up toward the Ontario level. Hopefully, the approach here would address some of the over-equalization concerns aired above. The amount allocated to this tier could be fixed, or perhaps could grow in line with what was proposed in the 2004 federal-provincial agreement on Equalization. The second tier would involve the Canada Health Transfer and the Canada Social Transfer (CHT/CST). For 2006-07 these transfers equal $932 per capita, except for Ontario with $846 and Alberta with $740 per capita. These smaller amounts are the result of a limited income-tax-based clawback dating back to provisions originally adopted in 1977. This clawback needs to be both expanded and redesigned. Specifically, the clawback would be calculated in terms of comprehensive provincial revenues, namely NAS fiscal capacity (including all resource revenues) plus Equalization. Provinces with, say, 110 percent of this national average fiscal capacity would lose, say, 20 cents of the CHT/CST for every dollar by which their revenues exceed this 110 percent threshold. This implies that a province with a fiscal capacity that is $4,660 per capita above the 110 percent threshold (i.e., five times the $932 transfer per capita) would have its entire CHT/CST taxed back.

Thus the Equalization Program would bring the low-fiscal-capacity provinces up toward the national average while the clawback would scale down the CHT/CST cash transfers for the high-fiscal-capacity provinces. The federal savings here could be applied either to increase the Equalization envelope or to address vertical fiscal imbalance. It is instructive to note that this approach replicates the philosophy underpinning our two-pronged policy toward our seniors. Low-income seniors receive the guaranteed income supplement (GIS), which is essentially equivalent to the equalization component of the above model. All seniors also qualify for the OAS, except that it begins to be clawed back for richer seniors beyond a generous threshold. This corresponds to the CHT/CST component of the above horizontal balance model. Canada's model for the golden agers receives wide international acclaim. Surely, the resulting equity in terms of the distribution and the funding of benefits associated with this equalization proposal suggests that this two-pronged approach merits application to the provinces as well.

By way of a final observation, while analyses of federalism tend, of necessity if not by definition, to focus on how best to allocate money and power across the various government levels, the underlying reality is that federalism cannot just be about satisfying the demands of competing governments. Rather, federalism must also be, as Lincoln would say, "of the people, by the people and for the people."

In this context, it is instructive to return to the national-interest/provincial-jurisdiction nexus as it relates to the information era. Consider the parallel between medicare and human capital. Whereas medicare became a defining feature of Canada under the previous paradigm, the defining feature in this knowledge/information era must be ensuring equal opportunities for Canadians to develop and enhance their human capital. While not denying the importance of medicare for Canadians, it is more in the way of a "consumption good," while enhancing human capital falls more in the "investment good" category, so that our living standards (including our ability to pay for medicare) 20 years out, say, will be higher if we can find ways to privilege human capital relative to medicare. Indeed, there is also ample evidence that suggests that a richer and more educated society is also a healthier society.

Ottawa's obvious role here is to champion the notion of a human capital future for all Canadians, to focus on the "pan-Canadian" aspects of this challenge and to work together with the provinces to develop a general framework within which the provinces can experiment with alternative design and delivery mechanisms. The good news here is that there is plenty of room at the analytical level for pendulum swings in formal federalism models, but there ought to be no room at the implementation level for models that do not give enhancing Canadians' skills and human capital the pride of policy place it so deserves.

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