

THE FISCAL IMBALANCE: CUTTING TO THE CHASE

France St-Hilaire

With the arrival of the new Harper government, “it has been quite fascinating to watch the dramatic change in the dynamics of the debate” on the fiscal imbalance between Ottawa and the provinces, writes France St-Hilaire, vice-president for research at IRPP. As she observes, the debate is no longer just about money, and Ottawa is no longer in denial. But as she also notes, in this trenchant analysis of the issue, the prime minister intends “to engage the provinces in a more fundamental discussion of the respective roles and responsibilities of the two orders of government, strengthening the economic union and ensuring a more collaborative management of the federation.” A key to all of this is the federal discussion paper *Restoring Fiscal Balance*, which indicates the government’s intention to return to classical division-of-powers federalism. St-Hilaire regards this as a welcome development: “As the federal discussion paper indicates, there is already more than enough for Ottawa to do in its own areas of jurisdiction without attempting to run universities, hospitals and daycare centres by remote control, not to mention building local roads and sewage systems.”

Depuis l’élection du gouvernement Harper, « il a été fascinant d’observer le changement radical de dynamique entre Ottawa et les provinces autour du débat sur le déséquilibre fiscal », écrit France St-Hilaire, vice-présidente, recherche de l’IRPP. Un débat qui ne porte plus uniquement sur l’argent, note-t-elle, et qui ne suscite plus la dénégation d’Ottawa. Mais comme elle le précise dans cette analyse tranchante de la question, le premier ministre veut à la fois « engager les provinces dans un débat plus fondamental sur les rôles et responsabilités des deux ordres de gouvernement, renforcer l’union économique et assurer une gestion plus collaborative de la fédération ». Autant d’objectifs dont la clé se trouve dans le document *Rétablir l’équilibre fiscal*, qui dénote son intention de renouer avec une division classique des pouvoirs. Une évolution bienvenue aux yeux de l’auteure : « Comme l’indique le document d’accompagnement, Ottawa a déjà tant à faire dans ses propres champs de compétence sans tenter de gérer à distance les universités, les hôpitaux et les garderies, et moins encore la construction des routes locales et des systèmes d’égouts. »



It was a most unexpected result, but on second thought...When the IRPP gathered a group of 12 distinguished policy experts in January to agree on a list of the most important policy challenges facing Canada with respect to the economic and social well-being of its citizens, we were somewhat surprised to see the federalism issue emerge near the top of the list (see *Policy Options*, April/May 2006). However, as the group’s discussions converged on key policy priorities such as human capital, the environment, population aging, productivity and economic security, it became evident that addressing these challenges will require not just the right policies, but also a well-functioning federation to implement them effectively. That a significant majority of our participants viewed this as a

major challenge speaks to the degree of deterioration in federal-provincial relations over the past decade.

With two recent expert panel reports recommending fundamental reforms in fiscal federalism and a new Conservative government intent on coming to a new understanding with the provinces not just on fiscal imbalance but also on the economic and social union, the functioning of the federation is certainly on the agenda. Having observed the first rounds of sniping and posturing among the premiers in reaction to these reports, Canadians could be forgiven for giving a collective sigh of exasperation and dismissing the whole debate as “same old same old.” After all, fiscal imbalance has been the object of “yes there is / no there isn’t” dispute between Ottawa and

the provinces for almost a decade now. And since the majority of the public view fiscal arrangements as somewhat of a black box, the relevance of this issue often escapes them.

The problem is that in Canada both orders of government have traditionally played a role in major areas of social policy without any institutions or formal mechanism in place to ensure a collaborative outcome. Instead the nature of federal-provincial interaction has been defined by the ebb and flow of economic circumstances, evolving policy needs and related changes in intergovernmental fiscal arrangements whereby the unilateral actions of one order of government can significantly affect the fiscal parameters of the other. This occurred in a most dramatic fashion in the mid-1990s as a result of Ottawa's measures to balance its books. Major cuts in social transfers, the end of cost-sharing for social assistance and EI reforms all had a destabilizing and structural impact on provincial finances and, by ricochet, on municipal finances from which these governments are still recovering.

More importantly, the country has been mired ever since in a most unconstructive and acrimonious debate between Ottawa and the provinces over whether fiscal imbalance does exist and what it would take to fix it. The core issue until recently was health care funding. Quite rightly so, since this is the key long-term pressure point on provincial budgets and the area where Ottawa has been most keen to maintain a visible and active policy role. But it took several years, many false starts and a number of short-lived "accords" before first ministers managed to reach a genuine long-term agreement on health care transfers, which finally allowed the country to focus on other important issues.

That episode served to expose some of the more dysfunctional aspects of our federal system, including the lack of

mutual trust and respect, and the lack of transparency and accountability — this, on the issue of foremost concern to Canadians. Instead of having a clear and honest debate about the types of reforms needed to ensure the long-term sustainability of the health care system, both orders of government have been busy shifting the blame for lack of progress onto each other as each side struggled to find the right political balance in order to concede (extract) as little (much) federal money with as many (few) strings attached as possible.

This is why, as we head into another round of discussions on fiscal bal-

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ance, many observers are asking whether the time has come to do away with social transfers altogether. By having the federal government devolve appropriate tax room to the provinces, we could clarify the lines of accountability, enhance fiscal responsibility and put an end to counterproductive intergovernmental bickering. In other words, we could opt for the "layered" rather than the "marbled" cake model of federalism.

One thing is certain. There is a real sense in many quarters that this dispute has diverted too much attention away from the real policy issues confronting

the country for too long — indeed it might even have provided a useful pretext to put off needed reforms — and that it is time to move on. It is also the case, however, that in most of the policy areas in question, entanglement is practically unavoidable and will require concerted action on the part of both orders of government, whether transfers are part of the equation or not. The bottom line is that resolving the fiscal imbalance issue in a satisfactory manner is a prerequisite to improving the workings of our federal system. Moreover, there is currently a unique window of opportunity to do so.

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The discussion paper *Restoring Fiscal Balance*, which was tabled with the federal budget in May, was remarkable in a number of respects. While it reiterated many of the counter-arguments on fiscal imbalance put forward by the Department of Finance in recent years, it also clearly and fairly articulated the issues and concerns raised by provincial governments and other proponents of the case in a kind of "we hear you" gesture. The paper essentially acknowledges the problems stemming from a lack of budget transparency and the use of larger than planned federal surpluses, delays in restoring federal support for health care and the fact that "some transfers have not yet been put on a principle-based, predictable, long-term track." The issues raised by the



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expanded use of the federal spending power in areas of provincial responsibility in recent years are also duly recorded — intergovernmental strains caused by lack of prior consultation or consensus on priorities; additional cost and spending pressures imposed on provinces as a result of federal funding conditions; and increased uncertainties due to the lack of long-term funding commitments.

have the federal government declare that it is prepared to:

- put in place “predictable and equitable fiscal arrangements for the long term”;
- respect local autonomy and diversity and the roles and responsibilities that other orders of government are best placed to perform;
- ensure that “excess federal rev-

public pension funds to alleviate the burden on younger workers;

- is committed to strengthening Canada’s economic union by working with the provinces to reduce barriers to internal trade and labour mobility, enhance tax and securities regulation harmonization and improve processes for recognizing foreign skills credentials.

Two statements in particular signal a revised federal stance on the issue of fiscal imbalance. The first goes to the heart of what was Ottawa’s official position, until recently, that “fiscal imbalance cannot exist because provincial governments have the legal authority to increase their revenues as required,” by recognizing that “concerns about competitiveness and the overall tax burden of Canadians limit the extent to which they can and should raise additional revenues in practice.” The second is the clear statement of the government’s objective, which is “to ensure a return to balanced fiscal arrangements in which all governments have access to the resources they need to meet their responsibilities.”

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While Ottawa has apparently abandoned its former strategy of denial, it is proposing a multipronged approach to restoring fiscal balance that could entail more than simply adjusting the mechanics and sum totals of existing fiscal arrangements. Several of the elements put forward would go a long way in removing the main irritants flagged by the provinces in recent years. It is likely music to their ears to

enues [are] used primarily to reduce federal taxes rather than to launch new policies in areas where the federal government is not best placed to design or deliver programs”; and

- ensure effective collaborative management of key policies where both orders of government will continue to play a role.

At the same time the paper also makes clear that Ottawa:

- considers long-term funding for health care to be settled and that it is now up to the provinces to deliver on their commitments in the health care agreement;
- must also have access to the revenues required to fulfill its roles and responsibilities, not only to fund Equalization and other transfers to the provinces, but also to refocus its attention toward core areas of federal responsibility that have been neglected or have acquired new salience and to pursue its debt repayment objectives;
- is prepared to discuss appropriate rules and mechanisms to allocate unplanned surpluses — its initial proposal is to set them aside in the

Whether one agrees with the approach being proposed or not, the agenda for discussion laid out in this document is essentially the right one. It shifts the debate away from the arcane arithmetic of fiscal federalism to three key elements of the fiscal imbalance debate that has to take place in order to set a more constructive course for future federal-provincial relations:

the need to clarify the respective roles and responsibilities of each order of government, the importance of greater accountability and transparency, and the emphasis on national priorities and emerging policy challenges.

While there is no doubt that the economic union needs to be put back on the front burner, one wonders about the benefits of linking it to the fiscal imbalance debate. It would be helpful if the federal government was able to leverage its willingness to revisit transfer payments to obtain concessions on some of these items. But there is also a risk that the whole exercise might be jeopardized if the agenda is too broad and ambitious. Moreover the provinces are currently making some progress on the economic union file on their own volition. And ultimately, this is an area where Ottawa has constitutional authority that it could afford to exercise if required, especially if it was seen to be doing its part to address other contentious intergovernmental issues.

The fiscal imbalance debate is fundamentally about the social union. That is where the origins of and the solutions to the problem lie. The reality is that



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Provincial premiers around the table at their annual meeting in St. John's in July. They failed to come to an agreement on how Ottawa should address the fiscal imbalance: through an enhanced equalization formula or through increased transfer payments to the provinces.

Canada's fiscal architecture has not yet fully recovered from the major restructuring of the nation's public finances that occurred in the mid-1990s. As a result of this fiscal turnaround, the country can now boast of having the best record of any country in the G7. But it is also true that in the aftermath of significant reductions in federal and provincial program spending and subsequent tax cuts at both levels, the system is still out of kilter in terms of an appropriate matching of revenues and responsibilities.

One of the reasons for this mismatch is that much of the fiscal adjustment took place at the level of intergovernmental transfers (from Ottawa to the provinces and then from the provinces to the municipalities) and the pendulum has not fully swung back with a return to balanced budgets (and perhaps never will). With the federal

government posting substantial surpluses year after year since 1997, the provinces and municipalities' strategy has been to try to tap into those surpluses and to resist raising their own revenues to cover their expenditure needs. Ottawa, for its part, has been quite reluctant to restore social transfers, preferring to reinvest directly in areas of provincial jurisdiction of its own choosing, often on an ad hoc and temporary basis, causing the difficulties already mentioned.

As Robin Boadway points out in his work, fiscal imbalance is the outcome of decisions made independently by the two orders of government, but it is a process where the federal government has first-mover advantage. The extent of imbalance depends on the amount of tax room it occupies and the amount of transfers it chooses to make.

Restoring some sort of equilibrium in the finances of the federation, therefore, will entail more than simply increasing transfer payments to the provinces. There needs to be a new consensus on two key issues: (a) what should be Ottawa's share of existing tax room relative to the other two orders of government; and (b) whether achieving a more appropriate matching of revenues to expenditure responsibilities will mean a higher tax burden for Canadians. This is not a straightforward process or one that can occur in the context of a single round of budgets, but it could be made easier with certain conditions in place.

For instance, the notion that Ottawa is prepared to change tack and respect local autonomy, while focusing on the roles and responsibilities that it is best suited to perform, is welcome news. As the federal discussion paper

indicates, there is already more than enough for Ottawa to do in its own areas of jurisdiction without attempting to run universities, hospitals and daycare centres by remote control, not to mention building local roads and sewage systems. The successful settlement of immigrants, improving the

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Significant new spending in some of these areas has already been announced, and further initiatives could put a serious dent in previously projected federal surpluses. This development along with the government's expressed intention to maintain ambitious debt reduction objectives, however, raises questions regarding how meaningful is its commitment to use excess revenues to reduce federal taxes (and therefore vacate tax room). This is why greater budget transparency and accountability are so essential. Canadians will have to judge whether this particular allocation of public resources reflects their priorities overall — particularly if it translates into higher taxes, lower spending, or deficits at the provincial and municipal levels over time. The proposal to allocate unplanned federal surpluses beyond the contingency reserve to the CPP/QPP fund adds yet another (intergenerational) dimension to this debate.

Finally, it is important to recognize that the shelf life of this renewed

federal mission statement might not extend beyond the mandate of the current minority government, if that. The reality is that there is very little short of new binding constraints on the federal spending power or institutionalized intergovernmental ground rules to prevent a return to old habits.

It is also hard to know what to make of the federal government's intentions on the transfer front. The view that productivity growth, innovation, knowledge and skills will be the key to increasing Canada's standard of living in the context of an aging population and changing global trade and investment patterns is widely shared. It provides a strong rationale for Ottawa's choice of priority items, that is post-secondary education, training and infrastructure, where it is prepared to reinvest and put funding on a predictable long-term track. While talk of prior consultations with counterparts, clarifying roles and ensuring greater accountability is reassuring, there are causes for concern.

Infrastructure is a case in point. The deteriorating state of Canada's infrastructure is well known and a direct result of the steep and steady decline in the level of investment in public infrastructure as a share of GDP by all governments since the early 1960s. This trend has been most pronounced at the provincial and local levels, where governments have for some time essentially relied on intermittent federal initiatives to come to the rescue. This has evidently not worked out very well. There is a federal role in ensuring that Canada is equipped with the

necessary large-scale public infrastructure to ensure a well-functioning economy and the free movement of people and goods across the country and its borders. This task will require sustained effort and investment. But the continuing reliance on federal largesse to fill the gaps left by other orders of government

fails to provide the transparency and clarity of roles and responsibility that is required at this juncture. Ottawa's move to share a portion of the gasoline excise tax with municipalities is one of the more evident manifestations of fiscal imbalance (using excess tax capacity at the top of the government hierarchy to palliate the effects of insufficient revenue at the bottom). But the program operates essentially as a

special purpose grant and weakens fiscal responsibility — the principle according to which the government that spends should be the one that taxes. This is clearly one of those areas where, for both constitutional and comparative advantage reasons, the federal government is not best placed to intervene.

Ottawa's change of heart on transfers for post-secondary education (PSE) is interesting to say the least. Indeed, PSE transfers have been treated more or less as an afterthought since 1977, when they were combined with health transfers and converted from shared costs to block funding. And they have essentially been on life support since 1996, when all remaining social transfers were placed into a single funding envelope (the CHST) and cut by a third. As the federal government's fiscal situation improved, any transfer increases have been almost entirely earmarked for health care. This pattern was made more transparent in 2004, when the Canada Health Transfer (CHT) was carved out of the CHST with provisions for increased base funding and 6 percent annual increases over 10 years. The remaining Canada Social Transfer (CST), meanwhile, was left dormant, growing

at a rate of 3 percent (barely enough to cover inflation and population growth).

It is not that the federal government has not been active in post-secondary education. In fact, this is one of the main areas where Ottawa has preferred to provide direct support, primarily for university research and student financial assistance. Direct federal spending on PSE had grown to an estimated \$5 billion in 2004/05, more than double the current amount of PSE transfers (\$2 billion). The government characterizes these trends as merely a change in the mix of funding, as if they were interchangeable. The reality, however, is that federal transfers as a share of provincial expenditures on PSE have been reduced by half since the early 1990s, even as the provinces themselves have also cut spending. And while some of that direct federal spending undoubtedly helps lighten the provincial load, it has also in some cases created added institutional costs, overlaps and funding uncertainties that the provinces have had to cope with. Direct-cost research grants without related overhead and infrastructure support have been particularly problematic.

Here we can see several aspects of the health care funding saga being repeated as both orders of government are eager to respond to growing public concerns about rising tuition fees, declining levels of public funding and the system's capacity to meet increasing demand. Hopefully, the lessons of the past few years have been learned. The key elements in achieving a sustainable agreement on health care transfers have been ensuring transparency (re-establishing a separate, dedicated health transfer), linking renewed base funding to historic federal funding levels and providing predictability (a commitment to a fixed annual rate of growth for 10 years).

As was the case for health care, the provinces need to know what they can

expect for the foreseeable future in terms of financial contribution from Ottawa for planning purposes. PSE institutions require stable funding to operate and maintain facilities, and

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they need multi-year investment commitments if they are to provide added capacity. More fundamentally, the whole federal transfers issue needs to be finally settled so that provincial governments will be in a position to assess realistically their own-source revenue requirements relative to expenditure needs over the medium term and act accordingly. The annual public campaigns by the provinces to extract more federal money undermine good governance and the functioning of the federation and they must end.

Earmarking a share of federal revenue or reallocating tax room to the provinces would be the most expedient and permanent solution, but there are other factors to consider in the case of PSE. Given the central importance of knowledge, skills and human capital to Canada's future prosperity, this is the one area where genuine intergovernmental cooperation and partnership could prove most valuable. Maintaining a federal-provincial silos approach to public investments in post-secondary education and research simply makes no sense. While provinces have clear jurisdiction in this area, one would be hard pressed to argue that there is no federal role as it relates to research and innovation, labour mobility and promoting equal opportunities for all Canadians.

What is needed is for both orders of government to work jointly and devise a coherent strategy based on shared goals and a clear recognition of respective roles and responsibilities.

This would allow them to determine where and what level of federal transfers would be more appropriate and to ensure that ongoing direct federal spending does not interfere with provincial operations. Other federations such as Switzerland and Australia that are facing the same imperatives have already taken even more ambitious steps to improve and coordinate intergovernmental action on this front. If our governments cannot find common ground on this issue, it is hard to imagine what the prospects might be in other areas of national interest.

Then there is the orphan transfer — what will remain of the Canada Social Transfer once PSE funding is carved out. The federal discussion paper is completely silent on this issue, much as the provinces have been ever since they decided to make health care the focus of the dispute on fiscal imbalance. Yet of all the changes in fiscal arrangements in the last decade, the ones relating to social assistance and social services (the former Canada Assistance Plan) have been the most dramatic. When they were folded into the CHST in 1996, CAP transfers amounted to close to \$7.8 billion and were allocated among provinces as a share of their spending on welfare programs. Ten years later, the corresponding envelope is about \$5.5 billion and is

distributed on an equal per capita basis. The share of federal cash transfers as a proportion of provincial social assistance spending has dropped sharply from 44 to 23 percent, and the effects have been particularly onerous for regions with higher than average welfare burdens. This has also made provincial budgets more vulnerable to economic downturns and gaps in other income security programs.

The latter point is no trivial matter. A number of recent reports have called attention to the lack of coherence that exists among the patchwork of income security programs and benefits for working-age adults that has emerged after more than a decade of tinkering, cutting and offloading by all governments. Employment Insurance and social assistance, the two main pillars of the system (if it can be called that), have proven woefully inadequate and inequitable in providing needed support to the unemployed and chronically poor. More importantly, the system is not equipped to provide the training and other services needed to facilitate the return to and continuing participation in the labour market of individuals who could be active given the right tools and incentives.

These analyses suggest that a comprehensive redesign of adult benefits is long overdue particularly in light of new labour market realities. This could be achieved only by conducting a full review of existing programs at all levels to identify the gaps, overlaps and disincentive effects, and by considering all options, including an intergovernmental realignment of roles and responsibilities. One could even argue that such a reform is as much part of the solution to the aging population and productivity challenges as are education and training. It is in this context that the CST should be reassessed. However, since this scenario appears unlikely at the moment and, given that the purpose and meaning of this transfer has long been

lost, perhaps the best outcome would be to close the books through a formal tax point transfer. This would allow the provinces to cut their losses and it would provide governments with a clean slate when the time comes to have this broader yet unavoidable discussion.

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It is ironic that after having spent almost 10 years trying to engage the federal government in a full debate on the issue of fiscal imbalance, the provinces have for all intents and purposes dropped the ball at the very moment when they have finally obtained a hearing on the matter. Whereas provincial and territorial governments had been united and successful in their efforts to obtain adequate long-term funding for health care, the prospects of major reforms to the Equalization Program have reignited perennial interregional squabbles about who wins and who loses out of Confederation.

obtained a hearing on the matter. Whereas provincial and territorial governments had been united and successful in their efforts to obtain adequate long-term funding for health care, the prospects of major reforms to the Equalization Program have reignited perennial interregional squabbles about who wins and who loses out of Confederation. This has resulted in a confusing and often disingenuous exchange of arguments, where issues of horizontal fiscal imbalance (among provinces) have been melded with those of vertical fiscal imbalance (among orders of government) and topped up

with recriminations about fiscal gaps (what each province contributes to and receives from federal coffers).

By blurring all of these issues, the provinces have managed to turn the fiscal imbalance debate into the same kind of zero-sum game of interprovincial politics that has always left them short-changed in the past. This has made them incapable of articulating a joint position on the expert panel report that they had commissioned. This summer's Council of the Federation meeting can only be described as a failure. Failure to agree on ways to renew Equalization, failure to agree on the need for increased PSE or other social transfer funding, failure to agree even on the call for a First Ministers' Meeting on these issues this fall.

As a result, again ironically, the leadership on this issue could come from the federal government. The document for discussion that it tabled in May lays out the key fundamental issues that need to be resolved in order to improve the workings of our federal system to the benefit of all Canadians. Ottawa has since indicated that it is even prepared to discuss limiting federal spending power in areas of provincial jurisdiction and allocating a portion of unplanned federal surpluses to the provinces. Its proposals are expected in the fall.

Another such opportunity could be a long time coming — the provinces had better come prepared.

France St-Hilaire, vice-president for research at IRPP, is one of Canada's leading authorities on fiscal federalism in general and the fiscal imbalance in particular. She has written in Policy Options on these matters in the December 2005 and February 2004 issues, available at www.irpp.org. She was co-coordinator of the symposium that produced The Canadian Priorities Agenda (see our April-May issue.) fsthilaire@irpp.org