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objectives leads to several potential sources of friction. These include the definition of the conditions, the extent of intrusiveness of the federal government in provincial decision-making, the extent of transfers needed to enforce the spending power when it is first initiated and as it is subsequently maintained, the interpretation of the general conditions, and their enforcement by the federal government. Obviously these problems are made more difficult the less cooperation there is between the provinces and the federal government. They are also made more difficult the smaller the size of the transfers used to engage the spending power in a given provincial program.

Moral suasion. It is conceivable that the federal government can have considerable influence over provincial program design simply by combining federal-provincial transfers with moral suasion. This avoids the need to codify general conditions as well as to interpret them. The effectiveness of this will depend upon both the extent of cooperation between the two levels of government and the size of transfers. It is difficult to know the extent to which moral suasion has been used in the past. However, it is possible that moral suasion has had some implicit effect in both the welfare and post-secondary education areas, and that this effect waned as federal transfers declined. Thus, until recently, provinces treated out-of-province residents on a par with their own residents when it came to determining the terms under which services in these areas could be used.

Federal-provincial agreement. Some of the problems with the spending power as a means by which the federal government exercises its responsibility for achieving national objectives can in principle be overcome by negotiating agreements with the provinces rather than applying spending power conditions unilaterally. However, this too is fraught with difficulties. Agreement is notoriously difficult to achieve, especially where near unanimity is required. A negotiated agreement must spell out the terms of the agreement with more precision than those attached to the spending power. It must include not only the conditions that provincial programs must satisfy, but also federal financial obligations and dispute settlement procedures. These difficulties account for the relative lack of success of federal-provincial negotiation as a means of achieving national objectives, except in fairly narrow policy areas. The two agreements that have been negotiated to address national efficiency objectives (the AIT) and national equity objectives (the SUFA) have had very limited success. The AIT lacks an effective dispute mechanism, while the SUFA is really more an agreement over process. It is not clear that any negotiated agreement can have a dispute settlement mechanism that is as effective as that used in the spending power, that is, federal government enforcement.

The relevance of these alternatives is very much bound up with the nature of rebalancing that the federation might undergo. Before turning to that, it is necessary to clarify the conceptual nature of rebalancing the federation.

VFG versus VFI

We have used the two terms *vertical fiscal gap* (VFG) and *vertical fiscal imbalance* (VFI). A subtle but important distinction between these concepts should be cleared up before proceeding to more prescriptive arguments. Both of these concepts are highly imprecise, but the conceptual distinction between them is nonetheless an important one. The concept of VFG is related to one's view of the optimal division of responsibilities between the federal government and the provinces, and the optimal exercise of those responsibilities. It is useful to take the division of expenditure responsibilities between the federal and provincial governments as given. There is much less disagreement about this than about the revenue side. Expenditure responsibilities are after all set out in the Constitution. Suppose then that one has a view about the optimal exercise of these responsibilities. This leads one to a view about the optimal size of federal and provincial expenditures and how they are likely to evolve over time.

Given these expenditure requirements, the issue is then how should they be financed. It is here that the concepts of VFG and VFI kick in. Setting aside issues of budget deficits, there will be a total amount of revenue that has to be raised to finance the sum of provincial and federal expenditures. The extent of VFG is equivalent to a view about how revenue-raising should be divided between the two levels of government. There may be various reasons why the federal government should be responsible for raising more revenues than it requires for its own spending purposes, and the provinces correspondingly less. These include arguments about the benefits of tax harmonization, the use of the tax system for national redistributive objectives, the costs of destructive tax competition, and the very different revenue-raising capabilities of the provinces. And, the need for federal-provincial transfers also factors into one's view about the ideal VFG: that is, federal-provincial transfers may be desirable in their own right rather than being a residual determined by the separate determination of expenditure and taxing responsibilities. These arguments will be relevant when we consider the pros and cons of rebalancing later one. For now, we simply note that the VFG refers to the *desired* asymmetry in revenue-raising between the federal and provincial governments. The higher the VFG, the more centralized is revenue-raising, and vice versa. Equivalently, the more centralized is revenue-raising, the larger should be the amount of federal-provincial transfers required to finance the spending at the two levels of government.

The federal fiscal system will be in balance if federal-provincial transfers are sufficient to finance the optimal level of provincial and federal spending given the division of revenue-raising, that is, given the VFG. A VFI will exist if the level of transfers is not consistent with the division of revenue-raising, given expenditure responsibilities. There can either be a positive or a negative VFI, although given the preemptive nature of federal decision-making, concern is typically over the imbalance taking the form of inadequate transfers. In any case, the VFG and the VFI are conceptually distinct. It is possible to have any size VFG without any VFI, and it is useful to keep that in mind in what follows.[1]

To repeat, there is nothing precise about these concepts. There will be disagreement about the optimal sizes of provincial and federal expenditures, as well as about the division of revenue-raising responsibilities. Moreover, given the independent discretion over tax policy, the division of revenue-raising cannot really be taken as exogenously given. The existence of federal and provincial public debt makes the concept even more imprecise. Nonetheless, the distinction between VFG and VFI is useful as a way of organizing one's thoughts. If one thinks the current fiscal system exhibits VFI but is otherwise satisfied with the VFG, the remedy is to increase transfers to the provinces. On the other hand, one may have a more fundamental problem with VFG and prefer either more or less decentralization of revenue-raising.

Interestingly, the Seguin Commission understood clearly the distinction between VFG and VFI (without using the terminology), and even attempted to estimate empirically the sizes of the two. Their policy recommendation was intended to address both their perception about the existing VFI and their normative views about the VFG. In particular, they argued—convincingly in my view—that there was a serious VFI, brought about in large part by the substantial unilateral reduction in federal transfers to the provinces during the deficit reduction years of the Paul Martin Finance Ministry. Federal reductions in cash transfers to the provinces were much larger in percentage terms than reductions in other federal spending programs, effectively reshuffling the federal deficit problem to the provinces. At the same time, they argued that the underlying VFG—the division of revenue-raising responsibilities—was much too large. This view was not based on some notion of the ideal division of revenue-raising responsibility, but on the role of the VFG as a source of federal-provincial transfers. Their view was that federal-provincial transfers should only be used to fulfill equalization commitments,

[1] Conceptually, one can think of the relationship between the VFG and the VFI as follows: VFI=VFG-Actual Transfers. Of course, in the real world where

and not for any other spending power purpose, especially conditional grants in areas of provincial jurisdiction. The Seguin Commission implicitly discounted arguments about the disadvantages of a more decentralized tax system. They argued that the combination of eliminating the CHST transfer and turning over the GST to the provinces would both undo the VFI and correct what they saw as an underlying VFG.

The precise recommendation of the Seguin Commission in fact makes little sense from the point of view of the rest of Canada. The federal GST and the Quebec Sales Tax (QST) are already harmonized, and by a unique arrangement, Quebec collects both the QST and the GST within its borders. Turning over full responsibility for the GST to Quebec would be a relatively simpler matter. It would be much more difficult elsewhere in Canada where either provincial retail sales taxes are not harmonized with the GST (or do not even exist, in the case of Alberta), or where they are harmonized but the federal government administers the tax. But the more important point of the Seguin Commission is their insistence that both a VFI and a VFG exist, and that this can only be addressed by a major reallocation of tax room from the federal government to the provinces along with a reduction in federal transfers. That the tax room reallocation cannot reasonably be achieved by decentralizing the GST is not a telling criticism. The obvious alternative of the federal government turning over income tax points to the provinces is a viable alternative that commentators elsewhere in Canada have proposed.

This leads us to address the key issues raised by the Seguin Commission of whether the Canadian federation is out of balance, and if so how a new balance can be struck.

Rebalancing the Federation

The evidence presented by the Seguin Commission pointing to a VFI in the current fiscal transfer arrangements is reasonably convincing. It was based on projections done by the Conference Board of Canada of future public expenditure requirements relative to revenue growth and the ability of the current structure of transfers to cope with it. These kinds of projections are naturally judgmental and have led to considerable debate and dispute, especially by the federal government. Without going into the details, the existence of a VFI of some magnitude is plausible. Taking that as a given, two interdependent questions arise, and they parallel the questions asked by the Seguin Commission. How should that imbalance be addressed? And, should the VFG be adjusted at the same time?

Taken together, this is equivalent to asking what combination of changes in federal-provincial transfers and tax room reallocation should be undertaken to address the existing imbalance. The answer ultimately depends upon one's view of the appropriate VFG, the issue addressed head-on by the Seguin Commission. To assess this issue, let us consider in turn the arguments in favour of a lower VFG and for maintaining the existing VFG. The former would support addressing the VFI by relying largely on turning federal tax room over to the provinces, while the latter would protect federal tax room and increase federal transfers to the provinces.

Arguments for Reducing the VFG

There are a large number of arguments for reducing the VFG and making the provinces more fiscally self-reliant. A list of some of the more important ones would include the following.

Provincial sovereignty. Foremost in the minds of some provinces—including, but not exclusively, Quebec—is to eliminate the use of the spending power in areas of exclusive

identified by the Mintz Technical Committee on Business Taxation were due to provincial and municipal taxes.

Tax competition. Related to this, it might be argued that the more decentralized the tax system, the more likely it is that the tax system will be used for adverse purposes, such as beggar-thy-neighbour policies, or simply as an instrument for self-destructive tax competition leading to a race-to-the-bottom in program spending. Of course, as the literature has shown, one might counter that provinces will find ways to engage in fiscal competition if the use of taxes are limited, and some of these other ways can be more harmful that tax competition.

National redistributive objectives. A VFG is indispensable to the extent that one views redistribution as at least partly national in nature, given that the federal government is the only government capable at addressing national goals. Of course, the extent to which redistribution is regarded as national versus provincial is a matter of judgment. It depends on the extent of consensus for redistribution and the extent to which solidarity is national versus regional. There are two ways in which a VFG contributes to the achievement of national redistributive objectives. The first is that it allows the inter-personal tax-transfer system to be designed with some common degree of progressivity nation-wide, albeit one that co-exists with provincial tax-transfer schemes. The second is that a VFG allows for the use of the spending power as an instrument for inducing national standards in provincial programs in accord with the principles set out in Section 36 of the *Constitution Act*. Given the division of legislative responsibilities, the use of the spending power is arguably the only effective policy instrument available for the federal government to fulfil these commitments.

National efficiency objectives. Similar arguments apply with respect to the role of the federal government in addressing issues of efficiency in the internal economic union. In addition to the benefits of tax harmonization already mentioned, the spending power that the VFG enables can be used to encourage provinces to design their programs in ways that facilitate national efficiency. For example, the inclusion of mobility and portability provisions in health and welfare programs have that effect.

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some extent benevolent in nature, and moreover, undertake functions that reflect strong equity objectives. It would be difficult to explain programs like EI, welfare, public health insurance, and public pensions solely on the basis of the self-interest of the median voter. This not to imply that governments are perfect, and that there is no self-serving element to their behavior. But the discipline of re-election and the extent of scrutiny of government behavior—especially at the national level—are powerful constraining devices, arguably much more powerful than those presumed to result from decentralization.

- Redistributive goals of society must ultimately be based on the sort of consensus that exists among the citizens of the nation, what the Europeans refer to as *social solidarity*. There is evidence that considerable consensus exists in Canada for a national dimension of redistributive equity, that is, for national social citizenship. The progressive income tax system, the EI system, the public pension system, the equalization system, the system of refundable tax credits for less well-off families all incorporate national standards of redistributive equity.

- There is also evidence that there is support among citizens in all regions of the country—including Quebec—for minimal national standards in some social programs that are delivered by the provinces, such as health care.

- To the extent that one takes the Constitution seriously, the principles of Section 36 clearly imply a federal role in achieving important social objectives of a redistributive nature.

Given these views, what does it imply for the rebalancing of the federation? That is, what advice would one give to a Martin government about the rebalancing of the federation? My advice would include the following elements.

- The imbalance that exists between the federal government and the provinces should be addressed by an increase in transfers from the federal government to the provinces.

- The transfers should not be contingent upon the size of the federal surplus. This puts all the risk on the provinces, which are less able to bear it than the federal government. Nor should it be contingent on federal revenues, and for the same reason. That is, we should not adopt a revenue-sharing scheme along the lines of what is used in some countries, such as Germany.

- The transfer system should be revised in some significant ways.

    1. Equalization should be rationalized along the lines suggested by the provincial and territorial Finance Ministers. In particular, we should move to a ten-province standard, which will bring oil and gas revenues into the equalization scheme. There may be some need to treat natural resource revenues of all sorts on a preferential basis because of the adverse incentive effects associated with equalizing resource the federal (coll147jnesdelude.1.6995 T28960027 Tc0 Tv

without unduly influencing provincial incentives.

5. The allocation among provinces should reflect need. The simplest measures of need are demographic, and could be relatively broad.

- The federal government should desist from introducing direct spending programs in areas of provincial jurisdiction and use transfers to provinces instead. This would include Millennium Scholarships, transfers to municipalities, infra structure grants, and so on. I would even argue that transfers to universities for chairs and infrastructure are better run through the provinces.
- In the longer run, the federal share of the tax room should be jealously guarded and even enhanced.
- Perhaps most important, the process of managing federal-provincial fiscal relations should be addressed. Currently almost all decisions with respect to fiscal federalism are introduced as part of the annual budget process. This has a number of disadvantages. Decisions tend to be taken with regard mainly to current budgetary concerns rather than longer-term concerns for the federation. They are taken behind the veil of budget secrecy, and from time to time result in bad surprises for the provinces. There is relatively little input from outside the Finance Department, and even within that department, federal-provincial issues seem to have relatively little priority. Despite the size of federal-provincial transfers, the federal-provincial division is part of the branch that includes social policy and might not have the weight of, say, tax policy. The result is that major decisions that affect the federation are taken more by default than being matters of conscious policy. One way to open up the process and make it more transparent would be to create the kind of arms-length inter-governmental body that exists in other federations to advise on federal-provincial fiscal relations. We have mentioned the examples of Australia and South Africa earlier, but other federations have similar institutions. Of course, these bodies cannot usurp the role of Parliament in passing spending bills, but they can make the process more transparent and accountable, and provide a vehicle for taking into account the longer-run consequences of fiscal actions for the functioning of the federation.